Section 2. Monetary and Fiscal Policies

2.1. Monetary policy

The key developments in Russia's monetary policy in 2014 were determined by adverse processes in the Russian economy, which related to the tense geopolitical situation, massive capital outflow and the decline in the price of energy resources.

In 2014, the Bank of Russia encountered a series of global challenges while pursuing its monetary policy. The economic situation in 2014 was distinguished by bilateral sanctions and the drastic depreciation of the national currency in January-December 2014, which resulted in an inflation of 11.4%, above the target level of 5% set forth for 2014 in the central bank's Guidelines for the Single State Monetary Policy for 2014–2016. In an effort to stabilize the ruble's exchange rate and inflations expectations, the Bank of Russia more than once lifted the CBR key rate, from 5.5% in January to 17% in December 2014.

On 10 November 2014, the Bank of Russia abolished the previously applicable exchange rate policy mechanism, revoking the acceptable range of the ruble value of dual-currency basket and regular interventions within/outside the specified operational band. In fact, the Bank of Russia migrated to a floating exchange rate for the first time in Russia's contemporary history, reserving the right to undertake operations in the domestic FX market only when financial sustainability is at threat.

2.1.1. Money market

In the period between January 2014 and December 2014, the monetary base (broad definition) increased 7,9%, running at Rb 11,3 trillion as of 1 January 2015. The Bank of Russia's operations aimed at providing commercial banks with money remained the key factor responsible for the growth in the monetary base in 2014, whereas the factor responsible for the shrinking of monetary base in 2014 was the Bank of Russia's transactions aimed at selling foreign currency in the domestic market. As a reminder, the monetary base increased 6.6%, up to Rb 10,5 trillion in 2013.

It is worthwhile noting that, despite the central bank's statements about migrating by 2015 to an inflation targeting regime and implementing measures aimed at increasing the flexibility of the exchange rate regime, the central bank in 2014 increased largely its presence in the FX market, selling considerable amounts of foreign currency through respective transactions. To compare, net purchases of foreign currency saw a decline in annual volume beginning with 2010 ($34,1bn in 2010, $12,4bn in 2011, $7,6bn in 2012). On the other hand, net sales of for-

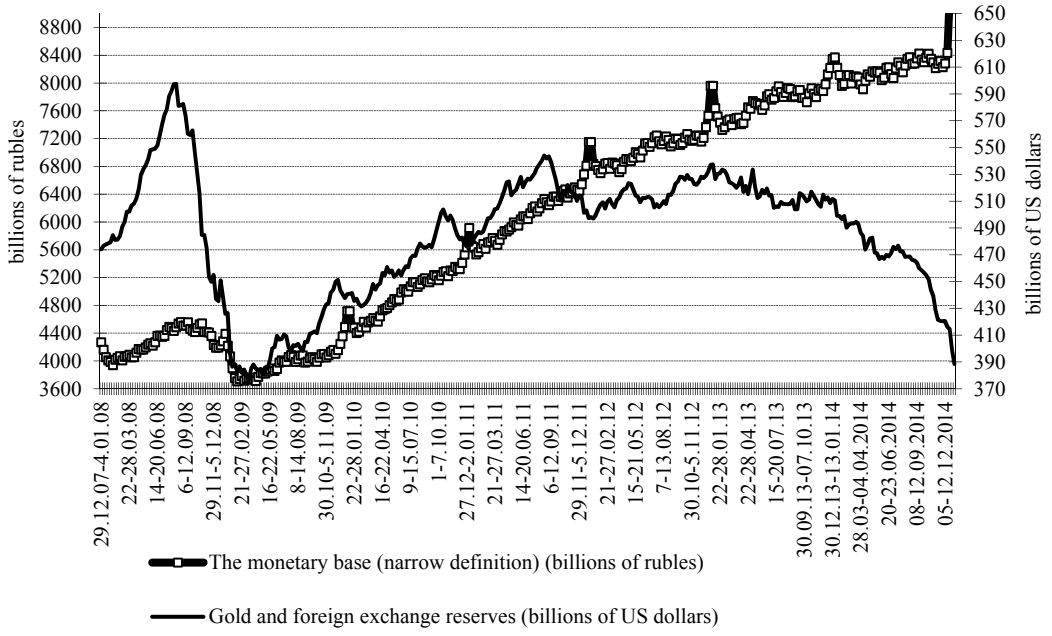
eign currency reached $27bn in 2013 and more than $83,4bn in 2014. Those measures were caused by the Bank of Russia seeking to set back the depreciation of the national currency exchange rate, considering the adverse foreign economic and geopolitical conditions.

Such an intervention policy of the central bank meets in general the objective of migrating to inflation targeting, because due to the effect of exchange-rate pass-through to prices, the ruble's depreciation appeared to be a key factor of the accelerated inflation in 2014. However, the spending of international reserves to support the national currency exchange rate eventually appeared to be inefficient, considering the actual scope of ruble's depreciation. Apparently, the central bank should have either undertaken stronger interventions to be able to reduce the possibilities for market players to benefit from short-term exchange rate volatility and prevent devaluation expectations from growing, or a one-time, sharp depreciation of the ruble's exchange rate, instead of making it a longer-lasting process. Additionally, a well-timed imposing of limits on the provision of ruble liquidity, thus making it less possible for commercial banks to play against the ruble, would have allowed the regulator's policy to be more efficient. As a reminder, it was not until November 2014 that the $2bn limit on the provision of ruble liquidity through FX swap transactions was introduced.

However, the key short-term measure of the monetary policy should have been a timely lifting of the CBR key rate to a level making it economically inefficient to use short-term ruble-denominated loans to purchase foreign currencies, expecting the ruble to depreciate. It is worthwhile noting that it was not until December 2014 that the central bank decided to considerably increase the CBR key rate (to 17% p.a.) (see Section 2.3.1. "The main decisions concerning the monetary and exchange rate policies").

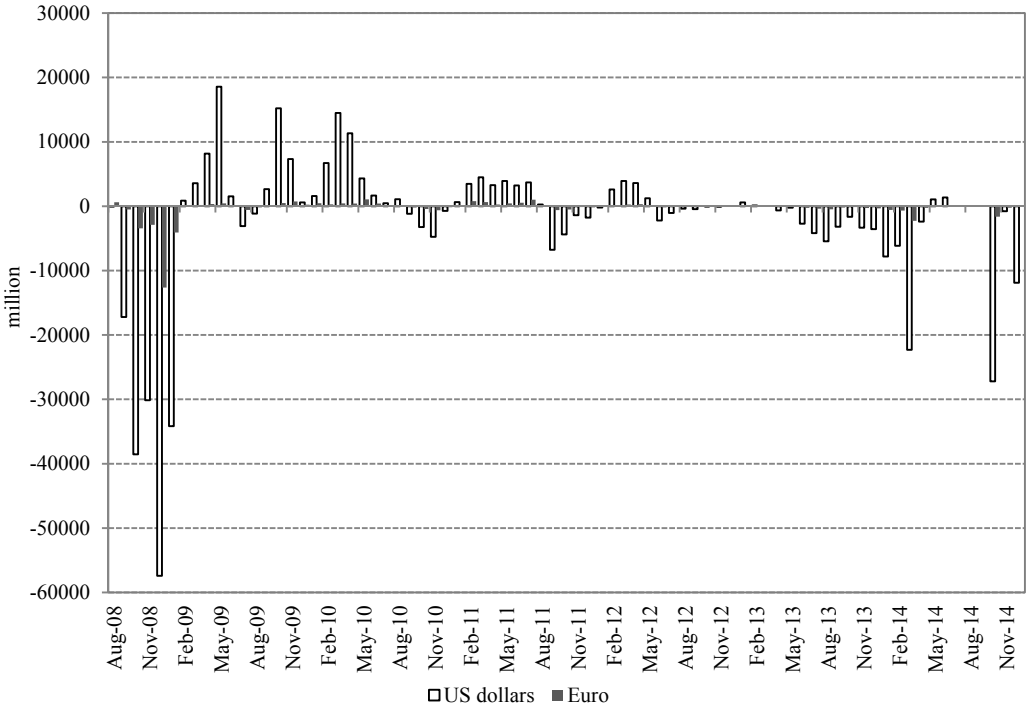
In the 12 months of 2014, Russia's international reserves shrank by $124,1bn (24.4%) and were running at $385,5bn as of the beginning of January 2015 (see *Fig. 1* and *2*). In 2014, Russia's foreign exchange reserves declined by $130,2bn (–27.7%). In 2013, the same reserves lost $17bn (–3.5%). The monetary gold stock increased $6,1bn (+15.3%) compared to that seen early in the year, the increase was basically determined by an upward revaluation of the stock. As a result, as of 1 January 2015, the foreign exchange reserves accounted for 88.0% (92.2% in 2013) of the total amount of reserve assets, while gold did for 12.0% (7.9% in 2013). At present, the reserves are sufficient to maintain a stable balance of payments, because they cover both 10 months of imports of goods and services in the Russian Federation (13 months in 2013) and external debt repayments due in 2014–2015. However, should the reserves see further shrinking, they may be found to be below the level allowing Russia to be rewarded a credit rating and maintain its macroeconomic sustainability.

The general government's funds accumulated on accounts with the central bank in the first 11 months of 2014 saw a Rb 2,7 trillion (46%) increase in volume, which basically can be explained by an upward revaluation of the foreign currency assets accumulated in the Reserve Fund and the National Wealth Fund (see *Table 1*).



Source: The Bank of Russia.

Fig. 1. The dynamics of monetary base (narrow definition) and the gold and foreign exchange (international) reserves of the Russian Federation in 2008–2014.



Source: The Bank of Russia.

Fig. 2. The Bank of Russia currency interventions (foreign currency net purchases) in 2008–2014

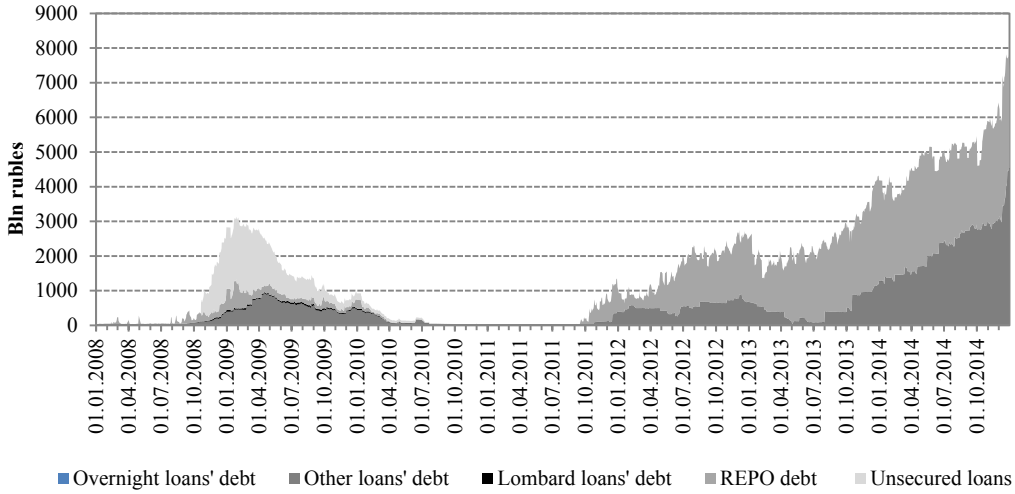
Table 1

The Bank of Russia Balance Sheet in 2013–2014

	01.01.2013		01.01.2014		12.01.2014	
	billions of rubles	**as a percentage of assets/ liabilities**	**billions of rubles**	**as a percentage of assets/ liabilities**	**billions of rubles**	**as a percentage of assets/ liabilities**
Funds placed with nonresidents and securities issued by nonresidents	14,525,436	70.4	15,091,147	66.9	17,366,198	60.8
Credits and deposits	3,158,355	15.3	4,881,376	21.6	7,263,702	25.4
Precious metals	1,646,187	8.0	1,394,150	6.2	2,299,460	8.1
Securities	456,314	2.2	450,306	2.0	630,958	2.2
Other assets	251,549	1.2	99,468	0.4	128,815	0.5
Total assets	**20,630,744**	100	**22,562,411**	100	**28,580,786**	100
Cash in circulation	7,667,950	37.2	8,307,755	36.8	7,922,408	27.7
Funds in accounts with the Bank of Russia	9,404,984	45.6	10,358,984	45.9	12,577,139	44.0
of which: Russian government funds	4,913,764	23.8	5,848,761	25.9	8,536,119	29.9
funds of resident credit institutions	2,185,349	10.6	2,196,821	9.7	2,174,339	7.6
Float	158	0.0	5,680	0.03	17,415	0.06
Bank of Russia bonds	–	–	–	–	–	–
Liabilities to the IMF	447,686	2.2	500,028	2.2	695,697	2.4
Other liabilities	138,183	0.7	108,785	0.5	4,199,069	14.7
Capital	2,724,457	13.2	3,151,918	14	3,169,058	11.1
Profit of a fiscal year	247,326	1.2	–	–	–	–
Total liabilities	**20,630,744**	100	**22,562,411**	100	**28,580,786**	100

Source: The Bank of Russia.

The dynamics of commercial banks' debt owed to the central bank is shown in *Fig. 3*. The uptrend in volumes of the Bank of Russia liquidity provision to credit institution has been observed since 2011. In the 12 months of 2014, the debt doubled (2.1 times) the peak levels seen in the crisis-hit 2009 and was running at Rb 9,3 trillion as of 1 January 2015. As of 1 January 2014, five banks accounted for 70% of the total debt of Rb 6,7 trillion owed by credit institutions to the regulator. Credit institutions raised liquidity from the regulator basically from the single source as repo auctions, on which the debt averaged Rb 2,69 trillion in the 12 months of 2014 (Rb 2,63 trillion in 2013, Rb 1,9 trillion in 2012, Rb 1,1 trillion in 2011), as well as loans secured by non-marketable assets and guarantees, on which the debt averaged Rb 2,3 trillion in the 12 months of 2014 (Rb 0,46 trillion in 2013, Rb 0,55 trillion in 2012). The maximum amount of funds can be raised at 1-week repo auctions (an average of Rb 2,6 trillion in 2014, Rb 1,6 trillion in 2013).



Source: The Bank of Russia.

Fig. 3. Commercial bank's debt owed to the Bank of Russia in 2008–2014

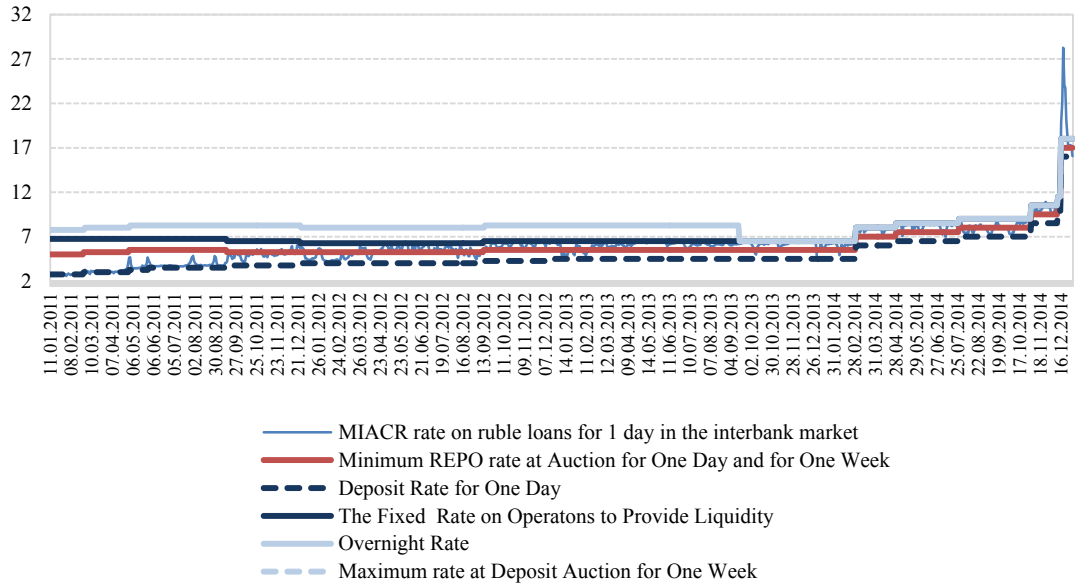
Weighted average interest rates on short-term repo operations were 8.3% in the period between January 2014 and December 2014. The debt of the banking sector on central bank loans secured by non-marketable assets and guarantees saw a rapid increase in 2014, because of the dried up collateral base for repo transactions. However, the increase in the debt secured by non-marketable assets and guarantees in Q2 and Q3 2014 had a positive effect on the volume of unencumbered market collateral. In particular, in Q3 2014, the utilization of marketable assets declined to 51% from 53%. According to the Bank of Russia's estimates, risks of the market collateral facing a deficit in the short run can be regarded as low given the slowdown in lending rates and the monetary base.

In 2013, the Bank of Russia introduced a 3-month repo auction to provide loans secured by non-marketable assets (promissory notes, credit claims) at variable interest rate. In 2014, the regulator allotted through this tool an average of Rb 490bn at an weighted average rate of 7.8%. As a reminder, the minimum value of a loan is linked to the 1-week repo key rate, plus 0.25 p.p. A 18-month repo auction secured by non-marketable assets was held on 10 November 2014, banks raised Rb 150bn at a rate of 9.75%, corresponding to the maximum amount of allotted funds. The advantage of 3-month auctions over similar longer-term auctions is that the former provides readily available collateral with a required term for credit institutions and a higher value of the collateral available at banks through a reduced term of the provision of funds. Despite the easy terms of lending at a variable interest rate, such an auction is available only for large banks whose collateral base is visibly bigger.

The interest rate in the interbank lending market[1] increased by 2.5 times in the 12 months of 2014 (to 15.5% on average in December 2014 from 6.3% on average in January 2014). The interbank loan interest rate was at the upper level of the central bank interest band, nearing closer to its cap from time to time (see *Fig. 4*). The most critical crossing of the MIACR on overnight interbank ruble-denominated loans was seen in 10 thru 24 December 2014 due to panic sentiments in the interbank lending market caused by the lifted CBR key rate and the

[1] Interbank interest rate is (Moscow InterBank Actual Credit Rate) MIACR on overnight interbank ruble-denominated loans

limits imposed on the ruble liquidity provision. Overall, the annual average MIACR on overnight interbank ruble-denominated loans increased by 2.6 times to 16.1% in 2014 from 6.1% in 2013. It is worthwhile noting that in the situation when central bank operations is the main channel to increase the monetary base, it is Bank of Russia's decisions that determine the dynamics of interest rates. The fact that the United States and the European Union restricted the access of certain Russian state-controlled banks to external financing, and the central bank lifted the CBR key rate, turned out to be a supplementary growth factor for the interest rate in the interbank lending market, beginning with Q2 2014.



Source: The Bank of Russia, calculated at the Gaidar Institute.

Fig. 4. The Bank of Russia interest rate band and the dynamics of interbank lending market in 2012–2014

It is worthwhile noting that further expansion of Bank of Russia tools designed to provide liquidity for long terms (3-months, 1-year repo auctions secured by non-marketable assets) will allow banks to release the market collateral and create conditions for further growth of interbank lending volumes and making the same more available.

Let's take a closer look at the structure of the monetary base (broad definition) (see *Table 2*).

Table 2

The dynamics of monetary base (broad definition) in 2014 (billions of rubles)

	01.01.2014	01.04.2014	01.07.2014	01.10.2014	01.01.2015
Monetary base (broad definition)	10504	9344,7	9672,4	9947,9	11332
- cash in circulation, including cash on hand at credit institutions	8308	7620,7	7779,9	7943,8	8840,5
- correspondent accounts of credit institutions with the Bank of Russia	1270	1162,6	1371,5	1358,6	1215,5
- mandatory reserves	442,7	450	432,1	429,4	471,3
- credit institutions' with the Bank of Russia	118,7	220	89	216,1	804,6
- Bank of Russia's bonds held by credit institutions	0	0	0	0	0
For reference: excess reserves	1788	1281	1461	1575	2020

Source: The Bank of Russia.

