MONITORING OF RUSSIA'S ECONOMIC OUTLOOK:

TRENDS AND CHALLENGES OF SOCIO-ECONOMIC DEVELOPMENT

No. 2(85) February 2019

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

GAIDAR INSTITUTE FOR ECONOMIC POLICY

RANEPA
THE RUSSIAN PRESIDENTIAL ACADEMY OF NATIONAL ECONOMY AND PUBLIC ADMINISTRATION

Monitoring of Russia's Economic Outlook: trends and challenges of socio-economic development. 2019. No. 2 (85). February / Abramov A., Bozhechkova A., Zhemkova A., Kaukin A., Knobel A., Lavrisheva A., Miller E., Trunin P., Khromov M., Tsukhlo S. Edited by: V. Gurevich, S. Drobyshevsky, P. Kadochnikov, V. Mau and S. Sinelnikov-Murylev. Gaidar Institute for Economic Policy, Russian Presidenti al Academy of Nati onal Economy and Public Administrati on. 25 p. URL: http://www.iep.ru/files/text/crisis_monitoring/2019_2-85_February_eng.pdf

TRENDS AND CHALLENGES OF SOCIO-ECONOMIC DEVELOPMENT

The U.S. Fed's intentions to ease (stop tightening) its monetary policy do not only cater to President Trump's needs but also add a bit of optimism to projections for the prospects that may face emerging economies in the short term. The effect of the factor contributing to capital outflows, devaluation of national currencies and inflation build-up is fading.

Another factor that could have theoretically influenced the global market, at least the hydrocarbons market, is the Venezuelan factor. While the prospects of applying sanction pressure on Iran's crude exports alone was sufficient to see oil prices hike, the actual blockade of exports from Venezuela has not yet shaken the market. Should the U.S. regain its influence in Venezuela, then both the U.S.A. and China will be interested in recovering and boosting the country's oil production and in using it as a tool to push global oil prices down as opposed to the OPEC+ policy – that is the only thing that can possibly be predicted.

Nowadays, there is less certainty about the dynamics (and therefore projections) of some key figures that represent Russia's GDP, industrial production, construction, investment. An unexpectedly swift economic spike at 2018 year-end that was presented by Rosstat revealed a gap between official and expert evaluations that is wide enough as to require tenable, consistent and cogent arguments. It is not always, however, that higher than expected figures or record highs raise questions.

According to data from the regulator, Russia's Balance of Payments for 2018 posted the highest on record positive current account balance ($114.9bn) since 1992, 2.5 times the amount recorded in 2017. Our experts examined consistently the sources of the growth.

The pivotal contribution to the growth was made by a positive balance of trade, totalling over $194bn (68% above the value seen in 2017). This was on the one hand spurred by increased prices for almost all Russia's primary export commodities and on the other hand by actually stagnant imports amid a weakening Russian currency. Russia's current account balance rose high enough as to not to be hurt even by a substantial financial account deficit, including a nearly 2.5-fold rise (relative to 2017) in capital outflows from Russian banks and enterprises. The share of non-residents in the OFZ market reached its highest (34.5%) in April 2018 and then dropped by early December 2018 to 24.7%.

According to the experts, a minor appreciation of the rouble real exchange rate, stabilization in value terms of export and import volumes, thus keeping a high current account balance unchanged – that is what can be expected in 2019 if global crude prices and the rouble's nominal exchange rate remain as they are now. Nonetheless, risks of further tightening in sanctions, particularly sanctions against Russia's sovereign debt, may lead to capital outflows and a highly volatile rouble's exchange rate in 2019.

Experts of the Gaidar Institute carried out decomposition of industrial growth and presented an industrial output quarterly analysis in 2018. They concluded that most of the real sector's segments exhibited in the first quarter no signs of transition to a sustainable growth. The manufacturing sector posted "near to zero" growth rates in output despite increased gas and coal production (triggered by market forces). No structural preconditions for growth were observed throughout 2018.

Rosstat announced late in the second quarter that it had updated data on the dynamics of industrial output over the last two years. Given all the updates, one may suggest that a moderate growth emerged in the first half of the year in some sectors (refined petroleum products, woodworking, metallurgy, construction materials). Given the updates, however, one should be very careful while interpreting data. The third quarter saw the manufacturing output move back to "near to zero" growth rates, and the fourth quarter confirmed the overall trend of the year: a sustainable growth in the extracting sector and a stagnant manufacturing sector (positive dynamics was seen only when the state was involved). In 2019, the key risk for output growth rates lies in a possible contraction in the extractive sector production, whereas there are no reasons for changes in the manufacturing sector: export-led industries (chemical industry, metallurgy, forestry) with a small value added can see growth.

Researchers of the Gaidar Institute carry out since 1992 surveys as part of a monitoring of Russian industrial enterprises. On the one hand, they reported in 2018 a lack of crisis-related developments and on the other hand a slowdown in recovery from stagnation. According to surveys, industrial enterprises' upbeat expectations that were observed in 2017 became less optimistic. Enterprises' predictions for future sales were affected most. Although enterprises' assessments of their financial and economic situation were not quite optimistic, most of the surveyed enterprises were overall satisfied with their financial and economic situation: 88% enterprises said their financial and economic situation was "good" or "satisfactory") (90% enterprises in 2017).

The experts examined the situation in the Russian banking sector. According to the exports, as of 1 January 2019, 484 credit institutions operated in the banking system, compared to 542 a year earlier. Early in 2013 their number reached more than one thousand (1094). The Bank of Russia has in recent five years revoked more than 400 banking licenses through its banking sector purge policy. The policy happened to coincide with an economic downturn and imposition of sanctions against Russia's biggest banks. The biggest number of revoked banking licenses (97) was recorded in 2016, involving assets totalling Rb 1.7 trillion (representing 2% of the assets held by the banking sector). However, the regulator applied its license revocation policy mainly to small banks so far.

In 2017, a turnaround procedure was initiated for a few big private banks, but resolution in 2018 was applied to only one bank (Asia-Pacific Bank), with the average asset total falling to Rb 9.5bn compared to Rb 19bn in the "peak" years of 2015 and 2016.

Analysis was made of the Russian equity market at 2018 year-end, showing that the Russian equity market in 2018 was one of the most volatile markets in the word. Furthermore, the market was more profitable and stable than many other emerging markets. For example, in terms of dividend yield, the Russian market in 2018 moved up to the world's top three. In the longer and medium term, however, the market was still behind competitors in terms of returns to investors and investment risk indicators. Risks, including risks of sanctions, contributed to outflow of non-residents. The same reasons were behind the decline in placement of corporate bonds.

According to the experts, polices are needed in the present context to accelerate the development of institutions that could help accumulate internal savings of individuals and banks. There are constraints though: the retirement savings system is still “frozen”, there are delays in drafting a supplementary pension legislation, and individuals have no confidence in collective investment mechanisms in place.

1. RUSSIA'S BALANCE OF PAYMENTS 2018: CURRENT ACCOUNT BALANCE HITS HIGHEST

A.Bozhechkova, A.Knobel, P.Trunin

In 2018, Russia posted the highest on record positive current account balance since 1992, 2.5 times the amount recorded in 2017, due to increase in fuel and energy exports on the back of improved terms of trade and stagnant imports led by a weakening rouble. At the same time, the private sector saw substantial capital outflows that were driven by reduced foreign liabilities and increased foreign assets for banks and enterprises.

According to preliminary data on the BoP for 2018 from the Bank of Russia, Russia's current account balance was recorded at $114.9bn, or 2.5 times (an increase of $81.6bn) the amount recorded in the preliminary data for 2017.[1] In absolute terms, the country saw its current account balance hit its highest on record (since 1992). As a percentage of GDP, however, the current account balance was even higher in the period between 2001 and 2006.

The balance of trade in goods amounted to $194.4bn, posting an increase of 68% (by $79bn) over the amount recorded in 2017 (*Fig. 1*). The pivotal contribution came from a 25% rise in exports from $353.5bn in 2017 to $443.4bn in 2018. The growth was mostly due to increase in the annual average price of crude oil, petroleum refined products and natural gas as well as other Russia's primary export commodities (*Table 1*) amid stable physical volumes of exports.

Table 1

PRICES OF RUSSIA'S PRINCIPAL EXPORT COMMODITIES IN 2018 COMPARED TO 2017

Commodity	Commodity's share of exports, %	Average export price in January-November 2018 (thousand US dollars /tonne)	Average export price in January-November 2017 (thousand US dollars /tonne)	Gains in prices, %
Crude oil	29	501	365	+37
Refined petroleum products	18	521	388	+34
Natural gas*	11	221	180	+23
Ferrous metals	5.2	506	440	+15
Hard coal	3.8	85	75	+14
Wheat and meslin	1.9	190	176	+8
Fertilizers	1.7	237	209	+14
Liquefied natural gas (LNG)**	1.2	142	131	+9
Aluminium	1.2	1,757	1,646	+7
Sawn timber	1.0	234	217	+8
Copper	0.9	6,355	6,133	+4
Fresh and frozen fish	0.7	1,822	1,587	+15
Nickel	0.4	13,058	10,044	+30

* for billion cubic meters

** for thousand cubic meters

Sources: Federal Customs Service, own calculations.

