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Russian Economy: Macro Trends, Prospects and Policies

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The year 2006 proved to be successful for the Russian economy, as were previous few years. GDP volume grew 6.7% (as compared to 6.4% in 2005), labour productivity increased by 5.8%. Overall GDP growth in the last 7 years amounted to 58%. In the year 2007 GDP volume exceed for the first time the pre-reform level of 1991.

Of special importance is accelerated investment growth: volume of fixed investment rose by 13.7% in 2006, as compared to 10.9% in the previous year. Impressive break-through was reached in foreign capital inflow: its amount hiked from just US$1 bn in 2005 to US$42 bn. Even more important is marked hike of FDI: its value grew more than twice in one year (from US$15 bn to US$31 bn).

Macroeconomic stability further enhanced in 2006. Inflation not only slowed down, but also entered for the first time 'one-digit' range (9.0%, as compared to 10.7% a year before). Current account surplus reached US$96 bn. (9.8% of GDP), and foreign currency reserves exceeded US$300 bn., making Russia world third country by their size (following China and Japan).

The federal budget was executed with surplus 7.5% of GDP (exactly the same as in 2005). The general government surplus amounted to 8.5% of GDP. More than quarter of the federal budget revenues (6.1% of GDP) had been automatically forwarded to the Stabilization Fund. As of March 1 size of the Stabilization Fund exceeded US$100. The government again refrained from external borrowing, and, more than that, used US$23 bn. of the Stabilization Fund to pre-pay debt of the former USSR to the Paris Club of official creditors. As a result external public debt dropped to just US$52 by the end 2006 (5% of GDP), and total stock of the public debt fell below 10% of GDP (i.e. less than assets of the Stabilization Fund). Worth noting is that its size in the end of 1999 was close to 100% of GDP. The conclusion is that at present macroeconomic risks for Russian economy are quite small.

Real effective exchange rate of the ruble grew 9.4% in 2006. Marked GDP growth in the recent years, combined with rapid ruble appreciation resulted in a record high increase of GDP in US$ terms: it hiked 5 times over the last 7 years, coming close to US$1 trillion.

Private consumption grew 10.7% in 2006, to reach US$473 bn. Retail turnover rose 13% in 2006, and its value reached US$317 bn. Rapid growth of domestic market and its scale at present are among key factors of attractiveness of Russian economy for foreign investors.

The government continued efforts to alleviate remaining barriers for foreign economic relations. In the mid-2006 restrictions on capital operations were abolished, and since that Ruble is fully convertible currency. Main bi-lateral negotiations on the WTO accession have been completed, so the government looks forward to finalizing multilateral negotiations this year.

Despite clear positive trends, Russian economy may face strong challenges in a near future. First, recent growth was supported with pronounced increase of the world commodity prices. Windfall gains were boosting consumer and (to some extent) investment demand, which served as growth engines. The situation may change this year: both international agencies and Russia's government expect that oil prices will go down in the coming years. The mechanism of Stabilization Fund makes deterioration in the terms of trade safe for the budgetary system. More than that, taking into account quite conservative fiscal policy pursued by Russian government in the previous years, it is even possible to increase somewhat fiscal spending without loss for macroeconomic stability. Still, in a couple of years expansion of domestic demand may slow down. The problem is aggravated with deceleration of exports volume growth. According to the government projections, it will lag behind GDP growth in the medium term. The conclusion is that inertial scenario would result in a gradual slow-down of economic growth. The critical role in keeping growth rate envisaged by the government (around 6% per year for the period 2007-2010) will play accelerated investment growth.

