

# **MONITORING OF RUSSIA'S ECONOMIC OUTLOOK:**

TRENDS AND CHALLENGES OF SOCIO-ECONOMIC DEVELOPMENT

**No. 18(35) November 2016**

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**РАНХиГС**  
РОССИЙСКАЯ АКАДЕМИЯ НАРОДНОГО ХОЗЯЙСТВА  
И ГОСУДАРСТВЕННОЙ СЛУЖБЫ  
ПРИ ПРЕЗИДЕНТЕ РОССИЙСКОЙ ФЕДЕРАЦИИ



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## MAIN TRENDS AND CONCLUSIONS

V.Gurevich

Russia's Prime Minister Dmitry Medvedev said the detention of Economic Development Minister Alexei Ulyukaev is beyond his understanding. Almost the same feeling holds true about Donald Trump's victory in the US presidential elections, including the economic effect thereof.

While US-Russia relations are, at least in part, likely to warm up, the newly elected US President may introduce economic measures whose effect on Russia's economy may be found to be less encouraging than expected. Whether sanctions against Russia will be watered down is beyond understanding for now. However, some of Trump's pre-election initiatives appear to be plausible and potentially feasible.

First, stimulating the US extraction industry. Not only shale deposits can be boosted by lifting bans and introducing tax incentives. These measures can increase considerably the evaluation of serviceable resources, which does not suggest a further fall in crude oil prices that are highly likely to stay as low as they are now, and one should not expect US oil producers to scale back production if crude is traded at \$50 a barrel and to face mass bankruptcies when the crude price goes down to \$40. With Donald Trump as president, the United States may keep hold of the global crude price tag, that was picked up due to the shale revolution, for long enough.

Second, imposing limits on imports of Chinese products. Even if Donald Trump manages to implement at least a few of his protectionist measures, this would be an unpleasant experience and an extra throttle on the economy of China that relies heavily on the US market. Furthermore, this would automatically turn out to be an unpleasant experience awaiting all the resource-based economies.

Third, employing a combination of Trumpanomics elements (not to mention efforts to implement all of them in full) including tax cuts, large-scale infrastructure upgrade, wage raise, decline in external competition, etc. will inevitably entail growth in the yield on US government bonds and hoist expectations of inflation increase. Even if Trump's presidential campaign pledges turn out to be leaner and softer, it is almost most likely that the Federal Reserve will raise interest rates. More importantly, interest rate hikes are likely to be seen on a regular basis within more than a year. For emerging markets, or those willing to become so, this means, in particular, that capital will flight from these markets, lending terms will worsen and commodity prices will drop.

No wonder that Bank of Russia's draft *Guidelines for the Single State Monetary Policy in 2017–2019* considers the US monetary policy as an important factor that has an effect on the Russian economy.

According to our experts, analysis of the draft shows that the regulator's stance is "reasonable and substantiated", including the switch to inflation targeting and a free-floating rouble exchange rate. The experts also agree with the central bank on that mass industry financing based on printing money will not prove an efficient means of industrial development. Furthermore, the regulator points to the fact that the overall debt burden in the corporate sector is heavy enough, and any further expansion of crediting is exposed to

the risk of facing a bad debt crisis. They also believe that if the government see a need for a mass low-rate crediting of selected industries, it would be reasonable to spend budget resources that could be allocated via development institutions. In this context, costs and risks of such a non-profit crediting would apparently be covered by the budget, the price of such a policy would become visible, encouraging more rational appropriation of funds, whereas costs and risks would be covered by the economy if the central bank resorts to financing based on printing money.

However, with the federal budget as it is now, there are serious limits to supporting the industrial sector. This also holds true for regional budgets. Although the equilibrium of consolidated budgets of subjects of the Russian Federation has improved over the past few months (in particular, tax revenues have been higher than the inflation rate), the regional budgets structure by itself makes it unlikely that they would prove a solid source of development. For example, the share of budget expenditure on wages is on the rise, whereas the share of budget investment is shrinking. Overall, according to the experts, the downward trend that since 2009 has been seen in real volume terms of regional budget revenue and expenditure is expected to continue in 2017–2019.

Apparently, the federal budget and regional budgets are very limited in capacity following a plummet in oil and gas revenues. Low prices driven by a supply glut in the global market could raise a bit due to falling production at cost-intensive fields in Canada, USA and in some other regions. However, the downswing was offset in full by growth in the production in some OPEC countries including Iran and Saudi Arabia. Russia is also exhibiting high dynamics in crude production that will hit its highest level in 2016 since the onset of the post-Soviet period.

The experts note that oil production in Russia has been on the rise over the past few years despite crisis developments in the economy, whereas oil refining has been declining in volume terms due to change in domestic demand for refined petroleum products. While analyzing the so-called tax manoeuvre in oil production and refining, the experts note that even the “incomplete version” of the same has spurred change in the production structure of refined petroleum products. The output of gasoline motor fuels has increased slightly, whereas that of dark petroleum products dropped. Exports of refined petroleum products (especially fuel oil and diesel fuel) have begun declining, while exports of crude oil are on the rise in physical terms. Note that growth in physical terms of these suppliers is an attempt to compensate for falling volumes in value terms of crude oil exports. ●

## 1. THE MAIN AREAS OF MONETARY POLICY: PRICE STABILITY, RESISTANCE TO SHOCKS

**E.Goryunov, S.Drobyshevsky, P.Trunin**

*The draft Guidelines for the Single State Monetary Policy (hereinafter – the Draft) prepared by the Bank of Russia does not involve significant changes in monetary policy in the upcoming mid-term period. Russian monetary authorities see their main task in maintaining price stability and improving financial sector resilience to possible macroeconomic shocks. The Bank of Russia does not give up the goal of reducing consumer inflation to 4% by the end of 2017, so the regulator plans to maintain a moderately tight monetary policy. There are no plans for active intervention in the foreign exchange market, and the exchange rate will remain floating.*

The consistency of the monetary authorities is due to the fact that the actual macroeconomic dynamics generally corresponds to that predicted by the regulator when determining the target parameters of monetary policy. Foreign economic background has been relatively stable in the last year, and Russian economy has continued to adapt to the new levels of oil prices and the new level of the exchange rate.

### **The risk of emission lending**

The Draft emphasizes that rapid economic development is impossible without changing the growth model from that oriented on raw materials to that oriented on investment. High prices for hydrocarbons was the factor leading to the increase in output in Russia in the 2000s. The growth was extensive in nature and not accompanied by diversification of the economy. The potential of this model is now exhausted, so steady growth is only possible if there are structural reforms, which, according to the Bank of Russia, should be focused on increasing productivity and management efficiency, renewal of fixed assets, development of infrastructure and creation of high-quality institutions.

