Weekly Review
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Russia

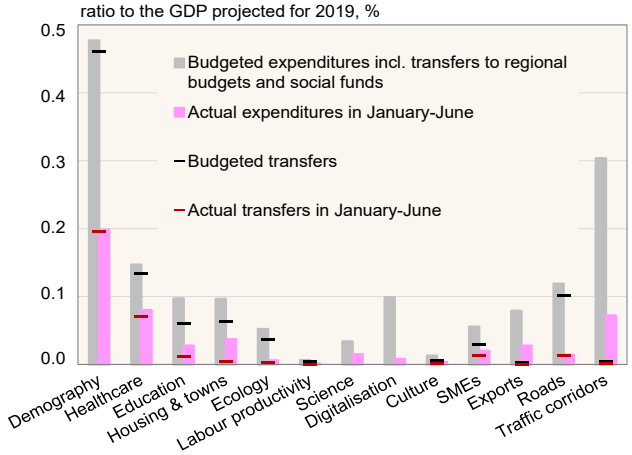
Implementation of Russia's national projects plods ahead. Total funding for the 13 national projects is scheduled to exceed 3 % of forecast GDP during 2019–2024. This includes the roughly 1 % of GDP ordered when the national projects were laid out in president Putin's inauguration decree (*ukaz*) in May 2018.

The funding of national projects comes from different sources. The equivalent of about 2.5 % of GDP is planned to come out of the consolidated government budget (federal, regional and local budgets plus state social funds). The rest should be provided basically by the corporate sector. Budget funding represents about 7 % of estimated total government sector budget spending, of which five percentage points will come out of the federal budget. The Accounts Chamber notes that most measures under the national projects are such that they are already being implemented under other government programmes.

The federal budget funding allocated for national projects this year exceeds 4.5 % of total government sector budget spending or about 1.5 % of this year's forecast GDP. About 96 % of the funding had already been given to the fund users by the end of June. Roughly a third of the money had been spent, but the situation varies considerably depending on the project. However, about 60 % of federal budget spending on the projects in January-June were transfers to regional budgets as well as the Pension Fund and Medical Insurance Fund.

Regional and local budget spending on project implementation has corresponded to about 60 % of realised project spending from the federal budget (includes transfers to regional budgets). Russia's finance ministry has set a general guideline that a 95% federal to 5 % regional division to project financing should be followed. At the moment, regions have thus coughed up a considerably larger proportion of the project financing. Information on corporate financing for national projects is yet to be released.

Federal budget funding of national projects in 2019



Sources: Finance ministry and Accounts Chamber of Russia.

UNCTAD's estimate of ultimate sources of foreign direct investment emphasises Western investment in China and Russia. As part of its annual international investment report, the United Nations Conference on Trade and Development (UNCTAD) released its first estimate of the ultimate origins and targets of foreign direct investment. According to the estimate, the United States and wealthy European states are the biggest sources of foreign direct investment in Russia. For China, the first three countries are Hong Kong, the United States and Japan.

Estimated ultimate ownership of inward foreign direct investment stock in 2017

Russia		$530 billion*	China		$2.726 trillion*
1	United States	8.9 %	1	Hong Kong	18.3 %
2	Germany	7.5 %	2	United States	9.7 %
3	United Kingdom	7.1 %	3	Japan	8.2 %
4	Russia	6.5 %	4	China	7.8 %
5	Netherlands	6.5 %	5	Germany	4.9 %
6	France	4.5 %	6	Singapore	3.8 %
7	Switzerland	4.3 %	7	United Kingdom	3.7 %
8	Singapore	2.9 %	8	Netherlands	3.0 %
9	Ireland	2.7 %	9	South Korea	2.9 %
10	China	1.6 %	10	France	2.5 %
11	Austria	1.5 %	11	Switzerland	2.3 %
12	Italy	1.5 %	12	Canada	1.6 %
13	Sweden	1.5 %	13	Taiwan	1.5 %
	Other	14.8 %		Other	11.9 %
	Unspecified	28.2 %		Unspecified	18.0 %

Sources: UNCTAD, CBR and PBoC.

**) Value of FDI stock based on the international investment position.*

Traditional figures only report the immediate source of foreign direct investment and make no attempt to track down its ultimate source. This distorts the figures as it is common to move money via third countries to gain e.g. tax advantages or legal protections. Especially in the case of Russia and China, countries specialised in financial services figure prominently. For example, Cyprus accounts for over a quarter of foreign direct investment to Russia, while Hong Kong is the immediate source of over half of China's FDI.

UNCTAD's method chains the official statistics on immediate investors in order to trace ultimate investors. While this removes the disproportionate representation of financial hubs, it does not precisely identify the ultimate source of investment. UNCTAD itself emphasises the experimental nature of their efforts aimed at filling in deficient data with simplifying probabilistic assumptions. The model's basic assumption is that ownership chains do not have any bias back towards their origins. In fact, investors often recycle investment via a financial hub back into their own country or a neighbouring country. As a result, the model may overestimate direct investment in Russia and China by foreigners and underestimate Russian and Chinese investment via financial hubs back to the home country.

