Weekly Review
22 • 2.6.2017

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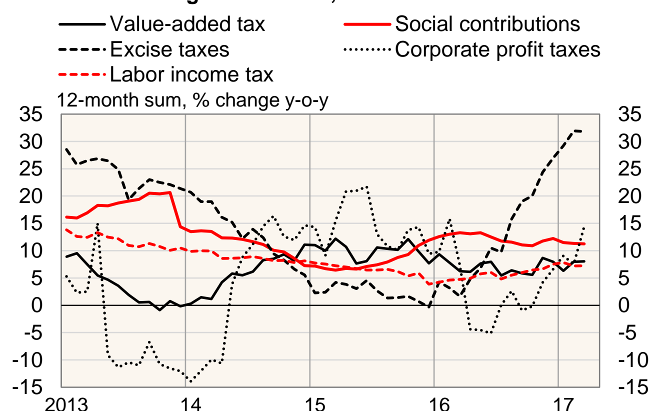
Russia

Russia's government budgets started to grow again; government drafted supplementary budget. First-quarter revenues to the consolidated budget (includes federal, regional and municipal budgets, as well as state social funds) were up by 20 % y-o-y in nominal ruble terms. Revenues generated from the production and export of oil & gas were up by more than 50 %. Over half of the revenue increment, however, came from other revenues that rose far above inflation. Revenues from excise taxes (particularly tobacco products) and corporate profit taxes were up sharply. Revenues from the value-added tax and mandatory social contributions from firms on worker wages also increased. Consolidated budget spending rose by about 10 %. The fast recovery in budget revenues produced a tiny surplus (0.2 % of GDP).

The government last week submitted to the Duma its draft proposal for this year's supplementary budget. Budget revenues are now expected to increase more than in the budget approved earlier (the excess is 0.4 percentage points of GDP). In nominal terms, revenues should rise by 6 % this year if the earnings from the Rosneft share sale are excluded from the 2016 numbers. The excess comes mostly from revenues from oil & gas taxes, with the assumption that the price of Urals oil this year will average USD 45.60 a barrel (the previous assumption was USD 40/bbl). Other additional revenues to the budget assume GDP growth of 2 % this year.

Budget expenditures also rise a bit under the supplementary budget. They are set to grow by 6 % in nominal terms this year if the one-time sum given to defence industry for debt repayment is not included in the 2016 figures. Federal budget deficit will be 2.1 % of GDP (earlier estimate 3.2 %). The supplementary budget calls for hardly any changes in domestic borrowing or funding out of the government's Reserve Fund (RF) and the National Welfare Fund. While the RF will be drained this year, extra oil revenues flowing to state coffers this year will be put into the RF next year.

Nominal change in main non-oil revenue streams to Russia's consolidated budget 2013–2017, %



Source: Russian finance ministry.

The finance ministry, however, still expects government spending to rise a bit further this year, bringing the deficit to 2.4 % of GDP. Observers note that the figure may reflect the unused portion of last year's budget. Finance minister Anton Siluanov says the money will be spent this year.

FDI inflow to Russia boosted by the sale of Rosneft stake. Net direct investment inflows to Russia (investment of foreign firms in Russia minus funds repatriated by foreign firms) amounted to USD 33 billion last year, a nearly five-fold increase from the 2015 nadir and roughly the same level as in 2009. The single most important event last year affecting investment flows was the December sale of a 19.5 % stake in oil giant Rosneft to the Qatar Investment Authority and the Swiss mining giant Glencore. The deal was valued at about USD 11 billion. Because of the financing arrangement under the deal, most of the FDI appeared to come from Singapore.

Without the Rosneft deal, positive net FDI inflow was mainly thanks to reinvestment of profits as in earlier years. This largely reflects the weakened interest of foreign firms in making new investments in Russia. Geographically speaking, the largest sources of positive FDI inflows to Russia came last year from the Bahamas and Bermuda. At least some of that investment is likely of Russian origin as a considerable amount of Russian outward FDI flows is also directed to these and other countries that provide friendly tax treatment.

Net FDI outflows from Russia (investments of Russian firms abroad minus repatriated investments) last year amounted to nearly USD 23 billion or almost as much as a year ago.

Rapid growth in Finnish-Russian trade. In the first quarter of this year, the value of goods exported to Russia increased by nearly 30 % y-o-y. Russia's total goods imports grew at roughly the same pace supported by gradually recovering demand and significant ruble appreciation. Finnish exports to Russia were up in nearly all product groups. Exports of machinery & equipment rose by 50 % y-o-y and food exports by 12 %. Finland's goods exports to Russia, however, were still down nearly 40 % from their 2012–13 peak. Growth in goods exports should continue in coming months, albeit probably at a slower pace than in the first quarter.

The value of goods imports doubled in the first quarter compared to a year earlier. Much of the powerful growth came from higher oil prices and imports of pipelines apparently reflecting supplies for the Nordstream 2 gas pipeline project.

Services exports also appear to be recovering strongly this year led by tourism services. The number of Russian overnight stays in Finnish hotels and lodging during 1Q17 was up 23 % y-o-y. Even more dramatic growth figures seem to have been posted for purchases of Russians visiting Finland.

