

# No 18

## The World Bank in Russia

# Russian Economic Report No. 18<sup>1</sup>

*The world has entered the first global recession since the Second World War. The impact of the crisis worldwide is proving far deeper and broader than previously thought. The impact on Russia has been accentuated by its structural vulnerabilities: dependence on the oil and gas sector, a narrow industrial base and limited small and medium-size enterprise sector. As a result, Russia's real GDP is likely to contract in 2009 by 4.5 percent. The fiscal space for further support to the economy has shrunk but the government will be able to finance its fiscal deficit thanks to its large fiscal reserves. Russia's early fiscal policy response has been proactive, larger than that of many other G-20 countries and greater than the internationally recommended 2 percent of GDP. Reflecting the early crisis impact, policy has so far focused mainly on supporting the financial sector and enterprises. Future policy response will have to be more selective, cushioning the impact on the vulnerable, addressing the most critical infrastructure bottlenecks, and supporting small and medium-size enterprises.*

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## RUSSIAN ECONOMIC REPORT No. 18

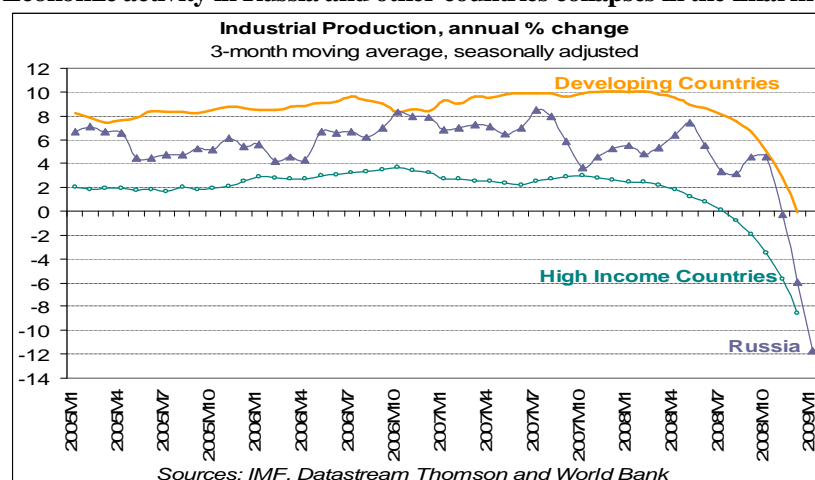
**Summary.** *The world has entered the first global recession since the Second World War. The impact of the crisis worldwide is proving far deeper and broader than previously thought. The impact on Russia has been accentuated by its structural vulnerabilities: dependence on the oil and gas sector, a narrow industrial base and limited small and medium-size enterprise sector. Early labor market and poverty impacts have been severe. The global outlook remains extremely uncertain, with declines in world output and trade and very limited capital flows to developing countries this year and world oil prices in the USD40-50 range in 2009-10. As a result, Russia's real GDP is likely to contract 4.5 percent in 2009. The fiscal space for further support to the economy has shrunk, but the government will be able to finance its fiscal deficit thanks to its large fiscal reserves. Future policy responses will have to be more selective, cushioning the impact on the vulnerable, addressing the most critical infrastructure bottlenecks, and supporting small and medium-size enterprises.*

### 1. RECENT ECONOMIC DEVELOPMENTS

**The evolving global financial crisis has turned out to be broader and deeper than previously thought possible—and its sources, outcomes, and policy responses are still widely debated.** Despite massive policy responses in many countries, the world economy is now in the first simultaneous recession—with declines in global output and in global trade—since the Second World War.

**Data for the last quarter 2008 and early 2009 show industrial production, trade, and global demand collapsing around the world.** Developed countries are hard hit, with many developing countries following suit. But in all countries, a vicious circle of declining or rapidly slowing economic activity and trade—and rising unemployment and poverty—is making for a very troubling international environment. Consumers and businesses confidence and credits have evaporated and asset price bubbles have burst with massive adverse wealth effects. The painful process of global deleveraging is likely to last much longer than anticipated just a few months ago.

**According to the World Bank's current forecast, global real GDP in 2009 is likely to decline by 1.7 percent, with particularly deep drops in industrial production.** World trade is expected to decline by 6.1 percent. In high-income countries industrial production contracted by 8.5 percent (year-on-year, three-month moving average) as of December 2008—down from a recent peak of 3 percent growth in October 2007. In developing countries it slowed sharply, with output growth reaching zero in December 2008, down from the recent high of 10.1 percent growth in February 2007 (figure 1.1). With weak global demand and rising oil inventories, the World Bank has revised its 2009 forecast for average crude prices (Brent, Dubai, and WTI) downward from USD 75 a barrel to the mid-USD 40s (box 1.1 and box figure 2).

**Figure 1.1. Economic activity in Russia and other countries collapses in the final months of 2008**

### Output and investment—rapidly decelerating since the fourth quarter of 2008

*The decline in global demand, the fall in commodity prices, and the tightening of credit have accelerated Russia's economic slowdown since the fourth quarter of 2008 (table 1.1).* Estimated real GDP growth in the fourth quarter of 2008 was about 1.1 percent, down from 9.5 percent during the same period in 2007 (Rosstat). Strong growth during the first three quarters of 2008 (7.7 percent on average) ensured solid overall growth of 5.6 percent for the year, but lower than the 8.1 percent in 2007. Growth in industrial production dropped to 2.1 percent in 2008 from 6.3 percent a year earlier. In December 2008 industrial production fell 10.3 percent relative to December 2007. It then dropped 16 percent year-on-year in January and 13 percent in February 2009.

**Table 1.1. Main macroeconomic indicators, 2006-09**

	2006	2007	2008	Q4 2008	Jan-09	Feb-09
GDP growth, %	7.7	8.1	5.6	1.1***	-8.8*	-7.3*
Industrial production growth, y-o-y, %	6.3	6.3	2.1	-6.1	-16.0	-13.2
Fixed capital investment growth, %, y-o-y	16.7	21.1	9.8	-2.3	-15.5	-14.1
Federal government balance, % GDP	7.4	5.5	4.0	4.0	15.0	2.6
Inflation (CPI), % change, e-o-p	9.0	11.9	13.3	13.3	2.4**	4.1**
Current account, billion USD	95.6	76.6	98.9	8.1	n/a	n/a
Unemployment, % (ILO definition)	7.2	6.1	6.3	7.1	8.1	8.5
Memo: Oil prices, Urals (USD/barrel)	61.2	69.5	95.1	54.9	44.2	43.1
Reserves (including gold) billion USD, e-o-p	303.7	478.8	427.1	427.1	386.9	384.1

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

\* Preliminary estimate by Ministry of Economic Development.

\*\* Cumulative from end-2008.

\*\*\* Preliminary estimate by the WB staff.

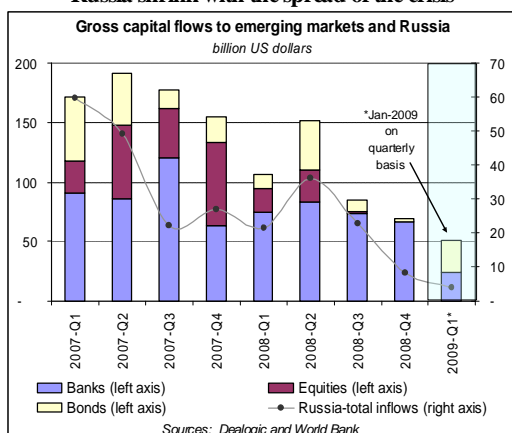
### Domestic demand—slowing in late 2008, collapsing in early 2009

*Tighter credit, collapsing global demand, huge global uncertainty, and rising unemployment have hurt both investment and consumption growth in Russia (figure 1.2).* According to Rosstat, total fixed capital investment grew 9.8 percent in 2008, compared with 21.1 percent growth in 2007. More worrisome is the investment decline by 2.3 percent in the fourth quarter of 2008 (year-on-year), largely reflecting escalating liquidity problems in the banking sector and the resulting credit crunch and a deceleration in consumption growth due to rising unemployment and lower growth.

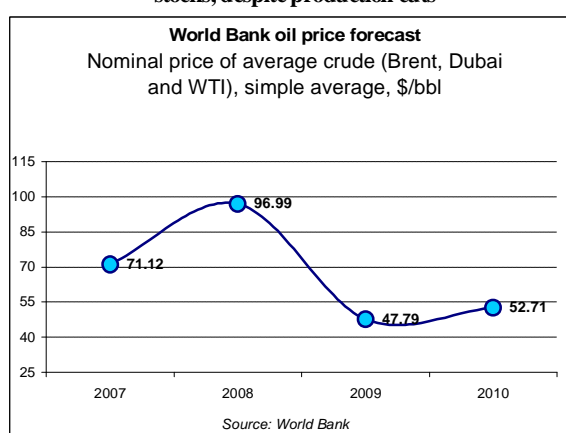
### Box 1.1. Global environment and oil prices—outlook much worse than anticipated

Total gross capital flows to emerging markets plummeted in the fourth quarter of 2008—down 61 percent from the same period in 2007. Bond issuance and equity placements collapsed, while cross-border syndicated bank lending remained fairly resilient. In comparison, total flows to Russia showed a steeper, 70 percent drop in Q4-08 relative to Q4-07, with nearly all inflows limited to bank lending. Equities posted the steepest decline in 2008, falling 76 percent over 2007, followed by a 51 percent decline in bond issuance. Bank lending posted a less stark 23 percent decline over the same period. With the spread of the financial crisis to the real sector, the Institute for International Finance projects that net inflows to emerging markets will shrink dramatically, from USD 929 billion in 2007 and USD 466 billion in 2008 to only USD 165 billion in 2009 (box figure 1).

**Box figure 1. Capital flows to emerging markets and Russia shrink with the spread of the crisis**



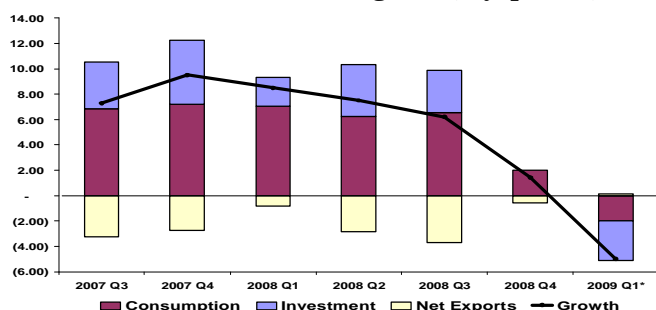
**Box figure 2. Oil prices plunge on faltering demand and rising stocks, despite production cuts**



Weak demand and rising supplies are reflected in the World Bank's revised average crude price forecast from an annual average of USD 97 a barrel in 2008 to a mid-USD 40 a barrel range in 2009 and USD 53 a barrel in 2010 (box figure 2). U.S. oil demand fell nearly 6 percent in 2008, with gasoline consumption off 3.3 percent. With falling demand, inventories soared. Demand also declined in other OECD countries, and has recently started to fall in some developing countries, notably in Asia. Meanwhile, OPEC agreed to cut production by 2.2 million barrels a day as of January 1, 2009, bringing total cuts since September to 4.2 million barrels a day.

