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AEB North-Western Regional Committee

WORLD BANK BRIEFING

**BASED ON THE WORLD BANK
ECONOMIC REPORT #31**

10th April, 2014

**St. Petersburg
Consulate General of Finland**



Timo Mikkonen

AEB North-Western Regional Committee Chair

Welcome address

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World Bank

Confidence Crisis Exposes Economic Weakness



Russia Economic Report
April 2014 | Edition No. 31



Russia Economic Report No. 31

1. Recent Economic Developments
2. Outlook and Risks
3. Economic Mobility and Middle Class Formation



Main messages



1

Russia is in economic downturn as business and consumer sentiments remain weak

- Real GDP growth slowed to an estimated 1.3 percent in 2013 from 3.4 percent of 2012
- Lack of structural reforms eroded investors' confidence - masked by a growth model based on large public demand stimuli and oil revenues.
- Frail domestic demand was a drag on economic growth.

2

Two lower growth scenarios for Russia in an environment of more volatile global markets

- Crimean events have compounded the lingering confidence problem into a crisis and exposed the economic weakness of the growth model.
- World Bank low-risk scenario projects 1.1 percent growth for 2014 (1.3 in 2015), the high-risk scenario -1.8 percent (2.1 in 2015).
- Global risks remain prominent with higher market volatility.

3

Economic mobility and middle-class formation could be on hold

- Poverty-reduction and middle-class growth was explained by high growth in average incomes and consumption during 2000-2010.
- Weaker growth prospects and stabilizing consumption at a lower rate dim the economic mobility outlook.
- Middle-class growth needs job creation and higher employment rates.

4

Crisis response could replace the structural reform agenda

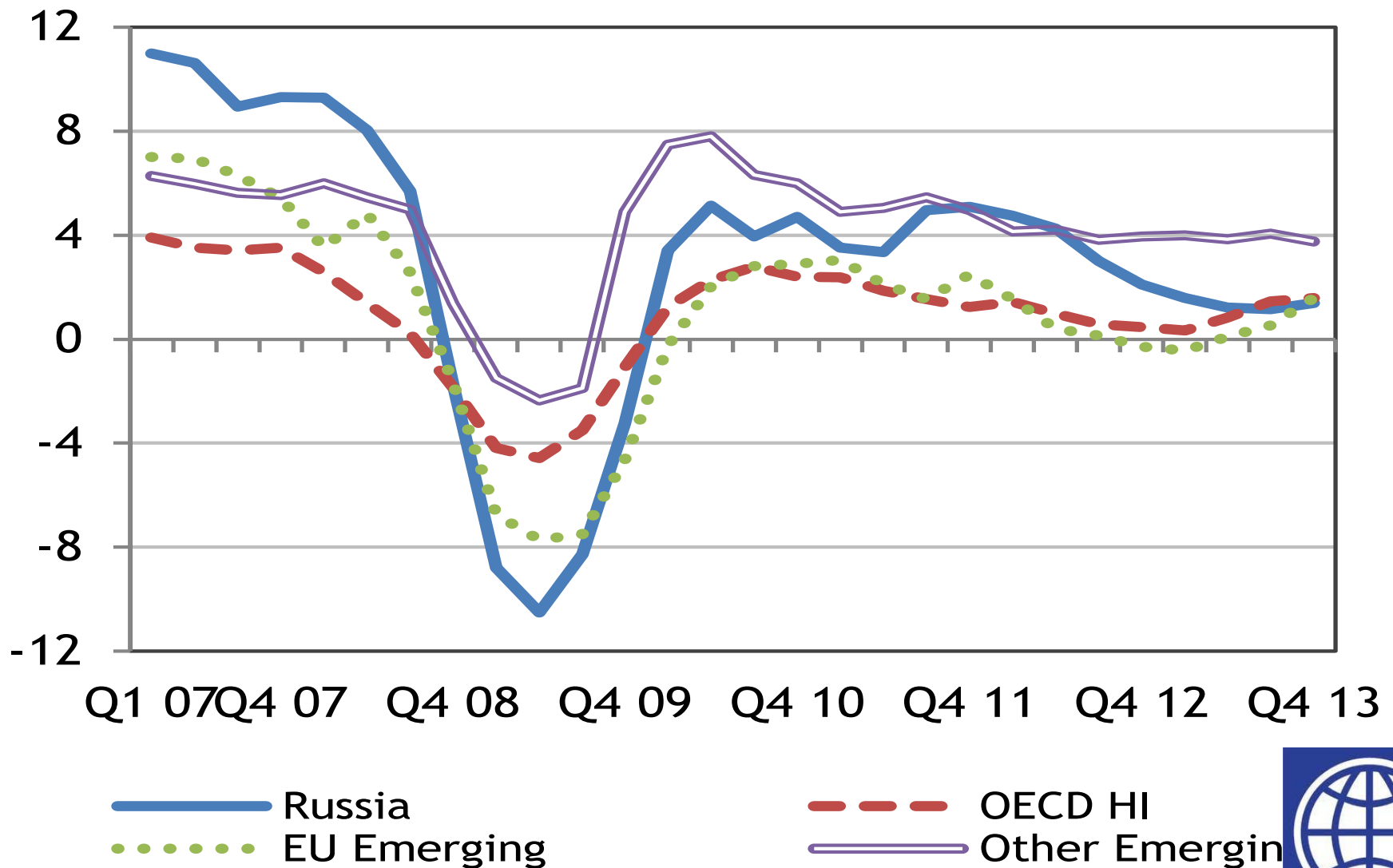
- To overcome the current confidence crisis and achieve sustained long-term growth, structural reforms would need to resume.
- Risk that policy choices will be about responding to short-term crises and upholding macroeconomic stability, depending on the evolving scenario.

Recent Economic Developments: Loss of Confidence Leads to Unfulfilled Expectations



