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## New conditions for growth in Russia



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## New conditions for growth in Russia

### Abstract

The Russian economy has grown rapidly in the 2000s but growth remains heavily reliant on energy and Russia continues to be basically a natural resource economy. Sustained strong economic growth in the long term requires diversification of the economic production structure. Regional development has been uneven and regional policy is being reformed to better correspond to the needs of the regions themselves. The pursuit of fiscal policy has been consistent in times of high oil prices, thus stabilising public finances. The large budget surpluses recorded over the last few years are probably exceptional, and the Russian public finances will move closer to balance over the next few years. The strong economic growth in Russia is reflected in the rapid expansion of Finnish exports to Russia and the increase in Finnish investments in Russia. However, export volumes to Russia, adjusted for re-exports, have grown more slowly than total Russian imports, with Finland having lost market shares to Asia, in particular. Asia's effect on the Russian economy has been seen in an increase in trade between Russia and Asia, and in the rapid increase in Chinese market shares in Russia, in particular. Russia occupies a challenging location between Asia, which has a large market and cheap labour, and Europe, which stands in the forefront of technology. Russia has been lucky in the 2000s in that it has succeeded in improving the foundation of its economy, relying on the strong economic growth. There still are, however, many bottlenecks in the economy that threaten long-term growth, the removal of which will pose a considerable challenge.

Key words: Russia, economic growth, natural resources, energy

Simon-Erik Ollus

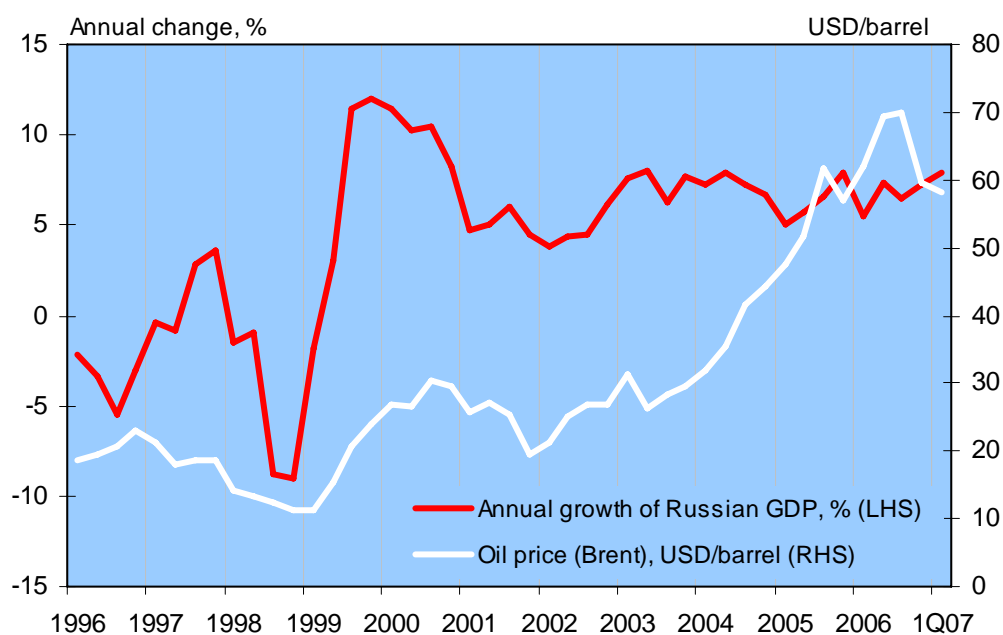
## Natural resources – a blessing or a curse?

### The economy has grown rapidly since the 1998 crisis

The Russian economy has been growing at an astonishing pace since the 1998 crisis. In 1999–2006, the Russian economy grew at an average annual rate of 6.7%. At this rate, the size of the economy will double in 12 years. Long-standing economic growth has boosted the standard of living and the wealth of the population.

Economic growth is however largely based on the high price of energy and oil. Oil and gas still have a significant, direct impact on economic growth. Oil and gas production and refining account for approximately one-fourth of GDP. The rapid economic growth witnessed since the 1998 crisis was accompanied by an increase of over sixfold in the world market price for oil. According to estimations done at the Bank of Finland, a 10-dollar increase in international oil prices accelerates Russian economic growth by approximately 2%. Russia is the second largest producer of oil and the largest producer of gas in the world, and these commodities account for about two-thirds of the country's export revenues. The remaining proportion of exports consists mainly of other raw materials, and low value-added products, eg metals and wood. High-value added products account for only a few percentages of total exports. In terms of production structure, Russia is clearly a natural resource economy.

Chart 1.1 Russian GDP growth and international oil prices 1996–2007



Source: Russian Ministry of Finance.

Economic growth has also been supported by tight fiscal policies and the rapid growth in consumption in recent years. The federal government budget has been in surplus for several years. Russia has accumulated a huge Stabilisation Fund, paid off its external debt and thus improved its external credit rating. The rapid growth of real incomes is reflected in brisk growth of consumption, particularly in retail trade, as well as in construction. It is nevertheless justifiable to ask the following question: could fiscal policies have been tight and consumption growth rapid if the world market price for oil had not risen so rapidly and if energy exports had not generated such huge export revenues for Russia? The answer is: probably not.

Russia has been lucky during President Vladimir Putin's era, and the country has benefited from high oil prices. However, only a few natural resource-rich countries have in the long term been able to rapidly increase economic growth and reach the Western level of wellbeing. Norway is an exception, but the country was a Western welfare state already before oil was discovered in the North Sea.

As the Russian economy is based on natural resources it is not entirely justifiable to compare its transition to a market economy directly with the new Central and Eastern European (CEE) member states of the EU. These countries have a completely different starting point than Russia, both in terms of history and the structure of the economy. The basic institutions of a market economy were in place in the CEE countries already before the socialist era and the degree of refinement was higher than in the Soviet Union. Moreover, the transition in the CEE countries has had a clear direction, ie EU membership, and the reforms have had clear market economy targets. This partly explains Russia's slower transition to a market economy. The right reference group for Russia would be the other economies rich in natural resources which are still in transition to a market economy, countries such as Mexico and South Africa. In these countries, economic developments have not been particularly favourable, despite the extensive natural resources and the related industries. Natural resources have, on the contrary, hindered economic developments. In economic theory, this phenomenon is often referred to as a natural resource curse or trap.

## What is a natural resource curse?

In theory, the natural resource curse is manifested in various ways. In countries rich in natural resources, the majority of total output is typically based on the extraction of natural resources and the industry's degree of refining is low. Raw materials account for the majority of exports and export receipts are vulnerable to fluctuations in world market prices of raw materials. When prices of raw materials are high, the country gains large export revenues, which causes large inflows of foreign currency into the economy, which in turn strengthens the real exchange rate. The success of the natural resource industry will increase wages, and labour will start to move to the natural resource industry from other fields of industry in hope of higher wages. Other industries (usually some degree of value-added manufacturing) are unable to compete with the natural resource industry in terms of wages, and their exports will wither due to the appreciation of the exchange rate. Manufacturing will eventually focus only on the production of raw materials. In economic theory, this impact is called the *resource movement effect of the Dutch disease*.

Economic theory also identifies the *spending effect of the Dutch disease*. This effect occurs when the appreciation of the exchange rate increases imports and demand for services (eg in retail trade), which also causes labour to shift from the other sectors of industry to the service sector. The spending effect also includes the loosening of fiscal policies as a result of large inflows of export revenues. With the next downturn in world market prices of raw materials, it is impossible to quickly curb spending, which rapidly pushes government finances and the terms of trade into deficit, and the country starts to accumulate debt. This has happened to several African countries rich in natural resources.

Dutch disease was first identified in the Netherlands. In the 1960s, the country discovered vast natural gas deposits in the North Sea. Gas production and exports resulted in large inflows of currency, which strengthened the Dutch gilder and at the same time weakened the export competitiveness of the other sectors of industry. The Netherlands recovered from the disease fairly quickly, but the term 'Dutch disease' remains.

Symptoms of the natural resource curse often also include *weak administration* and *high corruption*. In economic theory, this is explained by the easiness of monopolising natural resources such as oil fields and diamond mines. Natural resources accumulate to the chosen few who benefit immensely from natural resources and are able to participate in political corruption, which weakens and destabilises the administration and hinders the implementation of structural reform. By contrast, the general public does not, by and large, benefit from natural resources.

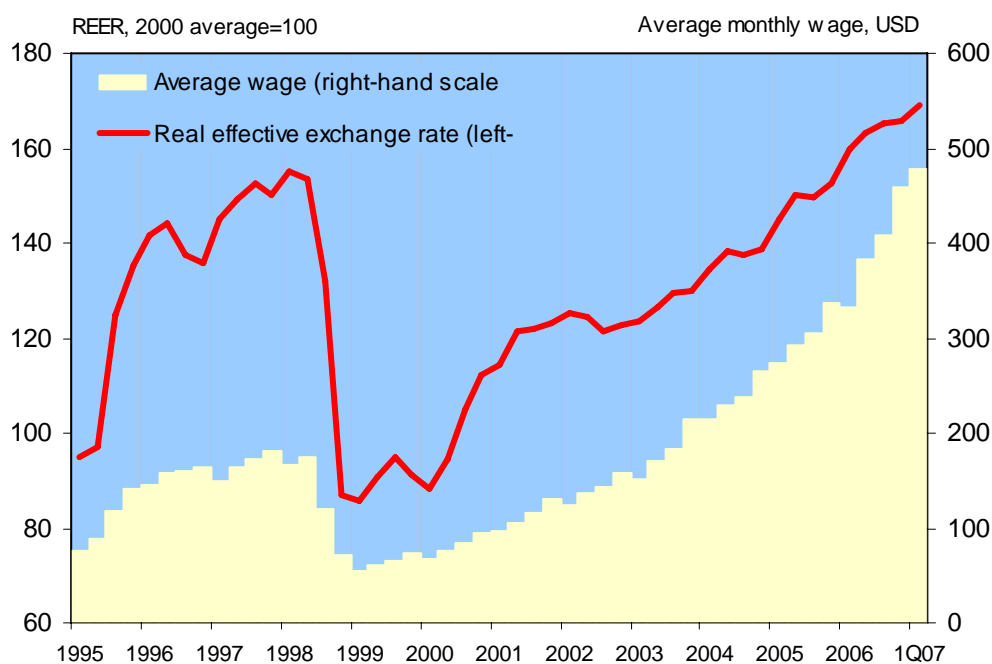
Another key factor explaining the natural resource curse is the *neglect of human capital accumulation*. It is not worthwhile for the country to focus on accumulating human capital and improving the competitiveness of the other sectors of industry as natural resource revenues enable the country to spend extensively, and educated people move to the natural resource industry. Arab countries are often cited as an example of this phenomenon.

## Is Russia in a natural resource trap?

Dutch disease has been studied extensively in context of the Russian economy. The real exchange rate of the rouble has appreciated rapidly as a result of high oil prices, and it is currently broadly at the pre-1998 crisis level. The rouble was long considered an undervalued currency. Lately it has nevertheless already been suggested that the rouble might be overvalued. The rouble's real effective exchange rate has gained since the 1998 crisis, on average 8% year-on-year, due to sizeable export revenues. This development reflects the high rate of inflation and the rapid growth of wages (see Chart 1.2). The decline in the world market price of oil since summer 2006 has nevertheless slightly eased the upward pressure on the rouble.

Of Russian labour, only less than 2% is employed by the extractive industry (mainly in energy production) and the proportion has remained broadly unchanged for quite some time. This is partly due to the rigidity of the labour market and the fact that the extractive industry is concentrated in areas with negative migration. The average wage in the energy-producing extractive sector (USD 1,052/month in January 2007) is nearly 2.5 times higher than the average wage in the country. There is nevertheless no evidence of a resource movement effect, ie a trend of labour shifting from other fields of industry to the extractive sector.

Chart 1.2 Real effective exchange rate of the rouble and average wage 1995–2007



Source: Rosstat.

The proportion of the extractive sector of GDP has increased slightly in the current decade. Official statistics show that still in the early 2000s, the extractive sector (excl. refining) accounted for approximately 7% of GDP, and in 2006, it accounted for 11% of GDP. The proportion of retail trade and agricultural trade of GDP has decreased slightly whereas the proportion of manufacturing has increased somewhat. Official statistics however do not cover oil and gas refining and transportation and transfer pricing associated with oil and gas production, which are included in the statistics of other branches of production. Oil and gas are generally estimated to account for approximately one-fifth of GDP. A recent calculation by the investment bank Renaissance Capital suggests that the proportion of oil and gas of GDP has grown slightly in recent years and that it reached 22% in 2006. According to the resource movement effect, the proportion of oil and gas should indeed increase, but mainly at the expense of the other sectors of industry and not the service sector, while the spending effect should be reflected in growing imports and the expansion of the service sector.

One of the symptoms of Dutch disease is the strengthening of the rouble. It weakens the competitiveness of the other domestic industries and at the same time increases Russia's propensity to imports. Currently, import growth is three times GDP growth. Other domestic industries, outside the natural resource industries, have major difficulties in competing with imports. There has however not yet been a broad-based decline in manufacturing output.

So far Russia has succeeded fairly well in avoiding the loosening of fiscal policy. The general government budget has posted a large surplus throughout the current decade, and the surplus gained as a result of high oil prices has been transferred to reserves. High taxation of oil production and export has however had a negative impact on oil companies' results and incentives to increase production in times of high oil prices. At current prices, two-thirds of the export price of a barrel of oil is taxed away and transferred to the

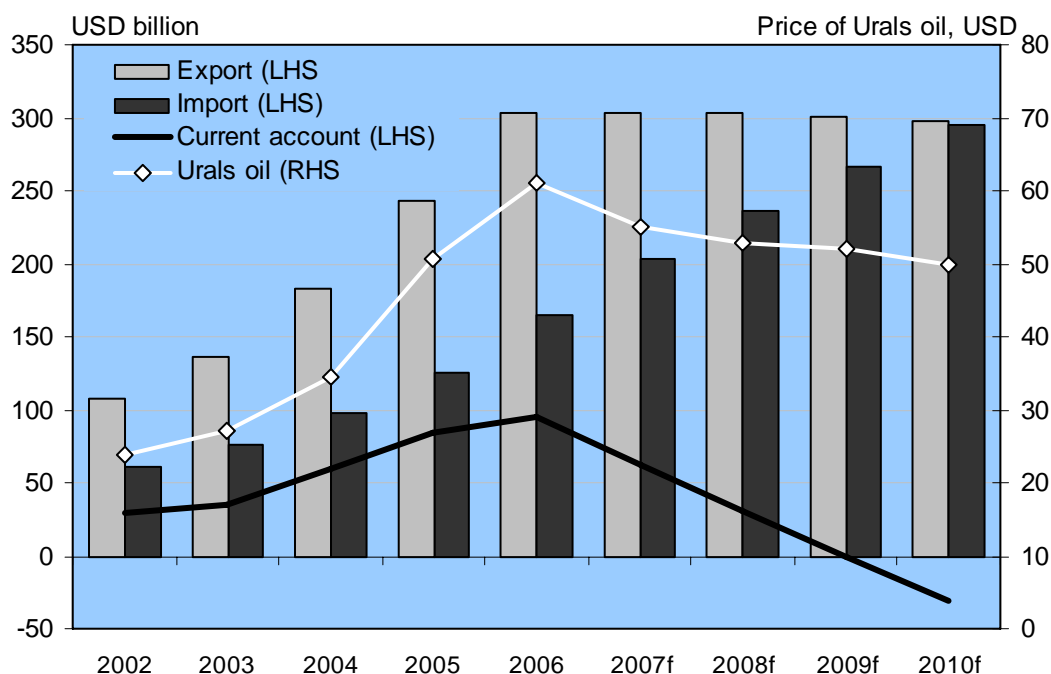


Stabilisation Fund. The Fund is already over double the size of the Russian Federation's external debt. Transferring oil revenues to the Stabilisation Fund has slightly helped to sterilize excess liquidity from export earnings and thus dampened the upward pressure on the rouble and hence prevented Russia from catching Dutch disease.