Medium- and long-term dynamics of oil prices must also be noted. In 2009, global oil demand is expected to fall by at least 1 mb/d (million barrels a day), with continuing large declines in high income countries and only moderate growth in developing countries. Production in Russia, which provided much of the growth this decade, fell by nearly 0.1 mb/d in 2008, and is projected to fall by nearly 0.3 mb/d in 2009, due to low prices and deteriorating investment climate. In the medium- and long-term, oil prices should reflect the long-run marginal costs of new development. Key drivers are demand and OPEC production policies. Over the past few decades, OPEC has helped keep prices above the costs of production. The Bank's long-term oil price forecast is USD75 a barrel (constant 2008 USD), based on costs of oil sands development in Canada. It assumes that OPEC will manage to keep high oil prices at a level that does not discourage demand, while not encouraging too large growth in non-OPEC oil supplies.

**Figure 1.2. Demand sources of Russia's real GDP growth, by quarter, 2007-2009 (% change)**



Source: World Bank decomposition and estimates based on Rosstat data.  
\* World Bank staff projected estimate.

*The Russian economy is showing across-the-board slowdowns that are deepening in late-2008 and then entering deep recession beginning in 2009 (table 1.2).* With few exceptions, all sectors reported lower growth rates in 2008, but tradables are slowing faster, in line with collapsing global demand. These sectors grew by only 1.8 percent in 2008, compared with 3.9 percent in 2007, with growth in manufacturing turning negative in late 2008. Nontradables—driven mainly by retail and construction—sustained growth of 7.4 percent for 2008, compared with 10.3 percent growth in 2007. The economy deteriorated dramatically in early 2009. Demand- and finance-sensitive construction reported a 18.8 percent decline in January-February relative to the same period in 2008, while transport contracted by 18.2 percent. Retail trade reported modest growth of only 3.1 percent in January, but then registered a decline of 2.4 percent in February.

**Table 1.2. GDP growth by main sectors, 2006–08 (value added)**

	2006	2007	2008
<b>Total GDP growth</b>	<b>7.7</b>	<b>8.1</b>	<b>5.6</b>
<b>Tradable sectors</b>	<b>3.4</b>	<b>3.9</b>	<b>1.8</b>
Agriculture, forestry	3.8	2.6	8.4
Extraction industries	-3.3	-2.6	0.2
Manufacturing	7.3	7.8	0.9
<b>Non-tradable sectors</b>	<b>9.7</b>	<b>10.3</b>	<b>7.4</b>
Electricity, gas, water production and distribution	5.7	-0.7	1.2
Construction	11.8	9.3	13.2
Wholesale and retail trade	14.1	13.7	8.4
Financial services	10.3	12.5	6.6
Transport and communication	9.6	3.4	6.9

Source: Rosstat; World Bank staff calculations.

*Manufacturing output plunged with the collapse in demand in the last two months of 2008, and it is likely to contract further in 2009 (table 1.2).* Five of 14 major manufacturing industries reported output declines in 2008, with electronics, electrical, and optical equipment hardest hit (-7.9 percent), followed by textile and sewing (-4.5 percent) and by chemicals (-4.2 percent). Most of this dislocation took place in November and December 2008, when total manufacturing output respectively fell 10.3 and 13.2 percent (year-on-year). As credit continues to tighten and demand to fall, manufacturing is likely to contract further this year. According to recent statistics, manufacturing output dropped 24.1 percent in January 2009, compared with January 2008, and 18.3 percent in February 2009, compared with February 2008. In February 2009 the most significant declines were registered in the production of electro-technical and optical equipment (-46.6%), other non-metal products (-33.3%), and transport and transportation equipment (-31%).

*Foreign direct investment inflows remained robust in 2008 but this will worsen significantly in 2009.* FDIs remained at almost the same level as in 2007. According to recent estimates from Rosstat, FDI inflows totaled USD 27 billion in 2008, close to the USD 27.8 billion in 2007. Even in the fourth quarter of 2008, FDI inflows were USD 7.8 billion, only slightly less than for the same period in 2007 (USD 8.2 billion).

### **Labor markets—adjusting through all channels: employment, wages, and arrears**

*The speed of adjustment in Russia's rather flexible labor markets has been dramatic.* It started with the major slowdown in output in the last quarter of 2008. And it has affected employment, incomes, and wage arrears. Although average unemployment in 2008 remained relatively unchanged (6.3 percent in 2008 and 6.1 percent in 2007), it shot up to 8.5 percent in February 2009 (ILO definition), from 8.1 percent in January 2009 (and from a record low of 5.4 percent in May 2008) (table 1.3).

**Table 1.3. Labor productivity, disposable income, wages, and unemployment**

	2006	2007	2008	Q4 2008	Jan-09	Feb-09
GDP growth, %	7.7	8.1	5.6	1.1**	-8.8*	-7.3*
Total employment, million people	68.8	70.5	71	70.6	69.6	69.2
Employment growth, %	0.8	2.4	0.6	-0.3	-0.4	-0.4
Labor productivity growth, %	6.8	5.6	5	1.4	n/a	n/a
Real disposable income growth, %, y-o-y	13.5	12.1	2.7	-5.8	-10.2	-4.7
Real wage growth, %	13.3	17.2	10.3	5	1.9	0.1
Average monthly wage, USD	392	532	694	668	544	524
Unemployment (% , ILO definition)	7.2	6.1	6.3	7.1	8.1	8.5

Source: Rosstat.

\* Preliminary estimate by ministry of economic development.

\*\* Preliminary estimate by the WB staff.

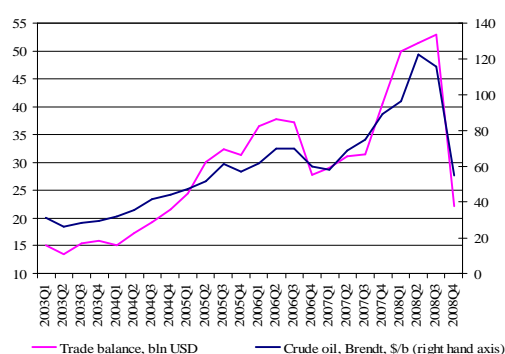
**Real incomes declined substantially at the end of 2008 and the beginning of 2009, mainly due to rising unemployment and worsening enterprise finances; wage arrears increased.** In the fourth quarter of 2008 alone, real disposable income dropped 5.8 percent, compared with the same period in 2007, and 10.2 percent in January 2009 (year-on-year). And unpaid wages as a share of total enterprise turnover tripled to 0.12 percent in December 2008, compared with August 2008. The stock of wage arrears as of March 1, 2009 (8 billion rubles or about USD 240 million) remains small but will increase with the continuing crisis. The arrears are estimated to affect up to 450,000 people, significantly less than 1 percent of total employment. Growth in real wages came to a halt in January-February 2009, following double-digit increases in previous years.

### Balance of payments—deteriorating sharply due to capital outflows and low commodity prices

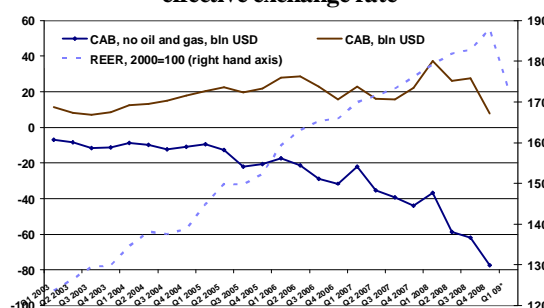
**The current account is deteriorating sharply as a result of shrinking demand in Russia's main export markets and a major terms of trade shock.** Although the current account balance registered a record USD 98.9 billion in 2008 (up from USD 76.2 billion in 2007), it contracted to USD 8 billion in the last quarter of 2008 due to worsening terms of trade (table 1.4 and figure 1.3). This hurt the nonoil current account (figure 1.4).

**Table 1.4. Balance of payments (USD billions), 2006-08**

	2006	2007	2008 <sup>a</sup>
Current account balance	94.5	76.2	98.9
Trade balance	139.2	130.9	176.6
Capital and financial account	11.9	85.9	-128.4
Errors and omissions	1.1	-13.2	-15.8
Change in reserves (+ = increase)	107.5	148.9	-45.3

Source: CBR. <sup>a</sup> Preliminary estimates.**Figure 1.3. Oil prices and the trade balance**

Source: CBR and World Bank staff.

**Figure 1.4. Current account balances and the real effective exchange rate**

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

Note: Real effective exchange rates for 2009 Q1 include only January-February.

**The structure of the Russian capital account shows a “sudden stop” and then a massive reversal of private capital inflows in the last two quarters of 2008.** In the fourth quarter of 2008 alone, total net capital outflows were USD 130.5

billion, with USD 56.2 billion from the banking sector and USD 74.3 billion from the non-banking sector, partly reflecting short-term repayment obligations of Russian banks and corporations (table 1.5).

**Table 1.5. Net capital flows (USD billions), 2003-08**

	2006	2007	2008	4Q 2008 <sup>a</sup>
Total net capital inflows to the private sector	41.9	81.2	-129.9	-130.5
Net capital inflows to the banking sector	27.5	45.9	-57.5	-56.2
Net capital inflows to the non-banking sector	14.4	35.4	-72.5	-74.3

Source: CBR, <sup>a</sup> – preliminary estimate.

**Total external public and corporate and banking debt reached over USD 540 billion by the end of third quarter 2008, with USD 72 billion maturing in the last quarter of 2008.** Despite the market perception of sharply higher repayment risk and difficulties with refinancing reflected in high corporate spreads, which hovered around 700 basis points during that quarter, external debt repayments in the last quarter of 2008 were orderly. But going forward, even though the external debt stock of the private sector has stabilized—mostly due to limited access to new borrowing—rollover risk is expected to increase in 2009 because of a much weaker real economy and extremely tight liquidity.

### Monetary and exchange rate policy to contain the impact of the crisis

**The CBR's monetary and exchange rate dilemma has been to provide sufficient liquidity and unfreeze the credit markets while preventing excessively rapid adjustment in the value of the ruble against the backdrop of the sharp reversal of capital inflows.** In September 2008 the CBR loosened monetary policy to alleviate the confidence crisis and unfreeze the interbank credit market but with limited impact on the money supply, due to massive capital outflows and flight into foreign currency.

**Although CPI inflation remains fairly high, tight monetary conditions and slower growth and capital outflows are likely to ease pressure on inflation in the medium term.** After end-2008 inflation of 13.3 percent, in January-February 2009 CPI inflation reached a cumulative 4.1 percent. It reflects in good part increases in imported food and seasonal adjustments in administered prices (utilities) while producer prices continued declining in January for the fifth consecutive month.

