BOFIT Russia Desk

BOFIT Russia Review Yearbook 2006

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Economic Developments

Growth accelerates

GDP growth in Russia accelerated to 7 % y-o-y in 3Q05, bringing the on-year growth figure for the first three quarters to 6.2 %. This surpassed most projections and encouraged the Russian authorities to further raise their growth projection for the full year 2005 to 6.4 %, which implies an expected growth rate of over 7 % for 4Q05.

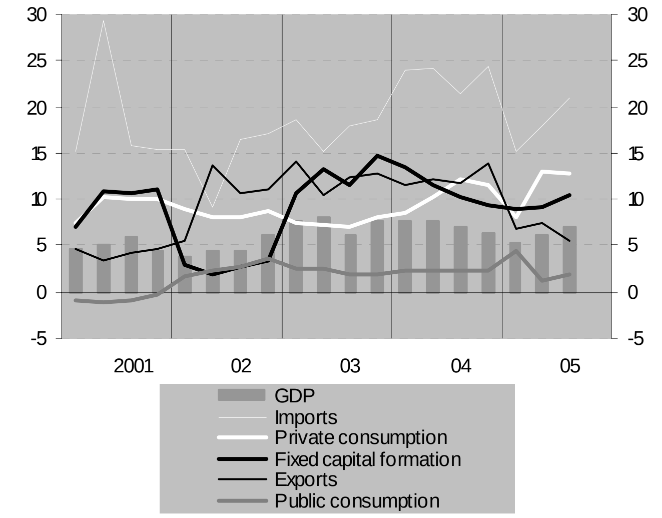
The renewed acceleration of growth is not necessarily surprising. If anything, the deceleration of growth in 1H05 against a background of skyrocketing world market prices for Russia's main export products over the past two years may have been the surprise. The price for crude oil and major oil products has doubled since the beginning of 2004, the price for natural gas has risen around 50 % and many of the relevant metals prices are up strongly. The additional export income earned by Russia has been considerable as exports of these products account for about a quarter of GDP. The economy ministry estimates that about two percentage points of GDP growth in 2005 resulted from higher oil prices.

Growth increasingly driven by domestic demand

Although the government has tightened taxation of the oil sector (especially oil exports) and placed part of the tax revenue into the state stabilisation fund to prevent all of the export income from feeding into the economy, export earnings have still been sufficient to support rapid growth in wages, public spending and bank lending. Thus, growth of domestic demand exceeded 9 % for the first three quarters, accelerating to over 11 % y-o-y in 3Q05.

Private consumption growth, a key demand driver, reached a record pace of 13 % in 2Q05, and virtually retained that pace in 3Q05 (see chart). Moreover, growth in fixed capital formation (investment) picked up to over 10 % in 3Q05. Nevertheless, the GDP data suggest that an increase in inventories accounted for most of the growth spurt. Such inventory variations are rather common in Russian GDP data and are prone to soften assessments about the durability of any quarterly acceleration. Exports, another demand component, provide a much clearer picture. Russian exports of crude oil have started to decline (falling 1.5 % in the first three quarters), and growth of the overall volume of exports of goods and services has dropped considerably from the 2002-04 pace.

GDP, demand components and imports, % change four quarters previous



Source: Rosstat

Imports over domestic supply growth, continually

For GDP supply components, import volume growth accelerated back to over 20 % y-o-y in 3Q05. Rapid import growth restrained the increase of domestic supply at around 6 % in the first three quarters (although a pick-up to almost 7 % took place in 3Q05).

Rapidly rising imports also partly explain why the trade sector has been the leading domestic supply component for years. The sector makes a remarkable contribution to GDP growth as it expands fast (about 11 % in the first three quarters of 2005) and constitutes a large share of GDP (officially close to a quarter, although the figure, even today, may be exaggerated by transfer pricing). The other relatively important sectors showing faster growth in 3Q05 were construction and real estate. Manufacturing also improved its performance after an anaemic showing in 1H05. Transports, which also generate a substantial share of GDP, performed more modestly in 2005 than in previous years.

Macroeconomic indicators

	1997	1998	1999	2000	2001	2002	2003	2004	2005,	as of
GDP, %	1.4	-5.3	6.4	10.0	5.1	4.7	7.3	7.2	6.2	1-9/05
Industrial production, % [1]	2.0	-5.2	11.0	11.9	2.9	3.1	8.9	7.3	4.0	1-11/05
Fixed investments, %	-5.0	-12.0	5.3	17.4	10.0	2.6	12.5	10.9	10.2	1-11/05
Unemployment, % (end of period)	9.0	13.2	12.4	9.9	8.7	9.0	8.7	7.6	7.8	11/05
Exports of goods, US$ billion	86.9	74.4	75.6	105.0	101.9	107.3	135.9	183.5	220.1	1-11/05
Imports of goods, US$ billion	72.0	58.0	39.5	44.9	53.8	61.0	76.1	96.3	111.1	1-11/05
Current account, US$ billion	-0.1	0.2	24.6	46.8	33.9	29.1	35.4	58.6	62.9	1-9/05

[1] *New methodology from Jan. 1, 2005; figures for 2001–2004 revised and not comparable with previous years.*
Sources: Rosstat, CBR.

Structural shifts in 2006 federal budget

The structure of the 2006 federal budget signed into law by president Putin at the end of 2005 resembles the revised 2005 budget after the two supplementary budgets in summer and fall. Nevertheless, there are several differences in revenue and expenditure levels and areas of emphasis.

Revenues set to fall

Like the revised 2005 budget, foreign trade duties and VAT each account for a third of revenue, while natural resource fees are expected to bring in about 15 % of total federal budget revenues. However, total revenues as a share of GDP are expected to fall by three percentage points if the anticipated fall in tax revenues, especially of those related to natural resources, comes about. This reflects the assumption that the average price of Urals-grade crude falls from about $50 a barrel in 2005 to $40 in 2006. Federal budget revenues last year were also boosted by several major one-time revenue events, including the redemption of tax arrears from Yukos and Sibneft and the auction of Yukos' core production unit, Yuganskneftegaz.

Pension spending up, priority sectors get extra funding

Despite the expected fall in revenues, expenditures as a share of GDP are to increase compared to 2005. Non-interest expenditures will rise in real terms by some 15 %. However, the inflationary impact of higher budget expenditures has raised some discussion. After the passage of the 2006 budget, finance minister Kudrin proposed (albeit with no response so far) limiting the rise of non-interest expenditures in the future to the level of real GDP growth.

After the top rate of the unified social tax was slashed at the start of 2005, UST revenues fell by half. This forced the government to increase the financing of pension outlays directly from the federal budget. In the 2006 budget, transfers to pension fund (PF) make up over 20 % of all federal budget expenditures. Moreover, their relative share is expected to rise further in coming years. Transfers to the PF and other much smaller social funds are included in the Russian budget classification as transfers to regions.

Actual transfers to regions amount to some 15 % of total budget expenditures and 2.3 % of GDP. In relation to GDP and in real terms, they are smaller than in the revised 2005 budget and almost exclusively in the form of federal programs or subsidies.

Financial aid to regions includes part of the additional funding for the national priority sectors, i.e. health care, housing, education and agriculture. In the expenditure breakdown, direct federal expenditures earmarked for the priority sectors are somewhat larger than last year both as a share of GDP and total spending. Taking into account the resources resources distributed via regional transfers, total financing of the four priority sectors in 2006 equals roughly 2 % of GDP.

Transfers to regions also include resources for salary hikes of employees in the budget sector. From the start of 2006, military salaries were increased by 15 %. The overall federal budget sector salaries will also be boosted 15 % in May and another 11 % in October. Regional authorities may introduce salary hikes for regional budget employees.

Traditional sectors of focus in the federal budget, i.e. defence and national security, make up some 15 % of total expenditures. They will receive resources worth some 5 % of GDP, which means no essential change from 2005. In real terms, however, their resources will increase. More money will go to general administration.

The financing of infrastructure projects is set to increase from the estimated 2005 level of about 1.8 % of GDP to over 2 % of GDP in 2006.

Is the 2006 budget already outdated?

At the end of December, just a few days before the 2006 budget went into force, finance minister Kudrin stated his assessment that the actual budget revenues in 2006 will end up higher (almost 7 %) than anticipated in the budget. Based on his estimates, the surplus (barring changes in spending) would exceed 4 % of GDP. Considering the large discrepancies between the approved and realised federal budgets in recent years and the likely scenario that the average Urals oil price will remain well above the $40-a-barrel assumption, a surplus of such magnitude is not unlikely.

Main categories of approved federal budgets for 2005* and 2006

	2006, % of GDP	2005*, % of GDP	2006 %	2005* %
Total revenues	**20.7**	**23.7**	**100**	**100**
Total, excl. social tax	19.5	22.4	94.0	94.7
VAT	*6.7*	*7.1*	*32.4*	*30.1*
Profit tax	*1.4*	*1.6*	*6.8*	*6.6*
Excise taxes	*0.4*	*0.4*	*1.8*	*1.8*
Natural resource fees	*3.1*	*4.0*	*14.9*	*16.7*
Export and import duties	*6.8*	*7.8*	*33.0*	*33.0*
Total expenditures	**17.5**	**16.9**	**100**	**100**
Total, excl. social tax	16.3	15.6	92.9	92.5
Total, excl. social tax and interest payments on debt	15.5	14.5	88.3	86.0
*General administration***	*1.8*	*1.4*	*10.3*	*8.3*
Defence	*2.7*	*2.8*	*15.6*	*16.3*
Security	*2.2*	*2.2*	*12.7*	*12.9*
Production, transport, etc.	*1.4*	*1.3*	*7.9*	*7.4*
Housing	*0.2*	*0.1*	*0.9*	*0.3*
Education	*0.8*	*0.8*	*4.7*	*4.5*
Health care	*0.6*	*0.4*	*3.5*	*2.7*
Social policy	*0.8*	*0.9*	*4.8*	*5.3*
Transfers to regions	*2.3*	*2.6*	*13.1*	*15.7*
Transfers to pension fund	3.6	3.1	20.5	18.7
Surplus	**3.2**	**6.9**		

* Includes supplementary budgets approved in summer and autumn 2005.
** Does not include interest payments as in the Russian budget expenditure classification.

Fiscal indicators for federal government (% of GDP, unless otherwise indicated; end-period figures for debt)

	1997	1998	1999	2000	2001	2002	2003	2004	2005,	As of	2006 budget
Revenues [1]	13.3	11.4	12.6	15.4	17.8	20.3	19.5	20.4	24.0	1-10/05	20.7
Expenditures [1]	20.9	17.4	16.8	14.6	14.8	19.0	17.8	16.1	15.8	1-10/05	17.5
Balance	-7.7	-6.0	-4.2	0.8	3.0	1.4	1.7	4.4	8.3	1-10/05	3.2
Foreign currency debt	30.2	50.1	87.7	55.3	44.4	36.2	25.7	19.6	12.5	9/05	
Foreign currency debt, $ bn	134.6	158.2	154.6	143.4	133.1	123.5	119.7	114.4	86.8	9/05	

[1] *Since 2002 the unified social tax is included in the federal budget.*
Source: Budget: IMF 1997–2000, Rosstat 2001–2005. Debt: IMF 1996–1999, Minfin 2000–2005.

Macro and regulatory aspects of consumer price inflation

Consumer prices rose 10.9 % y-o-y at the end of 2005. There has been little change in consumer price inflation since end-2003 (12 %). Both monetary and regulatory measures had their impact.

Inflation has been supported by the *macroeconomic* regime, whereby external currency inflows (basically from large current account surpluses) exert upward pressure on the rouble's exchange rate while the CBR has pursued a policy of limiting nominal appreciation of the rouble. The CBR has purchased large amounts of foreign exchange to check appreciation, even as it lacks sufficient monetary policy instruments to absorb the resulting domestic liquidity and could face high interest rate costs if it went for absorption on a wider scale. Instead, Russia has relied on fiscal policy to absorb liquidity: the state continues to deposit part of its earnings in the stabilisation fund and place that money as well as other surpluses at the CBR. These federal government deposits account for 25–30 % of the entire domestic money mass (includes rouble and foreign exchange deposits and cash in circulation). By comparison, the stock of central bank bonds on issue (the main market instrument for absorbing liquidity) amounts to little over 1 % of the money mass. Mandatory reserves of banks stand at around 2 %. Both figures are less than what banks keep in their CBR correspondent accounts.

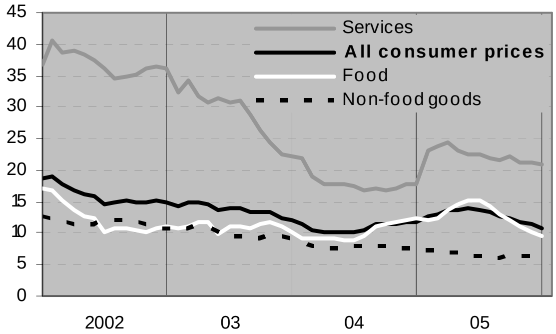
Despite fiscal efforts to absorb liquidity, domestic money growth picked up to almost 40 % y-o-y in 2005 (excluding hard-to-trace foreign cash holdings). The trend was supported by a strong surge in bank deposits and lending, as well as fiscal easing during the year. Wages have increased rapidly.

Regulatory policies have also influenced the prices of important consumer items. Prices for food, which accounts for about half of the consumer price basket, rose almost as fast last year as in previous years (see chart). Some of the increase reflects restrictions imposed on meat imports; instead of creating the hoped-for increase in the domestic supply, the import quotas induced a major upward price spiral from 2004 to mid-2005. The rise of meat prices only moderated after import restrictions were relaxed. The effects of the earlier spike in agricultural producer prices have by now also worked their way through the economy. Price growth for non-food goods declined, partly as a result of the rouble's strength. Gasoline rose steeply until the autumn, when domestic oil companies and the federal authorities agreed on a price freeze until the end of year. Prices for services rose strongly last year as regulated prices were hiked to better reflect their actual market value. Price hikes were especially sharp in the housing sector (rents and housing-related services were up 33 %). In some regions, occupants now pay the full unsubsidised cost of housing.

Anti-inflationary measures readied

In response to president Putin's call last autumn for anti-inflationary action, including systemic measures, the government has prepared a package. In addition to underlining the need to maintain macroeconomic stability, the plan proposed greater support for domestic food production and regulation of certain prices. The government has already limited price hikes in the housing sector this year to 15–20 %. It aims to set forth rules on the pricing of housing services and regulatory oversight for the sector by mid-2006. The plan also foresees lower taxation on oil and easier imports of meats.

Consumer prices, y-o-y change, %

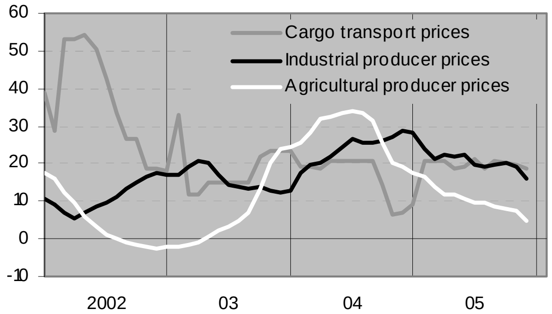


Source: Rosstat

Producer price pressures abate but still not low

The rise in industrial producer prices slowed overall last year (see chart), although they were still up over 15 % y-o-y due to higher domestic price for crude oil (up about 60 % y-o-y) and major fuel oils. The rise in agricultural producer prices abated significantly. Cargo transport prices increased almost 20 % as energy pipeline tariffs were boosted over 20 % and rail tariffs about 13 %.

Producer prices, y-o-y change, %



Source: Rosstat

Monetary indicators

	1997	1998	1999	2000	2001	2002	2003	2004	2005,	as of
Inflation (CPI), 12-month, % (end of period)	11.0	84.4	36.5	20.2	18.6	15.1	12.0	11.7	10.9	
M2, 12-month growth, % (end of period)	29.0	21.3	57.5	61.5	39.7	32.4	50.5	35.8	38.0	11/05
Average wage, $ (period average, except last)	164	108	62	79	111	142	180	237	314	11/05
Deposit interest rate, % (period average)	16.8	17.1	13.7	6.5	4.9	5.0	4.5	3.8	3.7	10/05
Lending interest rate, % (period average)	32.0	41.8	39.7	24.4	17.9	15.7	13.0	11.4	10.6	10/05
Forex reserves, $ bn (incl. gold)	17.8	12.2	12.5	27.9	36.6	47.8	76.9	124.5	182.2	
RUB/USD exchange rate (end of period)	5960	20.65	27.00	28.16	30.14	31.78	29.45	27.75	28.78	
RUB/EUR exchange rate (end of period)			27.23	26.14	26.49	33.11	36.82	37.81	34.19	

Sources: Rosstat, CBR.

Delicate nominal rouble rate
by Vesa Korhonen*

For the past couple years, the Central Bank of Russia has quite determinedly leant on upward pressures on the nominal exchange rate of the rouble. CBR interventions on the domestic foreign exchange market resulted in net purchases of foreign exchange corresponding to 8–9 % of annual GDP during 2003–05. The central bank's foreign currency reserves now equal over 70 % of the total domestic rouble money supply (M2) and the roubles issued to purchase foreign currency have helped inflation. Thus, Russia may continuously find itself considering allowing greater exchange rate flexibility to the benefit of price stability.

Russia's approach to such a shift has so far been cautious, and at most, showed slow movement towards flexibility which in 2005 meant the rouble appreciated about 4 % in nominal terms against its trade-weighted currency basket. At the background, various considerations have been aired.

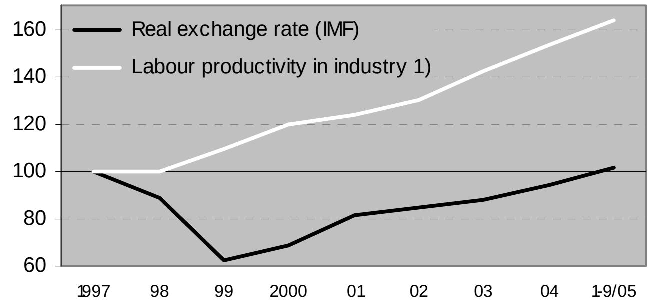
Domestic production worries

A major concern long voiced in Russia claims there is a risk that nominal appreciation of the rouble might hamper growth of domestic production especially by encouraging import growth. This argument has possibly gained attention in recent years as rapid economic growth has been made an explicit top priority of the national leadership. In a context of economics and politics, the rouble can easily be a meeting point for tensions between differing views.

Opponents of rouble flexibility tend to perceive change as unsafe. They possibly fear that the pressing effects of an appreciating rouble on domestic producers would be sure and immediate, while inflation would only decelerate with a lag and show notable downward stickiness both due to market behaviour and the need to raise regulated prices. Proponents, on the other hand, stress that lower and less volatile inflation would bring fundamental stability to the whole economy.

An overarching view recognises that Russia, facing continuous large external surpluses, cannot avoid a rising real exchange rate (RER) even in the relatively short term, be it through a rising nominal exchange rate or inflation. Those less worried remind us that Russian industry has been able to counter the effects of a higher RER through productivity gains. Their opponents note that past productivity gains might not continue as capacity limits are close and the investments needed are surrounded by uncertainty. Finally, there is the position that brisk import growth will continue anyway since Russian industry lacks sufficient real competitiveness to make considerations of price competitiveness relevant.

Rouble real exchange rate and labour productivity in industry



1) volume of value-added per employee

Sources: Rosstat, IMF, BOFIT calculations

Concerns about capital inflows and asset values

A somewhat less-discussed topic in Russia is that expectations of upward nominal exchange rate flexibility can attract capital inflows or decrease outflows, while establishment of the flexibility can as such discourage short-term capital flows. These considerations should also be relevant at least to a degree in the Russian context, even if the major capital flows have so far been caused more by systemic uncertainty, as reflected in the large grey outflows. In practice, larger speculative inflows of this type would likely mean parking most such money in Russian banks as domestic liquidity is already abundant and then seeking assets to invest in.

A nominal appreciation of the rouble would also devalue foreign currency deposits in Russia (over 5 % of GDP), foreign cash (something between 4 % and perhaps 10 % of GDP) and the CBR's foreign currency reserves (almost a fifth of GDP). On the other hand, at least part of the majority holding rouble deposits (17 % of GDP) and rouble cash (9 % of GDP) would perceive their assets revalued. Over time, potentially rather quickly, nominal appreciation would further encourage the shift from foreign currency to roubles.

Prudently ahead

Surrounded by such pros and cons, and given that the current election cycle in Russia (the parliamentary and presidential elections are only two years away) keeps makers and shapers of decisions inclined to avoid radical changes, Russia would likely only cautiously move towards nominal flexibility of the rouble over the next few years. For the long run, the rouble may look grossly undervalued, a matter that shall be rectified over time by nominal appreciation or inflation – or both.

** The author is an economist at BOFIT.*

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Economic Developments

Rapid growth retained in late 2005, external trade boomed

Rosstat's GDP data for all of 2005 indicate that Russian GDP grew 6.4 %. Although the annual growth figure is smaller than the score of 2004 (and although quarterly data for 2005 are still incomplete), it implies that, after a slowdown in 1H05 and a pickup of growth to around 7 % in 3Q05, the economy maintained such a higher pace in 4Q05.

Private consumption, which accounted for 47 % of GDP, continued to expand in 2005 at the 11 % tempo it achieved in spring 2004. For 4Q05, this was reflected in continued fast growth in the trade and service sectors. Growth of fixed investments again exceeded 10 % last year, due to a pickup in 2H05 when construction grew at a pace not seen since spring 2004. Although the share of fixed investments in GDP was still at the same relatively low level of 18 % as in the four previous years, the investment structure saw diversification from fuels production to e.g. manufacturing industries. Export volume growth apparently abated further in 4Q05, pulling overall 2005 growth to below 6 %. Exports slightly increased their weight in GDP to 35 % as energy export prices rose sharply.

Imports equalled over 21 % of GDP, and continued to decline in 2005 as import prices rose less than other prices. The import volume grew 16 % in 2005 (over 22 % in 2004). Brisk real growth, inflation and a strong rouble lifted the value of Russian GDP and domestic demand by about 30 % in euro or dollar terms in 2005, which made the euro or dollar value of Russia's imports grow by more than one quarter. In 2005, Russia's GDP reached €618 billion or $765 billion (€4,300 or $5,350 per capita) at nominal exchange rates.

Russian GDP and external trade, % change of euro and dollar value

Sources: Rosstat, BOFIT

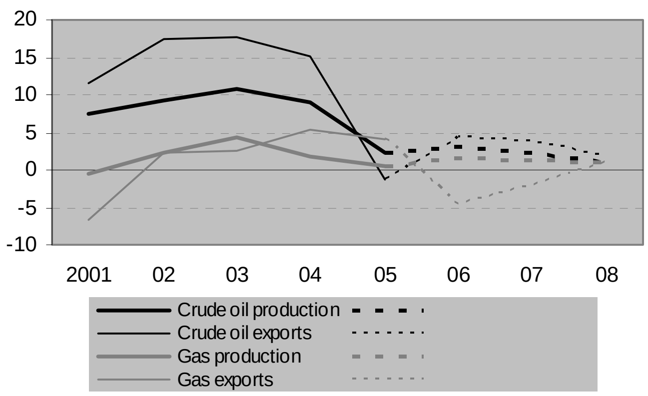
Russia's growth projections expect cautious energy growth

Like many major forecasters, Russian authorities have started to foresee that world energy prices could stay high or decline only moderately in 2006-08. Such assumptions are contained in the optimistic variants of their forecasts prepared around the year-end. However, both where the forecasts project smaller oil price declines (about 10 % in 2006 and 2007) and steeper drops (20 % in 2006 and 13 % in 2007), GDP growth chugs along at 5.6–5.9 % per year in 2006-08. A stable oil price from 2005 to 2006 would yield 6 % growth this year and a rise of more than 15 % in the oil price would give 6.1 % growth. The projections suggest Russia's economy would become less dependent on the oil price. One external factor that counteracts the effect of a declining oil price is the rise in the average gas export price (the assumptions in Russia's projections range between 20 % and 30 % for 2006) since almost all CIS clients have been required to pay more.

Another counteracting factor is the view included in Russia's projections of late 2005 that production and exports of oil and gas will develop modestly in 2006-08. The projections anticipate that Russia's oil production will grow only 2–3 % per year in 2006 and 2007 and exports of crude will reach 4–5 % growth per year. Gas production is expected to increase a modest 1–1.5 % per year in the period, while gas exports are foreseen to decline as supplies to the Ukraine will fall. Gas deliveries to non-CIS countries are to rise in 2007.

Russia's forecasts thus project the economy will become more diversified as GDP growth will not slow very much despite much slower growth of oil and gas production (p. 2).

Oil and gas production and exports, % change



Note: Dotted lines are projections (highest variants).
Source: Rosstat, Ministry of Economy

Macroeconomic indicators

	1997	1998	1999	2000	2001	2002	2003	2004	2005,	as of
GDP, %	1.4	-5.3	6.4	10.0	5.1	4.7	7.3	7.2	6.4	
Industrial production, % [1]	2.0	-5.2	11.0	11.9	2.9	3.1	8.9	7.3	4.0	
Fixed investments, %	-5.0	-12.0	5.3	17.4	10.0	2.6	12.5	10.9	10.5	
Unemployment, % (end of period)	9.0	13.2	12.4	9.9	8.7	9.0	8.7	7.6	7.7	
Exports of goods, US$ billion	86.9	74.4	75.6	105.0	101.9	107.3	135.9	183.5	245.3	
Imports of goods, US$ billion	72.0	58.0	39.5	44.9	53.8	61.0	76.1	96.3	125.1	
Current account, US$ billion	-0.1	0.2	24.6	46.8	33.9	29.1	35.4	58.6	62.9	1-9/05

[1] *New methodology from Jan. 1, 2005; figures for 2001–2004 revised and not comparable with previous years.*
Sources: Rosstat, CBR.

Russia's economic forecast stresses investments

Russia's economic forecast from late 2005 projects slow growth for agriculture and extractive industries in 2006-08, along with little acceleration of growth in manufacturing. Such domestic market sectors as trade, construction and telecommunications are predicted to grow rapidly.

The forecast critically notes that a moderate decline in the world oil price (about 10 % in 2006 and 2007) would reduce GDP growth to around 5 % a year in 2006-08 if a programmatic approach was not applied by channelling resources to the new national priority sectors of health care, education, housing and agriculture and by making an overall increase in public sector investment. With these two elements, the forecast concludes growth close to 6 % a year can be sustained. The forecast reinforces that the policy adopted for 2006 of augmenting public investment from the federal budget will be continued in 2007-08. In addition to investments where the state is the sole investor, there would also be a rise in public-private partnership investments. In such projects, the government's contribution would come out of the newly created federal investment fund. Total public investment is projected to climb from 3 % of GDP in 2005 to about 3.5 % in 2007 and bring the share of total fixed investment in Russia to about 20 % of GDP.

Monetary policy continuously facing real rouble appreciation

The CBR's monetary policy programs of recent years have acknowledged that resisting real appreciation of the rouble is not an option as long as oil world market prices and Russia's current account surpluses remain high. Ahead of his nomination to a second term last November, the CBR Chairman also stressed that central bank measures can only temporarily affect real appreciation of the rouble. He later noted that the CBR's estimates suggest real appreciation has so far not had a noticeable negative effect on the economy's growth.

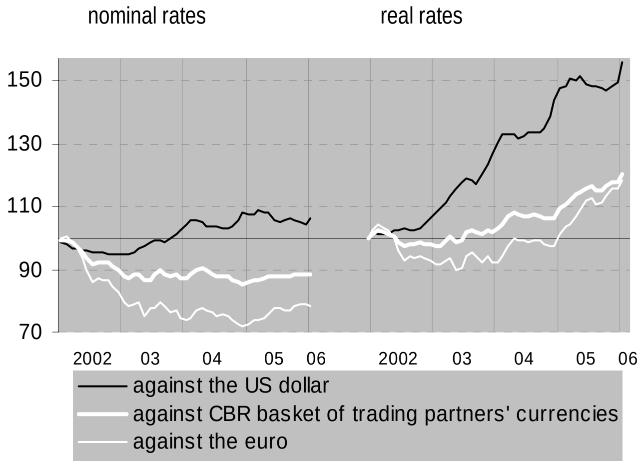
According to the 2006 program, if the world market price of oil remains at its 2005 level, Russia's current account surplus will continue to exceed 10 % of GDP. This, together with the projection about relatively small public and private net capital outflows, means that the CBR's foreign reserves would balloon to over $250 billion by the end of this year. The growth of reserves also implies a continuation of the CBR's managed exchange rate policy, whereby it intervenes in the foreign exchange market to stem the rise of the rouble's nominal exchange rate. The 2006 program, however, foresees some nominal appreciation is possible if the oil price matches or exceeds the 2005 level. During the course of recent years, several large foreign exchange market interventions have been conducted (often late in the year). These moves have helped keep the rouble's value stable against the CBR's trade-weighted currency basket. In 2005, the rouble gained just 3 % against that basket (see chart).

