

On the development of the Russian Economy in 2011 and forecast for 2012-2014²

1. The Development of the Russian Economy in 2011

The following are this year's main attributes of economic development:

1. The transition to moderate rates of economic growth, approximately 4%, which are insufficient for addressing the major challenges in the areas of combatting poverty, developing infrastructure, stepping up science and technology development effort, modernizing the armed forces and the law-enforcement system. There is clear deficit of economic growth factors.
2. Mechanisms used in the past to sustain the income and consumption have been exhausted; those mechanisms were based on intensively increasing private sector wages and budget spending simultaneously.
3. Significantly improved employment situation due not just to economic growth, but also to the start of a decline in labor force, a long-term trend.
4. A uniquely low inflation rate, primarily event-driven (price stabilization thanks to a large crop);
5. Massive capital outflow weakening balance of payments;
6. In the second semester, a larger-than-seasonal-variation weakening of the ruble.
7. Moderately stringent fiscal policy. Continued growth of of the Reserve Fund. Balanced budget achieved.

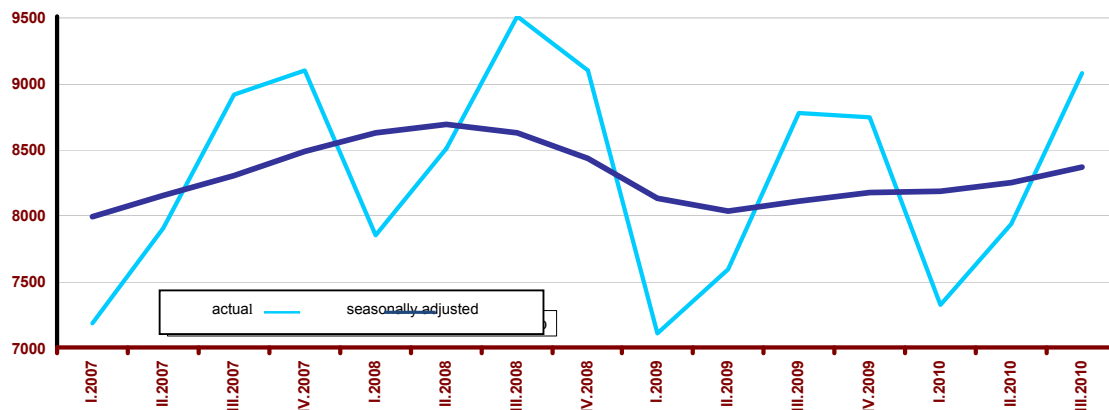
Economic Growth

In 2011, economic growth generally had a recovery nature thus continuing the trend that started as far back as 2009-2010 (see graph 1.1).

¹ We thank E. Penukhina, O. Solntsev, M. Mamonov, A. Pestova for assistance in the preparation of the material

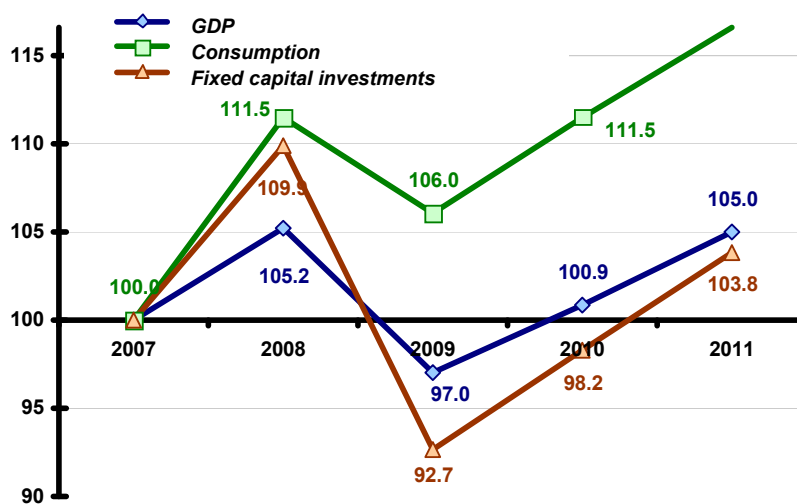
² The material is prepared as part of the project of Ministry of Education and Science of the Russian Federation and the program of fundamental researches of NRU-HSE in 2011

Graph 1.1. Gross domestic product in equivalent prices (billions of rubles in 2007 prices)



In the current year, real GDP will most likely reach the 2008, pre-crisis levels (see graph 1.2). However, no signs of a post-crisis jump in fixed capital investments are observed so far. Moreover, the revival in consumer demand is also rather moderate. In the meantime, while the population's consumption levels did reach pre-crisis levels as early as last year and are slowly expanding further, fixed investments will reach the pre-crisis levels in 2012 at best (and if large companies yet again refuse to implement investment programs and projects, then it won't happen until 2013).

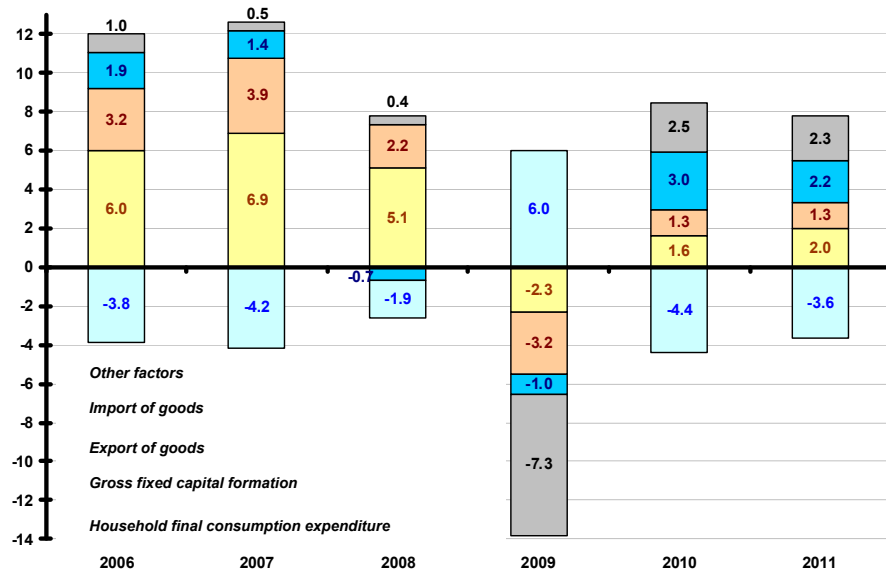
Graph 1.2. Main components of economic growth in Russia (2007 = 100)



This situation is reflected by the structure of economic growth factors. In the first half of the year, the GDP was to a very large extent based on companies' inventory expansion (in the current year, as was the case last year, their contribution to the GDP growth was approximately 2.5 percentage points).

Therefore, the contribution of fixed capital investments to economic growth has decreased from approximately 3 percentage points before the crisis to less than 1.5 percentage points, and that of household's consumption levels (see below) – to the level of approximately 2 percentage points (see graph 1.3).

Graph 1.3. Economic growth factor structure (GDP growth rate, percentage points)

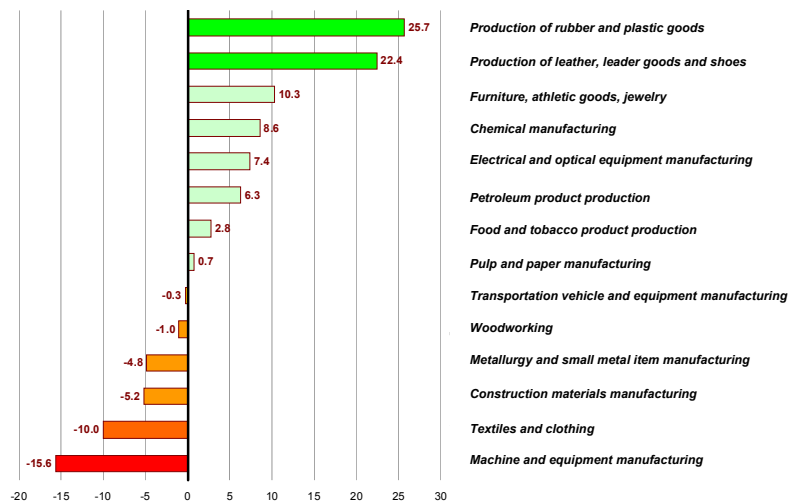


Additionally, so far, to a large extent, the growth is concentrated in areas that have not recovered to pre-crisis production levels, including machine-building facilities. However, the post-crisis “growth idea” has still not demonstrated itself, i.e., the idea that facilities that have upgraded its capabilities and product lines in the crisis period become growth engines, which in turn should serve as the basis for new competitive products, the latter becoming the basis for further full-blown recovery growth and increased investment activity of primary areas.

It demonstrates itself in the following processes:

- a slower growth of 2010 recovery growth leader industries, i.e., raw and investment industries, first of all, that have reached pre-crisis production levels and that subsequently stabilized (see Graph 1.4). Only a few of the industries have reached levels above the pre-crisis ones, primarily those producing consumer goods.

**Graph 1.4. Production growth rates in primary economic industries
(July 2011 versus January-September 2008, seasonally adjusted, %)**

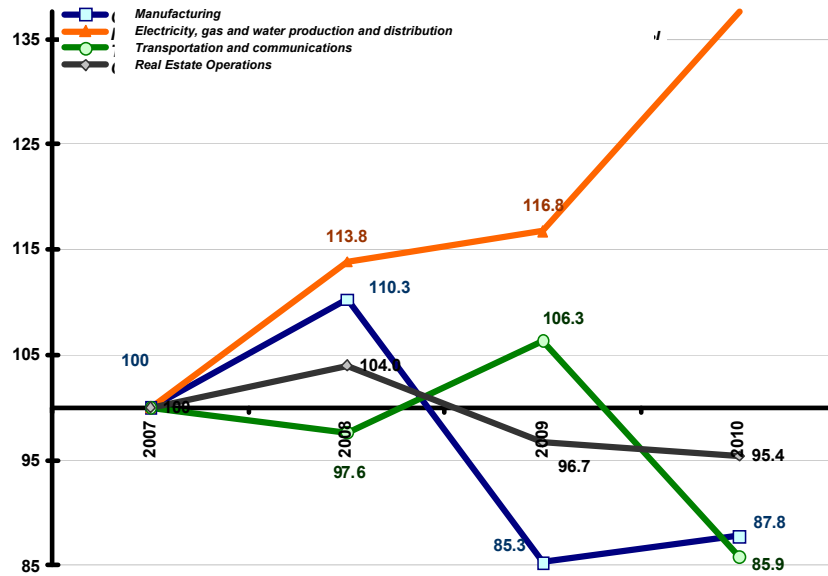


- unexpectedly low investment trend that does not extend beyond making up for the crisis fall (except the electric power industry where both the private and the state-owned company investment programs are being actively implemented, including Rosatom, see Graph 1.5). While in 2009-2010, the analysis of the investment programs of the largest companies yielded an investment growth rate value of 8-9% in 2011, today we would not obtain anything above 6% in terms of actual numbers.

