

1 Recent Economic Developments

Russian economic growth and investment accelerated notably in early 2007. For the first time in years, manufacturing posted very impressive growth relative to the same period in 2006, although at least some of the factors supporting manufacturing were temporary in nature. The investment boom has continued into the second quarter of the year, and 2007 looks to be a year of relatively rapid economic growth for Russia.

Contrary to some expectations, Russia's balance of payments has strengthened still further due to high capital inflows in the first half of the year. This has created challenges for macroeconomic policy. Money supply growth is reaching record levels, and less of the monetary expansion is being sterilized by accumulation in the Stabilization Fund than in the past. Inflation has remained under control in early 2007, but could very well become problematic in the second half of the year.

Table 1 Main Macroeconomic Indicators

	2001	2002	2003	2004	2005	2006	2007-4M
GDP growth, %	5.1	4.7	7.3	7.2	6.4	6.7	n/a
Industrial production growth, y-o-y, %	4.9	3.7	7.0	8.3	4.0	3.9	7.5
Fixed capital investment growth, %, y-o-y	8.7	2.6	12.5	10.9	10.5	12.6	19.9
Federal government balance, % GDP	3.0	2.3	1.7	4.2	7.5	7.5	5.9
Inflation (CPI), % change, y-o-y	18.6	15.1	12.0	11.7	10.9	9.0	4.0
Current Account, billion \$	35.1	32.8	35.9	60.1	86.6	94.5	21.8*
Reserves (including gold) billion \$, end-o-p	36.6	47.8	76.9	124.5	182.2	303.7	369.1

* Data for the first quarter; Source: Rosstat, Minfin, CBR

The Russian government has approved and submitted to the Duma its first three-year budget, which represents important progress in increasing the horizon of budgetary planning. It has also changed the rules for the management of surplus oil revenues, and will divide the Stabilization Fund into a Reserve Fund for insuring the budget against fluctuations in oil prices and

a Fund for Future Generations, which will be invested in longer-term assets. But questions and controversies persist over the investment strategy and potential uses for the Fund for Future Generations.

GDP and Industrial Production

The Russian economy experienced accelerated growth in the first four months of 2007 in the context of strong energy prices, substantial capital inflows, a rapid expansion of domestic demand, and an unusually warm winter. Almost all sectors of the economy reported a considerable increase in their rates of growth relative to the same period in 2006. Sectors servicing the domestic market like trade (13.6 percent growth) and construction (23.7 percent) continued to boom. More surprising to many economic experts has been the strong growth in industry (7.5 percent) and, particularly, manufacturing (12.5 percent), during this period. By official estimates, the rate of aggregate output growth of the base industries and sectors (often used as a proxy for GDP growth) amounted to 8.8 percent in the first quarter of 2007, as compared to 4.2 percent for the corresponding period of 2006 (table 2).

The 12.5 percent growth in first four months of 2007 represents a sharp

Table 2 Output Growth by Sectors: 2006-2007

	2006	4M-2006	4M-2007
Base industries and sectors	6.1	4.2*	8.8*
Agriculture	2.8	1.3	2.2
Extraction of mineral resources	2.3	1.9	3.7
Manufacturing	4.4	3.5	12.5
Electricity, gas, water production and distribution	4.2	5.9	-5.0
Construction	15.7	4.8	23.7
Retail trade	13.9	11.4	13.6
Transport	2.3	1.7	2.8

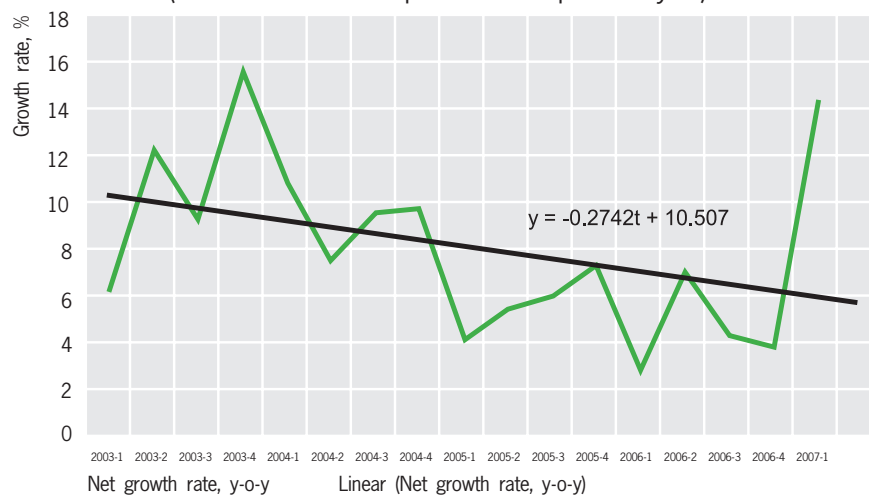
* Data for the first quarter of a year; Source: Rosstat

break from the steady downward trend in manufacturing growth rates in recent years, which occurred in the context of the rapid real appreciation of the ruble, low investment rates, and high capacity utilization (Figure 1).

