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The World Bank in Russia **Russian Economic Report**

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Russia's decade-long economic expansion accelerated in 2007–08—despite worsening global conditions. But with the economy likely overheating, the new government has to adjust its macroeconomic policy mix to reduce inflation. And to ensure sustainable economic growth, it has to tackle the remaining structural reforms.

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“Russia in the next four years should focus on four I’s: institutions, infrastructure, innovations, investment”

*President Dmitry Medvedev
East Siberian Krasnoyarsk Economic Forum, 15 February 2008*

Russia’s short-term economic growth has run above its long-term trend, despite weak global conditions. In 2007, the economy grew by 8.1 percent on the heels of high oil prices, robust domestic demand, and strong macroeconomic fundamentals. Preliminary data show even faster real growth in GDP, at 8.5 percent, for the first quarter of 2008 and industrial production of 6.2 percent. But inflation is rising, productive capacity is strained, infrastructure constraints are tightening, and real wage increases are greater than productivity gains. All this suggests that the economy is overheating—that aggregate demand is outpacing Russia’s long-term productive capacity. The new government’s key policy challenges are reducing inflation and tackling the remaining structural reforms.

Recent Economic Developments¹

Russia’s short-term growth has accelerated above trends, with signs of overheating. Russia’s real GDP growth accelerated to 7.4 percent in 2006 and 8.1 percent in 2007—well above the long-term trend of 7 percent (box 1.1). And early data for 2008 show growth above 8 percent (table 1.1). Compare that with estimates putting long-term growth potential at about 6 percent (IMF 2006). Suggesting that the economy is straining its productive capacity, capacity use is up from 69 percent in 2001 to 81 percent in March 2008, with two of five firms surveyed reporting more than 90 percent. And unemployment is at its lowest since 1994 (6.1 percent at the end of 2007).

An overheating economy—amid weaker global conditions

After eight years of declining inflation, consumer price inflation rose in 2007. Consumer price index (CPI) inflation accelerated to 11.9 percent at end-2007, exceeding the initial government target of no more than 8 percent. Driving this inflation are excess liquidity, fiscal relaxation, and food price inflation. The excess—high liquidity from unsterilized capital inflows, partly unsterilized oil revenues, negative real interest rates, and a tightly managed exchange rate—fed a boom in credit and domestic demand. Part of the 2007 inflation was related to higher prices for imported food, but monetary and fiscal factors were more important, adding to inflationary expectations reflected in demands for higher wages.

Table 1.1: Main macroeconomic indicators, 2003–08

	2003	2004	2005	2006	2007	4M-2008
GDP growth, %	7.3	7.2	6.4	7.4	8.1	8.7*
Industrial production growth, year-on-year, %	8.9	8.0	5.1	6.3	6.3	6.9
Fixed capital investment growth, %, year-on-year	12.5	13.7	10.9	16.7	21.1	20.3
Federal government balance, % of GDP	1.7	4.3	7.5	7.4	5.5	9.0
Inflation (CPI), % change, end of period	12.0	11.7	10.9	9.0	11.9	6.3
Current account, USD billions	35.4	58.6	84.2	95.6	76.6	37.0*
Unemployment, %	8.6	8.2	7.6	7.2	6.1	6.6
Reserves (including gold), USD billions, end of period	76.9	124.5	182.2	303.7	476.4	534.4

* data for Q1, 2008.

Source: Rosstat, Minfin, CBR.

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Box 1: Signs of overheating

An economy overheats when its productive capacity cannot keep pace with aggregate demand. This typically happens when economic growth is above its long-term potential, opening a gap between actual and potential output. Although data constraints make it difficult to estimate the output gap for an economy undergoing structural transformation, there are six signs of overheating:

- Double-digit or accelerating inflation, seemingly unresponsive to monetary policy.
- High use of factors of production (capital and labor).
- Nominal wage growth significantly outpacing inflation.
- Real wage growth higher than productivity growth.
- Infrastructure constraints reflected in tighter electricity balance or shortages, transport congestion, and additional infrastructure costs to maintain steady service supply.
- Rapid growth in real estate prices (higher than general inflation).
- Rapid growth of imports and deterioration in the external current account.

All these signs are present in Russia today. The current account surplus from high oil prices masks the rapid growth of imports and the deepening of the nonoil current account deficit.



Note: Labor productivity is measured as (GDP per person employed).
Source: World Development Indicators, World Bank (GDP per employed person), and Rosstat (real wages).

The difficult global environment offers both opportunities and risks to Russia's economic expansion. The run-up in oil prices has brought windfalls, but it has also increased Russia's dependence on oil exports and revenues. If oil prices soften as new supplies come on stream and global demand declines further, a rapid weakening of oil and fiscal revenues would complicate macroeconomic management (figures 1.1 and 1.2).

GDP and industrial production—shifting to nontradables

Real GDP growth has shifted toward nontradables, reflecting booming domestic demand and an appreciating ruble. There is a clear shift away from resource extraction and toward trade and construction. In 2003–04, oil and some industrial sectors drove economic growth, but the subsequent expansion was driven largely by nontradable goods and services for the domestic market, including manufacturing goods. In 2007, wholesale and retail trade alone accounted for almost a third of economic growth. Booming construction and manufacturing contributed another 30 per-

cent. Manufacturing expanded by 7.4 percent in 2007, up from 2.9 percent in 2006. By contrast, growth in resource extraction virtually stopped, reflecting capacity constraints (table 1.2). The good news, so far, is that high rates of productivity growth underlie this robust growth.

Changes in output by sector indicate similar trends, with construction and retail trade growing particularly fast. Construction grew at 14.5 percent a year in 2003–07, and retail trade at 13.0 percent, outpacing the rest of the economy. Reflecting tighter capacity constraints, industrial expansion is now driven much less by extraction industries, but almost entirely by manufacturing. Early data for 2008 suggest continued, strong growth in industry: 6.9 percent.

Detailed manufacturing data for the first four months of 2008 continue to show robust growth across a range of manufacturing subsectors (figures 1.3–1.6). Rubber and plastics products—growing by more than 30 percent, up from 13 percent a year before—fed the boom in domestic construction and durable goods (figure 1.4). Machines and equipment continued

to expand by more than 20 percent. But several industries reported lower growth, especially electro-technical equipment, food, and chemicals (figures 1.3–1.5). Rising labor costs and appreciating currency are likely behind the gradual slowing of these sectors.

Investment—propelling short-term growth but...

Booming domestic demand, particularly investment, propelled short-term growth, but overall investment remains moderate.

Investment demand, rising by more than 20 percent, drove economic growth in the first four months of 2008. Even so, investment remains lower in Russia as a share of GDP (21 percent) than in other emerging market economies that have sustained high growth. Republic of Korea (38 percent), China (42 percent), and India (34 percent) all maintained significantly higher rates of investment over long periods (1980–2007). Budgetary investments have remained modest for infrastructure rehabilitation and investment, but nonbudgetary investments, including those by state corporations, have grown (table 1.4).

Russia's investments remain concentrated in a few sectors, reflecting the economy's limited diversification.

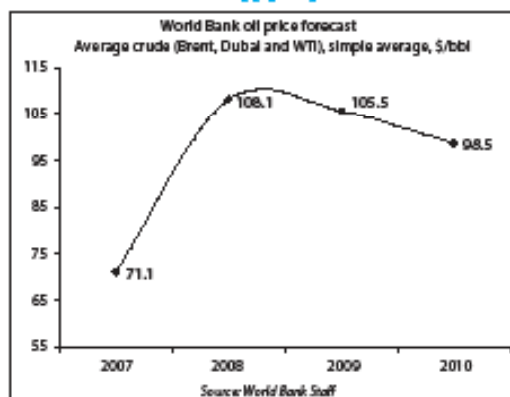
This parallels the growth of nontradables noted above. The bulk of investment is in resource industries and in transportation and communication services (table 1.5). As a result, resource industries increased their share in total investment to 17.3 percent in 2007 (from 15.2 percent in 2005), while manufacturing industries reduced their share to 15.7 percent in 2007 (from 17.6 percent in 2005). So, Russia does not appear to be investing in industries that could diversify its economic structure. Why? Because of the difficulties of diversifying from oil and gas and the uncertainties in the business and investment climates.

Figure 1.1: Weakening growth in Russia's export markets is projected through 2008



Source: Contributed by Annette de Kloos under the advice of Hans Timmer (DECPG), World Bank.

Figure 1.2: Oil prices are projected to moderate on slowing demand and supply response



High oil and gas prices and profits—and the appreciating ruble—have brought record foreign direct investment inflows, mainly to the extractive industries.

Russia recorded foreign direct investment (FDI) inflows of USD 27.8 billion in 2007 (Rosstat definition, excluding profits), up from USD 6.8 billion in 2003 (table 1.6). Per capita FDI rose almost sevenfold to USD 369, far higher than in other BRIC countries (Brazil, Russia, India, China) but lower than the average in developed market economies. In 2007 extractive industries received about 50 percent of FDI inflows, while man-

Table 1.2: GDP growth by main sectors, 2003–07 (value added)

	2003	2004	2005	2006	2007
Total GDP growth	7.3	7.2	6.4	7.4	8.1
Agriculture, forestry	5.5	3.0	1.1	3.6	3.1
Extraction industries	10.8	7.9	0.5	1.6	0.3
Manufacturing	9.5	6.7	6.0	2.9	7.4
Electricity, gas, water production, and distribution	1.6	2.0	1.2	4.7	-1.9
Construction	13.0	10.3	10.5	11.6	16.4
Wholesale and retail trade	13.2	9.2	9.4	14.6	12.9
Financial services	9.6	9.9	11.9	10.3	11.4
Transport and communication	7.2	10.9	6.2	9.6	7.7

Source: Rosstat.

Table 1.3: Output growth by main sectors (percentage change over the same period of the previous year)

	2003	2004	2005	2006	2007	4M-2007	4M-2008
Industrial production	8.9	8.0	5.1	6.3	6.3	6.9	6.9
Extraction industries	8.7	6.8	1.4	2.5	1.9	3.5	0.6
Manufacturing	10.3	10.5	7.6	8.3	9.5	11.8	10.2
Production and distribution of electricity, gas, and water	3.3	1.1	0.9	4.9	-0.2	-5.7	4.5
Agriculture	1.3	3	2.3	3.6	3.3	3.7	4.6
Construction	12.8	10.1	13.2	18.1	18.2	18.3	26.7
Transport	7.7	6.4	2.5	2.7	2.3	3.0	5.5
Retail trade	8.8	13.3	12.8	14.1	15.9	14.7	15.6

Source: Rosstat.

