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## **Russian Federation: GDP growth weakens, investments disappoint**

The Russian economy grew by just slightly over 4% in 2002 – the lowest rate since the August 1998 crisis – as devaluation effects and high world market energy prices have been gradually fading. Neither the already implemented reforms nor greater political stability of Putin's presidency are bearing fruit sufficiently; investors remain extremely cautious. Moreover, the external surplus has been falling as imports rose faster than exports (though growing in volume, in euro terms the latter even fell last year owing to changes in the EUR/USD exchange rate). Investments were disappointingly weak and the main growth stimulus in 2002 came again from the expanding services sector. Annual inflation dropped to 16% (producer prices increased by less than 12%) and the federal budget again recorded a surplus – even after deducting debt service expenditures.

This positive news (which includes some improvements in the living standards as private disposable income grew by almost 9% and unemployment fell) are clouded by the recent reform stalemate and growing structural distortions in the economy. Despite some progress in the former, sound institutional foundations for a sustainable development are still largely missing. The impressive GDP growth during the last four years (almost 6% per year on average) has been just a windfall of the rouble devaluation and high world market energy prices; the larger part of manufacturing industry remains decimated. The main concern is about investments, which picked up temporarily during 1999-2001 but remained nearly flat last year. Apart from the oil sector (and booming housing construction in Moscow) investments actually declined and the drop in machinery and equipment investments is especially worrying. Moreover, FDI inflows have been disappointingly low; net inflows have even declined in 2002, and there is little FDI outside the fuels and metallurgy industries. In sum, the outlook for sustainable growth remains problematic as the country continues to be highly dependent on volatile commodity prices and investors' confidence remains weak. As a result, economic growth is expected to hover around 4%, and it may accelerate only slightly after reforms have gradually borne fruit. Needless to say, this forecast rests on the assumption that no major shift in energy prices will occur. With 50% of export revenues coming from energy carriers, any larger drop in the oil price would substantially alter the GDP and budgetary outlook.

Industry in particular has been losing steam gradually: it grew by just 3.7% last year (after nearly 5% in 2001 and more than 10% in 1999-2000). Agricultural production almost stagnated (despite another good grain harvest). Also construction output was weak, whereas the retail trade turnover (the latter increased by 9% last year) continues to record robust growth. As in the previous two years, the main growth impetus came

from the expansion of domestic demand, last year with a clear shift towards more private consumption. The direct contribution of net exports to real GDP growth has become negligible. The trade surplus remains very high – it amounted to more than USD 46 billion in 2002. The current account surplus was USD 32 billion (9% of GDP). According to the Central Bank of Russia (CBR), total external debt decreased slightly in the course of 2002. Within total external indebtedness (USD 150 billion), the share of state debt is declining whereas debts of the banking system and non-financial enterprises are rising. The so-called '2003 debt service problem' is definitely no longer acute. Last but not least, budget revenues are increasing (to about 20% of GDP in 2002) and despite some growth in expenditures the federal budget recorded a primary surplus of 3.5% of GDP in 2002.

Several key pieces of reform legislation were adopted and implemented during 2001, but in 2002 – apart from the adoption of the Land Code, which legalized sales of agricultural land to Russian citizens – not much has happened. After the introduction of a flat income tax of 13% and new corporate taxation rules (since the beginning of 2002 a profit tax of 24% instead of previously 35% is being levied while numerous exemptions were simultaneously abolished), discussion regarding further tax reforms continue. Especially the unified social tax and VAT rates are likely to be modified. Import tariffs have been lowered and streamlined in the course of the preparations for WTO accession. As of 1 April 2002, Russia has been recognized as a market economy by the USA, and the EU followed suit in May. Apart from the political symbolism, the market economy status will make future anti-dumping claims against Russian exports more difficult. Unfortunately, virtually no progress has been achieved so far in the envisaged restructuring and improved transparency of natural monopolies (including UES Electricity System, RAO Gazprom and Railways), nor in the banking system reform.

The state budget plan for 2003 reckons with a smaller surplus (0.6% of GDP, about 2 percentage points less than in 2002). This implies that real budget expenditures will actually stagnate and revenues will fall. Annual inflation is projected at 10% to 12%, the average exchange rate at RUR 33 per USD. Official GDP growth projections range between 3.5% and 4.4% in 2003. On the whole, the official growth projections seem to be realistic, but WIIW does not expect GDP growth to significantly exceed 4% in the coming two years. In view of the forthcoming parliamentary (December 2003) and presidential elections (Spring 2004) no major reform steps can be expected. The re-election of President Putin – and with it some degree of political stability – is almost certain.

