

RUSSIAN ECONOMIC REPORT #19

From Crisis to Recovery – Policies Matter



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Fitch Ratings Conference

*How is Russian economy and banking sector coping with
the global financial crisis?*

Moscow

June 30, 200



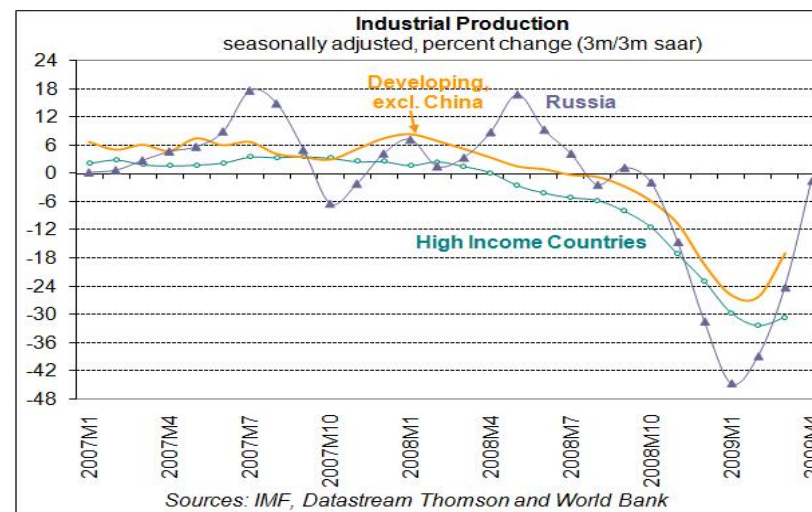
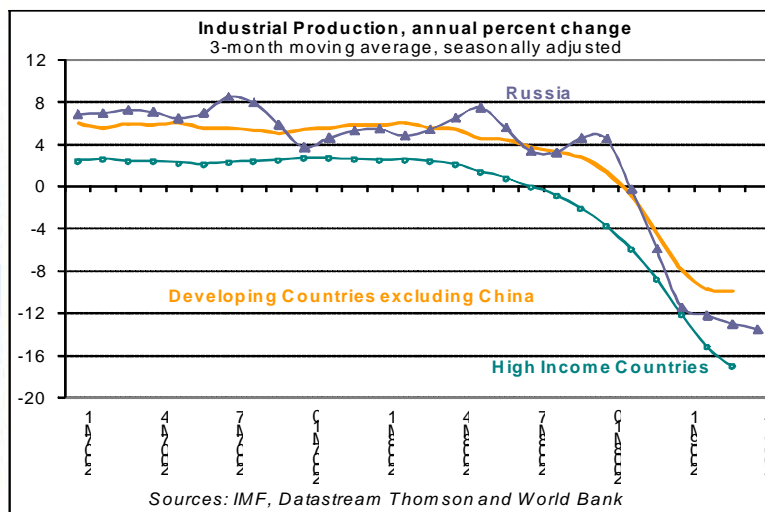
- I. External environment
- II. Recent developments in Russia
- III. Economic and social outlook for 2009-2010
- IV. Policy challenges

I. External Environment: global crisis escalates in Q1 2009

The impact of the global financial crisis escalated throughout the first quarter of 2009 with sharp contractions in developed and emerging markets



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From financial to full blown, massive real sector crisis

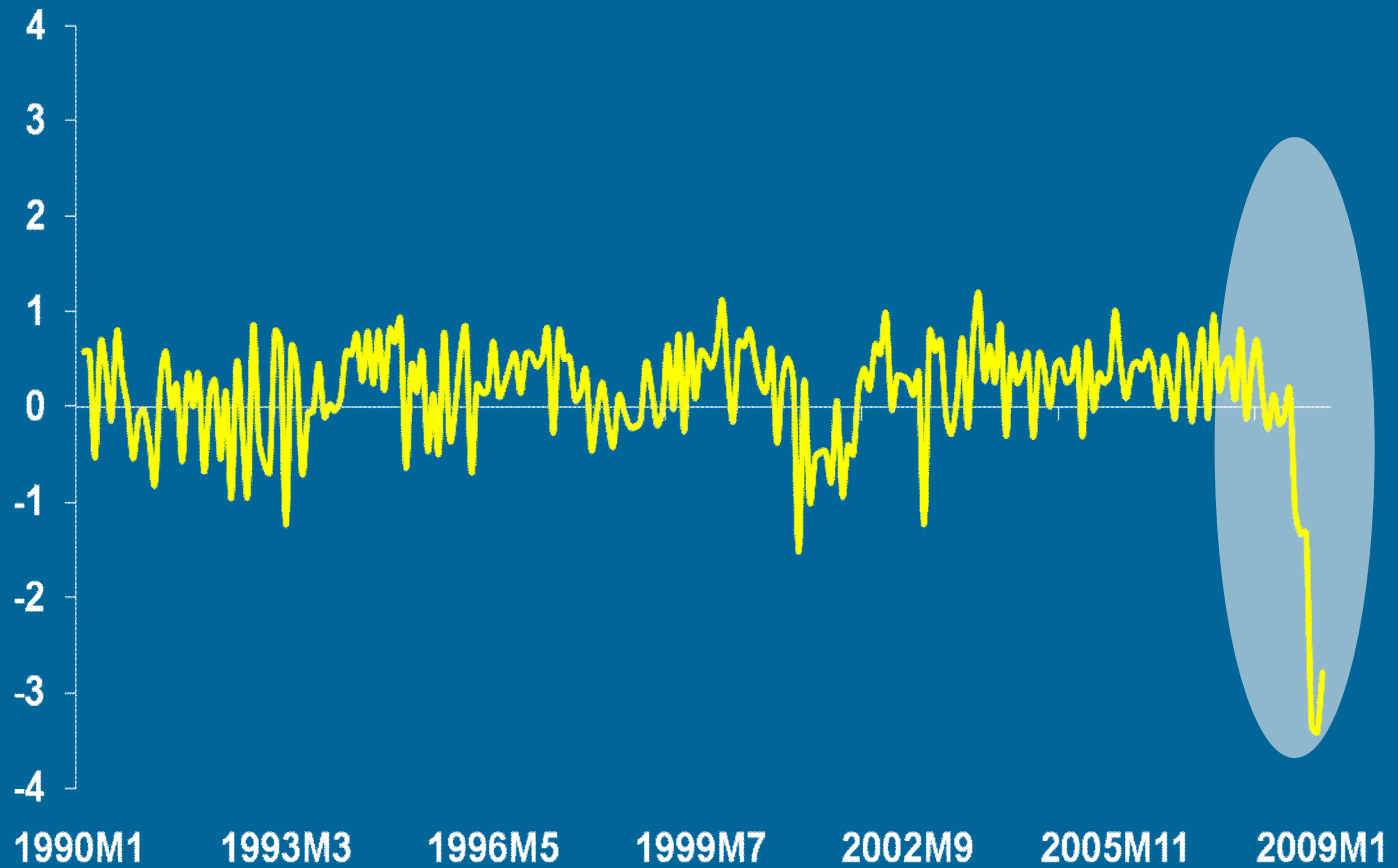
- Following Lehman...
- Huge rise in uncertainty led to sharp rise in precautionary savings
 - Firms put investment projects on hold
 - Households delayed durable goods purchases
- Investment collapsed
- With rise in unemployment, consumption suffered, too
- This translated into sharp, synchronized decline in production, trade and GDP. A private sector crisis.
- Effects on developing countries heightened coming on the heels of the severe food and fuel crisis.



