MONITORING OF RUSSIA'S ECONOMIC OUTLOOK:

TRENDS AND CHALLENGES OF SOCIO-ECONOMIC DEVELOPMENT

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MAIN TRENDS AND CONCLUSIONS

V.Gurevich

Russia's oil industry, which still remains the biggest donor of the federal budget, is undergoing a process of profound modernization, both mental and physical, thus making the future of the Russian treasury cloudy and uncertain.

Thus, when negotiations on the oil industry's transition to new taxation principles (revenue-added tax) were entering their final phase, *Rosneft*, followed by the rest of Russia's leading oil producers, demanded that their mature water-flooded reservoirs with active oil reserves should be granted considerable tax benefits, and that the old taxation scheme should be preserved for them. However, the RF Ministry of Finance has some misgivings about succumbing to this demand: it fears that once this happens, the whole system of tax innovations will be emasculated. At the same time, the federal budget will gradually be losing more and more tax receipts from the oil industry because most of Russia's oil production will shift to new oil fields, which were already granted long-term tax benefits at the start of their exploitation and development. If the old tax-breaks are to be accompanied by the tax benefits granted to mature oil fields, how will Russia be able to raise money to fill holes in the federal budget?

The oilmen counter the alarmist misgivings of the Ministry by accentuating the well-known calculation showing that in Russia, the tax burden (including excise taxes) per physical unit of produced oil (one tonne) or sold gasoline is already very high by global standards. Moreover, the already implemented fiscal innovations have drastically reduced the profitability of oil refining, while the profitability of retail sales of oil refining products has likewise tumbled and continues to slide. The prospects for marketing petroleum fuel products have indeed become so grim that LUKoil has reputedly decided to get rid of one-third of its filling stations. One can only guess as to whether this decision was predominantly motivated by the fact that the fuel retail business is characterized by a very narrow margin between costs and revenue, or by the low quality of the entire business climate in Russia. Nevertheless, one cannot but realize that the era of the blissful and mutually prosperous cohabitation of the federal budget and the oil industry is giving way to a long period of bitter wrangling over taxes.

While Russia's major oil producers are certainly not underdogs on the home front, they cannot control a number of important and poorly predictable factors outside of Russia. Some of these factors are as follows: Saudi Aramco, 5% of which will likely be worth more than any Russian corporation as a whole, after that Saudi company's next year's IPO; Elon Musk, with his penchant for electric motors; the Harvard engineers inventing ever more efficient energy storage systems; and, of course, the small and medium-sized shale-oil companies that have come out of the blue and now are apparently here to stay.

Naturally, there are some people within the oil industry itself who are eager to promote abstract mental constructions, and who are effectively ignoring both the existence of such factors and the speed of their development. Thus, having emerged in 2010, shale oil producers turned the oil market upside down over the course of only four years. It is also true, however, that the oil industry can reassure itself by the indisputable fact that the price of oil is still used as a reference indicator in all long-term scenarios of Russia's economic development (in other words, as a traditional 'spiritual brace'). Which means that the authorities openly admit that oilmen need not fear that they may become redundant in the foreseeable future, and that the upper limit to their 'working life expectancy' is not even hinted at by the authors of the aforesaid scenarios. Nevertheless, the former ideas regarding the role and importance of oil (coal, nuclear energy) are undergoing a radical transformation. Therefore, both the trajectory of tax rates and the trajectory of investment have also remained vague. It should be added with regret that the same is equally true of the entire process of 'kicking the oil habit'.

The process of curbing the rate of inflation is much more obvious. The visible decline in the inflation rate has made it possible for the RF Central Bank to slightly reduce its key interest rate, and for the reinstatement of Elvira Nabiullina as its head to be justified and understandable.

Our experts explain the Bank of Russia's decision to cut its key interest rate, among other things, by the behavior of the inflation rate, which was declining even faster than forecasted by the regulator itself: down to 4.3% as of the end of the second decade of March. It should be said that as recently as October 2016, the RF Central Bank had expected that the inflation rate would drop to 5.5% only in October 2017. The decline in the rate of inflation was also contributed to by the slow pace of demand recovery and by the strengthening of the ruble. The deceleration in the growth rate of prices is taking place across a broad range of major categories of goods and services: food commodities; prices for services/tariffs; and non-food commodities. It is noteworthy that the latter category of goods, which had experienced a 0.7% rise in prices during January and February 2017, has made the largest contribution (almost 50%) to the general increase in prices.

As far as the strengthening of the ruble is concerned, it is predominantly related to non-residents' interest in Russian financial assets due to their higher interest rates coupled with the relatively high oil prices. According to our experts, in early 2017 the real effective exchange rate of the ruble, after having been close to the fundamentally justified level throughout 2016, began to deviate from it, which has resulted in the ruble being currently overvalued by approximately 5%. A return of the ruble's real effective exchange rate to a 'balanced' trajectory will require the ruble's nominal weakening by about 8% (which means that the real effective exchange rate of the ruble amounts to Rb 62–64 per USD).

Thus, the medium-term risks of the ruble's weakening remain relatively high. The same is true of inflation expectations – actually, in February they rose by 1.4 p.p., to 12.9%. Because of the forthcoming elections, the government's intentions with regard to its budget policy continue to be elusive. Bearing all this in mind, the RF Central Bank is most likely to proceed with gradually softening its policy, which will nevertheless remain moderately rigid. The question of just how rigid this policy should be remains open. Having amounted in 2016 to an average of 11.3%, the growth rate of Russia's money supply (M2) in January 2017 amounted to 12.0% (relative to January 2016).

