

The World Bank in Russia

Russian Economic Report¹

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Amid heightened global uncertainties, Russia is experiencing a bumpy recovery. Domestic demand is rising, but unemployment remains high, and credit and investment remain limited. The budget has benefited from higher oil prices, but fiscal consolidation remains important in the medium term. Crumbling infrastructure, especially in transport, could hamper the economy's competitiveness and longer-term growth prospects. The debt crisis in Western Europe sharpens the downside risks to global recovery and oil prices. But the effects on Russia are likely to be blunted by its stronger fiscal and debt positions and by limited trade and financial links with the affected countries. Russia is likely to grow by 4.5 percent in 2010, followed by 4.8 percent in 2011, as domestic demand expands in line with gradual improvements in the labor and credit markets. Employment is expected to improve gradually, however, enabling some further reductions in poverty.

A Bumpy Recovery

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RUSSIAN ECONOMIC REPORT No. 22

I. RECENT ECONOMIC DEVELOPMENTS

Summary. Amid heightened global uncertainties, Russia is experiencing a bumpy recovery. Domestic demand is rising, but with high unemployment and limited credit and investment activity. Budget execution is better than anticipated due to higher oil prices. Implementing fiscal consolidation is a key medium-term policy objective. Dilapidated infrastructure, especially in transport, could pose serious risks to competitiveness and longer-term growth prospects.

Global trends—emerging markets led recovery

Growth in large emerging market economies accelerated in the first quarter of 2010. This was especially the case in Brazil, China, India and South Africa. Stronger external demand and incipient recovery in domestic demand fueled growth in industrial output in high-income countries, with growth accelerating to 11.7 percent in the first quarter from close to 8 percent in the previous quarter (quarter on quarter, seasonally adjusted annualized rates) (figure 1.1). By contrast, Russia’s industrial production growth lost momentum, after posting growth of close to 6 percent in the fourth quarter of 2009.

The growth in import volumes in emerging economies continued at a brisk pace in the first quarter of 2010. Imports in developing countries outside China and Russia expanded 30 percent in the first quarter (q-o-q saar), down from the 40 percent in the previous quarter (figure 1.2). But import volume remains close to 4 percent below its pre-crisis peak. China’s import demand, very robust, was 35 percent higher than in April 2008—though momentum eased to 38 percent in the first quarter (q-o-q saar), down from 81 percent in the previous quarter, when imports surged in preparation for the Lunar New Year.

Figure 1.1: Industrial production—global growth picking up, but Russia lagging behind

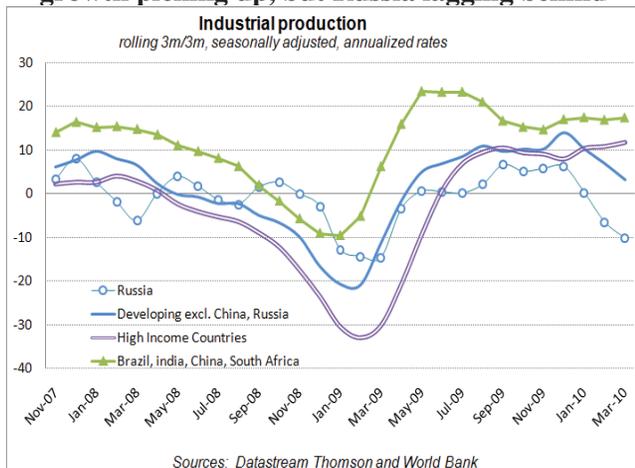


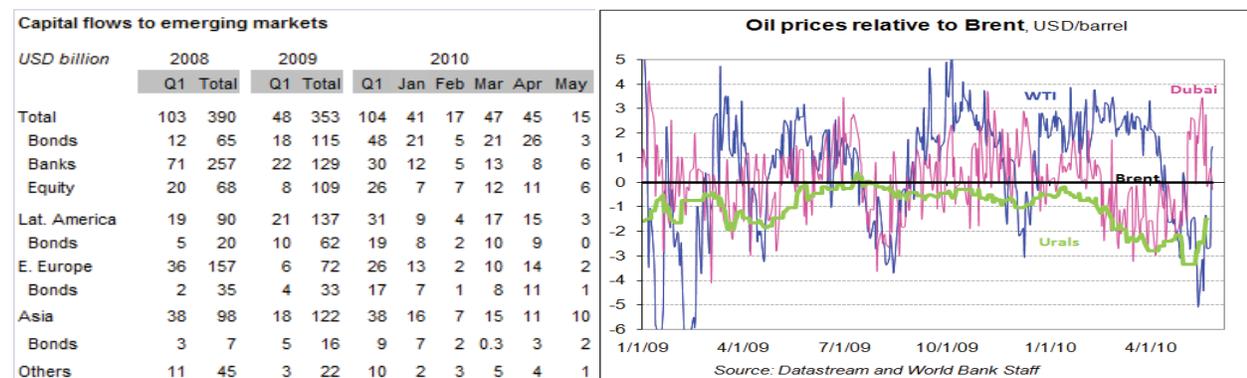
Figure 1.2: Imports continuing to surge in developing economies, but moderating in Russia



So far, the impact of the European debt crisis appears limited. As discussed in more detail in the second chapter of this report, the overall impact on the global recovery is likely to be limited in the current scenario of no debt default/restructuring and no broader European contagion. Also, risks to Russia are muted due its stronger fiscal and debt positions and limited trade and financial linkages with the western European periphery

Box 1.1: External environment for Russia: capital flows and oil prices

After a surge in the first quarter, capital flows remained steady in April 2010, but faltered in May as a result of the European debt crisis. Capital flows to emerging markets remained steady in April, with year-to-date flows more than doubling from the corresponding period of 2009. *Bond financing* increased to USD 26 billion in April, which in part reflects Russia’s return to the international bond market (its first in more than a decade). The Russian government issued USD 5.5 billion in 5-year and 10-year bonds, the largest sovereign deal in emerging markets (EM) history. *Bank flows* are well below the level in pre-crisis years—notably for Russia, which accounted for a large share of total bank lending to EMs during 2005-08—and bank flows are unlikely to rebound quickly, given the continued impact of the global recession on the banking sector. Meanwhile, in May capital flows dropped sharply to this year’s low, as bond issuance and equity placement faltered due to the current European debt crisis. Bond issuance activity was sluggish in the month with only one sovereign deal (by Malaysia for USD1.25 billion) and worse than the volume reached in February when the market first began worrying about Greece. This is the lowest monthly volume since December 2008, and is historically lower compared to the May average of USD8 billion between 2003 and 2009. Although the European crisis is unlikely to produce effects similar to the Lehman episode of 2008, a complete shutdown of the EM bond and equity markets for several months, it is too soon to suggest that the worst is over.



Source: World Bank staff.

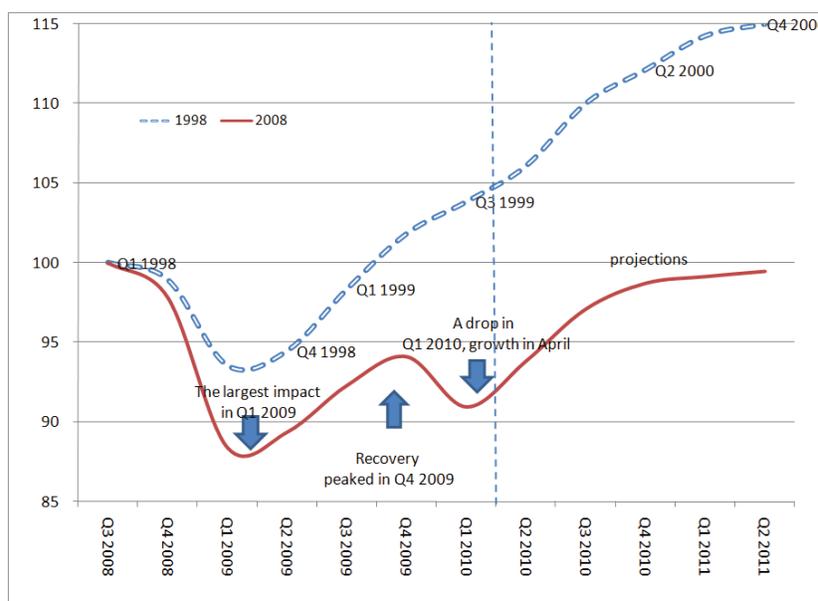
Recovery in world oil demand continued. After falling for five consecutive quarters, global oil demand increased by nearly 1 percent in the fourth quarter of 2009 and is projected by the IEA (International Energy Agency) to rise 2 percent in 2010—with all of the growth in non-OECD countries. OECD oil demand, which contracted in the past four years, is expected to be flat, with growth in North America and declines in Europe and the Pacific. U.S. oil demand rose for the third straight month in April, up 2 percent. While demand is improving, supplies continue to outstrip it. OECD stocks rose atypically in the first quarter and U.S. stocks surged into May. Meanwhile, floating crude oil storage at the end of April rose to 81 million barrels, due in part to additions of Iranian crude storage.

Oil prices plunged on the Euro Area debt crisis and price differentials expanded. Oil prices, which peaked at nearly USD 87 a barrel on the first day of May, fell sharply to less than USD70 a barrel. The drop was sparked by the financial crisis in Greece, but fears of contagion added to investor concerns about global economic growth and oil demand. Amid the slump, oil prices relative to Brent (the international marker for light sweet crude) have diverged. West Texas (WTI) prices, which normally trade at a premium to Brent, have fallen significantly below due to large buildups of inventories in the U.S.. Meanwhile, the price of Dubai—which normally trades at a discount to Brent—has surged above Brent due to strong demand for the sour grade. The price of Urals versus Brent was unusually firm in 2009, owing to a tight sour crude market reflecting OPEC production cuts. Differentials have been volatile due to supply-demand balances for each grade, but should return to more typical levels once global demand recovers and the inventory overhang is reduced. That would put the price of Urals 5 percent below Brent.

Russia's output—a bumpy recovery

According to Rosstat estimates, real GDP increased by only 2.9 percent in the first quarter of 2010 compared with the year before, much less than most market observers expected (table 1.1). The growth momentum of the second half of 2009, which was supported by the fiscal stimulus, faded away in the first quarter of 2010. The reported growth (2.9 percent) implies that the real GDP level has even contracted in the first quarter of 2010 compared with the last quarter of 2009 on a seasonally adjusted basis. In a much more constrained international environment, such a bumpy recovery differs markedly from the relatively smooth recovery path observed after the 1998 crisis (see figure 1.3). But even taking into account special factors such as very cold winter months, weak demand conditions were a constraining factor on the economy. This also implies that the observed growth on a year-to-year basis was mostly the result of a very low base in 2009. The sectoral composition of growth also shows a mixed picture. The tradable sector and manufacturing, in particular, performed well in the first quarter of 2010, growing by 10.9 and 11.8 percent, respectively (table 1.2). Among non-tradables, by contrast, transport and communications rebounded strongly in support of industrial recovery, but retail and wholesale trade remained stagnant and construction fell by 9 percent.

Figure 1.3: Real GDP Level (Index, seasonally adjusted): 1998 vs 2008-09 crises



Source: World Bank staff calculations based on Rosstat data.

The most recent output statistics for April 2010, however, display much more positive dynamics, with manufacturing taking the lead and non-tradables gaining momentum. According to Rosstat, industrial output increased by 10.4 percent in April 2010 (year on year), with manufacturing industries reporting growth of 15.7 percent (table 1.1). All main manufacturing industries registered healthy growth rates in April, with producers of transportation devices reporting the highest growth (26.4 percent), followed by electro-technical equipment (25.8 percent), and metallurgy (24.2 percent). Growing external demand for metals and chemical products, and the government-sponsored program for the purchase of used cars boosted demand in the car industry in April. With rising real wages and incomes, non-tradables also grew much faster in April 2010. Retail trade grew by 4.2 percent, while the transport and communication sectors reported an increase of 14.8, respectively. Even the

construction sector, depressed for almost two years, showed signs of recovery in April 2010; the construction of residential housing increased by 16.2 percent (year on year).

