Weekly Review
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BOFIT

Russia

Russian first-quarter economic growth well below expectations. Preliminary Rosstat figures show Russian GDP growth in the first three months of the year was just 0.5 % y-o-y, a figure clearly lower than anticipated by most forecasts. At the end of 2018, the Central Bank of Russia forecast growth in the range of 1–1.5 %, while the responses of analysts interviewed by *Bloomberg* averaged 1.2 %. Even Russia's economic development ministry, which updates its forecast monthly, expected 0.8 % growth.

The Russian economy last grew as slowly in the fourth quarter of 2017. The slowdown in growth from 4Q18 (2.7 %) was, however, expected due to low growth in domestic demand. The value-added tax increase introduced at the beginning of January appears to have boosted wholesale trade at the end of last year in anticipation of higher VAT rates. Wholesale activity in the first quarter of this year contracted by 7.4 % y-o-y, even as retail sales rose by 1.8 %. Besides the larger-than-expected impact from the VAT hike, observers also point to weak economic development relative to previous years due to a reduction in defence materials orders and a milder-than-usual winter that reduced energy consumption and gas exports.

Inflation (5.3 %) negatively impacts general income levels. Rosstat estimates that real incomes fell by 2.3 % y-o-y in the first quarter. Industrial output rose by 2.1 %.

The CBR and the business press believe the growth slowdown is temporary. In the most hopeful scenarios, the launch of large state investments in national infrastructure, healthcare and education at the end of the year will spur higher economic growth next year.

Tainted oil fouls Druzhba oil pipeline. On April 19, Belarus reported detecting a large quantity of organic chlorides in the crude oil moving through the Druzhba (Friendship) pipeline. Pipeline transmission from Russia was suspended for several days, and subsequent efforts to re-establish flow were sporadic. Many European customers turned to their own stores and suspended payment to Russia until disputes over damages are resolved.

As even small quantities of organic chlorides, which are used in oil drilling, can foul refinery processes, contaminated oil must be kept away from refinery equipment. In this case, the concentration of organic chlorides appears to be rather high. While the problem seems to have been traced to a small private oil refinery in the Samara region, details of the events leading to the contamination have yet to be released.

The fouled pipeline is a major artery for oil flows from Russia to Europe. Crude oil streams from various Russian oil fields are blended before they are placed in the pipeline, which starts in Tatarstan, 1,000 kilometres east of Moscow. A mix of crude oil from Urals, Siberian and Kazakh fields enter the pipeline to be pumped west to Belarus. From there the pipeline forks, with the northern fork crossing Poland to Germany, and the southern fork traversing Ukraine, Slovakia, Czech Republic, Hungary and Croatia. The pipeline is also linked to Russia's Ust-Luga oil port on shores of the Gulf of Finland. About a third of all crude oil exported from Russia goes through the Druzhba pipeline. Oil going to customers in Western Europe can alternatively be shipped via Baltic and Black Sea ports. Even with these alternatives, Russia has had to lower output somewhat to accommodate the decreased flow of oil. Profitability of refineries in Central and Eastern Europe is dependent on oil coming through the pipeline, even if they can procure oil supplies via oil tanker or use their own stockpiles.

The contaminated oil has been found almost throughout the entire length of the pipeline. Estimates put the amount of spoiled oil at more than one million metric tons, a half-billion dollars in oil at current prices. The fouled oil may be salvaged by diluting it with untainted crude and selling it at a discount. As these measures apply to the entire length of the pipeline, oil will have to also be shipped by rail to the oil ports. At least some Chinese companies seem to be keen on purchasing the cheap oil. Despite these measures, cleaning of the pipeline, disposal of the tainted oil, identification of the culprits and recovery of damages could take months or years.

Russia's hydrocarbon-centric energy security doctrine stresses import substitution. President Vladimir Putin last week (May 13) approved Russia's updated energy security doctrine. The document includes a list of general challenges and threats to Russia's national energy security, as well as desirable policy measures. Energy security is interpreted to comprise of both uninterrupted domestic energy distribution as well as smooth flow of energy exports. Energy security in Russia's case is an inextricable part of its foreign, fiscal and national security policies.

While the energy security doctrine notes that the global shift to renewable energy poses challenges for Russia, the proposed response is to increase support for the oil & gas sector rather than fund development of renewable energy sources or new technology. The policy of import substitution has particular prominence, and import substitution was strongly evident already in the economic security strategy approved in May 2017. The energy security doctrine takes a positive view of international efforts to mitigate climate change as long as they do not interfere with Russia's national interests. The document gives only scarce consideration for domestic security threats such as mismanagement and corruption, which may partly explain events like the contamination of the Druzhba oil pipeline.

Energy sector development goals will be tackled in detail in a separate energy strategy. The current energy strategy, which extends to 2030, was approved in 2009. The updating of the strategy has taken years. Its most recent cabinet discussions was postponed from April to December this year. The energy strategy update (ES-2035) was supposed to be approved already in 2014.

