Weekly Review
29 • 21.7.2017
BOFIT

Russia

New Russian budget rule frames government spending; sovereign funds to be combined. The Duma this week passed legislation designed to keep budget expenditures within a limit imposed by relatively low oil prices. Under the new rule, federal budget spending (excluding government debt interest payments) cannot exceed estimated budget revenues. The estimate will be based on revenues from oil & gas taxes calculated at a base oil price and a projected ruble-dollar exchange rate, while non-oil & gas revenues will be those estimated in the budget. Thus, the budget's primary balance (i.e. the balance before interest payments) must be zero or positive with the calculated revenues. The base price of Urals crude is defined to average $40 a barrel this year and will be raised by 2 % per year starting in 2018. A transition will take place in 2018, when the primary balance is allowed to show a deficit of 1 % of GDP. The permitted budget deficit overall would be slightly larger, as interest payments from the federal budget in 2016 equalled 0.7 % of GDP.

In its recent annual Article IV consultations with Russia, the IMF considered the new fiscal rule to be generally appropriate. The IMF suggested that a more flexible base price for oil would smooth budget spending responses to changes in oil prices and reduce the need to suspend the rule in the event of large changes in the oil price. The IMF also proposed that the budget rule should seek to produce budget surpluses to generate more government savings.

In the new legislation, the government's two reserve funds will be merged. The Reserve Fund will be terminated by February 1, 2018 and any remaining assets will be moved to the National Welfare Fund. Any oil & gas revenues exceeding this year's budget estimate will also be transferred to the National Welfare Fund before October 1, 2018.

Later, extra oil & gas revenues will be used to increase the National Welfare Fund, while the Fund may be used to cover a budget deficit up to the amount of a shortfall in oil & gas revenues. The extra revenues and the shortfall will be determined as the difference between the oil & gas revenues calculated at the oil price projected for the budget year, or actual oil & gas revenues, and the oil & gas revenues calculated using the base oil price. If the Fund's assets at the central bank (i.e. liquid assets) are less than 5 % of GDP, annual use of the Fund is allowed up to the oil & gas revenue shortfall or an amount equal to 1 % of GDP. Fund assets can be invested elsewhere than the central bank as long as the assets at the central bank do not fall below 7 % of GDP. This will not apply to infrastructure projects or Vneshekonombank projects already financed from the Fund and started before 2018.

This year's IMF Article IV consultation provides important recommendations to Russia. The IMF kept its forecast for Russia's GDP growth in 2017 unchanged at 1.4 % assuming an average oil price (Brent) of $53 a barrel. Medium-term potential GDP growth is estimated at 1.5 % p.a. assuming no reforms are made. The IMF noted that the current effort to reduce government budget deficits is appropriate for adjusting to persistently lower oil prices. The IMF said expenditure measures should be durable and better targeted (e.g. in social spending) and include pension system reform in order to safeguard growth-enhancing spending on e.g. infrastructure (for Russia's new budget rule, see previous item).

The IMF saw Russia's current monetary policy stance as tight and recommended further easing although gradually as it is possible disinflation may reverse. It also encouraged Russia to elaborate on its inflation target frame beyond 2017 and communicate it to the public. Regarding problem banks, the IMF said bank reforms should make owners to shoulder more recapitalisation, remove obstacles that discourage investors from acquiring assets and liabilities from bank owners, replace central bank financing with federal funding, and otherwise, to tighten rules on related-party lending and strengthen efforts to deal with money laundering.

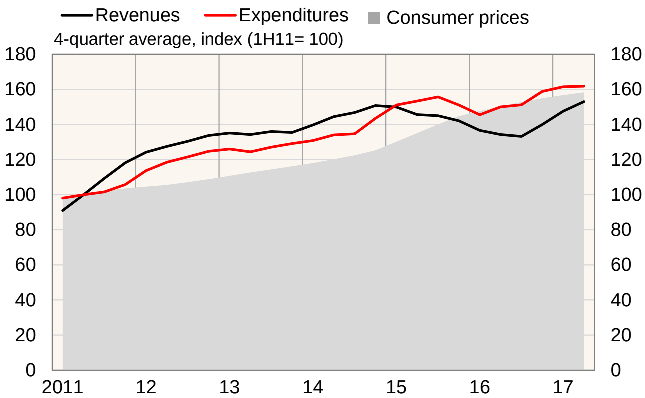
The IMF noted Russia had taken just some steps of economic reforms in the past year and advocated setting priorities on e.g. property rights, privatisation, labour markets, innovative business environment and stronger trade relations.

Russian federal budget revenues and spending recover, but are still at a low level. Second-quarter revenues were up substantially from a year earlier, like in 1Q. First-half revenues were up by over 20 %, well outpacing inflation (consumer prices were up 4.4 %). Revenues from oil and gas taxes rose by over a third. Other budget revenue streams overall grew nearly 13 %, including a rapid rise in VAT revenues.

Budget spending under tighter budget policies increased by just over 4 % y-o-y in the first half. Defence spending fell by 5 %. The budget deficit contracted to 1.2 % of GDP, leading towards this year's deficit target of 2.1 % of GDP, even if the deficit is typically larger in the second half.

In real terms, the revenues and spending in the federal budget are still low due to high inflation in recent years. Largely due to lower oil & gas tax revenues, real first-half revenues were notably lower than in 2011. First-half spending in real terms exceeded the level of 1H11.

