MONITORING OF RUSSIA'S ECONOMIC OUTLOOK:

TRENDS AND CHALLENGES OF SOCIO-ECONOMIC DEVELOPMENT

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TRENDS AND CHALLENGES OF SOCIO-ECONOMIC DEVELOPMENT

Two, virtually opposite, trends have developed in the Russian economy early in September. The former refers to disclosure of plans for launching new, mostly infrastructural, megaprojects, while the latter is that the Bank of Russia has recognized publicly that it may raise the key interest rate.

While both trends meet the requirements of economic reality, they raise certain concerns. Although the shortage of developed infrastructure is a self-evident fact, the majority of lobbied megaprojects suffer from a scarcity of convincing argumentation. Either investments (that are worth trillions of roubles) are planned against the backdrop of extremely precarious environment and rely upon the most optimistic of all possible projections, or it turns out that the ultimate effect of huge construction projects on the economy dies out as soon as such projects are completed.

Against this background any possible tightening of regulator's policy (following a period of its gradual easing) can hardly make it easier to raise funds in the internal market; this is what many called for amid restricted access to external money markets. The existence of opposite trends implies that publicly sponsored loans or direct government support for major projects will increase through inertia despite newly emerging financial risks. An example of Turkey, a country geographically adjacent to Russia, is an online demonstration of what credit pumping can ultimately bring about to a successful economy if the regulator is reluctant to make timely adjustments to its monetary policy (more specifically, to raise the key interest rate).

An expert analysis of threats the external debt of Russia might pose to its financial stability appears to be relevant in this context. Experts conclude that the Russian external debt as of 1 July 2018 was not more than \$50bn (non-residents reduced their holdings of Russian government bonds by nearly \$10bn because of concerns about new sanctions against Russia). The total debt owned by public administration bodies and the central bank stood at \$77bn, or 15% of total debt. However, since many Russian companies and banks with liabilities denominated in foreign currency are owned or controlled by the state, the external debt owned by the public sector is broadly estimated at \$255bn, or 49% of total debt.

The figures representing the external debt of Russia are positive, according to experts' estimates. As of the end of Q1, the ratio of external debt to GDP and exports of goods and services was equal to or less than 32% and 120%, respectively, which is considered insignificant at the international level. However, since Russia's external debt is a short-term debt, the ratio of external debt redemptions in the next year and GDP as well as exports of goods and services is 8% and 32%, respectively, indicating a fairly high degree of risk. However, since Russia holds substantial international reserves which are three times the amount of external debt redemptions due later in the year, Russia's external debt is acknowledged as stable enough and posing no threats.

At the same time, the experts note that non-resident investments can be the primary source of investment financing and economic growth. Stagnation of external borrowings over the past few years has been a negative sign showing both the reluctance of non-residents to invest in Russian companies amid slow economic growth and heightened geopolitical risks and a lack of new profit-making projects for which Russian economic agents would be prepared to borrow from abroad.

Our experts analysed key parameters of the H1'18 federal budget (hereinafter – "compared to the same period a year earlier") to note that budget revenues increased 1.8 p.p. of GDP while expenditure decreased by 1.2 p.p. The share of oil and gas revenues incoming at an outperforming pace reached 45.6% (compared to 40.4% a year ago). As a result, the federal budget ran a surplus of 1.9% of GDP (compared to a deficit of 1.0% of GDP a year earlier). The key parameters show positive dynamics from the perspective of maintaining fiscal sustainability, the authors conclude.

An expert analysis of regional budgets for H1 2018 concludes the same. Consolidated budget revenues of subjects of the Russian Federation increased overall by 9.7% (compared to the same period a year earlier) nearly across the board (at 80 subjects of the Russian Federation). The structure of revenues remained unchanged, while the structure of expenditure increased overall by 9.1%, including at 80 subjects of the Russian Federation. Concurrently, the public debt of subjects of the Russian Federation was reduced by 5.4% from the beginning of the year and by 2.1% to Rb 2.16 trillion from July 2017. Publicly sponsored loans still represent the biggest share of debt structure, but the share of securities and loans of credit institutions will increase down the line. However, regions with lowest revenues are still facing a heavy debt burden.

Guided by the results seen in the first seven months of 2018, the banking sector saw its profits decline a little mainly because of resumed growth in loan loss provisions. However, recovery of profits from regular banking operations apparently became the main positive trend for this sector. The main contributor was growth in the net interest income of banks. According to our experts, the dynamics of profits from regular banking operations will be governed till later in the year by previously seen factors such as key interest rate decisions of the central bank, the process of financial recovery of big banks, as well as the dynamics of rouble's exchange rate. If the central bank raises the key interest rate before the end of this year, then new loans in 2018 will nevertheless remain 2–3 p.p. lower than a year earlier, and the value of borrowings may increase because banks will compete for fundraising. Keeping the key interest rate unchanged till later in the year will most likely keep the developed structure of interest income unchanged without influencing the overall financial performance figures of the banking sector.

Our experts analyzed the implementation of presidential executive orders of 2012 in the social sector with regard to salary targets set for publicly sponsored industries. Based on the data for H1 2018, the experts conclude that the targets will be fulfilled later in the year across the country except at a few regions. This was due to, among other things, an increase in salaries through a one-time payment earlier in the year and an increase in the minimum salary level to equal the subsistence level. As a result, salaries in the public sector increased by 1.9 times in nominal terms (the average salary in the economy rose by 1.6 times) since 2012.

At the same time, our experts point to, for example, a sharp (more than a double) formal reduction in the number of junior medical staff in the health-care sector in the course of implementation of the presidential executive orders. This was due to not only layoffs but also reassignment of these personnel to the position of cleaners. In the end, the job description remained unchanged for this category of workers, but they fell outside the scope of the presidential executive orders and therefore were not eligible for salary increase. The experts also remind that switching to a new methodology contributed partially to the implementation of the presidential executive orders, which refers to the public sector as a whole. Since 2015 the average salary is estimated based on not only salaries of employees hired by organizations, but also those hired by individual entrepreneurs and natural persons. The average level of salaries in the country is reduced by 10–12% when these categories of workers is taken into account. This version is frequently used to assess the implementation of the presidential executive orders, while the old version remains the key measure for salaries level, including only employees hired by organizations.

1. RUSSIA'S EXTERNAL DEBT: GO THREATS TO STABILITY

P. Trunin

In 2018 Russia continues to reduce, since the 2014–2015 crisis, its external debt. An additional factor contributing to the reduction of debt to non-residents is that non-residents have reduced their holdings of OFZ bonds over fears of new sanctions against Russia. Therefore the today's level of external debt poses no threat to financial stability of the country.

Until 2008, Russia's economy was on the rise as the external debt piled up at a rapid pace. The accumulation of external debt was prevented by the global economic crisis of 2008–2009, which spurred a deep slump of prices for Russian basic export commodities and extensive capital outflow from Russia. The growth of external debt resumed in 2012–2014 although it was interrupted by a new crisis. The external debt has been reduced over the past two years by approximately $200bn (nearly by 30%) owing to a sharp decline in the rouble's exchange rate and debt redemptions amid reduced possibilities of acquiring new loans. The external debt is now equal to the decade-ago level (*Fig. 1*).