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Decline in activity was extremely rapid

Global IP m/m % growth



Source: World Bank, DEC Prospects Group.

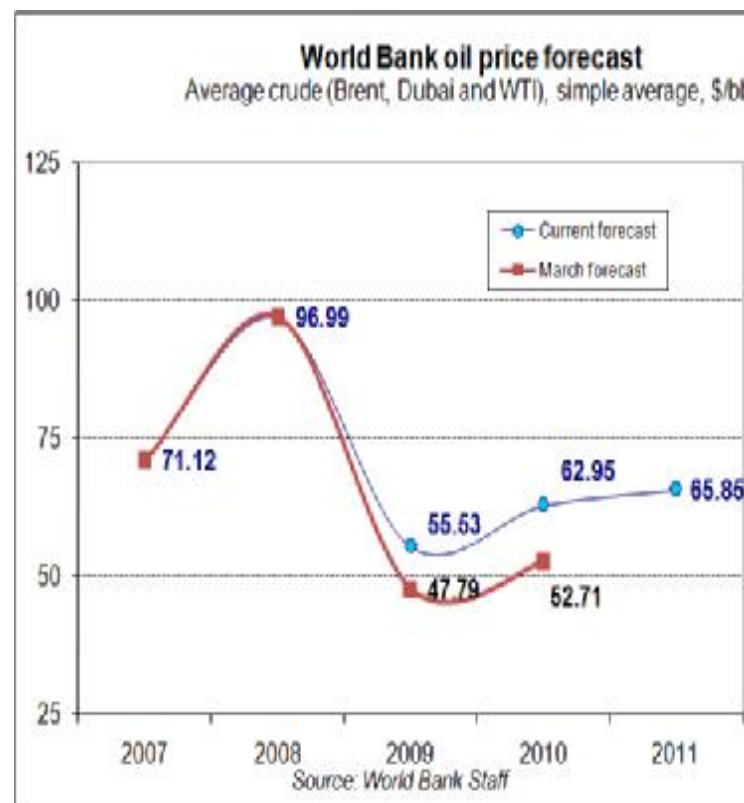
Source: World
Bank.

...on the other hand, there are some positive signs – “green shoots” – at the global level—spreads, credit, capital flows, oil prices.

Box table 1. Capital flows to emerging markets down sharply in Q1 2009, but show some recovery in April-May

Gross capital flows to emerging markets									
\$billion	2007		2008			2009			
	Q1	Total	Q1	Jan-May	Total	Q1	Apr	May	YTD
Total	156	652	103	194	389	45	13	22	80
Bonds	58	146	12	36	65	18	5	8	31
Banks	72	312	71	115	257	19	2	8	29
Equity	26	194	20	43	68	9	5	6	20
Lat. America	42	156	19	46	90	21	2	4	27
Bonds	20	45	5	16	20	10	2	1	13
E. Europe	79	247	36	66	157	5	4	7	16
Bonds	27	64	2	15	35	3	3	5	10
Asia	24	188	38	57	98	17	7	9	32
Bonds	8	23	3	3	7	5	1	1	6
Others	11	61	11	24	44	2	0	3	5

Box figure 2. Oil prices projected to moderate on slowing demand and weak supply response



Global Economic Outlook for 2009-10 remains grim

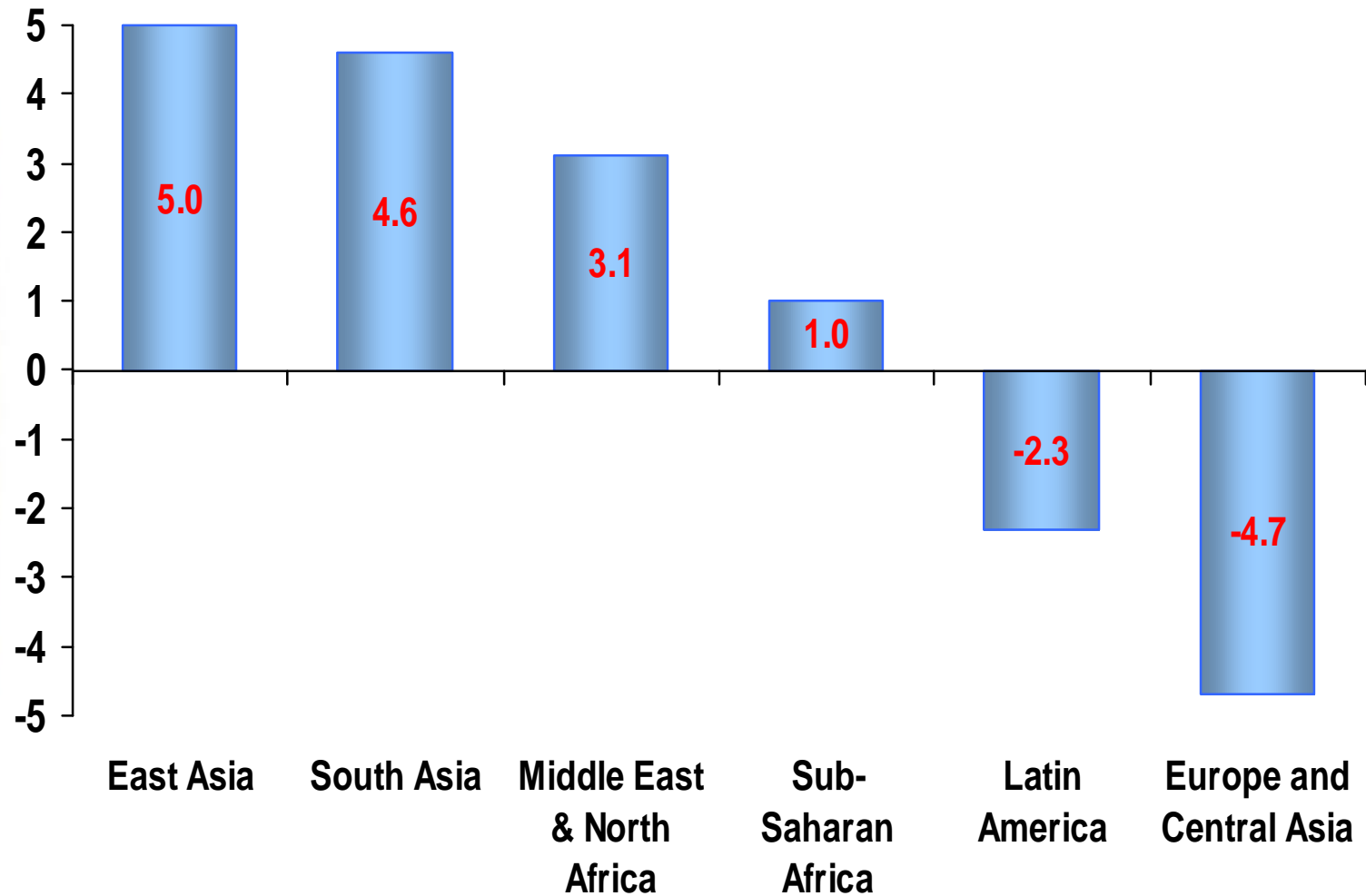
- Real GDP growth
 - -2.9% (2009)
 - +2.0% (2010) (recovery possible but uncertain)
 - High-income countries about -4.5% (2009) and developing countries +1.2% (2009), downward revisions from previous forecasts in March
- World trade
 - -9.7% (2009)
 - +3.8% (2010)
- Oil prices
 - USD 55.53 (2009) [Urals: \$50-53]
 - USD 62.95 (2010) [Urals: \$55 -\$60]



