

ONLINE MONITORING OF RUSSIA'S ECONOMIC OUTLOOK

TRENDS AND CHALLENGES OF SOCIO-ECONOMIC DEVELOPMENT

№ 3(21) February 2016

MAIN TRENDS AND CONCLUSIONS	3
1. BANKING SYSTEM: THE STATE RUSHES TO RESCUE (M.Khromov)	6
2. AUSTERITY: A TREND ACROSS RUSSIA'S REGION (N.Zubarevich).....	10
3. BUDGET LOANS AND SUBSIDIES TO REGIONS: WHO AND HOW MUCH RECEIVED IN 2015? (A.Mamedov, E.Fomina).....	15
4. IMPORT SUBSTITUTION IN RUSSIA'S MANUFACTURING INDUSTRY: A WEAK EFFECT (A.Kaukin, P. Pavlov)	22
5. AGRICULTURE: IMPORT SUBSTITUTION'S 'FRUITS'(N.Shagaida, V.Uzun)	26
AUTHORS.....	30

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

Editor: Vladimir Gurevich



GAIDAR
INSTITUTE FOR
ECONOMIC
POLICY



RANEPA
THE RUSSIAN PRESIDENTIAL ACADEMY
OF NATIONAL ECONOMY
AND PUBLIC ADMINISTRATION



Online Monitoring of Russia's Economic Outlook: trends and challenges of socio-economic development. 2016. №21 (3). February / A. Mamedov, N. Shagaida, V. Uzun, E. Fomina, A. Kaukin, P. Pavlov, N. Zubarevich, and M. Khromov. Edited by: V. Gurevich, S. Drobyshevsky, P. Kadochnikov, V. Mau, and S. Sinelnikov-Murylev. Gaidar Institute for Economic Policy, Russian Presidential Academy of National Economy and Public Administration, Russian Foreign Trade Academy [Digital resource] URL: http://www.iep.ru/files/text/crisis_monitoring/2016_3-21_february_eng.pdf

The reference to this publication is mandatory if you intend to use this material in whole or in part.

MAIN TRENDS AND CONCLUSIONS

The economy met the beginning of spring in a mood that can be called moderately pessimistic, if we compare it with the major forecasts for 2016 that have already been made public. To be more particular: there are no signs of growth, but no general downfall of GDP either (this single fact, however, does not brighten in any way the overall bleak outlook for some sectors), with a persistently negative trend displayed by the behavior of the population's real income in face of a relatively high employment rate and the increasingly strained budget, so that it has become much more difficult to attempt any tactical measures designed to support one or other important sector of the national economy, while not yet ruling out completely the actual possibility of implementing such measures.

Against this background, and with a view towards the forthcoming electoral season, the following tasks are coming to the fore: a) to undertake a number of much more drastic measures in order to radically improve the economic situation; b) to alter the economic policy itself, by making financial resources easily accessible, to be granted – if needed – at the expense of a multi-trillion money emission and administrative control over the interest rates set by banks and other institutions. As it often happens in crisis situations, the radical demands that are actually being voiced imply that certain factors should be relied upon that are not really compatible. So, while consumers complain mostly of price growth and view it as a major problem, those who demand that the monetary policy be eased argue that the inflation rate is not really so high, and that it will become even lower once their demands are satisfied.

Meanwhile, the inflation rate itself demonstrates signs of a slight slowdown, although it still contrasts sharply with the inflation indices observed practically in any other country around the globe, and besides, in Russia its behavior remains rather unpredictable. This situation has to do not only with the effect of the national currency's devaluation which has not yet made itself to be felt fully, but also with the possibility of introduction of still more economic sanctions against Russia, and Russia's retaliatory sanctions. Besides, two current goals – that of bringing down the inflation rate and that of replenishing the budget – have repeatedly been in conflict with each other, as it happened, for example, when excises on petrol were raised, and when the toll payment system *Platon* was launched. And the discussion of excises on palm oil and other harmful products is a vivid illustration of the fact that the list of measures that can be implemented in order to adjust the inflation targets is very far from being exhausted – both in its length and its content.

Nevertheless, the developments observed over Q1 have so far failed to confirm the worst fears that arose in connection with the recent sharp plunge of oil prices and the new wave of the ruble's depreciation. The absence of any signs of panic in the foreign exchange market (and even its slight oversaturation) – in view of which the recent acts of the RF Central Bank appear to be unexpected and hardly explainable, and the relatively calm situation in the

banking sector may be regarded as positive a factor, whose real benefits can become evident only when they give way to negative ones.

It is not by chance that the substantial support granted last year to the banking sector was met with public response that can be boiled down to this: 'so much to banks, and so little to the real sector!'. In addition to the general dislike of credit institutions – which, by the way, is a common phenomenon in many countries – this public viewpoint relied on the fact that the capitalization of banks did not noticeably boost their lending activity. Nevertheless, one cannot overestimate the very fact of absence of panic in the banking sector, let alone a cascading failure of the entire banking system.

In 2015, the volume of government support granted to the banking sector amounted to Rb 1.7 trillion. The cost of recapitalization of some major banks was in excess of Rb 1.1 trillion (including Rb 800bn granted to major state banks). The amount of support received by the banks that were being restructured is estimated to be Rb 500bn. Over the same year, the payments by the Deposit Insurance Agency to the clients of the banks whose licenses had been revoked amounted to Rb 369bn. Since the Mandatory Insurance Fund was able to cover only part of those payments, the Deposit Insurance Agency could rely on the aid of the Bank of Russia. On the whole, according to our experts, the availability of support measures points to the fact that bank capital sustainability is sufficient.

However, the continuing relative stability in that sector cannot mask the fact that it is stagnating. Besides, the cost of this stability amounts not only to the trillions of rubles already spent, but to the ongoing effective nationalization of the banking system. The forthcoming privatization of VTB (even if this transaction is not going to be an exception) cannot reverse the monopolization process going on inside the system.

The current situation in Russia's budgetary system appears to be much more complex and tense, including the situation with regional budgets, which are less self-sufficient, and so are more dependent on the federal budget. As the potential of the latter is evidently shrinking, federal aid to the budgets of regions has also been on the decline. In 2015 (by comparison with the situation in the previous year) the volume of budget loans to the regions shrank by 1% even in nominal terms, and that of grants intended to properly balance their budgets – by 34% (or by 43% less the Crimea).

The fact that the aggregate regional budget deficit (Rb 171bn) in 2015 turned out to be approximately 2.5 times lower than in 2014, and still lower than in 2013. However, this became possible, firstly, due to the big surplus budget displayed by the city of Moscow, and secondly, because many regions had been actively economizing, making cuts, among other things, on their investment in the economy. The aggregate debt of regions and municipalities over that year increased by 11% (being slightly below the inflation rate), thus amounting to Rb 2.66 trillion. The issuance of super-cheap budget loans to the regions did not result in any significant improvement in the structure of their debt: banks are still topping the list of their creditors.

The socioeconomic situation in the regions demonstrates the still slack growth of the unemployment rate, slow growth of the rate of part-time employment, declining real incomes and the consumption index, plummeting investment and shrinkage of industrial production, estimated by experts as being moderate and 'geographically localized'. While the production index

declined in 36 regions, it rose in some territories that house production entities belonging to the defense industry and the agro industrial complex.

The hopes that the import substitution efforts across Russian industry may translate into some visible positive effect have so far proved to be futile. In part, this can be explained by the short time that has elapsed since the onset of that campaign, by shortage of investment, by the need for imported products, which are still needed for the implementation of import substitution projects. Some import substitution – which can by no means be estimated as a serious achievement – can be observed in metallurgy, textile manufacturing, the automotive industry. But on the whole, the reliance on imports remains high, and as far as the production of machines, equipment and pharmaceuticals is concerned, something rather opposite to import substitution is actually taking place.

Agriculture remains the sector where the ‘fruits’ of import substitution can be expected to grow. The retaliatory sanctions reduced the physical volume of foreign agricultural supplies to the Russian market, while the ruble’s sharp weakening has made too expensive those products that continue to be imported. But while food imports over the past year shrank in dollar terms (by 34%), their ruble-denominated value increased by 5%. Our experts consider this to be an indirect sign that people have not reduced their expenditures on imported products, but their physical consumption volume has shrunk.

The experts also note that the share of Russian foodstuffs (in kind) within the main groups of consumer goods has increased. However, this substitution can be viewed as a positive outcome only if the consumption of these products is on the rise, or at least if it does not decline. The experts have come to the conclusion that domestic production growth has resulted in import substitution only with regard to two items – poultry meat and vegetables (their quality and prices are not taken into consideration). The imports of other products have been shrinking at a rate that is faster than the growth rate of their production. As for the production sphere, over the past year Russian farmers adapted better to the new situation and increased their share in the agricultural market more successfully than big public companies, although the government preferred to grant its support to the latter.

From the point of view of successful exports, the agricultural sector has unquestionably benefited from the ruble’s devaluation. Over the past year, food exports (denominated in rubles) increased by a third, and nearly doubled on 2013. The positive factor created by the ruble’s low exchange rate against the world’s major currencies will probably be benefiting Russian agricultural producers for a long time, unless they join the popular campaign under the slogan ‘cheap money, and the more of it the better’ and manage to reverse the situation with inflation, thus quickly losing their newly acquired competitive capacity. ●

1. BANKING SYSTEM: THE STATE RUSHES TO RESCUE

M.Khromov

The volume of state support to the banking sector totaled Rb 1.7 trillion in 2015. In particular, recapitalization of major banks has exceeded Rb 1.1 trillion of which major state banks received Rb 800bn. These measures maintained capital adequacy at the required level.

In 2014-2015, government financial support to the banking sector included growth of its capital and implementation of procedures aimed at weak banks resolution. Moreover, guarantee of continuous operation of deposit insurance system required additional financial investment as the Deposit Insurance Agency (DIA) was already to run out of assets in mid-summer of 2015¹. Consequently, missing funds needed to pay to the depositors of closed banks had to be provided as a loan by the Bank of Russia extended to the Deposit Insurance Agency. What was the total amount of funds provided by the state to the banking sector? Let us make an in-depth analysis of aforementioned categories of support provided to the banking sector.

