MONITORING OF RUSSIA'S ECONOMIC OUTLOOK:

TRENDS AND CHALLENGES OF SOCIO-ECONOMIC DEVELOPMENT

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The oil and gas agenda continues to be the primary determinant linking Russia's local issues and external (global) economic issues, as often evidenced in the form sensitive for both producers and consumers. Theoretically, one can easily imagine that interstate manoeuvres surrounding oil output might lead straight to pump price surge on forecourts. The reality, however, is more complex than it might seem, brining about new (or well overlooked old) challenges.

The erosion of the OPEC+ output cut agreement became apparent after Russia's and Saudi Arabia's energy ministers announced that both countries would likely increase their oil output. However, when it emerged that the U.S. administration had urged Riyadh to boost output to prevent further growth of crude prices, then a non-standard, ad hoc but still coincidence was detected. Both Russia and the United States are seeking to ramp up oil output because they would like to halt growth in oil market quotations leading to sensitive increase in local fuel prices inside the two countries. The difference between them is that Russia has a so-called 'tax manoeuvre' underway – with time breaks and with varying degrees of success over the recent four years – in its oil industry, which now seems to entering its final stage amid an unfavourably sharp increase in global prices.

Our experts remind that the tax manoeuvre was intended establish zero rates of the duty on crude oil exports (while equivalently rising severance tax rates) to improve the oil refining effectiveness and to encourage modernization of oil refineries while offsetting price increases in the local market that could possibly be triggered by higher exports, lower excise duties on refined products. A positive effect was that Russia posted an increase in the average oil refining depth from 71.6% in 2013 to 81.0% in 2017 (90–95% in developed countries). However, modernization of many refineries was rescheduled until later, the subsidization of inefficient oil refining remained in force, the export duty was kept unchanged, while excise duties were on the rise for two straight years. A noticeable increase in retail prices of refined products on the back of higher excise duties and the upsurge in global oil prices added more problems to the situation over the past few months.

With oil prices as they are today, the tax manoeuvre will be more painful (excise duties will have to be cut in a more radical manner) than if it had been done at the time when prices were at their lowest: "the best chance has been missed", according to the experts. This does not rule out, however, the need to implement the manoeuvre, because keeping an inefficient oil refining will lead to more losses for the state, and the Finance Ministry's proposal to raise export duties on refined products will discourage companies to produce refined products and to upgrade refining facilities in the long term, leading to far-reaching consequences for both retail prices and the oil refining industry as a whole. The experts conclude that a Gaidar Institute's solution for the completion of the taxation system reform in the oil industry can still be useful in the present context, including scrapping of duty rates on exports of crude oil and refined products while equivalently rising severance tax rates in 2019, reducing the excise duty on refined products to dampen increases in local petrol prices until 2024, introducing a subsidy to oil refineries with the aim to modernize production facilities, with incremental cuts in the subsidy until it is scrapped in 2024.

Exports of crude oil make up the majority of Russia’s exports to the markets of Russia’s most important trade partners, particularly China. This trade commodity is dominant in terms of exports to China from EEU (the Eurasian Economic Union) countries as a whole. Analysing the EEU-China agreement on trade and economic cooperation of May 2018, our experts note that it is too early to speak about establishing a full-fledged free trade zone between the EEU and China: some EEU are not yet prepared to liberalize their markets for China’s goods and investments. In the meantime, Russia and China continue talks on a bilateral agreement including provisions liberalizing access to services markets and investment cooperation (these areas are regulated at the national level).

Mutual investments between the two countries have so far been at a relatively low level. In general, however, according to data from the Russian central bank, foreign direct investments to Russia actively increased to around \$25bn in the first nine months of 2017. However, foreign capital inflows began to decline to total less than \$28bn by the end of 2017 (a 14% decline from 2016), mainly because of foreign investors’ negative expectations over new U.S. sanctions against Russia.

In the today’s context, foreign investments will more likely serve as a supplement to local sources of capital which are now facing gradual changes. Considering the local financial market situation (at end-Q1 2018), our experts note that non-finance institutions had reached Rb 32.7 trillion in overall debt on loans in the market. Although bank loans to corporate customers represented the majority of overall loans, they increased at slow pace: last year they almost stagnated (+0.4%), posting a minor increase in the first few months of 2018 (up 1.9% over January–March 2017). The debt on foreign exchange loans to banks continued the descent – the same period saw the proportion of non-financial entities’ foreign currency loans in the local market drop from 24.1% to 20.4%.

What is most remarkable, however, is that non-financial entities are still active in Russia’s bond market. Corporate bonds totalled Rb 6.7 trillion by April 2018, with a more than 20% increase (compared to that of 16.8% a year earlier) in the local debt market. Our experts note that the bond market rally largely offsets the decline in foreign exchange lending, while also pointing to the fact that it is the Rosneft’ entrance to the market (representing a third of the total corporate bond issues over the past five quarters) that deserves most of the credit for the rally. Gazprom ranks second (with less than 10% of bonded loans over the same period), albeit trailing far behind Rosneft. Excluding Rosneft, however, it is obvious that the Russian corporate sector is set to increase gradually its bonded loans’ share of the debt instruments structure.

It is telling that a similar trend is unfolding in the Russian regions’ policies. Analysing the state of regions’ budgets, our experts believe that loans from credit institutions gave way to securities in the public debt’s structure of subjects of the Russian Federation. Debt servicing costs continued the descent due, among other things, to interest rates cuts. Overall, Q1 2018 saw both regions’ revenues and expenditures increase at high enough pace with noticeably uneven monthly dynamics accounted, according to the experts, for by the preparation for the 18 March presidential election.

Experts from the Institute of Applied Economic Studies of The Russian Presidential Academy of National Economy and Public Administration have traced (based on data from a social wellbeing monitoring launched in 2015) specific features in the dynamics of social wellbeing before and after the recent presidential election in Russia. According to the experts, last year saw massive perception of economic stabilization expand further. According to data as of 2017 year end, there were more respondents thinking the crisis had been over than those who said the crisis continued. Sentiments differ largely between respondent age groups: persons at the age below 35 accounted for 27% of those expecting the situation to get worse, while those aged 60+ reached 44%. The share of persons not hit by the crisis had doubled (to 12.8%) by the end of 2017 compared to what was reported earlier in 2015.

Massive perceptions became noticeably more optimistic at the time of the March 2018 presidential election, with a 10% decline in the share of those confident that the situation had deteriorated, whereas the share of those thinking the situation had improved reached its peak value (16%) in the entire monitoring period. More than a quarter of respondents (a 3-year all-time high) were set to expect the situation to improve soon. There was a decline in the share of those concerned about job losses, wage cuts and wage arrears, moving to a part-time week schedule: finally, for the first time since the monitoring kick-off the share of those facing low personal risks reached more than a half of the working population, while the share of those facing high risks dropped to 17%. The latest data (April 2017), however, show some decline in upbeat sentiments. There was minor (3.4%) decline in the proportion of those seeing the economic situation improve, as well as there were heightened concerns and risks of job loss. Therefore, the emerged hopes that the principal trend will reverse – when the majority focus on the so-called "negative stabilization" – have not yet been met, as the experts note.

1. BEST TIME TO COMPLETE TAX MANOEUVRE IN RUSSIA'S OIL INDUSTRY

A.Kaukin, E.Miller

Some positive results have been achieved since a tax reform was kicked off in the Russian oil sector late in 2014. The 2014–2017 period saw an increase in the average depth of oil refining in Russia. Despite ongoing disputes, now is a good time to complete the so-called "tax manoeuvre" and to create effective incentives for Russian oil refineries to enhance their operative efficiency. The key risk here lies in specific parameters of the reform, particularly in the amount, period and distribution mechanism of oil refineries subsidization.

The post-Soviet Russia's oil industry underwent a series of tax restructurings[1] aimed in particular at increasing investment in oil production, improving the oil refining capacity utilization and the oil refining depth. The most recent stage of the tax restructuring in the oil sector fell on 2014.

The tax manoeuvre was intended to establish zero rates of the duty on crude oil exports while equivalently rising severance tax rates. In so doing, appreciation of the petroleum feedstock's value in the local market (by bringing prices on par with global prices, less transportation costs) was supposed to increase with growth in the severance tax taking extra profits out of extracting companies. This made it possible to release extra fiscal resource that was previously retained within the oil refining industry[2]. The purpose of the above measures was to improve substantially the effectiveness of the Russian oil refining industry, encourage Russian companies to upgrade oil refineries, invest in technologies designed to increase the oil refining depth and to move the production structure towards greater proportion of light fractions[3]. Excise duties on refined products were supposed to be cut gradually in order to partially offset the price rise in the local market.

However, the above-described configuration was not realized; instead, an option was chosen to reduce gradually, but not to zero, the crude oil export duty until 2017, with the change in local prices being only partially offset by higher severance tax.

In 2015, the tax manoeuvre plan was deviated from what was approved because the federal budget needed more revenues after the crisis, so the duty on crude oil exports was frozen (not lowered), without giving up raising the severance tax rate[4], nor the plans to reduce excise duties on refined products were implemented – excise rates were raised twice in 2016[5] to resupply regional road funds, leading to a considerable increase in the proportion of

1 Milestone reforms are the reforms of 1995, 2011, 2013.

2 G. Idrisov, A. Kaukin "Tax manoeuvre: Boosting economic growth at the expense of budget consolidation" // Russian Economic Developments. 2016. No. 6. P. 35–39.

3 A. Kaukin, A. Knobel, A. Firanchuk. "The effects of tax manoeuvre: Oil and refined products production" // Russian Economic Developments. 2016. No. 12. P. 29–33.