**The CBR began to gradually loosen its exchange rate policy by widening the dollar-euro currency basket trading band and then tightened monetary conditions.** Since early November 2008 the CBR has widened the trading band for the bilateral currency basket (consisting of 55 percent dollars and 45 percent euros) in stepwise fashion 21 times from an initial ceiling of 30.7 rubles on 11 November 2008, to 41 rubles on 23 January 2009, the ceiling that remains in effect. The CBR tightened monetary conditions in early February 2009 to prevent further loss of foreign exchange reserves. It appears that a large share of additional liquidity, initially provided to the financial system was immediately converted into foreign currency, putting more pressure on the ruble and forcing the CBR to spend even more of its reserves to defend the currency and avoid excessive volatility. Foreign exchange reserves fell to about USD 380 billion in mid-March 2009, from its record of more than USD 580 billion in September. To cope with currency volatility, in early February the CBR increased policy rates and withdrew liquidity from the repo market.

### Fiscal policy—worsening fiscal position requires tight expenditure management

**The fiscal position has worsened considerably, and fiscal space is shrinking rapidly, limiting the government's options for further fiscal stimulus. But the large fiscal reserves will make it possible for the government to finance its deficit.** This is the result of declining oil and gas revenues, the shrinking of the non-oil tax base and additional public expenditures related to the crisis. The Ministry of Finance has released the main parameters of its revised federal budget for 2009. It is prudently based on the low oil prices (USD 41 a barrel, Urals) and a drop in budget revenues from the original 21.2 percent of GDP (under the old assumption of USD 95 a barrel) to 16.6 percent, or RUB 6.72 trillion. At the same time, expenditures will be increased by RUB 667.3 billion to RUB 9.69 trillion, to produce a deficit of RUB 2.98 trillion (about 7.4 percent of GDP), a massive reversal of the fiscal position from the 4.1 percent surplus in 2008. The consolidated general government deficit is expected to be 8 percent in 2009 deficit and will be financed largely from the Reserve Fund (7 percent of GDP) with modest domestic borrowing (up to 1 percent of GDP) (table 1.6). With a large fiscal deficit, however, and the need to preserve some reserve fund resources for the uncertainty likely to extend into 2010, the space for more fiscal stimulus this year appears limited.

**Table 1.6. Consolidated budget of the Russian Federation**

General Government (consolidated budget)	% of GDP				Percentage point change in GDP over previous year	
	2006	2007	2008	2009	2008	2009
Revenues	39.7	40.2	38.5	24	-1.7	-14.5
Expenditure	31.3	34.1	33.7	32	-0.4	-1.7
Balance (surplus/deficit)	8.4	6.1	4.8	-8	-1.3	-12.8
Non-oil balance	-2.6	-2.7	-5.8	-		
Primary non-oil balance	-1.8	-2.2	-5.3	-		
Financing	-	-	-	8		
Drawdown from reserve fund				7		
Domestic borrowing				1		
<i>Memorandum item</i>						
Stabilization funds	8.7	11.7	-			
Reserve fund /1	-	-	9.7			
National welfare fund 1/	-	-	6.2			

Source: Ministry of Finance; preliminary; World Bank estimates.

1/ End-of-period stock.

### Policy challenges going forward

*In the short term the authorities will face twin challenges of containing the social impact and managing the new round of real economy's impact on the financial sector.* The first is the challenge of limiting the adverse social consequences of the crisis within an increasingly tight budget. Unemployment and poverty are expected to rise rapidly this year—and more rapidly than previously thought—even after taking into account the policy measures taken and announced so far. Some regions with already high unemployment and poverty will be particularly hard hit. But the large fiscal deficit of 8 percent of GDP projected for 2009 leaves little additional room for further fiscal expenditures, given the need to preserve part of the Reserve Fund in view of extreme uncertainties and further deficit financing needs in 2010. So, the authorities will have to be much more selective, focusing squarely on cushioning the impact on vulnerable groups.

*Given the deteriorating international and financial conditions in Russia, the Russian banking sector will face new pressures, and rollover risk is likely to increase in 2009.* Credit markets in Russia will remain tight and nonperforming loans are expected to rise. As business conditions deteriorate and unemployment continues to increase, according to CBR estimates the share of nonperforming loans in the total banking sector loan portfolio increased from 2.5 percent at beginning of 2008 to 3.8 percent on January 1, 2009; that share is expected to increase further with the downturn of the economy, possibly exceeding 10 percent by the end of 2009. After including demand deposits held by the banking sector, total scheduled repayments of the banking and corporate sectors in 2009 exceed USD 135 billion, with more than USD 30 billion due in the first quarter of 2009.

### Outlook for 2009-10

*With a much worse global financial outlook and oil prices in the USD 45 a barrel range, Russia's economy is likely to contract by 4.5 percent in 2009, with further downside risks.* This represents a major downward adjustment from our forecast in November 2008, which saw growth at 3 percent, based on growth of the world economy and oil prices around USD 75 a barrel. The scale of this downward revision reflects the dislocation of the global economy in the intervening months. World growth is expected to be negative 1.7 percent in 2009 and then positive 2.3 percent in 2010 (table 1.7). Most of the adverse impact in Russia is concentrated in the first two quarters of 2009. As the crisis continues to spread to the real economy around the world, initial expectations that Russia and other countries will recover fast are no longer likely.

**Table 1.7. Outlook for 2009-2010**

	2009	2010
World growth, %	-1.7	2.3
Oil prices, Urals, USD/bbl	45	45
GDP growth, %	-4.5	0.0
Federal government balance, %	-7.4	-6.0
Current account, USD bln.	31	16
<i>Net capital outflows, USD bln.</i>	170	90

Source: World Bank projections.

***The inflation outlook remains broadly unchanged for 2009, and the balance of payments will deteriorate further.*** We project end-year 2009 inflation at 11-13 percent, reflecting several opposing factors. Rising import prices and considerable relaxation in fiscal stance will be the main factors contributing to higher inflation. But sharply slowing domestic demand, a continuing credit crunch, and large capital outflows may contribute to a further tightening of monetary conditions—and lower inflation. The surplus on the external current account will contract significantly, and the capital account deficit will rise with further capital outflows, largely on account of external repayments by the banking and corporate sectors (table 1.4). The capital account would deteriorate to a deficit of about USD 170 billion in 2009 and USD 100 billion in 2010, largely reflecting repayment obligations, the lack of large new FDIs or portfolio investments, and capital outflows.

***The number of unemployed, expected to increase further, will likely surpass 12 percent by year-end.*** Most sectors would continue to adjust their cost structures in an environment of uncertain demand, lower profit margins, and limited credit. The crisis will change not only the level of employment but also the sectoral and regional composition, as well as migration and urban-rural flows.

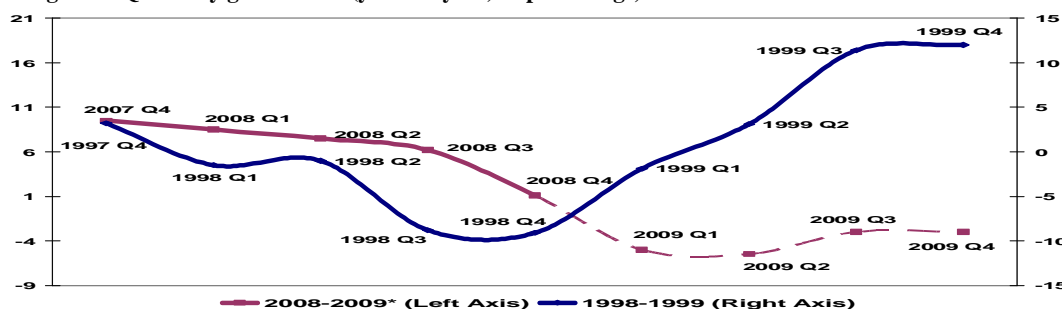
***Looking at the long term, Russia must address economic diversification and competitiveness.*** Some of these challenges can begin to be met even during the crisis—for example, dealing with worst infrastructure bottlenecks, strengthening public administration and fighting corruption, improving the investment climate, and fostering competition and small and medium size enterprises to engender long-term productivity gains. The international economic environment is likely to remain constrained for several years, and countries like Russia will have to work harder to attract foreign capital, knowhow, and technology and to export abroad under more competitive conditions. This provides an opportunity to jumpstart structural reforms for long-term productivity growth and a more diversified and competitive economy.

### Box 1.2. An early comparison of the 1997-98 and 2008-09 crises

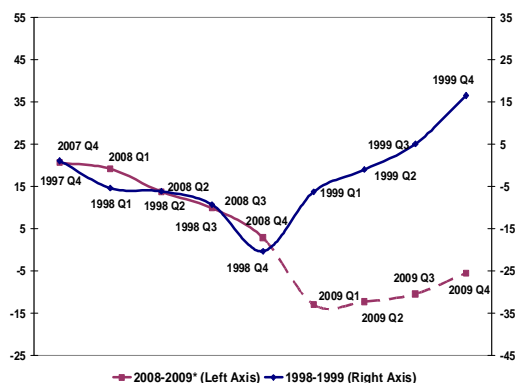
*The current crisis is now likely to be deeper (in terms of growth deceleration) and longer than the 1998 crisis (box figure 1) but Russia's sound management of public finances and large fiscal and reserve buffers provide important cushion.* The economy contracted by 8.8 percent and 9.1 percent in the third and fourth quarters of 1998, respectively. But by the second quarter of 1999 the economy was growing by 3.1 percent, reaching 12 percent by the end of 1999, reflecting a rapid, V-shaped recovery with a sharp economic downturn followed by a rapid bounceback. By contrast, in 2008 the growth failure in terms of short-term *negative* growth is not expected to be as severe but the rate of growth *deceleration* in percentage points is likely to be much more pronounced and prolonged, mimicking an L-shaped growth path in the short term.

*The reasons behind these different paths are complex, but the role of the international environment and oil prices must be noted.* Russia's 1998 was a classic *fiscal and currency* crisis that resolved itself in a currency crash, debt default, deep devaluation, and a steep, export-led recovery from an extremely low base in a broadly benign international environment. But essentially, it was a national public sector and currency crisis. By contrast, 2008 was largely a *private sector crisis* incited by excessive borrowing by the private sector faced by major triple shocks—terms of trade, capital outflows, and tight external borrowing—while public sector accounts were in extremely strong shape. Unfortunately the current crisis is compounded by the worst international economic environment since the Second World War. And this—a weak global demand and international financing environment coupled with a longer period of low oil prices—is what is likely to determine the very gradual pace of recovery. Domestic demand will also be constrained by high unemployment and a loss of real income. As illustrated in box figures 2 and 3, during the present crisis, investment and net exports recovery will be much more gradual relative to 1998-99 due to much worse global demand conditions, higher uncertainty, and worse financial constraints.

