Weekly Review
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BOFIT

Russia

Presidents of Russia and Turkey try to repair economic relations. Russia-Turkey relations cooled substantially last November after Turkey shot down a Russian fighter jet. Russia's retaliatory measures included restrictions on food imports, tourism and operations of Turkish construction companies in Russia. In late June, Turkish president Recep Tayyip Erdogan apologised for the downing of the Russian plane and Russian president Vladimir Putin cancelled the restrictions on Russians' traveling to Turkey and ordered the other sanctions under reconsideration. At the presidents' meeting in St. Petersburg at the start of the week, Putin said the sanctions on Turkey would be lifted gradually, but gave no specific timetable.

Putin and Erdogan also discussed joint energy projects such as the Turkish Stream gas pipeline and the Akkuyu nuclear power plant. Work on the Turkish Stream project came to a halt last summer, due e.g. to delay in issuing required permits in Turkey. Now Russia's energy minister stated that next negotiations are planned for October. The Akkuyu project was launched in 2010, but has made little progress due to legislative delays in amending Turkish law.

Russia's public sector planning a shift to domestic software. At the end of July, prime minister Dmitri Medvedev approved a plan aiming at the federal administration renounce foreign computer software and switch to domestic software by the end of 2018. Under the plan, the practice would be extended to include other administrative levels and state businesses by the end of 2020.

Software for public procurement was already earlier subject to import restrictions as part of Russia's import substitution policies. Other product categories subject to restrictions include e.g. pharmaceuticals and textiles. The economy ministry estimates that Russia's public procurement amounts to about 8 trillion rubles (€120 billion, 10 % of GDP) a year. Of that, about 1 trillion rubles was last year subject to import restrictions and preferential treatment for domestic producers. The economy ministry estimates that these policies have increased the prices of public procurements. The average price of public procurements subject to these policies rose 40 % last year, whereas the average price of all public procurements fell nearly 20 %. There has been discussion on extending import restrictions to cover also the purchases of enterprises owned by the public sector, but nothing concrete has materialised so far. The economy ministry put the 2015 value of these purchases at 23 trillion rubles or 30 % of GDP.

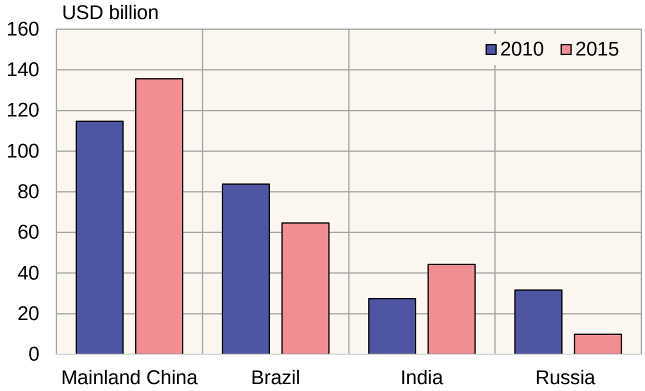
Russia's share of global investment falls sharply. The latest report from the UN agency UNCTAD finds that the flow of foreign direct investment into Russia last year slowed substantially to just $10 billion, about a third of levels in recent years. Most of last year's inflows consisted of re-invested earnings. The flow of new investment was very small.

Falling oil prices and geopolitical tensions, as well as additional restrictions on foreign media ownership, have dampened interest in new investment in Russia and caused some firms to pull back on investment (e.g. General Motors and Raiffeisen Bank) or pull out from the Russian market altogether (e.g. ConocoPhillips and Axel Springer).

The global flow of direct investment rose nearly 40 % last year. Only 0.6 % of global direct investment went to Russia. Russia's share in earlier years was about 2 %. The outflow of FDI from Russia to other countries was $27 billion last year, less than half the outbound FDI of 2014.

FDI flows to Kazakhstan fell last year by nearly half of the 2014 level. FDI flows to Ukraine, however, increased substantially from the previous year, when they hit a record low.

Foreign direct investment flows to BRIC countries in 2010, 2015



Source: UNCTAD WIR 2016.

Corruption, bad institutions and lack of openness dog Russian competitiveness. The World Economic Forum (WEF) global competitiveness index last year ranked Russia 45th among 140 countries surveyed. Russia had little success in institution-building, financial market development and commodity market efficiency. Corruption was the biggest obstacle to doing business. Russia's ranking actually improved slightly over the past decade: the WEF's 2005 survey ranked Russia 53rd of 117 countries surveyed.

Transparency International's Corruption Perception Index (CPI) measures perceived corruption of public sector agencies. The 2015 CPI ranked Russia at 119th of 168 surveyed, putting it on par with Azerbaijan, Guyana and Sierra Leone. TI noted that conditions that promote civil society development and press freedom have weakened in Russia. Such factors are considered important in fighting corruption. Russia ranked 126th of 153 countries in the 2005 survey.

