Period of Rapid Growth Over in Russia?

Seija Lainela
Russian European Centre for Economic Policy (RECEP)
Editor-in-Chief
Russian Economic Trends

Russia's current economic situation has largely resulted from three factors over the past few years, namely the 1998 crash of the Russian ruble, the significant increase in the price of energy on the world markets, and the economic policies of the present political decision makers.

The last three years have been marked by favorable development in Russia after its economy begun staging a quick recovery from the deep crisis of 1998. That crisis caused total output, which had just recently turned up, to collapse and cut three-quarters out of the external value of the ruble. A devaluation of the currency caused imports to decline sharply and substituting domestic industries started to gain ground. Ruble-denominated export revenue ballooned, and as the world market price of oil also started to climb in 1999, the stage was set for an economic up cycle. However, economic growth has again slowed down starting last year, in part due to the lagging performance of the world economy.

The overall economy has become more balanced over the past three years, even though annual inflation still runs close to 20 percent. The current account balance shows a surplus, as does the federal budget, thanks to tight fiscal policies and commodity-related tax revenue. Unemployment fell steadily from its 1998 peak until the summer of 2001. Meanwhile, the collapse of the ruble wreaked havoc with people's standard of living. Real incomes dropped so much that nearly 40 percent of the population lived below the official poverty level in 1999. The situation has gradually improved since, but 30 percent of the population still continued to live in poverty in 2001 based on official yardsticks, which meant that their personal incomes were below the minimum subsistence level.

Economic policies took a turn for the better in 2000 when President Vladimir Putin took office. The impact of the new President was evident in increasingly stable economic policymaking and the resumption of systematic economic reforms. In this respect Russia's progress has actually been surprisingly good. It is difficult to estimate how significant the improved economic policies have been for the recent growth because reforms take time to be implemented in reality and their effects show up slowly. In any event, increased consistency in economic policies has turned expectations more upbeat and has increased economic players' confidence in the future.

The Russian economic outlook is currently overshadowed by the slower global growth, and the consequent fall in the price of crude oil. Even though Russia's domestic demand has grown briskly over the past two years, the rate of economic growth, and especially whether the national budget will be met, will greatly depend on export revenue from energy and other commodities.

According to most observers, the Russian economy will still continue to grow 3% to 4% this year on the momentum of prior years. Next year's performance, however, is uncertain. In order for Russian economic growth to be sustainable, many remaining structural problems will need to be solved. This applies particularly to improving Russia's business environment so that it promotes long-term business development and investment. The growth of investment spending in various sectors of the

Key Economic Indicators
(12-month percentage change, unless indicated otherwise)

	1997	1998	1999	2000	2001	2002*
GNP	0.9	-4.9	5.4	9.0	5.0	-
Industrial production	2.0	-5.2	11.0	11.9	4.9	-
Fixed investment	-5.0	-12.0	5.3	17.4	8.7	-
Inflation (end of period)	11.0	84.4	36.5	20.2	18.6	19.0
M2 (end of period)	29.5	36.3	57.2	62.4	40.0	-
Unemployment (ILO,%)	10.8	11.9	13.7	10.5	9.0	-
Federal budget surplus (% of GNP)	-6.7	-4.9	-1.7	2.5	2.9	-
Current account balance (% of GNP)	0.5	0.3	13.5	18.5	11.0	-

* January

Sources: State Committee of the Russian Federation on Statistics, Bank of Russia, Ministry of Finance, RET.

economy is increasingly important in order to enhance domestic competitiveness and to reduce the economy's dependence on price fluctuations in the international commodity markets.

Domestic Demand to Fuel Growth

After the crisis year of 1998, export demand was the most important engine driving Russian economic growth, but the significance of domestic demand – first investment spending and subsequently also private consumption – has gradually increased, partly due to the recent fall in the world market price of oil. In 2001, economic growth was increasingly relying on domestic demand, which still continued to grow briskly.

