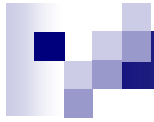




# Russian Economic Report

*April 2006*

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**World Bank**



# **I. Recent Economic Developments**



## Overall, trends from the second half of 2004 have continued

- n Sustained economic growth and improvements in living standard
- n Industrial slowdown
- n Stronger balance of payments position (increasing pressure on the ruble and inflation)
- n Sterilization of huge foreign inflows through the accumulation of surpluses in the Stabilization Fund



# Relatively new trends

- n An increase in capital inflows, including foreign direct investments
- n Changes in monetary (exchange rate) policy and other possible measures to bring down inflation

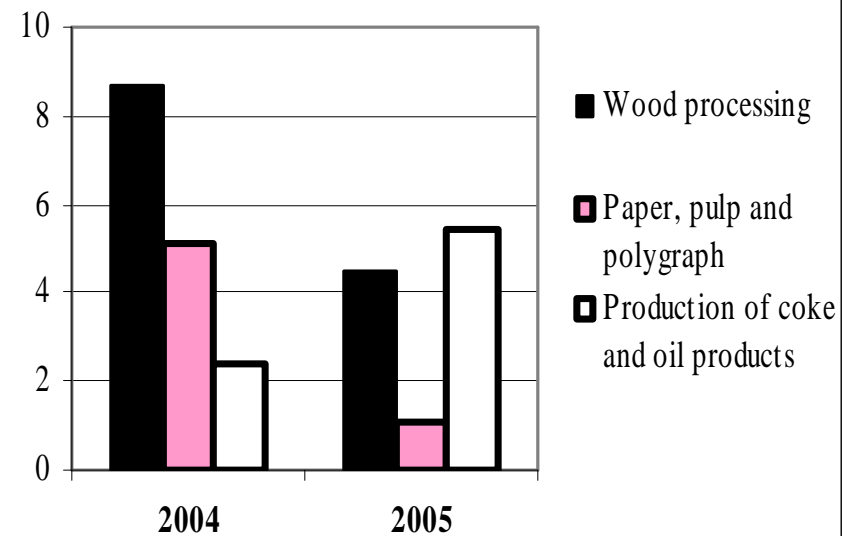
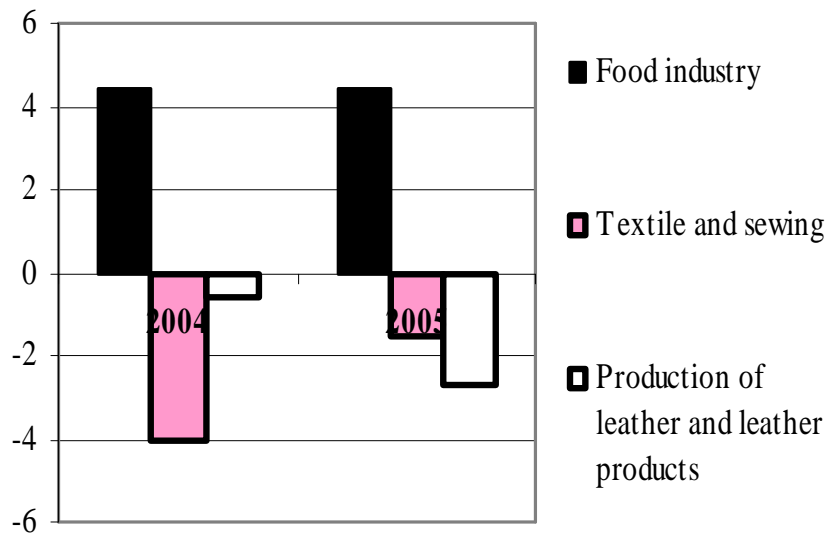
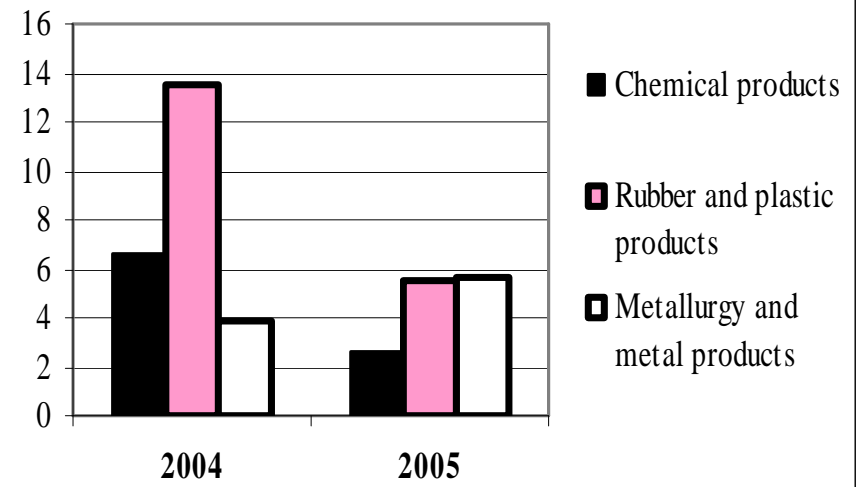
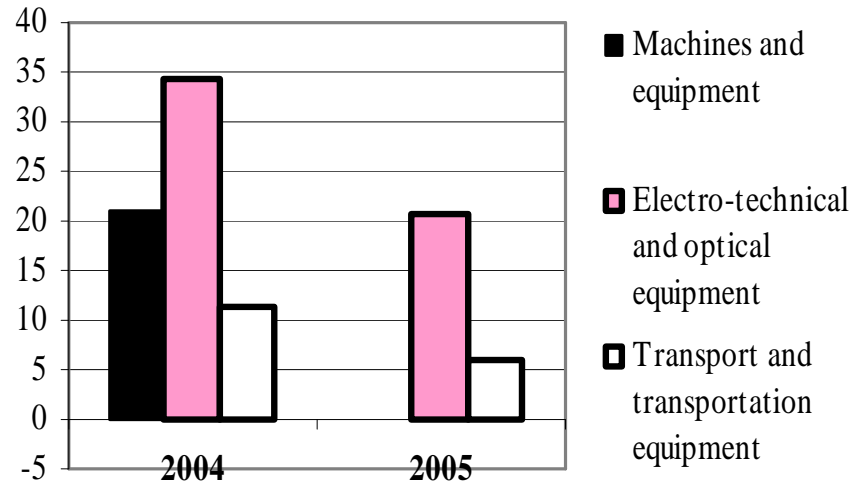
# Russian Economic Growth: 2003-2005

