MONITORING OF RUSSIA'S ECONOMIC OUTLOOK:

TRENDS AND CHALLENGES OF SOCIO-ECONOMIC DEVELOPMENT

No. 8(69) April 2018

Monitoring has been written by experts of Gaidar Institute for Economic Policy (Gaidar Institute) and Russian Presidential Academy of National Economy and Public Administration (RANEPA).

Monitoring of Russia’s Economic Outlook: trends and challenges of socio-economic development. 2018. No. 8 (69). April / A. Bozhechkova, Yu. Zaitsev, N. Zubarevich, A. Kaukin, E. Miller, P. Trunin, S. Tsukhlo. Edited by: V. Gurevich, S. Drobyshevsky, P. Kadochnikov, V. Mau and S. Sinelnikov-Murylev. Gaidar Institute for Economic Policy, Russian Presidential Academy of National Economy and Public Administration. 24 p. URL: http://www.iep.ru/files/text/crisis_monitoring/2018_8-69_April_eng.pdf

TRENDS AND CHALLENGES OF SOCIO-ECONOMIC DEVELOPMENT

None of the important indicators of the Russian economy has become of late ominously turbulent, and foreign investors have even increased their investments in Russian assets. However, there is little doubt that these investments are in the main speculative, and that turbulence can easily come back with a vengeance. Even the unexpected decision of United States Department of the Treasury to soften some of the anti-Russian sanctions should be logically interpreted not as an indicator that the situation has begun to improve, but rather as a sign of further growth in uncertainty.

The same vector is also typical of the steadily rising oil prices. The opinion that they played a positive role in overcoming the volatility of the ruble's exchange rate and its stabilization, as well as preventing inflation growth, is likely to be sound. However it should be said that oil prices are becoming less and less dependent on market factors and are being increasingly determined by geopolitical, and therefore unpredictable, circumstances. When prices are artificially highly inflated, this factor alone increases the risks of their decline, the scope and the timing of which are weakly predictable.

It is evident that for the time being such a situation in the hydrocarbons market has been producing good results, as confirmed by the findings of our experts who analyzed Russia's balance of payments in Q1 2018. By comparison with Q1 2017, the current account surplus increased by 9%, to $ 28.8m. In the main, this increase was due to a notable growth in Russia's foreign trade surplus, to be more specific – in the accelerated growth of exports, whose composition, as of January and February 2018, was as follows: 30% – crude oil exports, 19% – petroleum product exports, and 11% – natural gas exports.

Net capital outflow from Russia somewhat reduced relative to Q1 2017. It should be pointed out that in Q1 2017, the main contributor to that outflow was the banking sector, while in Q1 2018 the main contributor was the non-banking one. This is believed to be caused by expectations that the anti-Russian sanctions would be toughened. According to experts, it can be expected that the inevitable gradual stabilization of the situation in the aftermath of the destabilization of the market in April may result in some strengthening of the ruble (which is buoyed by the currently high oil prices), although not to its initial level. According to their estimates based on a number of fundamental factors, although the nominal USD to RUB exchange rate does not exceed RUB 60 per US dollar, the process of the ruble's rebound to its fundamental values can be a very long one.

The experts who have analyzed the consequences of the latest sanctions package, including their long-term effects, see them to be as follows: an outflow of foreign investments, a return of funds of sanctions-hit Russian companies, and a rise in their losses. The ongoing decline in the capitalization of these companies can continue to create a negative backdrop for investors, which may result in a downgrading of Russia's sovereign ratings, which has recently been upgraded by the international rating agencies. Our authors have a negative opinion of the package of draft counter-sanctions presented to the RF State Duma for consideration. This package of draft sanctions envisages the imposition of constraints on the selling, in RF territory, of a large variety of products manufactured in the USA, and likewise on the selling, in the US market, of some industrial products manufactured by Russian producers. Our experts believe that in order to neutralize the ant-Russian sanctions, it would be better for Russia to take a number of short-term measures, including those designed to attract finance necessary for Russian companies to refinance their Eurobonds to the value of $ 22.8bn by the year-end of 2019.

The analysis of branch indices of industrial production carried out by the Gaidar Institute's specialists is related to Q1 2018, and therefore does not take into account the effect of the April package of anti-Russian sanctions. According to this study, the period-end results of Q1 2018 make it possible to affirm that Q1 indeed saw a slow growth in the extracting industry due to an increase in natural gas and coal production (in both cases triggered by an improvement in the foreign trade situation). At the same time, the growth rate of the manufacturing industry remained close to zero, as it had been the case in late 2017. A relatively stable positive movement of the main indices was observed in the textile and chemical industries, and in metallurgy.

It should be said that it is the latter that can suffer negative effects from the imposition of the afore-mentioned sanctions. On the other hand, the sanctions have significantly increased world metal prices (which had already been very high), including the prices of non-ferrous metals.

According to the latest business surveys carried out by the Gaidar Institute in Q1 2018, the so-called Industry Adaptability Index (the percentage of enterprises considering their situation to be 'normal') plummeted to 74%, only slightly above its record low registered in early 2009, the year of global financial crisis. The negative behavior of this index was related, first of all, to the polled enterprises' dissatisfaction with the state of demand for their products (only 58% of them considered the state of demand for their products as normal, which was 7% less than in late 2017). A total of 85% of industrial enterprises believed that their financial situation was good or satisfactory. Although their percentage was smaller than last year, it should be taken into account that last year's index was an all-time high since the beginning of these surveys.

Our analysis of the socio-economic situation in Russia's regions (including data for January and February 2018) indicates that the absolute majority of them (74) experienced industrial growth. However, 18 regions experienced slump, including in a number of oil-producing territories (Nenets and Khanty-Mansi Autonomous Okrugs, the Komi Republic) and Tula Oblast (-20% due to a decline in the state defense order). Most of the regions registered a growth in investment, Crimea and Sevastopol being the leaders in this respect, while Moscow chalked up a 13% growth. Almost one-quarter of all investments allocated from the federal budget are linked, one way or another, with the Crimea, while Moscow accounts for more than one-third of investments financed from regional budgets. Moreover, growth in the revenue and expenditure sides of consolidated regional budgets was similarly achieved, to a large extent, at the expense of Moscow. Budget deficit, as seen by the year-end results of 2017, was registered in 43 regions (vs. 56 in 2016), the largest budget deficit being in Mordovia, where expenditure overshot revenue by 25%.

1. BALANCE OF PAYMENTS IN Q1 2018: ANALYSIS AND FORECAST

A.Bozhechkova, A.Knobel, P.Trunin

Russia's positive balance of trade increased in Q1 2018 reflecting an increase of exports value amid slower growth of imports deliveries. Private capital outflow was observed triggered by the growth of foreign assets of Russian enterprises amid negative geopolitical expectations.

According to Bank of Russia's preliminary data on BoP for Q1 2018, the current account balance ran at $28.8bn, gaining 29% against the same indicator of Q1 2017 which constituted $22.3bn (up $6.5bn). As in the previous periods[1] this change was driven first of all by positive balance of trade increase by $7.8bn (from $34.5bn seen in Q1 2017 to $42.3bn reported in Q1 2018) (*Fig. 1*) reflecting exports growth by 20% in value terms (from $82.6bn in Q1 2017 to $99.3bn in Q1 2018 – up $16.7bn). Exports growth is twice exports increase in value terms (from $48.1bn in Q1 2017 to $57.0bn in Q1 2018 up $8.9bn).

