Oesterreichische Nationalbank

The Russian Economy: Long-Term Prospects

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Stylized features of growth in Russia

- **Before transition**:
  quantitative expansion of inputs of physical capital (incl. land, natural resources) and labor as main driver of economic growth
- Before 1998: Contraction / stagnation, low capacity utilization
- **As transition proceeds**:
  qualitative upgrading of factor inputs / enhancement of TFP as driving forces of growth
- **After 1998**:
  Return to potential output alongside with restructuring / expanding potential output

Stylized features of growth in Russia (2)

Since 1998: Return to potential and expanding potential

Major factors:

- Strong initial devaluation (1998)
- Major ToT improvement (since 1999)
- Prudent macroeconomic policies
- Earlier and ongoing reforms – but signs of reform fatigue since 2004
- Strengthened state institutions – but still insufficient rule of law
- Take-off of investment growth – but from a low base → investment ratio still low indicating remaining weaknesses in investment climate
- Associated with and possibly helped by financial deepening
- Increase in real wages – but rising ULC

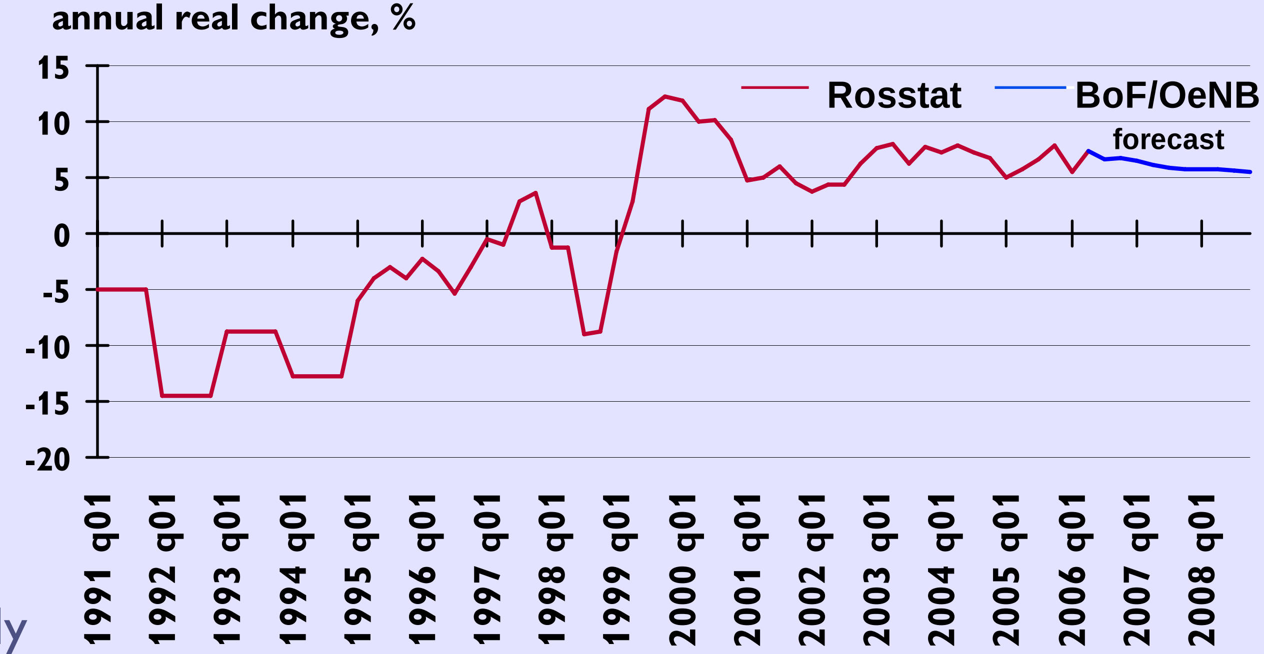
Some capacity constraints emerging in 2005 *(esp. in energy, transportation)*

Short-term outlook
BoF / OeNB forecast 2006-2008

- Assumption: **oil prices** at elevated (summer 2006) levels
- **Continuing robust growth, softening a bit towards 2008**
- **Private consumption growth** as main driver, with some contribution also from capital formation
- Growth supported partly by some fiscal loosening (in 2007)

Chart 1

Development of Russian GDP 1991-2008



Source: Rosstat 1991-2006 (Q2), BoF/OeNB forecast 2006 (Q3)- 2008. 1991-1994: annual data, 1995-2008: quarterly data.