The most important factor containing the investment trend is the lack of private investment growth in housing (due to the households's slower real income and mortgage trends), as well as stagnating government investments and investments made by state-owned companies in infrastructure facility construction (railroads, first and foremost). Additionally, the massive outflow of capital, lasting almost the entire year (see below) and tied to the entry of the global economy into a turbulent period³, had a significantly negative impact on the investment processes.

³ Experience shows that the growth of instability of the developed markets, whether it is the US in 2008-2009 or the EU in 2011, produces a capital outflow from the developing markets, including the Russian market, and that, even if there is nothing significantly adverse happening on the latter ones.

Graph 1.5. Investment trends in the main economic sectors (2007 = 100)



- the general economy slowdown trend. While last year, the GDP growth was 4.1%, in the first six months of the current year it was just 3.7% (against the first semester of last year). The current year's expected GDP growth of approximately 4% is due to the low base effect in the second half of last year, which in turn was due to a very poor harvest. This year's large crop and the revival in some machine-building facilities means a higher rate of GDP growth in the second half of the current year. However, it is not a given that even these growth rates will continue.

Population's Income Source Deficit Issue

Household's consumption has been in the past and still remains the main driver for Russia's economic growth, both due to its high percentage of total GDP (at 40-45% it has twice the weight of investments), and due to the rather high income and consumption expansion rates.

At the same time, it is specifically in this area, one that is crucial for the economy, that things are changing for the worse (and they are apparently medium-term in nature).

First, this is about a deficit of income necessary for intensive economic growth.

On the one hand, the companies' behavior has changed during the 2008-2009 economic crisis, resulting in them forgoing the very rapid expansion of salaries of the pre-crisis times, which was occurring at approximately twice the rate of labor productivity.

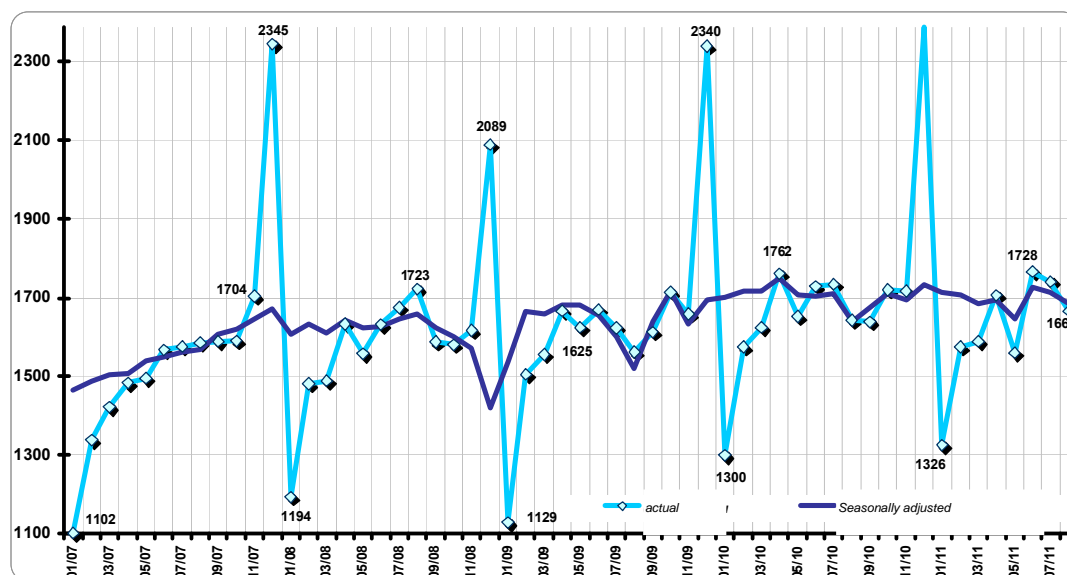
In any event, both the actual state of affairs and the poll results show that according to the companies' published expectations, by contrast with the previous period, the increase in real salary will match the growth of labor productivity.

This year, the tax burden hike on businesses, i.e., the social security contribution increase from 26% to 34%, became an additional factor restraining salary growth. Appropriately, real salaries turned out to grow even less labor productivity (total of 3.6% versus 4.0%; for comparison, in 2010, labor productivity expanded by 5.2%).

At the same time, the attempt to stabilize the budget after the crisis lead to a significant decline of real pensions growth rates. While in the previous years the growth of real pensions was not less than 10% a year (and in 2010 it jumped 35% at once after pensions were recalculated to deliver on previous years' obligations), this year, it is estimated that they grew by less than 1.5%.

The above yields the total for the current year where the increase in the household's real income is estimated to be no more than 2%. Also, beginning mid-year, a certain decrease in real income was even being observed. (see Graph 1.6).

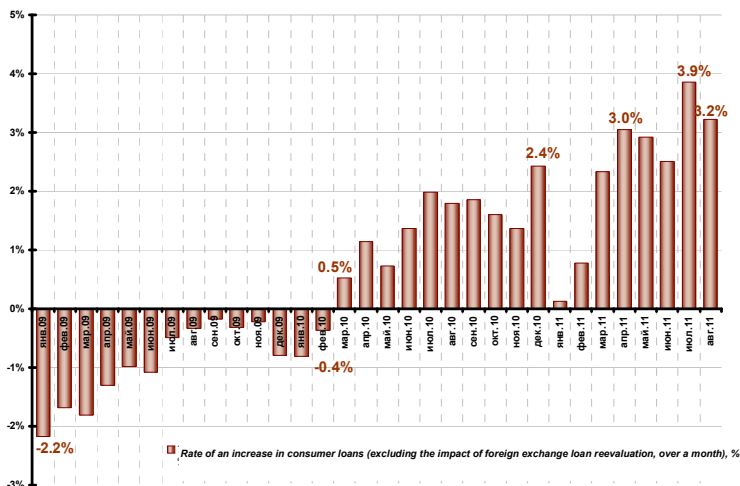
Graph 1.6. Household's real income (in 2007-equivalent prices)



The expansion of consumer demand (today's most important economic growth factor for Russia) became a resultant force composed of several trends pointing in different directions.

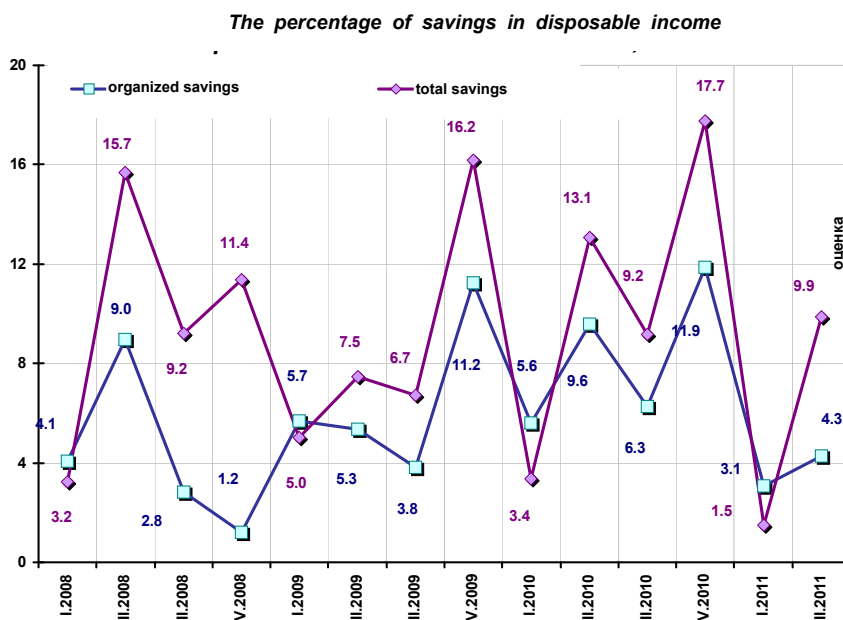
On the one hand, it is the revival of consumer lending, which very suddenly started despite the very low household's income trend. Over the past year and a half, there was stable growth of consumer lending if expressed in nominal values; moreover, starting in March, it was growing by a factor of 3% a month (see Graph 1.7; strictly speaking, it shows the total debt of the population held by the banks, but since mortgage has virtually not been revived, in reality then, the graph shows consumer lending). The fastest paced growth occurs in the high-risk unsecured retail lending (i.e., credit cards, cash advances), as well as in small retail loans obtained on the spot right in household appliance stores – and that, despite the shock experienced by both the banks and the households in 2008-2009.

Graph 1.7. Household's loan debt trends (growth increase, %)



Another factor that had supported household consumption is the household's lower savings rate. The proportion of organized savings as part of income is a historical low, according to mid-year data (see graph 1.8). It is a virtually inevitable result of the very low, bordering on negative, real bank deposit interest rates and the highly volatile nature of other financial markets (foreign exchange market, stock market).

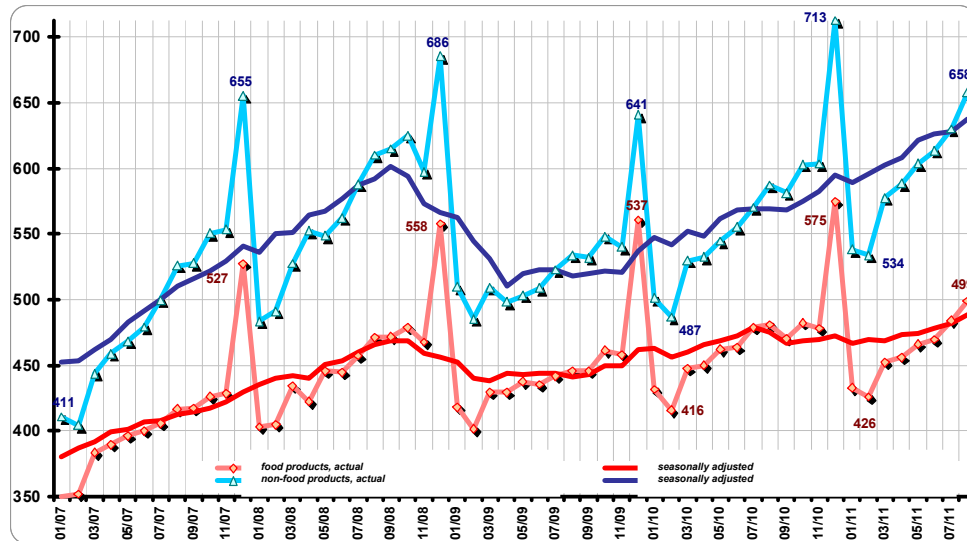
Graph 1.8. The percentage of household's savings in disposable income (%)



On the other hand, the slowing of the demand for food caused by food product sales reaching the pre-crisis level has had a restraining impact on the expansion of trade volume (see graph 1.9).

