SUOMEN PANKKI FINLANDS BANK EUROSYSTEM 1811

Weekly Review
35 • 28.8.2015

BOFIT

Russia

Falling oil prices weaken the ruble and increase risks to Russia's economy. The ruble's slide accelerated after the price of Urals-grade crude oil approached the $40 mark last week. The ruble has lost about a third of its value against the euro and dollar since its recent peak in late May. It hit new lows of the year this week. The currencies of other commodity-producing countries have also been affected. For example, oil-producer Kazakhstan last week announced of switching to free-float and saw the tenge drop over 20 % against the dollar.

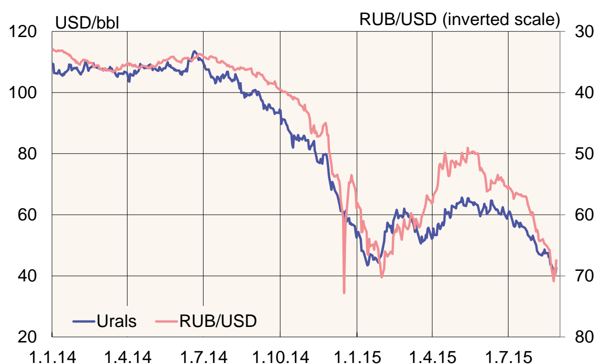
Adding to depreciation pressures on ruble, nearly double the recent average monthly amount of private-sector foreign debt comes due in September. The Central Bank of Russia has, however, estimated that a large part of the debt is intra-group and could be refinanced. Prime minister Medvedev recently expressed his confidence in the ruble, saying the exchange rate should get a boost when exporter firms will sell additional forex proceeds in the near future. Medvedev added that the government has not relaxed its supervision of exporters' sales revenues launched at the end of 2014.

The global drop in oil prices and anxiety on international financial markets was evident also on the Russian exchange this week as the RTS index fell to its lowest point this year.

Low oil prices forced the economy ministry to revise downward by a half percentage point its GDP forecasts for 2015 and 2016. In the new forecast, GDP shrinks 3.7 % this year, but next year grows 1.8 % (still optimistic compared to the consensus view) assuming an average oil price of $55 a barrel. If the oil price stays at $40 a barrel next year, the ministry sees GDP contracting 0.9 %.

Low oil prices also put pressure on the government for further fiscal tightening. The current 2016 draft budget assumes an average oil price of $60/bbl, an exchange rate of 57 rubles to the dollar and 2.3 % GDP growth. Even under these parameters, the 2016 federal budget deficit would still be 2.4 % of GDP. As part of its July budget calculations, the finance ministry also estimated that the Reserve Fund will correspond to 2.9 % of GDP at the start of next year.

Ruble-dollar exchange rate and price of Urals crude



Source: Reuters

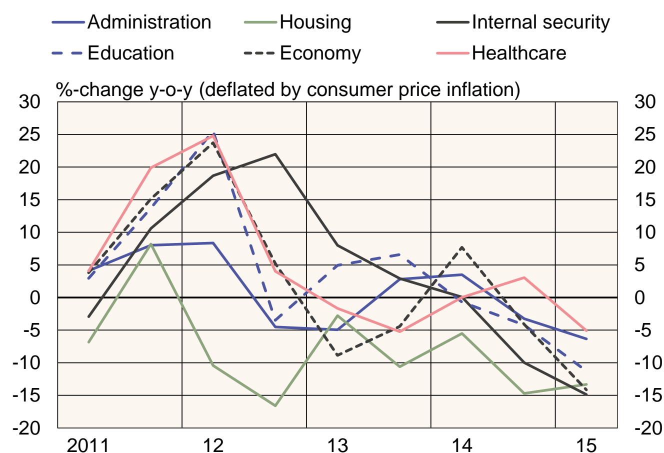
Large shifts in structure of government revenues and spending. In the first half of 2015, revenues to the consolidated budget (federal, regional and local governments, plus state social funds) remained unchanged in nominal ruble terms as 9 % y-o-y growth in other budget revenues offset a 20 % drop in tax and fee revenues from oil & gas. The non-oil share of revenues rose to 77 % and equalled over 28 % of GDP.

Nominal ruble revenues from income and excise taxes increased just a few percent and VAT revenues were up 6 %. Revenues from mandated social contributions, however, rose 9 % and revenues from corporate profit taxes were up even 30 %. The unusually large increase mostly came from higher profits of exporters in the oil and metal branches. These firms have seen their ruble denominated profits rise sharply due to ruble depreciation. Nominal budget revenues from property taxes were up 10 %. Revenues from state property rose 60 % as income from investment of government assets quadrupled (again, partly due to the ruble's collapse) and the transfers to the state from CBR surplus increased by 2.5 times.

A nearly 20 % rise in first-half consolidated budget spending (in nominal ruble terms) was driven largely by higher social and defence spending (both up by over a third). As defence spending increase was more front-loaded than usually (i.e. allocated early in the year), its share of budget spending rose to 14 % and exceeded 5.5 % of GDP. Social spending rose by 36 % to 14 % of GDP. Debt-servicing costs, due in part to ruble weakness, also increased over 30 %.

