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RUSSIAN ECONOMIC REPORT #17

"Limit the impact of the crisis, Deepen Structural Reforms"

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The World Bank

I. Recent economic developments

II. Anatomy of the crisis

III. Energy efficiency reform

I. Recent economic developments and policies

1. Worsening international environment

2. Financial crisis: new challenge for policy

3. But structural weaknesses and oil dependence worsen the crisis

4. Yet, crisis presents opportunity to address longer term challenges of competitiveness, diversification, and financial sector modernization.

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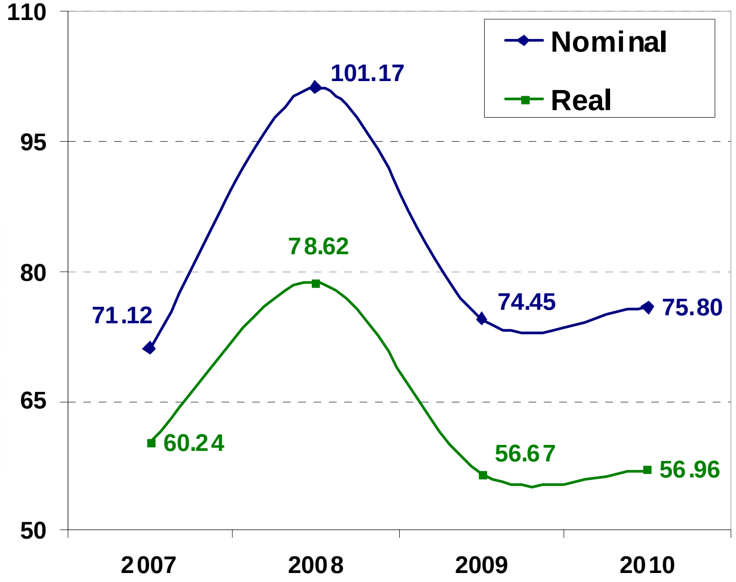
Worsening international environment

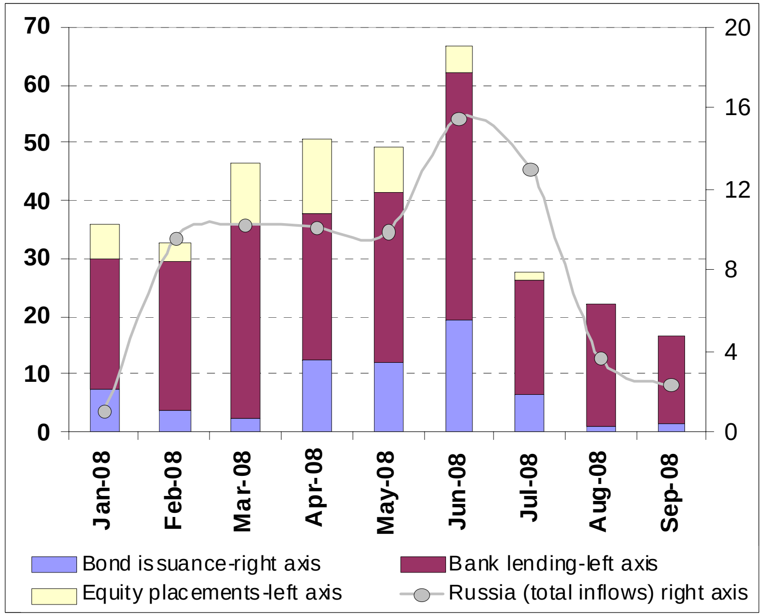
Box figure 1. Oil price forecast and capital flows to emerging markets

World Bank oil price forecast: Average crude (Brent, Dubai and WTI), simple average, USD/bbl



Sources: Dealogic and World Bank.

Gross capital inflows to emerging markets (BRIC countries) in 2008 (USD billions)



Source: World Bank staff.

- Global financial crisis
- Global slowdown
- Oil price collapse
- Capital flows drying up

Simultaneous, triple shock

- Oil price: USD144/b (July) - *USD55/b* (Nov)
  - +/-USD1 oil price on avg = +/-USD1.6 billion/year in export revenue (or USD4.3 million/day)
  - +/- USD1 oil price on avg = +/-USD1.1 billion/year in fiscal revenue (or USD3.0 million/day)
- “Sudden stop” in capital flows: USD81.2 billion (07) to *USD -50* billion (10 months 08)
- Sharply tightening borrowing conditions by domestic banks and corporations
  - Russian corporate bond spreads widened, reaching 940 bp on October 6 (up 629 bp from end-2007), compared to a 381 bp increase in corporate emerging market bond index to 676 bp

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Russia's growth and investment—slowing significantly

Table 1.1: Main macroeconomic indicators, 2003-08

	2003	2004	2005	2006	2007	2008Q1-3
GDP growth, %	7.3	7.2	6.4	7.4	8.1	8[a]
Industrial production growth, y-o-y, %	8.9	8	5.1	6.3	6.3	5.4
Fixed capital investment growth, %, y-o-y	12.5	13.7	10.9	16.7	21.1	13.1
Federal government balance, % GDP	1.7	4.3	7.5	7.4	5.5	8.1
Inflation (CPI), % change , e-o-p	12	11.7	10.9	9	11.9	11.6[b]
Current account, billion USD	35.4	58.6	84.2	95.6	76.6	91.2
Unemployment, %	8.6	8.2	7.6	7.2	6.1	5.3
Reserves (including gold) billion USD, e-o-p	76.9	124.5	182.2	303.7	478.8	487[c]

[a]*. data for 2008Q1-2*
[b]*. data for 10 months*
[c]*. data as of October 24, 2008*
Source: Rosstat, CBR, Ministry of Finance

Across-the-board, general slowdown

- Tradable sectors were first to register slower growth, to 3.4% in Q2 from 5.2% in Q1 2008:
  - Rapid increase in wages, outpacing productivity growth, and currency appreciation continued to undermine competitiveness.
  - Manufacturing—the engine of Russia's industrial growth—did well through Sept 2008 (7.7%). The growth momentum is partly a result of past orders (SOEs), but a slowdown is taking place in Q4.
- Non-tradables—down from very high growth rates: grew by 9.5% in H1 2008 (compared with 9.8% in 2007), driven by strong consumer demand in construction and retail trade.
  - Construction sector growth slowed to (a still high) 18.7% in Q2 2008, down from 28.3% in Q1 2008; construction growth is likely to decelerate further to only 9.5% in Q3 2008 compared to 15.7% during the same period in 2007.

