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Russian Federation: Economic growth, political stalemate

The economy has been growing by about 4% per year. Huge fluctuations in prices and inventories are affecting the reliability of GDP growth figures. Inflation has accelerated and remains stubbornly close to 10%. The long-term strategic target of economic diversification and modernization remains high on the agenda. The wiiw forecast reckons with continued, yet unspectacular, GDP growth over the period 2011-2013. With some luck, inflation may remain in single digits during 2011 and the budget deficit will evolve into a surplus. We have every expectation of President Medvedev being re-elected and the ruling Medvedev-Putin tandem continuing after March 2012.

The Russian economy has currently been growing at a rather moderate rate – especially in the emerging market and BRICs context – of about 4% per year. The current GDP growth has been quite modest both in comparison to the pre-crisis period (around 7% per year on average during 2005-2008) and in view of the depth of the recent crisis (GDP fell by nearly 8% in 2009) and also given the strong recovery of oil prices and the related surge in Russian export revenues. With oil prices exceeding 100 USD per barrel in the first quarter of 2011 (nearly 40% more than in the previous year's period) export revenues were up by more than 20%. Simultaneously, imports were rising even faster (by close to 40% in nominal EUR terms) thus dampening the robustness of the export-led recovery. Huge fluctuations in prices and inventories, along with statistical discrepancies, are affecting GDP growth figures.

In 2011 again, large gaps between the nominal and real growth rates of exports and imports, together with the ongoing replenishment of inventories, exert a disproportionate impact on forecast GDP. Preliminary official data published in June 2011 put the real GDP growth for the first quarter of the year at 4.1% while the GDP deflator accelerated to 14.1%. Yet similarly to previous years there are considerable inconsistencies: the official estimates for 2010 suggest that domestic demand remained relatively subdued as final consumption expenditure grew by just 2.5% and gross fixed capital formation increased by 6%. Still the overall gross investment jumped by nearly 30% owing to the increase in

inventories. At the same time, real net exports contracted by about 20% since the volume of exports grew by 7% while imports soared by 25%.¹

The latest economic data provide a mixed picture as well: The growth of industry and goods transport has slowed down in the first months of 2011. Construction output has ceased to fall after two years of contraction but gross fixed investments dropped. Agriculture is recovering from last year's drought and forest fires: the 2011 grain harvest is expected to reach about 95 million tonnes and the export ban imposed one year ago was lifted as of 1 July 2011. Household consumption and retail trade turnover rose somewhat in the first quarter of 2011 – despite declining real incomes and stagnating real wages (both suffering from price increases yet growing in euro terms thanks to the rouble's nominal appreciation).

The inflation slowdown (and even producer price deflation) that occurred during the 2009 crisis was short lived. Inflation has accelerated since late 2010 and remains stubbornly high: the annual consumer price inflation is approaching 10%, in particular due to food price hikes (especially vegetables). The producer price inflation even exceeded 20% in the first quarter of 2011 as a consequence of rising energy and metals prices. It can be expected that the rising producer prices will be eventually felt by consumers as well. The only factor (apart from a slight tightening of monetary policy) mitigating inflationary pressures is the above-mentioned nominal rouble appreciation – a by-product of surging export revenues and related foreign exchange inflows. After a short-lived depreciation during the peak of the crisis at the turn of 2008/2009, real appreciation – by some 20% against the euro since the beginning of 2010 – has been one of the factors behind surging imports. That notwithstanding, foreign exchange reserves are being gradually replenished, although capital flight again accelerated in late 2010-early 2011, most likely due to political uncertainties before the pending Duma and especially presidential elections in December 2011 and March 2012, respectively. The banking sector has consolidated: both deposits and credits have been growing, and 2010 bank profits have probably reached the pre-crisis level. The share of non-performing loans hovers at around 7% (though at least one third of credits have been restructured); the volume of new mortgages doubled between the first quarters of 2010 and 2011.

¹ Wide fluctuations in individual components of GDP are not unusual: in the crisis year 2009, inventories and net exports moved in the opposite direction as the former were cut during the crisis while the export surplus surged owing to deep import cuts. Needless to say, such large swings involve serious valuation and other statistical problems, thus leaving much room for uncertainty and future adjustments. The discrepancy between nominal and real growth rates of exports and imports was particularly high in 2010: in nominal euro terms, both exports and imports increased by nearly 40% and the export surplus rose by more than EUR 30 billion (+37%) according to balance of payments data.