Long-term outlook (1)

Table 1

Study/ forecast (author/s and year of publication)	**Medium- to long-term average annual estimated / forecasted real economic growth in %**[1)]
Fischer, Sahay, Vegh (1998)	4.8 – 5.9
World Bank (2002)	1.5 – 2.2 – 4.1 - 5.2
Palmeda, Lewis (2002)	up to 8
Komulainen et al. (2003)	2.0 – 3.0 – 4.7
Kaitila (2003)	2 – 4 – 6
Clement (2004)	3 – 5
Ministry of Economy (2004)	4.4 – 6.8
IMF (2005)	5.0 – 5.5
World Bank (2005)	4.5 – 5.0
ING (von Dewall, 2005)	5.0

1) Where more than two numbers are shown, they correspond to alternative scenarios.

Long-term outlook (2)

→ **Long-term growth estimates for Russia** vary within fairly wide range

- **Baseline ranges** of **4-5% p.a.** in most cases, assuming continuing reforms
- Even assuming some reform momentum, growth would probably be significantly lower than needed to achieve the officially stated goal of doubling GDP within 10 years
- Still, **Russia** would be **one of the faster expanding European economies**, while its performance would most likely not match fast-growing emerging market economies of Asia
- With more ambitious reforms, catching-up could be faster

Long-term outlook (3)

- The **potential** of the Russian economy is huge
- Russia could become a "**powerhouse of the world**"
- ***Russia's investment growth needs to be raised to sustain robust economic expansion in the longer run***
  - Prime task to this end: ***improve the overall business climate***
    - mainly by strengthening the rule of law and state governance
    - and by maintaining an open attitude to FDI
- ***Russia also needs to tackle other factors that could dampen long-term growth***
  - Key challenges in this respect:
    - guard against possible Dutch disease effects
    - overcome serious demographic and health problems

Long-term outlook (4)

→ ***Guarding against possible Dutch disease effects***

→ Russia's resource-based economy is ***potential* Dutch disease *candidate***

Available empirical studies provide **no** clear-cut **hard evidence** that Russia has contracted the Dutch disease…

… but persistent real appreciation merits continued monitoring

Preliminary results of **BoF / OeNB** research on one aspect of the Dutch disease, namely the competitiveness of Russia's manufacturing sector, also convey a mixed picture:

- Much faster **import** than **production** growth in some manufacturing sectors
- However, modest market shares **Russian manufacturers** enjoy in EU25 have **not declined** in the last five years, and in some cases have increased
- Moreover, **bottlenecks in oil sector** seem to contain pressures to some extent

→ ***Need for continued macroeconomic prudence and re-invigoration of reforms to ensure that manufacturers remain competitive***

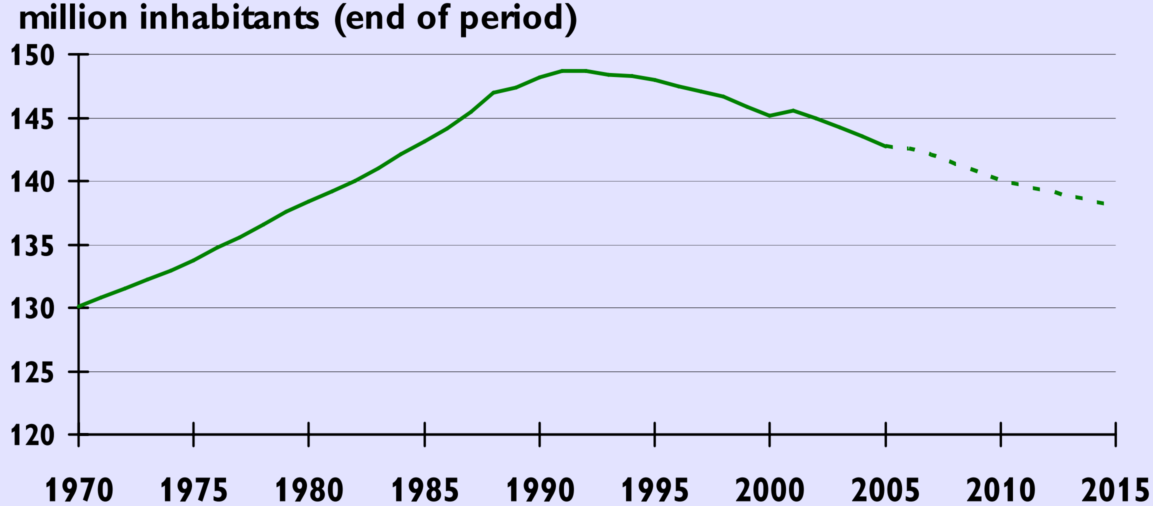
Long term outlook (5)

