Russian Federation

Export Diversification through Competition and Innovation: Overview

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Trade performance in Russia is characterized by a narrow product base and untapped trade potential.

1. **Russia’s exports are increasingly dominated by petroleum and natural gas.** The oil and gas sector experienced double-digit annual export growth in the last decade and represented almost 65 percent of Russia’s exports value in 2009 – a product of higher commodity prices and higher export volumes. Export growth rates of the non-oil and gas sector were also notable. Industries such as machinery, electronics, transportation equipment and chemicals reached a combined growth rate in export value of 10 percent in the last decade. This more positive development in export growth outside the oil and gas sector, however, hides relevant structural limitations in Russia’s trade performance.

2. **Russia’s revealed comparative advantage (RCA) is concentrated in sectors that do not create many forward or backward linkages to the rest of the economy.** As a consequence of this lack of linkages to the rest of the economy, these growing export sectors cannot serve as engines of diversification. In addition to the oil and gas sector, industries with limited spillover effects to the rest of the economy include raw materials (26 products) and forestry (11 products) out of a total of 97 identified products. Such specialization may be considered problematic because the capabilities developed in those sectors are not easily redeployed to other industries, hindering the process of economic diversification. Yet, several resource-rich countries have managed to expand trade beyond the traditional, natural resource-intensive products.

3. **It is not for a lack of trying that firms have yet to emerge from other sectors to export.** Exporters from Russia face difficulties not only entering but remaining in foreign markets once they have entered. In the period 1999-2009, 57 percent of export attempts to establish a foothold in a market outside of Russia survived for more than two years. In the case of China the export survival rate is over 70 percent. Brazil and India also perform better than Russia but both economies do less well than China. While some level of export “mortality” is common, the comparatively low export survival rate in Russia indicates a possible lack of international competitiveness in the non-oil and gas sectors. International experience shows that the entry of new exporters has been a driving force behind several export booms.

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1 The Product Space analysis is based on the tools pioneered by Hidalgo et al. (2007). The position of a product in the product space map determines the products to which companies in that economy may be able to produce related products, based on the existing set of capabilities available and the location of corresponding products on the map. The process of accumulating specific capabilities therefore results in diversification and economic development.
The Figure indicates probability that a export relationship last two or more years. In Russia, the probability of export relationships surviving until the second year is about 0.57 (on a 0-1 scale), and of maintaining a relationship for 5 years is 0.22 (Figure 4). In comparison, the survival rates of the export relationships of other BRICs are much higher, particularly in China, where the survival rate is roughly 0.70 for the first two years. This result suggests that export diversification strategies in Russia may want to consider paying particular attention to the factors affecting the survival of new exports (export discoveries).

4. A lack of success in sustaining entry into foreign markets stunts the Russian economy’s trade growth potential and leaves several foreign markets relatively untapped. Russia under-trades with China and India, as well as with several G-8 countries including the U.S., Italy and Germany. More interestingly, the number of countries with which Russia seems to be under-trading rises when the oil and gas industries are excluded from the model. Indeed, despite the increase of China in global trade, the share of the country in Russia’s total exports remained stagnant at around 4-5 percent in the 1998-08 period. The number of countries rises significantly when the oil and gas industries are excluded from the model. This result suggests that there is scope for exploring other opportunities for export diversification in Russia.
Expanding Russia’s narrow export base will likely require addressing the relatively modest levels of domestic competition.

5. This study finds that existing levels of modest domestic competition in Russia may be the core, microeconomic constrain to improving Russia’s export performance. Competition positively contributes to the probability of exporting – where more market power is related to a decreased likelihood of exporting. An economy characterized by higher levels of competition pushes firms to improve productivity and innovate. This is important because this study finds that productivity is a significant and relatively the most important factor in explaining export propensity in a sample of 19 countries, including Brazil, South Africa and Turkey. This relationship between productivity and export propensity is likely explained by the observation that improvements in productivity translate into the pricing of goods and services at competitive levels and innovation that renders improvements in offerings to the market. By inducing improvements in productivity and spurring innovation, stiff domestic competition prepares firms to compete in hyper-competitive international markets.

6. Price cost margins (PCM) for inputs of exportable goods tend to be larger than those of their international peers. Relatively higher PCM reduce incentives for local exports. Moreover, Russian firms register larger PCMs compared to the average of the (Europe and Central Asia) region in every manufacturing sector except for food, garments and chemicals. A more detailed PCM analysis in selected sectors reveals that firms in sectors where Russia registers higher PCMs than regional counterparts, tend to be (i) older; (ii) have more employees; (iii) are less likely to export and invest in R&D; (iv) are more likely to operate in local markets; and (v) in some cases, are less likely to operate in a competitive market structure. The analysis of market structure within Russia at the geographic and product market level also reveals a high degree of concentration, with significant variations across regions and sectors, as illustrated in Figure 5 below.

Figure 3: PCMs are greater in Russia than in other European and Central Asian economies.

Figure 4: Concentration levels in selected Russian industries, by region

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2 According to the World Economic Forum, for instance, market dominance in Russia is much higher than in the EU and the average OECD country.
7. **Relatively high levels of control of the economy by state-owned enterprises does not contribute to healthy competition.** State ownership is twice as large in Russia as in the EU-10 countries, with state-owned enterprises commanding about 17 percent of employment. Available data indicate that, with national, state, or provincial government controlling at least one firm in 16 (out of 19) sectors – a relatively high figure compared to OECD averages, where the typical member economy registers government participation in only 9 of the same sectors. The EBRD Transition Indicators also show that enterprise restructuring in Russia is lagging behind that of Poland, Turkey and the average of the Europe and Central Asia (ECA) region.

