Weekly Review
41 • 14.10.2016

BOFIT

Russia

Russian cabinet decides to increase spending this year, abandons last spring's budget framework. The Russian government this week submitted to the Duma a proposed amendment to this year's federal budget act that increases budget spending by 0.3-0.4 % of GDP compared to this year's approved budget. This differs visibly from the policy goals underlined last spring, when leading policymakers stated on numerous occasions that spending cuts this year were essential to reining in the federal budget deficit. In the spring the cabinet decided, however, to postpone any spending cuts to this autumn.

Under the amendment and according to prime minister Dmitri Medvedev, spending rises and redirection of existing spending will allocate more money to the National Pension Fund and other priority spending areas. The proposal apparently includes a substantial increase in defence spending.

Lower-than-expected oil prices have reduced federal budget revenues. This year's budget initially assumed that the price of Urals-grade crude oil would average $50 a barrel this year. The average price this year has been about $40. The spending increase means that the federal budget deficit will widen this year to 3 trillion rubles (€43 billion), or 3.7 % of GDP (original deficit ceiling 3 %). The deficit increase is planned to be covered through e.g. increasing domestic debt and divestment of stakes in state-owned enterprises. Most of the budget deficit, of course, will be funded out of the Reserve Fund, but in the amendment there are no propositions to increase the amount of planned withdrawals this year.

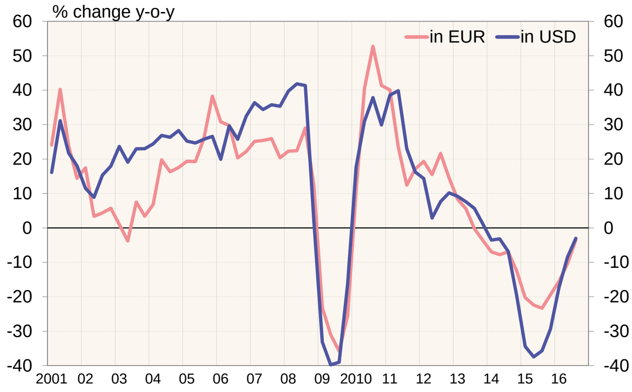
Russian imports recover to nearly same level as a year ago. Preliminary balance-of-payments figures released by the Central Bank of Russia show that Russia's spending on imports of goods and services in the third quarter was only a few per cent below the level of 3Q15. Spending on goods imports was, however, already up on-year by several per cent. Russian spending on travel service imports was still in a deep slump, down 35 % y-o-y. Revenues from exports of goods and services were also still down 10 % y-o-y. The 3Q16 current account remained slightly in surplus, but the surplus was among the smallest in three years.

In the first nine months of the year, Russia's cumulative current account surplus was just $16 billion, down from $54 billion a year earlier. The shrinking surplus mainly reflects the larger drop in exports than imports. In the last four quarters, the cumulative current account surplus has amounted to less than 3 % of GDP.

In the third quarter, the net flow of private capital on the financial account turned again slightly negative. This was due mainly to banks paying down slightly more foreign debt than in the second quarter. In addition, other firms also paid off their foreign debt while increasing their accounts receivable from abroad.

The private sector net capital outflow in the first nine months of this year amounted to $10 billion, down from nearly $50 billion in the same period last year. Underlying the shift was the contraction in foreign debt payments of banks and an increase in repatriations of foreign receivables. The net inflows of direct investment and portfolio investment to other sectors also increased, even if they were still rather modest.

Change in Russian spending on imported goods and services



Source: Central Bank of Russia.

Russian government sells Bashneft to Rosneft. The state's 50.08 % stake in the Bashneft oil company has been on this year's privatization list. Russian government decided this week to sell the stake directly to oil company Rosneft in which state also has majority ownership. The stake was sold for 330 billion rubles (€4.7 billion), which was slightly higher than analysts expected. The money from the sale will go to covering this year's budget deficit. The government is also still planning to sell this year a 19.5 % stake in Rosneft to cover the budget deficit. Chinese and Indian oil companies are among those interested in acquiring Rosneft stakes. Rosneft also recently said it might be willing to buy back its own shares.

There has recently been considerable criticism in Russia of the state's disproportionately large role and the lack of competition in the economy. Russia's Federal Antimonopoly Service has found that the share of economic activity involving state or state-owned enterprises has increased substantially over the past decade, seriously impairing competition and hampering the operations of private companies. The CBR says that high level of monopolisation across many industries materially complicates the use of monetary policy channel in managing inflation. The finance ministry has stated that reducing the role of state companies in the economy should be a central policy goal in coming years, noting that state-owned firms consume economic resources inefficiently and crowd out private firms in financial and labour markets.

