

Russia

Current budget framework calls for sharp hikes in spending on defence and national security. Under the federal draft budget before the Duma, defence spending is set to increase very rapidly during 2012–2014. Much of next year's boost in defence spending will go to raising the pay of members of the military.

Spending on national security and law enforcement will increase next year, in part because funding of police operations that have been covered partly by regional and local budgets will now be exclusively funded out of the federal budget. Moreover, higher police salaries are part of the wider reform of police operations.

Social spending will continue to rise next year with more money for pensions, including larger transfers to the state Pension Fund. The already underfunded Pension Fund will lose income with the reduction in the mandatory social contributions of employers in January 2012.

Funding for the economy will be reduced overall, with increases mainly slated for road construction and applied research. While there will be a bump in spending on health care and education next year, part of funding health care and education will shift in the out years from the federal budget to regional and local administrations.

Main federal budget spending categories, 2012–2014

	2012	2013	2014	2011	2014
	change (%)			share (%)	
Total expenditure	14	8	6	100	100
Public administration	-1	0	-2	8	6
Defence	21	26	18	14	19
National security & law enforcement	47	9	5	11	14
Social security	24	7	0	28	29
Economy	1	-4	-4	16	11
Health care	9	-9	-8	5	3
Education	8	-7	-11	5	3
Housing	-42	-23	-29	2	1
Debt servicing	11	24	20	3	4
General transfers to regional and local budgets	-11	-9	-12	6	3

Source: Ministry of Finance

Consumer prices remain flat. There was no change in consumer prices during the third quarter of the year, and it appears the same trend has continued this month. The cause appears to be the seasonal drop in food prices, a regular annual event in Russia.

The rise in consumer prices overall was still 7.2 % y-o-y in September. Inflation is expected to remain at this level for the rest of the year.

The structure of consumer spending shows 37 % of spending going to food items (consumer price basket, including alcoholic beverages), followed by transportation 12 %, housing 11 % and clothing 11 %.

Russia and China consider deeper economic cooperation. During his visit to China this week (Oct. 11–12), prime minister Vladimir Putin kept the emphasis on economic issues, indicating Russia's growing interest in economic cooperation with Asian countries.

During the visit, the Russian Direct Investment Fund (RDIF) and the China Investment Corporation (CIC) signed a memorandum of understanding on creation of a joint Russia-China investment fund. RDIF was established last summer to participate in joint investments in the Russian economy with foreign investors. CIC is the fund's first partner. The parties each committed to contribute \$1 billion to the fund initially. Other participants, mainly Chinese investors are expected to pony up \$1–2 billion. The Russia-China investment fund would make 70 % of its investments in Russia, Belarus and Kazakhstan, and would focus on the agriculture, consumer goods manufacturing and eco-friendly energy production.

A highlight of the visit was an agreement on Russia-China cooperation in economic modernisation. China has surpassed Germany as Russia's top foreign trade partner, and Russia wants to diversify its structure of exports and develop technology with China. For its part, China is interested in improving transport connections between the two countries through e.g. construction of the bridges, roads and railways needed to increase economic cooperation. For the time being, Russia gave a cautious reaction to the notion of improving transport connections.

Russia and China have haggled all this year over the price of crude oil supplied by Russia. From the start of this year, Russia has been supplying China with crude oil under its long-term contract tied to completion of the first phase of the East Siberia–Pacific Ocean Pipeline (ESPO). China, however, would like to see a discount to what it says is a steep contract price given the excessive transport fees built into the pricing structure of the contract. In fact, China has paid less than the official contract price all the time. As part of Putin's visit, the parties agreed in principle on a new pricing arrangement.

Even with years of discussion, no agreement was reached on how Russian natural gas supplied by pipeline transmission will be priced. The countries agreed in principle on gas supplies by pipeline in 2006. Russia would like to bind the natural gas price to the price of oil products, as it does for its European customers. China continues to balk at this type of arrangement. Rapid growth in gas supplies to the booming Chinese market is an opportunity for Russian export growth and market diversification.