Subsequent “frontal” growth of food product consumption may be due only to a higher consumption of food by the poor, in line with the rather problem-fraught growth of its well-being. Additionally, food consumption trends will be clearly shifting toward more valuable and quality products.

Graph 1.9. Food and non-food product retail sales (in 2007-equivalent prices)



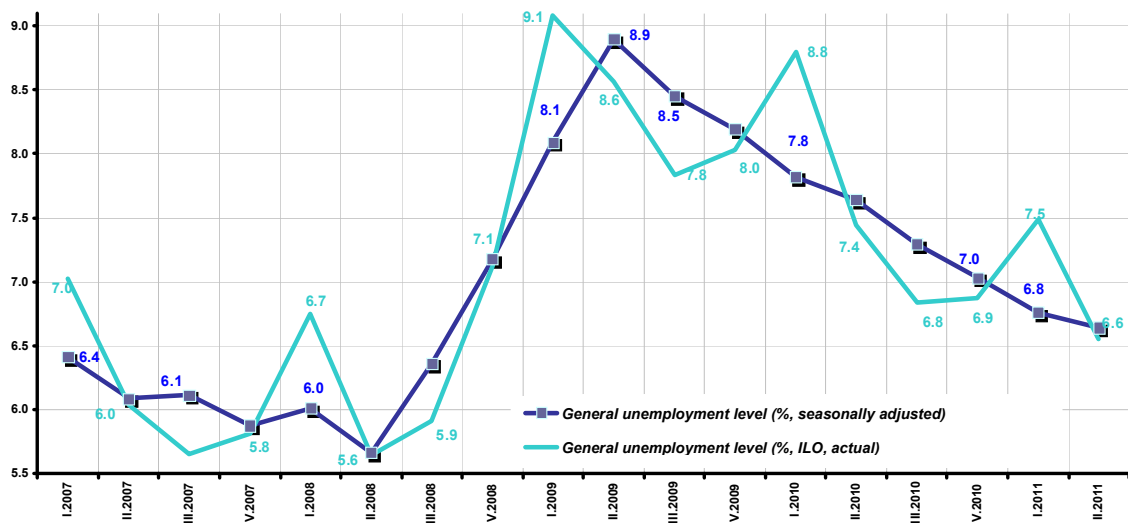
Whatever happens, while before the crisis and in the first post-crisis period, i.e., through the middle of 2010, population’s consumption growth had two engines, so to speak, both food-item driven and non-food item driven, now sales are expanding almost exclusively due to non-food items. Also, non-food item sales expansion is to a large extent due to a temporary lending increase. Which means that without an increase in the household’s income, it will turn out to be unstable at best.

Unemployment Rate: Rapid Improvement

The strange aspect of this years is that the employment situation is rapidly improving, all against the background of unstable economic growth.

Even today the unemployment rate has returned to the levels seen at the very start of the economic crisis, that is, to approximately 6.5% of the labor force (seasonally adjusted, see graph 1.10).

Graph 1.10. Unemployment rate (% of the labor force)



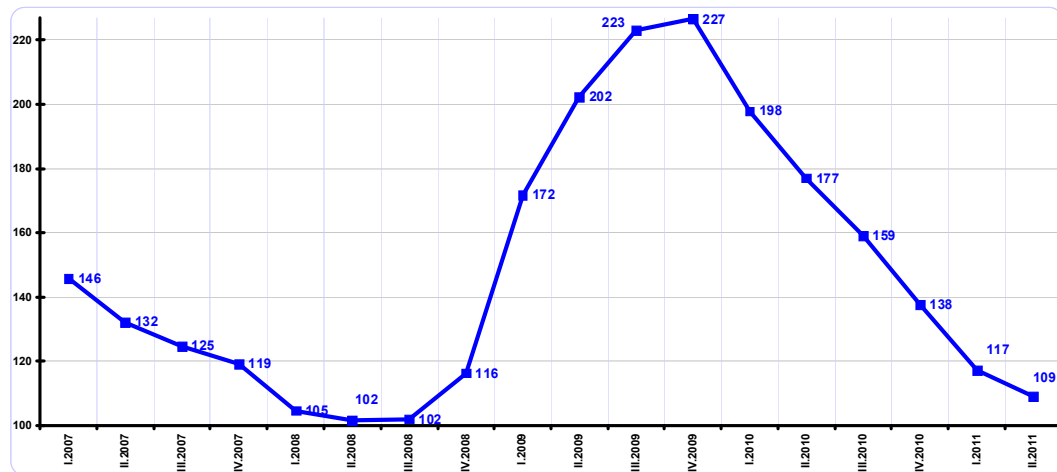
The labor market situation is even more interesting. Despite the fact that economy is far from being fully restored after the crisis, the officially recorded number of the unemployed and the number of job vacancies announced at companies have been virtually balanced out. Again, this type of balance had been last observed at the very beginning of the crisis when unemployment was just beginning to rise (see graph 1.11).

This situation is due not just to the emerging economic growth. A factor that is equally important (and increasingly so) is the decrease in labor force supply⁴.

In the future, the already visible deficit of labor force will stimulate salary growth (possibly to the detriment of other ways of utilizing companies' financial resources) and, simultaneously, the growth of government expenditures, which would mean, first and foremost, an increase in the budgets of regions of the Russian Federation.

⁴ Of course, balance has so far only been reached for the observed (and recorded by the Federal Labor and Employment Service) unemployment and for Russia as a whole. In reality, this means a dire shortage of workforce in certain types of workers (highly skilled industrial workers and engineers), and for some regions, the first ones to emerge from the crisis (the Moscow and St. Petersburg megalopolises, and a number of industrial areas) – as well as the overt and hidden excess of labor force in the Northern Caucasus, in agricultural and non-competitive areas, i.e., the so called “old industrial” areas.

**Graph 1.11. Recorded jobless rate v. open vacancies at companies
(the number of unemployed per 100 vacancies)**



Sudden Inflation Decrease

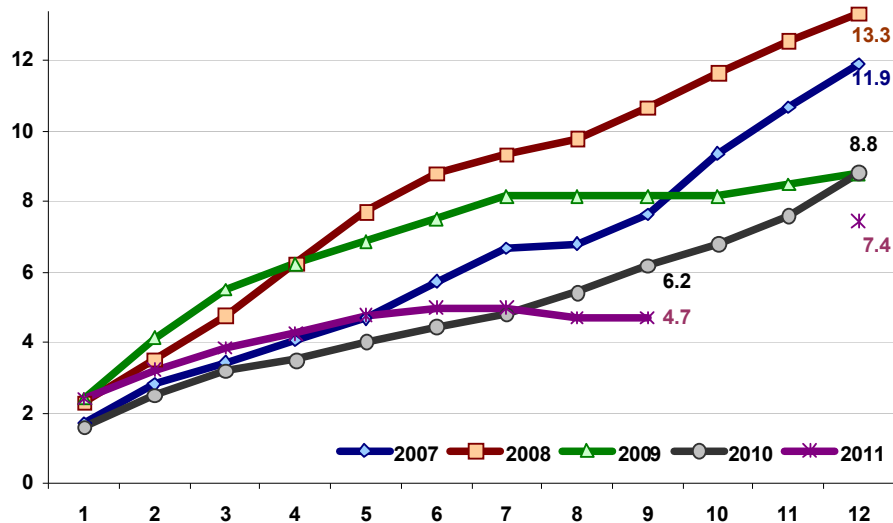
The year 2011 is special because of the sort of about turn in the inflation processes, i.e., from an accelerated growth in the first six months to the all-time low rates starting in the middle of the year (see Graph 1.12).

The inflation level (by December of last year) is today at just 4.7%, i.e., at a historic minimum over the period of the past several years. And, through the second quarter, “nothing forebode success”: propelled by the increase in natural monopoly service fees, and, after accounting for time lags, by the consequences of the weakened ruble and the jump in budgetary expenditures at the end of 2010, the level of inflation was higher not just than the 2010, crisis level, but also than the “overheated” 2007 level.

The turnaround did not occur until the summer of 2011. The main aspect of this turnaround was not some sort of a particularly lucky macroeconomic policy (though the strengthening ruble has undoubtedly become an anti-inflationary agent), but the pedestrian result of cheaper seasonal food products. The very favorable weather conditions yielded a bumper crop. Accordingly, a landslide fall in the prices of these products started in April. Nine months later it was already totaling 27% (for 2010, poor harvest - +31%). If one were to add the stabilized prices of the rest of the food products to the mix (January-August: the increase in food product prices was only 2.8%), then the low inflation level becomes real, and that, despite the continued inertial increase in non-food item and service prices.

Taking into account the weakening of the ruble that started occurring in September and that extended beyond the seasonal trend, a stronger inflation can be expected in the fourth quarter. As a result, it might be approximately 7-7.3% total for the year (December to December).

Graph 1.12. Month-by-month consumer price trend
(by December of last year, growth rates, %)



Current State of the Budget System

The present budget system situation is defined by the following primary trends and processes:

- The inflow of oil and gas income unplanned for by the Budget Law, due to beneficial conditions for international trade, which will make it possible to end the year with a near-zero federal budget deficit;
- Increased dependency of the federal budget from oil and gas revenues which in turn increases the risk related to the changes in the state of the international economy;
- A “freeze” of oil and gas funds, and their decreased importance as an instrument of economic policy;
- Escalating competition between the various budget resource allocations under the policy of gradual transition to zero-deficit budget;
- An increase in budget system receipts (extrabudgetary funds) due to the higher social security payments, which in turn significantly increases the tax burden on businesses;
- An increasingly centralized budget system, the growth of the dependency of the regional budgets and the budgets of extrabudgetary funds from interbudget transfers.

