

MONITORING OF RUSSIA'S ECONOMIC OUTLOOK:

TRENDS AND CHALLENGES OF SOCIO-ECONOMIC DEVELOPMENT

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MAIN TRENDS AND CONCLUSIONS	3
1. THE EXECUTION OF THE FEDERAL BUDGET FOR H1 2017: FURTHER CONSOLIDATION (A.Deryugin, T.Tishchenko)	6
2. RUSSIAN INDUSTRY IN MID-2017 (A.Kaukin, E.Miller).....	12
3. INDUSTRY ADAPTABILITY INDEX: A NEW ALL-TIME HIGH (S.Tsukhlo)	16
4. BANK OF RUSSIA UPDATES BANK RESOLUTION MECHANISM TO INCREASE ITS CONTROL (M.Khromov)	18
AUTHORS.....	21

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MAIN TRENDS AND CONCLUSIONS

Had it not been for banking sector's mounting tensions till September, further deceleration of inflation late in summer/early in fall this year would have looked like a favourable macroeconomic backdrop.

It is characteristic that historically low growth rates of prices (and, just as important, inflation expectations) are no longer attended by speculations concerning a deflation threat. A deflation in the Russian economy is much less expected than price upsurges, as was proved by unexpected acceleration of food inflation due to a cold summer this year. This was followed by fast decline in prices, which seemed reasonable for the season, as well as expectations of a new key rate cut against this backdrop.

The above was not the case for the banking sector. A banking "purge" was underway for years in a persistence but relatively quiet manner until competition and super aggressive expansion put at stake a country's largest private bank which is also closely related to the pension and insurance markets. What should be considered a positive factor in this context is that while staving off the "domino effect" and a possible panic the regulator was not hesitant to embark on drastic, and even non-standard, policies. And the goal seems to have been achieved to this extent. However, the oversight practice, immediate intervention tools, and relevant regulations will now most likely change at accelerated pace, and therefore no high quality can be guaranteed. Most importantly, however, is that while being criticized for "unreasonable indecision" and for "undue interference" the regulator's degree of independence remains the same as before, otherwise consequences would have been far more serious than liquidation or forced nationalization of a few important banks.

Bankruptcies and resolutions of some credit institutions did not (at least visibly) export tensions to Russia's major financial markets and to the real economy. The sovereign bond market, the interbank market, the rouble exchange rate operated quietly enough, GDP was growing at faster-than-projected pace, and the federal budget was executed with predicted or even higher parameters.

When summarizing the first half-year results, our experts have noted an increase in federal budget revenues (+1.8 percentage points of GDP from the same period of 2016) owing to both oil and gas and to non-oil and gas revenues, with the former increasing its share of the total budget revenues from 35.9% to 40.6%. In other words, the decline in the reliance on oil and gas revenues is yet to become a steady trend. This inference can be described in concrete terms: with positive dynamics almost for all types of tax revenues, the increase in mineral extraction tax payments played a key role driven by growth in this "mineral" tax rate and in crude oil prices.

As to budget expenditures, with a growth in absolute terms of more than Rb 300bn they decreased as a percentage of GDP by 0.6 percentage points from the same period of 2016. The federal budget deficit was therefore reduced from 3.6% to 1.0% of GDP at the first half-year end. Note that the 2017 year-end figure will most likely differ from this one because of growing costs in the next months of the year: the Russian Finance Ministry projects

a year-end deficit of 2% of GDP. According to our experts, this year's federal budget is more balanced than what it was last year, as well as they believe that with the existing trends (growing oil and gas revenues, and the government's ability to refrain from active redistribution of revenues) budget risks can be mitigated.

More or less positive, according to the experts, are the half-year results for the consolidated budget of subjects of the Russian Federation, with a 9.4% growth in revenues. However, while donor regions used this for higher-than-anticipated growth in revenues, regions with leaner budget revenues (by the way, their revenues were growing in comparable pace) tend to spend less while continuing to save. The situation with regions' debts is considered moderately positive because growth in revenues helps reduce the debt load. The debt to revenue ratio for these regions fell to 29.1% in June 2017 from 33.2% in June 2016. However, account should be taken of the fact that the growth in regions' revenues was first of all driven by excellent dynamics for profit tax revenues, which, however, has recently seen a marked deceleration.

Further, the industrial production dynamics also started decelerating by mid-2017. An analysis made by Gaidar Institute's experts shows deceleration of the growth rates recorded earlier this year and a reversal of the industrial sector's dynamics towards a stagnation.

While the extractive sector is still on the rise, the manufacturing industry is rather facing a stagnation. Most sectors here now see no growth or even a slow downturn. There are no factors in sight (except maybe for varying trends in foreign trade or one-time government support measures) that could provide a visible and long-term growth in industrial production.

Nevertheless, industrial enterprises view the current situation as rather positive, according to Gaidar Institute's regular business surveys. Both the integral "industry adaptation index" (the share of enterprises that assess their performance figures as 'normal') and assessments of most of the specific items such as financial and economic status, capacity utilization, labour supply, raw materials and supplies inventory, and demand hit their peak in the third quarter.

Although it is difficult to predict the results that could be obtained through this type of survey among Russian bankers, they are not expected to be the same.

The experts have noted that the Bank of Russia has for the first time applied a new bank resolution mechanism on the basis of a newly established entity, the Fund for Banking Sector Consolidation (FBSC). This is the first case that has been applied to Bank Otkrytie FC. The Bank of Russia proceeds from the fact that the old resolution mechanism involving the State Agency for Deposit Insurance (SADI) has failed to provide efficient spending of the money allotted for bank resolution. Quite often, however, investing banks used SADI's bank resolution money for the purpose of their own business development. The central bank provided money (in the form of loans) to the SADI not only for the purpose of bank resolution but also insurance compensation to depositors. The SADI' debt to the central bank within the deposit insurance framework reached Rb 657bn as at 1 July 2017. Together with the money (approximately Rb 1.2 trillion) borrowed for bank resolution the SADI's debt to the Bank of Russia accounts for more than 2% of GDP.