Figure 1.3: Growth rates in machine building (percent)

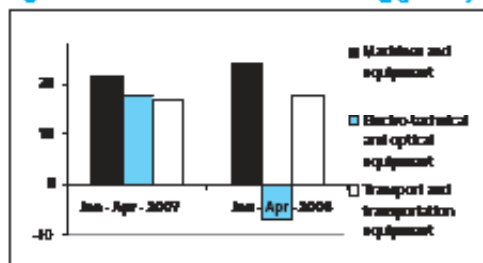


Figure 1.4: Growth rates in chemicals and metallurgy (percent)

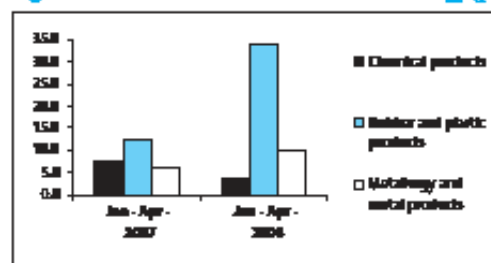
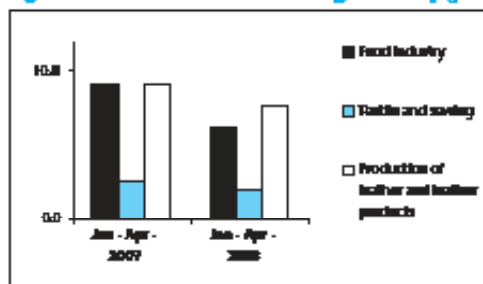
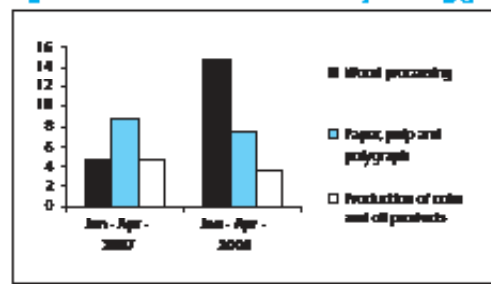


Figure 1.5: Growth rates in food and light industry (percent)



Source: Rosstat.

Figure 1.6: Growth rates in wood and oil processing (percent)



ufacturing—the current engine of growth—received only 15 percent (table 1.7), and in the first quarter of 2008 only USD 5.6 billion, half the amount in the first quarter of 2007. The structure of FDI has also changed, with electricity, gas, and water suddenly receiving a third of the inflow (USD 1.9 billion), reflecting new investments in TGK (*teretorialnaya generiruushaya kompania*) and OGKs (*optovaya generiruushaya kompania*) electricity generating companies. Meanwhile, the share of FDI in manufacturing declined to 13.1 percent.

Inflation pressures and food prices—accelerating

Inflation momentum has accelerated, reflecting money supply growth and food price inflation. Money supply (M2) growth slowed significantly in recent months, but the excess liquidity from past capital inflows, domestic monetary expansion, and the fiscal stimulus at the end of 2007 continues to pressure prices, independent of food prices (table 1.8). As a result, year-on-year inflation doubled to 14.3 percent in April, up from 7.4 percent a year before. Core price inflation has also grown, reflecting broad liquidity pressures, again independent of food price inflation (figure 1.8). Administrative measures to control food inflation, introduced in October 2007 and lifted at end-April 2008, proved ineffective. Indeed, food inflation—

including that for the six socially sensitive food items—accelerated in early 2008, with 12-month inflation on all food products at 21 percent in March, up sharply from 4 percent a year before (figure 1.9).

Monetary and exchange rate policy—loose

The Central Bank of Russia has resisted ruble appreciation with heavy monetary interventions, pushing considerable liquidity into the system. But this has encouraged capital inflows, foreign borrowing, and high inflation, resulting in the real appreciation of the ruble and pressure on nontradable goods and services. Changes in net foreign assets remain the largest source of money growth. Combined with the more relaxed fiscal policy, the macro policy mix is excessively expansionary as the economy overheats.

This policy mix risks further increases in inflation and a real appreciation of the ruble, which will eventually undermine growth. The macro policy mix has to be adjusted to reduce inflation by increasing interest rates, raising reserve requirement, and implementing a more flexible exchange rate policy and a tighter fiscal policy. These adjustments would help cool the economy, producing a more sustainable growth path. ***Since February 2008 the central bank has very gradually adjusted the direction of***

monetary policy, but with the balance of risks shifting to inflation, further tightening is needed. The central bank raised the refinancing rate at the beginning of the year from 10 percent to 10.5 percent and, on May 26, raised reserve requirements on liabilities to nonresident banks from 5.5 percent to 7 percent. The reserve requirements on liabilities to households in national currency have also been raised from 4.5 percent to 5 percent, and those on other liabilities from 5 percent to 5.5 percent. More tightening will be required to reduce inflation. This could result in further appreciation of the ruble, but in today's international environment of reduced capital inflows this risk appears lower than that of accelerating inflation.

Despite liquidity pressures, food inflation contributed more to CPI inflation in the first four months of 2008 than in the previous year, complicating macroeconomic management and compromising poverty reduction. Food inflation has also hurt the incomes of the poor, especially in the poorer regions (box 1.2). The seasonal increase in administered prices for housing and utilities remained almost unchanged, at about 1.2 percentage points in January–April 2008, compared with 1.1 percentage points in the same period of 2007 (figure 1.9). But the prices of fruits and vegetables, bread and bakery products, and meat, milk, and milk products—with significant import content—contributed to higher inflation (table 1.9). Even so, the increase in the CPI across all categories of goods reflects broader monetary and fiscal factors.

Income and employment—rising incomes, tighter labor markets

Robust economic growth has come with double-digit increases in real incomes and wag-

Table 1.4: Fixed capital investments, growth rates, and shares

	2003	2004	2005	2006	2007	4M-2008
Fixed capital investment growth, %	12.5	13.7	10.9	16.7	21.1	20.3
Gross fixed capital formation growth, %	12.8	12.6	10.6	17.7	20.8	n/a
Share of gross fixed capital formation, % of GDP	18.4	18.4	17.7	18.5	21.1	n/a
Consolidated budgetary investments, % of GDP	2.8	2.5	2.8	2.9	3.2	n/a

n/a is not available.
Source: Rosstat.

Table 1.5: Sectoral structure of fixed capital investments (percentage of total, unless otherwise indicated)

	2005	2006	2007	Growth rates, 2007, year-on-year
Agriculture, hunting, forestry	3.2	4.0	4.3	25.2
Extraction of mineral resources	15.2	17.0	17.3	19.1
Manufacturing	17.6	16.1	15.7	10.8
<i>Food industry, including beverages, tobacco production</i>	3.1	2.8	2.8	10.4
<i>Coke and oil products</i>	1.8	1.6	1.6	4.4
<i>Machine building</i>	0.5	0.6	0.7	12.0
<i>Transportation devices</i>	1.0	1.0	1.2	38.6
<i>Chemical products</i>	1.7	1.8	1.7	4.8
<i>Other nonmetal mineral products</i>	1.5	1.2	1.6	45.5
<i>Metallurgy and metal products</i>	4.7	4.1	3.6	-2.0
Electricity, gas, and water production and distribution	7.8	7.6	8.7	30.0
Construction	2.9	3	2.4	5.1
Retail and wholesale trade, maintenance of vehicles, home appliances	2.8	3.1	2.9	12.8
Transport and communication	28.8	25.5	25.3	8.2
<i>Railways</i>	6.4	3.7	4.3	16.6
<i>Pipelines</i>	7.7	8.5	7.0	-8.4
<i>Communication</i>	6.7	5.3	5.1	2.6
Real estate operations, leasing, and services provision	11.5	12.0	12.0	18.3
Health care and social services	2.3	2.7	2.6	15.2
Provision of other public utilities, social and personal services	2.6	2.8	2.7	11.7

Source: Rosstat.

es, a trend that continues in 2008. According to Rosstat, average real wages increased by 13.1 percent, and real disposable incomes by 11.8 percent in the first four months of 2008 (figure 1.10 and table 1.10). The increases continue to exceed real GDP and productivity growth. Almost all sectors reported increases in real wages well above 10 percent, with those in the public sector, retail trade, and construction increasing by 16–17 percent. The average monthly dollar wage rose to USD 649.4 in the first four months of 2008, up about 40 percent from the first four months of 2007, partly re-

Table 1.6: Foreign direct investment in Russia and comparator countries

	2003	2004	2005	2006	2007
Russia gross FDI inflow, USD millions	6,781	9,420	13,072	13,678	27,797
Russia FDI inflow, USD per capita (BOP)	54.9	107.1	89.8	226.8	369.3
FDI for comparator countries, USD per capita					
<i>Brazil</i>	56.7	100.0	81.8	100.6	182.8
<i>China</i>	36.4	42.3	60.5	59.4	60.3
<i>India</i>	4.1	5.4	7.0	17.7	22.0
<i>Emerging market economies</i>	38.8	51.7	69.3	85.2	97.9
<i>Industrial countries</i>	405.5	427.2	604.4	824.7	1066.6

Source: Rosstat, CBR, IMF's World Economic Outlook.

Table 1.7: Shares of foreign direct investment, by sector (% of total)

	2005	2006	2007	Q1-2008
Agriculture, hunting, forestry	0.9	1.4	0.8	1.7
Extraction industries	30.7	33.1	50.1	22.6
Manufacturing	46.1	19.0	14.8	13.1
Electricity, gas, and water production and distribution	1.1	0.4	0.5	33.9
Construction	0.9	2	3.2	5.3
Retail and wholesale trade, maintenance of vehicles, home appliances	5.9	6.1	11.7	8.0
Hotels and restaurants	0.2	0.2	0.2	n/a
Transport and communication	1.9	2.8	2.1	1.5
Finance	4.5	11	4.0	1.3
Real estate operations, leasing, and services provision	7.1	23.5	11.8	11.9
Provision of other public utilities, social and personal services	0.6	0.4	0.5	0.5

Source: Rosstat.

flecting the nominal appreciation of the ruble against the dollar.

Unemployment fell in the first quarter of 2008, signaling tighter labor markets. The average unemployment rate in the first quarter of 2008 was an estimated 6.6 percent (by the ILO definition), down from 7.0 percent in the first quarter of 2007 (table 1.10). But unemployment varies across Russia's regions—lowest in the Central Federal Okrug, at 4.1 percent, and the highest in the Southern Federal Okrug, at 13.7 percent.

Balance of payments and capital inflows—still robust

Record-high oil prices and robust capital inflows contributed to continuing strength in the balance of payments and a further buildup of reserves during 2007. Contrary to earlier expectations, preliminary figures for the first quarter of 2008 suggest a current account that is still strengthening. Thanks to high oil prices and oil-related exports, the current account is up to an estimated USD 37.0 billion, against USD 22.9 billion in the first quarter

of 2007 (table 1.11). According to the central bank, imports grew by almost 42 percent in the first quarter of 2008, to USD 60.7 billion, up from USD 31 billion in the first quarter of 2007. And exports grew by more than 50 percent, to USD 108.1 billion, from USD 71.8 billion (figure 1.11). But excluding oil and gas, the current account deteriorated in the past few years, especially with the continuing currency appreciation since the beginning of 2007 (figure 1.12)

Russia registered record net capital inflows in 2007 into banking and nonbanking sectors, boosting liquidity. The inflows reflected strong fundamentals, an appreciating ruble, and low external vulnerability. They also maintained dynamic growth in the banking sector. Despite further growth in the Oil Reserve and National Welfare funds, the central bank could not fully sterilize the domestic monetary impact of oil revenues and the large inflows under a fixed exchange rate. So, the rapid growth in the money supply—44 percent in 2007—outpaced nominal incomes and brought inflationary pressures. Adding to these pressures were the rise in public spending, global food price inflation, and rapidly growing domestic demand. Temporary administrative measures touching the socially sensitive food items in October–April did little to contain inflation. Russia's USD 23 billion in net capital outflows in the first quarter of 2008 reflected turbulence in global financial markets, but new net inflows of USD 20 billion in April partly reversed that trend, according to preliminary data from the Ministry of Finance (table 1.12).