Imports growth was accompanied by ruble's devaluation – according to the data released by the Bank of Russia, the index of ruble's real effective ruble exchange rate against other foreign exchanges in Q1 2018 against Q1 2017 constituted -5.8%, leading to a substantial relative increase of costs of

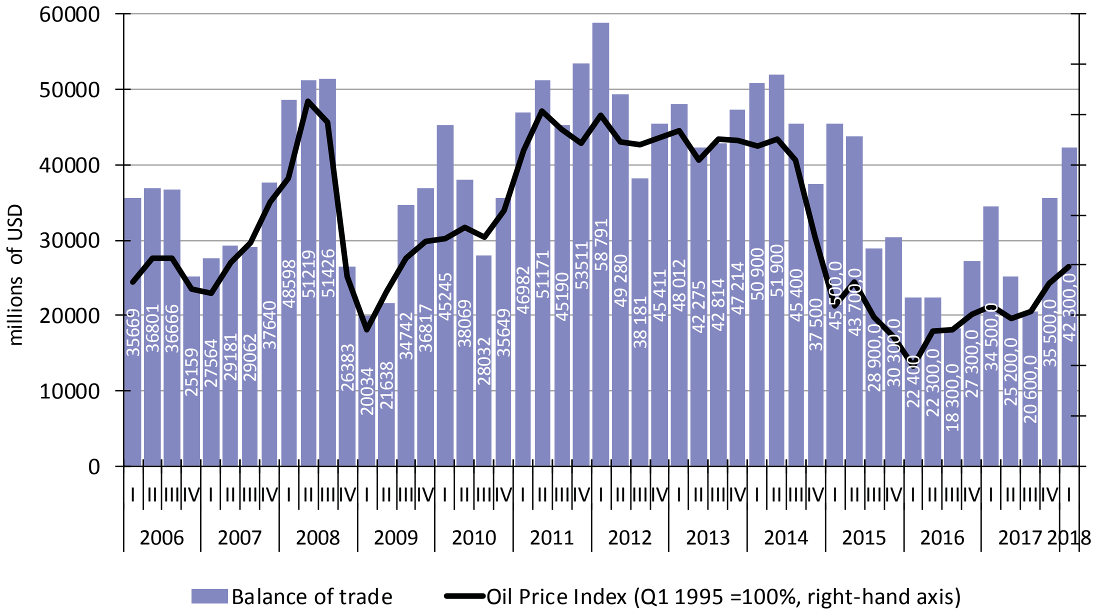

Fig. 1. Russia's balance of trade and the global oil price index in 2006–2018

Sources: Bank of Russia, own calculations.

1 See in detail: A. Bozhechkova, A. Knobel, P. Trunin. Balance of Payments of 2016 // Russian Economic Developments. 2017. Vol. 24. No. 2. P. 3–6; A. Bozhechkova, A. Knobel, P. Trunin. Russia's Balance of Payments of 2017 // Russian Economic Developments. 2018. Vol. 25. No. 2. P. 8–11.

imports. By contrast, with 2015-2017 when ruble's devaluation resulted in decrease in imports and its appreciation – by its growth, Q1 2018 demonstrates that imports can substantially increase on the back of gradually depreciating ruble. Apparently, this situation was linked with a prolonged previous period of national currency appreciation and a lag between signing import contracts and goods shipments[1].

Growth of exports volume in value terms is usually determined by exogenous for the Russian economy increase of world and regional prices on raw materials on the back of rapid global economic growth. This is the case of not only crude oil which constitutes 30% of Russia's exports (in January–February 2018 average prices of deliveries abroad constituted around $460 per ton[2] against $371 per ton in Q1 2017) but prices on petroleum products which constitute 19% of exports (in January–February 2018average export prices on petroleum products constituted around $470 per ton against $409 per ton in Q1 2017).

Ferrous metals prices moved up notably constituting 5.1% of exports (in January–February 2018 average delivery prices on ferrous metals averages $500 per ton, whereas in January–February 2017 were $421 per ton). Prices on hard coal, copper, aluminum, nickel, mineral fertilizers, iron ore, timber, and cellulose moved up. Price growth on these products traditionally came amid consistent values of deliveries volumes which determines their direct impact on the balance of payments and current account balance. Notable difference was registered in shipments of liquefied natural gas (LNG) abroad in January–February by more than two-fold from 2.1 mn cubic meters to 5 mn cubic meters which was driven by Novatek launching the first stage of Yamal LNG project

Prices for other Russian primary exports – natural gas (11% of Russia's exports) also moved up by 18% (export prices averaged around $201 per thousand cubic meters in January–February 2018, whereas in Q1 2017 they stood at $170 per thousand cubic meters). Long-term natural gas contracts are based on crude oil prices over the previous periods, export natural gas prices will be growing until the end of the year with retention of gas export volumes will drive up the current account balance.

At the same time, notable shifts in export (up 16.9% from $12.4bn in Q1 2017 to $14.5bn in Q1 2018) and import (up 23.4% from $17.5bn in Q1 2017 to $21.6bn in Q1 2018) of services are being observed due to small deterioration of trade balance in services (from -$5.2bn in Q1 2017 to -$7.1bn in Q1 2018). Compensation of labor balance is traditionally small (-$0.5bn in Q1 2018) as well as rent income balance (around 0). The investment income balance in absolute terms underwent minor changes (from -$4.6bn in Q1 2017 to -$4.1bn in Q1 2018) mainly due to certain reduction of investment income payable (from $15.2bn in Q1 2017 to $14.7bn in Q1 2018) with retention of investment income receivable at $10.6bn.

Thus, the trade in other goods of Russia's export and the trade balance which is exogenously reliant on hydrocarbon prices continued to be the prin-

1 More on exchange rate effect on trade see also A. Knobel, A. Firanchuk. Foreign Trade in 2016 // Russian Economic Developments. 2017. Vol. 24. No. 3. P. 8–17; A. Knobel, A. Firanchuk. Russia's Foreign Trade in 2017 // Russian Economic Developments. 2018. Vol. 25. No. 3. P. 6–13.

2 Corresponds ~$63 per barrel. According to Q1 results, value will change insignificantly.

cipal driver of the amount of the current account balance in the Russian economy.

The increase in the current account surplus occurred with an increase in financial account deficit constituting $8.2bn in Q1 2018 (against $11.7bn in Q1 2017). Banks and enterprises saw a net capital outflow for Q1 2018 to come to $13.4 bn down 18.3% compared to Q1 2017 (*Fig. 2*)

The dynamics of capital outflow was driven mainly by non-bank sector transactions. In particular, net capital outflow by enterprises came to $12.5bn in Q1 2018, whereas in Q1 2017 capital inflow was observed to the tune of $1.2bn. The major contribution to the balance of enterprises transactions with the rest of the world came from external assets growth. For example, outflow of funds for enterprises in the form of direct foreign investment came to $7.1bn ($8.3bn in Q1 2017) and was not offset by an inflow of direct investment from non-residents which came to solely $4.3bn ($4.9bn in Q1 2017). The amount of other foreign assets of non-bank sector went up by $5.6bn, whereas in Q1 2017, on the contrary, their decrease to the tune of $11.4bn was observed. Portfolio investment balance of non-bank sector was negative (-$0.5bn in Q1 2018 against -$6.7bn in Q1 2017). Contraction of inbound portfolio investments in non-bank sector constituted $0.2bn (-$5.1bn in Q1 2017) with an increase of outbound portfolio investments by $0.3bn ($1.6bn in Q1 2017).

Most likely, capital flight from non-bank sector seen in Q1 2018 was driven by expectations of tougher sanctions against Russia.

Net capital outflow by banks came to merely $0.9bn in Q1 2018, whereas it hit $17.6bn in Q1 2017. Capital outflow from the banking sector mainly driven by a contraction of foreign liabilities (-$1.7bn in Q1 2018 against -$3.9bn in Q1 2017).

