BOFIT Weekly Review – Russia 2017

6 Jan 2017 BOFIT Weekly 2017/01
Center for Strategic Research report finds little progress in economic reforms
Russian employment numbers rose, while unpaid leave and part-time work increased
New data show distinctly milder recession in Russia than earlier reported

13 Jan 2017 BOFIT Weekly 2017/02
Costs to firms from regulatory practices discussed in Russia
No changes in Russian social entitlements for the time being
Russian inflation slowed substantially in 2016

20 Jan 2017 BOFIT Weekly 2017/03
Tepid growth outlook for Russia
Russia’s Reserve Fund shrank by 70 % last year
Russian imports exceed the level of a year ago

27 Jan 2017 BOFIT Weekly 2017/04
Russian output recovers, but consumption slump drags on
Russian oil production hits post-Soviet record; growth in output expected to slow
Extraordinary budget measures in Russia boosted federal revenues and expenditures in late 2016

3 Feb 2017 BOFIT Weekly 2017/05
Bank profitability improved in Russia, even with a decline in corporate borrowing
CBR to buy forex on the market for the finance ministry
Russia drops in TI corruption rankings

10 Feb 2017 BOFIT Weekly 2017/06
Official figures indicate Russian economy contracted only mildly in 2016
CBR holds key rate unchanged; policy outlook slightly adjusted
Industry recovers in Russia’s federal districts, while retail sales continue to contract

17 Feb 2017 BOFIT Weekly 2017/07
Varying performance in Russian manufacturing branches last year
Growth returns to Russian goods trade
Slight reduction in foreign debt of Russian banks and other firms

24 Feb 2017 BOFIT Weekly 2017/08
Russian government revenues and spending continued to decline in real terms last year
Procurements of public sector and state-owned enterprises in 2016 exceeded 30 % of Russian GDP
Russian social security system – expensive and rigid

3 Mar 2017 BOFIT Weekly 2017/09
Russia revises industrial output data
Russian government sector still dealing with austerity
Finnish exports to Russia finally on the rise

10 Mar 2017 BOFIT Weekly 2017/10
Despite stable oil prices, the ruble strengthens and Russia’s stock markets fall
Fixed investment by Russia’s large and mid-sized firms still in low territory

17 Mar 2017 BOFIT Weekly 2017/11
Several factors affect decline in Russian household income and spending
Number of passenger cars on the road in Russia rises from 26 million to 45 million in just ten years
24 Mar 2017 BOFIT Weekly 2017/12
Russian economic situation remains weak
CBR opens representative office in Beijing
European Commission invites comments on EU-Gazprom gas dispute

31 Mar 2017 BOFIT Weekly 2017/13
BOFIT forecast sees Russian economy returning to growth
CBR lowers key rate by 25 basis points
No decision yet on extending Russian oil production cuts

7 Apr 2017 BOFIT Weekly 2017/14
Russian GDP figures confirm economic recovery in final months of 2016
Russia and Turkey limit bilateral food trade
Ukraine receives its fourth IMF loan tranche

13 Apr 2017 BOFIT Weekly 2017/15
Russian foreign trade and capital outflow increased sharply in first quarter
Russian central bank and economy ministry expect sluggish recovery in coming years
In Russian labour markets wages adjust downwards relatively easily

21 Apr 2017 BOFIT Weekly 2017/16
Russia’s economic recovery: waiting
Russian ruble continues to strengthen
Russian federal budget revenues get a big boost from higher oil prices

28 Apr 2017 BOFIT Weekly 2017/17
New information on Russian industrial output
Russian government and businesses have cut back on investments
Russia announces changes in banking supervision and restructuring troubled banks

5 May 2017 BOFIT Weekly 2017/18
Russian central bank lowers key rate again
Change in the law pushes millions of Russians into Mir payment cards
Russian defence spending has increased rapidly

12 May 2017 BOFIT Weekly 2017/19
Inflation slows in Russia
Russian defence industry continued to show fast growth last year
Russian authorities reconsidering the idea of virtual currency

19 May 2017 BOFIT Weekly 2017/20
Russian GDP growth remains positive
Brisk growth in Russian foreign trade
EBRD continues financing freeze on Russian projects

24 May 2017 BOFIT Weekly 2017/21
Domestic demand in Russia recovers
Russian youth unemployment near European average
Arms sales still a minor share of Russian exports

2 Jun 2017 BOFIT Weekly 2017/22
Russia’s government budgets started to grow again; government drafted supplementary budget
FDI inflow to Russia boosted by the sale of Rosneft stake
Rapid growth in Finnish-Russian trade
Despite falling stock and oil prices, the ruble has appreciated this year. Investment sluggish in Russia. President Putin evaluates economic programme proposals.

Russia prepares to raise public sector wages. Car sales revive in Russia, while other sales remain weaker. Russia has not yet dipped into its oil funds this year.

Russia’s central bank lowers key rate and revises forecast up slightly. Despite promising signs, the basis of Russia’s economic recovery remains fragile. US drafts changes to economic sanctions imposed on Russia.

Ruble exchange rate turned to drop. Russian bank lending turning to growth. Russia seeks to increase food supply independence through trade and agriculture policies.

EU and Russia extend sanctions. Russia’s finance ministry proposes continuing the pension funding practice of last years. Life expectancies in Russia up sharply, but gap between men and women remains huge.

Recovery in Russian export earnings and imports continued in second quarter. Capital outflows from Russia paused. Russia’s deposit insurance agency is given the administration of Yugra Bank.

New Russian budget rule frames government spending; sovereign funds to be combined. This year’s IMF Article IV consultation provides important recommendations to Russia. Russian federal budget revenues and spending recover, but are still at a low level.


Russian central bank keeps key rate unchanged. Number of employed all-time high in Russia. Trump signs new Russian sanctions bill. Increase in area of land classed as Russian arctic – with much less budget funding.

Brisk growth in Russian goods trade continues. Russia has the most barriers to trade for European exporters. Industrial output in Russian regions rises, while consumption gradually recovers.

Russian growth accelerates. Moscow launches ambitious housing programme. Wages in Russian industry recover to pre-recession top levels.
Russia's industrial output recovery varied boldly in recent months. Recovery of Russian government budget revenues has brought rebalance. Russia's regional budgets and social funds benefit most from recovery in government budget revenues.

Central Bank of Russia takes over Otkritie Bank. Recovery in Russian fixed investment. Russia lowers import duties under its WTO commitments, while devising new barriers to imports.

Corporate profits in Russia decline to more conventional levels. Changes in area and country structure of Russian goods imports show some stabilisation. Rapid growth in Finland-Russia trade.

Chinese CEFC to acquire 14% stake in Russian oil giant Rosneft. Russia introducing new import restrictions on public sector and SOE procurements. Impact of support measures for Russian monotowns hard to determine.

Russian economy showing more signs of recovery. B&N Bank now under CBR administration. CBR lowers key rate; announces around 4% inflation target for coming years.

BOFIT sees Russian economy continuing moderate growth in coming years. Russia has plenty of college graduates, but spends little on education.

Russia's public sector finances recover this year; tightening expected next year. Much of Russia's GDP growth spurt last spring came from inventories. CIS countries have had to relax foreign exchange policies in recent years.

Russian export earnings and imports continue to recover rapidly, even if the fastest pace has slowed. Moderate net outflow of private capital from Russia. Russian GDP forecasts increased in recent months. Russian inflation hits historical lows.

Russia posts uneven economic performance in September. Changes planned for Russian public sector spending structure already next year. Russia wants to spur e-commerce.

Ruble strengthening returns. Russian budget revenues expected to rise on favourable economic forecast and planned tax hikes. Russians moving to mobile banking.

Russian central bank continues accommodating monetary policy. United States revises its economic sanctions regime for Russia. Nearly a fifth of Russian workers classed as working poor.
Brisk rise in Russian industrial producer prices
CEFC China Energy actively investing in Russia, but goods trade remains the focus of economic relations
Russia ranks higher in World Bank Doing Business survey than in most comparisons

Russian GDP growth slows
Slowing growth in Russian foreign trade
State enterprises and the state may generate around 40% of Russian GDP

Recovery in Russian output stalls
Russia posts record grain harvests
Proposed changes to Russian legislation could reduce economic transparency

Recovery in fixed investment in Russia slows
Russian FDI on the rise
Russia's 2018-20 monetary policy guidelines stress the role of inflation expectations

Russia reaches agreement with OPEC and other oil-producing countries on keeping cuts in place
The fastest recovery phase for Russia's government budgets is over
Finland at 100: Finnish-Russian trade recovering, while Russia's share of exports is low compared to history

Strict 2018 spending rules approved for Russia's federal budget and pension fund
Yamal peninsula LNG production comes on stream
CBR becomes sole owner of Otkritie Bank

Russian industrial output decreased; consumption continues to make a comeback
Another cut in the key rate from the CBR
CBR takes over Promsvyazbank
Alexei Ulyukayev, Russia's former economy minister, convicted of soliciting bribes
BOFIT Weekly Review – China 2017

6 Jan 2017 BOFIT Weekly 2017/01
China adds several currencies to its currency index
Even with no major shifts in Chinese economic outlook in December, the discussion on 2017 economic growth targets takes a new tone

13 Jan 2017 BOFIT Weekly 2017/02
After a bumpy start, most of 2016 was smooth sailing for mainland China’s stock exchanges
China’s currency reserves fell to $3 trillion last year
Chinese producer prices up 5.5 % y-o-y in December

20 Jan 2017 BOFIT Weekly 2017/03
Chinese smog alerts and other pollution problems back in the news
China’s foreign trade surplus shrank last year by USD 85 billion

27 Jan 2017 BOFIT Weekly 2017/04
Growth of Chinese economy continued to slow as expected last year
Chinese credit stock continues to rise faster than output
Central bank of China boosts liquidity of money markets ahead of New Year’s holiday week

3 Feb 2017 BOFIT Weekly 2017/05
Economies of China and US deeply intertwined
International acceptance of the yuan faces headwinds
Birth and urbanisation rates up in China last year

10 Feb 2017 BOFIT Weekly 2017/06
PBoC tightens monetary stance; policy toolbox needs clarity
China’s currency reserves fall below USD 3 trillion
Consensus growth forecasts adopt China’s growth targets

17 Feb 2017 BOFIT Weekly 2017/07
FDI spending of Chinese firms hit record in 2016
Reliability of China’s output statistics raise questions

24 Feb 2017 BOFIT Weekly 2017/08
Chinese inflation accelerates
Chinese still borrowing like there’s no tomorrow
China’s current account surplus fell below 2 % of GDP in 2016

3 Mar 2017 BOFIT Weekly 2017/09
Wage growth slows; Chinese wage levels already high among emerging economies
China establishes itself as major arms exporter and importer
Exports to China outperformed Finnish exports overall in 2016

10 Mar 2017 BOFIT Weekly 2017/10
China yet to abandon strict GDP growth target
Growing worries that the China Manufacturing 2025 programme may distort markets
Mobile payments catch on in China; PBoC developing own virtual currency

17 Mar 2017 BOFIT Weekly 2017/11
No big changes in China’s 2017 fiscal policy
No big changes at the start of the year in China’s economic situation
China foreign trade revived in the first two months of the year
Guangdong, China's largest province, has an economy as big as Spain's.
PBoC again slightly raised rates used in its financial market operations.
China's filings of international patent applications jump last year.

BOFIT forecasts managed slowdown in China's growth, but debt and sluggish reform cloud outlook.
OECD recommends China focus on economic reforms.

No big surprises during president Xi's visit to Finland.
Lower costs help boost profits of Chinese banks.
New data on yuan as reserve currency.

Xi-Trump meeting diminishes fears of deteriorating relations.
Rising housing prices in China bring both growth and increased risk to real estate markets.
China establishes new testing area in Hebei province.

Industrial output and government spending spurs Chinese economic growth in Q1.
IMF raises its growth outlook for China, but warns of dangers ahead.
Robust 1Q growth in Chinese goods imports.

IMF concerned about sustainability of China's financial system; China changes its tune on financial risk.
China keeps the yuan-dollar exchange rate steady.
Industrial prices rising quickly in China.

China announces tax cuts but corporate taxation overall remains high.
China's business environment increasingly challenging to American firms.
Lower growth of car production in China.

Rates rise as China attempts to quell rising indebtedness.
Central government increases scrutiny of local government borrowing arrangements.
Slight drop in Chinese share prices.

Rate of China's output slowed in April.
United States and China announce limited measures to promote more open markets.
China's Silk Road project moves ahead.

China's current account surplus dwindling.
Restrictions on apartment deals in Chinese cities slowed sales growth in April.
Tighter regulation of online news providers in China.

Moody's lowers China's sovereign credit rating for the first time in three decades.
Despite the lack of foreign interest, China moves to open its bond markets to the world.
China's change in exchange rate mechanism raises eyebrows.
Trade policy differences overshadow EU-China summit
Asian trade policy on hold
The big push of Finnish firms to invest in their Chinese affiliates came in 2015

Officials reveal falsification of statistical reporting in two Chinese provinces
China posts fairly stable growth numbers in May
Chinese foreign trade enjoyed buoyant growth in first five months of 2017

Chinese A-shares to be added to the MSCI EM index
Wages in China's public-sector last year increased faster than in the private sector
Environmental problems constitute a huge burden on the Chinese economy

China's fixed investment ratio drops slowly
China's state-owned enterprises embellish financial data while resisting capacity cuts
Mainland China exchanges shrug off MSCI index inclusion; foreign investors in wait-and-see mode

20th anniversary of Hong Kong's handover to China; integration with mainland continues
Foreign institutional investors can now invest in mainland China bond markets via Hong Kong

Consumer price inflation holds steady in China
Yuan use as a reserve currency unchanged; use in international payments declines
Funding deficit threatens pension system; China must move ahead with reforms

China's second-quarter economic growth still robust
China's National Financial Work Conference raises debt issue to top-priority status
Chinese debt levels continue to rise; households piling on debt

Most recent GDP growth forecasts agree with China's official growth targets
China drops FDI restrictions; European Chamber wants more market access
Foreign direct investment from China and to China contract

Housing prices continue to rise in China
Small steps forward in reform of Chinese state-owned enterprises
Despite orders to cut overcapacity in steel production, China's first-half output increases anyway

Tightened capital controls dampen Chinese capital exports, but fail to fix true problems
Robust growth in Chinese foreign trade

After a strong first half, China's economic numbers dip in July
China seeks to be the world leader in artificial intelligence
CPC tries to elevate its role in China's state-owned enterprises

IMF warns debt driven high growth raises risk of hard landing for the Chinese economy
China's augmented public sector deficit stays around 10 % of GDP
1 Sep 2017 BOFIT Weekly 2017/35
China's housing markets may be cooling
Chinese firms get new guidelines on investment abroad
Summer harvest of China's grain crops better than last year

8 Sep 2017 BOFIT Weekly 2017/36
China's key party congress set to kick off on October
Finland-China trade soared in the first half
Trade with North Korea has little economic significance for China and Russia

15 Sep 2017 BOFIT Weekly 2017/37
Yuan appreciated substantially against the dollar
Margins of China's big banks narrow
Chinese inflation accelerated in August

22 Sep 2017 BOFIT Weekly 2017/38
Fixed investment subdues Chinese economic growth
EU Commission proposal for increased oversight of corporate acquisitions gets mixed reception
China shuts down cryptocurrency-related activities

29 Sep 2017 BOFIT Weekly 2017/39
BOFIT expects China's growth to slow; financial market worries on the rise
China's indebtedness still continues to rise
S&P lowers China's credit rating

6 Oct 2017 BOFIT Weekly 2017/40
European Union Chamber of Commerce in China wants to see promised reforms implemented
China has the most industrial robots
Chinese tourism continues to grow rapidly; emphasis shifting to domestic tourism

13 Oct 2017 BOFIT Weekly 2017/41
Central bank governor wants to speed up the opening of Chinese economy
China to lower bank reserve requirements in January
IMF raises its growth forecast for China, but warns of rising debt problems

20 Oct 2017 BOFIT Weekly 2017/42
President Xi Jinping sets out China's goals in opening address to party congress
Growth in Chinese goods imports remains strong
Rise in Chinese producer prices accelerates

27 Oct 2017 BOFIT Weekly 2017/43
China's new communist party line-up takes shape
China's top central banker lays out risks to the economy
Chinese GDP growth remains steady

3 Nov 2017 BOFIT Weekly 2017/44
First time since 2004, Chinese government issued a small amount of sovereign dollar debt
Slight acceleration in pace of Chinese wage growth this year
China's fight against air pollution intensifies, bringing new problems for industry and growth targets

10 Nov 2017 BOFIT Weekly 2017/45
Few surprises emerge from Trump-Xi meetings
China's current account surplus shrinks; foreign currency reserves increase
China opens up financial sector to foreign entities
China's economic growth slowed as expected in October
Rapid growth in Chinese goods imports continued in October

Chinese debt levels continue to rise
China tightens regulation of asset management products
Outward FDI growth of Chinese firms stalls this year

China's Silk Road Project targets countries of Central and Eastern Europe (CEE)
China lowers import duties on consumer goods
Coal will still account for over half of Chinese power generation in 2030

Finland at 100: China's significance as a trading partner continues to rise
Trade policy disputes impair China's relations with the West

IMF sees complexity and opacity of China's financial system as threats to financial stability
China's new financial market regulator begins operations
European Union, United States and Japan align their China trade policy

People's Bank of China tightens monetary stance a bit
China's leaders lay out areas of economic emphasis for next three years
Chinese taking on more debt to buy apartments; housing prices flat
Russia

New data show distinctly milder recession in Russia than earlier reported. Revised Rosstat GDP figures for 2015 show GDP contracted just 3 %, rather than 3.7 % as reported earlier. The new figures for key demand components indicate that a smaller drop in private consumption from 9.5 % to slightly below 9 % was largely responsible for reducing the GDP contraction. Private consumption accounts for about half of Russian GDP. The GDP number also improved as there was a change in the statistical discrepancy figure that is contained within the demand components. On the supply side, the largest components mitigating the fall in GDP were trade and the construction sectors, as well as public administration.

The upwardly revised 2015 GDP figure did so far not impact Rosstat figures for the first half of 2016. The first data for the third quarter of the year confirm that domestic demand in Russia was no longer very much smaller than in 3Q2015 (private consumption was down about 3 % and fixed investments down about 0.5 %). After a weak first half, Rosstat reports that the volume of Russian exports of goods and services in the third quarter was up by nearly 7 % y-o-y. Goods and services imports declined by no more than 3 %.

GDP, imports, demand components in 2012–2016, % change

<table>
<thead>
<tr>
<th></th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
<th>1-3Q16</th>
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<tbody>
<tr>
<td>GDP</td>
<td>3.5</td>
<td>1.3</td>
<td>0.7</td>
<td>-3.0</td>
<td>-0.7</td>
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<td>Imports</td>
<td>9.7</td>
<td>3.6</td>
<td>-7.6</td>
<td>-25.5</td>
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<td>Private consumption</td>
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<td>4.4</td>
<td>1.8</td>
<td>-8.8</td>
<td>-4.2</td>
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<tr>
<td>Public consumption</td>
<td>2.5</td>
<td>1.4</td>
<td>-1.5</td>
<td>-2.6</td>
<td>-1.3</td>
</tr>
<tr>
<td>Fixed investments</td>
<td>6.0</td>
<td>0.9</td>
<td>-0.3</td>
<td>-8.4</td>
<td>-4.4</td>
</tr>
<tr>
<td>Exports</td>
<td>1.4</td>
<td>4.6</td>
<td>0.5</td>
<td>3.7</td>
<td>0.4</td>
</tr>
</tbody>
</table>

Source: Rosstat.

Russian employment numbers rose, while unpaid leave and part-time work increased. Despite recession, Rosstat’s employment survey finds the number of people employed declined just modestly in 2015 and increased slightly last year. The biggest employment gains were seen in the fields of education, healthcare and social services. The employment rate among people aged 15–72 rose to around 66 %.

The survey finds the good employment trend has been reflected in a significant reduction in the number of people outside the workforce but wanting to work. In addition, the number of unemployed persons, which rose in 2015, dropped tangibly in the final months of 2016. The official unemployment rate was 5.4 % for the October-November period.

In contrast, Rosstat’s monitoring of firms in Russia found that the number of workers on unpaid leave in the survey increased by about 4 % between autumn 2014 and autumn 2016. Their share of all workers on payrolls in the companies covered by the survey, already notable earlier, reached 8.4 % last autumn. About a third of workers on unpaid leave worked in manufacturing businesses. Their share of workers in manufacturing was nearly 17 %. Unpaid leave in industries producing machinery, equipment & transport vehicles affected nearly a fifth of workers in that sector. The number of workers employed part-time in surveyed firms also increased. Part-time workers made up about 2.5 % of all those employed in autumn 2016 and about 3 % in the manufacturing industries.

Center for Strategic Research report finds little progress in economic reforms. A new report from the Center for Strategic Research (CSR), which is headed by Russia’s former finance minister Alexei Kudrin, came out at the end of December. The report is based on expert assessments of Russia’s progress in implementing economic reforms. Special attention was given to measures proposed in the unofficial “2020 strategy for developing the Russian economy” laid out by a vast group of experts in 2011. The report findings will be used by the CSR in drafting its 2018–24 economic development programme at the request of president Putin.

The report claims that less than a third of the reform measures laid out in the 2020 strategy have been implemented. In addition, measures already in place are mostly technical and deeper systemic reforms have been largely avoided. Monetary and fiscal policy are areas where the most reform success has been achieved. Examples include the shift to a floating ruble exchange rate and introduction of the “budget rule”. In many key areas of the economy not a single proposed reform has been fully implemented, and the response in some cases has even directly contradicted the reform proposal. These areas include shifting to a new growth paradigm, improving the business environment, reducing the state’s role in the economy, improving the quality of institutions and stemming Russia’s brain drain.

The report noted several obstacles to reform. A central problem is Russia’s administrative structure. The president alone has sufficient authority and resources to push through reforms. Given the vast amount of needed reforms, it is impossible that all could be personally shepherded by the president. Several respondents pointed out that reforms have been complicated also by other factors. Earlier high oil prices provided an easy excuse for putting off reforms, while in recent years geopolitical developments have led to a reordering of national priorities, with economic issues getting moved to a back burner. In addition, reforms face increasing resistance by different interest groups aiming to preserve their own advantage. On preparing development programmes, the report notes that the priorities should be formulated more carefully and precisely and resources mainly focused on realising these priority goals.

To enable reform implementation in the future, the report proposes e.g. the establishment of a new body to coordinate reform policies. It would have its own budget, staff and authority over ministries to implement reforms.
China

Even with no major shifts in Chinese economic outlook in December, the discussion on 2017 economic growth targets takes a new tone. The government’s official purchasing manager indexes (PMIs) for December declined slightly from their November readings. The manufacturing PMI fell from 51.7 in November to 51.4 in December, while the services PMI went from 54.7 to 54.5. An index reading above 50 indicates expansion from the previous month, while a reading below 50 signals a contraction in output.

The private Caixin/Markit manufacturing purchasing managers index, which focuses more on sentiment in small and medium-sized firms, saw a rise in its December reading to 51.9. While the official and private PMI indexes showed conflicting directions in December, their readings suggest economic conditions improved in 2016.

China’s 2016 GDP figures will be released on January 20. Earlier information suggests that economic growth in 2016 likely slowed modestly from the 6.9% pace of 2015. The growth is expected to slow further this year, as the debt situation worsens, uncertainty in the real estate sector continues and the net outflow of capital persists limiting possibilities to stimulate the economy. Rising market interest rates and possible disputes over trade policy with the incoming Trump administration have further clouded China’s growth prospects.

Yet even with lower growth, however, the performance of the Chinese economy should far exceed the global growth rate. Therefore, proponents of reform policies and sustainable growth welcome some recent comments on China’s growth targets. Bloomberg reported a couple weeks ago president Xi Jinping saying to economic decision-makers of the Communist Party of China he is ready to abandon the current blind pursuit of growth targets. This move is part of a wider reform policy committee called for more flexible growth targets. This should be based on the previous day’s ending rate and forecast forex supply and demand in the markets. Besides the CFETS RMB index, the PBoC publishes indexes based on BIS and SDR currency baskets.