The following monetary base (broad definition) components saw an increase in volume mandatory reserves of banks (up 15.3% to Rb 471bn), deposits of credit institutions with the Bank of Russia (up 55% to Rb 804,6bn), cash in circulation (up 6.4% to Rb 8840,5bn in 2014). Correspondent accounts of credit institutions declined (down 4.3% to Rb 1215,5bn).

In the period between January and November 2014, the money supply M2 increased at an average rate of 8.7% on an annualized basis (compared to the same period previous year). The monetary base M2 saw a slowdown in annual growth rates over much of 2014, to 6% in November from 14.6% in January. The monetary base saw average growth rates of 32.5% in 2010, 24.3% in 2011, 19.4% in 2012, 15.3% in 2013.

Therefore, the monetary aggregate M2 saw quite moderate growth rates in the first 11 months of 2014 compared to previous periods and by itself creates no preconditions for monetary factors to be able to affect the price stability.

Given that in the first 11 months of 2014 the monetary base and money supply shrank by 8.2% and 3.6%, respectively, the money multiplier (M2/monetary base ratio) increased 5%. In the period between January по November 2014, the money multiplier averaged 3.2. This value of money multiplier is average for developing economies (Ukraine, Belarus, Kazakhstan), whereas in developed countries it tends to vary within a range of 5 and 8. It is worthwhile noting that over the last two decades the money multiplier has been growing with the development of the banking system in the East European countries. For example, in Poland, the money multiplier increased to 6.1 from 3.1 in the period between 1993 and 2013.

In the period between 1999 and 2013, the level of monetization of the Russian economy (M2/GDP ratio) increased 2.7 times to 55.8% in 2013. To compare, in Belarus, the M2/GDP ratio increased by 1.8 times to 30.4% during the same period, in Kazakhstan by 2.5 times to 34.0% in 2013, in Ukraine by 3.7 times to 62.5%. Relatively slower growth rates of GDP monetization in the period of 1999–2013 were typical of most of the Central and East European countries, for example, the M2/GDP ratio in Poland increased by 1.5 times to 59.9% in 2013, in Germany it remained relatively stable and reached 163% in 2013. It is worthwhile noting that a relatively low level of monetization of the Russian economy is determined by a lower level of the development of Russia's financial system.

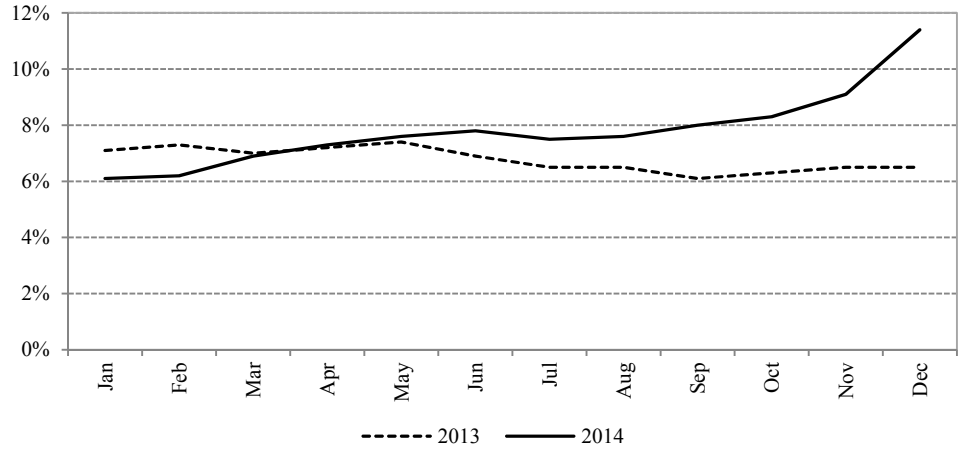
Analyzing the monetary base components, one can notice that in January–November 2014 retail deposits saw an average growth of 8.6% on an annualized basis (18.3% in 2013), deposits of nonfinancial organizations and financial organizations increased by an average of 8.3% (12% in 2013). The monetary aggregate M0 saw an average growth of 7.2% in 2014 on an annualized basis (8.2% in 2013), while its share in M2 averaged 22.4% (22.6% in 2013). It is worthwhile noting that the M0/M2 ratio in Poland was 17.1% in 2013 (18.5% in 2012), in Ukraine it was 26.2% (26.4% in 2012). The downtrend in the ratio of cash in circulation to M2 in developing countries is also related to the financial system development.

2.1.2. Inflation processes

In 2014, inflation turned out to be far above the target level of 5% for 2014 set forth in the central bank's Guidelines for the Single State Monetary Policy for 2014–2016. The year-end inflation was 11.4% (6.5% in 2013) (see *Fig. 5*).

The increase of inflation above the upper level of target range was basically caused by other than monetary factors. It is the ruble's depreciation induced by the geopolitical tensions, massive capital outflow and the decline in crude oil prices, as well as the ban on imports of food products of certain categories to Russia from the countries which imposed sanctions

against Russia that were responsible for most of the acceleration of inflation given a substantial share of imported goods in the consumption of Russian economic agents. It is worthwhile noting that our estimates show that the 2014 year-end double depreciation of the ruble against the U.S. dollar and the Euro will boost inflation at least by 10–15 p.p. in 2015.



Source: Rosstat (Russia's Federal State Statistics Service); calculated at the Gaidar Institute.

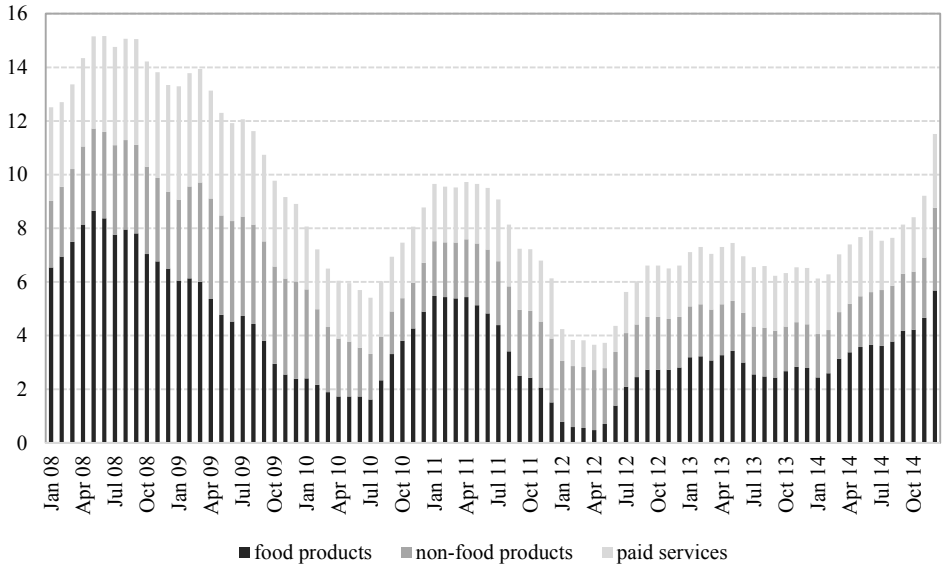
Fig. 5. The growth rate in consumer price index in 2013–2014 (% y-o-y)

Overall, despite the fact that the failure to maintain the target inflation level has little in common with the plans to migrate to inflation targeting. The central bank is not the one to be blamed for the failure, because such an adverse development of geopolitical processes can hardly be foreseen.

Let's take a closer look at the inflation processes in 2014. It is shown in *Table 3* that in the period between January 2014 and December 2014 the prices of consumer products were growing much faster than those in 2013. The price of the following food products contributed most to the price growth of food products: cereals and beans (+34.6%), fruits and vegetables (+22.0%), meat and poultry (+20.1%), fish and seafood products (+19.1%), butter (14.5%), milk and dairy products (+14.4%), alcoholic beverages (+13.7). The price growth of the foregoing food products was determined basically by the ban on imports of food products from the United States, Canada, Australia, Norway and the European Union.

The growth rate of prices of non-food products increased as well (+8.1%) in 2014. The prices of the following products of this commodity group saw faster growth rates due to the increase in excise duties as well as the ruble's exchange rate depreciation: tobacco products (+27.1). The price growth of electric products and other household appliances (+17.9%), audio visual goods (+15.8%), medicaments (+13.1%) and motor gasoline (+8.9%) is worth noting. Overall, the price growth of non-food products was associated with the ruble's depreciation amid the Russian market large dependence on foreign supplies.

In 2014, the prices of paid services to individuals increased 10.5% compared with those in 2013. The price growth of outbound tourism services (41.1%), insurance services (21.7%), utility services (19%), early childhood education services (15.6%), education services (13.8%) made a noticeable contribution to the price growth of paid services. The considerable price growth of outbound tourism services and insurance services was associated with the depreciated exchange rate of the national currency.



Source: Rosstat; calculated at the Gaidar Institute.

Fig. 6. The structure of inflation in 2008–2014 (in percent compared to same month previous year)

Table 3

The annual growth rate of prices of consumer goods and services of certain types in 2012–2014 (in percent compared to December previous year)

	2012	2013	2014	2012–2014
Consumer Price Index	**6.6**	**6.5**	**11.4**	**26.5**
Food products	**7.5**	**7.3**	**15.4**	**33.1**
Cereals and beans	–7.0	3.2	34.6	**29.2**
Butter	3.0	18.6	14.5	**39.9**
Sunflower oil	3.4	–3	5.0	**5.3**
Macaroni products	7.6	4.7	8.4	**22.1**
Milk and dairy products	4.4	13.1	14.4	**35.1**
Eggs	5.1	28.8	4.6	**41.6**
Bread and flour products	12.0	8.0	7.5	**30.0**
Meat and poultry	8.3	–3	20.1	**26.2**
Fish and seafood products	1.9	7.6	19.1	**30.6**
Fruits and vegetables	11.0	9.3	22.0	**48.0**
Alcoholic beverages	12.1	14.6	13.7	**46.1**
Non-food products	**5.2**	**4.5**	**8.1**	**18.8**
Medicaments	5.1	2.5	13.1	**21.8**
Motor gasoline	6.8	5.7	8.9	**22.9**
Tobacco products	22.6	29.3	27.1	**101.5**
Services	**7.3**	**8.0**	**10.5**	**28.1**
Utility services	9.4	9.8	9.4	**31.4**
Early childhood education services	6.4	9.9	15.6	**35.2**
Convalescence services	5.9	5.7	7.6	**20.4**
Passenger transportation services	6.9	8.9	7.3	**24.9**
Cultural organizations' services	8.8	10.5	9.9	**32.1**

Source: Rosstat.

Finally, the consumer price growth rates in Russia are compared with those in other countries in *Table 4*.

Table 4

The dynamics of consumer price indices in various countries in 2012–2014, % annual

	2012	2013	2014*	2012–2014*
Azerbaijan	–0.3	3.5	–0.8	2.4
Armenia	3.2	5.6	0.2	9.2
Belarus	21.8	16.5	14.8	62.9
Kazakhstan	6.0	4.8	6.3	18.1
Kyrgyzstan	7.5	4.0	6.8	19.4
Moldova	4.1	5.2	3.1	12.9
Russia	*6.6*	*6.5*	*7.1*	*21.6*
Tajikistan	6.4	3.7	6.1	17.1
Ukraine	–0.2	0.5	19	19.4
Germany	2.0	1.5	0.4	3.9
France	2.0	0.9	0.8	3.7
The United States	2.1	1.5	2.1	5.8
The Netherlands	2.5	2.5	1.5	6.6

* the data on January–October.

Source: the CIS Interstate Statistical Committee (CISSTAT) (http://www.cisstat.com/), the OECD data base (http://stats.oecd.org/).

In the period between January 2014 and October 2014, Russia was ranked 3rd after Ukraine and Belarus on consumer price growth rates among the CIS member countries. In the first 10 months of 2014, the rate of inflation in Ukraine and in Belarus was 19% and 14.8%, respectively. Inflation in Russia in January-October 2014 was 4.5 times that in developed countries (see *Table 4*). Hence Russia is facing a high level of inflation compared to both the developed countries and emerging economies.

In 2015, the economic decline and a moderate growth in money supply will be the factors that will constrain inflation. However, the effect of ruble's exchange rate pass-through to prices will definitely boost inflation which is most likely to be above 10–12% at 2015 year-end.

At the same time, the target-level inflation of 4% can be reached by 2017 given the fact that the effect of the ruble's depreciation on prices will cease to exist in the mid run, while there is almost no monetary prerequisites for the acceleration of inflation.

2.1.3. The main decisions concerning the monetary and exchange rate policies

In 2014, while gradually migrating to an inflation targeting regime, the Bank of Russia made a series of important decisions aimed at enhancing its interest-bearing toolkit, as well as making the exchange rate formation a more flexible process.

The decision to gradually increase the CBR key rate to 17% in January from 5.5% on 16 December 2014 was the most significant one the Bank of Russia made in 2014. On 3 March, the CBR key rate was lifted to 7% p.a. from 5.5% p.a., on 28 April to 7.5% p.a. from 0.5 p.p., to 8% p.a. on 25 July, to 9.5% on 5 November, and to 10.5% p.a. on 12 December. These decisions were intended to lower inflation expectations and maintain a financial stability.

It is worthwhile noting that the regulator was expected in 2014 to adopt a floating exchange rate regime and inflation targeting, increase gradually the CBR key rate in response to the rapid decline of the international reserves. It is our opinion that the Bank of Russia's decision to lift the interest rates was correct given the circumstances. With inflation getting higher, a lower real interest rate would have resulted in further depreciation of the ruble, having no effect on economic growth rates, because with the FX market being unsettled, economic

agents tend to curtail their fixed investment. At the same time, with lower inflation, the central bank may need to lower the CBR key rate in order to support economic activity.

In 2014, the central bank gradually upgraded the monetary policy mechanism based on interest rate management. In particular, fine-tuning operations to provide liquidity were introduced on 3 February in response to abolished daily overnight repo auctions. The regulator allotted an average of Rb 212bn as part of each "fine tuning" repo during the year. No such operations were conducted in February, June, August 2014. It is worthwhile noting that the demand for such operations in certain periods was governed by the substantial oversupply of liquidity in the banking sector. On 17 February 2014, the Bank of Russia complemented its monetary policy toolkit with fine-tuning operations to absorb liquidity. Such operations were undertaken as 1–6 day fine-tuning deposit auction at maximum interest rate equal to the CBR key rate. In the period between January 2014 and December 2014, only five such operations were undertaken – in July, August, and November – with the liquidity absorption varying between Rb 64,6bn to Rb 360bn per auction. From 12 to 44 business entities participated in such auctions, being indicative of weak demand for this tool.

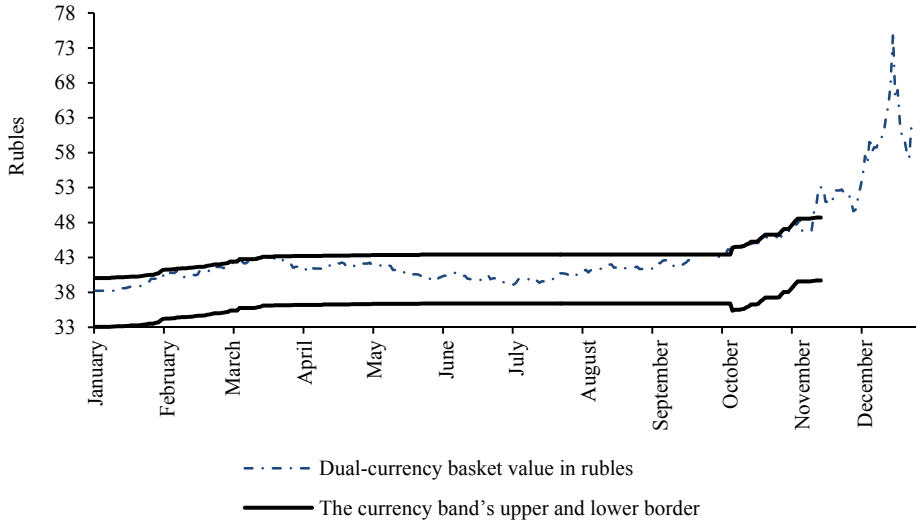
Credit institutions' stronger demand for Bank of Russia refinancing operations amid limited volumes of the collateral base for repo operations resulted in bigger volumes of bidding and the frequency of 3-month auctions for loans secured by non-marketable assets. Additionally, in June 2014, the maximum term of money provision were extended to 549 from 365 days for standing facilities, namely loans secured by non-marketable assets, guarantees or gold. This measure had an insignificant effect on the liquidity of the banking sector. It is 1-3-month loans that show the strongest demand among secured loans, which accounted for an average of 63% of the banks' total debt on secured loans in 2014, whereas 181-365-day secured loans accounted for as little as 7% on average. This liquidity provision tool shows a weak demand because of its high fixed interest rate, most banks have no collateral available for the required term (12 months), as well as high alternative costs from the decline of collateral available to credit institutions (lost opportunities to obtain short-term loans because of running short of the collateral available).

The Bank of Russia decided on 25 April to introduce an new tool designed to refinance credit institutions. The regulator employs this tool to provide loans to banks for a term less or equal to 3 years at a rate of 6.5% p.a.. The foregoing mechanism of refinancing is secured by claims on credits provided to finance investment projects guaranteed by the state. At the initial stage, the new mechanism is available only for large banks with an equity more than Rb 50bn. The tool is intended to stimulate investment, however, in our opinion, it is the financial system as a whole, not the central bank, that is to be involved in the formation of long money in economy. It is therefore the issues of enhancing the financial sector depth and the investment potential of Russian assets, not the growth in money supply, that are still quite relevant for the Russian economy.

The situation in the FX market in 2014 became, perhaps, the key challenge for the Bank of Russia, as the drastic ruble's depreciation made it impossible to reach the target level of inflation and put financial sustainability at threat. Let's take a closer look at the central bank exchange policy in 2014.

Early in 2014, the Bank of Russia implemented a series of policies aimed at increasing the flexibility of exchange rate formation mechanisms. As part of the planned migration to a floating exchange rate, the Bank of Russia decided on 13 January to discontinue target interventions. Having revoked the flattening of exchange rate volatility caused by fundamental

factors regarding the change in the foreign trade balance, the Bank of Russia participation in the process of exchange rate formation has been restricted since January 2014 to flattening a sharp short-term volatility of the exchange rate. The revocation of CBR target currency interventions increased the sensitivity of operational band boarders of the currency-band exchange rate policy to the volume of regulator's currency interventions. As a result, the currency band borders were gradually going up 2–3 times a week since early in the second half of January, reaching Rb 35,40 and Rb 42,40 late in February, whereas earlier in the year they were at Rb 33,05 and Rb 40,05 (see *Fig. 7*).



Source: The Bank of Russia, www.cbr.ru, the authors' calculations.

Fig. 7. The value of the dual-currency basket in rubles and the operational band border in 2014

Since 19 February, the Bank of Russia began to adjust currency interventions to the operations, taking into account the transfer of funds in foreign currencies by the Ministry of Finance of the Russian Federation and the Federal Treasury to the Reserve Fund.

In the period between January and February 2014, the monthly average volume of Bank of Russia sales of the European currency increased to 0,6bn Euro, US dollar to $7,0bn. Therefore, the value of net sales of U.S. dollars in January-February 2014 outperformed that in September 2011 ($6,8bn), only being less than the value seen in January 2009[1].

Further acceleration of the Russian currency depreciation against the world's primary currencies was sparked by the escalated conflict in Ukraine and raised geopolitical tensions. CBR currency interventions hit a record volume early in March, thus being the cause of the sharp reversal in of the exchange rate policy. The Bank of Russia decided on 3 March 2014 to increase the amount of accumulated interventions resulting in the 5-kopek shift of the operational band borders of the exchange rate policy, to $1,5bn from $350m. Operations related to foreign currency purchases by the Federal Treasury were suspended too.

The decisive measures of the Bank of Russia allowed foreign currency sales to be substantially reduced in volume and resumed operations in order to purchase the same as early as

[1] As a reminder, at the height of the crisis 2008–2009, the Bank of Russia monthly average sales of US dollars amounted to more than $35,4bn in the period between September 2008 and January 2009.

