

ONLINE MONITORING OF RUSSIA'S ECONOMIC OUTLOOK

TRENDS AND CHALLENGES OF SOCIO-ECONOMIC

DEVELOPMENT № 11(29) June 2016

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**GAIDAR
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RANEPA
THE RUSSIAN PRESIDENTIAL ACADEMY
OF NATIONAL ECONOMY
AND PUBLIC ADMINISTRATION



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MAIN TRENDS AND CONCLUSIONS

As one politically correct joker once remarked, 'Never ask the people any questions. Otherwise, you may hear *such* things...'

The economic and political elites of the world recently heard such things from the British people that they needed all their diplomatic skills and self-restraint to be able to express correctly their attitude to the initiators of that historic referendum. By that moment, the global arena had already been dominated by a variety of uncertainty factors. The unpredictability of raw materials markets. The jittery movement of currencies on the financial markets. The migration crisis in Europe. Syria. Ukraine. China's economic slow-down. And the presidential nominee with some quite extraordinary personal traits who had with assurance entered the final phase of the presidential race in the USA. This last factor, now coupled with the Brexit effects, has made it evident that the biggest threats for the most stable conservative systems do not arise along the peripheral zones of their influence – they actually emerge inside those systems.

The rather unpredictable and poorly measurable effects that the UK's withdrawal from the EU may have on Russia's economy will now coincide, quite unexpectedly, with one more development on a less than global scale which, however, can produce a more positive and direct effect. This is the possibility of reestablishing normal relations between Russia and Turkey. The potential scale of reestablished economic links in several sectors appears to be quite impressive: tourism; construction; agricultural products; transport and cargo shipment; energy infrastructure. These improvements are still far from being certain, but the vector of change is definitely positive. Meanwhile, the future destiny of the EU, several international institutions and Albion itself is being enveloped in such a thick blanket of fog that the true outcome (as they have wisely noted in our great eastern neighbor China) will become visible only five years or so from now.

Nevertheless, our experts attempted to estimate some of the earliest Brexit effects – for example, its possible consequences for Russia's economy and trade. First of all, these are the increased volatility of world markets and the oil price plunge (it should be noted that these effects were felt only in the first few days after the referendum). Another, less probable effect has to do with Russia's foreign trade. The United Kingdom accounted for only about 2% of Russia's total commodity turnover. Besides, 84% of Russia's exports to that country is represented by fuel (natural gas accounting for roughly half of that figure), which can be redirected to other markets. As for imports from the UK (whose share in RF imports had anyway shrunk from 6.6% in 2014 to 4.9% in the first four months of 2016), these are somewhat similar to Russia's total imports from the EU. The potential losses in the services sector may turn out to be bigger, as the share of the UK in Russia's services turnover amounts to 6%.

As for the macroeconomic risks of Brexit for Britain itself, the possibility of recession appears to be quite real: as a result of international trade shrinkage and capital outflow, the UK may lose up to 5% of its GDP. The labor market will suffer from the decreasing workforce mobility, which will push up costs.

A decline of capital inflow is also quite probable, which will pose a threat for the balance of payments and the pound sterling's sustainability. However, the UK banking system's capitalization index is so high that it will remain sustainable even in conditions of a stress scenario. It still difficult to offer any definite judgments concerning the other possible long-term effects of the UK's withdrawal from the EU, because the arrangements for that withdrawal have not yet been negotiated.

A special expert analysis addresses the Brexit effects on the status of the UK in international organizations and institutions, as well as its relations with its major geopolitical partners. Thus, experts believe that the UK will still retain its position within G7 even if Scotland decides to secede, while the role of the 'G7 club' for the UK will become even more important. No radical changes are expected in the framework of G20, although the potential secession of Scotland and Northern Ireland may somewhat undermine the UK's status there. As far as the WTO is concerned, according to its Director-General, the UK is faced with the prospect of a lengthy negotiation procedure involving all the 162 WTO member states. The UK is going to lose its preferential access to the markets of 58 countries in the framework of 36 trade agreements; besides, it will have to raise its tariffs for imports from those countries, while at the same time having to deal with the increased import duties levied on its own exports. The UK is unlikely to encounter serious problems in its dealings with international financial institutions, but its position in that sphere may weaken in the medium and long-term period. For example, as its share in world GDP shrinks, the size of its IMF quota and voting power may be revised. The influence of the Bank of England in the Bank for International Settlements and its Basel Committee on Banking Supervision will weaken. It will be difficult for the UK to fulfill its obligation, as a NATO member country, to allocate 2% of its GDP to defense. However, the UK will make efforts to strengthen its special relationship with the USA, while the latter, in its turn, will look to Germany as one of its key partners, because the opportunities for the UK to influence the standpoints of the EU will be significantly reduced. And finally, the UK will, most probably, retain its place as a permanent member of the UN Security Council, even if both Scotland and Northern Ireland secede. There was already such a precedent, when Russia became the legal successor of the USSR

Such is the still incomplete but seemingly endless 'garland' of the consequences of those tactical inter-party decisions that have been made inside one of the world's most mature and stable democracies.

As for the situation inside Russia's domestic political and economic system, our current observations have confirmed the already well-known thesis that this country has been adapting to the shock conditions that emerged two years ago, although it is still difficult to speak of a possibility of positive changes – say, in the social sphere.

In Q2 2016, judging by the results of business surveys conducted by the Gaidar Institute, the outlooks across Russian industry appear to be rather positive: the integral index of enterprises estimating their current economic situation to be 'normal' has hit its record high of 72%. The same index continues to be applied to their estimates of their finished product stocks, while the percentage of 'normal' estimates of raw material stocks is even higher. The index of enterprises reporting 'normal' demand for their industrial products has increased to 54% from 45% in Q1. Taken together, these and other

data point to a high level of adaptation to the consequences of the 2014–2016 crisis.

According to data for Q2 2016 released by the RANEPA's Social Analysis and Forecasting Institute, the Russian people are now viewing their current and future situation with more optimism. In May 2016, the largest group of respondents (35% vs. 24% in February) believed, when asked to estimate the scale of the crisis, that the situation had not changed. The number of those believing that it had worsened, declined. The number of those reporting their deteriorating material status in the crisis conditions declined by 5%. The share of those convinced that the crisis is here to stay has shrunk. In other words, as noted by our experts, "a certain calming-down with regard to the goings-on in the economy has taken place".

At the same time, the share of respondents reporting a job loss has remained unchanged (15%, as in several previous surveys), while the negative expectations of a possible job loss somewhat increased. A similar trend has been recorded with regard to the movement of wages: the same percentage of respondents as in the previous surveys report a shrinkage of their earnings, while the expectations of their potential shrinkage have increased. However, no further shrinkage of consumer spending is reported, contrary to what has been observed over the previous months.

Experts make a special note of this controversy between the increasingly optimistic general outlook and the absence of improvements with regard to employment and wages. It would be logical to assume that this is a sign of society's adaptation to the new reality. But if we try to offer a simplified description of the socio-psychological algorithm of that adaptation, it would probably be as follows: the shock reaction to the dramatic changes has given way to a calmer one, because that there have been no sudden new shocks, and the absence of these in itself can be a source of optimism, however small.

