

ONLINE MONITORING OF RUSSIA'S ECONOMIC OUTLOOK

TRENDS AND CHALLENGES OF SOCIO-ECONOMIC DEVELOPMENT

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Monitoring has been written by experts of Gaidar Institute for Economic Policy (Gaidar Institute), Russian Presidential Academy of National Economy and Public Administration (RANEPA) and Russian Foreign Trade Academy of the Ministry of Economic Development of Russia.

Editorial board: Sergey Drobyshevsky, Pavel Kadochnikov, Vladimir Mau and Sergey Sinelnikov-Murylev

Editors: Vladimir Gurevich and Andrei Kolesnikov



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MAIN TRENDS AND CONCLUSIONS

The recent lamentation by Igor Sechin - that decisions on oil prices are frequently taken by automated 'robot' traders on the trading floors, resulting in the chaotic up-and-down movement of oil price quotes – can also be applied to the movement of other global economy indicators. Thus, the US economy sometimes grows at a stable rate while practically at the same time demonstrating signs of a slowdown, and then the Federal Reserve hints that it may choose not to raise the key rate any further. Moreover, the FRS diligently analyzes the experience of others in introducing the exotic negative rate. One moment everybody is excitedly tracking the movement of the Chinese Yuan. The next, the Japanese yen unexpectedly strengthens against the US dollar, and the stagnating Japan seems ready to lay up claim to the status of 'accumulator' of international capital. One moment low prices for raw materials appear to benefit the majority of countries and continents. The next, suddenly it becomes crystal clear that those same prices get literally everybody in trouble. Eventually everyone begins to recognize that the modern world is suffering from the lack of robots capable of carefully sequenced and reasonable functional moves. Evidently, the parameters of the Russian budget, which are strongly dependent on the world economic situation, do not appear to be sufficiently stable and predictable in such conditions, either. It is noteworthy that the real situation may turn out to be both worse and better than expected.

Thus, our experts point out that the expectations of both the RF government and the specialists on public finance (who had believed that 2015 would become the most difficult year for Russia's budgetary system in the last 15 years) proved to be false. In spite of the obviously deteriorating federal budget parameters, this trend 'did not go as far as to reach critical rates', while budget deficit (2.7% of GDP) was much lower than in 2009–2010 (about 6% and 4% respectively).

It is another matter that the expectations of the experts themselves – now with regard to the prospects for 2016 – hardly look any better than the RF government's expectations a year earlier. Anyway, they fear that, without timely and proper measures designed to adapt the budgetary system to the new reality (or, to put it more plainly, to the current level of oil prices), the 2016 budget deficit may double that of the previous year, while the Reserve Fund will be completely depleted. In this connection they warn that an attempt to repeat a technical 10% sequestration of budget expenditure is fraught with the risk of a further misbalance in the federal budget's structure: leaving intact the untouchable ('protected') budget items, cuts will be made to those budget items that are essential for promoting economic growth.

Similarly to the situation with last year's budget, the balance of payments, the scale of capital outflows and some other parameters in 2015 looked better than could be expected in face of the dramatically fluctuating oil quotes (as well as the formal and actual restrictions on the access of Russian entities to international financial markets).

Thus, for example, the growth index displayed by the current account balance did not decline. On the contrary, it increased by 12.7% on 2014. At

the same time, the trade balance's growth index shrank by 23.2%, nevertheless amounting to \$ 145.6bn) due to a more rapid shrinkage of imports. In all evidence, in 2016, imports will continue to decline at a significant rate in response to further weakening of the ruble in late 2015 and early 2016. Net capital outflows from the non-banking sector dropped dramatically, by 2.7 times on 2014. Meanwhile, the banking sector continued to reduce the volume of its external liabilities (by \$ 61.6bn). However, the downward movement of another index – that of the inflow of foreign direct investment (FDI) in Russia's non-banking sector – can hardly be regarded as an achievement: it dropped to \$ 6.7bn (or nearly threefold relative to 2014), thus having reached its record low since 2003.

Among the positive developments, we may note that the population displayed a much lower demand for foreign cash than a year earlier. And the volume of foreign cash held by the population shrank by \$ 11.8bn, to \$ 40.5bn (the Bank of Russia's estimates for the first 9 months of 2015). However, this fact can be interpreted both as an evidence of the process of de-dollarization (which is good for the national finance) and as a sign of 'forced behavior' on the part of people who have to tap on their savings denominated in foreign currency due to shrinkage of their ruble-denominated incomes.

The relatively calm reaction displayed by the population by no means rules out the fact that the plunge of the ruble's real effective exchange rate was much deeper than that of the national currencies of the other major exporters of raw materials (over the period 2014–2015, the real effective exchange rate of the Russian ruble dropped on December 2013 by 31.1%, that of the Mexican peso by 14.3%, and that of the Norwegian krone by 12.2%). The high rate of the ruble's depreciation reflects not only the low prices in the raw materials market, but also the effects of the mounting geopolitical risks and the international economic sanctions introduced against the Russian Federation.

Our experts estimate that the ruble's exchange rate is presently close to a fundamentally justified level (that is, the level justified by such fundamental factors as oil prices, the dynamics of the economic growth rate, the scale of capital outflows, and the level of public expenditure). Our experts attribute the ruble's coming close to its equilibrium to the use, by the Russian foreign exchange market, of a market-oriented exchange-rate formation mechanism, as well as to the lack of panic in economic agents. Conclusion: in the absence of new shocks, further significant weakening of the ruble is highly unlikely.

At the same time, the decline in the exchange ruble over the past few months has already predetermined, to an extent, the growth rate of inflation during the current year. According to our experts, the pass-through effect of the ruble's exchange rate decline on the prices of consumer goods amounts to between 10% and 20% depending on a particular foreign currency and the observation period. In other words, the ruble's weakening by 14.4% over December 2015 – January 2016 will translate into an additional growth on the inflation rate by 1.4–2.9 p.p. in 2016.

The high inflation of late 2014 – early 2015 was the biggest contributor to the 9% decline in real wages over the course of 2015 (in a number of sectors, even the nominal growth in wages was less than 1%). It should be said that, in 2009, the drop in real wages had amounted only to 3.5%, although it had then fallen twice as much as it did in 2015. During the previous crisis, Russia's economy had responded to the worsening situation by (among other things)

a notable increase in the unemployment rate (by 2.7 p.p. in 2008–2009), while during the current crisis enterprises significantly reduced labor costs, but so far have refrained from cutting jobs.

At the same time, according to official data, the share of part-time workers and ‘temporarily absent’ workers increased over the course of past year by a mere 0.5%. Having recently become a worrisome problem for the authorities, wage arrears cases are still relatively rare. However, at first glance, the dynamics of such cases look impressive: as of the end of 2015, the number of wage arrears cases was 1.5 times higher than as of the end of 2014. Nevertheless, the number of workers affected by those wage arrears amounted to a mere 90 thousand (or only 0.12% of all employed persons). Thus, the above figures turn out to be extremely insignificant in both absolute and relative terms. The rise in the number of wage arrears cases was caused, among other things, by the bankruptcy of Transaero Airlines, which accounted for 19% of the total wage arrears accumulated by Russia’s medium-sized and large companies as of the end of 2015.

These statistical data do not reflect the wage issues of registered small businesses – let alone the unregistered ones. Instead, they point to another phenomenon: the size of the ‘informal’ sector is by no means shrinking. It has been on the rise, increasing to 19.2% in Q3 2013 (this figure shows the number of those employed exclusively in the ‘informal’ sector). This is a record high since early 2012.

The business surveys regularly conducted by the Gaidar Institute for Economic Policy also demonstrate that in 2015, the employment indices across Russian industry pointed to no significant crisis phenomena. The estimates of both redundancy and shortage of personnel were at their habitual levels as reported by the available multi-year survey data.