China adds several currencies to its currency index. The People’s Bank of China announced last week that from the start of 2017, its China Foreign Exchange Trade System (CFETS) RMB currency basket would be expanded from 13 currencies to 24 currencies. The added currencies are the Korean won, Turkish lira, Mexican peso, South African rand, Hungarian forint, Polish zloty, Swedish krona, Danish krone, Norwegian krone, as well as the Saudi Arabian riyal and United Arab Emirates dirham, which are both pegged to the dollar. The practical effects of basket expansion on the CFETS RMB index are likely to be minor. Moreover, it is still unclear whether there is any real need for the RMB currency index announced in December 2015 or what purpose it serves. The use of an index based on a large currency basket is not user-friendly, and dollar’s central role remains in any case. On every trading day, the PBoC announces its daily “fixing” rate against the dollar, and allows yuan to fluctuate within a 2% band from the fixing that does not trigger central bank’s automatic intervention. Market-makers report their anticipated fixing rate for the next day, which since the summer 2015 reform should be based on the previous day’s ending rate and forecast forex supply and demand in the markets.

During 2016, uncertainty over the performance of the Chinese economy accelerated capital outflows and caused the yuan’s exchange rate to weaken 6% against the dollar and 4% against the euro. The real effective (trade-weighted) exchange rate, or REER, which reflects the price competitiveness of Chinese goods, was down 7% y-o-y in November.

To quell depreciation pressure on the yuan, China has tightened capital controls and increased their oversight as well as intervened in forex markets. Interest rates are rising on both domestic money markets and in Hong Kong, where the offshore CNN 7-day interbank rate today (Jan. 5) rose to 18%. Media reports suggest that China is planning further measures to deal with depreciation pressure on the yuan. The yuan’s exchange rate has strengthened in recent days. Today, one dollar bought 6.88 yuan and one euro 7.26 yuan.

Yuan CFETS and REER indexes, CNY-USD exchange rate

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Russia

Russian inflation slowed substantially in 2016. Consumer prices were up 5.4 % y-o-y at the end of December, the lowest pace for 12-month inflation since spring 2012. Inflation was nearly 13 % at the end of 2015.

Most of the slowdown in inflation came from a relatively modest rise in food prices, up just 4.6 % last year compared to 14 % in 2015. Food makes up a very large part of the price basket of consumer goods and services. Last year, food (including alcoholic beverages) was 38 % of the basket, a slightly larger share than in previous years. Two food categories distinctly supported overall price moderation. Prices of greens, root vegetables and fruits, which rose rapidly in 2015, were at the end of 2016 considerably below the level of end-2015. Meat and meat products, which for many years have represented nearly 10 % of the consumer basket, only rose slightly compared to the rise in 2015. This was also reflected in the small increase in the price of the official minimum food basket (up a bit more than 3 % last year, compared to almost 9 % in 2015), even if prices of milk and dairy products were up nearly 10 % in 2016.

The rise in prices of non-food goods also slowed, but was still 6.5 % at the end of December. Among them, overall disinflation was mostly supported by a notably milder rise of prices than in 2015 in two categories: passenger cars and clothing & textiles (9 % and 7 % basket shares, respectively). The prices of services rose 10 % in 2015, but less than 5 % last year. A marked effect came from housing costs which rose considerably more slowly than in recent years (they make up 9 % of the consumer price basket). Especially increases in natural gas rates for households were again below inflation.

The most distinct factor underlying the slowdown in inflation was the ruble’s recovery in the course of 2016. The average exchange rate for 2016 was only around 5 % less than in 2015, when the fall was 25 %. In addition, the rise in producer prices moderated significantly, which also reduced pressure to raise consumer prices.

No changes in Russian social entitlements for the time being. The national minimum wage will increase by 300 rubles to 7,800 rubles (€120) a month, but only in June 2017. The labour ministry notes the change will affect about 900,000 wage-earners, over 70 % of whom work in the public sector. The minimum wage was last increased in June 2016. Although the minimum wage has been increased substantially in previous years, it remains well below the average subsistence minimum. The monthly subsistence minimum nationally for working-age people is 10,700 rubles (€170), but varies considerably across regions.

As its name implies, the minimum wage sets a national minimum. Regions are free to mandate higher minimum wage levels. For example, the official minimum wage in Moscow at the end of last year was 17,300 rubles (€270), only slightly less than the local subsistence minimum. The level of the minimum wage also affects many social entitlements.

At the beginning of February, pensions will be adjusted to reflect last year’s realised inflation rate. However, no similar index adjustment is planned for maternity assistance (matkapital). The lump sum benefit paid to families with two or more children is 453,000 rubles (€7,100). It is designed to support, e.g., improving family housing conditions.

Costs to firms from regulatory practices discussed in Russia. Official inspections and Russia’s new security-related laws were focal topics last year. Mikhail Abyzov, minister charged with improving administrative transparency, said that Russia annually conducts 2 million official inspections that cost the equivalent of 5 % of GDP. Inspections generate considerable paperwork and tie up company employees for processes that often last several weeks.

Inspections are numerous, but ineffective. As an example, Abyzov noted that deaths from alcohol poisoning in Russia are 20 times higher than the OECD average. In December, nearly 80 people died from poisoning in the Irkutsk region from drinking bath liquid, which, despite its labelling, contained methanol. Following the tragedy, the local deputy director for consumer protection was arrested and a national month-long ban was put on retail sales of several high alcohol-content products not intended for human consumption. Cosmetics boutiques and pharmacies criticised the breadth of the ban and its ineffectiveness in dealing with the problem.

Official inspections can be scheduled or unscheduled. A survey of the Russian union of industrial firms found that about 90 % of firms experienced scheduled inspections conducted in 2015, but about half of firms also experienced at least one surprise inspection. Some 14 % of surprise inspections had been ”requested” by competing firms and about 20 % by officials. A new study from the St. Petersburg European University finds a negative relationship between the number of inspections and corporate profitability, even when companies can prepare themselves for planned inspections. Inspection problems have been discussed for years, and the government is trying to solve them with a priority project.

The costs of legislative amendments relating to national security have also raised discussion. Russia’s tighter anti-terrorism legislation (the Yarovaya laws) approved in July, includes a requirement that firms offering telecom and data transfer services retain managed data and turn over on request such data to security officials. While estimates on the storage costs vary, an expert group estimate given to the government says they will cost firms about 5.2 trillion rubles (€70 billion). The law should enter into force in June 2018. Another law that came into force recently requires that firms handling personal data must store the data in Russia, creating more costs for firms, especially foreign firms. At the end of 2016, Russian officials shut down the LinkedIn website after inspectors declared it out of compliance with the law.
China

Chinese producer prices up 5.5 % y-o-y in December. The recovery in producer prices in China reflects higher commodity prices, the yuan’s weakening against the dollar and higher capacity utilisation. In contrast, the rise in consumer prices slowed to 2.1 % y-o-y in December. Core inflation, which excludes food and energy prices, remained unchanged from the November 1.9 % figure.

Higher producer prices have reduced worries about deflation and the need for additional stimulus.

After a bumpy start, most of 2016 was smooth sailing for mainland China’s stock exchanges. At the end of last year, China’s main stock indices were down about 10 % y-o-y. This reflects the crash in share prices in January 2016 induced partly from the failed introduction of an automatic circuit breaker mechanism to interrupt trading. The mechanism was decommissioned after four days of chaos. After January, China’s main share indices rose over 15 %. Chinese stock exchanges this year have seen a much calmer start.

The market capitalisation of the Shanghai stock exchange at the end of 2016 was about $4.1 trillion (40 % of GDP), while the market cap of the Shenzhen exchange was $3.2 trillion (30 % of GDP). In terms of market capitalisation, they were the fourth-and fifth-largest exchanges in the world after the New York Stock Exchange, NASDAQ, and the Tokyo Stock Exchange. Although share trading volumes today are less than half their 2015 peak, the Shanghai exchange is still second after the NYSE, and Shenzhen is number four directly after the NASDAQ in trading volume. At the peak of the 2015 stock craze, the Shanghai and Shenzhen exchanges were the world’s largest in terms of trading volume.

IPOs have accelerated in recent months. Last year, a total of more than 200 new listings took place on the Shanghai and Shenzhen exchanges, with several hundred firms still awaiting listing dates. Since summer 2015, when the stock market slide began, IPOs have often been postponed for months. Reform of the listing process and moving to a registration basis have long been under preparation.

Foreign investors remain reluctant to trade in mainland China’s stock markets via the 2-year-old Hong Kong-Shanghai Stock Connect arrangement or the Shenzhen-Hong Kong Stock Connect, which launched in December. In 2016, only 1.5 % of the Shanghai exchange’s turnover involved trading of foreign investors using Stock Connect. For Shenzhen, the share was just 0.5 % in December. Moreover, most trading activity was churn, so Stock Connect has done little to increase foreign investor participation. Trading of large mainland Chinese investors in Hong Kong rose in 2016. In December, trading of Chinese investors via the Shanghai and Shenzhen exchanges accounted for 9 % of the Hong Kong exchange’s daily turnover.

Mainland China’s major stock indices, 1.1.2015–12.1.2017

Source: Macrobond.

China’s currency reserves fell to $3 trillion last year. Since 2014, China’s large trade surpluses have not been sufficient to cover the deficit caused by capital outflows. Even with a brief idling period in the first half of 2016, China’s foreign currency reserves have been shrinking steadily. Last year reserves declined by about $320 billion.

The reduction in reserves poses no threat to China’s external liquidity. Reserves are still large relative the country’s short-term foreign debt and value of imports. Nevertheless, the outflow of capital, shrinking reserves and depreciation pressure on the yuan feed a vicious cycle that leads to recurring market disturbances and further tightening of capital controls that make the current situation untenable.
Russia

Russian imports exceed the level of a year ago. Spending on imports of goods and services was up about 5 % y-o-y in the fourth quarter of 2016, the first increase since 3Q2013. Goods imports increased by about 10 %. The decline in services imports was down less than in many previous quarters, cushioned by a smaller-than-earlier drop in spending by Russian travellers abroad (-10 %). Russia’s export earnings recovered close to the 2015 level. The fourth quarter current account surplus, however, was still relatively small.

The direction of net private capital flows of the corporate sector turned slightly inward in the fourth quarter. The shift came from the sale of Rosneft shares to foreign investors, a transaction that also sharply boosted direct investment flows into Russia. While direct investment outflows remained small, firms took notable amounts of other types of capital out of the country. Bank repayments of foreign debt remained distinctly smaller than in the peak periods of 2014–2015.

Main categories in Russia’s balance of payments, 2014–2016

<table>
<thead>
<tr>
<th>USD billion</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
<th>% of GDP 2014</th>
<th>% of GDP 2015</th>
<th>% of GDP 2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current account</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Exports (goods &amp; services)</td>
<td>563</td>
<td>393</td>
<td>329</td>
<td>27.7</td>
<td>29.4</td>
<td>26.5</td>
</tr>
<tr>
<td>- Imports (goods &amp; services)</td>
<td>429</td>
<td>282</td>
<td>266</td>
<td>21.1</td>
<td>21.1</td>
<td>21.4</td>
</tr>
<tr>
<td>Trade balance (goods)</td>
<td>134</td>
<td>111</td>
<td>63</td>
<td>6.6</td>
<td>6.3</td>
<td>5.1</td>
</tr>
<tr>
<td>- Exports</td>
<td>497</td>
<td>341</td>
<td>279</td>
<td>24.4</td>
<td>25.6</td>
<td>22.5</td>
</tr>
<tr>
<td>- Imports</td>
<td>308</td>
<td>193</td>
<td>191</td>
<td>15.1</td>
<td>14.5</td>
<td>15.4</td>
</tr>
<tr>
<td>Services trade balance</td>
<td>-55</td>
<td>-37</td>
<td>-24</td>
<td>-2.7</td>
<td>-2.8</td>
<td>-2.0</td>
</tr>
<tr>
<td>- Exports</td>
<td>66</td>
<td>52</td>
<td>50</td>
<td>3.2</td>
<td>3.9</td>
<td>4.0</td>
</tr>
<tr>
<td>- Imports</td>
<td>121</td>
<td>89</td>
<td>74</td>
<td>6.0</td>
<td>6.6</td>
<td>6.0</td>
</tr>
<tr>
<td>Other current account</td>
<td>-76</td>
<td>-43</td>
<td>-41</td>
<td>-3.7</td>
<td>-3.2</td>
<td>-3.3</td>
</tr>
<tr>
<td>Financial account &amp; net error</td>
<td>-123</td>
<td>-67</td>
<td>-62</td>
<td>-6.1</td>
<td>-5.0</td>
<td>-4.0</td>
</tr>
<tr>
<td>Government (excl. central bank)</td>
<td>30</td>
<td>-10</td>
<td>3</td>
<td>1.5</td>
<td>-0.7</td>
<td>0.3</td>
</tr>
<tr>
<td>Private sector total (A+B)</td>
<td>-151</td>
<td>-58</td>
<td>-56</td>
<td>-7.4</td>
<td>-4.3</td>
<td>-1.3</td>
</tr>
<tr>
<td>A. Banks</td>
<td>-66</td>
<td>-34</td>
<td>-9</td>
<td>-4.2</td>
<td>-2.6</td>
<td>-0.4</td>
</tr>
<tr>
<td>B. Other private sector</td>
<td>-65</td>
<td>-24</td>
<td>-11</td>
<td>-3.2</td>
<td>-1.8</td>
<td>-0.9</td>
</tr>
<tr>
<td>- Direct investment</td>
<td>-38</td>
<td>-15</td>
<td>8</td>
<td>-1.8</td>
<td>-1.1</td>
<td>0.6</td>
</tr>
<tr>
<td>- Inbound</td>
<td>18</td>
<td>6</td>
<td>26</td>
<td>0.9</td>
<td>0.4</td>
<td>2.1</td>
</tr>
<tr>
<td>- Outbound</td>
<td>55</td>
<td>20</td>
<td>18</td>
<td>2.7</td>
<td>1.5</td>
<td>1.4</td>
</tr>
<tr>
<td>- Portfolio investment</td>
<td>-18</td>
<td>-8</td>
<td>-3</td>
<td>-0.9</td>
<td>-0.6</td>
<td>-0.3</td>
</tr>
<tr>
<td>- Inbound</td>
<td>-12</td>
<td>-5</td>
<td>1</td>
<td>-0.6</td>
<td>-0.4</td>
<td>0.1</td>
</tr>
<tr>
<td>- Outbound</td>
<td>6</td>
<td>3</td>
<td>1</td>
<td>0.3</td>
<td>0.2</td>
<td>0.3</td>
</tr>
<tr>
<td>- Foreign currency cash *</td>
<td>9</td>
<td>14</td>
<td>6</td>
<td>0.4</td>
<td>1.1</td>
<td>0.5</td>
</tr>
<tr>
<td>- Fictitious transactions</td>
<td>-9</td>
<td>-1</td>
<td>-1</td>
<td>-0.4</td>
<td>-0.1</td>
<td>-0.1</td>
</tr>
<tr>
<td>- BoP net errors and omissions</td>
<td>8</td>
<td>4</td>
<td>0</td>
<td>0.4</td>
<td>0.3</td>
<td>0.0</td>
</tr>
<tr>
<td>Other</td>
<td>-17</td>
<td>-18</td>
<td>-21</td>
<td>-0.9</td>
<td>-1.4</td>
<td>-1.7</td>
</tr>
</tbody>
</table>

* Positive value = decrease in the stock of foreign cash

Source: CBR.

Russia’s Reserve Fund shrunk by 70 % last year. The value of the Reserve Fund fell from about $50 billion at the end of 2015 to $16 billion (972 billion rubles) at the end of 2016. The amount drawn down from the Reserve Fund was anticipated in the budget. Government spending in Russia typically spikes at the end of the year, and over 40 % of the withdrawals from the Reserve Fund last year took place in December. The government also credited from slightly over $11 billion in income from the sale of a 19.5 % stake in Rosneft to the December budget figures. Even by previous years’ standards, however, government spending was exceptionally high in December. Russia provided 800 billion rubles (about $13 billion) to defence firms to pay back their bank loans guaranteed by the state (see BOFIT Weekly Review 44/2016). The move is intended to assure that defence contractors are able to borrow money and operate.

As always intended, assets from the Reserve Fund were used last year to cover the budget deficit. Finance minister Anton Siluanov said the federal budget deficit last year was 2.95 trillion rubles, or about $44 billion. That corresponded to 3.6 % of GDP, slightly below the budget forecast of 3.7 %.

The value of Russia’s other sovereign oil savings fund, the National Welfare Fund, stood at $72 billion at the end of 2016. Of that, about two-thirds is invested in highly liquid securities. The combined value of the liquid funds of the Reserve Fund and National Welfare Fund equals roughly 4.9 % of GDP. The federal budget deficit this year is forecast to be 2.753 trillion rubles or 3.2 % of GDP if the oil price in 2017 averages $40 a barrel. Urals crude currently is selling at $52–53 a barrel. If the oil price remains at its current level for the rest of the year, the deficit might shrink by about 1.5 percentage points of GDP.

Tepid growth outlook for Russia. The January update of the IMF’s World Economic Outlook sees a slightly stronger revival in growth for advanced economies than in its October forecast, but the global growth outlook remains essentially unchanged. The IMF lifted its outlook for China’s GDP growth this year to 6.5 % (up from 6.2 % in October) thanks to expected policy stimulus, while the pace of economic growth in nearly all other emerging and developing economies is expected to be slightly below earlier projections., China and India together should account for nearly half of global economic growth this year. The forecast risks include a possible shift towards protectionism in some economies, and a more severe growth slowdown in China.

Despite a substantial rise in oil prices at the end of last year, Russia’s economic growth should only slightly exceed 1 % this year and next. The updated IMF forecast is well in line with other forecasts, including the most recent forecasts of the World Bank, EBRD, CBR and BOFIT.

GDP growth forecasts 2017–2018, %

<table>
<thead>
<tr>
<th>Share of world 2016 GDP, % (PPP) *</th>
<th>2017</th>
<th>2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>World economy</td>
<td>3.4</td>
<td>3.6</td>
</tr>
<tr>
<td>Advanced economies</td>
<td>1.9</td>
<td>2.0</td>
</tr>
<tr>
<td>Emerging market and developing economies</td>
<td>4.5</td>
<td>4.8</td>
</tr>
<tr>
<td>China</td>
<td>6.5</td>
<td>6.0</td>
</tr>
<tr>
<td>India</td>
<td>7.2</td>
<td>7.7</td>
</tr>
<tr>
<td>Russia</td>
<td>1.1</td>
<td>1.2</td>
</tr>
<tr>
<td>Brazil</td>
<td>0.2</td>
<td>1.5</td>
</tr>
</tbody>
</table>


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China

China’s foreign trade surplus shrank last year by USD 83 billion. The value of China’s exports of goods fell about 8% in 2016 to $2.1 trillion. Exports fell 3% in 2015. Imports shrank by 6% to around $1.59 trillion. In 2015, depressed commodity prices drove down the value of imports by 14%. With rising energy and commodity prices, the value of imports began to increase in the second half of 2016, whereas exports remained in the red.

The collapse of prices of imported commodities in 2014 produced rapid growth in China’s foreign trade surplus. The growth ended last year and the surplus began to shrink. The surplus for the entire year fell to $510 billion. The drop in the surplus also reflected slightly smaller trade surpluses with Europe ($135 billion) and the US ($254 billion). China’s yuan lost 6% of its value last year against the dollar and 4% against the euro. Even so, the depreciation does not appear to have conferred much competitive advantage on China – at least not in terms of higher trade surpluses.

China’s most important trading partners are the European Union and the United States. The EU accounted last year for 16% of China’s exports and 9% of imports. The US covered 18% of China’s exports and 9% of imports. Japan accounted for 5% of China’s exports and 9% of imports. Korea took only 4% of China’s exports, but provided 10% of China’s imports. Latin America and Africa each accounted for 5% of China’s exports, while Latin America provided about 6% of China’s imports and Africa about 4%.

A notable trend in imports was the soaring volume of major commodities last year. Imports of paper pulp rose 7%, iron ore 8% and copper 5%. Crude oil imports were up 16% to nearly 390 million tons. The increase in oil imports reflect continuing fast economic growth and lower domestic production, which was down about 6% y-o-y for the first eleven months of 2016. In addition, China’s efforts to fill its strategic oil reserves still seem to be driving crude oil demand in China.

Changes in China reflect adjustments in global production chains. Chinese figures show that the share of the processing trade of total trade continued to fall a couple of percentage points last year with respect to both imports (down to 31%) and exports (down to 38%).

Chinese smog alerts and other pollution problems back in the news. In what has become an annual winter-time ritual, waves of Chinese red alerts over poor air quality began to signal in December. Over 20 cities, mostly in northern China (including Beijing), declared highest-level air quality emergencies due to gagging air quality. The bad air quality has continued this month.

Red alerts trigger numerous responses such as school closings, production shutdowns at factories and restrictions on automobile use. Large numbers of scheduled commercial flights are also cancelled. The Chinese, who use coal extensively for space heating and electrical power generation, see heating demand rise in winter. Also rain and wind conditions matter. China’s air problems have not gone away despite efforts to move coal-fired power plants and industrial production away from cities and rapid adoption of environmentally friendly renewables such as wind turbines and solar.

Poor air quality has long-term health consequences. The International Energy Agency (IEA) estimates that China’s toxic air shortens the average human lifespan by about two years. Last year the city governments of Beijing, Tianjin and Hebei were sued over air pollution.

China’s environmental problems extend to degradation of soil and water quality. Measurement data published last year by the water resources ministry show that 80% of Chinese groundwater used for water supply has been tainted by industrial and agricultural runoff and is unfit for human consumption. In addition, a large share of China’s surface waters is polluted and unusable. China’s groundwater and soil protection rules are quite loose and poorly enforced.

Numerous plans to deal with China’s pollution problems have been proposed over the years. A programme announced last summer is supposed to end soil contamination by 2020. In December, the comprehensive 2016–2020 programme on the environment set forth targets for reducing air pollution and improvements in water quality. Despite these ambitious goals, the programmes fail to specify measures by which the targets will be met, leaving implementation largely to local decision-makers.

The environment ministry claims the comprehensive 2016–2020 environmental protection programme gives more possibilities to tackle problems. Regulators will also have more independence from local administrators in dealing with polluters. Falsification of air quality measurement data has been criminalised. The government last month approved the introduction of an environmental protection tax at the start of 2018. The tax partly replaces the web of environmental fees, which have a reputation of lax collection by local administrations.
Russia

Russian output recovers, but consumption slump drags on. Industrial output in November-December 2016 rose by about 3 % y-o-y. Growth was slightly over 1 % for all of 2016. Rosstat noted that its full-year data for 2016 include the largest changes that firms in its reporting system have submitted. The published figures for earlier periods of 2016 may change, as could the seasonally adjusted data that show a notable rise in industrial output in November-December.

Output of mineral extraction industries, which includes fossil fuels, was up on-year in November-December by nearly 3 % and 2.5 % for all of 2016. Most of the gain could be attributed to higher oil production. Manufacturing output in November-December increased 2.5 % y-o-y, but showed hardly any growth for the whole 2016 from 2015.

Agricultural production in 2016 exceeded the previous year’s output by nearly 5 %, thanks largely to bumper harvests. The volume of goods transportation rose by nearly 2 %. Construction activity fell for the third year in a row. The decline was nearly as steep as in 2015 (down over 4 %). Unlike earlier years, fewer apartments were built. Measured by the number of apartments completed, the drop was 1 % from 2015. In terms of floorspace, the decline was over 6 %.

The seasonally adjusted volume of retail sales dropped still in December, extending the slide to two years. The on-year decrease in 4Q16 matched the fall for the full year, i.e. about -5 %. Retail sales in 2016 were 15 % below their 2014 level. Real household disposable incomes fell 6 % last year.

Russian oil production hits post-Soviet record; growth in output expected to slow. Last year Russia produced roughly 550 million metric tons (an average of 11 mbd) of crude oil (includes gas condensates). It was the highest level of production since the dissolution of the Soviet Union. Production was up nearly 3 % y-o-y. Fastest growth was recorded in the new oil fields in the Sakhalin and Yamal-Nenets regions, while output at mature fields continued to decline.

Because growth in oil production depends on new deposits that are more difficult to exploit, output growth is expected to slow considerably during this year and in coming years. In addition, this year’s output should be restricted (at least in the first half) under the agreement between Russia and other oil-producing nations. Energy minister Alexander Novak reports that production will gradually be cut from last October’s level to around 10.9 mbd in May and June. At that level, Russian oil production in the first half of this year would roughly match that of H116. Prior to the agreement on restricting output, Russia’s economy ministry expected oil production to rise by 0.7 % this year. IEA’s forecast that was published after the agreement sees Russian output rising 0.3 % this year, while OPEC’s forecast expects a drop of 0.2 %.