Negative investors' expectations have also affected the state of the Federal Loan Obligations (OFZs) market. For example, in Q1 2018, a notable

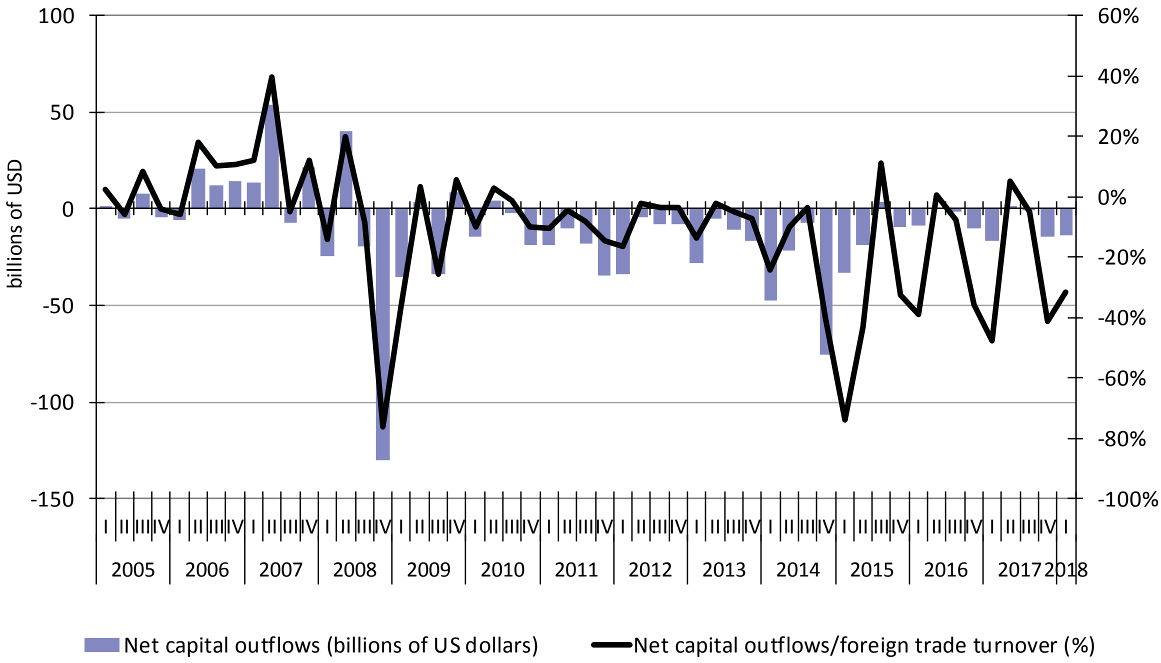

Fig. 2. Private sector's net capital outflows in 2005–2018

Sources: Bank of Russia, own calculations.

contraction of non-resident investments in liabilities of federal agencies of state administration ($1 billion in Q1 2018 against $4.4 billion in Q1 2017).

According to BoP data, the international reserves in Q1 2018 hit $19.3bn ($11.3bn in Q1 2017) due to purchases of foreign currency by the Finance Ministry to the tune of around Rb 700.3bn on the domestic market in the framework of the budget rule as well as banks repayment of foreign liabilities under repos with the central bank ($4.5bn).

Dollar to ruble exchange rate for January–February 2018 changed insignificantly down 0.6% to Rb 57.26 per dollar. Nevertheless, April saw a disruption on the foreign currency market due to ruble's sharp devaluation triggered by new tough sanctions against Russia. The situation was also aggravated by the economic agents' expectations regarding further imposition of new tough sanctions including their potential extension to Russia's sovereign debt as well as the military conflict in Syria. Consequently, from 6 through 17 April dollar to ruble exchange rate up 8.7% to Rb 62.3 to a dollar.

In addition to panic-driven fear dominating the currency market at that moment which translated into a large-scale sale of Russian assets and purchases of foreign currency, ruble's revaluation has fundamental reasons. Firstly, sanctions imposed against major Russian companies, most likely, can lead to certain contraction of Russia's exports which other things equal will decrease Russia's current account balance of payments. Secondly, investment risks in Russian assets have notable increased. In other words, risk weighted return on assets decreased in Russia. At the moment of panic, it is impossible to determine the effect of fundamental factors. However, with the stabilization of the situation ruble's appreciation will be observed although not to the initial level.

Crude oil prices which peaked during recent years will be a factor which will maintain ruble's exchange rate stabilization. According to our estimates and according to the status of fundamental factors rated value of the dollar exchange rate does not surpass Rb 60 per USD. However, in case of further new tough sanctions ruble's return to fundamental values can notably delay.

2. APRIL SANCTIONS: IMPLICATIONS FOR THE RUSSIAN ECONOMY

Yu.Zaitsev

On 6 April 2018 the United States imposed new round of sanctions against 15 Russian companies and 26 businessmen and public officials[1]. Such a wave of sanctions creates problems for the entire Russian economy and not only for certain sectors.

Russian market response

Imposed sanctions banned American companies from working with Russian corporations and individuals on the new list[2]. American business must terminate until 5 June 2018 all transactions on contracts signed prior to 6 April with 12 Russian companies[3], and until 7 May – with Rusal, EN+ Group, and GAZ Group[4].

Russian stock and currency exchanges were the first to respond to the new round of American sanctions. For example, four days after the announcement of restrictive measures the dollar exchange rate hit Rb 65 (for the first time since November 2017) and euro jumped to Rb 80.5 (for the first time since 4 August 2016). Moreover, MICEX and RTS indexes were down in trading by 9–11% on the back of Russian assets sale[5]. Securities not only of Russian public companies in relation to which sanctions were imposed (RUSAL dropped 31.78%[6]) but securities of other entities that were not slapped with US sanctions – Sberbank (-18.74%) and BTB (-8.84%)[7] shed value. This is due to high share of state banks securities in the overall portfolio of investment funds as well as risks carried by Sberbank in relation to companies slapped with sanctions that Fitch estimates to reach $11bn.

In the context of stock exchange general instability, the Russian sovereign bonds depreciated (Russia-2030 down 0.8%, Russia-2047 down 2.81%, and Russia-2043 down 3.75%). Now this can be assessed as a timeserving event. However, congressman Joaquin Castro introduced a bill on a new round of sanctions envisaging restrictions on transactions with Russia's new Eurobonds that raises risks for the Russian sovereign debt[8].

---

1 Full list of Russian citizens and Russian companies slapped with the US sanctions. URL: https://www.vedomosti.ru/business/articles/2018/04/06/756090-polnii-spisok

2 Treasury Designates Russian Oligarchs, Officials, and Entities in Response to Worldwide Malign Activity. US Department of the Treasury, 6 April, 2018. URL: https://home.treasury.gov/news/press-releases/sm0338

3 General License 12. US Department of the Treasury, 6 April, 2018. URL: https://www.treasury.gov/resource-center/sanctions/Programs/Documents/ukraine_gl12.pdf

4 General License 13. US Department of the Treasury, 6 April, 2018. URL: https://www.treasury.gov/resource-center/sanctions/Programs/Documents/ukraine_gl13.pdf

5 Euro exchange rate surpassed Rb 74 // Vedomosti, 9 April, 2018. URL: https://www.vedomosti.ru/finance/news/2018/04/09/760457-kurs-evro-previsil

6 https://www.vedomosti.ru/finance/articles/2018/04/09/759875-rossiiskie-aktivi

7 Investors sell Russian assets. Vedomosti, 09.04.2018. URL: https://www.vedomosti.ru/finance/articles/2018/04/09/759875-rossiiskie-aktivi

8 American sanctions threaten Russia's sovereign debt // Vedomosti, 10.04.2018. URL: https://www.vedomosti.ru/economics/articles/2018/04/10/764419-amerikanskie-sanktsii-ugrozhayut-dolgu-rossii

Nevertheless, a slump seen on currency and stock exchanges did not last long – three days later the ruble bounced back half of what it had lost since 9 April[1], pointing firmer at Rb 61.19 per USD and Rb 76.16 per euro[2].

Outcome for the Russian economy

The long-term effect of imposed sanctions will lead to the foreign investment outflow, capital inflow from the Russian sanctioned companies as well as growth of their losses. The latter can negatively affect certain sectors of Russian economy. For example, sanctioned Russian companies' loss in capitalization further can create negative environment for the investors[3] that can result in downgrading recently upgraded by S&P and Fitch agencies of Russian sovereign credit ratings. Thus, April sanctions represent threat not only for certain companies which status was hit on stock exchanges but a problem for the entire Russian economy.