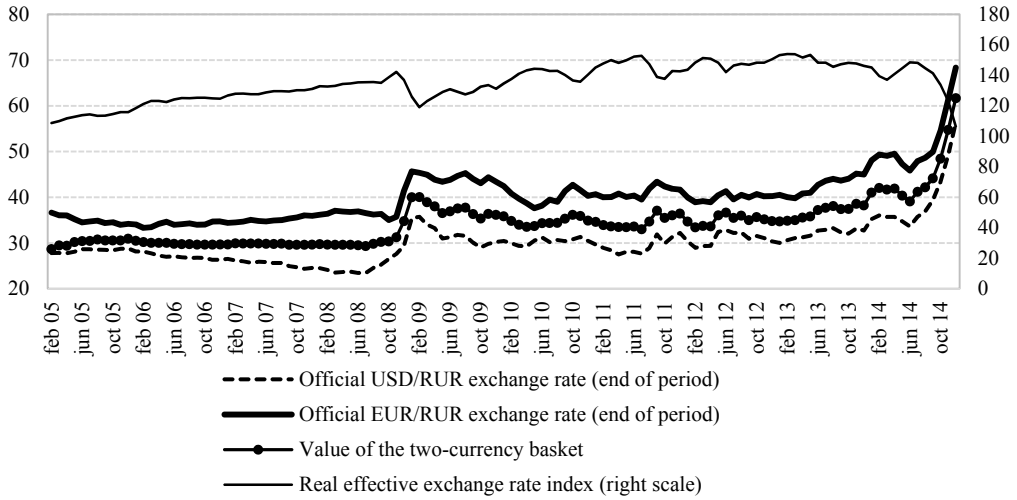
May–June. Furthermore, a decision was made to resume FX operations, effective 14 April, of Russia's Finance Ministry and the Federal Treasury, and gradually relax by the end of May the participation of the Bank of Russia in the exchange rate formation. On 22 May, the Bank firstly reduced by $100m the volume of CBR currency interventions within the range of the floating operational band and aimed at flattening the volatility of the exchange rate, while other parameters of the exchange rate policy remained unchanged. On 17 June, the Bank of Russia, first, further reduced by $100m CBR currency interventions within the range of operational band. Second, the Bank of Russia widened the range within which the Bank is not supposed to interfere with the exchange rate formation, to Rb 5,1 compared with Rb 3,1 in effect since 7 October 2013. And, finally, the Bank reduced to $1000m from $1500m the amount of accumulated interventions resulting in automatic shifting by 5 kopeks of the operational band boundaries. As a consequence, the Bank of Russia fully discontinued as early as July its operations in the domestic FX market.

Furthermore, despite the ongoing aggravation of the geopolitical situation and further sanctions, not only did the Bank of Russia decided on 18 August to reduce to $350m the volume of CBR currency interventions and revoke CBR currency interventions within the range of floating operational band, but it also decided to symmetrically widen the same to Rb 9 from Rb 7. As a result, the Bank of Russia conducted no CBR currency interventions in the period between August and September. Therefore, the of exchange rate formation of the Russian currency was driven exclusively by market factors within the three months (July–September) of 2014.

The situation worsened in the market in mid-September, when the decline in global prices of energy resources accelerated. At the same time, the Bank of Russia made a few statements that it will keep implementing its plan to completely migrate to a floating exchange rate in 2014. In September, the ruble weakened against the US dollar and the Euro by 13.1% and 7.9%, respectively, compared to previous period. As a result, the Bank of Russia resumed early in October sales of both U.S. dollars and Euros, and the volume of interventions exceeded $27bn and 1,6bn Euro, respectively, in the same month.

In an effort to ease the feverish demand for foreign currencies, the Bank of Russia employed additional tools designed to provide foreign currencies. First, the Bank of Russia began on 17 September to hold overnight FX swap operations in order to sell U.S. dollars for rubles to be subsequently purchased. Second, a new tool designed to provide foreign-currency liquidity – repo transactions denominated in foreign currencies – was introduced on 27 October. Initially, the term of repo US$/Euro transactions in the form of auctions was restricted to 1 week and 28 days. Minimum rates were equal to the LIBOR in terms of respective foreign currencies and with comparable terms, increased by 2 and 2,25 p.p. for operations for a term of 1 week and 28 days, respectively. At the same time, only four of the 33 currency FX swap auctions in the period between 17 September and 5 November can be recognized as held, with the volume of raised funds totaling $1476,5m. The demand for foreign currencies allotted by the Bank of Russia through repo operations was found to be weak. During the initial auctions in November, the volume of raised U.S. dollars for 1-weak term was running at $12,5m against the maximum limit of $2bn, whereas the volume of funds raised for 28-day term was running at $199,9m against the limit of $1,5bn. The currency band range was shifted upwards 17 times in October, and in certain months, e.g., on 23, 28 and 29 October, by 40 kopeks within a day. As a result, the operational band floor was Rb 38,55 while the cap was Rb 48,55

by the end of October (see *Fig. 8*). In October 2014 курс Russian currency depreciation weakened against the US dollar and the Euro by 7.1% and 5.4%, respectively.



Source: The Bank of Russia, calculated at the Gaidar Institute.

Fig. 8. Ruble exchange rate in January 2005 to December 2014

The weak demand for new tools from credit institutions resulted in softer terms of foreign-currency liquidity provision. Therefore, the central bank decided on 5 November to lower minimum interest rates on FX repo transactions for 1-week and 28-day term, equaling the same to the LIBOR expressed in corresponding foreign currencies and comparable terms, increased by 1.5 p.p. Additionally, the Bank of Russia decided to introduce another tool designed to provide long-term FX liquidity as FX repo transactions for 12-month term. The minimum interest rate on this tool was also equal to LIBOR expressed in corresponding foreign currencies, increased by 1.5 p.p. However, the total amount of funds allotted during the auctions in November was small, running at $403,8m. The auction for foreign-currency liquidity provision for 28-day term was most in-demand, during which $312,4m were allotted. A total of $87,7m were allotted, with the limit of $10bn during the initial annual auction. The 1-week repo results testified that there was no demand for в short-term liquidity: with the limit of $2bn, the volume of closed transactions was running at as little as $3,7m despite the growing demand for foreign currencies in the domestic FX market. According to the Bank of Russia estimates, in Q3 2014, the private sector's net capital export was running at $13,0bn. At the same time, the banks' net capital export was running at $20,8bn, and other sectors' net capital export was running at $33,8bn (nonfinancial and other financial corporations, as well as individuals) in the period between July and September. It is worthwhile noting that it is only Q4 2008 that saw no big volumes of exported financial resources ($78,1bn).

Under the circumstances, the Bank of Russia limited to $350m the volume of overnight operations on 5 November 2014. Additionally, the regulator reserved the right to conduct currency interventions only when during the entire trading session the value of dual-currency basket is within or outside the borders of the operational band. As a result, as recently as the following day the official ruble value of the dual-currency basket was above the cap of the operational band, whose role became nominal against the preset parameters of the exchange rate policy. And, finally, the Bank of Russia revoked on 10 November 2014 the previously

applicable exchange rate policy mechanism, revoking the acceptable range of the ruble value of dual-currency basket and regular interventions within/outside the specified operational band. In fact, the Bank of Russia migrated to a floating exchange rate for the first time in Russia's contemporary history, reserving the right to undertake operations in the domestic FX market only when financial sustainability is at threat. At the same time, having reached on 10 November the peak of Rb 53,02, the ruble value of dual-currency basket stopped to increase for a certain period of time, which supports the significant role of the speculative factors that boosted the depreciation of the Russian currency. However, the Russian currency resumed its depreciation by the end of the month amid the drastic fall of crude oil prices. As a result, the Russian ruble lost 16.2% year-on-year in 2014 against the U.S. dollar and the Euro. In the end, the USD/RUB and EUR/RUB exchange rate increased by the end of December to Rb 56,26 per US$ and Rb 68,34 per Euro, respectively, compared to Rb 32,73 and Rb 44,97 as of the end of December 2013. The depreciation of the ruble's real effective exchange rate in the period between January and December 2014 is estimated 8.3% compared to its 1.2% strengthening during the same period of 2013.

In December 2014, the Bank of Russia resumed currency interventions aimed at selling foreign currencies. As a result, while flattening the short-tem volatility of the ruble's exchange rate, the Bank of Russia sold more than $10,3bn in December.

It is worthwhile noting that there was no demand for the central bank's new tools designed to provide foreign currencies, because economic agents expected the ruble to depreciate and would rather purchase than borrow foreign currencies given that borrowed currencies had to be repaid at a much lower ruble's exchange rate against the US dollar and the Euro. Furthermore, the Bank of Russia provides commercial banks with ruble-denominated funds in big volumes and at an interest rate which can be easily covered with the plummeting ruble's exchange rate. The Bank of Russia conducted interventions in the FX market whereby reducing the monetary base in other words, in order to prevent the exchange rate sharp volatility. However, to be able to maintain the money market interest rate within the band, the central bank provided on a regular basis credit institutions with new ruble liquidity which the latter instantly transferred back to the FX market. Under such circumstances, the situation in the FX market (with the same macroeconomic and political factors) can be stabilized by contracting the surplus reserves at commercial banks. Therefore, the Bank of Russia announced on 11 November the introduction of a limit on the provision of ruble liquidity through FX swaps. The daily limit was set in rubles equivalent to $2bn in the period of 12 thru 30 November, as well as 15 thru 21 December 2014. Additionally, the regulator limited volumes of funds allotted through 1-week repo operations of more than Rb 100bn, compared to the formerly set parameters. It is noteworthy that the ruble liquidity limit may create problems for some banks, including large banks, and increase risks of worsening the banking crisis. Target support of ailing banks may be required to address the issue.

On 25 November 2014, the regulator announced that the maximum volume of funds for fine-tuning operations to provide ruble liquidity was set at Rb 200bn. It is worthwhile noting that the regulator's measures failed to contract the reserves at commercial banks. In particular, according to the data on the beginning of December 2014, the value saw a positive growth, 29.5% by the beginning of November and 50% compared to the same period previous year. Early in January 2015, the surplus reserves at commercial banks gained another 28.6%. Despite the limits on the provision of ruble liquidity, the regulator held repo auctions intended to replace Rb 1 trillion on the deposits withdrawn by Russia's Finance Ministry from the ac-

counts with commercial banks, in order to prevent the money market rates from a substantial increase. Therefore, the Bank of Russia increased Rb 400bn the limits on repo auctions early in December. There is no way to prevent the ruble's exchange rate from falling with such volumes of liquidity provision, while panic sentiments are developing in the market.

Overall, the objective to maintain both the ruble's exchange rate and the interbank market rate within the interest rate band cannot be met amid a feverish demand for foreign currencies. An upsurge of interest rates or massive interventions in the FX market should be required to stabilize the exchange rate amid the worsening fundamental factors (the decline in crude oil prices and capital outflow). However, it is worthwhile noting that such measures only should help prevent panic and stabilize the exchange rate in the short run, whereas in the long run the dynamics of ruble's exchange rate should be determined by the dynamics of prices of energy resources, market evaluations of foreign policy risks, as well as Russia's investment potential.

2.1.4. Balance of payments and ruble's exchange rate

The adverse foreign policy conditions, as well as the trend in the global markets of raw materials had a strong impact on Russia's balance of payments in the period between January and December 2014. As noted above, the central bank increased its presence in the FX market in 2014 despite the migration to an inflation targeting regime. In the 12 months of 2014, net capital outflow from the country appeared to be more than that in 2013, which was caused by closing down Russian economic agents, who have to repay their external debt, from foreign capital markets.

According to the Bank of Russia preliminary assessment of Russia's balance of payments in January–December 2014, current account surplus was running at $56,7bn, up 66% compared to that in 2013. Additionally, trade surplus increased 2.0% (to $185,6bn from $181,9bn). Export of goods dropped by 5.7% (to $494bn from $523bn), except that exports were running at $34,2bn in December 2014 compared to $45,9bn in December 2013. Import of goods contracted by 9.8% (to $308bn from $341,3bn) due to the ruble's depreciation and sanctions on food products, except that in imports were running at $44,6bn in December 2014 compared to $56,1bn in December 2013. It seems that if the current exchange rate remains the same, the decline of imports in 2015 would see a harder decline than that in December 2014, because supplies in December were made mostly under the previously concluded contracts, factoring in a different ruble's exchange rate.

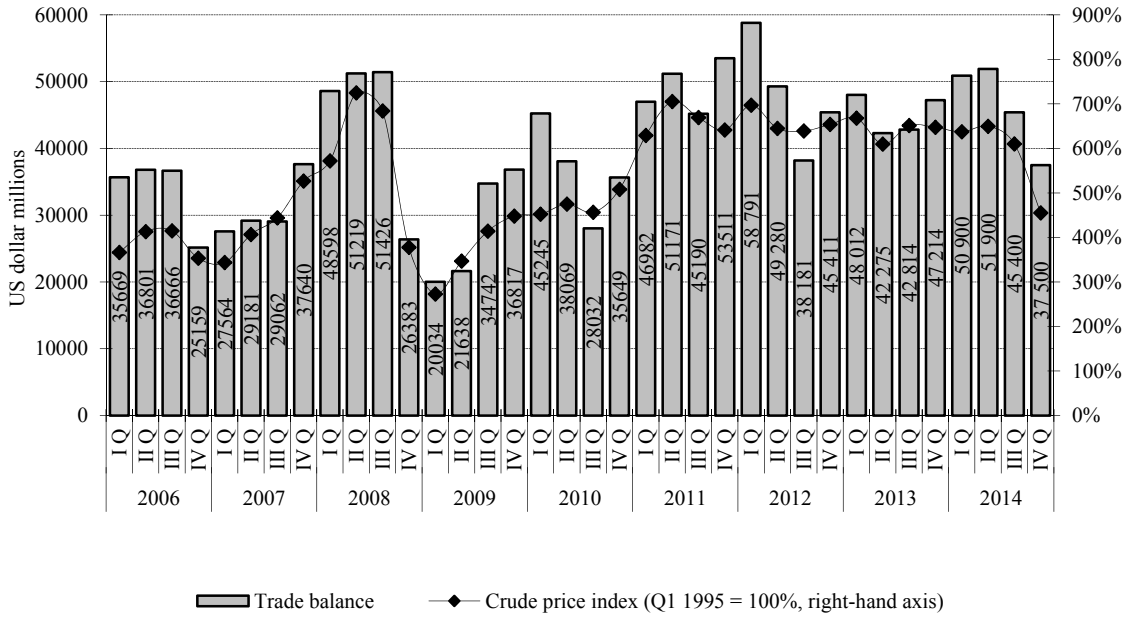
The trade balance whose balance in turn depends largely on the dynamics of prices of hydrocarbons was the key factor which determined the value of balance of the current account in the Russian economy throughout the 2000s. The same trend was observed in 2014 too (see *Fig. 9*).

Exports of crude oil, oil products and natural gas accounted for 65.3% of the total exports, down 1.6 p.p. compared to the corresponding period of 2013, given the 43% decline of crude oil prices in 2014, reaching $63 per barrel on average in December 2014, as well as the contraction of physical volumes of supplies (see *Fig. 10*).

Supplies of the key exported commodities were contracting while the terms of trade were worsening on all commodity items, except nickel and fertilizers of certain types.

In 2014, imports contracted basically on all commodity items, especially for engineering products from countries other than CIS member states, i.e., for explicitly investment products. Furthermore, supplies saw most of the contraction in December (–24% in December 2014 against December 2013 on engineering products).

In 2014, the deficit balance on services reached $54,6bn and declined by 6.3% (in absolute terms) compared to the corresponding period of 2013. Export of services were running at $66,6bn, a decline of $4bn (–5%) compared to previous year. Import of services in the 12 months of 2013 lost 5.6% to $121bn compared to the value seen 2013, which is for the most part determined by the decline in individuals' outbound travelling costs. The balance on the compensation of employees contracted by 32% to –$9,0bn in the period between January and December 2014 ((−13,2)bn US$ in 2013). The deficit balance on the investment income declined by 10% year-on-year in 2014 and reached $56,9bn. Investment income receivable increased 6% to $43,5bn from $37,9bn. The income payable declined by 2% to $81,1bn on non-financial organizations and 12.4% to $16,2bn on banks, which governed a 4.6% decline of the total revenue receivable to $100,3bn. The balance on the rent[1] was running at +$0,1bn in 2014 (+$0,1bn in 2013). The balance on the secondary income[2] in the 12 months of 2014 was running at (−8,7)bn US$ ((–9,3)bn US$ in 2013), and the balance on capital transfers was running at (–42,0)bn US$, ((–0,4)bn US$) in 2013) due to the write-off of the debts owed by Cuba, Uzbekistan and North Korea.

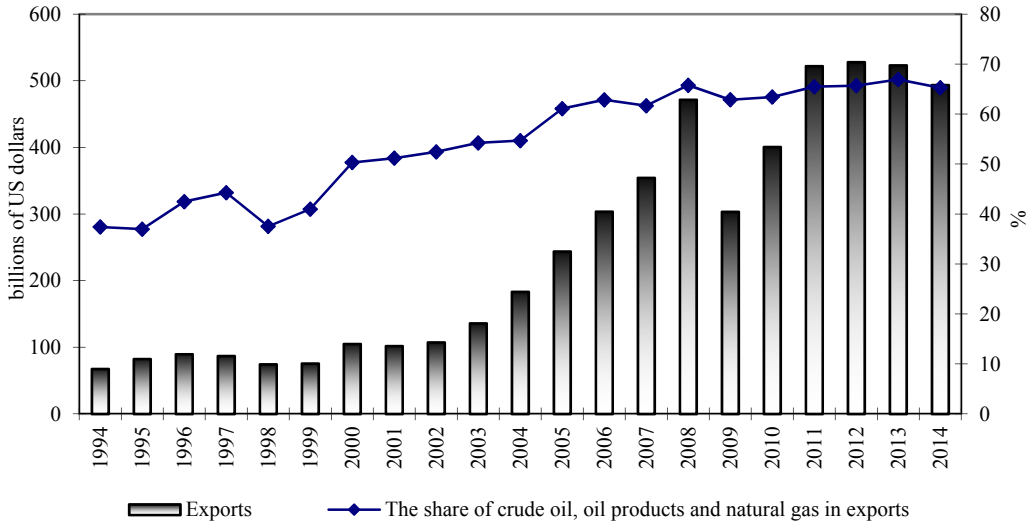


Source: the Bank of Russia; EIA; calculated at the Gaidar Institute.

Fig. 9. Russia's trade balance and the crude oil price index in 2006–2014

[1] The rent means an income receivable for making natural (mineral) resources available for other institutional entity. Examples of the rent include sums payable for land utilization, extraction of mineral resources and other extractable resources, as well as the right of fishing, forest and pasture utilization.

[2] The former balance on current transfers. According to the Central Bank of Russia, current transfers tend to increase the level of disposable income and consumption of goods and services of the recipient and reduce the disposable income and consumption potential of the donor, for example, a humanitarian aid provided in the form of consumer goods and services. Current transfers are recognized in the current account. Non-current transfers are inherently recognized as capital transfers. Capital transfers result in changes in the volume of assets or liabilities of the donor and the recipient and recognized in the capital account. If the donor and the recipient are residents of various countries, then capital transfer results in changes in the level of national wealth of the economies they represent. An example of capital transfers is free transfer of the title to fixed assets, waiver of debts.



Source: The Bank of Russia.

Fig. 10. The dynamics of exports of goods and the share of energy sector in 1994–2014

In 2014, the balance on the financial account was running at –$125,6bn (–$45bn in 2013) (see *Table 5*). The growth in the liabilities of Russian economic agents to foreign economic agents reached $48,7bn in the 12 months of 2014, 2.6 times less than the previous year growth ($125,8bn). The external liabilities of federal administration agencies declined by $9,4bn in 2014. The external liabilities of constituent territories of the Russian Federation were running at $0,1bn. A negative growth of the liabilities of monetary authorities in 2014 was less or equal to $3bn. The banking sector ceased to raise funds through external loans in 2014 due to sanctions and kept repaying on previously accumulated external liabilities. For instance, Russian banks' external debt increased $20bn in 2013, whereas in 2014 it decreased $37bn. The non-bank sector reduced drastically fundraising from non-residents in 2014, increasing its external liabilities as little as $1bn compared to $49bn raised in 2013. The inflow of foreign direct investment declined by $27bn (19 against $46bn). Other external liabilities (portfolio investment, credits and loans and other liabilities) declined by $18bn and by $3bn after the growth in 2013.

