Weekly Review
19 • 13.5.2016
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Russia

Russia dips into the Reserve Fund to cover the budget deficit. Russia waited until April to tap the Reserve Fund this year, withdrawing a total of 390 billion rubles ($6 billion). At the end of April, the Reserve Fund held assets worth 2.9 trillion rubles ($45 billion). The plan this year is to withdraw a total of 2.1 trillion rubles to cover the budget deficit, but more money might be needed if oil prices remain flat and budget is not amended. Some 1.3 trillion rubles were withdrawn from the Reserve Fund last year.

The National Welfare Fund held assets of 4.8 trillion rubles ($74 billion) at end-April. About a third of that was held in less liquid assets like long-term bank deposits or debt securities of Russian firms, while the rest consisted of highly liquid foreign-currency securities. The National Welfare Fund was originally established to fund the pension system, not budget deficits. In recent economic discussions and the economy ministry's latest forecast, however, both funds are lumped together as a source for financing budget shortfalls.

Russia's import substitution commission reviews progress. At the import substitution commission meeting at the end of April, the commission's chairman, prime minister Dmitri Medvedev, noted that by now the goals of Russia's import substitution programme are defined and the main processes for import substitution outlined. The means for supporting import substitution include such measures as import restrictions and provision of state financing. Medvedev noted that the share of imports in consumption has fallen in many branches, although mostly due to the ruble's devaluation.

Most of Russia's import restrictions currently apply to public procurements, but there are plans to extend them also to state-owned enterprises. Public procurements are currently subject to *import bans* (97 products in the branches of defence and national security, machine-building, light industry and software), *import restrictions* (46 products involving the medical technology and pharmaceuticals branches) and *preferential treatment* for domestic products (278 products enjoy a 15 % price advantage if originating in the Eurasian Economic Union). In addition, Russian countersanctions restrict all food imports.

State financing has been granted to support import substitute producers. The government last year handed out over 70 billion rubles (€1 billion) in financing and this year a similar amount is planned. Russia's total fixed investment in 2015 was about 17.7 trillion rubles.

The import substitution commission emphasised the need for supporting demand for import substituting production. Measures mentioned include coordination of branch- and region-specific import substitution plans and the procurement plans of state-owned enterprises, as well as setting of new national standards. Various agencies continuously come up with their own proposals to support new domestic production with varying success. These include e.g. a value-added tax to foreign firms providing services online (a "Google tax") currently under discussion in the Duma and a "mandatory surrender" of certain foreign medicine licences.

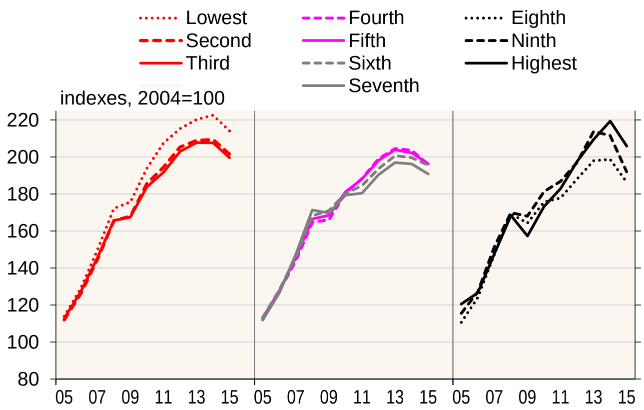
Import substitution policy has been criticised in Russia as it hurts competition and supports some domestic firms at the cost of the rest of the economy. Consumers and firms needing imported inputs must settle for narrower selections and lower quality products, while paying higher prices. Russia's economy ministry estimates the cost of public procurements has risen 40 % due to import substitution policies. The economy ministry would like to see a reduction in import restrictions, while the industry ministry wants more.

Russia's recession has slightly reduced income differences. Rosstat reports a narrowing of income disparity a bit similar to that seen in the 2009 recession. Nominal incomes in 2015 per family member rose in the three highest income deciles by 5–8 % and in the other deciles by about 12 % (a decile contains 10 % of the population). Incomes have risen fastest in recent years in high-income groups, but over the past ten years low-income groups have seen the overall fastest rise. This was due, in particular, to large hikes in pensions and public sector wages in certain earlier years.

A decline of the Gini index, an overall measure of income disparity, shows that income disparity in Russia has slightly shrunk over the past eight years. In 2007–2010, Russia's Gini index reading exceeded 42 and in 2015 it was 41.2, which was still higher than in the early 2000s (under 40). The figure roughly matches the US. It is lower than in countries showing very high income disparity, e.g. Brazil (about 53), but considerably higher than in the EU countries.

Russian real household incomes have in the past decade increased slightly more in lowest and highest income deciles than in middle deciles. The relative status of lower deciles, however, has not improved as much as nominal incomes suggest. Lower deciles spend much more on food, and food prices have risen faster than prices of non-food goods.

