MONITORING OF RUSSIA'S ECONOMIC OUTLOOK:

TRENDS AND CHALLENGES OF SOCIO-ECONOMIC DEVELOPMENT

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MAIN TRENDS AND CONCLUSIONS

Almost all official (Russia's Central Bank, Ministry of Economic Development) and judgmental forecasts that have been made over the last few years are known to contain a reservation, namely they are based on the assumption that sanctions against Russia would stay in force. Such a conservative approach seems to be reasonable. However, adoption (which seems inevitable) of a new US package of sanctions would prompt one to assume not only a stronger effect of the sanctions in terms of business but also of their institutional nature. However, comparing these sanctions with the notorious Jackson–Vanik amendment can barely reflect what is going on and what may happen.

Apart from a long-term effect on U.S.-Russian relations, a special emphasis should be placed on the extraterritorial effect of the sanctions, which has been deliberately made an integral part of the sanctions with an essentially unprecedented coverage. This may become a challenge for a host of countries, particularly in Europe and in Asia, as much as this will be a challenge for some other companies and for specific projects. Moreover, this has already become a challenge, given the readiness of European regulators and companies to observe the US legislation. The "longitude" and the "latitude" covered by the sanctions come to be understood taking The Blue Stream gas pipeline as an example (albeit not the most vivid one), through which Russia's gas has long been piped to Turkey: if a Japanese, Turkish, Italian or any other firm decides in the future to be involved in the repair, scheduled maintenance, or even consultancy services that concern the Blue Stream, such a firm should first of all assess possible consequences of being "blacklisted". All these potential consequences will have to be assessed from the angle of Russia's current and future domestic and foreign economic policies, possible market effects and with due regard to not only political environment but also economic regularities.

It is the aforementioned regularities that underlie our experts' macroeconomic projections for 2017–2019. Pointing to mixed signals seen in H1 2017 regarding prospects of economic development, the experts are sure of the fact that the economy is being on the rise. However, the experts have pointed to negative projections for the agricultural industry because of unfavourable weather conditions as well as falling oil prices. As a result, the experts have developed 3-year projections with regard for increasing factors of uncertainty. The baseline or business-as-usual scenario predicts that the Urals would be traded at USD 50 a barrel in 2017 and at USD 55 in 2018–2019, whereas the alternative or conservative scenario expects it to be worth USD 45.6 a barrel in 2017, USD 40.8 in 2018, and USD 41.6 in 2019.

Both scenarios predict that in 2017–2019 the Russian economy will grow in real terms. Under the BAU scenario, real GDP is expected to grow by 1.3% in 2017, 1.4% in 2018, and 1.2% in 2019, whereas the conservative scenario forecasts a smaller growth of 0.9%, 0.8%, and 0.7% respectively. Both scenarios also suggest an increase in investment comparable with GDP growth, which, however, is sufficient only to compensate for the loss of capital equipment due to natural depreciation. The projection for households' real disposable cash income looks somewhat different. Households' real disposable cash income in 2017 will increase (+0.4%) under the BAU scenario, whereas it will continue declining (-0.2%) under the conservative scenario. Households' real disposable income in 2018–2019 are expected to increase under both scenarios, with an increase of 1.6% and 1.5% respectively under the BAU scenario, and with a slower growth of 1.0% and 0.4% respectively under the conservative scenario (the growth under the conservative scenario is accounted for by, first of all, lower starting point after the decline of 2017 and by a more likely support to individuals from the state budget during the year of presidential elections in Russia).

The projection is based on the assumption that the Russian central bank would manage to hold the target inflation rate at 4.0%. However, under the conservative scenario, with inflation being influenced by the rouble's exchange rate and with a higher degree of uncertainty in the economy, the target inflation rate can be achieved through a tougher monetary policy whereby real interest rates are held high. Under the BAU scenario, the Bank of Russia conducts a policy whereby the base interest rate is gradually lowered, thus enhancing the affordability of loans for borrowers. With the predetermined external environment and with continuing the policy of free-floating exchange rate, we estimate the rouble-dollar average annual exchange rate at 58.4 roubles per US dollar in 2017, 59.4 in 2018, and 58.8 in 2019, whereas under the conservative scenario, the nominal exchange rate is projected at 59.6 roubles per US dollar in 2017, 66.5 in 2018, and 64.8 in 2019. Nevertheless, even if the conservative option for external environment is realized and if the crude oil price falls below USD 45 a barrel, the experts do not expect the rouble to depreciate steadily around 70 roubles per US dollar. This, in turn, poses risks of loss of oil and gas revenues to the federal budget in the next three years.

The experts have noted that they, as before, are not seeing real factors that could promote annual economic growth of above 1.0–1.5%, and that their projections for economic growth rates and the projections of the Ministry of Economic Development cannot be considered as acceptable for the economy. In this context, it would be extremely important to adopt a new package of economic reforms.

The projections of the authors and of analysts of Russia's Balance of Payments are based on the assumption that the rouble's exchange rate would continue to be free floating. Therefore, they do not express concerns about the BoP current account going negative. The experts have concluded that in the second quarter of this year the current account balance stood negative (-USD 0.3bn compared with +USD 23.3bn in Q1 2017) as a result of seasonal factors. This, above all, refers to the growth in payments to foreign investors and to imports of services, most of which are tourism services. Another factor was the rouble's appreciation which ramped up imports of depreciated goods. Thus the three key balances comprising the current account balance deteriorated.

This, however, poses no serious risks amid a free-floating rouble's exchange rate: the exchange rate is gradually corrected, thus increasing the value of exports and "equalizing" again the balance of payments. While in the first few months of 2017 the Russian rouble appreciated driven predominantly by the increase in current account surplus, it depreciated as the balance went negative. According to experts, with the terms of trade remaining approximately at a level as it is now, a certain depreciation of the Russian rouble would stabilize again the BOP current account at around zero.

Stable behaviour of macroeconomic indicators (at least, there were no sharp inflationary upsurges or drastic devaluations of the local currency) was definitely among the factors that made Russian industrial enterprises satisfied with the current situation. Traditional gauging of enterprises' adaptability to the current environment (according to the data for Q2 2017) gives evidence that the Industry Adaptability Index – the share of respondents describing the situation as "normal" – reached an absolute peak (76%) in business surveys conducted since 1994. This includes a sensitive indicator such as demand, with 64% of enterprises saying that they have a 'normal' effective demand (a 9-year high). However, the situation is heterogeneous: largest enterprises (with more than 1000 employees) continue to comprise a steadily high share of enterprises that are satisfied with the current situation (reaching the highest value (80%) in the second quarter), whereas small and medium-sized enterprises (with less than 250 employees) have comprised not more than 55–60% over the past 10 quarters.

Responses also vary according to the seniority level of respondents. Heads of Economic Departments upgraded their assessment of the state facing their enterprises compared with downbeat assessments of 2015 (with 75% of respondents saying the state is 'normal'). CEO's deputies gave quite upbeat responses throughout the entire period of crisis (78% to date). Finally, CEOs of enterprises upgraded their responses from 59% in 2015 to 72% in Q2 2017.

Individuals or ordinary people also upgraded their assessment of the situation. The share of people saving on food, clothing and footwear was down. The same is true for those who think their financial standing worsened over the past 2–3 months. According to our experts, this was due to, among other things, adaptation to a sluggish crisis or stagnation, as well as some positive dynamics for a series of social indicators.