4 A. Kaukin, E. Miller 'Tax manoeuvre in Russia's petroleum industry" // Russian Economic Developments. 2017. No. 10. P. 60–64.

5 D. Gordeev. Raising excise duties block the tax manoeuvre // Russian Economic Developments. 2016. No. 9. P. 49–53.

taxes (in rouble terms) as per tonne of refined products for the local market compared to exported refined products. Such an inconsistency in actions constituted a major headwind to the initial objectives of reforming the taxation system in the industry.

As of the time of tax manoeuvre, the oil refining depth of Russian oil refineries averaged 71% (compared to 90–95% in developed countries). A Russian refineries modernization program[1] provided for by quadripartite agreements between the state (represented by the FAS (Federal Anti-Monopoly Service), Rostekhnadzor (Federal Service for Environmental, Technological and Nuclear Oversight of Russia), Rosstandart (Federal Agency on Technical Regulating and Metrology)) and vertically integrated oil companies (VIOCs), was approved in 2011. In the initial stage, owners of refineries acted on their commitments under the state's supervision and managed to complete a few projects. Some oil refineries had to update their modernization programs on the back of the 2014 financial crisis: some projects were extended, while doubts were raised as to other more costly and complex conversion process facilities. The year that followed kicked off with a tax reform in the sector and with nearly halved investments in the refining and the petrochemicals sectors. Russia posted an increase in the average oil refining depth from 71.6% in 2013 to 81.0% in 2017 despite external shocks, as well as the residual fuel oil production fell, as presented in *Fig. 1*. Some companies switched to a non-residual-fuel-oil production, including OOO Lukoil-Permnefteorgsintez, with an oil refining depth of 98%.

Today, however, the economy continues to be subsidized by setting oil prices lower than global oil prices, with only one part of the subsidy partially reaching end consumers while

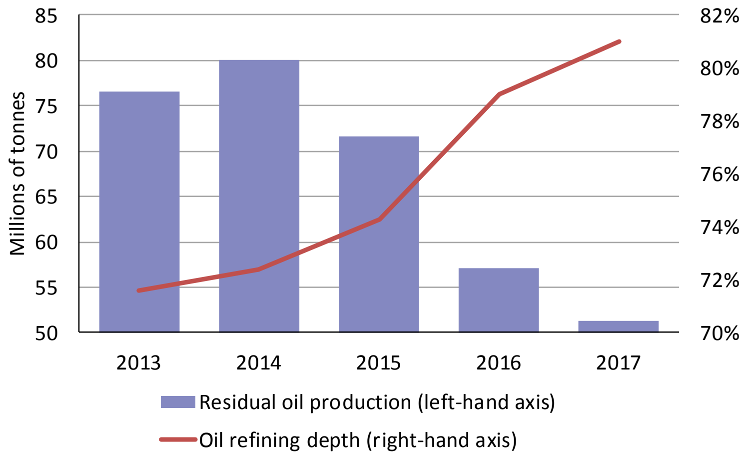

Fig. 1. Russian oil refineries' average oil refining depth, 2013–2017, %
Sources: Rosstat, Russia's Energy Ministry.

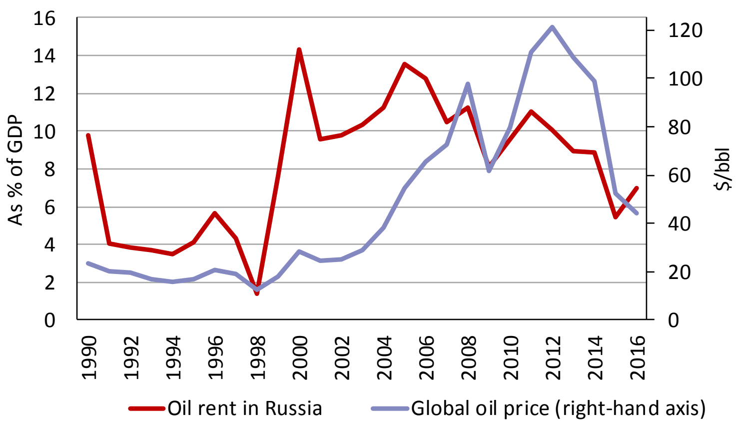

Fig. 2. Russia's oil rent, as a percentage of GDP
Source: World Bank.

1 The Customs Union Commission's decision dated 18 October 2011 No. 826 (last updated 30 June 2017) "Concerning the Approval of the Customs Union Technical Regulation "On Requirements to Automotive and Aviation Gasoline, Diesel and Marine Fuels, Jet Engine Fuel and Residual Fuel Oil" (CU TR 013/2011) (together with the Customs Union Technical Regulation "On Requirements to Automotive and Aviation Gasoline, Diesel and Marine Fuels, Jet Engine Fuel and Residual Fuel Oil" (CU TR 013/2011)).

the other one being retained in the oil industry. About 1.7% of GDP remains in the oil refining sector owing to economy's subsidization by maintaining oil prices lower than global prices[1], thereby evidencing that the sector is inefficient. Therefore, using export duties implies that Russian oil refineries are subsidized at the expense of the publicly (state) owned natural resource rent.

Fig. 2 presents the World Bank's 'oil rent' for the Russian economy, which represents the share of extracting companies' profit generated from using the natural resource in the course of production[2]. The data show that the oil rent volume in Russia has gradually declined over the last 5–10 years. The key potential factors of this dynamics are as follows:

- the change in the GDP structure, the increase in the share of the non-resource-based sector;
- the decline in crude oil production (with the relationship between revenues and costs per tonne of crude oil) brings down companies' total profit;
- the increase in extraction costs;
- the decline in local oil prices (on par with the decline in oil companies' revenues in the local market).

An analysis of the above factors reveals that in Russia the first two factors apparently did not have the crucial effect. Furthermore, given the specifics of the Russian oil and refined products market (vertically integrated companies), it is difficult to distinguish between the effect of costs and the effect of local prices, because the latter occurs in the context of internal corporate transfers. The increase in oil companies' extraction costs was in part be due to the following few reasons: gradual development of existing oil fields, less access to financial resources as a result of Western sanctions, higher reliance on imported equipment coupled with the appreciation of its rouble value after the 2014–2015 rouble's devaluation and with the technological sanctions regime shutting out access to the most demanded equipment. There also could be a decline in local oil prices on the heels of falling global prices in 2014–2015 (in which case local prices should have dropped less because of existing export duties with rates pro rata to the Urals crude global price). However, global oil prices rather have an indirect effect, through alternative costs, on the local market (producers choose whether they should export crude oil or instead to refine it to sell refined products in the local market).

Some growth in the oil rent late in the statistically covered period can be associated with (1) oil industry's preparation to ensure its compliance with the OPEC output cut agreement, (2) a higher than in the preceding year oil production on oil fields eligible the severance tax and export duty allowances (+17.5 million tonnes)[3], as also evidenced by the decline in federal budget oil and gas revenues by a 0.1 percentage percent of GDP compared to 2015.

The recent decline in the oil production rent suggests that placing greater focus on oil refining rather than on exports should become more appealing

1 G. Indrisov, S. Sinelnikov-Murylev. "Modernization or conservation: The role of duty on exports of oil and refined products" // Ekonomicheskaya Politika, 2012. No. 3. P. 5–20.

2 The World Bank's 'oil rent' is defined as a percentage of GDP, as the difference between the value of all the extracted oil across the country at local prices and oil production costs.

3 Vygon Consulting Russian Oil Industry Outlook: The 2016 Results and Outlooks for 2017–2018 [https://vygon.consulting/upload/iblock/036/vygon_consulting_russian_oil_industry_outlook_2018_p1.pdf]

for Russian oil companies in the present context than it was in recent years. This means that now is a good time to complete the tax manoeuvre, create extra incentives for the modernization of oil refineries, increase the oil refining effectiveness and volumes.

This trend, however, has been overlapped by the last month's developments, primarily a marked increase in retail prices of refined products. The trend was triggered by a combination of the following two key factors: the increase in global oil prices per barrel from $60–65 in December to $75–80 in June and the level of excise duties which increasingly rose over the past two years (being at variance with the target parameters of the 2014 tax restructuring). With oil prices as they are today, the tax manoeuvre will be more painful (excise duties will have to be cut in a more radical manner) than if it had been done at the time when prices were at their lowest; therefore, the best chance has been missed. However, this does not rule out the need to implement the manoeuvre: the practice shows that keeping the oil refining inefficient will just once again put aside the solution of the problem, which is costly for the state. The Finance Ministry's proposal to raise export duties on refined products, while expecting that local prices are likely to fall initially, will discourage companies to produce refined products and to upgrade refining facilities in the long term, leading to far-reaching consequences for both retail prices and the oil refining industry as a whole.

A possible solution in the present context is to complete the taxation system reform in the oil industry in the manner developed by the Gaidar Institute:

- to scrap the duty rates on exports of crude oil and refined products while equivalently rising severance tax rates in 2019;
- to reduce the excise duty on refined products to dampen increases in local petrol prices until 2024;
- to introduce a subsidy to oil refineries with the aim to modernize production facilities, with incremental cuts in the subsidy until it is scrapped in 2024.