Table 1.1: Main macroeconomic indicators, 2006-2010

	2006	2007	2008	2009	2010	
					Jan - Apr	April
GDP growth, percent	7.7	8.1	5.6	-7.9	2.9 ^a	-
Industrial production growth, year on year, percent	6.3	6.3	2.1	-10.8	6.9	10.4
Fixed capital investment growth, percent, year on year	16.7	22.7	9.8	-17	-2.3	2.3
Federal government balance, percent of GDP ^b	7.4	5.4	4.1	-5.9	-3.4	-3.4
Inflation (CPI), percent change, e-o-p	9	11.9	13.3	8.8	3.5	0.3
Current account, billion USD	94.7	77	102.3	47.5	33.9	-
Unemployment, percent (average for period)	7.2	6.1	6.4	8.4	8.7	8.2
Memo: Oil prices, Urals (USD/barrel, average for period)	61.2	69.5	95.1	61.5	77.1	82.8
Reserves (including gold) billion USD, e-o-p	303.7	478.8	427.1	439.0	461	461

^a Data for the first quarter of 2010.

^b Cumulative from the beginning of the year.

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

Domestic demand—recovering slowly

Supported by the gains in real disposable incomes and wages in the first quarter 2010, household consumption began to contribute to the recovery of domestic and aggregate demand, a process likely to continue in the rest of the year. As expected, the recovery on the demand side is being led by household consumption, but with high unemployment and sluggish credit activity, the pace of demand recovery is gradual.

With uncertainty about the outlook and limited credit activity, investment demand remains depressed. In the first quarter of 2010, fixed capital investment fell by 4.7 percent, compared with the same period in 2009. The observed decline in gross capital investment (especially from a very low base in 2009) indicates that investment activity in the economy remains low, while the majority of companies have not returned to an active investment strategy in the environment of high uncertainty and tight credit conditions. Most enterprises appeared to be increasing their utilization rate of existing capacity while restocking inventories to meet the potential increase in demand for their products.

Table 1.2: GDP growth by main sectors (value added): 2006–2010

	2006	2007	2008	2009	Q1- 2010
GDP growth	7.7	8.1	5.6	-7.9	2.9
Tradable sector	3.4	3.7	0.9	-9.4	10.9
Agriculture, forestry	3.8	2.5	7.2	0.3	2.7
Extraction industries	-3.3	-2.8	1.3	-3.1	11.5
Manufacturing	7.3	7.9	-0.7	-15.3	11.8
Non-tradable sector	10.1	11.8	9.4	-6.8	-0.4
Electricity, gas, water production and distribution	5.7	0.1	0.5	-7.9	8.5
Construction	11.8	13.7	11.2	-17.0	-9.0
Whole sale and retail trade	14.1	12.1	9.6	-8.6	0.0
Transport and communication	9.7	5.4	6.0	-3.0	9.3
Financial services	10.3	12.5	14.1	2.4	-7.3

Source: Rosstat; World Bank staff estimates.

Labor market—weak first quarter but strong April

With bumpy recovery and weak demand conditions, unemployment remained high in the first quarter of 2010, followed by a drop in April, likely reflecting seasonal gains in employment. By the end of March 2010, unemployment increased to 8.6 percent (ILO definition) from 8.2 percent at the end of 2009, reflecting uncertain economic recovery and seasonal reductions in employment in the winter months (figure 1.4). But the unemployment rate in April dropped to 8.2 percent with the rise in seasonal employment. The number of employed increased by 700,000 in one month (figure 1.5). Labor productivity turned positive but real wages continue to outpace productivity (table 1.3).

Data on part-time employment and vacancies also suggest some underlying improvements in the labor markets. In contrast to the peak of the crisis, when outright layoffs and an increase in part-time employment and involuntary vacations were used by companies as temporary mechanisms to withstand demand shocks, this process now seems to be working in reverse. Recent statistics show that part-time employment declined in January–April 2010 and stood at only 218,000 at the end of April, about the pre-crisis level (figure 1.6). Vacancies, rising since January, reached 261,000 by end-April (figure 1.7).

Table 1.3: Labor productivity, disposable income, wages, and unemployment, 2006--2010

	2006	2007	2008	2009	2010	
	Jan-Dec	Jan-Dec	Jan-Dec	Jan-Dec	Jan - Apr	Apr
GDP growth, percent, year on year	7.7	8.1	5.6	-7.9	2.9 ^a	n/a
Total employment, million people	68.8	70.5	70.9	69.4	68 ^a	68.9
Employment growth, percent, year on year	0.8	2.4	0.5	-2.1	-0.3 ^a	n/a
Labor productivity growth, percent, year on year	6.9	5.5	5.0	-5.9	3.2 ^a	n/a
Real disposable income growth, percent, year on year	13.5	12.1	1.9	1.9	6.5	3.7
Real wage growth, percent, year on year	13.3	17.2	11.5	-2.8	3.8	6.0
Average monthly wage, USD	392.5	533.2	692.1	593.0	659.9	695.9
Unemployment (percent, ILO definition, e-o-p)	6.9	6.1	7.8	8.2	8.2	8.2

Source: Rosstat

^a Data for the first quarter of 2010.

Figure 1.4: Unemployment rate (ILO definition), percent

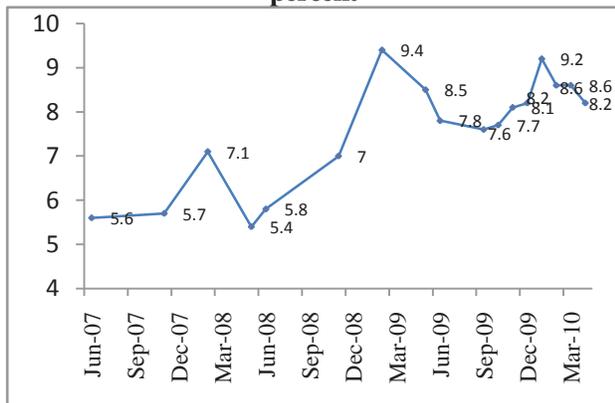


Figure 1.5: Number of economically active and employed population

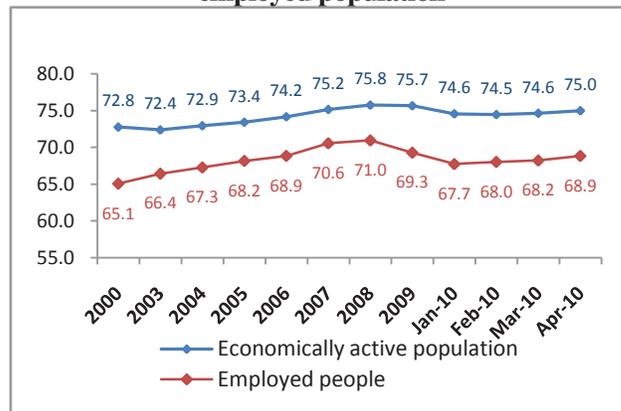


Figure 1.6: Part-time employment, thousands

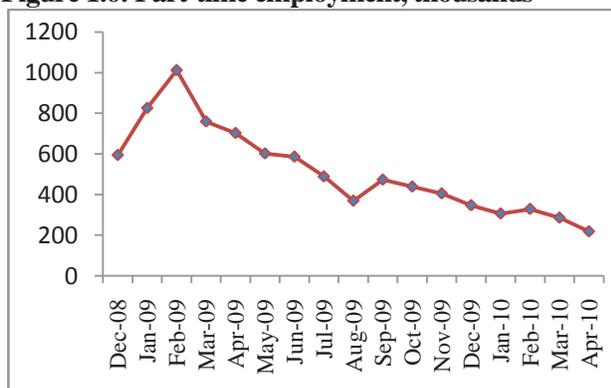
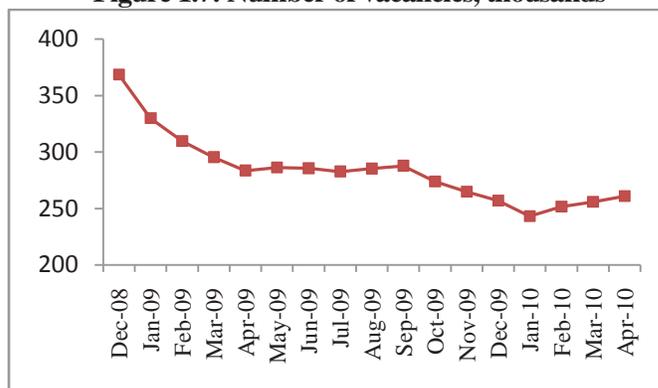


Figure 1.7: Number of vacancies, thousands

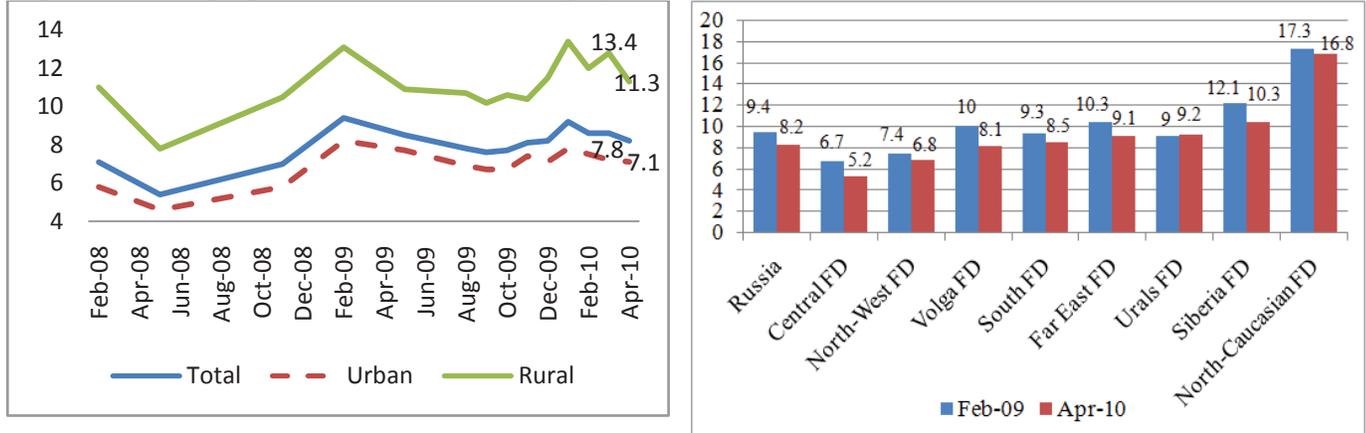


Source: Rosstat; World Bank staff calculations.

As expected, recent statistics indicate that unemployment in rural areas declined more than in urban areas, likely reflecting a seasonal increase in the demand for agricultural workers and, probably, migrant labor. According to Rosstat, unemployment in rural areas fell to 11.3 percent in April 2010 from 13.4 percent in January 2010. During the same period, urban unemployment dropped to 7.1 percent from 7.8 percent. Despite rising vacancies, the slow recovery of large, labor intensive sectors such as retail trade and construction is limiting employment growth in the cities.

The unemployment rate remains very uneven throughout Russia, with the highest reported for North Caucasus (16.8 percent), and the lowest for the Central Federal Okrug (5.2 percent) (figure 1.8). Rosstat statistics indicate positive trends in unemployment dynamics in almost all regions in April 2010. But the improvement is uneven, reflecting different rates of economic recovery in the regions, as well as differences in the structure of regional economies and seasonal employment.

Figure 1.8: Geographic distribution of unemployment, percent (ILO definition).



Source: Rosstat.

Despite weak economic activity in the first quarter of 2010, real incomes grew mainly due to the increases of pensions and social benefits. According to Rosstat, real disposable income increased by 6.5 percent in January–April 2010, relative to the same period of 2009. But an increase in real wages (3.8 percent in January–April 2010, year-on-year) was limited by slow economic recovery and high unemployment.

