



# Commentary on State and Business

144

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## ***1. Is stagnation the baseline scenario?***

What is the likelihood of a recovery in growth in the coming months, assuming no further increase in oil prices? Our modelling shows that industrial output is likely to stagnate, although some business climate indicators point to an improvement November.

In Bulletin 143 we noted that output in the primary sectors in mid-2017 had returned to the mid-2014 level (and GDP is almost at the mid-2014 level). Thus, growth driven by the recovery from the crisis has been exhausted. In this Bulletin, we show that the same applies to non-energy exports, which by the Autumn of 2017 had almost recovered to the mid-2014 level. Non-energy export volumes were last at this level in mid-2008. This suggests that there is limited potential for further growth in non-energy export for key goods (metals, machinery and chemical products). The only exception is agricultural produce, where output has significantly improved since mid-2011 and continues to improve in 2017. However, agriculture accounts for just 7% of total exports.

Household demand will also weigh on the short-term growth outlook. Owing to the ongoing decline in real disposable income, seasonally adjusted retail trade growth is fluctuating around zero, and in contrast to other economic indicators, there is little indication of a recovery in this sector. The introduction of monthly payments to mothers following the birth of their first child will have little impact on consumer demand, as it will affect a small cohort with low income.

The amendments to the 2017 budget adopted this Autumn will increase spending primarily in non-productive areas (including spending on defence and “other expenditure” on the national economy). The decision to cancel tenders for construction contracts for the military sector with a total value of Rb1trn will lead to an increase in costs and a reduction in the real volume of construction services procured by the government – not just in the coming months, but over the whole period of implementation of the defence procurement programme.

Finally, data on bank deposits and lending to enterprises points to weak business activity and a low investment rate.

Thus, based on current economic trends, the most likely scenario in the coming months is further economic stagnation rather than recovery, although the data will continue to fluctuate from month to month.

## ***2. The real sector: October 2017 – the month growth stopped?***

***In October 2017 industry recorded zero growth in year-on-year terms. At the same time, surveys pointed to improved output and demand expectations in October. The overall trend of industrial production points towards stagnation.***

The slowdown in industrial output following growth of 1.5% and 0.9% in August and September respectively year on year is even more notable given that there was an additional working day this October compared with the same month of 2016. While industry stagnated overall, the extractive sector contracted by 0.1%, while manufacturing grew by 0.1%.

Rosstat's seasonally and working-day adjusted data showed a contraction in industrial production of 0.5% month on month in September and 0.1% in October. After peaking in May, industrial output has contracted on average by 0.3% a month. It should be noted, however, that the industrial output index calculated by the Higher School of Economics suggests stagnation rather than contraction. October surveys conducted by Rosstat also suggest stagnation rather than contraction, and registered an increase in optimism regarding the growth prospects in the coming quarter.

Diffusion indexes of actual industrial production and demand in October were unchanged from September (51.5 and 50 respectively), while indexes measuring expectations rose – in the case of output, from 59.5 to 61, and for demand, from 59.5 to 60. In the extractive sector surveys recorded a growth in both recorded levels of output and demand, and expectations for the coming two-three months.

Industry as a whole increased output by 1.6% in January-October, with output of precious metals rising by 2.5%, production of electricity, gas and steam by 1.3%, and manufacturing output by just 0.9%. However, the prospects for the extractive sector to act as a driver of growth is uncertain. The rate of growth of oil and gas has slowed sharply. Whereas production of oil and gas rose by 0.2% and 12% respectively year on year in January to October, in October oil production fell by 2.1%, while gas extraction grew by just 2.2%. The pharmaceutical and the automotive sectors performed strongly. The latter was driven by a recovery in domestic demand, a rise in exports and a fall in imports. State support and the low base year also played a role.

Compared with the first half of 2014, 16 sectors have increased output and 15 have reduced output. The following sectors recorded output growth of more than 10% compared with January-October 2014: medicines, medical goods, chemical products, other means of transport, coal, paper, textiles, food, other minerals, and also enterprises providing services to the extractive industry. Output fell by more than 10% in the following areas compared with 2014: clothes, automobiles, printing, tobacco and related goods, machinery repairs.