The recovery of Otkrytie's solvency, a country's largest private bank, requires a lot of money. Our experts believe that the bank rescue also can be

considered in the long term as an attempt to promote competition. In other words, the goal is not just to calm down the market and the customers by bringing the bank under full control of the central bank but also gradually prepare the bank for sale.

However, they also have noted a negative signal in this major bank resolution by which the 'too big to fail' concept is de facto secured in the Russian banking market, thus showing the readiness to cover management failures at this large and important bank. According to the experts, the resolution of this particular bank is indeed a positive fact for the Otkrytie's customers, whereas the same fact is quite negative in terms of management of risks that may affect the financial system in the long term. ●

1. THE EXECUTION OF THE FEDERAL BUDGET FOR H1 2017: FURTHER CONSOLIDATION

A.Deryugin, T.Tishchenko

As demonstrated by the period-end results of H1 2017, the dynamic displayed by the main parameters of the federal budget points to revenue growth by 1.8 p.p. of GDP and expenditure decline by 0.8 p.p. of GDP relative to the corresponding period of the previous year. The upshot has been a shrinkage of the budget deficit to 1.0% of GDP. The relatively robust growth rate of the revenue side of the consolidated budget of the RF subjects observed over H1 2017 triggered an accelerated growth rate of expenditure in the wealthier regions. At the same time, the poorer regions continued to economize by suppressing growth of their budget expenditure.

According to data released by the RF Federal Treasury, over H1 2017 the volume of **federal budget** revenue gained Rb 1.253.3bn, or 1.8 p.p. of GDP (Table 1) relative to the corresponding period of the previous year. This was caused by an increase in its oil and gas component by Rb 780.4bn (or 1.4 p.p. of GDP), and in its non-oil and gas component by Rb 472.9bn (or 0.4 p.p. of GDP). The share of the oil and gas component in the structure of federal budget revenue jumped from 35.9% to 40.6% relative to the corresponding period of the previous year.

Federal budget expenditure executed over January–June shrank by 0.8 p.p. of GDP relative to H1 2016, while increasing by Rb 232.0bn in absolute terms – due in the main to a notable growth in the amount of non-interest spending (by Rb 218.4bn). Federal budget deficit amounted to 1.0% of GDP (or Rb 407.9bn) relative to 3.6% of GDP (or Rb 1.429.2bn) over the corresponding period of 2016.

On the whole over January–June 2017, tax-generated revenues gained Rb 1291.4bn, or 2.1 p.p. of GDP, relative to H1 2016 (Table 2). An improved dy-

Table 1

THE MAIN PARAMETERS OF THE FEDERAL BUDGET OVER H1 2016 AND H1 2017

Index	H1 2016			H1 2017			Change in H1 2017 relative to H1 2016	
	bn Rb	% of GDP	as % of actual volume	bn Rb	% of GDP	as % of planned volume	bn Rb	pp of GDP
Revenue, including:	5,868.7	15.0	43.6	7,122.0	16.8	52.8	1,253.3	1.8
– oil and gas revenues	2,108.2	5.4	43.5	2,888.6	6.8	57.2	780.4	1.4
– non-oil and gas revenues	3,760.5	9.6	43.6	4,233.4	10.0	50.2	472.9	0.4
Expenditure, including:	7,297.9	18.6	44.5	7,529.9	17.8	45.6	232.0	-0.8
– interest	314.0	0.8	50.5	327.6	0.8	45.0	13.6	0.0
– non-interest	6,983.9	17.8	44.2	7,202.3	17.0	45.6	218.4	-0.8
Deficit	-1,429.2	-3.6	37.7	-407.9	-1.0	13.5	1,021.3	2.6
Non-oil and gas deficit	-3,537.4	-9.0		-3,296.5	-7.8		-240.9	1.2
For reference: GDP (in current prices, bn Rb)*	39,245			42,390			-	

* Preliminary estimates for H1 2017.

Source: RF Ministry of Finance; Rosstat; Federal Treasury; own calculations.

Table 2

THE MAIN TAX RECEIPTS IN THE FEDERAL BUDGET OVER H1 2016 AND H1 2017

Index	H1 2016			H1 2017			Change in H1 2017 relative to H1 2016	
	bn Rb	% of GDP	as % of actual volume	bn Rb	% of GDP	as % of planned volume	bn Rb	pp of GDP
Tax-generated revenues, total, including	5,199.6	13.2	46.2	6,491.0	15.3	54.0	1291.4	2.1
Tax on profit of organizations	240.4	0.6	49.0	359.4	0.8	59.9	119.0	0.2
VAT on goods produced in RF territory	1,341.0	3.4	50.5	1,570.5	3.7	54.2	229.5	0.3
VAT on goods imported into RF territory	892.9	2.3	46.7	910.8	2.1	45.6	17.9	-0.2
Excises on goods produced in RF territory	301.1	0.8	47.6	436.3	1.0	54.0	135.2	0.2
Excises on goods imported into RF territory	25.5	0.1	41.1	31.9	0.1	50.3	6.4	0.0
MRET	1,270.8	3.2	44.4	1,955.5	4.6	58.9	684.7	1.4
Revenues generated by foreign trade	1,127.9	2.9	43.3	1,226.6	2.9	52.5	98.7	0.0

Source: Federal Treasury (operative data); own calculations.

dynamic, both in nominal terms and in terms of share in GDP, is noted for all types of tax-generated revenues, with the exception of VAT on goods imported into RF territory (this component shrank by 0.2 p.p. of GDP, most probably as a result of the ruble's strengthening). The amount of tax receipts increased in the main due to the inflow of tax on mineral resources extraction (MRET), which surged by 1.4 p.p. of GDP, or Rb 684.7 bn Rb, relative to the corresponding period of 2016. This dynamic was caused by the growth of the price of Urals crude from \$ 37.8 in H1 2016 to \$ 50.3 in H1 2017 coupled with the basic rate of tax on mineral resources extraction being raised from Rb 857 per tonne in 2016 to Rb 919 per tonne in 2017.

