Weekly Review
31 • 2.8.2019
BOFIT

Russia

CBR again lowers key rate and forecasts moderate inflation. Last Friday (Jul. 26), the Board of Directors of the Central Bank of Russia, as generally expected, decided to lower the key rate by 25 basis points to 7.25 % (effective July 29). Prior to CBR's previous rate cut in June, the board had left the rate unchanged since the rate hikes in the latter half of 2018.

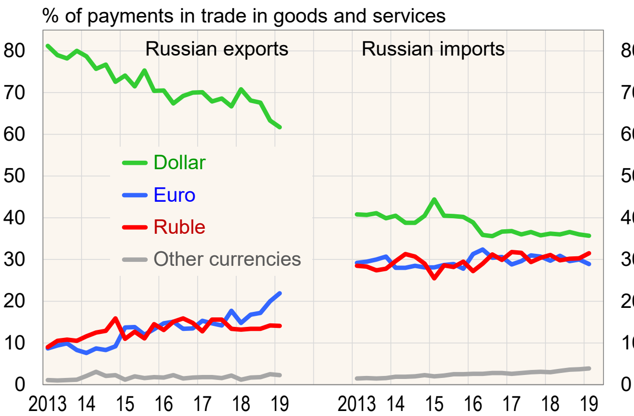
Like with its previous cut, the CBR noted that the move reflected slowing inflation and lower economic growth than expected. The CBR predicts consumer price inflation will slow from 4.6 % at the start of last week to 4 % in early 2020. If developments continue as the CBR forecasts, the CBR said it sees possible cutting the key rate further.

The CBR noted diminished inflation risks especially due to weak domestic and international demand. However, as earlier, the central bank paid attention to elevated inflation expectations, noting that increased government sector spending in the second half of this year could exacerbate inflation risks.

Russia tries to promote the ruble by easing the repatriation requirement for export earnings. The fresh law amendment applies to ruble-denominated export contracts, where the contracts also call for payment of export deals in rubles.

The repatriation requirement will be gradually phased out between the start of 2020 and start of 2024 for Russia's principal exports (commodities such as crude oil, petroleum products, natural gas, coal, as well as waste and scrap metal). The repatriation requirement for other ruble-denominated export earnings will be dropped completely in one go from the start of 2020. The explanatory note to the law amendment says that due to the large amount of criminal activity associated with the export of raw timber and raw timber materials, the law maintains complete repatriation requirements for that branch.

Major currencies in Russian exports and imports, 2013–2019



Source: Central Bank of Russia.

All export earnings are currently subject to the repatriation requirement regardless of the currency used in the export contract. However, Russia long ago did away with the requirement of converting export earnings into rubles.

The purpose for eliminating the repatriation requirement is to encourage the use of the ruble in e.g. Russian exports where the share of the ruble has seen no gains in recent years. The euro's share in Russian export contracts has doubled. Last winter, the euro's share exceeded 20 %.

Russia has a large, but relatively poor, middle class. Alfa Bank, Russia's largest private commercial bank, has released a study claiming that 30 % of the Russian population, about 43 million people, are "middle class." The middle-class reached its apex in 2014 at 37 %.

Estimating the size of a middle class is a non-trivial exercise. Depending on the methods used, a substantial majority or tiny minority of persons may be considered middle class. A recent Sberbank survey found that 47 % of Russians claim to belong to the middle class, while the same survey in 2014 found that 60 % of respondents claimed to be middle class. Under the Credit Suisse definition, the middle class consists of persons with savings amounting to at least double their annual earnings. By this definition, only 4 % of Russians could call themselves middle class, when the equivalent numbers for Germany are 42 % and 38 % for the United States. The OECD defines a member of the middle class as someone whose annual income is within the 75–200 % range around the national median income. For Russia, that range is 26,000–70,000 rubles (370–1000 euros) a month. By this measure, 53 % of Russians belong to the middle class. Alfa Bank uses the OECD definition of income, but limits its middle-class definition to those deciles in which at least half of the members own a car.

The consuming habits of Russia's middle class suggest relatively nonaffluent lives. They spend about 27 % of their income on food, which is a much larger share than in other industrialised nations. The middle classes in the US and Germany, for example, spend about 10 % of their incomes on food, while the middle classes in Poland and China spend about 15 %. In 2017, 26 % of Russia's middle class worked in the commerce and transportation branches, while 20 % in mining or industry. 15 % of the Russian middle class consisted of officials and members of the armed forces (up from 10 % in 2003).

The Alfa Bank study found that real incomes of Russia's middle class declined slightly during 2008–2018. For the top earnings decile, real incomes climbed 11 %, while those with small incomes rose by 4 %. The declining real earnings of Russia's middle class are reflected in its attitudes. Borrowing of the middle class and Russia's richest decile fell sharply as Russia experienced recession in 2015, but only borrowing of the top decile recovered after the economy emerged from recession. Russian risk aversion accounts in part for the negative perception of entrepreneurship. The study refers to a 2017 survey by the Levada Center that found 12 % of Russians wanted to start their own business (57 % in the US).