The current budget situation is to a large extent defined by beneficial conditions for international trade – the high oil prices (according to the 2011 year-end results, the Urals brand oil price will reach approximately \$108 a barrel) have stimulated an inflow of oil and gas receipts into the budget, which will make it possible to achieve year-end federal budget deficit of

just -0.4% of the GDP (see Graph 1.13) by contrast with the planned for -3.6% of the GDP according to the Federal Budget Law.

The flip side of the oil and gas revenue inflow has become the increased dependence of the budget system on the conditions for international trade. The percentage of oil and gas revenues in the federal budget in 2011 was at a record high -- 49.3%, exceeding even the 2008 levels. (see Graph 1.14). With the increasingly unstable development of the global economy, it becomes further fraught with risk.

Additionally, the external risks are compounded by the lack of sufficient accumulated backup resources to be used in case of a sharp drop in oil prices. Currently, budget rules stipulating obligatory payment of a part of oil and gas revenues into the respective funds have been temporarily suspended. The funds have been virtually “frozen”⁵ - their total volume as of the end of 2011 will total approximately 4260 billion rubles or 8.0 % of the GDP. For comparison, before the 2009-2010 crisis, total accumulated oil and gas funds represented approximately 16% of the GDP, which made possible to have stable budget during the sharp drop in oil prices and to fully satisfy expenditure obligations.

The goal to balance the budget was the driver behind the stringency of the current budget policy, i.e., the unplanned budget revenue growth was not accompanied by an increase in expenditures. Instead, virtually all of it was used to decrease the budget deficit which means increased competition for limited financial resources between various budget expenditure allocations. Here, government investments become the most vulnerable part of budget expenditures at the requisite limitation of expenditure growth is done at their expense.

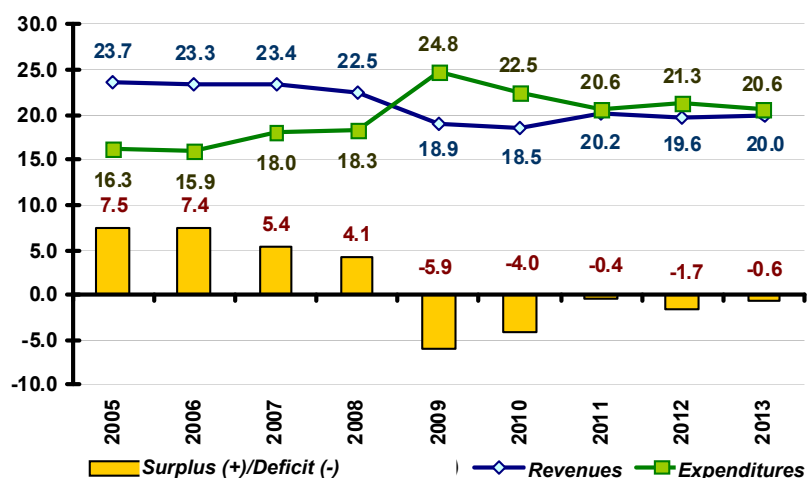
An attempt at softening the issue of a shortage of budget resources, and then at increasing the RF Pension Fund's income basis (PFRF), has been made by the 2011 social security payment rate increase. However, this measure resulted in a significant increase of the tax burden on businesses, which in turn had negative impact on economic development – Center for Macroeconomic Analysis and Short-Term Forecasting estimates that the introduction of this measure cost the Russian economy approximately 0.7 percentage points of GDP growth.

At this point, the decision to decrease social security tax rate starting in 2012 has already been made. However, the currently proposed rate decrease method consists of lowering the nominal rate, but also significantly increasing the regression threshold, and so for a number of activity types (high-tech manufacturing), it will be equivalent to tax-burden increase.

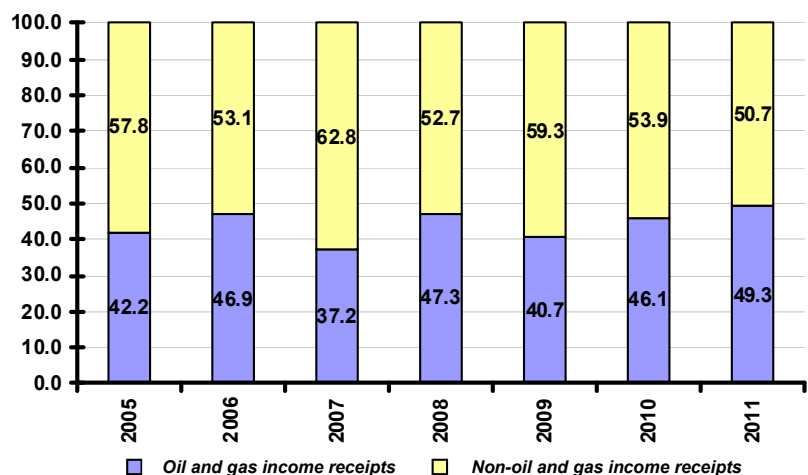
⁵ Year-end results show that approximately 900 billion rubles will be paid into the Reserve Fund; however, according to the draft of the 2012-2014 Federal Budget Law, there are virtually no plans for further payments into the oil and gas funds nor are they required (revenues to be paid into the Reserve fund, i.e., approximately 0.8% of the GDP per year, may be used to compensate for government loans and privatization revenue).

In 2011, the additional area of budget system stress is the increasingly unbalanced nature of regional budgets. The increase in social expenditures which are not backed up by the matching increase in the revenue base of the RF region budgets⁶, has led to a further decrease in the independence of regional budget policy and keeps the social area underfinanced. In 2011, the share of own budget revenues in the budgets of the regions of the Russian Federation fell to 71% (see Graph 1.15), which corresponds to the 2009 level, when the regional budget crisis occurred.

Graph 1.13. Federal budget revenues, expenditures and surplus (+)/deficit (-) in 2005-2013 (% of the GDP)

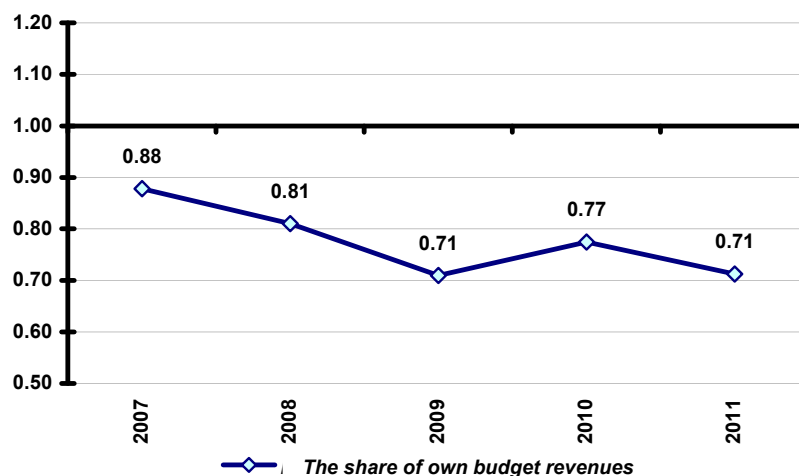


Graph 1.14. Federal budget revenues structure (%)



⁶ Calculated as the ratio of RF subject receipts less interbudget transfers, and expenditures.

Graph 1.15. The share of own budget revenues in the budgets of the subjects of the Russian Federation



Current Situation: Outflow of Capital from The Private Sector

The year 2011 saw a significant increase in net capital outflow from the non-financial sector. Estimates show that for the first three quarters of 2011, this outflow was approximately 50 billion dollars versus 14 billion dollars over the same period in 2010.

This year's larger net outflow has the following explanation:

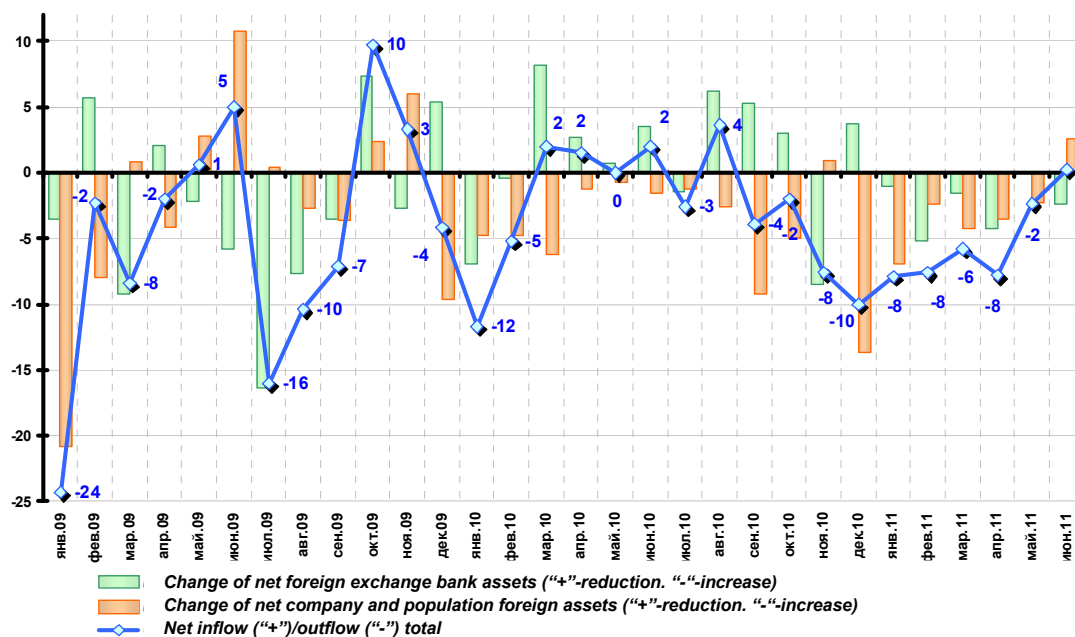
First, the expansion of direct and portfolio investments of non-financial companies abroad (first half of 2011: +14 billion dollars versus the same period in 2010). The reason for this expansion is the growing integration of the Russian companies in international value chains as well as by the businesses assessing the risk of investing in the Russian economy as higher;

Second, the increase in international asset investments by the banking sector (first half of 2011: +29 billion dollars versus the same period in 2010); this increase is a mirror image of the increase in the investment by companies and the households in currency deposits of the Russian banks, which is a reaction to the conversion to the more floating ruble exchange rate;

Third, the expansion of the population's investments in liquid foreign currency (first half of 2011: +7 billion dollars versus the same period in 2010).

