

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

TRENDS AND CHALLENGES OF SOCIO-ECONOMIC DEVELOPMENT

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## MAIN TRENDS AND CONCLUSIONS

Russian inflation reached the target rate of 4% year-on-year in mid-May 2017, which is essential for at least two reasons. First, this is a refutation of the mass pessimism spurred at the time (before the official inflation target rate for 2017 was announced) when the central bank said nothing but that such a target can possibly be reached. Second, this gives evidence that the threat of stagflation now appears to be less tangible in Russia. By contrast, more people are now taking about a potential, albeit less tenable, threat of deflation, as well as the target was expected to be reached at the end of the year, but not late in the spring. However, the essential issues of low inflation effect on economy and life will be left unanswered if inflation remains low.

Our experts have pointed to the two key factors that contributed to the deceleration of inflation, namely the slow pace of aggregate demand recovery and the rouble appreciation over the recent five months. At the same time, all the CPI components have been slowing: food products, non-food products (the main contributors to the last year inflation) and services to households.

However, there is clear evidence of risks of inflation acceleration, including diverse movements of interest rates in Russia and in the United States: Fed's monetary policy tightening coupled with interest rate cuts in Russia will make U.S. assets more attractive and trigger capital outflows. Consumer demand may recover at faster pace primarily because of lending growth. There is still uncertainty about fiscal policy, especially amid the current electoral cycle. Finally, although expectations for inflation hit an all-time low of 11%, they are still way above the actual inflation. Facing such risks, the Bank of Russia is likely to continue a moderately conservative monetary policy, easing it in a step-by-step manner. According to the experts, as economic growth recovers and economic agents adapt to a low inflation rate, the question of cutting the target rate may be raised. Additionally, it is likely there would be much less scepticism toward such a new target.

The inflation deceleration is regarded positively in general, while the rouble appreciation that has contributed largely to the deceleration is treated quite differently. Various departments and ministries repeatedly specified (and keep specifying) rouble exchange rates, around 62–65 roubles per U.S. dollar, which they think are desirable (optimal). The question about optimal rouble exchange rate was added to a regular business survey among Russian industrial enterprises that was conducted by Gaidar Institute during the last spring. Most answers differ largely from the optimal rates favoured by government officials and some economists, while industrial enterprises' options are based on their sufficient experience of operating amid both a depreciating and appreciating rouble.

According to the results, the Russian industrial sector said they would like the rouble exchange rate to be 52 roubles per U.S. dollar (it is revealing that nearly the same answer (51 roubles per U.S. dollar) was given during the last year survey initiated by the Russian central bank). The strongest rouble (42 roubles per U.S. dollar) was favoured by pharmaceutical enterprises because the pharmaceutical industry relies heavily on imported raw materials and equipment, followed by light and food processing industries (48–49 roubles per U.S.

dollar), whereas export-led iron and steel and chemical enterprises said the optimal exchange rate would be respectively 61 and 59 roubles per U.S. dollar.

According to the survey conducted in February 2015 when the rouble started to fall, 58% of enterprises said they need the rouble to be stronger, while only 2% of enterprises said they would like the devaluation to continue. Throughout the entire period of 2015–2017, the vast majority (up to 78%) of enterprises said that rouble appreciation is a must for reducing costs of production, while 67–72% of enterprises said devaluation tends to increase the cost of products. Similarly, manufacturers definitely give preference to a strong rouble as a driver of domestic demand. Finally, the share of Russian enterprises thinking that strong rouble tends to promote investment was 5–7 times that of enterprises saying investment can be boosted by rouble depreciation. Furthermore, this was proved again in the last spring when the rouble was relatively stronger, that is, enterprises said they would like the rouble to be even stronger.

The surveys also confirmed industrial enterprises' overall positive expectations in Q1 2017, which well correlates with the analysis of execution of regional and local budgets at that period. Revenues increased 16.8% (from Q1 2016) mainly due to a 30.5% hike of profits of enterprises and organizations (the dynamics of revenues slowed considerably in April mostly because profit tax was deferred to May). The positive result was obtained despite cutting the rate for regionally levied profit tax.

In January–April 2017, the consolidated budget expenditures of subjects of the Russian Federation increased (compared with the same months last year) at highly moderate pace and nearly equalled the inflation rate (on a April–April basis). Compared with the same period, not only did the regional public debt increase, but it also dropped 3.2% in nominal terms, to Rb 2.275 trillion. The composition of regional public debt continues facing positive changes for debtors – the share of federal budget loans increased (to 47.4% on 1 April 2017), while the share of expensive loans from credit institutions, which was bigger than that of budget loans as early as two years ago, shrank (to 28.7%). This is a reason for our experts saying “that there are real prospects of resolving the regional debt issue”. However, some regions are faced with a situation not as good as it might seem. The Kabardino-Balkarian Republic has been hit hardest (by, among other things, the drastic slump of budget revenues spurred by excise duties on alcoholic products which tends to be long-term).

Regional differences are still relevant for analysing the foreign economic situation. Despite sanctions and counter-sanctions, the European Union continues to be one of the major service importers and exporters in the Russian turnover of services. Furthermore, the European Union added 1.7 p.p. to its share of the Russian turnover of services, reaching 44.8% at 2016 year-end, which is higher than the figure seen in 2013–2015. China's share increased by 0.8 p.p., still accounting for a moderate 3.2% of the Russian turnover of services, which, for example, is smaller than Switzerland's share (4.6%). By contrast, Egypt's share fell down to 0 (from 2.3% in 2015) and Turkey's share decreased 2.5-fold (from 6.4% to 2.6%) because of administrative constraints.

On the whole, the turnover of foreign trade in services was down 11% to USD 125bn in 2016 (USD 140bn in 2015), which corresponds to an overall decline of 11% in the foreign trade turnover during the same period. Thus services remained unchanged (21.1%) in terms of a percentage of the Russian foreign trade. Russia's exports of services declined as little as 2%, while imports of services were down by 16%, due to the drastic plunge (-31%) facing travel

services (one of the major services) (imports of construction services dropped substantially, too), which is not unreasonable given Russia's sanctions against Turkey and ban on Russia-Egypt air travel. It is worthy of noting, however, that the imports of travel services were also affected by the continuing decline in households' real income in 2016: Russian outbound travels were expected to decline.

Amid the recent crisis, the dynamics of income, salaries/wages, subsistence level has taken on particular importance over the past two years. Our experts have analysed potential implications that may be faced because of adopting a draft bill to raise the minimum wage to equal the subsistence level. The relevant draft bill is currently underway – a task set by Russian Prime Minister Dmitry Medvedev – and the minimum wage is likely to reach the target value within the ensuing 2–3 years. The idea of raising the minimum wage was repeatedly debated in the past, and the Labour Code of 2001 stipulated that the minimum wage cannot be lower than the subsistence level for the workforce.

Given the current value of the minimum wage and subsistence level, the minimum wage should be raised by 40% so that the target value for both can be reached. This also means that the ratio of minimum to average wages will increase from the current 20% to 28%, which, however, will have no strong effect on the Russian position in the overall ranking: the ratio of minimum to average wages is about twice as high in European countries (it is merely 25% in the United States).

According to the experts' estimates, raising the minimum wage to equal the subsistence level could directly influence 3–4 million persons (5–6% of the total employed workforce) or, if real wages are raised, less. According to Rosstat, about 10% of the workers employed at enterprises and organizations were paid less than the subsistence level in 2016. However, the official number of workers employed at enterprises and organizations is approximately two thirds of the total employed workforce in Russia. A similar increase in the informal sector is difficult to project.

Based on the Russian practice of raising the minimum wage, as well as foreign research papers, the experts have assumed that raising the minimum wage may have both positive and negative effects. The former refers to inequality reduction, moderate decrease of poverty and overall wage increase in a given sector, while the latter refers to boosting the informal sector and the unemployment for the most vulnerable group of workers.

A special emphasis has been placed on the regional aspect of the problem. In 2007, Russian regions were offered an opportunity to set a minimum wage on their own, provided that it is equal or higher than the value set forth in the federal law. Fifty three regions took the opportunity, and now there are regions where the minimum wage is higher than the federal subsistence level. As a result, million persons are currently residing in the regions technically complying with the draft bill which has not yet been prepared. Therefore the reform will primarily embrace the poorest regions where the informal employment rate is high. However, efforts to promote productivity and reduce poverty of workers will face a weak regional economy and a lack of opportunity to attract extra investment. The strong inequality between regions makes it more difficult to address the issues of the working poor and of strong inequality in a uniform manner on a country-wide basis. Conclusion: the issues of low minimum wage should be addressed at the regional rather than at the federal level.●

## 1. RUSSIAN INFLATION HITS 2017 TARGET RATE

A.Bozhechkova, A.Kiyutsevskaya, P.Trunin

According to Rosstat, Russian inflation slid to 4% in mid-May 2017, which is the Bank of Russia's target rate for inflation in 2017. However, inflation expectations are remaining high despite substantial deceleration of the actual inflation rate. Monetary easing is slow amid risks of low crude oil prices and of capital outflows.