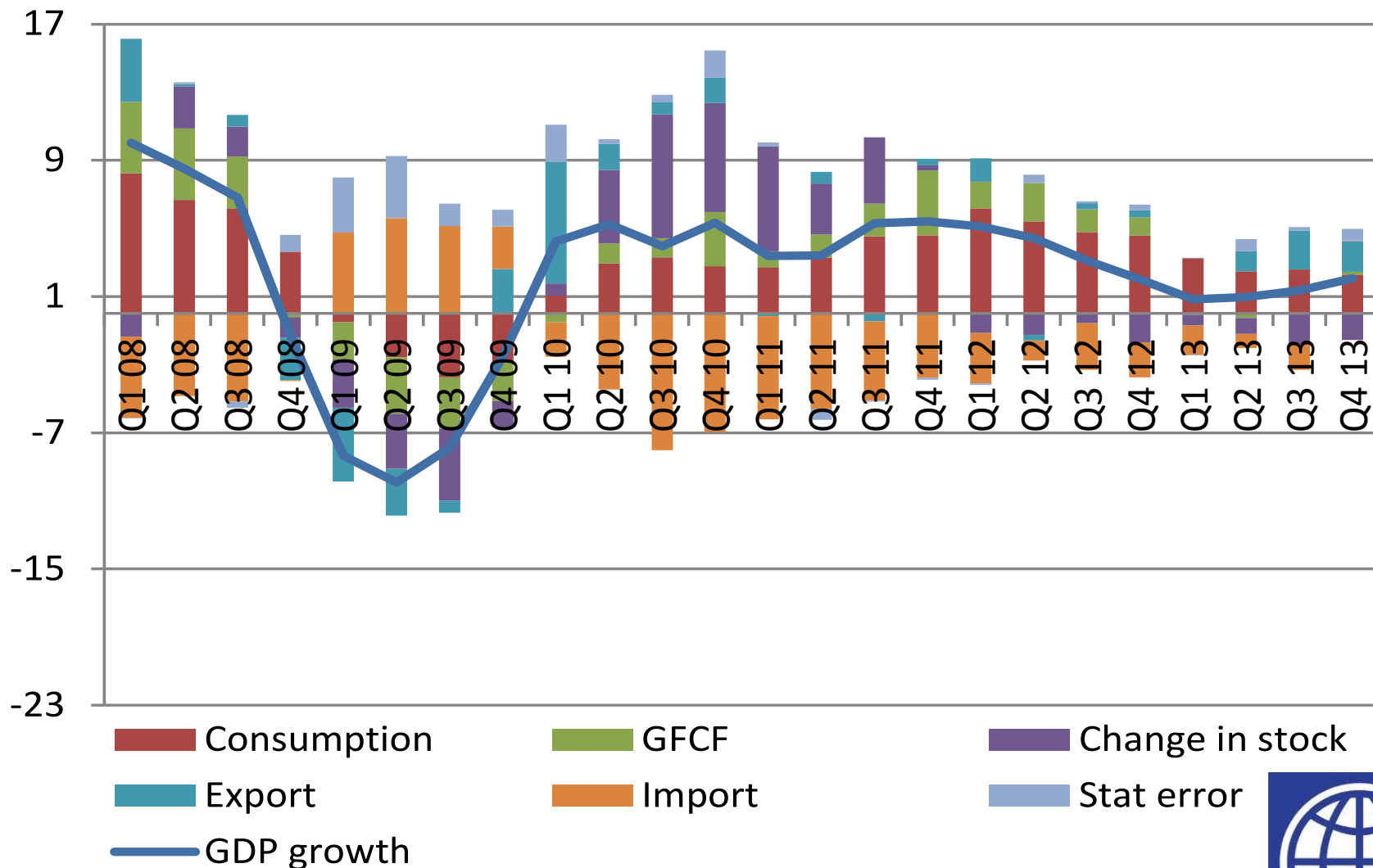
Russia's Economic Downturn

World GDP growth, y-o-y, percent

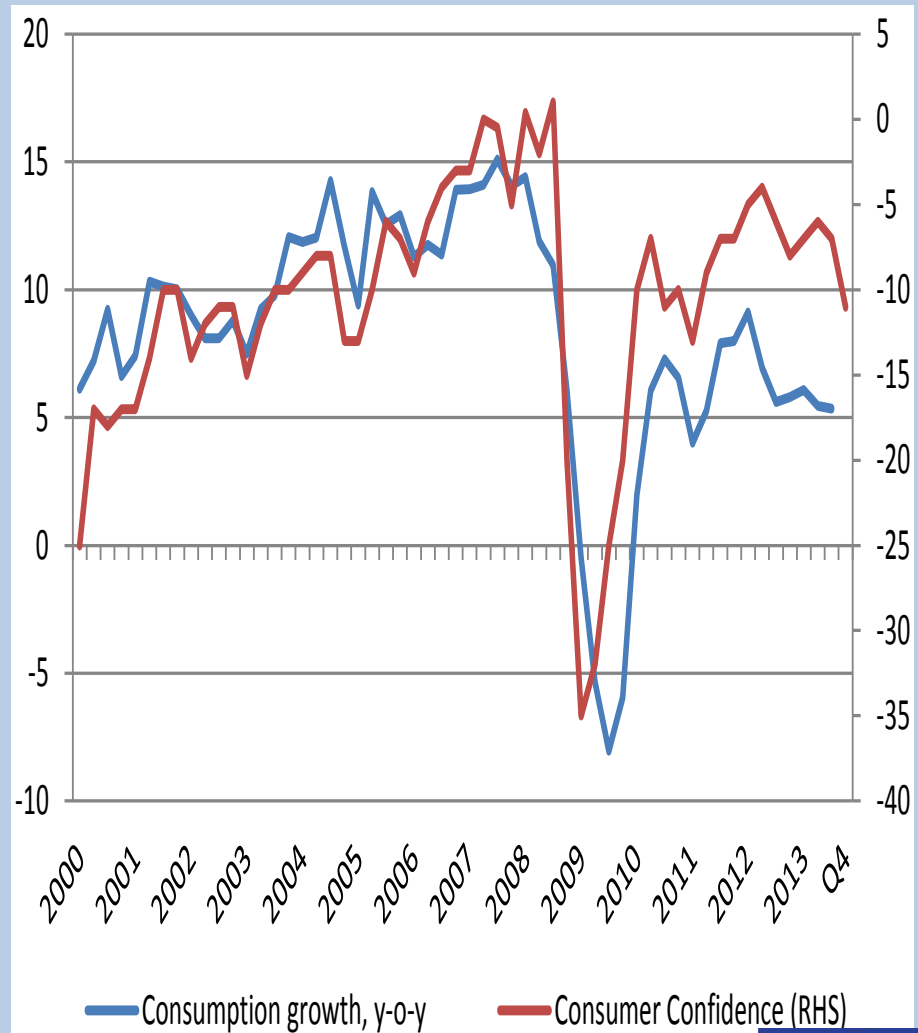
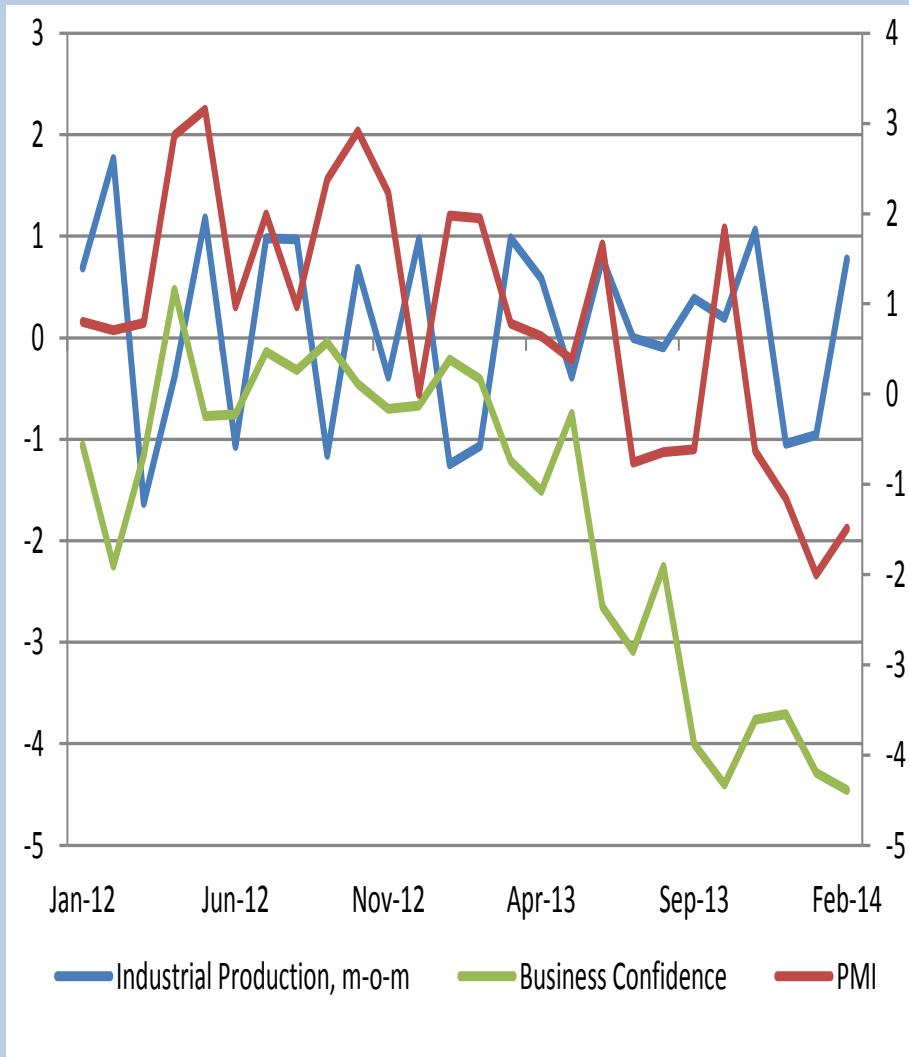


→ Weak Domestic Demand

Growth composition, percent, y-o-y



→ Confidence Loss: Businesses & Consumers

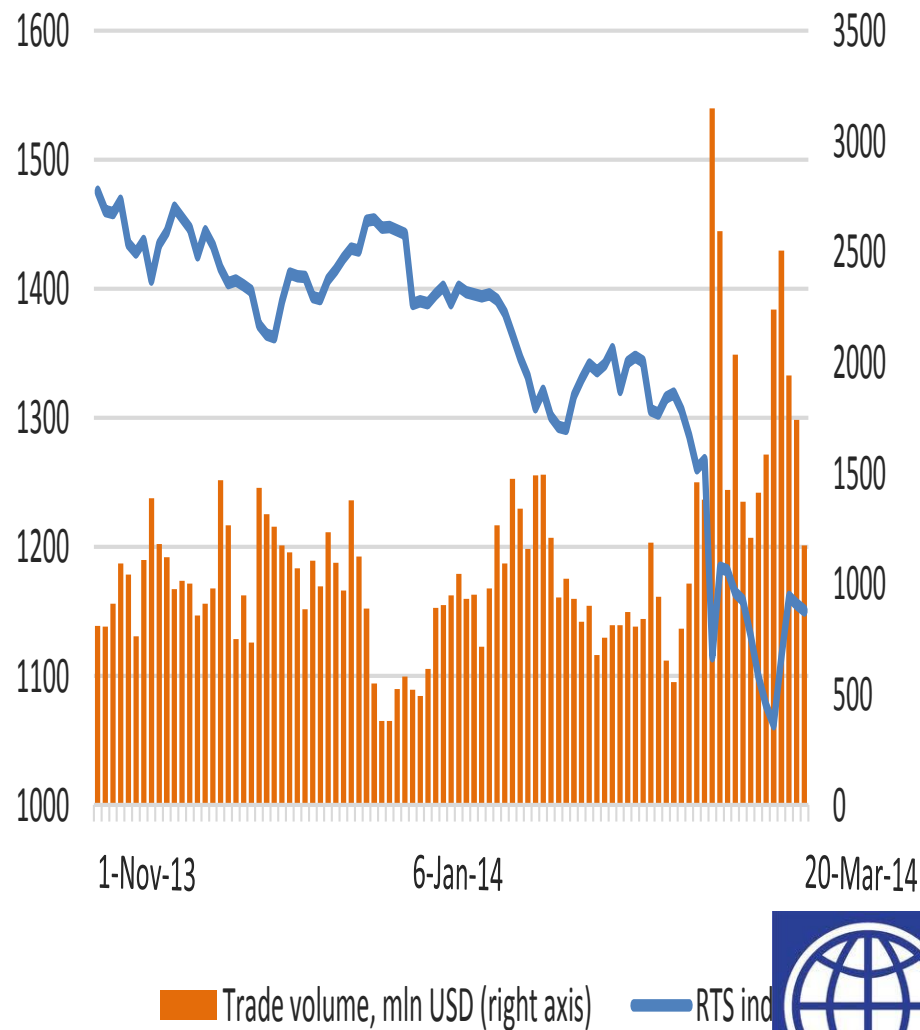
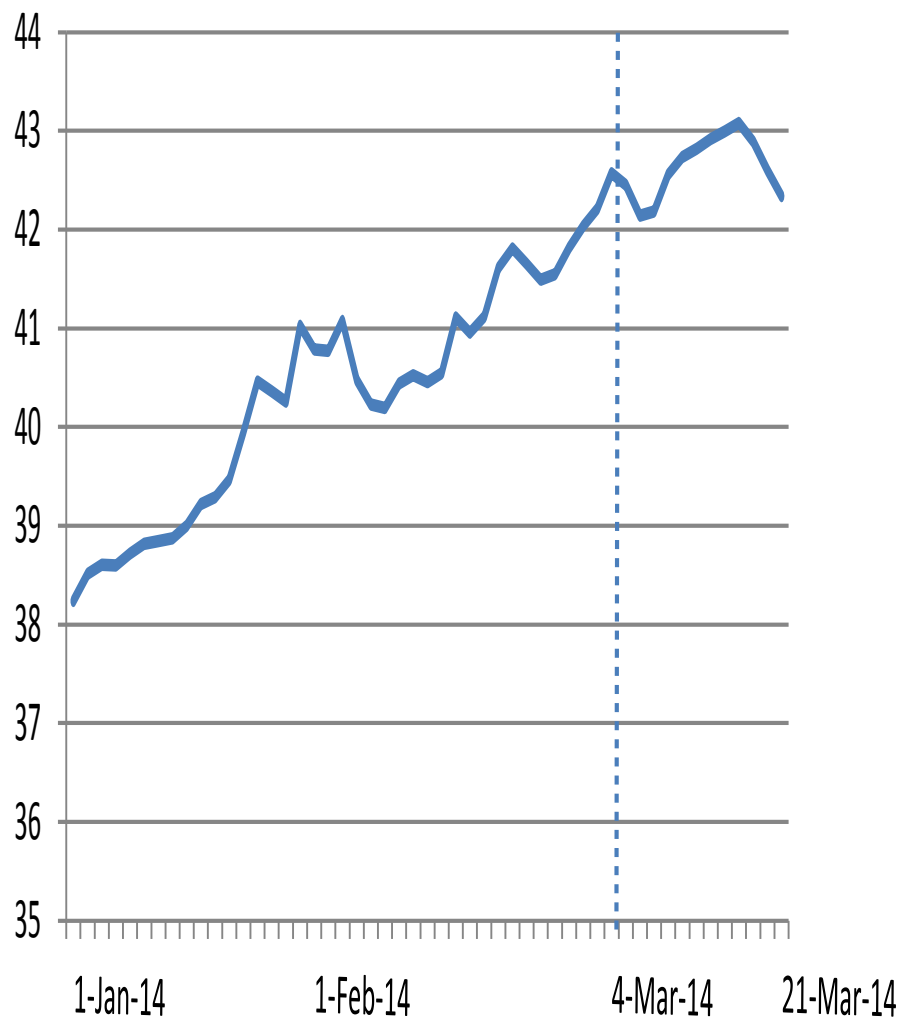


