Weekly Review
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BOFIT

Russia

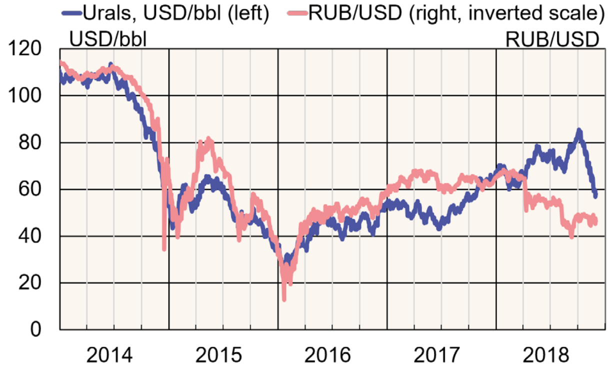
Ruble rate holds steady despite falling oil prices and Kerch Strait skirmish. The price of Urals-grade crude oil declined by 30 % in October and November, from above 85 dollars a barrel to under 60 dollars, but there was hardly any change in the ruble's exchange rate. Similarly, the naval incident on November 25 in the Kerch Strait had virtually no impact on the ruble's exchange rate. There is no unambiguous explanation for ruble's unusual behaviour.

However, the weakening of the link between ruble and oil can be partly explained by currency purchases by the Central Bank of Russia. Since the start of 2017, the Ministry of Finance has been accumulating foreign currency to the National Welfare Fund. Currency purchases have been made daily on the market by the Central Bank. According to the government's fiscal rule, the higher the price of oil is, the more foreign currency is accumulated. While such forex buying has a depreciating effect on the ruble's value, the effect's magnitude is not simple to quantify. However, the connection between the ruble's exchange rate and the oil price has diminished substantially during the forex-buying programme. In August, the Central Bank suspended the forex-buying programme until the end of the year. This may have supported the ruble's value during autumn.

In an indirect manner, the longer-term effect of sanctions may also account for the ruble's stability in recent months. After the declaration of new sanction packages in April and early August, the ruble fell steeply, but it has had a slight tendency to rebound to some extent during the following months. Thus, recovery from the initial sanction effect may have partly cancelled the effect of oil price on the ruble's exchange rate. However, such an explanation remains rather speculative in lack of direct evidence.

The ruble's exchange rate could also be getting some support from Russia's monetary policy and relatively benign fiscal environment. Public sector finances are in surplus and government debt is quite low relative to most countries. In addition, emerging-market currencies have generally bounced back from their lows earlier this year.

Urals oil price and ruble exchange rate



Source: Reuters

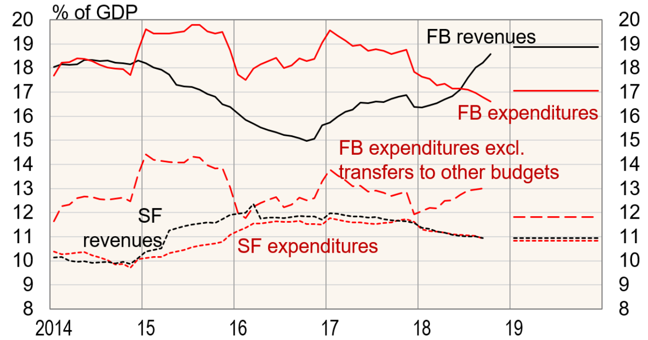
Russia approves 2019 federal budget and social fund budgets. The finance ministry expects federal budget revenues to increase next year by about 5 % relative to this year's expected revenues. Oil and gas tax revenues are expected to decline by a few per cent, if the price of Urals-grade crude oil falls according to the assumptions of this year's supplementary budget. The price is expected to average 70 dollars a barrel this year and 63.4 dollars a barrel next year. In contrast, other revenue streams will rise by 15 %. Nearly a third of the gains will come from the increase in value-added tax at the beginning of 2019. Another third is related to increases in value-added tax revenue for other reasons. Dividend income from state-owned enterprises is expected to soar as well.

Federal budget spending will rise next year by a few per cent from this year's forecasted expenditures. Federal budget expenditures excluding transfers to regional budgets and state social funds will correspond to 12 % of GDP. In nominal terms, defence spending next year will be roughly the same as in 2017 and 2018.

The 2019 federal budget is expected to produce a surplus equal to 1.8 % of GDP. However, the Russian government will take on new debt. This is because under the calculated low price of oil in the budget rule a large share of oil tax revenues must go into the National Welfare Fund. The total value of the assets in the Fund is expected to correspond to 7.5 % of GDP at the end of next year.

