ONLINE MONITORING OF RUSSIA'S ECONOMIC OUTLOOK

TRENDS AND CHALLENGES OF SOCIO-ECONOMIC

DEVELOPMENT **No. 13(31) July 2016**

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MAIN TRENDS AND CONCLUSIONS

Donald Trump's verbal attacks, including his ostentatiously provocative questions about defaulting on the national debt, exiting the WTO, have had no impact on the global economy either because it makes little of it or because it doesn't believe he will win the upcoming presidential elections.

By contrast, the Russian economy has taken seriously a high-level discussion that have emerged unexpectedly: suppose the Russian rouble is re-strengthening? Almost the following day, however, the rouble stopped "re-strengthening" and then went down guided by falling crude prices. As a result, a barely noticeable uplifting trend (the rouble is on the rise despite falling crude prices) came to an end in less than a few weeks. This is another chance to evaluate the role of verbal interventions in Russia's business life, as well as to see the extent to which plurality of opinions can influence some of the vital issues of economic policy.

For example, is it good or bad for the rouble to be weak (strong)? Who exactly can benefit from a weak (strong) rouble? And who of those who benefit or not from this are more important for us?

Or, is it real that the rouble is free floating or there are administratively set limits that are publicly unknown? Is it always possible to "tamper" with the exchange rate to raise extra money for the federal budget?

Finally, should inflation targets be reconsidered now (and each time) in order to be ranked inferior to other targets that are innumerable? This is because the rouble's chances for strengthening (re-strengthening) are next to nothing, but there is chance it will weaken again.

A lack of intelligible answers, or doubts about the questions that seem to have been answered, hamper analysis and assessment of what is going on and what is to be expected in the economy.

According at least to our experts who studied the status of the Balance of Payments for the end of H1 2016, the Russian rouble exchange rate was close to its fundamentally substantiated level. The current account's downward pressure upon the rouble – a positive current account balance shrank drastically compared to the same period previous year due to more than a 2-fold decline in a positive foreign trade balance – was offset by a sweeping decline in capital outflows. Although the rouble strengthened in H1 2016, there is risk that it will depreciate, which, according to the experts, may be associated with a possible fall in crude prices. The external debt payments that come due later in the year may be found to be much less than the scheduled payments, most of which are actually intra-group payments or debts that will most likely be deferred or refinanced.

External debts are normally not a problem for Russia's regions, although the debt issue is still pressing. Regions' debts to the federal budget accounted for 35.3% of their revenues by June 2016, slightly down compared to the level seen earlier in the year. A federal policy for replacing expensive commercial loans accumulated by regions with state budget loans (the share of the former and the latter shrank to 31.4% and 45.2%, respectively) contributed to this. The growth in the consolidated budget revenues of subjects of the Rus-

sian Federation contributed, too. Although they increased in nominal terms only 2.7% in H1 2016 (compared to the same period of 2015), they outran the inflation rate as recently as May/June.

In particular, profit tax and personal income tax revenues began to grow (altogether they account for more than a half of the budget revenues in the regions). Personal income tax revenues outran the inflation rate, too, up 8.5% in H1 2016. The experts also note "positive dynamics of the personal income tax base after recovery earlier in the year from a long-lasting downward trend".

Indeed, it is difficult to picture a situation in which income tax revenues could be for a long time positive while incomes are negative. This is especially true in regard to wages, as payroll tax is paid on a monthly basis. Indeed, wages increased twice in real terms in M5 2016, which, in general, is not the case with incomes.

At the same time, the poverty rate ceased to grow and even edged down in Q1 2016 (compared to the same period previous year). A decline in inflation rates contributed most to this. This, first of all, refers to food prices that influence the minimum subsistence level. The declining inflation rate also makes it possible for the poverty rate to be reduced further this year.

One can most likely conclude that a period of virtually across-the-board decline in personal incomes, as well as the process of rapidly expanding poverty zone, is nearing its end.

Also, a few of the major industries, including the banking sector, showed stabilization and even a relative advance. Although the performance of regular banking transactions remains noticeably below the levels before the crisis, the banking sector saw profits upsurge in Q1 2016 (compared to the same period of 2015). This allowed the Russian banking system capitalization to be maintained to some extent. However, almost all the banking sector's profit was generated by state-run banks and state-affiliated banks (including Sberbank with more than 80% of the banking sector's profit). Anyway, the results for H1 2016 were much better than those at the end of 2015, in which Sberbank's profit outstripped that of the banking sector, i.e., the rest of the banks were in the red in the aggregate.

As to the situation in the Russian industrial sector, Gaidar Institute's business surveys show that enterprises' adaptation was at a fairly high level in Q2 2016, most of which considered their finished goods inventory, manufacturing capacity, financial status, human resources etc. as 'normal'. Food industry enterprises gave most positive assessment of the situation (or, more precisely, they assessed it as "normal"), 83% of the surveyed food producers shared the same (normal situation) assessment (the situation with demand was assessed worse by 64% of the respondents, but the assessment was better compared to that in the first quarter). The situation in the consumer goods industry was assessed most negative. In terms of adaptation, the engineering industry was ranked "in between", i.e., below metallurgy and chemical industry and above construction and forest industries.

1. BALANCE OF PAYMENTS: JANUARY–JUNE 2016

A.Bozhechkova, P.Trunin

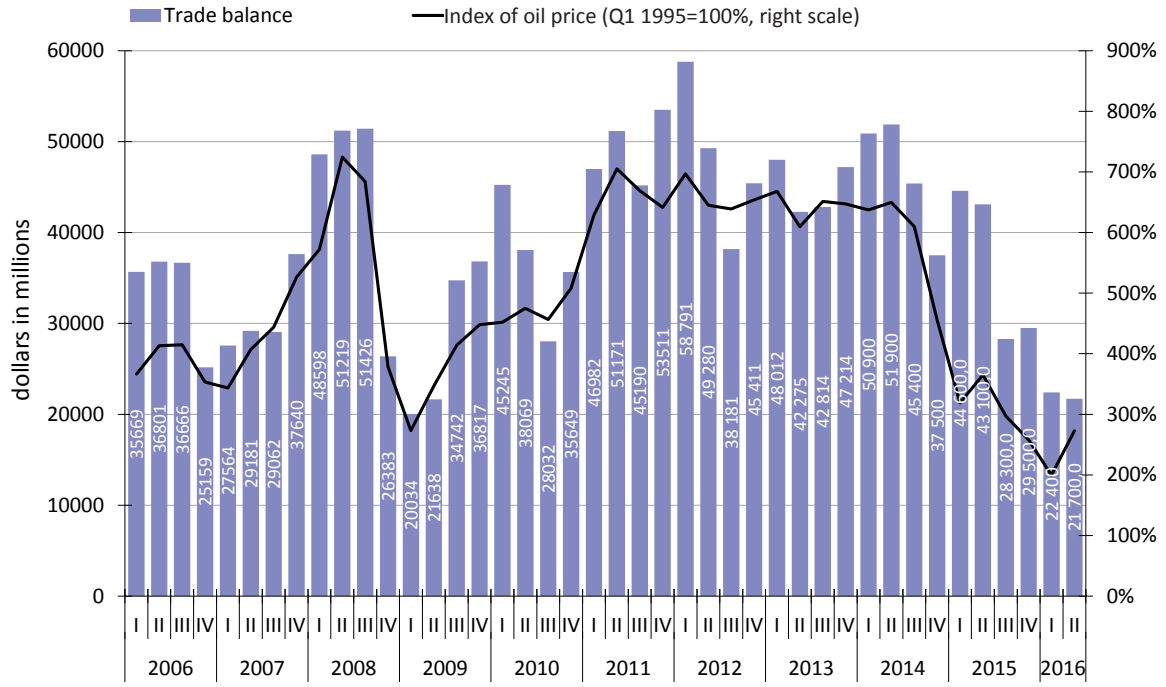
The BOP (Balance of Payments) data show that a current account surplus contracted considerably in H1 2016 over the same period previous year. This is because there were serious cutbacks in exports while the decline in imports slowed down. Despite growth in non-bank sector's foreign asset holdings, there was a sweeping decline in net capital outflow in the private sector because banks and other sectors met their debt obligations at slower rate. As a result, the rouble appreciated as of the end of H1 2016, reaching a fundamentally substantiated level, although there are risks that it will depreciate.

According to the Bank of Russia's preliminary assessment of the BOP for January-June 2016, the current account balance stood positive at $15.9bn, down 66% ($46.5bn) over H1 2015. Such a considerable contraction resulted from a decline in the trade balance because exports declined at a faster rate than the contraction of imports of goods and services.

