Russia Economic Report[1]

Confidence crisis exposes economic weakness

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[1] This report is produced twice a year by World Bank economists of the Europe and Central Asia Region Poverty Reduction and Economic Management Department. The team was led by Birgit Hansl (Lead Economist and Sector Leader for Economic Policy in Russia, bhansl@worldbank.org) and consisted of the following members: Sergei Ulatov (Senior Economist), Stepan Titov (Senior Economist), Olga Emelyanova (Research Analyst), Mikhail Matytsin (Consultant), John Pollner (Lead Financial Officer), Lawrence Kay (Consultant), Mizuho Kida (Economist), Damir Cosic (Economist), Ekaterine Vashkmadze (Senior Economist), John Baffes (Senior Economist) and Irina Rostovtseva (Team Assistant). Moritz Meyer (Consultant), Carolina Sanchez-Paramo (Sector Manager for Russia, Ukraine, Belarus, and Moldova) authored the focus note on economic mobility and emergence of the middle class in Russia. Peer reviewers were Wolfgang Fengler (Lead Economist), Raju Singh (Lead Economist) and Denis Medvedev (Senior Economist). The report was edited by Christopher Pala (Consultant), and the graphic design was provided by Robert Waiharo (Consultant). We are grateful for advice from discussions with Michal Rutkowski (Country Director for Russia), Roumeen Islam (Acting Director for Poverty Reduction and Economic Management in the Europe and Central Asia Region), Lada Strelkova (Country Program Coordinator for Russia), Zeljko Bogetic (Lead Economist in the Europe and Central Asia Region), Kaspar Richter from ECFIN and the IMF team for Russia, led by mission chief Antonio Spilimbergo.

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ABBREVIATIONS AND ACRONYMS

APEC	Asia-Pacific Economic Cooperation
BoP	Balance of Payments
CA	Current Account
CBR	Central Bank of Russia
LAC	Latin America and the Caribbean
CPI	Consumer Price Index
ECA	Europe and Central Asia
EU	European Union
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
IEA	Institute for Economic Analysis
NPL	Non-Performing Loan
NWF	National Welfare Fund
OECD	Organization for Economic Cooperation and Development
OPEC	Organization of the Petroleum Exporting Countries
PMI	Purchasing Managers Index
QE	Quantitative Easing
RLMS - HSE	Russian Longitudinal Monitoring Survey – Higher School of Economics
PPP	Purchasing Power Parity
US	United States
WTI	West Texas Intermediate

Executive Summary

Russia's economy is navigating an economic downturn. Real GDP growth slowed to an estimated 1.3 percent in 2013 from 3.4 percent of 2012. In January 2013, we projected 3.6 percent growth for 2013, but while the global economy has continued to improve at a moderate pace, Russia's is struggling to find its footing. The first part of this report explores the recent economic developments that underlie this slowdown. To emerge from the downturn with improved long-term prospects Russia will need a combination of cyclical and structural policy measures. As the relative weight of the reasons for Russia's downturn is tilted toward structural factors, structural measures will need to lead the rebound. The lack of more comprehensive structural reforms in the past has led to a gradual erosion of investor confidence. This was masked by a growth model based on large investment projects, continued increases in public wages, and transfers – all fueled by sizeable oil revenues. Recent events around the Crimea have compounded the lingering confidence problem into a crisis of confidence and more clearly exposed the economic weakness of this growth model. Investor pessimism became the decisive factor affecting Russia's economic outlook, presented in part two of the report. The special focus note in part three discusses the link between Russia's growth in the past decade and how it fueled an unprecedented growth in household welfare.

Russia's external environment remains volatile. The recovery in high-income countries is robust, yet settling at growth rates much lower than before the 2008 global economic and financial crisis. Russia's external demand recovered in line with expectations during the second half of 2013 and exports grew robustly. However, global markets appear to normalize to a higher level of volatility and their reactions to the gradual withdrawal of the U.S. monetary stimulus remain erratic. The Ruble came under increasing pressure, triggered by the ongoing deterioration of the current account and by higher volatility in capital outflows. This was in part related to uncertainties around the quantitative easing policies by the U.S. Fed, but unrealized growth expectations and large foreign debt payments by the corporate sector played a more prominent role in Russia. In 2014 so far, global markets have seen little disruption from the growing tension between Ukraine and Russia, and oil markets remained stable. But such geopolitical and commodity risks could actually play out to the benefit of Russia by pushing oil and gas prices temporarily up. Most of all, confidence in a broad-based global recovery is still wavering and becoming increasingly driven by a higher differentiation into regional and country-specific sentiments.

Business and consumer sentiment in Russia remain weak. In 2013, frail domestic demand dragged the Russian economy close to stagnation. When major infrastructure projects came to an end in early 2013, the spare capacity was immediately felt in the economy. Then the anticipation that private investors would start investing more during the second half of 2013 did not materialize. The lack of growth-supporting structural reforms and decreasing profit margins weighed heavily on business sentiment and pushed down industrial activity and investment. The contribution of fixed investment to GDP growth turned negative in 2013, compared to 1.4 percent in 2012. Companies also continued drawing down inventories. Consumption remained the main growth driver, supported by fast credit and wage growth, yet its pace of expansion more than halved compared to 2012.

The World Bank outlook for Russia comes with two growth scenarios—both project lower growth than our forecast in November. The scenarios reflect the increased market volatility created by the Crimean crisis in early March 2014. We assume that political risks will be prominent in the short-term. If the Russia-Ukraine conflict escalates, uncertainty could rise around sanctions from the West and Russia's response to them. This could further worsen business and consumer confidence and raise market volatility, dimming prospects for domestic demand and growth. The World Bank's low-risk scenario assumes a limited and short-lived impact of the Crimea crisis and projects growth to slow to 1.1 percent in 2014 before a slight increase to 1.3 percent in 2015. The World Bank's high-risk scenario assumes a more severe shock to economic and investment activities from the Crimean crisis and projects a contraction in output of 1.8 percent for 2014.

Economic mobility could be on hold. Weaker growth prospects and stabilizing consumption at a lower rate would dim the outlook for economic mobility and continued middle-class formation in Russia. We project in our low-risk scenario that consumption growth will decrease to about 2 percent in 2014-2015, compared to 3.4 percent in 2013 and 6.9 percent in 2012. We expect some already announced labor shedding which will be realized throughout the year. This will dampen households' income prospects and as a result consumption growth. In the medium to long term labor market demand relaxation will be partly compensated by a shrinking of the labor force due to demographic factors, such as population aging, but in the short-term upward economic mobility is likely to slow down. Our special focus note shows that most of poverty-reduction and middle-class growth was explained by high growth in average incomes and consumption during 2000-2010.

Crisis management response could replace efforts to advance the structural reform agenda. Russia's long-term outlook will depend on a sustained positive shift in investor and consumer confidence. To overcome the current confidence crisis and achieve sustained long-term growth, structural reforms would need to resume in the coming years. The dearth of such reform efforts is darkening Russia's growth outlook. Attracting larger private investment in a sustained manner and on a larger scale—through innovative firms of all sizes—would require that inefficiencies in factor allocation across the economy be addressed. It would also require creating a level playing field for such businesses by improving the quality of regulatory and market institutions, so that rules are implemented evenly. No matter how the Crimean crisis plays out, there is the risk that the Russian government will be put back into a crisis mode to uphold macroeconomic stability, depending on the evolving scenario. It is likely that policy choices will be about managing short-term issues, and the medium-term agenda of structural reforms will continue to take a back seat.

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Part I. Recent Economic Developments

The continued growth recovery in high-income economies provided support to economic activity in developing and emerging countries. Financial markets in both developing and high-income countries underwent a significant transition as strengthening growth in high-income countries prompted a normalization of the extraordinary measures taken in the wake of the 2008-2009 crisis. Russia's 2013 growth outturn surprised on the downside, tumbling from 3.4 percent in 2012 and a projected 3.6 percent for 2013 to just 1.3 percent that year. Frail domestic demand with zero investment growth dragged the Russian economy close to stagnation. Consumption drove what little growth there was, supported by fast growth in credit and wages, yet its pace of expansion in 2013 was barely more than a third of what it was in 2012. Key labor market indicators reflected the stagnation in the real sector. As a result, income growth stabilized at a new, much lower level and led to a slight moderation in the growth of the productivity gap. The slowdown in real-sector growth translated into a slight increase in the poverty rate for 2013. Russia's balance of payments position weakened in 2013 while the current account surplus shrank to less than half of its 2012 level. During the second half of the year, capital outflows from the private sector picked up as a result of the scaling back of the US monetary stimulus and large external debt payments. The Ruble came under increased pressure as the current account deteriorated and investors became more risk-averse in anticipation of the impact of the scaling-down of the US monetary stimulus. Perceived credit risks rose as firms and households found it increasingly difficult to service their debts. Inflation pressure remained high in 2013, driven by food and service prices. The overall fiscal balance worsened slightly on a year-to-year basis and the non-oil deficit continues to exceed 10 percent of GDP. The consolidated budget ended in a deficit for the first time since the crisis period as sub-national public finances weakened. The funds that serve as Russia's fiscal buffers increased moderately, but their investment decisions became more subject to political pressures.

1.1 Global Trends 2013 – Growth recovers despite tighter financial conditions

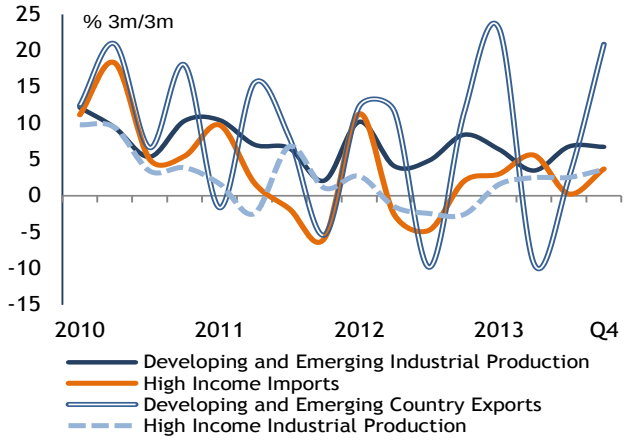
The continued growth recovery in high-income economies provided support to economic activity in developing and emerging countries. Financial markets in both developing and high-income countries underwent a significant transition as strengthening growth in high-income countries prompted a normalization of the extraordinary measures taken in the wake of the 2008-2009 crisis.

During 2013, the global economy continued to improve at a moderate pace, led by a recovery in high-income countries (Figure 1). Following a robust expansion of GDP in the third quarter (Q3) of 2013 by 4.1 percent in the quarter-on-quarter seasonally adjusted annual rate (q/q saar), the US economy continued to grow at 3.2 percent in Q4, supported by strong consumer spending and rising exports that offset a significant drag from lower government spending. In Japan, the monetary and fiscal stimuli boosted the Tankan business confidence index to a six-year high, but they also pushed up core inflation to 1.3 percent in December. Japan's GDP continued to expand by 1.0 percent (q/q saar) in Q4 while growth in private consumption and investment remained strong, suggesting that the domestic economic recovery remains intact. The Euro Area has managed to expand for three consecutive quarters with GDP growth accelerating to 1.2 percent (q/q saar) in Q4, double the pace of Q3. The recovery was broad-based, with France growing in Q4 at 1.3 percent and Italy becoming the fourth periphery economy to exit recession.

But tighter international financial conditions from mid-2013 created headwinds for developing and emerging countries. Financial conditions in developing countries were unsettled in mid-2013 by a portfolio adjustment that was triggered by speculation over the timing of eventual tapering of the US Federal Reserve's quantitative easing (QE) policies. This portfolio adjustment caused a temporary but significant reversal in capital flows from developing and emerging countries, leading to the withdrawal of a net total of US$64 billion from their mutual funds between June and August. Those losses during the summer of 2013 were partially recouped later in the year as the initial portfolio rebalancing came to an end and with the Federal Reserve's decision in September to postpone the tapering of QE. Credit-default swap spreads and borrowing costs for developing and emerging countries declined from their June peaks and stock markets regained some of the lost ground (Figure 2). Nevertheless, none of the indicators fully recovered their pre-summer levels. Overall, developing and emerging country stock market volatility was lower in 2013 than in any other post-crisis year, following a decline in market uncertainty and financial stability concerns in high-income countries.

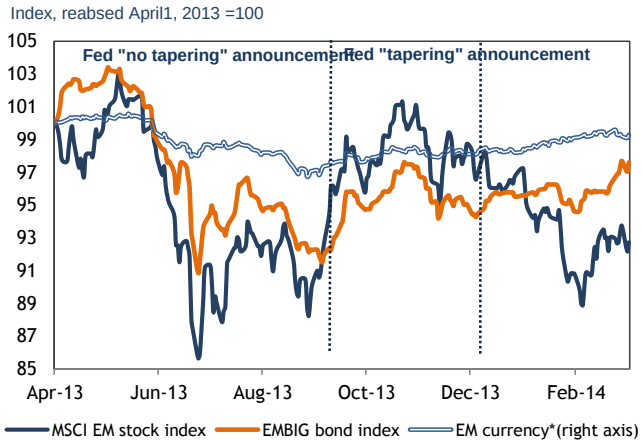
Despite financial market tensions, growth in developing and emerging countries began to strengthen. Steady demand for imports from high-income economies and China, combined with depreciated local currencies, contributed to a continued expansion of developing-country exports (Figure 1). The recovery in the Euro Zone has boosted export growth in the Europe and Central Asia region, following an earlier period of contraction. While Q4 GDP figures are still unavailable for developing-country and regional aggregates, more timely manufacturing Purchasing Managers' Index (PMI) data for developing and emerging countries moved into the above 50-zone in August and continued to show sustained expansion in four out of five regions with data.

Figure 1: Global industrial production and trade growth



Source: Datastream and World Bank Prospects

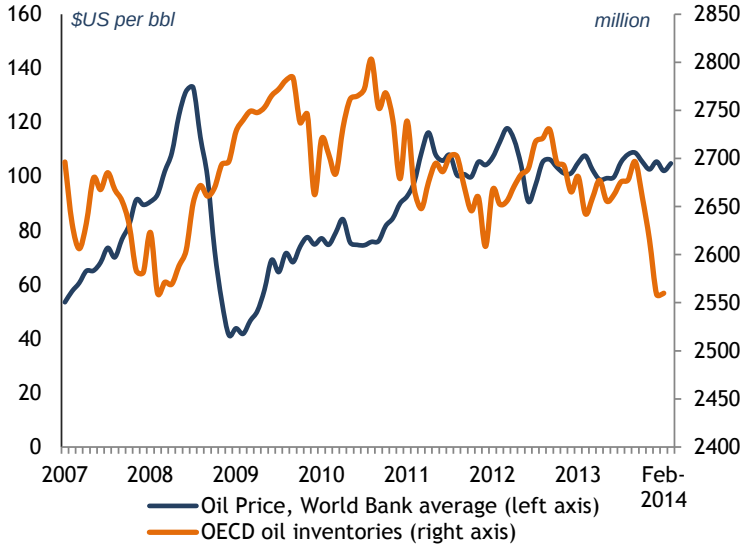
Figure 2: Fed tapering effect on emerging markets



Source: Bloomberg * Nominal Effective Exchange Rate

Oil prices averaged US$104/barrel in 2013, down slightly from US$105/barrel in 2012. The three years from 2011 to 2013 have been among the least volatile for the oil market in recent history. Crude oil prices[2] fluctuated within a remarkably tight band around OPEC's "desired range" of US$105/barrel (bbl) after reaching US$100/bbl in early 2011 for the first time since the 2008 financial crisis (Figure 3). During 2013, fluctuations in oil prices were driven on the supply side by geopolitical concerns over Egypt and Syria and output disruptions in Iraq and Libya, and on the demand side by concerns around developing-country growth prospects. However, fears that the Syrian conflict might spread to the Gulf and cause a major disruption in oil supplies have been replaced by cautious optimism. For Iran, the interim arrangement between the country and Western powers eased some sanctions, including lifting the ban on insuring oil shippers, but the ban on crude exports remained in place.

Figure 3: Oil prices and OECD inventories



Source: Datastream and World Bank Prospects

1.2 Growth 2013 — Loss of confidence leads to unfulfilled expectations

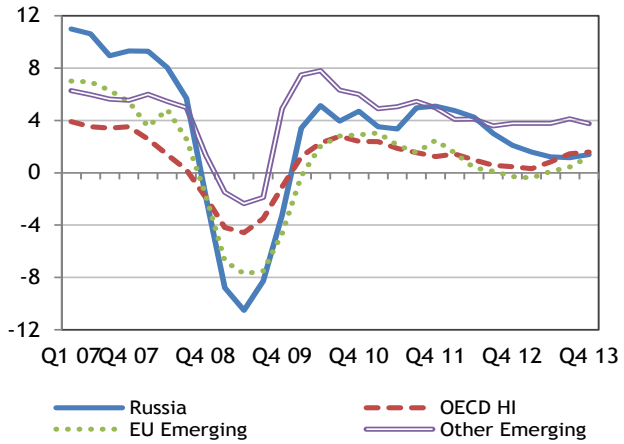
Russia's 2013 growth outturn surprised on the downside, tumbling from 3.4 percent in 2012 and a projected 3.6 percent for 2013 to just 1.3 percent. Frail domestic demand with zero investment growth dragged the Russian economy close to stagnation. Consumption remained the main growth driver, supported by fast credit and wage growth, yet its pace of expansion more than halved in 2013 compared to 2012.

In 2013, Russia's economic growth dipped under that of other high-income economies and remained only slightly above that of EU emerging countries (Figure 4**).** Growth in high-income economies and EU emerging ones picked up substantially in Q3 and especially in Q4, while the expected acceleration of growth in the second half of 2013 for Russia did not materialize. Russia's 2013 third-quarter growth slowed to 1.2 percent from 3.0 percent in the same period a year ago. In Q4 2013, growth was estimated at 1.4 percent, compared to 2.1 percent in 2012. The gap between Russia's growth rate and that of non-EU emerging economies dramatically increased in the second half of 2012 and persisted in 2013. Russia's external demand, reflected in robust export growth, recovered in line with expectations during the second half of 2013. However, weak domestic demand persisted throughout the second half of 2013, with zero investment growth and consumption expanding at a slower pace.

Hopes for acceleration in domestic demand during the second half of 2013 did not materialize and were the main reason behind Russia's lower-than-projected growth outturn of an estimated 1.3 percent for 2013. This is only slightly more than a third of the growth we projected for the year in January 2013 and well below the 3.4 percent growth in 2012 (Table 1). In fact, the continued slowdown of domestic demand during the second half of 2013 forced Government and analysts, including us, to drastically revise downward the short-term outlooks. The lack of growth-supporting structural reforms and decreasing profit margins weighed heavily on business sentiments and saw industrial and investment activities stalling.

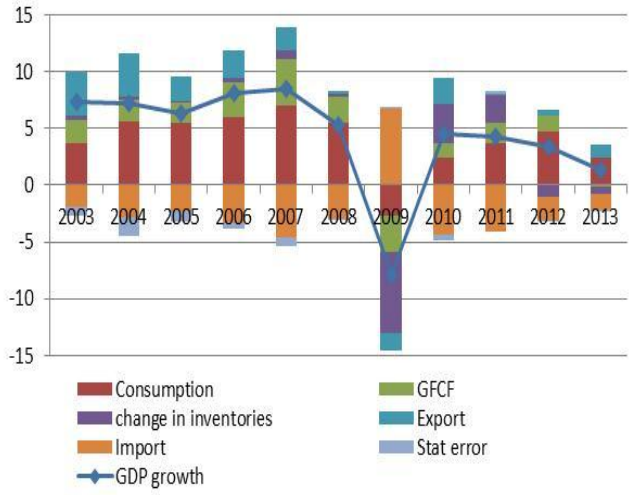
[2] World Bank average

Figure 4: World GDP growth, y-o-y, percent



Source: Rosstat and World Bank staff estimates
Note: Emerging EU economies include the six central European countries that are member both of the EU and the OECD: Czech Republic, Estonia, Hungary, Poland, Slovak Republic, and Slovenia. Other emerging economies include seven countries: Brazil, China, India, Indonesia, Mexico, South Africa and Turkey.