Moreover, the Industry Adaptation Index (IAI), calculated by the Gaidar Institute’s Business Surveys Laboratory on the basis of a set of main economic activity indices of enterprises) shows that the majority of enterprises have been rather successful in their adjustment to the crisis conditions of 2015. Paradoxically, their own estimations of their business situation differ little from those reported by them over the previous years. Thus, for example, 61% of enterprises estimated their investment volume for 2015 to be ‘sufficient’ (the same figure as in 2014).

However, the initial IAI estimations for Q1 2016 have already pointed to a different picture (first of all, the estimated demand for enterprises’ products). No similarly negative changes in the Industry Adaptation Index have been observed since the 2008–2009 crisis. Nevertheless, this trend is quite compatible with the changes in the forecasts for the development of the Russian economy as a whole. ●

1. THE FEDERAL BUDGET: RISK OF EXPENDITURE PATTERN DETERIORATION

A.Mamedov, E.Fomina

In 2015, the federal budget was executed with a deficit of 2.7% of GDP (in 2014, 0.5% of GDP). Compared to 2014, revenues have fallen significantly – by 2.0 p.p. of GDP, expenditure volume has gone up slightly – by 0.2 p.p. of GDP. The year 2016 and the following medium-term period can become more frustrated for the budget and domestic economy as a whole, in the event there are no timely decisions regarding operational and strategic measures aimed at adjusting the budget system to the new normal. At the same time, renewal of the technical ten percent budget cut in the context of protected budget lines (social obligations, defense, public-sector employees' wages) lead to risks of further deterioration of the federal budget expenditure with decreased share of expenses, which contribute to the economic growth in the long-term (human capital and infrastructure).

According to the RF Treasury data, the federal budget revenues for 2015 (Table 1) have constituted 18.3% of GDP, down 2.0 p.p. of GDP compared to 2014, what is more, this reduction is due to the fall of oil and gas revenues. In 2015, their volume was down 2.6 p.p. of GDP against 2014. Meanwhile, non-oil and gas revenues have reached around 10.3% of GDP up 0.6 p.p. of GDP against 2014. The volume of the federal budget expenditure has moved up insignificantly by 0.2 p.p. of GDP and came to 21.0% of GDP. On the whole, the federal budget during 2015 was executed with a deficit of 2.7% of GDP up 2.2 p.p. of GDP against 2014. At the same time, non-oil and gas deficit has come to 10.7% of GDP down 0.4 p.p. of GDP compared to 2014.

During 2015, with macroeconomic outlook deterioration the 2015 federal budget framework was revised¹. Considering volatility of the main macroeconomic indicators and difficulties related to their forecasting, one-year federal budget was approved for 2016 (as it was with 2010 budget). In autumn 2015, the 2016 federal budget framework was subject to significant revisions against the original budget framework approved in the Law on the Federal Budget for 2015–2017. Largely revisions affected the resource base of the federal budget, reduction constituted 1.5 p.p. of GDP (17.5% of GDP) against the original framework. The decrease of the federal budget revenues was due to further projected decline of oil and gas budget revenues to 7.7% of GDP (against 9.7% of GDP) resulting from the fall of crude oil prices.

In the original medium-term forecast, the federal budget revenues in 2016 were calculated on an assumption of oil price at \$96 per barrel, meanwhile the one-year document was based on the price of crude oil at \$50 per barrel. Approved volume of expenditure reached 20.5% of GDP up 1 p.p. of GDP

¹ In March 2016, amendments were adopted due to the revisions of main macroeconomic indicators allowed for the 2015 budget projections. According to the adjustments, the price of crude fell from \$87.6 to \$50 per barrel, ruble exchange rate cut from 37.97 to 61.5 to the dollar, inflation rate up from 5.5 to 12.2%. As a result of adopted changes, the revenues forecast down 0.6 p.p. of GDP, and spending plan up 0.8 p.p. of GDP. As a result, the budget deficit moved up to 3% of GDP (growth 3.1 p.p. of GDP).

Table 1

	Actual execution							2015	2016		nts in against ution, p
	2008	2009	2010	2011	2012	2013	2014	executed	or 7	for	
Revenues,	22.3	18.9	17.9	20.3	20.7	19.7	20.3	18.3	19.0	17.5	-0.8
of which:											
Oil and gas revenues	10.8	7.8	8.3	10.4	10.7	10.1	10.6	8.0	9.7	7.7	-0.3
Non-oil and gas revenues	11.5	11.1	9.6	9.9	10.0	9.6	9.7	10.3	9.3	9.8	-0.5
Expenditures,	18.2	24.8	21.8	19.5	20.7	20.2	20.8	21.0	19.6	20.5	-0.5
of which:											
conditionally approved deficit (-) / surplus (+)	4.1	-5.9	-3.9	0.8	0	-0.5	-0.5	-2.7	-0.6	-3.0	-0.3
Non-oil and gas deficit	-6.7	-13.7	-12.2	-9.6	-10.7	-10.6	-11.1	-10.7	-10.3	-10.7	0.0
GDP, Rb bn	41 277	38 807	46 309	55 967	62 177	66 190	71 406	73 708	83 208	78 673	
Urals bbl/doll.***	93.6	60.7	78.1	109.6	110.6	108.0	97.6	51.0	96.0	50.0	

* Treasury data.

** Federal Law of 14.12.2015 № 359-FZ "On Federal Budget for 2016".

** annual average.

Sources: Federal Treasury; Gaidar Institute calculations.

of the original calculations. As a result, the federal budget deficit went up to 3% of GDP against 0.6% of GDP in the original version. However, taking into account the fact that in January 2016 the price of crude oil fell below \$30 per barrel, there is a high probability that even in case of one-year budget it will impossible to avoid adjustments in the course of the budget year.

Main feature of the 2016 budget will be the need to come to terms with the new normal of very low crude oil prices – around \$30–40 per barrel (possibly less) in the context that the federal budget is approved on an assumption that the price of oil stands at \$50 per barrel and its balancing according to the Finance Ministry comes at \$82 per barrel¹.

In the absence of adequate measures of operative (for 2016) and strategic response (2017–2019) against the backdrop of persistence of current crude oil prices in the medium term, the budget deficit can double in 2016 amid complete depletion of the Reserve Fund assets.

The Finance Ministry submitted an initiative for approval, which envisages escrow or withdrawal of budget funds unless as of 1 October there are contracts within financing budgetary spending. This measure is aimed at increasing spending discipline in the course of a fiscal year in order to eliminate spending of up to 25% of annual limits during the last months of the year. Budgetary spending in the end of the year are mostly ineffective and very often is linked with budget disbursement before the year-end at any cost.

For 2016, anti-crisis plan is aimed at the support of key sectors of the economy. The RF government estimates this plan in excess of Rb 827 bn. It is

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

projected to continue supporting those sectors of the economy, which boast of high import substitution potential. In January 2016, were discussed measures to support three industries were discussed: automobile (tentatively Rb 20 bn for H1 2016 and Rb 5bn for 2016 as a whole of additional subsidies¹), transport machine building and light industry (around Rb 600 mn). Mainly, support measures were directed at production incentives and supporting demand for these industries' output. Moreover, they were talking about supporting construction and agriculture (within 'anti-crisis plan' – Rb 5.1bn). However, the list of measures, industries – recipients of assistance as well as volumes of funds were not finalized. In January 2016, they were developing approval procedures for additional funds.²

Within expenditure obligations revision, the RF government plans to slash the approved expenditure volume in 2016. For example, plans regarding federal spending optimization can comprise ten percent reduction across all unprotected budget items, which will allow to save according to the RF government around Rb 500–700bn. Officially, this is not about proportional reduction across all items but solely about their ineffective component. Continuation of a technical slashing of expenditure, for example, on educational institutions and health care facilities can place certain institutions in a position when they will lack funds to cover all current costs (except wages). Consequently, with the reform of the budget institution network a simple reduction of its funding carries big risks. That is why, it will be most important during the new budget expenditure revision to avoid another “technical cut” (in all its relative simplicity) and reveal really inefficient budget expenses. It is important to put into practice variable-based approach into the budget planning when those expenses, which are subject to reduction in the event macroeconomic conditions turn out worse than projections are predetermined (in Russian practice this could be implemented within the state program with picking up “mandatory” and “additional” parts in each program).

