

ONLINE MONITORING OF RUSSIA'S ECONOMIC OUTLOOK

TRENDS AND CHALLENGES OF SOCIO-ECONOMIC DEVELOPMENT

№ 7(25) April 2016

MAIN TRENDS AND CONCLUSIONS	3
1. INFLATION: LIMITS OF SLOWDAWN (A.Bozhechkova, E.Goryunov, P. Trunin).....	6
2. DEMAND ON FOREIGN ASSETS IS FALLING, BANK CURRENCY ACCOUNTS ARE STABLE (M.Khromov)	9
3. REGIONS – FOCUS ON REDUCTION OF EXPENSES (A.Deryugin).....	11
4. RUSSIAN INDUSTRY IN Q1 2016: THE ONSET OF STAGNATION? (A.Kaukin, G.Idrisov).....	15
5. ENTERPRISES RETAIN HIGH PROPENSITY FOR ADAPTABILITY (S.Tsukhlo).....	20
AUTHORS.....	23

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.

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Online Monitoring of Russia's Economic Outlook: trends and challenges of socio-economic development. 2016. № 7 (25). April / Bozhechkova A., Goryunov E., Deryugin A., Idrisov G., Kaukin A., Trunin P., Khromov M., Tsukhlo S. Edited by: V. Gurevich, S. Drobyshevsky, P. Kadochnikov, Mau, and S. Sinelnikov-Murylev; URL: http://www.iep.ru/files/text/crisis_monitoring/2016_7-25_april_eng.pdf

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MAIN TRENDS AND CONCLUSIONS

The calm macroeconomic landscape, which has not been disturbed even by the failure of major oil exporters to come to an agreement during their negotiations in Doha, offers two possible variants of an economic forecast. Either the official data that have been released for a third month in a row by *Rosstat*, the RF Central Bank and the world's major exchanges, are too good to be true and really are the indicators of a calm before yet another storm; or, Russia has indeed passed through the period of strongest shocks. In the latter case, the theme of 'eternal calamities' will begin to give way to the increasingly popular theme of 'eternal stagnation'.

The task of elaborating some specific measures designed to liven up this picture of absolute calm has evidently been postponed 'until after 2018'. However, this intention does not rule out the possibility of radical initiatives, most probably of a fiscal nature, to be put forth at an earlier date. These initiatives include a refreshed version of the planned pension reform as visualized by the RF Ministry of Finance, whereby it is envisaged that (alongside the raised retirement age) some serious cuts should be made to the government's social obligations, the tax load increased, and the existing accumulative pension system be replaced by voluntary pension saving plans, backed up by some minor incentives.

The idea that budget spending obligations should be reduced is quite understandable, and it is by no means a new one. But it is not quite understandable what will happen to budget revenue, and whether it is expected to demonstrate any growth sustained by economic growth. The rule that 'shortage of revenue is to be offset by shrinkage of expenditure' is a classical one, but in its simplified version ('the money that has not been received cannot be passed on to the recipients') it leads to the simple question: when and how that money is going to be got? An absence of a coherent answer to that question is actually one of the possible definitions of stagnation.

Another recent proposal is also noteworthy. In the basic macroeconomic forecast for 2017–2019, approved by the government, it is assumed that the price of oil will stay at \$40 per barrel over the entire three-year period. We for our part may say that this risky assumption equals a micro-revolution in official forecasting.

Although the forecast itself – the movement of GDP, investment, revenue – was instantly attacked as being 'inertial' (to be understood as 'non-implementable'), and perhaps for good reason, it must be admitted that its oil price indicators had never before been so conservative. And it should be remembered that this is a basic forecast. First of all, it covers a three-year period, whilst all the known forecasts never implied that such low figures should persist over the entire forecast period. And finally, and perhaps most importantly, the oil price index is expected to stay unchanged for three years, and this was stated deliberately and demonstratively in the forecast. In other words, this index is put outside of brackets. In theory, this creates possibilities for endlessly attempting to guess the unguessable, for accusing the un-

predictable that it has not been predicted, for hoping that the impossible can be achieved, and for speculating on one's own failure to perform adequately.

If, for the time being, we choose to disregard the longer-term prospects, the first few months of 2016 will reveal some relatively positive macroeconomic trends. Thus, over the entire period of Q1, inflation was steadily on the decline, and at a faster rate than had been expected. So, some observers even expressed their concerns that Russia may be faced with problems in an event of deflation. However, our experts, based on their study of the deflation processes occurring in various countries across the globe, have come to the conclusion that in Russia, no conditions for this course of events can be found. They consider Chile (in 2008–2009) to be the only country where deflation occurred under conditions that were similar to the current situation in Russia. Nevertheless, one vitally important factor – the movement of money supply – is missing, because in Russia, money supply is increasing. Money supply contraction can be possible only if the Bank of Russia continues to keep its key rates high for an exceedingly long period of time, failing to reduce them following a decline of prices.

Meanwhile, as the money supply index is moving upwards instead of downwards (due to tapping on the Reserve Fund), the inflation index, as shown by the preliminary period-end results for April 2016, has also halted its downward movement, but the inflation expectations remain high. So, in view of these developments, any fears associated with the prospects of deflation are based on an abstract hypothesis.

The fears that arose in connection with the high volatility of the forex market are also receding. In Q1, legal entities continued to display a shrinking demand for FX assets, while the FX assets held by individuals shrank in absolute terms. While last year, individuals began to gradually 'get rid of' their foreign currency cash, this year saw shrinkage of individual bank deposits denominated in foreign currency. It should be added that in terms of statistics, the share of monies held on individual and corporate bank accounts denominated in foreign currency continued to increase in Q1, but this movement pattern was caused by the behavior of the ruble's exchange rate (and not of that of account holders).

In any event, a panic in the forex market and the behavior of the ruble's exchange rate are no longer perceived as major threats. Much graver concerns are associated with budgets, including regional budgets. Nevertheless, the aggregate budget deficit of RF subjects does not appear to be too threatening, either. Last year, it even shrank to 0.2% of GDP (from 0.9% and 0.6% in 2013 and 2014 respectively). However, it should be borne in mind that, firstly, this is the 'overall' picture, and secondly, this is a sign not of an improving, but of a deteriorating financial status of Russia's regions. They have responded to the changing situation by drastically cutting back on their spending.

Judging by the year-end results of 2016, we may expect that regional budget revenues will continue to decline in real terms. The rising revenues generated by personal income tax in 2015 and the first few months of 2016 (which account for more than one-quarter of total regional revenue) may continue their upward movement, and the growth rate of budget transfers will also increase. However, the growth rate of profits tax receipts (which was rather high last year) has begun to decline. Quite possibly, this is an indication of the plummeting profitability of businesses in 2016, whereas in 2015 it was

at a high level. Now, neither inflation nor the ruble's devaluation can boost profitability on the same level as it used to be in the previous years.

In Q1, the production indices in the majority of segments across the real sector were on the rise, although the growth rate was slight. No serious decline was observed anywhere, except in a few segments. Industrial growth was sustained in the main by growth in the extracting industry. In the manufacturing industry, rising indices were reported with regard to production of consumer goods (foodstuffs, garments and footwear), metallurgy, and production of machinery and equipment (recovery growth after a deep plunge). By all indications, the decline of consumer demand for domestic products has halted, and this may become a basis for stabilization, or even for production growth.