Figure 5: Year-on-year growth composition, percent



Source: OECD

Investment activities came to a halt with the tapering of large infrastructure projects and a deterioration of business confidence in the economy in the second half of 2013. When the two major projects (the Nord Stream Pipeline and the Sochi Winter Olympics[3]) came to an end in in late 2012 and early 2013, the base effect of this on aggregate investment demand was immediately felt in the economy. As business sentiments failed to improve, the anticipation that private investors would kick in and start investing more in the second half of 2013 did not materialize. This clearly reflected a confidence crisis of investors in the domestic economy. At the same time, the external environment improved, translating into better demand for Russia's exports, which increased their contribution to growth to 1.2 percent last year from 0.4 percent in 2012. Despite this increase in external demand, the contribution of fixed investment turned negative (-0.1 percent) in 2013 compared to 1.4 percent in 2012 while companies continued inventory destocking (Table 1). This resulted in the contribution of gross capital formation to growth also turning negative (0.8 percent) in 2013 compared to 0.3 percent in 2012 and 4.2 percent in 2011(Figure 5).

Table 1: Contribution to growth by demand components, percentage points

	2008	2009	2010	2011	2012	2013
GDP growth, percent	**5.2**	**-7.8**	**4.5**	**4.3**	**3.4**	**1.3**
Consumption	**5.5**	**-2.6**	**2.5**	**3.6**	**4.8**	**2.4**
Households	*4.9*	*-2.5*	*2.8*	*3.4*	*4.1*	*2.5*
Government	*0.6*	*-0.1*	*-0.3*	*0.3*	*0.7*	*0*
Gross capital formation	**2.5**	**-10.5**	**4.7**	**4.2**	**0.3**	**-0.8**
Fixed Investment	*2.3*	*-3.2*	*1.2*	*1.9*	*1.4*	*-0.1*
Change in stocks	*0.3*	*-7.3*	*3.4*	*2.3*	*-1.1*	*-0.7*
Export	**0.2**	**-1.5**	**2.3**	**0.1**	**0.4**	**1.2**
Import	**-3.0**	**6.7**	**-4.3**	**-4.1**	**-2.0**	**-1.4**

Source: Rosstat and World Bank staff estimates

Added to the zero investment growth, the consumption slowdown confirmed the confidence crisis that swept through the Russian economy during 2013. Consumption remained the main growth driver, but both household and government consumption contributed significantly less to aggregate growth than in 2012 (Table 1). Consumption's contribution to GDP growth halved to 2.4 percent compared to 4.8 percent in 2012. Along with weakening household consumption, imports slowed, lessening the negative contribution of net export to growth to

[3] The cost of the *Sochi Winter Olympics* was estimated at RUB1.53 trillion, or US$50 billion.

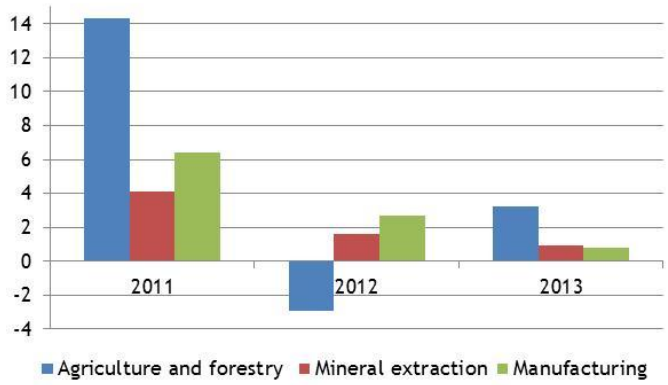
0.2 percent, compared to 1.6 percent in 2012. Decelerating real income growth and increased household indebtedness levels negatively affected consumers' sentiments. It appears that the observed adjustment in consumption growth last year to a significantly lower growth trajectory will be a medium-term event. This also means that the expansion of major non-tradable sectors, the main engine of growth during last two years, will also slow, dimming medium-term growth prospects (Box 1).

Box 1. 2013 GDP production structure

Non-tradable sectors prevailed as the main growth engine, yet their aggregate contribution to growth dropped to only 1.0 percent in 2013 from 3.0 percent in 2012 (Figure 7). It appears that the non-tradable sectors were also the main victims of slowing domestic demand and deteriorating consumer confidence in 2013. Major service sectors considerably slowed: retail and wholesale trade to 1.1 percent growth in 2013 compared to 3.8 percent in 2012, transportation and communication services to 0.9 percent growth in 2013 compared to 3.8 percent in 2012 and real estate operations to 1.6 percent growth compared to 6.4 percent. The financial services sector was the only bright spot, with growth registering a solid 12.0 percent, but still less than the 19.6 percent in 2012.

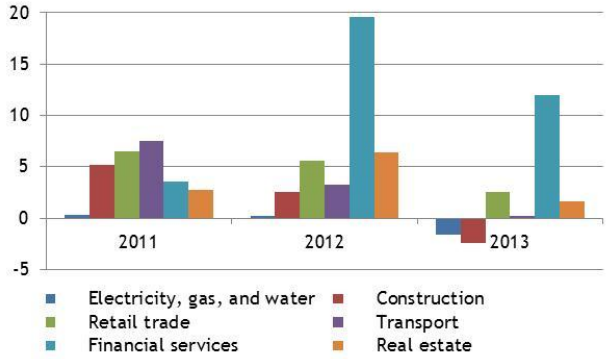
Despite strong growth in agriculture and fisheries, the aggregate contribution to growth from tradable sectors fell to 0.4 percent in 2013 compared to 0.5 percent in 2012 and 2.0 percent in 2011 (Table 2). Major industrial sectors, such as extracting industries and the production and distribution of electricity, gas and water, lost growth momentum during 2013. Industrial performance was especially shaky, with manufacturing growth dropping to 0.8 percent in 2013 compared to 2.7 percent in 2012 (Figure 6).

Figure 6: Tradable sector growth, percent, y-o-y



Source: Rosstat and World Bank staff estimates

Figure 7: Non-tradable sector growth, percent, y-o-y



Source: Rosstat and World Bank staff estimates

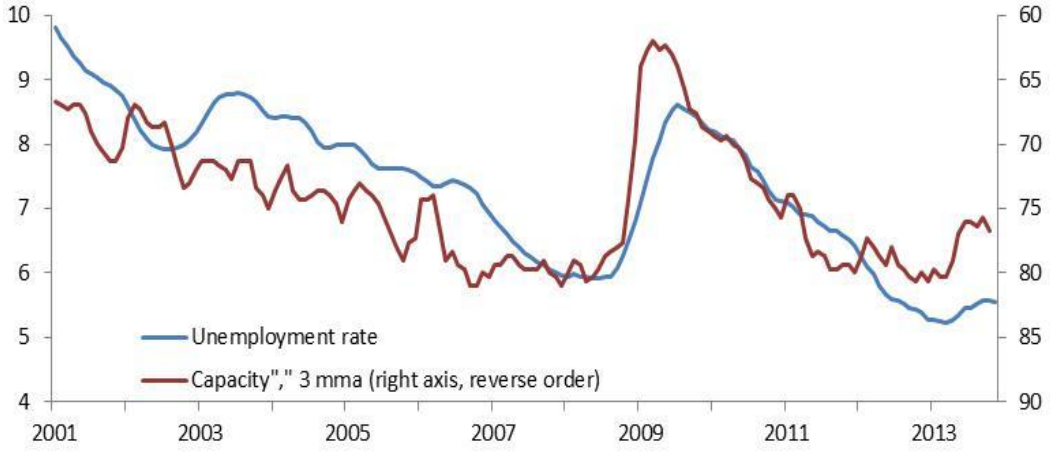
Table 2: Contribution to Growth by Sectors, percentage points

	2011	2012	2013
Tradable sectors	2.0	0.5	0.4
Non-tradable sectors	2.1	3.0	1.0
Public sector	-0.2	0.1	0.1
Discrepancy	-0.2	-0.2	-0.1

Source: Rosstat and World Bank staff estimates

The rate of capacity utilization fell towards the end of 2013 along with deteriorating business confidence. After having been rather sticky during 2012, the level of capacity utilization remained in the first half of 2013 near the upper historical limits of 80 percent, but it started falling during H2 2013. The adjustment in capacity utilization can be explained with the observed pessimistic sentiments on part of the producers. The seasonally adjusted HSBC Russia Manufacturing PMI remained below 50 during Q4 2013 and in January 2014, indicating a decline in economic activities in the manufacturing industries. Despite the somewhat lower capacity utilization, in our view the economy still faces structural supply constraints. These have implications for growth-supporting policies. Investment activities remained subdued for more than a year, with companies continuing inventory destocking and the labor market relaxed only marginally, relative to 2012 conditions.

Figure 8: Capacity Utilization in Industry, percent, 3-month moving average



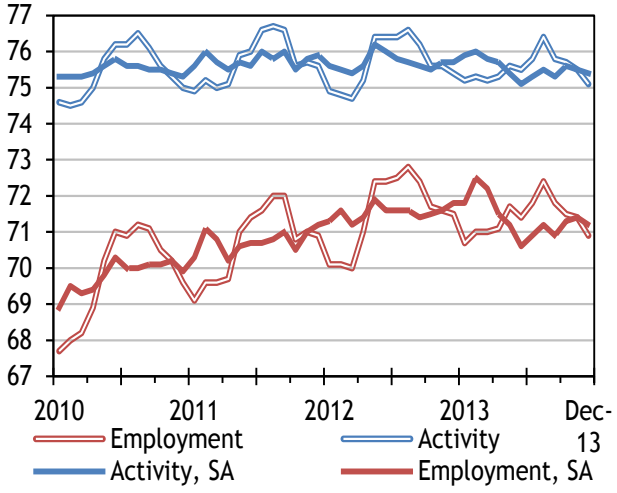
Source: Haver Analytics

1.3 Labor Market 2013 – Demand and income growth stabilize

Key labor market indicators reflected the stagnation in the real sector. As a result, income growth stabilized at a new lower level and led to a slight moderation in the growth of the productivity gap. The slowdown in real-sector growth translated into a slight increase in the poverty rate for 2013.

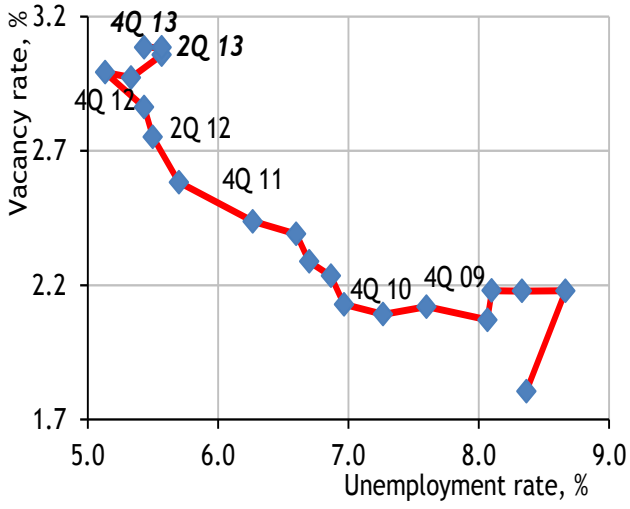
The demand for labor as measured by the vacancy rate did not change significantly during 2013 (Figure 10). Total employment declined sharply in the first half (H1) of 2013, but the seasonally adjusted indicator ended the year at 71.2 million people compared to 71.8 million people in 2012 (Figure 9). As results, the unemployment rate remained unchanged in H2 2013 at a seasonally adjusted level of 5.5 percent, suggesting a balanced labor market. On the regional level, against a backdrop of low population and labor mobility, unemployment rates remained highly heterogeneous across regions. The regions with the lowest unemployment in Q4 2013 were the largest Russian metropolitan areas: Moscow and St. Petersburg (2.0 percent, respectively), followed by Samara oblast (2.7 percent), Moscow oblast (2.8 percent) and Magadan oblast (2.9 percent) in the Far East. The highest unemployment rates are traditionally registered in the Northern Caucases federal district of Ingushetia (39.5 percent), Chechnya (25.7 percent) and the Kalmyk and Tuva republics (12.6 and 19.6 percent respectively). The latter also represent the two regions with highest poverty rates in Russia (Figure 14). Women's contribution to the labor market was reduced throughout 2013, with the female unemployment rate increasing and the average number of working hours for women slightly declining.

Figure 9: Number of employed and economically active population, million people



Source: Rosstat and World Bank staff estimates

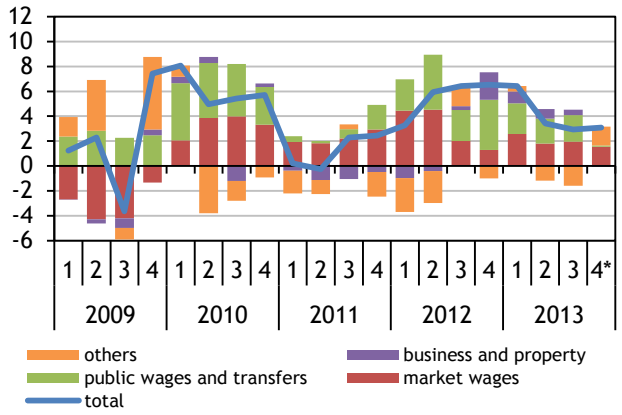
Figure 10: Beveridge curve, percent



Source: Rosstat and World Bank staff estimates

Real disposable income grew at 3.3 percent during 2013, compared to 4.6 percent in 2012. Disposable income growth decreased in the second half of 2013 to 2.9 percent from 4.2 percent in H1. Average income growth for the last five years stood at around 3.4 percent. The composition of growth remained driven by market wages (labor income) followed by public wages and pensions (transfers) (Figure 11). However, real wage growth decelerated in Q4 2013 as public wage growth slightly diminished. Although Q4 2013 data is still preliminary, the decline in public wages affected the composition of income growth. The contribution of public wages and transfers to income growth was lower than before, compared to other sources, such as market wages (Figure 11). Together with household credit as a share of GDP (Figure 19), households' indebtedness continued to grow from to 25.6 percent of disposable income at end-2013 from 21.9 percent in December 2012.[4] Considering continued high interest rates of 20-25 percent on a 3-year loan, pressure on consumption has increased as a significant percentage of household's disposable income (of up to 5 percent[5]) is used for servicing this debt.

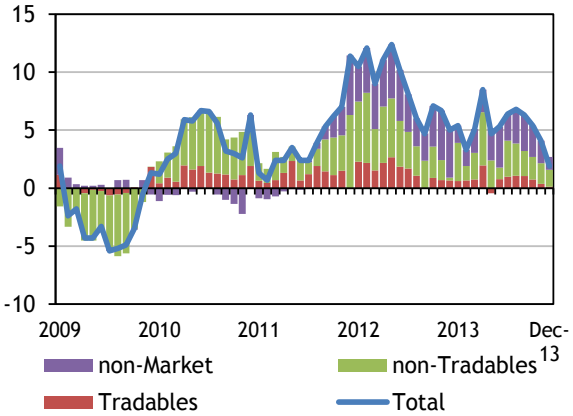
Figure 11: Contribution to income growth, percentage points, y-o-y



* For Q4 2013 the data for composition is preliminary

Source: Rosstat and World Bank staff estimates

Figure 12: Households' real wages dynamics, y-o-y growth

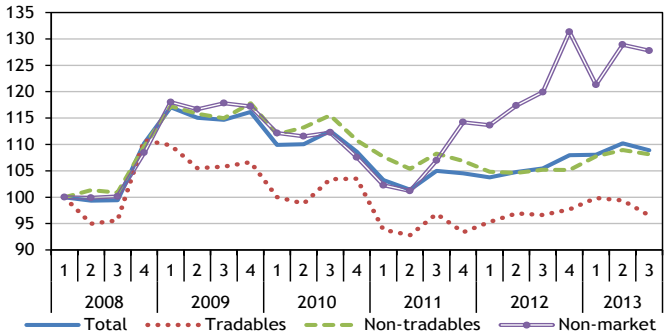


Source: Rosstat and World Bank staff estimates

Box 2. The gap between productivity and wages is highly unequal levels across sectors

The deceleration in GDP growth and shrinking total employment led to a moderation in the growth of productivity per worker. As real wages grew more slowly in line with productivity, the gap between real wages and total productivity leveled out. However, the situation continued to differ across the main economic sectors. In the largest sector of the Russian economy, the non-tradable sector (market services, construction, transport, etc.), which accounts for half of all jobs wage growth, was in line with productivity growth. But in the tradable sector (mining, manufacturing and agriculture), which is experiencing price competition with foreign goods, wage growth was actually lower than productivity growth, improving its competiveness. The sector where the gap between wages and productivity remained the highest was the non-market services sector, which includes education, health, public administration and defense. Wages there continued to grow much faster than productivity.

Figure 13: Gap between real wages and productivity growth by sectors, y-o-y growth



Source: Rosstat and World Bank staff estimates

[4] As a share of GDP consumer loans increased to 15.0 of GDP at end- 2013, compared to 12.4 percent in December 2012. However, the stock of household debt increased at a slower rate of 28.7 percent in 2013 compared to 39.3 percent in 2013 (y-o-y).
[5] World Bank staff estimate.

Poverty increased slightly during 2013 as a result of the observed economic slowdown, which brought with it a deceleration in nominal income growth (Table 1). Food and services-CPI continued to outpace headline inflation. As a result, the poverty line was increasing faster than the nominal income for lowest quintiles. The poverty rate increased slightly in the beginning of the year and remained at this level of 11.9 percent for the remainder of 2013 (seasonally adjusted). Regional poverty rates are very unequal (Figure 14). The lowest rates were registered in the most developed regions of Central Russia (e.g. Moscow region and Kaluga) as well as in the resource rich regions (Yamalo-Nenets autonomous okrug and Tatarstan). The highest rates are in the Eastern Siberian regions (Altai, Tuva republics), some regions of the Far East (Kamchatka oblast) and in the South of Russia (Kalmykia). Income inequality did not change during 2013.