Some, but not all, of the strong showing of Russian manufacturing in early 2007 can be explained by temporary factors: the very warm winter, a particularly low level of manufacturing in Q1 2006 and an unusually large increase in infrastructure orders for machine-building. Rapid growth in the food sector (12.6 percent in the first four months of 2007 relative to the same period in 2006) made an important contribution to overall growth in manufacturing. Output in the food sector was particularly low in early 2006, however, in the context of a very cold weather and new regulations on the sale of alcoholic beverages that depressed output. Thus, one reason for exceptionally high growth in 2007 was a low base in 2006. The numbers for March and April of 2007 show somewhat more modest, although still strong, growth relative to 2006 (8.0 and 9.6 percent respectively).

Machine-building was responsible for an even stronger contribution to high manufacturing growth in early 2007. An unprecedented increase in investment demand (see below) can be associated with a major jump in orders for machinery and equipment, electro technical and optical equipment, and transportation equipment (figure 2). The increase in orders for mechanical equipment was particularly strong: 52.5 percent in January-April 2007, which can be compared to a decline of 41 percent during the same period of 2006 (table 3). A good part of this demand might be associated with large state companies, including the electricity giant, RAO UES. The production of hydroelectric turbines, for example, increased by 2.7 times in the first four months of 2007, compared to a considerable decline reported a year ago. The same tendencies can be observed in the production of other electricity generating machines. The

Figure 1 Quarterly growth in Russia manufacturing: (relative to the same period of the previous year)



Source: Rosstat

production of specialized machines and equipment grew by 17.9 percent during the first four months of 2007, as compared to 6.0 percent increase a year ago. The production of specialized machines for oil-processing, ferrous and non-ferrous metallurgy expanded very quickly (table 3). The booming construction in-

Table 3 Production of selected machinery, growth rates to the same period of the previous year, (%)

	4M-2006	4M-2007
Mechanical equipment	-41.1	52.5
Gas turbines	-1.5	42.6
Hydraulic turbines	-74.2	170
General purposes machines	-10.9	8.9
Auto-cranes	4.0	30.7
Cranes	33.8	72.4
Specialized oil-processing equipment	-9.5	26.4
Production of specialized machineries	6.0	17.9
Technological equipment for nonferrous metallurgy	4.1	130
Blast-furnace and steel production equipment	-10.2	30.4
Bulldozers	6.1	64.2
Caterpillar tractors	-18.9	38.1
Transportation devices	3.7	16.2
Trucks	21.4	25.3
Trailers for tractors	23.0	75.1

Source: Rosstat

Figure 2 Growth rates in machine building, %

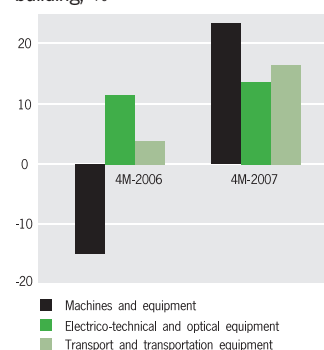
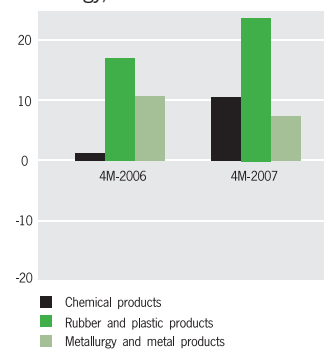


Figure 3 Growth rates in chemicals and metallurgy, %



Source: Rosstat

Figure 4
Growth rates in food and light industry, %

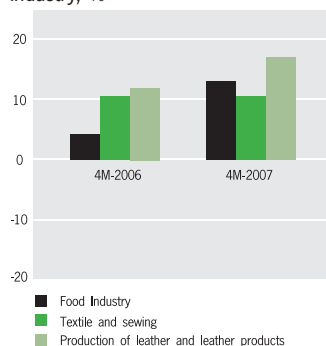
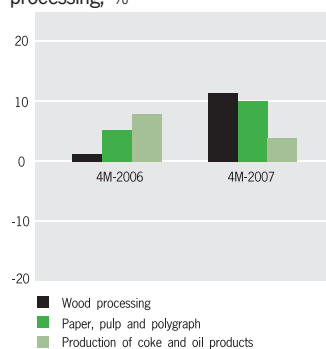


