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BOFIT Weekly
29 • 18.7.2014

Russia

Russia's latest three-year budget plan calls for higher revenues and small deficits. The government approved the 2015–2017 budget policy framework in early July as a basis for further refinement. The finance ministry sees total government budget (federal and regional budgets, and social funds) revenues increasing at 6–6.5 % a year, which is slightly higher than the economy ministry's forecast for inflation. In this prospect, the ratio of revenue to GDP will fall gradually towards 35 % (36.5 % in 2013). Government revenues from oil & gas production taxes and export duties will climb this year and then level off as long as the price of Urals-grade crude holds at around $100 a barrel. It is also expected that some production and exports in the sector will remain unchanged while others decline.

Various measures will be applied to boost growth in other revenue to 8–9 % a year. VAT revenues to the federal budget should rise strongly on improved collection. Among other taxes, the tobacco excise tax will go up by 50 % from this year, and an excise tax will be levied on gas exports to Turkey. Regional budgets will continue to receive less transfers, while hikes in excise taxes will support their revenues. The government is also considering whether to allow regions to launch sales taxes. Transfers to social funds will be boosted, along with a rise of the social tax revenues thanks to improved collection and hikes in certain categories of mandatory employer's social contributions.

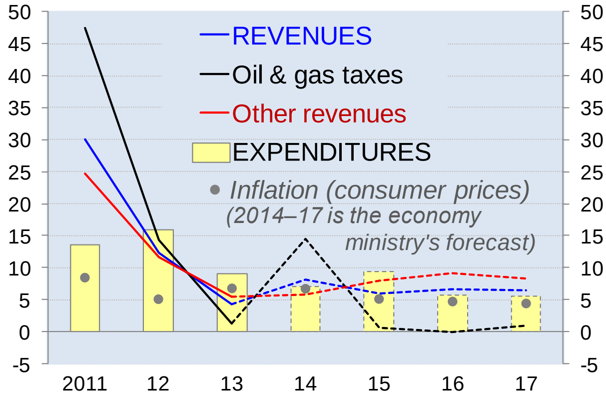
The finance ministry expects the government deficit to only rise slightly to around 1.5–2 % of GDP, mainly due to tight set-ups in regions. The government aims to hold the federal budget deficit at around 0.5 % of GDP, which is well below the 1 % ceiling called for in the budget rule.

While government expenditures will rise notably next year, particularly spending on pensions, spending growth will then remain slightly lower than inflation. From 2016, spending as a share of GDP will fall gradually to under 37 % (38 % in 2013), although so far only the 2015 expenditure figures include spending on Crimean investment. The three-year budget plan may imply a tangible reduction in government spending in real terms because prices for public consumption and investment have for years risen clearly faster than consumer prices.

The tight spending situation will be eased slightly by the state using long-term loans from the National Welfare Fund to part-finance big transport infrastructure projects. Based on current government decisions, lending for such projects would accumulate by end-2017 to about a quarter of the National Welfare Fund and correspond to 1 % of GDP.

The framework for government budget policy sees federal debt (including government guarantees) rising towards 15 % of GDP by end-2017. Debt alone would be about 10 % of GDP. The finance ministry expects the assets of the Reserve Fund to increase slightly. The combined value of the two funds would remain below 10 % of GDP.

Government revenues and expenditures (% change) and inflation (%)



Sources: Finance ministry, Rosstat, economy ministry

IEA encourages Russia to focus on energy efficiency and boost investment in the energy sector. The International Energy Agency (IEA) last month released its broad survey of Russian energy policy. The IEA noted that Russia's energy sector has experienced remarkable changes since its last survey in 2002, citing among the most positive ones the massive reform of the electricity sector, progress in liberalizing natural gas markets, as well as bringing undeveloped oil and gas deposits in East Siberia into production.

The IEA said improving energy efficiency and infrastructure investment should be the focus of Russian energy policy. Progress in these areas requires increased competition and liberalization, particularly for pricing household energy supplies. The phase-out of regulated household tariffs and the shift to consumption-based energy invoicing would give utility companies incentives to make long-needed investment in infrastructure for household electricity and heating. The negative effects of higher tariffs could be offset through social transfers to the poorest households.

The IEA forecasts Russian oil exports will decline in coming years as domestic demand rises and production plateaus. Natural gas production, however, is perceived to suffer from oversupply. Russian domestic demand is expected to rise only slowly, if at all, while growth in export demand is limited by greater competition and economic weakness in Europe, Russia's biggest gas customer. The IEA recommends that Russia become more efficient in its oil use and replace oil e.g. by shifting to vehicles powered by natural gas. The shift in energy consumption patterns would increase Russia's oil export possibilities.

