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BOFIT Weekly

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Russia

CBR says zero economic growth may be ahead in 2015–2016. The Central Bank of Russia released its annual guidelines for monetary policy, including various scenarios for the economy of the country. In the basic scenario, GDP does not grow in 2015 and 2016. This assumes OPEC countries cut oil production and the average price of Russian Urals-grade oil rises from its current level of less than $80 a barrel to $94–95. The forecast further assumes that current trade and financial sanctions will remain in place until 2017, when GDP is expected to increase by about 2 % p.a. If next year's oil price is $84 (i.e. still higher than currently), the CBR expects GDP to shrink by about 0.5 %. An increase in the oil price to $105 next year would bring a GDP growth of about 0.5 %.

In the basic scenario, private consumption grows only slightly during 2015–2016. Fixed capital investment is expected to decline slightly next year and in 2016. While the global economy recovers gradually in all scenarios, in most of them the volume of Russian exports remains at its current level next year and increases only slightly in 2016. Under the basic scenario, Russian imports further contract slightly next year and only begin to recover in 2017.

Economy minister Alexei Ulyukayev this week confirmed that his ministry's economic forecast was unchanged by noting that next year's projection still calls for GDP growth above 1 % and 2016 growth over 2 %.

The CBR forecasts GDP growth this year of 0.3 %, while the economy ministry says 0.5 %. Observers note that the transient factors that sustained better growth in January-September (0.8 % y-o-y) also impacted in October. The weak ruble and a soaring increase in defence spending in the early autumn fuelled growth in certain manufacturing branches, and consumers continued to accelerate big purchases amidst higher inflation and inflation expectations.

Profits of foreign-registered Russian firms are aimed to get under Russian taxation. The Duma last week approved tax law changes designed to restrict the common practice of offshoring profits of Russian companies by sending e.g. dividends and loan interest to companies in countries with low tax rates. The long-recognised problem has recently faced more vocal demands to promptly rectify the situation, including from president Putin himself.

The amendments require Russian firms and private individuals to pay taxes in Russia on the profits of their foreign-registered corporations if they own at least 50 % of the company. Starting in 2016, the minimum ownership cap falls to 25 %. Amendments include also some more detailed conditions, like that the foreign tax jurisdiction will still be recognised in certain circumstances, e.g. when at least 80 % of the earnings of the foreign-registered company are generated through business activities in the local economy.

The finance ministry and business groups, which have been preparing the bill for a couple of years, have been criticised on their slow progress. The finance ministry would have wanted to relax some of the draft bill's harshest rules ahead of the Duma's decisive second reading. The Duma, however, wanted the changes to be effective as soon as possible and chose to pass the law it in its original form. In the view of both the finance ministry and some Duma deputies, the revised law is impossible to implement in its current form. They aim at amending it in the spring session of the Duma. Because the issue concerns relaxing regulations, deputy finance minister Sergei Shatalov said it should be possible to implement the needed changes retroactively.

For the law to work in practice, Russian officials must still gain access to the necessary information from those countries where Russian-controlled firms are registered.

Deputy finance minister Shatalov said the reforms would add about 20 billion rubles (€360 million) a year to the federal budget. Next year's federal budget revenue estimate was about 15.1 trillion rubles (€270 billion).

Law changed on Russian oil sector taxation. In mid-November, the Duma approved major revisions of the tax and duty scheme for crude oil and petroleum products. The amendment shifts the taxation emphasis from exports to production.

The changes will come into force gradually over the next three years. During that time, export duties on crude oil, diesel fuel and gasoline will go down 70 %. The mineral extraction tax on crude oil production correspondingly will go up 70 %, and there will be an over 500 % increase in the extraction fee for byproduct gas condensate generated from oil drilling. One of the aims of the changes is to increase federal budget revenues. It is estimated that the reform should boost budget revenues by about 250 billion rubles (€4.5 billion) a year starting in 2016.

The tax structure reform will reduce earnings of oil refiners, because the domestic price they pay for crude oil will rise as a consequence of higher mineral extraction fees. The losses to refiners will be offset, however, through the corresponding drop in export duties on petroleum products. Igor Sechin, CEO of state-owned Rosneft, strongly opposes the reform, which he fears will endanger e.g. Rosneft's planned Nakhodka oil refinery.

Russia severely taxes the oil sector, and taxes are based on the global price of crude oil. It is estimated that about 70 % of the oil export price goes to the federal budget through various fees, duties and taxes. The system does not encourage companies to modernise their production facilities or make new investments. Russia has been encouraged to adopt international practices, i.e. taxation based on corporate earnings instead of the value of production.