As in earlier years, the 2006 monetary program contains an inflation objective worked out by the government and the CBR. The projected range of 7–8.5 % inflation this year is independent of the oil price assumptions (the economy ministry's forecast prepared in late 2005 foresaw 2006 inflation could be 8–9 % even if the world oil price declined about 10 %). In 2004-05, realised inflation exceeded the annual projection by roughly two percentage points. This was partly due to the foreign exchange market interventions that channelled much of the impact from large current account surpluses to domestic money growth rather than nominal exchange rate appreciation. The difference between consumer price inflation in Russia and its trading partners remained stubbornly at around 7 % in 2003-05.

The rouble's stability and the inflation differential naturally combined themselves into appreciation of the rouble's real exchange rate, for which the CBR's monetary programs set end-year ceilings. While real appreciation stayed well below the 6 % and 7 % ceilings of 2003 and 2004, real appreciation exceeded 10 % in 2005, surpassing the year's 8 % ceiling (chart). The CBR projects 4–5 % real appreciation this year in case the average oil price matches or exceeds the 2005 level. The ceiling is 9 %.

Another aspect of Russia's exchange rate policy is the dollar-euro axis. In this regard the policy is guided by the CBR's currency baskets in which the euro has considerable weight – 36 % in the trade-weighted basket and 40 % (since late 2005, after rising stepwise from 10 % in early 2005) in the dollar-euro basket used for daily exchange rate management. Still, the rise of the dollar against the euro during the course of 2005 made the rouble fall just 3 % against the dollar and rise 9 % against the euro. The rouble's real appreciation was about 4 % against the dollar and 19 % against the euro.

Rouble nominal end real exchange rates, December 2001 = 100



Source: CBR

Fiscal indicators for federal government (% of GDP, unless otherwise indicated; end-period figures for debt)

	1997	1998	1999	2000	2001	2002	2003	2004	2005,	as of	2005 budget
Revenues [1]	13.3	11.4	12.6	15.4	17.8	20.3	19.5	20.4	23.8	1-11/05	20.8
Expenditures [1]	20.9	17.4	16.8	14.6	14.8	19.0	17.8	16.1	15.3	1-11/05	17.5
Balance	-7.7	-6.0	-4.2	0.8	3.0	1.4	1.7	4.4	8.4	1-11/05	3.2
Foreign currency debt	30.2	50.1	87.7	55.3	44.4	36.2	25.7	19.6	12.5	9/05	
Foreign currency debt, $ bn	134.6	158.2	154.6	143.4	133.1	123.5	119.7	114.4	86.8	9/05	

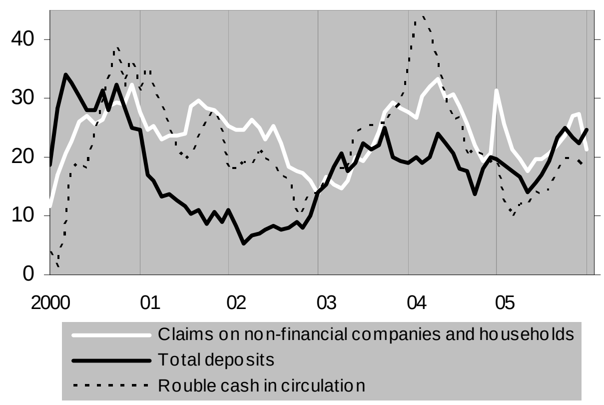
[1] *Since 2002 the unified social tax is included in the federal budget.*
Sources: Budget: IMF 1997–2000, Rosstat 2001–2004, EEG 2005. Debt: IMF 1996–1999, Minfin 2000–2005.

Domestic banking speeds up, borrowing from abroad booms

Growth of deposits at banks operating in Russia accelerated sharply since the middle of 2005. As of end-2005, the stock of deposits was nearly 40 % higher than at end-2004 in nominal terms and 25 % larger in real terms. The stability of the rouble exchange rate, combined with the appreciation pressure and higher interest rates for rouble deposits than foreign currency deposits (see below), induced strong growth in rouble deposits (almost 30 % in real terms) – the trend since early 2003.

The stock of rouble cash in circulation also grew briskly (almost 20 % in real terms), increasing the cash stock to more than 9 % of GDP at end-2005 (compared to 24 % of GDP for bank deposits). On one hand, this suggests that there is still considerable scope to build confidence in banks and develop the domestic payment systems. On the other hand, the strong rouble may have encouraged Russian households and companies to shift part of their cash holdings from foreign currency to roubles.

Bank claims on companies and households, bank deposits, and rouble cash, % change in real terms from 12 months previous



Source: CBR

As liquidity abounds in the Russian banking sector, growth of bank lending to companies in the non-financial sector and households also regained speed towards the end of 2005, moving ahead 20 % in real terms. A strong boom of corporate borrowing from abroad also took place in 2005 as interest rates for domestic bank loans denominated in foreign currencies tended to be higher than the cost of foreign financing available to Russia's soundest companies while upward pressure on the rouble's exchange rate continued. The financing needs of Russia's larger companies are also large compared to the size of Russian banks which have not been active in engaging themselves in loan syndications.

A snapshot of the magnitudes of domestic and foreign corporate borrowing is illustrative of the overall structure of the Russian economy. At the end of 2005, the stock of domestic bank loans to domestic companies – many of them private firms and of varying size – was about $139 billion (about 18 % of GDP). At the same time, the stock of corporate sector foreign debt (including relatively massive loans or bond deals) – held by large, often state-owned, companies – exceeded $110 billion. While the stock of domestic bank loans to domestic companies rose by $27 billion in 2005, the preliminary balance of payments figures suggest the foreign debt obligations of the corporate sector expanded some $40 billion.

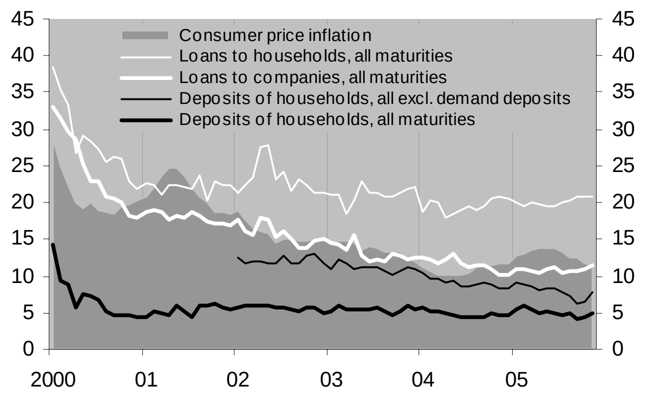
Margins between deposit and lending rates stay wide

Rouble deposits of households and companies in Russia have always been rewarded with interest rates well below inflation (i.e. strongly negative in real terms). Real interest rates on relatively long maturities (such as time deposits exceeding six months) have also been slightly negative on average, including last year.

Reflecting the abundant liquidity, interest rates on corporate rouble deposits generally declined in 2005. Household rouble deposit rates moved in the range of 4-6 %, initially rising only slightly compared to the pickup in inflation, and then partly following the general interest rate downward trend on the interbank market and the upturn late in the year. Although higher than in 2004, the 3-3.5 % average interest paid on foreign currency deposits and the upward pressure on the rouble eroded the attraction of depositing in foreign currencies.

Lending rates remain substantially higher. Even so, nominal rates on corporate rouble loans stayed negative in real terms until late 2005, and rates on longer-term loans ranged around the inflation rate. Household rouble loans continued to carry hefty rates at all maturities. The lower interest rates for dollar and euro loans, especially for household loans, helped foreign currency loans retain their share both in corporate loans (28 %) and household loans (15 %) in 2005.

Interest rates on rouble deposits and loans, %



Source: CBR

Monetary indicators

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006,	as of
Inflation (CPI), 12-month, % (end of period)	11.0	84.4	36.5	20.2	18.6	15.1	12.0	11.7	10.9	10.6	1/06
M2, 12-month growth, % (end of period)	29.0	21.3	57.5	61.5	39.7	32.4	50.5	35.8	38.6		
Average wage, $ (period average)	164	108	62	79	111	142	180	237	301		
Deposit interest rate, % (period average)	16.8	17.1	13.7	6.5	4.9	5.0	4.5	3.8	4.0		
Lending interest rate, % (period average)	32.0	41.8	39.7	24.4	17.9	15.7	13.0	11.4	10.7		
Forex reserves, $ bn (incl. gold)	17.8	12.2	12.5	27.9	36.6	47.8	76.9	124.5	168.4	188.5	1/06
RUB/USD exchange rate (end of period)	5960	20.65	27.00	28.16	30.14	31.78	29.45	27.75	28.78	28.12	1/06
RUB/EUR exchange rate (end of period)			27.23	26.14	26.49	33.11	36.82	37.81	33.94	34.04	1/06

Sources: Rosstat, CBR.

A closer look at Russia's goal of doubling GDP

by Sergey Nikolaenko*

What does the doubling of GDP mean?

In 2003, President Vladimir Putin declared the doubling of Russian GDP within a decade a national goal. Some aspects related to that objective require highlight.

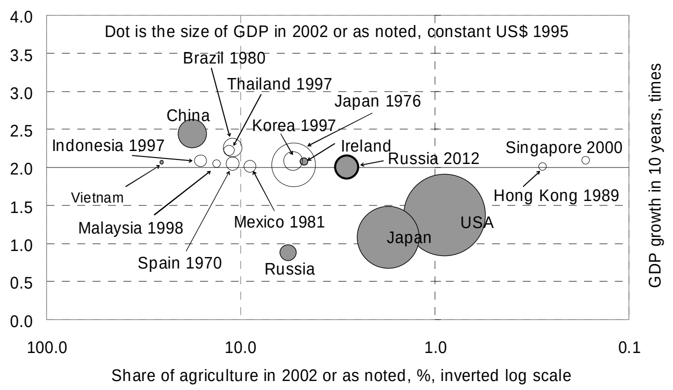
First, the goal could be taken as an appeal to Russian society to unite efforts to realize a common goal rather than a fixed cornerstone of government economic policy. Such a program would make sense only in the context of a command economy, and as a rule, the goal could be reached only at the expense of certain groups (typically agricultural producers or consumers). In a market economy, however, the state can only contribute to economic growth by creating a favourable environment for economic agents.

A second aspect is the aim's ambition seen against the starting point. Recalling the severe fall in production of the 1990s and using 1990 (when Russia's real GDP was 30 % higher than in 2002) as a base year, a doubling of GDP between 2003 and 2012 would only amount to growth of 50 % over 22 years (1990–2012). That is a slow growth rate by international standards.

International experience

For recent records, there were some countries that achieved GDP growth in excess of 100 % during the period 1992–2002. They were either small, like Ireland, or had a large share of the economy involved in agriculture, like China. Since 1970, quite many countries have managed to double their economy within a decade (e.g. Japan and Brazil in the 1970s, South Korea and China in the 1980s and 1990s). However, initially almost all of them were also either smaller or much more dependent on agriculture than Russia.

GDP growth, size of the economy and share of agriculture



Countries are marked as dots (size of GDP) in coordinates X (share of agriculture in GDP) and Y (growth of real GDP in 10 years). The ring in the middle is Russia as it would be in 2012 if it doubled GDP. White dots are selected non-oil economies that at least doubled their GDP 100% in ten years before 2002
Sources: World Bank, World development indicators 2003

Most of these countries had economies based on export industries. As the countries were smaller, they usually found it relatively easier to grow their exports to world markets. As their economies expanded, it became increasingly difficult to realize further production gains and the rate of growth slowed (e.g. Japan and Hong Kong in the 1980s). Countries with large economies face the challenges of finding enough additional demand and resources on world markets. For them, even large absolute increases in output do not necessarily mean rapid growth.

For countries lacking significant resources for exports, internal resources constitute a major driving force of development. There are examples of steady and rapid growth of industry, transportation and construction. In most cases, the labour and financial resources for development came from agriculture (this partly applies to China and Korea, or Russia in the 1930s). The demand for increased output was provided either by boosting investment or growing demand for consumer goods by former agricultural workers.

Obstacles to fast growth in Russia

Russia's main export products are oil and other energy resources. A doubling of real GDP based on exports of energy resources implies that the volume of energy exports would have to increase several fold. However, it would take more than a decade to realize projects involving the exploration, extraction and transportation of vast amounts of new oil and gas. Furthermore, a glut of energy on world markets would undermine current prices, and as prices declined, the profitability of most of the new production would erode. The situation is similar for many of Russia's other major export goods (e.g. metals, fertilizers, weapons). Production of other potential Russian export goods is so minuscule that a doubling of GDP would require that production of such goods would have to be ramped up hundreds or thousands of times, while it would be hard to find sufficient demand on the world market.

In turn, industrialisation as an internal resource for GDP growth is hardly possible in Russia as agriculture currently contributes only about 5 % of GDP in Russia and could not release substantial resources to industry.

Even though exports and industrialization were in many countries used to accelerate economic growth, there is little hope that these tools are applicable in contemporary Russia. Thus, Russia faces the added challenge of growing its economy through other sectors such as commercial services, which in turn, will have to be supported by adequate tangible and financial resources as well as demand.

Finally, Russia must face up to the fact that market economies always experience recoveries and recessions. In many cases, long periods of fast growth have lead into disproportions in the economy and have been followed by recession. If Russia is going to accelerate growth, it would either have to restrict market forces and direct additional resources to maintaining "optimal" structures of the economy – which earlier caused many misallocations – or it has to be ready for occasional declines in production and household living standards.

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Economic Developments

GDP growth in 2006–08

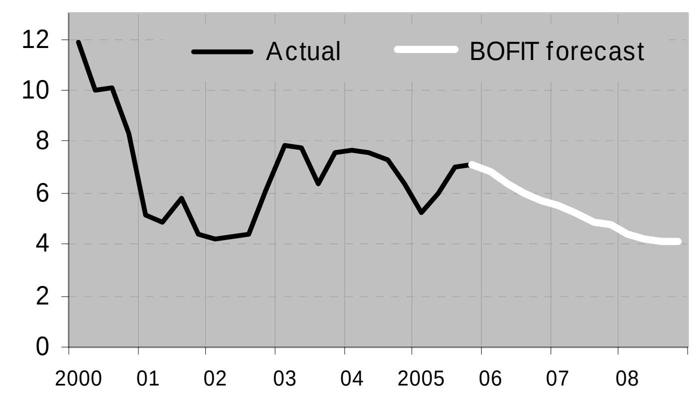
As part of the Bank of Finland's forecasting process for the Finnish economy, BOFIT in late February released its forecast for Russia in 2006-08 (see BOFIT's website). Russian GDP growth is forecast to approach 6 % this year, 5 % in 2007 and 4 % in 2008 (chart).

BOFIT's view is that although growth of Russian oil production has slowed, world oil prices still have a strong effect on the economy as oil and oil products make a large share of export revenue (44 % in 2005). The forecast assumes the price of Brent crude will rise to $64 a barrel by mid-2006 and then gradually recede to around $50 by end-2008.

Consumption growth is expected to slow towards end-2008, but it will still remain high enough to soften the economy's slowdown. Both public and private consumption are supported by pressures to increase budget expenditure. It would also appear the investment atmosphere is slowly improving and maintaining rapid growth of fixed investments. Growth of the export volume declined notably in 2005 as the expansion of oil production slowed and growth of oil exports halted. The export volume is expected to grow at last year's calmer pace in 2006-08.

Inflation stubbornly persists and is expected to drive up the rouble's real effective exchange rate another 10 % in 2006. A decline in the oil prices would moderate real appreciation towards end-2008. Combined with economic growth, real appreciation of the rouble will sustain rapid – even if slightly slowing – growth of the import volume, in the area around 15 % a year.

Russian GDP growth, % change y-o-y (BOFIT 2006-08 forecast)



Sources: Rosstat, BOFIT

Export prices and import volumes soared in 2005

The value of *exports* of goods jumped a third in 2005, with almost 85 % of the increase coming from the rise in energy export revenues. The share of all energy products in total goods exports reached a record 64 %, while the share of metals (excluding metal products) dropped to 12 %. Export revenues were boosted by export prices, which were up some 27 % in dollar terms. The gains were topped by soaring prices for fuel oils (50–60 %), crude oil (47 %) and natural gas (28 %). In contrast, growth of the export volume of goods slowed to about 5 % (from the 10 % level of earlier years) since Russia's previous oil export boom went into a decline (-2 %). Gas exports increased 3 % (6 % in 2004). On the other hand, exports of oil products grew rapidly (17 %) after some years while metal exports as a whole also increased. Similar to previous years, deliveries of basic chemical and forestry products continued to grow. Exports of machinery and transport equipment decreased.

Spending on *imports* of goods was up almost 30 % as their import volume continued to grow at well above 20 %, with import prices rising some 6 % (like in 2004). The value of non-CIS imports rose by a third, while CIS imports were up 10 %. Moreover, non-CIS import volumes expanded about 30 % (as in 2004), while CIS import volumes fell. In turn, prices for non-CIS imports were up about 5 % and prices for CIS imports climbed 15 % (after rising over 20 % in 2004).

Structural developments of imports remain partly unclear as Russian customs data underestimate imports by about a fifth. Official customs figures show that the value of imports of machinery and transport equipment rose 40 % in 2005 and their share in imports recorded by customs climbed to 44 %. This category includes passenger cars (8 % of imports), which enjoyed an almost 50 % quantitative increase (150 % in 2004) and booming imports of home and mobile electronics. Food and agricultural products retained their share (growth in meat imports resumed) as did chemical imports (medicament imports boomed), each category accounting for 17-18 % of the imports that customs data covers.

The economy ministry recently released estimates about the structure of imports according to the use of goods. The broad picture is that in both 2004 and 2005 investment goods accounted for a quarter of imports and consumer goods about one half. The remaining quarter consisted of intermediate goods and raw materials.

	1997	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**as of**
GDP, %	1.4	-5.3	6.4	10.0	5.1	4.7	7.3	7.2	6.4		
Industrial production, % [1]	2.0	-5.2	11.0	11.9	2.9	3.1	8.9	7.3	4.0	4.4	1/06
Fixed investments, %	-5.0	-12.0	5.3	17.4	10.0	2.8	12.5	11.7	10.7	1.5	1/06
Unemployment, % (end of period)	9.0	13.2	12.4	9.9	8.7	9.0	8.7	7.6	7.7	7.7	1/06
Exports of goods, US$ billion	86.9	74.4	75.6	105.0	101.9	107.3	135.9	183.5	245.3	20.9	1/06
Imports of goods, US$ billion	72.0	58.0	39.5	44.9	53.8	61.0	76.1	96.3	125.1	8.7	1/06
Current account, US$ billion	-0.1	0.2	24.6	46.8	33.9	29.1	35.4	58.6	62.9		1-9/05

[1] *New methodology from Jan. 1, 2005; figures for 2001–2004 revised and not comparable with previous years.*

Sources: Rosstat, CBR.

Customs and natural resource use continue to boost federal budget...

As long as world market prices for natural resources, especially oil, continue to increase, Russia's federal budget revenues keep growing. In 2005, the average price of Urals-grade crude oil was up about 50 % from 2004. Federal budget revenues also rose 50 % y-o-y in nominal terms. Additional revenues last year from redemption of back tax claims on the Yukos and Sibneft oil companies also contributed some 1 % of GDP to the revenue increase. The very favourable external situation resulted in a huge increase in the federal budget surplus, which jumped by 3 % of GDP.

The increase in revenues from customs duties and natural resource payments – both of which mainly derive from oil and gas – has risen sharply since 2000. In 2000, the combined share of these two revenue items amounted to 22 % of federal budget revenues or 3.4 % of GDP. The corresponding figures last year were 50 % and nearly 12 % of GDP. The increase reflects both higher energy prices and changes in oil taxation. The oil export duty regime was restructured in August 2004 to charge higher, progressive duties on oil prices exceeding $25 a barrel. From the start of 2005, the basic mineral tax rate on oil was also increased.

In 2005, profit tax revenues of the federal budget increased after a couple of years of decline which had been due in part to changes in the distribution of profit tax revenues between federal and regional budgets. High energy prices have also contributed to higher profit tax proceeds. VAT revenues continue to grow, while unified social tax (UST) revenues to the federal budget fell some 40 % after a cut in the tax rate.

Even with rising revenues, the government has seemingly managed to keep spending down. After a peak in expenditures in 2002 (almost 19 % of GDP), federal spending has stabilised in the last couple of years at a level of around 16 % of GDP. However, this total includes the cut in UST transfers to the Pension Fund in 2005. In fact, non-interest expenditures excluding UST rose by almost 2 % of GDP last year.

Although last year's amendments to budget expenditure classifications make detailed comparisons with 2004 difficult, general observations are still possible. Transfers to regional budgets declined both in real terms and in relation to GDP. Interest payments on debt were also down due to early payment and other amortizations of foreign debt. The declines in these two categories imply other federal budget spending categories saw large gains in 2005.

Finance minister Kudrin has called for stricter spending policies. He thinks it would be wise to increase the amount of stabilisation fund resources by directing there not only revenues from oil exports, but also those from gas and oil products. If realised, it could substantially cut expenditures of federal budget.

... while regional budgets are barely in surplus

Consolidated regional budgets have not been able to benefit directly from higher energy prices. Their impact is rather seen indirectly in increasing profit tax revenues. During the 2000s, the share of regional budgets in profit tax revenues has also increased, reaching 80 % last year.

Despite federal promises to refrain from further cuts in regional support, transfers have fallen. This seems odd given the publicised intentions to make federal injections to prop up salaries of public employees etc. In reality there may be alternative channels for transfers that blur comparisons. There was also a lively discussion last year of a draft program for regional policy based on a "growth pole" approach to replace the present equalisation policy. Under the proposal, seven to nine regions would be designated as growth poles and given relatively more resources than other regions. The other regions would eventually be pulled up by growth in the lead regions. Last year's diminished transfers may imply that total transfers to regions will be cut in the future and divided in a new manner.

Regions in aggregate posted a tiny surplus in 2005. They managed to cut spending in the face of falling regional revenues, and on average got along with the finances available. Spending increases in major categories such as housing indicate that there were further cuts amounting to over 1 % of GDP in many other smaller expenditure categories.

Realised federal and regional budgets, % of GDP

Federal budget	**2005**	**2004**	**Consolidated regional budget**	**2005**	**2004**
Revenues	**23.7**	**20.1**	**Revenues**	**13.8**	**14.1**
Customs duties	7.8	5.1	Profit tax	4.4	3.9
VAT	6.8	6.3	Income tax	3.3	3.4
Natural resource payments	4.0	2.6	Transfers	2.0	2.4
Profit tax	1.7	1.2	Property taxes	1.2	0.9
Unified social tax (UST)	1.2	2.6			
Expenditures	**16.2**	**15.8**	**Expenditures**	**13.6**	**14.0**
Non-interest expenditures (excl. UST)	14.0	12.1	Social spheres*	4.2	3.8
Of which transfers to regional budgets	2.0	2.4	Education	2.9	2.8
UST	1.2	2.6	Housing	2.1	1.7
Interest payments on debt	1.0	1.2			
Balance	**7.4**	**4.4**	**Balance**	**0.3**	**0.2**

* mainly healthcare and social policy, not including education.

Source: Rosstat

Fiscal indicators for federal government (% of GDP, unless otherwise indicated; end-period figures for debt and stabilisation fund)

	1998	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006,**	**as of**	**2006 budget**
Revenues [1]	11.4	12.6	15.4	17.8	20.3	19.5	20.1	23.7	26.2	1/06	20.7
Expenditures [1]	17.4	16.8	14.6	14.8	19.0	17.8	15.8	16.2	14.7	1/06	17.5
Balance	-6.0	-4.2	0.8	3.0	1.4	1.7	4.4	7.4	11.4	1/06	3.2
Foreign currency debt	50.1	87.7	55.3	44.4	36.2	25.7	19.6	12.5		9/05	
Foreign currency debt, $ bn	158.2	154.6	143.4	133.1	123.5	119.7	114.4	86.8		9/05	
Stabilisation fund, $ bn							18.9	43.0	55.6	02/06	

[1] *Since 2002 part of the unified social tax is included in the federal budget.*

Sources: Budget: IMF 1997–2000, Rosstat 2001–2005, Minfin 2006. Debt: IMF 1996–1999, Minfin 2000–2005.

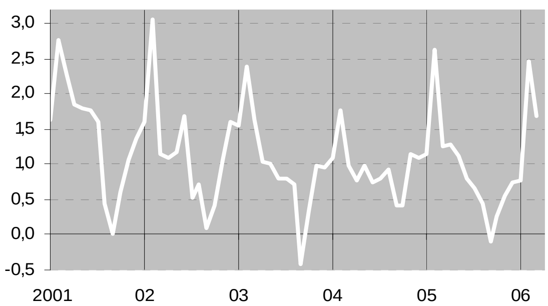
Food prices spike in early 2006

The Russian authorities' projected rise in consumer prices of 7–9 % this year appears threatened as prices climbed over 4 % during January-February. Consumer prices have also risen rapidly in the early months of the previous years, as hikes in regulated prices for services, especially in the housing sector, typically come at the start of the year.

This year, it was food prices that rose 5 % in the first two months, which was faster than in any year since 2001. The price of the minimum food basket was up 10 %, including hikes of 40–60 % for such basic staples as potatoes and cabbage that constitute a core element of the food basket for low-income households.

The government considers further inflation-fighting measures. Besides pointing out that the surge in prices is due to a range of factors that, in addition to seasonal variation, include higher budget expenditure, growing money supply, world market price increases on certain food items, Russia's import controls, temporary hoarding and higher farm costs, the authorities stress there are deficiencies in local food market structures that need to be addressed.

Consumer prices, % change from the previous month



Source: Rosstat

Bank balance sheets expand at record rate in 2005

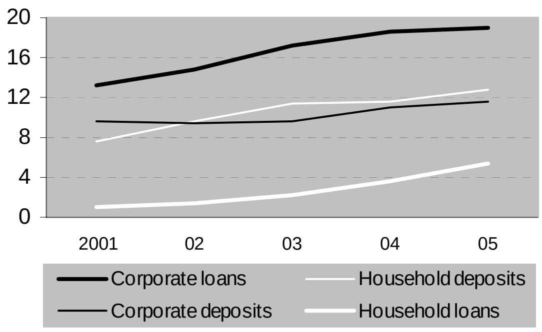
Total assets on the balance sheets of domestic and foreign-owned banks in Russia soared 37 % from end-2004 to end-2005 in nominal rouble terms and almost a quarter in real terms. In the recent years, only 2000 and 2003 matched that pace. Combined with a stable rouble, the rapid development implies that Russia's banking has expanded in international comparison. True, the banking sector is not yet large, with total assets of €285 billion or $340 billion (45 % of GDP). That size, while far larger in absolute terms than for any of the new EU member states of Central and Eastern Europe, surpasses the banking sector size in only two of the smallest old EU member countries.

In the banks' *liabilities*, growth of household deposits accelerated to 40 %, while growth of corporate deposits eased to 35 %. Both funding items retained their share of the total liabilities as of end-2005 (28 % and 26 %, respectively). Banks relied proportionately less last year on the issuing of debt securities (8 % of liabilities) as a funding source, although they issued more IOUs (*veksel*) than in 2004. This was done mostly by banks outside the top twenty. Bank liabilities to non-resident banks increased 50 % (to over 8 % of total liabilities). Growth of capital lagged slightly behind balance sheet growth, even after accounting for capitalisation of profits. Despite a slight decline in the capital adequacy ratio, it remained a hefty 16 % on average.

Banks channelled their *assets* strongly to lending and thus increasingly performed an important basic banking function – financial intermediation. Growth of loans to non-financial companies slowed to 30 % (from 40 % a year in 2003–04), decreasing their share of total assets to 42 %. Still, the rapid pace could entail risks as the banks' resources for credit risk assessment become stretched in an environment where corporate governance needs improvement and a grass-roots reform of corporate bookkeeping is under preparation. Loans to households doubled for the third year in a row, raising their share of total assets to 12 %. The level of household indebtedness is still low, while 2005 also saw a rise in reported arrears on household loans (to 2 % of the household loans). The banks' assets in non-resident banks rose over 50 % (about 5 % of their assets)

Banks also made changes in their investment portfolios. While further scaling down investments in corporate IOUs (*veksel*), they doubled their investments in other debt securities of non-financial firms (such as corporate bonds), sharpening the rise of previous years. Their equity share portfolios also doubled. Apparently due to awareness of corporate risks, a large part of the equity purchases included sell-back facilities. Most of the rest were acquisitions of controlling equity stakes and investments in quoted domestic shares. While these exposures together represent only 5–6 % of the banks' total assets, they indicate that banks are using their abundant liquidity to develop new business segments and limiting their old practices of keeping plenty of funds in correspondent accounts or depositing them with the CBR.