The biggest share of the Russian external debt is usually represented by debt owned by the private non-financial sector whose share has been increasing gradually: it was slightly higher than 50%, compared to what it is now (68%). This sector of economy acquires foreign financing predominantly through loans and deposits or debt liabilities to direct investors. The banking sector accumulates external debt mainly through current accounts and deposits representing nearly 90% of banks' total debt to non-residents.

Russia's external debt remained small throughout the entire period under review, and it was not more than $50bn as of 1 July 2018. Furthermore, in Q2 2018 non-residents reduced their holdings of Russian government bonds by nearly $10bn because of concerns about new sanctions against Russia.

However, what should be considered is that the state plays a large part in the Russian economy. Despite that Russia's external debt is formally insignificant, there is a considerable debt owned by companies with a government ownership stake of more than 50%. For instance, as of 1 April 2018, $72bn (69%) of $105bn of banks' external debt accrued to state-controlled financial institutions. The ratio for the non-financial sector was $107bn of $338bn (32%). The value for the banking sector is high because of dominant role of banks with public ownership.

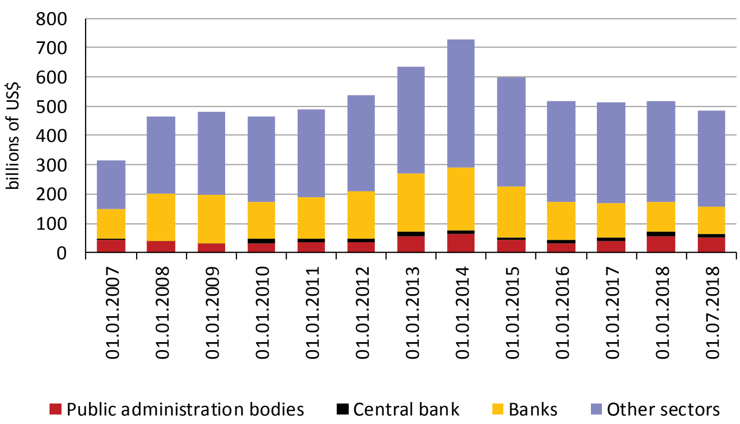


Fig. 1. Russia's external debt, 2007–2018

Source: Russia's central bank.

Thus, including state-controlled companies, the external debt of public sector is broadly estimated at $255bn, or 49% of total external debt compared with $77bn (15% of total debt) owned by public administration bodies and the central bank. On the one hand, this implies less risk premium – close to the country risk premium – payable by many big Russian companies. On the other hand, this debt structure should be considered when analyzing stability of the country's debt policy. External debt statistics is also a good illustration of increasing public ownership in the economy: the external debt of state-controlled companies accounted for 28% of total debt at the beginning of 2007 compared to 35% at the beginning of 2018.

An important feature of the debt is maturity. As of 1 April 2018, debt on demand represented $28bn of total external debt ($520bn), $89bn are payable within a year, $51bn mature in 1- to 2-year period and $284bn beyond a 2-year horizon. The redemption schedule for $67bn is either yet to be set, or is not existing. Bank of Russia's external debt is expectedly the shortest-term debt, and the longest term for redemption is envisaged for the external debt owned by public administration bodies: debt liabilities with a maturity beyond a 2-year horizon represent more than 93% of the total debt owned by the sector.

Analysis of the foreign exchange structure of external debt shows that rouble-denominated liabilities make up nearly a quarter of the external debt. This share underwent minor changes during the period under review, shrinking when the rouble depreciated, but increasing afterwards. Rouble-denominated liabilities play the most prominent role in the debt owed by public administration bodies, reaching 70%. This is due to substantial non-resident investments in Russian government bonds (OFZ) denominated in Russian roubles. Accordingly, rouble-denominated debt liabilities (excluding debt liabilities to direct investors) for the rest of institutional sectors varied between 18% for banks and 21% for the non-financial sector and 24% for debt liabilities of direct investment enterprises.

Analysis of the size and the dynamics of external debt includes a key issue of external debt stability because an excessive external debt and/or high debt servicing costs used to trigger crises in both developed and developing countries. However, these values remain good enough for Russia. For instance, as of the end of Q1, the ratio of external debt to GDP and exports of goods and services was equal to or less than 32% and 120%, respectively, which is considered insignificant at the international level, and demonstrates, given IMF[1] threshold values, an average degree of risk. However, since Russia's external debt is a short-term debt, the ratio of external debt redemptions in the next year and GDP as well as exports of goods and services is 8% and 32%, respectively, indicating a fairly high degree of risk. However, since Russia holds substantial international reserves which are three times the amount of external debt redemptions due during the year, Russia's external debt is acknowledged as stable enough and posing no threats.

At the same time it is important to note that non-resident investments can be the primary source of investment financing and economic growth. External borrowings may become necessary because of the need to meet the objective of increasing economic growth rates to a level higher than the worldwide average and limited internal sources of growth. Consequently,

1 https://www.imf.org/external/pubs/ft/dsa/

stagnation of external borrowings over the past few years has been a negative signal showing both the reluctance of non-residents to invest in Russian companies amid slow economic growth and heightened geopolitical risks and a lack of new profit-making projects for which Russian economic agents would be prepared to borrow from abroad.

2. THE FEDERAL BUDGET IN H1: REVENUES GROWTH AND SURPLUS

T. Tischenko

According to the results of H1 2018, federal budget revenues increased by 1.8 p.p. of GDP as compared to the relevant period of the previous year, while the share of oil and gas revenues rose from 40.4% to 45.6%. On the contrary, expenditures in relation to GDP fell by 1.2 p.p. As a result, in the first six months of this year the budget was administered with a surplus of 1.9% of GDP as compared to the deficit of 1.0% of GDP a year before.

According to the updated information of the Federal Treasury, in H1 2018 federal budget revenues rose by Rb 1,506.6bn or 1.8 p.p. of GDP (*Table 1*) as compared to the relevant period of the previous year. It was justified by growth of Rb 1,046.4bn (1.6 p.p. of GDP) and Rb 460.2bn (0.2 p.p. of GDP) in oil and gas revenues and non-oil and gas revenues, respectively. The share of the oil and gas component in the pattern of the federal budget revenues increased from 40.4% a year before to 45.6% owing to the speed-up of growth in oil and gas revenues which volume amounted to 71.8% of the forecasted annual values (48.2% in H1 2017). Non-oil and gas revenues amounted to 48.0% of the forecasted annual volume against 46.4% in January-June 2017.

In H1 2018, federal budget expenditures fell by 1.2 p.p. of GDP as compared to H1 2017 with comparable levels of cash administration of the budget (46.0% against 45.0%). In absolute terms, there was growth of Rb 166.1bn, including an increase of Rb 135.0bn in non-interest expenditures.

According to the results of H1 2018, the federal budget surplus amounted to 1.9% of GDP (Rb 902.6bn) as compared to the deficit of 1.0% of GDP (Rb 437.9bn) in the relevant period of 2017. Note that the non-oil and gas deficit decreased from 7.8% to 6.5% of GDP or by Rb 294.1bn.