Fiscal policy and the federal budget—a more relaxed stance

While oil windfalls sustain high fiscal surpluses, since the end of 2007 Russia's fiscal stance has become more relaxed, and the budget more dependent on oil revenues. The execution data on general government spending in 2007 (federal budgets, regional and local budgets, and the social funds) show substantially higher public spending compared with the two years before (table 1.13). Those increases were implemented largely in the last quarter of 2007. To finance priority infrastructure and social programs, the government boosted public expenditures by about 2 percent

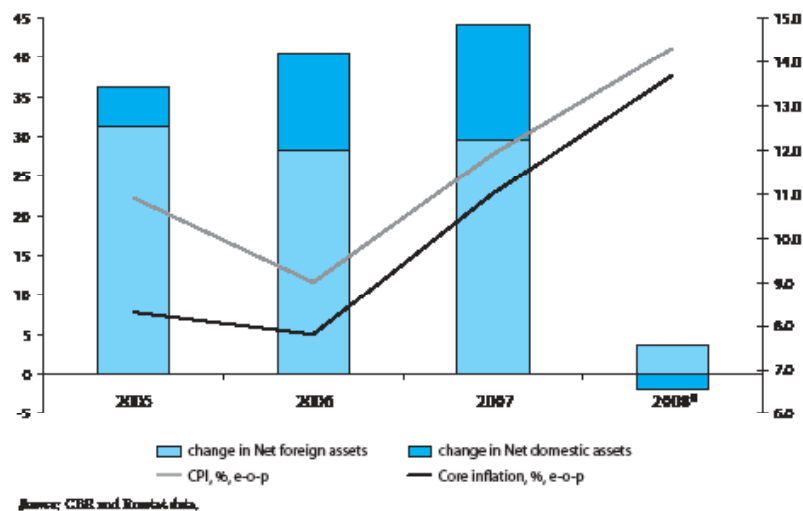
of GDP through various state corporations. With inflation gaining momentum, the fiscal stimulus added to the pressure. The general government surplus declined to 6.1 percent of GDP in 2007 from more than 8 percent in 2005–06. The data also indicate that budget is becoming more vulnerable to lower oil revenues.

Russia continues to enjoy healthy fiscal surpluses, but they are falling faster than required for effective disinflation. According to preliminary estimates for the first quarter of 2008, the federal budget generated a surplus of 6.6 percent of GDP on a cash basis, down slightly from 7.3 percent in the first quarter. Record-high oil prices helped the government generate revenues of 1.932 billion rubles (23.4 percent of GDP), exceeding the 20.7 percent target in the 2008 Budget Law. Federal spending so far totaled 1.383 billion rubles, or 16.7 percent of GDP on a cash basis, against 17.7 percent in the 2008 Budget Law. Pressures are building to spend additional windfalls without enough attention to the impact on inflation.

The recent revisions to the federal budget for 2008–10 envisage further relaxation in the fiscal stance. In February 2008 the government approved an amendment to the 2008 Budget Law to increase noninterest expenditures by 310 billion rubles, along with a further decline in the fiscal surplus to 3.0 percent of GDP in 2008 and to 1.0 percent in 2009–10 (table 1.14). The nonoil deficit is projected at about 6 percent of GDP in 2008–09 and 5.1 percent in 2010, covered mostly by oil and gas transfers.

By relaxing the fiscal policy stance when the economy is overheating, the government risks unwinding hard-won stabilization gains. The additional fiscal stimulus of 2007 likely contributed to accelerated inflation—rapidly increas-

Figure 1.7: Sources of monetary growth, CPI, and core inflation (percent)
(Monetary aggregates—left scale; inflation—right scale)



ing the money supply in the fourth quarter of 2007 and continuing to pressure inflation upward this year. Given the ambitious programs to develop state corporations and to adjust and index public wages and pensions, the 2008 oil windfall will tempt the government to further increase spending. The likely inflationary pressures will be difficult to suppress later.

External public and corporate debt—growing fast

External debt stock and external vulnerability remain within a comfortable range, but Russia's private corporate and banking debt is growing fast (figure 1.13). A rapid buildup of corporate and banking debt partly financed the massive consumption and investment spree of recent years. With general government external debt modest and declining, this banking and corporate debt—public and private—explains almost all the buildup of external debt (figure 1.13, left panel). External private debt almost tripled, from \$106

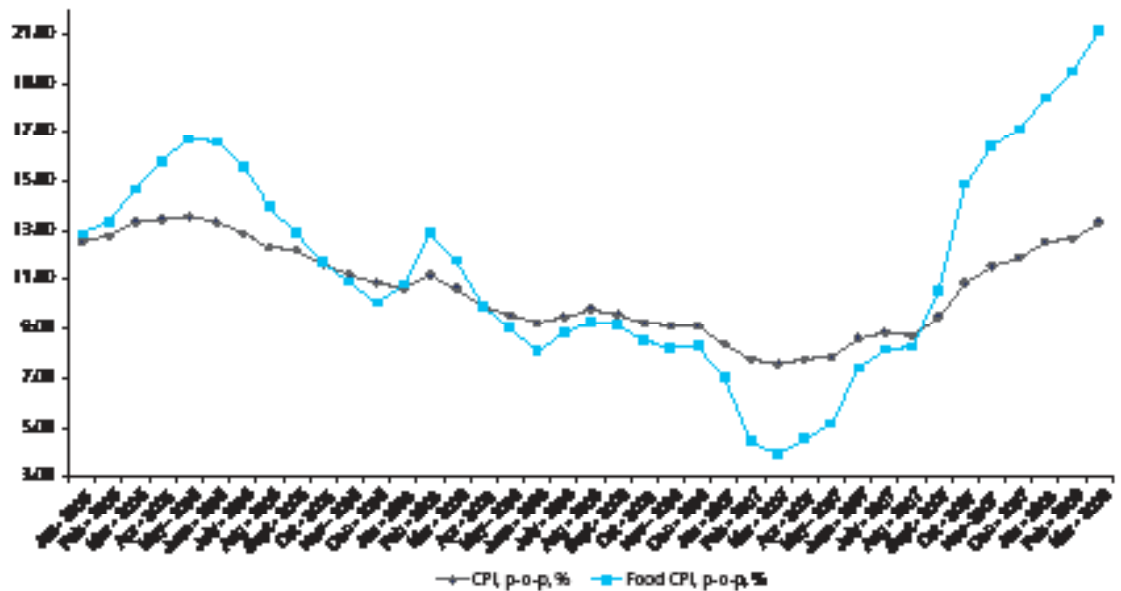
Table 1.8: Russia's monetary and inflation indicators (percent)

	2003	2004	2005	2006	2007	4m-07	4m-08
CPI inflation, end of period	12.0	11.7	10.9	9.0	11.9	4.0	6.3
Core CPI Inflation, end of period	11.2	10.5	8.3	7.8	11.0	2.2	4.5
PPI inflation, end of period	12.5	28.8	13.4	10.4	25.1	6.1	7.7
M2 growth, end of period	50.5	35.8	38.5	48.8	47.5	4.6*	0.8*

* data for the first quarter of 2008.

Source: CBR.

Figure 1.8: CPI Inflation and food prices (year-on-year, percent)



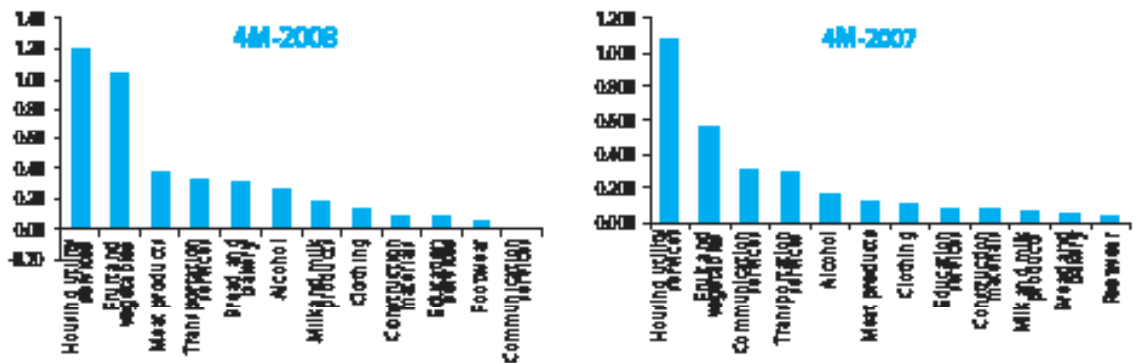
Source: Rosstat.

billion at the end of 2005 to \$275 billion at the end of 2007. External public debt, which includes the general government and public financial and nonfinancial organizations, has also grown thanks to borrowing in large state companies—but not nearly as fast as private sector debt. Although overall debt appears low compared with the economy’s size and its massive international reserves, it has become a concern at the central bank. That exuberant private borrowing, if continuing at the same pace during a prolonged global credit crunch, could undermine corporate liquidity and repayments, spilling over into the banking system, which faces its own risks.

Financial sector vulnerabilities— credit, liquidity, and market risks require monitoring²

Russian banking has enjoyed rapid growth and good profitability, partly on the heels of large capital inflows and foreign borrowing. Bank assets have grown at about 40 percent a year since 2004, rising to nearly 17 trillion rubles in 2007 from about 4 trillion in 2002. Loan portfolios increased more rapidly, accelerating to nearly 12 trillion rubles in 2007 (36.5 percent of GDP) from about 2.5 trillion rubles in 2002 (23.1 percent of GDP). The rapid growth in bank credit spurred strong earnings. Average returns on equity in banking grew from 18 percent in 2002 to about 26 percent in 2006,

Figure 1.9: Contribution of main components to CPI inflation (percentage points)



Source: Rosstat, WB staff calculations.

and average returns on assets ballooned from an already high 2.6 percent in 2002 to 3.2 percent in 2006. Both are well above those of most emerging market countries.

Russian banking has weathered global financial turbulence, but credit, liquidity, and market risks require monitoring. The credit portfolio may face strains from the rapid credit expansion over the last decade, the entry of new and inexperienced borrowers, and banks' uncertain ability to manage the risks. The brisk growth in mortgage lending could become a concern. Mortgage loans increased fivefold during 2000–06 and by at least 70 percent in 2007, though the consumer segment remains small (13 percent). The following issues are worth noting.

- The retail deposit base is concentrated in Sberbank, forcing large and medium-size banks to rely more on international funding. Household deposits represent 30 percent of bank liabilities on average, but they are concentrated in the state-owned banks, which hold more than 40 percent of bank assets (Sberbank, VTB, Gazprombank, Bank of Moscow, and the Russian Agricultural Bank).
- The concentration of corporate deposits remains a concern for smaller banks. Withdrawals by a few large customers could reduce liquidity. For some smaller banks, the 20 largest depositors account for more than

half of customer funding.