In so doing, the key risk of reforming lies in selecting tax manoeuvre specific parameters yet to be finally announced despite completed disputes between the government and representatives of the industry. In particular, the following three key issues can be highlighted. First, whether the replacement of the export duty with the severance tax will be neutral from the perspective of oil companies' profit (subject to this condition, the federal budget would see extra revenues inflow) and how this will go with a draft Bill on the replacement of severance tax with excess profits tax (EPT) submitted to the government. Second, what is the amount and the distribution mechanism of the oil refining subsidy to ensure rapid modernization and functioning amid rising costs. On the one hand, under the draft Bill concerning the EPT and the cut in the excise duty on petrol and diesel, the government will be able to raise duties on exports of refined products if oil refineries fail to keep prices of their products at bay. On the other hand, a discussion is underway[1] over introduction of two mechanisms at a time to support oil refineries: a negative excise duty on refined crude oil for petrol producers and a floating excise

1 Maneuver at reallocation of possibilities // Kommersant, 13 June 2018. URL: https://www.kommersant.ru/doc/3656838

duty pegged to global prices of refined products. The currently available information about the government's proposals on how to support oil refineries and to curb local prices of refined products suggests that the government's intervention in the market is somewhat inconsistent and perhaps excessive. Third, the effective term of the proposed support mechanisms has yet to be specified. Unlimited in time subsidization would only keep oil refining inefficient, by merely replacing one mechanism with another.

2. EAEU AND CHINA: AGREEMENT ON TRADE AND ECONOMIC COOPERATION FACILITATES TRADE PROCEDURES

T.Aliev, T.Flegontova

The agreement on trade and economic cooperation between EAEU and China signed in May has a non – preferential nature[1]. Due to the fact that a number of EAEU members are not prepared yet to liberalize their markets for Chinese goods and investments, the development of a fully–fledged free trade zone between them seems to be unlikely so far. Nevertheless, the signed agreement could promote an increase in efficiency of mutual cooperation between EAEU and China, facilitate, for example, trade procedures and transparency.

Asia and Pacific region represent one of key focuses of foreign trade and economic cooperation of the Eurasian economic union (EAEU). Cooperation with the People's Republic of China (PRC) has a major potential in this context[2].

China is the biggest foreign trade partner of the EAEU member countries (*Fig. 1*)(not taking the European Union as a single foreign trade counterpart)[3]. China ranks second solely for Belarus following the Ukraine. China accounts for 16.2% of the EAEU turnover.

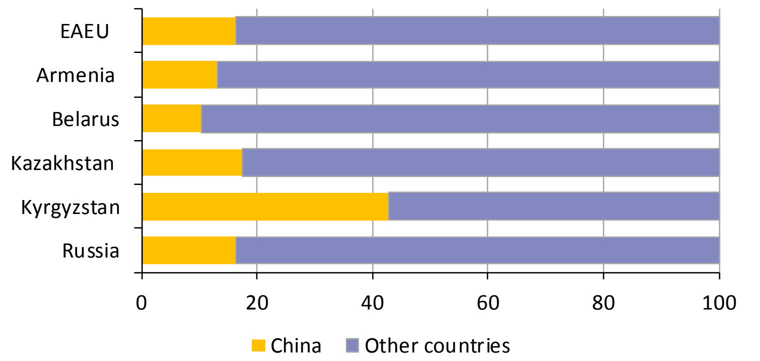

Fig. 1. Chinese share in the EAEU foreign trade with third countries in 2017

Sources: data of the European Economic Commission (EEC), calculations made by the RANEPA Russian APEC Study Center.

Recent years saw negative trends in the EAEU merchandise exports to China, i.e. the exports volume was reduced in 2014–2016 from $48.1 to $2.9 billion. However, merchandise exports from EAEU member countries to China hit $45.3 billion in 2017 having increased by 37.7% in comparison with the previous year. The recovery of EAEU merchandise imports from China commenced a year earlier. Following a significant fall, i.e. by 29.5% in 2015, the volume of Chinese supplies to EAEU countries increased by 4.4% in 2016 and by 25.6% in 2017 and the growth rate was worth $13.6 billion in absolute terms for two years[4]. Thus, EAEU trade with China was conducted with sustainable deficit balance.

1 Non-preferential nature of the agreement does not suggest to form a preferential way of accessing the market of goods i.e. to reduce and/or reset import customs duties relevant to trade between the countries, signatories of the agreement.

2 Ref. T.M. Aliev, I.Z. Aronov, M.A.Baeva, E.K. Bashkirova, M.A. Vorobiev, R.M. Gubenko, E.S. Guschin, I.S. Ermokhin, O.D. Ismagilova, A.Y. Knobel, A.A. Koval, A.E. Kuznetsova, A.D. Levashenko, O.V. Ponomareva, K.A. Proka, N.S. Pyzhikov, A.M. Rybakova, V.Y. Salamatov, A.N. Spartak, A.V. Tngaeva, et al. //Chinese market: issues of access. Analytic report / Moscow, 2017.

3 Foreign trade with third countries.

4 Calculation made by the Russian APEC Study Center according to EEC.

Table 1

EAEU/CHINA FOREIGN TRADE MAJOR COMMODITY ITEMS IN 2017

EAEU merchandise export to China			EAEU merchandise import from China		
Customs tariff number	Product classification number	Share as a percentage of total	Customs tariff number	Product classification number	Share as a percentage of total
2709	Crude oil including gas condensate	47.3	8517	Communication equipment and spare parts	10.8
2710	Petrochemicals	5.8	8471	Data processing computers	6.2
4407	Rip sawn timber	4,5	8419	Heat treating equipment	6.0
2701	Coal	3.8	8708	Parts and accessories for automobiles and tractors	2.2
7403	Refined copper and copper alloys	3.5	9503	Toys and puzzles	1.7
8411	Turbo jet and turbo propeller engines, other gas turbines	2.7	6402	Rubber or plastic sole and upper shoes	1.7
4403	Rough timber	2.6	8529	Parts for transmitting and receiving equipment	1.6
2603	Ores and copper condensates	2.3	8516	Domestic electric heaters, electric stoves	1.3
0303	Frozen fish	2.0	8473	Parts and accessories for data processing machines	1.2
7202	Ferrous based alloys	2.0	8528	TV sets, monitors and projectors	1.1

Sources: EEC data, calculations made by the RANEPA Russian APEC Study Center.

Raw materials, first of all fuel and energy products prevail in EAEU/China export merchandise structure, while EAEU imports from China are mainly represented by electric equipment (*Table 1*).

The scale of services trade between the EAEU and China is significantly smaller, with Russia taking the largest share in trade of services. In absolute terms, exports of services from Russia to China moved up from $1,530 to $2,390 mn in 2012–2017 while imports of services accounted to $2.0–2.4 billion during that period with the exception of 2015 when it amounted to $1.8 billion[1].

Amid a general trend towards transparency upsurge in the Chinese economy, China is pushing for regulatory restrictive measures. This applies to direct restrictions on access of goods, services and FDI (Foreign Direct Investments) to the Chinese market as well as to indirect trade barriers[2]. The latter include excessive demands on licensing, certification, registration of certain groups of goods. Such measures fulfil not only a regulatory function but frequently serve as implicit protectionist measures. This is manifested in the requirements to standards, challenges to access to key laws and regulations in the English language, substantial barriers related to the shortcomings of the mechanisms and procedures, for example, in the sphere of government contracts, customs procedures or protection of the intellectual property rights[3].

In recent years, the activities towards the institutionalization of economic cooperation between Russia, EAEU and China have intensified. Two–way negotiations were conducted with China[4]: non – preferential agreement on

1 Data released by the Bank of Russia.

2 For the effects of trade of services liberalization on industrial productivity refer to A.Yu. Knobel. Effect of liberalization of the services' sector on trade of services and industrial productivity in Russia and other CIS countries // Applied econometrics. 2016. No.4 (44). P. 75–99.

3 N.S. Pyzhikov Characteristics of the management of intellectual property rights in China// Russian Foreign Economic Journal. 2018. No. 4. P. 105–118.

4 See Monitoring of relevant developments in foreign trade, VAVT No.12, May 2018. http://www.vavt.ru/materials/site/bab4c2d911f497e24325829d004fb1e4/$file/Monitoring_12.pdf .

trade and economic cooperation between EAEU and China and preferential agreement on services and investments between Russia and China. The two-way simultaneous negotiations are justified by division of power in the sphere of trade and investments' regulations of EAEU member countries on the national and supra-national level.

Russia's membership in the Eurasian Economic Union and establishment of a uniform customs territory assume that a number of issues related to trade regulation shall be submitted to supra-national level. Access to the market of commodities is the competence of the Eurasian Economic Commission (EEC). Thus, it is feasible only on the EEC level to set up a classic free trade zone bearing in mind the reduction of tariff restrictions and incorporation of a number of other provisions in the agreement. This approach was already used for the establishment of a free trade zone between EAEU and Vietnam, which has been effective since October 2016. However, as opposed to Vietnam and a number of other countries that EEC is negotiating with regarding the establishment of a free trade zone i.e. Singapore, Egypt, India, Israel, Serbia, Iran, the reduction of restrictions in trade with China is rife with negative consequences for certain EAEU industrial sectors. The assessment of general consequences of the establishment of a free trade zone between EAEU and China suggest a potential advantage for major economies, i.e. Russia, Kazakhstan, China, while economies of Belarus, Kyrgyzstan and Armenia may lose as a result of a China trade liberalization[1]. As for the sectoral plans, the Kazakhstan automotive engineering, textile industry and production of clothing as well as Belarus mechanic engineering, are subjected to highest risks.