1 See A. Bozhechkova, A. Knobel, P. Trunin. Russia's Balance of Payments 2017 // Russian Economic Developments. 2018. Vol. 25. No. 2. P. 8–11.

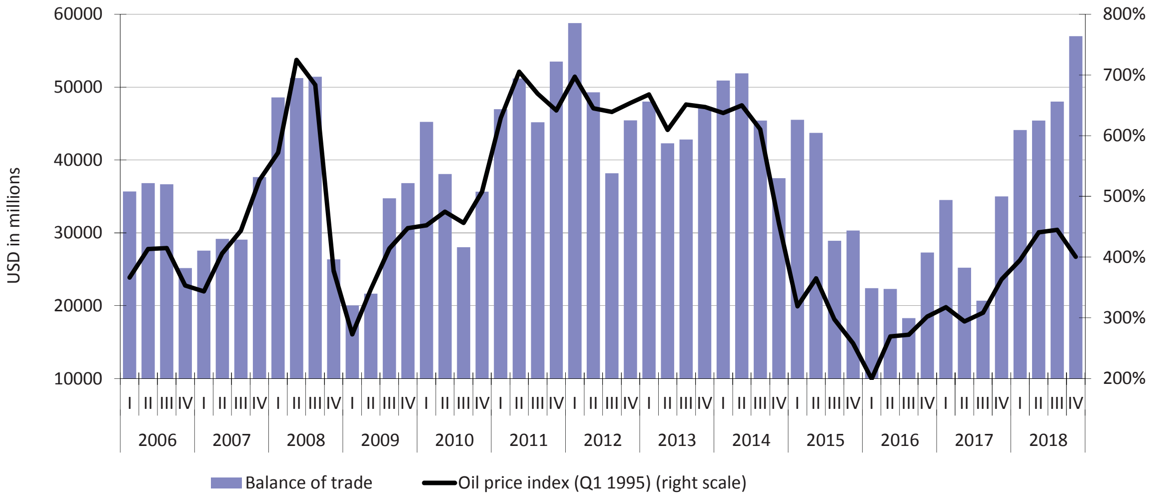


Fig. 1. Russia's balance of trade and oil price dynamics

Sources: Bank of Russia, IMF.

The growth in the balance of trade in goods was also driven by stagnant imports which increased in 2018 merely 4.6% (in absolute terms, the growth was $11bn) from $238bn in 2017 to $249bn in 2018. However, the second half of the year saw imports drop 2.3% (or $3bn) compared to H2 2017. The decline was primarily due to a weakening rouble: according to data from the Bank of Russia, the index for the rouble's real effective exchange rate against foreign currencies in 2018 lost 7.7% compared to 2017 – a substantial decline suggesting that imports appreciated on a relative basis[1].

Russia's balance of trade in services in 2018 amounted to -$30.2bn, or 2.9% below the amount (-$31.1bn) recorded in 2017. In 2018, exports of services increased from 2017 (due to mainly inbound tourism to Russia and transport services) and imports of services rose (due in large part to travels, transport and other business services). Additionally, exports saw a bigger rise in relative terms, but the increase in absolute terms was primarily due to the FIFA World Cup 2018 hosted by Russia. Exports saw an annual rise of 13% from $57.7bn to $65bn as imports were up 7.5% from $88.8bn to $95.5bn.

The investment income balance and the *compensation of employees balance* underwent minor changes in 2018. The former was up $0.9bn (from -$39.8bn to -$38.9bn) as the latter increased $0.5bn (from -$2.3bn to -$1.8bn).

Thus the key factor that governs the current account balance in the Russian economy still remains the same – the balance of trade in services and the balance of trade in goods which depends largely on prices of hydrocarbons (energy commodities) and other Russia's primary export commodities as well as the nominal exchange rate of the Russian rouble.

Russia's current account surplus increased alongside the rise in the financial account deficit which in 2018 was $76.8bn, 6 times the amount recorded in 2017 ($12.6bn). Banks and enterprises in 2018 saw net capital outflows reach $67.5bn, while in 2017 they were $25.2bn (*Fig. 2*). While in 2017 capital outflows in the private sector were almost entirely linked to banks' opera-

1 For details on the effect of exchange rate dynamics on trade see Knobel A., Firanchuk A. Russia's foreign trade in January-August 2017 // Russian Economic Developments. 2017. Vol. 24. No. 11. P. 12–18.

tions, the contribution of banks and enterprises in 2018 was comparable: \$30.9bn (\$23.3bn in 2017) and \$36.6bn (\$1.9bn in 2017), respectively.

Capital outflows in the banking sector were driven on the one hand by a \$7.0bn growth in foreign assets of banks (2017 saw foreign assets drop \$4.4bn) and on the other hand by a \$23.9bn reduction of foreign liabilities (foreign liabilities in 2017 were reduced by \$27.7bn).

Net capital outflows at enterprises were triggered mainly by a \$30.3bn increase in their foreign assets (an increase of \$18.2bn in 2017). Enterprises raised them mainly in the form of foreign direct investment (up \$25.8bn in 2018 from \$35.9bn in 2017) and other assets (up \$13.0bn in 2018 from -\$11.7bn in 2017).

In 2018, enterprises started reducing their foreign liabilities (a decline of \$7.1bn), whereas in 2017 they saw a rise of \$14.2bn. For instance, credits and loans were reduced as low as \$9.6bn (down by \$8.5bn in 2017) and portfolio investments were down \$0.5bn (\$4.5bn down in 2017). Their foreign direct investment were merely \$1.9bn versus \$27.1bn in 2017 as other liabilities reached \$1.1bn (\$0.1bn in 2017).

The OFZ bond (rouble-denominated Russian government bonds) market in 2018 was driven largely by investors' expectations of tighter sanctions against Russia's sovereign debt. In 2018, non-residents reduced their holdings of OFZ bonds by \$5.7bn (compared to an increase of \$13.6bn in 2017). As a result, the share of non-residents in the OFZ market reached its highest (34.5%) in April 2018 and then dropped by early December 2018 to 24.7%.

Russia raised its international reserves in 2018 to \$38.2bn (\$22.6bn in 2017) due primarily to Finance Ministry's (MinFin) foreign exchange purchases in the local foreign exchange market under the fiscal rule in effect. The international reserves saw their growth rates decelerate in 2018. They increased in the first quarter by \$19.3bn, in the second quarter by \$11.3bn, in the third quarter by \$5.0bn, and in the fourth quarter by \$2.6bn. This was due to the fact that with the aim to reduce volatility in financial markets, the regulator suspended sales of roubles to purchase foreign exchange for MinFin from 24 August 2018 until late December 2018, and since then MinFin purchased foreign currency directly from the Bank of Russia.

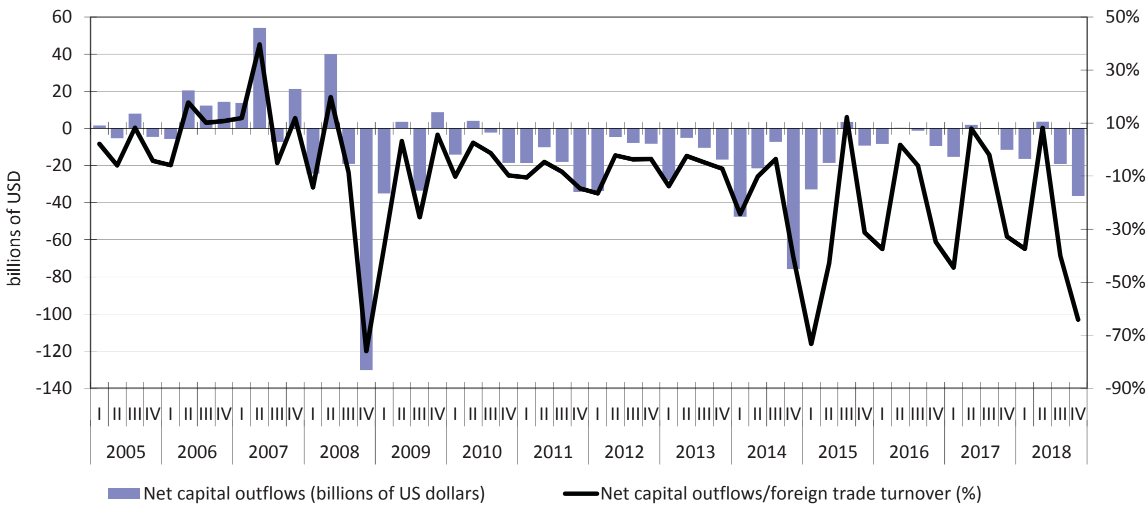


Fig. 2. Private sector's net capital outflows, 2005–2018

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

It is remarkable that the Rouble/Dollar exchange rate dropped 20.6% to 69.5 roubles per dollar despite record highs of the current account balance in 2018. The rouble plummeted to its weakest in April (down 8.3% to 62 roubles per dollar compared to late in March) and in August (down 8.4% to 68.1 roubles per dollar from late July). The rouble devaluation was triggered primarily by capital outflows driven by tightened sanctions against Russia. In addition, the rouble in 2018 was driven down by deterioration in all emerging markets as a result of U.S. tighter monetary policy, trade wars, heightened risks of investing in emerging markets because of financial turmoil facing Argentina and Turkey.