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Crisis effects on growth vary distinctly across developing regions in 2009

GDP growth, percent



Source: World Bank.

Medium to long-term

- Risks:
 - Second round impact of financial sector problems
 - Longer term stagnation, depressed demand
 - Deflation spectre
 - The debt problem
 - Need for major fiscal adjustment



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II Recent Developments in Russia: Output and investment—contracting sharply

A worsening global environment—contracting global demand, falling commodity prices, and tightening of credit—has accelerated Russia’s economic downturn in the first quarter of 2009

Main macroeconomic indicators, 2006-09

	2006	2007	2008	Q1-2009	Jan-Apr 09	Jan- May 09
GDP growth, %	7.7	8.1	5.6	-9.8	-9.8*	-10.1**
Industrial production growth, y-o-y, %	6.3	6.3	2.1	-14.3	-14.9	-15.4
Fixed capital investment growth, %, y-o-y	16.7	21.1	9.8	-15.6	-15.8	-17.7
Federal government balance, % GDP	7.4	5.5	4.0	-0.6	-3.3	-3.1
Inflation (CPI), % change, e-o-p	9.0	11.9	13.3	5.4	6.2	6.8
Current account, billion USD	95.6	76.6	98.9	11.1	n/a	n/a
Unemployment, % (ILO definition) (period average)	7.2	6.1	6.4	9.4	9.6	9.7
Memo: Oil prices, Urals (USD a barrel)	61.2	69.5	95.1	44.1	45.5	47.8
Reserves (including gold) billion USD, e-o-p	303.7	478.8	427.1	383.9	383.9	404.2

Source: Rosstat, CBR, Ministry of Finance, Bloomberg.

* Preliminary estimate by Ministry of Economic Development.

** Preliminary World Bank staff estimate.



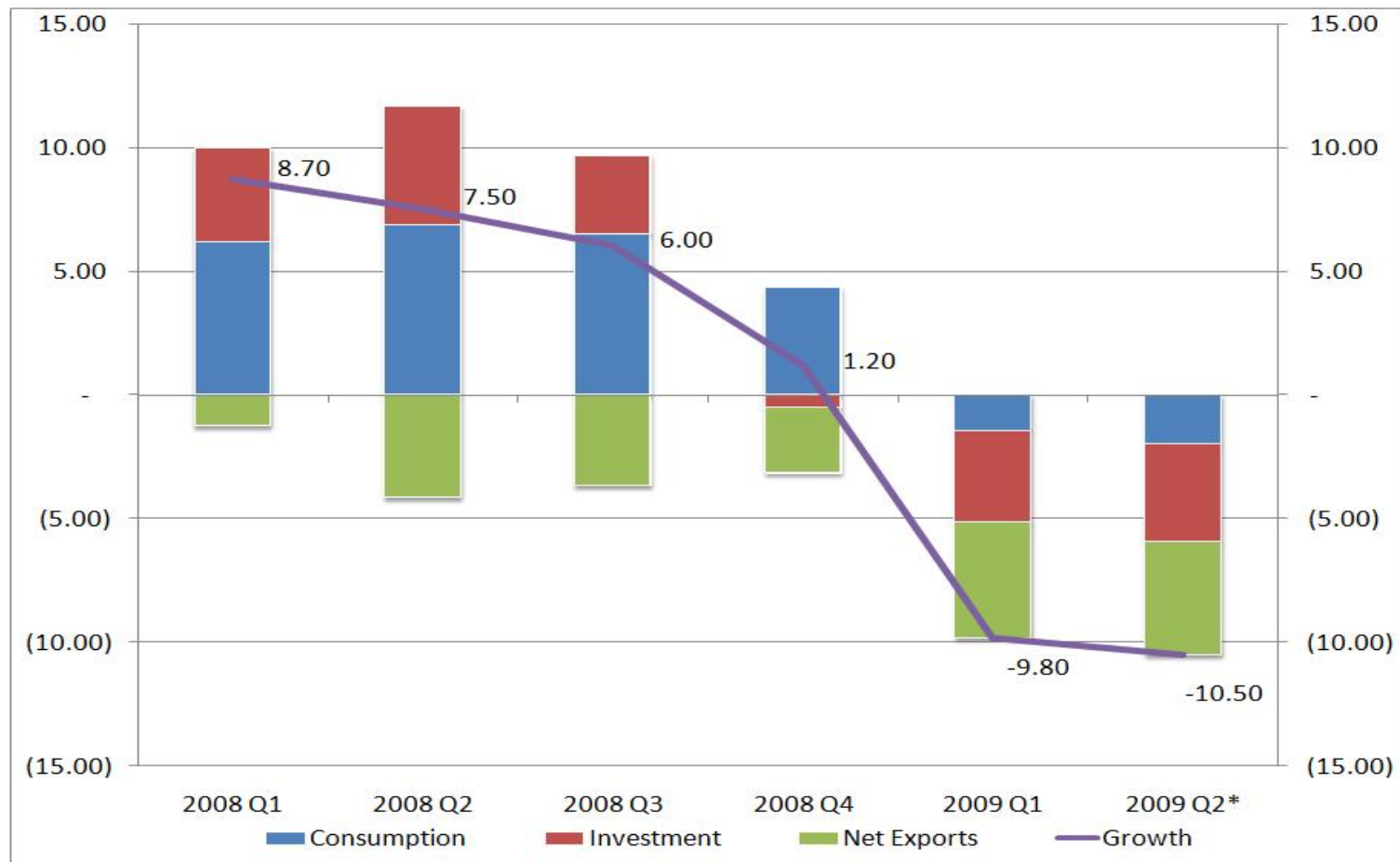
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In Russia: Domestic demand - collapsing