Households' real disposable cash income in June 2017 did not dwindle for the first time (compared with the same month of 2016). Up to now, since the beginning of the previous year, the dynamics has steadily been deteriorating (there was an increase in January 2017 due to a one-off payment to retired individuals). Real income in H1 2017 contracted overall by 1.4%, with a 2.7% rise in real wages compared with the same period of 2016. However, the steady growth (since August 2016) in real wages failed to offset falling incomes.

The foregoing was due to a series of causes. First, the so-call statistical traps: data for wages and incomes are based on various monitoring techniques and methods, and they have to be revaluated quite often, etc. Second, growth in real wages is yet to recover to pre-crisis levels (real wages in May 2017 comprised 96.1% of those in May 2014). And the real size of granted retirement benefits in May 2017 accounted for just 91.9% of that in May 2014 (and 100.0% from May 2016). The real size of social security benefits declined even more than retirement benefits. Third, the decline in income amid rising observable wages may indicate a decline in wages in the informal economy (or a partial redistribution of the non-observable payroll to the non-observable one). According to the experts, however, monthly figures are not sufficient for making final conclusions, not to mention the fact that Rosstat frequently performs post factum recalculations.

Considering the foregoing assumptions, the 15% decline in the proportion of the population with incomes below the subsistence minimum in Q1 2017 (compared with 2015–2016) should also be regarded as just a preliminary assessment.

1. MACROECONOMIC PROJECTIONS FOR 2017–2019: A GROWTH OF 1.0–1.5%

T.Gorshkova, S.Drobyshevsky, M.Turuntseva, M.Khromov

The results of H1 2017 on the one hand support the previous assumptions that the Russian economy is entering a growth phase, and on the other hand provide evidence of elevated uncertainty regarding the terms and prospects of economic development in the future. We expect that key macroeconomic indicators will be positive in the next 2.5 years, as well as the inflation target will be achieved. However, extremely low economic growth rates coupled with a tenuous external environment are posing high risk of loss of federal budget revenues.

Mixed signals were observed in H1 2017 regarding the outputs and prospects of economic development in Russia. The data from Rosstat and from alternative sources on the one hand have proven that the Russian economy has indeed been on the rise (real GDP in the first quarter increased 0.5%, the Industrial Production Index (IPI) in H1 2017 stood at 102.0% from H1 2016), and, on the other hand, unfavourable weather conditions facing the European regions of Russia have an adverse effect on projections for the agricultural industry which has recently become a growth driver. The factor of uncertainty in the second quarter was reinforced by falling crude oil prices. Thus, we had to broaden the range of changes in external environment and to revise our previous assumptions while making a projection for the next three years which should be considered when analyzing a new 3-year budget for the period in question.

Nevertheless, our baseline *business-as-usual* scenario for economic development until 2019 will draw on the assumption that the Urals average annually price in 2017 will be USD 50 a barrel (the actual price in the first and second quarters was USD 52 and USD 48.9 respectively) and will rise to USD 55 in 2018 and in 2019. Unlike in the previous projection[1], we have downgraded the oil price forecast for 2018–2019. Despite lower oil price, the terms of foreign trade for the Russian economy in the next 2.5 years would be more favourable than they were in 2016. As an alternative scenario – *conservative scenario* – we consider the option of oil price dynamics predetermined in the baseline scenario of the Russian Ministry of Economic Development: the Urals oil average annual price is expected to be USD 45.6 a barrel in 2017 and USD 40.8 in 2018, and USD 41.6 in 2019. In our view, this scenario reflects the lower border of possible external environment for the development.

Both scenarios predict that in 2017–2019 the Russian economy will grow in real terms. Under the BAU scenario, real GDP is expected to grow by 1.3% in 2017, 1.4% in 2018, and 1.2% in 2019, whereas the conservative scenario forecasts a smaller growth of 0.9%, 0.8%, and 0.7% respectively.

1 Averkiyev V., Drobyshevsky S., Turuntseva M., Khromov M. Macroeconomic projections for 2017–2018: The stake on a weak rouble will fail // Russian Economic Developments. No. 5. 2017. P. 3–9.

Under the BAU scenario, the Industrial Production Index (IPI) in 2017, in 2018, and in 2019 will increase 1.1%, 1.9%, and 1.8% respectively, whereas the conservative scenario predicts a growth of 0.8%, 0.8%, and 0.6% respectively. A slower growth under the conservative scenario is associated with slower growth rates for income and therefore final demand.

The fixed investment dynamics is expected to correspond with the GDP dynamics under both scenarios, with the BAU scenario predicting a higher steady growth, whereas the conservative scenario expects lower growth. Both scenarios show that investment is anticipated to outrun the GDP growth rate, and from the statistical perspective, *it is the investment dynamics that will be the key driver in the years to come*. Fixed investment are expected to increase 2.1% in 2017, 2.1% in 2018, and 1.9% in 2019. The conservative scenario predicts that investment will grow in 2017, in 2018, and in 2019 by 1.5%, 1.2%, and 1.1% respectively. However, such growth rates are sufficient only to compensate for the loss of capital equipment due to natural depreciation. It is therefore too early to speak of investment entering a growth phase.

The BAU scenario predicts that the unemployment rate in 2017, in 2018, and in 2019 will be 5.1%, 5%, and 4.8% respectively, whereas the conservative scenario expects it to stay at 5.2%, 5.4%, and 5.2% respectively. That is, it is possible to say that the unemployment rate would come to rest at approximately 5%, whatever the scenario, because the effect of overall decline in the economically active population will dominate in any case. The unemployment rate will thus remain stable, with a decline in the labour force size.

According to our estimates, households' real disposable cash income in 2017 will increase (+0.4%) under the BAU scenario, whereas it will continue declining (-0.2%) under the conservative scenario. Households' real disposable income in 2018 and in 2019 are expected to increase by 1.6% and 1.5% respectively under the BAU scenario, and by 1.0% and 0.4% respectively under the conservative scenario. The growth in real income under the conservative scenario is accounted for by, first of all, lower starting point after the decline of 2017 and by a more likely support to individuals from the state budget during the year of presidential elections in Russia.

The retail trade turnover will reflect the income dynamics under the BAU scenario. In terms of volume, the retail trade turnover in 2017 is expected to remain at the year-earlier level, with an increase in 2018 and in 2019 by 1.4% and 1.5% respectively. The conservative scenario predicts that consumption will face stagnation, and that the retail trade turnover will be contracting in real terms by 0.1%, 0.6% and 0.4% respectively.

Our projection for the Consumer Price Index was based on the assumption that the Russian central bank would manage to hold the target inflation rate at 4.0% throughout the entire period under review. It is apparent that under the conservative scenario, with inflation being influenced by the rouble's exchange rate and with a higher degree of uncertainty in the economy, the target inflation rate can be achieved through a tougher monetary policy whereby real interest rates are held high. Under the BAU scenario, the Bank of Russia conducts a policy whereby the key interest rate is to be gradually lowered, thus enhancing the affordability of loans for borrowers. Under the BAU scenario, the Consumer Price Index in 2017, in 2018, and in 2019 is expected to be 4.1%, 3.9%, and 3.6% respectively, whereas the conservative scenario shows 4.1%, 4.1%, and 4% respectively. Under the BAU scenario, the nominal interest rate on loans to non-financial organizations in 2017, in

2018, and in 2019 is projected to stay at 10.5%, 10.4% and 8.1% respectively, whereas real interest rates on loans to such organizations will be 6.1%, 5.1%, and 4.5% respectively. Under the conservative scenario, the nominal interest rate will be 10.7% in 2017, 16.4% in 2018, and 11.1% in 2019, whereas the real interest rate will be 6.4%, 11.8%, and 7.0% respectively. Therefore, indicators for monetary aggregates will be more moderate than in the BAU scenario.