Graph 1.16. Net inflow of capital into the non-government sector

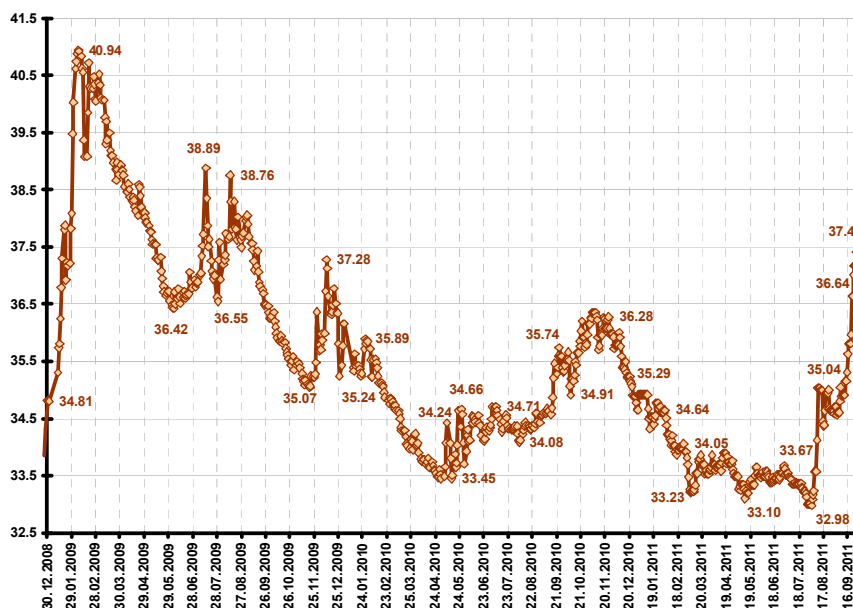
(«+» - inflow, «-» - outflow, billion dollars)



Current Situation: Ruble's Exchange Rate

In the middle of this year, the ruble significantly weakened: by 10% against the bi-currency basket for the third quarter. This is in sharp contrast with the ruble's strengthening trend observed in the first half of 2011, as well as with the exchange rate behavior over the same period last year. Here, in the third quarter of last year, the ruble's exchange rate was also observed to be going down against the bi-currency basket, though rather modestly, just by 3%.

Graph 1.17. Bi-currency basket value (55 cents + 45 eurocents) in rubles



The reason for the sharp exchange rate change in the third quarter of 2011 is the simultaneous combination of three groups of factors resulting in downward pressure on the ruble: fundamental, seasonal and situational.

The fundamental factors include the medium-term tendency of imports to expand due to the Russian economy's insufficient competitiveness. In 2010-2011, imports were growing at the rate of 30-40% per year. Through the middle of this year, the increasing demand of the importers for currency was satisfied by expanding currency inflows from exports, occurring thanks to the global oil and other raw material price increases. As global oil prices stopped growing in the middle of this year, inevitably demand and supply balance on the currency market deteriorated.

In addition to the fundamental ones, seasonal factors are also at play:

Seasonal fluctuations of the volume of imports. As a rule, the first quarter sees this indicator at the year's low, followed by a consistent growth in second to fourth quarters, culminating in the year's maximum;

Seasonal fluctuations of transborder capital flows into the private sector. In the third quarter, a seasonal excess of capital is usually observed, which stimulates its outflow abroad.

External shocks are classified as situational factors, i.e., international investors taking money out of the developing markets under the influence of tense situations in EU's periphery countries.

It is worth noting that until very recently, the impact of fundamental, seasonal and situational factors on the ruble's exchange rate was largely "amortized" by the changes in Russia's official currency reserves, which helped soften exchange rate fluctuations.

In recent years, however, the Bank of Russia has been gradually moving toward a floating ruble exchange rate. As a result, the smothering impact of the operations involving currency reserves is becoming less and less pronounced.

2. Forecast for 2012-2014

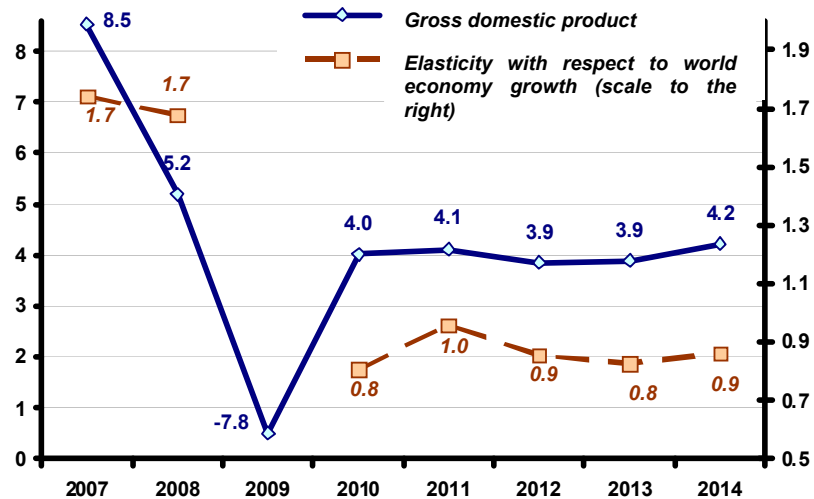
Economic Growth: Why So Little?

The main characteristic of economic growth in the outlook period is its slow rate, which is almost half of the pre-crisis rate.

Forecast calculations show that in the future, even if the generally favorable global market conditions remain (the Urals oil brand prices at approximately 100 dollars a barrel, global economy expanding at the rate of 4% per year), the Russian economy's growth rate will be approximately 4% per year -- and it will be extremely difficult to move off this level.

Consequently, in the future the Russian economy will probably lose its pre-crisis status as one of the world's economic growth leaders since its growth trend will not be ahead of the global trend by a factor of 1.5 to 2, but instead, and in the best case, the growth trend will match it. Additionally, the Russian economy will also be burdened by all the existing problems: ineffective structure, low standard of living, aged assets and others.

Graph 2.1. GDP Trends (growth rates, %)

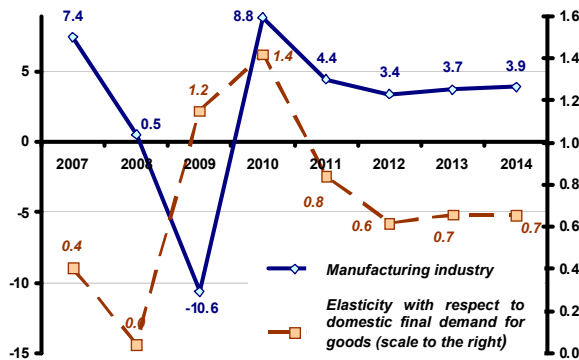


What causes such a low trend in the medium term? The answer is the continued insufficient competitiveness of the Russian economy, starting with the manufacturing industry. As was already stated above, the crisis did not lead to an increase in the effectiveness of the Russian economy. Therefore, after the crisis, as was the case before, the growth of industrial production is still lagging behind the domestic end-product demand trend (with an elasticity of 0.7-0.8, see Graph 2.2) – despite the slowdown of the trend experienced by the primary components of domestic demand, i.e., the population's consumption and investments.

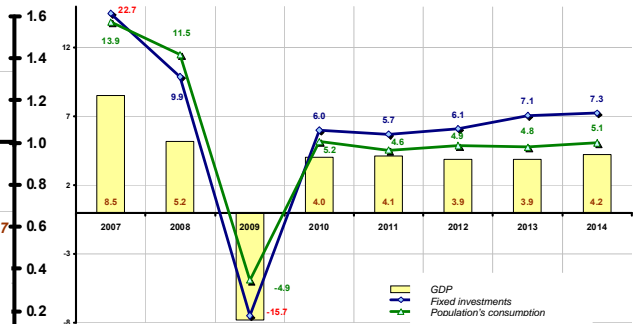
As a result, a self-sustaining “underdevelopment” cycle forms: a low demand trend (for example, population's consumption growth rates lag behind their pre-crisis values by a factor of approximately 2-2.5, see Graph 2.3) – a low manufacturing trend – depressed company and population income growth – a low demand level⁷.

⁷ And of low “quality” because of investment deficit, government and corporate depressed investment activity and other reasons.

Graph 2.2. Industrial growth trend
(growth rates, %)



Graph 2.3. Main economic trend components
(growth rates, %)



For Russia, economic growth slowdown means, first, an imbalance between disposable resources, and the need for structural reforms, the development of infrastructure, the fight against poverty and the implementation of many other large-scale projects all requiring significant resources both by the government and the business. These needs require then an estimated early average “balanced growth” of 5.2-5.7%, i.e., 1-1.5 percentage points above the expected level.

Significant consumer dead end

One of the most significant distinctive features of the upcoming period is the significantly slowed down expansion of population’s income and consumption resulting in macroeconomic (lower economic growth), as well as social consequences (greater social inequality and persistent poverty).

Here is how this group of problems unfolds.

1. The economic behavior of the Russian companies experienced significant transformation while they were emerging from the economic crisis. Before the crisis they were ready to increase labor remuneration levels at a rate almost twice that of employee effectiveness growth (i.e., labor productivity). Now, despite the significantly more complicated situation with labor supply, salary growth will probably be little more intensive than labor productivity growth. Accordingly, growth itself of real salaries (the primary income component of the population) is estimated to be 5% a year in the forecast time period (see Graph 2.4)⁸.

⁸ In 2011, the higher social security contributions restricted the growth of salaries (see Section 1). In 2012, the rate of social security contributions imposed on salaries per employee will be lowered to 30%. Simultaneously, a 10% tax will be introduced and imposed on amounts exceeding this threshold. Until 2012, no social security contribution obligations were imposed on amounts above the threshold at all. Accordingly, for a number of private sector companies, especially for those in the intensively developing sectors (including information and telecommunication technologies for example) with highly-salaried employees, the tax burden will not decrease, but instead will grow even more.