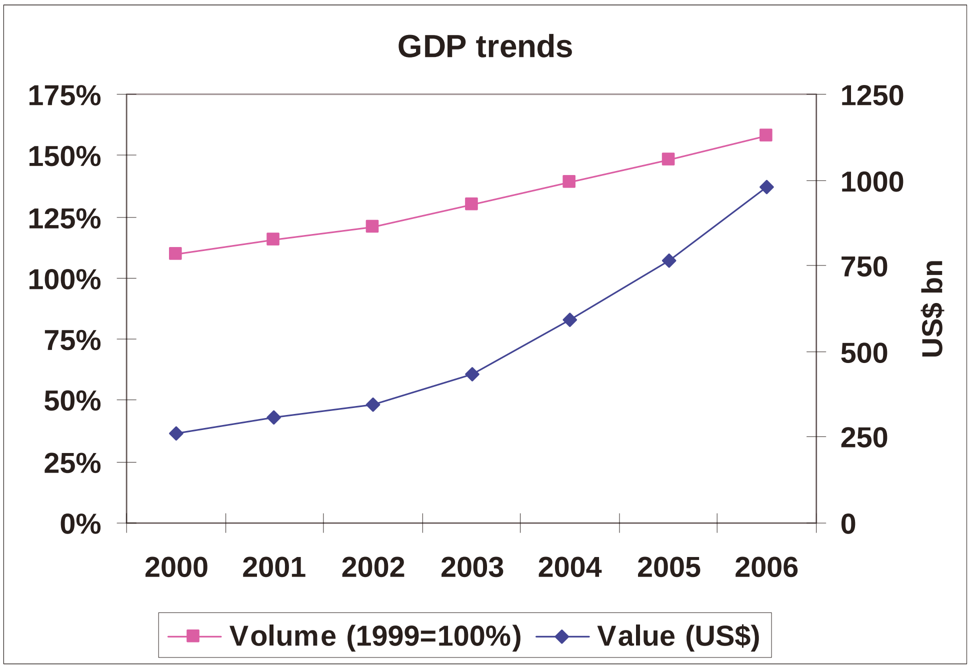
The Russia's government is assuming that safe cushions ensuring macroeconomic stability even in case of strong external shocks have been already created, and is turning at present to pro-active policy, aimed at fostering economic growth and economy diversification. Its top priorities include:

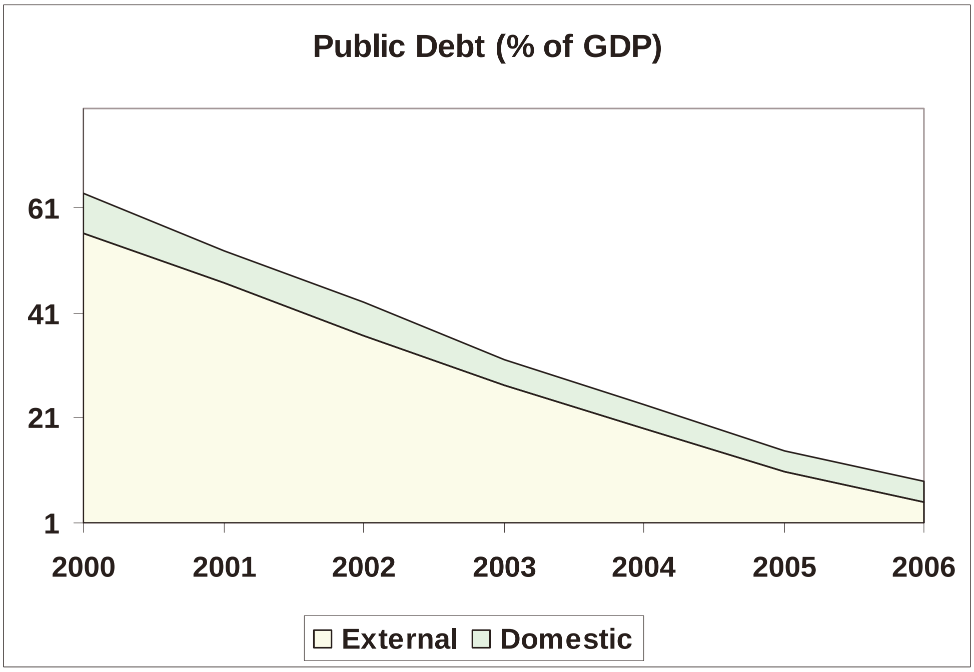
- Stipulating fast development of manufacturing sectors,
- Fostering all kind of innovations,
- Enhancing public infrastructure,
- Raising quality of 'human capital'.