World Bank Outlook for Russia: Two Lower Growth Scenarios



→ Market Response to Crimea Events

Exchange rate dynamics, Euro-Dollar basket Stock market reaction



A Questions of Confidence and Geopolitical Risks

Low-risk scenario: Assumes a limited and short-lived effect of the Crimea crisis

High-risk scenario*: Assumes a more severe shock to economic and investment activities due to escalation of Crimea crisis

Global real GDP growth, percent

	2009	2010	2011	2012	2013e	2014f	2015f
World	-1.9	4.3	3.1	2.5	2.4	3.2	3.4
High Income	-3.6	3.0	1.8	1.5	1.3	2.2	2.4
Developing Countries	3.0	7.8	6.3	4.8	4.8	5.3	5.5
Euro Area	-4.4	1.9	1.6	-0.6	-0.4	1.1	1.4
Russia	-7.8	4.5	4.3	3.4	1.3	1.1 (-1.8)*	1.3 (2.1)*



Low-risk Scenario Projections

Main economic indicators

	2012	2013	2014	2015
GDP growth, percent	3.4	1.3	1.1	1.3
Consumption growth, percent	6.9	3.4	2.2	2.0
Gross capital formation growth, percent	1.4	-3.4	-1.8	0.4
General government balance (percent of GDP)	0.4	-1.3	-0.5	-0.2
Current account (US\$ billions)	72.0	33.0	26.8	24.1
percent of GDP	3.6	1.6	1.3	1.2
Capital account (US\$ billions)	-42.0	-55.1	-68.0	-32.0
<i>percent of GDP</i>	-2.1	-2.6	-3.3	-1.6
Oil price assumption (US\$ per barrel)	105.0	104.0	103.5	99.8



High-risk Scenario Projections

Main economic indicators

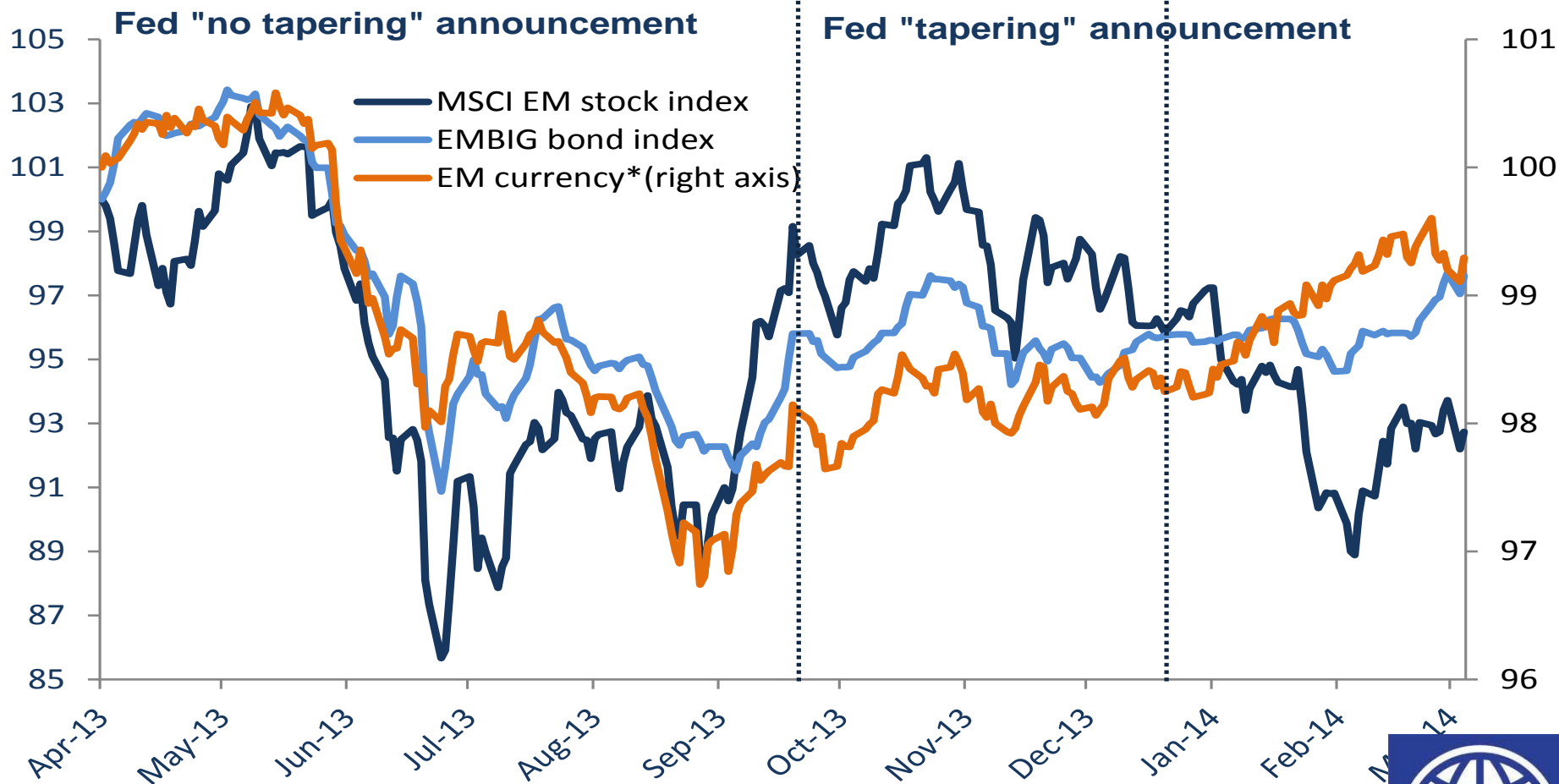
	2012	2013	2014	2015
GDP growth, percent	3.4	1.3	-1.8	2.1
Consumption growth, percent	6.9	3.4	0.8	1.1
Gross capital formation growth, percent	1.4	-3.4	-10.3	5.0
General government balance (percent of GDP)	0.4	-1.3	-0.9	-0.5
Current account (US\$ billions)	72.0	33.0	60.2	49.4
percent of GDP	3.6	1.6	3.0	2.5
Capital account (US\$ billions)	-42.0	-55.1	-133.0	-62.2
<i>percent of GDP</i>	-2.1	-2.6	-6.7	-3.1
Oil price assumption (US\$ per barrel)	105.0	104.0	103.5	99.8