Since the beginning of 2017, the Bank of Russia cut the key rate by 0.25 p.p. to 9.75% p.a. on 24 March and by 0.5 p.p. to 9.25% p.a. on 28 April. Until 2017, Russia's central bank maintained the key rate intact, seeking to pursue the trend toward steady inflation deceleration. In January–April 2017, the inflation rate slid from 5% on a January–January basis to 4.1% on an April–April basis. Given 0.3% of consumer price growth rates in April, the end-April inflation rate stood at 3.7% on a year-on-year basis. In the first half of May, the Consumer Price Index rose 0.2% to reach 4.0% (compared with the same period of 2016), according to Rosstat, which is in line with the Bank of Russia's year-end target (*Fig. 1*). As a reminder, the Bank of Russia anticipated as early as December 2016 that the inflation rate would not reach 4% until by the end of 2017. The inflation deceleration was driven by sluggish recovery of aggregate demand, as well as by a strengthening rouble, over the recent five months.

The consumer inflation slowdown was governed by all the CPI components. For instance, food prices increased as little as 1.8% in January–April (+2.7% in January–April 2016). At the same time, most of the contribution to the food inflation in April was made by the price growth for vegetable and fruits, up 4.7% from the value seen in March (-0.1% in April 2016), which was seemingly due to the depletion of supplies left from the last year's crop. The end-April food inflation rate therefore accelerated to 0.6% (0.4% in April 2016), while it stood at 0.1% in March. Nevertheless, relatively low growth rates of prices of the rest of food product categories compensated for the increase in prices of vegetables and fruits.

Non-food prices were up 1.1% in January–April (+2.9% in January–April 2016). All in all, the inflation deceleration in the non-food sector stood out well against the other components (0.2% in April 2017 vs. 0.6% in April 2016). Prices and rates of paid services to households increased 1.0% in the first four months of 2017 mostly due to the increase in prices of passenger transport services. On the whole, the inflation rate in the service industry in April was 0.2% relative to the month earlier (0.3% in April 2016).



Source: Rosstat.

Fig. 1. CPI growth rate in 2011–2017, % change, year to year

Weak consumer demand still remains one of the key factors restraining inflation. For instance, the decline in households' real disposable cash income accelerated again in April, reaching 7.6% from the value seen in April 2016 (-3.3% in February and -2.1% in March). It was only in January 2017 that this indicator saw growth since October 2014, due to a one-time supplement payment to retirees.

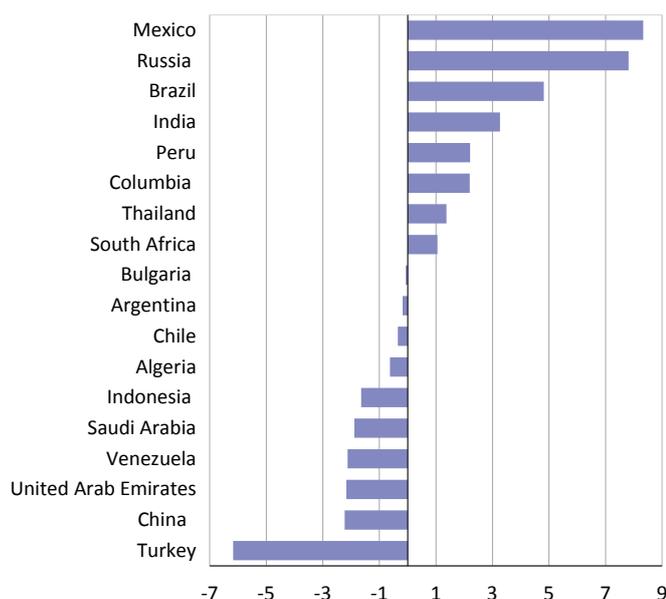
The rouble exchange rate was also responsible for the inflation slowdown. The rouble gained 4.0% against the U.S. dollar since the beginning of the year, up to 57.2 roubles per US dollar, according to the data dating to 20 May, reaching 55.85 roubles per U.S. dollar at the end of April, which was equal to the exchange rate seen in July 2015. In January–May, the RUB/USD exchange rate averaged 59.9 roubles per U.S. dollar.

The observed strengthening of the rouble was largely due to the crude oil price growth in January–May 2017, up 40% from the value seen in January–May 2016, or by 21.8% from the average of 2016. In January–April 2017, the increase in nominal effective rouble exchange rate was therefore much stronger (up 7.8% from to the exchange rate seen in December 2016) than the national currency of developing countries, ranking second after the Mexican peso (up 8.3% from December 2016) (*Fig. 2*).

Risks of inflation ramp-up are remaining high despite substantial slowdown in the actual inflation rate. This is primarily driven by risks of depreciation in the exchange rate due to falling crude oil prices. The exchange rate dynamics also may be affected by Fed's monetary policy tightening coupled with interest rate cuts in Russia, thus making U.S. assets more attractive and triggering capital outflows from other developed and emerging markets, including Russia. Facing such risks, the Bank of Russia is likely to continue a moderately conservative monetary policy, easing slowly terms of crediting.

Additionally, inflation is facing risks of possible recovery of aggregate demand. According to Rosstat, the retail turnover in April 2017 saw no changes compared to that of April 2016 following the annualized decline over more than two years. Given the above-mentioned continuous decline in real income, this may be related to growth of consumer crediting.

Besides the task of maintaining the inflation rate at 4%, the Bank of Russia is also faced with the task of reducing inflation expectations. Persistently high inflation expectations of economic agents seems to be another source of inflation forcing the Russian central bank to run a cautious policy. According to the Bank of Russia's estimates based on InFOM's survey, households' median expectation for inflation hit an all-time low of 11% in April (down 0.2 p.p. from March), which however was way above the actual inflation, thus giving evidence of the sluggish nature of inflation expectations.



Source: IMF.

*Fig. 2. Growth of national currency nominal effective exchange rate in developing countries, % change from December 2016*

Finally, uncertainty about fiscal policy, especially amid the current electoral cycle, remains a source of inflation risks. For instance, the Russian government approved on 18 May Finance Ministry's amendments to the 2017 federal budget, whereby budget expenditures will increase Rb 315bn, while spending of the Reserve Fund and of the National Wealth Fund will be cut down by Rb 91.1bn and Rb 4.7bn respectively.

Thus, given possible risks of inflation acceleration in 2017, the Bank of Russia is likely to continue easing its monetary policy on a step-by-step basis, taking account of the dynamics of aggregate demand, inflation expectations, as well as the fiscal policy. Note that the central bank's 4% inflation rate target seems to be reasonable and in line with the practice of central banks in developing countries (*Table 1*).

*Table 1*

## CENTRAL BANKS' INFLATION TARGETS

	Actual inflation rate (April 2017 from April 2016)	Target rate for 2017
Developing countries		
Turkey	11.9%	5% +/- 2 p.p.
Kazakhstan	7.5%	6–8%
South Africa	6.1%	3–6%
Mexico	5.8%	3% +/- 1 p.p.
Columbia	4.7%	3.0%
Indonesia	4.2%	4% +/- 1 p.p.
Russia	4.10%	4%
Brazil	4.1%	4.5 +/- 1.5 p.p.
Peru	3.7%	1–3%
India	3.0%	2–6%
Chile	2.7%	3% +/- 1 p.p.
Hungary	2.2%	3% +/- 1 p.p.
Poland	2.2%	2.5% +/- 1 p.p.
Romania	0.6%	2.5% +/- 1 p.p.
Developed countries		
Great Britain	2.7%	2.0%
Norway	2.2%	2.5%
New Zealand	2.2%	1–3%
Australia	2.1%	2–3%
Czech Republic	2.0%	2% +/- 1 p.p.
Canada	1.6%	1–3%
Iceland	1.9%	2.5%
Israel	0.7%	1–3%

Sources: central banks' official websites.