Table 1

THE MAIN FEDERAL BUDGET PARAMETERS IN H1 2017–2018

Indicator	H1 2017			H1 2018			Deviation, H1 2018/2017	
	Billion Rb.	% of GDP	% of the actual volume	Billion Rb	% of GDP	% of the forecasted volume	Billion Rb	p.p. of GDP
Revenues, including:	7122.0	16.7	47.2	8628.6	18.5	56.6	1506.6	1.8
Oil and gas revenues	2888.6	6.8	48.2	3935.0	8.4	71.8	1046.4	1.6
Non-oil and gas revenues	4233.4	9.9	46.4	4693.6	10.1	48.0	460.2	0.2
Expenditures, including:	7559.9	17.8	46.0	7726.0	16.6	45.0	166.1	-1.2
Interest expenditures	327.6	0.8	46.1	358.7	0.8	43.4	31.1	0.0
Non-interest expenditures	7232.3	17.0	44.9	7367.3	15.8	46.7	135.0	-1.2
Surplus/Deficit	-437.9	-1.0		902.6	1.9		1340.5	2.9
Non-oil and gas deficit	-3326.5	-7.8		-3032.4	-6.5		294.1	1.3
*For reference only: GDP (in current prices, billion Rb)**	*42585*			*46587*				

*The preliminary estimate for H1 2017.

Sources: The Ministry of Finance, the Rosstat, the Federal Treasury and own calculations.

In general, in January-June 2018 tax revenues (*Table 2*) increased by Rb 1,528.8bn or 2.0 p.p. of GDP as compared to H1 2017. All the types of tax revenues saw improvement in the dynamics in nominal terms and in shares of GDP, except for domestic excises which volume decreased by 0.1 p.p. of GDP or Rb 20.4bn and import excises, which volume in shares of GDP did not change and was equal to 0.1% of GDP with growth of Rb 9.7bn.

Growth was primarily justified by the dynamics of the severance tax revenues. In H1 they increased by 1.2 p.p. of GDP or Rb 723.7bn as compared to the relevant period of 2017 with the actual budget administration of 74.9% of the forecasted annual volume. In H1 2018, revenues from foreign economic activities rose by 0.5 p.p. of GDP or Rb 340.7bn as compared to January-June 2017 with cash administration of 62.6% of the forecasted annual volume. The accelerated dynamics can be explained by substantial gaps in the estimates of the main macroeconomic parameters used in formation of the 2018 federal draft budget. Calculation of the forecasted volume of severance tax revenues and export duties on energy commodities was based on the global price of Urals oil of $43.8 a barrel with the Rouble/Dollar exchange rate of 64.7 roubles per $1. Actually, in January-June 2018 the average price of oil was equal to $68.83 a barrel ($50.30 in H1 2017), while the average value of the national currency in the same period amounted to Rb 59.3 per $1.

Table 2

THE MAIN TAX REVENUES TO THE FEDERAL BUDGET IN H1 2017–2018

Indicator	H1 2017			H1 2018			Deviation	
	Billion Rb	% of GDP	% of the actual volume	Billion Rb	% of GDP	% of the forecasted volume	Billion Rb	p.p. of GDP
Total tax revenues, including:	6491.0	15.2		8019.8	17.2		1528.8	2.0
Corporate profit tax	359.4	0.8	47.1	457.7	1.0	56.8	457.7	0.2
VAT on goods sold in the RF	1570.5	3.7	51.1	1752.6	3.8	52.6	1752.6	0.1
VAT on goods imported to the RF	910.8	2.1	44.1	1105.5	2.4	48.2	1105.5	0.3
Excises on goods manufactured in the RF	436.3	1.0	48.0	415.9	0.9	42.3	-20.4	-0.1
Excises on goods imported to the RF	31.9	0.1	40.8	41.6	0.1	45.2	9.7	0.0
Severance Tax	1955.5	4.6	48.1	2679.2	5.8	74.9	723.7	1.2
Revenues from foreign economic activities	1226.6	2.9	47.1	1567.3	3.4	62.6	340.7	0.5

Sources: The Federal Treasury (updated information) and own calculations.

Federal budget revenues from VAT on imported goods amounted to 2.4% of GDP, an increase of 0.3 p.p. of GDP or Rb 1,105.5bn as compared to January-June 2017. Actual revenues were equal to 48.2% of the forecasted annual volumes mainly owing to the difference between the forecasted and actual Rouble/Dollar exchange rate and a 13.4% growth in imports in monetary terms.

As regards tax revenues related to domestic production and demand, H1 2018 saw growth of 0.2 p.p. of GDP (Rb 457,7bn) and 0.1 p.p. of GDP (Rb 1752,4bn) in profit tax revenues and VAT revenues, respectively, as compared to the relevant period of 2017 with cash administration of 56.8% and 52.6% of the expected annual volumes, respectively. According to the updated information of the Rosstat, in five months of 2018 the balanced financial result increased by 20.7% as compared to the relevant period of 2017 and amounted to Rb 4,885.8bn. The highest growth of 3.3 times was observed in industries related to provision of housing and public utility services, while in the overall profit volume the mining industry and manufacturing accounted for 35.2% and 24.4%, respectively. Growth in domestic VAT revenues was driven by positive dynamics of manufacturing which amounted to 103.0% in H1 2018 on the relevant period of 2017.

In terms of functional classification of federal budget expenditures in H1 2018 as compared to the relevant period of 2017 (*Table 3*), the following changes can be pointed out:

- growth in expenditures in shares of GDP and in absolute terms was observed in respect of four budget items: Federal Issues (Rb 85.0bn), Education (Rb 84.6bn), Healthcare (Rb 51.2bn) and Inter-Budget Transfers (Rb 69.8bn);
- reduction of funding in shares of GDP took place in respect of the following three budget items: National Security and Law Enforcement (0.1 p.p. of GDP or Rb 51.8bn), National Economy (0.3 p.p. of GDP or Rb 40.0bn), Social Policy (1.2 p.p. of GDP or Rb 295.1bn);
- as regards other items, expenditures in shares of GDP did not change.

A relatively low level of cash administration of the budget in H1 2018 and H1 2017 was observed in respect of the following sections: National Economy (33.9%), Culture and Cinema (39.2%), Healthcare (39.4%) and Physical Training and Sports (36.9%).

Table 3

FEDERAL BUDGET EXPENDITURES IN H1 2017–2018

	H1 2017			H1 2018			Deviation	
	Billion Rb	% of GDP	% of the actual volume	Billion Rb	% of GDP	Cash administration	Billion Rb	p.p. of GDP
Total expenditures, including:	7559.9	17.8	46.0	7726.0	16.6	45.0	166.1	-1.2
Federal issues	459.5	1.1	39.5	544.5	1.2	37.8	85.0	0.1
National Defense	1355.1	3.2	47.5	1483.3	3.2	49.5	128.2	0.0
National Security and Law Enforcement	808.0	1.9	42.1	859.8	1.8	41.4	51.8	-0.1
National Economy	863.7	2.0	35.0	823.7	1.8	33.9	-40.0	-0.3
Housing and Public Utilities	61.9	0.1	51.8	76.9	0.2	50.6	15.0	0.0
Environment Protection	55.9	0.1	60.6	66.1	0.1	70.2	10.2	0.0
Education	318.2	0.7	51.7	402.8	0.9	55.5	84.6	0.1
Culture and Cinema	37.3	0.1	41.6	42.0	0.1	39.2	4.7	0.0
Healthcare	174.2	0.4	39.6	225.4	0.5	40.8	51.2	0.1
Social Policy	2633.7	6.2	52.7	2338.6	5.0	49.8	-295.1	-1.2
Physical Training and Sports	28.7	0.1	29.9	24.6	0.1	36.9	-4.1	0.0
Mass Media	31.6	0.1	38.0	35.6	0.1	42.7	4.0	0.0
State Debt Servicing	327.6	0.8	46.1	358.7	0.8	43.5	31.1	0.0
Inter-Budget Transfers	374.2	0.9	47.3	444.0	1.0	48.1	69.8	0.1

Sources: The Federal Treasury, own calculations.

