

Section 2. Monetary and Fiscal Policies

2.1. Monetary policy¹

In 2015, the Bank of Russia faced global challenges while implementing measures as part of its monetary policy. The economic situation in 2015 was marked by the following: Western sanctions and Russia's countersanctions remained in effect, prices of Russia's key export commodities continued to fall, economic agents' expectations for high inflation remained intact. The sweeping depreciation of the Russian ruble in late 2014/early 2015 resulted in an inflation shock which kept the year-end inflation at high level: the Consumer Price Index (CPI) stood at 12.9% at the 2015 year-end, much higher than the 2017 mid-term target level (4%) set forth in the central bank's Guidelines for the Single State Monetary Policy for 2015–2017. In its official 2015 forecast, Russia's Ministry of Economic Development predicted inflation will not move beyond 6.3% in late 2014/early 2015, and Russia's central bank expected it to stay at 8.2–8.7% under the baseline scenario and 9.3–9.8% under the risk scenario. At the same time, the Bank of Russia cut its key rate gradually from 17% in January down to 11% in December 2015 as inflation slowed down over the course of the year.

2.1.1. Money market

In the period between January and December 2015, the broad monetary base shrank by 2.5% to Rb 11.04 trillion as of January 2016. It was the first time since 2010 that Bank of Russia's lending operations with commercial banks contributed most to the shrinking of the monetary base. Adding to the factor which contributed to the 2015 increase in the monetary base was the decline of balances on the accounts held by the general government with Russia's central bank, due to spending of funds from the Reserve Fund (see *Fig. 1*). As a reminder, the monetary base in 2014 was up 7.9% to Rb 11.3 trillion, while the Bank of Russia's currency interventions aimed at bolstering the ruble was the main headwind to money supply growth.

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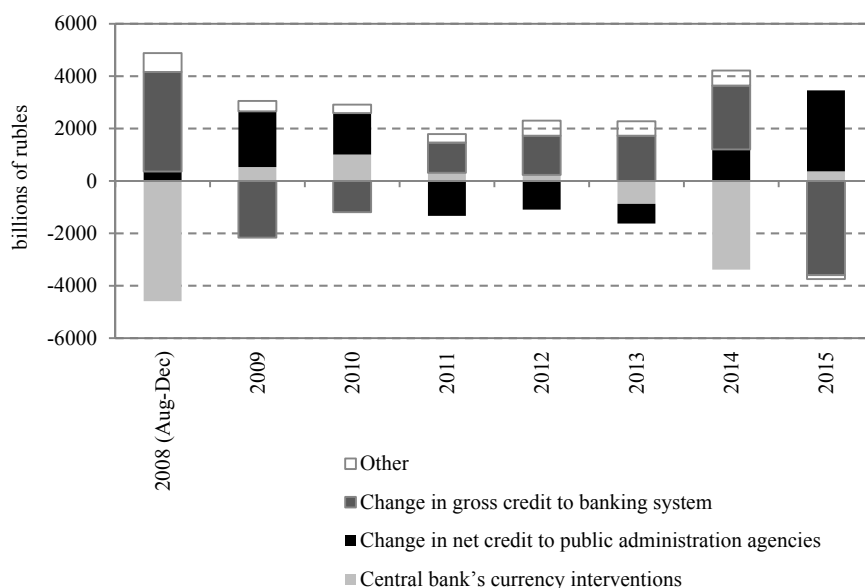


Fig. 1. Key factors that influenced change in the monetary base (broad definition) in 2008–2015¹

Sources: Bank of Russia, Gaidar Institute's own calculations.

In 2015, the Bank of Russia diminished substantially its presence in the FX market: the bank's foreign currency net purchases were worth as little as \$780m in the period between January and December 2015. For comparison, yearly net purchases of foreign currency amounted to \$34.1bn in 2010, \$12.4bn in 2011, \$7.6bn in 2012. However, the bank's foreign currency net sales increased to \$27bn in 2013 and to \$83.4bn in 2014. Note that the Bank of Russia decided in November 2014 to abandon its currency intervention policy as part of the transition to an inflation targeting regime. The decision aimed to ensure that the economy adapts faster to change in external conditions and is resilient to negative shocks. In our view, this decision was quite reasonable in view of the fact spending of the international reserves on bolstering the ruble in 2014 failed to prove efficient.

Russia's international reserves in 12M/2015 shrank by \$17.1bn (down 4.4%) to \$368.4bn as of the beginning of January 2016 (see *Fig. 2* and *3*). In 2015, the foreign currency reserves dropped by \$19.9bn (down 5.9%) largely because of foreign currency repos with banks. The year-to-date monetary gold reserves swelled by \$2.5bn (up 5.4%) because the Bank of Russia purchased gold. As a result, as of January 2016, foreign currency accounted for 86.8% (88% in 2014) of the total reserves, and gold made up 13.2% (12% in 2014). Russia now holds sufficient reserves to ensure sustainability of its balance of payments, because they cover both 16 months of imports of goods and services in Russia (11M/2014) and external debt payments that are due in 2016. Note that the adequacy of international reserves which have recently seen no change in volume enhances as imports of goods and services contract and the external debt becomes smaller. This allows Russia to ensure its macroeconomic and financial sustainability amid economic problems arising from worsening terms of trade and from Western sanctions freezing Russian economic agents out of global capital markets.

¹ The period under review covers 2008-2015, for which the data on the central bank's foreign currency interventions and balance sheet were available at the time of this review.

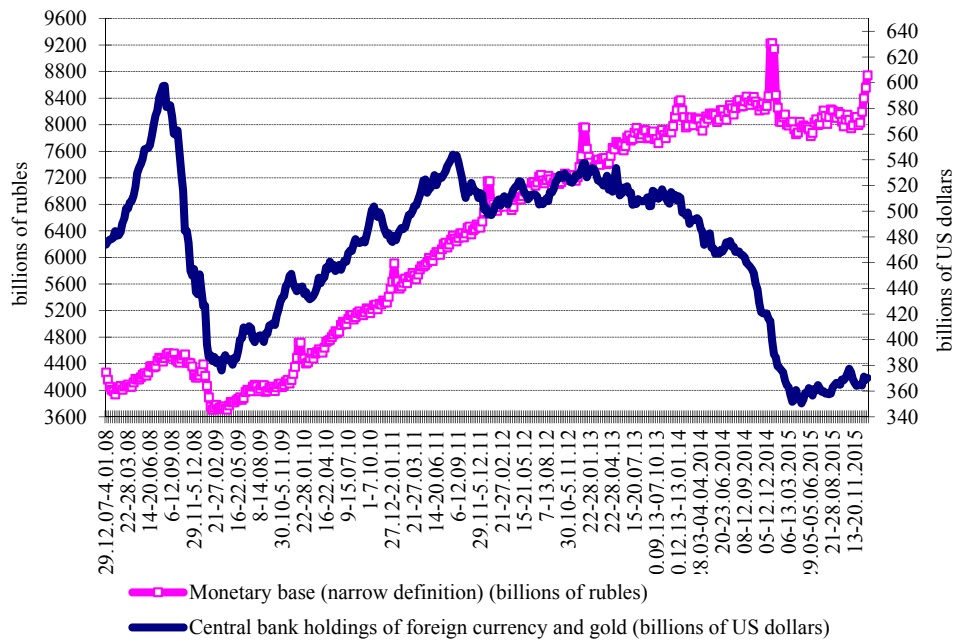


Fig. 2. Dynamics of monetary base (narrow definition) and Central Bank holdings of foreign currency and gold (international reserves) in 2008-2015

Source: Bank of Russia.

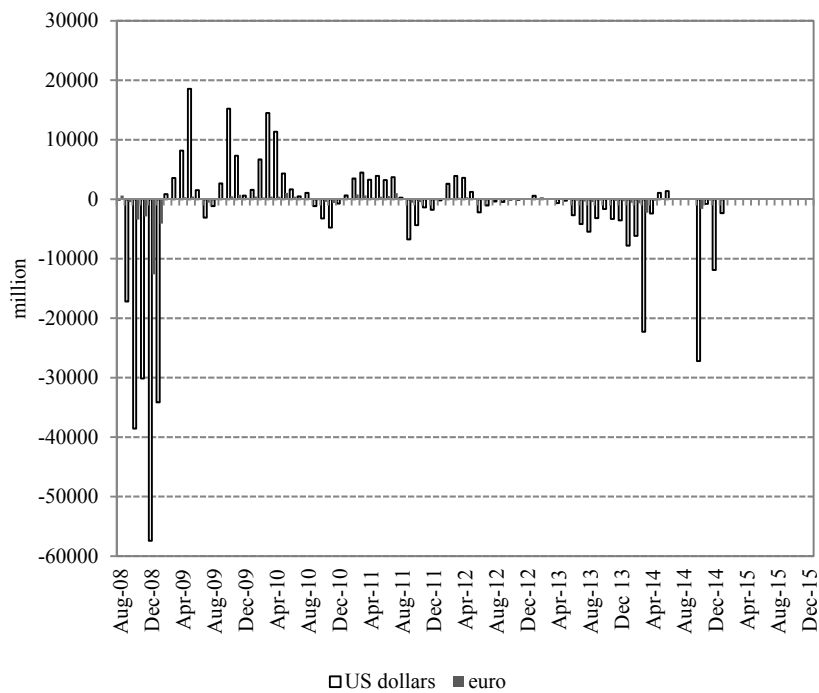


Fig. 3. Bank of Russia's currency interventions (net purchases of foreign currency) in 2008–2015

Source: Bank of Russia.

Table 1

Bank of Russia Balance Sheet, 2013-2015

	January 1, 2014		January 1, 2015		December 1, 2015	
	billions of rubles	% of assets/liabilities	billions of rubles	% of assets/liabilities	billions of rubles	% of assets/liabilities
Funds placed with nonresidents and securities issued by nonresidents	15,091.1	66.9	18,378.6	55.9	19,798.5	62.2
Credits and deposits	4,881.4	21.6	9,950.2	30.3	6,057.4	19.0
Precious metals	1,394.2	6.2	2,726.3	8.3	3,258.9	10.2
Securities	450.3	2.0	622.5	1.9	747.6	2.3
Other assets	99.5	0.4	186.6	0.6	841.6	2.6
Total assets	22,562.4	100	32,897.6	100	31,839.4	100
Cash in circulation	8,307.8	36.8	8,840.9	26.9	7,725.8	24.3
Funds in accounts with the Bank of Russia	10,359.0	45.9	13,876.0	42.2	12,106.2	38.0
<i>of which:</i>						
<i>Russian government funds</i>	5,848.8	25.9	9,144.3	27.8	8,667.6	27.2
<i>funds of resident credit institutions</i>	2,196.8	9.7	2,869.7	8.7	2,169.7	6.8
Float	5.7	0.03	1.9	0.01	22.4	0.1
Bank of Russia bonds	-	-	-	-	-	3.0
Liabilities to the IMF	500.0	2.2	840.8	2.6	966.9	6.1
Other liabilities	108.8	0.5	100.4	0.3	1,945.9	28.5
Capital	3,151.9	14	9,054.1	27.5	9,072.3	24.3
Profit of a fiscal year	-	-	-	-	-	38.0
Total liabilities	22,562.4	100	32,897.6	100	31,839.4	100

Source: Bank of Russia.

As noted above, the monetary base dynamics in 2015 was largely determined by the debt owed by credit institutions to the Bank of Russia (see Fig. 4). As a reminder, the trend of strong growth of the Bank of Russia's operations to provide loans to credit institutions has been afoot since 2011. As a reminder, the central bank's currency interventions was the key source of money supply prior to the global financial crisis of 2008–2009. However, Russia's central bank began to play key role in providing liquidity to the banking system, because it diminished the volume of its currency interventions in the FX market. In 2014, the debt was twice the peak values seen during the global financial crisis (H2 2008 – 2009), a 2.1-fold 12M increase, staying at Rb 9.3 trillion as of January 2015. The trend reversed in 2015: as of January 2016, loans, deposits and other borrowings of credit institutions stood at Rb 5.4 trillion, down 42% from 2014. The central bank's key lending instrument was one-week repo auctions under which banks borrowed Rb 1.4 trillion (Rb 2.69 trillion in 2014) in 12M/2015, as well as loans secured by non-marketable assets and guarantees, under which banks borrowed an average of Rb 3.0 trillion (Rb 2.3 trillion in 2014) in 12M/2015. The Bank of Russia diminished the volume of liquidity provision to commercial banks due to spending of funds of the Reserve Fund. In particular, banks borrowed Rb 3.1 trillion in January-December 2015, the funds were debited from the accounts held by the general government with the Bank of Russia.

The decline in banks' debt to Russia's central bank under repo auctions had a positive effect on the volume of unencumbered market collateral; in particular, the market asset utilization coefficient varied within a range of 40-50% in Q3 2015, whereas it reached 70% by the end of Q4 2014. According to the Bank of Russia's estimates, with a slowdown in lending and money

supply, there is low risks associated with running short of market collateral in the short run. Hence the volume of market collateral available in banks can be characterized as sufficient or adequate.

In 2015, the Bank of Russia continued to perform fine-tuning liquidity absorption operations through 1- to -6-day deposit auctions which were introduced in February 2014. Such operations were carried out in January (7 operations) and February (3 operations) of 2015, and from Rb 114.2bn to Rb 410bn of liquidity were absorbed per auction. Fifteen to 61 bidders (business entities) attended the auctions, this figure being indicative that the auctions were in low demand.

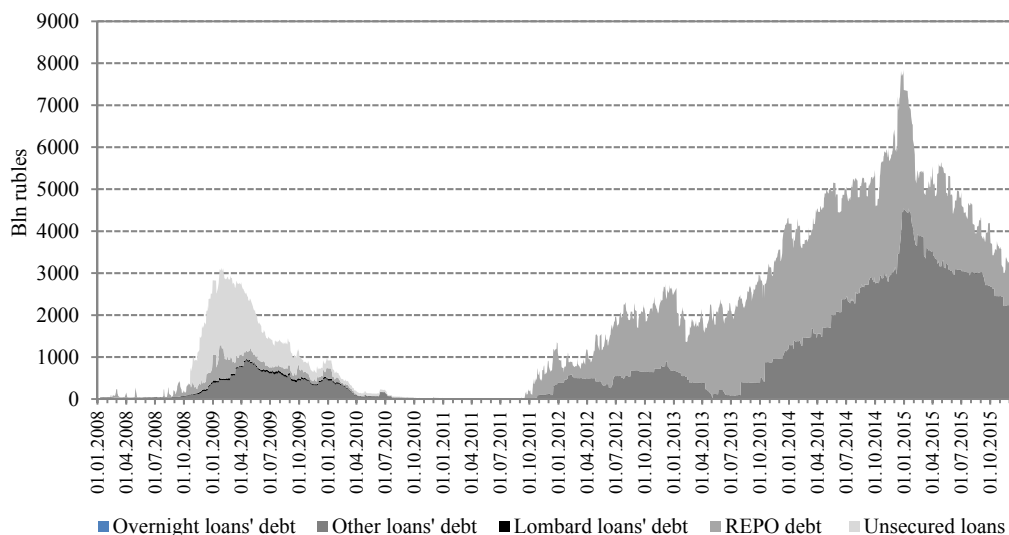


Fig. 4. Commercial banks' ruble-denominated debt (the key instruments) to the Bank of Russia in 2008–2015

Source: Bank of Russia.

The Bank of Russia' dollar-denominated loans to credit institutions was one of the key measures as part of its monetary policy, which were introduced in late 2014 and were aimed to push down the rush for foreign currency. Foreign currency swaps, foreign currency repos for a term of one week, 28 days, one year, as well as credit auctions to provide dollar-denominated loans secured by the pledge of claim on dollar-denominated loans to credit institutions were used as instruments of foreign currency refinancing.

Repos were the key instrument to provide foreign currency. Banks' foreign currency repo debt to the central bank continued to grow till late April 2015, hitting a peak of \$33.9bn, and then declined gradually till December 2015. According to the data available as of January 2015, banks' debt stood at \$24.9bn, including \$19.7bn under one-year foreign currency repos and \$5.1bn under 28-day foreign currency repos (see *Fig. 5*). The average weighted interest rate on one-year repo auctions increased from 1.2% per annum on January 12, 2015 to 3.2% on May 8, 2015¹, and the average weighted interest rate on 28-day repo auctions was up from 0.68% to 2.36% per annum in the period of January till early January 2016.

¹ On May 18th, the Bank of Russia abandoned 365-day foreign currency repos. See "Key monetary policy decisions" for details.

Note that foreign currency refinancing operations through repo auctions were first of all aimed at calming down panic sentiments in the FX market, and this objective was achieved in January–February 2015. In our view, a wide use of foreign currency repos proved efficient and helped release pressure from the FX market.

As to foreign currency swaps, an average of \$166.4m were allotted to banks through such swaps in 2015. Banks showed low demand for this type of swaps because of high interest rates (the interest rate on the ruble leg (of a swap) was gradually cut from 16% on January 12th to 10% on August 3rd, and the interest rate on the FX leg reached 1.5%).

In 2015, the Bank of Russia held credit auctions to provide 28- and 365-day dollar-denominated loans secured by the pledge of claim on dollar-denominated loans to credit institutions. In Q1 2015, \$2.8bn were allotted at an average weighted interest rate of 1.47% as part of one-year auctions. Later, such auctions were not held because the FX market was stabilized. In January and in February, \$0.6bn and \$2.5bn, respectively, were lent via loans with a maturity of 28 days at a rate of 0.92% per annum. Later, an average of \$0.44bn were lent in loans at an average weighted interest rate of 2.35% per annum (except March, May and November, when no bids arrived from credit institutions). Note that the Bank of Russia’s list of counterparties eligible for this type of lending includes credit institutions with an equity of at least Rb 100bn, as well as Vnesheconombank (VEB).

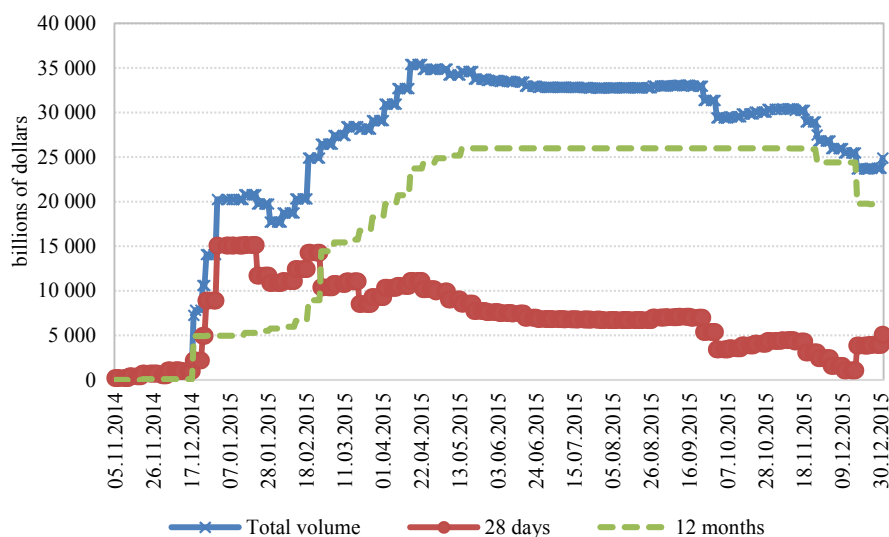


Fig. 5. Amount of funds to be repaid by credit institutions under second FX repo leg in 2014-2015

Source: Bank of Russia.

Let us consider in detail the dynamics of the broad monetary base (see *Table 2*).

Overall, emphasis should be placed on the following contracted components of the broad monetary base: required reserves for banks (down 21.5% to Rb 369.8bn), deposits of credit institutions with the Bank of Russia (down 30.7% to Rb 557.8bn), cash in circulation (down 3.6% in 2015 to Rb 8522bn). Only credit institutions’ correspondent accounts saw an increase (up 31.1% to Rb 1594bn). Overall, surplus reserves in 10M/2015 increased 6.5% to Rb 2152bn.

Table 2

**Dynamics of broad monetary base in 2015
(billions of rubles)**

	January 1, 2015	April 1, 2015	July 1, 2015	January 1, 2016
Monetary base (broad definition)	11,332	9,662.5	9,706.5	11,043.8
- cash in circulation, including cash in vaults of credit institutions	8,840.5	7,522.7	7,639.3	8,522.2
- correspondent accounts of credit institutions with the Bank of Russia	1,215.5	1,342.3	1,308.1	1,594.0
- required reserves	471.3	505.3	466.0	369.8
- deposits of credit institutions with the Bank of Russia	804.6	292.2	293.2	557.8
- Bank of Russia's bonds held by credit institutions	0	0	0	0
For reference: surplus reserves	2,020	1,635	1,601	2,152

Source: Bank of Russia.