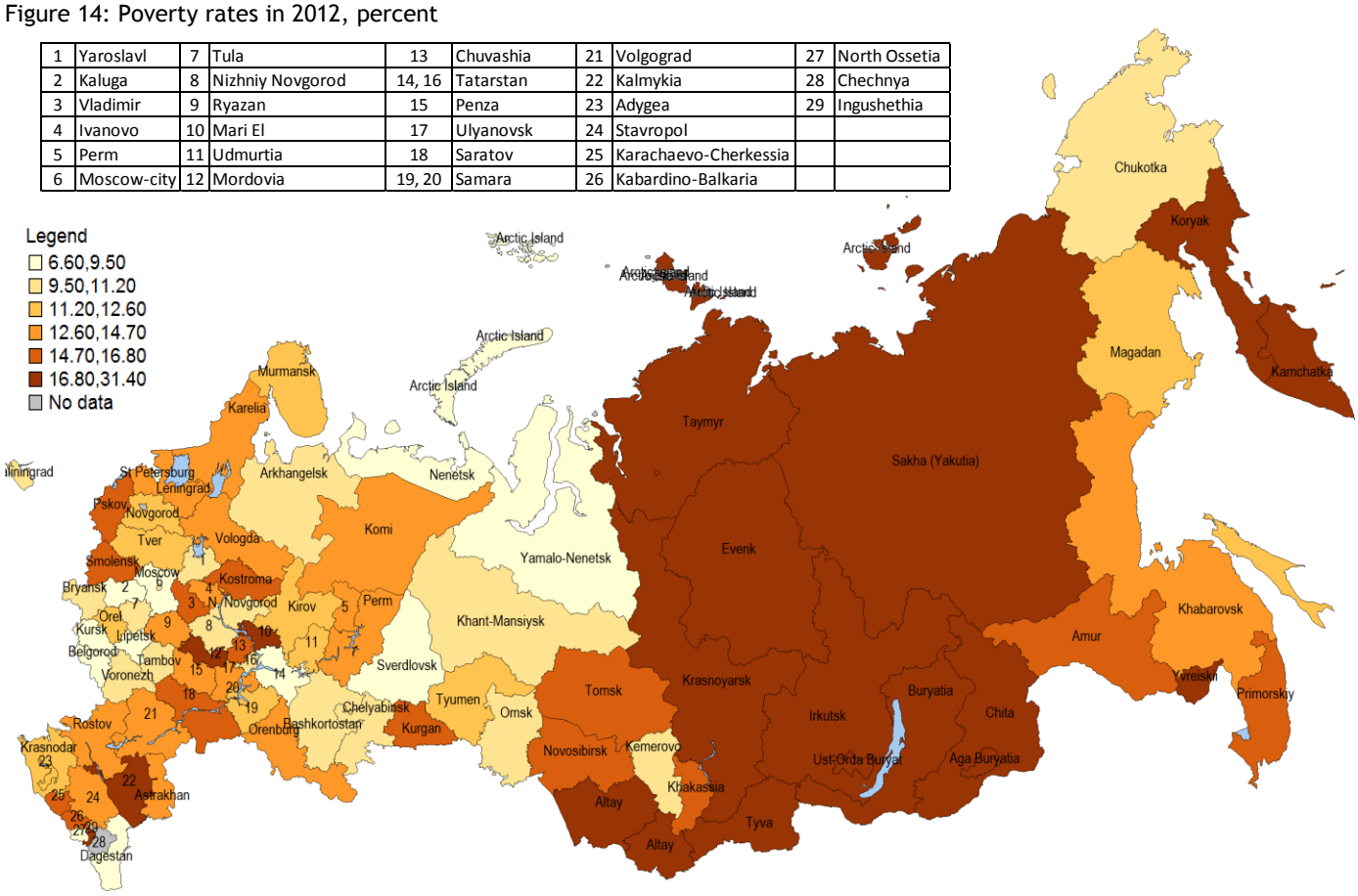
Table 3: Poverty rates in Russia, percent

period	*2010*	*2011*	*2012*	*1Q 2013*	*2Q 2013*	*3Q 2013*
poverty rate, percent	12.5	12.7	11.0	13.8	13.0	12.6

Source: Rosstat and World Bank staff estimates

Figure 14: Poverty rates in 2012, percent

1	Yaroslavl	7	Tula	13	Chuvashia	21	Volgograd	27	North Ossetia
2	Kaluga	8	Nizhniy Novgorod	14, 16	Tatarstan	22	Kalmykia	28	Chechnya
3	Vladimir	9	Ryazan	15	Penza	23	Adygea	29	Ingushethia
4	Ivanovo	10	Mari El	17	Ulyanovsk	24	Stavropol		
5	Perm	11	Udmurtia	18	Saratov	25	Karachaevo-Cherkessia		
6	Moscow-city	12	Mordovia	19, 20	Samara	26	Kabardino-Balkaria		



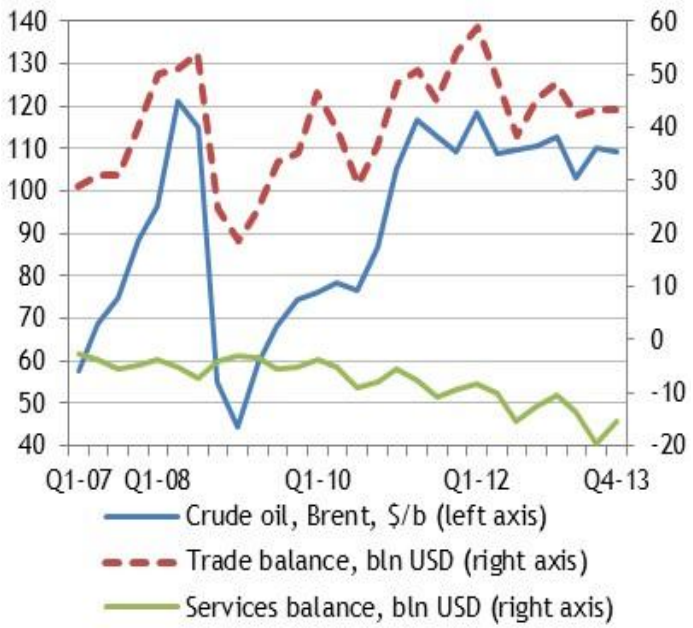
1.4 Balance of Payments 2013 — A weakening current account and increased vulnerability

Russia's balance of payments (BoP) position weakened in 2013 while the current account surplus shrank to less than half of its 2012 level. During the second half of the year, capital outflows from the private sector picked up as a result of the scaling back of the US monetary stimulus and large external debt payments.

Russia's BoP position has become more vulnerable to terms-of-trade shocks associated with a potential drop in resource prices. The current account (CA) continued deteriorating, which was especially reflected in an increase of the non-oil CA deficit, which reached US$315.8 (14.1 percent of GDP) compared to US$274.8 (13.8 percent of GDP) in 2012. The CA remained in surplus, but decreased by more than half, from US$72 billion (3.6

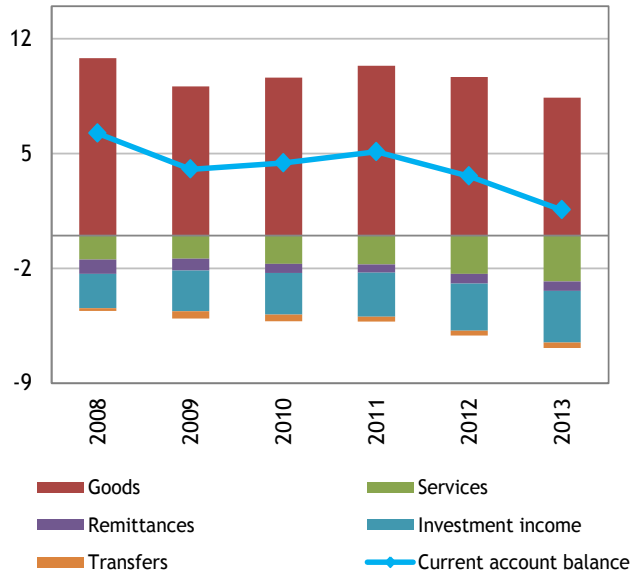
percent of GDP) in 2012 to US$33 billion (1.6 percent of GDP) in 2013 (Figure 15Figure 16). Three main factors contributed to this decrease: first, the trade surplus shrank to US$177.3 billion (8.5 percent of GDP) from US$192.3 billion (9.7 percent of GDP) in 2012 largely due to lower values of crude oil and non-oil exports (Figure 15). Second, the balance of services deteriorated to a deficit of US$59.0 billion in 2013 from a deficit of US$46.5 billion in 2012. Finally, the deficit of the investment income account increased to US$66.2 billion (3.1 percent of GDP) in 2013 from US$56.8 billion (2.9 percent of GDP) in 2012 as companies increased interest payments on outstanding debt and scaled up dividend payments (Figure 16).

Figure 15: Trade and services balances and oil prices



Source: CBR; and World Bank staff estimates

Figure 16: Current account balance, percent of GDP



Source: Rosstat and World Bank staff estimates

BoP vulnerability was amplified by more volatile and weakening capital and financial accounts. In a flexible exchange-rate regime, CA deterioration is balanced out by improvements in the capital account, other things being equal. Yet Russia's capital and financial accounts deteriorated to a deficit of US$42.8 billion (2.1 percent of GDP) in 2013, compared to a deficit of US$26.5 billion (1.3 percent of GDP) in 2012, putting additional pressure on the Ruble. Net capital flows from the private sector remained high and volatile. They were negatively affected by uncertainty regarding QE tapering, poor investors' sentiments and unrealized growth prospects. However, when adjusted for currency swaps, they amounted to US$62.5 billion dollars, the same level as the year before. Partly due to large external debt payments, capital outflows from the non-financial corporations intensified in the second half of 2013 to US$44.0 billion from US$12.7 billion in H1 2013 (Table 5), adding to the volatility in capital flows. Chronic structural problems in the economy and falling profit margins of Russian assets made them less attractive to investors, who increasingly preferred to move their funds abroad, adding to pressures on the BoP and its vulnerability.

The corporate sector reduced foreign borrowing in the second half of 2013. Apart from slowing investment activities, the increased cost of borrowing and limited access to international capital market may have reduced the borrowing and debt-rollover capacity of Russian corporations. However, Russia's external debt increased to US$732 billion (35.5 percent of GDP) by the end of 2013 from US$636 billion (31.7 percent of GDP) at the end of 2012 (Table 6). It is noteworthy that the new debt was predominantly accumulated by state or quasi-state companies and banks, while exposure of private banks and companies changed marginally.[6] Also, the bulk of new credits by non-financial corporations (US$32.5 out of US$35.8 billion) was acquired during Q1 2013. To a large extent, this increase is related to the purchase of Rosneft shares by British Petroleum as part of the TNK deal concluded in Q1 2013. Foreign borrowing from the corporate sector in Russia decreased since Q2 2013.

[6] Foreign liabilities of non-financial corporations increased by US$73 billion in 2013 amounting to US$437.8 billion by end-December, while banks' exposure rose by only US$13.3 to US$214.9 billion in the same period.

Table 4: Balance of Payments, 2007–2013, US$ billions

	2008	2009	2010	2011	2012	2013*	Q1 2012	Q2 2012	Q3 2012	Q4 2012	Q1 2013*	Q2 2013*	Q3 2013*	Q4 2013*
Current account balance	103.9	50.4	67.5	97.3	72.0	33.0	39.5	16.2	5.8	10.5	25.1	2.6	0.6	4.7
Trade balance	177.6	113.2	147.0	196.9	192.3	177.3	59.0	49.3	38.5	45.5	48.3	42.5	43.2	43.3
Non-oil current account balance	-206.2	-140.3	-186.6	-244.5	-274.8	-315.8	-50.7	-69.2	-75.4	-79.5	-61.7	-81.3	-86.8	-85.8
Capital and financial account	-139.8	-40.6	-21.6	-75.6	-31.7	-43.4	-29.6	0.8	-4.2	1.3	-12.8	-8.8	-6.8	-14.9
Errors and omissions	-3.1	-6.4	-9.1	-8.7	-10.3	-11.7	-5.3	-2.0	-0.1	-2.9	-7.3	1.8	-1.2	-5.0
Change in reserves (- = increase)	38.9	-3.4	-36.8	-12.6	-30.0	22.1	-4.6	-15.0	-1.5	-8.9	-4.9	4.4	7.4	15.2
Memo: average oil price (Brent, US$/barrel)	96.9	61.5	79.7	111.1	112.0	108.9	118.7	108.7	109.9	110.5	112.9	103.0	110.1	109.4

Source: CBR * Preliminary estimates

Table 5: Net Capital Flows, 2007–2013, US$ billions

	2008	2009	2010	2011.0	2012	2013.0	Q1 2012	Q2 2012	Q3 2012	Q4 2012	Q1 2013*	Q2 2013*	Q3 2013*	Q4 2013*
Total net capital inflows to the private sector	*-133.6*	*-57.5*	*-30.8*	*-81.4*	*-54.6*	*-62.7*	*-33.8*	*-4.7*	*-7.9*	*-8.2*	-28.2	-6.2	-11.6	-16.6
Net capital inflows to the banking sector	-55.2	-32.2	15.9	-23.9	18.5	-6.0	-9.7	11.6	7.7	8.9	-17.4	-4.4	10.9	4.9
Net capital inflows to the non-banking sector	-78.3	-25.3	-46.7	-57.4	-73.1	-56.7	-24.1	-16.3	-15.6	-17.1	-10.9	-1.8	-22.5	-21.5

Source: CBR * Preliminary estimates

Table 6: Russia's External Debt, US$ billions

	Jan-11	Jul-11	Oct-11	Jan-12	Apr-12	Jul-12	Oct-12	Jan-13	Apr-13	Jul-13	Oct-13	Jan-14
Total debt	**488.9**	**538.9**	**527.8**	**538.9**	**557.5**	**570.6**	**598.9**	**636.4**	**690.2**	**706.2**	**714.2**	**732.0**
Corporate	**442.4**	**491.0**	**482.6**	**492.6**	**509.1**	**517.1**	**538.8**	**566.4**	**613.2**	**631.3**	**634.1**	**652.8**
Banks	***144.2***	***159.0***	***157.3***	***162.8***	***169.2***	***175.4***	***189.9***	***201.6***	***205.9***	***211.9***	***207.1***	***214.9***
of which Private Banks	*80.8*	*89.1*	*86.8*	*89.5*	*90.6*	*78.7*	*84.1*	*86.2*	*81.1*	*82.4*	*79.4*	*n/a*
Non-financial corporations	***298.2***	***332.0***	***325.3***	***329.8***	***339.8***	***341.7***	***348.9***	***364.8***	***407.4***	***419.4***	***427.1***	***437.8***
of which Private Non-fin. Corporations	208.3	236.3	228.9	227.8	236.0	234.2	237.7	251.3	254.1	258.0	263.4	*n/a*

Source: CBR. As for the beginning of the month

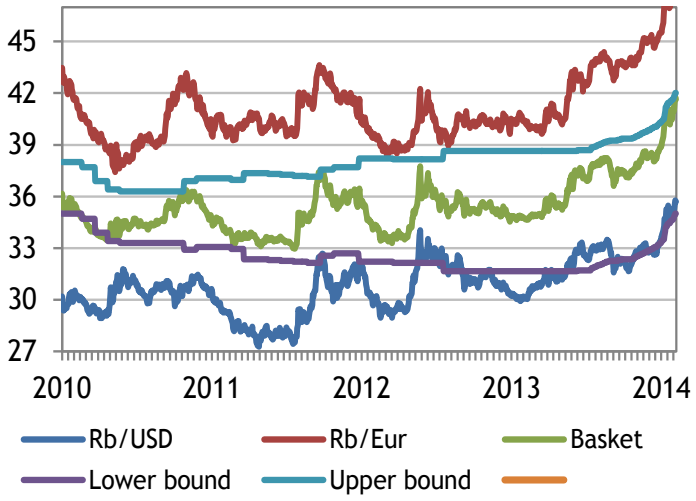
1.5 Monetary Policy and Financial Sector 2013 — Currency volatility and elevated credit risk

The Ruble came under increased pressure as the current account deteriorated and investors became more risk-averse in anticipation of the impact of the scale-down of the US monetary stimulus. Credit risks rose as firms and households found it increasingly difficult to service their debts. Inflation pressure remained high in 2013, driven by food and service prices.

Volatility of the Russian currency increased during 2013. The Central Bank of Russia (CBR) responded with a scaled-up intervention, drawing upon its foreign currency reserves. The Ruble was under increasing pressure since Q2 2013, triggered by the ongoing deterioration of the CA and by higher volatility in capital outflows. This was in part related to uncertainties around the scaling back of the U.S. monetary stimulus. However, unrealized growth expectations and large foreign debt payments by the corporate sector plaid a more prominent role in Russia. Despite a considerably increase of CBR's exchange-rate interventions, the Ruble depreciated 2.4 percent against the US dollar and 4.1 percent against the bilateral currency basket in 2013. The CBR spent about US$28.2 billion to support the currency, compared to US$5.6 billion in 2012 (Figure 17). As a result, the CBR's foreign-exchange reserves decreased by 5.5 percent to US$509.6 billion by end-2013 from US$537.6 billion at the end of 2012.

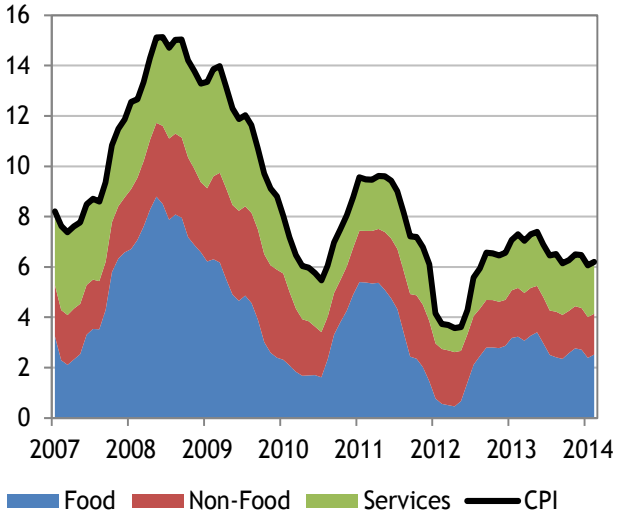
The 2013 Consumer Price Index (CPI) increased by 6.5 percent, exceeding the Central Bank target by 0.5 percentage points. Inflation pressures remained high during most of 2013, driven by non-monetary factors. Higher-than-expected prices for food (7.3 percent) and services (8.0 percent) pushed inflation up, especially in the first and last quarters of 2013 (Figure 18). The seasonal retreat in inflation during the summer months did not bring it down as much as expected. The CBR policy of keeping the key policy rates unchanged during 2013 appeared to be consistent with the changing economic fundamentals of a tight labor market, high credit growth and an increased level of monetization of the economy (M2/GDP ratio increased to 47.1 percent in 2013 from 44.3 percent in 2012). The central bank adhered to its regulatory commitment to complete its move to inflation targeting by the end of 2014 by resisting rising political and public pressures to relax monetary policy.

Figure 17: Exchange rate and its bilateral band



Source: CBR, World Bank staff calculations

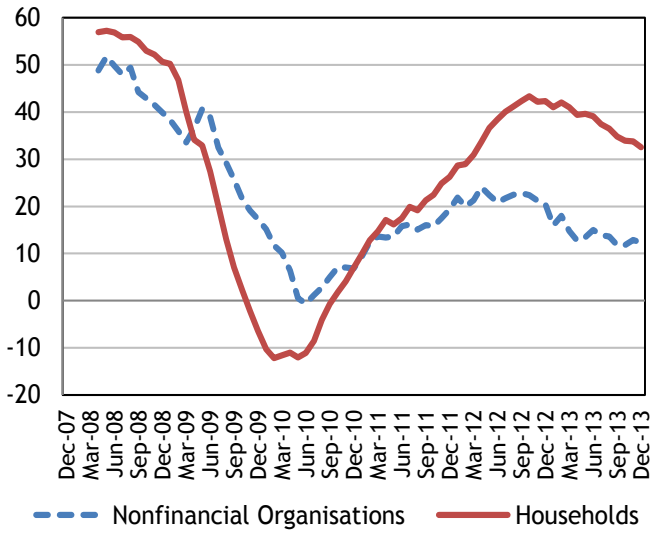
Figure 18: CPI inflation by component, percent, y-o-y



Source: Rosstat

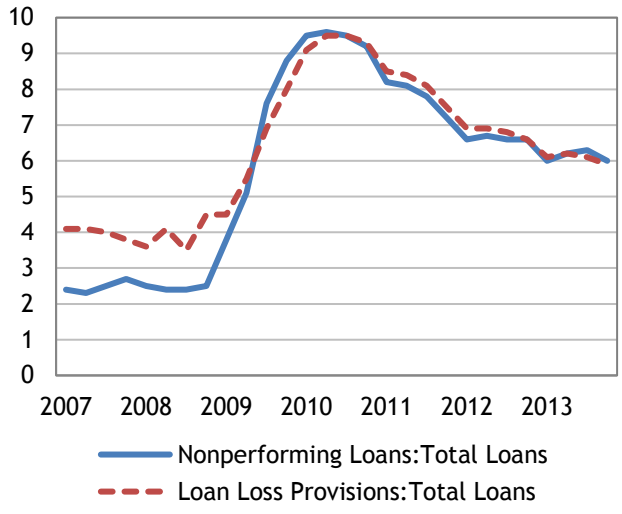
Credit growth remained significant in 2013, elevating credit risk as firms and households found it increasingly difficult to service debt. The stock of bank credit reached 53.1 percent of GDP by the end of 2013, compared to 48.2 percent in 2012. Despite the slowing economy, average credit growth was still very high: for household, 33.9 percent in 2013 (41.5 percent in 2012) and 19 percent for all lending. Credit growth to firms remained the same during 2013, averaging 12.7 percent as in 2012. Households spent an increasing share of their income to service loans (see labor market section).[7] As a result, the share of non-performing loans (NPLs) for households (category IV and V) increased to 6.5 percent in 2013 from 5.2 percent in 2012. The recent slowing trend in income growth and the gradual relaxation of the labor market are likely to contribute further to an increase in NPLs share by households.[8] Some companies also lost their debt-servicing capacity, to decreasing profit margins during 2013. CBR statistics shows that the share of NPLs of firms (categories IV and V) more than doubled last year to 3.3 percent at end-December 2013 from 1.4 percent at the end of 2012. Moreover, the share of the worst-quality loans (category V, provisioned by 86 percent) increased the most, to 2.3 percent from 0.8 percent in the corresponding periods.

