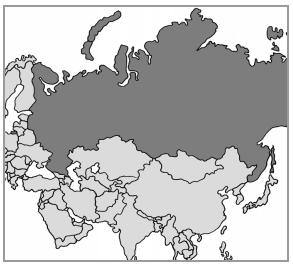


Peter Havlik and Vasily Astrov

Russian Federation:
oil price surge, new leadership and old problems

GDP growth and the ambivalent role of energy

The oil price nearing USD 150 per barrel, the new Russian President Dmitry Medvedev and the new Prime Minister Vladimir Putin were the key early 2008 news from Russia. The economy has been booming and most analysts have been busy repeatedly revising GDP growth forecasts upwards, largely owing to surging energy prices. Russian GDP growth exceeded 8% in 2007, driven by a double-digit expansion of household consumption and even faster growth of investments (Table RU). Since the start of Putin's presidency in 2000, Russian GDP has increased by nearly 60% in real terms and even more so in nominal euro terms (Figure 1). At purchasing power parity (PPP), Russia's GDP amounted to EUR 1750 billion in 2007 – about 80% more than in 2000 and 25% more than the aggregate GDP of the new EU member states of Central and Eastern Europe (NMS). In per capita terms, Russia's GDP at PPP exceeded EUR 12,300 in 2007 – about 50% of the EU average – and the speed of catching up to the average per capita GDP level in the EU has been impressive: about 15 percentage points since the year 2000.

Thanks to large windfall gains from high world market energy prices and the related terms of trade improvement (see Box 1), the Russian government was able not only to repay nearly all outstanding public external debts, but to accumulate almost USD 450 billion of foreign exchange reserves as of end-June 2008. Apart from the Stabilization Fund (recently renamed Reserve Fund), another part of windfall proceeds from oil and gas exports is being accumulated in the newly established National Welfare Fund (more on that, see below). Moreover, several national development projects (targeting infrastructure, housing, the health sector, education, and agriculture) were launched and salaries in the public sector and pensions were raised.

Box 1

Effects of rising energy prices on Russian economic growth

Russian GDP growth has been driven since 2004 by booming private consumption and investment. At the same time, the growth effect of real net exports (exports minus imports, both at constant prices) has been negative because the volume of exports is growing at a slower pace than that of imports (Figure 3 below). Per definition, the methodology used for the measurement of real GDP excludes price effects – not only of the domestic inflation, but the effects of export and import prices as well (the effect of the so-called terms of trade). The latter effect, highly relevant in the current Russian context, is captured by another indicator: the real gross domestic income (RGDI).

RGDI is defined as:[1]

$$RGDI = GDP + ToT \quad (1)$$

where:

$$ToT = (X-M)/P – (X/Px – M/Pm) \quad (2)$$

and X(M) are nominal exports (imports), Px (Pm) are deflators of exports (imports), and P is the average deflator of exports and imports. A positive (improving) terms of trade effect thus results in gross domestic income being higher than GDP.

Russian GDP and estimated Real Gross Domestic Income (RGDI), 2003-2008

Year	2003	2004	2005	2006	2007	2008*
GDP (RUB bn, 2003 prices)	13243	14197	15105	16223	17537	18800
real GDP growth (%)	7.3	7.2	6.4	7.4	8.1	7.2
ToT (2003 = 100)	100.0	116.0	133.8	149.1	155.6	186.0
ToT (RUB bn, 2003 prices)	.	652.8	1423.5	2243.9	2931.6	4645.5
RGDI (RUB bn, 2003 prices)	13243.2	14849.5	16528.8	18467.0	20468.8	23440.5
RGDI growth (%)	9.9	12.1	11.3	11.7	10.8	14.5
ToT effect, pp.	2.6	4.9	4.9	4.3	2.7	7.3
ToT effect (EUR bn)		18.8	41.0	64.7	84.5	133.9

*) Projection assuming that ToT will improve by 20% in 2008.

Source: Years 2001-2003: OECD (2006); own estimates and forecast based on ROSSTAT and Central Bank of Russia.

