1. Growth Mechanism is Changing

Russia's economic performance in 2002, with GDP up over 4.3%, compared favorably with slow growth in Europe and the US. However, even this represents a slowdown in growth on previous years, even with high oil prices.\(^1\) It is important to consider that high GDP growth rates between 1999-2002 (6.4% annual average) have been achieved on the back of high oil prices, a strong balance of payments, healthy fiscal performance, and increased capacity utilization. Increased fiscal revenues (which largely resulted from high oil prices) easily allowed the government to raise wages in the public sector and stimulate domestic demand considerably.

However, the period of «cheap» growth, as has been the case in recent years, has effectively come to an end. Higher capacity utilization, which contributed to rapid growth in productivity, is already out of the question\(^2\). Sooner or later oil prices are likely to go down and stabilize at some lower level, which will reduce export earnings. Apart from this, the recorded slowdown in economic growth in 2002 indicates that the existing model for economic growth has come to an end of its useful life. The drop in manufacturing concurrent with rapidly growing real disposable incomes in 2002 clearly proved that (fig. G1).

It is widely recognized that the structure of the national economy is skewed towards the fuel and energy sector, which accounts for 30% of industrial output, one third of consolidated budget revenues and over half of federal budget revenues. Exports of fuel and energy make up about 55% of total exports (for details see section 3). Russian manufacturing lacks competitiveness and thus the gap between rapidly growing incomes and domestic production was compensated for by increased imports in 2002 and early 2003. It is important to note that this occurred despite a relatively stable real effective exchange rate. In fact, this exchange rate actually decreased by 1.7% (chart 2) in 2002 due to that fact that the ruble gained slightly against the dollar in real terms, while strongly depreciating against the euro.

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\(^1\) According to the most recent data the Russian economy grew 6.4% in 1999, 10.0% in 2000 and 5.0% in 2001.

\(^2\) Especially in the sectors which are able to produce competitive goods.
G. Diversification of the Russian Economy and Growth

Growth slowed in 2002 as increased domestic demand saw consumer preference shift towards more expensive higher quality goods, a sector in which Russian manufacturers are unable to compete with imports. The food industry provides a clear example of how growing incomes have transformed consumer demand. In 1999-2000, when incomes were low,