Figure 19: Credit growth, percent, y-o-y



Source: CBR, World Bank staff calculations

Figure 20: Nonperforming loans and loan loss provisions, percent of total loans



Source: CBR, World Bank staff calculations

[7] The Russian household debt/income ratio increased from 15 percent in 2010 to around 24 percent in 2013.
[8] Also, there is a 1-2 year time-lag between households defaulting on loans and these loans actually showing up as NPLs, due to the definition of NPLs and the first immediate automatic restructuring attempts.

While aggregate financial indicators for the banking system remained solid, the CBR intensified its supervisory oversight and started to clamp down on financially non-viable banks (Box 3**).** By Q3 2013, average lending interest rates in the system hovered around 9.5 percent while deposit rates held at around 5.5 percent—a very healthy 4.0 percent intermediation spread. Also, the capital adequacy ratio for the system stood at 13.5 percent at end-December, well above the minimum. Gross NPLs were 6.0 percent of total loans at year-end, the same as at the start of the year. As part of strengthening its supervisory function, the CBR revoked licenses of several banks during the second half of 2013 and, in the first three months of 2014 alone, of 15 banks and several non-bank credit organizations.

Box 3. Sanitizing the banking system in Russia

During 2013, the risk of maintaining the quality of the credit portfolio increased and CBR started to revoke licenses of financially non-viable banks. CBR canceled the licenses of 29 banks between early 2013 and end-February 2014. While some egregious cases pertained to money laundering, several appeared to have been related to inappropriate-party lending, fraudulent reporting, an inability to pay creditors, overvalued assets and asset-quality issues. These factors have essentially made several banks insolvent (they became so-called 'zombie' banks) or illegal (in the case of anti-money laundering operations). A proposed increase by CBR in the minimum capital requirement for banks and other prudential requirements would adversely affect around 180 banks, of which 50 could be required to close or be bought out. The closure of these banks is unlikely to significantly affect household borrowing, as many banks being closed were pocket banks set up for specific businesses, individuals or related parties. The cleaning up of the banking system by CBR is a welcome initiative, but clear criteria by CBR for doing so should be set out to avoid generating any panic in the markets.

1.6. Government Budget 2013 – Balances under pressure

The overall fiscal balance worsened slightly on a year-to-year basis and the non-oil deficit continued to exceed 10 percent of GDP. The consolidated budget ended in a deficit for the first time since the crisis period as sub-national public finances weakened. Russia's fiscal buffers increased moderately, but their investment decisions became subject to political pressures.

Preliminary numbers showed the federal budget was executed at a deficit of 0.5 percent of GDP in 2013, compared to a deficit of 0.1 percent of GDP a year earlier (Table 7). The non-oil deficit improved slightly from 10.4 to 10.3 percent of GDP, but remained under the envisioned reduction to 9.7 percent of GDP at the beginning of the year. Federal budget revenues dropped to 19.5 percent of GDP in 2013 in from 20.5 percent in 2012. This decline was caused by a fall in both oil and non-oil revenue. Federal budget oil revenue (export and import duties) decreased in 2013 to 9.8 percent of GDP from 10.3 percent of GDP a year before. At the same time, the average Urals oil price (US$107.9 per barrel in January-December 2013) was only US$2.5 below average Urals oil price for the same period of 2012 and stayed above the oil prices envisaged in the 2013-2015 Budget Law (US$97 per barrel for 2013). This actually increased oil revenue inflows in comparison to the budgeted numbers. Federal budget non-oil revenues decreased by 0.5 percent of GDP from 10.2 percent in 2012 to 9.7 percent in 2013, due to decline in VAT proceeds. Federal expenditures shrank in 2013 slightly by 0.6 percent of GDP to 20.0 percent of GDP over last year. On a year-to-year basis, federal expenditures were cut primarily for social and healthcare expenditures: 0.6 percent of GDP less transfers to the Pension Fund and 0.3 percent of GDP reallocation of the federal expenditure assignments to the Medical Insurance Fund, as well as for subsidies to companies by 0.5 percent. On the other hand, defense expenditures increased by 0.2 percent of GDP over the same period.

Table 7: Federal budget 2011-2013, percent of GDP

	2011	2012	2013	2013	2013
	Execution	Execution	Budget Law	2013 Dec. Amendment	Execution
Expenditures	20.1	20.6	20.1	20.1	20.0
Revenues	20.9	20.5	19.3	19.4	19.5
Balance	0.8	-0.1	-0.8	-0.7	-0.5
Oil Revenues	10.4	10.3	8.9	9.7	9.8
Non-Oil Balance	-9.6	-10.4	-9.7	-10.5	-10.3
Urals oil price, US$/barrel	109.3	110.4	97.0	97.0	107.9

Source: Ministry of Finance, Economic Expert Group, World Bank staff calculations

A weak sub-national public finance situation led to the first deficit of the consolidated budget[9] since the crisis period. In 2013, the consolidated budget balance continued its decline for the second consecutive year, ending the year at a 1.3 percent of GDP deficit (Table 8). This reflects a deterioration of 1.7 percent of GDP compared to the previous year. Consolidated budget revenues dropped in 2013 to 36.1 percent of GDP from 37.0 percent a year earlier, again continuing a two-year trend in revenue decrease. Unfortunately, this decline was accompanied by a reverse trend on the expenditure side. Consolidated expenditures were growing from 2011 from 35.9 percent of GDP to 36.6 percent in 2012, and 37.4 percent in 2013.

Table 8: Consolidated Budget and Consolidated Subnational Budget in 2011-2013, percent of GDP

	2011	2012	2013
	Execution	Execution	Execution
Consolidated Budget			
Expenditures	35.9	36.6	37.4
Revenues	37.5	37.0	36.1
Balance	1.6	0.4	-1.3
Consolidated Subnational Budget			
Expenditures	13.8	13.3	13.2
Revenues	13.7	12.9	12.2
Balance	-0.1	-0.4	-1.0
Corporate Profit Tax	3.5	3.2	2.6

Source: Ministry of Finance, World Bank staff calculations

Increased fiscal pressures on consolidated budget stemmed from lower-than-expected subnational revenues. As a share of GDP, subnational revenues were steadily decreasing since 2011, dropping by 1.5 percent of GDP in 2013 compared to 2011 and by 0.7 percent compared to 2012. The trend was driven by lower corporate profits, especially in manufacturing, as a result of the economic slowdown. Corporate-profit tax proceeds dropped at the subnational level from 3.5 percent of GDP in 2011 to 3.2 percent in 2012, and 2.6 percent of GDP in 2013. On the expenditure side, subnational governments were unable to make adjustments in line with the decreasing revenues due to commitments to increase salaries of teachers and medical personnel. In 2013, subnational expenditures fell by a moderate 0.1 percent of GDP compared to 2012. Consequently, the subnational fiscal outturn worsened during 2013 and the subnational budget deficit increased to 1.0 percent of GDP compared to 0.1 percent in 2011 and 0.4 percent in 2012.

Russia's fiscal buffers increased moderately in 2013, but some discretion in their investment was introduced following political pressures. By the end of 2013, the Reserve Fund increased by 1.2 percentage points to 4.3 percent of GDP after replenishment at the beginning of the calendar year. The National Welfare Fund (NWF) decreased by 0.1 percent of GDP over the same period, although both funds increased in nominal terms due to the effect of the ruble devaluation, as their portfolio consists of a mix of different currencies. Both funds amounted to 8.6 percent of GDP, thus representing about half of the amount accumulated by the end of 2008. To allow for investments of the NWF into Ukrainian treasury bills, on December 23, 2013, Government passed a special resolution to change the original law on investing NWF resources. It allowed the fund to invest up to 10 percent of its volume into securities that had lower ratings than the originally prescribed AAA, per special Government decision. Later in December, the first US$3 billion tranche (of a planned US$15 billion) was used to acquire Ukrainian treasury bills with NWF proceeds.[10]

[9] The consolidated budget includes the federal budget, the subnational budgets and extra-budgetary funds, e.g. pension and social security.
[10] This was part of a broader package of about US$15 billion, which would have been partly funded through the purchase of Ukrainian T-bills by the National Welfare Fund.

Part II. Economic Outlook

Global markets have so far seen little disruption from the growing tension in between Ukraine and Russia, and oil markets remained stable. Growth of the world economy is projected to accelerate this year, with high-income economies appearing to finally turn the corner six years after the global financial crisis. However, markets are likely to remain volatile, as demonstrated by recent instability following the QE tapering commencement in the U.S. The World Bank projects oil prices to average US$103/bbl during 2014, given stable demand and increasing non-OPEC supply. The World Bank developed two alternative scenarios for Russia's 2014-2015 growth outlook in response to the higher-risk environment since political uncertainties around the Crimean crisis in early March 2014 led to increased market volatility. Confidence weakness continues to weigh down on domestic demand suggesting, first, that consumption growth is likely to slow and stabilize at a lower level than in previous years. Second, our growth outlook projects that at the margin, the rate of growth will be increasingly dependent on the recovery in investment demand. Third, in the short-term, growth will be impacted by the geopolitical tension that started with the Crimean crisis and depend on how it will be resolved. The World Bank's low-risk scenario assumes a limited and short-lived impact of the Crimea crisis and projects growth to slow to 1.1 percent in 2014 and slightly picking up to 1.3 percent in 2015. The World Bank's high-risk scenario assumes a more severe shock to economic and investment activities due to the Crimean Crisis and projects a contraction in output of 1.8 percent for 2014. We expect in both scenarios that non-monetary inflation pressures from the ongoing Ruble depreciation will increase inflation and put our projection slightly higher than the upper end of the CBR targeted range for 2014. The Government's medium-term fiscal outlook has consolidation at its core, but the targets for expenditure control and revenue increases are ambitious given the current low-growth environment and mounting political pressures. For that reason, our fiscal projections divert from the Government's medium-term framework. Risks to the global outlook remain prominent and they suggest higher market volatility. Russia's long-term outlook will depend on a sustained positive shift in investors' and consumers' confidence. There is the risk that as Russia's government is put back into crisis mode, attention will be diverted to manage short-term issues, while the medium-term structural reform agenda languishes.

2.1 Global Outlook - Improving growth prospects with higher market volatility

Global markets have so far seen little disruption from the growing tension between Ukraine and Russia, and oil markets have remained stable. Growth of the world economy is projected to accelerate this year, with high-income economies appearing to finally turn the corner six years after the global financial crisis. However, markets are likely to remain volatile, as demonstrated by recent instability following the QE tapering commencement in the U.S. The World Bank projects oil prices to average US$103/bbl during 2014, given stable demand and increasing non-OPEC supply.

Growing tension in Ukraine and Russia since late February has so far caused relatively limited disruption in global financial markets, but escalation of geo-political tension between Russia and the EU and the U.S. remains a key risk. Although financial markets in Russia and Ukraine have suffered large sell-offs in response to the crisis, global market reaction has so far been relatively muted. The VIX index, a gauge of global risk aversion, jumped 14 percent in early March and gold prices, a gauge of geopolitical risk, were up by 15 percent by mid-March, but both have subsequently come down. Wheat and maize prices, however, were up 15 percent and 8 percent on March 19 compared with a month earlier.

Global GDP growth is projected to increase to 3.2 percent in 2014 and 3.4 percent in 2015, compared to 2.4 percent in 2013 (Table 9). Most of the acceleration is expected to come from high-income countries, as the drag on growth from fiscal consolidation and policy uncertainty diminishes and private-sector growth gains a firmer footing. High-income growth is projected to strengthen from 1.3 percent in 2013 to 2.2 percent this year and 2.4 percent in 2015. Growth in developing and emerging countries is projected to pick up modestly from 4.8 percent in 2013 to 5.3 percent this year, and 5.5 percent in 2015. Stronger high-income growth and import demand will be an important tailwind for developing countries' exports, which should help compensate for tighter global financial conditions.

Table 9: Global real GDP growth, percent

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

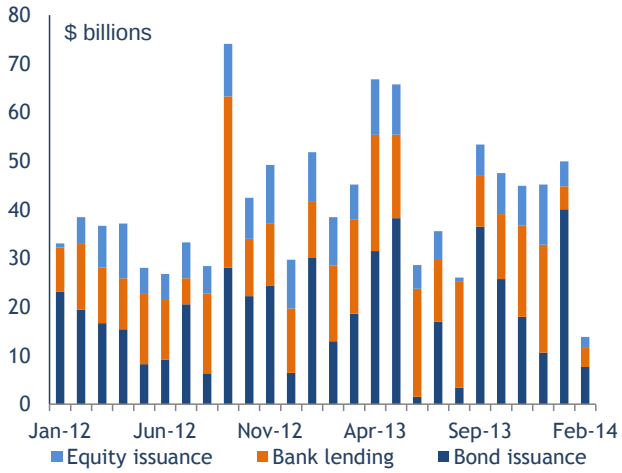
Source: World Bank Global Economic Prospects Group and World Bank Russia team
Note: * The number in brackets refers to the World Bank high-risk scenario, while the other to the low-risk scenario.

The Federal Reserve began tapering its QE program in January, prompted by the improving growth prospects of the U.S. economy. Financial market reaction was initially muted, with long-term U.S. Treasury yields remaining stable and volatility on currency markets remaining low, suggesting that a large part of the tapering impact had already been priced in. However, the period of relative market calm was broken at the end of January following the sudden depreciation of Argentina's peso, worries about the Chinese economy and other country-specific economic and political factors. Gross capital flows to developing and emerging countries reached a new record low in February (Figure 21). Stock markets and currencies in a number of emerging economies came under pressure, and several large middle-income economies embarked on aggressive policy-tightening to relieve the stress on their currencies and domestic inflation, including Argentina, Brazil, India, Indonesia, Turkey, and South Africa. The growth outlook for developing countries still remains positive in aggregate but, countries that have had to significantly increase interest rates in response to the recent market turmoil and where inflation is rising on account of weaker currencies can face weaker growth prospects. Should global interest rates increase more abruptly or market volatility prevail, more disorderly adjustments cannot be ruled out.

Despite the Russia-Ukraine conflict, oil prices have been remarkably stable. In fact, crude oil prices have been down 4.5 and 2.5 percent since the beginning of March. Russia is the world's largest oil supplier, accounting for 13 percent of global oil production. It also contributes 30 percent of the natural gas consumed in Europe. The World Bank expects nominal oil prices to average US$103/bbl during 2014 (down from $104/bbl in 2013) and decline to $100/bbl in 2015. In the longer term, prices in real terms are expected to fall due to growing supplies of unconventional oil, efficiency gains, and (less so) substitution away from oil. The key assumption underpinning these projections reflects the upper-end cost of developing additional oil capacity from Canadian oil sands, currently estimated at US$80/bbl in constant 2014 dollars. Since the start of 2014, crude oil prices have continued to be range-bound. Meanwhile, the U.S. mid-continent benchmark West Texas Intermediate (WTI) has

strengthened in recent weeks as refineries' utilization rates are high and the pipeline capacity draws stocks from the landlocked delivery point of Cushing, Oklahoma. Stocks at Cushing were at a four-month low of 34.8 million barrels at the end of February. The spread between WTI and Brent, the international benchmark, has narrowed to US$6.5/bbl, also a four-month low.

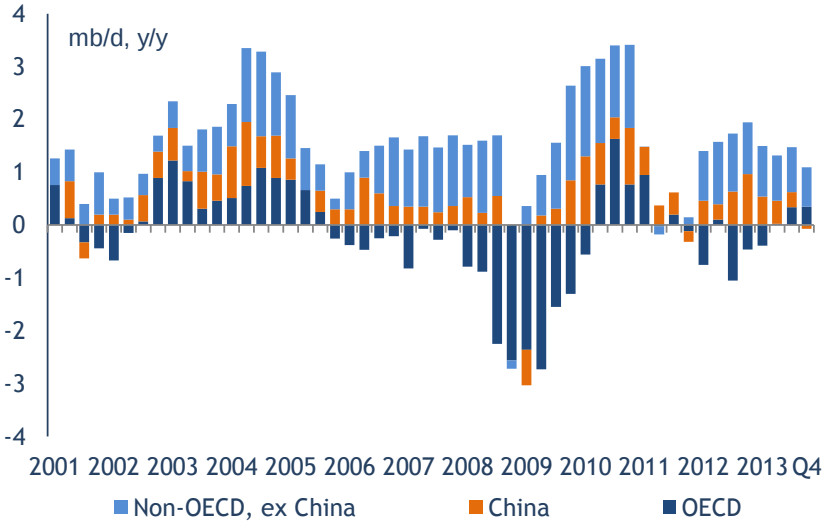
Figure 21: Gross capital flows to developing countries



Source: Dealogic and World Bank Prospects Group

World demand for crude oil is expected to grow at less than 1.5 percent annually over the next three years, with growth coming from non-OECD countries, as has been the case in recent years (Figure 22). Consumption growth in OECD economies will continue to be subdued by slow economic growth and efficiency improvements in vehicle transport induced by high prices, including a switch to hybrid, natural gas and electrically powered transport. Pressure to reduce emissions due to environmental concerns is expected to dampen demand growth at the global level. In early 2014, demand from OECD countries surprised on the upside, helped by the extreme winter in the U.S. and a sharp decline in commercial oil inventories during November and December 2013 to the lowest levels since early 2008. On the supply side, non-OPEC oil production is expected to continue its climb because high prices have prompted an increased use of innovative exploration techniques (including deep-water offshore drilling and extraction of shale liquids) and the implementation of new extractive technologies to increase the output from existing wells. For the first months of 2014, supply-side disruptions from Libya, Iran, Iraq, South Sudan, Nigeria, Syria and Yemen do not show signs of easing. Nonetheless, supply from non-OPEC countries remains robust and is expected to grow by 1.7 million barrels per day during 2014.

Figure 22: Growth of global oil demand by quarter, 2001-2014, percent change, y-o-y



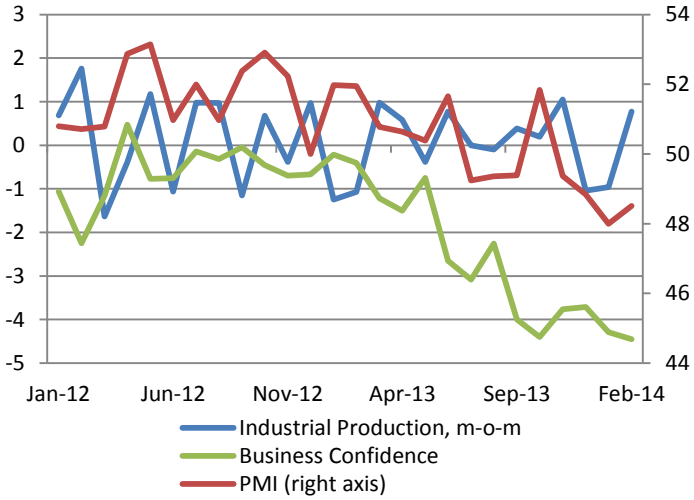
Source: World Bank; IEA

2.2 Growth Outlook for Russia – A question of confidence and geopolitical risk

The World Bank developed two alternative scenarios for Russia's 2014-2015 growth outlook in response to the higher-risk environment since political uncertainties around the Crimean crisis in early March 2014 led to increase market volatility. Confidence weakness continues to weigh down on domestic demand suggesting, first, that consumption growth is likely to slow and stabilize at a lower level than in previous years. Second, our growth outlook projects that at the margin, the rate of growth would be increasingly dependent on the recovery in investment demand. Third, in the short-term, growth would be impacted by the geopolitical tensions which started with the Crimean crisis and depend on how it will be resolved.

