INDEUNIS Papers[1]
WP-6

Challenges of Russian economic policy in the context of structural change and integration with EU
(Draft)

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Moscow- 2007

[1] INDEUNIS stands for 'Industrial Restructuring in the NIS. Experiences of and lessons from the new EU Member States', an international research project (No 516721) funded by the EU Sixth Framework Programme (www.wiiw.ac.at and www.cordis.lu).

Contents

Introduction

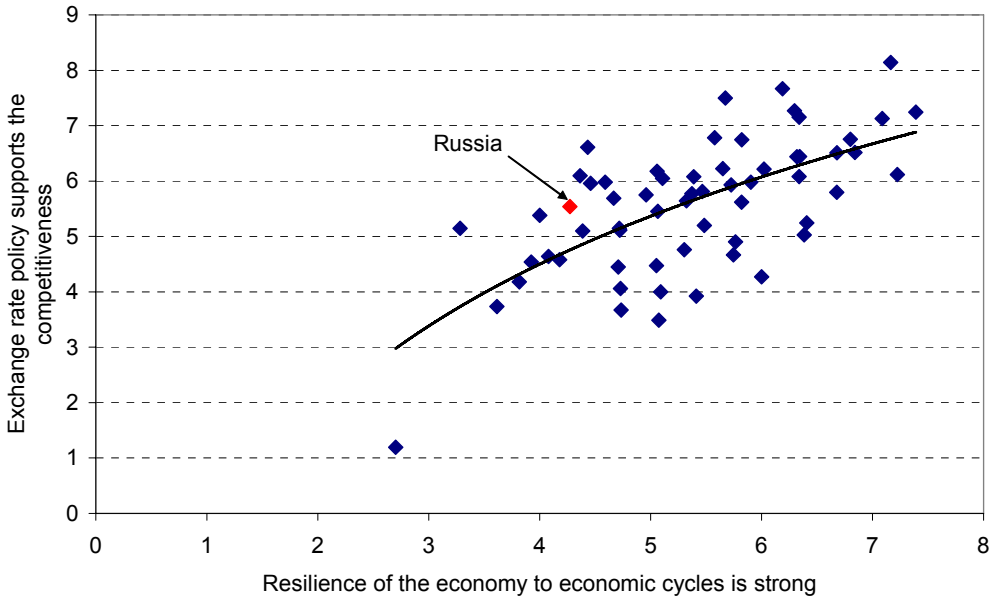
In the previous reports prepared by the Development Center under INDEUNIS project we looked into the nature and drivers of the Russian economy upturn after the financial collapse of 1998 (WP1+2). We have shown that one of the growth catalysts was a sharp reduction in wage expenses and improved price competitiveness resulting from ruble depreciation in 1998, especially in domestic-oriented industries. These sectors of the economy enhanced labor productivity and are the most dynamically growing. However, two negative trends emerged recently: while unit wages in the manufacturing sector slumped, the price competitiveness reached the pre-crisis level. Further development of the Russian economy depends on the industry's capabilities to ensure control over labor costs and productivity and neither is possible without economy restructuring and enhancement of its innovative component.

In our reports (INDEUNIS, WP1+2) we have also set forth the monetary policy scenarios and their impact on economic growth and production structure influenced by different oil price levels. We have shown that the policy of inflation curbing and ruble appreciation is more preferable from the macroeconomic perspective: in this economic setting, growth in GDP, investments and real household disposable income reaches its maximum. However, even with high oil prices, ruble appreciation as a tool to suppress inflation has its limitations, and a more balanced monetary policy is required. The year 2006, in all evidence, bucked the multi-year uptrend in oil prices now set on a downward path. The Russian economy forecasts put together by Development Center for 2007-2010 with respect to different oil price levels indicate that in the short-term the Russian economy can withstand any change on the oil markets, maintaining GDP growth rates in 2010 at 4-4.5%, even if the URALS grade oil price drops to $35 p/bbl. In the medium-term, however, the influence of the international economic environment will be much stronger, although a possibility of crisis (GDP contraction) in the coming seven years is estimated as «remote» or «unlikely», albeit the consensus forecast regularly compiled by the Development Center points to a cyclical growth deceleration in 2011-2012.

In these circumstances a logical question will be what economic policy is more important for the Russian economy: restructuring at meso and micro levels or competent macroeconomic monetary policy. Judging by the poll conducted by IMD experts, the Russian economy has more room for resistance to cyclical fluctuations, including price movements on the world commodity markets, than for improving quality of the monetary policy as an instrument to underpin the competitiveness of national producers (the respective scores in 2006 were 4.3 and 5.5, respectively, using a 10-grade scale). As stability of the Russian economy substantially depends on raw materials exports, these assessments may be interpreted as a chance for Russian authorities to upgrade their course in the eyes of the international

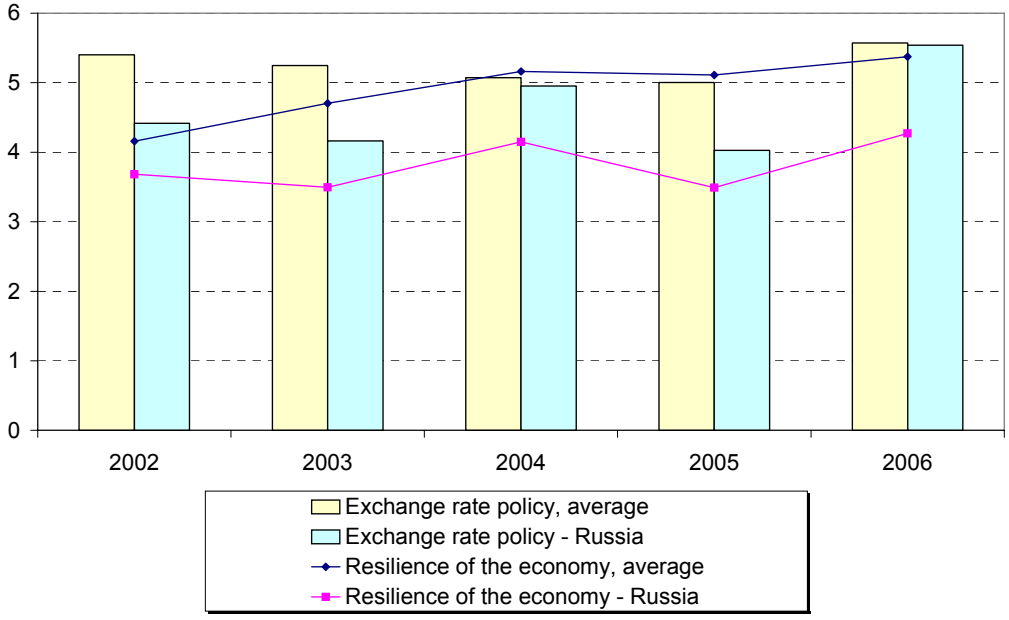
expert community through purposeful action aimed at diversifying the economy by developing sectors that are not directly exposed to the effect of oil price movements, primarily, the manufacturing sector. There are some unresolved problems in this segment.

Fig. 1. Resilience of the National Economies' to Economic Cycles and Quality of Exchange Rate Policy as a Tool to Support the Competitiveness of the National Producers, 2006



Note. Scores based on a 10–grade scale assigned to 61 countries, 2006.
Source: IMD, Executive Opinion Survey, 2006.

Fig. 2. Change in Resilience of the National Economies' to Economic Cycles and Quality of Exchange Rate Policy as a Tool to Support the Competitiveness of the National Producers



Note. Grades based on a 10–grade scale assigned to 61 countries, 2006.
Source: IMD, Executive Opinion Survey, 2006.

In one of the papers presented by the Development Center under this project (WP-5) we have highlighted that restructuring of the Russian automotive industry based on commercial assembly allowing practically duty-free import of auto components discourages auto makers from

building up partner relationships with Russian components producers. Bearing in mind, that the mission of the manufacturing sectors is to act as stabilizer assuring stability of the Russian economy in the fast changing global economic environment, the current reform of the Russian automotive industry has a long way to go to fit it, and is not a showcase for other industries[2].

In this paper we will further expand on the issues of economic policy focused on solving industry restructuring problems in a transition economy facing the need of integration with a mature regional market (for instance EU) and will consider the following aspects relating to the Russian economy.

In Section 1 we will track the development trends of the world manufacturing industry as the nucleus of the modern economy for the last 10-15 years, which have not yet transformed into post-industrial. In Section 2 we will compare competitive strengths and weaknesses of the Russian and EU industries. In Section 3 we will set out the prospects of industry restructuring in Russia and the EU to find the ways of mutually beneficial and complementary growth in competitiveness.

1. Trends and structure of the global manufacturing industry in 1990-2005: acceleration of developing and transition economies against the background of developed market economies' absolute dominance

With globalization of trading, investment and technological flows and accelerating change, the restructuring problems in transition economies should be considered in the context of the global change, taking into account their interregional dimension.

Development trends of economies of two major groups of the countries in the world during 1990-2005 were as follows:

in developed market economies[3] GDP annual average growth recoiled to a relatively moderate level of 1.9% in 2000-2005, typical for the first five years of the period under review (following the upswing the economies in the "mid five years" of 1995-2000 averaging 2.9% a year);

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[2] In our estimates, to bring the output of new locally produced foreign nameplates in Russia to 700 thousands automobiles per year (if started from scratch), about $2.8 billion of investments will be needed to set up assembly lines. The correlation of investments and production volumes in China whose successes in building the national automotive industry can hardly be overestimated illustrates that the Russian auto industry could have expected larger investment injections into production modernization. Only in 1999 – 2003, investments in the Chinese automotive industry made about $ 20 billion. In 2004 about 2 million automobiles were assembled. Therefore, considering the gap in production volumes of the two countries, production of the same number of cars in Russia required far less investment.

Unlike in China, where high import duties on cars and car parts resulted in a high cost of manufacturing, production of foreign brand cars in Russia is dominated by the assembly segment with a low level of localization.

[3] The countries included in this group are listed in Annex 1.

in 2000-2005 developing countries[4] picked up pace versus the preceding five year period (average annual growth of 4% and 3.2%, respectively), but failed to regain a 5% average growth rate observed in 1991-1995;

transition economies, including Russia,[5] demonstrated steadfast economic growth averaging 5.6% a year in 2000-2005, spelling out that these countries have successfully overcome the repercussions of the transformation slump in the early 1990s and have shot ahead as economic growth leaders. In terms of GDP annual average growth (6.1%) Russia is second best after China (7.8%).