Weak global demand and uncertainties combined with tighter credit and rising unemployment constrain both consumption and investment in Russia

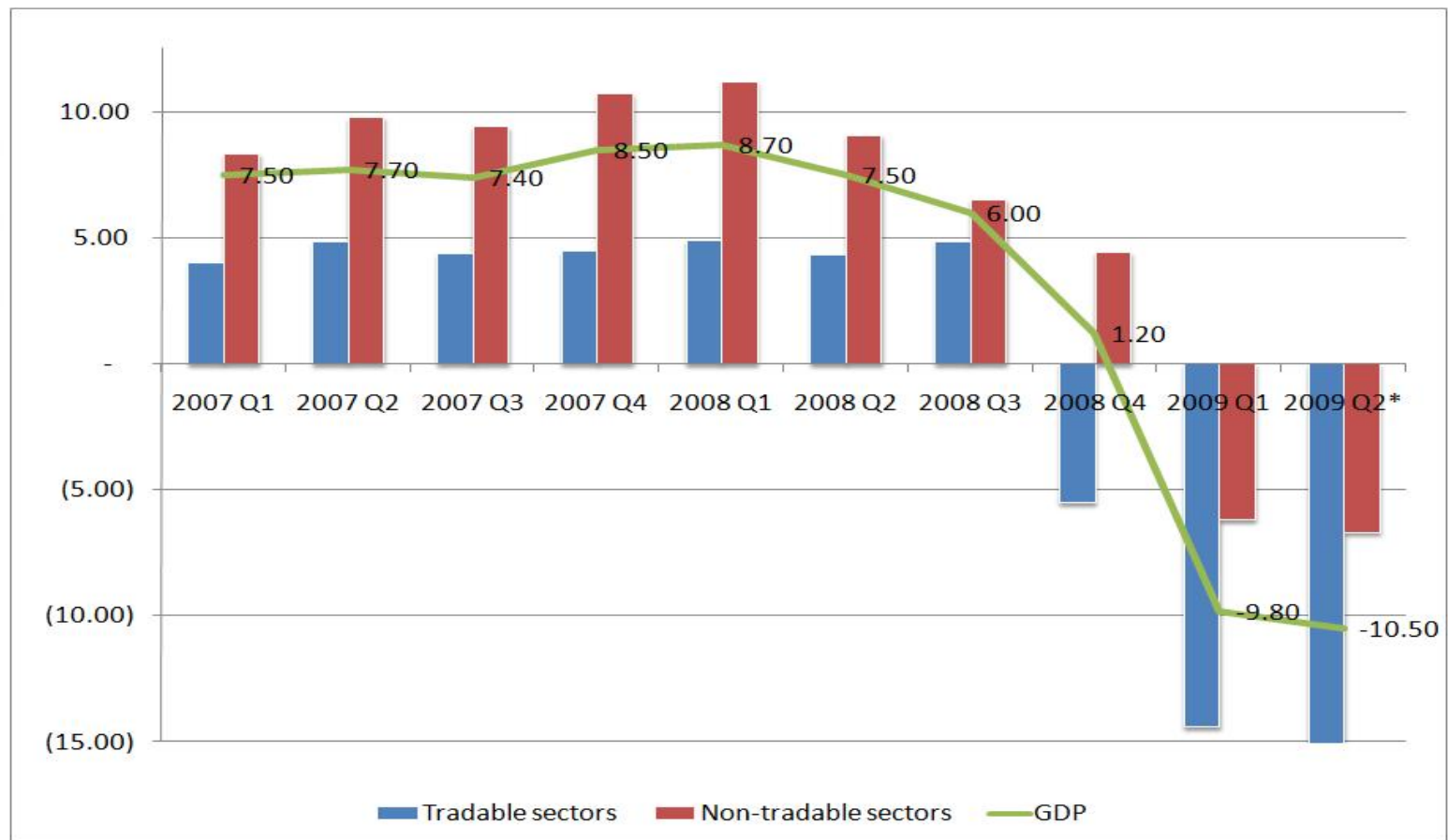


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No visible signs of recovery – decline in tradable sector worsening

The Russian economy continued an across-the-board decline in output in the first quarter of 2009



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Labor markets—adjusting downward sharply

A sharp downward adjustment in the labor market continued in the first quarter of 2009, following the dramatic decline in output

Labor productivity, disposable income, wages, and unemployment

	2006	2007	2008	Q4-2008	Q1-2009	Jan-May 2009
GDP growth, %, y-o-y	7.7	8.1	5.6	1.2**	-9.8	-10.1
Total employment, million people	68.8	70.5	70.9	70.4	67.8	68.0
Employment growth, %, y-o-y	0.8	2.4	0.5	-0.4	-2.9	-3.4
Labor productivity growth, %, y-o-y	6.9	5.5	5.0	1.8	-6.7	-6.6***
Real disposable income growth, %, y-o-y	13.5	12.1	2.9	-5.8	-1.3	-0.4
Real wage growth, %, y-o-y	13.3	17.2	10.3	5.0	-0.8	-2.0
Average monthly wage, USD	391.9	532.0	694.3	668.2	490.8	531.0
Unemployment (% , ILO definition, e-o-p)	6.9	6.1	7.8	7.8	10.0	9.9

Source: Rosstat.

* Preliminary estimate by Ministry of Economic Development.

** Preliminary estimate by the World Bank staff.

*** Jan-Apr 2009



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Balance of payments—improving with rising oil prices

A drastic downward adjustment in the current account, caused by terms-of-trade shock and shrinking demand for Russian exports, appears to have ended in Q1-2009

Balance of payments (USD billions)

	2006	2007	Q1-08	Q4-08	2008 ^a	Q1-09
Current Account Balance	94.7	77.0	38.0	8.6	102.3	11.1
<i>Trade Balance</i>	139.3	130.9	49.9	24.7	179.7	21.7
Capital and Financial Account	3.3	85.7	-25.7	-136.9	138.8	-29.9
Errors and Omissions	9.5	-13.8	-5.8	-2.8	-8.9	-12.3
Change in Reserves (+ = increase)	107.5	148.9	6.4	-131.1	-45.3	-31.1

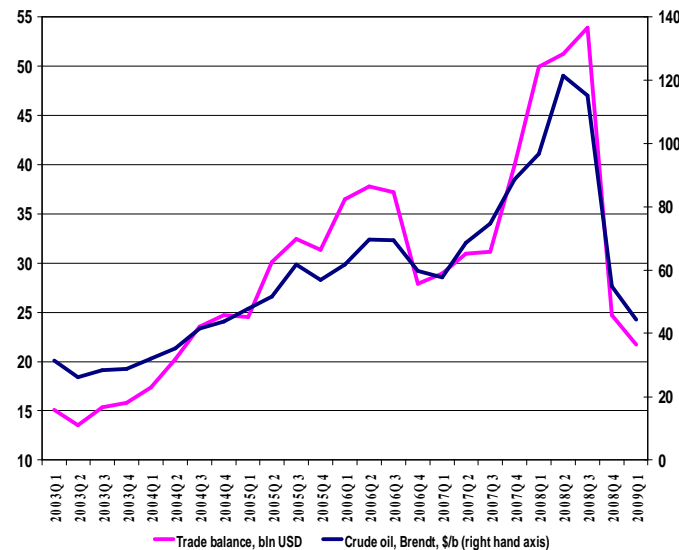
Source: CBR. ^a Preliminary estimates.