As of 1 July 2018, the state internal debt amounted to Rb 8,898.6bn, an increase of Rb 209.0bn (0.45% of GDP) on the index of the beginning of the year, while the state foreign debt increased by $1,132.9m to $50,960.2m.

From the beginning of the year, the overall volume of the National Welfare Fund in the rouble equivalent rose by Rb 1,086.3bn to Rb 4,839.2bn, including Rb 906.7bn worth of additional oil and gas revenues.

According to the results of Q1 2018, the dynamics of the main federal budget parameters were positive in terms of budget stability in the mid-term period.

3. REGIONAL BUDGETS: GROWTH IN REVENUES AND DECREASE IN THE DEBT BURDEN

A.Deryugin

According to the results of H1 2018, the growth rates of revenues of consolidated budgets of constituent entities of the Russian Federation largely exceeded the current level of the rate of inflation, so, at year-end most regional and local budgets can expect growth in their real incomes. A recent decrease in the debt burden of the less well-off constituent entities is another evidence of the financial situation getting back to normal at the regional level.

Revenues

According to the results of H1 2018, revenues of RF constituent entities' consolidated budgets rose by 9.7%, which value is higher than the consumer price index in the same period (102.3% in June 2018 on June 2017). In 80 regions, consolidated budget revenues exceeded the level of H1 2017, while in 78 regions out of that number revenue growth rates happened to be higher than the rate of inflation. The highest growth was observed virtually throughout all six months. Only in March growth rates turned out to be somewhat lower, that is, 100.5% on March 2017. Also, volatility of monthly growth rates of budget revenues, which was typical of regions in the past few years subsided (*Fig. 1*) and, consequently, administration of budgets has become more predictable this year.

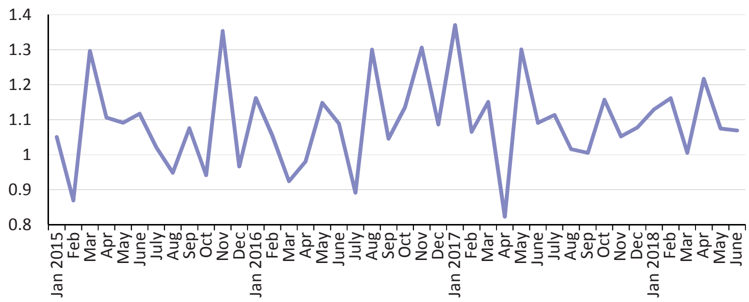


Fig. 1. Growth rates of the total volume of consolidated budget revenues of RF constituent entities on the relevant period of the previous year, %
Source: calculations based on the data of the Federal Treasury.

In January-June 2018, the individual income tax, aggregate income tax, corporate property tax, as well as inter-budget transfers from the federal budget demonstrated high growth rates of tax revenues (111.7%, 117.8%, 113.2% and 111.1%, respectively) as compared to the relevant period of the previous year.

The pattern of revenues of RF consolidated budgets did not change much: in H1 2018 the main sources of revenues were still the corporate profit tax (27.5% of the revenues) and the individual income tax (29.5%).

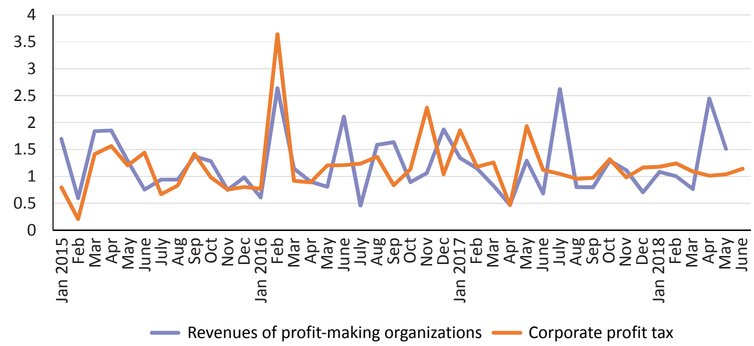


Fig. 2. Growth rates of corporate profit tax revenues to consolidated budgets of RF constituent entities and revenues of profit-making organizations, % change compared with the corresponding period of the previous year
Source: calculations based on the data of the Federal Treasury and the Rosstat.

As per the results of six months of 2018, among federal districts the leaders as regards revenues growth rates were the Urals Federal District (117.4%), the Siberian Federal District (111.2%) and the North-West Federal District (111.0%), while the Central Federal District with the growth rates of 107.5% was far behind. The above indicators point to some uniformity of growth rates of regions' budget revenues.

Also, the differentiation between better-off and worse-off constituent entities has somewhat shrunk: growth in consolidated budget revenues of 12 highly well-off regions (with a fiscal capacity above 1) which did not receive equalization transfers in 2018 amounted to 108.8% in H1 2018 as compared to H1 2017, while that in 41 medium well-off regions (with a fiscal capacity of 0.6 to 1) and 32 worse-off regions was equal to 109.9% and 112.3%, respectively.

At the same time, as regards growth rates of fiscal and non-fiscal revenues of consolidated budgets worse-off constituent entities (with revenues growth rates of 105.7%) still lag behind better-off constituent entities (109.3% and 110.5% with highly well-off regions and medium well-off regions, respectively). This trend has prevailed for the past two years and shows inequality in development between Russia's different regions.

Expenditures

In H1 2018, growth rates of expenditures of consolidated budgets of RF constituent entities amounted to 109.1% on the relevant period of 2017, which value is in line with growth rates of budget expenditures. Growth in consolidated budget expenditures was observed in 80 regions, while in 75 regions out of that number it exceeded the rate of inflation. From among the remaining 10 regions whose expenditures happened to be below the rate of inflation, six regions are situated in the Privolzhsky Federal District which situation explains the lowest expenditure growth rates of this federal district (100.8%) among Russia's other federal districts.

Table 1

THE FUNCTIONAL PATTERN OF EXPENDITURES

Item of budget classification of expenditures	Growth (6 months of 2018 on 6 months of 2017), %	The share in the total volume of expenditures, %	
		6 months of 2017	6 months of 2018
Budget expenditures, total:	109.1	100.00	100.00
Federal issues	112.6	6.12	6.31
National defense	105.0	0.04	0.03
National security and law enforcement	117.1	0.96	1.03
National economy	108.9	16.97	16.93
Agriculture and fishing industry	94.6	2.64	2.29
Transport	116.4	4.36	4.65
Public road system (road funds)	107.1	6.13	6.02
Housing and public utilities	100.9	8.01	7.41
Environment protection	145.5	0.23	0.31
Education	110.1	29.00	29.26
Culture and cinema	120.2	3.55	3.91
Healthcare	113.8	7.64	7.97
Social policy	108.4	23.07	22.92
Physical training and sports	103.2	2.43	2.30
Mass media	115.3	0.43	0.45
State and municipal debt servicing	81.9	1.55	1.16

Source: calculations based on the data of the Federal Treasury.