The level of central bank's inflation rate target is not high if measured by the standards of other developing countries, and its increase would counter with the worldwide practice. Moreover, as economic growth recovers and economic agents adapt to a low inflation rate, the question of cutting the target rate may be raised. ●

## 2. OPTIMAL ROUBLE EXCHANGE RATE FOR RUSSIA'S INDUSTRIAL SECTOR

**S.Tsukhlo**

*A survey of the Gaidar Institute to find out which rouble exchange rate is optimal for Russian industrial enterprises reveals that their preferences differ from industry to industry. Most respondents said they would like to see the Russian rouble appreciate.*

The question about optimal (desirable) rouble exchange rate for enterprises was added to the March 2017 regular business survey of the Gaidar Institute. The question wording mirrored that of the May 2016 survey among the same enterprises, as initiated by the Research and Forecasting Department of the Russian central bank<sup>1</sup>.

The results appear to be well founded because it has been more than two years since the Russian industrial sector has been operating (including demand for their products, prices, prices of raw and other materials, prices of machinery and equipment) amid a free-floating rouble exchange rate. As a reminder, in 2014–2017 the rouble exchange rate varied (according to Russian central bank's average monthly exchange rates) within a range of 33.78 to 77.93 roubles per U.S. dollar. The average monthly exchange rate hovered around 50.47 and 77.93 roubles per U.S. dollar after the devaluation of December 2014. Thus, enterprises had enough time for comparing the effects of both a weakening and strengthening rouble to find out which rouble exchange rate suites them best.

### Preferences

Our survey shows that 52 roubles per U.S. dollar was optimal for the Russian industrial sector in March 2017, which nearly matches the results (51 roubles per U.S. dollar) of the May 2016 survey. The industrial sector thus has a longstanding and time-proven view of the rouble exchange rate amid contemporary, real-life production and sale environment. However, the survey results differ, albeit quite reasonably, from industry to industry.

Pharmaceutical enterprises said they would like the exchange rate to be 42 roubles per U.S. dollar (the strongest rouble exchange rate among respondents from other industries), presumably because the pharmaceutical industry relies heavily on imported raw materials (substances) and equipment that have no comparable Russian counterparts, and the rouble exchange rate influences consumer demand, even for Russian medicines. By contrast, iron and steel enterprises said the optimal exchange rate would be 61 roubles per U.S. dollar, and the explanation for this would appear to be that they can export their products. A similar exchange rate (59 roubles per U.S. dollar) was favourable for the chemical industry which has a good export potential and implemented successfully investment programmes at times when the rouble was still strong.

The results, however surprising they might appear as first sight, showed that the light and food industries favoured nearly the same exchange rate of

<sup>1</sup> Bank of Russia. Talking Trends. Macroeconomics and Markets. 2016. No. 6. P. 46–49.

48/49 roubles per U.S. dollar, even though they are normally expected to hold absolutely opposite views regarding the exchange rate from the perspective of traditional view regarding import substitution and competition with imported products. Russia's food industry has long (1995–2017) been faced with the weakest competition (similar only to that for the construction materials industry) from producers of far-abroad countries. Since August 2014, the food industry has been enjoying an extra benefit from Russia's ban on food imports from Western European countries. Therefore, the competition from imported food products deteriorated in 2015–2017 and was regarded as 'weak' by Russian food producers (note that it was close to 'none' in 2000–2002). However, the industry relies heavily on imported equipment and materials, and therefore food enterprises said the rouble needs to be stronger. Not only will the latter enable enterprises to cut down their costs and prices, but it will boost households' real income and demand for food products.

The light industry is facing a different situation: none but the light industry has been involved in such a relentless competition with imported products on average in 1995–2017 and during the post-devaluation period of 2015–2016. The share of competitive (with imported products) markets within the industry reached 80% in 2011–2013 and declined slightly to 73% in 2015–2016. Only one third of light industry enterprises were satisfied with the demand on their produces in 2015–2017. Nevertheless, the industry needs the rouble to be strong, although it is supposed to advocate for a weak rouble. There is only one reason behind such an "abnormal" attitude to the rouble exchange rate: imported equipment, raw and other materials are critical for the light industry. A weakening rouble therefore tends to boost industries' ex-factory prices, deteriorate investment and hence the quality of products, lower demand in the domestic market. In this situation it is logical that the light industry leans toward a stronger rouble.

#### How do enterprises form their view of rouble exchange rate?

Our surveys as early as 2014 (April and December) showed that imported equipment, parts and components, raw materials are critical for Russian industrial enterprises. In April 2014, when such words as 'devaluation' and 'import substitution' were not yet part of the vocabulary of most politicians, economists and producers, 40% of enterprises admitted that they would continue buying imported products no matter how high the price might rise. The result was treated placidly and valued academically rather than politically. The same question was also added to the December (2014) questionnaire to ultimately show the same results: about 40% of enterprises kept saying they would continue buying imported products no matter how high

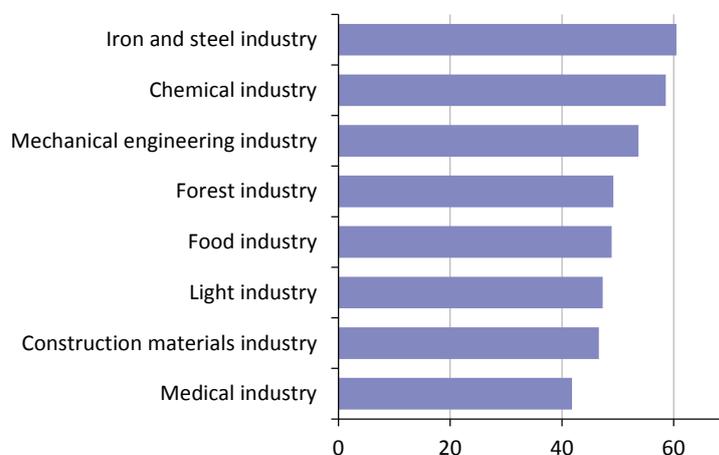


Fig. 1. Optimal rouble exchange rate for Russian enterprises, March 2017, RUB/USD

the price might rise, even amid the strongest rouble devaluation since August 1998, when a “what-if” scenario of import price upswing materialized.

Another remarkable result was delivered by the February (2015) business survey among industrial enterprises to find out which *counter-recession measures* were most efficient at the onset of the crisis of 2015–2016. Russian producers that were expected to praise the rouble devaluation because consumers would inevitably switch from appreciated imports to Russian taxes said that boosting the rouble exchange rate should be the top priority counter-recession measure. At that time, 58% of enterprises said they need the rouble to be stronger and taxes to be cut, while only 2% of enterprises said in February 2015 they would like the devaluation to continue. The 2015 result fits well with the results of the 2012–2014 surveys to find out whether the counter-recession measures would be efficient in case of a “second wave of crisis”. The (then!) hypothetically abrupt rouble devaluation during the inter-crisis period was favoured by only 3% of enterprises, and a smooth depreciation by 12%.

Russian industry's strong attitude towards the rouble devaluation prompted us to launch a monitoring to measure the effect of rouble exchange rate on enterprises' key performance figures and exchange rate variations that are desirable for industrial enterprises.

According to enterprises' direct estimates, it is the **cost of Russian products** that had the strongest dependence on the rouble exchange rate: only 11% of enterprises said their costs are not influenced by the rouble exchange rate during the monitoring period of three years on average. However, the industrial sector managed to make their costs less dependent, albeit only by 9 p.p., on the rouble exchange rate: from 93% in 2015 to 84% in 2017. The upward effect of rouble devaluation on the cost of Russia-made products was strong indeed, as was reported by 72% of enterprises in 2015 and by 67% in 2016 and 2017 each. Only 1–2% of enterprises managed to reduce costs (through successful transition to using less expensive Russian counterparts), while another 19% of enterprises reported that the rouble devaluation had no effect on their costs, presumably because they used substitutes while keeping prices unchanged. In terms of cost, the traditional balance of effects (growth less decline) stood at +64..+71 points, the highest level compared with the rest of performance figures.

The Russian industrial sector faced with such a situation shows reasonably the strongest demand for a stronger rouble with the express aim of reducing their costs. We obtained the same result in 2015, 2016, and 2017. January 2016 saw the strongest need for a stronger rouble, when the rouble was found to be the weakest during the entire post-devaluation period. At that time, 78% of enterprises said they need the rouble to appreciate to enable them to reduce the cost of products.

**Ex-factory prices** were ranked second in terms of being influenced by the rouble exchange rate. During the monitoring period of three years on average, only 15% of enterprises said their prices are not influenced by the rouble exchange rate. In 2017, the share of such estimates reached 19%. Another one-fourth of enterprises managed to avoid the rouble devaluation effect on their prices. However, the vast majority of enterprises reported their prices had been driven up by the devaluation, while only 3% of producers managed to lower their prices. The balance of rouble devaluation effects on prices hovered around +52..+58 points.