1. Change of conditions for state banks recapitalization during 2008–2009

In the course of 2008-2010 crisis, the banking sector also received significant amounts of public funds. In particular, in accordance with the Federal Law No 173-FZ "On Additional Measures for Supporting the Financial System of the Russian Federation" the Bank of Russia extended to Sberbank subordinated credits totaling to Rb 500bn. A number of major banks obtained subordinated credits from Vnesheconombank at the expense of assets from the National Wealth Fund (NWF) placed on depo accounts with Vnesheconombank. Initial loan periods were to terminate in December 2019. This means that already in 2015 loan repayment was to commence and discounted in the loan recipient's capital².

In order to avert this, in 2014 amendments were introduced into the Federal Law No 173-FZ, which upon government decision allowed to allocate the NWF funds to purchase preference shares by the banks, which cleared due payments on subordinated credits. To banks, this procedure signified not only stabilization of the capital base but also improvement of the capital quality. Instead of Tier 2 capital where usually subordinated credits are included, banks received Tier 1 capital. At the same time, by a provision these shares were exempt from mandatory dividend payments. In other words, the cost of drawn capital decreased for the banks. Moreover, growth of Tier 1 capital expanded banks' options to obtain new subordinated credits, whose inclusion in the banks' capital is limited by the volume of Tier 1 capital.

1 See: Micheal Khromov. The Insurance System Does Not Cope with Bank Sanation. OMES № 9, June 2015.

2 The amount of subordinated credit included in the calculation of bank capital even-ly decreases over last five years of the loan period. Thus, commencing with 2015, capital of banks – recipients of subordinated credits in accordance with Federal Law 173 FZ was to decline gradually by 5% of the credit amount per quarter.

As a result, since late 2014 such decisions were taken regarding three major banks: Bank VTB, Rosselkhozbank, and Gazprombank. Total amount of loans converted into preference shares came to Rb 279bn. Besides, VTB and Gazprombank since December 2014 obtained new subordinated loans from the assets of NWF totaling to Rb 164 bn (Rb 124bn for VTB and Rb 38bn for Gazprombank).

Special situation has come about Sberbank. First, Sberbank obtained subordinated loan totaling to Rb 500bn directly from its main shareholder – the Bank of Russia. In 2010, amid recovery growth of both the Russian economy and the lending market, Sberbank management considered this loan excessively expensive (initial rate was 8% per annum) that is why a part thereof in the amount of Rb 200bn Sberbank returned to the Bank of Russia prior to maturity.

In summer 2010, the Federal Law No 173-FZ got an amendment¹, which reduced the cost of the Sberbank subordinated loan to 6.5% per annum. In June 2014, Sberbank obtained \$ 200bn in accordance with the same law. According to the effective to that date version of 173-FZ the interest rate amounted to 6.5%.

In July 2014, the Federal Law No 173-FZ received amendments, which envisage extension of subordinated loans period granted to Sberbank to 50 years. In autumn 2014, amendments were introduced into Regulation 395-P (“On the Methodology for Determining the Amount of Own Funds (Capital) of Credit Institutions”), which allowed to include in the capital subordinated credits extended in accordance with new version of the Federal Law No 173 FZ.

Starting from reporting date 1 April 2015, subordinated loans extended to Sberbank in accordance with the Federal Law No 173-FZ were included in the amount of Rb 500bn, which means that they were fully rescheduled for a period of 50 years.

Consequently, amendments to the law introduced during 2014-2015 allowed Sberbank to increase its capital starting from 1 April 2015 by a minimum of Rb 215bn (Rb 200bn – repeated loan tranche drawn in June 2014, Rb 15bn – termination of depreciation to the tune of Rb 300bn due to extended period of subordinated loan).

Thus, since mid-2014, major state banks were able to improve the quality of their capital to the tune of Rb 779bn avoiding subordinated loans depreciation and additionally received Rb 164bn from the NWF assets.

2. State support of the banking sector with participation of the public corporation Deposit Insurance Agency.

In December 2014, DIA received additional contribution from the RF Government – special issuance of the federal loan bonds (FLB) totaling to Rb1 trillion for further allocation in the capital of commercial banks. After that, a list of banks was approved, which were eligible after meeting certain conditions for recapitalization from the DIA funds. One of the preconditions of recapitalization was contribution limit capped at 25% of the own funds of the recipient bank as of 1 January 2015. Because total capital of the eligible banks amounted to Rb 3.454 trillion (43.6% of the total capital of the banking sector) prospective volume of recapitalization was initially limited to Rb 864bn.

¹ Federal Law of 27.07.2010 № 206-FZ.

During 2015, 25 banks were eligible for recapitalization. As a result, they received from DIA contributions to their capital to the tune of Rb 803bn. At the same time, recapitalization of Bank VTB and 'Otkrytie' was carried out taking into account limits imposed on their subsidiary banks, which also were on the list.

3. Weak banks resolution.

2015 set record regarding the number of cancelled licenses: 93 credit institutions lost the right to carry out their activity. Nevertheless, apart from that, the financial restructuring procedure was launched against certain banks under the DIA supervision. In 2015, financial restructuring procedure was launched against 14 banks with total funds around Rb 900bn¹. Total number of banks subject to financial restructuring hit 28 in early 2016. Aggregate volume of financial support to these banks as of early 2016 totaled Rb 1.2 trillion, of which Rb 491bn was extended in 2015. The Bank of Russia is the main source of this financial support. It allocated Rb1.159 trillion (Rb 488bn in 2015). The DIA provided the remaining funds at the expense of asset contribution extended by the Russian Federation.

4. Financing payment to depositors of banks stripped of licenses.

Out of 93 credit institutions, which lost their licenses in 2015, 77 credit institutions participated in deposit insurance system. Aggregate volume of payments in 2015 carried out by the Deposit Insurance Agency to the bank depositors on the occurrence of insurance events totaled Rb 369bn, additional Rb 64bn DIA paid in January 2016. At the same time, as of early 2015 according to the DIA data, the Mandatory Insurance Fund totaled Rb 69bn. Over 9 months of 2015, contributions to the Fund came to Rb 82bn. Final data for a year was unavailable as of the date of this review, however, according to our estimates, contributions did not exceed Rb 100bn. Therefore, the Deposit Insurance Agency had to receive at least Rb 200bn from the alternative sources to be able to pay depositors in 2015. It is known that in August 2015, the right for unsecured loan application to Bank of Russia to the tune of Rb 100bn for a period of 5 years was approved in the event the liquid assets of the Fund fall below Rb 40bn.

Table 1

STATE SUPPORT MEASURES FOR BANKING SECTOR IN 2015
ALONG CERTAIN GROUPS OF BANKS, RB BN.

	Rescheduling of 2008 support		NWF investment	DIA recapitalization	Sanation	Deposit insurance system deficit
	Total volume	Effect on capital in 2015				
Sberbank	500	100				
VTB group	214	43	38	307		
Gazprombank	40	8	126	126		
Rosselkhozbank	25	5		69		
Other bank recapitalized by DIA				301		
Banks subject to financial restructuring					491	
Banks with lost licenses						200
Total	779	156	164	803	491	200

1 As of latest reporting date prior to commencement of bank resolution.

In view of this, we estimate aggregate volume of direct support provided to the banking sector in 2015 minimum at Rb 1.7 trillion (*Table 1*, columns 3–6). Moreover, additional effect for the capital of major banks totaled Rb 156bn due to change of recapitalization conditions within 2008 law. In 2015, aggregate capital growth of the banking sector hit Rb 1,080bn. At the same time, bank capital growth due to new contributions and reschedule of 2008–2009 loans came to Rb 1,123bn (*Table 1*, columns 2–4), Rb 822bn of which were received by major banks. In other words, all positive increment of the banking sector capital in 2015 was secured exclusively thanks to state support measures.

These measures, to a significant degree, maintained capital adequacy ratio within required limits. For example, the value of capital adequacy ratio of the banking sector as a whole without the implementation of aforementioned measures of recapitalization as of 1 January 2016 could be at 11.1% instead of 12.7% is reality. Regarding capital adequacy, state banks have gained still more: 2 p.p. (*Table 2*). Moreover, a number of banks would have failed to meet capital adequacy requirement without drawing additional funds. This is true of Bank VTB and a number of private banks such as MDM, Rossyisky capital, Binbank and some other.

Table 2

EFFECT OF MEASURES OF RECAPITALIZATION OF BANKING SECTOR
ON CAPITAL ADEQUACY

	H1 os af 1.01.2016	H1 without measures of recapitalization
Banking system	12.7	11.1
State banks	12.5	10.5
Sberbank	11.9	11.4
VTB group	12.4	8.7
Gazprombank	13.6	10.2
Rosselkhozbank	16.6	13.7
Other banks	13.0	11.9

2. AUSTERITY: A TREND ACROSS RUSSIA'S REGION

N.Zubarevich

The year of 2015 was marked by a few troublesome trends in the crisis unfolding in Russia's regions. The overwhelming majority of Russia's territories ran a budget deficit while regional and municipal debts were piling up. A new trend towards drastic shrinking of consumption took hold. Furthermore, investment continued to decline for three consecutive years. On the other hand, the industrial sector downturn was moderate and geographically localized, and the unemployment rate continued to grow at slowest pace. The outlook for 2016 is negative: the adverse trends are expected to worsen.

Budget disequilibrium and huge debts remained the principal (unaddressed) problem facing Russia's regions: 77 regions ran a budget deficit in 2013, 75 in 2014, 76 in 2015. Most of the top-ranked oil-and-gas producing regions and federal-status cities ran a budget surplus (Fig. 1). The total amount of regional budget deficit in 2015 dropped to Rb 171bn (Rb 642bn in 2013, Rb 448bn in 2014) mostly due to a huge surplus of Moscow's budget (Rb 144bn in 2015). Excluding the nine regions with budget surplus, the rest of the regions ran a total of Rb 370bn in budget deficit. Many regions endeavoured towards thrifting: consolidated budget expenditure increased mere 1%, income raised 6%.