## (%, by value added )

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	2003	2004	2005
GDP	7.3	7.2	6.4
Agriculture, hunting, forestry	5.5	3.0	1.1
Extraction of mineral resources	10.8	7.9	1.7
Manufacturing	9.5	7.8	4.4
Electricity, gas, water production and distribution	1.6	2.1	1.0
Construction	13.0	10.2	9.7
Retail and wholesale trade, repair and maintenance of vehicles, etc.	13.2	9.8	12.4
Transport and communication	7.2	10.5	6.2
Finance	9.6	4.5	6.4
Immovable property operations, leasing and service provision	3.0	4.5	9.0

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## Growth in profits in manufacturing seem to be slower than elsewhere in the economy...

### Index of Net Profits, %

	2004	2005
Total	152.4	136.6
Agriculture, hunting, forestry	230	75.3
Extraction of mineral resources	220	175.6
Manufacturing	157.5	116.2
Electricity, gas and water production and distribution	140.6	134.4
Construction	87.3	121.1
Retail and wholesale trade, repair and maintenance of vehicles, etc.	133.0	142.5
Transport and communication	127.36	130.3
<i>w/o communication</i>	113.2	161.5
Finance	160.3	151.5



...resulting in a continued flow of resources  
from manufacturing to other sectors

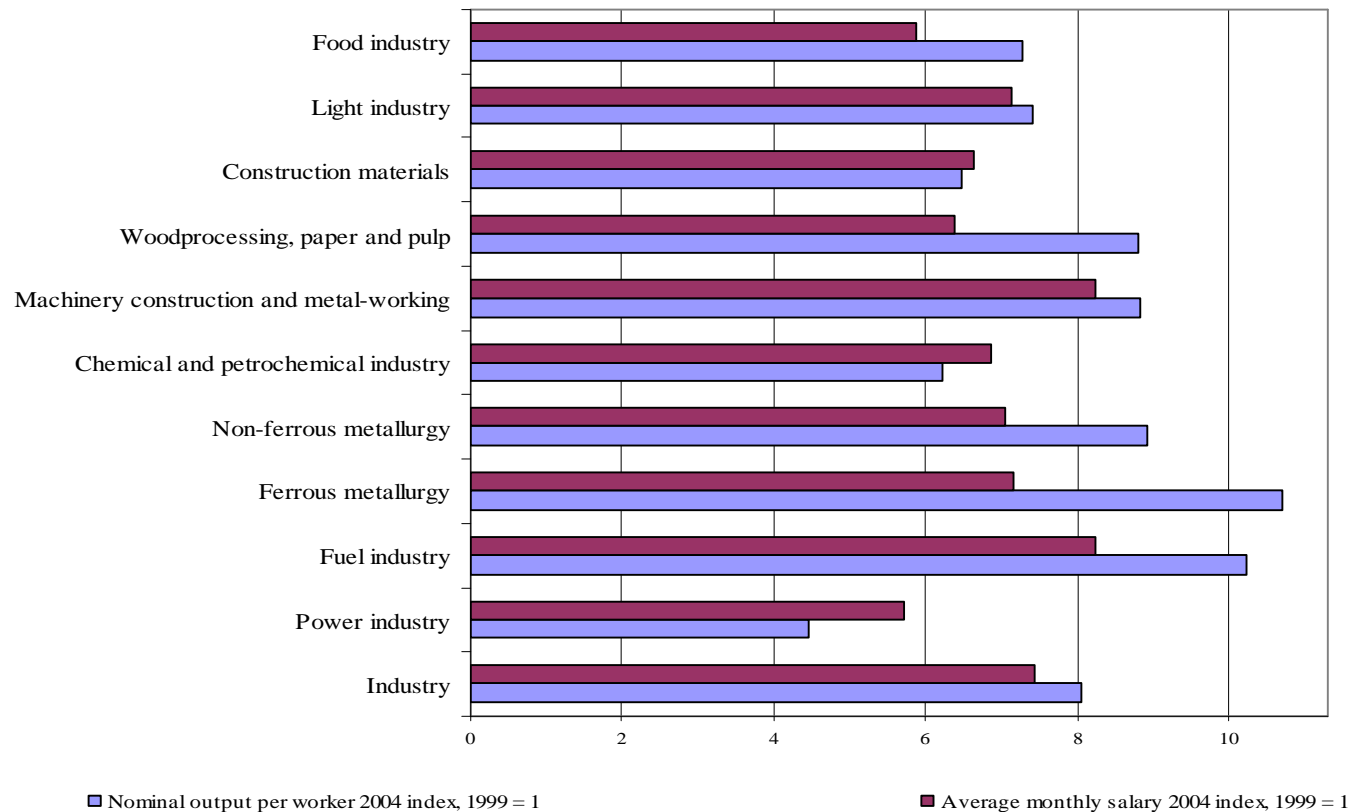
Growth in employment in selected sectors: 2005

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<b>Total</b>	<b>-1.0</b>
Agriculture, hunting, forestry	-11.9
Extraction of mineral resources	-2.3
Manufacturing	-4.0
Construction	-1.4
Trade and other msc. services	9.7
