# MONITORING OF RUSSIA'S ECONOMIC OUTLOOK:

TRENDS AND CHALLENGES OF SOCIO-ECONOMIC DEVELOPMENT


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# MAIN TRENDS AND CONCLUSIONS

Our experts analyzing Russia's balance of payments in Q1 2017 believe that it is unlikely that the strengthening of the ruble by 7.1% over the course of the first three months of 2017 was determined by the carry-trade operations performed by non-residents interested in Russian financial assets, because the share of such operations in Russia's balance of payments is rather small. A far greater contribution to the considerable increase in the current account surplus, which undoubtedly was the mightiest factor behind the ruble's rise in value, was the growing export surplus (after having amounted to $ 22.3bn in Q1 2016, it has risen to $ 34.5bn as of today). As a result, Russia's current account surplus of the past three months ($ 22.8bn) was almost equal to the surplus posted by Russia for the whole of 2016. This upward trend could not be undermined even by the unexpected rise in private capital outflow from Russia during the past three months ($ 15.4bn in Q1 2017), which was mainly caused by banking sector operations. Presumably this phenomenon should be associated with the granting of bridge loans to non-residents designed to help finance the purchase of shares in *Rosneft*.

As far as our experts' annual forecast for the entire 2017 is concerned, they have based it on the assumption that crude oil prices will remain at about $55 per barrel, and that the nominal exchange rate of the ruble against the USD will amount to Rb 55-60. If these predictions came true, the experts expect the real exchange rate of the ruble to strengthen against major foreign currencies, and the value of exports and imports to increase by 30–40% and 20–25% respectively (relative to 2016). As a result, Russia's current account surplus can climb this year to $ 60–80bn. However, despite the country's balance of payments staying stable, the risks of Russia weakening her currency remain in force, primarily due to the possible worsening of external trade conditions and the potential toughening of the FRS monetary policy.

It is certainly noteworthy that the first two months of 2017 saw a considerable growth in the volume of foreign currency loans, which amounted to $7.3bn, or to 81% more than in the same period of the previous year. It is true, however, that according to experts analyzing the situation in the corporate segment of the lending market, this upward trend is mainly limited to large companies, while small and medium-sized enterprises are now borrowing three times less foreign exchange than a year ago.

On the whole, the experts characterize this situation as near stagnation. The volume of loans issued by Russian banks to their corporate clients over the course of the first two months of 2017 amounted to Rb 4.55 trillion, or 1.5% more than a year ago. It should be said that, although the current growth in loans has been going on for the second year in a row, it is still far too modest to compensate for the radical slump in corporate lending that occurred in Russia in 2015. Nevertheless, this situation does have a positive side to it: the cost of borrowing for all categories of borrowers is on the gradual decline, although this decline could not have been significant against the background of the Russian Central Bank's persistently high key interest rate. However, against all odds, the cost of borrowing did decline for big clients from 11.5% per annum in December 2016 to 11.2% in February 2017 (and from 13.9% to 13.6% for small and medium-sized businesses).

However, as it has already been noted in the previous issues of our monitoring, Russian enterprises do not consider the issue of the cost of bank loans and their availability in general to be one of the factors most important for them. In any case, this is an inevitable conclusion that can be made on the basis of the surveys of Russian industry regularly carried out by our experts.

The latest data received for Q1 2017 indicate that the Adaptation (or Normalcy) Index (which reflects the share of generalized estimates, by Russian industrial enterprises, of their current conditions as 'normal') remains at its record high of the entire observation period (1994–2017). A similarly optimistic outlook can also be gleaned from the surveyed enterprises' responses to some of the more specific questions. Thus, in Q1 2017, 88% of manufacturers considered their financial and economic situation to be 'good' or 'satisfactory' (this index had been 2% higher only in the pre-crisis period 2007–2008); 82% of enterprises believed that their workforce was sufficient for their needs; 80% of enterprises were sure that that their stocks of raw materials and other production materials were at the 'normal' level and sufficient to ensure further output growth; 78% of enterprises believed that their production capacities were sufficient to satisfy the expected rise in demand for their products; and 53% of enterprises expressed the opinion that the level of demand for their products was 'normal'. However, the share of generalized estimates, by Russian industrial enterprises, of their current conditions as 'normal' did differ considerably from one branch of industry to another: from the highest share of such enterprises in metallurgy and the chemical industry (86% and 85% respectively) to their lowest share in light industries (55%).

The sampling analysis of the development of Russian industry carried out by our experts with regard to a number of Russian regions indicates that the economic policy formulated and pursued by a regional authority extremely seldom conduces to a rise in the competitive ability of local enterprises or in their ability to resist and adapt to crisis shocks. According to our experts, out of the five oblasts selected for a comparison analysis on the basis of their similarity in terms of geographical location, surface area, population size and the availability of natural resources (Kaluga, Ivanovo, Ryazan and Tula Oblasts), only one oblast (Kaluga) is implementing a priority-based regional economic strategy that has yielded positive results. As far as the positive output dynamics of the enterprises situated in Tula Oblast is concerned, our experts believe that it has been fueled exclusively by the considerable growth in the competitive capacity of long-established chemical industrial enterprises and the ever-growing size of state orders placed with defense industry enterprises, a phenomenon that can hardly be attributed to the high effectiveness of its regional economic policy.

# 1. THE BALANCE OF PAYMENTS IN Q1 2017

A.Bozhechkova, A.Knobel, P. Trunin

*In Q1 2017, the current account surplus increased significantly due to rising exports alongside a slower growth in imports. Growth of the positive current account balance was the main factor behind the ruble's strengthening. At the same time, net capital outflow from the private sector also increased, boosted by purchases of foreign assets by banks. If oil prices and the ruble's nominal exchange rate against major world currencies stay at their current levels, it may be expected that, in 2017, the ruble's strengthening in real terms and further growth of the current account surplus will take place.*

As demonstrated by the preliminary balance of payments estimates released by the Bank of Russia, the positive current account balance for Q1 2017 amounted to $ 22.8bn, which is practically equal to the total current account balance for 2016 ($ 25bn) and is 77% above the current account balance for Q1 2016, which was $ 12.9bn (growth by $ 9.9bn).