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

European companies want to see meaningful changes in China's business conditions. European companies doing business in China say the gap between words and practice is huge when it comes to Chinese reforms of the business environment. For example, a substantial share of companies engaged in high value-added production still are forced to surrender know-how to their Chinese counterparts, even if China officially claims to have ended the practice of mandatory technology transfers. Only a handful of responding firms felt that the discriminatory treatment they receive from China's regulators will improve in coming years.

This week, the EU Chamber of Commerce in China released its Business Confidence Survey 2019 conducted in January and February. The top three concerns expressed by the 585 of its 1,326 members were China's slowing growth, the slowdown in the global economy and the rapid rise in wage costs in China. The US-China trade war only ranked as the fourth biggest concern, possibly because direct fallout from the dispute has been less than feared though it has heavily worsened business sentiment. The EU Chamber blamed the "reform gap" (the government's slow-walking of reform even as the economy matures and grows rapidly) as the main cause for the trade war and lack of reciprocity in economic relations with the rest of the world.

While firms in many branches reported easier market access, EU Chamber is concerned about new barriers faced by law and ICT firms that serve businesses in many branches. European firms are increasingly united in seeking a level playing field and consistent treatment from regulators. About 70 % of European firms reported that Chinese state-owned firms do business in their fields and receive preferential treatment in e.g. public procurements, financing and licencing.

Despite the obstacles, over 60 % of respondent firms ranked China among their top-three investment countries. In the response to the survey's innovation question last year, the number of firms saying they considered Chinese firms at least as innovative as European firms exceeded half for the first time. This year, 62 % of firms considered Chinese inventiveness to be at least on par with European firms. Most EU firms saw this trend as a positive development also for them.

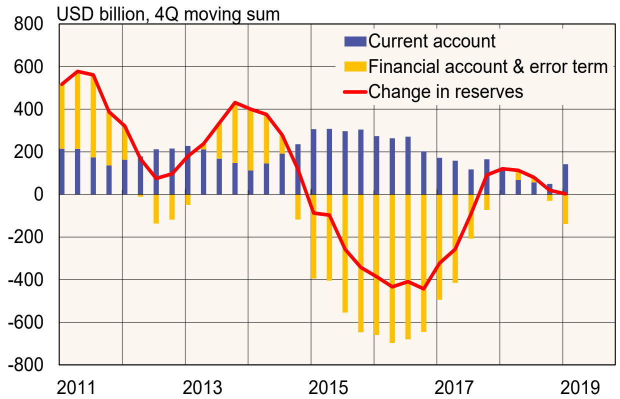
This week, also the American Chamber of Commerce in China (AmCham China) and its partner AmCham Shanghai released a joint survey of their members. Three-quarters of the nearly 250 member firms surveyed said that they had suffered under the US and Chinese tariff hikes. Slightly fewer than half of responding firms said they had also been subject to Chinese non-tariff retaliatory measures such as increased inspections, foot-dragging by customs authorities and delays in licencing processes. To get around tariffs, many firms have shifted their focus to buying and selling primarily in the Chinese market. About 40 % of firms said they were considering moving or had already shifted production away from China to other countries, especially Southeast Asia or Mexico.

China's current account surplus soared in the first quarter. China's current account surplus in January-March rose to 59 billion dollars. In the same period last year, the current account showed an exceptional deficit of 34 billion dollars. On annual basis, the current account surplus was 142 billion dollars, or 1 % of GDP (0.4 % in 4Q 2018).

The biggest factor growing the current account surplus was the rising goods trade surplus. Export revenues rose and import spending declined relative to 1Q 2018. The services trade deficit also contracted, due largely to a drop in Chinese spending on tourism abroad (down 10 % y-o-y).

Financial account data will be released later. Based on published data, it can be calculated that the net outflow of capital (including the net errors & omissions term) was slightly less than the current account surplus, indicating a small uptick in China's foreign currency reserves after slight declines in the previous two quarters. Monthly figures show China's foreign currency reserves (including gold) slightly exceeded 3.19 trillion dollars at the end of April.

Main items of China's balance-of-payments



Source: Macrobond.

Conflicting price data for China's housing markets. According to the 70-city sample used by China's National Bureau of Statistics (NBS), the weighted average price for new apartments increased last month by about 7 % y-o-y. Price changes in the four most important cities were still quite minor. Based on other sources, the rise in housing prices has been faster.

Business portal *Caixin* cited the E-House Real Estate Research Institute's survey of 100 cities, which claims apartment prices rose an average of 13 % y-o-y in the first quarter. In nearly a quarter of cities the annual price increase exceeded 20 %, and in China's four major cities, prices were up by 19 %. In the NBS 70-city sample, only Hohhot reported a price rise of 20 %. Data from real estate tracker *SouFun* also indicate a faster rise in prices than reported by the NBS.

It is difficult to draw a clear overall picture of housing price trends. Recent warnings on housing markets issued by China's decision-makers imply, however, that the situation may be more disconcerting than the NBS figures suggest.

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