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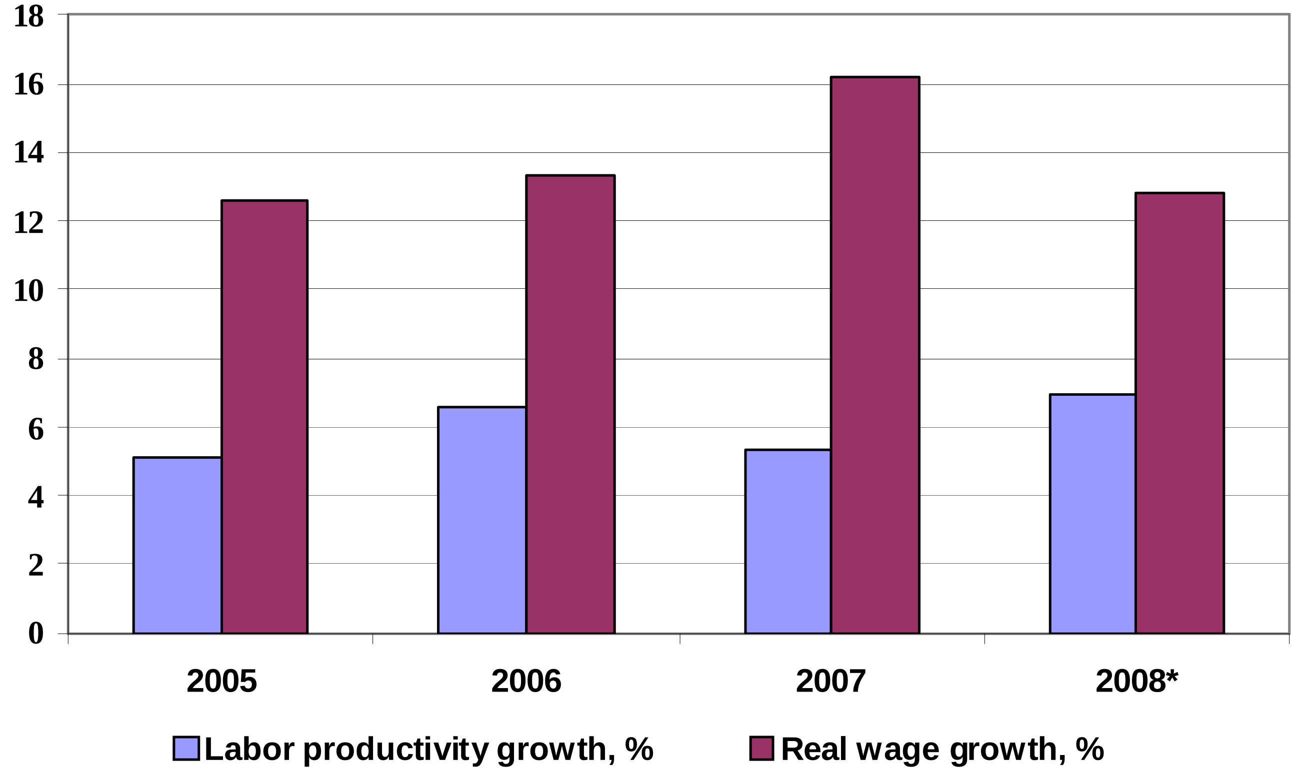
Further erosion of competitiveness: Real wage growth continue to outpace productivity gains, but growth in real wages is slowing

Figure 1.2. Labor productivity and real wage growth, 2005-2008 (in percentages)



Source: Rosstat and World Bank staff estimates.
* Labor productivity growth Jan-June 2008, the real wage growth Jan-September 2008.
Note: Labor productivity calculated as output (GDP) per employed person.

External current and capital account surpluses--declining

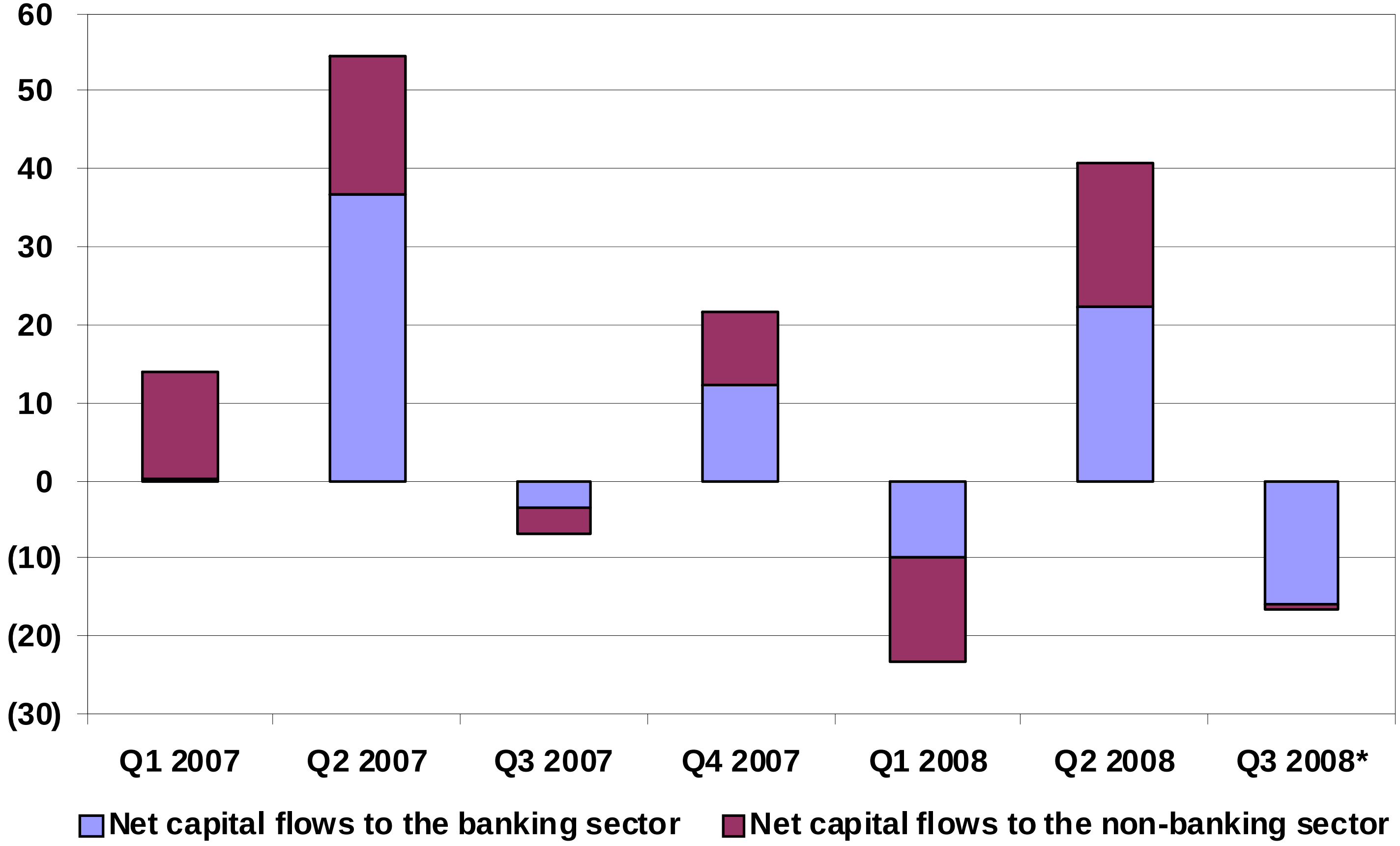
- *Non-oil* external current account deficit continues to deteriorate very fast in 2008 as import volumes grow faster than non-oil exports.