According to the long-term forecasts of global economy development devised by specialized institutes of the Russian Academy of Sciences, in 2006-2020 the countries of East, South East and South Asia will be growing fastest. GDP of Asia Pacific Region (excluding Japan) in 2006-2020 is expected to increase 2.1 times (versus 1.6-fold average world growth).

Table1. Average Annual Growth* in Value Added of the Manufacturing Sector and GDP in Russia, Major Groups of Countries and Regions of the World (%).

Country/Region	Value Added of the manufacturing sector			GDP		
	1991 - 1995	1995 - 2000	2000 - 2005	1991 - 1995	1995 - 2000	2000 - 2005
Russia	n/a	0.8	9	-9.1	1.6	6.1
World	1.9	3.3	3	2.3	3.1	2.7
Developed market economies	1.4	2.8	1.7	2	2.9	1.9
Transition countries	-11.5	3.1	8.1	-6.9	2.1	5.6
Developing countries	5.4	3.9	5.1	4.6	3.2	4
Including						
Sub-Saharan countries	-0.4	3.1	3.3	1.1	3.5	4.3
North Africa	2.2	5.1	3	2.1	4.6	4.3
Latin America and Caribbean	2.7	2.6	2.6	3.8	2.8	2.4
South East Asia	8.9	4.8	6.8	6.8	3.3	5.2
China**	13	8.3	9.2	10.5	7.2	7.8
West Asia and Europe	3.8	4.7	6.1	2.6	3.3	4.9

**in real terms*
***including Hong Cong and Taiwan, excluding Macao*
Source: UNIDO (IndStat), Development Center

Economic development in Latin American countries will substantially quicken the pace versus 1980-2005, primarily thanks to a more intensive integration to the world trade and foreign investment raising processes (GDP is expected to rise 1.7-fold in 2006-2020). GDPs in the group of economically advanced countries (the EU, the USA and Japan) are expected to grow modestly 1.4 times for the period under review, and their possible acceleration is largely associated with social reforms (for example, reforms of the pension system and social sector as a whole), the

[4] Ibid
[5] Ibid

implementation of which entail significant political complexities. In the rest of world, the pace of economic growth will, in many respects, depend on the ability of these countries to build up cooperation with the fast-track markets of the Asia Pacific Region. For example, economies of such traditionally "backward" regions as Sub-Saharan countries may stage a strong upswing in the medium term fueled by inflow of labor intensive industries from Asian countries. This migration of industries will occur in other sectors of the manufacturing industry as well, and its direction will depend on competitive advantages of a specific country.

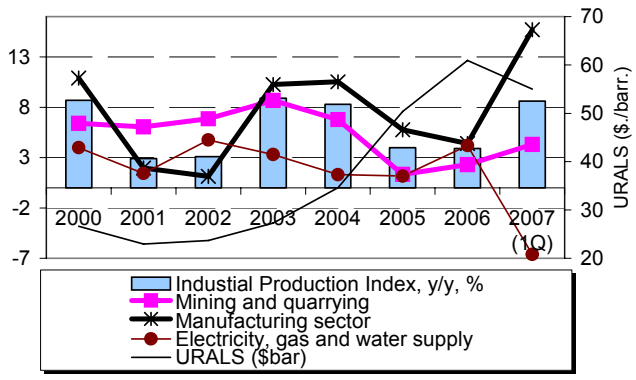
In this context, it is important to understand to what extent accelerating economic growth of growth leaders (primarily, transition economies) is in step with acceleration of the manufacturing sector of the economy, being its industrial nucleus. For this purpose we will analyze development trends of the manufacturing sectors in the groups of countries selected for our survey. Among these trends we may single out the following:

- Faster growth (or decline) in the manufacturing sector versus GDP growth in all surveyed groups of countries, excluding developed market economies;
- General growth trend in the period from 1990 to 2005 is generally in step with GDP growth, but absolute growth rates of the manufacturing sector are noticeably higher, especially in transition economies where growth coefficient exceeds 1.4 for this group of countries;
- Although recently Russia demonstrated one of the highest growth rates in the manufacturing sector (9% annual average), ceding leadership only to China (9.2%) and dependence of these rates on oil price movements is not so obvious , the growth rates are not yet stable. This is evidenced by mounting volatility of growth rates in the manufacturing sector and a short two year cycle of high (8-9%) and low (3-5%) growth in the entire industry and its manufacturing segment.

To assess the development prospects of the manufacturing sector in the developing countries and transition economies, and in the Russian industry as an example, one should be well aware of the global development trends and migration of technologies and production between the countries of different groups, which may be caused by various factors, for instance by relative price of production. Prospects for such "migration" volumes are rather high, as now developed market economies account for 50% to 90% of global output produced by the manufacturing sectors (excluding manufacture of tobacco products, clothes and footwear), according to UNIDO statistics. A significant share (from 10 to 40%) is concentrated in developing countries and only less than 10% is contributed by transition economies.

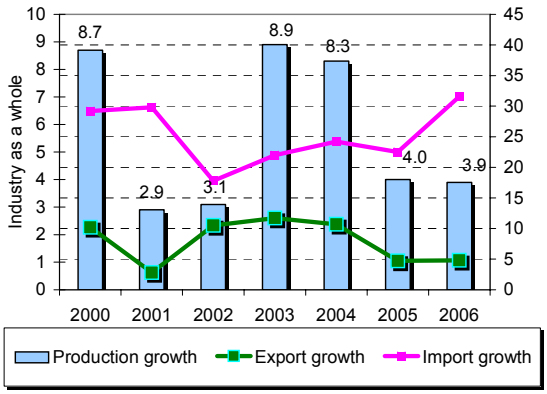
Fig 3-6. Russian Industry in 1999-2006 – Growth Factors and Indices

Fig 3. Trends by major industry (y/y growth, %) and world oil price



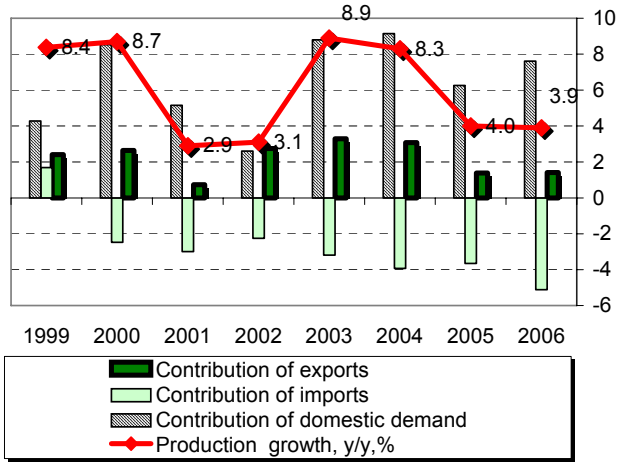
Source: Russian Statistics Service

Fig 4. Y/y Growth in physical volumes of exports, imports and industrial output (%)



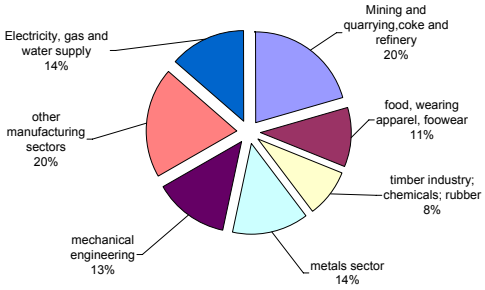
Sources: Russian Statistics Service, Federal Customs Service (FCS) – export/import data.

Fig 5. Factors' contribution[6] to industrial production growth (under OKVED) in 1999-2006 (%)



Sources: Development Center, Russian Statistics Service, FCS.

Fig 6. Industry turnover structure in 2006 (%)



Sources: Russian Statistics Service, Development Center.

Empirically in 1995-2005 we may single out the following trends in the manufacturing industry structure by group of countries:

- ***in developed market countries*** the output of the segments manufacturing leather, leather products and footwear, fur and fur products, textiles and tobacco products was steadily contracting for the last ten years. A recently transpired trend continuing for the last five years is a plunged output in printing and publishing, manufacture of non-metallic mineral products, manufacture of furniture and fabricated metal products. Notable is a sharply braked growth in output of wood products, paper and paper products, coal and refined petroleum products, basic metals and other transport equipment (excluding motor vehicles) versus the previous five year

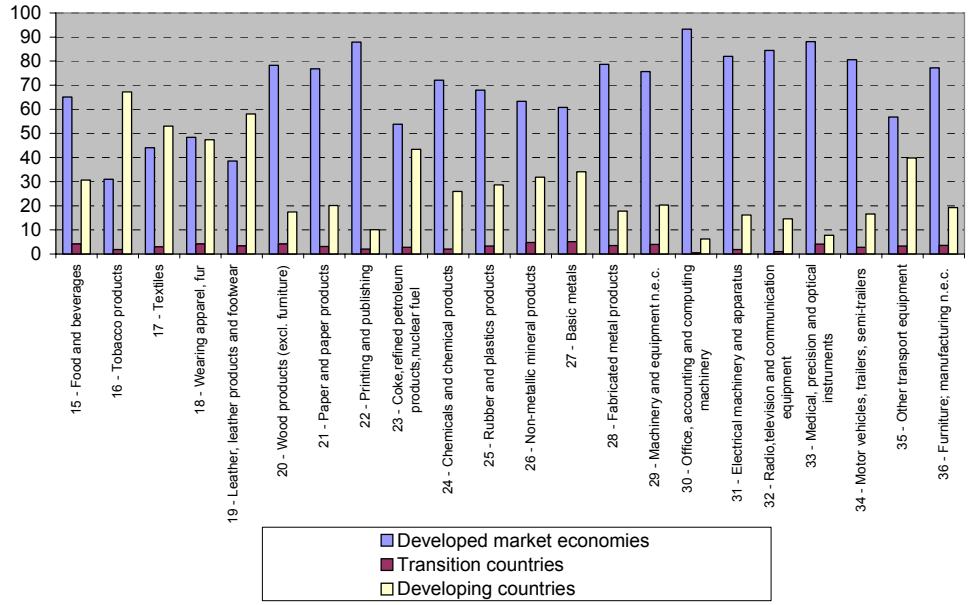
[6] Summation of factors' contribution (taking into account the sign) gives an actual increase in total industrial output y/y; 2006 – estimate. The calculation is based on the assumption that imports' contribution to industrial production growth of the current year is positive when imports decline and is negative when imports pick up. It is assumed that the share of goods inventory (in production and trade) is stable.

period. Among the growth leaders of the manufacturing industry (versus average growth in the manufacturing sector in this group of countries) are the sectors producing office equipment and computers, radio, television and communicating equipment, medical and optical instruments, and motor vehicles;

- ***in developing countries*** there has not been a sector for the last decade firmly set on a downward trend. The downswing in output of leather, leather products and footwear, coke and refined petroleum products, machinery and equipment in 1995-2000 was reversed by a steady uptrend in the following five years, with highest growth observed in manufacture of machinery and equipment (on average over 9% a year). Among the new trends is a tangible deceleration in output of fur and fur products versus the previous five year period. The growth leaders (versus average growth in the manufacturing sector in this group of countries) were represented by producers of rubber and plastic products, fabricated metals, machinery products (especially, office, computing, radio, television and communicating equipment), motor vehicles and furniture;
- ***in transition economies*** not a single sector in the last ten years has demonstrated a steady downtrend. Among the new trends is a considerable slowdown in output of tobacco products (versus the previous five year period) being a global trend, and declining growth in output of office and computing equipment. The growth leaders (versus average growth in the manufacturing sector in this group of countries) are represented by manufacturers of electrical equipment, radio, television and communicating equipment, other transport equipment, , and in the last five years – producers of motor vehicles.