However, experts believe that attempts to boost production by increasing demand may bring about only short-term positive effects. More importantly, the existing problems with supply should be properly dealt with (the competitive capacity of domestic products; development of technologies; manpower qualifications; sources of financing; administrative barriers; etc.). These are the fundamental factors, and our analysis of the movement of the most important segments of the real sector demonstrates that after the existing production potential is exhausted, the economy will enter a phase of zero growth.

So far, judging by the results of the surveys conducted by the Gaidar Institute's experts, Russian industrial enterprises continue to demonstrate their high adaptability to the current situation. One sign of this adaptability is the so-called normality index for Q1 2016 (which reflects the estimation, by enterprises, of the conditions for and results of their activity). Sometimes it so happens that different industries report radically different estimates of how they are managing to cope with the 'new reality'. While the food industry's estimates are probably near a record high of the entire observation period, light industry is near its lowest point. Meanwhile, machine-building is feeling much better than it did a year ago, when the surveys reflected an atmosphere of near-panic: now, 87% of enterprises operating in that industry estimate their financial and economic situation as being normal. This is how they described the situation in the 'fat year' 2007'. Or, we may hypothesize that the notion of normality has undergone a dramatic change since then. ●

1. INFLATION: LIMITS OF SLOWDOWN

A.Bozhechkova, E.Goryunov, P.Trunin

In Q1 2016, inflation slowed down both month-on-month and year-on-year, driven by further decline in internal demand amid a strengthening rouble, as well as due to the high base effect a year earlier. However, expectations for high inflation are still strong, which will stem decline in price growth rates in the mid-run.

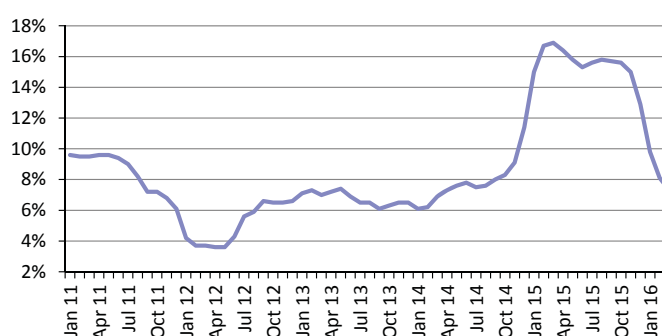
In Q1 2016, inflation slowed down from 1% as of January month-end to 0.6% in February and to 0.5% in March. The annualized consumer price growth rate (over the same period of 2015) fell from 9.8% in January to 7.3% in March 2016 (Fig. 1). The annual growth rate of consumer prices slowed down rapidly largely due to the high base effect. The decline in consumer price growth rates in the Russian economy was primarily determined by a decline in internal demand and hence by companies' efforts to minimize their costs. For instance, negative growth rates of the producer price index have been observed since November 2015, and they reached -1.3% in January and -1.5% in February 2016.

In January–March, food price growth rates were down from 1.3% in January to 0.7% in February and to 0.3% in March. Agricultural produce, eggs and sugar saw most of the decline. Note that inflation for this product group was driven down primarily by the rouble exchange rate that strengthened in February–March 2016. The product group 'red meat and poultry meat' has been facing deflation since October 2015 amid falling demand for meat and with consumers' refocusing on cheaper poultry meat.

In January–March 2016, food price growth rates remained high, increasing by 0.8% in March 2016. However, the rouble's appreciation was followed by considerably slower growth rates in prices of goods that are most sensitive to exchange rate trends, including electric and other household appliances, audio visual goods, as well as medicaments.

In January–March 2016, growth rates of prices and tariffs of paid services to individuals dropped for all the categories of services: from 1% to 0.3% in February and 0.1% in March. The dynamics of prices of outbound tourism services (down by 2.7% in March 2016) contributed most to the decline, due to a strengthening rouble.

Inflation stopped declining in April: the Consumer Price Index (CPI) reached 0.4% within the first 18 days of April. CPI stood at 0.5% in April 2015. In other words, the annualized inflation rate may cease slowing down in April.



Source: Rosstat.

Fig. 1. CPI growth rate in 2011–2016 (% change, year-over-year)

According to the estimates released by Russia's central bank, in March 2016 the median one-year ahead expected inflation rate stood at 14.7%, down by 1 p.p. from the value seen in February. The expected inflation rate reached its peak value of 16.7% in January. However, expectations for high inflation are still strong.

With price growth rates slowing down in Russia earlier in 2016, some experts have made an assumption that deflation may be anticipated. In particular, Bank of America analyst David Honer¹ believes that Russia is threatened by being caught in a deflation trap in the long term, and this will be facilitated by cuts on state budget expenditure, current account surplus and a strengthening rouble. Sociologists also note that individuals have changed their consumer behaviour² that tends to limit their spending amid a challenging macroeconomic context. All the above-listed factors do deter consumer demand and growth of prices of imported goods, that is, they slow down inflation growth rates.

In fact, deflation is not an exotic phenomenon at all. Price deflation was seen in both developed countries (Japan in 1993–2015, Ireland in 2010–2011) and emerging economies (China in 1998–1999, Lithuania in 2002–2003). While prices may fall for many reasons, there are two types of deflation that can be distinguished. The first one can be seen in advanced economies with an extremely low aggregate demand as a result of collapse of overheated financial markets, in which case a deflation spiral may occur: falling prices lead to higher unemployment rates that in turn entail a new decline in aggregate demand and bring an extra downward pressure on prices. Japan is a classic illustration of a deflation crisis in progress: since the mid 1990s Japan has been struggling to get out of the deflation trap. The current conditions in the Russian economy could not lead to this type of deflation. The second type of deflation is typical of emerging markets with a fixed exchange rate regime. The money supply and inflation processes in such countries tend to be extremely reliant on capital flows and trade balance. With a fixed exchange rate, capital outflows and net export cuts tend to force the money supply to shrink and prices to grow (Argentina in the mid 1990s). It is unlikely that Russia will face this type of deflation, because the rouble exchange rate is nearly free-floating.

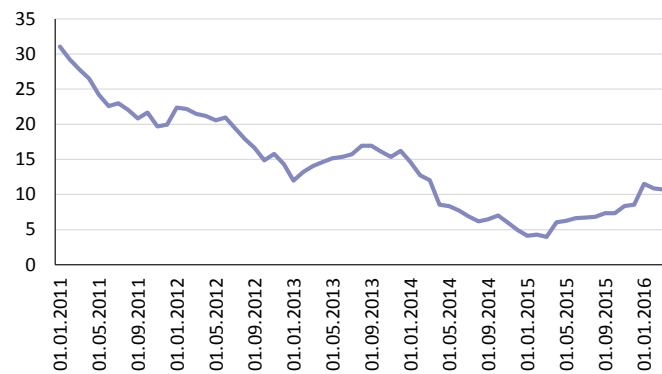
Russia may The deflation in Chile may be of interest for, because it occurred in the macroeconomic context similar to that in Russia. Chile's CPI dropped by 1.5% in 2009. That episode is distinguished by the fact that, first, Chile's central bank adhered to an inflation targeting policy, including a free floating exchange rate; second, prices of exported resource-based commodities plummeted in 2008–2009, that accounted for about 50% of Chile's total exports; third, capital inflows gave way to capital outflows at that period. Under these circumstances, Chile's trade balance fell, national currency depreciated and GDP declined. In an effort to deter the plunging exchange rate and inflation, Chile's central bank lifted the key rate up to 8.25% in the second half of 2008, whereupon the national currency began to firm up. With rapid slowdown of inflation and the economic downturn of 2009, Chile's monetary authorities lowered gradually the key rate to 0.5% earlier in 2010, and the mon-

1 <http://tass.ru/ekonomika/2727282>

2 <http://www.vedomosti.ru/economics/articles/2016/03/21/634351-naselenie-depressiyu>; <http://www.levada.ru/indikatory/sotsialno-ekonomicheskie-indikatory/>

ey stock shrank by 5%. The example shows that deflation may occur under conditions similar to those in Russia, and a plausible reason for this may be rapid diminution in demand amid tight monetary policy conditions.