Against the general background, it is the middle class that stands out for its more positive estimation of the current situation. In this group of respondents, those whose material status has not worsened dominate. They are less pessimistic in their estimations of opportunities for finding a new job. They twice more frequently generate new ideas as to what to do and how to behave in the nearest future, while they much more rarely than the representatives of other groups report that they are going to rely for survival on their household produce. ●

1. BREXIT RESULTS: MACROECONOMIC RISKS

E. Goryunov, A. Kiyutsevskaya, P. Trunin

The United Kingdom's potential exit from the EU poses a number of macroeconomic risks. Considering the overall growth of uncertainty, the recession in the UK cannot be ruled out. The decline in capital inflows to the UK economy can be predicted, which could pose a threat to the stability of the balance of payments and the exchange rate of the British Pound. Obviously, the exchange of goods and services between the UK and the EU will suffer, as well as labour mobility and the British labour market. According to various estimates, Britain can lose up to 5% of GDP as a result of capital outflows and shrinking international trade.

After the UK's exit from the EU, the country will cease to be in the common economic space with other European countries, so a need arises for the conclusion of numerous bilateral international agreements regulating areas such as migration and associated labour market, financial transactions between British and continental counterparts, international trade, taxation. Since neither the UK government nor Brexit supporters themselves have a clear, elaborated road map for exiting the EU, the fact that Britain decided to leave the European community creates considerable uncertainty¹.

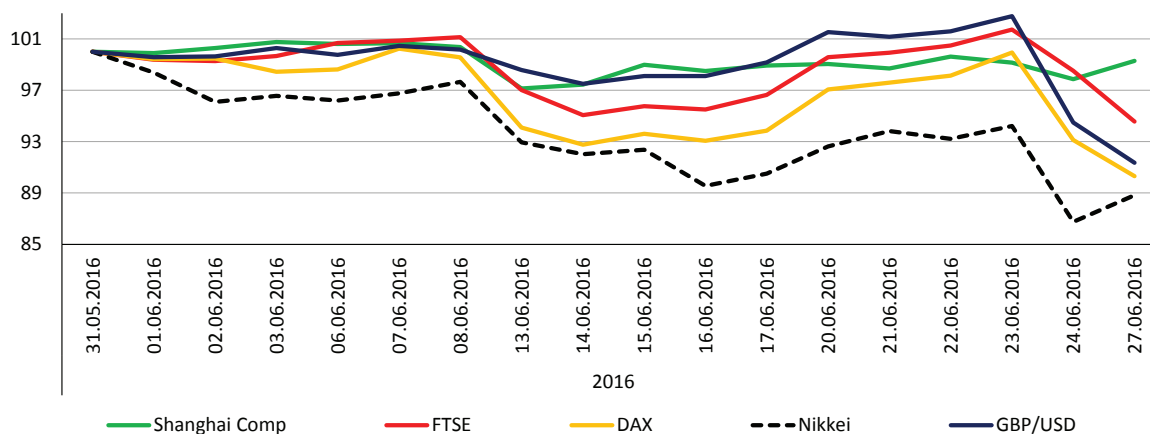
The sharp increase in macroeconomic and political risks led to a surge in volatility in financial markets. Economic agents' first reaction to the referendum results was panic. Oscillation amplitude of the FTSE stock index reached the historical maximum of 549.8 points: its quotes ranged from 6338.6 to 5738 points on the day the referendum results were announced. The pound sterling oscillation amplitude reached 0.179 on 24 June, whereas on average it did not exceed 0,019 US dollars in June and 0.013 US dollars in May (Fig. 1). In relation to the US dollar, the exchange rate of the pound sterling fell that day by more than 8%.

In response to Brexit, Fitch and Standard & Poor's rating agencies lowered the UK rating and forecast its further reduction. Fitch analysts also expect that the growth of risk premium and falling financial markets will lead to a reduction in aggregate demand and slowdown of economic growth in Britain from 2% to 0.9%. So far, it's difficult to say whether the slowdown of economic growth will really be so significant, but the negative effect on stock markets is already obvious, and the possibility of recession can not be ruled out, taking into account the growth of the overall uncertainty.

In the situation of volatility spike and growing likelihood of slowing economic growth, the Bank of England decided to extend the standing facilities, i.e. the volume of daily operations providing overnight loans to banks at the rate of 0.75% per annum, up to 250 billion pounds, which is only one-third less than the quantitative easing program (375 billion pounds) introduced after the 2008–2009 crisis. At the same time, the regulator estimated that the

¹ See Avery, G. et.al. (2016). Britain's Future in Europe: The known Plan A to remain or the unknown Plan B to leave. CEPS Paperback 2nd Ed., March 2016.

1. BREXIT RESULTS: MACROECONOMIC RISKS



Source: RosBusinessConsulting, www.rbc.ru, authors' own calculations.

Fig. 1. Quotes of select stock indices and the pound sterling exchange rate (31.05.2016 = 100%)

capitalization of England's banking system is currently ten times higher than its pre-crisis level, which, according to the results of stress tests carried out by the regulator, ensures its sustainability in the case of the stress scenario¹.

ECB also announced its readiness to support the banking system of the euro area by providing additional volumes of liquidity both in national and in foreign currency. The unanimity of the monetary authorities in this situation suggests that there are systemic macroeconomic risks not only for the UK but also for the euro area.

The United Kingdom's exit from the EU is not likely to significantly influence its budget policy. From a formal point of view, the UK will be freed from the commitment to observe budgetary discipline enshrined in the Maastricht Treaty, according to which the budget deficit should not exceed 3% of GDP and public debt – 60% of GDP. In practice, however, these requirements were constantly violated. The state of public finances in the UK is not exactly satisfactory, and it will deteriorate in case of recession. Nevertheless, it is far from critical and corresponds to the EU average level.

The UK's exit from the EU is likely to negatively influence the country's banking sector, which has played a special role as a bridge between American financial institutions and the European economy. Previously, Asian and American banks sought to work with Europe primarily through London, but now its appeal might significantly decrease in favour of Frankfurt and Paris. Goldman Sachs and HSBC announced their plans to shift the focus of their business interests towards continental Europe in response to the the British electorate's decision. As a result, capital inflows into the UK economy will decrease, which could pose a threat to the stability of the balance of payments and the pound sterling exchange rate, given the significant negative current account: -4.7% of GDP as of year-end 2015.

Industries related to international trade will also be affected, since Britain can lose free access to European markets. Continental European countries are the UK's main partners, and the emergence of additional barriers will reduce the exchange of goods and services, while redirecting export and import flows will take considerable time.

1 <http://www.bankofengland.co.uk/publications/Documents/news/2016/056.pdf>

An important consequence of the UK's exit from the EU may be restrictions on labour mobility, which would create obstacles for EU citizens' employment in the UK, reducing the flexibility of the UK labour market and leading to an increase in labour costs in the country.