Real household income grew by 8 percent last year, having climbed 11 percent the year before. This fast income growth was partly prompted by the government's decision to raise pensions and public sector wages and salaries. Wages and salaries were raised in social, educational and health care services, where they had significantly lagged the private sector. Despite the notable increase in income, real incomes remained some 13 percent below the pre-crisis levels of 1997.

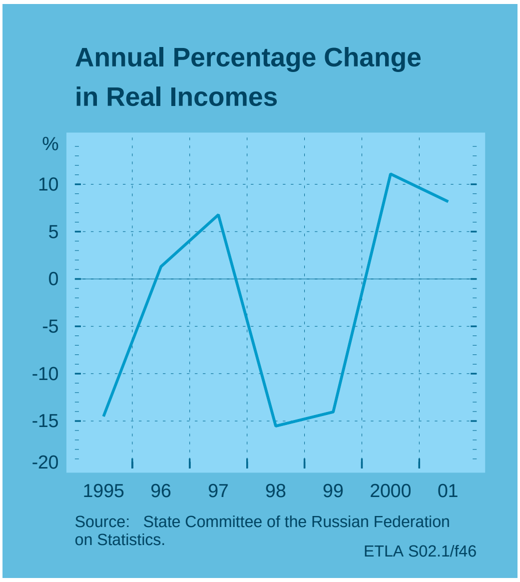
Consumption demand grew fast last year, at nearly 9 percent in real terms. This growth slowed down somewhat toward the end of the year, however. It is noteworthy that imported goods have attracted a relatively greater proportion of demand as incomes have grown. This has been due, in part, to the growing strength of the ruble since its devaluation in 1998. Domestic producers are fairly quickly losing their currency devaluation advantage, which indicates that the Russian economy still suffers from structural weaknesses.

Total Demand
January-September 2001

	Bill. rubles	% share
Gross national product	6 545	100
Private consumption	3 150	48
Public consumption	1 054	16
Gross fixed investment	1 139	17
Net exports	955	15
Inventory change and Statistical error	247	4

Note: Based on fair market values.

Source: State Committee of the Russian Federation on Statistics.



Investment Growth Slowing Down

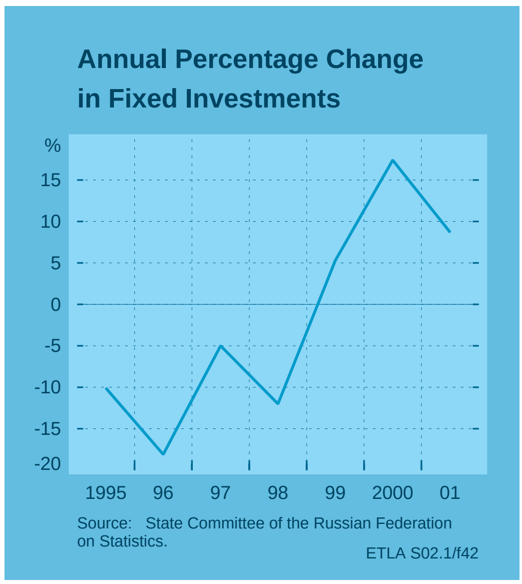
Although investment spending has grown quickly – faster than overall production – over the past three years, its total share of the GNP is still under 20 percent. Investment activity is restrained by the remaining unresolved institutional problems and the uncertain business environment, neither of which promotes long-term business development.

The outdated machinery of Russian industrial companies also constitutes a serious problem for the economy, and current investment spending is not even sufficient to maintain it, let alone update it. Investments have largely concentrated within the energy and transportation industries, with the transfer of energy playing a significant part in the latter as well. On the one hand, this energy production and transportation focus is natural when one considers Russia's sizable energy revenues over the past years. On the other hand, the lack of investment in other industries shows that the effects of increased energy revenues have not spread very far outside of the energy sector.

Over the 1999-2001 period, growth in fixed investment occurred almost exclusively within the energy and transportation industries. Investment spending remained constant or even declined in other sectors of the economy. During the first half of 2001, for example, fixed investment spending outpaced corresponding 1998 spending by 21 percent in real terms. This was due to more than 130 percent growth in energy and transportation spending, whereas spending in other industries was 10 percent below the pre-crisis levels of early 1998. The lack of investment in other sectors of the Russian economy constitutes a threat to sustainable growth and impedes attempts to reduce the economy's dependence on commodities.