A minor appreciation of the rouble real exchange rate, stabilization in value terms of export and import volumes, thus keeping a high current account balance unchanged – that is what seems to be expected in 2019 if *global crude prices remain as they are now* (~60 dollars per barrel) and *the rouble's nominal exchange rate is at 65–70 roubles per dollar.* Nonetheless, risks of further tightening in sanctions, particularly sanctions against Russia's sovereign debt, may lead to capital outflows and a highly volatile rouble's exchange rate in 2019.

2. DYNAMICS OF INDUSTRIAL OUTPUT IN 2018: THE PRIMARY SECTOR'S GROWTH[1]

A.Zhemkova, A.Kaukin, E.Miller

In 2018 the output dynamics of the manufacturing industries were close to zero. Growth was observed in the primary sector mainly on the back of a surge in production of natural gas and coal. In manufacturing, positive growth rates were related either with a favorable global market environment or direct state support, while in other cases output stagnated or even fell. According to the analysis, there are no structural prerequisites for growth in manufacturing industries.

The Beginning of 2018: Growth in Gas and Coal Production[2]

According to the analysis of industrial output dynamics carried out by the Gaidar Institute, after decomposition and identification of the trend component there were no prerequisites for a switchover to sustainable growth in most segments of the real sector in Q1 2018.

The primary sector demonstrated slow growth; a positive contribution to its dynamics was made by the gas industry and the coal industry (output in the oil industry fell somewhat as a result of extension of the agreement with the OPEC+ on reduction of oil production) because the former managed to increase exports to Europe (due to cold winter and production cuts in Europe) and put into operation the Yamal SPG project, while the latter took advantage of growing global prices of coal amid coal supply irregularities on the international market.

At the same time, the manufacturing sector saw around zero output growth rates. Slowdown of growth rates in the manufacturing industry was largely driven by production of transport vehicles, equipment, machinery and electrics. The textile industry, the chemical industry and the iron and steel industry demonstrated positive dynamics. The main growth factors in manufacturing industries were either a favorable global market environment or availability of state support (for example, in the light industry). No structural prerequisites for growth were identified; such a situation remained unchanged throughout the entire year.

Q2 2018: the Rosstat' Retrospective Statistical Review[3]

Late in Q2 2018, the Rosstat announced adjustment of output dynamics for the past two years for the following three main reasons: 1) replacement of real-time statistics on output and service volumes by the updated data; 2) availability of up-to-date statistical data on output of small enterprises; 3) adjustment of the statistical data on companies in the new version of the classifier of products (OKPD2) and types of activities (OKVED2).

1 The authors express gratitude to M. Turuntseva and T. Gorshkova for assistance in carrying out the statistical analysis.

2 A. Kaukin, E. Miller. Industrial Production in Q1 2018 // Russia's Economic Development. 2018. No. 5. P. 35–38.

3 A. Kaukin and E. Miller. Dynamics of Industrial Production in Q1 2018: A New Statistical Review by the Rosstat // Russia's Economic Development. 2018. No. 8. P. 25–29.

Calculation of trend components in various sectors of the Russian industry pointed to moderate growth in a number of industries in H1 2018. Output growth in the primary sector can be explained by appreciation of oil prices, as well as a surge in production of natural gas. Some growth in the manufacturing industry was facilitated by sectors specializing on exports of timber products, oil refined products and ferrous metal products, as well as a revival of activities in the building industry (there was growth in output of building materials). Note that it is important to take into account the fact that interpretation of indices of the period in question is complicated by discrepancies related to infeasibility to compare precisely the data on industrial output in the short-term and long-term prospects due to changes in the Rosstat's statistics.

Q3 2018: A Return to Around Zero Growth 1

According to the indicators of Q3 2018, the dynamics of output of manufacturing industries and the industry as a whole returned to around zero growth rates. This can be taken as indirect evidence of the fact that growth in Q2 could at least be partially explained by the abovementioned changes in the Rosstat's methods. Q3 saw imports falling, particularly, in the food industry, the machine-building industry and the chemical industry. According to some expert estimates, such a situation could be driven by the overall reduction of demand in the economy. However, contrary to experts' expectations the analysis of trend components of growth in the above industries did not identify any downturn of output at that stage.

Q4 2018: Production Growth and Stagnation in Manufacturing

According to the analysis of trend components of industrial production in Q4, common trends, typical of the year 2018, prevailed (*Fig. 1*): there was sustainable growth in the primary sector and stagnation in manufacturing. With seasonal and calendar factors excluded, industrial production growth amounted to 2.9% in December 2018 on December 2017 (0.2% compared to September 2018).

The primary sector's output (*Fig. 2*) surpassed by 0.3% the level of the beginning of Q4 2018 despite the fact that in November Russia assumed commitments under the OPEC+ agreement to cut oil production. The gas industry's growth was on the rise. Throughout 2018, the coal industry saw output growth: the annual output increased by 7% as compared to 2017. This trend was related to the Russian industry's drive to promote its presence on the global coal market. In December 2018, the overall production of fuel and energy commodities amounted to 1.7% and 7.2% as compared to September 2018 and December 2017, respectively.

The upward trend which was observed at the beginning of the year prevailed in the food

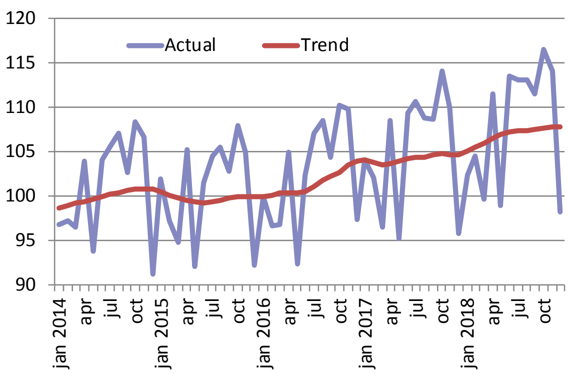


Fig. 1. Dynamics of industrial production index in 2014–2018 (actual data and trend components), % change on January 2016

Source: The Rosstat, own calculations.

1 A. Kaukin and E. Miller. Industrial Production in Q3 2018: Around Zero Growth // Russia's Economic Development. 2018. No. 11. P. 10–14.

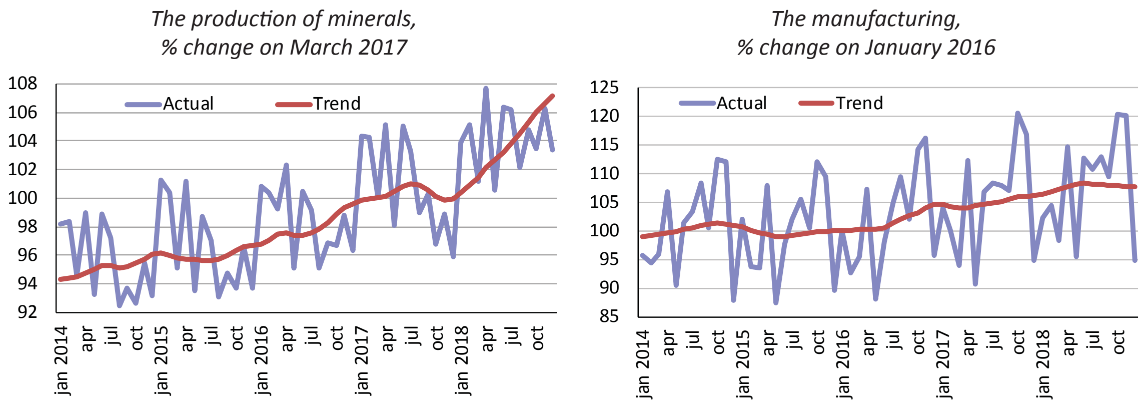


Fig. 2. Dynamics of industrial production indices by industry in 2014–2018, actual data and trend component

Source: The Rosstat, own calculations.

industry and the textile industry (*Table 1*). Despite limitations on the Rusal's imports to the US, the iron and steel industry's output volumes did not fall because of growth in domestic market supplies on the back of a temporary reorientation of local companies on replenishment of reserves until restrictions were lifted on supplies to the US[1] and measures aimed at stimulating domestic demand on aluminum.