Over the period under consideration, all the tax receipts generated by domestic production and domestic demand were on the rise. Thus, the amount of receipts of tax on profit of organizations increased by 0.2 p.p. of GDP to Rb 359.4bn (59.9% of the forecasted annual volume). Growth occurred due to the fact that the amount of advance tax payments for 2017 and the final amount of tax due to be paid for the previous year were calculated relative to the 2016 tax base (Rb 5,968.9bn in H1 2017 vs. Rb 6,680.8bn in H1 2016). However, should the downward trend displayed by the profits of successful enterprises (which emerged in January–June) persist, the year-end total for tax on profit of organizations in 2017 may shrink relative to 2016.

The amount of federal budget revenue generated by VAT and excises on domestic goods likewise increased relative to the corresponding period of last year – by 0.3 p.p. and 0.2 p.p. of GDP respectively. The growth of receipts of excises on domestic goods was caused by increased excises on ethanol produced from food and non-food raw materials and on motor gasoline (growth by Rb 71.5bn and Rb 61.9bn respectively, resulting in the main from the indexation, from 2017, of the rates for these types of excisable goods). The movement pattern of domestic VAT can be explained by the fact that retail turnover shrinkage occurred with regard to those categories of goods that were taxed at lower rates, while it increased with regard to those categories that were subject to the basic rate. According to data released by

Rosstat, in H1 2017 retail foodstuff turnover amounted to Rb 6.7 trillion vs. Rb 6.6 trillion in H1 2016, and retail non-food turnover – to Rb 7.2 trillion vs. Rb 7.1 trillion respectively.

The amount of federal budget revenue generated by foreign trade was 2.9% of GDP (same as in H1 2016), with a slight increase in absolute terms (by Rb 98.7bn). It should also be noted that, in spite of the reduction of the marginal rate of export duty on oil to 30% in 2017 (from 42% in 2016), the climbing exchange rate of the ruble coupled with the raised basic rate of MRET resulted in a situation where the federal budget revenues generated by export duties on oil and petroleum products amounted to 1.7% of GDP, thus jumping above their index for the corresponding period of 2016 by 0.2 p.p. of GDP.

If we look at the by-function distribution of federal budget expenditure over H1 2017, it demonstrates the following changes relative to the corresponding period of 2016 (*Table 3*):

- growth, both in relative and absolute terms, of expenditure allocated to the following two functions: *Social Policies* (by 0.1 p.p. of GDP, or Rb 234.9bn); and *Interbudgetary Transfers* (by 0.1 p.p. of GDP, or Rb 49.4bn);
- shrinkage of expenditure allocated to *National Defense* (-0.5 p.p. of GDP, or Rb 116.3bn); *National Security and Law Enforcement* (-0.2 p.p. of GDP, or Rb 26.5bn); *Education and Healthcare* (- 0.1 p.p. of GDP each, or by Rb 2.8bn and Rb 35.7bn respectively);
- shrinkage, in terms of share in GDP, of expenditure on *Nationwide Issues* – by 0.1 p.p. of GDP, or by Rb 18.7bn.

Table 3

FEDERAL BUDGET EXPENDITURE OVER H1 2016 AND H1 2017

	H1 2016			H1 2017			Change in H1 2017 relative to H1 2016	
	bn Rb	% of GDP	as % of actual volume	bn Rb	% of GDP	Cash execution, %	bn Rb	pp of GDP
Expenditure, total, including:	7,297.9	18.6	44.5	7,529.9	17.9	45.6	232.0	-0.8
Nationwide issues	478.2	1.2	43.6	459.5	1.1	35.3	-18.7	-0.1
National defense	1,471.4	3.7	39.0	1,355.1	3.2	47.8	-116.3	-0.5
National security and law-enforcement	834.5	2.1	44.0	808.0	1.9	42.5	-26.5	-0.2
National economy	787.5	2.0	34.2	863.7	2.0	36.4	76.2	0.0
Housing and community amenities	31.4	0.1	43.5	61.9	0.1	47.8	30.5	0.0
Environmental protection	43.3	0.1	68.6	55.9	0.1	72.1	12.6	0.0
Education	321.0	0.8	53.7	318.2	0.7	50.8	-2.8	-0.1
Culture and cinematography	34.6	0.1	39.6	37.3	0.1	36.7	2.7	0.0
Healthcare	209.9	0.5	41.5	174.2	0.4	39.4	-35.7	-0.1
Social policies	2,398.8	6.1	52.3	2,633.7	6.2	52.0	234.9	0.1
Physical culture and sports	17.1	0.0	28.7	28.7	0.1	29.3	11.6	0.0
Mass media	31.2	0.1	40.7	31.6	0.1	40.8	0.4	0.0
Government debt servicing	314.0	0.8	50.5	327.6	0.8	45.0	13.4	0.0
Interbudgetary transfers	324.8	0.8	48.3	374.2	0.9	49.3	49.4	0.1

Source: RF Federal Treasury; own calculations.

The pattern of the cash execution of federal budget expenditure as demonstrated by the period-end results of H1 2017 amounts to 45.6% of the planned annual target (thus being by 1.1 p.p. of GDP better than the corresponding index for 2016). As a result, the rate of budget spending crept closer to an even pattern of budget expenditure distribution throughout the year. At the same time, comparatively low levels of the cash execution of federal budget expenditure are noted with regard to the following functions: *National Economy* (36.4%); *Culture and Cinematography* (36.7%); *Healthcare* (39.4%); and *Physical Culture and Sports* (29.3%). In terms of by-function distribution, the less even federal budget spending patterns are observed in areas that have to do with co-financing of budget expenditure, in particular the fuel and energy complex (23.8%), motor road network (25.3%), housing amenities (26.1%), comprehensive education (22.1%), youth policies (14.4%), and other interbudgetary transfers earmarked for general purposes (20.5%).

In H1 2017, deficit in the federal budget was covered by the allocation of Rb 521.3bn from the proceeds generated by government securities placed on the domestic market. Meanwhile, the total volume of government borrowing in the domestic market amounted to Rb 853.5bn, or 45.4% of its planned annual target for 2017. As of 1 July 2017, accumulated government domestic debt amounted to Rb 8,469.1bn, which is Rb 465.6bn above the corresponding index for 1 January 2017.