The Russian aluminum industry can find itself in the most vulnerable position owing to the new round of sanctions. In particular, Rusal can come up short of 20% of its exports due to the loss of part of its external markets[4]. For instance, the company can not ship its products to the U.S. and the London metal exchange stopped transactions with it. Business can lose part of their clients from other countries that may start to avoid transactions with a "toxic" company. Japanese companies Mitsubishi, Marubeni, Sumitomo and Mitsui&Co as well as Anglo-Australian Rio Tinto have done it already.

The global market of aluminum oxide has faced the negative effects of the sanctions where the Rusal's share constituted around 7%. According to Financial Times, prices on shipments of aluminum oxide jumped 20% and of aluminum – 5%[5]. Sanctions will negatively affect the Russian banking sector whose losses can hit Rb 100bn due to capital revaluation and weak financial results affected by private sector's slack demand for tight money[6]. This will amount more than 6% of the banking sector income in 2018 projected by the Bank of Russia (Rb 1.5 trillion)[7].

Sovereign Eurobonds[8] as well as new Russian offshore zones[9] – new tools launched by the government can promote the return of Russian capital. The

1 On the effect of currency changes on trade (in particular, imports) see A. Knobel. Assessment of demand function on imports in Russia // Prikladnaya ekonometrika. 2011. No. 4 (24). P. 3–26.

2 The ruble bounced back nearly half of its losses since the start of the week. Vedomosti, 12.04.2018. URL: https://www.vedomosti.ru/finance/articles/2018/04/12/766537-rubl-otigral-pochti-polovinu-padeniya

3 Yu. Zaitsev, A. Knobel. Direct foreign investments in H1 2017 // Russian economic developments. 2018. No 1. P. 7–11. URL: https://elibrary.ru/item.asp?id=32363132

4 UC Rusal will slash the aluminum exports, 17.04.18. URL: https://www.vedomosti.ru/business/articles/2018/04/18/767005-rusal-eksport-alyuminiya?utm_campaign=newspaper_18_04_2018&utm_medium=email&utm_source=vedomosti

5 Aluminium prices rally to highest level since 2011 // Financial Times, 16.04.2018. URL: https://www.ft.com/content/151f278e-419a-11e8-803a-295c97e6fd0b

6 German Gref has estimated losses of the Russian banks from market volatility in the amount of Rb 80–100bn. 17.04.18. URL: http://ru.reuters.com/article/idRUKBN1HO2FC-ORUBS?utm_source=34553&utm_medium=partner

7 Banking sector liquidity and financial markets. N0 25, March 2018. URL: https://www.cbr.ru/Collection/Collection/File/5907/LB_2018-25.pdf

8 Authorities decided to capitalize on tougher sanctions – implement regular amnesty. 24.12.17. URL: https://www.vedomosti.ru/economics/articles/2017/12/25/746345-zarabotat-na-sanktsii?utm_campaign=Свежий%20номер%20«Ведомостей»%20за%2025%20декабря&utm_medium=email&utm_source=vedomosti

9 Russian authorities want to establish offshore to assist sanctioned oligarchs. 10.04.2018. URL: https://www.vedomosti.ru/economics/articles/2018/04/10/764372-ofshori-oligarham?utm_campaign=newspaper_10_04_2018&utm_medium=email&utm_source=vedomosti

list of support mechanism can be expanded depending on the companies' needs. For instance, they can be expanded by export credits, tax privileges, subsidized credits issued via development institutes, provide preferential access to state purchases and to investment contracts as well as establish a new institute to fight sanctions after-effects[1]. However, these measures can notably decrease competitiveness of Russian companies in the long-term. Moreover, infusion of money into economy always bring risks of inflation. In case of strengthening of negative trends the Bank of Russia allows for raising the key rate[2].

Capital outflow as a whole together with exacerbation of problems of certain companies can slow down GDP growth rates at 2018 year-end.

Countersanctions are riskier than sanctions

Submitted on 13 April 2018 by the State Duma a set of counter measures designed in response to the American sanctions proposes imposition of restrictions on metals, agricultural products, alcoholic beverages, tobacco, pharmaceuticals trade as well as cooperation in aircraft industry, rocketry, nuclear industry, consulting, auditing and law services.

On the one hand, this list of cooperation spheres spread to the most important spheres of Russian-American economic cooperation which is not close enough any way in relative terms. For example, the US share in Russian trade turnover in 2017 amounted to around 4%[3]. On the other hand, The US economy is significantly larger and more diversified versus the Russian economy and can easily reorient to other markets and suppliers. Whereas Russia can fail to find alternatives. In view if this, there is a risk that countermeasures can be more biting for Russians than for Americans.

Russia does not produce analogues for certain drugs imported from the US. As of today, the US share in Russia's imports of drugs amounts to 28%, whereas the total share of imported drugs on the Russian market in value terms exceeds 68.2% (as of February 2018)[4]. The Russian Health care Minister has confirmed Russia's ill-preparedness to give up on import of original drugs[5].

Refusal from metals deliveries for the industrial production will not lead a crisis neither in the US nor in the EU countries. Missing link in the production chain (although it will cause growing costs in the short-term) can always be replaced with another and restore business process. Major manufacturers as American Boeing or European Airbus can obtain a competitive proposal for supplies of titanium of the global market. That is why the government does not see a refusal from cooperation with these companies as a countersanctions priority[6].

1 Sanctions against security bodies // Vedomosti, 19.04.2018. URL: https://www.vedomosti.ru/opinion/articles/2018/04/19/767151-sanktsii-na-organi

2 The Bank of Russia lifted the taboo from raising the key rate // Vedomosti, 17.04.2018. URL: https://www.vedomosti.ru/economics/articles/2018/04/17/766877-tsb-klyuchevoi-stavki

3 Foreign trade statistics. FCS of Russia. URL: http://www.customs.ru/index.php?optioncom_newsfts&view=category&id=125&Itemid

4 Russia's pharmaceuticals market. February 2018. URL: http://dsm.ru/docs/analytics/february_2018_pharmacy_analysis.pdf

5 Not ready for hawthorn: head of Health care Ministry has acknowledged Russia's dependence on foreign drugs. 19.04.2018. URL: https://www.newsru.com/russia/19apr2018/skvortzovaboyar.html

6 Manturov excluded Russian ban on supplies of titanium for Boeing // RBC. 18.04.2018. URL: https://www.rbc.ru/rbcfreenews/5ad748429a7947fcf203260c?utm_source=amp_full-link

Undoubtedly, in the medium-term, we can expect the import substitution effect in a number of sectors (for example, agriculture, alcoholic beverages, tobacco products) but as in 2015 it will have its ceiling due to resource and production constraints on part of Russian producers. Ambiguity of proposed retaliatory measures forced the Russian government to put off their adoption.

Further measures designed to offset the impact from the new round of sanctions undoubtedly should focus on the solution of short-term issues. First of all, this is the case of raising funds for refinancing of Eurobonds by the Russian companies to the tune of $22.8bn until the end of 2019[1]. In the long-term, the issue of raising funds for the Russian economy will require revision of the fragile aspects of Russian foreign economic policy. China's experience which weathered sanctions in the 1980s demonstrates that investor who left the country are bound to return.

Search for ways out of the current crisis is feasible via extended cooperation with international financial organizations – the World Bank and regional development banks. In particular, participation in banks' projects in full parity with other developed countries (for instance, nanotechnologies development, other innovation projects)[2] are of significant interest. Moreover, these institutes boast of high potential in raising investments in capital stock of private enterprises.