Currently, the Russian foreign exchange reserves are the third largest in the world and due to the sizeable surplus in Russia's balance of trade, the country's current account records one of the largest surpluses in the world. The government budget has usually been prepared carefully, with much lower assumptions for oil prices than the actual outcome. Russia has indeed been a model country in conducting tight fiscal policies in times of high energy prices and in building up buffer reserves. But is this enough?

Russia has a large current account surplus, but the rapid appreciation of the rouble also rapidly boosts imports. The slight decline in oil prices since summer 2006 causes a downturn in export revenues and dampens the upward pressure on the rouble. According to the Russian Ministry of Finance, at the current trend both the balance of trade and the current account will turn negative latest in 2010. This means that the country would start incurring debt. In the short term, the deficits can however, be covered by spending the macroeconomic buffers and with a positive capital account. The private sector capital account has thus moved into surplus in recent years, due to foreign investments and increased foreign borrowing by Russian companies and banks. Maintaining a positive external balance will however, be difficult if oil prices continue to decline and if Russia is unable to create new export goods that would bring export revenues at times of low oil prices.

Chart 1.3 Russia's external balance 2002–2010.



The forecast (f) is based on an optimistic scenario (so-called innovation scenario) published in April by the Russian Ministry of Finance.

Sources: Central Bank of the Russian Federation, Rosstat and Russian Ministry of Finance.

Russia is still an economy in transition, and it is difficult to establish good governance and efficient administration from scratch. During Vladimir Putin's presidency, new laws have been approved and some progress has been achieved in structural reforms, but on the other hand, overall bureaucracy has not diminished and the efficiency of public administration has not improved significantly. In fact, the number of civil servants (particularly at the federal level) has increased by over a fourth in the current decade. Political corruption is still common and ownership of large companies is still relatively concentrated. According to the World Bank, in the early 2000s, approximately 40% of labour and companies' turnover was held by the 22 largest conglomerates of oligarchs. President Putin has sought to limit the oligarchs influence on economic policy and nationalised certain strategically important companies in the energy sector and created state conglomerates. These measures have however also created new forms of political corruption and a new class of bureaucrat oligarchs. Members of the President's inner circle have been appointed as heads of state-owned companies, and the companies have expanded to new sectors, which does not promote economic stability or dynamism.

In 2006, Russia ranked 121<sup>st</sup> (out of over 160 countries in the world) in terms of level of corruption. Various types of anti-corruption campaigns have been introduced, but the level of corruption has remained stable. Everyday corruption seems to have decreased slightly during President Putin's two terms in office, but risk premia and political corruption seem to have increased. Rooting out corruption is difficult. There are several examples of countries in which the level of corruption has been low initially but has quickly risen in times of crisis or a change in economic system. There are however few examples of countries that have succeeded in rooting out corruption with the help of some policy decisions. Decreasing corruption is however important for implementing sound governance and credible economic policies.

In the case of Russia we can hardly talk about neglect of human capital accumulation. The Soviet era left the country with a relatively high level of education. Illiteracy is virtually nonexistent, unlike, other so-called BRIC countries (Brazil, India and China). Russia has a higher proportion of people with an academic degree (55% of 25 to 34 year-olds) than the EU countries on average and in relative terms, Russia's investment in research and development (1.2% of GDP) is higher than that of several CEE countries. It should however be noted that about half of the R&D investments focus on the military industry.

The government has sought to support innovation and new forms of manufacturing through policy measures. At the end of 2005, it established six special economic zones: in St Petersburg, Dubna, Zelenograd, Lipetsk, Yelabuga and Tomsk. With the help of these special economic zones, the government seeks to foster the creation of industrial clusters and to promote investments in the refining industry. The government has also sought to create certain strategic production clusters in sectors in which the country is competitive or has potential. The clusters established so far are the military, space, aviation, shipbuilding, and automotive industries. In case of the military, space and aviation industries, we can talk about real cutting-edge know-how, less so in the case of the automotive and shipbuilding industries. The above-mentioned clusters are owned by the state or at least controlled by it. The government is also in the process of establishing eg a development bank, a Venture Capital fund and an investment fund to promote the creation of innovations.

## Russia's choices

Russia is indeed showing some symptoms of a natural resource curse. The risk of Dutch disease is real, and the promotion of stable administration is hampered by political corruption. In contrast, Russia has human capital, which provides opportunities. Russia has two roads to choose from: it can either confine itself to being a natural resource economy or it can fight back. If the country chooses the current production structure and does not actively strive to diversify its economy, it will either face a *natural resource economy* or even a *natural resource curse*, depending on whether the export price of oil remains high or not. If Russia chooses to *diversify the production structure* of the economy, it will continue to have better possibilities of maintaining rapid economic growth, depending of course on the method of implementing the diversification and on the industries to be focused on.

Russia's choices are not necessarily reflected in the short-term growth outlook. Sizeable energy revenues and the resulting macroeconomic buffers enable Russia to maintain economic growth in the next few years, despite a cautious decline in energy prices. In the Bank of Finland's winter forecast (February 2007), Russian economic growth was estimated to be 6.4% in 2006, and to recede to 5.6% by 2009. The biggest short-term threats relate to a sudden change in fiscal policies after the 2008 presidential elections and a sharp decline in oil prices. Both threats are however highly unlikely. In the medium and long term, the challenges for growth include breaking free of the natural resource dependency and easing the impact of negative demographic developments.

If Russia succeeds in modernising the structure of its economy, other sectors will do well even if energy prices fell. In terms of diversifying the economy and easing the dependency on natural resources Russia has two alternatives: *home-made modernisation* or *competitive modernisation*. Home-made modernisation is largely in line with the policies of the current president and government and it is likely to lead to a situation in which Russia has, in addition to its natural resources extraction industry, a couple of competitive fields of industry, (eg. military, space and aviation industries), ownership of the production structure is likely to remain relatively concentrated and the economy non-dynamic, with energy still having a major role in the economy. Home-made modernisation may not be sufficient to maintain rapid economic growth if world market prices of energy fall.

Competitive modernisation means creating new types of competitiveness; new investments and accumulation of human capital. Competitive modernisation is difficult to implement by home-made measures and it requires first and foremost opening up the economy. This would increase competition in the domestic market and above all, it would attract foreign know-how. Opening up the economy would also support the diversification of the ownership structure of the business sector and the creation of a real SME sector. Many countries (such as Finland) have also succeeded in supporting technological trends by implementing strong industrial policies, but in Russia, the efficiency of such policies have often been questioned due to the problem of high corruption. In contrast, a steered technology policy would probably bias the natural development of competitive branches of industries in Russia. In the case of Russia, ensuring macroeconomic stability, continuation of structural reform, opening up the economy, and promoting free competition seem to be the best type of industrial policy in current circumstances.

Opening up the economy would however, be a politically sensitive issue in Russia because high import duties (on average 12–13%) and other trade barriers are used to protect the domestic industry and to dampen import growth. A quick lowering of import

duties would boost imports significantly, which would bring the possible future problems of external balance even closer. In addition, the large-scale industry still has major social obligations inherited from the Soviet era and exposing companies to free competition is politically difficult. Moreover, approximately one-third of revenues in the federal budget come from customs duties (mainly export duties). This probably also explains why in the WTO accession process Russia has negotiated a long transitional period for lowering the duties. If Russia's WTO membership is realised, it will, at least not in the short term, lower Russia's high customs barrier. Increased competition through imports would however be welcome in the medium and long term because it would force the Russian industry to increase the efficiency of production and improve the quality of products.

Russia also urgently needs more investments. The investment-to-GDP ratio of Russia is only slightly less than 20%, which is considerably lower than that of the other countries with rapid economic growth. Growth has been achieved by maximum utilisation of Soviet-era infrastructure, which is now starting to disintegrate. This applies to the whole economy, and particularly to the energy industry, where rapid growth of production witnessed since 1998 has been achieved by utilising mainly old Soviet-era technology and through repair investments and where long-term production capacity has hardly been raised. As for gas, Russia already fulfils its international export obligations by increasing the import of Turkmenistan gas. Some energy consulting agencies have suggested that Russian oil production will start to decline already after 2010 if investments are not rapidly boosted. Across the economy as a whole, growth in investments – both in domestic and foreign – will not accelerate significantly unless there is an improvement in the investment climate.

The risk of a natural resource curse is more imminent than ever before, and Russia shows clear symptoms of Dutch disease. The competitiveness of sectors other than the natural resource industry will wither with the appreciation of the rouble and growing imports. So far, the price competitiveness of the Russian industry in the domestic market has been based on a high customs barrier. Russia however needs not only the natural resource industry but also other competitive export products and areas of know-how (other than the state run military, space and aviation sectors) that it currently lacks and hardly manages to create by home-made government-controlled diversification of the economy. It seems that during Vladimir Putin's two presidential terms, natural resources have thus far been more of a blessing than a curse. Economic growth has been boosted by the long-continued rise in oil prices. Russia is no longer the highly-indebted economy in transition that during the 1998 crisis neglected its international debt obligations. In contrast, today Russia is an important financier of global imbalances and the 11th largest economy in the world. A clear policy of diversification, together with continued structural reform and opening of the economy will eventually provide Russia with a good basis to avoid too strong a dependency on natural resources and the curse possibly resulting from it. Russia however needs a much bolder economic policy than the current if it wants to create a competitive, modern economy and achieve sustained rapid long-term growth. One thing is however certain: the next president of Russia will have a different basis for economic policy and face larger challenges than his predecessor.

Merja Tekoniemi

## Economic growth from the regional perspective

### New moves in regional policies

Economic growth in Russia remained strong in the 2000s. However, this has not led to the narrowing of regional differences, which have – in many cases – actually increased. Consequently, the best performing regions have grown more rapidly than others measured by several indicators. According to the regional policy programme released in 2005 (*Konseptsiya Strategii sochialno-ekonomicheskogo razvitiya regionov Rossiiskoy Federatsii*), the state seeks to address the situation using new measures. If the programme is approved the current policy, aiming solely at evening out income levels between regions, will become secondary. The focus will be shifted to a so-called growth pole approach, according to which regional development is supported on the basis of the specific needs of the various regions. This means that the regions would no longer be regarded as directly comparable, but that the benchmark and measure of success would be the reference group of each region, ie the category in which a region belongs to on the basis of the combined effect of several indicators.

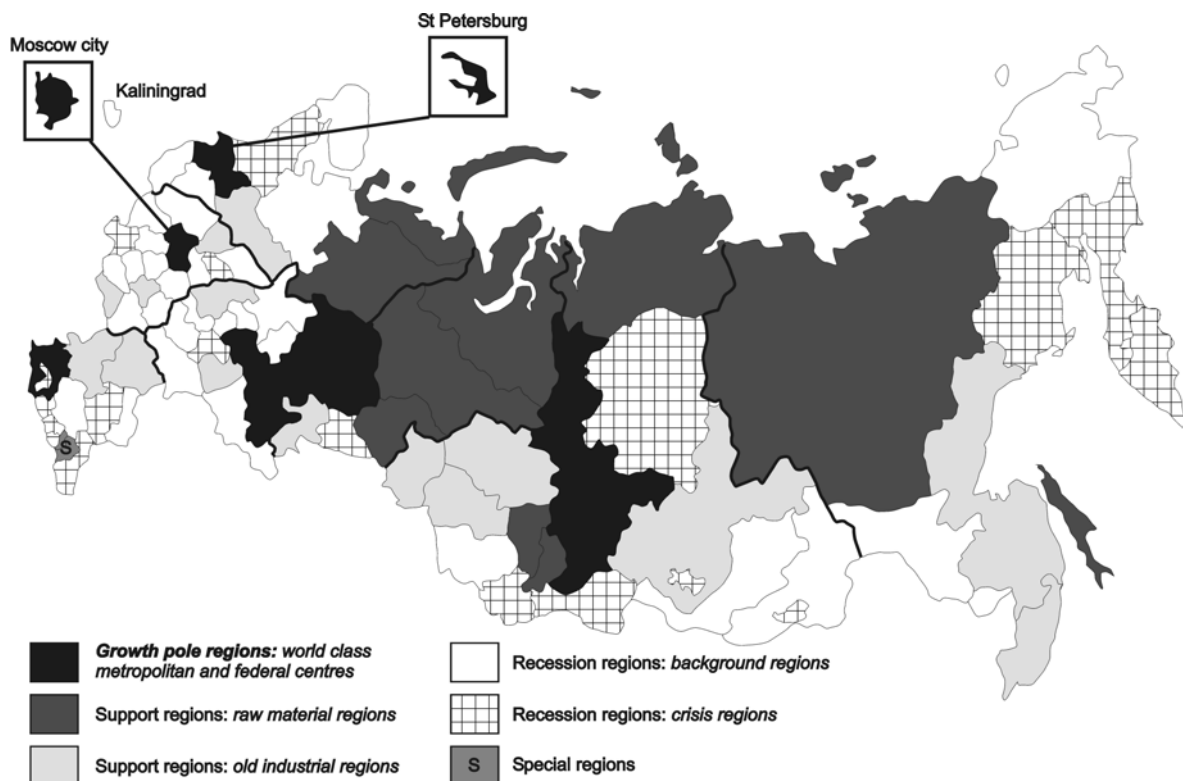
Some of the new programme's measures have already been implemented. According to the new regional classification issued by the Ministry of Regional Development in early 2007, the various regions are divided in four main categories and six subcategories. **Growth pole regions** comprise two cities regarded as world class metropolitan centres, ie Moscow and St Petersburg, as well as eight other growth centres. It is intended that special emphasis be put on the growth and development of these regions in particular. Growth is considered as diffusing from them to even larger hinterlands and enhancing growth in Russia as a whole. Growth pole regions can be found in all of Russia's federal districts except for the Far East (see Map 1). **Support regions** include both raw material regions and old industrial regions. **Recession regions** are divided into background regions (*fonovyye*) and crisis regions. The Republics of Ingushetia and Chechenia are classified as their own group, the **special regions**.

The regional policy programme is closely connected with the formulation of a so-called regional development plan, specifying what kind of regional policy is to be applied to the various regional categories. According to the regional policy programme, the drafting of the development plan was supposed to begin in 2006 and last for several years. Even though there is not yet specific information on the contents of regional policy in respect of the various regional categories, the regional classification of the Ministry of Regional Development identifies some objectives and problems relating to specific regional categories, intended to be addressed with regional policy.

The objectives concerning the *world class metropolitan areas and other growth poles* (10), include developing infrastructure, attracting global companies to locate their head offices in these regions as well as establishing or relocating there administrative bodies important at the federal level. *Raw material regions* (9) suffer similarly from inadequate infrastructure, but their needs are considerably greater than those of world class metropolitan centres. Their specific problems also include conflicts of interests arising

from the reconciliation of ecological, indigenous peoples' and raw material companies' viewpoints. The intention is to remove part of population from the northern raw material regions to other areas in a controlled manner. *Old industrial regions* (15) are faced with problems such as weak market position, a lack of skilled labourforce, technologically outdated equipment in industry as well as the prevailing low standard of living. The intention is to establish special economic zones in these regions. The problems of *background regions* (32) seem to be fairly similar to those of old industrial regions, and it is unclear how these categories differ from each other. *Crisis regions* (20 + the special regions Chechenia and Ingushetia) are characterised by clearly backward socio-economic indicators, high unemployment, social conflicts and weak city infrastructure with regard to growth. The purpose is to stimulate growth in crisis regions by developing infrastructure, promoting regional programmes aimed at improving employment growth, increasing labour mobility and granting budgetary support.