→ Higher Global Market Volatility

Fed tapering effect on emerging markets

Index, rebased April 1, 2013 = 100

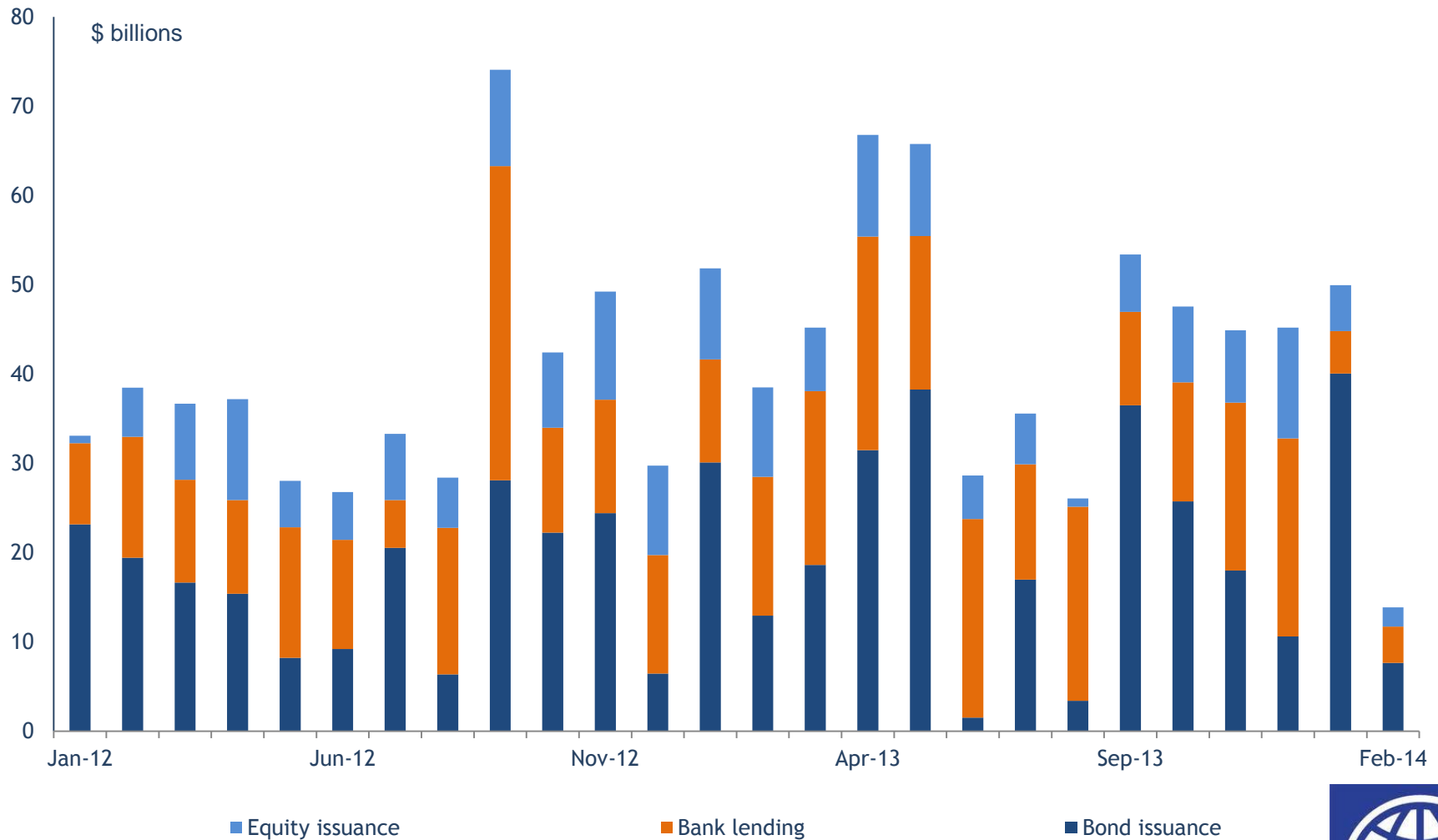


Note: * Nominal Effective Exchange Rate



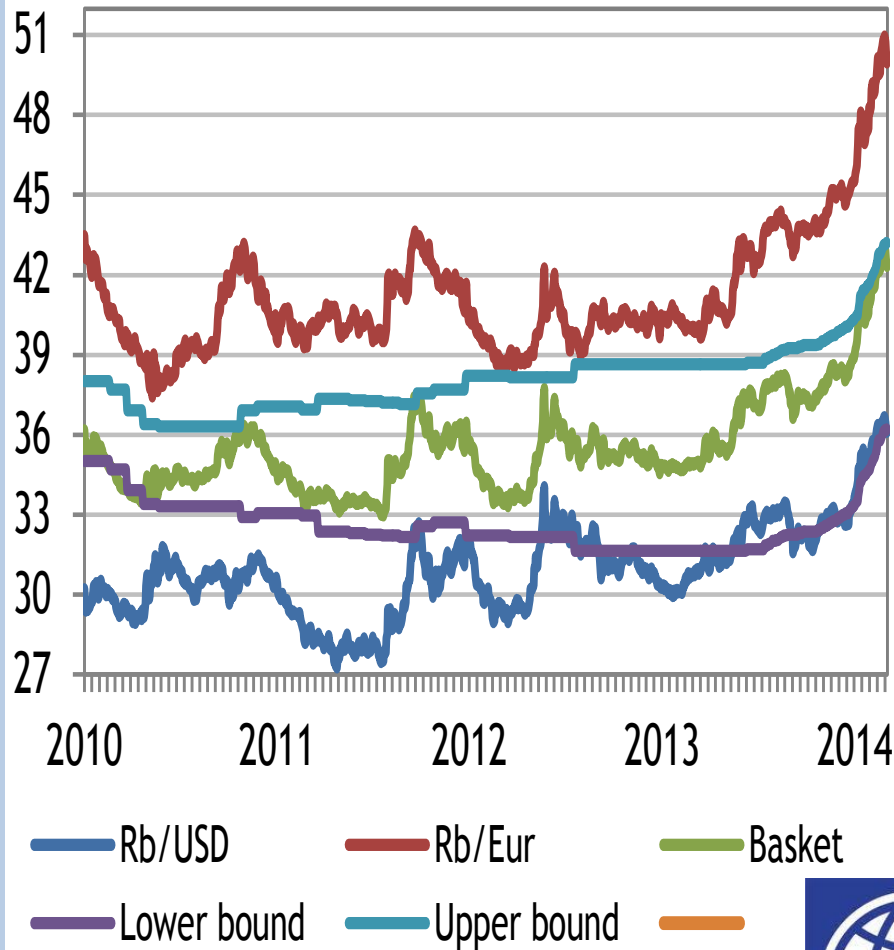
→ Tight International Financial Conditions

Gross capital flows to developing countries

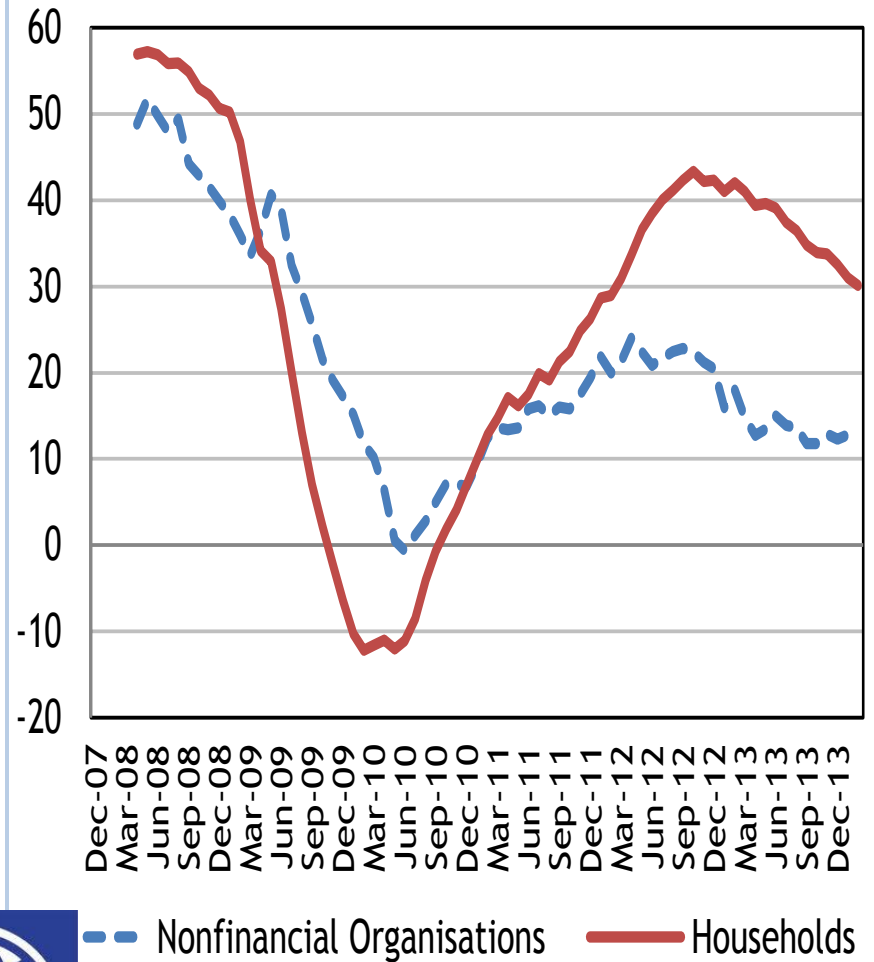


→ Increased Currency Volatility and Credit Risk

Exchange rate and its bilateral band



Credit Growth, percent, y-o-y



Policy Choices for a New Growth Model



Russia's long-term outlook depends on a sustained positive shift in investors' and consumers' confidence.



Lower growth and stabilizing consumption at a lower rate dim the outlook on economic mobility and continued middle-class formation.

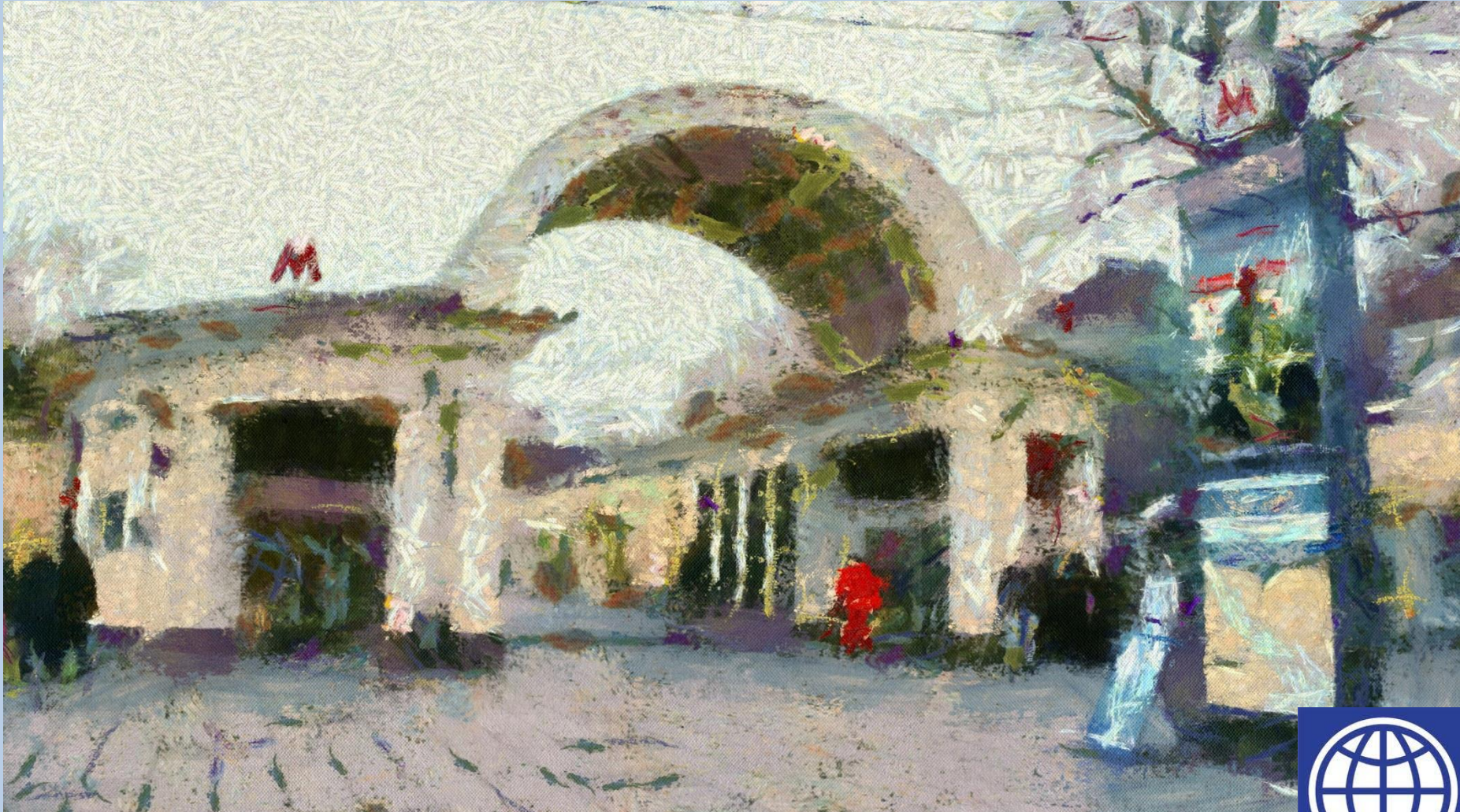


Risk that medium-term structural reform agenda is replaced by crisis response to uphold macroeconomic stability.