In 2015, Russia's central bank cut gradually its key rate following its drastic hike (17% per annum) in December 2014, attempting to stabilize the financial market. The reason for easing the monetary policy was gradual slowdown of inflation amid deep recession (GDP lost 3.3% in Q1, 6.2% in Q2, 5.1% in Q3 over the same quarters of 2014). The key rate was lifted in emergency from 10.5% to 17% per annum in December 2014 amid turmoil in the FX market. In our view, the Bank of Russia's decision to raise the key rate was adequate under the circumstances. Had the real interest rate been cut amid surging inflation, the ruble would have been hit even harder, producing no effect on economic growth rates, because economic agents tend to cut their fixed investment in a volatile FX market.

The key rate cut coupled with offering more options to credit institutions for refinancing in rubles or in foreign currency contributed to the stabilization of the interbank lending market. The interbank lending market rate¹ dropped 34.9% in 12M/2015 (from 17.0% on average in January 2015 to 11.1% on average in December 2015). As a reminder, the MIACR rate overnight interbank ruble-denominated loans moved beyond the upper boundary of the interest rate band in December 10-24, 2014 due to a turmoil in the interbank lending market amid tumbling crude oil prices, a weakening ruble, and a key rate hike. However, the money market was stabilized as early as January. Overall, in 2015, the interbank interest rate did not move beyond the boundaries of the interest rate band, nearing sometimes the lower boundary in H2 2015. Note that the MIACR rate on ruble-denominated interbank overnight loans dropped below the key rate because there was less demand from banks for liquidity, which came via the budget channel while the provision of funds through one-week repos was diminished. Overall, the annual average MIACR rate on overnight interbank ruble-denominated loans increased by 1.5 times, from 8.6% per annum in 2014 to 12.7% in 2015 (see *Fig. 6*). Hence the Bank of Russia's interest rate policy in 2015 proved efficient in terms of achieving the objective of narrowing the gap between interbank lending rates and the key rate.

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

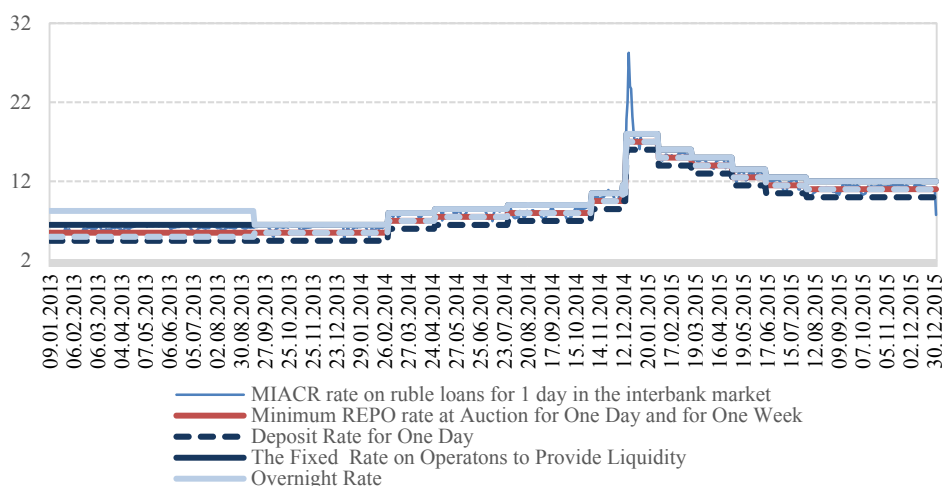


Fig. 6. Bank of Russia’s interest rate band, and dynamics of interbank lending market in 2013–2015.

Sources: Bank of Russia, Gaidar Institute’s own calculations.

Despite gradual key rate cuts in 2015, the money supply increased at moderate pace. In January-December 2015, the annualized M2 was growing at an average of 7.1%. The money supply increased from 2.2% year-on-year in January 2015 to 11.4% year-on-year in December 2015, whereas the money supply saw its annualized growth rate slow down through much of 2014, from 14.6% in January to 5% in December. Note that the annual growth rate of the money supply stood at 32.5% in 2010, 24.3% in 2011, 19.4% in 2012, 15.3% in 2013, 8.4% in 2014. The trend was first of all determined by low lending activity of banks. In 12M/2015, the annualized monetary base increased 1.3% and the annualized money multiplier (ratio of M2 to Monetary Base) advanced 1.1%. The money multiplier increased 14.5% given the fact that in December 2015 the monetary base shrank by 2.5% from December 2014, and the money supply increased 11.4% during the same period. In January-December 2015, the money multiplier averaged 3.3, which is an average value for developing economies (Ukraine, Belarus, Kazakhstan), whereas it tends to vary within a range of 5–8 in developed countries. Note that the money multiplier rose in Eastern Europe countries over the past two decades with the advancement of their banking system. For example, the Poland’s money multiplier increased from 3.1 to 6.5 during the period of 1993–2015.

The level of monetization of the Russian economy (ratio of M2 to GDP) in 1999–2014 tripled to 45% in 2014. According to the data available as of October 1, 2015, the level stood at 45%, either. For comparison, the ratio of M2 to GDP during the same period increased by 1.8 times to 30.8% in Belarus in 2014, by 2.5 times to 33.7% in Kazakhstan, by 3.6 times to 61.1% in Ukraine. However, a higher level of monetization is typical of the most of Central and East Europe countries. For example, the ratio of M2 to GDP in Poland stood at 61.3% in 2014. GDP monetization is even higher in developed countries due to a more advanced financial system: e.g., it reached 164% in Germany in 2014.

2.1.2. Exchange rate policy decisions and exchange rate dynamics

As noted above, in late 2014 the Bank of Russia nearly put on hold its operations in the FX market, restricting itself to foreign currency purchases to replenish sovereign funds by the Federal Treasury. The central bank abandoned its currency interventions on February 3, 2015,

letting the exchange rate be governed by transactions in the private sector. As a result, the ruble exchange rate at that period was driven by a balance between foreign exchange supply and demand in the corporate sector, which was influenced by oil prices, the state of global economy, geopolitical context, as well as development parameters of the Russian economy.

The domestic FX market saw the official US dollar exchange rate strike the highest level on December 31st, up to 72.88 rubles per dollar, and the euro rose to 81.15 rubles per euro on August 25th.

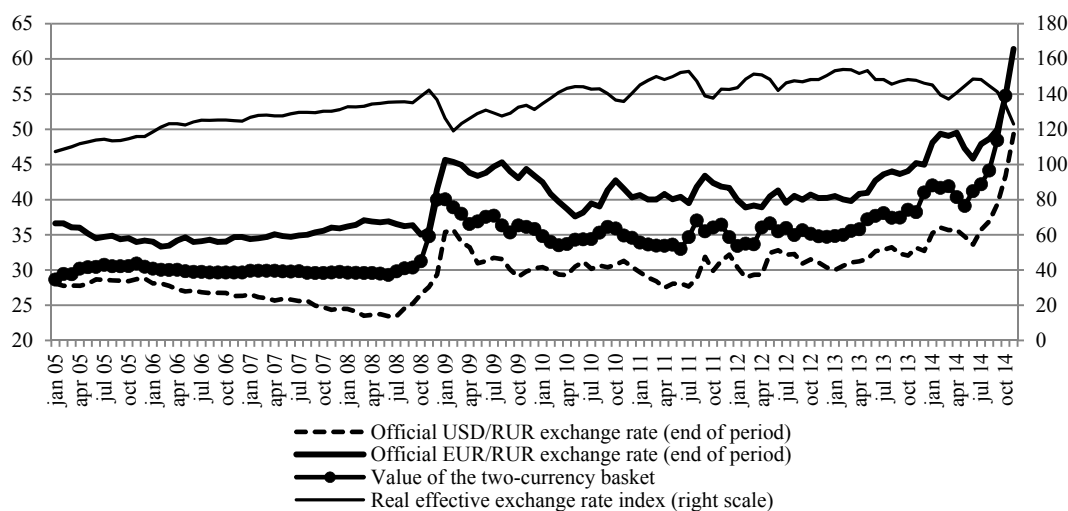


Fig. 7. Dynamics of ruble real exchange rate

Note: for ruble’s real effective exchange rate in January 2008=100%.

Sources: Bank of Russia, own calculations.

The situation in the FX market was improved by surging crude oil prices as well as stabilized geopolitical context. After hitting a local low of \$53.3 a barrel in mid-March, the monthly Brent crude price averaged \$61.6 a barrel as early as April and \$66.8 in the first half of May. As said above, the increase in volume of foreign currency provided by the Bank of Russia to credit institutions through repos contributed considerably to easing the turmoil which reached its highest level in the domestic FX market in December 2014.

With a rapidly strengthening ruble, the Bank of Russia announced on May 14th it will restart daily foreign currency purchases in the domestic FX market to increase its international reserves. The bank was expected to limit itself to purchasing \$100–200m a day. At that period the actual volume of Bank of Russia’s daily purchases neared the upper boundary of \$191m, and the total amount was slightly more than \$10bn in 2015. The Bank of Russia continued its currency interventions to build up the international reserves till July 28, 2015, when the US dollar official exchange rate moved beyond 58.78 rubles per dollar. Facing a new fall of crude oil prices and expectations for high inflation, the regulator decided to abandon its currency interventions. In our view, the decision to restart currency interventions was not rational, because it was inconsistent with the central bank’s key objective of taming inflation. As a consequence, the central bank failed to increase considerably the international reserves, and FX market players took the decision as a signal that the central bank was going to prevent nominal strengthening of the ruble, letting it go down.

The ruble continued to fall for five straight months: by September, the average monthly exchange rate of the US dollar rose to 66.77 rubles per dollar from 50.58 in May and of the euro increased to 75.04 rubles per euro against 56.52 rubles, respectively. Nevertheless, the ruble exchange rate went up as early as October, when Russia-West tensions relaxed a bit and the US dollar edged down, and hence global crude oil prices surged. However, the effect died out soon. In November-December the ruble lost 4.9% against the dollar and 1.0% against the euro following the October annualized increase of 5.9% of the ruble over the US dollar and over the euro.

Note that the swing to a free floating exchange rate policy amid drastically worsening external economic conditions resulted in a highly volatile ruble. As a consequence, intramonth volatility¹ of the dollar/ruble exchange rate in 2015 was more than 10%, which is way below the 2014 level (16.6%), but it is three times the value seen in 2010–2013 and in 2008, when the exchange rate was driven by a guided floating exchange rate policy (see *Fig. 8*).

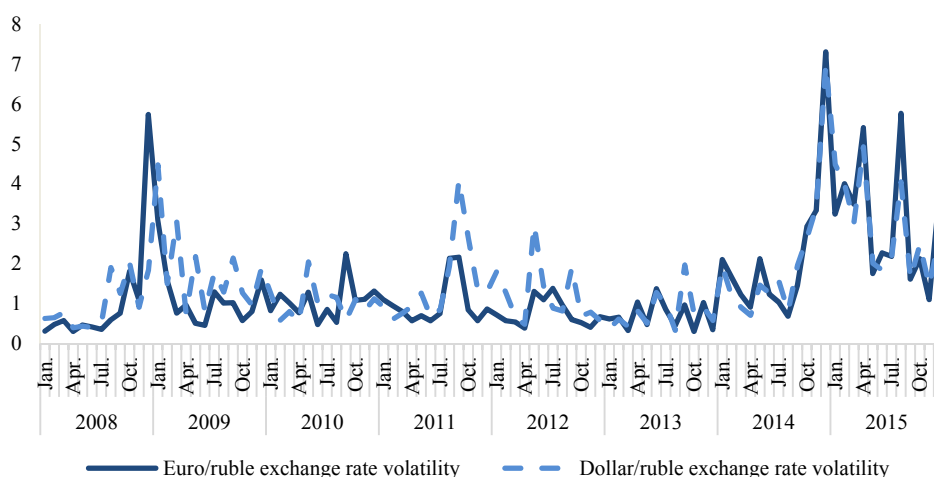


Fig. 8. Volatility of euro/ruble and dollar/ruble exchange rate

Sources: Bank of Russia, own calculations.

A growth in exchange rate volatility on the one hand may elevate FX risks of economic agents, but on the other hand this is what can curtail both speculative “games” in the FX market and growth rates of foreign currency deposits. As a result, although at the 2015 year-end the Russian ruble’s depreciated by 37.4% year-on-year against the US dollar and by 25.2% year-on-year against the euro, the foreign currency deposits² in credit institutions, which are held by the corporate sector (except banks) and individuals increased 18.3% in 2015 from the 2014 increase of 15.4%. Ruble deposits were up to 7.7% compared to a growth of 5.4% in 2014. As a result, the level of dollarization of the Russian economy measured as the ratio of foreign currency liabilities to the corporate sector and individuals to their end-November 2015 total value increased to 30.0% over 25.4% earlier in 2015, reflecting first of all the effect of exchange rate revaluation. For comparison, the level of dollarization stood at 15.7% earlier in 2014.

¹ Intramonth volatility of the ruble exchange rate against foreign currencies is calculated using daily official exchange rates and is expressed as a percentage ratio of exchange rate standard divergence to its average monthly value.

² An FX equivalent.

Hence, quick adaptation of the exchange rate to new economic realities helped avoid massive cash outflows from ruble accounts towards foreign currency accounts, as was the case during the crises of 2008–2009 and of 2014.

Overall, the dynamics of Russia’s ruble exchange rate against the key world currencies in 2014–2015 displayed the trends typical of developing countries’ currencies. However, the Russian ruble depreciated at faster rates, thus reflecting the effect of geopolitical risks, as well as a strengthening dollar in the global FX market and falling global crude oil prices. As a result, in that period the Russian ruble saw a 1.9-fold devaluation against the US dollar, while the Brazilian Real was down 1.6-fold, and the Turkish lira saw a 1.3-fold slide (see *Fig. 9*).

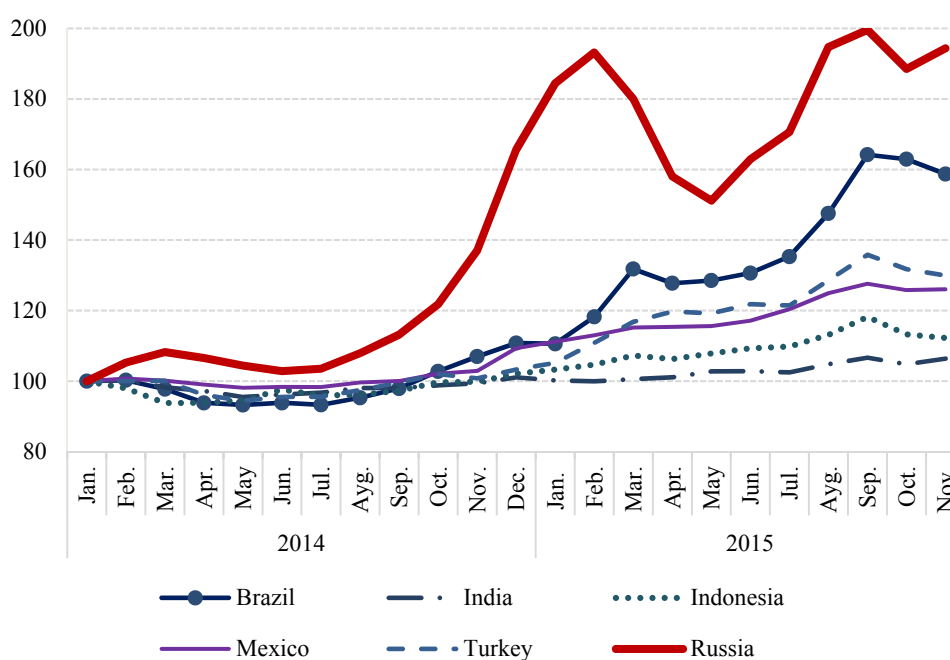


Fig. 9. Dynamics of US dollar exchange rate against currencies of developing countries (January 2014 = 100%)

Sources: International Financial Statistics (IMF), own calculations.

2.1.3. Inflation processes

In December 2015, inflation rate stood at 12.9% from December 2014, which was higher than the 2014 level (11.4%), and it was way above the target inflation rate for 2017 (4%) set forth in the central bank’s Guidelines for the Single State Monetary Policy for 2015–2017. March 2015 saw the highest inflation rate (up 16.9%) because of the peak of exchange rate depreciation pass-through to prices (see *Fig. 10*).

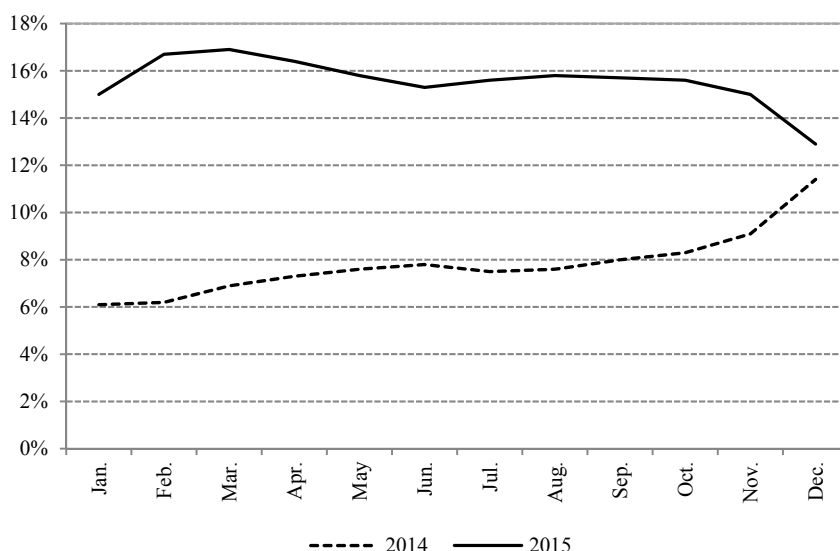


Fig. 10. CPI growth rates in 2014–2015 (% over the previous 12 months)

Sources: Rosstat; Gaidar Institute’s own calculations.

Inflation in 2015 was boosted basically by the effect of nonmonetary factors. The key factors that contributed most to the build-up of inflation, considering the fact that Russian economic agents consume a considerable share of imported goods, was the ruble devaluation which reached its peak earlier in the year due to massive capital outflows, expectations for further devaluation and falling crude oil prices, as well as in August 2015 (the ruble lost 10.6%), when the ruble sank in response to plummeting crude oil prices, from \$51.8 to \$42.4 a barrel. Note that, according to our estimates, the effect of exchange rate pass-through to consumer prices in Russia varied from 10% to 20% according to a currency and revaluation period. In other words, consumer prices increase 0.1–0.2% if the ruble slides by 1%. According to our estimates, the 2015 cumulative contribution of the ruble devaluation to the annual inflation as of the beginning of December was 9.5–10.2 percentage points. Note that according to the estimates of Russia’s Ministry of Economic Development, the ruble exchange rate depreciation pass-through contributed 8 percentage points to the annual inflation in August 2015.¹

Considering the magnitude of exchange rate pass-through to prices and heavy dependence of the Russian economy on highly volatile global hydrocarbons market, as well as rigid expectations for inflation in Russia, the central bank’s mid-term inflation rate target (up 4%) for 2017 will unlikely be fulfilled. Note that the M12/2015 inflation stood at 12.9%, whereas expectations for inflation rose to 16.4%. Furthermore, it should be borne in mind that the Bank of Russia failed since 1999 to reach the inflation targets set forth in its Guidelines for the Single State Monetary Policy, except in 2003 (the actual inflation rate was 12%, the target rate was 10–12%), in 2010, when the actual inflation rate was below the target range (the actual inflation rate was 8.8%, the target rate was 9–10%), and in 2011 (the actual inflation rate was 6.1%, the target rate was 6–7%). In that context, economic agents’ confidence in target inflation rates remains low, thus being a headwind to the fulfillment of the targets set. In our view, Russia’s

¹ Concerning the Current Situation in the Economy of the Russian Federation as of the end of January-August 2015. Russia’s Ministry of Economic Development.

central bank should set more realistic inflation rate targets, including a narrow range of permissible deviations (± 1 percentage point), in order to increase economic agents' confidence and lower expectations for inflation.