The monetary authority considers its role in this process to be to create conditions for economic growth, which involves ensuring normal money circulation with predictable inflation, maintaining substantial margin of safety of the financial system which excludes the possibility of a large-scale financial crisis, and managing interest rates in order to stimulate people to have a sufficient level of savings.

The Bank of Russia is critical of the possibility of large-scale use of concessional lending as a mechanism to stimulate growth, but allows some limited use of such measures to support individual businesses and industries. Massive emission financing of the industry, according to the Central Bank, will only accelerate price growth, undermine economic and social stability, but will not be an effective instrument for production development due to the lack of effective mechanisms of selecting the most promising investment projects. At the same time, the regulator estimates the total debt burden in the corporate sector as high, so further expansion of lending will lead to increasing imbalances and create the risk of bad debt crisis.

Also, the Bank of Russia is negative about the idea of returning to active monetary policy since they assume that free market pricing makes the exchange rate more responsive to external conditions, which helps the economy to adapt smoother to the changing environment. Exchange rate fluctuations may be significant, which would have a negative impact on macroeconomic processes, but as low diversification of the Russian economy and the dominance of raw materials in the structure of exports are fundamental causes of these fluctuations, monetary policy measures alone can not solve the problem of exchange rate volatility.

The Bank of Russia's viewpoint set forth in the Draft seems to us reasonable and justified. The strategic choice made by the Russian Central Bank when it decided for inflation targeting and switching to the regime of floating exchange rate has a solid scientific foundation and corresponds to the best international practices of monetary policy. The monetary regime chosen by the Bank of Russia can help manage the problems that can be solved with measures of monetary policy, while it does not involve attempts to influence the macroeconomic parameters which the Central Bank cannot effectively influence in the long term. These parameters include the potential level of output, rate of monetization of the economy, real exchange rate and real lending rate.

One can agree with the Bank of Russia's position that massive lending to industry by the Central Bank is undesirable. Moreover, soft lending, as well as other industrial policy measures, in our opinion, are not intrinsically related to monetary policy. If the government finds it necessary to actively give loans to selected sectors at lower rates, it would be right to use financial resources of the budget for these purposes. Those resources would be distributed through the corresponding development institutions. In this case, the costs and risks associated with non-profit lending will explicitly be on the budget reflecting the real cost of this policy and providing incentives for more efficient allocation of resources. At the same time, in case of emission lending by the Central Bank, the costs and risks will be on the entire economy as inflation tax burden.

#### **Factors of macroeconomic dynamics**

The Bank of Russia determines internal and external factors that will play a decisive role in mid-term macroeconomic dynamics. Among them, there are hydrocarbons market conditions, economy growth rate in Russia's partner countries, monetary policy in major economies (primarily the USA), and Russian government's fiscal policy. The Russian Central Bank is considering three scenarios, from oil prices dropping to \$25 per barrel to their growth up to \$50. Presumably, the fiscal policy in all scenarios will follow the approved conservative course. The proposed scenarios appear to be reasonable, but the Draft does not provide detailed commentary on the Central Bank's actions in case the actual policy of the Russian Ministry of Finance will be softer than planned. This course of events cannot be excluded, so it would be interesting to have a more detailed discussion on the measures that could be taken by the Central Bank in such case.

#### **Interest rates**

The policy of high real interest rates deserves a special comment. The aim to achieve price growth of 4% by the end of 2017 is very ambitious given the inertia of Russian inflation. In order to realize these intentions and anchor

inflation expectations of economic agents, the Bank of Russia conducts conservative interest rate policy. Over the past year, the key interest rate was reduced by only 1 p.p. while the inflation rate over the same period fell by nearly 9 p.p., and this, considering the simultaneous reducing of the expected inflation, means a significant increase of the real interest rate and tightening of monetary policy. Maintaining the positive value of real interest rate of the money market helps to curb the rise in prices by increasing the attractiveness of savings and thus helps to achieve the inflation target of 4% by the end of 2017. At the same time, it carries downside risks to economic activity. The main areas of last year's monetary policy were accompanied by commentary on recession risks; in the new Draft, these risks are not discussed. In our opinion, the document lacks the estimates of the probability of growing real interest rates' possible negative impact on economic growth.

#### **Information policy and market expectations**

The effectiveness of the regulator's information policy which implies influence on economic agents' expectations could be higher, in our opinion. It is the rate of inflation, when it's targeted, that is the most important factor of the effectiveness of monetary authorities' influence on the dynamics of prices and output through the expectations channel. To date, according to the Draft, economic agents expect that inflation will be higher than the one expected by the Russian Central Bank, and the key interest rate will be lower, respectively.

This mismatch between the market's expectations and the regulator's plans poses a threat of recession. If the Bank of Russia continues to follow the chosen course, the monetary policy will be tighter than expected by economic agents, which will be followed by a reduction in investment, a fall in aggregate demand, and the economic downturn. If the monetary authorities give up the target goals and adapt to current expectations by lowering the rate, economic agents will take it as an additional reason not to trust the regulator's declarations about achieving inflation target goals. The consequence of this would be increased inflation due to the background of high inflation expectations.

Thus, the mismatch between the Bank of Russia' plans and market players' expectations can have adverse effects either as a recession or as a loss of the regulator's reputation.

Although monetary authorities see the discrepancy between market expectations and their own intentions, they do not acknowledge the lack of efficiency of their information policy. In fact, economic agents' lack of trust in the Bank of Russia' claims is a significant limitation to the effectiveness of its policies, so the monetary authorities should pay special attention to this problem. In our opinion, the reason for limited trust in the Bank of Russia's declarations is not so much a lack of transparency of the interest rate policy, but rather the lack of provided information and outreach. Besides that, economic agents' trust in the Bank of Russia is strongly negatively impacted by the fact that the Bank of Russia has historically almost never reached the stated inflation targets.

In general, the monetary authorities' policy described in the Project is quite reasonable and justified from both the theoretical and practical points of view. The clear orientation of the monetary policy on achieving only the goals that can in principle be achieved with monetary measures seems right.