The foreign assets of residents (foreign economic agents' liabilities to Russian economic agents) increased by $76,9bn in the 12 months of 2014 ($170,8bn in 2013), whereas the foreign assets of monetary authorities contracted by $0,5bn (down $0,6bn in 2013). The foreign assets of the banking sector increased $12,7bn in 2014 ($27,9bn in 2013). Capital export from other sectors decreased 25% year-on-year in 2014 and reached $104,4bn, of which direct and portfolio investment in foreign assets was running at $47,1bn and $4,2bn respectively (–$85,4bn and –$2,2bn in 2013, respectively). The growth in investment in the foreign assets of the non-bank sector was basically determined by a growth in investment in foreign currencies in cash. According to the Bank of Russia estimates, the volume of foreign currencies in cash held by Russian residents increased $34bn in 2014, whereas it remained basically unchanged in 2013. Other assets of the non-bank sector increased in 2014 nearly 30% less than those of the previous year (67bn against 95bn), thus offsetting the growth in demand for foreign currencies in cash.

Table 5

The key accounts of the balance of payments and the dynamics of external debt in 2012–2014 (billions of US dollars)

Indicator	2012					2013					2014				
	Q1	Q2	Q3	Q4	*Year*	Q1	Q2	Q3	Q4	*Year*	Q1	Q2	Q3	Q4*	*Year*
Balance from current and capital accounts	34,7	16,1	5,6	10,3	*66,8*	25	1,8	-0,7	8	*34,1*	26,8	12,9	6,4	10,5	*26,8*
Financial account (excluding reserve assets)**	-24,8	0,8	-4,0	1,6	*-26,5*	-13,3	-7,8	-4,5	-19,3	*-45*	-50,7	-30	-5,1	-39,8	*-125,6*
Change in the foreign exchange reserves ('+' corresponds to an increase, '–' corresponds to a decrease in the reserves)	-4,6	-15,0	-1,5	-8,9	*-30,0*	-4,9	4,4	7,4	15,2	*22,1*	27,4	10,3	5,7	64,2	*107,5*
Net errors and omissions	-5,3	-2,0	-0,1	-2,9	*-10,3*	-6,8	1,6	-1,9	-3,8	*-10,8*	-3,3	6,8	3	-3,1	*3,4*
Change in Russia's external debt ('+' corresponds to an increase, '–' corresponds to a decrease of the debt)	18,6	13,1	28,3	37,5	*97,6*	55,3	16,1	8,5	12,6	*92,4*	-13,2	16,8	-53,0	-79,9	*-92,5*
Change in Russia's sovereign external debt	1,7	5,1	5,0	7,9	*19,7*	3,1	-1,5	6,7	-0,9	*7,3*	-8,1	3,5	-7,7	-7,9	*-20,2*
Change in Russian private sector's external debt	16,5	8,0	21,7	27,6	*73,8*	48,3	18,2	3,2	15,1	*84,8*	-4,5	12,8	-45,0	-66,9	*-103,6*

* – preliminary estimate; ** – net of foreign exchange reserves.
Source: The Bank of Russia.

Russia's external debt declined by 17.7% in 2014, being $599bn as of 1 January 2015. It is worthwhile noting that in 2014 the external debt of Russia's private sector dropped by $103,6bn (+$84,8bn in 2013) due to the imposed sanctions limiting the access to global capital markets (see *Table 5*). The sovereign external debt contracted by $20,2bn in 2014, whereas it saw a positive increase of $7,3bn in 2013.

The decline in the prices of Russia's key export commodities and high inflation in Russia for all of 2014 year-end pushed down the ruble's real effective exchange rate by 27.2% (a 2.8% decline in 2013), reaching the value seen in April 2014 (see *Fig. 9*). In the period between January and December 2014, the USD/RUB official exchange rate increased 69.6% to Rb 55,8 on average in December 2014 from Rb 32,9 on average in January 2014. At the same time, the EUR/RUB exchange rate in December averaged Rb 68,8, an annual growth of 49.2%. Eventually, the ruble depreciated against the dual-currency basket: the value of the dual-currency basket increased 56.8% during the same period to Rb 61,6 from Rb 39,3.

According to the Bank of Russia preliminary estimation, a trend setter in the dynamics of the balance of payments in 2014 was the dynamics of net capital outflow from the nonfinancial sector, running at $151,5bn, up $96bn above the value seen in the 12 months of 2013[1]. Given the adjustment for the amount of FX swaps between the Bank of Russia and resident banks, the amount of funds the Bank of Russia allotted in foreign currencies on a reverse basis (FX repos) to resident banks, as well as the funds held on the correspondent accounts of resident banks with the Bank of Russia – $130,5bn. At the same time, capital outflow was seen basically throughout the entire year, except June and September, when the net exports of capital through the private sector was running at $12,5bn and $0,1bn, respectively. In the period between January 2014 and December 2014, net capital outflow through banks and the private non-financial sector reached $49,8bn and $101,7bn, respectively.

In 2014, the migration to repayment of external loans and investment from fundraising was the key cause that triggered the growth in net capital outflow. Additionally, there was an upsurge in investment in foreign currencies in cash. Nonetheless, the capital outflow in 2014 was outperformed by that caused by the crisis of 2008–2009. The biggest capital outflow over a comparable period was seen during the four quarters between Q3 2008 and Q2 2009, when net capital outflow from the private sector was running at $183bn, nearly $31bn above that in 2014.

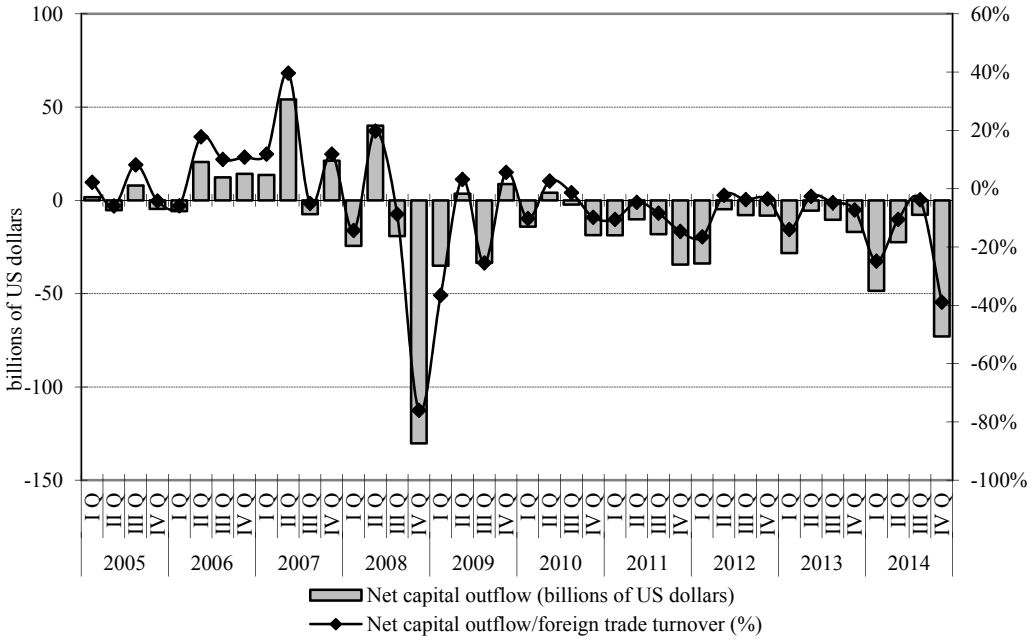
Even during the latest crisis, Russia's banking sector managed to increase its external liabilities, including direct investment, reaching a bigger volume than that in 2014 ($41bn during the crisis of 2008–09 against $18bn in 2014). Furthermore, at present, the stronger demand for foreign currencies in cash has been found to be more positive. During the crisis of 2008–2009, the growth in foreign currencies in cash was positive only within two quarters (Q4 2008 and Q1 2009), whereupon Russian residents began to gradually sell foreign currencies. This trend, however, is by no means surprising given the much more serious depreciation of the ruble in 2014.

Regarding the rest of net capital outflow components, the situation in 2014 remained visibly better than that amid the crisis of 2008–2009. The capital outflow from the banking sector in 2008–2009 was running at $32bn above the value seen in 2014. At that time banks were accumulating more intensively their foreign assets while making substantial repayments on their external debt. In 2008–2009, the foreign assets of the non-bank sector (save for foreign currencies in cash) increased more, running at $48bn above the value seen in 2014 ($115bn against $67bn)

The 2014 year-end capital flight (see *Fig. 12*) was running at $10,9bn, based on our estimates (in 2013 – $47,6bn)[2].

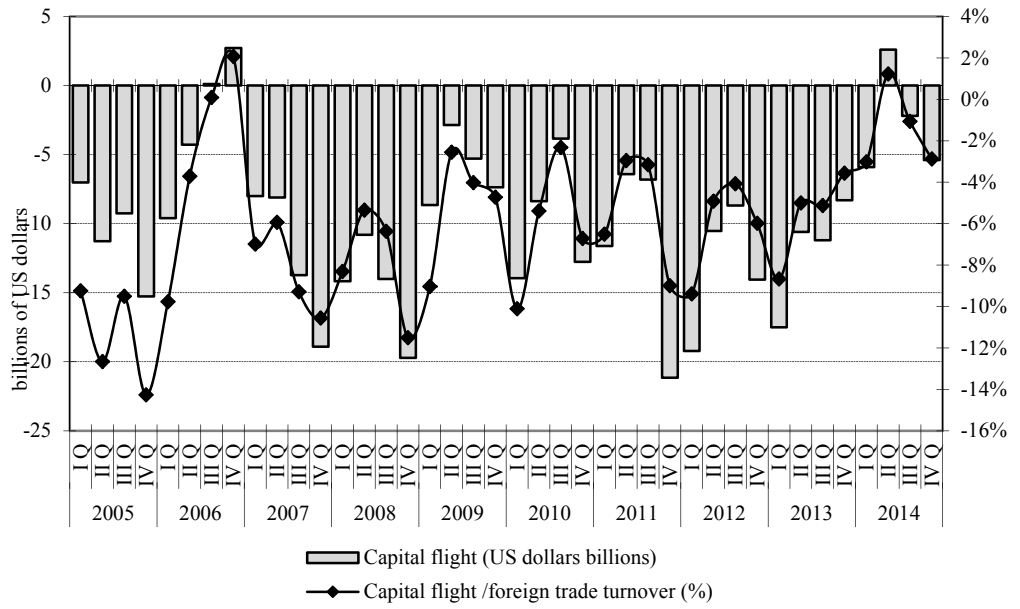
[1] While comparing the volumes of capital flows, the data on 2013 was purged from the effect of the Rosneft TNK-BP-purchase deal, Rosneft external fundraising for the purpose and the related increase in BP investment in the Rosneft's capital.

[2] The IMF capital flight measurement was used: the sum of "trade credits and advances", "timely not received export revenue and goods and services prepaid according to import contracts" and "net errors and omissions".



Source: The Bank of Russia; measured at the Gaidar Institute.

Fig. 11. The dynamics of net capital outflow in 2005–2014



Source: The Bank of Russia; measured at the Gaidar Institute.

Fig. 12. The dynamics of capital flight in 2005–2014

It is worthwhile noting that future trends concerning the state of Russia's balance of payments are mixed. On the one hand, the 2014 uptrend of the balance on the current account is likely to prevail in the mid run due to the ruble's depreciation and the respective fall in imports. On the other hand, the massive decline of crude oil prices, the geopolitical tensions, the downgrade of the credit rating for Russia are the factors that worsen the state of the balance of payments.

2.2. The State Budget

In 2014, Russia's budgetary sphere was operating under the cumulative influence of several negative factors. A further slowdown in the national economy's growth rate to 0.6% (vs. 1.3% in 2013) occurred due to the declining prices of oil in the second half-year of 2014. The average annual price of Urals in 2014 dropped to $ 97.6 vs. $ 107.9 per barrel in 2013. At the same time, it is necessary to emphasize that the slowdown in the Russian economy had first been noted during an earlier period, while oil prices had been even higher, and so this was by no means a decisive factor of economic development. However, for the budgetary system, and primarily from the point of view of the 'oil and gas' component of federal budget revenue, it was the price of oil that became the key determining parameter. As for the negative factors that the economy has been faced with, it is also necessary to point to the economic sanctions introduced against Russia from the spring of 2014 by the West, as a result of which investment activity declined and borrowed funds became far less easily obtainable. All these factors produced a negative effect on the growth rate of revenue inflow in the RF budgetary system. As estimated by the RF Ministry of Finance, Russia's loss of federal budget revenue in 2014 amounted to $ 150bn as a result of the downward movement of prices for oil, and to about $ 50bn due to the economic sanctions[1]. It is only thanks to the relatively high prices for energy carriers in the international raw materials markets over the period of January–June 2014, when the price of Urals never dropped below $ 106 per barrel, that the execution of budget revenue resulted in no shrinkage in the volume of receipts, neither in absolute nor in relative terms. Besides, another factor that conduced to increasing receipts was the decline of the ruble's foreign exchange rate, which in part compensated for the downward movement of oil prices over the second half of the year. On the whole over that year, the ruble-to-USD exchange rate rose from 33.5 in January to 55.5 in December 2014.

While the federal budget targets for 2014 were being planned, it was decided that the Pension Fund's retirement savings should be frozen, to be redistributed in favor of the fund current retirees' pensions, as a result of which the amount of federal budget transfers to the Pension Fund could be reduced. On the one hand, this measure helped to more economically spend the federal budget resources, while on the other the reliance on that mechanism further undermined the population's already feeble trust in pension reform and deprived the financial system of a new inflow of funds from one of the principal sources of 'long money'. The decision, taken in the autumn of 2014, that this measure should be prolonged into 2015, cast doubts as to the ultimate success of one of the major directions of pension reform, thus also significantly increasing the long-term risks for the budgetary system in view of the ongoing population ageing.

In late 2014, the federal government launched its antirecession package designed to support the national economy; the most impressive undertaking, in terms of volume of financing, was the measure aimed at recapitalization of the banking system, in the form of issue of new OFZ bonds to the total value of Rb 1 trillion, to be transferred to the Deposit Insurance Agency.

[1] http://1prime.ru/energy/20150129/801293885.html

2.2.1. The Main Parameters of the Budgetary System of the Russian Federation in 2014

According to data released by the RF Federal Treasury, the RF budgetary system's revenue for 2014 rose on 2013, both in absolute and in relative terms, to 37.2% of GDP (or Rb 26,371.1bn) vs. 36.1% of GDP (or 24,082.4bn) a year earlier (see *Table 6*). General government budget expenditure increased to 38.3% of GDP (or Rb 27,215.9bn), whereas in 2013 its volume had amounted to 37.3% of GDP (or Rb 24,931.1bn). As a result, in spite of the rising revenue, in 2014 the general government budget was executed with a deficit of 1.2% of GDP, which is only 0.1 pp. below the corresponding index for 2013.

Table 6

The Movement of the Budgetary System's Revenue and Expenditure in 2010–2014

	2010		2011		2012		2013		2014		Deviation, pp. of GDP, 2014 on 2013
	bn Rb	% of GDP	bn Rb	% of GDP	bn Rb	% of GDP	bn Rb	% GDP	bn Rb	% of GDP	
Federal budget											
Revenue	8, 305	17.9	11, 366	20.3	12, 854	20.7	13, 020	19.5	14, 497	20.4	0.9
Expenditure	10, 117	21.8	10, 935	19.5	12, 891	20.7	13, 343	20.0	14, 831	20.9	0.9
Deficit (–) / Surplus (+)	–1,812	–3.9	431	0.77	–37.0	–0.06	–322.9	–0.5	–333.8	–0.5	0.0
Consolidated budget of RF subjects											
Revenue	6, 537	14.5	7, 644	13.7	8, 064	13.0	8, 165	12.2	8, 906	12.5	0.3
Including inter-budgetary transfers	1, 399	3.1	1, 644	2.9	1, 680	2.6	1577	2.3	1, 728	2.4	0.1
Expenditure	6, 637	14.7	7, 679	13.7	8, 343	13.4	8,807	13.2	9, 353	13.2	0.0
Deficit (–) / Surplus (+)	–99.6	–0.2	–35.4	–0.06	–278.4	–0.5	–642	–1.0	–447.8	–0.6	0.4
General government budget											
Revenue	15, 716	33.9	20,853	37.2	23, 089	37.1	24, 082	36.1	26, 371	37.2	1.1
Expenditure	17, 301	37.4	20,005	35.7	22, 826	36.7	24, 931	37.3	27, 216	38.3	1.0
Deficit (–) / Surplus (+)	–15 851	–3.4	849	1.5	262.9	0.4	–848.7	–1.3	–844.8	–1.2	0.1
For reference: GDP, bn Rb	*66,755*		*62,218*		*55,967*		*66, 755*		*70,976*		–

Source: Rosstat; RF Ministry of Finance; IEP's calculations.

Over the course of the year 2014, the volume of federal budget revenue and expenditure increased by approximately the same amount: their growth in relative terms on 2013 amounted to 0.9 pp. of GDP. Federal budget deficit in 2014 remained at its 2013 level of 0.5% of GDP. According to preliminary estimates, the federal budget was expected to be executed with a surplus of approximately 0.4% of GDP. However, towards the year's end the government made the decision of a 1-trillion ruble recapitalization of the banking system (for further detail concerning this operation, see the sections on the budgetary system's expenditures and the RF government debt later in the text). The launch of this measure resulted in a 'technical' deficit in the year-end federal budget for 2014 (in view of the respective increase in the amount of expenditure by Rb 1 trillion).

In accordance with the initial budget targets stipulated in the Federal Law 'On the Federal Budget for 2014 and Planning Period 2015 and 2016', the amount of federal budget revenue was to be reduced by 1 pp. of GDP, with a simultaneous cut in expenditure by 1 pp. of GDP being planned for the year 2014. The approval of this cut in budget expenditure was effectuated in compliance with the budget rule whereby the budget deficit should be capped at 1% of GDP above the amount of revenue, provided that the price of oil stayed at its basic level.

Throughout the course of 2014, the discussion was underway as to the feasibility of softening the budget rule, to allow for the possibility to spend the surplus oil and gas revenues. Besides, that year saw the fundamental decision to the effect that part of the National Welfare Fund (NWF) should be spent on the infrastructure projects designed to boost economic growth. However, there remain certain issues relating to the choice of most efficient procedures for selecting such projects and assessing their real long-term effects on economic growth.

In late May 2014, the RF submitted to the State Duma a draft law whereby an adjustment of the main parameters of the federal budget for 2014 was envisaged.[1] Thus, in particular, the planned volume of GDP was to be reduced from Rb 73,315bn to Rb 71,493bn. At the same time, the increasing amount of oil and gas revenues produced by the relatively high prices of oil in early 2014 (over January–May 2014, oil prices never dropped below $ 106.7 per barrel) resulted in an upward adjustment of federal budget revenue from 18.5% of GDP to 19.9% of GDP. However, as early as July, the prices of oil went down to $ 95.6 per barrel, thus also bringing down the amount of budget revenue. The volume of federal budget expenditure was not revised, but due to the altered GDP index, the volume of expenditure amounted to 19.5% of GDP. As a result of these adjustments to budget parameters, the initially planned deficit gave way to a surplus of 0.4% of GDP. However, as noted earlier, after the issuance of new OFZ bonds this surplus once again gave way to a 'technical deficit'.