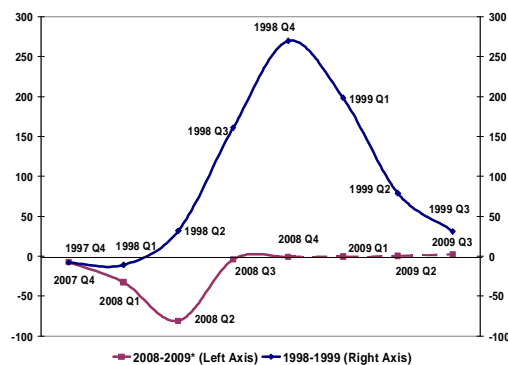
Box figure 1. Quarterly growth rate (year-on-year) in percentage, 1997-99 vs 2007-09



Box figure 2. Quarterly growth of investment in percent, 1997-99 vs 2007-09



Box figure 3. Quarterly growth of net exports in percent, 1997-99 vs 2007-09



Source: Rosstat, WB staff calculations.

## 2. THE FISCAL POLICY RESPONSE TO THE CRISIS

With a deepening crisis in Russia and the world, the question arises about the appropriate policy response in a difficult environment. Governments around the world, including Russia, have resorted to an unprecedented mix of policies to contain the impact, but financial markets remain under stress and the world economy is in recession.<sup>2</sup> With monetary policy limited in its ability to affect the real economy during the time of deleveraging without creating pressures on currency and prices, the ongoing policy debate and the following discussion is centered on fiscal policy. Russia's early fiscal policy response has been larger than that of many other G-20 countries and greater than the internationally recommended 2 percent of GDP. Policy has so far focused on supporting the financial sector and enterprises, with rather limited support to households. But with significant social impact now unfolding, the focus of future policy should shift toward cushioning the impact on the poor and vulnerable. A modest, temporary increase in the three social protection programs (costing about 1 percent of GDP) focused on child allowance, unemployment benefits and low-end pensions—targeting some of the most vulnerable groups at risk of poverty—could provide significant cushion of the impact of the crisis on the poor. In addition, addressing most critical infrastructure bottlenecks and providing support for small and medium businesses—with additional support even during the crisis—would help the economy in the recovery stage and benefit medium-term growth and diversification.

### Fiscal response so far—targeting banks and firms rather than households

*Russia's early fiscal policy response has so far focused on supporting the financial sector and enterprises, with rather limited support to households.* The total fiscal cost of measures implemented in 2008 and planned for 2009 amount to more than 2.9 trillion rubles or about 6.7 percent of GDP (table 2.1).<sup>3</sup> These measures are aimed mainly at (i) strengthening the financial sector and (ii) providing fiscal support for enterprises. As the crisis progressed from the financial sector towards the real economy, afflicting domestic demand, growth and employment, the policy focus began to shift in that direction.

**Table 2.1. Summary of fiscal anti-crisis measures—introduced in 2008 and announced for 2009**

	Billions of rubles			Total % of GDP	Distribution of each policy measure as percentage of total		
	2008	2009	Total		2008	2009	Total
Strengthening the financial sector	785	625	1410	3.3%	72.1%	34.1%	48.2%
Supporting the real economy	304	798.3	1,102.3	2.5%	27.9%	43.5%	37.7%
Protecting the vulnerable	-	111.5	111.5	0.3%	-	6.1%	3.8%
Transfers to regions	-	300	300	0.7%	-	16.4%	10.3%
Total	1,089	1,834.8	2,923.8	6.7%	100.0%	100.0%	100.0%
% of GDP	2.6%	4.1%	6.7%				

Source: World Bank staff estimates, Government of Russia

Note: Excludes quasi-fiscal and monetary measures, state guarantees in the amount of 300 billion rubles planned for 2009, measures planned before the crisis, such as increasing the minimum wage, indexing pensions, as well as external crisis-related lending to CIS countries and Mongolia.

*On 19 March 2009 the government announced a new broad set of priorities to address the impact of crisis.* Seven identified priorities focus on ensuring social protection for vulnerable, supporting important industrial and technological sectors, stimulating domestic demand, diversifying economic structure, easing the business environment, strengthening the financial sector and maintaining a sound macroeconomic environment.

### Strengthening the financial system—supporting liquidity and recapitalizing banks

*The Russian government's initial crisis response announced in September and October 2008 was focused on the most urgent priority—strengthening Russia's financial system.* The policy response to support the financial

<sup>2</sup> In the previous Russian Economic Report #17, we discussed Russia's broader policy response, comprising monetary, fiscal, and quasi-fiscal measures during the early phase of the crisis.

<sup>3</sup> Excluding below-the-line expenditures such as guarantees to corporate sector planned in amount of additional 300 billion rubles for 2009.

system included a set of fiscal, quasi-fiscal, and monetary policy tools to alleviate liquidity squeeze, recapitalize major banks, and ensure repayment of external obligations by major banks and corporations. The fiscal expenditures aimed at strengthening the financial system amounted for more than 3% of GDP, focused on capital injections into the banking system as well as providing liquidity through subordinated loans to the banking system. This helped stabilize the banking system under an extreme liquidity crunch and prevent financial panic: net deposit outflows from the banking system have stabilized, banks have attracted dollar deposits, no major banks failed and a relatively orderly consolidation of the banking sector was restarted (table 2.2).

**Table 2.2. Fiscal measures aimed at the financial system—introduced in 2008 and announced for 2009**

	Billions of rubles			Total as a share of GDP	Distribution of each policy measure as percentage of total		
	2008	2009	Total		2008	2009	Total
<b>Recapitalization and other direct support</b>	335	70	405	1.0%	42.7%	11.2%	28.7%
Recapitalization of Deposit Insurance Agency	200	-	200	0.5%	25.5%	-	14.2%
Recapitalization of AHML <sup>4</sup>	60	-	60	0.1%	7.6%	-	4.3%
Recapitalization of banks	75	45	120	0.3%	9.5%	7.2%	8.5%
Recapitalization of Rosagrolizing	-	25	25	0.1%	-	4.0%	1.8%
<b>Subordinated loans<sup>5</sup></b>	450	555	1,005	2.3%	57.3%	88.8%	71.3%
<b>Total</b>	785	625	1,410	3.3%	100.0%	100.0%	100.0%

Source: World Bank estimates, Government of Russia.

Note: Subordinated loans are included as a support for financial system. Excludes quasi-fiscal and monetary measures. Monetary policy measures were aimed at injecting additional liquidity into the financial markets. A combination of changes in the reserve requirements and increases in the amount of funds available through REPO resulted in additional 830 billion ruble injected into the financial system in 2008. A separate program to facilitate the foreign debt rollover of corporate and banking sector was announced but later suspended in 2009. USD 50 billion of the Central Bank's foreign reserves were initially earmarked for facilitating external debt payments. But after disbursing only USD 11 billion, this program was suspended indefinitely.

## Supporting the real economy—using direct support and easing the tax burden

*The initial fiscal response aimed at stimulating business investments by easing the tax burden in the corporate sector.* The total “fiscal stimulus,” which includes, by emerging convention, all fiscal measures excluding those aimed at the financial sector and below the line measures such as guarantees for the real sector (approximately 300 billion rubles in 2009), is estimated to be about 0.7 percent of GDP in 2008 and 2.7 percent of GDP in 2009. The majority of measures provide fiscal support to firms through a lower tax burden and direct support to key industries of strategic importance. Importantly, part of this support is not guaranteed but conditional (state support).

*The Government of Russia has published a list of 295 strategically and 1148 regionally important firms eligible, in principle, for direct state support.*<sup>6</sup> In 2009 up to 276 billion rubles (about USD 8.1 billion) from the federal budget and 300 billion rubles (about USD 8.5 billion) in state guarantees (an off-budget item) will be allocated for direct state support to strategic firms. In addition, these selected firms will be eligible to receive benefits including access to credit lines with reduced interest rates, and help in restructuring their tax arrears. On the surface, the total number of firms included in these lists seems to be too large to provide efficient targeted support for the most important firms.

*A closer inspection of the list of strategically important firms eligible for state support is, indeed, geared toward the most important enterprises for output and employment, but the lack of information about the rules to be used to distribute this aid at the firm level raises concerns about transparency.* These companies are spread across various economic sectors, and about 75 percent are large firms such as Gazprom, Lukoil, Rosneft, Rusal, avtoVAZ, and Aeroflot. More broadly, however, the support seems geared toward the existing industrial structure and not new and smaller and medium-size enterprises, which may be particularly important for the

<sup>4</sup> Agency for home mortgage loans.

<sup>5</sup> In 2009 VTB will receive 200 billion rubles, and VEB will receive 130 billion rubles, and commercial banks will be eligible for another 225 billion rubles in subordinated loans.

<sup>6</sup> The list is publically available from the government portal <http://www.government.ru/content/0f3310f4-3fad-4f84-a6a9-52b4a0dad10a.htm>. Importantly, the list does not necessarily mean that an enterprise will receive financial support, just that it is recognized as an entity of “systemic importance” and requires monitoring and, if needed, restructuring measures that may include forms of financial support.

long-term competitiveness and growth of the Russian economy. And the absence of clarity and transparency concerning the technical basis used to distribute potential state direct support at the firm level makes it difficult to evaluate the efficiency of policy toward these firms. Clarification of firm-level criteria and wider public disclosure of such information would improve transparency, raise investor confidence, avoid perceptions of favoritism, and limit the influence of firm lobbying.

*The proposed fiscal stimulus focuses to a large extent on revenue measures, not on infrastructure or households.* This has three implications for additional fiscal policy response that might be needed, albeit in a much more constrained fiscal environment. First, Russia appears to put greater emphasis on reducing the tax burden in its stimulus package than other G-20 countries (box 2.1), this at a time when tax base and revenues are dropping rapidly due to unfolding recession and the collapse of oil prices. This supply-side measure can, in principle, help companies invest more in future growth, but during a time of extreme uncertainty and collapsing demand, it is far from clear that it will produce the desired supply response. Second, infrastructure spending, if targeted on key bottlenecks, can pay off in supporting economic recovery and long-term growth. So, even during a major crisis, providing support to infrastructure could be a critical element of a stimulus package. Third, with the crisis entering the stage of major social impact, greater emphasis is warranted on support to households.

