BOFIT Weekly
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Russia

Decline of investment limited by oil and gas sector. Total investment of the economy has fallen since spring 2013. Last year, investment contracted 2.5 % y-o-y, and in the first quarter of this year, investment was down about 3.5 %. Nevertheless, investment has shrunk markedly less than forecast (at least until May, when the decline accelerated).

The drop in total investment has been mitigated in particular by briskly increasing investment in oil and gas production (up about 10 % in 2014 and about 15 % in the first quarter of 2015). In other core sectors, investments of large and medium-sized firms have declined considerably this year, with the exception of manufacturing, where investment (excluding oil refining) increased in the first quarter.

Rosstat reports that investment of small firms and the grey economy have seen higher investment than the rest of the economy over the past three years (2012–2014), as well as the first quarter of this year. One reason for this is the rapid growth of housing investment in recent years, though housing investment slowed in the first quarter of this year.

Russian government budget framework assumes lean years ahead. In its latest budget framework proposal to the government, the finance ministry expects the nominal value of government revenues to fall this year about 4 % in ruble terms. Revenues relative to GDP will decline to 35 %. The revenue projection is based on the economy ministry's forecast, which cautiously assumes the price of oil this year will average $50 a barrel. GDP is expected to contract 3 % this year and inflation to average about 15.5 %.

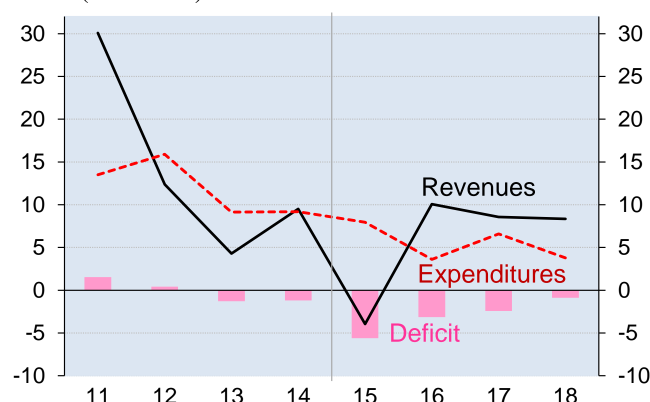
The ministry expects nominal federal budget revenues to fall this year by close to 15 % on a 25 % drop in tax revenues from oil and gas. Tax revenues raised by regional and municipal governments should increase about 6 %, but their total revenue growth will only amount to 2–3 %, because transfers to regions from the federal budget will be reduced significantly. Government social fund revenues will climb by over a fifth, because asset transfers (especially to the pension fund) will increase sharply. Tax revenues to these funds will also grow relatively well.

The ministry estimates that government spending will increase 8 % this year in nominal terms, and that the share of spending will rise to nearly 41 % of GDP. Federal expenditures, excl. transfers to other budgets, will grow a bit more (when figures exclude the large bank support paid out in December 2014). Regional and municipal budget expenditures will increase a mere 5 %. In contrast, social fund expenditures will increase by roughly one quarter.

The finance ministry calculates that the government deficit will worsen this year to 5.5 % of GDP. The federal budget deficit will be over 3.5 % of GDP. Financing the gap will be accomplished by depleting about half of the federal government's Reserve Fund. Regional budget deficits will be funded in part out of loans from the federal budget. The finance ministry is concerned about regional deficits and has proposed a legal deficit limit to be imposed on regional budgets that would be proportional to regional budget revenues without federal budget transfers.

The revenue estimates for the years ahead assume an oil price averaging $60 a barrel in 2016 and $65 a barrel in 2017, as well as GDP growth above 2 % a year. Government revenues would recover in the period. However, the ministry's calculations indicate that nominal spending growth would have to be limited to 5 % a year, i.e. slightly below the forecast inflation rate. In such case, the government deficit would be constrained to 2.5 % of GDP in 2017.

Change in government revenues and expenditures (%), and deficit (% of GDP)



Source: Finance ministry

Russian finance ministry expects spending on defence and social security to plateau next year. In its budget policy framework proposal, the finance ministry noted it expects defence and social spending to grow by about 25 % this year. Social spending will rise as high as to more than 14.5 % of GDP and defence spending to 4.3 % of GDP. Defence spending, however, is expected to decline in 2016, while spending on domestic security and law enforcement will continue flat in nominal terms this year and next. Spending directed to various sectors of the economy is expected to remain unchanged starting next year. There is an effort to match growth in social spending to the inflation rate from next year onwards. Such a move, however, would require pension increases are wound down, in line with the ministry's proposal, to slightly less than the projected inflation rate. The ministry further proposed increasing the general retirement age by six months a year until the pension age reaches 63 for both women and men (currently 55 for women and 60 for men).