However, the money stock growth rates in Russia have not been below 4% since the start of 2010, and now they are about 10% (Fig. 2). The international practice shows that the money stock growth per se cannot guarantee a positive inflation, because deflation may just as well be attended with growth in the money supply (Argentina in 1999–2000, Israel, Bulgaria in 2013–2014, Vietnam in 1996–2000). However, deflation used to follow a drastic slump in the money supply growth rates. Therefore, if the M2 growth rates are maintained at the current level, deflation is unlikely to occur. The money supply can shrink only if the Bank of Russia maintains high interest rates for too long, leaving them intact amid slowing down price growth rates. ●



Source: Bank of Russia.

Fig. 2. Growth in seasonally adjusted money stock series (% change, period on the same period previous year)

2. DEMAND ON FOREIGN ASSETS IS FALLING, BANK CURRENCY ACCOUNTS ARE STABLE

M.Khromov

2015 saw a noticeable reduction on the part of economic agents for assets in foreign currency. This signified a decrease in investments in foreign assets both for the population and for organizations (for individuals – savings in foreign exchange cash) with relatively stable (for organizations) and growing (for population) currency accounts in Russian banks.

The Russian residents' demand for assets in foreign currency¹ has been contracting since 2014. As of 2014 year-end, aggregate increase of these assets constituted \$118bn, including currency assets of individuals went up by \$25bn and of non-credit organizations – by \$93bn. In 2015, aggregate increase of foreign currency assets amounted to \$43bn, in other words, this indicator shrank by 3-fold in comparison with the previous year. Assets of legal entities have moved up by \$46bn, which is only half against a year earlier.

In Q1 2016, this trend on the whole remained. Individuals reduced their total foreign currency assets by \$3bn (in Q1 2015 – by \$4bn). Organizations were continuing reducing demand for foreign currency assets to \$14bn compared to \$23bn a year earlier.

As a result, by 2016 Q1-end, according to our estimates, demand for foreign currency assets fell to \$36bn in annual terms (sliding for four quarters). This is even below 2010 indicator when minimum values of the indicator fell to \$43bn. However, now this decrease differs from the one of 2010. Then, the reduction of demand for foreign assets was a reaction to an excessive dollarization registered at the end of 2008-beginning 2009 in the wake of the so called smooth devaluation. Simultaneously, the ruble money supply was growing, which attested to falling dollarization in the Russian economy. However, now the ruble money supply has grown not so significantly. Decrease of the foreign assets is due, to our opinion, to the political instability in relations with foreign partners, general contraction of the dollar volume of the Russian economy owing to significant devaluation of the national currency as well as reduction of income given the deterioration of terms of trade by 14% of GDP (\$180bn) in 2015.

Precisely, contraction of foreign assets has driven the decrease of demand for foreign currency assets. In 2014, foreign assets of non-banking sector

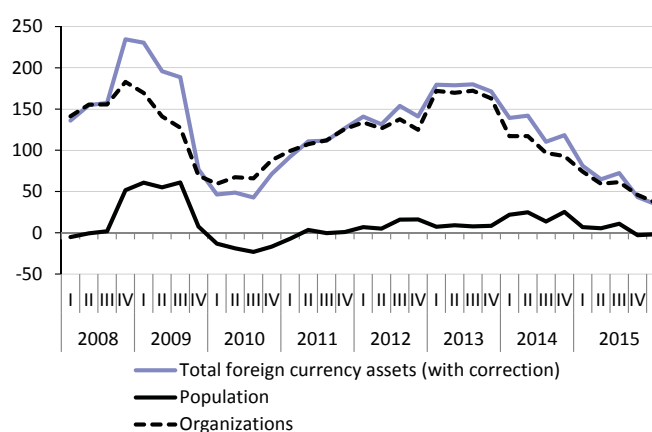


Fig. 1. Demand for foreign currency assets over 4 quarters, USD bn

¹ Growth of foreign currency accounts in Russian banks (foreign currency components of broad monetary base) and net increase of foreign assets including operation with foreign currency cash with Russian banks.

(including individuals and Russian non-credit organizations) moved up by \$105bn, which on the whole corresponds to the level of the previous years (2012 – \$114bn, 2013 minus Rosneft purchase operations of TNK-BP – \$94bn). In 2015, investments in foreign assets fell 5-fold to \$21bn. Dynamics of investments in foreign cash switched to the contrary from increment in the amount of \$30bn in 2014 to decrease by \$10bn in 2015. In Q1 2016, foreign currency reserves have remained practically unchanged. Other foreign assets in 2015 moved up by only \$32bn instead of \$75bn a year earlier. In Q1 2016, reduction of demand for foreign assets continued. Its growth constituted merely \$7bn, which is half the amount a year earlier (\$15bn).

For the population the year 2015 laid the foundations for selling foreign currency savings. Annual increment of foreign currency accounts (\$7bn) turned out to be lower than contraction of foreign currency savings. At the beginning of 2016, the population additionally reduced foreign currency accounts by around \$3bn. Nevertheless, the share of foreign currency accounts held by individuals so far remains rather high – close to 30%.

Where in case of the population in 2015 – the beginning of 2016, the unload of foreign cash was partially compensated by the growth of foreign currency accounts in Russian banks, then legal entities reduced both investments in foreign assets and in growth of foreign currency accounts in Russian banks from \$18bn in 2014 down to \$14bn in 2015. In Q1 2016, this trend continued: the foreign currency accounts of legal entities grew 1.5 time slower than a year earlier – by \$6bn instead of \$9bn. Meanwhile, the level of dollarization on corporate bank accounts remains at the maximum level since H2 2015, which is both above the peak of early 2009 and late 2014, reaching in March 2016 45%. It should be noted that the dynamics of foreign currency accounts share in the overall volume of broad money mass is to a greater extent defined by dynamics of the ruble exchange rate than by the operation of assets holders. According to the ruble exchange rate as of 1 January 2014, the level of dollarization across all non-cash assets would have constituted barely 25% as of 1 April 2016, including 16% for retail assets and 26% for corporate assets. ●

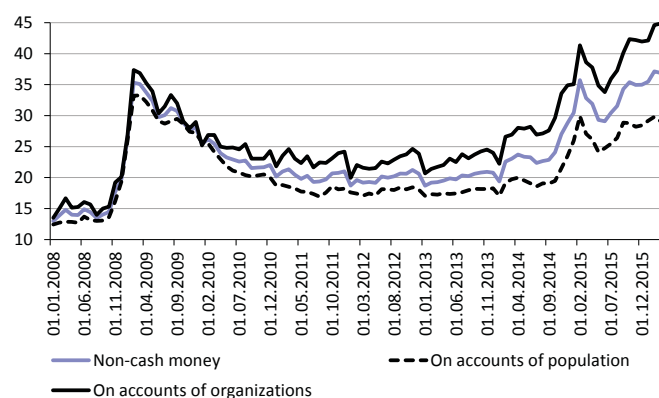


Fig. 2. Share of foreign currency accounts in the total volume of accounts in Russian credit organizations

3. REGIONS – FOCUS ON REDUCTION OF EXPENSES

A.Deryugin

Reduction of the deficit of the consolidated budgets of subjects of the Russian Federation in 2015 was due not to the improvement of the financial state of the regions but a decrease of borrowing possibilities and contraction of financial assistance from the federal budget. That is why ensuring non-deficit budget at the expense of cutting budget expenditure will be de-facto main priority for the fiscal policy of many regions during the current year and many years to come.