In H1 2018, the functional pattern of expenditures of RF constituent entities did not change much as compared to the relevant period of 2017 (*Table 1*). Reduction of expenditures on servicing of the state debt is related to growth in the share of public budget loans in the pattern of state and municipal debts and a gradual reduction of interest rates in the economy.

Equation and the State Debt

According to the results of H1 2018, the state debt of constituent entities of the Russian Federation decreased by 5.4% and 2.1% to Rb 2.16 trillion as compared to the beginning of the year and June 2017, respectively. Reduction of regions' state debt has been observed for two years in succession. By preliminary estimates, the ratio of regions' debts (as of 1 July 2018) to their fiscal and non-fiscal revenues decreased (as compared to the same period of 2017) from 29.4% to 26.3%. Such a situation was largely driven by relatively high growth rates of regional budgets' own revenues and restrictive measures taken by the Ministry of Finance of the Russian Federation to motivate regional authorities to carry out an austerity budget policy.

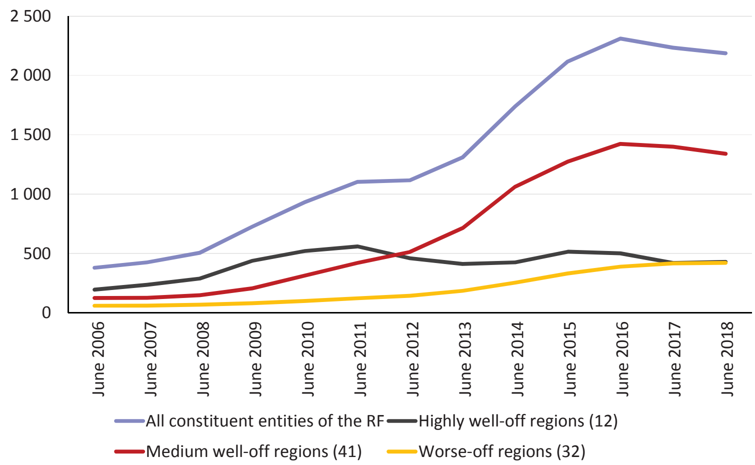


Fig. 3. Dynamics of the state debt of RF constituent entities, billion Rb

Source: calculation based on the data of the Ministry of Finance of the Russian Federation and the Federal Treasury.

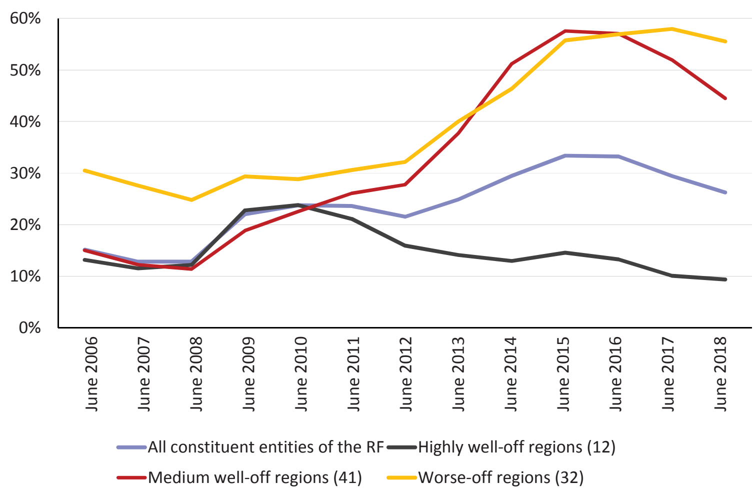


Fig. 4. Dynamics of correlation between the state debt of constituent entities of the RF and fiscal and non-fiscal revenues, %

Source: calculations based on the data of the Ministry of Finance of the Russian Federation and the Federal Treasury.

The ratio of regions' debt to regional budget revenues is declining (*Fig. 3* and *Fig. 4*). Such dynamics were untypical of worse-off regions, however, a high level of the debt burden still prevails in them.

By the end of H1 2018, in the pattern of regions' state debt public budget loans still prevailed. Despite restrictions imposed on utilization of the above instrument from 1 January 2018, the share of such loans remains at the maximum level (over 51%). Loans of credit institutions which occupied leading positions in the regional debt pattern in 2014–2015 are gradually replaced by securities whose share has been growing for two years in succession (*Fig. 5*).

In the short-term prospect, the pattern of regions' state debt is likely to change. Gradual repayment of public budget loans in compliance with the restructuring schedule and moratorium on extension of new ones will be

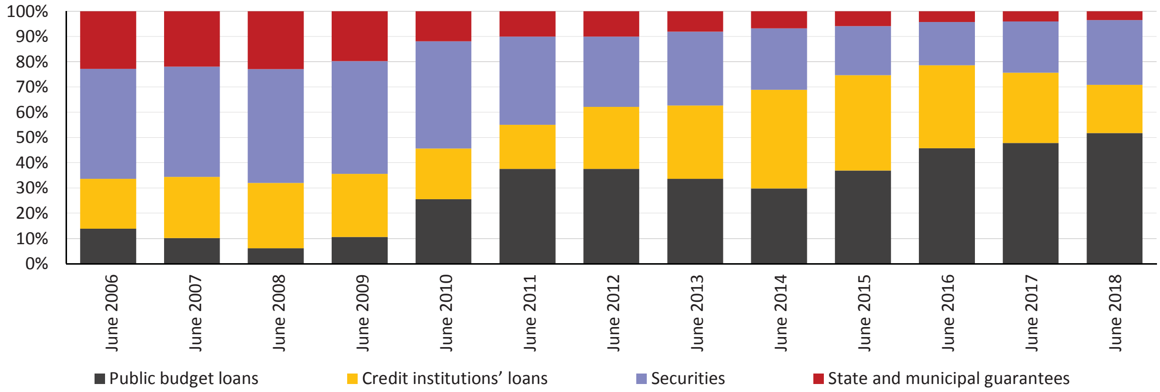


Fig. 5. The pattern of the state debt of constituent entities of the RF, %

Source: calculations based on the data of the Ministry of Finance of the Russian Federation.

accompanied by growth in the share of securities and credit institutions’ loans. In its turn, the dynamics of regions’ state debt will be largely defined by distribution of expenditure obligations and additional financial resources between the Federation and regions within the frameworks of fulfillment of the President’s Decree of May 2018.

4. BANKING SECTOR: BALANCE SHEET PROFITS DECLINE

M.Khromov

Balance sheet profits declined markedly in January-July 2018 compared to the same period of 2017 mainly because of resumed growth in loan loss provisions. A positive factor was represented by growth in net interest income and in profits from regular banking operations.

In the first seven months (January through July) of 2018, the balance sheet profit of the Russian banking sector reached Rb 776.2bn as the annualized return on assets (ROA) and return on equity (ROE) stood at 1.5% and 14.9%, respectively.

The financial performance of banks decreased by Rb 150bn from what was seen during the same period a year earlier. The banking sector profitability declined markedly as well. The previous year's ROA and ROE of the banking sector stood at 2.0% and 19% year-over-year, respectively. The financial performance of banks improved in general in 2018 compared to 2017 when the annualized ROA and ROE were only 1.0% and 9.4%, respectively.

As to the components of the banking sector's financial performance (*Fig. 1*), profits from regular banking operations[1] in January-July 2018 reached Rb 1359bn, loan loss provisions increased Rb 582bn, the loss from revaluation of foreign currency accounts was close to zero.