Hotels and restaurants	2.6
Transport and communication	-2.1
Finance	7.4
Real estate and leasing	-0.5
Government administration and social security	7.2

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Over the recent years labor productivity in the Russian industry seems to have been largely outpacing wages owing primarily to rising input costs and labor shedding in manufacturing





# Fixed capital investment

- n Continued to grow rapidly
  - .. double-digit fixed capital investment growth for a third consecutive year (10.5 percent) in 2005
  - .. FDI inflows grew by 39 percent in 2005 reaching \$31.1 bn
- n Remains relatively low (18% of GDP), while manufacturing accounts for a small share

## **Total fixed capital investment by sector (% of total)**

	2004	2005
Agriculture, hunting, forestry	3.2	3.2
Extraction of mineral resources	17.4	15.2
Manufacturing	17.3	17.6
<i>Food industry</i>	3.2	3.1
<i>Coke and oil products</i>	2.0	1.8
<i>Chemical products</i>	1.4	1.7
<i>Other non-metal mineral products</i>	1.2	1.5
<i>Metallurgy and metal products</i>	4.5	4.7
Electricity, gas and water production and distribution	8.3	7.8
Construction	3.4	2.9
Retail and wholesale trade repair and maintenance of vehicles, etc.	2.3	2.8
Transport and communication	19.1	22.1
<i>Communication</i>	6.4	6.7
Immovable property operations, leasing and services provision	12.2	11.5
Health care and social services	2.2	2.3
Provision of other public utilities, social and personal services	2.5	2.6