According to experts, over the course of the first two months of 2017, the volume of non-cash resources (the non-cash component of M2) increased by

0.4%. However, by March 1, 2017, non-cash ruble-denominated accounts had grown by 13.4% relative to the same date of the previous year, to Rb 30.8 trillion. The ongoing rise in the amount of non-cash monies is mostly due to the growth of individual persons' ruble-denominated bank deposits (by March 1, their foreign exchange-denominated accounts had also increased, by 6.2%, on the previous year, to $ 91.4bn). At the same time, the amount of monies kept in the bank accounts and deposits of organizations is growing at a much slower pace (while the amount of monies kept in the foreign exchange-denominated accounts of legal persons has declined by 6%, to $ 127.7bn). At the same time, the share of term deposits (as of the beginning of 2017, the amount of monies kept in fixed-term deposit accounts amounted to about Rb 12 trillion) is gradually declining. Experts believe that this may be indicative of a renewal of interest in investing in productive assets (real investment).

The business surveys regularly carried out by the Ye. T. Gaidar Institute for Economic Policy (IEP) likewise confirm that positive expectations are definitely on the rise across Russian industry. Moreover, the set of representative indicators obtained during 2015 and 2016 is by no means typical of a crisis period. According to the IEP's surveys, the Industrial Optimism Index (IOI) has been buoyant since the beginning of Q2 2016 and reached its five-year record high in November. The IOI's drop in 2015 and early 2016 had been insignificant in comparison with its dismal behavior in September 1998 and December 2008.

According to IEP researchers, the Industry Adaptation (Normality) Index designed to indicate the percentage of enterprises estimating their indicators as normal (or abnormal) also suggests that those who doubted the existence of an industrial crisis in 2015 and 2016 may have been right after all. The worst readings shown by this index date back to late 2013 and early 2014, while in late 2016, on the contrary, it hit its historic high of the entire period of observation since 1994.

The true crisis-like behavior was demonstrated by only two indices. First, the enterprises began to feel that bank loans had become unobtainable (the peak index (45%) in the number of enterprises reporting this opinion was observed over the period from September 2014 through February 2015). However, the lending crisis proved to be less severe than in 2008–2009 (the peak index then amounting to 65% of all enterprises). In early 2017, loan availability returned to its pre-crisis level. Besides, even at the height of the current crisis that factor was considered to be an obstacle to production growth only by 10% of enterprises (compared with, e.g., 36% of those who believed the weak ruble to be an obstacle). Secondly, the crisis-triggered slump was manifest in the investment plans across Russian industry (the percentage of negative estimates of that factor was on the rise from August 2014 until February 2015). It took nearly two years to overcome that trend. Although as early as March 2016 industry came close to a positive balance in its reported investment intentions, that index truly moved to plus side only early this year. On the whole, it can be said that industrial enterprises have rather successfully adapted to the current situation in the market.

The expert estimations of the prospects for the welfare services sector's transition to market conditions, in particular to relying on government orders for the provision of such services (to be placed on the market), and the plans to abolish government obligations to support the relevant budget-funded institutions, are quite different. The reform oriented to a switchover from budget-based funding to cost-based funding in that sector was announced more than a decade ago, but its actual implementation effectively started only in 2016. It was expected that this move will create incentives for cutting costs and creating appropriate conditions for a competition for budget money between public and private organizations.

Experts are very critical of this undertaking (viewing with skepticism many of its parameters, including the attempts to apply single norms to the ever-increasing list of new types of costs), believing that this approach is fraught with grave risks of degradation across the entire welfare services sector. They suggest that some of the major components of that reform should be abolished, having come to the conclusion that the idea of market placement of government orders for the provision of welfare services is essentially a dead end.

1. WHY THE RF CENTRAL BANK PURSUES A CAUTIOUS POLICY

A.Bozhechkova, P.Trunin

On March 24, the Bank of Russia decided to reduce its key rate by 0.25 p.p. to 9.75%. The Bank of Russia's intention to continue its moderately rigid monetary policy, in spite of the significant slowdown in real inflation, can be explained by the inertia of inflation expectations, as well as the persistent risks of potential worsening of the balance of payments as a result of a plunge of prices of energy carriers followed by considerable capital outflow.

The previous reduction of the key rate from 10.5% to 10% had taken place in mid-September 2016. The RF Central Bank did not change its key rate for six months in a row in an apparent effort to stabilize the downward trend displayed by inflation. In January–March 2017, the rate of inflation continued to decline, amounting to 5% in January (relative to January 2016) and to 4.6% in February (relative to February 2016). Over the first twenty days of March, the consumer price index (CPI) dropped to 4.3% (relative to the same period 2016), that is, its June 2012 level (*Fig. 1)*. As a result, the CPI index in early 2017 was below its target forecasted by the regulator. In October 2016, the Bank of Russia had believed that it would be possible to push down the inflation index to 4.5% only by October 2017. The slowdown in inflation had been conduced to by the low recovery rate of aggregate demand, as well as the ruble's continual strengthening for four months in a row.

Inflation decline has been continuing across all of its main components. Over the period January–February 2017, the prices of foodstuffs rose by 1.1%. The most significant factor responsible for their upward movement was the seasonal surge in prices of fruit and vegetable products. Overall, the slowdown of inflation in the foodstuff sector (from 4.6% in December 2016 relative to December 2015 to 3.7% in February 2017 relative to February 2016) was more noticeable than the downward movement of any other inflation component. In addition to the ruble's strengthening, the other important factor were the high crop yields in 2016, which had resulted in huge agricultural stockpiles.

The growth rate of the prices of nonfood commodities over January–February was 0.7% (vs. 5.7% in February 2017 relative to February 2016, and 6.5% in December 2016 relative to December 2015). Their contribution to the CPI growth rate in January–February 2017 was highest compared with all the other inflation components, amounting to 44.1%. The prices and tariffs established for commercial services rendered to the population gained 0.8% over the first two months of 2017, due in the main to the raised prices for passenger transport services. On the whole, inflation in the services sector in per annum terms declined from 4.9% in December 2016 to 4.3% in February 2017.