The overly optimistic plan to reduce price increase to the target level by the end of 2017 causes some doubts, but after the Central Bank publicly announced this intention, giving it up for a softer policy will lead to a loss of trust in the Bank of Russia. At the same time, economic agents' expectations regarding the interest rate policy differ markedly from the monetary authorities' plans, and the Bank of Russia has not yet succeeded in winning their full confidence in its policy. ●



## 2. REGIONAL BUDGETS: AT THE END OF TETHER

### A.Deryugin

*Improved parameters of the consolidated budgets balance of the subjects of the Russian Federation in July-October 2016 triggered by growing rates of budget revenues and curbing of expenditure growth will allow retaining the values of major budget indices at the 2015 level in real terms. Meanwhile, currently regions have got to the limits of their possibilities to raise wages to those categories of public employees who were indicated in May 2012 presidential decrees. Expected onward contraction of real volume of regions' revenues and expenses in 2017-2019 can lead to the incomplete implementation of decrees, further distortion on the structure of regional and local budgets' expenditures, debt problems as well as to the slowdown of economic growth rates.*

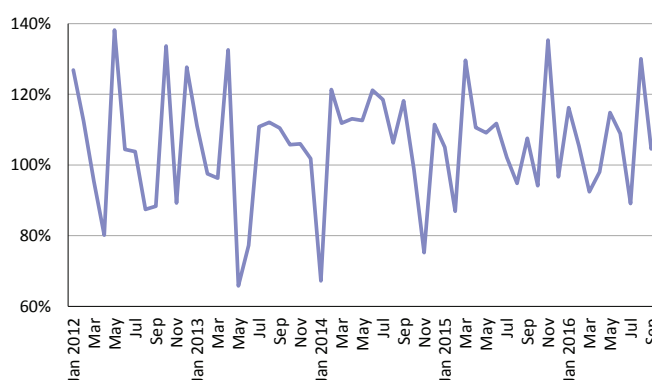
#### Revenues

According to preliminary results of regional and local budgets execution for 10 months of 2016, revenues of the consolidated budgets of the subjects of the Russian Federation have moved up by 4.4% in comparison with the same period of last year, meanwhile by H1-end this growth came to barely 2.7%. The number of regions' consolidated budgets whose revenues exceeded the corresponding level of last year has gone up (67 against 55 by H1-end), as well as the number of regions' consolidated budgets whose revenues growth rates exceeded the inflation level for 12 months (34 against 24). This is attributable to relatively good indicators of revenues growth registered in August (130.0% on August 2015) and October (113.9% on October 2015) (Fig. 1).

Thus, average growth rates of the consolidated budgets' revenues of the RF subjects for 10 months of 2016 have significantly come close to the level of the consumer price index for 12 months (106.1%), which gives some hope for retaining real volume of regional revenues at the 2015 level.

Having said that, dynamic of the RF subjects' consolidated budgets' revenues continues to be volatile, which hampers to forecast the developments to 2016-end.

Higher growth rates of the consolidated budgets' revenues are attributable to increasing average growth rates of proceeds generated by the corporate income tax (113.3% for July–August 2016 against 100.7% for H1 on the corresponding period of the previous year), excises (138.2% against 130.2%), tax on the assets of organizations (117.2% against 106.8%) as well as non-repayable receipts obtained from the budgets of other levels (101.6% against 89.5%).



Source: Calculated on data released by the Federal Treasury.

Fig. 1. Growth rates of general revenue volume of consolidated budgets of the RF subjects, to the same period of last year, %

Moreover, despite somewhat decrease of growth rates of proceeds from PIT (106.5% for July–August 2016 against 108.4% for H1), they have remained above the inflation, which to a considerable extent was due to positive dynamics of the PIT tax base, which since the turn of the year has come out of the prolonged downward trend (Fig. 2).

Thus, average growth rates of tax revenues by the period-end of 10 months of the current year have come to a level exceeding the inflation rate for 12 months and the only factor, which slows down regional and local budgets' revenues are non-tax revenues (growth from the turn of the year – 102.3%) as well as non-repayable receipts from the budgets of other levels (94.3%).

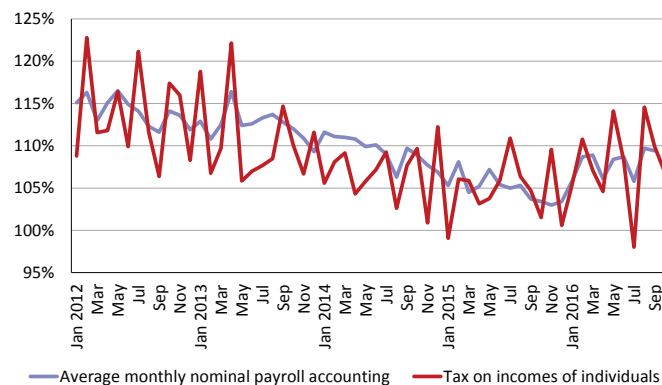
Geographically, there is a rather mixed situation: each federal okrug has regions with relatively high and low growth rates of budget incomes and the average indicators of growth rates of consolidated budgets' revenues across federal okrugs stay relatively close. If we analyze the situation from the point of view of a ratio of number of regions' consolidated budgets whose revenues grew faster than inflation to the total number of regions in the okrug, then leaders by growth rates are Far-Eastern and North-Western federal okrugs (67 and 55%, respectively), and lagging behind North-Caucasus (14%), Central (22%), and South (25%) federal okrugs.

### Expenditure

By the period-end of 10 months of 2016, total growth the RF subjects' consolidated budgets' expenditures has come to 104.2% on the same period of the previous year, which is below inflation registered for 12 months. Main curbing owed to wages, which in nominal terms have remained around the last year's level (100.1%). At the same time, by H1-end, one can note a significant growth of public and non-public social payments (114.1% to H1 2015), which is determined by the indexation following high inflation registered in 2015.

High rates of capital investment growth posted by H1-end (149.7% to H1 2015) have shrunk to 104.7% by 10 months-end, which attributes to their more active disbursement in H1, which, in its turn, was due to current phases of the electoral cycle in Russia. Consequently, further reduction of real volume of capital expenses from regional and local budgets is expected by the end of 2016.

Reduction of real expenditure volume had an impact on the implementation of May Presidential Decree No. 597 (2012), which envisages bringing salaries of a number of categories of state and municipal employees to the level of average or double average level existing in the economy. According to the Program of step-by-step improvement of the compensation plan in state (municipal) organizations for 2012–2018, ratio of average salary of state employees and average wage in the economy must annually grow to reach



Source: calculated on data released by the Federal Treasury and Rosstat.  
Fig. 2. Growth rates of the total volume of proceeds from PIT into consolidated budgets of RF subjects and average monthly nominal payroll accounting, % against the same period of previous year

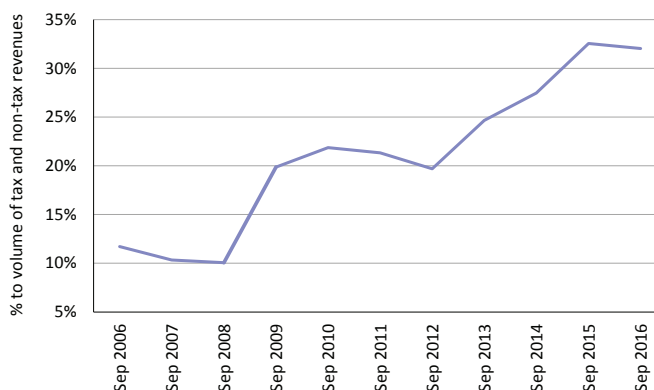
the target level. Along with that in H1 2016 compared to H1 2015, deterioration of indices of its implementation has been observed: “delay” of the target value has increased on a majority of categories: across 9 categories on the regional level, and across 7 categories on the municipal one. This fact either speaks about reaching regional potential to increase pay increase for “mentioned” categories or is purely technical consequence of growing rates of average wage in the economy (Fig. 2).