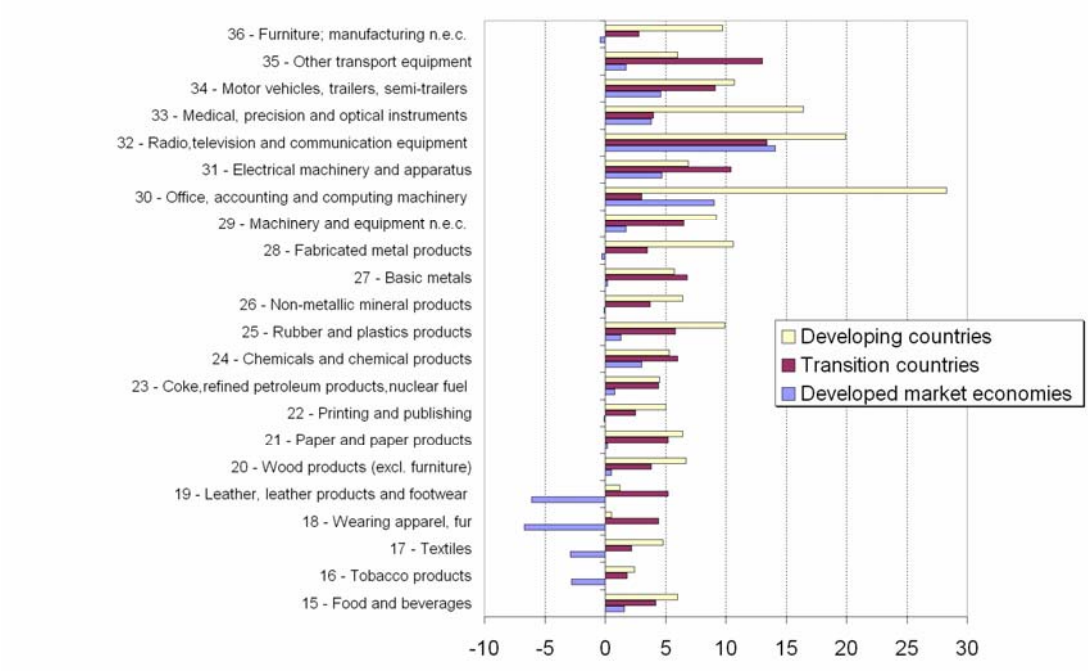
Against the background of serious shifts in the world economy brought about, among other things, by restructuring and international migration of the manufacturing industry sectors, the Russian economy faces a challenge to sustain high growth and strengthen stability in the manufacturing industry for further economy diversification and adaptation to falling growth in raw materials exports. In the context of rapidly declining price competitiveness of Russian commodities on the domestic and world markets pulled down by appreciation of the real ruble, special focus is placed on analysis of such economic growth factors which refer to non-price competitiveness factors, for instance, expansion of international economic cooperation, including cooperation with EU member states.

Fig 7. Global Value Added of the Manufacturing Industry Sectors by Group of Countries in 2005 (%)



** **ISIC (UNIDO** IndStat **Rev.3)**
Source: UNIDO (IndStat)

Fig 8. Average Growth Rates* of Value Added in the Manufacturing Sectors by Major World Region in 2000-2005 (%)



**at constant prices of 1995 (in $)*
Source: UNIDO (IndStat)

Table 2. Average Growth Rates * of Value Added in the Manufacturing Sectors ** by Major World Region in 1995-2005, %

	Developed market economies		Transition countries		Developing countries	
	1995-2000	**2000-2005**	**1995-2000**	**2000-2005**	**1995-2000**	**2000-2005**
15 - Food and beverages	0.3	1.6	3.3	4.2	0.7	6
16 - Tobacco products	-1.5	-2.8	4.8	1.8	6.7	2.4
17 - Textiles	-1.2	-2.9	2.8	2.2	0.1	4.8
18 - Wearing apparel, fur	-3.8	-6.7	2.9	4.4	2.3	0.5
19 - Leather, leather products and footwear	-2.9	-6.1	1.9	5.2	-3.9	1.2
20 - Wood products (excl. furniture)	0.9	0.5	0.9	3.8	5.5	6.7
21 - Paper and paper products	1.3	0.2	4.9	5.2	7.2	6.4
22 - Printing and publishing	2.8	-0.1	2.5	2.5	9.8	5
23 - Coke, refined petroleum products, nuclear fuel	2.2	0.8	3.3	4.4	-3.6	4.5
24 - Chemicals and chemical products	2.7	3	6.1	6	1.8	5.3
25 - Rubber and plastics products	3.3	1.3	5.6	5.8	10.8	9.9
26 - Non-metallic mineral products	1.2	-0.1	1.1	3.7	1.9	6.4
27 - Basic metals	0.5	0.2	4.6	6.8	1.1	5.7
28 - Fabricated metal products	1.3	-0.3	3.2	3.5	5	10.6
29 - Machinery and equipment n.e.c.	0.6	1.7	2.4	6.5	-1.2	9.2
30 - Office, accounting and computing machinery	18.1	9	10.5	3	3.5	28.3
31 - Electrical machinery and apparatus	7.6	4.7	11.5	10.4	9.1	6.9
32 - Radio, television and communication equipment	33.5	14.1	13.9	13.4	23.2	19.9
33 - Medical, precision and optical instruments	4.5	3.8	4.5	4	9.3	16.4
34 - Motor vehicles, trailers, semi-trailers	3.2	4.6	4.6	9.1	14.2	10.7
35 - Other transport equipment	3.7	1.7	8.3	13	3.7	6
36 - Furniture; manufacturing n.e.c.	2.2	-0.4	-0.1	2.8	5.3	9.7

Note: zones and periods of absolute output slump are marked by yellow color, zones and periods of overshooting growth versus average level for this group of countries is marked by brown color (see also Table 1).
**at constant prices of 1995 (in $)*
** ISIC (UNIDO IndStat Rev.3)
Source: UNIDO (IndStat)

2. Russian and EU economies – analysis of industry strengths and weaknesses

In terms of statistics, Russia and EU countries have different status in the world economy. Nominal volumes of the economies differ 19-fold. Adjusted for PPP, the gap narrows ninefold. At the same time, by the level of economic development measured by per capita GDP (PPP adjusted) Russia lags the EU-15 by a factor of three and is behind the states that joined the EU in 2004 only by one third.

Table 3. Russia and EU in the World Economy in 2005

	Population, million people	Territory, million km^2	Fertile territory, m^2 per person (2003)	Per capita GDP (EU-15 = 100%)		Volume $bn			
				nominal	PPP adjusted	GDP $bn		Merchan-dise exports	Merchan-dise and services imports
						nominal	PPP adjusted		
Russia	143,5	17,07	8 577	14	33	764	1519	244	164
EU-15	386,6	3,24	2 647	100	100	12 782	11 159	3 693	4 682
EU-6*	67,2	0,6	3 231	30	54	631	1 045	288	354

**Czech Republic, Estonia, Hungary, Poland, Slovakia, Slovenia*
Sources: Russian Statistics Service, IMD-2007

By fertile territory per person, Russia noticeably (2.3-3.5 times) outperforms the EU countries. In terms of mining core energy-producing materials, Russia is ahead of or on equal footing with the EU states. Indicators of ferrous metallurgy and electricity match and those of car manufacturing lag behind the relative indicators of per capita GDP. There is an obvious misbalance between performance indicators of agribusiness and resource base availability in Russia and EU, which spells an extremely low extent of fertile land utilization in Russia.

Table 4. Share of Russia and EU in Production of Staple Goods in 2003
(total world= 100%)

	Russia	EU (15)
Oil mining	12.2	3.8
Mining of natural gas	22.8	8.4
Mining of coal	5.6	6.7
Electricity supply	5.5	16.5
Production of steel	6.5	16.6
Production of crop and leguminous plants	3.2	9.1
Cattle and poultry	2.0	14.3
Motor vehicles	2.6	37.8

Source: Russian Statistics Service

A dynamic view on the situation reveals Russia's overshooting growth over the last seven years as compared to the EU countries, and the conditions are in place to maintain and even widen the gap, mainly due to two reasons.

First, growing heterogeneity of the EU after accession since 2004 of the new members, that will have to catch up with the old ones modifying the former concept of "integration at different

speed" into the "train" concept where "locomotive" countries are towing the "trailers". According to available forecasts, the process of convergence of almost thirty states may take about thirty years.

Table 5. Key Economic Indicators of Russia and EU in 1999-2005, % of annual growth, average for the period

	Russia	EU-15	EU-10
GDP*	6.6	2.8	4.5
Household final consumption	6.9	2.9	3.9
Gross capital formation	12.1	3.1	2.5
Industrial production**	7.5	2.3	5.1
Retail trade***	7.4	2.6	n/a

**1999-2006*

*** 9 countries from EU -10 (joined the EU in 2004) (net of Malta) for the period from 1999 to 2004.*

**** 14 countries from EU-15 (net of Luxembourg) for the period from 1999 to 2004.*

Source: Russian Statistics Service, IMD-2007

Second, a much higher growth in gross capital formation in Russia versus EU-15 countries (overshooting by a factor of four) and versus EU newcomers (overshooting by a factor of five). With the latter group Russia has comparable levels of gross fixed capital formation, which volumes versus private and public sector savings spell out a 10 p.p. GDP gap, allowing to assume that gross capital formation may grow 1.2-1.4 times (considering the need of growing Russian transnational corporations to invest in foreign real assets). Assessment of this growth prospect is very important, as the trends in gross fixed capital formation and fixed capital investments are key for modernization and improved competitiveness of the Russian industry and its manufacturing sector.