Low consumer demand remains one of the key factors that prevent rapid inflation growth. After their January surge, caused in part by the one-time pension benefit payment in the amount of Rb 5,000, real disposable money income once again lost 4.1% in February relative to the same period of last year. Retail turnover decline likewise continued, amounting in January 2017 to (-2.3%) relative to January 2016 (its year-end index for 2016 being (-5.2%)). Inflation's rapid slowdown has also been contributed to by the movement of the official exchange rates of foreign currencies against the ruble. Since early 2017, the ruble climbed 4.1% against the US dollar, amounting to Rb 57.4 per USD as of 25 March after having hit, in mid-February, its 18-month record high (Rb 56.55 per USD.). The average ruble-to-USD exchange rate for January–March was Rb 58.8 per USD, whereas the RF Ministry of Economic Development's basic scenario had been based on the assumption that the average annual exchange rate of the ruble against the US dollar would be Rb 67.5 per USD.

Source: Rosstat.

Fig. 1. The CPI Growth Rate in 2011–2017 (% Year-on-Year)

The ruble's current strengthening has had to do in the main with the significant interest in Russian financial assets displayed by non-residents in conditions of the persistently high interest rates in the RF coupled with high oil prices during the period from January through early March 2017 (on the average $ 55 per barrel). As a result, over January–February 2017, the Russian ruble gained more in nominal terms than the national currencies of nearly all the other developing countries, coming second only to the Brazilian real (growth by 6.7%).

According to our estimates, in early 2017 the real effective exchange rate of the ruble, after having been close to the fundamentally justified level throughout 2016, began to deviate from it, which has resulted in the ruble being currently overvalued by approximately 5%. As a result, over the period January–February 2017, the ruble's real effective exchange rate gained 5.7% relative to December 2016. So, a return of the ruble's real effective exchange rate to a 'balanced' trajectory[1] will require the ruble's nominal weakening by about 8%. This means that the fundamentally substantiated real effective exchange rate of the ruble amounts to Rb 62–64 per USD.

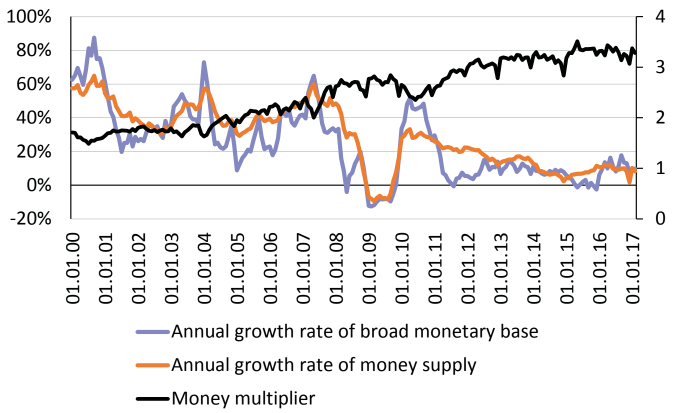
Thus, the medium-term risks of the ruble's weakening remain relatively high. The catalyst of its plunge may become the downward movement of oil prices caused by the continuing discrepancy between of supply and demand in the world oil market. The other potential threats are the economic slowdown in China and the tougher monetary policy of the US Federal Reserve. The latter may increase the attractiveness of US assets, thus triggering capital outflow from the other developed and developing markets, Russia including. All these factors are potentially fraught with inflation risks in 2017.

Another factor that has been responsible for the RF Central Bank exercising caution in its monetary policy is the inflation expectations of economic agents. It should be noted that in February, the index of inflation expectations of the population rose by 1.4 p.p. to 12.9% after a two-month long decline.

1 When the rate of inflation in Russia amounts to 4.6% (February 2017 relative to February 2016), and the average rate of inflation in Russia's trading partner countries amounts to 2%.

This fact, in spite of the current inflation index being close to its target value of 4%, points to the high inertia in inflation expectations. In our opinion, the currently observed lack of stability in inflation expectations confirms the correctness of the Bank of Russia's decision to continue its moderately rigid monetary policy course.

And finally, the key rate cannot be reduced at a faster rate due to the uncertainties associated with the government's budget policy, especially bearing in mind the forthcoming elections.



Source: Bank of Russia.

Fig. 2. The behavior of the monetary aggregates and money multiplier in 2000–2017

The question of just how rigid the current monetary policy should be remains open. Thus, while in 2016 the growth rate of Russia's money supply (M2) had amounted to an average of 11.3%, in January 2017 it was 12.0% relative to January 2016 (*Fig. 2*). In face of the current inflation slowdown, this will mean accelerated growth of real money supply, which is not quite compatible with the 'monetary policy toughening' hypothesis.

Thus, bearing in mind the existing risks of inflation processes acceleration in 2017, the Bank of Russia will most likely continue to gradually soften its policy, while taking into account the behavior of aggregate demand, inflation expectations and the government's budget policy.

2. BANK LIABILITIES ARE ON THE RISE DUE TO INCREASING INDIVIDUAL DEPOSITS

M.Khromov

Growth of non-cash monies has been sustained in the main by that of individual ruble-denominated bank deposits. The deposits and monies kept on their bank accounts by organizations have been growing at a slower pace, thus corresponding to the movement of their turnover in nominal terms. At the same time, the relative share of term deposits in the total amount of organizations' funds held in the banking system has been shrinking. This may be a sign of reviving interest in investing in real production.