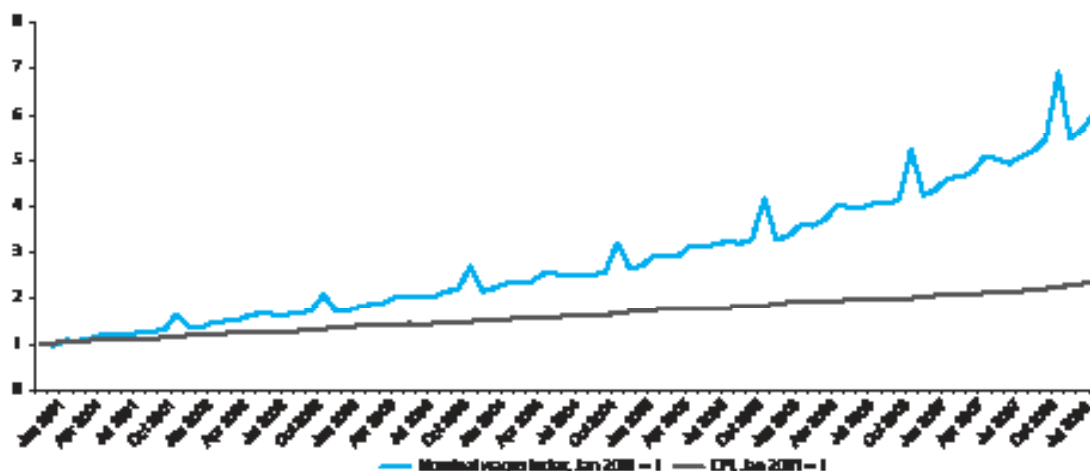
- Banks relying on external funding risk a contraction in global credit. Benefiting from abundant global liquidity, banks operating in Russia have borrowed significantly from abroad over the last few years. This may pose refinancing risks for some banks.
- Banks' exposure to market risk has grown with deeper capital markets and banks' greater sophistication. Securities portfolios, about 20 percent of assets at the end of 2007, are dominated by corporate bonds, though equity holdings are also significant for some banks. These securities expose banks to potential losses from adverse movements in

Table 1.9: Changes in prices of the main components of the CPI (index, December 2006 = 100)

Category	Weight in CPI	2007 level	Price change (end of period against December of the previous year)	
			4M-2008	4M-2007
CPI total	100.0	111.9	106.3	104.0
Meat products	9.81	108.4	103.8	101.3
Milk and milk products	2.82	130.4	106.1	102.1
Bread and bakery products	2.04	122.4	115.2	102.7
Fruit and vegetables	3.83	122.2	127.2	114.7
Alcohol	6.33	107.7	104.1	102.5
Clothing	5.13	108.0	102.6	102.1
Footwear	2.52	107.8	101.8	101.5
Construction materials	2.19	116.2	104.0	103.5
Housing utility services	8.57	114.0	114.0	112.6
Transportation services	3.26	113.6	110.2	108.6
Communication services	2.96	110.8	99.9	110.3
Education services	2.49	115.4	103.5	103.1

Source: Rosstat.

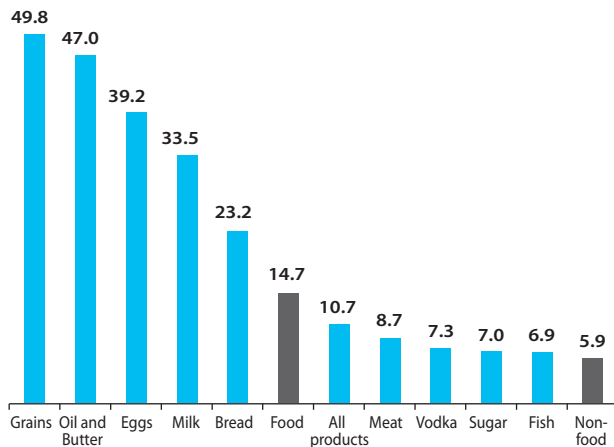
Figure 1.10: Changes in nominal wages and CPI (index, January 2001 = 100)



Box 1.2: Impact of world food inflation on Russia's poor

The impact of the world food price shock on Russia was significant. Over the past five years, and particularly in recent months, food prices in Russia grew much faster than nonfood prices, driving 82 percent of the CPI increase between July 2007 and March 2008 (box figure 1). Food prices increased the most in the Volga region, and least in the Far East Federal Okrug. Food inflation in western Russia was higher than in the eastern regions.

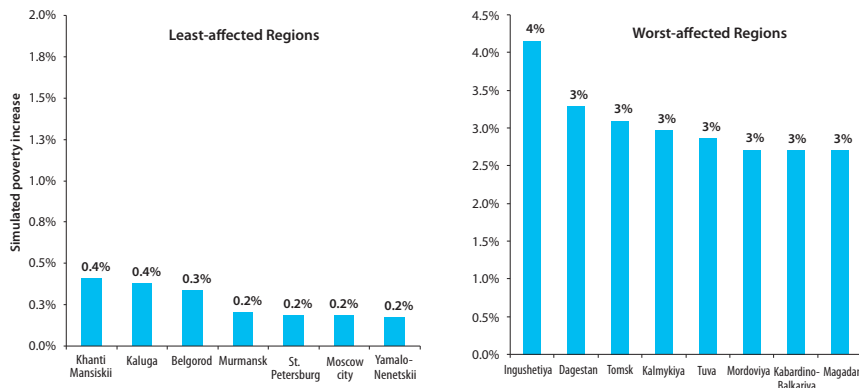
Box figure 1: Food inflation by CPI group—July 2007–March 2008



The implications for poverty are troubling. The food price spike could raise Russia's overall national poverty rates by 1.2 percentage points and its vulnerability rate by 4.3 percentage points, all else being equal, according to preliminary World Bank simulations based on the international poverty line of USD 2.15 per day. That would potentially push 1.7 million more people into poverty and render another 6 million vulnerable to poverty. The simulation excludes the interim increase in real incomes, particularly for households that are net producers of food, which may have offset the adverse price shock (box figure 2).

The Russian government responded with a mix of measures, as did many other countries. New export tariffs valid until April 2008 were introduced for wheat (10 percent) and barley (30 percent). Import tariffs were reduced on milk and milk products (15 percent to 5 percent), and on certain types of vegetable oils, cabbage, carrots, and beets. The main food suppliers and retail food chains agreed in January to fix the price of five key food products. These administrative price controls expired, however, on 1 May 2008.

Box figure 2: Rising food prices had a much higher poverty impact in Russia's poorer regions



Source: World Bank staff simulations using 2004 household budget survey data, with projections.

The government also announced that it would use strategic grain reserves to smooth sharp fluctuations in domestic wheat prices. But many governments have tried to limit domestic food price increases through mandated grain prices, export restrictions, procurement, and other such direct controls—with only a limited impact on domestic prices.

International experience and good practice suggest that for a net food exporter like Russia, a preferable policy response to a food price shock would be to:

- Allow a full pass-through of the price increase, to provide local producers the largest possible incentives to increase food production for domestic and international markets and to moderate domestic demand.

- Scale up targeted social assistance to truly needy households.
- Implement measures to boost agricultural productivity.

Source: Prepared by Salman Zaidi (Senior Economist) and Victor Sulla (Consultant), World Bank. Broader analysis of poverty in Russia may be found in the World Bank's Poverty Assessment for Russia (2008), forthcoming.

Table 1.10: Incomes and unemployment

	2003	2004	2005	2006	2007	4m-2007	4m-2008
Real disposable income growth, %	14.9	9.9	8.8	10.2	10.7	10.0	11.8
Real wage growth, %	10.9	10.6	12.6	13.4	16.2	18.4	13.1
Average monthly wage, USD	179.4	237.2	301.6	394.7	529.0	459.6	649.4
Unemployment, % (ILO definition)	8.6	8.2	7.6	7.1	6.1	7.0	6.6

Source: Rosstat.

equity or bond prices.

The continuing global credit crunch is straining banks' funding model. If the global credit crunch is prolonged, the system could face funding problems. With Russia's thin domestic capital markets and its retail deposits concentrated in the largest state banks, some banks must depend on foreign funding. Sustained, restricted access to foreign borrowing could increase funding costs, slow credit growth, reduce profitability and capital, and expose banks to refinancing difficulties. Rapid credit growth has so far sustained strong earnings, but profits are coming under pressure.

High interest rates on the fastest growing credit segment (consumer lending), along with low deposit rates, have translated into high spreads by international standards. But greater competition in lending is compressing margins. As banks renege their lending to remain liquid, funding pressures may reduce profits. And raising capital under today's market conditions could be a challenge. Slowing profits will constrain internal fund generation. The ongoing turmoil in international markets may also reduce investor appetite for Russian investments, making it more difficult and costly for Russian banks to tap those markets for capital. For smaller banks, capital increases will likely continue to rely on equity injections from core shareholders.

Structural reforms—much progress, but more needed

Russia has implemented important reforms in recent years, mainly fiscal

- Large oil windfalls were saved in the Stabilization Fund—not spent. That fund was transformed into the Reserve Fund, capped at 10 percent of GDP, and the National Welfare Fund, which accumulates oil surpluses beyond the Reserve Fund, possibly for priority investment and social programs. Healthy fiscal surpluses repaid the external debt and reduced external vulnerabilities.
- Budgetary and tax reforms brought three-year budget plans and long-term fiscal planning, following good practice in New Zealand and the United Kingdom. Russia also reduced the number of taxes and the overall

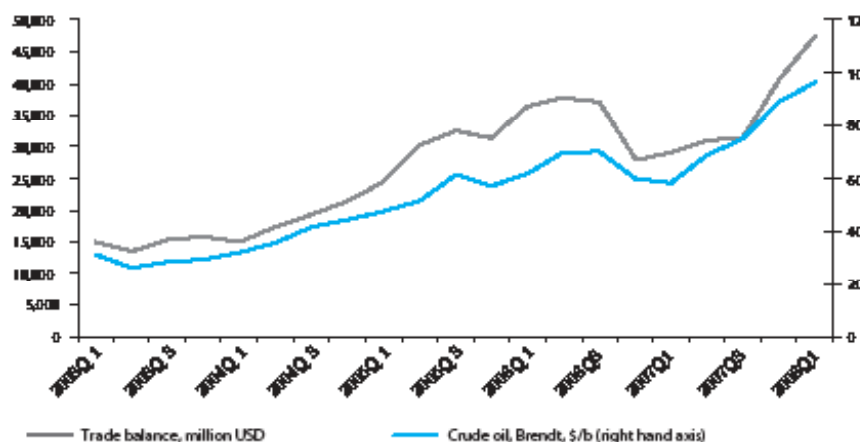
Table 1.11: Balance of payments (USD billions)

	2004	2005	2006	2007	Q1-2007	Q1-2008 *
Current account balance	58.6	83.8	94.5	78.3	22.9	37.0
Trade balance	85.8	118.4	139.2	132.0	29.0	47.5
Capital and financial account	-6.3	-13.6	11.9	84.3	14.2	-15.5
Errors and omissions	-7.1	-8.8	1.1	-13.6	-4.2	-9.4
Change in reserves	45.2	61.5	107.5	148.9	32.9	12.1

* preliminary estimates.