The Reserve Fund in 2014 increased by 72.9% to Rb 4,945.5bn, an equivalent of $ 87.9bn; the National Welfare Fund – by 51.3% to Rb 4,388.1bn, or $ 78bn. Such an impressive growth of Russia's sovereign funds can largely be explained by the downward movement of the national currency's foreign exchange rate, which had been observed since the autumn of 2014. As a result of foreign exchange rate adjustments over the period from 1 January through 31 December 2014, the growth in value of the Reserve Fund residuals denominated in foreign currencies, kept on its accounts with the Bank of Russia, amounted to Rb 1.9 trillion, and that of the NWF residuals – to Rb 1.5 trillion.

The consolidated budget revenue of RF subjects increased by 0.3% of GDP. At the same time, in early 2014 this index somewhat declined due to interbudgetary transfers. Thus, in particular, in January 2014, the amount of regional budget revenue shrank not only as a result of lower gratis receipts from other budgets of the RF budgetary system – by 0.7 pp. of GDP on January 2013, but also due to the back transfer, in the amount of Rb 187bn, of the residual amounts of subsidies, subventions and other targeted interbudgetary transfers received over the past years by the consolidated budgets of RF regions; later on, towards the end of 2014, this index shrank to Rb 74bn. From this fact it follows that, as far as the procedure of allocation of targeted interbudgetary transfers is concerned, the system of interbudgetary relations between the federal center and regions is still less than perfect. The volume of expenditure in the consolidated budget of RF subjects remained at its 2013 level of 13.2% of GDP. The consolidated budget deficit of RF subjects in 2014 shrank by 0.4 pp. of GDP – to 0.6% of GDP[2].

2.2.2. Analysis of the Receipts of Main Taxes in the Federal Budgetary System

In 2014, the amount of tax burden shouldered by Russia's economy rose on 2013 by 0.4 pp. of GDP; however when taken in real terms, the amount of tax-generated revenues

[1] Federal Law of 28 June 2014, No 201-FZ 'On Introducing Alterations to the Federal Law "On the Federal Budget for 2014 and Planning Period 2015 and 2016"'.
[2] For further detail on the situation in the sphere of regional budgets, see the corresponding section.

shrank by 2.7%[1] (see *Table 7*). This fact points to the increasing risks associated with the revenue sustainability of Russia's budgetary system. As for revenue growth in terms of share of GDP, this index reflects only the varying elasticity of revenue components with regard to the growth rate of GDP.

Table 7

Receipts of the Main Taxes in the General Government Budget of the Russian Federation in 2008–2014, % of GDP

	2008	2009	2010	2011	2012	2013	2014	Change in 2014 on 2013	
								pp. of GDP	in 2013 prices, %
Tax burden index	35.7	30.8	31.1	34.9	34.6	34.3	34.7	0.4	–2.7
Profits tax	6.1	3.3	3.8	4.1	3.8	3.1	3.3	0.2	2.9
Personal income tax	4	4.3	3.9	3.6	3.7	3.8	3.8	0.0	–3.0
SST / insurance contributions *	5.1	5.5	4.9	6.3	6.3	6.7	6.7	0.0	–3.8
VAT	5.1	5.3	5.4	5.8	5.7	5.3	5.6	0.2	–0.1
Excises	0.8	0.9	1.0	1.2	1.4	1.5	1.5	0.0	–5.3
Tax on mineral resources extraction	4.1	2.7	3.0	3.7	4.0	3.9	4.1	0.2	1.2
Customs duties and levies	8.6	6.8	6.8	8.3	8.0	7.6	7.7	0.1	–2.5

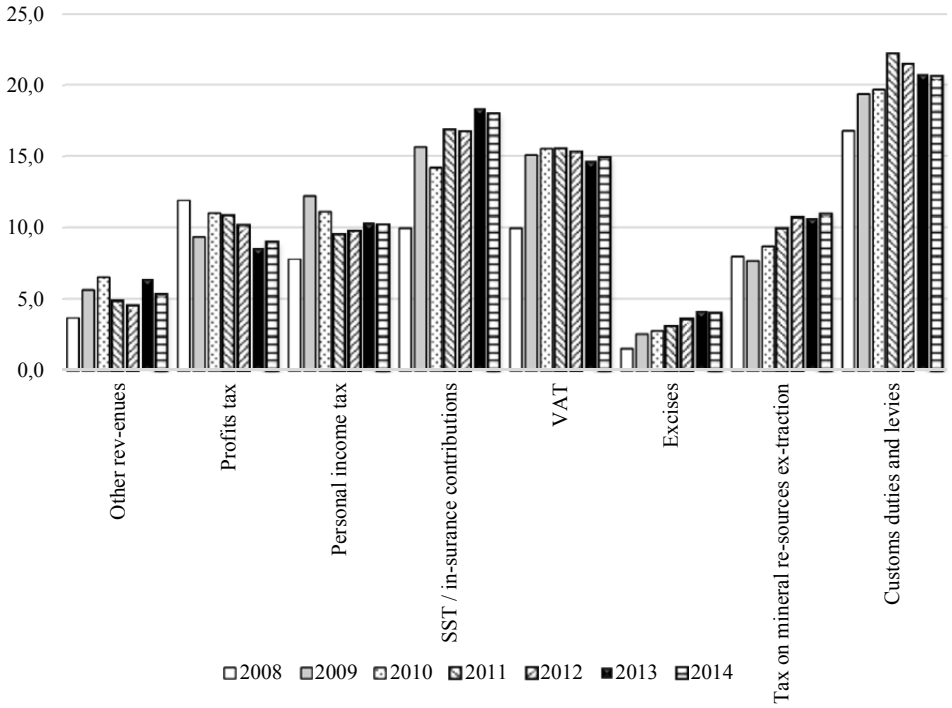
* from 2010 onwards, single social tax (SST) is transformed into insurance contributions, to be transferred directly to off-budget funds.
Source: RF Ministry of Finance; *Rosstat*; IEP's calculations.

From the general government budget revenue statistics presented in the table it follows that, in 2014, the tax burden in terms of percentage points of GDP increased on 2013 as follows: profits tax – 3.3 pp. vs. 3.1 pp.; VAT – 5.6 pp. vs. 5.3 pp.; tax on mineral resources extraction – 4.1 pp. vs. 3.9 pp.; and customs duties and levies – 7.7 pp. vs. 7.6 pp. of respectively. As for the other taxes, their burden in terms of share in GDP remained unchanged. However, when the movement of tax receipts is reviewed in real terms (with an adjustment by CPI), it becomes clear that all the relevant tax receipts declined in real terms, with the exception of tax on mineral resources extraction (growth by 1.2%) and profits tax (growth by 2.9%).

The structure of tax-generated revenues in the general government budget is shown in *Fig. 13*. In this connection, two circumstances are noteworthy. Firstly, personal income tax (PIT) retained its priority over profits tax as a major revenue source for the general government budget. Secondly, excise receipts, which since 2009 had been demonstrating a steady growth due to the indexation of their rates ahead of the inflation rate, in 2014 dropped in terms of share in GDP, while in real terms they were leaders in decline among all the other types of receipts (decline by 5.3%).

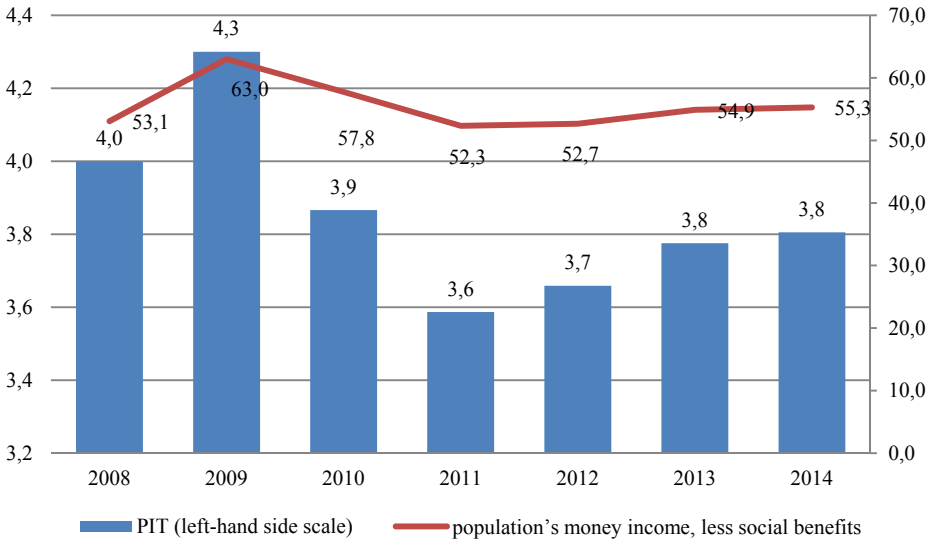
The receipts of PIT, as well as the index of their 'macro-base' – money income of the population less social benefits – in 2014 remained almost at the same level as in the previous year (see *Fig. 14*).

[1] In 2013 prices, adjusted by CPI.



Source: RF Federal Treasury.

Fig. 13. The Share of Tax Receipts in Aggregate General Government Budget Revenue in 2008–2014, as %



Source: RF Federal Tax Service; *Rosstat*.

Fig. 14. The Comparative Movement of PIT Receipts and Money Income of the Population less Social Benefits in 2008–2014, as % of GDP

The amount of oil and gas revenues in the federal budget in 2014 returned to their previous level of 10.6 pp. of GDP (see *Table 8)*. Their first component – tax on mineral resources extraction levied on hydrocarbons increased by 0.2 pp. of GDP. A sharp drop of price for oil

occurred in Q4 2014, as a result of which the average supply price for crude oil amounted to $ 93.9 (according to customs statistics). The negative effect of the decline of the average price by nearly $ 14 was compensated for by the decline of the ruble-to-USD exchange rate from Rb 31.2 in 2013 to Rb 38.6 in 2014[1].

Table 8

The Receipts of Oil and Gas Revenue and Tax on Mineral Resources Extraction in 2008–2014

	2008	2009	2010	2011	2012	2013	2014
Oil and gas revenues, as % of GDP	10.9	7.9	8.4	10.3	10.6	10.0	10.6
Tax on mineral resources extraction, as % of GDP	4.1	2.7	3.0	3.7	4.0	3.9	4.1
Oil extraction, including gas condensate, m tons	488	494	506	512	519	522	525
Average annual price of Urals, USD per barrel[2]	90.7	60.7	76.2	107.3	109.7	108.4	93.9
RF Central Bank's official average annual exchange rate of USD, Rb/USD	24.78	31.90	30.37	29.31	31.05	31.20	38.6

Source: Rosstat; RF Central Bank; RF Federal Tax Service; IEP's calculations.

The movement of the second component – the export customs duties on hydrocarbons – played an even greater role in pushing up the index of oil and gas revenues in terms of share in GDP (approximately 6.5% of GDP in 2014 vs. 6.1% in 2013). Importantly, growth of receipts occurred due to the increasing exports of crude oil and petroleum products (see *Table 9*). The plummeting foreign exchange rate of the ruble obliterated not only the effect of declining oil prices, but also the shrinkage of crude oil export by 5.6% in terms of physical volume (according to data released by Rosstat).

Table 9

The Receipts of Customs Duties in 2008–2014, % of GDP

	2008	2009	2010	2011	2012	2013	2014
Exporte duties on energy carriers	6.8	5.2	5.3	6.6	6.6	6.1	6.5
- on crude oil	4.3	3.1	3.6	4.2	4.0	3.5	3.7
- on natural gas	1.2	1.1	0.4	0.7	0.7	0.7	0.7
- on petroleum products	1.3	1.0	1.3	1.7	1.8	1.8	2.1
Customs duties and levies, total	**8.6**	**6.8**	**7.0**	**8.4**	**8.0**	**7.6**	**7.7**

Source: Rosstat; RF Federal Treasury; IEP's calculations.

Value added tax (VAT) is the only significant component of budget receipts that remained practically unchanged in real terms (-0.1%), and even somewhat increased in terms of share in GDP (see *Table 10).* VAT receipts were pushed up by the increased receipts of VAT on goods sold in RF territory ('domestic VAT'), while the corresponding index for goods imported into RF territory demonstrated no noticeable change in terms of share in GDP. It should be noted that, for Russia, a typical phenomenon has always been the higher amount of receipts of VAT on imports by comparison with VAT on domestic products. However, the data for recent years point to the emergence of a new downward trend displayed by the effective rate of VAT on imported goods.

[1] The rate of tax on mineral resources extraction levied on oil includes the coefficient of the movement of world oil prices (Ct) pegged to the average USD exchange rate for a given tax period.
[2] Ratio of crude oil exports in money terms to crude oil exports in terms of physical volume (according to data released by the Federal Customs Service).

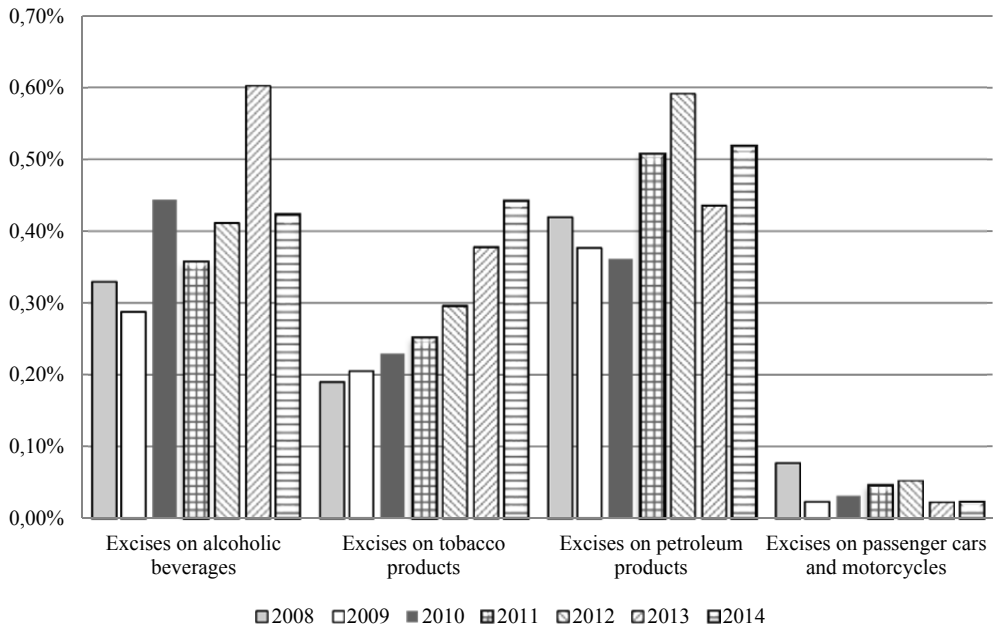
Table 10

The Movement of End-use Consumption, Imports and VAT Receipts in the RF Budgetary System in 2008–2014, % of GDP

	2008	2009	2010	2011	2012	2013	2014
VAT, total	5.2	5.3	5.4	5.8	5.7	5.3	5.6
VAT on goods sold in RF territory	2.4	3.0	2.9	3.1	3.0	2.8	3.1
VAT on goods imported into RF territory	2.8	2.3	2.5	2.7	2.7	2.5	2.5
Effective rate of VAT[1], %	8.4	7.6	8.2	9.3	8.3	7.4	7.5
Effective rate of VAT on goods sold in RF territory[2]	5.4	5.5	5.8	6.9	6.4	5.7	6.1
Effective rate of VAT on goods imported into RF territory[3]	12.5	11.0	11.9	12.3	12.1	11.1	10.7
Imports*	22.1	20.5	21.1	21.9	22.4	22.7	23.0

* The share of imports in GDP was determined as the ratios of imports indices (based on *Rosstat*'s data) to GDP.
Source: Rosstat; RF Ministry of Finance; IEP's calculations.

As seen from *Fig. 15,* the year 2014 saw increasing receipts, in terms of share in GDP, of excises on tobacco and petroleum products: from 0.38% and 0.44% in 2013 to 0.44% and 0.52% in 2014 respectively. In 2014, the excises on petroleum products once again became leaders among excises. It is noteworthy that the receipts of domestic excises increased, while those of excises on imported petroleum products declined. As before, the excises on sold passenger cars and motorcycles accounted only for a negligible part of this type of budget revenue.



Source: RF Federal Treasury.

Fig. 15. The Receipts of Excises for the Period 2008–2014, by Group of Excisable Goods, as % of GDP

[1] The VAT receipts to end-use consumption ratio.
[2] The ratio of the receipts of VAT on goods sold in RF territory to end-use consumption, less imports in money terms.
[3] The ratio of the receipts of VAT on goods imported into RF territory to imports in money terms.

At the same time, the decline in the amount of receipts of excises on alcoholic beverages was so steep that the index of 'alcohol-generated' excises fell below not only that of the excises on petroleum products, but also the excises on tobacco products. In *Table 11* one can see that the consumption rates declined with regard to practically every type of alcoholic beverage. The most impressive decline was observed with regard to the retail turnover of vodka and liquors – from 133.6 to 124.7 m dal. The retail turnover of wines and cognacs also somewhat shrank, but the sales volumes of beer and sparkling wines slightly increased.

Table 11

Consumption of Alcoholic Beverages and Tobacco Products in the RF in 2008–2014, m *dal*

Product type	2008	2009	2010	2011	2012	2013	2014
vodka and liquors	177.2	166.1	157.8	156.4	153.0	133.6	124.7
wines (less champagnes and sparkling wines)[1)]	102.9	102.5	103.4	97.1	93.6	83.6	83.3
cognacs, cognac products (including brandy, calvados)	10.8	10.6	11.1	11.6	12.4	12.1	11.9
champagnes and sparkling wines	26.0	25.5	27.3	28.5	28.3	27.7	28.6
beer	1,138.2	1,024.7	1,004.0	1,011.5	1,017.5	984.2	1,001.2
Cigarettes (including with cardboard mouthpieces), bn items	393.6	398.7	382.4	395.0	391.8	384.0	362.1

[1)] Prior to 2012: 'Grape wines and fruit wines'.
Source: *Rosstat*.

2.2.3. The Expenditure of Russia's Budgetary System in 2014

The expenditure side of the RF budgetary system in 2014 amounted to 38.3% of GDP, which is 1 pp. above the corresponding index for 2013 (see *Table 12*).

Table 12

General Government Budget Expenditure in 2009–2014, % of GDP

	2009	2010	2011	2012	2013	2014	Deviation for 2014 on 2013
Expenditure, total	40.8	37.4	35.7	36.7	37.3	38.3	1.0
Nationwide issues	2.7	2.5	2.4	2.3	2.3	2.3	0.0
Government and municipal debt servicing	0.6	0.6	0.6	0.6	0.7	0.7	0.0
National defense	3.1	2.8	2.7	2.9	3.2	3.5	0.3
National security and law-enforcement activity	3.2	2.9	2.7	3.1	3.2	3.1	-0.1
National economy	7.2	5.0	5.0	5.3	4.9	6.4	1.5
Housing and utilities sector	2.6	2.3	2.1	1.7	1.6	1.4	-0.2
Environment protection	0.1	0.1	0.1	0.1	0.1	0.1	0.0
Education	4.6	4.1	4.0	4.1	4.3	4.3	0.0
Culture, cinematography and mass media	0.8	0.8	0.7	0.7	0.7	0.7	0.0
Healthcare and sports	4.3	3.7	3.8	4.0	3.8	3.9	0.1
Social policy	11.7	12.7	11.6	11.9	12.6	11.8	-0.8

Source: RF Federal Treasury; IEP's calculations.

The amount of allocations to the majority of expenditure items for 2014 changed on 2013 by no more than 0.1-0.3 pp. of GDP. The most substantial shrinkage in the amount of expenditure occurred under the item *Social Policy* (-0.8 pp. of GDP). This happened first of all due to the redistribution of accumulated pension contributions to the funded component of the pension system in favor of the current retirees' pensions, so as to bring down the amount of transfers from the federal budget to the Pension Fund. On the one hand, this resulted in more economical spending of federal budget funds, while on the other, the introduction of this particular mechanism further undermined the population's already feeble trust in pension reform

and deprived the financial system of the inflow of funds from one of the major sources of 'long money'.