Map 1. Russian regions classified according to growth pole approach



Source: Ministry of Regional Development

The regional policy programme makes separate mention of innovation zones and regional clusters. An innovation zone is a broad upper concept which includes science cities, technology centres, research-oriented universities and special economic zones. Officially, there are over 10 science cities in Russia at the moment, the majority of which are situated in the Moscow Region (*oblast*). In 2006, six special economic zones were established, two of which concentrate on industrial production (Lipetsk, Jelabuga) and four on technological development (Dubna and Zelenograd in the Moscow Region, St Petersburg

and Tomsk). In addition, in February 2007 the government decided that special economic zones focusing on the production of tourism and recreation services will be established in the regions of Irkutsk, Zelenograd, Sochi, Krasnodar, Altai and Stavropol. Special economic zones for harbour services are also being planned. Within the special economic zones companies receive custom and tax reliefs and commit to making certain levels of investment in the region concerned. For its part, the state participates in the construction of the area's infrastructure.

A Cluster in the concept of the regional policy programme refers to a group of geographically neighbouring companies engaged in fundamentally interlinked fields and competing with each other. There are currently no globally significant clusters in Russia according to the programme. Clusters are regarded as an appropriate instrument that would support growth of small and medium-sized companies in particular. The state does not intend to actively establish clusters; rather, it wishes to promote their growth and development for example with infrastructure investment, education and research.

Based on the new regional policy programme, changes in the specific regional policy arrangements currently applied can also be expected, although there is no reference to this in the programme. It is unclear whether the current policy applied, for example, to the northern regions will continue if the new regional policy programme is finally approved. One logical alternative would be that the current policy would be renounced and the subsidy policy would be revised accordingly. In any case, the new regional policy framework indicates solutions different from those applied currently in the northern regions that are highly heterogeneous and fall under various regional categories. The fact that the state has approved and subsidised several specific programmes relating to individual regions in recent years could in turn indicate that similar programmes will also be implemented in future as part of the new regional policy.

Further ongoing regional policy priorities include fiscal-federalistic issues, ie issues related to the distribution and use of public funds between different administrative levels, the reduction of the number of regions and local government reform.

It is intended that the new regional policy framework will promote the general objectives, ie economic growth as well as higher welfare and standard of living. The programme outlines clear results aimed for with the implementation of the strategy. In the short term, administrative decisions can be transmitted faster and more successfully from federal centre to the regional level, cooperation between regions will increase and federal funds can be used more efficiently. In the medium term, population mobility will increase and cooperation between neighbouring countries' border areas will also strengthen. In the long term, there will be one own globally important federal subject<sup>1</sup> in Russia, the number of crisis regions will be decreased and Russia will remain regionally coherent.

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<sup>1</sup> Russia's administrative units at regional level (eg. republics, krais, territories etc.).

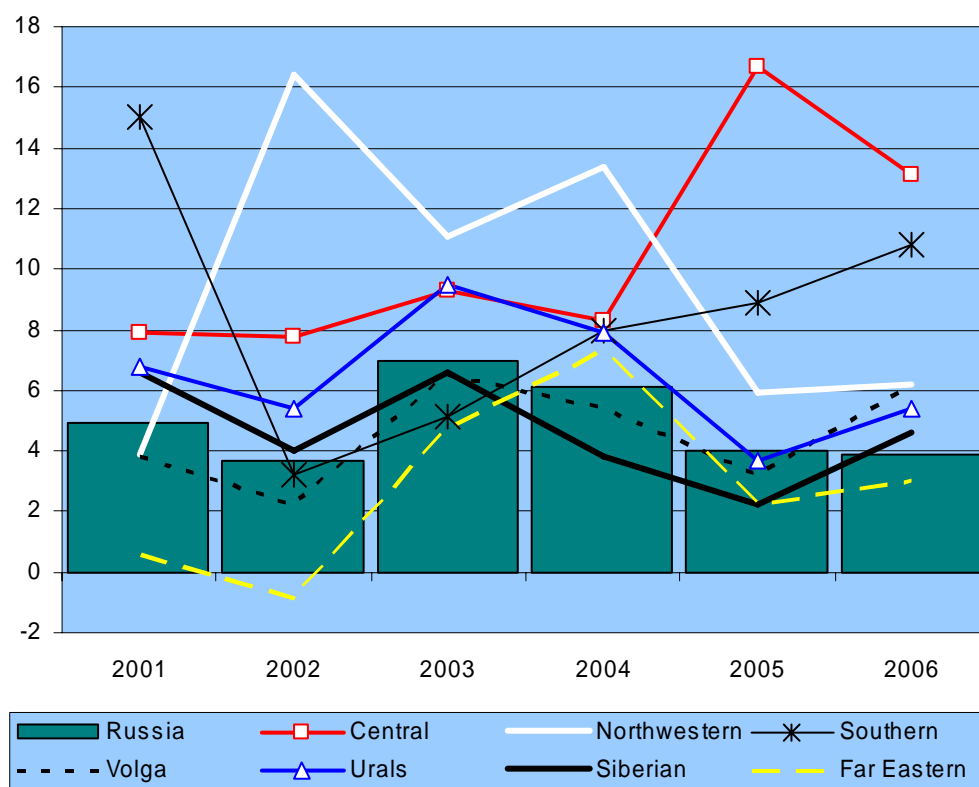
## Economic development in regions in 2006

Measured with various indicators, economic growth in Russian regions continued to develop very unevenly, although mainly favourably, in 2006. Differences between federal districts and between regions did not decrease considerably, and even within and between regions there were significant differences at the local administration level. The following chapters discuss regional development in industrial output, investment, income and retail sales in 2006.

### Industrial output continues to grow mainly at robust pace

Industrial output growth accelerated in all Russia's federal districts in 2006, but varied from 3% in the Far East to 13% in the Central Federal District. Even though the latter posted the highest growth rate, it was also the only federal district where growth slowed. Industrial output has continued to increase for several years in the Southern Federal District, and the pace of growth has strengthened continuously. (see Chart 1.)

Chart 1. Annual industrial output growth by federal district, percentage change



Source: Rosstat.

There were large differences in industrial output growth rates between federal districts, but the development was mainly positive. Industrial output grew by over 10% in almost 20 regions in 2006. The fastest growth rates in industrial output were observed in the Kaliningrad Region (68%), where growth has been markedly robust already for several



years. A federal programme for the development of the Kaliningrad Region up to 2010 was approved in 2001, and new legislation concerning the special economic zone of Kaliningrad came into effect in April 2006. Industrial output continued to grow at a very brisk pace also in Moscow and the Moscow Region, by about 18% year-on-year, although it slowed compared to the growth spurt in 2005.

Industrial output remained at 2005 levels or declined slightly in little over 10 regions. These include the city of St Petersburg where industrial output was 7 percentage points lower than in 2005. The level of year-on-year industrial output growth has varied considerably in St Petersburg, dropping from over 30% in 2002 to negative growth rates in 2006. The result for 2006 is mainly attributable to the clear fall in the production of machinery, equipment (especially electrical, electronic and optical equipment) and vehicles. Positive developments were registered in turn in the production of food, beverages and tobacco (11%). Despite the reduction in industrial output, St Petersburg is still one of Russia's most important industrial producers and has attracted large investments in recent years. The service sector also accounts for a considerable share of St Petersburg's economy, and preliminary data indicates positive development in the service sector, compensating the downward trend in industrial output. Industrial output growth has also varied in the Leningrad Region surrounding St Petersburg, although not as strongly as in the city of St Petersburg. In 2006, industrial output in the Leningrad Region grew at a robust rate (27%).

Industrial output growth has slowed in Russia's main oil and gas producing regions. The Khanty-Mansi Autonomous District saw industrial output grow by nearly 8% in 2005, but only by over 2% in 2006. In the Yamalo-Nenets Autonomous District, industrial output dropped in 2005, and last year it grew by slightly more than 1%. However, the aggregated share of these two regions in Russia's total industrial output is still considerable (almost 14% of Russia's total industrial output according to data from 2005).

Investments are increasing, but concentrating each year on almost same regions

In 2006 Russia's *fixed investment* increased by 14% and accounted for less than 20% of GDP. Over fourth of investments went to the Central Federal District, 17% to both the Volga and the Urals Federal Districts, 14% to the Northwestern, 10% to the Siberian and the Southern and 7% to the Far Eastern Federal Districts. The breakdown corresponds roughly to the cumulative breakdown of fixed investment in 2000–2006. It also shows clearly Russia's most important federal districts in terms of GDP and industrial output.

Investment within the federal districts is highly centralised, as over half of the investments were concentrated on 12 regions. The Moscow city received over 12% and the Moscow Region 5% of Russia's total fixed investment. The Khanty-Mansi region received almost 7% and St Petersburg, Yamalo-Nenets and Tatarstan about 4% respectively. Other major investment areas included Krasnodar, Sahalin, the Leningrad Region, Bashkortostan, Rostov, Krasnoyarsk and Kemerovo.

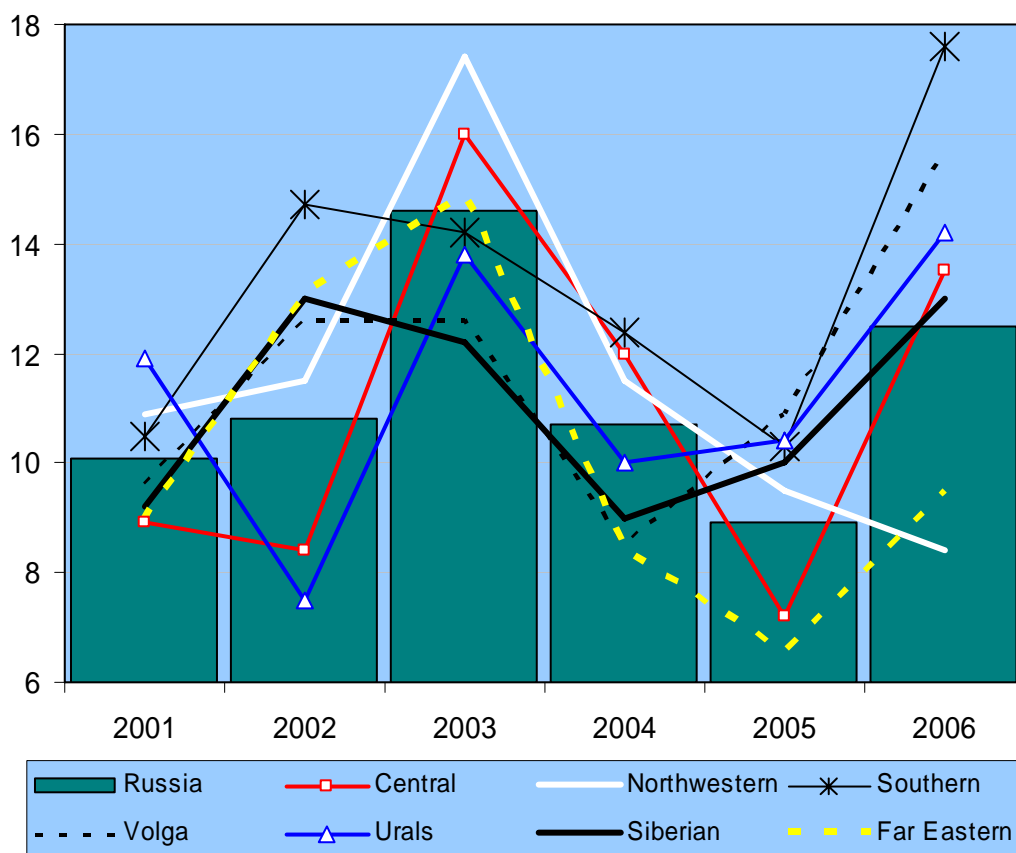
Investment levels vary considerably year-on-year, according to their nature. In 2006, annual investment grew by over 50% in some Russian regions where investment inflows have not traditionally been large and where industrial output growth has been slow. Investment inflows are still relatively small, but due to the low base level, the percentage growth is high. These regions include the Republic of Khakasia, the Arkhangelsk and the Tomsk Regions as well as the Autonomous Districts of Nenets, Aginsk-Buryat and Koryak. Growth spurts are caused by individual projects significant for the region, which in undeveloped regions are probably financed with federal budget funds.

**Foreign investment** is even more centralised than fixed investment on the whole. In 2006 approximately half of foreign investment (USD 30 billion) was made in the Central Federal District, with the majority flowing to the city of Moscow and the Moscow Region. St Petersburg's share of total foreign investment grew markedly in 2006 and totalled almost 10%. Considerable investments were made in the Far East, on account of energy projects in the Sakhalin island. In 2006, the Far East accounted for 12% of total foreign investment in Russia and almost 30% of total foreign direct investment. This also corresponds largely to the share of the Far East Federal District in cumulative foreign investment in 2000–2006.

Real income is increasing fast, but income differences remain large

Russians' income continued to grow fast in 2006, while income differences between federal districts, regions and population groups remained large. The Gini index measuring the equality of income distribution between population groups was 0.41, signifying very uneven income distribution. The top income quintile (20%) received almost half of the total monetary income in Russia, whereas the bottom income quintile received little over 5%. The share of the top quintile grew slightly compared with 2005. Monetary income per capita was over 11 times higher in the richest federal subject (Moscow city) compared with the poorest (Ust-Orda Buryatia Autonomous District).

Chart 2. Annual real income growth by federal districts, 2001–2006, percentage change



Source: Rosstat.

Real income increased by 13% in Russia as a whole in 2006. At 18%, growth was fastest in the Southern Federal District and slowest in the Northwestern Federal District that still recorded a growth rate of over 8%. Differences in growth are also naturally affected by the base level of income and wages, which in the Southern Federal District, despite the fastest rate, is the lowest in the entire Russia. Real income growth has slowed every year in the Northwestern Federal District since the growth spurt of almost 18% in 2003 (see Chart 2). On the other hand, income has increased very unevenly even in the Northwestern Federal District. In 2006, after several years of fast growth, real income growth came almost to a halt in St Petersburg. By contrast, in the Leningrad, Novgorod and Kaliningrad Regions real income grew clearly by over 20%.

Moscow's position as a retail trade centre is high, albeit declining

Retail trade, illustrating consumption growth, continued to increase very rapidly in 2006. Annual growth was slowest, but still almost 12%, in the Central Federal District. The fastest growth rate was recorded in the Urals Federal District, where annual growth in retail trade was as high as 19%.