## Share of Foreign Direct Investment by sector of the economy

	2004	2005
Agriculture, hunting, forestry	0.9	0.9
Extraction of mineral resources	43.3	30.7
<i>Energy resource extraction</i>	<b>42.3</b>	<b>29.9</b>
<b>Manufacturing</b>	<b>30.9</b>	<b>46.1</b>
<i>Coke and oil products</i>	<b>0.1</b>	<b>27.2</b>
Electricity, gas and water production and distribution	0.001	1.1
Construction	0.9	0.9
Retail and wholesale trade, repair and maintenance of vehicles etc	10.2	5.9
Hotels and restaurants	0.2	0.2
Transport and communication	2.1	1.9
<i>communication</i>	0.4	0.4
Finance	3.8	4.5
Immovable property operations, leasing and services provision	6.9	7.1
Provision of other public utilities, social and personal services	0.7	0.6



## The Balance of Payments continues to move from strength to strength—added by capital inflows

### Balance of Payments (USD billions)

	2003	2004	2005	2006* (Q1)
Current Account Balance	35.4	58.6	84.2	28.0
<i>Trade Balance</i>	<i>59.9</i>	<i>85.8</i>	<i>118.3</i>	<i>32.6</i>
Capital and Financial Account	-0.8	-6.3	-10.9	-4.5
Errors and Omissions	-8.2	-7.1	-11.9	-2.1
Change in Reserves	26.4	45.2	61.5	21.4



# Capital inflows exert pressure on the ruble and inflation

- n A pickup in inflation (4.1 %) and core inflation (2 %) in January and February compared to last year was driven by capital inflows in QIV of 2005.
- n In fighting inflation the CBR has changed its exchange rate policy.
- n Some anti-inflationary measures contemplated by the authorities raise concerns.
  - .. Practice in other countries confirms that the use of price controls as a means of reducing moderate inflation is a poor policy choice.
  - .. Anti-inflationary economic policy should target only core inflation.
  - .. The Ministry for Economic Development and Trade should not be made responsible for inflation as it does not control any appropriate instruments for affecting core inflation



# Fiscal expansion in 2006 remains contained

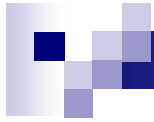
## The Federal Budget (% of GDP)

	2003	2004	2005	2006 Budget Law
<b>Revenues</b>	<b>19.6</b>	<b>20.4</b>	<b>23.6</b>	<b>20.7</b>
<b>Expenditures</b>	<b>17.9</b>	<b>16.1</b>	<b>16.2</b>	<b>17.5</b>

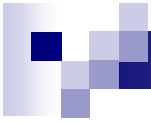
**The national projects should have a positive impact on the welfare of the Russian population and the Russian poor, however their benefits could be short-lived without the necessary structural reforms**

**Financing of the National Projects from Federal and Regional Budgets (in billions of rubles)**

	<b>2006</b>	<b>2007</b>	<b>Total (06-07)</b>
Health	88.4	120.5	208.9
Education	25.3	31.2	56.5
Housing	35.4	46.2	81.6
<i>government guarantees</i>	26.5	33.5	60.0
Agriculture	16.2	18.7	34.9
<b>Total (excluding guarantees )</b>	<b>165.3</b>	<b>216.6</b>	<b>382</b>



## **II. The Management of Surplus Oil Revenues: Major Opportunities for Russia**



How should Russia manage its growing oil inflows and use them to address its economic development and public welfare objectives?