Reduction of the total budget deficit of the consolidated budgets of the Russian Federation in 2015 to 0.2% of GDP from 0.9% and 0.6% of GDP in 2013 and 2014, respectively, has given grounds to say that the most difficult from the financial point of view period for the regions was left behind and presently they find themselves in a better shape. Is that true?

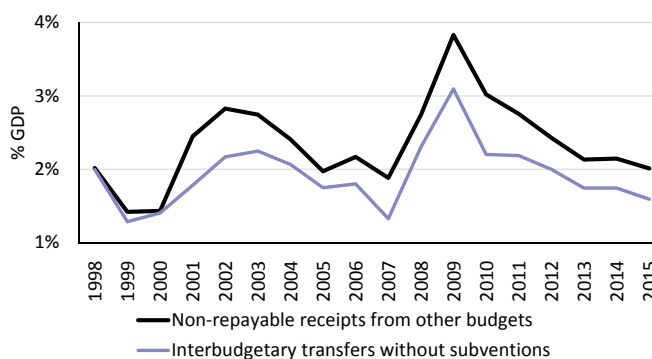
One should not forget that the region can not indefinitely maintain a high level of the budget deficit because their national debt grows. This will lead to an increase in interest costs that will require even more budget funds, to the problems of debt refinancing and to breaking of restrictions set by the RF Budget Code in relation to national debt. Thus, if prior to crisis of 2008, the ration of national debt of the regions to their tax and non-tax budget revenues constituted 15.2%, then by 2015 year-end, it already reached 36.5%.

In compliance with the Budget Code, such ration should not exceed 100% and for highly subsidized regions, there is a corresponding benchmark of 50%. There is an exception for public budget loans which volume can be subtracted from mentioned restrictions but solely up to 1 January 2018.

In the wake of a prolonged absence of any signs regarding stable improvement of terms of trade as well as short-term prospects for lifting economic sanctions from Russia, the regions come to terms with a prolonged character of financial problems. They also figure that the current state of the Russian economy is not a provisional malfunction as it was in 1998 and 2009, but a new normal of its functioning. Moreover, while experiencing problems with their budgets, the Federation has been cutting since 2010 the real volume of financial assistance to regions (Fig. 1).

In this context, the regions had no other way but cut spending. For example, in 2015, expenses of the consolidated budgets of the subjects of the Russian Federation for the first time since 1992 were below 12% of GDP (11.8% of GDP) (Fig. 2).

Thus, relatively good parameters of the balanced regional 2015 budgets were the result not of the improvement



Source: calculated on the data released by the Federal Treasury.
Fig. 1. Dynamics of interbudgetary transfers to regions from budgets of two levels, % of GDP

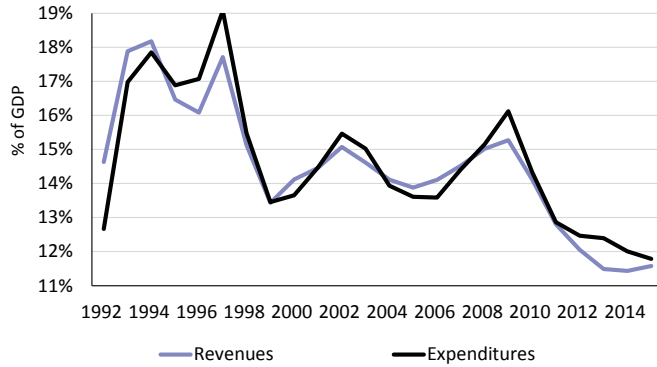
but of deterioration of the financial state of the regions and inability to borrow in required volume.

Consolidated budgets of RF subjects

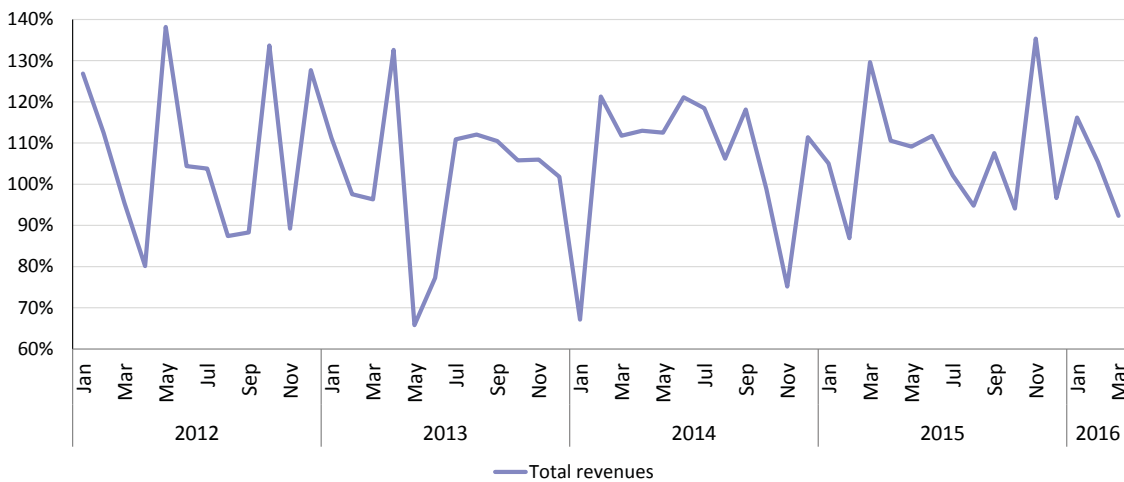
According to preliminary data for Q1 2016, revenues of the consolidated budgets of the subjects of the Russian Federation contracted by 0.8% against the same period last year. At the same time, main reduction was posted in March: -7.7% against March last year (Fig. 3). Such reduction was not owing to any negative trends observed in March. It is explained by a sharp growth of corporate tax receipts in March 2015 that was due, first of all, to *переносом налоговых платежей* from the previous month. Regarding general decrease of regional budgets' revenues posted in Q1 2016, and then a reduction of non-tax revenues and interbudgetary transfers from the budget of other levels exerted the main influence on it (98.3% and 95% against Q1 2015, respectively).

The corporate profits tax whose growth rates in 2015 somewhat exceeded the growth rates of tax and non-tax revenues (107.4% against 106.2%) on the contrary for Q1 2016, so far demonstrates lower rates (99.7% and 104.2%, respectively) and high volatility (its growth rates across the subjects of the Russian Federation vary from 5.4% in the Republic of Khakasia to 318.6% in the Magadan oblast). Volatility of the monthly dynamics of the corporate profits tax as was mentioned above was due to *переносом платежей этого на* in February 2015 (Fig. 4).

