MONITORING OF RUSSIA'S ECONOMIC OUTLOOK:

TRENDS AND CHALLENGES OF SOCIO-ECONOMIC DEVELOPMENT

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Recent economic developments both in Russia and on the global level have not been giving rise to much optimism.

Totally lacking any obvious reasons, the brief collapse of stock markets has further highlighted their instability amid expectations of various negative shocks. The beginning trade wars have induced the IMF to lower its forecast for global economic growth. The central banks of both developed and developing countries are hampering access to funding. The only exception to this general trend is China: having officially declared a lending policy toughening designed to rein in her debt growth, China continues to inject liquidity into the national economy in the hope of boosting business activity. The inconsistency of such a policy has been clearly demonstrated by the new data on the growth of off-balance sheet borrowing due to the infrastructure projects initiated for the purpose of achieving China's GDP growth target. The scale of China's unofficial debt has already exceeded that of her official debt, which raises doubts about the stability of this pyramid and prompts experts to assess the impact of its potential collapse on the state of the global economy.

Although still at a very modest level, the current positive dynamics of the Russian economy is being maintained primarily by the growing production of oil and natural gas. In this regard, a sobering note was struck by Saudi Arabia, Russia's giant oil producing partner, which has issued a forecast as to when exactly Russia will disappear from the oil market, and how this is going to strengthen the Saudi position in this field. However, it should be said that the quality of forecasts coming from this source is well illustrated by the Saudi claim, made two years ago, that 'by 2020, if oil stops we can survive'. Nevertheless, it is obvious that without a change in its investment priorities in favor of developing new technologies, the oil industry of the Russian Federation can be expected to stagnate, while the requested level of its further tax reliefs and exemptions may gradually make the activity in that sector economically senseless. It should be admitted that the level of investment activity throughout the economy as a whole is very low, and the dynamics of the real income of the population is varying and uncertain and tends to oscillate between weakly positive and negative values. At the same time, we can see no weakening in the trend toward increasing the state's dominance in Russia's core markets due to the ever-growing share of state-owned companies coupled with the actual ongoing toughening of the regulatory regime.

Having taken into account this and many other factors, our experts assessed the RF Ministry of Economic Development's forecast for 2019–2024, included in the package of documents attached to the draft law on the federal budget for 2019–2021, which had been submitted to the RF State Duma. According to our experts, the forecast virtually contains two major parts: one offering a sober and realistic prognosis for the next two years (2019–2020), and the other focusing on the fulfillment of the May 2018 Presidential Executive Order on National Goals and Strategic Objectives of the Russian Federation.

The experts believe that the forecast is controversial in many respects, and so may hinder Russia's embarking on the desired growth trajectory.

The forecast has been prepared in two versions (conservative and baseline). The conservative scenario envisages that Russia's development will be taking place in conditions of the sharp deceleration of global economic growth caused by China's 'crash landing' and the resulting decrease in the demand for energy carriers and other raw materials. As far as the baseline scenario is concerned, our experts characterize it as the combination of a sufficiently realistic forecast (for 2021–2024) and a scenario focused on the achievement of 'national goals and strategic objectives' through to 2024. The RF Ministry of Economic Development expects that the deceleration of Russia's economic growth will be only temporary, and later on the Russian economy will embark on the desired trajectory, increasing at more than 3% per annum from 2021 onwards. The logic behind the baseline scenario is that a rise in the activity of private businesses should be sufficient to guarantee a 6.5-8% annual rise in investment.

However, the mechanisms for stimulating the private sector's activity are not specified. The hypothesis that labor productivity will significantly increase is totally unsubstantiated, and a number of factors, including growth in production costs, are not taken into consideration. Our experts point out that the new economic sanctions to be imposed by the USA, coupled with the widely discussed retaliatory measures to be introduced by Russia, would mean that this country's economy is going to further shut itself off from the developed world, thus making its structure even more primitive and destroying the remaining prospects for production and exports diversification as one of its major growth drivers.

According to our experts, the forecast overlooks the asymmetry in the way that the ruble's exchange rate has been responding to the positive and negative shocks caused by the movement of oil prices. In the forecast, over the next six-year period, oil prices are expected to plunge from their present level of $ 75–80 per barrel to $ 53.5 per barrel, while the average annual ruble-to-USD exchange rate will stay at not less than RUB 66.5, and only as late as 2024 it will decline to RUB 68. However, in view of the expected decline (under the said scenario) of oil prices, maintained budget rule for foreign currency purchases on the domestic market, and continuing economic sanctions imposed by foreign countries, the experts consider the risk of the ruble's weakening at a faster rate and its plunge to RUB 80–90 per USD to be very high. Among the inflationary risks, they point out as the most relevant ones the high inflation expectations and the exchange rate pass-through effect (while the forecast considers only the short-term factors: raised VAT and absence of a noticeable seasonal deflation of prices for agricultural products). Because of these risks, until 2024 the RF Central Bank will be unable to abandon its moderately tough monetary policy and to switch over to a neutral one, and this factor will not be conducive to boosting investment activity, either.

And finally, our experts take note of the fact that even the conservative scenario is oriented to relatively high oil prices (above $ 40), and overlooks certain possible alternatives like a new financial crisis triggered by falling prices of financial assets or debt issues in the USA. Therefore, we need to analyze these other scenarios, the realization of which may require a change in the basic parameters of the current budgetary policy, including tapping the reserves earmarked for covering budget deficit, cuts on government debt, continuing budget consolidation and postponing the expenditures on national development goals.

The experts who have analyzed the draft law on the federal budget for 2019–2021 also pay attention to the planned budget maneuver in favor of productive expenditure. However, for example, according to their calculations, the planned VAT receipts in the RF Ministry of Finance's forecast are overestimated by approximately RUB 600bn per annum. This has to do with overoptimistic expectations with regard to VAT collection performance and final consumption expenditure as % of GDP. The experts consider the expected amount of oil and gas revenues to be received next year likewise to be overestimated (by RUB 100bn). The expenditure cap set by the budgetary rule to be introduced from 2019 onwards will be lower than the spending obligation projections in the draft budget. As tax receipts will be lower than expected, the government debt servicing costs may become higher than the corresponding expenditures planned in the forecast. By 2021, government debt will likely amount to 17.7% of GDP (against 16.5% of GDP in the forecast). The budgetary rule is structured in such a way that any shrinkage of non-oil-and-gas revenues will translate into an additional government debt growth, and thus into increased costs of its servicing.

