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## **Russian Federation: lower GDP growth, surging export revenues**

Russia's GDP has been growing by 6% on annual average during the past five years. In the first quarter of 2006, the growth rate slipped to some 5% as the performance of the real sector of the economy (industry, agriculture, transport and construction) weakened. The main driver of growth was rising domestic demand (in particular private consumption) while the contribution of real net exports to GDP growth was again negative. However, the boom in nominal export revenues continues thanks to the high energy and metal prices. The sizeable expansion of imports notwithstanding, the trade surplus reached EUR 30 billion and the current account surplus EUR 24 billion (14% of GDP) in the first quarter of 2006. Due to significant improvements in the terms of trade, Russian domestic absorption can grow much faster than GDP – even with rising trade and current account surpluses. The consolidated government budget is enjoying record surpluses (in 2005 close to 8% of GDP; in the first quarter of 2006 nearly 14% of GDP); foreign exchange reserves approached EUR 200 billion at the end of May 2006. After repaying all outstanding IMF credits, in 2005 the government agreed with the Paris Club creditors to pay back USD 15 billion of debt ahead of schedule. USD 10 billion credit provided by the former USSR to Syria was written off. Additional debt repayments to the Paris Club (in particular to Germany) were agreed in June 2006.<sup>1</sup> The Stabilization Fund, established in 2004 and fed from a portion of windfall energy export revenues, exceeded EUR 50 billion in May 2006. After long discussions, it was finally decided that the Fund will be invested in USD- and EUR-denominated assets (each 45% of the Fund, the rest in GBP) and the operations managed by the Central Bank.

The highly favourable financial indicators notwithstanding, the growth of GDP and of manufacturing in particular is decelerating. Domestic consumer and investment demand is increasingly covered by imports, which are more competitive on the Russian market not only due to better quality but increasingly thanks to the real appreciation of the rouble. Production costs are rising as wages grow faster than labour productivity. Symptoms of a Russian Dutch-disease variety are thus becoming apparent as the bulk of export revenues stems from resource-based industries – revenues from oil and natural gas exports accounted for nearly 70% of total exports in the first quarter 2006 – and huge foreign exchange inflows exert appreciation pressures on the rouble. With a roughly constant nominal exchange rate over an extended period (around 28 RUB per USD) and persisting inflation, the rouble has appreciated in real terms back to the level before the August 1998 financial crisis. Due to the combined effects of foreign exchange inflows (with the related money supply expansion) and the growth of consumer demand, the annual inflation

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<sup>1</sup> Simultaneously with the reduction of government debts, the external indebtedness of the private sector is growing.

exceeds 10% (producer price inflation is even higher). As a rapid disinflation is unlikely, wiiw expects consumer prices to hover around 10% in both 2006 and 2007. Growing incomes and employment (and declining unemployment) make Russia attractive to foreign migrant workers, who mitigate the effects of adverse demographic trends (the latter figuring prominently in Mr. Putin's latest Presidential Address).

The pace of reforms remains unimpressive. Economic policy discussions during recent months have concentrated on the issue of how to use the Stabilization Fund and on the extent and contents of state investment programmes. As one of the rare reform steps, an agreement on the split of the state electricity company RAO UES into power generating and distribution parts was reached in June (the former part will be opened to private, possibly also foreign, investors). Meanwhile, Gazprom, Rosneft and other large state-owned (or controlled) corporations are expanding. The Russian energy and metals giants are also acquiring assets abroad, not least in the former Soviet republics. While launching the new state investment programmes (in health, education, housing and transport) and establishing special economic zones with tax privileges and legal guarantees, the government restricts access of foreign investors to 'strategic' sectors. The energy sector in particular has become one of the contentious issues in Russian-EU relations. Nonetheless, inflows of FDI are rising, partly thanks to returning Russian offshore capital, and the country's credit rating is improving. WTO accession may be delayed again (an agreement with the USA is still pending); the future of EU-Russian relations after the expiry of the Partnership and Cooperation Agreement in 2007 is unclear.

The main growth pillar during the past few years has been private consumption fuelled by rising incomes. Investment growth has been less impressive and the share of investment in GDP is still quite low (about 20%). The situation of most Russian companies, in particular those which are engaged in export activities, is quite comfortable and they can easily finance investments from own resources (or from bond issue and credits). Yet many companies prefer to invest abroad and Russian outward FDI is rising, partly at the expense of capital flight. Given the surging government revenues, the federal budget reckons with rising expenditures. Despite planned spending increases (targeting investments, salaries of health and education personnel, housing construction and agriculture), the 2006 federal budget envisages a surplus of 3.2% of GDP. The actual outcome will probably be at least twice as high owing to the rather conservative oil price assumption underlying the budget. Taking into account the diminishing contribution of real net exports to GDP, wiiw expects GDP growth below 6% in the coming years. With more money and power consolidation at home, Russian self-confidence is growing. However, sustainable and broader-based long-term growth will require more investments and economic restructuring, neither to be expected in the absence of stepped-up institutional changes and improved transparency of legal regulations. A separate issue is the looming threat of labour shortages and the danger of an oil price collapse.