Figure 5
Growth rates in wood and oil processing, %



Source: Rosstat

dustry can be associated with a pick up in orders for cranes, tractors and other devices. In general, much higher investment demand for machines and equip-

Table 4
Growth rates in industry, % to the same period of the previous year

	Jan-Apr 2006	Jan-Apr 2007	April 2006	April 2007
Extraction industries	1.9	3.7	3.8	2.0
Manufacturing	3.5	12.5	5.6	7.0
Production and distribution of electricity, gas and water	5.9	7.0	3.5	-2.1

Source: Rosstat

ment has been coming primarily from natural monopolies, resource-oriented firms, metals and construction.

Is the turnaround in Russian manufacturing sustainable? The most recent data on industrial growth from April suggest that the first quarter of the year was indeed exceptional. Industrial output in April 2007 was only an estimated 4.6 percent higher than in April 2006, although manufacturing remained 7

percent higher, primarily due to continued strong performance in machine building (Table 4). The factors that have restrained growth in manufacturing in recent years are still present. The real appreciation of the ruble should again be quite significant in 2007 (see below). Parts of manufacturing that service domestic demand with limited competition from imports may continue to thrive in Russia's booming domestic market, but the key task of achieving export competitiveness outside of resources and metals will remain difficult in the current environment.

Investment

Russian investment growth has mushroomed into a genuine boom in early 2007. While part of the estimated 19.9 percent growth in fixed capital investment in the first four months of the year could be attributed to unusually warm weather in January and February, monthly figures for March (18.5 percent) and April (19.4 percent) suggest that investment growth in 2007 could even exceed the record 17.4 percent reg-

Table 5 Total Fixed Capital Investment by Sector (% of total)

	2005	2006	Q1-2006	Q1-2007	Growth rates, Q1-2007, y-o-y
Agriculture, hunting, forestry	3.2	4.0	2.9	3.8	62.8
Extraction of mineral resources	15.2	17.3	20.5	23.1	31.3
Manufacturing	17.6	16.4	21.4	17.9	4.0
Food industry, incl beverages, tobacco production	3.1	3.0	3.5	3.3	15.6
Coke and oil products	1.8	1.7	2.1	1.7	-1.1
Machine building	0.5	0.7	1.9	0.6	-53.0
Chemical products	1.7	1.9	2.6	1.9	-6.4
Other non-metal mineral products	1.5	1.2	1.2	1.5	37.9
Metallurgy and metal products	4.7	4.3	6.2	4.5	-8.8
Electricity, gas and water production and distribution	7.8	7.8	6.1	5.7	12.1
Construction	2.9	3.3	3.4	2.6	9.7
Retail and wholesale trade, maintenance of vehicles, home appliances and etc.	2.8	2.9	2.3	2.6	2.1
Transport and communication	28.8	26.8	25.7	24.6	13.3
Communication	6.7	5.5	5.2	4.6	-5.4
Real estate operations, leasing and services provision	11.5	11.5	10.7	12.4	36.1
Health care and social services	2.3	2.5	1.8	1.6	7.2
Provision of other public utilities, social and personal services	2.3	2.5	1.7	1.9	33.3

Source: Rosstat

istered in 2000. Both domestic and foreign investors have steadily increased their interest in investment in the Russian market, where the national currency is appreciating and profit margins are high relative to many other countries in the world.

Despite the unusual growth in manufacturing in early 2007 described above, resource sectors, metals, and the domestic market (non-tradables) remain the favorite directions for most domestic and foreign investment. Manufacturing received an estimated 17.9 percent of fixed capital investment in the first quarter of the year, almost half of which went into metals and food. Investment in manufacturing stood at only 4 percent higher in the first quarter of 2007 than in the same period of 2006. FDI inflows during the first quarter of 2007 reached an estimated record USD 9.8 billion. Most of this investment (USD 7.7 billion), was in the extraction industries (USD 7.4 bln. from the Netherlands). Manufacturing received only USD 0.7 billion in foreign direct investment (7 percent of all FDI inflows) with almost half of this total amount (USD 264 million) going to food, drinks and tobacco production. For comparison, in Q1-2006, FDI to-