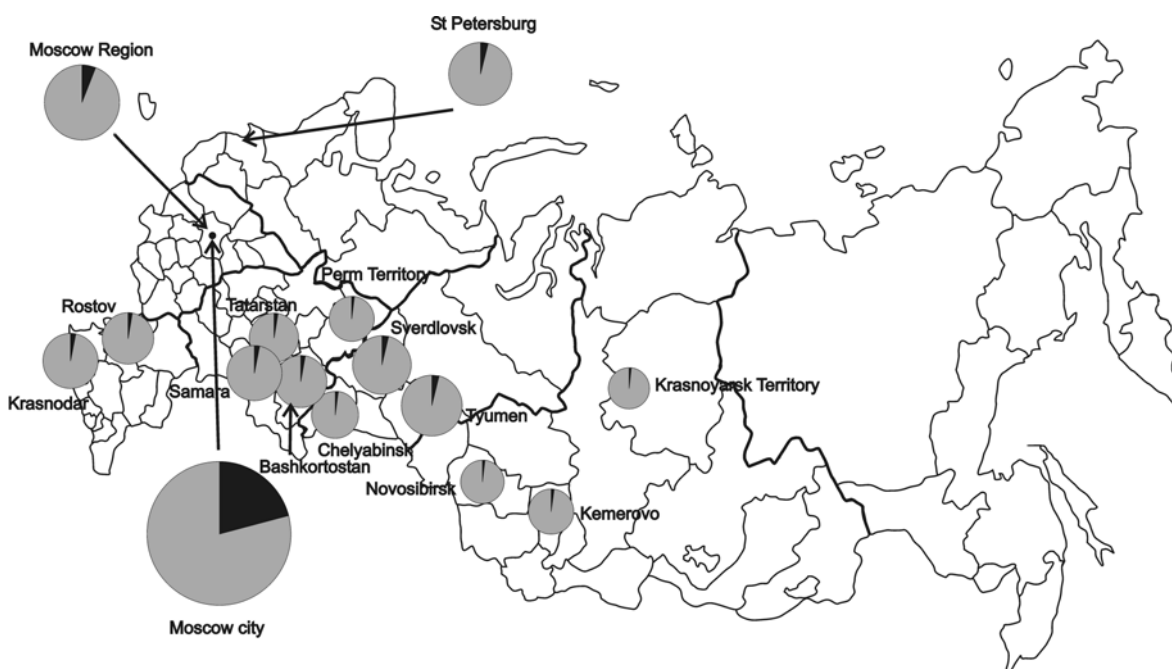
Since retail trade is growing more slowly in the Central Federal District than in the other federal districts, the region's share in Russia's total retail trade is decreasing. The trend has been visible throughout the 2000s. In the period from 2001 to 2006 the share of Central Federal District in Russia's retail trade has decreased by over 6 percentage points, even though it is still considerable, at 36%. The Urals, the Southern and Volga Federal Districts have increased their shares at the expense of the Central Federal District, while the Northwestern and Far Eastern Federal Districts seem to have stabilised their shares at 9% and 4% respectively.

Turning to developments in the most important individual federal subjects, Moscow city alone accounted for over one-fifth of Russia's total volume of retail trade in 2006. In 2001 its share was still almost 30%. Even though the disparity with the second largest retail trade centre is narrowing, it is still significant. The Moscow Region accounted for almost 6% of the total volume of retail trade in 2006, but its share has increased markedly from the 4% in 2001. Growth has accelerated in the past three years. St Petersburg increased its share to 4% in 2006.

In addition to the retail trade centres in the city of Moscow, the Moscow Region and St Petersburg, the retail trade centre situated in the southern part of the Urals Federal District has grown significantly in the 2000s. It comprises the Tyumen Region and especially the Khanty-Mansi Autonomous District as well the Sverdlovsk and the Chelyabinsk Regions. The share of these regions in Russia's retail trade has grown from over 7% in 2001 to nearly 10% in 2006.

The Volga Federal District has a retail trade centre comprising Tatarstan, Samara, Bashkortostan and Perm. This also increased its share slightly, and in 2006 it accounted for about 10% of the total volume of Russia's retail trade. The Southern Federal District has the retail trade centre of Krasnodar and Rostov (6%). Some individual important retail trade centres situated in the Siberian Federal District include Krasnoyarsk, Kemerovo and Novosibirsk. There are no important retail trade centres in terms of volume and from the point of view of Russia as a whole in the Far Eastern Federal District. (See Map 2.)

Map 2. Largest retail trade centres in Russia in terms of volume in 2006



The size of the pie chart corresponds to the volume of retail trade and the darkened sectors illustrate the share of the trade centre in Russia's total retail trade.

Source: Rosstat.

## Summary and conclusions

The positive development of Russia's regions in the 2000s has mostly been driven by certain regions. These regions have largely remained the same so far, and no new important growth regions have emerged. The new regional policy programme aims at expanding growth in future. However, it is not yet known precisely what kind of regional policy measures are intended to be implemented in the different regional categories and individual regions and what the size of financial investments they would require is. It is therefore difficult to compare the effects of the new regional policy with the current situation. This notwithstanding, some issues can be highlighted.

In the 1990s Russian regional policy consisted of a group of fragmented measures mostly aiming at evening out income levels between regions. It is positive that the new regional policy approach also understands the inefficiency of going to extremes in this issue, which has also become evident in practice by the ongoing widening of income differences among regions. Excessive evening out of income levels could become a disincentive for prosperous regions to maximise results and an incentive to weakly performing regions to avoid implementing reforms.

In principle, despite the good starting point, the new programme seems to include some features resembling the Soviet planned economy. Instructions on compiling the economic programmes, approved by the Ministry of Regional Development, have been

issued to the regions. The distribution of federal funds partly depends on the programme drafted. However, regions should be given ample freedom to define their own regional policy and change it according to their particular circumstances. It is important to enable healthy competition and cooperation between regions by reducing excessive centralism. However, as regional budgetary finances are anyway strongly in the hands of the federal centre, it has a strong say in all other questions as well. Practically speaking, the hands of the regions are therefore tied by guidelines issued from above. Whether the 'limits' are too strict remains to be seen.

Currently, the majority of regions is growing, albeit at very differing pace. Regions with highest industrial output growth in 2006 were concentrated in the western part of Russia, particularly in the Central Federal District in the Moscow surroundings, in the Northwestern Federal District in the Leningrad and Kaliningrad Regions, and in the Southern Federal District in the Krasnodar Region. In the Volga Federal District, industrial output exceeds the nationwide average in several federal subjects. Growth weakens towards the east and in Far East only the Sahalin and Primorsk Regions are growing. Investment concentrates on areas that are important in terms of industrial production, but significant investments have also been made in recent years in some small and weakly growing regions.

Income is increasing all over Russia, but growth has slowed since 2004 in the Northwestern Federal District. Higher income is also reflected in the increasing number of retail trade centres growing in terms of volume. The Moscow Region is becoming more important at the expense of Moscow city, even though the Region has not yet undermined the city's undeniable position as Russia's premier retail trade centre. In addition to the Moscow Region, some other retail trade centres have strengthened their positions.

Seija Lainela

## Fiscal policy challenges

Fiscal policy conducted in Russia is currently undergoing a change of course as a result of an extended period of strengthening in central government finances.

Russia – and President Vladimir Putin – have been very lucky in the 2000s as regards the country's economic performance. The unparalleled elevation of world market prices for oil and other raw materials has led to an enormous boost in export earnings and on-budget tax revenues and duties, on which Russia's recently enhanced economic and political weight is partly based.

Less attention has been paid to the fact that the situation has also greatly been influenced by a successful domestic economic policy. Following the rouble's collapse at the end of the 1990s, the pursuit of a consistent fiscal policy was initiated in order to stabilise the economy. Meanwhile, structural and institutional reforms launched in the 1990s to introduce market economy started to bear fruit and enabled new policy implementation.

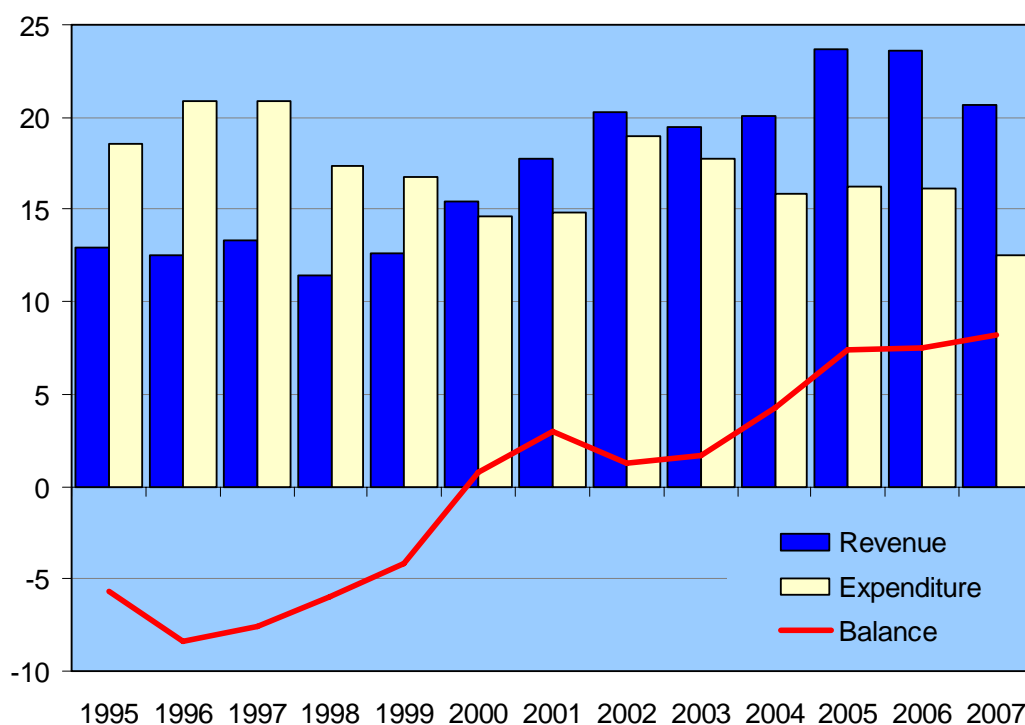
## Stabilisation of the economy

Central government finances started to gain strong momentum from 2000 onwards, when the federal budget was in surplus for the first time, with surpluses persisting since then. Despite substantial increases in tax revenue, public-sector expenditure was not allowed to expand in the same measure, as the economy had to be stabilised and inflation that had been rampant after devaluation in 1998 had to be contained as rapidly as possible. The 1998 fiscal collapse taught Russia the importance of responsible budgetary policies. The Ministry of Finance, led since 2000 by Aleksei Kudrin – one of the country's longest-serving ministers – naturally assumes main responsibility for the conduct of consistent policies, but it is clear that the Ministry enjoys the Kremlin's backing.

Public-sector expenditure has grown in real terms in the 2000s, but its increase has not exceeded GDP growth. Such expenditure restraint would be a respectable achievement for any European country, but particularly so for Russia. The country's budget and tax systems were only taking shape at the beginning of the 2000s and central government finances in the previous decade had been characterised by short-termism bordering on chaos. On top of which, public-sector financial requirements are, as a legacy from the Soviet era and the subsequent transitional period, immense, as is well known.

Although there has been upward pressure on budget expenditure figures, it has not been much discussed in public owing to Russian political culture, with the main parties backing the Kremlin's stance in economic and other policies. The current political culture includes the maintenance of a public image of the President as a good governor who acts in the best interest of his people. According to this image, the reason for defects is that ministries and officials are not always able to realise the President's objectives. Presidential popularity does not suffer, even if the policies might be inconvenient for the people.

Chart 1. Federal budget revenue and expenditure, % of GDP



Sources: Rosstat, IMF and Ministry of Finance.

## Maintenance of stability

An important step forward in maintaining budgetary discipline was taken in 2004, when an off-budget stabilisation fund was set up on the initiative of the Ministry of Finance. The aim of the fund is to adjust the budget for cyclical windfall revenue and to ensure expenditure financing in those years in which budget revenue is lower than normal for cyclical reasons. The fund is currently accumulated through taxation and duties on crude oil production and exports in so far as the world market price for the Russian Urals oil exceeds USD 27 per barrel. The assets of the stabilisation fund have increased rapidly, to almost USD 114 billion at the end of April 2007, equalling about 10% of GDP.

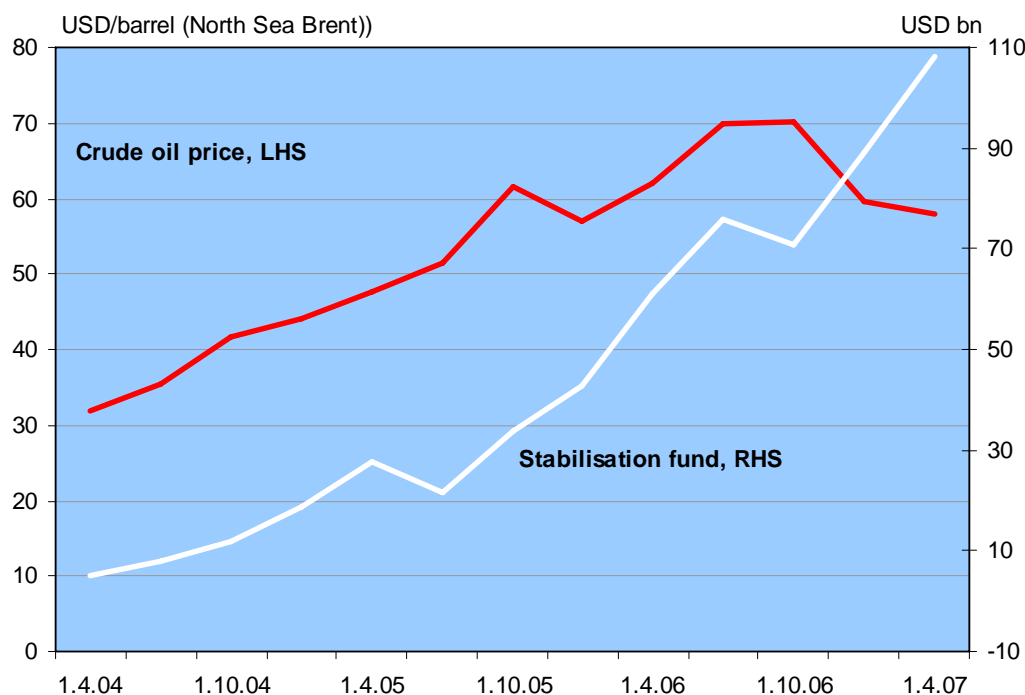
There has been ongoing debate on the accumulation, return on, and use of the stabilisation fund assets within economic and government circles, as the administration of the fund lacks a comprehensive legal basis and is largely dependent on individual decisions. As a result, the Ministry of Finance has sought to establish legally documented rules for the fund.

In April 2007, Parliament passed a new law on the budget system that will essentially alter the stabilisation fund, imposing strict rules on it. The law extends the base for the accumulation of fund assets, as part of taxes and duties levied on gas will also be deposited in the fund as from the beginning of next year.

Next year, the stabilisation fund will be divided into two parts: a reserve fund with an upper limit of 10% of GDP and a Norwegian-style oil fund, a fund for future generations, to which the portion of income exceeding the reserve fund's upper limit will be transferred. According to the Ministry of Finance, government finances will be secured by the reserve fund for three years in the event of an oil price fall to about USD 30 per barrel. The assets of the reserve fund are held in foreign currencies and administered on the same principle as Russia's total foreign reserves, with security and liquidity being the main investment criteria.

In his customary spring policy statement at the end of April, President Putin renamed the fund for future generations as the national welfare fund. Assets in the fund are to be used for financing major reforms, such as covering the financial deficit for the reformed pension system.

Chart 2. Stabilisation fund and crude oil price



Sources: Ministry of Finance and Bloomberg.