Therefore, the EAEU member countries are not ready yet to kick of negotiations on the establishment of a free trade zone. It was decided to launch negotiations on the non-preferential agreement between EAEU and China. These negotiations lasted less than two years and were terminated on October 1, 2017. The agreement was signed in May 2018. Despite the fact that articles relevant to the reduction of tariff restrictions were not part of this agreement, it contained a wide range of issues, which will contribute to the improvement of efficiency and facilitation of mutual cooperation between EAEU and China, when they are mutually agreed upon and regulated, in particular:

Facilitation of trade procedures i.e. provision of opportunities for electronic declaration, release of goods within the shortest time possible;

- improvement of transparency and work on mutual recognition of standards, technical regulations and conformity assessment procedures;
- Protection of intellectual property rights including digital environment;
- Regulation of electronic commerce, including encouragement of use and mutual recognition of practices of electronic authentication, use of electronic documents, protection of customers' rights and their personal data, improvement of transparency[2];

1 Effect of ATR integration processes on Russian economy. See A.Yu. Knobel, V.V. Sedalischev. Risks and advantages of various integration scenarios in Asian / Pacific region for EAEU // Economic policy. 2017. Vol. 12. No. 2. P. 72–85.

2 T.A. Flegontova Regulation of electronic commerce in China: risks and advantages for international cooperation // International organizations research journal. 2017. No. 4. P. 150–168.

- Cooperation in public procurement, including the access of information in this sphere.

The most significant achievement of this agreement is that WTO basic non-discrimination principles are applicable to Belarus non being a WTO member yet.

In case of bilateral agreement between Russia and China which is still being negotiated, it has a preferential nature and should include provisions on deregulation of access to the services and investment market. Thus, a feasibility study for the future framework trade agreement was approved during recent visit of President Vladimir Putin to China. The scope of the agreement, as opposed to the commodity component, is based on the application of EAEU single services market only to a number of sectors approved by each member country. In general, the regulation of the access to services’ market takes place on the national level.

The prospects for conclusion of a comprehensive preferential trade agreement between EAEU and China on goods and services shall be dictated not only by the readiness of the EAEU countries to open markets for Chinese companies but also by the EAEU feasibility to offer any preferences to China, to provide a open doors for Chinese investors. More likely, China will be prepared to sign more profound agreements only if they include commitments regarding mutual trade liberalization.

3. FOREIGN DIRECT INVESTMENTS IN THE RUSSIAN FEDERATION IN 2017

Yu.Zaitsev

An increase in the incoming foreign direct investments (FDI) in the Russian Federation in 2016 and the first three quarters of 2017 gave way to a decrease in the capital inflow in Q4 2017. This reflects change for the worse in foreign investors' sentiments due to negative expectations of new sanctions to be introduced by the US, as well as a drop in demand on Russian state bonds.

Investors' positive sentiments were reflected by positive dynamics of direct foreign investment flows in the first three quarters of 2017 when the volume of the incoming FDI amounted to $24.8bn, a twofold increase on the relevant period of 2016 (*Fig. 1*). Growth in the FDI inflow during that period is related to a number of large-scale projects, such as the startup of building of the Mercedes-Benz motor-works by Daimler, a German-based car-maker, at the Esipovo Industrial Park. This was actually the first major western project in Russia after anti-Russian sanctions were introduced[1].

The explicit positive FDI dynamics could give a confidence boost to foreign investors that the situation was favorable for expanding existing projects or starting up the new ones. However, a drop in the FDI inflow in the Russian economy which took place in Q4 2017 pulled down the annual FDI index to $27.89bn, a 14% decrease as compared to the index of the previous year ($32.54bn). This can be explained by a decrease in demand on Russian state bonds, concerns over introduction of new sanctions, as well as reduction of the volume of external obligations of the non-state sector[2].

According to the 2017 year-end results, the FDI outflow from the Russian Federation increased, too. By the estimate of the CBR, it amounted to $38.63bn, an increase of 1.7 times compared

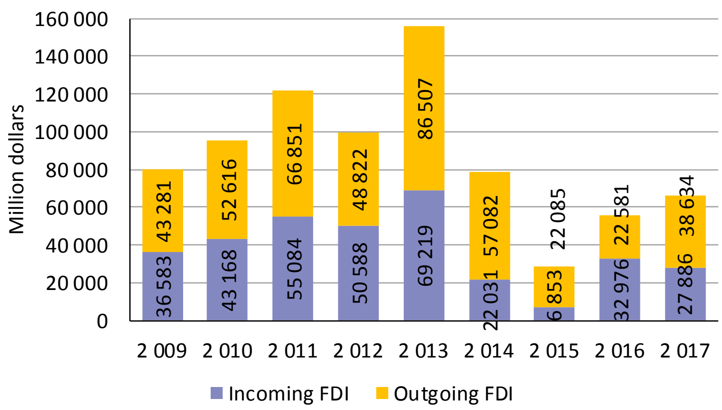

Fig. 1. Foreign direct investment flows to Russia in 2009–2017

Source: Authors' calculations based on the data released by the Central Bank of Russia (CBR)

1 The Daimler Has Started Building Motor-Works in the Moscow Region. The Vedomosti Daily. 20.06.2017. URL http://www.vedomosti.ru/auto/galleries/2017/06/20/695254-daimler-nachal-zavod (Reference date: 10 June 2018)

2 Yu.K. Zaitsev, A.Yu. Knobel Foreign Direct Investments in H1 2017 // The Economic Development of Russia. 2018. No. 1. P. 7–11. URL: https://elibrary.ru/item.asp?id=32363132 (Date of reference: 10 June 2018).

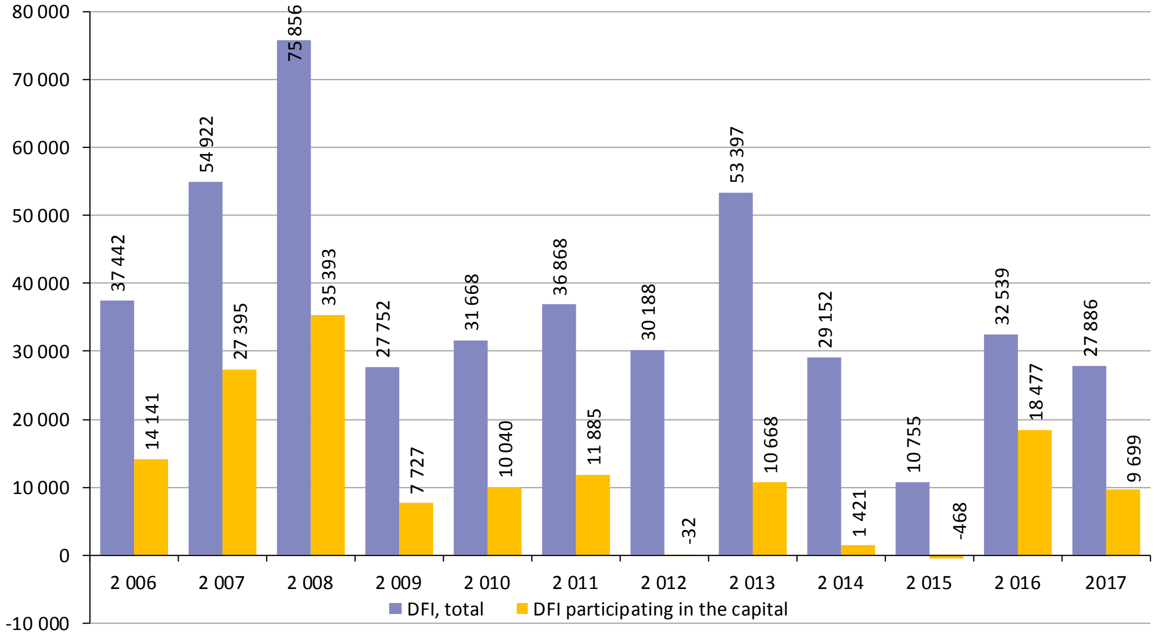

Fig. 2. Dynamics of the Direct Foreign Investment Inflow to Russia, million USD
Source: Authors' calculations based on the CBR's data.

to the value of 2016 ($22.31bn). The outflow can partially be explained by investors' uncertain mood due to aggravation of the situation after introduction of new sanctions by the US. Growth in outgoing direct investments from the Russian Federation is related to implementation of Russian investment projects abroad, including those in a number of CIS states. So, by the end of 2017 Russia made Rb 100bn worth of investments in Kirgizia for development of the gas transmission and gas distribution networks[1]. In Uzbekistan, the PAO KAMAZ is planning to start manufacturing of trucks based on the capacities of the UzAutoTrailer Company[2].

FDI to the Russian Economy

The FDI inflow to the Russian economy remains largely related to investments participating in the capital. According to the results of 2017, the share of such investments was equal to 34.78% of the total volume of the DFI ($9.7bn). This is below the share seen in 2016 when it amounted to 56.78% (*Fig. 2*). Other incoming FDI in Russia dealt mainly with reinvestment or debt instruments.

According to the 2017 year-end results, Russia's largest investment partner is still the European Union whose investments in the Russian economy exceeded $14bn. Note that the largest investor-countries making investments in the industrial projects in the Russian Federation are still Germany ($517bn) and France ($854bn). Investors from those two countries declared their willingness to make investments in new projects in H1 2018 and within the framework of the St. Petersburg International Economic Forum. So, BMW, a Ger-

1 Russia Invests Rb 100bn in Kirgizia's Gas Industry. The Vedomosti Daily, 27 November 2017. URL: https://www.vedomosti.ru/business/news/2017/11/27/743276-rossiya-investiruet (Date of reference: 10 June 2018).

2 The KAMAZ will Start Manufacturing in Uzbekistan. Rostekh, 03 November 2017. URL: http://rostec.ru/news/4521521 (Date of reference: 10 June 2018).

man-based company, decided to build a full-cycle motor-works in the city of Kaliningrad within the framework of the special investment contract worth euro 250bn with a prospect of securing budget subsidies[1]. The Siemens concluded contracts with a number of Russian higher education establishments on supply of euro 20 worth of software and signed a trilateral memorandum on cooperation with the AFK Sistema, and the Medsi in development of innovative projects in Russia's healthcare system. Veolia, a French-based utility operator and the Russian Private Investment Fund (RPIF) signed an agreement on cooperation to identify investment projects in Russia[2].

