EUROJÄRJESTELMÄ
EUROSYSTEMET

BOFIT Weekly

19 • 9.5.2014

Russia

IMF and OECD revise down their forecasts for Russia. The IMF cut its earlier forecast for Russian GDP growth this year from over 1 % to 0.2 %. The OECD also revised its earlier forecast for Russian GDP growth down to 0.5 %. Both forecasts were lowered on the expectation of a contraction in fixed capital investment from uncertainty surrounding the Ukraine situation. Both organisations see GDP growth recovering in 2015 as investment picks up. The IMF sees growth of about 1 % next year and the OECD 1.8 %.

Notably, both organisations took notice of trends in Russia's public sector finances. Government revenues from dollar-denominated duties and fees collected from the oil and gas sector should increase this year significantly more than earlier estimated due to ruble depreciation. The OECD would like to see the revenues used to avoid spending cuts and support the economy, especially through funding education, innovation and labour market programmes. The OECD notes, however, that this kind of temporary deviation in budget policy should be reversed when the economy picks up. The IMF also hinted that if the economic downturn would be deep and prolonged, a temporary increase in spending could be considered as long as it is executed in a focused and conscientious manner. The IMF emphasised that sticking to the government's approved budget rule, which limits the deficit to around 1 % of GDP, is crucial under the current uncertainty to preserving credibility. In addition, the IMF reiterated the need to continue reform of the pension system and pointed to the possibility of raising the retirement age.

IMF approves $17 billion support package for Ukraine. At its April 30 meeting, the IMF board approved a two-year reform programme for Ukraine. The loan package requires Ukraine to implement agreed economic reforms for the full $17 billion to be disbursed over this year and next. With the first measures already implemented, the first disbursement of over $3 billion has been released.

The IMF estimates that Ukraine's need for financing from external public institutional lenders in 2014 and 2015 totals $22.5 billion (nearly 8 % of Ukraine's GDP in 2014 and 2015). Of this amount, the IMF's net lending would come to nearly $11 billion, while financing from other institutional sources such as the World Bank, EU, EBRD and EIB, would amount to nearly $12 billion.

The IMF programme seeks to stabilise Ukraine's economy by returning sustainability of public finances and current account as well as by reinitiating the implementation of a broad package of economic reforms neglected during the crisis. After this year's fall in output the IMF expects Ukraine to achieve positive GDP growth next year if the measures agreed on in the programme are implemented.

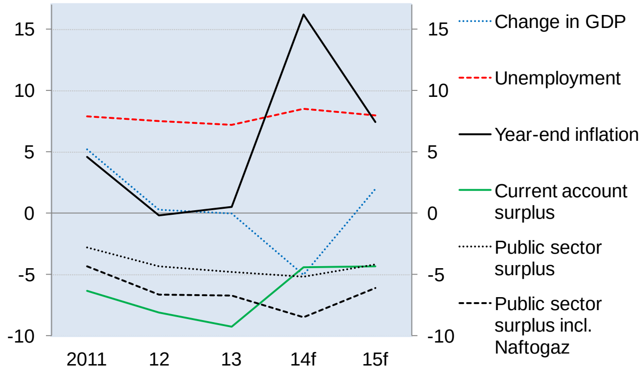
The programme seeks to keep the hryvnia's exchange rate flexible in order to support economic competitiveness and external balance. The deep public sector deficit will contract gradually through restrained public spending (nearly half of GDP over the past two years) and higher government revenues. The agreed spending limits are comprehensive and cover e.g. public sector wages, pensions, public procurements and the energy subsidies that have been a heavy burden on government budget and the state-owned gas company Naftogaz.

Household rate increases for gas and district heating are a cornerstone of Ukraine's energy sector reform. These rates are presently the lowest in Europe; nominally just 11–25 % of rates paid in other gas importing countries in the region. Gas rates were increased at the beginning of May by 56 % and district heating rates will go up 40 % at the start of July. During 2015–2017, rates are expected to double to bring them up to a level where they would cover gas sector costs. Rate hikes will be offset for the most vulnerable household by extending the social support for energy costs. After the reforms, it is expected that over a quarter of households will be covered by the support.

The IMF noted that implementation of the reform package involves significant, wide-ranging risks that include the Ukraine-Russia bilateral trade relationship (e.g. full realisation of the significant hike in the gas price for Ukraine demanded by Russia), Ukraine's geopolitical situation, tensions in eastern Ukraine, the country's political uncertainty, as well as potential problems exposed by the coming investigation of Ukraine's banking sector. The IMF noted that the reform package enjoys support in Ukraine also beyond the current leadership. Supporters include the leading presidential candidates, the key political parties and many NGO representatives.

Given the flood of conflicting information, the IMF reform package offers a clear and comprehensive anchor for Ukraine's stable development.