With the predetermined external environment and with continuing the policy of free-floating exchange rate, we estimate the rouble-dollar average annual exchange rate at 58.4 roubles per US dollar in 2017, 59.4 in 2018, and 58.8 in 2019. Accordingly, the rouble's real effective exchange rate will increase 10.2% in 2017 and 0.5% in 2019, except that it will remain unchanged in 2018.

Under the conservative scenario, the rouble's nominal exchange rate is projected at 59.6 roubles per US dollar in 2017, 66.5 in 2018, and 64.8 in 2019, in which case the rouble's real effective exchange rate will be more volatile: it will strengthen, albeit by 7.5%, in 2017 and then weaken in 2018 by 1.8%, rising again in 2019 by approximately 1.2%. Nevertheless, even if the conservative option for external environment is realized and if the crude oil price falls below USD 45 a barrel, we do not expect the rouble to depreciate steadily around 70 roubles per US dollar. This, in turn, poses risks of loss of oil and gas revenues to the federal budget in the next three years.

Since even the conservative scenario predicts that average crude oil prices in 2017 will be higher than they were in 2016, and that the rouble's real exchange rate will appreciate, we estimate exports and imports to increase in terms of volume. Exports of goods under the BAU scenario will rise up to USD 327.5bn in 2017, to USD 333.0bn in 2018, and to USD 337.4bn in 2019. The conservative scenario expects exports in 2017 to increase to USD 325.1bn and decline in 2018 and in 2019 to USD 319.8bn and USD 324.2bn respectively. Imports of goods in 2017 will rise to USD 187.4bn under the BAU scenario and to USD 184.2bn under the conservative scenario. In 2018, the forecast volume of imports are expected to increase to USD 199.4bn under the BAU scenario and to USD 191.2bn under the conservative scenario. The forecast volume of imports in 2019 is expected to increase to USD 219.2bn under the BAU scenario and to USD 206.2bn under the conservative scenario. Under both scenarios we expect exports of services to see a one-off growth by approximately USD 2.5bn in 2018 due to the 2018 FIFA World Cup.

As before, we are not seeing real factors that could promote annual economic growth of above 1.0–1.5%. It is apparent that our projections for economic growth rates and the projections of the Ministry of Economic Development cannot be considered as acceptable for the economy. In this context, it would be extremely important to adopt a new package of economic reforms to accelerate economic growth and to extend possibilities for, among other things, a budget manoeuvre.

Table

BAU scenario	**2017**					**2018**	**2019**
	Q1 *actual*	**Q2** *actual/ projection*	**Q3** *projection*	**Q4** *projection*	**year** *projection*	**year** *projection*	**year** *projection*
Urals oil, $/b	52.0	48.9	48.7	50.5	50.0	55.0	55.0
GDP							
billions of roubles.	20 091	21 843	24 424	25 732	92 090	97 182	102 030
physical volume index as % change from the same period previous year	100.5	101.3	101.5	101.8	101.3	101.4	101.2
deflator	106.3	105.5	105.9	105.0	105.6	104.1	103.7
Fixed investment							
physical volume index	102.3	101.6	101.9	102.4	102.1	102.1	101.9
Retail trade turnover							
% change from the same period previous year	98.2	100.0	100.3	101.5	100.0	101.4	101.5
Real disposable cash income							
% change from the same period previous year	99.7	99.8	100.0	102.1	100.4	101.6	101.5
Exports							
billions of US$	93.4	89.2	91.5	99.1	373.2	382.3	381.9
of which							
Exports of goods	82.1	78.4	79.4	87.7	327.5	333.0	337.4
Oil and gas exports	49.0	41.1	42.1	46.9	179.1	183.5	186.2
Other exports	33.1	37.2	37.3	40.8	148.4	149.5	151.2
Exports of services	11.3	10.8	12.2	11.4	45.7	49.4	44.6
Imports							
billions of US$	63.9	63.0	66.2	70.7	263.8	282.7	306.5
of which							
Imports of goods	47.6	43.6	44.9	51.3	187.4	199.4	219.2
Imports of services	16.3	19.4	21.3	19.4	76.4	83.3	87.3
CPI							
% change from the previous period	101.0	101.1	100.5	101.4	104.1	103.9	103.6
Interest rate on rouble loans average of period, % p.a.							
real	6.9	6.2	5.6	5.8	6.1	5.1	4.5
nominal	11.5	10.6	9.8	10.1	10.5	10.4	8.1
USD-Rouble exchange rate							
average nominal over the period	59.2	57.1	59.0	58.4	58.4	59.4	58.8
Rouble's real effective exchange rate							
At period's end as % change from previous period's end	9.2	1.2	-1.7	1.5	10.2	0.0	0.5
Monetary base							
trillions of roubles	11.5	11.5	11.7	12.8	12.8	13.0	13.3
Monetary aggregate (M2)							
At period's end, trillions of roubles	38.6	38.1	38.8	41.4	41.4	44.1	46.6
% growth from previous period	0.4	-1.3	2.0	6.6	7.7	6.6	5.8
IPI							
% change from the same period previous year	100.1	101.0	101.6	101.8	101.1	101.9	101.8
Unemployment							
%	5.6	5.3	4.8	4.9	5.1	5.0	4.8

Conservative scenario	2017					2018	2019
	Q1 *actual*	Q2 *actual/ projection*	Q3 *projection*	Q4 *projection*	year *projection*	year *projection*	year *projection*
Urals oil, $/b	52.0	48.9	40.6	41.0	45.6	40.8	41.6
GDP							
billions of roubles.	20 091	21 821	24 170	25 312	91 394	95 830	100 206
physical volume index в % change from the same period previous year	100.5	101.3	100.8	100.9	100.9	100.8	100.7
deflator	106.3	105.4	105.5	104.2	105.3	104.0	103.8
Fixed investment							
physical volume index	102.3	100.9	101.2	101.6	101.5	101.2	101.1
Retail trade turnover							
% change from the same period previous year	98.2	100.0	100.3	101.3	99.9	99.4	99.6
Real disposable cash income							
% change from the same period previous year	99.7	99.6	99.8	100.1	99.8	101.0	100.4
Exports							
billions of US$	93.4	87.4	90.3	98.3	369.4	367.5	366.3
of which							
Exports of goods	82.1	77.4	78.9	86.8	325.1	319.8	324.2
Oil and gas exports	49.0	40.6	41.6	46.4	177.7	171.1	173.8
Other exports	33.1	36.7	37.2	40.4	147.4	148.7	150.4
Exports of services	11.3	10.1	11.4	11.5	44.3	47.7	42.1
Imports							
billions of US$	63.9	61.6	64.8	70.3	260.6	268.1	285.4
of which							
Imports of goods	47.6	42.2	43.5	50.9	184.2	191.2	206.2
Imports of services	16.3	19.4	21.3	19.4	76.4	76.9	79.2
CPI							
% change from the previous period	101.0	101.1	100.5	101.4	104.1	104.1	104.0
Interest rate on rouble loans average of period, % p.a.							
real	6.9	6.7	5.6	6.3	6.4	11.8	7.0
nominal	11.5	11.1	9.7	10.5	10.7	16.4	11.1
USD-Rouble exchange rate							
Average nominal over the period	59.2	57.1	61.4	60.7	59.6	66.5	64.8
Rouble's real effective exchange rate							
At period's end as % change from previous period's end	9.2	1.2	-4.3	1.7	7.5	-1.8	1.2
Monetary base							
trillions of roubles	11.5	11.4	11.5	11.6	11.6	10.8	11.2
Monetary aggregate (M2)							
At period's end, trillions of roubles	38.6	38.1	38.5	40.4	40.4	42.6	45.1
% growth from previous period	0.4	-1.3	1.0	4.9	5.1	5.4	5.9
IPI							
% change from the same period previous year	100.1	100.8	101.3	101.0	100.8	100.8	100.6
Unemployment							
%	5.6	5.3	4.9	5.1	5.2	5.4	5.2

2. RUSSIA'S BALANCE OF PAYMENTS IN Q2 2017: THE BALANCE MOVES NEGATIVE

A.Bozhechkova, A.Knobel, P.Trunin

Russia's current account balance went negative in Q2 2017 due to a growth in imports of goods driven by a strengthening Russian rouble, seasonal growth in imports of services and investment income payments amid stagnating exports of goods after the rising oil price trend grinded to a halt. Therefore, the uptrend for the rouble exchange rate reversed in June.

