Weekly Review
38 • 21.9.2018

BOFIT

Russia

CBR raises the key rate by 0.25 percentage points and prolongs the suspension of currency-buying under the fiscal rule through December. On September 14, the Central Bank of Russia's key rate went up to 7.5 %, the first hike in the key rate since December 2014. The CBR said its decision takes into account a rising inflation forecast and increased inflation risks. The updated forecast on inflation is mainly driven by the approaching VAT hike from 18 % to 20 % on January 1, 2019, as well as ruble weakness arising from geopolitical tensions and emerging market volatility. The forecast sees inflation at the end of this year running at around 4 % (previous forecast 3.5–4 %) and 5–5.5 % (previously slightly above 4 %) at the end of 2019. In 1H2019, the VAT increase could temporarily boost the inflation rate as high as 6 %, but the CBR expects inflation to subside to 4 % in 2020. Main inflation risks stem from highly uncertain external conditions and their impact on financial markets.

The CBR also decided to prolong the suspension of foreign currency purchases under the fiscal rule until year's end. The CBR earlier said the purchase pause would last through September (see BOFIT Weekly 35/2018). The move is intended to stabilise ruble volatility and its influence on inflation. The CBR decision to resume foreign currency purchases under the fiscal rule will be made based on financial market conditions.

IMF's annual Article IV consultations with Russia stress ongoing need for reform. The IMF expects Russian GDP to grow by 1.7 % this year and 1.5 % next year if the oil price remains roughly around $72 a barrel. Largest risks comprise geopolitical tensions, weak growth in developed economies, lack of economic reforms in Russia and weaknesses in its banking system.

The IMF noted its outlook could change due to additional state spending arising from president Putin's May inaugural Decree. Extra spending on infrastructure, healthcare and education could amount to more than 1 % of GDP per year during 2019–24, raising GDP growth in the next few years to 2 %. However, the impacts e.g. on the economy's growth potential and inflation cannot be estimated based on available information. Growth in the outer years could become quite slow.

The IMF considers Russia's general policy of monetary easing correct, but also referred to a possible pick-up in inflation, persisting inflation expectations and risks to the inflation outlook stemming e.g. from the government budget sector. The IMF noted that refining monetary policy communication was important in lowering inflation expectations.

Concerning the banking sector, the IMF paid attention to last year's failures of several large banks. The IMF emphasised the need to improve supervision of risks, especially as regards related-party lending and the accuracy of financial statements. The IMF noted rehabilitated banks should be returned to private hands in an open way. Privatisation of state-owned banks appears difficult in current conditions.

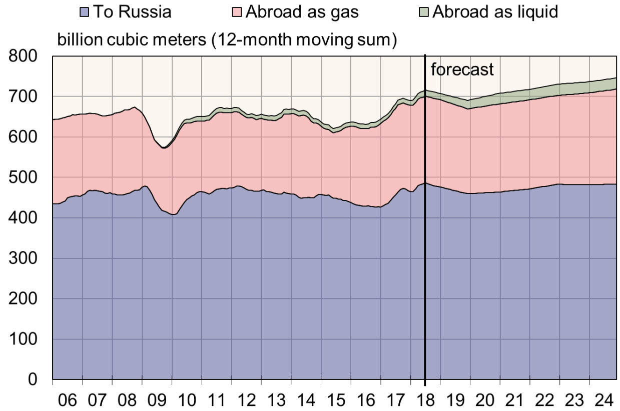
The IMF stressed that the lack of necessary economic reforms means that Russia's economic convergence to higher levels is stalled. The IMF staff estimate that the Russian government and state-owned enterprises contribute about a third of GDP. Reducing the role of the state in the economy should start from increasing competition by e.g. lowering barriers to entry and exit, using market-friendly public procurements and inducing changes in how state-owned enterprises operate. Challenges also include excessive regulation and customs operations. The IMF said barriers to foreign trade and FDI need to be reduced.

Russia's fourth large natural gas liquefaction unit started production. In August, the first cargoes were offloaded from the second unit (liquefied natural gas (LNG) train in professional terms) of the plant in the Yamal peninsula on the shores of the Arctic Sea. The third and last large unit is to be completed next year. Two more units are located on the Sakhalin Island in the Pacific Ocean. Each of these five large units is capable of condensing annually about 7 billion m³ of natural gas into about 5 million metric tons (the capacity of about 70 vessels) of LNG. These units account for almost all of Russia's production. Smaller facilities in the Baltic region produce much smaller amounts used e.g. as ship fuel.

In liquid form, Russian natural gas can be delivered beyond the reach of pipelines. Most of the LNG produced so far has been delivered by sea to Asia. After the completion of the plant in the Yamal Peninsula, nearly 15 % of Russia's natural gas exports may be delivered in liquid form. Russia's share of global LNG production capacity will rise to over 5 %. Russia would still be far below the levels of Qatar or Australia.

