Weekly Review
4 • 29.1.2016
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Russia

Ruble struggles back from record low. The ruble's exchange rate hit an all-time low January 21 after the price of Urals-grade crude oil fell below $25 a barrel. At bottom, one euro bought 93 rubles and one dollar 85 rubles. The oil price has since recovered a bit. On Wednesday (Jan. 27), Urals crude was going for about $29 a barrel. Higher oil prices have supported the ruble's external value, which has again recovered in recent days.

Central Bank of Russia governor Elvira Nabiullina stated on January 20 that the central bank would refrain from intervening to prop up the ruble unless financial stability risks warranted. Nabiullina later noted that the CBR always stands ready to act during a major market disturbance.

Russian economy continued to contract in December. Rosstat reports that industrial output and retail sales both continued to slide in December. In annual terms, retail sales were down 15 %, a fall amplified by its referencing to the December 2014 shopping spree caused by the sharp ruble depreciation. Fixed capital investment was down nearly 9 % y-o-y in December, while industrial output fell almost 5 %.

Russia's economy last year contracted for the first time since the 2009 economic crisis (GDP down 3.7 %), but growth was already slowing earlier due to structural problems. The current situation is somewhat different from the 2009 crisis, however. Household incomes and consumption have contracted much more violently, due e.g. to more modest public sector support as an increasing share of budget spending has been directed to the defence sector. Real wages declined last year nearly 10 %, while unemployment rose to just under 6 %. Retail sales fell 10 % last year.

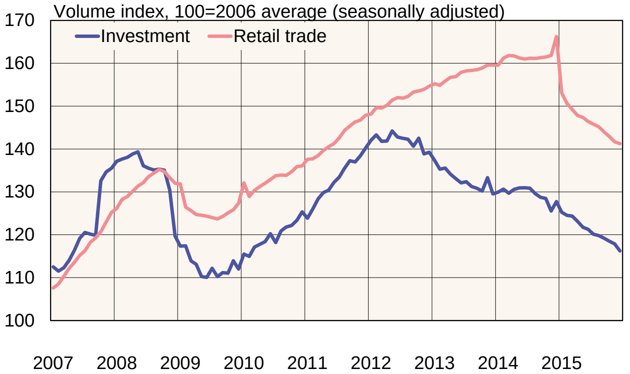
Fixed investment fell just over 8 % last year. While the contraction in investment was slower than during the 2009 crisis, it has gone on for several years due to Russia's poor business environment, lack of access to financing and increased uncertainty. Poor investment development also restricts future growth potential of Russian economy.

Given weak demand, industrial output last year contracted 3 % and construction activity fell 7 %. The mineral extractive sector (includes oil & gas) remained unchanged. Growth was only posted in the food industry (up 2 %) and the chemicals industry (up 6 %). The weak ruble caused imports to shrink substantially and gave a slight boost to some domestic producers. The government has also sought to support domestic producers through measures limiting imports. The effectiveness of these measures has been questionable and especially in longer term import substitution policies rather restrain economic growth by e.g. restricting competition.

Russian federal budget revenues declined last year, while defence spending soared. In nominal ruble terms, federal budget revenues last year contracted 6 %. In real terms (i.e. taking inflation into consideration), they were down about one fifth. Revenues from taxes on oil & gas (i.e. production taxes and export duties) going entirely to the federal budget fell by one fifth even in nominal rubles. The finance ministry's forecast from last spring was slightly exceeded, mainly because more oil than expected was exported. Other budget revenues increased 10 % (again, more than forecast) as value-added tax revenues, the budget's single largest revenue item, increased and revenues from federal property, assets and services were up by one half.

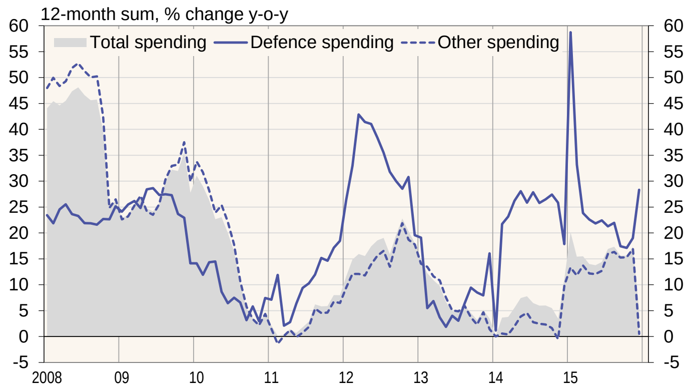
Federal budget expenditures rose 5 % in nominal terms and contracted substantially in real terms. Expenditures slightly exceeded the original spending estimate, even if that plan was cut last spring. After increasing at an average rate of 18 % a year during 2007–2014, defence spending increased 28 % last year. Defence spending as a share of GDP increased a percentage point to 4.3 %. The last time this share was so large was in 1994. The Stockholm International Peace Research Institute (SIPRI) estimates that the defence share of GDP already reached 4.5 % in 2014. In contrast, non-defence expenditures last year rose just 0.5 %. The budget deficit was 1.9 % of GDP with interest payments on debt excluded. With the interest payments included, the deficit was 2.6 % of GDP, which was still much less than had been expected in last spring's finance ministry estimate.