Bank deposits and loans, end-year stocks in % of GDP



Source: CBR

Monetary indicators

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006,	as of
Inflation (CPI), 12-month, % (end of period)	11.0	84.4	36.5	20.2	18.6	15.1	12.0	11.7	10.9	11.2	2/06
M2, 12-month growth, % (end of period)	29.0	21.3	57.5	61.5	39.7	32.4	50.5	35.8	38.6	39.4	1/06
Average wage, $ (period average)	164	108	62	79	111	142	180	237	301	329	1/06
Deposit interest rate, % (period average)	16.8	17.1	13.7	6.5	4.9	5.0	4.5	3.8	4.0	4.2	1/06
Lending interest rate, % (period average)	32.0	41.8	39.7	24.4	17.9	15.7	13.0	11.4	10.7	10.2	1/06
Forex reserves, $ bn (incl. gold)	17.8	12.2	12.5	27.9	36.6	47.8	76.9	124.5	168.4	201.7	10.3.06
RUB/USD exchange rate (end of period)	5960	20.65	27.00	28.16	30.14	31.78	29.45	27.75	28.78	28.12	2/06
RUB/EUR exchange rate (end of period)			27.23	26.14	26.49	33.11	36.82	37.81	33.94	33.33	2/06

Sources: Rosstat, CBR.

Russian banks facing lending constraints and higher systemic risk

by Natalia Orlova*

With strong growth of retail lending and emerging demand for investment, Russian banks are becoming an important driver for growth. However, their environment is not capable of addressing issues restraining long-term lending. Fast growth of the banks largely depends on the cabinet, and not just the CBR, of being aware of swift and necessary changes to legislation.

Loan markets expanding strongly

Banks are finally seeing strong demand from both households and the corporate sector. Retail lending, virtually non-existent just a few years ago, is expanding by nearly $20bn a year and now equals 5 % of GDP. Retail loans today finance 40 % of consumption growth while a year ago they contributed only 22 %. Corporate lending is becoming more diversified. For example, the oil and gas sector's share of Sberbank's loan portfolio fell from 26 % in 2000 to 8 % in 2005, implying that small and mid-sized firms are gaining access to loans.

In the coming years, demand for loans will continue to increase. High inflation (about 10 %) is pushing households to spend and reduce savings, and retail loans will see high demand. Russian companies looking to expand are increasingly using bank loans to finance their working capital. The government's desire to prevent electricity, transport and housing tariffs from rising too quickly ahead of the 2007-08 elections will likely boost demand for loans. VAT calculation on a delivery basis from 2006 will also deprive companies of some $2bn, which has to be replaced by bank loans.

A shift in demand for loans is also apparent in maturities. Only 14 % of corporate bank loans are currently longer than three years, implying that banks are not used to finance long-term investments. However, this is the area that will provide strongest growth to banks, which thus need to find long-term resources.

Capitalization and liquidity problems need to be addressed

Strong demand growth is a way to increase banking and profitability, but there are many unresolved weaknesses in the banking environment. First, to expand lending banks need to increase capital. Capitalizing profit is not enough to finance lending penetration, hence additional capital injections are needed. In 2005, the largest banks issued $2.6bn in subordinated loans to improve their capital adequacy ratios, which had suffered from retail penetration. However, we expect that banks will have to increase their capital by $18bn by 2008. Otherwise, the capital adequacy ratio could fall below 10 % in 2009.

In other transition and emerging market countries, the capital problem was solved through the entry of foreign banks or with local resources. Foreign banks control around 10 % of Russian banking assets, and a number of strategic players are waiting for the Russian market to mature. Therefore, Russian banks increasingly see IPOs as a chance to raise funds. However, changes in banking regulation to open the equity market to foreign investors are needed to ensure successful placements.

Even if the capitalization problem can be resolved via the equity market, fast growth in lending still makes banks vulnerable to longer-term risks. A problem is the lack of an inter-bank market, which prevents banks from ensuring liquidity management. Although the CBR expanded its range of refinancing instruments in 2005, the refinancing system as a whole is not accessible to most private banks as they are not involved in the low-yield state bond market and their lending to the largest companies is very limited. Instead, the refinancing system makes liquidity available to state banks that do not need it.

With the Stabilization Fund now at some 7 % of GDP, the CBR is gradually losing its ability to control the money supply. Fiscal policy, sterilizing $30bn a year, has a much larger impact on monetary parameters than the CBR, which at most can sterilize $6-7bn a year. The banking system is thus becoming very dependent on the stance of fiscal policy, and the Fund's growth pace is the key variable in forecasting banking market liquidity. The current monetary system is unable to address the risk of a sudden deterioration of the economy's external balance. In case commodity prices fell sharply, the banks would bear the full risk of adjustment of the monetary system as the CBR lacks sufficient instruments to inject money into the banking system while fiscal policy is unable to react fast enough.

Dominance of state banks is a long-term issue

Fast demand growth and increasing competition are pushing banks to new segments with longer maturities. However, this is not backed by longer maturity of their liabilities or improvement in the financial market infrastructure. The deposit insurance scheme, for example, has yet to have a significant impact on improving maturity. Sberbank still has some 55 % of deposits, mainly longer-term, and gets 70 % of its retail liabilities from so-called pension accounts.

Increasing risks on bank balance sheets is likely to favor state banks, which benefit during periods of instability. For example, the mini-banking crisis of summer 2004 induced a large flow of retail and corporate clients to state banks. The three largest state banks – Sberbank, Vneshtorgbank and Gazprombank – control 36 % of total banking sector assets, 45 % of retail loans and 33 % of corporate loans. The poorly developed state of CBR monetary instruments, due to unwillingness to take risks, is discouraging the privatization of state banks and represents an obstacle for deeper leverage of economic growth.

Lack of long-term funding in the Russian banking sector

	2002	2003	2004	2005	2006[ii]
Long-term corporate loans[i], % of assets	3	3	4	5	6
Long-term deposits, % of assets	1	1	1	2	3
Long-term corporate loans, % of loans	7	8	10	11	14

i) Long-term loans/deposits are those with maturity of above 3 years.
ii) Figures for 1 December 2005
Source: CBR

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Economic Developments

GDP projections slightly rise, Putin reiterates growth goal

Major projections this spring converge around 6 % GDP growth for 2006, including those from the economy ministry, the IMF, as well as consensus forecasts compiled in Russia and the west. In 2007, GDP growth is expected to slow to only slightly below 6 %. The economy ministry is expecting slightly over 6 % growth in 2007–08.

The potential impact of world commodity prices on the economy remains high. Over the past recent years, the share of earnings from commodity exports in GDP has increased. Presently, export earnings from crude oil, oil products and gas equal about a fifth of GDP (metals and precious stones add another 5 %). The projections suggest the actual impact of the oil price may be weaker than earlier. The IMF, for example, raised its GDP growth projection for 2006 from last autumn with virtually no revision of the oil price assumption (+15 % in 2006), while a new high-end oil price variant (+7 % in 2006) in the economy ministry's forecast barely changed the GDP projection from the one made in late 2005.

The brisk rise in the real exchange rate (RER) is apparently expected to continue as inflation would drop only slowly in the range around 9–10 % in 2006–07 (IMF and consensus forecasts) while the rouble's nominal exchange rate can be assumed to rise or stay stable with high oil prices and the resulting large external surplus. The economy ministry projects inflation will fall to 8–9 % in 2006 and 6–7.5 % in 2007, while the finance ministry currently expects the RER to rise 9 % in 2006. The CBR and finance ministry recently noted the RER could exert dampening effects on growth and domestic production.

As rapid GDP growth is projected to continue somewhat more independently of the oil price than earlier and with a briskly rising RER, the forecasts basically build on fast growth of consumption. The oil price effect may also have become weaker partly because the state has in recent years increased oil taxes, saved its surpluses with the central bank, and prevented oil income from flowing even more rapidly into the corporate sector, households and banks.

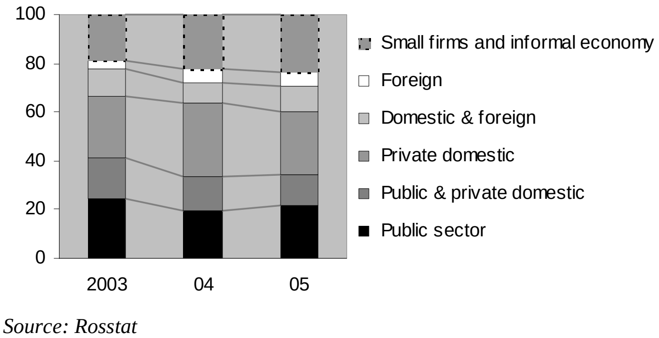
In his 2006 state-of-the-nation speech, president Putin reiterated the mission of doubling GDP within a decade, noting the task would require GDP growth above 7 %. In a pro-market comment, Putin stressed that meeting the goal was not possible without sufficient economic freedom, a level playing field for competition and stronger property rights.

Changes in investment structures

Fixed investment in Russia increased over 10 % each year in 2003–05. Behind the headline figure, Rosstat estimates that the share of small firms and the informal economy in total investment has increased considerably, reaching almost a quarter in 2005 (see chart). This implies their volume of investment has grown much faster than the total – a positive development as a vibrant small-business sector is important for growth. For 2005, Rosstat noted that other investment, i.e. by large domestic and foreign companies, as well as the public sector, increased 8 % in volume terms. Within that figure, the public sector regained share to some 22 % of the total, thanks largely to investment at the federal and regional levels. Foreign firms (on their own or with Russian partners) also raised their share. This, on the other hand, suggests less rapid growth of domestic private investment outside the small-business sector. This trend is less promising as larger companies will be very essential in boosting Russia to higher levels of economic development.

In the structure of investments by larger companies and the public sector in 2005, the volume of investments fell in fuel production – with notably little growth in oil extraction investment after the large pull-back in 2004 – and electricity supply, although the share of energy production and supply was still almost a fifth. Manufacturing investments were up over 10 % (with an 18 % share) even if a large chunk of the increase came from firms in metallurgy. Transportation investments were up sharply (over a fifth of investment). Among the four national priority projects, health care and education also saw sharp investment growth (although their relative shares are small).

Investments by different ownership sectors, % shares



Source: Rosstat

Macroeconomic indicators

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	as of
GDP, %	1.4	-5.3	6.4	10.0	5.1	4.7	7.3	7.2	6.4		
Industrial production, % [1]	2.0	-5.2	11.0	11.9	2.9	3.1	8.9	7.3	4.0	3.0	Q1/06
Fixed investments, %	-5.0	-12.0	5.3	17.4	10.0	2.8	12.5	11.7	10.7	5.1	Q1/06
Unemployment, % (end of period)	9.0	13.2	12.4	9.9	8.7	9.0	8.7	7.6	7.7	7.6	3/06
Exports of goods, US$ billion	86.9	74.4	75.6	105.0	101.9	107.3	135.9	183.5	245.3	67.4	Q1/06
Imports of goods, US$ billion	72.0	58.0	39.5	44.9	53.8	61.0	76.1	96.3	125.1	31.2	Q1/06
Current account, US$ billion	-0.1	0.2	24.6	46.8	33.9	29.1	35.4	58.6	84.2		

[1] *New methodology from Jan. 1, 2005; figures for 2001–2004 are revised and not comparable with previous years.*
Sources: Rosstat, CBR.

Putin worried about negative demographic trends

President Putin's 2006 state-of-the-nation speech was devoted mainly to three themes – defence, demographics and investment. Although the president has raised demographic issues many times before, it was the first time he got down to concrete proposals on ways to halt population decline. Of the three components affecting the population numbers – migration, death rate and birth rate – he stressed the last.

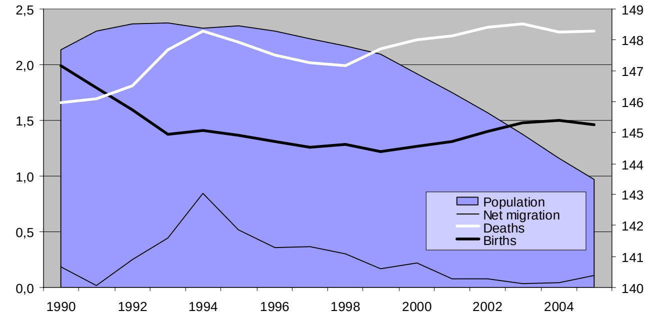
Putin called for greater financial resources for families and urged Duma deputies to take this into account in their work on the 2007 budget. He suggested increasing childcare benefits for small children, introducing state compensation for a share of pre-school childcare expenses and establishing a realistic minimum threshold for maternity benefits. Putin highlighted the situation of orphans and children with parents unable to take care of them. He proposed raising the material support to families adopting such children. He also suggested providing "maternity capital" of at least 250,000 roubles ($9,200) for mothers giving birth to a second child. The amount, about two-and-a-half times the average annual wage in 2005, is generous by Russian standards.

Putin's worries about the demographic situation are hardly groundless. During 1992–2005, the natural decrease of population amounted to some 11 million people. The death rate increased quite rapidly until 2003, while the birth rate declined until 2001, after which both indicators stabilised somewhat. However, there were still only about ten births for every 16 deaths in 2005. Putin's goal of doubling GDP in a decade is not helped by high proportion of working-age deaths and deaths from unnatural causes. Deaths of working-age (16-59) people rose from about 5 per 1,000 at the start of 1990s to 8 per 1,000 in 2004. Additionally, the figures for men are almost 2.5 times higher than those for women. Almost 8 % of deaths in 2000–04 were due to alcohol poisoning, transport accidents, suicide or homicide.

Without positive net immigration, the situation would be much gloomier. Net immigration compensated for more than half of the natural decrease of population in 1992–2005. Thus, in that period the total Russian population shrank about 4 %, or 5.8 million people. In his speech, Putin referred to encouraging Russians abroad to return home as well as prioritising "qualified migration," i.e. immigration of educated and law-abiding people to Russia. Since the collapse of the Soviet Union, the bulk of people migrating to Russia have been from CIS countries. In 2000–04, the share of CIS citizens in the total was almost 80 %. Over a third came from Kazakhstan, while about two-fifths came from Ukraine and Uzbekistan.

Finance minister Kudrin notes the ministry's preliminary estimates indicate that the president's suggestions for stopping the population decline will entail RUB 30-40 billion ($1-1.5bn) of public expenditure in 2007, and the "maternity capital" will require preparation for larger entitlements that will be probably payable starting in 2010 (for the second children born in 2007). Moreover, if the program succeeds, it will likely generate further budget costs down the road, e.g. for day-care services, paediatric care and schools.

Population, deaths, births and net migration to Russia, millions



Source: Rosstat

Rouble appreciated

As the current account surplus grew in 1Q06 and net capital outflow increased only slightly, the CBR allowed the rouble to appreciate in order to stem inflation. The rouble appreciated 3 % from end-December to end-March against the CBR's dollar-euro daily management basket. The rouble's monthly average against the CBR's trade-weighted currency basket was up over 2 % from December to March, but flat in April (for comparison, from December 2004 to December 2005 it was up about 3 %). The CBR recently reported it changed containment level in mid-March.

Even so, the CBR intervened on the foreign exchange market to the tune of over $20bn in 1Q06, and probably more in April. The CBR's foreign exchange reserves reflected that by increasing $20bn in 1Q06 and another $20bn in April, and stood at about $230bn in early May. That amount equals roughly 16 months of goods and services imports. Besides interventions via buying dollars, the CBR also made euro interventions (launched last August) while they amounted to just €18m in 1Q06 (less than during last autumn).

Putin wants to end currency controls early

President Putin's state-of-the-nation speech also included a proposal to complete the phase out of remaining restrictions on rouble convertibility by mid-2006 (i.e. six months earlier than scheduled). Earlier this spring, the CBR abolished the remaining (10 %) compulsory sale of export income and halved deposit requirements on certain capital inflows. In any case, free currency flows are so large in both directions that no major impact on the exchange rate is expected.

Fiscal indicators for federal government (% of GDP, unless otherwise indicated; end-period figures for debt and stabilisation fund)

	1998	1999	2000	2001	2002	2003	2004	2005	2006,	as of	2006 budget
Revenues [1]	11.4	12.6	15.4	17.8	20.3	19.5	20.1	23.7	25.7	1-4/06	20.7
Expenditures [1]	17.4	16.8	14.6	14.8	19.0	17.8	15.8	16.2	16.7	1-4/06	17.5
Balance	-6.0	-4.2	0.8	3.0	1.4	1.7	4.4	7.4	9.0	1-4/06	3.2
Foreign currency debt	50.1	87.7	55.3	44.4	36.2	25.7	19.6	12.5		9/05	
Foreign currency debt, $bn	158.2	154.6	143.4	133.1	123.5	119.7	114.4	86.8		9/05	
Stabilisation fund, $bn							18.9	43.0	66.2	04/06	

[1] *Since 2002 part of the unified social tax is included in the federal budget.*

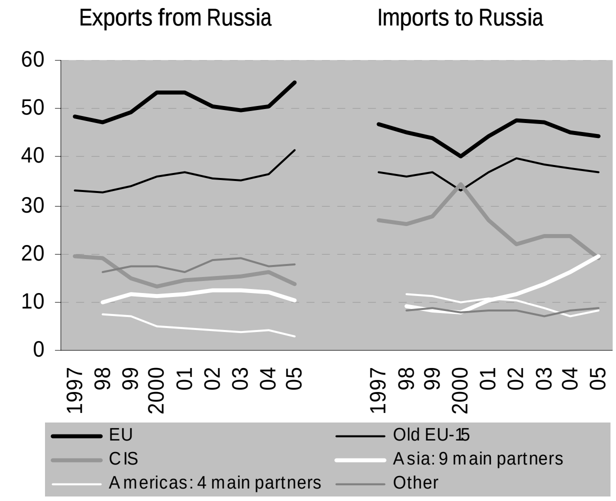
Sources: Budget: IMF 1997–2000, Rosstat 2001–2005, Minfin 2006. Debt: IMF 1996–1999, Minfin 2000–2005.

Imports from Asia on the rise

The EU countries took an even larger share of Russian exports in 2005, accounting for 55 % of the total. 14 % of all exports went to the EU's newest member countries (see chart). The Netherlands' ascension to the single largest destination for Russian exports (with a 10 % share) reflects the steep rise in oil prices, with Germany and Italy also raising their shares to 8 % each. The next largest export destinations were China and Ukraine (over 5 % each).

Import statistics from Russian customs are subject to the usual caveat of under-recording that necessitates a large coverage correction (amounting to 23 % of the CBR's corrected total import figure in 2005) and results in discrepancies with trade partner figures (e.g. EU data suggest the Russian customs did not record some 40 % of the imports from the EU in 2004-05). Even with the reporting problems, the figures suggest some notable supplier changes as the Russian market, like markets elsewhere, has not been unaffected by globalisation. While the EU countries' share remained at around 45 %, imports surged from Asia (China, Japan, Korea, etc.), as well as North and South America. The largest import source was still Germany (13 %), followed by Ukraine and China (7-8 % each), and Japan (6 %).

Shares of country groupings recorded in Russia's foreign trade, %



Sources: Rosstat, Russian customs

Consumer price basket sheds more light on households

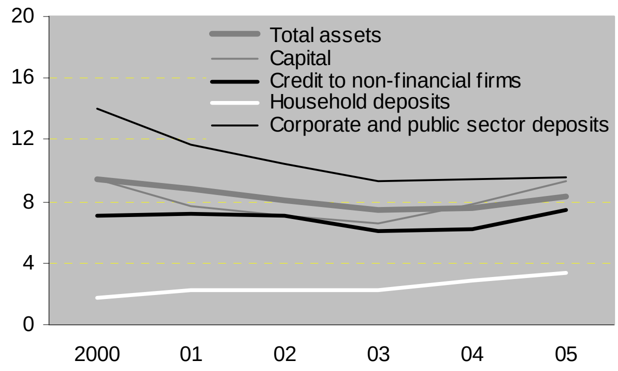
Rosstat earlier this year published the complete composition of its consumer price basket. The basket's structure, which is based on regular surveys of over 49,000 households, suggests households use about 43 % of their expenditure on food items (compared to 47 % in 2004 as indicated by earlier information available on the consumer price basket structure). Top food items include meat (11 % of the total) and alcohol (7 %). Household spending on non-food goods, almost 34 %, is led by clothing (over 5 %) and cars (4 %). The share of household spending on services climbed to nearly 24 % (from 20 % in 2004 in the earlier consumer price basket data), partly reflecting rapid increases in administratively set prices. Housing and related community services such as heating, gas and water take 9 % of household spending.

Foreign banks regain their presence

With the growth of the economy, trade and real sector financing for several years now, foreign banks have become increasingly interested in working on the markets. Besides boosting cross-border financing to large Russian companies, their local presence has grown as the number of foreign subsidiary banks (fully-owned and majority-owned) has risen from 42 at end-2004 to 56 at end-April this year.

Foreign banks also increased their share of banking sector total assets especially in 2005, signalling a return towards levels seen earlier in this decade (see chart). Foreign banks now feel justified in devoting further efforts to the core banking function of corporate lending: they raised the share of corporate loans to about 40 % of their total assets as of end-2005, approaching a level reached earlier by domestically owned banks. Corporate funding occupies a somewhat more important role for foreign banks (a third of their balance sheets) than domestic banks, but in recent years, foreign banks have made strong inroads into retail banking. Household deposits thus increased to about 12 % of their balance sheet (about 18 % in domestic banks other than Sberbank), although foreign banks still hold a small share of the total household market. The three largest foreign banks, which rank between 8th and 14th among Russia's banks in terms of total assets, grew slightly faster in 2005 than other foreign banks. At the end of 2005, they represented 4 % of total banking sector assets.

Shares of foreign banks (fully- and majority-owned) in banking sector balance sheet items, % at year's end



Source: CBR

Monetary indicators

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006,	as of
Inflation (CPI), 12-month, % (end of period)	11.0	84.4	36.5	20.2	18.6	15.1	12.0	11.7	10.9	9.9	4/06
M2, 12-month growth, % (end of period)	29.0	21.3	57.5	61.5	39.7	32.4	50.5	35.8	38.6	37.9	3/06
Average wage, $ (period average)	164	108	62	79	111	142	180	237	301	359	3/06
Deposit interest rate, % (period average)	16.8	17.1	13.7	6.5	4.9	5.0	4.5	3.8	4.0	3.8	3/06
Lending interest rate, % (period average)	32.0	41.8	39.7	24.4	17.9	15.7	13.0	11.4	10.7	10.3	3/06
Forex reserves, $ bn (incl. gold)	17.8	12.2	12.5	27.9	36.6	47.8	76.9	124.5	168.4	236.1	12.5.06
RUB/USD exchange rate (end of period)	5960	20.65	27.00	28.16	30.14	31.78	29.45	27.75	28.78	27.27	4/06
RUB/EUR exchange rate (end of period)			27.23	26.14	26.49	33.11	36.82	37.81	33.94	34.19	4/06

Sources: Rosstat, CBR.

Russian banking – state vs. foreigners
by Ivan Rozhinskiy*

In February 2006, a long-awaited event in Russian banking finally occurred. For the first time, a relatively large Russian bank (Impexbank, assets about $1.8bn), was sold to a foreign bank (the Austrian Raiffeisenbank). Does this mark the start of a large-scale sell-off? Some analysts suggest so and believe Western banks would get their bids in to secure a share in Russia's booming financial market. They also think owners of Russian banks could be lured to be more responsive to bids by expected price-to-book-value ratios above 3. This scenario would in few years lead to a banking system model of Central and Eastern Europe (CEE), whereby major western players control about 70 % of banking assets.

On one hand, the Russian market is potentially huge and booming, so players in the global financial industry can hardly afford to ignore it. Further market penetration by foreigners, by both organic growth and acquisitions, is inevitable. On the other hand, the Russian government clearly wants the banking system to remain mostly in Russian hands. Thus, FDIs are welcome, but to a more limited extent than in CEE. Given these two angles, what kind of future awaits Russian banking?

Prospects for foreign bank acquisitions

To analyse the prospects of Russia's banking system, it is useful to look at the 100 largest banks (ranked by total assets). As they account for 82 % of assets, as well as 73 % of equity and 84 % of all bank profits, they define the shape of the banking system. These banks can be divided into four groups depending on their ownership structure.

The first group contains state-owned banks, which are dominant with more than half of all assets and almost half of total equity. The second group, foreign-owned banks, hold about 9 % of assets and equity (a figure that will rise with the Impexbank acquisition). The remaining 40 % is represented in roughly equal shares by "oligarchic" and "non-oligarchic" private Russian banks. Owners of oligarchic banks also own large industrial assets, mainly in the raw materials sector, and rank among the largest of Russia's private banks.

There are reasons to believe that a sell-off of oligarchic banks may well start. A recent assessment by Goldman Sachs notes the main reason is a potential shortage of capital. Russian banks will need $17bn of new equity by 2008 to maintain their existing capital-to-risk-weighted-assets ratios. Based on the profitability forecast, such capital cannot be generated internally through retained earnings, so it must be supplied from external sources. Reliance on external sources means competing for capital. Given the structure of the Russian economy, banks have to compete for owners' capital mainly with raw material producers.

Banks do not seem to have many chances in such competition. In the short- and medium-term banking businesses in Russia are very likely to remain less profitable than oil, metals and other key commodities. For a typical oligarch who owns both industrial and banking assets it definitely pays to concentrate on the core non-bank business, which enjoys a much higher expected return on equity. Ownership of banking assets by the industrial oligarchs reflects the economic situation in the 1990s, when double-to-triple-digit inflation and operations with Russian Treasury bills (GKOs) made banking (when supported by the right government connections) fantastically profitable. This is not the case today. The industrial assets of oligarchic empires far exceed their banking assets. Moreover, Russia's largest industrial companies may borrow directly from the international market at rates substantially lower than what even Russia's largest private banks can receive. Finally, acting as a group treasury or settlement centre for a group of enterprises is not a particularly lucrative business. Thus, selling off oligarchic banks, rather than further capitalising them, is a probable option for rational owners.

The large oligarchic banks also typically have wider branch networks than the non-oligarchic banks. This makes them attractive to global players seeking both market share and extensive distribution channels.

Possible future structure of the Russian banking sector

Given this situation, what are the policy options for a government if it intends to preserve the bulk of the national banking system in Russian hands? First, it may discourage Russian owners from selling banking assets to foreigners. As the experience of Italy and numerous examples in other countries show, there would be nothing specifically Russian in such an approach. Second, if oligarchic banks are put up for sale and the non-oligarchic banks do not have financial muscles strong enough to counter-bid foreign investors, an evident option is to let state banks issue competing bids. This is exactly what we are seeing as state-owned Vneshtorgbank acquired two large private banks in 2004-05 and is unlikely to stop on that track. There is a third, and in the author's view, preferable option of trying to support capitalisation of non-oligarchic private banks. This option, which is most promising in the long run, is also most difficult as it would require e.g. generally acceptable eligibility criteria and anti-corruption measures, and would take time to implement.

The second option with the involvement of state-owned banks seems the most likely. Hence, oligarchic banks as well as some non-oligarchic banks may well be "distributed" among state-owned and foreign acquirers. As a medium-term projection, the share of state-owned banks in Russia may constitute 60 % of total banking assets, while the foreign share may climb to around 25 %.

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Economic Developments

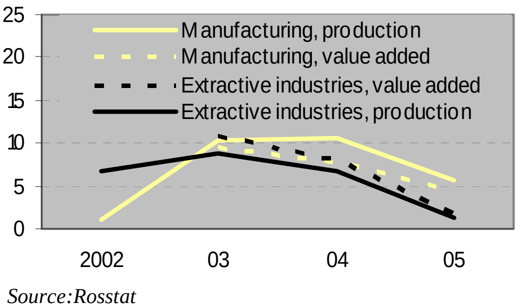
Slowdown in industrial growth contribution

The expansion of production in extractive industries, particularly oil, nearly halted in 2005. After booming in 2003-04, manufacturing also decelerated although it still grew almost 6 % (see chart). Growing segments in manufacturing in 2005 included such large branches as food and oil refining and individual booming sub-branches in e.g. metal products as well as electric and transport equipment.

Extraction and manufacturing impacted GDP growth notably as volume growth of value added by the two sectors fell rapidly in 2005 (to about 4.5 % for the manufacturing sector). While official statistics suggest the two sectors account for about a quarter of GDP, the prime minister recently stressed the weight of energy by noting the GDP share of the fuels and energy sectors alone was as high as 31 % in 2005 (although not specified, the figure likely included energy transportation as well as domestic energy trade and services).

To the extent that prices matter to the manufacturing branches in competing with imports, which have grown in volume by over 20 % a year throughout this decade, domestic costs may start to pose challenges. Alongside the standard real exchange rate (which reflects the difference with trading partners' consumer price inflation and continues to rise at over 10 % a year), the rise of manufacturing producer prices has outpaced import prices for many years now. Rapidly rising incomes are also prone to making Russians more critical of price-to-quality considerations in their purchasing decisions.

Industrial production and value added, % change of volume



Source:Rosstat

Agricultural growth remains modest

In the past five years, agricultural production has grown on average at over 4 % a year. After a burst in 2000-01, growth slumped, reviving slightly in 2004-05 (see chart).

Among the three types of farms, the share of collective (*kolkhoz*) and state (*sovkhoz*) farms in agricultural production has been around 40 % in this decade. The share of individual plots, which grew up to the late-1990s, has decreased gradually to about 50 % in 2004. In fact, the output of individual plots is often tied to kolkhoz-sovkhoz operations as the plot owners rely on the help of machines and devices from the former state farms. Private farms produced about 6 % of agricultural production in 2004, up from just 3 % in 2000.