The following are changes seen in the structure of financial performance of the banking sector compared to the previous year's period.

The main positive trend was recovered profitability of regular banking operations. Profits from regular banking operations increased Rb 250bn, or by 22% in nominal terms, over the same period a year earlier (2017). Accordingly, the profitability of regular banking operations increased relative to bank assets from 2.4% in the first seven months of 2017 to 2.7% in the same period of 2018.

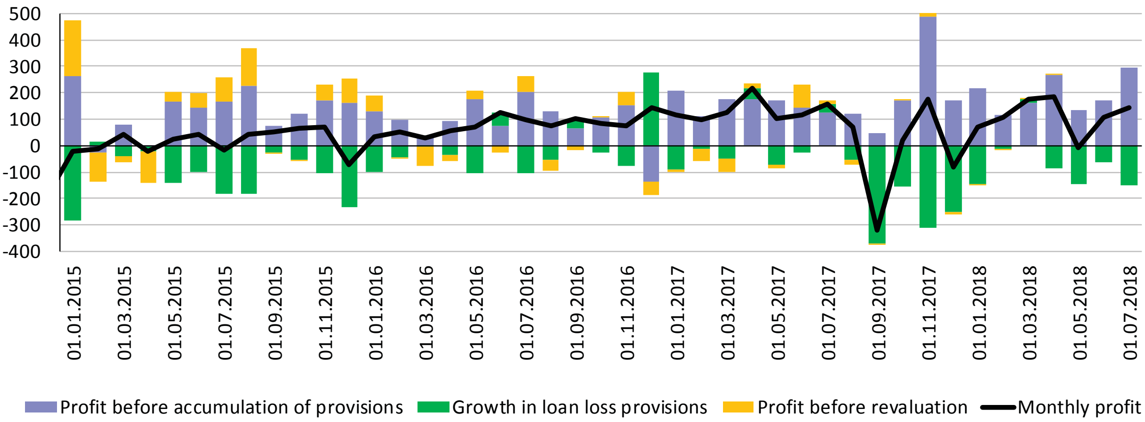


Fig. 1. Principal components of banks' monthly profit, billions of rubles

Source: Bank of Russia.

1 Profit less operations with reserves and revaluation of foreign currency accounts.

The decline in bank profits in the sector, as recognized in banks' official financial statements, was due to accelerated accumulation of bank provisions for loan loss and other types of assets. This indicator more than tripled (Rb 183bn to Rb 582bn) compared to the same period of 2017. And this is in stark contrast to the dynamics of provisions in the first quarter when the dynamics of quality of bank assets was better than a year earlier. The positive trend of previous year, when there was no increase in provisions, was followed by rapid growth in provisions, showing that serious problems continue to face the quality of bank assets. As a result, the ratio of accumulated provisions to aggregate bank assets has been remaining at a record level of 8.5% over recent months. Another point to note is that it is the sharp increase in loan loss provisions in H2 2017 that triggered substantial decline in bank profits. This was attributed to the beginning of resolution of some big private banks[1] that detected a considerable amount of non-performing assets. At the end of 2017, the total amount of accumulated loan loss provisions in banks reached a record high of Rb 7 trillion or 8.1% of total bank assets.

The principal factor contributing to higher profitability of regular banking operations in Q2 2018 was the increase in net interest income of banks. The decline in interest rates at that period affected more the volume of funds raised than of funds invested. Overall, in H1 2018 the net interest income of banks reached Rb 1084bn (compared to Rb 941bn a year earlier). Furthermore, the decline in interest rates affected both interest income and interest costs. In H1 2018, the interest income of the banking sector fell Rb 80bn to Rb 2698bn compared to H1 2017. Interest costs dropped at a noticeably more rapid pace, by Rb 224bn to Rb 1614bn.

In the offing, the dynamics of bank profits will be driven by previously seen factors till later in the year, such as the interest rate policy of the Bank of Russia, the processes of financial recovery of big banks, as well as the dynamics of ruble's exchange rate. In particular, the dynamics of profits from regular banking operations will be governed by key interest rate decisions of the Bank of Russia. If the central bank raises the key interest rate before the end of this year, then new loans in 2018 will nevertheless remain 2–3 p.p. lower than a year earlier, and the value of borrowings may increase because banks will compete for fundraising. Keeping the key interest rate unchanged till later in the year will most likely keep the developed structure of interest income unchanged without influencing the overall financial performance figures of the banking sector.

1 Otkritie FC., Binbank and Promsvyazbank.

5. IMPLEMENTATION OF THE PRESIDENT'S MAY 2012 DECREES: CONSEQUENCES FOR THE PUBLIC SECTOR

M.Lopatina, V.Lyashok

In early 2018, growth in wages and salaries in Russia was related to a substantial increase in the labor remuneration of employees in education and healthcare. Such an increase was feasible as a result of implementation of the President's May 2012 Decrees which set targets as regards wages and salaries of the public sector's employees. According to the data of January-June 2018, this objective has been achieved, except for individual regions.

In early 2018, there was a substantial growth in wages and salaries: in Q1 2018 this index grew by 10.2% in real terms as compared to the Q1 2017. The dynamics was largely driven by changes in labor remuneration in education and healthcare. In Q1 2018, growth in wages and salaries in nominal terms amounted to 17.4% and 30.7% in education and healthcare, respectively, as compared to the relevant period of the previous year. Substantial growth in wages and salaries was observed with employees of libraries, archives, museums and other cultural facilities (a 35.4% growth over that period) and R&D entities (19.4%). However, the number of employees at such institutions is not very high: aggregately less than 1 million persons. At the same time, over 5 million persons and 4 million persons were employed in the education sector and the healthcare sector, including social services, respectively, that is, totally over 14% of all those employed.

High growth rates of wages and salaries in the public sector – they were higher than in the private sector – make the situation different this year from that seen in 2016–2017 when wages and salaries in education and healthcare grew at a slower rate than in other sectors (*Fig. 1*). In 2018, the level of remuneration in the above sectors happened to be the maximum one in the past two decades as compared to the average pay across the country.

As seen from the monthly dynamics of growth rates of nominal wages and salaries in education and healthcare (*Fig. 2*), the main increase took place in January-February 2018 and after that it started to decline. However, in March-June 2018 the average level of labor remuneration in those sectors was much higher than in 2017. Such dynamics suggest that growth in wages and salaries in the public sector was driven by a few sectors.

