BOFIT Weekly

34 • 21.8.2015

Russia

Regions and local governments face precarious budget circumstances. First- and second-quarter revenues to the consolidated budget (federal, regional and local government revenues plus state social funds) were unchanged in nominal ruble terms from a year earlier. With 12-month inflation running at 16 %, however, revenues collapsed in real terms. While non-oil-&-gas budget revenues were up 9 % y-o-y nominally, revenues from taxes on oil, oil products & gas production and exports in 1H15 were down about 20 %.

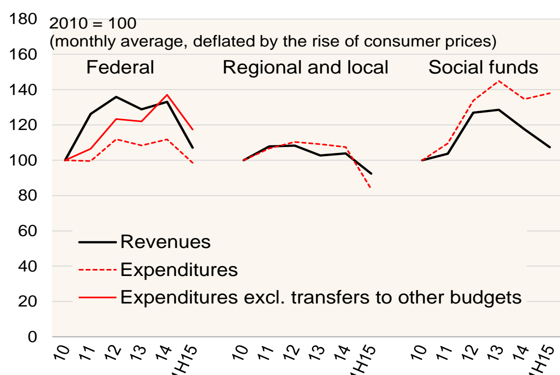
Spending in nominal terms rose by about a fifth, yielding a budget deficit equivalent to 2.6 % of GDP. Disbursements this year have followed an accelerated schedule compared to typical annual spending cycles. If the finance ministry's summer projection for 2015 spending is realised, the second half of 2015 will be very grim as nominal spending growth for the second half will be limited to just 1 %.

While federal non-oil-&-gas revenues were up over 6 %, the slide in oil & gas tax revenues reduced federal budget revenues by 7 % y-o-y. Transfers from the federal budget to other budgets were up over 15 %, with most of the new spending going to the Pension Fund. Other federal spending also rose over 15 %. The budget deficit was 2.3 % of GDP.

Revenues to regional and local budgets (incl. transfers) rose by over 10 %. While nominal received transfers only increased 6 %, other revenues were up 12 %, which is somewhat notable given the current recession. Budget expenditures, in contrast, rose just a few per cent, which kept the budgets in surplus. Most regions struggle with financing deficits and debt. Local budgets were already stretched in 2014 and this year they have only seen revenues, income transfers and spending increase 3–4 %. Growth in local revenues and spending also significantly lags long-term inflation.

Tax revenues of social funds and inter-budget transfers rose well in nominal terms. Due to the very rapid rise in spending, the social funds deficit was about 1.5 % of GDP.

Budget revenues and spending in real terms



Source: Ministry of Finance, BOFIT

Russian accounts inspector finds problems with National Welfare Fund use. The Accounts Chamber of the Russian Federation reports that assets invested from the National Welfare Fund to finance large infrastructure projects have not all been used as intended. The abuses of road-builder Avtodor, which is tasked with construction of a ring road around Moscow, received specific criticism. Avtodor has this year received from the Fund nearly 40 billion rubles (€600 million) through Gazprombank purchasing Avtodor bonds. The Accounts Chamber criticized Avtodor for not using the disbursed funds to break ground on construction work as planned, but deposited most of the money in Gazprombank also receiving interest income. The Accounts Chamber also uncovered similar discrepancies with most other investment projects funded out of the National Welfare Fund.

Number of banks in Russia continues to fall. There were just 783 banks operating in Russia at the end of July, down about 10 % from a year earlier. The reduction reflects license cancellations and bank mergers. The CBR has continued an activated cleaning up of the banking sector over the past two years. It has revoked 50 bank licenses already this year. Most banks losing their licenses are small or mid-sized. In about two-thirds of the cases, licenses were withdrawn due to suspected abuses such as illegal transfers of funds or violation of money-laundering regulations. In half of the cases, the reasons cited by the CBR included financial issues such as undercapitalisation or insolvency.

Banking sector problems are also reflected in the reliance on the deposit insurance fund. The fund paid out a record of 202 billion rubles (€4 billion) to depositors last year, and another 107 billion rubles in the first half of this year. The fund's assets have fallen from about 200 billion rubles at the start of 2013 to 30 billion rubles. The deposit insurance agency has given assurances that it can continue to compensate depositors – even if its obligations to depositors of Rossiyskiy Kredit, which lost its license in July, exceed 40 billion rubles. The fund gets most of its funding from member bank payments, but when needed it can also receive state support. Last year, a significant part of the fund's financing came from the state and the situation is expected to continue.

About 20 bank mergers have been initiated or completed since July 2014. A quarter of the acquired banks are mid-sized, and the rest are small. The buyers are mainly mid-sized banks. The markets expect more mergers ahead.

Russia's banking sector is still quite concentrated and the largest banks are state-controlled. The five largest banks held 54 % of total assets of the banking sector at the end of July. There were 106 banks with foreign majority owners at the end of June, and those banks held nearly 13 % of banking sector assets.