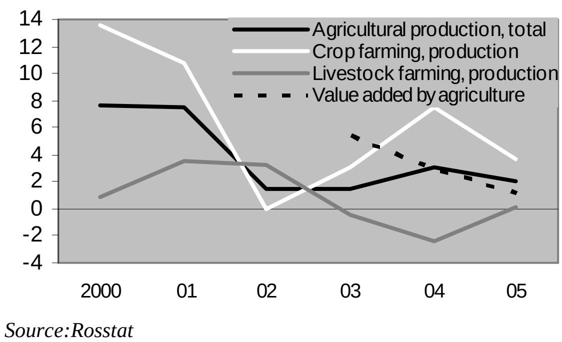
The share of agriculture in GDP has declined constantly as a result of factors that include sluggish reform efforts, low productivity and below-average price growth. In 2004, agriculture accounted for only about 5 % of GDP, down from 7-8 % in 1999, and over 16 % in 1990. The share of agricultural workers in the total work force, which hovered at about 13-15 % before 2000, declined to about 10 % in 2004.

In recent years, crop farming has come to generate over half of the value of agricultural production and has made better progress compared to livestock farming. For the period 2000–05, crop farming grew at over 6 % a year, while livestock farming increased at less than 1 % a year.

The 2005 grain harvest (78 million tons net) was almost the same as in 2004. However, the main grain areas in Southern and Volga federal districts produced 3 % less grain, while the Central federal district produced 9 % more. Production of other major crops was up over 4 %.

Russia's livestock herds continue to shrink. At end-2005, they were down 4 % on year, and almost 60 % from 1993. In the national priority program for agriculture, a main goal is to raise meat and milk production to lower reliance on imports that currently provide roughly a third of meat products and 16 % of milk products.

Agricultural production and value added, % change of volume



Source:Rosstat

Macroeconomic indicators

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	as of
GDP, %	1.4	-5.3	6.4	10.0	5.1	4.7	7.3	7.2	6.4		
Industrial production, % [1]	2.0	-5.2	11.0	11.9	2.9	3.1	8.9	7.3	4.0	2.7	1-2/06
Fixed investments, %	-5.0	-12.0	5.3	17.4	10.0	2.8	12.5	11.7	10.7	1.6	1-2/06
Unemployment, % (end of period)	9.0	13.2	12.4	9.9	8.7	9.0	8.7	7.6	7.7	7.7	2/06
Exports of goods, US$ billion	86.9	74.4	75.6	105.0	101.9	107.3	135.9	183.5	245.3	43.1	1-2/06
Imports of goods, US$ billion	72.0	58.0	39.5	44.9	53.8	61.0	76.1	96.3	125.1	18.9	1-2/06
Current account, US$ billion	-0.1	0.2	24.6	46.8	33.9	29.1	35.4	58.6	84.2		

[1] *New methodology from Jan. 1, 2005; figures for 2001–2004 are revised and not comparable with previous years.*
Sources: Rosstat, CBR.

New financial plan for 2006–08 introduced

As part of broad budget sector reform, the finance ministry has introduced three-year financial plans, starting with the 2006–08 period. The 2007–09 plan is under preparation. The 2006–08 plan foresees the overall public sector budget (federal and regional budgets plus non-budgetary funds) will show a surplus of some 3 % of GDP. Practically all of the surplus will be generated by the federal budget; the other budgets should be roughly balanced. Public sector revenues and expenditures will continue to increase in real terms and still equal well over 30 % of GDP, although the GDP share will decline. The plan assumes the Urals-blend oil price will decrease from $51 a barrel in 2005 to $46 in 2007–08.

On that basis, federal budget revenues are forecast to drop from almost 24 % of GDP in 2005 to 20 % in 2007. The plan assumes federal tax revenues will increase in relation to GDP in 2008, although there is no detailed information as to what tax categories are expected to grow. During 2000–05, the shares of profit taxes and taxes related to natural resources increased steadily. Total federal expenditures, as well as non-interest expenditures excluding social tax transfers to the pension fund, will increase this year and then fall in 2007. The latter non-interest spending category is planned to stabilise at around 15 % of GDP in 2007–08 against 14 % in 2005. The plan assumes the federal government will continue to collect most revenues and then distribute over a quarter of that to other budgets.

The financial plan foresees state debt shrinking to about 10 % of GDP, with the share of internal debt increasing slightly. The Stabilisation Fund will reach some $146 billion by the end of 2008, or 12 % of GDP. The fund would keep its current revenue floor of $27 per barrel of oil and virtually none of the fund's monies have been marked for spending.

Financial plan 2006–08, % of GDP

Public sector*	**2006**	**2007**	**2008**
Revenues	35.6	34.2	33.8
Expenditures	32.2	31.0	30.8
Balance	3.4	3.2	3.1
Of which, federal budget			
Revenues	*20.7***	*20.0*	*19.9*
Expenditures	*17.5*	*16.8*	*17.0*
Balance	*3.2*	*3.2*	*2.9*
State debt, end of year	14.0	11.3	10.4
Stabilisation fund, end of year	8.6	10.5	12.3

** Federal budget, consolidated budget of regions, non-budgetary funds.*
*** The finance ministry's recent estimate is almost 22 % of GDP as the oil price is projected to be higher in 2006 than assumed earlier.*
Source: Minfin

The financial plan gives no hints on the implementation of finance minister Kudrin's recent suggestion on dividing the budget into two parts – a non-oil budget and an oil budget. Kudrin would like to see all oil-related revenues placed in a special account, from which they would be transferred to cover non-oil budget deficits up to certain limits. The ministry's preliminary calculations suggest the deficit of the non-oil budget was almost 3 % of GDP in 2004, while the total budget including oil revenues showed a surplus of over 4 % of GDP. To back his suggestion, Kudrin invoked the example of Norway, which finances additional government spending by raising taxes or shifting spending rather than dipping into oil income.

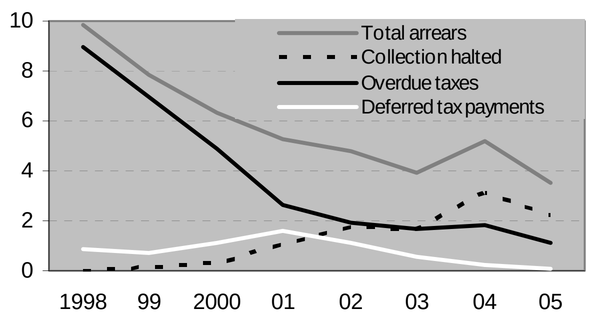
Tax arrears diminish steadily

Tax arrears to budgets of all administrative levels were a major problem during the last decade. At the end of 1998, a year of financial crisis, they accounted for about 10 % of GDP. With the economic upswing of the 2000s, as well as tightened measures by authorities, the situation has brightened steadily, except for a temporary increase in 2004. At the start of this year, tax arrears equalled 3.5 % of GDP, of which almost 90 % were owed to the federal budget and the rest to regional and local budgets. It seems regional and local authorities have been more successful than the federal government in cutting tax arrears since in the late 1990s sub-federal budgets were owed about 40 % of all arrears..

The total sum of tax arrears consists of overdue and deferred taxes as well as tax debts that are already treated as unrecoverable. Federal budget information indicates that about half of all arrears are from non-payments of VAT, over a quarter from shirked profit tax and 8 % from skipped natural resource payments. The share of the latter two has been increasing in recent years, while the share of VAT arrears has declined.

While the legal framework of tax reform is almost finished, the current legislation is still not always clear or comprehensive. The principal goal for 2006 tax legislation is to improve tax administration to prevent tax evasion, which is probably a much broader problem than tax arrears.

Tax arrears to consolidated budget, % of GDP, end-year



Source: Rosstat

Fiscal indicators for federal government (% of GDP, unless otherwise indicated; end-period figures for debt and stabilisation fund)

	1998	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006,**	**as of**	**2006 budget**
Revenues [1]	11.4	12.6	15.4	17.8	20.3	19.5	20.1	23.7	26.2	1-2/06	20.7
Expenditures [1]	17.4	16.8	14.6	14.8	19.0	17.8	15.8	16.2	14.7	1-2/06	17.5
Balance	-6.0	-4.2	0.8	3.0	1.4	1.7	4.4	7.4	11.4	1-2/06	3.2
Foreign currency debt	50.1	87.7	55.3	44.4	36.2	25.7	19.6	12.5		9/05	
Foreign currency debt, $bn	158.2	154.6	143.4	133.1	123.5	119.7	114.4	86.8		9/05	
Stabilisation fund, $bn							18.9	43.0	55.6	02/06	

[1] *Since 2002 part of the unified social tax is included in the federal budget.*
Sources: Budget: IMF 1997–2000, Rosstat 2001–2005, Minfin 2006. Debt: IMF 1996–1999, Minfin 2000–2005.

Dual external capital flows of the corporate sector

Russian balance-of-payments statistics indicate that since the start of the country's transition in 1992, the non-financial corporate sector has maintained a significant net capital outflow almost every year. In 2005, the outflow abated to less than 1 % of GDP. The net outflow, however, obscures a range of major outflows and inflows.

For inflows, companies continued to expand their borrowing from abroad from $15–16 billion a year in 2003 and 2004 to over $40 billion in 2005 (see chart). Most borrowing was still made as loans, but corporate bond issues also increased rapidly. The major borrowers were large state-owned enterprises, especially in the gas and oil sectors, and some ten billion dollars of the total was Gazprom borrowing to buy Sibneft. The debt stock rose to $126 billion as of end-2005, equal to almost 17 % of GDP. Balance-of-payments data show foreign direct investment (FDI) flows into non-financial companies declined slightly in 2005 to $13 billion, but if Gazprom's purchase of Sibneft from a foreign company held by Sibneft's Russian owner in 4Q05 is excluded, the FDI flows rose to well over $20 billion (see below).

Regarding outflows, Russian non-financial companies were continuously active in direct investment abroad ($13 billion). The main "grey" ways of channelling money out of the country retained their popularity, which suggests companies are still short of confidence in the Russian business environment. The CBR measures for such capital exports, i.e. non-repatriated export income, imports of goods and services that were paid but not delivered, and fictive transactions with securities (based on a predetermined difference in selling and buying prices), altogether climbed slightly to $27 billion in 2005. Securities transactions continued to be the most popular device. The net-errors-and-omissions item in the balance of payments increased to $12 billion negative, suggesting a strong rise in unidentified capital outflows.

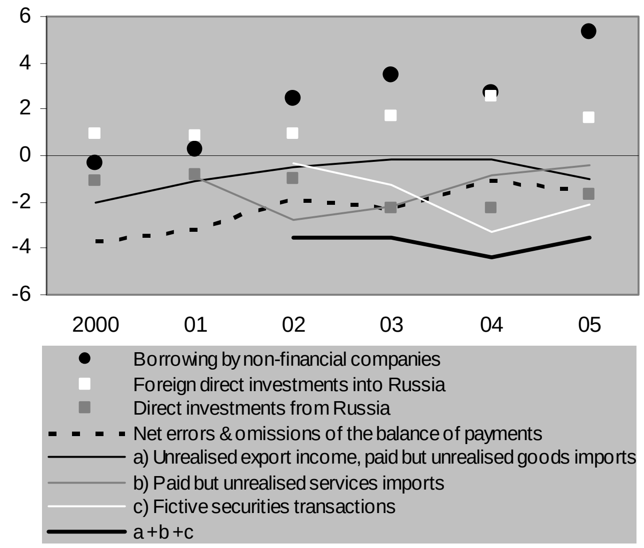
Foreign direct investments, old and new

The development paths of FDI flows into non-financial companies in Russia in recent years differ somewhat according to the source of information. The different types of FDI flows also show notable variations (see chart). Balance-of-payments data suggest that foreign investors with established companies have been eager to reinvest their earnings. While this activity has been significant in the FDI in recent years ($8 billion in 2005), company expansions are also reflected in the continuous inflow of lending from foreign owners (over $2 billion in 2005). At relatively small volumes, new equity is easily subject to sharp changes, e.g. when large foreign investors make capital injections or sell their businesses to domestic investors. In fact, equity FDI in Russia showed growth for 2005, excluding the Gazprom-buy-Sibneft event.

Foreign companies invest

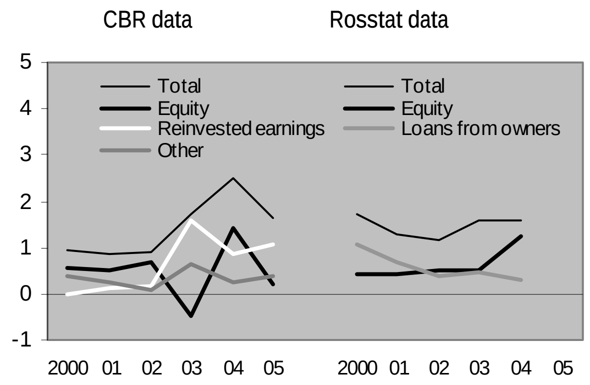
Partly separate from FDI is the investment made by foreign-owned companies in the economy. Foreign investors appear to play a notable role in Russia's future GDP growth, since foreign-owned companies accounted for 6–7 % of total fixed investments in 2004–05, and companies with joint domestic and foreign ownership accounted for another 10–13 %. In addition to investing actively in the trade sector (45 % of total investments in 2004), the share of fully and partly foreign-owned companies in key branches of manufacturing has also been quite high (e.g. in 2004, a quarter in the machine and metal processing industry, a third in the chemical industry, and about half in the food industry).

Major capital inflows and outflows of non-financial companies, % of GDP



Source: CBR

Foreign direct investment inflows into Russia, % of GDP



Sources: CBR, Rosstat

Monetary indicators

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006,	as of
Inflation (CPI), 12-month, % (end of period)	11.0	84.4	36.5	20.2	18.6	15.1	12.0	11.7	10.9	10.7	3/06
M2, 12-month growth, % (end of period)	29.0	21.3	57.5	61.5	39.7	32.4	50.5	35.8	38.6	37.3	2/06
Average wage, $ (period average)	164	108	62	79	111	142	180	237	301	323	2/06
Deposit interest rate, % (period average)	16.8	17.1	13.7	6.5	4.9	5.0	4.5	3.8	4.0	4.2	1/06
Lending interest rate, % (period average)	32.0	41.8	39.7	24.4	17.9	15.7	13.0	11.4	10.7	10.2	1/06
Forex reserves, $ bn (incl. gold)	17.8	12.2	12.5	27.9	36.6	47.8	76.9	124.5	168.4	205.9	3/06
RUB/USD exchange rate (end of period)	5960	20.65	27.00	28.16	30.14	31.78	29.45	27.75	28.78	27.76	3/06
RUB/EUR exchange rate (end of period)			27.23	26.14	26.49	33.11	36.82	37.81	33.94	33.47	3/06

Sources: Rosstat, CBR.

Russia's housing sector – on the verge of a better future?

by Merja Tekoniemi*

Housing sector largely unreformed

In autumn 2005, president Putin announced four top priority national programs, one of which was housing. The sector has lagged other reforms as state housing subsidies have discouraged market-based changes. Following Soviet tradition, subsidies have been allotted to everyone regardless of income. Despite the fact that at the start of 2005 over 60 % of the living area of residential buildings (or 85 % of all apartments) in Russia was privatised, the condition of the housing stock remains poor overall. Most old residential buildings (almost half of the current housing stock was built during 1946–1970) require comprehensive refurbishments. Yet most individual owners cannot afford that and municipalities are too poor to upgrade municipal infrastructure on a large scale. As a result, about half of the Russian population lives without some modern conveniences.

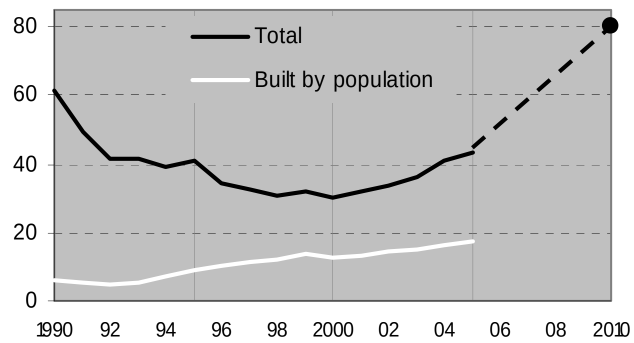
Until recently, the most visible changes in the housing sector have been the appearance of luxury blocks of flats in the best neighbourhoods of Moscow and new private detached houses near the bigger population centres. The number of residential buildings built with own funds or private bank loans has been growing steadily since the late 1990s. However, only a limited share of the population can contemplate this approach – most Russians still live under crowded circumstances in decaying buildings. Some middle-income Russians, who have taken mortgages for a new apartment, have met with different problems. Often they have paid for their flats in advance only to see the house never built or left unfinished. Those lucky enough to move in still often confront poor quality and broken promises. In Moscow, the city budget now covers some of these losses.

Ambitious housing program

The housing program for 2002–2010 adopted by the government at the end of 2005 aims at providing Russians with better housing. The annual volume of new living space should double during this decade (see chart). By 2010, new housing output should exceed the yearly level reached before the break-up of the Soviet Union. For the 2006–2010 period, the housing program will require about RUB 900 billion (€27bn), of which over a third would come from the public sector. To increase housing construction, administrative barriers will be cut and joint efforts of regions and municipalities to offer sites with municipal engineering will be promoted through federal subsidies.

Federally subsidised mortgage loans are expected to make acquiring a new home possible for more Russians. The share of Russians that can afford a new basic apartment should grow at least to 25 % from 15 % in 2003. In 2005, just RUB 50 billion ($1.8bn) in housing loans were granted. Of that, the share of mortgage loans was about 40 %.

New residential buildings, million m²



Source: Rosstat. 2010 is the goal for the total in the national housing program adopted December 31, 2005.

The era of federal housing subsidies officially ends

The Soviet practice of subsidised housing was officially abolished at the beginning of this year. The shift continues the government's policy introduced last year of monetising certain Soviet-era social benefits. However, the real world situation is not that clear. Anecdotal evidence suggests Russians currently pay on average about 60–80 % of true housing costs (electricity, water, heat, etc.). While some regions implemented 100% payment practices last year, residents in regions like Moscow city still only pay about half of true housing costs. The decision to voluntarily postpone the 100% payment means that the city budget must cover the difference. Moscow residents are even entitled to receive social assistance when the share of housing costs in total incomes of a family exceeds 10 %. Most of Russian regions apply the maximum limit, which according to federal law is 22 %.

Rapidly rising rents and prices for housing services (up over 30 %) was one of the driving forces behind the higher-than-expected inflation rate of 2005. As a consequence, a law limiting price hikes in housing sphere was approved at the end of 2005. The law calls for individual tariff limits for each of Russia's 88 regions. Despite the law there have been small protests in certain regions against the price hikes and the 100 % payment practice. Many Russians are dissatisfied with the fact that higher prices have not led to practical improvements in housing services and infrastructure. While people generally feel they are paying more for nothing, the way to help ordinary Russians get their money's worth would require bringing real competition to the housing sector.

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Economic Developments

Energy sector constrains growth

Slow growth of fuels production, as anticipated in Russia's forecasts, is having a dampening effect on the economy's growth. Fuels account for more than 30 % of all industrial production (in terms of value added), at least 15 % of total wholesale trade (sales value) and over 70 % of cargo transport (physical transport volume). Production of crude oil and gas, which together represent over 80 % of Russia's total energy production, was up 2.5 % y-o-y in January-May. Low growth has been the pace in oil production since early 2005 and in gas production for most of this decade. Coal production, about 12 % of the energy production, grew about 6 %, roughly the same pace as last year.

Pipeline transportation of oil and gas rose only about 1 % in January-May, after slowing to 2-3 % in 2005 from the boom of 2002-04 when oil and gas piping expanded at 6-8 % a year. On year, exports of crude oil were down slightly in January-April (after dropping 2 % in 2005), while growth of gas exports slowed to 2 %. On the other hand, production and exports of refined oil products continued to increase at around 8 %. In a broader view, higher growth in non-energy activities has sustained GDP growth at around 5-6 % this year. That way the economy is gradually diversifying.

Rising household incomes continue to drive growth

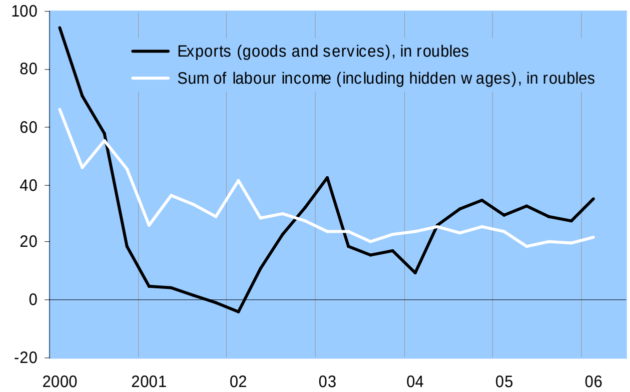
The general view that world prices of oil and Russia's other major export commodities such as gas and metals support Russia's economic expansion substantially has begun to gain more features as the impact has probably weakened and the different ways of the effects into GDP growth have seen some changes. Among other things, this is due to increased taxation of the oil sector. Despite high world oil prices, investments in the Russian oil sector have not grown like earlier. Stalling growth of crude oil exports has shifted to high growth in exports of refined oil products. Although perhaps more mildly than previously, oil income continues to feed consumption growth as oil income not taxed to the budget makes its way through the corporate sector into wages and taxes make their way through the budgets into public sector wages and pensions.

After sharp increases in 1999-2001 (around 45 % a year in nominal terms), growth of the average wage in the economy stabilised at 23-26 % a year in 2003-05 and went on at 22 % y-o-y in January-May this year (see chart). Pensions rose on the average 20 % a year in 2003-05. Total labour income flow to households (around 45 % of GDP in the recent years) and its increases are massive in relation to household saving flows (such as the continuous slight net absorption of funds from households to banks or growth of the cash stock) or household investments, so that wages are unequivocally the engine behind the private consumption boom. Wage growth is a parameter to watch, e.g. for forecasters as private consumption accounts for 47-48 % of GDP, and for exporters to Russia because private consumption feeds import growth.

Looking ahead, the economy ministry's forecasts from May project wages will rise more than 20 % this year and around 15 % a year during 2007-09. This includes the presumption of two hikes in public sector wages this year totalling nearly 28 %, followed by lower increases further out (15 % in 2007 and about 5 % a year in 2008-09). The plan is to raise pensions relatively slowly this year (14 %) and then more rapidly in 2007-09. This means that in 2009 both wages and pensions would be about 85 % higher than in 2005, which together with the anticipated rouble exchange rate strength translates into likely continuing rapid market growth.

The wage increases will naturally add to increases in production costs. For example, wages in manufacturing rose more than 25 % a year in 2002-03 and more than 20 % a year in 2004-05 and this spring. While the rise of real wages in manufacturing was well within the growth of labour productivity in 2003-04, it outpaced productivity growth in 2005 and this year.

Russia's exports and labour income,
% change from four quarters previous



Source: Rosstat

Macroeconomic indicators

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	as of
GDP, %	1.4	-5.3	6.4	10.0	5.1	4.7	7.3	7.2	6.4	5.5	Q1/06
Industrial production, % [1]	2.0	-5.2	11.0	11.9	2.9	3.1	8.9	7.3	4.0	4.8	1-5/06
Fixed investments, %	-5.0	-12.0	5.3	17.4	10.0	2.8	12.5	11.7	10.7	9.2	1-5/06
Unemployment, % (end of period)	9.0	13.2	12.4	9.9	8.7	9.0	8.7	7.6	7.7	7.2	5/06
Exports of goods, US$ billion	86.9	74.4	75.6	105.0	101.9	107.3	135.9	183.5	245.3	91.7	1-4/06
Imports of goods, US$ billion	72.0	58.0	39.5	44.9	53.8	61.0	76.1	96.3	125.1	43.1	1-4/06
Current account, US$ billion	-0.1	0.2	24.6	46.8	33.9	29.1	35.4	58.6	84.2	29.5	Q1/06

[1] *New methodology from Jan. 1, 2005; figures for 2001–2004 are revised and not comparable with previous years.*
Sources: Rosstat, CBR.

Government lifts main parameters for 2007 federal budget

At its mid-summer meeting the government discussed the 2007-09 financial plan and decided to revise upwards the revenue and expenditure estimates of federal budget, especially for 2007. The three-year financial plan, which includes federal and consolidated regional budgets as well as non-budgetary funds, is compiled once a year. The plan for 2006-08 was approved in March when the 2007-09 plan was already under preparation.

The 2007-09 plan assumes crude oil prices will decline 6-9 % in each year, while the 2006-08 plan assumed the oil price would drop more. Federal budget revenues in 2007 are now anticipated to reach nearly 22 % of GDP. While that level is lower than the record revenues accruing currently (about 25 % of GDP) due to the high oil price, it is above the 20 % of GDP foreseen in the 2006-08 plan approved in March. The revenues are anticipated to contract to about 19 % of GDP in 2009.

The upward revision of federal budget expenditures for 2007 sets the expenditures at 17.5 % of GDP, instead of less than 17 % of GDP in the 2006-08 plan. The increase comes fully from non-interest expenditures. Whatever the reasons for the increase in expenditures, it coincides with the fact that 2007 is a campaign year both for parliamentary elections (in December 2007) and presidential elections (March 2008). Expenditures are planned to drop to below 17 % of GDP in 2009.

The planned expenditure hikes during the period are directed to various policy areas such as population policy measures, wages of budget sector employees, implementation of national priority programs, defence and national security, transfers to the pension fund, regional supports, and road construction and maintenance. The preliminary 2007 budget also sets aside money for the planned phase-out of cross-subsidies in “natural monopoly” fields (gas, electricity and railways), suggesting utility rate hikes for households who currently benefit from low tariffs would be at least partly compensated to the poorest households from the budget. The state will also increase its equity stakes in the new electrical power companies created as spin-offs from giant UES where the state is the majority owner.

Despite higher spending, large revenue streams are to keep the federal budget in surplus although it would decline to below 3 % of GDP in 2009. The government's Stabilisation Fund could exceed 15 % of GDP by the end of 2008. Naturally, budget parameters will in reality change upwards if the oil price remains higher, as projected in various forecasts, than the assumptions in the 2007-09 plan.

Hikes of regulated prices in 2007-09 considered

In June the government also dealt with price increases for “natural monopolies”, i.e. gas, electricity and railways, as well as housing-related services and gasoline for 2007-09. The ceilings on price hikes in the government’s March economic forecast parameters meant that price increases for gas, electricity or railways would on average equal or slightly exceed the projected pace of inflation. Some of the ceilings proposed in the economy ministry’s May forecast, however, are notably higher even if they would mean lower price hikes than in recent years as inflation is expected to decline in the next three years. The new plan also defines some larger price hikes for households.

Ceilings for gas prices are envisaged to allow the increase of the wholesale prices on the average by 15 % in 2007 and slightly slower in 2008-09; gas prices for households would increase slightly more. The economy ministry’s plan notes that earlier ceilings were too low to allow sales of gas on the domestic market without incurring loss while the new proposed ceilings would cover long-term marginal costs of gas production. While higher prices would encourage more efficient use of gas and electricity, including application of energy-saving technologies, the economy ministry also stressed the electricity sector needs more income to finance its required investments. Higher gas rates would also put pressure on electricity prices that were proposed to rise 10 % in 2007 and a little slower in 2008-09. Electricity prices for households would increase 13 % in 2007 and about 10 % a year in 2008-09 (although actual prices for users other than households could also head up more rapidly as domestic trade of electricity with freer pricing expands).

A fairly modest rise in rail cargo tariffs is currently planned (8 % in 2007 and about 6 % a year in 2008-09). However, the plan explicitly notes that with a view to Russia becoming a member in the WTO the gap between tariffs for domestic and cross-border rail cargo would be narrowed by maintaining the current level of tariffs for cross-border traffic in 2007-08 and raising the tariffs for domestic cargo as well as export and import cargo railed via Russian ports by around 10 % a year in 2007-08. Railway passenger tariffs, which currently create loss, would be raised over 10 % a year in 2007-09.

Price hikes for housing-related municipal services, which became subject to stricter regulation this year, are slated to stay within 15 % in 2007 and 11-12 % a year in 2008-09. At the same time, it is foreseen that actual payments by households for these services may increase more rapidly as the principle of having residents pay the full costs for such services will be applied in those regions where it has yet to be realised. Price policies have also been activated for oil fuels and products, most specifically the gasoline price. Increases in gasoline prices are now planned to be kept within 3-4 % a year in 2007-09.