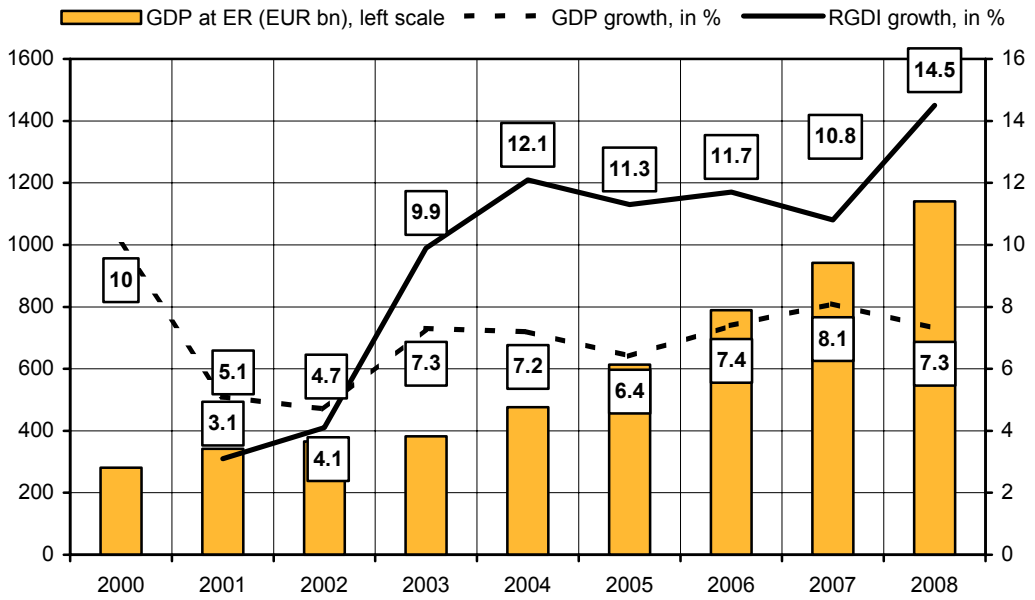
As can be seen, the terms of trade effect has been positive since 2003 and RGDI has been growing faster than GDP. RGDI in 2007 was nearly 17% higher than the corresponding GDP. During 2004-2007, the cumulated terms of trade gains exceeded EUR 200 billion and economic growth (measured by RGDI) exceeded 10% per year – matching closely the Chinese results. Taking into account the current oil price developments,[2] it can be expected that another substantial terms of trade gain will be realized in 2008. The expected slowdown in real GDP growth notwithstanding (which will again result from a negative contribution of real net exports), RGDI growth may exceed 14% and the associated terms of trade gain EUR 130 billion in 2008.

[1] The term 'real' does not refer here to constant prices, but the product that the country has at its disposal. It is sometimes referred to as 'command' GDP, reflecting the real purchasing power of domestic residents – see Kohli (2004). The relation between RGDI and GDP was analysed by Vintrova (2005) and Mora (2006) for Central and East European countries, in particular for the Czech Republic, which reported rising terms of trade and thus higher RGDI than GDP in the period 1996-2004. For Russia, the relation was analysed in OECD (2006) and recently also by Kuboniwa (2007), who calculated various price deflators. The table reproduces these results (for 2003) and provides the author's own estimates of RGDI for the years 2004-2008 using the above expression (2) and implicit price deflators of exports and imports, based on the latest (April 2008) official Russian data from ROSSTAT.

[2] During the first quarter of 2008, the average price of Urals crude oil (USD 93.5 per bbl) increased by 73% in US dollar terms compared to the first quarter of 2007. According to preliminary balance of payments data from the Central Bank of Russia (CBR), export revenues increased by 50% in nominal USD terms in the first quarter of 2008 (of which revenues from energy exports by nearly 70%). The actual terms of trade gain in 2008 may be even higher than assumed in Box 1.

Figure 1

Russian economic growth: GDP and RGDI*



*) RGDI is Real Gross Domestic Income – see Box 1 for details.

Source: Goskomstat, Central Bank of Russia, own estimates.

There have been a lot of other economic achievements of Putin's presidency which help to explain his extraordinary domestic popularity: rising incomes and wages, decreasing poverty levels, rising employment (and declining unemployment), nearly full repayment of the government's external debt, ballooning foreign exchange reserves, etc. At the same time, the Russian population has been declining due to a combination of high mortality rates and declining birth rates. Indeed, the adverse demographic developments and latent labour shortages are among the major challenges which Russia will be facing in the near future. And whereas the number of Russians with incomes below the official poverty threshold nearly halved between 2000 and 2006 (to 21.6 million, that is 15.3% of the population in 2006), the income differentiation increased substantially.[3]