Trends in Russian fixed investment and retail sales



Sources: Rosstat and BOFIT.

Federal budget expenditure growth in rubles, %



Source: Ministry of Finance.

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 Jouko Rautava• Email: Jouko.Rautava@bof.fi

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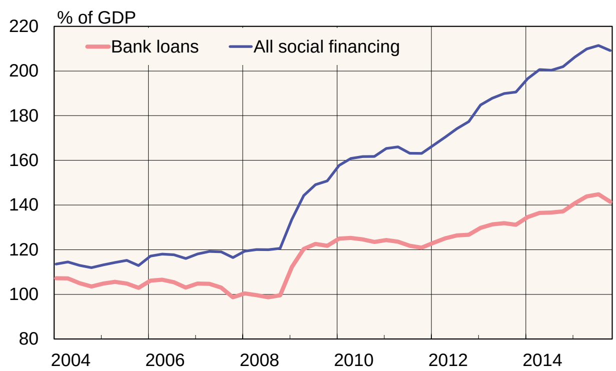
China

Indebtedness continued to rise last year in China. Total social financing (TSF), a broad measure of private debt in China's economy, grew 12 % y-o-y last year to around 210 % of GDP at the end of December. TSF growth slowed slightly, however, as local governments substituted off-budget debt included in TSF with bonds not counted in TSF calculations. Official figures for central and local government debts are not included in TSF, but off-budget debts are. According to IMF estimates, China's public sector debt currently stands at around 40 % of GDP (not including off-budget debts of local governments), and continues to rise. Foreign debt (public and private) amounts to about 10 % of GDP, so the total credit stock is about 260 % of GDP.

Two factors underlie the explosion in Chinese indebtedness. First, it has long been cheap to borrow money in China, a situation created by the country's earlier obsession with investment-driven growth. Even with deregulation of banks' lending rates, there have been no big shifts in interest rates. Financing remains relatively inexpensive (for state enterprises, at least). The second factor is the massive stimulus programme implemented by the government during the 2008 financial crisis. Stimulus measures involved shoving loans out the doors of state banks to finance investment projects.

As lending has soared, the risk of funding unprofitable ventures has grown substantially. The stock of non-performing loans held by commercial banks, despite growth, remains fairly small, averaging less than 2 % of the overall loan stock. Many observers say the actual share is significantly larger. As the government moving to close excess production capacity in numerous industries, the volume of non-performing loans is expected to continue to rise.

Private sector domestic debt



Sources: Macrobond, PBoC and BOFIT.

China has considerably higher debt levels than most emerging economies, and the increase in indebtedness growth has been rapid since 2008. In many countries, similar booms in lending growth have resulted in financial sector crashes and sharp drops in economic growth. Compared to other countries, however, China has exceptionally large buffers. The state holds massive amounts of assets (e.g. state-owned enterprises), the reserve ratio requirement for banks is high and it still has huge currency reserves to protect the country from external risks.

China's labour markets dealing well with lower economic growth. About 13 million new jobs were created last year in urban areas. That number well exceeded the government's target of 10 million urban jobs a year set for recent years. The rate of new job creation has remained roughly stable since 2013.

Urban private-sector service businesses is the key to the sustained high employment rate. The service sector is the only part of the economy where labour force has steadily increased. In contrast, the number of workers involved in primary production (mostly farming) plunged in 2013–2014, while the manufacturing workforce showed a slight decline. Primary production and manufacturing each now employ slightly less than 30 % of the Chinese labour force, while services account for over 40 %. Last year's purchasing managers' index (PMI) readings repeatedly showed service firms continued to take on new staff, while manufacturing shed jobs. The rapid growth of the service sector is critical also in the years ahead. By some estimates, about 10 million people work in overcapacity industries, where about 3 million jobs are to be cut.

China has begun to sporadically release findings of its 31-city survey on unemployment. The survey shows that unemployment rate is about 5 %, and it has budged very little over the past two years. While this may indicate continuing problems with unemployment statistics, it also tells about the extreme flexibility of Chinese labour markets. If an internal migrant to the city fails to find work, he or she just returns to the home village to farm the family plot. Such cases are not captured in the unemployment figures. Only one in ten migrant workers are covered by unemployment insurance.

China strengthens its Silk Road strategy in the Middle East. President Xi Jinping last week toured Saudi Arabia, Egypt and Iran to promote Chinese economic relations. His first Middle-East visit also emphasised China's growing international role in the region where the political and security situation is extremely complicated and difficult.

While the Middle East is clearly critical to Chinese energy security, Saudi Arabia and Iran (which has just seen international trade sanctions lifted) are also enticing export markets. The visits resulted in the signing of numerous deals on energy supplies and infrastructure projects.

Last year, Saudi Arabia accounted for about 1 % of China's total exports, Iran 0.8 % and Egypt 0.5 %. Saudi Arabia accounted for about 2 % of China's total imports and Iran 1 %. China imported almost nothing from Egypt. Saudi Arabia is China's number-one oil supplier, accounting for 15 % of all Chinese oil imports. Iran's share of Chinese oil imports is 8 %.