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

The information is compiled and edited from a variety of sources.
The Bank of Finland assumes no responsibility for the completeness or accuracy of the information, and opinions expressed do not necessarily reflect the views of the Bank of Finland.

BOFIT Weekly
34 • 21.8.2015

China

Turbulence continues on Chinese markets. Uncertainty on Chinese stock markets persists despite official efforts to stabilise the markets. The stock market turbulence is due to e.g. increased volatility in foreign exchange markets and speculation that officials may withdraw stock market support. On Tuesday (Aug. 18), share prices plunged over 6 % on the Shanghai and Shenzhen exchanges, and the markets remain shaky.

Chinese share prices, 1.1.2014–19.8.2015

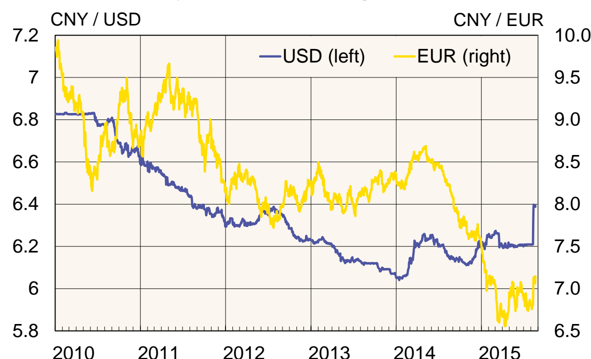
Sources: Macrobond, BOFIT

Uncertainty on foreign exchange markets increased last week after the People's Bank of China shifted to a more market-based regime for setting the yuan's exchange rate. The move was accompanied with a small devaluation; the yuan now stands about 3 % lower against the dollar than it did at the beginning of last week. The minor drop in the exchange rate will have only a tiny impact on the price competitiveness of Chinese export industries, so market comments emphasizing the devaluation appear as overblown. Daily fluctuations in the exchange rate have since been minimal, but volatility is expected to increase. A more market-based formation of the yuan's exchange rate is important in setting the stage for progress in economic reforms and increasing the flexibility of monetary policy.

Chinese exchange rate policy also has to deal with the acceleration in capital outflows seen in the first half of this year. According to media reports the PBoC has stabilised the yuan's market rate to reduce pressures that might otherwise cause capital outflows to pick up. Officials have also given assurances that they will continue to support stock markets. Government intervention to stabilise stock markets is not a sustainable solution, if the aim really is to give markets more power in the economy.

While the risks associated with the opening of financial markets should not be understated, there are no clear signs that the real economy is in excessive trouble. Indeed, available information suggests growth has slowed more or less as expected. Related to exchange rate issues, the contraction in exports has been balanced by a contraction in imports, so China's current account surplus continues to grow.

Yuan-dollar and yuan-euro exchange rates



Source: Reuters

IMF says China's shift to a more sustainable growth model essential. The IMF has released its latest annual staff review of the Chinese economy (Article IV Consultation). The main theme is that slower economic growth in coming years is an inevitable feature of more resilient economic structures. China's slowing growth is not simply related to the business cycle, but a needed structural accommodation to a more sustainable growth paradigm. The challenge for China's leaders is to accomplish a soft landing without exposing existing vulnerabilities.

The staff report repeatedly stresses the importance of rapidly advancing structural reform essential to raising China's growth potential. Important reforms include moving to a more market-based financial system, reforming state-owned enterprises and taking action to improve the competiveness and investment efficiency of the private sector. The IMF reiterated its wish that China move to a floating exchange rate regime within two to three years.

The IMF considers the latest trend of slower growth of credit (particularly evident in the shadow banking sector and real estate investment) a positive step. The IMF said that economic resilience would have to come from reducing the debt-to-GDP ratio and excess supply in real estate markets. The staff praised China's new budget act, aimed at helping local governments reduce off-budget borrowing. Financial market reforms have proceeded as expected. GDP is generated increasingly by labour-intense activities, having a positive impact on the labour market trends.

The IMF assessment assumes China will succeed in invigorating its economy and advancing economic reforms. GDP growth should come in at 6.8 % this year, 6.3 % next year and 6 % in 2017. Under the base scenario, economic growth will then cease to slow as the positive effects from reform begin to be felt.

The IMF emphasised that rising economic vulnerabilities need to be addressed immediately. One of the biggest risks is that economic reforms will move too slowly as China clings to its old growth paradigm. Failure to embrace change could seriously impair growth over the long run and hurt the global economy.

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
*The information is compiled and edited from a variety of sources.
The Bank of Finland assumes no responsibility for the completeness or accuracy of the information, and opinions expressed do not necessarily reflect the views of the Bank of Finland.*