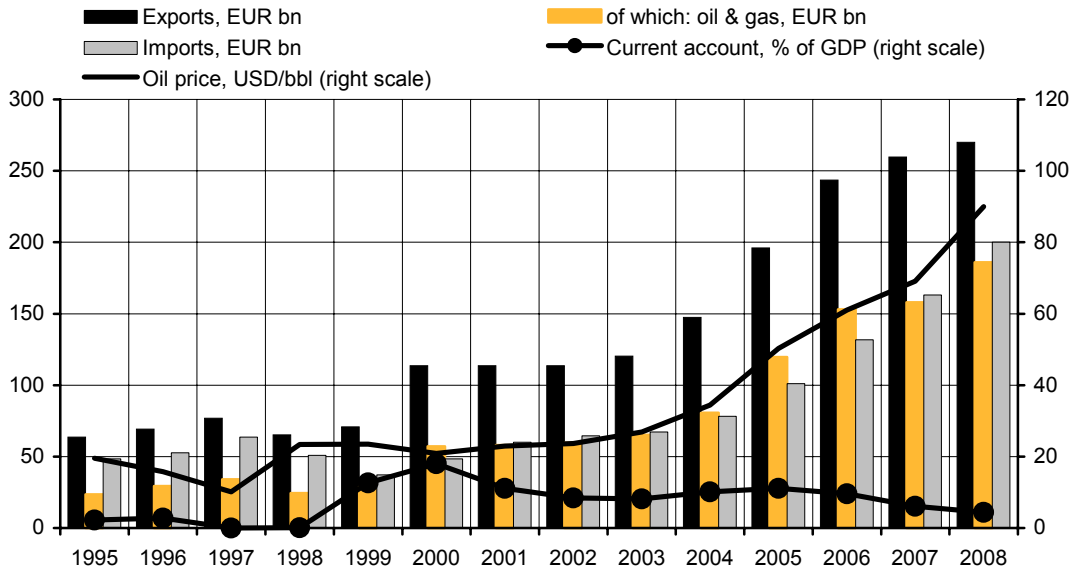
The recent economic boom can be explained to a large degree by surging world market commodity prices, in particular those of energy (Box 1). Figure 2 shows how the development of Russian exports has been closely linked to rising oil prices. Indeed, the surging revenues from energy exports have accounted for a major (and growing) share of total export revenues. During 1995-1998, energy export revenues fluctuated around EUR 25 billion per year (about 40% of total export revenues), compared to more than EUR 150 billion (and 60% of export revenues) recently. Yet after the surge of export revenues during 2004-2006, the export volume grew only slowly in 2007 while imports (in both real and nominal terms) soared by about 25%. As a result, the trade and current

[3] During the same period, the Gini coefficient increased from 0.395 to 0.410. For a more detailed analysis of recent Russian economic developments see, for example, Vinhas de Souza (2008).

account surpluses diminished and the contribution of real net exports to GDP growth has been negative already since 2004 (see Figure 3). 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 dropped by about 2 percentage points in 2007 compared to 2006 (to 61%) but increased in the first quarter of 2008 (to 68%) again.

Figure 2

Russian external sector and oil prices



Source: Goskomstat, Central Bank of Russia, own estimates.

Return of double-digit inflation

The appreciation pressure remains strong given the huge inflows of foreign exchange, despite some relief provided by the Reserve and National Welfare Funds which accumulate a larger part of energy-related export revenues. Since the beginning of 2000, the rouble has appreciated by almost 50% against the euro in real terms (appreciation against the US dollar was even more pronounced). Notwithstanding some tightening of monetary policy, i.e. increases in interest rates (to 10.75% as of 10 June 2008) and minimum reserve requirements, the still rapid growth of money supply makes meeting the official inflation target of 10.5% in 2008 extremely difficult. Consumer price inflation is fuelled by rising prices for food, energy and housing as well as by administered tariff adjustments and, last but not least, by demand cost-push factors such as rising wages and salaries as well. All these factors translated into double-digit annual inflation in late 2007 again (12% in December year-on-year) and consumer price inflation even accelerated in the first months of 2008 (to more than 14% against the previous year) – mainly on account of rising food prices (despite price controls for major staples). Double-digit inflation is likely to persist in 2009 as well, and producer price inflation will be even higher. Apart from food price increases, inflation is being fuelled by rising government spending (see below) and by gradual adjustments of electricity and gas tariffs for domestic consumers (the latter are set to

reach export prices by 2014-2015). Both the Central Bank of Russia and the Ministry of Finance (as well as the IMF and the World Bank according to press reports)[4] warn about overheating since the domestic supply is growing much less than demand. On the other hand, the Ministry of Economy and other less 'liberal' quarters of the government and the Russian economic community argue for additional spending aimed at boosting domestic investment, economic diversification and modernization. Given the abundance of money accumulated in the Oil Funds it is difficult to resist the temptation to spend more. Indeed, the government-sponsored Industrial Policy measures 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). Some of these initiatives were mentioned as the key priorities in the economic programme of the newly elected Russian President Dmitry Medvedev, yet the efficiency of their implementation raises serious doubts – not least due to widespread corruption and other institutional bottlenecks.