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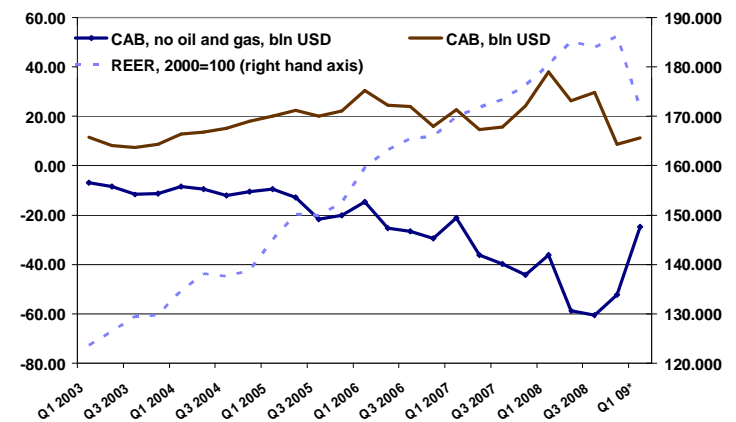
The trade balance, on the other hand, continued to deteriorate as a decline in exports outpaced import contraction

Figure 1.4. Oil prices and the trade balance



Source: CBR and World Bank staff.

Figure 1.5. Current account balances and the real effective exchange rate



Source: World Bank staff calculations based on Rosstat and CBR data. Note: Real effective exchange rates for 2009 Q1 include only January-February

Capital outflows have moderated considerably

A massive reversal of private capital inflows in the last two quarters of 2008 and January 2009 ended in mid February 2009 as CBR tightened monetary conditions and oil prices started to recover



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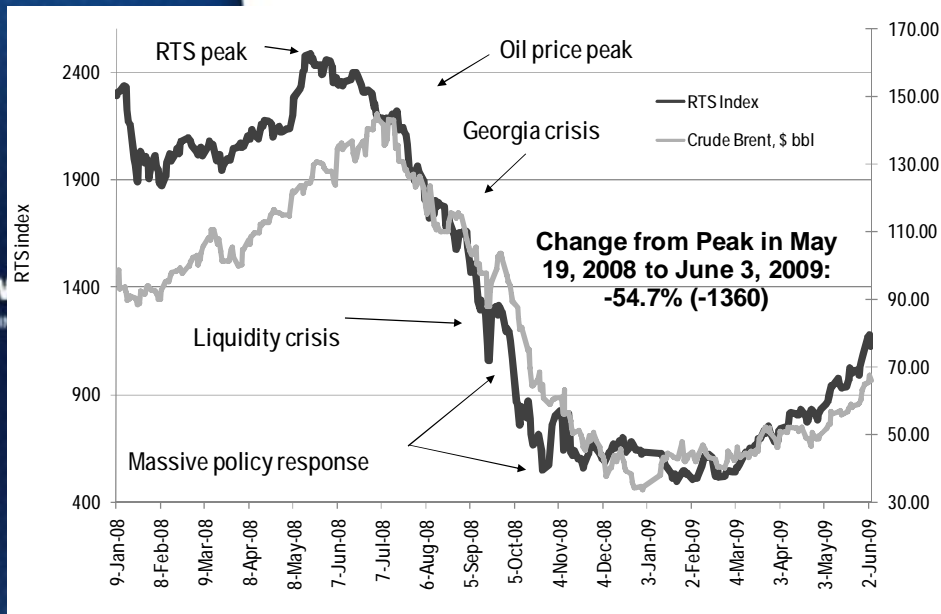
Net capital flows (USD billions), 2006-Q1 2009.

	2006	2007	2008	Q1- 2008	Q4- 2008	Q1- 2009
Total net capital flows to the private sector	41.4	82.4	-132.7	-23.6	-130.6	-38.8
Net capital flows to the banking sector	27.5	45.8	-57.6	-9.9	-56.3	-5.8
Net capital flows to the non banking sector	13.9	36.6	-75.1	-13.7	-74.3	-32.9

Source: CBR.

The Russian stock market—an important transmission channel of the crisis to the real economy—rebounded strongly on the back of a recent rise in oil prices

Figure 1.6. Recent Changes in the Russian Stock Market and Oil Prices



Source: RTS, Thompson Datastream, World Bank staff calculations

Figure 1.7 RTS, S&P 500, MSCI Emerging Market stock indices 2008-2009 (Jan 1 2008=100)