With regard to the period-end balance of payments for Q3, our experts remarked that although over the period of July to September the current account traditionally shrinks due to seasonal factors, this year it increased ($ 26.4bn) both on the previous quarter ($ 19.1bn) and relative to Q3 2017, when its balance was negative ($ -3.2 bn). This result was achieved in the main due to the record-high balance of trade produced by the rising oil prices coupled with shrinking imports, the latter being the upshot of the ruble's weakening and low demand. Meanwhile, there was a net capital outflow from the private sector, largely caused by a decline in companies' foreign liabilities (by $ 10.8bn).

Overall, the balance of payments data demonstrate an ongoing shrinkage of non-resident investment in the Russian economy (including a downfall, by $ 6bn, of foreign direct investment in Q3). According to expert estimations, given the record high current account, the ruble has remained undervalued: currently, its calculated value based on fundamental factors does not exceed RUB 60–63 per USD. However, the prospects of toughening economic sanctions may trigger the ruble's further plunge.

To achieve the target of heavily reducing the poverty rate, set in the May 2018 Presidential Executive Order, it will be necessary not only to increase wages and incomes, but also to make alterations to the existing social support system; in this connection, the experts take note of the fact that although in H1 2018 the poverty rate declined relative to the period 2015–2017, it was still above its level observed in the pre-crisis period (2012–2014). Poverty risks have significantly increased in the younger age groups (under 18 years), almost twice as high as the national average. In 2017, the relative share of expenditures earmarked for social support of the poor in the budgets of all RF subjects amounted to a mere 0.31% of GDP. However, it should be admitted that in recent year, the social support measures have become better targeted (that is, geared to the specific income level of recipients or households) in more than 30 regions. At the same time, only in a third of all cases better targeted social aid resulted in an increased amount of social benefits, including in 8% of all cases – in a significant increase (by more than 15%). In an overwhelming majority of cases, the social benefit size remained unchanged, and in 7% of cases it was reduced. In this connection, the experts observe that the principle of better targeted social aid is frequently applied in the regions in order to save their budget resources, although the amount of budget allocations earmarked for this purpose is per se insufficient.

1. SCENARIO-BASED FORECAST FOR 2019–2024: CHALLENGES AND RISKS

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A 2019–2024 forecast of the Russian Ministry of Economic Development can be regarded as a modest and realistic projection for 2019–2020 and a target projection intended to achieve the nation's development targets for 2021–2024. The forecast contains some controversial provisions which can prevent the Russian economy from taking the desirable trajectory of economic growth: a lack of mechanisms designed to trigger investment activity in the private sector, an increase in internal production costs, a potential increase in risks of higher exchange rate and inflation.

Russia's Ministry of Economic Development has presented a package of documents attached to a draft Federal Act "On the Federal Budget for 2019 and the 2020–2021 Planning Period", including a forecast for the nation's socio-economic development which provides for the achievement of the goals and objectives set forth in Presidential Executive Order No. 204 dd. 7 May 2018. The forecast includes two scenarios: the baseline scenario, under which the targets specified in the Executive Order are achieved, and the conservative scenario.

Under the baseline scenario, the Ministry of Economic Development expects the Russian economy to increase 1.3% year-on-year at the 2019 year end. Russia is expected to see a temporary deceleration in economic growth. If a structural reforms package (including national projects within the scope of socio-economic development of Russia, policies to increase investment activity, and a pension reform) proposed by the Russian government is implemented, GDP growth rates are expected to see a higher trajectory of growth thus ensuring that the conditions required for the achievement of the objectives set forth in the Executive Order are available. For instance, Russia's GDP is expected to increase 2% year-on-year by 2020, with an increase of above 3% from 2021 to 3.3% by 2024.

The conservative scenario expects that the Russian economy will develop amid considerable deceleration of the global economy in response to a Chinese hard landing and therefore weaker demand for energy resources and other types of primary commodities including their prices worldwide[1]. The forecast makes emphasis of the fact that the today's macroeconomic policy ensures little dependence of internal economic parameters on volatile oil prices. If, however, the conservative scenario comes to pass, the Russian economy would be affected by weak external demand for Russian export commodities.

The baseline scenario is thus represented by a combination of realistic forecast for 2019–2020 economic development and target option for the dynamics of key socio-economic figures formulated with consideration for

1 By 2024, for example, oil prices are expected to fall to $45.9 a barrel vs. $53.5 under the baseline scenario.

the achievement of national targets in 2024. Given the today's geopolitical environment with high degree of uncertainty about sanctions and the global hydrocarbons market, the scenario with a conservative forecast for oil prices and modest economic growth rates in Russia seems to be an absolutely reasonable baseline scenario. In our view, however, there are serious risks of failure to achieve the forecast target parameters in the period until 2024.

Prospects of new US sanctions and widely disputed Russia's countermeasures imply that the Russian economy might be further cut off from advanced economies. This is not only a headwind to a higher total factor productivity and sustainable economic growth, but it will also lead to a further simplification of its structure and lack of prospects of diversification of production and exports as a critical factor of economic growth.

The logic of achieving the target values, which is proposed in the baseline scenario, suggests that from 2019 the state should focus on a series of national projects, and then, following the implementation of the projects, the private business activity will be increased thus contributing to an annual increase of 6.5–8% in fixed investment. The internal market (based on the forecast dynamics of personal income and retail trade turnover) and external markets (based on the ratio of increased exports and output in the country) are expected to grow annually at not more than 2.5% and 2%, respectively. However, mechanisms that can provide investment and business incentives to private businesses are not specified.

An adverse factor that constraints the private sector's business activity is higher production costs inside the country. The implementation of measures aimed at increasing investment activity through changes in investment climate, improving the long-term predictability of economic development, enhancing competition and efficiency of companies with government equity participation, creating new sources of investment activity financing are supposed to build a new 6-year economic development model framework. However, the Russian economy is expected to see its costs grow through to 2021: real wage growth rates are way ahead of labour productivity growth rates (*Fig. 1*). A reversal of this trend without sharp cuts in real wages is highly questionable.

The assumption of substantial acceleration of labour productivity and corresponding wage increase in the private sector in 2021–2024 should apparently be more concrete.

