Weekly Review
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BOFIT

Russia

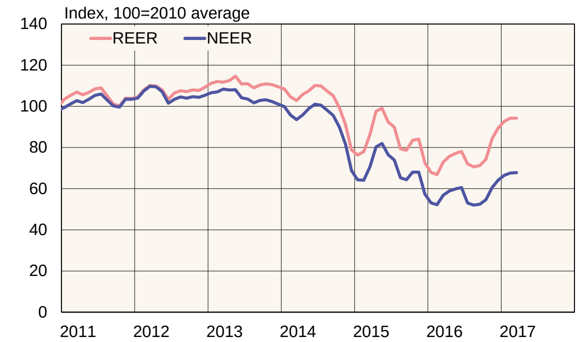
Russia's economic recovery: waiting. Rosstat reports that seasonally and workday-adjusted industrial output recovered in March, after a weak February. In the first quarter, industrial output was virtually at the same level as it was a year ago. Thanks to higher natural gas production, the trend has been positive for the extractive sector, with output rising by over 1 % y-o-y in the first quarter. Seasonally adjusted manufacturing output recovered in March, but for the first quarter output was still down almost 1 % y-o-y.

Rosstat noted that retail sales, which in January and February were supported by large pay-outs to pensioners, contracted slightly in March. For the entire first quarter, retail sales were down by nearly 2 % y-o-y.

Russian ruble continues to strengthen. The ruble has appreciated this year about 8 % against the US dollar and 5 % against the euro. The ruble has been supported by strong trade surplus and increased interest of foreign investors in the Russian market. The ruble has been on a nearly continuous upward trend after hitting the bottom in the first months of 2016, although strengthening has slowed down recently. In March, the ruble's real effective (trade-weighted) exchange rate was up nearly 30 % y-o-y.

In Russia, exchange rate shifts tend to pass through relatively quickly and strongly to consumer prices, so ruble strengthening tends to curb inflation. Ruble appreciation also reduces the government's ruble-denominated tax revenues, because oil taxes are largely based on the price of oil in US dollars. On the other hand, lower inflation enhances the purchasing power of tax revenues. For households, a stronger ruble means imported goods and services are more affordable.

Ruble's real and nominal effective exchange rates



Source: Macrobond

From the standpoint of Russian domestic businesses, a stronger ruble reduces their price competitiveness with respect to imports, but also lowers the cost of imported technologies and intermediates. Recent surveys show that most Russian manufacturers are relatively highly dependent on imports. Ruble appreciation also reduces the costs of foreign debt service for firms.

The trend in the volume of Russian exports is not particularly sensitive to exchange rate fluctuations. The bulk of Russian exports consists of oil or oil products that are based on world-market dollar prices, and demand reacts slowly to price changes. A stronger ruble does, however, lower the ruble revenues of the companies. Ruble appreciation also weighs on the price competitiveness of other exports (e.g. wood products and metals).

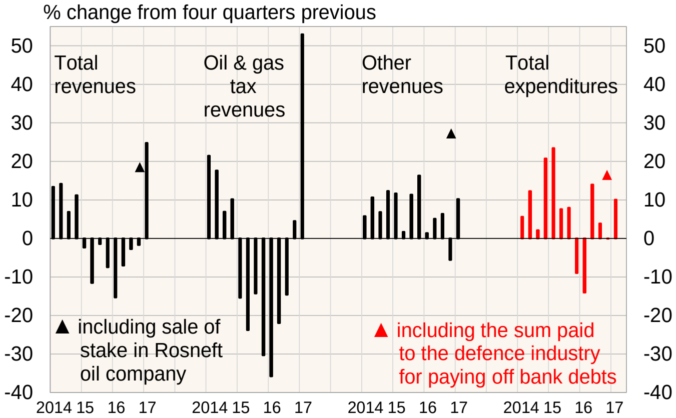
Russian federal budget revenues get a big boost from higher oil prices. Federal government revenues in the first quarter were much higher than in 1Q16. Revenues increased for the first time since late 2014 (i.e. before the fall in oil prices began to diminish government revenue streams). Revenues were also up in real terms from last year, but still far lower than in many previous years.

Most of the growth in revenues came from oil & gas tax revenues that jumped by one half from their bottom in 1Q16. The key driver was higher oil prices, which were up in dollar terms about 60 % y-o-y in the first quarter. On the other hand, the considerable on-year rise in the ruble's exchange rate limited the increase of oil & gas revenues in rubles (the taxes are essentially based on dollar pricing of oil & gas).

Other federal budget revenue streams also showed substantial gains in the first quarter that clearly outpaced inflation. Budget revenue streams from value-added taxes, which go entirely to the federal budget and are a major pillar of the federal budget's non-oil revenues, increased briskly. The same happened also with the rest of non-oil revenues.

Federal budget spending has increased quite moderately from its lows in early 2016, even with pensioners this year receiving their sizable one-time pay-out from the federal budget. In real terms, first-quarter spending was much lower than in several years preceding 2016. Defence spending fell markedly from 1Q16. On the other hand, at the end of last year the defence industry received a grand sum paid out from the budget for paying off a large part of their existing bank loans, which was aimed at creating more room for new borrowing by the defence industry.

Federal budget revenues and expenditures, 2014–2017



Sources: Russian Ministry of Finance and BOFIT.

