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Russia

The slide of Russian output deepened in April. Rosstat reports Russian GDP contracted 1.9 % y-o-y in the first quarter, and that the volume of economic activity as measured by indicators for the five core sectors of the economy (industry, agriculture, construction, trade and transportation) contracted 2.3 %. This was despite much poorer domestic demand, as e.g. fixed capital investment and retail sales plunged 6–7 % y-o-y. Several observers noted that the weak ruble supported output in certain branches of basic industries. Export volumes in the oil and metals branches were also up. Public sector spending rose a lot.

Strikingly, the minor contraction in industrial output in the first quarter turned to a dive in April. Industrial output overall was down 4.5 % y-o-y. The drop in manufacturing output exceeded 7 %.

Nominal increase in public sector revenues comes to a near halt. First-quarter revenues to the consolidated budget, which includes federal, regional and local government budgets, as well as state social funds, increased by 1 % y-o-y in nominal ruble terms. Taking inflation into account, real revenues plummeted.

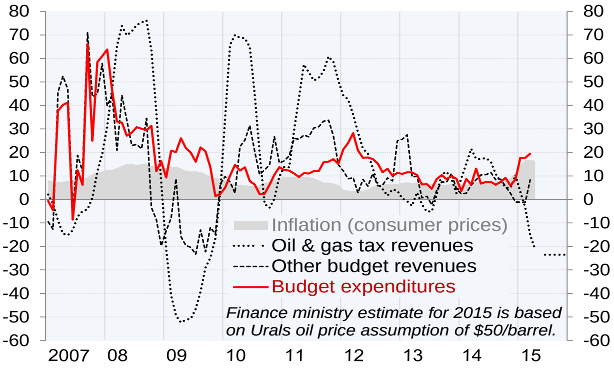
In the January-April period, revenues from export duties and production taxes in the oil & gas sector (which are nearly all denominated in dollars) were down over 20 % y-o-y in nominal terms (15 % in the first quarter). While lower oil prices reduced these revenues, the weakened ruble strongly offset the drop. The change in oil taxation implemented at the start of this year has also altered the revenue picture by reducing the oil export duty and raising oil production taxes. Other revenue streams to the consolidated budget were up 8 % y-o-y in the first quarter.

First-quarter consolidated budget spending increased by 20 % y-o-y in nominal terms. Topping spending growth was defence, this year an unusually front-weighted category (high outlays at the start of the budget year), which rose 50 % in the first quarter and 45 % for January-April. Pensions and other social security spending also increased about 30 %. Among spending in other major budget categories, spending on the economy and housing rose about 10 %. Spending on education and healthcare was unchanged in nominal terms from a year ago, while nominal spending on domestic security and law enforcement decreased slightly.

Federal budget revenues fell by more than 2 % y-o-y in the first quarter and more than 4 % in January-April. Regional and local government budget revenues, as well as revenues to state social funds, fell sharply. Federal budget transfers were used to make up for the reduced regional revenues and replenish social funds.

The consolidated budget deficit in the first quarter equalled 2.5% of GDP.

Change in public sector revenues and expenditures, 3-month moving total, %

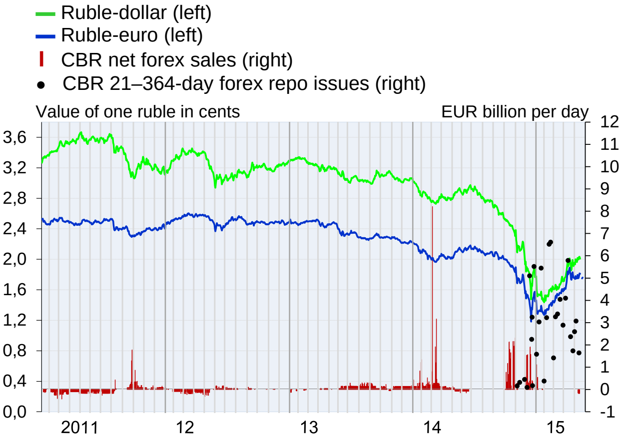


Sources: Finance ministry and Rosstat

CBR returns to the forex market. Last week (May 14), the CBR announced it started regular forex purchases to increase its forex reserves. The central bank emphasised that the purpose of the forex buying was not to support the ruble's exchange rate at any determined level. The CBR will purchase $100–200 million in forex daily on the market, but that amount can change with market conditions.

Since it announced the floating of the ruble last November, the CBR has made ruble support purchases only in exceptional situations. Also from November, the CBR has weekly provided banks with 6–364-day forex repo credits to help them repay foreign debt (which at the same time has supported the ruble). The ruble has also been supported by the government guideline issued in December to large state-owned exporters to limit the size of their forex assets, accompanied by signals from the state leadership that particular private companies should also limit their forex holdings.

