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BOFIT Weekly
10 • 7.3.2014

Russia

Crimean crisis accelerated ruble's decline. Political uncertainty increased the outflow of foreign currency from Russia early this week. The ruble hit an all-time low of 50.15 rubles to the euro, while the MICEX fell over 10 %.

The Central Bank of Russia responded on Monday (Mar. 3) by hiking its "key" rate by 1.5 percentage points to 7 %, noting the hike would restrain inflation and stabilise markets.

The CBR also changed the rules on the ruble's trading band so that the central bank will more aggressively intervene in the market to stabilise the ruble. The shift is seen by many as a deviation from the CBR's commitment to reducing the steering of the ruble's exchange rate and gradually shifting to a free-floating ruble.

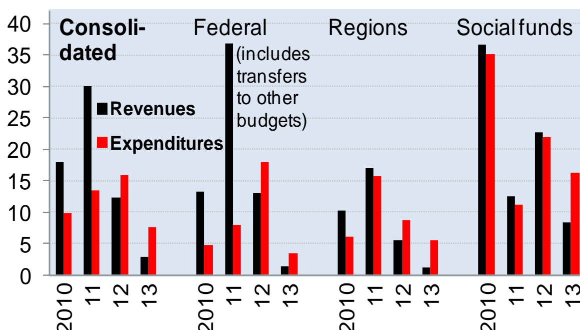
On Tuesday, the CBR sold over $11 billion in currency to prop up the ruble. The CBR's forex selling had previously averaged about $400 million a day.

The markets calmed soon, and on Thursday (Mar. 6), the CBR again sold just $400 million in forex. The ruble began to appreciate, and on Friday the rate was 49.59 rubles to the euro and 36.13 rubles to the dollar. Share prices have also clawed back some of their lost value.

Steep slowdown in government budget revenue growth. Revenues to the *consolidated* budget (combined federal, regional and local government budgets, plus state social funds) increased just 3 % in nominal terms last year, i.e. declined in real terms. Spending growth slowed to below 8 %, an increase of only about 1.5 % in real terms. The government budget deficit rose to 1.3 % of GDP. Budget income fell to 36 % of GDP (down from 38 % in 2012). Spending, meanwhile, remained above 37 %.

Federal budget revenues increased just 1 %, while expenditures climbed 3 to 4 %. *Regional and local* budget revenues also rose only about 1 %. Regions and municipalities get about a fifth of their revenues from the federal budget as transfers and subsidies.

Government budget revenues and expenditures, 2010–2013, (%-change y-o-y)



Source: Ministry of Finance

Government budget revenues from taxes and duties on production and export of oil, petroleum products and natural gas recovered strongly after the 2009 recession. Last year, however, growth in these revenue streams virtually halted despite an increase in the gas production tax. The share of these streams in consolidated budget revenues shrank slightly, but was still 27 %. Their share in federal budget revenues remained at 50 %. Tax revenues from corporate profits fell sharply on lower company earnings. Growth in VAT revenues halted. Income tax, mandatory social security contributions and hikes in excise taxes helped support budget revenues.

The fastest-growing item in state spending was still pension costs (up nearly 20 %), as well as spending on defence and national security (up 14 %). Spending on education was increased notably. The growth in healthcare spending essentially plateaued. So did the growth in spending on the economy, too, although spending on roads continued to increase rapidly.

Russia's relatively modest government debt is a trump card. As of end-2013, federal debt (including guarantees) was just over 11 % of GDP. The debt of regions and municipalities was only about 2.5 % of GDP. Moreover, the value of sovereign moneys that the state has set aside in two funds amounted to 8.5 % of GDP. However, some of the money will be invested as long-term loans to finance a few transport megaprojects. The ultimate return on these investments remains uncertain.

Finland's trade with Russia contracted last year. The value of goods exported from Finland to Russia last year was just under €5.4 billion, or nearly 6 % less than in 2012. The value of exports was dragged down by contractions in some of the biggest export categories. Exports of machinery & equipment shrank 9 %, while chemical products fell nearly 12 %. In contrast, exports of consumer goods such as food and textiles continued to enjoy mild growth. Russia was Finland's third largest export market last year with a nearly 10 % share of total goods exports.

The value of Finnish goods imports from Russia contracted by nearly 1 % to €10.5 billion. The contraction mainly reflected a slight drop in prices of mineral products (over 80 % of imports consisted of "mineral products," i.e. oil, petroleum products and natural gas). Russia provided nearly 90 % of the crude oil imported by Finland last year, and Finland gets just about all of its natural gas from Russia. From other major import products, metals imports saw sharp declines, whereas raw timber imports surged. Even so, import volumes of raw timber were still less than half the amounts seen in the peak years of early 2000s.

