Weekly Review
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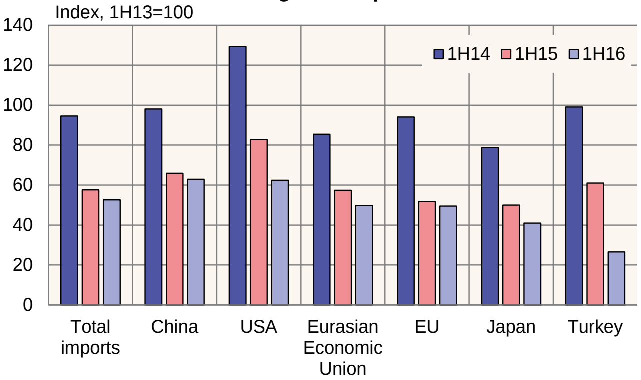
BOFIT

# Russia

**Russian goods imports near bottoming out.** The value of goods imports contracted 9 % y-o-y to $84 billion in the first half of this year. The value of imports fell in all major goods categories. The contraction in imports has slowed and the June imports were only slightly more than 1 % smaller than a year earlier. The value of imports of machinery, equipment & transport vehicles even rose in June for the first time in two years, up 7 % y-o-y. The contraction in imports of chemical products has nearly ceased, while the slide in food imports has accelerated in previous months. The EU's share of Russian imports increased slightly from 1H15 and was nearly 40 %. About a third of imports came from Asia, with China the largest import provider (nearly 20 %). Imports from Turkey were down over 50 % y-o-y in 1H16.

The value of goods exports in the first half was just under $130 billion, a decline of nearly 30 % y-o-y. The drop in the value of exports has slowed slightly in recent months on higher commodity prices. Export volume development has been varying. Measured on-year, export volumes of crude oil, natural gas, ferrous metals, timber and grain were up in the first half, while export volumes of oil products contracted substantially along with decreases in volumes of fertilisers, aluminium and copper. Less than half of exports went to EU countries (down from a year earlier), and about a fifth of exports went to Asia. Exports to most countries still shrank, but exports increased to e.g. Iran and Egypt.

**Trends in value of Russian goods imports**

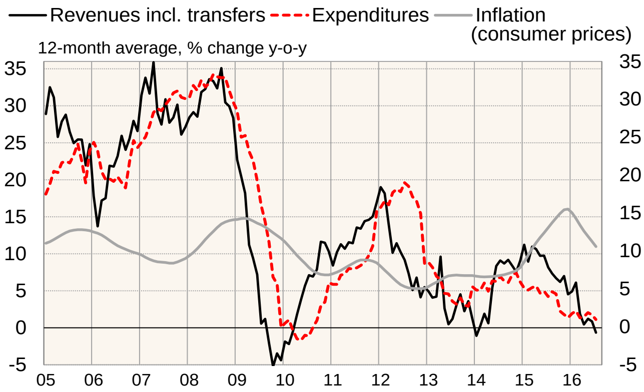



*Source: Federal Customs Service of Russia.*

**Further tightening of Russian regional budgets.** Nominal regional budget revenues in January-July 2016 were unchanged from January-July 2015. Transfers from the federal budget to regional budgets fell sharply, even after contracting in most previous years. However, it was covered up by an increase in other revenues in nominal terms, but similar to last year, the increase was quite a bit below inflation.

Regional budget spending in the first seven months of this year rose a couple of per cent in nominal terms from the same period in 2015. Overall spending growth has failed to keep up with inflation for three and half years in a row. Like revenues, spending this year is down in real terms well over 15 % from 2012–13. Among the biggest spending categories, education and healthcare have seen funding develop weakly in 2015 and 2016. Spending in the housing sector has seen the same for several years. Spending on the economy (roads, transport and agriculture) has experienced the greatest relative gains.

**Revenues and spending of regional budgets, 2005–2016**




*Source: Russia's Ministry of Finance.*

**Russians increasing domestic travelling.** Tourism abroad has fallen sharply over the past two years due to the weak ruble and falling real disposable incomes. Imports of travel services last year amounted only to $35 billion, a decline of over 30 % from 2014. The number of tourist trips abroad and the number of passengers on international flights fell nearly 20 % last year. This year, the slide has accelerated due e.g. to restrictions imposed at the end of 2015 on travel to Egypt and Turkey. In the first half of this year, imports of travel services fell nearly 40 % and the number of passengers on international flights declined almost 30 % y-o-y.

Russians have partly replaced trips abroad with domestic trips. The number of domestic travellers in Russian accommodation facilities last year increased 25 % (excluding the impact of Crimea) and the number of passengers on domestic flights rose 14 %. The growth in domestic travelling is expected to continue this year, but at a slower pace. In 1H16, the number of passengers on domestic flights rose 8 % and the volume of accommodation services was up 9 % y-o-y.

The tough economy and rising prices constrain Russian spending also on domestic tourism. Recent surveys found that the share of Russians planning to take no vacation at all or not go anywhere during their vacation is the highest in a decade. The average amount set aside for vacation this year was only slightly more than in 2015, even if prices of tourist services were up 8 % y-o-y in 1H16.