Exports of goods were down 29.7% in H1 2016 over the same period of 2015 (from $181.6bn to $127.7bn), including exports of crude oil (down 32.3% to $32.6bn) and natural gas (down 21.8% to $15.0bn) due to low global prices of energy-carrying resources. For instance, in H1 2016, the Brent crude was traded by an average of 31.7% below the price set in the same period of 2015. On the other hand, imports of goods dropped only 9.5% (from $92.3bn to $83.6bn) at the same period over Q1 2015 because the rouble gained 6% in real terms over December 2015 and the decline in aggregate demand slowed down (real wages declined by an average of 8.7% in January-May 2015, whereas the decline slowed down to -0.7% in January-May 2016). As a result, a positive trade balance contracted by 50.6% (from $89.3bn to $44.1bn) (see Fig. *1*).

A negative service balance, compensation of employees balance and investment income balance prevented the current account balance from contracting further in H1 2016. For example, a service balance deficit amounted to $9.9bn in H1 2016, down 44.5% (in absolute terms) over H1 2015: imports of services dropped 22.1% to $33.2bn mainly because the Russians continued to cut back on international travel expenses while exports of services fell 6.1% to $23.3bn.

In absolute terms, the compensation of employees balance dropped 69.7% to -$0.9bn (-$3.0bn in H1 2015). An investment income balance deficit was down 26.4% (from -$19.7bn to -$14.5bn) due to lower costs of servicing overseas debt obligations that were reduced. Investment income receivable dropped 7.3% (from $15.8bn to $14.6bn) due to contracting foreign asset holdings in the private sector. The income payable by non-financial enterprises decreased by 18.5% ($24.3bn). The income receivable by the banking sector increased from $4.2bn in H1 2015 to $5.3bn in H1 2016, resulting in an overall positive investment income balance of $1.4bn in the banking sector (it was negative ($0.5bn) in H1 2015).



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

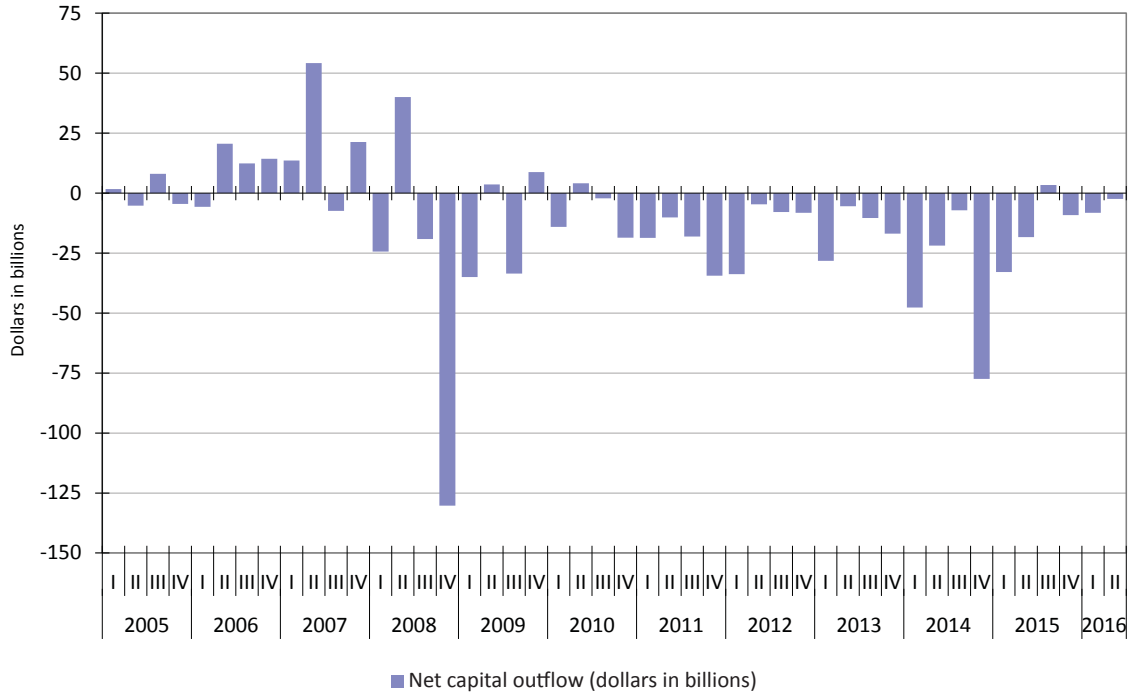
Fig. 1. Russia's trade balance and global oil price index in 2006–2016

The decline in BOP current account surplus was attended by a comparable contraction of the financial account deficit that stood at $4.5bn in H1 2016 (compared to $56.9bn in H1 2015). Russian economic agents' obligations to foreign economic agents were reduced by $3.2bn as of the end of H1 2016, whereas H1 2015 saw a decrease of $50.2bn in obligations to foreign economic agents. Furthermore, Q2 2016 saw an increase of $5.8bn in such obligations. In particular, banks reduced their overseas debt obligations by $12.0bn in H1 2016 (by $35.4bn in H1 2015) though repayments on previously accumulated debt obligations. By contrast, the non-bank sector increased their overseas debt obligations by $7.2bn ($8.7bn in H1 2015) through refinancing of a major share of their overseas debt obligations.

H1 2015 saw a foreign direct investment inflow of $2.0bn to the non-bank sector, while H1 2016 saw it increase to $6.5bn. Portfolio investment increased $2.4bn (down $0.8bn in H1 2015). Indebtedness under the item 'credits and loans" was reduced by $2.3bn compared to $10.6bn in H1 2015.

Note that Russian economic agents will have to pay $56.1bn on their overseas debt obligations in the period between July and December 2016. However, actual payments on the overseas debt obligations may be found to be less than scheduled. As a reminder, $37.1bn were actually paid in the period between July and December 2015 instead of the $62.5bn scheduled for the same period, due to intra-group payments and obligations that are very likely to be deferred or refinanced. Note that, according to the Bank of Russia, in Q3 and Q4 2016, non-financial organizations are to pay $17.8bn and $22.4bn, respectively, on overseas debt obligations, according to the schedule of payments. However, actual payments for the period may be found to be 38.2% and 4.0%, respectively, less than scheduled for the reasons given above.

The BOP data show that residents' foreign assets (foreign economic agents' obligations to Russian economic agents increased $1.3bn in the period be-



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

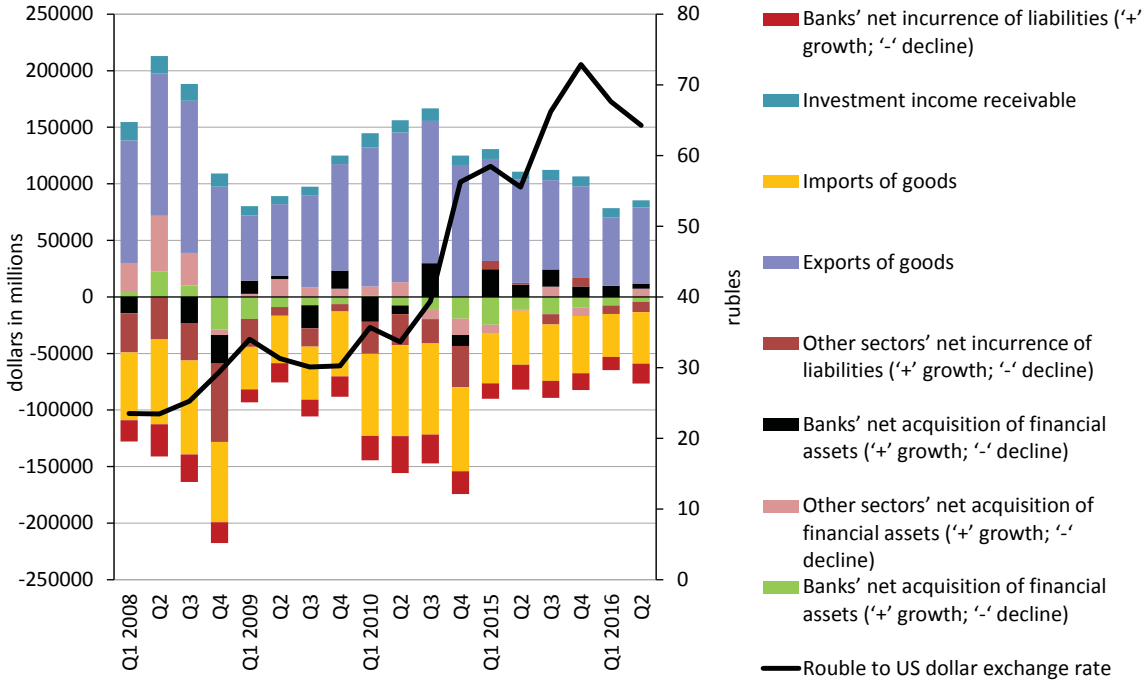
Fig. 2. Net capital outflow in private sector in 2005–2016

tween January and June 2016 (down $6.7bn in H1 2015). On the other hand, banking sector's foreign assets contracted $14.6bn (-$8.6bn in H1 2015). The foreign assets shrank partly due to banks' payments on foreign currency obligations to the Bank of Russia. Foreign currency liquidity received by credit institutions from the Bank of Russia dropped Rb 8.6bn in the period between January and June 2016. Capital exports from other sectors increased 14.7% to $16.5bn, of which direct and portfolio investments to foreign countries amounted to $12.2bn and $3.1bn, respectively ($9.1bn and $0.7bn, respectively, in H1 2015). Overall, net capital exports in the private sector stood at $10.5bn, which is five times below the value seen in H1 2015 (see Fig. *2*).