Let us study the parameters of the 2015 federal budget execution. As a whole, the volume of tax revenues contracted considerably: -2.6 p.p. of GDP against 2014.

While analyzing the structure of actual tax revenues flow of the federal budget (*Table 2*) one can note growth of revenues in relative terms generated from Mineral Extraction Tax (MET) (+0.3 p.p. of GDP), VAT of goods sold on the RF territory (+0.2 p.p. of GDP) and generated from corporate income tax (+0.1 p.p. of GDP. Revenues growth generated by MET is due to a drastic increase from the turn of 2015 of the MET base rate on crude oil from Rb 493 to Rb 766 per ton, which was implemented within the “tax maneuver”.

Customs duties by the period-end for 2015 have contracted significantly by 3.2 p.p. of GDP, which is due to the fall of crude oil prices and reduction of imports. Moreover, customs receipts have shrunk due to the reduction since the turn of 2015 of the effective marginal export customs duties rates on crude oil to 42% against 59% in 2014. This measure was implemented within the “tax maneuver”. The volume of receipts generated from VAT on goods sold on the RF territory in 2015 shows insignificant growth by 0.2 p.p. of GDP. Furthermore, proceeds generated from VAT on goods imported into the RF

1 From the additional assets allocated in the budget for targeted support of certain sectors.

2 <http://bujet.ru/article/288770.php>

1. THE FEDERAL BUDGET: RISK OF EXPENDITURE PATTERN DETERIORATION

territory and from excises (both “imported” and “domestic”) have remained as a share of GDP at the level of 2014.

Table 2

	January–December 2015		January–December 2014		Change, p.p. of GDP
	Rb bn	% GDP	Rb bn	% GDP	
Tax revenues, total, including	11 877	16.1	13 385	18.7	-2.6
Corporate income tax					
VAT on merchandise sold on the RF territory	491	0.7	411	0.6	0.1
VAT on merchandise imported into the RF territory	2 443	3.3	2 181	3.1	0.2
Excises on merchandise manufactured on the RF territory	1 838	2.5	1 750	2.5	0.0
Excises on merchandise imported into the RF territory	528	0.7	521	0.7	0.0
MET	54	0.1	72	0.1	0.0
Revenues from the foreign economic activity (customs dues)	3 160	4.3	2 858	4.0	0.3
	3 294	4.5	5 463	7.7	-3.2

Sources: RF Treasury; Gaidar Institute calculations.

Table 3 provides results of the 2015 federal budget execution broken down by the function cost.

Table 3

	2015		2014		Change, p.p. GDP
	Rb bn	% GDP	Rb bn	% GDP	
Expenditure total, of which:	15 500.8	21.0	14 830.6	20.8	0.2
General state issues	1 101.4	1.5	934.7	1.3	0.2
National defense	3 181.2	4.3	2 479.1	3.5	0.8
National security and law enforcement	1 966.0	2.7	2 086.2	2.9	-0.2
National economy	2 160.9	2.9	3 062.9	4.3	-1.4
Housing and utilities sector	141.9	0.2	119.6	0.2	0
Environmental conservation	49.7	0.07	46.4	0.06	0.01
Education	610.6	0.8	638.3	0.9	-0.1
Culture, cinematography	89.2	0.1	97.8	0.1	0
Healthcare	516.2	0.7	535.6	0.8	-0.1
Social policy	4 264.6	5.8	3 452.4	4.8	1.0
Physical fitness and sports	72.9	0.1	71.0	0.1	0
Mass media	82.1	0.1	74.8	0.1	0
Servicing state and municipal debt	581.9	0.8	415.6	0.6	0.2
Inter-budget general transfers	682.0	0.9	816.1	1.1	-0.2

Sources: RF Finance Ministry; Gaidar Institute calculations.

On the whole, the federal budget expenditure for 2015 went up 0.2 p.p. of GDP against 2014. Spending volumes were registered across the following items: “Social policy” (91 p.p. of GDP), “National defense” (0.8 p.p. of GDP), “General state issues” (0.2 p.p. of GDP) and “Servicing of public debt” (0.2 p.p. of GDP).

The most tangible reduction affected item “National economy” (-1.4 p.p. of GDP). Significant gap in the volume of budget spending on support of the economy in 2014 and 2015 is due to assets contribution by end-2015 to the

Deposit Insurance Agency (DIA) in the amount of one trillion rubles¹. Allocation of funds was envisaged by the measures of state support of the banking sector. Without funds transferred to DIA, the volume of spending along the item "National economy" for 2014 as a share of GDP is comparable with its volume for 2015 (2.9% of GDP).

Federal budget spending reduction for 2015 also affected items: "National defense and law enforcement" (-0.2 p.p. of GDP), "Inter-budget general transfers" (-0.2 p.p. of GDP) and "Education" (-0.1 p.p. of GDP).

Table 4 represents dynamic of the federal budget expenditure broken by operation in the state governance sector.

Table 4

FEDERAL BUDGET EXPENDITURE 2011-2015

	2011	2012	2013	2014	2015
Expenditure total, Rb bn	10 935	12 891	13 343	14 832	15 501
Growth in real terms, %	-0.3	12.2	-3.0	3.1	-9.5
of which:					
Investment character expenses, Rb bn	1 660	1 753	1 659	1 773	2 313
Growth in real terms, %	7.5	0.5	-11.4	-0.9	13.0
Including stock value growth and other forms of participation in capital	410	505	315	264	226
Growth in real terms, %	14.4	17.3	-41.6	-22.3	-25.9
Current expenses, Rb bn	9 275	11 137	11 684	13 059	13 188
Growth in real terms, %	-1.6	14.3	-1.7	3.7	-12.6

Sources: Federal Treasury; IEP's calculations

The federal budget expenditure for 2015 against 2014 went down by 9.5% in real terms. Current expenses take a large share in the federal budget expenditure structure. Largely their decline (-12.6%) caused actual contraction of the overall expenditure amount. Investment spending, on the contrary, demonstrate growth in real terms by 13% for 2015 against decline by -0.9% for 2014. Significant growth of budget investment was ensured by an increase (around 38%) along item "Increase in value of fixed assets", which was determined, most likely, by an increase of expenses of state defense order. It is difficult to make price assessment due to a classified component of defense expenditure. However, even in case of a disclosed component of defense expenditure by the period-end for 9 months of 2015 growth of the investment component reached around 48%. ●