Firstly, in January-February additional lump-sum bonuses were paid in numerous public sector entities. Probably, the

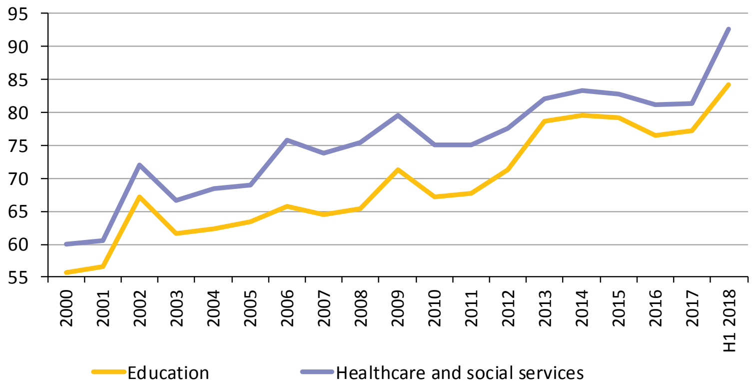
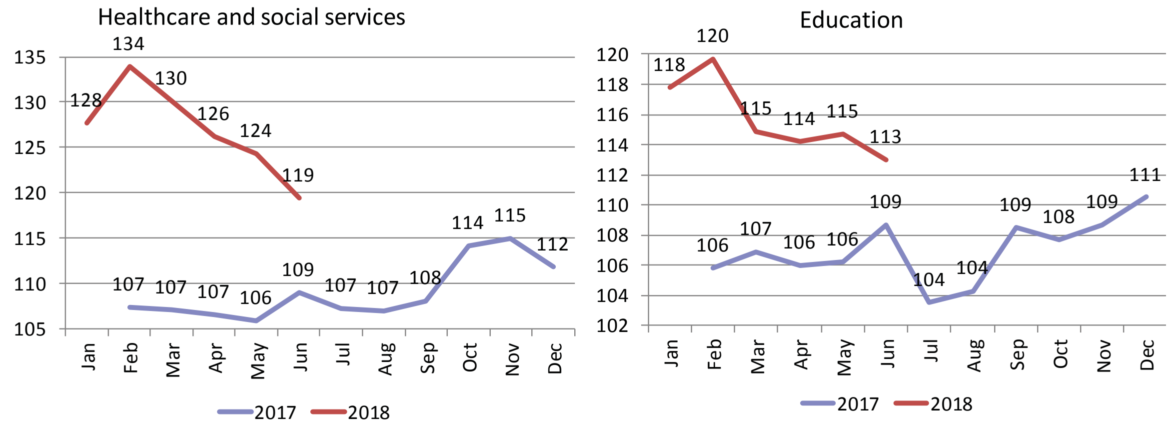


Fig. 1. Correlation between wages and salaries in education and healthcare and the average pay across the country, %

Source: The Rosstat.



Note: Due to a switch-over to the new classification of the types of economic activities – OKVED2 – the dynamics of this indicator are available only from February 2017.

Fig. 2. Nominal wages and salaries in education and healthcare in 2017–2018, % change compared with the corresponding month of the previous year, %

Source: The Rosstat.

main source of those funds was that portion of the labor remuneration fund which was usually paid out at the year-end.

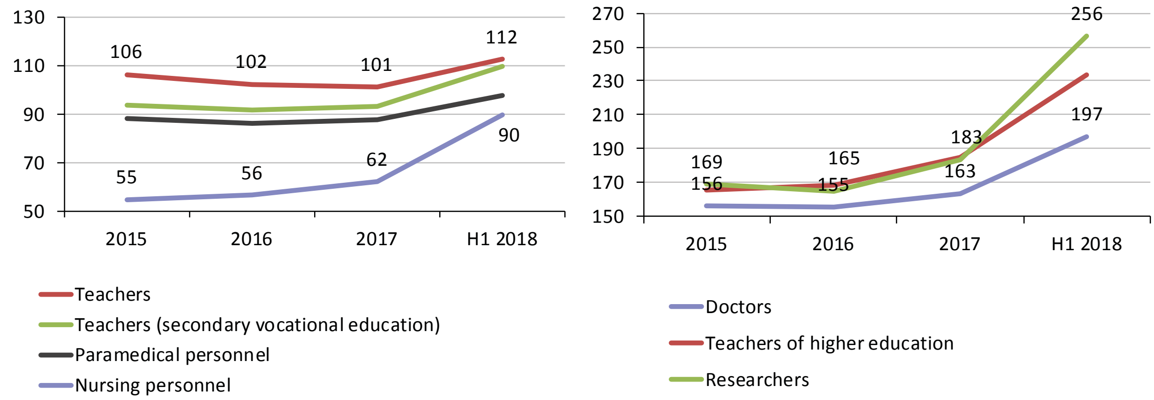
Secondly, employees' wages and salaries were simultaneously raised and it can be explained by the following: on one side the base portion of wages and salaries increased largely on the back of growth in the minimum monthly wage to the minimum subsistence level and on the other side the authorities had to fulfill Decree No.597 of 7 May 2012 of the President of the Russian Federation on Measures Aimed at Implementation of the State Social Policy.

The President's Decree suggested an increase in wages and salaries of teachers of general education institutions (schools) and secondary vocational education institutions (colleges and secondary technical schools) to average wages in the region. Salaries of teachers of higher education establishments and researchers were planned to be raised to the level exceeding two times over the average pay in the region. The average pay of teachers of pre-school establishments was to be increased to the average one of school teachers in a relevant region. Different deadlines were set: salaries of school and pre-school teachers were expected to be increased until 2012–2013, while those of other teachers, till 2018.

In healthcare, uniform deadlines were set (till 2018). The amount of the pay depended on the professional occupation: for doctors it was planned to increase salaries to the level exceeding two times over the average pay in the region, while for the nursing staff and paramedical personnel, minimum to the average pay in the region.

In 2012–2013, wages increased considerably (*Fig. 1*), however, later in education and healthcare they grew at a slower rate than in other sectors.

Implementation of the May 2012 Decrees was partially driven by a switchover to new methods: in calculating the average pay they started to take into account from 2015 both wages and salaries of entities' hired workers and the pay of workers employed by individual entrepreneurs and individuals. With the latter taken into account, the average index of wages and salaries is reduced by 10–12%. Note that the main indicator of wages and salaries is still the former version which took into account only salaries of entities' emp-



Note. Used as average wages and salaries was the pay of workers hired by entities, individual entrepreneurs and individuals.

Fig. 3. Correlation between the average pay of public sector workers and average wages across the country, %

Source: The Rosstat.

loyees, while the expanded version is actively used only for assessment of the progress in implementation of the above decrees .

Can one expect implementation of the President's May 2012 Decrees in 2018? The data of the federal statistical monitoring of labor remuneration of individual categories of workers employed in the social services sector and R&D in the 2013 – H1 2018 period permit to analyze which goals of the decrees can be achieved by the end of the year.

As seen from the data on H1 2018 (*Fig. 3*), salaries both of those employed in the education sector and researches approach target values. However, average annual indicators for teachers of different educational establishments are likely to be lower: due to the specifics of the remuneration of those jobs seasonal remuneration peaks take place in May-June, while ebbs, in July-August. Close to target values are salaries of doctors and paramedical personnel, while in January-June 2017 salaries of the nursing staff amounted only to 90% of the average pay of hired workers across the country.

However, growth in wages and salaries of the nursing staff turned out to be the highest one in 2018: within six months their labor remuneration increased 1.7 times over. Also, there was considerable growth (100%) in researchers' wages and salaries. School and pre-school teachers were less "lucky": in H1 2018 their salaries were only 9–11% higher than in the relevant period of the previous year. It can be explained by the fact that the level of their labor remuneration was already higher than the target one in most regions as early as 2015–2017.

Also, it is important to identify sources of growth: is it only the expansion of the labor remuneration fund or, simultaneously, job cuts in the public sector with a load increased on other workers whose jobs were preserved?