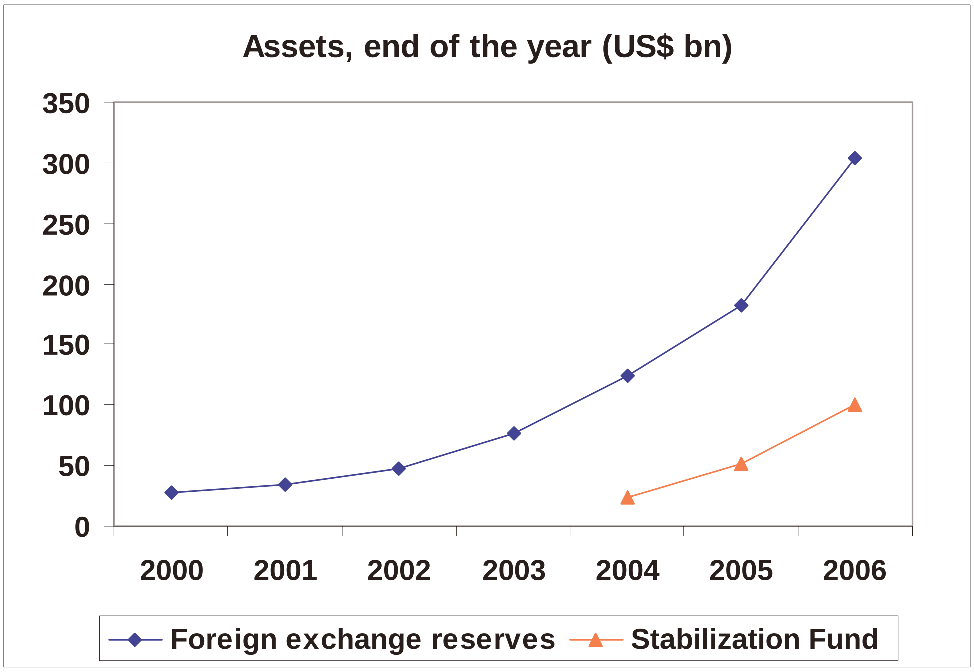
Several new institutions have been established (or are in the pipeline) to realize new approaches, including Investment Fund, State Venture Fund, Development Bank, special economic zones and technological incubators. Mechanisms of public-private partnership are being developed to raise effectiveness of investment projects funded by the government (say, 10 concession agreements in infrastructure were approved in 2006). As of late March 2007 funding of 12 projects has been approved by the government. Total investment amounts to RUR1021 bn., a bulk of them (over 70%) being co-financing by the private sector. The newly established State Venture Fund is going to enter capital of some dozen private venture funds to finance innovation projects.

The draft federal budget for 2008 envisages that 'National Economy' is the most rapidly growing expenditure item. Public expenditure funded from the federal budget will continue to increase as percentage of GDP: from 1.4% in 2004, and 2.1% in 2006, up to 2.7% in 2008. Taken with implementation of the 'National projects' aimed in particular at improving public health care and education, this required increase of spending as percentage of GDP from 16.3% in 2006 to 17.4% in 2007, and 18.6% in 2008. Additional expenditures will be funded by lower than in the previous years saving of oil revenues. This does not create short-term risks for the budget, taking into account projections of the oil and gas prices, and amount of fiscal reserves. Still to ensure longer-term budget safety, the government took decision to modify mechanism of the Stabilization Fund to subject management of oil revenues to even more strict rules. Starting next year all revenues from extraction and export of hydrocarbons (not only windfall gains) will be managed in a special regime. Regardless of international prices fixed (in percentage of the GDP) amount of oil and gas revenues will be used to finance budget expenditures, while the rest will be forwarded to the Reserve Fund or Future Generation Fund. The key fiscal rule will be formulated now as a restriction on the size of non-oil deficit: it may not exceed 'oil transfer' (equal to 3.7% of GDP) by more than 1% of GDP. The new mechanism will enhance long-term macroeconomic stability by restraining current spending and ensuring a source of funding for growing future liabilities (first of all, that of pension system). Another important innovation is introduction of multi-year budgeting. The Government has developed for the first time and submitted to the Duma a full-fledged 3-years budget for 2008-2010.

Further development of pro-active policy and at the same time introduction of more strict fiscal rules will allow to keep balance among macro stability and safety and acceleration and improving quality of economic growth. This makes good basis for sustained growth by some 6-6.5% per year in the forthcoming years.


GDP trends
175%
150%
125%
100%
75%
50%
25%
0%
1250
1000
750
500
250
0
US$ bn
2000
2001
2002
2003
2004
2005
2006
Volume (1999=100%)
Value (US$)


Public Debt (% of GDP)
61
41
21
1
2000
2001
2002
2003
2004
2005
2006
External
Domestic


Assets, end of the year (US$ bn)
350
300
250
200
150
100
50
0
2000
2001
2002
2003
2004
2005
2006
Foreign exchange reserves
Stabilization Fund