According to the Bank of Russia's BOP preliminary assessment for Q2 2017, the current account balance stood negative (-$ 0.3bn) (compared with +$ 2bn in Q2 2016 and +$ 23.3bn in Q1 2017). Such a considerable dwindle was induced by a decline in the following three key components of the current account.

First, the balance of trade in goods, which in Q2 2017 stood at $ 24.8bn, contracted in April–June by 28% from $ 34.4bn in Q1 2017 (this value, however, is 11% above $ 22.3bn in Q2 2016) (*Fig. 1*).

Exports in H1 2017 increased overall in value terms, but this was mostly due to the growth in prices of Russia's export products such as crude oil, petroleum products, hard coal, ferrous and non-ferrous metals, wheat[1]. However, prices in Q2 2017 saw minor changes from Q1 2017. Exports in the second quarter remained almost unchanged ($ 83.4bn) compared with the first

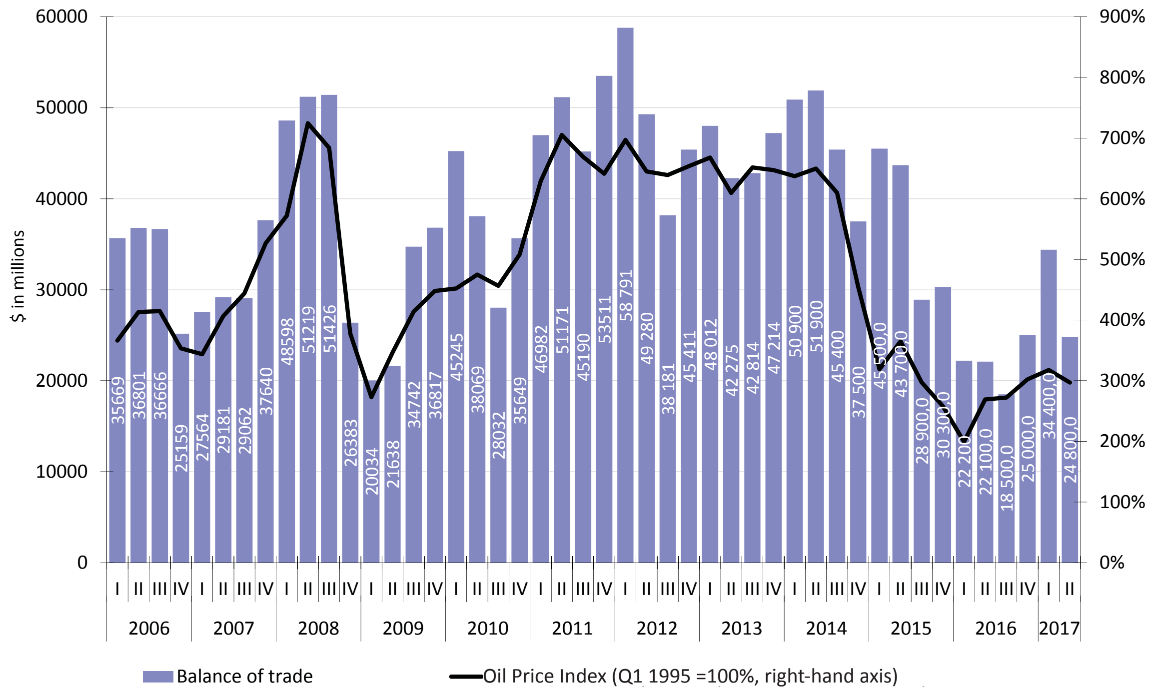

Fig. 1. Russia's balance of trade and global oil price index in 2006–2017

Sources: Bank of Russia, own calculations.

1 See A. Bozhechkova, A. Knobel, P. Trunin. Russia's Balance of Payments in Q1 2017. Russian Economic Developments. 2017. Vol. 24. No. 5. P. 10–13.

quarter ($ 82.4bn), whereas imports increased considerably by 22% (from $ 48.0bn in Q1 2017 to $ 58.6bn in Q2 2017) and therefore were responsible for the deterioration of the balance of trade. At the same time, the dynamics of imports keeps correlating with the rouble exchange rate: according to the central bank's data, the index of rouble's real effective exchange rate against foreign currencies in H1 2017 was 26.7% higher than in H1 2016, that is, the rouble gained considerably, indicating a relative depreciation of imports[1].

Second, the balance of trade in services deteriorated in April–June, reaching in Q2 2017 a negative value of -$ 7.1bn (down by 39% from -$ 5.1bn in Q1 2017 and by 18% from -$ 6bn in Q2 2016).

In Q2 2017, both exports of services increased (predominantly owing to inbound tourism and transport services) and imports of services were up (predominantly owing to travels) from the previous quarter and from Q2 2016. However, a negative balance of trade in services was deteriorated by imports outrunning exports (by respectively 21.7% and 14.5% on a quarter-to-quarter basis as well as 14.8% and 12.7% from the same period of 2016).

Finally, the second quarter saw investment income balance turn south, reaching -$ 16bn compared with -$ 3.9bn in Q1 2017 and -$ 12.8bn in Q2 2016.

Investment income payable increased considerably in the second quarter both from the previous quarter (up by 58.6% from $ 14.0bn to $ 22.2bn) and from Q2 2016 (up by 8.3% from $ 20.5bn to $ 22.2bn), whereas investment income receivable remained unchanged ($ 16.3bn) in H1 2017 compared with H1 2016. The growth in income payable was driven basically by non-bank organizations, reflecting mostly a seasonal increase in dividend payouts by Russian companies.

The rest of the current account components (compensation of employees balance, rent balance, secondary income balance) remain to be much smaller than the aforementioned key balances, with their dynamics having no significant effect on the current account.

Thus, the current account at the second quarter's end was driven by a typical seasonal downtrend associated with both the growth in investment income payments and in imports of services, most of which are tourism services. This year, the seasonal factors were also overlapped by accelerating imports due to the rouble's appreciation and falling global oil prices. Eventually, the current account went negative for the first time since Q3 2013. However, with a free-floating rouble exchange rate, this poses no substantial destabilization risks for the economy because the rouble exchange rate is gradually corrected, thus increasing the value of imports and 'equalizing' the balance of payments.

A current account deficit in the second quarter was attended by a financial account surplus which reached $ 10.8bn (compared with $ 1.7bn in Q2 2016). Russian economic agents' obligations to their foreign counterparts in April–June increased $ 4.5bn (+$ 3.3bn in Q2 2016). The growth in external obligations was supported by an increase of $ 9.3bn ($ 6.8bn in Q2 2016) in foreign direct investments in other sectors.