In Q4 2018, production of transport vehicles and equipment demonstrated positive growth rates as a result of stimulation of output of cars, trucks and buses by means of state support measures aimed at promotion of auto lending. Taking into account the fact that the terms of provision of state support have changed since the beginning of 2019, one can expect a decrease in this sector's output growth rates early in 2019. Based on the results of the analysis of the dynamics of the trend component, the output index of the machine-building industry pointed to recession driven by shrinking demand on investment equipment.

So, there are virtually no prerequisites for sustainable growth in the manufacturing in 2019 as in 2018. In 2019, a reduction of output of the primary sector may become the main risk for the industry as a whole. There are currently no objective reasons for a change in growth points in the manufacturing (the chemical industry, the iron and steel industry and the timber industry, that is, export-oriented industries with a small added value in production) in 2019.

1 IPEM Indices. The Industy Monitoring // IPEM (Institute of Natural Monopolies Research). December 2018. [http://ipem.ru/files/files/index_archive/20190117_indeks_2018.pdf]

Table 1

OUTPUT INDEX CHANGE BY INDUSTRIES, %

	Share in industrial production index	December 2018 on September 2018	December 2018 on December 2017	Change within past few months
Industrial production index		100.21	102.90	stagnation
Production of minerals	34.54	101.73	107.16	growth
Manufacturing	54.91	99.71	101.40	stagnation
including:				
Production of food products, including beverages and tobacco	16.34	101.49	108.32	slow growth
Textile and clothing manufacture	1.14	100.83	110.14	slow growth
Production of leather, leather products and footwear	0.27	96.81	90.36	recession
Woodworking and manufacturing of wood articles	2.02	103.50	116.86	growth
Pulp and paper production	3.35	95.86	87.02	recession
Production of charred coal and petrochemicals	17.25	100.14	101.44	stagnation
Chemical production	7.56	102.16	111.47	growth
Manufacturing of rubber and plastic articles	2.14	96.75	98.69	recession
Manufacturing of other non-metal mineral products	4.02	96.91	103.13	recession
Metallurgical production and manufacturing of fabricated metal products	17.42	101.47	105.82	slow growth
Manufacturing of machines and equipment	6.97	97.39	98.20	recession
Manufacturing of electrical and optical equipment	6.27	97.50	109.47	recession
Manufacturing of transport vehicles and equipment	6.75	101.68	78.16	growth
Other manufacturing	2.42	106.64	113.51	growth
Power, gas and water	13.51	99.29	102.16	slow recession

Source: The Rosstat, own calculations.

3. RUSSIAN INDUSTRY 2018: STAGNANT BUT NOT IN CRISIS

S.Tsukhlo

2018 was a tough year for the Russian industry, according to surveys. On the one hand, there were no visible crisis-related changes, but on the other hand, positive trends of 2017 slowed in 2018, affecting industrial enterprises' assessments of the situation in the industry. The pace of recovery from stagnation slackened.

The IET Industrial Confidence Index[1], as measured using business survey results, represents the initial view of the situation in the industry. The Index in 2018 remained unchanged since 2017 (*Fig. 1*). Thus, the Russian industry in 2018 managed to recover from the 2012–2016 stagnation. Note that the Index gives no reasons for separating the 2015–2016 period as a stand-alone crisis period. In the Russian industry, the two past years saw just continuation of the stagnation that started following a faltering (incomplete) recovery from the 2008–2009 crisis.

The worsened dynamics of industrial products demand was the key factor in 2018. According to average annual data, the balance of actual changes in sales was down 6 points. In this context, industrial enterprises opted for minimizing their excessive finished goods inventory. The balance of average annual inventory assessments was down from +7 to 0 points. Note that a small positive balance of assessments in 2017 suggested that enterprises were confident that sales could boost.

Industrial enterprises' production plans in 2018 were less optimistic. The average annual balance of their expectations was down 2 points after an increase of 5 points in 2017. The balance of assessments of demand volumes achieved in 2018 remained unchanged since 2017.

In 2018, the slowdown in recovery from the 2012–2016 stagnation affected also other projections (plans) of Russian industrial enterprises. The

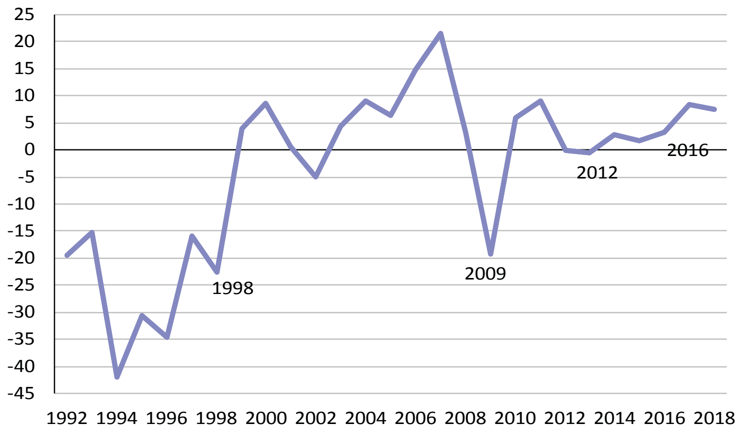


Fig. 1. IET Industrial Confidence Index, 1992–2018, percentage points

1 The Index is measured as the arithmetic mean of balances (differences of answers) of four questions included in a monthly business survey questionnaire compiled by the Gaidar Institute (IET): a) actual demand change, the balance = % up - % down; b) demand assessment, differences of answers = % higher than normal + % normal - % lower than normal; c) assessing finished goods inventory, the balance = % higher than normal – % lower than normal, opposite sign; d) output change plans, the balance = % up – % down. The Index can vary from -100 to +100 points.

Industrial Prediction Index[1] lost 3 points for industry's optimistic expectations after hitting in 2017 a local high, 5 points up (*Fig. 2*). The Industrial Prediction Index was stable in the period between 2012 and 2016, varying between +3.6 and +5.3 points, which is another evidence that the Russian industry slipped into stagnation after the recovery from the 2008–2009 crisis: there was a gradual loss of optimism in 2011 followed by transition to a stagnation in 2012.

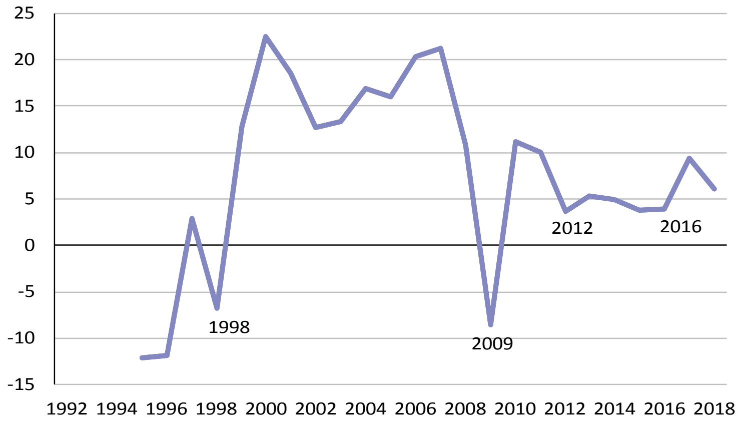


Fig. 2. Industrial Prediction Index, 1992–2018, percentage points

The decline in optimism in 2018 was observed through all enterprises' projections that were used for calculating the composite Industrial Prediction Index. Sales predictions saw most of the decline, sliding 5 points down in 2018. In 2017, the balance of predictions climbed 4 points but dropped again in 2018.

In 2017, the Russian industry posted for the first time since the onset of stagnation positive plans for changing the number of workers. The same but less optimistic plans were recorded in 2018.

The notable slowdown (in 2018) in recovery from stagnation after success in 2017 affected industrial enterprises' assessment of the situation that prevailed. The Industry Adaptability (Normality) Index for the Russian industry posted for the first time since 2013 a decline in average annual data (*Fig. 3*). The Index is measured by evaluative questions included in a business survey questionnaire asking industrial enterprises to measure their key performance figures using a grading scale: a "higher than normal", "normal", "lower than normal" performance. The average share of answers like "normal" shows the extent to which industrial enterprises consider their situation as acceptable, that is, the extent to which they are adapted to present economic conditions. The Industry Normality Index is measured by industrial enterprises' assessments of demand, finished goods inventory, raw and other materials, number of workers, provision of capacities and financial and economic situation.