The sector of bank loans to individuals is faced with progressive accumulation of risks. Bank outstanding loans to individuals as of mid-2018 amounted to Rb 13.7 trillion, with a growth of 19% year-to-year, surpassing considerably the growth in personal nominal income. The most troubling trend, however, is that bank loans constantly surpass growth rates of personal nominal income (*Fig. 2*), which means that loan service and repayment costs will increase as a percentage of personal spending.

The situation with regard to individuals' loan service and

Fig. 1. Growth rates in labour productivity and real wages, %

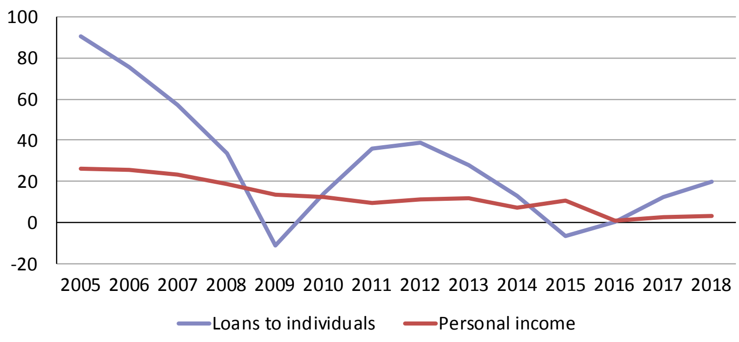

Fig. 2. Growth rates in bank loans and nominal personal cash income

repayment costs is back to what it was in 2013–2014, thus increasing the probability of the banking sector being hit by a bad retail debt crisis.

The forecast takes no account of the rouble's exchange rate asymmetrical response to positive and negative oil price shocks. Given the forecast external conditions, oil prices in 2019–2024 are expected to slide gradually from today's $75–80 a barrel to $53.5, the average annual exchange rate of the rouble is expected to remain unchanged (not lower than 66.5 roubles per US dollar) until 2023, and it is not until 2024 that it will drop to 68 roubles per US dollar (the exchange rate reported in 2018 when oil prices were higher than $70 a barrel due to anticipated risks of sanctions). In our view, assuming that oil prices will fall by 25% of what they are now, the fiscal rule will stay in force, including foreign currency purchases for the National Wealth Fund (NWF) in the local market, and external sanctions will remain in force, there will be very high risk of deeper rouble depreciation up to 80–90 roubles per US dollar, with oil prices at $50–55 a barrel.

As to inflation factors, the forecast covers only short-term inflation factors such as an increase of VAT by 2 percentage points in 2019 and a lack of visible seasonal price inflation for agricultural produce in 2018–2019. At the same time, we believe that economic agents' high expectations of inflation and the exchange rate pass-through to prices will remain the most serious pro-inflation factor throughout the entire period under review. Inflation expectations in Russia often correlate with the rouble's exchange rate dynamics. Therefore, the above possible weakening of exchange rate to 80–90 roubles per US dollar and the risk of further devaluation of the rouble (because of anticipated sustainable adverse trend in oil prices) will prevent the anchorage of inflation expectations at a level close to 4–5%. Also, the effect of exchange rate pass-through to prices is likely to increase despite the existing internal demand constraints.

The existence of factors pushing inflation upward in 2019–2024 is important for the assessment of central bank's policy and interest rates forecast. In our view, given risks of accelerating inflation, the central bank will not be able before 2024 to give up its moderately tight policy and to switch to a neutral monetary policy. Therefore, the central bank will keep the benchmark interest rate unchanged, 3–4 percentage points above the inflation rate, thereby stemming cuts in interest rates on loans to non-financial sector, which is another factor preventing the broadening of firms' investment activity.

A point to note is that the second (conservative) scenario is little different in content from the baseline scenario of the forecast. The former differs largely from the latter in the assumption of Chinese hard landing and deceleration of the global economy's growth, weaker demand and prices for oil in the global market. Oil prices, however, remain at a relatively high level (above $40 a barrel), and no reasons are given for the selection of this scenario vs. alternative scenarios (e.g., a new global financial crisis induced by falling prices of financial assets or debt problems facing the United States). We believe that analysis should be made of alternative scenarios involving tighter external sanctions or oil price collapse below $40 a barrel. If that is the case, that will require updates in the fiscal policy key parameters: spending from the National Wealth Fund to cover a budget deficit, reducing the issuance of sovereign debt (otherwise the cost of borrowing would be high), continuing the fiscal consolidation policy to keep control over the budget deficit, and deferring expenditure on the achievement of the nation's development targets.

2. THE THREE-YEAR BUDGET: A MANEUVER IN FAVOR OF PRODUCTIVE EXPENDITURES

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The draft law "On the Federal Budget in 2019 and the 2020–2021 Planned Period" suggests a budget maneuver in favor of productive expenditures. The federal budget is to become the main source of growth of the Russian economy in the next three years. There are problems related to the budget stability that limit funding of new expenditure obligations without borrowing of funds on the debt market.

The Main Parameters

The main parameters of the federal budget in 2019 and the 2020–2021 planned period are shown in *Table 1*.

Table 1

THE MAIN PARAMETERS OF THE FEDERAL BUDGET IN 2019 AND THE 2020–2021 PLANNED PERIOD, BILLION ROUBLES, % OF GDP

	2018 (estimate)	2019 (estimate)	2020 (estimate)	2021 (estimate)
Total revenues	18 747.5	19 969.3	20 218.6	20 978.0
% of GDP	18.5	18.9	18.3	17.7
including:				
Oil and gas revenues,	8 714.3	8 298.2	7 936.3	8 018.2
% of GDP	8.6	7.9	7.2	6.8
Non-oil and gas revenues	10 033.2	11 671.1	12 282.3	12 959.8
% of GDP	9.9	11.0	11.1	10.9
Total expenditures	17 424.5	18 037.2	18 994.3	20 026.0
% of GDP	17.2	17.0	17.2	16.9
Deficit (–) / Surplus (+)	1 323.0	1 932.1	1 224.4	952.0
% of GDP	1.3	1.9	1.1	0.8
For reference only: GDP, billion roubles	101 164	105 820	110 732	118 409

Source: The explanatory note to the draft federal law "On the Federal Budget in 2019 and the 2020–2021 Planned Period".

In 2018–2021, federal budget expenditures are expected to grow from Rb 18,747.5bn in 2018 to Rb 20,978.0bn in 2021; according to the annual dynamics growth in revenues in nominal terms will amount to 6.5%, 1.2% and 3.8% in 2019, 2020 and 2021, respectively, as compared to the previous year with the forecasted inflation rate of 4.3%, 3.8% and 4.0% in 2019–2021, respectively. The revenues in GDP shares tend to decrease from 18.5% of GDP in 2018 to 17.7% of GDP in 2021.