The BOP data show that Q1 2016 saw international reserves assets increase $7.0bn because the banking sector met outstanding foreign currency obligations to the regulator.

The data for January-March 2016 show that banks' assets increased $1.2bn as a result of foreign currency cash operations with non-residents (banks' assets decreased by $7.1bn during the same period of 2015). At the same time, banks' foreign exchange assets decreased by $1.9bn (an increase of $2.1bn in Q1 2015) as a result of selling/buying foreign currency in cash to/from individuals through exchange offices, as well as closing (opening) foreign exchange deposits through front offices. As a result, foreign currency in cash in hand increased $1.2bn to $41.5bn in the period between January and March 2016, according to the Bank of Russia. According to the BOP data, the non-financial sector transferred $2.8bn in foreign currency in cash to foreign counterparts in H1 2016 (compared to $6.1bn in H1 2015).

Thus, the current account's downward pressure upon the rouble due to a considerably declined positive trade balance in H1 2016 was offset by across-the-board cutbacks in capital outflow, especially in the banking sector. (see Fig. *3*).



Source: Russia's central bank.

Fig. 3. Key sources of foreign currency supply and demand

As a consequence, the US dollar to rouble nominal exchange rate decreased by 11.8%, from 72.9 to 64.3 roubles per US dollar in H1 2016. As a reminder, the rouble was traded at 80 roubles per US dollar in the foreign exchange market in the second half of January 2016. With a stable inflation rate and a strengthening (in nominal terms) rouble, the rouble real effective exchange rate increased 6.0% in H1 2016 over December 2015, reaching the levels seen in the fall of 2015. Growth in crude oil prices and FX market players' positive expectations pushed the rouble up in H1 2016.

According to our research, the rouble real effective exchange rate is currently set at a fundamentally substantiated level[1] driven by the dynamics of total factor productivity, terms of trade, capital flows, government spending. Overall, this is the result of applying a market-based exchange rate formation mechanism, with no Bank of Russia interventions, economic agents' panic sentiment, FX market shocks.

Despite the rouble appreciation in H1 2016, there is risk that the rouble will depreciate following a possible fall in crude oil prices because substantial reserves of crude oil and refined petroleum products have been accumulated in the global market. Besides, the rouble may depreciate due to a budget deficit that may develop because of financing from the Reserve Fund and, consequently, liquidity surplus in the banking sector. However, banks may trade their Russian rouble holdings in the FX market if negative exchange rate expectations prevail.

1 According to our research, the rouble real effective exchange rate was slightly underestimated by 0.4% in Q1 2016, whereas it was overestimated by 0.7% in Q2 2016.

2. REGIONAL BUDGETS: DEBT REDUCTIONS AMID AUSTERITY

A.Deryugin

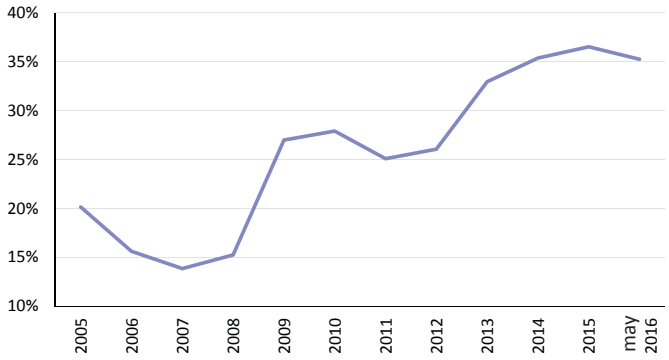
In May–June 2016, there was an insignificant growth of regional revenues together with restraint of spending growth, which resulted in contraction of regions' public debt. Moreover, tight commercial loans were partially replaced by the budget loans. In the meantime, overall low income growth rates commenced since the turn of the year and restrictions on borrowings will not allow regions to achieve positive growth rates of budget spending in real terms and, thus, depart from the austerity policy.

Public debt

By the end of 2016, the regional debt totaled 35.3% of the overall tax and non-tax revenues of the RF subjects. They somewhat decreased in comparison with the values reached by early 2016 (*Fig. 1*). This level still allows to increase borrowings but many regions have already reached the benchmark target set by the Budget Code according to which the volume of the public debt of RF subject should not exceed 100% (for highly subsidized ones – 50%) of the approved total annual volume of revenues of RF subject (excluding approved volume of non-repayable receipts)[1].

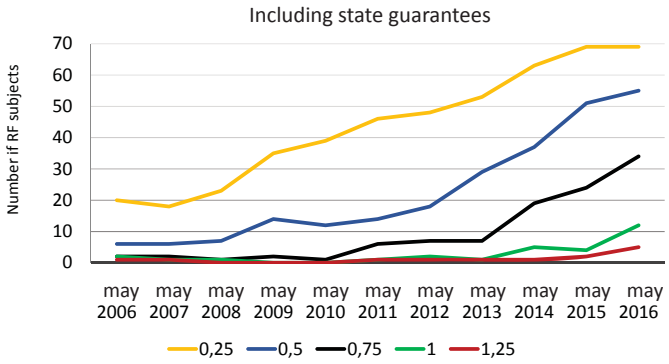
Throughout last ten years, the number of RF subjects whose public debt exceeds the taget in relation to regional budgets revenues has sharply gone up (*Fig. 2* and 3[2]). For instance, the ratio of debt to the tax and non-tax revenue of the budgets exceeding 75% has gone up since 2006 from 6 to 55 regions. In May 2016, public debt of twelve regions exceeded 100% meanwhile in 2006 there were barely 2 such regions.

Five subjects of the Russian Federation (Kostroma region, Republics of North Osetia-Alania, Karelia, Mordovia and Khakasia) register the volume of



Sources: calculated on data released by the Finance Ministry of Russia and by Federal Treasury.

Fig. 1. Dynamics of the volume of public debt accumulated by the RF subjects, in % to the volume of tax and non-tax revenues



Sources: calculated on data released by the Finance Ministry of Russia and by Federal Treasury.

Fig. 2. Dynamics of the number of RF subjects where the ration of public debt to tax and non-tax revenue exceeds the target

1 Prior to 1 January 2018, this restriction does not apply to public budget loans.

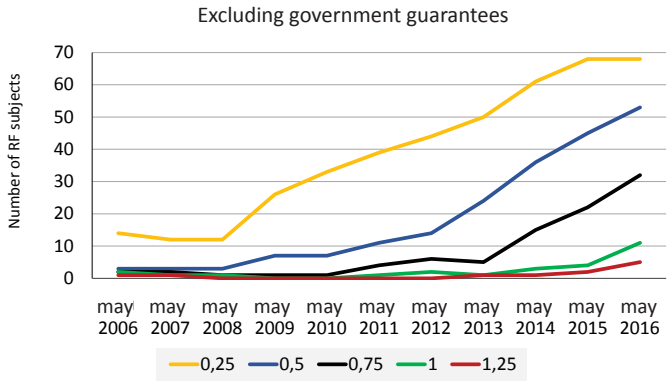
2 State guarantees, which are not definitely liabilities and consequently to a considerable degree formally increase the level of debt burden, now are small (4% of the overall volume of public debt as of May 2016). That is why their exclusion from the analysis does not significantly affect the overall conclusion regarding aggravation of the debt problems of the regions.

the public debt excluding government guarantees in excess of 125% of the total volume of revenue.

Thus, many RF subjects have already approached or are approaching legal restrictions regarding the accumulated public debt, which represent a factor of mandatory contraction of the total regions' budget deficit. On retention of legal norms regarding budget deficit and public debt in coming years one can suppose that the level of budget deficit of the regional will be relatively low.

