

# Policy Uncertainty Clouds Medium-Term Prospects



Russia Economic Report  
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# Russia Economic Report No. 32

1. Recent Economic Developments
2. Outlook and Risks
3. Paths to Diversified Development in Russia





# Main messages

1

**Russia's economy is stagnating and uncertainty is impacting investor and consumer decisions**

- Seasonally adjusted growth for the first two quarters was near zero.
- Structural impediments slowed economic expansion even before the impact of increased policy uncertainty amid increased geopolitical tensions.
- The economy needed to internalize several rounds of sanctions, countersanctions and measures to stabilize the economy: this meant operating in an environment of higher risk, which depressed domestic demand.

2

**There are substantial risks to Russia's medium-term outlook**

- Macroeconomic stability prevails and Russia remains in possession of large buffers to uphold stability in the near future.
- It is now policy uncertainty about the economic course the country will take that is casting the longest shadow on Russia's medium-term prospects.
- Our baseline projection is one of near stagnation with growth of 0.5 percent in 2014, 0.3 percent in 2015, and 0.4 percent in 2016.

3

**Economic recovery will need a predictable policy environment and a new model of diversified development**

- The stabilization effort should go hand in hand with renewed focus on improving the economy's microeconomic fundamentals.
- A more balanced portfolio of national assets will help overcome structural constraints to growth.
- Stabilization, transparent rules, better quality of public investment, and competition should be the reform priorities for the next decade.

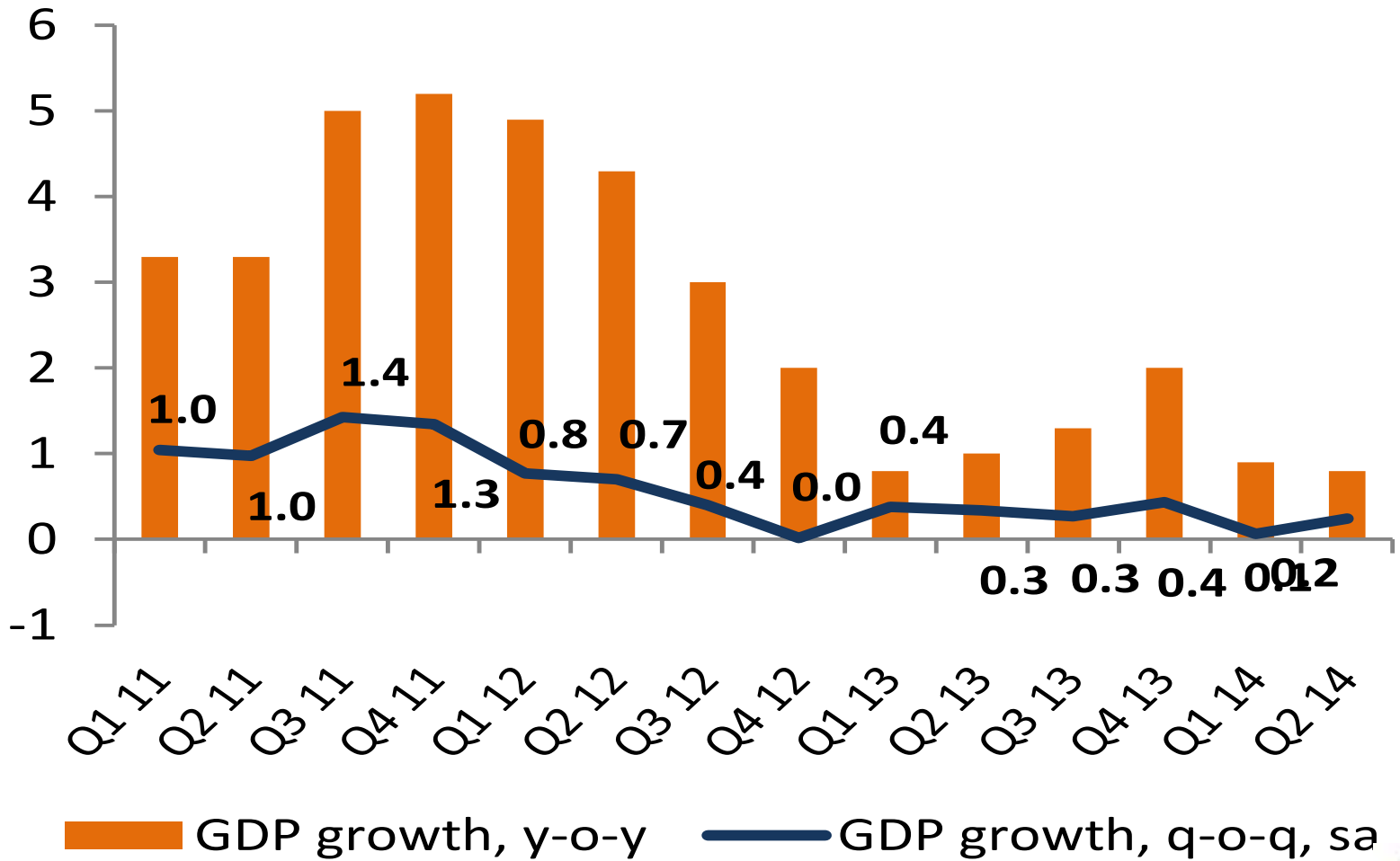
4

**Prospects for future poverty reduction and shared prosperity are limited**

- Restrained investment makes it less likely that well-paying jobs will be created, which could counterbalance the slowdown in income growth.
- Unless addressed, high inflation will hurt consumption growth, dimming the likelihood for further poverty reduction.