Ruble exchange rate, CBR forex interventions and forex repo credits



Source: CBR

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

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

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China

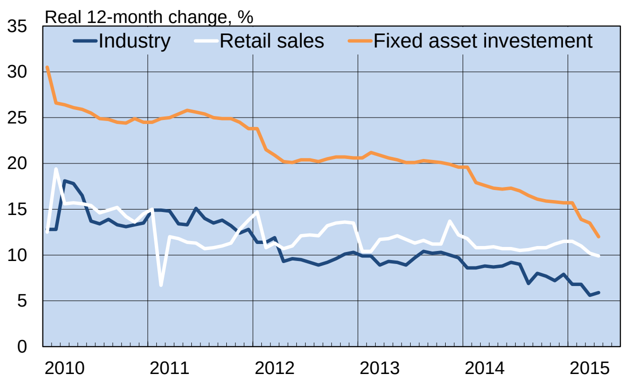
Investment growth slowed significantly in the first four months of the year. Growth in fixed asset investment (FAI) has slowed significantly all year, and was up just 12 % y-o-y in January-April. In comparison, FAI climbed 17 % y-o-y in the first four months of 2014. Falling growth in real estate investment caused by cooling in real estate markets particularly depressed investment growth.

Indeed, FAI growth, which was still above 20 % y-o-y in late 2013, has not been this tepid in at least a decade. The slowdown in growth reflects both China's cooling economy, and perhaps more importantly, on-going structural changes in the Chinese economy. The focus of Chinese economic activity continues to shift from manufacturing and primary industrial investment to consumption and services. As a result, FAI's significance is gradually waning as the Chinese economy evolves.

Several other indicators also point out to slowing economic growth in the first part of the year. For example, industrial output was up just 6 % y-o-y. While electricity production bounced back from a slight dip in March, the April level was nearly unchanged from a year earlier. On the other hand, retail sales, up 10 % y-o-y in April, grew faster than the economy and disposable incomes. Retail sales growth slowed only slightly in the first months of the year.

The April reading of the purchasing manager index (PMI) suggested a small rebound in industrial output. The PMI also tells of structural shifts in the economy; the service sector outlook remains strong, while new export orders are poised to fall.

Industrial output, retail sales and fixed investment



Source: Macrobond

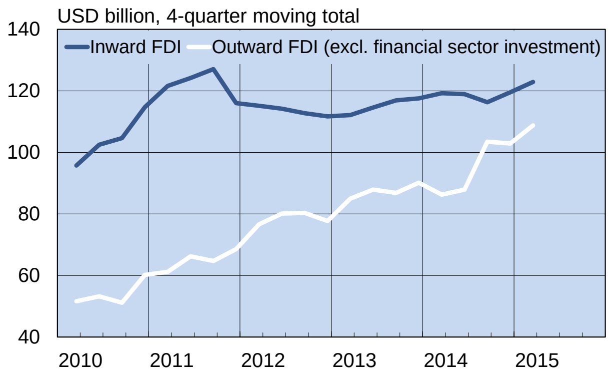
China's FDI flows up in the first quarter. China's foreign direct investment flows showed an overall increase in the first quarter of this year. Inbound FDI flows to China amounted to about $35 billion, up over 11 % from 1Q14. Outbound FDI flows from China increased 30 % y-o-y to $26 billion.

Although FDI flows from China have increased sharply over recent several years, they have yet to match inbound FDI flows to China. The difference in the amount of investment flows continues to narrow steadily, falling by half in the past year. When figures on the financial sector direct investments abroad are later compiled and included in outbound FDI, China's investment outflows are nearly on par with investment flows into the country.

The growth in FDI inflows to China has slowed and even remained flat in the recent few years, reflecting both lower growth of the Chinese economy and global growth in recent years. As Chinese companies continue to actively increase their foreign direct investment, the inbound-outbound FDI gap should vanish.

The OECD reports that last year China was the biggest receiver of FDI, followed by the US. The overall stock of FDI in China will remain considerably larger than the total stock of Chinese FDI abroad for years to come.

Chinese FDI inflows and outflows, USD billion



Source: CEIC

Demographic shifts affecting Chinese labour markets. Labour market figures released at the end of April show the number of job applicants fell 15 % y-o-y in the first quarter. The trend reflects China's aging population and fewer working-age Chinese relative to the general population – a trend exacerbated by China's one-child policy. While recent policy changes have sought to loosen rules to allow families to have more children, several observers note that many Chinese do not want more children, so the child-policy changes are unlikely to have much impact.

Given an environment of lower economic growth, the reduction in the labour supply has not led to significant labour shortages. Still, for example, there are more job openings than applicants in China's high-growth coastal provinces. The rapid rise in Chinese real wages, however, does clearly reflect pressure in the labour market. Soaring wages have accelerated the shifting of production of low-value-added export goods to countries with lower labour costs and to China's interior provinces that have lower wage levels.

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Phone: +358 10 831 2268 • Web: www.suomenpankki.fi/bofit_en

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