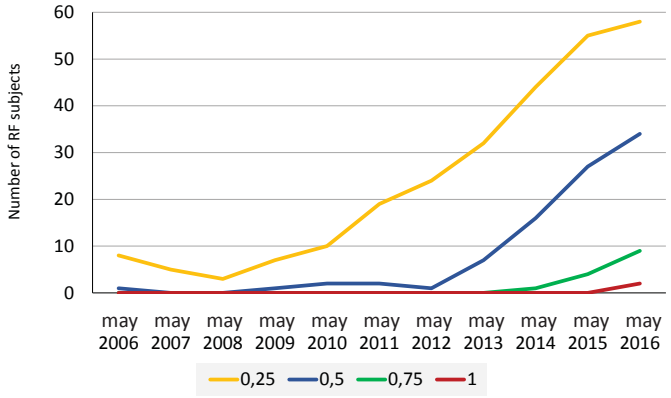
If we analyze regions' debt problem outside the context of legal restrictions linked to account for only tax and non-tax revenue but to take into account all receipts exclusive subventions (in other words, revenue for the implementation of their powers), then this will not significantly change the situation: the number of regions with high level of debt burden during 10 year have grown significantly (*Fig*. 4).

The pattern of the regions' public debt features an upward trend in the share of federal budget credits, which commenced in 2014, and which as of May 2016 hit 45.2% in response to tight commercial loans (*Fig*. 5). In 2014–2015, an increase of budget loans rather led to the contraction of borrowings in the form of govern-



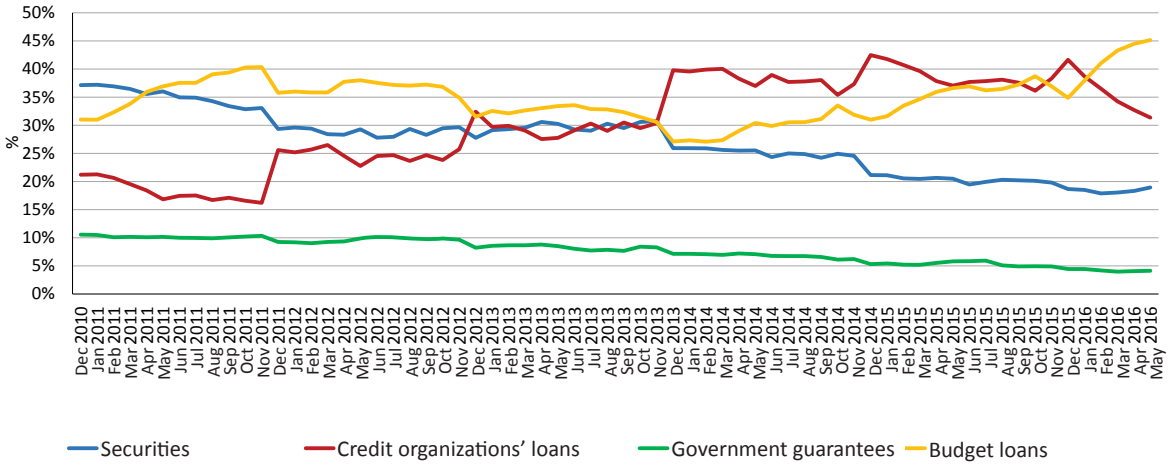
Sources: calculated on data released by the Finance Ministry of Russia and by Federal Treasury.

Fig. 3. Dynamics of the number of RF subjects whose ratio of public debt to tax and non-tax revenues exceeds the target



Sources: calculated on data released by the Finance Ministry of Russia and by Federal Treasury.

Fig. 4. Dynamics of the number of RF subjects whose ratio of public debt (excluding government guarantees) to their budget revenue (excluding subventions) exceeds the target



Source: calculated on data released by the Finance Ministry of Russia.

Fig. 5. Pattern of public debt of RF subjects

ment securities, but in 2016, commercial loans were replaced and their share by the end of Mas shrank to 31.4%, which is the lowest level since December 2013.

On retention of high volumes of budget loans origination and low budget deficit of RF subjects, one can project further contraction of the volume and share of tight commercial loans in the pattern of regions' public debt in years to come. This can result in a slowdown of growth rates and, possible, somewhat decrease of budget expenditure on regions' public debt servicing.

Revenues and expenditures

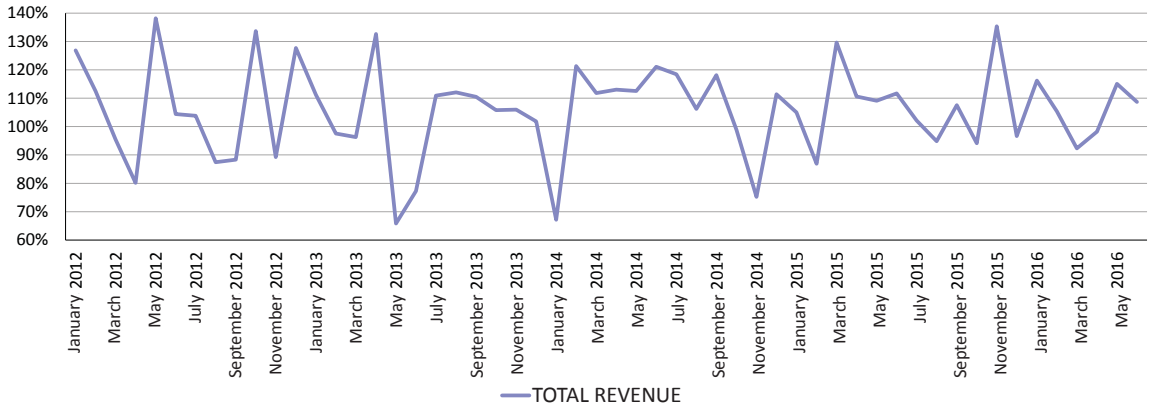
According to preliminary data, as of H1 2016, the revenues of the consolidated budgets of RF subjects moved up by 2.7% in comparison with the same period of last year. This was achieved thanks to high growth rates posted in May-June when the revenues went up by 15.1% and 8.7%, respectively against the corresponding period of the previous year (*Fig. 6*).

At H1 2016 as a whole, growth rates of the revenues remained low taking into account the inflation level (107.5% in June 2016 against June 2015). In real terms, these rates are negative.

At the same time, for May and June 2016, dynamics of tax and non-tax revenue of the consolidated budgets of RF subjects (117.6% and 114.9%) hold out some hope for higher growth rates of revenues in H2. For example, grow of receipts generated by profits tax following low values in March and April, in May and June remained at the level of 120% (to the corresponding period of 2015), which allowed to achieve the revenue schedule of the last year (100.7% at H1-end).

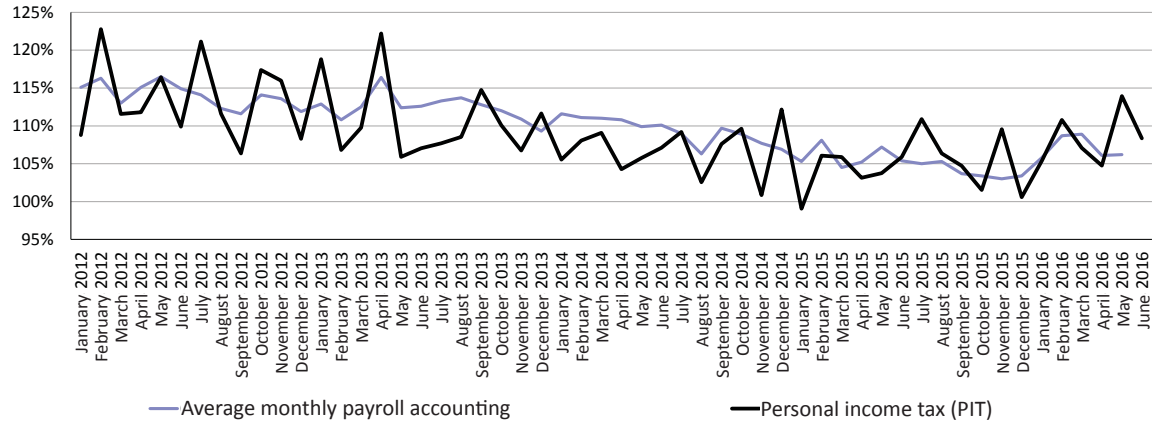
Growth rates of PIT posted in May-June although were not so impressive (113.9% and 108.4% against May and June of last year), nevertheless are also above the inflation level, and at H1-end amount to 108.5%. At the same time, it is worth noting positive dynamics of the PIT tax base, which since the turn of this year has moved out of the prolonged downward trend (*Fig. 7*).

These two taxes, profits tax and PIT, constituting over half of the total volume of receipts of the consolidated budgets of RF subjects, in May-June 2016, had a significant positive impact on the general growth trends of regional revenue. Excises, corporate property tax, as well as non-tax receipts of the regions grew at the rates, which exceeded inflation during that period.