Investment growth and the development of the entire business sector are hampered by the lack of development in the Russian financial sector. Almost 50 percent of corporate fixed investment spending was done using internally generated funds during the first three quarters of last year. The public sector financed 20 percent of all investments, while only 3 percent was funded by banks. Some of the latter also came from foreign banks. Five percent of all funding – i.e. more than all of the bank loans put together – consisted of loans from other organizations.[1)]

The heavy dependence of businesses on internally generated funds impedes continued investment growth given the overall poor financial condition of Russian businesses. Only 64



[1)] Statistics indicate that the remaining roughly 20 percent of investment funding comes from "other sources".

percent of large and medium-sized companies were profitable in 2001, and the relative share of profitable companies has not grown notably over the past two years despite the fast economic growth.

In 2001, the rate of growth in fixed investment spending fell down to one-half of the prior year's top speed, or to slightly under 9 percent. The rapid growth of the previous year was mainly due to a low 1999 starting point. The reduced profits of export-oriented businesses, in particular, also help to explain the slowing growth of last year.

A gradual normalization in the methods of payment used by businesses, which serves to improve corporate capacity for investment, can be viewed as a favorable development over the past couple of years. Only a few years ago barter, arrearages, and various types of promissory notes used in lieu of cash were very common in business transactions. The frequency of all of these has declined steadily, although they still remain significant. At the start of the current year, just over 20 percent of industrial companies continued to pay through barter or in promissory notes, whereas a year earlier some 30 percent did likewise. The fact that so many do even after two years of fast growth tells us that structural economic changes that would permanently replace barter with a more efficient payment system have not yet been carried all the way through.

Current Account Surplus Shrinks

The 1998 ruble crisis caused imports to fall and the current account surplus to grow quickly a year later. In 2000, on the other hand, the value of Russian exports started to grow rapidly as the world market price of crude oil rose. The next turn in the current account balance occurred in 2001 when the growth in oil export revenues begun to slow down while brisk import growth continued as a consequence of the economic expansion. A stronger ruble in real terms also spurred on import growth.

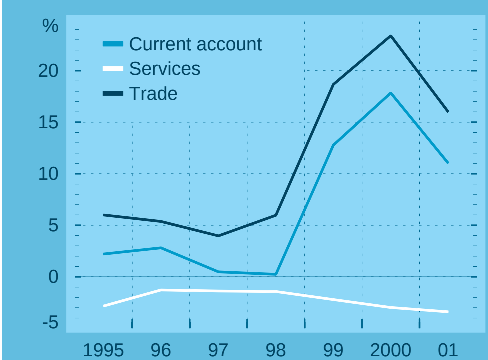
Based on preliminary reports, the 2001 current account surplus stood at $34 billion, which is one-quarter less than a year earlier. One can assume that the current account surplus will continue to shrink during this year as well since it is largely dependent on the world market price of oil. A smaller surplus will ease upward pressure placed on the real value of the ruble, but will simultaneously also curb the central bank's ability to prepare for possible harder times ahead by increasing its currency reserves.

The Russian economy has become more open as higher energy prices have boosted the value of exports. In 2001, exports accounted for 34

Change in Goods Export and Import Volumes

Source: Bank of Russia. ETLA S02.1/f38

Current Account Balance, Trade Balance and Services Balance as % of GNP



Source: Bank of Russia. ETLA S02.1/f39

percent of GNP. Imports' share of GNP grew to 18 percent last year. Russian exports are largely concentrated on energy and commodities, and higher energy prices further reinforced this tendency up to last year. Last year energy, together with metals and metal products, accounted for approximately 70 percent of registered merchandise exports. This dependence of exports on a few products is problematic for balanced economic development, and the situation does not appear to be changing anytime soon as the lack of investment outside the energy sector implies little opportunity for the development other industries.

