Russia’s 2000-2007 Economic Success: Pros and Cons

Petr Aven
Alfa Bank President
Economic trends remain favorable

Source: Rosstat

Source: CBR
Russia 2000-2007: A Success Story?

Higher rating positively affected growth

- In the previous seven years Russia became an investment-grade country, access to foreign capital helped accelerate the growth rate.
- Disposable income up 140% in 2000-2007, Russians have access to $115 bln in retail loans.
- Though strong, 2000-2007 accumulated growth was below that of some peers.

Private wealth in Russia increased faster than in peers *

- Sources: World Bank, S&P, CBR

*Note: Size of bubble reflects GDP per capita 2007
Russia 2000: Weak economy, poor macro story

Russia’s GDP growth trend was highly correlated with oil prices
Public sector employed 17% of population in 2000
In ’95-00 Russia had one of the world’s highest fiscal deficits, a debt burden equal to 40% of GDP and low import coverage by reserves

In ’95-00 Russia had a high fiscal deficit, high debt burden, low reserves *

Public sector employment is high at 17% of population

State Debt, % GDP

Fiscal balance, % GDP

Sources: Rosstat, Bloomberg, World Bank, Alfa Bank Research

*Note: Size of bubble reflects ratio of Central Bank reserves to imports
Russia 2000: Capital flight, low FDI

- Capital flight of $10-20 bln a year in 1995-2000 was offset by state foreign borrowing
- Russia failed to attract FDI despite low average monthly salary of $79
- Banking assets penetration was as low as 34% of GDP

Note: Size of bubble reflects enlarged budget spending, % GDP

Note: Size of bubble reflects private consumption per capita in 2000 prices (figures for Norway and Germany are scaled down by a factor of three)
Poor population, rising inequality

In 1999 living standards in Russia were very low

Income inequality worsened dramatically

- In Russia 50% of the population was living below $4 PPP/day in 1999, housing stock per capita was modest at 20 sq m
- Income inequality widened after 1990, with 47% of wealth in the hands of the richest 20% of the population in 2000
- Persistently high inflation destroyed savings, fuelled dollarization and lowered the deposits-to-GDP ratio to 10%

Sources: World Bank, UNECE, Rosstat, IMF, Alfa Bank Research
List of reforms 2000: Restructuring the economy

Financial infrastructure

Fiscal reform
Creation of stabilization fund
Total budget expenditures to be cut from 35% of GDP

Tax reform
Cutting profit tax, personal income tax, payrolls

Pension reform
Introduction of defined contribution system
Defined contributions invested in financial markets

Banking reform
Introduction of deposit insurance
Foreign access to banking sector to be liberalized
Privatization of state banks on the agenda

Industrial development

Liberalization
SMEs in Russia accounted for only ~10% of GDP vs. 50% in Europe
SMEs employed only 15% of the labor force in Russia vs. 49% in the UK and 54% in the US

Reform of natural monopolies
Cross-subsidization by UES, Gazprom as high as 5% of GDP
Number of accidents in communal housing sector had increased by five times since 1990

Administrative reform
Reducing and streamlining responsibilities of state authorities

Sources: Institute of Energy Policy, Rosstat, Alfa Bank Research
## 2000-2007: Macro stability achieved

<table>
<thead>
<tr>
<th></th>
<th>Russia 2000</th>
<th>Russia 2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Federal budget surplus, % GDP</td>
<td>1.5%</td>
<td>5.5%</td>
</tr>
<tr>
<td>CBR reserves, $ bln</td>
<td>$28 bln</td>
<td>$476 bln</td>
</tr>
<tr>
<td>Months of imports</td>
<td>8.0</td>
<td>25.0</td>
</tr>
<tr>
<td>% total foreign debt</td>
<td>18%</td>
<td>103%</td>
</tr>
<tr>
<td>Net capital flows</td>
<td>-$24.8 bln</td>
<td>$81.2 bln</td>
</tr>
<tr>
<td>Foreign currency retail deposits, % total</td>
<td>32.5%</td>
<td>13.0%</td>
</tr>
<tr>
<td>State foreign debt, $ bln</td>
<td>128.6</td>
<td>46.4</td>
</tr>
<tr>
<td>% of GDP</td>
<td>51.2%</td>
<td>3.6%</td>
</tr>
<tr>
<td>S&amp;P rating</td>
<td>CCC-</td>
<td>BBB+</td>
</tr>
</tbody>
</table>

Sources: CBR, Minfin, S&P, Alfa Bank Research
Russia 2007: Very strong macro picture

- Macro stability helped to accelerate consumption growth, private consumption rose to 60% of GDP.
- Investment growth accelerated to 21% y-o-y in 2007, the highest since 1992, capacity utilization rate went up to 80%.
- In 2007 Russia had one of the world’s lowest state debts (3.6% of GDP), one of highest fiscal surplus and held the world’s third-largest reserves.