These dynamics are justified by an expected decline in oil and gas revenues both in nominal terms (a decrease of 8.0% in 2021 as compared to 2018) and in shares of GDP (from 8.6% in 2018 to 6.8% by 2021) due to amendment of the legislation, in particular, completion of the tax maneuver in the oil and gas industry. Oil and gas revenues will increase from 9.9% of GDP in 2018 to 10.9% in 2021, so, their share in the federal budget revenues will rise from 53.5% in 2018 to 61.8% in 2021.

The Revenues

According to the draft law, federal budget revenues in shares of GDP will decrease from 18.5% in 2018 to 17.7% by 2021. The data on the pattern of the main tax revenues and customs duties payable to the federal budget in 2018–2021 are shown in *Table 2*.

Table 2

THE MAIN TAX AND CUSTOMS DUTY REVENUES TO THE FEDERAL BUDGET IN 2018–2021

	% of GDP				% of the result			
	2018	2019	2020	2021	2018	2019	2020	2021
	estimate	forecast			estimate	forecast		
Total revenues	18.5	18.8	18.3	17.7	100.0	100.0	100.0	100.0
Oil and gas revenues	8.6	7.8	7.2	6.8	46.5	41.5	39.3	38.4
Non-oil and gas revenues	9.9	11.0	11.1	10.9	53.5	58.5	60.7	61.6
VAT, total	5.8	6.5	6.7	6.7	31.4	34.5	36.7	38.1
VAT (internal)	3.4	3.7	3.9	3.9	18.4	19.9	21.2	22.1
VAT (import)	2.4	2.7	2.8	2.8	13.0	14.6	15.4	16.0
Profit tax	0.9	0.9	0.9	0.9	4.8	4.8	4.8	4.9
Import duties	0.6	0.6	0.6	0.6	3.3	3.3	3.4	3.6
Excises on imports	0.1	0.1	0.1	0.1	0.5	0.5	0.5	0.5
Excises (internal)	0.8	0.9	0.9	0.8	4.5	4.8	4.8	4.5
Other revenues	1.7	2.0	1.9	1.8	9.0	10.4	10.7	10.4

Source: The explanatory note to the draft federal law "On the Federal Budget in 2018 and the 2019–2020 Planned Period", own calculations.

In 2019–2021, oil and gas revenues are expected to decline due to the forecasted depreciation of global prices of oil. This is the main factor behind a decrease in federal budget revenues. In the draft law, the rates of the severance tax and export duties on petrochemicals vary in 2019-2021 in compliance with the tax maneuver developed and approved in the mid-2018.1

Non-oil and gas revenues – the VAT – are expected to grow on the back of raising of the main VAT rate from 18% to 20%. It is stated in the draft law that a factor of growth in VAT revenues is the work on upgrading the revenue administration. Also, one expects growth in "import" VAT revenues by means of upgrading the custom duty administration and preventing shadow import schemes. However, according to our estimates this forecast as regards VAT revenues is overstated by Rb 600bn a year (0.6–0.7% of GDP). In particular, it can be explained by an overoptimistic assessment both of growth in VAT collection and growth in the ultimate consumption share in GDP. Revenues from the profit tax, import duties and excises in general are forecasted in GDP shares in the entire 2019–2021 period at the level of the year 2018.

The Expenditures

Federal budget expenditures decrease from 17.2% of GDP in 2018 to 16.9% of GDP by the year 2021 due to higher GDP growth rates as compared to the dynamics of expenditures in nominal terms: 3.5%, 5.3% and 5.4% in 2019, 2020 and 2021, respectively, as compared to the previous year.

1 Federal Law No. 305-FZ of 3 August 2018 "On Amendment of Article 3.1 of the Law of the Russian Federation "On Customs Tariff" and Federal Law No.301-FZ of 3 August 2018 "On Amendment of Part Two of the Tax Code of the Russian Federation".

Table 3

FEDERAL BUDGET EXPENDITURES IN 2017–2021, BILLION RB

	Cash adminis-tration	Approved BA*	Draft law			Change 2021 on 2018	
	2017	2018	2019	2020	2021	Billion Rb	growth, %
Total expenditures	16 420.3	17 160.2	18 037.2	18 994.3	20 026.0	2 865.8	16.7
including:							
Federal issues	1 162.4	1 439.9	1 406.5	1 428.4	1 539.8	99.9	6.9
National defense	2 852.3	2 996.7	2 914.2	3 019.5	3 160.1	163.4	5.5
National security and law enforcement	1 918.0	2 075.3	2 247.4	2 216.6	2 295.9	220.6	10.6
National economy	2 460.0	2 425.3	2 655.7	2 602.2	2 813.7	388.4	16.0
Housing and public utilities	119.5	152.7	192.2	197.1	187.6	34.9	22.9
Environmental protection	92.3	94.2	197.1	230.9	267.5	173.3	1.8-fold
Education	615.0	724.2	829.2	847.1	881.3	157.1	21.7
Culture and cinema	89.7	107.5	125.3	116.2	122.1	14.6	13.6
Healthcare	439.8	552.1	653.2	918.4	855.9	303.8	55.0
Social policy	4 992.0	4 695.8	4 890.5	4 924.1	4757.7	61.9	1.3
Physical training and sports	96.1	65.6	54.7	54.7	49.4	-16.2	-24.7
Mass media	83.2	83.3	75.0	68.4	68.6	-14.7	-17.6
Public and municipal debt servicing	709.1	824.3	852.1	967.4	1095.0	270.7	32.8
General inter-budget transfers	790.7	923.3	944.1	928.1	929.8	6.5	0.7
Notionally approved expenditures	0.0	0.0	0.0	474.8	1 001.3		-

Source: The explanatory note to the draft federal law "On the Federal Budget in 2019 and the 2020–2021 Planned Period", the Federal Treasury and own calculations.

*As of 01 July 2018

In terms of the functional classification (*Table 3*), expenditure growth both in absolute and nominal terms in 2021 against 2018 is expected in all the items, except for "Physical Training and Sports" and "The Mass Media" on which budget allocations may decrease by Rb 16.2bn and Rb 14.7bn or 24.7% and 17.6% in nominal terms, respectively.

