Weekly Review
19 • 10.5.2019
BOFIT

Russia

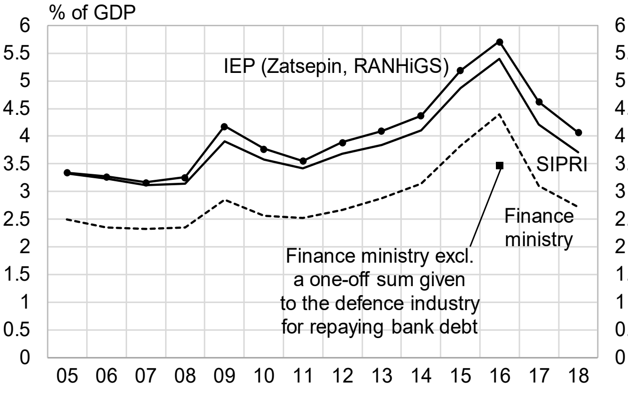
Russian defence spending large, even after declines. Russian government defence spending fell slightly in nominal ruble terms last year. In real terms, defence spending is down, but reminiscent of earlier years, still sizeable.

Developments in Russian defence spending are very similar in figures compiled by the Ministry of Finance (MinFin), the Stockholm International Peace Research Institute (SIPRI) for its global defence spending assessment and the Russian Presidential Academy of National Economy and Public Administration (RANEPA), which has its calculations published by the Gaidar Institute for Economic Policy (IEP). In real terms, adjusted for increases in domestic producer prices and wages, Russia's 2018 defence spending was about the same as the augmented level in 2014. The ratio of defence spending to GDP was also about the same as in 2013 (MinFin 2.7 %, SIPRI 3.7 % and IEP just over 4 %). Defence spending still accounts for a large share of total government sector spending (MinFin over 8 %, SIPRI and IEP 11–12 %, i.e. slightly more than spending on education or healthcare).

Added to the MinFin data for defence spending, the figures published by SIPRI and IEP include notable items from other budget spending categories. The biggest items added are military pensions, spending on domestic security as regards the national guard and border control, and classified budget spending on the economy. In the past two years, these additional spending items accounted for 27 % of total defence spending in SIPRI's figures and 33 % in the IEP figures. The IEP also publishes RANEPA figures for bank credit to defence industry. Repayment of bank loans exceeded new borrowing in the past few years by a sum equalling 0.2–0.3 % of GDP.

SIPRI reports defence spending by Russia's neighbours has increased sharply in real terms in recent years. From 2013, spending in eastern Central Europe and the Baltic countries was up an average of 45 %, Ukraine 53 %, Turkey 60 % and China 36 %. Nominal 2018 defence spending in Russia was 61 billion dollars, 250 billion in China, 266 billion in Western Europe and 649 billion dollars in the US.

Ratio of Russian defence spending to GDP, 2005–2018



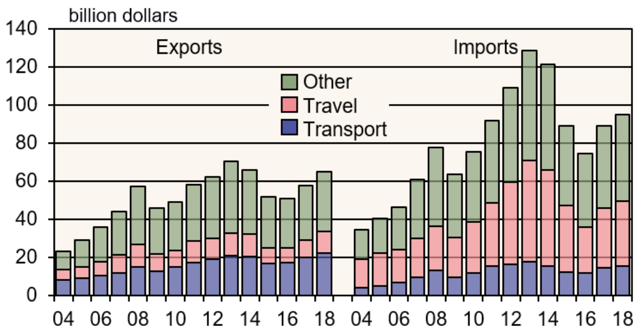
Sources: Finance ministry, SIPRI, IEP, Rosstat and BOFIT.

Russian services trade grew last year. The Central Bank of Russia reports that services exports last year rose by 12 % and service imports by 7 %. Thanks to some extent to the FIFA World Cup, travel service exports were up by 28 %.

In 2018, foreigners purchased Russian services worth a total of 65 billion dollars. Of that, 18 % consisted of tourism services, while 34 % was transport services. Air transport accounted for the bulk of spending on transport services. Of service exports, 11 % went to countries in the Commonwealth of Independent States (CIS), 45 % to Europe and 5 % to China.

Russians last year purchased services from abroad worth a total of 94 billion dollars. Of that, 36 % is due to tourism services and 16 % to transport services. Of service imports, 6 % came from CIS countries, 51 % from Europe and 3 % from China. Turkey, a favourite holiday destination for Russians, accounted for 7 % of service imports. Egypt, once a popular vacation destination, lost its position after a terrorist attack on a Russian charter plane in 2015 and Russia's ban on package tours to Egypt. Although the ban was lifted last year, charter flights to Egypt have yet to resume.

Russian services trade, 2004–2018



Source: Central Bank of Russia.

Progress in two natural gas transhipment terminals in Russia's Arctic and Pacific coasts. In March, Russian officials granted permits to the Russian gas company Novatek for siting a liquefied natural gas (LNG) storage and transhipment terminal in Avacha Bay on the Kamchatka Peninsula on the Pacific Ocean coast. In April, officials followed up with permits for construction of similar terminal in Ura Bay on the Kola Peninsula on the Arctic Sea coast. Once these ports are completed, expensive shipping vessels with ice-breaking capability will focus on transporting natural gas from Novatek's facilities at the Arctic Sea in the Gulf of Ob to these ice-free ports, where cheaper vessels without ice-breaking capability will transport the gas further. The approach substantially reduces transport costs.

