SUOMEN PANKKI FINLANDS BANK EUROSYSTEM

Weekly Review

37 • 13.9.2018

BOFIT

Russia

Russian oil companies see major improvements in earnings. Despite a global rise in crude oil prices, the ruble has lost about 16 % of its value against the US dollar this year. Geopolitical factors account for most of the headwinds battering the ruble. Global markets reacted negatively and swiftly in early April after the US broadened its sanctions roster to include a number of major Russian enterprises and private individuals. August brought additional uncertainty due to the US announcement it might go ahead with further sanctions, heightened tensions between the US and Russia over Syria and Iran and the novel sanctions imposed after findings of the UK's Skripal poisoning investigation.

While the price of Urals crude oil reached 76 dollars a barrel at the end of August (up 13 % since the start of January this year), the rise in oil prices has been significantly larger in ruble terms. At the beginning of this year, a barrel of Urals went for about 3,900 rubles. By the end of August, its price had climbed 33 % to 5,200 rubles. Higher oil prices in dollars coupled with the ruble's devaluation are shown in the first half year earnings of Russian oil companies.

Rosstat statistics, for example, show total pre-tax net profits of oil companies were up by over 140 % y-o-y in the first half of this year. Russia's largest oil company Rosneft announced that its first-half result (EBITDA) improved close to 50 % y-o-y. Similarly, Lukoil earnings were up about 30 % in the first half. Thanks to higher earnings, the companies have announced major share buy-back programmes. Rosneft plans to spend 2 billion dollars buying back its own shares, while Lukoil expects to spend 3 billion dollars on its shares. Both Rosneft and Lukoil report paying down considerable amounts of debt in the first half of 2018.

Russian state plays an ever-increasing role in directing investment. President Putin's 2018 May Decree included the goal of raising the investment-to-GDP ratio to 25 % by 2024. Deputy finance minister Andrei Ivanov has since clarified that Russia needs about 21 trillion rubles (300 billion dollars) in investment, and that companies should contribute about 8 trillion rubles of that amount. A wide variety of proposals have been made concerning the funding and targeting of this additional investment. Last month saw the publication of "Belousov's list" of 14 large industrial firms to be taxed on windfall profits totalling about 500 billion rubles. The government ultimately balked on capture of those profits, however, and instead the listed firms agreed to invest in projects that benefit society. The identification of such projects will involve the joint cooperation of the finance ministry, the presidential administration, the contributing firms and the Russian Union of Industrialists and Entrepreneurs (RSPP).

Russia has no shortage of potential investment targets. Media reports note, for example, that the price tag for Russia's revised national digitalisation programme for 2019–2024 has climbed to around 1.2 trillion rubles and that cost of the economic development ministry's infrastructure programme now stands at around 7 trillion rubles. Officials hope that both efforts will be partly funded out of the federal budget and partly by corporations, including those in the private sector. In addition, firms face added costs in complying with new rules on ID coding of goods and data storage in compliance with the Yarovaya anti-terrorism amendments.

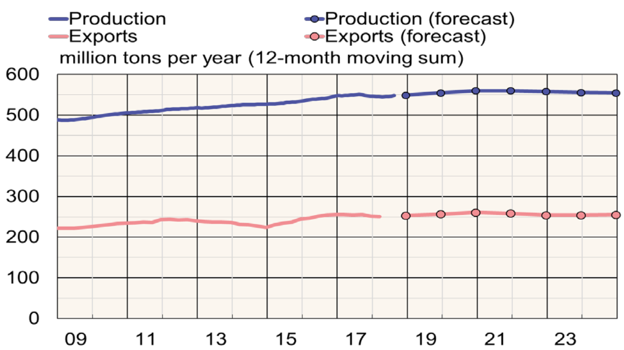
The finance ministry has proposed encouraging private investment through e.g. development of various financing instruments and reforming investment agreement practices. Under the latest proposal, large investment projects requiring joint commitments from the parties would be allowed to lock in their tax treatment for up to 12 years.

Russian oil production expected to increase slightly in coming years. According to the July forecast by Russia's economic development ministry, Russia will this year produce 549 million tons of crude oil (about 11 million barrels a day), which is about half a percent more than last year. Crude exports are expected to total about 250 million tons and exports of domestically refined products about 150 million tons.

The ministry forecasts that both output and exports will grow by about 1 % a year over the next two years and plateau thereafter. According to several estimates, Russian oil output will begin to decline sometime within the next ten years. However, forecasters have been continually pushing the date of Russian peak oil further into the future.

New fields are being brought on stream in both Russia's traditional oil production areas on both sides of the Urals as well as in the Yamal region and Eastern Siberia. As in many other countries, the advent of hydraulic fracking has made it possible to exploit a considerable amount of previously intractable deposits. Sanctions, however, complicate to some extent adoption of the latest technologies as well as upgrading current equipment and facilities.