Fiscal indicators for federal government (% of GDP, unless otherwise indicated; end-period figures for debt and stabilisation fund)

	1998	1999	2000	2001	2002	2003	2004	2005	2006,	as of	2006 budget
Revenues [1]	11.4	12.6	15.4	17.8	20.3	19.5	20.1	23.7	25.6	1-5/06	20.7
Expenditures [1]	17.4	16.8	14.6	14.8	19.0	17.8	15.8	16.2	16.1	1-5/06	17.5
Balance	-6.0	-4.2	0.8	3.0	1.4	1.7	4.4	7.4	9.5	1-5/06	3.2
Foreign currency debt	50.1	87.7	55.3	44.4	36.2	25.7	19.6	10.2			
Foreign currency debt, $bn	158.2	154.6	143.4	133.1	123.5	119.7	114.4	76.5			
Stabilisation fund, $bn							18.9	43.0	71.6	5/06	

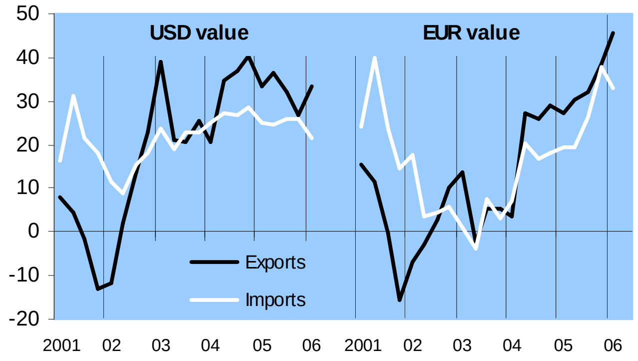
[1] *Since 2002 part of the unified social tax is included in the federal budget.*

Sources: Budget: IMF 1997–2000, Rosstat 2001–2005, Minfin 2006. Debt: IMF 1996–1999, Minfin 2000–2005 Stab.fund: Minfin.

Foreign trade boom continues

Russia's foreign trade expansion persisted in the first quarter of this year as export revenues from goods and services rose a third from 1Q05 (see chart). Similar to recent years, higher export prices largely accounted for the 50 % increase in revenue from exports of crude oil, oil products and gas. The value of exports of other goods rose 10 % and services 20 %. Russia's import expenditure increased over a fifth in dollar terms and a third in euro terms. As in 2003-04, the total import volume grew fast while import prices declined a bit.

Russia's exports and imports of goods and services, % change from four quarters previous



Source: CBR

Banking sector profits, income and expenses grow

Net profit of the Russian banking sector has increased rapidly in this decade – around 20 % a year in real terms in 2002-03 and 25-30 % a year in 2004-05. In line with their share of banking sector total assets, state-controlled banks (as defined and identified by the CBR) generated about 40 % of the profits in 2005. The 30 largest banks in Russia accounted for two-thirds of the total.

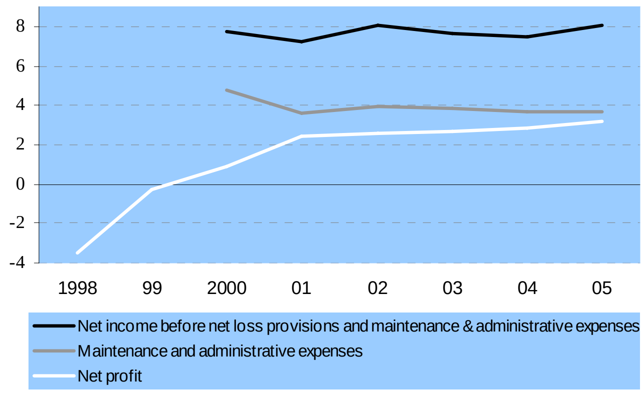
Bank profitability has also risen swiftly in recent years. Banks enjoyed a 20 % return on equity from 2001 until 2004 and 24 % return in 2005. The return on equity has provided bank owners with an increasing positive return in real terms that reached around 10 % in 2004-05. The nominal return on total assets has also climbed gradually to about 3 % in 2004-05 (see chart). In real terms, however, the return on assets has been quite deeply negative (minus 7-8% in 2003-04), suggesting that banks generally remain rather inefficient at intermediating and transforming their funds into assets. The low return may also be partly explained by the rapid roll-outs of banking activities that are anticipated to pay for themselves over time. The return on assets in state-controlled banks and foreign-owned banks averaged about 3 % in 2005. CBR information on the banks' financial statements based on transforming the accounts from Russian Accounting Standards (RAS) into accounts mimicking International Financial Reporting Standards (IFRS) indicates the net profit may be somewhat smaller (some 20 % smaller in 2004) than suggested by RAS.

Growth of bank profits has been driven by rapid increases in net income (in 2005, it was up about 25 % in real terms). Net income has hovered at about 8 % of total assets throughout this decade. The structure of net income has developed towards a banking economy pattern: the share of net interest income has risen to over 60 % of total net income and the share of net commission income to over 20 % of the total. This situation reflects a rapid expansion in bank lending to non-financial companies and households while margins remain wide between interest rates on deposits and lending, despite some narrowing over the years. Bank net income from operations with securities represented about 12 % of the net income in recent years. Foreign exchange operations brought about 5 % of the total.

Maintenance and administrative expenses at banks equalled about half of the net income during 2001-04 and 45 % in 2005, and increased around 15 % a year in real terms in 2003-05. The ratio of the expenses to total assets remained at nearly 4 %, which is slightly higher than in almost any of the EU member countries that joined in 2004. Besides expanding branch networks, the growth of expenses reflects brisk wage increases (although on the average the increases have been in line with the rest of the economy) as well as a growing number of bank employees.

Looking ahead, banks may start facing challenges in generating net income if gradually slowing inflation and growing competition narrow interest rate margins, the pace of expanding lending cannot reasonably be maintained at the very high levels seen in the past several years, or Russian equity markets remain volatile and therefore not very attractive to risk-averse investors.

Banks' net income, expenses and profit, % of total assets



Source: CBR

Monetary indicators

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006,	as of
Inflation (CPI), 12-month, % (end of period)	11.0	84.4	36.5	20.2	18.6	15.1	12.0	11.7	10.9	9.2	5/06
M2, 12-month growth, % (end of period)	29.0	21.3	57.5	61.5	39.7	32.4	50.5	35.8	38.6	42.8	5/06
Average wage, $ (period average)	164	108	62	79	111	142	180	237	301	370.8	5/06
Deposit interest rate, % (period average)	16.8	17.1	13.7	6.5	4.9	5.0	4.5	3.8	4.0	4.2	4/06
Lending interest rate, % (period average)	32.0	41.8	39.7	24.4	17.9	15.7	13.0	11.4	10.7	10.8	4/06
Forex reserves, $ bn (incl. gold)	17.8	12.2	12.5	27.9	36.6	47.8	76.9	124.5	168.4	250.6	6/06
RUB/USD exchange rate (end of period)	5960	20.65	27.00	28.16	30.14	31.78	29.45	27.75	28.78	27.08	6/06
RUB/EUR exchange rate (end of period)			27.23	26.14	26.49	33.11	36.82	37.81	33.94	33.98	6/06

Sources: Rosstat, CBR.

Market economy is… plus the electrification of the whole country!

by Merja Tekoniemi*

Russian power sector reforms in the 1990s were restricted to a few normative documents; the main laws and programs on restructuring the sector were approved in this decade. In practice the changes have proceeded slowly and the organisation of power sector today is a mixture of old and new.

How the market might look after 2010

The essence of the power sector reform is to reorganise the market through the break-up of RAO UES, the state majority-owned electricity monopoly created in 1992, in order to establish competitive markets for power generation and retail distribution, while leaving transmission and inter-regional distribution to state monopolies. In the target market situation, there would be a couple dozen *power generators* competing with each other. They would be shaped mainly from regional power companies, presently owned to varying degrees by UES and under restructuring. The current plans are based on formation of 14 territorial generation companies, six thermal companies and one super hydro generator. There will also be a nuclear power generator (RosenergoAtom). The share of private ownership in territorial generation companies would be in the range of 75–100 %, in thermal companies 51–100 %, and at least 52 % in the hydropower generator. RosenergoAtom will remain wholly owned by the state. The power generators sell their electricity on the wholesale market, of which about 15 % is already competitive and market-priced. By around 2010, wholesale prices should be wholly unregulated.

Power transmission remains under the Federal Grid Company, presently 100 % owned by UES. In the future, the state's share in FGC will increase to 75 % plus one share. Electricity would reach regional grids through seven inter-regional *distribution companies*. The private *retail companies* would sell the electricity to enterprises and households, which could choose their electricity provider freely.

Possible problems

Power sector reforms require a delicate balancing of the needs of various, often opposite, interests (market players, consumers, politicians, officials, etc.) at the same time trying to assure free and honest competition.

In Russia the most serious challenges relate to ownership, pricing and investment. Questions of ownership present a two-edged quandary. Planned regulatory institutions are not independent, so the very fact that the state acts as both a market participant and a market regulator carries an implicit threat of intentional government intervention. Moreover, the fact that Russian electricity markets are poorly integrated with each other could, in the situations of peak electricity demand, lead to excessive market power of certain regional electricity companies. This is why the International Energy Agency (IEA) recommends further diversification of ownership.

Under present plans, retail pricing, for social reasons, will remain regulated at both federal and regional levels during the transition period. Cross-subsidies (low residential electricity rates paid for with higher industrial rates) are to be abolished, although no deadline has been set. In any case, as long as price regulation remains, it acts as a serious impediment to investment flows into the sector.

Major electricity consumption growth ahead – investments needed

Russia's electricity production grew steadily in the 1980s, only to slump with the collapse of the Soviet Union. While it began to revive after the 1998 financial crisis, production overall has yet to reach the 1990 level. In 2004, Russian electricity consumption per capita hovered around 6000 KWh, which was only about a third of the consumption of another northern country, Canada.

President Putin wants to double the GDP within a decade, a goal that will require sufficient and secure electricity production. Russia's Energy Strategy projects that electricity production under the most optimistic scenario will increase by about a fifth in 2000–2010, which is in line with the projected electricity consumption estimate. In 2000-2005 electricity consumption grew less than 9 %. However, there are clear regional and seasonal variations in consumption, which recently have began to create problems. In many regions electricity consumption already exceeds the 1990 benchmark and in the critical areas like Moscow, Leningrad and Tyumen, there have been limitations on electricity use as well as restrictions on new connections to the grid.

To meet the higher electricity demand in the future as well as solve the problems of regional and seasonal variation, huge investments are needed. UES calls for more than tripling the 2006 investment level to at minimum $20 billion a year from 2008. The IEA estimates Russia's investment needs in 2003–2030 will amount to $380 billion (almost 2 % of GDP for the period), of which over half would go to investments in transmission and distribution and the rest to expanding generation capacity.

A key question is how Russia will attract such huge sums of money. Who outside the public sector is willing to invest in a sector presently mostly in state hands, functioning under price regulation and possessing fixed capital assets of little value? Finance minister Alexei Kudrin says the state will remain for the time being the main investor in the electricity sector. The recent decision of government to start offering minority shares in generation companies also implies private capital injections into the sector. But are investors confident enough that power sector reform will proceed as planned? Is minority ownership enough for them? These are crucial questions for Russia.

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Economic Developments

Oscillating growth

After accelerating to over 7 % y-o-y in the second half of 2005, GDP growth slowed in the early months of this year and more recently picked up (see chart). Rosstat estimates GDP grew 5.5 % in the first quarter. The slowdown occurred despite the rise of export prices to record levels, which has usually pushed growth. The export price for crude oil was up 35 % in the first four months of 2006 and for gas about 50 %. The moderation resulted primarily from a pause in investment growth early in the year and, as suggested by data on retail trade and services, a slightly slowed expansion of private consumption. On the other hand, retail trade still increased over 10 %. General structural changes continued as construction and industry revived in spring while agriculture and cargo transport increased slowly.

Real economy developments, % change from 12 months previous

*) agriculture, industry, construction, transportation, trade

Source: Rosstat

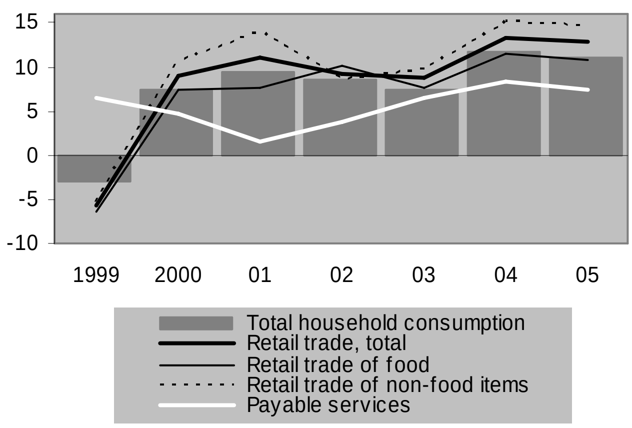
Domestic trade expansion – more non-food items and imports

Trade has been the outstanding expanding sector in the economy. In terms of both volume and value added, wholesale and retail trade have increased by well over 10 % per year in recent years. The trade sector's share of GDP, which has declined slightly due to lower price increases compared to other sectors, is presently about 18 %, making it larger than, for example, manufacturing. The trade sector is also an important employer, providing jobs for 17 % of the workforce (in comparison, the entire industrial sector employs about 21 %). Moreover, both the share and number of employees in trade have risen virtually every year since Russia's transition started.

The trade expansion reflects a simultaneous income effect from Russia's rising energy export earnings and transformation into a consumer society with an accompanying growth in consumer credit. Russia's national accounts statistics suggest that in this decade the volume of retail trade has grown fastest in total household consumption (presently representing about 68 % of the consumption), which is different from the services sector (between a fifth and a quarter of consumption) where prices have risen much faster than volume. Consumption as in-kind salaries e.g. in agriculture has developed slowest (some 6 % of total household consumption).

More organised forms of retail trade have begun to displace various types of local markets and bazaars that gained share in the 1990s, and they now control almost 80 % of all retail trade. Rising living standards have changed composition of the consumer shopping basket as retail volumes of food items (excluding alcohol) have increased more slowly than the total in this decade (although not in the past couple of years). Alcohol sales climbed rapidly early in this decade while retail volumes of non-food items steamed ahead fastest, including 13-14 % annual growth in 2004–05 and topped by 15 to 35 % annual increases in sales volumes of household equipment and cars. Finally, the share of imports in the value of retail trade has risen to over 45 %, including 35 % of food items and some 55 % of non-food items.

Consumption, retail trade and services, % change of volume



Source: Rosstat

Macroeconomic indicators

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	as of
GDP, %	1.4	-5.3	6.4	10.0	5.1	4.7	7.3	7.2	6.4	5.5	Q1/06
Industrial production, % [1]	2.0	-5.2	11.0	11.9	2.9	3.1	8.9	7.3	4.0	4.8	1-5/06
Fixed investments, %	-5.0	-12.0	5.3	17.4	10.0	2.8	12.5	11.7	10.7	7.4	1-4/06
Unemployment, % (end of period)	9.0	13.2	12.4	9.9	8.7	9.0	8.7	7.6	7.7	7.5	4/06
Exports of goods, US$ billion	86.9	74.4	75.6	105.0	101.9	107.3	135.9	183.5	245.3	91.7	1-4/06
Imports of goods, US$ billion	72.0	58.0	39.5	44.9	53.8	61.0	76.1	96.3	125.1	42.9	1-4/06
Current account, US$ billion	-0.1	0.2	24.6	46.8	33.9	29.1	35.4	58.6	84.2		

[1] *New methodology from Jan. 1, 2005; figures for 2001–2004 are revised and not comparable with previous years.*
Sources: Rosstat, CBR.

President Putin's annual budget address

In his annual budget speech, the president touched many of the same issues as a year ago. He reminded that while budget policy in 2005 was in line with strategic goals, inflation was still too high. Real wages in the budget sector, including those in the military and in national security rose, as did pensions, and that will one priority in the future as well. He added that the national projects to improve health, education, housing and agriculture will continue and that their financing is assured.

More efficiency and quality in state administration

A key issue taken up by Putin was increasing the efficiency of state administration. Budget organisations, he stressed, must balance independence against accountability and transparency. Currently, preparation and implementation of policies and measures suffer from numerous deficiencies. State property also has to be better administered and public procurement handled more effectively. Federal and municipal authorities should strive for joint long-term procurement contracts. He also underlined the importance of quality of state services, calling for clear indicators to measure performance and material rewards to state employees that help to raise the quality of services. Putin referred to insufficient quality when speaking about the tax and customs services, which have been publicly condemned for corruption and inefficiency. He noted that control of tax avoidance via transfer pricing should be improved, especially regarding foreign trade deals between related parties. In April, a program to reform the customs service was approved, and Putin recently fired the head of the Federal Customs Service.

After Putin's speech, government passed a decree on supporting state bodies to carry out administrative reforms. Resources to federal, regional and municipal budget organisations will be allocated on a competitive basis to the best reform proposals. The best implanted projects will also be rewarded. According to Deputy Economy Minister Sharonov, who is in charge of the administrative reforms, the government will introduce new regulations on the quality of state services. These include shortening queuing times and speeding up issuance of official documents.

More transparency and efficiency in spending policies

Russia has managed to adhere to fairly restrictive budget policies in recent years – a great achievement given the state's large income from energy. Putin noted budget expenditures have to be transparent and more tightly linked to set goals. In the case of regional support, this means not punishing regions for their good results but increasing incentives to motivate them to better performance. He said non-interest expenditures must be based on economic growth and long-term world market oil prices. The Stabilisation Fund should be divided into two parts – a reserve for supporting budget expenditures during periods of low oil prices and defined as a share of GDP, and another set aside for future generations.

2007–2009 plans see relaxation of natural resource taxes

The government approved its guidelines of tax policy for 2007-09 in May. President Putin also addressed many of the same issues in his budget speech.

The taxation of natural resources was one of the main topics. Under the guidelines, the extraction tax on oil will continue to be linked to the world market oil price at least until 2015. Oil production will be encouraged by lowering taxation of mature fields. In the guidelines tax holidays are assigned to new fields situated in eastern Siberia, while Putin also referred to fields on the continental shelf. The changes are intended to support growth of oil production, which has slowed in recent years partly because of the increased tax burden. Minfin data shows the extraction sector paid taxes (including unified social tax) worth over 50 % of its value added produced in 2005. The figure was 19 % in manufacturing and 13–17 % in other major economic sectors. In agriculture, it was a mere 4 %. At the same time, the guidelines contemplate new taxes in 2008 for producers of ferrous and non-ferrous ores.

The government is also considering increasing the share regional budgets get from extraction taxes. In recent years, most tax revenues on hydrocarbon extraction have gone to the federal budget, while tax money from certain non-energy natural resources has gone mainly to regional budgets. In 2002–03, the federal share of revenues from hydrocarbon extraction was already about 80 %, and has increased since then. Since 2005, all revenues from the extraction tax on gas and 95 % of revenues on other hydrocarbon resources have gone to the federal budget. The division has been justified by highlighting the role of federal government in distributing revenues back to regions to equalise differences in living standards. Under the current circumstances, however, natural-resource-rich regions lack much incentive to lure investors to develop new fields.

Putin stated that in 2005 taxes and other obligatory payments as a share of GDP – based on a fixed oil price of $20 per barrel – were down from 2004. However, taking into account the over 45 % rise in the price of Urals-grade oil in 2005, the burden clearly grew. This was apparently due to revenue from oil export duties (in 2004, total customs duties equalled 5 % of GDP; in 2005, they were about 7.5 %).

Official policy, supported also by Putin, remains geared to lowering the tax burden on non-extraction sectors. From the start of 2007, enterprises will be allowed to deduct all losses suffered in the previous year, as well as e.g. spending on R&D. VAT refunds should come back sooner, but no further lowering of VAT rate is foreseen. There will also be changes in excise taxes.

Fiscal indicators for federal government (% of GDP, unless otherwise indicated; end-period figures for debt and the Stabilisation Fund)

	1998	1999	2000	2001	2002	2003	2004	2005	2006,	as of	2006 budget
Revenues [1]	11.4	12.6	15.4	17.8	20.3	19.5	20.1	23.7	25.6	1-5/06	20.7
Expenditures [1]	17.4	16.8	14.6	14.8	19.0	17.8	15.8	16.2	16.1	1-5/06	17.5
Balance	-6.0	-4.2	0.8	3.0	1.4	1.7	4.4	7.4	9.5	1-5/06	3.2
Foreign currency debt	50.1	87.7	55.3	44.4	36.2	25.7	19.6	10.2		12/05	
Foreign currency debt, $bn	158.2	154.6	143.4	133.1	123.5	119.7	114.4	76.5		12/05	
Stabilisation Fund, $bn							18.9	43.0	71.6	05/06	

[1] *Since 2002 part of the unified social tax is included in the federal budget.*

Sources: Budget 1997–2000 IMF, 2001–2005 Rosstat, 2006 Minfin; Debt 1996–1999 IMF, 2000–2005 Minfin; Stab.Fund 2004- Minfin

Inflation slows

In the course of this spring, consumer price inflation slowed from a spike in the first two months of the year to a rate of 9.5 % y-o-y in May (see chart). That figure is more in line with Russia's revised official inflation projection of 8–9 % for the year. On the other hand, inflationary pressures have not disappeared as Russia continues to experience large external surpluses, briskly rising wages, some increased budget spending, rapidly growing bank lending, rising industrial producer prices (although down to 13 % y-o-y in May, the lowest rate in two years) and postponed increases in regulated prices.

On the macroeconomic front, the CBR reduced its interventions in foreign exchange markets and allowed the rouble to appreciate a bit in the first quarter of 2006. Nominal appreciation should have had an immediate effect in cooling the rise in consumer prices for both food and non-food goods, as a large share of them are imported, as well as in some industrial producer prices. The delayed downward effect of the smaller interventions involving reductions in domestic money growth, however, was countered by increased interventions later this spring. To soak up liquidity, the CBR raised its rates on deposits for banks (to 1.5–2 %) and offered higher yields on its own bonds (now over 5 %). Yet these monetary policy instruments did not have much effect so far as the deposit rates and bond yields are still low. Thus, the massive mechanism for liquidity absorption remains the government's stashing of its surplus cash (stabilisation fund monies and other surpluses) at the CBR. In early May, the government's deposits at the CBR constituted more than 40 % of domestic rouble money (the stabilisation fund alone held some 28 %).

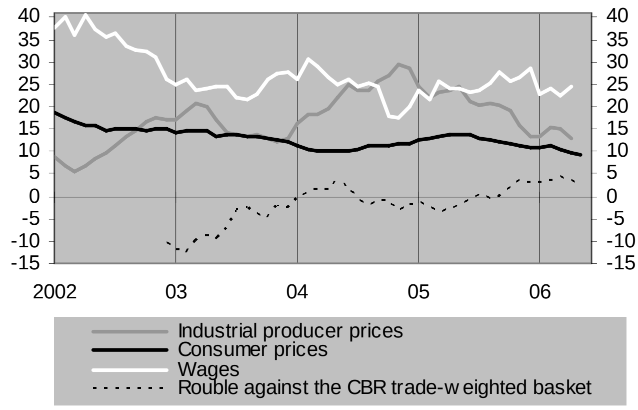
As for price regulation, prices of non-food goods have risen slowly partly because both consumer prices and producer prices for gasoline have been virtually frozen since last autumn. The government's projection about railway cargo prices for this year implies that there will be no further rises after the 9 % hike at the start of the year. Prices of consumer services have risen more slowly than in earlier years as the government's ceiling on price hikes by regional and local authorities for housing and community services seems to have held. The government projects such prices will rise 18–19 % y-o-y by end-2006 (compared to 33 % in 2005), implying moderate hikes during the rest of the year.

Equity markets shaky

Russian equity markets continued their steep upward climb this year. The RTS equity index in early May was up about 60 % from last December's levels, hitting an all-time high of 1,765 points (see chart). Similar to other emerging market stock indexes, the RTSI then tumbled 25 % in just three weeks. Presently, it is up about 15–20 % from December. As in other emerging markets, spreads on Russian sovereign bonds have risen, with the EMBI+ Russia climbing from around 100 basis points in early May to 120-130 basis points by mid-June.

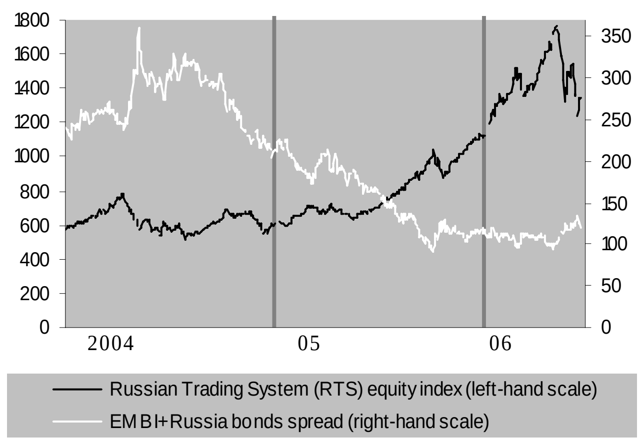
The moves of May-June have been part of a global shift from equities, especially those in emerging market economies, in reaction to expectations of higher inflation and interest rates in the west. They have also been seen as reflecting uncertainties relating to the oil price and as a correction in Russia after a huge rise in the stock market since May 2005. Individual Russian authorities have also noted that they have identified cases of insider trading. While Russia's relatively thin stock market compared to the sizeable flows of e.g. foreign investor money make it prone to high volatility, the main Russian stocks, mostly gas and oil companies, should enjoy some strength as long as world energy prices remain high.

Prices, wages and the exchange rate, % change from 12 months previous



Source: Rosstat, CBR

Russian equity and bond markets



Source: RTS, Cbonds.ru

Monetary indicators

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006,	as of
Inflation (CPI), 12-month, % (end of period)	11.0	84.4	36.5	20.2	18.6	15.1	12.0	11.7	10.9	9.9	5/06
M2, 12-month growth, % (end of period)	29.0	21.3	57.5	61.5	39.7	32.4	50.5	35.8	38.6	38.7	4/06
Average wage, $ (period average)	164	108	62	79	111	142	180	237	301	361	4/06
Deposit interest rate, % (period average)	16.8	17.1	13.7	6.5	4.9	5.0	4.5	3.8	4.0	3.8	3/06
Lending interest rate, % (period average)	32.0	41.8	39.7	24.4	17.9	15.7	13.0	11.4	10.7	10.2	3/06
Forex reserves, $ bn (incl. gold)	17.8	12.2	12.5	27.9	36.6	47.8	76.9	124.5	168.4	247.9	9.6.06
RUB/USD exchange rate (end of period)	5960	20.65	27.00	28.16	30.14	31.78	29.45	27.75	28.78	26.98	5/06
RUB/EUR exchange rate (end of period)			27.23	26.14	26.49	33.11	36.82	37.81	33.94	34.64	5/06

Sources: Rosstat, CBR.

CIS free trade – no quick fix

by Vesa Korhonen*

Since the fall of the Soviet Union soon 15 years ago, the CIS countries have pursued economic integration, among many other things, through free trade agreements (FTAs). Still, the share of intra-CIS trade has declined to about 20 % of their total exports and 30 % of imports. Their trade and economic growth are significantly constrained by slow economic reform, poor domestic and cross-border infrastructure, and geography. Many CIS countries face large reform challenges with enterprise reform, governance, competition, utilities and banking, and some CIS countries still with privatisation. Together with their trade partners, they need to facilitate integration through frameworks for freer trade in goods and services, capital flows (including direct investments) and movement of labour. Still, even in the area of trade in goods – normally the first area of cross-border integration – there remain various issues, small and large, to be addressed.

Web of CIS free trade agreements

In the first half of the 1990s, the CIS countries concluded preferential FTAs, which developed into a veritable web. An intended centrepiece is a regional FTA among 11 of the 12 CIS countries signed in and stipulated to apply from 1994, while all 12 CIS members also concluded some 30 bilateral FTAs (BAs) between each other. As a special complication, the regional FTA and various BAs may be applied in parallel, which presupposes interpretations about their contradictions. Besides the aspect that some BAs have reportedly not been implemented and all the FTAs suffer from implementation shortfalls, the FTAs address certain trade barriers only in general terms or otherwise give rise to discretion.

Partly unclear elimination of basic barriers at the border

While the regional FTA boldly provided for the abolition of customs duties and quantitative import and export restrictions without transition periods, products excepted were ultimately left to be agreed in BAs. In many cases, the exception lists are reportedly short or non-existent. However, the 17 available BAs notified to the WTO suggest that many BAs, instead of fixing exceptions, note that such exceptions shall or may be agreed going forward, in some cases annually. Such an approach may create uncertainty for investors, even if the regional FTA puts a standstill on restrictions beyond those contained in BAs. In addition, standard provisions allowing exceptions on such grounds as the environment, health and security are broadened to cover e.g. export products with domestic prices below world market prices.

As for measures at the border, the regional FTA allows customs fees in excess of actual customs costs within “reasonable” limits, a definition that also causes uncertainty in the discretionary customs environment found in CIS countries. While multi-document practices may favour corruption, the goal of launching a unified intra-CIS customs document remains to be reached.

Further, many BAs put the origin of goods on a bilateral basis, while the regional FTA allows intra-CIS cumulation of origin that promotes the formation of cross-border production chains. However, sufficiently detailed intra-CIS rules of origin are subject to gradual piecemeal negotiations. Certain product groups thus have interim rules of origin that may change. On an intra-CIS or bilateral basis, the rules should be identical to reach cumulation (in Europe, it took some years until cumulation was launched in 1997 among the EU, the EFTA countries and central and east European countries).