Balance of payments—strengthening on the back of higher oil and gas prices

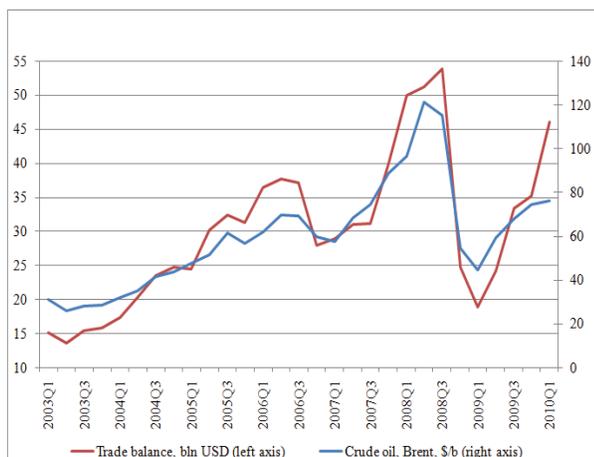
The external current account improved considerably in the first quarter of 2010 as a result of higher oil and gas prices and greater demand for non-oil exports (table 1.4). The Central Bank of Russia (CBR) reported a current account surplus of USD 33.9 billion in the first quarter of 2010, up from only USD 9.7 billion in 2009 (q-o-q). Most of this surplus was due to higher oil and gas prices and an increase in exports of oil, oil products, and gas which totaled USD 62.7 billion in the first quarter of 2010, compared with USD 34.9 billion in 2009 (q-o-q). At the same time, import growth remained low in the first quarter due to the slow growth in domestic demand. The total value of import increased to USD 45.3 billion in the first quarter of 2010 from USD 38.5 billion in 2009 (q-o-q). But preliminary customs statistics for March–April 2010 show accelerating import growth; this is likely to continue toward the year’s end, substantially reducing surplus on the current account. Non-oil current account deficit narrowed in the first quarter, but remains high (figure 1.10); the deficit is expected to widen as imports pick up with economic recovery.

Table 1.4: Balance of payments (USD billions), 2006–2010

	2006	2007	2008	2009	Q1-09	Q1-10 ^a
Current account balance	94.7	77	102.4	49.0	9.7	33.9
Trade balance	139.3	130.9	179.7	111.6	18.8	46.0
Capital and financial account	3.3	84.8	-135.8	-44.4	-32.6	-5.4
Errors and omissions	9.5	-12.9	-11.9	-1.2	-7.6	-11.8
Change in reserves (+ = increase)	107.5	148.9	-45.3	3.4	-30.5	16.6

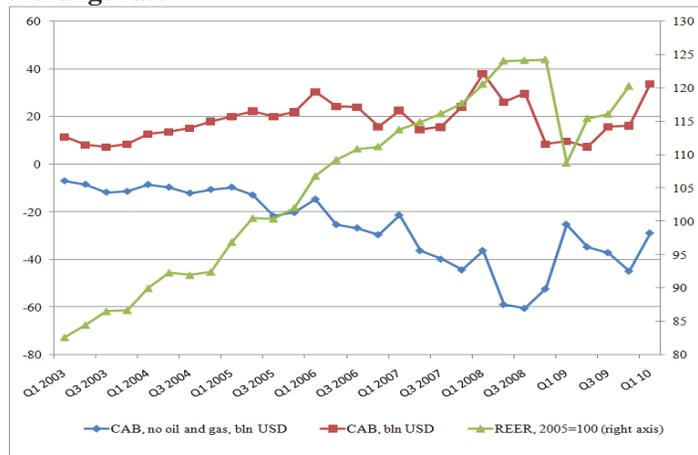
Source: CBR^a Preliminary estimates.

Figure 1.9: Oil prices and the trade balance



Source: CBR and World Bank staff estimates.

Figure 1.10 Current account balances and the real effective exchange rate



Source: World Bank staff calculations based on Rosstat and CBR data.

The capital flows remain volatile but balance of payments position improved and reserves rose. Capital outflows resumed in the first quarter of 2010 after inflows registered in the fourth quarter of 2009. According to preliminary CBR estimates, the capital account registered a deficit of USD 5.4 billion in the first quarter. Although the deficit is much lower than in 2009 (USD 32.6 billion in the first quarter of 2009), the capital account deteriorated from the fourth quarter of 2009, when the CBR reported a surplus of USD 10.3 billion. Capital flows remain volatile both in the banking and nonbanking sector, mostly reflecting the movement in oil prices and remaining uncertainty regarding the recovery of global demand. A complicating factor is the debt crisis in the Euro Area. In the first quarter, net capital flows to the banking sectors eased to only USD 0.8 billion, down from almost USD 9 billion in the fourth quarter of 2009. Capital outflows from the non-banking sector increased to USD 13.7 billion in the first quarter of 2010 from practically zero in the previous quarter (table 1.5). Despite the deteriorating capital account, the overall balance of payments improved in the first quarter of 2010, allowing the CBR to increase its foreign currency reserves to USD 461 billion by the end of April 2010 from USD 439 billion at the end of December 2009.

Table 1.5: Net capital flows (USD billions), 2006–2010

	2006	2007	2008	2009	2009 Q1	2010 Q1
Total net capital inflows to the private sector	41.4	81.7	-133.9	-56.9	-35	-12.9
Net capital inflows to the banking sector	27.5	45.8	-56.9	-31.4	-6.9	0.8
Net capital inflows to the non banking sector	13.9	35.9	-77	-25.4	-28.1	-13.7

Source: CBR.

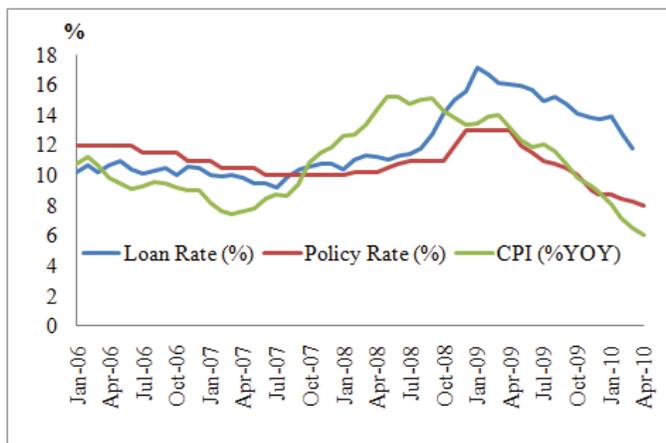
Banks and non-financial corporations were, by and large, able to service or rollover their external debt obligation in the first quarter of 2010. As expected, no major defaults on foreign debt obligations by banks or corporate entities were reported in January–April 2010. According to the CBR, banks had to pay off about USD 14.7 billion and non-financial corporations about USD 23.3 billion in the first quarter of 2010. Debt statistics also suggest that banks’ rollover capacity might have improved as banks were able to marginally *increase* their external debt exposure to USD 128.9 billion by the end of the first quarter of 2010, up 1.3 percent from the end of 2009. The non-financial corporate sector also rolled over its

external obligations, increasing its overall debt exposure to USD 301.7 billion by the end of the first quarter, up by 1.1 percent from the end of 2009. According to preliminary CBR estimates, the total external public and private debt totaled USD 473.7 billion at the end of the first quarter of 2010, compared with USD 471.6 billion at the end of 2009.

Monetary policy and credits—inflation continues to decline, monetary conditions ease

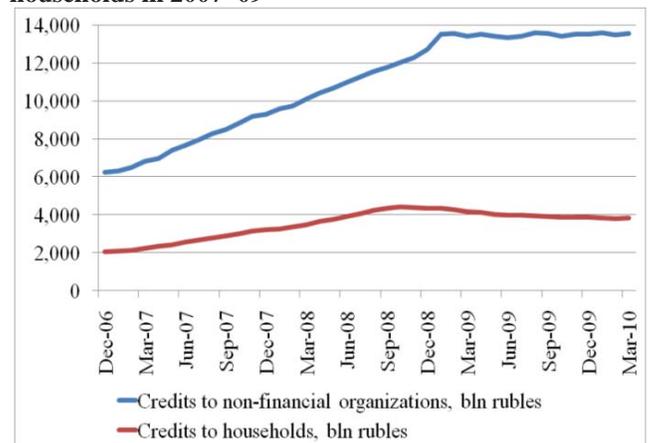
Monetary conditions continued to loosen in 2010 as the CBR cuts its main policy rates four times since December 2009 to facilitate credit recovery. Currently the refinance rate of the CBR is set at 7.75 percent, down from 13 percent a year ago. Yet these significant rate cuts had very limited effect on credit growth in the first quarter of 2010. Net credits to both household and enterprises were dismal or even negative in the first quarter. In April 2010, preliminary statistics show only a very modest credit growth: 0.9 percent growth in corporate lending and 1 percent growth in retail loans. To support this momentum, the CBR dropped the rate at the end of May 2010 by 25 basis points to 7.75 percent. The CBR officials have announced that they did not see any supporting factors for further reduction of its policy rates in the near future.

Figure 1.11: Lending rates and inflation in Russia 2006–09



Source: CBR; World Bank staff estimates.

Figure 1.12: Stock of credits to companies and households in 2007–09



Inflation continued slowing down in 2010, affected by limited growth of the money supply, slow recovery in domestic demand, and stagnant credit. Despite a sizable increase in administrative utility prices in January–February 2010, inflation (CPI) continued to slow. At the end of April 2010, the 12-month inflation rate dropped to 6.0 percent, down from 8.8 percent at the end of 2009. A large output gap, slow recovery in domestic demand, and previously depressed money supply remain the main factors keeping inflation down. But monetization of the economy rebounded in the fourth quarter of 2009 and first quarter of 2010. By the end of March 2010, M2 had increased 32 percent over its level in March 2009. While the immediate impact of the current money growth on inflation is limited, given an estimated time lag of 8–14 months between monetary expansion and inflation, the inflationary pressure could mount toward the end of 2010 and particularly in 2011. The CBR therefore faces a difficult tradeoff, between further rate cuts—to stimulate credit growth in today’s low-inflation environment—and a potential buildup of inflationary pressure in the next 6–8 months.

The exchange rate remained volatile due to the fluctuations in oil prices and a “flight” to USD associated with the debt crisis in Europe. The recent shift in oil prices has drastically altered the exchange rate dynamics. Until the end of April 2010, the ruble had been facing appreciation pressure from a stronger-than-expected balance-of-payments position, while the CBR accumulated about USD 21 billion in foreign reserves since the beginning of the year. The situation reversed after the European debt crisis escalated in May 2010. The new, downside risks for global recovery and the associated flight from “riskier” markets to the dollar have pushed down oil prices, which plunged by about 20 percent to below 70 USD a barrel in just two weeks. As speculative pressure set in, the ruble lost more than 8 percent of its value against the dollar in May 2010, and on June 15 was trading at 31.4 RUB/USD compared to 29 RUB/USD at the end of April. But this also reflects a more flexible exchange rate regime, allowing higher volatility and making CBR policy less predictable to avoid a possible carry-trade and destabilizing speculation against the ruble.

Fiscal policy—withdrawing the stimulus under renewed revenue and expenditure pressures

Following the sizeable expenditure increases in 2009, the government now aims to gradually withdraw the fiscal stimulus and strengthen the fiscal position in medium term. (Box 1.2) According to preliminary estimates from the Ministry of Finance, the consolidated budget had a surplus of 2.5 percent of GDP in the first quarter of 2010 (table 1.6). The revenues in the first quarter of 2010 were boosted by oil prices significantly above the conservative budget estimate of USD58 a barrel. Despite an improvement in the economic activity, non-oil revenues as a share of GDP remain below the levels seen at the peak of the crisis in the first quarter of 2009. In part, this is explained by a drop in investment income from the Reserve and Welfare funds transferred to the budget in the first quarter of 2010. But it also reflects the underlying weakness in economic activity. In addition, profit tax collections in the first quarter of 2010 were *lower*—by 0.2 percentage points of GDP—than in the first quarter of 2009, due to the new, 4-percentage-point lower profit tax rate (20 percent). So far, the federal budget was executed conservatively, with a deficit of 2.9 percent of GDP in the first five months of 2010. (The federal budget expenditures include a transfer to cover the pension fund deficit). But the European debt crisis casts a new uncertainty about oil prices going forward, which could result in the widening of the deficit later in the year.