Special Focus Note

Economic Mobility and Middle Class Formation



A few facts about the analysis

- **Focus:** Emergence and growth of middle class in Russia in 2000-2010, against broader background of economic mobility
- **Data:** Russian Longitudinal Monitoring Survey (RLMS-HSE, 2000-2010)
- **Some concepts**

Economic classes

- Poor: Household per capita income lower than \$5/day (2005 PPP)
- Vulnerable: Household per capita income between \$5/day and \$10/day (2005 PPP)
- Middle class: Household per capita income above \$10/day (2005 PPP)

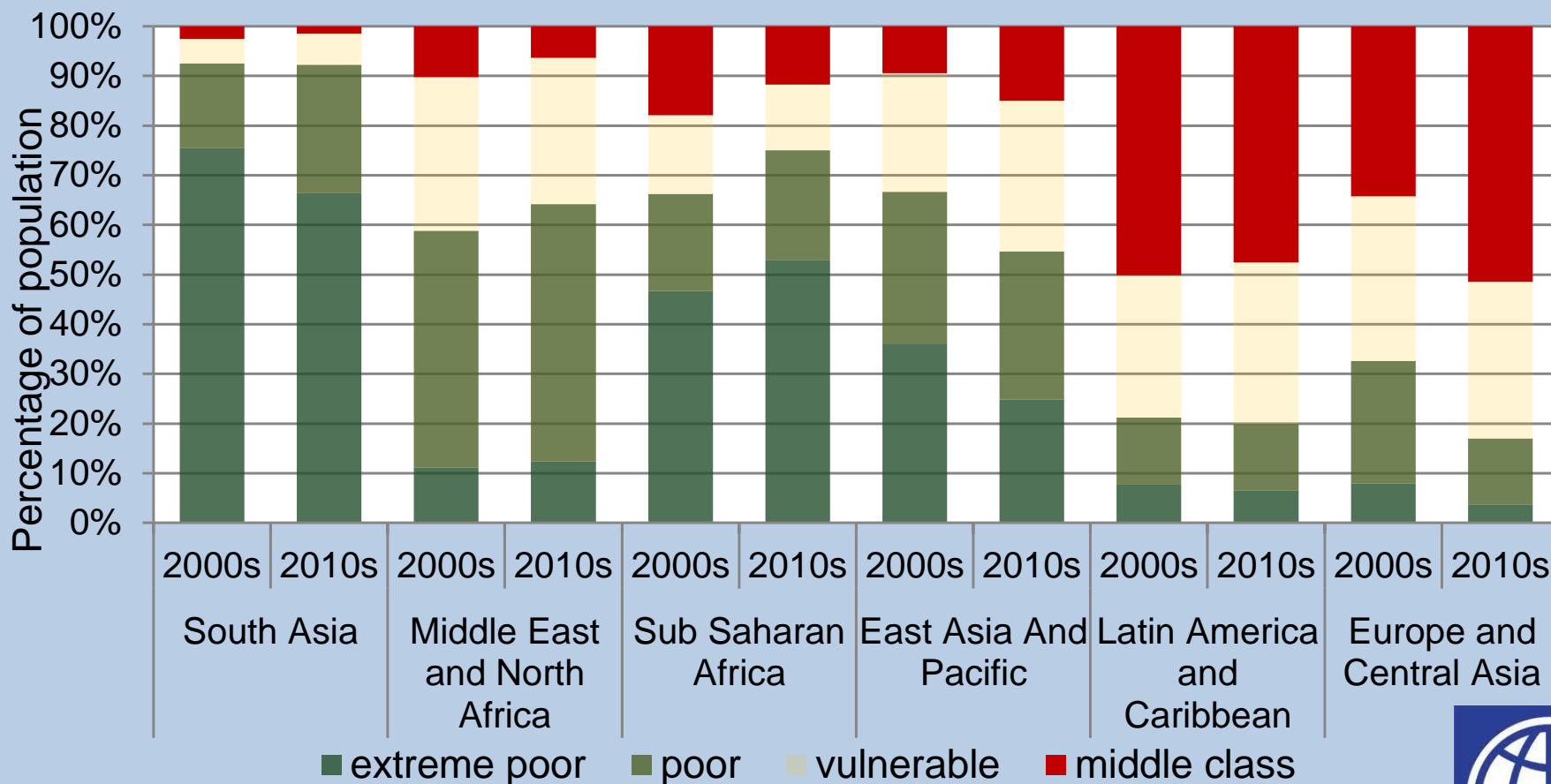
Economic mobility

- Upwards: Household experience positive real income growth over period of study
- Downwards: Household experience negative real income growth over period of study



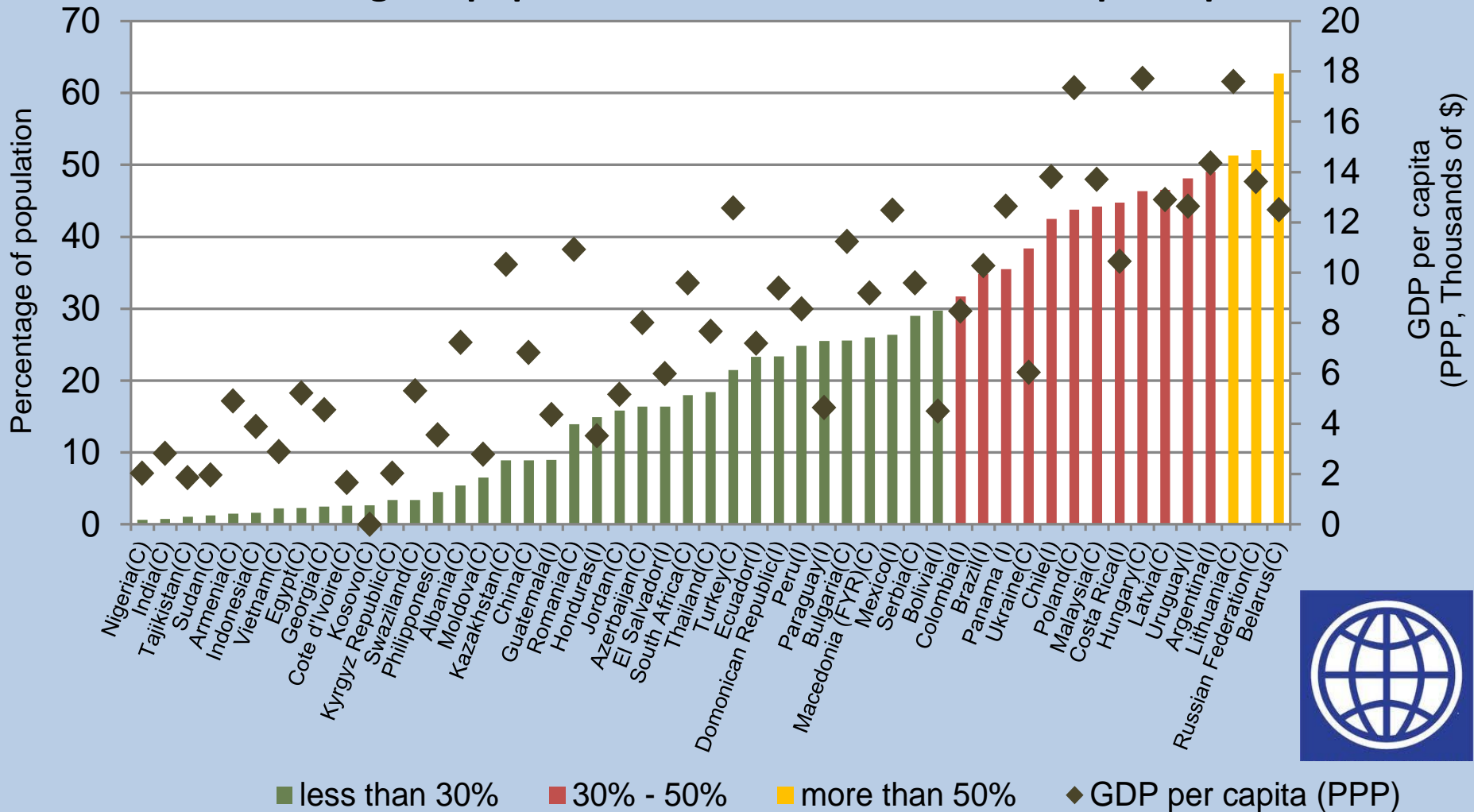
Rapid growth of the middle class, particularly in middle-income regions and countries...

Percentage of population in each income group by region, 2000-2010



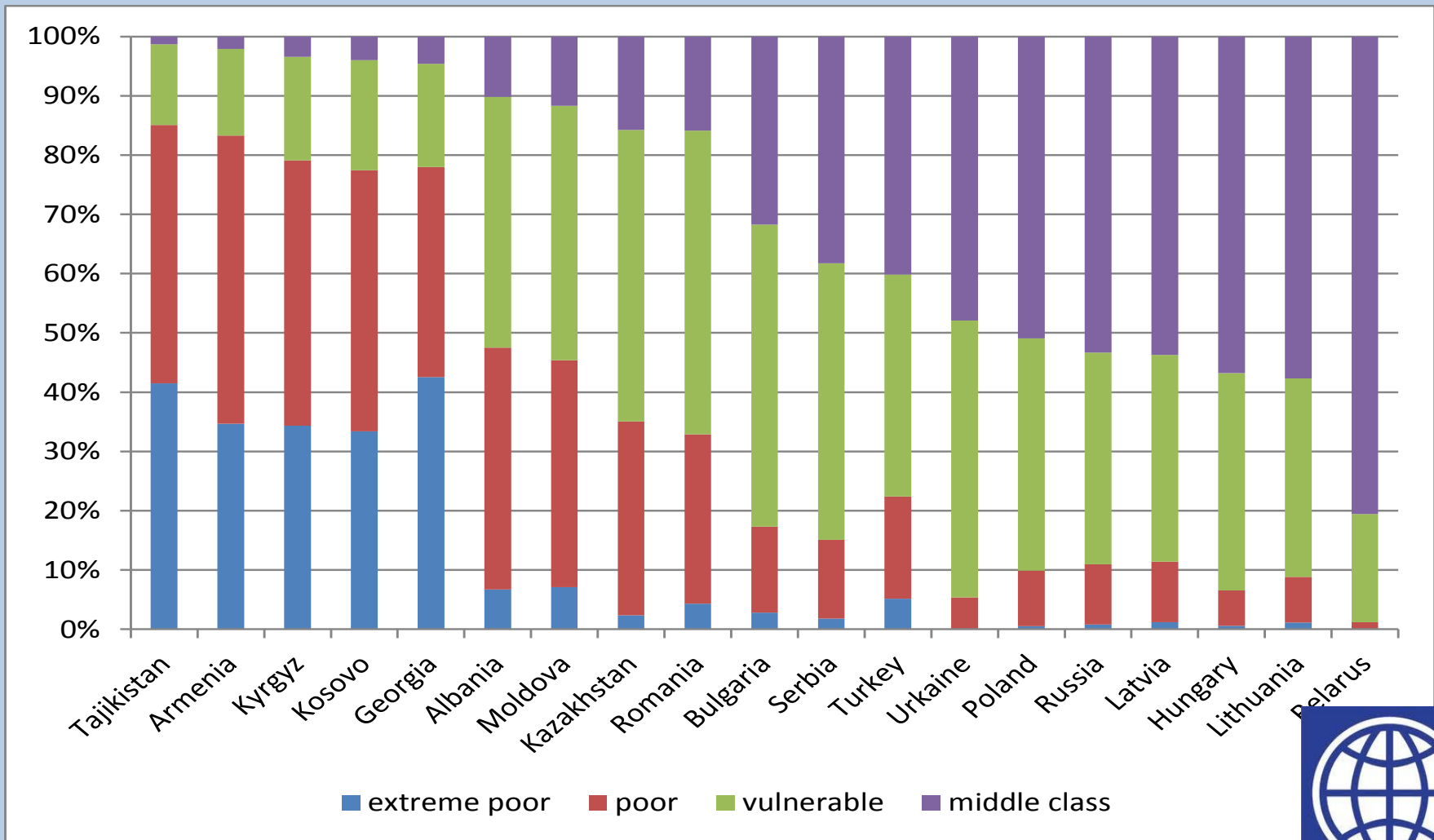
...but not all middle-income countries are middle-class societies