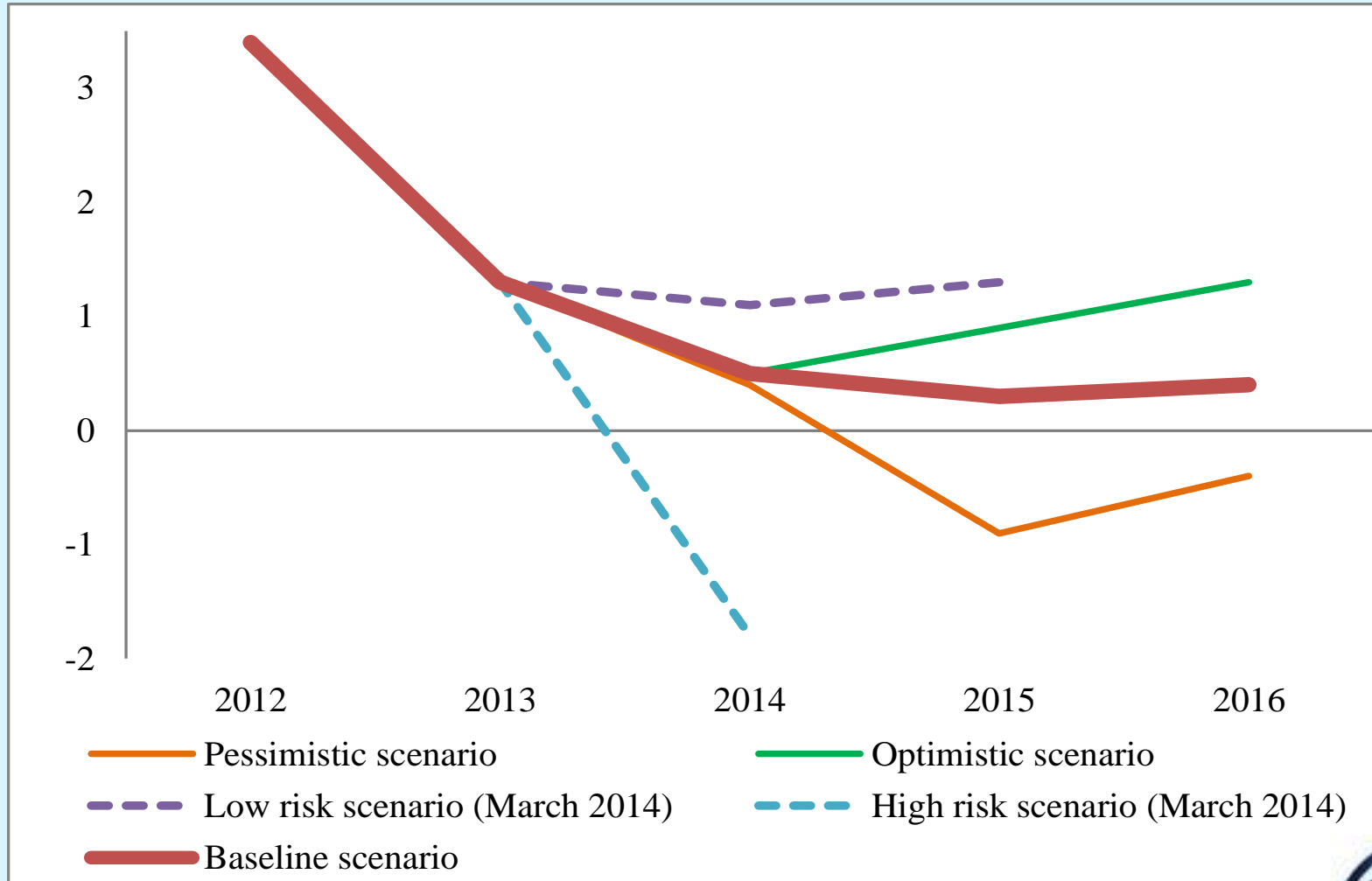
# Russia's Quarterly Growth

GDP growth, y-o-y and q-o-q sa, percent



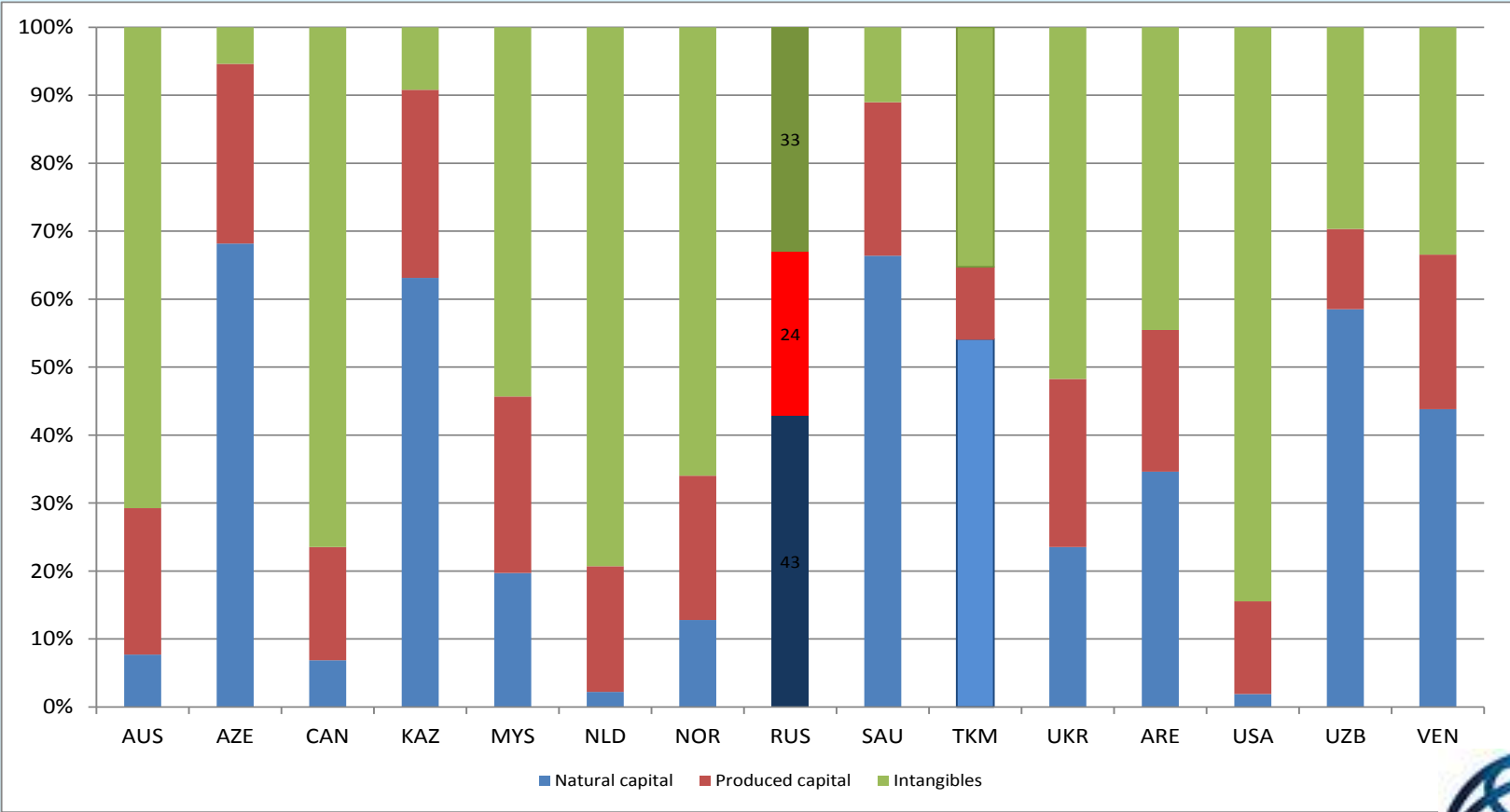
# Russia's Growth Outlook

GDP growth, percent, y-o-y



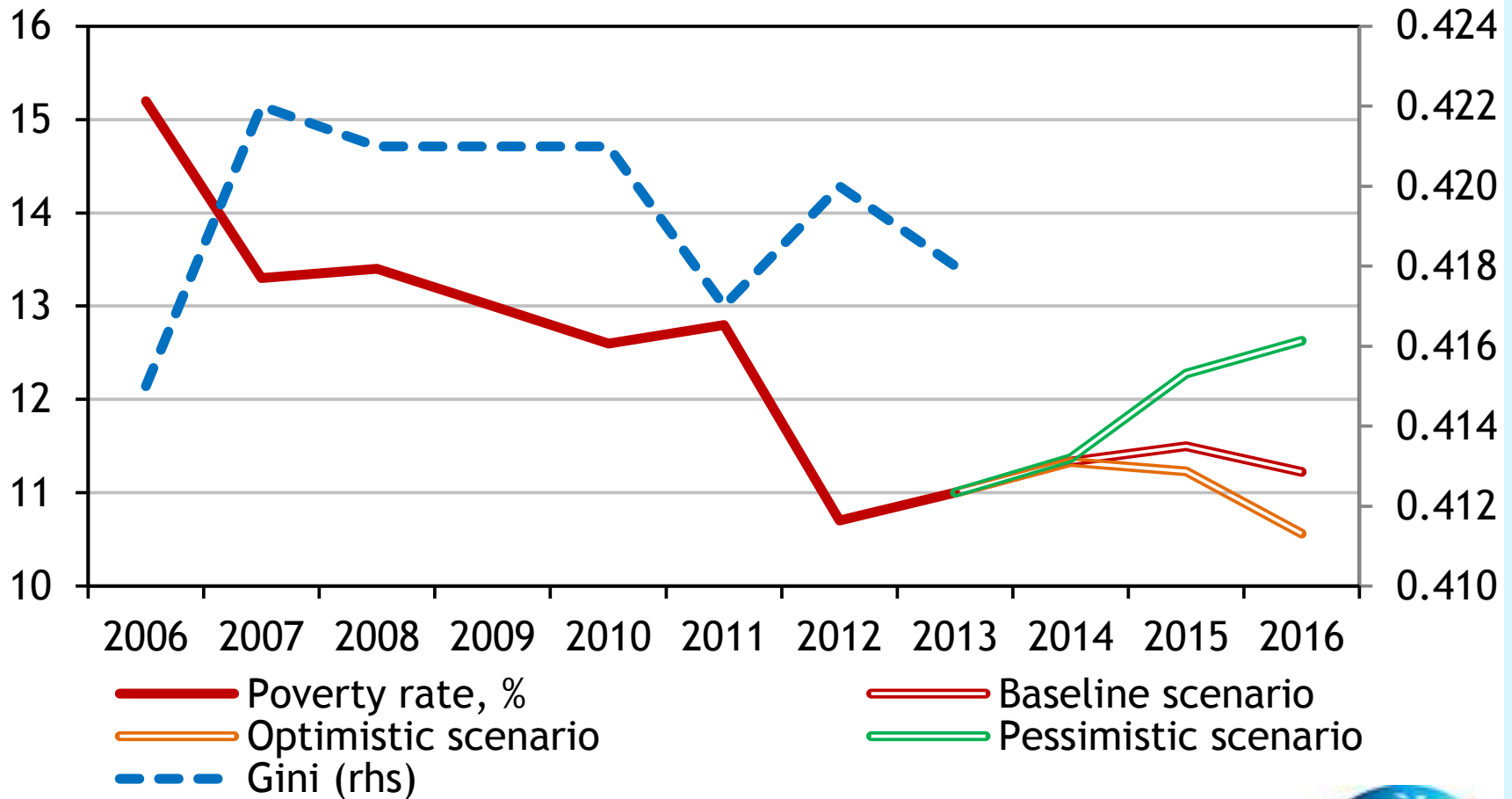
# Russia's current asset base: abundant natural resources, good human capital, improving infrastructure, but weak institutions

Russia's asset portfolio is heavy on natural resources: distribution of wealth by assets, 2005, in percent.



# → Development Challenges

## Poverty and Shared Prosperity





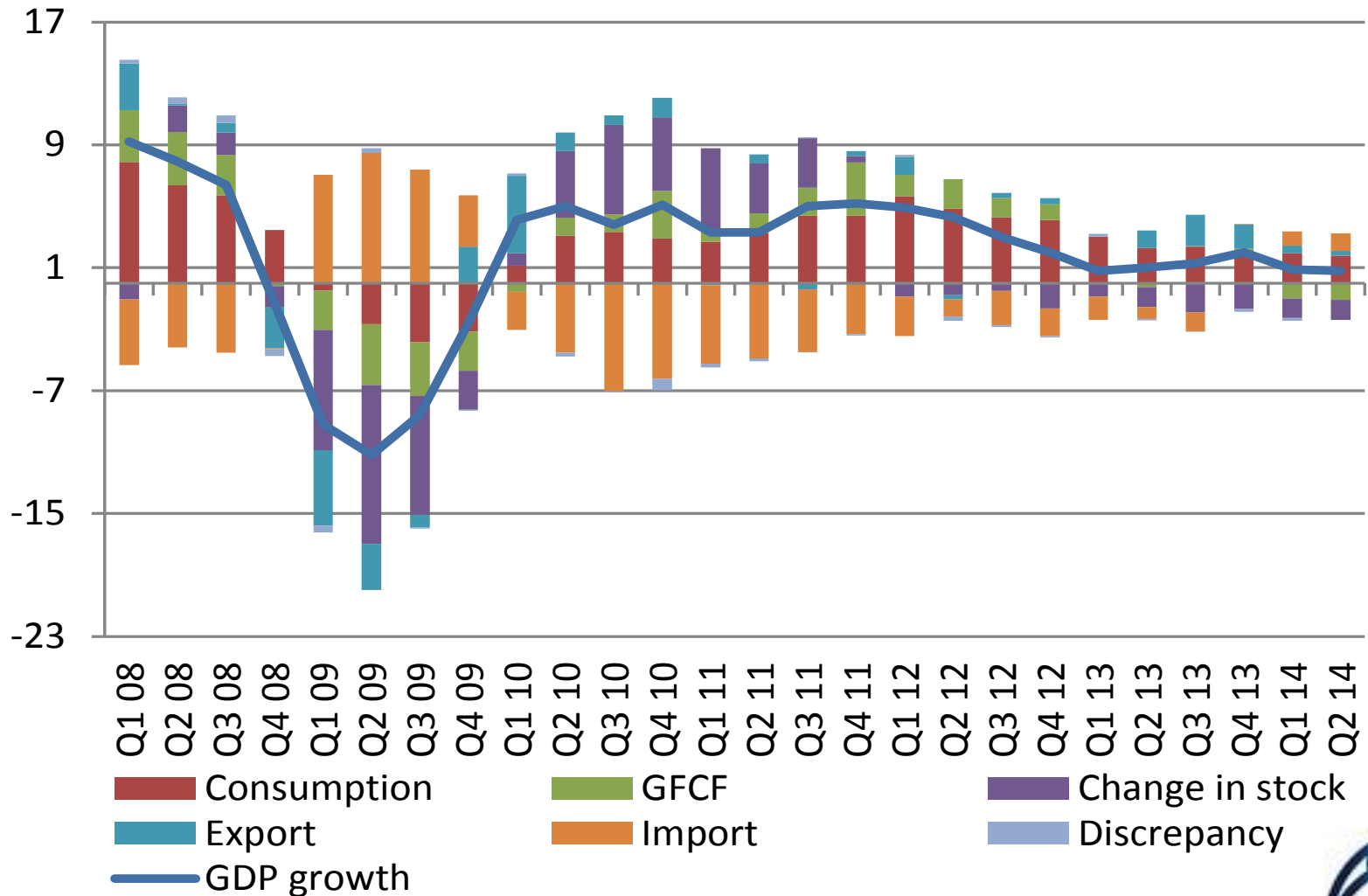
# Recent Economic Developments: An Economy on the Threshold of Recession





# → Weak Domestic Demand

Growth composition, percent, y-o-y

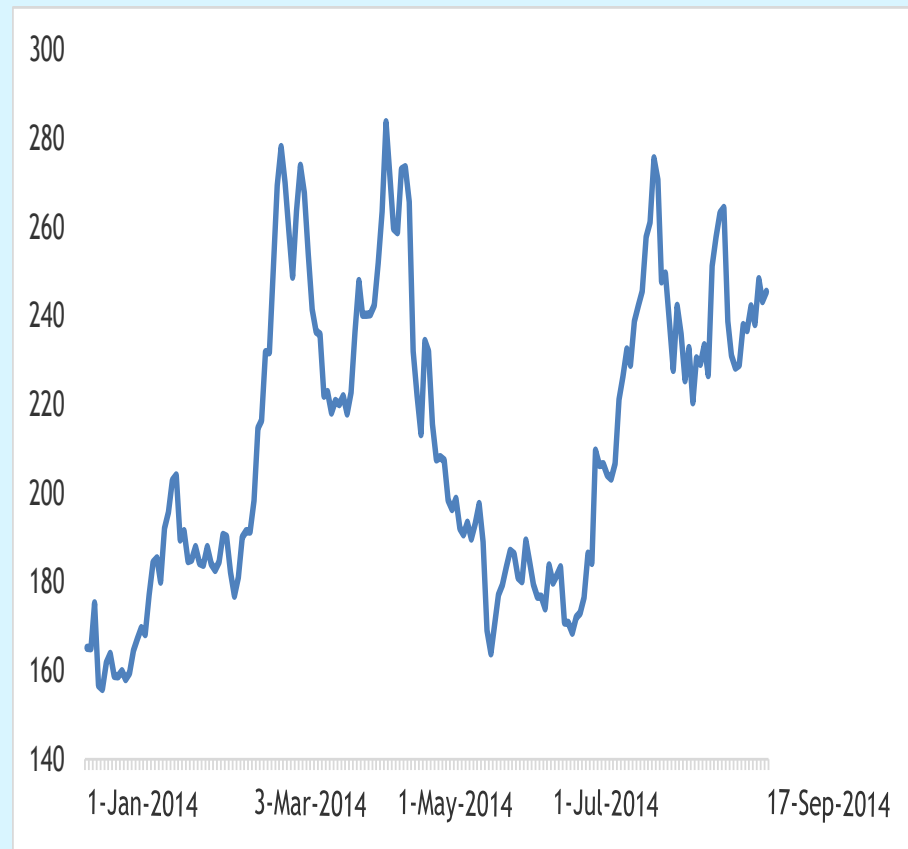
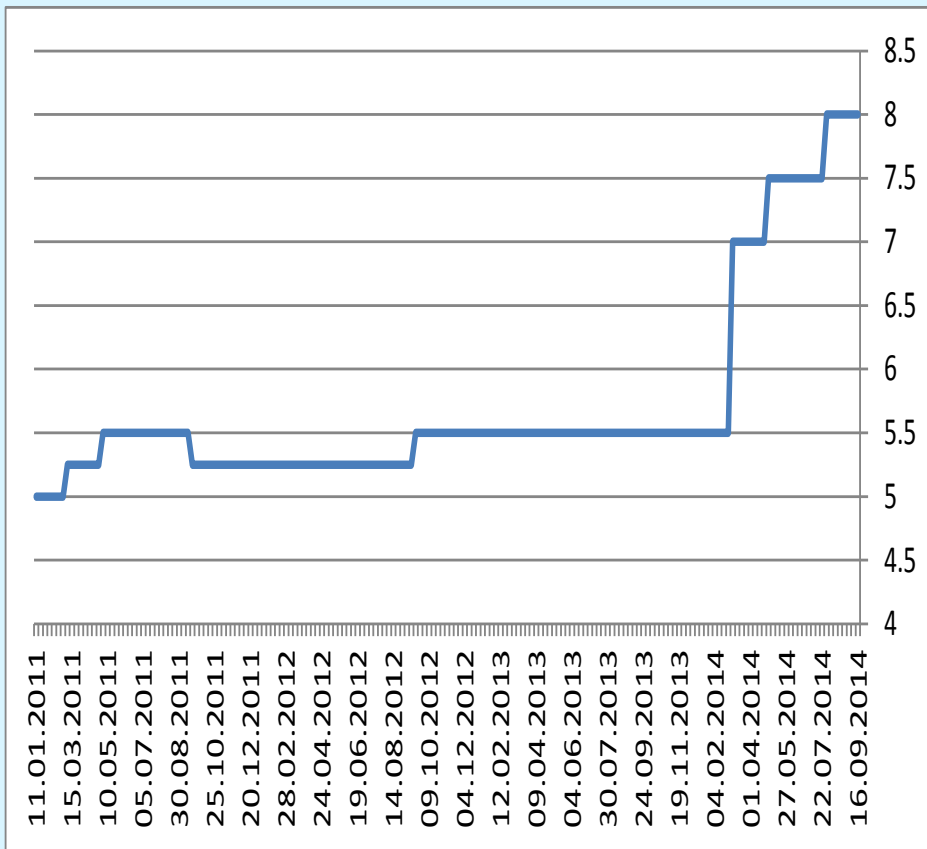