→ *Checking serious demography and health problems*

- **Persistent shrinkage of population** (despite net immigration)
- This **might shave off ½-1 ppt** p.a. from potential GDP growth
- **Policy implications**
  - improve health care
  - help society "grow" out of unhealthy lifestyles
  - promotion of education / human capital formation
  - halt environmental degradation
  - immigration policy

Chart 2

Russia's population 1970-2015



2006-2007: wiiw forecast
2008-2015: own forecast, based on various studies
Source: wiiw, Narodnoye khozyaistvo CCCP 1990

Conclusions

- **Important and historic efforts** have been made to harness Russia's huge potential and transform the economy
- **What appears to be still missing** or only **partly established** is
  - a stable and effective institutional framework,
  - an impartial state, a level playing field.
- Russia's upcoming **WTO accession** will be an important step in this respect
- **EU *acquis communautaire*** is example of more comprehensive set of rules
- A ***selective* adoption of the *acquis*** could fulfill a **dual purpose**:
  - to provide a **reliable rulebook** for the domestic economy
  - to foster **economic integration** between the two big players in Europe

→ thereby further **enhance Russia's status** and attractiveness as global player

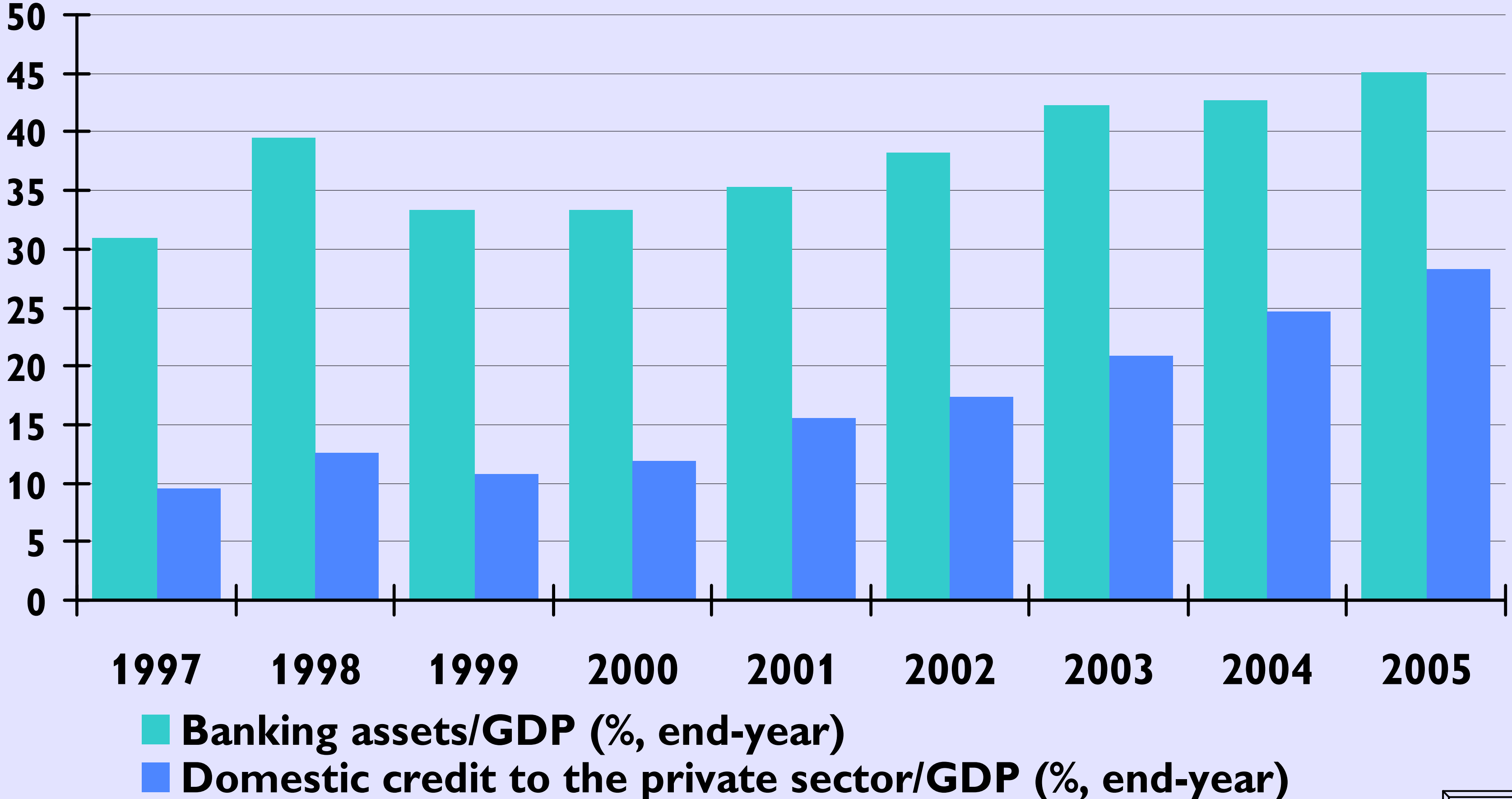
→ however, as **EU experience** − including its new members − shows: A good set of rules is only the first step, what matters as much is **sound implementation**