The total amount of regional and municipal debts in 2015 increased 11% to Rb 2.66 trillion as of 1 January 2016 (3.3% of GDP), accounting for 35% of the regional tax and non-tax consolidated budget revenues (excluding transfers). The debt problem remained unaddressed while the Finance Ministry nearly doubled (from Rb 160bn to Rb 310bn) the amount of super cheap budget loans for regions, but failed to make a serious contribution to improving the debt structure which continued to have a large share of expensive loans from commercial banks (44% as of 1 January 2016).

The budget system saw further destabilization because the 2015 federal budget ran a deficit (nearly Rb 2 trillion or 2.5% of GDP). Risks worsened, especially for the regions, which depend heavily on government grants, making up almost 2/3 of Russia's regions. In 2015, transfers to regions contracted by about 3% (although excluding Crimea, they remained unchanged), and the federal support to the regions in 2016 may weaken substantially.

The **drastic consumption downturn** was the second major problem in 2015, which was determined by a decline in personal income and wages by 4% and 9.5% respectively. A new trend towards drastic contraction in retail sales emerged in 2015, consumption was declining two times faster than personal income. The Russians in 2015 switched to an "austerity mode" after realizing the crisis could continue for long. Geographical differences in the retail sales dynamics between the regions can be explained mostly by statistics drawbacks, especially for the North Caucasus Republics, Zabaykalskiy Territory and Far East Federal District, where bazaars make up a larger share of the overall sales. The Central, North-western, Southern, Volga, Urals Federal Districts, as well as most of the Siberian Federal District, saw a sweeping

2. AUSTERITY: A TREND ACROSS RUSSIA'S REGION

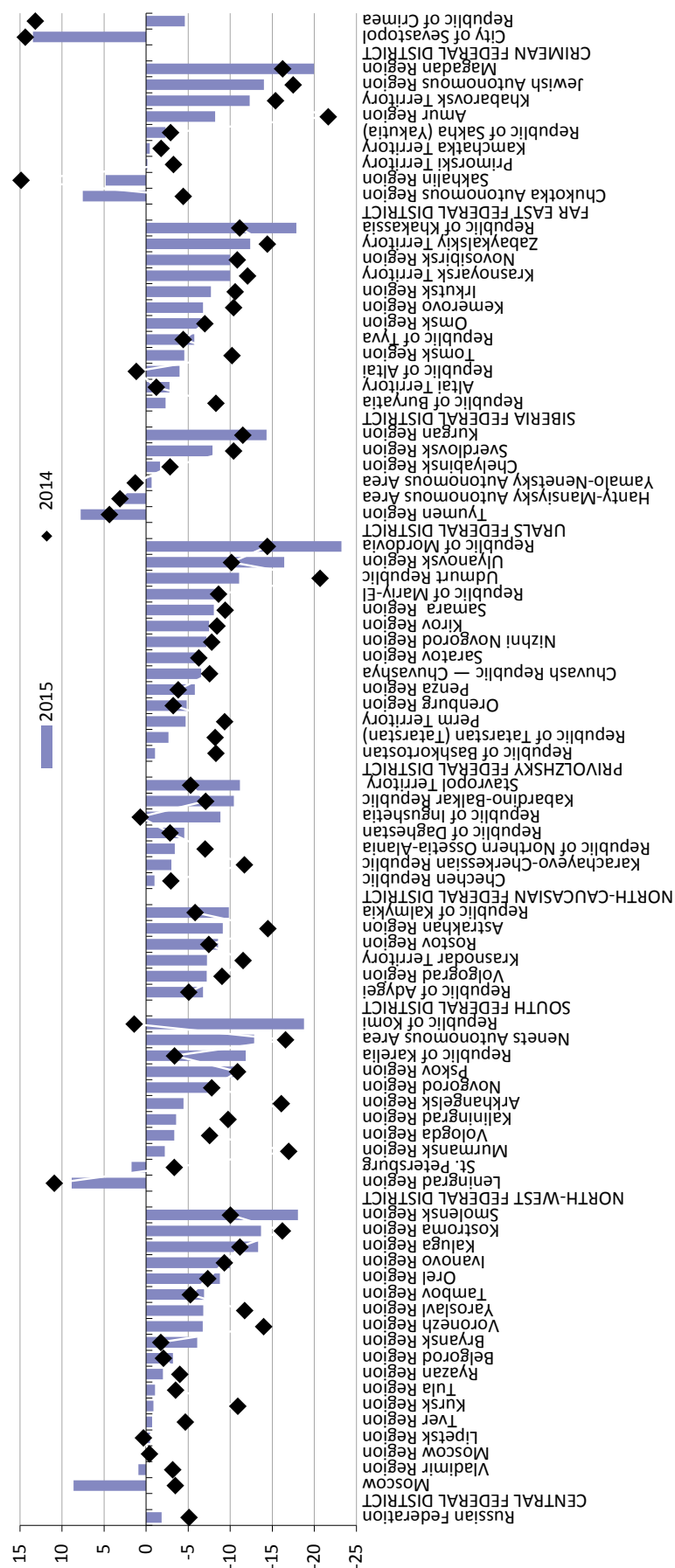


Fig 1. Budget deficit, as a percentage of a region's consolidated budget revenue

and severe decline in consumption (*Fig. 2*). The regional dynamics of personal income (according to the data for 11M 2015) is mostly similar to the consumption dynamics: with an average decline in personal income by 5%, the dynamics fell more steeply in the Central, North-western, Volga, Urals and Siberian Federal Districts. Only seven regions were reported to face no decline in personal income, which is most likely due to statistics drawbacks.

The **growing investment downturn** (for three consecutive years) is the third severe problem. The data for the three quarters of 2015 show that investment fell nearly 6% at a wide range of enterprises and organizations of 51 regions including many advanced regions, except new oil and gas areas (Sakhalin Region, Krasnoyarsk Territory, Nenets Autonomous Area), Hanty-Mansiysky Autonomous Area (the key oil producing region), as well as Moscow, Tatarstan, Bashkortostan, Belgorod, Voronezh, Novgorod, Orenburg, Ulyanovsk regions, and some other regions. The data for 11M 2015 (for large and medium-sized enterprises and organizations) show investment dropping even worse (9.5%) in 60 regions. Positive dynamics were reported basically in the same regions as before, except Moscow with zero dynamics. Economically advanced regions such as Kemerovo, Nizhniy Novgorod, Kaluga, Yaroslavl, Sverdlovsk and Chelyabinsk faced the deepest decline in investment (down 24–37%). The investment dynamics also reveals the failure to “go eastward”: investment continued to decline in half of the regions of the Far East Federal District, including all the major areas, namely the Khabarovsk Territory (down 33%), Primorsky Territory (down 5%), Yakutiya (down 2%).

Typical trends, such as industrial production downturn and rising unemployment rate, were less or even feebly marked in the course of this crisis. The **industrial production downturn** was not only moderate (3.4% in 2015) but also geographically localized, hitting only 36 regions. Although the manufacturing industry saw a deeper decline (5.4%), it faced only half of the 43 regions. The differences in the industrial production dynamics between regions developed in H1 2015 and continued till the end of the year, because they are determined by industry's sector-specific specialization.

An increase by one-third of federal defence spending contributed to the growth in defence industry regions (Bryansk, Tula, Yaroslavl, Penza and Kirov regions, Republic of Mari-El, etc.), although growth rates were slower than those seen in H1 2015. Industrial production increased in advanced agricultural regions, especially in the Black Earth Region and the South Federal District, because foreign competitors had left the market. Industrial growth continued in the key oil and gas producing regions, especially new ones (Sakhalin Region, Nenets Autonomous Area, Irkutsk Region, Yakutia), except the Hanty-Mansiysky Autonomous Area (down 2.5%) facing the downturn for two consecutive years. It is difficult to explain fantastic industrial growth rates in the Rostov Region (55%) even by a combination of all the three advantages deriving from its specialization (a new oil refinery kicked off, adding to defence enterprises and advanced food industry).

The regions facing the deepest economic slump were the same as in H1 2015, namely automotive industry regions (Kaluga and Kaliningrad regions, down 7–9%), semi-depressed regions with non-competitive industries that tend to be hit hardest by any crisis (Ivanovo, Kostroma, Tver regions, Republic of Mordovia, Chuvash Republic, Amur Region and Jewish Autonomous Region, down 6–9%), as well as federal status cities (5–7%), where the crisis tends to boost deindustrialization processes. The slump of the Orenburg Re-