The inflow of foreign direct investments was presumably associated with the reinvestment of dividend income. The $ 0.5bn growth in other sectors' in-

1 For more information about the effect of foreign exchange rate dynamics on trade see also Knobel A., Firanchuk A. Foreign Trade in 2016 // Russian Economic Developments. 2017. Vol. 24. No. 3. P. 8–17.

debtedness on "loans and credits" was offset by the $ 0.5bn decline in portfolio investments. The banking sector continued repaying external loans in the second quarter: banks' external liabilities were reduced by $ 11.7bn (down $ 3.9bn in Q1 2017).

Residents' foreign asset holdings (foreign economic agents' obligations to Russian economic agents) contracted in April–June 2017 by $ 6.3bn (whereas they increased $ 10.6bn in Q1 2017 and $ 1.6bn in Q2 2016). This was mostly due to a $ 7.0bn contraction of banking sector's foreign asset holdings. As a reminder, banks' foreign asset holdings in the first quarter reached a record value of $ 13.7bn, which was most likely associated with a bridge loan to non-residents in order to support the Rosnefts' Privatization Deal. The loan was presumably repaid in the second quarter.

In April–June, other sectors' foreign asset holdings increased $ 0.3bn (+$ 7.1bn in Q2 2016 and -$ 3.3bn in Q1 2017). Direct and portfolio investments in other sectors gained $ 1.5bn and $ 0.1bn respectively ($ 6.4bn and $ 2.2bn respectively in Q2 2016).

The second quarter saw an overall of $ 2.8bn of net private capital inflows compared with $ 3bn in Q2 2016 and with $ 7.5bn in Q1 2017. Banks' net capital outflows were $ 4.7bn, whereas the non-bank sector was found to be a net importer of foreign capital worth $ 10.4bn.

According to the BOP data, reserve assets in Q1 2017 increased $ 7.5bn ($ 11.3bn in Q1 2017) mostly because the Russian Finance Ministry purchased about $ 5bn of foreign currency in the local foreign exchange market and the banking sector repaid its foreign-currency debts due to the Russian central bank ($ 2.6bn in Q1 2017).

Thus, the appreciation in nominal terms of the Russian rouble against the US dollar (an increase of 6.8% to 56.5 roubles per US dollar as at the end of

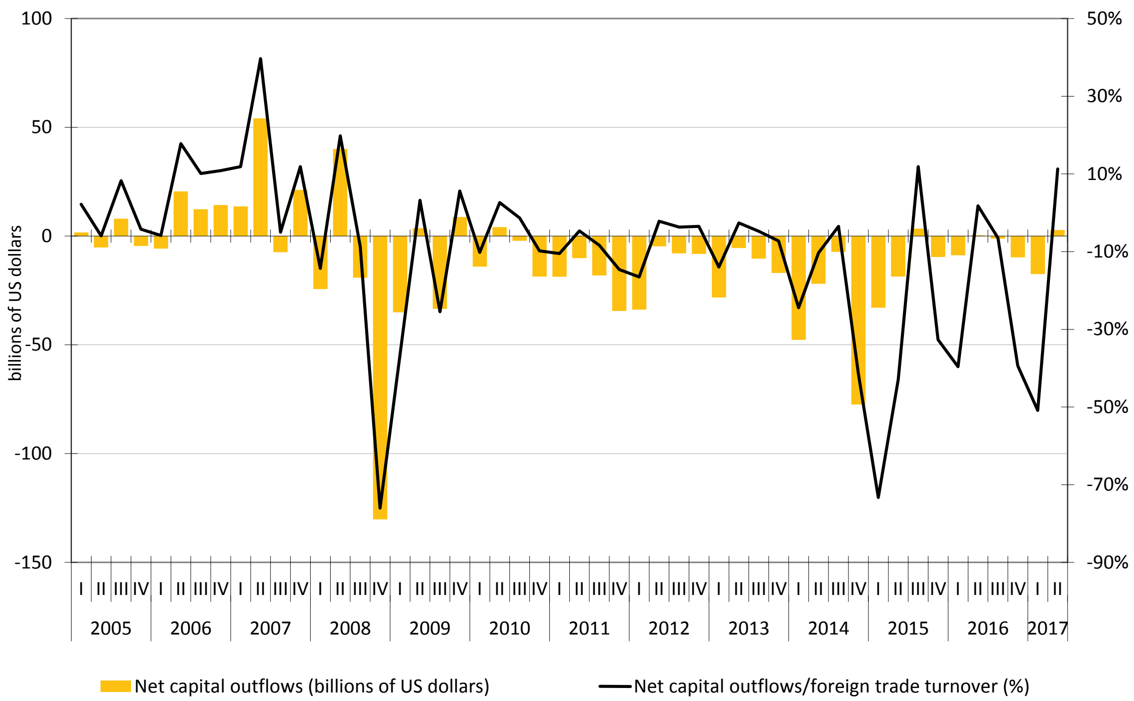

Fig. 2. Net capital outflows in private sector in 2005–2017

Sources: Bank of Russia, own calculations.

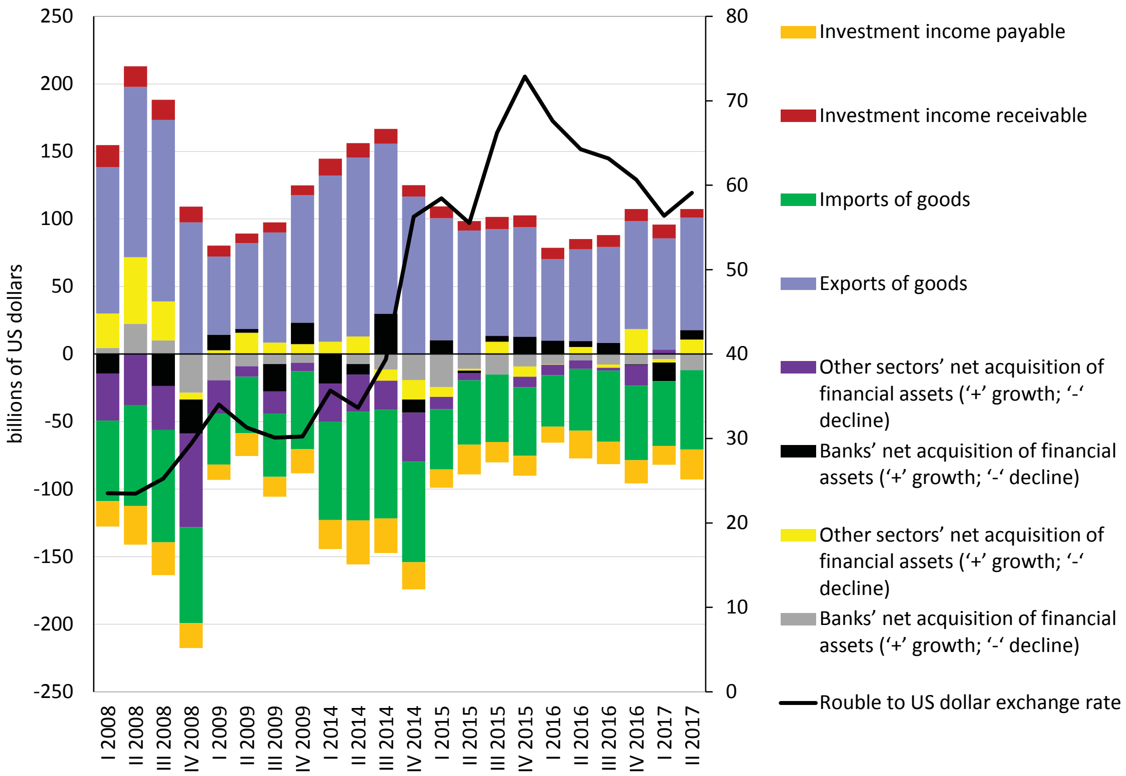

Fig. 3. Key components of Russia's BoP and rouble-dollar exchange rate

Source: Central Bank of Russia.

