

Economic Survey of the Russian Federation, 2004

Summary

The major economic challenge facing Russia is the achievement of long-term, sustainable growth that would allow for a relatively rapid convergence between living standards in Russia and the OECD economies. The nature of this challenge is largely determined by Russia's economic structure. At present, Russia's economy is highly dependent on the export of a limited range of natural resources, chiefly hydrocarbons and metals. This presents policy-makers with a number of specific problems. In particular, resource dependence makes the Russian economy especially vulnerable to external shocks. It is therefore difficult to overstate the importance of prudent macroeconomic policies, especially as the budget relies heavily on resource taxes and is thus influenced by volatile energy prices. Hence, exemplary fiscal discipline, in particular, is crucial to reducing Russia's vulnerability to commodity-price cycles. Yet while resource dependence brings with it certain macroeconomic risks, economic performance will continue to depend to a great extent on the performance of resource-exporting sectors for the foreseeable future. This makes reform of the natural gas sector an urgent priority. In the absence of substantial reform, the gas industry, which is critical to both exports and the domestic economy, could well stagnate or decline.

On the structural side, the major challenges facing Russia concern restructuring large, state-controlled monopolies in the banking, power and natural gas sectors, and creating legal and regulatory frameworks that combine robust competition with effective regulation. Reform of these sectors should make resource allocation more efficient-in the banking sector by fostering the development

This policy brief presents the assessment and recommendations of the 2004 OECD Economic Survey of the Russian Federation. A draft of this Survey was prepared by the Economics Department within the context of the country-specific programme for the Russian Federation of the Centre for Co-operation with Non-Members. The Economic and Development Review Committee, which is made up of the 30 member countries and the European Commission, reviewed this survey. It was revised following the Committee's discussions, and issued under the responsibility of the Secretary-General.

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of efficient financial intermediation and in the power and gas sectors by putting an end to the provision of implicit subsidies via prices which are below long-run cost-recovery levels. The fact that all three sectors will require a fair degree of regulation even after they are reformed makes issues pertaining to the competence and integrity of state institutions particularly relevant and draws attention to the challenge of state reform. Without substantial improvements in the probity, efficiency and accountability of the courts, the bureaucracy and other state institutions, the implementation of structural reforms will be extremely difficult and the state itself will remain a significant drag on growth. ■

What has been driving growth since the August 1998 financial crisis?

Economic growth since the August 1998 financial collapse has consistently exceeded expectations. The post-crisis recovery has been faster and more sustained than most observers believed possible in late 1998, with real gross domestic product (GDP) growing by an average of 6.7 per cent per year during 1999-2003. The recovery has been relatively broad-based: most major industrial sectors and services have grown strongly. However, growth has been driven primarily by export-oriented industries, particularly the oil industry, which has made by far the most important contribution to growth in recent years. In addition, rapidly growing oil exports-together with favourable terms of trade-have also been the main factor enabling the current consumption boom to unfold without putting the external balance in danger so far. However, significant increases in productivity have also been crucial, as they have helped Russian industry to stay competitive in the face of rising wages and a strengthening real exchange rate.

The economic growth of the last five years has had a direct, positive impact on incomes and employment. By 2004, real wages and real disposable incomes were well above their pre-crisis peaks, while the unemployment rate had fallen from over 13 per cent in 1998 to around 8 per cent. As a result, the proportion of the population living on incomes below the officially defined subsistence minimum has fallen by roughly one-third since 1999. Until recently, however, demographic and health indicators have continued to deteriorate, despite the resumption of economic growth. Life expectancy for both men and women remains below pre-crisis levels, and the incidence of many "poverty-related" illnesses has increased. Thus

far, growth alone has proved insufficient to bring major improvements in health and other social indicators. This points to an urgent need for reform of the health system, which is likely to require both restructuring and additional expenditure, not least in order to ensure adequate treatment for the less well off.