2. AUSTERITY: A TREND ACROSS RUSSIA'S REGION

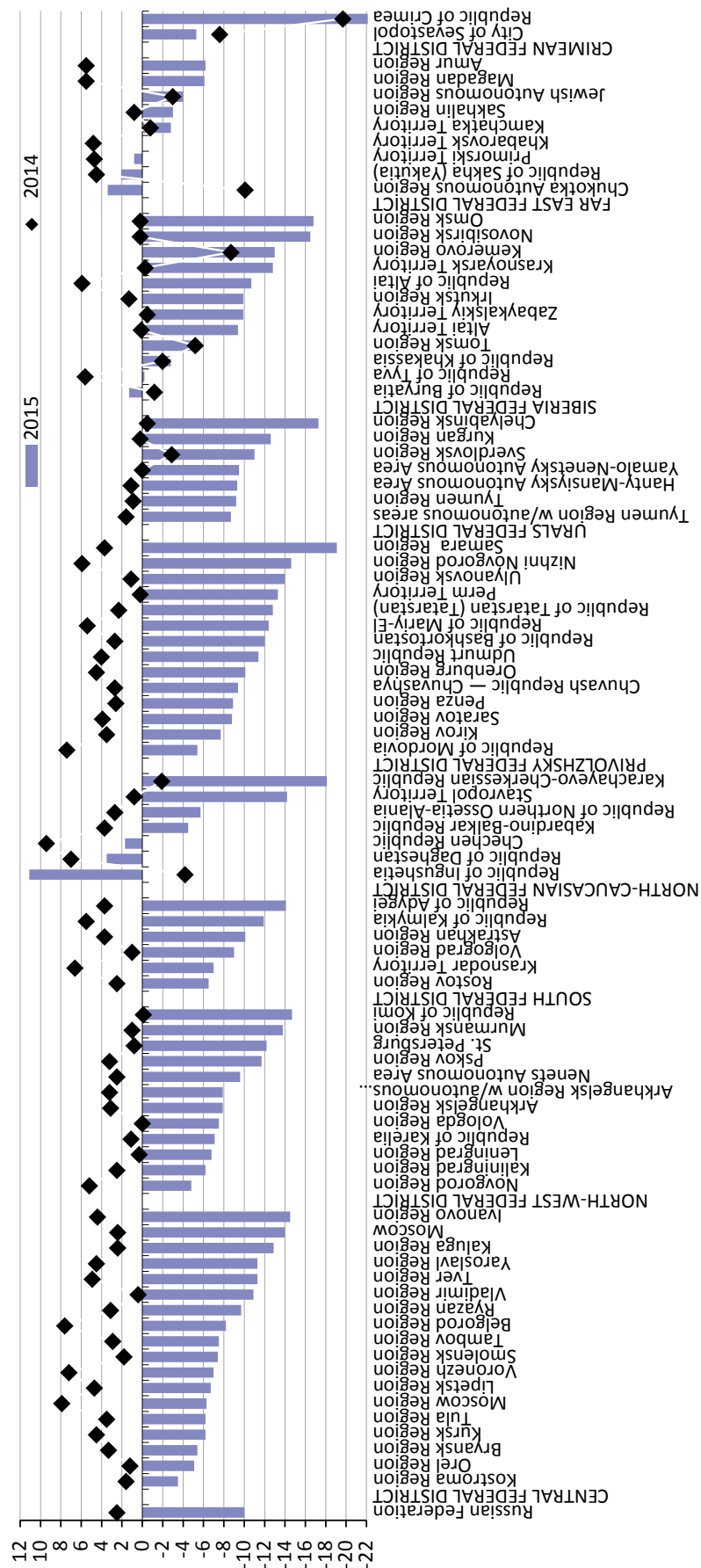


Fig. 2. Retail sales dynamics, % year-over-year

gion (8%) was partially determined by a tax manoeuvre in the oil industry, which rendered oil refiners loss-making, and the slump of the Primorsky Territory (down 12%) was caused by the downturn in the car assembly industry. 2016 faces high risks of the industrial downturn spreading out geographically in response to the decline in investment and effective demand.

Unemployment saw the slowest pace of growing in 2015, from 5.2% in October-November 2014 to 5.7% in October-November 2015. Furthermore, regional unemployment underwent small changes, except Vladimir, Yaroslavl, Vologda regions, Republic of Komi, Udmurt Republic, Republic of Buryatia and Republic of Khakasia, where it increased markedly (2–3 percentage points) but still remained relatively low. The crisis in regional labour markets has so far been following the pattern of slowly growing unemployment. According to the data for the three quarters of 2015, the regions facing the sharpest industrial downturn, namely Kaluga, Tver and Ivanovo regions (5–6% of the workforce), showed a bigger share of underemployment, forced downtime, or leaves without pay. Industrial regions such as Chelyabinsk and Sverdlovsk regions (10–12% of the workforce), as well as Republic of Buryatia, showed a bigger than normal share of leaves of absence without pay.

The unemployment issues are alleviated not only by using widely the underemployment mechanism but also the demographic factor – the low-numbered generation born in the 90s have been entering the labour market. Another mitigating factor is the reducing number and partial outflow of labour migrants of post-Soviet states, who were employed mostly in the construction and retail sectors. It is this factor that contributed to taming unemployment amid the sharp slump in these industries.

Overall, 2015 can be divided into two periods – the crisis-driven decline in the first 5–6 months and the following stagnation at a lower level until the end of the year, although the situation in the regions and the dynamics are more complex. The outlook for 2016 is negative, investment and personal income are expected to decline further due to, among other things, a new round of the rouble devaluation in January 2016, more regional economies are anticipated to decline further or stagnate at a lower level, the growth in the defence industry regions is foreseen to come to an end because of growing federal budget problems, and budget spending is expected to be streamlined even faster. Austerity is going to be a nationwide trend regardless of geographical differences. ●

3. BUDGET LOANS AND SUBSIDIES TO REGIONS: WHO AND HOW MUCH RECEIVED IN 2015?

A.Mamedov, E.Fomina

The volumes of financial aid extended by the federal budget via instruments of budget loans¹ and grants designed to secure regional budgets balance (hereinafter – grants designed to balance regional budgets) in 2015 contracted against 2014 volumes, meanwhile their decline rates differ considerably. For example, the volume of budget loans (balance) across the Russian Federation as a whole fell by 1% in nominal terms meanwhile that of grants designed to properly balance regional budgets contracted by 34% (43% less the Crimea). Distribution of budget loans and grants designed to balance regional budgets among the subjects is defined by significant unevenness. In 2015, around 70% of the total budget loans volume were distributed among 20 subjects of the Russian Federation (out of 85). Grants designed to balance regional budgets were also distributed unevenly: nearly 60% of their total volume were received by 20 regions in 2015.

In 2015, the RF subjects received via budget loans about Rb 167.4bn (balance including repayments) and grants aimed to balance regional budgets around Rb 152.4bn. Consequently, via these two instruments of “prompt” financial support to regional budgets as a whole, the federal budget allocated comparable amounts. How these volumes were distributed among RF subjects: financial support was provided to the same regions or different groups of regions.

In 2015, around 70% of the overall volume of budget loans were distributed among 20 RF subjects (of 85), which speaks about their high distribution unevenness across regions (*Table 1*). Khabarovsk Krai and Kirov oblast got the highest volume of budget loans: Rb 9bn each region. Distribution of grants intended to balance regional budgets was also uneven: around 60% of the total volume of grants in 2015 were received by 20 regions. Chechen Republic (around Rb 20bn) and Republic of Crimea (about Rb 17bn) display a significant gap regarding grants aimed to balance budgets.

Unevenness of the allocation of “prompt” financial aid, significant part of which is already being distributed during the federal budget execution is considered to be a normal practice. Theoretically, these types of aid should be granted to the regions facing maximum problems in their budgets execution. As a result, for further analysis we have selected two major indicators, which determine problems in the budget sphere of the RF subjects: debt burden including the share of commercial debt and dynamics of tax and non-tax revenues (revenues less interbudgetary transfers). They are easily verified by budget statistics and totally comparable among regions (i.e. it is possible to verify justification of the fact why one region received more funds than another did).

¹ Balance (receipt minus repayment) of budget loans from other budgets of the budgetary system.

Table 1

RF SUBJECTS WHO RECEIVED LARGEST AMOUNTS OF BUDGET LOANS
IN 2015, RB MN.

RF subjects	Budget loans from other budgets of budgetary system	RF subjects	Grants intended to secure regional budgets in 2015
Total for all RF subjects	167 354	Total for all RF subjects	152 369
Total for 20 subjects with largest volume of financing	114 966	Total for 20 subjects with largest volume of financing	92 299
including:		including:	
Khabarovsk Krai	9 351	Chechen Republic	20 413
Kirov oblast	9 166	Republic of Crimea	16 970
Republic of Tatarstan	8 938	Krasnodar Krai	5 738
Kaluga oblast	8 477	City of Sebastopol	4 804
Krasnoyarsk Krai	7 581	Irkutsk oblast	4 231
Perm Krai	7 479	Samara oblast	4 178
Yaroslavl oblast	6 358	Republic of Dagestan	3 271
Chuvash Republic – Chuvashia	5 544	Nizhny Novgorod oblast	3 095
Sverdlovsk oblast	5 494	Primorsky Krai	2 967
Republic of Komi	4 973	Rostov oblast	2 823
Stavropol Krai	4 857	Omsk oblast	2 695
Volgograd oblast	4 841	Republic of Bashkortostan	2 546
Primorsky Krai	4 724	Moscow Oblast	2 541
Arkhangelsk oblast	4 434	Perm Krai	2 484
Kursk oblast	4 385	Khabarovsk Krai	2 473
Republic of North Ossetia – Alania	4 084	Sverdlovsk oblast	2 353
Zabaikalsky Krai	3 931	Novosibirsk oblast	2 267
Tver oblast	3 674	Krasnoyarsk Krai	2 216
Astrakhan oblast	3 347	Arkhangelsk oblast	2 121
Samara oblast	3 329	Chelyabinsk oblast	2 114
Share of funds allocated to subjects with highest volume of financing, % of total volume across RF as a whole	68.7%	Share of funds allocated to subjects with highest volume of financing, % of total volume across RF as a whole	60.6%

Note. By semi-bold type are identified those RF subjects, which are on the list of regions with maximum volume of both budget loans and grants intended to balance budgets.

Sources: Federal Treasury, authors' calculations.

Table 1 shows that 7 out of 33¹ regions received maximum volumes regarding both financial instruments. Therefore, on the whole we cannot say that one and the same regions received financial support via two reviewed instruments.

Table 2 provides a list of 24 RF subjects grouped depending on the state of debt burden as of early 2015 (over 80%). Among them, a group of 5 RF subjects is identified with high share of commercial debt (over 62% – average indicator for Russia without Moscow, and Crimea Federal District) in the structure of regional debt. In the table, budget loans and grants intended to balance regional budgets are on per capita basis, which allows to ensure better comparability of identified regions with financing volumes (i.e. rate fixing

1 33=20+20–7 regions including the fact that 7 regions are on both lists.

was implemented). With the help of analysis of data given below, we will try to answer two questions:

1. Is there a correlation between the level of a region's budget debt burden as of the beginning of 2015 and volumes of financial support via instruments of budget loans and grants designed to balance regional budgets in 2015;

2. Did regions with maximum debt burden (especially with a large share of commercial debt in the overall debt volume) have an advantage in receiving support via budget loans? Whether they were able to replace an expensive in servicing commercial debt (bank loans and debentures) with cheap budget loans.