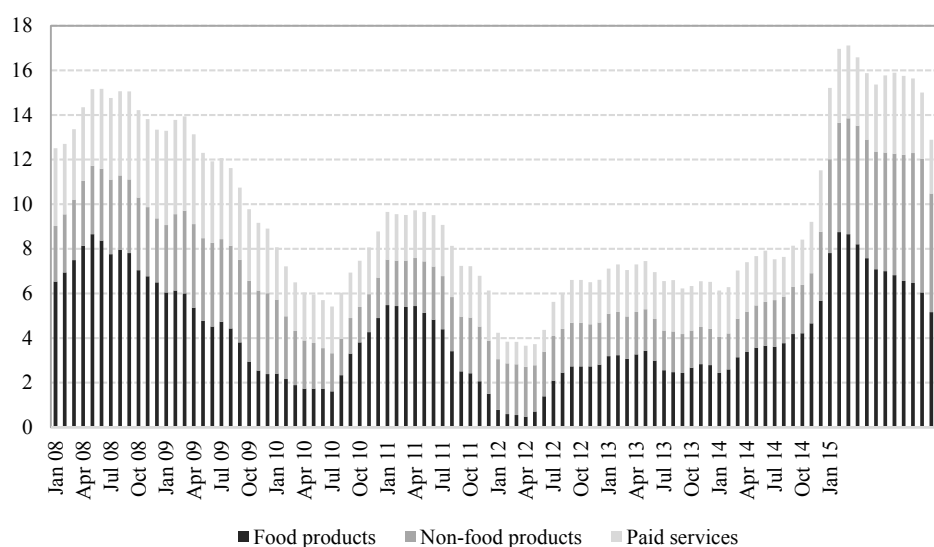
As shown in *Table 3*, consumer prices in the period between January 2015 and December 2015 grew up at slower rate than those in 2014. The price of the following food products contributed much to the increase in food prices: sunflower oil (up 37.2%), fish, other seafood and products thereof (up 20.9%), pasta-based food products (up 19.5%), fruits and vegetables (up 17.4%), cereal grains and beans (up 15.5%), bread and bakery products (up 13.2%). Note that the price of pasta-based food products, bread and bakery products was driven up by a considerable increase in the price of raw materials, including wheat and other grains. The sunflower oil price hikes were driven by the global oleaginous food market as well as lower per-hectare yield of sunflower as a result of a hot summer in some of the Russian regions. At the same time, the exchange rate depreciation pass-through to prices was a main tailwind to inflation build-up for certain types of food products.

In our view, the decision to maintain the ban on food imports from EU countries, Norway, the U.S.A., Canada and Australia, which the Russian government introduced in late June 2015, had no stronger effect on the dynamics of prices of the sanctioned goods, because manufacturers and retailers almost adapted to the ban, as was evident from slowing down growth of prices of the respective types of products.

Nonfood products saw their price grow faster in 2015 (up 13.2%). Prices of tobacco products rose faster (up 26.6%) than of other products in the same group due to an excise tax lift and depreciation of the ruble. A point of note is growth in prices of washing and cleaning agents (up 22.4%), medicaments (up 19.6%), textiles (up 19.7%), electrical and other household appliances (up 16.8%), footwear (up 15.1%). Overall, the price of nonfood products was pushed up by ruble depreciation, too, amid heavy dependence of the Russian market on foreign supplies.

In January-December 2015, the price of paid services to individuals increased 10.2% from 2014. The following services contributed most to the price rise: insurance services (20.5%), outbound travel (tourism) services (19.8%), early childhood education services (16.8%), utility services (12.1%), medical services (11.1%). Note that the increase in prices of outbound travel (tourism) services and insurance services was triggered by a weakening ruble. Insurance rates were affected considerably by the increase in the MTPL (Mandatory Third Party Liability) rates.

According to OOO INFOM's public opinion polls which are published monthly by the Bank of Russia, the median one-year ahead expected inflation rate in late 2014 spurred a considerable increase in the actual inflation rate over the prior 12 months (by 4–5.5 percentage points). The gap was narrowed (by 1.4–1.6 percentage points) in January-February 2015, thus showing that economic agents' panic sentiments settled down a little bit. Expectations for inflation in March-August 2015 were below the actual inflation rate largely due to a stable FX market. Expectations for inflation again rose by 0.5 percentage points to 15.8% in November and by 0.6 percentage points to 16.4% in December, because individuals expected the ruble exchange rate to decline at year's end. Note that high expectations for inflation hampered monetary easing, thus keeping inflation up.



*Fig. 11. Structure of inflation in 2008–2015
(% over the same month last year)*

Sources: Rosstat; Gaidar Institute’s own calculations.

Table 3

**Annual growth rate of prices of certain types of consumer goods and services
in 2012–2015 (% from December last year)**

	2013	2014	2015	2013–2015 ¹
CPI	6.5	11.4	12.9	33.9
Food products	7.3	15.4	14.0	41.2
Cereal grains and beans	3.2	34.6	15.5	60.4
Butter	18.6	14.5	10.6	50.2
Sunflower oil	-3	5.0	37.2	39.7
Pasta-based food products	4.7	8.4	19.5	35.6
Milk and dairy products	13.1	14.4	11.5	44.3
Eggs	28.8	4.6	9.8	47.9
Bread and bakery products	8.0	7.5	13.2	31.4
Meat and poultry	-3	20.1	4.3	21.5
Fish, other seafood and products thereof	7.6	19.1	20.9	54.9
Fruits and vegetables	9.3	22.0	17.4	56.5
Alcoholic beverages	14.6	13.7	10.7	44.2
Nonfood products	4.5	8.1	13.7	28.4
Medicaments	2.5	13.1	19.6	38.6
Motor gasoline	5.7	8.6	4.8	20.3
Tobacco products	29.3	27.1	26.6	108.1
Services	8.0	10.5	10.2	31.5
Utility services	9.8	9.4	10.1	32.3
Early childhood education services	9.9	15.6	16.8	48.4
Health and leisure services	5.7	7.6	14.4	30.1
Passenger transport services	8.9	7.3	10.7	29.4
Cultural organizations services	10.5	9.9	7.2	30.2

Source: Rosstat.

Finally, we will compare consumer price growth rates in Russia vs. other countries (see *Table 4*).

¹ Inflation rate in 2013–2015

Table 4

**Consumer prices dynamics in various countries in 2013–2015,
% a year**

	2013	2014	2015*	2013–2015**
Azerbaijan	3.5	-0.1	2.7	6.2
Armenia	5.6	4.6	-2.4	7.8
Belarus	16.5	16.2	10.1	49.0
Kazakhstan	4.8	7.4	8.2	21.8
Kyrgyzstan	4.0	10.5	1.4	16.5
Moldova	5.2	4.7	11.5	22.8
<i>Russia</i>	6.5	11.4	11.2	31.9
Tajikistan	3.7	7.4	4.1	15.9
Ukraine	0.5	24.9	39.5	75.1
Germany	1.5	0.9	0.4	2.8
France	0.9	0.5	0.2	1.6
The United States	1.5	1.6	1.3	4.5
The Netherlands	2.5	1.0	1.3	4.9

* The data for January–October.

** Inflation rate in 2013– October 2015.

Sources: Interstate Statistical Committee of the Commonwealth of Independent States (CIS STAT) (<http://www.cisstat.com/>), OECD database (<http://stats.oecd.org/>).

In the period between January and October 2015, Russia was ranked 3rd among CIS countries for consumer price growth rate, after Ukraine and Moldova. The inflation rate in Russia in January–October 2015 was 14 times the inflation rate in developed countries (see *Table 4*). Thus Russia kept facing high inflation vs. both developed countries and emerging market economies.

In 2016, low economic activity, moderate growth of the money supply will present a headwind to inflation build-up. However, the ruble's exchange rate pass-through to prices due to its devaluation by 3% in November 2015 and by 10% in December 2015 will keep inflation up, which will most likely stay at 1.5–2 percentage points (6.4%) above the 2016 level predicted by Russia's Ministry of Economic Development. Note that Russia's economic sanctions against Turkey which took effect on 1 January 2016 may have an extra proinflation pressure in 2016.

Overall, in our view, the target inflation rate (4%) will highly unlikely be reached by 2017 amid geopolitical tensions, highly volatile crude oil prices and exchange rate, although monetary factors have a suppression effect on inflation processes.

2.1.4. Key monetary policy decisions

In 2015, the Bank of Russia carried out a moderately tight monetary policy aimed to tame inflation with due consideration of the slugging economy. Russia's central bank lowered the key rate gradually from 17% in January to 11% in November 2015. On January 30, 2015, the key rate was slashed from 17 to 15% per annum, then it was cut by 1 percentage point to 14% on March 13th, slid to 12.5% on April 30th, to 11.5% on June 15th and to 11% on July 31, 2015. Note that it was absolutely reasonable to retain a relatively high key rate (in nominal terms) because interest rates in Russia are still low in real terms, and they are also low compared with other developing countries (see *Fig. 12–13*).

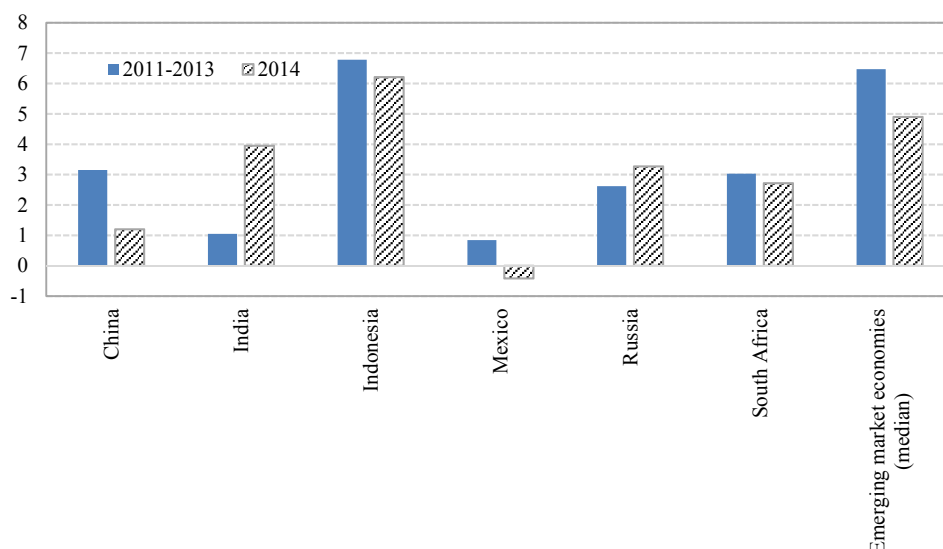


Fig. 12. Real money market interest rates in emerging market economies, G20 states (% per annum)

Source: IMF.

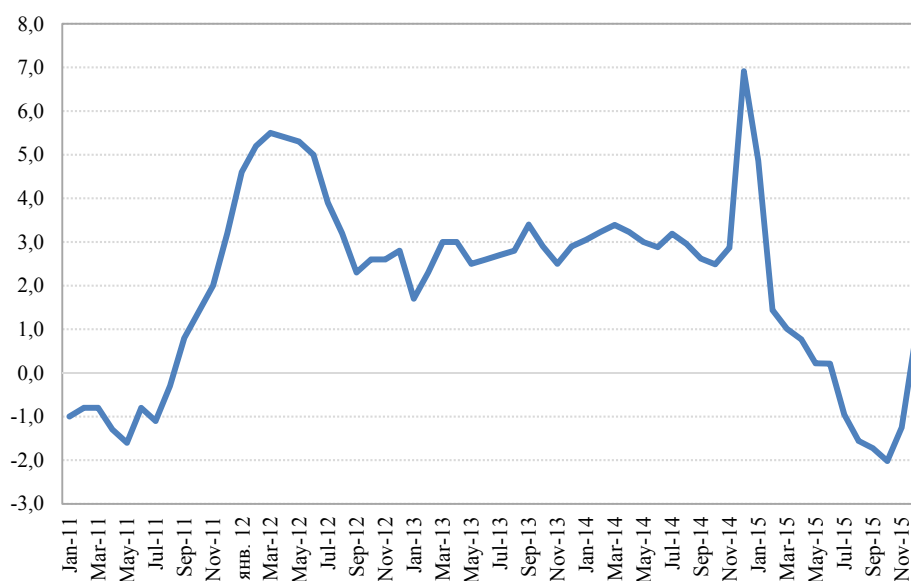


Fig. 13. Real interest rate on loans with less than one-year maturity to legal entities in Russia, 2011-2015 (% per annum)

Source: Russia's central bank.

Note that the price growth rate eased off at very slow pace (on an annualized basis, 15.7% in September, 15.6% in October, 15% in November) after inflation increased 15.8% year-on-year in August 2015. It would be unreasonable to cut the key rate amid expectations for high inflation, ruble depreciation risks attributed among other things to uncertainty about dynamics of oil prices, geopolitical tensions, investors' expectations for a tighter U.S. Fed's monetary policy.

With a stable FX market and low risks of financial instability, Russia's central bank in March-April 2015 cut the key rate and lifted (three times) minimum interest rates on foreign currency liquidity provision instruments. In particular, on March 30, 2015, the Bank of Russia lifted minimum interest rates on foreign currency repo auctions to LIBOR plus 1 percentage point (from LIBOR plus 0.5 percentage points). The new rates still remained appealing to borrowers, especially amid financial sanctions, but this measure showed that the Bank of Russia was positive that banks had sufficient liquidity. At the same time, there was still demand for foreign currency repo auctions which allowed foreign currency to be purchased at low rates and invested in, e.g., Eurobonds of major Russian companies, which deliver a much higher yield.

On April 21, 2015, Russia's central bank lifted again minimum interest rates by 0.5 percentage points to LIBOR plus 2 percentage points for 28-day foreign currency repo auctions, and by 2.5 percentage points for 12-month auctions. Furthermore, the central bank lifted minimum interest rates for auctions to provide FX loans secured by the pledge of claim on FX loans to LIBOR plus 2.25 percentage points for such loans with a maturity of 28 days and by 2.75 percentage points for loans with a maturity of 365 days. As in the case with the interest rates lift-off on April 13th, the value of one-year loans was much higher (by 0.75 percentage points) than that of loans with a maturity of 28 days and one week (by 0.5 percentage points). This measure aimed to prevent the ruble from strengthening on the back of stronger optimistic sentiments of investors inspired by raising oil prices and relaxing geopolitical tensions.

With a stable FX market, the Bank of Russia on May 18th abandoned 365-day foreign currency repos. However, the bank announced on November 27th it will restart such repos from December 14, 2015. This measure was dictated by the need to refinance commercial banks' debt on previous one-year foreign currency repo auctions and by the necessity to help Russian companies pay their external debts, as well as by upswing of demand for foreign currency after the U.S. Federal Reserve raised its benchmark interest rate in December 2015. However, we think this instrument should only be used when financial stability is at risk, and a free floating exchange rate regime should continue so that the economy adapts to change in terms of trade.

In order to offer more options for credit institutions to manage their liquidity, the Bank of Russia decided to raise from 0.7 to 0.8 (in effect from September 10, 2015) the averaging ratio used by banks for calculating the averaged value of required reserves. The averaging ratio for nonbank credit institutions involved in deposit/credit operations was elevated from 0.7 to 1.0. The decision aimed to redistribute funds between the balances of credit institutions' required reserves accounts and correspondent accounts with the Bank of Russia. As a reminder, the mechanism of averaging allows a bank to hold a part of its required reserves on its correspondent account, not special accounts, with the central bank.

On June 16, 2015, USD/RUB and EUR/RUB buy/sell fine-tuning 1- to 2-day foreign currency swap auctions were introduced as part of the system of monetary policy instruments introduced. With regard to fine-tuning 1- to 2-day foreign currency swap auctions, the Bank of Russia will decide on the expediency of holding such auctions according to the situation in the money market. A common maximum volume of funds is established for repo auctions and fine-tuning foreign currency swaps. The minimum interest rate on the ruble leg of foreign currency swaps equals the key rate, and there is zero interest rate on the foreign currency leg.

With this decision made, credit institutions were offered a wider range of options for managing their ruble liquidity and assets accepted by the Bank of Russia as collateral for refinancing operations. Such auctions can be held when the Bank of Russia sees more demand from

banks for ruble liquidity, seeks to encourage demand for standing foreign currency swaps, reduce volatility of short-term interest rates in the money market and narrow the gap between them and the key rate, as well as to enhance the effectiveness of the interest rate channel of the monetary policy's transmission mechanism.

With limited collateral available in the market, the Bank of Russia sought to create more options of refinancing for credit institutions. The Bank of Russia Lombard List was updated several times with new issues of securities in 2015. Additionally, the settlement dates of foreign currency repos of various maturities were synchronized with the settlement dates of one-week ruble repos so that credit institutions can manage more efficiently their market collateral portfolio. Furthermore, credit institutions were offered an option of using unrated bonds of non-financial enterprises and mortgage bonds, state guarantees of the Russian Federation, or AHML's (Agency for Housing Mortgage Lending) sureties in security for refinancing operations.

Finally, note that the Bank of Russia in 2015 continued working on making its monetary policy more open through regular releases of analytical reviews and statistics, including information on people's expectations for inflation, an external debt repayment schedule, etc., as well as a series of reports on economic studies of pressing matters. In our view, providing information about goals and performance of monetary policy measures, and discussing the nature of inflation processes in Russia can help raise economic agents' confidence in the central bank's policy, thus making it more efficient.

2.1.5. Balance of payments and ruble exchange rate

In 2015, Russia's balance of payments was adapting to drastically worsened terms of trade. The year-end positive current accounts balance was above the negative financial account balance, and the central bank's gross international reserves saw a small growth. In that context, Russia's net capital outflow in 2015 decreased considerably over 2014 in response to the contraction of bank's foreign assets and substantially slower growth of foreign assets in other sectors.

According to the Bank of Russia's preliminary estimate of Russia's balance of payments, the positive current accounts balance in January-December 2015 stood at \$65.8bn, an increase of 12.7% over 2014 (see *Table 5*). The positive trade balance fell by 23.2% (from \$189.7bn to \$145.6bn) due to a sweeping fall of prices of Russia's key export commodities (see *Fig. 14*). In particular, the 2015 exports of goods dropped by 31.8% (from \$498bn to \$340bn). Imports of goods dropped by 37.0% (from \$308bn to \$194bn) due to a weakening ruble and falling economic agents' income. Imports will quite likely decline considerably in 2016, too, because the ruble continued to tumble in early 2016.

Exports of crude oil, refined petroleum products and natural gas accounted for 58.3% of total exports, declining by 7 percentage points over the same period of 2014 largely because the crude oil fell by 22.5% in 2015, down to an average of \$38.8 a barrel in December 2015 (see *Fig. 15*).

Although the trade balance declined in 2015, the increase in the balance of current accounts was driven up by a decline in the deficit of the service balance, investment income balance and remuneration balance. For instance, the service balance deficit in 2015 reached \$37.1bn, declining by 32.9% (absolute value) over the same period of 2014. Exports of services stood at \$49.7bn, down \$16bn year-on-year (by 24.4%). Imports of services in 12M/2015 dropped by 28.3% to \$86.8bn over 2014, first of all because the Russians retrenched their foreign travel costs.

The remuneration balance in January-December 2015 was down 57.4% to -\$4.3bn (-\$10.1bn in 2014) possibly due to a reduction of the remuneration of migrants whose services were in less demand.

The investment income balance deficit in 2015 decreased by 44.7% year-on-year to \$32.0bn due to a decline in external debt service costs. The investment income receivable dropped 19.2% from \$42.2bn to \$34.1bn. The income payable by nonfinancial enterprises fell by 30.8% to \$55.5bn and by banks by 49.4% to \$8.6bn, cutting the total income payable by 34.0% to \$66.1bn. The rent balance¹ in 2015 stood at \$0.0bn (+\$0.1bn in 2014). The 12M/2015 secondary income balance² was -\$6.4bn, (-\$8.2bn in 2014), and the capital transfers balance was -\$0.2bn, (-\$42.0bn in 2014) as a result of the write-off of the debt owed to Russia by Cuba, Uzbekistan and North Korea).

