Weekly Review
18 • 4.5.2018

BOFIT

Russia

Russian central bank keeps the key rate unchanged at 7.25 % p.a. The Central Bank of Russia's decision was mainly driven by increased geopolitical tensions that have led to ruble depreciation and a possible pick-up in inflation down the road. However, Russia's current inflation is moderate, reflecting a slow recovery in domestic demand. Also household inflation expectations in March reached a historical low. The CBR estimated consumer prices rose 2.3–2.5 % in April.

The CBR earlier estimated to reach this year an inflation-neutral interest rate of around 6–7 %, but now finds that the estimated neutral interest rate has shifted close to the upper bound of this range. The CBR said the shift reflects tightened monetary policy in advanced economies and an increase in Russia's risk premium.

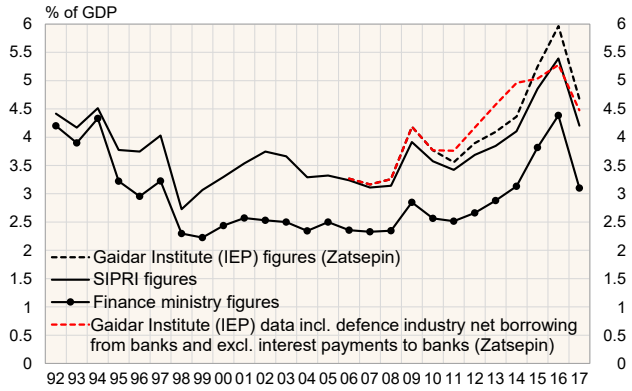
Russian defence spending declines, but remains substantial. Russia's finance ministry reports that government defence spending fell by 25 % in nominal ruble terms last year. The defence spending assessment of the Stockholm International Peace Research Institute (SIPRI) and calculations in the Gaidar Institute for Economic Policy (IEP) both suggest that Russian defence spending declined slightly less. The discrepancy reflects the fact that SIPRI and IEP figures include military spending outside the defence expenditure budget category, especially social security, homeland security and spending on the economy. Defence spending contained in these expenditure categories grew rather briskly last year, increasing their share in the accounting for total military spending. The share was 26 % in SIPRI figures and 33 % in data counted by IEP.

Overall, money flows from government budgets and domestic banks for defence fell notably last year. IEP bank figures mean the net flow of money also in 2017 was from the defence industry to banks due to the industry paying down principal and interest on bank loans. In 2016, the defence industry received a large sum from the federal budget to pay off bank loans. In contrast, in 2011–14 money flows to the defence industry were boosted with bank loans, raising the total flow to defence even faster than budget figures indicated.

The three sources mentioned all note the defence spending-to-GDP ratio in 2017 was similar to 2014 when spending had already surged. The finance ministry puts the ratio at slightly over 3 %, SIPRI 4.3 % and IEP 4.6 %.

SIPRI reports that US defence spending continued to fall in real terms in 2017, but otherwise spending in Russia's vast neighbourhoods continued to rise. During 2015–17, China and India increased their defence spending by 5.5–6 % a year. Annual spending growth in eastern central Europe and the Balkans was nearly 8 %, while spending of the Baltic countries rose at 20 % a year. Defence spending in western Europe rose 2 % a year. Turkey increased its spending by nearly 10 % a year, while Ukraine's spending, despite slight dips, was up 5.5 % from the 2014 level.

Ratio of Russian defence spending to GDP, %



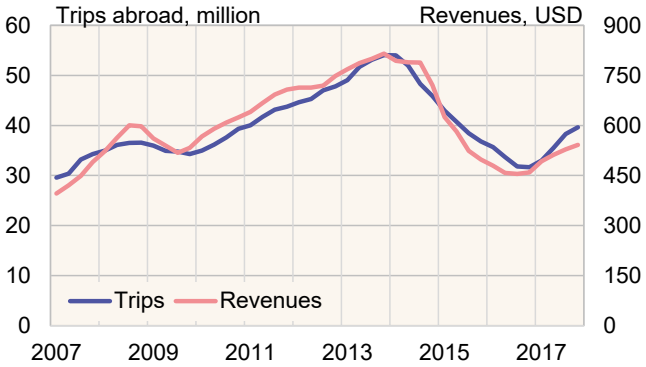
Sources: Russian finance ministry, SIPRI, IEP, Rosstat and BOFIT.

Russian tourism abroad up in 2017. Tourism rebounded last year in response to the mild economic recovery and ruble appreciation. Russians made 40 million journeys abroad and spent $31 billion on tourism, an increase of nearly 30 % y-o-y. The most popular tourist destination for Russians last year was Turkey, increasing nearly six-fold as Russia lifted its travel restrictions. Other popular destinations included neighbouring countries like Finland, Kazakhstan and China. Tourism is expected to grow briskly also this year.

A UN report finds that the total Russian tourism spending abroad was the eighth-largest in the world last year. The report also found that Chinese tourism spending abroad, by a large margin, was the biggest in the world. The Chinese last year made 143 million trips abroad (including Hong Kong) and spent nearly $260 billion. Relative to population, nearly one in three Russians travelled abroad last year, while one in ten Chinese travelled abroad.