**Budgets balance and public debt**

Increased growth rates of budget revenues of RF subjects and decline of growth rates of expenditure registered in H2 2016 have improved general parameters of regional budgets balance. As a result, total current surplus of regions’ consolidated budgets by the period-end of 10 months of 2016 has surpassed corresponding indicator for the same period of last year (Rb 539.7 bn against Rb 503.0 bn).

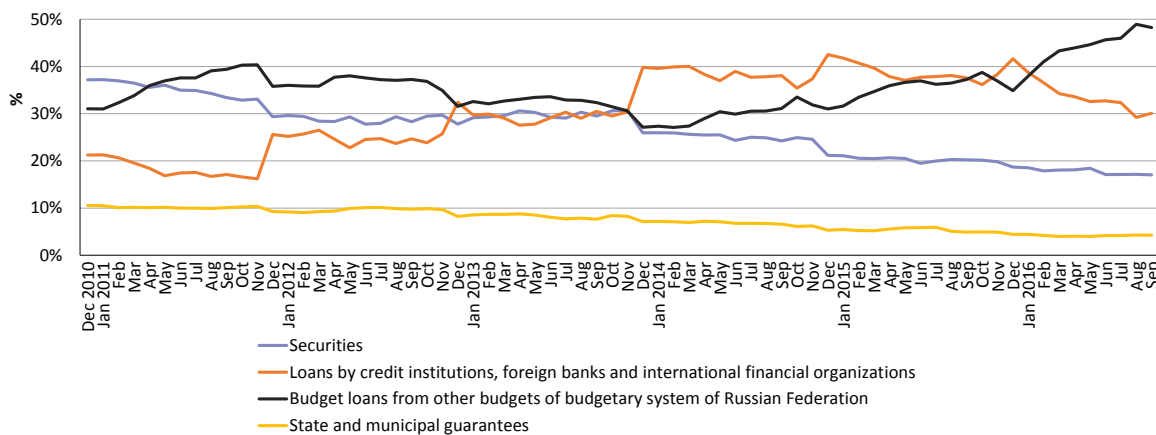
Improvement of parameters of regional budgets balance was bound to tell on the dynamics of regional public debt. For example, despite some growth of its nominal volume from Rb 2.17 trillion posted in September 2015 to Rb 2.26 trillion registered in September 2016, its ratio to the volume of tax and non-tax revenues of regional budgets has shrunk for the same period from 34.2 to 33.5%, which happened for the first time during last 4 years (Fig. 3).

Despite some average contraction of tax burden of the regions, the number of RF subjects has gone up whose ratio of public debt to the volume of tax and non-tax revenues of corresponding budgets exceeds 100%: from 11 posted in September 2015 to 13 registered in September 2016 and exceeding the level of 125% – from 3 to 4.



Source: calculated on data released by the Finance Ministry of Russia and the Federal Treasury.

Fig. 3. Dynamics of public debts of RF subjects, % to the volume of tax and non-tax revenues of budgets of RF subjects



Source: Calculated on data released by Finance Ministry of Russia.

Fig. 4. Structure of public debt of the subjects

Herewith, one needs to remember that the RF Budget code sets caps on corresponding ratio for general regions at the level of 100% and for highly subsidized ones – at the level of 50%. This limitation does not extend to budget credits until 1 January 2018. However, after that date, it is highly likely that over a dozen of regions will break this requirement, following which the issue of excessive regional overburdening with public debt will become a federal issue.

With respect to the structure of regional public debt, there is an ongoing upward trend in federal budget loans, which as of September 2016 came to 48.2% resulting from the growth of public budget loans, which commenced since 2014 aimed at replacing expensive commercial loans (Fig. 4).

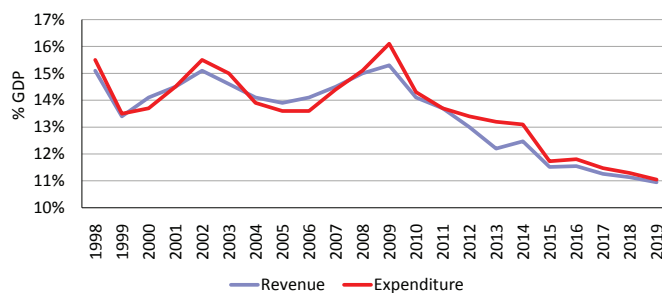
### Forecast

According to the forecast of the consolidated budgets' parameters of RF subjects indicated in materials to the draft law "On the Federal Budget for 2017 and the 2018–2019 planning period" (hereinafter – Draft law), the downward trend in real volume of budget revenue and expenditure unfolding since 2009 will be retained in the course of 2017–2019 (Fig. 5).

Contraction of real revenue volume by 2019 by 0.6% of GDP in comparison with 2016 will be due to a reduction of tax and non-tax revenue (constitutes 0.3% of GDP and linked with a transfer of 1.0% of income tax to the federal budget) and interbudgetary transfers from the federal budget (0.3% of GDP).

Centralization of part of corporate income tax at the rate of 1.0% commencing from 2017 with further reallocation of the corresponding volume among RF subjects via the system of interbudgetary transfers will not result in the increase of real revenue volume because it will be totally offset by a contraction of actual volume of subsidies and other types of transfers from the federal budget. For example, in 2017–2019 real volume of interbudgetary transfers from the federal budget will come to 1.77, 1.64 and 1.46% of GDP, respectively. This will be below the 2016 level (1.78% of GDP) and significantly lower average value for the period of 2005–2015 (2.4% of GDP).

Planned contraction of real volume of the consolidated budgets' expenditure (Fig. 5) happens without a corresponding change in the delineation of powers between federation and regions. Moreover, according to the Presidential Decree of 7 May 2012 No. 597 "On Measures for the Implementation of State Social Policy," salaries of 12 categories of public sector workers should be brought to the target values by 2018. Therefore, the actual volume of regional commitments, on the contrary, should move up. Its forecast contraction, obviously, will be owing to exclusively budgetary caps: reduction of real volume of the consolidated budgets revenue volume of RF subjects as well as decrease of the deficit due to tighter restrictions of the budget law. (Reduction of the deficit volume limit has been planned from 15 to 10% of the approved total annual volume of budget



Source: 1998–2015 – calculated on data released by Federal Treasury based on budget execution reports; 2016–2019 – calculated proceeding from parameters produced in the materials for the Draft law.