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

Weekly Review
41 • 14.10.2016
BOFIT

China

China's structural shift and economic slowdown profoundly impact global economy. The International Monetary Fund's semi-annual World Economic Outlook (WEO) report was released last week. The IMF lowered slightly its forecast for global growth this year to 3.1 %, mainly on an unexpectedly weak performance of the US economy in the first half. Global economic growth is expected to accelerate next year to 3.4 %. While growth in developing economies is still expected to slow this year to 1.6 %, growth in emerging market economies, after years of continuous slowing, should accelerate to 4.2 %. Emerging market economies now account for about three-fourths of all global economic growth.

The WEO took special note of the impacts of China's structural change and slowing growth on other countries. China is among the ten most important export markets for over 100 countries, so the slowing in Chinese growth and shifts in its growth model are strongly reflected in the global economy. Referring to earlier research, WEO reports, for example, that a 1 % negative shock to China's final demand lowers world GDP by about 0.25 %.

Most impacts are transmitted via the foreign trade channel and depend to a large extent on the country's export structure vis-à-vis China. As a rule, a change in the structure of Chinese demand benefits exporters of consumer goods and weakens the relative position of producers of investment goods. For energy and commodities producers, changes in Chinese demand are seen via changes in prices, but also China's oversupply in some sectors causes price disturbances. The IMF said that the spillover effects to financial markets from changes in China, while limited at the moment, are growing. Turbulence in China's financial markets has already increased volatility in international markets.

The slowdown in China's growth and structural adjustments creates pressures at all levels and the road ahead will not be smooth. The IMF stressed that, managed properly, changes in China will put it on a more sustainable development path, a trend that is in the world's interest.

Yuan's exchange rate volatility increases after addition to SDR basket. The yuan lost about 1 % of its value against the dollar when the markets reopened this week after the week-long National Day celebrations. In September, the yuan was relatively stable and its inclusion in the IMF's SDR basket on October 1 went without a hitch. Capital outflows from China have continued as the yuan has weakened. The country's foreign currency reserves this year have shed $164 billion and at the end of September stood at $3.166 trillion.

An increase in yuan exchange rate volatility reflects the policy goal of a free-floating currency. The yuan's average daily variation against the dollar has been 0.12 % over the past year. It was 0.07 % prior to the exchange rate reform of summer 2015. Even with the yuan's higher exchange rate volatility, it still fluctuates considerably less than free-floating currencies. The euro's daily average fluctuation this year has been 0.41 % and the yen's 0.52 % against the dollar. The average change in offshore yuan (CNH) against the dollar has also been larger (0.17 %) than for the onshore CNY rate. The largest single daily change in the yuan's exchange rate – 1.8 % – occurred in August 2015 in connection with the exchange rate reform. For comparison, on the day after the Brexit vote, the euro lost 2.1 % and the yen appreciated 3.4 %.

Onshore vs. offshore rates: CNY and CNH (HK) against USD

Source: Macrobond

China's competitiveness unchanged relative to other countries. The World Economic Forum (WEF) Global Competitiveness Index (GCI) rankings of 140 countries put China this year in 28th place. China has held its 28th position in the rankings for three years in a row. The GCI considers 114 indicators that matter for country's productivity and long-term prosperity. The indicators are grouped under 12 pillars that include institutions, infrastructure, macroeconomic environment, health and primary education, higher education and training, goods market efficiency, labour market efficiency, financial market development, technological readiness, market size, business sophistication and innovation. The comparison does not take into account national differences in, e.g. price competitiveness.

China consistently fell into the upper-middle group for most indicators. Notable virtues of China were the exceptional size of its economy, price stability, savings levels, opportunities for air travel, share of students starting primary education, and rates of HIV and malaria. In all these categories, China was the best or among the best. China performed poorly relative to other countries in e.g. investor protection, which have gotten worse in recent years, and corporate taxation, which has become more severe. Establishing a new business is still more difficult than in many other countries and corporate governance is weak. Moreover, the broadband capacity per user is still relatively small.

Switzerland topped the GCI rankings this year. Hong Kong ranked 9th, Finland 10th and Taiwan 14th. Russia climbed in the ratings to 43rd place, up from 67th five years ago. The WEF noted Russia's improvements in institutions, overall education level, innovation capacity and business environment. The conclusion raises questions about the reliability of the GCI indicators in capturing actual development.

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