Dynamics of the personal income tax receipts, which is the main source of revenues for regions (27.3% of the overall revenue volume of their bud-

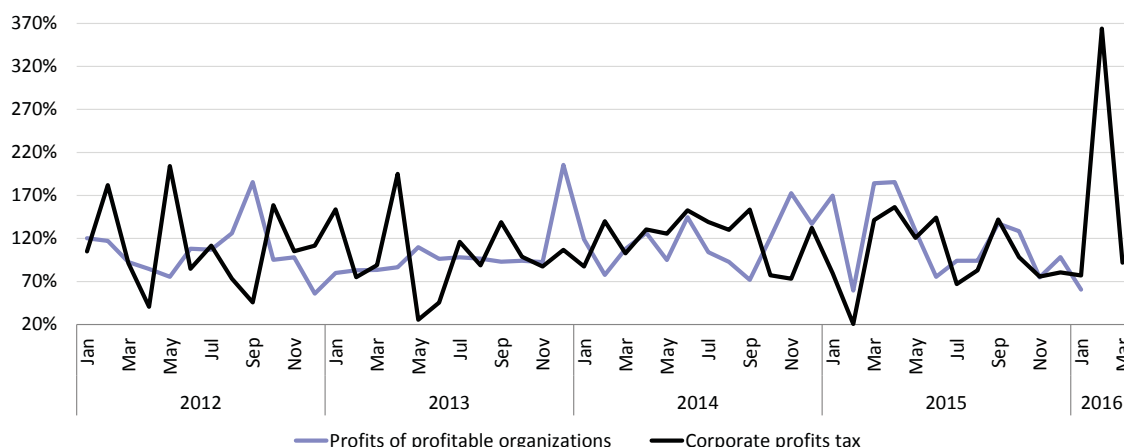


Source: calculation on the data released by the Federal Treasury
 Fig. 2. Dynamics of revenues and expenditures of the consolidated budgets of the Russian Federation, % of GDP



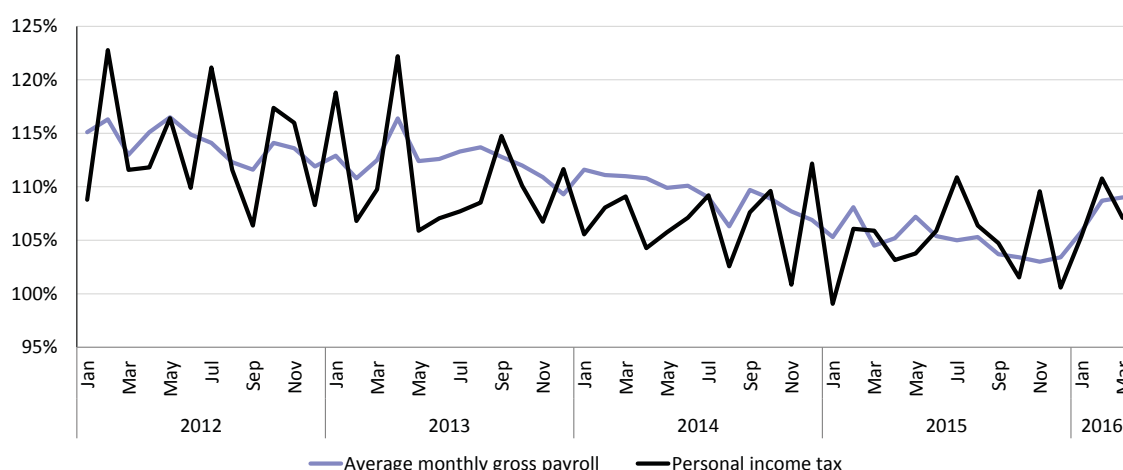
Source: calculated on data released by the Federal Treasury.
 Fig. 3. Growth rates of the revenues of the consolidated budgets of the RF subjects, %

3. REGIONS – FOCUS ON REDUCTION OF EXPENSES



Sources calculated on data released by the Federal Treasury and Rosstat.

Fig. 4. Growth rates of profits of the profitable organizations and the profits tax receipts, %



Sources: calculated on data released by the Federal Treasury and Rosstat.

Fig. 5. Growth rates of the personal income tax and average monthly gross payroll, %

gets in 2015), posted positive shifts following a prolonged downward trend. For the first time since November 2014, growth rates of this tax receipts as well as growth rates of the average monthly nominal wages exceeded 7% for two months in a row surpassing the inflation rate (Fig. 5). At end of 2016 Q1, the personal income tax receipts moved up by 8.1% compared to the corresponding period of the previous year. This brings some hope for the increase in the growth rates of the regional budgets in the months to come.

Growth rates of the personal income tax were affected by both three largest regional regarding collection of this tax (Moscow, St. Petersburg and the Moscow oblast) – they demonstrated growth rates that exceed the average Russian ones and the regions of the Crimean Federal District where corresponding growth rates constituted 155.4%. The picture regarding other regions is not so optimistic overall.

Excises and the corporate property tax in Q1 2016 also demonstrated positive dynamics – they have moved up by 6.2% and 10.2%, respectively.

Geographically, the situation is rather different. Growth of revenues of the consolidated budget in nominal terms proved to be positive solely in 34 subjects; only in 16 subjects it exceeded the current level of the annual inflation

rate. In Q1 2016, Southern and Siberian Federal Districts registered the worst situation with revenues, and the Far Eastern District posted the best situation.

The prospects of the regional budgets' revenues face the following:

- amid reduction of the inflation rate as well as absence of the devaluation effect in 2016 one can expect overall reduction of profitability of organizations which will negatively affect on the profits tax receipts which growth rates as a whole can prove to be below the 2015 rates;
- growth of the personal income tax receipts and its tax base to a considerable extent has a targeted character. That is why, one should not expect growth of receipts from this tax in excess of the inflation rate in the majority of regions;
- growth rates of transfers from the budgets of other levels will be somewhat over the level posted in Q1 (-5%). However, during the year as a whole they will remain negative as it comes from the parameters of the Law on The Federal Budget for 2016 according to which there is their reduction by around 2%.

Thus, at the year-end one can expect further reduction of real revenues and expenditures of the subjects of the Russian Federation. ●

4. RUSSIAN INDUSTRY IN Q1 2016: THE ONSET OF STAGNATION?¹

A.Kaukin, G.Idrisov

In Q1 2016, the production index in the majority of segments across the real sector of the national economy demonstrated low growth rates, which were often close to zero. Hardly any consequences of the ruble's plunge and the declining prices of oil in late 2015 are visible now. The exhausted potential of the existing demand-side and supply-side favorable factors can be the first signal of the Russian economy entering a long period of zero rate of growth.

For the Russian economy, the year 2015 was the period of overall downward movement towards the bottom point, which was the result of the combined effects of both the demand- and supply-side negative factors: the changed terms of trade; real income shrinkage; increasing uncertainty and rising risks; increased debt load on companies; the sanctions introduced against Russia, and Russia's retaliatory sanctions. Due to the differences in their growth models, in early 2015 the production indices in terms of physical volume were displaying multi-vectored movement in different industries. Some of the industries were able to take advantage of the existing favorable factors, and first of all those associated with demand, and so achieved some growth; in other industries – those that had been most noticeably damaged by the recent shocks – output was on the decline². Towards the year's end, no further growth of this 'polarization' could be seen, and on the whole, it can be said that the majority of industries had hit the bottom point of their decline³.

In late 2015 and early 2016, the economy was faced with further deterioration of the terms of trade; however, in contrast to the changes that had taken place in 2014, this plunge was not a permanent one. It appears that the changing world prices of oil and the resulting movement of the ruble's exchange rate against major world currencies can now be viewed as fluctuations caused by the instable situation in the foreign markets. The production statistics for Q1 2016 released by *Rosstat* on April 19⁴ can be treated as evidence that Russian enterprises likewise view these changes in the same way.