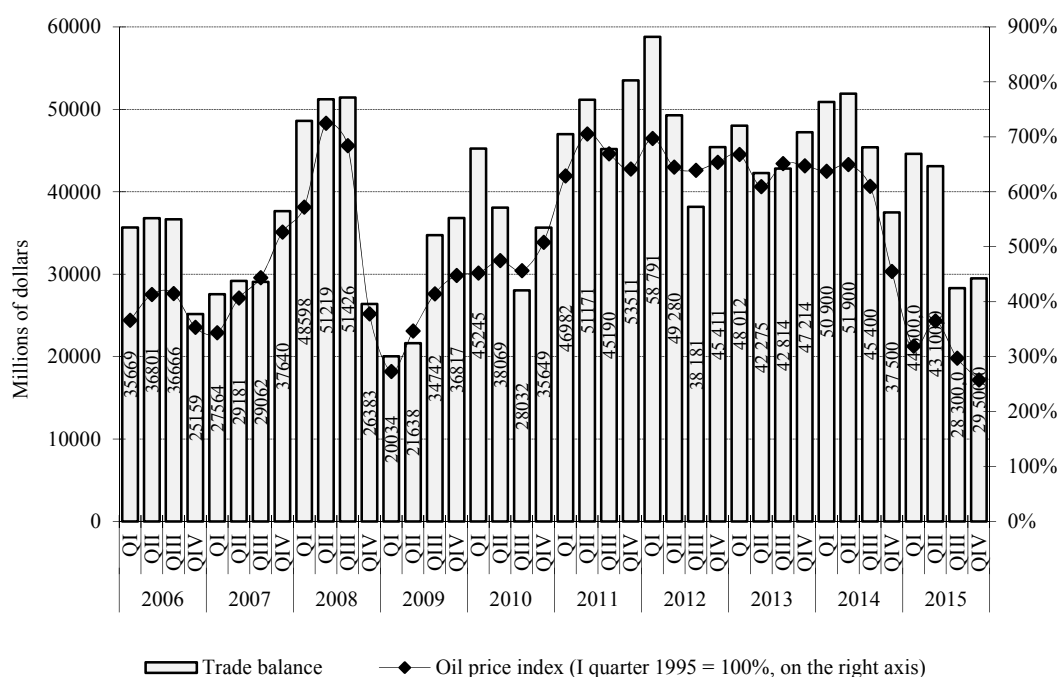


Fig. 14. Russia's trade balance and global oil price index in 2006–2015

Sources: Bank of Russia; EIA; Gaidar Institute's own calculations.

¹ The rent covers income receivable for putting natural resources at the disposal of another institutional unit. Examples of rent include amounts payable for the use of land, extracting mineral deposits and other subsoil assets, and for fishing and grazing rights.

² Formerly called the balance of current transfers. According to Russia's central bank, current transfers tend to boost the recipient's disposable income, consumption of goods and services, whereas they tend to diminish the originator's disposable income and potential capacity to consume, e.g., a humanitarian aid provided in the form of consumer goods and services. Current transfers are recognized in the current account. Non-current transfers are by definition regarded as capital transfers. Capital transfers tend to change the volume of assets and liabilities of the originator and the recipient, and they are recognized in the capital account. Should the originator and the recipient be residents of different states, capital transfer alters the level of the national wealth of the economies they belong to. An example of capital transfers is free transfer of title to fixed assets, and debt write-offs.

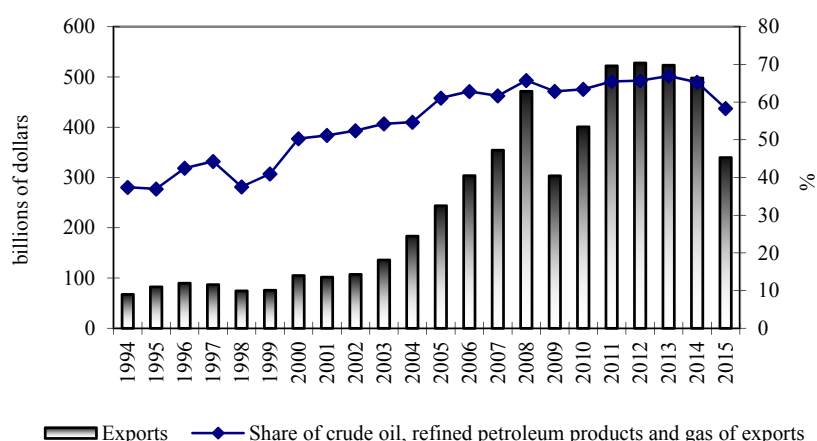


Fig. 15. Dynamics of exports of goods and of the share of fuel and energy sector products in 1994–2015

Source: Bank of Russia.

In 2015, the financial account deficit stood at \$61.1bn (\$130.2bn in 2014). Russian economic agents’ liabilities to foreign economic agents were cut by \$69.8bn in 12M/2015, 20.9% less than the value (\$48.9bn) recorded last year. Federal authorities’ external liabilities decreased by \$7.5bn in 2015. The subjects of the Russian Federation saw their external liabilities increase \$0.1bn. Monetary regulators’ liabilities in 2015 did not go beyond \$2bn. Banks in 2015 continued to slash their foreign liabilities which decreased by \$61.6bn during the year (down \$37bn in 2014). In 2015, nonbank institutions cut their external liabilities by \$2.7bn as compared to an increase of \$1bn in 2014. The inflow of foreign direct investments was \$6.7bn against \$18.5bn in 2014, lowest since 2003. Other external liabilities (portfolio investment, loans and credits and other liabilities) decreased by \$9.5bn in 2015 (a decline of \$17.8bn in 2014). Note that \$82.6bn should have been paid according to schedule in 2015, however external obligations contracted by \$2.7bn possibly due to in-house external debt management operations whereby banks pay debts to related lenders who use the money to pay the “real” external debt.

Residents’ foreign assets (foreign economic agents’ liabilities to Russian economic agents) dropped by \$8.6bn in 12M/2015 (up \$81.3bn in 2014). Monetary regulators’ foreign assets increased \$0.4bn (down \$0.5bn in 2014). Russian banks’ foreign assets were cut by \$28.2bn in 2015 (up \$48.5bn in 2014). The cut of banks’ foreign assets was partially due to banks paying their foreign currency debts to the Bank of Russia. In H2 2015 banks paid back \$10.9bn to the central bank, they also used foreign currency from their correspondent accounts with the Bank of Russia. Note that banks’ assets shrank by \$7.8bn (+\$50.4bn in 2014) due to foreign cash transactions with nonresidents, according to the data available for January-September 2015. Banks’ foreign cash holdings were cut as little as \$0.6bn (-\$38.1bn in 2014) due to retail operations. In other words, in 2015 there was much less foreign cash demand from individuals as compared to the previous year. Foreign cash in hand in 9M/2015 dropped by \$11.8bn to \$40.5bn, according to the Bank of Russia estimates.

Foreign assets held by private nonfinancial enterprises in 2015 increased as little as \$17.8bn as compared to a growth of \$72.6bn in 2014. In absolute terms, Russian residents’ direct investments abroad decreased most of all (from \$54.5bn in 2014 to \$20.5bn in 2015). Also, note that dubious operations continued to see the downtrend in volume, a decline by \$2.8bn to \$4bn.

Portfolio investment abroad dropped from \$5.6bn in 2014 to \$1.5bn in 2015. Other assets held by nonbank institutions in 2015 saw an increase which was 41.2% less than a year earlier (\$4bn against \$6.8bn in 2014).

Table 5

**Balance of payments' principal accounts and dynamics of external debt
in 2013–2015 (billions of dollars)**

Indicator	2013					2014					2015				
	Q1	Q2	Q3	Q4	Year	Q1	Q2	Q3	Q4	Year	Q1	Q2	Q3	Q4*	Year
Balance of current accounts and of capital accounts	25.0	1.8	-0.3	8.2	34.8	25.8	12.1	6.2	14.3	58.4	29.3	15.9	7.5	13.0	65.8
Financial account (excluding reserve assets)**	13.3	8.2	4.9	19.8	46.2	47.1	27.8	6.0	49.4	130.2	36.7	19.0	2.4	3.1	61.1
Change in foreign exchange reserves ('+' denotes an increase, '-' denotes a decrease in reserves)	4.9	-4.4	-7.4	-15.2	-22.1	-27.4	-10.3	-5.7	-64.2	-107.5	-10.1	-2.2	9.7	3.8	1.3
Net errors and omissions	-6.8	1.9	-2.0	-3.4	-10.3	-5.9	5.4	4.1	2.7	6.2	-2.8	1.1	4.6	-6.1	-3.2
Change in Russia's external debt ('+' denotes an increase, '-' denotes a decrease of debt)	55.3	16.1	8.5	12.6	92.4	-13.0	16.9	-51.9	-81.8	-129.8	-42.9	0.5	-18.5	-22.9	-83.8
Change in Russia's sovereign external debt	3.1	-1.5	6.7	-0.9	7.3	-8.1	3.5	-7.7	-7.8	-20.1	-8.1	2.9	-4.1	-1.6	-10.9
Change in Russian private sector's external debt	48.3	18.2	3.2	15.1	84.8	-4.4	12.6	-43.8	-68.8	-104.3	-35.9	-1.5	-14.4	-22.0	-73.9

* – preliminary estimate; ** – net of foreign currency reserves.

Source: Bank of Russia.

Russia's external debt in 2015 was down by 14% to \$515bn as of January 2016. Note that in 2015 the Russian private sector's external debt was cut by \$73.9bn (down by \$104.3bn in 2014) (see Table 5). Russia's sovereign external debt in 2015 dropped by \$10.9bn, whereas in 2014 it contracted by \$20.1bn.

In its preliminary estimate, the Bank of Russia estimated \$56.9bn in net capital outflow from nonfinancial enterprises in 2015, which is 2.7 times less than in 12M/2014. In 2015, net exports of capital by banks reached \$33.4bn and by private financial enterprises – \$23.5bn. Net capital outflow was worth as little as \$50.2bn, as adjusted for FX operations between banks and the Bank of Russia. Note that in Q3 2015 the Bank of Russia for the first time in a long period

recorded \$1.8bn in net capital inflow in the private sector, as adjusted for operations between banks and the regulator. Q2 2010 was the last time before that, when \$4.1bn in net capital inflow were recorded. The net capital inflow in Q3 2015 was determined by growth of external liabilities of other sectors due to new fundraising, an indication that economic situation was stabilized in some way at that period.

In 2015, net exports of capital by banks reached \$33.4bn, by private nonfinancial enterprises – \$23.5bn. Note that it is extremely difficult to encourage nonresidents to invest in Russia which faces a volatile economic situation worldwide and a recession, the heavy dependence of the Russian economy on exports of energy producing materials, as well as poor quality of institutional environment. As noted above, a key determinant of capital outflow from emerging markets in 2015, like in 2014, was investors’ expectations for the Fed’s QE taper.

We estimate the capital flight (see Fig. 17) was \$7.8bn at the 2015 year-end (\$9.4bn in 2014).¹

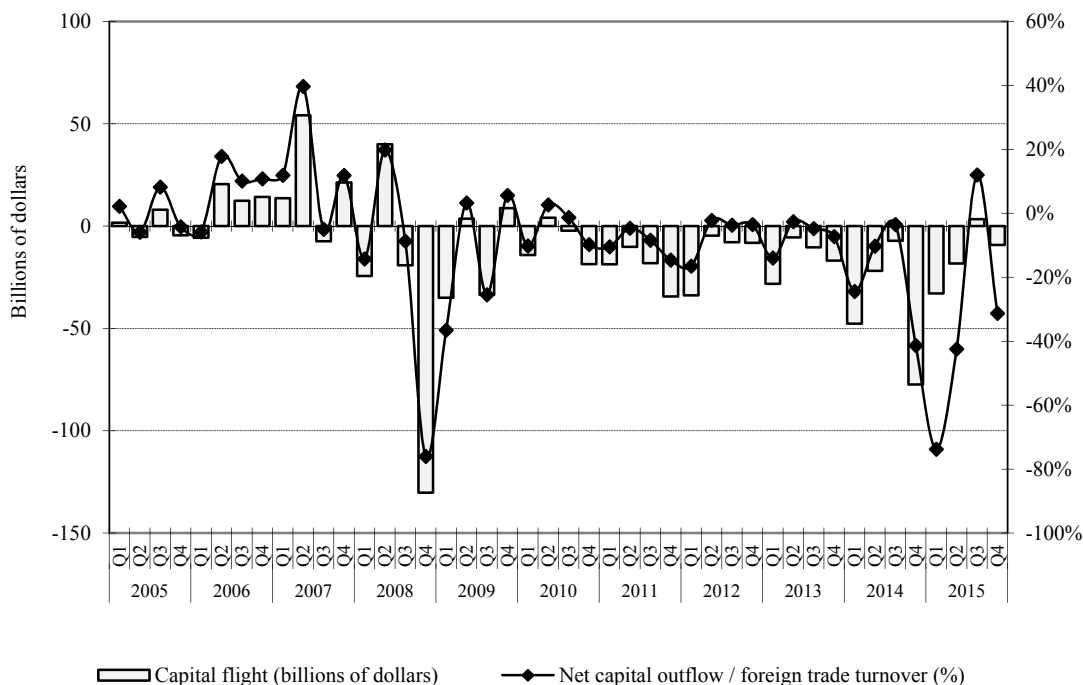


Fig. 16. Dynamics of net capital outflows in 2005–2015

Sources: Bank of Russia, Gaidar Institute’s own calculations.

Overall, the trends towards change in the balance of payments lead to a conclusion that the balance of current accounts will continue to grow in the medium term due to the ruble depreciation and lower demand for imported goods. Bank of Russia’s foreign currency repos, as well as a possible increase in volumes of external financing of other sectors, will contribute to releasing the pressure from the FX market. As a result, the 2016 balance of payments will most likely remain stable, thus helping stabilize the ruble.

¹ We use the IMF method to measure capital flight, that is, the sum of “trade credits and advances”, “dubious operations” and “net errors and omissions.”

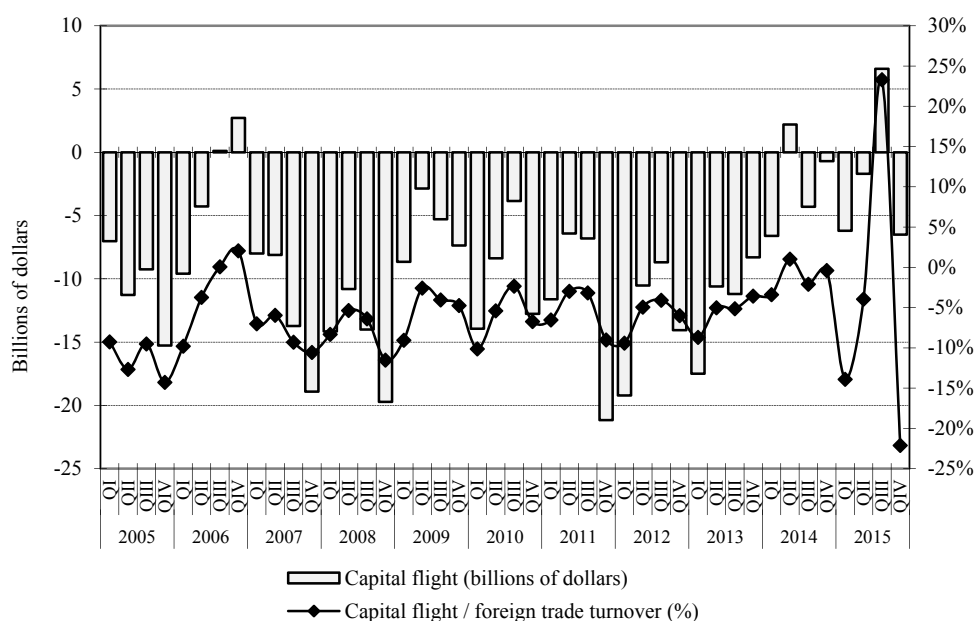


Fig. 17. Dynamics of capital flight in 2005–2015

Sources: Bank of Russia, Gaidar Institute’s own calculations.

2.2. State budget¹

2.2.1. Basic parameters of Russia’s budget system

The basic parameters of budget execution at various levels are shown in *Table 6*. In 2015, the general government increased their budget revenues in absolute terms by Rb 123bn from 2014, however the revenues dropped by 0.9 percentage points of GDP and by 13% in real terms (including CPI). The general government increased their budget expenditure both in nominal terms and as a percentage of GDP by 1.5 percentage points of GDP, whereas expenditure in real terms were cut by 7% over values seen in 2014. As a result, the general government ran their budget with a deficit of 3.5% of GDP (the 2014 budget deficit was 1.1% of GDP). Note that the 2015 deficit was many times the value recorded in 2013–2014, both in absolute terms and as a percentage of GDP, whereas a surplus was recorded in 2011–2012. Thus, in 2015 Russia’s budget system saw its balance deteriorate seriously over values seen in 2011–2014.

In 2015, the federal budget revenues fell by Rb 841bn in nominal terms, by 1.6 percentage points of GDP from 2014, and by 18% a in real terms. The federal budget expenditure increased by 0.4 percentage points of GDP, whereas they were cut by 9% in real terms. The 2015 federal budget ran a deficit 2.4% of GDP, by 2.0 percentage points of GDP above values seen in 2014. Note that while according to the originally approved parameters the 2015 federal budget was projected to run a deficit of 0.6% of GDP,² the April update expected deficit to reach 3.7% of GDP.

¹ Authors of this section: Belev S. – RANEP, Mamedov A. – Gaidar Institute for Economic Policy, Fomina E. – Gaidar Institute for Economic Policy.

² Federal Law “On the Federal Budget for 2015 and the Planning Period of 2016 and 2017” No. 384-FZ dated December 1, 2014. See versions dated April 20, 2015; July 13, 2015; November 28, 2015).

Table 6

State budget revenue and expenditure
in 2011–2015

	2011		2012		2013		2014		2015		Deviation as percentage points of GDP, 2015 or 2014
	rubles in bil- lions	as % of GDP	rubles in bil- lions	as % of GDP	rubles in bil- lions	as % of GDP	rubles in bil- lions	as % of GDP	rubles in bil- lions	as % of GDP	
Federal budget											
Revenues	11366	19.0	12854	19.2	13020	18.3	14497	18.6	13656	17.0	-1.6
Expenditure	10935	18.3	12891	19.3	13343	18.8	14831	19.0	15611	19.4	+0.4
Deficit (-) / Sur- plus (+)	431	0.7	-37	-0.1	-323	-0.5	-334	-0.4	-1955	-2.4	+2.0
Consolidated budgets of subjects of the Russian Federation											
Revenues	7644	12.8	8064	12.0	8165	11.5	8906	11.4	9308	11.6	+0.1
Including inter- budgetary trans- fers	1644	2.8	1680	2.5	1577	2.2	1728	2.2	1617	2.0	-0.2
Expenditure	7679	12.9	8343	12.5	8807	12.4	9353	12.0	9480	11.8	-0.2
Deficit (-) / Sur- plus (+)	-35	-0.1	-279	-0.4	-642	-0.9	-447	-0.6	-172	-0.2	-0.4
General government budget											
Revenues	20853	34.9	23089	34.5	24082	33.9	26371	33.9	26494	32.9	-0.9
Expenditure	20005	33.5	22826	34.1	24931	35.1	27216	34.9	29308	36.5	+1.5
Deficit (-) / Sur- plus (+)	848	1.4	263	0.4	-849	-1.2	-845	-1.1	-2814	-3.5	+2.4
<i>For reference: GDP, rubles in billions</i>	59698		66927		71055		77893		80413		-

Sources: Rosstat, Russia's Ministry of Finance, Gaidar Institute's own calculations.

Consolidated budgets of subjects of the Russian Federation saw less serious changes in 2015. Consolidated budget revenues of subjects of the Russian Federation increased by 0.1 percentage points of GDP. Consolidated budget expenditure of subjects of the Russian Federation stood at 11.8% of GDP, by 0.2 percentage points of GDP below values seen in 2014. Consolidated budget deficit of subjects of the Russian Federation in 2015 decreased by 0.4 percentage points of GDP to -0.2% of GDP.¹

Overall, the general government's budget structure that prevailed in 2015 was characterized by high sensitivity of the Russian budget system to trends in the global energy market, that in 2015 were driven by sharp plunge in prices. Prices of crude oil and of natural gas that started to go down in the mid-2014 continued to fall in 2015. For instance, in 2015, the Urals crude price averaged not higher than \$51 a barrel compared to \$97.6 in 2014.

With shrinking resource base of Russia's budget system, the Reserve Fund at the federal level and debt-based fundraising at regional and municipal levels were important sources of financing of public and municipal expenditure. The dynamics of debt owed by budgets at various levels is shown in *Table 7*.

¹ Refer to the respective section for details on budgets of regions.