Source: calculated on data released by the Finance Ministry of Russia.

Fig. 6. Growth rates of the total volume of revenue of consolidated budgets of RF subjects, %



Sources: calculated on data released by the Finance Ministry of Russia and by Rosstat.

Fig. 7. Growth rates of the total receipts generated by PIT to the consolidated budgets of RF subjects and average monthly nominal payroll accounting, in % to the corresponding period of the previous year

Interbudgetary transfers, which grew at the rate of 89.6% at H1-end was a factor, which significantly curbed the regional revenues growth. In compliance with parameters of the 2016 Federal Budget Law, by the year-end growth rates of transfers from budgets of other levels are projected at a higher level than at H1-end, although they will remain in the negative zone (-2.0%).

Geographically, the situation is rather manifold: each federal district has regions with relatively high and relatively low growth rates of budget revenues. At H1-end 2016, the situation with revenues of the consolidated budgets of RF subjects is relatively not very good in the Central, Southern, Urals, and Siberian federal districts and is relatively better in the North-Western, and Far-Eastern federal districts. Twenty-four RF subjects register revenues of the consolidated budget, which exceed the current level of annual inflation.

At the end of six months of 2016, total expenditure growth of the consolidated budgets of RF subjects came to 105.3%, which is below the inflation level. Main containment of spending was due to remuneration of labor and granting of subsidies to federal and autonomous organizations, which in nominal terms have remained at the last year level. At the same time, one can note rather significant growth of welfare payments (116.6% as of H1 2016) and capital investment (149.7%). Growth of welfare payments is due to their significant indexation and at year-end these expenses should grow by around 18.0%. Capital investment growth, in contrast to welfare payments, is due not to growth of planned allocations (at year-end they, on the contrary, should shrink by around 1.0%), but by a more effective disbursement: during H1 2016, nearly 30% of the annual allocations have been disbursed, meanwhile during the same period of the previous year – barely 20.0%. Both significant level of indexation of welfare payments, and higher rates of disbursement of budget funds allocated on capital investment can be explained by current phases of electoral cycle in the Russian Federation.

3. INCOME, POVERTY AND PRICES: TRENDS OF 2016

A.Burdyak, E.Grishina

In May 2016, households' real disposable cash income, real wages and the real size of grated pensions decreased as compared to the respective period of the previous year. In Q1 2015, the poverty rate amounted to 15.7%, having fallen somewhat as compared to the same period of the previous year which situation is related to a dramatic reduction of prices on a number of food products included in the consumer goods basket. In H1 2016, consumer prices rose by 7.8% as compared to the respective period of 2015, having virtually returned to moderate values after a 16% surge in H1 2015. With further reduction of the rate of inflation, the poverty rate may fall this year. At the same time, the number of overdue mortgage loans and the volume of overdue mortgage debt are growing. Credit burden is particularly high among households with children.

In May 2016, households' real disposable cash income, real wages and the real size of granted pensions fell as compared to the same period of 2015 and amounted to 94.3%, 99.0% and 95.7%[1], respectively. (*Fig. 1*).

In January-May 2016, as compared to the same period of 2015 households' real incomes, real wages and the real size of granted pensions amounted to 95.1%, 99.2% and 96.6%, respectively. In 2016, as compared to 2015 real cash incomes were falling at a higher rate, while a real wages decrease slowed down. Indexation of pensions carried out early this year (by 4% with the rate of inflation of 12.9% in 2015) failed to prevent their drop in real terms. Due to the above factor, further decrease in the real size of granted pensions can be expected.

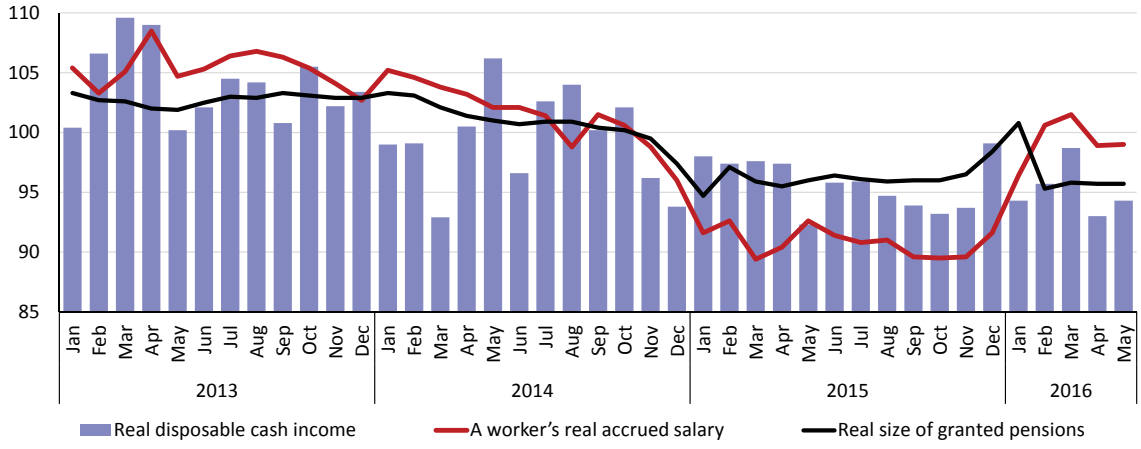


Fig. 1. Dynamics of households' real disposable cash income, real accrued wages and the real size of granted pensions in the 2013– 2016 period, as % of the respective period of the previous year

1 The Rosstat. Report: "The Social and Economic Situation in Russia", May 2016.

In Q1 2016, the rate of poverty amounted to 15.7%[1], which is somewhat below (by 0.2 p.p.) the respective period of 2015 (*Fig.2*). Some decrease in the rate of poverty can be substantiated by relatively slight growth in the poverty threshold -- the value of the minimum subsistence level – in Q1 2016 as compared to the same period of the previous year (by 1.2% with a 3.7% growth in cash incomes in nominal terms in the above period). In its turn, insignificant growth in the value of the minimum subsistence level in Q1 2016 as compared to the same period of the previous year (with a 8.4% growth in consumer prices in that period) took place due to a substantial drop in prices on potatoes (by 38% in Q1 2016 as compared to the same period of the previous year), white cabbage (36%), onion (30%), beet (21%) and carrot (20%)[2] included in the consumer goods basket on which basis the minimum subsistence level is calculated.

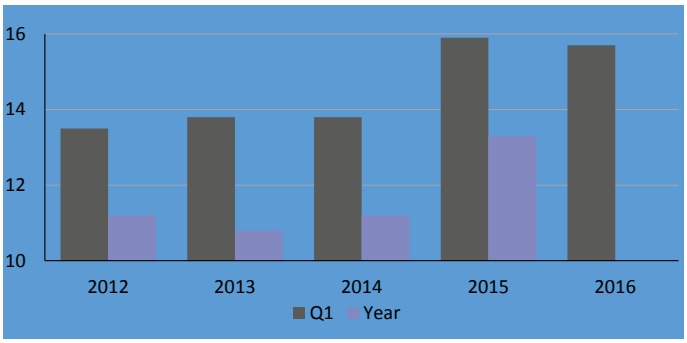


Fig. 2. The poverty rate, Q1 2012-2016, %

In H1 2016, consumer prices rose by 7.8% against the same period of the previous year which is evidence of improvement of the situation after a 16% surge in H1 2015. In the first six months of 2016, there was appreciation of prices on food product, non-food products and services by 6.3%, 9.1% and 8.4%, respectively.

In the monthly dynamics of consumer prices, in June 2016 (7.5%) as compared to June 2015 similar smoothing of the 2015 surge to the level of 2013–2014 was observed. It is to be noted that growth in consumer prices (by 15%) similar to that of 2015 took place in 2008. In both cases, the main driver of the rate of inflation was growth in food prices.

Changes in food prices play a key role as the index of the minimum subsistence level – the official marker of the poverty rate – is based on them. In a statistical survey of prices on food products, there are three sets of food products. For surveying long-term dynamics, the minimum (notional) set of food products suits the best. It is meant among other things for comparison of the cost of food products in different regions and due to the fact that the pattern of the set is strictly formalized in physical quantities (weight, quantity) it illustrates well changes in the cost of commodity groups. The set includes 33 items, for example, 110 liters of unskimmed pasteurized drinking milk (2.5%-3.2% fat), 180 eggs or 150 kg of potatoes a year[3]. Weight of goods is notional and does not reflect real consumption.

The survey of the minimum food set shows that in the past five years prices on fruits and vegetables changed dramatically (*Fig. 3*). In May 2013–2015, they amounted to 24%–26% of the cost of the minimum food set, while at present their share fell dramatically (by 5.6 p.p.) to 19% – similar values were

1 The Rosstat. On the Ratio of Households' Cash Income to the Value of the Minimum Subsistence Level and the Number of Low-Income People in General in the Russian Federation in Q1 2016; the Rosstat, The Social and Economic Situation in Russia, 2012–2016 .