## **Numerous proposals suggest one or another fiscal expansion -- there are risks and constraints**

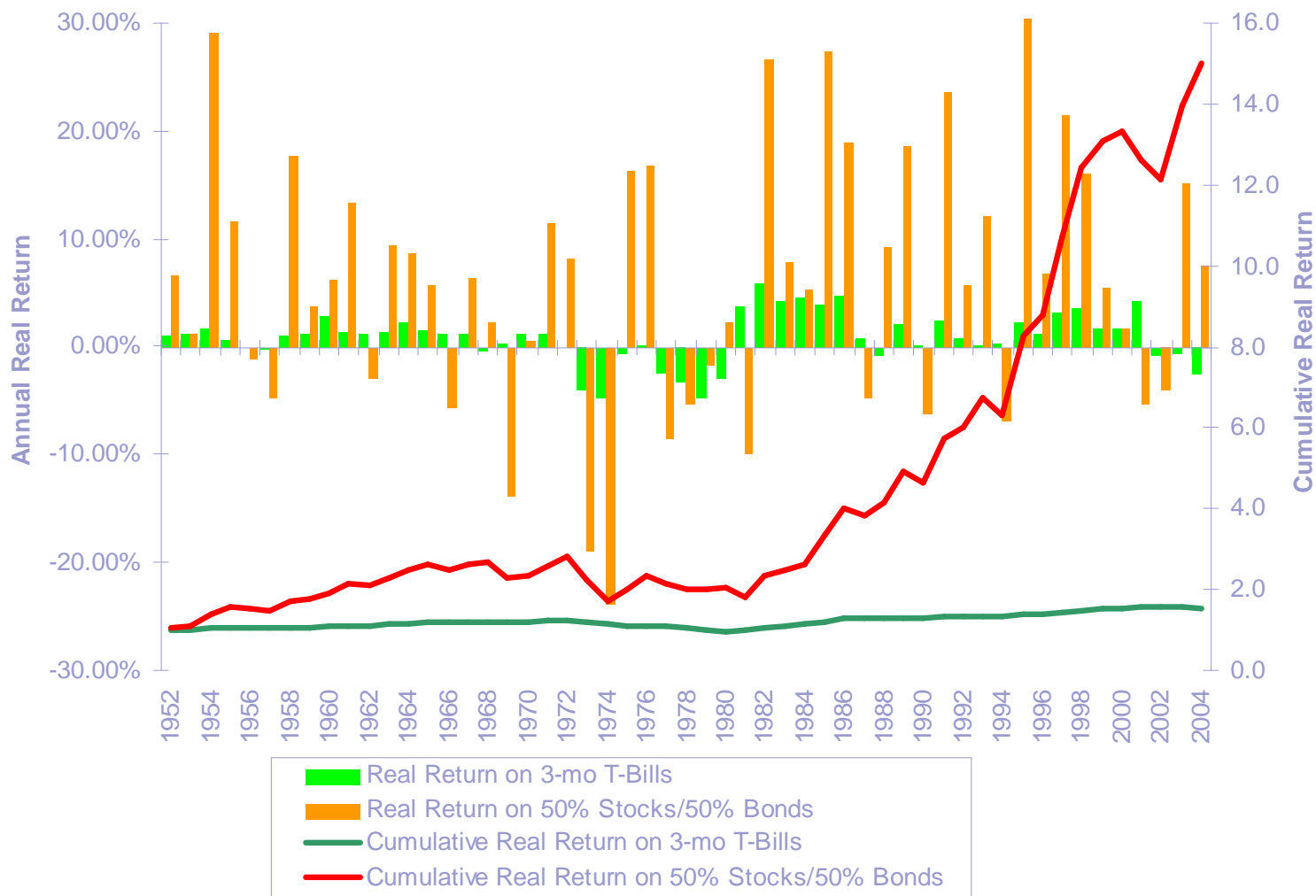
- n Accumulation of fiscal surpluses in the Stabilization Fund is critical to maintaining macroeconomic stability and preventing a rapid appreciation of the real exchange rate.
- n Reducing the tax burden on the non-oil sector would increase even further the high vulnerability of Russia's budgetary position to changes in oil prices.
- n Budgetary institutions for effective public investments remain weak.