Since 1998, Russia has confounded the sceptics. Yet concerns about Russia's capacity for sustained growth over the long term are not without foundation, given the well known problems associated with resource dependence. The Russian authorities are well aware of the dangers of resource-dependent development and rightly regard economic diversification as a key long-term goal. For some years to come, however, Russia is destined to remain highly dependent on resource exports, above all oil and gas. Indeed, this dependence has been growing in recent years and is likely to continue to increase in the medium term. Maintaining strong growth will continue to require significant export growth, and that will in all probability mean, in the first instance, increasing hydrocarbons exports. In recent years, export growth has been driven by Russia's private oil companies, which have rapidly been raising investment, output and exports. However, there are limits to Russia's ability to continue to increase oil exports at current rates. At some point, therefore, it will probably be necessary for the gas sector to become one of the main drivers of export growth. This makes the restructuring of the state-dominated and largely unreformed gas sector a particularly important priority. While further developing resource-sector exports over the medium term is not without risks, these should remain manageable, given the right policies and institutional framework. In this respect, a well-managed fiscal stabilisation fund should make a significant contribution to reducing Russia's vulnerability to international commodity price movements. ■

Why is prudent fiscal policy so critically important for Russia?

Prudent fiscal policy has probably been the government's single most important contribution to sustaining recent growth. The federal budget has been in surplus since 2000, and budgets have consistently been drafted on the basis of fairly conservative macroeconomic assumptions. While strong growth and favourable terms of trade-particularly in the form of high world oil prices-have facilitated improved fiscal performance, the federal budget would probably have remained in rough balance even had oil prices been at

long-term average levels throughout the period. This achievement was also in part the result of spending restraint. Although budgetary outlays grew rapidly during the first years after the crisis, the government was remarkably successful in holding down expenditure relative to GDP during 1999-2003. General government expenditures as a share of GDP are now around ten percentage points below pre-crisis levels, but public service provision has not deteriorated, and wage and pension arrears have all but disappeared.

Given Russia's vulnerability to commodity-price cycles, it is difficult to exaggerate the importance of continued fiscal discipline. While good policy cannot eliminate Russia's external vulnerability altogether, it can do much to mitigate it. In this respect, it is vital to keep the budget in balance across the oil-price cycle. Fiscal policy should be based on conservative oil-price assumptions. If budgetary oil price assumptions are above long-term averages, then budgets should be drafted to achieve corresponding surpluses. Russia's external vulnerability could further be reduced by making sure that foreign currency denominated debt—both private and state debt—remains fairly low relative to GDP, and by generally facilitating further progress in “de-dollarising” the domestic economy.

In view of the importance of ensuring fiscal sustainability across the oil-price cycle, the creation of a fiscal stabilisation fund is a welcome development. However, current plans imply that the maximum size of the fund might be too small relative to GDP. The fund will need to be rather large in order to ensure that the budget is adequately insured against oil-price drops. At some point, however, the fund may reach a level sufficient for this purpose, raising the question of what is to be done with any further windfall revenues arising from high oil prices. It would then be advisable to use surplus revenues in the first instance for early debt repayment. The temptation to use windfall revenues not needed by the fund to finance tax cuts or higher spending should be resisted, as using such windfalls in this way would be strongly pro-cyclical, would thus counteract the purpose of stabilisation, and would risk jeopardising the fiscal position should oil prices unwind thereafter.

The government's desire to increase the tax burden on resource sectors (not only the oil sector) in order to reduce it for the rest of the economy is in principle commendable. Such a shift could help to foster greater diversification of economic activity and also to reduce the risk of “Dutch disease”. The recent abolition of turnover taxes, levied without reference to

profitability, is also a positive step in this respect, as it will tend to benefit processing industries more than resource extraction sectors. A reduction in the Unified Social Tax would likewise be of particular benefit to processing industries. This could be financed by increasing certain price-independent resource taxes to make up the losses to the pension system resulting from such a cut. However, a careful balance must be struck here: given the importance of resource exports to continued growth, it would be undesirable to place too heavy a burden on those sectors. Moreover, any shift towards greater taxation of resource extraction would increase the vulnerability of the state budget to commodity price changes. This makes it all the more important to establish a large stabilisation fund and balance the budget across the oil price cycle. ■

How can the authorities ensure that inflation continues to decline?

