Peter Havlik

Russian Federation: high – and broader-based – growth continues

The Russian economy continues to grow at a brisk pace. GDP increased by more than 7% in 2003 – significantly more than most forecasters (including wiiw) had previously expected – and rapid economic expansion continued at a similar rate throughout the first few months of 2004. High world market prices for the main Russian export commodities (especially energy carriers, but metals as well) still provide the key growth stimulus; however, given the continued strength of export and budget revenues, growth is becoming broader-based and thus apparently more sustainable as well. In both 2003 and early 2004 investments increased markedly (by about 12% each year): in particular, in export-oriented and export-related sectors of the economy (such as energy, metals and transport). Robust investment demand stimulated rapid growth in the construction sector, as well as expansion of both domestic production and imports of machinery and equipment. Private consumption and real household incomes also continue to boom. With the government budget displaying a sizeable surplus (more than 4% of GDP in the first quarter of 2004) and foreign exchange reserves standing at a record level (USD 85 billion as at end of May 2004), the Russian economy is now in the best shape it has ever been since the transition began. After the financial crisis in 1998, Russian GDP increased by almost 40% (yet it is still almost 20% below the level of 1990). Doubling GDP by 2010, the official target proclaimed by President Putin in his inaugural speech following the elections, would call for annual growth of more than 9%: an unrealistic proposition. Nevertheless, the prospects of relatively high economic growth (5-6% per year) over the medium term are fairly good.

Consumer price inflation is gradually declining, albeit slowly, to some 10% per year in 2004, as the appreciating rouble eases somewhat the inflationary pressures stemming from increases in regulated prices and tariffs and the surging money supply (more than 40% year-on-year in mid-2004) fuelled by major inflows of foreign exchange revenues. At the same time producer price inflation has recently accelerated (to nearly 20% on an annual basis in mid-2004) as a result of an upsurge in energy and transport tariffs. Given the envisaged adjustments to administered prices (e.g. for electricity and gas), it is quite probable that lasting higher producer prices will eventually translate into higher consumer price inflation as well. In any event, the official inflation target (of less than 10% in 2004 and 8.5% in 2005) will be missed once again – though probably not too far off. From the macroeconomic point of view, a more important variable has been the exchange rate. The rouble has appreciated by some 10% against the US dollar in nominal terms (May 2004 against the pre-year period); in real terms by around 20%. With respect to the euro, the rouble has remained more or less stable; real appreciation has thus been considerable (10-20% between May 2003 and May 2004, depending on the deflator used). Diverging USD and EUR exchange rate developments not only mean that a unit of Russian exports (which are quoted predominantly in USD) buys less imports (a large part of which is billed in EUR), but also that appreciation of the rouble makes domestic products less competitive compared to imports. Whereas the volume of Russian exports is essentially unaffected by exchange rate movements, appreciation of the rouble has caused great pain, especially for the consumer goods industry where domestic production has to compete with cheaper and better-quality imports. Output in the textiles, footwear and leather industries dropped in the first quarter.

In the first quarter of 2004, exports were up by 20% in USD terms compared to a year earlier, largely thanks to higher energy revenues (crude oil, oil products and natural gas making up nearly 60% of the total). Imports increased by more than 20%, with imports of machinery and transport equipment (especially passenger cars) rising faster than average (in EUR terms both exports and imports were flat; Russia still publishes its foreign trade figures solely in USD terms). The foreign trade surplus (USD 18 billion) was higher than in the previous year, yet the current account surplus (USD 11 billion) showed a decline owing to a higher deficit in services trade and negative investment incomes. Despite high world market prices for energy and metals (and rising Russian production and exports), export revenue growth will most likely bottom out while imports, fuelled by robust domestic demand and an appreciating rouble, will continue to grow rapidly. Although the trade and current account surpluses are expected to remain appreciable, the contribution of net exports to GDP growth has been gradually diminishing. Apart from exports, the main pillar of growth over the past few years has been private consumption, yet investments have also been recently gaining in importance. In 2005, slightly lower growth in private consumption is likely whereas investment growth will remain robust. However, despite net FDI inflows picking up in the first quarter of 2004, we do not expect any marked upturn in FDI inflows (Russia registered a net outflow of FDI in 2003) as the investment climate – especially for foreign investors – will remain rough. The recent campaign directed against the 'oligarchs' may even discourage the return of flight capital. That notwithstanding, most Russian companies, especially those engaged in export activities, face a relatively comfortable situation (except for Yukos, which may face bankruptcy owing to an enormous tax fine imposed on the company recently); they can easily finance investments from their own revenues (or credits).