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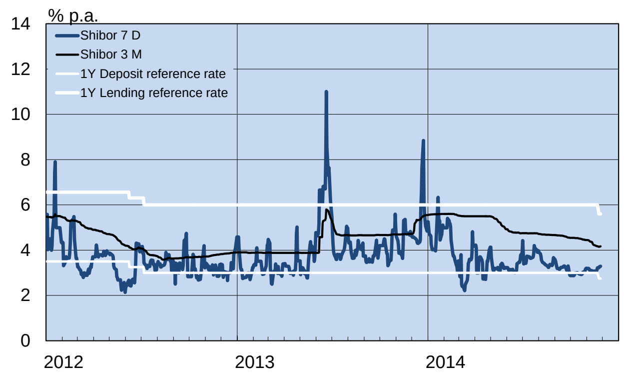
China

Cuts and looser rules for interest rates in China. In a surprise move after hours last Friday (Nov. 21), the People's Bank of China announced it was cutting the benchmark loan and deposit rates banks charge from their customers. The benchmark one-year credit rate was lowered by 0.4 percentage point to 5.6 % and the one-year benchmark bank deposit rate was lowered by 0.25 percentage point to 2.75 %. Reference rates were last adjusted in July 2012. The rate cuts mainly help the housing market, where housing loans are still subject to interest-rate regulation. Otherwise cuts are unlikely to have much impact on bank lending or economic growth as bank lending rates for the most part have been deregulated since July 2013.

More important than rate cuts as such is perhaps that the latest measures signal progress in deposit rate liberalisation. In connection with the rate cut, the PBoC also granted more flexibility to banks in setting deposit rates. Instead of the earlier ceiling of 10 %, banks can now offer up to 20 % above the benchmark rate on deposits. In practice, the ceiling for one-year deposit rate remains unchanged at 3.3 %. Reference bank deposit rates for longer maturities were also consolidated to reduce the overall number of reference rates.

Importantly, the rate cuts do not erode the competitiveness of formal banks relative to deposit rates and yields on investments offered on shadow markets. Banks now have less incentive to circumvent interest-rate rules, which in turn reduces their incentives in the hard-to-monitor shadow banking sector to develop alternative financial products. The PBoC also stressed that the main function of the rate cuts is to improve interest-rate transmission in the economy, not to change the current monetary policy stance.

Trends in Chinese policy and market rates, 2012–2014



Source: Macrobond

There was mixed, but modest, reaction to the rate drop on money markets with some rates rising and others falling. On Monday (Nov. 24), the yuan-dollar exchange rate declined only 0.3 % in the wake of the announcement.

Chinese monetary policymakers struggle to keep up with rapid changes in the market. Although China has only partially liberalised its financial markets at the moment, market structures and operations continue to evolve rapidly. The pace of market change, however, is not sufficiently reflected in the central bank's efforts to overhaul its monetary policy toolkit. As a consequence, Chinese monetary policy remains fairly opaque.

This year, the PBoC has tried to influence money markets and economic growth through offering credit directly to targeted banks. This policy approach has been criticised for lack of both fairness and transparency. The central bank has also cut the 14-day repo rate four times this year (including another cut this week), but the role of such cutting to the overall implementation of monetary policy remains unclear. As regards the latest cuts in benchmark credit and deposit rates, even the PBoC itself does not seem all that convinced that the lower reference rates will translate automatically to lower bank lending rates. By its acknowledgement, the PBoC will also resort to putting informal pressure on banks to pass on the lower lending rates to businesses. Market observers note that financial entities find it difficult to distinguish between measures by the PBoC merely to balance bank liquidity and more long-term measures that signal a tightening or loosening of the monetary stance.

It is obvious that the current monetary guidance does not work well, and many observers think that the central bank's most important monetary policy instrument is still the reserve requirement ratio (RRR). The RRR has been kept unchanged at a relatively high level from May 2012. This summer, however, the central bank announced that smaller banks focusing on lending to small businesses and the agriculture sector were entitled to a reduction in their RRR. Even in this case, it however remains somewhat unclear which banks actually benefitted from the move.

Many aspects of Chinese monetary policy adhere to the old ways. The PBoC still operates under the government, and thus lacks independence in its monetary policy decisions. For example, the government has recently sought to improve access to credit for small businesses and the agricultural sector as a way to boost economic growth, while the PBoC has emphasised cautious monetary policy due to e.g. the rise of non-performing loans in the banking sector. This has created contradictory policy messaging and the introduction of new monetary policy instruments that has resulted in even less transparency.

In recent years, the central bank has pushed reforms of the banking sector, as well as interest rate and currency policy. Recent trends and the PBoC's own messaging suggest, however, that the central bank's move to an interest-rate-based monetary policy regime is inevitable.

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