Table 6
Shares of Foreign Direct Investment
by Sector of the Economy

	2006 % total	Q1-2007 % total
Agriculture, hunting, forestry	1.4	0.2
Extraction of mineral resources	33.1	78.6
Manufacturing	19.0	7
Electricity, gas and water production and distribution	0.4	0.2
Construction	2.0	0.5
Retail and wholesale trade, maintenance of vehicles, home appliances and etc.	6.1	3.1
Hotels and restaurants	0.2	
Transport and communication	2.8	0.4
Finance	11.0	5.2
Real estate operations, leasing and services provision	23.5	4.6
Provision of other public utilities, social and personal services	0.4	0.1

Source: Rosstat

taled USD 3.8 billion, with manufacturing accounting for 15 percent of the total FDI inflows (USD 577 million).

The Balance of Payments, Capital Flows, and FDI

Major changes in Russia's balance of payments are altering the overall macroeconomic picture in the country, and are creating new challenges for macroeconomic policy. While rapid import growth is shrinking Russia's current account, capital inflows have much more than compensated for this decline, thereby pushing the balance of payments surplus to further record highs and exerting new upward pressure on the ruble.

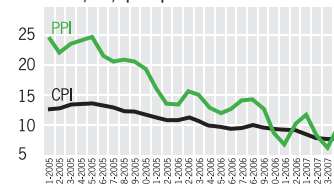
The current account has continued to weaken since the second half of 2006 due to the relative stabilization of energy prices and much more rapid import than export growth. Although a strengthening of energy prices generated a sizeable and higher-than-expected estimated current account surplus of USD 21.8 billion in the first quarter of 2007, this was smaller than the USD 30.5 billion surplus from the same period of 2006 (table 7). Import growth accelerated to over 35 percent in Q1 2007, while exports grew by only 3.7 percent during the same period. Unless oil prices increase, Russia's current account should continue to shrink.

Table 7
Balance of Payments (USD billions)

	2004	2005	2006	Q1-2006	Q1-2007*
Current Account Balance	58.6	83.8	94.5	30.5	21.8
Trade Balance	85.8	118.4	139.2	36.4	27.9
Capital and Financial Account	-6.3	-13.6	11.9	-7.3	11.4
Errors and Omissions	-7.1	-8.8	1.1	-1.8	-0.3
Change in Reserves	45.2	61.5	107.5	21.4	32.9

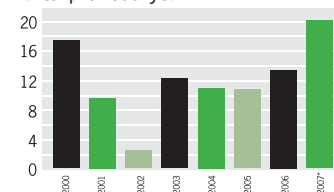
Source: CBR *preliminary estimates

Figure 6
CPI and PPI 12 months
inflation, %, p-o-p



Source Rosstat

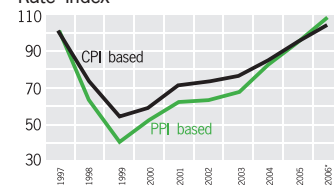
Figure 7
Capital investments,
% to previous year



Source Rosstat

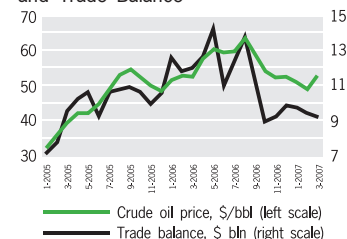
* data for January - April

Figure 8
Real Effective Exchange
Rate Index



Source: Staff estimates

Figure 9
Oil Prices
and Trade Balance



Source Rosstat

The big story of early 2007, however, has been the pick up in capital inflows, which has much more than compensated for the weaker current account, and led to a record accumulation of foreign reserves. In the first quarter of the year, the strong capital account reflected an acceleration in foreign borrowing by corporations (USD 24 billion), much of which can be associated with financing bids for the privatization tenders of remaining Yukos assets. While the corporate sector experienced strong inflows

Table 8
Net Capital Inflows
to the Private Sector (USD billion)

	2006	Q4- 2006	Q1- 2007
Total net capital inflows to the private sector	41.7	14.3	13.0
Net capital inflows to the banking sector	27.5	11.8	-8.9
Net capital inflows to the non-banking sector	14.2	2.5	21.9

Source: CBR

in Q1 2007, the banking sector actually experienced net outflows, which followed large inflows in the second half of 2006 (table 8).