The government increased healthcare spending by 10 % in the first half of this year. Other main spending categories rose slowly in nominal ruble terms or were unchanged from a year earlier. Inflation picked up dramatically last winter, so all spending not related to defence or social spending fell sharply in real terms relative to the first half of 2014.

Real changes in select government spending categories



Source: Ministry of Finance

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China

China's central bank continues monetary easing and liberalisation of interest rates. On Tuesday (Aug. 25), the People's Bank of China announced a rate cut of 25 basis points. The reference one-year lending rate now stands at 4.6 %, while the corresponding deposit rate is 1.75 %. The PBoC simultaneously eliminated the interest rate ceiling on time deposits over a year. The interest rate commercial banks can offer on deposits with shorter maturities is still limited to 150 % of the reference rate. This means that interest rate liberalisation in China is very near to completion.

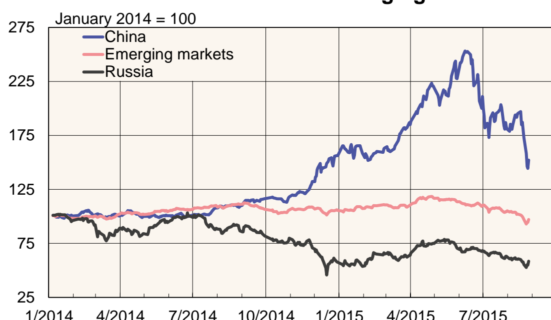
The PBoC also told that it will lower its reserve requirements from September 6. The reserve requirement ratio for all banks will go down by 0.5 percentage points. The impacts were hard to assess last time the reserve requirement was lowered as it only applied to banks meeting certain criteria. Now the PBoC again targeted some banks for reserve requirement cuts greater than 0.5 percentage point.

China has relaxed monetary policy already six times this year. The PBoC said its latest move was needed to keep real interest rates moderate and inject liquidity in money markets. Tighter liquidity conditions were partly due to the central bank yuan purchases to stabilise the exchange rate. An interest rate cut may create pressure to yuan depreciation and increasing capital outflows.

On-going volatility on the Chinese stock markets. On Monday (Aug. 24), Shanghai share prices fell 8.5 %, and continued to fall the next days. On Wednesday (Aug. 26) Shanghai stocks were still down about 27 % from the start of last week, but the market has since recovered some 5 %. Monetary easing has somewhat calmed the markets, but officials have refrained from market bailouts similar to what was done during the July plunge in share prices. Direct interventions in equity markets are poorly suited to the long-term goals of market liberalisation and modernisation.

Share prices on other emerging markets have also had a volatile two weeks. On Wednesday, emerging stock markets were still down on average about 7 % from the start of last week. In Hong Kong share prices also fell sharply, down 11 % y-o-y on Wednesday from the beginning of last week.

Stock trends in China and other emerging markets



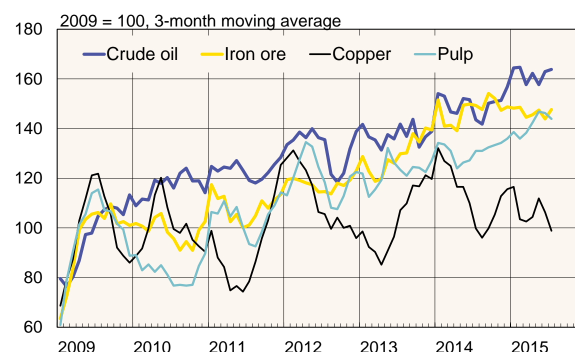
Source: Bloomberg

Chinese oil import volumes up 10 % this year. The slowdown in economic growth has yet to be seen in China's oil imports. In the first seven months of this year, China imported 194 million metric tons of crude oil, an increase of 10 % y-o-y. Imports soared in June and July, when China's imports of crude oil were up 28 % y-o-y. Due to the sharp drop in oil prices, the value of oil imports in dollar terms was down 40 % y-o-y in January-July.

Most of the growth in China's oil imports comes from a conscious effort to increase the national strategic reserves. The International Energy Agency (IEA) believes that demand for oil will exceed consumption for some time as China continues to add to its new strategic reserves.

In the January-July period, imports of crude oil from Russia amounted to 23 million tons, i.e. 12 % of China's total oil imports. Oil imports from Russia, measured by volume, increased faster than oil imports from the other major oil producer. Crude oil imports from Russia in January-July were up over 30 % y-o-y. At the same time, imports from Saudi Arabia were up 10 %, while imports from Iran and Angola declined. The value of oil imports from Russia fell 28 % in dollar terms in the period.

Commodity imports to China by volume



Source: Macrobond

Imports of many other commodities declined. Measured by volume, coal imports in the first seven months of the year were down 34 % y-o-y and copper 9 %. The volume of imported iron ore remained roughly unchanged from a year earlier. The on-going structural changes in China, even without a significant economic slowdown, will impact China's imports. Most affected are those commodities needed earlier during China's rapid infrastructure build-out. For example, imports of copper as well as iron ore and coal used in manufacture of copper and steel have fallen on the slowdown in construction.

Excess domestic capacity (e.g. in the steel industry) also affects commodity imports. China wants to reduce overcapacity and increase production efficiency. This will be manifesting in the reshaping of domestic production. Reduced emissions targets have also led to at least temporary shuttering of the worst polluting factories.

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