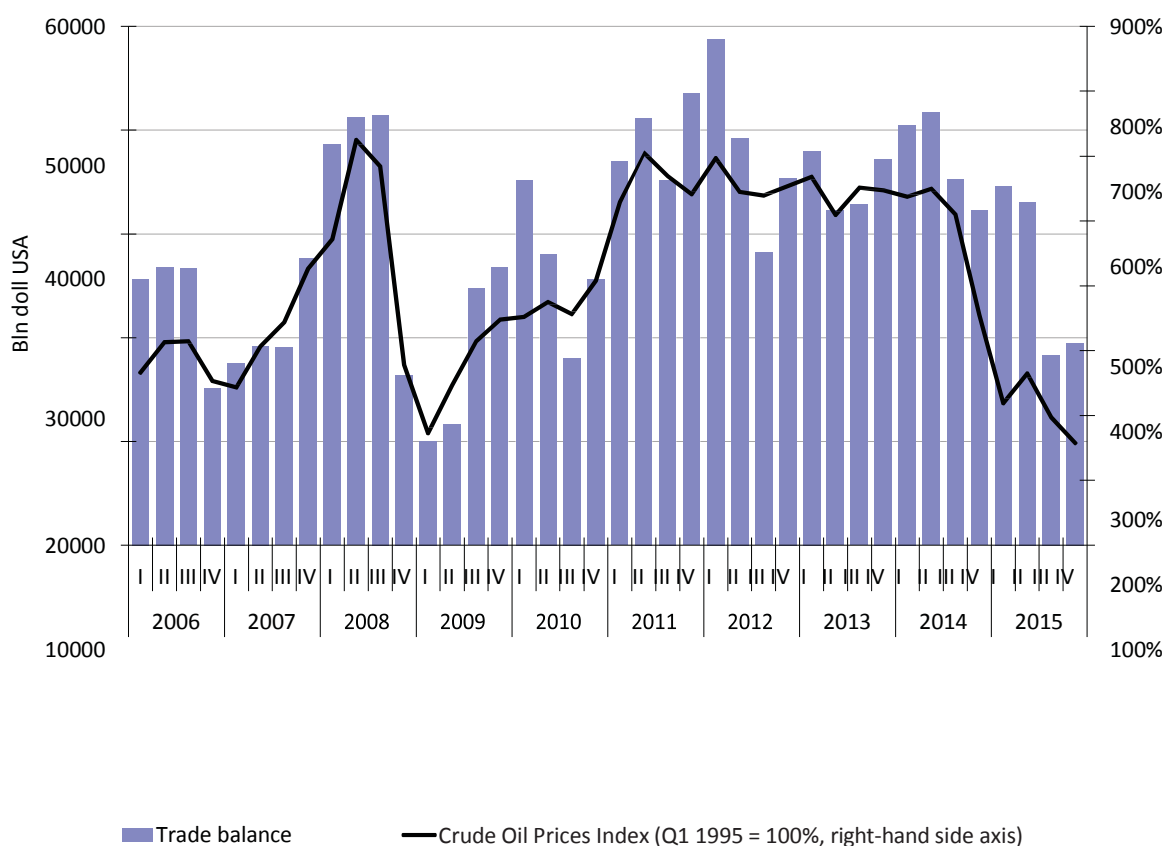
1 In December 2014, these funds were transferred via issue of OFZ and allocated for the banks recapitalization. By way of these contribution DIA received the right to recapitalize too big to fail banks, which capital is no less than Rb 100bn.

2. THE EXCHANGE RATE OF THE RUBLE IS CLOSE TO THE EQUILIBRIUM POINT

A.Bozhechkova, P. Trunin

The balance of payments for 2015 shows an increasing surplus in the current account balance, which has resulted from the shrinking deficit in the balance of services, the investment income balance and wages, coupled with the decreasing surplus in the trade balance. The accelerated weakening of the ruble in real terms against the national currencies of the developing countries during some prolonged periods of time in 2014–2015 was triggered by the mounting geopolitical risks and the plummeting oil prices.

As follows from the RF balance of payments preliminary estimates for 2015 released by the Bank of Russia, the growth index displayed by the current account balance amounted to \$ 65.8bn, having increased by 12.7% on 2014. The trade balance's growth index declined by 23.2% (from \$ 189.7bn to \$ 145.6bn) due to the general downfall of prices for major items of Russia's exports (Fig. 1). Over the past year, exports of goods declined by 31.8% (from \$ 498bn to \$ 340bn). Meanwhile, the drop in imports of goods as a result of the ruble's plummeting exchange rate against major world currencies and the shrinking incomes of economic agents was even more dramatic, having shrunk in monetary terms over the past year by 37.0% (from \$ 308bn to \$ 194bn). In all evidence, in 2016, imports will continue to decline at a significant rate in response to further weakening of the ruble in late 2015 and early 2016.



Source: Bank of Russia; EIA; estimates by the Gaidar Institute for Economic Policy.

Fig. 1. Russia's Balance of Trade and the Global Crude Oil Prices Index in 2006–2015

The current account balance increased, among other things, due to the shrinking deficits in the balance of services, the investment income balance, and the balance of wages. Thus, over 2015, the deficit in the balance of services had risen to \$ 37.1bn, and so shrank (in absolute terms) on the corresponding period of 2014 by 32.9%. Imports of services over 2015 dropped on 2014 by 28.3% to \$ 86.8bn, due in the main to the fact that Russians had begun to spend less on foreign travel. The balance of wages over January–December 2015 dwindled by 57.4%, to \$ -4.3bn (vs. \$ -10.1bn in 2014), most probably due to the shrinking wages of labor migrants, whose services had become much less in demand. In 2015, the deficit in the investment income balance declined on 2014 by 44.7%, to \$ 32.0bn, which was mostly due to a notable decrease in expenditures on external debt servicing. Thus, in 2015, in spite of the breathtaking collapse in oil prices, the current account demonstrated a noteworthy rise in the inflow of foreign exchange relative to 2014.

As estimated by the Bank of Russia, over 2015, net capital outflow from the non-financial sector amounted to \$ 56.9bn, which is 2.7 times below the corresponding 12-month index for 2014. Over 2015, net capital export by banks rose to \$ 33.4bn, that by the private non-financial sector – to \$ 23.5bn. When adjusted by the index of banks' FX operations with the Bank of Russia, net capital outflow amounts to only \$ 50.2bn.

In 2015, Russia's banking sector continued to reduce the volume of its external liabilities; over the past year, this index dropped by \$ 61.6bn (by \$ 37bn in 2014). Over the same year, the non-banking sector reduced the volume of its external liabilities by \$ 2.7bn, while in 2014 this index had risen by \$ 1bn.

The inflow of foreign direct investment (FDI) in Russia's non-banking sector amounted to 6.7bn vs. \$ 18.5bn in 2014, thus having reached its record low since 2003. The other types of their external liabilities (portfolio investments, loans and other liabilities) further shrank in 2015 by \$ 9.5bn, after their drop in 2014 by \$ 17.8 bn. It should be noted that, in 2015, the volume of scheduled repayments should have been \$ 82.6bn, but the actual shrinkage of external liabilities amounted to only \$ 2.7bn. Most likely, this situation can be attributed to intra-group transactions aimed at optimizing external debt management. In the course of such transactions, banks repay the debts due to intra-group creditors, who would then use the received funds to repay the 'real' external debt.

It should be reminded that, in Q3 2015, for the first time over a very long period of time, the Bank of Russia reported a net capital inflow into Russia's private sector which, if the banking sector's transactions with the regulator are taken into account, amounted to \$ 1.8bn. Previously, net capital inflow had been observed in Q2 2010 in the amount of \$ 4.1bn. Net capital inflow in Q3 2015 occurred due to the increasing external liabilities of the other sectors as a result of new loans, thus pointing to a certain palpable stabilization in the overall economic situation over that period.

Over 12 months of 2015, the foreign assets of residents (foreign economic agents' liabilities to Russian economic agents) decreased by \$ 8.6bn. (vs. growth by \$ 81.3bn in 2014). Over the same period of time, the banking sector's foreign assets declined by \$ 28.2bn (vs. growth by \$ 48.5bn in 2014). It should be noted that, over January–September 2015, the decline in the volume of banks' foreign assets resulting from their FX-denominated transactions with non-residents amounted to \$ 7.8bn (vs. growth by \$ 50.4bn in 2014).