Percentage of population in middle class and GDP per capita



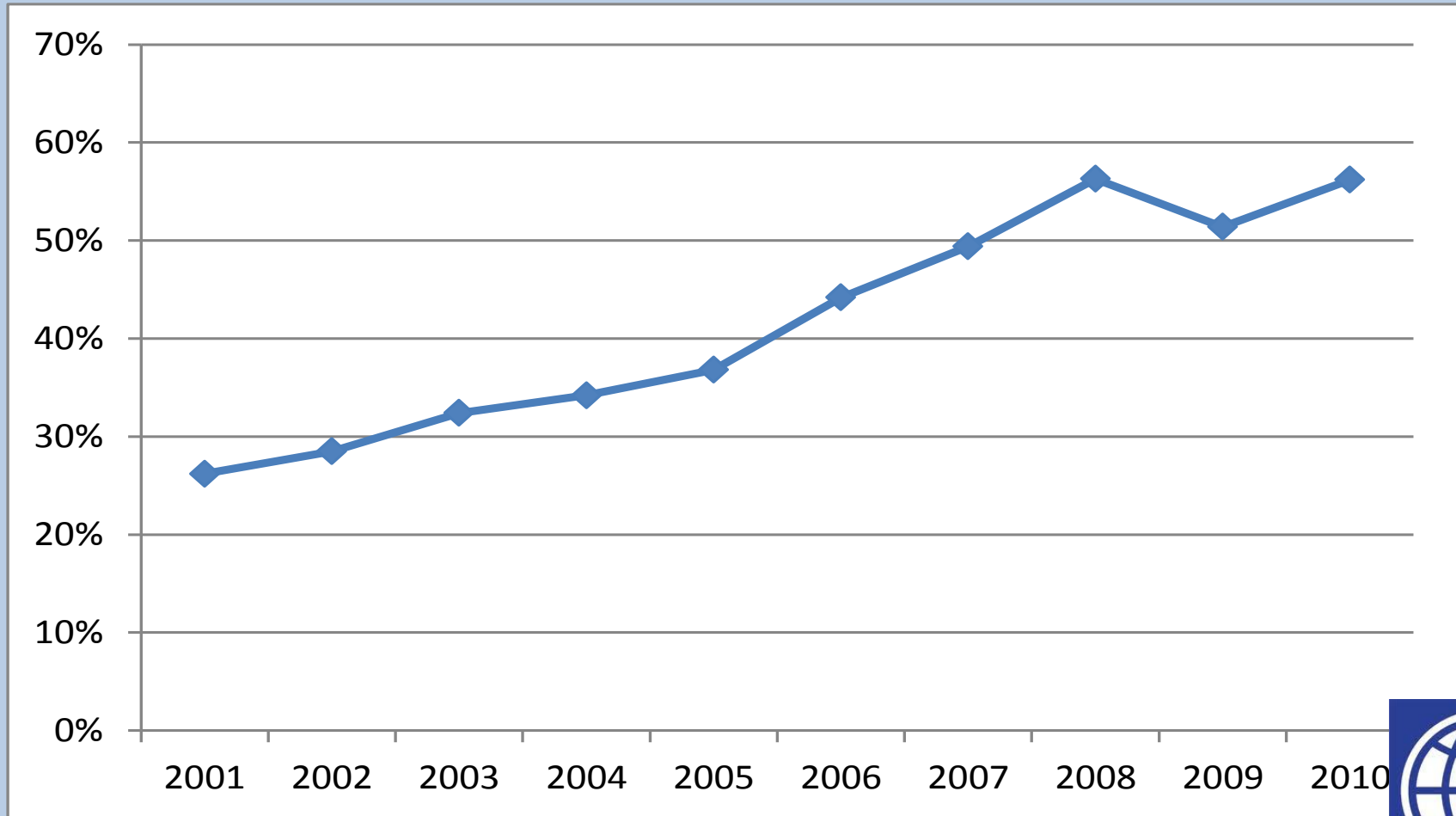
The Russian middle class is the largest in Eastern Europe and Central Asia

Percentage of population in each income group by country, 2010



The size of the middle class in Russia doubled from 2001 to 2010 ...

Percentage of population, 2001-2010



... and was part of a broader trend of strong upward mobility

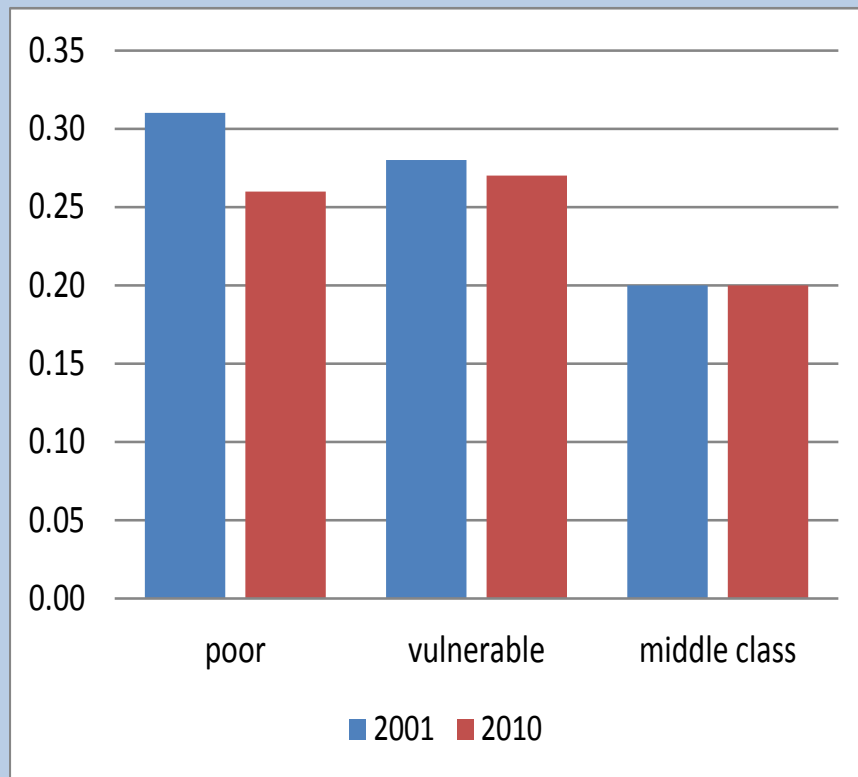
Percentage of total population classified by economic status in 2001 and 2005				
	Status in 2005			
Status in 2001	Poor	Vulnerable	Middle class	Total 2001
Poor	15.6	13.2	7.1	35.9
Vulnerable	6.8	14.8	15.3	36.9
Middle class	3.6	7	16.5	27.1
Total 2005	26	35	38.9	100
Percentage of total population classified by economic status in 2001 and 2005				
	Status in 2010			
Status in 2006	Poor	Vulnerable	Middle class	Total 2006
Poor	5.8	9	6	20.8
Vulnerable	3.2	12.9	19.3	35.4
Middle class	1.4	9	33.3	43.7
Total 2010	10.4	30.9	58.6	100



Middle-income households have better human capital endowments...

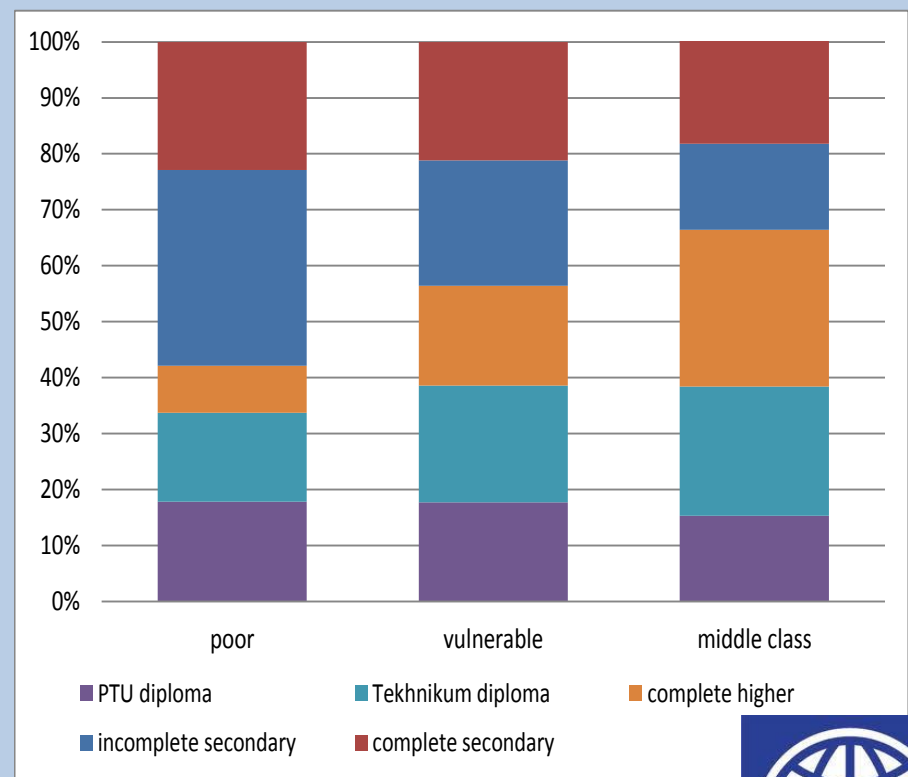
Lower old-age (and child) dependency ratios...

