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Russian Federation: booming domestic demand prevents overall growth slowdown

Contrary to most expectations, Russian economic growth apparently accelerated in 2007. In the first quarter of the year, the GDP increased by nearly 8% as the boom in domestic demand exceeded earlier forecasts. Both private consumption and especially investments expanded at double-digit rates, driven by rapidly growing real wages and incomes (consumption) and by record capital inflows (including FDI). As expected, real exports remain nearly flat while imports continue to surge. In terms of contributions to GDP growth, private consumption, with its share in GDP meanwhile exceeding 60%, has become a major driving force. The contribution of real net exports to GDP growth has again been negative; the export surplus is rapidly diminishing and the estimated trade balance at constant 2003 prices will turn into the red in 2007. Still, the GDP growth forecast for the current year had to be revised upwards – albeit slightly.

Domestic demand supports the extraordinary construction boom (housing in particular, but newly launched infrastructure projects as well) and that of retail trade. A growing part of retail sales represents imported goods: imports of passenger cars, for example, reached a record level in the first quarter of 2007. However, also the domestic industry seems to benefit as the output of manufacturing expanded by more than 12% in January-April 2007 compared to the same period of the previous year. And there is some evidence that not only domestic industrial sales are recovering: in the first quarter of the year non-energy export revenues increased by nearly 20% in US dollar terms and, for the first time in many years, their share in total export revenues went up (from 33% of the total in the first quarter of 2006 to 38% in the corresponding period of 2007). This is certainly a welcome development in view of stagnating exports of energy (natural gas in particular) and meagre extraction growth. Yet whether this signals a reversal of trend is doubtful – especially given the ongoing competitiveness losses that result from rapidly rising unit labour costs as wages are growing much faster than productivity and the rouble appreciates (in real effective terms by another 5% in the first quarter of 2007).

Indeed, the prevention of excessive rouble appreciation has been one of the key challenges for the Central Bank of Russia (CBR). The appreciation pressure is strong given the huge inflows of foreign exchange – despite some relief provided by the Stabilization Fund, which accumulates part of energy-related export revenues. Fund assets are currently being invested mainly in USD- and EUR-denominated sovereign bonds. Net inflows of foreign capital reached USD 41 billion in 2006, and more than USD 60 billion in January-April 2007. The CBR foreign exchange reserves exceeded USD 400 billion in June 2007 (about one quarter of which represents the Stabilization Fund) and are now the third highest in the world (after China and Japan). The managed peg exchange rate regime

(the rouble is pegged to a basket of USD and EUR with the share of the latter gradually increasing) and the full liberalization of capital account transactions (since June 2006) require massive currency interventions. As a result, the money supply is growing fast (M2 increased by nearly 50% in 2006 and by another 5% in the first quarter of 2007), in particular of household deposits and credits to companies in foreign currency. The rapid money supply growth makes the meeting of the CBR inflation target extremely difficult. Still, consumer price inflation dropped for the first time to single digits in 2006 and a gradual disinflation is expected to continue: the CBR target of 8% annual CPI inflation for 2007 seems to be within reach.

Revenues of the state budget jumped to nearly 40% of GDP in both 2005 and 2006 and the budget has been enjoying huge surpluses (around 8% of GDP). Thanks to windfall gains from high world market energy prices, the Russian government was able not only to repay nearly all of outstanding external debts but also to increase salaries in the public sector as well as pensions. Besides, several national development projects (infrastructure, housing, health sector, education and agriculture) were initiated. The recently (May 2007) adopted three-years budget plan for the period 2008-2010 reflects some important changes in economic policies. First, the 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 2006 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 should offer targeted support to various public-private partnership projects in the automotive, aviation and other high-tech industries. Whether the creation of a more favourable climate for foreign investors (as promised by President Putin at the June 2007 Economic Summit in St. Petersburg) will become a part of the government's IP remains to be seen.