Table RU

## Russia: Selected economic indicators

|   | 1996   | 1997   | 1998   | 1999   | 2000   | 2001   | 2002 <sup>1)</sup> | 2003   | 2004<br>forecast |
|---|--------|--------|--------|--------|--------|--------|--------------------|--------|------------------|
| Population, th pers., end of period                 | 147502 | 147105 | 146693 | 145925 | 145185 | 144321 | .                  | 143500 | 143200           |
| Gross domestic product, RUB bn, nom.                | 2145.7 | 2478.6 | 2741.1 | 4766.8 | 7302.2 | 9040.8 | 10863.4            | 12800  | 14600            |
| annual change in % (real)                           | -3.4   | 0.9    | -4.9   | 5.4    | 9.0    | 5.0    | 4.3                | 4.0    | 4.0              |
| GDP/capita (USD at exchange rate)                   | 2835   | 2909   | 1922   | 1323   | 1784   | 2141   | 2400               | .      | .                |
| GDP/capita (USD at PPP - wiiw)                      | 6580   | 5680   | 5480   | 5880   | 6590   | 7110   | 7560               | .      | .                |
| Gross industrial production                         |        |        |        |        |        |        |                    |        |                  |
| annual change in % (real)                           | -4.0   | 1.9    | -5.2   | 11.0   | 11.9   | 4.9    | 3.7                | 4      | 4.5              |
| Gross agricultural production                       |        |        |        |        |        |        |                    |        |                  |
| annual change in % (real)                           | -5.1   | 1.5    | -13.2  | 4.1    | 7.7    | 6.8    | 1.7                | .      | .                |
| Goods transport, bn t-kms                           | 3370   | 3256   | 3147   | 3315   | 3480   | 3592   | .                  | .      | .                |
| annual change in %                                  | -4.6   | -3.4   | -3.3   | 5.3    | 5.0    | 3.2    | 5.6                | .      | .                |
| Gross fixed investment, RUB bn, nom.                | 376.0  | 408.8  | 407.1  | 670.4  | 1165.2 | 1599.5 | 1660.5             | .      | .                |
| annual change in % (real)                           | -18.0  | -5.0   | -12.0  | 5.3    | 17.7   | 8.7    | 2.6                | 5      | 7                |
| Construction output total                           |        |        |        |        |        |        |                    |        |                  |
| annual change in % (real)                           | -16.0  | -6.0   | -5.0   | 6.0    | 11.0   | 9.9    | 2.7                | .      | .                |
| Dwellings completed, th units                       | 481.5  | 430.3  | 387.7  | 389.8  | 373.4  | 381.6  | 395.8              | .      | .                |
| annual change in %                                  | -20.0  | -10.6  | -9.9   | 0.5    | -4.2   | 2.2    | 3.7                | .      | .                |
| Employment total, th pers., average                 | 65950  | 64693  | 63812  | 63963  | 64327  | 64710  | 66600              | .      | .                |
| annual change in %                                  | -0.7   | -1.9   | -1.4   | 0.2    | 0.6    | 0.6    | 3                  | .      | .                |
| Employment in industry, th pers., average           | 16366  | 14905  | 14162  | 14297  | 14543  | 14692  | .                  | .      | .                |
| annual change in %                                  | -4.6   | -8.9   | -5.0   | 1.0    | 1.7    | 1.0    | .                  | .      | .                |
| Reg. unemployed, th pers., end of period            | 2506.0 | 1998.7 | 1929.0 | 1263.4 | 1037.0 | 1122.7 | 1309.0             | .      | .                |
| Reg. unemployment rate in %, end of period          | 3.4    | 2.7    | 2.7    | 1.7    | 1.4    | 1.6    | 1.8                | .      | .                |
| LFS - unemployment rate in %, average <sup>2)</sup> | 9.8    | 12.0   | 13.5   | 13.0   | 10.5   | 9.1    | 7.8                | 7.5    | 8                |
| Average gross monthly wages, RUB                    | 790.2  | 950.2  | 1051.5 | 1522.6 | 2223.4 | 3240.4 | 4426.0             | .      | .                |