- Net capital account, fell from USD84.3 billion in 2007 to USD0.5 billion in 9 months of 2008

- FDI—non-debt creating flows—declined, worsening the composition of capital flows towards borrowing

Capital flows became more volatile in 2008, and the banking sector experienced a sharp reversal of capital inflows

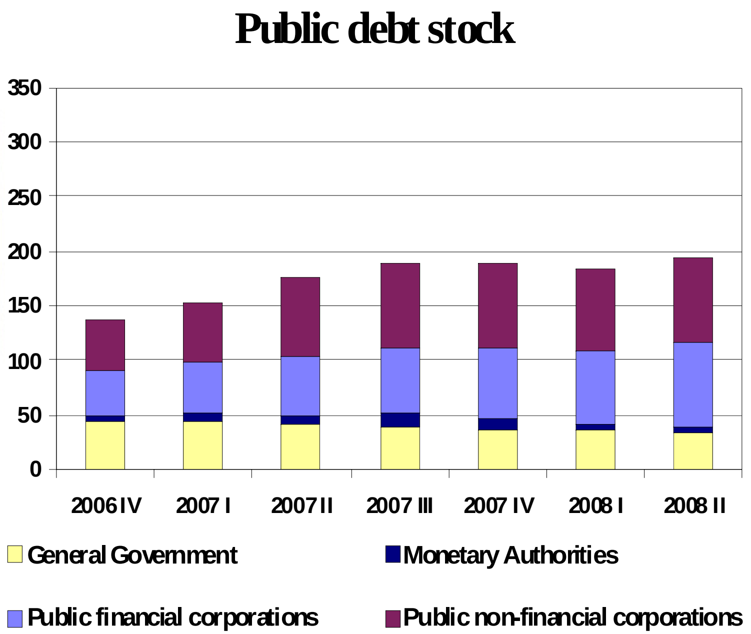
Figure 1.5. Quarterly net capital flows in USD billion, 2007–2008

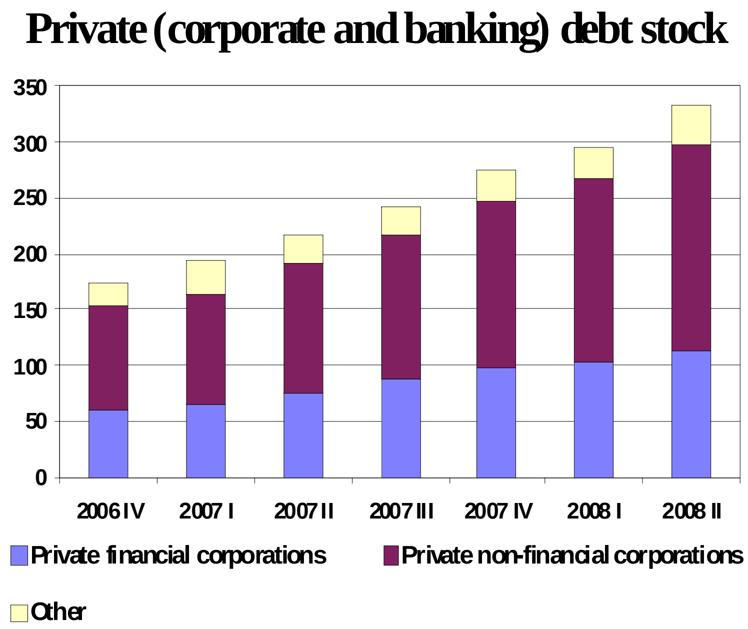


Source: CBR.

While public external debt remains moderate, private (corporate and bank) debt grew rapidly

Figure 1.6. Russian total external debt stock (USD billions)





Sources: CBR and World Bank staff calculations.

Many Russian banks were relying excessively on non-traditional (borrowing) sources of funding