Rising state expenditures, surging capital-related foreign exchange inflows (with the concomitant money supply expansion) and the strong growth of consumer demand will keep inflationary pressures alive. However, the main challenges for the Russian economy in the medium and long run are whether it succeeds in replacing energy exports as the key growth engine by other drivers, and how it will deal with the acute demographic crisis (the population is projected to decline by nearly 10 million in the coming decade). The officially endorsed development scenario (presented by the Ministry of Economic Development and Trade at the mentioned Economic Summit) relies on innovation and high-tech developments supported by the Industrial Policy referred to above. Growing investments in

transport infrastructure, education, health and R&D should help to generate an average annual GDP growth rate of 6.6% over the next decade. 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 growth of 5.3%. Such a growth slowdown appears inevitable, at least in the coming couple of years, before any (uncertain) modernization efforts bear fruit.

Needless to say, both scenarios implicitly assume stepped-up reforms – which have stalled in the past few years. Economic policy decisions have been overshadowed by politics, especially by the looming issue of Putin's successor in 2008. EU–Russian relations have deteriorated recently. The EU is concerned mainly with energy supplies; the future contractual relations with Russia are unclear after the expiry of the current Partnership and Cooperation Agreement (PCA) in November (and the start of EU negotiations is blocked by Poland). With growing economic strength, Russian external policies are becoming also more assertive. In particular, the Kremlin is gaining confidence that it can regain its foothold in the former Soviet republics (or at least prevent a more intensive involvement of the EU in this region). The strategy seems to bear some fruit, for example in Belarus, Kazakhstan and Ukraine, but also elsewhere as the influence of Russian investments is rapidly increasing. Meanwhile, Gazprom, Rosneft and other large state-owned (or state-controlled) corporations are going global while consolidating their control over domestic assets and strategic resources. Russian energy and metals giants acquire assets abroad, not least in the former Soviet republics. Simultaneously, the inflows of FDI to Russia are rapidly rising, thanks to both returning Russian offshore capital and the country's improved credit rating. The repeatedly delayed WTO accession still seems to be imminent – despite worsening relations with the West and remaining bottlenecks (e.g. with Georgia, Estonia). Broadly speaking, the economic outlook remains positive with both consumption and investments (including FDI) growing rapidly. With more money and power consolidation at home, Russian self-confidence will grow further – and this may lead to more conflicts with the West.