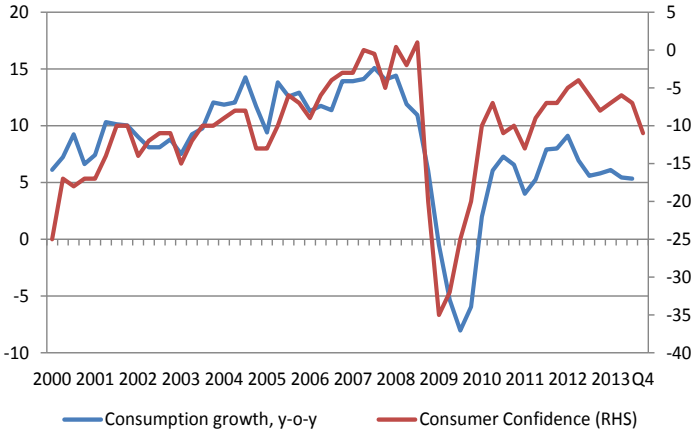
Lack of confidence is reflected in continuing depressed domestic demand and resulted in subdued economic activity in the beginning of 2014. That has implications for the growth outlook. Confidence remains at record-low levels (Figure 23 and Figure 24). High-frequency indicators showed weak readings for many economic sectors in January-February 2014. Aggregate industrial growth increased 0.9 percent (y-o-y) with manufacturing industries posting growth of 1.8 percent in the first two months of 2014 compared to 2.5 percent in Q4 2013 (y-o-y). Domestic demand weakened further, relative to Q4 2013 outcomes: retail trade grew 3.2 percent in January-February 2014 (compared to 3.4 percent in December 2013) and fixed capital investment dropped 5.0 percent (compared to 0.3 percent growth in December 2013). The overall weakness in domestic demand led to two core assumptions for our outlook: (1) consumption growth is likely to continue its movement to a new and slightly lower equilibrium level than in previous years; and (2) at the margin, the rate of growth will be increasingly driven by changes in investment demand.

Figure 23: Manufacturing and business surveys



Source: Rosstat, Haver Analytics and World Bank staff estimates

Figure 24: Consumption and consumer confidence



Source: Rosstat and World Bank staff estimates

Political uncertainties around the Crimean crisis led to high volatility on the Russian markets. In early March, increased political risk greatly affected the markets which plummeted on the news of the authorization of Russian troop deployment to the Crimea (Box 4). This suggests that political risks could be a deciding factor in the short-term. If the Russia-Ukraine conflict escalates, uncertainty could rise around political and economic sanctions from the West, and Russia's response to them. This could further worsen business and consumer confidence and raise market volatility with negative impact on domestic demand and growth prospects. To acknowledge this risk environment, we developed two alternative scenarios for the Russia 2014-2015 growth outlook.

The World Bank's low-risk scenario assumes a limited and short-lived impact of the Crimean crisis. The crisis could be contained in a peaceful fashion with some political tension remaining in 2014. In that case, the economic impact is expected to be limited with no trade restrictions introduced trough sanctions. The main transmission channels of this contained crisis would be through the capital account and impacts on market confidence. In 2015, political tension could subside following an orderly resolution of the geopolitical tension around the Russia-Ukraine affairs and accommodation with the West. Access to international capital and financial market would be restored and confidence would improve.

Our low-risk scenario projects growth to slow to 1.1 percent in 2014, slightly picking up to 1.3 percent in 2015. The growth outlook in this scenario is based on the following expectations regarding domestic demand and external conditions in 2014-1015. Consumption is expected to be constrained by lower income growth in previous

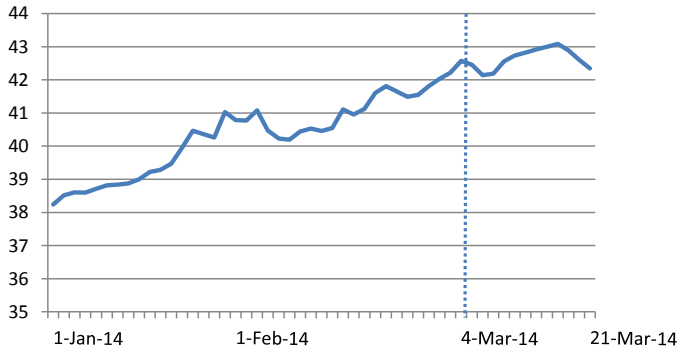
periods, remaining inflation pressures due to devaluation (see outlook for inflation below) and, to a lesser extent, relaxation of labor market conditions. Thus, we estimate that consumption growth slows and stabilizes at lower levels. The baseline scenario is based on global outlook and oil price trends described above. This essentially implies robust demand for Russian exports in the projected period. Import demand will continue slowing due to lower income growth and devaluation of the national currency. As a result, the contribution of net exports to growth will become positive over the projection period.

Box 4: Market response to the Crimea Events

Speculative attacks on the Ruble considerably intensified during the first days of March as uncertainty rose over tensions between Russia and Ukraine (Figure 25). On March 3 alone, CBR spent US$11.3 billion, which is close to the historical maximum of US$15 billion on January 19, 2009 (at the time about 2.3 percent of its foreign currency reserves), to support the currency and moved the foreign exchange corridor up by 35 kopeks. To curb volatility on the financial market, CBR decided during an emergency meeting on March 3 to temporarily hike its main policy rates by 150 basis points to 7 percent. In addition, CBR switched to defining parameters for its foreign exchange interventions on a daily basis in accordance with the current situation on the domestic foreign exchange market. On March 3, the CBR raised the amount of cumulative interventions sufficient for moving of foreign exchange corridor by 5 kopeks from US$350 million to US$1.5 billion. Thanks to CBR's strong response and the Ministry of Finance's decision to temporarily put on hold its daily purchases of currency for the Reserve Fund, some confidence into the Ruble was restored. However, we expect that there will remain volatility and speculation in the foreign exchange market until the political crisis is resolved.

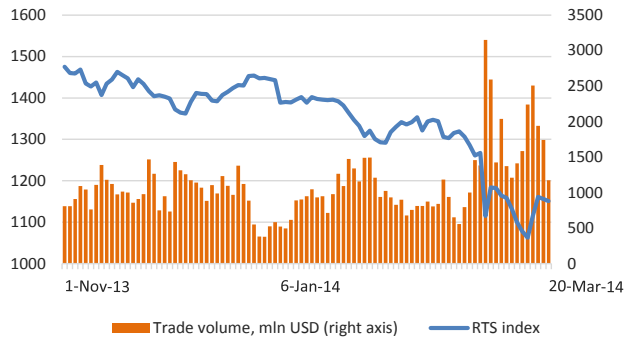
The stock market reacted negatively to the news of the Russia-Ukraine conflict and saw massive sell-offs on March 3 (Figure 26) as the RTS index fell by 13.8 percent to 1092.48, the lowest level since August, 2009. The trading of several stocks has been suspended due to losses of more than 20 percent. The stock markets remain sensitive to daily news and will likely retain higher volatility until the crisis cool down.

Figure 25: Exchange rate dynamics, Euro-Dollar basket



Source: CBR

Figure 26: Stock market reactions



Source: MICEX

The low-risk scenario assumes no changes in economic policy that could produce significant positive shocks on investment or consumption over the projection period (Table 10)**.** Consumption would decrease to 2.2 percent in 2014 and to 2.0 percent in 2015, negatively affected by slowing income growth in preceding periods. Investment activities would remain subdued, with a marginal but positive impact on gross fixed investment dynamics from some recently announced infrastructure projects, especially in 2015. We assume that construction of the ring road around Moscow, stadiums for the soccer World Cup 2018 and infrastructure projects in the Far East will commence in the second half of 2014 and gradually pick up in 2015. The aggregate impact of changes in inventories is projected to be neutral due to no noteworthy changes in business sentiments. As a result, gross capital formation is projected to shrink 1.8 percent in 2014 and grow marginally at 0.4 percent in 2015. Thus, without an additional stimulus, the economy's growth is projected to slow further in 2014 before slightly picking up in 2015, supported by improved investment demand, robust external demand and stable consumption.

Table 10: Main economic indicators: low-risk scenario

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

Source: World Bank staff estimates
Note: *Current account minus change in reserves

The World Bank's high-risk scenario assumes a more severe shock to economic and investment activities from the Crimean Crisis. An intensification of political tension could lead to heightened uncertainties around economic sanctions which would further depress confidence and investment activities. Yet, this scenario assumes that the international community would still refrain from trade sanctions. In 2015, political tension could subside with an orderly resolution of the political crisis. Domestic demand would stay depressed longer than we projected in our low-risk scenarios as the following factors would assert additional negative pressure on sentiments and investment activities:

- *For companies, access to the international capital market would become increasingly restricted*. Large corporations that borrow abroad (notably in the commodities sector) might find it increasingly difficult to access external financing. This could reduce their debt rollover capacity and lead to a scale-down of their investment programs.
- *Russian banks would face new restrictions in accessing international capital markets*, at a time when domestic money and capital markets already suffer from high volatility due to low confidence and increased political risks. As a result, credit activities could slow down, negatively affecting the ability of firms to raise funds for their investment program.
- *The relative risk for foreign investors would increases as profit margins fall*. As a result, a foreign investors and banks might pull out funds as gross FDI inflows drop.
- *Exchange-rate volatility would intensify* to a degree that depends on the markets' reaction to the ongoing QE tapering and CBR's path to implement the flexible exchange-rate regime. As a result of higher depreciation, external borrowing could become more expensive just as international financial markets tighten. This could force companies into a wait-and-see mode until volatility drops to levels where the exchange-rate risks become more manageable.
- *Banks' credit portfolios would deteriorate faster as growth tumbles*. Banks would charge their creditors higher risk premiums and would increase their collateral requirements. Borrowing costs would increase. Reduced debt-servicing and rollover capacity would hamper investment activities. In addition, higher consumer credit defaults would further curtail consumption growth.

The World Bank's high-risk scenario projects a contraction in output for 2014 of 1.8 percent as a result of a deeply negative investment shock and further slowdown in consumption growth. The contraction in real GDP is mostly driven by a sharp decline in gross capital formation of 10.3 percent (Table 11) and an aggregate consumption slowdown to 0.8 percent, affected by lower income growth, higher unemployment and plummeting confidence.

But if there is an orderly resolution of the Crimean Crisis, the economy would recover in 2015. This would allow Russian authorities to refocus their attention on domestic policies to shore up business and consumer confidence, which in turn would lead to higher growth. Nevertheless, there would remain some tail risk of continued tensions, which would adversely affect growth over a longer period. Real GDP growth is projected to rebound to 2.1 percent, largely due to a low base in 2014. Investors' access to capital and financial markets is expected to be gradually restored and investment demand will improve. Growth in gross capital formation would

resume to 5.0 percent in 2015, which is still lower than its 2013 levels, as investors remain cautious about long-term prospects. Consumption growth is expected to recover slightly to 1.1 percent, still impacted by lower income growth during the preceding periods. Economic recovery in 2015 and afterwards would depend on solid private investment growth. In addition to a stable macroeconomic environment, this would require a positive shift in business and consumer confidence. Without significant structural reforms directed to strengthening regulatory and market institutions and tackling large inefficiencies in factor allocation across the economy, this is unlikely to happen and would subdue long-term growth prospects.

Table 11: Main economic indicators: high-risk scenario

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

Source: World Bank staff estimates
Note: * *Current account minus change in reserves

External Balances – Deteriorating CA and volatile capital flows

For our low-risk scenario, the BoP outcome will be largely driven by import performance, income account and capital flows. Export performance will be affected in line with the projected global outlook and oil prices. Low income growth and a weaker Ruble are expected to result in slowing imports and stable trade balances. As a result, the estimated deterioration of the CA is not going to be as profound as it was in 2013. We estimate surpluses on the CA to decrease to US$26.8 billion (1.3 percent of GDP) in 2014 and further to US$24.1 billion (1.2 percent of GDP) in 2015 (Table 10). Net capital outflows are projected to increase somewhat in 2014, largely driven by heightened political uncertainty, and diminish gradually in 2015, along with the CA deterioration. The deficit on the capital account is estimated to amount to US$68.0 billion in 2014 and US$32.0 billion in 2015. Volatility of capital flows is likely to remain high during the projection period and will be a key downside risk to BoP outcomes, especially in 2014. The Ruble is expected to depreciate according to changes in BoP fundamentals, both in 2014 and 2015. Also, the volatility of the exchange rate will remain high as markets test CBR's commitment to move to a flexible exchange-rate regime, especially in the first half of 2014 when nervousness about QE tapering is likely to persist and political tension around the Russia-Ukraine conflict remains.

In our high-risk scenario, BoP pressures are expected to increase with much larger net capital outflows. However, the CA is projected to improve to US$60.2 billion as import demand decreases due to the contraction of GDP and the faster depreciation of the Ruble (Table 11). Yet the improvement on the CA would not be enough to compensate for the sharp deterioration of the capital account. Restricted access to the international capital market, reduced FDI inflows and additional reallocation of assets away from Russia would result in a sharp increase in net capital outflows. As a result, the capital account is projected to deteriorate sharply to a deficit of US$133.0 billion (6.7 percent of GDP) in 2014 from US$55.3 billion (2.6 percent of GDP) in 2013. The CBR would need to finance the gap between the CA surplus and the growing deficit on the capital account with its reserves. In 2015, uncertainty is expected to decrease and access to financial markets restored: the capital account would improve to a deficit of US$62.2 billion (3.1 percent of GDP) and BoP pressures would ease.

Inflation and credits – high devaluation and credit default risks

For both scenarios we expect the ongoing Ruble depreciation is likely to impact inflation dynamics in 2014-2015. Inflation pressure remained high at the beginning of 2014, driven by food prices. As a result, 12-month CPI inflation totaled 6.2 percent in February 2014, compared to 6.1 percent in January and 6.5 percent at the end of 2013. In 2013, CBR had limited capacity to manage inflation expectations related to non-monetary factors. We expect that the stricter controls for utility prices that were introduced by Government in 2014 should help the regulator better control inflation dynamics. The recent increase in main policy rates (from 5.5 to 7.0 percent) also

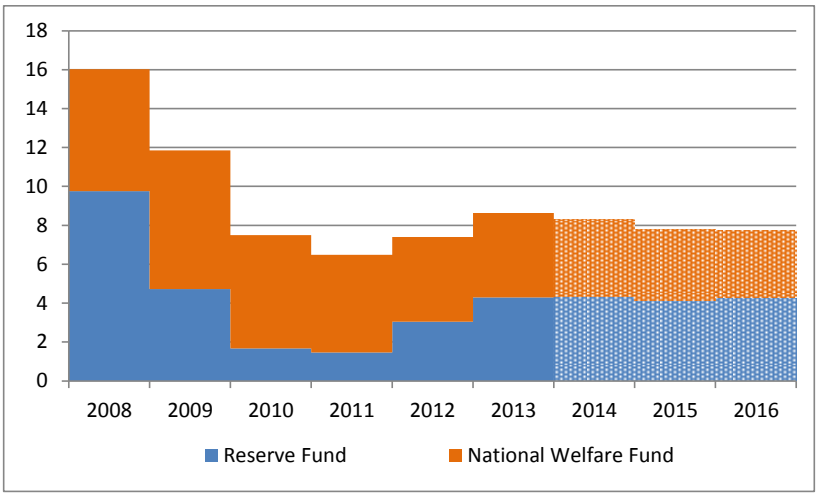
curbed inflation expectations in 2014. Yet, we believe that non-monetary pressures, resulting from elevated depreciation risk, will remain high. Amidst those pressures, we project inflation slightly higher than the upper end of CBR targeted range for 2014 of 4.0-5.0 percent, which could require further tightening if the high-risk scenario materializes.

In our forecast we assume that CBR completes its move to a flexible exchange-rate regime by 2015. Yet, we believe that CBR will continue using active interventions on the foreign exchange market in the first half of 2014 to fight off excessive volatility largely related to remaining political tension around the Crimean crisis and continuing QE tapering: in Q1 2014 alone, it spent about US$38.9 billion on interventions to support the Ruble. Thus, we assume a loss of foreign reserves in 2014 and a stable reserve position in 2015 in both scenarios.

Fiscal Balances – Is consolidation achievable?

Our fiscal projections divert from Government's medium-term framework of 2014-2016 (Box 5)**.** Government's medium-term fiscal outlook for 2014-2016 has consolidation at its core, but the targets for expenditure control and revenue increases are ambitious, given the current low-growth environment and mounting political pressures. Government envisions that fiscal buffers decline moderately in in 2014-2016 (Figure 27).[11] Our fiscal projection reflect the following underlying assumptions for both scenarios: (1) external conditions and oil prices reflect the global outlook presented in the report; (2) expenditures are projected in line with the Government medium-term budget parameters; (3) the fiscal rule remains effective throughout projection period, with government having limited capacity to significantly increase expenditures. Our projections suggest a stable fiscal position in both low and high risk scenarios. We do expect different revenue levels, depending on the size of the economic slowdown. They would be compensated by the positive effect of deprecation. As a result in low risk scenario consolidated fiscal deficit will total 0.5 percent of GDP in 2014 and 0.2 percent in 2015. The outcome for the high-risk scenario would be slightly worse: a deficit of 0.9 and 0.5 percent of GDP in 2014 and 2015, respectively.

Figure 27: Government Projections for the Reserve Fund and National Welfare Fund, percent of GDP, e-o-p



Source: Ministry of Finance

[11] These fiscal buffers are part of the Government's fiscal rule. It includes funding a moderate federal budget deficit through the placement of Treasury bills and Eurobonds. The Reserve Fund was replenished in 2013 at the beginning of the fiscal year. However, for 2014 the replenishment remains delayed as the Ukraine-Russia crisis impacted negatively the exchange rate. Since earlier this year, Government also postponed the placement of its Treasury Bonds because of unfavorable market rates.

Box 5: **Government's Medium-Term Budget Framework for 2014-2016**

Government's medium-term budget envisages relative stability of fiscal outturns in 2014-2015 and improvements by 2016. This might be difficult to achieve, given the already mounting fiscal stress on the sub-national budgets and the increasing political pressure to increase transfers and grants. The key assumption of the medium-term budget framework is that a gradual reduction in the non-oil federal budget deficit will occur, decreasing from 10.3 percent of GDP in 2013 to 8.4 percent of GDP in 2016. This is envisioned to be achieved first of all through adjustments on the expenditure side, by 1.1 percent of GDP.[12] The consolidated budget deficit is expected to decrease quite significantly from 1.3 percent of GDP in 2013 to 0.2 percent in 2016, accompanied by a sizeable increase in revenues by 0.7 percent points of GDP and only a moderate expenditure decline by 0.4 percent points of GDP over the three-year period. Both the Reserve Fund and the NWF are projected to remain well below 2009 pre-crisis levels (of 9.8 percent of GDP and 6.3 percent of GDP respectively) and their new medium-term targets are modest at 7.7 percent of GDP in 2016. By 2016, the Reserve Fund is expected to stabilize at 4.3 percent of GDP. The NWF (currently at 4.3 percent of GDP) is forecasted to decline to 3.4 percent of GDP by 2016. It is expected that the NWF could invest up to 450 billion Rubles into domestic securities associated with priority infrastructure projects. Simultaneously the quality of the NWF's portfolio is subject to increased risks, given the recent legal amendment by Government to allow for buying lower-than-investment grade securities for up to 10 percent of its funds, in effect allowing for higher discretionary investment decisions.