According to the data of the Rosstat, the number public sector workers whose occupations were specified in the decrees became smaller in 2013–2018. In education, the reduction was not substantial: from 2.32 million people to 2.27 million people by H1 2018 (*Fig. 4*). Note that the number of high-skilled workers – teachers of higher education establishments and researchers – decreased. It is noteworthy that growth in the labor remuneration of the above categories of workers was the highest one: in the past five years their average salaries doubled in nominal terms. In the same period, the reforms of higher education system were underway: a large number of higher education establishments closed down and were restructured with most branches shut down. Within the framework of the Federal Target Program for Development of Education in 2016–2020, in the past three years their number decreased over 50% (by 1097 institutions) ; institutions providing substandard education services were restructured. Substantial growth in average wages of employees of higher education establishments was driven among other things by the reforms: this sector got rid of jobs with the lowest salaries.

It is noteworthy that the actual reduction of the number of workers in the higher education sector in the past five years was not that considerable as shown in *Fig. 4*. For calculation of the number of workers, the Rosstat used staff compositions, that is, one worker, one staff position. On the back of the increase in normal hours per one staff position, the average number of staff positions for teachers used to decline in the past five years and that resulted in the reduction of the nominal number of workers, but not the actual one.

In the past five years, the number of pre-school and secondary school teachers did not virtually change.

Random surveys of the workforce carried out by the Rosstat on a monthly basis make it possible to assess the dynamics of actual and nominal working hours for workers employed in education and healthcare. As seen from the analysis, the average number of working hours per week among those employed as experts in education of different levels did not virtually change and amounted to 35.8 hours both in 2013 and 2017. Note that correlation between the actual time spent at work and the normative one decreased somewhat from 94.1% in 2013 to 93.5% in 2017.

In healthcare, medical personnel was the worst hit in the course of implementation of the decrees in question (*Fig. 5*): within five years the number of the nursing staff fell from 687,000 persons to 299,000 persons, while that of paramedical personnel, from 1,442,000 persons to 1,324,000 persons. The number of doctors decreased insignificantly by 3%.

In reality, reduction of the nursing staff was not that dramatic as shown in *Fig. 5.* In 2013–2018, healthcare institutions actively transferred their nursing staff to positions of cleaners though their job responsibilities remained the same or functions were outsourced. The audit of workers at such job positions permitted to prevent raising of wages of unskilled workers. As a result, this category of workers was not only excluded from the scope of application of the above decrees, but was also deprived of various advantages which medical workers were entitled to: reduced average weekly hours and an additional paid leave. A portion of their responsibilities was probably taken by paramedical personnel.

Such a practice is largely justified by sheer targets set in the decrees under which the minimum limit of wages and salaries for both the groups of the medical personnel was set at the single level. However, it is impossible to get rid of inequality in remuneration of these groups due to the difference in skills. So, with a limited labor remuneration fund healthcare institutions managed to bring wages and salaries of the paramedical personnel to the target level, having preserved most of paramedical jobs, while their nursing staff was either dismissed or transferred to other job positions which were not specified in the decrees. Also, this process was facilitated to some extent by Letter No.16-3/10/2-705 of 7 February 2018 of the Ministry of Health Care and Social Development which set the procedure for a transfer of nursing medical personnel to positions of cleaners of office premises.

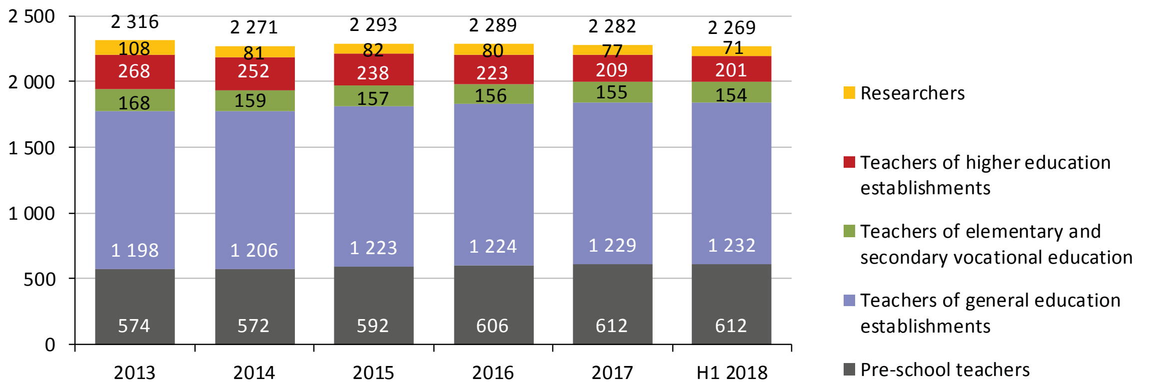


Fig. 4. Dynamics of the number of workers in the education sector, 2013–2018, thousand persons

Source: The Rosstat.

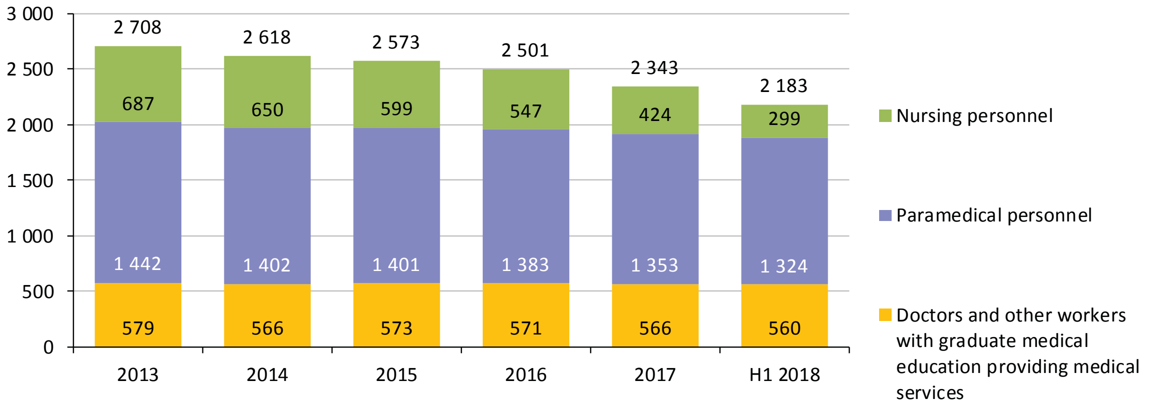


Fig. 5. The dynamics of the number of workers in healthcare, 2013–2018, thousanf persons

Source: The Rosstat.

The analysis of the number of working hours of doctors and paramedical personnel based on random workforce surveys points to the fact that the latter's intensity of work became somewhat higher. If doctors worked on average 37.7 hours per week both in 2013 and 2017, the number of working hours per week of the paramedical personnel increased from 38.0 to 38.1. However, the data of the Rosstat's random surveys do not underpin speculations about an increase in average weekly hours of workers employed in education and healthcare sectors.

Pay rises in the public sector at the expense of lump-sum payments early in 2018 and raising of the minimum monthly wage to the minimum subsistence level make one expect targets set in the President's May 2012 Decrees to be implemented in most regions at year-end 2018.

So, in 2012 in the public sector wages and salaries increased 1.9-fold in nominal terms (with growth of 1.6 times in average wages in the economy in the same period). However, the decrees in question had a different effect on different groups of workers. Secondary school teachers, pre-school teachers and doctors benefitted the most from the reforms. According to the data of random surveys, their working hours did not virtually change. The nursing personnel which was cut by over 50% and partially transferred to lower job positions was hit the worst. In the past five years, the number of researchers and teachers of higher education establishments fell by 25%, however, these dynamics were largely facilitated by reforms of Russia's higher education system.

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