Note: Q2 2014: World Bank estimate



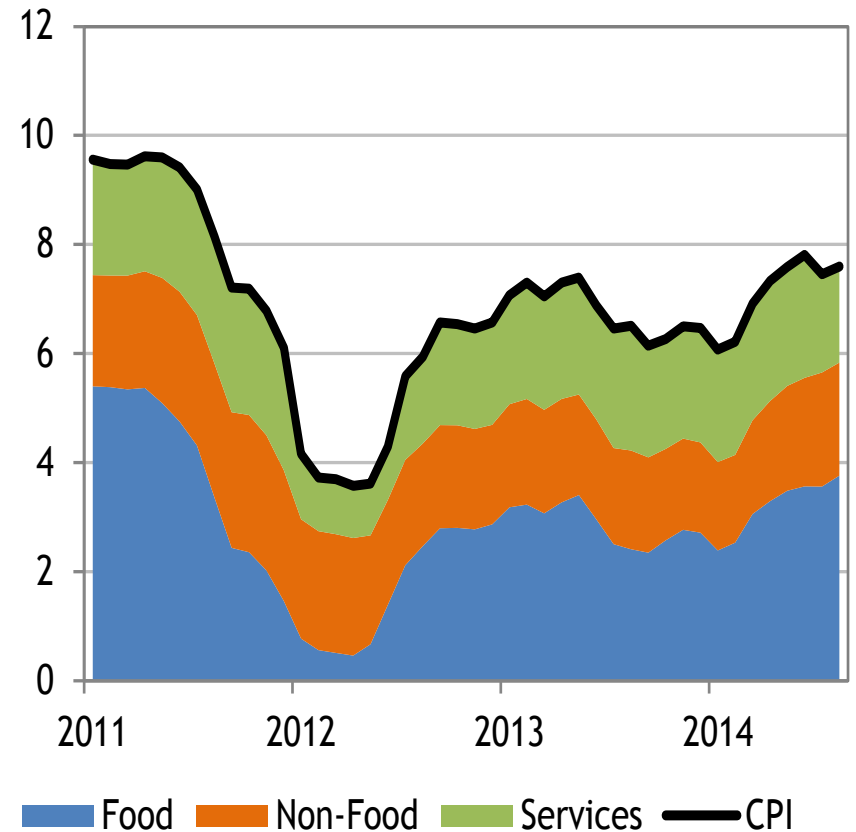
# → Increasing Borrowing Cost Depress Investment

Central Banks Key Policy Rate (percent) and Russia's CDS spreads (bps) for 5 year bonds



# → Depreciation and Inflation Dampen Consumption

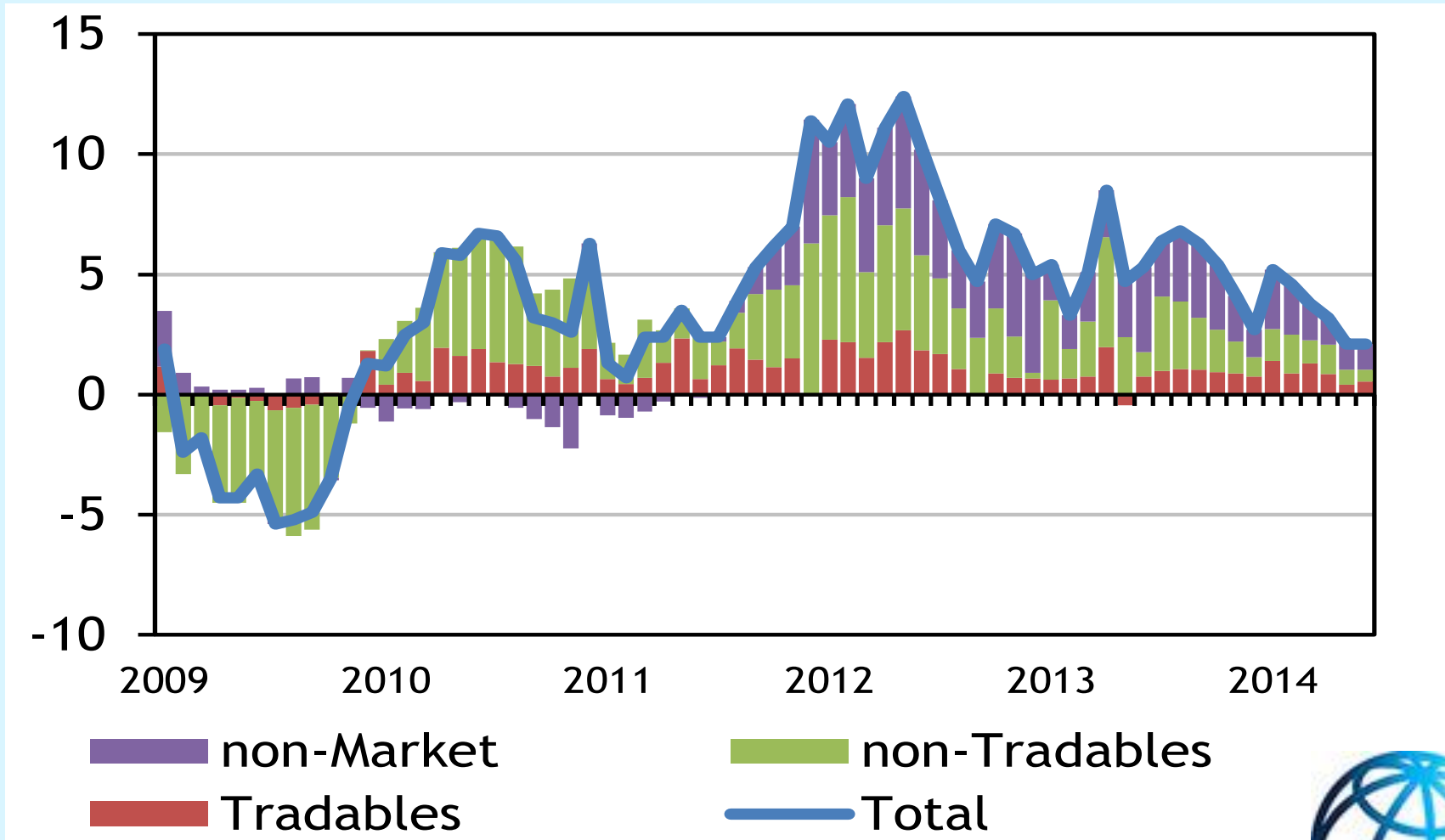
Exchange rate dynamics (Euro-Dollar basket) and Russia's CPI inflation by components





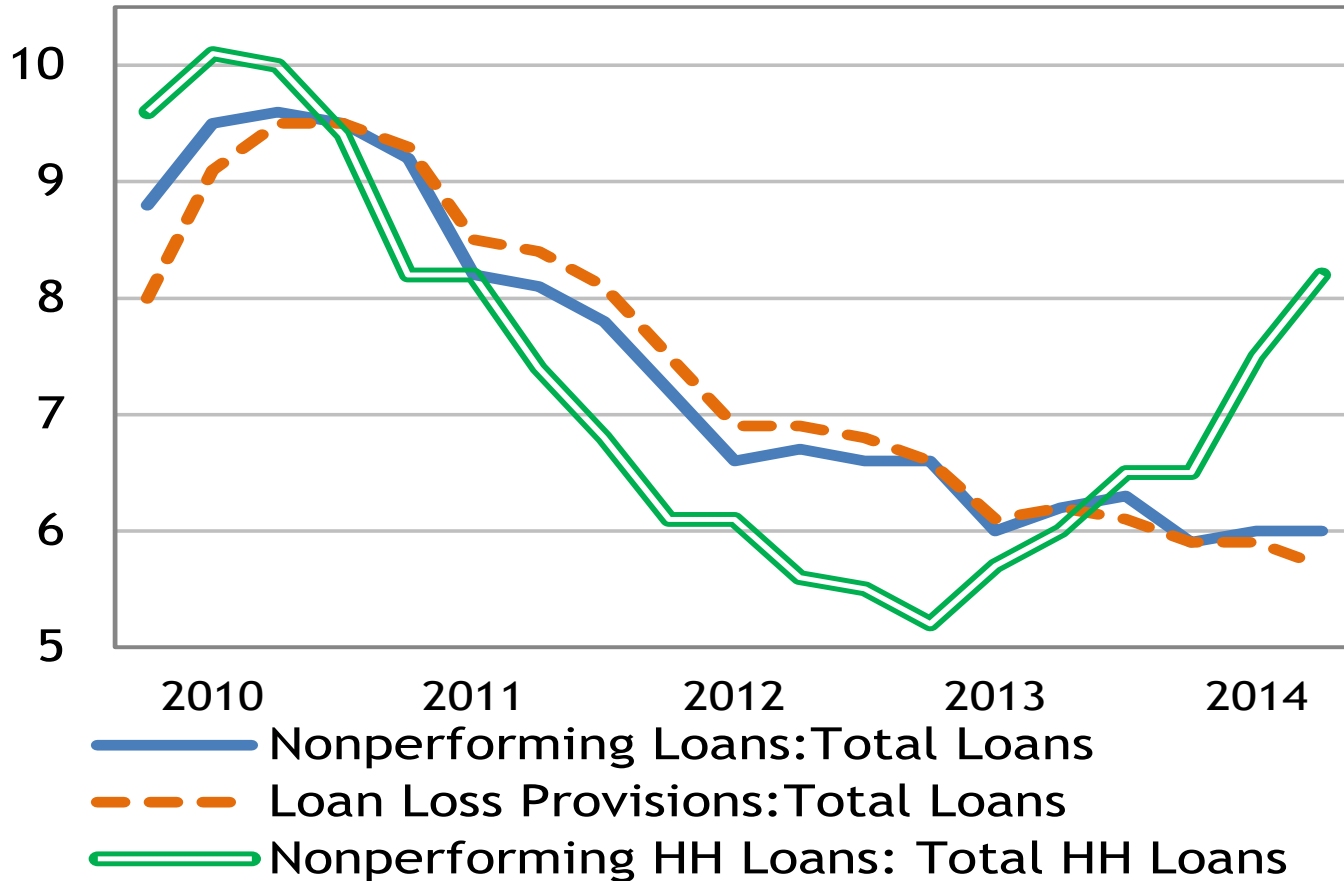
# → Consumption Held Back by Stagnating Real Wages