**Table 2.3. Summary of “fiscal stimulus” measures aimed at supporting the real economy—introduced in 2008 and announced for 2009**

	Amount in billions of rubles			Total as a share of GDP (%)	Distribution of each policy measure as percent of total		
	2008	2009	Total		2008	2009	Total
<b>Fiscal stimulus aimed at firms</b>	<b>272</b>	<b>763.3</b>	<b>1,035.3</b>	<b>2.4%</b>	<b>89.5%</b>	<b>63.1%</b>	<b>68.4%</b>
Sector specific support <sup>7</sup>	52	276.7	328.7	0.7%	17.1%	22.9%	21.7%
Small and medium enterprises <sup>8</sup>	-	6.2	6.2	0.0%	-	0.5%	0.4%
Export industries	-	6	6	0.0%	-	0.5%	0.4%
Decrease in tax burden <sup>9</sup>	220	474.4	694.4	1.6%	72.4%	39.2%	45.9%
<b>Fiscal stimulus aimed at households</b>	<b>32</b>	<b>146.5</b>	<b>178.5</b>	<b>0.4%</b>	<b>10.5%</b>	<b>12.1%</b>	<b>11.8%</b>
Purchase of housing units for military and vulnerable groups	32	35	67	0.2%	10.5%	2.9%	4.4%
Labor market policies (including an increase in unemployment benefits)	-	111.5	111.5	0.3%	-	9.2%	7.4%
<b>Fiscal stimulus aimed at regions</b>	<b>-</b>	<b>300</b>	<b>300</b>	<b>0.7%</b>	<b>-</b>	<b>24.8%</b>	<b>19.8%</b>
<b>Total</b>	<b>304</b>	<b>1,209.8</b>	<b>1,513.8</b>	<b>3.4%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>
<b>Total (as a share of GDP)</b>	<b>0.7%</b>	<b>2.7%</b>	<b>3.4%</b>				

Note: Excludes quasi-fiscal and monetary measures. In addition to fiscal measures to support firms, the government is planning to issue state guarantees of 300 billion rubles (not reflected in the budget).

Source: World Bank estimates, Government of Russia.

### Supporting the vulnerable—limited interventions in the labor market

*Fiscal stimulus measures include limited support for labor markets interventions.* But given the social impact discussed below, the scale and scope of these steps are only a small fraction of all measures introduced by the government. The 80 billion rubles earmarked for active labor market policies and additional funding for unemployment benefits in 2009, for example, represent only 7.4 percent of the total fiscal stimulus package.

*Labor market interventions include active labor market measures and higher unemployment benefits, but implementation will be a challenge because of regional capacity constraints.* The planned active labor market measures include providing on-the-job training, creating temporary work programs for the unemployed, ensuring direct support to households, including facilitating internal labor mobility, and providing support for small and

<sup>7</sup> Including for defense industry (80 billion rubles), auto industry (39 billion rubles), transport (70 billion rubles), agriculture (18.1 billion rubles), and construction (69.3 billion Rubles).

<sup>8</sup> In addition up to 50 billion rubles allocated to Vneshekonombank are earmarked to refinance credits to small and medium enterprises.

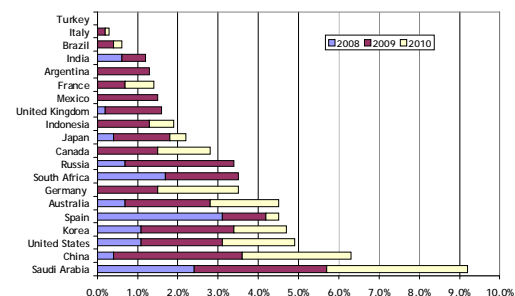
<sup>9</sup> Includes a reduction of corporate income tax from 24 to 20 percent, a reduction in the tax on business income from 15 to 5 percent, an increase in annual amortization rate from 10 to 30 percent, reduction in crude export duties, tax support for fisheries, and support for households' purchases of housing.

medium enterprises. They will be designed and implemented by the regions, and co-financed by the federal (95 percent) and regional (5 percent) governments. But the design of such programs, often time consuming, requires adequate regional implementation capacity. Such capacity is scarce in the poorest regions, and this might prolong implementation where programs are most needed. In addition to the active labor market policies, the upper limit for unemployment benefits was increased to 4,900 rubles a month, from 3,124 rubles a month, in January 2009. Given the small initial benefit, the increase is unlikely to provide much cushion to the unemployed. Moreover, fewer than a third of all unemployed are officially registered, limiting the effectiveness of this measure.

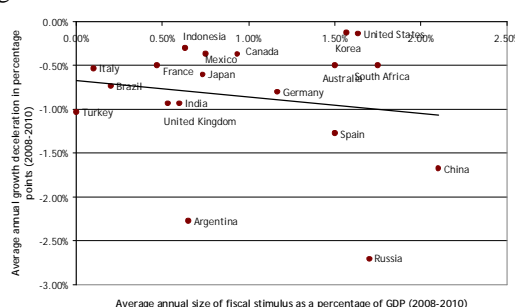
### Box 2.1: How does Russia’s fiscal stimulus compare?

In the current global crisis, compared with other G-20 countries, the “fiscal stimulus”—defined for comparability and convention as the fiscal measures excluding support for the financial sector—Russia’s has been of the larger size (more than the internationally recommended 2 percent of GDP) and has put more emphasis on the revenue measures (a decrease in tax burden) and less on expenditure measures (see box table below). In addition, the expenditure component of Russian policy response is almost exclusively focused on support for firms with only a small fraction of the expenditures allocated to measures directly targeting households.

Box figure 1. Estimated size of fiscal stimulus measures in G-20 countries



Box figure 2. Estimated size of fiscal stimulus and growth deceleration in G-20 countries



Source: Data for non-Russia G-20 countries, IMF (based on packages announced through late February). The figures do not include (i) below-the-line operations, (ii) measures that were already planned for, (iii) banking-sector support measures. Estimates of planned expenditures for 2010 are not available for Russia, Argentina, India, Mexico, and South Africa.

Box table 1. Comparison of proposed Russian fiscal stimulus with that of G-20

	Russia	Other G-20
Composition	Revenue measures account for 45% of all fiscal stimulus	On average, revenue measures account for one third and expenditure measures for two-thirds of all fiscal stimulus
Revenue measures	Decrease in the tax burden for the corporate sector and SMEs using cuts in corporate income tax; A decrease in excise tax for oil exporters	Cuts in personal income taxes (Canada, Germany, Indonesia, Italy, the U.K., United States). A decrease in corporate taxes (Canada, France, Germany, Indonesia, United States). A decrease in indirect taxes
Expenditure measures	An increase in unemployment benefits; Support for strategic sectors, including, defense, agriculture, construction, exporters, SMEs	An increase in spending on infrastructure (Canada, China, France, Germany, Indonesia, Italy, Korea, Saudi Arabia, United States); Strengthening unemployment benefits (Canada, the UK, United States) Cash transfers to poor households (Canada, Korea, Japan) Cash transfers to support children (Australia, Germany) Cash transfers to support pensioners (Australia, Canada) Concessional loans to low-income citizens (Saudi Arabia) Support for SME (Korea) Support for strategic sectors e.g. construction (Canada and Germany) Health and education (Australia, China, Saudi Arabia, United States) Incentives for development of environmentally-friendly technologies

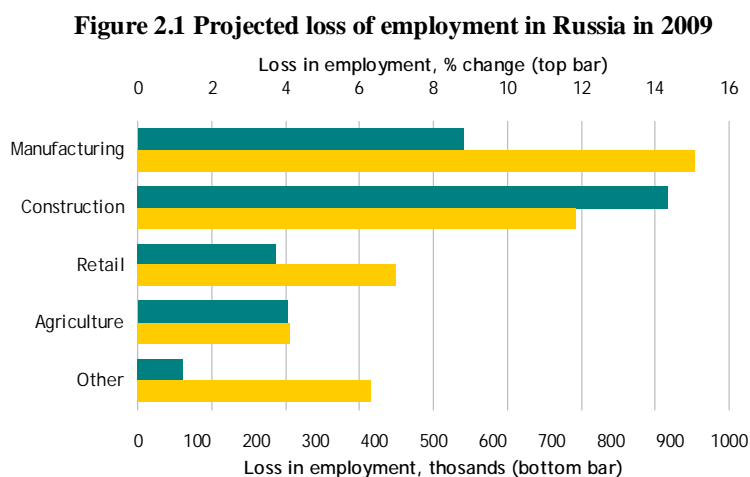
Source: based on packages announced through late January 2009. (World Bank, IMF).

*Perhaps most important, there is an urgent need to supplement social assistance policies with a federal level package of income support that targets vulnerable households.* In 2005 the social assistance policy has been fully delegated to the regions. Absent a federal body to oversee the social assistance policy, there is little information on the regional responses. Moreover, past experience in Russia and elsewhere suggests that any regional response to a sudden increase in poverty will be suboptimal in the absence of a strong federal intervention. The response would

be especially weak in the poorer regions with severe capacity constraints, and possibly larger than optimal in the richer ones.

### The social impact—deepening and spreading fast

*The deeper and more prolonged economic crisis is likely to have a major social impact, already spreading fast.* The impact of the crisis on households has worked through adverse effects on aggregate demand, labor demand, and asset prices. The labor markets are adjusting through a combination of reduced employment and wages. In general, employment declines will concentrate losses in certain sectors and segments of the population and employment, while earnings declines will spread losses more evenly among the workforce. Thus, under more flexible wage setting characterized by the Russian labor market, the burden of the crisis is likely to be more equally spread across households than in more rigid labor markets. It is estimated that aggregate unemployment in Russia will increase by 2.7 million people in 2009, reflecting both a contraction in employment levels as well as changes in the sectoral structure of employment. The sectors most affected will likely be manufacturing, construction and retail trade (figure 2.1).



Source: World Bank staff preliminary simulations based on aggregate output projection and household survey data.

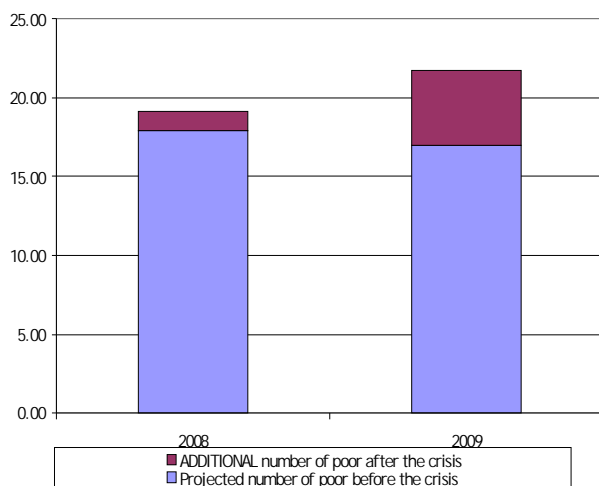
*The poverty impact will be significant.* Using the growth outlook discussed in the part 1 of this report and household survey data and national poverty lines,<sup>10</sup> the number of poor people in Russia will likely increase by 2.75 million, wiping out part of the gains in reducing poverty in recent years. This translates into a likely end-2009 headcount poverty rate of 15.5 percent, an increase of 2.84 percentage points relative to the 2008 pre-crisis level. In comparison with the pre-crisis growth path, this implies that the number of poor people increased by around 1.1 million in 2008 and would increase by another 4.7 million in 2009 (figure 2.3). By contrast, during the 1998 crisis the poverty rate increased by 2.6 percentage points in 1998 and an additional 5 percentage points in 1999 reaching 28.4 percent.