On the contrary, the volume of government external debt shrank by \$ 653.2m over January–June 2017, due in the main to the redemption of external bond loans to the value of \$ 619.5m. Out of the proceeds of the placement of securities and loans on foreign markets, Rb 180.4bn was allocated to setting off the budget deficit in H1 2017, the planned annual target being Rb 472.5bn (38.1%). To redeem the external debt, Rb 148.2bn was allocated (38.2% of the planned annual target).

Over H1 2017, due to an asset value recalculation relative to exchange rate changes, the Reserve Fund and the National Welfare Fund increased in ruble terms by Rb 15.1bn and Rb 31.9bn respectively. So, as of 1 July 2017, the Reserve Fund amounted to Rb 987.3bn, and the National Welfare Fund — to Rb 4385.5bn. In H1 2017, no expenditure allocations from the sovereign funds were made.

Overall, the situation concerning federal budget execution, as demonstrated by the period-end results of H1 2017, can be viewed as being better balanced than that observed over the corresponding period of 2016. The persistence of the current upward trend in the movement of oil and gas revenues and the government's ability to abstain from allocating the surplus oil and gas revenues can lower the existing budget risks and improve the sustainability of the entire budgetary system.

The period-end results of H1 2017 demonstrate a 9.4% increase in revenue in the **consolidated budgets of the RF subjects**. The relatively high growth indices displayed by regional budget revenues were achieved in the main over Q1, when growth amounted to 116.8%. In Q2, it slumped to 103.7%. However, preliminary data for July concerning the execution of regional and local budgets point to budget revenue growth indices that plunge above the average results of H1, thus contradicting the hypothesis of a drastic trend reversal in the dynamic of regional budget revenue, while still being indicative of its high volatility throughout the year (*Fig. 1*).

The main sources that triggered revenue growth in the consolidated budget of the RF subjects were tax on profit of organizations¹ (112.4% relative to H1 2016), tax on property (111.9%), and non-tax revenues (111.0%).

Relatively low rates of growth were also displayed by interbudgetary transfers received from the budgets of other levels (105.8%), while receipts of excises declined (94.5%). The growth rate of personal income tax (PIT) — the principal revenue source for regional and local budgets (30.4% of total consolidated budget revenue in 2016) — amounted to 108.2%.

Similarly to their volume indices, the movement patterns of the consolidated budget revenues of RF subjects in Q2 2017 significantly differed from those observed in Q1 (104.6% vs. 115.5%), which was caused in the main by the plunge of the growth rate of profits tax receipts (98.5% in Q2 vs. 130.5% in Q1). The situation also varies between territories. The leaders in growth are the Southern Federal District (growth rate of 118.9% in H1 2017) and the Central Federal District (114.1%). The lowest growth rates are observed in the Far Eastern Federal District (90.5%), the Ural Federal District (104.4%), and the North-Caucasian Federal District (105.6%).

Over H1 2017, growth of consolidated budget revenues in the 14 donor regions that had not received any equalization subsidies over the previous two years turned out to be practically the same as the average growth index for the not so well-provided regions (109.2% vs. 109.5%), which point to absence of any noticeable upward or downward trends in the fiscal differentiation between the wealthier and poorer regions.

In H1 2017, overall growth of expenditure in the consolidated budget of the RF subjects amounted to 106.3% relative to the corresponding period of last year. However, in contrast to the revenue movement patterns, which over the same period displayed largely similar growth rates in the donor regions and the other RF subjects, the rates of expenditure growth in these two groups of regions varied. While the donor regions could afford to spend more (expenditure growth of 110.3%), the less wealthy ones pursued more prudent spending policies, increasing their expenditure only by 3.2% — that is, actually reducing it in real terms. This trend became more prominent due to the volatility of the budget revenue movement patterns, which increased uncertainty with regard to the ultimate year-end financial result.

Over the period from 1 July 2016 through 1 July 2017, regional debt declined by 3.4% to Rb 2.2 trillion, being pushed down by the high growth rates of revenues in the regional and local budgets, the measures undertaken by the RF Ministry of Finance in order to create incentives for regional authorities to resort to tough budgeting policies, and the fiscal policies of the donor regions de-

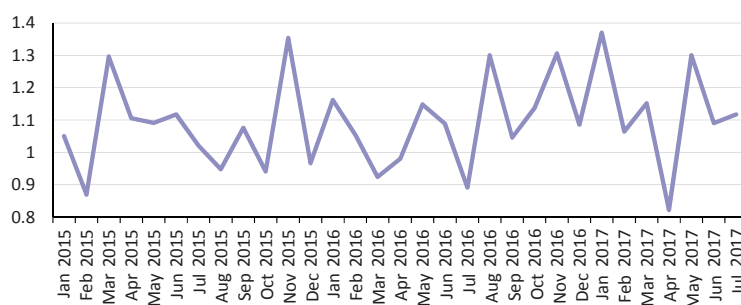


Fig. 1. The growth rates of the total consolidated budget revenues of the RF subjects, as % relative to the corresponding period of the previous year
Source: own calculations based on data released by the RF Federal Treasury.

1 In spite of the transfer, from 1 January 2017, of 1 percentage point of the tax rate from the regional to the federal level.

signed to further reduce their debt burden. A comparative analysis of the government debt movement patterns in the donor regions and the other RF subjects reveals that the total debt index declined only thanks to the government debt reduction achieved by the donor regions (*Fig. 2*). The amount of debt owed by the other regions changed very little over the period under consideration, remaining at the level of Rb 1.7 trillion.

As before, loans received from the federal budget prevail in the regions' government debt structure, amounting as of 1 July 2017 to 47.6% of their total government debt.

