BOFIT Weekly
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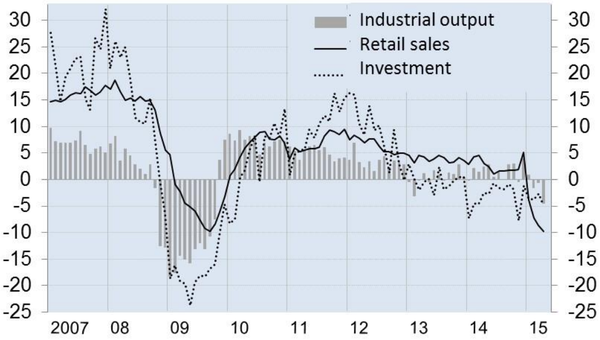
Russia

Russian domestic demand down sharply in April. The slide in the volume of retail sales accelerated to 10 % y-o-y, a drop similar to that witnessed during the 2009 recession. In January-April, the contraction was 7.5 % y-o-y.

The decrease in fixed capital investment continued last month at an annual rate of 5 %. For January-April, investment fell about 4 %. Construction activity was off 5 %. Measured in liveable floorspace, however, there was a 30 % increase in the volume of completed new apartments from a year ago. The increase echoes a building boom ignited a few years ago, when housing loans and mortgages were made widely available.

The economy ministry estimates Russian GDP contracted 4 % y-o-y in April, a rate higher than in the first three months of the year. The GDP contraction was accentuated by lower retail sales and industrial output.

12-month change in retail sales, investment and industrial output, %



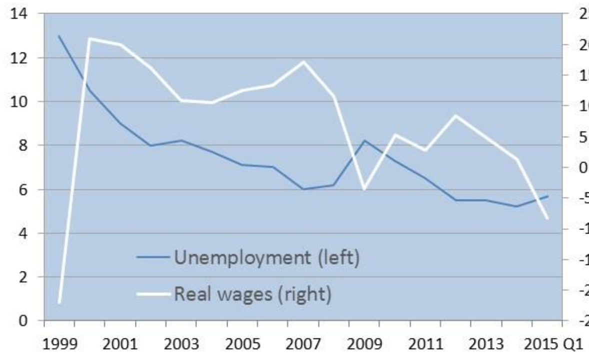
Source: Rosstat

Real wages continue to slide in Russia. Real wages declined in the fourth quarter of 2014 – the first time this has happened since the 2009 recession. The decrease has continued this year. For January-March, preliminary figures show real wages declined 8 % from 1Q14. The slide accelerated to 13 % y-o-y in April. Wage arrears also rose.

The real value of pensions began to fall at the end of last year, but not as fast as wages. Preliminary figures for January-March show a 4 % decline from 1Q14. Despite hard economic times and slated budget cuts, the government still struggles to hold the line on the real value of pensions. Russia's leaders still remember the 2005 nationwide demonstrations of disgruntled pensioners precipitated by changes in the social security system.

Russia's economic difficulties now affect the daily lives of most people. A March survey by the Sociology Institute of the Academy of Sciences found that 46 % of respondents said their economic situation had deteriorated over the past year. In October, only 22 % of interviewees held this view.

Unemployment rate and on-year change in real wages, %



Source: Rosstat

Russia's low unemployment partly reflects a shift of dismissed workers to the shadow economy. Based on ILO methodology, Russia's unemployment rate was 5.8 % in April. The unemployment rate has climbed gradually since last summer after hitting a post-Soviet record low of 4.9 %. In light of Russia's deteriorating economic conditions, the relatively modest increase in unemployment is striking.

A low unemployment rate may not so much reflect a robust labour market as the special characteristics of the Russian economy, particularly low labour productivity. Furthermore, wages are flexible, but jobs tend to be more or less permanent. As much as half of a worker's wage package in Russia can consist of various bonuses that the employer finds easier to adjust than wages. Workers, in turn, tend to stick with their employer even after a wage cut due to the modest size of unemployment benefits.

A part of the workforce is employed in the shadow economy, where taxes and social security contributions are not paid. As redundancies in the formal economy increase and unemployment benefits are small, workers move to the shadow economy, even to take jobs unrelated to their skillsets. The social affairs ministry reports the number of the people working in the shadow economy increased by 5 % in 1Q15.

Russia's low unemployment rate is also a manifestation of its shrinking labour pool. The latest cohorts of people reaching working age are smaller than before. This demographic trend is set to continue, restricting the growth possibilities of the economy also over the long run.