Table 7

**Volume of public debt in 2011–2015 by budget system level,
as % of GDP**

	2011	2012		2013		2014		2015	
	value	value	growth	value	growth	value	growth	value	growth
Federal level									
Russia's internal debt	7.0	7.4	0.4	8.1	0.6	9.3	1.2	9.1	-0.2
<i>excluding state guarantees</i>	6.0	6.1	0.1	6.2	0.2	7.0	0.8	6.9	-0.1
Russia's external debt	1.9	2.3	0.4	2.6	0.3	3.9	1.4	4.5	0.6
<i>excluding state guarantees</i>	1.9	1.8	-0.1	2.0	0.3	3.1	1.0	3.5	0.4
Total, rubles in billions	9.0	9.7	0.8	10.6	0.9	13.2	2.6	13.6	0.4
<i>excluding state guarantees</i>	7.8	7.9	0.0	8.3	0.4	10.1	1.8	10.4	0.3
Subnational level									
Debt owed by subjects of the Russian Federation	2.0	2.0	0.1	2.4	0.4	2.7	0.2	2.9	0.2
<i>excluding state guarantees</i>	1.8	1.9	0.1	2.3	0.4	2.5	0.3	2.8	0.2
Debt owed by municipalities	0.4	0.4	0.01	0.4	0.04	0.4	0.00	0.4	0.02
<i>excluding state guarantees</i>	0.3	0.3	0.01	0.4	0.04	0.4	0.00	0.4	0.03

As of January 1, 2016, the Russian Federation owed Rb 10954bn (13.6% of GDP) in sovereign debt, including Rb 7308bn in public internal debt (9.1% of GDP) and \$50002m in public external debt (4.5% of GDP). The total volume of debt in 2015 stood at 0.4 percentage points of GDP (excluding state guarantees, the growth was 0.3 percentage points of GDP). The public external debt saw a more notable increase of 0.6 percentage points of GDP (excluding state guarantees, the increase was 0.4 percentage points of GDP) amid inconsiderable decline in public internal debt (excluding state guarantees, the decline was 0.2 percentage points of GDP and 0.1 percentage points of GDP). As a result, the structure of public debt in 2015 changed due to shrinkage of the share of public internal debt to 66% (from 70–78% in 2011–2014). The volume of public external debt in ruble terms increased as a percentage of GDP mainly due to depreciation of the Russian ruble, whereas it was lower in foreign currency terms than that seen in 2014. In 2015, the volume of ruble state guarantees dropped both in nominal terms (by Rb 30bn) and as a percentage of GDP (by 0.1 percentage points of GDP). This suggests that state guarantees at the federal level were not used for supporting Russian enterprises amid recession.

At the subnational level, in 2015, subjects of the Russian Federation saw their debts increase by 0.2 percentage points of GDP (excluding state guarantees, the debts saw equal changes in value). At the same time, debts at the municipal level increased by 0.02 percentage points of GDP (excluding state guarantees, the growth was 0.03 percentage points of GDP). The data show that state guarantees at the subfederal level were not used actively, too.

Overall, the volume of both federal and subfederal debts is at safe level, posing no threat to macroeconomic stability. As to the regional level, however, the situation differs largely from one region to another.

2.2.2. New tax revenues in Russia's budget system

2015 was the first year after the crisis of 2009, when revenues from all the main taxes dropped in real terms. For instance, tax revenues to Russia's budget system dropped in general by 13.6%, and the tax burden as a percentage of GDP was eased by 1.8 percentage points to 29.8% of GDP (see *Table 8*). As a result, the level of public withholdings in 2015 turned out to be lower than 30.8% of GDP during the crisis of 2009. Analysis of the basic components of tax revenues as a percentage of GDP shows mixed dynamics: revenues from some taxes declined at slower pace than GDP.

Table 8

Revenues from main taxes in the budget of general government of the Russian Federation in 2008–2015, as % of GDP

	2008	2009	2010	2011	2012	2013	2014	2015	Percent change 2015 from 2014	
									as percentage points of GDP	in real terms, %
Tax burden level	35.7	30.8	31.1	34.9	34.6	34.3	31.6	29.8	-1.8	-13.6
Profit tax	6.1	3.3	3.8	4.1	3.8	3.1	3.0	3.2	0.2	-3.1
personal income tax	4	4.3	3.9	3.6	3.7	3.8	3.5	3.5	0.0	-7.9
UST/insurance contributions*	5.1	5.5	4.9	6.3	6.3	6.7	6.1	6.6	0.5	-0.4
VAT	5.1	5.3	5.4	5.8	5.7	5.3	5.1	5.3	0.2	-4.8
Excise duties	0.8	0.9	1.0	1.2	1.4	1.5	1.4	1.3	-0.1	-11.7
the mineral extraction tax	4.1	2.7	3.0	3.7	4.0	3.9	3.7	4.0	0.3	-1.6
Customs duties and charges	8.6	6.8	6.8	8.3	8.0	7.6	7.0	4.1	-2.9	-46.4

* in 2010, the unified social tax (UST) was transformed into insurance contributions charged directly to offbudget funds.

Sources: Russia's Federal Treasury, Rosstat, Gaidar Institute's own calculations.

Drastic decline in the volume of customs duties and charges (by 2.9 percentage points of GDP or by 46.4% in real terms from 2014) contributed most to the decline in general government's budget revenues. In addition to customs duties, only excise duties dropped as a percentage of GDP by 0.1 percentage points of GDP or by 11.7% in real terms. Insurance contributions were ranked first in terms of upward dynamics (an increase of 0.5 percentage points of GDP and a decrease of 0.4% in real terms), followed by the mineral extraction tax (grew up by 0.3 percentage points of GDP and went down by 1.6% in real terms), profit tax (went up by 0.2 percentage points of GDP and slid by 3.1% in real terms), VAT (an increase of 0.2 percentage points of GDP and a decline of 4.8% in real terms), the personal income tax (remained at the level seen in 2014 as a percentage of GDP and dropped by 7.9% in real terms).

The structure of tax budget revenues of the general government is shown in *Fig. 18*. Two aspects are worth noting here. First, insurance contributions became the basic tax withholdings in economy. Second, in 2014 customs duties and charges moved down to third place, giving way to not only insurance contributions but also VAT.

As *Fig. 19* suggests, revenues from the personal income tax and GDP changed at nearly similar pace, so the volume of revenues as a percentage of GDP remained at the level seen in 2014. Given that real personal income continued to fall in 2015 (although cash income increased as a percentage of GDP), regions are expected to face problems while fulfilling their budget commitments in 2016, because their own tax base – with the personal income tax being ranked first – may shrink.

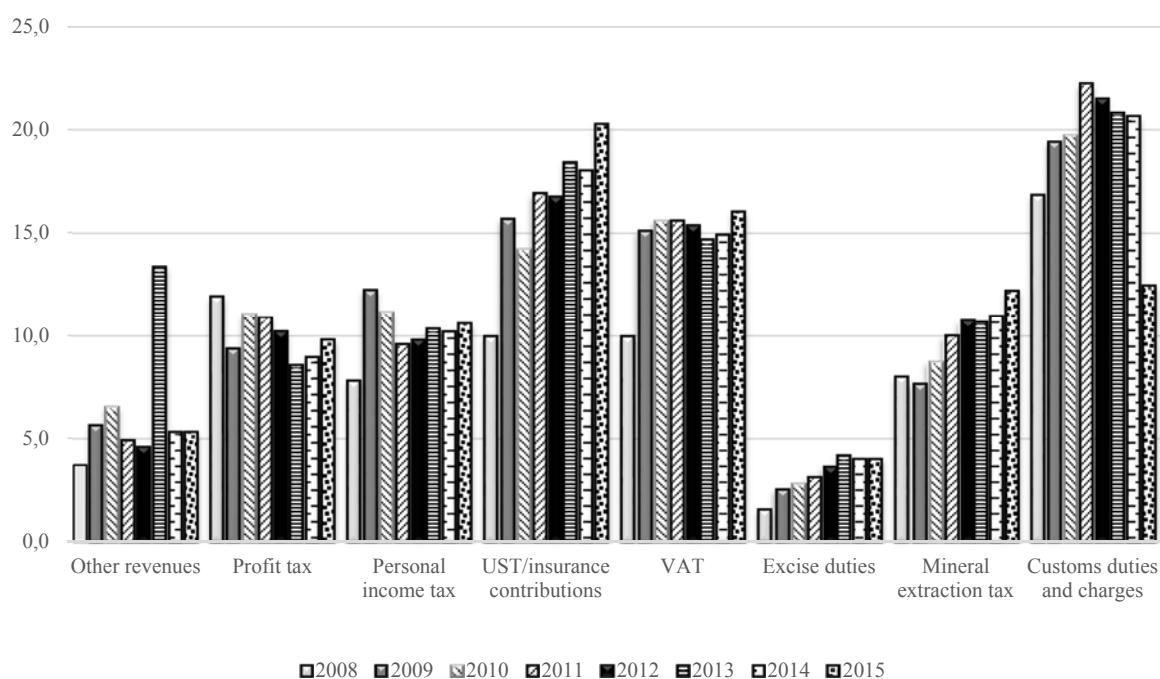


Fig. 18. Share of tax revenues of general government's total budget revenues in 2008–2015, %

Source: Russia's Federal Treasury.

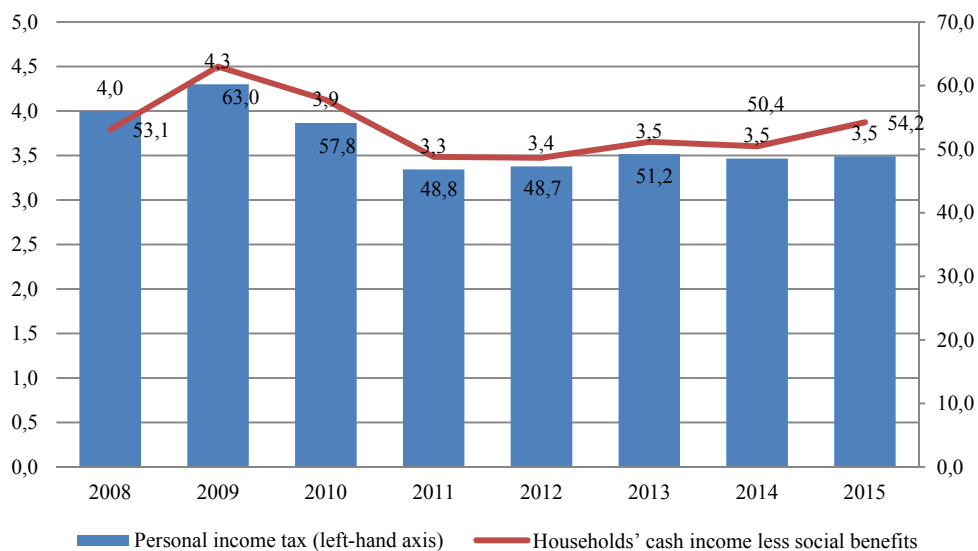


Fig. 19. Comparison between dynamics of personal income tax and dynamics of households' cash income less social benefits in 2008–2015, as % of GDP

Sources: Russia's Federal Tax Service, Rosstat.

2015 saw revenues from profit tax decline in real terms and increase slightly as a percentage of GDP (by 0.2 percentage points). At the same time, the balanced financial result of organizations of all the industries as a percentage of GDP increased more notably from 7.1% to 10.5% of GDP (see *Fig. 20*) in part due to depreciation of the ruble that helped Russian exporting enterprises to enhance competitiveness against foreign manufacturers by partially offsetting the effect of falling aggregate demand, as well as to generate “extra” revenues for such enterprises. At the same time, the share of loss-making organizations of Russia’s economy remained at the level seen in 2014 (28.1%). Overall, the relatively favorable dynamics of the profit tax in 2015 is rather temporal, and it may deteriorate as early as 2016, affecting first of all budget revenues in regions.

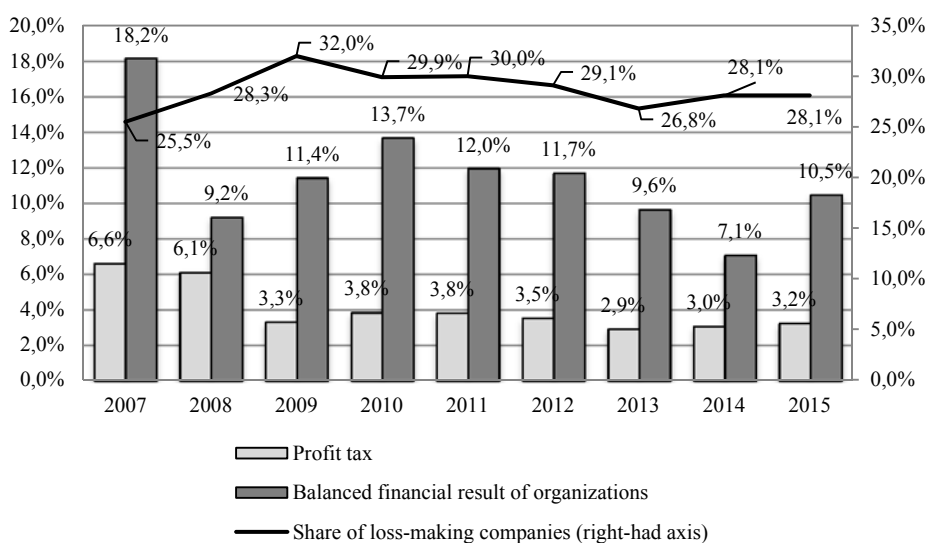


Fig. 20. Dynamics of profit tax revenues in Russia’s state budget, balanced financial result of organizations and share of loss-making companies in 2007–2015, as % of GDP

* based on Rosstat’s preliminary estimates.

Sources: Russia’s Federal Tax Service, Rosstat.

The decline of global crude oil prices in 2015 had a strong adverse effect on federal budget revenues from oil and gas (more than \$40 a barrel of Urals crude oil at prices for tax purposes). In 2015, oil and gas budget revenues plunged below the level seen in 2009 (7.4% of GDP in 2015 compared with 7.9% in 2009) (see *Table 9*). The ruble’s devaluation failed to offset the decline in crude oil prices.

Revenues from the mineral extraction tax increased by 0.3 percentage points of GDP, and the dynamics of the second component, that is, export duties on energy-carrying materials (3.4% of GDP in 2015 against 6.5% in 2014) contributed most to pushing down oil and gas revenues as a percentage of GDP. At the same time, revenues from customs duties on natural gas were driven by more favorable dynamics than those on crude oil and refined petroleum products (see *Table 10*). The difference in dynamics of the oil extraction tax (inconsiderable growth) and customs duties on crude oil and refined petroleum products (sharp plunge), as well as more favorable dynamics of customs duties on gas, are determined first of all by the commencement of a so-called ‘tax maneuver’ in the oil sector in 2015. As part of this oil sector taxation reform, the basic rate of oil extraction tax was lifted from 493 to 766 rubles per ton,

whereas the marginal rate (coefficient in equation) of customs export duties on crude oil was cut from 59% to 42%.

Table 9

**Volume of oil and gas revenues and mineral extraction tax
in 2008–2015**

	2008	2009	2010	2011	2012	2013	2014	2015
Oil and gas revenues, as % of GDP	10.9	7.9	8.4	10.3	10.6	10.0	10.2	7.4
the mineral extraction tax, as % of GDP	4.1	2.7	3.0	3.7	4.0	3.9	3.7	4.0
Crude oil extraction, including gas condensates, tones in millions	488	494	506	512	519	522	525	534
Urals crude average annual price, USD a barrel	90.7	60.7	76.2	109.6	110.6	108.0	97.6	51.0
Central bank's average annual RUB/USD exchange rate, rubles per dollar	24.78	31.90	30.37	29.31	31.05	31.20	38.63	60.98

Sources: Rosstat; Russia's Central Bank; Federal Customs Service, Federal Tax Service; Gaidar Institute's own calculations.

Table 10

**Revenues from customs duties in 2008–2015,
as % of GDP**

	2008	2009	2010	2011	2012	2013	2014	2015
Export duties on energy-carrying materials	6.8	5.2	5.3	6.6	6.6	6.1	6.5	3.4
- on crude oil	4.3	3.1	3.6	4.2	4.0	3.5	3.7	1.8
- on natural gas	1.2	1.1	0.4	0.7	0.7	0.7	0.7	0.7
- on petroleum derivatives	1.3	1.0	1.3	1.7	1.8	1.8	2.1	0.9
Customs duties and charges	8.6	6.8	7	8.4	8.0	7.6	7.0	4.1

Sources: Rosstat; Russia's Federal Treasury; Gaidar Institute's own calculations.

In 2015, VAT on goods sold on the territory of the Russian Federation ("internal VAT") rose slightly as a percentage of GDP (by 0.2 percentage points), whereas VAT on goods imported in the territory of the Russian Federation remained the level seen in 2014 (see *Table 11*). Russia continues to have better tax collection rate of VAT on imported goods over that on goods manufactured in Russia, as well as a downtrend of the VAT effective rate on imported goods.

In 2015, like in 2014, revenues from excise duties went down as a percentage of GDP. As *Fig. 21* suggests, excise duties on tobacco products turned out to be the sole excisable products on which charges increased as a percentage of GDP. At the same time, excise duties on tobacco products were for the first time ranked first in volume of revenues (0.47% of GDP in 2015). A policy of higher-than-inflation indexation of rates resulted in a decline of revenues from excise duties on alcoholic products (from 0.39% in 2014 to 0.34% of GDP in 2015). Revenues from excise duties on refined petroleum products dropped from 0.47 to 0.44% of GDP, too. Revenues from excise duties on sales of motor vehicles and motorcycles continued to make up an inconsiderable share of revenues.

Table 11

**Dynamics of imports and VAT revenues in Russia's budget system
in 2008–2015, as % of GDP**

	2008	2009	2010	2011	2012	2013	2014	2015
VAT revenues	5.2	5.3	5.4	5.8	5.7	5.0	5.1	5.3
VAT on goods sold on the territory of the Russian Federation	2.4	3.0	2.9	3.1	3.0	2.6	2.8	3.0
VAT on goods imported in the territory of the Russian Federation	2.8	2.3	2.5	2.7	2.7	2.4	2.3	2.3
VAT effective rate ¹ , %	8.4	7.6	8.2	9.3	8.3	7.4	7.0	7.2
VAT effective rate on goods sold on the territory of the Russian Federation ²	5.4	5.5	5.8	6.9	6.4	5.7	5.5	5.8
VAT effective rate on goods imported in the territory of the Russian Federation ³	12.5	11.0	11.9	12.3	12.1	11.1	10.7	10.4
Imports*	22.1	20.5	21.1	21.9	22.4	21.1	20.9	21.3

*Share of imports of GDP was measured as the ratio of imports values based on Rosstat's data and GDP.

Sources: Rosstat; Russia's Ministry of Finance; Gaidar Institute's own calculations.

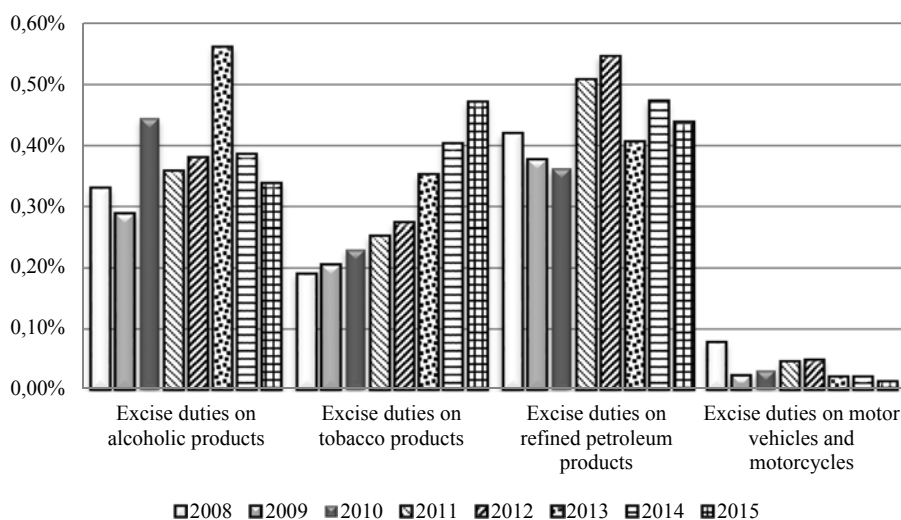


Fig. 21. 2008–2015 revenues from excise duties by group of excisable goods, as % of GDP

Source: Russia's Federal Treasury.

Note that efforts to turn excise duties into a source of budget revenues are exposed to serious risks that elasticity of demand for respective goods might happen to be so high as to lead eventually to decline in charges. Table 12 shows that consumption of all types of alcoholic and tobacco products continued to decline in 2015. Thus, alcoholic products faced the risk in practice.

¹ The ratio of VAT revenues to final consumption.

² The ratio of revenues from VAT on goods sold on the territory of the Russian Federation to final consumption less the value of imports.