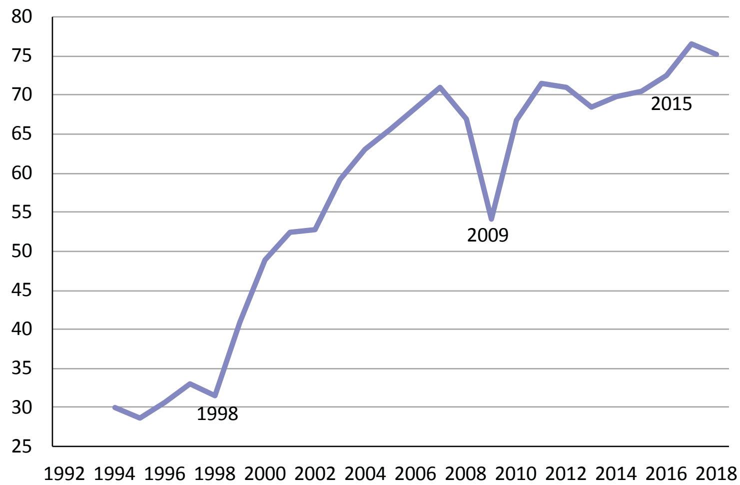


Fig. 3. Industry Adaptability (Normality) Index, 1994–2018, %

The Industry Adaptability Index for 2015–2016 revealed no

1 The Industrial Prediction Index is measured as the arithmetical mean of the balances of three questions included in a survey questionnaire: demand change forecasts, output changes plans and expected employment changes. The Index can vary from -100 to +100 points.

crisis-related developments at that period in the Russian industry, at least according to industrial enterprises. Furthermore, enterprises assessed the situation in the industry more positively in the 2015 crisis year than they did in 2014. The Index gained 1 point, hitting an all-time high that was previously recorded only in 2007 and in 2011. Another 1 point was added next year. The first year of recovery from the 2012–2016 stagnation contributed to a substantial rise in the Industry Normality Index, reaching the absolute highest of 77% in the period of 1994–2018.

However, the slowdown in positive processes in 2018 pushed down the Industry Normality Index. However, "normal" assessments of finished goods inventory at 2018 year-end hit the absolute highest in all the 27 years since the IET launched the business survey.

However, "normal" provision of capacities in the Russian industry dropped in 2018 by 5 points due to both an increase in the number of answers like "more than sufficient" as well as in the number of answers like "less than sufficient". A similar situation was observed for enterprises' assessments of their manpower. Enterprises' assessments of their financial and economic situation in 2018 lost 2 points, although this indicator had the lead in the Russian industry in terms of the degree of enterprises' satisfaction, that is, most of the surveyed enterprises were overall satisfied with their financial and economic situation ("good" or "satisfactory") (88% in 2018, 90% in 2017). The Russian industry was always less satisfied with other indicators since 2003.

4. THE BANKING SECTOR IN 2018: KEY TRENDS

M.Khromov

In 2018, the number of banks whose banking licenses were withdrawn increased. The overall size of those banks' assets as well as their average value decreased considerably, while the mechanism of financial rehabilitation was applied only once in 2018.

As of 1 January 2019, there were 484 credit institutions in the banking sector compared to 542 a year before, while in the beginning of 2013, their number exceeded 1,000 (1094).

The most important factor behind reduction of the number of banks was the policy carried out by the Central Bank of Russia during the past five years to sort out things in the banking sector. During that period, the Central Bank of Russia withdrew over 400 banking licenses. From the end of 2014, the Russian Central Bank had to pursue its policy of removal of credit institutions which failed to meet the regulator's requirements amid worsening of the economic situation in Russia and introduction of international sanctions against large Russian banks.

As early as 2014, the rate of withdrawal of banking licenses increased. If in 2013 banking licenses were revoked on average from 4–5 banks, in 2014 up to seven licenses were withdrawn per month, while during the peak of the economic and financial crisis of 2015–2016 the regulator revoked on average eight banking licenses a month. The year 2016 saw a new record: the number of licenses withdrawn within a year was equal to 97. In addition, in 2016 the overall size of assets of banks with revoked licenses attained its maximum, that is, Rb 1.7 trillion or 2% of the total volume of assts of the banking sector.

It is noteworthy that the regulator removed mainly small banks from the market. So, even in the period of a peak withdrawal of licenses (2015–2016) the average size of assets a bank had as of the date of withdrawal of the license did not exceed Rb 19bn.

In 2017, the regulator terminated the activities of the mere 51 credit institutions, that is, half as much than in the previous year. In 2017, the average size of a bank with a revoked license did not virtually change (Rb 17.9bn). Consequently, the total volume of assets of banks whose licenses where withdrawn in 2017 fell to Rb 773bn or 0.9% of the total volume of assets of the banking sector.

Reduction of the number of license withdrawals in 2017 was probably related with other factors, particularly, the burden on the deposit insurance system. As early as the mid-2015, payments to depositors of banks with revoked licenses were financed by means of the Russian Central Bank's credit facility provided to the Deposit Insurance Agency.

In 2018, the Central Bank of Russia stepped up its license-withdrawal activities. As of 24 December 2018, the regulator revoked 60 banking licenses. Note that the average size of a bank with the license revoked in 2018 fell to Rb 9.5bn, while the total volume of assets of such banks amounted to Rb 562bn or 0.65% of the total volume of assets of the banking sector.

In 2018, the regulator did not virtually apply financial rehabilitation procedures. After starting rehabilitation of a number of large private banks in 2017 (the FK Otkrytie, the Binbank and the Promsvyazbank), the regulator took a break and applied that mechanism only once in 2018 to the Asian-Pacific Bank.

5. RUSSIA'S FINANCIAL MARKET 2018: INVESTMENT RISKS

A.Abramov, A.Lavrishcheva

The Russian equity market in 2018 came to be more profitable and stable than many other emerging markets, but it continued to lag behind competitors in terms of returns to investors and investment risk indicators. There were more problems that came from non-residents outflow.

In 2018, the Russian equity market was one of the most volatile markets in the word. Nonetheless, it became a top-ranked market in contrast to 2017, when it posted the lowest investment returns, according to a 36-market survey. The Moscow Exchange (MOEX) Russia Index (MICEX Index) in 2018 gained 12.3%, whereas the RTS Index lost 7.4%. In 2018, the MOEX Russia Index ranked as high as stock indices in Brazil, India and Argentina, which managed to give positive returns (*Fig. 1*). Being composed of the same companies, the two Russian indices differ in bigger returns for the dollar-denominated RTS Index than for the rouble-denominated MOEX Russia Index.

The BRICS nations experienced slow recovery after the 2008 crisis (*Fig. 2* and *Table 1*). To compare the results, country-specific MSCI stock indices in dollar terms were used as indicators. Changes in the Russian stock market were assessed using the RTS Index in dollar terms, including a similar index including the dividend yield for Russian stocks that compose the index.

Two of the five BRICS members, Russia and Brazil, as of December 2018, saw their U.S. dollar-denominated stock indices fail to recover after the 2008 crisis. Three of the BRICS nations saw their indices hit pre-crisis highs

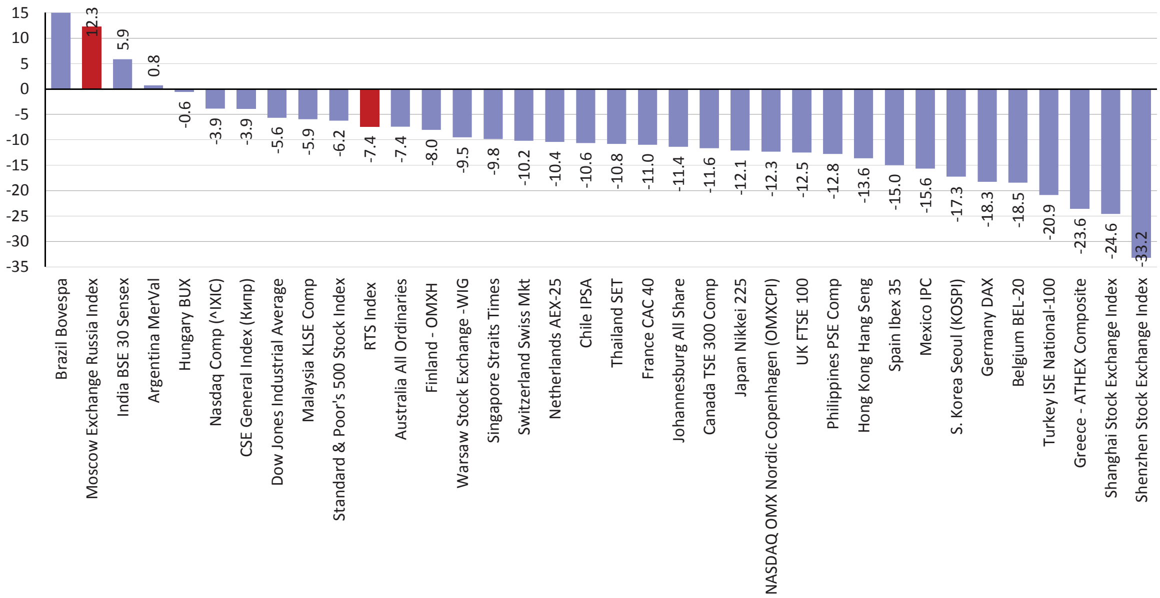


Fig. 1. Investment returns in 2018 for 36 world stock indices at world's biggest stock exchanges, % p.a.