The role of the Oil Fund(s)

The Russian Oil Stabilization Fund (OSF) was established in January 2004 with the purpose of (1) reducing the vulnerability of the state budget to the volatility of world oil prices, and (2) sterilizing the impact of oil-related foreign exchange inflows on the money supply and inflation. The OSF accumulated money as long as the world price for Russia's Urals oil exceeded the cutoff price (initially set at USD 20 per barrel, but raised to USD 27 as of 2006) and could be tapped for covering federal budget deficits when the Urals price fell below the cutoff price. The fund collected revenues from two taxes: (1) a portion of the export duty on crude oil, and (2) a portion of the mineral resources extraction tax on oil (both referred only to that part of the tax that stemmed from the world price in excess of the cutoff price). In addition, parts of the federal budget surpluses (which were attained even though the additional tax revenues from high oil prices were absorbed by the OSF rather than by the current budget) were transferred to the OSF as well. The OSF was managed by the Ministry of Finance and until mid-2006 was held entirely in Russian roubles that were deposited interest-free at the Central Bank of Russia (CBR).[5] However, in summer 2006, a strategic decision was taken on converting the OSF into foreign-currency denominated assets, and the conversion was completed by the end of the year. The government guideline was that the OSF should be invested in high-quality sovereign bonds of 14 developed countries – the euro area countries, the UK and the US. In practice, it was held in a currency basket with the following composition: 45% in US dollar, 45% in euro and the remaining 10% in pound sterling.

Apart from covering the federal budget deficits, the OSF could also be tapped for other purposes in case it had accumulated more than RUB 500 billion. Given the persistently high oil prices that hovered far above the cutoff price, this threshold had already been surpassed by the end of 2004. As a result, the OSF funds were subsequently used to repay the country's foreign debt,[6] to cover the

[4] See, for example, http://www.rb.ru/topstory/economics/2008/06/03/093829.html.

[5] The main consideration behind were the perceived fears of the Russian assets 'abroad' being frozen as a result of possible international legal disputes.

[6] The early settlement of public foreign debt enabled Russia to economize on interest payments, despite the penalties charged to the country for the premature contract withdrawal.

public pension fund deficit, and – more recently – to finance the newly established Investment Fund and the equity stakes in the so-called 'state corporations', notably the one dealing with nanotechnologies. Still, by the end of 2007, the OSF had built up assets worth more than RUB 3.8 trillion, corresponding to nearly 12% of Russia's GDP (see Table 1), and nearly eight times the value of the RUB 500 billion threshold, above which the funds could be used for purposes other than budget deficit financing. Besides, the pressure to spend the OSF was all the more intense as most short- and medium-term oil price forecasts assumed values above USD 50 per barrel, and it seemed extremely unlikely that the price would fall below USD 27 (the cutoff price set for the OSF). This implied that stabilization in the sense in which it was meant at the time when the OSF was set up, i.e. as a buffer for federal fiscal balances, was unlikely to be required anytime soon.

Table 1

Dynamics of the Oil Stabilization Fund

RUB billion	**2004**	**2005**	**2006**	**2007**
Inflows/revenues				
Unspent federal budget surplus from previous year	106	218	48	157
Oil revenues (export duty plus extraction tax)	416	1,175	1,641	1,587
Interest accrued	.	.	23	152
Outflows/withdrawals				
External debt repayment				
IMF	.	94	.	.
Paris Club	.	430	605	.
Vneshekonombank	.	124	.	.
Other	.	.	.	34
Pension Fund	.	30	.	.
Investment Fund and equity stakes in 'state corporations'	.	.	.	300
Net inflows	**522**	**716**	**1,107**	**1,529**
As % of GDP	*3.1*	*3.3*	*4.1*	*4.6*
Balances, end of year*	**522**	**1,238**	**2,347**	**3,849**

* Balances in a given year may deviate from the sum of balances in previous years and net inflows due to changes in valuation.

Source: Ministry of Finance, own calculations.

The mounting OSF reserves were one of the major reasons behind the recent decision by the Russian government to implement a profound budgetary reform, the details of which are presented in Box 2. Most notably, as of February 2008, the OSF was divided into the so-called 'Reserve Fund' (with essentially the same function and the same allocation strategy as the previously existing OSF) and the 'National Welfare Fund' (NWF), which is supposed to save the oil-related wealth for future generations (based on the idea of intergenerational equity) and may be invested into riskier but potentially more profitable assets.[7]

[7] Currently, the existing regulations allow the NWF to be invested into a wider range of foreign bonds with investment rating above AA (according to Standard and Poor's), implying some (moderate) relaxation compared to the very conservative investment approach applied to the Reserve Fund. At the same time, discussions on the allocation strategies for the NWF are going on.