April and May brought still new record capital inflows to Russia that far exceeded expectations. Preliminary estimates place capital inflows at USD 17 billion for April alone, and the Central Bank is now projecting about USD 45 billion in inflows for the first five months of the year. US\$ 8 billion alone in recent inflows came from an IPO of Vneshtorgbank. The gross reserves of the Central Bank mushroomed from USD 303.7 billion at the beginning of 2007, to USD 338.8 billion at the end of the first quarter of the year, to US 369 billion at end-April, and over USD 400 billion by the end of May. Thus, despite a weakening current account, the balance of payments continues to strengthen, and the pace of reserve accumulation in Russia has accelerated notably. This raises a number of questions for the conduct of macroeconomic policy, which are discussed below.

Inflation and stabilization policy

Inflation remained largely under control in early 2007, although the government may be challenged to keep it under control until the end of the year and meet the yearly target of 8 percent. According to preliminary data, CPI inflation for the first three months of 2007 amounted to 3.4 percent, as compared to 5.0 percent during the corresponding period of 2006 (table 9). Relatively high inflation in the early months of the year can be associated with annual increases in administratively controlled utility prices, as well as some other seasonal factors. These increases were smaller in 2007 than in 2006. However, core CPI inflation (excluding administrative and seasonal price increases) was also a percentage point lower than during the same period last year, despite the more rapid monetary expansion in late 2006 and early 2007. Money supply (M2) growth for the first four months of the year reached 11.2 percent versus 5.2 percent in the same period of 2006.

An examination of the basket of goods used to calculate the CPI reveals the source of lower inflation in early 2007 relative to 2006 (table 10). The majority of the difference in inflation (1% out of 1.6%) can be attributed to two sets of prices: those for fruits and vegetables and those for housing and utilities. The latter are regulated administratively. Lower increases in food prices reflect more favorable weather conditions and higher food production, as discussed above. For other major items in the CPI basket, Rosstat reported either relatively modest decreases or even increases

Table 9 Monetary Indicators

	First Quarter		April	
	2006	2007	2006	2007
CPI inflation, %	5.0	3.4	0.4	0.6
Core CPI Inflation, %	2.8	1.7	0.4	0.5
M2 growth, %	2.0	4.6	3.1	6.3

Source: CBR

(most services). Thus, lower inflation in early 2007 should not be considered a breakthrough in the reduction of core inflationary pressures. Preliminary estimates suggest that consumer prices in April 2007 grew faster than a year ago (0.6 versus 0.4 in 2006).

Table 10

Changes in prices of the main components of the CPI

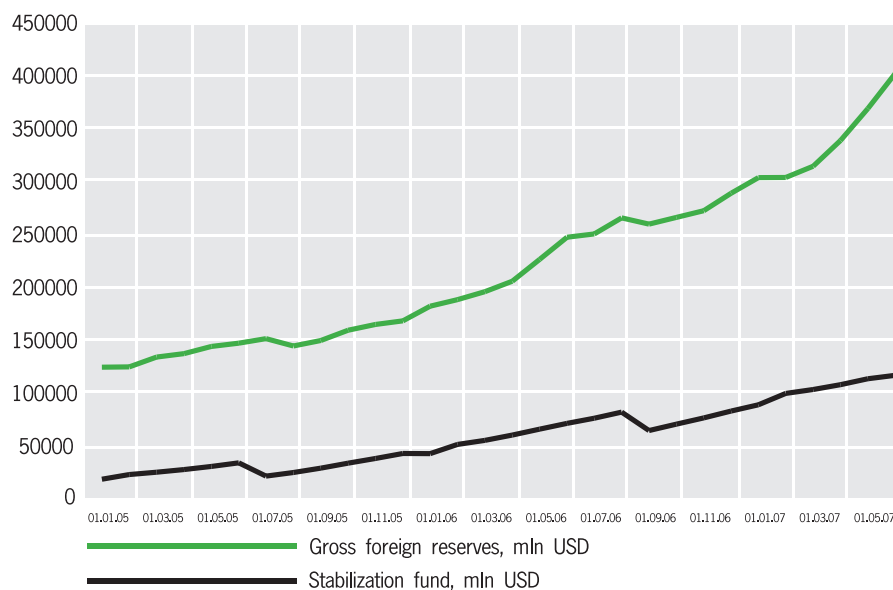
	weight in CPI	Price change (end period)	
		Q1-2007	Q1-2006
Meat products	10.28	0.9	0.9
Milk and milk products	2.68	1.9	3.4
Bread and bakery products	2.23	2.2	4.6
Fruit and vegetables	3.83	11.2	29.3
Alcohol	6.63	2.0	2.2
Clothing	5.27	1.5	1.9
Footwear	2.55	0.8	1.1
Construction materials	2.07	2.2	1.5
Housing utility services	8.83	12.7	15.6
Transportation services	3.26	6.7	5.8
Communication services	3.19	10.4	0.5
Education services	2.5	2.6	1.9