May 2017) over the entire first half of 2017 was governed predominantly by the growth in a positive current account balance from the same period of 2016 (*Fig. 3*). The current account balance's move to a negative value triggered the rouble's depreciation in spring and summer this year. According to our preliminary estimates, the rouble's real effective exchange rate in Q2 2017 was 2.5–3.5% above the fundamentally substantiated level driven by the dynamics of productivity, terms of trade, capital flows[1]. In that context, returning the rouble's real effective exchange rate back to the equilibrium path, with inflation in Russia staying at 4.4% (June 2017 from June 2016), and with inflation in trade partner countries varying within an average range of 1.5–2.5%, would require the rouble to depreciate in nominal terms by approximately 5%.

In general, according to our estimates, with the terms of trade remaining approximately at a level as it is now, a certain depreciation of the Russian rouble would stabilize again the BOP current account at around zero. Furthermore, with a free-floating exchange rate, the balance of current account and of financial account are expected to undergo no serious changes in the near term, unless positive or negative shocks occur.

1 We use the following fundamentals for the rouble's real effective exchange rate: the ratio of the Russian LPI (Labour Productivity Index) to the LPI of Germany as a key trade partner, real crude oil price, private sector' foreign asset holdings, government's consolidated budget expenditure as a percentage of GDP.

3. INDUSTRY ADAPTABILITY INDEX IN Q2 2017: “NORMAL” ASSESSMENTS

S.Tsukhlo

The final evaluation of the Industry Adaptability (‘Normality’) Index (IAI) for Q2 2017 has produced exactly the same results as our previous estimates: the Russian industrial sector has been increasingly adapting to the sluggish recovery from the crisis of 2015–2016. The IAI has come to rest at an absolute (1994–2017) peak of 76%. Therefore, more than one fourth of Russian industrial enterprises have confirmed that their current state is ‘normal’.

Even effective demand – the most painful indicator for any producer – was ranked very high in Q2 2017 by enterprises, with 64% of them saying that they have a ‘normal’ effective demand, thus hitting a 9-year high.

Enterprises’ responses about finished goods inventory in the previous quarter were getting closer to the previous crisis level of ‘normality’ of late 2016/early 2017, when industrial enterprises started reconsidering their inventory in anticipation of a stage of possible recovery from the recent crisis. As a result, the share of respondents with ‘normal’ inventory dwindled to a 3-year low. However, the euphoria of rapid recovery from the crisis in 2017 seems to have gone, and enterprises are returning to the inventory managing policy of 2015–2016, focusing on holding surplus at a minimum level.

It is, however, very large enterprises (with more than 1000 employees) that are contributing most to the Russian industry’s successful adaptation to the current environment. Sixty to 71 percent of very large enterprises were satisfied with demand in Q2 2017. Note that the best result (74%) in this group was recorded in 2007.

Consequently, largest Russian enterprises (with more than 1000 employees) said their financial and economic status is very good during the current crisis.

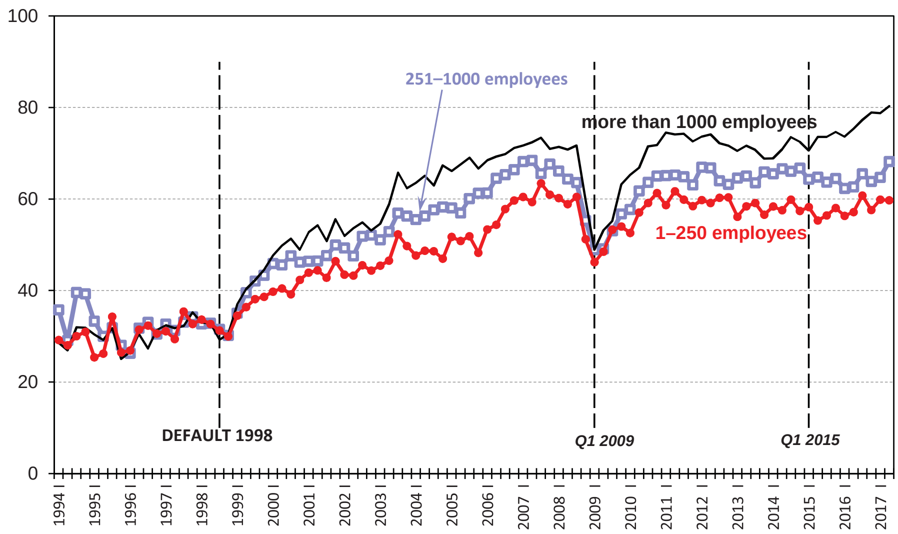

Fig. 1. Industry Adaptability Index according to the size of enterprises, 1994–2017, % (the share of enterprises that assess their performance as ‘normal’)

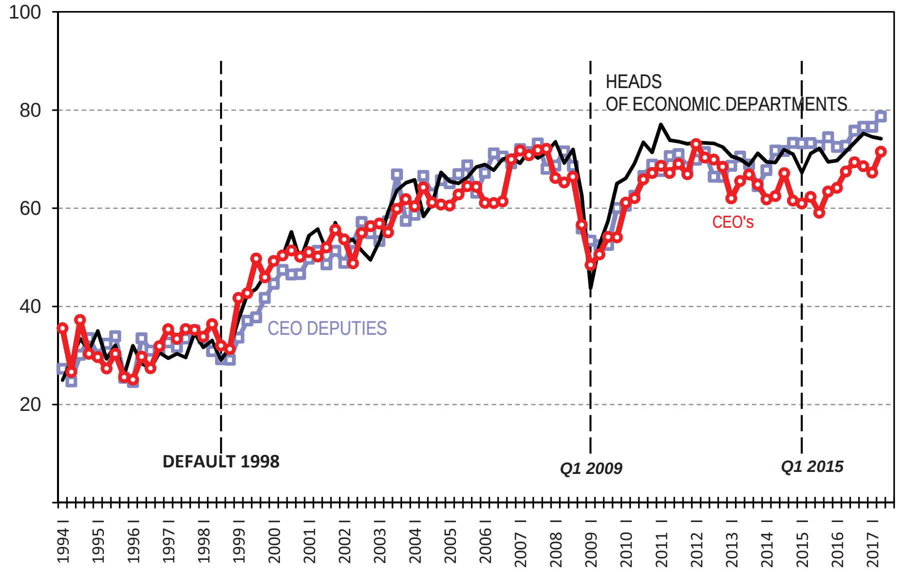

Fig. 2. Industry Adaptability Index according to the level of seniority, 1994–2017, % (the share of enterprises that assess their performance figures as ‘normal’)

The share of respondents facing a normal financial and economic status increased in Q2 2017 up to 96%, whereas 77% of large enterprises (with 251–1000 employees) and 66% of small and medium-sized enterprises (with 1–250 employees) were satisfied with their financial and economic status.