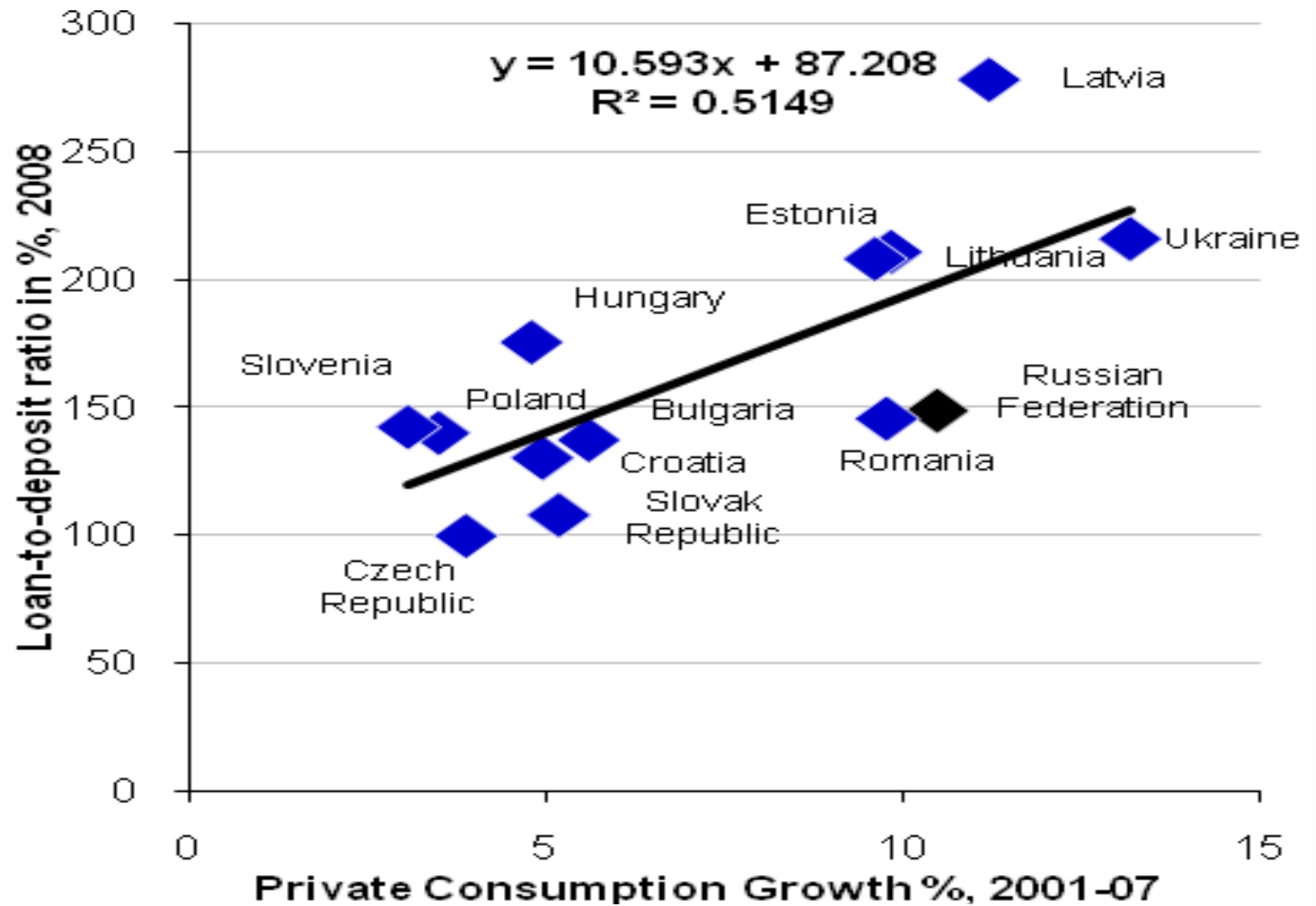
Monetary and exchange rate policy -easing monetary conditions, higher exchange rate volatility

- At the end of April 2009 the CBR started to loosen monetary conditions, lowering its policy rates—by 50 basis points at the end of April and by another 50 basis points in May and June—to 11.5 percent
- CBR is exercising more flexible exchange rate policy. With higher oil prices putting upward pressure on ruble, the CBR can increase its foreign exchange reserves to avoid excessive appreciation of the currency that might undermine the economic recovery
- Meanwhile the liquidity conditions remain fairly tight, while the interbank market continues to be constrained by escalating problems with non-performing loans and worsening balance sheets of banks



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Banking sector vulnerability: Rapid growth of credit, consumption and loan-to-deposit ratio



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Fiscal policy—rising deficit and declining fiscal reserves as fiscal stimulus plans are implemented

Consolidated budget: revenues, expenditures, and the fiscal surplus, 2007-09

	2007 (actual)	2008 (actual)	Federal Budget Law (Nov)	Federal Budget Law Revised (Apr)	2009 Jan- April (actual)
Consolidated budget					
Revenues, % GDP	40.2	38.5	n/a	n/a	32.6
Expenditure, % GDP	34.1	33.7	n/a	n/a	33.0
Surplus, % GDP	6.1	4.8	n/a	n/a	-0.4
Non-oil balance, % GDP	-2.9	-5.8	n/a	n/a	
Federal budget					
Revenues, % GDP	23.6	22.3	21.2	16.6	19.8
Expenditure, % GDP	18.1	18.2	17.5	24.0	23.1
Surplus, % GDP	5.4	4.1	3.7	-7.4	-3.3
Non-oil balance, % GDP	0.6	-6.4	-5.4	-12.5	-11.9

Source: Ministry of Finance, Economic Expert Group (EEG).

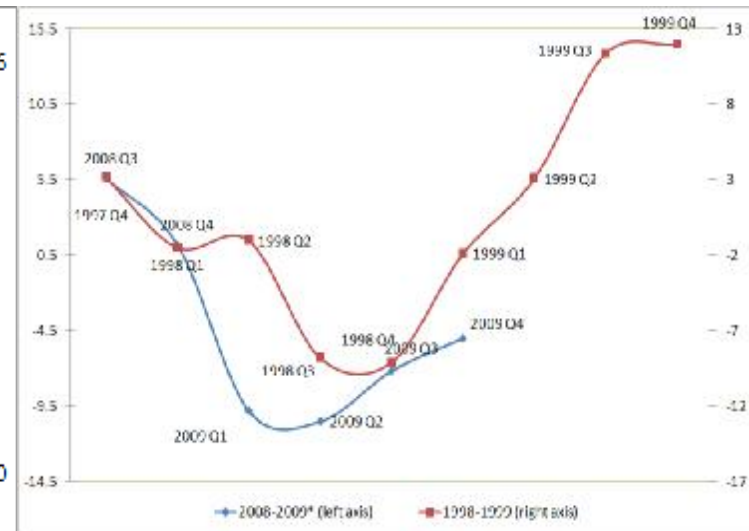
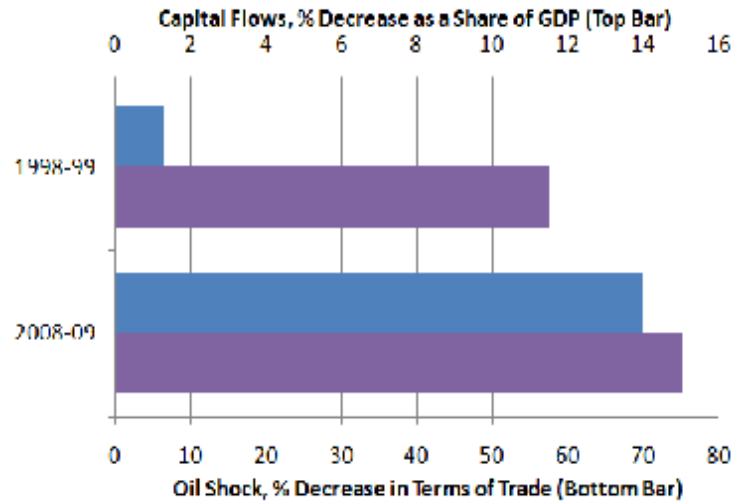


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Fraternal twins: Russia's two crises 1997-98 and 2008-09

Oil Price Drop and Capital Outflows
Were Much Deeper in 2008

Comparing Recovery Paths, 1998-99 vs 2008-09



III Economic and Social Outlook for Russia, 2009-10

Given a much larger GDP contraction in the first quarter of 2009 than anticipated, Russia's economy is likely to contract by 7.9 percent in 2009, despite higher oil prices assumed in the current forecast



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	2009	2010
World growth, %	-2.9	2.0
Oil prices, World crude average, USD/bbl	56	63
GDP growth, %	-7.9	2.5
Federal government balance, %	-7.2	-6.0
Current account, USD bln.	32	36
<i>Capital account, USD bln.</i>	-60	-30

Source: World Bank projections.