We can name a number of trends characterizing the inflow of investments in the Russian economy based on analysis of statistics for the recent years and the results of 2006.

First, foreign direct investment into the real sector of the economy (unlike investments in the financial sector) has settled at $ 13-14 bn versus 2005. This may cool off the euphoria from growth rates of foreign investment into the Russian economy in 2006 and to the financial sector, in particular, and prompt a conclusion that a substantial inflow of foreign investment to the Russian industry in 2007 can hardly be expected, given stabilized oil prices and resulting slowdown in the ruble's strengthening as a growth driver of foreign investment.

Second, 2006 saw a steep rise in outward investments of Russian industrial producers. This is a sign that domestic investments are not so much contained by the lack of resources, but by other factors, assumingly, the investment climate, absence of feasible projects and adequately trained management. Continuing growth in the financial sector and roughly achieved parity of inflow-outflow of foreign capital to/from Russia also point to institutional and not financial constraints.

Third, the share of banks as a source of investments made up 9% preserving the level observed in 2005, while the share of the securities market is several times lower. Despite a 50

percent growth in the banking sector indicators in 2006, this proportion remained the same. Subsiding inflation does not allow to cut interest rates on bank loans so that enterprises could recoup the finance costs given the current level of profitability. To put it differently, interest rates should be slashed to make the banks loans accessible.

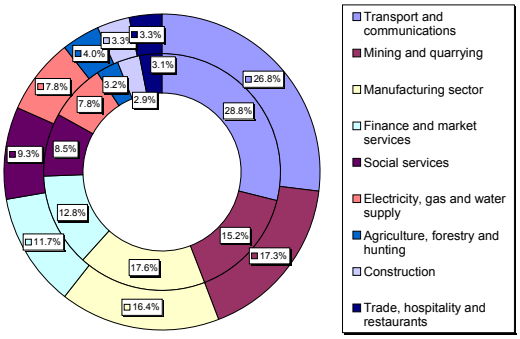
Fig. 9-12. Trends of Fixed Capital Investments in Russian Economy

Fig 9. Growth in fixed capital investments (%, y/y) and their volume by sector

	2004	2005	2006	2006, $ bn
Total fixed capital investments (covering all enterprises)	11.7	10.7	13.5	165.1
Fixed capital investments, net of small business and informal activities	н/д	7.9	10.7	130.2
Agriculture	8.7	10.6	40.6	5.2
Mining and quarrying	-8.0	-0.3	22.2	22.6
Manufacturing sector	11.1	10.6	7.4	21.3
food and beverages;tobacco products	-10.3	7.5	3.9	3.9
timber industry; chemicals and chemical products; rubber	4.3	20.6	10.3	4.1
metals sector	45.1	19.1	12.8	5.5
mechanical engineering	-0.6	-5.8	13.2	2.7
Electricity, gas and water supply	14.9	-0.4	2.2	10.2
Construction	-33.8	31.1	8.6	4.4
Transport and communications	20.6	14.4	5.2	34.9
Social services	-3.4	16.9	22.5	12.1

Source: Russian Statistics Service, Development Center

Fig. 10. Structure of fixed capital investments in the Russian economy in 2005 (internal circle) and 2006, %



Note: excluding small businesses

Sources: Russian Statistics Service, Development Center

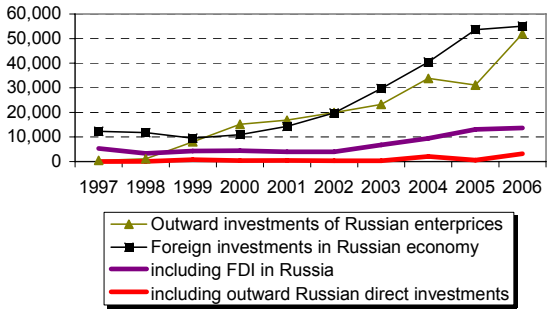
Fig. 11. Credit availability as source of economic growth for industries*

	2003	2004	2005	2006
Mining and quarrying	4.8	19.7	25.6	21.1
food and beverages;tobacco products	-6.2	-5.3	-3.7	-1.0
wood products	-8.8	-8.2	-7.6	-6.0
pulp and paper	-4.0	-2.0	0.3	4.1
manufacturing of coke, refined petroleum products	1.1	9.5	10.1	16.7
chemicals and chemical products; rubber	-4.2	1.0	6.2	11.7
metals sector	9.3	19.4	14.3	22.0
mechanical engineering	-6.5	-4.9	-4.1	-1.5
Electricity, gas and water supply	-8.0	-7.4	-5.3	-7.0

*The table shows the difference in turnover profitability (according to direct data of Russian Statistics Service based on accounting data, 2006 – Development Center estimates) and average interest rate on bank loans (data of Russian Economic Barometer).

Source: Russian Statistics Service, Development Center

Fig. 12. Major transborder investment flows in the non-financial sector* ($bn)



** Net of banks and monetary authorities*

Source: Russian Statistics Service

Fourth, there are serious factors reining in the inflow of investments into mechanical engineering where correlation of investments and pre-tax profit was by far lower than 1, signifying the dearth of equity preventing implementation of large investment projects. And the lack of inflowing borrowed funds precludes the entry to the world market. A spurt in investment activity in mechanical engineering will be followed by expanding investments in domestic assets in the metals sector having ample room for such growth due to low propensity to investments in domestic assets (internal fixed capital investments accounted for a modest 30-40% of the pre-tax profit).

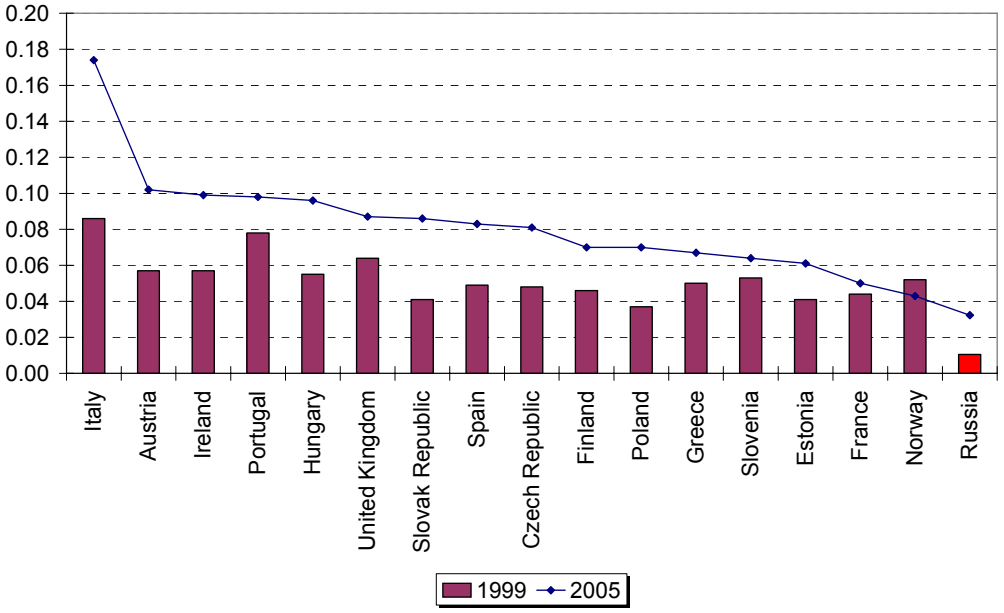
In January-February 2007, fixed capital investments grew by 21.2 % (y/y), and adjusted for low base of last year – only by 11-12%. Despite the likely continuation of neutral and negative trends of the previous year described above, investments may pick up in 2007. If investment plans devised by UES of Russia for 2007 are to materialize, envisaging investment growth from $ 6.6 bn in 2006 to $20 bn in 2007, we may expect investments to rise by 7-8 percentage points up to 20-21% y/y, taking into account the share of this company in the total investment volume. Besides, 90% of investment growth in UES of Russia should be financed with borrowed funds, thereby their portion in investment sources is expected to broaden from 31% to 71%. To this end, at least ten IPOs should be conducted, which looks a remote prospect considering the recent volatility of the world stock markets.

Analysis of prospects for accelerated investment activity in Russia is also important in the context of possible toughening of the competition between Russia and the EU-10 countries for deployment of labor and energy intensive productions withdrawn from Western Europe and from the EU-15 countries, on the whole. As one of Russia's industrial weaknesses is high "haul distance" in industrial cargo transportation, which, according to the Russian Statistics Service, is 4.5-6 times longer than in the EU countries, equaling 1100-1300 km per 1 ton of cargo, it is important to perform the analysis of relative trends in other competitiveness indicators, measuring relative investment potential of the economy and prospects for competitiveness growth.

The key competitiveness indicators are movements in real effective exchange rate (RER) of the ruble and unit labor costs (ULC). If the first indicator is always in the center of analysis, the second one is often ignored. We all know that, according to the CBR data, in 2002 through 2006 the real effective exchange rate of the ruble appreciated by 23.7% on an annualized basis and by 22.6% according to period end data. In this context, a question arises to what extent the movements in unit costs in the Russian industry , determined, inter alia, by trends in electricity prices and ULC (also versus major trading partners) compensates (or exacerbates) the problems of the price competitiveness associated with the exchange rate? Below we have addressed some aspects of this problem drawing on fresh statistics.