Substantial expenditure growth in 2021 as compared to 2018 is expected in nominal terms in the following budget items: "Environmental Protection" (1.8-fold; an increase of Rb 173.3bn), "Healthcare", "Housing and Public Utilities" and "Education" (growth of 55.0%, 22.9% and 21.7%, respectively, or Rb 303.8bn, Rb 34.9bn and Rb 157.1bn, respectively) and some other items on which an increase in budget allocations is justified by implementation of the national priorities in compliance with Decree No.204 of 7 May 2018 of the President of the Russian Federation.

In addition, adjustment of budget allocations in 2019–2021 as compared to 2018 is planned as regards the following budget items:

- "Federal Issues": growth of Rb 11.6bn in expenditures on arrangement and holding of the elections of deputies to the State Duma of the 8th calling in 2021;
- "National Defense": growth of Rb 228.0bn in expenditures on the ongoing maintenance of the Armed Forces in 2019–2020;
- "National Defense and Law Enforcement": growth of Rb 20.1bn in budget allocations on implementation of the draft of the Decree of the President of the Russian Federation "On Setting of the Coefficient to Official Salaries of Public Prosecution Officers of the Russian Federation" in 2019–2021;

Table 4

FEDERAL BUDGET EXPENDITURES PLANNED ON IMPLEMENTATION OF THE NATIONAL PRIORITIES IN COMPLIANCE WITH DECREE NO.204 OF THE PRESIDENT OF THE RUSSIAN FEDERATION, BILLION RB

Name	2019	2020	2021	Total in 2019–2021	Share in the total volume of funding priorities, %
Total,	1 685.5	1 862.7	2 084.8	5 633.0	
including:					
“Demography”	512.0	522.2	528.8	1 563.0	27.7
Comprehensive plan of modernization and expansion of the main infrastructure	323.2	343.0	408.6	10748	19.1
“Healthcare”	159.8	299.1	238.8	697.7	12.4
“Digital Economy of the Russian Federation”	107.9	128.7	177.9	414.5	7.4
“Safe and High-Quality Motor Roads”	129.7	104.3	137.4	371.4	6.6
“Education”	103.2	117.6	127.7	348.5	6.2
“Housing and Urban Environment”	105.3	105.3	108.4	319.0	5.7
“International Cooperation and Exports”	82.5	70.4	119.6	272.5	4.8
“Ecology”	49.6	77.8	113.7	241.1	4.3
“Small and Mid-Size Business and Support of Individual Enterprise Initiative”	57.3	32.5	46.8	136.6	2.4
“Science”	35.2	41.4	53.5	130.1	2.3
“Culture”	12.7	13.6	16.7	43.0	0.8
“Labor Efficiency and Facilitation of Employment”	7.1	6.9	6.9	20.9	0.4

Source: The explanatory note to the draft federal law “On the Federal Budget in 2019 and the 2020–2021 Planned Period”, the Federal Treasury and own calculations.

- “National Economy”: a decrease of Rb 21.0bn in expenditures in 2019–2020 on subsidies to Russian manufacturers to compensate a portion of costs related to procurement of component parts (parts, blocks and integral units) required for manufacturing of industrial equipment and a decrease of Rb 40.9bn in other inter-bank transfers in 2019–2021 to refund a portion of costs related to payment of interests on investment loans in the agrarian sector because of fulfillment of loan agreements;
- “Housing and Public Utilities”: an increase of Rb 2.7bn in expenditures in 2019–2020 on subsidies to facilitate development of utility and engineering infrastructure of the public property of constituent entities of the Russian Federation and their decrease of Rb 0.5bn in 2021;
- “Education”: an increase of Rb 43.8bn in expenditures on pay rises for teachers to comply with target indicators set in Decree No.597 of 7 May 2012 of the President of the Russian Federation, an increase of Rb 24.6bn in expenditures in 2019–2020 on building and overhaul of the infrastructure of higher education establishments, as well as an increase of Rb 42.4bn due to bringing of the volume of the state assignment of higher education establishments in 2019–2020 to the level calculated in compliance with the approved requirement criteria;
- “Healthcare”: an increase of Rb 41.7bn in expenditures in 2019–2021 on pay rises for federal public institution employees in order to comply with target indicators set in Decree No.597 of 7 May 2012 of the President of the Russian Federation;
- “Social Policy”: an increase of Rb 127.3bn in budget allocations in 2019–2020 on support of the funded-mortgage scheme of housing provision for military servicemen because of growth in the number

of participants and an increase of Rb 26.1bn in budget allocations on social payments to the unemployed as a result of modification of the terms of provision of payments to persons of a preretirement age;

- "Public and Municipal Debt Servicing": growth of Rb 270.7bn or 32.8% in expenditures in nominal terms in 2021 as compared to 2018 due to an increase in the volume of public borrowings on the domestic market.

In 2019–2021, the share of budget allocations on implementation of the national priorities in compliance with the May Decree of the President of the Russian Federations (*Table 4*) amounts on average to 9.8% of the total volume of federal budget expenditures. So, the pattern of the federal budget is mostly of an inertial nature.

Funding Sources and Budget Stability

In 2019–2021, the surplus of administration of the federal budget is planned to amount to 1.9% of GDP, 1.1% of GDP and 0.8% of GDP, respectively. State borrowings will become the main source of the deficit funding in the above period (*Table 5*). It is not planned to utilize the National Welfare Fund (NWF) to finance the federal budget deficit and the budget of the Pension Fund in 2019–2021. The NWF's only line of spending will be co-financing of pension savings of insured persons who paid extra insurance contributions to the funded part of their pensions.

Table 5

THE SOURCES OF FUNDING THE FEDERAL BUDGET DEFICIT IN 2018–2021, BILLION RB, % OF GDP

	2018 (estimate)	2019 (draft)	2020 (draft)	2021 (draft)
Total sources	-1 323.0	-1 932.1	-1 224.4	-952.0
% of GDP	1.3	1.8	1.1	0.8
including:				
Internal deficit funding sources	- 1 227.6	- 1 623.2	- 943.5	-945.0
% of GDP	1.2	1.5	0.9	0.8
Public borrowings	669.9	1 497.7	1 670.0	1 743.0
Change in ledgers of federal budget (FB) account balances	-1 945.2	- 3 364.8	-2 773.2	- 2 628.6
Including NWF funds	1 113.3	4.4	3.7	3.3
Privatization	15.8	13.0	10.9	0.0
Other sources	31.9	230.9	148.8	-59.4
External deficit funding sources	-95.4	-308.8	-280.9	-7.0
% of GDP	0.1	0.3	0.3	0.0

Source: The explanatory note to the draft federal law "On the Federal Budget in 2019 and the 2020–2021 Planned Period", the Federal Treasury and own calculations.