The number of tourists coming from Russia to Finland continued to rise, albeit at a significantly slower pace. Russian border-crossings and overnight stays rose by nearly 10 % last year. Growth in 2012 was nearly twice as fast.

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China

China will strive to match last year's economic performance. In his opening speech to the National People's Congress, premier Li Keqiang announced China's GDP growth target of about 7.5 % for this year, similar as last year. Also unchanged were the inflation target (around 3.5 % for this year) and the broad money supply target (M2 at 13 %). The budget foresees a public sector deficit of 2.1 %; again, about the same as the budgeted 2013 deficit. None of the announced targets were unexpected. For example, many of the released GDP forecasts of observer institutions are also around 7.5 %. BOFIT publishes its China growth forecast at the end of this month.

In addition to the quantitative targets for economic performance, Li presented a long list of proposed reforms. Most were already green-lighted at the plenary session of the Communist Party's Central Committee last autumn. The reform direction includes further opening of the economy, improving the business climate for private firms, strengthening of market economy, increased public sector transparency, improved quality of economic growth, promoting structural reform of the economy and improving general well-being.

The National People's Congress comprises nearly 3,000 members and is officially the country's highest decision-making body. Its actual function, however, is largely to rubber-stamp proposals brought before it, e.g. key nominations, new legislation, state budgets and action plans. The People's Congress convened on March 5 and adjourns March 13.

China gets more serious about environmental issues. Premier Li Keqiang said China will commence wide-ranging measures to deal with pollution. Air pollution will be reduced through many approaches, including improvement in energy efficiency. Sulphur, nitrogen and dust emissions from coal-fired power plants will be cut and small coal plants phased out. Taking 6 million old vehicles off the road will help to reduce vehicle emissions.

China is also taking on protection of its groundwater resources, which may be a greater challenge than cleaning up the sky. Although the details of the new action plan have yet to be released, it is clear that strong measures will be needed to protect remaining sources of potable water and improve wastewater treatment. When officials sampled groundwater at 5,000 sites in 2012, they found that about 3,000 of the sites tested were severely polluted. By some estimates, 200 million rural residents lack access to *any* potable water.

While the slavish reliance of local governments on a single measure of performance – economic growth – has been a huge driver of pollution, the system is being changed with the adoption of additional performance indicators. Moreover, the central government has begun to offer local administrations direct incentives to tackle pollution. In February, officials announced they would distribute a total of 10 billion yuan (€1.2 billion) in bonuses to cities and regions that make significant progress in improving air quality this year.

China reforms its pension system. In February, the government announced a plan to merge China's rural and urban pension systems. The reform aims to reduce the income gap between rural residents and city-dwellers, and systematise China's fragmented pension scheme. The *South China Morning Post* reports the reform will allow rural pensioners to get an annual increase in their pension payments. News agency Xinhua also claims that migrant workers will be able to receive pensions regardless of their current domicile under the household registration system (*hukou*). The change encourages labour mobility and urbanisation. It is estimated that the basic pension ranges from 100 yuan (€12) to 2,000 yuan (€240) a year.

China's leadership has also undertaken social reforms to maintain internal stability. China's current pension system is viewed as highly inequitable. Even with reform, many problems with China's pension arrangements will remain unsolved. Pensions not only reflect China's large income disparities but also differ between public and private sectors and across regions. Civil servants receive generous pensions despite the fact that they are excused from contributing anything to their pensions. A report from the University of Chicago's Paulson Institute finds significant variations in pensions for working individuals, reflecting differences in local practices and principles. The report notes that different pension practices inhibit labour mobility as moving earned benefits from one place to another is challenging.

The coverage of China's mandatory pension scheme has been expanded in recent years. An OECD report released late last year found that some 28 % of the working-age population was covered by the pension system (OECD member country average 65 %, India 10 %), while just two years ago that share was below 20 %. Around 2010, rural residents were given the option of making voluntary pension contributions. Since then, figures from the ministry of human resources and social security show the number of rural people receiving pensions has risen rapidly.

Central and local administrations subsidise the pension system by paying a part of pensions. Xinhua reports the reform will create additional financing needs because underdeveloped provinces need support to meet their pension commitments. In addition to this, the cohort of working-age people began to decline in 2012. China's changing demographics will challenge the financial sustainability of any pension arrangement. The OECD estimates that China's dependency ratio will fall from about 8.4 per pensioner at present to 2.4 by 2052. The dwindling dependency ratio adds to pressures for higher retirement ages. The current pension age is 60 years for men and 55 for women.

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