8. **In addition to distorting the economy directly through state ownership, state aid favors larger, less productive incumbent companies.** State aid (for example, in the form of loans, subsidies, and tax cuts) is often applied unevenly across regions, sectors, and firms. According to the World Bank Trade Restrictiveness Index, incumbent firms are more insulated from international competition, especially through non-tariff barriers in the form of technical regulations and quantitative restrictions, than in most comparable countries. Actions of regional governments also influence competition conditions in domestic markets.

9. **These are signs that competition is not completely healthy in Russia.** For example, comparing the productivity of registered, taxpaying firms that compete for the same markets in which informal (grey market) firms participate in indicate lower productivity than firms that do not have to contend with grey market competition. The relatively lax enforcement of laws and regulations for some firms creates distortions in competition. In addition, receiving public subsidies is associated with lower levels of productivity, indicating that these subsidies are likely substitutes for productivity improvements. Finally, Russia’s productivity shows that the output commanded by the more productive firms corresponds to half the value for Brazil in the early 2000s. In other words, while one would expect that more productive firms would command higher market shares, the market share of Russia’s more productive firms is substantially less than those of Brazil.

10. **In addition to competition, other business environment obstacles likely constrain firm-level export performance.** For instance, firms with a higher number of power outages per month or relatively more dependent on their own power generator for electricity are less likely to enter foreign markets. Also, businesses that spend comparatively more time dealing with bureaucratic issues show lower export propensity, indicating that regulations have ramifications to firm performance beyond their cost of compliance. Finally, firms that purchase a relatively higher share of inputs on credit (after delivery) – which we interpret as evidence of being more cash-constrained – have a lower probability of exporting.
While higher firm-level productivity levels will help firms more readily cover the fixed costs of entering international markets, unfortunately in Russia, preliminary findings in this study indicate that fixed costs to export are on average higher than in comparator countries. So business environment reforms as well as promoting healthy competition need to take place in order to improve export performance.

**Well designed and enforced competition policy could usefully level the playing field, favoring the emergence of more efficient and innovative firms.**

11. Leveling the playing field, facilitating market entry, and encouraging orderly exit of less efficient firms would contribute to higher productivity and likelihood of exporting. At its core, the policies to improve competition may want to promote a reduction of state ownership; a more uniform, transparent, and result-oriented enforcement of state aid regulations; the simplification of the business environment in which firms operate; and the promotion of competition in service and network industries. As in the cases of Australia and the European Union, such policies could help increase productivity and consolidate Russia’s domestic market, enabling domestic firms to benefit from additional gains from trade. Specific measures should include: (i) advancing government reforms of public enterprises, minimizing their distortive impact on the marketplace (ii) broadening the mandate on state aid regulation in order to diminish firm- and sector-specific state aid; (iii) aligning state aid regulation to international best practices; and (iv) eliminating preferential treatments for state or municipality-owned corporations. Sector specific policies in key service industries (such as transport, construction and professional services) would further increase competition, promote entry and reduce the prices of services.

**Reducing anti-export bias of Russia’s trade policy and aligning export promotion strategies to international best-practice will further enable export diversification.**

**Efforts to liberalize trade have been one of the highlights of Russia’s economic reform for the past two decades.** Parallel to making efforts in lowering tariffs, reducing quotas, and diminishing import subsidies, the country has also advanced the process of negotiating accession to the World Trade Organization (WTO), with bilateral market access negotiation completed with interested WTO members, including the U.S., and with accession expected to be near. Yet, some hurdles remain for Russia’s full integration with the rules-based trading system, including increased tariff rates in several industries such as processed foods, light manufacturing, the automotive sectors, and some construction equipment in light of the economic crisis. Adopting a low and uniform tariff structure could bring benefits for an economy that seeks to enhance export diversification through innovation. Moreover, based on our findings of high fixed (sunk) costs to exports in Russia, reducing such costs could provide opportunities to encourage firm exports and to facilitate enterprises in establishing new export relationships. Advancement of the development of regional coordinating centers would in turn facilitate both the creation of new exports as well as help sustain current trade partnerships.

**A strategy for increased export diversification in Russia may usefully focus on improving the conditions for emergence of productive and innovative firms.**

12. **Analysis indicates that a focus on improving the conditions to facilitate the emergence of productive and innovative firms and improving the chances of firm survival in foreign markets may be a successful export diversification strategy.** Raising the share of non-resource based exports in Russia has so far proved a difficult task, reflecting similar difficult experiences elsewhere. Experience
also shows that there is no magic recipe to promote export diversification. Export diversification depends on a number of macro- and microeconomic conditions, including a competitive exchange rate and solid governance system. Yet, by affecting competition, improving innovation and facilitating trade, the government can enable economic renewal, and the ability and capacity of firms to enter international markets. This in turn could trigger a positive cycle of productivity, innovation and trade integration through existing feedback effects.

13. **Healthy domestic competition provides the incentives to improve productivity and offers good training for future export success in the hyper-competitive international market.** Finally, a good business environment allows firms to quickly adapt to market signals efficiently. Improvements in all of these areas is likely required if Russia is to succeed in diversifying its economy.