Federal budget revenues & expenditures, inflation, 2011–2017



Sources: Ministry of Finance and Rosstat.

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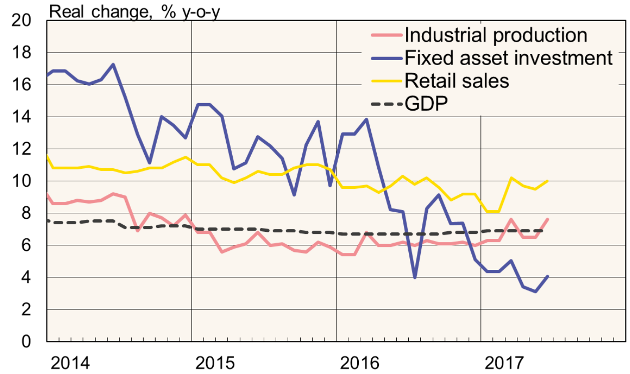
China

China's second-quarter economic growth still robust. The National Bureau of Statistics (NBS) reports that the Chinese economy maintained its first-quarter GDP growth pace of 6.9 % p.a. in the second quarter. Quarterly growth picked up in April-June to 1.7 % q-o-q. This year's growth target of "about 6.5 %" appears quite achievable, even if the officially reported growth slows slightly in 2H17.

Higher domestic and foreign demand lifted industrial output, resulting in higher GDP growth. National accounts data show industrial growth accelerated in the first half to 6.5 % y-o-y (6 % in 2016), while growth of the service sector remained at about 8 %. Monthly indicators support this view. Growth in industrial output accelerated in June to nearly 8 % y-o-y and retail sales grew by 10 %. After falling in 2016, China Customs figures show export freight volumes recovered this year.

With growth in fixed investment slowing, economic growth has become increasingly reliant on consumption demand. Second-quarter real growth in fixed asset investment (FAI) slowed to 4 % y-o-y, while private investment growth was 2 %. Public investments are supported by infrastructure investments, which increased in real terms by 17 % y-o-y in the first half. They now account for a fifth of all FAI. Domestic consumption was supported by relatively good growth in incomes. The NBS notes that real income growth exceeded 7 % y-o-y in the first half, one percentage point higher than in 2016.

Trends in major economic indicators for China



Sources: Macrobond, CEIC and BOFIT.

China's National Financial Work Conference raises debt issue to top-priority status. The National Financial Work Conference met in Beijing last weekend. The conference, which is held every five years, was led by President Xi Jinping. Contrary to previous times, Xi's speech shoved reforms and financial sector opening to the back burner and instead focused on the financial sector's risks and capital market's role as a servant of the real economy. Some analysts see the president's comments as evidence that China's rising debt problem has become the leadership's top concern. Xi concentrated his criticism on rapid increase of the shadow bank lending and on the state-owned enterprises, many of which are so called zombie firms kept on life support with cheap loans.

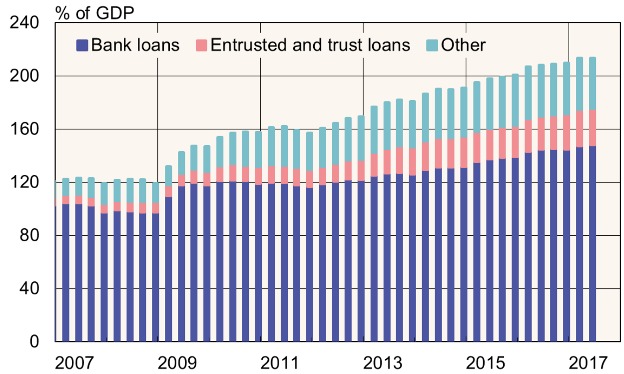
The conference had less to offer when it came to economic reforms. It celebrated the creation of a Financial Stability and Development Committee, which will operate under the State Council. It seeks to coordinating in a broad manner with the three main regulatory bodies overseeing China's banking, securities, and insurance sectors, as well as the People's Bank of China. Competition between these regulators has caused regulatory gaps and heightened market risk and indebtedness. The central bank will play a key role in the committee's work, but no detailed information has yet been released on the committee's organisation or tasks.

Several major international bodies that monitor China consider the rapid rise in indebtedness to be the top risk to its economy. The Communist Party leadership has recently adopted a harder line on corporate indebtedness. Tighter regulation should slow China's economic growth from a brisk first half.

Chinese debt levels continue to rise; households piling on debt. PBoC figures show that the stock of domestic bank lending in China was up 13 % y-o-y at the end of June, with stock of bank loans exceeding 150 % of GDP. Similar to last year, about half of new bank loans in January-June went to households (mostly housing loans). While households in China carry relatively little debt, they are currently taking on debt much faster than the corporate sector. The stock of bank loans granted to households in June increased by 31 % y-o-y to 24 % of the total credit stock.

Under China's broader debt concept of Total Social Financing (TSF), the credit stock (financing to households and non-financial businesses) in June was up 13 % y-o-y. Lending by the shadow banking sector (bank's acceptances, trust and entrusted loans) has continued to increase again this year. In June, the shadow lending stock was up 16 % y-o-y. In contrast, corporations have cooled from last year on new financing with stock and bond issues. Growth in the debt-to-GDP ratio has slowed this year, as nominal on-year GDP growth in the first half was over 11 %, compared to 7 % in 1H16.

Domestic debt-to-GDP (excl. central and local governments)



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