Thank you very much for your attention!

Extra slides for possible reference

Banking activity in Russia

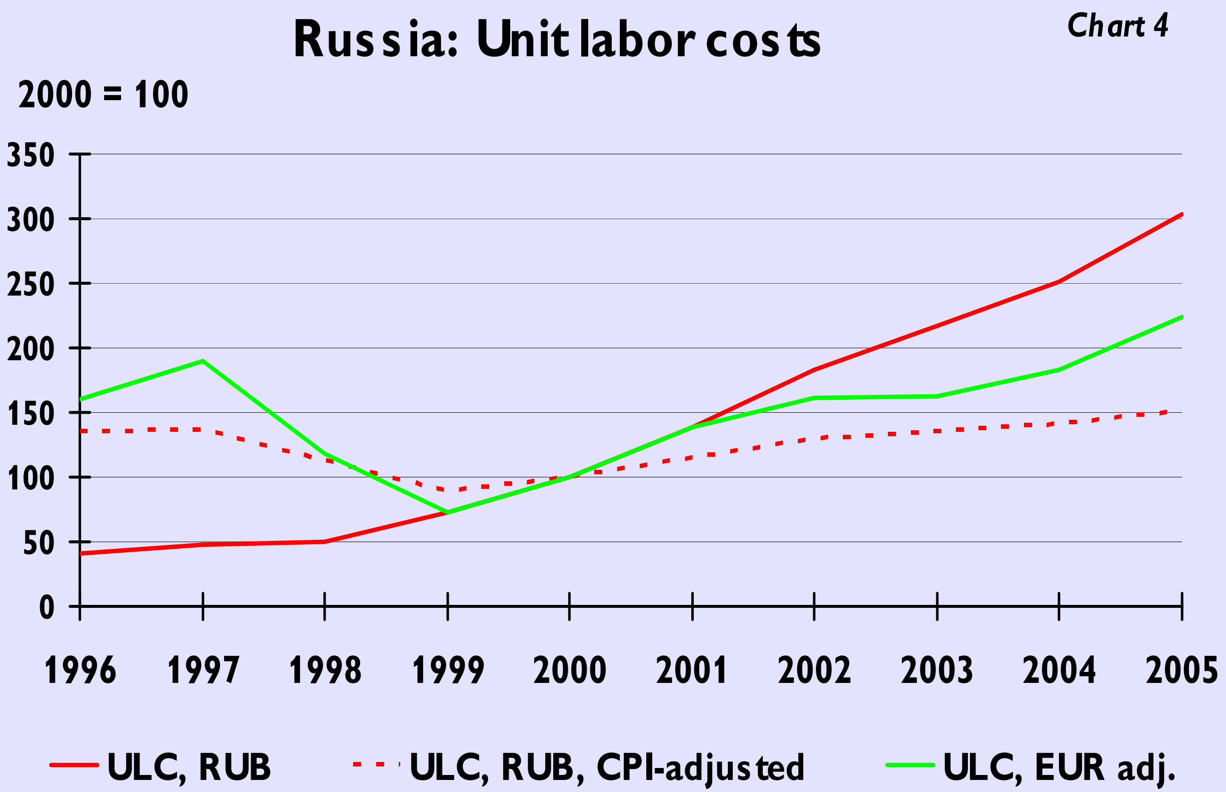
Chart 3



Source: Bank Rossii, EBRD

Economic recovery and unit labor costs

- **Expanding real wages** have boosted standard of living and **reduced poverty**
- **Whole-economy ULC on the rise** since 1999 (see chart)
- **ULC dynamics in industry** contained by solid **productivity growth** until recently
- But: Lately, **wages** are expanding tangibly faster than productivity (also in industry)