Fig. 5. Dynamics of revenue and expenditure of consolidated budgets of RF subjects, % to GDP

revenue of RF subjects minus approved volume of non-repayable transfers).

Consequently, financial outlook of the regions will be deteriorating, which will result in further distortion of structure of regional budgets expenditure.

According to calculations made by RANEPА's experts based on the data released by the Finance Ministry and Rosstat, in the wake of contraction real volume of expenditure of consolidated budgets of RF subjects (minus Republic of Crimea and the city of Sebastopol), the spending on gross payroll of "mentioned" categories went up from 1.69% of GDP in 2012 to 1.7% of GDP in 2015 and is expected to be at the level of 1.84% of GDP in 2016. Along with this, there is a reduction of the total number of "indicated" categories of the public sector workers (by 5.1% for the period since 2013 up to mid-2016). Despite this fact, the share of budget spending on gross payroll has moved up from 28.5 to 32.6% of the total volume of expenditure of regional consolidated budgets. Meanwhile, the share of budget investment has fallen from 13.4 to 10.1%. Forecast continuation of these trends creates preconditions for the slowdown of economic growth.

Possibilities for replacing commercial loans with budget ones in 2017–2019 will also be restricted. Draft law envisages decrease of the volume of the budget loans origination in 2017–2018 threefold compared to 2016 – from Rb 310bn to Rb 100bn and to Rb 50bn by 2019. Thus, there will appear preconditions for building up expensive commercial debt, which will also reduce investment potential of regions. ●

### 3. OIL MARKET: LOW PRICES RETAINED

Y.Bobylev

Low world crude oil prices have resulted in scaling back oil production on high-cost oil deposits and in contraction of investment in the development of unconventional deposits. At the same time, reduction of crude oil extraction from the cost-intensive deposits, first of all, in the US, is offset by the built up production by leading OPEC countries who strive to increase their market share. In 2016, Iran and Saudi Arabia have significantly raised their crude oil output. Russia has also built up production, which hit all-time high since 1990. In 2017, one should expect relatively low oil prices to remain. At the same time, some growth is feasible in comparison with the current year.

The current oil glut market has led to a significant drop of the world prices on oil. The fast growth in tight oil production in the United States was the main factor for supply increase. In this context, OPEC refused to reduce set quotas of crude oil production and actually conducted policy of retaining its market share. As a result, in 2015, average price of Russian Urals moved down to \$51.2 per barrel, and in January–October 2016 averaged \$40.6 per barrel (Table 1). In January, it fell to \$28.8 per barrel, and in October constituted \$47.7 per barrel (Fig. 1).

Table 1

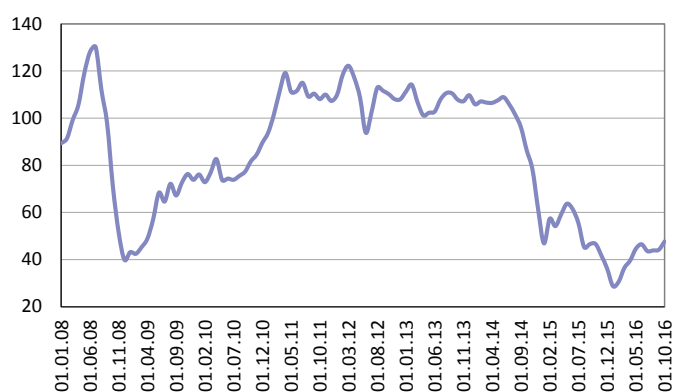
WORLD OIL PRICES IN 2014–2016, USD/BBL.

	2014	2015	2015 Q4	2016 Q1	2016 Q2	2016 Q3
Price of Brent, Great Britain	98.9	52.4	43.4	34.4	45.9	45.8
Price of Urals, Russia	97.7	51.2	41.5	32.0	43.6	43.9

Sources: IMF, OECD/IEA.

Owing to low prices posted in 2016, downward oil output trend in the cost-demanding oil-fields was retained, first of all regarding tight oil reserves in the US. The US production of oil peaked to 9.6 mn/bbl per day in April 2015, following which it decreased to 9.2 mn/bbl per day in December 2015, and 8.5 mn/bbl per day in September 2016. It fell by 11% in comparison with April of last year (Fig. 2). Oil output is falling also in China, Mexico, and Australia.

In the wake of low oil prices, investment in the development of the most cost-intensive oil-fields, tight oil in US, bituminous sands in Canada, and



Source: OECD/IEA.

Fig. 1. Price of Urals in 2008–2016, USD/bbl

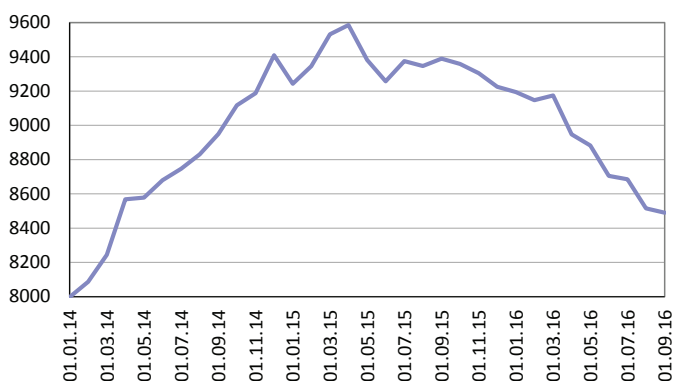
deep-water deposits in various parts of the world has shrunk significantly. For example, the number of active oilrigs reached the maximum of 1,596 in October 2014, after which reduction of their number followed (Fig. 3). In December 2015, the number of rig count came to 537 and in September 2016 – 416. In other words, the number fell by 74% in comparison with the pre-crisis period. Downward trend in the investment activity will result in the new future in further fall of the oil output in the United States. Further dynamics of the oil production in the country will depend on the global crude oil prices, as well as on the policy conducted by the new US administration regarding introducing preferential tax treatment of oil companies and allocation of new license blocks.

Contraction of cost-intensive production could have reduced oversupply of crude oil and create preconditions for surge of global oil prices. Policy conducted by OPEC presents a serious problem. Those countries strive to extend their market share. Those governments whose revenues decisively depend on the oil export with depressed oil prices enhance incentives to expand the market share. By raising supplies, they want at least partly to offset contraction of revenues owing to the oil price plunge. As a result, contraction of output in high-cost regions currently is offset by production growth in OPEC.