Despite positive economic indicators prevailing in recent times, sustainable long-term development is still uncertain given the lack of progress in administrative reforms, insufficient transparency of legal regulations and, last but not least, structural distortions in an economy which is excessively dependent on fluctuating world market commodity prices. wiiw expects Russian GDP growth to exceed 6% in 2004 (and probably 5% in 2005), yet there is broad consensus that the current rate of economic growth cannot be sustained unless the pace and, especially, the implementation of structural, institutional, legal and banking sector reforms increase substantially. Annual consumer price inflation may drop below 10% in 2005, yet there is every risk that producer price increases (especially hikes in regulated energy and transport tariffs) will soon translate into higher CPI as well. In addition to fuelling inflation, buoyant export revenues also reduce the pressure on governments to accelerate reforms and focus on attracting foreign direct investments. Both are urgently needed for the diversification and modernization of the Russian economy.

The recent investment recovery can be explained by several factors, both internal (domestic) and external. First, favourable prices have paved the way to high revenues and profits in the Russian energy and metals sectors (and to equally high revenues in the state budget) which together account for about two thirds of total investment. Secondly, low interest rates and depressed yields in international bond markets have made Russian assets a more attractive investment proposition. Over the past few months these positive developments have come to halt (or were even reversed in May 2004 when the Russian stock market suffered a swingeing blow), partly as a reaction to the Yukos affair. In terms of medium- and especially long-term investment and growth prospects, it will be crucial not only to restore investor confidence, but also to shift investment flows from extractive to manufacturing industries. As far as foreign investors are concerned, they should not expect a particularly warm welcome in Russia, especially in ‘strategic’ sectors such as energy, metals, banking and telecommunications – from either the domestic owners or government officials.

The newly elected parliament (Duma) is dominated by pro-Putin forces. President Putin was confirmed in office in March 2004 by an overwhelming majority. Not only does he face almost no opposition, but he also continues to enjoy huge popular support. Political stability is thus guaranteed, unlike the speed (and above all the efficiency) of the reform process – even though virtually any draft reform law can now pass through parliament. Neither the recent shenanigans surrounding the privatization deals dating back to the early 1990s nor the recently announced plan to set up a ‘Common Economic Space’ (together with Belarus, Kazakhstan and Ukraine) are likely to have a significant impact on Russia’s economy. More importantly, at the end of April 2004 Russia finally accepted the extension of the Partnership and Cooperation Agreement with the EU covering the new member states from Central and Eastern Europe. In May 2004, a deal was struck in Moscow with the EU that resolved a number of obstacles hindering Russia’s accession to the WTO. Russia agreed to lower its average import tariffs by about 2 percentage points (from the current level of 11%), while maintaining higher import protection for aircraft, passenger cars, textiles, shoes, furniture and foodstuffs. In view of its enlargement, the EU agreed to increase the import quotas for Russian steel by 35%. A compromise solution was also found for domestic energy prices which the EU regards as being artificially low and constituting unfair indirect subsidies to Russian manufacturers. On that particular issue Russia promised to raise domestic gas prices by 2010 to USD 49-57 (from the current price of USD 27) per thousand cubic metres, while maintaining the Gazprom monopoly.

The ratification of the Kyoto Protocol has apparently been put on hold. Furthermore, certain restrictions pertaining to opening branches of foreign banks and providing foreign companies access to Russian insurance and telecommunication services will also remain in place. Once an agreement has been reached with other major trading partners (especially with the United States, China and Japan), Russia’s accession to the WTO and its further integration in the world economy will become quite a realistic proposition – possibly taking effect as early as 2006.