Table 12: Medium-Term Government Budget Projections for 2014-2016, percent of GDP

	Execution	Preliminary Draft			Approved Law		
	2013	2014	2015	2016	2014	2015	2016
Consolidated Budget							
Expenditures	37.4	35.8	35.4	34.9	37.2	37.3	37.0
Revenues	36.1	35.1	34.9	34.4	36.4	36.4	36.8
Balance	-1.3	-0.7	-0.5	-0.5	-0.8	-0.9	-0.2
Federal Budget							
Expenditures	20.0	18.7	18.6	18.0	19.0	19.3	18.9
Revenues	19.5	18.2	18.0	17.4	18.5	18.3	18.3
Balance	-0.5	-0.5	-0.6	-0.6	-0.5	-1.0	-0.6
Non-Oil Balance	-10.3	-8.5	-8.4	-7.8	-9.4	-9.6	-8.4
Urals crude oil price, US$/barrel	106.4	101.0	100.0	100.0	101.0	100.0	100.0

Source: World Bank staff estimates

2.3 Other Risks

Risks to the global outlook remain prominent and they suggest higher market volatility. Russia's long-term outlook will depend on a sustained positive shift in investors' and consumers' confidence. There is the risk that as Russia's government is put back into crisis mode, attention will be diverted to manage short-term issues, while the medium-term structural reform agenda languishes.

Risks to the global outlook remain prominent and suggest higher market volatility. The recovery in high-income countries, led by the U.S., Germany and Japan, is fragile and could be offset by a gradual decline in investment and growth in emerging economies, especially in China. Geopolitical and commodity risks, including those linked to the recent Russia-Ukraine crisis, could actually play out to the benefit of Russia by pushing oil and gas prices temporarily up. This is the main upside risk for Russia's growth outlook. However, global markets appear to normalize to a higher level of volatility and their reactions to the gradual withdrawal of the QE policies remain erratic, preserving the already elevated risk for currency speculations and capital outflows. Further interest increases are likely, keeping the cost of borrowing elevated and limiting access to international capital markets. Most of all, confidence in a broad-based global recovery is still wavering and becomes increasingly driven by a higher differentiation into regional and country-specific sentiments.

[12] The projected decline in federal expenditure by 2016 is proposed through a number of quite radical measures. They include (1) federal budget spending cuts by 5 percent across almost all expenditure items, (2) a reduction of subsidies to budgetary and autonomous entities by 2 percent annually in 2014-2016 and (3) zero indexation of salaries of staff of federal state entities, civil servants, judges, prosecutors, investigators and, military personnel. However, there are exceptions to federal budget spending cuts under (1): (i) legally binding public commitments, expenditure commitments made according to the Orders of the President on May 7, 2012 (indexed by 4.5-5 percent); (ii) salaries of military personnel; (iii) transfers to extra budgetary funds; (iii) subsidies to budgetary and autonomous entities; (iv) federal equalization transfers to regions (indexed by 5 percent); (v) targeted federal transfers to regions; (vi) pensions (even increases in pensions of the retired military); (vii) stipends (indexed by 4.5-5 percent); (viii) expenditures for the judicial system; (ix) program on purchases of military equipment and (x) contributions to be made according to international treaties.

Credit growth in Russia is expected to slow while credit risk is likely to increase. Household credit growth slowed from it record levels in 2012 of 39.4 percent to a still-high 28.7 percent in 2013. Indebtedness will continue to rise and in the medium-term we expect relatively fast credit growth that could increase credit risks.[13] Currently, these risks appear to be contained and the CBR does not see any systemic risk, according to the results of their recent stress tests. There remain, however, concerns about the stock of refinanced and restructured loans in the system. We expect the share of restructured loans in the total portfolio to increase, thus masking the rise in credit risks. Restructured loans will be kept in or moved to a less-risky category of loans, thus allowing banks to keep the provisioning of non-performing loans at relatively low levels. Given the overall lower-growth trajectory and increasing indebtedness of households, the risk that these loans will again become non-performing is rather high.

Russia's long-term outlook will depend on a sustained positive shift in investors' and consumers' confidence. In order to overcome the current confidence crisis and achieve sustained long-term growth, structural reforms would need to be started in the coming years. The dearth of such reforms efforts is darkening Russia's growth outlook. In order to mobilize private investments in a sustained manner and on a larger scale, inefficiencies in factor allocation across the economy would need to be addressed. It would also require creating a level playing field for such businesses by improving the quality of regulatory and market institutions, so that rules are implemented evenly. Moreover, both of our scenarios are driven by short-term developments in the recent Crimean crisis. There is the risk that as Russia's government is put back into crisis mode, attention will be diverted to manage short-term issues, while the medium-term structural reform agenda languishes. Even another positive investment shock through fiscal or quasi-public investments is unlikely to lift the Russian economy's long-term growth prospects. .

Stabilizing consumption at an altogether lower rate would also dim the outlook on economic mobility and continued middle-class formation in Russia. The topic of economic mobility and its recent trends in Russia is explored in the third part of this report. We project in our low-risk scenario that consumption growth will decrease to about 2 percent in 2014-2015, compared to 3.4 percent in 2013 and 6.9 percent in 2012. In 2014, we expect some labor market relaxation. In recent months, several large corporations in the state owned/controlled or financial sectors (e.g. Russian Railways, Sberbank, VTB, Uralsib Bank, Avtovaz) announced labor optimization measures. This will dampen households' income prospects and as a result consumption growth. While in the medium to long-term labor market demand relaxation will be partly compensated by a shrinking in the labor force due to demographic factors such as aging of the Russian population, in the short-term, upward economic mobility is likely to slow down. Our special focus note in part three shows that most of poverty-reduction and middle-class growth was explained by high growth in average incomes and consumption during 2000-2010.

[13] Compared to other eastern European countries the level of household debt is still low and Russia's ratio of credit to GDP remains notably below its peers. In addition, the depth of financial intermediation is still very low in Russia with only about 25 percent of the population currently using formal financial services.

Part III. Economic Mobility and Middle-Class Formation in Russia [14] [15]

As in the rest of the emerging world, the Russian middle class, defined as those with per capita consumption levels of $10/day or higher (2005 PPP), grew dramatically during 2001-2010. As a result, the Russian middle class is today one of the largest, in terms of its share of the population, in the Europe and Central Asia region and the even in emerging word. However, though living standards improved across the board, questions about economic mobility patterns and their determinants have re-entered the public debate in Russia in recent years. This reflects a renewed preoccupation with inequality (on the rise since the mid-2000s) and with the distribution of gains associated with the transition to a market economy and the accompanying policy reforms. The growth of the middle class in Russia was part of a broader trend of upward economic mobility during 2001-2010. Upward economic mobility was the result of both increases in average income levels and changes in the distribution of income. This paper documents the rapid rise of the Russian middle class during 2001-2010 and its main drivers. Though demographic factors (related to aging and other social changes) and economic factors both matter for middle class entry, it is the latter that best explain most of the observed changes in the period of study. Wage and pension growth accounts for over half of the observed income growth among middle class entrants in 2001-2010, with demographics factors playing a secondary role. Access to good, productive jobs—i.e. jobs that require a higher level of skills and thus pay higher wages—and wage growth in both the private and public sectors have served as the main platforms for the rise of the middle class in Russia. In addition, significant increases in pensions have helped many escape poverty and vulnerability and join the middle class, particularly during 2006-2010. Further expansion of the middle class will require continued job creation, combined with an increase in labor force participation among youth, women and older workers, so as to increase the overall employment rate in the economy and strengthen the role of labor income as the main driver of middle income growth.

[14] *This note summarizes selected results from a forthcoming World Bank report on economic mobility in Russia, "Social Mobility and Opportunities", to be launched in the spring of 2014. The results presented in this note draw from background work done by the authors and by Maria Ana Lugo (Economist in the Poverty Unit of the Latin America and the Caribbean region of the World Bank).*

15 Moritz Meyer is an Extended-Term Consultant in the Poverty Unit of the Europe and Central Asia region of the World Bank. Carolina Sanchez-Paramo is the Sector Manager of the unit.

3.1. Introduction

Over the past decade or so, the emerging world has been witness to unprecedented growth in household welfare, lifting many out of poverty and allowing many others to join the ranks of a growing middle class. As a result, the subject of the middle class has received much attention in the literature in recent years[16]. This discussion has covers a variety of topics, ranging from how to define and measure the middle class to how to best characterize it as distinct from other social classes to its the potential economic and social role.

Russia has been no exception to these global trends. The poverty rate, defined as the share of the population with per capita consumption levels equal to or below $5/day, fell from 35 percent in 2001 to 10 percent in 2010. At the same time, the middle class, defined as those with per capita consumption levels equal to or above $10/day, grew from 30 percent to 60 percent of the total population (see Box 5, Meyer and Sanchez, 2013, for details on the definitions used in this paper). These developments have been documented in a number of thematic surveys and reports in recent years[17].

However, even as living standards have improved across the board, questions about inequality, economic mobility patterns and their determinants have re-entered the public debate in Russia in recent years. This reflects a renewed preoccupation with inequality, which has been on the rise since the mid-2000s, and with the distribution of gains associated with the transition to a market economy and the accompanying policy reforms.

Box 6: Mobility and the middle class – Definition and measurement

There is no single way to define or measure the middle class. Some researchers have proposed "relative" measures, where the middle class is defined as the share of people "in the middle" of the income distribution (Barro, 1999; Birdsall, at alia, 2000, Easterly, 2001; Thurow, 1997); others have used absolute measures instead, where middle-class households are those "above an absolute poverty threshold, but that lack the economic assets to ensure complete protection against poverty" (Banerjee and Duflo, 2008; Birdsall, 2010; Kharas, 2012; Milanovic and Yitzhaki, 2002; Ravallion, 2009) [18]. These two concepts reflect different perceptions of the role of the middle class and can potentially lead to significant differences in outcomes. Consider, for example, a fairly egalitarian but low-income country. Under a "relative" definition, such a country would have a large middle class, but under the "absolute" definition, the middle class might be fairly small.

In this paper, the middle class is defined using a monetary measure. Specifically, households with per capita consumption equal or higher than $10/day (real 2005 PPP values) will be considered middle-class households. In addition, households with per capita consumption equal or below $5/day will be considered poor and households with per capita consumption between $5/day and $10/day will be considered vulnerable.

The choice of the $10/day cut-off for the middle class is not arbitrary, but rather draws from a growing body of work by WB teams and others. This cut-off has been used in Latin America and the Caribbean (World Bank, 2012), and increasingly in other regions, to identify the middle class (in middle-income countries). This was also the value chosen for the discussion on middle class societies during the MIC Forum at the 2012 Annual Meetings. Following the same criteria therefore allows us to compare Russia to other middle-income countries. Similarly, the choice of the $5/day cutoff for poverty reflects the current practice in the Europe and Central Asia (ECA) region of the World Bank, where two standardized poverty lines are used to measure extreme poverty ($2.5/day) and poverty ($5/day) in all countries in the region. Following the same practice therefore allows us to compare Russia to other ECA countries.

This paper uses information from the Russian Longitudinal Monitoring Survey (RLMS-HSE) and other data sources (see Meyer and Sanchez-Paramo, 2014) to analyze the emergence and growth of the middle class in the Russia in 2001-2010 and discuss how these trends relate to broader patterns of economic mobility in the country. The paper builds on the existing literature on the topic and aims to add value to this literature in two complementary ways. First, by using a standardized definition of the middle class that is relevant for (high) middle-income countries, the paper is able to present international comparisons with other middle-income countries so as to place numbers and trends in Russia in the global context. Second, the paper provides both a characterization of the Russian middle class and a discussion of the main drivers underlying its growth during 2001-2010, distinguishing the roles of demographics, markets and public policy.

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[16] See, for instance, Banerjee and Duflo, 2008; Birdsall, 2007 and 2010; Easterly, 2001; Kenny, 2011; Kharas, 2012; Milanovic and Yitzhaki, 2002; Pressman, 2007; Ravallion, 2009; World Bank, 2012.

[17] See, for instance, Bogomolova and Tapilina, 1999; Bogomolova, 2011; Carnegie Moscow center, 2003; Denisova, 2007; Expert Journal, 2006; Fedorov, Lvov and Baskakov, 2009; Gerry and Li, 2010; Gorshkov, 2008; Gorshkov and Tichonova, 2006; Gorodnichenko and Peter and Stolyarov, 2010; Grigoryev, 2012; Hayashi, 2007; Maleva, 2002 and 2008; Maleva and Ovcharova, 2009; Nissanov, 2012; Ocharova, 2012; Tichorova, 2007 and 2008; Tichorova and Gorunova, 2008; Tichorova and Marreva, 2009; Trusova, 2001; World Bank, 2009.

[18] See Torche and Lopez-Calva, 2010 for a complete discussion.

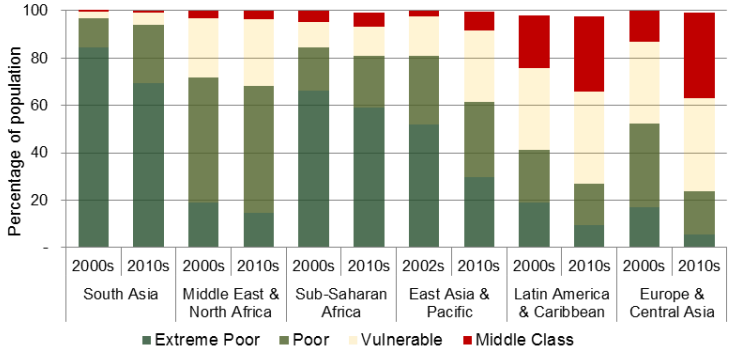
3.2 Russia in the global context

During 2000-2010, the size of the middle class grew the world over and in particularly in middle-income regions and countries. The share of the population whose per capita consumption levels at or above $10/day (the middle class definition used in the paper) increased marginally in South Asia and the Middle East and Northern Africa, and a bit more noticeably in Sub-Saharan Africa, East Asia and the Pacific. However, in all cases, less than 10 percent of the population belonged to the middle class in 2010. In contrast, in Latin America and the Caribbean (LAC) and, especially, in Europe and Central Asia (ECA), the middle class grew rapidly from close to 20 percent of the population circa 2000 to close to 40 percent circa 2010 (Figure 28.A).

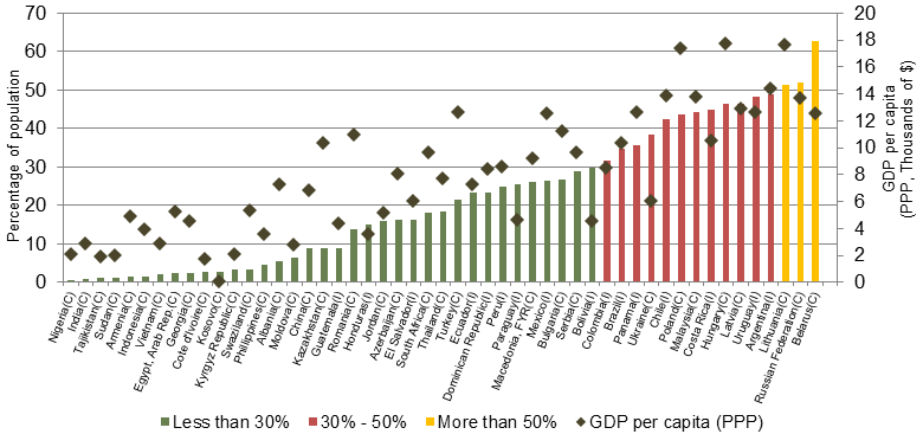
Not all middle-income countries are middle-class societies however. Despite rapid growth in 2000-2010, only a few countries in the world can be considered middle-class societies in which a large fraction of the population is in the middle class. Not surprisingly, most of these countries are middle-income countries and many of them are in LAC and ECA. Russia is part of this group (Figure 28B).

Figure 28: A panorama of the middle class in the emerging world

A. Rapid growth of the middle-class, particularly in middle income regions and countries
Percentage of population in each economic group by region, circa 2000-2010



B. Middle income countries versus middle class societies
Percentage of population in middle class and GDP per capita

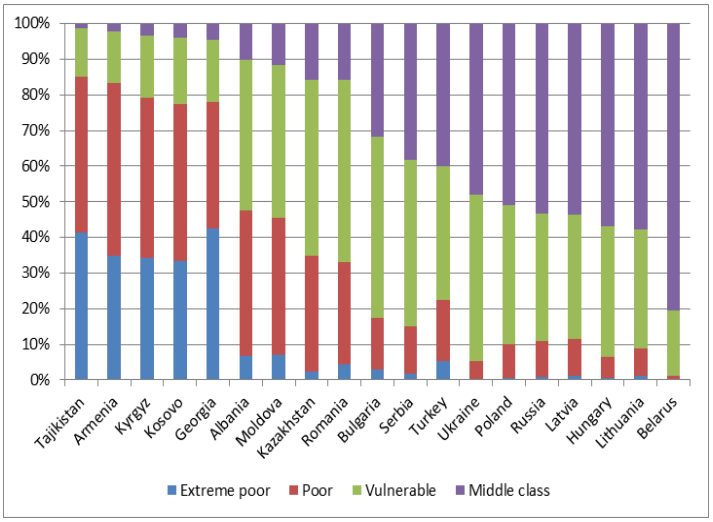


Source: Staff calculations using data from the PovCalNet database. Estimates for LAC are based on income, for the other regions on expenditures. Estimates in panel A are population-weighted.
Note: Numbers for Russia are based on a 2008 Household Budget Survey.

At 60 percent of the population, the Russian middle class is one of the largest, in terms of its share of the population, in the ECA region and the emerging word. The size of the middle class among ECA countries ranges from a low 2-3 percent in Tajikistan and Armenia to a high 80 percent in Belarus (Figure 29). Within this spectrum, very few countries surpass the 50 percent mark. These are Russia, Latvia, Hungary, Lithuania and Belarus. Similarly, with more than 50 percent of the population in the middle class, Russia is in the group of emerging economies with the largest share of its population in the middle class (Figure 28B). Although there are small differences in the size of the middle class across Figure 28B and Figure 29 due to differences in the data harmonization process, the results are qualitatively consistent across both figures and with the analysis presented below.

Figure 29: The Russian middle class is the largest in the Europe and Central Asia region

Percentage of population in each economic group by country, circa 2010



Source: Staff calculations using the ECAPOV database.

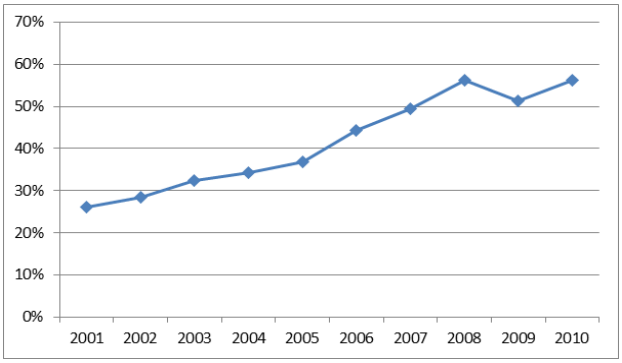
Note: Numbers for Russia based on 2008 Household Budget Survey

3.3 Aggregate trends and developments: A bird's eye view

The Russian middle class, defined as those with per capita consumption levels of $10/day or higher, grew dramatically during 2001-2010. According to data from the Russian Longitudinal Monitoring Survey (RLMS-HSE, see box 1 for details), the relative size of the middle class doubled, from 27 percent to almost 60 percent of the Russian population in a span of 10 years (Figure 30). And although the middle class was disproportionally affected in Russia and many other middle-income countries by the global financial crisis in 2008-9, the number of middle-class households recovered quickly and continued to grow after the crisis, albeit as a slower pace.[19]

Figure 30: The size of the middle class in Russia doubled from 2001 to 2010

Percentage of population in each economic group by country, circa 2010



Source: Staff calculations using data from the RLSM-HSE, 2001-2010

And with growing numbers came increased aggregate economic weight and purchasing power. The middle class controlled almost 50 percent of total household income and accounted for over 60 percent of total household consumption, as measured in the RLMS-HSE, in 2001. By 2010, these numbers were 74 percent and 86 percent respectively, making the middle class the only game in town when it comes to the behavior of private consumption and consistent with the notion of Russia as a middle-income society (Figure 31).