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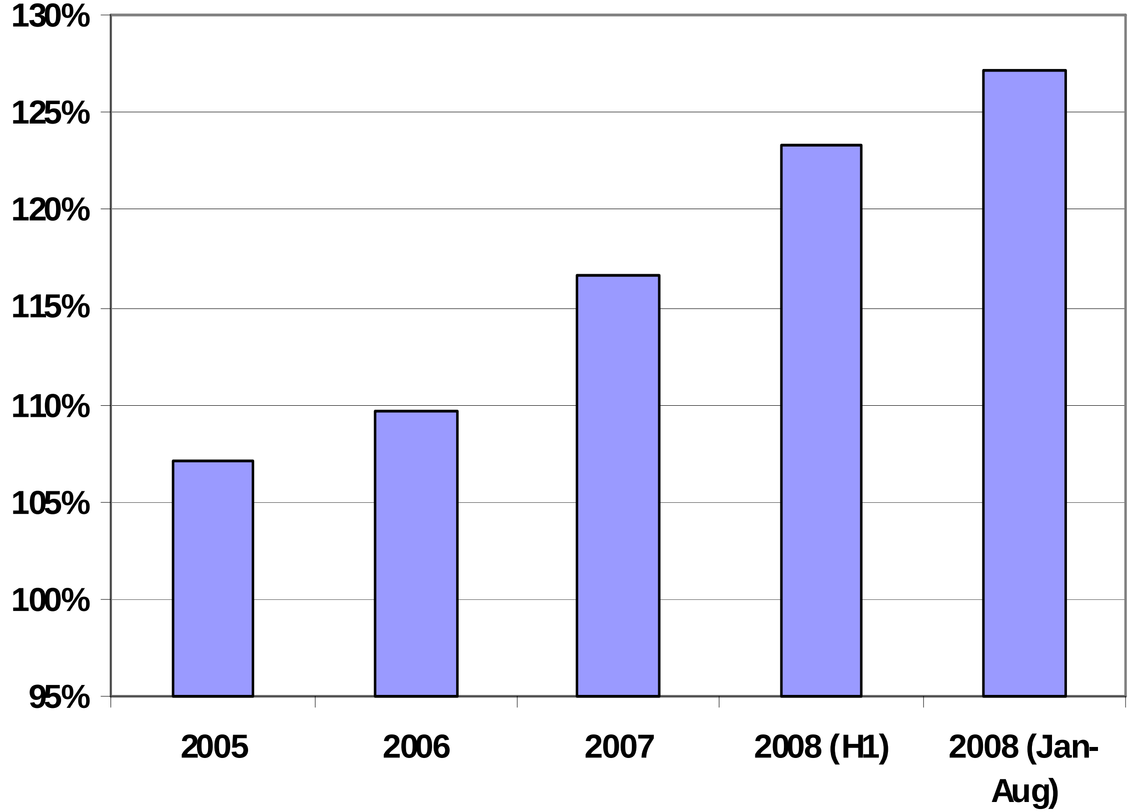
Figure 2.2: Evolution of the loan-deposit ratio

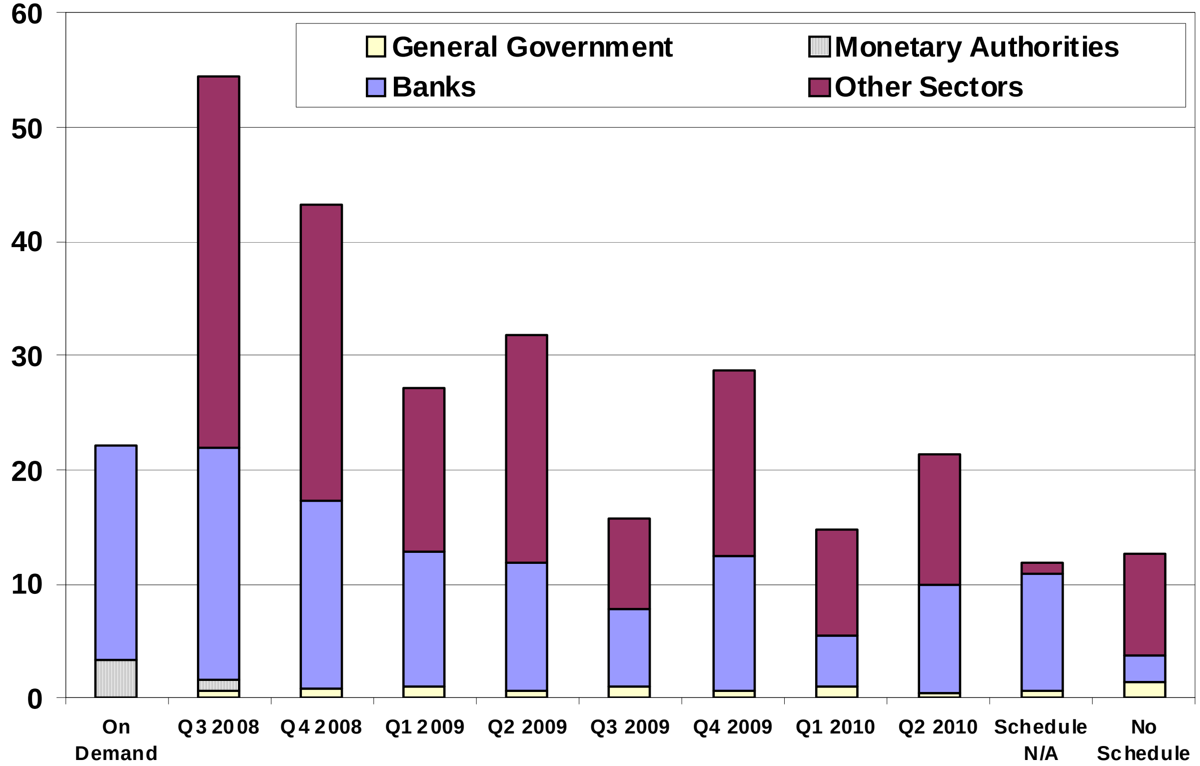


Source: CBR.

Banking—rollover risk sharply rising and consolidation starting

- Short-term external debt remains low (20% of total external debt) —but in private financial institutions (small and medium-sized banks) this share is significantly higher (40%), and thus more vulnerable to rollover risk.
- With hefty repayment obligations at a time of tighter global credit, the rollover risk has risen, but the systemic risk is limited.
- A number of banks were taken over or withdrawn licenses—consolidation started

Figure 1.7. Repayment schedule of Russia's external debt (in USD billion), Source CBR



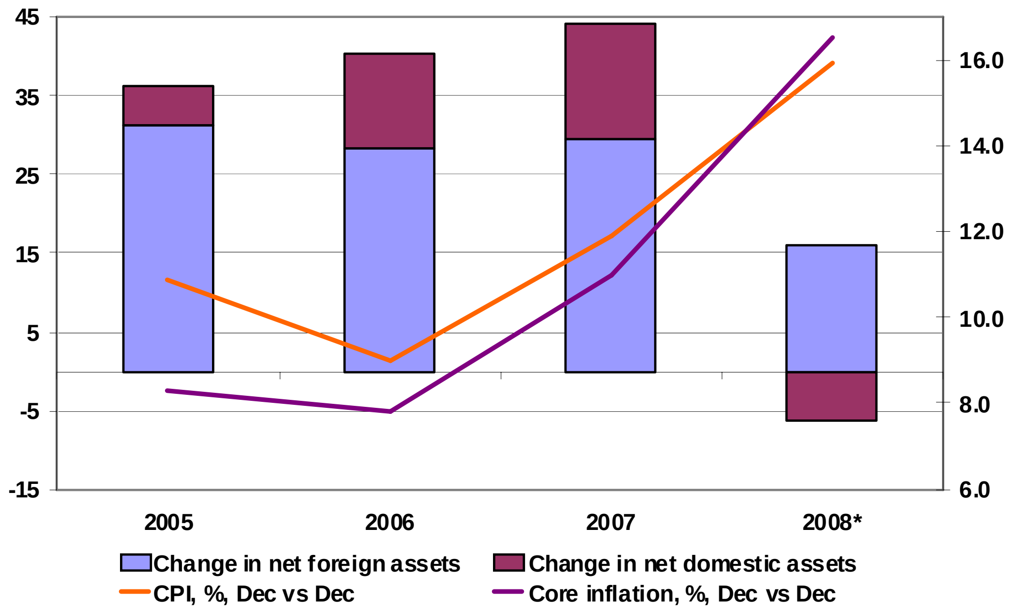
Against these developments, monetary and fiscal policy proactively responded to contain the impact of the crisis

