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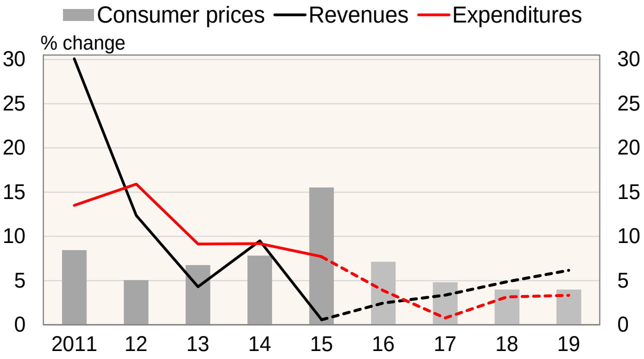
Russia

Bleak outlook for Russia's government finances. In its fresh budget policy framework for 2017–2019, the finance ministry sees revenues to the consolidated budget (federal, regional and municipal budgets, and government social funds) still failing to keep up with inflation next year. The estimate cautiously assumes a price of Urals-grade crude oil of $40 a barrel for the whole period, which equals the average of January-September of this year. The ruble's exchange rate, which also affects tax revenue from oil, is assumed to weaken slightly. Other revenues are expected to slightly outpace inflation next year. To mend the revenue side, the government plans to treat the income (nearly 0.9 % of GDP) raised from the sale of a 19.5 % stake in state oil giant Rosneft as budget revenue, although by nature that income is a financing item to cover the budget deficit. It would be channelled to the budget as dividend income from the state-owned firm selling the Rosneft stake. The sale could be completed this year.

The ministry expects low government spending growth in coming years as targets have been set to shrink the deficit. The 2017 growth figure is also depressed by this year's abrupt spending boomlet caused by the 2016 supplementary federal budget (currently in the Duma) that boosts defence spending by a whopping 0.9 % of GDP. The ministry now estimates the government budget deficit will reach 4 % of GDP this year even if the Rosneft deal goes through, and 4.8 % of GDP without the deal. Next year's targeted deficit is 3 % of GDP.

Changes in government revenues and expenditures, and inflation rate, 2011–2019 (2016–2019 are finance ministry estimates)



Source: Ministry of Finance.

Russia drops slightly in the *Doing Business 2017* rankings. The World Bank's latest business environment survey ranks Russia 40th out of 190 countries. Russia's current ranking puts it on par with Bulgaria, Hungary and Belgium. China rose slightly in the rankings to 78th position.

Longer term developments are harder to figure out from the data due to major methodological changes especially in recent years. For example, Russia ranked 36th or 51st last year depending on the methodology applied.

While *Doing Business* is the widest and best-known international business climate comparison, it has its limits. By concentrating on narrowly defined sample cases, the results cannot necessarily be generalised to the broader business environment. It does not take into account e.g. corruption or the cost of inspections by officials, which are often quite substantial in Russia. Prime minister Dmitri Medvedev recently noted that the inefficiencies caused by officials' inspections cost firms around 5 % of GDP. In addition, the regional business climate survey used by the Russian administration showed that last year the worst declines were in indicators of official oversight and administrative coercion for firms.

The narrowness of *Doing Business* survey criteria is also reflected in the fact that some of its results differ markedly from the findings of other surveys. In the *Doing Business* comparison Russia ranks high in sub-indicator topics such as registering property (9th) and enforcing contracts (12th). In contrast, the WEF competitiveness rankings give Russia significantly lower marks in similar topic categories, e.g. property right enforcement (123rd) and judicial efficiency in dispute resolution (82nd).

Moreover, the *Doing Business* survey only looks at big cities, i.e. Moscow and St. Petersburg in Russia's case. However, the differences in business climates across Russia's regions are large. Russia's ranking in the survey showed greatest improvement in the sub-indicator for ease of starting a business, which considers, among other things, how long it takes to set up a company. The reported average time was less than 10 days. A survey of the Russian Union of Industrialists and Entrepreneurs (RSPP) found that last year it took less than 10 days to set up a business in only 18 % of Russian regions.

Unpredictability of administrative regulation diminishes corporate investment appetite in Russia. The World Bank recently published a study (Levina & al. 2016) that examines how informal administrative regulation is related to the eagerness of firms to invest in Russian regions. Most of the data are based on the Russian Firms in the Global Economy survey conducted in autumn 2014. The data set has been supplemented with regional variables, BEEPS survey material on corruption factors and the NGO "Companies Against Corruption" information on hostile takeovers. The sample covers about 1,500 Russian companies in 35 regions.

The findings show companies adjust to the level of administrative corruption in a region if corruption is a predictable and foreseeable component in an investment decision. If, however, the firm's experience with administrative corruption in the region varies greatly, the unpredictability of corruption diminishes the company's appetite for investment. Corporate eagerness to invest is also hurt by inconsistent enforcement of property rights and the possibility of unexpected hostile takeovers. While the study makes no policy recommendations, it reinforces earlier views that the uncertainty in the business environment discourages investment, which then impedes economic recovery in Russia.