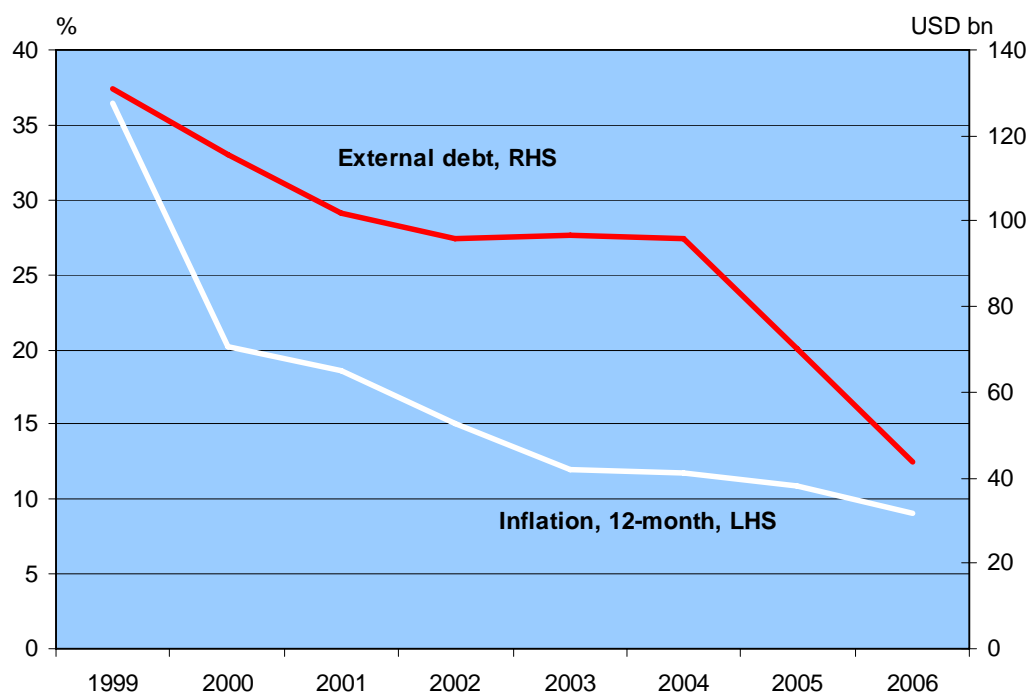
## Achievements brought by stability

On account of underdeveloped financial markets, the central bank did not have access to adequate instruments for absorbing the inflow of huge export earnings from the market. This task was partly assigned to fiscal policy, which has handled the task through budget surpluses. Although other factors have also played a role, moderate fiscal policy has been the key to curbing inflation. A gradual decline in the upward trend of consumer prices has been achieved, even if price hikes are still relatively strong, close to 8% annually.



Another important achievement is that, by using budget surpluses, Russia has repaid its external debt ahead of schedule. The state, insolvent 9 years ago, currently has public external debt accounting for only about 5% of GDP, which is an exceptionally low level by international standards. Russia's international credit rating is presently good and Russian companies' chances of obtaining finance from external sources are better than ever, which is reflected in increased foreign borrowing by the corporate sector.

Chart 3. Inflation and public external debt



Sources: Central bank, Rosstat and BOFIT.

## Preparing for the future

The budget system originating from 1998 was fundamentally revamped by the budget law passed in April 2007, in the drafting of which reliance was placed on international experience. The new system was prepared in cooperation with foreign advisers and experience was collected from countries that have moved fastest in the area of results-based budgeting, for instance. Swedish experts, in particular, have been closely involved in building up the system. The Ministry of Finance has aimed at building a more transparent and clear-cut budget system, which would constrain the potential for populist policies and large expenditure increases in coming years. Experts' assessments of the reform are positive and the reform is perceived as strengthening the stability of the budget system.

Upward pressure on public expenditure has picked up in the 2000s, in line with the expansion of budget surpluses and stabilisation fund assets. The Ministry of Finance has sought to refrain from augmenting expenditure during cyclical upswings to levels that would prove unsustainable if the crude oil price were to return to its long-term average.

The new budget law supports this objective by reforming the budget system so that, as from 2008, budgets will be drafted exclusive of taxes and duties on oil and gas, which will be deposited in the reserve fund. This procedure imposes a ceiling on budget deficits to GDP. Deficits will be financed out of assets from the reserve fund and through borrowing, which will also be subject to a maximum limit.

Budgets will be guarded against sudden expenditure increases by a changeover to a three-year budgeting period as from the beginning of next year. This will allow for more long-term expenditure planning and more effective use of assets. Owing to the general election for the Duma in December and the presidential election in March next year, the budgetary preparations for 2008–2010 have been brought forward, with the aim of obtaining Duma approval for the budgets during the summer. Accordingly, the hands of the new Duma and the President Elect next year will be tied by the first three-year budget extending over the next three years.

## New economic policy stance

During the last couple of years, budget policy has been gradually eased, but the budget's expenditure composition has not materially changed. The current year's federal budget saw the largest increases in expenditure for the budget item 'national economy', of which financing is provided eg for energy production and transports, and for the education and health care items. It is worthwhile noticing that increases in defence spending have not generally exceeded average expenditure growth in the 2000s, and have mostly been used to improve the army's social conditions, such as the construction of housing.

Dilapidated infrastructures and low-level public services require immediate remedying, and these problems have already been approached from a new angle in recent economic policy debate. Clearly, one reason for stronger interest is the imminence of Duma and presidential elections.

Table 1. Federal budget expenditure composition in 2006 and 2007

	2006			2007			
	RUB bn	%-osuus	%/GDP	RUB bn	%-osuus	Change from previous year, %	%/GDP
Transfers into funds and regional budgets	1 444	33	5,3	1842	33	28	5,9
General affairs	642	15	2,4	821	15	28	2,6
Defense	659	15	2,6	821	15	25	2,6
Security	540	13	2,0	665	12	23	2,1
National economy	347	8	1,3	496	10	43	1,6
Social policy	217	5	0,8	211	4	- 3	0,7
Education	208	5	0,8	279	5	34	0,9
Health care and sports	156	4	0,9	206	4	37	0,7
Housing and municipal services	53	1	0,2	50	1	- 6	0,2
Culture	51	1	0,2	65	1	27	0,2
Environmental protection	6	...	...	8	...	33	...
<b>Total</b>	<b>4 324</b>	<b>100</b>	<b>16,5</b>	<b>5 464</b>	<b>100</b>	<b>26</b>	<b>17,5</b>

Source: Ministry of Finance.

## Social priorities

Of recent increases in budget expenditure, allocations for social priorities, ie national programmes published by President Putin in a grand style in 2005, have gained greatest public visibility. Four programmes, targeted at improving health care, education, housing and agriculture, have been announced. Additional resources allocated for these programmes account for about 4% of the current year's federal budget expenditure. Assets dedicated to these programmes have been employed to resolve acute problems in the concerned sectors: health care and teaching staff have seen their pay levels revised upwards, missing technology has been purchased, and housing construction and acquisition have been boosted.

Experts criticise the national programmes for their failure to include urgently needed structural reforms. In recent years, reform progress has slowed or even stalled. The health care system, for example, requires a fundamental overhaul to ensure a stable financing base, in order to prevent the collection of obscure charges from customers for nominally free services. Without reforms, not even substantial funding can bring long-term relief to any sector's problems.

## Structure of the economy

Russia has increasingly been witnessing discussion on the need to use government assets for alleviating a major barrier to the country's development: the economy's dependence on natural resources. Diversification of the economy has been declared by the President, the government and political parties as one of the most important tasks of economic policy. In his April policy statement, President Putin strongly emphasised the need to improve the economy's growth potential through public financing.

While still in the early 2000s Russia relied on the private sector as the driver of economic expansion, the current focus is on the role of the state as bellwether and active economic agent. This is reflected in policy statements that have been recently presented for diversification of production structures.

This policy also includes the designation of 'strategic' sectors, which are, above all, the energy sector and transports. Foreign companies only have limited access to these sectors, whereas state-owned companies or companies closely related to the state are encouraged to be active players there. In a number of economic sectors, projects are underway for the creation of 'national champions' – large state-owned corporate groups or corporate groups with close links to the state. The intention is to allocate resources to these companies so as to enable them to assume a leading role in development in their respective sectors. Such sectors include car industry, aviation, shipbuilding and arms manufacturing. In order to support entrepreneurship, special financing institutions, technology parks and projects aimed at fostering high-technology have also been established recently.

In addition to funding through the government budget, the requisite investment is expected to come from the private sector, and a new concept for public-private partnership has been introduced. The private sector's involvement should, in principle, ensure greater efficiency in investment projects, compared with mere public funding. Under the circumstances prevailing in Russia, however, this does not necessarily hold true, as private companies are linked to the state and its decision-making through a number of formal and informal ties.

It is clear that the financing needs for infrastructure and the social sector are enormous and that the public sector needs to assume responsibility for improvements in these sectors. Even so, the Russian operational environment, in which the essential institutions are not fully fledged in all respects and which is prone to bureaucracy, corruption and biased jurisdiction, will not automatically lead to proper and effective use of funds.

## Future outlook

Recent years' large budget surpluses are likely to remain an exceptional phenomenon and Russia's public finances to move closer to balance in the future. The need to step up public funding for raising the population's living standards and developing the economy will remain substantial, whereas a corresponding increase in budget revenue is not to be expected unless world market prices for energy rebound to record highs. The Ministry of Finance has, in its (fairly conservative) budget calculations prepared for the erosion of the federal budget surplus by 2010.

As next year marks the passing of 10 years since the collapse of the Russian economy and the country has in the meantime become prosperous at a robust pace, there is reason to hope that the lesson then drawn from the importance of fiscal discipline will still be remembered. Continuation of the current consensus policy is not necessarily guaranteed for the future.

Heli Simola

## Does Finland benefit from Russia?

Russia's rapid economic growth has also benefited Finland. Finland's trade with Russia has expanded rapidly in the early 2000s and Russia has emerged as one of Finland's major trading partners. In addition, a large proportion of Russia's other foreign trade, imports in particular, passes through Finland as transit traffic. Bilateral investments have been on the rise and travel has increased. Thus, Russia has an influence on the Finnish economy in many ways. The most important impact is naturally related to Finnish exports to Russia, which employ tens of thousands of Finns. In addition to exports, Russia constitutes an immense market area for Finnish companies with a view to business expansion. This section focuses on Finnish exports and business operations in Russia since they provide, at least for the time being, the biggest opportunities for Finland to benefit from the favourable economic developments in Russia.

### Finnish exports to Russia and re-exports

Russian imports have grown very fast in the early 2000s and growth has accelerated in recent years amid huge export revenues flowing into the country. Import demand has increased particularly fast as regards investment and durable goods due to Russians' growing disposable income. Finnish exports to Russia also seem to have kept pace with the development and have concentrated particularly on the most sought-after products, such as mobile phones, electronics, household appliances and passenger cars. Finnish exports to Russia have increased even faster than Russian total imports up until last year. In 2006, however, the growth of Finnish exports to Russia slowed down markedly, particularly due to a contraction in mobile phone exports. Therefore it would seem that Finland has done a good job in maintaining its position in the Russian markets until 2006, when its position seems to have been clearly compromised. According to Russian customs statistics, too, the proportion of Finland in Russian imports has stayed at about 3% throughout the 2000s.

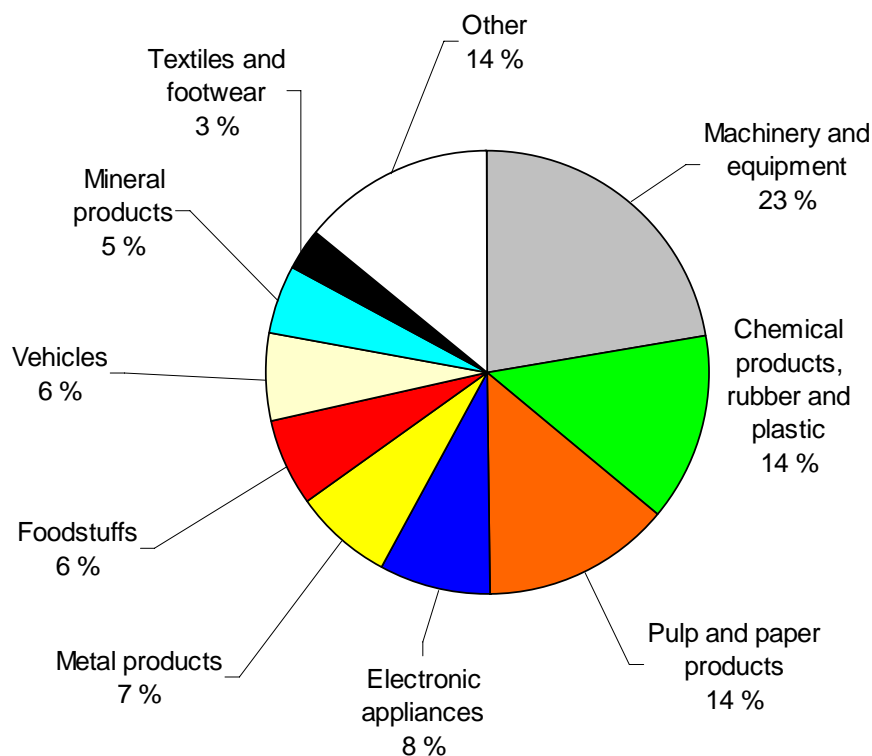
However, review of the development of Finland's market shares is complicated by statistical problems. An increasing share of Finnish exports to Russia in the 2000s has consisted of re-exports. Re-export refers to goods that have been manufactured elsewhere, first imported to Finland and then exported to Russia. Re-exported goods are not processed further in Finland but re-exported as such. They may only be repacked, Russian user instructions may be added etc. Re-export goods are declared in customs as normal imports to Finland and exports to Russia, while transit deliveries to Russia have no impact on Finnish trade statistics. In 2005, the proportion of re-exports of Finnish exports to Russia was a good quarter, and the figure was almost at the same level in preliminary assessment for 2006. The relatively high proportion of re-exports indeed blurs the picture of the developments in Finland's market share in Russia, since re-exports have grown more rapidly than exports of goods manufactured in Finland.

Re-exports have concentrated on passenger cars, electronics, household appliances and certain pharmaceutical drugs. Some product groups can be distinguished fairly clearly as re-exports, since they are manufactured in Finland only in very small quantities or not at all. A more problematic category is mobile phones, which are manufactured in Finland but also transported through Finland to Russia in significant quantities. In the following discussion, all largest re-export product categories have been excluded from Finnish exports to Russia. Among the product categories, mobile phones and drugs also include exports of goods manufactured in Finland, but for simplicity, exports are reviewed completely without these product categories.

## Structure of domestic exports to Russia

The share of re-export product categories in Finland's exports to Russia has grown from less than 16% in 2000 to over 40% in 2006. Finland's exports to Russia, eliminating re-exported product categories, have grown in the early 2000s 16% annually on average, while Finland's total exports to Russia have increased on average 22%, on an annual basis. Hence, growth in exports of re-export product categories has been clearly faster than growth in exports of other product categories up until last year.

Chart 1 Structure of Finland's exports to Russia without re-export product categories in 2006, %.



Source: National Board of Customs, own calculations.

The exclusion of re-export product categories from Finland's exports to Russia change the structure of exports clearly. As shown in Chart 1, the significance of Finland's traditionally important export goods is high in exports to Russia. On the other hand, eg the proportion of foodstuffs in exports to Russia is clearly higher than Finland's other exports. The most important product categories in Finland's exports to Russia are machinery and equipment with a share of about one-fifth in 2006. The combined share of chemicals, plastic and rubber in exports is 14%, at the same level as pulp and paper products. The shares of other product groups are below 10%. The share of electronics would obviously be higher, if mobile phones manufactured in Finland were included in it. In the 21<sup>st</sup> century, the share of machinery in exports to Russia has increased significantly, and the share of mineral products has also increased somewhat. In contrast, the share of foodstuffs has contracted quite significantly.