It is difficult to reason about other possible long-term macro-economic consequences of the UK's exit from the EU because the conditions under which the exit will occur are unclear. One cannot rule out that political delaying of the exit process and changes in public sentiments will lead to Britain eventually remaining in the European Union. According to different estimates, as a result of capital outflows and shrinkage of the international trade, Britain can lose up to 5% of GDP¹. The most pessimistic estimates suggest the loss of up to 8% of GDP². So, the overall effect of the exit from the EU is most likely to be negative, and the factor determining its scale will be the terms on which British manufacturers and financial institutions will be able to access the European market. ●

1 See OECD (2016), "The consequences of Brexit: a taxing decision", OECD Economic Policy Paper No. 16.; PwC (2016), "Leaving the EU: Implications for the UK economy"; Open Europe (2015), "The consequences, challenges and opportunities facing Britain outside EU"; Ottaviano, Gianmarco, João Paulo Pessoa, Thomas Sampson, and John Van Reenen (2014), "The costs and benefits of leaving the EU".

2 See Dhingra, Swati, Gianmarco Ottaviano, John Van Reenen and Jonathan Wadsworth (2016), "Brexit and the impact of immigration on the UK", CEP Brexit Analysis paper CEP-BREXIT05; Bertelsmann Stiftung (2015), "Costs and benefits of a United Kingdom exit from the European Union"; HM Government (2016c), "HM Treasury analysis: the long-term economic impact of EU membership and the alternatives".

2. BREXIT AND TRADE AND ECONOMIC RELATIONS BETWEEN RUSSIA AND THE UK

A. Knobel, A. Firanchuk

The UK's exit from the EU can affect Russia primarily through an increase in volatility in the world markets and the consequent reduction in medium-term oil prices. Impacting Russia directly through trade is less likely. First, the United Kingdom accounts for about 2% of Russia's trade turnover. Second, Russia's exports are mainly raw fuel (84% in 2015), which can be easily redirected to other markets; in addition, about half of these exports are gas trading. The structure of imports from UK is very similar to that from other EU countries. The impact on Russia through trade in services seems more likely, as the UK's share in Russia's services turnover is about 6%.

International financial markets reacted to the results of the UK referendum not only with sharp depreciation of the pound sterling (by about 11%) and a decrease in British companies' share prices, but also with a sharp decrease in their P value. The latter circumstance may have an impact on the size of Russia's export earnings and Russian budget revenues. Today, however, it is difficult to say whether the results of the referendum on the UK's exit from the EU will have a long-term impact or only lead to a short-term deviation of the global oil prices' trajectory from its trend.

In the medium term, a negative impact on Russian economy may emerge due to the likely effect from GDP changes in the United Kingdom and other EU members happening because of the recovery of trade barriers between the UK and continental Europe. At the same time, given the high degree of integration among the economies of the United Kingdom and other members of the European Union, it can be assumed that the parties will strive to maintain mutual benefits in trade and not to hurry with the introduction of significant trade barriers. At least, one should not expect the abolishment of the free trade regime between the EU and the United Kingdom in the foreseeable future (*for details, see the text by M. Larionova, A. Sakharov, A. Shel'epova in this issue of the real-time monitoring*). At the same time, however, London will get the possibility to conduct independent trade policy and introduce a variety of protective measures (anti-dumping, compensatory, special safeguard measures) in relation to Russian production (in the risk zone, there will be chemical products, natural rubber, metals and metal products).

If we talk about mutual trade between Russia and the United Kingdom, it should be noted that the share of the UK in the Russian foreign trade in goods in 2015 amounted to 2.1%, while Russian exports to the UK are mainly commodities, particularly mineral fuel (83.9% of exports in 2015). According to the Federal Customs Service, a significant proportion of these exports accounts for natural gas (39.5% of total exports in 2015), which is not export in the conventional sense (it is not the gas produced in Russia), but rather trading (according to BP¹, Russia does not supply pipeline gas to the United Kingdom).

¹ <https://www.bp.com/content/dam/bp/pdf/energy-economics/statistical-review-2015/bp-statistical-review-of-world-energy-2015-full-report.pdf>

Dynamics and structure of trade turnover between Russia and the United Kingdom

Dynamics and structure of trade turnover between Russia and the UK is not very different from that of Russia's trade with the European Union (see *Table 1*). The United Kingdom's share in the total trade turnover ranges from 2.1 to 2.9% in recent years (2013–2016). One can only note the decrease in the UK share in Russian imports of goods from the EU from 6.5% (in 2014) to 4.9% (in the first four months of 2016).

Table 1

DYNAMICS OF TRADE TURNOVER BETWEEN RUSSIA AND THE UNITED KINGDOM

| | 2013 | 2014 | 2015 | January–April 2016 |
|--|-------|-------|-------|--------------------|
| Trade turnover, billion dollars | 24.56 | 19.28 | 11.19 | 3.17 |
| Share in trade turnover total, % | 2.9 | 2.5 | 2.1 | 2.4 |
| Share in trade turnover with the EU, % | 5.9 | 5.1 | 4.7 | 5.4 |
| Exports, billion dollars | 16.45 | 11.47 | 7.47 | 2.22 |
| Share in exports total, % | 3.1 | 2.3 | 2.2 | 2.7 |
| Share in exports to the EU, % | 5.8 | 4.4 | 4.5 | 5.7 |
| Imports, billion dollars | 8.12 | 7.81 | 3.72 | 0.96 |
| Share in imports total, % | 2.6 | 2.7 | 2.0 | 1.9 |
| Share in imports from the EU, % | 6.0 | 6.5 | 5.3 | 4.9 |

Source: authors' calculations based on Federal Customs Service data.

The structure of Russian exports to the United Kingdom is largely the same as the structure of its exports to the EU. Goods, except fuels (customs commodity code 27), account for 22.1% of exports to other EU countries, and only for 16.1% of exports to the UK.

Table 2

STRUCTURE OF RUSSIAN EXPORTS TO THE UNITED KINGDOM AND OTHER EU COUNTRIES IN TOTAL RUSSIAN EXPORTS TO THE EU IN 2015

| Customs Commodity Code | Commodity items | Exports to the UK, million dollars | Share in exports to the UK, % | Share in exports to other EU countries, % |
|------------------------|--|------------------------------------|-------------------------------|---|
| 01–24 | Foods and agricultural raw materials (except textile) | 64 | 0.9 | 1.2 |
| 27 | Fuel | 6267 | 83.9 | 77.9 |
| 28–40 | Chemical products, natural rubber | 354 | 4.7 | 4.7 |
| 44–49 | Wood, cellulose and paper | 152 | 2.0 | 1.4 |
| 71 | Precious metals and stones and products made from them | 129 | 1.7 | 1.8 |
| 72–83 | Metals and metal products | 252 | 3.4 | 8.7 |
| 84–92 | Machines, equipment, transport facilities | 98 | 1.3 | 2.6 |
| | Other items | 156 | 2.1 | 1.7 |

Source: authors' calculations based on Federal Customs Service data.

The structure of Russian imports from the United Kingdom similarly repeats the structure of its imports from other EU countries — about half of it are machines, equipment and transport facilities.