At the same time, government spending under the item *National Economy* increased at a record rate to 6.4% of GDP (+1.5 pp. of GDP). A higher value of 7.2% of GDP had been observed only back in 2009; it was associated with the implementation of anti-crisis measures designed to support the national economy. The significant growth in expenditure under the item *National Economy* observed in 2014 was also associated with the launch of a new anti-recession package in support of the financial sector of the economy. Thus, in December 2014, a total of Rb 1 trillion was transferred from the federal budget as a property contribution to the Deposit Insurance Agency (DIA), in the form of a new issue of OFZ bonds. With this contribution, the DIA was granted the right to recapitalize the banks considered to be systemically important — with equity to the value of no less than Rb 100bn. If this transfer had not taken place, the amount of expenditure allocated to *National Economy* in 2014 would have amounted to 5% of GDP.

The budget allocations to *National Defense* continued to be on the rise, demonstrating growth by 0.3 pp. of GDP on 2013. The allocations to defense had been increasing consistently since 2012 (when their amount increased from 2.7% to 2.9% of GDP), with a subsequent surge to 3.5% of GDP in 2014. The boost to army expenditures is associated with the launch of the government armaments program for the period 2011-2020, as well as with the introduction of a new system of money allowance for military servicemen and army retiree pensions.

The amount of expenditure under the item *Healthcare and Sports* in the general government budget for 2014 increased by 0.1% of GDP on 2013 due to the allocation of funding through off-budget funds (compulsory medical insurance system CMI)). At the same time, the amount of federal budget expenditure and the budget expenditure of RF subjects remained at its 2013 level. For many years already, gradual reform has been underway in the healthcare funding system that included, among other things, the switchover to a 'one-channel' allocation of CMI funds.

On the whole, in recent years there has emerged a distinct trend towards increasing the amount of government spending obligations, which takes place notwithstanding the existing constraints on the growth of resources (the revenue part) of the budgetary system. In 2012, the budget expenditure index began to increase, moving from 35.7% of GDP in 2011 to 38.3% of GDP in 2014. At the same time, the amount of the budgetary system's revenue over the same period fluctuated around 37% of GDP (with a marked drop, in 2013, to 36.1% of GDP). It should be noted however, that the changes occurring in the structure of expenditures are rather controversial. On the one hand, the amount of expenditure allocated to education was increased over the period 2013-2014, primarily in compliance with the May 2012 Presidential Executive Orders, while the expenditures on healthcare and sports in terms of share in GDP were reduced. In other words, on the whole the 'productive expenditures' (that is, those intended to boost long-term economic growth) and targeted investments in human capital rose on 2012 by only 0.1 pp. of GDP. Over the same period, the amount of expenditure allocated to defense ('nonproductive expenditures' in excess of the necessary minimum) increased by 0.6 pp. of GDP (on 2012). So, the structure of the budgetary system's expenditure is becoming less effective from the point of view of long-term socioeconomic development.

2.2.4. Government Debt of the Russian Federation in 2014

As of 1 January 2015, the volume of Russia's government domestic debt amounted to Rb 7241bn, or approximately to 10% of GDP, having increased over the previous year by Rb 1519bn. The volume of government domestic debt increased in the main over the month of December (+Rb 1 482bn), due to the RF Government's decision to recapitalize Russian banks by issuing a federal bond issue to the value of Rb 1 trillion (federal loan bonds with variable coupon rate – OFZ-PK). Over the same period, the volume of government guarantees increased by Rb 433bn. As of 1 January 2015, the share of government guarantees in the total government domestic debt volume amounted to 24.4%.

The year-end results of 2014 for the first time demonstrated a shrinkage in the volume of market debt in nominal terms, represented by exchange-traded federal loan bonds with fixed coupon rate (OFZ-PD), federal loan bonds with debt amortization (OFZ-AD), and the new market instrument launched in December – zero coupon federal loan bonds (BOFZ). In face of the deteriorating international political situation, mounting pressure produced by the economic sanctions, and declining economic growth rate, only 20 out of the 48 auctions on placement of OFZ bonds planned for 2014 were actually held. The aggregate face value volume of placed bonds amounted to Rb 158bn, or 21% of the planned bond offer volume (see *Table 13*).

Table 13

The Final Results of Auctions on Placement of OFZ Bonds

bn Rb	Q1 2014	Q2 2014	Q3 2014	Q4 2014	2014
1. Aggregate planned OFZ bond offer volume	275	150	140	200	765
2. OFZ bond offer volume at auctions that actually took place	90	90	45	40	265
3. OFZ bond placement volume, face value	38	65	40	16	158
4. Bond placement coefficient, as % of bond offer at auctions that actually took place (3/2)	42	72	88	40	60
5. Bond placement coefficient, as % of planned aggregate offer volume (3/1)	14	43	28	8	21

Source: RF Ministry of Finance.

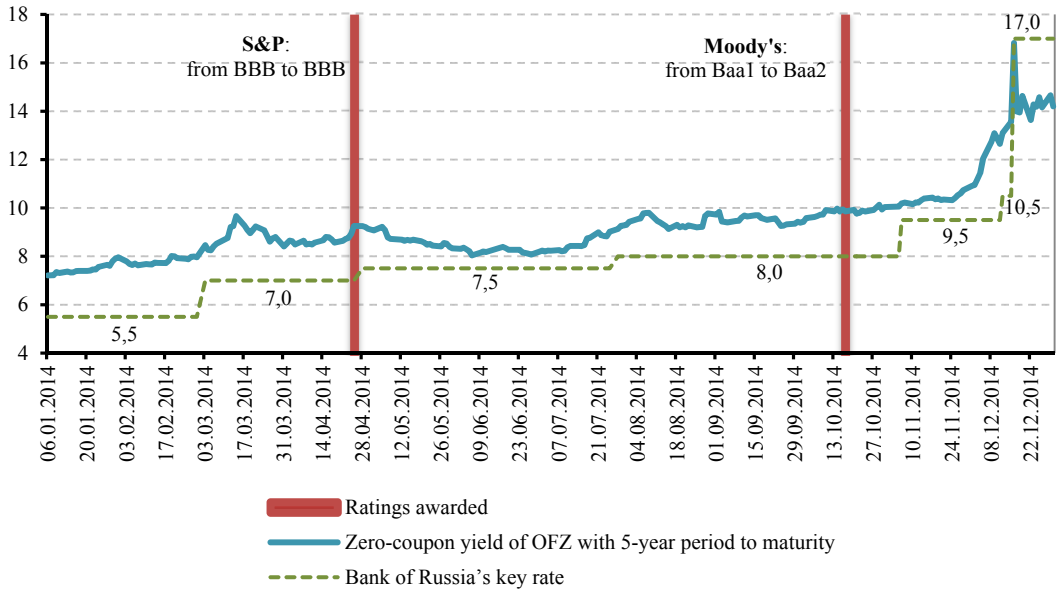
The proceeds from the placement of OFZ bonds by the RF Ministry of Finance in 2014 amounted to Rb 146bn, or approximately to 93% of the placed volume of bonds at face value. It should be pointed out that, in Q4, the placement was less successful due to the plummeting bond prices – the proceeds amounted to only 85.5% of the face value of bonds vs. 96.4% in Q1.[1]

As shown by the year-end results of 2014, the RF Ministry of Finance had not managed to properly refinance market debt[2]: the net sum yielded by OFZ-PD, OFZ-AD and BOFZ amounted to Rb 60bn[3], and if the cost of their servicing is added up – to Rb 318bn.

In 2014, two international rating agencies (Standard&Poor's and Moody's) downgraded Russia's sovereign credit ratings one notch from BBB to BBB- (25 April 2014) and from Baa1 to Baa2 (17 October 2014) respectively. The new rating assigned to Russia by S&P came close to speculative status (BB+); Moody's rating still stood one notch above the non-investment grade (Baa3). The knocking-down of Russia's sovereign rating came as no surprise for market participants – the zero-coupon yield curve of OFZ showed no 'jerks and starts' on the rating reduction dates (see *Fig. 16*). The movement of yields on government bonds was determined by

[1] For reference: in Q2 and Q3 2014 – 92.3% and 92.5% respectively.
[2] Less the new OFZ-PK issue to the value of Rb 1 trillion for recapitalization of Russian banks.
[3] Net borrowing is the amount of attracted market loans less the amount of market debt redemption.

the worsening international political situation as a result of sanctions levied against Russia, and Russia's retaliatory measures (the introduction of an embargo on certain imported foodstuffs), as well as by the rising recession trends in the Russian economy.



Source: data released by the Bank of Russia; Standard&Poor's; Moody's.

Fig. 16. The Movement of OFZ Yields in 2014

Thus, if the tense economic and international political situation should persist throughout the course of 2015, the federal budget may be weighed down with an additional burden due to the impossibility to refinance government debt in full through the issuance of new bond loans on the domestic market (the redemption of government securities in 2015 should amount to approximately Rb 627bn[1]).

As of 1 January 2015, Russia's foreign debt amounted to $ 54.4bn, having shrunk over the past year by $ 1.5bn. However, if taken in terms of the ruble's foreign exchange rate (which markedly declined in 2014), the amount of foreign debt rose by more than 1 trillion Rb: from Rb 1.8 trillion (as estimated on the basis of the Bank of Russia's exchange rate as of 1 January 2014) to Rb 3.1 trillion (as estimated on the basis of the Bank of Russia's exchange rate as of 1 January 2015). The reduction in the amount of foreign debt denominated in USD was noted with regard to all items except government guarantees, which demonstrated growth by nearly $ 700bn. The absence, in 2014, of foreign loans in the form of Eurobonds can be explained by the tricky international politicaloй situation and the reassessment, by foreign investors, of the risks associated with investing in Russia's government bonds. The cost of servicing and redemption of Eurobonds in 2014 amounted to $ 1.4bn. On the whole, it can be concluded that foreign loans cannot become a major source of funding to cover federal budget deficit in 2015.

[1] Based on data released by the RF Ministry of Finance. The debt redemption volume is calculated as of 1 February 2015.

2.2.5. The Prospects for Medium-term Budget Policy

Thanks to the relatively high oil prices in the first half year of 2014 and the ruble's depreciation over the second half year, it became possible to avoid the shrinkage of oil and gas revenues, which had been largely determining the availability of resources in the budgetary system. However, in the medium-term perspective the decline of oil prices may acquire a critical momentum. In absence of opportunities for attracting foreign loans, and given the limited domestic resources available for borrowing, the Reserve Fund may be fully spent, by way of covering federal budget deficit, within the next two years. In view of these grim prospects, it will be necessary to exercise an even greater caution when making decisions concerning the launch of 'mega-projects' funded from the NWF, to prevent rapid evaporation of Russia's sovereign funds.

Under the conditions of limited economic growth sources, both domestic and foreign ones, it will be necessary to boost budget spending efficiency. Part of budget expenditure could be redistributed in favor of items representing investment in human capital (education, healthcare) or fixed assets (infrastructure), while correspondingly reducing the allocations to the upkeep of the government apparatus and the power structures (the so-called *budget maneuver*). Another important goal is to boost the efficiency of 'anti-recession' budget expenditures. Thus, for example, it may be feasible to create incentives for the recapitalized banks to use their resources as corporate and individual loans, and not as a source of funding for speculations in the foreign exchange or stock market.

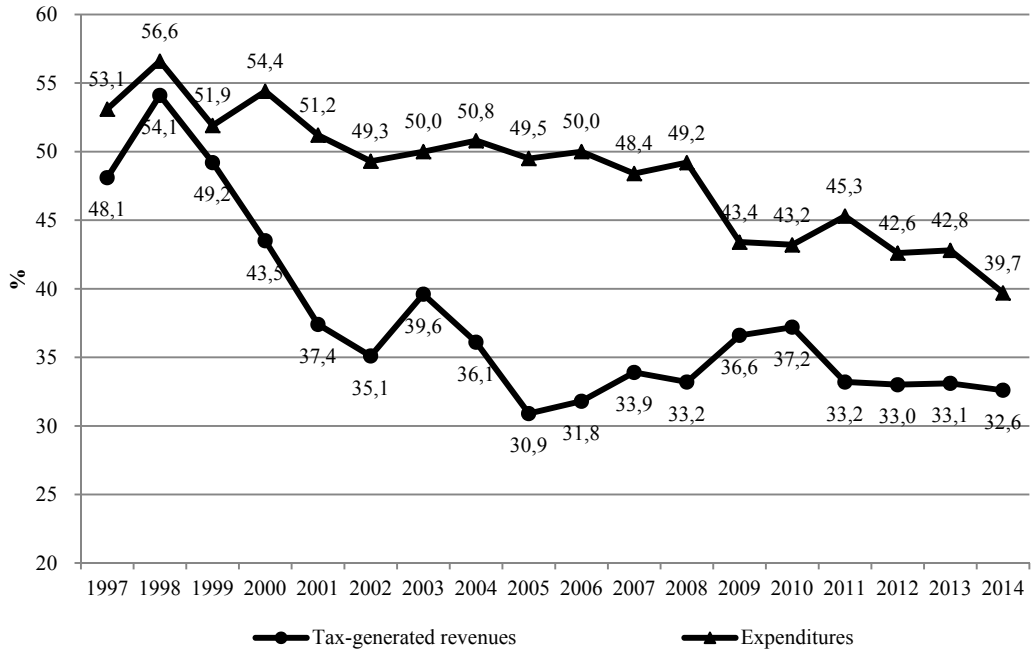
Besides, it is necessary to take into consideration the fact that the federal budget is 'the budget of last resort', and that the problems arising throughout the budgetary system will, sooner or later, but inevitably be translated into an additional burden shifted onto it. This effect can be further enhanced by the significant shortcomings of Russia's federalism model where, in spite of the formal division of powers between the Federation and regions, the federal government is the principal decision-maker on issues that directly influence the actual volume of subnational budget expenditure (one example being the May 2012 Presidential Executive Orders). The attempt to solve the problems faced by subnational budgets by applying the instrument of budget loans can only delay the ultimate solution – the achievement of a well-balanced budget status. In the medium term, this policy will either necessitate the issuance of new loans in order to redeem the old ones, or make inevitable the writing-off (or restructuring) of part of outstanding debt to the federal budget. Both scenarios imply a very negative course of events, because the fiscal incentives for regional administrations will become even more distorted, and the issues relating to the soft budget constraints imposed on subnational authorities will become still more complicated.

Another important precondition for maintaining well-balanced federal budget over a long-term period is the solution to the pension reform issue, including the issue of raising the retirement age. Instead of putting forth strategic initiatives in this sphere, the government has chosen to 'freeze' the accumulated insurance contributions to the funded pension component for a second year in a row (2014 and 2015), thus increasing the risk that this direction of pension reform may ultimately result in a failure. In the long run, this will inevitably become translated into an increasing burden on the budgetary system, which will become responsible for providing funding to the solidarity (distributive) pension component under the conditions of population ageing.

2.3. Interbudgetary Relations and Subnational Finance

2.3.1. Analysis of the Main Parameters of the Consolidated Budget of Subjects of the Russian Federation

The main trends observable in the relations between different tiers of government authority are reflected by the structure of revenue and expenditure in the consolidated budget of the Russian Federation. *Fig. 17* presents data on the movement of the relative shares of tax-generated revenues and expenditures of subjects of the Russian Federation in Russia's consolidated budget.



Note. No calculations were done for the Crimean Federal District's regions.
Source: RF Federal Treasury; authors' calculations.

Fig. 17. The Share of Subnational Tax-generated Revenues and Expenditures in Russia's Consolidated Budget in 1997–2014

The year 2014 saw a slight shrinkage in the share of tax-generated revenues received by subnational budgets in the consolidated budget of the Russian Federation - from 33.1% in 2013 to 32.6% in 2014. Over the same period, the share of expenditure demonstrated a more notable decline - from 42.8 to 39.7% (less the amount of expenditure for the Crimean Federal District). The shrinkage of the share of subnational budget expenditure in the total consolidated budget expenditure of the Russian Federation can largely be explained by the accelerated growth of federal budget expenditure (by 11.4% in nominal terms). The leaders in growth in the federal budget were the expenditures earmarked for national defense and national economy. Over the same period, the amount of subnational budget expenditure increased by only 4.6% (less the amount of expenditure for the Crimean Federal District).

Now let us take a closer look at the revenue side of subnational budgets. The movement of the main components of the consolidated budget revenue of subjects of the Russian Federation is shown in *Table 14.*

Table 14

Consolidated Budget Expenditure of Subjects of the Russian Federation in 2008–2014

	Volume of revenue (in nominal terms), bn Rb							Growth in real terms, %				
	2008	2009	2010	2011	2012	2013	2014	2009/ 2008	2010/ 2009	2014/ 2008	2014/ 2009	2014/ 2013
Revenue, total	**6,196**	**5,924**	**6,537**	**7,644**	**8,064**	**8,165**	**8,743**	**-12.1**	**1.4**	**-11.2**	**1.1**	**-3.9**
Tax-generated and non-tax revenues	**4,912**	**4,243**	**4,980**	**5,827**	**6,385**	**6,588**	**7,141**	**-20.6**	**7.9**	**-8.5**	**15.3**	**-2.7**
including tax-generated revenues:	*4,384*	*3,792*	*4,520*	*5,273*	*5,800*	*5,967*	*6,461*	*-20.5*	*9.6*	*-7.2*	*16.7*	*-2.8*
profits tax	1,752	1,069	1,520	1,928	1,980	1,720	1,962	-43.9	30.6	-29.5	25.7	2.4
PIT	1,666	1,665	1,790	1,996	2,261	2,499	2,679	-8.1	-1.2	1.3	10.2	-3.8
taxes on aggregate incomes	161	152	179	215	272	293	314	-13.6	8.5	22.6	42.0	-3.7
taxes on property	493	570	628	678	785	901	955	6.1	1.4	21.9	14.9	-4.8
excises	189	246	327	372	442	491	479	19.2	22.5	59.2	33.6	-12.5
Transfers	**1,131**	**1,486**	**1,398**	**1,644**	**1,624**	**1,515**	**1,545**	**20.7**	**-13.5**	**-14.0**	**-28.8**	**-8.5**
Other revenues	**153**	**195**	**159**	**173**	**56**	**62**	**57**	**17.4**	**-25.1**	**-76.3**	**-79.8**	**-16.4**

Note. No calculations were done for the Crimean Federal District's regions.
Source: RF Federal Treasury; authors' calculations.

As can be seen from the data presented in *Table 14*, in 2014 the amount consolidated budget revenue of subjects of the Russian Federation in 2014 on the whole declined on 2013 - by 3.9% in real terms. The total amount of revenue in real terms in 2014 shrank due to the declining rate of economico growth, and also because the rate of growth (in nominal terms) of the main revenue sources was lagging behind the inflation rate[1]. Among all the main sources of revenue in 2014, only the profits tax receipts in real terms displayed a positive rate of growth of 2.4% on the previous year. At the same time, another main source of tax-generated revenues – PIT – moved in the opposite direction, declining in 2014 by 3.8% in real terms. As a result, the structure of tax-generated revenues also changed: the share of profits tax in the total volume of tax-generated revenues increased from 28.8 to 30.2%, while the share of PIT somewhat declined - from 41.9% to 41.3%. Growth of the profits tax receipts can largely be explained by the low base effect of 2013, while even when taken in nominal terms, the revenue volume is below its 2012 level (Rb 1,962bn vs. Rb 1,980bn respectively). With regard to PIT it should be noted that, in 2014, for the first time over several years, the population's real disposable income declined (by 1% on 2013), which was the main reason why the receipts of PIT in 2014 dropped for the first time since 2011 (in real terms).

We can also note the uneven spread of the receipts of main tax-generated revenues over the course of each year. Thus, the monthly amount of profits tax receipts in October and November 2014 shrank, in nominal terms, by 22.8% and 26.7% respectively on the corresponding periods of 2013; a decline of this index was also observed in January 2014 (-12.7%). In November 2014, a sharp slowdown in the flow of receipts from another major revenue source (PIT). In December the revenue growth index more or less returned to its usual value, which happened due in the main to the profits tax receipts. So, if the situation in the national econo-

[1] Thus, while in 2010 Russia's GDP growth rate amounted to 4.5%, and in 2011 – to 4.3%, in 2012 it dropped to 3.4%, in 2013 to 1.3%, and then in 2014 to 0.6%. At the same time, in 2014 the inflation rate amounted to 11.4%, which is its record high for the period under consideration (2010–2014).

my should deteriorate any further, the vector of the main tax receipts (PIT and profits tax) will be persistently negative; however, these taxes largely determine the level of budget revenue in those regions that receive no dotations or only a small amount of dotations (whereas the situation in those RF subjects that are highly dependent on dotationsis more strongly dependent on the movement of transfers from the federal budget).