Russia's tourism sector employs 1.3 million people. 2015 turnover for the sector was around 3 trillion rubles ($50 billion, 2 % of the total turnover of all companies). Russian tourism sector largely relies on domestic tourists, with foreigners representing only 14 % of travellers in hotel accommodations.

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

# China

**IMF calls for decisive action from China to tackle rising vulnerabilities.** In its annual Article IV consultation, IMF staff recognises China's advances in shifting to a growth model increasingly driven by consumption and its progress in certain areas of structural reform. Nevertheless, the report puts emphasis on of increasing economic vulnerabilities and a distinct lack of progress in many critical reforms. In particular, soft budget constraints on state-owned enterprises (SOEs) means cheap money gets channelled to inefficient projects and corporate indebtedness balloons. The ability of firms to service existing debt burdens has faltered with the declining profitability of industrial firms. This includes a growing group of firms with insufficient profits to cover even loan interest.

As firms have piled on debt, financial sector has swelled in size and the links between banks and nonbanks have expanded rapidly. Growth of the shadow banking sector and development of novel financial instruments has made the sector opaque and officials overseeing it find risk assessment increasingly difficult. Moreover, interconnections of the sector increase the risk of spill-overs, which will fuel further problems.

As corporate indebtedness continues to rise, the likelihood of the emergence of disruptive adjustment keeps growing, which could lead to banking crisis and cause a rapid slowdown in economic growth as has happened elsewhere in similar circumstances. For this reason, the IMF hopes for decisive action from China to reduce the vulnerabilities, even if it means lower growth in the near term. SOE indebtedness must be curbed, heavily indebted firms must be restructured or liquidated, and losses need to be recognized and shared among firms, banks and creditors. The state should also be prepared to participate in clean-up costs and help find work for the displaced and make it easier to start new firms. The financial sector should also be better prepared to take such measures as bolstering bank asset buffers, writing down bad loans as credit losses and reducing risks associated with the shadow banking sector. Officials need to intensify their supervision efforts and get crisis management plans in place.

**IMF encourages China to shift to monetary policy based on inflation targeting and floating exchange rate.** The latest IMF's Article IV Consultation praises China's formal deregulation of interest rates and adoption of a new exchange rate mechanism as steps towards an increasingly market-based policy regime. The IMF staff assessment found that it would be beneficial for China to introduce a floating exchange rate as rapidly as possible, preferably already by 2018. They further recommended widening the fluctuation band for current the trade-weighted exchange rate as a policy transmission mechanism, noting that a more flexible exchange rate would protect the economy from external shocks and confer monetary policy independence as access to capital markets opens up. The yuan's current valuation is now largely in line with fundamentals according to the IMF.

The IMF would like to see Chinese monetary policy adopt a system where the government sets an explicit medium-term inflation target for policy guidance and gives the central bank operational independence over achieving the target. The IMF said the 7-day repo rate could be used as the new policy rate, providing a basis for the central bank's earlier proposed interest rate corridor (see BOFIT Weekly Review 48/2015). The shift to market-based monetary policy should be accompanied by an increase in exchange rate flexibility. The IMF would also like to see consistent, clearly communicated monetary policy to improve its efficiency.

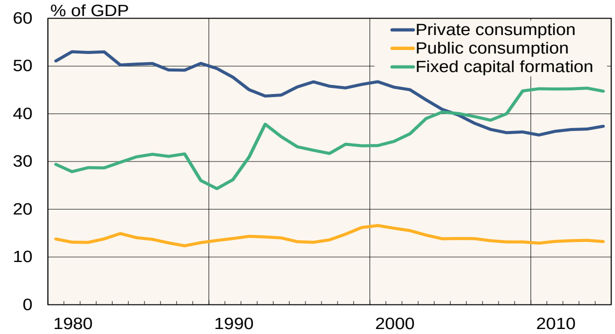
Unlike many market observers, the IMF sees China's current accommodative monetary stance as appropriate. The staff noted that economic fundamentals suggest that real interest rates could even be higher. The IMF expects a pick-up in inflation, so interest rates should rise accordingly. Slightly higher interest rates would help quell the incessant build-up in indebtedness, particularly borrowing outside the official bank sector, which is beyond most of the regulatory controls.

In contrast, the IMF took a cautious view on China's efforts to lift capital controls. The opening up of capital account should only proceed after China's financial system and corporate governance are improved and exchange rate flexibility has increased.

**Relatively slow growth in fixed capital formation hastens speed of structural reform of Chinese economy.** Consumption generated 52 % of Chinese GDP last year, with private consumption contributing about three-quarters of that. Fixed capital formation accounted for 43 % of GDP. National accounts data show real consumption grew 8 % y-o-y last year, while investment growth slowed to 6 %. Consumption contributed about 60 % of GDP growth last year.

China's National Bureau of Statistics updated its GDP calculation methodology in July. Although the revised figures slightly increased the share of fixed capital formation in GDP, it did not disturb the overall shift in the structure of the Chinese economy; the ratio of fixed capital formation to GDP still fell gradually and the ratio of consumption to GDP continued to rise. China's calculation methods for GDP still fail to fully capture activity in China's service sector, and thus the actual contribution of consumption to GDP is believed to be higher.

**Evolving structure of Chinese GDP, 1984–2015**




*Source: CEIC.*

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