Table RU

## Russia: Selected economic indicators

	2001	2002	2003	2004	2005 <sup>1)</sup>	2005 1st quarter	2006	2006 forecast	2007
Population, th pers., end of period	145649	144964	144168	143474	142739	142824	142600	142500	142000
Gross domestic product, RUB bn, nom.	8943.6	10830.5	13243.2	16966.4	21598.0	4399.6	5722.3	26000	30000
annual change in % (real)	5.1	4.7	7.3	7.2	6.4	5.0	5.5	5.8	5.9
GDP/capita (EUR at exchange rate)	2345	2514	2641	3294	4285	.	.	.	.
GDP/capita (EUR at PPP - wiiw)	6440	6940	7510	8280	9040	.	.	.	.
Gross industrial production									
annual change in % (real)	4.9	3.7	7.0	6.1	4.0	3.2	3.0	4.0	4.5
Gross agricultural production									
annual change in % (real)	7.5	1.5	1.4	3.1	2.0	-0.1	1.3	.	.
Construction output total									
annual change in % (real)	9.9	2.7	14.4	10.1	10.5	5.0	-0.1	.	.
Consumption of households, RUB bn, nom.	4318.1	5400.3	6547.6	8132.6	10152.5	2207.7	.	.	.
annual change in % (real)	9.5	8.5	7.5	11.6	11.1	8.7	.	11	11
Gross fixed capital form., RUB bn, nom.	1689.3	1938.8	2432.2	3106.5	3926.1	606.0	.	.	.
annual change in % (real)	10.2	2.8	12.8	11.3	10.5	8.2	5.1	7	9
LFS - employed persons, th, avg. <sup>2)</sup>	64400	66163	66527	67385	68283	67067	68300	.	.
annual change in %	0.2	2.7	0.5	.	1.3	1.5	1.8	.	.
Reg. employment in industry, th pers., avg.	14692	14534	14345	14301	.	.	.	.	.
annual change in %	1.0	-1.1	-1.3	-0.3	.	.	.	.	.
LFS - unemployed, th pers., average <sup>2)</sup>	6416.0	5828.4	6227.5	6016.2	5608.5	5985.3	5793.7	.	.
LFS - unemployment rate in %, average <sup>2)</sup>	9.1	8.1	8.6	8.2	7.6	8.2	7.8	7.5	7
Reg. unemployment rate in %, end of period	1.6	2.1	2.3	2.6	2.5	2.7	2.6	.	.
Average gross monthly wages, RUB	3240.4	4360.3	5498.5	6739.5	8550.0	7638	9397	.	.
annual change in % (real, gross)	19.9	16.2	10.9	10.7	10.2	8.4	10.3	.	.
Consumer prices, % p.a.	21.6	16.0	13.6	11.0	12.5	12.9	10.8	10	9
Producer prices in industry, % p.a.	19.1	11.8	15.6	24.0	20.7	23.3	14.7	14	13
General governm.budget, nat.def., % GDP									
Revenues	30.0	32.5	31.3	32.0	35.2	39.3	37.9	.	.
Expenditures	27.1	31.6	29.9	27.5	27.5	24.3	24.2	.	.
Deficit (-) / surplus (+), % GDP	3.0	0.9	1.3	4.5	7.7	15.0	13.6	.	.
Public debt, nat.def., in % of GDP <sup>3)</sup>	44.1	37.0	28.6	21.7	14.9	.	.	.	.
Refinancing rate of NB % p.a., end of per.	25	21	16	13	12	13	12	.	.
Current account, EUR mn <sup>4)</sup>	37885	30789	31330	47127	67695	15461	23250	80000	60000
Current account in % of GDP	11.1	8.4	8.2	9.9	11.0	12.8	13.7	10.8	6.8
Gross reserves of NB, excl. gold, EUR mn <sup>4)</sup>	37026	42290	58531	88663	148094	103142	181240	.	.
Gross external debt, EUR mn <sup>4)</sup>	169530	147067	148776	157423	214274	170165	.	.	.
FDI inflow, EUR mn <sup>4)</sup>	3069	3660	7041	12422	11731	4573	.	.	.
FDI outflow, EUR mn <sup>4)</sup>	2828	3736	8606	11085	10547	2382	.	.	.
Exports of goods, BOP, EUR mn <sup>4)</sup>	113744	113468	120265	147357	195709	38274	56088	240000	250000
annual growth rate in %	0.2	-0.2	6.0	22.5	32.8	28.4	46.5	23	4
Imports of goods, BOP, EUR mn <sup>4)</sup>	60022	64470	67304	78327	100682	19572	25993	125000	140000
annual growth rate in %	23.8	7.4	4.4	16.4	28.5	22.9	32.8	24	12
Exports of services, BOP, EUR mn <sup>4)</sup>	12773	14393	14359	16321	19739	3627	4484	22000	24000
annual growth rate in %	23.6	12.7	-0.2	13.7	20.9	16.1	23.6	11	9
Imports of services, BOP, EUR mn <sup>4)</sup>	22967	24848	23997	27132	31546	5608	6726	36000	40000
annual growth rate in %	30.9	8.2	-3.4	13.1	16.3	9.2	19.9	14	11
Average exchange rate RUB/USD	29.17	31.35	30.69	28.81	28.30	27.88	28.10	28	27
Average exchange rate RUB/EUR (ECU)	26.13	29.65	34.69	35.81	35.22	36.52	33.84	35	34
Purchasing power parity RUB/USD, wiiw	8.15	9.27	10.36	12.07	14.04	.	.	15	16
Purchasing power parity RUB/EUR, wiiw	9.52	10.74	12.20	14.25	16.70	.	.	18.4	19.8

Notes: 1) Preliminary. - 2) From 2004 according to census October 2002. - 3) wiiw estimate. - 4) Converted from USD.

Source: wiiw Database incorporating national statistics; wiiw forecasts.