Ratio of household members ages 65 and up to working-age adults



... and higher education levels among working age adults

Percentage of all working-age adults with different levels of education



... and better access to markets and economic opportunities



- Higher percentage of middle income households resides in **urban areas**....
 - 70 percent versus 58 percent (vulnerable) and 37 percent (poor)

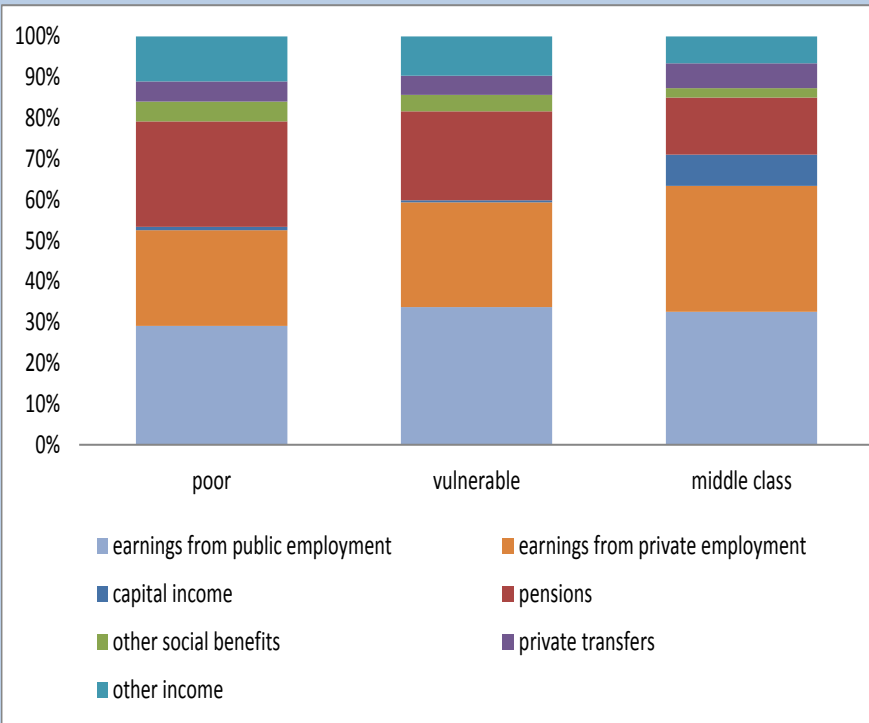
... although middle class not exclusively an urban phenomenon

 - 25 percent of middle class households resided in rural areas in 2010, compared to 17 percent in 2000
- Better **labor market outcomes** among middle income households
 - 70 percent of working age adults in middle class households are employed versus 60 percent (vulnerable) and 50 percent (poor)
 - 4 percent of active adults are unemployed in middle class households versus 8 percent (vulnerable) and 12 percent (poor)

As a consequence, labor earnings are relatively more important for middle-class households

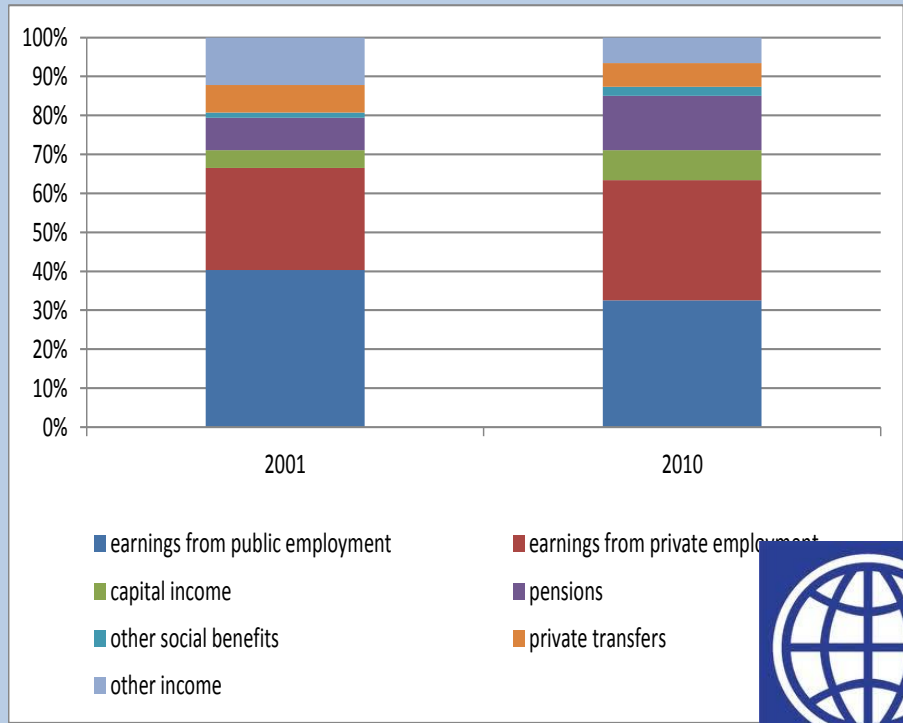
Better human capital and access to economic opportunities translate into higher shares of labor and capital income in total income among middle class households....

Percentage of total income accounted for by different income sources by economic groups, 2010



... although there is an increased share of pensions in total income among middle class households in 2006-2010

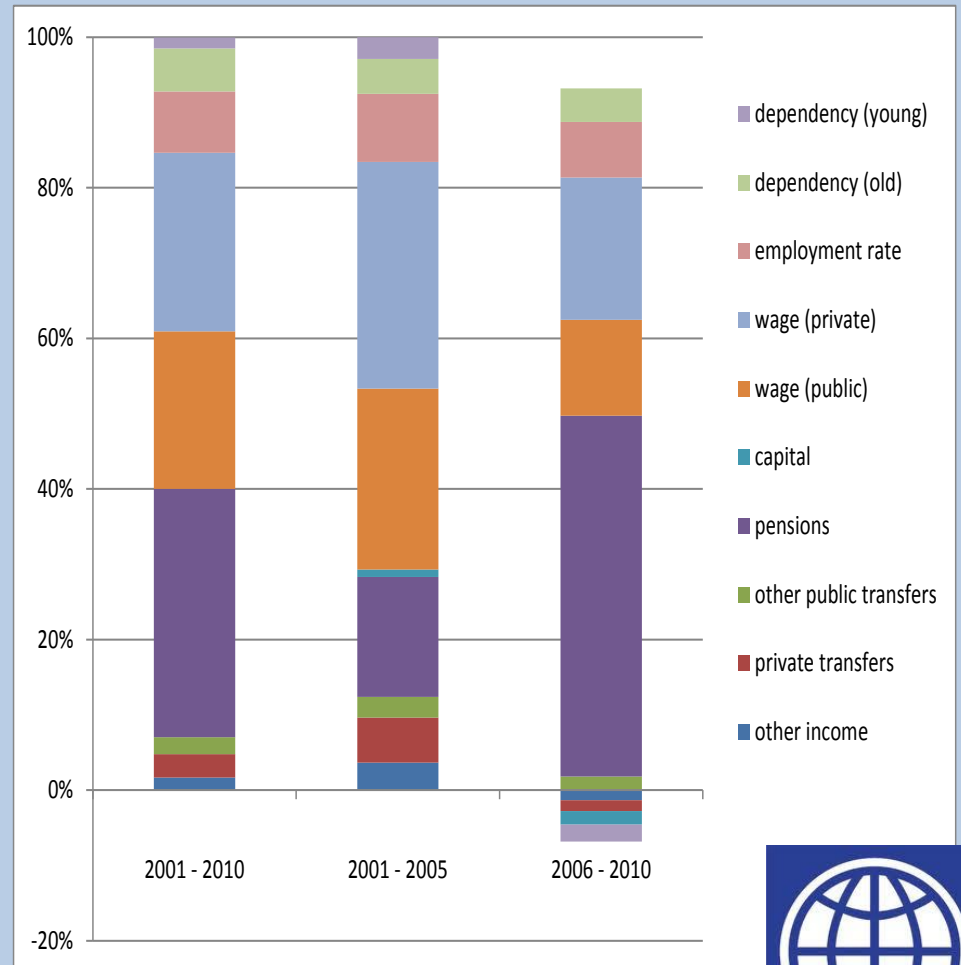
Percentage of total households income accounted for by different income sources, 2001 and 2010.



Drivers of middle-class entry in Russia

Contribution to observed inflow into middle class, 2001-2010

- **Economic rather than demographic factors** drove middle class growth in 2001-2010
- **Wage and pension** growth accounted for over half of observed income growth among middle class entrants
- Relative contribution of wages to income growth decreased between 2001-2005 and 2006-2010 while that of pensions increased



Conclusions

Both, demographic and economic factors affected middle-class entry in Russia, but economic factors explained most of the observed changes during 2001-2010.

Access to good and productive jobs (i.e. jobs that require a higher level of skills and thus paid higher wages) in the public and private sector drove middle-class formation in Russia.

Significant increases in pensions helped many to escape poverty and vulnerability and join the middle-class.

In the current environment of slower growth and fiscal consolidation, a further expansion of the middle class will require job creation and increased labor-force participation among young, women and older workers.



Thank you!