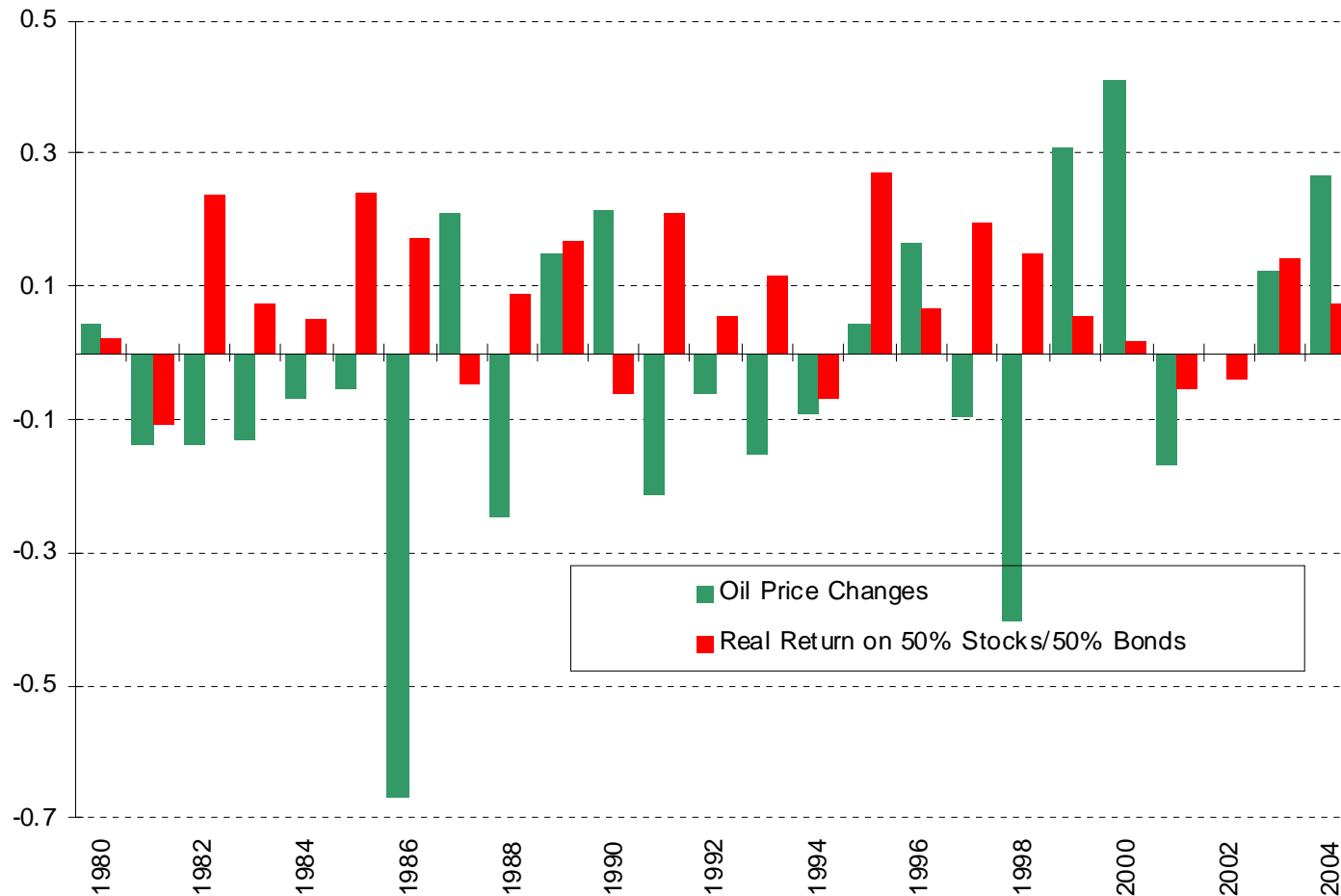
## **A large diversified portfolio of foreign assets would open significant opportunities for Russia**


- n A return on a diversified portfolio would alleviate the vulnerability of the budget to changes in oil prices, which would provide security for the country and open new opportunities for a counter-cyclical fiscal policy promoting growth.
- n Social security (particularly, pension fund and healthcare) in the face of a deepening demographic crisis.
- n Postponing expenditures on some investment projects until the fiscal reform is completed to enhance their efficiency.

# Generating investment income: US T-bill returns versus portfolio of equities/bonds



# Smoothing of f/x revenues through investment in financial assets with negative correlation to oil/gas





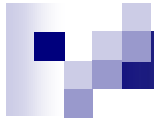
# How can the budget be protected against oil price shocks?

- n By placing a relatively large portfolio of highly liquid assets in the short term, and only gradually expanding the longer-term (volatile) invested portion of the portfolio.

**or**

- n By purchasing guarantees of minimum future prices for sales of oil.