Monetary-exchange policy and inflation—risk shifting towards liquidity and CBR loosening the monetary stance

- Earlier monetary tightening was not enough to reduce inflation
- With slowing of domestic demand, drying up of capital inflows, liquidity crunch, lower import food inflation and sharply lower oil prices, inflation pressures have eased
- But with liquidity risks rising sharply, in September, CBR moved decisively to boost liquidity (e.g., dropping interest rates and reserve requirements) and help restore confidence during the liquidity crunch.
- Greater flexibility of the exchange rate, since mid-November

Figure 1.8. Monetary growth and inflation

(in percent; monetary growth-left scale; inflation-right scale)



Source: CBR; Rosstat; World Bank calculations; Note: 2008 data are as of September.

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Fiscal policy—aiming to limit the impact of the crisis

- Russia's consolidated (general) budget was executed with the strong surplus of 11.1% of GDP in the first nine months of 2008, compared with 9.4% for the same period in 2007.
- The government is aiming to provide fiscal/quasi-fiscal support to banks and enterprises facing liquidity and external repayment difficulties

Table 1.12. Consolidated budget: revenues, expenditures, and the fiscal surplus, 2005-08

	2005	2006	2007	9m-2007	9m-2008
Revenues, % GDP	39.7	39.6	40.2	38.2	39.5
Expenditure, % GDP	31.5	31.2	34.1	28.8	28.3
Surplus, % GDP	8.1	8.4	6.1	9.4	11.1
Non-oil balance, % GDP	-2.1	-2.8	-2.9	0.7	-0.2
Primary non-oil balance, % GDP	-1	-2	-2.3	1.3	0.3

Source: Ministry of Finance.

II. Anatomy of the Crisis and remaining policy challenges

1. Origins
2. Evolution in Russia
3. Policy response
4. Impact on poverty
5. Remaining Policy Challenges
6. Outlook

A perfect storm—the US subprime mortgage and financial crises

- Housing market bubble in the US (2007)
- Sub-prime mortgages/derivative bubble
- Russia was initially immune
- By mid-2008, the global financial crisis began to reach Russia on the back of a weakening and highly oil-dependent economy.

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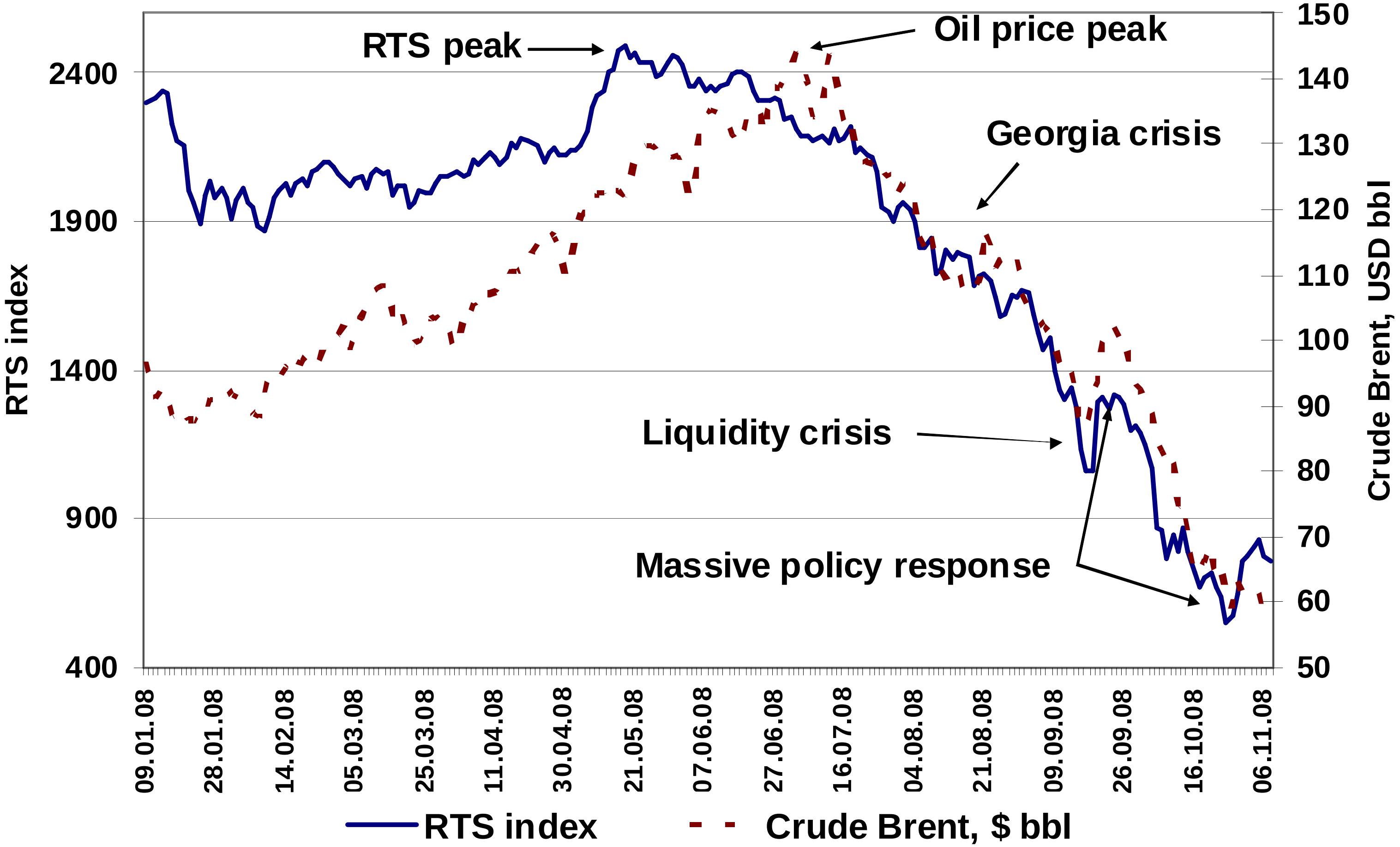
Since July, near perfect correlation of the RTS index with the price of oil

Figure 2.1. Russian stock market and oil price dynamics during crisis



Source: RTS; Thomson Datastream.