³ The ratio of revenues from VAT on goods imported in the territory of the Russian Federation to the value of imports.

Table 12

**Volume of alcoholic and tobacco products consumed in Russia
in 2008–2015,
dL in millions**

Product	2008	2009	2010	2011	2012	2013	2014	2015
Alcoholic products								
vodka and liqueurs and spirits	177.2	166.1	157.8	156.4	153.0	133.6	112.4	104.9
Vine products (except champagne and sparkling vines)*	102.9	102.5	103.4	97.1	93.6	83.6	90.4	89.6
low-alcohol beverages (with ethanol content of 9% or less)	–	–	31.9	31.4	26.9	23.3	17.8	13.8
cognac, brandy spirits (including brandy, calvados)	10.8	10.6	11.1	11.6	12.4	12.1	11.5	11.0
Champagne and sparkling vines	26.0	25.5	27.3	28.5	28.3	27.7	26.4	24.6
Beer	1138.2	1024.7	1004.0	1011.5	1017.5	984.2	895.9	868.1
Cigarettes, pieces in billions	393.6	398.7	371.8	358.0	355.7	359.1	338.6	326.7

*Until 2012, ‘Grape and Fruit Vines’.

Source: Rosstat.

Overall, 2015 turned out to be an extremely off year for state budget revenues: all types of tax revenues dropped in real terms. Oil and gas revenues of the federal budget were hit the hardest amid drastic slump of global crude oil prices, whereas budget revenues in regions saw “extra” profit tax revenues due to devaluation of the Russian ruble. However, one should realize that this effect covered a limited number of subjects of the Russian Federation, whose economy relies on export-oriented industries such as oil and gas sector, metallurgy etc.

2.2.3 Characteristics of Russia’s budget system

With a decline of 0.9 percentage points of GDP in budget revenues of the general government in 2015, the volume of the country’s budget system saw a reverse dynamics, that is, a growth of 1.6 percentage points of GDP (see *Table 13*).

Table 13

General government budget expenditure in 2011–2015, as % of GDP

	2011	2012	2013	2014	2015	Change 2015 from 2014, percentage points of GDP
Expenditure, total	35.5	34.1	35.1	34.9	36.5	1.6
General National Issues	2.8	2.7	2.8	2.8	3.1	0.3
Public and Municipal Debt Service	0.6	0.6	0.6	0.7	0.8	0.1
National Defense	2.5	2.7	3.0	3.2	4.0	0.8
National Security and Law Enforcement	2.5	2.9	3.0	2.8	2.6	-0.2
National Economy	4.7	4.9	4.6	5.8	4.7	-1.1
Housing and Utilities	2.0	1.6	1.5	1.3	1.2	-0.1
Environmental Protection	0.06	0.06	0.07	0.09	0.09	0
Education	3.7	3.8	4.0	3.9	3.8	-0.1
Culture, Cinematography and Means of Mass Media	0.7	0.7	0.8	0.7	0.7	0.0
Healthcare and Sports	3.5	3.7	3.6	3.6	3.9	0.3
Social Policy	10.9	11.0	11.8	10.8	12.5	1.7

Sources: Russia’s Federal Treasury, Rosstat; Gaidar Institute’s own calculations.

In 2015, the general government saw serious changes in their budget expenditure: values of financing of various types of expenditure in 2015 varied from 2014 within a range of 0.1 and 1.7 percentage points of GDP.

The biggest expenditure were recorded for ‘Social Policy’ (an increase of 1.7 percentage points of GDP and of 3.5% in real terms). At the same time, expenditure for social policy increased mainly for ‘Pension Provision’ and ‘Other Matters Related to National Policy’. As a result, expenditure for ‘Pension Provision’ remained at the level seen in 2014 (declined by 1.1% in real terms). However, indexation of pensions in 2015, namely the insurance part of labor pension by 11.4% (from February 1, 2015) and social pensions by 10.3% (since April 1, 2015), was not followed by higher pension payments: the actual inflation rate (12.9%) was above indexation rates. Additionally, in 2015 pension accruals were transferred to nongovernment pension funds at 2013 year-end (the transfer was “frozen” in 2014 simultaneously with “freezing” the transfer of new contributions of the then current year of 2014 to the funded pension component), which explains the growth of expenditure for ‘Other Matters Related to National Policy’.

The uptrend since 2011 towards expenditure for ‘National Defense’ continued in 2015, an increase by 0.8 percentage points of GDP. Military spending in real terms reached 11% (total expenditure were cut by 7%). The increase in government spending for this line item is first of all associated with further implementation of measures as part of the State Armament Program for 2011–2020.

Additionally, expenditure for ‘General National Issues’ and ‘Healthcare and Sports’ increased slightly each by 0.3 percentage points of GDP, however a minor decrease within 1% was reported in real terms for each of the line items. A detailed analysis of expenditure for healthcare shows a decline in expenditure for ‘Inpatient Medical Assistance’ and ‘Outpatient Medical Assistance’. At the same time, expenditure for ‘Other Healthcare Matters’ increased notably in real terms by about 8%. The growth in expenditure for ‘Other Healthcare Matters’ was possibly determined by increased funding of, above all, certain measures implemented as part of the Healthcare Development Program financed under this line item. As a result, a redistribution of funds between financing the expenditure for inpatient and outpatient medical assistance was performed in favor of financing the Healthcare Development Program.

In 2015, government spending for ‘National Economy’ were cut considerably by 1.1 percentage points of GDP (nearly 4.7% of GDP). However, note that the decline below the 2014 parameters is technical and related to Rb 1 trillion in asset contribution from the federal budget to the Deposit Insurance Agency (DIA), that took place late in 2014.¹ The appropriation was envisaged as part of state support for the banking sector. Excluding the contribution, the expenditure for the national economy in 2014 would make up less than 4.5% of GDP. Overall, the level of financing measures of support for the national economy in 2015 is comparable with that in 2011–2013 (4.6–4.9% of GDP). Extra spending for support of the banking sector via the DIA can be actually attributed to both 2014 (when the foregoing operation was performed) and to 2015 (when the DIA could have spent the funds). Thus, with mounting crisis developments in the economy, government expenditure for the national economy increased in 2014–2015 as part of spending on anti-crisis measures.

In 2015, national defense expenditure continued to decline to 2.6% of GDP, by 0.2 percentage points of GDP below the level seen in 2014, and they were cut in nominal terms, too. The rest of the budget expenditure line items saw no notable changes in 2015 (within 0.1 percentage points of GDP).

¹ In December 2014, these funds were transferred using federal government bonds (OFZ) and were allocated to increase banks’ capital. The DIA was entitled to use the contribution to increase the capital of systemically important banks whose capital is worth not less than Rb 100bn.

In general, note that in 2015 the prevailing upward dynamics of the general government's budget and the resource base shrinkage contradict in a way the policy aimed at spending less budget funds in order to prevent the risk of "inflation spiral" and of higher than normal deficit in the budget system. Also, what raises concern is the decrease in real terms of "productive" expenditure for education and healthcare amid growing "nonproductive" expenditure for defense and social policy. It is important to realize that the decline in expenditure for human capital may worsen the problem of Russia's economy entering a new growth path in the mid- and long term perspective.

2.2.4. Basic parameters of the 2015 federal budget and outlooks for 2016

The federal budget revenues in 2015 (see *Table 14*) stood at 17.0% of GDP, a decline of 1.6 percentage points of GDP below the value seen in 2014, and the decline was driven by falling oil and gas revenues. In 2015 they were 2.4 percentage points of GDP below parameters seen in 2014. At the same time, oil and gas revenues reached nearly 9.7% of GDP, an increase by 0.8 percentage points of GDP over the value seen in 2014. The volume of federal budget expenditure increased by 0.4 percentage points of GDP to 19.4% of GDP. Overall, the 2015 federal budget ran a deficit of 2.4% of GDP, a growth of 2.0 percentage points of GDP over the value seen in 2014. Furthermore, oil and gas deficit stood at 9.7% of GDP, a decline by 0.4 percentage points of GDP over the value seen in 2014.

Table 14

**Federal budget basic parameters
in 2011–2016**

	Actually executed				2015 executed	2016		Deviation in 2015 from 2014, per- centage points of GDP
	2011	2012	2013	2014		Federal Budget Law for 2015– 2017	Federal Budget Law for 2016*	
Revenues	19.0	19.2	18.3	18.6	17.0	19.0	17.5	-1.6
Including:								
oil and gas revenues	9.6	9.8	9.3	9.7	7.3	9.7	7.7	-2.4
oil and gas revenues	9.4	9.4	9	8.9	9.7	9.3	9.8	+0.8
Expenditure	18.3	19.3	18.8	19.0	19.4	19.6	20.5	+0.4
Including: conditionally approved	0	0	0	0	0	0.5	0	0
Deficit (-)/ surplus (+)	+0.7	-0.1	-0.5	-0.4	-2.4	-0.6	-3.0	+2.0
Oil and gas deficit	-8.9	-9.9	-9.8	-10.1	-9.7	-10.3	-10.7	-0.4
GDP, rubles in billions	59.698	66.926	71.055	77.893	80.412	83.208	78.673	-
Urals crude price, USD**	109.6	110.6	108.0	97.6	51.0	96.0	50.0	-

* Federal Law "On the Federal Budget for 2016" No. 359-FZ dated December 14, 2015.

** Average annual value.

Sources: Russia's Federal Treasury, Gaidar Institute's own calculations.

The 2015 federal budget parameters were updated due to a worsening macroeconomic situation early in 2015. The federal budget law was updated three times in 2015 (in April, July, and in November). Updates to the key macroeconomic indicators budgeted for 2015 were approved in April, whereby the crude oil price was down from \$100 to \$50 a barrel, the ruble to US dollar exchange rate was up from 37.7 to 61.5 rubles per dollar, the inflation rate was up from 5.5% to 12.2%. Given the approved updates, the forecast for revenues was downgraded by 2.4 percentage points of GDP, and the expenditure plan increased by 0.8 percentage points of GDP,

with the result that budget deficit increased to 3.7% of GDP (a growth of 3.1 percentage points of GDP). The updates in July 2015 concerned Rb 20.1bn in financing of measures to ensure sustainable economic growth and social stability. A share of the funds was allocated to support the economy in the form of deposits and grants to joint-stock companies and federal unitary enterprises; the volume of grants to strategically important organizations of the Military-Industrial Complex (MIC) increased, too. Updates to the basic macroeconomic and budget parameters (increase of GDP, growth in federal budget revenues and expenditure) took effect in November 2015.

Let's analyze in detail the ultimate parameters of federal budget execution in 2015.

Overall, tax revenues dropped considerably by 2.6 percentage points of GDP below the level seen in 2014. Analysis of the structure of tax revenues (see *Table 15*) shows that in relative terms revenues from the mineral extraction tax increased by 0.3 percentage points of GDP, revenues from VAT on goods sold on the territory of the Russian Federation were up by 0.2 percentage points of GDP, and revenues from the corporate profit tax rose by 0.1 percentage points of GDP. In 2015, the year-end revenues from customs duties plunged sharply by 2.9 percentage points of GDP. The dynamics of mineral extraction tax and customs duties was driven by two factors, namely by the decline of global crude oil prices and by the abovementioned "tax maneuver" in the oil sector. Revenues from VAT on goods imported in the territory of the Russian Federation, and from excise duties (both "import" and "internal" ones) remained at levels (expressed as a percentage of GDP) seen in 2014.

Table 15

**Main tax revenues of federal budget
in 2014–2015**

	January-December 2014		January-December 2015		Change as per- centage points of GDP
	rubles in billions	% of GDP	rubles in billions	% of GDP	
Tax revenues, total	13.366	17.2	11.886	14.8	-2.4
corporate profit tax	411	0.5	491	0.6	0.1
VAT on goods sold on the territory of the Russian Federation	2.181	2.8	2.448	3	0.2
VAT on goods imported in the territory of the Russian Federation	1.750	2.2	1.785	2.2	0.0
excise duties on goods manufactured on the territory of the Russian Federation	521	0.7	528	0.7	0.0
excise duties on goods exported to the territory of the Russian Federation	72	0.1	54	0.1	0.0
mineral extraction tax	2.858	3.7	3.160	3.9	0.3
revenues from foreign economic activities (customs duties)	5.445	7.0	3.295	4.1	-2.9

Sources: Russia's Federal Treasury, Gaidar Institute's own calculations.

All things considered, the following can be concluded: the dynamics of tax revenues of the federal budget in 2015–2016 was determined basically by a decline in oil and gas revenues amid falling global crude oil prices, whereas main types of non-oil and gas revenues were relatively stable.

Table 16 presents actual execution of the federal budget in 2015 in terms of functional classification of expenditure.

Table 16

**Federal budget expenditure in 2014–2015
(functional classification of expenditure)**

	2014		2015		Change as percentage points of GDP
	rubles in billions	as % of GDP	rubles in billions	as % of GDP	
Expenditure total, including:	14.831	19.0	15.611	19.4	0.4
General National Issues	1.350	1.7	1.627	2.0	0.3
National Defense	2.479	3.2	3.181	4.0	0.8
National Security and Law Enforcement	2.086	2.7	1.966	2.7	-0.2
National Economy	3.063	3.9	2.324	2.9	-1.0
Housing and Utilities	120	0.2	144	0.2	0.0
Environmental Protection	46	0.1	50	0.07	0.0
Education	638	0.8	611	0.8	-0.1
Culture and Cinematography	98	0.1	90	0.1	0.0
Healthcare	536	0.7	516	0.6	0.1
Social Policy	3.452	4.4	4.265	5.3	0.9
Physical Culture and Sports	71	0.1	73	0.1	0.0
Mass Media	75	0.1	82	0.1	0.0
Public Debt Service	416	0.5	519	0.7	0.1
General Purpose Inter-Budget Transfers	816	1.0	682	0.9	-0.2

Sources: Russia's Finance Ministry, Gaidar Institute's own calculations.

Overall, the federal budget expenditure in 2015 were 0.4 percentage points of GDP above those in 2014. However, the inflation-adjusted expenditure in 2015 was down by 9%. Spending for 'Social Policy' increased by 0.9 percentage points GDP, for 'National Defense' by 0.8 percentage points of GDP, for 'General National Issues' by 0.3 percentage points of GDP, and for 'Public Debt Service' by 0.1 percentage points of GDP. Note that in 2015 the expenditure for the above listed line items increased not only as a percentage of GDP but also in real terms: the dynamics of growth varied between 4% and 11%.

In terms of equality in spending, note that in January-March 2015 military spending were higher than other types of expenditure. For instance, in January, allocations accounted for 21.6% of the updated quarterly expenditure worksheet for 2015, and for 49.2% as a whole in January-March. This effect was smoothed in the months that followed in 2015. The drastic growth in military spending in 2015 was driven first of all by financing of measures envisaged as part of the state defense order. The growth of 7% in social spending in real terms was driven first of all by the growth (by 13% in real terms) in the pension provision expenditure due to indexation of pensions.

The expenditure for 'National Economy' were cut the most, by 1.0 percentage points of GDP. As noted above, the wide gap in volumes of expenditure in support of the economy in 2014 and 2015 is partially "technical" and related to appropriations to the DIA for support of the banking sector. Additionally, federal budget expenditure for 'National Security and Law Enforcement' were cut by 0.2 percentage points of GDP, for 'Inter-Budget Transfers' by 0.2 percentage points of GDP and for 'Education' by 0.1 percentage points of GDP. Note that even expenditure related to investment in human capital – most "productive" government expenditure – were cut in nominal terms. In real terms, the federal budget expenditure for education and healthcare reached about 17% in 2015.

Table 17 presents the dynamics of federal government spending budget as regards to operations in the public administration sector (economic classification of expenditure).

**Federal budget expenditure in 2011–2015
(economic classification of expenditure)**

	2011	2012	2013	2014	2015
<i>Total expenditure, rubles in billions</i>	10.935	12.891	13.343	14.832	15.611
Growth in real terms, %	-0.3	12.2	-3.0	3.1	-8.9
including:					
<i>Investment expenditure, rubles in billions</i>	1.660	1.753	1.659	1.773	2.476
Growth in real terms, %	7.5	0.5	-11.4	-0.9	20.9
Including growth in the value of shares and other types of shareholding	410	505	315	264	388
Growth in real terms, %	14.4	17.3	-41.6	-22.3	27.3
<i>Current expenses, rubles in billions</i>	9.275	11.137	11.684	13.059	13.135
Growth in real terms, %	-1.6	14.3	-1.7	3.7	-12.9

Sources: Russia's Federal Treasury; Gaidar Institute's own calculations.

The dynamics of federal budget expenditure slowed down in real terms by 8.9% in 2015 from 2014. Current expenses made up most of the structure of federal budget expenditure. The 12.9% decline in current expenses was responsible largely for the decline in total amount of expenditure. By contrast, investment expenditure increased in real terms by 21% against the 0.9% decline a year earlier. Budget investment increased considerably (about 39%) due the growth under the item 'Increase in the value of fixed assets', that was determined possibly by increase in spending related to the state defense order. It is difficult to perform quantitative assessment due to a lack of data as regards to classification of operations in the state administration sector for a few expenditure items in the Federal Treasury's reports. The volumes of budget financing for 'Growth in the value of shares and other types of shareholding' were declining steadily in nominal terms throughout the entire period of 2013–2014, possibly evidencing that charter capital contributions and purchases of shares became a less important tool of supporting enterprises. However, in 2015 this trend gave way to a 27% increase in real terms in these expenditure.

The Russian government's policy aimed at curtailing growth and cutting back gradually on the volume of government spending appears reasonable. It is unreasonable and highly risky to increase the volume of expenditure by increasing the volume of deficit. The current level of federal budget expenditure is above the level of corresponding current macroeconomic context. Government expenditure were too "fat" in the period of high crude oil prices, with further growth thereof during the crisis of 2009–2010, but then they were cut down to the pre-crisis level of 18% of GDP (the expenditure have recently been steadily above 20% of GDP).

The principal feature of the **2016 federal budget** was the need to adapt to the new context of very low oil prices of about \$30–40 a barrel, whereas the federal budget was approved on the assumption that the crude oil price is \$50 a barrel, and the budget balance is reached when the oil is traded at \$82 a barrel, as estimated by Russia's Finance Ministry.¹

Given the fact that the key macroeconomic indicators are volatile and difficult to forecast, the 2016 federal budget was adopted for a single year (as was the case with the 2010 budget). However, as early as May 2015, the Russian Government considered a three-year budget plan for 2016–2018 (the Urals crude was projected at \$60–65–70 a barrel respectively).²

¹ <http://www.minfin.ru/ru/#ixzz3yTTiNNKR>

² <http://government.ru/news/17821/>

As early as the fall of 2015, the 2016 federal budget parameters were updated seriously from the original version approved as part of the law on the federal budget for 2015–2017. The resource base of the federal budget was reduced substantially by 1.5 percentage points of GDP (to 17.5% of GDP) below the parameters that were set originally. Federal budget revenues dropped in response to expectations for further decline in oil and gas budget revenues to 7.7% of GDP (against 9.7% of GDP) as a result of falling crude oil prices globally. Federal budget revenues for 2016 were estimated on the assumption that the crude oil price is \$96 a barrel in the original version of the mid-term forecast and \$50 a barrel in the single year version. The approved volume of expenditure reached 20.5% of GDP, nearly 1 percentage point of GDP above the originally set targets. As a result, federal budget deficit increased to 3% of GDP against that of 0.6% of GDP in the original version. However, given that in Q1 2016 the crude oil price was way less than \$50 a barrel, it is highly likely that even the single year budget parameters will have to be updated within the fiscal year.

The complexity of the situation is that, on the one hand, a balance between searching for new sources of the resource base and cutting back on inefficient commitments has to be reached, and, on the other hand, the possibility of recovering Russia's economy and entering a new growth path should not be undermined. Budget deficit may double in 2016 and the Reserve Fund may be fully depleted in the absence of government's adequate measures of tactical response (for 2016) and strategic response (for 2017–2019) towards optimizing the 2016 budget expenditure, and if the current crude oil prices remain the same in the medium term,.