The Russian industrial sector, despite traditional views, failed to boost **domestic demand** for their products because of the rouble devaluation in December 2014. Throughout the entire monitoring period (3 years) the balance of rouble depreciation effects on domestic sales has been negative, as estimated by enterprises, increasing gradually its adverse effect from -6 to -15 points. At the same time, most (more than 60%) enterprises said that domestic demand for their products was either influenced by the rouble exchange rate or changed under the influence of varying exchange rate. Devaluation-led demand for Russian products hit a peak in 2015, as was noted by 17% of enterprises. By 2017, however, the share of such enterprises dropped to 11%. The latter is explained by both the rouble appreciation and buyers' gradual adaptation to a new economic environment, whereas the adverse (recession!) effect of the rouble devaluation on domestic demand exhibited rather reverse dynamics (estimated by respectively 23%, 25% and 26% of enterprises) or was at least stable.

This popped up unexpectedly for some analysts and prompted practitioners' (managers of Russian industrial enterprises) need for a stronger rouble in order to stimulate growth of domestic demand for Russia-made products. The need was found to be strongest in January 2016, when the rouble exchange rate hit the lowest level on record in every month of 2014–2017, and it was January 2016 that we asked the question about which exchange rate would be optimal to ensure growth of domestic demand for the products manufactured by Russian industrial enterprises. Based on the experience gained in the (recession) year immediately following the devaluation, more than a half (52%) of Russian industrial enterprises said they would like the rouble to appreciate, while only 12% of enterprises wanted the rouble to depreciate to boost domestic demand. Today (amid rouble appreciation in 2017 and at the beginning of recovery from the recession), when further rouble appreciation is less needed, only 27% of enterprises say they want the rouble to appreciate to boost domestic demand for their products. Once again, further appreciation of the Russian rouble remains the most sought-after change in the rouble exchange rate that can spur on domestic demand in 2017.

In addition, the Russian industrial sector needs the rouble exchange rate to be changed to ensure **investment growth**. Throughout the entire monitoring period industrial enterprises responded that a strong rouble would stimulate capital investment. The same response hit the highest early in 2016, when the rouble was very weak and the industrial sector started recovering from investment pessimism for the first time since Russia had entered a period of sanctions and collapsing investment plans. At that time, 73% of enterprises said the rouble needs to be stronger to boost investment, while only 8% of them said the rouble needs to be weaker to boost capital investment. In March 2017, when industrial enterprises' investment plans hit a positive peak amid crisis and the average monthly exchange rate stood at 58 roubles per U.S. dollar, almost half of enterprises said that further rouble appreciation could stimulate investment, while 11% of them wished the rouble to be weaker. The balance of rouble exchange rate effects on investment still tips definitely toward a stronger rouble. ●

### 3. REGIONAL BUDGETS: REVENUES ON RISE, TOUGH POLICIES CONTINUE

I.Arlashkin, A.Deryugin

Despite cutting the rate for the regionally levied profit tax, profit tax revenues have contributed largely to boosting growth rates of regional budget revenues and to the partial recovery of productive expenditures. However, most of the regions are still opting for a tough fiscal policy, trimming growth of revenues.

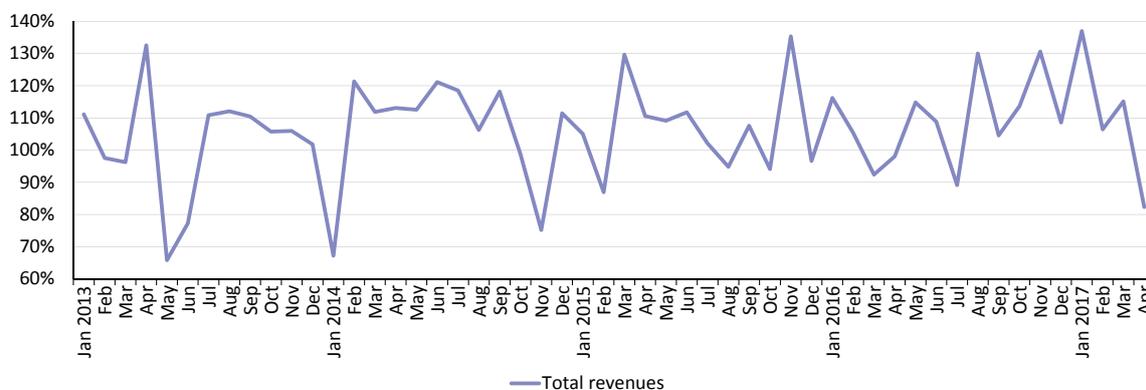
#### Revenues

According to the data on the execution of regional and local budgets in Q1 2017, subjects of the Russian Federation saw their consolidated budget revenues increase 16.8%, which is much higher than the inflation rate (104.3%) recorded in the period between March 2016 and March 2017. In Q1 2017, 70 regions generated more consolidated budget revenues than those recorded in Q1 2016, of which 64 regions saw revenues overtake the inflation rate. This was due to high growth rates of revenues in January and March of 2017, which stood at 137.0% on a January-January basis and at 115.1% on a March-March basis (Fig. 1).

The growth of revenues in Q1 2017 was driven up basically by corporate profit tax (130.5% over Q1 2016), property taxes (112.9%), as well as non-tax revenues (113.2%).

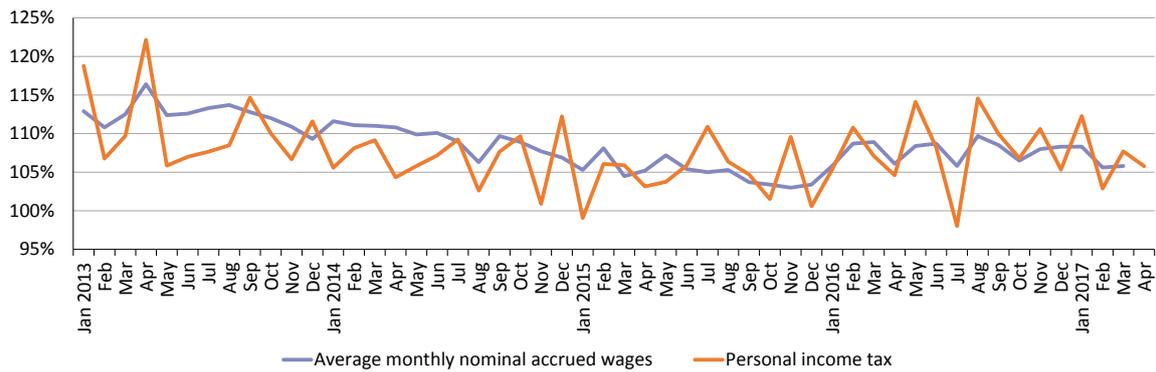
High growth rates of profit tax revenues of regional budgets were noticed despite the fact that one p.p. of the profit tax rate has been transferred (since 1 January 2017) from the regional to the federal level.

Growth rates of personal income tax – the principal source of revenues of regional and local budgets (30.4% of total consolidated budget revenues in 2016) – stood at 106.9% in Q1 2017, which is below both the average growth rate of tax and non-tax revenues (115.8%) and the growth rate of personal income tax in 2016 (107.5%). All in all, the dynamics of personal income tax corresponded with the dynamics of wage/salary growth in economy (Fig. 2)



Source: figures are based on the data released by the Federal Treasury of Russia.

Fig. 1. Growth rates of total consolidated budget revenues of subjects of the Russian Federation, % change from the same period previous year



Source: figures are based on the data released by the Federal Treasury of Russia and by Rosstat.

Fig. 2. Growth rates of total personal income tax revenues of the consolidated budget of subjects of the Russian Federation and the average monthly nominal accrued wages, % change from the same period previous year

Growth rates of local tax and non-tax revenues of the consolidated budget of subjects of the Russian Federation stood at 115.5% in Q1 2017 compared to Q1 2016. Among the principal sources of revenues, apart from personal income tax, intergovernmental fiscal transfers from budgets of other tiers saw a relatively slow pace of growth (103.9%), which is well in line with the year-earlier trends.

The situation differed largely from region to region. In terms of average growth rates of revenues regionwide, Central Federal Okrug (119.8%), North-West Federal Okrug (120.0%), South Federal Okrug (132.8%), Privolzhskiy Federal Okrug (121.6%) and Siberia Federal Okrug (121.9%) ranked at the top, while North-Caucasian Federal Okrug (106.5%), Urals Federal Okrug (98.1%) and Far East Federal Okrug (101.0%) hit the bottom of the ranking. Thus, the federal okrugs split up into two groups, of which, the former faced rapid growth rates, and the latter slow ones.