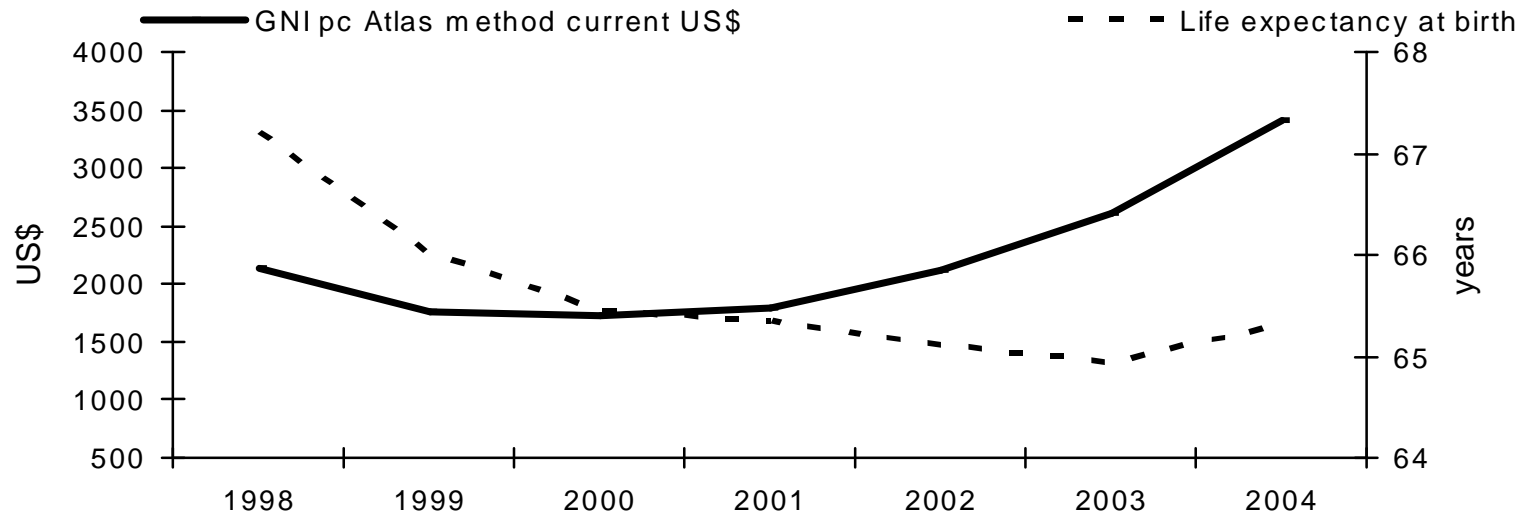
- n If Russia manages to accumulate a sufficiently large Fund, the negative correlation of the Fund's returns with oil prices would protect the budget.