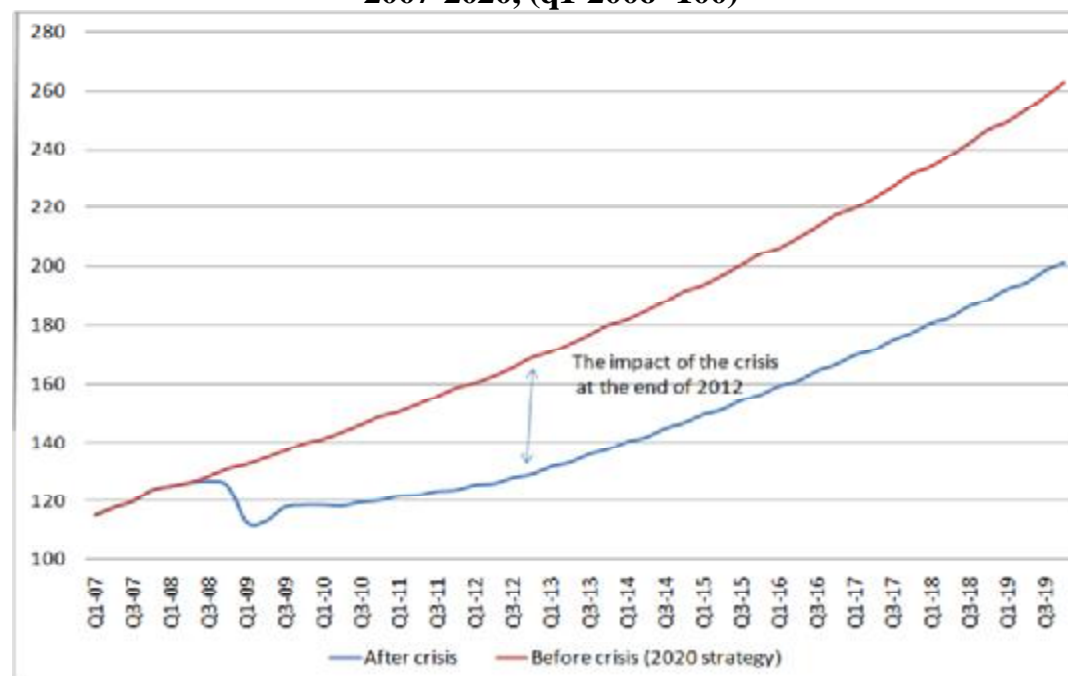
The impact of the crisis on the long-term development objectives in Russia

Looking into medium term, with the current growth profile and possible growth of 3.5 percent in 2011 and 2012, real GDP levels in Russia will reach pre-crisis high only at the end of third quarter of 2012



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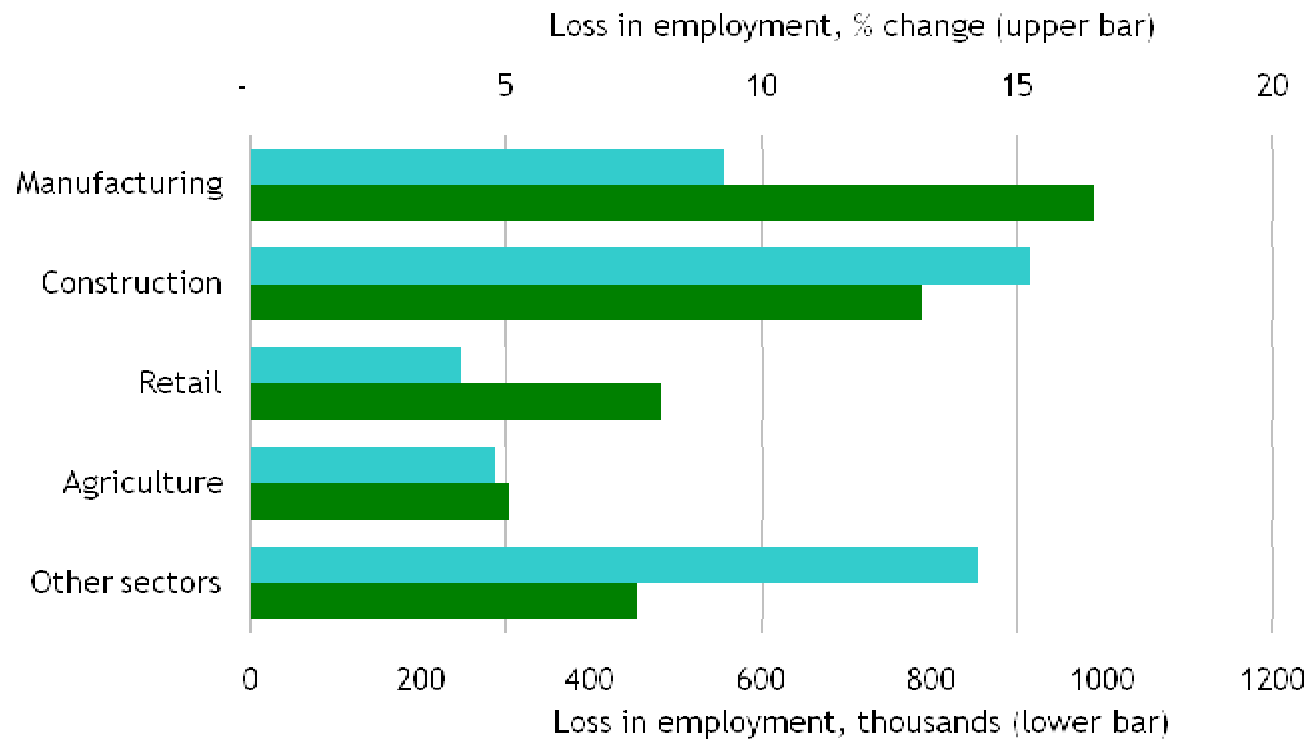
The impact of the crisis on the long-term development objectives in Russia: dynamics of GDP level in Russia 2007-2020, (q1-2006=100)



Source: world bank projections. Strategy 2020

Labor markets—adjusting downward sharply

Figure 1.4 Projected loss of employment in Russia in 2009



Source: World Bank staff estimates.