Table 2

VOLUME OF BUDGET LOANS AND GRANTS INTENDED TO BALANCE REGIONAL BUDGETS (PER CAPITA) IN 2015 IN RF SUBJECTS WITH HIGH DEBT BURDEN

RF subject	Debt burden as of 1 Jan. 2015, %	Share of commercial debt as of 1 Jan. 2015, %	Per capita budget loans for 2015, Rb/person	Per capita grants for 2015, Rb/person	Total budget loans and grants per capita for 2015, Rb/person	Share of grants in total volume of budget loans and grants per capita, %
Regions with debt burden over 80% and with share of commercial debt in total debt volume above 62%	92	68	3291	1294	4585	28
Republic of Khakasia	86	71	590	1189	1779	67
Udmurt Republic	95	69	810	942	1752	54
Arkhangelsk oblast	101	68	3278	1957	5235	37
Zabaikalsky Krai	88	66	3616	1864	5480	34
Kirov oblast	85	64	7029	752	7781	10
Over 80% of debt burden and below 62% of commercial debt	100	49	925	1049	1974	53
Amur oblast	98	62	99	1527	1626	94
Ryazan oblast	99	59	581	586	1167	50
Kostroma oblast	121	58	1304	1594	2898	55
Republic of Mari El	95	58	-1485	607	-877	-
Novgorod oblast	83	58	2835	506	3341	15
Penza oblast	87	55	0	901	901	100
Republic of Karelia	119	55	1064	3026	4090	74
Pskov oblast	88	55	504	799	1303	61
Vologda oblast	100	54	1031	704	1735	41
Orel oblast	86	54	1446	915	2361	39
Republic of North Ossetia – Alania	115	52	5784	1050	6835	15
Saratov oblast	100	51	270	702	972	72
Belgorod oblast	106	48	1256	1192	2448	49
Smolensk oblast	116	46	3057	569	3626	16
Krasnodarsky Krai	93	45	499	1052	1551	68
Karachaevo-Cherkessk Republic	104	37	-353	424	71	-
Republic of Mordovia	121	36	2472	1041	3513	30
Republic of Ingushetia	113	0	2103	2635	4737	56
Chukotka Autonomous Okrug	144	0	-19412	14799	-4613	-

Table 2, cont'd

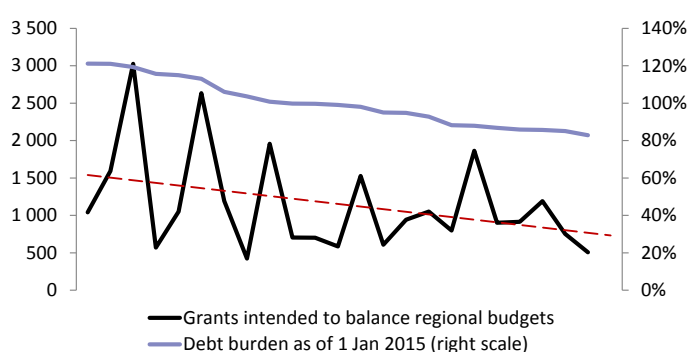
RF subject	Debt burden as of 1 Jan. 2015, %	Share of commercial debt as of 1 Jan. 2015, %	Per capita budget loans for 2015, Rb/person	Per capita grants for 2015, Rb/person	Total budget loans and grants per capita for 2015, Rb/person	Share of grants in total volume of budget loans and grants per capita, %
RF on the whole	35	64	1144	1042	2186	48
RF on the whole (without Moscow and Crimean FD)	44	62	1271	991	2262	44

Sources: Federal Treasury, authors' calculations.

Analysis of *Table 2* data as a whole does not allow to reveal a clear dependence of extended budget loans and grants intended to balance regional budgets in 2015 on the value of debt burden of RF subjects as of the beginning of 2015 and share of commercial debt in the structure of regions' debt. However, replacement of commercial credits with budget loans is observed in a number of regions. In 8 regions (out of 24 regions reviewed in *Table 2*) the volume of commercial debt in the structure of debt fell during 2015: Republic North Ossetia – Alania (-43%), Kirov oblast (-34%), Astrakhan oblast (-11%), Novgorod oblast (-9%), Zabaikalsky Krai (-6%), Ryazan oblast (-2%), Vologda oblast (-2%), Kostroma oblast (-1%). At the same time, during 2015, 10 regions (of 24) on the contrary were building up their commercial debt: Republic of Mai El (+15%), Karachaevo-Cherkessk Republic (+11%), Republic of Khakasia (+9%), Republic of Mordovia (+8%), Orel oblast (+5%), Amur oblast (+3%), Pskov oblast (+2%), Krasnodarsky Krai (+2%), Saratov oblast (+1%), Republic of Karelia (+1%).

Fig. 1 and 2 demonstrate more vividly the lack of clear dependence of the volume (per capita) of allocated funds on the regions' debt burden as of the beginning of the year (in group of regions with high debt burden of over 80%).

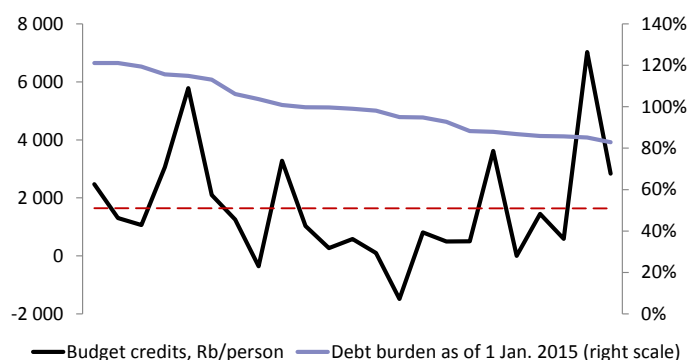
We conducted further analysis regarding dependence of budget credits and grants on balance of regional budgets in 2015 depending on dynamics of tax and non-tax revenues of the RF subjects in H1 2015 against the same period of 2014 (*Fig. 3*). We asked ourselves a question, was it really via inter-



Note. Less Chukotka Autonomous Okrug.

Sources: Federal Treasury, Finance Ministry of Russia

Fig. 1. Volume of grants intended to balance regional budgets and debt burden as of beginning of year (24 regions)



Note. Less Chukotka Autonomous Okrug.

Sources: Federal Treasury, Finance Ministry of Russia.

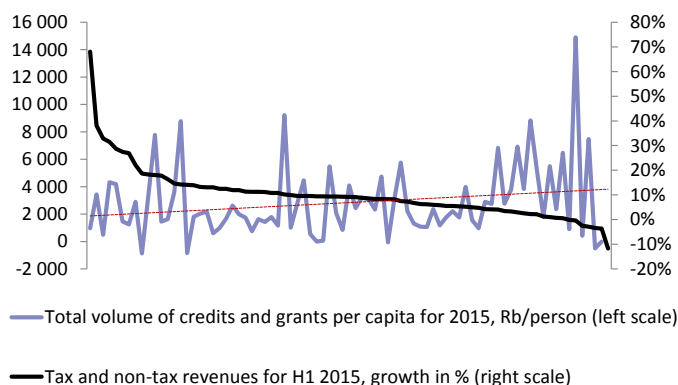
Fig. 2. Volume of budget credits per capita in 2015 and debt burden as of 1 January 2015 (24 regions)

budgetary instruments the “prompt” financial support was provided above all to the regions facing problems with revenue side of the budgets in the course of the year?¹ Given below figure shows that dynamics of tax and non-tax revenues of regional budgets in H1 apparently was not the main indicator taken by the Finance Ministry of Russia as a benchmark for allocation of additional financial support.

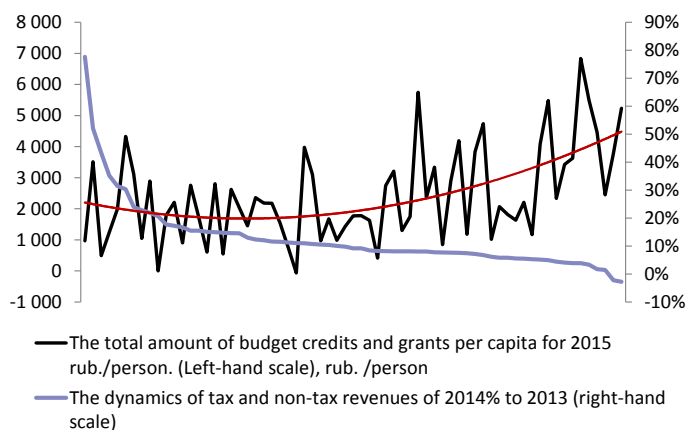
Additionally, we analyzed an issue as to whether during 2015 the volumes of additional aid (budget credits and grants intended to balance regional budgets) to a greater degree were affected by dynamics of tax and non-tax revenues of the regional budgets as of the period-end for 2014 (against 2013, Fig. 4). If we exclude RF subjects with maximum and minimum values regarding reviewed indicators, the Figure shows certain regularity: with a decrease of growth rate of tax and non-tax revenues in 2014, general volume of “prompt” financial aid somewhat increased on average as of the period-end for 2015. Nevertheless, a significant range of values is observed regarding volumes of budget credits and grants intended to balance regional budgets. Subsequently, we can say that other factors exerted no less but even greater influence while determining volumes of additional financial aid.

Finally, let us analyze main indicators used in the aforementioned analysis separately for 7 RF subjects which were identified as regions which received absolute maximum volumes of financial aid both in terms of grants intended to balance regional budgets and in terms of budget credits (Table 3).