As a result, largest enterprises continued to stay at the very top of the ranking in terms of adaptability to the recent economic environment amid crisis (*Fig. 1*). The IAI for this group of enterprises reached a new absolute record of 80%. Small and medium-sized enterprises have been hit hardest by the current crisis, with the IAI for this group over 10 quarters varying between 55% and 60%, with no changes whatsoever.

According to our data, adaptability to the specifics of the crisis depends on the level of seniority of respondents. Since late 2014, the highest degree of adaptability has been shown by CEO’s Economy Deputies at industrial enterprises. Furthermore, according to this group of respondents, the IAI in late 2014/early 2015 was steadily high, hitting (by then) an all-time high of 73%, a new record in Q2 2017, when 78% of CEO’s Deputies said their enterprises were facing a normal situation.

Close results were shown in 2016–2017 by heads of economic departments (*Fig. 2*). However, they said that the onset of the 2015 crisis was challenging for their enterprises: the IAI for this group of respondents dropped to a 5-year low of 67%. Then it started increasing to reach 75% by now. From the CEOs’ perspective, the crisis has been more challenging. According to CEOs, adaptability in early 2015 stood at 61%, declining to 59% in Q3 2015. Nevertheless, adaptability increased 69% as early as mid-2016, staying at 72% for now.

4. INCOMES AND THE POVERTY RATE: STAGNATION AND CAUTIOUS OPTIMISM

E.Grishina

In June 2017, households' real disposable cash income did not change as compared to June 2016. For the first time since January 2016 (if January 2017 is not taken into account), there was no decrease in real income. In Q1 2017, the poverty rate fell relative to Q1 2015 and Q1 2016. In H1 2017, the volume of consumer lending to individuals increased as compared to H1 2016, with lending growth being much higher in regions with a high poverty rate. As compared to 2016, people started to assess more positively the dynamics of their financial standing and the share of those who saved on food, clothes and footwear decreased.

In June 2017, households' real disposable cash income did not change as compared to the same period of 2016, but real accrued wages and salaries increased by 2.9% as compared to the corresponding period of 2016 (*Fig. 1*).

For the first time since January 2016, there was no decrease in households' real income unless January 2017 – when a 8.2% real income growth was driven by a lump sum payment of Rb 5000 to pensioners – is taken into account. However, it is early to speak about a turning point in the trend of reduction of the real cash income and its growth recovery.

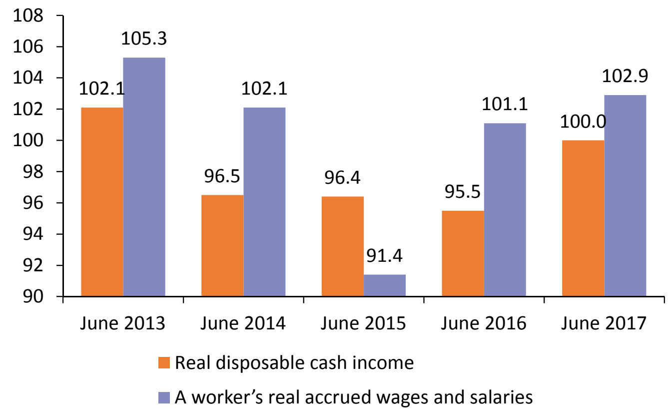

Fig. 1. Dynamics of households' real disposable cash income and real accrued wages and salaries in June 2013–2017, % change compared with the corresponding period of the previous year
Source: Central Bank of Russia.

In general, in H1 2017 as compared to H1 2016 households' real disposable cash income fell by 1.4%, while real wages and salaries increased by 2.7%. It means that growth in real wages failed to make up for a decrease in households' real cash income and that can be justified by the following several factors.

Firstly, it is worth mentioning the so-called "statistical traps". The data on wages and households' disposable cash income are based on different statistical survey methods: a direct statistical accounting (wages and salaries) and a population survey (households' aggregate cash income). In addition, statistical revaluations are normally utilized to determine the indices of wages and households' incomes. Due to the above, comparison of the indices of wages and households' incomes does not necessarily provide comprehensive diagnostics, so it should be carried out with possible statistical errors related to formation of those indices taken into account.

Secondly, sustainable real wages growth was observed for less than a year (from August 2016) and so far failed to achieve the pre-crisis level. So, in May 2017 real wages amounted only to 96.1% over the level of May 2014, while the actual amount of accrued pensions, to 91.9% over the level of May 2014. In the above period, real social benefits kept falling more dramatically than pensions whose depreciation was mitigated by a lump-sum payment to pensioners in January 2017. Thus, depreciation of pensions and social payments in real terms against growth in real wages limited growth potential for households' real cash incomes.

Thirdly, reduction of households' real incomes against growth in visible real wages and salaries can be the evidence of wage-cuts in the informal sector of the economy.

Fourthly, one can expect redistribution between the "visible" and "invisible" labor remuneration funds in favor of the latter. However, more reliable conclusions should be based on the analysis of the annual statistics of the system of integrated national accounts.

Fifthly, it is necessary to point out that it would be wrong to draw final conclusions based on the analysis of the indicators' monthly dynamics. In the previous periods, monthly indicators of households' real incomes, wages and pensions were often adjusted (sometimes substantially) by the Rosstat, for example, in March 2017 real wages and salaries were adjusted upwards by 1.7%. So, it is the annual data that are more reliable for final conclusions to be made.

As regards the actual amount of accrued pensions, in May 2017 it amounted to 100.0% on the level of the previous year. It is higher than the level registered in May 2015, but below the one seen in May 2012–2014. In January–May 2017, growth in the actual amount of accrued pensions amounted to 7.2% as compared to the corresponding period of 2016 because a lump-sum payment was made to pensioners in January 2017.

In the Russian Federation as a whole, in Q1 2017 the share of the population with cash income below the subsistence level – it is an official indicator of the extent of poverty – amounted to 15.0%. It is below the level of Q1 2015 and Q1 2016, but higher than the level of Q1 2012–2014[1]. Amid lower prices of fruits and vegetables, growth in the subsistence level value was not high (in Q1 2017 the value of the subsistence level grew by 1.6% in nominal terms as compared to Q1 2016, while the consumer price index of goods and services was growing much faster in Q1 2017 and amounted to 104.6% over the level of Q1 2016). Eventually, the poverty rate diminished somewhat.

The dynamics of the poverty rate greatly varied across regions. From 2013 till 2016, the poverty rate in Russia increased 1.25 times over (from 10.8% to 13.5%). Note that from 2013 till 2016 the poverty rate grew 1.10–1.19 times over in 28 regions; 1.20–1.29 times over in 20 regions and 1.30 and more times over in still other eight regions (the Perm Territory, the Zabaikalye Territory, the Nenets Autonomous Region, the Republic of Kabardino-Balkaria, the Ingush Republic, the Astrakhan Region and the Tyumen Region) (*Fig. 2*). The poverty rate increased less than 1.10 times over in 23 regions and only in 7 regions (the Republic of Kalmykia, the Chechen Republic, the Kostroma Region, the Leningrad Region, the Maritime Territory, the Khabarovsk Region and St. Petersburg) it did not change in 2016 as compared to 2013 or even fell a little.