Real wage growth, percent, y-o-y



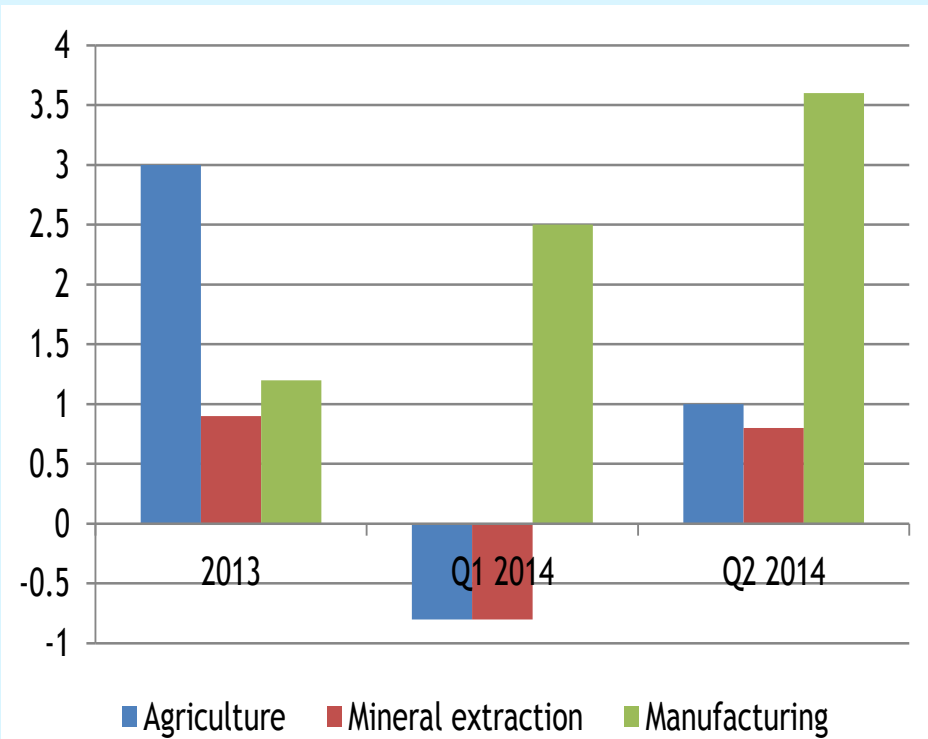
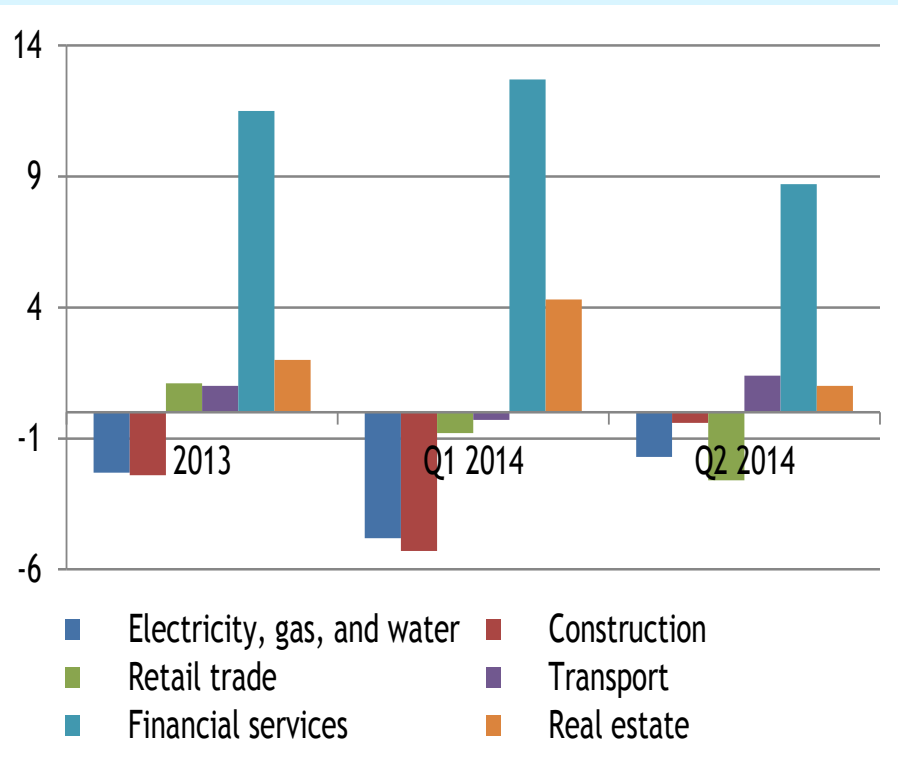
# → ... and by Households' Debt Obligations

Non-performing Loans as a share of total credit, y-o-y, percent



# → Output Growth by Sectors

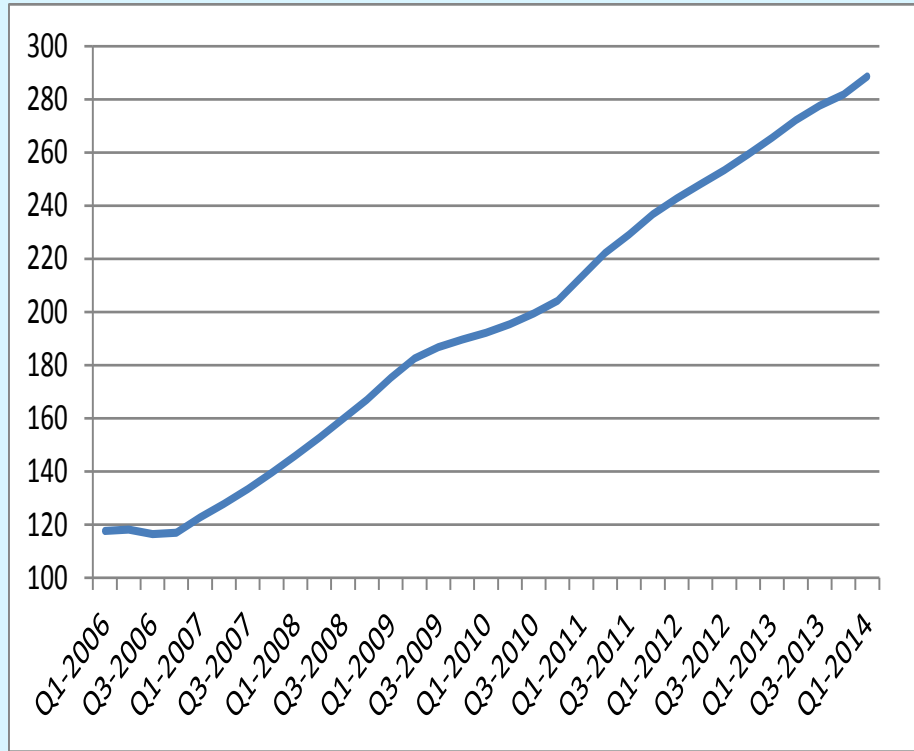
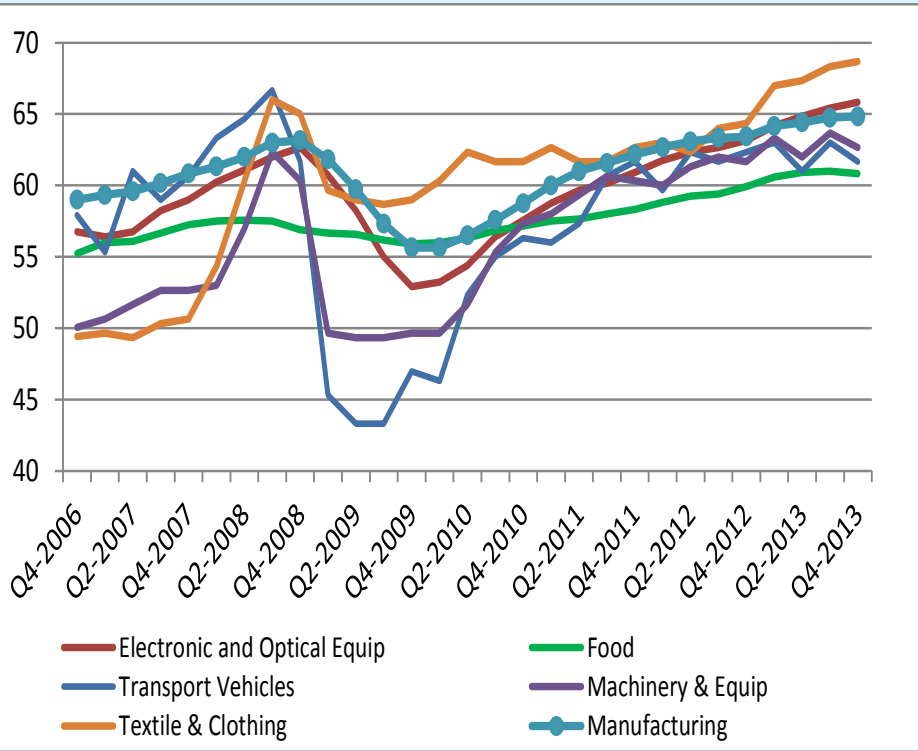
## Non-tradable and tradable sector growth, y-o-y





# → Limited Import Substitution Potential

Capacity utilization rate in manufacturing in percent and unit labor cost (2005=100)

