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Russia

Demand in Russia recovered starting in the second quarter. GDP demand indicators released by Rosstat this week indicate growth in seasonally adjusted private consumption slowed just slightly in the second quarter, but fixed investment came back. Consumer growth was up 6–7 % from 2Q2010 and capital investment 5 %.

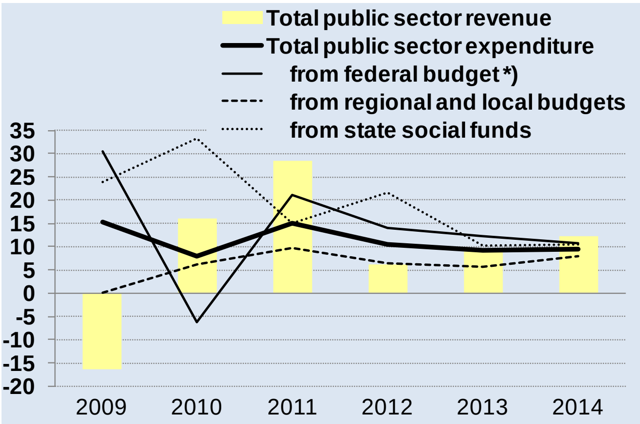
In contrast, growth in seasonally adjusted public consumption remained low with very modest on-year growth. Growth in exports volumes came to a halt while scoring an increase of a few per cent on year. The growth rate in inventories also slowed, even if growth was still brisk.

Seasonally adjusted GDP growth faded to a very slow pace in the second quarter, yielding 3.4 % y-o-y growth. One aspect behind the slowing GDP growth was the ongoing strong growth in imports, up 23 % y-o-y in the second quarter (the same as registered 1Q2011).

Preliminary figures suggest good growth in consumption, investment and GDP towards the end of summer. Other data indicate slowing growth in exports and imports.

Increases in public sector spending ahead affirmed. The plan for aggregate government finances (federal budget, regional and local budgets and state social funds), attached to the proposed federal budget submitted to the Duma at the end of September, sees public sector revenues rising much faster this year than expected earlier − nearly 30 % in nominal terms and almost 20 % in real terms. The estimates for 2012–2014 revenues were also raised slightly. The oil price assumption was raised to around $100 a barrel (Urals export blend) for 2012–2014.

Public sector revenues and spending, % change



**) excluding transfers to regional budgets and state social funds*

Source: Finance ministry

Public sector spending should increase 15 % this year in nominal terms and 6–7 % in real terms. On top of this, expenditures should rise in 2012–2014 at a nominal pace of 9–10 % a year. Spending out of the state social funds will grow rapidly, especially in 2012. Federal budget spending (excluding transfers to regional budgets and social funds) will grow briskly. Regional and local budget spending should also increase, but nominal growth is estimated to be only slightly above projected inflation.

The aggregate public sector budget will slide into deficit after achieving balance this year. Higher revenue projections hold the deficit to 1.5 % of GDP in 2012 and 2013.

New export duty scheme for crude oil and petroleum products now in force. In August, prime minister Vladimir Putin signed a decree reforming export duties on oil products. The export duty on light fuel oils was reduced, while the export duty on heavy fuel oil was increased. The duty scheme launched on October 1 sets the average export duty on petroleum products at 66 % of the crude oil export duty (see BOFIT Weekly 35/2011). The duty on gasoline remains unchanged at 90 % of the crude oil export duty. The reform is designed to promote refining of light fuel oils and reduce production and export of heavy fuel oil.

The crude oil export duty was reduced from 65 % to 60 % on October 1. This marginal duty on exports applies to that portion of the export price above $25 a barrel. The government's original intention was to lower the marginal rate permanently to 60 %, while for the time being it is decided monthly at the same time as calculating the export price for determining the export duty.

For producers, crude oil taxation in Russia is exceptionally harsh. While the main form of taxation is export duties, oil production is also subject to an extraction fee that amounts to 22 % of the price of a barrel above $15. VTB Capital calculates that oil companies currently pay taxes amounting to about 72 % of their gross sales revenue.

After over a year of preparation, the cut in the oil export duty is hoped to encourage companies to invest more in oil exploration and production. Most oil pumped in Russia today comes from peaking fields that face declining production in the years ahead. New investment is needed simply to sustain current production levels. East Siberian fields such as Vankor and Talakan have been granted temporary reductions on export duties to fund their development.

Over the long term, observers say the taxation scheme for the oil sector needs to be overhauled to give producers incentive. The role of export duties needs to shrink and emphasis shifted from taxing sales to taxing profits.