Change in real household incomes by income decile



Sources: Rosstat and BOFIT.

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China

Wider discussion of economic policy in China. On Monday (May 9), the *People's Daily*, the main paper of China's Communist Party, carried on its front page an interview with an "authoritative person" that commented with rare frankness and openness on key economic issues and criticized sensibility of debt-fuelled stimulus. The authoritative person is believed to be a senior economic policymaker. The next day the paper followed up with a summary of a speech by president Xi Jinping, who gave his own views on the Chinese economic situation that echoed the authoritative person's comments. Both stressed the importance of proceeding with reforms and structural adjustments of the world's second-largest economy.

The authoritative person bluntly stated that there is nothing on the horizon to suggest a revival in growth, but rather that China's pace of growth would inevitably have to slow. Given the thorny problems that may arise from a real estate bubble, industrial overcapacity, non-performing bank loans and the indebtedness of local governments, the authoritative person said the government needs to keep its focus on reducing indebtedness, moving ahead with reforms and stop whipping up hopes of stimulus relief. The article also stated that stock markets, forex markets and real estate markets need to return to their original purpose and not be manipulated to sustain artificially high growth.

This year, official comments on economy have emphasised the need to hit established growth targets meaning debt-fuelled stimulus and leaving reforms partly on the back burner. Thus, Monday's mysterious interview is a welcome call for maintaining long-term economic perspective, acknowledging the dangers of debt-driven stimulus and the importance of pursuing reforms. It may also indicate internal differences in the party over economic policy.

Regional neighbours and commodity producers likely to suffer most from Chinese slowdown. The May issue of the IMF's *Regional Economic Outlook* sees Asian growth slowing to 5.3 % p.a. for 2016 and 2017. Strong domestic demand should continue to counterbalance the weak trends in the global economy and lower Chinese growth. The IMF sees China's GDP growth slowing from 6.9 % last year to 6.5 % this year and 6.2 % in 2017.

China's significance for other countries has increased rapidly as its share of the global export market has risen from 3 % in 2000 to 9 % last year. Over the same decade-and-a-half, China's share of Asian countries' exports has increased from 9 % to 22 %. In addition to the direct impacts of trade, the IMF survey noted the indirect impacts through commodity prices and financial markets.

The survey reports estimates of the impacts of China's structural shifts and slowdown suggest that a drop of 1 percentage point in China's GDP reduces GDP of its Asian neighbours by 0.15–0.30 percentage points over the short run. The size of the impact depends on the nature of the affected country's exposure to China. Countries dependent on Chinese investment (e.g. Taiwan, South Korea) will suffer more in the short run from China's structural change and slowing growth than countries focused on serving Chinese consumers (e.g. New Zealand, India). Commodity producers have been hit by falling prices which, however, are mainly due to other factors than China. Indeed, only a few commodity-producing countries have seen significant declines in volumes of exports to China.

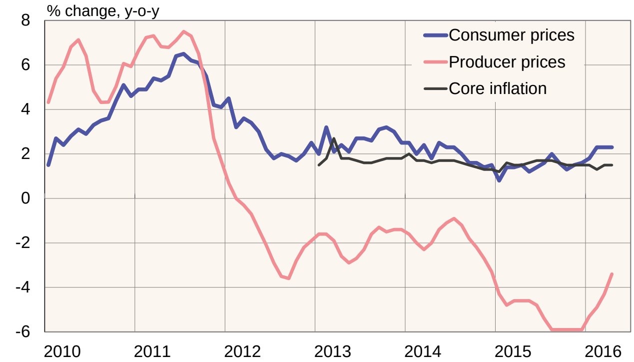
The impacts of China's structural changes and slowing growth on countries outside the Asian region and countries not dependent on commodity exports will naturally depend also on how much their value-added production is linked to Chinese consumption and investment. The average impacts, however, are smaller than for Asian countries. China's adjustments will also alter international production chains as it gradually replaces intermediate products manufactured elsewhere with its own production.

The IMF stressed, however, China must adopt a sustainable growth model. Over the long run, successful structural reforms will add to regional and global growth.

China's inflation largely unchanged in April. China's National Statistics Bureau reports that consumer prices rose 2.3 % y-o-y in April and that 12-month core inflation (not including food and energy prices) was 1.5 %. China's inflation rate has remained modest and quite steady in recent months, even if food prices climbed 7 % y-o-y. The slide in producer prices has moderated in recent months.

In earlier years, changes in food prices had a significantly larger impact on consumer prices. At the start of the year, the NBS revised the contents of its consumer basket on which it bases the consumer price index. The weighting of food in the basket has been reduced substantially, while housing, transport and healthcare services were given larger weights. Financial services were among the new items making their debut in the current basket formulation. The NBS adjusts its consumer basket every five years to reflect consumer habits. As households grow wealthier, it is typical that households devote a smaller share of their income to food.

Price trends in China



Sources: China National Bureau of Statistics and Macrobond.

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