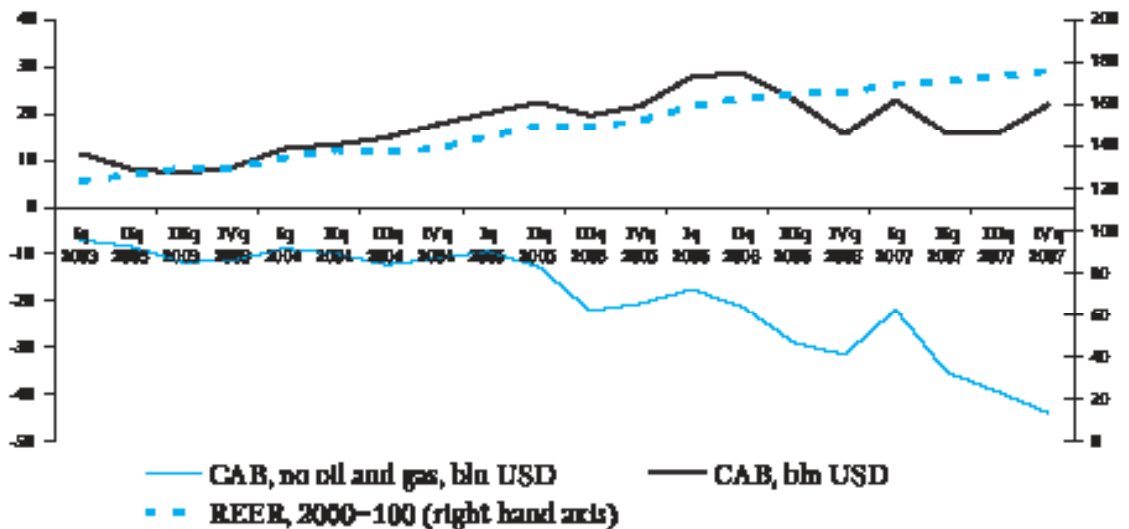
Source: CBR

Figure 1.11: Oil prices and Russia's trade balance



Source: Rosstat.

Figure 1.12: Russia's current account balances (CAB) and real effective exchange rate (REER)



Source: World Bank live database.

Table 1.12: Net capital flows (USD billions)

	2003	2004	2005	2006	2007	Q1-2007	Q1-2008
Total net capital inflows to the private sector	-1.9	-8.9	0.1	41.9	81.2	13.5	-22.8*
Net capital inflows to the banking sector	10.3	3.5	5.9	27.5	45.9	0.1	-7.9
Net capital inflows to the nonbanking sector	-12.2	-12.4	-5.8	14.4	35.4	13.4	-15.0

* In April 2008, Ministry of Finance reported positive net capital inflows of \$20 billion.

Source: CBR.

tax burden—including cutting the flat income tax to 13 percent and the VAT to 18 percent.

- The government improved tax collection and customs administration, eliminated noncash budgetary settlements, and strengthened budget management and controls, including establishing a single treasury account.
- Intergovernmental finances were reformed, with the government adopting a modern transfer equalization formula, phasing out unfunded mandates, and creating more stable revenue and expenditure assignments among different layers of government.
- The foreign exchange system and financial markets were liberalized, from a low base. But scope for financial deepening remains.
- The government began to improve judicial efficiency and independence through higher salaries, publication of judicial decisions, and an April 2008 instruction from the Chairman of the Supreme Arbitration Court prohibiting judges from confiscating private property to settle tax disputes.

To regain momentum on structural reforms, in early 2006 the government approved the Medium-Term Social-Economic Program for 2006–08. The program targeted inefficient government operations, weak diversification, limited competition, the large share of the non-market economy, infrastructure constraints, the low mobility of production factors across regions, and inadequate incentives and opportunities to rapidly develop human capital. Efforts were also made on administrative and judicial reform—a formidable agenda.

Structural reforms have stalled in the past few years. There was some progress—for example, on the four national projects in health, education, housing, and agriculture. But important structural challenges remain, especially for the business and investment climate, for small and medium-size enterprises, and for governance. Russia's investment climate still suffers from uncertain public governance, especially on fighting corruption, protecting and enforcing property rights, facilitating competition, removing barriers to migration, and strengthen-

ing judicial independence and transparency.

Policy challenges going forward

The new Russian government has inherited a booming economy, but important policy challenges remain. The first challenge is to reduce inflation and strengthen macroeconomic stability, the linchpin of the economic growth over the past nine years. The seeming choice between high growth or macroeconomic stability—as sometimes formulated in domestic debates—is a false dilemma. International experience overwhelmingly suggests that high, sustained growth cannot be achieved with high inflation, which hurts both saving and investment. So, reducing inflation is necessary for sustained high rates of economic growth.¹ But reducing inflation is not enough to ensure sustained, fast, and inclusive growth. For this, Russia needs to jumpstart progress on the remaining structural reforms, especially institutional reforms and infrastructure gaps. Doing so will sustain rapid, long-term productivity growth.² Advancing social reforms and promoting regional development will ensure a wider distribution of growth's benefits across Russia's large population and vast territory.³

To reduce inflation, the macroeconomic policy mix needs adjustment. Fiscal and monetary policies have to be tightened to reduce excess liquidity, cool domestic demand, and moderate private borrowing. That could mean tightening the fiscal stance in the short term, phasing planned public expenditures over the longer term, continuing monetary tightening through gradual increases in interest rates and reserve requirements, and introducing a more flexible exchange rate, as announced by the central bank. Avoiding further recourse to administrative price controls and export restrictions would support these shifts, as would selecting and phasing planned public investments in line with capacity by strengthening the screening of investment projects and reducing nonpriority public expenditures.

Major challenges remain: improving the business environment and investment climate, reducing barriers to small and medium-size businesses, closing the infrastructure gaps, and deepening the environment for open trading. The needed changes are likely to require reducing the inspection and regulatory burden on

Table 1.13: General government budget—revenues, expenditures, and fiscal balance (percentage of GDP)

	2005	2006	2007
Revenues	39.7	39.6	40.2
Expenditure	31.5	31.2	34.1
Surplus	8.1	8.4	6.1
Nonoil balance	-2.1	-2.8	-2.9
Primary nonoil balance	-1.0	-2.0	-2.3

Source: based on the information from the Ministry of Finance.

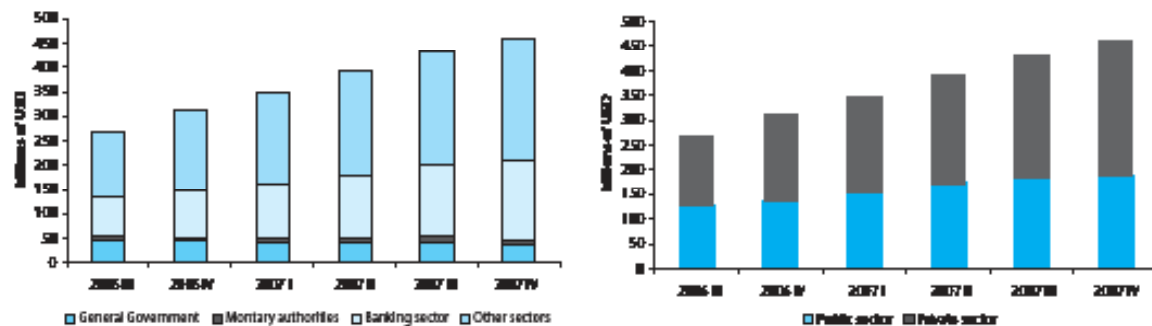
small and medium-size businesses, fighting corruption, strengthening the rule of law, and reducing infrastructure gaps by enhancing efficiency. They will also require new public investments and public-private partnerships, along with greater competition and a deeper open trading environment. For many of these reforms to succeed, strengthening judicial efficiency, independence, and transparency will be key. President Medvedev's policy emphasis on the four I's—institutions, infrastructure, innovations, and investment—outlines important priorities for the new government to reinvigorate structural reforms, foster productivity gains, and form a base for sustained economic growth.

Table 1.14: Federal budget—main indicators (percentage of GDP)

	2008	2009	2010
Revenues	20.7	19.5	18.5
Oil and gas revenues	8.9	7.0	5.9
Expenditures	17.7	18.6	17.8
Transfers to extrabudgetary funds	3.9		
Reserve fund	9.0	10.0	10.0
Total noninterest expenditure	17.2	18.1	17.3
Interest payment	0.5	0.5	0.5
Oil and gas transfer	5.5	5.5	4.5
Overall fiscal balance	3.0	1.0	0.7
Nonoil fiscal balance	-5.9	-6.0	-5.1
Nonoil balance after oil/gas transfer	-0.5	-0.5	-0.7

Source: EEG, 2008 Budget Law.

Figure 1.13: Russian external debt stock (USD billions)



Source: CBR.

² This section was contributed by Fernando Montes-Negret (Sector Director, ECSPF), Lalith Raina (Sector Manager, ECSPF) and Sylvie Bossoutrot (Sr. Operations Officer, ECSPF), World Bank.

³ See the just-released report on the new consensus on economic growth by the International Growth Commission, chaired by the Nobel Prize-winner Michael Spence at www.growthcommission.org.

⁴ See the World Bank's report *Unleashing Prosperity: Productivity Growth in Eastern Europe and the Former Soviet Union* (2008), World Bank, Washington D.C. (also on the Bank's external website for Europe and Central Asia region: www.worldbank.org/eca).

⁵ See the World Bank's report *Regional Development and Growth Agglomerations: The Longer-Term Challenges of Economic Transition in the Russian Federation* (2008), A Country Economic Memorandum for Russia, World Bank, forthcoming.

2 Long-term Fiscal Sustainability of the Russian Federation¹

Russia faces major long-term fiscal risks: uncertain, volatile oil and gas revenues and rising spending on pensions, health, and education. Unless solutions are put in place in the short to medium term, Russia's strong fiscal position will unwind. That would imperil its ongoing economic expansion.

To deal with the risks, the new government should take four actions: make fiscal sustainability a top priority, expand the tax base outside oil and gas to substitute when oil revenues decline, identify possible savings to create room for spending priorities, and consider a fiscal "permanent income" rule—keeping the nonoil primary fiscal deficit below what can be financed safely from oil revenues—to keep fiscal policy on an automatically sustainable trajectory.

Over the past nine years, Russia's fiscal policy was prudently conservative, but the future fiscal risks are significant. Russia has wisely chosen to reduce spending volatility by diverting a stable flow of oil revenues to the budget and allocating the rest to a stabilization fund. This reduced the adverse impact on the domestic economy and its competitiveness. Solid fiscal management created the foundation for nine years of strong economic growth. But fiscal prudence should not be taken for granted: Russia faces serious risks in the long term, which threaten to unwind the hard-won gains from reforms. This section elaborates the implications of three risks that threaten Russia's fiscal position—from oil price volatility, from expenditure pressures linked to pensions, education, and health spending, and from the renewed debt that could ensue. It argues that

the new government should make preserving fiscal prudence and sustainability its key policy objective, proposing a fiscal rule—the permanent income rule—that could ensure long-term fiscal sustainability automatically.

Three fiscal challenges—uncertain revenues, rising expenditures, and the specter of renewed debt

Issue 1: Oil revenues, booming today, could become a drag on economic performance

The strong recovery of oil prices since 2000 increased Russia's dependence on oil and gas revenue, making it more vulnerable to price declines. The share of oil revenue in total fiscal revenue increased substantially—from 10 percent of GDP to about 30 percent. Instead of diversifying, Russia has specialized in oil, which now accounts for about 60 percent of exports (figures 2.1 and 2.2). Higher oil revenues create more room for spending, but they also complicate macroeconomic management and foster dependence on a volatile, uncertain source of income. This has not been a problem in the face of high oil prices, but it could become a major vulnerability if oil prices begin a rapid descent.