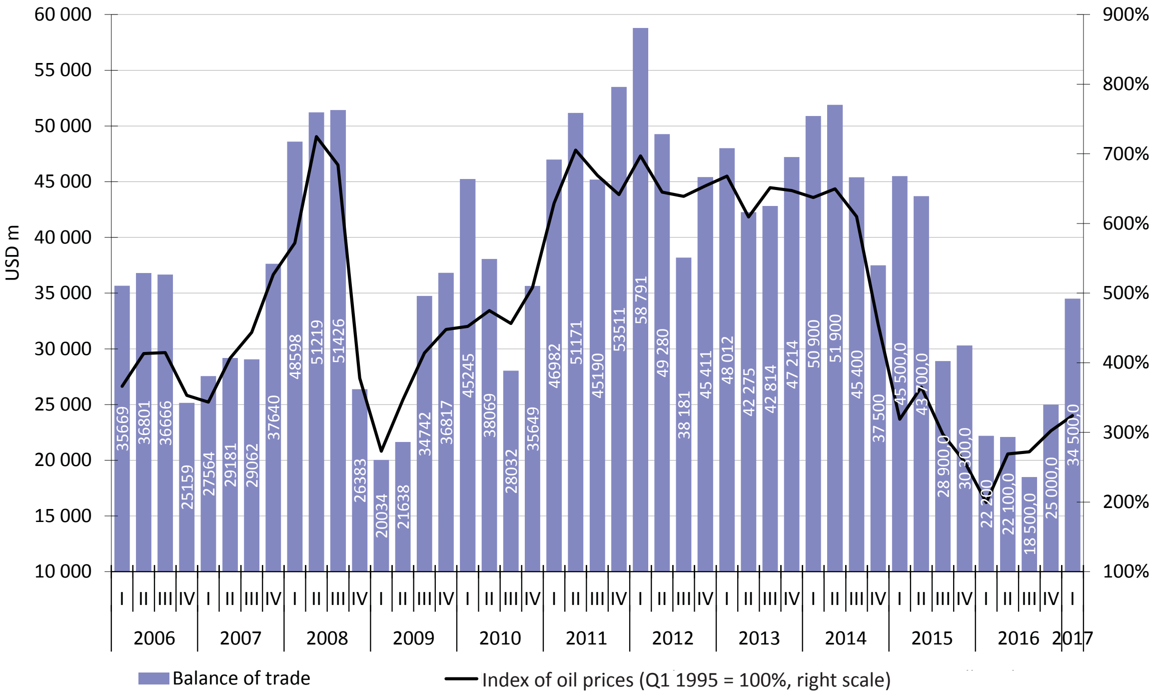
This growth was caused by the balance of trade increase by $ 12.2bn (from $ 22.3bn in Q1 2016 to $ 34.5bn in Q1 2017), the latter, in its turn, being strongly pushed upwards by a 36% rise in exports 36% (from $ 60.4bn in Q1 2016 to $ 82.1bn in Q1 2017, or by $ 21.7bn), which were clearly outpacing imports, whose growth amounted to a mere 25% (from $ 38.1bn in Q1 2016 to $ 47.6bn in Q1 2017, or by $ 9.5bn).

The increase in the value volume of imports can be explained by the movement pattern on the national currency's exchange rate: according to data released by the Bank of Russia, the real effective exchange rate of the ruble against major foreign currencies gained 33.2% in Q1 2017 relative to Q1 2016, which points to the ruble's significant strengthening that translates into relatively cheaper imports[1].

Growth in the value volume of exports has occurred due to the effects of two external factors – the upward movement of world and regional prices for Russia's main exports (*Fig. 1*).

These factors have affected by no means just the behavior of prices for crude oil and petroleum products; ferrous metals, coal, aluminum, copper, wheat and meslin seed have also become significantly more expensive (*Table 1*). Growth of prices for these items occurred in face of a stable physical volume of supplies of these goods. The prices for another major item on the list of Russia's main exports (natural gas) have remained practically unchanged. However, their stability has to do with the prices of the existing long-term contracts being pegged to the oil quotes of the previous periods. This means that towards the year's end, the prices of gas exports are going to increase, and considering their unchanged physical volume, they are going to translate into growth of the positive current account balance.

1 For more details concerning the forex rate's pass-through effect, see Knobel A., Firanchuk A. Foreign trade in 2016. Russian Economic Development, 2017, Vol. 24, No. 3, pp. 8–17.




*Sources:* Bank of Russia; Gaidar Institute estimates.

*Fig. 1. The RF balance of trade and world oil quotes in 2006–2017*

*Table 1*

PRICES OF RUSSIA'S MAIN EXPORTS

| Russian exports of goods | Share in total exports, % | Prices in January–February 2017, USD per tonne | Prices in January–February 2016, USD per tonne |
|---|---|---|---|
| Crude oil | 30 | 373[1] | 227[2] |
| Petroleum products | 19 | 379[3] | 248 |
| Ferrous metals | 5.1 | 406 | 270 |
| Natural gas | 13 | 170[4] | 168[5] |
| Coal | 3.1 | 73 | 53 |
| Aluminum | 1.7 | 1648 | 1328 |
| Wheat and meslin seed | 1.1 | 178 | 167 |
| Copper | 1.1 | 5,690 | 4,490 |

**Note.** The 2016 prices for crude oil, petroleum products and natural gas are those for Q1 2016.
*Source:* data released by RF Federal Tax Service and the Bank of Russia.

At the same time, exports of services changed negligibly (growth of 0.9% from $ 10.4bn in Q1 2016 to $ 11.3bn in Q1 2017), and so did imports (growth of 1.4% from $ 14.9bn in Q1 2016 to $ 16.3bn in Q1 2017), which produced only a minor change in the total balance of trade in services (from $ -4.5bn in Q1 2016 to $ -5.0bn in Q1 2017).

The change in the balance of wages was habitually insignificant ($ -0.8bn in Q1 2017), on par with that in the balance of rent (around 0). The balance

1 Corresponds to ~$ 51 per barrel. The final period-end value for Q1 will be slightly different.

2 Corresponds to ~$ 51 per barrel.

3 The final period-end value for Q1 will be slightly different.

4 USD per 1,000 m³.

5 USD per 1,000 m³.

investment-generated revenues in absolute terms likewise changed negligibly (from $ -3.3bn in Q1 2016 to $ -3.9bn in Q1 2017), due in the main to the low growth of gross investment income (from $ 11.9bn in Q1 2016 to $ 12.6bn in Q1 2017), while net investment income stayed at its previous level of $ 8.6bn.

Growth of the current account surplus occurred against the backround of the capital account deficit, which in Q1 2017 (less the reserve assets) amounted to $ 8.6bn (vs. $ 7.4bn in Q1 2016). Over the first three months of 2017, the liabilities of Russian economic agents to foreign economic agents gained $ 7.6bn, while their plunge in Q1 2016 had amounted to $ 8.7bn. Growth of foreign liabilities was boosted by the increased amount of 'foreign direct investment by other sectors', which gained $ 6.9bn in Q1 2017 (vs. $ 0.5bn in Q1 2016). Most obviously, the inflow of foreign direct investment became vastly more abundant thanks to the closure of the *Rosneft* privatization deal.