Box 2

Features of the Russian federal budgetary reform as of 2008

- three-year budget planning (now for 2008-2010);
- division into 'oil' and 'non-oil' budget;
- 'oil budget' now *also* collects revenues from oil products and natural gas – unlike the OSF, which collected revenues from oil only;
- OSF ('oil budget') divided as of February 2008 into two funds: 'Reserve Fund' (RUB 3.1 trillion) and 'National Welfare Fund' (RUB 0.8 trillion);
- Reserve Fund serves the purpose of fiscal stabilization (in line with the original OSF goal), is maintained at 10% of GDP and invested in highly liquid and low-yielding foreign securities;
- annual transfers from Reserve Fund to 'non-oil' budget (in 2008 envisaged at some 6% of GDP);
- 'non-oil' budget deficit capped at 4.7% of GDP, and the maximum transfer from the Reserve Fund to the 'non-oil' budget at 3.7% of GDP – both effective starting from 2011 (in 2008-2010, 'oil transfer' is expected to be significantly higher);
- the National Welfare Fund preserves the oil-generated wealth in the long term – for the benefit of future generations.

Essentially, the present dilemma for the Russian authorities is to decide whether the NWF should be increasingly spent or saved. In case the government opts for saving, one possibility would be to invest into foreign equities. This would be in line with, e.g., Norway's experience and might have the advantage of higher returns in the long run as compared to foreign sovereign bonds (as demonstrated by past performance). Besides, in terms of risk diversification, investing in foreign (rather than domestic) assets seems justified, since securities issued by countries which would benefit from falling oil prices – such as the United States or the EU – provide, to some extent, a hedge against excessive reliance on the oil revenues. However, in terms of profitability, such a decision appears rather ambiguous.[8]

Alternatively, the government could decide to spend at least part of the NWF money now, or else spend (part of) the future inflows into the NWF on a current basis. Indeed, given the good growth prospects for the Russian economy, concerns about intergenerational solidarity appear to be of minor relevance, as future generations will presumably be much wealthier than the present generation of Russians. Instead, the Fund's money could be directed to upgrading the country's infrastructure, thus encouraging private investment in the non-energy branches of the economy. The government could also target, for instance, education, health and ecological cleanup activities with these investments. So far, spending from the Fund has been largely countered by two main arguments: (1) given the extensive corruption at all government levels, any spending within Russia would be inefficient, and (2) any domestic spending would be inflationary. However, provided that the (net) benefits are positive, additional spending could be advocated even if institutional

[8] In particular, it is questionable whether the return on foreign equities will match the combined effects of the Russian rouble's (likely) nominal appreciation and of the return on rouble-denominated assets.

weaknesses limit the effectiveness of public expenditures. One might also argue that some additional spending, e.g. in the area of public sector wages, in combination with other measures, could even reduce the incentives for corruption in these areas, which in many cases reflect people's efforts to make ends meet. Besides, the additional inflationary pressure arising from government spending is likely to be kept within limits as long as it is import-intensive, e.g. made within the framework of infrastructure development programmes involving large-scale imports of investment goods.

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 by the development of other sectors (diversification towards manufacturing, high-tech branches, services, etc.), 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 until the year 2020 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 Industrial Policy measures, as well as the completion of reforms aimed at improving the 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 in the medium and long run. Alternative scenarios, based on continued heavy reliance on energy resources, lower oil prices and less investment 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 – see Dashkeyev (2008).

Growth slowdown appears inevitable, current account surplus melting down

The range of GDP growth forecasts for the year 2008 fluctuates between 6% and 8%, largely depending on assumptions regarding the level of energy prices. As shown in Figure 3, since 2004 the Russian GDP growth has mainly been driven by booming private consumption and, increasingly, also by expanding investment. The contributions of real net exports to GDP growth has become negative as the volume of exports has been growing only at a modest pace (less than 10% per year) whereas import volumes have been surging by more than 20% per year.