In terms of adjusting their expenditure commitments in 2016, the Russian government plan to cut back on the approved volumes of budget expenditure. For instance, plans to optimize federal spending may include a 10% cut-back on all the unprotected budget line items, thereby saving about Rb 500–700bn, as estimated by the Russian government. Budget holders are expected to analyze by themselves their own budgets and to decide on cutting back on inefficient spending thereof (in a volume of 10%). Officially, this is not just cutting volumes in all the expenditure items, this is cutting the inefficient component thereof. This is where the major challenge resides. Each of the federal budget expenditure contains expenditure that may be recognized as inefficient by an audit, as evidenced by audits conducted by Russia's Chamber of Accounts. However, does it suggest 10% cuts on all the expenditure?, especially on the "protected sectors" such as defense and social policy, as well as the "protected items" such as wages of public employees in every expenditure item. Further technical cuts of expenditure for educational and medical institutions may result in some institutions running short of funds and being unable to cover even their current expenses (other than wages). As a result, just mere cuts on financing are exposed to high risks if the budget institution network undergoes no reform. Therefore, while introducing new updates to budget expenditure, it is very important to avoid new "technical cuts" (although this is relatively easy to do) and to identify budget expenditure that are really inefficient. Additionally, it is significant that a variable approach is introduced into the practice of budget planning (like in New Zealand or Austria), predefining beforehand the expenditure to be cut if the macroeconomic context happens to be worse than the forecast (in the Russian practice this could be done as part of state programs, specifying "mandatory" and "supplementary" parts in each program).

2.3. Intergovernmental fiscal relations and subnational finance¹

2.3.1. Analysis of principal parameters of consolidated budgets of subjects of the Russian Federation

The revenues and expenditure structure of consolidated budgets of the Russian Federation reflects main trends in relations between various levels of public administration. *Fig. 22* presents data reflecting the share of tax revenues and expenditure of subjects of the Russian Federation, that are expressed as corresponding indicators of Russia's consolidated budget.

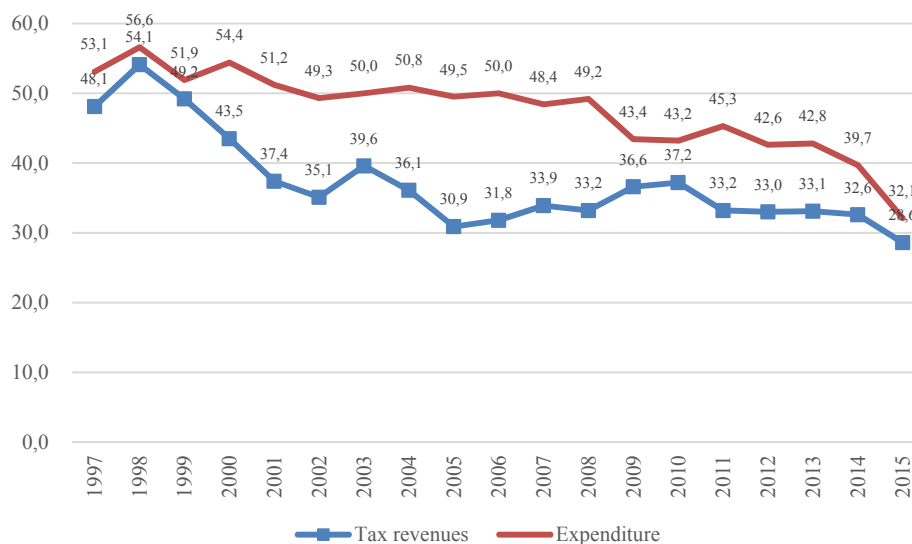


Fig. 22. Share of tax revenues and of subnational budget expenditure of Russia's consolidated budget in 1997–2015

Note: No calculations were made for regions of the Crimean Federal Okrug.

Sources: Russia's Federal Treasury, Gaidar Institute's own calculations.

In 2015, the share of subnational budget expenditure of the Russian Federation consolidated budget dropped considerably from 39.7% in 2014 to 32.1% in 2015 (excluding expenditure for the Crimean Federal Okrug). The share of tax revenues shrank to a lesser extent, from 32.6% to 28.6%, during the same period. The decline in the share of subnational budget expenditure of the total volume of Russia's consolidated budget expenditure is explained largely by faster-than-normal growth of the federal budget expenditure (by 5.6% in nominal terms). The federal budget expenditure increased first of all for 'General National Issues' (by 18.6%), 'National Defense' (by 28.3%), 'Housing and Utilities' (by 20.5%), 'Social Policy' (by 23.5%), 'Municipal and Public Debt Servicing' (by 24.8%). Subnational budget expenditure increased in the period under review by 1.4% (excluding expenditure for the Crimean Federal Okrug).

Let us analyze in detail the revenue side of subnational budgets. The dynamics of principal components of consolidated budget revenues of subjects of the Russian Federation are shown in *Table 18*.

¹ Authors of this section: Authors of this section: Alaev A. – Gaidar Institute for Economic Policy, Mamedov A. – Gaidar Institute for Economic Policy, Fomina E. – Gaidar Institute for Economic Policy.

Table 18

**Consolidated budget revenues of subjects of the Russian Federation
in 2008–2015**

	Volume of revenues (in nominal terms), rubles in billions								Growth in real terms, %			
	2008	2009	2010	2011	2012	2013	2014	2015	2009/ 2008	2015/ 2008	2014/ 2013	2015/ 2014
Revenues, total	6.196	5.924	6.537	7.644	8.064	8.165	8.743	9.191	-12.1	-17.2	-3.8	-8.6
Tax and nontax revenues	4.912	4.243	4.980	5.827	6.385	6.588	7.141	7.585	-20.6	-13.8	-2.7	-6.4
<i>Including tax revenues:</i>	4.384	3 792	4.520	5 273	5.800	5.967	6.461	6.890	-20.5	-12.3	-2.8	-6.0
profit tax	1.752	1.069	1.520	1.928	1.980	1.720	1.962	2.099	-43.9	-33.1	2.4	-5.2
personal income tax	1.666	1.665	1.790	1.996	2 261	2.499	2 679	2.788	-8.1	-6.6	-3.7	-7.9
Taxes on total income	161	152	179	215	272	293	314	346	-13.6	19.8	-3.8	-2.7
property taxes	493	570	628	678	785	901	955	1 067	6.1	20.7	-4.8	-1.3
excise duties	189	246	327	372	442	491	479	484	19.2	42.6	-12.4	-10.5
Transfers	1.131	1.486	1.398	1.644	1.624	1.515	1.545	1.538	20.7	-24.1	-8.4	-18.5
Other revenues	153	195	159	173	56	62	57	68	17.4	-75.1	-17.4	4.8

Note: No calculations were made for regions of the Crimean Federal Okrug.

Sources: Russia's Federal Treasury, Gaidar Institute's own calculations.

The data in *Table 18* show that in 2015 consolidated budget revenues of subjects of the Russian Federation dropped in real terms by 8.6% from the level seen in 2014. The 2015 decline in real terms in the total level of revenues was driven by a fall in retail trade turnover (a 10% decline below the level seen in 2014), in the volume of fixed investment (-8.4%), that is, an economic slowdown that was reflected in the 3.7% fall of GDP. Furthermore, inflation rate reached 12.9% in 2015, the highest since 2003, which affected inevitably the dynamics of fiscal indicators in real terms.

The above listed adverse factors dragged down in real terms all the principal sources of revenues of subnational budgets. The personal income tax fell the deepest among major types of taxes, driven by negative dynamics of revenues for two consecutive years (-3.8% in 2014, -7.9% in 2015). The structure of tax revenues was changed accordingly: the share of the personal income tax was down from 41.5% to 40.5%, whereas the share of profit tax – another source of budget revenues – increased slightly from 30.4% to 30.5%. Note that in 2015 profit tax revenues dropped by 5.2% in real terms, too. Revenues from aggregate income taxes and property taxes declined less, by 2.7% and 1.3% respectively. Subnational budget revenues from excise duties continued to fall at fast pace (a decline of 12.4% in 2014 and of 10.5% in 2015).

In 2015, nontax revenues dropped on an annualized basis (a decline in real terms of 9.5%). As a result, the share of this source of revenues of the total structure of consolidated budget revenues of subjects of the Russian Federation shrank inconsiderably from 7.8% to 7.6%. It is significant that intergovernmental fiscal transfers in 2015 decreased in real terms by 18.5% amid falling tax and nontax revenues of consolidated budgets of subjects of the Russian Federation.¹

Let us analyze tax and nontax revenues at the regional level (see *Table 19*).

¹ Detailed analysis of the dynamics of federal budget transfers is made below.

Table 19

Grouping Russia's regions according to changes in major types of tax and nontax revenues of consolidated budgets of subjects of the Russian Federation in 2015

	Change in major types of tax and nontax revenues of consolidated budgets of subjects of the Russian Federation					
	growth by more than 25%	growth by 10 to 25%	growth by less than 10%	decline by less than 10%	decline by 10 to 25%	decline by more than 25%
in nominal terms						
Tax and nontax revenues, total	2	16	49	15	1	0
Profit tax	15	16	15	12	15	10
Personal income tax	0	4	56	23	0	0
in real terms						
Tax and nontax revenues, total	2	0	9	48	24	0
Profit tax	9	6	10	19	21	18
Personal income tax	0	0	2	41	40	0

Notes: 1. Arkhangelsk Region and Nenets Autonomous Okrug are presented as a single subject of the Russian Federation. 2. No calculations were made for regions of the Crimean Federal Okrug.

Sources: Russia's Federal Treasury, Gaidar Institute's own calculations.

The presented data show that the situation with own-source revenues of subnational budgets remained as much challenging as it was in 2013–2014 in most Russia's regions.¹ In 2015, 72 regions (71 regions in 2014) saw their own-source revenues of subnational budgets decline in real terms, including 48 regions facing a decline of about 10%. Profit tax revenues dropped across the country, and 18 regions saw their profit tax revenues fall by more than 25% in real terms. The deepest fall in profit tax revenues was recorded in the Republic of Tyva (-50.6%), Chechen Republic (-56%), Republic of Mordovia (-76.1%). Overall, the profit tax dropped in real terms in 58 regions. The rest 25 regions saw their profit tax revenues grow in real terms, and in nine subjects of the Russian Federation this tax increased by more than 25%, namely Tambov Region (29.3%), Republic of Karelia (50.1%), Murmansk Region (34.8%), Kirov Region (32.2%), Chelyabinsk Region (27.2%), Republic of Buryatia (108.6%), Magadan Region (49.1%), Sakhalin Region (64.0%), Chukotka Autonomous Okrug (81.1%). Profit tax revenues in the Sakhalin Region increased considerably as a result of implementation of oil and gas projects Sakhalin-1 and Sakhalin-2 as part of production sharing agreements. Profit tax revenues in the Republic of Buryatia soared due to large export-oriented manufacturing facilities (first of all, the Ulan-Ude Aviation Plant). Accordingly, depreciation of the Russian ruble pushed up currency proceeds, and the profit tax charged to the regional budget was on the rise accordingly. Only two subjects of the Russian Federation saw their own-source revenues grow up by more than 25%: Sakhalin Region (31.4%) and Chukotka Autonomous Okrug (28.3%). Revenues from the personal income declined in almost all the regions (81). A minor growth in the personal income tax was recorded only in Belgorod Region (3.7%) and Republic of Mordovia (8.2%).

Let us next analyze changes to the expenditure side of consolidated budgets of subjects of the Russian Federation in 2015 (see *Table 20*).

Overall, given a decline, in real terms, of both tax/nontax revenues and federal budget transfers, and with the debt accumulated by a few subjects of the Russian Federation, Russian subnational authorities conducted a conservative fiscal policy: total volume of expenditure increased only by 1.4% in nominal terms, resulting in a decline of 10.2%, as adjusted for inflation.

¹ In 2014, 71 subjects of the Russian Federation saw own revenues fall in real terms (51 subjects in 2013). Profit tax revenues dropped in real terms by more than 25% in four regions in 2014 and in 23 regions in 2013.

Table 20

**Consolidated budget expenditure of subjects of the Russian Federation
in 2014–2015**

	As % of total		As % of GDP		Growth, %	
	2014	2015	2014	2015	in nominal terms	in real terms
General National Issues	6.2	6.4	0.74	0.75	4.5	-7.5
National Security and Law Enforcement	1.1	1.1	0.14	0.13	0.5	-11.0
National Economy	18.8	19.7	2.26	2.32	6.1	-6.0
Including:						
agriculture and fishery	3.0	3.3	0.35	0.39	13.1	0.1
Transport	4.1	4.2	0.49	0.50	4.2	-7.7
Public Road System (Road Funds)	7.6	7.8	0.91	0.92	4.3	-7.6
other issues related to the national economy	2.3	2.4	0.28	0.29	4.8	-7.1
Housing and Utilities	9.6	9.0	1.16	1.06	-5.1	-15.9
Environmental Protection	0.3	0.2	0.03	0.03	-12.7	-22.7
Education	26.2	26.1	3.15	3.07	0.8	-10.7
Including:						
pre-primary education	7.0	7.3	0.84	0.86	5.3	-6.7
general education	15.0	14.6	1.80	1.72	-0.9	-12.3
secondary vocational education	2.1	2.0	0.25	0.24	-2.1	-13.3
other issues related to education	1.4	1.3	0.17	0.15	-8.6	-19.0
Culture, Cinematography	3.4	3.3	0.41	0.39	-2.5	-13.7
Healthcare	13.9	14.3	1.66	1.69	4.6	-7.4
Social Policy	15.1	15.8	1.82	1.86	5.8	-6.3
Physical Culture and Sports	2.0	2.0	0.24	0.24	1.3	-10.3
Mass Media	0.5	0.5	0.05	0.05	2.9	-8.9
Municipal and public debt servicing	1.3	1.6	0.16	0.19	22.4	8.4
Expenditure, total	100.0	100.0	12.01	11.79	1.4	-10.2

Sources: Russia's Federal Treasury, Gaidar Institute's own calculations.

Analysis of changes in various line items of budget expenditure in regions reveals the following. In 2015, the annualized expenditure for 'Environmental Protection' (a decline of 12.7% in nominal and of 22.7% in real terms) declined the most. However, these expenditure left the total expenditure structure unchanged because the share of the former stood at 0.03%. The structure of expenditure was changed due to a decline in expenditure for 'Housing and Utilities' (down by 15.9% in real terms). Regions' policy aimed at cutting expenditure for 'Housing and Utilities' was a measure to counter fiscal disequilibrium, budget deficit and large debts. Note that the downtrend towards expenditure for the housing and utilities sector is likely to continue in the near term. For example, in 2016 federal budget allocations for the foregoing expenditure are planned to be cut by 47.2% from the value seen in 2015. Running short of their own-source revenues and facing cuts on federal co-financing, regions are unlikely to be able to spend more on 'Housing and Utilities'. Overall, the decline in expenditure in real terms can be seen for all the expenditure line items, except for 'Municipal and Public Debt Servicing'. These expenditure increased first of all because the volume of public and municipal debt rose by 11% and 9% respectively (see below for more details). However, the growth in expenditure for debt servicing slowed down inconsiderably as a result of replacement of a share of commercial debts with budget loans at an extremely low interest rate¹ (the volume of budget loans increased by 24.9% as of 2015 year-end). The 2015 year-end expenditure for 'Municipal and Public Debt Servicing' of the total expenditure structure rose from 1.3% in 2014 to 1.6%, by 0.03 percentage points of GDP: from 0.16% to 0.19% of GDP.

¹ 0.1% per annum.

Overall, expenditure increased in nominal terms for all the line items, except ‘Housing and Utilities’, ‘Environmental Protection’, ‘Culture and Cinematography’. Efforts were made to increase inconsiderably expenditure for ‘National Economy’ as a whole (6.1%) and the subitems related thereto. In particular, expenditure for ‘Transport’ and ‘Public Road System (Road Funds)’ increased by 4.3% and 4.8% respectively. ‘Agriculture and Fishery’ saw the biggest growth in expenditure not only in nominal terms (by 13.1%) but also in real terms (by 0.1%).

Let us next consider the dynamics of principal (not only expenditure) parameters of consolidated budgets of subjects of the Russian Federation, as a percentage of GDP (see *Table 21*).

Table 21

Dynamics of revenues and expenditure of consolidated budgets of subjects of the Russian Federation in 2008–2015, as % of GDP

	2008	2009	2010	2011	2012	2013	2014	2015
Revenues	15.02	15.27	14.12	12.80	12.05	11.49	12.30	12.93
Including:								
profit tax	4.24	2.76	3.28	3.23	2.96	2.42	2.76	2.95
personal income tax	4.04	4.29	3.87	3.34	3.38	3.52	3.77	3.92
Federal budget transfers	2.65	3.81	2.98	2.42	2.15	2.13	2.17	2.16
Expenditure	15.15	16.12	14.33	12.86	12.47	12.39	12.97	13.17
Deficit (-) / Surplus (+)	-0.13	-0.85	-0.22	-0.06	-0.42	-0.90	-0.67	-0.24
For reference: GDP, rubles in billions	41.277	38.807	46.309	59.698	66.927	71.055	77.893	80.413

Note: No calculations were made for regions of the Crimean Federal Okrug.

Sources: Russia’s Federal Treasury, Gaidar Institute’s own calculations.

2009 saw the biggest volume as a percentage of GDP of both revenues and subnational budget expenditure in the period of 2008–2015. Revenues rose in 2009 as a result of considerable growth (by 35.2%) of federal budget transfers, and expenditure increased due to the implementation of measures as part of an anti-crisis program (both at the federal level – using subsidies and subventions – and at the regional level). However, tax revenues in regions dropped in 2009 mostly as a result of declining profit tax revenues. It is therefore more appropriate to take the pre-crisis year of 2008 as the comparative base (recessionary trends in the fiscal sector were not visible until the last few months of 2008).

The data in *Table 21* show that in 2015 revenues from the personal income tax, profit tax, federal budget transfers did not reach levels recorded in 2008. Sources of revenues such as the profit tax and intergovernmental fiscal transfers were the farthest behind the 2008 levels. However, expenditure were much less in volume: 13.2% of GDP in 2015 against 15.2% of GDP in 2008.

In 2015, both revenues and expenditure increased as a percentage of GDP from 2014, by 0.63 and 0.2 percentage points respectively. The growth was observed for two consecutive years. Note that total expenditure and revenues increased in volume while they fell in real terms. The dynamics was observed amid slowing down GDP growth rates, with a 3.7% fall in 2015. The processes suggest that the economy is shrinking faster than changes in the principal parameters of subnational budgets of subjects of the Russian Federation. As a result, the deficit in 2015 was reduced in volume from 0.67% to 0.24% of GDP. Furthermore, in 2015, 36 regions reduced their expenditure even in nominal terms compared with the level recorded in 2014. Expenditure were reduced the most in the Amur Region (-13.8%), Yamalo-Nenets Autonomous Okrug (-13.2%) and Pskov Region (-10.6%).

Let us analyze in detail the situation with execution of consolidated budgets of subjects of the Russian Federation (deficit/surplus) in various regions (see *Table 22*).

Table 22

**Execution of (deficit/surplus) consolidated budgets of subjects
of the Russian Federation in 2008–2015**

Year	Number of subjects of the Russian Federation that executed their budgets	
	with a deficit	with a surplus
2008	45	39
2009	62	21
2010	63	20
2011	57	26
2012	67	16
2013	77	6
2014 ¹	74	9
2015 ¹	75	8

¹ Excluding regions of the Crimean Federal Okrug.

Sources: Russia's Federal Treasury, Gaidar Institute's own calculations.

The data in *Table 22* show that in 2015 consolidated budgets of subjects of the Russian Federation remained nearly as balanced in terms of quantity of regions as they were in 2014. Seventy five subjects of the Russian Federation ran a budget deficit in 2015 (74 in 2014). At the same time, five subjects (Lipetsk Region, Kaliningrad Region, Republic of Ingushetia, Yamalo-Nenets Autonomous Okrug, Republic of Altai) ran a budget surplus in 2014 and a budget deficit in 2015.¹ Three of the five regions increased their expenditure above the Russia's average level (1.4% in nominal terms).

Overall, in 2015 the parameters of consolidated budgets of subjects of the Russian Federation continued to be affected by adverse macroeconomic factors. Cost optimization opportunities continued to be sought at the subnational level. As a result, in 2015 expenditure were maintained at the year-earlier level, with a minor increase for 'National Economy'. The situation with revenues is more complex, first of all, because of the prevailing downtrend towards personal income and revenues from the personal income tax. Profit tax revenues were kept at a steady level largely due to export-oriented industries. The financial standing of Russia's regions is mixed in general. For instance, subnational budget deficit in 2015 dropped by 2.5 times due to a surplus of Rb 144.3bn in Moscow (a deficit of Rb 54.3bn in 2014) rather than because of financial rehabilitation across the regions. The downtrend towards federal budget transfers had an adverse effect on the volume of revenues in regions, too (see below for details).

2.3.2. Financial support from the federal budget

In 2015, total volume of intergovernmental fiscal transfers to consolidated budgets of subjects of the Russian Federation (including the Crimean Federal Okrug) contracted both in nominal terms (-0.2%) and in real terms (-11.6%) from 2014 (see *Table 23*).