1 The US sanctions raise the cost of loans for the Russian companies // Vedomosti, 16.04.18. URL: https://www.vedomosti.ru/business/articles/2018/04/16/766853-povishayut-stoimost-zaimov-rossiiskih

2 Yu. Zaitsev. International development assistance programs in the context of assistance to the Russian banks investment activity in developing countries: possibilities and challenges. Problems of national strategy

3. INDUSTRIAL OUTPUT IN Q1 2018: GAS AND COAL EXTRACTION GROWTH[1]

E.Miller, A.Kaukin

By-sector analysis of industrial production indices shows that there are still no conditions for transition to sustainable growth in the majority of sectors. The trend component of the industrial production index points to a growth in manufacturing industry in the amount of 0.4% in March 2018 compared to December 2017. Extraction of mineral resources grew mainly due to gas and coal sectors.

According to Rosstat statistics, the industrial production index in Q1 2018 moved up 1.9% (without seasonal or calendar adjustment) compared with similar period of the previous year. Manufacturing industry growth hit 2.2% while the extraction sector growth hit 1%.

Analysis of dynamics of industrial sectors' output done by the Gaidar Institute demonstrated that following time series decomposition and removal of the trend component[2] it is possible to speak about a slow growth in the mining sector in Q1 of the current year. While manufacturing industry's growth stands close to zero, just like in late 2017 (*Fig. 1*).

In March 2018 oil extraction (including gas condensate) declined by 0.7% compared to March 2017 due to extension of the agreement with OPEC+ on cutting oil production and monitoring oil exports signed in November 2017[3]. Extraction of mineral recourses grew mainly owing to increase in gas and coal sectors (14% and 9%, respectively against March 2017).

Extraction of natural gas grew on the back of an increase in European exports, where domestic gas production fell,4 as well as due to 'Yamal SPG' project reaching its working capacity. Large part of supplies from that project will go to the Asia-Pacific region.

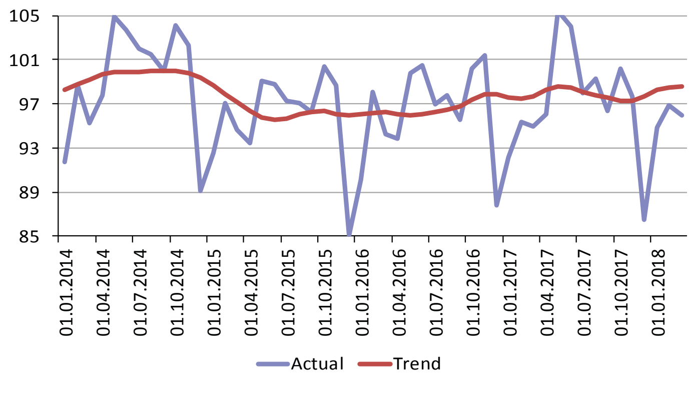

Fig. 1. Dynamics of industrial production index in 2014–2018, as % to 2014

Sources: Rosstat, own calculations.

Increase in coal production reflects the continuation of a positive trend on the global market that started in summer of 2017, when coal prices stopped falling and then went up for the first time in 5 month. That trend reflected the closure of old and un-

1 Authors should like to thank M. Turuntseva and T. Gorshkova for their contribution to statistical analysis.

2 The trend component was removed by using Demetra software package based on X12-ARIMA.

3 According to statistics released on the official website of the Ministry of Energy of the Russian Federation.

4 A. Zlobin. Fuel for sanctions: Gazprom exports grew by a third // Forbes. 2017. URL: http://www.forbes.ru/biznes/358721-toplivo-dlya-sankciy-eksport-gazprom-vyros-v-marte-pochti-na-tret

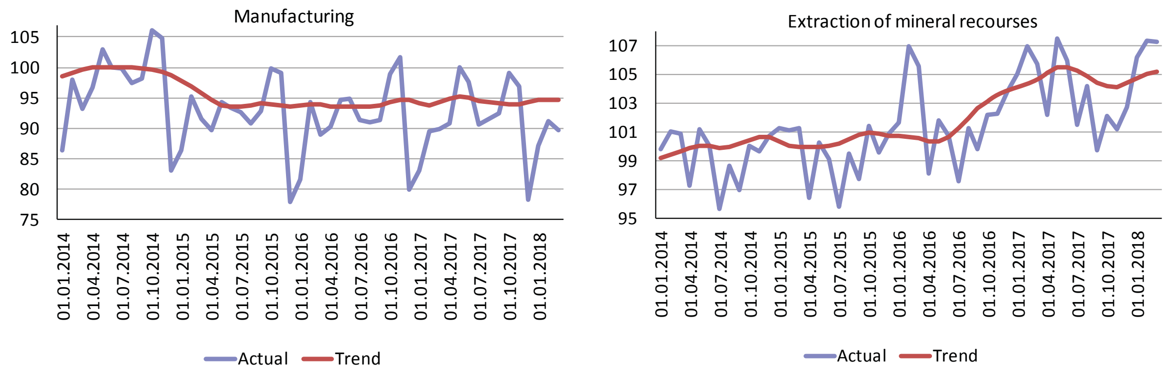

Fig. 2. Dynamics of sector production index in 2014–2018, in % to June 2014
Source: Rosstat, own calculations

profitable mines in China in 2016 and a halt of production for a few-months in Australia due to weather conditions. The market faced strong disruptions in coal deliveries. Readiness to increase supplies was, as it seemed, determined by relatively sound state of Russian companies – following the ruble’s devaluation in 2014, along with cuts in ruble costs in the final price of products, the global market observed an increase in own investments in production.

Unlike the mining sector, most of manufacturing sectors posted decline (*Table 1*). Manufacture of means of transport and transport equipment (although the output decline over recent months is not as high as it was in late 2017, when the slump was due to output decrease in defense industry), manufacture of machinery and equipment, electrical equipment negatively contribute to the dynamics of the aggregate production index in manufacturing industry.

Relatively stable positive dynamic is still observed in the textile industry, chemical industry and metallurgy. As to the latter, despite current anti-dumping duties imposed on steel imports by Indonesia, Turkey and Mexico, dynamics of trend component grew owing to demand on foreign markets (according to FCS statistics, the value of exports of metals and metal products in January–February of 2018 grew by 45%, while physical export value grew by 13% comparing with the same period of last year). It should be noted that there is a possible decrease of volumes of exports in future, mostly due to customs duties on imports of steel and aluminum coming into force in the US in March 2018, as well as customs duties on steel import in Egypt.

Table 1

INDEX CHANGE IN OUTPUT OF DIFFERENT INDUSTRIAL SECTORS, %

	As % of the industrial production index	March 2018 to July 2014, %	March 2018 to December 2017, %	Changes in recent months
Industrial production index		98.67	100.88	Slow growth
Extraction of natural resources	34.54	105.25	100.75	Slow growth
Manufacturing industry	54.91	94.73	100.41	Stagnation
including:				
Food products, including beverages, and tobacco	16.34	110.64	100.32	Stagnation
Textiles and wearing apparel	1.14	114.62	102.55	Growth
Leather, articles of leather, and footwear	0.27	94.22	97.50	Decline
Woodworking and articles of wood	2.02	100.59	97.55	Decline
Pulp, paper and paperboard	3.35	65.39	93.67	Decline
Coke, refined petroleum products	17.25	98.26	100.01	Stagnation
Chemicals and chemical products	7.56	141.18	103.99	Growth
Rubber and plastic products	2.14	106.55	98.94	Slow decline
Other nonmetallic mineral products	4.02	89.97	100.94	Slow growth
Metallurgy and finished metal products	17.42	105.58	102.66	Growth
Machinery and equipment	6.97	92.06	98.75	Slow decline
Electrical, electronic and optical equipment	6.27	81.75	98.38	Decline
Means of transport and transport equipment	6.75	71.57	97.62	Decline
Other	2.42	106.02	98.03	Decline
Electricity, gas and water	13.51	102.81	103.92	Growth

Sources: Rosstat, own calculations.