The Joint Ministerial Monitoring Committee of the countries involved in the deal held its first meeting last weekend.

While there were no production figures for this year yet available, the ministers said that production in their countries has fallen as planned. The price of oil jumped as the deal was signed at the end of November. Since then the Brent crude spot price has stabilised around $55 and the futures contract price at end-2017 around $57 a barrel.

Extraordinary budget measures in Russia boosted federal revenues and expenditures in late 2016. Budget revenues were significantly increased with the sale of a minority stake in state oil giant Rosneft. Money from the sale was channelled as dividends from a state-owned enterprise that owned the shares and came as revenue to the federal budget. Thus, budget revenues contracted in nominal ruble terms in 2016 by just 1.5 %. If the sale of Rosneft shares is omitted, revenues would have declined nearly 7 %. The sale of state property is not typically treated as budget revenue, but rather as an item to finance the budget deficit.

Revenues from oil and gas taxes declined last year by nearly 20 %. This was a slightly smaller drop than in 2015. In the final months of 2016, the revenues exceeded the level of 12 months earlier. Value-added tax revenues (which go entirely to the federal budget) rose by nearly 8 %, or about the same as in 2015 (even if inflation no longer lifted the nominal value of VAT collections as much as in 2015). Other budget revenues (excl. revenues from oil and gas taxes, VAT and sale of Rosneft shares) fell sharply from their 2015 peak.

Federal budget spending took a big bounce in late 2016, when the defence industry was given a large sum to pay back their bank debts. Without this special operation, nominal budget spending for the year would have been roughly the same as in 2015. The operation lifted spending growth to 5 %. Defence spending growth slowed from previous years but was still nearly 20 % due to the special operation. Nominal spending on domestic security and order, which comes almost entirely from the federal budget, again declined slightly. Nominal growth of other spending was only 2–3 %.

The federal budget deficit was 3.5 % of GDP. Without the income from the Rosneft sale, the deficit was 4.4 % of GDP.

Source: Russian Ministry of Finance.
China

Growth of Chinese economy continued to slow as expected last year. China’s gross domestic product in 2016 rose 6.7 % in real terms, down from 6.9 % in the previous year. Nominal GDP increased to about 74.4 trillion yuan ($11.2 trillion). The usual caveats apply and the numbers should only be taken as rough indicators, as China’s GDP growth seems implausibly stable and the reliability of statistics has its issues. Statistical problems were highlighted in January with the revelation of a massive statistical manipulation that had gone on for years in the Liaoning province.

China’s production structure is changing as growth slows. Services last year contributed 52 % of GDP, while the share of industrial and construction activity fell to around 40 %. Agriculture and other primary production accounted for less than 9 % of the Chinese economy’s total output, even though the farming sector employed over a quarter of the workforce. Industry employs slightly more than primary production, but its share of the workforce overall also began to shrink a couple of years ago. At the same time, the number of people employed in the service sector has soared. Services now employ perhaps 44–45 % of the workforce.

Demand-side GDP figures will only be released later. The available indicators show that fixed asset investment (FAI) has experienced a dramatic slowdown in growth. The pace of private investment growth fell to 4 % in real terms. Even the stimulus policies that drove 17 % growth in public investment failed to offset the impact of the slowdown. This suggests investment represents a dwindling share of total demand, while the significance of private consumer demand is rising (even if the growth in real disposable incomes has slowed to around 6 %). The rapid growth in consumer demand and tepid growth in foreign trade has reduced foreign trade’s share of GDP. This has been expected, and does not signal a waning of the general importance of openness or international economic relations to China’s development.

Main indicators of Chinese economic growth

Chinese credit stock continues to rise faster than output. The stock of bank loans issued in yuan increased by 13.5 % last year, even if the pace of growth slowed slightly from 2015. Growth in the corporate loan stock slowed, but the pace at which new loans were granted to households increased to over 60 %. The share of new household loans rose from a third in 2015 to half of all new loans made last year. About 80 % of household loans are housing loans. The stock of loans denominated in foreign currencies continued to diminish.

Under the central bank’s broader definition of credit, total social funding (TSF), the credit stock (domestic borrowing of households and businesses, excluding financial sector) grew 13 % last year, rising to 210 % of GDP. The stock of shadow banking sector’s trust and entrust loans grew by 19 %, while the stock of bank acceptance bills declined sharply. In lieu of bank loans, firms increasingly sought to raise money through bond issues. In December, however, corporate bond issues fell and the use of shadow banking instruments increased.

China’s domestic debt (excl. central and local government debt) % of GDP

Sources: CEIC, BOFIT.

Central bank of China boosts liquidity of money markets ahead of New Year’s holiday week. The People’s Bank of China has increased the money supply via open market operations, credit instruments and special arrangements ahead of the week-long Lunar New Year holiday that starts today (Jan. 27). Media reports note that the reserve requirements on large banks have also been eased temporarily to prevent excessive tightening in money markets.

In contrast, the PBoC’s 10 basis point hike in rates on its medium-term lending facility (MLF) loans to commercial banks on January 24 has increased costs of long-term funding and signals a tightening in the monetary stance. The interest rate charged on a one-year MLF credit rose to 3.1 %. Market interest rates in China have been rising for a while.

Interbank yuan rates: Shanghai (Shibor) and Hong Kong (Hibor)

Source: Macrobond.
**Russia**

**Bank profitability improved in Russia, even with a decline in corporate borrowing.** Figures from the Central Bank of Russia show total banking sector assets nominally declined last year by 3.5%. If ruble appreciation is considered, total assets were up nearly 2% from end-2015. Much of the decline reflected a 10% reduction in the corporate credit stock and corporate deposits. When exchange rate shifts are considered, the corporate loan stock shrank about 4%. The stock of credit granted to households increased by over 1%. Given that the stock of household credit contracted 7% in 2015, the improved performance is rather modest.

The stock of non-performing loans (NPLs) relative to the entire stock of corporate loans still exceeded 6%. For household credit, the NPL ratio was about 8%. In recent months, the share of NPLs has begun to shrink. The total 2016 profits of the banking sector rose to 930 billion rubles ($15 billion), over 1%. Given that the stock of household credit contracted 7% in 2015, the improved performance is rather modest.

The stock of non-performing loans (NPLs) relative to the entire stock of corporate loans still exceeded 6%. For household credit, the NPL ratio was about 8%. In recent months, the share of NPLs has begun to shrink. The total 2016 profits of the banking sector rose to 930 billion rubles ($15 billion), a five-fold increase from 2015. The large state-controlled banks – Sberbank, VTB and Gazprombank – generated over half of the sector’s profits.

The CBR has proceeded systematically with efforts to shut down or merge the banking sector’s sick banks and go after banks that fail to comply with banking supervision requirements. It is not at all unusual that the audits during bankruptcy proceedings of banks that have lost their licences reveal a wide variety of misdemeanours and felonies. At the beginning of 2017, Russia had 625 active credit institutions, of which 205 banks held general banking licenses. There were 735 credit institutions a year earlier. Four credit institutions had their licences cancelled in January.

**CBR to buy forex on the market for the finance ministry.** The finance ministry announced that the background is refraining from using extra oil & gas tax revenues (i.e. income that results from Urals-grade crude exceeding the budget assumption price of $40 a barrel) for budget spending this year. Instead, the excess oil & gas tax income is placed in the Reserve Fund. The current plan is to keep on in this manner until the law can be amended to launch a new budget rule.

The assets in the Reserve Fund and practically all liquid assets of the National Welfare Fund have long been invested in liquid foreign-currency assets such as treasuries. The finance ministry now begins to specify monthly forex purchase amounts needed based on how much the oil price assumption of the federal budget approved in December is exceeded, as well as how much the dollar-ruble exchange rate differs from the assumption used in the budget. Deviations to the other direction would lead to selling currency. The amounts of monthly purchases (or sales) are announced beforehand, and are carried out by the CBR on the Russian forex market. The currency operations will be conducted in the course of each day from this month, and some sources report this policy is operational since the early days of the month.

The CBR said the ruble’s floating exchange rate regime will remain in place, and that the exchange rate will not be steered through forex interventions. The inflation target set at end-2017 will remain in place. The CBR noted the new purchases of forex will have very little impact on banks’ liquidity.

Banks and observers estimate that the amount of the new forex purchases will be small relative to Russia’s total forex market trade volumes. Even so, the new measures have baffled many. Authorities are thought to contain the ruble’s appreciation to assure the budget gets more oil & gas tax revenues (the taxes are mostly denominated in dollars). A weaker rouble would add to inflation and inflation expectations. It has been noted that the official forex market actions and the uncertainty that emerged around them among market participants could cause some shift from ruble-denominated assets to forex-denominated assets, increase speculation in the currency markets, and weaken the rouble. Some have also wondered why the additional oil & gas tax budget revenues would simply not be channelled to the budget and less money taken out of the Reserve Fund than planned in the approved budget.

**Russia drops in TI corruption rankings.** The 2016 Corruption Perceptions Index published by Transparency International (TI), downgraded Russia’s position in the rankings from 2015. This was mostly due to the addition of new, less corrupt countries to the survey. Out of the 176 countries reviewed for perceived corruption, Russia scored 29 points, which meant it shared the rank of 131 with Ukraine, Kazakhstan, Iran and Nepal. In 2015, Russia also scored 29 points, which gave a ranking of 119th among 168 countries surveyed.

China’s ranking improved from 2015. As a country with a score of 40 points, China shared 79th place with India, Brazil and Belarus. China in recent years has made efforts to fight corruption, with much of the action focused on corruption in the public sector and state-owned enterprises. Although the rank of India and Brazil remained rather unaltered, they showed slight improvements in their corruption scores. The least corrupt countries were Denmark and New Zealand. The TI Corruption Perceptions Index rates perceived public sector corruption on a scale of 0 to 100, with 100 being the least corrupt. The score is calculated from indexes compiled by many other institutions. Countries that perform poorly typically have weak economic and political institutions, including justice systems, media, civil society and public administration.

<table>
<thead>
<tr>
<th>Public sector corruption 2016</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Ranking</strong></td>
</tr>
<tr>
<td>Russia</td>
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<tr>
<td>China</td>
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<tr>
<td>India</td>
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<tr>
<td>Brazil</td>
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<tr>
<td>Finland</td>
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</tbody>
</table>

Source: Transparency International.
China

Economies of China and US deeply intertwined. China’s goods exports to the United States last year amounted to $389 billion (down 5 % y-o-y), while the value of imports was $135 billion (down 10 %). Despite a slight contraction in the goods trade surplus from 2015, the US-China trade balance was hugely in China’s favour. The trade imbalance with China accounted for about half of the entire US trade deficit. Even with the drop in the value of trade, China and the US are each other’s most important trade partners. Some 14 % of China’s foreign trade is conducted with the US, and China accounts for 16 % of US foreign trade. Together they generated a 23 % share of global trade in 2015. The value of their bilateral trade alone was worth 4 % of global trade.

The imbalance in services trade, in contrast, favoured the US. American trade figures value 2015 services exports to China at $48 billion and services imports from China at $15 billion. Over half of services exports from the US to China involved Chinese spending on travelling and living in the US, of which nearly half is study in the US. China is the largest consumer of US travel exports. In 2015, China accounted for 14 % of total foreign travel spending in the US and 32 % of study-related travel.

Many US businesses operate in China. In 2014, the total turnover of US firms operating in China were $341 billion and they employed 1.7 million people (5 % of the turnover of US companies operating outside the US and 12 % of the labour force). Rhodium Group estimates that during 1999–2015, US firms invested a total of $228 billion in FDI in China. This is significantly more than the FDI stock of $75 billion in China reported by the US official figures for 2015.

China’s foreign direct investment in the US in recent years has also risen rapidly. The Rhodium Group reports that last year the US was the top destination for Chinese FDI. The value of FDI tripled from the previous year to $46 billion. For the period 2000–2016, the cumulative value of FDI amounted to $109 billion. Over 70 % of investments were made by privately owned Chinese firms. Rhodium estimates that at the end of 2015, just under 2,000 Chinese-owned firms operated in the US, directly employing over 90,000 persons.

Chinese firms have successfully raised capital in the US. In January, the NASDAQ and New York stock exchanges had 130 listed Chinese firms with a combined market capitalisation of over $900 billion (3 % of the exchanges’ market cap).

Economic relations between the countries has diversified and deepened in recent years. During his campaign, president Trump expressed considerable discontent for the US trade imbalance with China. Since taking office two weeks ago, he has continued to decry globalisation and measures to promote global trade. If this anti-China rhetoric is translated into concrete constraints on trade and business, it would have profound economic impacts for both countries.

International acceptance of the yuan faces headwinds. SWIFT, the Society for Worldwide Interbank Financial Telecommunication, reports a significant drop in international use of the yuan. In December, only 1.7 % of international bank payment transfers were denominated in yuan, down from 2.3 % a year earlier. Use of the yuan has also decreased in China’s foreign trade payments. As an invoicing currency in China’s exports and imports, the yuan’s share has declined from an average share of 25 % in 2015 to just over 10 % in recent months. In December, yuan deposits fell by a record amount in Hong Kong. The level of deposits is now at roughly half the peak levels of 2014 and 2015.

There are several reasons for the drop in international use of the yuan. First, the yuan’s exchange rate has depreciated and the pressures for a weak yuan persist, encouraging people to hold on to other currencies. Second, China has tightened its capital controls in recent months to calm depreciation pressure on the yuan, thereby restricting opportunities to use yuan. Third, the PBoC last summer stiffened the offshore yuan deposit reserve requirement, which has meant that more offshore yuan have had to be repatriated to the People’s Bank of China. While trying to stabilize the yuan’s exchange rate, it seems that the government has postponed efforts to make the yuan a major international currency.

Birth and urbanisation rates up in China last year. China’s National Bureau of Statistics reports that the country’s population increased last year by 8 million to 1.383 billion. The population increase reflects easing of family size policy that has resulted in the birth of over a million more babies than in 2015. Even so, China’s demographic structure remains distorted, with the size of pension-age cohorts growing rapidly. The Chinese pension age is still quite low, typically 55 years for women and 60 years for men while the current expected average Chinese life expectancy is 76 years. Raising the pension age has occasionally been mentioned, but no decisions have yet been announced. The newest estimates published by the Chinese government suggest that China’s population will peak at 1.45 billion in 2030, and decline thereafter.

Urbanisation, a major driver of Chinese economic growth, remained strong last year. At the end of 2016, 57 % of the population lived in cities, up from 50 % in 2010. That share has been boosted by migration to cities and the expansion of cities. The share of urbanised Chinese in the general population is still considerably less than in advanced economies, however. For example, 93 % of the population in Japan lives in cities or towns, 75 % in Germany, 84 % in Finland and 82 % in the US.

The number of rural migrant workers continues to grow and the number was estimated at around 282 million last year. However, the number of people that have been residing over six months outside their household registration (hukou) area decreased by a couple million, indicating that a small number of migrant workers succeeded in changing their hukou status.
Russia

Official figures indicate Russian economy contracted only mildly in 2016. Defying forecasts and various earlier estimates by others based on output data, Rosstat reported its first calculations that Russian GDP contracted just 0.25% last year. Earlier figures suggested that in the first three quarters the GDP fell by 0.7% y-o-y. The fresh annual data suggest those quarterly figures will likely change to less negative. Moreover, the rate of the 2015 GDP contraction became smaller again, scoring less than reported at end-December, and was now -2.8%.

The supply-side items that kept the 2016 GDP drop mild included manufacturing, the real estate sector and agriculture, which showed fair increases in their value added to the GDP. The volume of Russian goods and services imports fell by 5%, and was 35% smaller than in the peak year of 2013. As for demand-side items, private consumption fell 5% in 2016, while revised estimates for 2015 show a decline of nearly 10%, a larger drop than reported in last December’s revision. Public consumption shrank just slightly last year. Fixed investment fell only about 1.5% last year, but the revised 2015 drop was again clearly deeper (-9.5%) than shown by earlier figures. The volume of Russian goods and services exports, which grew briskly already in 2015, increased by a couple of per cent last year. Inventories turned from a fall to rise, further braking the slide in GDP tangibly.

The re-revision of the 2015 GDP decline within a short period has raised comments about possible impacts of changes in Rosstat’s statistical methodology. Rosstat recalled that the revisions are not due to change of methodology which was applied already earlier, starting from 2014 data published in December 2015. Rosstat noted the revisions of 2015 GDP reflect better data on operations of small and medium-sized firms and additional information on the government sector. In the normal course, the fifth round of publishing GDP 2015 data is planned to take place at the end of 2017.

CBR holds key rate unchanged: policy outlook slightly adjusted. At its regular meeting, the board of the Central Bank of Russia last Friday (Feb. 3) decided to keep the key rate at 10%, the level it has been at since last September. The CBR said that disinflation was in line with its forecast, with a gradual decrease in inflation expectations and a more-rapid-than-expected economic recovery. At the end of January, 12-month inflation had fallen to 5.0%. The CBR said the slowdown in inflation was due in part to transient factors (last year’s record harvest and the ruble’s exchange rate). The CBR expects inflation to slow to its target rate of 4% p.a. by the end of this year.

The CBR said that the daily forex purchases made for the finance ministry (BOFIT Weekly 2017/3) do not represent considerable inflation risks, given that monetary policy will remain moderately tight. It also mentioned other risks to meeting the inflation target, including the possibility that inflation expectations remain high or the household savings rate decreases.

The CBR slightly adjusted its outlook for lowering the key rate. A rate cut had earlier been envisioned for the first half of 2017 if inflation fell as expected. Now the CBR said that internal and external developments have reduced its capability to cut the key rate in the first half of this year. The key rate is notably positive now in real terms. The next regular CBR board meeting is scheduled for March 24.

Industry recovers in Russia’s federal districts, while retail sales continue to contract. Industrial output increased in 2016 in all of Russia’s federal districts (FD), which encompass numerous regions, and in greater Moscow, which includes the city and the surrounding Moskov region, as well as St. Petersburg. Growth was only 0.5–1.5% in the Northwest, Volga and the three FDs east of the Urals, but over 6% in the greater Moskov region and in the south.

In contrast, the volume of retail sales continued to fall last year in all FDs. While the drop was no longer deeper than a couple of per cent in the Northwest, Volga and the south, it was 6–7% in the Central and Urals FDs. In 2015–16, retail sales dropped 16–18% quite widely, i.e. in the greater Moskov region and elsewhere in the Central FD, as well as in the Volga, Urals and Siberian FDs. Retail sales in St. Petersburg fell about 6% during the two years.

Over the past decade, industrial output and retail sales have grown at very different rates in different parts of Russia (chart). The sharpest increases in retail sales were in the south, and in the Volga and Far East FDs. Greater Moskov still dominates, however, accounting last year for well over 20% of all retail sales in Russia. Industrial output has risen fast in the Far East and Siberia due to extractive industries, and in the south due mainly to manufacturing. Industrial growth has been slow in the Central and Northwest FDs, and non-existent in the Urals, where growth has been constrained by high dependence on declining oil & gas production.

Development of real industrial output and retail sales in federal districts and Russia’s two largest urban areas, 2007–2016

Source: Rosstat.
China

PBoC tightens monetary stance; policy toolbox needs clarity. With the reopening of China’s financial markets after the Chinese New Year Holiday, the People’s Bank of China applied slightly higher interest rates than before the holiday for its open-market operations and for its short-term lending facilities. The main open-market operations tool for the PBoC currently is reverse repos, where the central bank lends money to commercial banks against collateral for certain maturities. The reverse repo rate was increased by 10 basis points so that last Friday (Feb. 3) the 7-day lending rate stood at 2.35 %. The central bank also supplies short-term lending to commercial banks through standing lending facility (SLF), which saw rates raised by 10–35 basis points. The PBoC earlier this year raised rates on credit provided to banks under its medium-term lending facility (MLF).

Money market rates and proposed interest rate band

While the rate hikes are quite modest, they signal the readiness of the PBoC to tighten monetary stance and that the PBoC has the blessing of the country’s top leadership to do it. On the monetary policy front, the challenge is still balancing rising indebtedness and the outflow of capital against the supporting economic growth and providing life support to struggling state-owned enterprises through cheap loans.

Besides the tightening of the monetary policy stance, China’s monetary policy is undergoing a huge systemic overhaul, whereby administrative regulation will be gradually phased out in favour of market-driven policies. The interest rates that commercial banks set for their customers were dephased in favour of market-driven policies. The interest rate at a given moment is not necessarily public knowledge. Communication of the policy would also be much easier if the PBoC would pick one money market interest rate as its target rate.

The sheer number of targets are a burden on monetary policy in China. The PBoC still steers exchange rates and uses monetary policy tools for fiscal policy purposes. For example, the PBoC offers cheap financing to projects favoured by the state. Pledged supplementary lending (PSL), and to some extent MPL instruments, are used for these purposes. Reserve requirements are also lowest for banks that support preferred projects and sectors. The IMF would like to see Chinese monetary policy focused more on inflation targeting, paving the way for a fully floating exchange-rate regime for the yuan.

China’s currency reserves fall below USD 3 trillion. At the end of January, China’s foreign currency and gold reserves stood at $2.998 trillion, or about $1 trillion less than at the summer 2014 peak. The contraction in the forex reserves shows that China’s foreign trade surplus is not sufficient to cover its net outflow of capital.

Depreciation expectations on the yuan currently drive the increased outflow of capital from China. To influence expectations, China’s central bank has sold currency in the forex markets to quell yuan depreciation. The PBoC has also sought to stem the outflow of capital through stricter capital controls, while making it easier to invest in China.

The value of China’s reserves fell by $12 billion in January, which was considerably less than the $50-billion-per-month average of October to December. While tighter regulation and heavy-handed intervention in currency markets seem to have achieved their objectives for the time being, they represent a set-back for Chinese reforms and do nothing to solve fundamental issues related to the current situation.

Consensus growth forecasts adopt China’s growth targets. China’s gross domestic product rose 6.7 % in real terms last year. The latest IMF and World Bank forecasts now expect Chinese GDP to rise 6.5 % this year. The OECD foresees 6.4 % growth. All three forecasters see growth in 2018 slowing to around 6 % p.a. Moreover, most of the other major forecasters expect China’s economic growth this year and next to be somewhere in the range of 6.0–6.5 %.

The IMF last month raised its growth forecast for China this year, because it expects China’s current stimulus policy to support growth more than originally thought. The World Bank also noted stimulus-led growth in its January forecast, as well as the OECD in its forecast last autumn. International institutions are concerned about debt-fueled stimulus policies that add to China’s debt and help keep old, inefficient structures in place.
Russia

Varying performance in Russian manufacturing branches last year. In 2015, the volume of manufacturing output fell 5.4%. Last year, the output was virtually unchanged from 2015. Credit for ending the overall decline goes to 5–6% gains in output in the sizeable chemical branch and a couple of percentage gains in the large food industry. The smaller rubber and plastics branch, a boom industry, also returned to growth. Growth of machinery & equipment output ended years of decline (thanks to two sub-branches), and output rose in forest industries.

Manufacturing was pulled down mainly by three branches. Production of oil products fell after many years of growth, while the metal and construction materials industries experienced their second year of decline in a row. Production of electrical machinery & equipment, as well as transport vehicles, continued to contract.

Output of various Russian manufacturing branches, 2008–2016

Growth returns to Russian goods trade. Fourth-quarter goods imports were up 9% y-o-y in value terms. Growth was seen in all largest product categories, with highest growth posted for imports of machinery, equipment & transport vehicles. Import growth should continue this year on gradually reviving demand and a stronger ruble. The ruble’s real effective (trade-weighted) exchange rate was up 34% y-o-y in January from its low in the first months of last year.

The value of goods imports in 2016 contracted by less than 1% to about $190 billion. About half of goods import consisted of machinery, equipment & transport vehicles. Chemicals and foodstuffs were also important goods categories. The value of goods exports was $280 billion, nearly 20% less than in 2015. The sharp decline in oil prices also reduced the share of oil and natural gas in exports (just 60% in 2016). Correspondingly, the shares of other goods categories in exports increased slightly, even if the value of their exports also fell.

The EU was still Russia’s most important trading partner last year, accounting for nearly half of exports and almost 40% of imports. 22% of exports went to countries in Asia, and 34% of imports came from Asia (China’s shares were 10% and 21%, respectively). CIS countries accounted for roughly 10% of Russia’s imports and exports.