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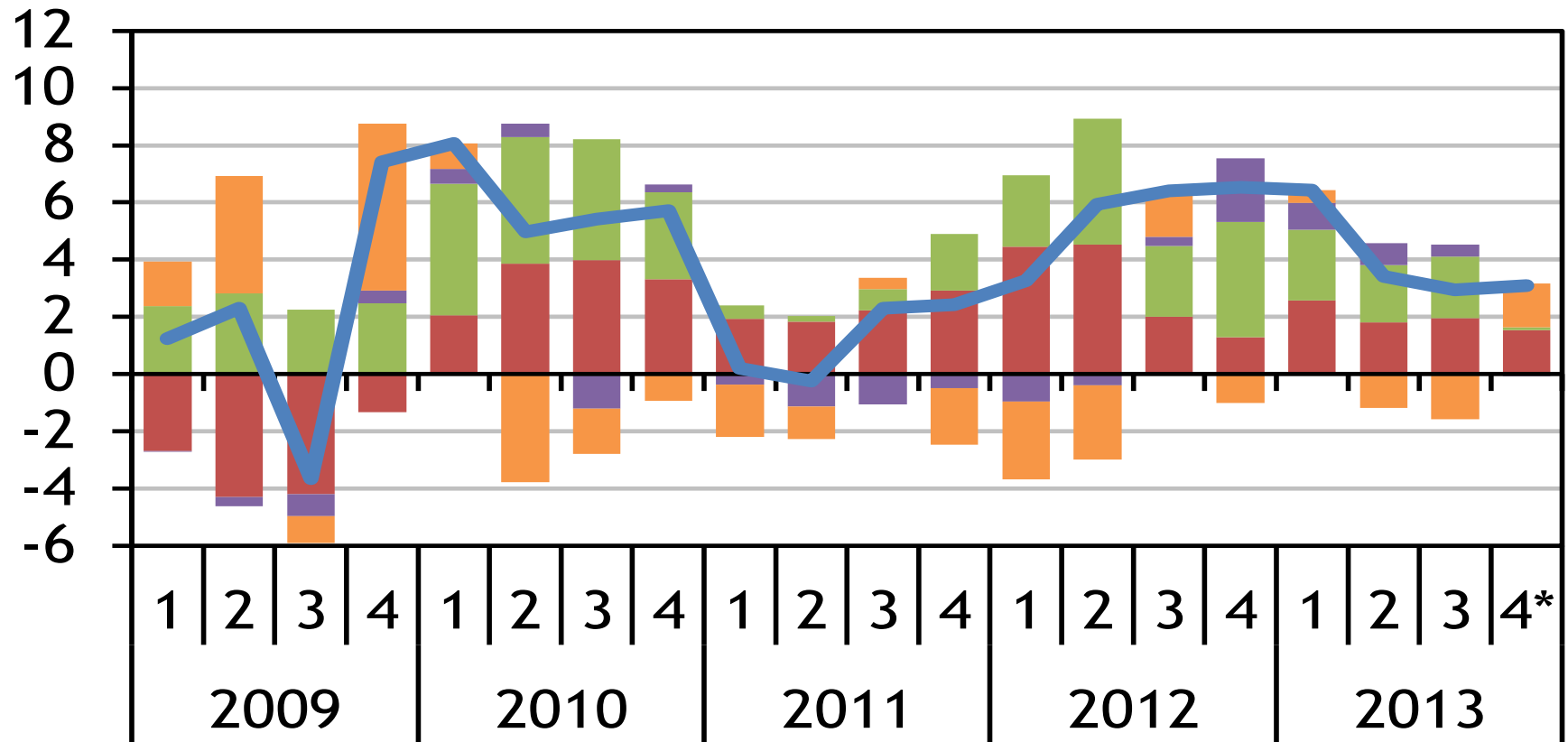
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EXTRA SLIDES

Disposable Income Growth Decreased

Contribution to income growth, percent, y-o-y



others
public wages and transfers
total

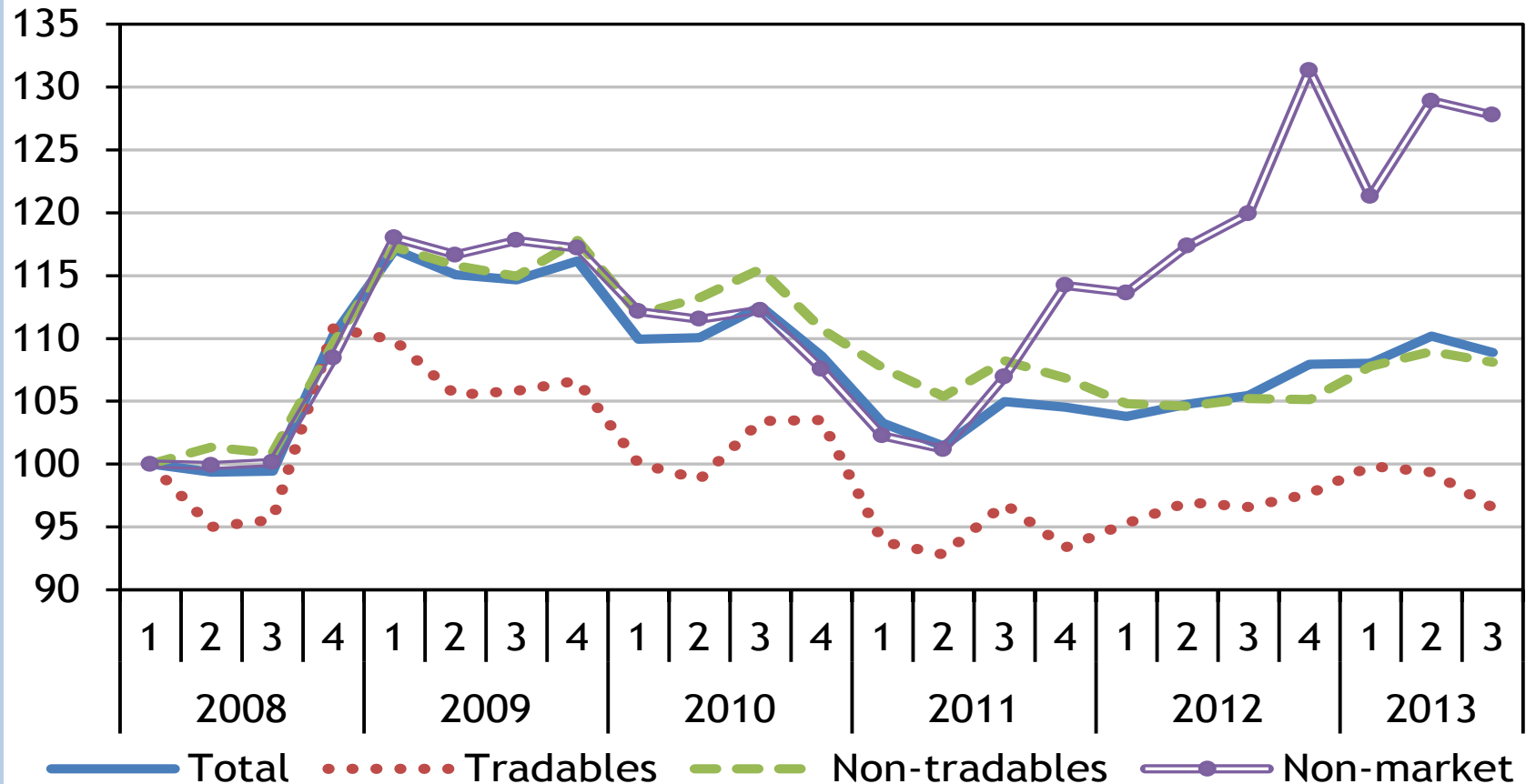
business and property
market wages



Gap Between Real Wages and Productivity

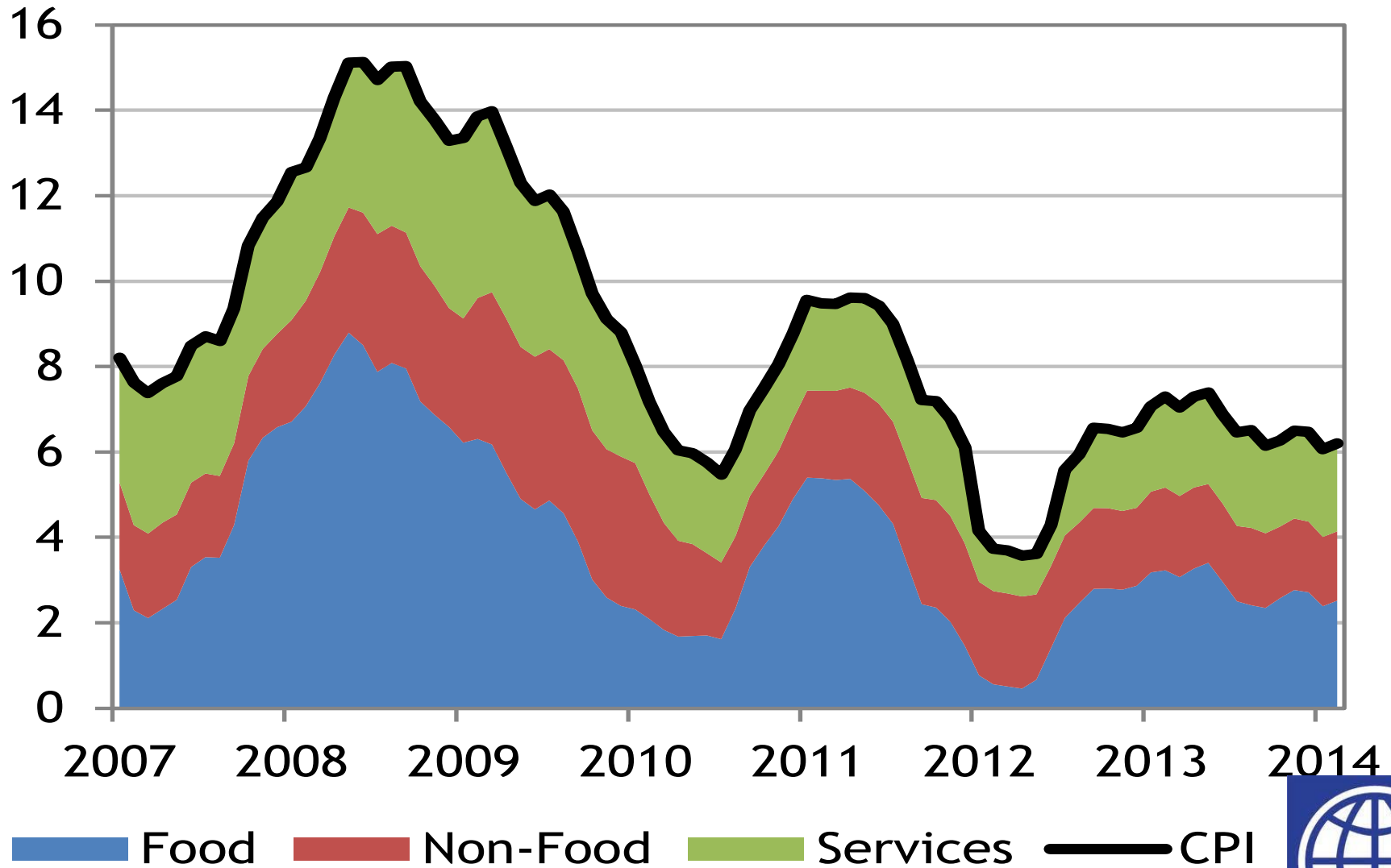
Differs Across Sectors

Gap between real wages and productivity growth by sector, y-o-y change



Ongoing Depreciation Will Impact Inflation Dynamics

CPI inflation by component, percent, y-o-y



Fiscal Impact: Balances under Pressure

percent of GDP	2011	2012	2013
	Actual	Actual	Preliminary
Federal Budget			
Expenditures	20.1	20.6	20.0
Revenues	20.9	20.5	19.5
Balance	0.8	-0.1	-0.5
Consolidated Budget			
Expenditures	35.9	36.6	37.4
Revenues	37.5	37.0	36.1
Balance	1.6	0.4	-1.3
Consolidated Subnational Budget			
Expenditures	13.8	13.3	13.2
Revenues	13.7	12.9	12.2
Balance	-0.1	-0.4	-1.0

Note: The consolidated budget includes the federal budget, the subnational budgets and extra-budgetary funds, e.g. pension and social security.





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