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Russia

Rising trend in federal budget spending will continue in coming years. Russia's finance ministry this week released a summary of its new proposed budgetary framework for 2012–2014. The cabinet will take up the full proposal next week.

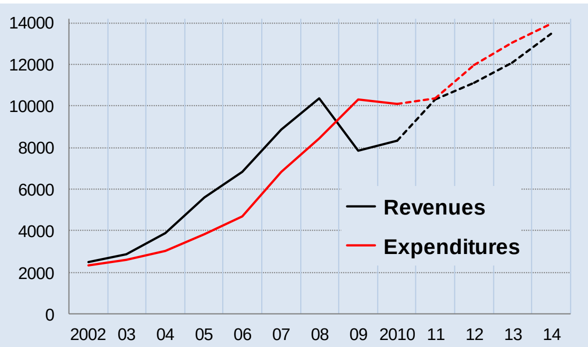
Compared to the framework projections of early July, the latest plan increases estimated budget revenues substantially. Revenues are now expected to grow next year 7 % in nominal terms and 9 % a year over the following two years. Growth depends to a large extent on the assumed average Urals oil price of about $100 a barrel in the 2012–2014 period. This year's budget revenues are expected to increase by a third.

Budget expenditure projections were also raised from the June framework. Nominal expenditures are now seen as rising 15 % next year and 7–8 % in 2013 and 2014. In real terms, spending should increase about 1 % this year 7–8 % next year.

With the strong revenue performance, the budget deficit should fall to just 1.5 % of GDP in 2012 and 2013, and 0.7 % of GDP in 2014. The finance ministry noted that the price of Urals oil would have to reach a level of $116/bbl to bring next year's budget into balance.

Finance minister Alexei Kudrin remarked that he was surprised by how great the pressure to increase spending before the elections has been. If most election promises are kept, the new government that will be formed after the elections will have to raise taxes. The IMF also has expressed worries that increased spending based on high crude oil prices heightens the economy's dependence on energy and increases its sensitivity to external shocks.

Russian federal budget (actual and projected) in real terms, billions of 2010 rubles (consumer price deflator adjusted)



Source: Russian Ministry of Finance

Fixed investment remained heavily focused on the energy sector in the first half. Rosstat estimates that total fixed capital investment increased in the first half of the year nearly 3 % over 1H10. The figure includes estimates of investments by small firms and investments not reported in the data-gathering process. Investments in both the small-firm and unreported categories declined sharply in the first half, while investment in other categories, mainly large and medium-sized firms, climbed 12 %.

As in previous years, investments of large and medium-sized firms were dominated by increases in the oil and gas pipeline category, which again climbed over 40 %. Investments in oil and gas production also rose briskly (up 13 %). Unlike in previous years, however, investment in oil refining capacity showed almost no growth and investment in the electricity sector declined. The share of the four main energy categories (oil & gas transmission, production, and refining, and electricity) in overall investment was over 40 %.

Investment in manufacturing increased a bit faster than last year (up 10 % y-o-y). In the major industrial branches, investment grew fastest in metallurgy and food processing. The share of manufacturing branches (excluding oil refining) in total investment remained at about 13 %. Investment in the real estate sector fell slightly after suffering a huge decline last year.

Despite strong exports of wheat and arms to North Africa and the Middle East, the region still only has marginal economic significance for Russia. Russia posts huge trade surpluses with Arab countries in North Africa and the Middle East. Last year, the value of Russian exports to the region totalled $7.5 billion, compared to just $970 million in imports. Even so, exports to the region constitute less than 2 % of Russia's total exports. The share of imports is minimal, consisting largely of food items and low-value-added goods.

Russia's top export goods to the region are assorted grains, arms, and steel and steel-industry products. Egypt is the largest export market for Russian grains, buying over a third of all Russian grain exports. Last year, Egypt imported a quarter of all its grain imports from Russia. About 60 % of Russian grain exports now go to Arab countries.

Russia is the world's second largest arms exporter after the US. India and Arab states are the main buyers of Russian arms. According to the Stockholm International Peace Research Institute (Sipri), about a quarter of Russian arms exports in recent years have gone to Arab countries in North Africa and the Middle East. Of these, Algeria, the United Arab Emirates and Syria were the biggest buyers of Russian arms. The lion's share of arms imported by Algeria and Syria came from Russia. Russian arms exports have recently been reduced by unrest in Arab states and the UN ban on arms exports to Libya imposed in February.

The biggest investments of Russian firms in Arab countries in Northern Africa and the Middle East are at the moment in the energy and infrastructure branches.