Another complication arises from the safeguard clauses of the FTAs that differ in defining the measures allowed and situations where safeguard measures may be applied.

Room for trade barriers inside the economy

Various behind-border barriers can dilute or even nullify the trade benefits gained from the abolition of barriers at the border. While FTAs in general do not always set high ambitions when tackling inside barriers and the CIS countries have made progress in lowering technical barriers to trade, especially in the area of standards, their FTAs only rather softly address some domestic barriers and as such warrant development. For example, subsidies, which are tempting mechanisms during hard times of transition and still relatively wide-spread in various CIS countries, are only prohibited by the FTAs, notably including export subsidies, if they violate fair competition or “normal” economic conditions. The competition rules in the regional FTA are fairly standard in stressing the effect on trade but most BAs only emphasize such cases of agreements between enterprises that are made specifically to limit competition. The behaviour of state trading enterprises is not separately addressed in the FTAs.

Larger moves in CIS free trade may take time

CIS countries may probably work undisturbed to develop the aspects of their existing FTAs, while larger efforts in CIS trade integration could create extra questions in the WTO negotiations where seven CIS countries are seeking WTO membership (four CIS countries are already in the WTO). Such larger steps will rather be feasible after at least the most important CIS countries become WTO members. A regional CIS effort could ultimately consist of a customs union that six CIS members (including Russia) aim to create and – since a customs union would be a party to any FTA on behalf of its members – an FTA/FTAs between the union and the other six CIS countries. A customs union would also be an actor in the WTO as regards various issues of trade in goods, which might mean revisiting some of its external tariffs until all union members have joined the WTO.

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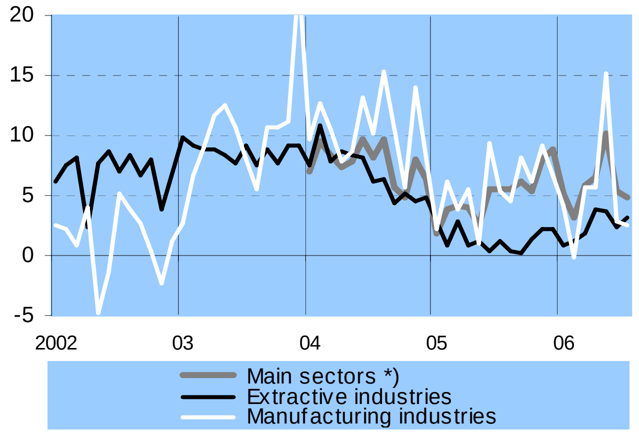
Economic Developments

Growth up and down, partly mixed signs of diversification

Economic growth revived in spring, then slowed in summer. This is what the composite indicator of output in five main sectors (agriculture, industry, construction, transportation, trade) suggests (see chart), although the economy ministry estimates GDP rose some 7 % y-o-y through April-July. The economy was largely driven by a further acceleration of private consumption, as suggested by retail trade (up 12 % y-o-y in 2Q06) and a recovery in investment growth (to almost 12 %) which was reflected in increasing construction.

Growth in domestic production remained clearly lower than domestic demand as the accelerated domestic demand growth only weakly drove domestic industrial production (up in spring but down to 3 % y-o-y in summer). Extractive industries revived as most fuels, minerals and ores fared slightly better than early in the year (see chart), and it was the many manufacturing branches that created the spring-summer variation. There were also other mixed signs. Contrary to the various growing manufacturing branches (food, paper, chemical & petrochemical, construction materials, furniture and metal industries), production of machinery and equipment seemed to stagnate as a whole while the various sub-branches showed large increases and decreases.

Main sectors and industrial production, % change from 12 months previous



*) agriculture, industry, construction, transportation, wholesale & retail trade

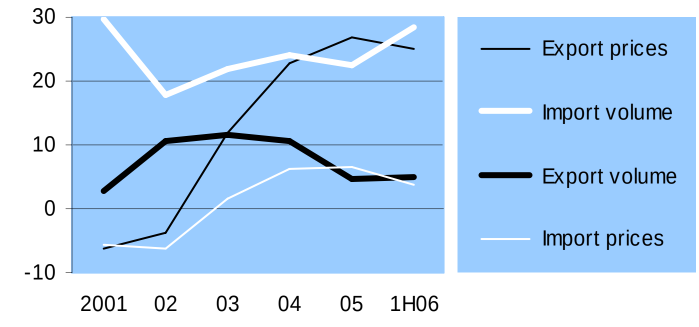
Source: Rosstat

Export revenues and import volumes surge ahead

Central Bank of Russia data indicate Russia's export revenues from goods rose almost 30 % y-o-y in 2Q06 (35 % in 1Q06). As in recent years, export prices were the key revenue driver (see chart) as the price of crude oil was up 35 % y-o-y, and natural gas destined for export rose almost 50 % (in part due to the ending of low friendship pricing for certain CIS countries, especially Ukraine). Global demand, especially from China, also pushed up prices for certain major export metals. Russian customs estimates the total export volume increased 5 % y-o-y in 1H06, even if exports of both crude oil and gas dropped slightly (gas exports to non-CIS countries were up over 5 %). The export volume was propped by growing deliveries of oil products (up well over 10 %) as well as individual metals, chemicals and wood.

Imports of goods surged almost 30 % y-o-y both in dollar and euro terms in 2Q06 (24 % in dollars and 34 % in euro in 1Q06). The increase was even faster for non-CIS imports. Russian customs computes the import volume increased well over 25 % y-o-y in 1H06. Imports of machinery and equipment, not counting passenger cars, were up almost 50 % in value and stood at 37 % of total customs-recorded imports. Passenger car imports also rose 50 % in value and accounted for a 9 % share. Imports of chemicals and individual food and other consumer items also increased rapidly. High growth rates for certain imported consumer items may partly reflect improvements in customs recording regarding coverage and pricing of goods. Indeed, total imports according to customs data rose 33 % y-o-y against 26 % in the CBR's corrected data. The gap between the two data sets narrowed from last year to clearly less than 20 %.

Volume and prices (in dollars) of Russia's exports and imports of goods, % change



Source: Russian customs

Macroeconomic indicators

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	as of
GDP, %	1.4	-5.3	6.4	10.0	5.1	4.7	7.3	7.2	6.4	5.5	Q1/06
Industrial production, % [1]	2.0	-5.2	11.0	11.9	2.9	3.1	8.9	7.3	4.0	4.2	1-7/06
Fixed investments, %	-5.0	-12.0	5.3	17.4	10.0	2.8	12.5	11.7	10.7	10.8	1-7/06
Unemployment, % (end of period)	9.0	13.2	12.4	9.9	8.7	9.0	8.7	7.6	7.7	7.3	7/06
Exports of goods, US$ billion	86.9	74.4	75.6	105.0	101.9	107.3	135.9	183.5	245.3	144.1	1-6/06
Imports of goods, US$ billion	72.0	58.0	39.5	44.9	53.8	61.0	76.1	96.3	125.1	69.5	1-6/06
Current account, US$ billion	-0.1	0.2	24.6	46.8	33.9	29.1	35.4	58.6	84.2	56.8[e]	H1/06

[1] *New methodology from Jan. 1, 2005; figures for 2001–2004 revised and not comparable with previous years.*
Sources: Rosstat, CBR.

Russia pays off its Soviet-era debt to Paris Club

In June, Russia and the Paris Club of sovereign creditors struck an agreement on debt repayment to 17 countries. The agreement relates to the Soviet Union debt that Russia agreed to take care of after the break-up of the USSR. Under the deal, Russia paid the Club about $22bn in August. After a $15bn instalment a year ago, the final repayment – the largest ever early repayment to the Club – came as no surprise. The deal involves a one billion dollar compensation for advance repayment, of which Germany received the lion's share ($700m). After the August repayment, Russia still owes $3-4bn in restructured Soviet-era debt to Paris Club countries. This will be paid in products and services. For example, Finland will receive about $25m in scientific and technical equipment.

The road to this point has not been easy. After the collapse of the Soviet Union, Russia's negotiations with the Club were delayed due to disagreements especially with Ukraine on how to divide up Soviet debt and property. After Russia and the Paris Club reached a deal in early 1993, there were two major restructurings of the debt in the course of the 1990s as Russia failed to keep to its agreed payment schedules. Russia also unofficially began to seek partial debt forgiveness. At the start of 2001, Russia asked yet again for another debt rescheduling and said it would probably only be able to cover interest costs. Years of rising oil prices and tighter oil taxation have now reversed the situation. The stabilisation fund, from which the prepayment is financed, is bulging with oil revenues.

Early repayment has many advantages for Russia. First, the Ministry of Finance (MinFin) estimates Russia will save up to $12bn in interest costs. The resulting savings will be put into the newly created investment fund to be used mainly for important infrastructure projects. Second, debt repayment does not fuel inflation. In addition, Russia hopes to improve its credit rating and get access to cheaper loans. A month before the prepayment, Fitch already upgraded Russia's long-term foreign currency rating to BBB+, which is three notches above the level some three years ago. S&P and Moody's are expected to follow.

2007 budget ready for Duma

After the government completed its 2007 federal budget discussion in August, the budget was sent to Duma. Both revenues and expenditures were revised upwards compared to figures approved in the mid-summer meeting. The latest figures are based on slightly higher estimates of GDP and the Urals-grade crude oil ($61 per barrel). The revenues are now planned to amount to 22.3 % of GDP, up 13 % from the 2006 projected revenues in nominal terms. Spending is slated at 17.5 % of GDP, which is nominally 24 % more than anticipated for this year. Non-interest spending will rise by more than a quarter nominally or about 17 % in real terms. The spending increases partly reflect the upcoming Duma election at the end of next year and the presidential election in March 2008.

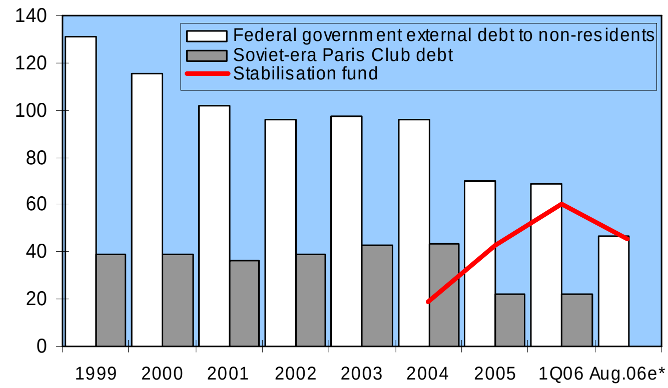
Part of stabilisation fund converted to foreign currencies

In late July, some stabilisation fund assets were converted to foreign currencies for the first time since the creation of the fund at the start of 2004. Of the RUB400bn (approximately $15bn or less than fifth of the fund resources at the time of conversion) 45 % were converted to dollars and another 45 % to euros, while the remaining 10 % was exchanged for British pounds. These conversions will continue in the future. Fund resources can also be invested in government bonds of 14 countries with the highest possible credit ratings of Fitch, S&P and Moody's.

While MinFin is in charge of administering the stabilisation fund resources, the actual funds are held by the CBR, which invests them according to instructions from the ministry. The August conversion was a straightforward internal CBR operation: part of stabilisation fund resources were transferred from rouble accounts to various foreign currency accounts. Thus, the conversion should cause no changes in Russia's balance of payments.

Although the resources were only converted to foreign currencies, Minfin reports a deduction of RUB400bn from the stabilisation fund, which seems odd. However, according to preliminary information, MinFin will later begin to publish separate figures on fund resources in foreign currencies.

Russian government external debt and stabilisation fund,
end of period, USD billion



* The stabilisation fund figure reported by MinFin since the end of July 2006 does not include the RUB400bn converted to foreign currencies in July 2006; e=BOFIT estimate.

Sources: CBR, Ministry of Finance, BOFIT

Fiscal indicators for federal government (% of GDP, unless otherwise indicated; end-period figures for debt and stabilisation fund)

	1998	1999	2000	2001	2002	2003	2004	2005	2006,	as of	2006 budget
Revenues [1]	11.4	12.6	15.4	17.8	20.3	19.5	20.1	23.7	23.9	1-7/06	20.7
Expenditures [1]	17.4	16.8	14.6	14.8	19.0	17.8	15.8	16.2	15.2	1-7/06	17.5
Balance	-6.0	-4.2	0.8	3.0	1.4	1.7	4.4	7.4	8.7	1-7/06	3.2
External debt[2]		66.8	44.5	33.3	27.7	22.5	16.3	9.2	8.5	3/06	
External debt [2], $bn		130.8	115.5	102	95.7	96.9	95.7	70.1	68.5	3/06	
Stabilisation fund, $bn							18.9	43.0	67.4	7/06	

[1] *Since 2002 part of the unified social tax is included in the federal budget.*
[2] *i.e. debt to non-residents*
Sources: Budget: IMF 1998–2000, Rosstat 2001–2005, Minfin 2006. Debt: Central Bank. Stab.fund: Minfin.

Foreign direct investments in fuels rise

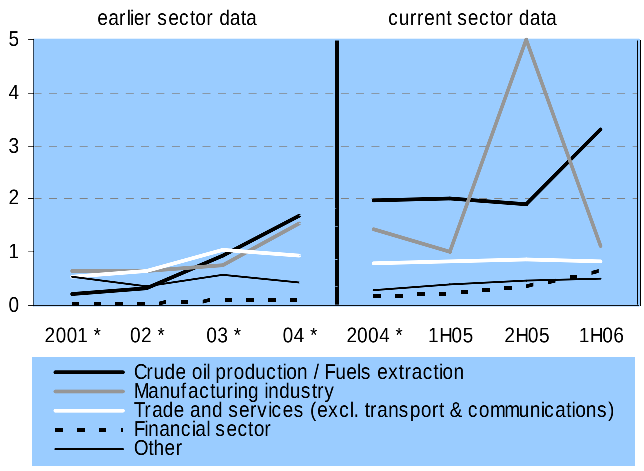
Foreign direct investments into Russia, as reported by Rosstat, increased over 40 % y-o-y in 1H06. However, FDI inflows may be subject to large variations and in fact the 1H06 FDI inflow was at last year's average level. In 2005 and 2006, FDI inflows equalled about 1.5 % of GDP. Even taking into account that the FDI inflows reported by the CBR have been clearly larger, FDI overall is still quite low for having a notable impact on economic development.

Moreover, while FDI could be useful in Russia's declared quest for export diversity, FDI continues to be concentrated quite heavily on crude oil production. This likely applies to the surge of FDI in 1H06 as well, even if the FDI sector statistics currently lump extraction of all fuels together (see chart).

Apart from the peak in late 2005, FDI into the manufacturing sector has been relatively modest. This reflects shortcomings in Russia's investment conditions compared to current FDI opportunities elsewhere, not least in China. An amount almost equalling the FDI into Russian manufacturing has flowed to the trade and trade-related services sector to take advantage of the ongoing consumption boom.

A large share of FDI is constantly of Russian origin, channelled via offshore gateways, especially Cyprus, which as of mid-2006 accounted for almost a third of the stock of FDI in Russia. A recent example is the transfer of ownership in one of Russia's largest private banks to a foreign company owned by Russian investors, which partly explains the rise of the FDI in the financial sector in 1H06.

Foreign direct investments into Russia by sector, USD billion



**) For comparability, figures for each full year have been divided by two.*
Source: Rosstat

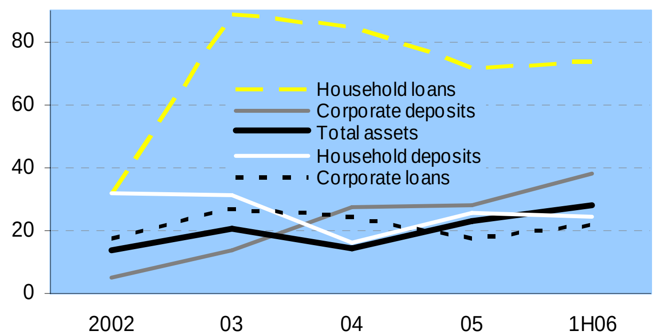
Rapid expansion in banking continues

The banking sector in Russia is evolving rapidly and is supported by surging earnings from oil and gas exports. Total assets on the aggregate balance sheet of domestic and foreign-owned banks in Russia thus rose 40 % from mid-2005 to mid-2006 in nominal terms and nearly 30 % in real terms.

Household deposits, a crucial source of bank funding (28 % of their total liabilities in mid-2006), continued to grow at the fast 2005 pace (see chart). The gradual build-up of confidence in banks appears to continue, and cash keeps getting changed into bank deposits even if interest rates on household bank deposits remain considerably negative in real terms. There is a lack of alternatives for households to invest their money reasonably risk-free. Corporate deposits (also 27-28 % of the liabilities) rose rapidly, reflecting abundant liquidity in the corporate sector and also in their case a possible gradual shift from cash to bank accounts. While rouble cash in the economy increased slower (24 % in real terms) than total bank deposits, there is still quite a lot of cash around. In mid-2006, rouble cash in circulation equalled 37 % of the sum of all bank deposits, and foreign cash at least 15 % (as suggested by the CBR estimate for end-2005). Funds of non-resident banks (8 % of liabilities) and firms in the banks were up sharply.

Banks in Russia went on expanding their lending rapidly as growth of loans to domestic non-financial companies (over 40 % of the total assets) revived slightly from 2005 (see chart). Loans to households (13 % of the assets) continued to soar. Banks increased their exposure to domestic firms also by sharply increasing their investments in domestic corporate bonds as well as equity (together representing about 5 % of assets) while additional exposures to corporate papers were wrapped in sell-back contracts. Reflecting both the plentiful liquidity and limited bank coverage of the interbank market in liquidity provision, cash kept in bank vaults and at the central bank remained high – over 8 % of total assets as of end-June 2006.

Banks' total assets and main balance sheet items, end of period, % change in real terms from 12 months previous



Source: CBR

Monetary indicators

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006,	as of
Inflation (CPI), 12-month, % (end of period)	11.0	84.4	36.5	20.2	18.6	15.1	12.0	11.7	10.9	9.3	7/06
M2, 12-month growth, % (end of period)	29.0	21.3	57.5	61.5	39.7	32.4	50.5	35.8	38.6	45.0	7/06
Average wage, $ (period average)	164	108	62	79	111	142	180	237	301	416.8	7/06
Deposit interest rate, % (period average)	16.8	17.1	13.7	6.5	4.9	5.0	4.5	3.8	4.0	4.0	6/06
Lending interest rate, % (period average)	32.0	41.8	39.7	24.4	17.9	15.7	13.0	11.4	10.7	10.5	6/06
Forex reserves, $ bn (incl. gold)	17.8	12.2	12.5	27.9	36.6	47.8	76.9	124.5	168.4	275.0	18.8.06
RUB/USD exchange rate (end of period)	5960	20.65	27.00	28.16	30.14	31.78	29.45	27.75	28.78	26.87	7/06
RUB/EUR exchange rate (end of period)			27.23	26.14	26.49	33.11	36.82	37.81	33.94	34.11	7/06

Sources: Rosstat, CBR.

Russian investment levels hardly adequate

by Vladimir Pantyushin*

Adequate investment in the Russian economy is critical if the country is to achieve sustainable economic advancement. Despite double-digit growth in the past few years, investment still lags behind the rest of the economy, and the recent variation of investment dynamics adds uncertainty to growth potential. Moreover, there are several factors that complicate the situation further.

Net investment moderate – capacity utilization up

First, the positive economic impact of healthy investment growth has been weakened by high capital replacement needs. The infrastructure, buildings and equipment – neglected throughout the early transition period – show clear signs of deterioration. Depreciation has exceeded 10 % of GDP in recent years, thus keeping net investment levels relatively low. In other words, a substantial part of gross investment goes to maintaining the existing capital stock.

Second, a major factor behind Russia's solid industrial growth since 1999 has not been new investment, but improving utilization of existing capacity, where average rates have increased from 50 % in 1999 to 67 % in 2004.

A production function approach allows separation of the dynamics of the key inputs (capital and labour). We add capacity utilization dynamics to the usual structure (see chart). This reveals that while both physical inputs of the manufacturing process – labour and total capital – have been declining in real terms, output has been improving primarily due to the better use of production facilities.

In the last two years, however, the utilization-driven growth gave way to a regular investment-based expansion. Incidentally, this has apparently been an important factor behind the slowing industrial production growth in the last two years. Because the higher utilization option has been to a large degree exhausted, future output growth depends critically on investment. Although we expect capacity utilization to further increase in the near future, most of this will come as a natural by-product of new investment, not as a result of an improvement in the existing facilities. Nevertheless, in some sectors, particularly in agriculture, the better use of existing facilities still presents a significant potential for boosting output.

Really old equipment

Third, the bulk of existing assets remains outdated. Moreover, the past decade has been marked by continuous ageing of industrial facilities, and even the recent investment expansion has been unable to reverse this trend. The quality and age of equipment in Russia thus remains a drag. Official estimates of equipment depreciation show that 45 % of industrial equipment was worn out as of end-2005 compared to 38 % a decade ago. Only recently has the situation started to improve in some sectors, but it still requires more effort from the authorities in improving the investment climate and providing additional tax incentives.

Sector variation

At the sector level, investment volumes are distributed quite unevenly. Although some variation is due to different shares of fixed assets in the production processes, there is additional dispersion because of the different paths that the sectors took during the transition period.

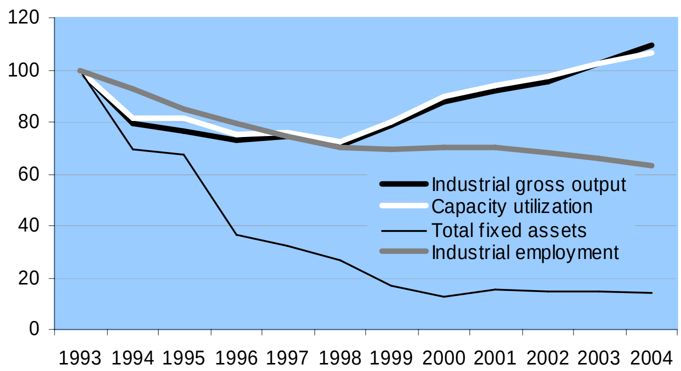
The available evidence indicates that the natural resource industries have advanced further than the rest of the economy, since oil companies have been the most active investors after telecoms in the recent years. Auto manufacturers, on the other hand, are clearly lagging behind in this area. This is one of the key reasons for their relatively poor overall performance.

Macro implications and optimal policy choice

Our calculations also show that keeping GDP growth rate at the 6 % level would require roughly 10 % real investment growth, while 7.2 % GDP growth (which would imply a doubling in the size of the economy in ten years) would require almost 13 % annual growth in investment. As a reference, in 2004-05 annual investment growth was 10.5-11 %. Therefore, recent growth rates, although still high, remain inadequate for the purpose of doubling GDP in a decade. If the investment dynamic continues to slow, this will naturally reduce growth prospects further.

The government's top priority, in our view, should be to improve the investment environment and create favourable conditions for domestic and foreign investors. We believe that encouraging FDI presents the best option for the authorities. Besides increasing the overall investment level, it will bring much-needed technology, know-how and expertise.

Industrial output and its main components, 1993=100



Sources: Rosstat, Bessonov, Renaissance Capital

** The author is the Chief Economist of Renaissance Capital, Moscow.*

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Economic Developments

Russia's robust growth should continue in 2006-2008

In connection with the Bank of Finland's bi-annual outlook for the Finnish economy, BOFIT last month released its forecast for the Russian economy in 2006-2008. We expect Russia's real GDP to increase this year by 6.4 % then decelerate slightly to 6.1 % next year and 5.6 % in 2008. We have revised Russia's growth figures slightly upwards from our predictions last February due to higher-than-expected oil prices. The average oil price assumptions for 2006-2008 are now $68, $72 and $65 dollars per barrel, respectively.

Oil remains a highly significant influence on the Russian economy, even if the growth in Russian oil production has substantially slowed. January-August oil production was up just over 2 % y-o-y. Crude oil exports in volume terms were essentially stagnant, while exports of refined oil products experienced growth exceeding 11 % (partly due to increased taxation on crude exports).

The slowing in crude exports has significantly affected the overall growth of export volumes, which is now expected to settle in around 7 % annually during the forecast period. On the other hand, rapid economic growth and a strengthening rouble should sustain strong growth in import volumes through 2008. The volume of imports is estimated to increase at about the same rate as last year, i.e. approximately 17 %. The rapidly growing import levels should pose no threat to the external balance in the next two years; the current account surplus in the first half of 2006 was nearly 13 % of GDP.

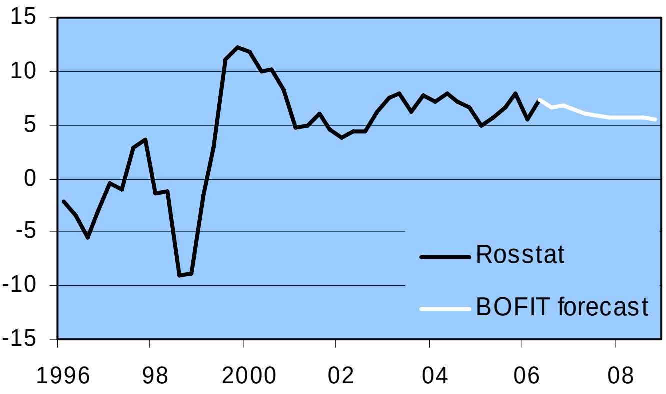
Despite the slowdown in growth for Russian oil production and export volumes, record-high oil prices still have a powerful effect on Russia's export earnings, which have boosted overall purchasing power and promoted growth in other sectors (e.g. retail trade and construction). Moreover, not all growth is due to oil price developments. Assuming no changes in international oil prices and the rouble's real exchange rate, we estimate that the annual trend growth of the Russian economy is some 4 %.

Regarding other demand factors than exports, Russia's growth is currently driven mainly by private consumption. We see no change in this respect as household real incomes are expected to keep rising by some 10 % per year in the outlook period. Despite recent negative news concerning foreign investment in the energy sector, we predict total fixed investments will continue to climb at their current rate of 11 % in the coming years. This implies the investment-to-GDP ratio will increase somewhat from the current 21 %.

The Ministry of Finance reports oil- and gas-related revenues currently account for half of all federal budget revenues. Oil revenues have allowed the government to build up significant reserves in the Stabilisation Fund ($71 billion at the beginning of October) and pay off in August its outstanding Soviet-era debts ($22 billion) to the Paris Club of sovereign creditors. We expect the central government's fiscal balance to remain in surplus in spite of the upcoming elections and a significant real increase in government spending. A strong fiscal performance would enhance the overall situation in the outlook period, while rapidly rising real spending – particularly on wages and other current items – could undermine fiscal credibility.

Thus, disciplined fiscal policy will remain crucial in dealing with the liquidity flows from oil exports and the resulting inflation pressures. Even with prudent fiscal policies, however, Russian monetary authorities still face difficulties in their efforts to simultaneously restrain inflation and maintain the rouble's nominal exchange rate. We do not expect major changes in the country's monetary policy framework as the continuing high price of oil will keep fuelling inflation throughout the forecast period, and thereby strengthen the rouble's real exchange rate further. Conceivably, a strong rouble could undermine Russia's competitiveness, but for now there are no clear indications the rouble is overvalued.

Growth of Russian GDP 1996–2008, % y-o-y



Source: Rosstat 1996–2006(Q2), BoF forecast 2006 (Q3)–2008

Macroeconomic indicators

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	as of
GDP, %	1.4	-5.3	6.4	10.0	5.1	4.7	7.3	7.2	6.4	6.5	H1/06
Industrial production, % [1]	2.0	-5.2	11.0	11.9	2.9	3.1	8.9	7.3	4.0	4.3	1-8/06
Fixed investments, %	-5.0	-12.0	5.3	17.4	10.0	2.8	12.5	11.7	10.7	11.1	1-8/06
Unemployment, % (end of period)	9.0	13.2	12.4	9.9	8.7	9.0	8.7	7.6	7.7	7.2	8/06
Exports of goods, US$ billion	86.9	74.4	75.6	105.0	101.9	107.3	135.9	183.5	245.3	198.0	1-8/06
Imports of goods, US$ billion	72.0	58.0	39.5	44.9	53.8	61.0	76.1	96.3	125.1	97.8	1-8/06
Current account, US$ billion	-0.1	0.2	24.6	46.8	33.9	29.1	35.4	58.6	84.2	79.9e	1-9/06

[1] *New methodology from Jan. 1, 2005; figures for 2001–2004 revised and not comparable with previous years.*

Sources: Rosstat, CBR.

1H06 federal budget performance again exemplary

Russia posted very strong federal budget performance in January-June. Both revenues and expenditures increased sharply in real terms, while the resulting surplus reached 9 % of GDP. The fact that revenues were down as a share of GDP is explained mainly by the large lump-sum tax arrears payments by Yukos and Sibneft in the first half of 2005. Expenditures were slightly lower as percentage of GDP, mainly a reflection of diminished interest payments.