Overall, the volume of financial support shrank for almost all types of transfers, except 'Other intergovernmental fiscal transfers' (hereinafter – "other IBTs") that increased by 67.4% in real terms at 2015 year-end as a result of greater support for the development of the public road system as part of the Transport System Development State Program. In 2015, Rb 83.4bn (Rb 3.7bn in 2014) were allocated for this purpose.

¹ Excluding regions of the Crimean Federal Okrug.

Table 23

Federal budget transfers to subjects of the Russian Federation in 2009–2015*

	2009		2013		2014		2015		Growth %, 2015 from 2014	
	rubles in bil-lions	as % of to-tal	rubles in bil-lions	as % of to-tal	rubles in bil-lions	as % of total	rubles in bil-lions	as % of to-tal	in nomi-nal terms	in real terms
Transfers to regions, total	1.480,3	100	1.487,9	100	1.607,0	100	1.603,6	100	-0.2	-11.6
Grants	578.3	39.1	609.1	40.9	774.7	48.2	650.9	40.6	-16.0	-25.6
Including:										
equalization transfers	374.0	25.3	418.8	28.1	439.8	27.4	487.7	30.4	10.9	-1.8
grants for measures to ensure budget balance	191.9	13.0	177.8	12.0	334.9	20.8	163.2	10.2	-51.3	-56.8
Subsidies	530.0	35.8	515.6	34.7	409.9	25.5	400.2	25.6	-2.4	-13.5
Including:										
subsidies to develop the national economy	214.3	14.5	268.3	18.0	241.9	15.1	258.2	16.1	6.7	-5.5
Subventions	284.4	19.2	273.7	18.4	308.2	19.2	336.6	21.0	9.2	-3.3
Other intergovernmental fiscal transfers	87.6	5.9	89.5	6.0	114.2	7.1	215.9	13.5	89.1	67.4

* Unlike the previous paragraph, here volumes of transfers include the Crimean Federal Okrug.

Sources: Russia's Federal Treasury, Gaidar Institute's own calculations.

The structure of transfers was changed drastically due to considerable growth of other IBTs and cuts on other types of transfers. For instance, the share of other IBTs increased from 7.1% to 13.5% while the share of subsidies and subventions rose from 25.5% to 25.6% and from 19.2% to 21.0% respectively. In real terms, the volume of subsidies dropped by 13.5% while subventions decreased in volume by 3.3%. Overall, the decline in the volume of subsidies (both in nominal and real terms) was offset by a sharp hike of other IBTs. The volume of subventions is largely determined by the size of indexation of social benefits, and its growth rate tends to slow down. In fact, subnational budgets have not become less reliant in terms of exercising delegated powers. Although transfers have been reduced in volume, there is still a great number of subsidies with overdetailed spending of budget funds, as well as with considerably wide scope of delegated powers. For instance, 86 subsidies were planned for 2015 (92 subsidies in 2014). However, the 2015 year-end subsidies increased in number to 96 under the amended federal budget law. The mechanism of subsidization is more efficient to ensure proper spending of budget funds than to reach the target, a great number of subsidies facilitates growth of administrative costs on monitoring the spending of subsidies. Under the state sub-program called "Enhancing the system of allocation and reallocation of financial resources between the levels of the budget system of the Russian Federation", federal budget subsidies to budgets of subjects of the Russian Federation are to be reduced in number on a step by step basis, with their number set to be optimized (consolidated) to 70 at Stage I (2013–2015) and to 42 at Stage II (2016–2020).

Note that total number of subventions increased from 18 in 2014 to 21 in 2015. The number of subventions increased on the back of consolidation of nine subventions into a single subvention. The number of subventions increased partly due to delegation of certain powers to budgets of the Republic of Crimea and of the federal city of Sevastopol.

Reducing the share of targeted financial support is a priority of the fiscal policy.¹ The share of grants was formally reduced from 48.2% to 40.6% in 2015, which, however, corresponds to the target value stipulated in the Guidelines of the Fiscal Policy for 2016–2018 (41.2% in 2015, 45.1% in 2016). In 2015, grants were reduced in volume because, first, financing under the state program called “Creation of conditions for efficient and prudent management of regional and municipal finance, enhancement of sustainability of budgets of subjects of the Russian Federation” was completed, whereby Rb 167bn were allocated in 2014 (excluding expenditure as partial compensation for extra expenditure to increase public sector wages). In 2015, as little as Rb 62.7bn were allocated for the implementation of the state program called “Development of federative relations and creation of conditions for efficient and prudent management of regional and municipal finances”. Second, in 2015 the volume of financial support as partial compensation for extra expenditure to increase public sector wages was cut in half to Rb 59.8bn, as a result of which the share of grants allocated in support of measures aimed at ensuring budget equilibrium in the structure of transfers shrank from 20.8% to 10.2% (by Rb 171.7bn).

In general, the decline in the share of grants allocated in support of measures aimed at ensuring budget equilibrium is a positive factor, because the grants are much less transparent than equalization transfers that in 2015 saw the least negative dynamics (-1.8%) compared with other types of transfers. However, the federal government’s policy aimed at a broader application of the budget loan instrument instead of equalization grants raises some questions, because regions will have to repay budget loans. Should Russia’s economy see no improvements in the years to come, there may be risks of regions being unable to repay their federal budget loans, in which case the federal government will have to extend new budget loans to ensure that old budget loans are repaid, or they will have to decide on writing off (or “freezing”) outstanding budget loans. Such a situation will deteriorate the transparency of intergovernmental fiscal relations, and it will inevitably deteriorate the fiscal discipline of regional government authorities.

Analysis of the process of allocation of federal government transfers to regions should consider the effect of federal support on differentiation of revenues of subjects of the Russian Federation, measuring the equalization performance of financial support from the federal budget (see *Table 24*).

Table 24

**Variation coefficient of consolidated budget revenues in regions
(per capita, with consideration for budget expenditure index) in 2008–2015, %**

Year	Tax revenues	Tax revenues and equalization transfers	Tax revenues, grants, 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
2015	66.1	60.3	56.0

Note: No calculations were made for regions of the Crimean Federal Okrug.

Sources: Russia’s Federal Treasury, Ministry of Finance, Gaidar Institute’s own calculations.

The data in *Table 24* show that differentiation of subnational budget revenues increased in 2015. The coefficient of tax revenues of consolidated budgets of subjects of the Russian

¹ See, e.g., the Guidelines of the Fiscal Policy of the Russian Federation for 2016 and for the Planning Period of 2017–2018.

Federation was up from 59% to 66.1%, reaching the level seen in 2012. With equalization transfers, the variation coefficient of budget revenues in regions increased from 51.3% in 2014 to 60.3% in 2015, and with all the allocated grants and subsidies, it increased in 2015 to 56% (49.9% in 2014). Differentiation of regional revenues in 2015 increased largely because the profit tax was up in a few subjects of the Russian Federation, which was related to export-oriented industries. For instance, the profit tax rose by more than 25% from 2014 in 15 regions (in nominal terms) and in 9 regions (in real terms).

2.3.3. Debt policy at regional level

Table 25 shows data on the dynamics of volumes of public debt owed by subjects of the Russian Federation and municipal debt in 2010–2015. The Table shows that in 2015 the year-to-date growth in the debt owed by regional budgets was nearly 11% in nominal terms (for comparison: 28.2% in 2013, and 20.3% in 2014), excluding 14% in Moscow and Moscow Region (37.9% in 2013, 23.8% in 2014). The volume of debt owed by municipal budgets rose by 8.9% during the same period (17.8% in 2013, 8.4% in 2014). In December 2015, the debt of subjects of the Russian Federation was equal to or less than 6% over the volumes recorded as of December 1st, which differs notably from the practice of 2012–2014, when the year-end debt increased by 15–20%.

Table 25

Subnational budgets’ public and municipal debt in nominal terms in 2011–2015, rubles in billions

	As of 2011 year-end		As of 2012 year-end		As of 2013 year-end		As of 2014 year-end		As of 2015 year-end	
	volume, rubles in billions	growth, %	volume, rubles in billions	growth, %	volume, rubles in billions	growth, %	volume, rubles in billions	growth, %	volume, rubles in billions	growth, %
Total in regional budgets	1172	7	1355	16	1738	28	2090	20	2319	11
Total in regional budgets (excluding Moscow and Moscow Region)	832	28	1069	28	1474	38	1825	24	2079	14
Total in municipal budgets	216	27	245	13	289	18	313	8	341	9

Sources: Russia’s Ministry of Finance, Rosstat, Gaidar Institute’s own calculations.

Regional debt growth rates slowed down considerably in 2015, following the earlier downtrend at the municipal level (municipal debt growth rates slowed down notably as early as 2014). 2015 saw debt growth rates slow down at the subnational level largely as a result of curtailing growth in expenditure that increased in nominal terms by mere 1.4% year-over-year (to compare, 5.6% in 2013 and 6.2% in 2014) amid favorable dynamics in nominal terms of tax and nontax revenues of regional consolidated budgets: a growth of 6.2% (however, a decline of 5.9% in real terms). As a result, subjects of the Russian Federation ran a consolidated budget deficit of 0.3% of GDP in 2015 against 0.6% of GDP in 2014 and 0.8% of GDP in 2013.

Overall, the dynamics of regional debt in 2011–2015 revealed a steady uptrend from 2.0% of GDP as of 2011 year-end to 2.9% of GDP as of 2015 year-end¹ (see *Table 26*). The volume of regional debt is estimated to be insignificant for the budget system and the economy as a whole. Given the slowdown in 2015, the regional debt does not yet pose a serious macroeconomic risk at the national level. However, a more correct assessment of the situation with the regional debt and with related budget risks requires analysis by subject of the Russian Federation.

Table 26

**Volumes of public and municipal debt of subnational budgets
in 2011–2015, as % of GDP**

	As of 2011 year-end		As of 2012 year-end		As of 2013 year-end		As of 2014 year-end		As of 2015 year-end	
	as % of GDP	growth, percentage points of GDP	as % of GDP	growth, percentage points of GDP	as % of GDP	growth, percentage points of GDP	as % of GDP	growth, percentage points of GDP	as % of GDP	growth, percentage points of GDP
Total to budgets in regions	2.0	-	2.0	0.1	2.4	0.4	2.7	0.2	2.9	0.2
Total for regional budgets (excluding Moscow and Moscow Region)	1.4	-	1.6	0.2	2.1	0.5	2.3	0.3	2.6	0.2
Total for municipal budgets	0.4	-	0.4	0.0	0.4	0.0	0.4	0.0	0.4	0.0

Sources: Russia’s Ministry of Finance, Rosstat, Gaidar Institute’s own calculations.

Note that previously only two subjects of the Russian Federation, namely Moscow and Moscow Region made up the major share of regional debt (as of January 1, 2011, they accounted for 40.7% of the total regional debt), whereas as of January 1, 2016 they accounted for about 10% of the total debt. This reflects the recently mounting problem with executing budgets at the regional level, which prompted not a few but many regions to raise funds to cover their current expenses rather than to finance investment.

The data on regions reveal that many subjects of the Russian Federation increased their debt volumes in 2015 (see *Table 27*). At the same time, it is significant that there was redistribution of regions towards growth in the number of subjects of the Russian Federation with a more moderate (less than 15% a year) growth in indebtedness, as well as the number of regions that reduced the volume of their debt increased notably (from 8 in 2014 to 16 in 2015).

The 2015 debt structure of Russia’s regions was changed towards considerable growth in the volume of federal budget loans (see *Fig. 23*). The share of budget loans increased to 34.9%, by 3.9 percentage points above the value seen earlier in 2015. Outstanding budget debts increased as the share of commercial loans and government securities shrank by 0.9 and 2.5 percentage points respectively. In absolute terms, the volume of the commercial share of debts owed by subjects of the Russian Federation (government securities and commercial loans) shrank by about Rb 56bn. Thus, a trend unfolded towards replacing commercial loans with budget loans across regional budgets, reflecting region-focused priorities of the federal government’s current policy.

¹ The presented data rely on Rosstat’s data calculated using a new method for GDP in 2011–2015.

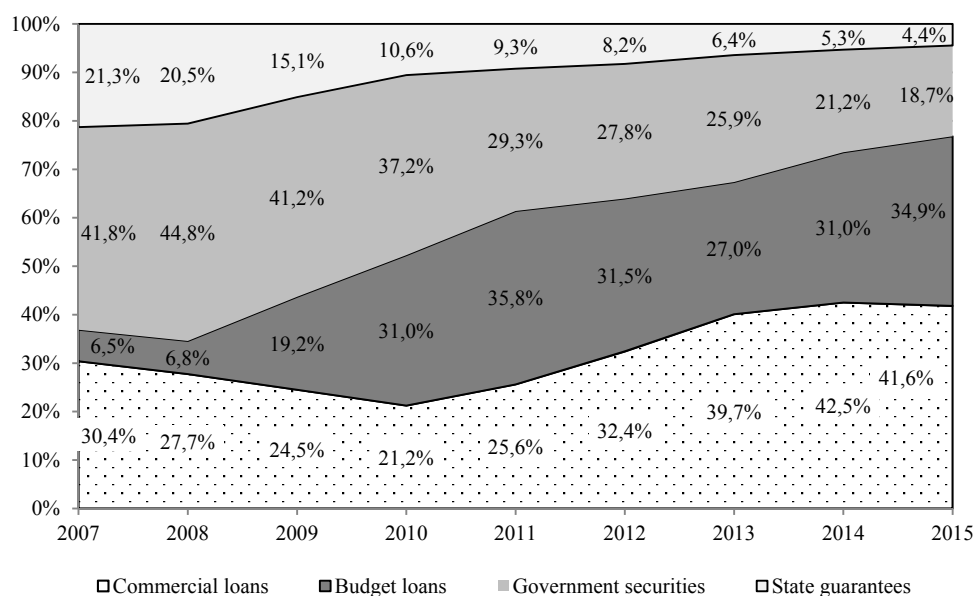
Table 27

Dynamics of public debt owed by budgets of subjects of the Russian Federation in 2008–2015

	Dynamics of public debt owed by subjects of the Russian Federation in a certain period (in nominal terms), number of subjects of the Russian Federation					
	growth by more than 50%	growth by 15 to 50%	growth by less than 15%	decline by less than 15%	decline by 15 to 50%	decline by more than 50%
2008	21	20	10	6	12	9
2009	37	18	11	6	4	2
2010	29	24	8	11	7	0
2011	21	27	13	14	6	0
2012	18	29	14	8	10	1
2013	31	36	8	6	1	0
2014	12	44	18	5	1	2
2015	7	27	31	15	1	0

Note: Arkhangelsk Region and Nenets Autonomous Okrug are presented as a single subject of the Russian Federation; the presented data exclude the Crimean Federal Okrug (to ensure full compatibility at various years).
Sources: Russia’s Ministry of Finance, Gaidar Institute’s own calculations.

However, the situation differs largely from one region to another, which may necessitate further growth in the volume of budget loans (for regions that continue accumulating commercial debts). This creates risks of even heavier reliance of subjects of the Russian Federation on federal budget loans, which in turn would build up political pressure on Russia’s Ministry of Finance over making a decision on writing off or “freezing” repayments. Although such a measure seems to be simple in terms of tackling the problem of debts accumulated by some subjects of the Russian Federation, it can substantially undermine the fiscal discipline at the regional level and deteriorate the problem of soft fiscal constraints of subnational authorities in Russia.



Note: The presented data exclude the Crimean Federal Okrug (to ensure full compatibility at various years).

Fig. 24. Structure of public debt owed by subjects of the Russian Federation in the period of 2007–2015

Fig. 23 shows a breakdown of subjects of the Russian Federation according to the dynamics of debt burden and growth rates in debt volumes in 2015. Subjects of the Russian Federation

located in II quadrant are more vulnerable in terms of fiscal sustainability. This group includes 28 regions where the level of debt burden (the ratio of debt amount to the volume of regional budget revenues, excluding transfers) and growth rates of debt volumes in 2015 were higher than Russia's average values (excluding Moscow). In terms of general values (excluding debt structure), the following regions faced the most challenging situation: Republic of Mordovia (in 2015, the debt volume increased by 26.2%, the level of debt burden was 182.5% as of January 1, 2016), Smolensk Region (+20.8% and 121.4%), Republic of Khakassia (+53.6% and 116.8%), Republic of Ingushetia (+21.5% and 113.3%), Jewish Autonomous Region (+41.3% and 109.5%), Zabaykalskiy Territory (+32.3% and 107.2%), Republic of Mariy-El (+21.9% and 106.1%).

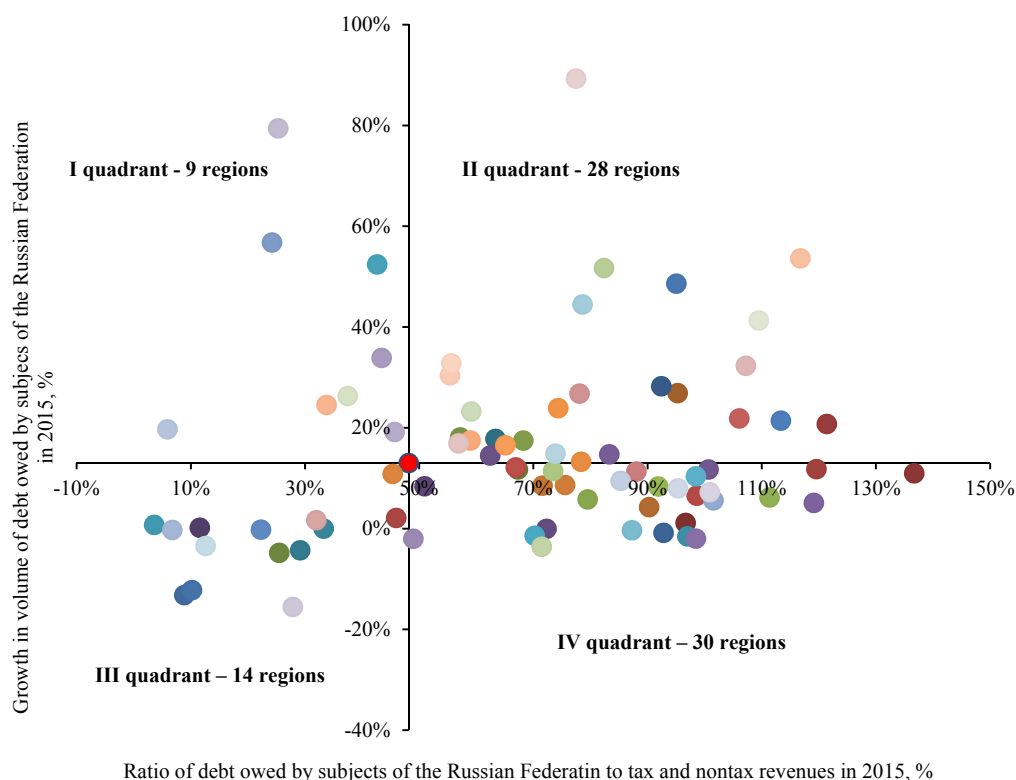


Fig. 24. Debt burden and change in volumes of public debt owed by subjects of the Russian Federation in 2015

Notes: 1. The axes intercept at the point where debt burden and growth of volume of debt owed by subjects of the Russian Federation in 2015 take on Russia's average values (48.2% and 13% respectively, excluding Moscow).
2. The figure shows Tyumen Region (0.89%, 256.9%), Republic of Mordovia (182.5%, 26.2%).
Sources: Russia's Federal Treasury, Ministry of Finance, Gaidar Institute's own calculations.

However, to assess sustainability of regional budgets, it is important to consider not only the general dynamics of debt but also the structure thereof. Analysis of the structure of indebtedness of the subjects of the Russian Federation located in II quadrant shows that the most challenging situation unfolded in 9 of 28 regions, where commercial loans and bonded loans increased in volumes in 2015. The rest 19 subjects increased the volume of their regional debt due to budget loans and/or state guarantees. Note that in 2015 a few subjects of the Russian Federation in-

creased their commercial debt despite considerable volumes thereof in the regional debt structure as early as 2015. Analysis of the 2015 data shows that six regions faced the most alarming situation: Magadan Region (in 2015, the outstanding commercial debt increased by 95% in nominal terms; the share outstanding commercial debt of the total regional debt was 88% as of the beginning of 2015), Republic of Khakassia (+73%; 71%), Republic of Mariy-El (+55%; 58%), Kurgan Region (+53%; 73%), Ivanovo Region (+52%; 75%), Novosibirsk Region (+38%; 74%).