US investors showed more interest in making investments in Russia. So, in 2017 direct foreign investments from the US grew 4 times over to $495m as compared to 2016 ($125m). The interest is still evident in 2018 as a number of US companies concluded investment contracts with their Russian partners. In particular, the Mars Company signed an agreement on cooperation with the Ministry of Investments and Innovations of the Moscow Region to introduce new technologies worth Rb 800m in ecology and environmental activities[3].

ASEAN countries retained their positions as traditional investment partners (primarily thanks to Singapore's contribution), despite a dramatic drop in FDI to Russia to $2.31bn in 2017 as compared to $16.28bn in 2016. Further behavior of foreign investors will largely depend on their assessment of their own risks amid the existing sanctions and flexibility of business models that are able to reduce risks.

Foreign Investors amid Sanctions

Sanctions are still a key factor behind foreign investors' behavior In 2017, some European companies which were affected by Russian countersanctions localized their production in the Russian Federation. Those companies operated in the food industry and agriculture.

The selection of the localization strategy is related to direct losses suffered by the EU from the Russian countersanctions in the agro-industry; those losses amounted to about euro 2 bn[4], (which is anyway lower than the damage caused by the EU to its own companies when it adopted sanctions against Russia)[5].

An example of localization is a purchase by Savencia Fromage & Dairy, a French-based food company specializing on cheese manufacturing, of a con-

1 The BMW Picked Up a Region for Building a Motor-Works in Russia. The Vedomosti Daily. 15 February 2018. URL: https://www.vedomosti.ru/auto/articles/2018/02/15/751031-bmw-zavoda-rossii?utm_campaign=Свежий+номер+«Ведомостей»+за+15+февраля&utm_medium=email&utm_source=vedomosti (Date of reference: 10 June 2018).

2 The St. Petersburg International Economic Forum – 2018: Main Investment Contracts. RBK, 24.05.2018. URL: https://www.rbc.ru/economics/24/05/2018/5b0673799a794716683ceea2?story=5af980859a7947b069a0a9d3 (Date of reference: 10 June 2018).

3 The St. Petersburg International Economic Forum – 2018: Main Investment Contracts. RBK, 24.05.2018. URL: https://www.rbc.ru/economics/24/05/2018/5b0673799a794716683ceea2?story=5af980859a7947b069a0a9d3 (Date of reference: 10 June 2018).

4 Optimization of Russian Foreign Investment Ties amid Worsening of Relations with the EU / edited by A.V. Kuznetsov. Moscow: IMIMEMO of the Russian Academy of Sciences, 2016, p.120.

5 Yu.K. Zaitsev. The Diagnostics of Foreign Direct Investment Inflow to Russia: From Theory to Practice // Economic Analysis: Theory and Practice. Moscow: Finansy i Kredit. 2015. No.19 (418). P. 18. URL: https://elibrary.ru/item.asp?id=23504374 (Date of reference: 10 June 2018).

trolling interest in the Belebeisky Dairy Plant (Russia's major cheese manufacturer) in the Republic of Bashkortostan in 2017[1]. In its turn, in August 2017 Auchan, French-based food retailer, opened up its first meat-producing plant in the Tambov Region. Backaldrin Kornspitz, an Australian-based producer of bakery products opened up its first plant at the Stupino Kvadrat Special Economic Zone (Moscow) on 13 October 2017[2].

As regards companies which were not affected by sanctions, the case for localization of production was a favorable macroeconomic situation in 2017: GDP growth, low inflation rate and appreciation of the rouble. In particular, Viesmann, a German-based company (heating installations) increased its output in Lipetsk by $17m[3], while Bionorica, a German-based pharmaceutical company started building production facilities worth euro 30m in the city of Voronezh in July 2017[4].

However, a number of European companies left Russia. Kesko, a Finnish-based retail holding declared its intention to sell a larger portion of its shops specializing on repair materials and goods for home to Leroy Merlin, a French-based company, because Kesko's competitive performance diminished as compared to that of Russian and foreign competitors[5].

As seen from the above examples, the localization strategy may facilitate the FDI inflow to the Russian economy. Note that local markets benefit the most from localization of production by foreign manufacturers in Russia because this process suggests support to local manufacturers through provision of new competences and technologies.

Regulatory measures which are currently discussed by the Russian Government may facilitate in future the positive FDI inflow dynamics. The latest initiatives include the following: simplification of imports of foreign raw materials for manufacturing of goods in Russia and subsequent exports thereof by means of exemption from customs duties and the VAT[6] and the proposal by the Ministry of Finance to reduce the severance tax for the Gazprom's joint-ventures and its foreign partners to retain foreign investors' interest in joint development of deposits in Russia[7].

In addition, one can expect growth in the FDI inflow to Russia through the amnesty of capital which is planned to be carried out via Eurobond mecha-

1 Nerala Cheese will Mature on French Capital. The Kommersant Daily. 25.10.2017. URL: https://www.kommersant.ru/doc/3448664 (Date of reference: 10 June 2018).

2 An Australian-Based Bakery Company Opened Up a Plant in the Moscow Region. TASS, Russia's Information Agency. 13.10.2017. URL: http://tass.ru/moskovskaya-oblast/4643972 (Date of reference: 10 June 2018).

3 In Lipetsk, the Viesmann Company opened up a new plant URL: http://russiaindustrialpark.ru/news/v-lipecke-otkrylsya-novyy-zavod-kompanii-vissmann (Date of reference: 10 June 2018).

4 Bionorica, a German-based company, started building a plant near the city of Voronezh. RIA Novosti, 10.07.2017. URL: https://ria.ru/economy/20170710/1498223844.html (Date of reference: 10 June 2018)

5 Kesko Has Decided Not to Sell Products In Russia . The Vedomosti Daily, 26.10.2016. URL: https://www.vedomosti.ru/business/articles/2016/10/26/662433-kesko-rossii (Date of reference: 10 June 2018)

6 The Government is Going to Improve Export Conditions for Foreign Investors. The Vedomosti Daily. 31.10.2017. URL: https://www.vedomosti.ru/economics/articles/2017/10/31/739940-pravitelstvo-uluchshit-usloviya-eksporta (Date of reference: 10 June 2018).

7 The Cazprom's Partners Get a Discount for Complication. The Vedomosti Daily, 09.11.2017. URL: https://www.vedomosti.ru/business/articles/2017/11/08/740861-partneri-gazproma-skidku (Date of reference: 10 June 2018).

nisms in 2018 because of the new western sanctions[1], as well as establishment of offshore zones in Russia[2]. Such an option can become an effective mechanism of protection against risks and facilitate return of capital to Russia without taxes being paid.

However, the current policy of countersanctions entails a number of risks to foreign investors. So, the introduction of a criminal liability for compliance with sanctions against Russia can be attributed to the Russian investment climate's negative factors which facilitate the outflow of foreign companies' capital.

1 The Authorities Have Decided to "Make Money" on Toughening of Sanctions: A New Amnesty is Planned The Vedomosti Daily. 24.12.17. URL: https://www.vedomosti.ru/economics/articles/2017/12/25/746345-zarabotat-na-sanktsii?utm_campaign=Свежий%20номер%20«Ведомостей»%20за%2025%20декабря&utm_medium=email&utm_source=vedomosti (Date of reference: 10 June 2018).

2 The Russian Authorities are Going to Establish Offshore Zones to Help Oligarchs against Whom Sanctions were Imposed. The Vedomosti Daily. 10.04.2018. URL: https://www.vedomosti.ru/economics/articles/2018/04/10/764372-ofshori-oligarham?utm_campaign=newspaper_10_04_2018&utm_medium=email&utm_source=vedomosti (Date of reference: 10 June 2018).

4. THE BOND DEBT IS GROWING AT ADVANCED RATE

M.Khromov, E.Khudko

Early in 2018, growth rates of bank lending to non-financial institutions are gradually growing. The market of domestic bonded loans is building up its positions in the total funding of the real sector of the Russian economy. Issuers from the oil and gas sector occupy the leading position there.

According to the results of Q1 2018, the overall debt of non-financial institutions on loans of the domestic financial market[1] amounted to Rb 32.7 trillion. A larger portion of the internal debt of the non-financial sector is still made up of bank loans. However, the unit weight of bonded loans keeps growing. Let us consider in detail how these two main segments of the financial market were developing.

Banks' lending to corporate customers demonstrates quite moderate dynamics. In 2017, the non-financial sector's volume of debt on bank loans did not virtually change (an increase of the mere 0.4%). In Q1 2018, the lending dynamics sped up somewhat and the relevant debt rose by 1.9%.

In the past few years, there was a trend of replacing the foreign currency debt by the ruble-denominated one. So, the debt of non-financial institutions on ruble loans increased by 3.5% in 2017 and by another 3.6% in Q1 2018. The debt on bank loans in foreign currency decreased in US dollar terms by 4.7% and 3.6% in 2017 and Q1 2018, respectively. Amid appreciation of the ruble, the ruble equivalent of loans in foreign currency is decreasing at a faster rate. As a result, the share of foreign currency loans in the total volume of bank loans to non-financial institutions fell from 24.1% early in 2017 to 20.4% at the end of Q1 2018.

Throughout 2017, borrowings by corporate issuers[2] on the Russian domestic bond market demonstrated positive trends which prevailed in the beginning of 2018, too. (*Fig. 1*). More importantly, despite a traditional seasonal decline on the market early in the year growth in the debt in Q1 2018 happened to be 34% higher as compared to the relevant index of Q1 2017. As a result, the overall corporate debt as of the end of Q1 2018 became record high (nearly Rb 6.7 trillion) in the entire history of the bond market of Russia.

