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Russian Federation: slowdown in sight, external surplus shrinks

The Russian economy has been booming in the past couple of years and most analysts – including wiiw – have been busy repeatedly revising forecasts upwards owing to surging energy prices. GDP growth exceeded 8% in 2007 according to the preliminary official data, driven by a double-digit expansion of household consumption and even faster growth of investments. During the past five years, real GDP grew by more than 40% and even more so in euro terms. At purchasing power parity, Russian per capita GDP exceeded EUR 12,000 in 2007 – 50% of the EU average – and the speed of catching up has been impressive (nearly 20 percentage points since the year 2000). After the surge of export revenues during 2004-2006, the export volume grew only slowly last year while imports (in both real and nominal terms) soared by about 25%. As a result, the trade and current account surpluses diminished and the contribution of net exports to GDP growth was again negative. Higher oil prices helped to increase energy export revenues, yet proceeds from other exports – in particular metals – expanded even faster in 2007. The share of energy in total export revenues thus dropped by about 2 percentage points in 2007 (to 61%) but it is too early to say whether this signals a reversal of the earlier trend.

Russia is awash in money: both foreign exchange reserves and capital inflows are at record levels (the inflow of FDI in 2007 amounted to some EUR 35 billion), the government budget runs a large surplus and public foreign debt has largely been paid back. The shadow side of the current economic boom is – apart from growing assertiveness, nationalism and ugly remnants of Soviet stereotypes – the return of double-digit inflation and strong rouble appreciation in real terms.

Return of double-digit inflation

The appreciation pressure remains strong given the huge inflows of foreign exchange, despite some relief provided by the Stabilization and Development Funds which accumulate part of energy-related export revenues. The managed peg exchange rate regime (the rouble is pegged to a basket of US dollar and euro, with the share of the latter gradually increasing) and the full liberalization of capital account transactions (since June 2006) require massive currency interventions. The rapid growth of money supply makes meeting the CBR inflation target extremely difficult. Besides, consumer price inflation is fuelled by rising prices for food, energy and housing as well as by administered tariff adjustments. These factors will translate into double-digit annual inflation in 2008; the official inflation target of 6-7% is out of reach again (producer price inflation will be even higher).

Thanks to large windfall gains from high world market energy prices, the Russian government was able not only to repay nearly all outstanding public external debts (although private debt increased) but to raise salaries in the public sector and pensions as well. Besides, several national development projects (infrastructure, housing, health sector, education and agriculture) were initiated. The recently (May 2007) adopted three-year budget plan for the period 2008-2010 reflects some important changes in economic policies. First, future budget revenues will depend less on energy proceeds (apart from the Stabilization Fund, which has been renamed Reserve Fund and will be maintained at 10% of GDP; another part of windfall proceeds from oil and gas exports will be accumulated in the newly established Development Fund). As a result, the share of budget revenues in GDP will decline by about 5 percentage points between 2007 and 2010. Second, government expenditures will increase (even as a share of GDP) with state-sponsored priority programmes to benefit most. In this way, the current government budget surpluses will be eliminated almost completely. The long-discussed controversial idea of Industrial Policy (IP) has apparently gained official blessing. The government-sponsored IP will offer targeted support to various public-private partnership projects in the automotive, aviation, shipbuilding and selected high-tech industries (such as nano, nuclear and space technologies).

Diversification with Industrial Policy tools

The main challenge for the Russian economy in the medium and long run is whether it will succeed in replacing energy exports as the key growth driver, and how it will cope with the acute demographic crisis (the population is projected to decline by nearly 10 million in the coming decade). The officially endorsed long-term development programme envisages in its ‘innovation scenario’ an ambitious economic diversification away from the current heavy reliance on energy and a gradual switch to innovation-based development supported by the above-mentioned IP, as well as the completion of reforms aiming at an improved climate for investments and entrepreneurship. Growing investments in transport infrastructure, education, health and R&D should help to generate an average annual GDP growth rate above 6% over the next decade. In this scenario, the Russian economy will restructure, become more efficient, modern and competitive. Alternative scenarios, based on continued reliance on energy resources, lower oil prices and less investments would generate GDP growth rates around 4-5% whereas the Urals oil price at last year’s level (USD 70 per bbl) would help to keep GDP growth at 7% in 2008.

