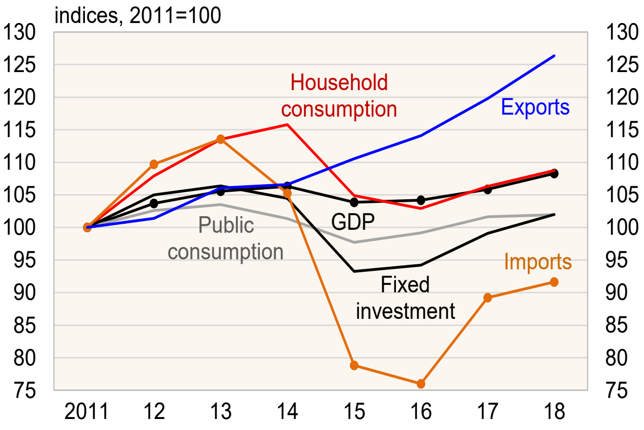
Weekly Review
14 • 5.4.2019
BOFIT

Russia

New data on last year's improved performance of Russian economy. Rosstat's fresh figures reinforce their first-round estimate that 2018 GDP growth at 2.3 % clearly beat out the 2017 performance (1.6 %). GDP growth in the first nine months of last year was adjusted upward to over 2 % (previous estimate 1.6 %). Mainly household consumption helped boost growth in the fourth quarter to 2.7 %.

The updated figures modify earlier views on the evolution of the main GDP components last year. Import growth was revised downward to just 2.7 %. The economy was still led by export growth, even if the new data show export volumes boomed (5.5 %) less than earlier announced. Fixed investment growth was revised up to nearly 3 %, while growth in public consumption was lowered to close to zero.

Real GDP, imports and demand components, 2012–2018



Source: Rosstat.

Russia's national ecology project addresses a range of environmental issues. One of the twelve programmes included in president Putin's inaugural May Decrees of 2018 (BOFIT Weekly 08/2019) seeks to improve the environment. The programme in principle deals with all environmental problems, but waste management is given a rather prominent place in it. Dumps constitute a contentious issue is Russia as citizens have started to pay more attention to the problems involved with it. In contrast, climate emissions play a small role in this programme.

While the cost estimate has fluctuated since May 2018, the plan released in February calls for 4.041 trillion rubles or a bit more than 50 billion euros during 2019-2024. This corresponds to about half a percent of gross domestic product. Polluting firms are expected to finance up to three-quarters of the national project, while the state will subsidise interest payments on loans taken for this purpose. The firms are expected to raise funds by issuing special green bonds. Money raised by these kinds of bonds is earmarked for environmental investments. Russia's first green bonds were issued in December on the Moscow Exchange.

Funding of the national ecology project, 2019–2024

		mrd. RUB	EUR*
Sources		**4 041.1**	**54.0**
1	Federal budget	701.2	9.4
2	Budgets of the federal subjects	133.8	1.8
3	Other funds	3 206.1	42.8
Expenditures		**4 041.0**	**54.0**
1	Clean land	124.2	1.7
2	Management of municipal solid waste	296.2	4.0
3	Management of hazardous waste	36.4	0.5
4	Clean air	500.1	6.7
5	Clean water	245.0	3.3
6	Improvement of the Volga River	205.4	2.7
7	Protection of the Baikal Lake	33.9	0.5
8	Protection of unique bodies of water	15.2	0.2
9	Protection of biodiversity and development of nature travel	6.3	0.1
10	Protection of forests	151.0	2.0
11	Adoption of best available technologies	2 427.3	32.4

* Converted at the average exchange rate of the first quarter of 2019 (74.7 RUB = 1 EUR).

Source: Russian government.

However, the principles for calculating the costs may not be straightforward. The figures may include already-funded public works, and the companies might have planned to make some of the investments even without the project. According to the finance ministry's estimate, the programme doubles direct federal spending on environmental protection.

The programme has evoked contentment as well as contempt. While the plan mentions several concrete actionable measures to be taken at the worst polluted sites, it falls short of giving a precise description of a general tightening of environmental regulation. For example, World Wildlife Fund (WWF) Russia has pushed for greater focus e.g. on recycling, modernisation of production methods and improving the market environment for small waste management firms.

New bridges across Amur River are set to open soon. The Amur River, that flows into the Pacific Ocean, and its tributaries form the roughly 4,000-kilometre long border between Russia and China in the Far East. To improve the lack of bridges across the Amur, China and Russia began building a rail bridge in 2014. China finished its part of the bridge in 2016, but the Russian part was connected to the Chinese side only in March 2019. The bridge is set to open later this year. In 2016, the countries began to construct a trans-border road traffic bridge that should be completed next year.

The new rail bridge is located near the small Chinese city of Tongjiang at the confluence of the Songhua River. This spot is connected by rail to the large Chinese city of Harbin and to the Russian Trans-Siberia railroad. It was already possible earlier to use the Trans-Manchurian line running through Harbin to reach the Trans-Siberian line in Vladivostok to the east and Chita to the west. Additionally, there is a rail connection from Beijing through Mongolia to Russia's Ulan-Ude. It seems that an important use of the new bridge will be to facilitate iron ore transport from mines on the Russian side of the border to China. The new road traffic bridge is located at the confluence of the Zeya River, allowing crossing between Blagoveshchensk on the Russian side and Heihe on the Chinese side. A freeway runs directly from Heihe to Harbin.