Table 3

STRUCTURE OF RUSSIAN IMPORTS FROM THE UNITED KINGDOM
AND OTHER EU COUNTRIES IN 2015

| Customs Commodity Code | Commodity items | Imports from the UK. million dollars | Share in imports from the UK.% | Share in imports from other EU countries.% |
|------------------------|--|--------------------------------------|--------------------------------|--|
| 01–24 | Foods and agricultural raw materials (except textile) | 329 | 8.8 | 8.0 |
| 27 | Fuel | 46 | 1.2 | 0.7 |
| 28–40 | Chemical products. natural rubber | 1087 | 29.2 | 27.1 |
| 44–49 | Wood. cellulose and paper | 81 | 2.2 | 3.2 |
| 71 | Precious metals and stones and products made from them | 14 | 0.4 | 0.2 |
| 72–83 | Metals and metal products | 148 | 4.0 | 5.9 |
| 84–92 | Machines. equipment. transport facilities | 1881 | 50.5 | 47.4 |
| | Other items | 136 | 3.7 | 7.4 |

Source: authors' calculations based on Federal Customs Service data.

The dynamics of trade in services

The EU share in the turnover of services in Russia is rather stable: 46% to 43% in 2013–2015, which is almost equal to the EU share in the Russian trade turnover. At the same time, the share of the United Kingdom in the Russian foreign turnover of services is much higher than that in the trade turnover – it's 5.8%, making the country one of the most important Russian partners on trade in services. It also increases the risks to our country from shocks in the British economy, especially considering the significant share of “other business services” and “insurance” in the services turnover between Russia and the UK compared to the shares of these areas in the services turnover between Russia and other EU members.

Table 4

DYNAMICS OF TRADE IN SERVICES BETWEEN RUSSIA
AND THE UNITED KINGDOM

| | 2013 | 2014 | 2015 |
|---|-------|-------|------|
| Services turnover. billion dollars | 11.68 | 10.78 | 8.26 |
| Share in services turnover total. % | 5.9 | 5.8 | 5.9 |
| Share in services turnover with the EU. % | 13.8 | 12.9 | 13.7 |
| Services exports. billion dollars | 4.87 | 4.53 | 3.16 |
| Share in services exports total. % | 7.0 | 6.9 | 6.1 |
| Share in services exports to the EU. % | 17.5 | 16.7 | 16.1 |
| Services imports. billion dollars | 6.81 | 6.25 | 5.11 |
| Share in services imports total. % | 5.3 | 5.2 | 5.8 |
| Share in services imports from the EU. % | 12.0 | 11.1 | 12.5 |

Source: authors' calculations based on the Russian Central Bank data.

The structure of services exports to the United Kingdom is different from that to other EU member states: the share of “transportation services” and “telecommunication and other services” is somewhat larger, while the share of “travel” and “construction” is much smaller. The structure of services imports from the United Kingdom differs from that from other EU countries in

that the share of “travel” is much smaller. and the share of “other business services” and “insurance” is significantly larger.

Table 5

STRUCTURE OF RUSSIAN EXPORTS OF SERVICES TO THE UNITED KINGDOM
AND OTHER EU COUNTRIES IN 2014

| | Exports to the UK. million dollars | Share in exports to the UK. % | Share in exports to other EU countries. % |
|---|------------------------------------|-------------------------------|---|
| Processing of goods belonging to other parties | 5 | 0.1 | 2.6 |
| Maintenance and repair | 39 | 0.9 | 2.6 |
| Transportation services | 1493 | 32.8 | 24.1 |
| Travel | 222 | 4.9 | 19.2 |
| Construction | 57 | 1.3 | 8.1 |
| Insurance and services of private pension funds | 85 | 1.9 | 0.6 |
| Financial services | 419 | 9.2 | 2.2 |
| Charges for the use of intellectual property | 41 | 0.9 | 1.0 |
| Telecommunication. computer and information services | 595 | 13.1 | 7.3 |
| Other business services | 1554 | 34.2 | 31.3 |
| Services to individuals and services in the field of culture and recreation | 32 | 0.7 | 1.0 |

Source: authors' calculations based on the Russian Central Bank data.

Table 6

STRUCTURE OF RUSSIAN IMPORTS OF SERVICES FROM THE UNITED KINGDOM
AND OTHER EU COUNTRIES IN 2014

| | Imports from the UK. million dollars | Share in imports from the UK. % | Share in imports from other EU countries. % |
|---|--------------------------------------|---------------------------------|---|
| Processing of goods belonging to other parties | 0 | 0.0 | 0.0 |
| Maintenance and repair | 153 | 2.4 | 1.5 |
| Transportation services | 335 | 5.4 | 4.5 |
| Travel | 1072 | 17.2 | 44.9 |
| Construction | 159 | 2.5 | 4.8 |
| Insurance and services of private pension funds | 649 | 10.4 | 1.0 |
| Financial services | 223 | 3.6 | 1.5 |
| Charges for the use of intellectual property | 527 | 8.4 | 10.2 |
| Telecommunication. computer and information services | 657 | 10.5 | 7.0 |
| Other business services | 2308 | 36.9 | 23.3 |
| Services to individuals and services in the field of culture and recreation | 166 | 2.6 | 1.2 |

Source: authors' calculations based on the Russian Central Bank data.

Therefore. the possible impacts on the Russian economy would be the increase of uncertainty in the markets. short-term and possible medium-term negative effects on oil prices. a possible change in the regulation of international trade in services in the United Kingdom. and independent use by the UK of various restrictive trade measures in relation to the Russian chemical industry. metals and metal products. Considering that London has the toughest stance on sanctions against Russia among all EU member states. one can say that the United Kingdom's exit from the EU will probably result in London imposing the same or more severe sanctions on Russia. this time unilaterally. ●

3. POST-BREXIT BRITAIN: ITS RELATIONS WITH THE EU AND ITS FUTURE IN THE FRAMEWORK OF MULTILATERAL INSTITUTIONS

M. Larionova, A. Sakharov, A. Shelepov

In the next two years, the UK will be faced with a complicated geopolitical situation. The relations with its two key partners – the EU and the USA – will be changed. The USA, when dealing with European issues, will begin to rely on Germany rather than on the UK. It will be necessary to negotiate with the EU a new relationship model that will envisage that the UK should not participate in the decision-making process inside the European Union, and should have no internal influence there. Simultaneously, there will be a need for negotiations on new trade agreements with a number of countries that are not EU member states, because the UK, once it has withdrawn from the EU, will automatically find itself outside of the international trade agreements concluded on behalf of the EU, including those in the framework of the WTO.