As mentioned in our previous assessments, the crisis has not been used as a stimulus for an overhaul of economic policies towards a more favourable business climate. And Russia has become even more dependent on exports of commodities; restructuring, modernization and the 'innovation development' preached by the authorities already for a couple of years have so far been just slogans. The costs of anti-crisis measures implemented from late 2008 added up to some 10% of GDP; judging by the sharp fall in consumption and particularly of investment during 2009, their effects have been rather disappointing. Largely due to surging exports and related tax revenues, but also due to expenditure cuts as fiscal stimuli have been gradually phased out (at least as a proportion of GDP), the federal budget turned from deficit into a surplus between January-April 2010 and the same period of 2011. At the same time, the non-oil budget deficit remains high, at more than 10% of GDP, which underlines the Russian economy's vulnerability to oil price fluctuations.

The long-term strategic target of economic diversification and modernization remains high on the agenda and is being pursued, at least verbally, by President Medvedev. Apart from priority modernization areas announced already in early 2008 before the crisis hit (innovation, institutions, infrastructure and investment), the sectoral programmes include energy, nuclear technologies, global information technologies, medical equipment and pharmaceuticals. The highly publicized innovation centre Skolkovo near Moscow has become a (controversial) symbol of the current innovation drive. Russia's accession to WTO (postponed once more in June 2009 on the pretext of forming a Customs Union with Belarus and Kazakhstan) came back on the agenda and may be finalized before the end of 2011. The privatization plan for the period 2011-2013 has recently been (re)launched again.

The anxiety surrounding the forthcoming Duma (December 2011) and presidential elections (March 2012) fuels uncertainty. There is a lot of speculation whether it will be Putin or Medvedev (less likely both) who will announce his candidacy. The electorate is becoming increasingly apathetic and the leadership's concern is how to mobilize the voters (the Russian president is elected directly by a popular vote). In May 2011, Prime Minister Putin initiated a new 'National Front' movement on the basis of the no-thrill and largely discredited United Russia party. Other political moves in the pre-election reshuffles were the dismissal of the Federation Council speaker S. Mironov and the announcement of one of the key Russian oligarchs, M. Prokhorov, to head the liberal opposition party Pravoye Delo (a creation of Kremlin spin doctors according to some pundits). President Medvedev, who attempts to strike a more liberal tone, and Prime Minister Putin have so far been silent regarding their candidacy in the presidential elections (though none of them excluded it either)

The current wiiw forecast reckons with continued, yet unspectacular GDP growth during 2011-2013. The GDP growth forecast for 2011 has been revised slightly upwards owing to higher than originally expected export revenues and the related increase in domestic spending, in particular the pick-up of investment (partly associated with the forthcoming elections). Still, growth will be much lower than in the pre-crisis period and will gradually diminish given the stabilized oil prices (Urals costing around USD 100 per barrel). This baseline scenario assumes no abrupt policy changes or external shocks. Real export growth will continue to be sluggish at best since the volumes of exported oil and gas will hardly increase in the forecasting period (and there will be not much else to export since the progress in export diversification will be limited), while import volumes will grow at a faster rate as household consumption and investment will gradually pick up, both fuelled by the ongoing real currency appreciation. This (optimistic) scenario implies a negative contribution of real net exports to GDP growth in the coming years and, in nominal terms, gradual reductions of the trade and current account surpluses. With some luck the annual CPI inflation will stay in single digits during 2011 and the budget deficit will turn into a surplus again.

Yet the high oil prices are a double-edged sword: on the one hand, export revenues (and taxes) fill government revenues enabling the state to finance various spending programmes which range from rising pensions to infrastructure investments. This is helpful – especially in the pre-election period. On the other hand, the Russian economy's growing vulnerability concerning commodity prices is risky – as demonstrated during the 2008/2009 crisis. Besides, high revenues from commodity exports put off the pressure to diversify and modernize the economy, stimulate currency appreciation and impede the competitiveness of non-commodity exports (Dutch Disease syndrome). Therefore, a new collapse of world market energy prices (which appears rather unlikely at the moment) would result in major troubles for the Russian economy: a sharp fall in economic growth with a simultaneous increase in the fiscal deficit, both adversely affecting all components of GDP.