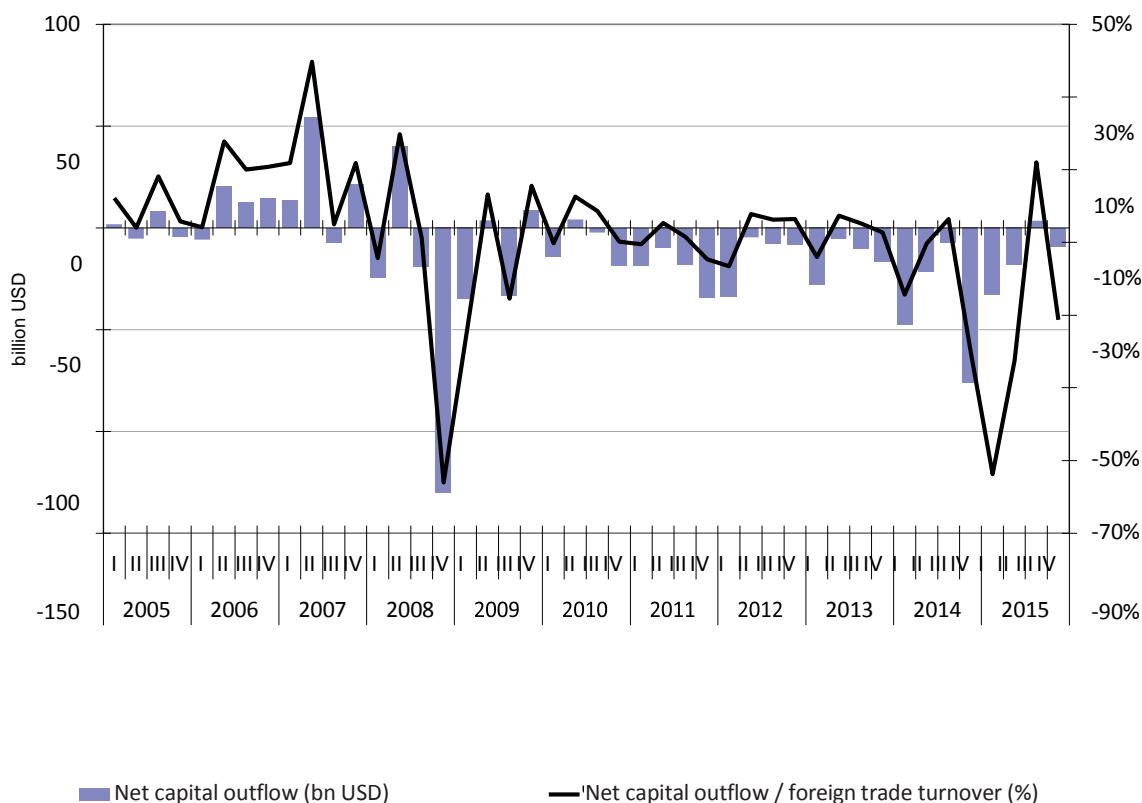
2. THE EXCHANGE RATE OF THE RUBLE IS CLOSE TO THE EQUILIBRIUM POINT

At the same time, as a result of their retail operations with the population, banks' foreign assets amounted to only \$ 0.6bn (vs. \$ -38.1bn in 2014). In other words, in 2015 the population displayed a much lower demand for foreign cash than a year earlier. As estimated by the Bank of Russia, over the first 9 months of 2015, the volume of foreign cash held by the population shrank by \$ 11.8 bn, to \$ 40.5bn.

In 2016, the foreign assets held by Russia's private non-banking sector increased by only \$ 17.8bn (vs. by \$ 72.6bn in 2014). The deepest plunge in absolute terms was demonstrated by the index of Russian residents' direct overseas investment (from \$ 54.5bn in 2014 to \$ 20.5bn in 2015). Also noteworthy is the continuing downward trend displayed by the volume of dubious operations, which shrank by \$ 2.8bn to \$ 4bn.

The decline in the volume of capital outflow was caused, among other things, also by the Bank of Russia's policy, when the regulator chose to abstain from interventions in the FX market and to switch over to a freely floating foreign exchange rate of the national currency. As demonstrated by the 12-month period-end result of 2015, as of the beginning of January 2016, Russia's international reserve assets shrank by \$ 17.1 bn (-4.4%) to \$ 368.4bn. Over 2015, the volume of foreign exchange reserves declined by \$ 19.9bn (-5.9%), due in the main to the foreign exchange repo operations with banks. The monetary gold reserves over the same period increased by \$ 2.5 bn (+5.4%) on their index as of the year's beginning, which was the result of gold purchases by the Bank of Russia.

Over the course of 2015, these developments pushed up the official USD-to-ruble exchange rate by 12.9% – from the average index of Rb 61.7 for January 2015 to Rb 69.7 for December 2015. At the same time, the average euro-to-ruble exchange rate for December 2015 amounted to Rb 75.8, having increased over the year by 4.4%.



Sources: Bank of Russia; estimates by the Gaidar Institute for Economic Policy.

Fig. 2. Net Capital Outflow in 2005–2015

2. THE EXCHANGE RATE OF THE RUBLE IS CLOSE TO THE EQUILIBRIUM POINT

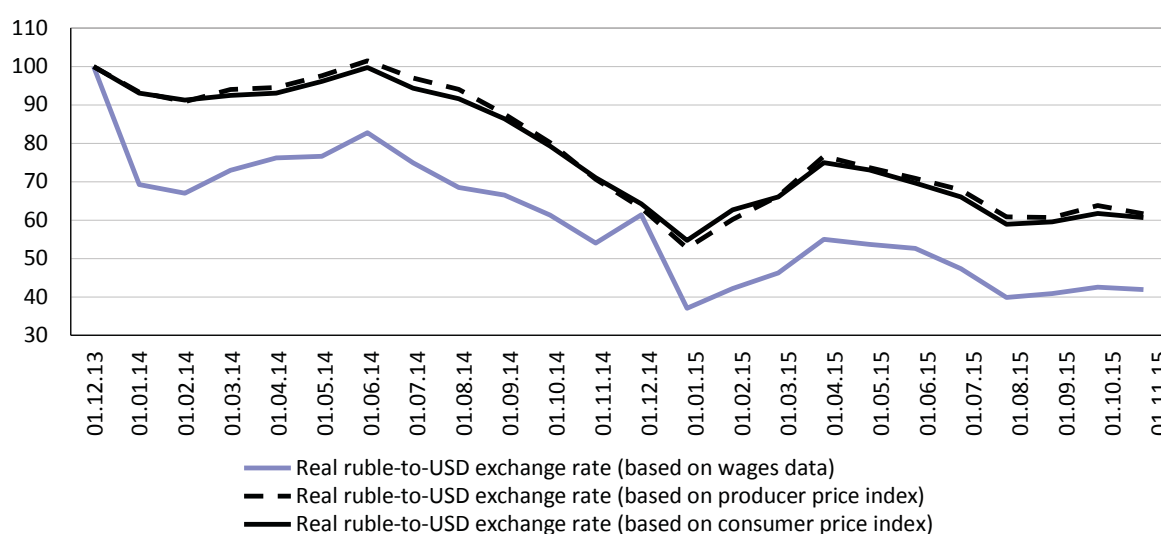
In January 2016, due to the ongoing plunge of oil prices, the ruble-to-USD exchange rate declined by 4.7%, from Rb 72.9 to Rb 76.3; over the same period, the euro-to-ruble exchange rate rose by 4.0% to Rb 82.8, while the value of the bi-currency basket increased by 4.3% to Rb 79.2. As a result, on 22 January, the official USD-to-ruble exchange rate hit its record high of Rb 83.6.