In 2019–2022, the volume of annual state borrowings will amount to Rb 1.5–1.7 trillion, that is, growth both in the state internal debt from the expected Rb 9.8 trillion in 2018 (9.7% of GDP) to Rb 15.2 trillion in 2021 (12.8% of GDP) and the state external debt from Rb 3.9 trillion in 2018 (3.9% of GDP) to Rb 4.3 trillion in 2021 (3.7% of GDP).

An important factor that underpins long-term budget stability is compliance with the budget rule. According to our estimates, the "ceiling" of acceptable expenditures – under the budget rule which is in effect from 2019 – will be lower than the expenditure obligations provided for in the draft budget (*Fig. 1).*

According to our forecasts, except for the above overoptimistic expectations as regards VAT revenues, in 2019 oil and gas revenues will be about Rb

100bn lower than expected. In subsequent years, expenditures on the state debt servicing due to short-received tax revenues may happen to be higher. By 2021, the state debt is expected to amount to 17.7% of GDP (against 16.5% of GDP as per the forecast of the Ministry of Finance of the Russian Federation). Eventually, any possible decrease in non-oil and gas revenues will result in further growth in the state debt and, consequently, expenditures on its servicing.

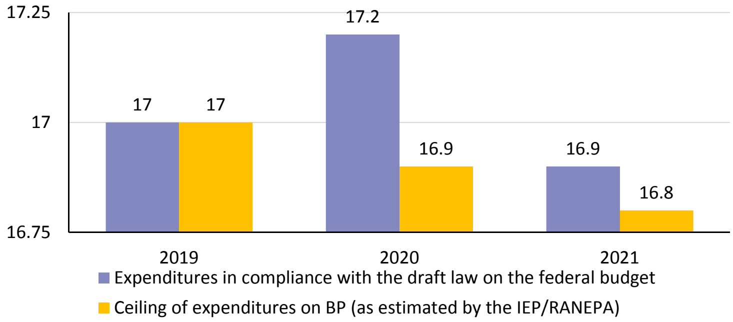


Fig. 1. Expenditure obligations provided for in the draft budget and the "ceiling" of acceptable expenditures as per the budget rule which is in effect from 2019 and own calculations

3. RUSSIA'S BALANCE OF PAYMENTS, Q3 2018: NON-RESIDENTS' INVESTMENT CONTINUED TO FALL

A.Bozhechkova, P.Trunin

The third quarter of 2018 saw Russia register the highest positive BoP on record on the back of growth in country's exports amid higher oil prices and decline in imports induced by rouble depreciation. BoP data show that non-residents continued to reduce their investment in the Russian economy. Although the rouble's exchange rate remains fundamentally underestimated, it may continue to fall amid heightened risks of new sanctions against Russia.

Although Russia's current account balance is often prone to the annual seasonal decline in July-September, it reached $26.4bn in Q3 2018, according to Bank of Russia's preliminary data on the 2018 BoP. The amount was much bigger than that ($19.1bn) in Q2 2018 and in Q3 2017 when the balance was negative (-$3.2bn).

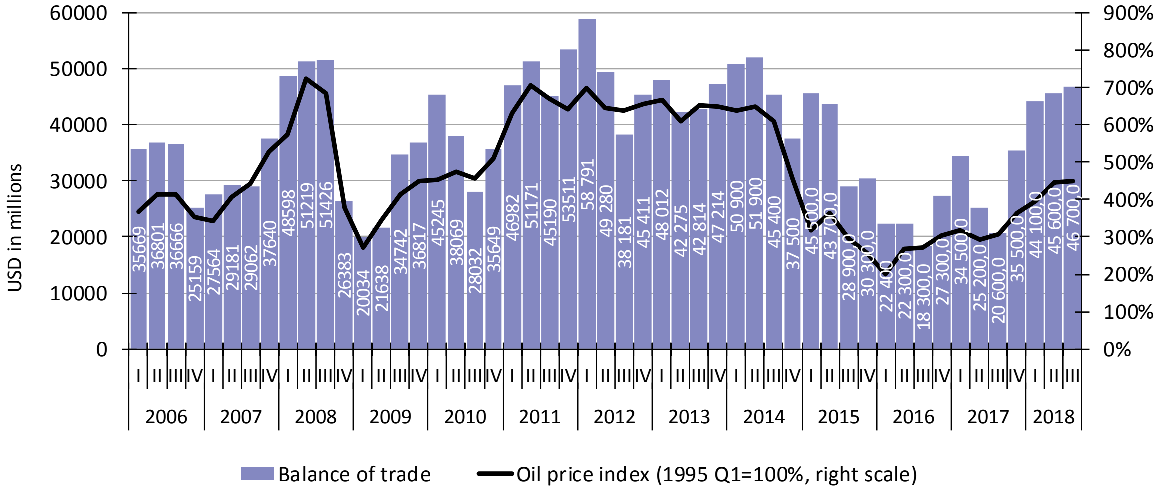
The balance of trade in goods reached $46.7bn, posting an increase of 2.4% over $45.6bn in the previous quarter and 126% over $20.7bn registered in Q3 2017 (*Fig. 1*). In the end, the balance of trade in the first three quarters of 2018 stood at $136.3bn, an increase of 70% over $80.43bn recorded in January–September 2017.

The foregoing amounts were reached mostly due to stable exports (in value terms) of $109.6bn (by contrast, exports were $101.5bn in the Q1 and $108.9bn in the Q2). That was due to both unchanged physical volumes of exports and higher than 2017 global prices of Russia's principal export commodities such as crude oil, natural gas, metals, fertilizers, coal[1]. Furthermore, imports dropped to $63.0bn, sliding by 0.5% from $63.3bn recorded in the previous quarter and by 1.3% from $63.8bn seen in Q3 2017, driven largely by depreciation of the Russian rouble. According to central bank's data, the index for the rouble's real effective exchange rate against foreign currencies in January–September 2018 fell from January–September 2017 to -8.0%, showing a prominent depreciation evidenced by substantial appreciation of imports amid slow growth in prices of Russia-made products. Another reason was heightened uncertainty about the exchange rate dynamics due to risks of sanctions[2]. In addition, the decline in imports was led by weaker consumer demand.