What is the outlook for industry? Our model had projected modest growth in October compared with last year followed by a slowdown and stagnation after adjusting for seasonal factors. However, growth had already fallen to zero in October. Given this, we believe industrial output is likely to stagnate in the coming two-three months compared with the same period of last year.

### ***3. The balance of payments: Exports values are not recovering despite the oil rally***

***The price of oil has steadily risen for five months in a row and in November Urals averaged \$62.7/barrel, 38% higher than in June this year. However, current trends point to a stagnation in exports.***

We estimate that in October the value of Russian exports on a balance of payments basis stood at \$29.4bn, compared with \$30.6bn a month earlier. In year-on-year terms exports were up by 19% and 21% respectively.

However, this growth is driven by price factors, while physical volumes of Russian exports have barely changed. According to the Federal Customs Service, physical export volumes actually fell by 0.4% year on year in September (the latest month for which data is available). Russia's participation in the OPEC agreement to manage the global oil supply has constrained oil sales. Weak demand in Europe has weighed on gas exports. Energy export volumes in October are likely to be comparable to September (-5.7%). After recording growth of 36% and 20% respectively in August and September year on year, the value of non-energy exports fell in October to last year's level (just over \$10bn). Non-energy exports consist primarily of machinery, metals (each account for around 10% of total exports in September) as well as chemical products and agricultural products (7% each).

Aggregate prices of these product groups are rising in line with the growth in resource prices. However, according to the Customs Service, physical export volumes of chemical products fell by 10.1% year on year, compared with growth of 13.7% in the first nine months of the year. Agricultural products declined by 15.1% against growth of 3.5% in January-September. At the same time, exports of machinery rose sharply (by 40% against 7.3% in the first nine months) as did exports of metals (by 9% against 2.6% in the first nine months). However, our calculations indicate that the boom in machinery exports ended in October, which is logical given the tightening of western sanctions. Seasonally adjusted data show a sharp slowdown in growth in non-energy exports in September. Combined with a fall in the physical volume of energy exports, this is holding back overall export growth despite the recovery in oil prices.

If oil prices remain at the September-November level and the current trend in the non-energy export groups is retained, overall exports may total \$336bn this year (growth of 23%).

#### ***4. Federal budget: Additional revenues have been spent on the military***

***According to preliminary data, Federal budget revenue in January-October was Rb12.3trn, 17.6% higher than the same period last year. Higher than forecast non-hydrocarbon revenues have prompted another revision to the 2017 budget.***

In January-October 2017 Federal budget revenues rose significantly compared with the same period of 2016. Federal revenue was equivalent to 16.6% of GDP, 1.3 percentage points higher than in the same period of 2016, principally due to higher oil prices, which led to a 24% increase in hydrocarbon revenues. Hydrocarbons accounted for 38.8% of total federal revenue in January-October 2017, against a budget forecast of 37%.

Non-hydrocarbon revenues rose in the first ten months of 2017 by 14% compared with the same period of 2016. VAT income on domestic sales was up by 12%, excise revenue by 46%, corporation taxes by 53%. The latter was primarily due to the fact that an additional 1 percentage point of the corporation tax rate was reassigned from the regions to the federal budget. VAT on imports rose by 7% and revenue from import tariffs by 2%. (See Table 1.)

**Table 1. Federal budget revenue in January-October 2011-17, % of GDP**

	2011	2012	2013	2014	2015	2016	2017
Total revenue	19,40	19,41	18,59	19,01	17,24	15,30	16,64
Oil and gas revenue	9,52	9,80	9,28	9,77	7,56	5,65	6,46
Non-oil and gas revenue	9,88	9,61	9,31	9,24	9,68	9,65	10,19
VAT	3,12	2,98	2,69	2,90	3,25	3,40	3,53
Excise Taxes	0,40	0,51	0,65	0,68	0,66	0,76	1,02
Corporation taxes	0,60	0,60	0,53	0,56	0,67	0,63	0,89
VAT on imported goods	2,51	2,53	2,36	2,23	2,18	2,26	2,24
Excise duty on imported goods	0,08	0,08	0,08	0,09	0,06	0,07	0,08
Import tariffs	1,15	1,14	0,98	0,84	0,70	0,68	0,64
Other	2,02	1,78	2,02	1,93	2,15	1,86	1,78

Source: Ministry of Finance, HSE Development Centre calculations.