However, it is to be noted that growth in bond debt was

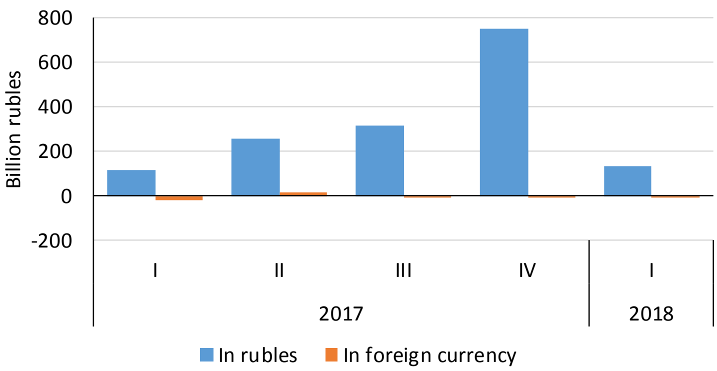

Fig. 1. Growth in the volume of bonded loans issued by non-financial institutions (quarter on quarter, %)
Source: The Central Bank of Russia, own calculations.

1 Bank loans and bonded loans.
2 Without financial institutions not taken into account.

driven by issues made in the national currency (from the beginning of 2017 till the end of Q1 2018 the ruble bond market increased by more than Rb 1.5 trillion). The debt on foreign currency bonds whose share amounts to less than 5% of the overall volume of the corporate segment of the domestic bond market has remained at the same level during the past few quarters. Minimum changes were completely justified by foreign exchange rate fluctuations. So, replacement of external foreign currency borrowings by domestic foreign currency issues, which process was highly evident in 2016, came to a halt.

On the back of active growth in bonded loans amid stagnation of bank lending, the share in debt financing of the non-financial sector of the Russian economy keeps growing (*Fig. 2*). Early in 2017, the domestic bond market accounted for 16.8% of the overall internal debt of non-financial institutions, while following the results of Q1 2018 the index exceeded 20%. Explosive growth in bonded loans largely replaced shrinking lending in foreign currency.

What factors were behind rapid growth in bonded loans? In 2017, the maximum volume of placements traditionally fell on Q4. However, as seen from the analysis of the pattern of initial offerings and bond income, the situation was not quite classical. According to the data[1] presented in *Fig. 3*, the peak value in Q4, as well as quite a high offering volume in Q 3 (as compared to the relevant period of 2015 and 2016) were justified by entry of the PAO NK Rosneft, a major issuer, to the primary bond market. In the abovementioned periods, the volume of funding attracted by the PAO NK Rosneft on the bond market amounted to nearly a half of the overall volume of issues placed by other corporate issuers, while

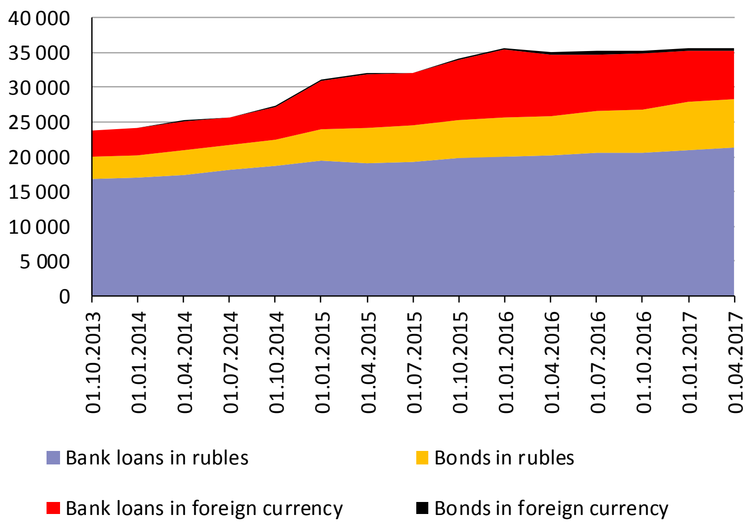

Fig. 2. The volume of debt of non-financial institutions on bank loans and domestic bonded loans, billion rubles
Source: The Central Bank of Russia, own calculations.

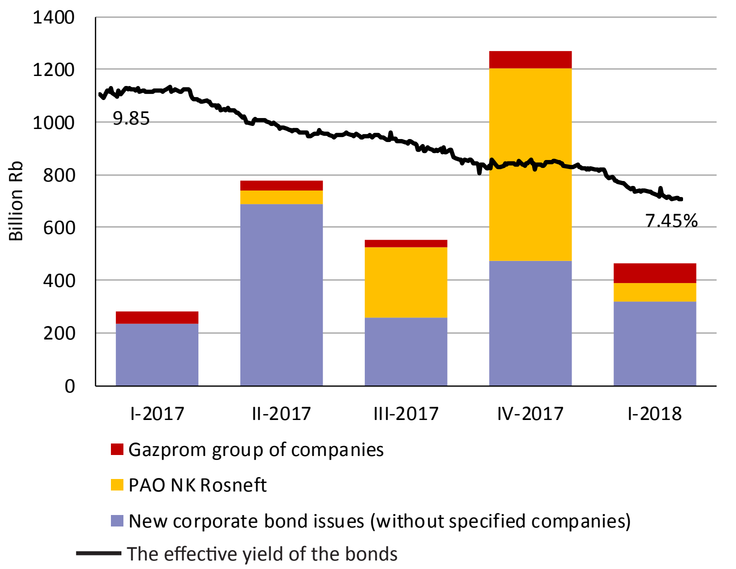

Fig. 3. Dynamics of the effective income of bonds included in the IFX-Cbonds index and the volume of placement of new ruble-denominated bond issues by financial and non-financial institutions
Source: Cbonds, an information agency, own calculations.

1 The statistics presented does not take into account short-term commercial papers issued by the VTB and the Vneshekonombank with a maturity of 1 to 40 days.

for five quarters the company's share was equal to 1/3 of the total volume of new bonded loans. The second largest volume of funding was attracted on the market by the Gazprom group of companies, however its share of placements for five quarters was less than 10%; the share of other major market players which managed to place over Rb 100bn worth of bonds in the above-stated period did not exceed 5%.

So, if one takes a look of the dynamics of the primary market, except for the offerings by the NK Rosneft, the seasonal factor is not quite explicit at the end of the year, while the placement volumes in Q3 fell nearly to the level of the relevant period of the crisis 2014.

Note that a drop in issuers' activities on the primary market took place despite consistent cuts in interest rates. This was caused by a number of external factors. In H2 2017, the market was affected by depreciation of the ruble and prices of oil, expansion of US sanctions and a statement by the Central Bank of Russia on gradual exclusion from the Lombard bond list of most financial institutions and introduction of tougher requirements to other issuers' securities. Due to the above, numerous issuers (particularly new market players) made up their mind to postpone their initial offerings. During that period, only large and trustworthy issuers could place their initial offerings on favorable terms. However, the negative effect subsided by the end of the year and as early as January 2018 the activities on the primary bond market revived and the earlier postponed offerings were placed.

In addition, a few foreign currency issues worth aggregately about $1.5bn have been placed on the market since the beginning of 2017. The largest offerings were carried out by the Vneshekonombank in Q2 2017 ($550m) and the PAO State Transportation and Leasing Company in Q3 2017 ($170m). In addition, the Alfa Bank placed euro 20m worth of bonds, the only offering in euro on the Russian market.

So, as in previous years[1] a considerable effect on the Russian bond market has been made by the NK Rosneft, a major market borrower. However, the Russian non-financial sector keeps increasing the share of bonded loans in the borrowed funds pattern even without the NK Rosneft taken into account.

1 M.Yu. Khromov and E.V. Khudko. Corporate Borrowings in 2014–2016: The Bond Market is Gaining in Importance // The Economic Development of Russia. 2017. No. 6.

5. REGIONS' BUDGETS: REVENUES AND EXPENDITURES RISING WITH TAX BURDEN ON LOWER-REVENUE SUBJECTS OF RUSSIA

A.Deryugin

Q1 2018 saw relatively high growth rates in regions' revenues and expenditures. Regions with lowest revenues posted relatively slow growth rates in revenues for two straight years, thereby mounting their debt burden and reflecting further differentiation in the development of Russia's territories.

Revenues

At end-Q1 2018, consolidated budgets of subjects of the Russian Federation increased 6.9%, surpassing inflation during the same period (102.2% in Q1 2018 relative to Q1 2017). Sixty nine regions saw their revenues increase in Q1 2018 over the previous year's first quarter, and the revenues in 65 regions outpaced the inflation rate, due to high growth rates in revenues in January–February 2018, 113.0% and 116.2%, respectively, over previous year's January and February. March 2018 saw substantially slower growth pace (100.5%) relative to March 2017 (*Fig. 1*) possibly on the back of coming presidential election requiring extra budget expenditure in the pre-election months, and therefore some transfers to the budget were deferred from March until a later period.

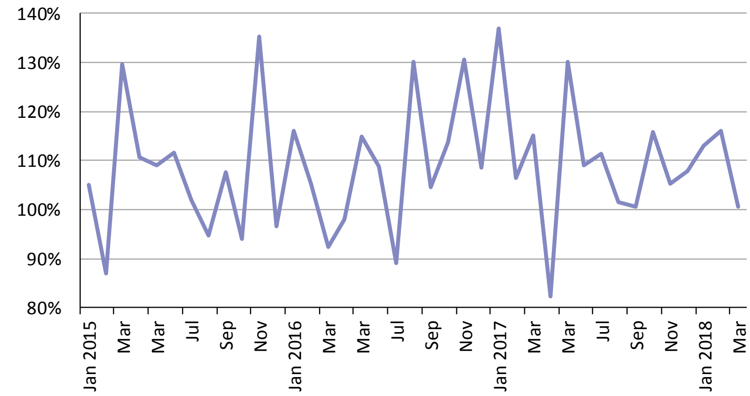

Fig. 1. Growth rates of total consolidated budget revenues of subjects of the Russian Federation, % change from the same period previous year
Source: calculations are based on data released by the Federal Treasury of Russia.