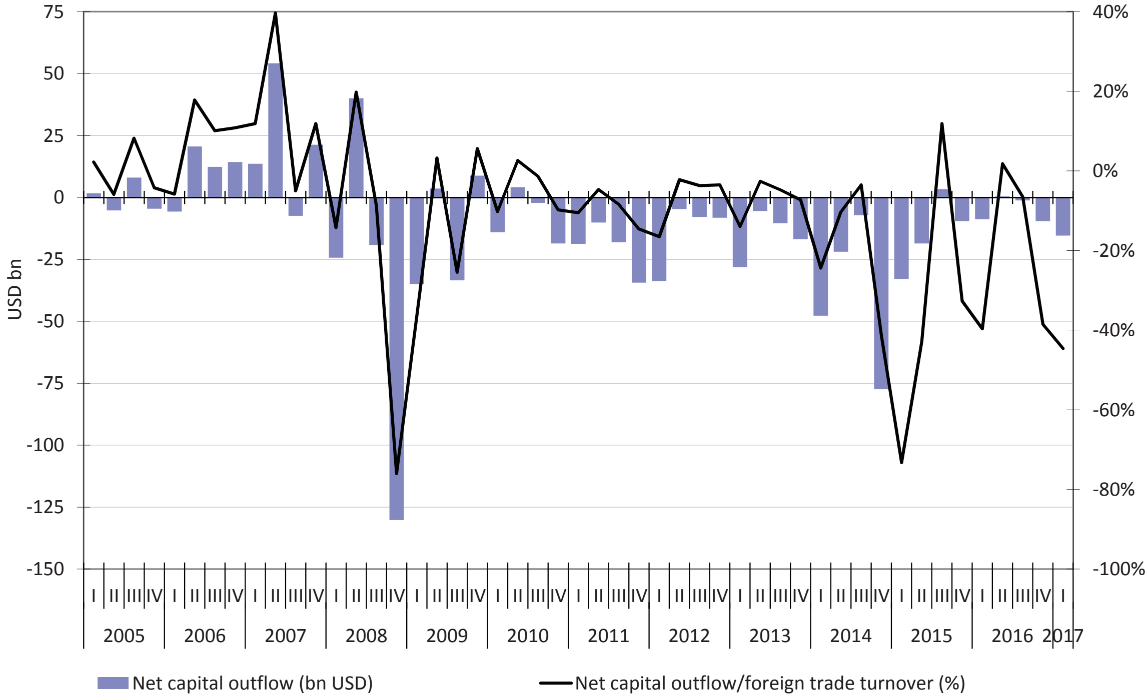
Growth of the liabilities of other sectors in the 'loans and borrowings' category, to the value of $ 1.9bn in Q1 2017, was offset by the shrinkage of portfolio investments by the same value. The amount of foreign loans taken by the non-banking sector is indicative of successful foreign debt refinancing, which happened in spite of the access to the world capital market being restricted as a result of the economic sanctions imposed on Russia. In Q1 2017, the slowdown in the debt redemption rate in the banking sector continued unabated due to the shrinkage of the debt burden on the latter. Thus, the foreign liabilities of banks in Q1 2017 shrank by $ 2.2bn (vs. $ 7.6bn in Q1 2016).

The foreign assets of residents (the liabilities of foreign economic agents to their Russian counterparts) over the period of January–March 2017 increased by $ 16.2bn (in Q1 2016, they had plunged by $ 1.3bn). Despite the repayment of their forex loans by banks through their repo operations with the Bank of Russia ($ 7.5bn), in Q1 2017 the amount of foreign assets held by the banking sector soared to a record high of $ 17.0bn, observed for the first time since Q4 2008 (in Q1 2016 this index plunged by $ 9.9bn). This movement pattern displayed by the banking sector's foreign assets can probably be explained by the bridging credit granted to non-residents by way of supporting the *Rosneft* privatization deal.

The amount of foreign assets held by other sectors declined by $ 0.2bn (vs. growth by $ 8.5bn in Q1 2016). A significant decline was also observed with regard to 'other assets held by other sectors', which shrank by $ -9.9bn (vs. $ +1.5bn in Q1 2016). The amount of direct and portfolio investments by other sectors increased by $ 7.5bn and $ 1.1bn respectively (vs. $ 6.3bn and $ 0.9bn respectively in Q1 2016).

On the whole, net capital outflow from the private sectors amounted to $ 15.4bn, which is 1.8 times above the corresponding index for Q1 2016 (*Fig. 2*). At the same time, the specific capital outflow movement pattern was largely caused by the operations in the banking sector. Thus, in particular, the net capital outflow index reported by banks was $ 19.2bn ($ +2.3bn in Q1 2016), while the non-banking sector reported a net foreign capital inflow of $ 3.8bn ($ -11.1bn in Q1 2016).

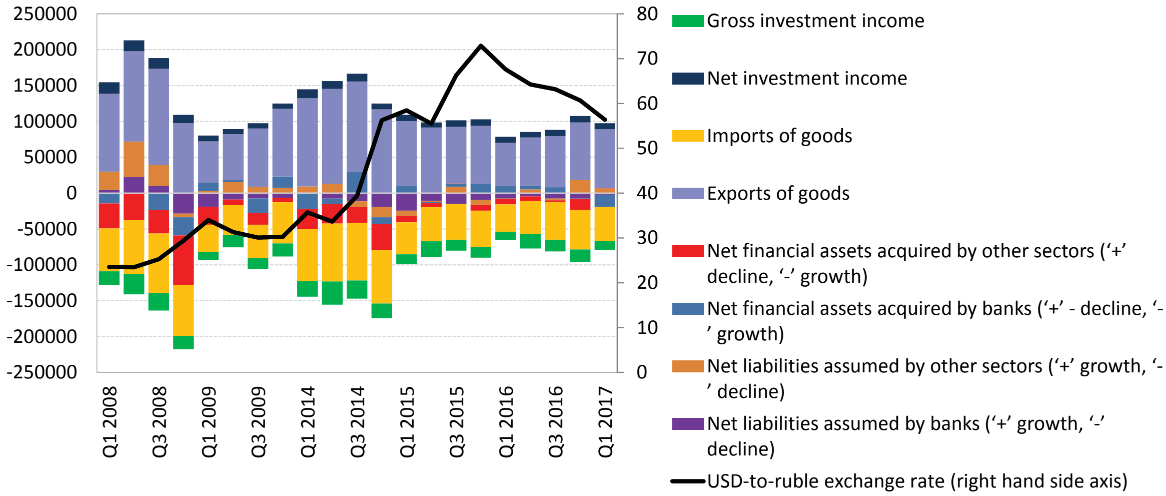
As seen from the balance of payments data, the amount of reserve assets over Q1 2017 increased by $ 11.3bn (vs. $ 2.6bn in Q1 2016), caused in the main by the repayment, by the banking sector, of its forex debt to the RF Central Bank ($ 7.5bn in Q1 2017), as well as by purchases of foreign currency in the domestic foreign exchange market by the RF Ministry of Finance, to the total value of Rb 168bn (or approximately $ 2bn).




*Sources*: Bank of Russia; Gaidar Institute estimates.