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

Chinese government pushes to get debt restructurings going for troubled state-owned firms. China has been preparing a programme since last spring to ease the massive debt choking state-owned enterprises and stop the mounting level of banks' non-performing loan portfolios. Early this month, the State Council posted guidelines for reducing corporate debt. It made clear that the arrangement only applies to high-quality firms with good chances of long-term survival. The government emphasized that the arrangement does not apply to unviable "zombie" firms, many of which operate in branches suffering from overcapacity.

The guidelines seek to avoid the problems that arose after debt-equity swaps at the end of the 1990s. They also draw on expert advice on the dangers of keeping unviable businesses on life support and the inability of banks to step in as an owner and manage troubled firms. For these reasons, the government emphasises the role of market forces in debt restructurings. In practise, debt-for-equity swaps would be performed by asset-management companies owned by banks or third parties, and the exchange of debt and shares would take place at market prices. Although the government states that it will not answer for the loans of over-indebted SOEs, it has promised extra funding to viable companies that move ahead with restructuring. The government also hopes that mergers, acquisitions, and bankruptcy actions will restore the debt-burdened corporate sector to sound basis.

While restructuring and winding down of state-owned enterprises has been slow and painful, something is happening. Earlier this month, the court approved the bankruptcy plan of state-owned Dongbei Special Steel Group after large state banks refused to swap junk bonds for shares despite pressure from the Liaoning provincial government. While the incident shows financiers that state-owned companies can also go bankrupt, it is still unclear what will be left of Dongbei after it emerges from bankruptcy and how much steel production capacity will eventually be taken off the market.

Second-child births keep China's maternity wards busy. Late last year, China announced it was abandoning its long-standing one-child policy, replacing it with a new general two-child limit. Official estimates now see a net increase of 3 million births a year over the next five years as a result of the policy change. Even with the change, the population is on track to peak at 1.45 billion in 2029, and thereafter begin to shrink. Many urban maternity clinics now face a rush as families apparently decided as soon as the policy change was announced to go for number two. In Beijing, for instance, some 360,000 babies will be born this year, over 100,000 more than in 2015. Facilities and staff are stretched to the limit, even if more maternity beds have been set up.

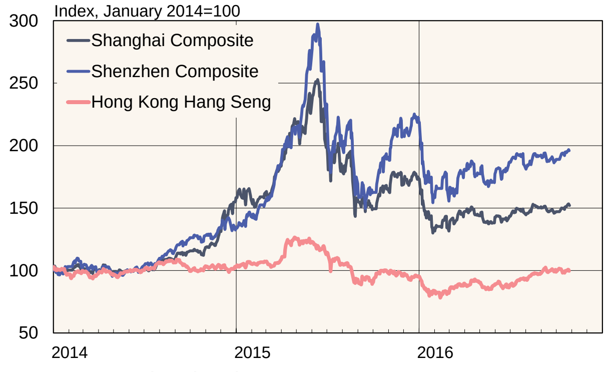
Even with numerous exceptions granted since China adopted the one-child policy in the late 1970s, China's demographics have become distorted. China's dependency ratio is rising rapidly, with large age cohorts reaching pension age and much smaller cohorts entering the labour force. More boys than girls continue to be born. The imbalance is the world's most severe, even if it has fallen a bit in recent years. In 2015, 114 boys were born for every 100 girls. Such imbalance could lead to social tensions if young people are unable to find a suitable match.

The one-child policy also affects care of the elderly, a job that has traditionally fallen on the shoulders of the children. A Peking University nationwide survey of 20,000 over-45-year-olds found that over half of China's elderly already live without the assistance and support of their children. The need for public and private elder care has increased.

Mainland China stock markets await investment of pension savings and foreign investors. Prices on mainland China stock markets have remained relatively stable this year and trading has calmed considerably from last year's boom. New possibilities to invest in the stock exchange are increasing. A change in the law approved last year now allows pension funds to invest in equities and debt securities. According to press reports, China's local governments are beginning to invest pension assets in publicly traded stocks this year, which could bring 200–400 billion yuan to the market before the end of the year. The amount is less than 1 % of the market capitalisation of mainland China stock exchanges. Local pension funds will be transferred to China's national social security fund, which will administer the invested assets.

The long-awaited Shenzhen-Hong Kong Stock Connect project has reached its technical phase, with trading expected to begin in late November. Investor interest in the Shanghai-Hong Kong Stock Connect project that launched in November 2014 has been relatively modest and inter-exchange trading under Stock Connect still accounts for less than 2 % of the Shanghai stock exchange's daily turnover. The programme has also failed to close the price gap between Shanghai and Hong Kong, even if it has narrowed slightly in recent months. Prices of Chinese company shares in Shanghai on average are still 22 % higher than the same shares in Hong Kong.

Trends in Chinese stock markets



Sources: Macrobond and BOFIT.