Realised H1/06 federal budget, % of GDP

Revenues	**H1/05**	**H1/06**	**Expenditures**	**H1/05**	**H1/06**
Total	**25.8**	**24.1**	**Total**	**15.6**	**15.2**
Customs duties	7.3	8.8	Transfers to non-budgetary funds	3.4	3.6
VAT*	8.4	5.9	Defence	2.6	2.6
Natural resource payments	4.0	4.5	Transfers**	2.3	2.2
Profit tax	1.9	1.9	Social sphere***	2.1	2.0
Unified social tax (UST)	1.4	1.2	Law and order	2.0	2.0
			Interest on debt	1.1	0.7
Other	2.8	1.8	Other	2.1	2.1
Balance	**10.2**	**8.9**			

* includes VAT on production in Russia as well as on imports
** mainly transfers to regional and local budgets, not including UST
*** mainly professional education and military and law enforcement pensions, but also health, social policy, mass media, culture and the arts spending. *Sources: Rosstat, Minfin*

Last year's substantial tax arrears payments boosted especially VAT revenues. However, estimates of the Economic Expert Group found VAT revenues in 1H06 were down on year, even after deducting the influence of tax arrears payments. While this is due mainly to changes in the VAT payment schedule and other practices, it could also signal problems with VAT collection. All other major tax revenue sources grew considerably, both as shares of GDP and in real terms. The decrease in social tax revenues reflects its regressive nature; as incomes rise, UST revenues decrease as more people benefit from relatively lower tax rates.

The expenditure structure did not change substantially, with interest payments continuing to fall and accounting for a mere 4 % of federal budget expenditures in the first half. The noticeably large transfers from federal budget to non-budgetary funds have grown, especially since the beginning of 2005 when the maximum UST-rate was cut from over 36 % to 26 % and revenues from the tax halved. The impact of the change affect the finances of the Pension Fund most. Thus, transfers from the federal budget have had to be increased to meet the shortfall. The share of transfers to non-budgetary funds (mostly to Pension Fund) in 1H06 represented about a quarter of non-interest expenditures.

Gas market deregulation ahead?

Presently two-thirds of Russia's electricity production is based on thermal generation, with nearly two-thirds of that heat provided by natural gas. The state majority-owned Gazprom and its subsidiaries account for 85 % of Russian gas production. The Russian press has recently been covering Gazprom's reluctance to supply gas for the domestic electricity production. Gazprom has important export obligations for years ahead, which has led to speculation that it prefers to shirk its domestic obligations for its more profitable export business. Regulated prices of gas sold to domestic producers run around $40-55 per thousand cubic metres, while the same amount exported brings in an average of $200-250.

Electrical power energy giant RAO UES also further acknowledges that the lack of capacity and poor state of Russia's electrical grids hinders its abilities to transmit electricity even if UES had adequate gas supplies to produce it. Last winter, vulnerable areas including Moscow, St. Petersburg and Tyumen had to restrict electricity use. The situation seems destined to remain chronic without major investment in Russia's power infrastructure. Electricity shortages also have knock-on effects on other industries.

UES head Anatoly Chubais and energy minister Viktor Khristenko recently revealed parts of a preliminary plan to liberalise Russian domestic gas markets starting next year. While the overall stance of the Russian government remains unclear, the plan has been publicly opposed by the economy minister German Gref. Under the current plan, the share of gas sold at the domestic market at unregulated prices is to be gradually increased. In the first stage, the unregulated gas market would reach 100 billion m^3, about 15 % of total gas production in 2005 or a quarter of the domestic gas consumption. Deregulated gas prices would mainly affect industrial enterprises, while the general population and municipal services would be subject to a longer deregulation schedule. Next year, industrial consumers would be expected to stick to long-term contracts based on gas prices in the European market.

The increase in the price of gas would likely result in electricity rate hikes. UES has already demanded higher electricity rates, because it has been forced to use expensive coal and heating oil, instead of gas, to produce electricity.

The Russian economy should benefit from the partial deregulation of gas prices. While it raises costs for domestic producers and could increase bankruptcies in power-intense industries, higher prices would rationalise the use of gas and give more resources to both gas and electricity sector to invest in infrastructure. Naturally, there are still many hindrances to a fully liberalised gas market – notably Gazprom's monopoly on the access to gas pipelines.

Fiscal indicators for federal government (% of GDP, unless otherwise indicated; end-period figures for debt and stabilisation fund)

	1998	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006,**	**as of**	**2006 budget**
Revenues [1]	11.4	12.6	15.4	17.8	20.3	19.5	20.1	23.7	23.8	1-8/06	20.7
Expenditures [1]	17.4	16.8	14.6	14.8	19.0	17.8	15.8	16.2	15.0	1-8/06	17.5
Balance	-6.0	-4.2	0.8	3.0	1.4	1.7	4.4	7.4	8.8	1-8/06	3.2
External debt[2]		66.8	44.5	33.3	27.7	22.5	16.3	9.2	7.6	6/06	
External debt [2], $bn		130.8	115.5	102	95.7	96.9	95.7	70.1	65.9	6/06	
Stabilisation fund, $bn							18.9	43.0	70.7	9/06	

[1] *Since 2002 part of the unified social tax is included in the federal budget.*
[2] *i.e. debt to non-residents*
Sources: Budget: IMF 1998–2000, Rosstat 2001–2005, Minfin 2006. Debt: Central Bank. Stab.fund: Minfin.

Inflation stops falling?

The pace of consumer price inflation eased smoothly from mid-2005 until early this summer. During the last three months, however, inflation has hovered around an on-year rate of 9.5 % without visible declining trend any longer (see figure). The revised official target for CPI inflation at the end of the year is presently 8-9 %.

Strong increases in the money supply and wages appear to be preventing further significant inflation declines in Russia. According to a CBR estimate, the January-September current account surplus was $80 billion. As capital inflows and outflows have been more or less in balance, Russia's foreign reserves have increased accordingly, leading to acceleration in money supply growth. In recent months, broad money supply (M2) growth has reached 45 % y-o-y, compared to 30 % in spring 2005. Moreover, robust economic growth and ample liquidity keep the pressure on for higher wages. Real wages in roubles are currently increasing 14 % y-o-y; the average monthly wage in dollars now exceeds $400, compared to just $300 at the end of 2005. In addition to cost-push effect, large income gains fuel consumer spending and, consequently, demand-pull inflation. Some markets (e.g. Moscow housing) seem already to be overheated.

In addition, producer prices are climbing even faster than consumer prices, raising concerns regarding the persistence of high-inflation era in Russia.

Rouble's real exchange rate keeps strengthening

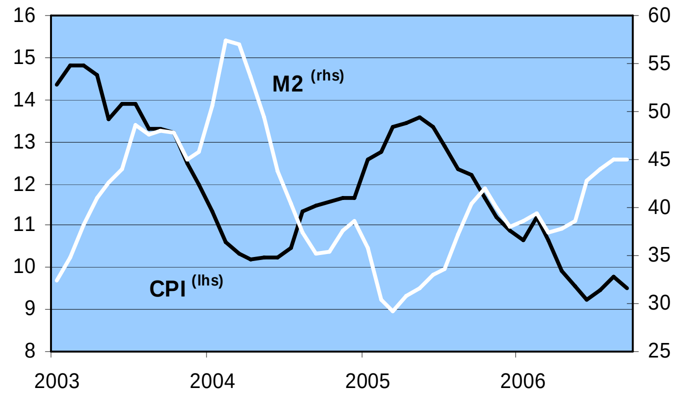
While the statements of Russian policymakers have been contradictory with regards to inflation and exchange rate policy, the CBR consistently pursues its policy of keeping the nominal exchange rate relatively stable (see figure). Measured by the CBR's nominal effective (trade-weighted) exchange rate index, the rouble keeps appreciating at 3.5 % y-o-y with practically no monthly variation during the year. In nominal terms, the rouble has appreciated 2.8 % against the US dollar and 4.6 % against the euro over the past twelve months.

The major dilemma of Russia's monetary policy, however, relates to the real exchange rate, a key measure of price competitiveness. Relatively brisk inflation, combined with a modestly appreciating nominal exchange rate, have caused the rouble to appreciate 9.9 % y-o-y in real effective terms over the last twelve months. The corresponding real exchange rate figures for the US dollar and the euro are 9.0 % and 12.9 %, respectively.

Oil prices drive Russian stock market

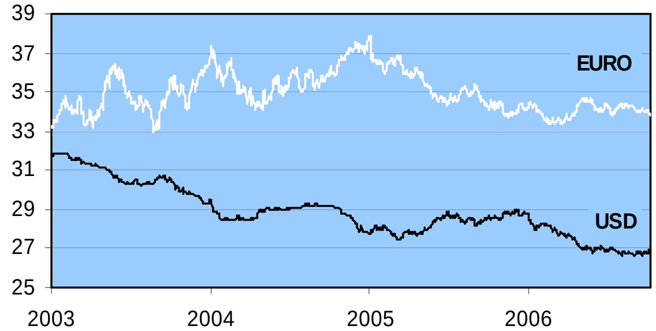
Following the collapse of global equity markets in May, the Russian stock market rebounded during the summer months (see figure). In September, a significant decline in oil prices hit energy company shares. Given the heavy weighting of the energy sector on the Moscow stock exchange, the drop was sufficient to pull down Russian equity markets overall. At the beginning of October, the situation again reversed. For the year, Russian equity prices have gained 40 %. Emerging market equity prices are up about 10 % on average.

Inflation and money (M2) growth 2003-2006, % y-o-y



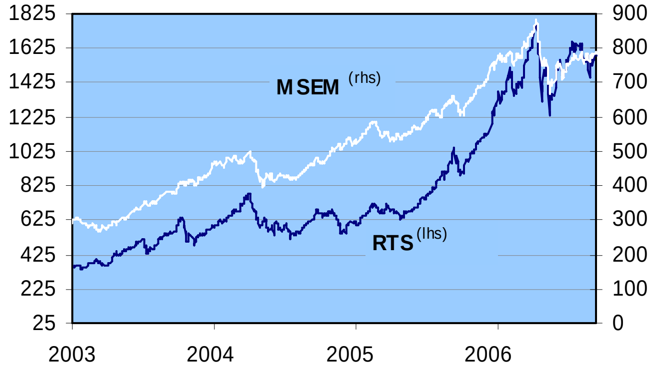
Source: Rosstat, CBR

Nominal exchange rate of rouble vs. US dollar and euro, 2003-2006



Source: CBR

Russian (RTS) and emerging market (MSEM) stock exchange indices



**Morgan Stanley emerging market index (USD)*
Source: RTS, Bloomberg, BOFIT

Monetary indicators

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006,	as of
Inflation (CPI), 12-month, % (end of period)	11.0	84.4	36.5	20.2	18.6	15.1	12.0	11.7	10.9	9.5	9/06
M2, 12-month growth, % (end of period)	29.0	21.3	57.5	61.5	39.7	32.4	50.5	35.8	38.6	45.0	8/06
Average wage, $ (period average)	164	108	62	79	111	142	180	237	301	407.3	8/06
Deposit interest rate, % (period average)	16.8	17.1	13.7	6.5	4.9	5.0	4.5	3.8	4.0	3.9	7/06
Lending interest rate, % (period average)	32.0	41.8	39.7	24.4	17.9	15.7	13.0	11.4	10.7	10.1	7/06
Forex reserves, $ bn (incl. gold)	17.8	12.2	12.5	27.9	36.6	47.8	76.9	124.5	168.4	266.2	9/06
RUB/USD exchange rate (end of period)	5960	20.65	27.00	28.16	30.14	31.78	29.45	27.75	28.78	26.78	9/06
RUB/EUR exchange rate (end of period)			27.23	26.14	26.49	33.11	36.82	37.81	33.94	33.98	9/06

Sources: Rosstat, CBR.

Diagnosing Dutch Disease: Does Russia have the symptoms?

by Nienke Oomes and Katerina Kalcheva*

Russia is a major producer of natural resources. It is estimated to hold the world's largest natural gas reserves, second-largest coal reserves and seventh-largest oil reserves. Crude oil, oil products and gas together account for almost 60 % of Russia's total export revenues and an estimated 20–25 % of Russian GDP. In recent years, record high oil prices have generated significant windfall revenues, but they have also set the real exchange rate on an appreciation path that threatens the competitiveness of Russia's manufacturing sector. This has led many observers to suggest Russia could be coming down with "Dutch Disease."

The three symptoms of Dutch Disease

Briefly summarized, the Dutch Disease hypothesis, posited by Corden (1982) and Corden and Neary (1984), states that an increase in resource prices or resource output results in real exchange rate appreciation and a decline of the manufacturing sector, which, in turn, may induce lower long-run growth. Assuming that the supply of commodities is not entirely inelastic, an increase in the resource price raises the demand for labour and capital in the resource sector, implying higher wages and a higher return to capital. If factors are mobile, this will induce labour and capital to move to the resource sector. In Russia, however, this "resource movement effect" seems unlikely to play a very significant role, given that the oil sector employs relatively few workers and labour mobility is generally low. More important for Russia is the "spending effect" that results from rising oil prices that generate higher wages and profits in the oil sector. This raises aggregate demand in the economy, which, in turn, raises the prices of nontradables relative to that of tradables. The result is real appreciation of the currency.

Using detailed sectoral and time series analyses, we study whether Russia has exhibited the three main symptoms of Dutch Disease: (1) real exchange rate appreciation, (2) a slowdown in manufacturing growth and (3) acceleration in services-sector growth (assuming the spending effect dominates the resource movement effect).

As for the first symptom, it is clear that the rouble's real effective exchange rate has appreciated substantially in recent years. This cannot necessarily be regarded, however, as evidence of Dutch disease. To avoid a spurious diagnosis, we must ask whether the effect of oil prices on the real effective exchange rate is significantly positive after controlling for other real exchange rate determinants, including government consumption, net international reserves, and the productivity differential. Based on data through the end of 2005, we estimate the statistical long-run relationship between the real exchange rate and its determinants, after which we interpret the error-correction term as a deviation from the long run equilibrium, i.e. as the extent of exchange rate misalignment. Subject to the usual caveats regarding the difficulty of estimating a long-run relationship for a sample period of less than ten years for an economy in transition, we find that higher oil prices and government consumption significantly contributed to real appreciation. We also find that pressure on the real exchange rate has been eased by accumulation of foreign exchange reserves and, consistent with the Balassa-Samuelson hypothesis, that appreciation has been proportional to productivity differential growth. We do not, however, find evidence that the real exchange rate has been overvalued in recent years.

Regarding the second and third symptoms, we find evidence that output and employment have increased less rapidly in Russia's manufacturing sector than in its services sector. In particular, our sectoral data show that the manufacturing sector has grown more slowly than other sectors since 2001, while manufacturing employment growth has fallen. We also find evidence that the share of the services sector has increased, suggesting that the spending effect has indeed been more important in Russia than the resource movement effect. Even so, it is difficult to conclude that the observed patterns are actually the result of resource movement or spending effects. There can be other reasons why the manufacturing sector has shrunk and why the services sector has expanded. In particular, an increase in the relative size of the services sector may be a natural "transition" phenomenon, given that, during socialism, the manufacturing sector received significant state support, while the services sector remained undeveloped.

Russia may not be Dutch Diseased yet, but risks remain

While Russia appears to display all the symptoms, we conclude that it may not have contracted Dutch Disease yet. That is, we find evidence of a declining manufacturing sector and an expanding services sector, but no evidence that this is the result of an overvalued real exchange rate. What likely have helped to prevent the disease thus far are Russia's prudent policies of saving its oil windfall revenues in the Stabilisation Fund and rapidly repaying foreign debt. Given that oil prices are projected to remain high, however, the risk of Dutch Disease remains and warrants close monitoring.

** Nienke Oomes is an economist at the International Monetary Fund, and currently the IMF Resident Representative in Armenia. Katerina Kalcheva is an economist at Morgan Stanley International. The article is based on a forthcoming BOFIT Discussion Paper. The views expressed here are those of the authors and do not necessarily represent those of the IMF, IMF policy or Morgan Stanley.*

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Economic Developments

No big changes in sector-level output dynamics

The latest figures on output in the most important sectors of the Russian economy indicate no significant changes in the output dynamics this year compared to last year (see table). Rosstat's composite indicator for the five core sectors of the Russian economy (agriculture, industry, construction, transportation, trade), which is sometimes used as a leading indicator for GDP, points to approximately 6 % output growth in January-September.

Strongest growth was again recorded in services, which includes retail trade. Robust domestic demand has also supported growth in the construction sector, while industrial growth continues to be clearly slower. The performance of agriculture remains poor and may evidence severe problems in implementing agricultural reforms.

While the big picture concerning output developments remains unchanged, the detailed data on industrial output reveal several interesting insights. First, growth of the mining industry has continuously – though slowly – recovered from last year's slump as oil output in January-September increased 2 % and gas output 3 %. Second, the slowdown of output growth in manufacturing reflects the corrosive effects of falling output in machine building and stagnation of output growth in the chemical industry and electrical machinery and equipment production. These sectors together account for almost a fifth of Russia's total manufacturing output. The poor performance of domestic machine building industries is reflected also in Russia's foreign trade (see next item).

Output growth in the core sectors of Russia's economy, % y-o-y

	2002	2003	2004	2005	2006*
Industry	3.1	8.9	7.3	4.0	4.2
Mining	6.8	8.7	6.5	1.0	2.4
Manufacturing	1.1	10.3	9.2	6.1	4.4
Agriculture	1.5	1.3	3.1	1.2	-0.1
Transportation	5.9	7.7	6.4	2.5	2.5
Construction	3.9	12.8	10.1	8.3	11.4
Retail trade	9.3	8.8	12.5	11.7	12.3

* January- September

Source: Rosstat

Trade surplus widens despite pick-up in imports

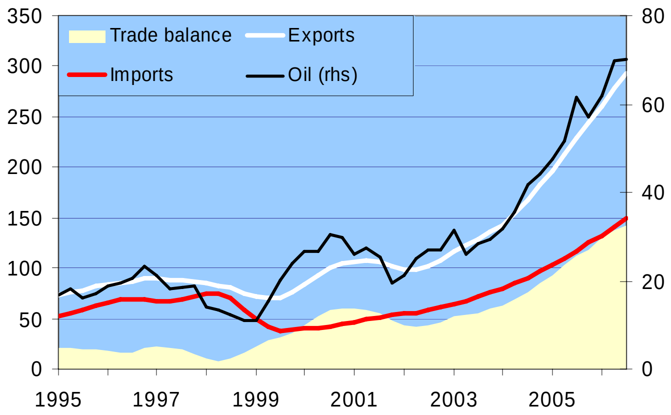
The Federal Customs Service reports that the value of Russian goods exports in January-September was $222 billion, a 28 % increase from a year ago. In the same period, import growth matched exports, reaching $93 billion. Given the huge disparity between export and import levels, the trade surplus continued to increase even if import growth (32 % y-o-y) outstripped export growth (23 %) in the third quarter. The trade surplus equalled about 17 % of GDP.

As the figure below shows, Russian export revenues are heavily influenced by oil price trends. With prevailing high energy prices, we see energy accounts for 67 % of Russia's total exports. Metals and metal products, another important export sector, have a 13 % share. Chemical products and machinery each account for about 5 %, while the forest sector only accounts for 3 % of Russia's total exports.

Machinery and equipment accounted for 46 % of total imports in January-September. Car imports represented a fifth of total machinery imports. Chemical products and foodstuffs had 17 % and 15 % import shares, respectively.

The European Union, by far Russia's most important trading partner, accounted for 53 % of Russia's total trade turnover. The role of the CIS countries continues to decline; currently these countries represent only about 15 % of Russia's foreign trade. Russian trade with China (6 % of total trade) is double the size of Russian trade with the US.

Russia's foreign trade, 12-month sum, US$ billion



Source: Federal Customs Service

Macroeconomic indicators

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	as of
GDP, %	1.4	-5.3	6.4	10.0	5.1	4.7	7.3	7.2	6.4	6.6e	1-9/06
Industrial production, % [1]	2.0	-5.2	11.0	11.9	2.9	3.1	8.9	7.3	4.0	4.2	1-9/06
Fixed investments, %	-5.0	-12.0	5.3	17.4	10.0	2.8	12.5	11.7	10.7	11.7	1-9/06
Unemployment, % (end of period)	9.0	13.2	12.4	9.9	8.7	9.0	8.7	7.6	7.7	7.1	9/06
Exports of goods, US$ billion	86.9	74.4	75.6	105.0	101.9	107.3	135.9	183.5	245.3	223.9	1-9/06
Imports of goods, US$ billion	72.0	58.0	39.5	44.9	53.8	61.0	76.1	96.3	125.1	112.4	1-9/06
Current account, US$ billion	-0.1	0.2	24.6	46.8	33.9	29.1	35.4	58.6	84.2	79.9e	1-9/06

[1] *New methodology from Jan. 1, 2005; figures for 2001–2004 revised and not comparable with previous years.*

Sources: Rosstat, CBR.

Finance ministry wants to reorganise stabilisation fund and budget formation

There has been a lot of discussion lately on how the government's financial assets from natural resources (mainly oil and gas) should be handled. The finance ministry's contribution to this discussion is a proposal for new budget policy principles.

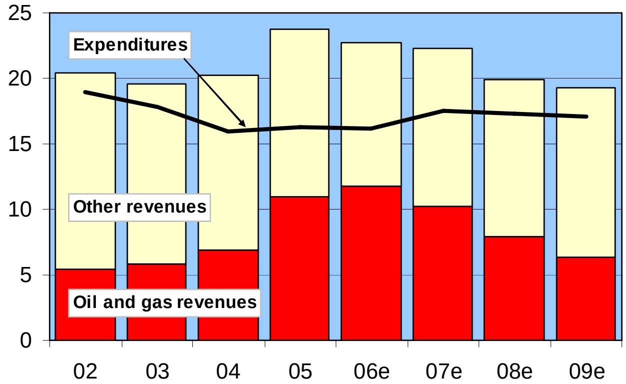
The proposal recognises risks related to an economy dependent on raw material production. Russia's oil and gas sectors account for about half of federal budget revenues and over 60 % of export revenues. High oil and gas prices carry the risk of encouraging generous spending that is hard to cut when prices retreat. Fluctuating world market prices also have impact on the rouble's exchange rate, interest rates and inflation – all of which affect investment levels and economic growth.

Presently oil and gas revenues are split up, with a part going to the budget and part set aside in the national stabilisation fund. Natural resource use fees on oil and oil export tariffs exceeding a $27-per-barrel limit go to stabilisation fund. Federal budget surpluses may also be saved in the fund. According to the proposal, also revenues from profit taxes, excise taxes and certain minor revenue sources deriving from oil as well as oil products and gas would go to the stabilisation fund. The fund would be divided into two parts. One part would resemble the current fund, continuing to provide macroeconomic smoothing in the face of volatile world energy prices. The other part would be dedicated to expenditures of future generations. The proposal does not include a suggestion on how stabilisation fund assets would be divided between the two parts.

Federal budget revenues are proposed to be divided into two categories: "oil and gas" and "other" revenues. Specified shares of oil and gas revenues would be transferred to both parts of the stabilisation fund, with the remainder used for covering the deficit of the "other" budget. By gradually diminishing the share of oil and gas revenues going to the budget, its dependency on oil and gas revenues is to be diminished. In 2006, oil and gas revenues worth some 5.5 % of GDP would be transferred to budget. The transfers should on the basis of ministry's calculations gradually decline to 3 % of GDP by 2015. During the early years of the new budget policy, also additional government borrowing to finance the essential expenditures may be needed. In the more distant future, only yields accrued from invested stabilisation fund assets would be used to finance budget expenditures.

The dependency of the budget on energy revenues should diminish also if the oil-price projections made in the three-year financial plan are fulfilled. Under the plan, total federal budget revenues are set to gradually decrease in relation to GDP as the average price of oil is expected to go down (from a forecast $65 per barrel in 2006 to $48 per barrel in 2009). The share of oil and gas revenues in total revenues would therefore also decrease. Already next year other revenues should exceed those deriving from oil and gas. By 2009, oil and gas revenues are estimated to account about half of other revenues (see chart).

Selected federal budget indicators (2002-2009), % of GDP



Source: Finance ministry

Diversifying investment of stabilisation fund assets

The finance ministry began converting stabilization fund resources into foreign currencies in July. The assets are now in dollars, euros and sterling pounds. However, the finance ministry is examining possibilities to widen both the list of currencies as well as the instruments used. In order to balance risks, the ministry has considered widening the list of currencies available for conversion to include the Japanese yen and the Swiss franc. Presently, stabilization fund assets can be invested in the government bonds of 14 countries with highest possible credit ratings. Minfin is also considering to invest a part of assets into corporate bonds or company shares. However, such investment would require legislative changes.

2006 budget amended

At the start of November, the Russian government approved amendments to the 2006 budget. The changes will soon be brought before the Duma and are likely to pass. The amendments include increasing budget revenues by 22 % (corresponding to 22.7 % of GDP) and budget expenditures by 4 % (16.3 % of GDP) compared to the original budget act. The surplus would rise by a quarter to 6.4 % of GDP. The higher revenues are mainly due to higher-than-estimated oil prices and accrue largely from export duties and natural resource fees. The bulk of the expenditure increase is proposed to be spent on transfers to regions, defence and improvements in the national infrastructure (e.g. transport and production).

Fiscal indicators for federal government (% of GDP, unless otherwise indicated; end-period figures for debt and stabilisation fund)

	1998	1999	2000	2001	2002	2003	2004	2005	2006,	as of	2006 budget
Revenues [1]	11.4	12.6	15.4	17.8	20.3	19.5	20.1	23.7	23.2	1-10/06	20.7
Expenditures [1]	17.4	16.8	14.6	14.8	19.0	17.8	15.8	16.2	14.6	1-10/06	17.5
Balance	-6.0	-4.2	0.8	3.0	1.4	1.7	4.4	7.4	8.6	1-10/06	3.2
External debt[2]		66.8	44.5	33.3	27.7	22.5	16.3	9.2	7.6	6/06	
External debt [2], $bn		130.8	115.5	102	95.7	96.9	95.7	70.1	65.9	6/06	
Stabilisation fund, $bn							18.9	43.0	76.5	10/06	

[1] *Since 2002 part of the unified social tax is included in the federal budget.*
[2] *i.e. debt to non-residents*
Sources: Budget: IMF 1998–2000, Rosstat 2001–2005, Minfin 2006. Debt: Central Bank. Stab.fund: Minfin.

Middle class make strong earning gains

The emergence of a middle class in Russia has important political and economic ramifications. Unfortunately, defining and measuring “middle class” are non-trivial tasks. Estimates of the size of Russia’s middle class vary from less than 15 % to nearly 40 % of the population.

Sociologists typically consider several aspects (income, wealth, education, occupation and self-identification) when attempting to define and estimate the share of the middle class in a population. Such studies find that the share of the middle class in Russia has been rather stable – about 20 % or nearly 30 million people – throughout this decade. However, given the robust growth of real wages and other incomes in the last six years, the current middle class popular is far better off in economic terms than their middle class counterparts at the beginning of the decade.

In market research, the approach is usually narrower as purchasing power factors are given priority in defining middle class. Market research reports may give quite diverse estimates on the share of middle class, but they are consistent in their identification of growth in this share in past years.

According to the Levada Center’s monthly survey from October 2006, only 13% of Russians can afford to purchase consumer durables. In the survey, Russians define the monthly income level needed for a Russian to lead a “normal” life as $400-450 in 2005. Rosstat reports that 18% of Russians had an income of at least $450 in 2005. The average monthly wage in Russia at the end of last year was $300.

The change in the structure of Russian consumer expenditures is another indication of the gradual emergence of a middle class. During 2000-2005, the share of foodstuffs in total expenditures decreased considerably, from 48% to 33%. Although the change was partly explained by higher inflation in prices of services, there was also a clear increase in the share of income going to consumer durables such as vehicles, furniture, household apparel and electronics. For example, personal computers per 100 households rose from 6 in the beginning of the decade to 20 in 2004, home musical centres increased from 12 to 28 and the share of households with passenger cars was up from 27 to 33 %. Consequently, also consumer lending has increased considerably from a low starting level. During the past three years bank lending to households has annually increased over 80 % in real terms. Even so, households’ debt ratio of 10 % of yearly cash incomes is still low by international standards.

CBR publishes monetary policy guidelines for 2007

The Central Bank of Russia stated that the main principles of monetary policy applied in previous years will remain in place in 2007. The CBR’s 2007 consumer price inflation target range will be 6.5–8 %, a half-percentage-point shift from this year’s target of 7–8.5 %. The CBR only cautiously touched the issue of real effective appreciation of the rouble, forecasting strengthening in the range of 0–10 % depending on economic developments and its success in holding down inflation. Four scenarios of economic development, each using different assumptions for the price of Urals crude oil ($45–85 per barrel), were considered in developing the monetary policy strategy. The four scenarios see 2007 GDP growth coming in at somewhere between 5–6.6 %, growth in fixed investment in the range of 9–12 % and growth in real disposable incomes on the order of 9–11 %.