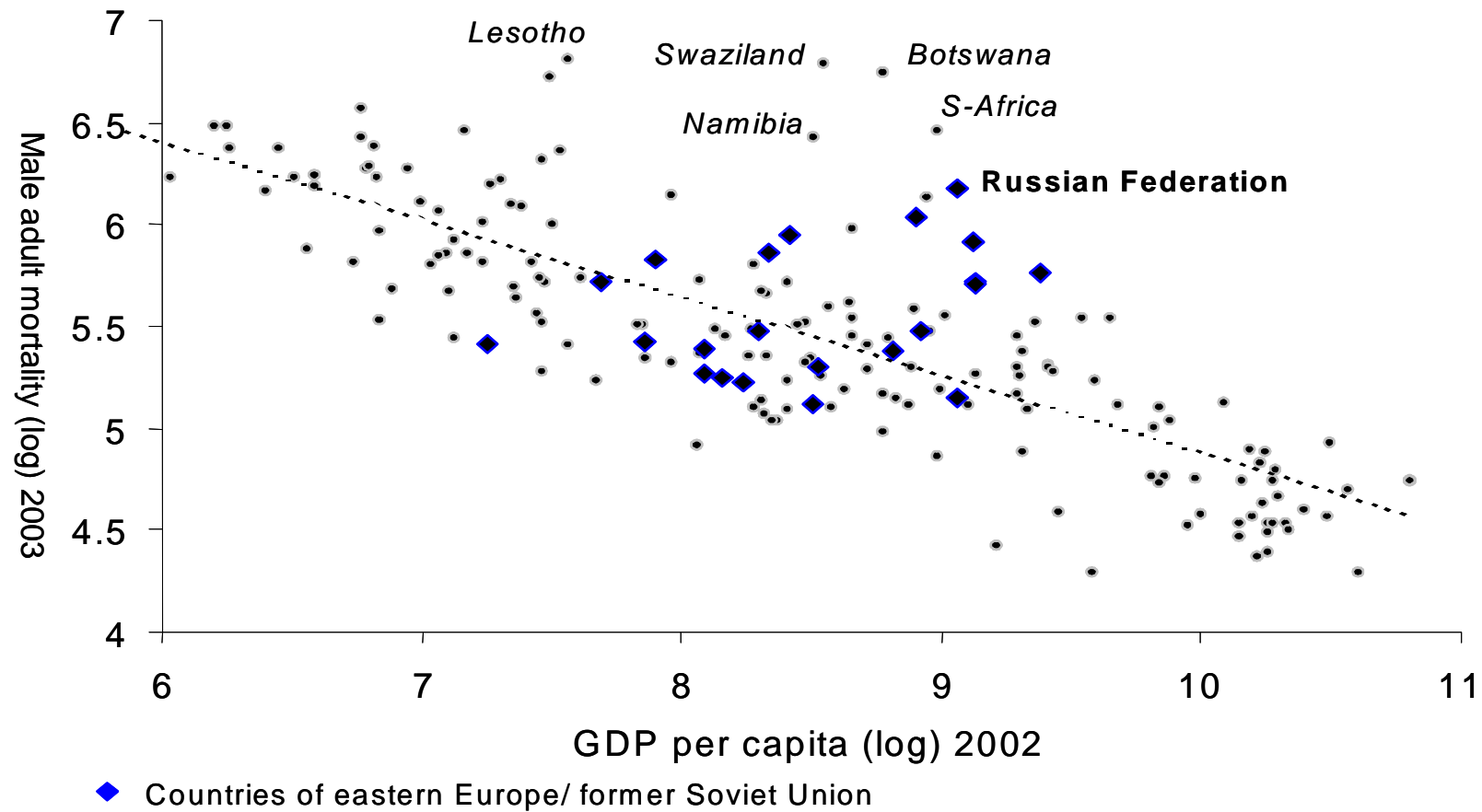
### **III. Mortality and the Health of the Russian Population**

Until 2004, declines in life expectancy in Russia contrasted sharply with strong growth in incomes and poverty reduction since 1998

## Gross National Income per Capita and Life Expectancy.



Mortality rates for males are extraordinarily high in Russia relative to other countries at similar income and development levels



**A composite variable of “healthy life expectancy”**  
 illustrates a problem of ill health among Russian women  
*Life expectancy (LE) and healthy life expectancy (HLE) in Russia*

	Country/Region	At age 20		At age 40		At age 65	
		LE	HLE	LE	HLE	LE	HLE
Males	Russia	41.9	36.7	22.4	17.3	11.4	6.7
	Western Europe	54.5	50.4	31.2	27.6	15.0	12.5
Females	Russia	54.2	40.6	31.1	18.5	15.2	5.8
	Western Europe	60.2	53.7	36.0	30.3	18.1	14.0
Female-male gap (years)	Russia	12.3	3.9	8.7	1.2	3.9	-0.9
	Western Europe	5.7	3.3	4.8	2.7	3.1	1.5



# What explains exceptionally high mortality and morbidity rates in Russia?

- n Heart disease, cancer, and injuries account for 78 percent of deaths among the male working age population.
- n Evidence continues to mount to the effect that alcohol may indeed be a primary culprit.
- n Tobacco consumption and unhealthy diets.
- n Poor compliance with safety standards, including the highest road death rate (per 100 thousand population).
- n Poor access of much of the population to quality healthcare services.
- n Environmental pollution.



## What is the proper policy response to the Russian health crisis?

- n Given that the root causes of this crisis appear linked to the unhealthy lifestyles of Russian citizens, particularly men, programs aimed at affecting lifestyles, together with preventive care, are of particular interest.
- n Russia can learn from the experience of a number of other countries in this regard, including programs in Sweden and Finland that have succeeded in reducing alcohol consumption.



## **Reforms in the health care system should also have a measurable impact on the situation**

- n Inefficient allocation of healthcare costs:
  - .. Outperforming other countries in terms of a large number of per capita hospitals, doctors, hospital beds and average lengths of hospital stays, but lagging behind in terms of health promotion and disease prevention services
  - .. Inefficient distribution of health workers across geographic areas
- n Weak incentives for providing quality services
- n Little budgetary flexibility at the municipal level
- n The national medical insurance system in need of reform