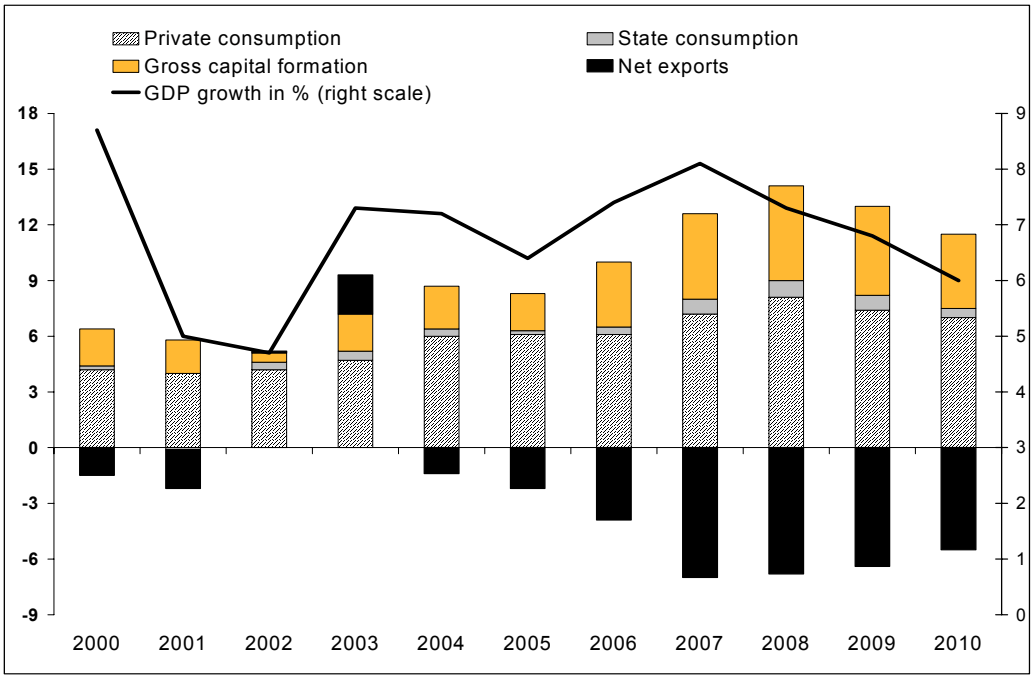
The wiiw medium-term forecast of Russian GDP growth for the coming years is closer to the official 'intermediate' scenario which reckons with ongoing reliance on the (modernized) energy sector, possibly with a few high-tech niches, and an average annual GDP growth of around 6% in 2010. The expected modest growth slowdown appears inevitable, at least until the end of the decade, before any (uncertain) modernization efforts start to bear fruit.

This forecast is based on relatively stable oil prices (Urals costing not more than USD 100/bbl on average) and limited effects of any (potential) impact of current financial markets turmoil. Both private consumption and investments are expected to grow at double-digit rates and thus faster than

GDP, real exports will continue to be sluggish while imports will expand roughly in line with private consumption (see Table RU for details). 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 2009-2010).[9] Inflation will remain above 10% in 2008 and stubbornly close to 10% thereafter. Assuming a fairly constant nominal rouble exchange rate against the euro, 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. 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) represent a cushion and should help to avoid any major financial crisis.

Figure 3

Drivers of Russian GDP growth (contributions of main components)



Source: Goskomstat, own calculations and forecasts.

[9] Higher oil price (say USD 130/bbl) would only marginally increase the current GDP growth (but substantially higher RGDI growth) since a larger part of additional export revenues would be sterilized. Possible higher growth of consumption and investments would be initially associated with more imports (and thus with a larger negative contribution of net exports to GDP growth).

A potentially more serious barrier to future sustainable economic growth and a successful diversification of the Russian economy away from resource-based sectors is – apart from labour shortages – related to the danger of Dutch Disease and the gradual erosion of costs competitiveness. The latter results from a combination of factors such as the ongoing real appreciation of the rouble, rapid growth of wages and only sluggish productivity improvements. Average gross wages exceeded EUR 370 per month in 2007, which represents a nominal increase by almost 25% year-on-year. During 2000-2007, unit labour costs were rising by more than 20% per year and their level is now already higher than in some Central European new EU member states (such as Bulgaria and Slovakia – see Annex for a detailed comparison). Given the competition from Central and Eastern Europe (including Ukraine) and especially from China, Russia could soon become a location too expensive (and thus non-competitive) for export-oriented manufacturing. Rising local production costs may distract even such investments (in particular FDI) which are oriented at the (rapidly expanding) domestic market since the respective imports are becoming cheaper. The expected accession to WTO (possibly already in 2008 since all bilateral talks have been completed) and the related reduction of import tariffs may even aggravate these problems. It is also not clear whether some of the above-mentioned envisaged Industrial Policy tools may not be conflicting with the WTO accession rules.

Duo Medvedev-Putin working in tandem or potentially dissonant?

The recent economic developments have been overshadowed by politics, in particular by the issue of Vladimir Putin's successor after the presidential elections of 2 March 2008. Putin's last-minute support of the United Russia party had helped to secure it a comfortable majority in last year's Duma elections; his endorsement of Deputy Prime Minister (and Gazprom Chairman) Dmitry Medvedev as the preferred candidate while agreeing to serve as Prime Minister in the new government secured Mr Medvedev's easy victory (70% of the vote). The elections were not entirely fair since Putin's preferred candidate had been disproportionately endorsed by the state-controlled media, yet there is little doubt that both Mr Putin and Mr Medvedev (the latter seen as a guarantee for the continuity of Putin's successful policies) enjoy overwhelming support in the Russian electorate. Owing to his popularity and age, Mr Putin is likely to dominate Russian politics in the years to come – he may even return to the Kremlin after some time. Despite more than 17 years of working together and notwithstanding their good personal relationship, the present constellation (President Medvedev and Prime Minister Putin) may lead to tensions, at least between their respective apparatuses.[10] Some preliminary hints regarding future political stability in Russia appeared already in April-June 2008, when the new government was formed and the reshuffle in the presidential administration initiated. Both went on rather smoothly, with Prime Minister Putin taking some of his close allies (notably I. Sechin, S. Sobyanin and I. Shuvalov) into the government. Under the Russian Constitution, the new President Medvedev keeps the control of the power ministries where only a few replacements occurred (such as the appointment of one of Medvedev's allies, A. Konovalov, as Minister of Justice). Simultaneously, the mighty presidential administration will be headed by S. Naryshkin (with one of the Kremlin's chief ideologues, Mr. V. Surkov, continuing as a Deputy Head) and the Security