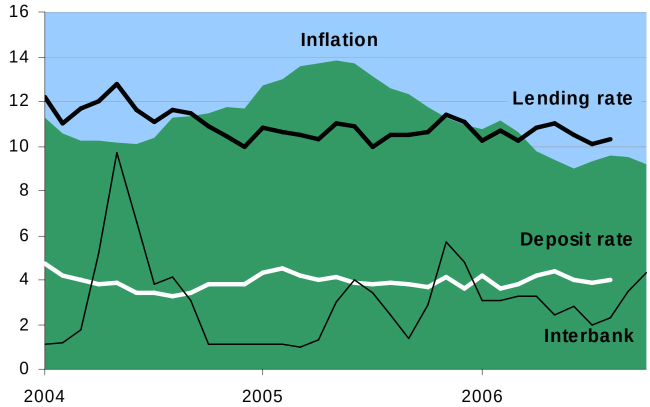
Money market interest rates on the rise

At the end of October, the interest rate for one-day loans in the interbank market jumped to 9.8 %, a record high for this year. While Russia's money market rates are typically higher at the end of month, there presently seems to have been a shift in the level of money market rates; the interest rate for one-day interbank loans in the first half of November averaged 6.3 % compared to 2.8 % for January-October. High interest rates reflect a harsher liquidity situation due to exceptionally high tax payments for earlier oil exports.

While recent money market developments emphasise difficulties of monetary policy implementation, they also point to existing problems in the banking sector. Several lower rank banks were reported to have been forced to pay unusually high interest rates due to their lack of liquidity. The true stress test for the banking sector viability, however, would be a major drop in oil prices or a significant decline in inflation that would bring about positive real interest rates.

In October, the CBR lowered its refinancing rate for commercial banks by a half percentage point to 11 %. The central bank’s refinancing rate plays only a minor role in monetary steering as banks do not take refinancing loans from the central bank. It is mainly used in setting penalty interest rates for belated payments.

Russia's inflation and interest rates, % p.a. (monthly data)



Sources: CBR, BOFIT

Monetary indicators

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006,	as of
Inflation (CPI), 12-month, % (end of period)	11.0	84.4	36.5	20.2	18.6	15.1	12.0	11.7	10.9	9.2	10/06
M2, 12-month growth, % (end of period)	29.0	21.3	57.5	61.5	39.7	32.4	50.5	35.8	38.6	46.6	9/06
Average wage, $ (period average)	164	108	62	79	111	142	180	237	301	413.9	9/06
Deposit interest rate, % (period average)	16.8	17.1	13.7	6.5	4.9	5.0	4.5	3.8	4.0	4.0	8/06
Lending interest rate, % (period average)	32.0	41.8	39.7	24.4	17.9	15.7	13.0	11.4	10.7	10.3	8/06
Forex reserves, $ bn (incl. gold)	17.8	12.2	12.5	27.9	36.6	47.8	76.9	124.5	168.4	272.5	10/06
RUB/USD exchange rate (end of period)	5960	20.65	27.00	28.16	30.14	31.78	29.45	27.75	28.78	26.75	10/06
RUB/EUR exchange rate (end of period)			27.23	26.14	26.49	33.11	36.82	37.81	33.94	34.03	10/06

Sources: Rosstat, CBR.

Russia's automotive industry: looking under the hood

by Dmitriy Plekhanov *

This year marks the seventh consecutive year of growth in the Russian automotive market, with some 2 million cars expected to be sold. By ICSS estimates, passenger car sales will reach $33 billion this year – a more than five-fold increase over the 2000 level (see figure). The major factors underlying the recent market dynamics are rapid income growth, increased availability of consumer credit, low per capita ownership rates and an ageing car fleet. As these factors will persist in Russia for years to come, the potential for further market growth will remain. Unlike the booming domestic market, Russia's car exports remains relatively staid at around 130,000 vehicles annually.

A prominent feature of market expansion in Russia is that it has been driven primarily by import growth; domestic model production volumes have decreased steadily from 1,022,000 units in 2000 to 911,000 in 2005. Despite a 30% average annual growth rate in imports, domestic carmaker AutoVAZ has retained its dominance in the market with annual production of more than 700,000 units. However, as rising domestic costs and rouble appreciation erode the price competitiveness of domestic models, Russian carmakers must focus on quality enhancement by looking to possible alliances with foreign manufacturers or other ways to access innovative technologies. For example, the GAZ group this year acquired a British light commercial vehicle manufacturer, as well as US automotive plant of DaimlerChrysler and its production licenses. Moreover, the ubiquitous Volga will be redesigned to maintain current production volumes rather than phased out.

Humble charm of industrial assembly

In April 2005, the Russian government proposed an "industrial assembly" regime to promote foreign carmakers to set up assembly plants in Russia and bring in original equipment manufacturers (OEMs). Under the regime, a declared amount of auto components can be imported at either zero or 3-5% import tariffs. To receive the dispensation, OEMs are required to organize production of at least 25,000 units a year on Russian soil and reduce imports of components by 30% within 7-8 years. As of October 2006, nine investment agreements had been concluded with foreign OEMs on construction of greenfield plants in Russia (Toyota, Nissan, GM, Volkswagen and Ford) or joint ventures (Autoframos-Renault, GM-AutoVAZ) and Russian-owned companies (Izh-auto, Severstal-auto), which have already begun assembly of South Korean Kia and SsangYong models at existing production sites.

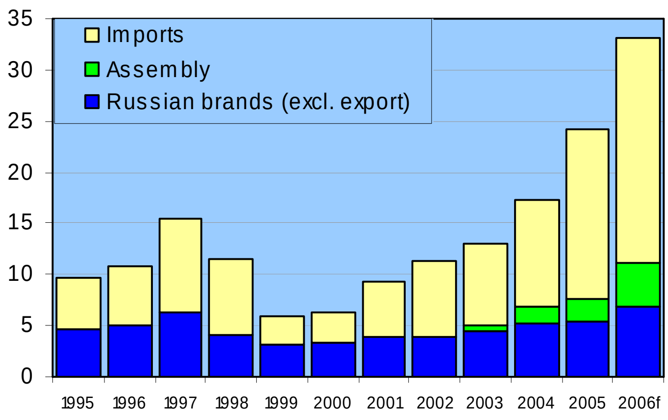
The total number of foreign vehicles assembled in Russia in 2010 should reach around 600,000 units, a four-fold increase from the 2005 level. Despite this impressive projection, foreign OEMs face numerous challenges as they enter the Russian market. The average capacity of their Russian assembly plants will be held to a suboptimal level of 50,000 units, which is quite small compared to similar plants in Eastern Europe (average capacity 230,000 units). Moreover, no international suppliers have plans for massive expansions into Russia. Given the humble OEM capacity plans, it comes as no surprise that foreign auto component manufacturers will concentrate mainly on producing car parts for the Russian after-sales market.

Auto components make a crucial difference

Russia's automotive industry remains highly vertically integrated, with domestic manufacturers producing up to 60% of their components in-house. Thus, despite a relatively high volume of car production, there are currently very few independent auto component manufacturers in Russia. This is especially striking when compared with the recent rise of the auto component sector in Eastern Europe and China. Several large auto component suppliers have emerged as OEM spin-offs, but domestic production is still highly concentrated within carmakers. Russian manufacturers have a strong position in the component market for domestic models where they possess competitive advantages in price, location and customer relations, but the majority of them still fail to produce innovative products or meet required quality levels.

In our opinion "industrial assembly" should be viewed as necessary but not sufficient tool of government automotive policy. The crucial task for the industrial policy in Russia now is to propose effective measures for stimulating production of modern auto components as well as emphasize domestic R&D and import of technologies.

Structure of Russia's domestic car sales in 1995-2006, USD billion



Source: ICSS

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Economic Developments

Robust growth of fixed investment

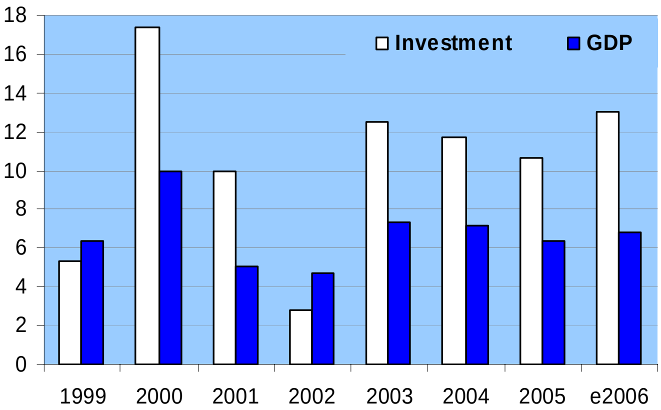
Most output indicators show growth of the Russian economy has continued robust, prompting many analysts to revise upwards their forecasts for this year. At the beginning of December, the economy ministry raised its 2006 GDP growth estimate to 6.8 %. Russian growth has been driven for some time by domestic demand, particularly private consumption supported by strong income gains. Retail trade, which has been increasing at 13 % y-o-y, has prospered most from robust household demand.

Regarding the sustainability of Russia's growth, it is noteworthy that investment growth has recently accelerated. In January-October, fixed investment was up almost 13 % compared to the same period last year. October on-year growth reached 19 %. This implies a gradual increase in Russia's investment-to-GDP ratio, which is important as the current investment level of 18 % is considered a far too low in light of Russia's actual needs.

Industry (44 % of total investments) and transportation (26 %) accounted for the bulk of investment. A large and increasing amount of investment (over a third of total investment) was related to the energy sector (mining, refining, electricity, pipelines). Housing accounted for 7 % of total fixed investments.

Investment growth varies considerably among Russia's regions. This year, fastest growth has been recorded in the Far Eastern Federal District, which is solely due to the Sakhalin energy projects.

Growth of Russian GDP and investment, % y-o-y



Source: Rosstat

Government dominates R&D activities in Russia

A new OECD publication *Science, Technology and Industry Outlook 2006* shows that the large emerging BRIC economies, which traditionally spent relatively little on research and development, have increased their R&D emphasis as their global role has changed over the last ten years. In particular, China's R&D performance has been outstanding; this year it will surpass Japan to become second in R&D spending after the US.

In the period from 1995 to 2004, Russian R&D spending doubled in real terms and the ratio of R&D expenditures to GDP increased from 0.9 % to 1.2 %. Nevertheless, Russia's R&D intensity is still more than one percentage point below the OECD average. In spite of higher spending, the number of researchers in Russia decreased by one-fifth from 1995 to 2004, reflecting post-Soviet adjustments. Russia's 470,000 researchers still put it in the fourth place, while its R&D spending is the eleventh highest in the world.

A peculiar feature of Russian R&D activity is that 61 % of R&D financing comes from the government, while industry only provides 31 %. In most OECD countries and China, the situation is the other way round. Moreover, unlike in China, in Russia R&D efforts do not yet show up as significantly increased international patent activity.

Russia closer to WTO membership

In November, Russia and the US signed a bilateral agreement on Russia's WTO membership. Russia has now completed almost all of its bilateral negotiations and can proceed to multilateral talks before membership. The ultimate duration of remaining negotiations is, however, difficult to forecast because there are still open questions related to sensitive issues like agricultural subsidies, state enterprises and trade-related intellectual property rights.

In bilateral negotiations, Russia has already reached agreements on liberalisation of its finance sector and reductions in many import duties. Russian import duties on food products and industrial products will be lowered an average of three percentage points. The most significant reductions affect passenger cars, electronics and technology products.

Given the long transition periods related to opening up of Russia's market and the protectionist mood among decision makers in Russia, possible WTO membership is not likely to produce significant changes quickly.

Macroeconomic indicators

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	as of
GDP, %	1.4	-5.3	6.4	10.0	5.1	4.7	7.3	7.2	6.4	6.6e	1-9/06
Industrial production, % [1]	2.0	-5.2	11.0	11.9	2.9	3.1	8.9	7.3	4.0	4.3	1-10/06
Fixed investments, %	-5.0	-12.0	5.3	17.4	10.0	2.8	12.5	11.7	10.7	12.6	1-10/06
Unemployment, % (end of period)	9.0	13.2	12.4	9.9	8.7	9.0	8.7	7.6	7.7	6.6	10/06
Exports of goods, US$ billion	86.9	74.4	75.6	105.0	101.9	107.3	135.9	183.5	245.3	248.8	1-10/06
Imports of goods, US$ billion	72.0	58.0	39.5	44.9	53.8	61.0	76.1	96.3	125.1	128.1	1-10/06
Current account, US$ billion	-0.1	0.2	24.6	46.8	33.9	29.1	35.4	58.6	84.2	79.9e	1-9/06

[1] *New methodology from Jan. 1, 2005; figures for 2001–2004 revised and not comparable with previous years.*

Sources: Rosstat, CBR.

2007 federal budget passes

The 2007 federal budget was approved by the Duma at the end of November in its fourth and final reading. In nominal terms, revenues will rise 13 % and expenditures 23 % with inflation projected to be in the range of 6.5–8 %. Thus, the budget surplus is set to decrease to 4.8 % from an estimated 6.4 % of GDP this year.

Structurally, the new budget has few changes. The share of VAT in revenues, which is down this year compared to 2005 (excluding 2005 tax arrears payments), should rise to former levels. Revenues from natural resource fees as well as export and import duties should decline both relative to GDP and as a share of budget revenues.

While almost all main expenditure categories receive extra funds ranging from 20 % to 40 % in nominal terms, the expenditure structure remains fairly stable. Defence and security expenditures will go up over 10 % in real terms, while transfers to regions and general administration will see real increases exceeding 15 %. Social spending gets a mere 3 % nominal boost. It is the only spending category set to decrease in real terms. However, it may be possible that the increased transfers to regions compensate for some of the losses. Social spending is generally the purview of regions.

The 2007 budget assumes an average price for Urals-grade oil of $61 per barrel, compared to $40 this year. The threshold price for stabilisation fund transfers will remain, however, at $27 a barrel. The stabilisation fund is forecast to hold $160 billion by the end of 2007. At the start of December, it had assets of about $83 billion.

Main federal budget categories for 2006* and 2007**

	2006*, % of GDP	2007**, % of GDP	2006* %	2007** %
Total revenues	**22.7**	**22.3**	**100**	**100**
Total, excl. social tax	21.5	21.1	95.0	94.7
VAT	*5.4*	*6.6*	*23.8*	*29.7*
Profit tax	*1.8*	*1.9*	*7.9*	*8.3*
Excise taxes	*0.3*	*0.3*	*1.5*	*1.5*
Natural resource fees	*4.0*	*3.4*	*17.6*	*15.3*
Export and import duties	*8.2*	*7.7*	*36.3*	*34.4*
Other revenues	*2.9*	*2.4*	*13.0*	*10.7*
Total expenditures	**16.3**	**17.5**	**100**	**100**
Total, excl. social tax	15.1	16.3	93.0	93.2
General administration	*2.4*	*2.6*	*14.5*	*14.8*
Defence	*2.5*	*2.6*	*15.6*	*15.0*
Security	*2.0*	*2.1*	*12.4*	*12.1*
Production, transport, etc.	*1.3*	*1.6*	*8.1*	*9.1*
Housing	*0.2*	*0.2*	*1.0*	*1.0*
Education	*0.7*	*0.9*	*4.6*	*5.1*
Health care	*0.6*	*0.7*	*3.4*	*3.8*
Social policy	*0.8*	*0.7*	*4.7*	*3.9*
Transfers to regions	*5.4*	*5.9*	*33.3*	*33.7*
Other expenditures	*0.4*	*0.3*	*2.3*	*1.4*
Surplus	**6.4**	**4.8**		

*Includes supplementary budget approved in November 2006; based on economy ministry's GDP estimate of 27,220 billion roubles ($1,039bn).
** Includes figures from the original draft (mainly revenues) and figures approved in the fourth reading (mainly expenditures); based on GDP estimate of 31,200 billion roubles ($1,177bn using the approved average exchange rate assumption of 26.5 roubles to the dollar) included in the 2007 budget.

Municipal reform in focus

The municipal reform, launched with the passage of requisite legislation in 2003, has not proceeded smoothly. The law was supposed originally to come into force from the start of 2006, but after complaints from many regions about their unreadiness to start its implementation, enforcement was postponed until 2009. However, several regions have voluntarily started to apply the law.

The main goal of the municipal reform is to create a clear, unified municipal administration system throughout the country. The new municipal units are to get both clearly defined responsibilities and the financial resources for their implementation. As such, the main purpose of the reform is very welcome and in line with the broader reform of fiscal federalism.

The first phase of the reform, defining the borders of the new municipal units, is already complete – at least in principle. According to anecdotal evidence, the process has been fraught with difficulties. The reform has doubled the number of municipal units to over 24,000, which has meant a huge increase in the number of civil servants and bureaucracy. In addition, for a country as large as Russia, municipal units under same appellation may differ substantially in terms of population and area they cover. This naturally creates a high variation in operational needs. Establishing tiny municipal units may also be economically hard to justify.

The discrepancy between assigned duties and financial possibilities has been at the centre of discussion since the start of the reform. The law assigns municipal units the responsibility for providing pre-school, primary and secondary education, which MinFin data show accounted for over a third of their expenditures in January-September 2006. During the same period, 17 % of municipal spending went to housing, 14 % to health care and sports and 9 % both to social policy and administration. Municipal units finance these services mainly with transfers from the federal budget and the compensation fund, which together account for some 60 % of all municipal revenues. The share of tax revenues in total revenues is about 30 %. The lion's share (84 %) comes from income tax, some 15 % from land tax and a sliver from property tax and the unified agricultural tax. It has to be noted that only land tax and property tax revenues accrue solely to local budgets, while other tax revenues are shared with the federal budget. Thus, municipalities are highly dependent on higher administrative levels – especially the federal level – from a fiscal standpoint.

Municipal reform also faces other challenges, including resolving the division of duties at the practical level, creating a well-functioning system of municipal budget transfers and finding competent civil servants to staff municipal administrations.

Federal government fiscal indicators (% of GDP, unless otherwise indicated; end-period figures for debt and stabilisation fund)

	1998	1999	2000	2001	2002	2003	2004	2005	2006,	as of	2006 budget[3]
Revenues [1]	11.4	12.6	15.4	17.8	20.3	19.5	20.1	23.7	24.0	1-11/06	22.3
Expenditures [1]	17.4	16.8	14.6	14.8	19.0	17.8	15.8	16.2	15.5	1-11/06	17.5
Balance	-6.0	-4.2	0.8	3.0	1.4	1.7	4.4	7.4	8.4	1-11/06	4.8
External debt[2]		66.8	44.5	33.3	27.7	22.5	16.3	9.2	7.6	6/06	
External debt [2], $bn		130.8	115.5	102	95.7	96.9	95.7	70.1	65.9	6/06	
Stabilisation fund, $bn							18.9	43.0	83.2	11/06	

[1] *Part of the unified social tax has been included in the federal budget since 2002.*
[2] *Debt to non-residents.* [3] *Includes supplementary budget approved in November 2006.*
Sources: Budget: IMF 1998–2000, Rosstat 2001–2005, Minfin 2006. Debt: Central Bank. Stabilisation fund: Minfin.

Labour costs shoot up

Consumer prices increased much faster in November than in previous months. However, monthly inflation was marginally lower compared to the situation a year ago (0.6 % vs. 0.7 % in November 2005) and, consequently, 12-month inflation decelerated slightly to 9.1 % (see figure). The government's inflation target range for this year is 8–9 %.

Wage increases have clearly outpaced consumer price increases; nominal monthly average wages were up last month 24 % y-o-y. Given the rouble's nominal appreciation against dollar, wages in dollars have increased even faster than in roubles (see figure). Regional differences in wage levels remain substantial, however. While the average monthly wage in Russia in dollars is currently about $425, it is $750 in Moscow and $500 in St. Petersburg. Moreover, there seems to be shortage of labour in many sectors and, consequently, salaries for competent people with good command of foreign languages in these two cities are said to approach western European levels.

Rosstat reports labour productivity in Russia has increased 6–7 % in recent years, implying that real wages have increased on average twice as fast as productivity. Given recent developments and the demographic outlook, Russia can hardly be considered a promised land for low wage/cost production.

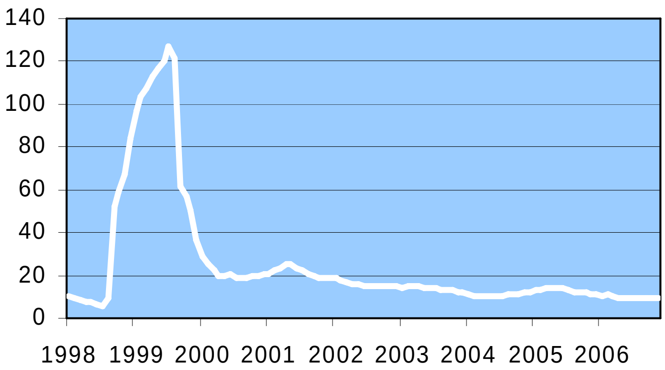
Moscow and St. Peterburg housing markets overheat

While overheating of labour markets is debatable, it is indisputable in the Moscow and St. Petersburg housing market's case (see figure). Real estate analysts report the average price of Moscow apartments has risen to over $4,000 per square metre, a doubling from a year ago. Developments in St. Petersburg are comparable. Although there is no nationwide data available for 2006, presumably the situation is more balanced outside the two metropolises. The rise in prices of Moscow apartments has slowed in recent months as most members of Moscow's middle class can no longer afford to buy an apartment.

Housing demand has been fuelled by rising real incomes, the movement of people from remote areas to major cities and development of a home loan market. During 1H06, home loans were up 50 % y-o-y. Russia's home loan market overall (200 billion roubles, or $8 billion) is still small relative to the country's size.

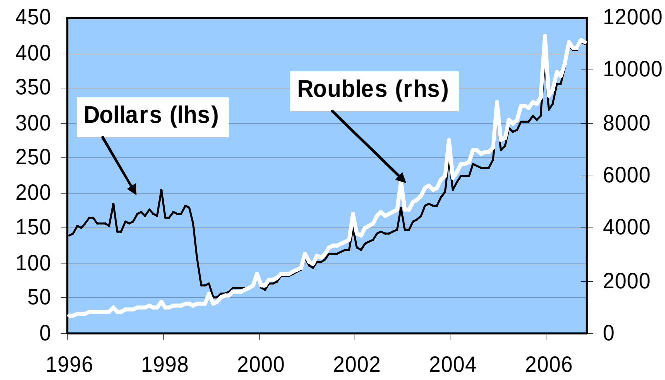
Rosstat reports nearly 300,000 new apartments were completed in first nine months of 2006. The amount of living floorspace was 12 % more than in the same period in 2005. About a quarter of apartments, measured in terms of living floorspace, were built in and around Moscow. However, housing construction has stagnated in Moscow and St. Petersburg this year, which partly explains the recent price increases in the Russian metropolises.

Consumer price inflation in Russia, 12-month % change



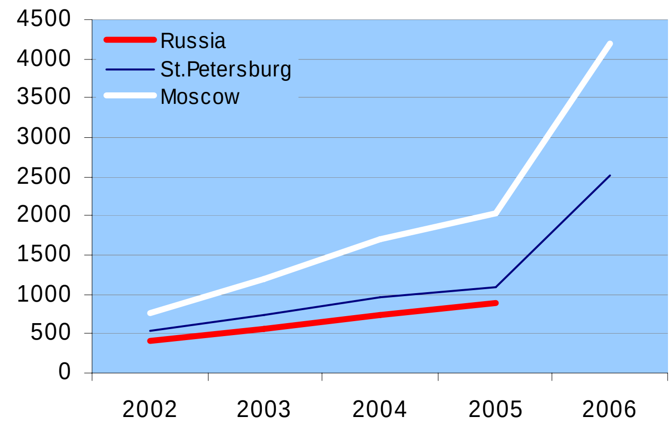
Source: Rosstat

Russia's average monthly wages in roubles and dollars



Sources: Rosstat, BOFIT

Housing price developments in Russia*
- average price, USD/m², end of period (October in 2006)



** The figure is indicative as the data is collected from various sources and the series are not necessarily compatible.*
Sources: Rosstat, Prices in Russia 2006 *(in Russian), rating.rbc.ru, www.irn.ru, BOFIT*

Monetary indicators

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006,	as of
Inflation (CPI), 12-month, % (end of period)	11.0	84.4	36.5	20.2	18.6	15.1	12.0	11.7	10.9	9.1	11/06
M2, 12-month growth, % (end of period)	29.0	21.3	57.5	61.5	39.7	32.4	50.5	35.8	38.6	46.2	10/06
Average wage, $ (period average)	164	108	62	79	111	142	180	237	301	413.9	10/06
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Lending interest rate, % (period average)	32.0	41.8	39.7	24.4	17.9	15.7	13.0	11.4	10.7	10.5	9/06
Forex reserves, $ bn (incl. gold)	17.8	12.2	12.5	27.9	36.6	47.8	76.9	124.5	168.4	290.1	11/06
RUB/USD exchange rate (end of period)	5960	20.65	27.00	28.16	30.14	31.78	29.45	27.75	28.78	26.31	11/06
RUB/EUR exchange rate (end of period)			27.23	26.14	26.49	33.11	36.82	37.81	33.94	34.68	11/06

Sources: Rosstat, CBR.

Are we able to forecast Russian long-term growth?
by Pekka Sutela*

In the first issue of BOFIT Russia Review, almost nine years ago, we asked whether Russia was at long last entering a period of economic growth. The answer was sceptical: at least a repetition of the earlier Polish growth experience based on new entrepreneurship and restructuring of state-owned enterprises was not to be expected.

We failed to foresee several things. Russian growth was to be kick-started by the huge deterioration of the rouble after the 1998 crisis. Devoid of the possibility of deficit finance, fiscal policy would turn stability oriented. Global commodity prices would soar. And a new middle class would change the structure of domestic demand, signalling the beginnings of a consumer society.

Our understanding is limited

Economists have a well-deserved poor reputation for long-term growth forecasts. Thus, while we know relatively well many things that will affect Russia's long-term growth (e.g. demography), there is considerable amount of uncertainty related to most of our analysis.

The Putin regime has been favoured by a number of one-time incidents. The 1998 crisis is perhaps the most important and it has forced analysts to ask again whether Russian growth has a sustainable basis.

While the importance of energy for the Russian economy is undeniable, the picture in volume terms has changed since 2004. Energy output growth is modest and predicted to remain so for many years to come. The consensus seems to be that huge price changes in the global energy market should not be expected. Therefore, energy will not be the driving engine of Russian economic growth. In fact, without major improvement in domestic energy efficiency, it will be difficult for Russia to increase export volumes.

This situation, together with booming imports, should over time lead to a melting away of Russia’s massive balance-of-payments surplus. This would ease macroeconomic policymaking, as pressure on inflation and real appreciation of the currency would diminish. The rouble remains an undervalued currency, but the time of superior price competitiveness has passed. As the energy sector is a modest employer, the challenge of providing competitive jobs in non-energy open sectors will be severe, and hence, protectionist pressures may well dominate the practical impact of WTO membership.

Structural change should not be undervalued

Undoubtedly, Russian growth will most certainly be driven by ongoing structural change; a fact all too often forgotten (see figure). The USSR simply did not have most of the services that first emerged in the metropolitan cities and are now spreading across the country. This is also true of several types of small-scale production. The Russian economy is becoming increasingly heterogeneous. While instances of catching-up abound, much of the Soviet inheritance continues its inevitable decline and deterioration.

Several of the caveats in our analysis nine years ago remain pertinent. New entrepreneurship is still oriented towards domestic markets, and it is unclear how much innovation-oriented restructuring has taken place in traditional industries. R&D expenditure by Russian firms remains extremely modest.

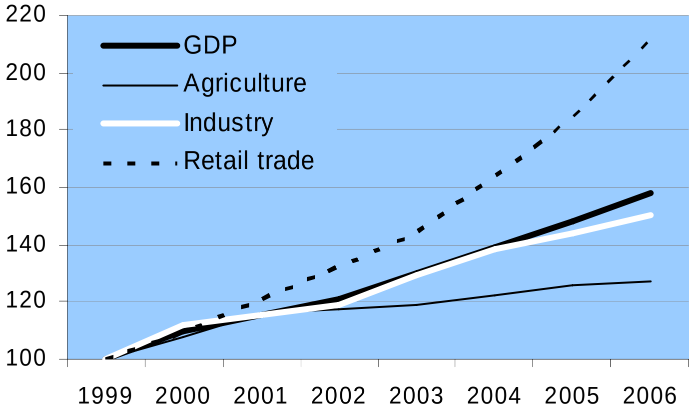
Nine years ago we concluded that “the probability of the Russian state supporting growth at any time soon is close to nil.” This has certainly not been the case in monetary and fiscal policy, but the general strengthening of the grip of the state is undoubtedly a burden on future growth prospects.

Overall, we remain modestly optimistic on Russian growth for several years to come. Major problems cast a shadow on the more distant future. They range from export diversification through the inherent contradictions of the political and economic goals of the current regime to such well-known issues as demography. These challenges are often recognised, but like in most countries, true strategic thinking and policy measures are rare.

Last issue of BOFIT Russia Review

This is the final issue of BOFIT Russia Review. BOFIT will increasingly concentrate on high-standard economic research. Part of the traditional contents of this report will be available on BOFIT Weekly report as well as on our website.

Russian output dynamics in the Putin era, index 1999 = 100



Source:Rosstat, BOFIT

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