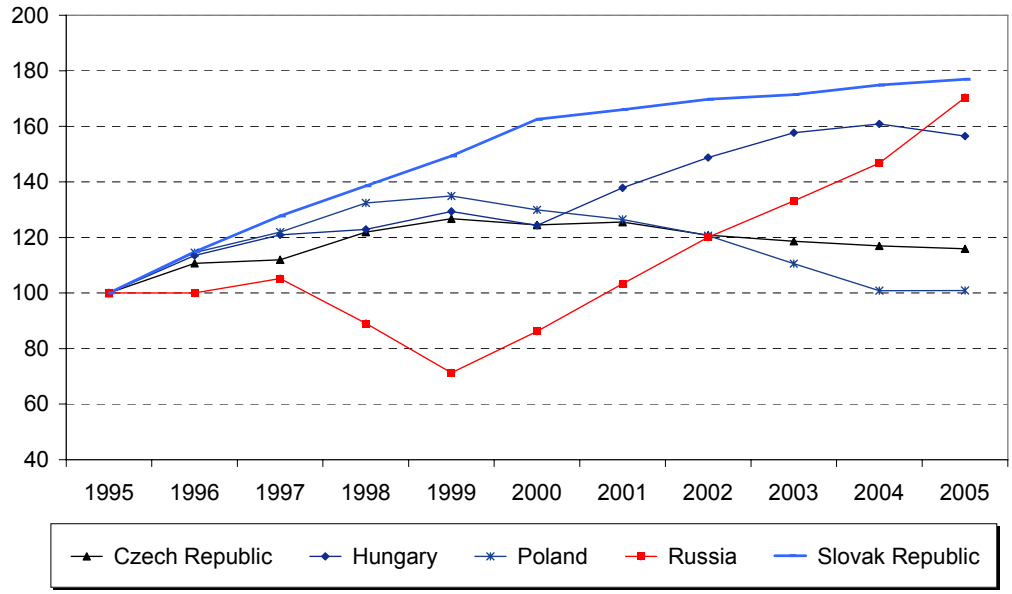
Electricity prices are critical not only for the Russian economy but also in the light of the new Energy Strategy of the EU entailing the creation of a single energy market. Our research has shown that in terms of electricity cost, Russia's competitive advantages against the background of trebled growth in electricity cost over the last seven years have noticeably weakened, despite the upturn in electricity prices for industrial consumers in this period in almost all European countries (excluding Norway, where they dropped).

Fig. 13. Electricity Prices for Industrial Consumers in EU and Russia in $, per kWt/hour



Source: IMD statistics, 2007

Fig 14. Trends in ULC in Russia and Some European Countries, 1995=100%.



Source: IMD statistics, 2007

Talking about ULC determined on the basis of relative movements in wages and labor productivity in Russia and its trading partners, the statistics analysis of the1995-2005 period shows that the Russian economy has no positive reserve here as well.

From the perspective of ULC growth in the period after the ruble's free fall in 1998 Slovakia's situation is the worst, and next comes Russia. Most likely, the calculation of ULC versus the total portfolio of Russia's trading partners dominated by developed market countries (similar to the CBR basket used to calculate the real effective exchange rate of the ruble (RER)), will produce

different results and their slower growth in Russia, comparing to its competitors, versus appreciation of RER. However, identification of the group of fast growing economies has more sense, due to the catching trend of transferring many labor and energy intensive productions from developed market economies, for instance, from the EU-15, to the countries competing for the right to host such productions. In terms of relative growth, Russia has no special advantages in this\respect, although sound absolute competitive strengths remain (level of currency-denominated wages).

Table 3. Hourly Wages in Manufacturing Industry in EU and Russia, $*

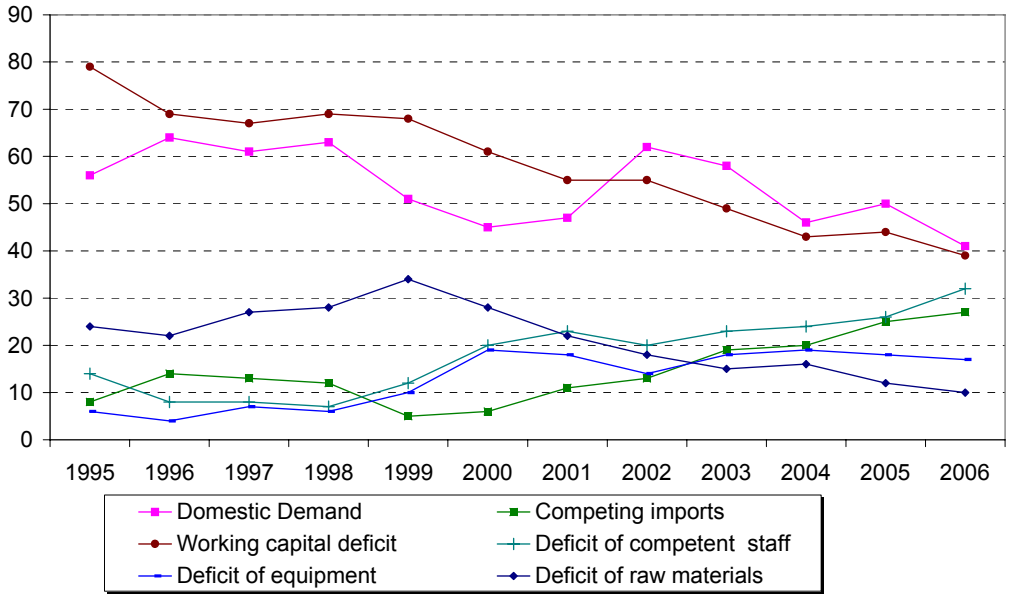
Values	1999	2000	2001	2002	2003	2004	2005
Austria	21.7	19.2	19.2	20.6	25.3	28.3	28.3
Belgium	22.1	20.1	19.8	21.7	26.5	30.0	30.0
Czech Republic	2.9	2.8	3.1	3.8	4.7	5.4	5.8
Denmark	24.5	21.9	22.1	24.3	30.2	33.8	33.7
Estonia	1.6	1.7	1.8	2.1	2.7	3.2	3.6
Finland	21.6	19.4	19.9	21.7	27.1	30.6	30.6
France	17.1	15.5	15.6	17.1	21.1	23.9	23.9
Germany	24.6	22.6	22.5	24.1	29.6	32.5	32.5
Hungary	2.8	2.8	3.2	3.9	4.8	5.7	5.8
Ireland	13.9	12.8	13.6	15.2	19.1	21.9	21.9
Italy	15.9	13.8	13.6	14.7	18.1	20.4	20.4
Luxembourg	19.7	17.5	17.2	18.7	23.1	26.5	26.5
Netherlands	21.5	19.4	19.9	22.1	27.4	30.7	30.7
Portugal	5.1	4.5	4.6	5.1	6.2	7.0	7.0
Slovenia	5.0	4.5	4.6	5.2	6.7	8.1	9.0
Spain	12.0	10.7	10.9	11.9	14.9	17.1	17.1
Sweden	21.6	20.3	18.4	20.2	25.2	28.4	27.9
United Kingdom	17.5	16.7	16.8	18.2	21.2	24.7	24.5
On average by group of countries in the EU							
EC-14	18.5	16.8	16.7	18.2	22.5	25.4	25.4
EC-4 (since 2004)	2.5	2.4	2.5	3.0	3.8	4.5	4.9
Reference data:							
Russia	0.5	0.5	0.7	0.7	0.9	1.2	1.4

**basic and additional wages*
Source: IMD statistics, 2007; Development Center – 2004-2005 estimates for Russia

3. Prospects for industry restructuring in Russia and EU – seeking ways of complementary competitiveness growth

In the recent years Russia's economy underwent serious changes. Net of the market conditions reviewed above, such newly emerged factors as deficit of equipment, competent staff and escalating competition with imports begin to play a weightier role as economic growth constraints alongside traditional growth limiting factors (insufficient domestic demand and equipment).

Fig. 15. Russian Industry Output Limiting Factors (% to the number of respondents)



Source: Institute of the Economy in Transition (IET) Surveys, November 2006

Concurrently, radical change was observed in approaches to economic policy targeted at industry restructuring and overcoming de-industrialization of the Russian economy manifest in industry underperforming of GDP growth. ***On the one hand***, we see a tendency to pursue actively the traditional industrial policy in the country, but the proposed measures have no new drive, lack effectiveness and disregard regional specifics. ***On the other hand***, the former strategic focus of foreign trade is now being revised, and a new strategy is still in the making (several scenarios are being developed), which contains and is likely to continue to hamper business development at least up to 2009 – the start off of new government formed after presidential elections . Below we offer a more detailed overview of these problems.

3.1. New industrial policy – pro et contra

In October 2006 MOEDT of Russia put together the industry support plan for the period from 2006 to 2007 mapping out specific steps to spur fixed capital investments and innovation, improve the system of state development institutions, underpin exports of industrial commodities, train competent staff, develop production infrastructure, stimulate SME, develop industrial design. These measures also provided for development of specific industries.

In our opinion, the problem does not lie in the fact that direct government industry support policy based on identifying priorities has become outdated. Today we should think about new concepts creating the mechanism of economic self-development, for instance the concept of innovation, although two important processes make successful use of selective interventions more

problematic than earlier. First, because of spiraled competition among the governments of the developing markets, which increasingly strive to support selected industries in the economies[7]. Second, cheapening cost of information, higher capital mobility, creation of global supplier chains and permanent technological changes lead to rapid changes in industrial development patterns and competitive advantages[8].

We believe that development of traditional industries and innovation are inseparable interrelated processes and transition to innovation phase is impossible to pull off though a spurt, it is an organic consequence of traditional industries development.[9] The problem is ***to reshape traditional industrial policy conducted at the macro-level***. First, to mitigate the risk of government interventions' failures (although they cannot be avoided[10]), they should be undertaken in line with basic measures aimed at improving the investment climate (non-selective measures) to assure clear and reasonable goal setting, exercise tough control over the recipients of government subsidies and regularly monitor the effectiveness of government programs[11].

Understanding the drawbacks of selective industrial policy, the started effort in this direction should not be yet abandoned and the existing gaps in the Russian regulatory base should not be ignored. For example, the report of the Development Center under WP5 has shown that the Russian auto market is most open to import of foreign brand cars due to low 25% import duty. Besides, the terms of industrial assembly of automobiles in Russia – close to duty-free import of auto components given the annual output is at least 25 thousand cars and the volume of auto components produced in Russia is brought to 30% of the total used auto components within 6-7 years – are actually a gateway for foreign car manufacturers to Russia.

As a result, the existing legislative environment does not sufficiently motivate foreign car manufacturers to set up fully-fledged (in terms of output and production of components) production capacities in Russia and does not contribute to building respectable status of Russian subsidiaries within foreign automotive concerns.