Growth slowdown inevitable, current account surplus disappears

The wiiw forecast for the coming years is closer to the official ‘intermediate’ scenario which reckons with ongoing reliance on the (modernized) energy sector, possibly with a few high-tech niches, and average annual GDP growth of around 5-6%. The expected growth slowdown appears inevitable, at least until the end of the decade before any (uncertain) modernization efforts start to bear fruit. Our forecast is based on relatively stable oil prices and limited effects of any (potential) impact of financial markets turmoil. Both private consumption and investments are expected to grow faster than GDP, real exports will continue to be sluggish while imports will expand roughly in line with private consumption. This implies an ongoing negative (albeit diminishing) contribution of real net exports to GDP and – in nominal terms – a gradual reduction of trade and current account surpluses (in fact, the current account surplus may disappear already in 2009). Inflation will remain stubbornly close to 10%. Assuming a fairly constant nominal rouble exchange rate, this implies continued real appreciation. The latter represents – apart from the less likely risk of an oil price collapse – the major challenge for Russian growth, restructuring and competitiveness owing to its adverse effect on unit labour costs.[1] Another potential risk is related to the danger of overheating in consumer and credit markets where especially consumer credits were growing particularly fast (by about 40% per year during 2006-2007, albeit from a low level). The danger of contagion from the current subprime crisis cannot be ignored either, particularly if the possible recession in the United States this year leads to a slump in global oil prices. However, the accumulated foreign exchange reserves (including the two Oil Funds) should help to avoid any major financial crisis.

Duo Medvedev-Putin potentially dissonant

The recent economic developments have been overshadowed by politics, in particular by the issue of Vladimir Putin's successor in March 2008. Putin's last-minute support of the United Russia party helped to secure it a comfortable majority in the Duma; his endorsement of Deputy Prime Minister (and Gazprom Chairman) Dmitri Medvedev as the preferred candidate while agreeing to serve as Prime Minister in the new government will secure Mr Medvedev's easy victory in the March presidential elections. There is little doubt that Mr Putin will dominate Russian politics in the years to come and the suggested constellation (President Medvedev and Prime Minister Putin) may lead to tensions, at least between their respective apparatuses. Nevertheless, the economic outlook remains broadly positive with both consumption and investment (including FDI) expanding. The risks of overheating in housing and credit markets appear manageable. With a stronger economy, more financial resources and power consolidation at home, Russia's self-confidence (as well as outward investments) will grow further – and this may lead to more conflicts with the West, although tensions may calm down after the elections.

[1] Average gross wages exceeded EUR 370 per month in 2007. During 2000-2007, unit labour costs in Russia were rising by more than 20% per year and are now already higher than in Bulgaria and Slovakia.