Table 1.6: Consolidated budget: revenues, expenditures, and the fiscal surplus, 2007-2010

	2007	2008	2009		2009Q1	2010Q1	
Consolidated budget*							
Revenues, % GDP	40.2	38.5	34.4		36.1	35.8	
Expenditure, % GDP	34.1	33.7	40.6		33.4	33.3	
Surplus, % GDP	6.1	4.8	-6.2		2.7	2.5	
Non-oil balance, % GDP	-2.9	-5.8	
Federal budget	2007	2008	2009	2010 budget	2010 budget with proposed amendments**	2009 Jan-Apr	2010 Jan-Apr
Revenues, % GDP	23.6	22.3	18.8	16.1	17.6	19.4	19.9
Expenditure, % GDP	18.1	18.2	24.7	22.9	23.0	22.5	23.3
Surplus, % GDP	5.4	4.1	-5.9	-6.8	-5.4	-3.1	-3.4
Non-oil balance, % GDP	0.6	-6.4	-13.5	-14.2	-13.9	-9.0	-12.1

Source: Ministry of Finance, Economic Expert Group.

* Including extrabudgetary funds, transfers of funds from the Reserve and Nation welfare funds, and consolidated sub-national budgets.

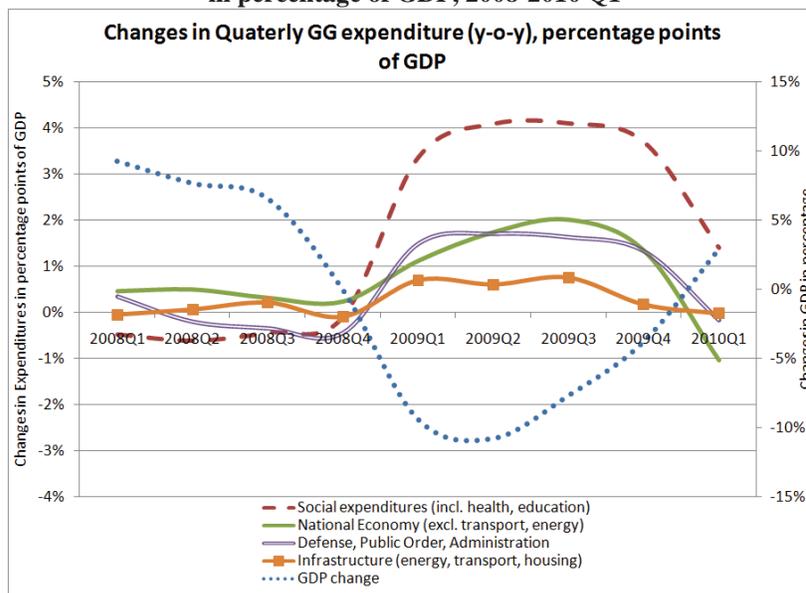
** Based on government’s proposal approved on June 10, 2010. The proposed budget amendments are based on revised nominal GDP figure (44.4 trillion rubles), slightly higher than the nominal GDP included in the original budget law (43.2 trillion rubles).

Box 1.2: The Phasing of the Expenditure Stimulus

The anti-crisis public expenditure measures in 2009 were focused mainly on wages, pensions, and social assistance targeting the broad middle class (figure 1.13). Social expenditure increases, broadly, were timely. A considerable increase in social expenditures occurred already in the first quarter of 2009 when the economy contracted the most. The increase in the minimum wage on January 1, 2009, increased outlays in education and health where a significant part of expenditures consist of remuneration for employees affected by an increase of the minimum wage. As discussed in previous RERs, this approach helped limit the impact on real incomes and, therefore, on household consumption. But an increase in expenditures on supporting real economy (functional category national economy) were mainly concentrated in the third and fourth quarter of 2009, coinciding not with the decline but with a gradual recovery phase of GDP. The bulk of these expenditures went to the existing, large, often state-owned enterprises with little going to small and medium-size and new enterprises or infrastructure.

The focus on people’s incomes has helped mitigate the social impact of the crisis, but at the expense of greater rigidity in the expenditure structure and infrastructure expenditures. Only modest increases in capital expenditures will likely limit the impact on growth. Evidence from other countries indicates that the discretionary capital expenditures, especially if they address acute infrastructure bottlenecks, could have much larger fiscal multipliers (the impact of percentage change in expenditures on percentage change in total output) than the increases in current expenditures.

Box Figure 1: The Phasing of the Expenditure Stimulus: Changes in Consolidated Budget Expenditures, quarterly (year on year) in percentage of GDP, 2008-2010 Q1



Source: World Bank staff estimates based on MOF data.

On the expenditure side, the 2010 budget includes a planned fiscal adjustment of around 1.8 percent of GDP; but the planned 46 percent increase in pensions by the end of 2010 would result in new expenditure pressures. In addition to the scheduled increase of pensions, a reevaluation of Soviet era pension contributions will result in an increase in pension levels. In April 2010, the basic pension was already raised by 6.3 percent in addition to the scheduled increase in January 2010. In the first quarter of 2010, a gradual withdrawal of fiscal stimulus measures began as expected—expenditures to support various sectors of economy were reduced by about 1 percent of GDP, compared with the previous year. The proposed budget amendment that was approved by the government on June 10, 2010 is likely to result in the lower deficit due to higher oil and non-oil revenues but part of this windfall will be spent on additional expenditures. Even so, the latest official estimates expect the federal deficit to be lower (at 5.4 percent of GDP) than in the original budget (6.8 percent).

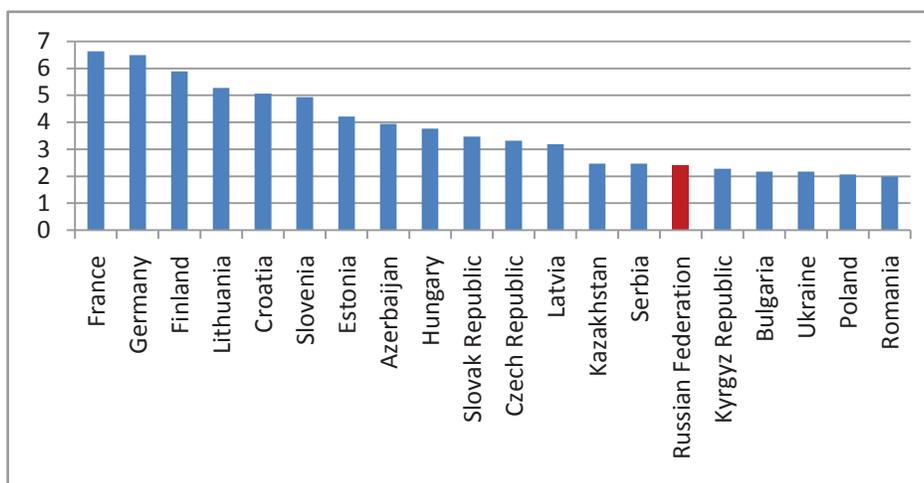
To support expenditure adjustment and improve expenditure outcomes, the government approved in May 2010 a comprehensive program to improve the expenditure efficiency. The program introduces ambitious steps to overhaul the budget process. By 2012, the budget will be transformed into a program budget consisting of specific programs grouped into seven key areas linked to Russia's development objectives and concrete monitoring frameworks. Such a reform will eventually make it possible to link allocated funds to target indicators with timelines for their implementation to improve expenditure monitoring, efficiency, and service delivery.

Looking to the rest of 2010, while a fiscal consolidation is necessary, there is a risk that a significant part of the adjustment will again fall on the much needed infrastructure maintenance expenditures. In 2010, public expenditures on transport are estimated to fall by 0.6 percent of GDP from the (already) low level of 2.5 percent of GDP in 2009. Public infrastructure, long recognized as a key to regional and economic development, and represents a primary channel for the government to promote competitiveness, international and inter-regional interconnectivity, and productivity growth. Inadequate maintenance is identified as one of the reasons for the deterioration of transport infrastructure in Russia (box 1.3). Lower allocations for improving existing road infrastructure, combined with emphasis on new construction, are therefore likely to result in additional cuts in maintenance expenditures. The World Bank's preliminary estimates from an ongoing public expenditure review suggests a *funding gap for road network maintenance alone of about 1.2 percent of GDP per year*. Adequate provision for maintenance is cost effective and markedly cheaper than addressing a mounting backlog of maintenance and new investments later on.

Box 1.3: Infrastructure constraints in Russia

The state of Russia’s transport infrastructure is generally poor for an upper middle income country and has been declining due to underinvestment in maintenance and rehabilitation. According to the just released *2010 Enabling Trade Index* (World Economic Forum), Russia ranks 48th on the availability and quality of transport infrastructure. (the state of transport infrastructure across all modes of transport in each country, as demonstrated by the density of airports, the percentage of paved roads, and the extent to which they are congested, as well as the transshipment connections available to shippers from each country).

Box figure 1: The quality of road infrastructure index (from 0 (worst) to 7 (the best)) in select countries of Europe and Central Asia



Source: Enabling Trade Index, 2010, The World Economic Forum.

While the quality of transport infrastructure in Russia varies significantly across different modes of transport—and different parts of the country—the road infrastructure is estimated to have deteriorated the most. According to the World Economic Forum’s 2010 Enabling Trade Index (ETI), Russia’s railway infrastructure quality ranks 33rd in the world, relatively good but still significantly behind the Western European levels which the country aspires. But its ranking on the quality of road infrastructure is 111th, among the world’s worst; this—in a vast country that is heavily resource-intensive and that depends on transport of goods and services for its exports. The quality of port and air infrastructure is also comparatively poor—Russia ranks 82th and 87th, respectively. These differences are also evident in comparing the asset *deterioration* in recent years, by transport modes. According to Rosstat, the asset deterioration rate reached 48 percent for air transport, roads and maritime port infrastructure in 2008. The deterioration in railways was much lower—24 percent. A recent survey of quality of the federal road network indicates that majority of roads do not meet the minimum riding quality requirements (box table 1).

Box table 1. Length and percentage of federal road network not meeting standards (2009)

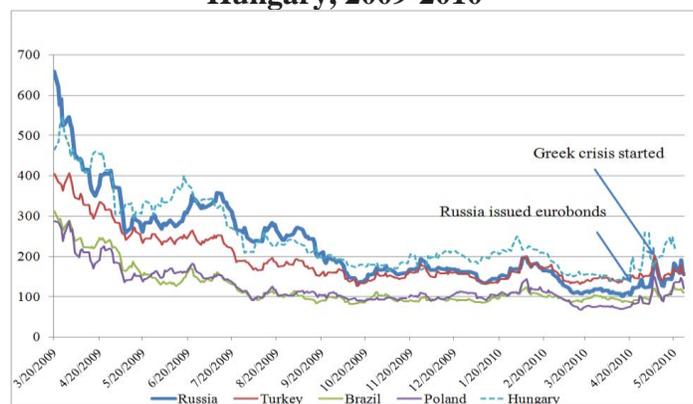
	Length (km)	Percentage
Failing to meet minimum riding quality requirements	28,500	57.1
Failing to meet minimum grip requirements	12,200	24.4
Failing to meet minimum strength requirements	24,900	49.9
Failing to meet minimum defects requirements	35,100	70.3

Source: Avtodor, Long-Term Program of the Russian Motor Roads Public Company (2010-2015), Dec 31, 2009.

In April, the government returned to the international capital markets by placing USD 5.5 billion in Eurobonds, the second biggest emerging market dollar debt offering on record and Russia’s first international bond issue since 1998. USD 2 billion in five-year Eurobonds were priced at 1.25 percentage points above US Treasuries (equivalent to a yield of 3.741 percent), and USD 3.5 billion in ten-year bonds were priced at 1.35 percentage points above US Treasuries (a yield of 5.082 percent).