Ukraine's GDP growth (%), unemployment ratio (%), inflation (%) and key deficits (% of GDP)



Source: IMF

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

Editor-in-Chief Seija Lainela • Email: Seija.Lainela@bof.fi

BOFIT Weekly
19 • 9.5.2014

China

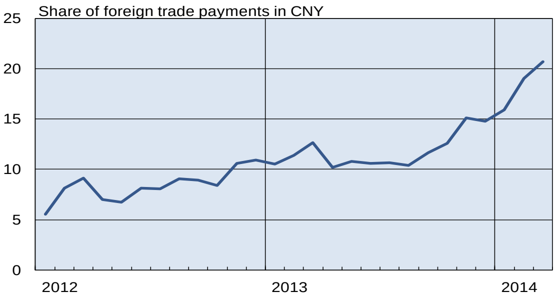
Yuan's international role continues to grow. SWIFT, the global provider of bank information services, reports that the yuan climbed again in its rankings in March to become the world's seventh-most-used international payments currency (1.6 % global share). Singapore in recent months also surpassed London as the top offshore yuan trading centre after Hong Kong.

Assuming no dramatic downturn in the Chinese economy and that the country continues to lift capital controls, the yuan is on track to overtake the Canadian dollar (current global share 1.8 %) and the Australian dollar (1.8 %) to challenge the fourth-place Japanese yen (currently 2.5 %). The US dollar (40.2 %) and the euro (31.8 %) dominate international payments, with the British pound coming in a distant third (9.2 %).

Contrary to the intentions of Russia's leadership, SWIFT payments figures show the ruble losing ground as an international payments currency. As recently as February 2013, the ruble was ranked 13th ahead of the yuan. SWIFT's March 2014 list put the ruble in 18th position.

The increased international acceptance of the yuan can be seen in other indicators, too. For example, yuan deposits this year in Hong Kong have continued to grow and the share of Chinese foreign trade invoiced in yuan has increased to 20 %.

Share of Chinese foreign trade conducted in yuan, %



Source: Macrobond

Slight improvement in Chinese foreign trade in April. After two consecutive months of decline, the value of goods exports saw modest growth in April. The value of exports rose by nearly 1 % y-o-y to $190 billion for the month. After dropping in March, the value of imports also grew nearly 1 % in April. The revival in exports drove the trade surplus to $18 billion, over double the March surplus. Total exports in the first four months of the year contracted by over 2 % on poor February and March numbers.

Interpreting Chinese foreign trade data has this spring been problematic due to problems with last year figures. In the first half of 2013, Chinese firms tended to exaggerate their export prices to circumvent capital controls and repatriate earnings to take advantage of yuan appreciation. Even if the exaggeration effect on growth figures has declined from previous months, it was still significant in April. Since most of the skewed trade figures pertain to Hong Kong trade, it is hardly surprising that the value of exports to Hong Kong nose-dived this year after the introduction of stricter reporting rules. Excluding the Hong Kong figures, China's exports rose by nearly 10 % in April and over 5 % in the first four months of the year. The distorting impact of Hong Kong on import figures has been less severe.

April exports showed sharp gains to EU countries (up 15 %), the US (12 %), South Korea (14 %) and Vietnam (22 %).

Latest ICP figures show China's cost-of-living-adjusted GDP nearly matching the United States. The International Comparison Program (ICP), which is hosted by the World Bank, last week released its latest country-specific GDP estimates adjusted for purchasing power parity (PPP). The ICP calculates that China's real PPP-adjusted GDP in 2011 was 87 % of the US level. With China experiencing far higher GDP growth than the US over the past three years and the current forecasts for GDP growth this year, China is on track to overtake the US economy in the terms of purchasing power some time during 2014. The news has received considerable attention in the global media as it has been interpreted as a milestone in world economic development. Chinese per capita income, on the other hand, lags the US by a long distance under any measure.

The ICP figures show that China's share of global output was about 15 % in PPP-adjusted terms in 2011. Based on nominal GDP, the share was just over 10 %. The GDP share of emerging economies increases in PPP-adjusted figures due to their relatively low price levels. For example, India beat out Japan in ICP figures as the world's third largest economy, even if its nominal GDP figure suggests a much smaller economy than Japan's. By taking price differences into consideration, the ICP seeks to make GDP statistics more meaningful, by making the valuing of non-tradable goods and services more comparable.

One should be cautious about reading too much into PPP-adjusted figures, given that the methodology is fraught with pitfalls. Defining price levels starts with an assumption that people across countries consume the same basket of goods and services. Yet it is obvious that even within China itself consumer habits vary widely. Critics also point out that customs and skills in computing GDP vary across countries. The ICP concedes that the greater the differences between countries surveyed, the more problematic it is to interpret the data. For example, much of China's growth is driven by fixed investment, which itself is hard to estimate due to many special features of the Chinese economic system.

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

Editor-in-Chief Seija Lainela • Email: Seija.Lainela@bof.fi