2. The small size of the Pension Fund's resource base (as well as the federal one supporting it) leads to a sharp slowdown of the real pension trend. In recent years, real pensions were growing at a rate of approximately 10% and higher, while in 2011-2014 their growth will be between 1.2% and 2.5-3% per year (incidentally, this also means that the wage replacement ratio, one of Russia's key pension policy parameters, has fallen from 37% in 2010 to 32.7% in 2014.⁹)

This increase in real salaries and pensions defines the population's future real income trend, i.e., an annual growth of approximately 4.5-5% (see graph 2.5).

3. The population's low real income trend and specifically, its socially most important component, pensions, mean that significant social risks will arise.

Even under the conditions of an intensive increase of the Russian population's income in the previous years, the only thing that actually stabilized was social inequality. Income inequality ratio was decreased only from 17 to 16 – and that, under conditions of a unique, one-of-a-kind intensive growth of incomes as well as pensions (see graph 2.6).

In reality, the above means that centers of sustained, long-standing poverty, with its concomitant degradation of human capital, massive skill loss and the very ability to come out of poverty start emerging in a number of Russia's regions (primarily the agrarian ones).

The issue is further compounded by the higher growth of the so called "inflation for the poor" that has emerged over the past several years (2011 became a happy coincidence), due to the intensive appreciation of food products consumed by them (see graph 2.7).

The issue has largely to do with the fact that both the calculations of social expenditures coming out of the budget and the assessment of their effectiveness are based specifically on average yearly inflation. While the growth of social expenditures was sufficiently intensive, the statistical underestimation of inflation for the socially vulnerable population groups was merely leading to a more or less noticeable income growth slowdown of the salaries of the low-income population. However, if it is planned to increase social expenditures by a minimum, then the potential jump in food prices, having a moderate impact on the general inflation level, would have the ability to make things worse for poor households.

4. A significant factor impacting the expansion of turnover even before the crisis, and then in 2010-2011, was the expansion of consumer lending. However, the capabilities of future

⁹ V. V. Putin, Chairman of the Government of the Russian Federation, has defined 40% as the target level.

credit expansion that would ensure an increase in population's consumption are limited. The growth of the nominal volume of loans to households is expected to stabilize at approximately 15-20% per year (11% on average per year in real values, see graph 2.9).

There are limitations on both sides here:

- on the one hand, under the conditions of a relatively slow expansion of the population's incomes, the debt burden on incomes will start quickly growing, all the way through pre-crisis levels (principal repayment – 13-14% of disposable income, see graph 2.8), which means a corresponding growth of credit risks;
- on the other hand, the Russian banks have already transitioned to a 20-25% proportion of consumer lending in bank credit of all commercial banks (see graph 2.9), characteristic for a range of Eastern European and Asian countries comparable with Russia. Further expansion of consumer loans in this situation will be taken at least as something that would lead to unbalancing the credit portfolios.

Accordingly, the growth of consumer lending will occur naturally, most likely, along with the expansion of the banks' funding base. However, the latter will be growing slower than before the crisis, at least because the deposit base stopped growing.

5. As a result, in the future the population's total consumption growth (which includes both goods and fee-based services) might turn out to be two to three times smaller than before the crisis. Population's consumption will be growing at the rate of 4.5-5% per year (before the crisis, it was 10-15% per year, see Graph 2.10). This factor alone subtracts 1.5-2 percentage points from the economic growth rate.

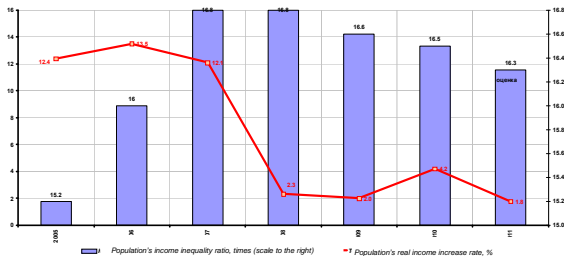
Graph 2.4. Real salary trend
(rate of increase, %)



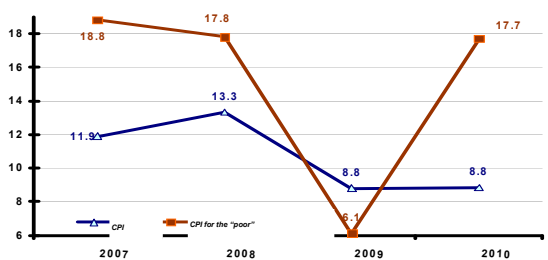
Graph 2.5. Primary component of population's income trend
(rate of increase, %)



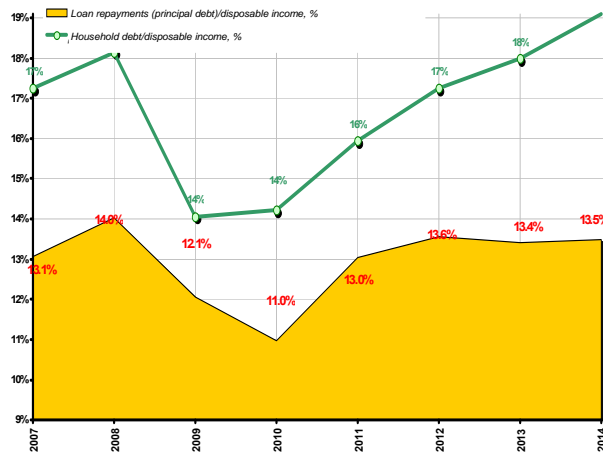
Graph 2.6. Levels of inequality in the Russian economy (income inequality ratio, times)



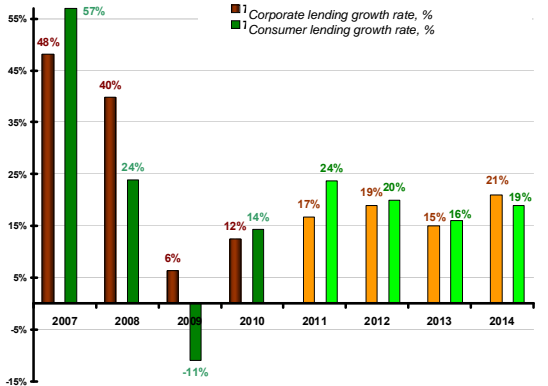
Graph 2.7. "Inflation for the poor" level
(increase rate, December to December)



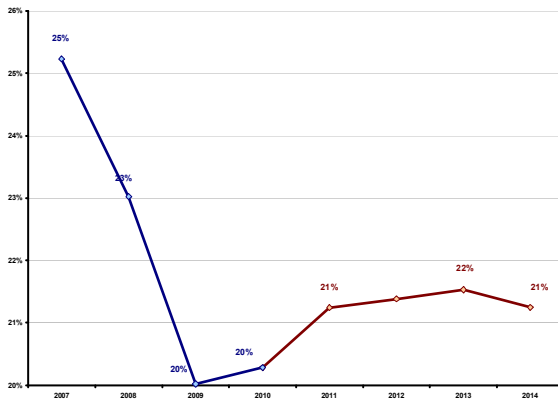
Graph 2.8. Population's debt burden (%)



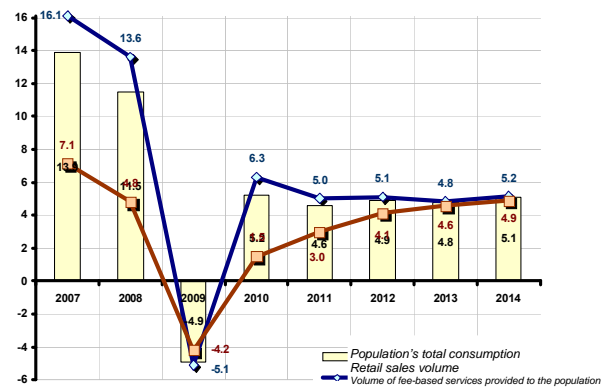
Graph 2.9. Banks' consumer and corporate lending trend
(increase rate, %)



Graph 2.9. The share of consumer lending in commercial banks' loan portfolio (%)



Graph 2.10. Population's consumption trend (%)



Will growth become investment-oriented?

In the medium term, fixed investments are expected to experience an accelerated growth at the rate exceeding the general economic trend by a factor of 1.5 or 2, i.e., almost equal to the pre-crisis times. It is expected that as international and domestic economic conditions gradually improve, the rate of investment growth will be gradually increasing from 6% in 2012 to 7-7.5% in 2013-2014 (see graph 2.11). This level is of course much lower than before the crisis, but in 2007-2008 the investment environment was apparently overheated.

Accordingly, the percentage of investments in the GDP can be expected to grow from the current 19% up to 21%, all owing to a rapid decrease in the percentage of household consumption in the GDP (see graph 2.12).

At the same time, this investment trend is insufficient for solving main development goals, especially those in the areas shaping the level of long-term competitiveness of the Russian economy, i.e., the development of new technologies and high-tech industries (using government investments and foreign direct investments), infrastructure (government investments), the development of human capital (government investments).

The quick decline in the percentage of government investments in the GDP, from 3.5% of the GDP in 2011 to 2.8% in 2014 (see Graph 2.13), becomes the limiting factor here, and that, keeping in mind that before the crisis there was a plan to increase the percentage of government investments to approximately 4% of the GDP¹⁰ in 2011-2013. As such, the government is doing

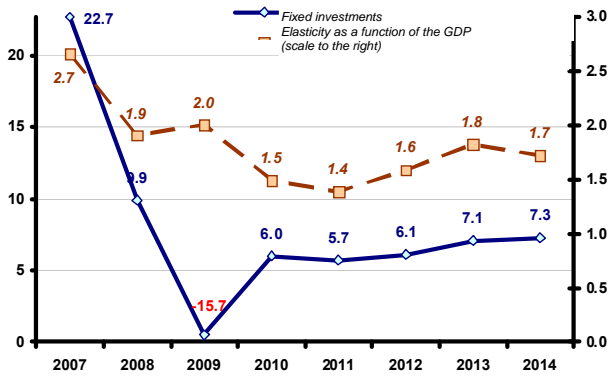
¹⁰The drop in the percentage of government investments in financing fixed investments by a factor of 1.5 is indicative here – it went from 15% in 2011 to 10-11% in 2014 (see graph 2.15).

virtually no railroad construction aside from infrastructure projects within the framework of megaprojects, keeping in mind that before the crisis there was a whole range of these types of large-scale projects envisioned.