Reviewed 7 regions significantly differ across volumes of “prompt” financial aid in terms of per capita. At the same time, in this group there are RF subjects with different level of calculated tax capacity (prior to distribution of grants for 2015). In the meantime, general per capita volumes of budget credits and grants designed to balance regional budgets have no clear correlation with a single of reviewed budget indicators: debt burden, share of commercial debt, share of spending on debt servicing, and movement of tax and non-tax revenues. At the same time, as in the analysis across all regions,



Sources: Federal Treasury, Finance Ministry of Russia, authors' calculations.
Fig. 3. Total volume of budget credits and grants intended to balance regional budgets per capita in 2015 and dynamics of tax and non-tax revenues in H1 2015 (all RF subjects)



Sources: Federal Treasury, Finance Ministry of Russia, authors' calculations.
Fig. 4. Total volume of budget credits and grants intended to balance regional budgets (per capita) in 2015 and dynamics of tax and non-tax revenues of regional budgets in 2014 (less maximum and minimum values)

¹ In order to facilitate analysis it is assumed that additional volumes are primarily allocated in H2 based on results of regional budgets execution carried out in H1. Partially, this reflects real practice.

Table 3

**SAMPLED BUDGET INDICATORS ON 7 RF SUBJECTS WITH MAXIMUM VOLUMES OF BUDGET CREDITS
AND GRANTS INTENDED TO BALANCE REGIONAL BUDGETS IN 2015**

	Level of tax capacity prior to equalization transfer	Total volume of budget credits and grants intended to balance re- gional budgets per capita in 2015, Rb/person	Share of grants intended to balance regional budgets in total volume of financial aid, %	Debt burden as of early 2015, %	Share of commercial debt as of early, %	Share of spending on public and municipal debt servicing in 2015, %	Dynamic of tax and non-tax revenues for H1 2015, (growth in % to H1 2014)	Dynamic of tax and non- tax revenues in 2014 (growth in % to 2013)
Average on Russia	1.000	2 186	48	35	64	1.6	12.3	9
Khabarovsk Krai	0.776	8 837	21	42	78	2.0	2.2	2
Arkhangelsk oblast	0.593	5 750	32	72	66	2.1	7.5	6
Primorsky Krai	0.717	3 979	39	14	79	0.9	5.2	7
Perm Krai	0.894	3 778	25	17	83	0.3	3.3	-5
Krasnoyarsk Krai	0.900	3 426	23	60	84	2.9	38.1	5
Samara oblast	1.148	2 336	56	49	81	3.2	8.4	3
Sverdlovsk oblast	1.099	1 814	30	35	84	1.5	13.9	1

Note. Debt burden indicator is given for the budgets of RF subjects, and dynamics of tax and non-tax revenues is given for the consolidated budgets of RF subjects.

Sources: Federal Treasury, Finance Ministry of Russia, own calculations.

some correlation is observed solely with dynamic of revenues less transfers in 2014 (i.e. with 1-year lag): regarding this indicator, all regions were below average value across Russia. However, this indicator does not explain differences in volumes of financial aid inside this group.

What major conclusions can be drawn from this analysis? First, significant volumes of “prompt” federal financial aid transferred to regions via instruments of budget credits and grants intended to balance regional budgets are concentrated in a limited group of RF subjects. Second, there are regions, which concentrate significant amounts of both credits and grants. However, the share of such regions turned out to be below 50% (7 out of 20 in each group with maximum volumes of credits and grants respectively, total 7 out of 33). Accordingly, various regions were supported via these instruments. Third, volumes of “prompt” federal financial aid to regions are barely correlated with such indicators, which reflect the scale of problems in regional finances, as the level of debt burden (including share of expensive in servicing commercial debt) and movement of tax and non-tax revenues.

Incidentally, one cannot say that allocated volumes of financial aid do not correlate at all with any indicators and are allocated arbitrarily. In our case, another factor is paramount: volumes of budget credits and grants designed to balance regional budgets have turned out to be barely correlated with the most simple, transparent and comparable among regions indicators, which reflect the magnitude of problems during the regional budgets execution. This significantly reduces transparency and justification of usage of these tools for interbudgetary relations. This can create conditions for soft budget constraints for subnational authorities and thus worsen their fiscal incentives.

The lack of correlation can also be indicative of a conflict between the objectives of interbudgetary relations regulation and applied budget instruments. Allocation of a share of grants to balance regional budgets in order to offset additional regional budgets spending serves as a striking example of

such practice. As a matter of fact, these grants serve as subsidies. Such practice also decreases efficiency and transparency of interbudgetary relations.

Distribution of grants designed to balance regional budgets has an element of politics. This is reflected in the fact that maximum volumes of financial aid were sent to Chechnya and Crimea. The amount of additional financial aid depends on the political heft and consequently lobbying capacity of specific governor. All this results in the fact that total distributed amounts hardly correlate with general and objective indicators, which reflect the scale of the problem manifested in regional finances. ●

4. IMPORT SUBSTITUTION IN RUSSIA'S MANUFACTURING INDUSTRY: A WEAK EFFECT

A.Kaukin, P. Pavlov

Russia's import substitution policy has so far failed to have an across-the-board effect. Only a few industries, such as manufacture of metals, textiles, motor vehicles, have managed to replace some of the imported goods with domestically manufactured products. Russia's economy continues to be heavily depending on imports, including machinery and equipment. Most of the Russian manufacturing sectors are poorly integrated into international value-added chains, which limits their production volume growth.

There are three key factors in Russia, which can be highlighted as having potential to facilitate the substitution of foreign-made goods with domestically manufactured products:

1. Ruble's devaluation¹. Industries (such as automotive industry, engineering industry, pharmaceuticals industry, manufacture of electrical equipment) that depend heavily on imported intermediate goods and supply most of their products to the domestic market stand to be hit the hardest by a sliding rouble, whereas export-led industries that are less dependent on imports (such as manufacture of ferrous and non-ferrous metals, chemical and petrochemical industry, manufacture and dressing of leather) stand to benefit from the same².

2. Trade sanctions. Sanctions were imposed against Russia in 2014–2015, covering technology goods and supplies of oil and gas equipment, including equipment for producing offshore oil and gas, as well as Russian defence contractors³. Theoretically, the shortage of such equipment in the domestic market could have contributed to producing similar products in Russia. Russia's countersanctions against food imports and special economic measures against Turkey contribute to replacing imported food products and consumer goods. The geopolitics-driven decline in the Russia-Ukraine merchandise trade turnover in 2014–2015 contributed to strengthening the import substitution potential in the metallurgy industry and manufacture of building materials.

3. Purposeful measures by economic authorities. The objectives of stimulating import substitution have recently been in the focus of attention at the top level of Russia's Executive Branch⁴. To date, Russia's Industry and Trade

1 In January–December 2015, the year-over-year real effective ruble exchange rate to foreign currencies lost 16.5%, thus following the trend of 2014, when the rate dropped 8.4% in January–December. See Basic Derived Indicators of Ruble's Exchange Rate Dynamics in January–December 2015 // Russia's central bank official website, 6 February 2016 [http://www.cbr.ru/eng/statistics/print.aspx?file=credit_statistics/ex_rate_ind_15_e.htm&pid=svs&sid=analit]

2 Indrisov G. The winners and the losers: the effect of terms of trade changes on Russia's industry // *Ekonomicheskoye Razvitiye Rossii*. No. 4. 2015. PP. 26–28.

3 EU restrictive measures in response to the crisis in Ukraine // European Council [<http://www.consilium.europa.eu/en/policies/sanctions/ukraine-crisis/>]. Ukraine and Russia Sanctions // U.S. Department of State [<http://www.state.gov/e/eb/tfs/spi/ukrainerussia/>]. Sectoral Sanctions Identifications (SSI) List // US Department of the Treasury, 22.12.2015 [<http://www.treasury.gov/ofac/downloads/ssi/ssi.pdf>]

4 See, e.g., The materials of a meeting on the development of the petrochemical industry // Official Internet Resources of the President of Russia, 15 October 2013 [<http://kremmlin.ru/catalog/keywords/121/events/19420>]

Ministry has developed a package of import substitution action plans embracing the full range of manufacturing sectors¹. Analysis of the effectiveness of import substitution measures has acquired special importance amid Western sanctions and Russia's countersanctions, as well as the unfolding dynamics of the key macroeconomic indicators².

The recent statistics show (*Fig. 1*) that import substitution is accelerated most in the automotive industry, where the yearly average share of imports³ in 2015 decreased by 22.5 percentage points from 2014, manufacture of motor vehicle parts and accessories (down 5.7 percentage points), metals and metal ores (down 4.5 percentage points), narrow fabrics (down 7.8 percentage points), food products (down 4.1 percentage points).

A sharp decline in the share of imports of the motor vehicles sales turnover was determined by the establishment of assembly factories jointly with foreign partners (e.g. Avtovaz, Sollers). Judging by the dynamics of the share of imported motor vehicle parts (motor vehicle spare details and accessories), the level of localization of these industries continues to grow as well.

The dynamics in the metallurgy industry can possibly be explained by stalled imports of Ukrainian goods that are now replaced (at least in part) by Russia-made products. However, consideration must be given to the fact that production volumes in the metallurgy industry in 2015 declined due to the overall decline of both domestic and foreign demand.

The decline in the share of import of textiles may be associated with both strengthening the appeal of domestic production due to cut costs expressed in dollars (labour costs in particular) and implementing investment projects that contributed to enhancing the effectiveness of such production amid changes in the terms of trade (e.g. Vologda Textiles, Kamyshinsk Textiles, etc.). The factors concerning a weakening rouble and countersanctions explain the decline in the share of imports of the food sales turnover in 2014–2015.

On the other hand, some industries, such as, first of all, the pharmaceutical industry and the manufacture of machinery and equipment (including electrical equipment), appear to face a reverse process to that of import substitution.

Russia's pharmaceutical industry is under hard pressure of its global competitors. The yearly average share of imports of the sales turnover of pharmaceutical and medical goods was significant, varying within a range of 50–60%,

1 Russia's Industry and Trade Ministry Executive Order No. 197 dated 29 January 2016 "Concerning the approval of the import substitution action plan for the chemical industry of the Russian Federation, and the annulment of Russia's Industry and Trade Ministry Executive Order of 31 March 2015". Russia's Industry and Trade Ministry Executive Order No. 4129 dated 17 December 2015 "Concerning the amendments to the import substitution action plan in the radio-electronic industry of the Russian Federation approved by Russia's Industry and Trade Ministry dated 31 March 2015 No. 662". Russia's Industry and Trade Ministry Executive Order No. 762 dated 2 April 2015 "Concerning the approval of the sectoral import substitution action plan for the conventional arms industry of the Russian Federation". Russia's Industry and Trade Ministry Executive Order No. 645 dated 31 March 2015 "Concerning the approval of the import substitution action plan for the oil-and-gas machine building industry of the Russian Federation" [<http://minpromtorg.gov.ru/docs/>], etc.

