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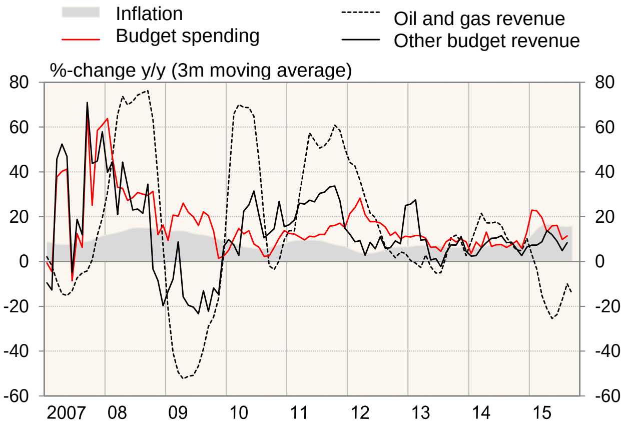
Russia

Russian government issues lean proposals for 2016 federal and state social fund budgets. In submitting its draft budgets to the Duma, the finance ministry included an estimate for total government-sector revenues (regional and local government budgets included) that anticipates a growth of around 5 % next year in nominal ruble terms. The calculations are based on the economy ministry assumptions of an inflation rate of 7.4 % next year, along with an average price of crude oil (Urals) of $50 a barrel and GDP growth of 0.7 %. Government spending is expected to increase about 2 % in nominal terms.

The finance ministry projects the government deficit next year will equal 3.8 % of GDP. The estimate includes a federal budget deficit of 3 % of GDP as laid out by president Putin.

The projected increase in federal budget revenues next year reflects changes in specialised taxes and fees. Along with changes decided earlier, the biggest revenue boost will come from revised taxes on oil production and oil exports. Adjustments in the tax on gas production, the automobile use fee, and distribution of central bank profits and income of state reserve funds are also important to bring extra revenue. Tax revenues from oil & gas, which in practice go entirely to the federal budget, should increase about 3 % after a roughly 20 % drop this year. The finance ministry expects the increase in revenues overall to be spread rather evenly across the various budget categories (federal, regional, municipal and social funds).

Change in public-sector revenues and expenditures



Source: Russian finance ministry

Federal budget spending will grow slightly faster than other categories, but still only about 4–5 % y-o-y (also excluding inter-budget transfers). Defence spending will not rise even in nominal rubles. In contrast, funds reserved for support spending (which must be decided by the president or the cabinet), as well as spending on space exploration, are likely to grow substantially. Asset transfers to the Pension Fund should rise, while transfers to regional budgets should fall slightly.

The nominal amounts of regional budget spending are expected to remain roughly unchanged next year, as well as Pension Fund and other social fund spending. To curb Pension Fund spending growth, hikes in pensions will be limited to just 4 %. The cabinet has, however, agreed on the option of a supplemental increase that will depend on the economic situation in the first half of 2016.

Russia charts near depletion of Reserve Fund next year. Under the current federal budget draft, 90 % of the budget deficit will be financed with money from the state Reserve Fund. The finance ministry estimates that the Reserve Fund would be depleted by the end of 2016 to a level that corresponds to 1.3 % of GDP. The finance ministry reports that the Reserve Fund held assets equal to 6.4 % of GDP at end-September and that the Fund is on track to shrink to 4.6 % of GDP by the end of this year. The contraction of the Reserve Fund's value this year has slowed in ruble terms with the decline in the ruble's exchange rate.

There are no plans at the moment to borrow nothing more than a tiny bit from the National Welfare Fund to finance the deficit (i.e. the situation remains similar to previous years). Under the latest budget proposal, the National Welfare Fund will still have assets corresponding to 6 % of GDP at the end of next year. It will also not be used very much to finance e.g. infrastructure projects or corporate support by acquisition of equity stakes. Possible investment in loans and shares do not alter the size of the fund, but remain on the fund balance sheet as receivables (although they extend maturities of receivables and may increase fund risk).

World Bank *Doing Business* report shows no major changes in Russia's business regulation last year. Russia ranked 51st out of 189 countries examined in the World Bank Group's annual *Doing Business* report, which was released this week. Taking into account methodological changes and data revisions, Russia's comparable ranking last year was 54th. CIS countries Georgia, Armenia, Kazakhstan and Belarus posted rankings better than Russia. EU members Greece, Luxemburg and Malta all underperformed Russia. China (84th) was nearly unchanged in the rankings.

Especially in Russia's case, *Doing Business* seems to mainly reflect formal business regulation, where e.g. legislation has improved visibly over the past decade. In practice, however, companies often experience the Russian business environment very differently. Numerous surveys in recent years have noted that the main problems encountered in Russia largely have to do with capricious application of the law and the costs of corruption – factors overlooked in the Doing Business indicators. In addition, Doing Business indicators are based on very narrowly specified case studies which cannot necessarily be generalised to the overall business environment, even if it eases comparison across countries.