4. INDUSTRY ADAPTABILITY INDEX IN Q1 2018

S.Tsukhlo

18 Industry Adaptability Index notably fell (Fig. 1) – just 74% of enterprises have assessed their main indicators as "normal". Such negative change in consolidated indicators has not been registered since the crisis of 2009, when Index fell by 10 points. Note, that in Q1 2015 adaptability Index fell by only 2 points.

It should be noted, that the crisis of 2015–2016 has not provoked the adaptability Index decrease. On the contrary, in 2014, 70% of enterprises reported status of their main consolidated indicators (demand, stocks, headcount, production capacities, and financial status) as normal, in the first year of crisis – 71%, in the second – 73% of enterprises. Therefore, throughout the crisis of 2015–2016, industry did not report any signs of a crisis and even managed to adapt to new conditions, unlike in previous periods. While 77% of Russian industrial enterprises adapted to the exit conditions out of the 2017 crisis, which was an all-time high for the entire 24 years of its computing.

What made industry to downgrade the estimates of the current situation in Q1 of 2018? Current demand estimates were downgraded the most. Around zero demand dynamics seen in 2018 didn't provide industry with enough sales to recover from crisis. When compared to Q4 of 2017, sales satisfaction declined by 7 points to 58%, results registered at the end of the previous year (65%) turned out to be the best for the period of 2008–2017.

Enterprises downgraded their "normal" assessments of financial and economic status which was the second most notable factor. Since all-time high values seen in H2 2017 for the entire period of monitoring this indicator shed 6 points and now constitutes 85%. Therefore, the majority of Russian industry considers their status as satisfactory or even good. Possibly, low inflation

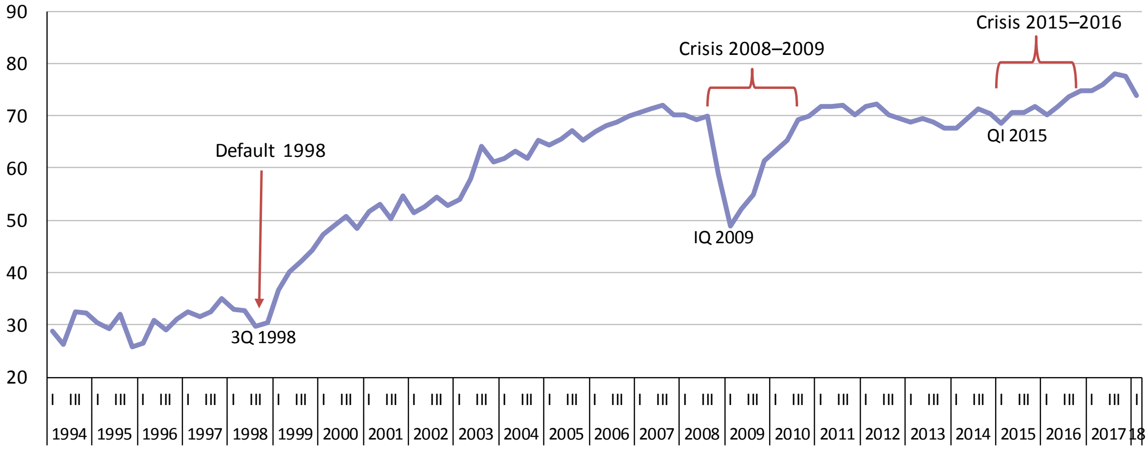

Fig. 1. Industry Adaptability index (normality), 1994–2018, % (Businesses that consider their records as 'normal')

coupled with sluggish demand hamper to obtain enough funds for day-to-day operations and for financing post-crisis investment programs.

Third and last negative factor that explained downgrade of current situation assessment as normal was the enterprises' response to headcount. Regarding shifts in demand, 77% of enterprises saw their sufficient headcount down 5 points against the previous quarter. While in Q3 of 2017 satisfaction with headcount reached the all-time high for the entire period of monitoring hitting 84%. Note, hitting high headcount level was possible only with the beginning of the crisis of 2015–2016, when enterprises managed to reduce the outflow of qualified employees and then (in 2017) maintain the achieved levels of employment. However, in Q1 2018, there started an outflow of workers from businesses. If in January it was a normal trend, then continued resignations reported in February was not in industry's plans.

Production capacities assessments did not undergo changes in early 2018. That index from mid-2016 to end of 2017 sharply fluctuated within a range of 67–83%, which reflected businesses attempts to estimate the pace of Russian industry recovery from the crisis of 2015–2016 and from stagnation. However, only in 4–9% of businesses reported shortage of production capacities which almost hit the all-time low. At 2017 year-end results as a whole, amid expected demand sufficient production capacities of Russian industry grew up to 78%, which was the all-time maximum. In early 2018, provision of sufficient production capacities constitutes 73% while 20% of enterprises boast of capacities surplus. Consistency of production capacities assessments is more important than moderate shortage (7%).

In the beginning of 2018, levels of stocks of finished products demonstrate continuation of high values of "normality" – 73% of businesses for half a year report adequate amounts of stocks, which is almost a maximum of that index. In other words, businesses control situation regarding their products sales, which is not that hard in the context of weak and protracted crisis and prolonged stagnation without any hopes of recovery in the near future. Industry, yet again, does not see many prospects to recover from the prolonged stagnation. At least, industry is not getting ready for it. Stocks of raw materials are considered to be "normal" by 81% of entrepreneurships. That index remained at the previous quarter level, which is an all-time high. Moreover, since the beginning of 2016, enterprises report not only the best provision with raw materials, but also demonstrate consistency of their assessments: 9 quarters in a row index remains in the range of 78–81%. This factor ensured high consistency of assessments of stocks of raw materials.

5. RUSSIAN REGIONS IN 2017 AND EARLY 2018

N.Zubarevich

In early 2018, Russian regions saw their socioeconomic status less problematic. However, none of them has reported sustainable development. Budgets have improved somewhat. Dynamics of income and expenditure less Moscow was rather moderate. Federal assistance is channeled to regions of geopolitical priority.

Socioeconomic development

The slump of 2017 terminated according to the majority of indicators. The industrial output has grown in 74 regions. Among industrially-led regions the following ones were in the lead – Arkhangelsk and Astrakhan regions (31–37%), Khabarovsk and Primorsky Krai (17–20%), Yaroslavl, Kaluga, and Moscow regions (12–14%), besides the majority of them registered slump in the course of two previous years. Industrial output has declined in oil producing regions – Khanty-Mansi AO, Republics of Komi and Udmurtia, Tomsk region, and Nenets AO. The manufacturing industry has practically remained flat (0.2% in 2017 in Russia as a whole), although 15 regions reported slump.

In January–February 2018, in the wake of all-Russia growth by 2%, industrial output decreased in 18 regions and most of all in Tula region (-20%) due to contraction of Defense procurement and acquisition order. Slump was ongoing in a number of oil producing regions – Nenets AO (-10%), Republic of Komi (-3%) and Khanty-Mansi AO (-1%).

2017 saw investment growth in Russia as a whole (4.4%) and in around two third of the regions. Crimea (2.3-fold growth) and Sevastopol (up 65%), and several oil and gas producing regions (Nenets AO – up 65%, and Yakutia – 35%). However investment dynamic 2013-To-Date shows that the crisis was not weathered. Investment volume in real terms in 2017 declined 8% against 2013 and it failed to meet the pre-crisis level in 58 regions (*Fig. 1*). Over the four years investments increased notably in regions with new oil and gas production (Nenets AO, Yakutia, and Yamal-Nenets AO) and the implementation of large projects (Amur region).

Leading oil and gas producing regions and largest agglomerations contributed to most of the total growth of investments. In 2017, two okrugs of Tyumen region accumulated 12.7% of all investments, Moscow – 12.4%, Moscow region – 4.2%, and St. Petersburg – 4.1%. Thus, five leading subjects of the Russian Federation accounted for one third of all investments in the country. Far East accumulated solely 7.6% of investments, its share increased insignificantly in comparison with 2014 (6.0%), and the share of Siberian Federal Okrug contracted from 10.9% seen in 2014 to 9.5% in 2017. Territorial structure of investments does not contribute to of the

Russian economy to the East.