2 See the list of instructions drafted following evaluation of the effectiveness of measures to accelerate the import substitution process for priority and essential products and technology in the automotive industry // Official Internet Resources of the President of Russia, 18 January 2016 [<http://kremlin.ru/catalog/keywords/121/events/51179>]

3 The yearly average share of imports is calculated as the arithmetical mean of quarterly shares of imports of the merchandise trade turnover in a given year.

in the period between 2010 and 2015, and in 2015 it increased 3.2 percentage points from 2014. Hence the rouble devaluation made no contribution to import substitution because there is a wide range of medicaments and medical equipment that Russia cannot replace so far. Nonetheless, the industry may achieve a small increase in the domestic output in the longer term: the rouble's depreciation in 2014–2015 may have an effect over the next 2–3 years because licensing new medicaments is a time-consuming process.

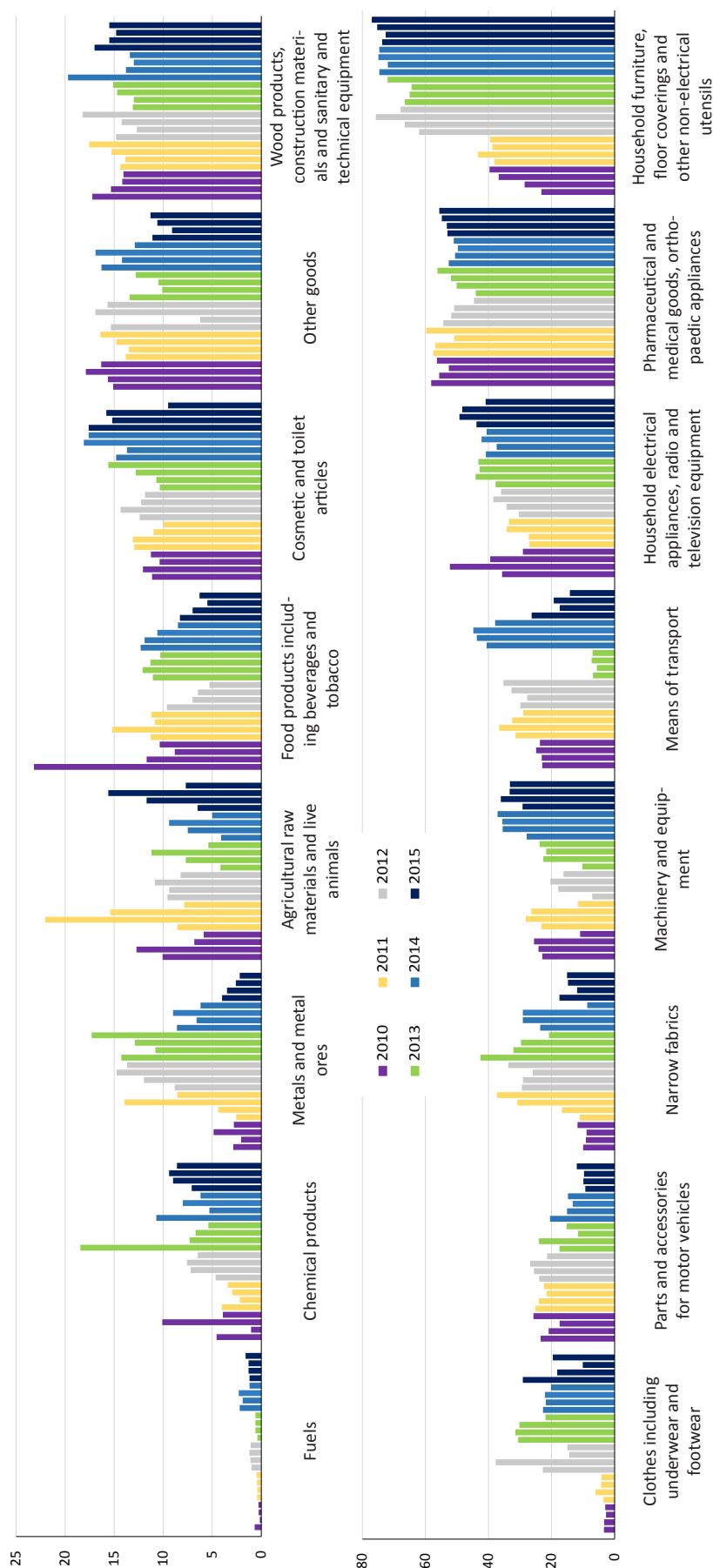
A similar situation was seen in the sector of machinery and equipment, where the yearly average share of imports increased 17.6 percentage points in the period between 2012 and 2015, and it is still premature to interpret the 2015 decline of mere 1.1 percentage points in the yearly average share of imports as reversal of the mid-term trend towards stronger dependence of Russia's manufacturing industry on foreign production of capital goods¹.

The dynamics of the share of imports of the sales turnover of pharmaceutical goods and investment goods (machinery and equipment) highlights the import substitution issues which have to be addressed: the industries that produce such goods failed to take advantage of improved terms of trade, the fall of the real effective rouble exchange rate in 2014–2015, which, among other things, showed itself in the overall decline in the output of these industries throughout the entire 2015.

* * *

All in all, the unfolding situation reveals that the import substitution potential was poorly exploited. Unfortunately, only a few industries took advantage of the presented opportunities to increase the share of locally manufactured products in the domestic market (manufacture of metals and textiles, motor vehicles and motor vehicle parts and accessories). Import substitution processes of the rest of the industries were nearly invisible in 2015.

1 The share of imported electrical equipment in 2015 increased 5.3 percentage points from 2014 (or 10.8 percentage points from 2012).



Note: It is worth noting that the presented data in some cases should be interpreted with care. An example is the sharp decline (see the diagram) in the share of imports of motor vehicles in 2013, which can be partially explained by the decline at that period in the sales of foreign cars manufactured in Russia. Given the indicator dynamics that followed, the decline seems to be unreasonably deep, which may lead to the conclusion that Russia's Federal Service of State Statistics (Rosstat) uses an imperfect methodology. Nevertheless, in our view, the presented data give a good description of the above mid-term trends.

Source: Rosstat.

Fig. 1. The share of imported goods of the overall sales turnover, % (quarterly data)

5. AGRICULTURE: IMPORT SUBSTITUTION'S 'FRUITS'

N.Shagaida, V.Uzun

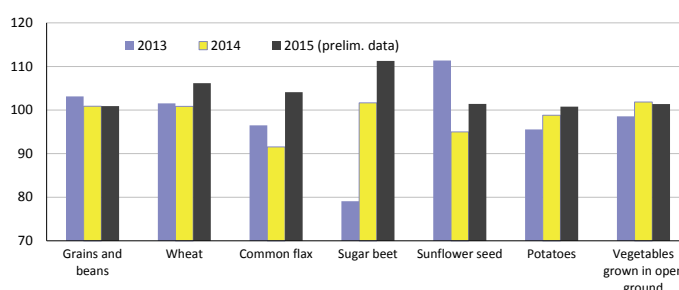
The food embargo has failed to create favorable conditions for Russia's agricultural production to thrive. Instead, such conditions arose as a result of the ruble's devaluation, when imported goods had lost their competitive capacity in Russia's domestic market. On the one hand, the ruble's declining exchange rate against the world's major currencies made life more difficult for Russian agricultural producers, because imported resources became more expensive; while on the other, in 2015 they could still increase their production of major categories of edible plants and modify their production structure in accordance with the structure of demand in the domestic and foreign markets.

The introduction, by Russia, of a food embargo in August 2014 did not create many advantages for domestic agricultural producers: the market remained open, and the ban on imports from some countries resulted in increased imports from other countries, often at a slightly higher price, which, in its turn, pushed up domestic prices and was beneficial for domestic producers. The most advantageous factor for domestic producers was the plunge of the ruble's exchange rate. As early as 2014, Russia's main agricultural products became actually competitive in the world market, or were approaching the competitive price level. This has been explicitly conformed by data released by the OECD.

Russian cereal grains, sunflower seed, poultry meat, eggs and milk in 2014 competed well with imported products: domestic purchasing prices became roughly equal to world prices. The domestic purchasing prices for beef and pork were somewhat higher than the prices for similar imported products. However, over recent years, even the prices for these two categories of products (especially prices for pork) have been approaching the world levels. Given the ruble's further devaluation in 2015, Russia's pork producers have, most probably, become serious rivals of foreign producers.

The import substitution opportunities for Russian products have increased since late 2014, when the ruble's exchange rate sharply plunged. Russia's agricultural producers did not reduce their field crops, and as far as agricultural plants are concerned, they have even increased their output (Fig. 1).

The downfall of the ruble's exchange rate against the world's major currencies also produced some negative effects: prices for imported resources soared (hybrid seeds, pesticides, breeding eggs, etc.). In spite of all these drawbacks, in 2015, the crops of main agricultural plants were higher than their indices for the favorable year 2014 (Table 1).



Source: Rosstat.

Fig. 1. Changes in Area under Crops in All Types of Farming Enterprises, Relative to Previous Year, %

Table 1

AVERAGE ANNUAL CROPS OF MAJOR TYPES OF AGRICULTURAL PLANTS
(MILLION TONS)

	1990– 1994	2000– 2004	2010– 2014	2014	2015*
Grains and beans (in weight after processing)	99	76	85	105	104
Sugar beet	24	17	38	34	38
Sunflower seeds (in weight after processing)	3	4	9	9	9
Potatoes	35	29	29	32	34
Vegetables grown in open ground	9	11	13	14	16

*Preliminary data as of 1 February 2016.

