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BOFIT Weekly

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Russia

Russia government finances: higher oil revenues and defence spending. Russian defence expenditures were up about 40 % y-o-y in the first five months of this year. At least some of the increase can be attributed to this year's abnormally front-weighted defence spending (54 % of 2014 defence budget took place in the first five months). There is no indication yet of changes in overall defence spending this year, however. In its proposed supplemental federal budget bill presently before the Duma, the cabinet requests only a slight hike in defence spending. A small part of total budget spending would be reallocated, but the overall level of spending would remain unchanged.

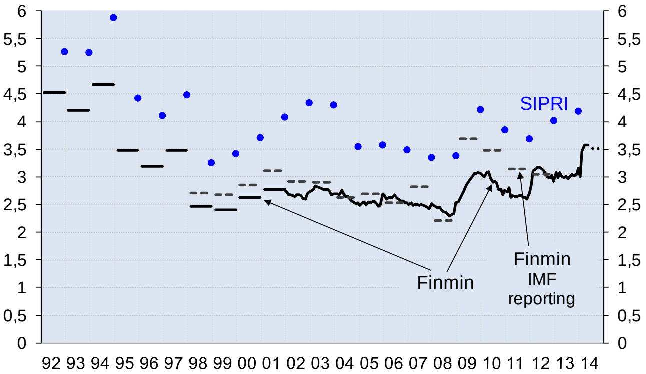
Defence spending (including the supplemental budget) will grow by 20 % this year. It will account for some 9–9.5 % of government spending and 3.5 % of GDP. The last time defence spending reached such levels was nearly 20 years ago. The Stockholm International Peace Research Institute (SIPRI), however, puts Russian defence spending last year at over 4 % of GDP.

Total government spending increased in the first quarter by 6 %, lagging inflation. Non-defence spending was about the same as last year in nominal terms as social spending was down sharply. The finance ministry expects social spending also to increase for the year.

Government revenues rose 10 % y-o-y in the first quarter as the ruble's slide boosted the take on dollar-based tax revenues from oil and gas. Under the supplemental budget, oil and gas revenues will approach earlier highs, rising 15 % this year to over 10 % of GDP. This assumes the price of Urals-grade crude oil holds at $104 a barrel and the ruble's exchange rate remains around its current level (35.5 rubles to the dollar, or about 10 % less than in 2013). With the stalling Russian economy, other government revenues increased by just 6 % y-o-y in the first quarter.

With higher actual oil and gas revenues, the federal budget at least should show a small surplus this year.

Government defence spending, 12-month sum, % of GDP



Sources: Finance ministry (2014 supplemental federal budget), IMF, SIPRI

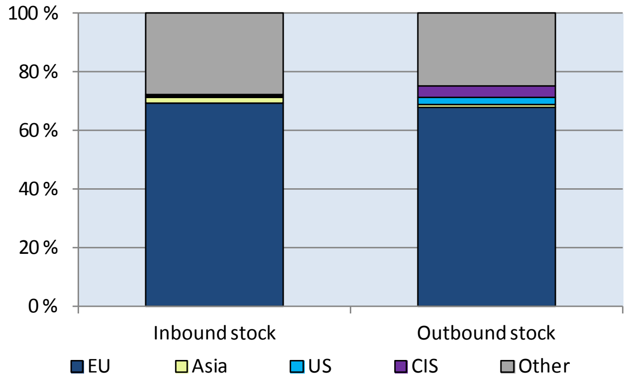
Rosneft-BP deal lifts Russia's 2013 FDI figures. Flows of foreign direct investment into Russia reached $80 billion in 2013. FDI outflows from Russia amounted to $95 billion. Although FDI inflows were significantly higher than in 2012, the growth was largely due to the buyout of BP's stake in its joint venture with Rosneft (TNK-BP).

The deal made the British Virgin Islands Russia's top destination for FDI outflows last year because TNK-BP was domiciled there. The British Virgin Islands has long been, along with Cyprus and the Netherlands, one of the most popular destinations and sources of Russian FDI. The three countries account for over half of Russia's total inward and outward FDI stocks. Most of the assets moving between Russia and these countries are likely Russian capital moving through foreign-registered firms back to Russia due to e.g. taxation issues. The BP-Rosneft deal also boosted Russian FDI inflows to the oil sector as part of the buyout was paid for with Rosneft shares.

Even without the TNK-BP deal, FDI inflows to Russia were up last year. Cyprus restored its position as the largest source of investment flows after a dramatic drop in 2012. As in previous years, other large FDI inflows came from e.g. Luxembourg and Ireland. Growth in French FDI was rapid, while the Swedes focused on repatriation of assets, especially in the second half of the year. In recent years, service branches have been the top recipients of FDI in Russia. Over half of FDI inflows last year went to trade or financial services.