Table RU

Russia: Selected Economic Indicators

	2002	2003	2004	2005	2006	2007 1)	2008	2009	2010
								Forecast	
Population, th pers., end of period 2)	144,964	144,168	143,474	142,754	142,221	141,500	141,000	140,500	140,000
Gross domestic product, RUB bn, nom.	10,831	13,243	17,048	21,625	26,883	32,989	37,200	43,000	49,000
annual change in % (real)	4.7	7.3	7.2	6.4	7.4	8.1	6.4	6	5.5
GDP/capita (EUR at exchange rate)	2,514	2,641	3,310	4,290	5,536	6,642	.	.	.
GDP/capita (EUR at PPP - wiiw)	7,680	8,310	9,170	10,030	11,070	12,320	.	.	.
Gross industrial production									
annual change in % (real)	3.1	8.9	8.3	4.0	3.9	6.3	5.5	5	5
Gross agricultural production									
annual change in % (real)	1.5	1.3	3.0	2.3	3.6	3.3	.	.	.
Construction output total									
annual change in % (real)	2.7	14.4	10.1	10.5	18.1	18.2	.	.	.
Consumption of households, RUB bn, nom.	5,400	6,540	8,406	10,590	12,883	15,804	.	.	.
annual change in % (real)	8.5	7.5	12.1	11.8	11.3	13.1	12	8.5	6.3
Gross fixed capital form., RUB bn, nom.	1,939	2,432	3,131	3,837	4,957	6,940	.	.	.
annual change in % (real)	2.8	12.8	12.6	10.6	17.5	20.8	12.9	10.4	9.4
LFS - employed persons, th, avg.	66,659	66,432	67,275	68,169	68,693	70,528	70,300	70,500	70,600
annual change in %	2.4	-0.3	.	1.3	0.8	2.7	.	.	.
Reg. employment in industry, th pers., avg.	15,135	14,934	14,775	14,469	14,325	.	.	.	.
annual change in %	-1.2	-1.3	-1.1	-2.1	-1.0	.	.	.	.
LFS - unemployed, th pers., average	5,698	5,959	5,675	5,263	5,001	4,639	.	.	.
LFS - unemployment rate in %, average	7.9	8.2	7.8	7.2	6.8	6.2	5.8	5.5	5.5
Reg. unemployment rate in %, end of period	2.1	2.3	2.6	2.5	2.3	2.1	.	.	.
Average gross monthly wages, RUB	4,360	5,499	6,740	8,555	10,634	13,518	.	.	.
annual change in % (real, gross)	16.2	10.9	10.6	12.6	13.3	16.0	.	.	.
Consumer prices, % p.a.	16.0	13.6	11.0	12.5	9.7	9.1	10	9	8
Producer prices in industry, % p.a.	11.8	15.6	24.0	20.7	12.4	14.1	15	13	10
General governm.budget, nat.def., % GDP									
Revenues	32.5	31.3	31.9	39.7	39.7	40	41	.	.
Expenditures	31.6	29.9	27.4	31.5	31.3	36	38	.	.
Deficit (-) / surplus (+), % GDP	0.9	1.3	4.5	8.1	8.4	4	3	.	.
Public debt, nat.def., in % of GDP 3)	37.0	28.6	21.6	14.9	8.9	.	.	.	.
Refinancing rate of NB % p.a., end of per.	21	16	13	12	11	10	.	.	.
Current account, EUR mn 4)	30,788	31,330	47,868	67,851	77,091	56,000	25,000	5,000	-15,000
Current account in % of GDP	8.4	8.2	10.1	11.1	9.8	5.9	2.4	0.4	-1.1
Gross reserves of NB, excl. gold, EUR mn	42,290	58,531	88,663	148,094	244,190	317,220	.	.	.
Gross external debt, EUR mn	147,067	148,776	156,689	216,553	256,609	310,000	.	.	.
Gross external debt in % of GDP	45.0	41.4	34.8	34.2	32.5	33.8	.	.	.
FDI inflow, EUR mn 4)	3,660	7,041	12,422	10,354	24,496	34,380	40,000	.	.
FDI outflow, EUR mn 4)	3,736	8,606	11,085	10,258	18,570	25,000	30,000	.	.
Exports of goods, BOP, EUR mn 4)	113,468	120,265	147,358	195,894	243,793	258,000	265,000	275,000	285,000
annual growth rate in %	-0.2	6.0	22.5	32.9	24.5	6	3	4	4
Imports of goods, BOP, EUR mn 4)	64,470	67,304	78,327	100,787	132,106	165,000	200,000	230,000	255,000
annual growth rate in %	7.4	4.4	16.4	28.7	31.1	25	21	15	11
Exports of services, BOP, EUR mn 4)	14,393	14,359	16,564	20,064	24,808	28,000	30,000	32,000	35,000
annual growth rate in %	12.7	-0.2	15.4	21.1	23.6	13	7	7	9
Imports of services, BOP, EUR mn 4)	24,848	23,997	26,774	31,229	35,887	43,000	50,000	55,000	60,000
annual growth rate in %	8.2	-3.4	11.6	16.6	14.9	20	16	10	9
Average exchange rate RUB/USD	31.35	30.69	28.81	28.30	27.34	25.58	25.3	25.5	26
Average exchange rate RUB/EUR (ECU)	29.65	34.69	35.81	35.22	34.08	35.01	35.4	35	35
Purchasing power parity RUB/USD, wiiw 5)	8.47	9.45	11.03	12.74	14.29	15.84	.	.	.
Purchasing power parity RUB/EUR, wiiw 5)	9.70	11.02	12.92	15.06	17.04	18.87	21.6	23.1	24.8

Note: The term "industry" refers to NACE classification C+D+E.

1) Preliminary and wiiw estimates. - 2) Resident population. - 3) wiiw estimate. - 4) Converted from USD to EUR at the official cross exchange rate. - 5) wiiw estimates based on the 2005 International Comparison Project benchmark.

Source: wiiw Database incorporating national statistics; wiiw forecasts.