While the government's latest energy strategy, which extends to 2030, largely comports with IEA recommendations, the IEA emphasizes its proper implementation.

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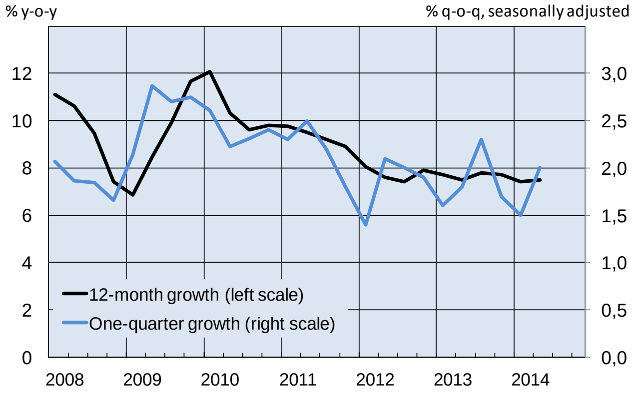
China

Chinese economic growth picked up slightly in the second quarter. China's National Bureau of Statistics reports the Chinese economy grew at a rate of 7.5 % y-o-y over the April-June period. Economic growth strengthened from 7.4 % in the first quarter. Seasonally adjusted GDP growth hit 2 % q-o-q in the second quarter, up from the revised 1.5 % for the first quarter.

Real GDP growth from the previous quarter (q-o-q) and four quarters previous (y-o-y), %



Sources: NBS and BOFIT

Some of the pick-up in growth came from public investment, particularly infrastructure projects, public housing production and rules to ease bank lending. These measures have all injected liquidity into the economy. Growth in the broad measure of money supply (M2) accelerated in June relative to the first five months of the year, while the loan stock grew 14 % y-o-y, slightly higher than in April and May.

Public project spending helped boost investment towards the end of the quarter. Real growth in investment (not including rural households) in the first half of the year was 16 % (down from 20 % in 1H2013). Growth in real estate investment slowed to 13 % y-o-y, down from 20 % in 1H2013. Construction starts in the first half fell 16 % y-o-y in terms of floorspace production. Real estate sales also declined.

Real per capita disposable income increased about 8 % in 1H2014, slightly outpacing overall economic growth. The volume of retail sales grew 11 %, about the same as in 1H2013. The pace of growth in the service sector slightly exceeded economic growth overall, which meant that the contribution of services to overall output continued to increase.

Two local governments form first wave of bond issues under new policies. The southern province of Guangdong and the northern Shangdong province have together issued 30 billion yuan in bonds this summer. The bond issues are part of the Ministry of Finance's pilot program that allows local governments and municipalities to sell bonds (see BOFIT Weekly 21/2014). Finance minister Lou Jiwei hopes that eventually the possibility of selling bonds will extend to a larger assemblage of local governments.

While local governments sold their own municipal bonds earlier, the central government has always been liable for debt repayment. Under the new arrangement, local governments are responsible for keeping their commitment to pay back the bonds. To participate in the new bond market, investors should be more aware of the credit risks of issuers.

The yield on Guangdong's 5–10-year bonds settled around 4 % p.a., which is rather close to the yield on Chinese sovereign bonds issued by the Ministry of Finance. It thus appears that investors are not pricing provincial credit risk into their bond purchases. Many investors may still assume the central government will step in and bail them out if a local government defaults. The 3.9 % yield on Shangdong bonds is even lower than the Guangdong product.

Finance ministry rules require local governments to be evaluated by an independent credit rating agency before issuing bonds. Guangdong received the top credit rating from a Shanghai-based ratings agency. Observers note, however, that the Guangdong economy relies heavily on real-estate construction.

China seeks to support the yuan's role in international payments. China's central bank has granted two large Chinese banks the right to clear offshore yuan transactions in Europe. The Frankfurt branch of the Bank of China and the China Construction Bank's subsidiary office in London have been named as official clearing banks. The presence of clearing hubs in Europe should speed up the yuan payments clearing process. At the moment, the yuan's limited availability outside mainland China impedes payment processing. Similar clearing bank arrangements are already operational in Singapore, Taiwan and Hong Kong.

The measures are designed to facilitate faster cross-border payments. When a European firm earlier wished to pay a Chinese firm in yuan, it had to use a clearing bank located inside China to convert, say, euros to yuan.

While over 20 % of China's foreign trade was transacted in yuan in March, the share has retreated to around the 15 % level in subsequent months. SWIFT, the Society for Worldwide Interbank Financial Telecommunication, reports the yuan accounted for around 1.5 % of all international payments traffic in May.

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