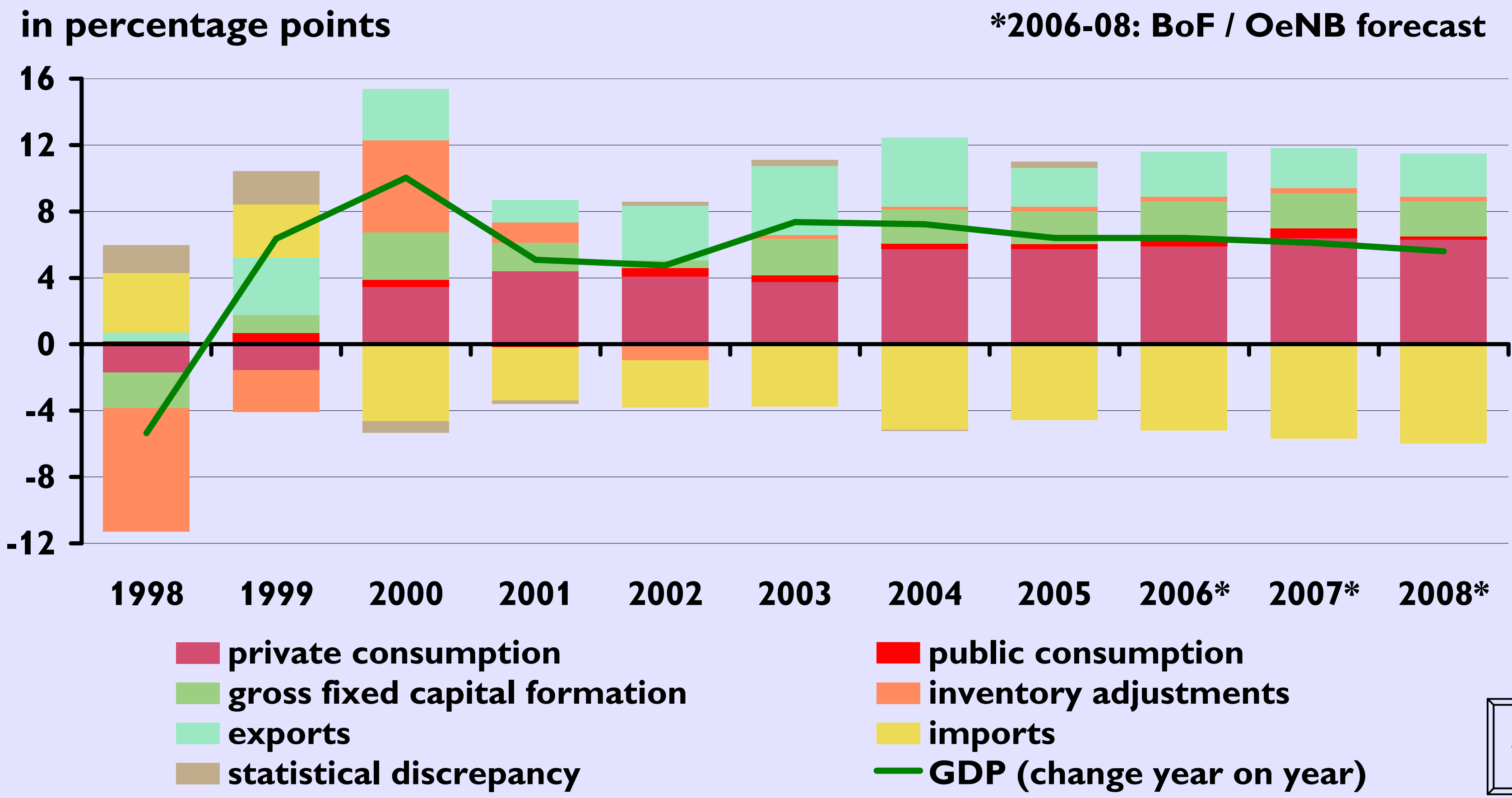
Source: wiiw

Investment activity and business climate

- Notwithstanding Russia's huge potential
  - relative modest **investment ratio** (18% of GDP in 2003-05) *alongside with annual growth rates of investment of 10-13% in this period*
  - comparatively **weak levels of FDI**, and
  - apparently **hesitant return** of **flight capital**
- Weaknesses in investment climate
  - **insufficient rule of law**, application of rules (e.g. oil industry): level playing field?
  - lingering **red tape** and **corruption**
  - **expanding role of state-owned enterprises** in some strategic areas (oil, aviation, finance): efficiency gains?
  - **taxation of oil sector** sharply increased in 2004