Source: Rosstat

Given mounting balance of payments inflows and limited monetary instruments for sterilization, keeping inflation in check promises to be a difficult task for the Russian government and Central Bank. As in previous years, the accumulation of large fiscal surpluses in the Stabilization Fund remains a primary means of sterilizing the large inflows. In the past, most these additional inflows came as a result of sharp increases in oil prices. In this case, the Stabilization Fund is an automatic stabilizer, as the majority of additional oil revenues due to higher prices accrues to the government through high marginal taxes, and is then accumulated in the Stabilization Fund. The strong growth in balance of payments inflows in 2007 was not due to higher oil prices, however, but to capital inflows, which are not sterilized through the Stabilization Fund.

Figure 10 illustrates the close relationship in recent years between growth in gross foreign reserves (driven mostly by balance of payments inflows) and the Stabilization Fund. Money supply growth in Russia follows a similar path to reserve accumulation, as forex purchases are the primary source of money emission in the economy. Until the Spring of 2006, the Stabilization Fund grew largely in parallel with foreign reserves. During this time, accumulation in the Stabilization Fund represented about half of the amount of growth in gross foreign reserves, i.e. more than half of the additional monetary expansion from the purchase of foreign reserves was effectively sterilized by the Stabilization Fund. Since this time, capital inflows, which are not absorbed into the Stabilization Fund, have become an increasingly important source of reserve accumulation (and money supply expansion). Correspondingly, the relationship between accumulation in the Stabilization Fund and reserve accumulation between April 2006 through April 2007 has become much weaker, and averaged only 33 percent. From March-May 2007, accumulation in the Stabilization Fund amounted to only 15.2 percent of reserve accumulation. At the

Figure 10 Accumulation of Foreign Reserves and the Stabilization Fund



Source: CBR

same time, as indicated above, money supply growth has accelerated.

While the pick up in growth has so far helped to absorb additional liquidity in the Russian economy, the implications for stabilization policy in Russia of the weakening of its automatic stabilizer in the form of the Stabilization Fund are potentially serious. As the pressures are coming from the balance of payments, the most obvious policy response would be to allow a more rapid nominal appreciation of the ruble. Since the end of 2006, the ruble appreciated in nominal terms by 1.7 percent against the US dollar, although it depreciated by 0.4 percent against the Euro. If the pressures for the real appreciation of the ruble are not relieved through nominal appreciation, then significant inflation for relatively non-tradable goods and services will be exceedingly difficult to avoid. For the Russian case, however, more rapid nominal appreciation carries important risks as well as benefits. The danger is so called “leakages” from the capital account. Expectations of rapid nominal appreciation can potentially attract even more foreign capital to Russia, which could potentially swamp the stabilizing effect of this policy measure. Speculative capital flows in the last few years appear to be closely connected to nominal exchange rate appreciation (See RER 13). While maintaining overall stability on currency markets, various options that would allow more flexibility (nominal appreciation) are nevertheless worthy of consideration in the present situation.

The sterilization of capital inflows through other policy measures in Russia is quite difficult. The domestic bond market is still very small in relation to the size of inflows. The Central Bank has already increased reserve requirements for commercial banks from 3.5 to 4.5 percent (4 percent for ruble deposits of households) as of July 1, 2007. Further increases in reserve requirements might help absorb excess liquidity in the event that the recent pace of foreign inflows does not slow. Increasing inter-

est rates is another potential means of tightening liquidity, but has the same risks as nominal appreciation for attracting more capital inflows.

Regardless of the specific choices made in monetary policy, the unexpectedly high balance of payments inflows should make 2007 another year of rapid real exchange rate appreciation. By the end of April, the ruble had already appreciated in real terms in by 2.3 percent, and the pace of this appreciation should increase.

Fiscal policy and the Federal Budget

According to preliminary estimates for the four months of 2007, the Federal Budget generated a surplus of 5.9 percent of GDP. Nevertheless, federal budgetary revenues (21.2 percent of GDP) were considerably lower than during the same period of 2006 (24.3 percent). The difference reflects lower receipts from energy taxes in the context of lower oil prices and lower VAT revenues relative to GDP. The government is currently drafting a supplementary budget that should increase federal spending for the year by at least 0.8 percent of GDP. The additional spending will likely correspond to two special sources of finance: (a) receipts of debts for Yukos following sales of its remaining assets and (b) a one-off transfer to the budget from the Stabilization Fund. Much of this additional spending will likely be directed at capitalizing special state development organizations, including a Development Bank, a Venture Fund, and a Housing Construction Fund. The extent of additional federal spending in 2007 is still uncertain, and Table 11 gives a very conservative estimate. The latest proposed revised federal budget also envisages a reduction in revenue collection by 2 percent of GDP (Table 11).