Budget investments account for solely 16% and they are equally divided between the federal budget and consolidated regional and local budgets. The

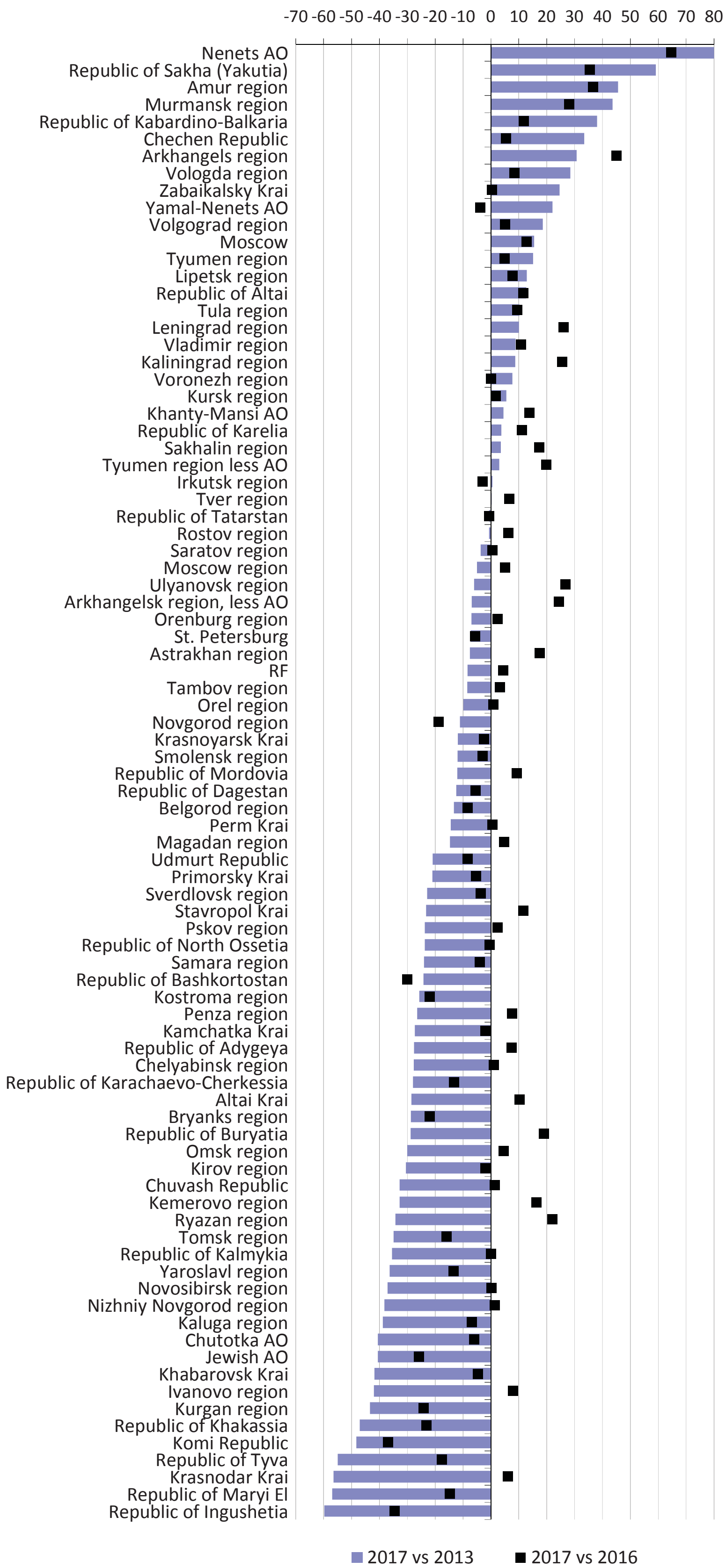

Fig. 1. Fixed investment from all sources, %

Source: calculations based on data released by Rosstat.

federal budget in 2017 invested in geopolitical priorities: Crimea and Sevastopol accumulated around 13%, sharply increased the investment in Krasnodar Krai and Rostov region (each 7%) to finance infrastructure in Crimea and in Rostov region to fund the World Cup facilities.

Quarter of all federal budget investments some way or other are linked with Crimea. Regional budget investments are more geographically targeted – Moscow accounted for 33% and St. Petersburg – less than 9%. Huge investment potential of the Moscow budget increases the margin with the whole country in terms of infrastructure development and improvement of the urban environment.

Commission of housing contracted by 2.1% in the whole country compared to 2016. Slump in 2017 was observed in 42 regions, in 2016 it was observed in 48 regions. Siberian Federal Okrug and Far East Federal Okrug were hit hardest, down 16% and 10%, respectively. Growth was reported solely in Southern Federal Okrug (up 6%) owing to 3-fold increase of housing commissioning in Crimea.

In January–February 2018 commissioning of housing moved up by 25% against the same period of 2017. Among regions with large residential supply the best dynamics were reported by Moscow region (2.9-fold), Novosibirsk, Tyumen, Novgorod regions (1.9–2-fold), and Tatarstan (up 47%). The housing market recovery was triggered by fast mortgage growth.

Slump in the retail trade terminated in 2017. All federal okrugs registered upward dynamics minus Urals Federal Okrug due to slump in Sverdlovsk and Chelyabinsk regions (down 1.5–3%).

Slump in the retail trade terminated in 2017. All federal districts minus the Urals one (due to a recession in Sverdlovsk and Chelyabinsk regions (down 1.5–3%) reported upward dynamics. The number of regions that registered recession in the retail trade shrank to 16. In January–February 2018, the retail trade moderate growth continued (up 2% against the same period of 2016) and the number of regions with downward dynamics shrank to six.

Regions' labor markets remain stable. The unemployment level is minimal – 5.1% (December 2017 – February 2018). The regions did not report shifts over the year. Part-time employment contracted from 3.1% of headcount seen in Q4 2016 to 2.7% reported in Q4 2017. The number of regions with an outsize part-time employment rate is small: Republic of Crimea (7.5% of headcount), Sevastopol (4.9%), Perm Krai, and Republic of Altai, Tomsk, Samara, and Novgorod regions (4.0–4.6%). Overdue wage arrears were minimal across the country. Primorsky Krai, Nenets AO, Republic of Karelia, and North Ossetia reported elevated indexes in early 2018.

The principal issue of 2017 was the continuing decline in real personal cash income in the country as a whole (-1.1%) and in 65 regions. Actual statistical data unreliable that is why it is hard to explain the dynamics. Recession hit most Far eastern and Siberian regions. The strongest increase of cash personal income was reported in Crimea (13%). Real personal income decreased by 11% from 2014 through 2017. The strongest decrease happened in Urals Federal Okrug (17%), Privolzhsky (14%), and Siberian Federal Okrugs (12%), and weaker increase in Southern and North-Caucasus Federal Okrugs (7–8%), i.e. in regions with predominantly agrarian structure of the economy.

Table 1

DYNAMICS OF INCOME AND EXPENDITURE OF REGIONAL CONSOLIDATED BUDGETS IN 2017 AGAINST 2016, %

	All regions	Less Moscow	Moscow		All regions	Les Moscow	Moscow
Revenues	8.4	7.3	13.2	Expenditures	8.8	6.3	20.6
Profit tax	10.9	8.8	17.1	Nation-wide issues	5.2	3.8	17.1
PIT	7.7	7	10.1	National economy	14.3	10.4	26.5
Excises	-7.6	-7.5	-8.6	Housing and public utilities	20.5	6.2	52.5
Property tax	11.9	9.4	28.8	Education	5.6	5.6	5.5
Total income tax	15	13.1	23.5	Welfare policy*	2.7	0.1	4.0
Transfers	8.4	10.8	-40	Health care*	8.1	4.9	10.5

* Own calculations with adjustment to spending structure change.
Source: data released by the Federal Treasury.

