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## **Russian Federation: GDP growth slows down, reform stalemate**

For the Russian economy 2004 was another year of robust growth. The GDP increased by about 7% according to preliminary official figures, slightly less than in 2003 (7.3%) yet still more than expected.<sup>1</sup> However, economic growth decelerated markedly in the closing months of the year and the final results might have to be revised downwards. The slowdown was recorded in industry, construction as well as agriculture, while output growth of services (particularly trade, telecommunications and transport) accelerated. On the demand side, it was mainly investment and private consumption that boomed. Exceptionally high world market prices of Russia's main export commodities (particularly of energy carriers and metals) represented once again the key growth stimulus. The export surplus increased markedly, reaching more than 13% of GDP (in 2003: 11% of GDP), and also the current account surplus (EUR 47 billion) exceeded 10% of GDP. The Stabilization Fund, which accumulates part of the windfall profits from energy exports and is to be used mainly for debt repayment, reached more than RUR 500 billion (around USD 20 billion) by the end of 2004. With lasting strong export (and therefore also state budget) revenues, economic growth may have become broader-based and therefore apparently also more sustainable, yet the reliance on resource-intensive sectors and structural distortions have increased. Reforms have stalled as well (with the exception of housing and social benefits reforms – see below) and the investment climate has been poisoned by the handling of the Yukos affair. A series of terrorist attacks in Russia, culminating in the tragic school siege in Beslan, was used by President Putin as a pretext for curtailing regional decision making powers.

Due to the combined effects of high foreign exchange inflows, expanding money supply, robust economic growth, and price hikes in food and services, the pace of disinflation has diminished. Consumer price inflation has been gradually declining for a couple of years - a process facilitated by the appreciating rouble (especially with respect to the US dollar). Nevertheless, the CPI increased on average by around 11% in 2004 and the official inflation target of less than 10% was missed once again. Even more disturbing is the fact that producer price inflation has been accelerating during the past two years: it reached nearly 25% in 2004, mainly as a result of surging energy and metals producer prices. Given the envisaged further adjustments of administered prices, e.g. of electricity and gas, it is quite likely that permanently growing producer prices will eventually translate into higher consumer price inflation as well. A rapid disinflation is therefore highly unlikely – not least due to rapidly rising unit labour costs.

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<sup>1</sup> This can be partly explained by the revision of industrial output growth which amounted, according to the latest figure, to 7.3% in 2004 (compared to 6.1% previously published).

Despite the general deterioration of the investment climate in Russia, investment continued to increase in 2004, by more than 10%, in particular in export-oriented and export-related sectors of the economy such as energy, metals and transportation. Robust investment demand stimulated growth of construction, not least also in housing. Apart from the growing export surplus, private consumption and real household incomes continue to boom; employment has been growing as well and unemployment has declined. With the government consolidated budget in a sizeable surplus and foreign exchange reserves exceeding USD 120 billion as of end-2004, the Russian economy is now in its best shape since the beginning of transition. Nevertheless, the official target – to double the GDP by 2010 – proclaimed by President Putin in his inaugural speech after the April elections is not realistic, though prospects for relatively high economic growth (around 5% per year) in the medium term are fairly good – barring a (rather unlikely) collapse of oil prices or a (perhaps more probable) major devaluation of US dollar, which would have a similar effect on Russian terms of trade.

In 2004, goods exports were up by more than 20% (+35% in USD terms) compared to a year earlier, largely thanks to higher energy revenues (revenues from crude oil exports grew by nearly 70%). Imports of goods increased by 13% (+25% in USD terms), with machinery and transport equipment (in particular passenger cars) imports rising faster than average. The foreign trade surplus (USD 87 billion) was significantly higher than a year earlier, as was the current account surplus (USD 58 billion – more than 10% of GDP). Despite the prevailing expectation of lasting high world market prices of energy and metals (and moderately growing Russian production and exports), the growth in export revenues will most likely decelerate due to the bottoming-out of energy prices (and to export capacity constraints) while imports, fuelled by robust domestic demand and the ongoing real appreciation of the rouble, will continue to grow faster. Though the trade and current account surpluses will remain large, the contribution of net exports to GDP growth will gradually diminish.

Apart from net exports, the main pillar of growth during the past couple of years has been private consumption, with investments gradually gaining importance as well. However, the share of investments in GDP is still quite low (about 20% of GDP) and their growth is expected to slow down. In particular, we do not expect any marked upturn in FDI (during 2004, FDI inflows declined whereas the net outflow of FDI from Russia continued) as the investment climate – especially for foreigners – will stay rough. Yet the situation of most Russian companies, in particular those which are engaged in export activities, is quite comfortable (except Yukos, which is facing liquidation after its main asset Yuganskneftegas was sold to a subsidiary of Gazprom), and they can easily finance investments from own resources (or credits – as was the case in Gazprom's recent acquisition of Yukos assets).