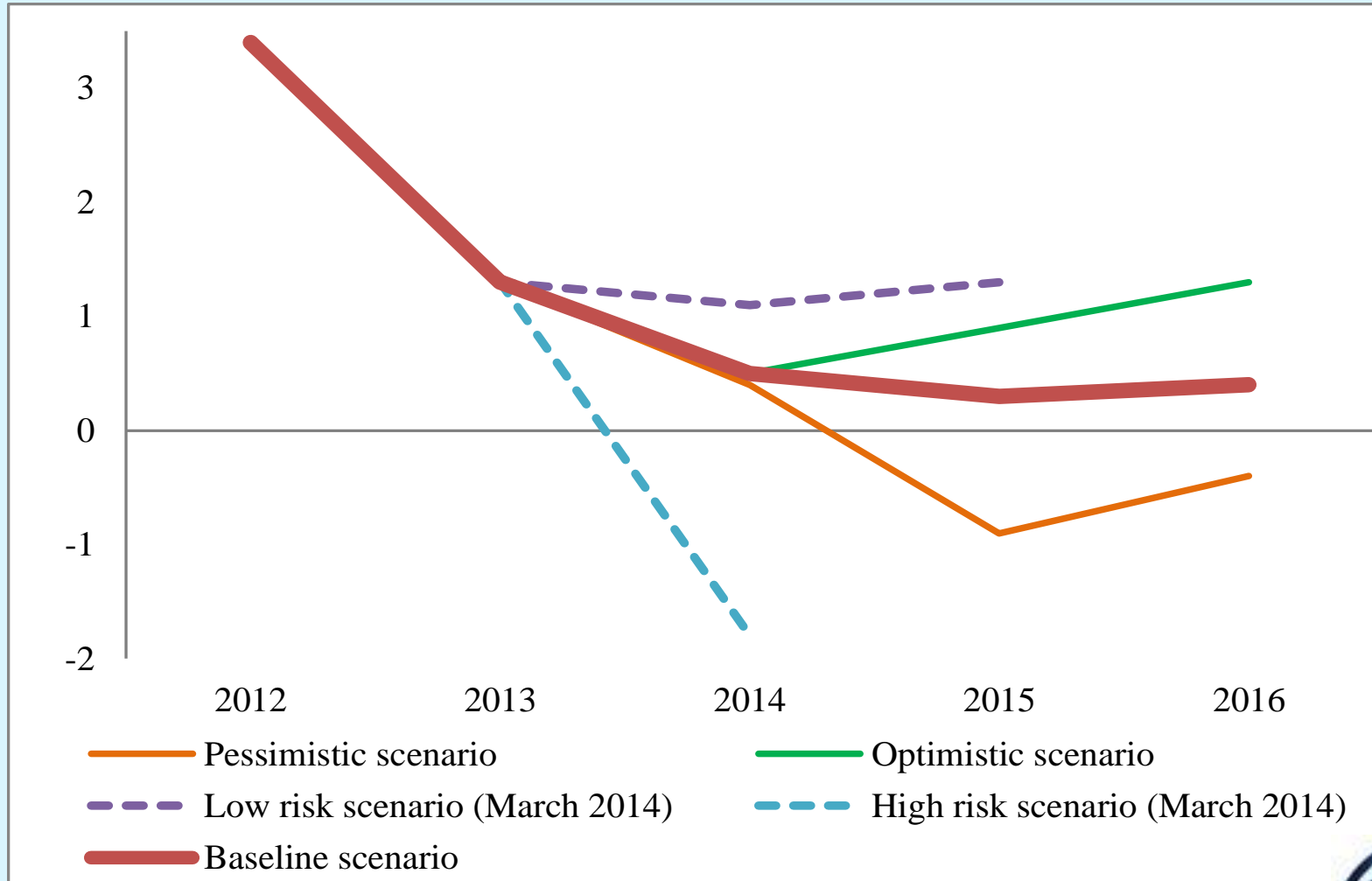


# World Bank Outlook for Russia: Stagnation in the Face of Policy Uncertainty



# Russia's Growth Outlook

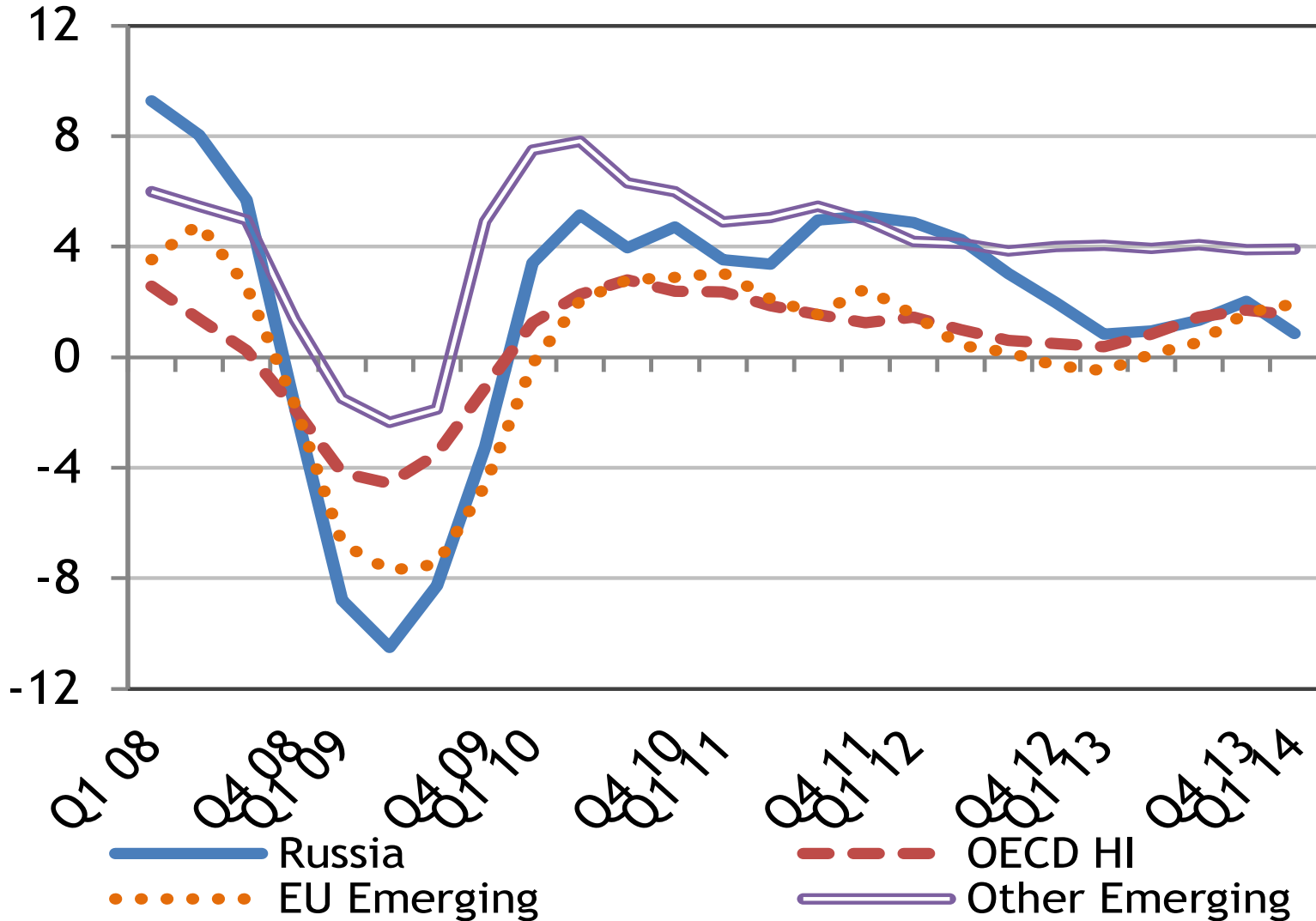
GDP growth, percent, y-o-y





# Benchmarking Russia's Growth

Global GDP growth, percent, y-o-y



# Subdued Global Growth Outlook

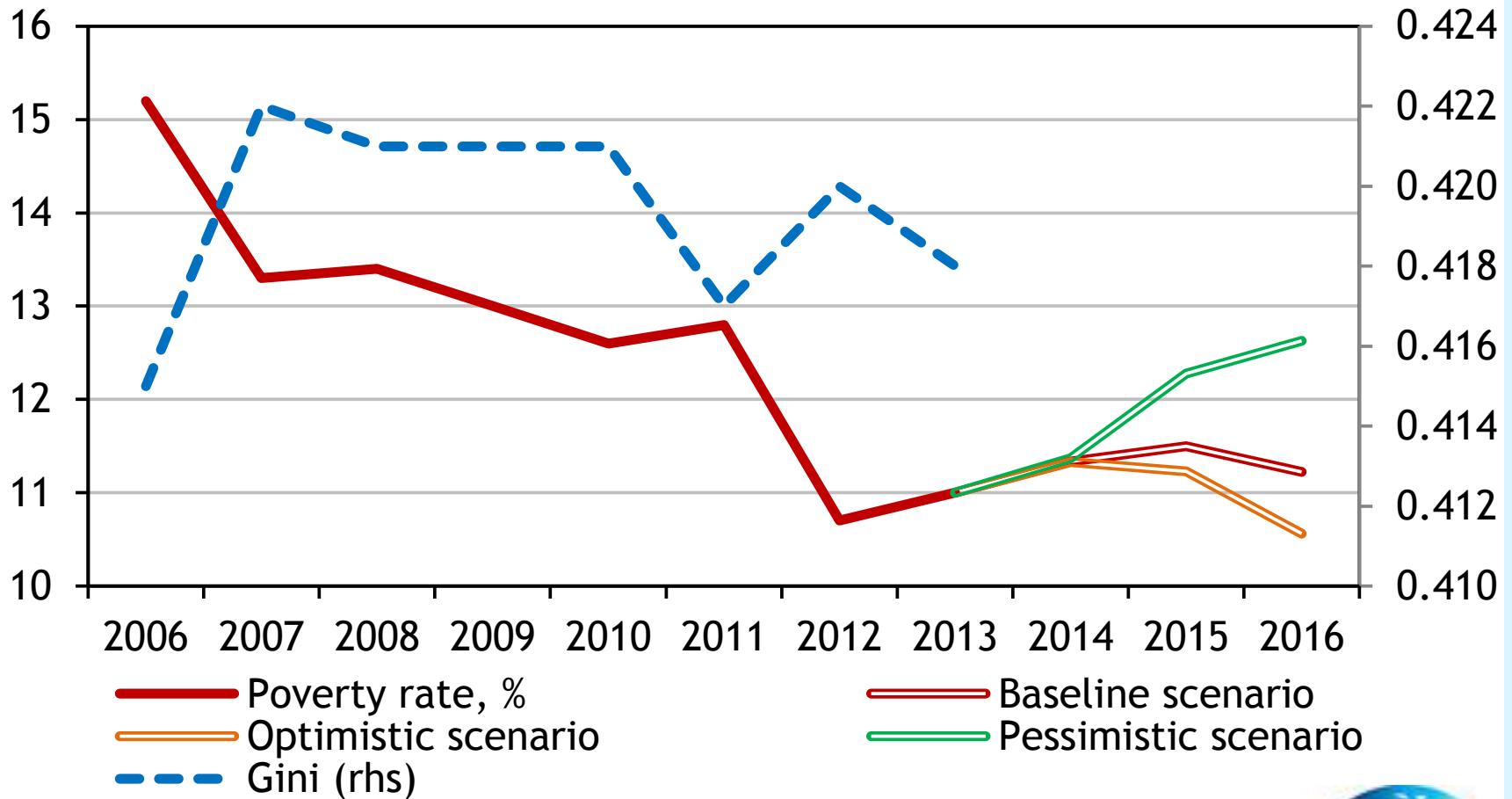
## Global real GDP growth, percent, y-o-y

	2009	2010	2011	2012	2013	2014f	2015f	2016f
World	-1.9	4.3	3.1	2.5	2.4	2.6	3.2	3.4
High Income	-3.6	3.0	1.8	1.5	1.2	1.8	2.4	2.5
Developing Countries	3.0	7.8	6.3	4.8	4.8	4.5	5.0	5.3
Euro Area	-4.4	1.9	1.6	-0.6	-0.4	0.9	1.4	1.8
Russia	-7.8	4.5	4.3	3.4	1.3	0.5	0.3	0.4



# → Development Challenges

## Poverty and Shared prosperity



# Policy Risks



The stalling of structural reforms represents a down-side risk to Russia's medium- and long-term outlook.



Structural constraints in the economy could diminish the effectiveness of the Central Bank's disinflation policy.

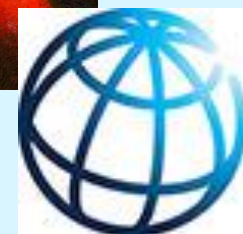
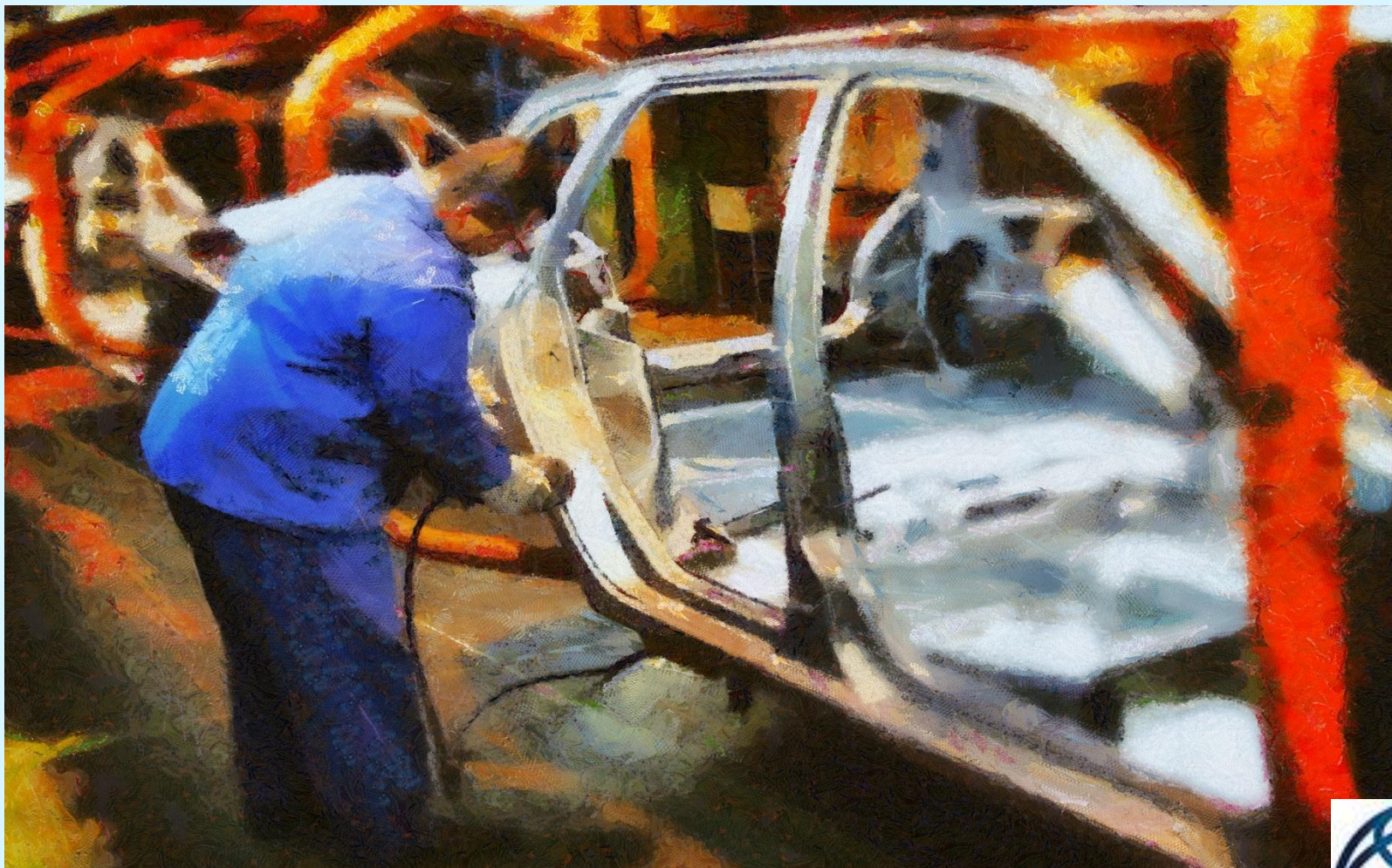


In the current environment of elevated inflation risk, it will be particularly important to adhere to fiscal prudence.