Nevertheless, the relatively high revenue growth rates in regional budgets will conduce to shrinkage of their debt burden. Thus, if the revenue growth rates in the budgets of RF subjects stay at the same level as in H1 2017 until the end of the year, the government debt to revenue ratio for June 2017 will plunge from 33.2% to 29.1% relative to June 2016. Consequently, we may speak of a persistence, in 2017, of the downward trend displayed by the regions' debt burden since 2016. ●

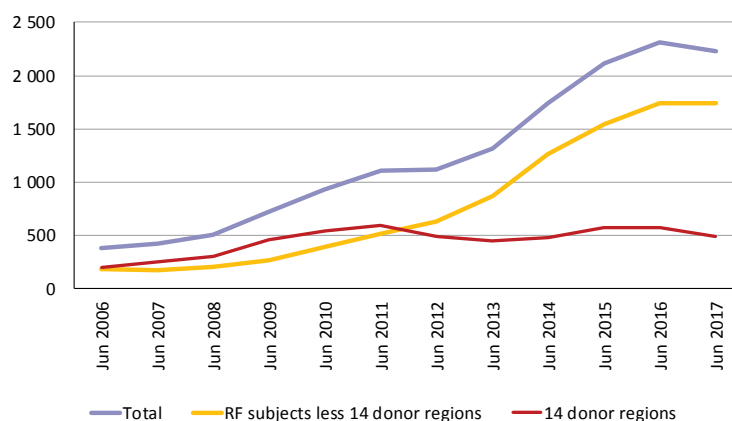


Fig. 2. The movement of the government debt of the subjects of the Russian Federation, bn Rb

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

2. RUSSIAN INDUSTRY IN MID-2017¹

A.Kaukin, E.Miller

The characteristic feature of mid-2017 is a slowdown in the production growth pattern that emerged earlier this year, and its downward slide towards stagnation. The majority of manufacturing industries continue to display a zero or negative dynamic, the only exception being those that are linked to the ongoing infrastructure projects. In conditions of shrinking investments, any prospects of a move towards sustainable growth in the short-term period appear to be unrealistic.

Over the first third of 2017, Russia's industrial production index was indicative of a slight output growth both in the extractive and the manufacturing industries. As for the latter, the situation there was far from being homogeneous: growth was sustained by only a few sectors while all the others continued to stagnate, or were showing signs of a likely decline².

In order to analyze the by-sector dynamics of industrial production indices across Russian industry over the period of May–July 2017, the Gaidar Institute experts decomposed the corresponding time series and removed the trend component of the industrial production indices for each industry³. As the initial dataset, we applied current Rosstat (Russian Federal State Statistics Service) statistics⁴; in order to make our decomposition procedure more accurate, we relied on the by-sector classification applied by Rosstat as OKVED-2007, we added our own calculations based on 2017 data and performed in accordance with Rosstat's methodology⁵.

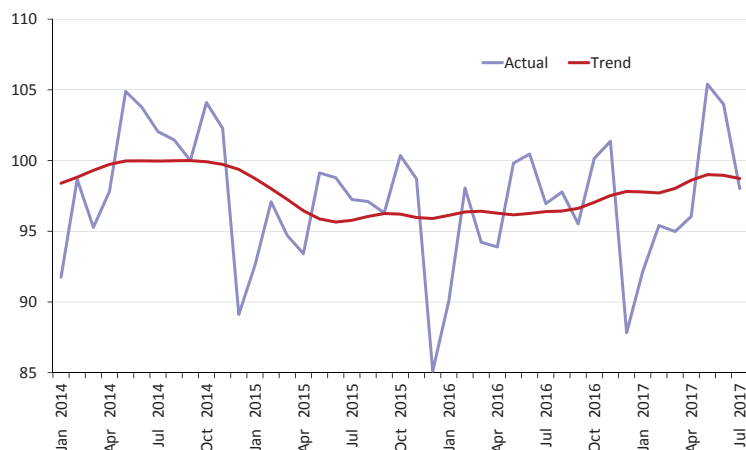


Fig. 1. The movement pattern of the Industrial Production Index over the period 2014–2017, actual data and trend components, as % relative to September 2014

Source: Rosstat; own calculations.

1 The author should like to thank M. Turuntseva and T. Gorshkova for their help in statistical analysis.

2 For more details, see A. Kaukin, E. Miller. Rosstat's New Methodology and the By-industry Movement Patterns of Production Indices in Early 2017 // Monitoring of Russia's Economic Outlook: Trends and Challenges of Socio-economic Development, No. 11(49), June 2017.

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

4 Information on the socio-economic situation in industrial production in Russia, January–July 2017. Federal State Statistics Service (Rosstat).

5 For more details concerning the procedure of removing the trend component of the industrial production time series after Rosstat's switchover to its new classification (OKVED2), see A. Kaukin, E. Miller. Rosstat's New Methodology and the By-industry Movement Patterns

Our results demonstrate that the industrial production growth trend, which first became visible at the year's beginning, failed to strengthen over the next few months: the trend component of the industrial production index points to a slowdown, or even sometimes a slight decline, over June–July 2017 (Fig. 1).

The situations in the manufacturing and the extractive industries have continued to display significant differences over the past few years. As can be seen in Fig. 2 and 3, the trend components of output were moving in opposite directions. The extractive industry demonstrates significant sustainable growth. Thus, in particular, biggest companies have been increasing their output of key energy carriers, especially natural gas¹ – among other things, in response to the increased domestic demand for such products. Meanwhile, experts do not expect any significant plunge of oil exports, the agreements with the OPEC notwithstanding; moreover, in any case it can be compensated by increased exports of petroleum products². However, as far as the manufacturing industry is concerned, we are more likely to speak of stagnation, with output slightly hovering around a certain equilibrium value in response to changes in some of its segments.

The majority of sectors across the manufacturing industry display stagnation or slow decline (Table 1).