The federal government has been making some important progress in budgetary reform, particularly in the development of longer-term strategic budgeting. Fol-

lowing amendments to the Budget Code, the Russian government approved and submitted to the Duma the first three year (2008-2010) medium-term federal budget for the Russian Federation. The preparation of this budget involved substantial work on a registry of federal expenditure liabilities and a division of functions between ministries, agencies and budget organizations. Federal targeted (investment) programs and national priority projects are incorporated completely into the budget according to functional and organizational classifications. Three year budgetary projects took into account statements of intent and performance from ministries, federal agencies, and federal services as a first step toward the development of performance-based budgeting. For future years, federal expenditures are divided into baseline priority outlays that are pre-allocated according to specific budget obligations and conditionally approved general expenditures that will be allocated only during the future process of confirming the yearly budget. General planned parameters of the 3-year budget are given in Table 11 above.

World experience with medium term budgetary planning suggests that the development of an effective such instrument in Russia will require some time and effort. Nevertheless, the process itself of preparing the 3-year budget, and of taking stock of federal expenditures, priorities, and investment programs, was most likely very valuable for increasing the effectiveness of budgeting in Russia. The budgetary process has suffered from an excessive myopic focus on the yearly budget to the detriment of a longer-term vision and the multi-year finance of priority projects.

Recent amendments to the Budget Code also have major implications for the management of surplus oil revenues (Stabilization Fund resources). Under the new amendments, the Stabilization Fund will be split into two funds in 2008: a Reserve Fund and a Fund for Future Generations. Surplus revenues from both oil and gas will accrue to

Table 11 The Federal Budget (% of GDP)

	2007 Budget Law (approved)	Possible 2007 Budget (with additions)	Three year budget plan		
			2008	2009	2010
Revenues	22.3	20.3	19.0	18.8	18.1
Expenditures	17.5	18.3	18.8	18.8	18.1
Of which:					
General state management w/o interest expenditure	2.1		2.1	1.9	1.8
National defense	2.6		2.7	2.7	2.7
National security, law enforcement	2.1		2.2	2.3	2.2
National economy	1.6		2.1	2.0	1.2
Education	0.9		0.9	0.8	0.8
Culture, mass media	0.2		0.2	0.2	0.2
Health and sport	0.7		0.6	0.6	0.6
Social policy	0.7		0.8	0.9	1.0
Interbudgetary transfers	2.5		2.6	2.3	2.0
Transfers to extrabudgetary funds	3.4		3.8	3.8	4.1
Total non-interest expenditure	17.0	17.8	18.2	18.2	17.5
Interest payment	0.5	0.5	0.5	0.5	0.6
Oil and Gas Transfer		4.9	6.1	5.3	4.5

Sources: Minfin, EEG, World Bank staff calculation

these funds (as opposed to only oil revenues in the past). The Reserve Fund will ensure the budget against fluctuations in energy prices. It will hold surplus revenues up to 10 percent of GDP, and will be invested in safe and liquid assets such as government bonds. Additional surplus revenues will accrue to the Fund for Future Generations, which will be invested in a diversified portfolio that includes longer-term and riskier assets such as blue chip stocks.

A yearly "oil and gas transfer" to the budget from oil and gas revenues (present or past) will be used to finance the non-oil deficit of the federal budget (the deficit that would exist in the absence of oil and gas tax revenues). The draft 3-year budget plan sets the oil and gas transfer at 4.9 percent of GDP for 2007, 6.1 percent in 2008, 5.3 percent in 2009 and 4.5 percent in 2010. After this time, it should amount to 3.7 percent of GDP. The Budget Code also restricts the non-oil and gas federal budget deficit to less than 4.7 percent of GDP. By implication, deficit finance of the annual

budget cannot amount to more than 1 percent of GDP.

Much uncertainty still surrounds the Fund for Future Generations. According to best practices in other oil producing countries, this fund would be invested in longer-term foreign assets that would, over the medium term, provide the country with a major source of budgetary revenue that is independent of oil and gas. One proposal is that this fund could also be used to capitalize the Russian pension fund, which is experiencing mounting deficits that would otherwise continue to widen in the medium term. In his recent Address to the National Assembly, the President suggested that parts of the Fund for Future Generations (aka the “National Welfare Fund”) could be used for current projects or for covering pension fund deficits. Furthermore, it has been suggested that part of the Fund for Future Generations may be invested not in foreign assets, but in domestic Russian corporate stocks. This would partially negate the Fund’s purpose as a means of sterilizing surplus energy revenues and creating a source of income for the country that is independent of oil and gas. It would also add to already substantial inflationary pressures in the country.