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 frees interest rates. Effective last Saturday (Oct. 24), the People's Bank of China eliminated its last remaining interest rate limits – the interest rate ceiling on deposits of less than one year. Following deregulation of credit interest rates in 2013 and the ending in August of the rate ceiling on deposits of more than a year, the era of limits on bank interest rates is now formally over. Freeing of interest rates is seen as a major step on China's road to a market economy; it promotes financial market competition and allows further liberalisation of capital movements. Progress in actual deregulation of deposit rates is going to have the salutary effect of reducing demand for the more problematic and hard-to-regulate investment instruments of the shadow banking sector.

Deregulation of interest rates also encourages the shift to monetary policy implementation used in developed economies, i.e. use of true monetary policy interest rate as the main policy tool. Lacking this tool, China has been left with adjustment of reserve requirements as its main monetary policy option while the role of current reference rates is unclear. Further muddying monetary signalling is the fact that the central bank still provides funding directly to certain enterprises via state development banks. Moreover, bank lending remains directly subject to "window guidance," which is neither transparent nor well suited to market economy rules.

China further eases monetary stance. The PBoC last week also lowered its reference rates. The reference rate on one-year bank loans was lowered by 25 basis points to 4.35 % and the one-year deposit reference rate to 1.5 % by a similar amount. Even with the end of formal rate regulation, banks appear timid to stray far from reference rates in their deposit and credit pricing. Lending rates were permanently freed in summer 2013, yet today most bank loans are still granted at rates close to the reference rate.

Bank reserve requirements were also lowered at least 50 basis points (the requirement was lowered 100 basis points in some cases). The reserve requirement of large banks is now 17.5 % and smaller banks 2–3.5 percentage points less.

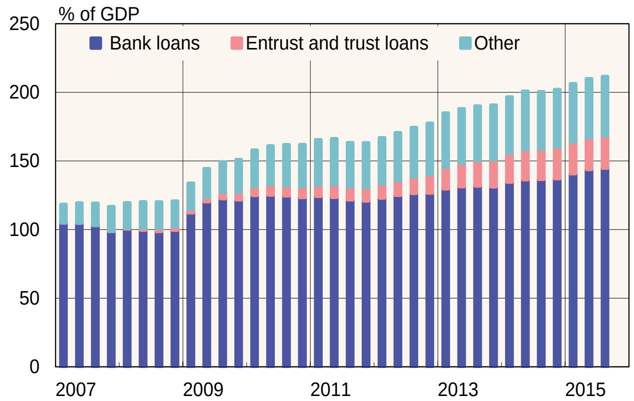
The latest cuts in interest rates and reserve requirements followed on cuts at the end of August. This month, the PBoC also expanded its trial programme of providing commercial banks with credit secured by debt securities held by banks.

The shaky economic outlook is the main motivation for monetary easing. Even with repeated rounds of easing and Chinese third-quarter GDP growth holding steady at nearly 7 %, price development remains lax. The central bank's latest moves may also reflect anticipation of an eventual US rate hike, which, when implemented, would make monetary easing more difficult also for China. The bigger problem, however, is that monetary stimulus worsens the debt problem, already the biggest risk to China's economy.

Chinese domestic indebtedness continues to soar. Using its broad concept of "total social financing," China's central bank reports that domestic indebtedness climbed 13 % y-o-y in the third quarter while the nominal value of GDP increased 6.2 %. Growth of the credit stock slowed slightly from 2014, when on-year growth was 15 %. In contrast, growth in the stock of bank deposits has accelerated this year, increasing 17 % y-o-y in the third quarter. Deposits in 2014 increased about 13 % y-o-y.

On-year growth in the stock of bank loans has been steady, remaining at 13 % for about a year. However, the stock of foreign currency-denominated bank loans has contracted during this year. In the third quarter, the stock of entrust and trust loans issued in the shadow banking sector grew by 14 % y-o-y. Growth in shadow bank lending has slowed significantly over the past two years. A year ago, lending of the shadow banking sector grew by nearly 30 % y-o-y.

Ratio of domestic credit stock to GDP



Sources: Macrobond, BOFIT

China's president promotes closer economic ties during UK visit. During his visit to the UK last week, president Xi Jinping focused on deepening economic cooperation and promoting international use of the yuan. The UK wants to see London become the West's main hub of yuan exchange.

In connection with Xi's visit, the PBoC issued in London its first offshore bond ever, a 1-year bond worth 5 billion yuan ($790 million). The bond issue was well received by the market, with demand far exceeding supply. Earlier this month, two Chinese banks (Agricultural Bank of China and China Construction Bank) also issued yuan-denominated bonds in London. The PBoC's successful bond issue should encourage other Chinese banks to seek yuan-denominated financing in London.

The visit included deals on several major Chinese investments in the UK energy sector, health care, car manufacturing and the entertainment industry. The single largest investments were from China's state-owned China General Nuclear in two nuclear power plant projects in England.

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