Three Phases of the Crisis: (1) Orderly decline; (2) liquidity crisis; and (3) swift policy response

- First phase (May 19-Sep 12): gradual decline in the RTS index (-46.1%), largely driven by oil price decline and worsening international crisis. No major policy response.

- Second phase (Sep 15-18): confidence crisis generated a liquidity freeze leading to a sharp increase in selloffs; massive margin calls as investors cashed in their rapidly declining equity positions (RTS down -21.1%).

- Third phase (Sep 19-Nov 14): market initially bounced back, recovering losses from the second phase, but the subsequent impact of the set of policy measures on equity markets was limited. Oil prices kept falling and a panic in world markets ensued (RTS down -48.1%).

Policy response: timely, massive, and broadly appropriate, loosening monetary stance and providing fiscal support to ease liquidity crisis

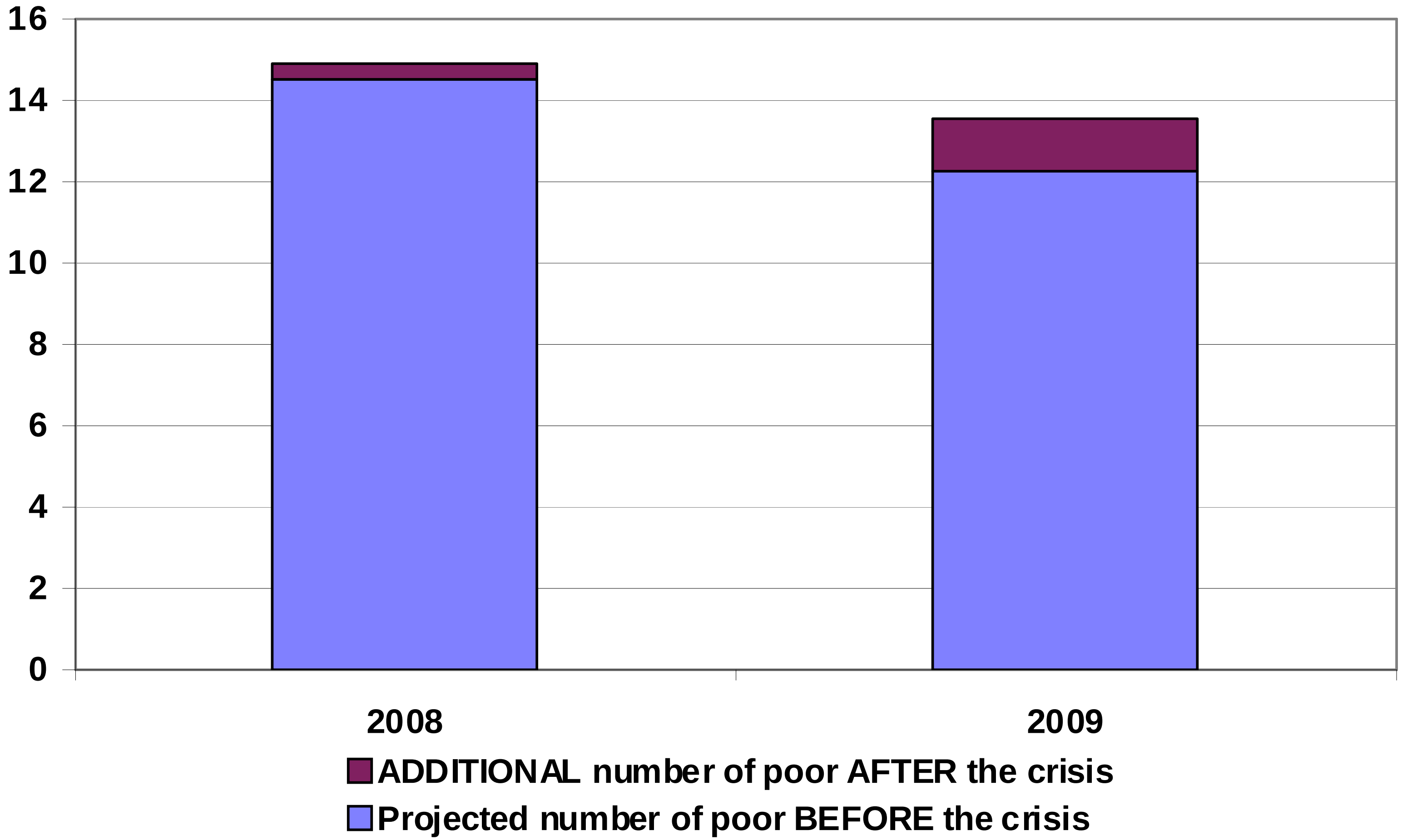
Aggregate fiscal, quasi-fiscal and monetary cost and sources of financing of anti-crisis policy measures

	Fiscal	Quasi-fiscal	Monetary	Total
Federal Budget	190	up to 2,839		up to 3,029
..o/w National Welfare Fund		*up to 700*		*up to 700*
Central Bank of Russia		up to 1,800	830	up to 2,630
Total (in bln rubles)	**190**	**up to 4,639**	**830**	**up to 5,659**
Total (in bln USD)	**7.6**	**up to 185.0**	**33.0**	**up to 225.6**

Source: World Bank staff estimates.

The implications of the financial crisis on Russia's poor are troubling; also, while unemployment is low, it is bound to increase

Projected amounts of poor people before and after the crisis (millions)



Source: World Bank staff calculations based on Rosstat's Household Budget Surveys

So what are the remaining policy challenges going forward?

1. Limiting the impact of the crisis on liquidity and the real economy while safeguarding macro stability.

2. Intensifying structural reforms to diversify the economy, strengthen institutions and financial sector for sustained, long-term growth.