In comparison to Russia's other major trading partners' (EU, United States, Japan, China and Korea) combined exports to Russia, the structure of Finland's exports, excluding re-export goods, is quite similar. However, in Finland's exports to Russia, the shares of foodstuffs and textiles are smaller, while the shares of pulp and paper products and mineral products are much higher in comparison to the exports of other countries. When re-export product categories are excluded, Finland's exports are slightly weighted towards industries with slower growth. Exports to Russia are certainly growing relatively rapidly in all sectors, since even in the category with the slowest growth, foodstuffs, combined exports have grown annually on average by 14% in the 2000s. Average growth has also been slightly slower than total exports growth in pulp and paper products and mineral products.

## Finland's market share in Russia decreasing

Exclusion of re-export product categories from Finland's exports to Russia also changes the picture of the development of Finland's market share in Russia. The development of market share is assessed in this review by comparing Finland's exports to the combined Russian exports from the EU countries, the United States, China, Japan and Korea. The combined share of these countries in Russian imports has remained at about two-thirds in the 2000s. The benchmark in the assessment of market share is the combined exports from the largest export countries instead of Russian total imports, since Russian customs statistics do not record all imports actually entering the country, by a long shot. The combined exports of the benchmark countries to Russia increased in the early 21<sup>st</sup> century by an average of 26% annually, while Finland's exports grew clearly more slowly.

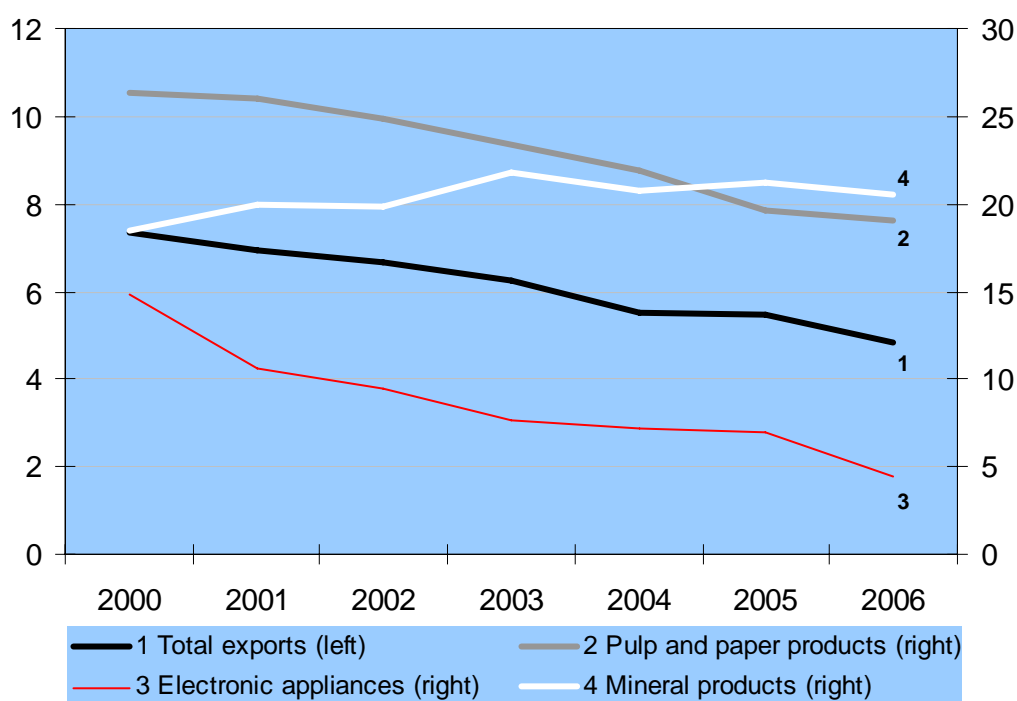
When assessing Finland's exports to Russia eliminated of re-export product categories at an aggregate level, it becomes apparent that Finland's market share in Russia has actually diminished slowly for almost the entire 2000s, to date. In 2006, the market share decreased slightly more than before but by no means dramatically, when mobile phones are excluded. On the whole, Finland's share of the combined exports to Russia of the benchmark countries has dropped from the good 7% in 2000 to less than 5% in 2006. However, the exclusion of mobile phones slightly overemphasises the contraction in Finland's market share.

When the development of Finland's market share is assessed by sector, it is seen that Finland's market share has decreased in almost all product categories. The decrease of



market share has been most noticeable in Finland's traditionally strong export industries, such as paper products and metal products. In paper products, Finland's share of combined exports has dropped from 26% to 19% in 2006 and in metal products from about 11% to less than 5%. In addition, in the exports of electronic appliances, Finland's share has dropped quite significantly: from almost 15% to less than 5%. In Finland's most important export product category, machinery and equipment, however, Finland's share has only decreased a little. Furthermore, in the exports of mineral products, Finland's share has increased by a few percentage points.

Chart 2 Finland's proportion of the combined exports of EU 25, United States, China, Japan and Korea to Russia in certain product categories in 2000–2006, %.



Source: Eurostat, UN, national statistics agencies, own calculations.

Part of Finland's loss of market share is explained by the increased presence of Asian countries in the whole global economy. Exports from Asian countries to Russia, and to the rest of the world, have increased significantly in recent years. Asian countries have won market shares from the whole EU and also the United States. The EU has lost market shares particularly clearly in the exports of textiles and footwear as well as metals and electronic appliances. In contrast, as regards vehicles and also machinery and equipment, Asian countries have expanded their market share particularly at the expense of the United States.

Finland's market share in Russia has, however, decreased also relative to EU countries in most product categories, particularly paper products, electronic appliances and metal products. Finland's share of combined exports from EU countries to Russia has decreased in the 21<sup>st</sup> century from a little less than 10% to a good 6%. Also within the EU, the lower-cost countries in the Central and Eastern Europe have increased in many product categories their share of EU's exports to Russia and other countries as well. In Finland's

traditionally strong export sectors, the paper and metal industries, particularly Poland has emerged as a competitor, whose share in EU's exports to Russia has almost doubled in the 2000s. In contrast, Sweden has been able to maintain its share of EU countries' exports to Russia fairly well and even increase it somewhat eg in paper products, but Sweden still has a significantly smaller share than Finland.

## Operations of Finnish companies in Russia and exports

Investments made by Finnish companies in Russia may also have an impact on the development of exports to Russia. However, this impact is not fully unequivocal; rather it depends on the nature of investments. Investments may replace exports when manufacturing of the same product in its entirety is launched in the local markets. In this case, investments may be considered an alternative to exports. However, investments may also increase exports. Agencies and distribution points of Finnish companies promote awareness of the products in the markets and facilitate their availability. In addition, production in Russia may require eg machinery or components imported from Finland.

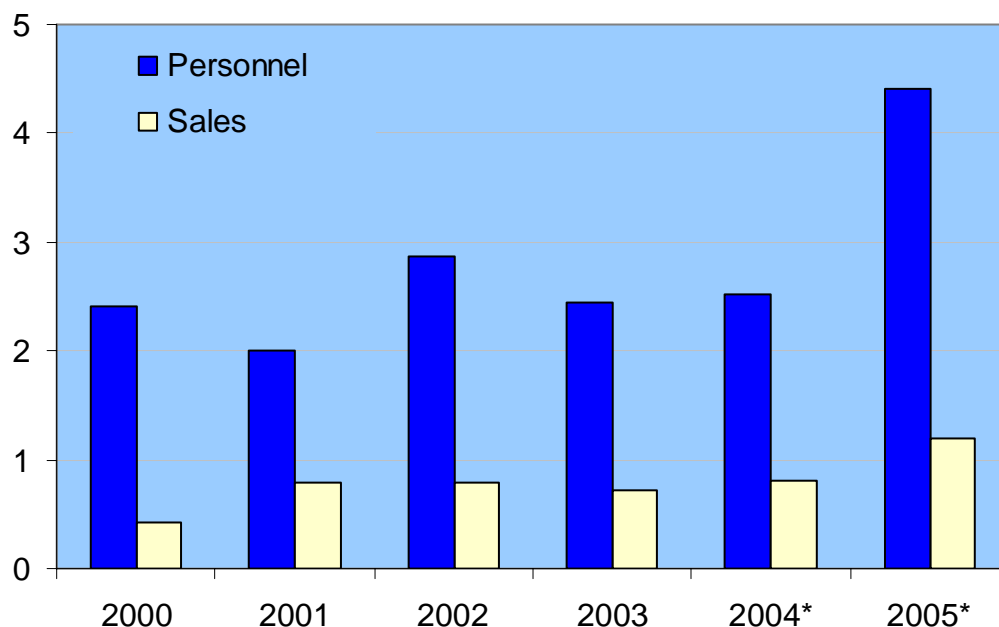
If imports and investments are assessed as alternative operating modes, in Russia's case investments are preferable to exports due to eg arduous and time-consuming border formalities and high duties on certain products. These factors have a similar impact on all Russian borders and not only in Finland, so the related problems or costs may be often avoided only by operating on site in Russia. In addition, investments are attracted by Russia's ample raw material resources and, for the time being, relatively low production costs. On the other hand, exports are better to avoid problems in the business environment and risks related to investments. The short distance also decreases the significance of transportation costs. In addition, the appreciation of the rouble in recent years supports the growth of export demand in particular. Launching of production in Russia is hindered by problems common to all companies, such as the lack of infrastructure, lack of sites and suitable premises and partly of skilled labour.

Companies' foreign operations are often assessed in terms of their direct investments. However, it is difficult to distinguish bilateral flows of certain countries with direct investments in the current global economy. Direct investments primarily illustrate the finance of operations and not the actual operations, thereby not giving the best possible picture at least of companies' production operations abroad. In addition, direct investments are reported in net terms, ie purchases made abroad are recorded less of sales abroad. Therefore, direct investments may indicate low investment activity between countries even if, in reality, there had been large transactions.

Perhaps a better picture of Finnish companies' operation in Russia is provided by statistics on the foreign subsidiaries of Finnish companies. The share of subsidiaries located in Russia of the total personnel and sales of foreign subsidiaries has been rising in the 2000s. In 2005, the share of subsidiaries located in Russia of the personnel in all foreign subsidiaries was already a good 4%. Subsidiaries located in Russia already employed more than 15,000 people. On the other hand, subsidiaries located in Estonia still have more personnel than in Russia, not to mention China. The combined sales of Russian subsidiaries in 2005 was a good EUR 1.5 billion, which, however, only amounted to a good 1% of the sales of all foreign subsidiaries. Since Finnish companies have so far

invested relatively little in operations in Russian markets, it is clear that investments have not had a significant impact on the overall development of exports.

Chart 3 Proportion of Finnish companies' subsidiaries in Russia of the personnel and sales of all foreign subsidiaries, %



\* preliminary data

Source: Bank of Finland.

There are no sectoral statistics on investments made by Finnish companies in Russia or their business operations in Russia, so their connection with exports is difficult to study systemically. In certain sectors, such as the production of foodstuffs or rubber products, Finnish companies have significant production operations in Russia. In these industries, the decrease of Finland's share of exports may partially also be due to the fact that demand is now met by local production instead of by exports.

## Russia's future WTO membership and Finland

Russia's future WTO membership is related to Finland particularly with a view to the opening of the Russian economy. WTO's membership negotiations address issues related to both trade policy and foreign investments, so Russia's membership also has an impact on the economic relations between Finland and Russia. The negotiation process that has lasted already for more than a decade has reached its final stages now that Russia has almost concluded its bilateral negotiations. However, in multilateral negotiations there remain unresolved issues varying from the agricultural subsidies and intellectual property rights that have been negotiated for a long period of time already to the lumber duties that

have surfaced only recently. Russia's membership may actualise at the earliest in the beginning of next year, but the negotiation process may also last considerably longer.

Russia's WTO membership is unlikely to have a major impact on Finland at least in the short term. Russia will lower its import duties by an average of three percentage points and even abolish part of the duties altogether, but all changes will only occur after a transitional period of 1–7 years. Detailed information on duty reductions have only been published to a small degree, but for Finland, the material cuts include eg paper products (on average from more than 10% to 5–6%) and certain pharmaceutical drugs (from 15% to 5–6%). In addition, the predictability of the operating environment is improved by the fact that Russia has to lock its duties in the membership treaty to a certain maximum amount, where they are quite difficult to increase.

With regard to investments, WTO membership is also unlikely to have significant ramifications for Finland. In the service sector, restrictions concerning foreign ownership will be reduced in many sectors, with the exception of sectors defined as strategic by the state or related to them. Furthermore, following membership, legislation relevant to business will have to be brought in line with international standards, but there will certainly be initial difficulties in the implementation of the laws. Generally speaking, WTO membership is a step in the right direction to improving the business environment and to creating closer international economic relations.

## Summary

According to statistics on total exports, Finland seems to have been able to keep apace with the rapid increase in Russian imports up until the collapse last year. However, a large proportion of Finland's exports to Russia are re-exports consisting of goods manufactured abroad and transited to Russia through Finland. Re-exports blur the actual picture of the developments in Finland's exports to Russia. When Finland's exports to Russia are assessed eliminated of re-export product categories, it is seen that Finland's market share has in fact decreased slowly for almost the whole 2000s, to date. However, the negative development is somewhat overemphasised by the fact that the review excludes the exports of mobile phones and drugs manufactured in Finland. The decrease in Finland's market share is partly due to the rapid export growth of particularly Asian, but also European, emerging economies, which has had an impact on all industrial nations. In addition, Finland's exports to Russia are weighing somewhat more than other countries to industries growing slower than average. The operations of Finnish companies in Russia have also increased in the 2000s. Expansion to Russia may contribute to the fact that Finland's exports to Russia are growing slower than exports from other countries, if demand is met with local production instead of exports. Russia's future membership in the WTO is, at a general level, a positive signal of efforts to improve the business environment and to adopt international practices, but in the short term it is unlikely to have any significant practical impact for Finland.

Jouko Rautava

## Russia's challenging location between Asia and Europe

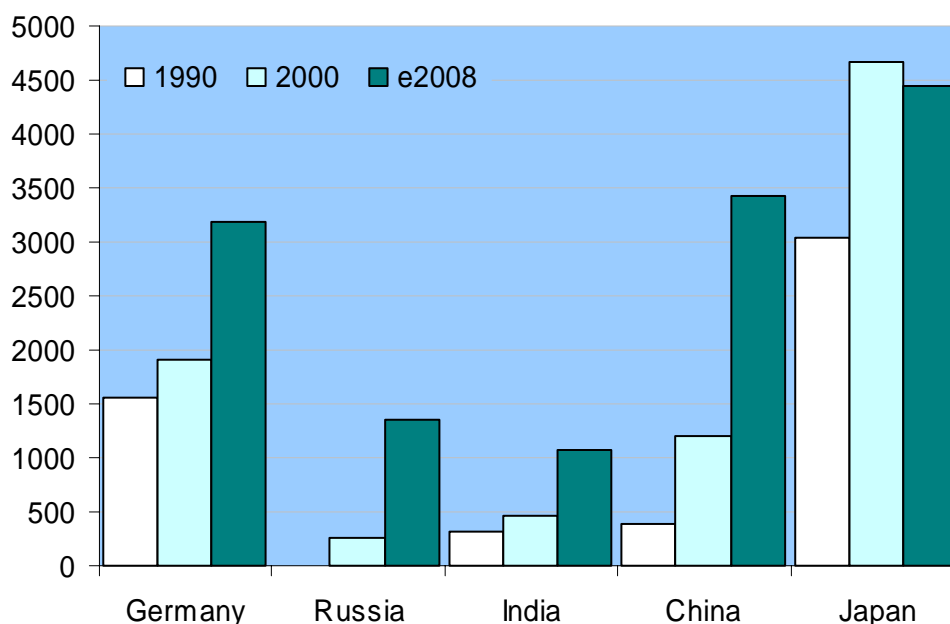
After the liberal market reforms carried out in President Putin's first term of office, economic policy priorities have clearly shifted in his second term from market reform and competition to a growth strategy based on energy and commodities and strong government involvement. The vocabulary of economic policy still includes diversification of economic structure but this goal is pursued through a priority-based approach and industrial policy rather than by a market-driven approach. To evaluate the current trend of Russian economic policy it is useful to examine the role of Russia, situated between the rapidly growing and developing Asia and developed Europe.