Production and exports of Russian crude oil



Sources: CDU TEK, Ministry of economic development (forecasts) and Russian customs.

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China

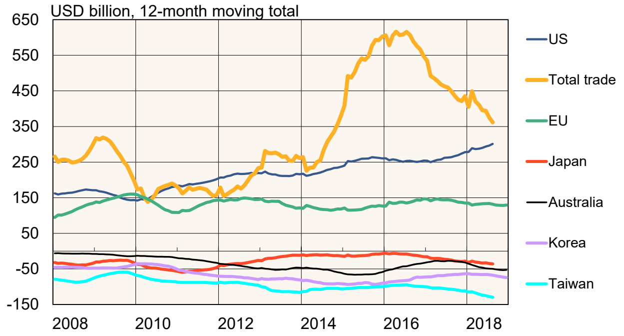
China's goods trade surplus with the US widened in August. China customs reports that growth in goods trade last month was roughly the same as in previous months. On-year growth in the value of exported goods remained at around 10 % y-o-y, while the value of goods imports rose by about 20 %. Growth in the volume of imports has been double that of exports. Robust import growth has reduced China's overall trade surplus. However, there is much variation in bilateral trade balances as illustrated in the chart below.

China customs adds that growth in goods exports to the United States remained strong last month, outpacing growth in exports to both Japan and Europe. As a result, China's trade surplus with the US hit an all-time high in August. US customs figures back up the growing imbalance in trade with China. US imports have accelerated on strong growth of the US economy, creating strong import demand with countries other than China as well. Moreover, imports from China have picked up as firms operating in the US have moved up scheduled shipments from China in anticipation of higher tariffs.

China's trade war with the US continues to escalate. The US last week completed hearings on raising import tariffs on Chinese imports worth about 200 billion dollars a year. At the conclusion of the hearing period, US president Donald Trump announced the US could move ahead rapidly in expanding the tariff regime to apply to all imports from China.

China has announced it is ready to impose its own new tariffs. To ease the distress of its struggling export industries, China's finance ministry announced increases in export tax rebates on nearly 300 products.

China's goods trade balance with major partners



Sources: China customs and Macrobond.

Falling prices make foreign investors wary about mainland China stock markets. As scheduled, the weight of Mainland Chinese shares was increased in the MSCI Emerging Markets Index at the beginning of September (BOFIT Weekly 22/2018). However, their weighting in the index is still quite small. Despite the fact that China represents a roughly 30 % weighting in the MSCI Emerging Markets Index, only 0.8 percentage point comes from mainland China A-shares. This amount is miniscule considering that Hong Kong-listed Chinese Tencent represent alone nearly 5 % of the MSCI EM weighting, or that, Alibaba, a heavy on the New York Stock Exchange, has a nearly 4 % weighting. Index provider FTSE Russell is expected to follow suit with MSCI by including mainland Chinese shares in its flagship indexes.

Share prices have slumped in mainland China this year. The slide accelerated at the beginning of June on rising fears about a trade war, China's own deteriorating domestic economic conditions and increased risk facing financial markets. On Wednesday, the Shanghai Composite Index was down 20 % from the start of the year, while the Shenzhen Composite Index was off by 26 %.

As expected, MSCI's move of giving more weight to mainland shares in its emerging markets index has had little impact on foreign holdings of mainland shares. Foreign holdings of Chinese shares increased by 125 billion yuan (18 billion dollars) in May, but fell by 45 billion yuan in June along with a fall in equity prices. Foreign investors owned 1.275 trillion yuan (190 billion dollars) of mainland China shares at the end of June, about 2.5 % of the Chinese stock exchanges' market capitalisation. Foreign investor trading on the Shanghai and Shenzhen stock exchanges via the Stock Connect arrangement with the Hong Kong stock exchange also showed almost no reaction to the decision to include mainland shares in major emerging market indices.

The Chinese government has taken steps to enhance the appeal of Chinese stocks to foreign investors. To show good faith in current trade dispute talks, China announced an easing of foreign ownership rules and extended shareholding possibilities to such critical sectors as car manufacturing and finance. In June, the restrictions on participants in the QFII and RQFII programmes for qualified foreign institutional investors were relaxed by abolishing monthly repatriation limit of 20 % of net value of the portfolio in the previous year.

Starting Monday, China will attempt to attract new investors to the market by allowing qualified foreigners operating in China to trade directly on mainland stock exchanges. This pool of potential investors is estimated to contain nearly a million people. At the same time, firms listed on stock exchanges in mainland China will be permitted to offer stock incentives also to their foreign employees.

Mainland China and Hong Kong stock exchange indexes

Source: Macrobond.

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