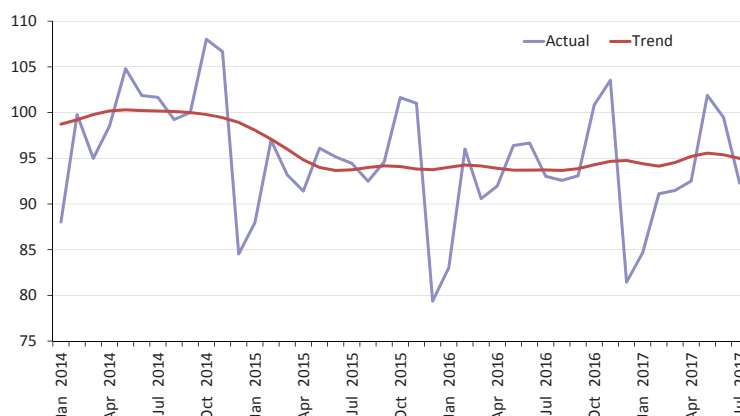


Fig. 2. The movement pattern of the Industrial Production Index in the manufacturing industry over the period 2014–2017, actual data and trend components, as % relative to September 2014

Source: Rosstat; own calculations.

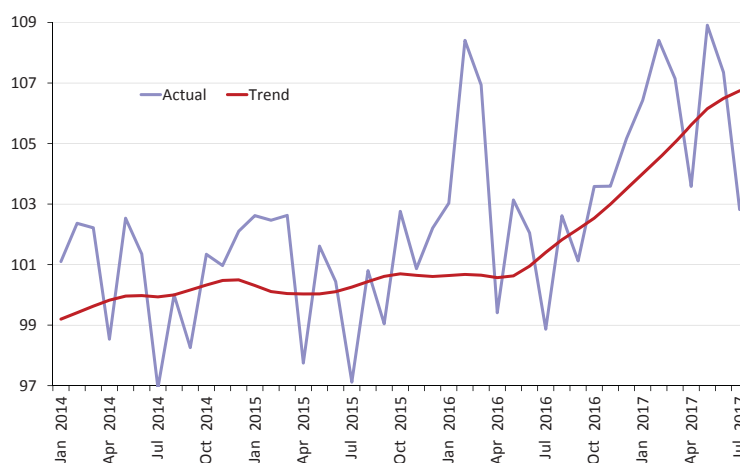


Fig. 3. The movement of the production index in the mineral resources extraction sector over the period 2014–2017, actual data and trend components, as % relative to August 2014

Source: Rosstat; own calculations.

of Production Indices in Early 2017 // Monitoring of Russia's economic Outlook: Trends and Challenges of Socio-economic Development, No11 (49), June 2017.

1 See, e.g., Rosneft Increased Oil Production by 12% over the First Six Months of This Year // The Russian Gazette, 4 August 2017 [<https://rg.ru/2017/08/04/rosneft-velichila-dobychu-nefti-za-pervoe-polugodie-na-12.html>]; or Natural Gas Extraction Growth in Russia Rose above 25% in Q2 // Vzglyad, 14 August 2017 [<https://www.vz.ru/news/2017/8/14/882593.html>]

2 Russia May Cut Its Oil Production for the First Time in a Decade // Vedomosti, 6 August 2017 [<https://www.vedomosti.ru/business/articles/2017/08/07/728217-rossiya-mozhet-sokratit>]

Table 1

BY-INDUSTRY MOVEMENT OF THE INDUSTRIAL PRODUCTION INDEX

	Share in industrial production index, %	July 2017 on July 2014, %	July 2017 on December 2016, %	Changes over recent months
Industrial production index		98,76	100,93	stagnation
Extraction of mineral resources	33.99	106.82	103.14	slow growth
Manufacturing industries	52.50	94.82	100.23	stagnation
including:				
Production of foodstuffs, including beverages, and tobacco products	17.05	108.19	102.38	slow growth
Textiles & textile products manufacturing	1.43	102.15	110.26	slow decline
Leather production and leather products & footwear manufacturing	0.32	95.01	100.83	decline
Timber & wood product processing	2.20	100.33	97.70	stagnation
Cellulose & paper production	3.92	76.87	92.78	slow decline
Production of coke & petroleum products	18.78	98.74	100.83	stagnation
Chemical production	7.46	125.82	101.49	decline
Manufacturing of rubber & plastic products	2.26	103.33	101.05	slow decline
Manufacturing of other non-metallic mineral products	4.41	87.54	102.49	slow growth
Metallurgical production & finished products	17.23	101.08	111.18	stagnation
Machinery & equipment manufacturing	6.24	89.86	95.03	growth
Electric, electronic & optical equipment manufacturing	6.05	90.84	101.00	stagnation
Transportation equipment manufacturing	7.06	66.74	84.00	decline
Other industries	5.59	91.73	102.18	slow growth
Electric energy, gas and water	13.51	100.91	99.66	slow decline

Source: Rosstat; own calculations.

The only exceptions are metallurgical production where, as of July 2017, output had jumped 11% relative to December 2016, and machinery & equipment manufacturing, where the trend component had been increasing over several previous months. In case of the former, the positive dynamics can be explained by the favorable international and domestic market situation¹: the world steel market is on the rise, while the high demand in the domestic market has been sustained primarily by the building construction sector (and in particular by major construction projects like the Kerch Strait Bridge, the Power of *Siberia* gas pipeline, etc.), and the machinery & equipment manufacturing sector. In case of the latter, output growth has been sustained, in all likelihood, by one-time support measures delivered by the government².

Another noteworthy phenomenon is the halt of growth and the onset of decline in the chemical industry where, over recent years, output has been demonstrating a stable upward trend sustained by its orientation to exports and the ruble's plunge in 2014–2015. The current decline can be interpreted as the upshot of the ruble's strengthening in late 2016 and early 2017.