The Gaidar Institute's experts decomposed these statistical data and removed the trend component⁵ of the by-sector industrial production time se-

1 The authors should like to express their gratitude to Marina Turuntseva and Olga Morgunova for their help in statistical analysis.

2 See, e.g., G. Idrisov, A. Kaukin, O. Morgunova, M. Turuntseva. The two poles of Russian industry. Online Monitoring of Russia's Economic Outlook, No 12 (September) 2015; G. Idrisov, A. Kaukin, O. Morgunova, M. Turuntseva. The deepening industrial slump: trends have become a fact. Online Monitoring of Russia's Economic Outlook, No 9 (June) 2015.

3 G. Idrisov, A. Kaukin, O. Morgunova, M. Turuntseva. Russian industry rebounds from the bottom. Online Monitoring of Russia's Economic Outlook, No 15 (November) 2015.

4 Information on the social and economic situation in Russia, January–March 2016, Rosstat.

5 The trend component was removed by using Demetra software package based on X12-ARIMA.

ries. The decomposition results demonstrate that in Q1 2016, the situation in industry was sufficiently stable, and no significant decline similar to that observed in late 2014 – early 2015 could be seen. Moreover, we can even speak of growth, however slight (approximately 0.7% in Q1 2016 on December 2015).

Industrial production growth over the first few months of 2016 had to do in the main with the increased production index in the extracting industry, where the situation was not so bad even during the most tricky periods of 2014–2015; the manufacturing industry in general is more likely to be undergoing a period of stagnation (*Table 1, Fig. 1*), while in each of its subsectors the situation is by no means homogeneous. The variability of its by-sector production indices can be explained by the different development models applied in each of these sectors. Depending on their specificity and the configuration of each related market, a slower growth rate or a declining output rate can be caused by a variety of demand-side and supply-side factors¹. As a rule, when speaking of the 'demand-side problems', economists imply that a decline of the real demand for goods and services displayed by economic agents had taken place, its most obvious effects being unemployment, underused production capacities, and a declining price growth rate. When the supply-side is mentioned, it means availability of skilled labor, competitive production capacities, economic productivity, access to financial resources and technologies, competition and regulation, and administrative barriers to doing business. The most obvious consequences of the existence of supply-side problems are a slowdown in the potential/structural rates of economic growth² and rising prices.

The slight but rather stable growth in the extracting sector of the economy, which was observed, as mentioned earlier, in the beginning of 2016, became possible because the impact of negative factors on that sector was by no means crucial. No doubt, the major shock experienced by Russia's economy in 2014–2015 was on the demand side, and it took the form of changed terms of trade, when the Russian economy began to get less income for the same quantity of crude oil³ (according to our estimations – by \$ 180bn). However, due to the specific structure of Russian export duties and the delayed movement of contractual prices relative to oil price quotes on the exchanges⁴, there were positive effects on the supply side – Russian companies began to receive more money in ruble terms for each sold tonne of oil. As a result, even at the new level of demand for (and prices of) oil in dollar terms, it was worthwhile to increase the production of energy resources, and so output surged. The old 'growth model' in this sector is still working, which is confirmed by statistics.

1 Hausmann R., Rodrik D., Velasco A. Growth diagnostics. The Washington consensus reconsidered: Towards a new global governance. 2008, pp. 324–355; Rodrik D. Diagnostics before prescription. The Journal of Economic Perspectives, 2010, V. 24, No. 3, pp. 33–44.

2 See, e.g., M. Kazakova, S. Sinelnikov-Murylev, S. Drobyshevsky, M. Alexeev. Decomposition of Russian GDP Growth Rates. Published Papers Series No 167, Gaidar Institute, 2015. 128 pp.; M. Kazakova, S. Drobyshevsky. Decomposition of GDP: Can the Russian economy grow faster? Forbes, December 11, 2014; M. Kazakova, S. Sinelnikov-Murylev, S. Drobyshevsky. Decomposition of Russian GDP Growth Rates in 1999–2014. Economic Policy (In Russian). 2014. No. 5. P. 7–37.

3 See Idrisov G.И., Ponomarev Y. Y. Sinelnikov-Murylev S. G., Terms of Trade and Russian Economic Development. Economic Policy (In Russian). 2015. No. 3. pp. 7–37.

4 Bobylev Yu, Idrisov G., Kaukin A., Rasenko O. Oil, budget and tax maneuver. Online Monitoring of Russia's Economic Outlook, No. 15 (November 2015), pp. 11–14.

Table 1

THE BY-SECTOR MOVEMENT OF OUTPUT INDICES, APRIL 2016 ON JULY 2014

	Share in total industrial production index, %	March 2016 on July 2014, %	Changes over recent months
Industrial production index		96.94	slow growth
Mineral extraction	33.99	100.86	slow growth
Manufacturing industry	52.50	93.53	stagnation
including			
production of foodstuffs, including beverages, and tobacco products	17.05	103.72	growth
textiles & textile products manufacturing	1.43	83.69	growth
leather production and leather products & footwear manufacturing	0.32	96.73	growth
timber & wood product processing	2.20	97.62	stagnation
cellulose & paper production	3.92	95.69	slow growth
production of coke & petroleum products	18.78	101.16	slow growth
chemical production	7.46	111.10	slow growth
manufacturing of rubber & plastic products	2.26	97.12	stagnation
manufacturing of other non-metallic mineral products	4.41	84.28	decline
metallurgical production & finished metal products	17.23	92.60	growth
machinery & equipment manufacturing	6.24	92.43	growth
electrical, electronic and optical equipment manufacturing	6.05	90.18	slow decline
production of means of transport and transportation equipment	7.06	79.91	decline
other industries	5.59	84.96	stagnation
Electricity, natural gas & water	13.51	98.66	slow growth
Retail trade		86.66	decline
Wholesale trade		89.28	stagnation
Transport		100.40	slow decline
Construction		90.86	slow decline
Commercial services rendered to population		97.15	slow decline

In the manufacturing sector, confident growth rates are demonstrated only by the industries specializing on production of consumer goods (foodstuffs, garments and footwear), as well as metallurgical production (due to growth in the fuel-and-energy complex, and machinery and equipment manufacturing)¹ and machinery and equipment manufacturing (recovery growth after last year's very deep plunge). In these sectors, negative factors were present both on the supply side (increased debt load on companies as a result of the weakened national currency, rising import prices of intermediate goods, lower competition as a result of retaliatory sanctions, increasing interest rates), and on the demand side (the initial surge of activity on

1 Idrisov G., Ponomarev Y., Sudakov S. Russian metallurgy: the ruble weakness alone does not suffice any longer. Online Monitoring of Russia's Economic Outlook, No 18. (December 2015), pp. 12–15.

the markets that later gave way to consumption decline, plummeting investments in response to increasing uncertainty, and budget sequestration in 2015). By now, the downward movement of consumer demand for domestic products has evidently been halted and gave way to stabilization (in light industry, it could even slightly increase on its pre-crisis level in response to the rising prices of foreign products in ruble terms), thus creating preconditions not only for curbing the downward movement of output, but for reversing it towards growth.