Income and Employment

Consistent with the economic expansion, real disposable income and wages of the population exhibited even more rapid growth in January-April 2007. Official estimates place this growth at 11.5 and 18.5 percent, respectively. Almost all sectors of the economy reported wage growth above 15 percent. Wage

growth was the highest in the public sector, trade, and construction (about 22-23 percent). Current trends in wage growth, together with the continued real appreciation of the ruble, suggest that the average monthly dollar wage in Russia for 2007 should exceed USD 500.

Despite high and increasing demand for labor in Russia and negligible growth in the working population, the rate of unemployment (ILO definition) has remained quite stable in the range of 7.2 - 7.6 percent since 2005. Most of this unemployment is likely either structural (associated with restructuring) or regionally concentrated. Indeed, unemployment is particularly concentrated in the poorer agriculturally-oriented republics of the Southern Federal Okrug. Data on registered unemployment (available by region) suggests that unemployment in Southern Russia is roughly three times as high on average as in the Central, North West, or Volga Okrugs, and about twice as high as in Siberia and the Far East.

Recent Policy Initiatives

Economic policy initiatives in Russia have become particularly focused on two major speeches of President Vladimir Putin: the Budgetary Address on March 9, 2007 and the Address to the National Assembly on April 26, 2007. The budgetary address stressed the importance of maintaining restrictive fiscal policy in the presence of inflationary pressures, of developing institutions for medium-term budgeting, and of realizing the current reforms in interbudgetary relations and local self-government that delegate more expenditure autonomy to lower levels of government. The Address to the National Assembly focused on policies to realize key development objectives in the country, including the availability of housing, infrastructure, innovation, diversification, and the pension system. On the latter subject, the President proposed not only increasing average pensions by at least 65 percent during 2007-2009, but also introducing

Table 12 Social Indicators

	2003	2004	2005	2006	4M- 2006	4M- 2007
Real disposable income growth, %	14.9	9.9	8.8	10.2	7.1	11.5
Real wage growth, %	10.9	10.6	10.0	13.4	10.4	18.5
Average monthly wage, USD	179.4	237.2	301.6	394.7	341.4	459.7
Unemployment (% , ILO definition)	8.6	8.2	7.6	7.1	7.9	7.1

Source: Rosstat

Table 13 Main projects proposed by the President

Proposal/Project	Amount (bln. Rubles)	% of cur- rent GDP
Housing and municipal services	250	0.8
Capitalizing development institution (Development Bank, Investment Fund Russian Venture Company)	300	1.0
Intracity road construction	100	0.3
Capitalization Fund for Nanotechnology development	180	0.6

Source: Putin's State of the Nation Address

a scheme to stimulate the development of a savings-based pension system in Russia: 1000 state rubles for every 1000 rubles of individual savings in a volunteer pension fund. For the realization of development objectives, the President proposed the creation of a number of state funds and development organizations. He also remarked that the new "Fund for Future Generations" would be better to name the "National Welfare Fund," as proceeds should be spent on both current and future generations. He indicated that support for the deficit-ridden pension system would be a proper function for the "National Welfare Fund"

Table 13 lists the major important proposals for government programs in the President's Address to the National Assembly, as well as their proposed costs. Some of these costs have already been incorporated into the draft 3-year budget discussed above. Other costs are to be covered by receipts in 2007 from Yukos and a one-off transfer from the Stabilization Fund to the budget. The question of affordable housing received special attention: A 250 billion ruble fund for construction and renovation is to be set up in 2007. This includes 100 billion for relocating people out of dilapidated housing. The capitalization of state development institutions and road construction are to receive 300 billion and 100 billion rubles, respectively, in 2007. The Address also surprised many specialists in its proposal to devote 130 billion rubles (50 billion of which was already included in the draft Budget) for the capitalization of a Nanotechnology Support Fund. The commitment of this amount to a single branch of science is unprecedented in Russia.

Increasingly tense economic relations between Russia, the EU, and other G-8 countries have again raised some uncertainty about the date of Russia's accession to the WTO. Russia has stated that it remains committed to completing the accession process, and the EU and US have given indications that they continue to support Russia's membership.