Among major sources of revenues that posted high growth

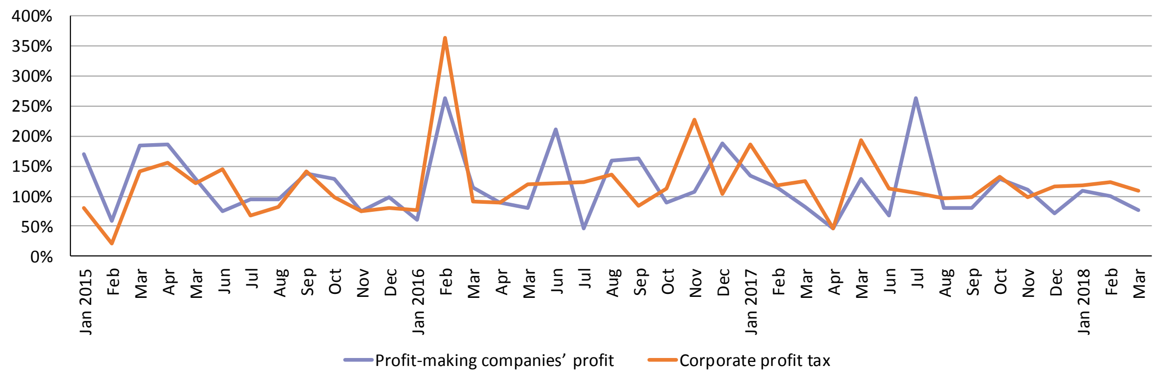

Fig. 2. Growth rates of corporate tax revenue inflows to consolidated budgets of subjects of the Russian Federation and profit-making companies' profits, % change from the same period previous year
Source: calculations are based on data released by the Russian Federal Treasury and by Rosstat.

rates in January–February 2018 (over the same period previous year) and then slowed in March were the corporate profit tax (117.9%, 124.1% and 109.1%, respectively), taxes on aggregate income (111.2%, 129.9% and 99.7%, respectively), corporate property tax (130.1%, 106.7% and 67.3%, respectively), as well as transfers out of the federal budget (109.5%, 117.2% and 91.5%, respectively).

In Q1 2018, corporate profit taxes (112.1% relative to Q1 2017) and personal income taxes (114.0%) contributed most to the increase in revenues. However, the profit tax outpaced corporate profits over the entire Q1 2018 (*Fig. 2*). It's beyond doubt that this trend cannot continue for long; therefore, inflows of revenues from this tax to regions' budgets are expected to slow down over the next few months.

By contrast, revenues from excise duties as well as property taxes decreased by 98.5% and 81.2%, respectively.

Geographically, inflows from aggregate incomes to consolidated budgets of subjects of the Russian Federation were not uniform although it's worth noting that the first quarter saw them increase in a rather uniform manner.

The Urals Federal Okrug and the Far Eastern Federal Okrug were in the lead, with growth rates at 111.0% and 112.0%, respectively, among Russia's federal okrugs, whereas the Southern Federal Okrug moved to the bottom of the ranking, with a 99.5% growth. However, average values for a federal okrug are often influenced by one or two major regions, thereby failing to reflect the situation in the majority of the subjects inside the okrug. By way of illustration, 63% of the regions inside the "lagging" Southern Federal Okrug posted higher than 110% growth rates in budget revenues, while the average value across the regions was 31%. Excluding the effect of some territories on the picture as a whole and considering only the regions with growth rates surpassing the inflation rate, all the federal Okrugs posted close values varying within a range of 71% and 83%.

Relatively uniform growth rates of consolidated budget revenues of subjects of the Russian Federation was also seen in terms of regions' fiscal capacity. In terms of growth rates of tax and non-tax revenues of consolidated budgets, subjects with lowest revenues (with a 100.4% growth rate over the period in question) continued to trail behind wealthier regions (107.3% and 108.3%, respectively, for medium- and higher-revenue regions).

Preliminary data on regions' budgets outturn in the first four months of 2018 show recovery of high growth rates in revenues following the March decline.

Expenditures

In Q1 2018, consolidated budget expenditures of subjects of the Russian Federation increased at a pace of 108.4% over the same period previous year and mimicked in general the revenue dynamics: January, February and March saw expenditures increase at a pace of 114.9%, 109.6% and 103.9%, respectively, in line with the assumption that the presidential election contributed to more spending in January–February.

At end-Q1 2018, subjects of the Russian Federation of 78 regions saw their budget expenditure increase, of which 75 regions surpassed inflation over the same period.

In terms of expenditure (*Table 1*), there was some increase in spending on Nationwide Issues, Environmental Protection, Culture, and Healthcare. Cuts in expenditure on public debt servicing continued on the back of high proportion of federally funded loans in the debt structure and of incremental cuts in interest rates.

Table 1

BUDGET EXPENDITURE FUNCTIONAL BREAKDOWN

Type of budget expenditures	Change (Q1 2018 compared to Q1 2017), %	As a % of total expenditures	
		Q1 2017	Q1 2018
Budget expenditures, total	8.4	100.0	100.0
Nationwide Issues	12.7	6.3	6.5
National Defence	9.9	0.0	0.0
National Security and Law Enforcement	9.3	1.0	1.0
National Economy	8.6	14.0	14.0
Housing and Utilities	0.2	8.3	7.7
Environmental Protection	47.3	0.3	0.4
Education	8.6	28.0	28.1
Culture and Cinematography	20.0	3.6	4.0
Healthcare	14.5	7.9	8.4
Social Security Policy	6.9	26.0	25.7
Physical Culture and Sports	12.0	2.3	2.3
Mass Media	21.5	0.5	0.5
Public and Municipal Debt Servicing	-17.6	1.8	1.4

Source: calculations are based on data released by the Federal Treasury of Russia.

Equilibrium and public debt

At end-Q1 2018, the public debt owed by subjects of the Russian Federation was 2.2% down on a quarter-to-year basis and 0.7% from March of previous year, to Rb 2.26 trillion. The ratio of regions' debt (as of 1 April this year) to tax and non-tax revenues contracted from 30.0% to 27.8% (compared to the same period of 2017). This was largely due both relatively high growth rates in regions' budget revenues coupled with the Finance Ministry's policies aimed at encouraging regional authorities to adopt a tough fiscal policy.

The debt owed by higher- and medium-revenue regions was on the slide as well, both in nominal terms and relative to regions' budget revenues (*Figs. 3* and *4*). By contrast, the debt of lower-revenue regions ticked up on year-over-year basis; therefore, the trend towards higher tax burden on the regions (the ratio of regions' public debt to tax and non-tax revenues) may just as well continue into the end of the year.

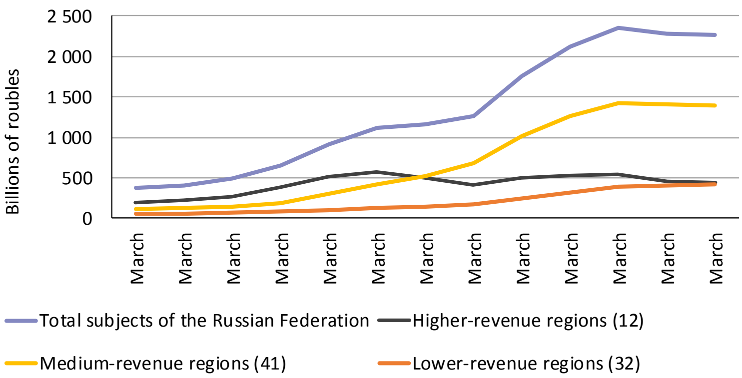

Fig. 3. Dynamics of public debt owed by subjects of the Russian Federation, Rb bn.
Sources: own calculations based on data released by the Ministry of Finance and the Federal Treasury of Russia.

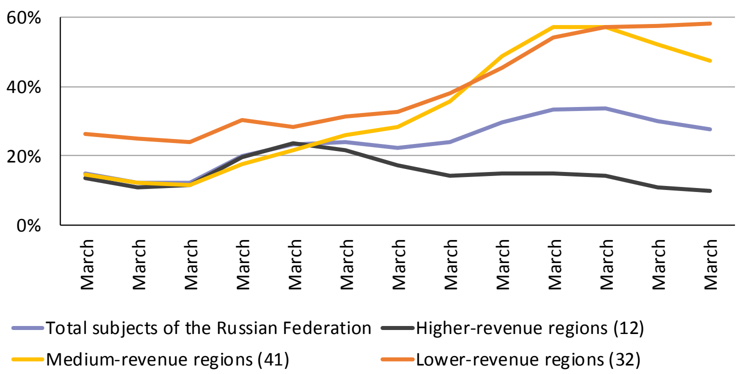

Fig. 4. Dynamics of public debt owed by subjects of the Russian Federation relative to tax and non-tax revenues, % of Russia

Sources: own calculations based on the data released by the Ministry of Finance and the Federal Treasury of Russia.