Source: calculated by Gaidar Institute using data from Factiva and The Wall Street Journal.

within 127 days elapsed since May 2008, but the RTS Index and the MSCI Brazil Index recovered as low as 43.4% and 40.2%, respectively, with the former having a faster recovery pace than the latter, suggesting indirectly that Russia and Brazil, both being reliant on fuel and energy export prices, are faced with structural issues to a much greater extent than the other BRICS nations.

It took the MSCI indices for India, South Africa and China in dollar terms 22, 28 and 82 months, respectively, to recover to their pre-crisis levels after May 2008. After recovery, however, the markets did not exhibit a sustainable growth: the MSCI indices for India, China and South Africa in December 2018 accounted for merely 112.7%, 87.2% and 98.6%, respectively, of what they were in May 2008.

Table 1

BRICS STOCK EXCHANGE INDICES RECOVERY AFTER 2008 CRISIS, U.S. DOLLARS.

Indices	Index recovery period since May 2008, months	Recovery completed	Index current value, % (May 2008 = 100%)
RTS	127	No	43.4
RTS – total return	127	No	64.9
MSCI Brazil	127	No	40.2
MSCI South Africa	28	Yes	87.2
MSCI India	22	Yes	112.7
MSCI China	82	Yes	98.6

Source: calculated by Gaidar Institute using data from Moscow Exchange and Bloomberg.

In terms of investment risk (as measured as the average standard deviation), of the 30 world stock indices, Russia's RTS Index (35.4%) over 11 years from January 2008 to December 2018 was only behind the indices for Argentina, Brazil, Turkey and Greece, as shown in *Fig. 3*. In terms of geometric mean return (-7.0% p.a.), the RTS Index over the same period outperformed

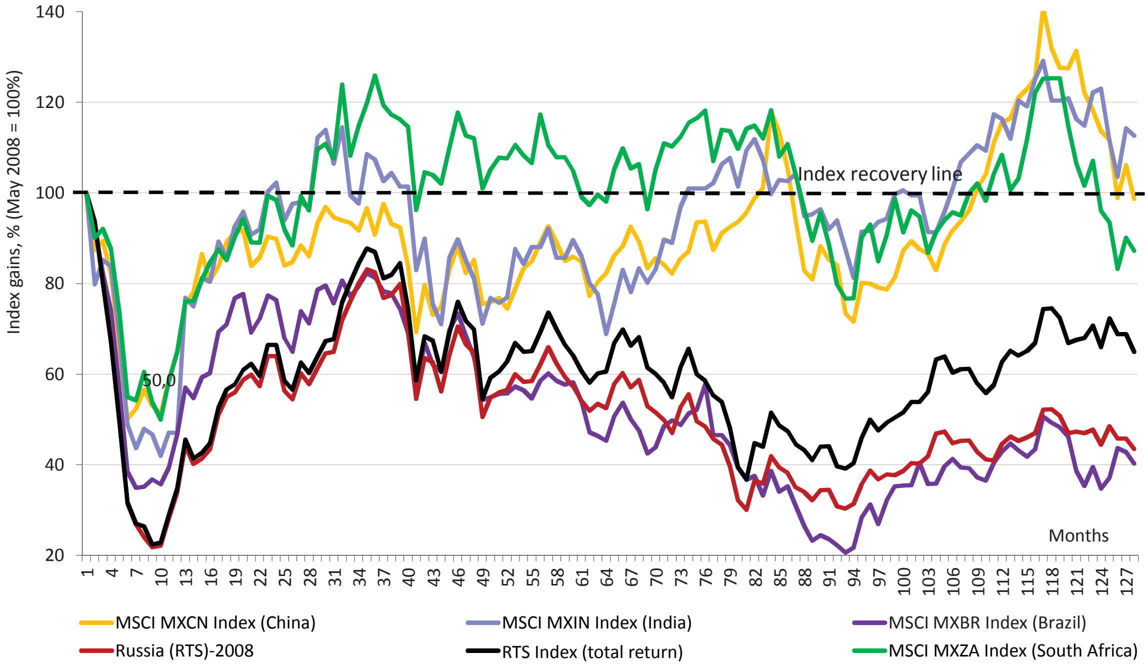


Fig. 2. Depth and duration of the 2008 financial crisis effect on BRICS stock exchange indices, U.S. dollars, as of December 2018 (a peak in May 2008 = 100%)

Source: calculated by Gaidar Institute using data from Moscow Exchange and Bloomberg.

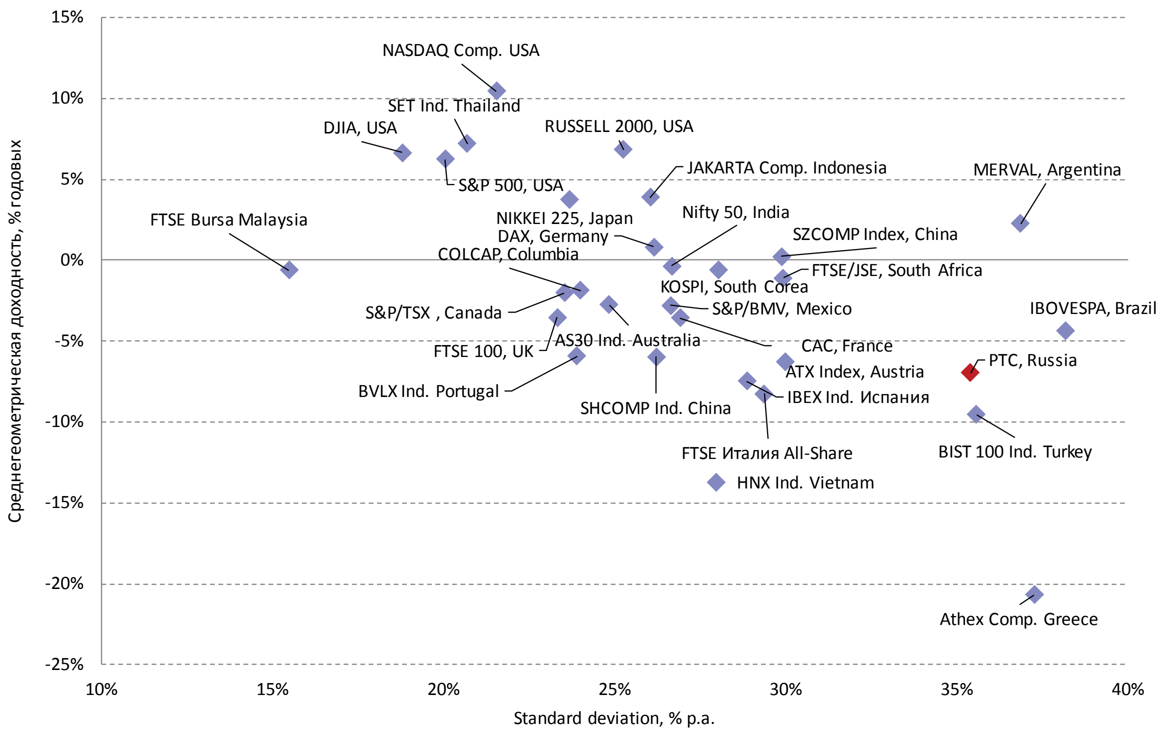


Fig. 3. Parameters of average annual returns and risk for 30 stock exchange indices of various nations from January 2008 to September 2018, U.S. dollars, % p.a.

Source: calculated by Gaidar Institute using data from Moscow Exchange and Bloomberg.

only five countries, namely Greece, Spain, Italy, Turkey and Vietnam. Thus, the RTS Index exhibited the highest investment risk and the lowest returns in the world, which deteriorated substantially its investment appeal.