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China

China's public sector budget deficit unchanged; revenue-side a major concern. Last month's National People's Congress approved the finance ministry's proposed 2019 budget. With total revenues to central and local governments of 19.25 trillion yuan (2.5 trillion euros, or nearly 20 % of GDP) and expenditures of 23.52 trillion yuan (estimated at 24 % of GDP), the deficit would be 4.27 trillion yuan, or 4.3 % of GDP. The budget deficit as a share of GDP is slightly larger than the realised 2018 deficit. Figures do not include budgeted withdrawals from state funds.

The finance ministry's budget report indicates concern over the government's ability to realise the budget, particularly in light of the bleak revenue outlook. While budget revenues are projected to climb 5 % this year, economic growth is slowing and the government has committed to 2 trillion yuan (300 billion dollars) in stimulative cuts to taxes (including VAT and income taxes) and fees. This does not include earlier agreed cuts that will further reduce revenues.

The need to spend to prop up economic growth and commitments to earlier public projects provide strong incentives for officials to spend beyond their budgets. While spending will increase 6 %, greater effort must be made to target spending effectively. The finance ministry has called for spending cuts at all administrative levels and placed strict controls on officials in their foreign travel, car use and business-related entertaining. The finance ministry plans to cut its own spending by at least 5 %. *Caixin* reports that about 50 central government ministries and agencies had already committed to spending cuts by early April. However, a similar number of ministries and agencies have increased budget expenditures.

The budget report notes many fiscal ailments in China's public sector. Some cities are struggling to provide basic services, conduct other normal activities and even make payroll. Such basic government spending is hard to cut, even when revenue prospects are shaky. Nearly 40 % of provincial budget revenues consist of income transfers from the central government. A nearly as large share of revenues is derived from the sale of land-use rights. Sales of land-use rights declined in the first three months of this year. The finance ministry also points out that excessive commitments by provincial administrations have endangered the sustainability of their finances. Provincial governments continue to guarantee credit or lend against the rules, making it even harder to assess debt risk.

By official estimates, China's public-sector debt is less than 40 % of GDP. Local governments, however, hold large amounts of off-budget "hidden" debt. Last summer, the IMF estimated that China's actual government debt was 70 % of GDP. This week Zhang Xiaojing, a deputy director of the Institute of Economics at the Chinese Academy of Social Sciences (CASS), valued China's current government debt at more than 90 % of GDP. Media have recently run stories about the debt problems of several city governments.

Bloomberg Barclays index to include Chinese government and policy bank debt securities. On April 1, Bloomberg Barclays added yuan-denominated bonds issued in mainland China to its Global Aggregate Index. The weighting of Chinese bonds in the index will rise incrementally over the next 20 months to 6 %. Yuan bonds were also added to two other Bloomberg Barclay bond indices. Mainland Chinese bonds have never before been included in any major global index.

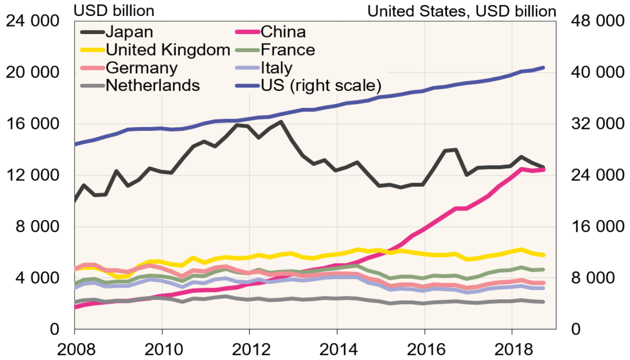
The rapid growth of China's bond markets since 2015 is largely a reflection of growth in local-government indebtedness. Foreign investor ownership in mainland China is, however, concentrated almost entirely in sovereign debt or bonds issued by the three state policy banks. FTSE Russell, one of the biggest index producers, is also considering adding Chinese bonds to its main index next autumn. J.P. Morgan, too, is contemplating the move, but has yet to include Chinese bonds.

The Bloomberg Barclays Global Aggregate Index is followed by about 2.5 trillion dollars in managed assets. Many investment banks assume that investors are reluctant to immediately shift investments to China as a passive tracking of the index would suggest. Even so, the credibility from index inclusion should bring in over 100 billion dollars in investment to China over coming years. That amount would increase if other central indices also include mainland Chinese bonds.

Index inclusion reflects the opening up of China's financial markets to the world, but there is still plenty of room for improvement. Foreign investors can presently only participate in China's bond markets through special programmes. Moreover, the availability of financial instruments to hedge interest-rate or currency risk is limited. Shifting investment assets to China is further restricted by the relatively low liquidity of Chinese markets and the fact that it is difficult to anticipate or defend against official regulatory changes.

Foreign ownership on China's bond markets grew last year by about 75 billion dollars to 250 billion dollars, which still was just over 2 % of the market. Foreign participation grew by about 50 billion dollars in 2017. Last year's developments are notable in that a large share of the increase in foreign ownership possibly came from Russia. The Central Bank of Russia reports that it last year shifted about 55 billion dollars of its currency reserves into yuan assets.

Bond market size in select countries (USD billion)



Source: BIS.

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