[10] Formally, the Russian Constitution gives much more power to the President who may, *inter alia*, appoint (or dismiss) the Prime Minister.

Council by former FSB Chief N. Patrushev. All these appointments suggest that the Medvedev-Putin team may work in tandem rather than conflict – at least for the time being.

The economic outlook remains broadly positive with both consumption and investment (including FDI) expected to expand further. The risks of overheating, particularly in housing and credit markets, appear manageable whereas the above-mentioned concerns regarding inflation, real appreciation and the erosion of competitiveness may represent a more serious potential threat in the medium and long run. 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 both the EU and USA, although the present tensions may calm down provided the new President Medvedev keeps his credentials as a liberal politician who supports the rule of law and fight against corruption. However, there is little doubt that both Mr Medvedev and Mr Putin will defend Russian interests, and these need not necessarily be identical with those of either the EU or the USA and may lead to additional tensions.[11] Apart from energy issues, which dominate EU-Russian relations, some of these challenges will be addressed in the negotiations of the new EU-Russia agreement which started at the EU-Russia Summit in Siberia in June 2008.

Summary conclusions

The Russian economy has been booming in the past couple of years; the period of Putin's presidency has been very successful economically. The per capita GDP reached 50% of the EU average in 2007 and the speed of catching-up was even faster than that of the new EU member states of Central and Eastern Europe. Russian economic growth has been fuelled mainly by surging energy revenues which gave a boost to both private consumption and investments. The government's external debts were paid back, foreign exchange reserves reached almost EUR 350 billion by mid-2008, the current account and state budget are both in surplus. However, the excessive dependence on energy represents – together with adverse demographic developments – a major challenge for the sustainability of growth in the medium and long run. The Russian rouble has considerably appreciated in real terms, inflation has returned to double digits and cost competitiveness has deteriorated.

Policy makers are aware of these vulnerabilities and have launched an ambitious economic modernization programme which aims to diversify the economy and foster innovations with the help of Industrial Policy tools and public-private partnership financing schemes. There are, however, serious doubts that these efforts will lead to the desired results, *inter alia* due to the high risk of abuse, inefficiency and other institutional bottlenecks. In addition, there are also political risks related to the transition of power since the new governing duo Medvedev-Putin can be potentially dissonant. The medium-term growth outlook is still positive, although a growth slowdown appears inevitable and the current account surplus will soon disappear.

[11] For a balanced overview of Russian foreign policy after the year 2000 and an analysis of reasons underlying the worsened relations with the West see Sakwa (2008).

Apart from the collapse of oil prices and potential spillover effects on Russia from the global financial turbulence (which both seem manageable), other challenges relate to the future integration in the world economy, in particular regarding Russia's accession to the WTO (which may conflict with the planned Industrial Policy tools) and the relations with the EU. The latter have deteriorated recently owing to Russia's growing assertiveness, which went together with the economic recovery and the enlargement of the EU. Despite large economic asymmetries between Russia and the EU (most evident in the areas of foreign trade, investments and economic size) and sometimes conflicting interests (in particular regarding energy supplies and the contest for influence on the post-Soviet space), mutual interdependence requires cooperative approaches which would serve best the interests of both Russia and the EU.