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China

Moody's lowers China's sovereign credit rating for the first time in three decades. The American Moody's, one of the big international credit ratings agencies, lowered its rating of Chinese sovereign credit by one notch from Aa3 to A1. The new rating puts China's sovereign rating on par with Japan and Estonia. Moody's noted that China's high economic growth targets can only be met by continued debt-fuelled stimulus. Moreover, China faces added pressure to rely on stimulus as structural factors will slow potential economic growth further in coming years. The central government's debt burden will increase, and it faces increased contingent liabilities risks from state-owned enterprises, policy banks and off-budget financial vehicles created by local governments. Moody's highlighted the fact that current reforms to put economic growth on a sustainable basis and slow the credit growth are insufficient and proceeding too slowly. Moody's last downgraded China's sovereign credit rating in 1989. Fitch, another big ratings agency, downgraded China in 2013.

The change in credit rating produced little immediate market reaction as the change was largely seen as a reminder of China's financial issues. However, China's ministry of finance responded immediately to Moody's announcement, saying it saw no basis for the downgrade.

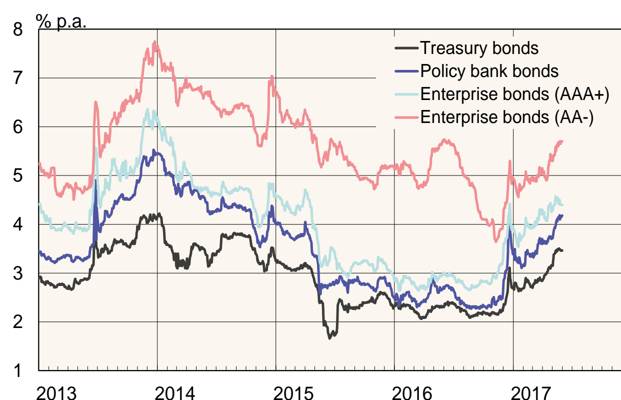
On the heels of its China decision, Moody's also lowered the sovereign rating of the Hong Kong special administrative region – a reflection of how intertwined the Hong Kong economy is with China's. Observers believe there is pressure to downgrade the ratings of some of China's neighbours. While the sovereign downgrade could also ding corporate credit ratings of Chinese firms, the immediate impact should be minor as Chinese firms hold relatively little foreign debt.

Despite the lack of foreign interest, China moves to open its bond markets to the world. China's central bank and Hong Kong's monetary authority announced plans in May to give foreign investors the opportunity to trade bonds in mainland China's interbank market via Hong Kong. Initially, investment will be permitted without quotas only from the Hong Kong side. Later, authorities will consider mainland Chinese's chance to invest in Hong Kong's bond market. The decision initially allow only one-way investment reflects the current market situation, where Chinese officials worry about capital flight. While there is no detailed information available on how the programme will be implemented, premier Li Keqiang said already in March that he expected trading to begin this year.

Due to many uncertainty factors, the programme is unlikely to attract major foreign investor interest in the short term. Given that China's national credit rating system diverges from international practice, it is difficult to objectively appraise the financial health of most Chinese firms. An IMF study last year found that over 90 % of bonds traded in China had received excellent ratings (AA or AAA). In the United States similar high ratings were granted to less than 2 % of firms. This reflects partly the fact that most issuers are linked to the government and enjoy implicit guarantees.

China's bond market has grown rapidly to become the third largest in the world after the United States and Japan. At the end of March, the Chinese bond market had a nominal value of 66.34 trillion yuan (USD 9.6 trillion). Of that, 35 % was government issued bonds, 39 % financial sector bonds and 27 % for the rest of the corporate sector. Foreigners held just over 1 % of the bond market or about 830 billion yuan (USD 120 billion) worth of Chinese bonds. Moreover, most foreigners exclusively hold Chinese government bonds or bonds issued by Chinese state policy banks. Indeed, most foreign holders of Chinese bonds are central banks. At the end of last year, the value of yuan-denominated investments held by foreign central banks and reported to the IMF was USD 85 billion, most of which are typically invested in low-risk assets such as government bonds.

Rates of 1-year bonds on the interbank market



Source: CEIC.

China's change in exchange rate mechanism raises eyebrows. Last Friday (May 26), the People's Bank of China announced that it was changing the way it fixes the dollar-yuan exchange rate at the start of the trading day. The new method combines earlier criteria with "countercyclical factor." Officials said that the move was intended to deal with overreaction of markets driven by herding behaviour. To date the fixing rate has been said to be based on bids of selected banks, which in turn are based on the closing rates of the previous trading day and the supply and demand situation in forex markets.

Even with the current criteria, it is still unclear how the daily fixing rate is actually determined. Adding a vague countercyclical factor does not clarify the situation. The reform apparently increases the flexibility of currency officials to affect exchange rate trends, even if the exchange rate toolbox has been adequate to date in steering the exchange rate. Market participants, for example, see the yuan's recent strengthening against the US dollar as a political response to Moody's downgrade of China's sovereign credit rating.

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