Structure of Russian goods trade in 2016

Slight reduction in foreign debt of Russian banks and other firms. Preliminary CBR figures show companies and banks in Russia (Russian and foreign-owned) owed $470 billion (€446 billion) in foreign debt as of end-2016. The external debt-to-GDP ratio remained roughly unchanged at 36%. Banks owed $119 billion (end-2015 $132 billion) and firms $351 billion (end-2015 $345 billion). For comparison, the domestic bank loans to firms amounted to $426 billion.

Unlike in the previous two years, the ruble’s appreciation in 2016 supported the forex valuation of the foreign debt held by banks and especially other firms. Nearly 20% of corporate debt and 13% of bank debt is denominated in rubles. Banks continued to pay down substantial chunks of foreign debt last year, although the repayments were only about half of what they had been in the two previous years (effect of ruble exchange rate changes on dollar-value of debt eliminated). Corporate foreign debt payments became even more minor than in 2014–15 when they were already relatively small due to renewal of debt and postponed repayments. Unlike previous years when firms received some debt from parent companies and subsidiaries abroad, they slightly reduced this debt last year. Repayments of the other foreign debt of firms were very small compared to the two previous years.
China

**FDI spending of Chinese firms hit record in 2016.** China’s official figures show outward foreign direct investment flow (excluding financial sector investments) last year amounted to $170 billion, an increase of 40% from 2015. While final FDI numbers for the financial sector have yet to come in, they typically represent 10–20% of total FDI. Thus, the total value of FDI outflows from China last year was probably around $200 billion. The value of FDI inflows to China, on the other hand, fell last year to $126 billion. Outbound FDI of Chinese firms also exceeded inbound FDI in 2015.

Official Chinese figures fail to give a complete picture of where investment ultimately ends up. The statistics don’t give a correct picture of the final-destination countries or even branches. Alternative estimates confirm the rise in FDI, however. For example, the Rhodium Group estimates that Chinese FDI flow increased by about 40% last year to some $200 billion. China Global Investment Tracker (CGIT), which monitors large foreign investments of Chinese firms, reports that such FDI rose 46% last year to $169 billion.

Chinese investments in Europe have risen particularly fast. The Rhodium Group reports that FDI flows from China to Europe reached €35 billion last year, a nearly 80% increase from 2015. Two-thirds of all FDI going to EU countries came from privately held Chinese firms. The flow of FDI from EU to China fell last year to around €8 billion. Also figures from the CGIT database show that FDI flows from China to EU countries grew about 80% last year.

The largest direct investment by a Chinese firm in Europe last year (€6.7 billion) was made by Tencent to purchase a majority stake in the Finnish mobile video game company Supercell. According to Rhodium, the acquisition by itself was sufficient to make Finland the fifth-largest cumulative recipient of Chinese FDI in the EU. Large acquisitions in Europe last year included investments in advanced machinery (Midea’s purchased a large stake in German robot-maker Kuka AG and ChemChina’s acquisition of German industrial machinery-maker KraussMaffei), as well as companies in the fields of renewable energy and entertainment. Investment in real estate fell. ChemChina has also made a $43 billion offer for Swiss agribusiness giant Syngenta. The deal awaits clearance by competition officials in the EU and US.

The growth of outward FDI flows from China should slow this year as officials pay increased attention to “irrational” investments by state-owned enterprises. The government wants to attract FDI into China by opening new branches to foreign firms and allowing broader access to domestic financing. In January, the State Council published goals on allowing more access for foreign firms in branches such as the financial sector, manufacturing, the telecom sector, transport and education. No schedule or details on the reforms have yet been released. EU countries have repeatedly criticised China for limiting entry of foreign firms to certain branches.

**Reliability of China’s output statistics raise questions.** Early this month, Bloomberg News reported that China’s deputy prime minister Zhang Gaolin was pushing statistics officials to ensure reliable reporting. For sure, there are good reasons for this as the reliability of official statistics is an issue that has been surfacing repeatedly for a long time. Last time matters came to a head in January with widely reported revelations about a massive, multi-year manipulation of official statistics in the Liaoning province.

Looking at economic growth figures over the past two years, eerily unwavering growth performances catches one’s eye. For example, on-year GDP growth figures last year were reported as 6.7% p.a. in each of the first three quarters of the year, and 6.8% in the fourth quarter. In 2015, reported GDP growth was 6.9% just about as stable as last year. Given that the Chinese economy is undergoing a massive readjustment, such stable growth figures are dubious.

In the same vein, reported industrial output figures show remarkably steady growth in 2015–2016 (see chart). Other indicators of industrial activity give quite different assessments. For example, both the official and private purchasing manager indices for manufacturing (PMI and Markit PMI) suggest growth came to a halt and began to fall in early 2015. Strict interpretation of the weak PMI index trends suggests that 12-month industrial output growth had fallen to around zero or even below it by the start of 2016. This dreary view is backed by industrial electrical power consumption figures. The inference of a substantial slowdown in the growth of electricity consumption holds even if figures for troubled heavy industry is not included in the industrial electrical power consumption figures. Interestingly, an indicator made from satellite images further support the notion there was a severe slowdown in industrial output growth.

Looking at recent growth figures and forecasts, the notion that they merely reflect official growth targets rather than actual economic dynamics does not seem far-fetched. In any case, rigid growth targets no longer serve the needs of responsible economic policy in present-day China. Moreover, their elimination would remove the incentive to manufacture numbers.

**Indicators for Chinese industrial output growth**

![Graph showing indicators for Chinese industrial output growth](image-url)

Sources: Macrobond, BOFIT.
Russia

Russian government revenues and spending continued to decline in real terms last year. The consolidated budget, which combines federal, regional and local budgets, and state social funds, showed a slight revenue increase from 2015 in nominal ruble terms. In real terms, revenues fell almost 5%. If the funds received from last year’s sale of the stake in Rosneft are included (as they are in the official budget data), the drop in real revenues was 2%. In real terms, revenues were down by 17% from 2014 and at the same level as ten years ago. Once again, it was falling revenues from oil & gas taxes that produced a weak total revenue performance due to a continuous fast rise of revenues from health insurance payments. Revenue growth for other large major taxes kept pace with inflation. Many of the minor budget revenue streams exceptionally declined.

In real terms, consolidated budget spending fell by about 1.5% in 2016. Real spending was down 8% from 2014 and at the level of 2011–2012. Besides the boom in defence spending, only the increase of healthcare spending managed to outpace inflation slightly. Pension spending and other social spending rose slightly slower than inflation as normally scheduled inflation adjustments e.g. to pensions were omitted last year. Other spending continued to plunge in real terms. The deficit amounted to 4.5% of GDP.

### Russia’s government (consolidated budget) revenues, expenditures and surplus, 2014–2016

<table>
<thead>
<tr>
<th></th>
<th>2014</th>
<th>2015</th>
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<tbody>
<tr>
<td><strong>Revenues</strong></td>
<td></td>
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<td></td>
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<tr>
<td>% of GDP</td>
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<tr>
<td>Oil and gas taxes</td>
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<td>-1.1</td>
<td>-3.4</td>
<td>-4.5</td>
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</table>

### Sources: Ministry of Finance and BOFIT.

Procurements of public sector and state-owned enterprises in 2016 exceeded 30% of Russian GDP. The economy ministry reports that public procurements in Russia last year were valued at 5.3 trillion rubles (€72 billion) and procurements of state-owned enterprises were valued at 21.1 trillion rubles (€285 billion) (not including procurements classified as secret). The sizeable procurements have been attempted to make more efficient and less costly through regulatory measures.

Legislation governing public procurement has been tightened in recent years. To increase efficiency and transparency, procurements should be carried out by electronic competitive bidding. The economy ministry reports that last year two-thirds of public sector procurements were subject to competitive bidding, but only 5% of those by SOEs. The competitive bidding, however, has been criticized to be illusory to some extent. Competitively bid public sector procurements last year attracted on average less than three tender offers and most procurements were won by a handful of bidders. Planned measures to increase effectiveness of public sector procurement include the introduction of a standardized catalogue for most common procurements.

Lately, procurements have been used increasingly as a tool of industrial policy, thereby reducing competition and raising prices. Among other things, many import restrictions have been imposed on public sector procurements. Russia is not a signatory to the WTO Agreement on Government Procurement (GPA). In addition, many procurements of SOEs are subject to domestic-content requirements and provide preferable treatment to domestic suppliers. There are also procurement quotas for many large SOEs, requiring them to direct a certain share of purchases to small and medium-sized enterprises and to innovative products.

**Russian social security system – expensive and rigid.**

A fresh World Bank report finds Russia’s social security costly and complex. Social spending on federal and regional levels, and via social funds, is the consolidated budget’s largest spending category – about 35% of all spending in 2016 (12–13% of GDP). Of that, about two-thirds consist of pension spending, with the rest going to other social safety spending. Many social benefits are tied to age, domicile or former profession. The average pension is small, so many social programmes are designed to complement pensions.

Despite the federal government’s central role in financing social spending, implementation of social policies is dispersed. There is wide variation across regions for the amount and efficacy of programmes. Russia has over 150 social programmes managed by the federal government, and at least 500 programmes by the regions. Programmes often overlap. Only about 15% of all social spending goes to means-tested programmes that take into account the needs of the recipients. Moreover, most of the support formats are rigid to administer and do not adjust flexibly to the changing circumstances of beneficiaries.
China

**Chinese inflation accelerates.** Consumer prices rose 2.5 % y-o-y in January, up from 2.1 % in December. Core inflation, which excludes food and energy prices, also picked up to over 2 %. The rise in prices of many items has been quite even, while prices in the travel industry rose nearly 10 % y-o-y in January. The true inflation picture was distorted somewhat by the fact that the Lunar New Year holidays occurred in January this year and February last year. The increase in producer prices picked up from 5.5 % y-o-y in December to 6.9 % in January. The increase in producer prices is largely driven by rising global commodity prices.

Even so, China’s inflation rate remains modest, and is even expected to fall a bit February as the impact of the Chinese New Year holiday fades. Inflation is also below the target of “about 3 %” set by the People’s Bank of China last year. The PBoC is expected to announce this year’s inflation target at the National People’s Congress next month.

**Chinese still borrowing like there’s no tomorrow.** The PBoC reports that January issues of total social financing (TSF), a broad measure of the credit supply, broke all historical records last month. Especially financing provided by the shadow banking sector soared (i.e. bankers’ acceptances, trust loans and entrusted loans). January is typically a big month for new lending in China. The stock of TSF lending in January was up about 13 % y-o-y.

The Bank of International Settlements (BIS) estimated that the total debt held by Chinese firms, households and the public sector equalled 255 % of GDP in June 2016. In other words, China has much more debt than in other emerging countries. China’s piling debt is considered as a huge risk to both the country itself and the global economy. Most of the other countries that have experienced similar high debt growth have then seen rapid decelerations in economic growth. In many countries, it has also led to banking crises. China’s debt is almost entirely domestic, which alleviates foreign exchange risk from the debt.

China has only taken minor measures to slow the pace of rising indebtedness. Its economic policy has been geared to sustain high GDP growth and assuring that China’s goal of doubling GDP between 2010 and 2020 is not threatened. The monetary policy stance remains loose, even if the PBoC raised rates slightly in January-February on its lending to the financial sector. At the same time, however, it also boosted liquidity on the market by other means, especially ahead of the New Year’s holiday week. The central bank last week announced targeted relaxation of bank reserve requirements. Banks that lent extensively to small businesses and agriculture last year will be entitled to lower reserve requirements (15–16 %) from the end of February. Similar targeted incentives have been used before and banks that fail to keep with the policy track lose their eligibility for the lower reserve requirement. The usual reserve requirement is 16.5 % at present.

**China’s current account surplus fell below 2 % of GDP in 2016.** Preliminary balance-of-payments figures show China’s goods trade surplus last year was $485 billion (4.3 % of GDP). The value of goods exports was $1.989 trillion and imports $1.504 trillion. The value of exports contracted more than the value of imports, causing the goods trade surplus to shrink from the previous year. The value of services trade also fell from the previous year. The value of China’s services exports last year amounted to $282 billion, while services imports were worth $525 billion. Thus, the services trade deficit increased to $242 billion, of which the deficit in travel services alone hit $223 billion (2 % of GDP). The total current account surplus fell to $210 billion (1.9 % of GDP).

China’s balance-of-payments figures showed that Chinese travellers abroad spent $341 billion last year. Measured in yuan, travel spending rose 25 % y-o-y. Foreign travellers spent $118 billion in China last year. According to China’s National Tourism Administration, Chinese tourists made 122 million trips abroad, 4 % more than in 2015. Spending on tourism has increased much faster than the number of tourists. Balance-of-payments figures show spending on tourism last year was nearly triple compared to 2013, while the volume of tourism increased by 25 %. Statistics suggest that the Chinese tend to be bigger spenders abroad than other nationalities. Some suspect, however, that part of phenomenal growth in tourism spending actually reflects capital outflows that are improperly recorded as tourism imports.

**China’s main current account categories, 2009–2016 (% of GDP)**

<table>
<thead>
<tr>
<th>Year</th>
<th>Goods trade</th>
<th>Income and transfers</th>
<th>Services trade</th>
<th>Current account</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009</td>
<td>-2.0</td>
<td>6.0</td>
<td>-4.0</td>
<td>-6.0</td>
</tr>
<tr>
<td>2010</td>
<td>-1.3</td>
<td>7.0</td>
<td>-4.3</td>
<td>-5.6</td>
</tr>
<tr>
<td>2011</td>
<td>-0.5</td>
<td>7.5</td>
<td>-4.0</td>
<td>-5.5</td>
</tr>
<tr>
<td>2012</td>
<td>-0.2</td>
<td>8.0</td>
<td>-3.8</td>
<td>-5.8</td>
</tr>
<tr>
<td>2013</td>
<td>0.0</td>
<td>8.5</td>
<td>-3.5</td>
<td>-5.5</td>
</tr>
<tr>
<td>2014</td>
<td>0.5</td>
<td>9.0</td>
<td>-3.5</td>
<td>-6.0</td>
</tr>
<tr>
<td>2015</td>
<td>1.0</td>
<td>9.5</td>
<td>-3.5</td>
<td>-6.5</td>
</tr>
<tr>
<td>2016</td>
<td>1.5</td>
<td>10.0</td>
<td>-3.5</td>
<td>-7.0</td>
</tr>
</tbody>
</table>

Sources: Macrobond and BOFIT.
Russia

Russia revises industrial output data. Rosstat’s 2015 figures for GDP production components were revised upwards earlier this winter, and the 2016 figures were less negative than expected. Both outcomes forebode changes also in industrial output figures. The new figures show that total industrial output fell by less than 1% in 2015, rather than by over 3% in previous figures. The 2016 growth figure was corrected slightly upwards to 1.3%. The new figures also show seasonally adjusted industrial output returned to growth in mid-2015 rather than in 2016.

The change in manufacturing output figures for 2015 was very large (from a decline of 5.4% to a drop of just 1.3%). 2016 growth was adjusted upwards to a half per cent. The output growth of mineral extraction industries, which includes the oil & gas sector, rose slightly to 0.7% for 2015 and to 2.7% for 2016. Revised data for the various industrial branches are yet to be published, as well as for the years before 2015.

Rosstat said the adjustments in its industrial figures reflect the adoption of new branch and product classifications (harmonised to EU classifications), improved product baskets, a broader application of price deflation according to UN recommendations, as well as more accurate production data on most important products. Going forward, changes in data for other sectors of the economy may also arise.

Russian government sector still dealing with austerity. Revenues to the federal budget performed weakly in 2016 also in areas other than taxes from oil & gas. Non-oil & gas revenues were up just 1.5% in nominal ruble terms (without the sale of a stake in Rosneft). While transfers from the federal budget to the pension fund rose further, by over 8%, the need for transfers was diminished by exceptionally small pension increases last year. The increase in spending from the federal budget and social funds was below the inflation rate.

Transfers from the federal budget to regional budgets continued to drop. In contrast, revenue growth at the regional level was rather good, especially revenues from excise taxes. Spending growth from regional and municipal budgets lagged inflation as was the case in a couple of previous years.

Finnish exports to Russia finally on the rise. After contracting for 14 consecutive quarters in annual terms, the value of goods exports rose 6% y-o-y in 4Q16. Fastest growth was recorded for metals exports partly buoyed by higher prices, but exports of e.g. machinery & equipment and foodstuffs also rose. The recovery remains shaky, however, as the value of exports fell slightly again in December. Exports this year are expected to achieve more robust growth supported by a gradual recovery in Russian demand and stronger ruble. In the first part of the year exports could see even quite brisk growth relative to the low starting point, but later growth is constrained by Russia’s weak growth trend.

Exports of travel services seem to have also revived late last year. After contracting for eight quarters in a row, Russian overnight stays in Finland rose by 7% y-o-y in 4Q16, and were up by nearly 20% y-o-y in December. As suggested by double-digit growth figures for border crossings and tax-free purchases in January, the recovery in Russian tourist traffic to Finland is likely to continue this year, but the levels of tourism are nowhere near the peak of earlier years.

The value of Finnish goods imports from Russia was up in 4Q16 by nearly 30% y-o-y, lifted largely by higher oil prices. Oil accounts for the majority of Finnish imports from Russia. Imports of metals showed strong growth towards the end of last year, with import volume of nickel mattes rising many fold. Growth in sawn wood imports continued despite ruble appreciation, while raw timber imports fell.

For all of 2016, Finnish goods exports to Russia still shrank 6% y-o-y to slightly under €3 billion. The last time exports were so low was in 2001. Finnish goods imports from Russia grew by 3% to over €6 billion. 6% of Finnish goods exports went to Russia and Russia provided 11% of Finnish goods imports in 2016.
China

Wage growth slows; Chinese wage levels already high among emerging economies. The latest household survey of China’s National Bureau of Statistics finds that wage growth in urban areas slowed to 7% last year, down from 8% in 2014 and 2015. The rise in rural wage levels also slowed, but was slightly faster than in cities. Based on China’s earlier official wage figures, we estimate the average urban wage last year was about €750 a month. However, there are huge variations in wage levels across provinces and branches. For example, the average private sector wage in the advanced Jiangsu and Guangdong provinces is 50% higher than in provinces such as Jilin and Heilongjiang. In recent years, the rise in private sector wages in poor provinces has been slower than in advanced provinces.

Information from Hay Group, a global management consultancy, also shows slowing wage growth similar to the NBS household survey. China’s rapidly rising wages over many years have made it pricey by emerging economy standards. The average wage for Hay Group’s customer base in China was higher than in Russia and already about a third of the average wage in the United States. Wage spreads are larger in China than in Western countries, especially between upper management and staff.

The rapid rise in labour costs has caused an ongoing shift of labour-intense production away from China to other countries. In addition, Chinese firms are automating and China is already the world’s largest market for industrial robots. China has moved to more sophisticated products and production. These trends seem destined to continue in coming years.

China establishes itself as major arms exporter and importer. A report published last month by the Stockholm International Peace Research Institute (SIPRI) finds that the volume of international arms trade in the five-year period 2012–2016 was 8% higher than in the previous 2007–2011 period. The US share of global arms trade rose in the most recent five-year period to 33%, while Russian fell slightly to 23%. China’s arms exports have soared, with the country consolidating its position as the world’s third-largest supplier of arms. In 2016, China exported 8% of global arms exports.

Even with booming weapons production industries, China continues to import e.g. freight carriers, helicopters, ships, and engines for aircraft and other vehicles. Russia supplied 57% of China’s arms imports, Ukraine 16% and France 15%.

Russian arms exports rose 5% in the research period. With its 38% share, India was by far Russia’s largest arms client. The next closest arms-buyers were Vietnam and China, each with 11% shares. Russia exported weapons to 50 countries and the rebels in eastern Ukraine. 68% of exports went to the Asia and Pacific region, 12% to Africa (Algeria 10%), the Middle East 8% and Europe 6%.

Exports to China outperformed Finnish exports overall in 2016. New figures from Finnish Customs show the value of Finland’s goods exports to China rose by 5% last year to €2.7 billion. Imports from China increased by 1% to €4.1 billion. Finland’s trade deficit with China shrank from 2015 to €1.4 billion.

China last year became Finland’s sixth-largest export destination (5% of total exports). Exports to Hong Kong last year were valued at €170 million, or 0.3% of Finland’s total exports. Exports to Taiwan were roughly of the same scale. China is Finland’s fourth-largest provider of imports (just over 7% of Finnish imports).

Pulp represents a fifth of all Finnish exports to China, with pulp exports to China rising 13% last year. The value and volume of exports of Finnish furs and pelts to China fell by half from their 2015 level. Furs and pelts represented 5% of Finland’s total exports. Exports of machinery, equipment and devices increased by 8%, representing 43% of total value of Finnish exports to China. There were no changes in the structure of imports. Over half of Finland’s imports from China were machinery, equipment and devices, and over 15% clothing and footwear.

Statistics Finland figures for commercial lodging show that overnight stays of Chinese travellers in Finnish hotels & inns increased by 27% last year, and for the first time exceeded the volume of overnight stays of Japanese travellers. Overall, overnight stays of foreign travellers grew by 5%. Some 6% of foreign visitors to Finland were from China.

Finland’s top export destinations (share of total export value, %)

<table>
<thead>
<tr>
<th>Country</th>
<th>Share of Export Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany</td>
<td>16%</td>
</tr>
<tr>
<td>Sweden</td>
<td>12%</td>
</tr>
<tr>
<td>USA</td>
<td>9%</td>
</tr>
<tr>
<td>Russia</td>
<td>8%</td>
</tr>
<tr>
<td>UK</td>
<td>7%</td>
</tr>
<tr>
<td>China</td>
<td>5%</td>
</tr>
<tr>
<td>Netherlands</td>
<td>4%</td>
</tr>
</tbody>
</table>

Source: Finnish Customs and BOFIT.
Russia

Despite stable oil prices, the ruble strengthens and Russia’s stock markets fall. In recent years, the ruble’s exchange rate and Russian stock market prices have closely tracked trends in oil prices. The oil price to a large extent defines the value of Russian exports, and the weight of oil & gas companies in Moscow stock index is over half. This year, however, the ruble has appreciated and share prices fallen even as the price of a barrel of Urals crude has remained relatively stable at around the $53 level.

Many analysts have been surprised by the ruble’s gains of around 5% against the dollar and the euro since the start of the year. The finance ministry’s decision to start buying foreign currency was expected to slightly lower the ruble’s external value, but the volume of purchases has been quite modest. Currency-buying in February amounted to around $2 billion and the amount announced for this month is $1.2 billion.

Many market analysts view the ruble’s recent strengthening to stem from “carry trade” investing that takes advantage of Russia’s relatively high interest rate level. The Central Bank of Russia’s research department, however, notes that the ruble’s attractiveness as a carry trade currency is reduced by its higher volatility. It sees the recent appreciation instead as a reflection of seasonal fluctuations in the current account, capital flows related to the December sale of the Rosneft stake and a general increase in interest among international investors in emerging markets.

The ruble’s appreciation has been slightly stronger in real terms due to Russia’s higher inflation rate relative to its main trading partners. Moreover, compared to its lows in the first months of 2016, the ruble has recovered considerably. The ruble’s nominal effective (trade-weighted) exchange rate (NEER) in February was up 36% y-o-y. The real effective exchange rate (REER) was up 38%.

The Moscow exchange’s dollar-denominated RTS index is down about 9% this year. Among reasons mentioned for the decline are the rapid rise in share prices last year (up nearly 30%) and the disappointment of some investors from overly optimistic expectations of an early lifting of US sanctions.

Fixed investment by Russia’s large and mid-sized firms still in low territory. Rosstat reports that the recovery in seasonally adjusted total fixed investment continued in the fourth quarter of 2016. As for the year in its entirety, 4Q16 investment was down about 1% from 2015. The slide was notably less than Rosstat’s earlier figures suggested for the previous quarters of 2016. However, last year fixed investment was down by 11% from 2014, because Rosstat’s revised figures deepened the drop in investment in 2015.

About a quarter of total investment comes from small firms and the grey economy. Rosstat figures mean that such investment remained at about the same level in 2016 as in the previous year. During the current recession, these investments only contracted in 2015, when they fell several percent. Other fixed investments, which are mostly investments of large and mid-sized companies, shrank by about 1% last year. However, the slide in such investments in the previous three years was steep (down 10% in 2015 alone), so their level last year was several per cent below that of the 2009 recession.