*Fig. 2. Net capital outflow from the private sector in 2005–2017*

Thus, in Q1 2017, the main factor behind the ruble's strengthening against the US dollar in nominal terms (by 7.1% to Rb 56.4 per USD) was the growth of Russia's current account surplus (*Fig. 3*). It should be noted that over the same period, the volume of carry-trade operations (which are indicative of a potential desire of non-residents to buy Russian financial assets in view of the persistently high interest rates was relatively low in terms of its share in the total balance of payments: the liabilities of federal bodies over Q1 2017 amounted to only $ 1.3bn (vs. $ 0.1bn in Q1 2016). Meanwhile, the portfolio investments of the non-banking financial sector declined in January–March by $ 1.9bn, whereas in Q1 2016 their index had gained $ 1.6bn.




*Source:* Bank of Russia.

*Fig.3. The main sources of demand for and supply of foreign currency, USD m*

In all probability, provided that over the course of 2017 world oil prices and the ruble's nominal exchange rate against the US dollar remain at their current levels (~ $ 55 per barrel and Rb 55–60 respectively), we can expect the ruble's strengthening in real terms, growth of the value volume of exports by 30–40%, and growth of imports by 20–25%, relative to their 2016 indices. All these factors may push the current account balance to $ 60–80bn in 2017.

The increased current account balance will be offset in part by foreign currency purchases by the Bank of Russia for the RF Ministry of Finance, to the value of budget revenue to be received in excess of the selling oil price target of $ 40 per barrel in the framework of the temporary budgetary rule, and also by the purchases of foreign assets by the private sector.

However, in spite of the sustainable balance of payments, the risk of the ruble's weakening does not disappear. The major potential risk factors are worsening terms of trade and monetary policy toughening by the US Federal Reserve, which may trigger capital outflow - first of all, from the developing markets.

## 2. CORPORATE LENDING IN EARLY 2017

**M.Khromov**

*The corporate segment of Russia's loan market is experiencing stagnation. The volumes of new loans are declining relative to the size of the economy, while the amount of debt has been demonstrating practically no increase. Interest rates are continuing to follow their downward trend. The quality of the credit portfolio is no longer improving, although this trend may possibly be associated with seasonality.*

The volume of loans issued by Russian banks to their corporate clients over the course of the first two months of 2017 amounted to Rb 4.55 trillion, which represents a 1.5% rise on the corresponding period of 2016. Although the volume of granted loans has been increasing for the second year in a row, so far it has failed to compensate for its staggering collapse in January–February 2015, when the lending volume shrank by 23% relative to early 2014 – the year when the Russian loan market reached its maximum. As a result, in the first two months of 2017, the volume of the loan market remained 12% smaller than its maximum achieved in 2014.

As far as the loan market is concerned, its most distinctive feature in the first two months of 2017 was a significant rise in bank loans denominated in foreign currencies and a visible stagnation of ruble-denominated loans. In January–February 2017, the volume of new loans denominated in rubles declined to Rb 4.12 trillion, which represents a 1% drop relative to the same period of 2016. Nevertheless, relative to the maximum achieved in early 2014, the ruble segment of corporate lending, despite having dropped by 10%, still looks better than the loan market as a whole.

In January–February 2017, the volume of new loans denominated in foreign currencies amounted to $ 7.3bn, which represents a 81% increase on the same period of 2016. All the same, this index was 56% lower than that registered in January–February 2014, when the volume of forex-denominated loans granted by banks to their corporate clients had amounted to $ 16.5bn.

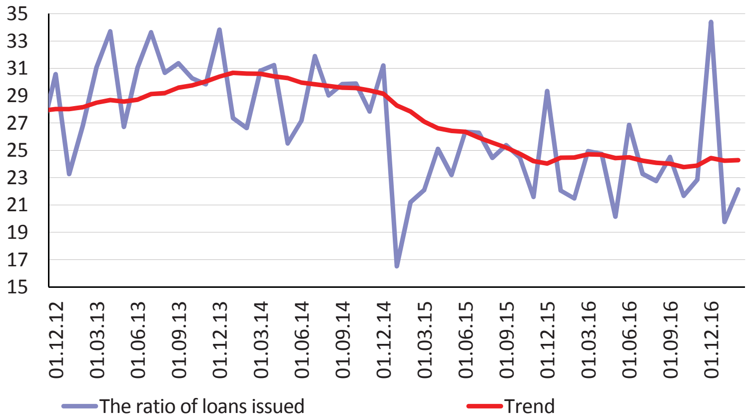
Over the course of the first two months of 2017, the size of the loan market slightly shrank relative to the scope and scale of economic activity. In January–February 2017, the turnover of organizations increased by 5.5% on the corresponding period of 2016, which exceeded the pace of growth of the credit market. In early 2017, the ratio between the issuance of new loans and the turnover of organizations amounted to 20.9%, which represents a slight rise relative to the disastrous year 2015 (18.9%). However, this ratio was still well below the maximum achieved in 2014 (27%). When taken in annual terms (from March 2016 through February 2017), the size of the loan market was equivalent to 24% of the turnover of organizations, having remained practically unchanged since the end of 2015 (*Fig. 1*).

The slow dynamics of the issuance of new loans naturally resulted in a sluggish pace of growth of the banking sector's credit portfolio. Over the course of the first two months of 2017, the volume of debt accumulated by corporate borrowers increased by 0.3%[1], while during the 12-month period (from March 1, 2016 to March 1, 2017) the amount of this debt remained practically unchanged, having grown by a mere 0.1%.

In early 2017, the most active borrowers were representatives of small and medium-sized businesses (SMB). The volume of new loans granted to this category of borrowers rose by 5.3 relative to the same period of 2016, while bank lending to big borrowers increased by just 0.8%.

At the same time, it was due to big borrowers that the volume of loans denominated in foreign currencies began to grow. The volume of new ruble-denominated loans granted by banks to their big clients dropped by 3.0%, while the volume of new forex-denominated loans increased almost twofold. As far as lending to small and medium-sized businesses is concerned, the observed trend was just the reverse of the aforesaid one: the volume of new ruble-denominated loans increased by 7.7%, while the already insignificant volume of new forex-denominated loans granted to businesses belonging to that category continued to decline. Over the course of the first two months of 2017, it decreased, in dollar terms, to 31% of its level observed during the same period of the previous year.

Having reached stabilization in 2016, the quality of loans granted to corporate borrowers once again began to deteriorate. Over the course of two months, the share of outstanding debt increased from 6.9% to 7.2% of the aggregate volume of loans granted to all categories of borrowers. Meanwhile, quality deterioration was




*Sources:* Bank of Russia; Rosstat; Gaidar Institute estimates.

