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Russia

Economy ministry puts out ever-rosier forecasts. Over the past two months, the economy ministry has drafted four economic forecasts. The latest draft reduces slightly its expected GDP contraction this year to 2.8 %. One reason for the upbeat revision comes from the ministry's preliminary first-quarter performance estimate that shows GDP declining only 2.2 % y-o-y. The ministry's assumption for the average crude oil price this year remains at $50 a barrel. Most forecasts of independent research institutions see Russian GDP contracting about 4 % this year. In a further departure from other forecasters, the economy ministry also expects GDP could grow as much as 2.3 % next year under its scenario of an average oil price of just $60/bbl. In the forecast, annual GDP growth in 2017 and 2018 reaches 2.5 %.

The draft forecast also includes a more optimistic scenario. On request from the president, a target variant of even faster growth has been drafted. In that case, growth would be boosted by targeted infrastructure investments using assets from the National Welfare Fund (up to 80 % of the fund's assets), as well as assets from pension funds.

The economy ministry has also prepared a draft version of the three-year government action plan. Goals include raising the investment-to-GDP ratio from below 18 % this year to a range of 22–24 % by 2020. GDP growth should reach the average level of growth of the global economy by 2018, which would result from a resurgence in private investment. The draft places relatively heavy emphasis on encouraging private entrepreneurship.

Dispute over pension system resolved. On April 23, the government declared a resolution to its two-year dispute over the suspension of the "funded component" of the pension system. The funded component will be reintroduced at the start of 2016.

Russia fundamentally overhauled its pension system in 2002. At that time, Russia shifted to a two-pillar system that introduced the funded element. This required a part of the pension contributions paid in by employers for younger workers to be set aside in private pension funds or a state pension fund managed by state development bank VEB for covering their future pensions. Prior to 2002, Russia had a simple pay-as-you go scheme, whereby contributions paid by employers into the federal pension fund were paid out to meet existing obligations. The shift was justified on the basis that Russia needed to prepare for rising future pension costs from an aging population and a smaller workforce supporting a larger pensioner population.

The shift to including a self-funded component initially was a drag on the pension system as paid-in contributions no longer could be used in full amount to paying current pensions. Together with significant hikes in pensions, temporary reductions in pension contributions and several years of poor economic performance pushed the federal pension fund into deficit. The pension fund deficit has expanded especially rapidly since 2008.

The pension fund shortfall is funded out of the federal budget. In order to restrict the need for budget funding the government adopted an exceptional arrangement for 2014 and 2015, whereby pension contributions collected in these years would be used entirely on a pay-as-you-go basis.

The social ministry and the labour ministry have supported the suspension of the funded component, going so far as to suggest making the funded arrangement completely voluntary. The ministries have justified this by the so far poor returns of pension fund assets that has led to weaker pension security than the pay-as-you-go approach with indexed increases based on cost of living.

The finance ministry and the economy ministry opposed abandoning the funded component. One of the goals for the introduction of the funded component was to enhance the development of Russia's financial markets. Pension savings funds could offer the long-term capital for investment that Russia's financial markets are currently lacking.

Russia's acute need for investment financing was the specific factor that led the government to continue the funded component. Prime minister Dmitri Medvedev has now tasked the government with finding more productive ways to invest pension assets. Experts have not warmed to the finance ministry's proposal that private pension funds commit to investing part of their assets in high-priority state infrastructure projects.

Russia bans re-export of plant products from Bulgaria. The ban is designed to prevent imports of EU plant products from circumventing Russia's ban in food imports imposed last August. The Federal Service for Veterinary and Phytosanitary Surveillance (Rosselkhoznadzor) imposed the ban on Saturday (Apr. 25), noting that it sought to stop banned products from entering Russia via Bulgaria through deceptive practices. The agency cited as an example Polish apples with re-export documents indicating their origin outside the EU (e.g. Morocco and Brazil).

The ban on transit imports will remain in force for an unspecified period. Rosselkhoznadzor claims the document forging has reached substantial proportions, so it could widen the ban to cover all plant product imports coming via EU countries. To prevent fraudulent labelling, Rosselkhoznadzor is designing a system that would require EU officials to pre-deliver their export documents.