The government decided in March to finance work projects in localities threatened with rising unemployment. The regions getting the most support feature large or regionally important companies such as Tatarstan and Samara, home to Russia's car industry. Observers have criticised the plan for directing support to large, established enterprises, which have significant influence on social conditions in their regions. Such support, they note, does not promote the structural change needed to grow the economy and reinforces old structures.

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

IMF no longer considers the yuan undervalued. Concluding its annual Article IV country review, the IMF consultation mission this week released a brief appraisal of the Chinese economy and its policy recommendations. The IMF expects China's economic growth to slow this year to 6.8 % and inflation to remain around 1.5 % at year's end. It said China's labour market has performed well under slowing growth, which has supported household consumption.

Since the global financial crisis, China's growth has been largely based on fixed asset investment financed with debt. The problems related to debt and overcapacity will require an on-going response in the years ahead. If the GDP growth exceeds the official 7 % target due to further declines in oil prices and stimulus actions already taken, China should reduce its debt and overcapacity problems faster. If GDP growth falls below 6.5 %, however, further stimulus should come transparently from fiscal easing. Furthermore, any stimulus should be geared to protecting those in weakest position and supporting balanced economic growth and reforms.

To increase productivity, IMF recommends transition to a market-based financial system. In practice, it is time to liberalise deposit interest rates and transit to monetary policy based on interest-rates. This requires the introduction of genuine policy interest rates in implementing monetary policy. The implicit guarantees that affect the entire financial system must be gradually lifted.

The IMF estimates that the yuan's real effective exchange rate has strengthened to the point where the yuan should no longer be considered undervalued. However, the large current account surplus requires further reforms to reduce excessive saving. The IMF strongly recommends allowing more adjustment of the yuan and moving to a floating exchange rate within 2–3 years. The IMF said it will be only a matter of time when the yuan will be added to its Special Drawing Rights (SDR) basket currency.

Nominal and real effective yuan exchange rates

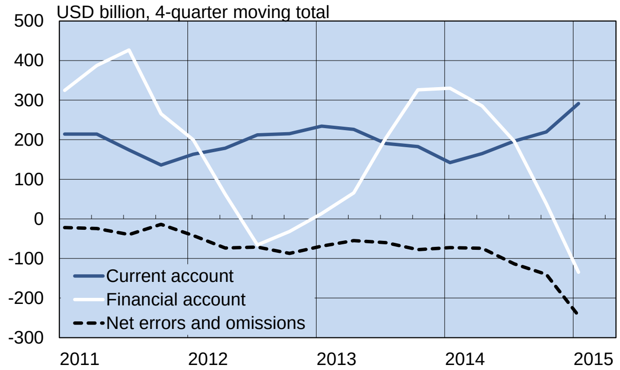
Source: BIS

China's foreign currency reserves shrink as capital exports rise. The goods trade surplus continued to rise in January-March on lower commodity prices that reduced the value of imports. The services trade deficit was up on increased Chinese tourism abroad. The services deficit was, however, insufficient to balance overall trade surplus growth, so the current account surplus was still up in the first quarter. On-year, the current account surplus reached nearly $300 billion, or about 2.8 % of GDP.

Net capital flows have recently been negative. Preliminary balance-of-payments figures show a net outflow of capital from the country in the past four consecutive quarters. The aggregate deficit of the capital and financial accounts amounted to $135 billion for 2014. The balance of payments "net errors and omissions" item was deeply negative, suggesting covert capital exports on a large scale and/or a smaller current account surplus than reported.

With increased capital exports and shifts in foreign exchange rates, China's currency reserves decreased in January-March by $113 billion to about $3.73 trillion.

Chinese balance-of-payments main items, USD billion



Source: Macrobond

Changes in capital flows reflect natural trends in the Chinese and global economies. Besides the government encouraging companies in recent years to invest in production abroad, the possibilities for Chinese to invest abroad have increased in step with rising living standards and relaxation of capital controls. There will be even more foreign investment options for Chinese at the beginning of July, when mainland Chinese will be allowed to invest in mutual funds in Hong Kong and mainland Chinese mutual funds can sell their products in Hong Kong.

The increased mobility of capital in the evolving environment forces the government to come to grips with the challenges of policy formulation. It is evident that China's former expansionary policy no longer yields the same benefits it once did, and that capital flows now play a greater role in the formulation of exchange rate policy and monetary policy as a whole.

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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