It is noteworthy that, according to our estimations, the pass-through effects of the ruble's exchange rate decline in Russia's sector of consumer goods amounts to between 10% and 20% depending on a particular foreign currency and the observation period. In other words, the ruble's weakening by 14.4% over December 2015 – January 2016 will translate into an additional growth of the inflation rate by 1.4–2.9 p.p. in 2016.

In spite of the declining prices for Russia's major exports and the ruble's depreciation in nominal terms, the high inflation rate in Russia over the 12-month period of 2015 pushed up the national currency's real effective exchange rate by 1% (over 2014, it had shrunk by 27.4%) to its December 2014 level, which also corresponds to its index for January 2005.

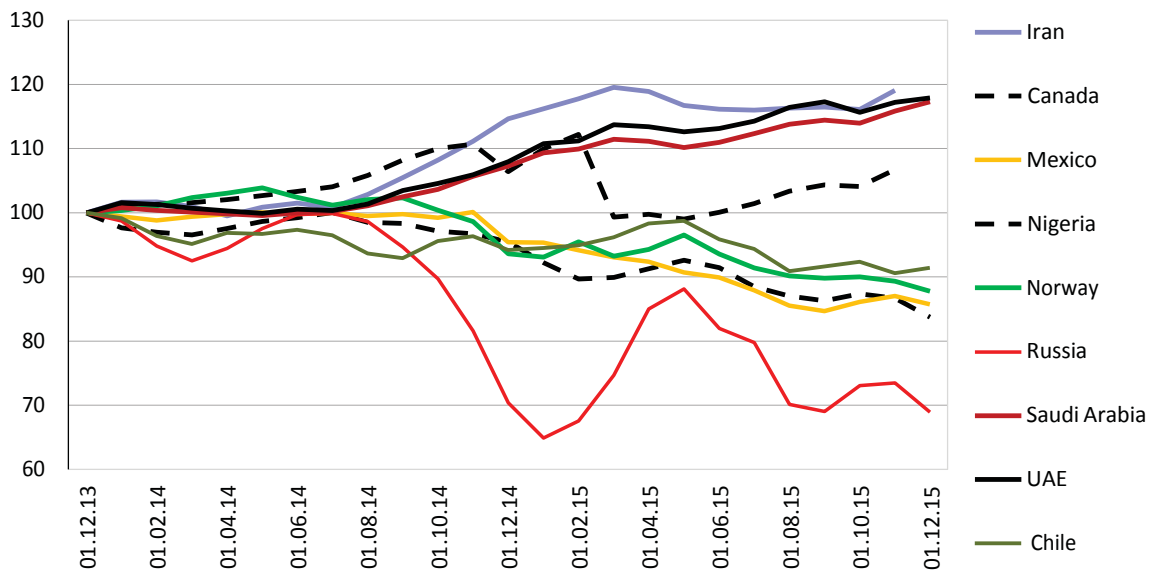
An analysis of the variances in the movement of the real ruble-to-USD exchange rate (based on such data as consumer price indexes (CPI), producer prices, and the average monthly charged wage in nominal terms) demonstrates that the competitive capacity of Russian goods in the world market is on the rise (Fig. 3). As of November 2015, the base ruble-to-USD exchange rate in real terms (calculated with due regard for the relative movement of wages in Russia and the USA) was 1.5 times below the same index calculated on the basis of CPIs estimated in relative terms. These findings indicate that the competitive potential of Russian producers has been increasing in the current crisis situation due to the shrinkage of the wage component of their costs.

In general, over the period 2014–2015, the plunge of the ruble's real effective exchange rate was much deeper than that of the national currencies of the other countries - major exporters of raw materials. For reference: over the period 2014–2015, the real effective exchange rate of the Russian ruble dropped on December 2013 by 31.1%, that of the Norwegian krone by



Sources: OECD; Bank of Russia; Rosstat; authors' calculations.

Fig. 3. The Real Ruble-to-USD Exchange Rate Movement Based on Different Price Indexes (December 2013=100%)



*data for Iran and Nigeria are for the period from January 2014 through November 2015.

Sources: BIS; International Financial Statistics (IMF); authors' calculations.

Fig. 4. The Movement of Real Effective Rates of the National Currencies of Countries -Exporters of Raw Materials, 2014–2015 (December 2013=100%)

12.2%, that of the Canadian dollar by 16.3%, and that of the Mexican peso by 14.3% (Fig. 4). The fact that the depreciation rate of the Russian ruble in the second half year of 2014 and over June-September 2015 was so high in real terms can be explained, among other things, by the mounting geopolitical risks and the international economic sanctions introduced against the Russian Federation.

The ruble's real effective exchange rate is currently hovering around its point determined by fundamental factors, this situation being an upshot of the natural behavior of the foreign exchange market, without any interference on the part of the Bank of Russia or the effects of a panic among economic agents. In absence of any new shocks, we do not expect any further dramatic plunges of the national currency's exchange rate. ●

3. RUSSIA'S LABOR MARKET: THE SPECIFICITIES OF ITS ADAPTATION TO THE CURRENT CRISIS

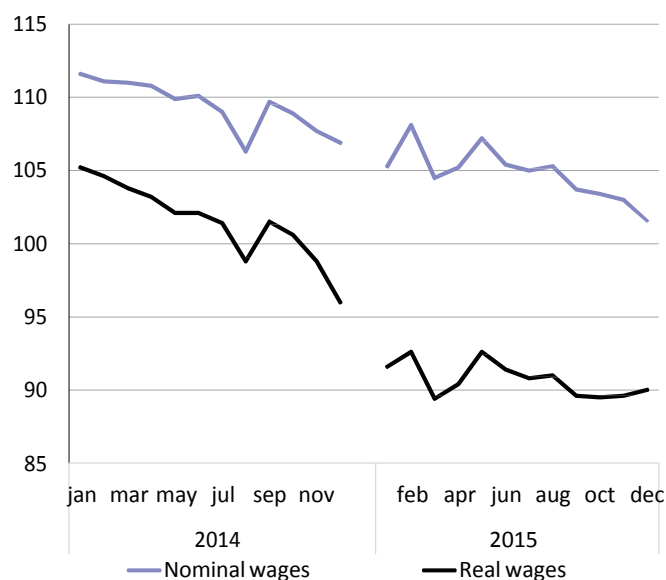
V.Lyashok

As in all of Russia's earlier economic crises, wage flexibility has become the main mechanism of the labor market's adaptation to the current crisis. As a result of the high rate of inflation observed in late 2014 – early 2015, real wages dropped by 9.5%, although nominal wages remained unchanged. The considerable reduction in labor costs made it possible for employers to abstain from cutting jobs, due to which the rise in the unemployment rate was utterly insignificant.

Like in earlier cases of economic recession, the main factor of the labor market's adjustment to adverse economic conditions was wage dynamics. The sharp rise in the rate of inflation in late 2014 – early 2015 meant that employers could significantly reduce labor costs by simply not increasing nominal wages. According to preliminary estimates released by Russian Federal State Statistics Service (*Rosstat*), in 2015, the average nominal monthly charged wage amounted to Rb 33,925, which represented a 4.6% rise on 2014. Moreover, its growth in some types of economic activity was even more modest than that: by only 0.2% in financial activities, and by 1.8% in construction, while in public administration, military security provision, and social insurance nominal wages declined even lower – by 0.9%. The largest growth in wages was observed in agriculture and the fishing industry – the two sectors least affected by the crisis. The insignificant rise in nominal wages, which took place against the backdrop of high inflation, resulted in real median wages sinking by 9.5% in 2015. Thus, they suffered a much more severe decline than that observed during the previous crisis, when real wages had dropped by only 3.5%, although Russia's GDP had plummeted by 7.8%.