Assuming the ministry's forecast materialises, spending on education in coming years will still only match inflation and healthcare spending will rise just slightly faster than inflation.

Bank of Finland • Institute for Economies in Transition, BOFIT
P.O. Box 160, FI-00101 Helsinki
Phone: +358 10 831 2268 • Web: www.suomenpankki.fi/bofit_en

Editor-in-Chief Jouko Rautava • Email: jouko.rautava@bof.fi
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China

China's central bank extends monetary easing. Last Saturday (June 27), the People's Bank of China announced it was lowering reference rates by a quarter of a percentage point. The one-year loan rate now stands at 4.9 % and the one-year deposit rate at 2.0 %. The PBoC also lowered the deposit reserve requirements for most banks by a half percentage point. Bank reserve requirements, however, remain high, averaging 14.5–18.5 % of bank deposits and tying up considerable lending potential.

Simultaneous declines in reference rates and reserve requirements are rare. The last time such an event occurred in China was during the international financial crisis in 2008. The PBoC gives no justification for its decisions, causing speculations on what triggered the policy shift. Chinese officials are clearly concerned about the economic slowdown. The timing might point to the latest round of monetary easing being a response to increased uncertainty after the plunge in share prices. It might also be that the stock market drop created an opportunity for relaxing the monetary policy stance without having to worry that further easing might fuel borrowing and add to a stock market bubble.

In addition to the lack of a well-articulated policy, the opacity of Chinese monetary decision-making is increased by its unfinished nature. In principle, interest rates on bank loans to the general public have been freed and flexibility in setting deposit interest rates increased to such an extent that it is hard to determine what the current role of reference credit rates is. There is still no definitive steering rate for financial markets, however. The central bank also steers funding directly to strategic sectors, but the rules of granting of loans and methods for calculating reserve requirements are less than transparent. This time funding of farmers or small and medium-sized firms was set as a perquisite for a reserve requirement decrease, but the actual definition for such criterion remains unclear.

Reforms on complete deregulation of interest rates move ahead in China. Last week the State Council approved an amendment that removes the required loan-to-deposit ratio of commercial banks. Under current law, the loan stock of a bank may not exceed 75 % of its deposit stock, thereby limiting the bank's ability to lend. In March, the ratio for the banking sector averaged 66 %, although many banks were near the 75 % ceiling. The change is expected to take effect next year and is likely to reduce lending costs and promote market-based pricing.

The deposit insurance scheme implemented at the start of May is considered a prerequisite for ending rate regulation. Moreover, from the start of June, banks are allowed to issue certificates of deposits (CDs) to private investors and non-financial institutions. At this point, the arrangement is only available to large investors that invest enough to meet minimum requirements. Earlier trading in CDs was only possible on the interbank market. All of China's largest banks have emitted new CDs, which can be priced freely and are not subject to deposit interest rate restrictions.

The range in which banks can offer deposit interest rates relative to the central bank's reference rate has gradually widened so that the current ceiling is 150 % of the reference rate. As there is little reason to increase flexibility, the next step is likely to be elimination of the ceiling altogether. Lending rates were deregulated in 2013, when also the lower limit on deposit rates was eliminated. According to central bank governor Zhou Xiaochuan, complete deregulation of interest rates will likely happen before the end of this year.

Chinese stock markets continue to seesaw. The boisterous rise in mainland China stock markets in the early part of the year gave way to declines last week. Shares prices in Shanghai declined for several days in a row at a pace of about 5 % a day. Shenzhen share prices plunged an average of 6 % a day for several days. Prices of over two-thirds of Shanghai's listed shares declined 10 % of their value last Friday, the maximum permitted change in price per trading session before trading in such shares is suspended.

Since their mid-June peak, prices of Shanghai-listed shares have dropped over 20 %, while the tech-heavy Shenzhen is down over 25 %. Share prices on the Shanghai exchange on average are still about 25 % higher than at the start of the year, while the average price of Shenzhen-listed shares is still up about 75 % from the start of the year.

China's extreme stock market volatility is driven by the rush of small investors into the market, rapid growth in margin buying and large swings in market sentiment. Several observers have noted that stock price trends have become delinked from trends in the Chinese economy. Even if private investors hold the lion's share of mainland-exchange-traded shares, only 7 % of Chinese households hold stocks. As a result, a market correction might not have a particularly large impact on household consumption.

Stock market trends in China

Source: Macrobond

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P.O. Box 160, FI-00101 Helsinki
Phone: +358 10 831 2268 • Web: www.suomenpankki.fi/bofit_en

Editor-in-Chief Jouko Rautava• Email: Jouko.Rautava@bof.fi

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