A positive trend in the Russian market was accelerated growth in the stocks’ dividend yield. In terms of dividend yield, the Russian market in 2018 moved up to the world’s top three. The RTS Index’s dividend yield from January 2010 to September 2018 rose from 1.6 to 5.4%, higher than the indices in Argentina, Brazil, India, China, Turkey, South Africa, as well as U.S. stock indices, according to data from Bloomberg (*Fig. 4*). In terms of dividend yield growth rates, the RTS Index in the period under review showed the most dynamic growth worldwide. This reflected on the one hand publicly traded companies’ efforts to maintain capitalization amid lower than prior to the 2008 crisis oil prices and stagnant economic growth and, on the other hand, the availability of spare money that was not used to financing investment projects.

In 2018, the bonded debt in Russia continued to climb in price to Rb 20.0 trillion, posting an increase of 3.2% from 2017 (*Fig. 5*). Compared to 2017, when the domestic bond market volume was up nearly 20%, 2018 saw the debt market grow at a substantially slower pace. In 2018, corporate bonds, including non-market bond issues, appreciated in price from Rb 11.4 trillion to Rb 11.9 trillion, or by 4.5%; federal bonds (OFZ, GSO, etc.) were up from Rb 7.2 trillion to Rb 7.3 trillion, or by 0.5%. Outstanding regional bonds in 2018 remained unchanged compared to one year ago at Rb 0.7 trillion. Despite high demand for cash to finance federal budget expenditures, Russia’s Finance Ministry in 2018 was following a moderate policy of raising the internal public debt, which was in a large part due to a lack of sufficient demand for federal bonds in the domestic market amid non-residents out-

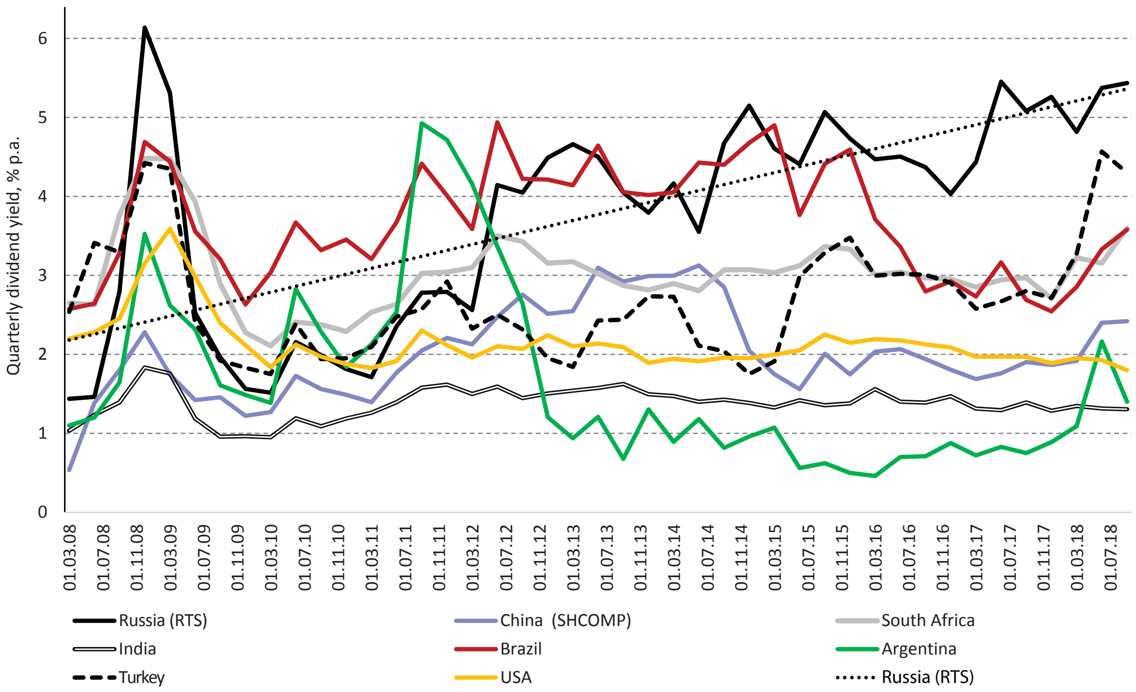


Fig. 4. Dividend yield from 1 March 2008 to 30 September 2018 for stock exchange indices in 7 biggest emerging markets and in the U.S., % p.a.

Source: calculated by Gaidar Institute using data from Moscow Exchange and Bloomberg.

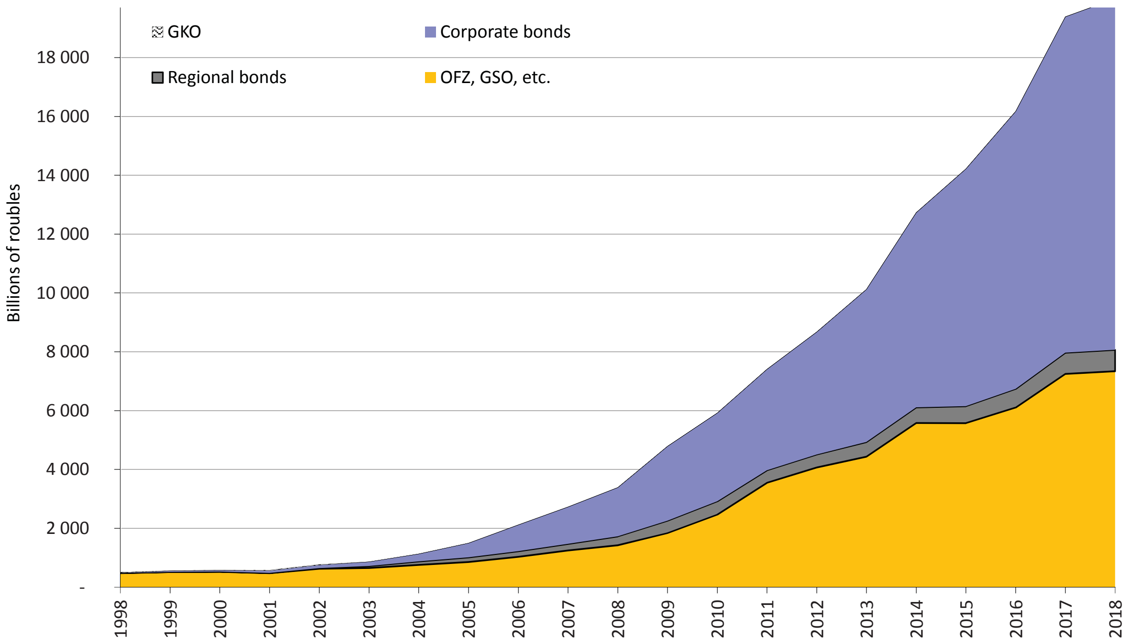


Fig. 5. Outstanding rouble-denominated bonds volumes, from 1998 to 2018, billions of roubles

Source: calculated by Gaidar Institute using data from Russia's Finance Ministry and Cbonds.ru.

flow[1] over fears of further sanctions. In 2018, issuing volumes of corporate bonds dropped substantially because of sanctions and uncertain domestic economic policy (*Fig. 6*): from Rb 2.9 trillion in 2017 to Rb 1.6 trillion in 2018,

1 According to data from the Bank of Russia, the share of OFZ bonds held by non-residents fell from 33.1% in December 2017 to 24.4% in October 2018.

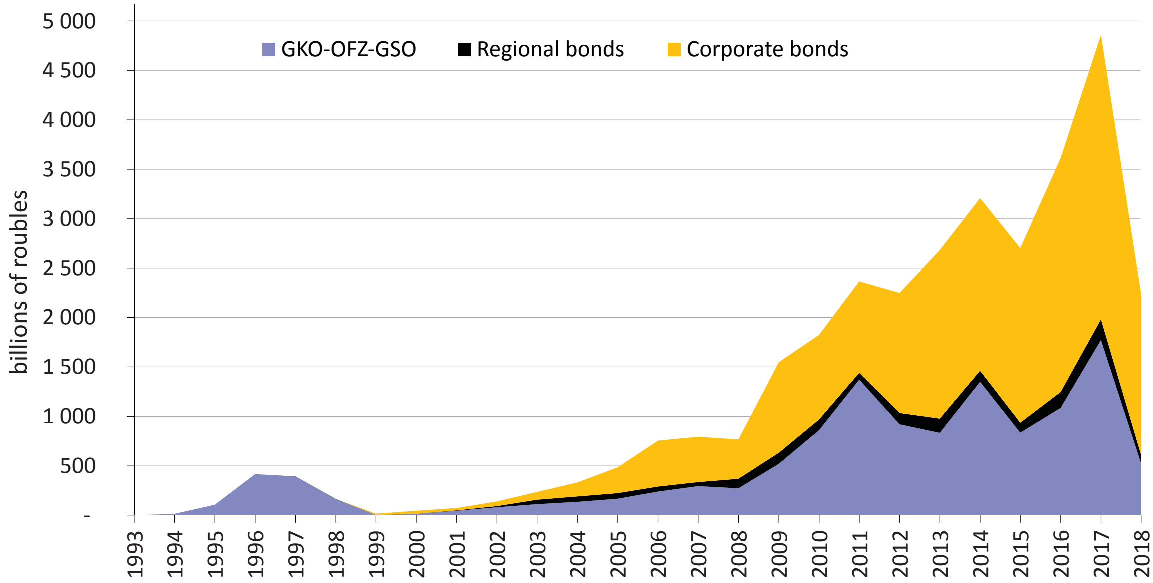


Fig. 6. Rouble-denominated bond issues volume, 1993–2018

Source: calculated by Gaidar Institute using data from Russian Finance Ministry and Moscow Exchange.