# Special Focus Note

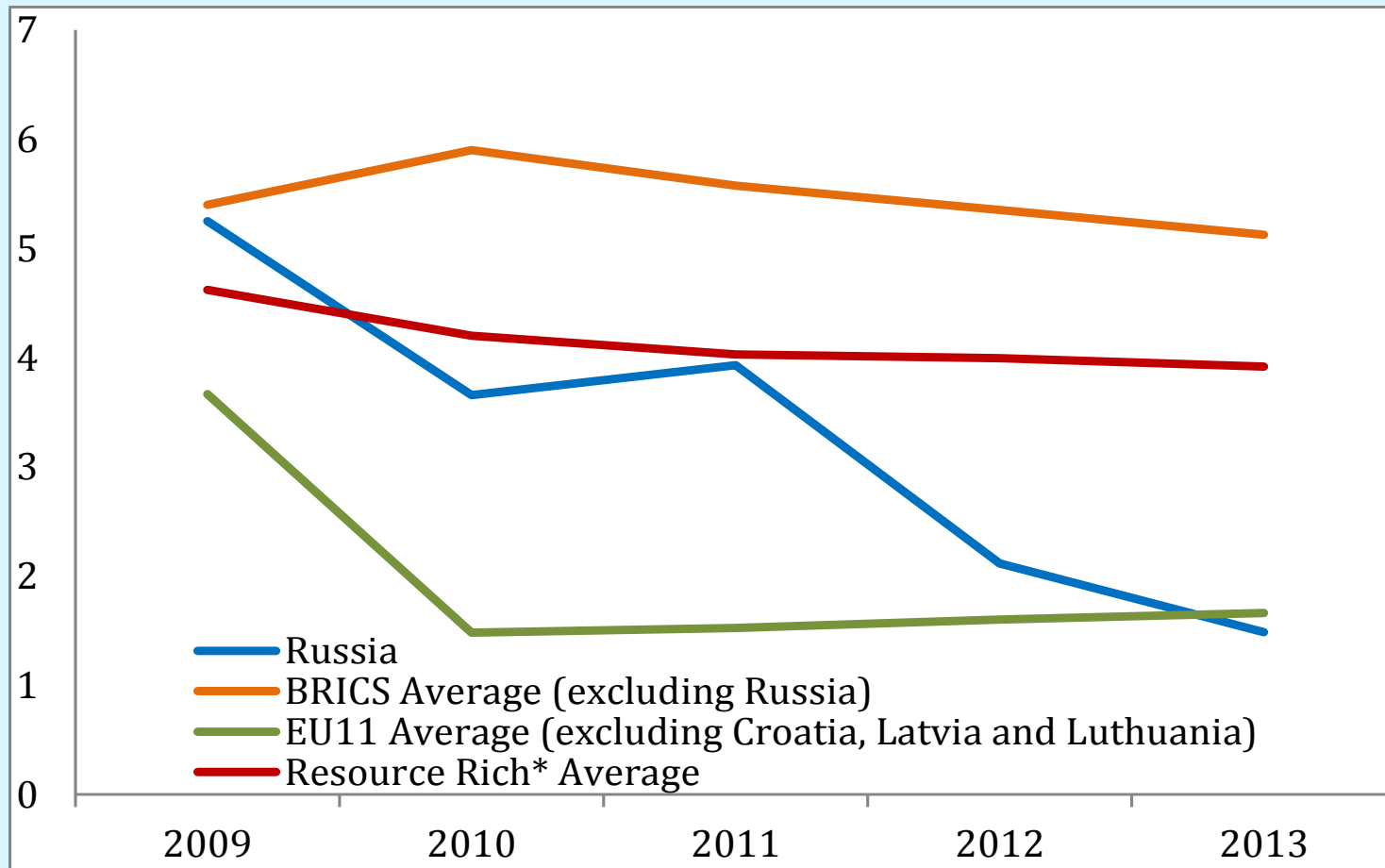
## Paths to Diversified Development in Russia





# Russia reached its potential output

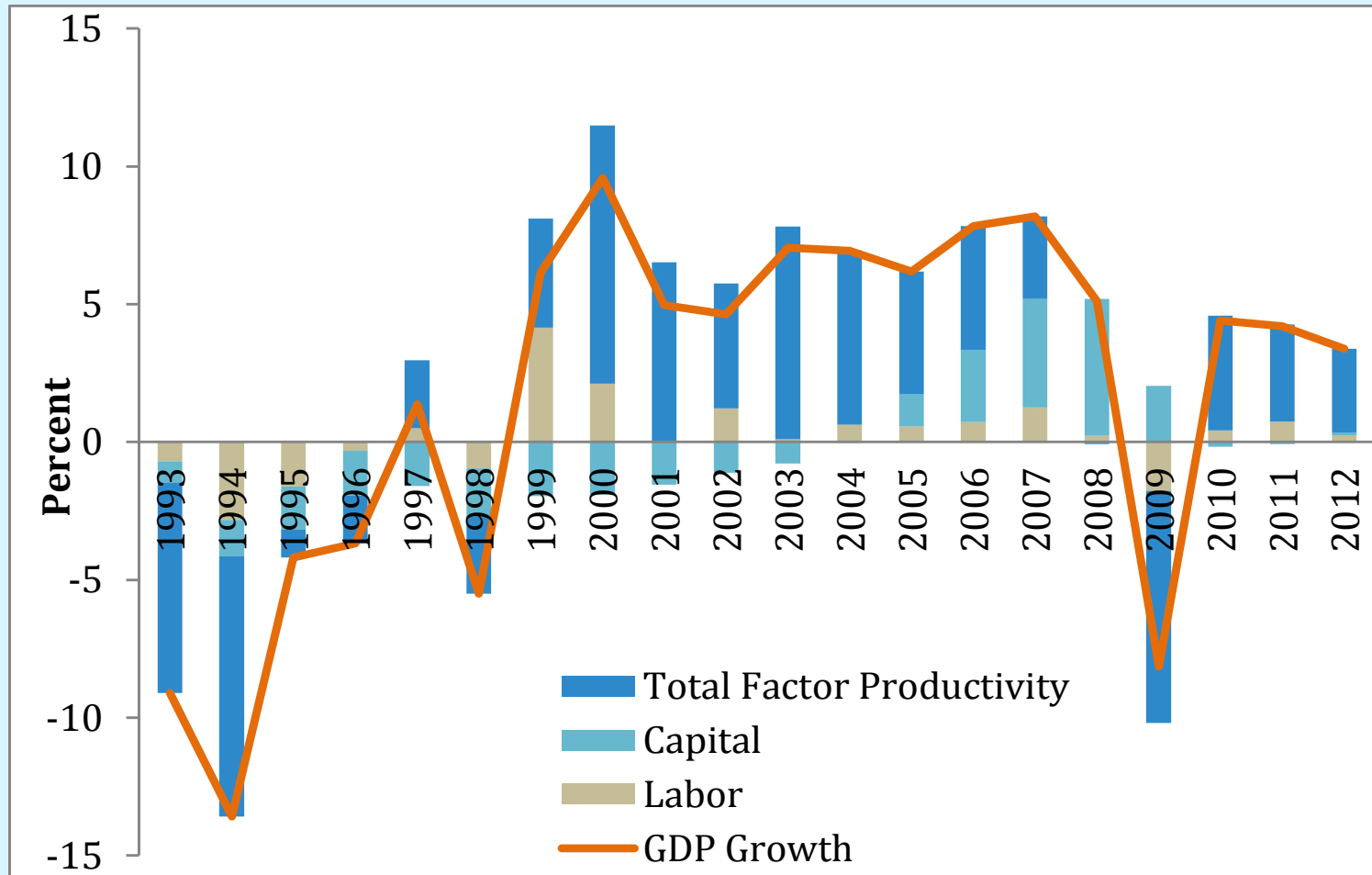
Russia's potential growth (in percent) may be slowing.



# How to reverse the slowdown in potential output?

In the boom years growth became gradually less driven by productivity increases.

Total factor productivity growth growth slowed as productivity gains from first generation reforms wore off





# The National Asset Approach

Assets can be classified into three categories: **natural resources**, **built capital**, and **national institutions**.

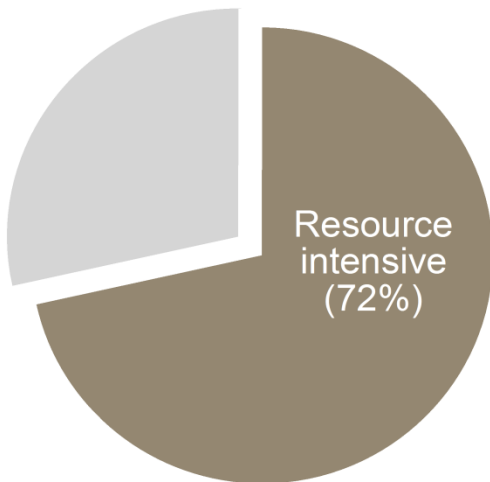
**Natural resources** - minerals, arable land, and forests - are largely endowed, but technological progress and better management can radically alter their economic value.

**Built capital** - physical and human capital, in the form of adequate infrastructure and a healthy and skilled labor force.

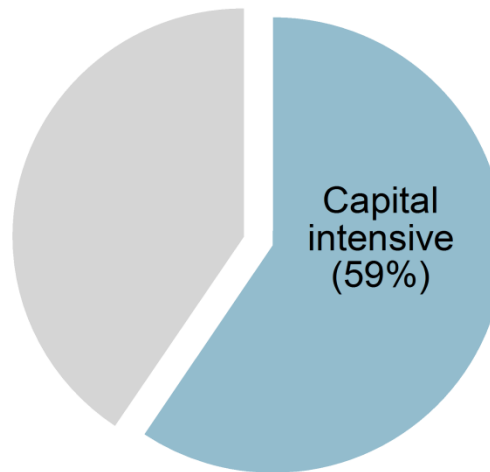
**National institutions** - the regulations and mechanisms that a country has put in place to manage resource rents, deliver public services - such as roads, security, health care, and education - and regulate private enterprise.