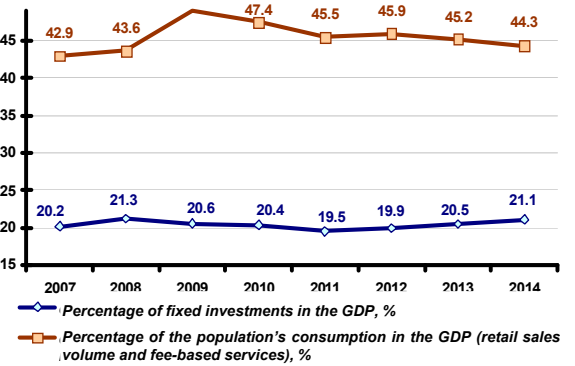
Additionally, in the “turbulent” global economy, there is no stable foreign direct investment inflow into Russian non-financial companies. Even in 2014, their percentage of the GDP will not reach the pre-crisis levels (see graph 2.14).

In this situation, the scale of possible revitalization of investment activities is driven, first, by the actions of domestic private investors (investments funded by companies’ own resources have been and remain the core of the investment process in Russia, see Graph 2.15), and second – by the development of domestic financial institutions (the stock markets, including bonds) and greater access of the Russian companies to foreign financial markets.

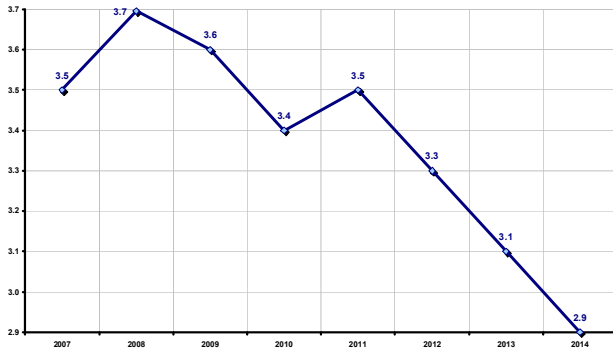
Graph 2.11. Fixed investment trends (rate of increase, %)



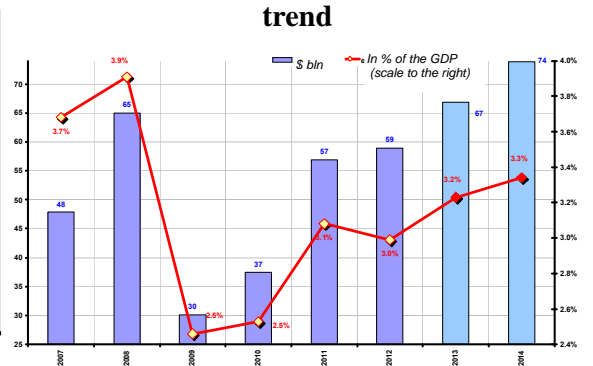
Graph 2.12. The percentage of the population's investment and consumption in the GDP (%)



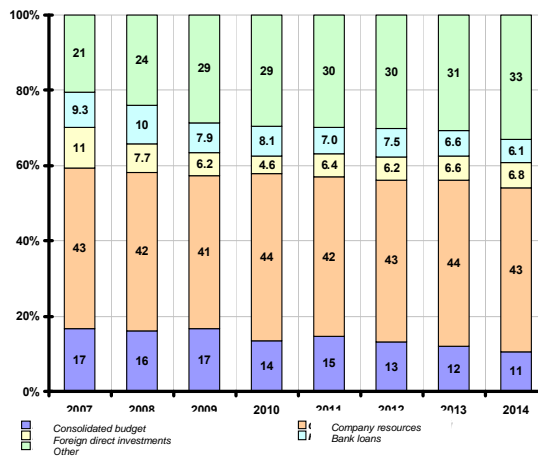
Graph 2.13. The percentage of government investments in the GDP (%)



Graph 2.14. The proportion of foreign direct investments in non-financial companies: trend



Graph 2.15. The fixed investment structure by investment sources (%)



Foreign Trade Situation

The main contradiction related to foreign trade is the gradual, though steadily growing imbalance of the balance of trade due to the accelerated growth of imports and the stabilization of exports (see graph 2.18).

On the one hand, in the future, oil production can be expected to stabilize, and, consequently, the export of oil and petroleum products as well (see graph 2.16). The above situation is related to bigger limitations related to oil production – in the medium term, the new oil fields, mostly located in the removed, environmentally vulnerable and not well-developed areas of Eastern Siberia and Northern Russia will, at best, compensate for the decommissioned capacities in the Volga River area and in Western Siberia.

It is true that gas exports will be growing thanks to the introduction of new pipelines and the increase in production levels – but this growth is fraught with additional risks because new gas markets are emerging (shale gas, global condensed gas market and others).

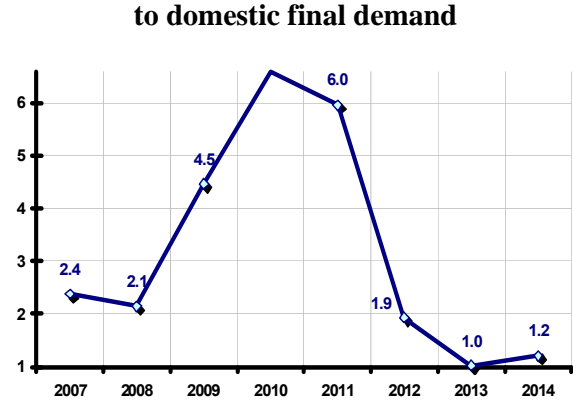
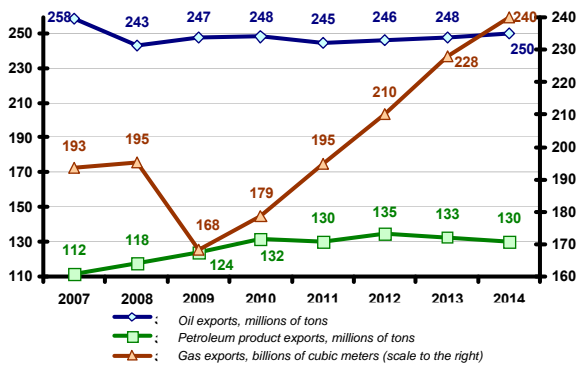
The expansion of non-energy products, such as metals, chemical products, timber, vehicles and equipments, and grain, all require significant effort to increase new capabilities, and is at the same time limited by global market demand, so it cannot be sufficiently large in the medium term.

At the same time, as has already been mentioned above, Russian products did not become significantly more competitive after the crisis. Imports continue to grow faster as compared to domestic market trends (see graph 2.18). It is the quick recovery of domestic demand and the significant strengthening of the ruble¹¹ that have become the primary factors impacting such a significant import growth.

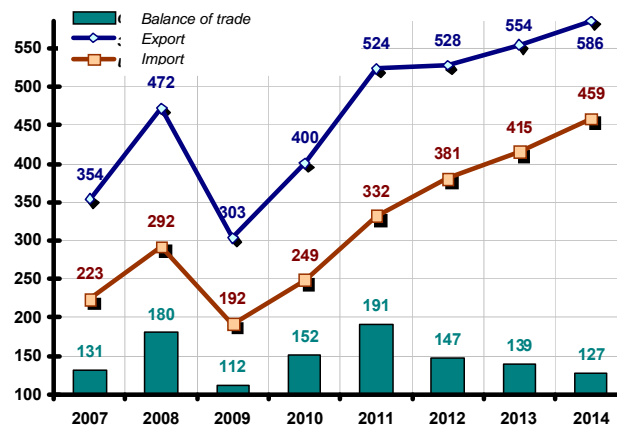
The growth of the monetary value of the imports and the stagnation of the exports (under the conditions of stable oil prices) will lead to a rapid shrinking of the balance of trade, and also, in light of the structure of Russia's balance of payments, to a smaller current account balance.

¹¹ Russian exports (by contrast with imports) are not very sensitive to the exchange rate trend –expecting an improvement of the situation in this area is not feasible.

Graph 2.16. Vital raw material export trend **Graph 2.17. Elasticity of import with respect**



Graph 2.18. Main foreign trade indicators (billions of dollars)

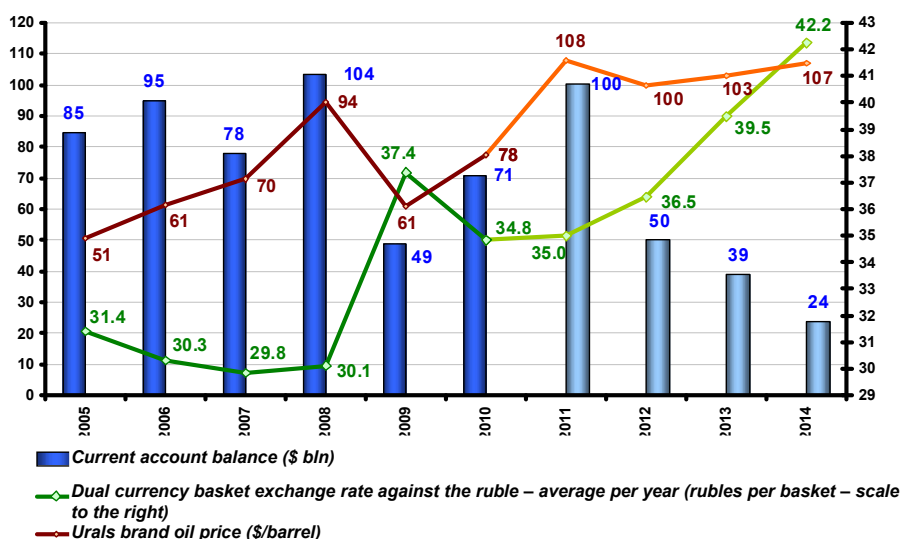


Balance of Payments and the Exchange Rate: Changing Areas

Over 2012-2014, the **current account balance** will be falling (see graph 2.19). The main reason is the stable expansion of the import of goods which is occurring at a rate significantly higher than that of monetary value of imports trend. *Additionally, balance of payments deficit will likely continue to grow in the medium term.* Why – because the Russian economy will continue to need an inflow of labor force from abroad.

The global debt market rate increases, which are likely to occur at the end of the forecast time period, will not make it possible to lower the existing investment income balance deficit. The private sector, which has a negative net foreign investment position (foreign liabilities exceed foreign assets), will lose from an increase in rates. It is unlikely that the government (the Bank of Russia and the Ministry of Finance), with its positive net international investment position, will win by a degree that would compensate for the losses of the private sector. The above is explained by the higher risk premium paid by Russian non-government borrowers.