Investments of large and mid-sized companies saw a strong increase last year in investment in oil & gas production. It was the third year in a row of investment growth in that sector. Last year's growth, however, came from an investment boom in the LNG sector. The decline in investment in oil refining was still really sharp for the second year in a row, and other manufacturing investment continued to fall quite steeply. Investment in the electricity sector and the energy pipeline transmission branch also continued to decline.

After contracting for two consecutive years, investments in machinery & equipment by large and mid-sized companies remained more or less flat last year. Construction activity was down over 4% last year, thus falling for the third year in a row. Notably, despite a drop already in 2015, far fewer commercial and industrial buildings were completed last year than in 2015. Fewer apartment buildings were also completed last year compared to 2015. It was the first drop in housing completion since 2010.

Real fixed investment developments in Russia, 2010–2016

Source: Rosstat.
China

China yet to abandon strict GDP growth target. In his address on Sunday (Mar. 5) to the opening session of the annual National People’s Congress, premier Li Keqiang presented a passel of numeric targets to provide guidance for this year’s economic development plans. The 2017 GDP growth target was set at “around 6.5% or higher if possible.” Last year GDP target was a range of 6.5-7% and realised growth was 6.7%. The leadership’s current focus on rigid numerical growth targets limits its ability to proportion economic policy appropriately and focus on pressing issues.

Despite the structural change and needed economic reforms, the government aims to sustain high growth through boosting domestic consumption and fixed investment. However, Li’s speech emphasised the need to keep financial market risks in check. One aspect of maintaining stability is to rein in the rapidly rising indebtedness of state-owned firms through such measures as closing unviable “zombie” firms. This year’s goals include increased energy efficiency and improved environmental protection, greater emphasis on innovation and reducing production capacity especially in the coal and steel industries. The themes are familiar from previous years, even if many partial reforms e.g. in the corporate sector have failed to reach their intended targets. The government this year wants to create 11 million new jobs in urban areas, while keeping the pace of income growth in line with economic growth. The economy created 13 million new jobs last year.

China’s monetary policy is constrained by the rapid rise in debt levels and, among other things, the anticipated interest rate hikes in the US. The monetary policy targets were set a little bit tighter than last year. The money supply (M2) and total social financing (TSF) are targeted to increase 12% this year, a percentage point less than last year. The growth target, however, is significantly higher than nominal GDP growth, which suggest that the growth in indebtedness will continue. This year’s 3% inflation target is not expected to constrain monetary policy, however. Premier Li said that measures to liberalize the exchange rate will continue. Unlike earlier years, his speech did not emphasise the importance of exchange rate stability, but instead stressed maintaining stable position of the yuan in international monetary system.

Li emphasized the stability of economic development and president Xi’s mantle-bearing as the “core” of the party. He set the stage for the Party Congress meeting in October-November, when the persons selected for the next five-year administration are approved and start setting directions in economic policy. The National People’s Congress and People’s Political Consultative Conference will meet through next week.

Growing worries that the China Manufacturing 2025 programme may distort markets. The European Union Chamber of Commerce in China this week released a report giving its assessment of the Manufacturing 2025 programme that China announced in May 2015. The programme reflects typical Chinese industrial policy. Officials have selected ten fields with promising futures that the government commits to support. The designated fields are high-tech aerospace, shipbuilding, rail equipment, IT, electrical equipment, electric and hybrid cars, farm machinery, robotics, new materials, biopharmaceuticals and medical equipment. The EU Chamber claims that the central government and regional administrations have committed hundreds of billions of euros already to support these fields.

The EU Chamber also noted that guidance through heavy-handed industrial policy conflicts with China’s efforts to continue with market reforms and grant market greater say in directing the economy. According to the EU Chamber, a strong industrial policy will likely result in the same types of problems encountered earlier. Chinese firms will overinvest in these fields creating overcapacity, which will depress price levels. As a result, firms struggle with low profitability in both China and abroad. Resources are wasted. Moreover, overcapacity may lead to protectionist measures in other countries. Manufacturing 2025 places high emphasis on domestic content and indigenous innovation. The EU Chamber fear that the position of foreign firms will be further eroded.

Instead of heavy-handed industrial policy, the EU Chamber would like to see China pursue market reforms. Markets are often much better at deciding on how economic resources should be allocated than public officials.

Mobile payments catch on in China; PBoC developing own virtual currency. In recent years, China has become the global leader in mobile payments. The Chinese consulting firm iResearch Global estimates that about 450 million Chinese used mobile payments services last year. The apps of the largest mobile payments service providers (Alibaba’s Alipay and Tencent’s WeChat Pay) are now in such wide use in China’s big cities that people can get through an entire day with only their phone. Mobile payments are now a standard option in restaurants, taxis, shops, cafes and parking fees. The shift of providers of investment services to mobile platforms has fuelled the growth of mobile payments. Many Chinese seem to be switching directly from cash to mobile payments without ever going through the intermediate step of acquiring a credit or debit card.

Various forms of virtual currency such as bitcoin are also popular in China. The PBoC has also been developing its own virtual currency for couple of years. The currency and its related payment systems are now in trial use in select banks in Shenzhen and Guiyang. China’s central bank will probably become the first central bank in the world to issue its own virtual currency. A goal of China’s virtual money is to increase efficiency of interbank payments and transparency, thus making banking supervision easier and financial crime more preventable. The PBoC’s eagerness of release own virtual currency may also be motivated by the fact that virtual currencies can be used to circumvent China’s capital controls. Lately, officials have significantly increased supervision and tightened regulations concerning virtual currency transactions.
Russia

Several factors affect decline in Russian household income and spending. Private consumption last year fell by 5% and real household incomes by 6%, even as the average real wage rose slightly. Several factors underlie the difference. Rosstat’s data for the total sum of household wages give a far weaker picture of last year’s wage performance than its average wage figures. Current data suggest that growth of the nominal ruble wage sum was flat last year, so the sum fell by over 7% in real terms. Wages represented 65% of total household income (Rosstat estimates include grey wage payments). Given that employment levels remained unchanged and the wage arrears growth was marginal, the weak wage sum performance of households could reflect a drop in grey wages or an increase in part-time employment.

The increase in social support paid to households (nearly a fifth of total household income) slightly lagged inflation last year, mainly due to small pension increases. Households’ finance behaviour did not prop up consumption very much. Household borrowing was rather slack and the savings rate did not drop appreciably.

Higher payments of taxes and related fees cut into household spending. Spending on goods and services increased last year in nominal ruble terms by just 3%. Spending on services increased slightly more, contracting a little in real terms. Spending on goods purchases rose by a couple of per cent, i.e. declined about 5% in real terms (same as the drop in retail sales). Private consumption overall was further depressed by a steep decline in spending of Russian tourists abroad.

Real growth of household revenues and spending, 2008–2016

Data on household spending and income could improve after a possible revision. The Central Bank of Russia computed that the volume of retail sales may have contracted by only a couple of per cent in 2016. The CBR also noted that its estimate is supported by certain datasets and surveys on consumption and retail sales. Final conclusions are complicated by difficulties in estimating inflation and changes in the composition of shopping baskets of consumers.

Number of passenger cars on the road in Russia rises from 26 million to 45 million in just ten years. In 2005, there were just 180 cars per 1,000 people in Russia. Since then, the number of cars has risen rapidly. In the wake of the global financial crisis, subsidies were provided to support sales of new cars. This drove new car sales up to around 2.6 million sales a year in 2010–2014. The economic recession in 2015 led to a drop in car sales to around 1.6 million. Just 1.4 million new cars were sold last year. The stock of cars on the road, however, is expected to keep rising as the number of cars relative to Russia’s overall population remains on the low side. The average rate of car ownership in EU countries is about 500 cars per 1,000 persons. The corresponding number for Russia is currently about 315 per 1,000 persons.

A growing share of cars sold in Russia have been manufactured domestically, so the market share of imported vehicles has now shrunk to around 25%. The growing market and tighter domestic-content requirements have caused the major foreign car manufacturers to build their own assembly lines or take ownership stakes in Russian carmakers. The best-known example is Renault-Nissan’s 2014 acquisition of a majority stake in Avtovaz. Avtovaz produces Lada, Russia’s top-selling make. The latest on the scene is Daimler, which announced in February that it plans to build a Mercedes-Benz car assembly plant in the Moscow region. When Daimler’s new plant is included, Russia now hosts 17 assembly plants of foreign carmakers. Over half of all cars sold in Russia are foreign makes assembled domestically.

The new assembly plants have squeezed out some inefficient domestic production, and the car industry now employs fewer than 190,000 persons. Production of all types of vehicles and parts employs almost a million Russians, and accounts for slightly less than 15% of all manufacturing jobs. In recent years, the car industry has joined the ranks of industries given top priority under the government’s subsidy programme. In 2017, some 62 billion rubles ($1 billion) were earmarked in the federal budget for the automobile industry to be allocated via a range of support programmes. The government’s goal is two-fold: support domestic production and increase exports of Russian-built cars. Assembly plants currently have little interest in exporting, because production is geared specifically to the Russian market. The weakening of the ruble has not significantly improved the competitiveness of Russian cars on international markets, because most components are still imported from abroad. In 2016, Russia exported 68,000 passenger cars, or about 50% fewer than in 2014.

From the start of this year, all cars sold in Russia or imported to Russia are required to be equipped with a Russian ERA-GLONASS alarm system. The requirement is particularly costly for imported used cars. Such domestic regulations do little to boost export efforts.
China

No big changes in China’s 2017 fiscal policy. The Ministry of Finance expects the general government deficit to come in at around 2.6 trillion yuan this year, slightly over 3% of 2017 GDP. Last year’s government budget report foresaw a similar sized deficit, but actual spending was higher and the deficit ultimately amounted to nearly 4% of GDP. This year’s budget report contains an exceptional amount of references to the status of president and party chairman Xi Jinping, as well as various political frameworks and programmes.

As in previous years, the government’s budget report did not address how much and where public assets would be allocated this year. Of the spending categories, it is known only that military spending will continue to grow briskly (up 7%), reaching a level of 1.04 trillion yuan or 1.3% of GDP this year. However, the report does mention some concrete measures. For example, several official fees charged to firms will be eliminated or cut, taxation of small business will be reduced and small and medium-sized firms will be able to deduct a larger share of R&D spending from their taxes.

China’s public sector finances remain murky overall. This is because regional and local administrations have extensive off-budget activities. When revenues, expenditures and financing are reported in a more conventional way the general government budget deficits are considerably larger. The IMF estimates that the so-called augmented public sector deficit has been running at around 10% of GDP since 2013.

<table>
<thead>
<tr>
<th>Public sector revenues, spending and deficits, % of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Renances</td>
</tr>
<tr>
<td>2013: 23</td>
</tr>
<tr>
<td>2014: 22</td>
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<tr>
<td>2015: 23</td>
</tr>
<tr>
<td>2016: 21</td>
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<tr>
<td>2017: 21*</td>
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<tr>
<td>2016: 25</td>
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<tr>
<td>2017: 24*</td>
</tr>
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</tr>
<tr>
<td>2013: 8</td>
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<tr>
<td>2014: 9</td>
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<tr>
<td>2015: 9</td>
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<td>2016: 3</td>
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<tr>
<td>2017: 3*</td>
</tr>
<tr>
<td>Augmented deficit</td>
</tr>
<tr>
<td>2013: 10**</td>
</tr>
<tr>
<td>2014: 10**</td>
</tr>
<tr>
<td>2015: 10**</td>
</tr>
<tr>
<td>2016: 10**</td>
</tr>
<tr>
<td>2017: 10**</td>
</tr>
</tbody>
</table>

*) Nominal GDP is expected to grow by 9% in 2017.
**) IMF estimate
Sources: IMF and China’s budget reports for 2016 and 2017.

No big changes at the start of the year in China’s economic situation. The basic economic data for January and February released this week offered no big surprises. Industrial output grew by 6% y-o-y in real terms in the period. This was slightly higher than in the final months of 2016 and about a percentage point higher than in January-February 2016. Retail sales increased by just over 8%, which was about a percentage point lower than at the end of last year and one and a half percentage point lower than in January-February 2016.

Fixed asset investment (FAI) in urban areas is an important indicator as capital formation still accounts for over 40% of GDP. FAI in January-February was reported to be up nearly 9% y-o-y in nominal terms. However, even a restrained rise in investment prices should reduce real investment growth to around 7%. Although investment growth in January-February was higher than in December, the slowing trend in investment growth most probably remain unchanged. At the beginning of 2016, when investment growth was heavily boosted by public investment, FAI grew nearly double the rate of the first two months of this year. Also in January-February 2017, public investment grew significantly faster than private investment. Private investment, however, account for about 60% of total fixed investment.

China’s economic growth seems to remain strong, but the growth is if anything slowing down. However, several statistical issues make it hard to give a proper appraisal of the current conditions. Official figures show unusually steady GDP growth in recent years that seem to more reflect official growth target than actual trends. Numerous other indicators suggest that China’s actual growth has occasionally been significantly lower than reported, especially since 2014. There is also reason to suspect that the statistical fraud recently revealed in the Liaoning province is not an isolated incident.

Industrial output, retail sales and fixed investment*

<table>
<thead>
<tr>
<th>Real change, % y-o-y</th>
</tr>
</thead>
<tbody>
<tr>
<td>Industry</td>
</tr>
<tr>
<td>Fixed asset investment</td>
</tr>
<tr>
<td>Retail sales</td>
</tr>
</tbody>
</table>

Sources: Macrobond and BOFIT.

China foreign trade revived in the first two months of the year. The value of imports measured in dollars increased by 26% y-o-y in January-February. The value of exports remained at the same level as in early 2016. Import growth reflected last year’s exceptionally low comparison point caused by depressed energy and commodity prices. Import prices in January were up 13% y-o-y. The yuan, however, has been losing ground against the dollar compared to early 2016, and in yuan terms, growth in foreign trade was even brisker. The balance of trade entered negative territory in February, something quite unusual for China. The event, however, largely reflects the impact of Chinese New Year. China’s shifting Lunar New Year dates always makes statistical comparison of economic performance difficult in the first months of the year. The total goods trade surplus for January and February was $42 billion, or less than half of the January-February 2016 surplus.

The value of imports grew rapidly for all major trading partner countries. The growth in imports from Australia, which was driven by rising commodity prices, was extremely rapid. Compared to a year ago, exports to the US, Japan and South Korea were up, while exports to the EU and Australia declined slightly. The goods trade deficit with Japan and Australia increased and the surplus with the US and EU contracted.
Russia

Russian economic situation remains weak. In the first two months of this year, seasonally adjusted and workday-adjusted industrial output continued to lack clear direction. After lurching ahead in January, production fell considerably in February. The volume of industrial production for January-February was slightly lower than a year ago, whereas the on-year drop in February was more than 2.5%. Part of February’s weakness reflected a difference in the number of workdays compared to February 2016.

Manufacturing output fell 5% y-o-y in February, with a combined January-February drop of nearly 2% y-o-y (and well over 2% less than three years ago). Production of extractive industries was up 1.7% y-o-y in January-February, with crude oil output rising by 2% and natural gas output up by nearly 10%. Economy minister Maxim Oreshkin said that the industrial output figures may well be revised later this year, noting that the switch-over to a new statistical classification system had not proceeded successfully.

After a two-year slide, seasonally adjusted retail sales rose slightly in the January-February period. Even so, the sales volume was down by a couple of per cent from a year ago. Food sales were still down 4% y-o-y, while sales of non-food goods were no longer down more than 1%. The performance in retail sales was sluggish compared to real household incomes.

Real incomes in January-February were up as a total by 1% y-o-y, even if they dipped markedly in February. Real incomes were supported by higher real wages and two substantial pension pay-outs. In January, all pensioners received (as promised in the lead-up to last autumn’s Duma elections) a hefty one-time payment. At the start of February, pensions of non-working pensioners were adjusted fully for inflation. Pensioners continuing to work, due to a rule change last year, were entitled to the annual inflation adjustment. Russians kept a large part of the household income increases in January-February in their bank accounts.

CBR opens representative office in Beijing. The Central Bank of Russia opened its first overseas office last week in Beijing, making it the 13th representative office of a foreign central bank in that city. In Moscow, People’s Bank of China opened the first yuan clearing bank in Russia this week. There are about 20 yuan clearing banks in the world.

In recent years, Russia and China have sought to intensify cooperation in the financial sector. Russians are eager for access to Chinese financing, especially since Western sanctions have made it harder to get foreign loans. China, in turn, wants to promote increased international use of the yuan.

While use of the yuan in bilateral transactions has increased in recent years, it is still relatively modest. In the first nine months of 2016, Russia’s private sector (excluding banks) borrowed $2.2 billion from Chinese lenders, which amounted to about 5% of the private sector’s entire foreign borrowing. Yuan-denominated borrowing amounted to about $200 million. About 10% of bilateral trade last year was conducted in yuan and 4% in rubles. The Russian government holds no yuan-denominated debt, but has planned to issue yuan bonds. None of Russia’s currency reserves are presently invested in yuan assets.

Russia’s private sector (excl. banks) borrowing from China and yuan-denominated borrowing, flows in 1Q2011–3Q2016

European Commission invites comments on EU-Gazprom gas dispute. An investigation launched in autumn 2012 into European gas markets initially found that Gazprom violated EU competition rules in many EU member countries of Central and Eastern Europe. Commission findings on the matter were delivered to Gazprom in April 2015. Gazprom recently responded to the Commission with its own proposal on revisions of its practices found to violate EU competition rules. The Gazprom commitments include e.g. a promise to eliminate restriction on gas resellers and increase pricing flexibility. The Commission last week released Gazprom’s response for comment. Customers and stakeholders have until the end of April to give input. The commissioner in charge of competition policy, Margrethe Vestager said Gazprom’s proposed solution enables the free flow of gas in Central and Eastern Europe at competitive prices.
China

Guangdong, China’s largest province, has an economy as big as Spain’s. After almost four decades of rapid growth, some Chinese provinces have GDP numbers like those of mid-sized national economies. China’s National Bureau of Statistics reports that the nominal GDP of Guangdong province last year reached $1.2 trillion, putting it size-wise on par with the Spanish economy and approaching Russian GDP. China’s second-largest provincial economy, Jiangsu, had a GDP larger than Mexico’s, while number-3 Shandong province’s GDP was nearly as large as Mexico’s. Looking at China’s megaloplis, both Beijing and Shanghai had larger economies than either Hong Kong or Singapore.

China’s provincial GDP data should be viewed with considerable caution, however. Much of the problem arises from the fact that provinces are expected to hit their hard growth targets. Failure to do so can be harmful to the career trajectories of regional leaders. Provincial administrations, which have strong connections with both regional firms and financial institutions, are well positioned to support economic growth. When this is still insufficient, however, officials may resort to falsification of their statistical data. Aware of the problem, the NBS has long performed its own surveys with a resort to falsification of their statistical data. The Financial Times reported last week that the reported GDP figures of four other provinces traditionally engaged in heavy industry (Hebei, Shaanxi, Shanxi and Inner Mongolia) were surprisingly strong in 2012–2016, even as output volumes of their main products declined and prices fell.

GDP and populations of select Chinese provinces and nations

<table>
<thead>
<tr>
<th>Province</th>
<th>GDP (2016), USD billion</th>
<th>Population (2015), million</th>
</tr>
</thead>
<tbody>
<tr>
<td>Russia</td>
<td>1 280</td>
<td>147</td>
</tr>
<tr>
<td>Spain</td>
<td>1 210</td>
<td>46</td>
</tr>
<tr>
<td>Guangdong</td>
<td>1 200</td>
<td>108</td>
</tr>
<tr>
<td>Jiangsu</td>
<td>1 150</td>
<td>80</td>
</tr>
<tr>
<td>Mexico</td>
<td>1 050</td>
<td>121</td>
</tr>
<tr>
<td>Shandong</td>
<td>1 010</td>
<td>98</td>
</tr>
<tr>
<td>Netherlands</td>
<td>780</td>
<td>17</td>
</tr>
<tr>
<td>Zhejiang</td>
<td>700</td>
<td>55</td>
</tr>
</tbody>
</table>

Sources: CEIC, Macrobond and IMF.

PBoC again slightly raised rates used in its financial market operations. In response to the US Federal Reserve’s 25-basis-point rate hike on March 16, the People’s Bank of China responded immediately by hiking rates used in its open market operations and lending programmes. The increases were small. For example, the 7-day reverse repo rate increased from 2.35 % to 2.45 %. Also most of the lending rates for liquidity programmes (SLF and MLF) were lifted by 10 basis points. While the rate hikes indicate a slight tightening of the monetary stance, they suggest the PBoC is better prepared than earlier to react to changes in the financial markets. Rates were also raised in February.

The impact of rate hikes on the economy, especially regarding debt growth, is expected to be marginal. On money markets, rates were up slightly. Today (Mar. 24), the 7-day SHIBOR stood at 2.8 %.

China’s filings of international patent applications jump last year. The number of Chinese patent applications in 2016 increased by 45 % y-o-y, totalling 43,170 filings. Patent application filings globally under the international Patent Cooperation Treaty (PCT) amounted to 233,000, an increase of 7 % y-o-y. Almost all of last year’s increase in patent application filings reflects the increase in Chinese activity. The US remained the top filer of the applications but its number of applications fell slightly to 56,600. Some 1,530 PCT filings last year came from India (up 8 % from 2015), 1,520 from Finland (down 4 %), and 850 from Russia (down 3 %). Russian patent applications have fallen significantly from their peak in 2013, when near 1,200 applications were filed.

Shenzhen-based telecom company ZTE was most active in filing patent applications (4,120 filings), with second place going to its neighbour telecom giant Huawei (3,690). Third place in PCT filings went to San Diego-based Qualcomm (2,470).

In terms of numbers, the explosion of patent activity in China would seem to imply an impressive boom in innovation. However, the quality and relevance of Chinese patent filings are often quite modest relative to those of advanced economies. The OECD reports that the growth in the number of patent applications has largely been driven by state subsidy rules, which favour large state-owned enterprises and hi-tech firms. The benefits of Chinese patents are usually rather low, and the share of genuine inventions represents only a miniscule share of patent applications and thus have little impact on productivity in China.
Russia

**BOFIT forecast sees Russian economy returning to growth.** Preliminary data suggest Russian GDP still contracted last year by 0.2%, but our latest Forecast for Russia sees GDP rising by 1.5% this year. Growth will be supported by higher oil prices, which markets currently expect to average nearly $55 a barrel over the next three years.

A gradual revival in private domestic demand will drive growth. Household consumption is expected to increase moderately on higher household incomes and lower inflation. Fixed investment should also rise slightly as industrial capacity is already almost fully utilised. Russia’s poor business environment and uncertain economic outlook, however, will inhibit fixed investment demand.

The impact of public sector spending on growth will continue to fade. The approved 2017–2019 budget framework calls for reducing government spending in real terms. The Central Bank of Russia has kept its monetary stance moderately tight to reach its 4% inflation target this year.

The gradual revival of demand and a significantly stronger ruble should bolster growth in imports this year. The volume of imports, which in total fell by over a third in recent years, is expected to increase by 6% y-o-y over the next three years. Growth in imports will be moderated in part by import restrictions on several food items and public procurements. The volume of exports will grow slowly in coming years due to constraints on both supply and demand.

A key risk to the forecast is the price of oil. Any large price swings could be quickly reflected in Russia's economic performance. The approaching presidential elections next year could increase pressures to boost public spending, which could temporarily accelerate growth. GDP growth might be slower than predicted, however, if imports rebound from their deep slump faster than expected.

The Russian economy should continue the moderate 1.5% p.a. growth in 2018 and 2019. The economy is already operating near its limits of capacity and currently there are no decisions on the structural reforms needed for achieving higher sustained growth.

**CBR lowers key rate by 25 basis points.** The key rate is 9.75% from this week. The CBR noted that a faster-than-expected drop in inflation and a slight decline in inflation expectations justified the rate cut. The board added that further gradual rate cuts are possible in 2Q17 and 3Q17.

The CBR estimates that 12-month inflation has recently slowed to 4.3%. It sees that an important factor in the recent slowdown of inflation has been the ruble’s strengthening on rising oil prices and increased interest of foreign investors. CBR governor Nabiullina said the central bank does not share the finance ministry’s view of a visibly overvalued ruble.

