Weekly Review
26 • 1.7.2016
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Russia

Brexit result has had only minor impact on Russian economy so far. The immediate effects of the UK EU referendum on the Russian economy are quite marginal at this point. Oil prices fell, the ruble lost ground a little, and Moscow share prices dropped slightly on news of the vote outcome last Friday (June 24). They all recovered this week. President Vladimir Putin and his top cabinet ministers commented the effects mainly by noting they expected the initial market reaction to pass within a few days, although e.g. economy minister Alexei Ulyukayev said heightened uncertainty from the Brexit vote will continue.

The impacts via real economy channels will only emerge gradually along with the Brexit process. The direct impact from Russia's trade with the UK will be small, given that the UK only accounts for around 2–3 % of Russian foreign trade. A much larger issue for Russia is how Brexit will affect economic growth in EU countries. The indirect effects of Brexit on the Russian economy and markets are hard to estimate in light of the great economic and political uncertainty surrounding the UK's departure from the EU.

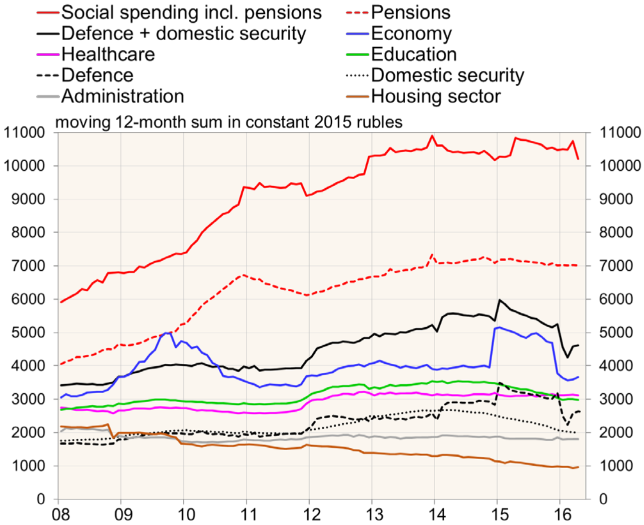
Despite unprecedented budget-cutting, Russia posts large government deficits. Revenues to the consolidated government budget (includes federal, regional and municipal budgets plus state social funds) fell 3 % y-o-y in nominal ruble terms in the first five months of this year after having been essentially flat in 2015. Government spending has begun to adjust to the reduction in revenues. Expenditures measured in nominal rubles fell about 1 % y-o-y in January-May. The consolidated budget deficit amounted to 3 % of GDP, a deficit equal to that posted in January-May 2015. Given Russia's established pattern of increasing government spending towards the end of the year, this presages a larger consolidated budget deficit for 2016 as a whole unless the federal government and regions take additional budget-cutting measures. For all of 2015, the deficit was 3.8 % of GDP.

Despite a clear slowdown, inflation remains quite high and continues to erode purchasing power. For government spending, the most important figures were the 8 % y-o-y rise in consumer prices in January-May and 3.5 % y-o-y increase in industrial producer prices. The figures for all of 2015 were slightly over 15 % and slightly over 12 %, respectively. Therefore, government spending contracted substantially in real terms already last year. Over the past twelve months, spending has been around the spring 2012 level. This was the first decline in spending in real terms since 1999.

Government spending has not contracted in real terms in all main categories, however. In large social spending outlays, such as pensions, the exceptionally meagre increases of the benefits this year are only now beginning to show. The ongoing health insurance reform has sustained healthcare spending. For the moment, spending on government administration has also contracted a relatively small amount.

In contrast, the earlier upward trajectory of defence spending has turned sharply downward this year, reflecting what was decided when the federal budget was approved. Spending on domestic security and order have continued to diminish and are back to 2011 levels. Spending on education has been squeezed quite strongly, and in a few other main spending categories some of the heaviest spending cuts have been borne by research and development budgets. Russia's government spending has not provided economic stimulus comparable to the 2009 recession (with the exception of the large lump of bank support disbursed from the federal budget in December 2014).

Real government expenditure in main spending categories



Sources: Ministry of Finance, Rosstat, BOFIT.

Shanghai Cooperation Organization meets in Tashkent. The Shanghai Cooperation Organization (SCO), founded in 2001, consists of Russia, China and four Central Asian countries (Uzbekistan, Kazakhstan, Kyrgyzstan and Tajikistan). The heads of the six member countries gathered for the annual SCO summit last week in the Uzbek capital of Tashkent. Ahead of the summit, many observers expected the SCO to grant full member status to India and Pakistan. The final summit communiqué, however, only noted that terms of membership had been agreed. Countries with observer status include India, Pakistan, Afghanistan, Iran, Mongolia and Belarus. The summit also recognised Azerbaijan, Armenia, Cambodia and Nepal as cooperation partners. The official languages of the SCO are Chinese and Russian.