Despite the recent predominantly positive economic indicators, a sustainable long-term development is still uncertain considering the lagging reform progress, insufficient transparency of legal regulations and, last but not least, structural imbalances in the economy, which is excessively dependent on the fluctuating world market commodity prices. In line with most observers and even the official government forecasts, wiiw expects that Russia's GDP growth will slow down to some 5% in both 2005 and 2006. There is a broad consensus – both in- and outside Russia – that the current rate of economic growth is unsustainable unless the pace of structural, institutional, legal and banking sector reforms (and especially their implementation) increases substantially. After the lacklustre implementation of public sector administration and tax reforms, the latest example was the botched attempt at social benefits reform. The 'monetization' and streamlining of social benefits introduced at the beginning of 2005 and directly affecting more than 35 million Russian citizens, was poorly implemented as well. It lacked sufficient funding in particular at the regional level and had to be watered down after widespread popular protests. After President Putin's intervention, pensions will be increased in March 2005 while the fate of several reform-oriented ministers – G. Gref, A. Kudrin and M. Zurabov (responsible for the economy, finances and social affairs, respectively) – is uncertain.

In view of recent events which seem to diminish the role of government reformers while that of *siloviki* from Mr. Putin's apparatus is increasing, an acceleration of liberal reforms is unlikely. On the contrary, a tendency towards increasing state intervention in the economy (especially in strategic sectors such as energy) and to exert more influence on decision making at the regional level (President Putin's proposal to appoint regional governors adopted by the Duma after the tragedy in Beslan) is becoming more apparent. While a stronger state, in the sense of better law enforcement and institution building, would certainly be welcome, the real outcome of the government's attempts at direct involvement in the economy will hardly yield positive results.

Perhaps as a side effect of rising economic strength, Russia's assertiveness has increased and its external relations with nearly all partners subsequently deteriorated. The EU has been increasingly concerned with a revival of authoritarian tendencies in Russia (Chechnya, press freedom violations, growing state influence in the economy, etc.). In the negotiations prior to EU enlargement, Russia had attempted to create some obstacles before agreeing to extend the coverage of the Partnership and Co-operation Agreement to the new EU Members from Central and Eastern Europe. An agreement was finally reached in May 2004, not only on travel modalities to the Russian exclave Kaliningrad, but also regarding an increased quota on steel imports from Russia. The EU had also expressed its support for Russian WTO accession in exchange for the Russian promise to gradually raise domestic prices for electricity and natural gas (WTO membership is still at least two years ahead). Russia had also ratified the Kyoto protocol yet it made hardly any concessions regarding improved market access of foreigners to the domestic services

sector. EU-Russian relations cooled down again before the presidential elections in Ukraine, with each side openly supporting opposing candidates. Even before, Russian relations with Georgia also deteriorated, and the plans for a Union with Belarus have apparently been put on ice as well (here the blame lies mainly with Belarus' President Lukashenko). Russian relations with the USA focus on the fight against terrorism mainly (a WTO deal has not yet been reached, with financial services and intellectual property rights being the main stumbling issues), though Mr. Putin has been one of the few European politicians to openly support President Bush's re-election. The only silver lining may have been a (still fragile) warming of relations with China, after the last controversies over the Russian-Chinese border (as well as deals on energy deliveries and WTO accession) have been finally settled, and with Japan, where negotiations over the Kurile Islands (for Japan: Northern Territories) are slowly progressing.