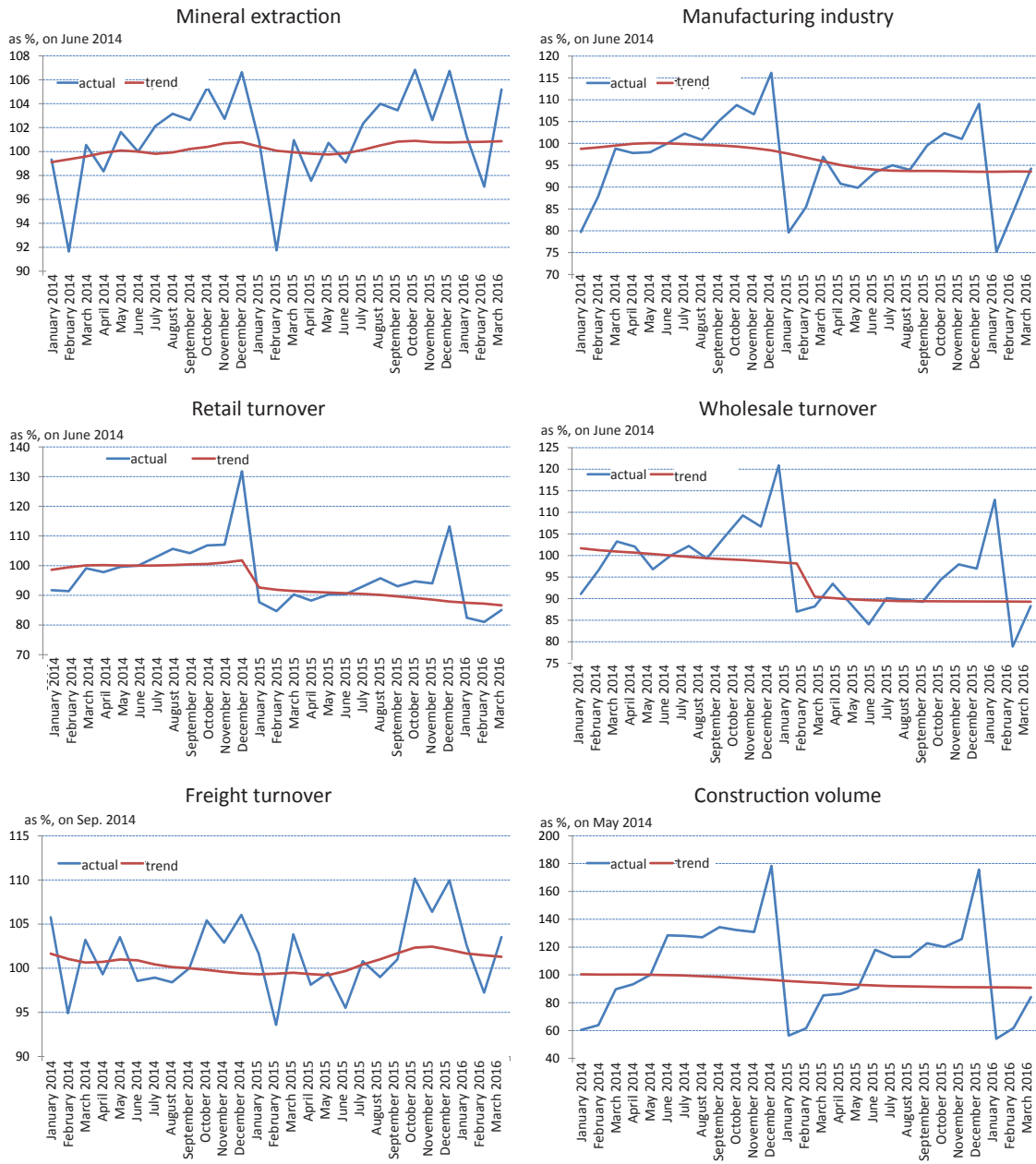
The movement of the other industries is proceeding at a rather lazy pace, which is very close to zero rate of growth; some of them continue to display decline (production of other non-metallic mineral products, electrical equipment, and means of transport). For all these subsectors, the main obstacles to growth appear to be on the supply side – high dependence on imports of intermediate goods and production factors, inadequate technologies, high interest rates on loans, low product competitiveness, etc. Clearly, there also exist some demand-side problems, but output can be boosted by demand only in the short-term perspective, while the medium- and long-term problems existing in these industries can be properly dealt with only after the supply-side bottlenecks are removed.

A similar picture can be observed in some other major industries of the real sector of the economy (*Fig. 1*).

The indices of retail and wholesale turnover have been declining at slow rates for a long time; the decline of wholesale turnover seems to be giving way to stagnation. A similar movement pattern is demonstrated by the construction volume index. Freight turnover, for which the end of 2015 was the period of slight recovery growth, in recent months has also remained practically unchanged.

The specific movement patterns of the trend components of production time series plotted for the most important segments of the real sector of the economy may be regarded as the first signal of the Russian economy's entry into a phase of zero growth, after the favorable effects of the demand-side and supply-side factors have been exhausted.

4. RUSSIAN INDUSTRY IN Q1 2016: THE ONSET OF STAGNATION?



Source: Rosstat; own calculations.

Fig. 1. The by-sector movement of production indices in 2014–2016, actual data and trend components

5. ENTERPRISES RETAIN HIGH PROPENSITY FOR ADAPTABILITY

S.Tsukhlo

Assessment of the state of affairs in Russian industry and the level of its adaptability to real conditions as of Q1 2016 demonstrated rather positive values of the normal index that reflects the estimation by the enterprises of indicators and conditions of their activity. Industry retains a high level of adaptability to all shocks of recent seven quarters.

The final evaluation of the normal index (adaptability) for the last quarter (Fig. 1) has been upgraded according to the results of March survey owing to the positive correction of the stocks of finished products and satisfaction with demand compared to the previous assessment obtained by the period-end for January–February 2016. However compared to Q4 2016, a decrease in the estimates of demand and capacities were registered. Meantime, satisfaction with demand demonstrated maximum decline against intercrisis maximum (60%) of this indicator posted in 2011. Estimates of capacity sufficiency deteriorated against that maximum but owing to the growth of responses “more than sufficient,” which can not be considered as an undoubtedly negative factor. Other components of the aggregate indicator lost against their maximum and appraisals of stocks of finished products reached the maximum level in Q1 2016.

Branches of Russian industry demonstrate different level of entering the new normal of 2016 (Fig. 2).

Achievements of the food industry

Index of Adaptability of the food industry has reach an absolute (for 1994–2016) maximum of 84%. In other words, 84% of businesses considered normal the volumes of demand, stocks, capacities, number of workers and their financial and economic situation in Q1 2016. Although in Q4

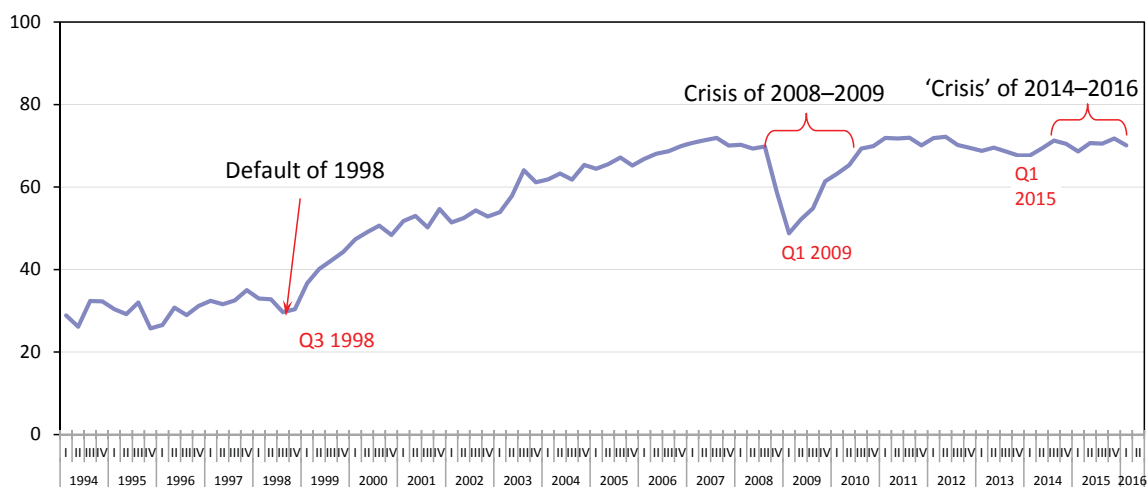


Fig. 1. Adaptability Index (normal) of industry, 1994–2016, % (share of enterprises assessing their indices as 'normal')