Finance minister Anton Siluanov recently stated that the ruble is overvalued by 10–12%. The ruble’s exchange rate affects also a large part of Russian budget revenues through oil taxes, which are largely based on the dollar price of oil. Thus, these tax revenues decline in ruble terms when the ruble appreciates.

**No decision yet on extending Russian oil production cuts.** Last year, OPEC and eleven non-OPEC countries agreed, under a voluntary arrangement, to cut their production in the first six months of this year by a total of nearly 1.8 million barrels a day (mbd). The committee tracking the agreement’s implementation said last week that the total production of participating countries had dropped nearly as much as planned. The committee did not give yet any recommendation whether the cuts should be extended to 2H17.

Russia committed to reducing its output gradually to a total of 0.3 mbd from last October’s level. Russian energy minister Alexander Novak reports that Russia had agreed to reduce output by the end of March by 0.2 mbd and that last week the realised reduction was 0.185 mbd.

Due to varying methodologies applied in the statistical data on oil, it is difficult to track precisely whether Russian oil output is declining as agreed. However, according to most data sources production in January-February was 0.12–0.15 mbd lower than in record-breaking peak of October 2016. While January-February output was lower, it was up on year. Moreover, it is difficult to distinguish to what extent production declines are due to an actual cut or normal seasonal fluctuations.

While complying with the agreed reductions in output could be important for Russia-OPEC relations, the direct impact on global oil markets is small. Global oil production averaged about 96 mbd in February, so Russia’s promised cuts amount to just 0.3% of that. In recent weeks, oil prices have fallen a bit, due to e.g. higher levels of production and higher inventories in North America.

**Russian oil production (incl. condensates), mbd**

<table>
<thead>
<tr>
<th>Sources: Rosstat, BOFIT Forecast for Russia.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Russian GDP and import volumes, realised and forecast</td>
</tr>
<tr>
<td>GDP growth, %</td>
</tr>
<tr>
<td>30</td>
</tr>
</tbody>
</table>

**For Minenergo and Rosstat Jan-Feb realised, IEA and OPEC 1Q estimates**

<table>
<thead>
<tr>
<th>1Q16</th>
<th>2Q16</th>
<th>3Q16</th>
<th>4Q16</th>
<th>1Q17*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minenergo</td>
<td>11.02</td>
<td>10.83</td>
<td>10.89</td>
<td>11.22</td>
</tr>
<tr>
<td>Rosstat</td>
<td>11.19</td>
<td>10.83</td>
<td>10.83</td>
<td>11.10</td>
</tr>
<tr>
<td>IEA</td>
<td>11.24</td>
<td>11.18</td>
<td>11.27</td>
<td>11.58</td>
</tr>
<tr>
<td>OPEC</td>
<td>11.07</td>
<td>10.96</td>
<td>11.03</td>
<td>11.32</td>
</tr>
</tbody>
</table>

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China

BOFIT forecasts managed slowdown in China’s growth, but debt and sluggish reform cloud outlook. China’s economic growth remained brisk in the start of this year, and may even have accelerated slightly since last summer. The long-term trend, however, is clearly to a lower-growth environment. China’s economic trends remain largely in line with BOFIT’s previous forecasts. Under our current Forecast for China, we still see GDP growth slowing to 6% this year and falling further to 5% p.a. in the out years of 2018 and 2019. As Chinese economy has developed, the easy opportunities for boosting growth become increasingly scarce. Growth will also be constrained by an ageing population, the growing share of services in the production structure and environmental problems.

China’s growth has been largely debt-fuelled. Due to lax fiscal and monetary policy, China’s debt-to-GDP ratio now exceeds 255%, an enormous figure for an emerging economy. Corporate debt is high even compared to many advanced economies. The slow-down of GDP growth combined with the continued rapid expansion of debt predict difficulties, which are reflected in financial markets as increased capital outflows and expectations of yuan depreciation.

Officials have sought to calm the markets by tightening restrictions on capital movements and intervening in forex markets. Lasting improvement of the situation would require a faster progress in economic reforms, but things are presently quiet on the reform front. The government’s strict adherence to a 6.5% GDP growth target is unfortunate from the standpoint of responsible economic policy. Growth targets force government borrowing at all levels to pay for stimulus, even though China’s labour markets seem well able to tolerate lower growth conditions. Targets also encourage falsification of statistical data. With the recent revelations of instances of data fraud, this is now considered a real problem.

Our forecast assumes that reform policy will assume a higher priority after the National Party Conference this autumn, when key party posts are filled.

OECD recommends China focus on economic reforms. The OECD last week released its latest OECD Economic Survey of China. The report sees economic growth slowing slightly, but remaining above 6% p.a. in 2017 and 2018 with the help of extensive stimulus measures. The survey’s main emphasis, however, concerns China’s need to tackle emerging problems to place the economy on a sustainable long-term growth trajectory.

Chinese fiscal policy has been very expansionary. In addition to increased budget spending, fiscal stimuli have been channelled through re-capitalized policy banks and allowing local governments’ off-budget financing vehicles to restart borrowing. The OECD would like to see China adopt more prudent fiscal policy, given rising pressure for public spending as the population ages and the need to expand social safety nets. Improving and expanding coverage of pensions and health care services, as well as providing better education opportunities, would reduce the need for households to save. This, in turn, would boost consumption demand and facilitate structural change of the economy.

With the elimination of business tax, local governments have had to make up for lost revenues by resorting to extensive sales of land-use rights. The OECD notes that regional administrations could compensate for the loss with environmental taxes and more progressive personal income taxes, taxing other types of income such as rents, as well as the introduction of real estate and inheritance taxes. The tax changes would help to address income inequality and mitigate environmental problems.

Financial sector risks have increased with the rapid rise in housing prices, purchases of securities and real estate on credit, as well as the extremely high corporate indebtedness. Moreover, an increasing share of money invested in wealth management products offered by banks is simply reinvested into other wealth management products rather than corporate loans as earlier. Should shocks occur, there is a heightened risk of contagion. To avoid problems, the OECD suggests that China improve its financial sector regulation, increase supervision and restrict leveraged investment in asset markets. The OECD also recommends improving the financial literacy of households.

The OECD estimates that productivity growth has slowed in recent years, due mainly to poor investments made in the wake of the financial crisis. Improving production in the corporate sector remains critical. It should be easier to set up a new business and wind down non-viable zombie firms. One needed step is to update China’s bankruptcy law. Competition could be improved further in some branches and pricing of for example energy rates could be revised so that end-user prices reflect actual production and transmission costs. Many problems would be ameliorated through improved corporate governance practices, including better internal and external supervision. For example, laws on whistle-blower protections need improvement. Management of state-owned enterprises should be professionalised and compensation more closely tied to performance.
**Russia**

**Russian GDP figures confirm economic recovery in final months of 2016.** The first set of quarterly GDP data for the entire year 2016 from Russia’s national statistics agency Rosstat tell about the economy’s recovery. In the fourth quarter of 2016, GDP was up by 0.3 % y-o-y. The total import volume in 4Q16 was also up 0.3 % y-o-y.

Looking at demand components of the economy, however, the volume of private consumption was still down by more than 3 % y-o-y in the fourth quarter. While fixed investment in the third and fourth quarters was no longer down more than only about 0.5 % y-o-y, it is worth recalling that it was especially during those periods that the decline in fixed investment was offset by a massive investment in the giant liquefied natural gas project on the Yamal peninsula. Economic activity got its biggest support from Russian exports. As in the second and third quarters, the total volume of exports of goods and services was up remarkably in the fourth quarter (nearly 4 % y-o-y).

The backward-updating of Rosstat’s GDP figures since its change in statistical methodology continues. Rosstat to date has released its revised GDP data according to the latest internationally accepted methodology that it applies (SNA 2008) only back to 2014. The first SNA 2008 data for 2014 and 2015 released over a year ago raised the size of Russia’s GDP by nearly 10 %. The extent to which annexation of Crimea apparently exaggerates the 2014 growth figures has not been clarified either. Instead, the GDP data releases still carry the note that Crimea is included in the 2014 data both as regards the level of GDP and also GDP growth. With Crimea included, Russian GDP grew by 0.7 % in 2014.

The lack of longer GDP time series decreases the reliability of cleaning the basic data from the normal seasonal variations that the data includes. Notably, it has been a while since Rosstat released any seasonally adjusted GDP figures.

With a decision signed by president Putin this week, Rosstat becomes an agency of the economy ministry. The move does not necessarily relate to the ongoing statistical reform.

**Russia and Turkey limit bilateral food trade.** In mid-March, Turkey ceased allowing duty-free imports of certain food items from Russia. Wheat and corn imports from Russia were the most affected items. The new 130 % import tariff on them is assessed to have stopped their imports. Turkey is one of Russia’s largest export markets for wheat and corn, with Russian exports last year valued at roughly $550 million. Relative to Russian exports overall, however, the value of wheat and corn exports to Turkey is minuscule.

Russia still has import bans in place for several Turkish foods, mostly fruits and vegetables. The import bans were imposed at the beginning of 2016 after the Turks shot down a Russian fighter plane in November 2015. After the countries resolved the matter last summer, Russia promised to gradually lift its sanctions. So far, only some of the food import bans have been lifted. Russia last year imported about $350 million in these food products previously subject to the ban. The value of food imports still subject to bans was estimated to be about $550 million in 2015. Moreover, Rosselkhoznadzor, Russia’s federal food safety agency last year forbid importation of several other Turkish-grown plants under its veterinary and phytosanitary regulations. The agency has noted that lifting of bans on these plants is not even under consideration.

**Ukraine receives its fourth IMF loan tranche.** At its meeting this week, the executive board of the International Monetary Fund approved release of the fourth tranche of a $17.5 billion support programme for Ukraine under its Extended Fund Facility. The value of this latest tranche was $1 billion. To date, Ukraine has received a total of $8.4 billion from the IMF since its four-year EEF lending programme commenced in March 2015. This week, Ukraine also received a €600 million loan tranche from the EU.

In its report relating to the approval decision, the IMF noted that Ukraine has made progress in reforming many sectors. However, the IMF added that privatisation efforts were moving too slowly and that not sufficiently has been made with fighting corruption. Nevertheless, the country has succeeded in holding down its public sector deficit to relatively low levels by, in particular, reducing energy subsidies.

The IMF forecasts that Ukraine’s GDP will grow about 2 % this year and about 3 % in 2018. With an acceleration of structural reforms, the IMF estimates that Ukraine could reach GDP growth approaching 4 % p.a. over the medium term. After two years of steep decline, Ukraine’s GDP grew by 2.3 % in 2016.

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China

No big surprises during president Xi's visit to Finland.
On Wednesday (Apr. 5), Chinese president Xi Jinping met in Helsinki with Finnish president Sauli Niinistö and other Finnish political leaders. Xi congratulated his hosts on Finland’s 100-year independence celebrations. Controversial topics were avoided, at least publicly. The countries confirmed a new type of partnership agreement and signed several cooperation agreements. Topics discussed included cooperation in Arctic issues and in winter sports. Perhaps the biggest news story of the visit was the Chinese soft diplomacy gesture of promising a pair of giant pandas to Finland. On Thursday (Apr. 6), Xi travelled on to the United States to meet with president Trump.

As is the custom, many investment agreements were signed during the visit. Most of the signings, however, were simply affirmations of previously announced intentions. No large new initiatives were announced. The agreements were related to the construction of a pulp mill in Kemijärvi and cooperation between the Finnish Jokerit ice hockey team and the Beijing Kunlun Red Stars. The Chinese press described Finland as a neutral EU country that supports free trade, IT, environmental protection, as well as its expertise in education. While Finland’s economy slows, structural reforms proceed and a variety of mobile and internet-based competitors vie for banking business. Most expect the NPL problem to worsen and see top priority of banks in coming years is to improve NPL-related debt collection and writing down of NPL losses.

New data on yuan as reserve currency. The IMF’s latest report on Currency Composition of Foreign Exchange Reserves (COFER) included the Chinese yuan separately for the first time. As of end-December, the value of yuan-denominated foreign exchange reserve assets was $85 billion, just over 1% of the $7.9 trillion of foreign exchange reserves globally. In addition to currency investments, central banks have other assets in their reserves, so that the total value of central bank foreign exchange reserves at the end of 2016 was around $10.8 trillion. COFER data are based on the information of 146 reporters. The IMF does not publish data on the structure of the reserves of individual countries.

The decision to specify yuan-denominated investments reflects the inclusion of the yuan in the IMF’s SDR currency basket at the beginning of October 2016. Besides the other four SDR currencies, the Canadian dollar and Australian dollar are more important than the yuan as international reserve currencies.

Expectations of yuan depreciation and China’s capital control measures have eroded international confidence in the yuan. The yuan had managed to approach the Japanese yen last year to become the world’s largest foreign exchange trader. But since has again been surpassed by the Canadian dollar. The yuan had managed to approach the Japanese yen last year to become the world’s largest foreign exchange trader. But since has again been surpassed by the Canadian dollar.

Yuan deposits in Hong Kong have fallen substantially from their record levels of 2015.

Weights of main currencies in SDR basket, shares in global currency reserves (12/2016) and international payments (2/2017), %

<table>
<thead>
<tr>
<th>Currency</th>
<th>Weight in SDR basket</th>
<th>Share of currency reserves</th>
<th>Share in international payments</th>
</tr>
</thead>
<tbody>
<tr>
<td>USD</td>
<td>41.73</td>
<td>63.96</td>
<td>40.86</td>
</tr>
<tr>
<td>EUR</td>
<td>30.93</td>
<td>19.74</td>
<td>32.00</td>
</tr>
<tr>
<td>CNY</td>
<td>10.92</td>
<td>1.07</td>
<td>1.84</td>
</tr>
<tr>
<td>JPY</td>
<td>8.33</td>
<td>4.21</td>
<td>3.30</td>
</tr>
<tr>
<td>GBP</td>
<td>8.09</td>
<td>4.42</td>
<td>7.41</td>
</tr>
</tbody>
</table>

Sources: IMF and SWIFT.
Russia

Russian foreign trade and capital outflow increased sharply in first quarter. Preliminary balance-of-payment figures from the Central Bank of Russia indicate that the dollar value of Russian goods and services imports increased in the first three months of this year by more than 20% y-o-y (16% in euro terms). Goods imports rose much faster than services imports. In the services imports category, tourism showed the highest growth (up 18% y-o-y). The value of exports of goods and services in dollar terms was up over 30% y-o-y, mainly on higher oil prices. The 1Q17 current account surplus was USD 23 billion or nearly as much as for all of 2016.

The financial account showed that the private sector net capital outflow increased substantially from a year earlier, reaching USD 15 billion in 1Q17 (compared to USD 19 billion for all of 2016). The biggest impact came from the soaring increase in the foreign accounts receivable of Russian banks. Some analysts have suggested this might be related to financing of the sale of a large stake in the state oil company Rosneft to foreign investors in December. There was a slight increase in the net inflow of foreign direct investment in non-banking Russian companies (to about USD 7 billion), while the net outflow of direct investments abroad by Russian businesses was nearly USD 8 billion.

Russian central bank and economy ministry expect sluggish recovery in coming years. The latest forecasts of the CBR and economy ministry both see Russian GDP increasing by 1–2% a year during 2017–2020. The forecasts assume the annual price of Urals crude to average between USD 40–50 a barrel. Economic recovery will be driven largely by domestic demand. Both household consumption and fixed investment are expected to grow at 2–3% a year. Exports are expected to grow slowly and imports should rise faster than exports.

Both forecasts have the current account remaining in surplus, even if the surplus falls to USD 6–8 billion at the end of the forecast period. The financial account deficit (excluding currency reserves) is expected to persist in coming years, with deficit running in the range of USD 6–10 billion annually.

The forecast risk scenarios show GDP growth slowing to around 1% at USD 35 a barrel and zero growth at the USD 25 level. The economy ministry has also prepared a scenario with growth accelerating to 3% p.a. by 2020. Achieving this performance requires successful reforms that include improvements in the business environment, investment in education and increased competition in the economy.

The economy ministry is currently overseeing the drafting of Russia’s long-term development strategy to the year 2035. A survey of 137 Russian experts conducted by the Institute of National Projects (INP) found that most respondents viewed as most desirable a growth model based on e.g. high-quality institutions and enrichment of human capital. Only a small percentage of respondents, however, viewed this model as the most likely outcome by 2035.

In Russian labour markets wages adjust downwards relatively easily. The Centre for Strategic Research, an institute headed by former finance minister Alexei Kudrin, recently released a wide-reaching report on Russia’s labour market. The report finds that Russia differs from most countries in that during economic downturn wages adjust downwards but unemployment remains low. The factors behind this phenomenon include difficulties in laying off workers, the low minimum wage level set by law and the fact that wages are often tied to corporate performance. Workers are further incentivised to remain on the job at lower wages by Russia’s meagre unemployment benefits. Labour unions are relatively weak in Russia.

Unemployment in Russia has remained low throughout the 2000s, even with notable structural adjustments taking place in the labour markets. Jobs have largely shifted from agriculture and industry to the service sector, which now employs over two-thirds of the employed. Higher paying jobs requiring high levels of professional skill and training have increased in all branches, while jobs involving simple repetitive tasks have diminished. While the wage differential has shrunk, it is still high by international standards. Structural changes in Russia’s labour markets have to some extent fostered productivity gains, but progress has slowed down since 2008.

Russian wage flexibility and low minimum wage, however, mean that some workers do not earn a living wage. As a result, the number of workers in the informal labour market has increased during the 2000s. The report estimates that in internationally comparable terms about 10-15% of the employed in Russia work in the informal labour market. Hikes in the legal minimum wage level have supported the growth of the informal labour market, as the lowest-paying jobs are shifted to the informal labour market. This effect has been strongest in poor regions, because the minimum wage is the same everywhere in Russia. Regional labour markets tend to be quite isolated as worker mobility is limited by such factors as high moving costs.
China

Xi-Trump meeting diminishes fears of deteriorating relations. Chinese president Xi Jinping and US president Donald Trump had their first meeting last week (Apr. 6–7) during Xi’s visit to Trump’s Florida estate. Given Trump’s harsh criticism of China during the campaign, the get-together was followed globally with great interest. The meeting appeared quite congenial. The two countries agreed to conduct trade negotiations within the next 100 days to discuss ways of boosting US exports to China. China said it would start importing of American beef again after a ban that it had imposed in 2003 on fears of mad cow disease. The impact of such measures on rebalancing the trade is likely to be minimal, but the threat of the US imposing heavy retaliatory tariffs on Chinese goods now seems unlikely.

China also promised to improve access of US firms to its financial sector. Opening of the financial sector was a part of the bilateral investment treaty negotiations during the Obama administration. The treaty is reportedly close to finalisation. However, Trump has yet to take a public stance on it.

Chinese media report that strategic and economic dialogue that began during the Obama administration will go on in a modified form. Moreover, the communication channels between the US and Chinese militaries will be improved through a “dialogue mechanism” to avoid misunderstandings.

Rising housing prices in China bring both growth and increased risk to real estate markets. China’s National Bureau of Statistics reports that the rapid rise in housing prices is only under control in a couple of China’s largest cities. The rise in prices is broad based, although the climb in prices outside big cities has been much less. The NBS reports apartment price trends in 70 cities. The February reading showed prices were up over the past 12 months in 60 cities, and down in 10 cities. Smaller cities and towns have not experienced the same real estate boom and often suffer a glut of unsold apartments. Tracking prices in real estate markets is complicated by the fact that the information on certain private actors has been unavailable this year.

Efforts to curb speculative trading, and thus an excessive rise in apartment prices, have been strongest in large cities (BOFIT Weekly 44/2016). The introduction of a property tax that would increase the cost of apartment ownership and reduce speculative investment has been planned for years. Such a tax would increase revenues to local governments currently reliant on sale of land use rights. Postponement of the tax appears likely, however.

The rise in apartment prices has fuelled a renewed boom in apartment construction. New housing starts, measured in terms of liveable floorspace, increased 9 % y-o-y last year and 15 % in January-February. Measured in floorspace, the volume of completed apartment buildings increased by 15 % y-o-y in January-February. Housing construction was still in decline in 2015. The volume of apartment sales rose by 22 % last year and growth has remained strong this year.

The bursting of the Chinese real estate bubble could have profound effects on financial markets. Moody’s recently warned that the exposure of banks to real estate risk has increased. The stock of housing loans increased last year by 35 % and corresponded to 26 % of GDP. In addition, many large developers are heavily indebted.

Prices of secondary market apartments in China’s large cities

Sources: National Bureau of Statistics, CEIC, BOFIT

China establishes new testing area in Hebei province. President Xi Jinping announced at the start of April the creation of Xiongan New Area, which lies about 130 kilometres south of Beijing. The government expects the Xiongan New Area to foster development in the Beijing and Tianjin municipalities and the adjoining Hebei province. News agency Xinhua reports that the area will have similar status to the Shenzhen special economic zone established in the 1980s and Shanghai’s Pudong New Area set up in the 1990s. Besides promoting development in the capital area, the Xiongan will be a test area of reforms and serve as a new model for urbanisation and urban infrastructure.

Even with the project’s long timeframe, the fact that it has president Xi’s blessing provides confidence to many that it will succeed. After the creation of the Xiongan New Area was announced, local apartment prices skyrocketed. The share prices of dozens of firms expected to benefit from the project also rose on the news. The speculative reactions highlight the current nature of China’s markets.

As part of its economic experimentation, China has established several special economic zones and new areas. The Caixin news service reports that Xiongan is China’s 19th new area. China has also created several free-trade zones (FTZs) since 2013. The announcement of seven new FTZs at the beginning of this month brings the FTZ total to 11. However, new economic areas do not have the same impact on growth and reforms as the Shenzhen and Pudong projects in 1980s and 1990s. Experiment zones gradually change the current economic system and help in designing specific reforms. Even so, they are no substitute for much needed market reforms at the national level.
Russia

Russia’s economic recovery: waiting. Rosstat reports that seasonally and workday-adjusted industrial output recovered in March, after a weak February. In the first quarter, industrial output was virtually at the same level as it was a year ago. Thanks to higher natural gas production, the trend has been positive for the extractive sector, with output rising by over 1% y-o-y in the first quarter. Seasonally adjusted manufacturing output recovered in March, but for the first quarter output was still down almost 1% y-o-y.

Rosstat noted that retail sales, which in January and February were supported by large pay-outs to pensioners, contracted slightly in March. For the entire first quarter, retail sales were down by nearly 2% y-o-y.

Russian ruble continues to strengthen. The ruble has appreciated this year about 8% against the US dollar and 5% against the euro. The ruble has been supported by strong trade surplus and increased interest of foreign investors in the Russian market. The ruble has been on a nearly continuous upward trend after hitting the bottom in the first months of 2016, although strengthening has slowed down recently. In March, the ruble’s real effective (trade-weighted) exchange rate was up nearly 30% y-o-y.

In Russia, exchange rate shifts tend to pass through relatively quickly and strongly to consumer prices, so ruble strengthening tends to curb inflation. Ruble appreciation also reduces the government’s ruble-denominated tax revenues, because oil taxes are largely based on the price of oil in US dollars. On the other hand, lower inflation enhances the purchasing power of tax revenues. For households, a stronger ruble means imported goods and services are more affordable.

The trend in the volume of Russian exports is not particularly sensitive to exchange rate fluctuations. The bulk of Russian exports consists of oil or oil products that are based on world-market dollar prices, and demand reacts slowly to price changes. A stronger ruble does, however, lower the ruble revenues of the companies. Ruble appreciation also weighs on the price competitiveness of other exports (e.g. wood products and metals).

Russian federal budget revenues get a big boost from higher oil prices. Federal government revenues in the first quarter were much higher than in 1Q16. Revenues increased for the first time since late 2014 (i.e. before the fall in oil prices began to diminish government revenue streams). Revenues were also up in real terms from last year, but still far lower than in many previous years.

Most of the growth in revenues came from oil & gas tax revenues that jumped by one half from their bottom in 1Q16. The key driver was higher oil prices, which were up in dollar terms about 60% y-o-y in the first quarter. On the other hand, the considerable on-year rise in the ruble’s exchange rate limited the increase of oil & gas revenues in rubles (the taxes are essentially based on dollar pricing of oil & gas).

Other federal budget revenue streams also showed substantial gains in the first quarter that clearly outpaced inflation. Budget revenue streams from value-added taxes, which go entirely to the federal budget and are a major pillar of the federal budget’s non-oil revenues, increased briskly. The same happened also with the rest of non-oil revenues.