3. Continuing integration into the global economy, including the acceleration of accession to the WTO.

4. Limiting the impact of the crisis at the regional level and of non-payment problems.

5. In 2009, deeper recession might require an introduction of a fiscal stimulus package.

Outlook for 2008 and 2009

- **World output growth:** expected to be low in 2008 (2.5%) and 2009 (0.93%)
  - High-income: growth of 1.35% in 2008, and -0.15% in 2009
  - Developing: growth of 6.3% in 2008, and 4.45% in 2009

  Oil prices: USD101.5/barrel in 2008; USD74.5/barrel in 2009.

  High uncertainty in world economic outlook.
- **Russia's outlook: deteriorating but with recovery towards end-2009**

- **Growth**: 6% real GDP growth for 2008 (compared to 6.8% estimated before the crisis), and 3% in 2009 (6.5% before the crisis).
- **Unemployment:** moderate rise to 5.9% by end 2008 (up from 5.3%), then further to 6.6% in 2009.
- **Inflation** broadly unchanged: 13.5% by end 2008. Will be difficult to reduce inflation below 12% in 2009.
- Decline in twin surpluses (**federal fiscal and external current account**), and widening capital account deficit.
  - Current account surplus around USD100 billion in 2008 and about USD40 billion in 2009.
  - Capital account would deteriorate in 2008 to a deficit of about USD50 billion and to deficit of USD100 billion in 2009
  - Impact on CBR reserves should be limited to a possible loss of no more than additional USD100 billion in 2009, still leaving a comfortable reserve cushion.

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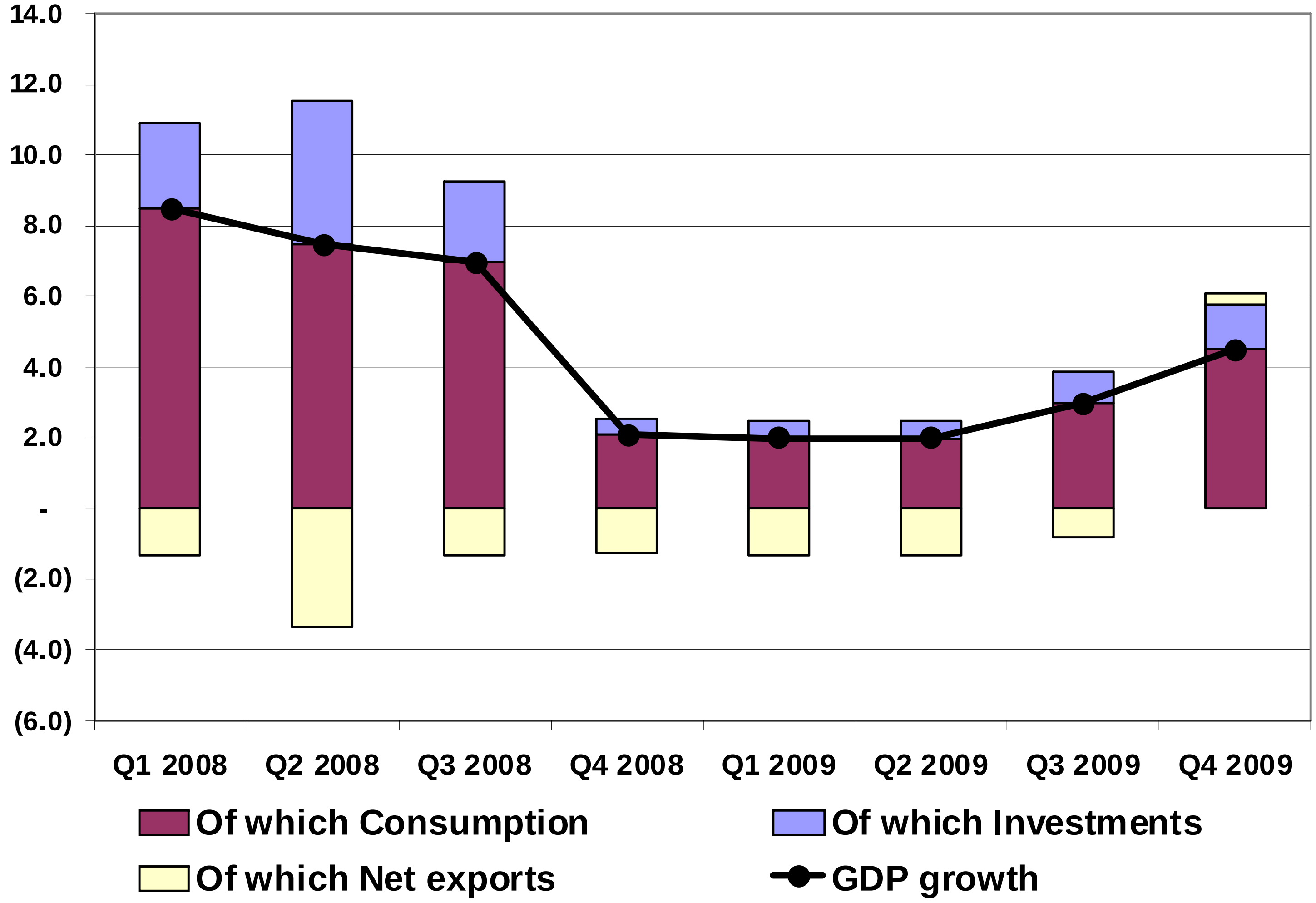
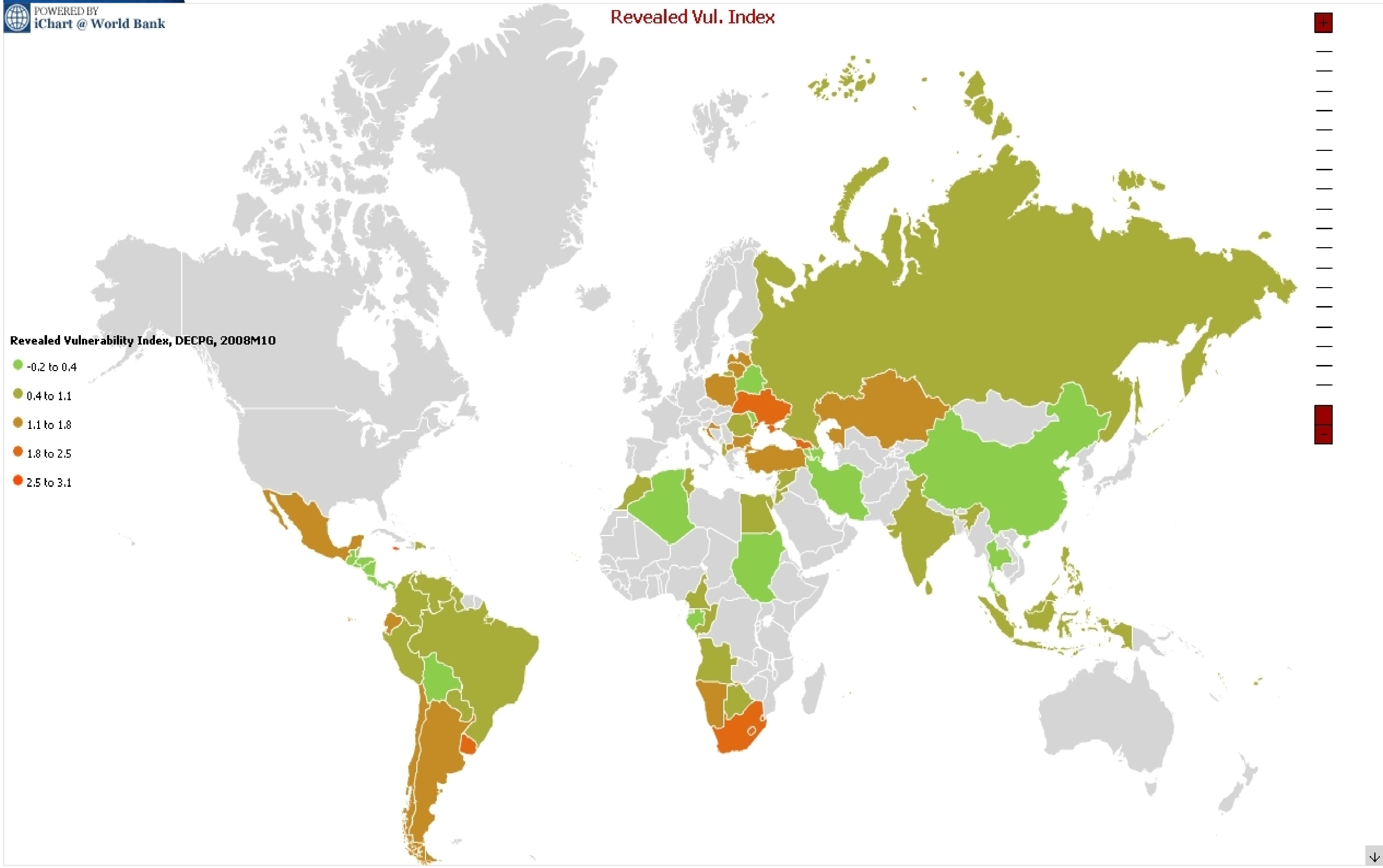
Real GDP Growth: Fall in consumption and investments between Q4 2008 and Q2 2009, followed by a slow recovery in Q3-Q4 2009