Having got accustomed to the slowly-rolling crisis (including a permanent slight decrease in real incomes), people do not experience any dramatic wors-

1 On Correlation of Households' Cash Income with the Subsistence Level and the Number of Low-Income People in the Russian Federation as a Whole in Q1 2017 / The Rosstat.

ening of their financial situation any longer. According to the data of the FOM (Public Opinion Fund)[1], more and more people assess positively the dynamics of their financial situation; if in July 2015 and July 2016 the share of people who believed that their financial situation in the past two-three months got worse amounted to 44% and 32%, respectively, in July 2017 it was equal to 28%. In July 2017, the share of people who stated that their financial standing did not virtually change in the past two-three months amounted to 64% (50% and 60% in July 2015 and July 2016, respectively).

Due to the fact that negative developments prevailed in the economy for quite a long period of time, people cannot cut further their consumption. According to the data of the Institute of Sociology of the Russian Academy of Sciences[2], in spring 2017 the share of people who saved on food, as well as clothes and footwear decreased from 51% to 35% and from 61% to 47%, respectively, as compared to the corresponding period of the previous year. Private subsidiary farming became the most widespread option for the population to improve its financial situation: in spring 2017 nearly one third of the respondents (32%) engaged in it against the mere 20% in spring 2014. So, the old-fashioned methods of improving a financial well-being (they were popular during the "survival" crisis of the 1990s), rather than active innovation practices still dominated in people's behavior.

As regards the middle class, in Q2 2017 the share of those who saved on eating out amounted to 69% (73% in the corresponding period of 2016)[3]. Note that 63% of the middle class representatives tried to save on their holidays (60% in Q2 2016). So, the middle class was affected by the crisis, too, and had to adjust its consumer behavior strategies.

According to the data of the Central Bank of Russia, in H1 2017 the volume of individuals' deposits rose by 4.3% (in H1 2016 it fell by 0.7%)[4].

1 FOM, the data of the FOMnibus surveys, July 2015–2017, the sample of 1500 respondents.

2 The Izvestia daily. The Russians have Adapted to the Economic Situation, 11.07.17, https://iz.ru/616017/kirill-kudrin/rossiian-spasaet-ogorod

3 Sberbank CIB, Upgrading of the Ivanov Consumer Index, 11.07.2017, https://sberbank-cib.ru/rus/about/news/index.wbp?number=2589

4 The Central Bank of the Russian Federation. On the Dynamics of the Development of the Banking Sector of the Russian Federation in June 2016 and 2017.

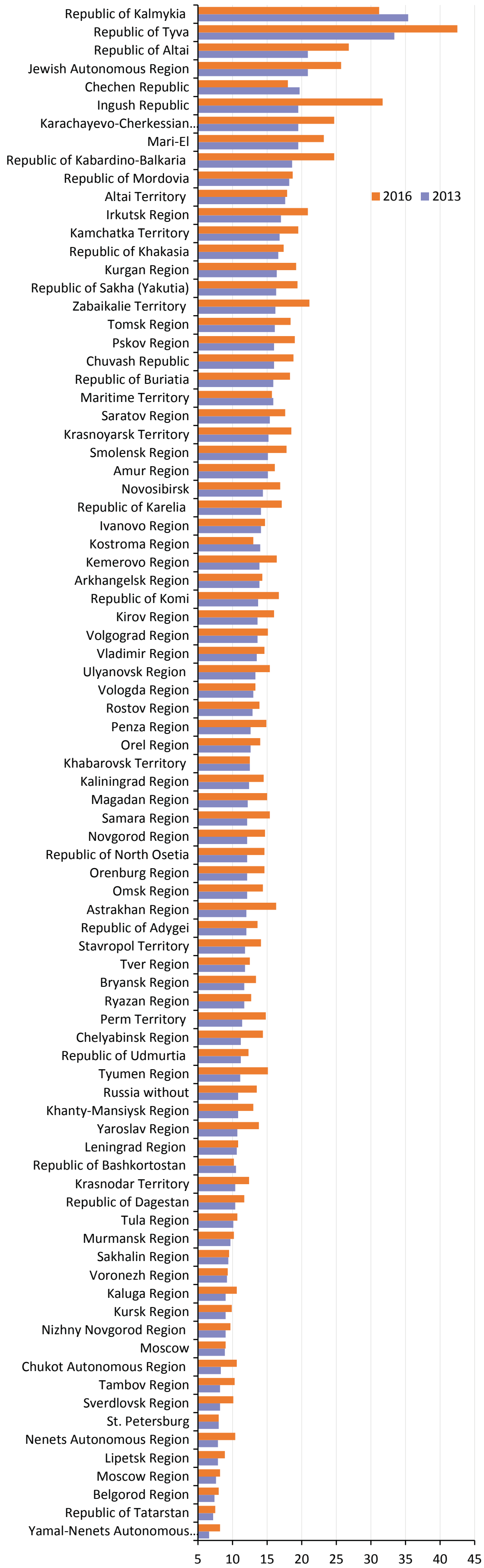

Fig. 2. The number of people with cash income below the minimum susbistence level, %

Source: The Rosstat.

However, it does not mean that savings increased in all income groups. According to the data of the Deposit Insurance Agency, the deposits for the sum of over Rb 700,000 accounted for more than 60% of their entire volume[1], so the dynamics of large deposits had a decisive effect on average indices. For instance, in Q1 2017 the share of deposits below Rb 100,000 fell from 13.6% to 8.6% as compared to Q1 2013, while that of deposits over Rb 700,000 increased from 47.2% to 61.5%[2]. The above is evidence of underlying growth in deposits by better-off people. In June 2017, loans to individuals grew by 1.1% within a month. Generally, in H1 2017 loans to individuals rose by 3.8% (within the corresponding period of 2016 they decreased by 1.0%)

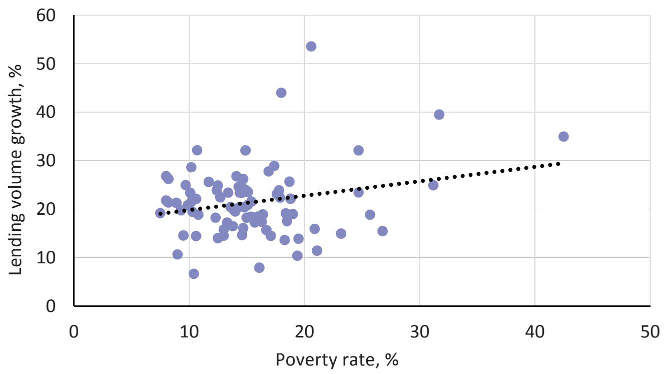

Fig. 3. Distribution of the regions depending on the povery rate in 2016 and growth in the volume of lending to individuals in January–May 2017 as compared to the corresponding period of 2016
Source: The Rosstat

According to the National Bureau of Credit Histories, in H1 2017 the volume of consumer loans increased by 38.4% as compared to H1 2016, while the number of consumer loans, by 28.9%[3].

The analysis shows that growth in the volume of lending to individuals was higher in regions with a higher rate of poverty (*Fig. 3*).

So, the population is trying to make up partially for a long-term drop in real cash incomes through borrowing. A higher growth in the volume of lending to individuals in the worse-off regions points to the fact that borrowing is the only option available to low-income people to make both ends meet.

1 The Deposit Insurance Agency. The Analysis of the Market of Individuals' Deposits in Q1 2017, 22.05.2017, https://www.asv.org.ru/agency/for_press/pr/473533/

2 The Deposit Insurance Agency. The Analysis of the Market of Individuals' Deposits in Q1 2013, 13.05.2013, https://www.asv.org.ru/agency/for_press/pr/296217/

3 The National Bureau of Credit Histories (NBCH): In H1 2017 banks extended Rb 1 trillion worth of consumer loans, 19.07.2017, https://www.nbki.ru/press/pressrelease/?id=21373

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