Tourism from abroad to Russia has developed more weakly. In 2017, about 24 million foreign tourists visited Russia, a decrease of about 1 % from 2016. Russia's foreign tourism earnings were about $9 billion. The majority of foreign tourists came from CIS countries. Non-CIS visitors were most often from China or Finland. Tourism this year is expected to rise with the FIFA World Cup Soccer championships.

Russian travel abroad and average monthly income



Sources: CEIC and Rosstat.

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

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China

IMF GFSR: Complex corporate arrangements obscure risk assessment of China's financial sector. The IMF's latest *Global Financial Stability Report* released in April finds the Chinese financial markets remain susceptible to shocks, despite regulatory reforms by Chinese officials. The IMF repeated its message that China's large-scale and opaque interconnections within the financial sector continue to pose stability risks.

The traditional banking sector is linked to shadow banking sector through exposure to high-risk off-balance-sheet investment vehicles. In addition, insurance companies have invested extensively in poorly regulated investment products and depend on them to reach their profitability targets. Small banks and insurance companies are among the most exposed and vulnerable. They must deal with complicated financial instruments even as they poorly grasp the associated risks and are less prepared to absorb potential losses. The IMF welcomed China's decision to create a unified financial regulator (China Banking and Insurance Regulatory Commission, CBIRC), and expects it to bring about much-needed cooperation. The GFSR notes, however, that assessment of financial sector risk is complicated by opaque cross-holding arrangements and leverage structures, as well as a lack of clarity on the actual risk of investment products.

In April, IMF also released its *World Economic Outlook*. The IMF expects Chinese GDP to grow by 6.6 % this year and 6.4 % next year.

Higher foreign investor quotas for Chinese stock markets. The daily net purchase quota for foreign investors on the Shanghai and Shenzhen exchanges under stock connect arrangements with the Hong Kong stock exchange was quadrupled on May 1 to 52 billion yuan (USD 8 billion). Similarly, the allowed daily net purchases of Chinese investors on the Hong Kong exchange was quadrupled to 42 billion yuan. In mainland China, access to the Hong Kong stock exchange via stock connect is limited to large investors (investment assets over RMB 500,000 or about USD 80,000).

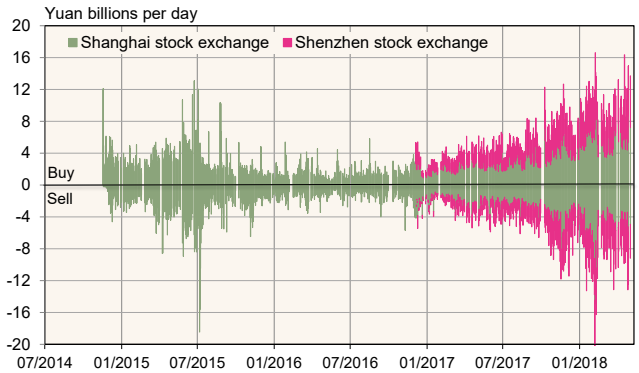
The increased quotas reflect last year's decision by share index publisher MSCI Inc. to include mainland China shares in its indices from the start of June (BOFIT Weekly 25/2017). Even if a large share of the China-weighting in indices will still come from Hong Kong-listed shares and the weighting of shares listed on mainland exchanges is marginal, many believe that the index reforms will increase trading under stock connect programmes.

The increased quotas, however, are of minor practical significance; purchases by foreign investors via the Shanghai exchange this year under stock connect has averaged just 5.7 billion yuan a day with sales of just 5.1 billion yuan. In other words, average net purchases rarely even approach the old daily quota of 13 billion yuan.

Foreign investor trading via the stock connect programmes on mainland exchanges has nevertheless increased. An average of 1–2 % of the Shanghai exchange's trading volume was generated by the stock connect programme between its launch (11/2014) and last summer. Since then, the stock connect share has risen to around 5 %. About 3 % of the Shenzhen exchange's trading volume is generated by the stock connect for foreign investors. The amount of Chinese investor trading under stock connect arrangements with the Hong Kong exchange has been roughly similar in value to foreign investor trading with mainland China bourses. Trading via the stock connects this year has accounted for an average of 13 % of the Hong Kong exchange's trading volume.

Overall, foreign ownership in mainland Chinese stock markets (through both stock connect and QFII and RQFII programmes) at the end of March was just 1,202 billion yuan, or 2 % of the exchanges' combined market capitalisation.

Trading volumes under stock connect programmes in mainland China stock exchanges



Sources: CEIC and BOFIT.

China eases operating possibilities of foreign firms in the financial sector. Besides boosting foreign investor quotas on Chinese stock markets, foreign securities firms this week gained the right to raise their ownership stakes in local Chinese securities firms from 49 % to 51 %. The 20 % ceiling on ownership by one foreign entity was abolished. The regulation of foreign holdings is supposed to be phased out completely over the next three years. The measures, announced by PBoC governor Yi Gang at the Boao economic forum last month, are part of efforts to accelerate opening up China's financial markets to international investors. Additional deregulatory measures of foreign companies operating in the financial sector are expected in coming months.

Based on the experience of previous years, foreign securities firms are wary of the proposed reforms. In April, the *Financial Times*, citing the Asian Securities Industry & Financial Markets Association (Asifma), noted that a draft bill presented in March on foreign securities firms seeking majority stakes imposed unreasonable burdens and favoured Chinese firms. Officials, at will, can in practice continue to thwart the expansion of Western businesses in China.

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