The downward movement of total consolidated budget revenue of RF subjects was also influenced by the movement of receipts of excises on petroleum products, which happened in part due to the introduction of the Customs Union's new technical regulation (on the whole, the amount of excise receipts shrank by 12.5% in real terms).

In 2014, the amount of non-tax revenues remained practically at the same level as over the previous year (a decline in real terms by 1.7%). However, in spite of this decline, the share of that source of revenue in the overall structure of consolidated budget revenue of RF subjects slightly increased – from 7.6% to 7.8%. It much be emphasized in this connection that, while the amount of consolidated budget revenue proper (tax-generated and non-tax) was on the decline, the amount of transfers in 2014 likewise declined, and at a faster rate – by 8.5% in real terms. The movement of transfers from the federal budget is dealt with in more detail in Section 2.3.2.

Here we are going to view more closely the situation with regard to receipts of tax-generated and non-tax revenues in various subjects of the Russian Federation (*Table 15*).

Table 15

Russia's Regions Grouped in Accordance with the Movement of Major Tax-generated and Non-tax Revenues in the Consolidated Budget of Subjects of the Russian Federation

	Movement of major tax-generated and non-tax revenues in consolidated budgets of RF subjects					
	growth by more than 25%	growth between 10% and 25%	growth by less than 10%	decline by less than 10%	decline between 10% and 25%	decline by more than 25%
in nominal terms						
Tax-generated and non-tax revenues, total	5	9	62	5	1	0
Profits tax	19	15	20	16	11	1
PIT	0	6	74	2	0	0
in real terms						
Tax-generated and non-tax revenues, total	1	5	5	63	8	0
Profits tax	9	12	12	20	25	4
PIT	0	0	2	78	2	0

Note. 1) Arkhangelsk Oblast and Nenets Autonomous Okrug are treated for the purpose of our calculations as one and the same subject of the Russian Federation. 2) No calculations were done for the Crimean Federal District's regions.
Source: RF Federal Treasury; authors' calculations.

As seen from the data presented above, the majority of Russian regions continued to experience difficulties with regard to the availability of subnational budget revenue proper (just as they did in 2013[1]). Thus, in 2014, a decline of subnational budget revenue proper in real terms was observed in 71 regions, and in 63 of these the revenue decline was within 10%. In spite of the general rise in the profits tax receipts on a national scale, in 4 regions the revenues gener-

[1] In 2013, 51 subjects of the Russian Federation experienced a decline in the amount of their revenue proper in real terms. Over the same period the amount of profits tax receipts in real terms dropped by more than 25% in 23 regions. Meanwhile, the receipts of PIT increased practically in every region.

ated by this source dropped by more than 25% in real terms: in Belgorod Oblast (-25.9%), in Kaluga Oblast (-27.7%), in the Republic of Karelia (-25%), and in the Republic of Buryatia (-39.1%). Overall, the amount of profits tax receipts in real terms declined in 49 regions. In the other 33 regions this index displayed growth in real terms, and in 9 RF subjects it increased by more than 25%: in Lipetsk Oblast (28.2%), in Kaliningrad Oblast (57%), in Leningrad Oblast (53.9%), in the Republic of Mordovia (201.9%), in Tyumen Oblast (39,4%), in the Khanty-Mansi Autonomous Okrug (61.2%), in the Republic of Sakha (Yakutia) (42.3%), in Sakhalin Oblast (109.8%), and in Chukotka Autonomous Okrug (59.9%). Due to the increased profits tax receipts, Sakhalin Oblast managed to push up its revenue proper by more than by 25% (55.1%), which represents an exceptional case by comparison with the general situation in this country. As far as PIT receipts are concerned, the majority of regions (78) experienced a decline in the range of 10%. Growth could be observed only in Samara Oblast (0.2%) and Tambov Oblast (2%).

Now let us analyze the changes that occurred in 2014 in the expenditure side of the consolidated budget of subjects of the Russian Federation (*Table 16*). On the whole, the amount of aggregate expenditure declined on 2013 both in real terms (-4.7%), and in terms of share of GDP (by 0.12 pp. - from 13.30 to 13.18%).

Table 16

Consolidated Budget Expenditure of Subjects of the Russian Federation in 2013–2014

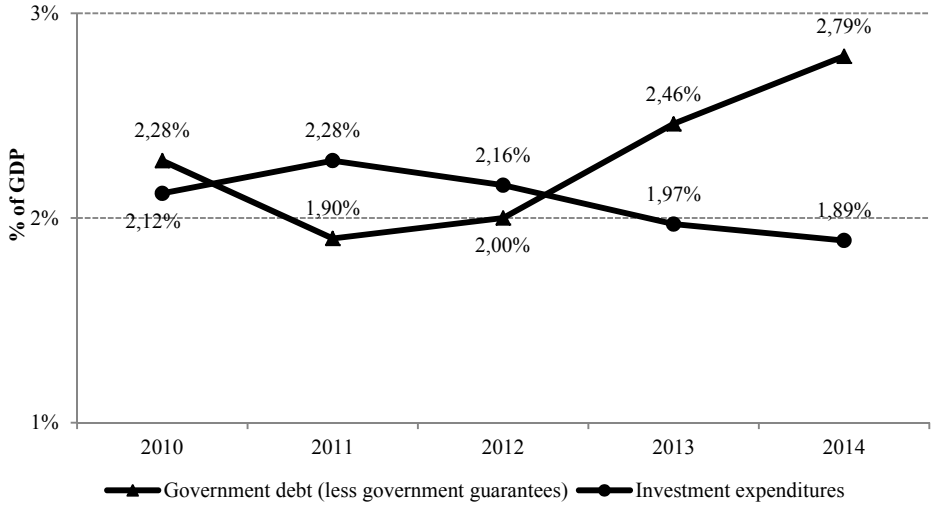
	% of total		% of GDP		Growth, %	
					in nominal terms	in real terms
	2013	2014	2013	2014		
Nationwide issues	6.2	6.2	0.82	0.81	5.8	-5.1
National security and law-enforcement activity	1.2	1.1	0.16	0.15	0.4	-9.8
National economy, including:	19.6	18.8	2.61	2.48	1.6	-8.8
Agriculture and fishery	3.4	3.0	0.45	0.39	-7.0	-16.5
Transport	3.4	4.1	0.45	0.54	29.4	16.2
Road sector (road funds)	8.3	7.6	1.10	1.00	-3.1	-13.0
Other national economy issues	2.5	2.3	0.33	0.31	1.4	-9.0
Housing and utilities sector	10.2	9.6	1.36	1.27	-0.1	-10.4
Environment protection	0.3	0.3	0.04	0.04	2.5	-8.0
Education, including:	26.5	26.2	3.53	3.45	5.1	-5.7
Pre-school education	6.7	7.0	0.90	0.92	10.3	-1.0
General education	15.0	15.0	1.99	1.97	6.1	-4.8
Secondary professional education	1.6	2.1	0.21	0.27	36.8	22.8
Other education issues	1.6	1.4	0.22	0.19	-8.0	-17.4
Culture and cinematography	3.3	3.4	0.44	0.45	10.6	-0.7
Health care	14.2	13.9	1.89	1.83	3.7	-6.9
Social policy	14.9	15.1	1.98	1.99	7.8	-3.2
Physical culture and sports	1.9	2.0	0.26	0.27	11.6	0.2
Mass media	0.5	0.5	0.06	0.06	4.7	-6.1
Government and municipal debt servicing	1.0	1.3	0.14	0.17	33.5	19.8
Expenditure – total	**100.0**	**100.0**	**13.30**	**13.18**	**6.2**	**-4.7**

Source: RF Federal Treasury; authors' calculations.

Our analysis of the movement of various expenditure items in regional budgets has led to the following observations. In 2014, the most impressive expenditure decline was demonstrated by *Housing and Utilities Sector* (-0.1% in nominal terms and -10.4% in real terms). As shown by the year-end results, the share of housing and utilities expenditures in the total amount of expenditure shrank from 10.2% to 9.6%. This happened in the main due to the decline in regions' allocations to investment. On the whole, expenditure decline in real terms was observed with regard to every budget item, with the exception of *Physical Culture and Sports* (growth by

0.2%) and *Government and Municipal Debt Servicing* (19.8%). The positive dynamics of expenditures allocated to *Physical Culture and Sports* can be explained, among other things, by the necessity to provide funding for the infrastructure projects launched in the framework of preparations for the 2018 FIFA World Cup. The amount of expenditure allocated to *Government and Municipal Debt Servicing* increased due to growth in the volume of government and municipal debt by 20.2% and 8.4% respectively (for further detail, see Section 2.3.3). First of all, the year 2014 saw an increase in the volume of regions' commercial debt (by 28.6% on the year-end index for 2013), simultaneously with the increasing share of expenditure allocated to the servicing of this relatively costly debt in the overall structure of expenditure (from 1.0 to 1.3%) and their share in GDP (by 0.03 pp. – from 0.14 to 0.17% of GDP).

On the whole, the amount of expenditures в in nominal terms rose with regard to all budget items except *Housing and Utilities Sector*. At the same time, the trajectory of by-subitem movement of expenditure was less homogenous. Thus, the amount of expenditure allocated *Agriculture and Fishery* and *Road Sector (Road Funds)* dropped not only in real terms (by 16.5% and 13.0% respectively), but also in nominal terms (by 7.0% and 3.1% respectively). The decline by 8.8% in real terms in the amount of expenditure allocated to *National Economy* was caused primarily by the shrinking investment under all the major budget items. In recent years, the amount of government investment in the regions has been displaying a stable downward trend (*Fig. 18*).



Note. Investment expenditures are understood as operations compatible with the definitions stipulated in Articles 310–330, 530 of the Classification of Operations in the State Management Sector (COSMS [*KOSGU*]).
Source: RF Federal Treasury; RF Ministry of Finance; *Rosstat*; authors' calculations.

Fig. 18. Government Debt and Investment Expenditures of Subjects of the Russian Federation in 2010–2014[1]

[1] It should be noted that reliance on data grouped in accordance with the Classification of Operations in the State Management Sector (COSMS [*KOSGU*]). is fraught with certain problems, because part of the expenditures that should be treated as investment may instead be charged to the item 'gratis transfers to state and municipal organizations' (as part of subsidies to autonomous and budget-funded organizations). However, the bulk of investment expenditures, as before, is being recorded separately.

From 2012 onwards, investment expenditures have been on the decline, and the amount of government debt in terms of share in GDP – on the rise. Thus, in the interval from 2011 through 2014, government debt increased from 1.9% to 2.8% of GDP, while investment expenditures, on the contrary, shrank from 2.4% to 1.9% of GDP. As a result, it appears that there is no connection between the level of investment expenditures and the volume of government debt, and so at least some part of newly borrowed funds is earmarked for covering running expenditures. When borrowed funds are used to solve current problems, the debt burden is thus shifted onto the next generations. A short-term decline in investment expenditures, especially when it occurs in a difficult economic situation, represents a measure traditionally applied in the management of public finance in order to boost budget sustainability. The process of public infrastructure development is usually only slightly affected by a reduced funding flow. However, cuts in investment expenditures over a long-term period may produce a grossly underdeveloped infrastructure in the long run, and consequently these territories can become economically backward.

Besides, it is very important also to look at the movement of the main parameters of RF subjects' consolidated budgets in terms of share of GDP (and not only consolidated budget expenditure) (*Table 17*).

Table 17

The Movement of Consolidated Budget Revenue and Expenditure of Subjects of the Russian Federation in 2007–2014, as % of GDP

	2008	2009	2010	2011	2012	2013	2014
Revenue	**15.02**	**15.27**	**14.12**	**13.66**	**12.98**	**12.33**	**12.32**
including:							
Profits tax	4.24	2.76	3.28	3.44	3.19	2.60	2.96
PIT	4.04	4.29	3.87	3.57	3.64	3.78	4.05
Transfers from FB	2.65	3.81	2.98	2.58	2.32	2.29	2.18
Expenditure	**15.15**	**16.12**	**14.33**	**13.72**	**13.42**	**13.30**	**12.98**
Deficit (-)/ Surplus (+)	**-0.13**	**-0.85**	**-0.22**	**-0.06**	**-0.45**	**-0.97**	**-0.66**
For reference: GDP, bn Rb	41, 277	38, 807	46, 309	55, 967	62, 147	66, 194	70, 976

Note. Data for 2014, less data for the Crimean Federal District.
Source: RF Federal Treasury; *Rosstat*; authors' calculations.

Over the period 2008–2014, the highest volume of both consolidated regional budget revenue and consolidated regional budget expenditure in terms of share in GDP was observed in 2009. Growth of revenue in 2009 occurred due to the significantly increased amount of transfers from the federal center to the regions (from 2.7% of GDP in 2008 to 3.8% of GDP in 2009), while the rising volume of expenditure can be explained by the implementation of the anti-crisis program (both federal expenditure through the allocation of subsidies and subventions, and expenditure on the regional level). However, the volume of revenue in regional budgets actually *fell in 2009* on the previous year - by 12% in real terms. Thus, it would be more correct to apply as a base for comparison the data for the entire pre-crisis year-long period 2008 (the crisis-linked trends in the budgetary sphere became noticeable only in the last few months of 2008).

From the data presented in *Table 17* it follows that, while the receipts of PIT in 2014, when taken in terms of share in GDP, rose to their pre-crisis level recorded in 2008, the other two major revenue sources – profits tax and interbudgetary transfers – were significantly below their 2008 indices (this is especially true for profits tax). As for the volume of expenditure, it also became significantly lower: 13% of GDP in 2014 vs. 15.2% of GDP in 2008. However, as noted earlier, this was achieved in the main by bringing down the volume of investment

expenditures. The financial pattern visible in the consolidated regional budgets for 2014 can also be compared with the situation in 2011, when under the conditions of post-crisis economic recovery the subnational budgets were for most part drawn up without a deficit. In this case it is obvious that over the period 2012–2014 the volume of regional revenue dropped by 1.3 pp. of GDP, while expenditure could be reduced by only 0.7 pp. of GDP, which resulted in a general deficit displayed by regional budgets. At the same time, the sum of receipts from the two major source of tax-generated revenue in 2014 turned out to be the same as in 2011 – 7% of GDP (due to the increased PIT receipts and the shrinkage of the profits tax receipts in terms of share in GDP over the period under consideration). Meanwhile, the volume of interbudgetary transfers declined by 0/4 pp. of GDP, which was ultimately the principal factor responsible for the reduced total sum of revenue in terms of share in GDP received by RF subjects.

It only thanks to the decline in the volume of expenditure from 13.3% of GDP in 2013 to 13.0% of GDP in 2014 that the consolidated budget of RF subjects for 2014 could be drawn up with a lower deficit than the corresponding budget for 2013 (-0.66 vs. -0.97% of GDP respectively), while the volume of revenue remained practically at the same level as in the previous year (12.3% of GDP). In 18 regions, expenditure declined on 2013 even in nominal terms. The most impressive decline could be noted in Chukotka Autonomous Okrug (-20%), in Amur Oblast (-16.7%), in Belgorod Oblast (-9,2%), in Jewish Autonomous Oblast (-7.2%), in Smolensk Oblast (-6.4%), and in Ryazan Oblast (-5.6%). It is noteworthy that in 2014, 17 out of the 18 regions where budget expenditure declined were dependent on dotations from the federal budget. Only Tyumen Oblast, with its high budget sufficiency level, managed to bring down the volume of its expenditure on its own.[1]

Now we are going to discuss in more detail the situation with regard to execution of the consolidated budget of RF subjects (deficit/surplus) in each individual region (*Table 18*).

Table 18

The Execution (deficit/surplus) of the Consolidated Budgets of Subjects of the Russian Federation in 2008–2014

Year	Number of RF subjects where budget is executed with	
	deficit	surplus
2008	45	39
2009	62	21
2010	63	20
2011	57	26
2012	67	16
2013	78	5
2014*	74	9

* less data for the Crimean Federal District's regions.
Source: RF Federal Treasury; authors' calculations.

The data presented in *Table 18* point to the fact that the 2014 index for how well-balanced the consolidated budgets of RF subjects are has remained practically at the same level as in 2013. While in the previous year 78 regions had executed their budget with a deficit, their number in 2014 dropped to 74. It should be noted that in 2014, budget deficit was displayed by 5 RF subjects that in 2013 had had a surplus (Moscow Oblast, St. Petersburg, the Republic of Karachaevo-Cherkessia, the Republic of Chechnya, and Kamchatka Krai). At the same

[1] Besides, that particular region was able to bring down its volume of government debt by 55.6% on the corresponding index as of 1 January 2014.

time, in 3 of these 5 regions the amount of expenditure increased at a rate that was above Russia's national average (4.6% in nominal terms).[1]

On the whole it can be said that, in 2014, the situation with regard to execution of the consolidated budget of RF subjects remained rather tense. In spite of the observable decline in the volume of expenditure, the volume of revenue was such that regional budgets could not for most part become well-balanced. One of the main factors responsible for stagnation in the sphere of regional revenue over recent year was the movement of transfers allocated from the federal budget.

2.3.2. Financial Aid from the Federal Budget

In 2014, the total volume of interbudgetary transfers received by the consolidated budget of RF subjects dropped on 2013 by 3.1% in real terms (*Table 19*).

Table 19

Transfers from the Federal Budget to Subjects of the Russian Federation in 2008–2009 and 2013–2014

	2008		2009		2013		2014		Growth in 2014 on 2013, %	
	bn Rb	% of total	bn Rb	% of total	bn Rb	% of total	bn Rb	% of total	in nominal terms	in real terms
Transfers to regions, total	**1,094.7**	**100.0**	**1,480.3**	**100.0**	**1,487.9**	**100.0**	**1,607.0**	**100.0**	**8.0**	**-3.1**
Dotations	**390.4**	**35.7**	**578.3**	**39.1**	**609.1**	**40.9**	**774.7**	**48.2**	**27.2**	**14.2**
Including:										
dotations to budget sufficiency equalization	328.6	30.0	374.0	25.3	418.8	28.1	439.8	27.4	5.0	-5.7
dotations to support measures designed to ensure well-balanced budgets	46.0	4.2	191.9	13.0	177.8	12.0	334.9	20.8	88.3	69.1
Subsidies	**435.9**	**39.8**	**530.0**	**35.8**	**515.6**	**34.7**	**409.9**	**25.5**	**-20.5**	**-28.6**
Including:										
subsidies to sustain national economy's development	181.2	16.5	214.3	14.5	268.3	18.0	241.9	15.1	-9.8	-19.1
Subventions	**153.2**	**14.0**	**284.4**	**19.2**	**273.7**	**18.4**	**308.2**	**19.2**	**12.6**	**1.1**
Other interbudgetary transfers	**115.2**	**10.5**	**87.6**	**5.9**	**89.5**	**6.0**	**114.2**	**7.1**	**27.7**	**14.6**

Source: RF Federal Treasury; authors' calculations.