Regional budgets

In 2017, regions' consolidated budget revenues were growing at a higher pace than in 2016 (up 8.4%) with the Moscow budget contributing the most (*Table 1*), which accounted around 20% of Russia's regions' budget revenues.

The highest growth in budget revenues in 2017 was seen in Crimes and Sevastopol (37 and 42%) owing to sharply increased transfers (up 32% and 62%). Crimea reported 3-fold growth of proceeds from the profit tax mainly due to contributions from major construction companies. Nenets Autonomous Okrug reported budget revenues to move up by 37% owing to crude oil price growth. Kaliningrad region's revenues were up 30% due to two-fold increase in government transfers aimed at compensating special economic zone resident companies. Growth of budget revenues registered in Belgorod, Kemerovo regions and Yamal-Nenets AO by 18–23% was due to the increase of proceeds from the profit tax. Only 9 regions saw their budget revenues drop in 2017.

Government transfers to the regions in 2017 moved up by 8%. The highest share of transfers in budget revenues was posted by Republics of Ingushetia and Chechnya (80–81%), Tyva (74%), Dagestan and Altai (69–70%), Karachaevo-Cherkassia (65%), Crimea (63%), as well as Kaliningrad region, Kamchatka Krai and the city of Sevastopol (60%). Crimea and Sevastopol are in the lead (total Rb 119 bn, growth in 2017 by around Rb 32bn), Dagestan (Rb 75, growth by Rb 10bn), Yakutia (Rb 66bn), and Chechnya (Rb 62bn, growth by Rb 6bn). Support of the priority for the federal authorities regions has gone up.

Regions' consolidated budget expenditures increased in 2017 grew faster than in 2016 (by 8.8%), mostly driven by the Moscow's budget (*Table 1*). Moscow reported high acceleration of spending on housing services and utilities by virtue of urban redevelopment expenditure, which constituted around 12% of total Moscow budget expenditure in 2017 and was comparable to spending on education (Rb 246 and 277bn, respectively).

Social expenditures in regional budgets grew at a slower pace (*Table 1*), financing of education decreased solely in six regions. Spending on social welfare policy less Moscow have practically stopped growing as well as social benefits. On the eve of the federal elections social welfare expenses usually go up. Public sector wages and pensions indexation in early 2018 became a priority this time round.

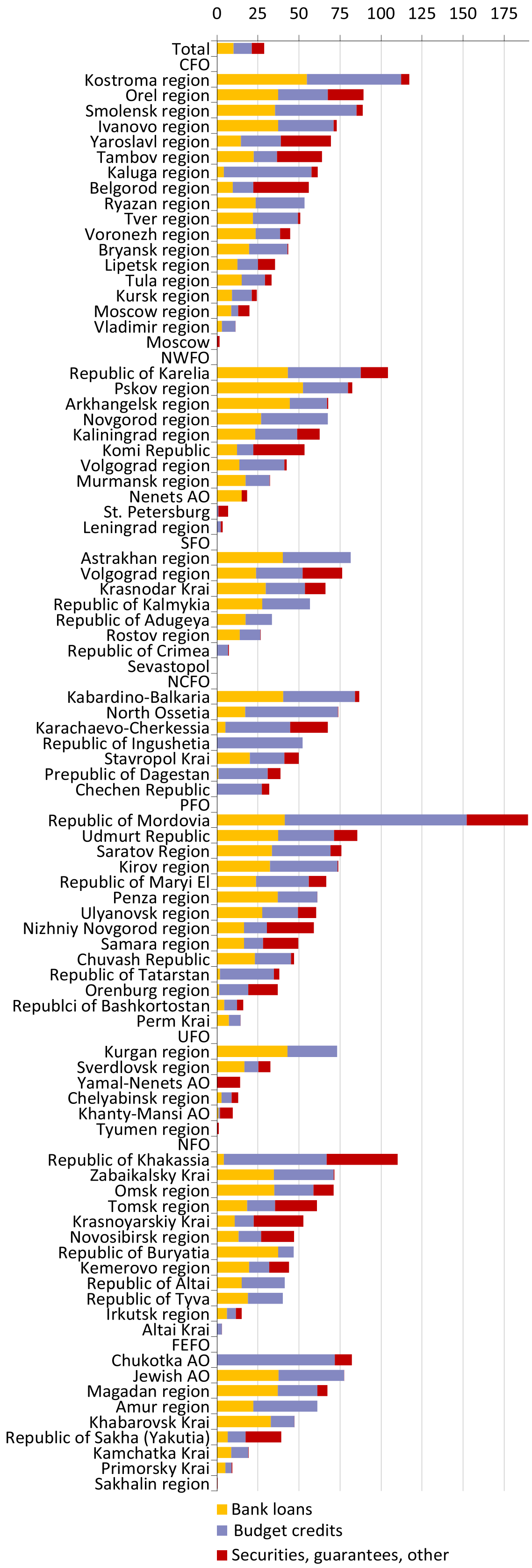

Fig. 2. Total debt of regions and municipalities as of 1 January 2018, in % to tax and non-tax revenues (less transfers) of regional consolidated budget for 2017
Source: calculations based on data released by Finance Ministry.

Forty three regions were running a budget deficit in 2017 (56 regions in 2016). Republic of Mordovia (expenses outstripped revenues by 25%) was ranked at the top deficit runners. Budget deficit is significant in Kostroma, Orel, and Tomsk regions, Republic of Kabardino-Balkaria, St. Petersburg, Sevastopol and Khanty-Mansi AO (8–9%).

Total debt of regions and municipalities in 2017 practically remained flat. As of early 2018, the highest debt compared to tax and non-tax revenues of regions consolidated budget remained in Republic of Mordovia (190%), Kostroma region (117%), Republic of Khakassia (110%), and Karelia (104%). Another 17 regions stay in the risk zone. Their debt constitutes between 70 to 90% of own revenues (Fig. 2). Debt increased in 35 regions throughout 2017. The share of debt expenses in Republic of Khakassia exceeded 8% of total budget expenditure, in Kostroma region it hit 6%, and in Republics of Udmurtia, Mordovia, and in Astrakhan region – around 5% of expenses.

In 2017 and in early 2018, socioeconomic development was less problematic than two years earlier, however the vast majority of regions did not register sustainable growth. Budget status somewhat improved, but the dynamics of revenues and expenditures minus Moscow remained moderate. The deficit issue alleviated insignificantly, debt remained flat. Regarding the majority of indexes, Moscow is leaving the rest of the regions trailing behind, and the federal support is focused on regions with geopolitical priorities.

AUTHORS

Alexandra Bozhechkova, Head of Monetary Policy Department, Gaidar Institute; senior researcher, Center for Central Banks Studies, IAES, RANEPA

Yuri Zaitsev, senior researcher, Center for International Trade, IAES, RANEPA

Natalia Zubarevich, principal researcher, Demography, Migration and Labor Market research Department, Institute of Social Analysis and Forecasting, RANEPA

Andrei Kaukin, Head of Industrial Organization and Infrastructure Economics Department, Gaidar Institute; senior researcher, System Analysis of Sectoral Markets and Infrastructure Department, Institute of Sectoral Markets and Infrastructure, RANEPA

Alexander Knobel, Head of World Trade Laboratory, Gaidar Institute; Director of Center for International Trade, IAES, RANEPA

Evgenia Miller, researcher, Industrial Organization and Infrastructure Economics Department, IAES, RANEPA

Pavel Trunin, Director of Center for Macroeconomics and Finance, Gaidar Institute; Director of Center for Central Banks Issues, IAES, RANEPA

Sergey Tsukhlo, Head of Business Surveys Laboratory, Gaidar Institute

Designed by E.Nemeshaeva