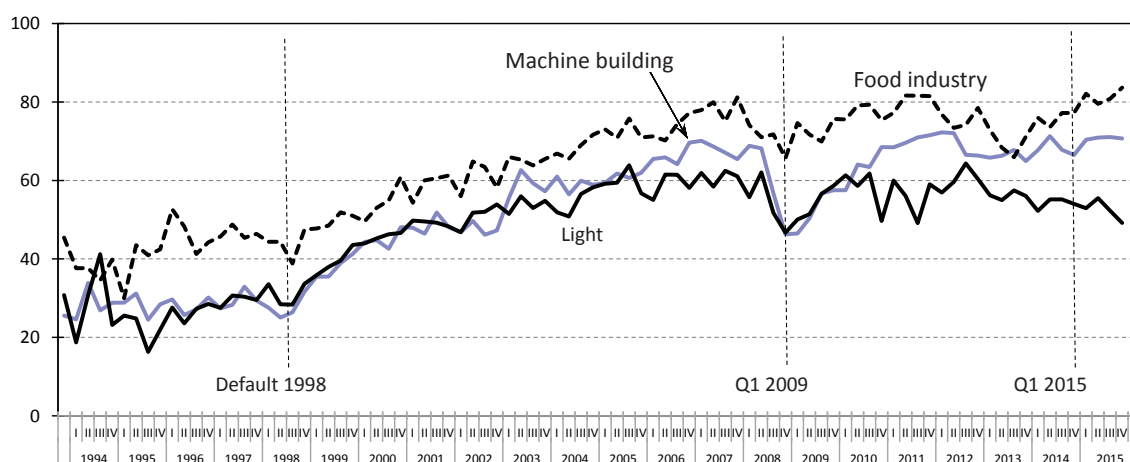


Fig. 2. Industrial Indices of adaptability (normal), 1994–2016, % (share of enterprises that assess their indicators as "normal")

2013, this sectoral indicator declined to the crisis (2008–2009) minimum of 66%. However, this industry has not been demonstrating confidence over recent quarters. Satisfaction with demand (for the normal evaluations of its volume) shed 14 p.p. during two quarters and declined to 53% now. The food industry hoped, most likely, for large marketing volumes of domestic products amid counter-sanctions and ruble's devaluation. However, the Russians have "tightened their belts" and started not only to earn less in real terms but also to spend less on food. At the same time, the industry as never before is sufficient with resources required for domestic production. Nearly all food-processing enterprises (96%) have normal sufficiency with inputs, 91% – with headcount, 87% – with capacities, and 85% – with stocks of finished products. As a result, 90% of businesses assess their financial and economic situation as good or satisfactory.

Problems of the light industry

The light industry is at the other pole now. Barely 49% of enterprises managed to adapt to the conditions of the protracted crisis of 2014–2016 by Q1-end 2016, which is the worst indicator since Q1 2009 (i.e. since the last crisis). Then, the industrial index of adaptability fell to 47%. However, the indicator was still worse by the end of crisis-year 1998 – 28%. The best value of the indicator was posted in 2005 and 2012.

Deterioration of the light industry industrial index values is, first of all, due to insufficient demand. At the turn of 2016, barely 13% of enterprises of the industry were satisfied with demand volume, although in mid-2015 this indicator was 3-fold higher, and during the inter-crisis peak (2010) was 4 times higher. Inferior values of demand satisfaction were registered only in 1998 and 1996. The industry was not boosted by the ruble's devaluation as was expected. Obviously, it was due to consumers' behavior.

Other assessments made by the light industry enterprises have not undergone such critical changes, although they are far from the values registered in better time. Only 51% of enterprises estimate their stocks of raw and other materials as normal – they do not manage to purchase everything at acceptable prices in the context of falling demand. At the same time, the share of

responses of excessive stocks of inputs went up, which is already explained by mistakes made during purchases of raw materials. Stocks of finished products are considered as normal by 57% of enterprises amid significant prevalence of responses “above normal” over responses “below normal”, which one more confirmation of the marketing issues. Fifty five percent of enterprises register capacity sufficiency with 36 percent of enterprises posting their excess. Since mid-2014, evaluation of capacities experience considerable fluctuations (the share of normal responses changed during this period from 42 to 72%). This signifies that the enterprises are unsure in their assessment of the near future of the industry. Best of all, the light industry is sufficient with headcount – 62% of normal responses in Q1 2016.

Confidence of the machine building industry

Index of Adaptability in machine building demonstrates stability following the decline of Q1 2015 when the industry was in to panic and degraded estimates related to the situation awaiting a full-scale crisis of 2008–2009. However, the reality turned out to be quite different and from Q2 2015, the machine building industry gave positive assessments and up till now retains 70% level of adaptability to the new normal.

Although, the machine building enterprises practically always assess the demand volume less well than other indicators during many years of our monitoring. However, its current evaluation (Q1 2016) did not undergo critically crisis shifts compared the previous years.

Appraisals of stocks of finished products, which in 2015–2016 reached all-time high of normality, demonstrate that the industry successfully copes with the main shocks of recent years and in its absolute majority is ready for the awaited surprises of the current crisis. The share of enterprises with insufficient stocks of finished products at the turn of 2016 remains at the all-time low. Lower value of the indicator was obtained solely in 1992 and it is incorrect to compare 2016 with 1992.

Stocks of raw and other materials are at the all-time maximum of normality and confirm resolve of the industry to upcoming triumph over crisis.

The industry is well sufficient now with industrial capacities and headcount. This is due to “expected shifts in demand.” To that end, 20% of enterprises even have excess capacities. However, 10% of machine building plants all the same consider their industrial capacities insufficient for the satisfaction of expected shifts in demand for their products. However, the sectoral balance remains positive, i.e. the industry boats of excessive industrial capacities. Russian machine building registers such situation for the eighth year in a row – since 2009.

Russian machine building industry is worse provided with personnel. Although, the share of “normal” responses of the available headcount (again “due to expected shifts in demand”) is higher (i.e. better than capacities estimates) and solely is one point behind the all-time maximum of the 21-year monitoring. However, among other part of the machine building plants responses “below normal” dominate over the responses “more than sufficient.” In other words, in 2016, the industry incurs a deficit of headcount. Excess of personnel was registered in machine building solely in 2009 and 2010. During all other years the industry was operating amidst the deficit of personnel including 2015.

Positive state of the industry allowed 87% of enterprises to estimate their financial and economic situation as normal. This result posted at the turn of 2016 was a repetition of the situation of 2007. ●

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