*Fig. 1. The ratio of corporate loans to the turnover of organizations, %*

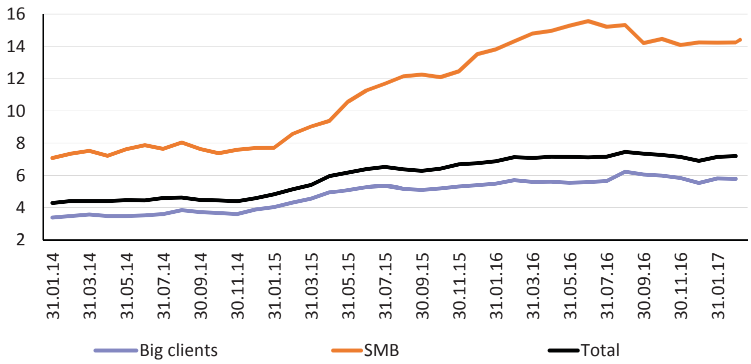
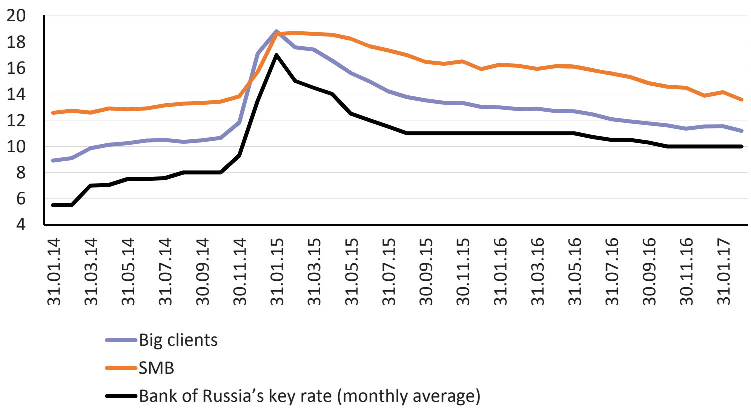



*Fig. 2. The share of outstanding debt against loans issued to different borrower categories*




*Source:* Bank of Russia.

*Fig. 3. The interest rates on corporate ruble-denominated loans and the Bank of Russia's key rate*

1 With an adjustment for the revaluation of earlier issued forex-denominated loans.

observed with regard to almost all loan categories. The share of outstanding debt against ruble-denominated loans increased from 8.0% to 8.3%, the corresponding index for forex loans – from 3.1% to 3.2%. The share of outstanding debt against loans issued to big clients increased from 5.5% to 5.8%, and the corresponding index for loans issued to small and medium-sized businesses – from 14.2% to 14.4%.

This trend is largely a seasonal one; it appears because towards year's end, both the lenders and the borrowers try to report the highest possible quality of their payables. For each of the loan categories described above, the quality of account payables was no lower than the corresponding indices as of December 1, 2016.

In spite of the Bank of Russia keeping its key rate at one and the same level (it was reduced only in March), the interest rates on loans were gradually declining for all borrower categories. Thus, in February 2017, the average weighted interest rate on ruble-denominated loans for all categories of borrowers and for all loan terms amounted to 11.5% per annum (vs. 11.8% per annum in December 2016). The cost of ruble-denominated loans for big clients dropped from 11.5% per annum in December 2016 to 11.2% per annum in February 2017, and the corresponding index for small and medium-sized businesses – from 13.9% to 13.6%. This interest rate plunge has confirmed our conclusion as to the seasonal character of the downward trend displayed by loan quality. Most likely, the actual credit portfolio quality did not deteriorate, otherwise the banks would have had no reason for continuing to reduce the cost of loans for final borrowers.

# 3. INDUSTRY ADAPTABILITY INDEX IN Q1 2017

**S.Tsukhlo**

*The final evaluation of the Russian Industry Adaptability Index for Q1 2017 has confirmed the conclusion that enterprises have been exhibiting a persistently high degree of adaptation to the economic environment. The Index remains at a record high of 75% (in 1994–2017) (Fig. 1).*

The Index remains at an all-time high level because of growth in the share of enterprises which say they exhibit a 'normal' index value for adequacy of production capacity to meet anticipated changes in demand. The other four indices were slightly downgraded in terms of assessing the situation as 'normal', while 'normal' assessments of production capacity adequacy saw a sharp increase of 10 p.p. In general the observed variety of capacity adequacy assessments in late 2016/ early 2017 is accounted for enterprises' attempts to assess their prospects and rate of recovery from the crisis of 2015/2016.The Russian industry exhibits a high degree of resistance to stress and protection against the recent shocks. Enterprises assessed the situation seen in 2015/2017 within a range that shows no crisis.

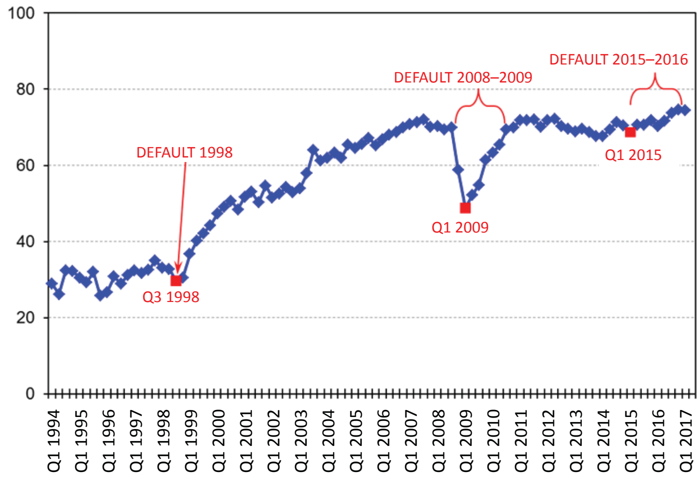



*Fig. 1. Industry Adaptability Index, 1994/2017, %*
*(enterprises that assess their performance as 'normal')*

In early 2017, 88% of producers said their financial and economic status was "good" or "satisfactory", while it was only in the pre-crisis quarters of 2007/2008 that this indicator reached 89–90%.

82% of enterprises say they have a sufficient labour supply which was secured by the possibility of hiring workers during the crisis of 2015/2016. Note that the Russian industrial sector continues (and plans to continue) recruiting workers, fearing it might lack enough qualified workers in case of a more or less substantial growth of demand and output.

80% of enterprises say they have normal raw materials and supplies inventory to boost output in response to the still-anticipated growth in the industry.

78% of enterprises say they have adequate production capacity to meet the anticipated changes in demand. Another 14% of enterprises say they have redundant capacity, while 8% of enterprises are running short of production capacity.

67% of enterprises say they had a normal level of finished goods inventory in early 2017. Although this level of normality is the lowest in the recent 12 quarters, it indicates that producers are searching actively for a 'new normality' of their inventories to enter the stage of recovery from the crisis of 2015–2016.

53% of enterprises say they had normal demand for their products in Q1 2017. The industrial sector needs bigger sales volumes to exhibit a statistically indisputable growth in production in 2017.