2 The Rosstat, The Central Statistical Database

3 The Official Statistical Methods of Organization of Statistical Survey of Consumer Prices on Goods and Services and Calculation of Consumer Price Indices. Approved by Order No.734 of 30 December 2015 of the Rosstat.

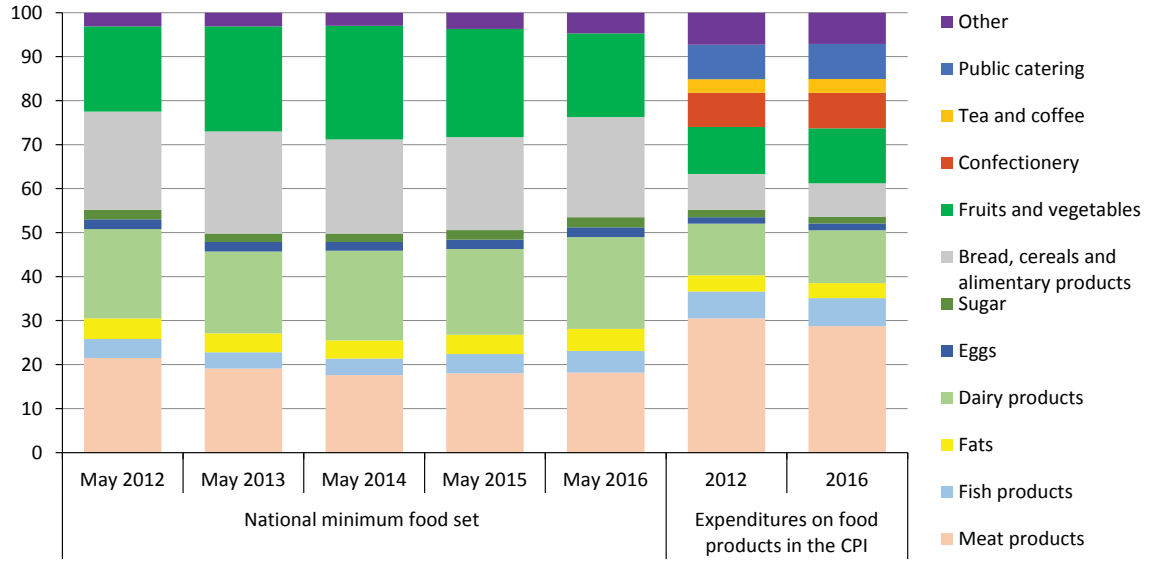


Fig. 3. The pattern of consumer expenditures on food of the notional minimum food set in May 2012–2016 and annual food set for calculation of the CPI, %

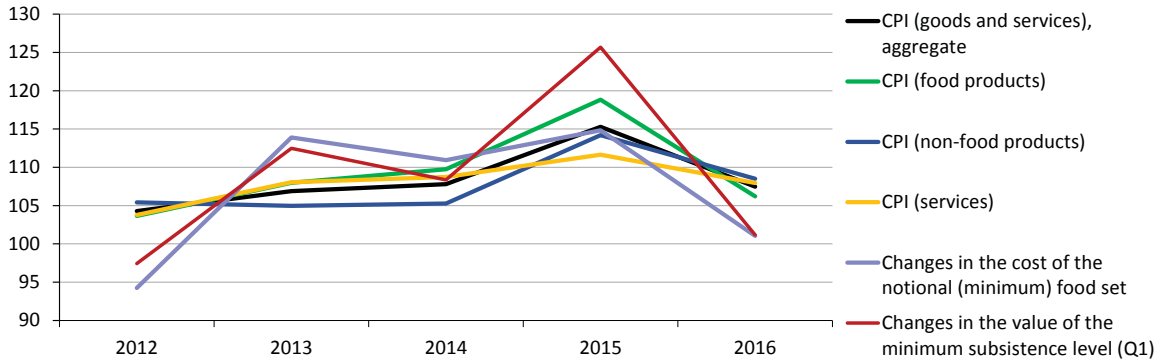
observed in May 2012. On the contrary, in the past few years meat products appreciated at a slower rate than other groups of food products and their share did not change much this year (18.2%). In May 2016 prices appreciated on dairy products (+1.4 p.p. against the previous year) and cereals, alimentary products and bread (+1.6 p.p.).

Contrary to the minimum food set whose pattern does not change, the consumer price index (CPI) – the main indicator of headline inflation – is linked closely to the pattern of households' consumption. The pattern of the set of goods and services for the purpose of calculation of the rate of inflation is set on the basis of a statistical survey of households' budgets over a two-year period, to be precise, during full eight quarters preceding the accounting quarter. On the one side, it smooths seasonal spikes, while on the other side provides a lagging reflection of changes in the consumption pattern. In reality, it means that in calculating the rate of inflation in 2016 the average pattern of households' expenditures in 2015 (when prices appreciated dramatically) and the quiet 2014 is taken into account.

The pattern of actual food consumption differs greatly from the minimum food set. In consumer expenditures, meat products amount to 29%. Though their share over the past four years decreased, it is anyway higher than in the minimum food set. Households' expenditures on fruits and vegetables rose from 10.7% to 12% of food expenditures. The CPI takes into account a wide range of goods as opposed to six components of the commodity group in the notional food set (potatoes, white cabbage, carrot, onion and apples).

The third food set is used for calculation of the minimum subsistence level. In surveying the long-term dynamics of the size of the minimum subsistence level, it is necessary to take into account the fact that recently, from 2013, while in some regions from 2014, methods of calculation were changed. The new approach[1] is based on the idea that the dynamics of the minimum sub-

1 Resolution No.56 of January 29, 2013 of the Government of the Russian Federation on Approval of the Guidelines for Calculation of the Value of the Minimum Subsistence Level



Note: Made by the authors on the basis of the Indices of Consumer Prices on Goods and Services in the Russian Federation in the 1991-2016 Period. http://www.gks.ru/free_doc/new_site/prices/potr/tab-potr1.htm

Fig. 4. Consumer price indices, changes in the cost of the notional minimum food set, June on June of the previous month and changes in the value of the minimum subsistence level, Q1 on Q1 of the previous year, %.

sistence level is determined by changes in the price of the food basket which is made up of a slightly larger set of food products than the notional minimum food set. For example, apart from apples it includes oranges, bananas and grape. Among cereals, in addition to rice and millet, the basket includes for the purpose of calculation buckwheat, oat, barley and semolina. Vegetables and root crops are supplemented by tomatoes and beet. And, finally, the minimum food set and the food basket of the minimum subsistence level differ in weight (kg).

What is the contribution of growth in prices on food to the headline inflation and poverty growth? In the past five years, 29.2%-30.6% of households' all consumer expenditures were spent on food products and alcoholic-free beverages[1] – the weight of that commodity group in the aggregate consumer price index. As regards low-income households, a higher share of food expenditures is typical and in the minimum subsistence level food products amount to 50%. In June 2014, all the three food price indicators rose almost equally against the previous year, however, in June 2015 their values differed greatly.

Food price inflation in CPI terms amounted to 18.8% against June 2015, while the minimum subsistence level rose then by 26% against 2015 (Q1 data) (*Fig. 4*). In June 2015, the notional minimum food set appreciated the least (by 15%) which situation can be explained by a high share of "social" segment products (potatoes, onion and bread) in the above set; growth in prices on those products was partially checked. In June 2016, the cost of the minimum food set did not virtually change (+1%) as compared to June 2015 and the size of the minimum subsistence level in Q1 2016 remained at the level of the similar period of the previous year (+1%).

However, in terms of changes during the past two years the consumer price index on food products showed growth of 26.6% as compared to June 2014, while the notional minimum food set and the minimum subsistence level demonstrated growth of 16% and 27.2%, respectively.

Per Capita and By the Main Social and Demographic Groups of the Population in General in the Russian Federation.

1 The Official Statistical Methods of Organization of Statistical Survey of Consumer Prices on Goods and Services and Calculation of Consumer Price Indices. Approved by Order No.734 of 30 December 2015 of the Rosstat.

So, in a two-year retrospective the minimum subsistence level and the headline inflation correlated, a surge in the size of the minimum subsistence level above the inflation rate early in 2015 was smoothed over and provided that the above trend continues it may become the basis for further reduction of the rate of poverty in 2016.