Over the first two months of 2017, the volume of ruble-denominated non-cash monies (non-cash component of M2) remained practically unchanged[1]. As of March 1, 2017, it amounted to 100.4% relative to its index as of the year's beginning. Thus, for the first time in several years, the seasonal money supply plunge that occurred in early 2017 was offset by its growth, as shown by the period-end results of Q2. Over the period of financial instability (2014–2016), the plunge of ruble-denominated non-cash monies over the first two months of each year amounted to 1.2–2.8%. In those years, the seasonal factor's effects were strengthened by the effects of devaluation – the ruble's weakening was followed by shrinkage in the demand for ruble-denominated cash residuals. However, even prior to 2014, the movement of money supply over each year's first two months had always been negative – the seasonal decline in January was usually offset by growth towards the third month's end.

The growth of non-cash monies kept in ruble-denominated bank accounts that occurred over the first few months of 2017 (relative to their last year's growth rate) translated in their higher annual growth rate, while the total amount of ruble-denominated non-cash monies as of March 1, 2017 amounted to Rb 30.8 trillion. While their year-end growth index for 2016 was 9.9%, as of March 1, 2017 is amounted to 13.4% (relative to March 1, 2016). The overall movement trajectory of this index since early 2016 has been rather stable. Its year-end value for 2015 was 14.3%, and since then, it has been hovering around 10–14%.

Among the main components of ruble-denominated non-cash monies in the money supply structure, the highest growth rate, as before, was demonstrated by individual bank deposits. Ruble-denominated bank accounts and deposits of individuals demonstrated 0.7% growth since the year's beginning, while those of organizations shrank by 0.1%. By the end of February, the annual rate of growth demonstrated by individuals' monies rose to 16.2% relative to its 2016 year-end index of 14.2%. The growth rate of ruble-denominated non-cash monies held by individuals, similarly to that of the total amount of non-cash monies, had largely recovered by the year-end of 2015, demonstrating growth by 19.4% after the slowdown in 2014. Over the course of

1 Hereinafter, the money aggregate indices as of March 1, 2017 correspondent to the Gaidar Institute's estimates based on bank reports for February 2017.

2016, the annual rate of growth demonstrated by that component of money supply remained at the level of 15–16%. The growth rate of ruble-denominated funds of organizations rose from its 2016 year-end index of 4.0% to 9.6% as of the end of February.

The total amount of funds kept by individuals and legal entities on bank accounts, including foreign exchange-denominated bank accounts and deposits, over the period of January–February 2017 climbed by 0.8% in ruble terms. Meanwhile, its foreign exchange-denominated component in early 2017 demonstrated growth of 6.2% in US dollar terms, or 1.7% in ruble terms. That growth resulted, almost entirely, from the increased amount of funds kept in their foreign exchange-denominated bank accounts by organizations (by 11.1% in US dollar terms), while the same index for individual foreign exchange-denominated bank accounts and deposits remained at nearly the same level (growth of 0.4% over two months).

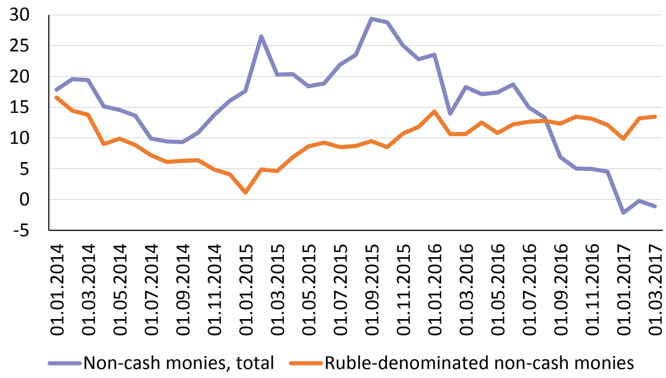


Fig. 1. The growth rate of non-cash monies, as %, relative to the same date of the previous year

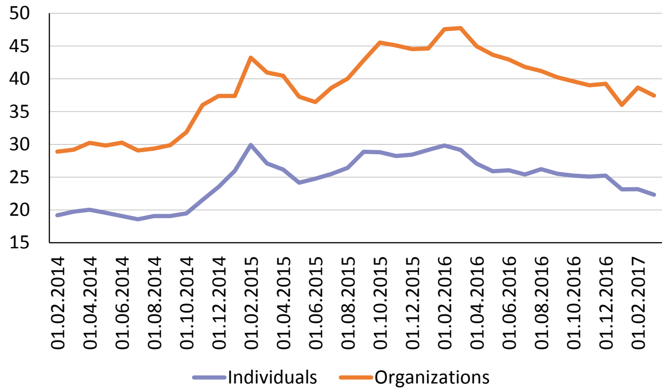


Fig. 2. The relative share of foreign exchange-denominated deposits in the total volume of non-cash monies placed with banks by individuals and legal entities

At the same time, the annual growth rates of these indices were moving in the opposite direction – over the period from March 1, 2016 through March 1, 2017, the amount of foreign exchange-denominated funds placed by individuals with banks gained 6.2% in US dollar terms, rising to $ 91.4bn, while the amount of funds held in foreign exchange-denominated bank accounts by legal entities, on the contrary, shrank by 6.0% to $ 127.6bn. The movement of foreign exchange-denominated non-cash monies in ruble terms remained negative over the past year due to the ruble's strengthening against major foreign currencies. This translated into a shrinkage, by 1.1% in ruble terms, of the total amount of monies kept by bank clients in their accounts over the 12-month period preceding March 1, 2017, as well as a reduced relative share of foreign exchange-denominated funds in the total volume of funds kept in bank accounts and as bank deposits by individuals and legal entities. As of March 1, 2017, the relative share of foreign exchange-denominated bank deposits placed with banks by individuals declined to 22.3% vs. 29.1% a year earlier. As of the same date, the relative share of foreign exchange-denominated funds placed by legal entities amounted to 37.4% vs. 47.7% a year earlier.