Excluding the effect of certain regions on the overall situation facing a given federal okrug and considering the contribution of regions with consolidated budget revenues growth rates above a certain level, the outsider was North-Caucasian Federal Okrug. Privolzhskiy Federal Okrug took the lead (100%), while half of the regions within the federal okrug exhibited more than 120%.

In Q1 2017, like in the previous year, the consolidated budget revenues of 14 donor regions which did not receive equalization grants/transfers over the past two years saw slower growth compared to lower-revenue regions (115.7% vs. 117.8%). The difference becomes even more evident when it comes to growth rates of profit tax revenues (119.3% vs. 149.8%). It is however too soon to say there are trends toward less fiscal differentiation between high- and low-revenue regions.

Preliminary data on the execution of regional budgets in the first four months of 2017 show serious change in growth rates of revenues in April. While the data dating to Q1 2017 show a 116.8% growth of consolidated budget revenues of subjects of the Russian Federation, the 4-month figure was merely 104.3%. Corporate profit tax revenues of regional budgets dropped by more than a half (to 46.9%) from April 2016.

However, these results should not be interpreted as reversal of the trend in budget revenues because profit tax was deferred to 2 May. The 4-month figures of 2017 therefore appear to be incomparable with the same period of 2016, so it is not until the end of 5-month period that conclusions can be made.

### Expenditures

In the first four months of 2017, total growth of consolidated budget expenditures subjects of the Russian Federation stood at 104.4% compared to the same period previous year, which is close to the CPI (104.1%) during the same period (on a April-April basis).

While positive growth of consolidated budget expenditures of subjects of the Russian Federation was observed in 46 regions at the end of the first four months, only 22 of them saw expenditure outpace the inflation rate over the same period. Therefore most of the regions cut their real spending during that period.

The cash execution of consolidated budget expenditures of subjects of the Russian Federation stood at 27.1% in the first four months of 2017, which is close enough to the “ideal” figure of 33.3% (one third of expenditures during one third of the year). Only four regions had cash execution higher than 33.3%. At the same time, the cash execution was less than 25% of the approved expenditures in eight regions.

The functional breakdown of consolidated budget expenditures of subjects of the Russian Federation in Q1 2017 remained unchanged compared to Q1 2016 (*Table 1*), except that spending on National Economy and Housing and Utilities slightly increased. In addition, debt servicing costs decreased primarily due to proactive federal policy of replacing bank loans (expensive in terms of servicing) with cheap budget loans.

The drastic change in spending on Healthcare and Social Security Policy was most likely of technical nature: since 2017 almost all the regions started recognizing compulsory medical insurance contributions for unemployed individuals as part of spending on Social Security Policy, while many regions previously recognized such contributions as part of spending on Healthcare. There was an adverse trend in shrinking the share of spending on education by 0.8%. In addition, in Q1 2017, expenses on capital investment in public (municipal) properties and on social security and other payments to individuals as part of spending on Education dropped by respectively 12% and 15% from Q1 2016.

*Table 1*

FUNCTIONAL BREAKDOWN OF BUDGET EXPENDITURES

Type of budget expenditures	Growth (M3 2017 to M3 2016), %	As % of total expenditures	
		2016	2017
Budget expenditures, total	7.1	100.0	100.0
Nationwide Issues	7.7	6.3	6.3
National Defence	6.9	0.0	0.0
National Security and Law enforcement	6.3	1.0	1.0
National Economy	12.7	13.3	14.0
Housing and Utilities	18.8	7.5	8.3
Environmental Protection	18.1	0.3	0.3
Education	4.1	28.8	28.0
Culture and Cinematography	12.6	3.4	3.6
Healthcare	-47.1	16.0	7.9
Social Security Policy	47.3	18.9	26.0
Physical Culture and Sports	35.7	1.8	2.3
Mass Media	-6.4	0.5	0.5
Public Debt Servicing	-8.2	2.1	1.8
General intergovernmental fiscal transfers to budgets of the budget system of the Russian Federation	-39.2	0.0	0.0

Source: figures are based on the data released by the Federal Treasury of Russia.

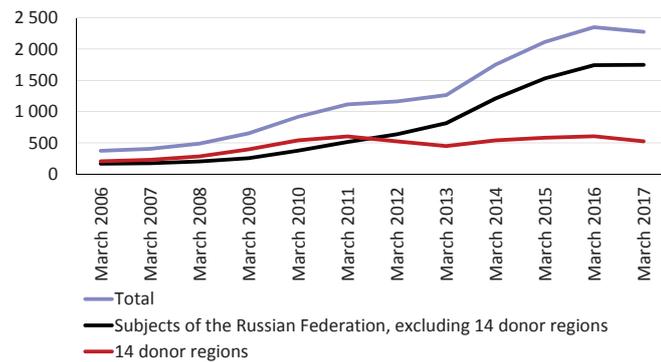
**Equilibrium and public debt**

Maintaining growth rates of tax and non-tax revenues at a relatively high level, as well as Russia's Finance Ministry's policies aimed at encouraging regional authorities to implement a tight fiscal policy, minimized the budget deficit and stabilized regions' public debt. For instance, not only did the regional public debt increase in the period between 1 April 2016 and 1 April 2017, but it also dropped 3.2% in nominal terms, to Rb 2.275 trillion.

Despite a positive trend in resolving the regional debt issue, now it is too soon to say the trend is strong and steady. A comparative analysis of the dynamics of debt owed by donor regions and the rest of the subjects of the Russian Federation has shown that the decline in total debt was triggered exclusively due to reducing the donor regions' debt which is relatively low enough as it is (Fig. 3). The public debt of other regions stabilized rather than decreased.

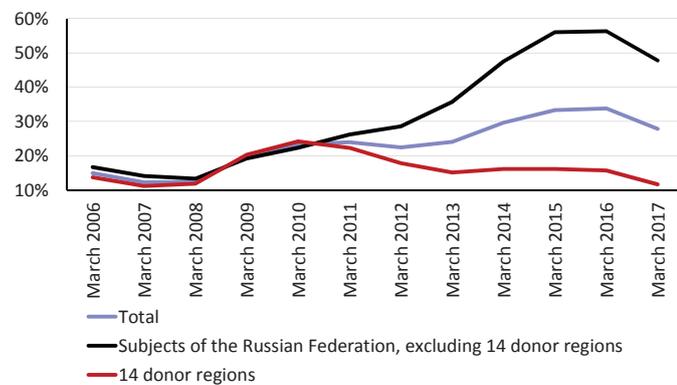
Nevertheless, achieving almost zero growth rates of public debt in lower-revenue regions amid relatively good growth rates of revenues would help reduce their debt burden. Should growth rates of tax and non-tax revenues of the budget of subjects of the Russian Federation remain at the level of Q1 2017, the ratio of regional public debt to revenues would drop from 33.8% to 27.9% on a March-March basis, while in regions faced with a more severe debt issue the ratio would increase further from 56.3% to 47.8% (Fig. 4).

The composition of regional public debt was overall driven by the year-earlier trends, that is, the share of federal budget loans increased (to 47.4% on 1 April 2017), while the share of expensive loans from credit institutions, which was bigger than that of budget loans as early as two years ago, shrank (to 28.7%) (Fig. 5).



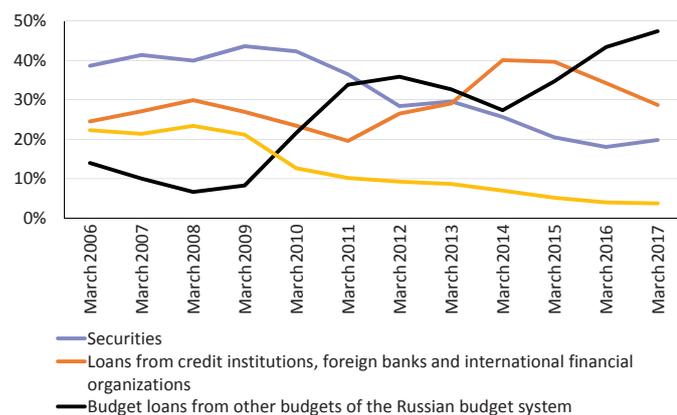
Source: own calculations based on the data released by the Ministry of Finance and the Federal Treasury of Russia.

Fig. 3. Dynamics of public debt owed by subjects of the Russian Federation, Rb bn



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

Fig. 4. The ratio of public debt owed by subjects of the Russian Federation to tax and non-tax revenues, %



Source: figures are based on the data released by the Ministry of Finance of Russia.