On the whole, our analysis of by-sector output dynamics across Russian industry demonstrates that there have been no signs of transition from stag-

1 The Period-end Overview of the Metallurgical Industry for January–March 2017 Has Been Prepared // Riarating.ru, 3 June 2017 [http://riarating.ru/industry_newsletters/20170630/630066803.html]

2 In particular, budget allocations to the value of Rb 6bn for the purchases of 1,000 ambulances and 1,500 school buses; see Profit Decline Undermines Investment Growth // Kommersant, 28 August 2017 [<https://www.kommersant.ru/doc/3395834>]

nation, which began more than a year ago, to any noticeable growth, however small. The majority of sectors continue to display stable near-zero growth rates, while increased output in some of them has occurred in response to current changes in the market situation that cannot become long-term output growth drivers. Likewise, the declining volume of investment in the manufacturing industries (with the exception of those oriented to consumer demand and infrastructure projects)¹ may be viewed as a sign of absence of any growth factors in the short-term perspective. ●

¹ Capital Investments Avoid Growth // Kommersant, 31 August 2017 [<https://www.kommersant.ru/doc/3397738>]

3. INDUSTRY ADAPTABILITY INDEX: A NEW ALL-TIME HIGH

S.Tsukhlo

The evaluation of the Industry Adaptability ('Normality') Index for Q3 2017 shows that the Index continued to grow, hitting a new historical all-time high. Seventy nine percent of Russian enterprises said they were adapted to the current stage of economic development and considered their status as "normal" at this stage.

The level of Russian industrial sector's adaptability in the third quarter was up 2 points, with an overall growth of 7 points for the Industry Adaptability Index over the recent 11 quarters (i.e. since late 2014) (Fig. 1). Furthermore, within the period of 2015–2017 the Index lost not more than 2 points in Q1 2015 and in Q1 2016 (when the industrial sector did not "bounce back from the bottom of the crisis" as was expected). This is the most unusual crisis the Russian industrial sector has ever experienced for the entire period covered by our monitoring.

There is no difference between the capacity utilization during the crisis of 2015–2016 and in the pre-crisis period of 2013–2014, the former being 1–2 p.p. below the inter-crisis low registered in 2012. However, the capacity utilization in 2017 (according to the data for the last three quarters) dropped 2 p.p. from 2016.

Nevertheless, the Russian industrial sector feels relatively comfortable even if there is a possible delay in recovering from the crisis. 92% of enterprises said their financial status is normal ('good' + 'satisfactory') in Q3 2017, reaching the highest ever level for this basic aggregate indicator for the Industry Adaptation Index.

A similar situation is observed concerning enterprises' responses about their production capacity. Adequate supply of machinery and equipment "due to expected changes in demand" is also heading towards a historical high. 84% of enterprises said they had adequate capacity. Another 13% of enterprises said their capacity was more than adequate. Thus, only 3% of enterprises said they were faced with capacity shortage, nearly an all-time low. The Russian industrial sector had less capacity shortage prior to the Russian Default of 1998.

Note that the share of capacity shortage responses saw

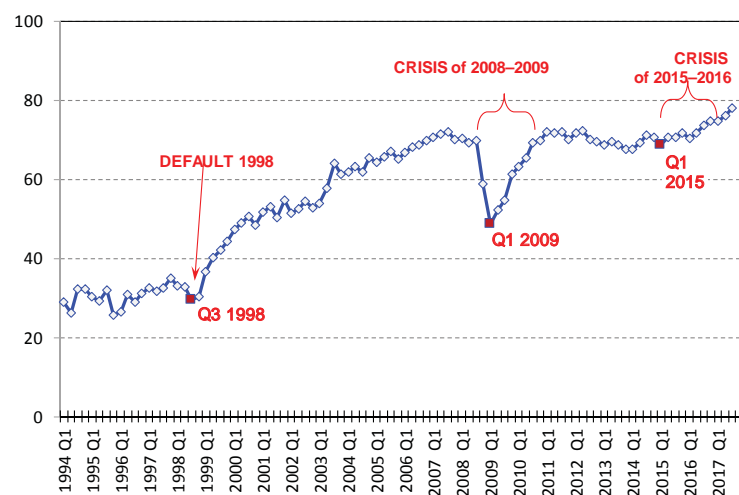


Fig. 1. Industry Adaptability (Normality) Index, 1994–2017, % (the share of enterprises that assess their performance figures as 'normal')

sharp fluctuations over the last few quarters within a range of 66–84%. The latter can be explained by the fact that enterprises differ in viewing the pace of recovery from the crisis, which, however, is logical due to constantly changing projections and seeking new economic policies that could revive the Russian economy. However, Russian industrial enterprises' capacity evaluations in the third quarter show that nowadays, more than ever before, they are prepared for recovery from the protracted crisis.

Russian industrial enterprises evaluated in the same manner their labour supply. In mid-2017, 84% of enterprises managed to achieve an adequate staff headcount because of expected changes in demand. This was attained through focused recruitment policies in 2017. The Russian industrial sector continued recruiting new personnel while facing shortage of qualified personnel and still hoping for recovery from the protracted crisis. In August 2017, the balance of changes in actual employment remained positive, albeit low in absolute terms. Hiring of workers in the Russian industrial sector over the past six months (excluding January and May) of 2017 has been registered. This was not the case during the crisis of 2015–2016, or in the pre-crisis period of 2011–2014. Note that shortage of personnel was mentioned less among the factors constraining output growth in the third quarter, reaching an inter-crisis low of 20%, although 25% of enterprises said as early as Q2 2017 that they were running short of personnel (a 10-quarter high), which was explained by the highest hopes of recovery from the ongoing crisis. It is the loss of these hopes amid positive dynamics for the employment that was responsible for the reduction of the current shortage of employees.

The raw materials and supplies inventory has been reported steadily 'normal' since mid-2015, with 80% of enterprises having normal inventory in the third quarter. No such figures have been reported for the industry over the past 25 years. Raw materials and supplies will thus not be a headwind to a possible, albeit unlikely, explosive revival of output. This conclusion is also supported by a monitoring of output growth constraints: shortage of raw materials and supplies ranks 9th in the monitoring, with 10% of responses.

The finished goods inventory is the only basic indicator that saw a decline in the third quarter. The share of responses about "normal" finished goods inventory was down 2 points, reaching a 14-quarter low. Apparently, this was due to a difficult and long search for a new inventory (in quantitative terms) that can be used for recovery stage.