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[7] Starting from 1962, when countries of South-East Asia were successfully experimenting with the so-called "industrial policy" aimed at supporting exports, the number of countries exporting electric equipment trebled and the number of countries exporting components for motor vehicles more than doubled (2005)

[8] See World Development Report 2005 by World Bank

[9] High level of R&D expenses is typical for developed market economies, where the bulk of expenses is borne by private companies. In less developed economies private businesses are often not motivated to engage in innovation activities, as demand of production companies for innovation depends on the quality requirements of the end-use products consumers (domestic and international) and is therefore contingent on successes in development of traditional industries , traditionally measured by investment growth in the Russian economy.

[10] The failures may be illustrated by lame efforts of state support to aircraft building industry in Japan and production of liquid crystal monitors in the USA.

[11] See World Development Report 2005 by World Bank

It should be understood, that often the process of industrial policy development is more important than the result[12]. The sectoral policy, according to some specialists, should be viewed as a research process, in the course of which the company and the government become aware of the key costs and opportunities and get involved in strategic interaction. A hypothesis is offered that this interaction can be targeted at solving two kinds of problems:

- support of imitating quasi-innovations[13];
- solving problems of coordinating complementary types of activity[14].

Export support measures devised by the Russian government since 2003 do not bring noticeable successes either. It follows not only from objective statistics on the export trends and structure, but also from the fact that already proposed mechanisms do not enjoy business demand. In 2005 state guarantees for export support were offered in the amount of $ 214 million (to support supplies of aircraft building products and atomic power). In 2006 state guarantees, due to procedural bureaucracy, were not given at all (as at 1 October 2006). The same organizational barriers prevent timely refund of VAT to the exporters. Actually, the period of refund 2-4 times exceeds a legally established 3 month period.

In all evidence, measures aimed at enhancing the volumes of non-raw materials exports lack comprehensive approach and leverages of its support that have absolutely no relation to control over financial flows. New approaches, on the one hand, can aim to use purely organizational mechanisms – for example, massive political lobbyism of Russian exporters and preventive creation on the basis of industrial unions of Russian exporters' consortiums participating in international tenders to stave off price reduction, and on the other hand, to provide for clear communication by federal authorities to the regions of prospects and timeframe of export transport infrastructure development projects.

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[12] For instance, Dani Rodrik from Harvard University states that the analysis of industrial policy needs to focus not on the policy *outcomes*—which are inherently unknowable ex ante—but on getting the policy *process* right. (Dani Rodrik, INDUSTRIAL POLICY FOR THE TWENTY-FIRST CENTURY, Harvard University, article available at www. opec.ru).

[13] At the current stage of development we should not overlook support not only to new operations and industries but also to the types of products new to a particular country – the so-called discoveries (terminology of Dani Rodrik, Harvard University). «Indeed, we showed how whole industries often arise out of the experimental efforts of lone entrepreneurs. Garments in Bangladesh, cut flowers in Colombia, IT in India, and salmon in Chile. For such innovations the entrepreneurs need the guarantee of receiving a rent which is possible through subsidies, credits to venture capital». (Dani Rodrik, INDUSTRIAL POLICY FOR THE TWENTY-FIRST CENTURY, Harvard University, article available at www. opec.ru).

[14] «Profitable new industries can fail to develop unless upstream and downstream investments are coaxed simultaneously. The main coordination problem is a difficulty to match investments against production solutions of different entrepreneurs. This suggests that what needs support is not specific sectors per se, but the type of technologies that have scale or agglomeration economies and would fail to catch on in the absence of support». Dani Rodrik, INDUSTRIAL POLICY FOR THE TWENTY-FIRST CENTURY, Harvard University, article available at www. opec.ru).

Industry restructuring policy does not sufficiently reflect ***regional specifics and the risk of regional disintegration.*** It is true that the session of Presidium of Russian State Council on 19 February 2007 addressed the issue "On measures to support industry development in the Russian Federation" pointing out that functions of federal authorities first of all consist in fostering favorable conditions for implementing effective focused measures at the regional level aimed at realizing competitive advantages of the respective territories. In this respect, a decision was made to set up a legal framework for concluding investment agreements between development institutions (Development Bank, Rosselkhozbank, Rosagroleasing, Investment Fund, and Venture Fund), federal authorities, regions and investor companies. In addition, it was decided to develop a legal base allowing to subsidize interest rates on investment loans aimed at implementation of high-tech projects in priority sectors of the economy. To conduct a cluster policy aimed at brining out the competitive advantages of the regions, a decision was made to develop the Concept of territorial and production clusters. A crucial step, even disregarding regional specifics, was approved by the State Council to liquidate staff deficit in the industry to satisfy the requirements of industrial development in the regions and create a special system of mortgage crediting oriented at educational personnel, engineers and qualified workers.

At the same time, in our opinion, the relationships between the regional and new industrial policy need to be further elaborated and require new approaches. As empirically shown in a number of research papers, the revenue base of the RF regions is far more volatile (sensitive to regional revenue shocks) than that of US and EU country regions (EU-15)[15]. The volatility stems from uneven concentration of natural resources on the territory of Russia and the legacy of the Soviet economic policy hinged on centralized selection of the region specialization. Besides, a much lower than in the developed market economies level of labor force mobility also affects the ability of the regional economy to respond adequately to recession (deflationary) or inflationary shocks. These facts spell out for Russia the importance to develop and implement a regional policy that would, on the one hand, facilitate fast growth of regions acting as the locomotives of the economic growth, and on the other, eliminate the most odious manifestations of regional economic differentiation, avoiding traditional Russian slant towards equalization, and contribute to realization of the "constructive inequality" principle in the regional policy.

Following the old perception of the regional policy, two systems of sate governance should work in parallel and independently with actually duplicated functions. The objectives to level off regional lopsidedness so critical in the period of restructuring slump should now give way to development tasks. Currently, the regional policy and region development policy should become different although inter-related processes. Region development is the task of regional authorities and the

[15] Russian Federation: Selected Issues, September 2004, IMF Country Report # 04/316, p.75-88

regional policy pursued by federal authorities should seek and maintain the equilibrium of regional interests by various directions, adjusting them so as to assure maximum realization of their potential and overall economic growth in the country.

Resolving of the national tasks should not lead to centralization of all powers, both managerial and financial, at the federal level. The ideal option is to track shaping trends in the development of companies, population migration, etc, to subject them to analysis and form the policy above these trends that will be used either to accelerate these trends or to iron them out, depending on a situation.

3.1. Changing the approach of the Russian Government to foreign trade strategy

The recent years saw a change in the Russian government objectives as regards further course of foreign economic operations. One of the key priorities identified in the program of social and economic development of the Russian Federation for the medium-term (2005-2008) published in early 2005 was to complete accession to the multi-facet system of regulation on terms acceptable to the Russian Federation and transition from bilateral contractual base of trade to multilateral. Now, against the background of foiled talks on multilateral investment agreement and protracted Doha round negotiations under the aegis of WTO, more experts root for bilateral, and first and foremost, regional agreements based on the "free trade zone+" principle (trade liberalization with partial liberalization of capital flow). In this context, the task considered as first priority several years ago moves to the forefront again - to expand a list of trading partners, seek new merchandise and services markets based on bilateral treaties and more active participation of Russia in regional and political blocks. When the above development program was devised in 2005, its respective section mentioned primarily CIS countries, Evrazes, Common Economic Space, but not the EU.

Possible foreign trade development scenarios are linked with four core alternative scenarios – Asia-reorientation strategy, US cooperation strategy, creation of a single energy transit system "European Russia – Far East" to be able to exercise operational management of supply volumes by different geographic zone, using the unique transcontinental location of Russia, and, finally, traditional loyalty to cooperation with the EU.

The first scenario requires creation of large specialized trade terminals on the Pacific coastline and development of infrastructure for rail deliveries to China and Republic of Korea, as well as entering into long-term contracts on economic cooperation with the countries of this region aiming to facilitate access of goods produced by the Russian manufacturing sector to this market.

The second scenario – orientation towards the USA – is primarily based on spurring exports of energy-producing materials and expanding cooperation in the area of production and exports of high-tech services requiring investments in the development of the respective infrastructure.

The third scenario is targeted at diversifying exports of energy-producing materials and taking advantage of the transcontinental position of Russia as a bridge between Europe and Asia.

The final fourth scenario provides for development of infrastructure for energy deliveries to Europe with the aim to exclude unreliable transit countries and ensure supplies oriented towards energy-saving and diversification of imports under the new EU Energy strategy (2007 draft). Due to low growth rates in the EU economy (Section 1 of the Report) and predominantly resource-driven Russian exports to European countries (Section 2 of the Report), this option have prospects only if agreement is in place on creation of a single economic environment with the EU, stipulating removal of barriers to Russian non-raw materials exports. In any other case, materialization of this scenario is not likely to resolve the piled up problems. Some of these problems were addressed in our report under WP (3+4) of this project. For example, one of our assertions was that the short-term result of the EU expansion in 2004 was a certain increase, in real terms, in raw materials exports from Russia to EU-10 countries against the background of a more considerable growth in finished goods exports from EU-10 to Russia. In future a number of institutional issues related to prospects of fulfillment by new member states of the EU Energy policy provisions and transition of the EU-10 countries to EU technical standards and similar certification procedures may potentially contain the growth in the Russian exports of machinery and equipment, industrial goods and end-use products. With further diversification of the Russian economy and rising demand for ecologically clean agricultural products on the European market, these problems may be become of crucial importance to the Russian enterprises operating in the manufacturing sector and agribusiness.

One of the ways to materialize the fourth scenario may be a course towards cooperation with the EU in the framework “free trade zone +” (trade liberalization with partial liberalization of capital flow) or a course towards “more profound” integration with the EU entailing conclusion of the agreements aimed at creating a single legal framework for economic activity. In the current political setting that would mean for Russia to accept the basic “playing rules” adopted in the EU. The second course would allow substantial cuts in investment costs associated with development of the transport infrastructure through attraction of European investors and providing Russian companies with access to the EU transport infrastructure. At the same time, inevitable inclusion of the Transit Protocol to the Energy Charter will impose tight constraints on the freedom of choice for the Russian government. We cannot overrule that situation either, considering the recently voiced intention of First Vice-Premier Sergey Ivanov to remove the differences in the Russian and EU legislation to enable unimpeded access for Russian commodities, and especially high-tech products, to the European market.

Alongside problems arising from variances in the legislations, the poll conducted by our experts under WP3+4 of INDEUNIS project to find out the opinions of Russian top industrialists about implications of the EU enlargement mentioned above, allowed, inter alia, to identify organizational, economic and political factors impeding the expansion of Russian trade with EU member states.