### Market size and growth

Last year, Russia's total output, expressed in euro terms, grew by EUR 170 billion to EUR 780 billion. The increase corresponds to the total output of Finland for 2006. From Finland's point of view, Russia has been an important market area in this decade.

Russia has also performed well on the global scale in the present decade and the size of its economy measured by nominal GDP has outgrown India. Despite the strong growth rate, Russian market growth expressed in euros lags behind Europe and China, both of which posted an increase in the value of total output of around EUR 300 billion, last year.

Chart 1 Nominal GDP 1990, 2000 and 2008, USD bn



Source: IMF (WEO).

In a comparison of market size and growth, it should be noticed that the rise of Russia in the present decade has been fuelled by the price developments of energy and commodities. Another factor contributing to market growth was the very strong real appreciation of the rouble. By contrast, the price development of commodities in China and Europe has restricted growth, which emphasises the achievements of China, in particular, in the field of growth policy.

Hence, economic growth in the Putin era has largely been based on exceptional factors, the importance of which will decline in the future. The price of energy and commodities may remain high in the future but they cannot continue their increase at the same rate as in the past few years, which means that the growth dynamics created by the price increases will slow. The real appreciation of the rouble is, in turn, partly related to the collapse of the rouble during the 1998 crisis and it cannot continue to appreciate as much as it has done to date; otherwise the price competitiveness of Russia will be undermined and growth will come to a standstill due to lack of competitiveness.

The problems related to market size and growth are accentuated in the Far East of Russia. Although the Far East Federal District covers 36% of the area of Russia (one and a half times the area of EU), the population of less than 7 million scattered around the area does not make the area an interesting investment object, save for commodities. Many of the problems related to the operating environment of Russia are exacerbated in the Far East, which also contributes to the low attraction of the area.

## The rise of China in Russia

The economic relations between Russia and Europe are more or less established: with a proportion of over 50% of trade, the EU is Russia's most important trading partner, while Russia is an important supplier of energy and commodities to Europe. The situation is different in Asia, where the development of China is rapidly altering the picture.

Sino-Russian trade has grown very strongly during the past few years. According to Russian statistics, exports to China increased to USD 16 billion last year, while imports from China rose to USD 13 billion. Despite its neighbour status and the strong increase in trade, Russia only accounts for approximately 2% of Chinese foreign trade, and Russia's importance as supplier to China is limited to raw timber, oil products and weapons.

From Russia's viewpoint, the situation looks completely different. In spite of the high world market prices for commodities, Russia's share of the Chinese market has not grown. However, the proportion of Russian imports accounted for by Chinese products has increased from 3% at the beginning of the decade to over 9% last year. Russian companies are strongly affected by Chinese imports, as are other foreign companies active in Russia.

Despite requests by Russia, cooperation between the two countries has not led to a diversification of Russian exports, rather trade and cooperation has been conditional on China's need to utilise Russian commodity and energy resources. The Chinese have invested in the Russian energy and commodities sector and also compete with Russian companies in the pursuit of the energy resources of Central Asia. Sino-Russian relations are likely to continue being dominated by energy and commodities in the future, as well.

## Energy

Russia is a key energy and commodities supplier to Europe, as well as increasingly to China and other Asian countries. Currently, Russia satisfies 15% of European crude oil consumption and 30% of imports, while it satisfies a fourth of European natural gas consumption. Russia contributes 24% of French, 31% of Italian and 43% of German gas imports, and in the countries east of them for 60–100% of their needs. So far, Russia's contribution to Chinese oil imports has been clearly below 10% but China's dependence on imported oil is increasing rapidly and Russia is an important source of additional energy.

Russia will undoubtedly continue to be an important supplier of natural resources to Europe and China in the near future, as well, but in the longer term the role of Russia as energy supplier is surrounded by many interesting issues. First of all, the increase in oil and gas production in Russia has slowed considerably from the early years of the decade, while, at the same time, its own energy consumption is growing. According to the Russian government and international observers, Russia should urgently step up its investment in the energy sector to prevent production from making a turn-down in the following decade. To attract investment, the Russian government must consider the introduction of a lower tax on oil production.

Another interesting issue concerns the role of Central Asia in the energy game. In connection with the Ukrainian gas disputes, the countries of Central Asia became aware that they, too, could ask for a higher price for the gas delivered to Russia. This will increase Russia's own energy bill and reduce the profits earned from the transmission of Central Asian gas to Europe. The new energy transportation routes westwards from Central Asia, together with China's strong progress in the area, have undermined Russia's position in the Central Asian energy sector. A third factor worth mentioning is the efforts of China and Europe to reduce their dependence on one energy supplier and increase alternative forms of energy production.

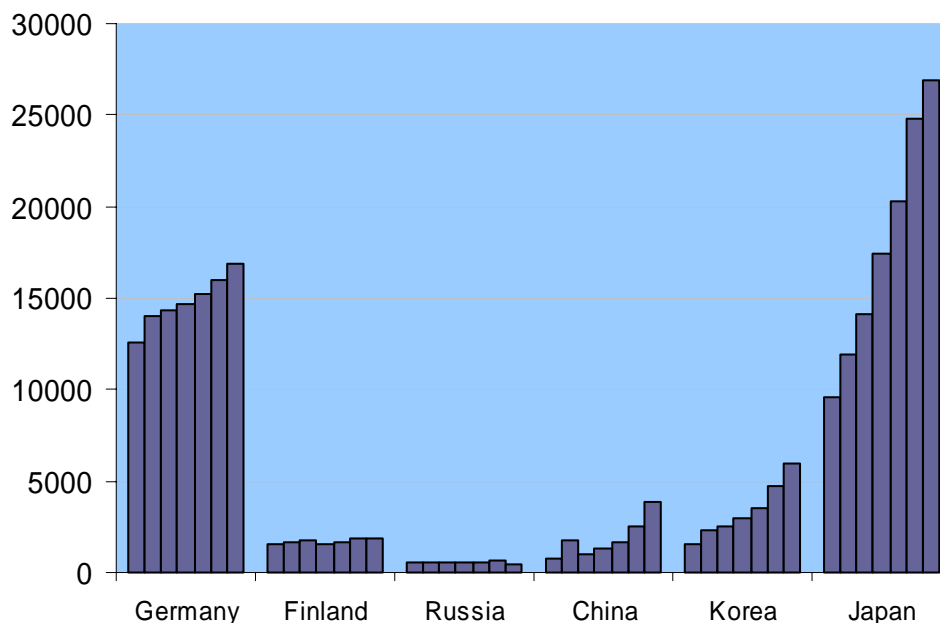
However, perhaps the most important issue in the energy sector is the fact that despite the country's vast natural resources, the energy and commodities resources of Russia are not big enough to guarantee its population of 143 million the high living standards enjoyed in the developed world. In this respect, the situation in Russia differs from that of many oil producing countries with a much smaller population. Calculated at the price of, for instance, USD 60 per barrel, the value of oil production per inhabitant in Russia is below USD 1,500 a year, whereas the corresponding figure for Saudi Arabia is over USD 10,000.

## Technology

The decision-makers in Russia have repeatedly stated that the Russian economy should become more diversified and its dependence on commodities reduced. Recently, in his annual state of the nation address at the end of April this year, President Putin brought this up forcefully by emphasising the importance of technological know-how and innovative ability as a basis of economic development. In accordance with current policy, measures will be taken to establish, under government leadership, a large-scale company, a national high-performer, in the key industries with the mandate to take Russia to the top of the

business in the world. The key industries include, for example, aircraft industry, shipbuilding and nanotechnology.

Chart 2 International patent applications (PCT) 2000–2006, No.



Source: WIPO.

In view of the current situation, these are major challenges. Although Russia possesses leading-edge skills in military and space technology, its location between Europe and Asia is most awkward in the context of commercialisation of innovations and inventions. This is revealed by a review of the developments in international patent applications.

Last year, 145,000 patent applications under the International Patent Cooperation Treaty (PCT) were filed, a third of which originated in the United States, almost a fifth in Japan and 12% in Germany. The strong increase in the number of patent applications from Japan, Korea and China is noteworthy. China has rapidly advanced to 8<sup>th</sup> position in the number of filed patent applications (with nearly 4,000 applications), accounting for 3% of all applications last year. At 14<sup>th</sup> place, Finland, too, is a major global player in the field. Last year approximately 1,900 international patent applications originated from Finland, a good half of which came from Nokia. Russia, by contrast, does not rank among the top countries, which is well illustrated by the fact that Finland is clearly ahead of Russia even when the Finnish figures are adjusted for Nokia.

Research and product development expenditure in Russia represents approximately 1.2% of GDP, against 2.5% for Germany and 3.5% for Finland. Among the Asian countries, the proportion of total output accounted for by R&D is 3.1% for Japan and close to 2.9% for Korea. China's research investment expenditure as a percentage of GDP is only slightly higher than that of Russia but it is increasing very strongly, and in 2004, by comparable prices, the US dollar-denominated research investment expenditure of China was already 6 times bigger than the R&D investment expenditure of Russia.

Although the relatively low research investment expenditure of Russia is a reflection of the structure of the Russian economy, which is heavily reliant on natural resources, there

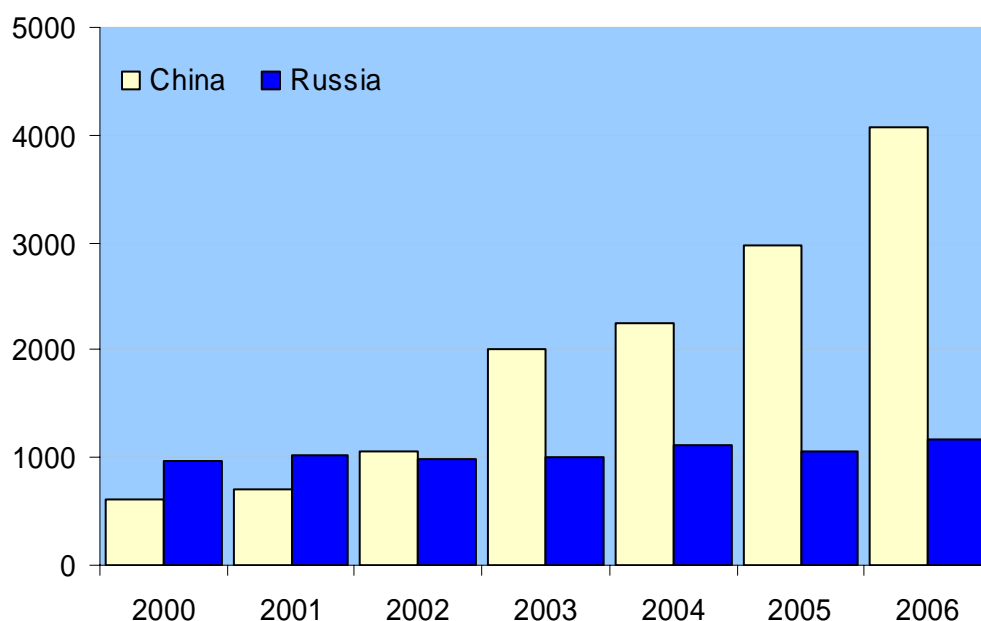


are also other interesting features involved which are of importance for the efficiency of innovations. A big difference between Russia and the OECD countries and China is that whereas in the latter government typically finances less than a third of R&D expenditure, in Russia most of the research is government financed. In view of the results, government-financed activities are inefficient and would call for a broadly based reform. The enhancement of private research activities could be promoted by a reform of incentive schemes and reinforcement of intellectual property rights (IPR). The Russian government has paid attention to these issues but, when speaking of it, it is the establishment of 'strategic sectors' and 'national high-performers' that seem to be given more emphasis. It is questionable whether the reform of the innovation scheme and the priority-based approach can be reconciled in Russia today.

## Motor industry

The motor industry provides an interesting example of the challenge thrown at Russia by Europe and Asia. The small number of cars per inhabitant, the aging car stock and favourable economic development has resulted in a strong increase in car sales in Russia. However, Russia's indigenous motor industry has not been able to benefit from the situation but the stronger demand has been satisfied by imported cars, and the cars manufactured at the assembly factories established in Russia by foreign car manufacturers in increasing numbers since 2003. The market share of indigenous models has fallen rapidly from three-quarters in the early part of the decade to less than 40% presently. Car exports from Russia are negligible and there have been little changes in export volumes over the past few years.

Chart 3 Production of passenger cars, 1,000s



Source: CEIC.

By contrast, the production of cars has increased rapidly in China. As late as the beginning of this decade, car production volumes in China were smaller than in Russia but currently they exceed those of Russia fourfold. Concurrently, car exports are growing very rapidly in China, although export volumes exceeded Russian car exports only slightly last year. Chinese cars are already starting to make their appearance on the streets of Moscow.

China is no model country of liberal policy-making in the motor industry, but the large and rapidly expanding market compensates for many of the problems affecting foreign car manufacturers from the economic policy and protection of the indigenous industry. The entry of foreign companies on the Chinese market has, at any rate, boosted competition. The importance of competition has been strengthened by China's WTO membership, which other countries have taken advantage of in forcing China to also open up its market to car part imports.

The problems of the Russian motor industry are not related to any lack of public protection, as the industry has benefited from special attention by the government. Rather, the poor situation is related to outdated policies and the industry's inability to renew itself. There is, for instance, no modern network of subcontractors capable of manufacturing products of high and uniform quality, which is the cornerstone of the modern motor industry. The lack of companies capable of subcontracting and undertaking related development work is not merely a problem of the motor industry but it also impairs the development of many other Russian industries. Against this background, the question again arises of how government-led choices in priority could support the diversification of centralised production structures in Russia.

## Summary

Comparisons of Russia with China, which is rapidly growing, and Europe, which stands in the forefront of technology, creates a juxtaposition. In reality, there should be no such paralleling. Economic growth is no zero-sum game, but the benefits produced are typically divided between several parties. In the economy, competition rather takes the form of global competition between companies than national competition between neighbouring countries, although it is true that governments compete to attract companies and their investments to their own territory. Comparisons with China and Europe, nevertheless, help to identify the external operating environment and economic policy challenges of Russia today.

In the present decade, economic growth in Russia has largely been based on rapidly increasing commodity prices and the gains in competitiveness stemming from the cheap rouble, but the importance of these exceptional factors is in decline. Russia is a country with a massive population and so the natural resources do not in general suffice to guarantee the inhabitants of the country the living standards of the developed world, but economic growth should be more broadly based.

Russian economic policy has returned to the path of government-led economic and industrial policy. In economic policy, the energy and commodities sector plays a key role, but a number of other business sectors have been identified as strategic sectors. The problem already is that there is no predictability as to which sectors are or will be subject to special attention and regulation by the government. In his state of the nation address in April, Putin added commercial fishing to the list.

The Russian economy suffers from a lack of competition and the current economic policy priorities do not increase faith in the situation changing in this respect. It is also difficult to see the government-centred economic policy as a solution to the problems and inefficiency of Russia's innovation policy. In evaluating the implementation of the economic policy and its prospects for success, it should be borne in mind that Russia performs poorly in international comparisons of, for instance, corruption, bureaucracy and intellectual property rights issues.