New projects are under consideration, but none has reached the construction phase. They would be operational several years from now at the earliest. In addition to the expansion of the Pacific Ocean and Arctic Sea plants, there is a plan to build a large plant in the port of Ust-Luga at the Gulf of Finland. Instead of being close to a gas field, this plant would be fed through the pipeline grid. The route of Nord Stream 2 gas pipeline also happens to start near Ust-Luga.

Destinations of natural gas produced in Russia



Sources: Rosstat, Russian customs and economy ministry (forecast).

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China

US-China trade war escalates; American firms operating in China suffer. On Monday (Sept. 17), United States president Donald Trump unveiled a new round of tariffs on imported Chinese products with a combined value of $200 billion a year. The additional 10 % tariffs enter into force on September 24 and rise to 25 % at the start of next year unless US-China talks manage to resolve the intensifying dispute. The US had already imposed import tariffs on China worth $34 billion a year at the beginning of July, as well as additional tariffs on another $16 billion worth of Chinese imports in August. US tariffs announced so far apply to about half of US goods imported from China.

As in the previous instances, China retaliated immediately to the US measures by imposing additional tariffs on American goods. China's additional tariffs, 5 % and 10 % depending on the product, apply to US goods imports worth $60 billion a year. They enter into force on the same day as the newest round of US tariffs. Trump has indicated that the US is prepared apply additional tariffs to practically all goods imports from China if China continues to rebuke US measures. No high-level trade talks have been announced.

While the American Chamber of Commerce in China notes that trade wars only produce losers, they do not believe the dispute will be resolved quickly. According to its survey made during the August-September cusp, the before and newly imposed tariffs harm 75 % of American firms operating in China. Nearly half of the 430 firms responding said the tariffs imposed by the US have a "strongly negative effect" on their operations, and just a handful of firms saw themselves as benefitting from Trump's tariff policies. Tariffs have driven up production costs for American firms, reduced demand for their products and increased prices to end consumers. About half of the responding firms expected their profits to shrink. The trade war is also apparent in the fact that firms have postponed or cancelled their investment plans and are seeking to restructure their supply chains. For example, 31 % of American firms operating in China reported that they are trying to reduce their purchases of US-made parts or component assembly operations in the US. Very few firms said they were considering moving their production back to the US. Respondents also noted that, in addition to the burdens from new tariffs, Chinese bureaucrats have complicated their lives through increased inspections and oversight, as well as slowing goods handling at customs.

The latest annual survey of the European Union Chamber of Commerce in China (EUCCC) asks about the impacts of higher tariffs on European firms operating in China. It finds that roughly half of firms see tariff increases as harmful to their businesses, while the rest see a neutral impact. Most European firms were taking a wait-and-see position and they have yet to take any measures to respond to the tariff hikes.

Even with China's leaders trying to portray the country as a beacon of free trade, the EUCCC asserts that the roots of the trade war originate with China's foot-dragging on market-economy reforms and slowness in opening its economy to the world. The EUCCC reports that domestic Chinese firms still face far fewer barriers and operate far more freely than foreign firms in China. Already for years, American and European firms have called for China to open its markets and assure foreign firms of a level competitive playing field.

Large Chinese banks report improved profitability. The semi-annual financial reporting of China's Big Four banks (Agricultural Bank of China, Bank of China, China Construction Bank and Industrial and Commercial Bank of China) shows all increased their margins and profits during the January-June period. Most of the earnings growth came from a widening spread between lending and deposit rates. The situation has improved for these banks since 2015 and 2016, when the tough competitive environment dramatically shrank margins. Other profitability indicators like various return on capital ratios also suggest higher bank profitability. The Big Four appear to have benefitted from recent campaigns by the country's leadership on lowering debt levels and tighter regulation. Concerns about banking system stability are primarily focused on small and mid-sized banks.

There has long been a cloud surrounding the reliability of economic reports published by Chinese banks. The solidity of Chinese banks, which are famously reluctant to for example report non-performing loans, is generally seen as weaker than represented. During the past few years, Big Four financial reports increasingly portray themselves as enthusiastic participants in the government's economic development campaigns and initiatives.

No evidence of an impact from recent stimulus measures in China's July-August investment figures. China's official economic figures for August show no large changes in economic circumstances relative to previous months. However, while monthly figures show little fluctuation, it seems third-quarter GDP growth will fall well below the growth pace of 3Q17.

Retail sales, a widely-used indicator of services output and consumption, rose in real terms by 6.6 % y-o-y in July-August. The corresponding growth in July-August 2017 was 9.3 %. Figures for goods freight indicate an even sharper slowdown in growth. Industrial output growth appears to have slowed only marginally since July-August 2017, but the lack of almost any fluctuations in official figures over the past three years has also been astonishingly consistent – especially in light of changes in other indictors tied to industrial output. Real on-year growth in fixed asset investment (FAI) has been around zero for over a year. Despite stimulus measures to boost growth, there were no signs yet in July and August of an increase in FAI.

China's quarterly reporting of on-year GDP growth has fluctuated a mere 0.1 percentage point around the 6.8 % level during the past three years. Third-quarter GDP figures will be released on October 19.

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