The growth of the middle class in Russia was part of a broader trend of upward economic mobility during 2001-2010. Positive and sustained economic growth for most of the period translated into strong per capita consumption growth from $9/day in 2001 to almost $17/day in 2010 (2005 PPP) and a significant decline in poverty and, to a lesser extent, vulnerability.[20]

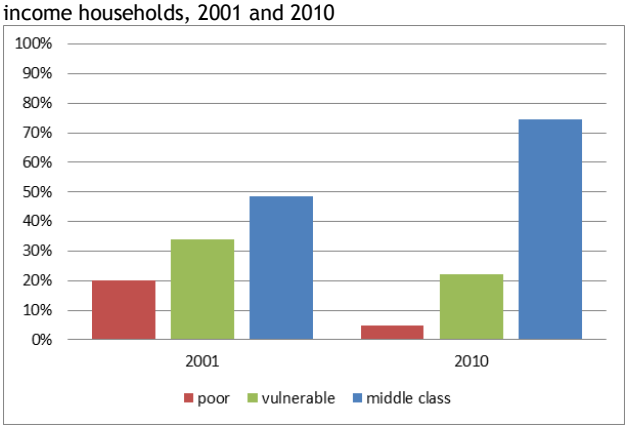
[19] Data for RLMS-HSE 2011 and 2012 are currently being processed and the analysis will be updated as soon as results for these years are available.

[20] An individual is considered poor if his consumption is equal or less than $5/day (in real 2005 PPP values); similarly, an individual is considered vulnerable is his consumption is high enough to be above the poverty threshold but too low to be considered middle class (i.e higher than $5/day but less than $10/day in real 2005 PPP values).

Underlying these aggregate changes are movements of households in and out of different economic groups. To examine the nature of these movements, we constructed two panel datasets for the periods 2001-2005 and 2006-2010 using the RLMS-HSE and compare the economic status of each household at the beginning and the end of each period. The results are presented in Table 1. Panel A and panel B correspond to 2001-2005 and 2006-2010 respectively. Within each panel, rows capture economic status in the first year of the period and columns capture economic status in the last year of the period. The number in each cell represents the percentage of the total population that belongs to the economic group described in the row heading for the first year of the period and the economic group describe in the column heading for the last year of the period. Thus, between 2001 and 2005 (first panel), 13.2 percent and 7.1 percent of the total population transitioned out of poverty and into the group of vulnerable and middle class households respectively, while 15.6 percent remained in poverty.

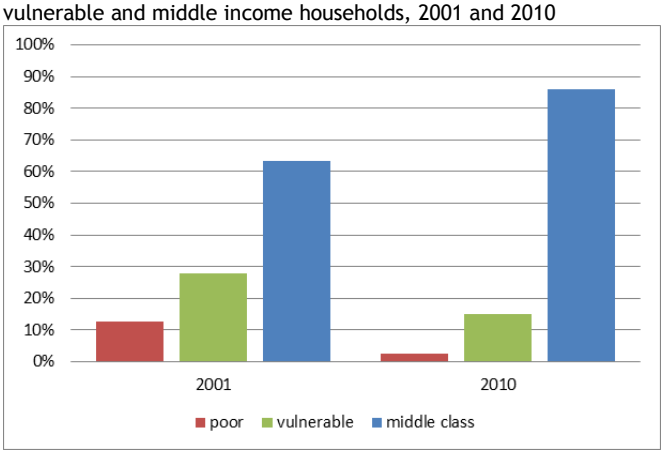
Figure 31: The middle class controls a large share of total income…

Percentage of total income held by poor, vulnerable and middle income households, 2001 and 2010



… and accounts for most aggregate private consumption in Russia

Percentage of total private consumption accounted for by poor, vulnerable and middle income households, 2001 and 2010



Source: Staff calculations using data from the RLSM-HSE, 2001-2010

During 2001-2005, 20 percent of the total population (or 75 percent of the poor) moved out of poverty, with an additional 15 percent following suit in 2006-2010. Similarly, 22 percent of the total population became part of the middle-class in 2001-2005, and an additional 25 percent did the same in 2006-2010. As a result, 10 percent, 30 percent and 60 percent were poor, vulnerable or middle-class respectively in 2010, compared to 36 percent, 37 percent and 27 percent in 2001 (Table 13). Overall, 35 percent of the total population climbed up the economic ladder to join a better-off economic group between 2001 and 2005, and 34 percent did the same between 2006 and 2010 (in green in Table 13).

Still, not all households moved up the social ladder during the period. In fact, in both 2001-2005 and 2006-2010, approximately 15 percent of the total population experienced large enough declines in per capita income to push them into a lower socio-economic group (in red in Table 13), suggesting that vulnerability to shocks remains an issue at all socio-economic levels. For instance, more than 30 percent of those considered middle class in 2001 were either vulnerable or even poor in 2005; and the same can be said about 2006-2010.

Table 13: The emergence of the middle class is part of a broader pattern of strong upwards mobility

Percentage of total population classified by economic status in 2001 and 2005				
	Status in 2005			
Status in 2001	**Poor**	**Vulnerable**	**Middle class**	***Total 2001***
Poor	15.6	**13.2**	**7.1**	*35.9*
Vulnerable	**6.8**	14.8	**15.3**	*36.9*
Middle class	**3.6**	**7.0**	16.5	*27.1*
Total 2005	*26.0*	*35.0*	*38.9*	*100*
Percentage of total population classified by economic status in 2001 and 2005				
	Status in 2010			
Status in 2006	**Poor**	**Vulnerable**	**Middle class**	***Total 2006***
Poor	5.8	**9.0**	**6.0**	*20.8*
Vulnerable	**3.2**	12.9	**19.3**	*35.4*
Middle class	**1.4**	**9.0**	33.3	*43.7*
Total 2010	*10.4*	*30.9*	*58.6*	*100*

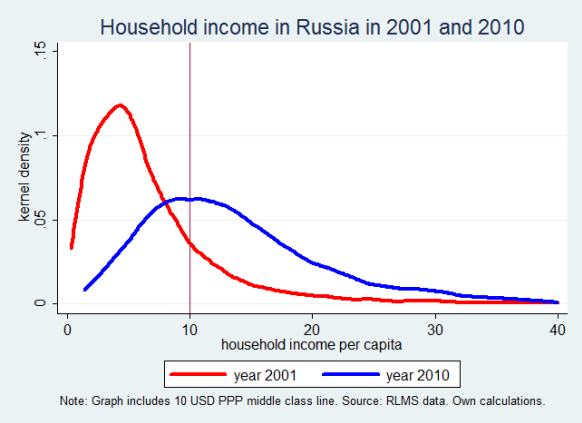
Source: Staff calculations using data from the RLSM-HSE, 2001-2010

Combined, these data revealed a more complex picture of economic mobility in which both upward and downward mobility took place at the same time, producing a dominant upward trend accompanied by significant churning. This differed from the experience of other middle-income regions and countries. For instance, a comparable exercise for the LAC region covering the period circa 1995-2009 showed upward mobility of similar magnitude, with approximately 50 percent of the poor (23 percent of the population) exiting poverty and over 30 percent of the population joining the middle class. But there was less downwards mobility and thus churning as only 3 percent of the total population fell into a worse-off economic group during the period. The figure for those initially in the middle class was 4 percent (World Bank, 2012).

Upward economic mobility was the result of both increases in average income levels and changes in the distribution of income. The distribution of household per capita income changed significantly between 2001 and 2010 as both average household per capita income and its variance rose (Figure 32). We use a well-established decomposition technique (Datt and Ravallion, 1992) to further examine the impact that these changes had on economic mobility and, particularly, the emergence of the middle class. Over three-fourths of the observed decline in poverty could be explained by changes in average income, while the remaining fourth was be explained by changes in the distribution of income. In contrast, growth in average income levels accounted for "only" half of the movements into the middle class, with the remaining half was linked to changes in the distribution of income.[21] This differed from the experience of other European and Central Asian (ECA) countries, where changes in the distribution of income had a negative (albeit very small) impact on the growth of the middle class during the same period, as well as with that of countries in Latin America and the Caribbean (LAC), where income growth explained almost of the observed growth in the middle class in 1995-2010.[22]

Figure 32: The distribution of income shifted to the right and widened during 2001-2010

Kernel distribution of per capita household income in 2001 and 2010 (USD 2005 PPP)



Source: Staff calculations using data from the RLSM-HSE, 2001-2010

Upward economic mobility was accompanied by a widening income gap, in absolute terms, between the middle class and the rest of society (the bottom 40 percent in 2010). In 2001, the average per capita income level of the middle class was $12/day, compared to under $4/day among the poor. By 2010, both groups had seen their per capita income levels grow significantly—to $18/day for the middle class and $7/day for the poor. As a result of these changes, the ratio of the average per capita income of the middle class to the average per capita income of the poor declined slightly (i.e. income differences in relative terms were smaller in 2010 than in 2001). In contrast, the absolute difference in per capita incomes between both groups increased from $8/day to $11/day during the same period, suggesting a wider dispersion in per capita income in 2010 than in 2001.

There is however no evidence in the survey of increasing accumulation of income at the top end of the distribution. The income shares of the top 10 percent and 20 percent of the distribution (equivalent to the top 30 percent of the middle class in 2001 and 2010 respectively) remained relatively constant throughout the period at around 24 percent and 40 percent respectively. Although this would appear to be at odds with the widespread perception of high and growing income inequality in Russia, it is important to keep in mind that this perception refers mostly to the very rich and wealthy. These households are seldom represented in household surveys.

[21] These results are robust to the use of consumption instead of income as the welfare aggregate.

[22] Based on calculations prepared by ECA and LAC staff as background material for a discussion on "inclusive middle income societies" at the Middle Income Forum in the 2012 Annual Meetings, using data from the PovCalNet database (see Box 1 for details). Reference years are 1995-2010 for LAC and (circa) 2000-2010 for ECA.

3.4 The role of assets, markets and the state in the middle-class formation

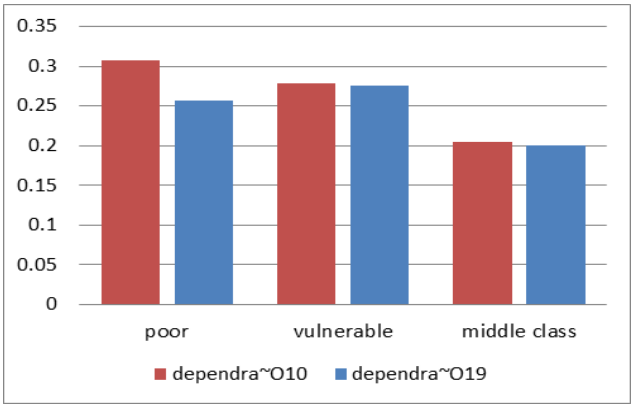
In this section, we examine the potential micro-economic drivers of the trends described earlier, with a particular focus on the emergence of the middle class. For this purpose, it is useful to think of per capita/household income as the sum of market (primarily labor) and non-market income (primarily public transfers and remittances). Households and individuals endowed with more and/or higher-quality human capital and other assets and with higher access to markets are likely to both enjoy higher income levels and have high income growth potential than others, other things being equal. Similarly, public and private transfers could compensate for the lack of assets.

Profile of the middle class in Russia

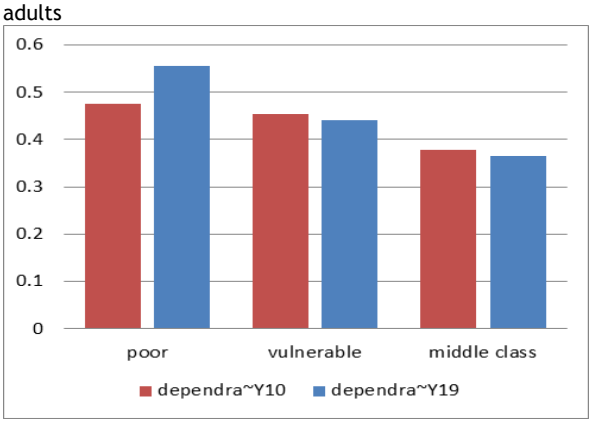
Human capital endowments are significantly higher among middle-income households than among poor or vulnerable households. Although middle-class households are smaller than poor and vulnerable households, they contain a relatively larger number of working-age adults. The size of average middle-class household in the 2010 RLMS-HSE survey is 3.3 people, compared to 4.1 and 3.8 for poor and vulnerable households. In addition, the ratio of older (65+) and younger (<18) household members to working-age adults is significantly lower among middle income households—0.2 and 0.4 respectively, compared to 0.2 and over 0.5 among poor households (Figure 33). This implies that every working-age adult in a middle-income household has to (potentially) provide for a smaller number of dependents, other things being equal. In addition, working-age adults in middle-income households have levels of education that are significantly higher than those of their counterparts in poor and vulnerable households. Specifically, almost 30 percent of working-age adults in middle-income households have completed higher education. An additional 38 percent holds a PTU or a technical diploma, compared to 8 percent and 34 percent respectively for poor households and 18 percent and 39 percent among vulnerable households (Figure 34).

Figure 33: The ratio of older (65+) and younger (<18 years) household members to working-age adults is smallest among middle income households

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



Ratio of household members ages 17 and under to working-age adults



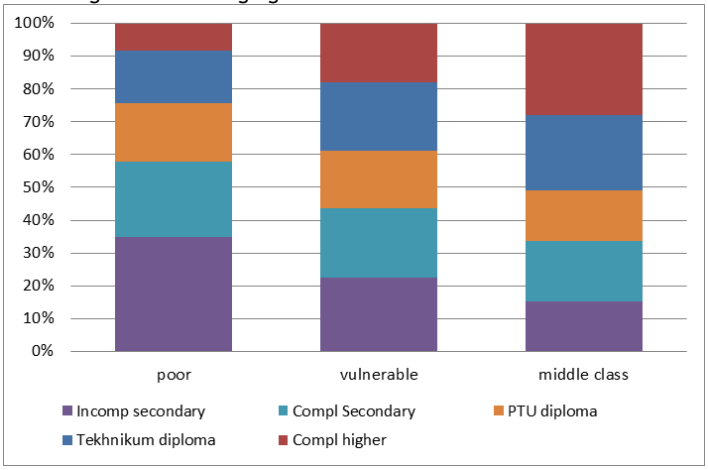
Source: Staff calculations using data from the RLSM-HSE, 2001-2010

Access to markets and economic opportunities is also higher among middle-income households than among poor or vulnerable households. A large fraction of middle-income households reside in urban areas, compared to other groups (70 percent versus 58 percent and 37 percent among vulnerable and poor households respectively). But middle-class status is not just an urban phenomenon and became less so during 2001-2010. In fact, 25 percent of middle-class households resided in rural areas in 2010, compared to 17 percent in 2001. Because urban areas are normally associated with a higher concentration of economic activity and diversification, middle-income households are likely to enjoy better access to markets than poor and vulnerable ones, which are more likely to reside in rural areas. At the same time, it is likely that urbanization itself contributes to the growth of the middle class.

Employment rates are higher and unemployment rates lower among middle-income households. Seventy percent of working-age adults in middle-income households are employed, compared to 60 percent in vulnerable households and 50 percent in poor households. Similarly, the unemployment rate among middle-income households is 3 percent, half of that experienced by vulnerable households and a third of the rate for poor households.

Figure 34: A third of working-age adults in middle income households had completed tertiary education in 2010

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



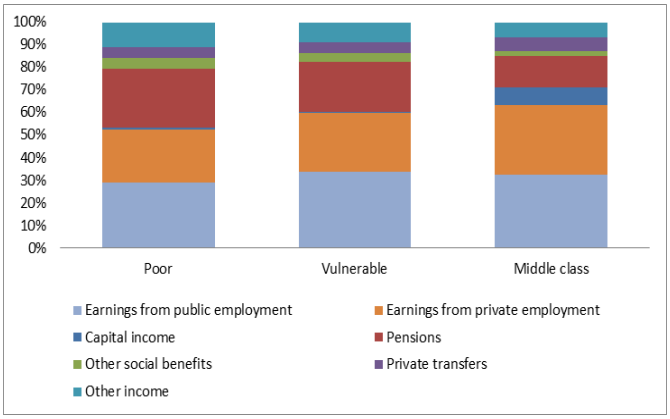
Source: Staff calculations using data from the RLSM-HSE, 2010

Ultimately, better human capital and higher access to economic opportunities translate into higher shares of labor and capital income in total income for middle class households and, consequently, lower levels of dependency on non-labor sources of income, such as public transfers or family support. Income derived from wages or self-employment accounts for the lion's share of total per-capita household income for households in all income groups, although relatively more so for middle-income households. There are also differences across economic groups in terms of the source of the labor income. Specifically, earnings from private employment (i.e. in a private firm or from self-employment) account for more than 50 percent of the total labor income among middle-income households, but it's less than half for other economic groups. In addition, while the contribution of capital income is negligible for poor and vulnerable households, it accounts for almost 10 percent of total per capita household income among middle-income households. Combined, these numbers show that the share of total per-capita household income derived from productive assets (both human and physical/financial) is 15 percent higher among middle-income households than among poor and vulnerable households).

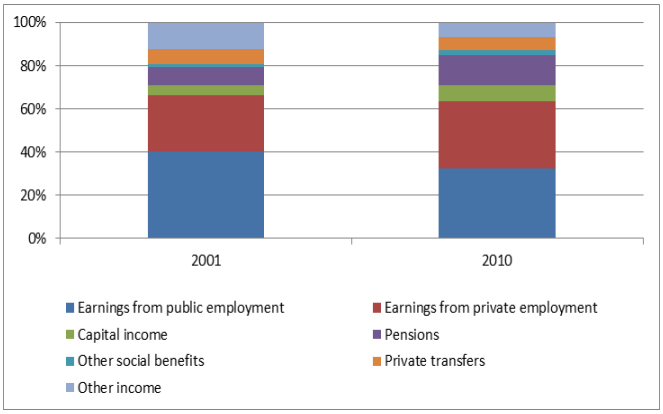
This characterization of the Russian middle class is broadly consistent with the existing literature on the topic. Although there is no single set of characteristics that can be consistently associated with middle-class status across countries and time (Kenny, 2011), many traits of the Russian middle class identified here are similar to those described elsewhere in the literature, particularly the literature on developed countries (see footnote 4 for relevant references). These traits include a lower number of children, a higher probability of living in urban areas, working in stable jobs and/or specific occupations (usually skilled and/or white collar) and investing in human capital (both education and health), higher levels of asset ownership and increased ability to cope with shocks and smooth consumption over time. The middle-class profile is also consistent with the Russian literature, which identifies it on the basis on a series of quantitative and qualitative traits as opposed to a single monetary cut-off as is done here, including education level, occupation, income level and self-identification (see, for instance, Nisanov, 2012; Beliaeva, 2011, Tichonova, 2009; Maleva and Ovcharova, 2009). In contrast, the contribution of public transfers, both pensions and safety-net programs, to total income is a modest 15 percent (over 10 percent from pensions alone), compared with almost 35 percent among the poor and 25 percent among the vulnerable. (Figure 35, left panel)

Figure 35: Labor earnings are relatively more important for middle-income households, while public transfers are relatively more important for poor and vulnerable households

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



Percentage of total household income accounted for by different income sources
Middle class only in 2001 and 2010



Source: Staff calculations using data from the RLSM-HSE, 2001-2010

3.5 Demographic and economic drivers of middle-class emergence

Differences in endowments and access to markets and to economic opportunities between the middle class and other economic groups remained stable over 2001-2010. A middle-class profiling exercise in 2001 generated results that were remarkably similar to the one presented above for 2010. Even though it was significantly smaller at that time (30 percent of the total population), the middle class could already be characterized as having better endowments (both in terms of household demographics and education levels), a higher probability of living in urban areas and access to more and better (more productive) jobs.