Monetary policy in recent years has been characterised by a fundamental tension between two conflicting goals: reducing inflation and limiting the rate of appreciation of the real effective exchange rate (REER). While the authorities are rightly concerned that the REER not strengthen too rapidly, some degree of exchange-rate appreciation is desirable. It helps to limit inflation, increases households' purchasing power, puts pressure on Russian industry to restructure further and eases the burden of foreign debt service. In current conditions, REER appreciation is also all but unavoidable. In recent years, high oil-driven foreign-exchange inflows have maintained constant upward pressure on the rouble. Until 2002, large net outflows of private capital helped to reduce the pressure on the rouble, and fiscal sterilisation also played a significant, if secondary, role. In 2003, however, the importance of both these factors declined and the central bank increasingly sought to reduce the pressure on the exchange rate by buying foreign exchange. Given the limited sterilisation mechanisms available, this resulted in very rapid increases in the money supply, with rouble M2 growing by over 50 per cent in 2003 alone. Nevertheless, the monetary authorities have so far managed to keep inflation on a gradual downward trajectory, aided by strong money demand and smaller increases in regulated prices than in past years.

While a loose monetary policy may have been understandable in terms of the desire to prevent overly rapid real appreciation of the REER, it is highly unlikely that

further sustainable disinflation could be achieved with monetary expansion continuing at anything like the rates seen in recent years. In this connection, the increase in core inflation in late 2003, after two years of steady decline, is a source of concern. It is very important to keep inflation on a downward trend, as otherwise expectations might shift to increasing inflation, which would make future disinflation much more costly. Given that large foreign exchange inflows can be expected to continue for awhile, at least as long as oil prices remain high, reducing inflation while avoiding excessive appreciation of the REER will require greater capacity to sterilise such inflows in a non-inflationary way. The newly established fiscal stabilisation fund will help, particularly in conjunction with increased taxation of windfall profits in resource sectors. Nevertheless, it will also be important to strengthen significantly the central bank's capacity to sterilise the monetary effects of its interventions on the foreign exchange market. This could be done in part by enabling the central bank to issue its own bonds. The need to expand the range of sterilisation instruments at the central bank's disposal is all the greater in view of the further liberalisation of capital movements that is set to occur under legislation adopted in late 2003. However, under a high oil price scenario and with private net capital flows turning inwards, monetary sterilisation alone is unlikely to be sufficient to counteract remaining inflationary pressures. The authorities should therefore be prepared to allow for somewhat faster real and nominal appreciation of the rouble than in the recent past. ■

What are the key priorities for structural reform?

During 2000-03, the Russian authorities seized the opportunity provided by a combination of economic recovery and political stability to pursue a number of important structural reforms. Since the previous *OECD Economic Survey*, the government has embarked on a major restructuring of the electricity sector, further tax reforms, an overhaul of the pensions system and reform of the railways. New land, labour and customs codes have been adopted since 2001, as well as new laws on joint-stock companies, bankruptcy and money laundering. A package of laws designed to reduce bureaucratic interference in businesses' activities has already brought about a limited but nevertheless palpable improvement in the business climate. The ongoing reform of technical regulation, which includes not only

an overhaul of the regulations themselves but also a reform of the *process* whereby new regulations are formulated and adopted, is of particular importance. After years of delay, the government and the central bank have stepped up the pace of banking reform. Finally, an overhaul of the judicial system has resulted in the adoption of new codes of procedure for the various courts, eliminating some gaps and contradictions in Russian legislation that had often facilitated the abuse of judicial processes. Implementing these reforms will, of course, be much more difficult than adopting them. It is already clear that the implementation of much of the new legislation is extremely uneven, owing to the weaknesses of the state administration and the courts.