Table RU

## Russia: Selected Economic Indicators

	1998	1999	2000	2001	2002	2003	2004 <sup>1)</sup>	2005	2006
	forecast								
Population, th pers., end of period <sup>2)</sup>	146328	145559	144819	143954	144964	144168	143400	14300	142500
Gross domestic product, RUB bn, nom.	2629.6	4823.2	7305.6	8943.6	10817.5	13201.1	16778.8	20300	24000
annual change in % (real)	-5.3	6.4	10.0	5.1	4.7	7.3	7.1	5	5.5
GDP/capita (EUR at exchange rate)	1618	1256	1928	2365	2536	2643	3258	.	.
GDP/capita (EUR at PPP - wiiw)	5000	5460	6030	6480	7000	7520	8270	.	.
Gross industrial production									
annual change in % (real)	-5.2	11.0	11.9	4.9	3.7	7.0	7.3	5.5	4
Gross agricultural production									
annual change in % (real)	-13.2	4.1	7.7	7.5	1.5	1.5	1.6	.	.
Construction output total									
annual change in % (real)	-5.0	6.0	17.0	9.9	2.7	14.4	10.1	.	.
Consumption of households, RUB bn, nom.	1462.3	2526.2	3295.2	4318.1	5408.4	6559.9	8010.7	.	.
annual change in % (real)	-3.4	-2.9	7.3	9.5	8.5	7.5	11.3	9	8
Gross fixed capital form., RUB bn, nom.	424.7	693.9	1232.0	1689.3	1938.8	2407.6	3002.1	.	.
annual change in % (real)	-12.4	6.4	18.1	10.2	2.8	12.8	10.8	8	8
LFS - employed persons, th, avg.	58437	62475	64255	64400	66071	65800	67383	.	.
annual change in %	-2.6	6.9	2.8	0.2	2.6	-0.4	2.4	.	.
Reg. employment in industry, th pers., avg.	14162	14297	14543	14692	14534	14143	.	.	.
annual change in %	-5.0	1.0	1.7	1.0	-1.1	-2.7	.	.	.
LFS - unemployed, th pers., average	8902.0	9323.0	7515.0	6416.0	5712.0	6231.0	5856.0	.	.
LFS - unemployment rate in %, average	13.5	13.0	10.5	9.1	8.0	8.6	8.2	8.5	9
Reg. unemployment rate in %, end of period	2.7	1.7	1.4	1.6	2.1	2.3	2.6	.	.
Average gross monthly wages, RUB	1051.5	1522.6	2223.4	3240.4	4360.3	5498.5	6828.0	.	.
annual change in % (real, gross)	-13.3	-22.0	20.9	19.9	16.2	11.0	10.8	.	.
Consumer prices, % p.a.	27.6	85.7	20.8	21.6	16.0	13.6	11.0	11	10
Producer prices in industry, % p.a.	7.1	58.9	46.6	19.1	11.8	15.6	24.4	20	15
General governm. budget, nat.def., % GDP									
Revenues	26.1	25.2	28.7	30.0	32.5	31.4	32.0	.	.
Expenditures	32.0	26.1	26.8	27.1	31.6	30.0	26.0	.	.
Deficit (-) / surplus (+), % GDP	-5.9	-0.9	1.9	3.0	0.9	1.3	6.0	.	.
Public debt, nat. def., in % of GDP <sup>3)</sup>	142.7	94.2	57.1	44.1	36.9	28.7	.	.	.
Refinancing rate of NB % p.a., end of per.	60	55	25	25	21	16	13	.	.
Current account, EUR mn <sup>4)</sup>	192	23100	50619	37885	30789	31334	46865	42000	40000
Current account in % of GDP	0.1	12.6	18.0	11.1	8.4	8.2	10.0	7.2	6
Gross reserves of NB, excl. gold, EUR mn	6650	8387	26139	37026	42290	58531	88663	.	.
Gross external debt, EUR mn	160089	176298	172903	169530	147067	148536	155951 <sup>ix</sup>	.	.
FDI inflow, EUR mn <sup>4)</sup>	2424	3105	2933	3069	3660	7042	5300 <sup>5)</sup>	.	.
FDI outflow, EUR mn <sup>4)</sup>	1114	2071	3433	2828	3736	8607	7000 <sup>5)</sup>	.	.
Exports of goods, BOP, EUR mn <sup>4)</sup>	65327	70898	113510	113744	113468	120282	147530	150000	155000
annual growth rate in %	-15.0	8.5	60.1	0.2	-0.2	6.0	22.6	2	3
Imports of goods, BOP, EUR mn <sup>4)</sup>	50910	37102	48483	60022	64470	67314	76337	84000	92000
annual growth rate in %	-20.0	-27.1	30.7	23.8	7.4	4.4	13.4	10	10
Exports of services, BOP, EUR mn <sup>4)</sup>	10857	8509	10337	12773	14393	14361	16346	18000	20000
annual growth rate in %	-12.8	-21.6	21.5	23.6	12.7	-0.2	13.8	10	11
Imports of services, BOP, EUR mn <sup>4)</sup>	14441	12529	17540	22967	24848	24000	27620	32000	36000
annual growth rate in %	-18.5	-13.2	40.0	30.9	8.2	-3.4	15.1	16	13
Average exchange rate RUB/USD	9.71	24.62	28.13	29.17	31.35	30.57	28.84	28	29
Average exchange rate RUB/EUR (ECU)	11.06	26.24	26.03	26.13	29.65	34.55	35.81	35	36
Purchasing power parity RUB/USD, wiiw	3.26	5.54	7.16	8.15	9.27	10.37	12.06	13	14
Purchasing power parity RUB/EUR, wiiw	3.58	6.04	8.33	9.53	10.74	12.14	14.11	14	15

Notes: 1) Preliminary. - 2) Resident population; from 2002 according to census October 2002. - 3) Estimated. - 4) wiiw calculated from USD. - 5) wiiw estimate.

Source: wiiw Database incorporating national statistics; wiiw forecasts.