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BOFIT Weekly

11 • 13.3.2015

Russia

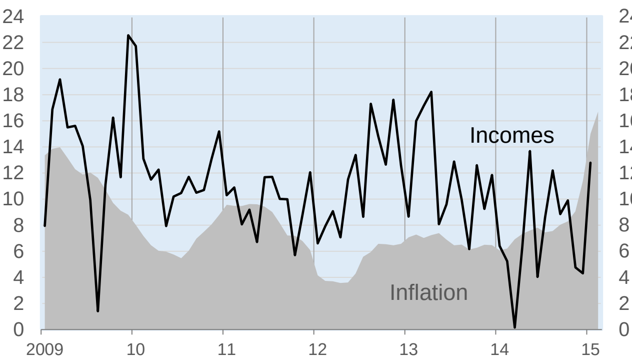
Russians experienced drop in real household incomes last year. Rising inflation caused real household incomes to contract by nearly 1 % last year. When inflation flared in November and December 2014, real incomes fell 5 % y-o-y. Russian incomes policy over the past 15 years has been to grow real incomes even in hard times. Real incomes had not sunk on-year at any time since 1999 until last year.

The slowdown in public sector wage growth has been profound. As recently as 2013, public sector wages were rising nearly 20 % a year. By the end of 2014, however, on-year nominal wage growth had fallen to zero, while inflation was running at 11.4 %. Hence, real wages in the public sector fell substantially. Room for wage hikes is eroded by the collapse in oil prices and the government's reduced tax take due to the economic slowdown. These trends were already apparent last year, and this year's budget parameters are likely to bring more pain.

Private sector wages managed a better showing last year, but still lagged the inflation rate by a couple of percentage points. While pensioners managed better (pensions were raised last year about 10 % on average), soaring food prices have decimated their purchasing power. For pensioners, food constitutes a larger spending category than for the population on average.

The drop in real wages continued in the first two months of this year, and if this year's forecast of inflation at or above 12 % pans out, the decline in real wages would accelerate.

Growth in household incomes and inflation, % y-o-y



Source: Rosstat

At the beginning of March, Rosstat revised its consumer goods and services basket, increasing the share of food items by nearly a percentage point to 37.3 % of household spending. The consumer basket, which is used in measuring consumer price inflation, is reviewed annually on the basis of the previous year's structure of consumption. Food items make up on average 17 % of the EU consumer basket.

The average 2014 wage (excluding grey-sector wages) was about €650 a month. In January this year, due to a massive drop in the value of the ruble, the average monthly wage was only about €450. The average pension last year was €220 a month, but in January, that amount had fallen to just €150.

Finnish-Russian trade contracted last year. The value of Finnish goods exports to Russia last year was just €4.6 billion, its lowest level since 2009. While the value of exports was down 14 % y-o-y for all of 2014, it was down over 20 % in the final two months of the year. Russia, which accounts for 8 % of Finland's total exports, remained Finland's third largest export destination.

Exports declined for the second year in a row, with the rate of decline steepening last year as economic conditions in Russia deteriorated. Import restrictions imposed at the beginning of last August hindered Finnish food exports to Russia, the value of which contracted in the final months of 2014 by 60–70 % y-o-y. Exports to Russia, however, only generate about 3 % of total sales of Finland's food industry.

Finnish exports to Russia this year are set to contract further on the ruble's weakness and the recession the Russian economy is experiencing. Recovery in exports will take time as Russian economic growth is expected to remain weak for a while. Due to the significant reduction in re-exporting goods produced in third countries to Russia, a return to the previous high levels of exports seems unlikely. Finnish Customs estimates that the share of re-exports in Finnish exports to Russia fell from nearly 40 % to 24 % between 2008 and 2013.

Some re-exports are prone to huge fluctuations due to rapidly shifting production and logistics chains. Re-exports of cars and mobile phones from Finland to Russia soared in the early 2000s. When Finnish exports to Russia peaked in 2008 at around €7.6 billion, some €2 billion of that figure consisted of mobile phones and cars made elsewhere than Finland. Following the 2009 financial crisis, re-exports of cars and phones evaporated, with production structures and transport routes shifting so that the business is unlikely to ever return. With the collapse in re-exporting of cars and mobile phones, the biggest re-export categories became e.g. pharmaceuticals and tools. While the 2014 estimate of re-exports has yet to be released, re-exports already dropped far more in 2013 than other exports, following the pattern of 2009.

The direct impact of re-exports on Finnish output and employment is not as large as for other forms of export, because re-exported goods are not manufactured in Finland.

The value of goods imports from Russia contracted by nearly a fifth last year to €8.7 billion. Much of the shrinkage was due to the fall in oil prices; some 80 % of Finnish imports from Russia consist of mineral fuels. Russia was still the top goods provider for Finland, accounting for 15 % of Finland's total imports. Low oil prices have continued to depress the value of imports this year. In January-February, the price of Urals-grade crude oil averaged just over $50/bbl, down from nearly $110/bbl a year ago.