The effects of the crisis on employment have been rather modest and the labour market situation is gradually improving: unemployment dropped by about 1 million persons within one year. But the shrinking labour force due to demographic factors, emerging skill shortages that are magnified by outward migration (mostly to the West) and the demand for unskilled workers usually met by migrants (mostly from former Soviet republics) are among the challenges constraining future economic growth. Our previous assessment thus remains largely unchanged regarding GDP growth prospects, sources of growth and labour market developments: GDP growth will stay below pre-crisis levels, labour

shortages are likely to reappear soon and will definitely put a brake on economic growth already in the medium run. The chances for a successful modernization and restructuring of the economy remain slim – at least in the forecasting period up to 2013. Our bet is on the re-election of President Medvedev and the continuation of the ruling Medvedev-Putin tandem after March 2012.

Table RU

Russia: Selected Economic Indicators

| | 2007 | 2008 | 2009 | 2010 ¹⁾ | 2010 1st quarter | 2011 | 2011 Forecast | 2012 Forecast | 2013 |
|---|---------|---------|---------|--------------------|---------------------|---------|------------------|------------------|--------|
| Population, th pers., average ²⁾ | 142115 | 141956 | 141902 | 142938 | . | . | 139500 | 139000 | 138500 |
| Gross domestic product, RUB bn, nom. ³⁾ | 33247.5 | 41276.8 | 38786.4 | 44939.2 | 9571.9 | 11410.0 | 51600 | 58000 | 64800 |
| annual change in % (real) ³⁾ | 8.5 | 5.2 | -7.8 | 4.0 | 3.5 | 4.1 | 4.5 | 4.4 | 4.1 |
| GDP/capita (EUR at exchange rate) | 6700 | 8000 | 6200 | 7800 | . | . | . | . | . |
| GDP/capita (EUR at PPP - wiiw) | 12500 | 13200 | 12000 | 12600 | . | . | . | . | . |
| Consumption of households, RUB bn, nom. ³⁾ | 16031.7 | 19966.9 | 20979.9 | 23096.6 | 5170.4 | . | . | . | . |
| annual change in % (real) ³⁾ | 14.3 | 10.6 | -4.8 | 3.0 | -0.5 | . | 4.2 | 5.5 | 5 |
| Gross fixed capital form., RUB bn, nom. ³⁾ | 6980.4 | 9200.8 | 8530.7 | 9843.7 | 1385.2 | . | . | . | . |
| annual change in % (real) ³⁾ | 21.0 | 10.6 | -14.4 | 6.1 | -4.4 | . | 3 | 6 | 6 |
| Gross industrial production | | | | | | | | | |
| annual change in % (real) | 6.3 | 2.1 | -9.3 | 8.2 | 9.5 | 5.9 | 5 | 6 | 5 |
| Gross agricultural production | | | | | | | | | |
| annual change in % (real) | 3.4 | 10.8 | 1.4 | -11.9 | 3.6 | 0.7 | . | . | . |
| Construction industry | | | | | | | | | |
| annual change in % (real) | 18.2 | 12.8 | -13.2 | -2.3 | -11.1 | 1.6 | 5 | 8 | 5 |
| Employed persons - LFS, th, average | 70570.5 | 70965.1 | 69284.9 | 69803.0 | 67998.3 | 69426.7 | 69500 | 69300 | 69000 |
| annual change in % | 2.5 | 0.6 | -2.4 | 0.7 | 0.4 | 2.1 | -0.4 | -0.3 | -0.4 |
| Unemployed persons - LFS, th, average | 4589.0 | 4791.5 | 6372.8 | 5645.0 | 6562.0 | 5618.3 | 5500 | 5300 | 5000 |
| Unemployment rate - LFS, in %, average | 6.1 | 6.3 | 8.4 | 7.5 | 8.6 | 7.5 | 7.3 | 7 | 6.8 |