The uncertainty factors

The first uncertainty factor is the **future candidate for Prime Minister**: Boris Johnson, former Mayor of London, or Michael Gove, Secretary of State for Justice. Anyway, none of them possesses sufficient experience of working at multilateral international institutions, and both have only limited experience of dealing with the EU. The second uncertainty factor is **the timing of the negotiations on the withdrawal agreement** setting out the arrangements for the UK's withdrawal from the EU and the framework for its future relationship with the Union. These can be expected to take place no earlier than October 2016, or perhaps even later, if the new Prime Minister and the Cabinet ministers should need more time for elaborating the starting terms for negotiating their standpoint and thinking over the EU's proposals concerning the provisions of the withdrawal agreement. The third uncertainty factor is the actual **length of the negotiation process**. As stipulated in Article 50 of the Treaty on the European Union, the Treaty should cease to apply to the State that has notified the European Council of its intention to withdraw from the date of entry into force of the withdrawal agreement or, failing that, two years after the said notification. However, the European Council may decide to extend this period. So, the negotiations can be expected to round up by autumn 2018 or later. For 2017, presidential elections are scheduled to occur in Germany and France – two EU member states that used to be part of the EU 'axis', now depleted by the loss of the UK. The **viewpoints on the terms of future cooperation with the UK of the potential presidents-to-be of both Germany and France** represent yet another uncertainty factor.

The choice made by Scotland and Northern Ireland, who both backed staying in the EU (62% and 55.8% respectively), may actually shape the nation's future. This is one more uncertainty factor. If Brexit becomes reality, Scotland and Northern Ireland can then hold their own national referendums concerning their secession from the United Kingdom. The Eurosceptics will then get one small country (England + Wales), and consequently, a much lower potential for influencing international issues.

And finally, the new framework for the relationship with the Union is yet to be known. However, no matter what the outcome of the negotiations might be, the uncertainty that will be shaping the foreseeable future and the altered relationship with the EU will inevitably have an impact on the UK economy. If the free trade agreements under the Europe 2020 Strategy are actually realized, the country's GDP will plunge by 3%, and if the UK and the EU operate on the basis of WTO rules – by 5.5%. Alongside the GDP plunge, an unemployment surge to 7–8% can also be expected from its current rate of 5%.

The status in multilateral institutions

Group of Seven

The Group of Seven (G7), alongside NATO, will remain a major floor for the UK to shape its common viewpoints and decisions on a broad spectrum of issues, including economics, finance, development, security. When the UK withdraws from the EU, G7 will gain in importance even more, as it will become a bridge to the EU, while at the same time offering possibilities for influencing the world agenda. The their declarations made shortly after the referendum results were published, G7's ministers of finance and heads of central banks emphasized their solidarity with the UK and their preparedness to introduce the necessary measures designed to play down the excessive volatility of world markets.

The UK will stay in G7 even if, say, Scotland should decide to secede.

Group of Twenty

The position of the UK within G20 is not going to change in any significant way. The predicted plunge of its GDP will have no radical effect on the country's status, as it will remain the world's leading economy. The question as to the legitimacy of the UK's membership in G20 may be raised only in the event of the secession of Scotland and Northern Ireland. Nevertheless, tension can be expected between David Cameron, Angela Merkel and François Hollande at the forthcoming Hangzhou Summit. Germany's G20 presidency will not be free of tension, either. It can be assumed that later on, as the new relationship model for the EU and the UK takes shape, a new formal for consultations concerning G20 agenda will also be created during the period of Indonesia's presidency.

WTO

The UK's withdrawal from the European Union will give rise to some serious reshuffling in the sphere of international trade. Among other things, this will affect the multilateral trade system established in the framework of the WTO, where the UK's place used to be defined by its membership in the EU.

According to WTO Director-General Roberto Azevêdo, the UK will enter a lengthy negotiation procedure involving all the 162 WTO member states, where its new status in the WTO will be redefined, and it will also have to revise its preferential trade agreements with other countries. The UK will lose its preferential access to the markets of 58 countries in the framework of 36 trade agreements, it will have to raise its tariffs for imports from those countries, while at the same time being faced with increased tariffs for its own exports.¹ In fact, UK foreign trade will be revised in its entirety. One more issue

¹ Brexit: the impact on the UK and the EU. <https://www.global-counsel.co.uk/analysis/special-report/brexit-impact-uk-and-eu>

for the United Kingdom will be its lack of a qualified corps of international trade negotiators, as all negotiations in the sphere of trade have been conducted, on behalf of the UK, by EU experts.¹

As far as rethinking of the terms of trade with the European Union is concerned, the UK will not have to negotiate separately with each of its member states. Evidently, a single UK-EU agreement will be signed.²

Besides, the UK will experience some difficulties in the course of trade negotiations due to the shrinkage of its aggregate share in global trade, and also because its market will become less attractive for foreign investors and trade partners. The United Kingdom's share in world trade is estimated to be 4.3%, whereas that of the EU amounts to 15.4%.³ Under these new conditions, the country will have to ease its approach to negotiations, and probably to make some concessions, including in the context of the forthcoming negotiations with Russia as a member of the WTO.

For Russia, the complex issues that the UK will have to deal with during the negotiations aimed at regulating the terms of trade in the framework of the WTO, are fraught with no significant risks. According to data released by the Russia's Federal Customs Service, the commodity turnover between Russia and the UK in January-March 2016 amounted to \$ 3.17bn, or 2.4% of the total volume of RF foreign trade. This index dropped on the same period of 2015, when the commodity turnover between the two countries was \$ 3.73bn.⁴

Thus, given the fact of the shrinking commodity turnover between Russia and the UK, as well as the existing restrictions on trade and investment, the Russian economy cannot be expected to suffer noticeably from any strong negative effects created by the UK's withdrawal from the EU and the revision of its trade relations with its major partners in trade in the framework of the WTO.

At the same time, as a result of the UK's withdrawal, Russia may hope for a more speedy coordination of its issues with the European union and for a certain easing of the standpoints of its member states concerning the relations between Russia and the EU, including in the sphere of trade policies.

International financial institutions

In the short-term perspective, in spite of its planned withdrawal from the EU, it is highly probable that the UK will retain its key roles in the leading international financial institutions.⁵ Its withdrawal from the EU will give rise

1 WTO warns on tortuous Brexit trade talks. <http://www.ft.com/cms/s/0/745d0ea2-222d-11e6-9d4d-c11776a5124d.html#axzz4ClrMZPQw>

2 How will Brexit affect Britain's trade with Europe? <https://www.theguardian.com/business/2016/jun/26/how-will-brexit-affect-britains-trade-with-europe>

3 Brexit: the impact on the UK and the EU. <https://www.global-counsel.co.uk/analysis/special-report/brexit-impact-uk-and-eu>

4 Foreign trade of the Russian Federation, by main country, for January-April 2016 http://customs.ru/index2.php?option=com_content&view=article&id=23490&Itemid=1976

5 The UK's member quota and voting power in the IMF amount to 4.26% and 4.05% respectively (it holds 5th place among all its member countries) (<http://www.imf.org/external/np/sec/memdir/members.aspx>). The similar indices for the UK in the International Bank for Reconstruction and Development are 4.145 and 3.94% respectively (<http://siteresources.worldbank.org/BODINT/Resources/278027-1215524804501/IBRDCountryVotingTable.pdf>). The UK also plays major roles in the other organizations of the World Bank Group. The country comes fifth by its voting power in the International Finance Corporation (IFC) (<http://siteresources.worldbank.org/BODINT/Resources/278027-1215524804501/IFCCountryVotingTable.pdf>) and the Multilateral Investment Guarantee Agency (MIGA) (<http://siteresources.worldbank.org/BODINT/Resources/278027-1215524804501/MIGACountryVotingTable.pdf>)

to a short-lived recession produced by the resulting economic shock, as well as an economic growth slowdown in the medium-term perspective. However, although the voting shares and quotas in some international financial institutions depend of the actual economic status of each member state, the parameters of UK participation will, most probably, remain unchanged in the nearest future. This will be possible due to the absence of automatically applied mechanisms for recalculating the quotas and votes, as well as to the strength and sustainability of the highly developed UK economy, which is resilient to negative external shocks, and so makes it possible for the country to fulfill its obligations assumed in the framework of those institutions.