Bank of Finland • Institute for Economies in Transition, BOFIT
P.O. Box 160 • FI-00101 Helsinki
Phone: +358 10 831 2268 • Email: bofit@bof.fi • Web: www.bof.fi/bofit

Editor-in-Chief Seija Lainela

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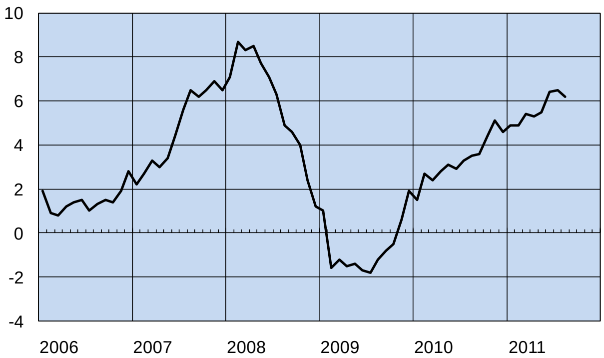
China

Industrial production growth remained strong in August. Industrial output climbed 13.5 % y-o-y in August, a half percentage point below July. The industrial output figures were awaited with particular interest this time as they could have signalled an impact on China's economic growth from the debt crisis in the industrialised world. In fact, the latest figures reinforced the view that China's economy is resilient to the first-world debt problems.

Highest growth in the August numbers was posted in metal products and machine-building; lowest growth was recorded for the textile industry. The strong growth in metal products and machinery and the 25 % y-o-y growth of fixed capital investment in the January-August period indicate that investment demand continues to play a strong role in economic growth. The investment figures also reveal a geographic shift in emphasis from coastal provinces to inland provinces. Investment growth in Central and Western China was up about 30 %, well outstripping growth in Eastern China (up 22 %).

Growth in retail sales remained fairly brisk throughout the late summer, and were up in August 17 % y-o-y. The highest growth (around 40 % in terms of value) was posted in retail sales of jewellery and petroleum products, reflecting in part sharp rises in raw material prices over the past year. Sporting goods registered the lowest growth of any retail sales category.

Consumer price inflation, %-change, y-o-y



Source: China National Bureau of Statistics

Inflation declines as expected. The 12-month rise in consumer prices fell to 6.2 % in August. The rise in food prices, which has become a sensitive political topic in China, slowed slightly to 13.4 %.

Although the slowdown in inflation is generally good news, China's policymakers remain well off their declared inflation target of 4 % for the year. However, any further monetary tightening measures at this point could choke off growth which is challenged by the debt crisis in industrialised countries that affects the global growth outlook substantially.

Order-books of Chinese shipyards down. Figures published by the China Association of National Shipbuilding Industry (CANSI) show that in the first seven months of this year, the total stock of ships built was 38 million deadweight tons, an increase of 9 % y-o-y. The order-book for ships has shrunken dramatically due to uncertainty about the outlook for the global economy. New ship orders fell 30 % in January-July to a total of 24 million dwt. The order-book in January-July amounted to 176 million dwt, a 6 % decline from a year earlier.

A large share of ships built in China is exported. Some 84 % (32 million dwt) of ships completed in January-July went to export. Some 78 % (18 million dwt) of new orders received in the period were also for export.

The shipbuilding industry is a strategically important branch for China. The Chinese government has enshrined the development of the shipbuilding sector in the latest five-year plan. Shipbuilding activities currently focus on freighters, especially dry-cargo container ships. While China dominates in price competitiveness in construction of basic ships, its efforts to build technologically advanced vessels has yet to pay off internationally. The competitive challenge for China's shipbuilders at the moment is developing sophisticated labour skills, while dealing with rising raw material and labour costs and yuan appreciation.

South Korea, Japan and China have long ranked as the world's top shipbuilding countries. Over the past two years, China has risen from third to first place. In 2010, China built 38 % of ships globally. Former shipbuilding king South Korea accounted for 33 % of world production and Japan 21 %. China scooped up 43 % of new ship orders in 2010, followed by South Korea (36 %) and Japan (14 %).

China links offer of financing to indebted EU members with trade policy concessions. The Italian government has expressed hopes that China would make substantial investments in Italian sovereign debt and companies. The Italian government is highly indebted. The demand for its bonds has declined significantly at the financial markets in connection with the escalation of the EU sovereign debt crisis.

Speaking at this week's World Economic Forum in Dalian, China, premier Wen Jiabao encouraged European debtors to "get their houses in order." According to the *Financial Times*, Wen linked future financing to the requirement that the EU first grant China market economy status − a long-time goal of Chinese trade policy. Market economy status would make it easier for Chinese companies to defend themselves in trade policy disputes over e.g. dumping claims.

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