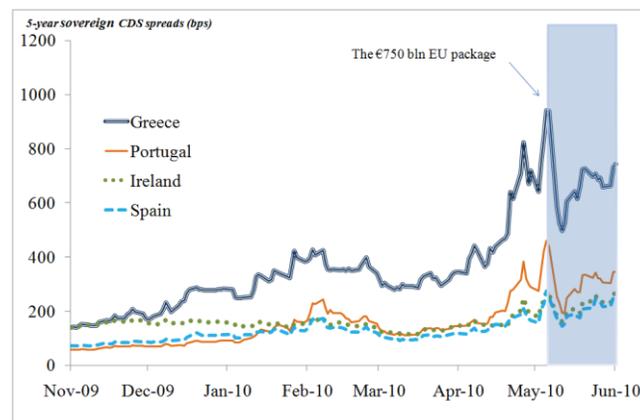
Russia had taken advantage of a window of opportunity before sovereign risk perceptions among investors have started to rise as a result of the debt crisis in high-income Euro Area countries. Just in the last month, sovereign credit default swaps (CDS) spreads for Russia and other emerging countries have increased from post-crisis lows in April 2010 (figure 1.14 and 1.15) with the largest increase in Greek spreads. But the government is not facing additional external financing needs this year. The external financing needs are considerably less than the USD 17.8 billion planned in 2010 due to the improved oil price outlook.

Figure 1.14: Dynamics of Credit Default Swap Spreads Russia, Turkey, Brazil, Poland and Hungary, 2009-2010



Source: Bloomberg.

Figure 1.15: CDS spreads in select countries of Western Europe



Overall, therefore, Russia's developments in early 2010 so far may be characterized as a bumpy recovery in the context of higher international uncertainty. Slower-than-expected domestic demand recovery coupled with the risks of broader contagion of the Greek crisis to other Western and Eastern European economies have cast a new cloud over the recovery of the Russian economy. In this environment, macroeconomic policy must carefully balance the objectives of implementing the required fiscal adjustment while supporting the nascent recovery and dealing with the remaining social and regional issues.

Finally, while the external risks cannot be controlled, it is prudent to minimize short-term and longer-term policy risks. The short-term policy risk to guard against is that fiscal adjustment is delayed while oil prices may plunge again, and large increases in current expenditures become entrenched, making the adjustment much more difficult to implement later on. So prudent execution of the budget by year-end will be all the more important. How forcefully and directly the government deals with the long-term policy challenges, discussed in the previous RER, to advance Russia's remaining structural reforms in public and sectors, financial sector, and investment climate will to a large extent determine the outcome of its modernization agenda.

II. ECONOMIC AND SOCIAL OUTLOOK FOR 2010–11 FOR RUSSIA

Summary: *The debt crisis in Western Europe has sharpened downside risks to global recovery and oil prices. But the impact on Russia is likely to be limited because of Russia’s better fiscal and debt positions and limited trade and financial linkages with the affected countries. Taking into account global developments and assuming no default/restructuring and no broader contagion in Europe, Russia is likely to grow by 4.5 percent in 2010, followed by 4.8 percent in 2011 as domestic demand expands in line with gradual improvements in the labor and credit markets. Employment situation is expected to improve only gradually with attendant reductions in poverty.*

Russia’s bumpy recovery is taking place in the context of increased uncertainty about the global economic recovery. Assuming that measures in place prevent a default or major restructuring of the European sovereign debt, global GDP is projected to increase 3.3 percent in 2010 and 2011, and 3.6 percent in 2012 (table 2.1) as private capital flows to developing countries rise from around 3.0 percent of their GDP in 2009 to 3.5 percent in 2012. Reflecting stronger productivity growth and less pronounced headwinds from the need to tighten fiscal and monetary policies, developing country growth (around 6 percent in all three years) is projected to be more than twice as rapid as in high-income countries, whose growth is projected to strengthen from 2.3 percent in 2010 to 2.4 and 2.6 percent in 2011 and 2012. World oil demand is expected to increase by 2 percent or 1.7 million barrels a day in 2010, while non-OPEC supplies are expected to rise by 0.7 million barrels a day. Oil prices are expected to average USD 78 a barrel in 2010 and slip to USD 74 a barrel, as OPEC is expected to remain accommodative to increases in demand, and to keep prices within its preferred range of USD 70-80 a barrel (figure 2.2).

Table 2.1. The summary of the global outlook

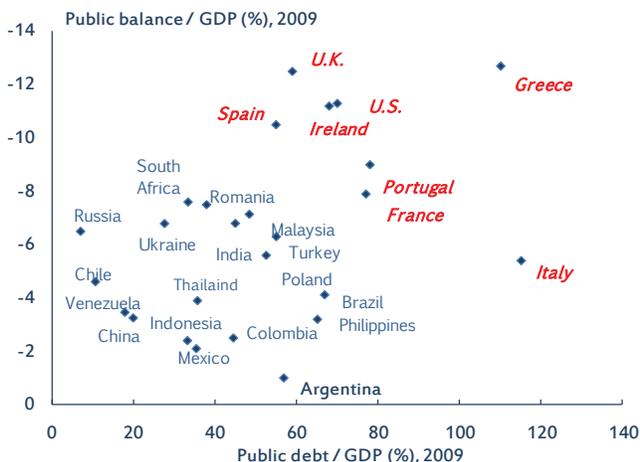
	2009(actual)	2010	2011	2012
World	-2.1	3.3	3.3	3.6
High income countries	-3.3	2.3	2.4	2.6
Developing countries	1.7	6.1	5.9	6.1
China	8.7	9.5	8.5	8.7
Japan	-5.2	2.5	2.1	2.2
The United States	-2.4	3.3	2.9	3.0
Euro area	-4.1	0.7	1.3	1.8
Russia	-7.9	4.5	4.8	4.7

Source: Global Economic Prospects, June 2010, The World Bank.

The ongoing debt crisis in high-income Europe poses a new challenge for the global recovery (box 2.1); while direct impact of the crisis on Russia is likely to be limited, this is predicated on the assumption that the Eurozone will avoid large-scale debt default and restructuring and broader contagion. Russia’s fiscal and debt outlook is much less pressing than in other countries because both fiscal deficits and debt-to-GDP ratios are much lower (figure 2.1). Also, Russia’s trade with the main affected European countries is relatively small, making the potential impact through this channel limited (box 2.1, figure). The possible contagion and the broader debt crisis in Europe, however, could transmit new shocks to Russia through two key channels: oil prices and financial/capital flows. A likely growth slowdown in the EU and an increase in risk premia could then lower oil prices and, thus export and budget revenues, exerting downward pressures on the exchange rate and capital flows. An increase in risk premia would likely affect Russian corporations with large external debts. The maturing debt in 2010 is equal to USD 114.5 billion (about 7 percent of GDP), with USD 35.6 billion in the

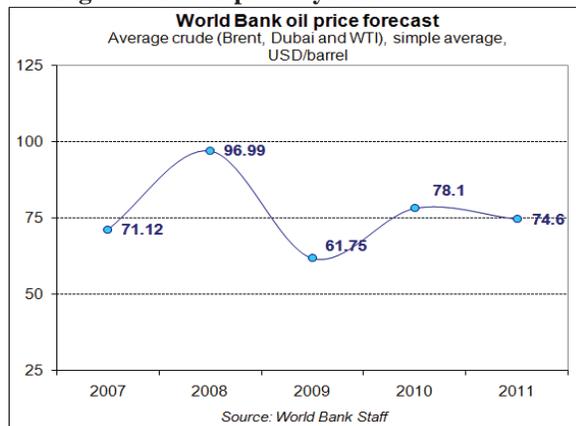
financial sector—about a third less in 2009. Sovereign CDS spreads for Russia, currently at around 200 basis points, have increased by 40 basis points in the last month, but they remain 100 basis points lower than a year ago.

Figure 2.1: Fiscal deficit and debt in selected countries



Source: World Bank.

Figure 2.2: Oil price dynamics



Source: World Bank Staff

With a slower-than-expected recovery in the first quarter 2010 and new downside risks to global economic recovery emerging, we revised our real GDP projection to 4.5 percent in 2010, followed by a 4.8 percent growth in 2011 (table 2.2). After a disappointing first quarter in 2010, a number of leading indicators for April-May show a pickup in economic activity that is likely to be sustained throughout the rest of the year. For example, fixed capital investment registered modest growth in April 2010 (2.3 percent, year on year), supported by an increase in credit activity. In addition, producer prices increased considerably reflecting a pickup in demand for intermediary goods registered by the Purchasing Managers Index (PMI). The sources of growth are likely to come from consumption and inventory restocking in the first half of 2010, reflecting recovery from a very low base in 2009. But the pace of economic growth in the rest of 2010 and 2011 will be constrained, depending on sustained gains in consumption against high unemployment and only gradually improving credit conditions to facilitate growth in fixed investment.

Table 2.2: Outlook for Russia, 2010-2011

	2010	2011
World growth, %	3.3	3.3
Oil prices, average, USD/bbl	78.1	74.6
Russia		
<i>GDP growth, %</i>	4.5	4.8
<i>Consolidated government balance, %</i>	-4.6	-3.8
<i>Current account, USD bln.</i>	58	33
<i>Capital account, USD bln.</i>	31	60

Source: Global Economic Prospects (World and oil prices), and Russian Economic Report, The World Bank.

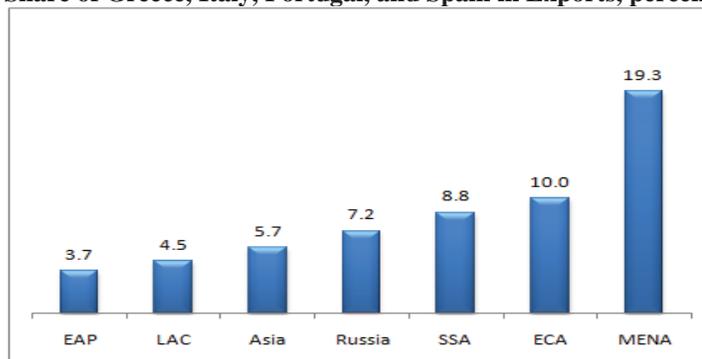
Box 2.1: The impact of the debt crisis in Europe on global recovery

The debt crisis in high-income Europe poses a new challenge and risks for global recovery. Although relatively orderly resolution of the fiscal problems in high-income Europe is most likely, a disorderly adjustment could have serious consequences for both high-income and developing countries. According to the IMF, fiscal consolidations ranging between 9.2 percent of GDP (Greece) and 4.8 percent of GDP (Italy) are required to bring their debt-to-GDP levels down to 60 percent. Such a consolidation will significantly hamper demand in the affected economies over the short to medium term.

The Europe and Central Asia region will be affected due to its closer trade ties (except for Middle East and North Africa) with the heavily indebted high-income European countries (EU-5) most likely to undergo a significant fiscal contraction (figure 1). Russia's links with Greece are very limited (accounting for less than 1 percent of Russia's exports but its export exposure to the four affected European countries including Greece rises to 10 percent. In countries such as Albania and Azerbaijan, 20 percent or more of their exports goes to Greece, Italy, Portugal and Spain. How hard these countries are hit, will depend on the extent of the fiscal contraction initiated, and how successful they are in shifting sales to other markets.

Also at risk are countries, with financial sectors closely linked to these highly indebted countries. FYR Macedonia, Bulgaria, Serbia, Albania and Romania are economies that have benefitted from heavy capital inflows from Greek financial institutions. Should banks in the debt-affected high-income European countries be forced to re-capitalise or retrench, capital flows to all developing countries and regions could contract heavily, potentially imposing further significant cuts to domestic demand—particularly among those that still have large external financing needs. Russia's financial sector is not significantly exposed to the four affected European countries, but an adverse impact on Russia's capital flows is possible given the flight to quality from the European periphery into the larger European countries and the dollar.