Saudi Arabia, the largest OPEC oil producer, has significantly raised oil output: by 0.96 mn/bbl per day over last two years (by 0.37 mn/bbl per day in 2015 and 0.59 mn/bbl per day in 2016). Iraq, the second largest oil producer in OPEC, has made a major contribution in oil oversupply in 2015 by increasing the output by 0.82 mn/bbl per day. In 2016, Iran, the third largest oil producer in OPEC, was a major “destabilizer” on the oil market. Thanks to lifted sanctions, Iran increased oil output from 2.8 mn/bbl per day in Q4 2015 to 3.65 mn/bbl per day in Q3 2016 (Table 2). Thus, output growth in Iran completely offset output contraction in the US in 2016. In the end, there was a constant excess of the previously set production quota on oil production by OPEC (30 mn/bbl per day).

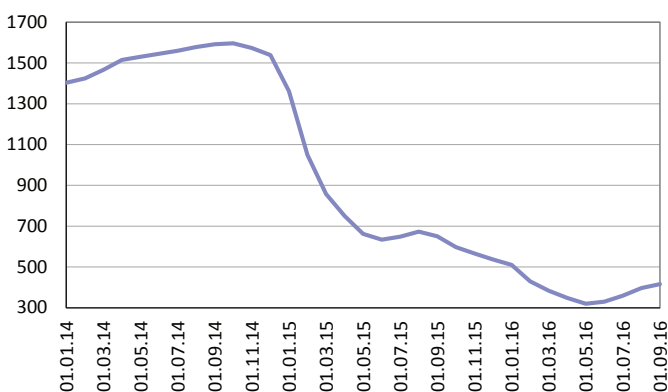
Russia also boasts of upward trend in oil production (Table 3). According to preliminary estimates, Russia’s crude oil output will hit 544 m t, which is the highest level since 1990. Recent years’ investments and the ruble’s devaluation have significantly contributed to the crude oil production.

A number of factors, which contribute to retention of relatively low oil prices, characterizes current global oil market. The paramount among them



Source: USEIA.

Fig. 2. Oil production in USA in 2014–2016, thousands of barrels per day



Source: Baker Hughes.

Fig. 3. Number of active rigs in the US in 2014–2016

Table 2

## OIL OUTPUT IN US AND OPEC IN 2014–2016, MN BARRELS PER DAY

	2014 Q4	2015 Q1	2015 Q2	2015 Q3	2015 Q4	2016 Q1	2016 Q2	2016 Q3
USA	9.25	9.49	9.47	9.41	9.30	9.17	8.85	8.68
OPEC, total	30.34	31.06	31.74	32.19	31.99	31.77	32.41	32.84
Saudi Arabia	9.63	9.73	10.07	10.22	10.00	9.98	10.33	10.59
Iraq	3.53	3.49	3.97	4.30	4.35	4.29	4.38	4.42
Iran	2.80	2.80	2.80	2.80	2.80	3.03	3.57	3.65

Source: USEIA.

are significant volumes of tight reserves in the US, which will be rapidly drawn into development and will increase supply with oil prices above \$60 per barrel; slowdown of economic growth in China; highly low level of discipline in OPEC, as well as feasibility of increasing production in certain countries, which are beyond OPEC. In this context, retention of relatively low prices of oil in the years to come is the most likely prospect for the oil market.

At the same time, in 2017, owing to a fall of tight oil production and reduction of oversupply of oil, some increment of global oil prices is feasible in comparison with the current year. Latest forecasts made by leading international organizations regarding global oil prices for 2017 stay in the range of \$45–55 per barrel. According to the IMF forecast basket price for oil in 2017 will come to \$50.6 per barrel, the World Bank forecast – \$55.2 per barrel, the US Energy Information Administration – \$50.9 per barrel, OPEC – \$45 per barrel. Some growth of world oil prices is expected in the future. For example, according to the IMF forecast, in 2018 the oil price will hit \$53.1 per barrel (Table 3).

Table 3

## FORECASTS OF GLOBAL OIL PRICES, USD/BBL

Organization	2017	2018
International Monetary Fund: basket price of oil*	50.6	53.1
World bank: basket price of oil *	55.2	59.9
OPEC basket price	45.0	50.0
US Energy Information Administration: Brent price	50.9	

\* Average price of Brent, Dubai and WTI.

Sources: IMF, WB, OPEC, USEIA.



## 4. THE IMPLICATIONS OF TAX MANEUVER: PRODUCTION OF OIL AND PETROCHEMICALS

**A.Kaukin, A.Knobel, A.Firanchuk**

*A tax maneuver in the oil and oil refining industries contributed to some changes in the pattern of production of petrochemicals: the total volume of oil refining decreased, while the volume of production of motor gasoline increased somewhat. It is to be noted that the tax maneuver had an effect on the pattern of exports of petrochemicals, too: with duties increased on residual oil its exports fell dramatically, while with export duties reduced on commercial gasoline, directly distilled gasoline and light and medium distillates their exports increased. Reduction of export duties on diesel fuel brought about growth in its share in the total exports of petrochemicals.*

### **Production of Oil and Petrochemicals**

Late in 2014, amendments of the tax legislation in the oil and oil-refining sector were approved and they were called a “tax maneuver”<sup>1</sup>.

According to the parameters of the tax maneuver, the ratio of the Russian oil price in the export duty calculation formula should be gradually reduced to 0.42, 0.36 and 0.30 in 2015, 2016 and 2017, respectively. Simultaneously, it was expected to increase the severance tax base rate to Rb 766 per ton, Rb 857 per ton and Rb 919 per ton, respectively. In addition to the above, export duty rates on petrochemicals linked to the value of export duties on oil were adjusted further: as regards light petrochemicals they decreased, while as regards dark ones, they rose. Also, some reduction of excises on petrochemicals was provided for.

The purpose of the above changes was to promote efficiency of the Russian oil refining industry which during the past few years produced a negative added value in terms of global prices. The complete version of the tax maneuver<sup>2</sup>, which was not actually implemented and was only partially reflected in changes of the legislation suggested that by means of nulling of export duties on oil and petrochemicals with a simultaneous raising of the severance tax rate on oil the Russian vertically integrated companies (VIC) would have motivation to modernize oil refineries, increase oil refining depth and change the pattern of petrochemicals so that either the share of light fractions increases or inefficient loss-making industries are closed down<sup>3</sup>.

In 2016, a deviation from the tax maneuver’s initial parameters – which were approved in 2014 – took place: reduction of oil exports was frozen for

1 Federal Law No.366-FZ of 24 November 2014 “On Amendment of Part Two of the Tax Code of the Russian Federation and Individual Statutory Acts of the Russian Federation.”

2 For more details on factors behind the tax maneuver, refer to: G.I. Idrisov and S.G. Sinelnikov-Murylev. Export Oil Duties: It is Impossible to Abolish, It is Impossible to Preserve // The Neft Rossii. Issue No.12, December 2011, pp. 72–77; G.I. Idrisov and S.G. Sinelnikov-Murylev. Modernization or Conservation: The Role of Export Duties on Oil and Petrochemicals // The Economic Policy. 2012. No 3. pp. 5–19.