Federal budget spending has increased quite moderately from its lows in early 2016, even with pensioners this year receiving their sizable one-time pay-out from the federal budget. In real terms, first-quarter spending was much lower than in several years preceding 2016. Defence spending fell markedly from 1Q16. On the other hand, at the end of last year the defence industry received a grand sum paid out from the budget for paying off a large part of their existing bank loans, which was aimed at creating more room for new borrowing by the defence industry.

From the standpoint of Russian domestic businesses, a stronger ruble reduces their price competitiveness with respect to imports, but also lowers the cost of imported technologies and intermediates. Recent surveys show that most Russian manufacturers are relatively highly dependent on imports. Ruble appreciation also reduces the costs of foreign debt service for firms.
China

Industrial output and government spending spurs Chinese economic growth in Q1. China’s National Bureau of Statistics reports GDP grew by 6.9 % y-o-y in the first three months of 2017. A robust growth legacy from the last three quarters of 2016 was sufficient to produce a slight uptick in the growth, even as growth in the first quarter of 2017 was on annualized basis just over 5 %.

Industrial output, lifted by the recovery in heavy industry and the booming housing market, rose by nearly 8 % y-o-y in March. Steel production hit an all-time high in March, even if it appears that demand failed to keep up with supply. Measured by floorspace, the volume of completed buildings increased 15 % y-o-y in 1Q17, while sales were up by 20 %.

Real growth in fixed asset investment (FAI) slowed to 5 % in the 1Q17. The drop was largely due to a slowdown in public investment spending growth from last year to 8 %. Private investment rose 3 % in real terms. Even with a pick-up in March, real growth in retail sales grew by just 9 % y-o-y in the first quarter. The slowdown in growth reflected lower car sales caused by a change in tax rules at the start of the year.

First-quarter economic figures can be interpreted in several ways. Structural change of the economy seems to be proceeding as 77 % of growth was generated by consumption (65 % in 2016), while investment contributed just 18 % of growth (42 % in 2016). Government consumption seems to have picked up. Public sector expenditure was up 21 % y-o-y in the first quarter, while household disposable incomes rose by 7 % in real terms. External demand recovered and the reported contribution of net exports to growth turned positive again.

Nevertheless, growth is still largely financed with new debt. Especially, financing from the shadow banking sector increased rapidly. The latest burst of economic growth has no sustainable basis, however, so it is critical that policymakers take advantage the current economic tailwind to rein in the growth of indebtedness and implement economic reforms. Economic growth at the end of the year is expected to slow and the real estate boom should subside as cities implement additional measures to slow rising housing prices.

IMF raises its growth outlook for China, but warns of dangers ahead. The IMF released its latest World Economic Outlook (WEO) this week. For the global economy, the April 2017 forecast remains basically unchanged with the global economy expected to grow by about 3.5 % p.a. in both 2017 and 2018. The IMF slightly raised its forecast for Chinese GDP growth to 6.6 % this year and 6.2 % in 2018. The strong growth outlook for China assumes that the current debt-fuelled policy support will remain in place as China seeks to meet current official growth targets. However, the IMF warns that China’s current policies encourage inefficient use of resources and raise the risk of disruptive adjustment in the medium term. The IMF expects the Russian economy to grow by 1.4 % p.a. this year and next, which is slightly higher than its January forecast.

Robust 1Q growth in Chinese goods imports. China Customs reports that the dollar-value of goods imports increased by 23 % y-o-y in the first quarter. Similar robust growth figures were last seen in 2011. Exports also rose in the first quarter, but at a rate distinctly lower than imports. Thus, the trade surplus shrank considerably. High growth was also seen in the volume of imports, which rose by nearly 20 % in January-February. Export volumes were up nearly 5 %.

It is challenging to identify any specific factors behind the current revival in imports; the growth in Chinese imports stretches across the board. Looking at the various goods categories, imports of machinery & equipment were up sharply. Import growth of key commodities such as crude oil, coal, pulp and certain farm products was also brisk. By country, imports from nearly all of China’s main trading partners saw strong gains. The value of imports from the EU increased by 15 %, by 30 % from the US and by 20 % from Japan. Imports from many emerging economies also showed vigorous growth. In contrast, the value of imports from Hong Kong in the first quarter shrunk by half from a year earlier. Much of this is believed to reflect improved enforcement and oversight of capital controls last autumn. The Chinese have long used goods trade as a means for circumventing capital controls.

China’s quarterly USD-based goods trade growth and trade balance

Sources: Bloomberg and BOFIT.
**Russia**

**New information on Russian industrial output.** Rosstat has released more data based on new industrial branch classifications and other statistical changes. The new data now reach back to the start of 2014. The new figures show that Russian industry as a whole almost avoided a downturn over the past two years and only experienced a rather small contraction of production in 2015. Rosstat earlier this year laid out the reasons for its industrial output data changes (BOFIT Weekly 9/2017).

During the economy’s recession, mining and quarrying (or extractive industries) all the time showed growth that was slightly higher in the new data. Figures on production and supply of electricity, gas fuel & heating were revised upwards.

The new figures show that the downward slide in manufacturing output in 2015 was quite moderate, although the situation has deteriorated this year. Output performed better in many manufacturing branches in 2014–2016 than the old situation has deteriorated this year. Under the old classification, GDP is just 21 %. Government investments (state, regions and municipalities) have shrunk. In 2015–2016, investments of fully private and joint private-state firms have also declined. Except in 2015, investments of fully foreign-held firms have fallen sharply. In contrast, investments of joint firms of Russian and foreign owners have risen, especially in 2016 when the joint venture investment boom was driven entirely by investments in the natural gas sector (Yamal LNG project). Private domestic firms accounted for 55 % of total investments. The government’s share has fallen to below 20 %.

**Nominal growth of private sector and government investments**

<table>
<thead>
<tr>
<th></th>
<th>Total investments</th>
<th>Government including regions and municipalities</th>
<th>Fully or partly private Russian firms and other investors</th>
<th>Fully or partly foreign-owned firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>2013</td>
<td>15</td>
<td>15</td>
<td>15</td>
<td>15</td>
</tr>
<tr>
<td>% change of the value in rubles</td>
<td>10</td>
<td>10</td>
<td>10</td>
<td>10</td>
</tr>
</tbody>
</table>

Source: Rosstat.

**Russia announces changes in banking supervision and restructuring troubled banks.** The weeding out of weak players in the banking sector has meant that the amount of support funds needed by Russia’s Deposit Insurance Agency (DIA) has grown continuously as the DIA has received an increasing number of deposit insurance claims for failed banks, and has dealt with the costs of terminating or restructuring sick banks. Since the end of 2015, the DIA has largely relied on Central Bank of Russia funding to cover its liabilities. In 2016, CBR loans covered about 70 % of the DIA’s 660 billion rubles (about €9 billion) in expenditures. The Duma last week approved a bill that will shift the responsibility for dealing with troubled banks to the CBR. The change is hoped to improve the effectiveness of bank restructurings and slow the pace of rising costs.

At the same time, the Duma approved a law on changes in bank licensing. From the start of 2018, banks will have either general or basic operating licences. A basic licence grants the right to engage in limited banking activities, and reduces the supervisory burden. The minimum capital requirement is 300 million rubles for a basic licence and 1 billion rubles for a general licence. Banks operating on a basic licence are believed to focus on regional banking and financing small and medium-sized firms. Banks with equity exceeding 3 billion rubles must have a general licence and are subject to full supervision. Russia had about 160 such banks at the beginning of March. The reform should clarify supervision and allow supervision to focus on the systemically important banks. The law includes a 1-year transition period.

The Duma quickly passed both bills on unanimous votes, signalling broad political support.

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**Output growth in largest industrial branches, 2014–2017**

<table>
<thead>
<tr>
<th></th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total industrial production</td>
<td>2.5</td>
<td>-0.8</td>
<td>1.3</td>
<td>0.1</td>
</tr>
<tr>
<td>(before new classification &amp; other changes)</td>
<td>1.7</td>
<td>-3.4</td>
<td>1.1</td>
<td>0.1</td>
</tr>
<tr>
<td>Mining and quarrying</td>
<td>1.7</td>
<td>0.7</td>
<td>2.7</td>
<td>1.2</td>
</tr>
<tr>
<td>(before new classification &amp; other changes)</td>
<td>1.4</td>
<td>0.3</td>
<td>2.5</td>
<td>0.3</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>3.2</td>
<td>-1.3</td>
<td>0.5</td>
<td>-0.8</td>
</tr>
<tr>
<td>(before new classification &amp; other changes)</td>
<td>2.1</td>
<td>-5.4</td>
<td>0.1</td>
<td>0.1</td>
</tr>
<tr>
<td>- food industry, excl. beverages and tobacco</td>
<td>4.9</td>
<td>3.1</td>
<td>3.1</td>
<td>2.4</td>
</tr>
<tr>
<td>- oil refining (and coke production)</td>
<td>6.1</td>
<td>0.9</td>
<td>1.7</td>
<td>1.8</td>
</tr>
<tr>
<td>- chemical industry, excl. pharmaceuticals</td>
<td>2.3</td>
<td>5.8</td>
<td>6.3</td>
<td>7.5</td>
</tr>
<tr>
<td>- construction materials industry</td>
<td>1.1</td>
<td>-6.1</td>
<td>-6.0</td>
<td>2.9</td>
</tr>
<tr>
<td>- metal industry</td>
<td>7.2</td>
<td>4.0</td>
<td>-1.0</td>
<td>-8.9</td>
</tr>
<tr>
<td>- metal product industry</td>
<td>4.5</td>
<td>3.5</td>
<td>1.3</td>
<td>-6.4</td>
</tr>
<tr>
<td>- machinery and equipment, excl. electrical</td>
<td>7.9</td>
<td>-4.7</td>
<td>-0.7</td>
<td>8.2</td>
</tr>
<tr>
<td>- car industry</td>
<td>-11.3</td>
<td>-23.1</td>
<td>0.5</td>
<td>13.5</td>
</tr>
<tr>
<td>- installation &amp; repair of machinery and equip.</td>
<td>-5.6</td>
<td>-5.7</td>
<td>-11.4</td>
<td>2.0</td>
</tr>
<tr>
<td>Production and supply of electricity, gas fuel &amp; heating</td>
<td>1.0</td>
<td>-1.0</td>
<td>1.7</td>
<td>1.3</td>
</tr>
<tr>
<td>(before new classification &amp; other changes, including water &amp; waste water services)</td>
<td>-0.1</td>
<td>-1.6</td>
<td>1.5</td>
<td>-1.0</td>
</tr>
</tbody>
</table>

Source: Rosstat.
China

IMF concerned about sustainability of China’s financial system; China changes its tune on financial risk.
The IMF’s latest Global Financial Stability Report suggests that the risks to China’s financial system are still rising. Indebtedness continues to soar as meeting official growth targets requires on-going debt-fuelled stimulus. Vulnerabilities of the financial system are highlighted by the fact that financial institutions rely on extremely short-term market financing to cover their long-term liabilities. Thus, financial institutions are quite susceptible to changes in money market rates. In addition, the structure of the financial sector has become more complex as the shadow banking sector provides means to increase leverage through various financial chains. The IMF would like to see China make special efforts to supervise smaller banks and the shadow banking sector, as well as focus its attention on possible contagion problems in the interbank markets. The policy contradiction between the need for deleveraging and high growth targets must be resolved. The IMF said that it is as urgent as ever to solve the debt problem as the likelihood of a major financial crisis increases the longer action is postponed and the larger is the size of the debt.

The Chinese have become far more serious about rising financial market risk in recent weeks. In a speech to the politburo this week, president Xi Jinping stated that government should attach great importance to ward off any financial risks and make sure there are no systemic risks. Since Guo Shuqing took over as chairman of the China Banking Regulatory Commission (CBRC) at the end of February, banking rules have been tightened and oversight increased. For example, the CBRC has tried to crack down on shadow banking operation designed to evade banking regulation and banned certain types of complex financial arrangements. Issuance of certificates of deposit on the interbank market has been restricted and banks are required to provide more information than earlier to officials. Officials last week announced that they would begin to reassess collateral and loan guarantors. A number of cases have emerged in recent months in which companies have cross-guaranteed each other’s loans.

The growth of Chinese debt remained brisk in the first quarter of this year. The stock of total social financing, China’s broader concept of credit, grew by 12.5% y-o-y. The strong growth in bank lending remained steady overall, even if lending by the shadow banking sector accelerated to its highest growth level in two years. Some observers expect the new measures to restrain the growth of indebtedness. However, hitting growth targets requires rapid debt growth. In any case, disturbances like those seen before are likely to continue on China’s financial markets.

China keeps the yuan-dollar exchange rate steady. Already for a long time, the growth in the amount of Chinese debt and volatility on financial markets has increased depreciation pressures on the yuan’s exchange rate. At the end of last year, Chinese officials significantly tightened rules on buying foreign currency and capital controls to stem forex outflows and alleviate some of the more immediate depreciation pressure on the yuan. The restrictions have helped the People’s Bank of China keep the yuan’s exchange rate extremely stable in the first quarter around 6.9 yuan to the US dollar.

The current situation gave the US no ground for portraying China as a currency manipulator in the US Treasury Department’s report published in April.

Yuan CFETS, REER and USD exchange rate

![Graph showing Yuan CFETS, REER and USD exchange rate]

Source: Macrobond.

Industrial prices rising quickly in China. With the decrease in prices of fresh foods, the rise in consumer price inflation, remained below 1% in February and March. Core inflation (energy and food prices removed) stayed around 2%.

Lifted by rising commodity prices, Chinese producer prices rose 8% y-o-y in March. The month-on-month rate of increase has slowed, however. Commodity prices were exceptionally low at the start of 2016, so their base impact the start of this year on inflation will moderate as this year proceeds. Import prices were up 14% y-o-y in March, while export prices were up 5%. The rise in industrial prices was also apparent in China’s GDP deflator (difference between nominal and real GDP growth), which was up 5% in the first quarter.

Chinese price trends

![Graph showing Chinese price trends]

Sources: Macrobond and BOFIT.
Russia

Russian central bank lowers key rate again. At its regular meeting on April 28, the Central Bank of Russia Board decided to lower the key rate by 50 basis points to 9.25 %, effective May 2. The CBR justified the cut by pointing to a considerable slowing in inflation and lower inflation expectations. The CBR had earlier cut its key rate by 25 basis points on March 27.

The CBR added that its assessment of potential further rate cuts this year is unchanged. However, it did not note when the next cut might be possible. The CBR expects 12-month inflation to reach its 4 % target by the end of this year and remain close to the 4 % in 2018–19. The economy is expected to grow in 2017–19, even if the average oil price falls by $10–15 from its current level of around $50 a barrel. The next regularly scheduled CBR Board key rate meeting is set for June 16.

Change in the law pushes millions of Russians into Mir payment cards. At the start of the week, president Putin signed legislative amendments, whereby wages paid from government budgets and many social benefits like pensions must be paid to accounts linked to Mir payment cards (or no card whatsoever or a cash disbursement). The change goes into effect in full on July 1, 2018, but includes a longer transition for pension payments. Under the amendments, all banks must be able to accommodate Mir charge cards in e.g. their automatic tellers, and all businesses with net sales of more than 40 million rubles (about €650,000) must accept Mir cards.

The project to create a national payments system with payment cards was given a boost in spring 2014 after international sanctions were imposed on some Russian banks. The first Mir cards were introduced at the end of 2015. The CBR is currently the sole owner of the company administering the national payments system and Mir cards. The law specifies that the CBR must maintain a majority stake in the company. Over 70 Russian banks now issue Mir cards, and over 5 million Mir cards have already been issued. The use of Mir cards outside Russia remains limited. Currently Russian banks issue co-badging cards only with two foreign systems (Maestro and JCB), but Mir has announced it has reached deals with American Express and UnionPay, and is in talks with other majors such as Visa and Mastercard.

Russian defence spending has increased rapidly. The annual global military spending report from the Stockholm International Peace Research Institute (SIPRI) finds that the ratio of government defence spending to GDP in Russia reached 5.3 % last year. Fresh figures from the Russian Gaidar Institute for Economic Policy (IEP) indicate that defence spending rose to 5.7 % of GDP last year. Russia’s finance ministry figures also show that the defence-spending-to-GDP ratio rose to 4.4 %, the highest level since the early 1990s.

Notably, 2016 defence spending includes budget money given to the defence industry (OPK) intended for early repayment of bank loans granted from 2011 onwards to OPK with federal guarantees. The federal accounts chamber reports the amount paid from the budget for the repayment exceeded 1 % of GDP. If this amount is excluded, defence spending fell markedly last year even in nominal rubles. However, the to-be-paid-off OPK loans in fact earlier came on top of the rapid growth in defence spending, especially during 2013–14.

The differences in defence spending numbers reflect the fact that SIPRI and IEP include items in other budget spending categories outside the budget’s defence category such as domestic security, the economy and social security. IEP figures also include e.g. budget spending on earlier defence activities such as weapons destruction costs, which SIPRI does not treat as defence spending.

In SIPRI’s international comparisons, Russian defence spending has grown rapidly in recent years. Spending in 2016 hit $69 billion. China’s defence spending has also climbed briskly, even if the spending growth slowed last year to below 5.5 %. SIPRI estimates Chinese spending last year at $215 billion and says that its estimates for recent years have been running at about 1.5 times China’s official defence budget. Even so, SIPRI noted that Chinese defence spending relative to GDP was still less than 2 %. China recently launched the first Chinese-built aircraft carrier.

SIPRI reports global military spending in 2016 reached nearly $1.7 trillion. US spending alone amounted to $611 billion, an increase after several years of decline. The US defence-spending-to-GDP ratio was 3.3 %. Growth in India’s annual defence spending leapt to 8.5 %, putting it together with France as regards the nominal dollar level of spending. Both countries spent about $56 billion last year on defence, giving both a defence-spending-to-GDP ratio of just under 2.5 %. SIPRI reports that nearly all countries of Central and Eastern Europe, the Baltics and Ukraine have increased their defence spending rapidly in recent years. Defence spending also rose briskly in all but a few countries in Western Europe.

Russian defence-spending-to-GDP ratio, %

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

China announces tax cuts but corporate taxation overall remains high. China’s tax code reforms last year involved bringing the remainder of service branches under the value-added tax (see BOFIT Weekly 18/2016). At the end of April, the State Council announced the elimination on July 1 of the 13% VAT category, which includes agricultural products and natural gas. Both product groups shift to the 11% VAT category, and just three VAT categories remain: 6%, 11% and 17%.

Tax cuts on small firms were broadened at the start of the year and the tax-deductibility of R&D spending by certain scientific and technology firms has been extended for three years. Firms with taxable earnings of less than 500,000 yuan a year are now eligible for a tax break that allows them to pay a 20% corporate tax on half of their earnings. The earlier ceiling for taxable annual earnings was 300,000 yuan. Some other temporary tax break programmes also continue.

The government estimates that its announced reforms will reduce the tax burden on firms and individuals this year by 380 billion yuan and reduce various payments by a total of 200 billion yuan. In March, premier Li Keqiang said that the move from the business tax to VAT reduced the tax burden on firms last year by a total of 570 billion yuan (€76 billion). However, combined VAT and business tax revenues increased last year by 4% to 5.22 trillion yuan.

While China’s 25% corporate tax rate does not differ much from other countries, companies operating in China encounter other charges and fees that raise costs. The World Bank estimates that China’s total tax rate of 68% of commercial profits in 2016 (when mandatory contributions are factored in) is one of the world’s highest. The World Economic Forum global competitiveness report finds China’s rank near the bottom for indicators relating to business tax rates and the amount of red tape involved in starting a business. The problem has gotten traction lately and firms have begun to express dissatisfaction with the current situation. In February, the State Council directed government departments to examine their fees and other costs imposed on firms and eliminate those they find superfluous. The government hopes to have a nationwide list of fees levied on firms by the end of the year, as well as clear rules on when such fees are mandated.

China’s business environment increasingly challenging to American firms. AmCham China, the American Chamber of Commerce in China, released its annual report on the business climate for US firms operating in China. AmCham finds the current conditions exceptionally challenging for firms: political tensions between the US and China have increased over the past year, China’s economic growth has slowed, and the investment climate has deteriorated. AmCham estimates that the pace of reform and opening up of China to the outside world have slowed. In addition, domestic firms are being supported by several government programmes, eroding foreign firms’ room to operate.

AmCham said that all parties benefit when trade is as free as possible, business is based on market principles and firms have easy access to markets. The Chamber of Commerce hopes that China would open its markets even more to foreign entities and move ahead with talks on bilateral investment treaty. The report noted that US firms see China’s unclear laws and inconsistent regulatory interpretations as one of the largest challenges facing US firms. AmCham proposes improving the situation through better information distribution on e.g. court rulings and official investigation reports, as well as clarification of customs and tax regulations. It also noted room for improvement in allowing firms to comment on draft legislation and regulations.

Lower growth of car production in China. In the first quarter of 2017, China produced 6.1 million passenger cars, an increase of about 7% from 1Q16. The rate of production growth is slowing down, however. China last year produced nearly 25 million passenger cars and almost 4 million trucks and buses.

Car sales in the first quarter were up 5% y-o-y. Chinese car sales and production go hand in hand as less than 2% of production is exported and less than 4% of cars sold in China are imports.

Part of the burst of growth in passenger car production and sales in the second half of 2016 reflected the known tax hike on January 1st 2017. As part of stimulus policies, small-engine car buyers were entitled to a tax break last year that meant they only paid a 5% sales tax on the car. The sales tax is 7.5% this year and 10% next year.

Even if imported cars account for a tiny share of the Chinese market, foreign brands dominate the market. Less than half of cars sold in China are domestic makes. Foreign carmakers must engage in joint ventures with Chinese firm because foreign firms can only own up to 50% of a production plant in China. Bloomberg reports that this limitation might be loosened as a part of efforts to make state-owned enterprises more efficient and response to pressures for open markets. The car industry’s future is further affected by planned producer-specific minimum quotas for electric vehicles.

China’s annual passenger car production and foreign trade

![Graph showing China’s annual passenger car production and foreign trade](image)

Source: CEIC.
Russia

Inflation slows in Russia. April 12-month consumer price inflation was 4.1%, slightly lower than the first-quarter pace (4.5%). Inflation was running at 5.4% at the end of 2016. The rise in consumer prices peaked at around 17% in spring 2015 after the sharp fall of the ruble in late 2014 and early 2015 led to a spike in consumer and producer prices. Over the past two years, the pace of inflation has slowed gradually due to the ruble’s exchange rate recovery, two consecutive bumper grain harvests and the Central Bank of Russia’s reconfiguration of monetary policy that has set inflation targeting as its objective.

The CBR’s inflation target remains 4% by the end of this year. Given the high inflation episodes of the past two decades, however, inflation expectations remain considerably higher than the inflation target. Expectations have also softened somewhat in recent months, providing the CBR with room to lower rates (the key rate is currently 9.25%). Nevertheless, real interest rates in Russia are historically high, with the nominal average rate on corporate loans of under a year’s maturity above 11%.

12-month inflation and average interest rate on corporate loans, %

Sources: CBR and Rosstat.

Russian defence industry continued to show fast growth last year. Preliminary figures show that production of military and civilian products by Russia’s defence-industrial complex (OPK) increased by over 10% in real terms last year, even if the pace of growth slowed from the previous three years. Despite the rapid growth of the OPK, manufacturing overall, which includes OPK, has shown sluggish growth and even contraction in recent years. In fact, during 12 of the past 15 years growth of OPK production has been much faster than overall manufacturing growth.

Within the OPK, production of military products increased substantially faster than civil industry for over a decade. Unlike the military industry, the civil industry was not spared large drops in production during the Russian economy’s recession years of 2009 and 2015. Production intended for civilian use amounted to just 17% of OPK production in 2016, down from about 45% in the mid-2000s.

Boosting OPK production by about 9% a year, and bringing growth in OPK’s civilian production to 5% a year is the aim of the 2016–2020 OPK development programme approved a year ago by the government. While this year’s federal budget would reduce defence spending to below the 2016 level, Russia’s defence ministry has pointed out that the cuts do not affect the armament programme. Prime minister Dmitry Medvedev recently noted that the share of civilian production in the OPK is intended to increase notably in the 2020s.

The OPK employs about 2 million people, of which over 1.4 million work in the defence industry. Estimates put the share of OPK in Russia’s total industrial output at 5–6%.