Federal spending in January-October 2017 stood at Rb12.6trn, an increase in nominal terms compared with last year of 5.2%. This was 1.3 percentage points higher than the rise in consumer prices – in other words there has been a modest growth in expenditure in real terms. Nevertheless, spending in constant prices was 13% lower than in 2012.

The budget deficit in January-October was Rb294bn, or 0.4% of GDP, which was financed by domestic borrowing (net inflows stood at Rb1trn). Rb328bn was transferred from the National Wealth Fund (NWF) to cover the deficit in the Pension Fund. It should be noted that the Ministry of Finance is using additional hydrocarbon revenues to accumulate foreign currency reserves. Nevertheless, revenue from the sale of sovereign debt and the NWF enabled the Ministry of Finance in January-October 2017 to accumulate significant funds on account.

Higher than forecast revenue growth has led to the adoption of a second set of amendments to the 2017 budget. As a result of the amendments in July, federal expenditure increased by Rb361.8bn. The second set of amendments increased net expenditure by Rb125.7bn, which is equivalent to the expected annual increase in non-hydrocarbon revenue. Spending on defense was increased by Rb180bn, on the media by Rb3bn, on debt service by Rb10bn, and on inter-budgetary transfers by Rb37bn. Expenditure in other areas either did not significantly change or was reduced.

The changes in the structure of federal expenditure in 2017 are the result of the two rounds of budget amendments adopted during the year, and changes to the *svodnaya byudzhetskaya rospis'* (changes in budget allocations for individual spending lines). The latter increased total expenditure by an additional Rb278bn compared with the original budget. The main source of the additional financing is likely to be primarily funds on account. Overall, expenditure increased by Rb766bn compared with the original budget. The changes in expenditure after the two sets of budget amendments and the changes to the *svodnaya byudzhetskaya rospis'* are set out in table 2 below.

**Table 2 Federal budget expenditure in 2016-17, Rb bn.**

	2016	2017 budget law	2017 Budget law after amendments	Change compared with budget law
Total expenditure	16 416	16 241	17 007	766,2
State administration	1 096	1 205	1 267	61,7
Defence	3 775	2 836	3 052	216,2
National security	1 899	1 943	1 979	35,9
National economy	2 302	2 318	2 565	246,6

	2016	2017 budget law	2017 Budget law after amendments	Change compared with budget law
Housing and utilities	72	60	124	64,1
Environmental protection	63	76	93	16,5
Education	598	569	620	51,5
Culture and cinematography	87	96	98	2,2
Health	506	378	447	69,0
Social policy	4 588	5 084	5 022	-61,5
Sport	60	90	102	12,0
Media	77	74	83	9,3
Public debt service	621	729	730	1,3
General inter-budget transfers	672	784	824	40,5

Source: Ministry of Finance, HSE Development Centre calculations.

As the table shows, the additional resources from non-hydrocarbon revenues and the use of funds on account have been primarily spent on defense and the national economy. Expenditure on the economy has been principally directed to the sub-category entitled “other areas of the national economy.” In other words, the main beneficiary of the budget changes is the security sector. The increase in spending on the health services compared with the initial budget (as happens almost every year) should also be noted. Nevertheless, even after these amendments, expenditure will be below the 2016 level in nominal terms. Transfers to the regions will also increase slightly, as the pressure on regional budgets has increased in recent years. Despite many public declarations to the contrary, spending on state administration has been increased. The increasingly non-transparent use of budget funds should be noted, which are often not amended through legislation, but through decisions by the Ministry of Finance and other agencies.