Source: Rosstat.

Agricultural producers reacted quickly to the changing situation. So, while the production of rye, barley and oats declined, that of wheat (Russia's major agricultural export), corn (also an export product), millet, buckwheat, rice and beans increased, as the demand for these products in the domestic market was high. The production of flax as an alternative to the increasingly expensive cotton imports rose by more than 24%, and this was achieved not only in terms of increase in net area sown, but also (and almost always) in terms of crop yield.

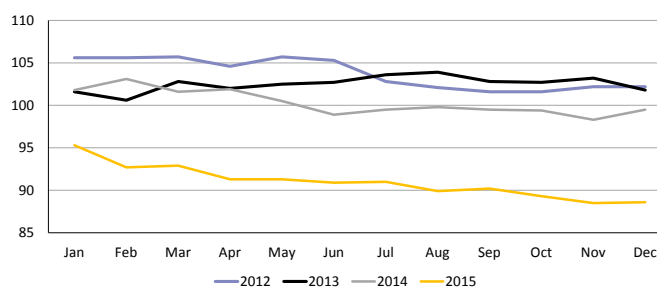
Although the government preferred mainly to support big agricultural companies, in 2015 farmers demonstrated their better ability to adjust to the new situation: their share in the structure of production rose with regard to cereal grains (from 25.3 to 26.4%), sugar beets (from 10.3 to 11%), potatoes (from 7.5 to 8.6%), and vegetables (from 13.6 to 15.1%). The achievements of agricultural companies have been more modest: their share in the production of cereal grains and sugar beet slightly shrank (they lost 1.1 p.p. and 0.6 p.p. respectively), and their growth rates in the production of sunflower seed, potatoes and vegetables gained between 0.2 p.p. (sunflower seed) and 1.7 p.p. (potatoes).

Some improvements have been observed in pig and poultry farming. Pig and poultry population growth indices amounted to 9.6% and 3.8% respectively. In 2015, the decline of the overall cattle population amounted to 1.6%, that of dairy cows – to 1.8, that of sheep and goats – to 0.7%. Besides, in 2015, the growth rate in meat production remained at the same level as in 2014 (4.2%), that in egg production increased (by 1.6%), and that in milk production displayed a zero change.

On the whole, the agricultural sector displayed production growth rate of 3% in per annum terms (vs. 3.5% in 2014).

Production growth, however, was constrained by the factor of inadequate effective demand. The real disposable money income shrank by 4%, and real wages – by 9.5%¹. This brought down the turnover in retail trade of food products, which by December 2015 had lost 11% on 2014 (Fig. 2).

Owing to the combination of all these circumstances (the ruble's de-



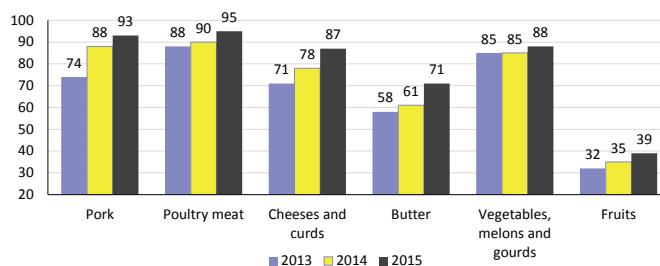
Source: Rosstat.

Fig. 2. The Turnover in Retail Trade of Food Products (In Comparable Prices, Relative to Previous Year), %

1 Data released by Rosstat.

valuation, income decline), the demand for imports sharply plummeted, which has been confirmed by data released by the RF Ministry of Agriculture: the share of domestic food products across the main groups of food products increased in terms of volume¹ (Fig. 3).

However, such substitution can be regarded as a good result only when the consumption index is on the rise, or at least is not declining. In absence of reliable data on food consumption for 2015, we may derive some indirect estimates on the basis of the year-on-year data released by the RF Ministry of Agriculture on imports and domestic production. By applying this approach, we can see that domestic production growth in response to increased consumption resulted in import substitution only with regard to two product types – poultry meat and vegetables (Table 2).



Source: RF Ministry of Agriculture.

Fig. 3. The Share of Domestic Food Products Relative to the Sum of Imports and Domestic Output, %

Table 2

THE BEHAVIOR OF THE CONSUMPTION INDEX IN 2015 RELATIVE TO 2013 (THOUSAND TONS)

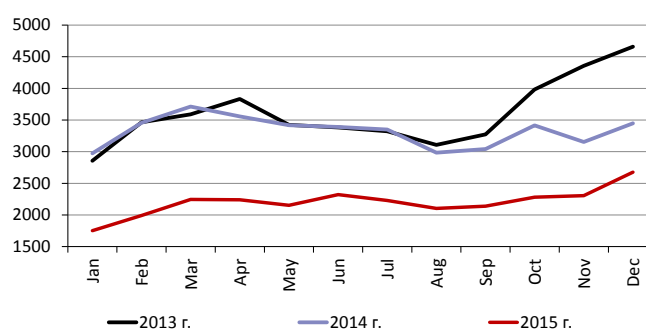
Product type	Production growth	Decline in imports	Behavior of consumption index
Pork	299	-730	-431
Poultry meat	661	-277	384
Cheeses and curds	211	-256	-45
Butter	40	-55	-15
Vegetables, melons and gourds	1,365	-317	1,048
Fruits	205	-1,641	-1,436

Source: RF Ministry of Agriculture; authors' calculations*.

The imports of the other product types were declining at a faster rate than the domestic production index was rising, which can hardly be regarded as a positive trend in the import substitution process.

Usually the shrinkage of imports in terms of value is interpreted as a positive outcome of import substitution. Indeed, in 2015, food imports in dollar terms shrank on 2013 by 39%, and on 2014 – by 34% (Fig. 4).

At the same time, when taken in ruble terms, imports increased: their growth on 2013 amounted to +17%, and to +5 % on 2014 (Fig. 5). This is an indirect sign that people did not reduce their expenditures on imported products; instead, their expenditures slightly increased. In other words, the con-



Source: Federal Customs Service.

Fig. 4. The Behavior of Imports (Groups 1–24, OKVED Codes), Million USD

1 Calculated as the ratio of imports to imports plus output. Data released by the RF Ministry of Agriculture.

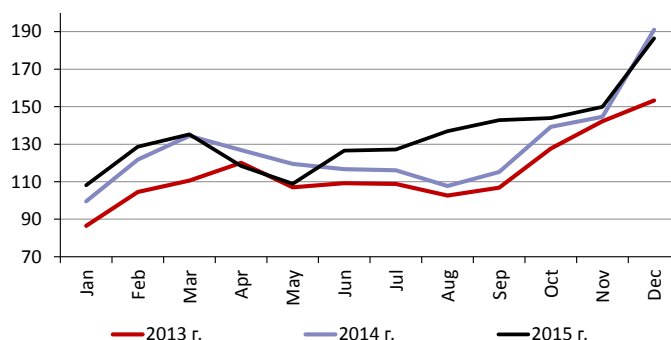
sumption of imported foodstuffs shrank in terms of physical volume, but not in ruble terms.

In 2015, the dependence on meat and milk imports in terms of physical volume, calculated as the ratio of the balance of imports and exports to the production index and the individual consumption index, sharply declined (Fig. 6).

In 2015, food exports (Groups 1–24, OKVED Codes) declined on 2014 by 15% in dollar terms (Table 3).

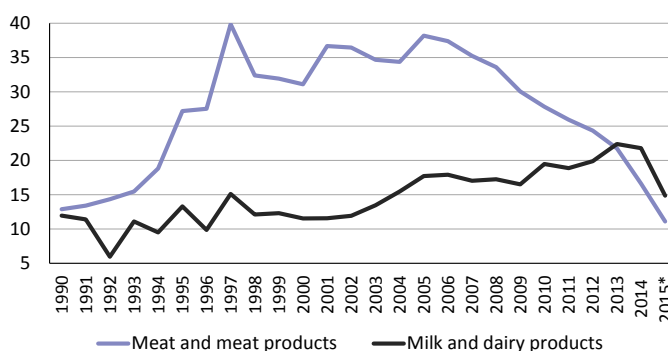
The ruble's declining exchange rate has made Russia's exports of agricultural products and foodstuffs very profitable. In 2015, in spite of export decline in terms of physical volume, Russia's exports in ruble terms increased by 35% on 2014, and by 92% on 2013.

The choice of development priorities for each sector has remained a relevant issue for the government. Is it necessary to support those industries that have so far failed to satisfy in full the existing domestic demand for their products (as estimated on the bases of the recommended consumption targets)? Or would it be better instead to grant support to those products whose prices are competitive both in the domestic and foreign markets, so that Russia could get closer integrated into the system of international division of labor? The correct choice is not determined by the framework of agriculture alone, or the agricultural sector's budget. It will depend on the government's general strategy.



Source: Federal Customs Service.

Fig. 5. The Behavior of Imports (Groups 1–24, OKVED Codes), bn Rb



Source: Rosstat; calculated on the basis of the balance sheets for 2015 (data for September).

Fig. 6. Russia's Dependence on Meat and Processed Meat Products, Milk and Dairy Products, %

Table 3

THE BEHAVIOR OF EXPORTS OF AGRICULTURAL PRODUCTS AND FOODSTUFFS
(GROUPS 1–24, OKVED CODES)

	2013	2014	2015	2015/2014,%	2015/2013,%
Million USD	16,262	18,981	16,181	85.2	99.5
Bn Rb	521	737	998	135.4	191.6

Source: Federal Customs Service.

AUTHORS

Zabarevich N. , principal researcher, Institute of Social Analysis and Forecasting, RANEPA

Kaukin A., Head of Industrial Organization and Infrastructure Economics Department, Gaidar Institute for Economic Policy

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

Pavlov P., senior researcher, IAES, RANEPA

Uzun V., principal researcher, IAES, RANEPA

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

Khromov M., Head of Financial Research Department, Gaidar Institute for Economic Policy

Shagaida N., Director of the Center for Agro-Food Policy, RANEPA