The Heritage Foundation's 2016 Index of Economic Freedom ranks Russia 153rd out of 178 surveyed. Russia got low marks for rule of law (e.g. property rights and fighting corruption) and market openness (investment). The 2008 IEF ranked Russia 134th of 157 countries surveyed.

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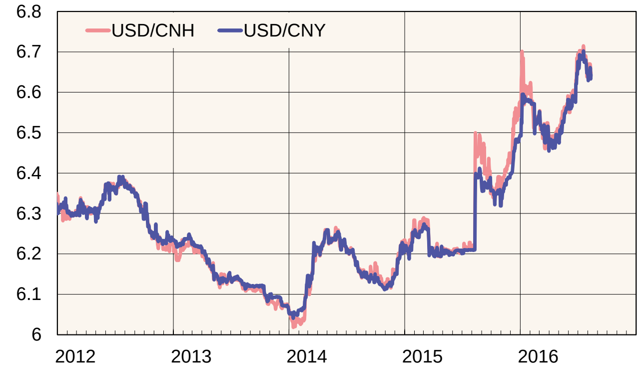
China

China's central bank tightens the control of capital flows. The yuan's slide this year has provided Chinese investors with motivation to take advantage of existing possibilities as well as invent new ways to sneak capital out of the country. In response, the People's Bank of China has tightened enforcement of capital controls and imposed new rules on commercial banks that limit large transfers of capital out of the country. The PBoC has considerable say in the operational aspects of commercial banking in China and lately "window guidance" policy has been used to control outbound capital flows. Media reports assert that commercial banks are now required to provide much more details of their clients' forex trading. Certain banks apparently are now also required to alert officials in advance of large forex purchases and some banks have had to limit repayment of forex loans ahead of payment schedule.

Private individuals are allowed under current law to purchase up to $50,000 in foreign currency each year, so many schemes have been devised to circumvent this rule. For example, Chinese customers have shown recent appetite for pricey Hong Kong insurance policies that pay out claims in dollars and are accepted as collateral for dollar loans. In February, China's State Administration of Foreign Exchange (SAFE) imposed a $5,000 ceiling on single UnionPay credit card purchases of financial products. UnionPay is China's national credit card company. The planned QDII2 programme to expand foreign investment opportunities for private Chinese investors has been put on ice and SAFE has not granted domestic institutional investors new foreign investment quotas since March 2015.

Yuan-dollar exchange rate onshore (mainland China, CNY) and offshore (Hong Kong, CNH).



Source: Macrobond

The capital outflow pressure also effects China's monetary policy. In its June quarterly report released last week, the PBoC warned that any lowering of the general reserve requirement would increase liquidity in the market, which might lead to increased depreciation pressure on the exchange rate and fuel speculative trading. These policy goals partly explain the PBoC's reliance on targeted lending programmes (e.g. MLF, PSL) at the moment. These have become key instruments of implementing monetary policy.

Capital outflows appear to have slowed this year compared to the second half of 2015 and China's foreign currency reserves have remained at around $3.2 trillion since January. This week the yuan gained slightly against the dollar. On Friday (Aug. 12), one dollar bought 6.64 yuan. The yuan has lost about 5 % against the dollar after last August's implementation of a revised exchange rate mechanism and a surprise 2 % devaluation.

Value of Chinese foreign trade declines, volume increases. The value of Chinese goods imports and exports measured in dollars has declined 7–10 % this year. Much of the decline reflects exchange rate shifts. The yuan was down about 7 % y-o-y against the dollar in July. As a result, a better perspective on foreign trade might be offered by volume trends. Volumes of both exports and imports have risen about 3 % y-o-y this year. Export growth accelerated slightly in the second quarter.

Export volumes rose in nearly all sub-categories. Export volumes in machinery & equipment, the largest sub-category, have increased on average about 1 % y-o-y over the first six months of this year. Exports growth was highest for coal, crude oil, gas and refined oil products. In a notable bifurcation of import trends, import volumes of commodities and foodstuffs have increased, while import volumes of industrial products have fallen from a year ago.

While the weak yuan has boosted price competiveness of Chinese products, export gains have been fairly slim. Moreover, a rapid rise in Chinese labour costs that has offsets at least partly gains in price competitiveness. Company surveys give a contradictory picture as to whether the export outlook has improved over the course of this year or not. The impact of yuan depreciation to Chinese exports is also diminished by the fact that it also means higher import prices. About 35 % of Chinese exports still consists of "processing trade," that is, export activities that involve assembly of imported components or processing of semi-finished imported products. In recent years, the share of processing trade in China's overall trade has dwindled and is expected to continue to fall in coming years.

Change in method of calculating Chinese GDP only marginally eases path to 2020 growth targets. China is targeting to double the GDP from 2010 level by 2020. Reaching this goal requires real GDP growth of nearly 6.5 % a year. Last month's change in the methodology for calculating GDP should make it only slightly easier for China to hit its growth targets. Many experts feel that the growth target is unreasonably ambitious and distorts economic policy.

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