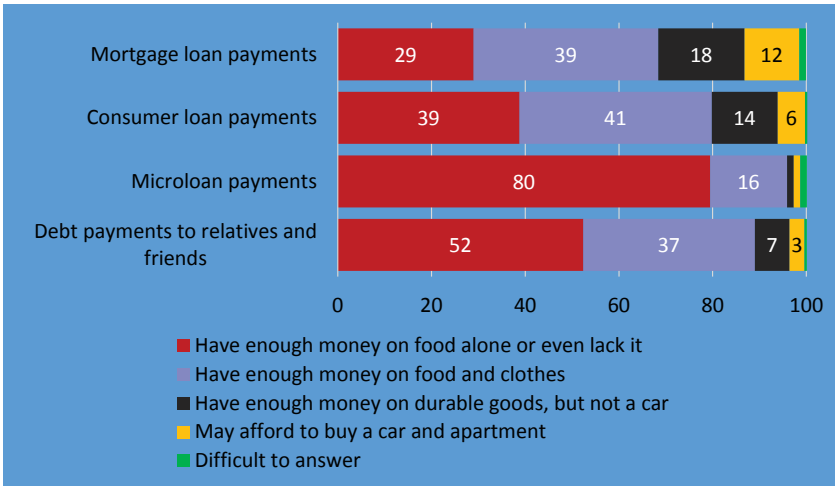


Fig. 5. Distribution of households carrying out different types of debt payments depending on their level of per capita income, %

At the same time, among average income and low-income households there are loan recipients who have to make regular payments on those loans, so their consumption possibilities shrink considerably. According to the data of the United Credit Bureau (UCB), in May 2016 for the first time in 12 years the share of overdue loans exceeded 18%[1]. From the beginning of the year, high growth rates of overdue mortgage loans (a 22% growth) and the volume of overdue mortgage debt (a 17% growth) have been observed[2].

The data of a households survey carried out by the Institute of Social Analysis and Forecasting in March 2016[3] shows that payments of mortgage loans, consumer loans, microloans and debts to relatives and friends are made by 9%, 36%, 2% and 14% of households. It is to be noted that mortgage and consumer loan payments prevail among households with children: 14% and 46%, respectively.

Also, 29% of households repaying a mortgage loan said that they had enough money only on food alone or even lacked it (*Fig. 5*). Among households repaying a consumer loan, the share of those who have enough money only on food alone amounts already to 39%, while that among households repaying microloans, to 80%.

1 The UCB: for the second year running indicators of the growth rates of the share of overdue debts remain at the same level, https://www.eg-online.ru/news/317809/

2 The UCB: On the basis of the results of May the share of overdue loans exceeded for the first time 18%, http://www.bki-okb.ru/press/news/dolya-prosrochennyh-kreditov-po-itogam-maya-vpervye-prevysila-18

3 Representational survey of households across the RF (3,039 respondents).

4. BANKING SECTOR: STATE BANKS GENERATE ALL PROFIT

M. Khromov

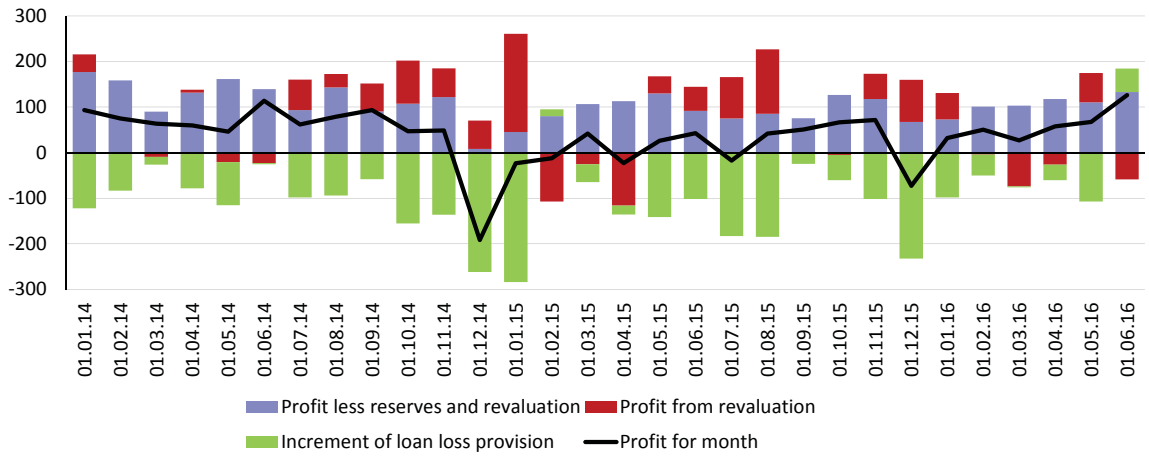
In Q1 2016, the banking sector earnings went up significantly compared to last year. This fact has noticeably maintained the banking sector capitalization by offsetting a reduction of other sources of banks' own funds. However, the profits generated by regular bank transactions remain noticeably lower than it was during pre-crisis period. Earnings continue to concentrate in major Russian bank – Sberbank and other major banks.

In H1 2016, the Russian banking sector balance profits hit Rb 360 bn. It is 7-fold more than a year earlier (in H1 2015 the banking system generated only Rb 51 bn of profits) and nearly twice as much as throughout 2015 when the banking sector profits totaled Rb 192 bn.

In H1 2016, return on assets (ROA) amounted to 0.9% on a year-on-year basis, which corresponds the 2014 level as a whole. However, then up to December assets profitability remained at a far higher level – around 1.5% year-on-year. Thus, despite a significant growth of profits generated by the banking sector, its volume remains quite moderate in comparison with pre-crisis levels. In 2011-2012, profitability of bank assets exceeded 2.0% year-on-year.

The major part of half-year profits was shown in June 2016: Rb 126 bn, in other words more than one third of total profits generated during six months. June happened to be the most profitable month for the banking sector taken in nominal terms. The previous regarding volume result was registered in June 2014 when banks generated Rb 114 bn. At the same time, even such record volume of monthly profits happens to be not too significant from the point of view of assets profitability. In June, it constituted barely 1.9% year-on-year.

The structure of the bank's profits demonstrates a reduction of its "crisis" components – formation of reserves against potential losses and earnings



Sources: Bank of Russia, IEP calculations.

Fig. 1. The main components of the banking sector profits, Rb bn

obtained from the exchange rate revaluation. For example, throughout H1 2016, growth of reserves against loan and other assets losses constituted Rb 237 bn. This is even less than for the corresponding period of 2013 (Rb 260 bn), not to speak of 2014 (Rb 399 bn) and 2015 (Rb 517 bn). Hereby, reduction of provisions for potential losses, in other words a slowdown of risk growth in bank assets, became the major factor of the banking sector profitability growth registered in 2016.

At the same time, the net earnings generated from the revaluation of accounts denominated in foreign currency went down. In H1 2016, it was negative (Rb -41bn), meanwhile a year ago throughout the same period banks earned due to a decline of the ruble exchange rate Rb 52bn. This was owing to a growth of the national currency cost. In H1 2016, ruble appreciated to the US dollar by 12,0% and to euro – by 10.5%. In H1 2015, ruble/USD rate practically remained unchanged, appreciation came to 0.7%, and appreciation to euro amounted to 8.8%.

Regarding banks earnings generated from the regular bank transactions, i.e. minus growth of reserves against potential losses and the net income obtained from revaluation of currency accounts, its growth happened to be not so impressive. During H1, the banks earned Rb 638bn from these transactions, which is only by 12.5% more than in H1 2015 (Rb 566bn). Return on assets along this component of earnings has not practically changed during the year, totaling 1.6% year-on-year in comparison with 1.5% in H1 2015. For comparison, up to 2014, in H1 banks managed to generate profit from regular transactions equivalent to 2.7-2.9% of the average assets volume in annual terms. This means that at present profitability from main bank transactions is nearly half of its regular level characteristic for periods of stable development of the banking sector.

Nevertheless, banks' profits growth in 2016 has allowed to maintain the level of the banking sector' own funds. For the first five months[1] of 2016, the amount of aggregate own funds of the banking sector has contracted by Rb 44bn. At the same time, reduction of the subordinated credits volume accounted in the banks' own funds has mainly contributed to the contraction of capital. In the course of five months, it fell by Rb 232bn. Positive financial result obtained by the banks over this period allowed to level the indicator of own funds reduction. As a result, capital adequacy ratio during the turn of the year has dropped by barely 0.3 p.p. from 12.7% as of 1 January 2016 to 12.4% as of 1 June 2016.

Major portion of banks earnings as before accrues to one major bank – Sberbank. In H1 2016, earnings of Sberbank hit Rb 299bn – more than 88% of the earnings of entire banking sector. In other words, Sberbank, which accounts for less than 30% of the total assets of the banking sector, has generated five time more profits than all other banks. However, this is the move to normalizing the distribution of profits in the banking sector because by the end-2015 earnings of Sberbank (Rb 282bn) exceeded earnings of the entire banking sector (Rb 192bn) – other banks in the whole showed a loss.