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China

Industrial output and government spending spurs Chinese economic growth in Q1. China's National Bureau of Statistics reports GDP grew by 6.9 % y-o-y in the first three months of 2017. A robust growth legacy from the last three quarters of 2016 was sufficient to produce a slight uptick in the growth, even as growth in the first quarter of 2017 was on annualized basis just over 5 %.

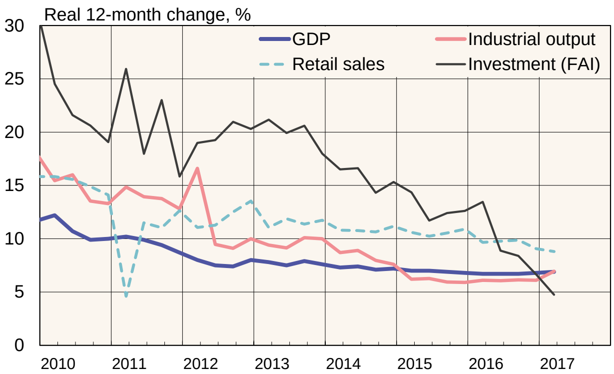
Industrial output, lifted by the recovery in heavy industry and the booming housing market, rose by nearly 8 % y-o-y in March. Steel production hit an all-time high in March, even if it appears that demand failed to keep up with supply. Measured by floorspace, the volume of completed buildings increased 15 % y-o-y in 1Q17, while sales were up by 20 %.

Real growth in fixed asset investment (FAI) slowed to 5 % in the 1Q17. The drop was largely due to a slowdown in public investment spending growth from last year to 8 %. Private investment rose 3 % in real terms. Even with a pick-up in March, real growth in retail sales grew by just 9 % y-o-y in the first quarter. The slowdown in growth reflected lower car sales caused by a change in tax rules at the start of the year.

First-quarter economic figures can be interpreted in several ways. Structural change of the economy seems to be proceeding as 77 % of growth was generated by consumption (65 % in 2016), while investment contributed just 18 % of growth (42 % in 2016). Government consumption seems to have picked up. Public sector expenditure was up 21 % y-o-y in the first quarter, while household disposable incomes rose by 7 % in real terms. External demand recovered and the reported contribution of net exports to growth turned positive again.

Nevertheless, growth is still largely financed with new debt. Especially, financing from the shadow banking sector increased rapidly. The latest burst of economic growth has no sustainable basis, however, so it is critical that policymakers take advantage the current economic tailwind to rein in the growth of indebtedness and implement economic reforms. Economic growth at the end of the year is expected to slow and the real estate boom should subside as cities implement additional measures to slow rising housing prices.

China's main economic growth indicators



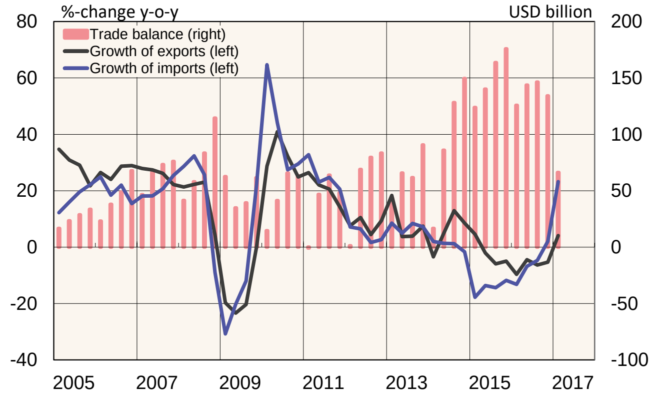
Sources: Macrobond and BOFIT.

IMF raises its growth outlook for China, but warns of dangers ahead. The IMF released its latest World Economic Outlook (WEO) this week. For the global economy, the April 2017 forecast remains basically unchanged with the global economy expected to grow by about 3.5 % p.a. in both 2017 and 2018. The IMF slightly raised its forecast for Chinese GDP growth to 6.6 % this year and 6.2 % in 2018. The strong growth outlook for China assumes that the current debt-fuelled policy support will remain in place as China seeks to meet current official growth targets. However, the IMF warns that China's current policies encourage inefficient use of resources and raise the risk of disruptive adjustment in the medium term. The IMF expects the Russian economy to grow by 1.4 % p.a. this year and next, which is slightly higher than its January forecast.

Robust 1Q growth in Chinese goods imports. China Customs reports that the dollar-value of goods imports increased by 23 % y-o-y in the first quarter. Similar robust growth figures were last seen in 2011. Exports also rose in the first quarter, but at a rate distinctly lower than imports. Thus, the trade surplus shrank considerably. High growth was also seen in the volume of imports, which rose by nearly 20 % in January-February. Export volumes were up nearly 5 %.

It is challenging to identify any specific factors behind the current revival in imports; the growth in Chinese imports stretches across the board. Looking at the various goods categories, imports of machinery & equipment were up sharply. Import growth of key commodities such as crude oil, coal, pulp and certain farm products was also brisk. By country, imports from nearly all of China's main trading partners saw strong gains. The value of imports from the EU increased by 15 %, by 30 % from the US and by 20 % from Japan. Imports from many emerging economies also showed vigorous growth. In contrast, the value of imports from Hong Kong in the first quarter shrank by half from a year earlier. Much of this is believed to reflect improved enforcement and oversight of capital controls last autumn. The Chinese have long used goods trade as a means for circumventing capital controls.

China's quarterly USD-based goods trade growth and trade balance



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