The problems of present-day Russian policy are most pronounced in the Far East of Russia, which is characterised by poor performance of the economy despite strong growth of the surrounding Asian countries. The major reason behind this is the introversion of the area and its reluctance for genuine integration on market terms. The current priorities of Russian economic policy do not seem to offer any new prospects in this regard.

Pekka Sutela

## New conditions for growth

Russia's annual economic growth rate of nearly 7% has been one of the fastest reached by any relatively major economy since 1999, lagging behind China but rivalling India. In fact, the Russian economy was, at the end of last year, more or less equal in size to the Indian economy, with annual GDP reaching the landmark of USD 1 billion. Equal in size are also the economies of South Korea and Mexico. If Russian economic growth remains brisk and the rapid strengthening of the rouble in real terms continues over the next few years, Russia's GDP performance will reach that of Italy's. A major question is, whether Russia will grow and develop during the next decades into Europe's largest single economy, a possibility put forward by the so-called BRIC projections, or is it instead approaching the peak of its relative GDP.

In many respects, Russia has been fortunate in these past years. The fact that the world market price for oil started to rise and reached at best a six-fold increase from the low of 1998, naturally served as major impetus for economic growth to start. Cash flow at key export companies swelled and most of it could be subjected to tax to cover the needs of the public sector. Salary and pension arrears were paid up, at least the majority of them, and the monetarisation of the economy turned to a swift increase. Bartered trade, which in autumn 1998 accounted for more than 60% of the turnover of industry, was soon a mere memory. General government finances that had run into insolvency had to be stabilised by the beginning of the new millennium. This was achieved by way of dramatic cost cutting. As export taxes and other income started to grow, Russia could primarily concentrate on servicing its general government debt faster than initially planned. This has resulted in the rapid improvement of Russia's credit rating. Companies and banks have increased their credit taking, partly even at an alarmingly rapid pace.

In the second phase, cash flow was started to be directed into funds. Russia's foreign currency reserve, which had practically been exhausted in 1998, swelled up to be the third largest in the world after China and Japan. The stabilisation fund, which was initially designed to even out fluctuations in budgetary income, grew unexpectedly to such an extent that in spring 2007, after prolonged discussions, it was decided to be split in two by 2008. The size of the so-called the reserve fund will be kept at one tenth of GDP. This would safeguard the needs of the budget, if the world market price for oil were to fall to the level of USD 30 per barrel for three consecutive years or to USD 20 per barrel for two consecutive years. Both are threats that are not generally considered likely to materialise. Any remaining income would be invested in what is known as fund for future generations, in line with a Norwegian model.

In the third phase, the increasing cash flow was started to be channelled towards increasing public spending. The needs of defence have been the most widely debated topic outside Russia. It is true that significantly more resources need to be allocated to defence, if Russia wishes to maintain its competitive weapon industry and create tolerable conditions for Russian soldiers. The increase in expenditure has been even faster in social expenses and public sector salaries. At the moment, decisions are being made about large additional expenditure on residential and road construction.

The major crisis of 1998, which dramatically affected the standard of living, was in fact – paradoxically – in part beneficial for future economic developments. The rapidly weakening rouble served as a major booster for Russian producers' price competitiveness. They benefited from the weak currency, but only in domestic markets. New export products with a significantly higher added value have not emerged. Recent years have seen a rapid strengthening in the real exchange rate of the rouble, which is an unavoidable consequence of the undervaluation brought about by the crisis and of the massive current account surplus caused by elevated export prices. Foreign currency-denominated export income has been exchanged into roubles, the supply of which has proliferated. Although Russia has succeeded in keeping inflation on a constant downward trend, it is still rather high. In fact, 2006 was the first year when inflation remained below 10%, and the target for the current year is 7.5%

The monetary authorities have wanted to keep the nominal exchange rate of the rouble almost stable. This is an exceptional target, but well understood in a traditionally dollar-dominated economy; an environment in which economic entities, especially households, may react very strongly to changes in the nominal exchange rate. With speedy domestic inflation, however, the policy of practically fixed nominal exchange rates turns into rapid strengthening of the real exchange rate. This undermines the price competitiveness of domestic production, thereby consolidating Russian consumers' purchasing power of foreign products. The strengthening rouble is reflected in expanding imports: last year, imports to Russia grew by 22%, while export growth remained at only 7%. Indeed, debate in Russia often raises concerns over the far too rapid appreciation of the rouble. Half of the 5.1% real-term appreciation target for 2007 was already reached in the first quarter.

Unit labour costs have not risen apace with the real-term strengthening of the rouble. Productivity has been relatively easy to improve in the wake of economies of scale produced by higher capacity usage rate. This is one of the paradoxical benefits of the 1990s with a view to developments in the current decade. Although exact measurement attempts are of minor importance owing to the need for adjustments to the structure of production, a significant portion – as much as one half – of the production capacity was unused in 1999. When demand started to grow, for the reasons presented above, it could be responded to without major investment. Minor acts of rationalisation were able to have a major impact. The opportunities provided by price competitiveness were thus capitalised on, but in an environment where no major needs for investment existed, technical advancements and structural changes to inherited industry remained modest.

The 1998 crisis also served as final consolidation for the consensus supporting economic policy based on equilibrium-oriented monetary and fiscal policy. On the one hand, budgetary deficits could no longer be funded through debt financing; yet no one wanted to return to the massive deficits of the 1990s, as everyone was well aware of their connection to rapid inflation, oscillating exchange rates, plunging investment, contraction of production, unemployment and poverty. Allegations that Russia in the 1990s constitutes 'the world's most expensive introductory course in economics' may be cynical, but they are not entirely without foundation.

This notwithstanding, other developments in the 1990s also contributed to the root of Russia's future success. Economic liberalisation had given way to entrepreneurship; companies privatised in unconventional ways were perhaps not functioning very well, but they performed better than their Soviet-era counterparts and they improved their corporate governance, especially senior management's professional skills. That, indeed, is the

foundation of economic growth. It means that this year the performance of the economy is better than in the previous year. It does not necessarily mean that the economy is efficient and competitive.

## Not energy alone

We tend to focus in solely on Russian oil and gas reserves. Indeed, there is no denying their huge importance. According to different estimates, they contribute at least one fifth to the Russian GDP. As hydrocarbon production growth has, since 2004, declined to around 2% – and similar growth is expected to continue in the next few years – its share of total production will diminish. Oil and gas production has also accounted for approximately 40% of public sector income. If oil prices do not continue to rise, this share will also subside. Furthermore, two thirds of export income is attributed to oil and gas.

Eyes blinded by energy do not see the flip side of the coin, ie the structural change that started in the Russian economy two decades ago and now fuels growth. In a nutshell: Russia now has modern service industries that were virtually non-existent in the former Soviet Union. The prospering middle class demands these commodities. At the same time, their production provides jobs for exactly that group, which accounts for perhaps between a quarter and a fifth of the entire population. Russia is witnessing the emergence of a consumer society, which is characterised by an increased propensity to import. The global economy always provides more choice, quality and brands than any national economy is able to produce.

Consolidation of the consumer society is also supported by the rapidly developing financial system. Mortgages are only now becoming more common, and credits for the purchasing of consumer durables are still not widely available. The stock of household credit is growing rapidly. It is still proportionately small, but some loans will eventually turn out to be problematic.

## Changing terms of growth

The model for growth-fostering economic growth in Russia since 1999 is now coming to an end. The capacity usage rate can hardly be increased any further; growth must be based on investment. In fact, real investment appears to be increasing rapidly. In 2006, growth totalled more than 13%, and the current year may produce even higher growth figures. Nevertheless, at slightly below 20% of GDP, the investment ratio is still rather low. It can be anticipated as growing at an annual pace of perhaps one percentage point. It is, in a way, good that growth is not any faster, as it lessens the likelihood of large wasteful projects and unstable economic developments.

Investment-based growth also provides opportunities for technical advancement and structural changes in inherited production. After all, innovations are often related to new equipment and machinery. This also adds to the propensity to import in the short term.

The growth in consumption and investment demand's propensity to import, coupled with export prices that are anticipated as remaining stable, mean that Russia's current account surplus is melting away. It could even take place within a few years, despite the

surplus being, up to now, significantly large, accounting for 10–15% of the GDP. This is reflected in last year's difference between export and import growth rates. Only a major diversification in exports would change this picture. In practice, however, no major changes can take place in the structure of exports in a few years.

Another large surplus in the Russian economy is also disappearing: the budgetary surplus has varied between 5–10% of GDP. This surplus has been the foundation for the expansion of reserves. The current tax structure means that income growth remains slow. For example, the introduction of progressive income taxation might change the situation, but even that is not certain in an economy accustomed to circumventing different regulations. On the other hand, pressures on public sector spending are very strong. This is reflected in the national programmes approved in 2006: agriculture, housing, health care and education. Decisions have been made on large increases in military expenditure and public sector salaries. The different energy subsectors, ie oil, gas and electricity, have 10-year investment programmes amounting to some USD 100 billion each. Government spending will also be needed. Furthermore, the pension system is in need of an overhaul, and road construction has emerged as a new area of priority. Expenditure will inevitably rise faster than income.

Melting of the current account surplus signifies three factors: Russian companies' concerns over price competitiveness will be alleviated, inflationary pressures will weaken and, from an external perspective, the Russian market will grow more slowly. Following the possible disappearance of double surpluses, the present swelling of funds will come to an end. Fiscal policy will centre on 'normal' questions with regard to the prioritisation of expenses. This will change the nature of debate on economic policy. Monetary policy will shift from the exchange rate target to inflation target and the rapid appreciation of the rouble will slow down.

The current account surplus could be replaced by the capital account surplus, when long-term direct investment would be more welcome than often unstable short-term financial investment.

The disappearance of double surpluses would mean that the Russian monetary and fiscal policy framework would become more like that of many other developing economies with average income levels. Based on prior experience, they can be very unstable, but not necessarily. Much would depend on how well the current consensus over equilibrium-oriented monetary and fiscal policy would hold.

## Bottlenecks may hinder economic growth

The emergence of various bottlenecks is more or less unavoidable when economy grows fast and approaches maximum use of production capacity. Two particularly important bottlenecks are found in Russia.

Paradoxically, one of them is the availability of energy. True, Russia is the world's largest energy producer. Nevertheless, occasional shortages of electricity and gas do occur, at least locally. It can be debated whether the ultimate reason is in the slow growth of production or rather in distribution, low pricing and inefficient usage, but shortages have occurred at least in some of the largest cities during the coldest spells of winter. The availability of energy and partly of other infrastructure restricts construction and has to some extent redirected investment from the largest cities to the surrounding areas. The

need for improving the efficiency of energy usage is great, but so are the possibilities. It is only by realising these possibilities that Russia can increase energy exports. Already, Russia imports gas from Central Asia, mainly from Turkmenistan, by up to an amount corresponding to the third of gas exports to Europe.

Another bottleneck is the availability of skilled labour. Partly it is a question related to population structure. The youngest working-age group is already dwindling, and this contraction is set to continue. Partly it is a question of insufficient and ill-directed professional training. Another culprit is the fact that companies did not really recruit new labour in the 1990s, as finding employment for the existing labour was difficult. Consequently, many sectors have virtually no employees in the 30–40 age bracket.

This lack of employees raises labour expenses, and Russia will not remain a low salary country. Measured in foreign currency, Russians' average wage level has doubled in ten years. The contrast to post-crisis years is even starker, and the primary concern is not in average income. Income differentials are extremely large. Russian corporate managers' earnings often exceed those of their Finnish counterparts.

It is also worthy to note that although growing, investment is heavily dominated by some selected sectors. In 2006, the energy sector again increased its share of total investment. This is probably necessary in order to increase production and heighten the added value. Increasingly abundant resources are also devoted to construction, especially housing construction. In contrast, hardly any investment is being made in labour-intensive and potentially very important industries such as the textile and forest industries. This may prove to be very difficult for future competitiveness and job creation.

## Problematic competitiveness

Most major indicators portray the Russian energy sector as vast, yet it employs only less than 2% of the working-age population, depending on the exactness of definition. The remaining 98% have to find jobs elsewhere. Much depends on whether this labour force is competitive or not, such as the path of Russian integration into the European and world economies.

One way of simplifying the problem is to say that Russia lies between Asia and Europe, areas characterised by low production costs on the one hand and high technology on the other hand. Russian labour costs will not remain low owing to the reasons discussed above. Commitment to raise the costs of energy and transportation has been made for many viable economic and environmental reasons. Russia naturally aims to make extensive use of high technology, but it is a long path of intense competition, filled with pitfalls.

Russia allocates 1.2% of GDP to research and product development. Although low in comparison to Finland and Sweden, it rivals China's R&D investment. Russia also has inherited an extensive field of research from the Soviet Union and statistics show Russia employs a very large number of researchers.

However, a number of problems are hidden behind the figures illustrating the resources devoted to R&D. The majority of the expenses are made by the government, and often the aim is not to produce new products that can be marketed. On the contrary, the government prioritises military research. The research sector still follows the division into education (universities) and scientific research (research institutes), dating from Soviet times and even earlier, as well as the division into basic research (academy of sciences)



and applied research (other research institutions). The basic guidelines governing the science and technology policy and the innovation policy have been laid down. They are based on international experience and appear sensible, but they are still allocated very little resources. Perhaps surprisingly, they have often been met by strong opposition from the research community. It seems to be particularly difficult to compromise academic sovereignty and self-sufficiency in research, inherited from the former Soviet Union. Yet, Russia needs to find its own niche in the division of labour between science and research.

In 2006, the number of patent applications lodged by Russians accounted for only a quarter of the number of applications submitted by Finnish researchers. This is comparable to the research investment made by such countries as Singapore, Norway and Spain.

In reply to questions regarding the future of Russia's economic future, the present administration gives an unambiguous, justified and perhaps the only possible response: Russia has to learn to capitalise on its natural resources even more than before. If successful, Russia would repeat the path to success on which the Nordic countries, among others, have been advancing for the last 150 years more or less. But how good will the large Russian companies capitalising on natural resources be in achieving this goal? They are often rigid, hierarchical and reclusive. They do not engage in research and product development, and personnel training is scarce. Backed by their solid cash flow, they have, in recent years, sprawled into many directions that often have no connection to the core business. The return to core competencies is still ahead. In addition, the government favours the development of large conglomerates, the 'national champions', which are, in practice, in a position of domestic monopolies. International experience shows this cannot be the right solution.

A leading Russian university of economics has recently published a survey of the competitiveness of Russian industrial companies. The good news was that competitive companies were found in all industries. However, their share of all companies varied between 10% and 45%, depending on the industry. What is worse, even these companies had some of the previously mentioned unfavourable characteristics, which is why their competitiveness could not be considered stable.

## Conclusion

In the recent past, economic growth in Russia has been excellent – and still is. Terms of growth are changing, however. Short-term change does not necessarily slow down growth, at least to any major extent, but it will change the conditions of monetary and fiscal policy. Long-term changes are already in the pipeline. Russia must already face problems arising from declining labour force numbers and population ageing, increases in expenses, lack of technological advances as well as innovations and deceleration in the growth of energy production. A key economic policy expert has said that the golden era of hydrocarbons in the Russian economy will be over within two decades. Two decades is a short period. That is how long it now is since the start of serious economic reforms in the Soviet Union.

In order for Russia to become Europe's largest economy, it has to undergo many changes. This holds true if those who feel that the future belongs to openness, creativity and flexibility – to new innovations – are correct.

If, however, those who believe that Russia is already close to its greatest relative economic size are correct, it will be revealed to us in two decades that Russia was not able to change, after all.

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