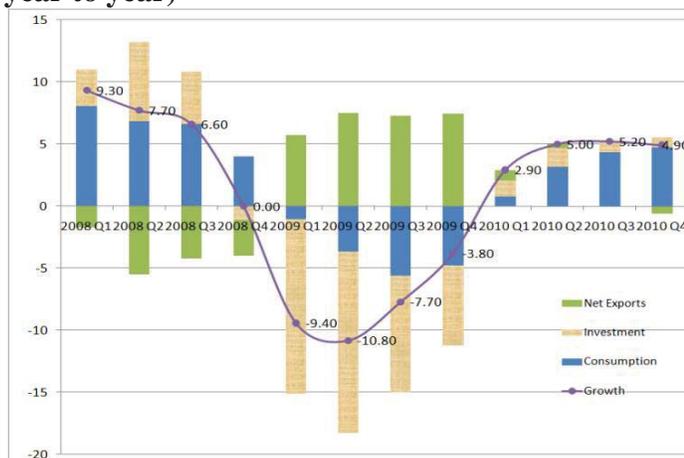
Box Figure 1: Regions with high trade exposure to heavily indebted European economies
Share of Greece, Italy, Portugal, and Spain in Exports, percent



Source: World Bank; UN-COMTRADE.

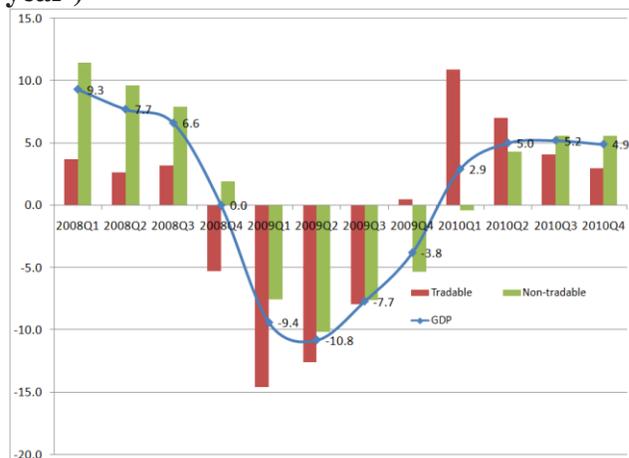
Growth in Russia in 2010 will be predominantly driven by a modest growth in consumption and the base effect, reflecting a low base of the first two quarters of 2009 (figures 2.3 and 2.4). Consumption, particularly household consumption, will be the main driver of economic growth in 2010, especially toward the year's end. A modest contribution to growth is likely to come from inventory restocking in the second quarter of 2010. At the same time, we do not expect large increases in fixed capital investment in 2010 given the excess production capacity and limited credit. So an increase in investment in the second quarter will be due mainly to inventory restocking. In April, the producer price index increased by 17.9 percent over April 2009, suggesting that the inventory restocking process is already underway. But the positive contribution of net exports to aggregate growth from 2009 is likely to turn negative in by the end of 2010, as import volume picks up in line with economic recovery. Finally, possible revisions of historical quarterly growth rates by Rosstat, in particular the strong quarter-to-quarter growth at the end of 2009, could alter the profile of quarterly growth in 2010 due to changes in the base.

Figure 2.3: Demand sources of Russia’s real growth, by quarter, 2008–10 (percent change year to year)



Source: Rosstat; World Bank staff estimates.

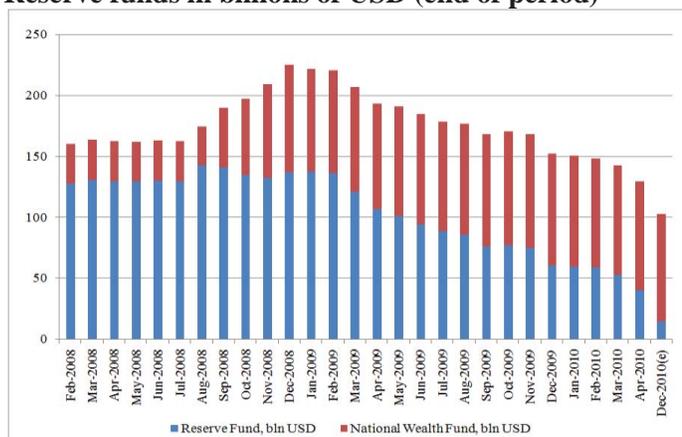
Figure 2.4: Sectoral sources of Russia’s real GDP growth by quarter, 2008–10 (percent change year to year)



Given the outlook for oil prices and global demand, we expect the current account to remain relatively strong in 2010 with a slight deterioration in 2011, while the capital account is likely to improve. If oil prices remain at their forecast levels, the surplus on the external current account would amount to about USD 58 billion in 2010 (about 3.9 percent of GDP) and would deteriorate to USD 33 billion in 2011 with recovery of imports and output. If the European debt crisis has no significant contagion effect (which cannot be ruled out, however) the capital account is projected to improve to surpluses of USD 31 billion in 2010 and USD 60 billion in 2011, reflecting an increase in non-debt capital inflows, lower debt repayments, and improved borrowing capacity of banks and non-financial corporations. We expect the exchange rate to remain volatile in the short term, with upward pressure on the ruble if the oil price stays close or above USD 80 a barrel—and downward pressure, if the oil price falls below USD 70 a barrel.

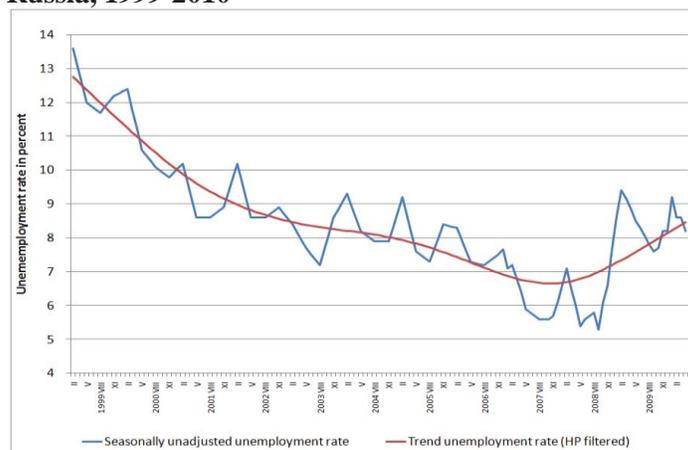
An increase in fiscal revenues due to higher oil prices is likely to be partly offset by new expenditure pressures from additional social spending and increases in pensions. We project the fiscal deficit at 4.6 percent of GDP in 2010 and at 3.8 percent in 2011, taking into account additional pensions expenditures. Despite somewhat higher oil price outlook this year, the deterioration in fiscal balance compared with the last RER21 is due to the much larger increases in pensions. The balance of the Reserve fund at the end of 2010 is estimated to be around USD15 billion (figure 2.5). Therefore, the expected budget deficit in 2011 and 2012 will have to be mostly financed with domestic and external borrowing. The downside risks associated with high volatility of oil prices and global demand will remain. Looking into the 2011 budget process, it would be prudent to maintain the Ministry of Finance’s good practice of the low assumption of oil prices in order to keep the buffer in the budget against bad oil price surprises.

Figure 2.5: Balances of the National Welfare and Reserve funds in billions of USD (end of period)



Source: Ministry of Finance
* End of the year estimate

Figure 2.6: Monthly Unemployment Rate Dynamics in Russia, 1999-2010



Source: World Bank estimates based on Rosstat data.

Given the current trends in inflation and money supply, the downward outlook for inflation in 2010 remains unchanged. We keep our previous projection for CPI inflation in the range of 7 to 8 percent, reflecting the relatively slow growth in money supply in 2009 and remaining credit constraints. But risks of higher inflation are related to a possible relaxation in the fiscal stance due to the planned increases in pensions and public wages, and the monetization of the deficit in the future.

Larger banks or corporations should be able to finance or roll over their debt obligations in 2010. But the European crisis may result in a new tightening of borrowing conditions in emerging markets, *including Russia*. According to the CBR, banks will have to pay about USD 40.8 billion in 2010 in principal and interest and corporations about USD 84.2 billion (table 2.3).

Table 2.3: External debt service, including interest payments (USD billion)

	2009*	2010				2010	2011				2011
		I q	II q	III q	IV q		I q	II q	III q	IV q	
All sectors	152	39.6	28.9	25.8	35.5	129.8	16.8	23.2	25.3	64.5	129.8
Government	4.8	1.6	0.8	1.5	0.9	4.8	1.6	0.9	1.8	1	5.3
Banks	60.3	14.7	10.2	6.3	9.6	40.8	4	7.5	5.6	8.4	25.5
Other sectors	86.3	23.3	17.9	18	25	84.2	11.2	14.8	17.9	55.1	99

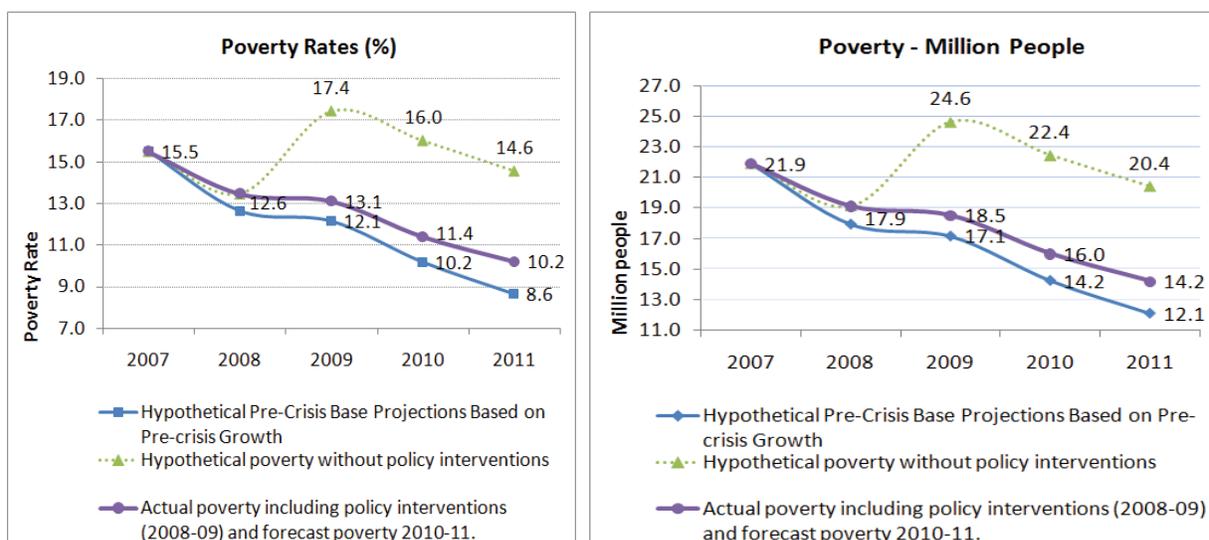
Source: CBR, schedule of payments as of January 1, 2010.

* - schedule of payments as of April 2009.

The economic recovery is likely to have a limited impact on labor markets with unemployment levels remaining relatively high in the medium term, cushioned by spikes in seasonal employment. Russia will likely experience moderate job growth recovery, but with sustained, high unemployment rates—a “jobless recovery” that is also likely to prevail in many European countries (Discussed in the previous Russian Economic Report No. 21). Unemployment is expected to stay between 8 and 9 percent by the end of 2010, with some improvement throughout the year, mostly a result of higher seasonal employment. We also expect that in the medium term, employment would recover only gradually, and at a rate lower than real GDP (figure 2.6).

Poverty statistics recently published by Rosstat indicate that poverty in 2009 remained at around 2008 levels (figure 2.7). This is potentially a reflection of the unemployment increasing less than initially feared and likely also due to increased transfers to the population. The scale-up of pensions and other benefits in 2010, in particular, will likely have additional positive impacts on poverty, which is projected to fall further to 11.4 percent in 2010 and to 10.2 percent in 2011. But the resulting increase in public consumption will make the required medium-term fiscal adjustment more difficult and more prolonged than anticipated earlier, and the scale-up could also have other, less desirable fiscal consequences in terms of a more rigid expenditure structure and crowding out of productive infrastructure expenditures.

Figure 2.7: Projected impact of the crisis on the poverty rate, percentage of people with income level below minimum subsistence, 2007–2011



Source: World Bank staff estimates based on aggregate output forecast and household survey data on employment and incomes.