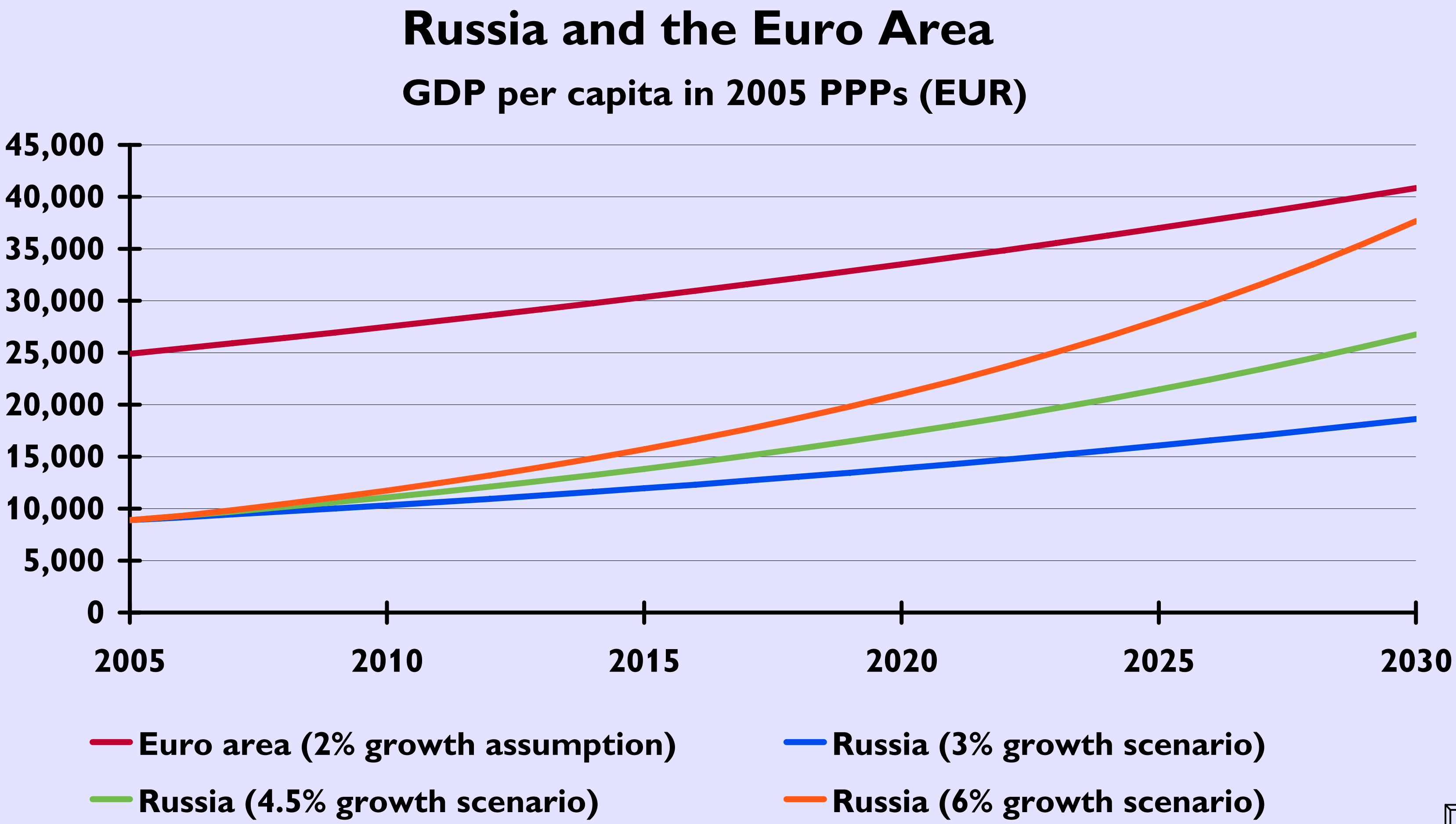
Short-term outlook
BoF / OeNB forecast (2006-2008)

Composition of Russia's GDP growth



Source: Goskomstat.