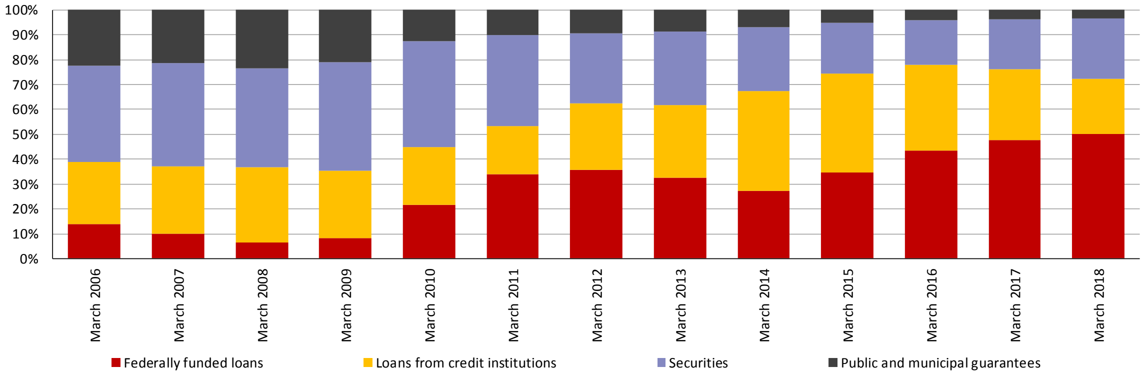

Fig. 5. Breakdown of public debt owed by subjects of the Russian Federation, %
Source: calculations based on the data released by the Ministry of Finance.

By the end of Q1 2018, federally funded loans continued to represent the majority (more than 50%) of the regions' public debt structure. Loans from credit institutions, which made up the majority of the regions' debt structure in 2014 and in 2015, had been outnumbered by securities rising for two straight years (*Fig. 5*).

Under the federally funded loans restructuring schedule, the amount and the proportion of federally funded loans in the overall amount of regions' debt commitments will contract over the longer term with a shift more towards securities and less towards bank loans. Regions' debt servicing costs will expectedly remain unchanged (or even decline) at the backdrop of falling interest rates and yields on securities.

The debt issue is far from over in many regions. For instance, the number of subjects of the Russian Federation with a public debt/revenue ratio above 100% remained 7 over the recent 12 months[1], with nearly 250% in the Republic of Mordovia. This is due to not only higher public debt but also slow growth rates of the Mordovia's budget revenues in Q1 2018.

From the perspective of balance as well as expenditure structure, further dynamics of regions' budgets will depend on the implementation of a new Presidential Executive Order of May in terms of the segregation of additional expenditure commitments between the Russian Federation and the regions.

1 End-March 2017 through end-March 2018.

6. PUBLIC SOCIAL FEELINGS PRIOR TO AND AFTER THE PRESIDENTIAL ELECTIONS

E.Avraamova, D.Loginov

Common perception of the stabilization of economic situation without any signs of its improvement dominated prior to the presidential elections. Social optimism has significantly grown during the elections. Expectations of the positive development have slightly diminished during one month following the elections.

Common perception regarding stabilization of economic situation increased in 2017. By the end of the year this point of view was shared by over a half of those surveysand this was the best indicator during the monitoring period[1]. At the same time, more than a third of respondents were less optimistic having assumed that in 2017 the situation has slightly (23.7%) or notably (12.5%) declined. Twelve percent (12%) of the respondents expected improvement by the end of the year. A considerable number of respondents had trouble to assess the prospects of economic development.

Thus, a significant number of respondents perceived the situation as stable though without any signs of its positive development.

According to the data obtained by 2017 year-end two groups of population popped up: the larger group consists of those who thought that crisis had been already overcome and the smaller group – of those who believed in its continuation. Representatives of these groups differ significantly by age: the younger respondents are, the more positive assessment they gave regarding the prospects of economic situation. Thus, the share of respondents at 35 who expect the deterioration of the situation come to 27% while respondents at 60 and older hit 44%. Other factors, such as level of education or type of the respondents' residential location did not provide such a significant impact on the nature of vision about the prospects of economic development.

The assessment of negative events in the economy that affected people personally have changed least of all during the whole period. The two-fold growth of those who have not been affected by crisis in comparison with 2015 could be attributed to positive social feelings. Their share accounted to 12.8% at the end of 2017 growing at 2% for the year.

March 2018 data, at the time of the presidential elections in Russia, reflected a slightly different picture when perception became visibly more optimistic. On one side, the number of those who thought that the situation deteriorated, fell by 10%, while those who believed in its improvement, significantly increased. The respective indicator reached 16%, the highest mark for the whole period of monitoring.

Social optimism was manifested also in the assessment of prospects for economic development: more than one quarter of respondents expect-

1 The RANEPA Institute for Social Analysis and Forecasting has conducted since 2005 a total of 8 annual rounds of the their survey Monitoring of Socio-Economic Situation and Perceptions of the Population.

ed fast improvement of the situation, and this was also the highest mark obtained over the last three years. At the same time, a number of pessimists who thought that improvement of the economic situation could be expected in two years at the earliest has decreased. However, a percentage of those who had trouble to assess the prospects, was still high (17.8%).

The March round revealed another important shift in the popular social perception , that is, the pressure of negative expectations related to personal economic risks has visibly, i.e. twice, decreased. In particular, it was evident that the share of working population, who expected employment risks, fell over a month. Then, the share of those who feared of a job loss decreased by 10%; a number of those who feared a wage cut and switch to part–time employment decreased by 7% and 8%, respectively; a number of those who feared the unpaid leave and delay in paying wages decreased by 10% and 10%, respectively (*Table 1*).

Table 1

THE SHARE OF RESPONDENTS SUBJECT TO EXISTING OR POTENTIAL EMPLOYMENT RISKS, ACCORDING TO SUBJECTIVE ASSESSMENT, % OF THOSE EMPLOYED

Employment risks	Number of respondents				
	March 2015	March 2016	March 2017	February 2018	March 2018
Job loss	30.5	37.6	35.5	32.1	21.5
Wage cut	49.3	53.2	44.3	37.5	30.7
Switch to part-time week	26.9	33.9	25.6	27.3	18.8
Unpaid leave	24.8	29.0	23.5	27.5	19.3
Delay in paying wages	— *	43.9	39.0	35.7	25.4
Switch to informal forms of remuneration	25.0	27.2	25.8	26.5	17.9

*Question not asked

Consequently, a number of those in the low risk zone exceeded half of the employed population in March 2018 for the first time during the period of monitoring. At the same time, 17% of those employed were placed in the high risk zone which was the smallest indicator compared to previous survey (*Fig. 1*).

People having high vocational education represented the largest share of those employed who did not expect any risks regarding their employment. They made up for the 2/3 of the respective group and only 13% of the university graduates felt those risks. Among those who faced maximum risks were people who had primary or secondary vocational education.

Citizens of major cities and metropolitan areas where employment opportunities were more diverse and widespread were least exposed to such risks while rural population felt the biggest risks.

Perception of the employment as well as the consumption issues significantly changed in March 2018. Respondents expressed their

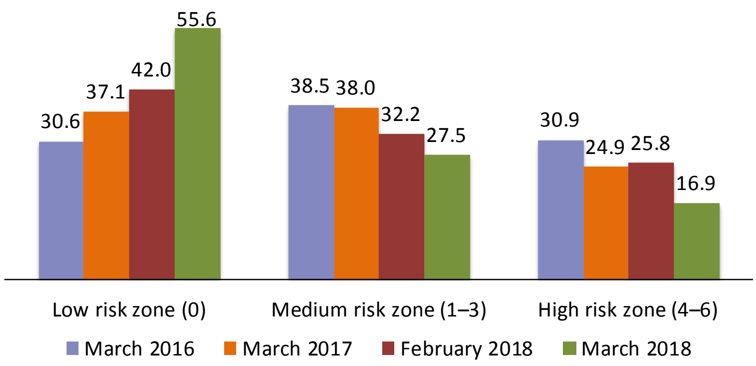

Fig. 1. Concentration of existing or potential employment risks, % of those employed

willingness to increase their consumption activity on all forms of expenditures for purchasing goods.

Thus, the March monitoring round reflected the optimistic spirit of electorate and their hopes for the fast improvement of economic situation. It was important to understand whether this spirit could be turned into a trend. The latest data of April 2018 showed that there was a kind of a slowdown of the optimistic attitude. Indeed, a number of respondents who observed improvement in the economic situation slightly (3.4%) decreased. At the same time, a group of respondents who saw slight or obvious decline moved up by 8%. Herewith, majority of the population, i.e. 53.7% vs 56.4% in March, still were of the opinion that economic situation did not change. Awareness on the prospects of economic development became more pessimistic: a group of those who expected improvement in two years at the earliest has increased by 12% compared to March.

Fears and risks in the employment area rose in April at the expense of three parameters: fears to job loss (+8.4%), risks related to delays in paying wages (+3.2%), switch to informal ways of remuneration (+5.5%). As for other positions, the level of negative expectations corresponds to the data of previous surveys.

Integral assessment of major risks in the employment sphere demonstrated that number of the employed in the low risk zone decreased by 5.6% within one month, while number of those in the high risk zone did not change. Thus, 5.6% of those employed moved up from the low risk to medium risk zone, that is to say, negative expectations became typical for them.

If the data of the March round demonstrated the popular willingness to increase consumption in different spheres, the April data showed that they still had such intentions only with regard to the expenses on education, and consumption risks slightly increased with regard to other types of goods.

Consequently, the period of the presidential elections reflected significant improvement of social feelings of the majority of Russian population in the wake of political rising tide. This gave grounds for hope that the main trend, that is, the focus of the majority on “negative stabilization” will make a difference, i.e. economic situation will be fixed without any signs of its development. These hopes have not been justified yet.

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