Table RU

Russia: Selected Economic Indicators

	1999	2000	2001	2002	2003 1)	2003	2004	2004	2005
						1st quarter		forecast	
Population, th pers., end of period	145925	145185	144317	143467	143500	.	.	143000	142700
Gross domestic product, RUB bn, nom.	4823.2	7305.6	8943.6	10834.2	13285.2	2892.1	3598.9	15500	17700
annual change in % (real)	6.4	10.0	5.1	4.7	7.3	7.5	7.4	6.3	5.5
GDP/capita (EUR at exchange rate)	1256	1928	2365	2540	2676	.	.	3100	3450
GDP/capita (EUR at PPP - wiiw)	5460	6130	6630	7160	7890	.	.	8340	8860
Gross industrial production									
annual change in % (real)	11.0	11.9	4.9	3.7	7.0	6.0	7.6	6	5
Construction output total									
annual change in % (real)	6.0	17.0	9.9	2.7	14.4	13.7	13.8	.	.
Consumption of households, RUB bn, nom.	2526.2	3295.2	4318.1	5418.1	6561.1	1445.9	.	.	.
annual change in % (real)	-2.9	7.3	9.5	8.9	7.9	7.9	11	9	9
Gross fixed capital form., RUB bn, nom.	693.9	1232.0	1689.3	1943.4	2417.7	376.7	412.5	.	.
annual change in % (real)	6.4	18.1	10.2	3.0	12.9	12.5	13.1	12	12
LFS - employed persons, th, avg.	62475	64255	64400	66071	65700	64104	65300	.	.
annual change in %	6.9	2.8	0.2	2.6	-0.6	-1.4	1.9	.	.
Reg. employment in industry, th pers., avg.	14297	14543	14692	14768	.	.	.	.	.
annual change in %	1.0	1.7	1.0	0.5	.	.	.	.	.
LFS - unemployed persons, average	9323.0	7515.0	6416.0	5712.0	5948.0	6575	6387	.	.
LFS - unemployment rate in %, average	13.0	10.5	9.1	8.0	8.3	9.3	8.9	8.7	9
Reg. unemployment rate in %, end of period	1.7	1.4	1.6	2.1	2.3	2.3	2.3	.	.
Average gross monthly wages, RUB	1522.6	2223.4	3240.4	4360.0	5509.0	4794.3	6167.0	.	.
annual change in % (real, gross)	-22.0	20.9	19.9	16.2	10.3	9.7	15.0	.	.
Consumer prices, % p.a.	85.7	20.8	21.6	16.0	13.6	14.6	10.8	10	9
Producer prices in industry, % p.a.	58.9	46.6	19.1	11.8	15.6	19.4	19.0	18	15
General governm.budget, nat.def., % GDP									
Revenues	25.2	28.7	29.9	32.4	31.1	30.3	29.0	.	.
Expenditures	26.1	26.8	26.9	31.4	29.8	26.6	24.7	.	.
Deficit (-) / surplus (+), % GDP	-0.9	1.9	3.0	1.0	1.4	3.7	4.3	.	.
Public debt, nat.def., in % of GDP 2)	94.2	57.1	44.1	36.9	28.7	.	.	.	.
Refinancing rate of NB % p.a., end of per.	55	25	25	21	16	18	14	.	.
Current account, EUR mn 3)	23100	50619	37885	30789	31772	10824	10393	30000	25000
Current account in % of GDP	12.6	18.0	11.1	8.4	8.3	12.7	9.6	6.8	5.1
Gross reserves of NB, excl. gold, EUR mn	8387	26139	37026	42290	58531	48388	65187	.	.
Gross external debt, EUR mn	176298	172903	169530	147067	145337	145193	152984	.	.
FDI inflow, EUR mn 3)	3105	2933	3069	3660	1012	1296	3238	.	.
FDI outflow, EUR mn 3)	2071	3433	2828	3736	3657	567	3499	.	.
Exports of goods, BOP, EUR mn 3)	70898	113510	113744	113468	120282	28958	29796	125000	125000
annual growth rate in %	8.5	60.1	0.2	-0.2	6.0	16.0	2.9	4	0
Imports of goods, BOP, EUR mn 3)	37102	48483	60022	64470	66753	14749	15338	73000	80000
annual growth rate in %	-27.1	30.7	23.8	7.4	3.5	4.7	4.0	9	10
Exports of services, BOP, EUR mn 3)	8509	10337	12773	14393	14185	2845	3116	14000	14000
annual growth rate in %	-21.6	21.5	23.6	12.7	-1.4	-6.7	9.5	-1	0
Imports of services, BOP, EUR mn 3)	12529	17540	22967	24848	24001	4773	5126	25000	26000
annual growth rate in %	-13.2	40.0	30.9	8.2	-3.4	-11.4	7.4	4	4
Average exchange rate RUB/USD	24.62	28.13	29.17	31.35	30.57	31.66	28.63	29	30
Average exchange rate RUB/EUR (ECU)	26.24	26.03	26.13	29.65	34.55	33.98	35.83	35	36
Purchasing power parity RUB/USD, wiiw	5.54	7.47	8.50	9.73	10.94	.	.	12	13
Purchasing power parity RUB/EUR, wiiw	6.04	8.20	9.32	10.51	11.74	.	.	13	14

Notes: 1) Preliminary. - 2) Estimated. - 3) wiiw calculated from USD.

Source: wiiw Database incorporating national statistics; wiiw forecasts.