Nevertheless, over the medium- and long-term periods, the UK's status in these institutions may weaken. Firstly, as its share in world GDP shrinks, the pressure from the other members of those institutions will increase (for example, in the framework of the next general redistribution of IMF quotas), as the member countries are striving for a more fair distribution of quotas and voting powers that will reflect the existing economic realities. Secondly, if in the future the UK should be faced with the implementation of an adverse scenario like the withdrawal of Scotland or Northern Ireland, it is very likely that its member's quotas and voting powers will be redistributed in favor of the new sovereign member countries. Thirdly, this course of events will also have an adverse effect on the UK's role in those international financial institutions where the membership is based on the principle of equality, and not on quotas, including the Financial Stability Oversight Council, the Bank for International Settlements and the Basel Committee on Banking Supervision, as the influence of representatives of the Bank of England, HM Treasury and UK financial supervisory bodies there will also weaken.

The less prominent roles of the UK in international financial institutions will have a negative effect not only on the country itself, but also on the stability of these institutions and the sustainability of the international financial system as a whole. The necessity to find a replacement for the resources currently invested by the UK may result in a shrinkage of the volume of operations carried on by these institutions, and trigger a new round in the country's struggle for influence over their activity.

NATO

Although, post-Brexit, it will be difficult for the UK to fulfill its obligation, as a NATO member country, to allocate 2% of its GDP to defense,¹ NATO will gain even more in importance (and probably also in strength) in the framework of relations between the UK, the EU and the USA. NATO will remain the only organization uniting almost all the relevant member states of the EU and the USA. The purpose of NATO's Warsaw Summit (to take place 8–9

[bank.org/BODINT/Resources/278027-1215524804501/MIGACountryVotingTable.pdf](http://www.imf.org/BODINT/Resources/278027-1215524804501/MIGACountryVotingTable.pdf)), and third in the International Development Association (IDAC) (<http://siteresources.worldbank.org/BODINT/Resources/278027-1215524804501/IDACountryVotingTable.pdf>).

Besides, the UK holds big stakes in regional development banks, including the Asian Development Bank (ADB), the African Development Bank (AfDB), the Inter-American Development Bank (IADB), the Asian Infrastructure Development Bank (being among the top twenty shareholders in each of them), as well as in the EBRD (sharing second place with Germany, France, Italy and Japan) (<http://www.ebrd.com/shareholders-and-board-of-governors.html>).

¹ UK Chancellor of the Exchequer George Osborne promised a cut on defense expenditures, given the ministry's calculations demonstrating that two years after the country's withdrawal from the EU its GDP will decline by 3.6%, and the pound sterling will weaken by 12%.

July 2016) is to demonstrate unity of the Alliance to the entire world, and in particular to Russia. Brexit will not change the UK's choice of NATO as a major multilateral defense institution. Moreover, the UK will make efforts to strengthen the practical aspects of its special relationship with the USA, including in the framework of NATO. As for the USA, it will promote Germany as one of its key partners, because the opportunities for the UK to influence the standpoints of the EU will be significantly reduced, once it finds itself outside of its framework.

United Nations Security Council

The UK will, most probably, retain its place in the Security Council, even in the event of Scotland and Northern Ireland's secession. No doubt, this may give rise to the issue of legitimacy of the former's membership in the UN Security Council, as the membership rights belong to the United Kingdom. However, there was already a precedent in the UN Security Council's history, when Russia became the legal successor of the USSR, while the USSR is still listed in Article 23 of the UNO Charter as one of its fifteen permanent members. The probability of the UNO Charter being amended is very low, although the discussion of its reform has been underway for a long time, and in November 2015, the EU considered, as its long-term goal, the possibility of it becoming a member of the UN Security Council in place of the UK and France. ●

4. THE RUSSIAN ECONOMY IN EXPECTATION OF GROWTH

S.Tsukhlo

Generalizing assessment of the existing economic situation (Adaptability index) has demonstrated in Q2 2016 the fact that the Russian economy persisted in high level of adaptability to the 2014–2016 crisis. By the end of two months of the quarter, the indicator hit the all-time maximum of 72%. Estimates of demand and employments are the principal positive drivers of the Index.

The share of demand potential as “normal” in Q2 2016 hit 54% following 45% in Q1. At the same time, 42% of enterprises consider current demand volumes for their products as insufficient, which a maximum for the recent seven quarters.

The share of “normal” responses regarding the headcount went up from 76 to 80%. The remaining 20% were distributed as follows: 12% as excessive employment and 8% as insufficient employment. The customary balance remains positive (+4 p.p.) and happened to me maximum since Q1 2010.

In the turn of 2010 to date 25 quarters, Russian industry oftener operated in the wake of a significant shortage of personnel than a meager surplus. The maximum surplus was registered in Q2 2016.

Stocks of finished products, according to the businesses, remain in mainly normal volumes. The share of responses “normal” since the outset of the 2014–2016 crisis does not fall below 70% on average for a quarter (in Q2 2016, it constituted 72%) and the remaining 27–30% register moderate and far from crisis predominance of responses “above normal.” Relying on the official statistics related to stocks, which releases data on the reduction of their *physical* volumes, and then Russian industry is conducting a highly rational policy of managing stocks by purposefully and orderly cutting their volumes in the context of extremely unlikely hike for their products.

The same situation is developing in industry regarding stocks of industrial inputs. The 2014–2016 crisis has not resulted in any crisis changes of enterprises’ responses regarding their volumes. The share of responses “normal” in late 2014–turn of 2015 demonstrated a far from crisis stability. During last four quarters, the indicator remains in the range of 77–80%, which were hard for businesses to ensure during previous non-crisis years. The balance of remaining responses (“above normal” – “below normal”) in 2014–2016 stays in

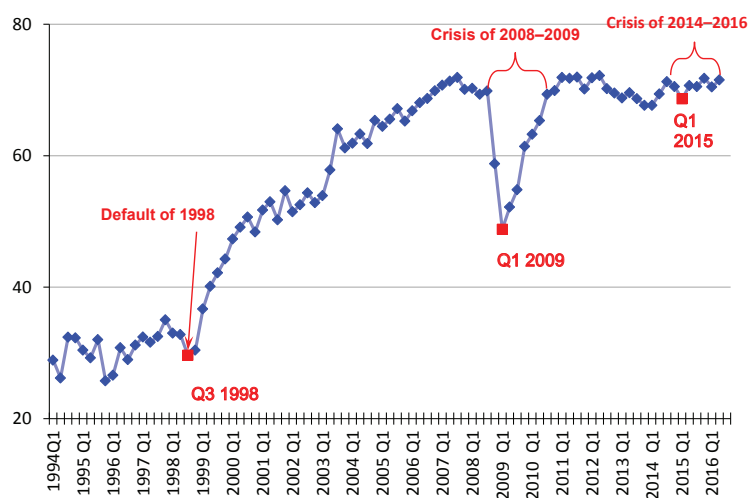


Fig. 1. Adaptability Index (normal) of industry, 1994–2016, % (share of enterprises estimating their indicators as “normal”)

the range of 13– -7 points, which also does not look like the crisis values of 2009 indicator (when balance fell to -26 points or its prior to default values -70– -60 points).