## Three ways to integrate and grow: export product share, by factor intensity

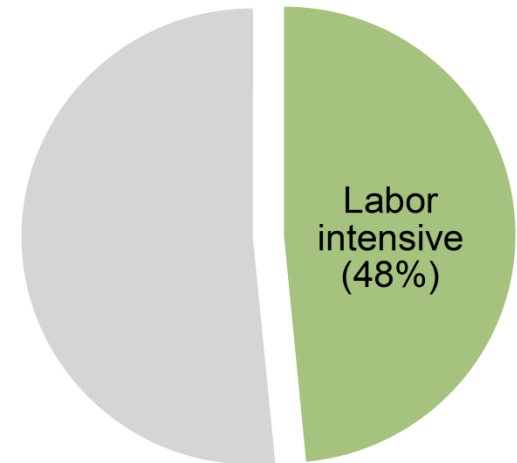
Eurasia  
2010-11



EU12  
2000-01

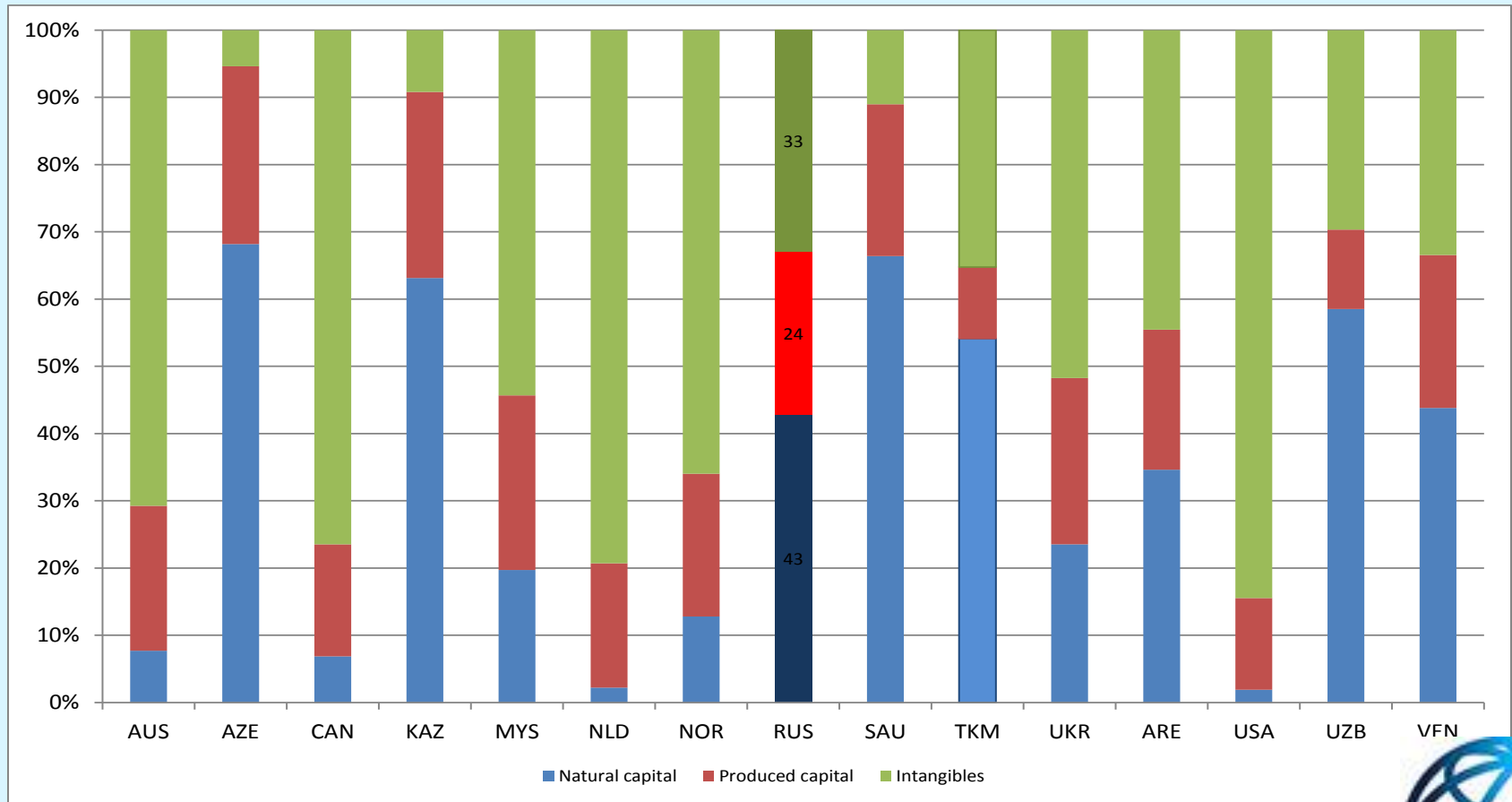


East Asia  
1990-91



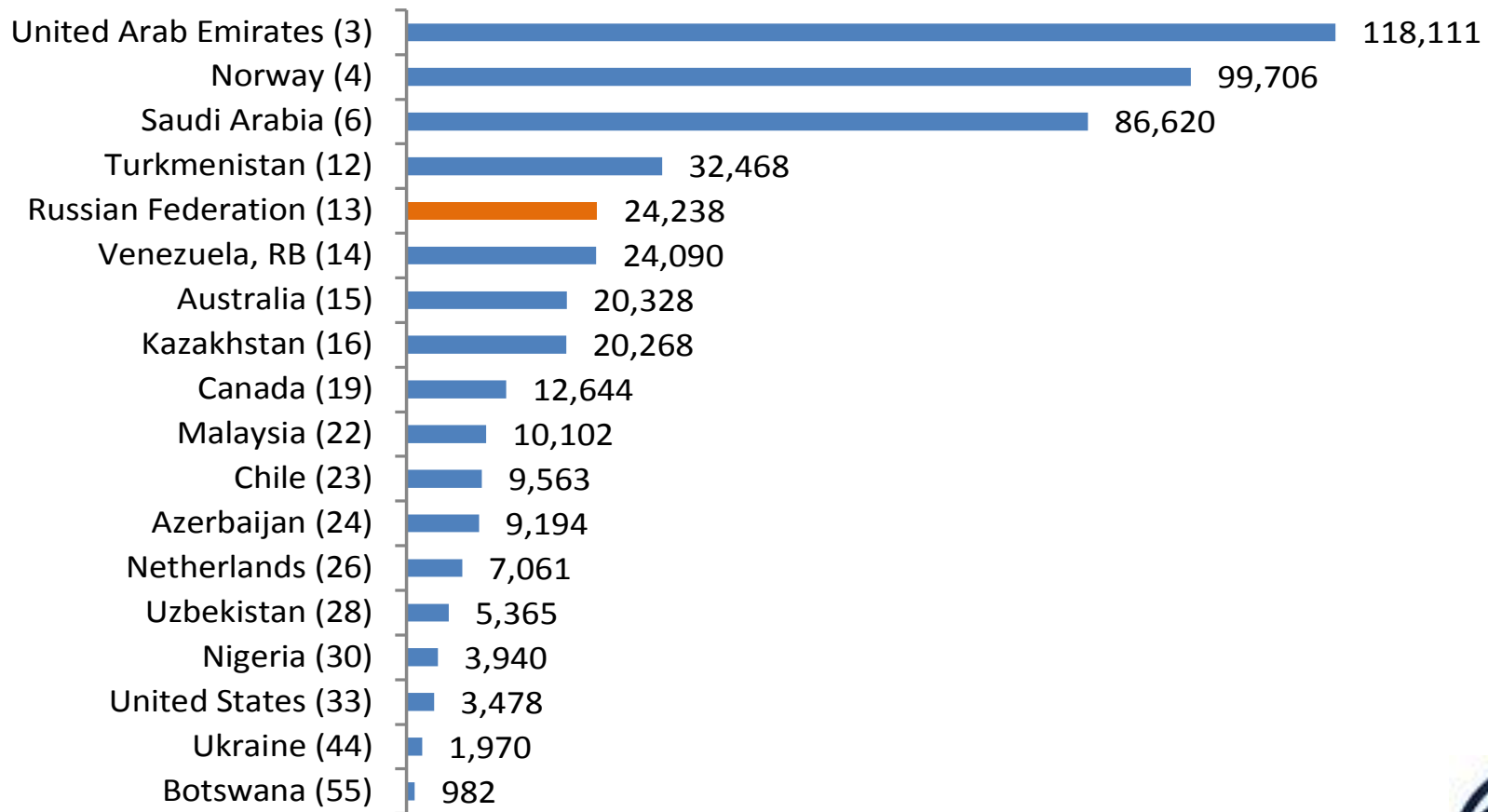
# Russia's current asset base: abundant natural resources, good human capital, improving infrastructure, but weak institutions

Russia's asset portfolio is heavy on natural resources: distribution of wealth by assets, 2005, in percent.



# → Abundant natural resources

Russia is one of the richest countries in the world in subsoil wealth: Subsoil natural resource wealth per capita, 2005, in constant 2005 US\$.



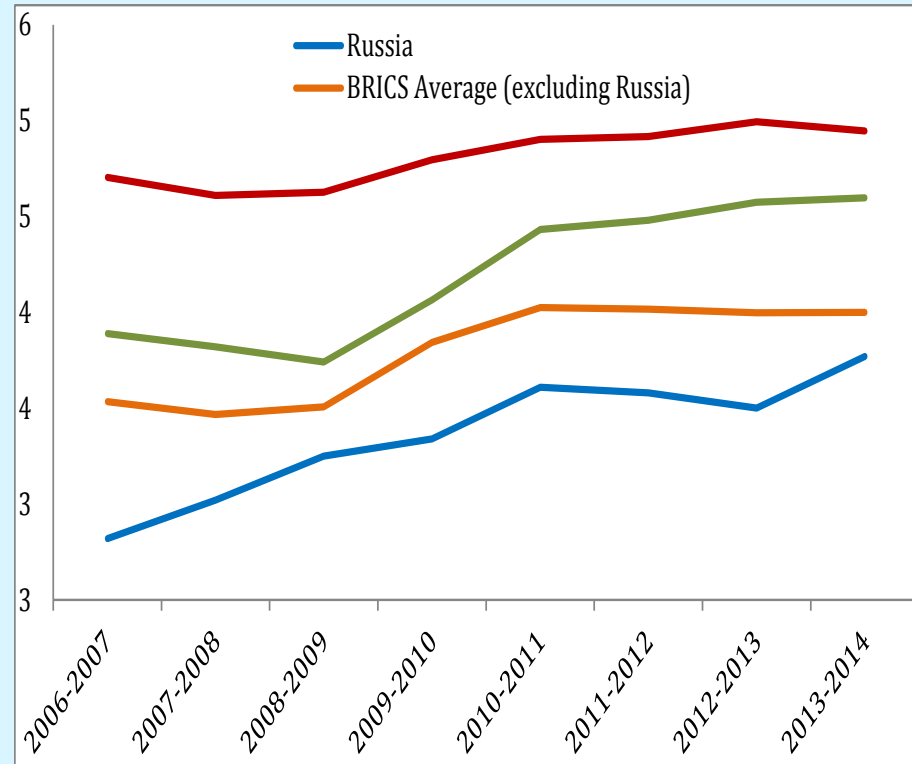
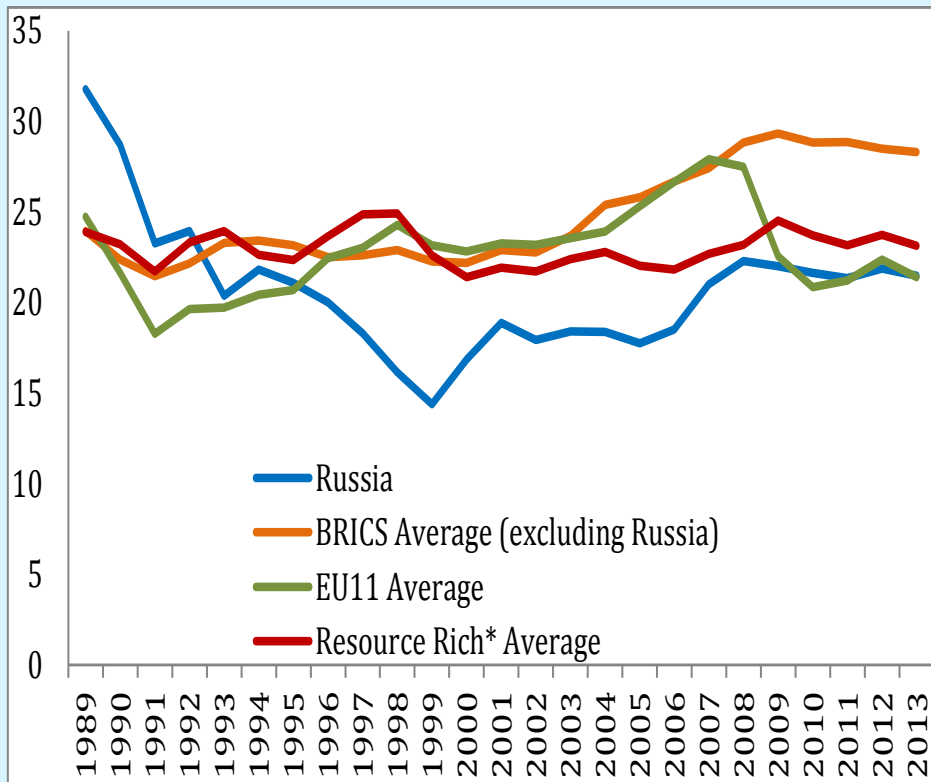




# → Improving infrastructure

Investment rates have improved but remain lower than comparators: Gross capital formation, percent of GDP –

Quality of infrastructure has been improving: Global Competitiveness Index: Quality of infrastructure, score 1 (low) to 7 (high)