Investment growth exceeded 20% in 2007

Investment growth, %
Capacity utilization, % of total

Lower unemployment supports consumption

Private consumption, % GDP in fixed prices
Unemployment, %

Countries by budget deficit, reserves and debt in 2007

Investment growth exceeded 20% in 2007

Sources: Rosstat, CBR, World Bank, Alfa Bank Research

* Size of bubble reflects Central Bank reserves to import ratio
Russia 2007: Stabilization fund at $158 bln

Since 2005 Russia has seen a strong capital inflow

- After receiving investment-grade rating in 2003, Russia benefited from capital inflows ($81.2 bln in 2007) and increase in FDI ($27.8 bln in 2007)
- Unlike the other largest reserves holders, Russia is running both a capital and current account surplus
- Russia has used high commodity prices to resolve its debt problem

Russia’s stabilization fund and state foreign debt, $ bln

Sources: Rosstat, CBR, Bloomberg, Alfa Bank Research
Emerging markets have become more stable

Emerging market countries now have a current account surplus of $1,445 bin versus a $170 bin deficit in 1990-1993

All emerging market countries have managed to reduce state foreign debt since 1995

Russia has one of the world’s largest fiscal surpluses, at 5.5% of GDP, and one of lowest state foreign debt levels, at 3.6% of GDP

Sources: IMF, WB, Alfa Bank Research
Social issues: Living standards improved

- Number of cars per capita tripled from 1991
- Over 10 mln Russians travel abroad annually
- Number of students has more than doubled over the past 10 years
- Birth rate has increased compared to 1995, infant mortality dropped from 15 to 11 per thousand

Sources: Rosstat, CIA World Factbook 2007, World Resources Institute
Quality of life up, but should be better

Russia saw very strong growth in real disposable incomes, which has been in the double digits in the past several years.

State spends only 3.2% of GDP on health, while the avoidable mortality rate continues to increase.

Pension-to-salary ratio staying flat at a modest 26%, down from 40% in 1998.

Sources: World Bank, Rosstat, Independent Institute of Social Policy Research, Alfa Bank Research
Russian banks are not highly dependent on foreign borrowing, with only 20% of assets funded from abroad.

Banking penetration still weak, assets-to-GDP was 63% in 2007 versus 95% in Kazakhstan and 84% in Ukraine.

Russian banks have just started to penetrate the mortgage market, mortgages-per-capita only $211.
Restructuring should remain on the agenda

Financial infrastructure

Budget policy
Russia will face the need to increase state social expenditures, including a likely increase in pension payments of some 3% of GDP

Pension reform
Only 2% of population has transferred pension savings to private management, $15 bln of defined contribution is managed by the State Pension Fund

Banking reform
Number of banks still exceeds 1,000
Foreign banks’ penetration in Russia is low

Industrial development

Liberalization
The role of SMEs remains modest, estimated at 17% of GDP

Reform of natural monopolies
Cross-subsidization by UES, Gazprom still as high as 3% of GDP

Administrative reform
The state still has to reinforce its role as a regulator
Public sector still employs 16% of population, number of state bureaucrats increased at least 25% since 2000

Share of oil in Russia’s exports is increasing; some 61% of revenues in 2007 came from fuel exports versus 37% in 1995

Sources: Minfin, Rosstat, Alfa Bank Research
Russia’s challenges

The gap between Russia and Brazil on the one hand and China and India on the other has widened in the past several years.

Russia has a low SMEs-to-GDP ratio, and with 12% of the population over 65, the economy is not flexible enough.

Demographic situation suggests the need to increase state social expenditures in coming years.

Sources: World Bank, IMF, Alfa Bank Research