*Groups most at risk of poverty include rural households, unemployed, and households with children.* The headcount poverty rate in the rural areas is expected to increase by more than 5 percentage points (figure 2.4). The rural population is the most vulnerable to poverty: a large concentration of poor households, chronic pockets of poverty, and the fact that incomes are very close to the poverty line increase vulnerability to even small changes in income. The poverty rate for unemployed is expected to increase by more than 4.8 percentage points. And that for households with children is expected to exceed 4 percentage points in 2009. Finally, pensioners, especially those with low-end pensions, are also likely to experience a large increase in headcount poverty rate by more than 3 percentage points (Figures 2.2 and 2.3). Finally, labor market adjustments are likely to increase the poverty rate.

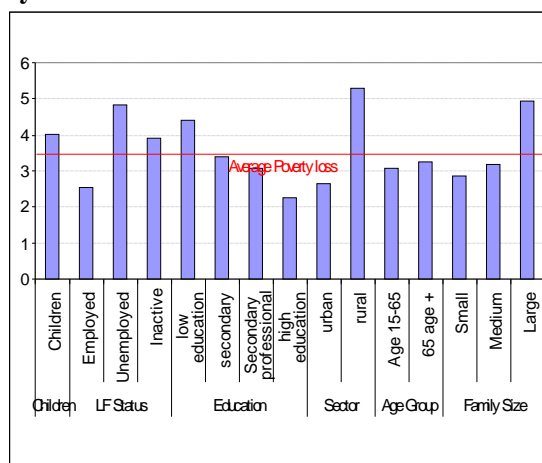
<sup>10</sup> Defined as the percentage of population with money incomes below subsistence minimum level set by the government of Russia. In the third quarter 2008, this line amounted, on average, to 4,630 rubles per person (about \$185).

Preliminary regional simulations show that the likely increase in unemployment is clearly correlated positively with the rate of poverty.

**Figure 2.2. Projected number of poor people before and after the crisis (in millions), 2008-09**



**Figure 2.3. Estimated change in headcount poverty rate in percentage points, households by different characteristics in 2009**



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

### Adjusting the fiscal policy response—targeting households, infrastructure, and small and medium enterprises

*The social impact unfolding suggests that the focus of future policy should shift towards cushioning the impact on the poor and vulnerable.* The priorities the government announced on 19 March 2009 commendably put emphasizes social protection, but the issues is to implement that shift in the short term before the social impact escalates too rapidly. Such a shift would, of course, need to be affordable. And it could be used as an opportunity to begin to improve the efficiency and effectiveness of social spending by better targeting the most vulnerable. First, channeling money directly and immediately to the most vulnerable households limits the risk that the funds will leak into savings, imports or foreign exchange markets. This target group has a high propensity to consume but cannot afford expensive imported goods or have saving balances that could be converted into foreign exchange. So, such pro-poor public spending would also support aggregate consumption at a time of collapsing demand. Second, the spending measures might work better than the tax cuts, given the highly uncertain environment for income, production, and investments. So, a package focusing on households contributes to both objectives by protecting the most vulnerable and ensuring the impact on domestic consumption.

*The spending stimulus targeting households should be focused on expanding existing interventions that have a proven track record.* In practice, this means, a temporary increase (say, over a 12-month period) in social assistance spending (child allowance), unemployment benefits, and low-end pensions. The fiscal implications of such a possible package are not marginal<sup>11</sup>, but the package is affordable. The cost can be contained through good design, while the cost of inaction, in rising poverty and lost opportunities and human capital for future generations, could be much higher. So, for reasons of both fiscal stimulus and efficiency, interventions need to be quickly implementable, well targeted, have a proved track record, and be temporary.

*The criteria for selecting programs for the proposed package could include the following.* The programs should be:

- Fiscally affordable, given the shrinking fiscal space.
- Cost-efficient in alleviating poverty with emphasis on a subset of social protection programs with superior impact and targeting accuracy among existing programs in Russia.

<sup>11</sup> The cost is substantially larger in Russia than in other post-transition economies, because Russia lacks an effective mechanism to identify the poorest.

- Possible to scale-up through simple, feasible parametric reforms, such as a temporary increase in benefit levels—or simple eligibility criteria, such as providing a temporary top-ups to, for example, 30 percent of the pensioners with the lowest pensions.
- Compatible with the level and the pattern of existing social protection spending in Russia.

*Simulations of the potential impact of the proposed temporary increase in the three social protection programs by about 1 percent of GDP over a period of one year suggest significant potential to cushion the impact of the crisis on the poor.*<sup>12</sup> Such a program could be affordable because it would raise the 2009 fiscal deficit by at most about 0.75 percentage point of GDP (because it would extend into early 2010) and still be financeable from the reserve fund. If some unproductive expenditures can be cut to make room for this stimulus, the net impact on the budget would be smaller. But such an anti-crisis social program could significantly reduce the poverty rate in Russia compared with a no-program scenario (table 2.4).<sup>13</sup> The headcount poverty rate would drop by 2.9 percentage points, to 12.6 percent, comparable with pre-crisis level, and about 4.1 million people would be lifted out of poverty. So, a modest increase in the government spending oriented to those most in need can produce significant poverty alleviation impact.

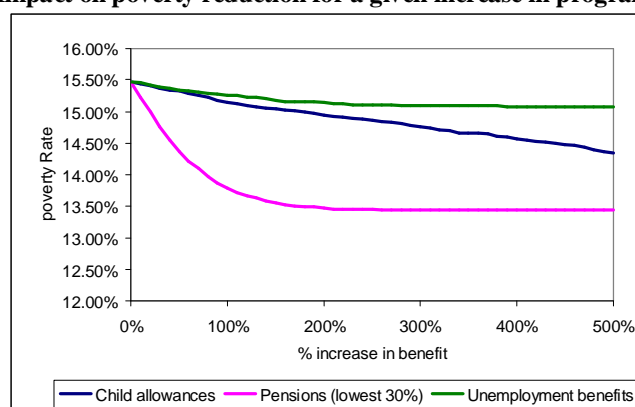
**Table 2.4. A potential social protection stimulus package of 1 percent of GDP, implemented in a period from April 2009 to March, 2010 could help move 4.1 million people out of poverty compared with a no-program scenario**

	Cost of the program as a share of GDP (%)	Reduction in poverty rate (% points)	Reduction in poverty (million people)
Child allowance	0.28	0.80	1.13
Low-end pensions	0.59	1.80	2.54
Unemployment benefits	0.14	0.30	0.42
Total	1.0%	2.90	4.09

Source: World Bank estimates.

*The size and composition of the stimulus aimed at households are constructed in order to maximize impact on poverty reduction for a given budget.* Specifically, it simulates a reduction in poverty that can be obtained for a given increase of selected social program budgets. This impact is large for a moderate increase in benefit levels, and vanishes thereafter (Figure 2.4). For example, a pension supplement focused on 30 percent of pensioners receiving the *lowest* pension would have a large poverty reduction impact for up to 120 percent increase in benefits, but not more.

**Figure 2.4. Impact on poverty reduction for a given increase in program budget**



Source: World Bank staff estimates.

<sup>12</sup> Excludes the impact of the announced pension indexation announced before the crisis. This impact alone, however, because of its more modest size and its extension to all pensioners would have much more limited impact on poverty than the proposed package.

<sup>13</sup> We assume an increase in child allowances by 220 percent, an increase of the unemployment benefit budget by 70 percent and an increase of 20 percent of the pensions of 30 percent of pensioners living on lowest pensions. The temporary stimulus programs would run for the period from April 2009 to March 2010 and would automatically expire at that time under the assumption that the economic recovery (return to positive growth) would get under way, eliminating the need for extensions and extraordinary measures. Alternatively, if the recovery is delayed, the program could, in principle, be extended for another six months or a year.

***Finally, in addition to short-term interventions on social protection, it is important to look to the medium- to long-term, even during the crisis.*** To set the stage for a faster economic recovery and long-term growth, Russia must accelerate structural reforms that increase competitiveness and productivity: opening the trading regime, continuing to modernize the banking system, improving regulatory oversight, strengthening the efficiency of public sector, improving governance and transparency, and improving the investment climate and transparency. In addition, explicit support to small and medium enterprises and funding to address key infrastructure bottlenecks (if possible, combining it with suitable public works) in amounts not larger than 0.5 percent of GDP should be possible within the current budget. Ensuring support for small and medium enterprises will allow a more balanced playing field with large corporations dominating the industrial structure and limit market distortions from providing support to large corporations.

### 3. WHAT HAPPENED TO POVERTY, VULNERABILITY, AND INEQUALITY DURING 2002-06?<sup>14</sup>

*Russia's strong macroeconomic performance over 2002–06 led to robust growth and significant productivity increases with labor and output moving to more productive uses. Real wages grew faster than productivity in most sectors. These improvements raised employment, wages, and income for most of the population, though the employment gains were modest. Growth has been the key to improving incomes for the vast majority of the population. However, the poverty reduction between 2002 and 2006 was accomplished largely by reducing the number of transient poor. And the recent economic slowdown has significantly increased the vulnerability to poverty. While sustaining broad-based growth in the long term remains crucial for reducing overall poverty, improving the effectiveness of social and regional policies becomes more important in reaching the chronic poor and reducing the vulnerability to poverty.*

#### **Poverty fell substantially during 2002–06**

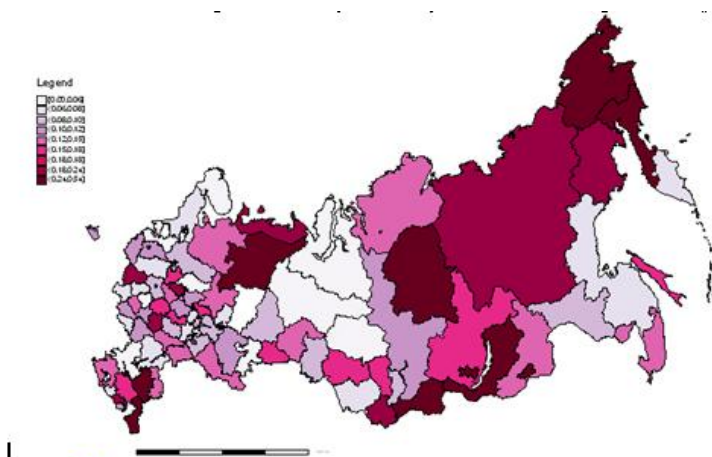
*The number of poor people in Russia was reduced by an estimated 12.5 million between 2002 and 2006.* The headcount index of poverty declined from 19.6 percent in 2002 to 11.1 percent in 2006 an 8.5 percentage point reduction. This is based on a poverty line of 1,056 rubles per capita per day in 2002. Similar trends are observed using Rosstat's higher poverty line and international benchmarks. Most of this reduction took place during 2002–04, after which the pace slowed.