According to the group of enterprises involved in foreign trade, among the main depressants (in the order of priority) were the drawbacks of the Russian economic policy and complicated taxation being, to a certain extent, one of the consequences of this policy. The following two problems – low quality goods and insufficient information about EU merchandise legislation - can be resolved by top managers of these enterprises themselves. A sizable share of managers from this group indicated that one of the significant problems for them is state support of the competing firms in the EU.

The problems challenging domestic-oriented producers are revealed in their responses to the questions on factors hindering expansion of trade with the EU countries. Thus, a much larger share of the respondents named a language barrier (almost 12% versus 2% in the export-oriented group and 4% in the entire sample) and low quality of their products (over 20% versus 14% in the export-oriented group).

We also note a higher percentage of the respondents (comparing to the entire sample and the export-oriented group) who have no or very vague idea of the EU merchandise legislation (over 20 % against 14%), and a very low percentage, evidently due to the lack of the relevant practical experience, of the respondents who pointed to visa regimes and government support of the competing firms.

An additional grasp of problems the resolution of which would contribute to overcoming the competitive weaknesses of the Russian economy and enhance the chances for diversification of Russian export deliveries to the EU maintaining the necessary for the EU volumes of exported hydrocarbons and other raw materials is provided by IMD competitiveness indices[16].

The competitiveness rating shows that Russia is lagging behind, ranking the 50th in the recent years versus 35-40th ratings of the EU-10 countries and 20th ratings of the EU –15 countries (Annex 2).

[16] There two most respectable world competitiveness ratings developed by (World Economic Forum, WEF and International Institute for Management Development, IMD. Country competitiveness indices are calculated by IMD on the basis of 4 factors: economic performance, government efficiency, business efficiency and infrastructure (Annex 4). Each of the factors is further broken down into five sub-factors aggregating the statistical data (over 314 criteria). Altogether 20 sub-factors are used in the calculations (Annex 5). Unlike the WEF ratings, where the share of surveyed criteria is over 50%, the survey data in IMD research represent a weight of one third. Another difference in approach applied by IMD is that each sub-factor has the same weight in the overall consolidation of results.

However, analysis of ratings assigned to Russia, EU-15 and EU-10 countries by main indices and the respective sub-indices shows their uneven allocation. So, from the perspective of economic policy it is important to pay special attention to the sub-indices of Government Efficiency and Infrastructure.

By Government Efficiency, Russia is ahead of the EU countries in such areas as quality of public finance and fiscal policy (according to IMD ratings) and seriously lags in such areas as development of the economy institutional framework, business legislation and social interaction infrastructure (Annex 3).

By Infrastructure, Russia is ahead of the EU countries in the area of science and education infrastructure development and lags by such parameters as development of technological infrastructure, health and environmental protection (Annex 3).

These spheres of activity may be further examined to enable technological and institutional transfer from the EU to Russia in exchange for the resources and developments needed by the EU economy to raise its competitiveness versus USA, Japan and South East Asia countries, as set forth in the respective EU documents, for example, the Lisbon program providing for creation in the EU of the most dynamic and competitive economy in the world based on this knowledge. Therefore additional priorities for cooperation between Russia and the EU may be identified apart from those set out in the Road Map to general economic environment developed in Moscow in May 2005: information and communication technologies, electric machinery and equipment, medical products, automotive, textile and pharmaceutical industries[17].

Summary

This report tackles a number of issues of economic policy focused on solving industry restructuring problems in a transition economy facing the need of integration with a mature regional market (for instance EU).

We have shown in ***Section 1*** of our report that transition economies including Russia[18] demonstrated steadfast economic growth of 5.6% a year in 2000-2005, spelling out that these countries have successfully overcome the repercussions of the transformation slump in the early 1990s and have shot ahead as economic growth leaders. Although recently Russia demonstrated one of the highest growth rates in the manufacturing sector (9% annual average), ceding leadership only to China (9.2%) and dependence of these rates on oil price movements is not so obvious , the growth rates are not yet stable. This is seen in mounting volatility of growth rates in the

[17] This document is published in: V.N. Sumarokov, N.V. Sumarokov, “Expansion of the European Union and Russia’s foreign economic ties”, Moscow, 2006, pages 208-224.
[18] Ibid

manufacturing sector and a short two year cycle of high (8-9%) and slow (3-5%) growth in the entire industry and its manufacturing sector.

According to long-term forecasts of global economy development devised by specialized institutes of the Russian Academy of Sciences, in 2006-2020 the countries of East, South East and South Asia will be growing fastest. GDP in the group of economically advanced countries (EU, USA and Japan) is expected to grow modestly 1.4 times for the period under review, and their possible acceleration is largely associated with social reforms (for example, reforms of the pension system and social sector as a whole), the implementation of which entail significant political complexities. In the rest of world, the pace of economic growth will, in many respects, depend on the ability of these countries to build cooperation with the fast-track markets of the Asia Pacific Region, and on successful hosting on their territories of migrating manufacturing industries impacted by the evolution of competitive advantages of the countries. Prospects for such "migration" turnovers are rather high, as now developed market economies account for 50% to 90% of global output produced by the manufacturing sectors (excluding manufacture of tobacco products, clothes and footwear), according to UNIDO statistics. A significant share (from 10 to 40%) is concentrated in developing countries and only less than 10% is contributed by transition economies.

Against the background of serious shifts in the world economy brought about, among other things, by restructuring and international migration of manufacturing industry sectors, the Russian economy faces a challenge to sustain high growth and strengthen its stability in the manufacturing industry for further economy diversification and adaptation to falling growth in raw materials exports. In the context of rapidly declining price competitiveness of Russian commodities on the domestic and world markets pulled down by appreciation of the real ruble, special focus is placed on analysis of such economic growth factors which refer to non-price competitiveness factors, for instance, expansion of international economic cooperation, including cooperation with EU member states.

In Section 2 we have a concise comparative analysis of the Russian and EU economies to identify competitive strengths and weaknesses in the respective industries. In terms of statistics, Russia and EU countries have different status in the world economy. By level of economic development measured by per capita GDP (PPP adjusted) Russia lags the EU-15 by a factor of three and is behind the states that joined the EU in 2004 only by one third.

A dynamic view on the situation reveals Russia's overshooting growth over the last 7 years as compared to the EU countries, and the conditions are in place to maintain and even widen the gap, mainly due to much higher growth in gross capital formation in Russia versus EU-15 countries

(overshooting by a factor of four) and versus EU newcomers (overshooting by a factor of five). With the latter group Russia has comparable levels of gross fixed capital formation, which volumes versus private and public sector savings spell out a 10 p.p. GDP gap, allowing to assume that gross capital formation may grow 1.2-1.4 times (considering the need of growing Russian transnational corporations to invest into foreign real assets).

Analysis of prospects for accelerated investment activity in Russia is also important in the context of possible toughening of the competition between Russia and the EU-10 countries for deployment of labor and energy intensive productions withdrawn from Western Europe and on the whole from the EU-15 countries. As one of Russia's industrial weaknesses is high "haul distance" in industrial cargo transportation, which, according to the Russian Statistics Service, is 4.5-6 times longer than in the EU countries, equaling 1100-1300 km per 1 ton of cargo, it is important to perform the analysis of relative trends in other competitiveness indicators, measuring relative investment potential of the economy and prospects for competitiveness growth.

Our research has shown that in terms of electricity cost, Russia's competitive advantages against the background of trebled growth in electricity cost over the last seven years have noticeably weakened, despite the upturn in electricity prices for industrial consumers in this period in almost all European countries (excluding Norway, where they dropped).

Talking about ULC determined on the basis of relative movements in wages and labor productivity in Russia and its trading partners, the statistics analysis of the1995-2005 period shows that the Russian economy has no positive reserve here as well, although it preserves substantial absolute competitive advantages (in terms of wages denominated in foreign currency).

In ***Section 3*** we set out the prospects of industry restructuring in Russia and the EU to find the ways of mutually beneficial and complementary growth in competitiveness.

We have tried to show that in the recent years, such newly emerged factors as deficit of equipment, competent staff and escalating competition with imports begin to play a weightier role as economic growth constraints alongside traditional growth depressants (insufficient domestic demand and working capital).

Concurrently, radical change was observed in approaches to economic policy targeted at industry restructuring and overcoming de-industrialization of the Russian economy manifest in industry underperforming of GDP growth. *On the one hand*, we see a tendency to pursue actively the traditional industrial policy in the country, but the proposed measures have no new drive, lack effectiveness and disregard regional specific. *On the other hand*, the former strategic focus of foreign trade is now being revised, and a new strategy is still in the making (several scenarios are being developed), which contains and is likely to continue to contain business development at least up to 2009 – the start off of new government formed after presidential elections .

Possible foreign trade development scenarios are linked with four core alternative scenarios – Asia-reorientation strategy, US cooperation strategy, creation of a single energy transit system "European Russia – Far East" to be able to exercise operational management of supply volumes by different geographic zone, using the unique transcontinental location of Russia, and, finally, traditional loyalty to cooperation with the EU.

An additional grasp of problems the resolution of which would contribute to overcoming the competitive weaknesses of the Russian economy and enhance the chances for diversification of Russian export deliveries to the EU maintaining the necessary for the EU volumes of exported hydrocarbons and other raw materials is provided by IMD competitiveness indices

We have shown that Russia is ahead of the EU countries in such areas as quality of public finance and fiscal policy (according to IMD ratings) and seriously lags in such areas as development of the economy institutional framework, business legislation and social interaction infrastructure. Russia is ahead of the EU countries in the area of science and education infrastructure development and lags by such parameters as development of technological infrastructure, health and environmental protection. These spheres of activity may be further examined to enable technological and institutional transfer from the EU to Russia in exchange for the resources and developments needed by the EU economy to raise its competitiveness versus USA, Japan and South East Asia countries, as set forth in the respective EU program documents.

Annex 1. List of Economies in UNIDO Data Base (IndStat) Classification

List of Developed Market Economies (25): Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Israel, Italy, Japan, Luxembourg, Netherlands, New Zealand, Norway, Portugal, South Africa, Spain, Sweden, Switzerland, United Kingdom, United States of America.