Foreign Trade by Type of Goods, %
January-September 2001

	Exports	Imports
Agricultural products and foodstuffs	1	23
Energy and fuels	56	3
Chemical products	7	19
Wood and paper	5	4
Textiles and shoes	1	5
Metals and metal products	15	8
Machinery and equipment	9	32
Other	6	6
Total	100	100

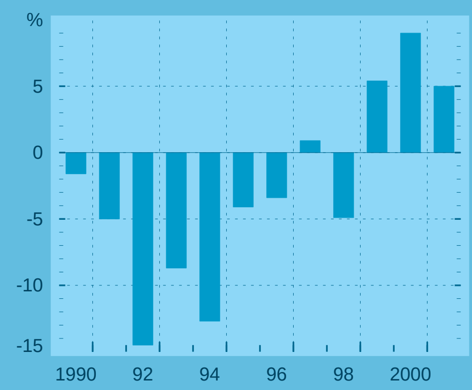
Source: State Customs Committee.

Total Output Growth Slowing Down

The Russian economy begun to feel the effects of slowing global economic growth last year in the form of lower export revenues, for example. Based on preliminary reports, Russia's GNP grew by 5 percent, having grown at the record-setting pace of 9 percent a year earlier. The growth of industrial output also slowed down to approximately 5 percent last year from nearly 12 percent in 2000. Construction volumes grew by approximately 10 percent, largely due to a rapid increase in residential construction. Agriculture saw the second relatively good year in a row thanks to a successful harvest, and output grew just under 7 percent, or almost as much as the year before.

According to preliminary estimates, the seasonally adjusted GNP still continued to grow at the fast rate of 1.4 percent during the fourth quarter (approximately 5.6 percent annualized) compared to the prior quarter. Seasonally adjusted industrial output, meanwhile, remained roughly flat with the previous quarter. Business

GNP Volume Change



Source: State Committee of the Russian Federation on Statistics.
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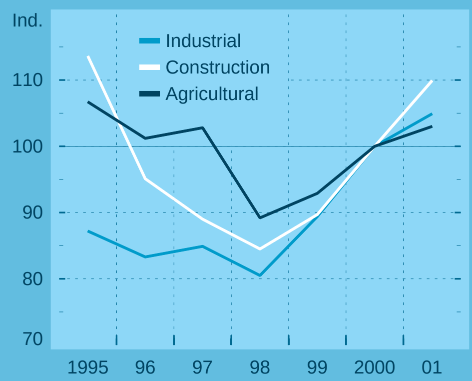
Output of Goods, 2000 = 100



Sources: State Committee of the Russian Federation on Statistics, RECEP.
ETLA S02.1/f45

surveys indicate that the opinions of industrial producers on the state of the economy have become more pessimistic at the end of last year and beginning of this year for the first time since the current economic expansion started three years ago.

The composition of industrial production has changed since 1998 due to changing demand. Output growth has been fast in export-oriented sectors, such as chemicals, forest products and metallurgy. The energy sector's output, meantime, has not grown as much despite significant investment spending, which apparently has, in part, gone into maintaining current production capacity. As a consequence of the recovery in domestic demand, machinery manufacturers, light industrial companies and foodstuffs producers have grown faster than average.

Total Supply
January-September 2001

	Bill. rubles	% share
Gross national product	5 864	100
Industrial companies	1 814	31
Construction	387	7
Agriculture	507	9
Transportation and communications	530	9
Retailing and food service	1 127	19
Other services	1 467	25

Note: Taxes excluded. Ruble-denominated figures do not exactly add up to the total.

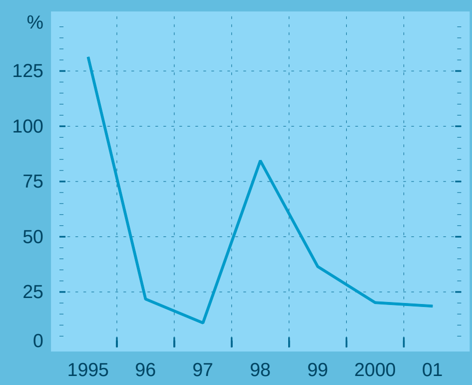
Source: State Committee of the Russian Federation on Statistics.