Thus, industry has never experienced shortages with supply of industrial inputs in the context of the current crisis. This conclusion is supported by another indicator – downward pressure on output by a shortage of raw and other materials. According to businesses, this factor during recent crisis years stayed at all-time minimum of its negative impact on industrial growth for the entire monitoring period (1995–2016). Merely 8–9% of enterprises indicate in 2012–2016 the shortage of industrial inputs as an obstruction to their output growth.

Estimates of existing industrial capacities have positively contributed to the Adaptability Index. It is true that the share of enterprises with sufficient capacities went up barely by 1 p.p., however 28% of enterprises report excess of capacities. Business surveys have not registered such a significant share of domestic producers with excess capacities during recent 13 quarters. In other words, we have received the maximum value for the indicator in the wake of the current crisis. Thus, industry is much better secured with capacities for potential growth than with personnel.

Estimates of enterprises to a certain degree depend on the production. Although such dependence is not observed everywhere. Although, traditionally the largest Russian producers face fewer problems with recruitment but the lag of enterprises of other sizes constitutes as a rule not more than 10 p.p. In 2016, it fell to 5 p.p.

Sufficiency of industrial capacities to a lesser degree depend on the size of an enterprise. Recently this indicator does not fall below 90% for enterprises of all sizes and along first two quarters of 2016, it stays in the range of 92–94%.

However, on the whole, adaptability of producers to the economic realities still depends on the size of an enterprise (Fig. 2). The Adaptability Index demonstrates higher values in the group of the largest (over 1,000 workers) enterprises. In Q2 2016, it hit an all-time maximum of 75% in this group. Small and medium enterprises retain inferior potential for adaptability to crisis. Since Q2 2010, the Adaptability Index in the latter group stays in the range of 57–62%.

Estimates of demand secure major gap of the Index in the group of largest enterprises. In 2016, this group boasts of sales satisfaction to the tune of 54%, meanwhile small and medium enterprises – merely 24%. Gap of 30 p.p. was also registered in 2015.

The next factor, which determines leadership of the largest enterprises, is sufficiency of industrial inputs. Along the level of their normal sufficiency, the gap constitutes 25 p.p. Advantage of responses “normal” regarding estimates of stocks of finished products and financial and economic state of enterprises comes in each case to 18 p.p. ●

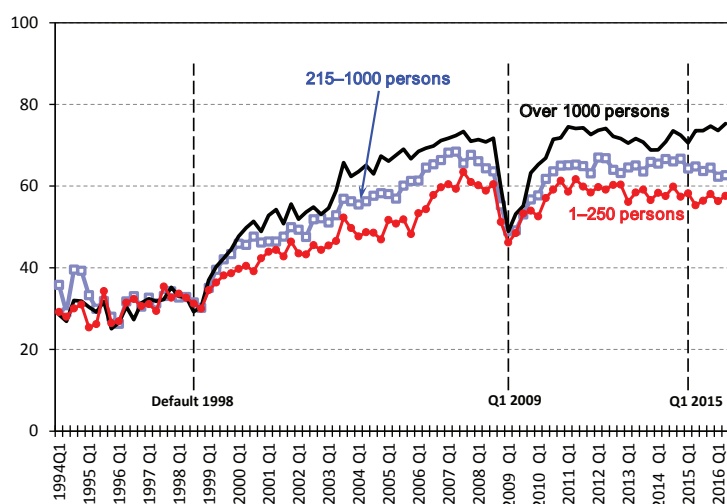


Fig. 2. Adaptability indices along enterprises' sizes, 1994–2016, % (share of enterprises, estimating their indicators as “normal”)

5. POPULATION'S SOCIAL SENTIMENT, Q2 2016

E. Avraamova, D. Loginov

Research findings obtained by the Institute of Social Analysis and Forecasting, RANEPA, demonstrate that in Q2 2016 the population with more optimism began looking to the future, which testifies about the adaptability potential of the respondents. The research provides negative stabilization with the emphasis on greater adaptability. Except the middle class, it to a considerable extent, is observed in the archaic forms of employment (for instance, private plots)¹.

Dynamics of the estimate change

In May 2016, assessing the scale of the crisis, the population opted in favor of stabilization of the situation: the largest group comprising 35% against 24% in February 2016 regard the situation on hold. The number of respondents who observe significant deterioration has dropped. Thus, a relative moderation has taken place regarding what is happening in the economy.

The prospects of economic recovery get more optimistic assessments. The number of those who previously thought that it would take a protracted character. Simultaneously, the number of citizens whose material well-being deteriorated during the crisis has shrunk by 5%. Furthermore, the number of those whose situation improved has not grown.

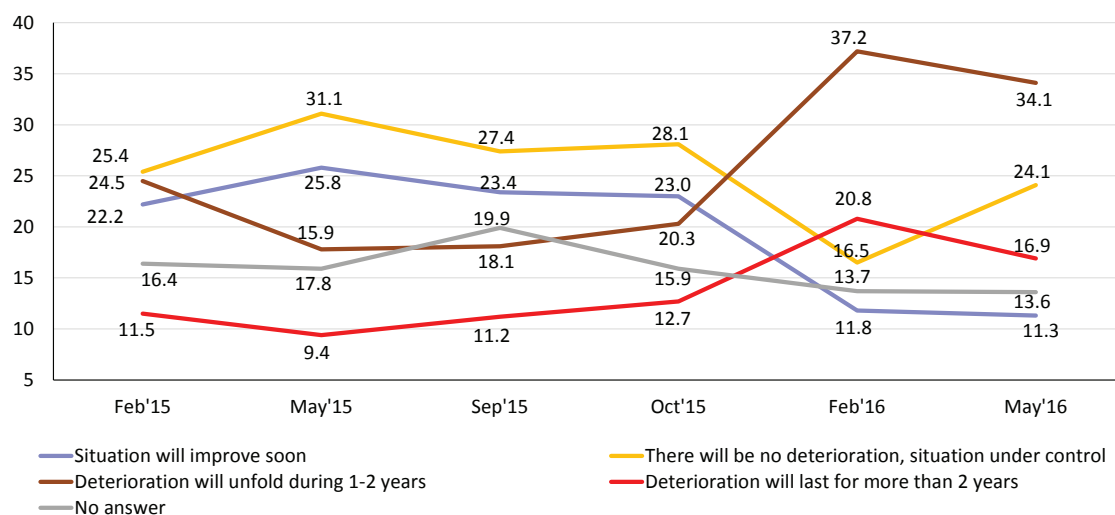


Fig. 1. Assessment of deterioration of negative effects in the economy, %

1 The population's social sentiment is represented through dynamics of the population's assessments of the current economic outlook, prospect for economic recovery as well as situation in the spheres of employment and consumption and assessments of risks of standard of living reduction. Adaptability strategy of the population was studied aimed at reflecting corresponding risks. The state of Russian middle class in the current situation was investigated. Monitoring "Social Assessment of Crisis" (along representative sample 1,600 respondents are interviewed monthly) and special study "Inequality Challenges" (in April 2016, 3,600 respondents across Russia were interviewed) conducted by the Institute served as an information basis for the research.