3 On the Effect of the Tax Maneuver on Oil and Gas Transfers in the Eurasian Economic Union. See: A.Yu. Knobel. The Eurasian Economic Union: The prospects of Development and Possible Obstacles // Voprosy Ekonomiki. 2015. No. 3, pp. 87–108.

a year<sup>1</sup>, while the severance tax rate smoothly increased. Apparently, such changes were related to the need to increase budget revenues after the crisis 2015 year.

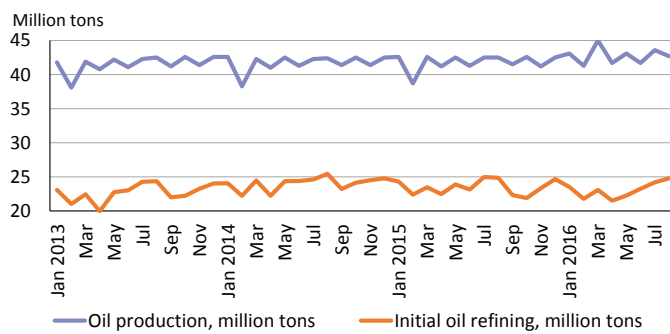
In terms of the consequences of those changes for volumes of oil production and refining in 2015–2016<sup>2</sup>, the effect is insignificant (Fig. 1).

Despite the crises phenomena in the Russian economy, the volume of oil production rose every year<sup>3</sup> (including 2016 on the basis of the results of the three quarters), while the share of refined oil fell gradually from 57.7% in 2014 to 53.9% in the first three quarters of 2016.

It is to be noted that the observed dynamics of oil production and refining could be related among other things to changes in domestic demand on petrochemicals; such changes were caused by a general drop in demand in the economy during the crisis period.

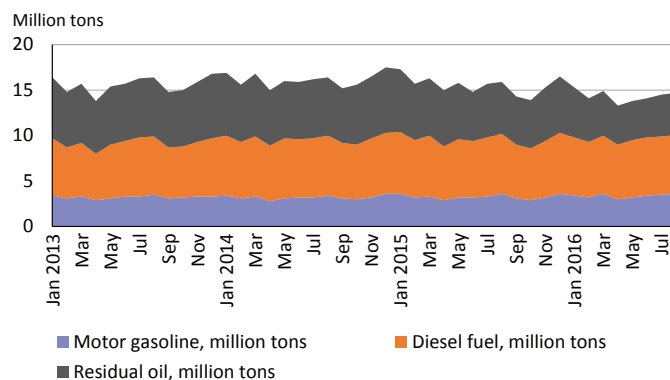
Changes in the output pattern of Russian oil refining companies are most explicit (Fig. 2). The ratio of the volume of produced motor gasoline to that of primary oil refining at refineries increased from 14.1% in 2014 to 14.4% and 14.5% in 2015 and the first three quarters of 2016, respectively. It is to be noted that a similar indicator for residual oil changed more considerably: from 28.7% in 2014 to 26.2% and 20.1% in 2015 and the first three quarters of 2016, respectively. The share of the produced diesel fuel fell from 28.2% to 27.9% and 27.3%, respectively.

So, it can be cautiously stated<sup>4</sup> that even the incomplete version of the tax maneuver contributed to some changes in the pattern of production of petrochemicals: the total volume of oil refining fell primarily due to reduction of output volumes of dark petrochemicals, while the output volume of motor gasoline increased somewhat.



Source: The Rosstat, The Short-Term Economic Indicators of the RF

Fig. 1. Dynamics of Oil Production and primary processing of petrochemicals in Russia in 2013–2016.



Source: The Rosstat.

Fig. 2. Dynamics of production of petrochemicals in Russia in 2013–2016

1 According to the draft of the 2017 Federal Budget, the formula of calculation of export duties next year will correspond to the values approved in 2014. .

2 Henceforward, the dynamics of indicators in 2016 is described by changes in the first three quarters of 2016 as compared to the first three quarters of 2015.

3 The consequences of the crisis for the domestic oil industry were insignificant as compared to processing sectors as the new level of prices on oil was acceptable for producers: first, a larger portion of the industry's costs was denominated in rubles and, second, a drop in oil prices affected largely the state's revenues and not the oil industry. For more information, see: G. Idrisov, A. Kaukin, O. Morgunova and M. Turuntseva. The Two Centers of the Russian Industry // The Online Monitoring of Russia's Economic Outlook: Trends and Challenges of the Socioeconomic Development. Issue No.11 (September 2015), pp. 19–22.

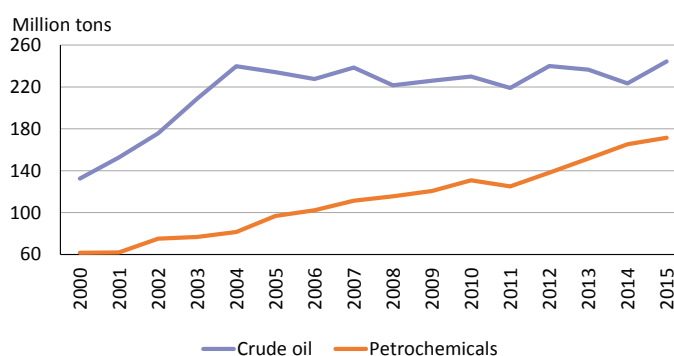
4 The period under review is affected by consequences of crisis phenomena in the Russian economy.

### Exports of Oil and Petrochemicals

The analysis of dynamics of the Russian exports of oil and petrochemicals shows that starting from 2004 exports of crude oil from Russia were fairly stable (in physical terms); their fluctuations amounted to 219 m tons and 244 m tons in 2011 and 2015, respectively. At the same time, considerable growth in exports of petrochemicals continued (Group 2710 of the Harmonized System Codes) from 81m tons in 2004 to 172m tons in 2015 (Fig. 3).

Dynamics of exports of petrochemicals and crude oil are given in Table 1; the data were given for January–August of all the

years for the sake of comparison with 2016. In the first eight months of 2016 physical volumes of exports of crude oil rose by 6% as compared to the same period of 2015, while the volumes of exports of petrochemicals in the first eight months of 2016 fell by 11%, but still exceeded the values of 2013. In 2013–2015, volumes of exports of residual fuel and diesel fuel were growing, but in 2016 they fell dramatically. It is to be noted that fairly sustained growth in physical volumes of exports was demonstrated by directly distilled gasoline, commercial gasoline, light distillates and lubricants.



Source: The RF Federal Customs Service.