Fig. 5. Composition of public debt of subjects of the Russian Federation, %

This resulted from the growth since 2014 of budget loans aimed at replacing expensive commercial loans. The high equilibrium of regional budgets will help maintain this trend, thus reducing debt servicing costs.

Thus the 2016 trends toward slowing growth and then reducing the debt burden on regions continue in 2017, which makes it possible to say that there are real prospects of resolving the regional debt issue.

As to certain subjects of the Russian Federation, the most severe debt issue is facing the Kabardino-Balkarian Republic: the public debt has risen 74% over the past 12 months (mainly because of commercial borrowings) due to the drastic slump of budget revenues spurred by excise duties on alcoholic products which tends to be long-term and a 18.1% fall of consolidated budget revenues in the Republic in the first four months of 2017, which is 137% relative to tax and non-tax revenues in the Republic. In this case, the major challenge is not so much the amount of accumulated public debt as the prospects of its further growth in the course of the year. ●

## 4. INTERNATIONAL TURNOVER OF SERVICES IN 2016: IMPORTS DOWN DUE TO ADMINISTRATIVE CONSTRAINTS

A.Knobel, A.Firanchuk

*Service exports and imports, except for travel services, stopped falling after Q2 2016 – equalling the figures recorded in 2015. Travel services were down 31% at 2016 year-end due to Russia's sanctions against Turkey and restrictions on Russia-Egypt air travel – both countries are major destinations for the Russian outbound tourism. Construction service imports dropped markedly, which is also accounted for by the anti-Turkish sanctions.*

The turnover of foreign trade in services was down 11% to USD 125bn at 2016 year-end (USD 140bn in 2015), which corresponds to an overall decline of 11% in the foreign trade turnover in 2016. Thus, services remained unchanged (21.1%) in terms of a percentage of the Russian foreign trade.

The trade turnover decline was caused by a 17% drop of exports amid stable imports (-0.3%)<sup>1</sup>. By contrast, the foreign trade turnover of services declined primarily because of a 16% fall of imports (to USD 74.4bn) accounting for 29.0% of total imports of goods and services, which equals to what was seen in 2013. Service exports lost as little as 2% (to USD 50.5bn), the share of services in total exports reached an all-time high of 15.0% driven by a deeper fall exports of goods.

However, service imports were driven down by administrative rather than economic factors. The anti-Turkish sanctions and the restrictions on air travel to Egypt spurred the reduction of imports of travel and construction services by 31% and 22% respectively.

In terms of a percentage of foreign trade turnover, EEU (Eurasian Economic Union) countries saw no serious change. The decline in CIS-countries' share was primarily associated with a one-third decline of service exports to Ukraine. APEC countries' share of Russia's service turnover was driven up mostly by the increase in exports to the United States, South Korea and China and in service imports from China. The European Union raised its share of Russia's turnover of services to 44.8% (+1.7 p.p.), remaining the major importer (49%) and exporter (39%) of services. Egypt's share fell down to 0 (from 2.3% in 2015) and Turkey's share decreased 2.5-fold (from 6.4% to 2.6%) because of administrative constraints.

### **Total imports and exports of services**

The decline in service exports seen since Q4 2014 ended in Q1 2016 (*Fig. 1*). The decline in the first quarter was 11% (from Q1 2015). At the same time, service exports almost stabilized in the second quarter compared to the earlier-year figures (down by 3.3%). In the second and fourth quarters of 2016, service exports stood at the levels seen in the same period of 2015 (+0.3%).

Although service imports were falling over the entire 2016, there was a clear evidence that the fall was slowing. In the first quarter imports dropped

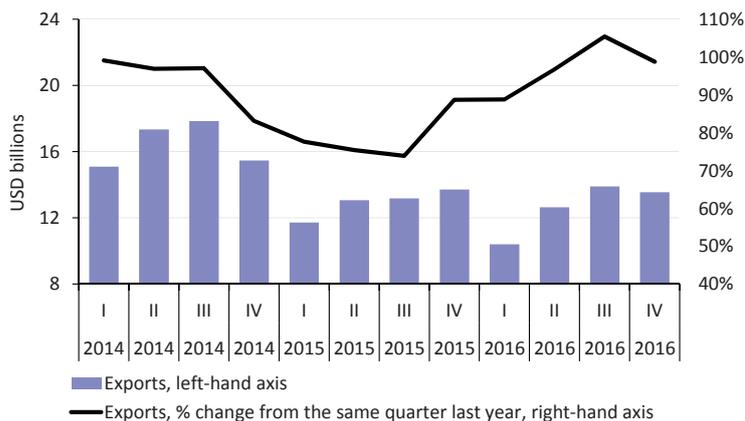
<sup>1</sup> A. Knobel, A. Firanchuk. Foreign trade in 2016 // Russian Economic Developments, 2017, No. 3 (24). P. 8–17.

#### 4. INTERNATIONAL TURNOVER OF SERVICES IN 2016

25% from Q1 2015, in the second and third quarters they were down 17% each, and in the fourth quarter they fell merely 5% below the level seen in 2015. The decline in the overall service imports was primarily due to downward dynamics of imports of travel services (compared to the figures of 2015) (Fig. 2). Both overall imports of other service industries and exports stopped falling in Q2 2016.

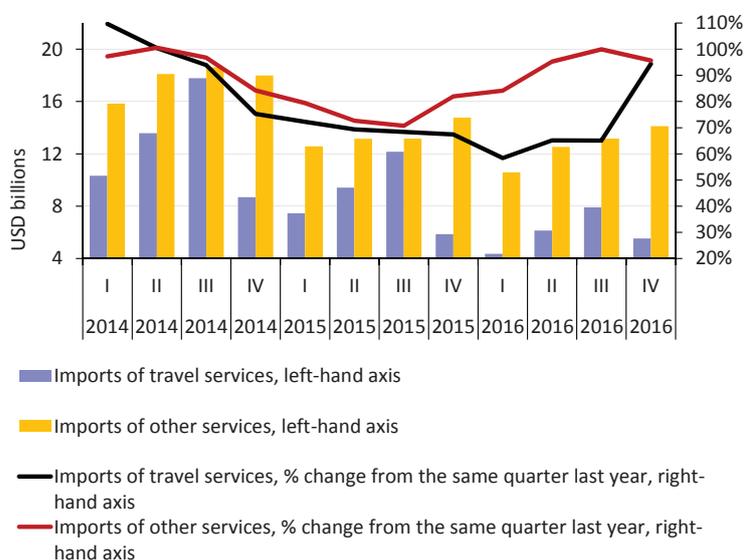
Imports of travel services exhibited a substantial year-to-year decline until the final quarter of 2016. The reduction in the number of outbound travels is accounted for by two factors. First, the (2016) year-long decline (from 2015) in households' real disposable income and the shift to a saving model of consumption. Under the circumstances, it appears most reasonable for many households to opt for cutting down their vacation expenses. Second, a major adverse factor was the ban that compels travel operators and travel agencies to refrain from offering tourist products to Russian citizens that include visits to Egypt<sup>1</sup> (since 6 November 2015) and a similar ban on selling tourist products that include visits to Turkey<sup>2</sup> (since 28 November 2015). In 2016, the decline in service imports to Egypt and Turkey reached USD 7.67bn, and the overall fall of travel service imports was USD 10.98bn. The ban created a gap between the dynamics of outbound travels and other services in Q4 2015, while the stabilization in the final quarter of 2016 was associated with the low base effect: the ban affected the volume of travel service imports in Q4 2015.

In 2016, service exports hovered around 68–75% relative to the level seen in the same periods of 2013, imports stood at 55–59%. This fostered the im-



Source: own calculations based on the data released by the Central Bank of Russia.

Fig. 1. Service export dynamics



Source: own calculations based on the data released by the Central Bank of Russia.

Fig. 2. Service import dynamics

<sup>1</sup> The Executive Order *On Specific Measures to Ensure the National Security of the Russian Federation and on the Protection of Citizens of the Russian Federation against Criminal and Other Illegal Acts*, <http://kremlin.ru/events/president/news/50647>

<sup>2</sup> The Executive Order *On Measures to Ensure the National Security of the Russian Federation and on the Protection of Citizens of the Russian Federation against Criminal and Other Illegal Acts and on the Application of Special Economic Measures Against the Turkish Republic*, <http://kremlin.ru/events/president/news/50805>

provement of the service turnover balance from -USD 58.3bn in 2013 and -USD 36.9bn in 2015 to -USD 23.9bn in 2016.

### **Composition of import and service exports**

The export dynamics of five major services (accounting for more than 5% of total service exports) was moderately negative as a whole. Transport services that rank first in terms of export volume saw a slight increase of 2%, while the second-ranked other business services and the third-ranked travel services dropped 7% each at 2016 year-end.