Issue 2: Russia will confront major public spending on pensions, health, and education in the medium to long term

Russia's well-documented demographic trends are key drivers of major social spending. A declining, aging population, higher demand for pension and health services, and a changing demand structure for education will mean that public spending on these areas is likely to increase significantly. Main social expenditures are likely to increase by 3.5 percentage points of GDP—from 14.1 percent of GDP in 2008–10 to about 17.3 percent in 2016–20. This estimate is in line with recent comments by the finance minister. If, as assumed, long-term fiscal revenues remain stable

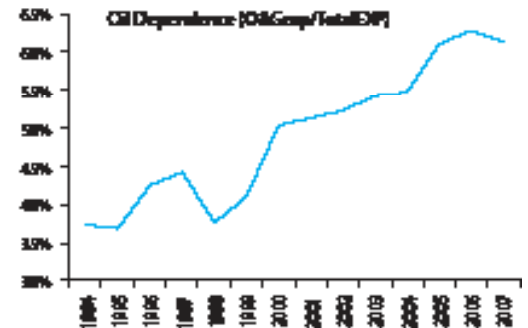
¹ Prepared by Zeljko Bogetic, Lead Economist for Russia and PREM Country Sector Coordinator. The note draws on a series of technical notes prepared by the World Bank for the Ministry of Finance in February 2008 and the paper "Oil Revenues, Expenditure Pressures, and Fiscal Sustainability in Russia," with S. van Wijnbergen and N. Budina, presented at Higher School of Economics Conference in Moscow, April 1-3, 2008. This research is part of a larger, on-going World Bank's project Russia: Long-Term Fiscal Study.

Figure 2.1: Oil's share in government revenues increases with rising prices



Source: Government of Russia.

Figure 2.2: Oil and gas making up a rising share of total exports



and total public spending remains at about 31 percent of GDP, this would mean that long-term spending in other categories would need to adjust to avoid growth in total public spending (table 2.1).

Total revenues are anticipated to stabilize around 34 percent of GDP over the long term as oil revenues and prices moderate. Expenditures, meanwhile, are likely to increase during 2008–10, reflecting the three-year budget plan, but are then projected to remain broadly constant at about 31.3 percent of GDP until 2020. This scenario would mean that the government

to 13.5 percent in 2020. This adjustment should be feasible, still allowing for real growth in other spending. In a baseline scenario with 5.8 percent average real GDP growth over 2008–2020, other spending would grow at 3.7 percent a year in real terms.

Issue 3: Unless the government undertakes fiscal measures to ensure sustainability, Russia will once again become a net debtor in the long term.

Under a baseline fiscal scenario—the scenario underlying today's macroeconomic framework and the 2008–10 budget—Russia saves and dis-saves at the same time.² Resources are added to the Reserve Fund, but meanwhile the transfers from the National Welfare Fund are not enough to cover the nonoil primary (noninterest) fiscal deficit. So, gross debt increases as a share of GDP. Continuing passively on this path, Russia could consume its oil fund assets and its other foreign exchange assets by the end of

the planning horizon in 2040, reaching zero net debt. After that, Russia could again fall into debt. With gross debt increasing, oil funds will begin to shrink—budget transfers will exceed oil revenues (figures 2.3 and 2.4).

Table 2.1: Russia's general government expenditures—an emphasis on social expenditures (percentage of GDP)

	2008–10	2011–15	2016–20
Total expenditures	31.1	31.3	31.3
Total noninterest expenditures	30.7	31.1	31.0
Education	4.7	5.5	6.0
Health	4.5	5.5	6.0
PAYGO Pensions	4.9	5.2	5.3
All other functions	16.7	14.9	13.7
Interest	0.4	0.3	0.3

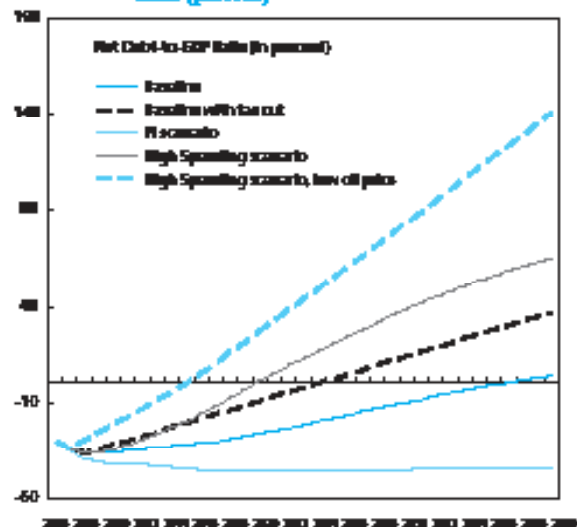
Source: Preliminary calculations; ongoing Russia: Long-Term Fiscal Study, World Bank.

maintained fiscal prudence and kept some surpluses, if substantially less than in recent years.

The long-term increases in social spending, combined with estimates for total expenditures, will put significant downward pressure on all other public spending categories. Spending on all other functions would have to decline from 17.2 percent of GDP in 2008

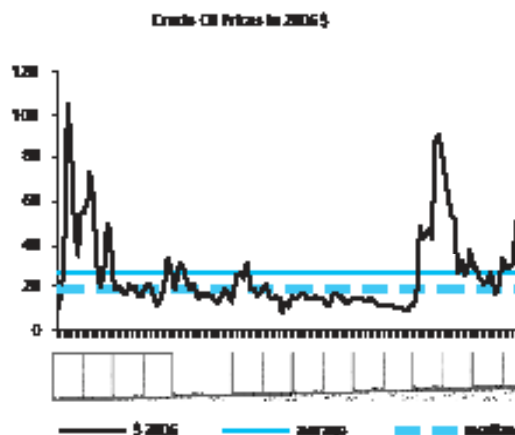
² All scenarios assume that oil prices fall back to about USD 60 per barrel but remain constant in real terms thereafter, as assumed by the government.

Figure 2.3: Five scenarios for Russia's net debt-to-GDP ratio (percent)



Source: The World Bank staff authors' calculations.

Figure 2.4: Crude oil prices in 2006 dollars per barrel



If spending is higher—say, if social spending pushes the expenditure-to-GDP ratio up by 4 percentage points, without offsetting cuts in other spending or revenue gains—net assets would deteriorate much faster. In that case, Russia could become a debtor country after 2018, with net debt reaching 61 percent by 2040. That shows the cost of not responding to spending pressures.

Cutting taxes—say, reducing the VAT rate by 4 percentage points—could raise the nonoil primary fiscal deficit by at least 1.5 percent of GDP against the base case. Russia would be able to finance this deficit with oil fund assets for only the next 20 years. From 2025 the country would start accumulating net debt again, reaching 37 percent of GDP by 2040. That shows the cost of a hasty tax cut while revenues are booming.

But if Russia adopts a “permanent income” rule—keeping the nonoil primary fiscal deficit below an estimated 4.7 percent of GDP—sustainability would not face a threat. This deficit could be fully financed from the permanent income from Russia’s oil assets. The net debt position would remain more or less unchanged over the planning horizon.

Four policy implications

1. *The new government could prepare for the possible decline in oil and gas prices and revenues by expanding its nonoil tax base and revenues.*

This would require reviewing the nonoil tax bases, beginning with major tax instruments such as the VAT, excise, and income taxes, to identify the losses from exemptions and other features that narrow the tax base. That review should yield recommendations to eliminate nonoil tax exemptions, along with the estimated revenue impact. This could be done during the ongoing preparations for the 2010–12 federal budget. Any cuts in key tax rates (e.g., VAT) should be delayed after the tax base is expanded in order to avoid precipitous revenue losses.

2. *The government could identify specific functional categories of unproductive spending to target for cuts in the medium term, to create room for rising priority expenditures—social spending and infrastructure investment.* This would require a systematic, annual review of public spending categories, in the context of the annual budget reviews, to identify the scope for cuts without affecting the desired service delivery.
3. *The government should keep fiscal sus-*

tainability a high priority. The government should return the nonoil primary fiscal deficit to a level consistent with fiscal sustainability—about 4.7 percent of GDP—and keep it there. This would be broadly in line with the government's own fiscal rule already in place for 2010 and later, but higher deficits are planned for 2008–09. But the actual nonoil primary fiscal balance now exceeds that required for the permanent income rule to function. And the 2008–10 budget plans further increases.

4. ***One way to establish automatic fiscal sustainability is to put in place a permanent income rule for fiscal policy.*** The rule says that Russia should spend only as much from oil assets as it earns on them in the long run. In practice, this would mean limiting the nonoil primary fiscal deficit to what can be financed from the permanent income from oil assets—an estimated 4.7 percent of GDP—leaving the overall oil assets (in financial terms) intact for future

generations. Today, the nonoil primary fiscal deficit is about 5 percent of GDP, so relatively small adjustments could return it to a permanently sustainable level. But unless the rule is implemented systematically, the nonoil primary fiscal deficit will likely increase and begin depleting oil assets, using them for current consumption and leaving less—or nothing—to future generations.

Russia could also ensure long-term fiscal sustainability with prudent discretionary fiscal policy, with adjustments through its annual and three-year budget reviews—as it has done in the past nine years. But applying the permanent income rule would eliminate uncertainty and make fiscal policy less vulnerable to political pressures. It would also likely lower external borrowing costs, thanks to greater certainty about the stance and direction of fiscal policy, and dampen economic volatility, given the more stable fiscal position.

Tackling Health Reform

The roots the Russian Federation's health crisis are not entirely, or even primarily, in its health care system. High mortality and morbidity, particularly among working-age men, reflect factors that transcend the health system—population aging, rapid urbanization, changing lifestyles, and risky behaviors. Spending more money on health care is necessary. But that will not be enough to sustainably improve health outcomes. A multisectoral strategy is needed—one that addresses the poor health outcomes, the rising health expenditures, and the structural reforms needed to improve health care organization and service delivery. The task will be complex, requiring attention over the medium to long term. The new government should address it—forcefully—as soon as possible.

The health challenges—poor outcomes, insufficient spending

Grim statistics highlight the large health gap between the Russian Federation and other G8 and middle income countries. The Russian life expectancy at birth, 66 years, lags 16 years behind the Japanese and 14 years behind the European Union average. The leading causes of premature death, ill health, and disability among adults are noncommunicable diseases—heart attacks, strokes, cancer—and injuries due to traffic accidents.

High mortality and morbidity among Russia's working-age people threaten national security and economic and social development. With Russia's demographic crisis more serious than Western Europe's, the labor supply is set to become a greater constraint on economic growth. Russia's population has declined by 6 million since 1992 to an estimated 143 million. Most experts project a decline of about 30 percent by 2050 though immigration and better living conditions linked to strong long-term growth could partly counteract the

projected decline. An annual inflow of roughly a million working-age migrants will be needed to fill the gap after 2007.

Poor health among the working population has economic costs—low productivity, early retirement, and high medical spending. An accelerating dependence on migrant labor also raises national security questions, as does poor health in the military. And the Russian population is aging, reflected in a shrinking youth cohort and an expanding proportion of the population aged 60 and older.

Russia's declining health status came alongside real decreases in public health spending. In the 1990s public spending for health care declined by a third in real terms, the result of big drops in the early years of the transition (figure 3.1). Spending rose above pre-transition levels in real terms only with additional resources from the National Priority Health Program in 2006–07.