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China

China's struggling local governments can now convert more debts into bonds to deal with their debt problems. On Sunday (Mar. 8), the finance ministry announced it would allow local governments to issue municipal bonds this year totalling 1 trillion yuan (€150 billion). The money raised would be used to pay down high-interest loans owed by local government financial vehicles (LGFVs). A new quota adds to an earlier municipal bond quota of 500 billion yuan for this year.

It is not clear how bonds will be issued under the new quota, how old debt obligations will be swapped for new bonds or what protections investors might enjoy. It is also unclear which regions are authorised to issue these bonds. The finance ministry estimates, that the debt-servicing costs of local governments this year will decline by 40–50 billion yuan (€6–7 billion) with the refinancing arrangements.

Earlier, local government budgets were mandated by law to be balanced. This forced local administrators to create off-budget LGFVs to fund their investment projects. This highly opaque approach to financing stood out during the stimulus policies adopted in the wake of the international financial crisis in 2008–2009. At the moment, the indebtedness of local governments is estimated to be around 20–25 trillion yuan (€3.0–3.7 trillion), or around 30–40 % of GDP. Moody's estimates that about 2.8 trillion yuan (€420 billion) of local government debt comes due this year.

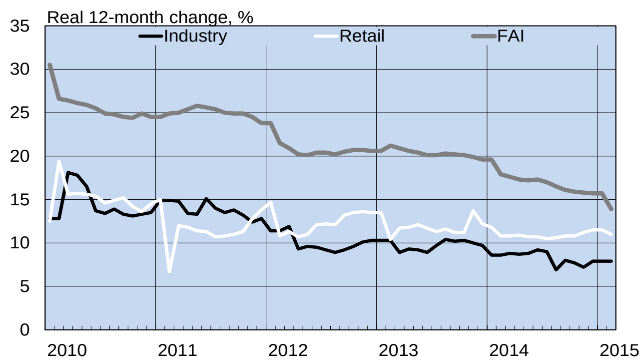
A representative of China's Banking Regulatory Commission warned this week that the indebtedness of local administrations constitutes the single largest risk to China's financial markets and fiscal policy. Budget documents, however, provide little indication as to the revenues that projects financed with debt will ultimately generate or how debt-servicing costs of local governments will be financed. This makes any attempt at risk assessment challenging. In any case, debt-swap agreements will only provide temporary respite to the deep debt problems of local governments.

Domestic demand shows signs of weakening in China. Several key economic indicators came in below market expectations for the first two months of this year. Among other things, the figures suggest a softening in domestic demand. January-February industrial output was up 7 % y-o-y, a percentage point less than in December 2014, while the markets expected 8 % growth. Weak domestic demand has been a large driver of slowing growth, while export growth continues to thrive. Although consumer demand is still robust, retail sales growth has also slowed by a percentage point from December. On-year growth in retail sales was 11 % in the first two months of this year.

The 12-month rise in consumer prices accelerated from 0.8 % in January to 1.4 % in February. While food prices largely explain the acceleration, prices in several other goods categories also increased. Producer prices are declining for the third year due to falling prices for energy and raw material inputs as well as industrial overcapacity. The slide in producer prices accelerated in February to 4.8 %.

Even with the slight pickup in inflation, real interest rates are still high, which for its part has slowed growth in fixed asset investment (FAI). FAI increased by 14 % y-o-y in the first two months of this year, down from 16 % in 2014. Growth in industrial investment slowed by 3 percentage points in January-February to 11 % y-o-y. In contrast, growth in real estate investment remained nearly unchanged at 10 %. Investment in infrastructure continued to grow at a 21 % y-o-y pace.

Industrial output, retail sales and fixed asset investment, %



Source: Macrobond

Boom in Chinese tourism balances goods trade surplus. The goods trade surplus hit record highs again in January and February, with exports rising 15 % y-o-y and imports dropping by 20 % y-o-y. The growth in exports reflected recovering demand in China's main export markets in Europe, North America and Southeast Asia. Exports to Russia and Japan contracted.

While the reduction in the value of imports largely reflected the on-going drop in global commodity prices, import volumes of commodities also declined. In addition to basic commodities, the value of other imported goods fell in the first two months of this year. This demonstrates the weak domestic demand, which is further indicated by the slowdown in industrial output growth despite strong exports.

The massive goods trade surplus is to some extent offset in the current account by the deficit in services trade, which continues to rise as Chinese travel abroad. Last year the goods trade surplus amounted to $470 billion, while the services trade deficit was just under $200 billion, with some 60 % of the services trade deficit generated by foreign travel. The number of Chinese tourist travelling abroad and the amounts they spend are expected to rise rapidly also in coming years.

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