*The incidence of poverty declined in urban areas from 15.9 percent in 2002 to 7.4 percent in 2006, and in rural areas from 30.0 percent to 21.2 percent.* Between 2002 and 2006, real average household consumption increased by 33 percent in urban areas but by only 19 percent in rural areas. Overall, average consumption in Moscow increased by 84 percent. Not surprisingly, the most significant poverty reduction was in Moscow, where the poverty rates fell below 1 percent.<sup>15</sup> As a result, poverty rates in rural areas are now more than three times higher than in urban areas.

*Poverty is fairly shallow in Russia, with a large number of people concentrated around the poverty line—this implying high vulnerability of the non-poor to economic shocks.* This is also reflected in the sensitivity of poverty rates to the choice of the poverty line. If the poverty line is increased by 10 percent, it would add 2.5 percentage points to the poverty rate, while lowering the poverty level by 10-percent would reduce poverty by 3.7 percent. So, a 10-percent increase in household consumption would lead to a 3.7 percentage point reduction in the poverty rate. Similarly, a 10 percent decrease in household consumption would lead to a 2.5 percentage point increase in poverty.

*A spatial analysis of poverty in Russia reveals broad regional variations in poverty reduction, with pockets of poverty concentrated in the northeastern and southern parts of the country.* Richer regions are more concentrated in the European and central part of the country, while Asian and southern territories are poorer (figure 3.1). Poverty and inequality vary substantially across Russia's regions, with poverty rates in the poorest regions 45 times those in the richest. Regions with higher population densities and greater urbanization have lower rates of poverty and faster rates of poverty reduction.

<sup>14</sup> This note is a resume of a larger World Bank report *Russian Federation: Addressing the Challenge of Chronic Poverty and Vulnerability*, analyzing poverty incidence during 2002-06 (2009, forthcoming). The authors of the report were Paloma Anos Casero (task team leader), Victor Sulla (poverty, vulnerability and inequality analysis), Emil Tesliuc (social protection), Isak Froumin and Tigran Schmis (education), Patricio Marquez (health) and Ellen Hamilton (housing).

**Figure 3.1: Poverty rates vary across Russia's regions, 2006**

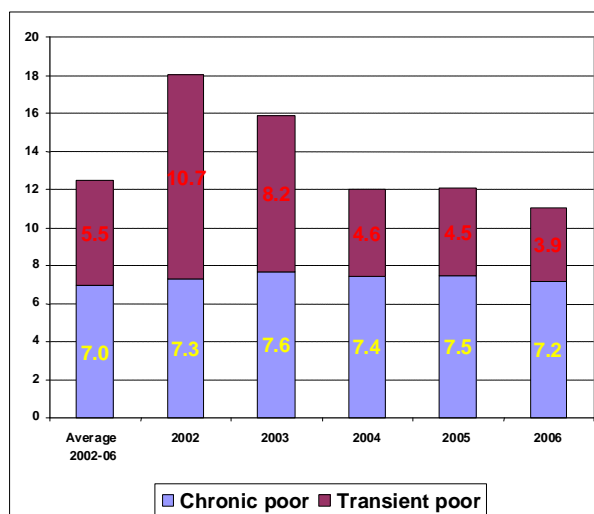
Source: Russian household budget survey, 2006

***In addition to halving the poverty headcount between 2000 and 2006, Russia's inequality did not increase markedly.*** Inequality levels remains moderate despite Russia's being oil rich (high dependency on oil revenues tend to be associated with increased inequality). The Gini coefficient went from 34.6 in 2000 to 35.6 in 2006.

**Notwithstanding these achievements, chronic poverty and vulnerability to poverty remain a critical challenge for Russian policy-makers**

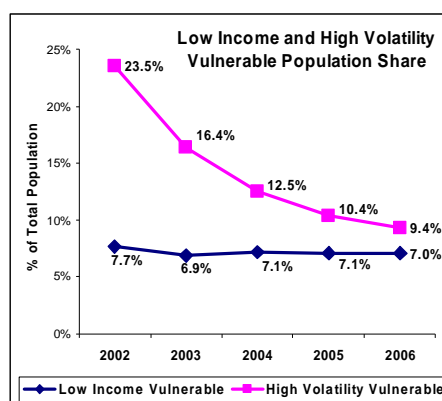
***In 2006 about 7.2 percent of the Russian people were chronically poor*** (figure 3.2). Analysis of the household budget survey reveals, for the first time, that while the number of chronic poor remained about the same over 2002–06, its share among the poor jumped from 40 percent in 2002 to 65 percent in 2006. Chronically poor households are those with average consumption below the poverty line during the entire 2002–06 period. In 2002 there was a clear preponderance of the transient poor—households poor during some periods, with average consumption above the poverty line over the entire period. These are people who move in and out of poverty due to changing economic conditions.

***The persistence of chronic poverty in Russia is rather worrisome, posing a special policy challenge.*** The poverty decline over 2002–06 was accomplished largely by reducing *transient* poverty, most of it during 2002–04. Data suggest that the chronic poor are typically workers in agriculture, unskilled workers, those employed in housing services, and those in large families. Given the new composition of the poor, future gains in poverty reduction may be more difficult because the chronic poor have a lower probability of getting out of poverty. Chronic poverty—as a developmental problem—poses new challenges for policy. First, growth alone may not be able to reach unskilled workers or those without higher education. Second, targeted social assistance may be needed for large families and the unskilled. Third, appropriate regional policies can benefit those in regions that host most of the chronic poor.

**Figure 3.2: Chronic poverty was less responsive to growth between 2002 and 2006**

Source: Russian household budget survey, 2006; Authors' calculations

**Another issue of concern is the relatively high vulnerability to poverty, affecting about a quarter of the population.** Household budget survey panel data suggest that *about 26 percent of the population—or 37 million people—were vulnerable to poverty in 2006.* (figure 3.3). Vulnerability is defined as the probability of falling below the poverty line. Two groups emerge in this category: those who are vulnerable to poverty because their income is low (close to the poverty line) and those who are vulnerable to poverty because the volatility of income is high. While vulnerability to poverty due to high income *volatility* fell sharply in 2002–06, the vulnerability to poverty due to low *levels* of income remains high. The finding is not surprising given the rapid growth in incomes during this period. The average consumption of the high income volatility group significantly increased, reducing their probability of being poor, typically the self-employed. But vulnerability due to low income remained almost unchanged, at about 7 percent (mostly comprising the unemployed and those that are not active in the labor force).

**Figure 3.3: Vulnerability was high in 2006, increasing risks of higher poverty due to shocks**

Source: Russian HBS, 2002-2006 Authors' calculations.

**Chronic poverty and vulnerability to poverty could be mitigated through two broad sets of policy actions:**

- **Improve the human capital assets of the chronic poor** (education, health, and housing status) to improve employability.
- **Implement active labor market policies and safety nets.** The highest vulnerability rates (largely due to low income levels) are observed among individuals with low skills, the unemployed, agriculture and service workers (construction, household services) and people in rural areas. The chronic poor are also concentrated in these categories. This calls for greater attention to active

labor market policies and unemployment insurance schemes that might help mitigate the vulnerability to poverty.

## **Improving the effectiveness of social policies is key in fighting poverty**

### ***Social protection—the crisis response needs to be accompanied by structural reforms***

In the previous section we discussed possible additional, short-term fiscal stimulus centered on emergency social protection programs focused on the poor and vulnerable. Here, we examine long-standing structural issues in Russia's system of social protection and consider possible reforms towards its greater efficiency and targeting.

***Social protection is the largest budget item in the consolidated social expenditures.*** In 2006 consolidated spending for social sectors—publicly financed programs in education, health, culture, mass media, sport, and social protection—was 15.4 percent of GDP, with social protection spending representing 55 percent. The economic growth of the last years triggered substantial increases in real spending for the social sector from 2004 to 2006. But while health spending almost doubled and education spending increased by two-thirds, social protection spending increased by only one-third, leaving it more or less stable at about 9 percent of GDP.<sup>16</sup>

***Russia's public spending on social protection and social assistance is at the average for former transition economies.*** Spending on social protection as a share of GDP averages 10 percent for 24 countries; in the Russian Federation it was 9 percent in 2006. The share of social assistance spending in GDP for the same group of countries was 1.7 percent, and for the Russian Federation it was 1.8 percent. Accounting for regional privileges—including the conservative estimate of 0.8 percent of GDP—increases total social protection spending to 9.8 percent and noncontributory spending to 2.6 percent. That noncontributory spending places Russia among the higher spenders.

***The largest share of social protection spending (about 80 percent) finances social insurance.*** The social insurance system comprises pensions for former employees or farmers (for old age and disability) and their dependents (survivors), and other programs providing benefits for contributors in case of sickness, maternity, or unemployment. Overall spending on these programs accounted for 7.2 percent of GDP in 2006. While social insurance programs do not have an explicit poverty alleviation mandate, some parts are explicitly designed to reduce the risk of poverty among contributors or beneficiaries (minimum pension provisions) or cover vulnerable groups (such as social pensions for the disabled elderly without other sources of income).

***Noncontributory social assistance programs and subsidies channel an additional 1.8 percent of GDP, plus an unknown cost associated with regional subsidies to privileged citizens.*** There are three broad categories of noncontributory social assistance programs.

- ***Subsidies for privileged citizens (lgoti).*** These include merit-based benefits to vulnerable groups, such as the disabled, war invalids, dependents of war victims, and those affected by radiation. But they also cover numerous privileges for groups based on their occupational status.
- ***Income-tested social assistance programs.*** The system of income-tested social assistance includes three main programs implemented by regional authorities since January 2005: child allowances, allowances for housing and utility services, and regional programs for the poor or vulnerable. In 2006 these groups of programs channeled 0.3 to 0.4 percent of GDP, of which 0.1 percent was for child allowances, 0.2 percent for housing and utility services allowances, and an estimated 0.01 percent for other regional programs.
- ***Other programs.*** Other social protection programs channel about 1 percent of GDP. Included here are programs for institutionalized care, to facilitate migration, youth development, protection against homelessness, and applied research.

<sup>16</sup> Additional spending on social protection is also incurred by parastatals (such as utility companies and state-owned enterprises) and is not captured in the estimates here.

## But little goes to the poor

**Although noncontributory spending in Russia is high, few resources actually go to the poor.** Estimates suggest that noncontributory spending still accounted for at least 2.6 percent of GDP in 2006. That ranks Russia among the generous spenders, with most countries spending 0.5–2.0 percent of GDP on noncontributory social assistance programs, around half for finance privileges and regressive subsidies for different categories of citizens. Only a small part of the subsidies go to the poorest 20 percent of the population.