However, computation of the 'normality' Index by sector shows a large difference between enterprises in the degree of adaptation to the environment prevailing at the final stage of the crisis of 2015/2016.

Surveys recorded the highest level of normality in the iron and steel industry (86%) and the chemical industry (85%). The labour force situation facing these industries contributed most to record low levels of normality, with the former and the latter showing a 95% and 96% of labour supply respectively. These are the best figures for this indicator in the first quarter, while the worst is 55% in the light industry.

The case is different with normal ('adequate') production capacity, which is 94% in the iron and steel industry and only 82% in the chemical industry. This may prompt chemical industry to boost investment in 2017. The foregoing industries have adequate ('normal') raw materials inventory, too: iron and steel producers and chemical manufacturers report 93% and 88% respectively. Eighty percent of enterprises in each of the industries say they have normal finished goods inventory. On the whole, 93% of iron and steel plants and 97% of chemical enterprises are satisfied with their financial and economic performance in Q1 2017.

In general 79% of food producers say they have a normal status, which is mainly due to a good financial and economic performance (91% of producers are satisfied with their financial and economic performance). Eighty five percent of food producers are satisfied with their raw materials and supplies inventory, 84% with production capacities, 80% with labour supply, 78% with finished goods inventory. Demand is the only indicator which doesn't fit into such a positive evaluation of the situation: only 58% of enterprises are satisfied with the demand. It cannot be helped for now because households have switched to an austerity budget.

The machine engineering industry was back to a traditional 71% level of normality in Q1 2017. Today, 85% of enterprises within the industry are satisfied with their financial and economic status, about 77% of enterprises are satisfied with adequacy of production capacity, labour supply and raw materials inventory, 63% with finished goods inventory. Demand is the only indicator which satisfies less than a half (48%) of enterprises.

The light industry shows a traditionally lower degree of adaptation to the crisis of 2015/2016, standing at 61% in early 2017, which is primarily (and naturally) due to (low) demand which now satisfies just 31% of enterprises within the industry. Another issue is the labour supply which satisfies only 55% of enterprises in 2017. More than 60% of enterprises are satisfied with their raw materials and supplies inventory and with adequacy of production capacity. Nevertheless, Q1 2017 saw quite a good financial and economic performance which was assessed as good by 89% of enterprises. However, this value appears to be a 'serge' following a 74% level of satisfaction with the financial status in the previous quarters.

# 4. REGIONAL STRATEGIES AND COMPARATIVE CASE STUDIES OF INDUSTRIAL PRODUCTION DYNAMICS

**A.Kaukin, E.Miller**

*Industrial development case studies show that Russian regions have indeed failed, except in extremely rare cases, to strengthen their competitive power on account of well-developed economic policies. None of the regions under review was geared up for the crisis of 2014, each facing either aggravated problems or a lack of diversified sale markets.*

After the crisis of 2014, Russia's industrial production dynamics was determined by new terms of trade and geopolitical tension, falling crude prices and a depreciating rouble exchange rate, sanctions and countersanctions, a halt in Russia-Ukraine economic cooperation, mounting uncertainty and a decelerating global economy. According to the 2015 year-end data, only a few segments of the manufacturing industry and the fuel and energy segment of mineral extraction industry could to see a small growth, whereas the rest of the industries slid into downturn or stagnation[1]. In 2016, Russian globally competitive industries (e.g., chemical industry) continued to grow at slow pace, whereas the rest of the industries neared zero growth rates[2]. In terms of regions, the industrial output dynamics of certain sectors were heterogeneous over the recent decade[3]. This report is an effort to track the reasons for the heterogeneity through case studies.

The case studies cover Kaluga Oblast, Tula Oblast, Ivanovo Oblast and Ryazan Oblast, all of which have similar geographic location, area size, population size and natural resource endowment.

*Table 1*

KEY SOCIO-ECONOMIC INDICATORS FOR IVANOVO OBLAST, KALUGA OBLAST, RYAZAN OBLAST, TULA OBLAST AND FOR RUSSIA AS A WHOLE

| Region | GRP per capita in current prices, thousand roubles | | Population size, thousands of persons | | Life expectancy at birth, years | | Unemployment rate, % | | Population whose cash income falls below poverty threshold, % | | Total area, thousand km2 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2009 | 2015 | 2009 | 2015 | 2009 | 2015 | 2009 | 2015 | 2009 | 2015 | |
| Ivanovo Oblast | 81.3 | 165.5 | 1 071 | 1 033 | 66.8 | 70.6 | 10.8 | 5.6 | 22.7 | 15.8 | 21.4 |
| Kaluga Oblast | 152.2 | 331.5 | 1 015 | 1 010 | 67.6 | 70.7 | 6.2 | 4.3 | 12.3 | 10.9 | 29.8 |
| Ryazan Oblast | 131.9 | 279.0 | 1 162 | 1 130 | 67.7 | 71.5 | 9.2 | 4.7 | 15.9 | 12.7 | 39.6 |
| Tula Oblast | 136.9 | 315.6 | 1 571 | 1 510 | 66.9 | 70.1 | 6.0 | 4.1 | 12.5 | 10.6 | 25.7 |
| Russia | 224.2 | 445.1 | 142 833 | 146 545 | 68.7 | 71.4 | 8.4 | 5.6 | 13.0 | 13.3 | 12 125.2 |

*Sources:* Rosstat, data posted on the official websites of the regional governments in question.

1 G. Indrisov, A. Kaukin, Yu. Ponomarev. Industrial production dynamics in certain industrial sectors // Russian Economy in 2015. Trends and Outlooks, No. 37, pp. 221–253.

2 A. Kaukin, E. Miller. Industry in Q3 2016 // Russian Economic Developments. 2017. No. 1, pp. 49–53.

3 Regional development disparity is still high – the results obtained in 2016 // RIARATING, 06 March 2017. [http://riarating.ru/regions/20170306/630057799.html].

Ivanovo Oblast adopted its regional development strategy in 2015[1]. The following priority sectors are set forth in the strategy: textile and industrial cluster[2] (regional legacy sector), machine engineering complex (manufacture of textile equipment), chemical industry.

Kaluga Oblast adopted its socio-economic development strategy[3] in 2009, whereby the automotive cluster is selected as the baseline development priority.

Ryazan Oblast had its development strategy under construction as of the date of this report[4]. There is a presentation on the Ryazan investment potential posted on Ryazan Government's official website[5], specifying development options selected according to the existing educational establishments, production and manufacturing enterprises: agro-industrial cluster, IT cluster, pharmaceutical and concrete clusters.

According to media sources[6], Tula Oblast plans to adopt its regional development strategy not later than 2017. There is a draft strategy which includes the following priority industries: chemical industry, machine engineering industry and agro-industrial sector.

**Kaluga Oblast**

*Fig. 1–4* show production index dynamics for the industries that are most valuable for the regional economy, with decomposition of statistical series[7].