Table 1

#### FOREIGN TRADE IN SERVICES WITHIN BROAD CLASSIFICATION OF SERVICES

Service	Service imports				Service exports			
	2015, bn USD	2016, bn USD	growth rate, %	services' share in 2016, %	2015, bn USD	2016, bn USD	growth rate, %	services' share in 2016, %
Processing services for goods owned by other parties	0.14	0.14	99	0.2	1.02	1.61	157	3.2
Maintenance and repair services	1.36	1.56	115	2.1	1.60	1.54	97	3.1
Transport services	11.73	11.56	99	15.5	16.72	17.03	102	33.7
Travel services	34.93	23.95	69	32.2	8.42	7.79	92	15.4
Construction services	4.83	3.78	78	5.1	3.66	3.56	97	7.0
Insurance and non-government pension funds' services	1.39	0.97	69	1.3	0.61	0.41	68	0.8
Financial services	2.00	2.03	101	2.7	1.21	1.17	97	2.3
Charges for the use of intellectual property	5.63	5.00	89	6.7	0.73	0.55	75	1.1
Telecommunication, computer and information services	5.52	5.40	98	7.3	3.97	3.94	99	7.8
Other business services	18.46	17.48	95	23.5	12.61	11.66	92	23.1
Private services and cultural and recreation services	1.09	1.03	94	1.4	0.34	0.42	123	0.8
Public goods and services not elsewhere classified	1.53	1.51	98	2.0	0.81	0.83	102	1.6
Total	88.62	74.38	84	100.00	51.70	50.50	98	100.00

Source: own calculations based on the data released by the Central Bank of Russia.

The import dynamics of six major services (accounting for more than 5% of total service imports) was negative, albeit less homogeneous. The top-ranked travel services suffered the deepest decline (31%) in 2016, down to 32.2% (way below the average of 41% in 2013–2015). Imports of other business services, transport services and telecommunication services dropped 1–5%, charges for the use of intellectual property fell by 11%. Construction service imports fell considerably by 22% due to a 25% decline in imports for 'construction in Russia'. Note that Turkey accounted for 33% of construction service imports in the 'construction in Russia' sub-group in 2015. Hence the economic sanctions against Turkey contributed seriously to the decline in overall imports in this service sector in 2016.

### **Regional structure of foreign trade in services**

The regional structure of Russian foreign trade in services with major partners is presented in Table 2. In 2016, EEU's share changed insignificantly to 5.3%, while Belarus's share added 0.2 p.p. to the figure seen in 2015

Table 2

## REGIONAL STRUCTURE OF RUSSIAN FOREIGN TRADE IN SERVICES

Region/country	Service imports				Service exports				Turnover of services			
	2015. USD bn	2016. USD bn	growth rate. %	region/country's share in 2016. %	2015. USD bn	2016. USD bn	growth rate. %	region/country's share in 2016. %	balance in 2016. USD bn	turnover in 2016. USD bn	region/country's share in 2016. %	region/country's share. % change
<b>CIS:</b>	5.78	5.26	91	7.1	8.41	6.68	79	13.2	1.42	11.94	9.6	-0.56
<b>EEU:</b>	3.04	2.86	94	3.8	4.42	3.70	84	7.3	0.84	6.56	5.3	-0.07
Armenia	0.27	0.25	92	0.3	0.32	0.31	95	0.6	0.05	0.56	0.4	0.02
Belarus	1.70	1.66	98	2.2	1.23	1.24	101	2.5	-0.43	2.90	2.3	0.23
Kazakhstan	0.79	0.70	89	0.9	2.52	1.85	74	3.7	1.15	2.56	2.0	-0.31
Kyrgyzstan	0.28	0.24	87	0.3	0.35	0.30	87	0.6	0.06	0.54	0.4	-0.01
Ukraine	0.96	0.79	82	1.1	1.87	1.25	67	2.5	0.46	2.05	1.6	-0.38
<i>Services not attributed to specific CIS countries</i>	0.82	0.69	84	0.9	0.36	0.29	81	0.6	-0.39	0.98	0.8	-0.05
<b>EC</b>	40.80	36.20	89	48.7	19.64	19.74	101	39.1	-16.46	55.94	44.8	1.68
<b>APEC:</b>	11.22	10.43	93	14.0	6.87	7.94	116	15.7	-2.49	18.37	14.7	1.81
USA	4.92	4.02	82	5.4	2.77	3.38	122	6.7	-0.64	7.41	5.9	0.44
China	1.76	2.01	114	2.7	1.55	1.96	127	3.9	-0.05	3.98	3.2	0.82
South Korea	0.81	0.79	97	1.1	0.47	0.49	105	1.0	-0.30	1.27	1.0	0.11
Japan	0.61	0.55	91	0.7	0.45	0.42	94	0.8	-0.13	0.98	0.8	0.02
<b>Other countries:</b>	18.90	11.25	60	15.1	10.87	9.65	89	19.1	-1.61	20.90	16.7	-4.50
Turkey	6.64	2.16	33	2.9	2.34	1.13	48	2.2	-1.03	3.29	2.6	-3.77
Switzerland	2.64	2.56	97	3.4	3.05	3.18	104	6.3	0.62	5.74	4.6	0.54
Egypt	3.21	0.02	0	0.0	0.07	0.04	54	0.1	0.02	0.05	0.0	-2.29
<i>Services not attributed to specific far-abroad countries</i>	11.71	11.24	96	15.1	6.00	6.50	108	12.9	-4.74	17.74	14.2	1.57
<b>Total</b>	88.40	74.38	84	100.0	51.79	50.50	98	100.0	-23.88	124.88	100.0	

Source: own calculations based on the data released by the Central Bank of Russia.

(to 2.3%), Kazakhstan's share lost 0.3 p.p. (to 2.0%). Belarus's share dropped because the turnover of services in dollar terms stood at the level of 2015 (USD 2.9bn) amid its overall decline.

CIS's share fell mainly because of continuing downward dynamics of the turnover of services with Ukraine<sup>1</sup>. While the 2015 decline was primarily spurred by the falling volume of service imports, the decline in 2016 was triggered by a more than one-third fall of service exports. Over the past few years the turnover of services with Ukraine fell from USD 6.88bn in 2013 to USD 2.05bn in 2016, with the share shrinking by more than two times: from 3.5% in 2013 to 1.6% in 2016. The trend toward worsening Russia-Ukraine economic relations continued: the share of trade turnover fell from 4.7% in 2013 to 2.2% in 2016<sup>2</sup>.

The dynamics and the share of trade in services with Turkey and Egypt are presented above.

1 A. Firanchuk. Foreign trade dynamics // Russian Economic Developments, 2016, No. 6 (23). P. 18–22.

2 A. Knobel, A. Firanchuk. Foreign trade in 2016 // Russian Economic Developments, 2017, No. 3 (24). P. 8–17.

Despite bilateral economic sanctions, the U.S. and EU's share of Russia's foreign turnover of services increased.

The European Union, like in the case with trade in goods, continues to be one of Russia's major trade partners in terms of turnover of services, accounting for 49% of service imports and for 39% of service exports. In addition, EU's share of turnover of services stood at 44.8% (+1.7 p.p.) in 2016, overtaking the figures seen in 2013–2015. The US share increased 0.4 p.p. to overtake the figures seen in 2013–2015.

This corresponds to the trend toward increasing the US share of Russia's trade turnover. Note that EU's share of Russia's trade turnover was largely associated with the dynamics of energy resource prices – the principal source of exports to the European Union<sup>1</sup>.

China appeared to be a major trade partner with a 14% growth of service imports. Service exports to China reached a record growth of 27%, thus increasing China's share of service turnover to 3.2% (+0.8 p.p.).

Switzerland's share was brought up to 4.6% (+0.5 p.p. from 2015) because of stable service imports and exports.●

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<sup>1</sup> A. Knobel, A. Firanchuk. Foreign trade in 2016 // Russian Economic Developments, 2017, No. 3 (24). P. 8–17.