While the structural reform record of the last few years has been impressive, there is still a great deal to be done, especially with respect to the reform of the state itself. To date, improvements in the quality of legislation have not been matched by improvements in the quality of the institutions that implement or enforce that legislation. At present, the weakness, inefficiency and, in many cases, corruption of the state administration, the judiciary and the law-enforcement agencies are among the most important factors limiting progress with respect to implementing structural reforms. Reform of these institutions is thus an increasingly urgent priority, not least as a necessary precondition for the establishment of secure, clearly defined property rights. The arbitrary exercise of state power remains one of the main threats to the security of property rights in Russia. It is a deterrent to foreign direct investment as well as a major barrier to the development of many businesses, especially small and medium enterprises. However, reform of the state administration and law-enforcement agencies, though widely discussed since 2000, has barely begun. With respect to the courts, in particular, the mandatory publication of all significant judicial decisions would be a significant step forward. This reflects a more general need for greater transparency in the operations of state bodies at all levels, a need which underscores the importance of free and independent media in combating corruption and making state institutions more open and accountable.

The accountability, transparency and integrity of state and private institutions alike will be critical in determining the fate of the pension reform begun in 2002-03. The current overhaul of the pension system is perhaps the most far-reaching social reform now under way. Its success or failure will have enormous implications for both fiscal policy and financial market development, as well as for the welfare of ordinary Russians as they

reach retirement age. Yet its success will depend not only on the design of the pension reform itself but also on reform progress in other areas. Given the role assigned to private management companies in the fully funded segment of the new system, both improved corporate governance and financial market reform will be critical. It will also be important that the state manages the system in a consistent, transparent manner in order to establish the credibility of the reform in the eyes of ordinary Russians. Finally, the authorities will almost certainly need to increase the pension age gradually in order to ensure the fiscal sustainability of the reformed system over the long term while maintaining pensions at satisfactory levels. ■

What must be done to ensure the successful completion of electricity sector restructuring?

Russia in 2003 embarked on the restructuring of its electricity sector. The goal of reform is to introduce competition into electricity production and supply, leaving dispatch, transmission and distribution as regulated natural monopolies with non-discriminatory third-party access to the networks. This builds on recent experience in OECD and other countries. The overall approach embodied in the reform is promising and the reform plan is thorough and well thought out. However, there remains a risk that its aims could be subverted by special-interest lobbying during the lengthy implementation phase. The government's challenge will be to ensure that the reform is implemented in a manner consistent with its overall goal of combining effective competition and effective regulation.

This means, in particular, that the marketised segments of the sector must be characterised by real competition based on economically meaningful prices. There are two dangers here. The first is that private-sector interests will secure strategic holdings that allow them to exercise market power or even local monopoly power. The second is that the state itself will use the assets it retains, combined with the considerable regulatory powers at its disposal, to "manage" the market. Even after the wholesale market is liberalised, the state will retain considerable capacity to hold down electricity prices, if it so chooses and it could do so in ways that unduly distort the signals the market is sending and deter the very investment that the reform is meant to attract. At the same time, a stable legal and regulatory framework, with predictable policies, will be needed to attract

investment over the long term. However, it will be difficult, within the structures currently envisaged, for the government credibly to commit to the stability of the arrangements being put in place. The absence from the entire scheme of plans for a strong, independent regulator, in particular, must cause concern. This is an area where the reform should be amended. ■

What measures are needed to reform the gas sector and why are they so important?

Russia's other great energy monopoly stands in stark contrast to the electricity sector. The reform of the natural gas sector has repeatedly been postponed, and it is not clear that any substantial reform will be undertaken in the foreseeable future. Despite its enormous importance, the natural gas industry is perhaps the least reformed major sector in Russia. Most gas continues to be sold at regulated prices that are below full cost-recovery levels, although regulated tariffs for all consumers except households are now rapidly approaching cost-recovery levels. Both the up- and down-stream sectors are dominated by a state-controlled, vertically integrated monopolist, OAO Gazprom. Though organised as a joint-stock company, Gazprom in some respects operates as an arm of the state. It combines commercial and regulatory functions, and maintains tight control over the sector's infrastructure and over information flows within it. Gazprom's control over information is particularly problematic, as it renders opaque much of what happens in the sector. The inefficiencies inherent in the sector's architecture would, on their own, constitute compelling arguments for reform: an economy as dependent on its resource sectors as Russia's can ill afford such inefficiencies in what is arguably its most important resource industry. Moreover, the sector as it is currently constituted is highly unlikely to be able to sustain sufficient output growth to satisfy both rising export commitments and domestic demand. Given that the importance of gas exports to Russian growth is likely to increase over the medium term, this is a particularly serious concern.

