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# BOFIT Weekly

**41 • 10.10.2014**

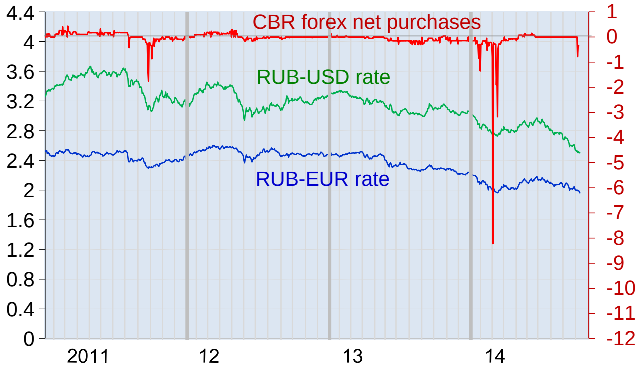
# Russia

**Ruble facing depreciation pressures.** The ruble's exchange rate has declined about 4 % over the past two weeks and over 10 % since the end of June. Responding to the ruble's on-going slide, Bank of Russia (CBR) this week lowered the floor of the ruble's fluctuation range and following its policy aimed at a flexible exchange rate widened the fluctuation band.

On the other hand, the CBR also bought rubles on domestic forex markets for the first time since midsummer and started currency swaps to help banks meet their overnight currency liquidity demands. CBR chairwoman Elvira Nabiullina reports the central bank further plans to provide foreign-currency repo credits of one to four weeks to help banks with their currency liquidity.

The immediate devaluation pressures on the ruble's exchange rate are caused by the long-standing trend of more capital flowing out of Russia than into Russia. The situation has been made more difficult now that access of Russian banks and corporations to foreign lenders has diminished very significantly due to uncertainties relating to Russia, which, in turn, has made it even harder to service their existing loans.

**Ruble exchange rate in US cents and euro cents (left) and CBR forex market interventions in EUR billion per day (right)**




*Source: Bank of Russia*

**Structural changes for Russian government spending larger than scheduled earlier.** The government last week submitted to the Duma its drafts of the federal budget and state social funds for 2015, along with the budget frameworks for 2016–2017 as well as the finance ministry's projection of consolidated government budget revenue and spending (including regional budgets). The finance ministry sees consolidated government spending rising over 11 % in nominal terms next year, slightly faster than its previous estimate this summer. The ministry also expects a slight rise in revenue growth to over 7 %. The deficit forecast remains at over 2 % of GDP.

Defence spending, of which virtually all comes from the federal budget, will rise next year to even higher levels than planned earlier. In nominal terms, spending will rise 33 % from this year, will constitute 11 % of overall government spending and correspond to over 4 % of GDP. As another change to earlier plans, however, the finance ministry now foresees that defence spending will fall considerably after 2015.

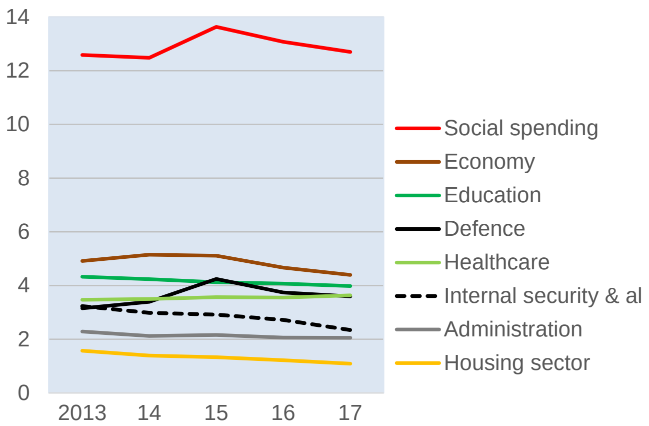
Government spending policies have also been adjusted to reflect the fact that the estimated spending on the various sectors of the economy will be notably larger in 2015–2017 than estimated this summer – even if the growth in spending will remain much below the projected rate of inflation. The biggest spending increases have to do with the transport sector and spending on the road network (e.g. Crimea projects).

The finance ministry also expects spending on pensions and other social entitlements to increase faster in coming years than foreseen in the summer plan. Spending should rise fairly sharply next year (16 %). On the other hand, much of the increase is due to pension savings included in the social spending figures. A return to this pension savings scheme policy begins next year. Running social costs will grow at a more modest rate (next year about 10 %). Social spending will rise to about 35 % of government spending and to over 13 % of GDP.

The finance ministry sees other core government spending areas slightly more squeezed in the years ahead than earlier. Growth in spending on education will at best match the predicted inflation rate. Spending on healthcare will grow a couple of percentage points faster than the inflation rate.

To ease the situation in the country's different regions, the government will break from earlier plans by increasing transfers of federal budget funds to regional budgets, starting already this year.