At the same time, the composition of household income varied significantly over the period for middle-class households. The share of labor income in total per-capita household income fell from 73 percent to 64 percent over the decade. This decline was coupled with a substantial change in the composition of labor income as the share of earnings from the public sector in total per-capita household income fell from 40 percent in 2001 to a little above 30 percent in 2010. Meanwhile, that of earnings from the private sector grew from 25 percent to 30 percent during the same period (Figure 35, right panel). At the same time, the share of capital income and public transfers, particularly pensions, increased significantly, suggesting that their growth exceeded that of labor income during the period—at least for middle-class households.[23]

This suggests that both markets and public policy played a role in the growth of the middle class in Russia. On the one hand, asset ownership and the ability to make productive use of such assets are both stepping stones into middle-class status. In this respect, education levels have changed slowly and only modestly in Russia during 2001-2010, making human-capital accumulation an unlikely candidate when it comes to explaining middle-class growth. In contrast, employment grew at an average of 2 percent per year for most of the decade, bringing unemployment levels to record lows even after the crisis. Wages increased rapidly (13 percent per year on average) until 2008 and continued to grow at a slower rate afterwards. On the other hand, the government proactively used fiscal policy for redistributive purposes during this period, and especially as a policy response to the 2008 global financial crisis, when pensions and other public transfers increased substantially. Finally, labor market and public policy changes took place against the background of the demographic pressure generated by the rapid aging of the Russian population and the associated shrinkage of the labor force and growth of the old-age dependency ratio.

In this section, we examine the role that economic and demographic factors played in the emergence of the Russian middle class over the last decade. For this purpose, we present two complementary empirical exercises. The first one focuses on those who joined the middle class during 2001-2010 and decomposes the observed growth

[23] An alternative explanation for the rise in the share of public transfers in total income among middle class households could be an increase in the number of beneficiaries, particularly pensioners. However, given that the old-age dependency ratio remains constant during the period, this seems unlikely.

in their average per capita household income into three basic components: demographics, market income and non-market income, as well as the elements within each of them. The second exercise uses information on the characteristics of all poor and vulnerable households at the beginning of the period of study, as well as information on shocks that may have occurred during the period (e.g. change in employment status, change in eligibility status for a particular social program) to predict which of these households will transition into the middle class at the end of the period (see Meyer and Sanchez for details on both exercises).

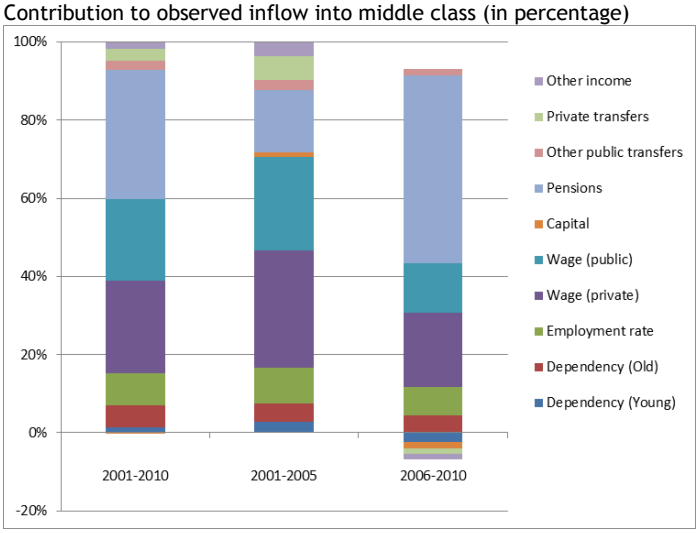
Middle class entry: A first look

Economic rather than demographic factors drove middle-class growth in 2001-2010. Changes in the household ratio of members aged 65 and up versus working-age adults (the old-age dependency ratio) and changes in the ratio of households members aged 17 and under to working-age adults (the child-dependency ratio) explained less than 10 percent of the observed changes in per-capita household income among households that joined the middle class in 2001-2010, or during any of the sub-periods under consideration. In contrast, changes in income from labor due to changes in the employment rate of working-age adults, along with changes in wages or both, accounted for almost 50 percent of the observed growth in income, while changes in public transfers made up an additional 40 percent (Figure 36).

Wage and pension growth accounted for over half of the observed income growth among middle-class entrants in 2001-2010. Increases in employment, measured through changes in the employment rate of working-age adults, explained 8 percent or so of the observed increase in income while wage growth accounted for over 40 percent, playing a similar role in the public and private sectors. This is in line with the macroeconomic developments discussed earlier and consistent with the recent literature on labor market adjustments in Russia, which suggests that prices (wages) are relatively flexible and thus adjust significantly over the business cycle while quantities (employment) remain relatively stable (Gimpelson and Kapeliushnikov, 2011). In addition, pensions account for 35 percent of the observed change in income, more than other social transfers and almost overshadowing the impact of wage growth (Figure 36).

Figure 36: Wage and pension growth were the two main drivers of middle class growth in 2001-2010

Contribution to observed inflow into middle class (in percentage)



Source: Staff calculations using data from the RLSM-HSE, 2010

The relative role of labor markets and public transfers changed over the decade. During 2001-2005, employment and especially wage growth explained over 60 percent of the observed change in per-capita household income among middle-class entrants. Wage growth in the private sector alone accounted for almost 30 percent, or half of the impact of labor markets, compared to 10 percent for employment changes and 20 percent for public-sector wage growth. In contrast, in 2006-2010, the contribution of employment and especially wage growth declined significantly. Employment growth accounted for less than 7 percent of the observed changes, and private sector and public sector wage growth explained about 20 percent and 14 percent respectively. This is likely the reflection of the impact of the financial crisis which, as mentioned before, did not eliminate many jobs but substantially slowed wage growth in Russia. On the other hand, the contribution of pensions to overall per-capita income growth climbed from less than 20 percent in 2001-2005 to over 50 percent in 2006-2010 (Figure 36).

The size and direction of the contribution of other variables considered in the decomposition also changed between 2001-2005 and 2006-2010, but their overall impact on income growth among middle-class entrants is very small relatively to that of wages and pensions. Perhaps not surprisingly, capital income had a small but positive impact on per-capita household income growth in 2001-2005 and a negative impact in 2006-2010. Public transfers other than pensions had a positive impact in both periods, while private transfers (e.g. remittances, inter-household transfers such as alimony payments, charity donations, etc.) also contributed positively to income growth in 2001-2005 (about 6 percent percent) and virtually disappeared from the picture in 2006-2010, suggesting a potential shift of the burden of income support from private to public hands over the decade.

Middle class entry: A deeper look

We now turn to the results from the regression analysis[24]. The characteristics of household heads and the composition of households both affected the probability of middle-class entry. Households headed by more educated individuals, and particularly individuals with tertiary education, were more likely to rise into the middle class, but this effect was only significant in 2006-2010. In addition, female-headed households were less likely to enter the middle class than male-headed households in both 2001-2005 and 2006-2010. Bigger households and households with larger shares of dependents (particularly elderly dependents) in 2001 or 2006 were less likely to become middle class than their counterparts during both periods. In addition, increases in household size and in the old-age dependency ratio over the period decreased the probability of entry into the middle class in 2001-2005 and 2006-2010. In contrast, increases in the child-dependency ratio had no significant effect. Notice that these results are consistent with those from the decomposition exercise discussed above. Combined, these two sets of results suggest that while changes in household composition had a significant impact on the probability of joining the middle class at the household level (i.e. among households that did experience such changes), the number of households that actually experienced these changes and the magnitude of the changes were relatively small when aggregated across all households, and hence their impact on overall dynamics was also limited.

Access to economic opportunities, as well as the nature of jobs, mattered for middle-class entry. Whether the household head was employed, in either the public or private sector, significantly modified the household's probability of middle-class entry in 2001-2005, but had no significant impact in 2006-2010. In both periods, the impact of private employment on middle-class entry was slightly larger that of public employment, irrespective of whether the household head held a formal or an informal job[25]. Households headed by individuals employed in highly skilled white-collar jobs were also more likely enter the middle class over the period compared to those headed by individuals employed in other occupations or without a job.

Households were less likely to enter the middle class if, other things being equal, the household head became unemployed during the period (i.e. the household head was employed in 2001 and unemployed in in 2005, or employed in 2005 and unemployed or out of the labor force in 2010).The opposite was true when the household head became employed during the period, although this effect was not always significant or robust.

Impacts were not limited to the employment status of the household head. Households with a larger number of employed adults at the beginning of the period (i.e. 2001 and 2006), as well as those experiencing an increase in the number of employed adults during the period, were more likely to rise into the middle class than other households. And, even if the employment rate at the household level was similar at the beginning and end of the period, the occurrence of one or more employment shocks, measured as job loss by any adult in the household, negatively impacted the probability of joining the middle class (more significantly in 2006-2010). This suggests that these events were associated with a relatively large drop in household income. As before, these results were consistent with the discussion above on the importance of employment and particularly wage increases for middle class growth since only those holding a job (especially a formal job) could benefit from these increases. In other words, households with more employed individuals and/or with individuals who were employed for longer periods benefited the most from strong wage growth and hence were more likely to join the middle class, other things being equal.

Higher-than-average increases in benefit payments, rather than receipt of benefits, impacted the probability of entering the middle class. Receiving a public pension or other form of public transfers in 2001 or 2005 had no significant impact on middle-class entry. But a more detailed look at the role of pensions and other transfers revealed some interesting, though not statistically significant, results. In particular, households where pensions accounted for more than 20 percent of total per-capita income—that is, households with relatively higher dependency on public transfers—were less likely to become middle class during the periods under study, while households that received higher-than-average pensions in 2001 or 2006 and/or experienced larger-than-average increases in pension payments during 2001-2005 or 2006-2010 were more likely to do so.

[24] Regression results can be found in Meyer and Sanchez (2014).
[25] Results on the impact of formal versus informal employment have to be interpreted with caution as the RLMS contains limited information to this effect and, as a result, informal is likely to be significantly underestimated.

3.6 Conclusions

This paper has documented the rapid rise of the Russian middle class during 2001-2010 and identified its main drivers. Though demographic factors (related to aging and other social changes) and economic factors were both found to affect middle-class entry, the latter explained most of the observed changes in the period of study. Access to good, productive jobs—i.e. jobs that required a higher level of skills and thus paid higher wages—and wage growth in both the private and public sectors served as the main platforms for the rise of the middle class in Russia. In addition, significant increases in pensions helped many escape poverty and vulnerability and join the middle class, particularly during 2006-2010. In the current environment of slower economic growth and constrained fiscal resources, further expansion of the middle class will require continued job creation combined with an increase in labor-force participation among youth, women and older workers, so as to increase the overall employment rate in the economy and strengthen the role of labor income as the main driver of middle-income growth.

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Annex

Main indicators

						2012													2013												
Output Indicators	2007	2008	2009	2010	2011	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	2012	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	2013	Jan	Feb
GDP, % change, y-o-y 1/	8.5	5.2	-7.8	4.5	4.3	-	-	4.8	-	-	4.5	-	-	4.0	-	-	3.4	3.4	-	-	1.6	-	-	1.4	-	-	1.3	-	-	1.3	1.3		
Industrial production, % change, y-o-y	6.8	0.6	-10.7	7.3	5.0	3.8	6.5	2.0	1.3	3.7	1.9	3.4	2.1	2.0	1.8	1.9	1.4	3.4	-0.4	-3.1	-0.1	1.1	-0.5	1.7	0.8	-0.2	1.3	1.0	2.8	0.4	0.4	-0.2	2.1
Manufacturing, % change, y-o-y	10.5	0.5	-15.2	10.6	8.0	4.8	6.3	2.4	3.6	7.0	3.4	5.7	4.1	3.3	3.0	4.0	1.5	5.1	-1.1	-2.2	-0.9	0.4	-1.9	2.0	1.5	-0.7	1.1	0.6	4.8	1.7	0.5	0.0	3.4
Extraction of mineral resources, % change, y-o-y	3.3	0.4	-2.8	3.8	1.8	1.4	3.7	0.8	1.2	-0.3	0.2	0.9	0.8	1.8	2.1	0.3	0.2	1.0	0.2	-2.0	0.9	1.7	1.7	1.7	0.1	1.0	1.9	1.7	1.8	2.0	1.1	0.9	0.8
Fixed capital investment, % change, y-o-y	23.8	9.5	-13.5	6.3	10.8	16.6	16.3	16.6	8.5	13.7	9.2	9.5	7.8	-0.3	6.2	2.5	-0.4	6.8	2.9	0.3	-2.0	-0.5	0.1	-2.9	2.4	-1.8	-1.3	-0.1	0.4	0.6	-0.2	-7.0	-3.5
Fiscal and Monetary Indicators																																	
Federal government balance, % GDP 1/	5.4	4.1	-5.9	-4.1	0.8	0.7	-2.4	-0.5	-0.4	0.6	1.0	0.9	1.4	1.5	1.5	1.4	-0.1	-0.1	-0.3	-1.8	-0.4	0.0	0.7	1.2	0.8	0.9	1.2	1.1	1.0	-0.5	-0.5	9.3	0.3
M2, % change, p-o-p 2/	51.3	27.2	-3.5	30.6	23.3	-3.5	0.7	0.8	0.8	0.8	1.3	-0.5	0.0	0.3	0.3	1.4	9.3	17.9	-2.4	1.6	1.1	1.4	0.9	1.5	0.8	0.2	-0.5	-0.3	2.2	7.7	15.4	-4.0	
Inflation (CPI), % change, p-o-p	11.9	13.3	8.8	8.8	6.1	0.5	0.4	0.6	0.3	0.5	0.9	1.2	0.1	0.6	0.5	0.3	0.5	5.1	1.0	0.6	0.3	0.5	0.7	0.4	0.8	0.1	0.2	0.6	0.6	0.5	6.8	0.6	0.7
Producer price index (PPI), % change, p-o-p	25.1	-7.0	13.9	16.7	13.0	-0.2	1.1	2.2	0.7	-2.4	-0.8	-1.1	5.1	4.8	-1.6	-1.2	-1.1	6.8	-0.4	0.8	0.5	-1.2	-1.0	0.4	2.0	2.8	1.4	-1.2	-1.5	1.0	3.5	0.4	-0.4
Nominal exchange rate, average, Rb/USD	25.6	24.8	31.7	30.4	29.4	31.5	29.9	29.4	29.5	30.7	32.9	32.5	32.0	31.5	31.1	31.4	30.8	31.1	30.3	30.2	30.8	31.3	31.2	32.3	32.7	33.0	32.6	32.1	32.6	32.9	31.8	33.5	35.2
Reserve Fund, bln USD e-o-p		137.1	60.5	25.4	25.2	61.4	62.4	62.3	62.2	60.2	60.5	59.9	60.5	61.5	61.4	61.4	62.1	62.1	86.2	84.7	83.9	84.9	84.4	84.7	85.4	85.4	86.4	87.2	86.9	87.4	87.4	87.1	87.3
National Wealth Fund, bln USD, e-o-p		88.0	91.6	88.4	86.8	88.3	89.8	89.5	89.2	85.5	85.6	85.2	85.9	87.6	87.2	87.5	88.6	88.6	89.2	87.6	86.8	87.3	86.7	86.5	86.9	86.8	88.0	88.7	88.1	88.6	88.6	87.4	87.3
Reserves (including gold) billion $, end-o-p	478	427	439	479	499	505	514	513	524	510	514	511	515	530	527	528	538	538	532	526	528	533	518	514	513	510	523	524	516	510	510	499	493
Balance of Payment Indicators																																	
Trade Balance, billion $ (monthly)	130.9	179.7	112.1	151.4	198.2	20.4	20.3	18.3	18.1	17.3	13.9	11.5	11.3	15.7	14.4	14.7	16.4	192.3	17.2	15.3	15.8	14.3	14.6	13.6	13.3	14.0	15.9	12.7	16.6	15.8	179.0	18.9	
Current Account, billion $	76.6	102.4	48.9	70.3	98.8	-	-	39.5	-	-	16.0	-	-	5.9	-	-	10.0	72.0	-	-	25.1	-	-	2.6	-	-	0.6			4.7	33.0		
Export of goods, billion $	354.4	471.6	304.0	400.1	522.0	39.5	45.0	46.7	44.9	45.5	40.8	41.2	41.2	43.1	46.5	45.3	48.3	528.0	38.9	41.9	44.5	44.5	41.0	41.9	43.8	42.6	44.8	43.6	46.7	49.2	523.3	39.5	
Import of goods, billion $	223.5	291.9	191.9	248.7	323.8	19.1	24.7	28.4	26.8	28.2	27.0	29.7	29.9	27.4	32.2	30.6	31.9	335.7	21.7	26.5	28.7	30.2	26.4	28.3	30.5	28.6	28.9	30.9	30.2	33.4	344.3	20.6	
Gross FDI, mln USD 1/	27,797	27,027	15,906	13,810	18,415	-	-	3,863	-	-	7,598	-	-	11,333	-	-	18,666	18,666	-	-	6,384	-	-	12,139	-	-	18,610	-	-	26,118	26,118		
Financial Market Indicators																																	
Average weighted lending rate for enterprises, % 3/	10.8	15.5	13.7	9.1	9.3	8.8	8.9	9.2	9.0	8.9	9.3	9.5	9.1	8.9	9.1	9.1	9.4	9.4	8.8	9.6	10.0	10.2	9.9	9.5	9.2	9.3	9.5	9.2	9.0	9.4	9.4	9.2	
CBR policy rate, %, end-o-p	10.0	9.5	6.0	5.0	5.3	5.3	5.3	5.3	5.3	5.3	5.3	5.3	5.3	5.50	5.50	5.50	5.50	5.5	5.5	5.5	5.5	5.5	5.5	5.5	5.5	5.5	5.5	5.5	5.5	5.5	5.5	5.5	5.5
Real average rate for Ruble loans, % (deflated by PPI)	-3.4	-6.8	-0.1	-6.5	-3.2	-1.5	0.8	0.2	1.3	4.8	3.6	3.9	1.7	-2.6	0.0	2.3	3.9	3.9	3.5	4.7	6.4	8.5	7.0	5.6	2.4	4.5	7.5	7.1	7.3	5.5	5.5	4.3	
Stock market index (RTS, ruble term, eop)	2,291	632	1,445	1,770	1,382	1,577	1,735	1,638	1,594	1,242	1,351	1,377	1,390	1,476	1,436	1,437	1,527	1,527	1,622	1,534	1,460	1,407	1,331	1,275	1,313	1,291	1,437	1,496	1,413	1,450	1,450	1,324	1,268
Income, Poverty and Labor Market																																	
Real disposable income, (1999 = 100%)	245.6	251.5	259.3	272.5	274.7	203.4	253.4	253.4	274.5	258.8	290.1	270.7	281.5	278.7	277.6	295.3	415.9	286.2	205.0	270.8	279.2	297.4	258.1	298.4	283.8	288.9	277.3	292.3	301.6	425.0	295.7	204.4	272.7
Average dollar wage, US $	532	697	588	698	806	754	804	868	875	861	835	821	804	824.7	862.1	873.9	1185.4	859	887	883	932	958	951	960	923	885	899	938	928	1,205	942	883	843
Share of people living below subsistence, % 1/	13.3	13.4	13.0	12.5	12.7	-	-	13.5	-	-	12.5	-	-	12.1	-	-	10.9	10.9	-	-	13.8	-	-	13.0	-	-	12.6	-	-				
Unemployment (%, ILO definition)	6.1	7.8	8.2	7.2	6.1	6.3	6.2	6.3	5.6	5.2	5.2	5.2	5.0	5.0	5.1	5.2	5.1	5.1	6.0	5.8	5.7	5.6	5.2	5.4	5.3	5.2	5.3	5.5	5.4	5.6	5.6	5.6	5.6

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

1/ Cumulative from the year beginning.

2/ Annual change is calculated for average annual M2.

3/ All terms up to 1 year.