The month-on-month dynamics of nominal wages indicate that their growth rate gradually declined over the period 2014–2015. By the end of that period, their growth had practically ended (*Fig. 1*). Thus, in December 2015, nominal wages were only 1.6% higher than in December 2014.

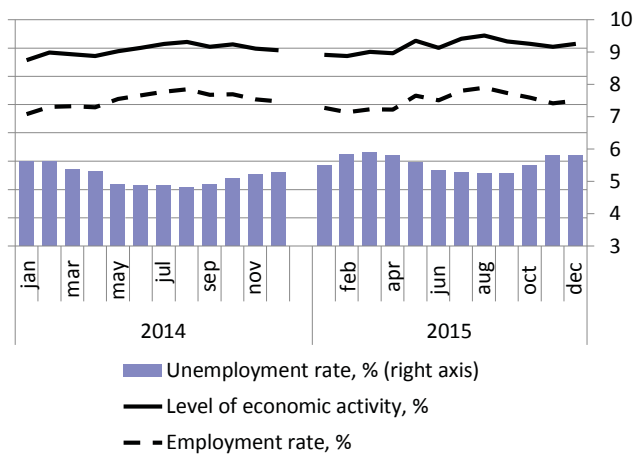
The drop in real wages caused by rising inflation made it almost unnecessary for employers to resort to other mechanisms of reducing labor costs. ●



Source: *Informatsiia o sotsial'no-ekonomicheskom polozhenii Rossii, dekabr' 2015 g* [Data on the social and economic situation in Russia, December 2015], *Rosstat*.

Fig. 1. The Dynamics of Nominal and Real Wages, As a Percentage of the Corresponding Month of the Previous Year

According to preliminary estimates released by Rosstat, in 2015, the number of individuals involved in economic activities increased by 1.2 million (without taking into account the Republic of Crimea and the city of Sevastopol), while the level of economic activity grew by 0.3 p.p. Despite the rise in the size of Russia's labor force, employment-related indicators remained unchanged relative to 2014, while the unemployment rate based on the ILO definition increased only by 0.4 p.p. The increase in the number of individuals involved in economic activities



Sources: *Sotsial'no-ekonomicheskoe polozhenie Rossii, dekabr' 1914 – noiabr' 2015 g.* [The social and economic situation in Russia, December 2014 – November 2015]. Rosstat; *Zaniatost' b bezrabotitsa v Rossiiskoi Federatsii v dekabre 2015 g. (po itogam obsledovaniia naseleniia po problemam zaniatosti), operativnaia informatsiia* [Employment and unemployment in the Russian Federation in December 2015 (labor force survey data), operational data], Rosstat.

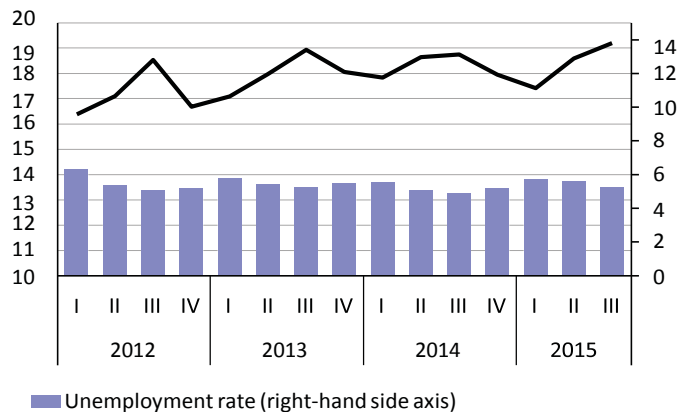
Fig. 2. The Rates of Economic Activity, Employment and Unemployment in 2014 and 2015 (Without the Crimean Federal Okrug)

was primarily due to the growth of its number in urban areas. The registered unemployment rate also went up only slightly on 2014.

Thus, the economic recession has not as yet resulted in any noteworthy increase in the unemployment rate. This feature distinguishes the current situation from the previous economic crisis of 2007–2009, when the unemployment rate had grown by 2.7 p.p.

The share of part-time workers (working less than 30 hours per week) and temporarily absent workers went up only slightly – from 8.3% over the first three quarters of 2014 to 8.8% over the same period of 2015.

Frequently, the move into the informal sector is one of the ways to escape unemployment. Therefore, the dynamics of these indicators usually show countervailing trends (Fig. 3). Rosstat data for Q1–3 2015 indicate that the number of persons employed exclusively in the informal sector has remained at the level of 2014 (however, with a slight upward trend which emerged in Q3).



Source: *Obsledovanie naseleniia po problemam zaniatosti* [Labor force survey, Q3 2015], Rosstat.

Fig. 3. The Unemployment Rate and the Share of Persons Employed Exclusively in the Informal Sector

Delays in the payment of employees' wages as one of the ways to cut labor costs, which were so widespread in the 1990s, has become a rather rare phenomenon nowadays. Although the number of wage arrears cases as of the end of 2015 was 1.5 times higher than as of the end of 2014, the number of workers affected by such policies amounted to only 90 thousand (or 0.12% of all employed persons). The rise in the number of wage arrears cases was caused, among other things, by the bankruptcy of Transaero Airlines, which

accounted for 19% of the total wage arrears accumulated by Russia's medium-sized and large companies as of the end of 2015¹.

Thus, the current situation on the labor market resembles in many respects the situation in the other sectors of Russia's economy: a decline in many indicators, but no catastrophic drops. The only exception is the ongoing decline in real wages caused by rising inflation. This situation can be explained by fact of the present crisis being so slow-motion and lengthy. ●

¹ Vedomosti [The Record], Dolgi Transaero po zarplatam isportili federal'nuiu statistiku [Transaero's wage arrears have spoiled federal statistics], See <http://www.vedomosti.ru/business/articles/2016/01/29/625974-dolgi-transaero-zarplatam-isportili-federalnuyu-statistiku>

4. THE RUSSIAN INDUSTRY HAS ADAPTED TO CRISIS

S.Tsukhlo

The majority of harmonized indicators in the IEP business surveys, which describe changes and state of the Russian industry, bear little resemblance to the crisis dynamic of 1990's or of 2008–2009 crisis. Moreover, part of indicators failed to demonstrate any crisis movements during 2015. Analysis of the data allows only by a long stretch of imagination to call last year a crisis one for the Russian industry. Enterprises managed to adjust to the slow rolling downturn. Herewith, there are struggling indicators: at the beginning of 2016, current demand volumes were assessed as “normal” by 42% of enterprises' managers, which was the worse value since the beginning of 2010.

In order to assess adaptation of the Russian industry to the current crisis, the IEP Business Surveys Laboratory has computed the Industry Adaptation (normality) Index¹. The findings permitted to draw unexpected for the long-held belief about the Russian industry conclusions (*Fig. 1*).

Firstly, the year 2015 has not seen in the industry as a whole any unusual crisis. The index steadily preserved high values by demonstrating in Q4 of last year the all-time maximum of 72%. Even during the most difficult Q1 2015, the Russian industry was not so panicky as the Russian authorities or the expert community. From this comes the conclusion that industry has adjusted to the slow-rolling dynamics of recent years. Moreover, the Index shows that from late 2010 the Russian industry constantly retained high resilience for adaptation to economic conditions true of each quarter of this period. During these 5 years, the Index was in the range of 68–72%. Maximum quarter reduction amounted to 2 points and “worst” values of the indicator (68%) were obtained by far from crisis 2015 but in late 2013 – early 2014.

Secondly, the crisis of 2008–2009 has turned out to be harder for the industry. Then this indicator lost 21 points over two quarters and its recovery took 6 quarters. In other words, enterprises required 1.5 years in order to adjust to the new economic conditions.