The trend component of the manufacture of transport equipment series in Kaluga Oblast shows (*Fig. 1*) a change in the trend that took place after the implementation of the regional development strategy kicked off: the production growth in late 2014 stood at about 105% compared with the business-as-usual development scenario. The observed growth of the manufacture of transport equipment suggests that strengths and opportunities were successfully combined through economic policies: on the one hand, inadequate investment in modern production technologies and a lack of inflow of know-how required to manufacture competitive products that could meet domestic demand were addressed, on the other hand, a good basic personnel training level was attained, thus enabling a manifold increase in labour productivity in modern assembly lines. The decline since mid-2013 in the trend component of the manufacture of transport equipment series is accounted for by the growth model adjustment due to subdued domestic demand for brand new motor cars.

The output index of manufacture of chemicals and chemical products exhibits a change in the trend similar to that in the automotive industry and an acceleration of growth rates after the Strategy kicked off. However, there was

1 Socio-economic development strategy in Ivanovo Oblast until 2020 // Ivanovo Government's official website [http://www.ivanovoobl.ru/materials.aspx?part=941].

2 Public persons discuss a new draft regional socio-economic development strategy // Ivanovo Government's official website [http://www.ivanovoobl.ru/eventdetails.aspx?id=13253].

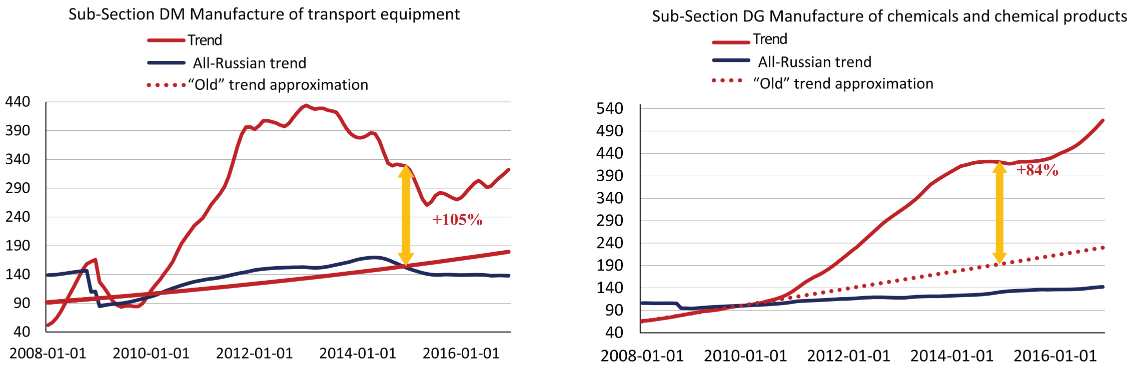
3 Socio-economic development strategy in Kaluga Oblast until 2030 // Kaluga Government's official website [http://admoblkaluga.ru/sub/econom/strategy/].

4 Ryazan Oblast adopted Regional Act No. 90-OZ of 21 December 2016 "On Strategic Planning in Ryazan Oblast"

5 Ryazan Oblast's investment potential // Ryazan Government's official website [http://invest-r.ru/files/blocksgallery/investitsionniy_potentsial_ryazanskoy_oblasti_rus_.pdf].

6 Tula Oblast to adopt its regional development strategy not later than 2017 // October 22, 2016, TulaMedia [http://tulamedia.su/news/550606/].

7 Decomposition of the trend component is performed by the Demetra package using X12-ARIMA.




**Note.** "Old" trend approximation is a region development scenario that excludes implementation of the adopted strategy.

*Fig. 1. Dynamics of the index of manufacture of transport equipment and of the index of manufacture of chemicals and chemical products in Kaluga Oblast in 2008–2016 (December 2009 = 100)b*

almost no decline in production volumes, particularly in the pharmaceutical industry, in 2014–2015: first, the products are goods that consumers are not ready to turn their backs on; second, many enterprises of the pharmaceutical cluster were originally focused on overseas sale markets, too.

Hence the priorities selected in the Kaluga development strategy worked fine.

### Ivanovo Oblast

Light industry is historically a leading industry in Ivanovo Oblast, accounting for 33.5% of the regional economy and for 70% of the Russian manufacture of textiles products and cotton fabrics[1]. The dynamics of the trend component of manufacture of textiles and textile products mirrored the all-Russian dynamics, that is, a downturn during the crisis of 2008 and then a slide into stagnation. A recovery growth was observed at the all-Russian level in the period between 2009 and 2014. However, that period saw many enterprises go out of business due to their inability not to operate at a loss, even on a subsidized basis, amid the developed economic environment[2]. Only survived enterprises could be see better conditions for upgrade and conduct of business, and therefore their production growth spurred by the vast shutdowns in the industry had no impact on the regional index dynamics.


*Fig. 2. Dynamics of the index of manufacture of textiles and textile products and of the index of manufacture of machinery and equipment in Ivanovo Oblast in 2007–2016 (December 2009 = 100)*

1 For more details on Ivanovo Oblast, refer to Ivanovo Government's official website [http://www.ivanovoobl.ru/materials.aspx?part=33].

2 Analysis of the life cycle stages of the textile industry development in Ivanovo Oblast (Russia) // Ekonomika y Banki Journal (2013), No. 2, pp. 88–96.

As shown in *Fig. 2*, the recession and the recurrence of all-Russian trend suggest that the implemented strategy may well envisage adequate policies of eliminating the long-standing issues facing the industry, namely inadequate supply of raw materials, outdated production facilities, low degree of technological equipment upgrade. However, the regional economic policy failed to yield any tangible results.

The same conclusion can be obtained for the machine engineering industry[1]. The only difference is the period after 2014 when the trend was below the all-Russian trend. External conditions had a stronger impact on light industry related sectors that focus on the domestic market.

**Ryazan Oblast**

According to the investment presentation, Ryazan Oblast's regional industrial potential includes oil refining industry, electric power industry and manufacture of construction materials. Oil refining contributes substantially to the regional chemical industry (the Oblast hosts Ryazan Oil Refinery[2], one of the major oil refinery plants in Russia), and therefore the Oblast saw a deeper downturn compared with the all-Russian figures (*Fig. 3*), particularly due to falling global crude oil prices, in times of recession[3].

The downward trend in the oil refining sector reversed in early 2015. This occurred because (1) external conditions stabilized, (2) Ryazan Oil Refinery underwent modernization[4], (3) the regional government started introducing elements of the Ryazan investment strategy aimed at diversifying the industry by manufacturing medicines, agricultural chemicals, wood chemistry products (wood fibreboards, insulating materials, etc.).