**Main areas of government spending, % of GDP**




*Source: Russian Ministry of Finance*

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# China

**IMF calls for further structural reforms in China.** The IMF's just-released World Economic Outlook (WEO) sees China's economic output growing 7.4 % this year and 7.1 % next year. The slowdown remains steady; GDP growth in 2013 was 7.7 %. The projections for this year and next have been revised down slightly from the WEO released in April.

Lower future growth for China reflects the slowdown in housing investment and a deliberate shift away from investment in fixed assets to a more sustainable consumption-driven growth model. In its basic forecast, the IMF expects China will continue to rein in credit growth and indebtedness of local governments to secure a stable financial system. Moderation of credit growth will support structural change in the Chinese economy.

Even though the geopolitical risks and a potential prolonging of low growth in the Euro Area will affect China as well, China's biggest challenges come from domestic trends. The most immediate threat is a sharper than expected cooling in the real estate sector, since real estate investment has been a major engine of economic growth. Problems would be aggravated due to the potential for contagion; the banking sector (official and shadow) provides the bulk of lending to the real estate sector and relies on real estate values in collateralising loans. Problems in the real estate sector could also hurt local government revenues; many are dependent on the sale of land use rights as an important source of income.

Over the medium term, the IMF sees indebtedness and overcapacity in many branches as major causes for concern particularly as growth still seems to rely largely on capital investments and additional debt. From the economic policy point of view, it is difficult to balance between growth targets and structural reforms, but continuing with the old growth model would increase the risk of major financial market disruptions and a sharp slowdown in growth. If this dark scenario materialises, the impact would be felt throughout the global economy.

Thus, the WEO calls on China's leaders to implement previously agreed structural reforms to sustain growth. Reforms include strengthening of financial market supervision, reduction of indirect subsidies, deregulation of deposit interest rates and shifting monetary policy to emphasise market-based interest-rate-setting. The IMF supports China's efforts to increase exchange rate flexibility, which, together with other reforms, will help to narrow global imbalances. The IMF also mentioned state enterprises, local governments and the social security system as key targets for reform.

The October WEO report projects that the world economy will grow 3.3 % this year and 3.8 % next year. The IMF warns, however, that the risks to growth have also increased since its April forecast.

**IMF 2014 and 2015 growth projections, %**

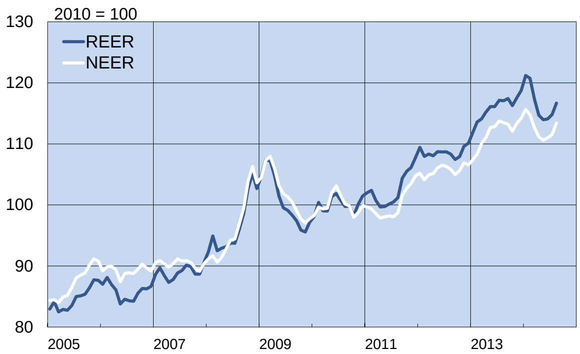
| | 2013 | f2014 | f2015 |
|---|---|---|---|
| **World output** | **3.3** | **3.3** | **3.8** |
| **Advanced economies** | **1.4** | **1.8** | **2.3** |
| United States | 2.2 | 2.2 | 3.1 |
| Euro Area | -0.4 | 0.8 | 1.3 |
| Japan | 1.5 | 0.9 | 0.8 |
| **Emerging economies** | **4.7** | **4.4** | **5.0** |
| China | 7.7 | 7.4 | 7.1 |
| India | 5.0 | 5.6 | 6.4 |
| Russia | 1.3 | 0.2 | 0.5 |

*Source: IMF World Economic Outlook, October 2014*

**Yuan strengthening continues.** The People's Bank of China intervened in the currency markets in the first half of the year to deliberately weaken yuan and provide a wakeup call to market participants that yuan appreciation was not inevitable. In mid-March, the PBoC also widened the permitted fluctuation of the yuan from its daily fixing of the yuan-dollar exchange rate from 1 % to 2 %. The changes herald central bank efforts at preparing the markets for a more volatile yuan exchange rate, even if no specific timeline for deregulation of the yuan's exchange rate has yet been announced.

The yuan's exchange rate started again to strengthen in the summer in terms of its trade-weighted real effective exchange rate or REER (which takes into account inflation-rate differences with China's main trading partners) and the yuan's nominal effective exchange rate (NEER). The yuan hit its weakest point against the US dollar this year at the end of May and early June, when it was down over 3 % from the beginning of the year. Since then the yuan has strengthened and the dollar exchange rate is currently slightly more than 1 % below its level at the start of the year. On Friday (Oct. 10), one dollar bought 6.13 yuan. The yuan-euro rate stood at 7.79, which means the yuan has gained 7 % against the euro since the start of the year.

**Yuan real and nominal effective exchange rates**




*Source: BIS*

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