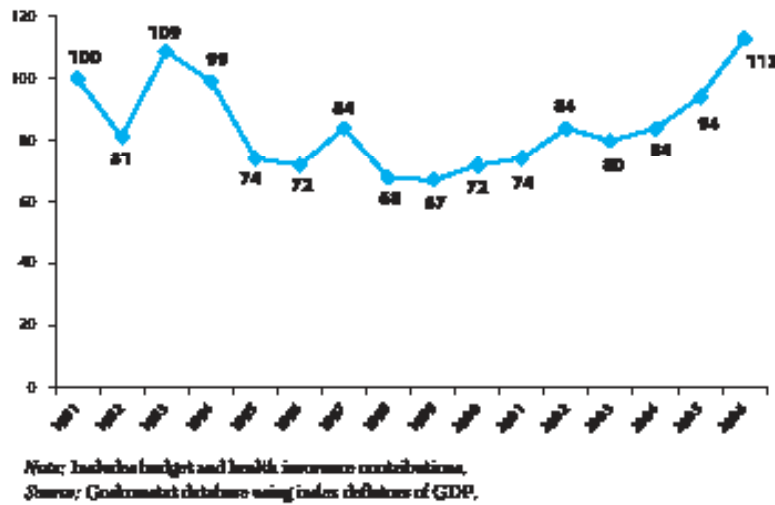
Public spending on health has fluctuated between 2.7 percent of GDP and 3.6 percent since 2001—low compared with European Union countries, which typically spend from 6–8 percent of GDP on health. Russia's total spending, both public and private, remains below that of countries with similar per capita incomes, at 5.3 percent of GDP. The large share of private spending reflects out-of-pocket payments for informal charges and pharmaceuticals. Those hinder access to quality health services, particularly among the poor.

Russia's health spending is also poorly allocated and inefficiently administered within regions. The result: an urgent need to improve the structure of health care spending and its efficiency. A recent IMF study shows that countries spending 30–40 percent less on health achieve health outcomes similar to Russia's.²

Local government spending on health accounts for about 85 percent of Russia's health spending, but the burden varies across re-

¹ This chapter is based on Marquez, P. et al. 2008. «Better Outcomes through Health Reforms in the Russian Federation: The Challenge in 2008 and Beyond.» Policy Note. Washington, D.C.: The World Bank.

Figure 3.1: Public expenditures on health in real terms, 1991–2006 (index, 1991 = 100)



gions. Local spending on health is usually 2–4 percent of gross regional product, but it can be as much as 15 percent. The IMF study also shows large differences in efficiency across regions. If the less efficient regions emulated the more efficient ones, about two-thirds of today’s inputs could produce the same health outcomes. A 2003 survey of more than 45,000 households found that poorer households, particularly in rural areas, pay more for informal medical care, and more as a percentage of consumption. This suggests that many families could be vulnerable and could perhaps fall into poverty—or deeper into poverty—as a result of rising costs to meet their health needs.

Three actions to address the health challenges

Russia’s new government should consider three broad lines of action to address the health care crisis.

First, to solve the health crisis, the government must look beyond the health sector. Few would argue that the roots of the health crisis are entirely, or even primarily, in the health care system. High mortality and morbidity, particularly among working-age men, reflect factors that transcend the health system—population aging, rapid urbanization, changing lifestyles, and risky behaviors. Overwhelming interna-

² “Benchmarking the Efficiency of Public Expenditure in the Russian Federation,” David Hauner; IMF Working Paper 07/246; October 1, 2007.

tional evidence suggests that a multisectoral strategy is the most cost-effective way to address the challenge from noncommunicable diseases and injuries. In Russia, priority interventions should be:

- *Discourage excessive alcohol consumption.* Interventions should target supply (regulating production, distribution, prices, access, and advertising) and demand (with information, education, and communications campaigns).
- *Discourage tobacco consumption.* Interventions could include policies for smoke-free worksites and public places, taxation, and legislation for banning tobacco advertising, promotion, and sale to minors—in accordance with the International Framework Convention on Tobacco Control, recently ratified by Russia.
- *Promote changes in diet and physical activity.* This would mean incentives and dietary guidelines for healthier eating, along with school programs on the importance of healthy nutrition and physical activity.
- *Improve road safety by enforcing laws to prevent traffic accidents.* Drunk driving requires action. Today’s road infrastructure can be retrofitted with low-cost safety design features—medians and separation for pedestrians and cyclists. Also needed is systematic maintenance to minimize road hazards.

Political leadership and more funding, both federal and regional, are required to introduce and scale up these interventions. Broad public-private partnerships are also needed: employees’ poor health has a short-term impact on the financial bottom line of every company, and a longer term impact on the prospects for profitable growth. The government could encourage these partnerships with tax credits.

Second, Russia needs to spend more on health. The Russian health system lacks the funding to cover government promises of free basic medical services for the whole population. For a country that spends a relatively low share of GDP on health care, the guarantee package is extensive, however. With available resources insufficient to cover the package, access has been consistently compromised over the last 15 years. The public system, likely to remain an important pillar, could and should meet part of the needed increase. The Russian government, therefore, would need to gradually increase aggregate

public funding for health from the 3.5 percent of GDP in 2006 to 4.5–6.0 percent within the next five to ten years—comparable to other middle-income countries (table 3.1).³ Private spending is also expected to increase in the long term from 1.8 percent of GDP to about 2.5–3 percent.

Increasing public spending could help address long-standing problems. It could raise base salaries for physicians and nurses. It could introduce incentives for improving performance by differentiating pay by the volume and quality of health services. It could ensure free drugs for hospital care and fund targeted outpatient drug programs for children and the elderly. And it could rehabilitate health facilities, replace outdated equipment, and train personnel.

How will Russia fund the higher spending? From reallocating expenditures from lower to higher priorities. Public spending will have to shift toward the long-term needs of health, education, and pensions and away from less productive uses—untargeted subsidies and transfers, general administration spending, and unproductive public investments. Because the health financing system is based mostly on general budget revenue rather than on earmarked payroll taxes, mechanisms should also be explored to raise more funding from regional budgets as contributions to mandatory health insurance for the nonworking population. Another area that merits attention is channeling more private health spending through voluntary health insurance to complement mandatory insurance.

Third, structural reforms to improve efficiency must complement higher spending. Spending more is necessary. But it is not enough to improve Russia's health outcomes sustainably. Structural reforms are needed to improve the efficiency and effectiveness of health care's organization and service delivery. Four areas should be targeted to gradually improve the allocation and use of health funds within regions:

- **Revenue pooling should be centralized.** Russia's health financing system is fragmented—far more decentralized than in most middle- and high-income countries. It is also inefficient, with unnecessarily duplicated administrative procedures and high transaction costs. Funding comes from federal, regional, and municipality budgets, as well as from the mandatory health insurance scheme established in 1993. Bud-

get funding accounts for about 60 percent of public health spending, the mandatory health insurance scheme for the rest. Most public sector funds—more than 85 percent—are raised and allocated regionally through general revenues and the 3.1 percent payroll tax. But budget equalization transfers from the federal government have never been earmarked for health, and regions have been mostly unwilling to contribute for non-working groups or to pool necessary funds under the regional health insurance funds, as called for in the legislation.

Gradually integrating financial resources from federal and regional government transfers and from the mandatory health insurance scheme would enable establishing single-payer funding for public health services. This would, in turn, allow more meaningful strategic planning for regional health systems, encourage integration and coordination, reduce barriers to intrasectoral activities, and provide greater flexibil-

Table 3.1: Projected public

2006–07	2008–10	2011–15	2016–20
3.5	4.5	5.5	6.0

Source: World Bank staff estimates.

ity to transfer funds between services.

- **The guaranteed package of medical benefits needs revision.** Health care spending is expected to continue to climb, both in absolute terms and relative to GDP. But the balance between commitments and resources cannot be restored merely by increasing resources. The guaranteed package of medical benefits will have to be reexamined. This means more than just assessing what the state can afford. If the state guarantee is to be meaningful, the package must be transparent to providers and patients, specifying the types, volumes, procedures, and conditions of health care provision. It must also give citizens the tools to assert their rights if commitments are not met. A set of services and drugs should be established for priority diseases, to be provided free based on government guarantees. The state guarantees should ideally be funded from a single source, preventing perverse incentives for unjustified shifting of costs from one source to another.
- **The organization of health care services must be rebalanced.** Russia's regions need significant capital investment to restruc-

³These projections are based on the prevailing demographic trends and strong outlook for the Russian economy, expected to generate significant additional demand for health services.

ture, renew, and equip their health provider infrastructure. Some additional infrastructure will be needed because of geographic dispersion and severe climatic conditions. But modernizing the existing network is a greater need. Judicious investments—in intermediate care centers, primary care facilities, emergency medical services, human resources, and management systems, including introducing electronic medical records—can substantially reduce the number of admissions and the length of stay in Russian hospitals. Meanwhile, the coverage of ambulatory services could be expanded.

Many facilities have unused capacity, so resizing costly hospital infrastructure could improve the quality and usefulness of today's capital stock and create an environment that promotes applying new technologies to current and emerging health needs. Attention is also needed on how to strengthen the organization and financing of long-term care services, including nursing home and home care, for people dependant on ongoing help due to aging, chronic diseases, or physical or mental disabilities.

- ***Provider payment systems need incentives to enhance quality and efficiency.*** Building on the new contracts introduced in Voronezh and the Chuvash Republic—with the support of the World Bank-funded Health Reform Implementation Project—the government should introduce incentives to expand the scope of services and to improve the quality of primary health care.

Per capita payments should be combined with performance pay, linked to achieving quality standards or providing new services. Bonus payments could be provided for reaching quality and efficiency targets—say, expanded coverage for immunization, cervical screening, annual health advice, smoking cessation, alcohol reduction, elderly checks, and developmental checks for infants and children.

Alternatively, fee-for-service payments could be used to strengthen services and to expand their scope, by introducing new

services for general health promotion, dedicated chronic disease management programs (for diabetes mellitus, ischemic heart disease, heart failure, hypertension, asthma, chronic obstructive pulmonary disease, epilepsy, and stroke), and minor surgery.

The payment systems for primary health care should be modified so that 20–25 percent of the payment for primary health units is related to outputs and outcomes—not inputs. Quality targets for key noncommunicable diseases—cardiovascular diseases, cancer, diabetes, chronic lung diseases—should be clearly defined. These constitute Russia's greatest disease burden.

Hospitals in Russia are paid mostly per treated case, but some items of expenditure (mostly fixed) are not included in mandatory health insurance tariffs, instead covered directly from budgets controlled by governments at various levels. This combination is inefficient. Line item budgeting pays for inputs, with little incentive for providers to improve efficiency. Funds provided through line item budgeting should be incorporated into the existing tariffs, which in turn should be modified to incorporate quality and efficiency standards—for example, stipulating average lengths of stay in line with what can be achieved through more cost-effective medical interventions. Because case-based payment methods are inflationary, encouraging providers to increase activity to generate maximum revenues, they should be combined with cost and volume contracts that specify a level of activity for a given year and specialty.

Summing up: Addressing Russia's health challenges will require broad policy and institutional reforms—at the federal, regional, and municipal levels—and covering many sectors, not just the health system. Implementing the proposed reforms as a package will bring the coherence needed for this complex effort. Reform is a medium to long term undertaking, but the new government should accelerate progress—forcefully—as soon as possible.