Rate of Inflation Unchanged

Even though the inflationary peak caused by the 1998 currency devaluation soon subsided, prices continue to escalate quickly. Consumer prices went up by nearly 19 percent in 2001, and by roughly 20 percent the year before, clearly exceeding the national budget targets for both years.

High inflation has been sustained by notable wage and salary increases over the past two years and by relatively sizable governmentally set increases in the price of energy and transportation, for example. The main reason for this high rate of inflation can be found outside of cost pressures, however.

Percentage Change in Consumer Prices



Source: State Committee of the Russian Federation on Statistics.
ETLA S02.1/f41

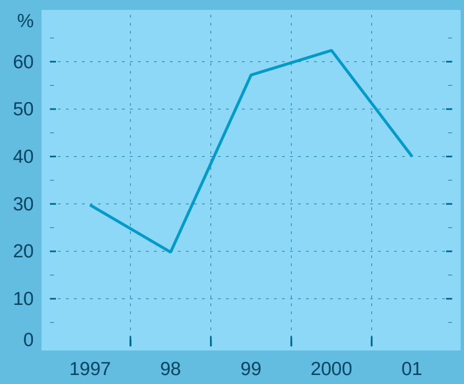
One of the most significant factors boosting the rate of inflation has been money supply growth. According to the current monetary policy, the Bank of Russia seeks to manage the value of the ruble such that its real value increases steadily in relation to the U.S. dollar. The central bank has tried to keep the ruble from appreciating too fast due to the current account surplus by buying the increased foreign exchange revenues of exporters in the currency markets. This, however, has boosted the available money supply because the relatively undeveloped local money market does not include effective instruments the central bank could use to sterilize the increased volume of money.

The central bank has also notably increased its foreign exchange reserves and thus added flexibility to fiscal policies under a scenario where the world market price of oil continues to decline, for example. At the end of 2001, Russia's foreign exchange reserves stood at $36.6 billion – roughly triple the balance recorded at the end of 1999 – corresponding to slightly over 8 months' worth of imported goods.

Broad money supply growth slowed down materially over the past year and stayed at 40 percent. This was, in part, due to a lower current account surplus, along with the early repayment of public foreign debt.

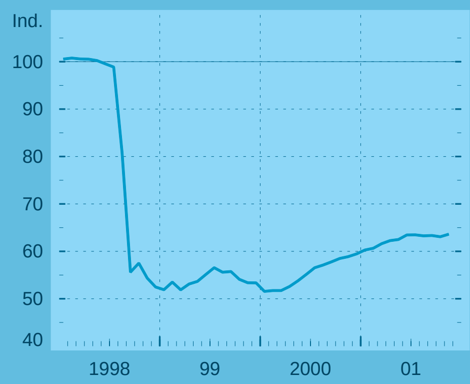
declined faster than before. Shrinking export revenues, foreign debt repayments, and central bank support buying caused foreign exchange reserves to decline by some $4 billion between the start of the year and the middle of February.

Percentage Change in Broad Money Supply (M2)



Source: Bank of Russia. ETLA S02.1/f43

Real Ruble-Dollar Exchange Rate



Source: Bank of Russia. ETLA S02.1/f44

The Bank of Russia has allowed the ruble to lose nominal value in relation to the dollar fairly consistently over the past two years. Due to the high Russian inflation rate, the ruble has meanwhile been getting stronger in real terms, save a few exception periods. During the past year, the ruble gained 7 percent on the dollar, and as much as 15 percent on the euro. This has caused an increasing number of Russians to demand that the strengthening of the ruble be slowed down or stopped. The government's 2002-2004 economic program, however, casts the moderate strengthening of the ruble as one of the cornerstones of its economic policy. The goal is to promote foreign investment in Russia and structural economic reform, and to provide businesses with a stable operating environment. In January of 2002, the value of the ruble still remained some 20 percent below the 1998 pre-devaluation levels.