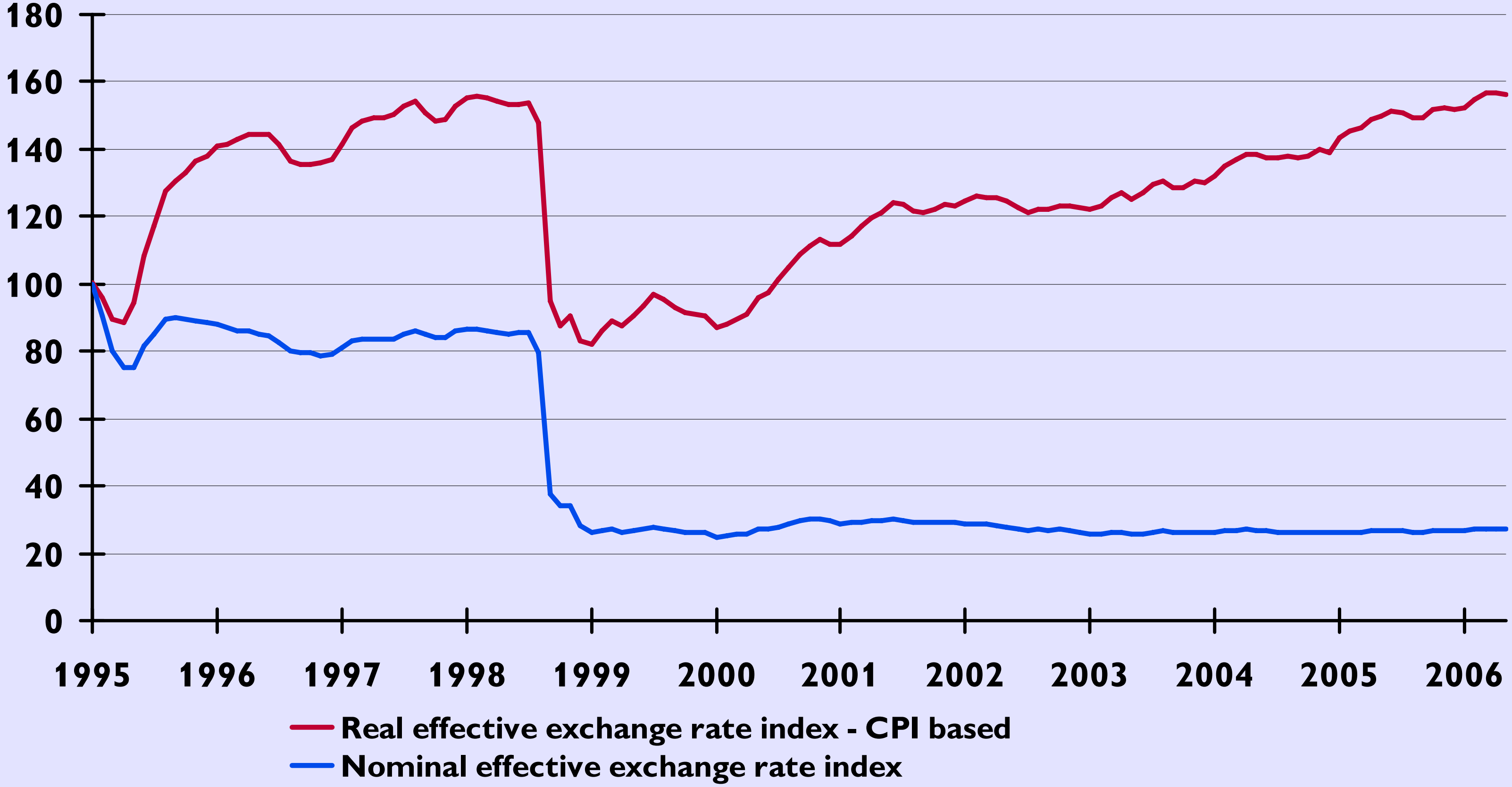
Catching-up scenarios



Source: Eurostat, Rosstat.

Effective exchange rate developments in Russia

Nominal and real (CPI based) effective exchange rate index (increase = appreciation)



Source: Thomson Financial.