The trends displayed by various types of transfers had different vectors, thus altering the overall structure of financial aid. Thus, in 2014, the volumes of the following types of transfers increased on 2013: transfers in the form of dotations (growth by 14.2% in real terms); other interbudgetary transfers (hereinafter 'other IBT) – by 14.6%; and subventions - by 1.1%. At the same time, the movement of various components within each transfer category differed. In particular, the total volume of dotations increased in the main due to the higher amount of dotations earmarked for the support of measures designed to ensure well-balanced budgets (growth by 69.1%). Such a surge was caused by the expenditures allocated in the framework of the government subprogram *Support of Sustainable Budget Execution by Subjects of the Russian Federation and Local Budget Execution* (49.5% of the total sum of dotations to support measures designed to ensure well-balanced budgets (Rb 165.9bn)), as well as

[1] Less the expenditures of the Crimean Federal District's regions.

the expenditures earmarked for compensation, in part, for the increased salaries in the budget-funded sphere (35.8% (Rb 120bn)) in connection with the implementation of the RF President's Executive Order of 7 May 2012. At the same time, in 2014, the amount of dotations to budget sufficiency equalization, on the contrary, shrank by 5.7% in real terms on 2013. Meanwhile, the share of dotations in the total volume of transfers on the whole increased from 40.9% in 2013 to 48.2% in 2014. On the one hand, the higher share of non-targeted transfers in the total volume of transfers boosts the regions' ability to independently implement their socioeconomic policies. However, on the other hand, from the point of view of economics, the dotations earmarked as compensation for the increased salaries in the budget-funded sphere are more like a substitute for subsidies. Consequently, the substantially increased share of dotations coupled with a shrinking share of subsidies (from 34.7 to 25.5%) cannot be regarded as an important move towards greater financial autonomy of Russian regions. And in a more general sense the increased share of dotations designed to ensure well-balanced budgets is a negative factor, because this channel of funding distribution is far less transparent than that of dotations to budget sufficiency equalization.

Subsidies turned out to be the only type of interbudgetary transfers whose amount in 2014 declined both in nominal and in real terms (by 20.5 and 28.6% respectively). The amount of subsidies shrank primarily due to a cut in the expenditures earmarked for the support of the national economy (by 19.1%). The positive vectors displayed by subventions and other IBT (growth in real terms by 1.1% and 14.6% respectively on 2013) also contributed to changes in the overall structure of transfers. Thus, the share of subventions increased from 18.4% to 19.2%, while that of other IBT in the total volume of interbudgetary transfers increased from 6% to 7.1%.

When analyzing the process of transfer allocation by the federal center to the regions, it is essential to review the impact of federal aid from the federal budget on the differentiation of the budget revenue of subjects of the Russian Federation, and to assess its actual equalizing effect (*Table 20*).

Table 20

The Variance Coefficient of the Consolidated Regional Budget Revenue (per Capita, with Due Regard for the Budget Expenditure Index) in 2008–2014., as %

Year	Tax-generated revenues	Tax-generated revenues and dotations to budget sufficiency equalization	Tax-generated revenues, dotations, subsidies
2008	90.6	80.4	71.5
2009	78.3	66.5	54.5
2010	74.2	63.9	57.8
2011	77.8	68.4	61.6
2012	66.1	57.8	51.9
2013	63.7	55.3	48.1
2014	59.0	51.2	49.9

Note. No calculations were done for the Crimean Federal District's regions.
Source: RF Federal Treasury; RF Ministry of Finance; authors' calculations.

As can be seen from data presented in *Table 20*, the year 2014 saw a continuation of the downward trend in revenue differentiation displayed by subnational budgets. The variance coefficient of tax-generated revenue in the consolidated budget of RF subjects declined from 63.7% in 2013 to 59% in 2014. After the allocation of dotations to budget sufficiency equalization, the variance coefficient of regional budget revenue dropped to 51.2% in 2014. If we wish to adequately assess the resulting figure after the allocation of all dotations and subsi-

dies, it must be borne in mind that the instrument of dotations has become less efficient from the point of view of budget sufficiency differentiation among the regions: the relevant variance coefficient slightly increased in 2014 to 49.9% (vs. 48.1% in 2013) and so, as the values of the first two variance coefficient declined, their ratios significantly dropped.

It is important to note that, from 2010 onwards, the total volume of transfers to subnational budgets has been gradually declining (*Fig. 20*). When taken in real terms, the volume of transfers displays a downward trend. While in 2008 this index amounted to Rb 1,094.1bn, in 2014 it was Rb 1,077.4bn, and by 2017 the amount of transfers may shrink to Rb 897.6bn (in 2008 prices). In the medium-term period (from 2014 through 2017) it can be expected that three types of transfers will be on the decline: subsidies (by 28.2%), dotations (26.8%), and subventions (13.3%). Only 'other interbudgetary transfers' are expected to grow in real terms by 84.2%. The most impressive decline will happen with regard to the volume of subsidies. The consolidation and decline of the share of subsidies in the total volume of interbudgetary transfers from the federal budget alongside a simultaneous increase of the share and volume of equalizing dotations could result in an improved structure of interbudgetary transfers, greater independence of the regions in pursuing their own budgetary policies, and thus in more efficient interbudgetary relations. But the decline in the volume of targeted interbudgetary transfers is not compensated for by an increasing volume of non-targeted transfers.

If we look more carefully at the adjusted parameters in the latest law on the federal budget,[1] it can be noticed specifically with regard to the year 2015 that the planned shrinkage of the total volume of interbudgetary transfers to subjects of the Russian Federation will amount to Rb 145bn, which corresponds to 9.2% of the total amount initially allocated to the budget for 2015, and that the net growth of budget loans to regional budgets will amount to Rb 212bn, being produced by the reduced target for budget loan repayment by the regions (by Rb 52bn) and the increased volume of budget loans issued to the regions (by 160bn). As far as the reduction of the total volume of interbudgetary transfers is concerned (by Rb 145bn), dotations will account for Rb 58.7bn, subsidies – for Rb 49.75bn, subventions – for Rb 22.7bn, and other IBT – for Rb 13.86bn. As a result, the total volume of interbudgetary transfers to the regions will amount to 1.95% of GDP, which is a record low for the past 10–15 years. It is also noteworthy that the federal government has fundamentally altered some of the principles of its budgetary policy aimed at providing support to the regions during times of crisis: if back in 2009 the total volume of interbudgetary transfers to the regions increased on the previous year by 1.1% of GDP to 3.8% of GDP, in 2015, on the contrary, it can be expected that the volume of gratis financial aid provided to the regions will decline by 0.3% of GDP on the previous year. In fact, this points to a change in the general vector of the Federation's budgetary policy towards the regions, the countercyclical approach giving way to the procyclical one.

2.3.3. An Analysis of the Situation with Government and Municipal Debt

The data on the movement of the amount of government debt held by subjects of the Russian Federation and that of municipal debt over the period 2011–2014 are presented in *Table 21.* As can be seen from these data, the aggregate volume of debt in regional and munici-

[1] In accordance with the draft of Federal Law No 744090-6 'On Introducing Alterations to the Federal Law "On the Federal Budget for 2015 and Planning Period 2016 and 2017"'.

pal budgets increased significantly over the course of the year 2014. Thus, the growth of government debt held by subjects of the Russian Federation amounted to 20.2%, having increased from 2.6% to 2.9% of GDP. Similarly to the pattern observed over the past few years, the bulk of borrowing occurred only in the course of a single month (December), when the amount of debt increased by Rb 226.9bn to Rb 2,089bn (growth of 12.8% on the previous month). The amount of municipal debt over the same period increased by 10.9% (from Rb 282.4bn to Rb 313.2bn). On the whole over the course of that year, the volume of municipal debt increased by 8.4%.

Table 21

Government and Municipal Debt in the Subnational Budgets in 2011–2014.

	2011	2012		2013		2014	
	volume	volume	change	volume	change	volume	change
Total debt in regional budgets, bn Rb	1, 171.8	1, 355.0	183.2	1, 737.5	382.5	2, 089.0	351.5
Rate of growth on previous year, %	-	*15.6*		*28.2*		*20.2*	
Total debt in regional budgets, % of GDP	2.1	2.2	0.1	2.6	0.4	2.9	0.3
Total debt in municipal budgets, bn Rb	215.5	245.3	29.8	288.9	43.6	313.2	24.3
Rate of growth on previous year, %	-	*13.8*		*17.8*		*8.4*	
Total debt in municipal budgets, % of GDP	0.39	0.39	0.00	0.44	0.05	0.44	0.00

Source: RF Ministry of Finance; Rosstat; authors' calculations.

It should be noted that while previously the bulk of regional debt had been held by only 2 regions – the city of Moscow and Moscow Oblast (as of 1 January 2011 – 40.7%, and as of 1 January 2012 – 29% of aggregate regional debt), as of 1 January 2015 these two regions already accounted for only 12.7% of the aggregate debt volume (which is 2.5 pp. below the index recorded as of 1 January 2014). At the same time, over the year 2014 within this group of regions, Moscow Oblast increased the amount of its debt by 22.5% (or by Rb 19bn). However, debt growth occurred in the main due to the build-up of indebtedness against commercial loans (from Rb 38bn in 2013 to Rb 64bn in 2014). The city of Moscow, on the contrary, over the year 2014 reduced its debt volume by 57.6%.

As of the end of 2014, the leaders in borrowing (assessed by the accumulated debt volume in excess of Rb 100bn) were Moscow Oblast (Rb 161.7bn), Krasnodar Krai (Rb 136.3bn), and the city of Moscow (Rb 103.1bn).

On the whole, the fact of an increasing debt burden on many subjects of the Russian Federation is also confirmed by the data broken up by group of regions (*Table 22*).

Over the course of the year 2014, in 74 out of 82 subjects of the Russian Federation (less the Crimean Federal District) the volume of government debt increased, and significant growth in the debt volume (by more than 15%) was observed in 56 regions. In 12 subjects of the Russian Federation the volume of debt rose by more than 50%, including Perm Krai (2,184.6%), Irkutsk Oblast (273.8%), Magadan Oblast (153.6%), Rostov Oblast (79.2%) and Kamchatka Krai (65.8%).

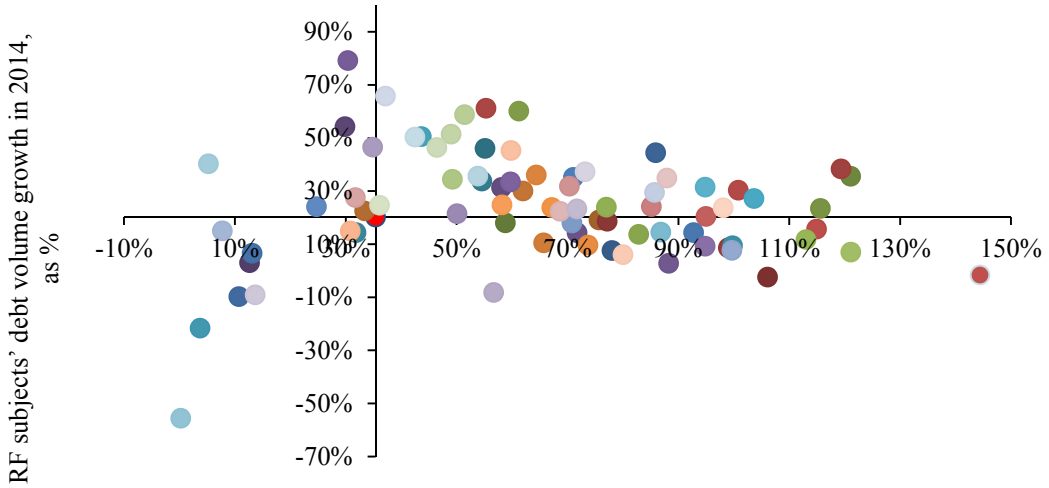
Table 22

The Movement of the Volume of Government Debt in the Budgets of Subjects of the Russian Federation in 2008–2014

Number of regions in	Movement of government debt volume held by subjects of Russian Federation over given period (in nominal terms), number of subjects of Russian Federation						
	growth by more than 50%	growth by between 15% and 50%	growth by less than 15%	no change	decline by less than 15%	decline by between 15% and 50%	decline by more than 50%
2008	21	20	10	3	5	13	10
2009	37	18	11	4	6	4	2
2010	30	24	9	1	11	7	0
2011	21	27	13	1	14	6	0
2012	18	31	14	0	8	10	1
2013	31	36	8	0	6	1	0
2014	12	44	18	0	5	1	2

Note. 1. No calculations were done for the Crimean Federal District's regions. 2. Arkhangelsk Oblast and Nenets Autonomous Okrug are treated for the purpose of our calculations as one and the same subject of the Russian Federation.
Source: RF Ministry of Finance; authors' calculations.

Especially alarming is the situation in those regions where, in 2014, not only the volume of debt surged, but the debt burden also significantly increased; the latter represents the ratio of government debt volume to the level of tax-generated and non-tax revenues of a given subject of the Russian Federation (*Fig. 19*).



Note. 1. The intersection of the axes is the point where the values of debt burden and RF subjects' debt volume growth over 2014 become equal to Russia's average (38.4 and 20.2% respectively). 2. This graph does not show Perm Krai (16.7%, 2,184.6%), Irkutsk Oblast (14.4%, 273.8%), Magadan Oblast (52.2%, 153.6%). 3. No calculations were done for the Crimean Federal District's regions.
Source: RF Federal Treasury; Federal Law of 1 December 2014, No 384-FZ 'On the Federal Budget for 2015 and Planning Period 2016 and 2017'; authors' calculations.

Fig. 19. The Debt Burden and the Movement of Government Debta Held by Subjects of the Russian Federation in 2014

From data presented in *Fig. 19* it follows that in 2014, in 40 out of 82 subjects of the Russian Federation the rates of growth displayed by the government debt and the debt burden were above Russia's national average. It should be noted that in 10 subjects of the Russian Federation the debt burden rate was found to be higher than the volume of tax-generated and non-tax revenues: in Belgorodя Oblast (106.1%); in Kostroma Oblast (121.1%); in Smolensk Oblast (115.6%); in the Republic of Karelia (119.3%); in Astrakhan Oblast (100.8%); in the Republic of North Ossetia – Alania (114.9%); in the Republic of Ingushetia (113%); in the Republic of Karachay-Cherkessia (103.6%); in the Republic of Mordovia (121.1%); and in Chukotka Autonomous Okrug (144.4%). In 2013, there were seven such regions. In spite of the overall trend towards increasing the amount of debt, in some regions with the highest debt burden it was successfully reduced, however slightly, which means the onset of the process of budget consolidation. Thus, for example, in 2014, in the Republic of Mordovia the debt burden index was brought down from 172.1 to 121.1%, in Belgorod Oblast – from 110.3 to 106.1%. At the same time, among those 7 regions where the year-end results of 2013 demonstrated the debt burden index to be above 100%, in 2014 it was further increased in 3 regions: Chukotka Autonomous Okrug (from 123% to 144.4%), the Republic of Ingushetia (from 103.2 to 113%) and the Republic of North Ossetia – Alania (from 103.2 to 114.9%). Saratov Oblast and Vologda Oblast, as demonstrated by their year-end results of 2014, no longer belong to the group of regions with the highest volume of debt liabilities; however, the level of debt burden in these RF subjects is still rather high: 99.7 and 99.8% respectively.

On the whole, in spite of the slight slowdown in the rate of growth displayed by government and municipal debt, the situation in this sphere continues to deteriorate. The overall amount of debt in subnational budgets has nearly hit the mark of 3% of GDP. In the majority of region, the volume of borrowing is on the rise, and in some RF subjects the level of debt burden continues to be excessively high. Some of the regions that had already been shouldering an impressive debt burden failed to revise their regional budgetary policies and bring down their debt levels. The recent changes in the structure of regional debt have also given some grounds for concern (*Fig. 20*).

From 2011 onwards, within the overall debt structure, a stable growth of the share of commercial (bank) loans has become visible. One serious drawback of commercial loans is the higher cost of their servicing by comparison with budget loans. However, in view of the limited supply of budget loan on the part of the federal center, this instrument has been actively resorted to by many Russian regions. Thus, as shown by the year-end results of 2014, in 11 RF subjects the share of commercial loans in the total debt volume at a level above 75%.

In order to reduce the risks associated with the increasing debt burden shouldered by the regions, the higher amount of funding earmarked in the federal budget for covering the cost of budget loans in 2014 was intended, among other things, to ensure the refinancing of commercial debt, and thus to curb the growth of expenditures allocated to debt servicing.

In 2015, this practice will be continued. For the year 2015, the following conditions for the allocation of budget loans earmarked for commercial debt refinancing are established[1]:

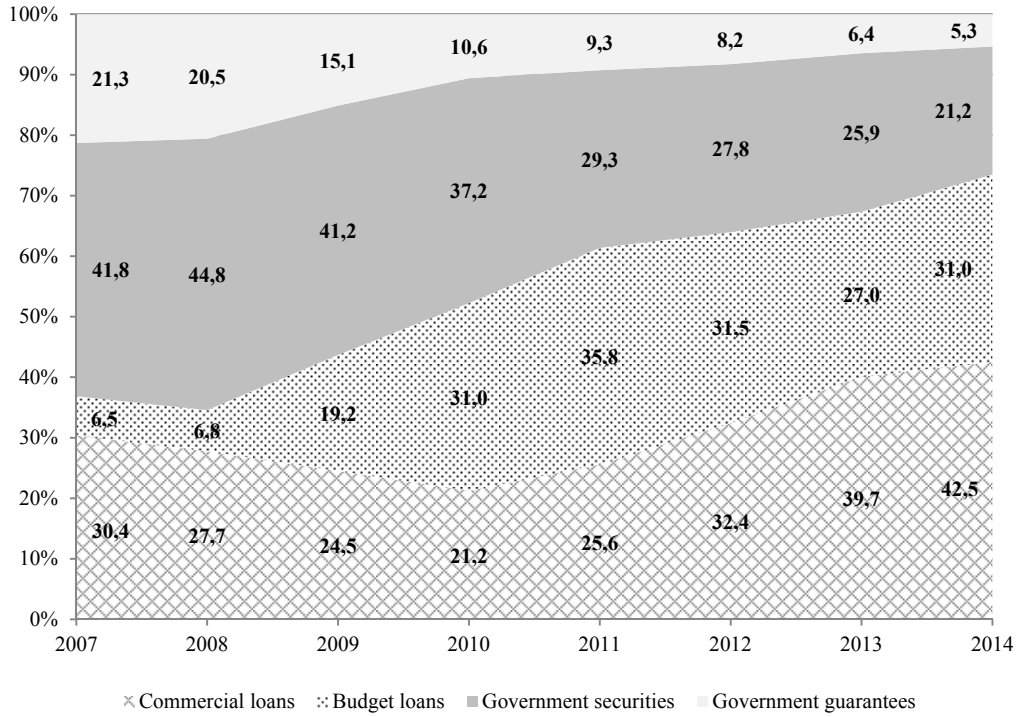
– if a loan received in 2015 by a subject of the Russian Federation from a credit institution is issued to that subject of the Russian Federation for a period longer that 1 year at a variable

[1] Order of the RF Ministry of Finance No 41 of 24 February 2015 'On Granting, to the Budgets of Subjects of the Russian Federation, of Budget Loans from the Federal Budget to Cover Part of Their Deficit, for the Purpose of Redemption of the Debt Liabilities of Subject of the Russian Federation Held in the Form of Liabilities against Loans Received by Subjects of the Russian Federation from Credit Institutions'.

rate pegged to the Bank of Russia's key rate and increased by more than 1.5 pp., with a mandatory requirement that the interest rate on the loan should be correspondingly altered no later than within 10 calendar days after the Bank of Russia has changed its key rate;

– if the consolidated budget of a subject of the Russian Federation is expected to be drawn up with a deficit for reasons that cannot be controlled by that subject of the Russian Federation, and the budget deficit will result (or may result) in that subject of the Russian Federation's inability to effectuate, in due time in the course of a current quarter (or a current financial year), the necessary payments against the loan received from a credit institution on certain specially determined terms;

– if the volume of payments made over the course of a current financial year against the loan received from a credit institution by a subject of the Russian Federation does not exceed the ceiling set for the current financial year.



Source: RF Ministry of Finance; authors' calculations

Fig. 20. The Structure of Regional Debt in 2007–2014, as %

Considering the general rise in the debt burden shouldered by the regions from 15.2% as of 1 January 2009 to 35.4% as of 1 January 2015, the planned reduction in the total volume of interbudgetary transfers in 2015 will have a negative effect on the financial status of the regions, even if the volume of issued budget loans should be increased. So, it will become necessary not only to make further cuts to regional investment in infrastructure projects, but also to downsize the existing network of state and municipal institutions. The dwindling flow of gratis financial aid to the regions will also impose serious constraints on their ability to implement anti-recession measures. According to our estimations, in 2015, the resulting decline on 2014 in the total volume of budget expenditure in the consolidated budgets of subjects Russian Federation may amount to 1% of GDP.