China

State increases its holdings in China's big banks. Central Huijin, the domestic arm of the state sovereign wealth fund manager China Investment Corporation, announced it would purchase shares of China's four largest banks on the secondary market. However, the amount of share purchases to date has been rather small. Central Huijin is already the largest stakeholder in all four of China's big state banks.

The measure is part of state efforts to prop up weak share prices. Bank shares, in particular, have fallen as credit losses from the exuberant stimulus-driven lending of 2009–2010 are expected to appear in the future. Shares of raw material producers have also been hit by the official announcement of plans to apply the source tax nationwide, as well as extend the tax to include coking coal and rare earth metals. The announcement that the state was buying bank shares had a slightly positive impact, but stock traders remained nervous ahead of other macroeconomic news.

Share price trends on China's main stock exchanges



Source: Bloomberg

US Senate approves bill aimed at punishing China for currency policy. The authors of the bill said they were making good on repeated warnings that China was holding the value of the yuan against the dollar artificially low to give Chinese firms an unfair competitive advantage over American firms. If implemented, the law would give American companies the right to impose sanctions on goods imported from China. Despite Senate approval on Wednesday (Oct. 12), however, chances of the bill becoming law are slim; not only must it pass House of Representatives and garner president Barack Obama's signature to become law, it must also conform to WTO rules to be enforceable. Chinese officials and also many influential American business lobbies have condemned the bill.

Oil and cars characterise challenges of China-Russia trade. During his two-day visit to China this week (see

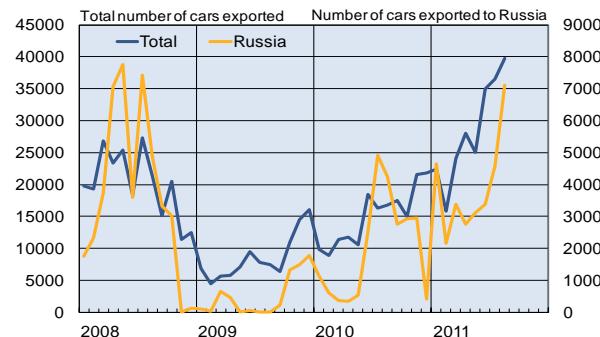
Russia section), Russian prime minister Vladimir Putin raised a number of issues, including measures to enhance bilateral trade. Although trade between the two countries has increased rapidly, Russian decision-makers have been dissatisfied with a structure of exports that emphasises providing raw materials to China. China's leaders, in contrast, appear quite content with the current situation.

Chinese figures show China's exports to Russia and imports from Russia increased about 40 % y-o-y in the January-August period. The value of exports and imports were both put at about \$25 billion, although for the year China appears to be running a trade surplus. Russia still only accounts for 2 % of China's total exports and imports.

China's imports from Russia consist largely of energy products, raw materials and low-value-added goods. Very little in the way of machinery and equipment is imported. Trade discussions between the countries have been dominated for years by wrangling over plans to build a natural gas pipeline from Russia to China, gas pricing and the China branch of ESPO oil pipeline inaugurated last January. Start-up of oil pipeline has been fraught with problems, with both sides blaming the other for contract breach and poor performance. Despite a huge leap in oil shipment capacity, oil imports from Russia were up less than 4 % y-o-y in the first eight months of the year, about two percentage points below China's overall growth in oil imports. Russia accounts for less than 7 % of China's oil imports.

China's exports to Russia are a diverse selection of products. While the largest product categories are machinery and equipment, clothing and footwear, cars are definitely an interesting export item. Over the past year, China has exported about 40,000 passenger cars to Russia; export volumes now approach the pre-crisis level of early 2008. Russia is an important foreign market for Chinese carmakers. About 13 % of Chinese car exports currently go to Russia. The arrival of Chinese-made cars is a blow to Russia's already struggling domestic carmakers and it highlights the competitive advantages of the Chinese car industry over the Russian car industry. In both countries, domestic carmakers have enjoyed strong government support.

Number of passenger cars (sedans) exported from China



Source: CEIC