The ruble has been under greater pressure than usual toward the end of last year and during the first months of this year, and its nominal exchange rate in relation to the U.S. dollar has

Running a Budget Surplus, But for How Long?

Among the greatest achievements of Russian economic policy over the past couple of years are the adherence to responsible budgetary policy and turning a budget deficit into a surplus, which is central to Russia's ability to service debt. The consolidated budget started to show a surplus in 2000.[2)] Based on preliminary reports, Russia's budget surplus grew slightly last year over the prior year to 2.9 percent of GNP.

Actual revenue exceeded budgeted revenue both last year and the year before, although part of this was due to a higher than estimated rate of inflation. The consolidated budget revenue amounted to nearly 30 percent of GNP during both years. The energy sector's success and growing export revenues were the main

2) The consolidated budget covers the Federation's budget, regional budgets, and off-budget funds.

reason behind the increase in budget revenue. Approximately 17 percent of the Federation's budget revenue came from export taxes over the past and preceding year, whereas just under 8 percent was raised this way in 1999. Energy export taxes are currently adjusted every two months based on world market prices.

Russia begun an extensive tax reform in 2001 aimed at simplifying taxation, lowering tax rates and expanding the tax base. The income taxation of individuals was the first to change at the start of 2001. A progressive tax system was replaced by a flat 13 percent income tax. The basic rate for the social security payroll tax paid by businesses was also cut from 38.5 percent to 35.6 percent. Many commentators expressed concerns before the reform that tax revenue would fall significantly as a consequence. This did not happen, however, and preliminary indications are that tax revenues grew slightly over the prior year in relation to GNP.

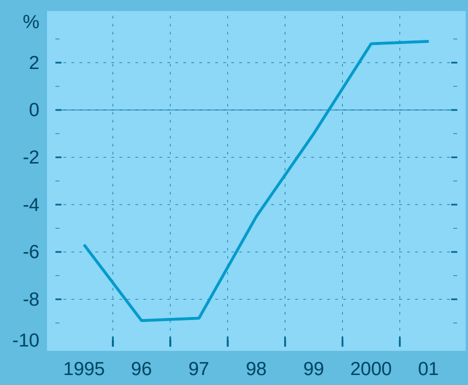
The tax system continued to be revamped at the start of the current year. A new business tax system was introduced which lowered the corporate tax rate to 24 percent from the earlier 35 percent while also reducing the number of opportunities for tax concessions and special treatment. Particularly regional authorities were able to grant oftentimes sizable tax concessions before, but the new law reduces the number of opportunities for this. One of the objectives of the tax reform is to unify taxation throughout the Federation.

Despite increased revenues, the government has been able to adhere to relatively tight fiscal policies. Last year's consolidated budget revenue remained flat with the preceding year in relation to GNP, or at slightly under 26 percent. The budget surplus was primarily used to service foreign debt.

Russia has managed to partially solve its 'year 2003 problem' during the past year, i.e. the heavy foreign debt service payments falling due next year. Russia's foreign debt service payments totaled approximately $14 billion last year, which is the estimate for this year as well, but the 2003 total would otherwise have been some $19 billion. However, the situation has been made easier by the fact that Russia repaid some loans ahead of schedule to such creditors as the International Monetary Fund, for example. State-owned banks have also apparently bought back Russian eurobonds in the international markets. This has brought the upcoming year 2003 payments down by at least two billion dollars.

Largely due to these actions and some foreign debt rescheduling Russia's national debt declined to 50 percent of GNP at the end of last year, having stood at 90 percent as recently as at the end of 1999.

The Federation's Consolidated Budget Surplus, % of GNP



Source: Ministry of Finance. ETLA S02.1/f40

Meeting this year's budget appears much more difficult than last year's. The budget act sets a surplus goal of 1.6 percent of GNP. However, the lower than expected price of oil probably only means breakeven performance even under the best of circumstances. This would preclude investing the planned surplus into an segregated stability fund for the 2003 debt service. Part of the surplus was also supposed to repay loans falling due this year.

In order for Russia to run a budget surplus this year, the price of crude oil (Brent) will need to exceed $20 per barrel.