Most plant products imported to Russia from outside the EU are transported through EU countries, where large logistics hubs are located. The more extensive bans could significantly restrict plant product imports to Russia and increase import costs.

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China

Economic slowing adds to risk on Chinese financial markets. While corporate solvency struggles have been visible for years, the first default on a domestically listed corporate bond issue only occurred in March 2014. Last month saw the first state-owned enterprise default on interest payments. Last week, the first Chinese firm defaulted on foreign bonds payments, leading to open speculation of deeper problems brewing. The stock of non-performing loans held by banks has also soared, even if the share of nonperforming loans in overall credit stock is still relatively small.

Because the public sector typically intervened in payment issues earlier to prevent market disruptions, these defaults may be a positive signal of long-awaited market discipline. Despite their high visibility, the impacts of these defaults on markets have been limited.

The emergence of payment problems, however, also reflects risks of a slowing Chinese economy, declining corporate profits and soaring indebtedness. Local government debt struggles and the decoupling of stock markets from trends in the real economy further increase financial market tensions. The deregulation of interest-rate setting and capital movements, along with other reforms, add to tensions.

The current financial market developments have largely been anticipated and various degrees of disruption are expected ahead. An encouraging sign is that the government has stuck with reform policies. The experiences of other countries with debt problems and financial market deregulation, however, suggest possible unpleasant surprises ahead.

Indebtedness of local governments continues to soar. Preliminary figures released last week put the debt of local governments at the end of 2014 at around 16 trillion yuan (€2.3 trillion), or approximately a quarter of GDP. Figures from mid-2013 put local government debt at 10.9 trillion yuan, which translates to a rise of around 33 % a year.

The high growth may in part reflect the fact that some of the local government loan guarantees have been reclassified as their direct debt. In addition to their own borrowing, local governments are indirectly responsible for a smaller amount of loan guarantees (although no information for end-2014 has yet been released). The total amount of liabilities at end-2014 is thought to be around 20 trillion yuan (€2.9 trillion), up from 17.9 trillion yuan in mid-2013.

Local governments can now seek relief from debt problems in the bond markets. In March, the government allowed local governments to issue a total of 1 trillion yuan in bonds to pay off high-interest loans held by local government financing vehicles. Investors apparently have not found the low yields on these new bonds very attractive. Commercial banks are the biggest investors in Chinese bond markets. Market information suggests that the PBoC is currently planning an arrangement to allow banks to swap debt purchased from local governments for central bank loans.

China's stock markets now among the largest in the world; meteoric rise causes concerns. In April, the daily trading volume of the Shanghai stock exchange exceeded 1 trillion yuan (€150 billion), making it the world's busiest stock exchange. The turnover volume in Shenzhen now exceeds that of New York's exchanges, making it the second-most-traded exchange. In terms of market capitalisation, at the end of 2014, the mainland China stock markets were the largest after the United States. In April, the Shanghai stock exchange alone surpassed the Tokyo stock exchange as the world's third largest after the NYSE and Nasdaq. The market value of mainland China stock markets is now nearly 90 % of GDP, over double that of 2013.

Share prices are up about 120 % over the past year. The average price-to-earnings ratio (P/E) of shares has also more than doubled: to 23 for Shanghai and 52 for Shenzhen. Some company P/E numbers are very high. Observers note that the prices of China's technology shares are now double that of US prices during the IT bubble.

The China Securities Regulatory Commission (CSRC) has this year already approved listings of 123 firms (compared to 125 new listings for all of 2014). The current approval process is complicated and hundreds of firms await listing approvals. The National People's Congress is currently considering changes in securities law so that, instead of official approval, only registration would be required and exchanges could themselves determine which firms go on the market.

Observers now question the sustainability of the recent rise in stock prices. Higher share prices allow companies to raise capital at lower cost than on the debt markets. However, there are more and more small investors on the market, for whom the consequences of a drop in prices would be more severe. The conditions for buying shares on credit have been tightened a bit, but it has not significantly slowed the growth in buying shares on margin. On the other hand, short selling of shares has been made easier.

Stock market trends in mainland China

Source: Bloomberg

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