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China

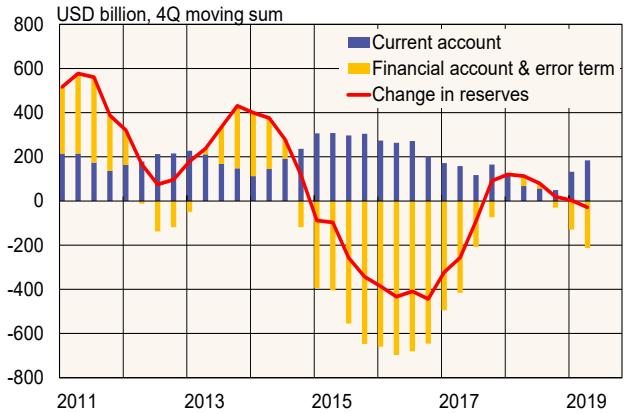
China's first-half 2019 current account surplus reached 106 billion dollars. China's current account showed a deficit in the first half of 2018, but finished the year with a surplus of 49 billion dollars. The 12-month current account surplus in the second quarter of this year rose to the equivalent 1.3 % of GDP, up from 0.4 % of GDP in 2Q18.

Growth in the current account surplus in the first half was largely driven by an increase of nearly 70 billion dollars in the goods trade surplus (223 billion dollars) from 1H18 as the value of exports grew by 1 % y-o-y and the value of imports fell by more than 5 %. Also the services trade deficit (129 billion dollars) diminished by about 20 billion dollars from 1H18. The goods trade surplus continued to rise in July.

While detailed financial account information has yet to be released, the published data are already adequate to establish that the capital outflow from China has increased. Based on the released information, the net outflow of capital from China in the first six months of this year was about 100 billion dollars. In 1H18, the net capital inflow into China was about 80 billion dollars.

The sharp decline in China's foreign currency reserves that began in the second half of 2014 came to a halt at the beginning of 2017. Since then, the amount of China's total foreign reserves has remained relatively stable at about 3.2 trillion dollars.

Main items in China's balance of payments



Sources: Macrobond, BOFIT.

Expanding US-China trade war complicates already difficult situation. In response to the US decision on August 13 to impose additional punitive tariffs on Chinese products at the start of September and in mid-December, China announced last Friday (Aug. 23) that it was imposing 5 or 10 % tariffs on about 5,000 American products. China will also reinstate in December its punitive tariffs on American cars and car parts that have been exempt from the retaliatory tariff scheme since the start of the year. The new tariffs target imports from the US valued at 75 billion dollars a year.

Immediately after China acted, president Donald Trump announced he was increasing the level of the punitive tariffs set to go into effect at the start of September from 10 % to 15 %, and all 25 % tariffs in place would rise to 30 % at the beginning of October. Trump exhorted American firms to seek alternatives to China and shift production back to the US.

The likelihood of resolving the US-China trade dispute in the near future is small as the conflict only seems to widen further. Trump linked trade talks to the Hong Kong demonstrations, saying that if China resorted to force in Hong Kong the chances of making a "deal" would become even smaller. Members of the US Senate this week proposed that the government cancel a decision by one of the biggest government pension funds to invest in China. China has let the yuan's exchange rate slide on currency markets as the trade war has ramped up. The yuan has lost about 3 % of its value against the dollar and euro this month.

China cuts subsidies on rail freight shipments to Europe. Rail connections between China and Europe have been a centrepiece of the Belt & Road Initiative (BRI) launched by China's leadership in autumn 2013. Because BRI is an important political project for China, authorities have lavishly subsidised shipping of freight containers by rail from China to Europe, which in turn has led to growth in rail freight volumes. The reduction in public support should affect the competitiveness of rail freight relative to shipping by sea or air.

Chinese media report that the formal cap of public subsidies for rail shipping to Europe peaked at 50 % in 2018. The top level of support will be reduced to 40 % this year, to 30 % next year, and subsidies should be abolished in 2022. Besides the central government, local governments have showered money on rail subsidies in efforts to garner real or imagined political points in BRI projects. Overall, the policies of subsidising rail freight to Europe are quite murky.

It is clear, however, that there are big problems associated with subsidy policies. Subsidies are a huge drag on public finances. Moreover, they have already encouraged fraud such as shipping empty containers just to collect the subsidy. The biggest issue, however, will be what happens to completed logistics investments in Europe and Asia once rail subsidies are phased out. The *South China Morning Post* reports that two rail connections between the northern China city of Harbin and Moscow and Hamburg did not operate last year due to insufficient public-sector subsidies.

The company China Railways Express (CRE) began shipping goods by rail from China to Europe in 2011. CRE and its partners currently offer shipping from about 60 Chinese cities to 53 European cities in 16 countries. While rail transport is suitable for e.g. cars, electronics, processed foods and clothing, only 3 % of the total value of goods (and only 1 % of the volume) shipped last year between China and Europe were shipped by rail. In comparison, air freight accounted for 27 % by value (2 % by volume) and maritime shipping 60 % (90 %).

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