List of Developing Countries (124):
Algeria, Angola, Antigua and Barbuda, Argentina, Bahrain, Bangladesh, Barbados, Belize, Benin, Bhutan, Bolivia, Botswana, Brazil, Burkina-Faso, Burundi, Cambodia, Cameroon, Cape Verde, Central African Republic, Chad, Chile, China, China (Hong Kong SAR), China (Taiwan province) Colombia, Comoros, Congo, Costa Rica, Cote d'Ivoire, Croatia, Cyprus, Dem.Rep.of the Congo. Djibouti, Dominica, Dominican Republic. Ecuador, Egypt, El Salvador, Eritrea, Ethiopia, Fiji, Gabon, Gambia, Ghana, Grenada, Guatemala, Guinea, Guinea-Bissau, Guyana, Haiti, Honduras, India, Indonesia, Iran Islamic Republic of), Jamaica, Jordan, Kenya, Kiribati, Kuwait, Lao P.D.R. Lebanon, Lesotho, Madagascar, Malawi, Malaysia, Maldives, Mali, Malta, Mauritania, Mauritius Mexico, Mongolia, Morocco, Mozambique, Namibia, Nepal, Nicaragua, Niger, Nigeria, Oman, Pakistan, Panama, Papua New Guinea, Paraguay, Peru, Philippines, Puerto Rico, Qatar, Republic of Korea, Rwanda, Saint Kitts and Nevis, Saint Lucia, Saint Vincent & the Grenadine, Samoa, Sao Tome and Principe, Saudi Arabia, Senegal, Seychelles, Sierra Leone, Singapore, Slovenia, Solomon Islands, Sri Lanka, Sudan, Suriname, Swaziland, Syrian Arab Republic, TFYR of Macedonia, Thailand, Togo, Tonga, Trinidad and Tobago, Tunisia, Turkey, Uganda, United Arab Emirates, United Republic of Tanzania, Uruguay, Vanuatu, Venezuela, Viet Nam, Yemen, Zambia, Zimbabwe.

List of Transition Economies (21):
Albania, Armenia, Azerbaijan, Belarus, Bulgaria, Czech Republic, Estonia, Georgia, Hungary, Kazakhstan, Kyrgyzstan, Latvia, Lithuania, Poland, Republic of Moldova, Romania ***Russian Federation,*** Slovakia, Tajikistan, Ukraine, Uzbekistan.

Annex 2. Change in competitiveness rankings of Russia and EU countries awarded by IMD from 2002 through 2006

Fig. 1-5 . Changes in key competitiveness factors of Russia and EU countries according to IMD world scoreboard from 2000 through 2006 (rankings awarded)

Fig 1.Overall Ranking

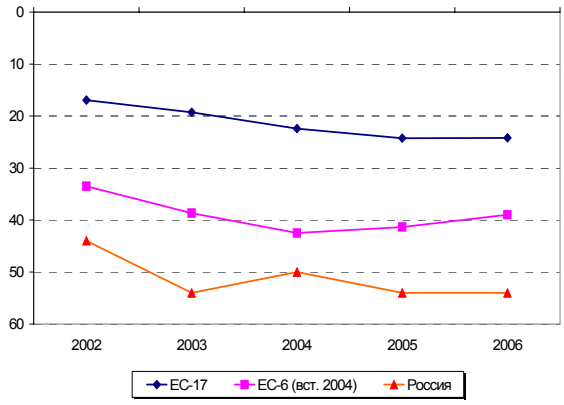


Fig 2.Economic Performance

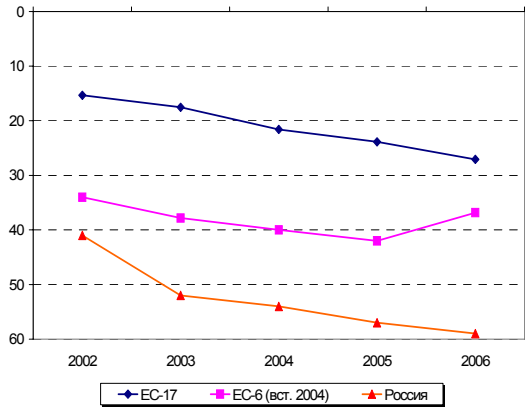


Fig 3. Business Efficiency

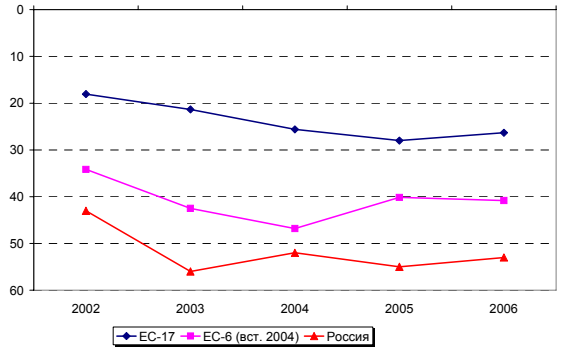


Fig 4. Infrastructure

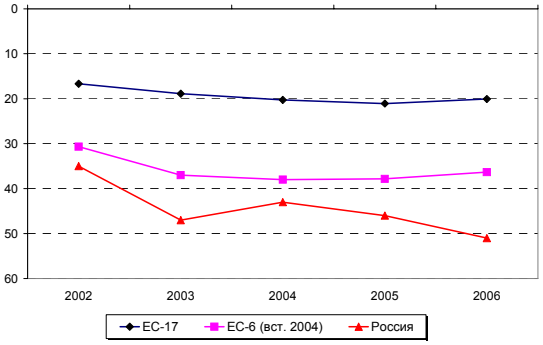
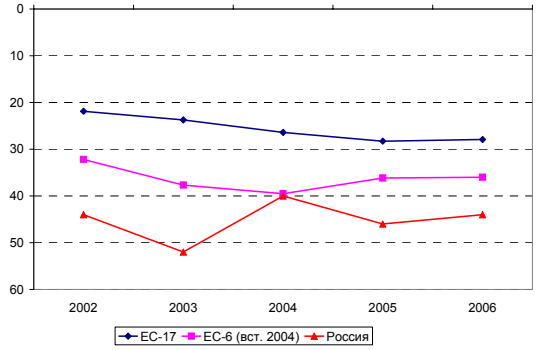


Fig 5. Government Efficiency



Source: IMD statistics, 2007

Annex 3. Changes in IMD world competitiveness rankings of Russia and EU countries: sub-factor breakdown of Economic Performance, Business Efficiency, Government Efficiency and Infrastructure

Table 1. Economic Performance – sub-factor breakdown of Russia's and EU countries' competitiveness (rankings assigned by IMD)

	2002	2003	2004	2005	2006
Domestic Economy					
EU-15	16	19	22	25	28
EU-10	30	41	41	44	34
Russia	26	45	21	30	23
International Trade					
EU-15	24	23	22	20	26
EU-10	19	23	31	23	25
Russia	6	10	5	7	17
International Investment					
EU-15	14	18	16	24	28
EU-10	34	30	24	30	24
Russia	4	21	30	33	33
Employment					
EU-15	22	27	31	34	31
EU-10	38	42	46	47	47
Russia	38	37	48	46	39
Prices					
EU-15	18	20	32	32	35
EU-10	28	30	31	34	32
Russia	48	58	59	60	61

Note: Competitiveness factors by which the Russian economy outperforms the economies of EU-10 and EU-15 countries are marked by yellow color. Competitiveness factors by which Russia outperforms only one of the EU-10 or EU-15 countries are marked by green color.

Source: IMD statistics, 2007

Table 2. Business Efficiency - sub-factor breakdown of Russia's and EU countries' competitiveness (rankings assigned by IMD)

	2002	2003	2004	2005	2006
Productivity and Efficiency					
EU-15	16	21	20	22	21
EU-10	23	35	35	34	29
Russia	33	46	14	47	51
Labor Market					
EU-15	27	32	37	38	35
EU-10	26	30	29	35	35
Russia	48	54	56	49	42
Finance					
EU-15	15	17	19	20	21
EU-10	37	42	48	42	43
Russia	36	58	57	59	56
Management Practices					
EU-15	19	22	26	28	26
EU-10	38	46	50	45	44
Russia	45	57	49	54	54
Attitudes and Values					
EU-15	22	26	30	34	32
EU-10	34	40	44	38	43
Russia	42	55	49	52	49

Note: Competitiveness factors by which the Russian economy outperforms the economies of EU-10 and EU-15 countries are marked by yellow color. Competitiveness factors by which Russia outperforms only one of the EU-10 or EU-15 countries are marked by green color.

Source: IMD statistics, 2007

Table 3. Government Efficiency - sub-factor breakdown of Russia's and EU countries' competitiveness (rankings assigned by IMD)

	2002	2003	2004	2005	2006
Public Finance					
EU-15	25	30	32	32	35
EU-10	26	35	31	29	28
Russia	26	17	3	3	2
Fiscal Policy					
EU-15	37	42	43	43	44
EU-10	35	39	39	40	40
Russia	23	28	21	18	23
Institutional Framework					
EU-15	17	20	24	26	22
EU-10	32	38	40	37	36
Russia	42	51	48	52	50
Business Legislation					
EU-15	18	19	21	25	24
EU-10	35	40	39	34	34
Russia	46	55	55	58	57
Societal Framework					
EU-15	17	19	21	22	21
EU-10	27	32	36	33	31
Russia	43	55	50	54	51

Note: Competitiveness factors by which the Russian economy outperforms the economies of EU-10 and EU-15 countries are marked by yellow color. Competitiveness factors by which Russia outperforms only one of the EU-10 or EU-15 countries are marked by green color.

Source: IMD statistics, 2007

Table 4. Infrastructure - sub-factor breakdown of Russia's and EU countries' competitiveness (rankings assigned by IMD)

	2002	2003	2004	2005	2006
Basic Infrastructure					
EU-15	19	22	23	23	23
EU-10	23	28	33	32	32
Russia	48	52	56	55	58
Technological Infrastructure					
EU-15	17	18	23	25	22
EU-10	30	39	38	39	39
Russia	48	58	54	55	57
Scientific Infrastructure					
EU-15	17	21	22	22	22
EU-10	33	43	43	43	44
Russia	10	12	12	21	24
Health and Environment					
EU-15	14	17	17	18	17
EU-10	38	44	44	43	42
Russia	47	58	59	59	59
Education					
EU-15	18	20	21	22	20
EU-10	25	29	31	31	31
Russia	23	29	26	27	37

Note: Competitiveness factors by which the Russian economy outperforms the economies of EU-10 and EU-15 countries are marked by yellow color. Competitiveness factors by which Russia outperforms only one of the EU-10 or EU-15 countries are marked by green color.

Source: IMD statistics, 2007