In contrast, FDI outflows from Russia actually fell if the TNK-BP deal is excluded. FDI outflows to Cyprus fell to half last year in the wake of the Cypriot financial crisis. In addition, the net FDI flow to the Netherlands turned negative as Russians' repatriated asset flows exceeded new investment. FDI outflows to Austria and Switzerland rose significantly. Russian FDI outflows typically originate from Moscow, which accounted for about 80 % of total FDI outflows last year. Some 8 % of FDI outflows came from the oil-and-gas-producing region of Tyumen and 4 % from St. Petersburg.

Geographical breakdown of Russian FDI stocks in 2012, %



Source: Central Bank of Russia

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China

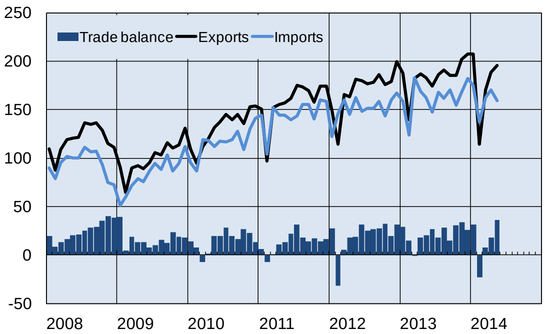
Chinese exports performed well in May; trade surplus swells on weak imports. The value of goods exports rose 7 % y-o-y in May to over $195 billion. Imports contracted by nearly 2 % to $160 billion. Strong exports and lower imports drove the trade surplus to a record high level of $36 billion in May.

The slight economic uptick in the EU area was reflected in May's trade figures. Exports to EU countries were up overall 13 % y-o-y, led by higher exports to Italy (up 22 %) and the UK (up 20 %). Despite the on-going East China Sea territorial dispute, exports to Vietnam rose by nearly 25 %. Exports to the US climbed 6 % y-o-y, a slight drop from the first quarter of the year. The unofficial manufacturing purchasing manager index compiled by the HSBC Bank showed that the level of new export orders climbed in May, raising the index to 53.2. A reading higher than 50 indicates that exports should continue to grow. In comparison, the unofficial PMI also showed that the level of new orders overall, including booked domestic orders, remained largely unchanged from earlier months.

The import trend suggests weaker domestic demand. For example, commodity imports failed to rise in May as in previous months. Growth in import volumes of oil, copper and iron ore slowed sharply from April. Import volumes of coal and pulp were down from last year.

Interpreting export growth figures in the first months of this year has been difficult because of the distortions in 2013 export figures. Chinese firms tended to exaggerate their export prices to Hong Kong in the first half of 2013 to circumvent capital controls. This created a large discrepancy between China's official figures for exports to Hong Kong and Hong Kong's reported imports from China. The gap was evidently narrower in May 2013 compared to the earlier months of the year, so the May export figures should give a more realistic picture of Chinese foreign trade than earlier this year.

Trends in Chinese foreign trade, US$ billion



Source: CEIC

Despite rising business uncertainty, most European firms operating in China are still profitable. Over 60 % of European firms operating in China report they were profitable last year, even if the costs of doing business in China have risen and competition has intensified in many industries. Profitability generally has been declining. About 75 % of European firms reported profits in 2010. Over half said they were struggling with rising costs and recruitment problems. The findings are part of the Business Confidence Survey released by the European Union Chamber of Commerce in China late last month. Most of the over 500 firms responding have operated in China for at least ten years.

The economic slowdown in China has curbed the incentive for European companies to expand operations in China, and fewer firms succeeded in increasing their sales volumes in China last year. There were huge differences in performance across branches, however. For example, car manufacturers and companies in the healthcare branch were far more likely to see increases in sales than companies in the financial or energy fields. The EU Chamber of Commerce in China remarked that there are European firms operating in heavily regulated fields or branches suffering from overcapacity, which limits opportunities for expansion.

The rise in the costs of doing business is reflected in the willingness of firms to invest. Some of the investments that would have earlier gone to China are now channelled to countries with lower costs. Rising labour costs increase pressure to increase productivity, raise added-value in production and boost demand for process automation.

European firms report that labour does not always meet company needs. Firms also have trouble enticing expatriate workers to China, largely on perceptions of poor air quality.

A greater share of the surveyed firms consider state-owned firms to be their biggest rival. In other words, it appears that the role of state-owned firms has not diminished, even if the country's leaders have promised to increase market based reforms by addressing the status of state-owned enterprises. The survey results show that over half of European firms see themselves in a weaker position than local firms. The IMF also reminded China in last week's Article IV consultations that pricing of factors of production, including financing, should be equal for all parties.

European firms are suspicious of China's promised reforms and only about half of firms believe that China can implement meaningful reforms over the next two years.

In its survey published earlier this year, the American Chamber of Commerce in China (AmCham China) also mentions many similar themes: profit growth of American firms has slowed and investment uncertainty has increased. Vague legislation increases business challenges. For example, about 70 % of American firms feel China's patent laws are ineffective. American firms were also sceptical of many reforms. For example, only a third of firms believed the Shanghai Free Trade Zone would have a positive impact.

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