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Table RU

Russia: Selected Economic Indicators

	2004	2005	2006	2007 [1]	2007 1st quarter	2008 1st quarter	2008 Forecast	2009 Forecast	2010 Forecast
Population, th pers., end of period [2]	143474	142754	142221	142009	142100	141900	141000	140500	140000
Gross domestic product, RUB bn, nom.	17048.1	21625.4	26879.8	32987.4	6747.9	8838.1	40500	43000	49000
annual change in % (real)	7.2	6.4	7.4	8.1	7.4	8.5	7.3	6.8	6.0
GDP/capita (EUR at exchange rate)	3310	4290	5536	6630	.	.	.	.	.
GDP/capita (EUR at PPP - wiiw)	9170	10030	11070	12330	.	.	.	.	.
Gross industrial production									
annual change in % (real)	8.0	5.1	6.3	6.3	7.2	6.2	6	6	6
Gross agricultural production									
annual change in % (real)	3.0	2.3	3.6	3.3	3.4	4.5	.	.	.
Construction output total									
annual change in % (real)	10.1	10.5	18.1	18.2	17.6	28.9	.	.	.
Consumption of households, RUB bn, nom.	8405.6	10590.0	12880.9	15815.5	3381.9	.	.	.	.
annual change in % (real)	12.1	11.8	11.2	12.8	12.4	.	13.8	12	11
Gross fixed capital form., RUB bn, nom.	3130.5	3836.9	4968.4	6951.1	978.5	.	.	.	.
annual change in % (real)	12.6	10.6	17.7	20.8	22.0	.	21	17	13
LFS - employed persons, th, avg.	67275	68169	68855	70573	69359	70233	70300	70500	70600
annual change in %	.	1.3	1.0	2.5	2.4	1.3	.	.	.
Reg. employment in industry, th pers., avg.	14775	14469	14325	.	.	.	.	.	.
annual change in %	-1.1	-2.1	-1.0	.	.	.	.	.	.
LFS - unemployed, th pers., average	5674.8	5262.8	5312.0	4585.0	5241.3	5134.0	.	.	.
LFS - unemployment rate in %, average	7.8	7.2	7.2	6.1	7.0	6.8	5.8	5.5	5.5
Reg. unemployment rate in %, end of period	2.6	2.5	2.3	2.1	2.3	2.0	.	.	.
Average gross monthly wages, RUB	6739.5	8554.9	10633.9	13527.0	11878.3	15432.3	.	.	.
annual change in % (real, gross)	10.6	12.6	13.3	16.2	18.2	14.0	.	.	.
Consumer prices, % p.a.	11.0	12.5	9.7	9.1	7.7	12.9	15	13	9
Producer prices in industry, % p.a.	24.0	20.7	12.4	14.1	8.6	25.7	19	16	15
General governm.budget, nat.def., % GDP									
Revenues	31.9	39.7	39.5	40.5	.	.	43	.	.
Expenditures	27.4	31.5	31.2	34.5	.	.	37	.	.
Deficit (-) / surplus (+), % GDP	4.5	8.1	8.4	6.0	.	.	6	.	.
Public debt, nat.def., in % of GDP [3]	21.6	14.9	8.9	7.2	.	.	.	.	.
Refinancing rate of NB % p.a., end of per.	13	12	11	10	10.5	10.3	11	.	.
Current account, EUR mn [4]	47868	67851	75696	57222	17524	24726	50000	5000	-15000
Current account in % of GDP	10.1	11.0	9.6	6.1	6.8	6.8	4.5	0.4	-1.1
Gross reserves of NB, excl. gold, EUR mn	88663	148094	244190	317220	247719	312936	350000	.	.
Gross external debt, EUR mn	156689	216553	256609	313956	260967	.	.	.	.
Gross external debt in % of GDP	34.8	34.2	32.5	34.2	.	.	.	.	.
FDI inflow, EUR mn [4]	12422	10354	25979	38344	13572	.	40000	.	.
FDI outflow, EUR mn [4]	11085	10258	18570	33358	4829	.	30000	.	.
Exports of goods, BOP, EUR mn [4]	147358	195894	243490	259740	54822	72239	270000	275000	285000
annual growth rate in %	22.5	32.9	24.3	6.7	-2.0	31.8	4	2	4
Imports of goods, BOP, EUR mn [4]	78327	100787	131777	163255	32679	40563	200000	230000	255000
annual growth rate in %	16.4	28.7	30.7	23.9	27.5	24.1	23	15	11
Exports of services, BOP, EUR mn [4]	16564	20064	24948	28751	5859	6282	30000	32000	35000
annual growth rate in %	15.4	21.1	24.3	15.2	18.7	7.2	4	7	9
Imports of services, BOP, EUR mn [4]	26774	31229	35967	43245	8320	8687	50000	55000	60000
annual growth rate in %	11.6	16.6	15.2	20.2	20.7	4.4	16	10	9
Average exchange rate RUB/USD	28.81	28.30	27.34	25.58	26.33	24.26	24.4	24.7	25
Average exchange rate RUB/EUR (ECU)	35.81	35.22	34.08	35.01	34.46	36.31	36.6	37	37.5
Purchasing power parity RUB/USD, wiiw [5]	11.03	12.74	14.29	15.79	.	.	.	.	.
Purchasing power parity RUB/EUR, wiiw [5]	12.92	15.06	17.04	18.83	.	.	21.7	24.4	27

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

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

Source: wiiw Database incorporating national statistics; wiiw forecasts.