Both Gazprom and the government acknowledge that non-Gazprom production must grow rapidly if the gas industry is to develop successfully, but Gazprom's current position within the sector constitutes a significant impediment to such growth, restricting both small producers' access to the market and consumers' freedom to choose their suppliers. There is significant potential

for accelerating the growth of non-Gazprom production and making gas supply in Russia more competitive. This potential cannot be realised until Gazprom's domestic rivals can be assured of equal treatment, which is impossible as long as Gazprom controls both the information flows and the infrastructure. There is thus an immediate need to increase transparency in the sector and also to transfer what are essentially regulatory functions from Gazprom to the state. Over the medium-to-long term, Gazprom's natural monopoly/infrastructure provision functions should be separated from its potentially competitive activities. In particular, this will necessitate unbundling Gazprom's transport and dispatch operations into separate entities. This will be a long and complex process, which should not be executed in haste; it is therefore important that restructuring be planned and started soon. ■

Is banking reform moving in the right direction?

The pace of banking reform has accelerated markedly since early 2002. The most important reform initiatives of the last two years have included deposit insurance legislation, a major reform of the framework for prudential supervision, steps to increase transparency in the sector, and measures to facilitate the development of specific banking activities. Each of these measures is an important step in its own right. Even more important is the "fit" between them: the various strands of reform complement each other well, which reflects the coherence of the authorities' overall strategy. The emphasis on transparency, in particular, is especially welcome, as greater openness will facilitate better monitoring of banks by private-sector agents. The importance of banking reform is particularly evident in view of the recent very rapid growth in bank lending. While the evidence suggests that this growth represents a welcome process of financial deepening, there is a risk that such rapid growth in bank credit may come at the expense of portfolio quality. This will require careful monitoring on the part of the authorities. By strengthening the framework of prudential supervision now, when the environment for the banks is fairly benign, the authorities can reduce the risk of problems arising as and when the external environment is less favourable and liquidity tightens.

The real test of the authorities' banking reform strategy will be in implementation. The reforms challenge

numerous vested interests and their successful realisation will require considerable political will as well as the development of regulatory capacities of a very high order. The establishment of the new deposit insurance system will constitute a critical early test. If the central bank proves unable or unwilling to enforce the criteria for admission to the system strictly and to exclude weaker banks, the credibility of all the central bank's regulatory reform efforts will suffer. By contrast, the exclusion of significant numbers of banks – on the basis of transparent criteria, consistently applied – would send a powerful signal of the authorities' determination to regulate the sector effectively. ■

Can the robust growth of recent years be sustained?

The Russian economy has the potential to sustain strong growth over the longer term, but, given Russia's inherently fragile economic structure, continued adherence to prudent macroeconomic policies will be essential to achieving this goal. Realising Russia's full long-term growth potential will also require further structural reform in a large number of areas, to render both the Russian state and the economy more efficient. In addition to those reforms that are the focus of the present survey, Russia faces daunting challenges with respect to health and education, fostering innovation, competition policy, trade and the environment. Fortunately, the Russian authorities have committed themselves to a wide range of needed structural reforms and also to continued macroeconomic discipline. Implementing many of these reforms is likely to prove far more difficult than designing and adopting them, however, and will place great demands on the political will and administrative capacities of the state. Nevertheless, if the authorities are able to deliver on their reform commitments, the Russian economy may well carry on surprising the sceptics. ■

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Public Affairs and Communications Directorate.

They are published under the responsibility of the Secretary-General.

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