| Reg. unemployment rate, in %, end of period | 2.0 | 2.0 | 2.9 | 2.1 | 3.0 | 2.2 | . | . | . |
| Average gross monthly wages, RUB | 13593.4 | 17290.0 | 18795.0 | 21090.0 | 19514.7 | 21158.7 | 23500 | 25800 | 28500 |
| annual change in % (real, gross) | 17.0 | 10.3 | -2.8 | 4.2 | 3.1 | 0.5 | 4.1 | 4.5 | 5.2 |
| Consumer prices, % p.a. | 9.1 | 14.1 | 11.8 | 7.1 | 7.2 | 9.5 | 9 | 7 | 5 |
| Producer prices in industry, % p.a. ⁴⁾ | 14.1 | 21.4 | -7.2 | 12.2 | 13.8 | 21.3 | 15 | 10 | 7 |
| General governm.budget, nat.def., % GDP | | | | | | | | | |
| Revenues | 40.2 | 38.8 | 35.1 | 35.3 | 36.2 | 38.5 | . | . | . |
| Expenditures | 34.2 | 33.9 | 41.1 | 38.9 | 33.7 | 31.3 | . | . | . |
| Deficit (-) / surplus (+), % GDP | 6.0 | 4.9 | -6.3 | -3.6 | 2.5 | 7.2 | 0 | 0 | 0 |
| Public debt, nat.def., in % of GDP ⁵⁾ | 6.7 | 5.7 | 8.3 | 8.6 | 7.2 | 8.1 | 8 | 7 | 6 |
| Central bank policy rate, % p.a., end of period ⁶⁾ | 10.0 | 13.0 | 8.8 | 7.8 | 8.3 | 8.0 | . | . | . |
| Current account, EUR mn ⁷⁾ | 56818 | 70642 | 34961 | 53899 | 24587 | 23250 | 60000 | 45000 | 40000 |
| Current account in % of GDP | 6.0 | 6.2 | 4.0 | 4.8 | 10.6 | 8.2 | 4.7 | 3.1 | 2.5 |
| Exports of goods, BOP, EUR mn ⁷⁾ | 258930 | 321792 | 218221 | 303202 | 68118 | 82327 | 330000 | 350000 | 370000 |
| annual growth rate in % | 7.0 | 24.3 | -32.2 | 38.9 | 55.6 | 20.9 | 9 | 6 | 6 |
| Imports of goods, BOP, EUR mn ⁷⁾ | 163282 | 199148 | 137960 | 188483 | 33748 | 47086 | 230000 | 250000 | 270000 |
| annual growth rate in % | 24.7 | 22.0 | -30.7 | 36.6 | 14.7 | 39.5 | 22 | 9 | 8 |
| Exports of services, BOP, EUR mn ⁷⁾ | 28681 | 34921 | 29918 | 33702 | 6692 | 7165 | 40000 | 45000 | 50000 |
| annual growth rate in % | 15.7 | 21.8 | -14.3 | 12.6 | 5.2 | 7.1 | 19 | 13 | 11 |
| Imports of services, BOP, EUR mn ⁷⁾ | 42481 | 51495 | 44185 | 54763 | 10124 | 11187 | 60000 | 70000 | 80000 |
| annual growth rate in % | 19.2 | 21.2 | -14.2 | 23.9 | 8.9 | 10.5 | 10 | 17 | 14 |
| FDI inflow, EUR mn ⁷⁾ | 40237 | 51177 | 26254 | 31215 | 5962 | . | 45000 | 55000 | 60000 |
| FDI outflow, EUR mn ⁷⁾ | 33547 | 37934 | 31407 | 39174 | 7566 | . | 40000 | 45000 | 40000 |
| Gross reserves of NB, excl. gold, EUR mn | 318840 | 291916 | 290432 | 335191 | 313085 | 330657 | . | . | . |
| Gross external debt, EUR mn | 316903 | 340688 | 325697 | 369242 | 342734 | 358469 | . | . | . |
| Gross external debt in % of GDP | 33.4 | 30.1 | 37.1 | 33.1 | 30.7 | 27.8 | . | . | . |
| Average exchange rate RUB/EUR | 35.01 | 36.43 | 44.14 | 40.30 | 41.41 | 40.03 | 40 | 40 | 40 |
| Purchasing power parity RUB/EUR, wiiw ⁸⁾ | 18.75 | 22.08 | 22.85 | 24.86 | . | . | . | . | . |

1) Preliminary. - 2) Resident population. 2010 according to Census October 2010. - 3) FISIM reallocated to industries, real growth rates based on previous year prices. - 4) Domestic output prices. - 5) wiiw estimate. - 6) Refinancing rate of Central Bank. - 7) Converted from USD with the average exchange rate. - 8) wiiw estimates based on the 2005 International Comparison Project benchmark.

Source: wiiw Database incorporating national statistics. Forecasts by wiiw.