**Analysis of the noncontributory social assistance programs shows the ineffective targeting.** For individual-level programs, such as privileges or child allowances, the information on beneficiary incidence is presented in two ways: the distribution of direct beneficiaries, and the distribution of direct and indirect beneficiaries, including all members of a recipient household, because they share household resources and thus the benefit from the transfer.

- **A large share of the population has privileged status.** In 2006 the share of the population enjoying privileged status was about a tenth for those with federal status and a quarter for those with regional status. The privileged come from all economic strata. Privileges are not targeted based on income, so the distribution by income is uniform, with around 10 percent for each decile of the population. With overall poverty among the bottom two deciles in 2006, more than 80 percent of the privileged citizens are not poor.
- **Benefit incidence analysis reveals that access to social assistance subsidies (privileges) is regressive.** The subsidies for the phone bill and transportation are among the most regressive. Only 4 to 5 percent of the beneficiaries of these privileges are in the poorest decile, while 25 percent of phone privileges and 15 percent of transportation privileges go to the richest decile. The only type of privilege with a somewhat progressive distribution is the subsidy for fuel given to rural inhabitants.

**The targeting performance of income-tested programs continues to be limited.** In 2006 only 26.9 percent of the child allowance beneficiaries and 30.3 percent of housing allowance beneficiaries were among the poorest fifth of the population. Other independent sources, such as the regionally representative surveys from Leningrad and Tomsk oblast, confirm the limited targeting. In Leningrad oblast 55 percent of the children and 62 percent of the beneficiaries of housing allowance programs were not poor in 2005. At the time of the survey the poverty rate was around 20 percent. For Tomsk oblast the corresponding figures were 54 percent and 73 percent in June 2006.

**The ineffective targeting translates into a modest impact on poverty reduction.** In Russia, despite the modest spending, a large share of funds channeled through income-tested programs ends up in the pockets of nonpoor beneficiaries, including the rich (10 percent of the money accrues to beneficiaries from the richest fifth of the population).

**The key policy recommendation is to improve the accuracy of targeting.** To improve targeting, the Russian regional and federal authorities could consider three options: strengthen the existing means-tested system, replace it with a proxy-means test, or combine elements from both systems and develop a hybrid means-tested system.

## Improving housing—reducing overcrowding

**Regardless of how housing need is measured, Russia faces a real housing shortage. About 7 percent of households share space with other households.** Approximately 11 percent of people live in units where more than two people share a room. And one in two persons has less than 10 square meters per capita.

**Overcrowding is more prevalent among the urban population than the rural.** Households living in communal apartments and in dormitories are particularly likely to be overcrowded. When measured by living space per capita, three-fourths of communal apartment dwellers are overcrowded, as are about four-fifths of dormitory residents. Overcrowding exceeds 60 percent for private renters, substantially more than the 40 percent for owners.

**The different measures of overcrowding are correlated with poverty.** Overcrowded households, regardless of the measure, are more likely to be in the lower deciles, understandable because households with more resources are more able to resolve their housing problems themselves.

*These issues, in turn, suggest several important implications for policymakers.* The continuing reliance on Soviet-era measures of physical output, rather than outcome-based measures of households and dwellings has resulted in a substantial underestimate of how much housing is needed to provide each household with a separate dwelling unit. To change the focus from producers to consumers, a paradigm shift is needed.

**Key policy recommendations:**

- *Adopt a modified methodology for projecting strategic housing needs.* Rather than the fairly arbitrary current system, targets should be set based on household needs, which together with purchasing power drives demand for housing.
- *Remove constraints to rental housing.* Alone, improving affordability will not allow low-income people to buy new units. Removing some of the constraints limiting rental housing supply (such as the difficulty of eviction) would support a more vibrant and accessible rental market.
- *Improve the effectiveness of government housing programs.* Given the cost of supplying a unit to a family and the number of units being supplied, the government should study eligible and recipient households to assess the actual performance of programs. Improving the targeting of housing subsidies is critical to achieving the government objectives for the National Priority Project for Housing.

Output Indicators	2006	2007	2008												2008		
			Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	
GDP, % change, y-o-y 1/	7,7	8,1	-	-	8,5	-	-	8,0	-	-	7,3	-	-	1,1	5,6	-	-
Industrial production, % change, y-o-y	6,3	6,3	4,5	7,5	6,5	9,2	6,7	0,9	3,2	4,7	6,3	0,6	-8,7	-10,3	2,1	-16,0	-13,2
Manufacturing, % change, y-o-y	8,3	9,5	4,0	11,2	10,4	14,5	10,0	0,6	4,6	6,5	8,2	0,3	-10,3	-13,2	3,2	-24,1	-18,3
Extraction of mineral resources, % change, y-o-y	2,5	1,9	0,6	2,3	-0,7	0,4	0,1	0,6	-1,8	0,7	3,2	0,8	-1,6	-2,3	0,2	-3,6	-6,0
Fixed capital investment, % change, y-o-y	16,7	21,1	21,6	26,0	23,1	25,1	18,7	11,4	10,7	10,1	14,3	5,3	-0,9	-7,5	9,8	-15,5	-14,1
<b>Fiscal and Monetary Indicators</b>																	
Federal government balance, % GDP 1/	7,4	5,5	10,4	8,2	7,2	9,0	8,2	7,1	9,2	8,7	8,1	7,8	6,4	4,0	4,0	15,0	2,6
Consolidated budget balance, % GDP 2/	8,5	6,1	-	-	12,1	-	-	10,6	-	-	11,1	-	-	4,8	4,8	-	-
M2, % change, p-o-p 3/	43,6	51,3	-2,7	1,3	2,3	-0,3	2,8	3,8	-0,2	2,3	-1,1	-5,9	-2,2	2,0	27,2	-11,1	0,3
Inflation (CPI), % change, p-o-p	9,0	11,9	2,3	1,2	1,2	1,4	1,4	1,0	0,5	0,4	0,8	0,9	0,8	0,7	13,3	2,4	1,7
GDP deflator 1/	15,5	13,9	-	-	20,7	-	-	22,1	-	-	24,2	-	-	18,8	18,8	-	-
Producer price index (PPI), % change, p-o-p	10,4	25,1	1,6	0,7	0,7	4,5	3,5	4,9	5,4	0,4	-5,0	-6,6	-8,4	-7,6	-7,0	-1,8	2,8
Nominal exchange rate, average, Rb/USD	27,1	25,6	24,5	24,5	23,8	23,5	23,7	23,6	23,4	24,1	25,3	26,4	27,3	28,1	24,8	31,5	35,8
Real effective exchange rate, 2000 = 100 (IMF)	163,4	172,7	179,9	179,5	181,5	184,1	184,8	186,0	186,0	183,6	181,9	185,0	184,2	181,7	183,2		
Real effective exchange rate, % change, p-o-p (IMF)	9,5	5,7	1,6	-0,2	1,1	1,4	0,4	0,7	0,0	-1,3	-0,9	1,7	-0,4	-1,4	6,1		
Reserve Fund, bln USD e-o-p			127,8	130,5	129,8	129,3	130,3	129,7	142,6	141,0	134,6	132,6	137,1	137,1	137,1	137,3	136,3
National Wealth Fund, bln USD, e-o-p			32,2	32,9	32,7	32,6	32,9	32,7	31,9	48,7	62,8	76,4	88,0	88,0	88,0	84,5	83,9
Reserves (including gold) billion \$, end-o-p	303,7	477,9	488,4	494,9	512,6	532,5	546,0	569,0	596,6	582,2	556,8	484,6	455,7	427,1	427,1	386,9	384,1
<b>Balance of Payment Indicators</b>																	
Trade Balance, billion \$	139,2	128,7	18,9	14,5	16,5	14,9	18,2	18,4	18,3	18,3	16,3	12,1	8,8	4,6	176,5	9,4	
Share of energy resources in export of goods, %	63,3	61,5	-	-	68,8	-	-	67,1	-	-	66,9	-	-	63,0	65,9	-	-
Current Account, billion \$	95,6	76,6	-	-	37,5	-	-	26,2	-	-	27,6	-	-	7,7	98,9	-	-
Export of goods, billion \$	303,9	354,0	34,5	35,7	39,9	40,3	42,6	43,9	47,3	45,7	43,8	39,2	30,4	28,5	469,0	19,7	
Import of goods, billion \$	164,7	225,3	15,6	21,2	23,4	25,3	24,4	25,4	29,0	27,4	27,5	27,1	21,7	23,9	292,5	10,3	
Gross FDI, mln USD 1/	13678	27797	-	-	5585	-	-	11080	-	-	19201	-	-	27027	27027	-	-
Average export price of Russia's oil, \$/bbl	56,2	64,4	84,3	84,7	91,0	95,8	105,0	114,5	122,0	112,0	96,5	82,7	60,7	44,8	91,2		
<b>Financial Market Indicators</b>																	
Average weighted lending rate for enterprises, % 4/	10,5	10,8	10,4	11,0	11,3	11,2	11,0	11,3	11,4	11,8	12,7	14,1	15,0	15,5	15,5		
CBR refinancing rate, %, end-o-p	11,0	10,0	10,0	10,3	10,3	10,5	10,5	10,8	11,0	11,0	11,0	11,0	12,0	13,0	13,0	13,0	13,0
Real average rate for Ruble loans, % (deflated by PPI)	-1,8	-3,4	-11,6	-11,8	-12,2	-12,4	-11,0	-12,8	-16,6	-14,9	-10,2	-2,8	10,3	24,3	-6,8		
Stock market index (RTS, ruble term)	1922	2291	1907	2064	2054	2123	2460	2303	1967	1646	1212	773	658	632	632	535	545
<b>Enterprises Finances</b>																	
Share of loss-making companies 1/	29,7	23,4	34,3	33,0	34,3	33,3	31,3	29,4	29,4	28,4	27,6	27,6	27,3	25,2	25,2		
Share of credits in capital investment 1/	14,3	15,5	-	-	17,3	-	-	17,2	-	-	17,8	-	-	17,6	17,6	-	-
Profitability (net profit/paid sales), % 1/	25,6	36,8	58,0	39,1	32,1	32,5	34,3	36,7	35,2	35,0	32,0	28,8	26,9	21,5	21,5		
<b>Income, Poverty and Labor Market</b>																	
Real disposable income, (1999 = 100%)	219,1	245,6	189,4	229,9	234,3	255,1	245,4	257,7	261,3	266,8	263,1	259,1	251,6	325,6	252,2	170,0	218,9
Average dollar wage, US \$	391,9	532,0	603,4	636,6	687,6	699,3	701,1	755,1	757,3	701,5	702,5	664,8	637,4	738,0	694,3	544,0	524,0
Unemployment (% , ILO definition)	7,2	6,1	6,6	7,1	6,5	6,6	5,4	5,5	5,6	5,9	5,9	6,0	6,6	7,7	6,3	8,1	8,5

1/ Cumulative from the year beginning

2/ Starting 2006 incl. extrabudgetary funds

3/ Annual change is calculated for average annual M2

4/ All terms up to one year

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