The substantial monies invested by organizations as bank deposits indicate that there are no attractive ways of investing in real production. However, one positive sign has been the halt in the growth of term deposits placed by legal entities, as demonstrated by the year-end results of 2016 and the first few months of 2017. The relative share of term deposits in the total volume of monies of organizations held in the banking system had hit its record high by the year-end of 2014 (62.8%); in 2015, this index remained practically unchanged (62.6%), and by the year-end of 2016 it had declined to 60.0%.

The volume of organizations' monies placed with banks as term deposits declined following the decline in business activity across the economy. While the 2015 year-end index of term deposits placed by legal entities was equivalent to 35-day turnover period of organizations, by the year-end of 2016 it plunged to 30 days, and then to 29 days as of March 1, 2017. The amount of monies held in settlements accounts remains stable relative to business activity, corresponding to a 20–22-day turnover. At the same time, in 2016 and early 2017, both the current accounts and term deposits of organizations demonstrated progressive de-dollarization. In early 2017, total term deposits placed by organizations with banks amounted to approximately Rb 12 trillion. Considering the fact that bank deposits have been gradually losing their attractiveness as a form of investment following the ruble's strengthening and interest rate decline, in 2017 these monies can become an important source of investment in fixed assets.

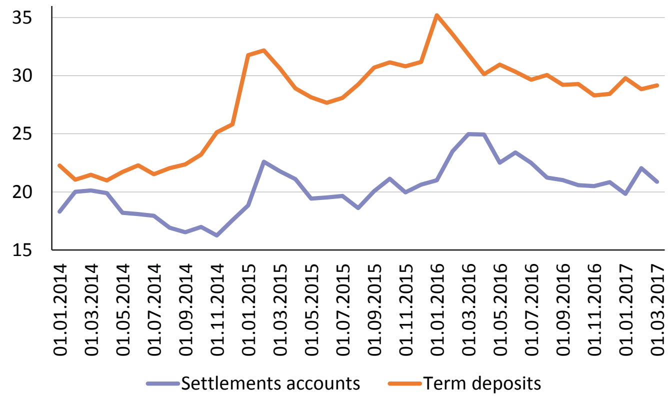


Fig. 3. The volume of monies kept in accounts and as deposits with banks by organizations

3. THE RUSSIAN INDUSTRY IN 2015–2016: WAS THERE ANY CRISIS?

S.Tsukhlo

The monitoring of a representative set of indicators of business surveys carried out by the Gaidar Institute permits to identify the specifics of the 2015–2016 crisis in Russian industry. Firstly, within the two crisis years the dynamics of the main indicators (demand, output and prices) were rather weak which situation was quite an unexpected one for observers and different from the previous crises. Secondly, one could get psychologically prepared to the 2015 crisis several years in advance when the thesis of "the second wave of the crisis" was introduced. The above factors formed the third specifics of 2015 – Russian enterprises went through that crisis rather smoothly. Fourthly, the only manifestations of the 2015–2016 crisis for Russian industry were a dramatic surge in the interest rate on bank loans and a collapse of investment plans.

Rather unusual dynamics of the Russian industry in the 2015–2016 crisis years coupled with an ambiguous estimate of the Rosstat's official data permit us to take a different view of the Gaidar Institute's business survey data. The main specifics of the Gaidar Institute's business surveys consists in the fact that a well-devised set of statistical indicators show what enterprise managers think of the most important aspects of their enterprises' business activities. The above set permits to get a better idea of how the Russian industry went through the 2015–2016 period.

Aggregate (Integral) Estimates of the State of Russian Industry

Aggregate indicators built on the basis of a set of initial indicators unique to the Russian survey statistics give the initial estimates and a general idea of the situation in the Russian industry. The industrial optimism index is a traditional derived indicator which is used in business surveys, while the Industry Adaptability Index (normality) is the Gaidar Institute's new elaboration which permits to reveal the specifics of the 2015–2016 period.

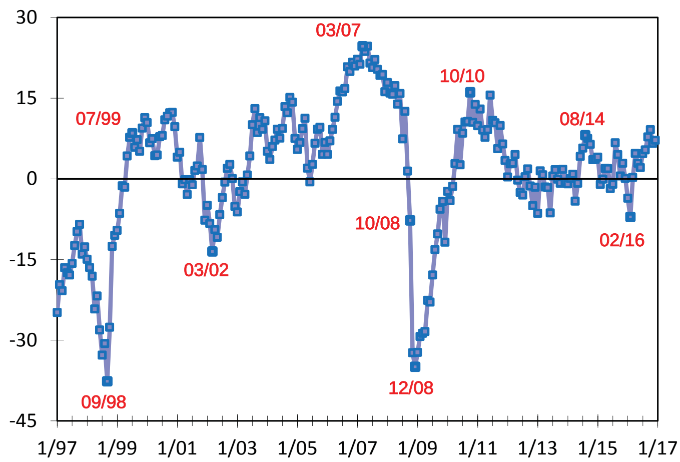


Fig.1. The Gaidar Institute's Industrial Optimism Index, 1997–2017

The industrial optimism index has shown that the initial estimates of the situation in Russian industry in 2015 were far from being crisis ones. The index remained in the positive zone and its value even improved as compared to November-December of the previous year. The indicator's subsequent fluctuations took place due to panic sentiments of officials and analysts who publicly got prepared to the crisis on the pattern of that in 2008–2009. However, a downturn in enterprises' sentiments turned out to be a small one, quite comparable to the indicator's values in the period between the crises and was overcome soon. As a result, though the aggregate indicator was in the negative zone it never amounted to its worst inter-crisis values (*Fig. 1*). In August 2015, the Gaidar Institute's aggregate index attained its local (2015) maximum under the influence of statements that "a rebound from the crisis bottom" was to take place soon. But the rebound which never materialized resulted in the local (crisis) minimum in February 2016.