| annual change in % (real, gross)                    | 6.4    | 4.7    | -13.3  | -22.0  | 20.9   | 19.9   | 16.6               | .      | .                |
| Retail trade turnover, RUB bn                       | 756.3  | 883.3  | 1077.0 | 1848.2 | 2416.2 | 3151.5 | 3600               | .      | .                |
| annual change in % (real)                           | 0.4    | 4.7    | -3.5   | -6.3   | 8.8    | 10.6   | 9.1                | .      | .                |
| Consumer prices, % p.a.                             | 47.8   | 14.8   | 27.6   | 85.7   | 20.8   | 21.6   | 16.0               | 12     | 10               |
| Producer prices in industry, % p.a.                 | 50.8   | 15.0   | 7.1    | 58.9   | 46.6   | 19.1   | 11.6               | 15     | 8                |
| Central government budget, RUB bn                   |        |        |        |        |        |        |                    |        |                  |
| Revenues  | 281.9  | 343.4  | 325.9  | 615.5  | 1132.1 | 1590.7 | 2200.0             | .      | .                |
| Expenditures  | 356.2  | 436.6  | 472.2  | 666.9  | 1029.2 | 1325.7 | 1970.0             | .      | .                |
| Deficit (-) / surplus (+)                           | -74.3  | -93.2  | -146.3 | -51.4  | 102.9  | 265.0  | 230.0              | .      | .                |
| Deficit (-) / surplus (+), % GDP                    | -3.5   | -3.8   | -5.3   | -1.1   | 1.4    | 2.9    | 2.1                | .      | .                |
| Money supply, RUB bn, end of period                 |        |        |        |        |        |        |                    |        |                  |
| M1, Money   | 192.4  | 298.3  | 342.8  | 526.8  | 879.3  | 1192.6 | 1337.4             | Nov    | .                |
| M2, Money + quasi money                             | 357.3  | 457.2  | 628.6  | 984.9  | 1560.0 | 2122.7 | 2602.7             | Nov    | .                |
| Refinancing rate of NB % p.a., end of per.          | 48     | 28     | 60     | 55     | 25     | 25     | 21                 | Nov    | .                |
| Current account, USD mn                             | 10847  | -80    | 219    | 24616  | 46839  | 34842  | 31700              | 27000  | 25000            |
| Current account in % of GDP                         | 2.6    | 0.0    | 0.1    | 12.7   | 18.0   | 11.2   | 9.1                | 7.0    | 6.0              |
| Gross reserves of NB, incl. gold, USD mn            | 15324  | 17784  | 12223  | 12456  | 27972  | 36622  | 47792              | .      | .                |
| Gross external debt, USD mn                         | 125000 | 130800 | 145000 | 158800 | 161400 | 151100 | 149700             | Sep    | .                |
| Exports total, fob, EUR mn <sup>3)</sup>            | 70731  | 76623  | 66467  | 70820  | 113672 | 113448 | 113172             | 115000 | 118000           |
| annual change in %                                  | 12.3   | 8.3    | -13.3  | 6.5    | 60.5   | -0.2   | -0.2               | 2      | 3                |
| Imports total, fob, EUR mn <sup>3)</sup>            | 53702  | 63474  | 51798  | 37061  | 48552  | 60025  | 64049              | 70000  | 76000            |
| annual change in %                                  | 12.2   | 18.2   | -18.4  | -28.5  | 31.0   | 23.6   | 6.7                | 9      | 9                |
| Average exchange rate RUB/USD                       | 5.12   | 5.79   | 9.71   | 24.62  | 28.12  | 29.17  | 31.35              | 33     | 35               |
| Average exchange rate RUB/EUR (ECU)                 | 6.63   | 6.54   | 11.06  | 26.24  | 26.03  | 26.13  | 29.65              | 35     | 35               |
| Purchasing power parity RUB/USD, wiiw               | 2.21   | 2.96   | 3.41   | 5.54   | 7.61   | 8.78   | 9.97               | 11     | .                |
| Purchasing power parity RUB/EUR, wiiw               | 2.40   | 3.25   | 3.73   | 6.04   | 8.26   | 9.53   | 10.76              | .      | .                |

Notes: 1) Preliminary. - 2) Up to 1998 data refer to October. - 3) Based on balance of payments statistics, including estimate of non-registered trade. Converted from USD to EUR using the ECB EUR/USD foreign exchange reference rate.

Source: wiiw Database incorporating national statistics; wiiw forecasts.