Table RU

Russia: Selected Economic Indicators

	2002	2003	2004	2005	2006 ¹⁾	2006 1st quarter	2007 1st quarter	2007 forecast	2008 forecast
Population, th pers., end of period ²⁾	144964	144168	143474	142754	142192	142600	142100	141500	141000
Gross domestic product, RUB bn, nom.	10830.5	13243.2	17048.1	21620.1	26781.1	5661.8	6566.2	31000	35000
annual change in % (real)	4.7	7.3	7.2	6.4	6.7	5.0	7.9	6.9	5.2
GDP/capita (EUR at exchange rate)	2514	2641	3310	4290	5516	.	.	.	.
GDP/capita (EUR at PPP - wiiw)	6940	7510	8280	9040	9880	.	.	.	.
Gross industrial production									
annual change in % (real)	3.1	8.9	8.3	4.0	3.9	3.0	8.4	6	5.0
Gross agricultural production									
annual change in % (real)	1.5	1.3	3.0	2.4	2.8	1.3	1.9	.	.
Construction output total									
annual change in % (real)	2.7	14.4	10.1	10.5	14.5	-0.1	23	.	.
Consumption of households, RUB bn, nom.	5400.3	6540.1	8405.6	10628.9	12910.9	2783.1	3332.6	.	.
annual change in % (real)	8.5	7.5	12.1	12.8	11.2	9.6	11.9	15	10
Gross fixed capital form., RUB bn, nom.	1939.3	2432.3	3130.5	3848.4	4795.6	679.0	922.4	.	.
annual change in % (real)	2.8	12.8	12.6	8.3	13.9	5.7	19.8	14	12
LFS - employed persons, th, avg.	66659	66432	67275	68169	68799	67704	68567	.	.
annual change in %	2.4	-0.3	.	1.3	0.9	1.0	1.3	.	.
Reg. employment in industry, th pers., avg.	15135	14934	14775	14469	.	.	.	.	.
annual change in %	-1.2	-1.3	-1.1	-2.1	.	.	.	.	.
LFS - unemployed, th pers., average	5698.3	5959.2	5674.8	5262.8	5309.3	5729.0	5333.3	.	.
LFS - unemployment rate in %, average	7.9	8.2	7.8	7.2	7.2	7.8	7.2	7	6.5
Reg. unemployment rate in %, end of period	2.1	2.3	2.6	2.5	2.3	2.6	2.3	.	.
Average gross monthly wages, RUB	4360.3	5498.5	6739.5	8554.9	10736.0	9395.0	11922.3	.	.
annual change in % (real, gross)	16.2	10.9	10.6	12.6	13.5	10.3	18.4	.	.
Consumer prices, % p.a.	16.0	13.6	11.0	12.5	9.8	10.9	7.8	8	7
Producer prices in industry, % p.a.	11.8	15.6	24.0	20.7	12.4	14.8	8.6	9	8
General governm.budget, nat.def., % GDP									
Revenues	32.5	31.3	31.9	39.7	39.7	35.1	.	40	41
Expenditures	31.6	29.9	27.4	31.5	31.3	22.5	.	36	38
Deficit (-) / surplus (+), % GDP	0.9	1.3	4.5	8.1	8.5	12.6	.	4	3
Public debt, nat.def., in % of GDP ³⁾	37.0	28.6	21.7	14.9	9.0	.	.	.	.
Refinancing rate of NB % p.a., end of per.	21	16	13	12	11	12	10.5	.	.
Current account, EUR mn ⁴⁾	30788	31330	47457	67368	75776	25339	16678.5	60000	55000
Current account in % of GDP	8.4	8.2	10.0	11.0	9.6	12.6	6.7	6.6	5.3
Gross reserves of NB, excl. gold, EUR mn	42290	58531	88663	148094	244190	164781	247719	300000	.
Gross external debt, EUR mn	147067	148776	157423	216553	255866	226590	.	.	.
Gross external debt in % of GDP	40.3	39.0	33.1	35.3	32.6	.	.	.	.
FDI inflow, EUR mn ⁴⁾	3660	7041	12422	10258	23047	6176.3	.	.	.
FDI outflow, EUR mn ⁴⁾	3736	8606	11085	10255	14422	4099.5	.	.	.
Exports of goods, BOP, EUR mn ⁴⁾	113468	120265	147357	195894	243792	55929	53406	250000	260000
annual growth rate in %	-0.2	6.0	22.5	32.9	24.5	46.0	-4.5	3	4
Imports of goods, BOP, EUR mn ⁴⁾	64470	67304	78327	100787	132106	25740	32166	155000	175000
annual growth rate in %	7.4	4.4	16.4	28.7	31.1	31.2	25.0	17	13
Exports of services, BOP, EUR mn ⁴⁾	14393	14359	16373	19767	24337	4808	5119	25000	25500
annual growth rate in %	12.7	-0.2	14.0	20.7	23.1	32.1	6.5	3	2
Imports of services, BOP, EUR mn ⁴⁾	24848	23997	27131	31688	36312	6981	7106	40000	43000
annual growth rate in %	8.2	-3.4	13.1	16.8	14.6	25.1	1.8	10	8
Average exchange rate RUB/USD	31.35	30.69	28.81	28.30	27.34	28.10	26.33	26	26
Average exchange rate RUB/EUR (ECU)	29.65	34.69	35.81	35.22	34.08	33.84	34.46	34	34
Purchasing power parity RUB/USD, wiiw	9.27	10.35	12.09	13.99	15.78	.	.	.	.
Purchasing power parity RUB/EUR, wiiw	10.74	12.20	14.32	16.72	19.03	.	.	.	.

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

1) Preliminary. - 2) Resident population. - 3) wiiw estimate. - 4) Converted from USD to EUR at the official cross exchange rate.

Source: wiiw Database incorporating national statistics; wiiw forecasts.