From the beginning of Q2 2016, the surveys pointed to improvement of the situation in the Russian industry. In November 2016, with small interruptions the index of optimism amounted to the five-year (!) maximum. It seems that the 2015–2016 crisis is over. At the same time, an extremely negligible drop in the industrial optimism index in 2015–2016 as compared to the results of September 1998 and December 2008 calls into question the definition of the 2015–2016 period as a crisis in the Russian industry. The above thesis is completely underpinned by the dynamics of another aggregate indicator received on the basis of the Gaidar Institute's surveys, that is, **the Industry Adaptability Index (normality).**

The Industry Adaptability Index (that is, assessment of the situation as normal and deviations therefrom) permits to broaden comprehension of the 2015–2016 crisis in the Russian industry. Firstly, *according to the estimates of enterprises* no crisis and abnormal things took place in the Russian industry either in 2015 or 2016. The index remained confidently high (*Fig. 2*). It is to be noted that the Russian industry's *estimates* of Q1 2015 – the most difficult period in emotional terms – were not that panic as those of Russian officials and observers. Proceeding from the above, an extraordinary conclusion can be made: the industry adapted itself for long and quite confidently to the actual dynamics of the past few years. More importantly, the Industry Adaptability Index shows that from the end of 2010 the Russian industry maintained a high level of adaptation to economic conditions which used to be formed in each quarter of that period.

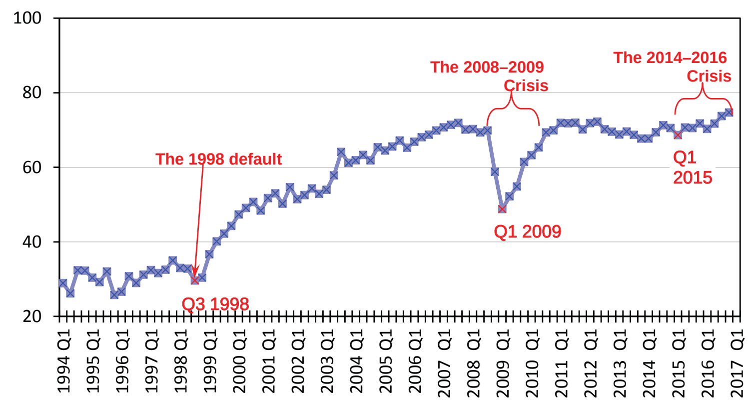


Fig. 2. The Industry Adaptability Index (normality), 1994–2017, %

In the 2011–2015 period, the Industry Adaptability Index was within the range of 68–72%. In the above period, the maximum reduction amounted to 2 points, while the worst values of the indicator (68%) were received late in 2013 and early in 2014, rather than in the crisis year of 2015. Also, late in the crisis year of 2016 the Industry Adaptability Index amounted to its absolute maximum (75%) in the entire period of calculations (1994–2016). Enterprises got completely accustomed to the realities of the Russian economy and economic policy.

The Dynamics of the Most Important Indices

Let us review the dynamics of estimates of individual indicators of Russian industry during the two crisis years.

According to the initial data on the situation of Russian industry early in 2015, there was not much evidence of a crisis. The actual dynamics of demand and output, estimates of volumes of finished goods and hiring plans were typical of January and looked optimistic amid the prevailing pre-crisis sentiments. However, forecasts of demand, output plans and investment plans failed to gain that extent of optimism which was typical of the beginning of a year. However, according to the results of Q1 2015 the industry managed to escape a crisis slump in production.

Amid lay-offs in other sectors of the economy and with slowdown of growth in wages and salaries, the Russian industry gained in general more opportunities of handling its personnel-related issues. According to surveys, as early as Q1 2015 (when crisis sentiments reached their utmost) a quarter of industrial enterprises experienced personnel shortages to maintain their output at the current level, while 15% of enterprises expected preservation thereof in the short-term prospect with forecasted changes in demand taken into account. In such a situation, it looked quite logical that positive dynamics of employment were attained in March 2015 (that is, the share of hiring reports exceeded that of lay-off reports), though it was not quite typical of a crisis.

In the 2015–2016 period, in terms of **employment**, Russian industry managed to escape a crisis surge in the rate of redundancy as it happened in the pre-default years and during the 2008–2009 crisis. Secondly, in the above periods the industry hardly managed to maintain the balance between the estimates of the existing number of its workers and those of small labor shortages, that is, industrialists responded more often that “it was insufficient”, rather than “more than sufficient”. Thirdly, the extent of labor shortages for the current output to be maintained exceeded largely that of shortages in other resources (capacities, raw materials and loans). Fourthly, in the 2016 crisis year the industry succeeded in gaining its historical maximum in normal (sufficient) provision of its needs with personnel: the index rose to 78%.

Enterprises’ estimates of **production capacities** in the 2015–2016 period did not have much evidence of a crisis, either. Firstly, as in case with a number of workers the industry managed without a crisis revision of estimates of installed capacities towards their excessiveness. This indicator remained at the level of the 2012–2014 period and amounted to 24%, which means that nearly a quarter of Russian industry in the 2012–2016 period believed that their output capacities were excessive due to expected changes in demand. Secondly, the balance of estimates of capacities in the 2012–2016 period was stable, too, but was drawn up by the industry with large surplus (unlike the balance of estimates of the number of workers). In other words, in industry there were much more enterprises with excessive capacities than those lacking them.