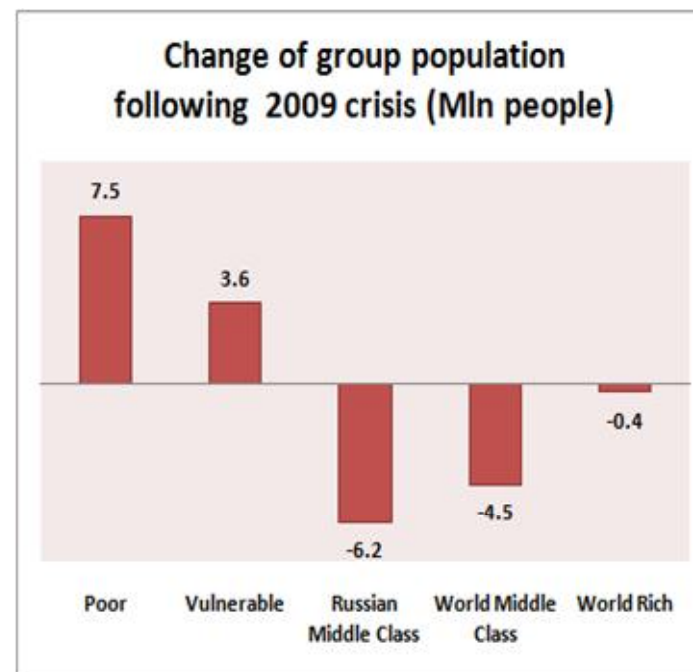
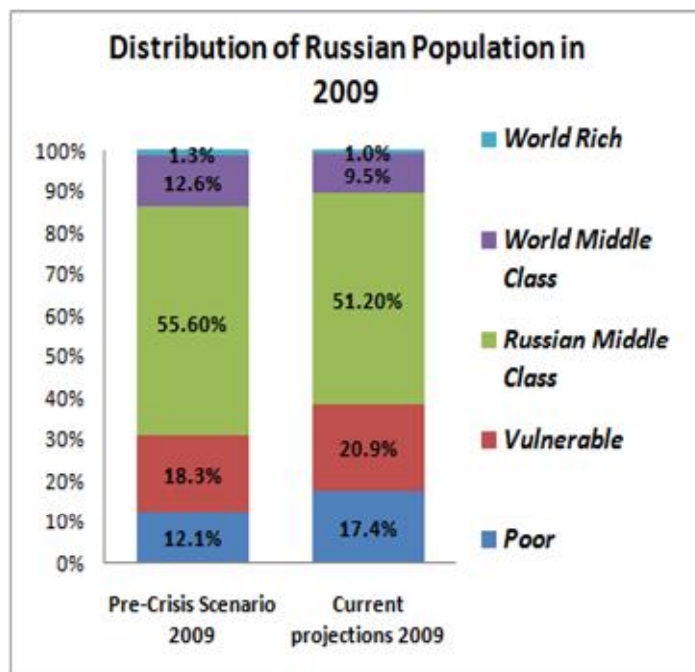
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The social indicators are expected to continue deteriorating

- Real incomes are likely to fall further and the number of unemployed is expected surpass 13 percent by year-end.
- Larger economic contraction in 2009 will result in additional increase in the number of poor and shrinking of the middle class.



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IV. Policy challenges going forward

- *Limiting the larger-than-anticipated social impact of the crisis (especially in the regions) while not losing control of the public finances and supporting economic recovery.*
- *Strengthening short-term the focus economic policy on increasing social protection, support for infrastructure and small and medium enterprises.*
- *Resisting pressure towards protectionism.*
- *Avoiding support to unviable enterprises, promoting restructuring.*
- *Improving investment climate and promoting diversification.*
- *Ensuring fiscal sustainability in medium term, which requires that additional increases in expenditures are also followed by reforms aimed at broadening the revenue base and ensuring greater efficiency in public programs.*
- *Consolidating the banking sector.*

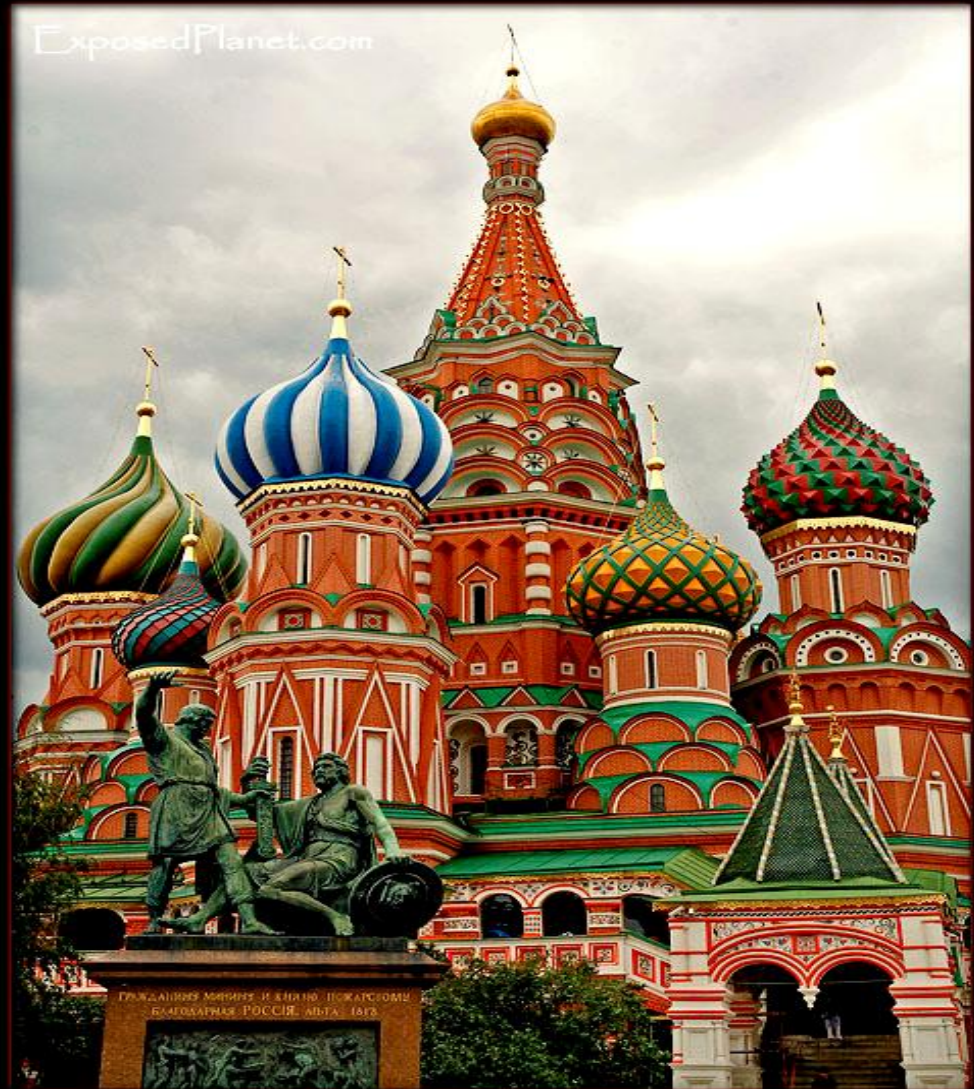


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Thank you!



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Saint Basil's Cathedral, Red Square
by Harry Kilstra