The goal of the SCO is to promote inter-state cooperation in the political, economic and security spheres. The tangible achievements of the SCO to date have been quite modest. China's focus is on deepening economic and energy cooperation, while Russia has sought to promote more the fight against terrorism and security issues.

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China

Chinese economy faces little immediate fallout from Brexit vote. China's currency markets seem to have been most affected by the outcome of June 23 UK referendum on the EU. Unlike the world's major stock exchanges, stock market reaction to the vote was quite modest in China. The largest immediate impact of the vote has been a general increase in uncertainty in global markets. Last Friday (June 24), the People's Bank of China issued a short statement noting that it had measures in place to deal with a possible Brexit shock to the markets. It is expected that the short-term negative effects of Brexit to China will be smaller than for other large economies. In coming months, Chinese consumers and investors could even benefit from the weak pound as the costs of travel to Britain and prices of British investment assets may fall.

Over the longer term, the biggest impacts on the Chinese economy will likely relate to how Brexit affects economic growth and export demand in Europe. The EU is China's most important trading partner, accounting for nearly 15 % of the value of Chinese goods trade. The UK accounts for about 16 % of Chinese goods exports to the EU and about 3 % of China's total exports.

China's relations with the UK are generally regarded to be stronger than its relations with most EU countries. The UK has provided a channel for Chinese firms seeking to penetrate European markets. Chinese firms have also invested heavily in the UK. Chinese figures show that a fifth of all FDI flows to Europe in 2010–2014 went to the UK. London is Europe's yuan-trading centre and has played an important role in promoting international acceptance of the yuan. The impacts of the possible split with the EU on the UK's position has yet to be seen.

In a big picture, China has unquestionably been a net beneficiary of globalisation trends. Some observers have expressed worries that the referendum outcome may reverse the globalisation trend and cause countries to turn inward and increase the use of protectionist measures.

Yuan weakens against the dollar. The PBoC has allowed the yuan to depreciate fairly swiftly over the past three months. The yuan has lost 3 % of its value against the dollar since end-March, and currently is plying levels not seen since 2010. On Monday (June 27), with the dust from the UK Brexit referendum beginning to settle, the PBoC set its daily average dollar fixing rate about 1 % weaker than its Friday posting. On Thursday (June 30), the market exchange rate in mainland China (onshore yuan or CNY) was 1 % weaker than a week ago and one dollar bought 6.64 yuan. Some market participants believe that the central bank intervened in the forex markets over the past week to stabilise the yuan's exchange rate. The movements of the Hong Kong offshore exchange rate (CNH) this week have been slightly larger, but the CNH rate is also down about 1 % from last week.

The underlying causes of the yuan's depreciation are the strong dollar and the PBoC's gradual shift to the use of a multi-currency basket to track the yuan's external valuation. Following the announcement of the Brexit result, the central bank said that it planned to keep the yuan's exchange rate "basically stable." While exchange rate stability is a fairly loose term, it is clear that yuan exchange rate flexibility will increase with the opening up of China's financial markets to the world. Increased exchange rate volatility in this case is a positive signal that China is progressing towards a floating yuan. The trend also increases China's need to enhance communication of its exchange rate policy.

Yuan-dollar onshore and offshore exchange rates: CNY (Shanghai) and CNH (Hong Kong)

Source: Macrobond

Chinese presence in energy projects in Russian Far East set to increase. As before, during president Vladimir Putin's official state visit to China on Saturday (June 25) dozens of agreements for various areas were signed and the leaders stressed the importance of bilateral economic cooperation and strategic partnership. Energy projects dominated the economic dialogue. Russian state oil company Rosneft penned a crude oil supply contract and framework agreements on including Chinese firms in energy projects in Russia's Far East. Rosneft agreed to get China National Chemical Corporation (ChemChina) involved with 40 % stake in a planned project to build a multi-billion-dollar petrochemical complex in Russia's Far East.

Despite the many economic agreements signed during state visits and their high collective value, many projects have either stumbled or never been realised. As a result of falling oil prices, Russian firms have found it increasingly difficult to finance necessary capital investments, which has helped Chinese firms insinuate themselves into Russian projects with partial equity ownership. For example, the Russians for some time now have been trying to sell a combined 20 % stake in Rosneft to Chinese and Indian oil companies.

Talks continue on a bullet train project spanning a 770-kilometre route between Moscow and Kazan. The Chinese want to play a central role in construction and financing of the project as China needs a successful bullet train project overseas to showcase its capabilities. Its bullet train projects in Mexico, the US and Indonesia are cancelled or on ice.

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