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China

Brief China-US trade talks end without much to show, Trump announces new tariffs. Little specific information has been forthcoming about the half-day talks held in Shanghai on Wednesday (Jul. 31) between the lead negotiators for China and the United States. Discussions apparently focused on boosting Chinese purchases of American farm products and the concessions from the US needed to make that happen. The parties said the next round of talks would take place in the US in September.

The same themes were front and centre at the side-line talks between China and the US at the Osaka G20 summit in June. At that time, president Donald Trump promised to refrain from imposing further tariffs on Chinese goods as long as talks continued. While the parties returned to the negotiation table after breaking off talks in May due to new tariff hikes, the situation is difficult. This is evidenced by the fact that the latest talks focused on very narrow aspects of trade relations, even if the US claimed that also such major topics as forced technology transfers, intellectual property protections and technical barriers to trade were discussed.

Given the bitter public exchanges between the Trump and Xi administrations during the talks, the prospects of quick resolution of trade differences seem unlikely. The uncertainty surrounding the talks has not been helped by the approaching US presidential election.

President Trump's announcement of more tariffs by tweet on Thursday (Aug. 1) have further muddied the waters. A 10 % tariff on rest of imports from China (300 billion dollars) is scheduled to go into effect on September 1.

SAFE releases for the first time ever information on the structure of China's forex reserves. In its just-released annual report for 2018, China's State Administration of Foreign Exchange (SAFE) said the dollar component of its currency holdings declined from 79 % in 1995 to 58 % at the end of 2014. From 2005 to 2014, the yield on China's forex holdings averaged 3.7 % p.a. SAFE did not reveal the share of other currencies in its forex reserves nor more up-to-date information.

The composition of China's forex reserves has traditionally been a closely guarded secret. The *Caixin Global* online financial magazine reports that China's forex reserves are likely composed of over 30 currencies, a broader holding assortment than in most countries. The IMF estimates that the dollar presently accounts on average for about 62 % of forex holdings of all central banks.

China's large current account surpluses in earlier years helped grow China's forex reserves into the largest reserves in the world. China's currency reserves peaked at 4 trillion dollars in mid-2014, only to decline rapidly until late 2016 when they levelled off at their current level. At the end of June 2019, China's currency reserves amounted to roughly 3.2 trillion dollars, which was still nearly 2.5 times larger than Japan's currency reserves (the second-largest reserves in the world). China's current account surplus has fallen to around 1 % of GDP, so it no longer fuels growth of China's reserves as it once did.

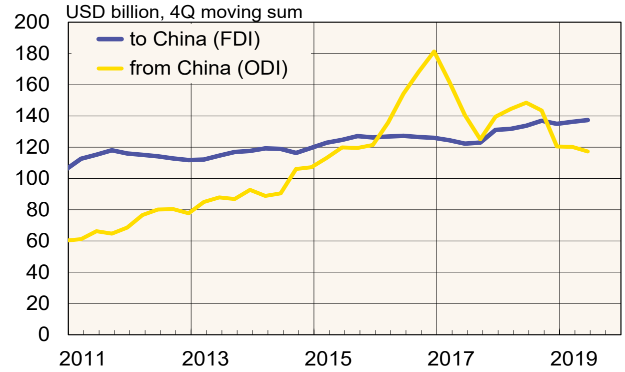
Record FDI flows into China in the first half of 2019, but China's FDI outflows continue to dwindle. China's commerce ministry reports that, despite uncertainty from the trade war, first-half foreign direct investment inflows into China (not including the financial sector) were bigger than ever – 71 billion dollars (up 4 % y-o-y). China's outward FDI fell by 6 % y-o-y to 54 billion dollars. The ministry's figures do not include financial-sector investments, which have corresponded to about a tenth of China's outward FDI investment in recent years, and just a few per cent of FDI inflows to China.

Private western databases on Chinese outbound FDI confirm the decline in investment. According to the *China Global Investment Tracker* database, Chinese corporate FDI in the first half (27 billion dollars) was down by 50 % from the same period in 2018. Investment in Asia increased by nearly 50 %, while investment in all other regions declined. The value of investment flows to Europe were a tiny fraction compared to last year. The regional growth figures are sensitive to the timing of when large investments are recorded.

A joint survey of the Rhodium Group and the multinational law firm Baker McKenzie finds that Chinese FDI fell by 60 % y-o-y in the first half to about 20 billion dollars. Chinese investments in Finland were the largest of all European and North American countries as the exchange-listed Finnish firm Amer was acquired by Anta Sports for over 5 billion dollars the start of the year. In the first half of this year, Chinese corporate FDI flows to Europe fell to 9 billion dollars (-26 % y-o-y), but rose to 3 billion dollars to North America (19 %).

UNCTAD figures show that at the end of 2018, the stock of FDI in China amounted to 1.63 trillion dollars (5 % of global FDI). China's global FDI stock amounted to about 1.94 trillion dollars (6 % of the global FDI stock). China last year accounted for 13 % of outward FDI flows globally.

China's inward and outward FDI flows (excl. financial sector)



Sources: China's Ministry of Commerce, CEIC.