Graph 2.19. Current account balance (billions of dollars), global oil prices, (\$/barrel), dual currency basket against the ruble (rubles per basket)



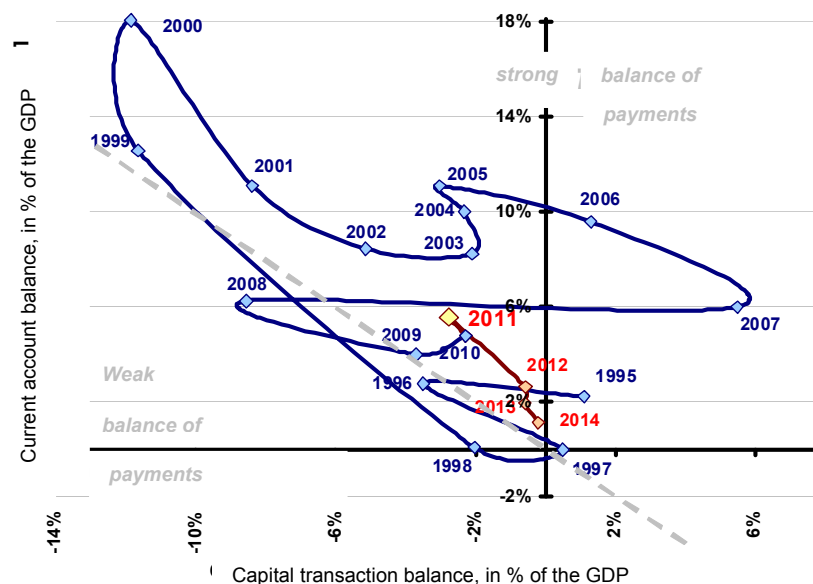
In the medium term, some decrease in the net outflow of capital transaction funds. However, the transition to a large-scale net inflow, comparable to those observed in the pre-crisis period (2006-2007), is extremely unlikely.

The volume of foreign direct investment inflow will probably grow, possibly exceeding maximum pre-crisis levels in 2013-2014.

However, this growth will be unable to compensate for the significant decrease, by contrast with pre-crisis volumes, of the inflow of capital via foreign borrowing. Net inflow of debt capital is narrowing first, due to the expected decrease in the differential between domestic and international interest rates, which will weaken the motivation to borrow. Second, the private Russian sector has already accumulated a level of foreign debt that is rather significant for a country with a developing market (approximately 80% of the goods and services export volume). Third, the country, being a borrower with still low levels of debt burden, is not planning to attract significant resources on the international market. According to the draft 2012-2014 federal budget, net attracted amounts will not exceed 0.1% of the GDP. The government chose in favor of domestic borrowing in order to minimize the budget's exposure to foreign currency risks, and to support domestic financial markets.

The combination of the narrowing current account balance and the lack of significant capital account balance improvement will exert downward pressure on the ruble's exchange rate. Russia's strong balance of payments situation, observed in 2000-2007, will not happen again in the medium term (see graph 2.20).

Graph 2.20. Russia's main balance of payments positions (in % of the GDP)



Consequently, the ruble's exchange rate is expected to transition from a stronger exchange rate to a weaker one in the medium term. With the global oil prices as we are forecasting them, the ruble's real effective exchange rate might fall by 6-7% over 2012-2014, and the average value of the dual currency basket against the ruble might grow by 20%.

It is worth mentioning that within the period of one year, ruble's exchange rate trend will continue to be very uneven. And so, at the beginning of 2012 for example, the strengthening of the ruble can be expected to resume under the influence of seasonal factors. This strengthening might continue through the middle of next year. In the second half of 2012, another round of the weakening of the ruble will be highly probable under the influence of seasonal factors. Notably, due to the medium-term downward trend, this weakening might end up being significantly more large-scale than the one observed this year.

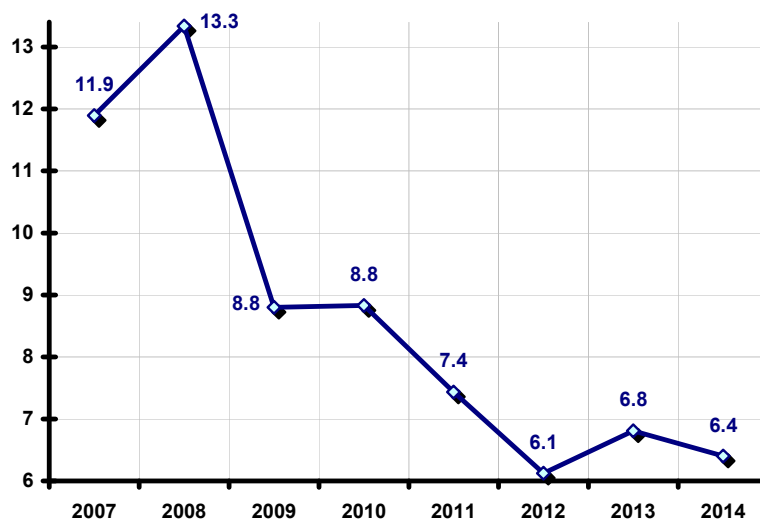
Reaching for the New Inflation "Support Level"

In the future, the level of inflation will be determined by two factors:

- continued greater growth of the pricing and fees of natural monopolies;
- transition from a strengthening ruble to a weakening ruble.

The influence of the two factors, and that of the weakening currency first, will lead to the inflation stabilizing at the level of approximately 6-7% per year (see graph 2.21). Its further slowdown in the medium-term is not realistic.

Graph 2.21. Inflation trend (December to December, growth rate, %)



The Future of the Budget System

Over the forecast time period, the budget system will be operating under fundamentally new conditions, both from the point of view of external factors, and from the point of view of internal limitations (see Table 2.1).

Overall, the future of the medium-term budget and fiscal policy will be defined by the ability to find a balance along two primary “key” axes:

expenditures – taxes – reserve funds;

social expenditures – inter-budget relationships – taxes imposed on the population.

Expenditures – taxes – reserve funds

On the one hand, an objective need to increase the expenditures of the expanded budget has emerged. Primarily, the need is due to:

- a deficit of the sources of economic growth;
- the need to return the “social debt”, for public employees, who, to a large extent, can currently be considered low-income;
- the country’s need for infrastructure investments, which would solve the problem of an economy with bad infrastructure;
- the physical ageing and functional obsolescence of the fleet of arms and military equipment.

A number of decisions (the extensive social security promises made during the crisis, the State Armaments Program (GPV), a range of large-scale international projects¹² and others) signify the existence of a difficult-to-rescind expenditure mandate effective for at least 2012.

It is already clear that in the next three years it is government investments (see above), and an adjustment to the State Armaments Program (GPV) that will become the elements sealing the deal, so to speak, and that will be used to balance the budget. Additionally, the launch of large-scale programs to modernize social institutions (first, education), which are also capable of restraining expenditure growth to a large extent, despite labor remuneration increases in these areas, though they are fraught with significant social risks.

A decision to increase the age of retirement might also be possible by the end of the same period¹³, a step without which balancing the Pension Fund and continuing to improve the population's welfare would be difficult to achieve.

On the other hand, opportunities for budget system receipt growth are very limited. Under the conditions of competing national tax rates, the growth of the tax burden on businesses will disincentivize the inflow of FDI, stimulating the outflow of capital abroad instead. As such, tax policy for the medium term assumes an increase in taxes imposed on the population (consumption taxes, specifically tobacco and alcohol excise taxes, and also property tax) and a simultaneous decrease in the tax burden on businesses (by lowering social security contribution rates).

Also, there is the option of funding expenditure growth using government debt (deficit level of 2-2.5% of the GDP over 3-5 years is acceptable for the Russian economy and may be financed without incurring the risk of macroeconomic destabilization)¹⁴. Currently, Russia's government debt does not exceed 8% of the GDP, and it can be increased to 15% of the GDP, which would be 1/4 of the Maastricht criteria.

However, under the conditions of appreciably high external risks to the operation of the Russian economy, there is a need to support a balanced budget and to accumulate reserve funds. While before the crisis, their role was primarily to sterilize excess liquidity in order to contain inflation, in the medium-term, they must specifically make sure they stabilize the budget system in case of an economic shock coming from abroad.

¹² Primarily, this is about four "mega projects" that today represent the core of government investments – the preparation for the Winter Olympics in Sochi (2014), APEC Vladivostok (2012), Universiade Kazan (2013) and the World Cup (2018), all requiring large-scale infrastructure and residential construction, as well as the implementation of a range of major pipeline projects.

¹³ Retirement age increase proposals are in the range 62 to 65 range

¹⁴ Particularly if the opportunity to privatize part of government property is taken into account, the number would be between 0.5-1% of the GDP under favorable conditions.

Social expenditures – inter-budget relationships – taxes imposed on the population

Second “key” axis is related to the need to ensure balanced regional budgets and extrabudgetary fund budgets (VBF). The growth of the social mandate of the regional authorities and the VBF that occurred during the crisis was not supported by a matching growth of the income base, which for all practical purposes caused them to lose their financial independence and to become fully dependent on inter-budget transfers from the federal center.

The need to ensure balanced regional budgets and retirement system drives the need to increase taxes distributed to regional budgets, and the potential redistribution of federal budget receipts to consolidated budgets of the subjects of the Russian Federation.

Table 2.1. External factors and internal limitations of the budget system

	Pre-crisis period	Medium-term future
1. The need to sterilize	The need to sterilize excess liquidity in order to contain inflation; accumulation of oil and gas funds	The need to contain inflation by the method of sterilization is lowered, the floating exchange rate is the primary method for protecting against volatility
2. Economic growth	Overheated economy, further growth of domestic demand at the expense of government expenditures would be undesirable	The deficit of the sources of growth, the need to stimulate economic development by using government expenditures or by lowering the tax burden
3. International economic conditions	Sustainably favorable international economic conditions, no expectation of crisis	Significant external risks, the need to preserve the reserves in case of a new crisis
4. Social security situation	The possibility (medium term) that social service fees will grow due to the growing improvement of the population’s welfare; the remoteness of the possibility that the demographic situation will deteriorate significantly	The need to increase social expenditures under the conditions of regional budget receipt deficit, the slowing of the growth of incomes of the population, and the start of the deterioration of the demographic situation
5. Acceptable tax burden level	High incomes earned by businesses were making it possible to comply with a rather high tax burden	The need to lower corporate tax burden in order to create favorable investment climate and to ensure FDI inflow