III. THE CHALLENGE OF RUSSIA'S MONOTOWNS

Summary: Monotowns present complex challenges for diversification and social and enterprise restructuring in the postcrisis period. Money alone will not solve them. Multipronged market-driven approaches, including active partnerships between the monotown and the private sector, based on good international practice, stand a better chance of success.

WHAT ARE MONOTOWNS?

Monotowns are urban settlements with economic bases dominated by a single industry or core enterprise. In a massive drive for industrialization and urbanization, Soviet planners created them at “rational” locations, in their minds a contrast with the “chaotic” and “wasteful” patterns of the capitalist economies. After World War II, Russia’s planned settlements grew rapidly, many in geographically inhospitable areas to the north and east of Central Russia. The main principle was the spatial division of labor, which meant maximum regional specialization in some types of production within the autarkic national economy, underpinned by military, strategic, political, bureaucratic, and economic rationales.

There is no firm consensus on what constitutes a monotown or on how many monotowns there are. The most authoritative study, “Monotowns and Core Enterprises,” commissioned in 1999–2000 by the Ministry of Economy, classified 467 cities and 332 smaller towns as monotowns—roughly two in five of Russia’s cities, with a population of 25 million, or a sixth of Russia’s people. With about 900 core enterprises, they produced more than 30 percent of industrial output. Nearly two-thirds of them are in manufacturing, fuels, metallurgy, food processing, and timber and pulp. So, the problems of monotowns in Russia—competitiveness, diversification, technological upgrading, jobs—are largely the problems of Russia’s urban-based manufacturing (box 3.1).

Box 3.1. Two monotowns

Togliatti

Togliatti has a population of more than 700,000, and is Russia’s largest monotown. It is home to the VAZ auto works, Russia’s largest car maker, directly contributing about 1 percent of GDP. VAZ employed about 106,000 at the end of 2008, and most other enterprises in Togliatti are tied to VAZ. As a result of the economic crisis, VAZ was in financial difficulties in early 2009. Industrial output fell 44 percent, wages and employment fell, and workers were forced into vacations or part-time employment. In September 2009, 27,600 VAZ employees were laid off, and further restructuring may be necessary. The company’s best prospects are an alliance with Renault to manufacture Renault, Nissan, and Lada cars.

Dalnegersk

Dalnegersk has 40,000 people, 524 kilometers from Vladivostok and 36 kilometers from the Sea of Japan. In 1897, a mining expedition discovered valuable lead and zinc ores in this area. By World War II, the town developed a complex plant producing tin. Today’s products include boron-containing substances like borax and other cleaning pastes. Two enterprises, GHK Bor and OAO GMK Dal’polimetal, which are currently subsidiaries of OOO UK Russian mining company (RGRK) that started operations in 2005 and took over these enterprises in 2005 and 2009, reprehensively. About 60 percent of the population depend on these companies for jobs and incomes.

- OAO GMK Dal’polimetal was first founded as an enterprise in 1897 and has currently about 2000 employees producing zinc and lead concentrates.
- GHK Bor was founded in 1958. During Soviet times, Bor employed 10,000, but in January 2009 employment was 3,421. Including their family members, about 12,000 people depend on GHK Bor that produced mainly boric acid colemanite.

Dalnegorsk's narrow specialization is linked to the limited job opportunities, falling living standards, a shrinking tax base, and deteriorating infrastructure. The enterprises have been in arrears for electricity debts, and the regional government has given them subsidies. Bor wants to sell its heating and energy facilities to Dalnegorsk or a local utility. Dalnegorsk's town budget is vulnerable to the crisis at these core enterprises, and the social infrastructure (schools, nurseries, cultural facilities) is suffering as well. GHK Bor owes the city 50 million rubles.

Monotowns went through difficult periods of ownership and restructuring reforms and phases of boom and bust. Most of the monotowns' core enterprises were privatized in the 1990s, ending up in the hands of large Russian industrial conglomerates, which sought to free themselves of social service obligations. In uncompetitive industries, such as textiles and machine-building, most went bankrupt by the late 1990s, bringing further decline to the towns (such as the old textile area of central Russia). Others—primarily those that found export markets—managed to survive. The government tried to devolve the social services to local municipalities, but lacked the resources to finance them. So, municipalities either closed the social facilities or postponed their transfer.

During the expansion of the 2000s, many monotowns benefited from high prices of resources and semi-finished products, which stimulated the local economy. The devolution of social assets stopped or reversed, as prosperous core enterprises reverted to providing social services for their employees. The situation reversed again with the Great Recession in 2008–09. Most core enterprises are in industries hit by the collapse of global and industrial demand—machinery, metallurgy, chemicals, wood and paper products. With core enterprises facing massive demand slump, the main social issue became unemployment and underemployment. With narrow economic bases, large-scale layoffs, and few short-term opportunities for alternative employment, monotowns took the brunt of the crisis. And limited outmigration—due to economic, social, and cultural factors—made the problem of monotowns even more acute.

THE MONOTOWN “PROBLEM”

The crisis in monotowns cannot be boiled down to a single “problem”; in fact, it has multiple dimensions: fiscal, social, and economic. Enterprises still providing social services have curtailed them, including central heating, critical in a northern country with cold climate. The collapse of the tax base tied to the core enterprises curtailed municipal finance and basic services. The revenues from personal income tax—the major source of municipal revenues—suffered from unemployment and falling wages. This has reduced the incomes (and the tax payments). Also falling were regional tax revenues from the personal income tax (shared by the regional and municipal budgets), the corporate profit tax (shared by the regional and federal budgets), and the corporate property tax.

In 2009, the social discontent in some of the monotowns led to public protests. The best known of these occurred in Pikalevo, a monotown of 22,000 near St. Petersburg, producing cement, aluminum, and potash. When the plant was closed there were no prospects for work, and there was no assistance. The company stopped paying its bills, and heat and hot water were shut off. The residents blocked an important federal highway,

prompting the Prime Minister to intervene. Disaffected residents in a few other monotowns have tried to emulate Pikalevo.

Most monotowns, have narrow and inflexible structures including obsolete physical capital, crumbling infrastructure, and an immobile population. The cause lay in the legacy of Soviet planning that created the monotowns and their economies. The system “worked” as long as relative prices were controlled to reflect domestic planning priorities rather than international relative scarcities, but it collapsed in the face of market realities when prices were liberalized. It is likely that only a few of the enterprises can compete in international markets although there has not been a systematic analysis of their viability, and many are vulnerable to commodity price volatility. Many produce the wrong products in the wrong places. Economically unviable monotowns are similar to the once booming mining towns that became “ghost towns.”

The debate over monotowns does not involve a simple choice between further government interventions and market solutions. Nor will a single approach work in all monotowns facing different circumstances, structures, and prospects. To deal with the monotown problem, the federal government created an Intergovernmental Committee on Monotowns, which invited monotowns to submit comprehensive plans with specific measures for current economic and social problems and a medium-term road map for diversification leading to sustainable long-term growth. To this end, the government approved 27 monotowns to receive 27 billion rubles (about USD 920 million) from the 2010 federal budget. Of this, 10 billion will come as interbudgetary transfers through the Ministry of Finance, 10 billion as subsidies from the Ministry of Regional Development, 5 billion from the federal Housing and Communal Services Reform Fund, and 2 billion from the Ministry of Economic Development as subsidies for small business.²

Because money alone will not solve the underlying problems for the 27 monotowns, a combination of restructuring and other reform measures is likely to be needed. Applying the same amount to all monotowns is clearly not feasible: that would cost about 460 billion rubles, or 7 percent of 2010 Russia's federal revenue. The monotowns' underlying problems are market unfriendly locations for enterprises which produce uncompetitive products. The government does not have the budget resources to move them to more suitable locations and equip them with modern technology to produce the right output mix. A menu of approaches tailored to the circumstances of specific monotowns stands a better chance of success than a “one-size-fits-all” approach, especially one that relies on financial support alone.

A MENU OF POLICY APPROACHES

A mix of policy approaches might be needed, using good practice examples from international experiences. Such approaches include fostering innovation and diversification through better investment climate to attract new partners with appropriate technology and market access and small and medium-size business development, increased mobility, more flexible and investment-friendly regulation, better functioning of land and housing markets, and stronger social safety nets and services. And while some monotowns will probably face depopulation and decline, others may be able to transform themselves.

² <http://www.rostechnologii.ru/archive/0/detail.php?ID=7106>

A modern economy is built on competition and innovation, which may present an opportunity for some monotowns. Traditional extractive industries involve processes and technologies that are relatively standard and can be planned and managed in more traditional ways. But modern activities are driven by continuous invention, reinvention, adaptation, and improvement of processes and products. Innovation cannot be planned, but it can be fostered and encouraged. The primary factor to promote innovation is human capital: creating and maintaining it through education, health, and other basic services, and placing it in an environment that enables it to thrive by combining it with other talented and skilled people. The first requires providing good basic human services everywhere; the second requires enabling people to move to opportunities in agglomerations where the returns of education are highest—both for themselves and for society.

Greater mobility would help to reduce monotowns' drain on public and economic resources. Mobile human and capital resources can move from unproductive to productive locations. In the long term, some monotowns should be abandoned, but others can be rededicated to diversified and more profitable production. Market-based mechanisms combined with appropriate government policies and planning to help overcome market failures and improve the business climate would be the best methods for determining each monotown's future and restructuring those firms that can become competitive.

Mobility, instrumental to a modern, innovative economy, can be improved by removing barriers. Reforms should neutralize these barriers so that they do not hinder migration and “lock up” labor resources and human capital in unproductive places:

- **Labor markets.** If workers were paid full wages, in cash on a periodic schedule, they would be more mobile than under the present system, which discourages them from moving because of wage arrears and in-kind payments. More rigorous enforcement of labor contracts could prevent firms from accumulating wage arrears or by establishing a market in wage arrears with the government acting as a guarantor of the wages and seizing the assets of firms that default.
- **Social services.** If social services were provided only by the government and were of uniform quality throughout the country, they would not be a factor in people's location decisions. But because many services are still provided by firms, particularly in monotowns, moving would mean losing these basic services. The government should thus devolve social services—health, education, housing, electricity, heat and hot water. The enterprises which are presently providing these services should be released from their responsibilities so that they can concentrate on their primary functions, and government entities should be accountable for serving all citizens at uniform levels at least as good as those of the enterprises.
- **Administrative obstacles.** If people could move without a complicated and bureaucratic registration system, they would be more willing to relocate. The main problems relate to the discretionary enforcement powers for local officials, and the differences in regional and federal registration laws.
- **Housing and land markets.** With efficient land and rental markets, people could receive fair value for their real estate holdings and feel confident of finding quality housing at new locations. But today,

people cannot sell land holdings. The government could intervene to create more liquid markets and to encourage developers to increase housing supplies in growing agglomerations.

In the near term, various public-private partnerships could restructure some of these enterprises and diversify their economic bases. There are proposals to make monotowns a priority of Russia's Federal Investment Fund, specifically designed to promote public-private partnerships. As noted above, further public interventions should complement, rather than circumvent, market forces. Essential near-term steps include:

- Reducing constraints to internal mobility so that labor resources can migrate to growing areas where labor shortages are likely.
- Completing the devolution of services (utilities, transportation, health, and recreation) from the core enterprises to the municipalities.
- Building stronger social safety nets to protect those stranded without work in monotowns and without useful skills for employment elsewhere.
- Further reforming intergovernmental financial relationships so that municipalities can collect revenues adequate for their social services responsibilities.

Experiences elsewhere in the world are useful for Russia. For example, depopulation in some East German cities (box 3.2) brought about demolitions and the relocation of social and administrative services into city centers to enhance spatial efficiency of service delivery, energy use, and economic vibrancy. In the United States, as manufacturing jobs moved overseas in the 1970s, Pittsburgh transformed itself from a manufacturing hub to a service-based economy (box 3.3). It did this in part through public-private partnerships with businesses in infrastructure investments and with local universities in research and development.