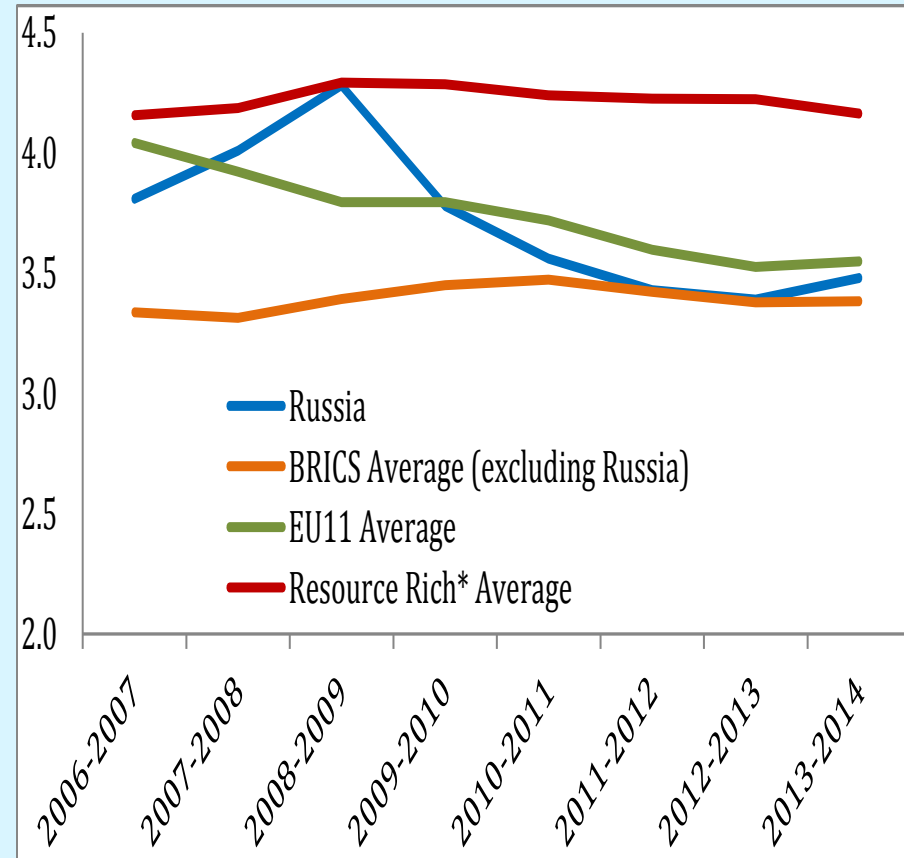
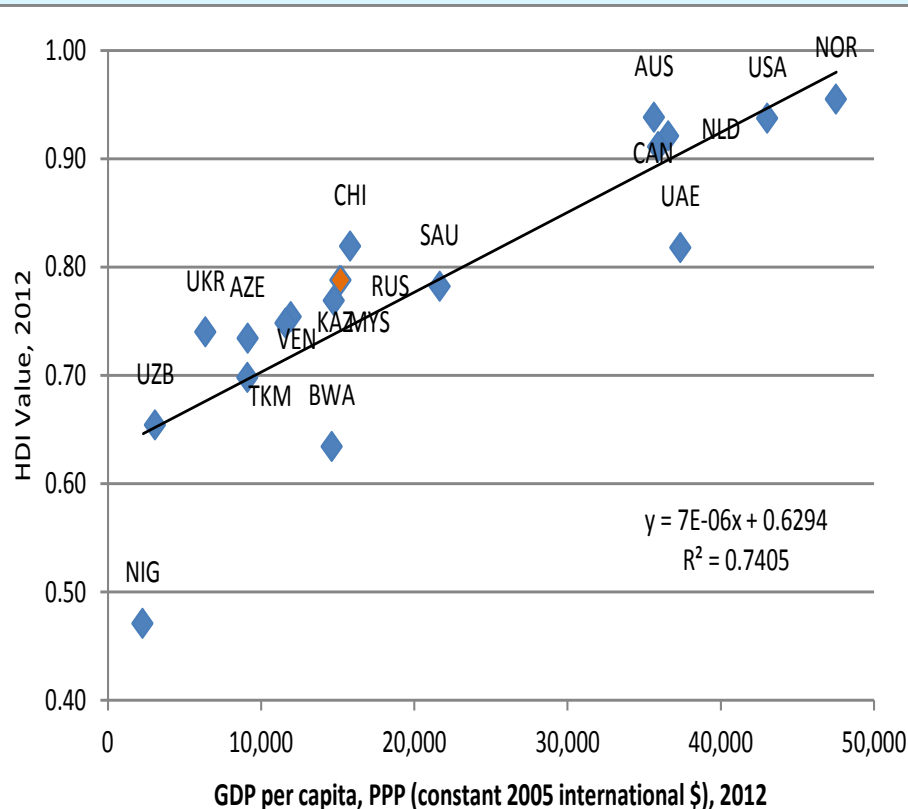




# → Good Human Capital

The quality of human capital is higher than predicted by income by capita.

But there is a mismatch between education achievements and employer perception of the quality of education: Global Competitiveness Index: Quality of education, score 1 (low) to 7 (high)



# But Weak Institutions ... for Managing Volatility, Providing Public Services and Regulating Enterprises

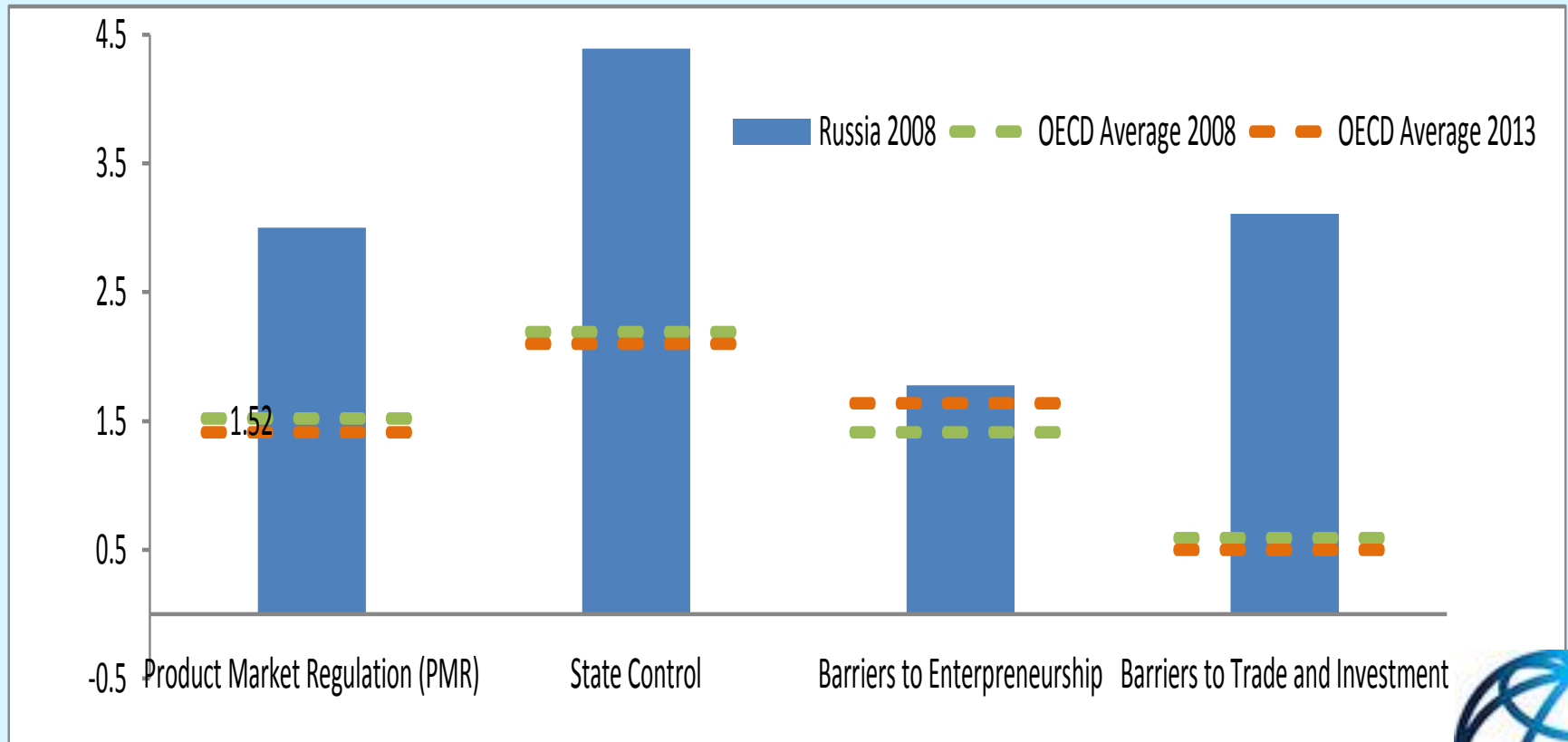
The quality of institutions lags in several dimensions:  
World Governance Indicators, 1996-2012 average

	Average of Governance Indicators	Government Effectiveness	Control of Corruption	Political Stability and Absence of Violence	Regulatory Quality	Rule of Law	Voice and Accountability
Netherlands	1.71	1.89	2.15	1.11	1.79	1.75	1.58
Norway	1.71	1.92	2.12	1.29	1.39	1.91	1.6
Canada	1.62	1.87	2.04	1.01	1.59	1.73	1.5
Australia	1.59	1.75	1.98	0.98	1.63	1.75	1.45
United States	1.32	1.64	1.51	0.44	1.54	1.55	1.22
Chile	1.15	1.21	1.43	0.56	1.48	1.25	0.98
Botswana	0.7	0.54	0.89	0.97	0.61	0.61	0.58
United Arab Emirates	0.49	0.85	0.84	0.86	0.66	0.54	-0.81
Malaysia	0.36	1.06	0.27	0.2	0.53	0.5	-0.39
Saudi Arabia	-0.36	-0.2	-0.23	-0.29	0.03	0.16	-1.62
Ukraine	-0.58	-0.68	-0.92	-0.21	-0.53	-0.85	-0.27
Kazakhstan	-0.63	-0.6	-0.98	0.16	-0.4	-0.89	-1.06
Russian Federation	-0.73	-0.47	-0.93	-1.05	-0.33	-0.89	-0.7
Azerbaijan	-0.88	-0.8	-1.08	-0.79	-0.59	-0.88	-1.13
Venezuela, RB	-1.02	-0.98	-1.01	-1.12	-1.07	-1.33	-0.62
Nigeria	-1.14	-1.02	-1.11	-1.73	-0.89	-1.24	-0.84
Turkmenistan	-1.32	-1.47	-1.25	0.15	-1.99	-1.42	-1.94
Uzbekistan	-1.34	-1	-1.07	-1.16	-1.66	-1.27	-1.91



# Weak Institutions ... for regulating enterprises

The regulatory environment is highly restrictive of competition: Product market regulation, OECD Product Market Regulation Index



# Rebalancing Russia's Asset Portfolio: Transparent Rules, Better Public Investment and Competition

More transparent rules for investors would enhance the contribution of natural resources to Russia's growth.

Better prioritization of expenditures and focus on results will strengthen the quality of public service provision.

Increased private participation could improve the quantity and quality of the delivery of public services.

Effective competition policy will increase the productivity of the business sector.





# Thank you!

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**EXTRA SLIDES**

# Baseline Scenario Projections

## Main economic indicators

	2012	2013	2014	2015	2016
GDP growth (%)	3.4	1.3	0.5	0.3	0.4
Consumption growth, percent	6.8	3.5	2.1	0.5	0.6
Gross capital formation growth, percent	0.6	-6.0	-8.1	0.3	1.0
General government balance (percent of GDP)	0.4	-1.3	-1.1	-2.1	-1.0
Current account (US\$ billions)	71.3	34.1	62.8	57.9	54.3
percent of GDP	3.6	1.6	3.1	2.8	2.5
Capital account (US\$ billions)	-32.3	-62.2	-113.0	-60.1	-55.6
percent of GDP	-1.6	-3.0	-5.6	-2.9	-2.6
Oil price assumption (US\$ per barrel)	105.0	104.0	102.9	99.5	100.1
Gross Domestic Product (mp), bln Rub	62218.4	66755.3	71785.3	76320.7	81223.6
CPI inflation	5.1	6.8	8.0	7.0	5.0



# Optimistic Scenario Projections

## Main economic indicators

	2012	2013	2014	2015	2016
GDP growth (%)	3.4	1.3	0.5	0.9	1.3
Consumption growth, percent	6.8	3.5	2.2	0.9	1.5
Gross capital formation growth, percent	0.6	-6.0	-8.1	1.5	2.5
General government balance (percent of GDP)	0.4	-1.3	-1.1	-2.3	-1.2
Current account (US\$ billions)	71.3	34.1	62.8	42.9	28.6
percent of GDP	3.6	1.6	3.1	2.0	1.3
Capital account (US\$ billions)	-32.3	-62.2	-113.0	-45.0	-25.5
percent of GDP	-1.6	-3.0	-5.6	-2.1	-1.1
Oil price assumption (US\$ per barrel)	105.0	104.0	102.9	99.5	100.1
Gross Domestic Product (mp), bln Rub	62218.4	66755.3	71785.3	76777.3	82441.9
CPI inflation	5.1	6.8	8.0	6.0	5.0



# Pessimistic Scenario Projections

## Main economic indicators

	2012	2013	2014	2015	2016
GDP growth (%)	3.4	1.3	0.4	-0.9	-0.4
Consumption growth, percent	6.8	3.5	2.0	-0.3	-0.3
Gross capital formation growth, percent	0.6	-6.0	-8.5	-4.3	-1.2
General government balance (percent of GDP)	0.4	-1.3	-0.7	-2.8	-1.2
Current account (US\$ billions)	71.3	34.1	69.3	82.2	80.8
percent of GDP	3.6	1.6	3.6	4.5	4.3
Capital account (US\$ billions)	-32.3	-62.2	-128.0	-82.3	-80.0
percent of GDP	-1.6	-3.0	-6.6	-4.5	-4.3
Oil price assumption (US\$ per barrel)	105.0	104.0	102.9	99.5	100.1
Gross Domestic Product (mp), bln Rub	62218.4	66755.3	71713.9	76753.9	81798.2
CPI inflation	5.1	6.8	8.0	10.0	8.0





# Fiscal Impact: Balances under Pressure

Federal budget revenue and balance, 2007-2014, percent of GDP