Annex

Table 1 - Russia's Export Market Composition

Russia's Merchandise Export Markets

Percent share of total, ranked by 2007 shares

	1995	2000	2005	2006	2007	<i>Difference 2007-1997</i>
Top 25 export markets						
Germany	7.8	9.0	8.3	8.4	9.6	1.9
Netherlands	4.1	4.2	10.3	12.3	7.6	2.3
Turkey	2.1	3.0	4.5	4.9	6.1	3.8
Italy	4.2	7.0	7.9	8.6	5.7	1.5
China, People's Republic of: Mainland	4.4	5.1	5.5	5.4	5.0	0.3
Ukraine	8.9	4.9	5.2	5.1	4.9	-3.6
United States	6.6	7.7	3.1	3.1	4.9	-0.9
Belarus	3.8	5.4	3.4	1.1	4.4	-1.1
Switzerland	4.8	3.9	4.4	4.1	3.9	-0.5
Poland	2.1	4.3	3.6	3.9	3.8	0.9
France	2.0	1.9	2.6	2.6	3.6	1.7
Kazakhstan	3.4	2.2	2.7	3.1	3.3	0.3
United Kingdom	4.0	4.5	3.5	3.6	3.1	-0.2
Finland	3.1	3.0	3.2	3.2	3.0	-0.3
Spain	0.4	1.0	1.2	1.1	2.4	1.7
Japan	4.1	2.7	1.6	1.6	2.4	-1.0
Hungary	2.1	2.3	2.1	2.1	1.6	-0.5
Belgium	...	0.7	1.0	0.9	1.5	0.5
Slovak Republic	1.5	2.1	1.3	1.6	1.4	-0.6
Czech Republic	2.7	1.7	1.6	1.6	1.3	-0.8
Sweden	0.8	1.7	1.0	0.8	1.2	0.0
Lithuania	1.3	2.0	1.7	1.4	1.1	-0.4
Romania	0.8	0.9	1.3	1.1	1.1	0.2
India	1.3	1.1	1.0	1.0	1.1	0.0
Greece	0.2	1.2	0.8	0.9	1.0	0.8

Source: Director of Trade Statistics, International Monetary Fund and World Bank staff calculations

Table 2 - Russia's Import Market Composition

Russia's Merchandise Import Markets

Percent share of total, ranked by 2007 shares

	1995	2000	2005	2006	2007	<i>Difference 2007-1997</i>
Top 25 import markets						
Germany	14.1	11.5	13.6	13.9	16.5	3.8
China, People's Republic of: Mainland	1.9	2.8	7.4	9.7	12.5	10.1
Italy	4.0	3.6	4.6	4.3	5.6	0.5
Ukraine	14.3	10.8	6.0	7.0	5.0	-2.6
Japan	1.6	1.7	6.0	5.9	4.8	2.9
Belarus	4.2	11.1	4.7	1.5	3.9	-5.0
Netherlands	3.5	2.2	2.0	2.0	3.8	1.5
Finland	4.4	2.8	3.2	3.0	3.8	0.2
Korea	1.1	1.1	4.1	5.1	3.6	2.0
United States	5.7	8.0	4.7	4.8	3.5	-4.3
France	2.3	3.5	3.8	4.4	3.4	0.4
Poland	2.8	2.1	2.8	2.6	2.8	0.8
United Kingdom	2.4	2.5	2.8	2.8	2.4	-0.4
Turkey	1.2	1.0	1.8	2.0	2.1	0.6
Kazakhstan	5.9	6.5	3.3	2.9	1.9	-3.3
Belgium	...	1.4	1.5	1.6	1.9	0.4
Austria	2.1	1.2	1.2	1.4	1.7	0.3
Brazil	0.8	1.1	2.4	2.3	1.6	0.7
Sweden	1.2	1.4	1.9	1.6	1.5	-0.2
Hungary	1.8	1.2	1.1	1.4	1.3	-0.4
Spain	0.5	0.9	1.3	1.5	1.3	0.3
Czech Republic	0.9	1.1	1.0	1.2	1.3	0.2
Lithuania	0.8	0.4	0.6	0.5	1.0	0.2
Denmark	1.0	1.0	0.9	1.0	0.8	-0.3
Uzbekistan	1.9	2.0	0.9	1.0	0.7	-1.3

Source: Director of Trade Statistics, International Monetary Fund and World Bank staff calculations

Output Indicators	2001		2002		2003		2004		2005		2006		2007		2008			
	Yr	Yr	Yr	Yr	Yr	Yr	Yr	Yr	Yr	Yr	Yr	Yr	Yr	Yr	Yr	Yr		
GDP, % change, y-o-y 1/	5.1	4.7	4.7	7.3	7.2	6.4	7.4	7.4	6.7	7.7	7.5	7.5	7.5	8.1	8.1	8.5	6.7	
Industrial production, % change, y-o-y	4.9	3.1	8.9	8.0	5.1	6.3	5.7	9.6	10.3	3.7	2.9	6.0	5.3	5.7	6.3	4.5	9.2	
Manufacturing, % change, y-o-y	-	1.1	10.3	10.5	7.6	8.3	7.6	13.6	15.2	5.0	3.8	9.0	7.4	7.1	9.5	4.0	14.5	
Extraction of mineral resources, % change, y-o-y	-	6.8	8.7	6.8	1.4	2.5	1.9	2.0	1.2	1.0	0.2	1.4	0.5	0.6	1.9	0.6	2.3	
Fixed capital investment, % change, y-o-y	10.0	2.8	12.5	13.7	10.9	16.7	23.9	25.9	25.0	17.0	13.7	19.6	15.4	24.5	21.1	19.0	20.2	
Fiscal and Monetary Indicators																		
Federal government balance, % GDP 1/	3.0	1.4	1.7	4.3	7.5	7.4	6.7	7.7	7.5	7.5	7.5	8.1	6.3	5.5	5.5	10.4	8.2	
Consolidated budget balance, % GDP 2/	-	-	1.3	4.5	7.7	8.5	10.3	-	-	9.5	-	9.5	-	6.1	6.1	-	12.1	
M2, % change, p-o-p 3/	44.6	34.1	44.8	42.5	35.6	43.6	6.9	1.5	0.6	2.2	3.0	-0.6	6.5	9.1	51.3	-2.7	1.3	
Inflation (CPI), % change, p-o-p	18.6	15.1	12.0	11.7	10.9	9.0	0.6	1.0	0.9	0.1	0.8	1.6	1.2	1.1	11.9	2.3	1.2	
GDP deflator 1/	16.5	15.7	14.0	20.1	19.2	15.7	9.9	-	-	-	11.2	-	-	13.5	13.5	-	20.7	
Producer price index (PPI), % change, p-o-p	8.3	17.7	12.5	28.8	13.4	10.4	5.4	2.5	0.7	2.1	-0.6	-0.1	3.1	3.7	25.1	1.6	0.7	
Nominal exchange rate, average	29.2	31.4	30.7	28.8	28.3	27.1	25.8	25.9	25.5	25.6	25.3	24.9	24.5	24.6	25.6	24.5	23.8	
Real effective exchange rate, 2000 = 100 (IMF)	120.3	123.6	127.3	137.3	149.3	163.4	171.6	172.1	173.2	173.2	173.5	175.5	176.0	177.1	172.7	179.8	179.5	
Real effective exchange rate, % change, p-o-p (IMF)	20.3	2.8	3.0	7.8	8.7	9.5	0.2	0.3	0.7	0.0	0.2	1.2	0.3	0.7	5.7	1.5	-0.2	
Stabilization Fund bln USD, end-o-p	-	-	-	18.7	42.9	89.1	116.9	121.7	127.5	132.9	141.1	147.6	144.4	156.8	156.8	157.4	-	129.3
Reserve Fund, bln USD e-o-p	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	129.3
National Wealth Fund, bln USD, e-o-p	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	32.7
Reserves (including gold) billion \$, end-o-p	36.6	47.8	76.9	124.5	182.2	303.7	403.2	405.8	416.2	416.0	425.4	447.0	463.5	476.4	476.4	483.2	490.7	
Balance of Payment Indicators																		
Trade Balance, billion \$	48.1	46.3	59.9	86.9	118.3	139.2	12.7	8.6	10.4	11.1	11.2	12.8	13.5	8.1	128.7	19.0	14.6	
Share of energy resources in export of goods, %	51.2	52.4	54.2	54.7	61.1	63.3	-	60.1	-	-	60.9	-	-	62.2	61.5	-	-	
Current Account, billion \$	33.9	29.1	35.4	58.6	84.2	95.6	-	15.9	-	-	15.8	-	-	22.1	76.6	-	37.0	
Export of goods, billion \$	101.9	107.3	135.9	183.2	243.6	303.9	30.3	27.1	29.7	30.9	29.9	34.8	36.0	35.3	354.0	34.6	35.6	
Import of goods, billion \$	53.8	61.0	76.1	96.3	125.3	164.7	17.6	18.5	19.3	19.9	18.7	22.0	22.6	27.2	225.3	15.6	20.9	
Gross FDI, mln USD 1/	3980	4002	6781	9420	13072	13678	-	15837	-	-	19644	-	-	27797	27797	-	-	
Average export price of Russia's oil, \$/bbl	20.9	21.0	23.9	34.1	45.2	56.2	59.8	63.0	67.5	68.5	67.3	73.2	79.9	83.7	64.4	84.3	84.7	
Financial Market Indicators																		
Average weighted lending rate for enterprises, % 4/	17.9	15.8	13.1	11.5	10.7	10.5	9.5	9.5	9.2	9.9	10.4	10.6	10.8	10.8	10.8	10.4	11.0	
CBR refinancing rate, % end-o-p	25.0	21.0	16.0	13.0	12.0	11.0	10.5	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.3	
Real average rate for Ruble loans, % (deflated by PPI)	-1.1	3.9	-2.2	-10.1	-8.4	-1.8	-3.8	-5.4	-4.7	-4.0	-1.6	-4.1	-9.1	-11.5	-3.4	-11.6	-11.8	
Stock market index (RTS, ruble term)	260	359	567	614	1126	1922	1780	1897	1994	1920	2072	2223	2220	2291	2291	1907	2064	
Enterprises Finances																		
Share of loss-making companies 1/	38.4	43.4	41.3	35.8	33.5	29.7	35.2	32.9	30.4	30.4	30.4	29.2	26.7	26.4	23.4	34.3	33.0	
Share of credits in capital investment 1/	-	10.8	14.5	15.2	13.8	14.3	-	16.8	-	-	-	16.5	-	15.5	15.5	-	-	
Profitability (net profit/paid sales), % 1/	25.6	17.4	20.7	25.5	25.3	25.6	32.1	32.6	35.5	31.6	32.1	33.0	33.0	36.8	36.8	58.0	62.5	
Income, Poverty and Labor Market																		
Real disposable income, (1999 = 100%)	121.7	135.3	155.5	171.7	190.6	216.0	234.3	245.5	246.8	249.0	251.5	251.5	264.0	361.7	238.4	192.1	238.2	
Average dollar wage, US \$	112.4	138.6	179.4	237.2	301.6	395.3	493.7	531.1	529.1	517.3	548.2	565.7	601.9	757.4	529.0	603.4	636.6	
Share of people living below subsistence, % 1/	27.5	24.6	20.3	17.6	17.7	15.2	-	14.1	-	-	13.3	-	-	13.4	13.4	-	-	
Unemployment (% ILO definition)	9.0	8.0	8.6	8.2	7.6	7.2	6.0	5.8	5.7	5.7	6.0	5.8	5.6	6.1	6.1	6.5	7.0	

1/ Cumulative from the year beginning

2/ Starting 2006 incl. extrabudgetary funds

3/ Annual change is calculated for average annual

M2

4/ All terms up to one year

Source: Goskomstat, CBR, EEG, IMF, staff estimates.

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