General more positive assessments of the current economic outlook as before do not correlate with the assessment of employment situation. The same share of respondents as in previous surveys (15%) respond about the job loss¹. Simultaneously, negative expectations regarding the possibility to lose a job are growing. Precisely the same trends are observed regarding dynamics of wage size: the same number of respondent inform about its reduction as before and negative expectations have grown somewhat.

Eight percent of respondent register transition to subemployment, 11% – to informal employment, and it broadly matches with the previous survey. The indicator regarding back pay is still high – 20% of interviewed register it.

Wi the first surveys, we observed a reduction of consumer activity among the population. However, compared to the previous months there is no further contraction of spending on goods and services. Negative expectations regarding the need to reduce consumer spending in the future do not grow either.

The status of the middle class

It is important to study the status of the middle class because hopes are rested in it for resolving the current situation, which not always and not by everybody is qualified as a crisis but undoubtedly is considered complicated.

The Russian middle class is extremely inhomogeneous. Its representatives come across all economic activities. This social stratum is most obviously observed in public administration, law enforcement, and financial activity. The share of employed in potentially innovation sectors (high-tech, education, health care, and science) is contracting in the middle class.

Those whose material status has not deteriorated during the crisis prevail among the middle class. Possible, it is due to the fact that in virtue of their competitive advantages the middle class representatives work at enterprises whose economic situation is better compared to other enterprises.

Lower stratum of society face notably higher risks of job loss than representatives of the middle class. In the perception of the majority of surveyed independently of the stratification group quest for a new job currently is connected with big difficulties. Moreover, according to 30% of representatives of lower stratum of society, it is practically impossible to find a new job. Around 20% of the middle class representatives think the same. This testifies to a contraction of the labor market and weak labor mobility.

Middle class to a greater extent than lower stratum of society manage to maintain the consumption level, however it is subject to costs saving: the share of those who cut consumption exceeds half of the middle class number. There are significantly fewer those who save on food, clothes and footwear, and especially on medicine, but they had to decline certain paid services, entertainment, and trips.

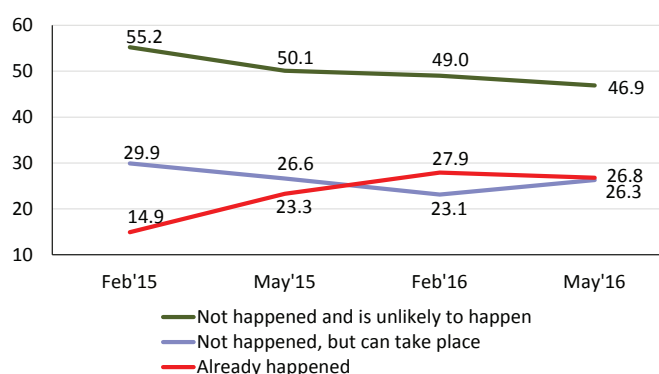


Fig. 2. Wage reduction, %

1 With possible further employment.

The resources of the middle class exceed the resources of lower stratum: its representatives oftener have relatively large savings (which permit to live for half year or longer), owners of second housing, and oftener have additional employment. The middle class representatives also have a more significant amount of property. The majority (62%) of the middle class have a complete set, which is quite modern. However, lower stratum lags behind not by much in this respect – 46% of the corresponding stratum have good material provision. In this extent, 'fat' years with high consumption were not for nothing.

At the same time, there is a significant group of middle class which needs to renovate possessions. Less than a third of this group have financial possibility for renovation. Consequently, reduction of the consumption activity can be viewed as a rather compressed in time adaptability strategy.

Adaptability behavior

In the course of recent six months just half of the population (49.2%) took any actions aimed at saving of spending their funds. On the assumption of actions (or inactions) of Russians during last year, we managed to reveal several adaptability strategies of the population to the dynamic life environment.

The investment strategy is the rarest (4.8%). It envisages the purchase of the investment assets and accumulation of funds. The savings strategy is a little bit more popular (13.6%). Its followers accumulate funds without purchasing the investment products nor durable goods. Change of profession (16.3%) through obtaining corresponding education is another strategy aimed at saving funds. The consumption strategy (33.3%) is mainly aimed at purchase of durable goods. Strategy of survival (32.0%) is the last one. It is characterized by the fact that its followers commenced using their plots of land more actively. Thus, traditional (archaic strategy) has the best of all the other.

The middle class stands out from the general structure of the population as a carrier of adaptability strategies: only 35% of its members lack adaptability strategies against 61.5% in the lower stratum.

Around one fifth of the middle class has invested in means of transport and property and is active adherents of the savings strategy. Give a cushion in the form of durables also largely corresponds the middle class behavior. The use of private plots of land as a survival is not its strategy.

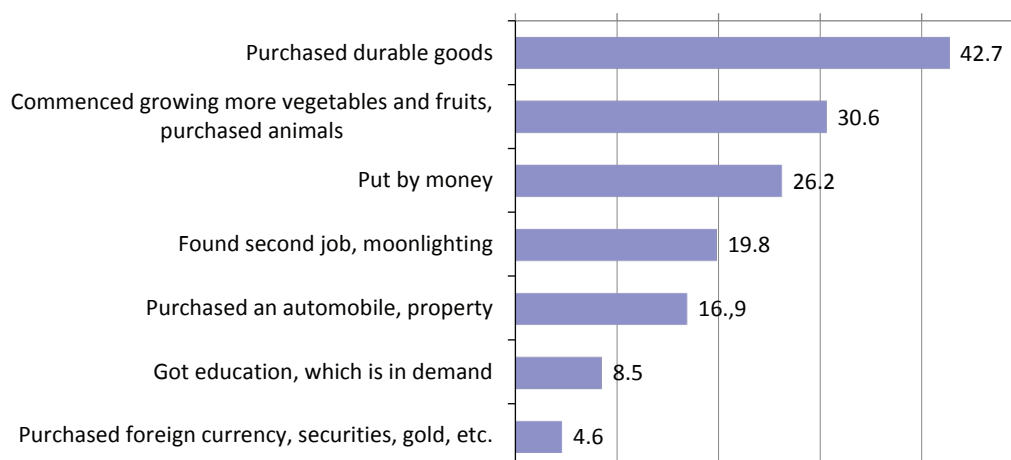


Fig. 3. Actions of Russians during the last half year, in % of those who did not take actions (several responses were accepted)

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