Estimation of output capacities was influenced among other things by a rather high **utilization of production capacities**. According to the data of the IEP surveys, the average annual utilization of capacities during the crisis did not change much as compared to the pre-crisis period and amounted to 66% and 67% in 2015 and 2016, respectively. However, it is to be noted that at present the Russian industry is capable of increasing utilization of its capacities to 82% using the equipment in a normal mode without investments being made and producing competitive products.

Estimates of volumes of finished products showed no evidence of a crisis of sales in the 2015–2016 period, either. As never before, the industry managed to control successfully the volumes of finished products. In Q1 2015 (that is, at the very beginning of the crisis), the share of normal estimates of supplies of finished products remained at its historical maximum level (70% of that achieved in 2014), while the average quarter balance of other estimates turned out to be zero. In other words, in the 1992–2014 period Russian industry had such good supplies of finished products as never before and, most importantly, those supplies were not typical of a crisis at all.

A similar non-crisis situation was observed in evaluating by enterprises of **volumes of primary products and materials**. The beginning of the 2015–2016 crisis did not cause any changes in estimates of volumes of such products, while in Q3 2016 the share of estimates of volumes of primary products and materials as normal amounted to the historical maximum of 80%. As never before, Russian industry was well supplied with primary products, materials and utilities for the current output to be maintained and even modified. Russian industry placed "the lack of primary products and materials" on the 12–13 place in the rating of 17 limitations of industrial growth (as per the version of enterprises).

The first place in the rating of industrial growth limitations is traditionally occupied by "insufficient demand". However, in 2015–2016 that factor (that is, a negative effect on output) was mentioned less than in the 2012–2014 period and much less than in 1994-1998 and 2009 crisis years for Russian industry. Direct estimates of the volumes of demand ranged as "above norm", "normal" and "below norm" show that a majority (though a minimum one) of enterprises were satisfied with volumes of demand on their products during the two "crisis" years.

What was the Actually Crisis Like for the Industry?

It is to be noted that the 2015–2016 crisis created anyway problems for the Russian industry, but only in two fields which a majority of enterprises did not regard as the most important ones in crisis conditions.

Enterprises' estimates showed dramatic growth – which is typical of a crisis – in **loans being unavailable**. From September 2014 till February 2015 that index rose 30 points up and amounted to the crisis maximum of 45%, that is, the percentage of enterprises which believed that loans were unavailable to them in the beginning of 2015. However, the maximum in question is much (20 points) lower than that of the previous crisis when loans were unavailable to 65% of enterprises. So, the crisis of lending in 2015–2016 turned out to be smoother than in 2008–2009. Early in 2017, the rate of both unavailability and availability of loans returned to the pre-crisis level.

It is to be noted that even at the peak of the 2015–2016 crisis the shortage of loans was far from being the most painful problem for the Russian industry. According to the version of enterprises, the above factor hindered output growth with maximum 10% of enterprises and rose only to the 12th place in the rating of 17 limitations of industrial growth. It is to be noted that the weak ruble was a more wide-spread limitation of output growth during the current crisis – up to 36% of enterprises pointed to that factor, so, according to the version of enterprises it was rated the third in the above rating of industrial growth limitations.

A crisis slump was registered by surveys in enterprises' **investment plans**, as well. As applied to the above index, the word "crisis" can be used without inverted commas and reservations as a drop in investment plans of the industry amounted to 43 points (the balance collapsed to -36 points). But according to our monitoring, that crisis actually began after Russia entered “a war of sanctions” in August 2014. In subsequent six months, the Russian industry’s investment plans steadily gained pessimism, having fallen to the crisis minimum by February 2015. It took enterprises almost two years to overcome it. Though as early as March 2016 the industry was close to attaining a positive balance of investment intentions, statements made by the authorities on a delayed nature of the crisis probably prompted enterprises to adjust their plans and the balance explicitly became positive only in the beginning of 2017.

4. RISKS OF THE NEW STAGE OF THE REFORM OF BUDGET-FUNDED ENTITIES

A.Zolotareva

The reform to switch over from budget financing of state-financed entities to payment of their services on the basis of unified cost standards was declared more than a decade ago, but actually launched only in 2016. At the new stage of the reform, it is planned to give up the practice of financing budget-funded entities and switch over to a state order for social services being placed on a tender basis. The above plans entail serious risks of the budget-funded institution network shrinking unchecked, state property dilapidating and the quality of social services getting worse. To reduce these risks, it is necessary to turn down the entire range of measures envisaged by the reform.

A switchover from budget financing of state-financed entities to payment of their services on the basis of cost standards was planned more than a decade ago[1]. The reform pursued the following two objectives: first, to create motivation for public institutions to cut costs and, second, to ensure conditions for competition between public and private entities for budget funding. However, until recently budget financing was abandoned rather formally in most sectors because subsidy volumes for each entity were determined on the basis of individual cost standards for services, that is, standards were adjusted to actual volumes of funding which existed before.

In 2016, a switchover to a state order being financed on the basis of unified cost standards for services began and adjustment ratios were introduced to take into account differences in types and conditions of activities of entities of the same profile[2].

The scope of entities' costs to be taken into account in calculating of standards is growing and in the short-term prospect the standard is to include all the costs except real property depreciation[3]. So, at present costs related to purchasing of particularly valuable movables are financed by means of subsidies for other goals and that makes it possible to take into account the extent entities were initially provided with such property. From 2018, standards are expected to include costs on provisions to be made for complete rehabilitation of particularly valuable movables, so disparities in entities' financial resources are inevitable.