Figure 1.1. Demand sources of Russia's real GDP growth by quarter, 2008-2009 (percentage change)



Source: World Bank decomposition and estimates based on Rosstat data.

Middle income countries–perceived vulnerability index



III. Energy efficiency in Russia

1. Outlook
2. Challenges
3. Policy recommendations

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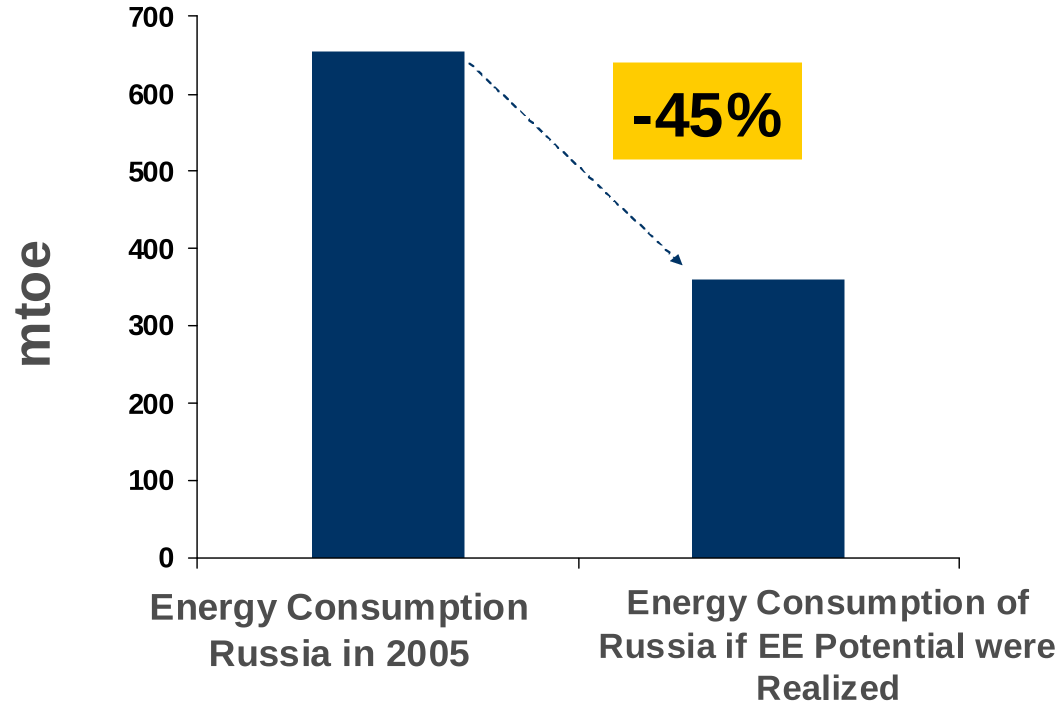
Low energy efficiency affects Russia's economy and requires government intervention

- Russia's energy efficiency (EE) potential is huge – some 300 mtoe/year, equivalent to 2% of all energy produced in the world in 2005.
- Comprehensive policy is required to tap into energy efficiency potential
- Energy waste mainly occurs on the demand side
- Russia can reduce energy consumption by 45%



Risks and policy challenges

Risks

- Little administrative resource and funding allocated to EE
- Poor coordination among ministries
- Underdeveloped mechanisms of implementation and monitoring

Policy challenges

- Raising awareness
- Removing barriers
- Creating targeted incentives
- Developing financing instruments
- Monitoring
- Creating a strong federal EE agency and leave and expand regional and local mandates in the area of EE

Thank you!

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