The concrete production industry was on the rise after 2009 due to higher-than-normal demand for construction materials that was driven up by an

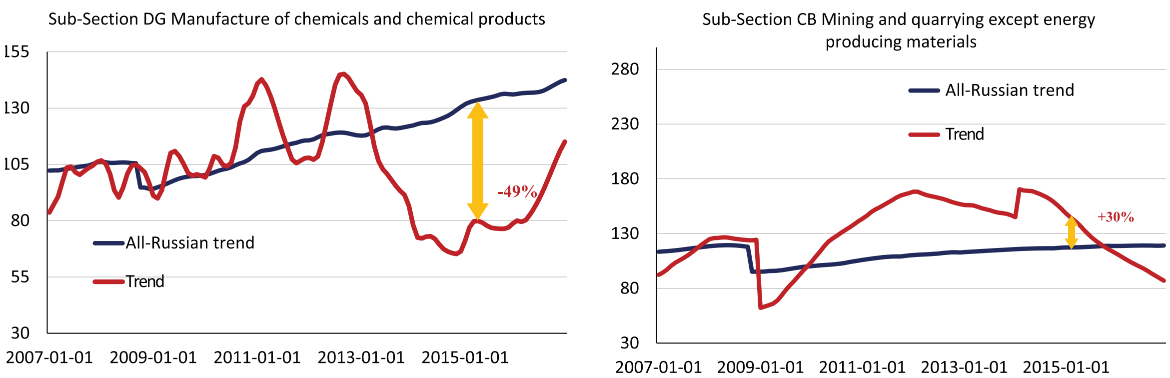



*Fig. 3. Dynamics of the index of manufacture of chemicals and chemical products and of the index of mining and quarrying except energy producing materials in Ryazan Oblast in 2007–2016 (December 2009 = 100)*

1 Region's passport: Ivanovo Oblast // Trans-regional business cooperation information portal [http://www.marketcenter.ru/content/file.asp?r=%7B314C5F4F-EA8A-43E4-91E8-CFEEC1C28EE1%7D].

2 Ryazan Oblast's investment potential // Ryazan Ministry of Economic Development and Trade's official website [http://invest-r.ru/files/blocksgallery/investitsionniy_potentsial_ryazanskoy_oblasti_rus_.pdf].

3 Russian oil refining industry is more reliant on crude oil prices // 24 January 206. Vedomosti [https://www.vedomosti.ru/business/articles/2016/01/24/625246-neftepererabotka-zavisima].

4 Rosneft's Ryazan Oil Refinery switches to Euro-5 grade gasoline // 01 December 2015. RIA Novosti [https://ria.ru/company/20151201/1333610558.html].

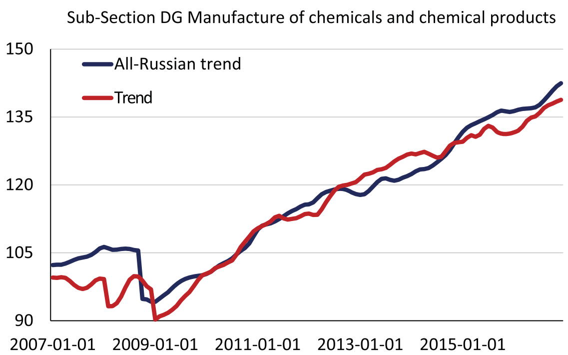
upturn in the construction sector.[1] The trend reversal of 2013–2014 could be accounted for by a high energy/output ratio and outdated production technologies at a few enterprises.

***Tula Oblast***

The manufacture of chemicals and chemical products and the machine engineering industry (jointly accounting for about 64% of the regional industrial sector[2]) contribute substantially to the local industrial sector. *Fig. 4* shows dynamics of the trend component of the index of manufacture of chemicals and chemical products, which is almost matching the all-Russian trend. The chemical industry remains one of the relatively competitive industries in Russia after the crisis of 2009[3]. The local chemical industry is nearly matching the all-Russian dynamics in the development strategy[4], and therefore no regional economic policies were required to achieve the results.

The local machine engineering industry is mostly comprised of major defence enterprises of the Russian industrial and military complex (e.g., KBP Instrument Design Bureau, Tulamashzavod Production Association, etc.). A swift upsurge in production volumes of the industry after the crisis of 2014 was driven up by growth of the number of public defence contracts, which had nothing to do with the local economic policy.

It is thus only the Kaluga policies of implementing the socio-economic development strategy that resulted in growth of output in the automotive sector selected as priority sector. The effect of the external shocks in 2014–2015 did not change long-term development prospects. The economic policy of Ivanovo Oblast and of Ryazan Oblast failed to produce notable changes in output dynamics compared with the all-Russian dynamics. The crisis of 2014



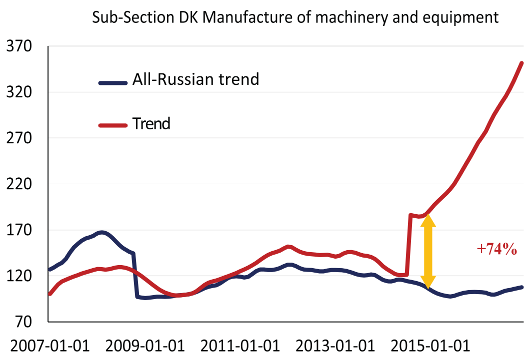




*Fig. 4. Dynamics of the index of mining and quarrying except energy producing materials (left-hand) and of the index of manufacture of machinery and equipment (right-hand) in Tula Oblast in 2007–2016 (December 2009 = 100)*

1 Market technology: independent growth // 01 July 2014. Vedomosti [http://www.vedomosti.ru/newspaper/articles/2014/07/01/nezavisimyj-rost].

2 Socio-Economic Development Strategy in the Central Federal Okrug until 2020 // Central Federal Okrug's official website. 06 September 2011. [http://cfo.gov.ru/acts/3].

3 See, for example, A. Kaukin, E. Miller. Industrial sector in Q3 2016: close to zero // Monitoring of Russia's Economic Outlook. Trends and Challenges of Socio-Economic Development, No. 20(38), December 2016.

4 Concerning the development of the chemical complex until 2030 (The development strategy for the chemical and petrochemical complex until 2030) // Ministry of Industry and Trade of the Russian Federation [http://minpromtorg.gov.ru/common/upload/files/docs/Razvitie_him_kompleksa.pdf].

developed in accordance with the all-Russian dynamics for both regions: industries that are reliant on imports of foreign raw materials and equipment and are not integrated into global value-added chains faced a decline or stagnation. Tula Oblast saw positive output dynamics owing to both a relative competitive power of certain industries (chemical industry) and public procurement contracts (defence industry), which however cannot be regarded as a merit of the regional economic policy.

A critical success factor of sustainable development is the development of a high-grade strategy aimed at strengthening the long-term competitive power of the region with account of its strengths and weaknesses, as well as potential external shocks. While the very existence of a strategy cannot guarantee success in achieving the set goals, a lack of sound economic policies in the medium- and long-term perspective may sentence the region to loss of the previously gained positions.

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