The balance of trade in services underwent some changes: it was -$8.6bn in Q3 2018, 13.2% below -$7.6bn seen in the previous quarter but 13.1% above -$9.9bn in the balance of trade in services registered in Q3 2017. A point to note, however, is that in the first three quarters of 2018 the balance of services stood at -$22.7bn, unchanged compared to January–September 2017.

1 For more details see A. Knobel, A. Firanchuk. Russia's Foreign Trade in January–May 2018 // Russian Economic Developments. 2018. No. 8. P. 10–16.

2 For details on the effect of exchange rate dynamics on trade see A. Knobel. Assessing the import demand function in Russia // Applied Econometrics. 2011. No. 4 (24). P. 3–26; A. Knobel, A. Firanchuk. Russia in global exports in 2017 // Russian Economic Developments. 2018. No. 9. P. 17–21.



Sources: Bank of Russia, IMF.

Fig. 1. Russia's balance of trade and oil price dynamics

If the rouble's real effective exchange rate declines down the line, imports of services would increase at a slower pace than exports[1] and therefore improve the negative balance of trade in services. These factors, together with high prices of the principal export commodities, would contribute to a higher current account balance.

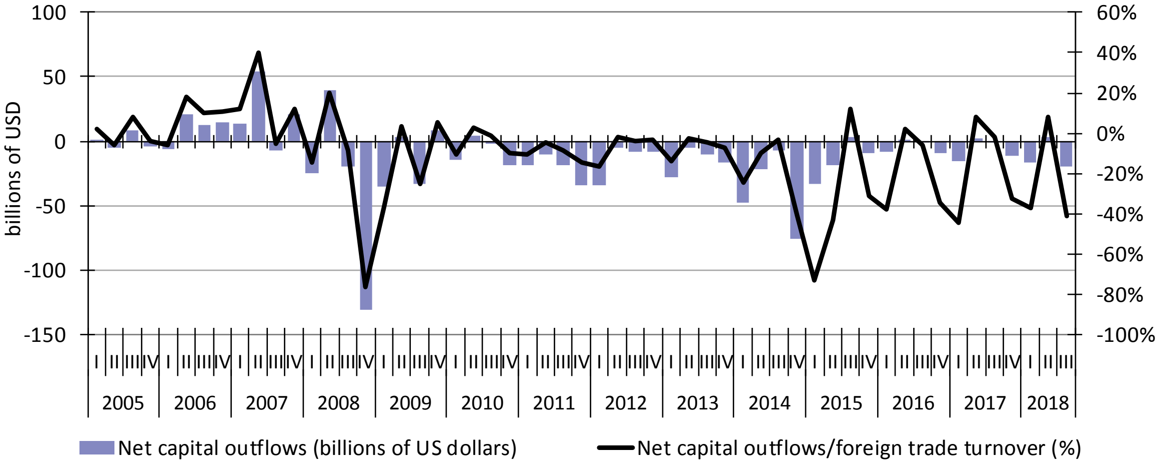
The investment income balance in Q3 2018 was -$9bn, showing a considerable change (due to the seasonal factor) compared to -$17bn in the Q2 and a small one compared to -$10.9bn in Q3 2017.

The rise in the current account surplus came amid an increase in the financial account deficit which reached $21.3bn in Q3 2018 (compared to a surplus of $10.5bn in Q3 2017). Net capital exports by banks and enterprises reached $19.2bn in Q3 2018, whereas net capital imports in Q3 2017 amounted to $0.4bn (*Fig. 2*). Additionally, banks saw a net capital outflow of $8.8bn in Q3 2018, whereas the third quarter of 2017 saw a net capital inflow of $8.5bn. Capital outflows from the banking sector were led, on the one hand, by an increase of $5.2bn in banks' foreign assets (by contrast, there was a decline in foreign assets of $16.3bn in Q3 2017) and, on the other hand, by a decline of $3.5bn in foreign obligations ($7.8bn in Q3 2017).

In Q3 2018, the private sector registered $10.4bn in net capital outflows ($8.8bn in Q3 2017). Enterprises' net capital outflows were almost completely driven by a decline of $10.8bn in foreign liabilities (in Q3 2017, by contrast, foreign liabilities increased $3.0bn).

Thus, the BoP data show that non-residents continued to reduce their investment in the Russian economy. For instance, inbound foreign direct investments dropped $6bn (in Q3 2017, by contrast, they increased $8.3bn), loans and credits payable fell $3.2bn (-$5.5bn in Q3 2017), other liabilities were reduced by $1.3bn (-$2bn in Q3 2017), and portfolio investment declined $0.4bn (in Q3 2017, by contrast, they increased $2.2bn). The private sector lost $0.6bn in foreign assets (in Q3 2017, by contrast, there was an increase of $11.0bn).

1 For more details see A. Knobel, A. Firanchuk. External turnover in services in 2017 // Russian Economic Developments. 2018. No. 6. P. 15–20.



Sources: Bank of Russia, Gaidar Institute's calculations.

Fig. 2. Private sector's net capital outflows, 2005–2018

Investors' downbeat expectations continued to influence the OFZ bond (rouble-denominated Russian government bonds) market. In Q3 2018, non-residents reduced their holdings of OFZ bonds by $1.8bn (by contrast, there was an increase of $7.3bn in Q3 2017). According to data available for the beginning of September 2018, non-residents' OFZ market share was 26.6% compared to 34.5% recorded as of 1 April 2018.

Russia's international reserves increased $5.0bn in Q3 2018 ($6.5bn in Q3 2017) on the back of MinFin's (Russia's Finance Ministry) foreign currency purchases of about Rb 548.2bn in the local foreign exchange market in compliance with the fiscal rule in effect. The growth in the international reserves slowed down compared to previous quarters: an increase of $19.3bn in January-March, $11.3bn in April-June. This can be explained by the fact that the regulator suspended on 24 August 2018 (till late December 2018) foreign currency purchases for the Finance Ministry in order to decrease volatility in financial markets.