The French oil and gas company Total announced plans in April to acquire 10 % stakes in both ports. Total is a minority shareholder in Novatek and has invested directly in the Yamal LNG plant and the planned Arctic LNG 2 plant. The sites of these plants are located on opposite shores of the Gulf of Ob.

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China

Trump announcement of more tariff hikes threatens to derail US-China trade talks. The Office of the United States Trade Representative announced on Wednesday (May 8) it was moving ahead with raising the current 10% punitive tariff imposed last September on Chinese goods to 25 %, effective today (May 10). The tariffs apply to a wide range of Chinese imports with an annual worth of about 200 billion dollars. China promised to take countermeasures. There was apparently little progress in the talks when lead negotiators adjourned on Thursday night (May 9) in Washington, DC. With the tariff deadline now passed, talks continue today.

The impending failure of trade negotiations came as a surprise to many as the parties on both sides earlier reported progress, last when the trade teams met on May 1 in Beijing. Despite apparent progress, president Trump said on Sunday (May 5) that the US would proceed with tariff hikes on Chinese goods. Besides his 25 % hike declared on Sunday, Trump said he also considers imposing tariffs on some 300 billion dollars in Chinese imports currently not subject to tariffs.

The US defended the hikes, claiming China had backed off from commitments it made in the previous rounds of talks. A central issue appears to be China's unwillingness to change its laws to reflect agreed rule changes. China instead wants to implement changes through administrative measures. Leaving implementation to administrators, however, makes US oversight difficult and unlikely to produce the desired changes in practice at the provincial level.

Little concrete information about the negotiations has been made public, causing additional uncertainty in world stock markets. Media reports up to early May implied that understandings had been reached on topics such as ending forced technology transfers, enforcement of copyright protection and cybersecurity. Even breakthroughs in certain areas of opening up access to China's markets were mentioned. Among the more difficult unresolved issues are the timetable for lifting current tariffs, free movement of information and allowing access of American cloud services providers to China. Particularly thorny issues are posed by the competitive distortions by preferred government treatment of Chinese state-owned enterprises and government subsidies. Now it also emerged that the earlier-claimed consensus on oversight of agreement implementation evaporated with China's reluctance to change its legislation to suit American wishes.

One of the main reasons for the current trade dispute is China's failure to deliver on promises that were part of its WTO accession in 2001, i.e. allowing access to its markets and the ending of unfair trade and investment practices. As such reforms would deeply impact China's current economic system, it was clear from the beginning that the trade negotiations would be difficult. Moreover, as the trade disputes are a part of wider great power competition, even a positive outcome this week would only provide temporary respite from ongoing trade tensions and uncertainty.

China's goods imports revive in April. China Customs valued April goods imports at 180 billion dollars. After shrinking by nearly 5 % in the first three months of the year, import growth recovered to 4 % y-o-y last month. The value of key commodity imports rose by 15 % y-o-y in April, while the value of other goods imports was up by 1 %. Imports of machinery & equipment (over 40 % of Chinese imports) contracted much less in April (-3 %) than in the January-March period (-8 %).

Trade with the United States continued to shrink. During January-April, imports of US goods to China fell by 30 % from a year earlier, while exports declined by 10 %. The April figures were similar to those of the first quarter. The EU showed the strongest rebound in Chinese imports from advanced economies (up 4 % in April).

Shifts in exchange rates also affected foreign trade trends in the first four months of this year. In dollar terms, the value of exports showed no growth in January-April (in April -3 %), while imports contracted by about 2 %. In yuan terms, exports rose by nearly 6 % y-o-y and imports were up almost 3 %.

China presents new measures to help open up its financial markets. Guo Shuqing, chairman of the China Banking and Insurance Regulatory Commission (CBIRC), announced a dozen measures at the beginning of May intended to open up access to Chinese markets. Ownership limits in the banking sector and foreign firm size requirements would be dropped, while foreign banks would no longer need to petition for permission to engage in yuan-based operations.

The measures include elimination of certain qualification requirements for foreign insurance groups, including ceilings on ownership shares and provision of a 30-year operating history. In addition, the government will make it easier to set up consumer financing firms. CBIRC says that the new rules for foreign banks and insurance companies will soon be published. The measures, which respond to China's promises to open up access to its financial markets, are intended to help with US trade talks.

Some foreign firms were recently granted licences to expand operations in China. They include the Swiss UBS, which increased its stake in its Chinese joint venture UBS Securities to 51 %; the German insurer Allianz, which got the go-ahead to found the first foreign-held insurance company in China; and American ratings giant Standard and Poor's, which can now operate as a credit ratings agency in China. The Dutch ING Group, which has a joint venture with the Bank of Beijing, seeks dominant shareholder status. If the regulators approve the joint venture, it would create the first Chinese bank in which a foreign entity holds the majority stake. Credit card issuer American Express finalised its licencing process November, gaining the right to operate in China under the form of a joint venture with a local entity. According to media reports, Visa and Mastercard have long sought operating licences. Mastercard is reportedly establishing a joint venture with a Chinese partner to ease its licencing process.

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