## 5. MINIMUM WAGE INCREASE: PROS AND CONS

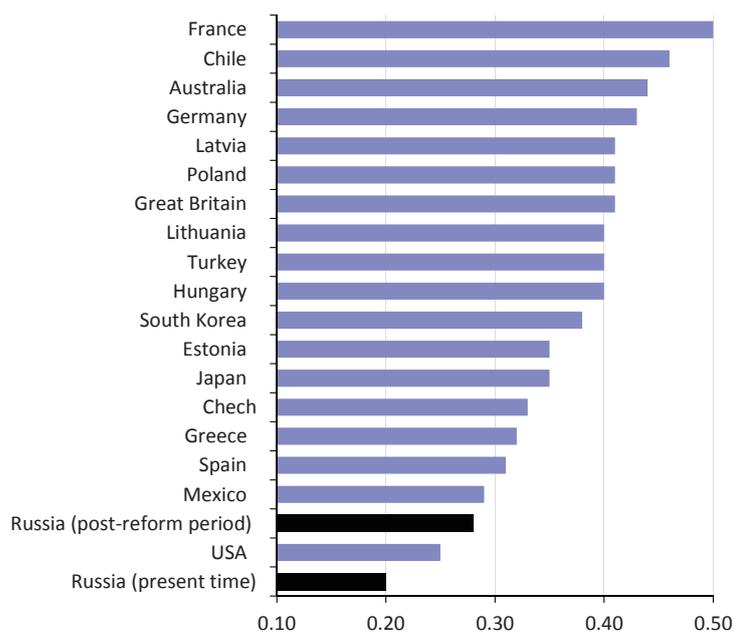
V.Lyashok

*A draft bill to raise the minimum wage to equal the subsistence level is under way – a task set by the Russian Prime Minister. This means that the minimum wage will be raised by 40% and the ratio of minimum to average wages may increase from 20% to 28%. According to various estimates, the draft bill may directly influence 3–4 millions of the employed workforce. Practice shows that raising the minimum wage may on the one hand reduce the inequality and spur overall wage growth in the formal sector, and, on the other hand, boost unemployment of the most vulnerable groups of the employed workforce and growth of the informal sector. It is however less developed regions that will be the first to see changes.*

In May 2017, Russian Prime Minister Dmitry Medvedev set a task of preparing a draft bill to raise the minimum wage to equal the subsistence level. The idea of raising the minimum wage was repeatedly debated in the past, and the Labour Code of 2001 stipulated that the minimum wage cannot be lower than the subsistence level for the workforce, and the minimum wage was expected to be raised in a stepwise manner to equal the subsistence level. It is likely that the draft bill will be prepared and adopted soon and the minimum wage will reach the target value within the ensuing 2–3 years.

The minimum wage is currently 7500 roubles (7800 roubles from 1 July 2017). The subsistence level is set quarterly with a lag of several months – 10466 roubles for the workforce in Q4 2016. Given the current figures, this means that the minimum wage will be raised by 40%. The ratio of minimum to average wages (the so-called Keynes' ratio) would therefore increase from the current 20% to 28%. This indicator is currently much lower compared with many developed countries including both Europe and the United States, whose labour market is much less over-regulated than that in Europe (*Fig. 1*). However, raising the minimum wage to a new level will have no effect on the Russian position in the overall ranking.

Many workers will be out of scope of the reform. The Rosstat's data show that about 10% of the workers employed at enterprises and organizations were paid less than the subsistence level in 2016, of which about 1–2% were paid



Sources: OECD Stat, Rosstat.

Fig. 1. Ratio of minimum to average wages

less than the minimum wage. The latter does not contradict the labour legislation because the workers could work on a part-time basis. Raising the federal minimum wage will downsize this group of workers, although some individuals will continue to be paid less than the subsistence level. At the same time, the official number of workers employed at enterprises and organizations is approximately two thirds of the total employed workforce in Russia. Raising the minimum wage can have a direct effect only on this group of workers, whereas the informal sector workforce (the self-employed, individual entrepreneurs and individuals employed by individual entrepreneurs) might be out of scope of the reform. The reform will therefore embrace 3–4 million persons or 5–6% of the total employed workforce, or, if real wages are raised, even less.

What does the minimum wage increase mean for the labour market? Economists have no clear cut and absolute answer to this question. The simplest economic model argues convincingly that the employment will deteriorate and the unemployment rate will increase, while more sophisticated theoretical models cannot give the same answer if a new level of the minimum wage appears to be “overestimated”. For example, amid monopsony (a situation in which a single firm is the only buyer within a given labour market. An example is single industry towns that are very typical of Russia), raising the minimum wage may boost the employment, as was shown by G. J. Stigler<sup>1</sup> and R. A. Lester<sup>2</sup> as early as the middle of the 20<sup>th</sup> century. At the same time, given a situation in which a second (informal) segment of the labour market exists alongside the formal segment, where institutional constraints have no effect on wages and workers can freely migrate between sectors, a minimum wage increase tends to force workers to migrate from one sector to another.

Uncertainties also arise when analyzing data on the introduction or raise of the minimum wage in various countries. D. Neumark and W.L. Wascher<sup>3</sup> analysed more than 150 research papers on the subject matter, two-thirds of which showed an adverse effect of legally enacted minimum wage on the employment. Moreover, there is no full certainty as to the effect on the informal unemployment.

The Russian data give a better view of the previous changes in the minimum wage which more than doubled, from 1100 to 2300 roubles, in September 2007 and was raised to 4330 roubles since January 2009. That is, within less than six months the minimum wage increased almost 4-fold. According to A. Oshchepkov and A. Muravyev<sup>4</sup>, the minimum wage more than doubled in 2007, boosting both the informal employment and the youth unemployment, while the reform had no effect on the employment of older age groups. The wage inequality was reduced in the formal corporate sector. According to A. Lukiyanova<sup>5</sup>, the wage growth period from 2007 to 2009 saw

1 Stigler G. J. The economics of minimum wage legislation //The American Economic Review. 1946. Vol. 36. No. 3. P. 358–365.

2 Lester R. A. Marginalism, minimum wages, and labor markets //The American Economic Review. 1947. Vol. 37. No. 1. P. 135–148.

3 Neumark D. et al. Minimum wages and employment //Foundations and Trends® in Microeconomics. 2007. Vol. 3. No. 1–2. P. 1–182.

4 Muravyev A., Oshchepkov A. Y. The Effect of Doubling the Minimum Wage on Employment: Evidence from Russia. 2015. Muravyev, Alexander and Oshchepkov, Aleksey (2013) Minimum Wages, Unemployment and Informality: Evidence from Panel Data on Russian Regions. IZADiscussion Paper No. 7878.

5 Lukiyanova A. Effects of Minimum Wages on the Russian Wage Distribution / NRU Higher School of Economics. Series EC “Economics”. 2011. No. 09.

sharp upsurge of wages for low-paid employees. According to A. Shanurina<sup>1</sup>, not only did the minimum wage increase result in higher salaries for public-sector low-paid employees, but it also moved up the entire pay grade in this sector. In general this helped narrow the wage gap between the public and non-public sectors. S. Kapelyuk answered the main question of whether the reforms of 2007–2009 fostered lowering the poverty<sup>2</sup>. He shows in his paper that the minimum wage increase did contribute to lowering the poverty, albeit in a limited way, according to the author.

Thus raising the minimum wage may have positive (inequality reduction and overall wage increase in the formal segment) and negative effects (informal sector growth, unemployment of the most vulnerable groups of workers), while the effect is often difficult to predict and depends on many parameters.

At the same time, the effect of minimum wage change on the labour market will predictably differ largely from region to region. In 2007, Russian regions were offered an opportunity to set a minimum wage on their own, provided that it is equal or higher than the value set forth in the federal law. As a result, 53 regions took the opportunity, and now there are regions where the minimum wage is higher than the federal subsistence level. The minimum wage for non-public sector employees and for workers employed by individual entrepreneurs was higher than 10500 roubles in 19 regions in late 2016/early 2017, most of which are northern regions (Yakutia, Murmansk region, Kamchatka Territory) and the richest regions (Moscow, St. Petersburg, Khanty-Mansi Autonomous Okrug). Forty four million persons are currently residing in the regions technically complying with the draft bill which has not yet been prepared. The minimum wage is equal to or higher than the regional subsistence level (which can be lower than the federal subsistence level) in 32 regions where 54% of Russia's population are residing.

This means that the reform will primarily deal with the poorest regions where the informal employment rate is high and the share of workers paid less than the minimum wage is way above 10%. Efforts to promote productivity and reduce poverty of workers will face a weak regional economy and a lack of opportunity to attract extra investment. The strong inequality between regions makes it more difficult to address the issues of the working poor and of strong inequality in a uniform manner on a country-wide basis. The issues of low minimum wage should be addressed at the regional rather than at the federal level. ●

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1 Sharunina A. V. Are the Russian public-sector employees “losers”? An analysis of intersectoral wage differences // *The HSE Economic Journal* . 2013. Vol. 17. No. 1. P. 75–107.

2 Kapelyuk S. The effect of minimum wage on poverty // *Economics of Transition*. 2015. Vol. 23. No. 2. P. 389–423.

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