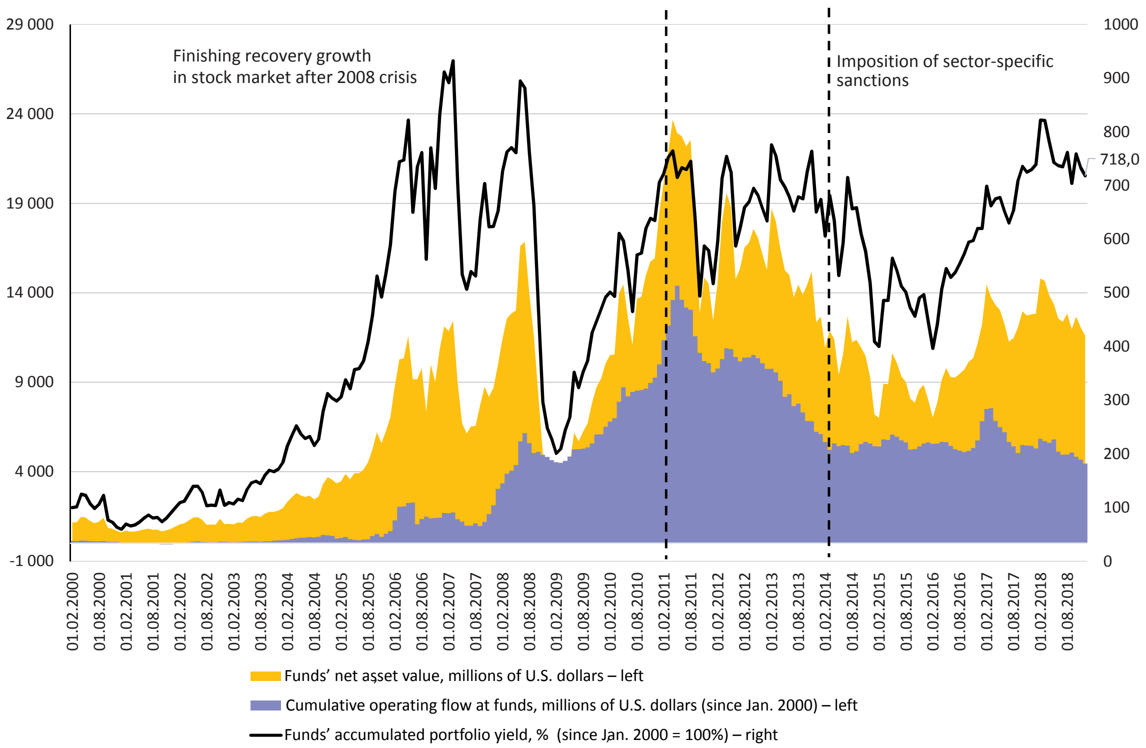
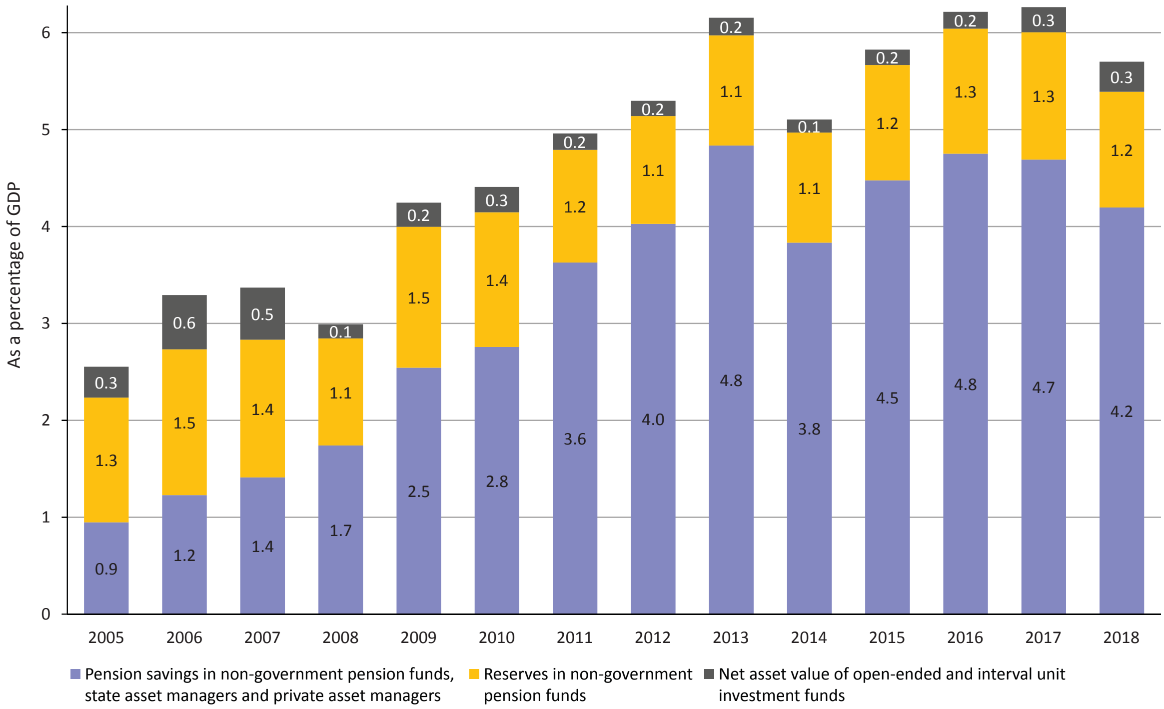


Fig. 7. Investment cash flow, net asset value (millions of U.S. dollars) and running total returns (%) of foreign investment funds specializing in investing in Russian corporate shares from February 2000 to November 2018

Source: calculated by Gaidar Institute using data from Emerging Portfolio Fund Research (EPFR Global).

or by 43.7%. Issuing volumes of federal bonds fell from Rb 1.8 trillion in 2017 to Rb 0.5 trillion in 2018, or by 70.6%. Issuing volumes of regional bond over the same period dipped from Rb 210.9bn to Rb 84.6bn, or by 59.9%.

The moderate growth problems facing the Russian equity market were largely due to investors demand constraints. In 2018, the US Fed's rate hike and, in part, further sanctions restricting Russian companies' access to glo-



Note. The value of retirement savings and pension reserves for 2018 is shown for the first nine months of the year.

Fig. 8. Size of retirement savings, pension reserves and value of net assets managed by open-ended and interval unit investment funds in 2005–2018, % of GDP

Source: calculated by Gaidar Institute using data from Rosstat, Bank of Russia, Investfunds.ru and Pension Fund of Russia.

bal equity markets spurred further outflows from funds investing in Russia (Russia-EMEA-Equity), Russian corporate shares (*Fig. 7*). While in 2016 the net investment inflow in funds specializing in investing in Russian corporate shares totalled $1.18bn, there was an outflow of $2.20bn in 2017 and of $0.85bn in the first 11 months of 2018.

Internal savings were not yet enough to make up for non-residents' slim demand for financial instruments of Russian issuers. In 2018, as shown in *Fig. 8*, internal local institutional investors, such as non-government pension funds, asset managers and unit investment funds, saw their assets grow at slower pace. The constraints to that, in our view, were as follows: the retirement savings system was still "frozen", there were delays in drafting a supplementary pension legislation, and individuals had no confidence in collective investment mechanisms in place. As a result, the total value of retirement savings, pension reserves and net assets managed by open-ended and interval unit investment funds fell from 6.1% of GDP in 2013 to 5.7% in 2018.

Given that Russia's biggest companies are faced with restricted access to global financial markets, the investment potential of the domestic equity market will depend largely on the progress towards achieving a higher level of performance efficiency at non-financial companies and financial organizations that accumulate savings of individuals.

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