In July-September 2018, the rouble to dollar exchange rate dropped 3.9% to 65.6 roubles per US dollar. In August, however, the rouble's exchange rate plunged to a record high level (since April 2016) of about 70 roubles per US dollar due to expectations of tighter sanctions against Russia and worsening conditions in emerging markets triggered by the Fed's tighter monetary policy. At the same time, the rouble weakened despite record-high oil prices (for the first time since November 2014) over $80 a barrel late in September 2018, reaching $84.95, according to data as of 1 October 2018. Therefore, with the aim to stabilize the situation, the Bank of Russia had to raise the benchmark interest rate in September for the first time since 2014 and suspend foreign currency purchases in the market. According to our estimates, the value of the rouble remains underestimated given a record high current account balance and is estimated at not more than 60–63 roubles per US dollar given the current state of fundamental factors. The rouble in the next six months will be shored up by seasonal factors that encourage a higher current account surplus.

That said, the risk premium for investing in Russian assets remains very high, triggering capital outflows from Russia. Further tightening of sanctions, particularly those against Russia's sovereign debt and state-run banks, may push the rouble's exchange rate further up.

4. SOCIAL SUPPORT OF THE POPULATION: IMPROVING TARGETING

E.Grishina, E.Tsatsura

Goal set by May Executive order of the President to reduce poverty by twofold will require not only growth of real wages and real incomes of population but also modification of the social support system for improving its targeting. This transformation has already started in the regions of Russia with more measures of social support accounting income of recipient or household.

As a result of 2014–2016 crisis, poverty level has increased in the Russian Federation from 10.7% in 2012 to 13.3% in 2017. At the same time, deficit of cash income, i.e. cash amount required for reaching subsistence level, increased from 0.5% GDP in 2012 to 0.8% GDP in 2017. Poverty risks among children younger eighteen years old have significantly increased. If in 2013 poverty in this age category exceeded poverty level of overall population by 1.8 times, in 2016 it was already by 2 times.

Gradual growth of real wages started again after it collapsed in 2015 by 9% against previous year. By August 2018, it amounted to 101.1% of the wages paid five years ago. However, real disposable monetary incomes have not been re-established yet. Despite their growth in January-August 2018 by 2.2% against the same period in 2017 it reached only 87.6% of August 2013.

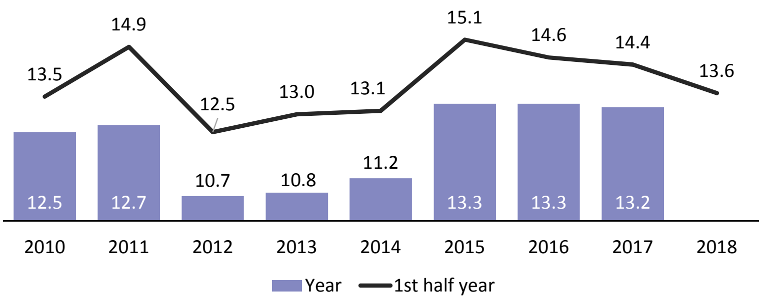
Thus, poverty level in H1 2018 exceeded the one of 2012–2014.

Implementation of the goal formulated by Executive order of the President, i.e. reduction of poverty level by twofold, suggest not only the growth of real wages and real incomes of the population but also modification of system of social support aimed at improvement of its targeting.

According to Rosstat, expenditures in consolidated budgets of subjects of the Russian Federation aimed at the implementation of social support measures for disadvantaged population across Russia amounted only to 0.31% GDP in 2017 compared to 0.27% GDP in 2016. Payment of all federal and regional subsidies and social assistance amounted to 3.1% GDP in 2016.

Average amount of regular cash payments to low-income population allocated from consolidated budgets of subjects of RF reached the level of Rb 884 in 2016 per capita, i.e. 9.0% of subsistence minimum.

Herewith, deficit of monetary income of low-income households amounted at an average to Rb 3085.2 per person in 2016, which equaled to 31.4% of subsistence minimum whereas deficit of monetary income of disadvantaged fami-



Source: Rosstat, Monetary incomes of the population vs subsistence minimum and number of disadvantaged people across Russian Federation in Q2 2018 – URL: http://www.gks.ru/bgd/free/B04_03/IssWWW.exe/Stg/d01/182.htm

Fig. 1. Share of the population possessing monetary incomes below minimum subsistence accross Russian Federation, %

lies with many children amounted at an average to Rb 3683.4 per person, i.e. 37.5% of minimum subsistence.

Thus, average amounts of regular social subsidies to low-income population paid from consolidated budgets of subjects of RF are not large enough and can not effectively contribute to poverty reduction.

Active amendments of the system of social support took place in regions of Russia over recent years, in particular, many measures became targeted, i.e. income of recipient or of a household was used as criteria securing the right to receive such assistance. In the last four years, such decisions were approved in at least 34 subjects of the Russian Federation and embraced more than one hundred measures of social support including support in the format of value in kind[1].

On one hand, these amendments prove that budget finances are focused on the most disadvantaged people. On the other hand, taking into consideration poor efficiency of social support of low-income population resulted from low payments, introduction of targeted assistance may provide recourses for the increase of payments at the expense of economy. However, as regional practice proves, such cases are rather rare. Approximately only one third of cases is associated with any increase of payment resulted from the introduction of income accounting to current social subsidies and payments, and significant increase, more than by 15%, happened only in 8% of all cases. In 59% of cases, the amount of payment remained the same and in 7% it has even reduced.

Incorporation of incomes accounting relates most frequently to various measures of support provided to families having children, i.e. 60% of cases while elderly people make up one third of all cases. Moreover, incorporation of income accounting under measures of social support aimed at families having children was associated with an increase of payments in 20% of cases. Therewith, in half of all cases introduction of income accounting under measures of social support of elderly people was associated with at least a slight increase of payments.

Two principal methods are used in order to improve targeting of social support. Firstly, this is a change of income threshold for individuals or households recognized as requiring support. Secondly, granting the right to receive social support at the expense of introduction of additional criteria for selection of recipients to a limited group of people.

Introduction of categorial filter in Krasnoyarsk region, property filter in Moscow, Tyumen region, labor status filter in Samara and Tyumen regions could serve as relative examples. Changes of threshold of the per capita income of recipients were the reason for a significant increase of payment only in one case out of seven and that happened in Yakutia. The amount increased in two cases out of five after introduction of additional filters. Thus, tightening of conditions required for granting subsidies can also be used as a tool for economy of budget financial means.

1 Measures of support in value in kind as well as individual payments will not be considered further in absence of relevant information. Research does not include remuneration to parents for child- care at the educational organizations, implementing educational program of pre-school education as in many regions this measure has to be provided by organizations responsible for education.

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