The share of notionally permanent property maintenance costs, which compensation is guaranteed to entities regardless of the number of consumers keeps falling, while from 2019 it is planned to give up completely compensation of costs on property which is not utilized in carrying out of the public order. It means that with the state order volumes reduced entities

1 Resolution No.249 of May 22 of 2004 of the Government of the Russian Federation on Measures Aimed at Upgrading Efficiency of Budget Expenditures.

2 See Article 69.2.5 of the Budget Code in the version of Federal Law No.406-FZ of December 29, 2015.

3 Resolution No.640 of June 26, 2015 on The Guidelines of Formation of the State Order for Provision of State Services (Fulfillment of Jobs) by Federal State-Owned Entities and Financial Support of the State Order.

may lack funds to pay costs related to reasonable property maintenance. The above may result in dilapidation and potential loss of property. From 2017, cost standards for fulfillment of jobs were introduced, too. With the above measures implemented, entities may find no financial reserves to cover costs which exceed for objective reasons the average level.

A permanent expansion of the scope of state entities' expenditures included in standards is justified by the government's intensions to motivate private providers to compete with state entities for budget funding provided in compliance with those standards. Also, the frameworks of such a competition were elaborated on. In 2016, the State Duma passed in the first reading the draft law[1], under which distribution of state order volumes between budget-funded entities based on capacities thereof should be replaced by tenders for the right to render state (municipal) services in which budget funded and private entities could participate on an equal basis. To make their positions equal, it is necessary to withdraw from entities' operating management the state property and include average costs on leasing thereof in cost standards. The RF Ministry of Finance is going to apply the above measure from 2019[2].

A large number of state-owned entities may find themselves on the downward path with the quality of their service to households getting seriously worse as a result of gradual implementation of the above plans. If it happens, it would be quite a problem to make investment spending and retain capital assets and personnel. Households' solvent demand in services rendered traditionally by budget-funded entities is insufficient to make up for possible demand fluctuations. With the public sector reduced, the government will have at best to buy at the same price services of inferior quality from fleeting and substandard providers, while at worst to increase prices because it cannot impose unfavorable conditions of the state order on private providers (in case of state-owned entities such a practice is feasible).

To avoid such developments, it is important to review plans of the reform of budget-funded entities and give up the most radical measures, including the following:

1) the idea of the state order for social services being placed on market terms. Attraction of private providers for those purposes should not be a goal in itself and restructuring of the budget-funded entity network is not to be carried out erratically under the effect of the current market situation. As long as a state (municipal) institution functions, it should be funded as saving of funds on property maintenance is a kind of economic mismanagement. If a budget-funded entity works below capacity due to insufficient demand on its services, it should not be the case for funding being automatically cut to that entity. It is necessary to identify factors behind this situation and find the ways of dealing with it (they may range from liquidation of an entity if it is no longer needed for objective reasons to provision of better funding to upgrade the quality if its services). Priority financing of budget-funded institutions does not exclude the prospect of private providers being attracted for rendering state services where necessary (for example: in case of a lack of a certain profile entities in the area; for rendering of services which are

1 Federal draft law on State (Municipal) Order for State (Municipal) Services in the Social Sphere.

2 Report of the Ministry of Finance on The Main Guidelines for Upgrading Efficiency of Federal Budget Expenditures, 2015. P.51. http://minfin.ru/ru/.

not included in the state order; in case of services being rendered against certificates issued to consumers for payment of services of the provider they select);

2) the idea of replacing the right to operating management of the state property which is at budget-funded entities' disposal with the right to leasing. It is inadvisable not only because there is a risk of property being withdrawn from budget-funded entities in case of insufficient subsidies to pay rentals, but also because in actual practice it would be impossible to withdraw from them the property which they cannot pay for or utilize efficiently;

2) the idea of further expanding of the scope of costs accounted for in cost standards for service-provision. On the contrary, it would be expedient to narrow the scope of such costs compared to the existing legislation. They may include only those types of costs which value varies depending on the number of consumers (the volume of services provided). These are mainly costs on labor remuneration and purchasing of inventory and property utilized in providing of services. Notionally permanent costs on property maintenance should be financed regardless of the volume of services rendered by an entity;

3) the idea of financing of jobs on the basis of standards. It is impossible to unify costs of jobs of the same type which differ by scope, quality, material inputs and labor resources required for fulfillment thereof. It is obvious, for example, that no adjustment ratios can take into account differences in the cost of production of movies or restoration jobs, so, they require budget funding.

The disadvantage of the measures proposed consists in the fact that if they are implemented the role of standards as drivers behind both growth in service volumes and reduction of costs will greatly diminish. However, the standards' motivating effect can be seen only in the free competition environment, which is infeasible in the social service domain where the state is the main customer. Being the monopolist, the state can only imitate a competitive environment by replacing the state order with tenders for selection of providers, but cannot ensure real competition because winners of such tenders are determined by a state authority which currently distributes the state order. As the state pays for social services without being a consumer thereof, the quality criteria of selection are not very effective. One can hardly expect distribution of budget funding on a tender basis with participation of private providers to stimulate upgrading of the quality of social services. On the contrary, there is a risk of the state order for social services distributed on a tender basis to be regarded as a method of cutting budget expenditures and founders may be instructed to select a provider on a price basis. In such a case, private providers may oust state entities from the market by means of a dumping to impose on the state their own conditions later on.

In our view, the above considerations show that the *idea of placing the state order for social services on market terms*, as well as the idea of economic motivation of state-owned entities to cut costs and increase volumes and quality of services *has no prospect*. Upgrading of quality and reduction of costs on social services should be ensured by setting of higher responsibility of customers and providers of services for the outputs of their activity, rather than through phantom competition. The effective legislation provides for evaluation of the quality of social services with consumers' opinion taken into account. The state authorities are required to promptly and adequately react to the outputs of such evaluations.

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