If we add to Sberbank those banks, which are affiliated to the RF Government and to the major state company Gazprom,[2] then it will turn out that

1 At the time of preparation of this material, the Bank of Russia has not released data on own funds and prudential supervision ratios as of 1 July 2016.

2 Banks of VTB group (VTB, VTB24 and Bank of Moscow), Rosselkhozbank and GPB.

nearly all bank income is accounted for major state banks. On aggregate, they generated Rb 356bn of earnings out of Rb 360bn generated to the entire banking sector. This means that other private banks are teetering on the brink of zero profitability. Private segment of the banking sector remains extremely unattractive from the investment point of view for the banks' owners. Support of banks by private capital is primarily hampered by considerations of existing business survival in the absence of significant investments into faster growth. Most likely, this fact will lead to further consolidation of state banks on the banking facilities market and continued growth of assets concentration in the banking sector.

5. ADAPTABILITY INDEX OF RUSSIAN INDUSTRY: STILL AT MAXIMUM

S. Tsukhlo

Generalized assessment of businesses of their state in Q2 2016 demonstrated continuation of high adaptability level of Russian industry to 2014–2016 crisis. This index retained its value at the all-time high (for the period 1994-2016). During the current crisis, this indicator showed the lowest value in Q1 2015.

Relatively protracted character of the current crisis has allowed Russian industry to succeed in managing its stocks of finished products. The share of responses "normal" in Q2 2016 hit the all-time high of this indicator for the entire period of monitoring since March 1992 (*Fig. 1*). Currently, 73% of Russian industrial enterprises consider their stocks as normal. During the current crisis the share of normal estimates of stocks of finished products demonstrate high resilience staying in the range of 70–73%. During 2008-2009 crisis, this indictor fell from 65 to 47%.

However, sectors have demonstrated different management results for their stocks of finished products. Where metallurgists, chemists and food industry workers on average increased for H1 2016 the share of their normal responses regarding stocks above 80%, the light industry – barely to 58%. Although the latest result can be considered a success of the sector following 46% obtained in 2014. However, the food industry has achieved the most impressive gains in stock management in the course of the unfolding crisis. Over the period 2014–2016 the sector has increased the share of normal responses of their volume by 24 p.p. – rom 60% to 84%. The latest value was the all-time maximum.

Thus, in each sector the vast majority of businesses consider their stocks as normal. The rest give responses "above normal" or "below normal". The positive balance (difference) of these responses indicate the excess of stocks of finished products, negative – the shortage. On the whole, Russian industry in the course of this crisis has avoided a hike (excess growth) or a pessimistic fall (when enterprises do not believe in the consistency of current demand dynamic). In 2014-2016, the balance of indicator remain in the positive around zero, which is another proof of the consistent control exercised by enterprises over their stock of finished products.

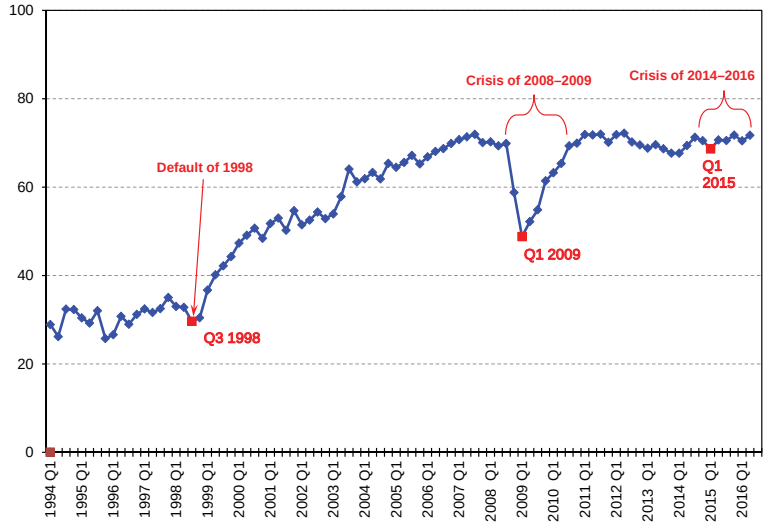


Fig. 1. Adaptability Index (normal) of industry, 1994-2016, % (share of enterprises estimating their indicators as "normal")

Industrial capacities: shortage or surplus?

Russian industry boasts of significant inoperative reserves of industrial capacities. Surveys' indicators speak in favor of this assessment by directly assessing the situation in this sphere.

First, real capacity utilization in 2014-2016 comes to 66% on industry as a whole. Thus, 6 p.p. remain in order to achieve a historic peak of 72%, 2007. The volumes of industrial production are capable to grow immediately by 9% (72/66 x 100 – 100 = 9) against the current output level. This is a large sum even against the backdrop of optimistic projections, which we have at the moment. Because "bottom out" (i.e. a sharp positive change in the output dynamic) poorly describes possible positive scenario in Russian industry, 9% will be sufficient for unfolding an investment activity and build up industrial capacities.

Second, Russian industry is capable to bring now capacity utilization up to 82% without the investment by using equipment in normal operating condition. This value proceeded from the IEP business surveys and brings current capacity reserve to 16 p.p.

Third, in 2016, the shortage of industrial capacities due to expected demand changes constitute in industry as a whole 6.4% (the share of enterprises in Russian industry assessing their capacities as insufficient owing to the projected demand changes). This indicator value is close to minimum, which was obtained in 2009 and came to 5.5%. However, mentioned above shortage is overlapped by the surplus (share of enterprises with excess capacities). In 2016, 27% of enterprises boast of excess capacities, which is the peak of the indicator for 2010–2016.

Not more than 8% of enterprises report the shortage of capacities, which is overlapped by the surplus. Solely the timber industry reports negative balance of capacities in 2016, i.e. enterprises with a shortage of capacities dominate over enterprises with excess capacities.

Sectoral indicators of adaptability

By end-Q2 2016, the levels of adaptability of Russian industry to the current economic situation have not suffered any significant changes (*Fig 2*).

The highest level of adaptability remains in the food industry, which retained its sector index at all-time (over 1994–2016) high. Five out of six base indicators (stock of finished products, inputs, capacities, number of employees, and financial state) got normal responses from 83% of enterprises. Moreover, solely demand was estimated as normal by 64% of enterpris-

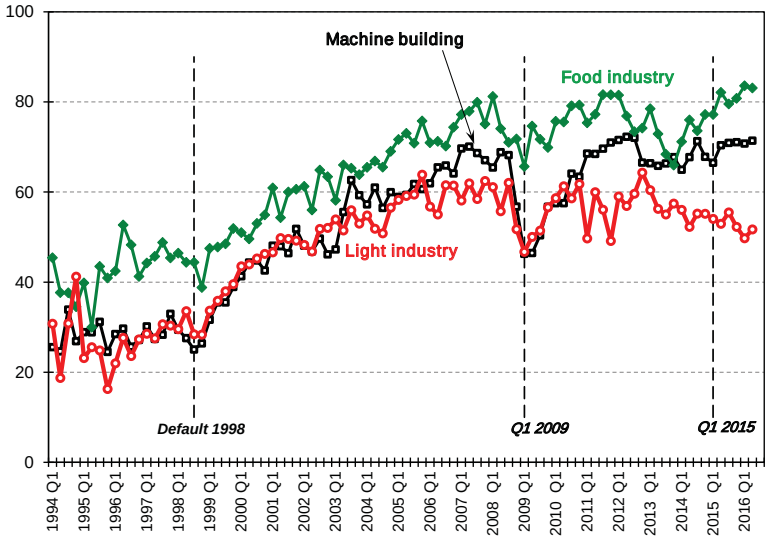


Fig. 2. Sectoral adaptability Index (normal) of industry, 1994-2016, % (share of enterprises estimating their indicators as "normal")

es in Q2 2016. Besides, growth of this indicator against Q1 2016 came to 11 p.p.

The light industry has been demonstrating the worst adaptability. Although in Q2 2016 its sector index went up by 2 p.p., its last place remained unchanged. Estimates of current demand volumes are weighting down: merely one third of enterprises of the sector consider them normal. In Q1 2016, the result was significantly inferior -14%. The sector gives low estimates to its capacities – barely 38% of enterprises estimates their volumes as normal and 56% as excessive. The situations look similar with employment but with an upward bias: normal headcount is given by 48% of enterprises and insufficient – 37%.

Machine building sector retains the adaptability index for the fifth month in a row at the level of 70-71% and takes an in between place along this indicator between the leader (food industry) and the outsider (light industry).

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