State social funds are a significant part of Russia's public finances, as the expenditures of these funds equal to 11 % of GDP. Tax revenue received by the funds consists almost entirely of mandatory social contributions collected from corporations. According to the budget, revenues to the Pension Fund, which is the biggest fund by far, will grow next year so well that transfers from the federal budget to the fund will remain unchanged. The fund's expenditures will increase only slightly as the general retirement ages begin to rise next year. In line with the guidelines set forth by the government through 2024, pensions will go up by 7 % at the beginning of next year. However, pensioners who continue to work are no longer entitled to such across-the-board pension rises. Rapid growth in revenues and spending of health insurance fund will continue.

Federal budget (FB) and social fund (SF) revenues and expenditures



Source: Russian Ministry of Finance.

Bank of Finland • Institute for Economies in Transition, BOFIT
P.O. Box 160, FI-00101 Helsinki
Phone: +358 9 183 2268 • Web: www.bofit.fi/en

Editor-in-Chief Jouko Rautava• Email: Jouko.Rautava@bof.fi

China

China and the US agree to postpone tariff hikes to give negotiators time to resolve trade disputes. Presidents Donald Trump and Xi Jinping held high-level bilateral talks during the G20 summit in Buenos Aires last weekend. The US and China agreed to work together in resolving their current trade impasse over the next three months, during which time the United States promised to refrain from imposing further tariff hikes.

The US had earlier threatened to raise the 10 % tariff imposed in September on 200 billion dollars' worth of Chinese imports to 25 % at the start of 2019 unless China committed to trade policy reforms demanded by the US. The US said that the tariff increases would go into effect in March if the two countries failed to reach an agreement within 90 days. China has consistently responded to US tariff hikes with retaliatory counter-tariffs.

The stated goals of the trade talks are quite ambitious. The US says the talks will address "structural changes" to such issues as forced technology transfers, protection of intellectual property, non-tariff barriers to trade, various cyber-threats, services and agriculture. China was vague on the goals of the bilateral talks and only confirmed that both countries were committed to easing access to their respective markets. Both countries confirmed a promise from China to increase its imports of energy, agricultural and industrial products from the US to reduce the trade imbalance.

The United States insists that China make real changes, not simply show good intentions. The appointment of China-critic Robert Lighthizer as US trade representative illustrates the US hard-line stance.

It will be difficult for the US to negotiate on "structural changes" as many go directly to the core of China's economic and political system. Reaching a meaningful outcome is complicated by the intricate and sensitive matters involved, the brief period for negotiation and the fact that trade policy disputes are just part of the broader power struggle between the world's leading economies. By stoking uncertainty in global markets, the ongoing US-China trade dispute has become quite toxic for global business communities.

China and United States defend WTO reforms, but still far apart on agreement content. The Argentina G20 summit produced a fairly thin final communiqué in which the member states committed to necessary reforms of the WTO to improve its operation. China's development and its economic policy practices are behind developed-economy calls for WTO reform.

The United States has been the sharpest critic of the WTO and China's exploitation of the system. A good sign is that the US now promises to continue discussions on trade policy on a multilateral basis. As regards China's commitment to WTO reforms, it is important that China itself participates in determining the rules-based international trading order. However, it will be very difficult to find a common premise for reform, given that member views on the matter are so divergent with to the substance of reform. No concrete initiatives on WTO reforms were announced in Buenos Aires.

The biggest challenge to WTO reform from the Chinese standpoint involves Western demands for elimination of public subsidies and other market-distorting practices. These are particularly sensitive issues for China and other emerging economies. As one of the world's trading superpowers, China can no longer hide behind its developing economy status and demand special treatment or concessions.

The WTO and the multilateral trade policy system are facing their deepest crisis in decades. The US-China trade disputes are at the centre of current problems. How the US and China succeed in their bilateral talks during the next three months may also indicate whether reforms of the WTO are possible at all or whether the crisis around it deepens further.

Markets reacted cautiously to Trump-Xi truce. Given the low expectations going into the G20 summit that the US and China would make progress on resolving their trade differences, the 90-day postponing of further sanctions was enough for both sides to put a positive spin on their meeting. Market reactions in China and the US, initially positive, grew more pessimistic as the week progressed, partly with news of the US-ordered arrest in Canada of Huawei CFO, Wanzhou Meng on December 1.

In the wake of the summit on Monday (Dec. 3), prices on the Shanghai stock exchange rallied nearly 3 % from their Friday levels, only to fall slightly later in week. Chinese stock performances this year have generally been weak, so the hoped-for injection of optimism gave way on Tuesday (Dec. 4) to uncertainty over the feasibility of resolving complex trade issues in a brief period. On forex markets, the yuan was up over 1 % against the dollar, only to weaken again to around 6.88 by Friday (Nov. 7).

Last week's publication of the official purchasing managers' index indicated that industrial output growth halted in November, adding to market jitters.

Mainland China and Hong Kong share indices

Sources: Macrobond.