Enterprises' responses about demand for their products in Q3 2017 showed that satisfaction with sales volumes continued to stay at a high level. It is the second consecutive quarter that this indicator stood at 63%, hitting a 9-year high. ●

4. BANK OF RUSSIA UPDATES BANK RESOLUTION MECHANISM TO INCREASE ITS CONTROL

M.Khromov

The resolution of Bank Otkrytie FC will be the first case of applying a recently introduced new mechanism for the resolution of commercial banks. The mechanism enables the Bank of Russia to control more efficiently bank resolution costs and can tilt the balance between banking license revocation and solvency recovery in favour of the latter.

New regulations securing an alternative mechanism for the resolution (solvency recovery) of banks are in force since June 2017. For this purpose the Bank of Russia has established an entity, the Fund for Banking Sector Consolidation (FBSC), and set up a FBSC management company fully controlled by the Bank of Russia. The updated mechanism has been proclaimed to be designed primarily for curtailing bank resolution costs and for increasing control over spending of appropriated resources.

Until recently bank resolutions have been performed basically at the cost of the Bank of Russia, involving the State Agency for Deposit Insurance (SADI) and investing banks that are interested in bailing out a given bank so that it can develop its business. Quite often, however, investing banks used the money allotted for bank resolution for the purpose of their own business development. The new bank resolution mechanism prevents using the money prior to selling the rescued bank. Thus two elements – the SADI and the investing bank – have been removed from the chain of financial aid for rescued banks and replaced with the management company controlled by the Bank of Russia.

What are the SADI's provisional results concerning procedures for the recovery of Russian banks' solvency? As at 1 August 2017, the State Agency for Deposit Insurance was involved in recovering solvency of 26 banks using the old procedure. Bank resolution procedures had been completed by the same date for another 20 banks. As a result of such procedures, rescued banks generally affiliated with investing banks.

As at 1 July 2017, the State Agency for Deposit Insurance allotted more than Rb 1.2 trillion in banks' solvency recovery procedures, most of which (Rb 1.14 trillion) were provided in the form of repayable loans from the Bank of Russia. Furthermore, actual maturity dates for such loans may be found to be long-term enough. SADI's repayments to the Bank of Russia within the bank resolution procedures in place have so far been less frequent than new loans. The SADI's debt in H1 2017 increased more than Rb 70bn. Moreover, this happened under the circumstances when solvency recovery procedures had not yet started for new banks. There were only two such banks in 2016/H1'17, one (Peresvet Bank) of which was already subject to a preliminary moratorium on the repayment of creditors' claims, that is, the insured event occurred from the perspective of the deposit insurance framework.

What should be kept in mind is that the financing of bank resolution procedures is just one of the channels available for crediting the SADI by the Bank of Russia. The SADI's core function – to provide insurance for retail bank

deposits and to ensure that the depositors of shutdown banks are repaid on a continuous basis – is loss making. The Statutory Deposit Insurance Fund ran out of its own money as early as summer 2015. Today, the deficit of the deposit insurance framework is covered by Bank of Russia's loans, with a credit limit being updated on a regular basis. As at 1 July 2017, the SADI owed Rb 657bn to the Bank of Russia. The debt arose from the support to the deposit insurance framework, of which Rb 108bn were borrowed in January–June of 2017. For comparison, participating banks paid only Rb 63bn in insurance premiums during the same period.

The ratio of these two items of Bank of Russia's spending on the SADI – on bank resolution and on payments to depositors – can be a criterion for making a decision on banking license revocation or for making attempts to revive a bank. As long as the Statutory Deposit Insurance Fund is able to cover payments to depositors, the decision-making on resolution of a given bank, particularly a big enough bank, could be a way to continue running a deficit-free deposit insurance framework. These considerations have not been applied since summer 2015 until now because both processes – deposit insurance and bank resolution – have been financed in a similar manner, that is, through the Bank of Russia's loan to the State Agency for Deposit Insurance. The amount of the financing is considerable enough – as at 1 July 2017, the SADI's total debt to the Bank of Russia accounted for more than 2% of Russia's GDP. Within the new bank resolution mechanism framework the Bank of Russia is supposed to increase its control over spending on solvency recovery of troubled banks, and therefore it may be assumed that bank resolution would be a more preferable regulatory tool than banking license revocation when it comes to controversial cases.

The Bank of Russia decided 29 August to implement policies aimed at increasing the financial sustainability of Bank Otkrytie FC. Otkrytie thus became the first bank in which the new bank resolution mechanism was applied just two weeks after the Bank of Russia's new regulations came into effect. Although no exact amount of the required aid has to date been announced, such an amount may be much bigger than what the Bank of Russia allocated in H1 2017 for bank resolution procedures. The Bank of Moscow project is still the largest ever solvency recovery project worth almost Rb 300bn in 2011. The Otkrytie rescue project has very good chances to hit a new all-time high.

It is safe to say, on the one hand, that as a result of this operation the Russian banking market would de facto miss a private player until the Otkrytie package is sold at a public auction. Until then the rescued bank will be managed by the regulator, with its development strategy being determined by regulator's actions. Indeed, this will have a strong effect on the market because Otkrytie has been a country's largest private bank over the past two years. However, an attempt to save a top private bank seems rather a step towards promoting competition in the banking market in the long term. Had the Otkrytie's banking license been revoked, top state-owned banks would have had a big share of retail deposits.

What in this case should be regarded as definitely negative signal is that this has secured the 'too big to fail' concept in the Russian banking market. Let us recall the liquidity crisis of 2004 at AlfaBank, representing the then largest private bank in Russia, facing a drastic deposit outflow. No deposit insurance framework was in place at that time. To prevent panic among cus-

tomers and to compensate the owners for liquidity loss, the bank owners had to use their own money to prop up the bank in short order. The owners of Otkrytie seemed to have neither money nor incentives to save the bank in 2017. The bank's customers however received a signal from the regulator suggesting that their money will be intact regardless of the quality of management and whether or not the owners want to keep the bank alive. This indeed was a positive fact for the Otkrytie's customers, whereas the same fact is quite negative in terms of management of risks that may affect the financial system in the long term. ●

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