Box 3.2. East German Bund–Länder-Program—depopulation and urban downsizing

After German reunification in 1990, many regions in East Germany experienced a massive population loss. This overlaps with the general aging process and population loss in Germany. The supply of apartments in such areas is much higher than the demand and has resulted in high vacancies, especially in big apartment blocks.

Solution

The German government and the German Länder initiated the Stadtumbau Ost (Urban Conversion East) program to improve the attractiveness of the East German cities and towns. It aims to renew town centers, reduce the oversupply of flats, and revalue property affected by shrinking processes. The demolition of 350,000 of the 1 million flats that remained unoccupied until 2009 is planned where there is an above-average vacancy rate and a revitalization concept. The municipalities will take actions for renewal, such as revaluing existing buildings and quarters with particular cultural and historical value, adapting urban infrastructure, reusing open land, and improving neighborhood quality. EUR 2.5 billion were available for the years 2002–09, and 342 municipalities took part in the program between 2002 and 2005.

Example: Aschersleben—contraction of the settlement and renovation of the city center

Ascherleben cut the less prosperous parts of city infrastructure and housing while strengthening the city core. The city authorities renovated central areas and increased their attractiveness while demolishing large areas of unattractive peripheral multistory apartment areas. Although demolition is costly in the short term, it will save money in the long term by removing underused infrastructure and improving the town's general appearance and image for the remaining population. The town also relocated schools and other administrative offices back into the center, making it more accessible and user friendly to the remaining population.

Source: European Environment Agency (2009). *Ensuring quality of life in Europe's cities and towns: Tackling the environmental challenges driven by European and global change.* EEA Report No. 5.

Box 3.3. Pittsburgh: a declining industrial region transformed

Pittsburgh, an example of successful structural change in the declining Pennsylvania Coal region, was the center of U.S. steel industry through the mid-20th century. Starting in the 1970s, the switch to electric furnaces led to the use of ferrous scrap iron, robbing the region of its advantage in coal mines. Then, mini mills were set up in the South, and steel-consuming durable-goods industries clustered in the South and the West. There was also increased international competition in steel. U.S. steel production peaked in 1973 at 137 million metric tons and by 1982 had fallen to 68 million metric tons. Pittsburgh's population followed suit: 676,806 in 1950, it declined by half to 334,563 in 2000.

But in part because of banks, corporate headquarters, and universities, Pittsburgh buffered the effects of this deindustrialization. Employment in health services, education, and other professional services rose from 18 to 28 percent between 1970 and 1990. There were large declines in precision production and machine operators and corresponding increases among executives, professionals, technical occupations, sales, and other services. From 1978 to 1998 alone, non-manufacturing jobs increased by 289,000.

The city has long had successful public-private partnerships, led by the Allegheny Conference on Community Development. Successive mayors teamed with businesses to promote investment in downtown real estate, infrastructure, and environmental projects. The city could also tap into the intellectual capital of its 25 colleges and universities. Telecommunications and robotics grew with the city's pool of skilled labor in research and development. As an example of its successful transformation, Pittsburgh hosted the G-20 Summit in 2009. Ranking among the most livable cities in the United States, Pittsburgh has become a model for other regions coping with industrial decline.

Box 3.4 Glasgow: an example of successful replacement of industries

Initial conditions. Glasgow has long been known as one of world centers of shipbuilding and locomotive manufacturing and often referred as the ‘Second City of the British Empire’. But from the mid 1960s, the city experienced a severe industrial decline as local heavy manufacturing enterprises were unable to compete against more cost-effective overseas companies. This was coupled with worsening housing conditions, growing deprivation, crime rate, and poverty.

Strategies. The city’s transformation began in the early 1980s when the local government developed and started implementing a new strategy aimed at regenerating of the city center, focusing on the retail sector development, attracting direct investments and office relocation, and fostering tourism. These policies were chosen based on a solid educational potential of the city that hosted four universities and a well-known, underutilized historical and cultural heritage. Also, these measures helped mitigate the city’s social problems at that time.

Financing. Glasgow’s development policy was largely funded from the European Union. The local government managed to quickly improve Glasgow’s basic infrastructure, build important motorways and transport facilities improving an access to the city, and refurbish old housing stock into attractive accommodation. Simultaneous opening of new art galleries, convention centers, and a successful promotional campaign changed the image of Glasgow from a polluted city with difficult social problems into a desirable tourist destination. Importantly, it resulted in a cultural renaissance so that in 1990, Glasgow was named the European City of Culture. Since then, the city’s development has been based on 5-10 year strategies supported by action plans addressing challenges in economic and community development, tourism sector, local transport, cultural development, sports activities, and historical heritage.

Outcomes. As a result, by the mid 2000s the city of Glasgow became a service-based economy utilizing its highly-qualified labor force in business services (19% of total employment), healthcare (10%), and financial services (7%) while only 6% percent were employed in manufacturing. Moreover, Glasgow remained one of the largest locations for businesses in the U.K. with over 13,000 employers providing about 400,000 jobs. Between 1994 and 2004 ca. 60,000 new jobs were created, sharply reducing the unemployment rates. The tourism sector became one of the main drivers of the local economy with some 3 million arrivals generating £670 million in revenues annually. Currently, Glasgow’s government is implementing its economic strategy 2006-2016 to strengthen city’s specialization in services and education and to mitigate weaknesses such as remaining high unemployment rate, low productivity and exports, insufficient innovation capacity, lack of entrepreneurship culture, and still underdeveloped high value-added activities.

Sources: Modernization in Russia: UK experience of modernizing and restructuring single industry cities (2009). Final report, UK Trade and Investment, 21 p.; A step change for Glasgow. Glasgow’s Ten Year Economic Development Strategy (2006). The Glasgow Economic Forum, 52 p.; Glasgow Tourism Action Plan 2002/07 (2001). Glasgow Tourism Development Group, 16 p.

Main indicators

Output Indicators	2006		2007		2008		2009		2010				
	Jan-Dec												
GDP, % change, y-o-y 1/	7.7	8.1	5.6	-	-9.8	-	-10.4	-	-9.9	-7.9	-	2.9	-
Industrial production, % change, y-o-y	6.3	6.3	2.1	-16.0	-13.2	-13.7	-16.9	-17.1	-17.1	-10.8	-7.9	7.8	1.9
Manufacturing, % change, y-o-y	8.3	9.5	3.2	-24.1	-18.3	-20.5	-25.1	-23.7	-16.0	-14.7	-16.8	7.6	0.8
Extraction of mineral resources, % change, y-o-y	2.5	1.9	0.2	-3.6	-6.0	-1.8	-1.8	-3.4	-4.0	-1.6	-3.8	6.9	6.6
Fixed capital investment, % change, y-o-y	16.7	21.1	9.8	-17.6	-16.9	-17.6	-20.9	-24.8	-22.3	-19.5	-18.4	-17.0	-8.7
Fiscal and Monetary Indicators													
Federal government balance, % GDP 1/	7.5	5.4	4.1	15.0	2.5	-0.4	-3.1	-3.2	-4.0	-4.2	-3.8	-4.7	-4.9
Consolidated budget balance, % GDP 1/2/	8.5	6.1	4.8	23.2	6.0	2.7	0.1	-1.1	-3.2	-2.7	-2.3	-1.9	-2.9
M2, % change, p-o-p 3/	43.6	51.3	27.2	-11.1	0.3	0.8	1.9	4.2	2.3	-0.3	1.4	2.6	1.6
Inflation (CPI), % change, p-o-p	9.0	11.9	13.3	2.4	1.7	1.3	0.7	0.6	0.6	0.0	0.0	0.0	0.3
GDP deflator 1/	15.5	13.9	18.8	-	5.7	-	5.7	-	4.2	-	-	3.3	-
Producer price index (PPI), % change, p-o-p	10.4	25.1	-7.0	-3.4	5.1	2.9	2.4	0.6	2.2	1.8	1.4	1.2	-0.9
Nominal exchange rate, average, Rb/USD	27.1	25.6	24.8	31.5	35.8	34.7	33.6	32.1	31.0	31.5	31.6	30.8	29.5
Real effective exchange rate, 2000 = 100 (IMF)	163.4	172.7	184.4	166.3	157.1	163.8	168.7	173.2	176.7	174.9	171.9	175.0	180.3
Real effective exchange rate, % change, p-o-p (IMF)	9.5	5.7	6.8	-8.8	-5.5	4.3	3.0	2.7	2.0	-1.1	-1.7	1.8	3.1
Reserve Fund, bin USD e-o-p	137.1	137.3	136.3	121.1	106.8	101.0	94.5	88.5	85.7	85.7	85.7	76.4	77.2
National Wealth Fund, bin USD, e-o-p	88.0	84.5	83.9	85.7	86.3	89.9	89.9	89.9	90.0	90.7	91.9	93.4	92.9
Reserves (including gold) billion \$, end-o-p	303.7	477.9	427.1	386.9	384.1	383.9	383.9	404.2	412.6	402.0	409.6	413.4	447.8
Balance of Payment Indicators													
Trade Balance, billion \$ (monthly)	139.3	130.9	179.7	7.5	5.2	6.4	6.3	8.9	9.2	10.4	11.7	11.1	11.1
Share of energy resources in export of goods, %	63.3	61.5	65.9	-	60.8	-	60.8	-	61.6	-	65.9	-	63.8
Current Account, billion \$	95.6	76.6	102.4	5.0	1.8	2.9	1.5	3.5	2.3	4.1	6.1	5.4	5.7
Export of goods, billion \$	303.6	354.4	471.6	17.9	18.6	20.9	21.1	22.7	24.5	26.4	27.3	28.8	30.4
Import of goods, billion \$	164.3	223.5	291.9	10.5	13.4	14.5	14.7	13.8	15.4	16.0	15.7	17.7	19.2
Gross FDI, bin USD 1/	13,678	27,797	27,027	-	3,183	-	3,183	-	6,090	-	-	9,975	-
Average export price of Russia's oil, \$/bbl	56.2	64.4	91.2	40.1	40.6	40.9	44.3	49.2	57.4	61.3	64.1	65.3	72.1
Financial Market Indicators													
Average weighted lending rate for enterprises, % 4/	10.5	10.8	15.5	17.1	16.6	16.1	16.0	15.9	15.6	14.9	15.2	14.7	14.1
CBR refinancing rate, % end-o-p	11.0	10.0	13.0	13.0	13.0	13.0	12.5	12.0	11.5	11.0	10.8	10.0	9.5
Real average rate for Ruble loans, % (deflated by PPI)	-1.8	-3.4	-6.8	32.4	26.4	23.1	25.5	29.1	32.1	36.0	35.1	26.3	18.4
Stock market index (RTS, ruble term, eop)	1,922	2,291	632	535	545	690	833	1,088	987	1,017	1,067	1,255	1,349
Enterprises Finances													
Share of loss-making companies 1/	29.7	23.4	25.2	38.9	38.5	39.5	39.5	38.1	35.5	36.0	35.1	33.4	33.9
Share of credits in capital investment 1/	14.3	15.5	17.6	n/a	n/a	13.4	-	-	12.0	-	-	11.1	-
Profitability (net profit/paid sales), % 1/	25.6	36.8	21.5	-25.8	0.2	12.1	17.4	23.4	24.8	24.0	25.7	26.7	27.2
Income, Poverty and Labor Market													
Real disposable income, (1999 = 100%)	219.1	245.6	252.2	174.2	234.3	241.5	260.9	252.8	261.6	254.0	242.6	250.4	268.9
Average dollar wage, US \$	391.9	532.0	694.3	483.5	478.7	533.0	541.6	581.2	615.1	594.2	580.8	626.1	647.1
Unemployment (% ILO definition)	7.2	6.1	7.8	8.7	9.5	9.2	8.8	8.5	8.3	8.1	7.8	7.6	7.7

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

1/ Cumulative from the year beginning.

2/ Starting 2006 incl. extrabudgetary funds.

3/ Annual change is calculated for average annual M2.

4/ All terms up to 1 year.

5/ Data for the first quarter of 2010.