Thirdly, only following 1998 default the Index managed to reach all-time high. Prior to that the Russian industry experienced high levels of “abnormality” where not more than one third of enterprises managed to adjust.

However, first estimates of the Adaptation Index for Q1 2016 have demonstrated a decrease of value by 4 points. The Index has not registered such sharp negative movement since 2008–2009. However, the period of 1996–1998 did not see similar or higher decline, when the industry together with the entire economy and society were approaching the August default. Thus, early 2016 fills less optimism into the Russian industry than the beginning of 2015.

¹ The Index is computed as arithmetical average of a share of normal estimates of six indicators: demand, stocks of finished products, stocks of raw materials, available production capacities, current employment, financial and economic state of enterprises. Gaidar Institute for Economic Policy has been analyzing a set of these estimates since 1994. The Index is computed on a monthly basis. The Adaptation Index (normality) shows the level of adaptation of the Russian industry to current economic conditions.

4. THE RUSSIAN INDUSTRY HAS ADAPTED TO CRISIS

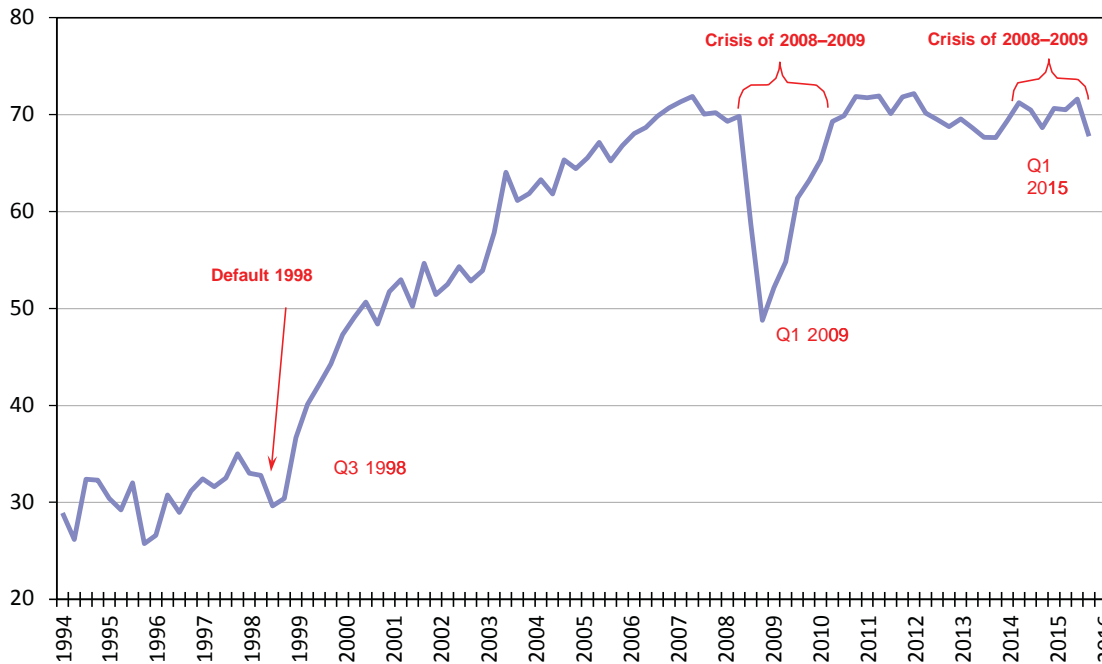


Fig. 1. The Industrial Adaptation (normality Index, 1994–2016, % share of enterprises estimating their indicators as “normal”)

Two paramount indicators for the Russian industry were the reasons for a reduction of the composite IEP Adaptation Index: estimates of demand and estimates of capacities availability in the context of expected orders. The first indicator lost 8 points and the second – 6 points. The remaining components of the Index posted meager changes in the range of -1...+1. Including – stocks of finished products.

On the basis of the official statistics, it is extremely difficult to analyze the last indicator due to lack of direct values and in the Russian circumstances the official statistics regarding stocks are unreliable. The latter makes experts to avoid using data on stocks in their analysis of the developments in the Russian industry. Although survey statistics of stocks (estimates of their volume along the scale “above norm”, “norm” and “below norm”) creates no problems for the enterprises’ managers and long-term (since March 1992) analysis of the results does not create problems for the interpretation of findings. For instance, estimates of stocks of finished products for 2015 – early 2016 speak about consistent industrial control over this indicator: the share of “normal” responses in that period reached a historical maximum. A similar situation looks logical in the context of the current slow-rolling recession, psychological preparation for which commenced even in 2012–2013. Minimization of stocks of finished products according to monitoring of priorities of industrial anti-crisis policy is being implemented by around one fourth of Russian industrial enterprises and falls under either the most widespread anti-crisis measures or is 2nd in this rating.

Additionally, current order books were estimated in early 2016 as “normal” by 42% of enterprises’ managers, which was the worst value of the indicator since early 2010, in other words for the recent 24 months. As before, the order books value is insufficient to prove statistically indisputable output growth.

In these circumstances, a reduction of production capacities looks logical taking into consideration the fact that the share of responses “more than sufficient” went up. In other words, excessive capacity hangover has gone up in the Russian industry and amounted to 28%. Barely 7% of enterprises’ managers estimate shortage of capacities. Thus, feasible industrial growth in 2016, according to enterprises, is well assured by availability of machinery and equipment. Although quite recently experts considered Russian industry to lack reserves of idle production capacities needed to increase output and thus requires investment for their expansion. Investment slump of 2015 should have deteriorated the situation with sufficiency of production capacities. However, as we can observe, it has not happened.

However, investment slump of the last year did not cause panic in industry as the one we can observe among officials and experts. Investment volumes are estimated as “sufficient” by 61% of enterprises. Investment volumes for 2014 received similar estimates. Taking into consideration responses “more than sufficient” (excessive investment), the share of enterprises with insufficient, due to expected orders change, investment constitutes 35% in 2014–2015. This indicator posted the best value in 2013 (31%).

Enterprises estimate the situation with supply of workers differently than the situation with capacities. Over 20 years (since Q2 2016, i.e. 80 quarters) industry always provided more responses “sufficient” (in %) in the assessment of available number of employees than in the assessment of capacities and investment. Prior to default of 1998, the situation with headcount was more often estimated as “excessive employment”, and then in 2005–2008 “shortage of workers” dominated in responses. In early 2009, enterprises’ responses indicated crisis growth of “more than sufficient” to 28%, which however, by the end of the year fell to rather traditional 15%, and in 2010 averaged 12%.

Estimates of employment in industry during 2015 have failed to show any crisis developments. Excessive employment in the Russian industry was estimated at 11–12%. Shortage of workers was at around the same level save only in July when the IEP business surveys registered this indicator’s hike to 17%, but by the end of 2015 – beginning of 2016, estimates of workers deficit returned to the previous 10%.

At the beginning of 2016, excessive employment has remained at the same level of 12%. Absolute majority of enterprises (78%) estimated the headcount number as “sufficient due to expected demand change”. ●

AUTHORS

Bozhechkova A., Head of Monetary Policy Department,
Gaidar Institute for Economic Policy

Lyashok V., researcher, Pension Systems and Actuarial
Forecasting of the Social Sphere Department, Institute of Social
Analysis and Forecasting, RANEPA

Mamedov A., Head of Budget Policy Department,
Gaidar Institute for Economic Policy

Trunin P., leading researcher, Center for Central Banks Research,
RANEPA

Fomina E., researcher, Budget Policy Department,
Gaidar Institute for Economic Policy

Tsukhlo S., Head of Business Surveys Laboratory,
Center for Real Sector, Gaidar Institute for Economic Policy