Weekly Review
7 • 19.2.2016

BOFIT

# Russia

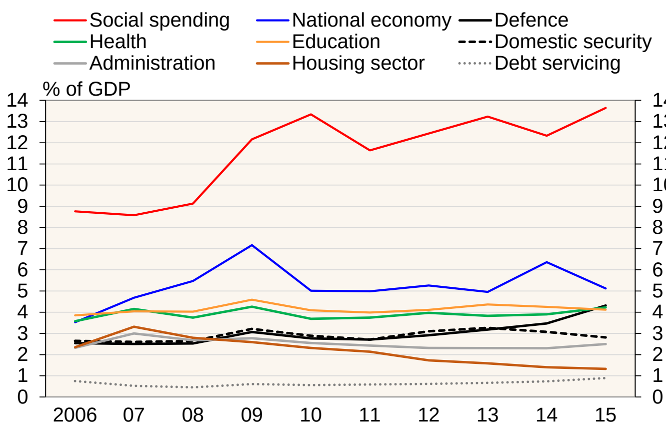
**Russian government deficit soared in 2015.** Revenues to the consolidated government budget (federal, regional and municipal budgets, plus state social funds) declined 1 % in nominal rubles, while expenditures increased by over 6 %. Using GDP data determined by Rosstat's old methodology (i.e. before the recent adoption of broader definitions), revenues declined to 36 % of GDP, while expenditures climbed to nearly 40 % of GDP. The consolidated government deficit, which corresponded to 3.9 % of GDP in the old GDP system, was just under 3.6 % of GDP using the new system.

The large hole created by the drop in government revenues from oil & gas taxes was partly filled with considerably increased revenues from social taxes as part of the health insurance financial reform. Revenues from corporate profit taxes were up as company profits in the oil sector and among exporters involved in basic manufacturing saw significant gains from the ruble's collapse at the beginning of the year. VAT revenues were also up in nominal ruble terms.

While defence spending continued to soar last year, increases in government spending otherwise averaged about 4–5 % in nominal ruble terms. Among major government spending categories, a notable spending increase was seen in public administration, although it is difficult to say where the increase went as it arose mainly from spending on unspecified international relations. In contrast, spending on domestic security and law & order contracted in 2014–2015.

Social spending is by far the government's biggest spending category, and most social spending goes to pensions. Social spending increased rapidly last year. Financial reform of health insurance also lifted healthcare spending by well over 10 %. The low spending growth for education in 2014 dropped further last year, failing to increase even in nominal ruble terms. With the exception of day-care facilities, zero budget growth fell on education at all levels.

**Largest government spending categories, 2006–2015**




*Source: Ministry of Finance.*

Spending on the housing sector continued to decline. Budget spending on the economy fell, which was due to December 2014 recording of a very large one-time support sum granted later to banks. Budget spending was raised for the energy sector and, following a notable drop last year, also for agriculture. Spending on road network construction and maintenance showed virtually no increase in 2014–2015. Debt servicing costs (interest payments) rose last year by over 25 %.

**Russian foreign debt declined last year.** Preliminary figures from the Central Bank of Russia put the country's foreign debt at $515 billion at the end of 2015. Foreign debt fell in 4Q15 by just over $20 billion as banks and firms paid down debt. During the whole 2015, the value of foreign debt decreased by over $80 billion. Some of the reduction reflects the depreciation of the ruble's exchange rate. About one-fifth of Russian foreign debt is denominated in rubles. Foreign ruble debt appears to have in fact even increased last year.

Russian government foreign debt amounts to about $30 billion (2 % of GDP according to the new GDP figures). If the debt of the CBR and state-majority enterprises and banks are included, the public sector's total share of Russian foreign debt is about half. Firms operating outside the banking sector hold most private sector foreign debt. However, over a third of that is debt in the form of intra-group liabilities.

Russia holds about $50 billion in short-term foreign debt. The CBR estimates that just under $30 billion of that comes due in the first half of 2016. Russia's foreign currency reserves stood at $370 billion at the end of January. So for the Russian economy as a whole, paying down debt should not cause problems to forex liquidity. Individual firms, however, could have trouble settling their debts.

**Russia's disputes with neighbours complicate road transport.** With the closure of routes through Ukraine and Poland, Russian lorries have currently practically no land connection to Central Europe. Russia and Ukraine this week declared reciprocal blockades on Ukrainian and Russian lorries seeking to cross their borders. Russia said it was blocking traffic in response to recent interference of Ukrainian protesters seeking to prohibit movement of Russian lorries through Ukraine. Ukraine responded with its own border shutdown. At the start of January, Russia imposed restrictions on Ukrainian road freight transiting Russia to Kazakhstan.

The situation is made more problematic for Russia by the fact that it already has a similar blockade in force with Poland. That bilateral transport agreement expired at the start of this month and negotiations on a new agreement have stalled over transport permit quotas. While economic effects of the transport feuds are likely to remain limited for Russia as a whole, the transport sector faces extra costs as do some firms that have to revise their logistics chains.