Fig. 3. Dynamics of the Russian exports of crude oil and petrochemicals in 2000–2015

Table 1

#### PHYSICAL VOLUMES OF EXPORTS OF CRUDE OIL AND PETROCHEMICALS, JANUARY–AUGUST OF THE RESPECTIVE YEAR

Name of the position	Volumes of supplies, million tons				Change in physical volumes, %	
	2013	2014	2015	2016	2016/2013	2016/2015
<b>Crude oil</b>	155.6	149.2	160.0	170.0	+9	+6
<b>Petrochemicals:</b>	100.1	110.3	117.0	103.7	+4	-11
Residual oil	55.3	57.3	61.0	48.4	-12	-21
Diesel fuel	28.9	32.9	35.7	32.4	+12	-9
Directly distilled gasoline	9.85	11.02	11.40	11.91	+21	+5
Commercial gasoline	3.52	6.38	6.01	7.39	+110	+23
Other:	2.6	2.7	2.9	3.5	+37	+19
Light distillates; medium distillates	1.76	1.98	2.22	2.41	+37	+8
Trimers and tetramers of propylene	0.02	0.02	0.02	0.01	-28	-32
Lubricants; other	0.78	0.69	0.69	1.07	+37	+55
Waste oils	0.0002	0.0002	0.0000	0.0002	+5	to 11-times
<b>Total</b>	<b>255.79</b>	<b>259.54</b>	<b>277.01</b>	<b>273.65</b>	<b>+7</b>	<b>-1</b>

Source: The authors' calculations on the basis of the data of the RF Federal Customs Service.

Dynamics of the unit weight of different petrochemicals in the total exports of petrochemicals (to all the countries, except for the Eurasian Economic Union) correlates negatively with changes in export duties<sup>1</sup> on those types of commodities (Table 2 and Fig. 4). With no export duties imposed

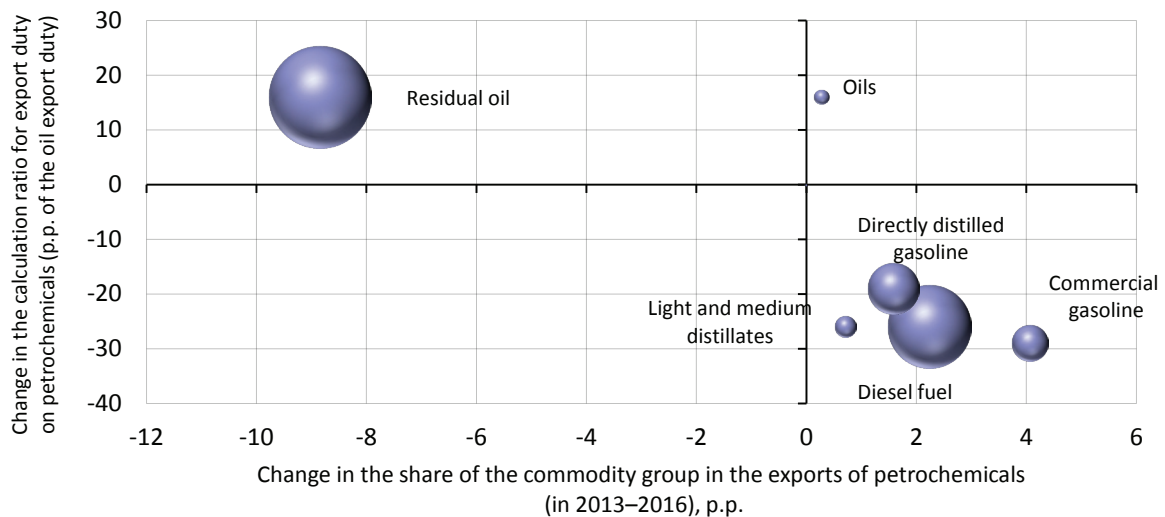
1 As percentage of the export duty on crude oil, the so-called calculation ratio for export duties on petrochemicals.

Table 2

CHANGES IN THE PATTERN OF EXPORTS OF PETROCHEMICALS TO ALL THE COUNTRIES,  
EXCEPT FOR MEMBER – STATES OF THE EURASIAN ECONOMIC UNION,  
JANUARY–AUGUST OF THE RESPECTIVE YEAR

Name of the position	Share of the commodity group in the volume of exports of petrochemicals, %				Change in share, p.p.		Change in calculation ratio for the export duty on petrochemicals, p.p. of the oil export duty	
	2013	2014	2015	2016	2016/2013	2016/2015	2016/2013	2016/2015
Residual oil	56.7	53.1	53.2	47.8	-8.8	-5.4	+16	+6
Diesel fuel	29.2	30.0	30.8	31.5	+2.2	0.7	-26	-8
Directly distilled gasoline	10.2	10.2	9.8	11.7	+1.6	+1.9	-19	-14
Commercial gasoline	1.9	4.7	4.0	6.0	+4.1	+2.0	-29	-17
Light distillates; medium distillates	1.3	1.5	1.7	2.0	+0.7	+0.3	-26	-8
Lubricants; other	0.7	0.6	0.5	1.0	+0.3	+0.4	+16	+6

Source: The authors' calculations on the basis of the data of the RF Federal Customs Service.



Note: The size of marker is proportional to the export volume.

Source: The authors' calculations on the basis of the data of the RF Federal Customs Service.

Fig. 4. Dynamics of shares of commodity groups in the exports of petrochemicals (to all the countries, except for the Eurasian Economic Union) and change in export duties for those groups

on oil and petrochemicals for the countries of the Eurasian Economic Union, Russia explicitly subsidizes the economies of those countries<sup>1</sup>.

The export duty was increased as a whole by 0.16 of the oil export duty for residual oil, oils and waste oils (the share of the latter is negligible). Due to a 8.8 p.p. drop in the share of residual oil (from 56.7% in January–August 2013 to 47.8% in 2016), the shares of other petrochemicals increased. It is to be noted that the exports of commercial gasoline increased the most (both in relative and absolute terms); export duties on that gasoline were reduced by 0.29 of the oil export duty.

Also, there was growth in shares of other commodity groups for which the export duty was reduced (Table 2). So, it can be concluded that the tax

1 For more details about the effect of the tax maneuver on Russia's value of the oil and gas transfer, see: A.Yu.Knobel The Eurasian Economic Union: Prospects of Development and Possible Obstacles // *Voprosy Ekonomiki*. 2015. № 3. Pp. 87–108.

maneuver had a direct effect on the export pattern of petrochemicals: all the large commodity groups (with a share of over 1% in the exports of petrochemicals) showed a negative effect of the calculation ratio for the export duty on petrochemicals (p.p. of the oil export duty) on changes in shares of commodity groups in the total exports of petrochemicals. ●

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