In terms of impact on the state budget, changes in taxation of oil and petroleum products are among the largest changes of taxation planned for the time being, although the finance ministry expects the government to lose oil revenue only the equivalent of about 0.1 % of GDP in coming years.

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China

PMIs readings suggest China's real economy weathered September in passable condition. Chinese share prices plunged nearly 10 % in September, but the PMI readings published at the beginning of October indicate no significant deterioration in conditions in the real economy. The official manufacturing purchasing manager index published by the China Federation for Logistics and Purchasing (CFLP) actually rose slightly to 51.2 for September (50.9 in August). The reading was particularly good news for the global economy as the subindex for export orders broke above the critical 50-point mark. This indicates a rebound in export orders increased in September relative to August, when export orders dipped below 50 for the first time since spring 2009. However, the persistent rise in input prices in the 20 industries surveyed suggest it will be difficult for officials to fine-tune economic policy.

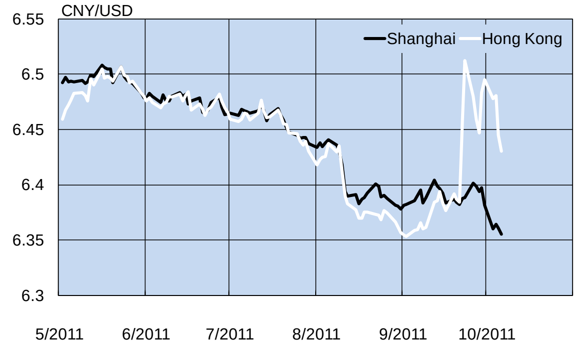
The "flash" PMI published by Hong Kong-based HSBC and Markit Economics signalled a slight slowdown in manufacturing activity for the third month in a row. The flash PMI value for September, however, did not indicate any exceptional drop from August.

Economic conditions in the service sector appear healthier than in the industrial sector; the official and unofficial PMI reading both stayed above the 50-point mark in late summer and early autumn, and both indexes strengthened in September. The recent trend appears to indicate an increased role for the service sector both relative to industry and in the domestic market. In contrast, industrial output grew faster than services in the first half, when the contribution of industrial output to GDP rose to 50 %, compared to service sector's contribution of 42 %.

Hong Kong's offshore yuan market hits quota ceiling, falls off cliff. The offshore yuan weakened sharply last week when the quarterly yuan quota set by the People's Bank of China reached its 4-billion-yuan trading limit a week before the end of the quarter. The difference between the offshore and official (Shanghai) yuan exchange rate widened to a record level. The event was a drawback to the Hong Kong's offshore yuan market, and revealed how easily China's currency controls can disrupt the nascent market. To calm the situation, the PBoC said it would double the quota for the fourth quarter to 8 billion yuan.

A month earlier, sentiment was upbeat on Hong Kong offshore yuan market. During his mid-August visit, Chinese vice premier Li Keqiang announced plans to increase market cooperation by permitting investments in securities issued by mainland China financial institutions and the issuance of corporate paper of mainland Chinese firms in Hong Kong. Although no timetable has been specified, China's long-term goal is to phase out currency controls. In August, officials announced that companies anywhere in China can make foreign trade payments in yuan.

Official (Shanghai) and offshore (Hong Kong) yuan rates



Source: Bloomberg

US Senate moves toward final vote on bill punishing China for currency manipulation. While passage in the Senate now seems likely, the bill still faces an uncertain future in the Republican-controlled House of Representatives and would have to be signed by the president to become law. The bill would permit the US to impose retaliatory tariffs on Chinese products if China is found to be engaging in currency manipulation. China has condemned the bill and warned that such measures would lead to a trade war. China's official view is that the yuan is not undervalued. The bill has also divided the US business community and experts.

Interest rates soar on grey loan market. Interest rates on China's informal "grey" market are typically multiples of regulated bank lending rates. The rise in already high interest rates has hit worst small and medium-sized enterprises (SMEs), which do not have access to normal bank credit. Chinese news media say that SME credit struggles have become so tough that some 80 CEOs of SMEs have "disappeared." The list includes heads of fairly sizable enterprises. The situation appears worst in the city of Wenzhou, where the officials set a ceiling on grey market rates. However, regulating the grey loan market is impossible.

An increasing amount of capital this year has moved to the grey market. Tight monetary policy has reduced opportunities for commercial banks to lend, which, in turn, has driven SMEs to the grey market. Moreover, private entities wishing to lend directly to companies have increased as inflation has kept real interest rates on deposits negative and the short-term yields of housing and stock market investment have shrunk. Moreover, firms with access to bank loans sometimes relend to SMEs at substantially higher rates.

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