# China

**China's lending soars, while share of nonperforming loans increases.** Some 2.5 trillion yuan ($380 billion) in new yuan-denominated loans were granted in January – more than in any single month ever. The amount was comparable to the combined value of lending last year in both January and February. The corporate sector (including public-sector businesses) borrowed 1.94 trillion yuan, an increase of 85 % from January 2015. New lending to households in January amounted to 610 billion yuan (up 43 % y-o-y). The total credit stock grew 15 % y-o-y in January.

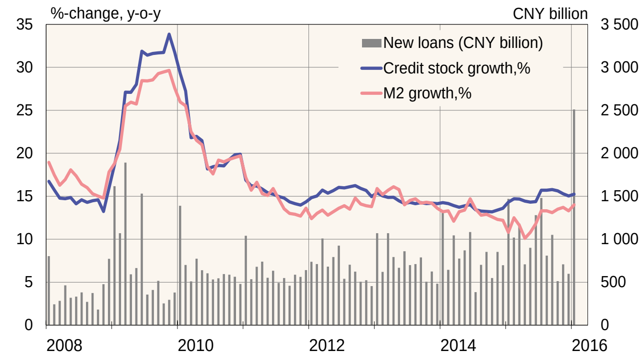
Lending usually surges at the start of the year due to high seasonal demand for money around the Chinese New Year's holiday week. This year, the growth in demand for yuan-denominated credit also reflects a fall in demand for foreign-currency loans and efforts to pay off foreign-currency debt. In January, the People's Bank of China stepped up its money supply expansion efforts through open-market operations and the use of targeted lending. Growth in the broad money supply (M2) accelerated to 14 % y-o-y in January.

Consumer price inflation accelerated to 1.8 % in January. Core inflation (excludes prices of food and energy) remained at 1.5 %, while producer price *deflation* reached 5.3 % in January.

The volume of non-performing loans (NPLs) on bank balance sheets rose in 2015. The banking sector's NPL stock amounted to 1.3 trillion yuan. When 'special mention loans' (a high likelihood of default) are included, the total amount rises to 4.2 trillion yuan ($650 billion), an increase of 41 % y-o-y. NPLs and special mention loans combined represented on average 5.5 % of the banking sector's total credit stock.

Loan-loss provisions on bank balance sheets amounted to 2.3 trillion yuan (up 18 %) at the end of 2015 – an amount sufficient to cover 180 % of total NPLs. Under current regulatory rules, bank need to hold loan-loss reserves equivalent to at least 150 % of their NPL stock. Media reports say a cut of loan-loss provision requirement is under consideration to help banks improve their profitability.

**Growth in credit stock and money supply (M2), new yuan loans**

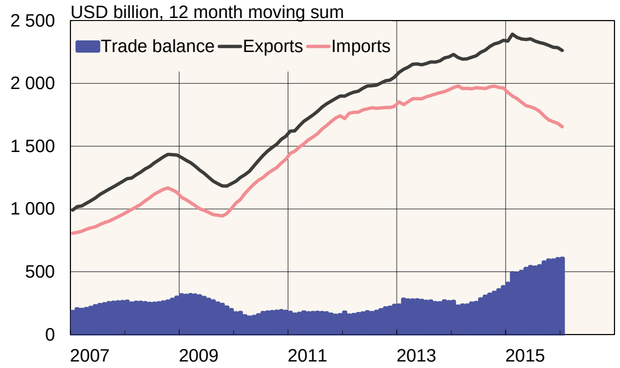



*Sources: Macrobond, Bloomberg.*

**Decline in Chinese foreign trade continued in January.** Measured in US dollars, the value of January goods exports fell 11 % y-o-y, while the value of good imports was down by 19 %. The contraction in exports was broad-based across trade partners and commodities. The contraction in the value of imports accelerated on further declines in world commodity prices, even if the volumes of many commodity imports increased. The goods trade surplus boomed in January to a record $63 billion.

The foreign trade numbers reflect weak demand in China and its key exports markets as well as exchange-rate shifts. Looking at the mirror trade data, the value of US's and Eurozone's exports to China fell 5–6 % last year measured in dollars and euros, respectively. Moreover, due to China's capital controls firms disguise capital movements as foreign trade transactions, which complicates interpretation of Chinese foreign trade figures.

**Trends in Chinese foreign trade**




*Source: Bloomberg.*

**PBoC reiterates commitment to opening Chinese economy.** People's Bank of China governor Zhou Xiaochuan commented on trends in Chinese exchange rate policy in an interview with the Chinese economics journal *Caixin* on February 13. In Zhou's view, China's massive current account surplus indicates that there is no basis for yuan depreciation. He further noted that China plans to gradually shift its exchange-rate policy to a system where one of the criteria will be to establish a relatively stable yuan against a yet-to-be-decided currency basket. Zhou said that increasing international use of the yuan and the dismantling of capital controls proceeds, but that the rate of progress depends on the amount of uncertainty in the markets.

It was somewhat surprising how strongly the interview emphasized the role of speculators in the PBoC's communication strategy, as messaging intended to influence speculative behaviour easily leads to overall confusing signalling. The views on the article on exchange-rate policy and capital movements did little to clarify the short-term outlook, but strongly suggested that China plans to stick with its opening up strategy.