Real growth of the defence-industrial complex and total manufacturing output

Sources: Industry ministry, Federalnyj spravochnik and Rosstat.

Russian authorities reconsidering the idea of virtual currency. Russian officials have earlier viewed the concept of virtual currency with scepticism. In spring 2016, for example, the finance ministry proposed a bill that included a fine of up to 2.5 million rubles (€34,000) and 7 years in prison for those caught using virtual currency. The proposal was premised on the ideas that virtual currency represented a threat to the financial system and was potentially connected to crime. Experts in the field and at the justice ministry responded with critiques of the proposal. In autumn 2016, the proposal was in practice withdrawn as it was on indefinite hold.

Russian officials this year have warmed to the idea of virtual currency. In February, CBR deputy governor Olga Skorobogatova said a national virtual currency could be possible in the future. Last month, deputy finance minister Alexei Moisyev said authorities could recognize bitcoin and other virtual currencies as legal tender as early as 2018. One reason for using a virtual currency would be preventing illegal money transfers. However, no final decision on regulation of virtual or cryptocurrencies has been taken yet.
China

Rates rise as China attempts to quell rising indebtedness. Money market rates have risen in all maturity classes. The overnight Shibor rate in May has averaged 2.8 %, up from 2.2 % in January. In addition to higher interest rates, the volatility of interbank repo rates has increased. Shibor rates are calculated from rates quoted by 18 highest-rated commercial banks, while the repo rate is based on the average rate of completed transactions. Over the past six weeks, the People’s Bank of China has stepped up open market operations to increase market liquidity and reduce pressure to further rate increases.

Financial market risks have been put in the spotlight in recent weeks by president Xi Jinping and supervisory officials announcing stricter guidelines. The shift has been manifested in lower liquidity on the interbank markets and efforts to take a stronger stance on risks created by the shadow banking sector. The China Banking and Regulatory Commission (CBRC) this month issued new guidelines on increased supervision of collateral used to secure loans.

The PBoC this year revised its macro prudential assessment framework to include wealth management products for the first time as part of banks “broad credit.” Banks have used wealth management products to increase their income through off-balance-sheet lending to “wealth” managers for reinvestment. While these products have higher returns than bank deposits, investors generally have a poor grasp of the associated risks. The market for wealth management products last year reached 29 trillion yuan (39 % of GDP), double its valuation at the end of 2014.

The rise in interest rates is also visible in bond markets, where the yield on the one-year government bond has risen from 2.7 % in January to 3.5 % this week. Yields on corporate products last year reached 29 trillion yuan (39 % of GDP), double its valuation at the end of 2014.

The rise in interest rates is also visible in bond markets, where the yield on the one-year government bond has risen from 2.7 % in January to 3.5 % this week. Yields on corporate and local government bonds are also rising. Real interest rates have risen faster than nominal rates this year due to low consumer price inflation at the start of the year. Consumer price inflation was 1.2 % in April, while producer prices rose on-year by 6.4 %, even if they declined on-month.

7-day interbank offered and repo rates; PBoC reverse repo rate used in open market operations

Central government increases scrutiny of local government borrowing arrangements. The Chinese media outlet Caixin reports that officials established a new system for oversight of local government indebtedness at the beginning of May. The arrangement seeks to take a pro-active approach to reducing systemic risk. Six major agencies and commissions are involved in the supervision effort.

Even as the central government has tightened local government budget policy and borrowing, local officials keep devising new ways to avoid scrutiny and take on new debt. Caixin’s list of recent avoidance tactics included public-private partnerships (PPP), use of various funds for bond issues and procurement contracts that effectively increase the local government’s debt load. The new rules limit the use of such gimmicks.

The IMF estimated last summer the total debt of local administrations and their financial vehicles was on track to exceed 33.4 trillion yuan ($4.8 trillion), or 42 % of GDP, by the end of 2016. The PBoC put the combined debt of central and local governments (including their financial vehicles and other off-budget borrowing) at about 60 % of GDP.

Slight drop in Chinese share prices. Share prices on Chinese exchanges have been relatively stable since early 2016 and volatility this year has been exceptionally low. In recent weeks, however Chinese stock indices have fallen, largely on lower share prices for industrial firms. The Shanghai A-index is now 1 % lower than in the start of the year and the Shenzhen A-index is down 8 % for the year. This week there were a reminder of the heavy-handed role of officials in Chinese stock markets. Bloomberg reports that officials are keeping an eye on large investors and have ordered funds operating in domestic stock markets to be prepared to act if there are any surprises in the lead up to the Silk Road summit on May 14–15.

MSCI, a leading provider of international stock indices, is reconsidering whether to include Chinese A-shares in its Emerging Markets Index. A new twist is that the index could initially include only a limited selection mainland China shares traded in Hong Kong under the Stock Connect programme. The weight of Chinese shares in the index could start out small and increase gradually over time. Even so, it would be the first time that mainland Chinese shares were included in a major international stock index.

Stock market trends in China and Hong Kong

Sources: CEIC and Macrobond.
Russia

**Russian GDP growth remains positive.** Rosstat’s first estimate shows 0.5% y-o-y GDP growth in the first quarter. The growth pace supports earlier reports from the economy ministry and central bank that the revival of seasonally adjusted GDP growth that gradually began in 2016 went on in 1Q17. Rosstat emphasized that the figure was preliminary, which partly reflects the earlier discussion in Russia about complexities in implementing its new GDP methodology.

The 4-quarter GDP growth figure is fairly good considering that first-quarter industrial output was essentially unchanged from a year earlier and that construction and retail sales decreased. Goods transport and wholesale trade, on the other hand, saw strong growth. Moreover, making early estimates of GDP growth is complicated by the fact that monthly data are not collected for real estate sector operations or public sector activities such as administration, healthcare and education, which together represent a third of GDP. From the demand perspective, GDP growth has been supported by buoyant gains in Russian export volumes.

**Real growth of Russian GDP and five core sectors**

![Graph showing real growth of Russian GDP and five core sectors]

**Brisk growth in Russian foreign trade.** Russian goods trade in the first quarter saw increases with nearly all trading partners across all main product categories. The value of exports exceeded $80 billion, while imports reached nearly $50 billion. The value of both exports and imports was still about a third less than in the peaks of 1Q12 and 1Q13.

The value of goods exports rose 36% y-o-y in dollar terms, mainly on higher oil prices. Export volumes also increased in nearly all major goods categories. Growth in crude oil exports was less than 1%, while exports of petroleum products turned to a growth of 7% and exports of natural gas grew by 10%. In addition, export volumes of many metals, fertilisers and wood products increased on year. Half of goods exports went to EU countries, about 20% to Asia and 10% to countries in the Eurasian Economic Union.

The value of goods imports in dollar terms rose 36% y-o-y in the first quarter. Imports of chemical products and machinery, equipment & transport vehicles climbed by nearly 30% y-o-y. The value of food imports was up 16% y-o-y. EU countries provided 37% of imported goods, Asian countries 34% and Eurasian Economic Union members 8%.

**Quarterly value of Russian imports in largest product groups**

![Graph showing quarterly value of Russian imports in largest product groups]

**EBRD continues financing freeze on Russian projects.** The majority of shareholders in the European Bank for Reconstruction and Development (EBRD) decided in summer 2014 to halt any new projects in Russia in response to Russia’s annexation of Crimea and its involvement in the conflict in Eastern Ukraine. Disbursements under earlier EBRD financial commitments, however, were allowed to continue.

Russia already previously asked to have the decision reversed. Bringing the matter to the EBRD annual meeting this month resulted in a vote where an overwhelming majority of the bank’s 67 shareholders (65 countries plus the EU and the European Investment Bank) found that the financing freeze on Russia complied with the EBRD’s rules. Media reported that three CIS countries and Mongolia joined Russia in seeking to overturn the decision, with two CIS countries abstaining from voting. Russia holds a 4% stake in the EBRD and has a 4% voting share.

At his address to the annual meeting, economy minister Maxim Oreshkin explained how Russia saw the restriction as violating the EBRD articles of establishment. Oreshkin said that the bank’s income, 30% of which has come from Russia in recent years, would be reduced by keeping the financing ban in place. Less officially, Oreshkin suggested that the current situation would make the EBRD’s AAA credit rating questionable, and Russia would draw the attention of credit rating agencies to the slide in the bank’s income from Russia. The EBRD has financial commitments to Russia of €3.7 billion (less than 10% of the bank’s total commitments). In 2012, financing commitments to Russia exceeded €10 billion (26%). Of the projects in Russia with EBRD participation, 84% are in the private sector. The EBRD was established in 1991 to support progress towards market-oriented economies in the bank’s countries of operation that today comprise over 30 countries in Central and Eastern Europe, Central Asia, and the Eastern and Southern Mediterranean.
China

Rate of China’s output slowed in April. National Bureau of Statistics figures show that on-year GDP growth accelerated to 6.9% in the first quarter, but several indicators last month suggested again a slowdown in on-year growth. For example, industrial output growth fell to 6.5% in April, due in part to a 3% y-o-y drop in passenger car production. For the first four months of the year, car production was still up nearly 5% compared to the same period in 2016. Despite a slight slowdown from March, retail sales volumes were still up nearly 10% y-o-y in April.

The growth in urban fixed asset investment (FAI) is a significant monthly demand-side item, as it should reflect the capital formation component of GDP growth. Nominal 12-month growth in the value of urban FAI slowed in April on sharply lower growth in private investment. If a cautious rise in prices of investment goods is assumed, real growth of FAI was only about 4% y-o-y. Moreover, realised on-year growth in investment in January-April slowed from over 12% in 2016 to below 5% in 2017.

Because capital formation still has larger weighting than private consumption in total demand, it is harder for private consumption to take up the slack in GDP growth when investment growth slows. Moreover, the trend in disposable incomes gives no indication of further acceleration in the already rapid rise in household consumption demand. Foreign trade (net exports) presently plays a minor role in the Chinese GDP trend. The volume of goods imports also increased faster than exports in the first quarter.

China’s industrial output, retail sales and fixed investment

![Graph showing real 12-month change in industry, fixed asset investment, and retail sales from 2012 to 2017.](image)

Sources: Macrobond, CEIC.

United States and China announce limited measures to promote more open markets. During president Xi’s visit to the US last month, the countries agreed to engage in talks over the next 100 days on reducing barriers to trade. Last Thursday (May 11), during the lead up to this week’s Silk Road summit, the United States and China issued a 10-point itemisation of breakthroughs in the current talks. Most of the achievements were broadly formulated and several were already agreed in principle.

Hard dates were set for when China will begin to allow imports of US beef and credit card companies will be allowed to file for operating licences in China. China also promised to allow foreign companies to provide credit ratings services and accelerate application processing for permits to import of genetically modified grains. Correspondingly, the US will allow the import of cooked poultry from China and export of liquefied natural gas to China. In addition, the United States formally recognised China’s Silk Road project and sent an official delegation to the summit last weekend.

These small advances are largely seen as an indication of the willingness of the two economic giants to cooperate, thereby reducing fears of a trade war between the two countries. China and the US are considering extending the 100-day trade talks to a year. Companies on both sides of the Pacific are withholding judgement on talks until they see more concrete outcomes.

China’s Silk Road project moves ahead. The “One Belt, One Road” (OBOR) summit was held in Beijing on May 14–15. The meeting featured delegations from over 100 countries, as well as the IMF, the World Bank and UN leadership. President Xi Jinping called OBOR the “project of the century,” as OBOR seeks to significantly increase investment in infrastructure and cooperation in Asia, Europe, as well as eastern and northern Africa. During the meeting, China promised a total of 580 billion yuan ($84 billion) in new funding for OBOR projects to be channelled via the Silk Road Fund, the Asian Infrastructure Investment Bank (AIIB) and China’s policy banks. China will also set up a separate investment fund to provide financing for projects that support cooperation in northeast China and the Russian Far East.

The OBOR project is basically an umbrella term covering a range of potential projects rather than a well-defined list of actual investment projects. To date, at least 1,700 projects have been started or green-lighted in OBOR’s name and have been allocated hundreds of billions of yuan in credit. The cost of financing is cheap. While some projects would very likely be implemented without OBOR support, others seem to lack viable economic basis.

China emphasises the economic benefits of the OBOR project will benefit all participating parties. At the same time, it is clear that the project increases Chinese influence in the region and creates demand for products made by branches in China now suffering from overcapacity. The OBOR project has been criticised for its lack of transparency and lop-sided treatment of foreign companies willing to participate in projects. As a result, numerous countries including Germany and France were unwilling to sign all of the summit’s final communiques. The project is not considered as a geopolitical smash hit by all parties. India boycotted the summit and criticised the project as neo-colonialism. Russia is concerned that the project will increase Chinese influence in several former Soviet Union countries.


Russia

Domestic demand in Russia recovers. Rosstat reports that the seasonally adjusted volume of retail sales increased slightly in April. Sales were the same as a year ago. Because the recovery was preceded by a 27-month slide in retail sales, the retail sales volume in April was still nearly 15 % less than in April 2014. Although the construction sector continued to struggle, first-quarter fixed investment was distinctly higher (2.3 % y-o-y) for the first time since Russia’s recent recession began.

Rosstat noted that seasonally adjusted and workday-adjusted industrial output increased further in April, raising the total output increase for the January-April period to 0.7 % y-o-y. Mineral extraction remained the main driver of industrial growth, with output in the first four months of the year rising by nearly 2 % y-o-y. Natural gas production was up 9 % y-o-y. The increase in manufacturing output was more modest, even if the output was slightly up in the March-April period in on-year terms.

Growth in goods transport, already climbing in the first quarter, picked up steam in April. In the first four months of the year, the volume of goods transport was up 6.4 % y-o-y. Rail transport and energy pipeline transmission, which, due to the long haulage distances, generate an overwhelming part of transport volumes, have experienced strong growth.

Russian youth unemployment near European average. Russia last year had about a million unemployed persons between the ages of 15 and 24. The youth unemployment rate was 16 %, while the overall unemployment rate was below 6 %. Most young people do not participate in the labour force as they are full-time students, so the share of unemployed in the total 15–24 age cohort was about 6 %. A broader concept than unemployment, “not in education, employment or training,” or NEET, comprises young people who do not study or work and thus face a higher risk of social exclusion. Russia had over 2 million NEET youth in 2015, which was about 12 % of the 15–24 age cohort. Slightly over half of unemployed young people were male, but most economically inactive NEET youth were female. The average youth unemployment rate in EU countries last year was 19 % and the share of NEET youth was 12 %.

A recent report from the Center for Strategic Research found that the share of NEET in Russia’s youth has fallen notably over the past two decades, largely due to increased participation in education. With the rise in the general level of education, however, the share of more highly educated in unemployed and NEET youth has also grown. Graduates of poorer vocational training institutes and young people living in rural areas face a heightened risk of falling into the NEET category. The level of Russian vocational training has received criticism recently. For example, a recent survey of Russian industrial firms found that half of respondents firms mentioned that graduates from vocational institutes and colleges were poorly trained or completely lacking in practical skills needed in the workplace.

Arms sales still a minor share of Russian exports. President Putin recently put the value of Russian arms exports last year at just over $15 billion, only a few per cent more than in 2015. Arms exports in 2016 accounted for about 5 % of total goods exports. The value of new export orders received last year was some $9.5 billion, a considerable drop from previous years ($26 billion in 2015 and $14 billion in 2014). Russia had about $50 billion in arms exports on its order-book at the end of last year.

The Stockholm International Peace Research Institute (SIPRI) estimates that the volume of Russian arms exports increased by 16 % last year. Much of that growth came from exports to Algeria and Vietnam, which have become Russia’s top arms exports markets after India. The volume of exports, however, was still well below the peak years of 2011 and 2012. For the past years, SIPRI has ranked Russia as the world’s second largest arms exporter after the United States, with about a 20 % share.

Russian arms exports

Source: SIPRI, Russian presidential administration.
China

China's current account surplus dwindling. China's first-quarter current account surplus this year amounted to just $19 billion, down from $45 billion in Q16. The running four-quarter surplus at the end of Q17 declined to $170 billion, which corresponded to 1.5% of GDP. Much of the drop in the current account surplus reflected a reduction in the size of the goods trade surplus, which itself was the result of higher growth in imports than exports.

The share of services imports has risen in this decade from 12% to 20% of China's current account expenditures. Most of this spending increase reflects the boom in Chinese tourism abroad. Chinese tourism spending for the twelve months ending in March exceeded $260 billion, which represented 57% of all services imports. The growth in tourism spending, however, was down from very high double-digit growth just a couple years ago, rising just 5% in the last 12 months. The slowdown in spending might partly reflect China's tighter currency controls, as some “tourism” spending is believed to be a cover for plain-vanilla capital exports.

China's earnings from services exports have represented less than 10% of current account income throughout the current decade. A fifth of the services exports income comes from tourism. Earning from tourists visiting China fell slightly last twelve months ending in March to $4.4 billion.

While the headline figures for the capital account in the first quarter have yet to be released, tighter currency controls have stemmed capital outflows to such an extent that the current account surplus is sufficient to cover capital imports. Thus, there was almost no change in China's currency reserves. As of end-March, China's total currency reserves stood at just under $3.1 trillion. Based on the goods trade and currency reserve data, China's balance-of-payments situation in April was largely unchanged from the first quarter.

Restrictions on apartment deals in Chinese cities slowed sales growth in April. The rise in housing prices in China's large cities does not appear to have slowed significantly despite restrictions. This year, several dozen cities tightened rules, including limiting the number of apartments one person may own, longer resale times to prevent “flipping” and higher downpayment requirements. The National Bureau of Statistics reports that prices of existing apartments in 70 cities were up on average about 10% y-o-y in April. Prices were lower on-year in just six cities. In some major metropolises, however, the rise in prices seems to be moderating. April prices were only up 5% y-o-y in Shenzhen, compared to over 20% in Beijing and Guangzhou.

Rising prices have boosted the value of apartment sales. In terms of floorspace, the restrictions appear to have been slowing the sales growth as the NBS reports that growth in apartment sales nationally slowed in April to 5% y-o-y, down from around 30–40% a year ago. Measured in terms of square metres of liveable floorspace, apartment building starts in the first four months of the year were up 18% compared to the same period a year earlier. Sales of land use rights increased by 8% in terms of surface area. The sale of land use rights fell during 2014–2016. The stock of apartments for sale on the market has been shrinking this year.

China's housing rental markets are fairly undeveloped and most of the population owns their own dwelling. Last week, the housing ministry released a draft of legislation concerning property sales and leasing that would improve tenant rights by encouraging longer rental periods, making it more difficult to raise rents during rental agreement period and requiring landlords to give three months notice before termination of the agreement. The proposal is open for comment.

Tighter regulation of online news providers in China. Newly announced regulations by China's Cyberspace Administration will reinforce the Communist Party's ability to police online news content. From the start of June, all producers and distributors of online news must have party-accredited editorial staff. The rules come into force at the same time as the new cybersecurity law.

The cybersecurity law has raised concern among foreign technology firms operating in China. The law mandates that foreign firms store certain data on servers in China, as well as get approval of their technology and permit system inspections by the authorities (BOFIT Weekly 2016/46). The EU and US Chambers of Commerce in China oppose the new law. In recent weeks, they submitted several requests that the government postpone the law's implementation.

The new cybersecurity law and the tighter controls on online news conflict with China's strategies for economic reform and opening the economy. Some observers say the media restrictions are part of party efforts to keep a lid on social unrest that could emerge as economic growth slows.
**Russia**

**Russia’s government budgets started to grow again; government drafted supplementary budget.** First-quarter revenues to the consolidated budget (includes federal, regional and municipal budgets, as well as state social funds) were up by 20% y-o-y in nominal ruble terms. Revenues generated from the production and export of oil & gas were up by more than 50%. Over half of the revenue increment, however, came from other revenues that rose far above inflation. Revenues from excise taxes (particularly tobacco products) and corporate profit taxes were up sharply. Revenues from the value-added tax and mandatory social contributions from firms on worker wages also increased. Consolidated budget spending rose by about 10%. The fast recovery in budget revenues produced a tiny surplus (0.2% of GDP).

The government last week submitted to the Duma its draft proposal for this year’s supplementary budget. Budget revenues are now expected to increase more than in the budget approved earlier (the excess is 0.4 percentage points of GDP). In nominal terms, revenues should rise by 6% this year if the earnings from the Rosneft share sale are excluded from the 2016 numbers. The excess comes mostly from revenues from oil & gas taxes, with the assumption that the price of Urals oil this year will average USD 45.60 a barrel (the previous assumption was USD 40/bbl). Other additional revenues to the budget assume GDP growth of 2% this year.

Budget expenditures also rise a bit under the supplementary budget. They are set to grow by 6% in nominal terms this year if the one-time sum given to defence industry for debt repayment is not included in the 2016 figures. Federal budget deficit will be 2.1% of GDP (earlier estimate 3.2%). The supplementary budget calls for hardly any changes in domestic borrowing or funding out of the government’s Reserve Fund (RF) and the National Welfare Fund. While the RF will be drained this year, extra oil revenues flowing to state coffers this year will be put into the RF next year.

**Nominal change in main non-oil revenue streams to Russia’s consolidated budget 2013–2017, %**

- **Value-added tax**
- **Social contributions**
- **Excise taxes**
- **Corporate profit taxes**
- **Labor income tax**

12-month sum, % change y-o-y

The finance ministry, however, still expects government spending to rise a bit further this year, bringing the deficit to 2.4% of GDP. Observers note that the figure may reflect the unused portion of last year’s budget. Finance minister Anton Siluanov says the money will be spent this year.

**FDI inflow to Russia boosted by the sale of Rosneft stake.** Net direct investment inflows to Russia (investment of foreign firms in Russia minus funds repatriated by foreign firms) amounted to USD 33 billion last year, a nearly five-fold increase from the 2015 nadir and roughly the same level as in 2009. The single most important event last year affecting investment flows was the December sale of a 19.5% stake in oil giant Rosneft to the Qatar Investment Authority and the Swiss mining giant Glencore. The deal was valued at about USD 11 billion. Because of the financing arrangement under the deal, most of the FDI appeared to come from Singapore.

Without the Rosneft deal, positive net FDI inflow was mainly thanks to reinvestment of profits as in earlier years. This largely reflects the weakened interest of foreign firms in making new investments in Russia. Geographically speaking, the largest sources of positive FDI inflows to Russia came last year from the Bahamas and Bermuda. At least some of that investment is likely of Russian origin as a considerable amount of Russian outward FDI flows is also directed to these and other countries that provide friendly tax treatment.

Net FDI outflows from Russia (investments of Russian firms abroad minus repatriated investments) last year amounted to nearly USD 23 billion or almost as much as a year ago.

**Rapid growth in Finnish-Russian trade.** In the first quarter of this year, the value of goods exported to Russia increased by nearly 30% y-o-y. Russia’s total goods imports grew at roughly the same pace supported by gradually recovering demand and significant ruble appreciation. Finnish exports to Russia were up in nearly all product groups. Exports of machinery & equipment rose by 50% y-o-y and food exports by 12%. Finland’s goods exports to Russia, however, were still down nearly 40% from their 2012–13 peak. Growth in goods exports should continue in coming months, albeit probably at a slower pace than in the first quarter.

The value of goods imports doubled in the first quarter compared to a year earlier. Much of the powerful growth came from higher oil prices and imports of pipelines apparently reflecting supplies for the Nordstream 2 gas pipeline project.

Services exports also appear to be recovering strongly this year led by tourism services. The number of Russian overnight stays in Finnish hotels and lodging during 1Q17 was up 23% y-o-y. Even more dramatic growth figures seem to have been posted for purchases of Russians visiting Finland.
China

Moody’s lowers China’s sovereign credit rating for the first time in three decades. The American Moody’s, one of the big international credit ratings agencies, lowered its rating of Chinese sovereign credit by one notch from Aa3 to A1. The new rating puts China’s sovereign rating on par with Japan and Estonia. Moody’s noted that China’s high economic growth targets can only be met by continued debt-fuelled stimulus. Moreover, China faces added pressure to rely on stimulus as structural factors will slow potential economic growth further in coming years. The central government’s debt burden will increase, and it faces increased contingent liabilities risks from state-owned enterprises, policy banks and off-budget financial vehicles created by local governments. Moody’s highlighted the fact that current reforms to put economic growth on a sustainable basis and slow the credit growth are insufficient and proceeding too slowly. Moody’s last downgraded China’s sovereign credit rating in 1989. Fitch, another big ratings agency, downgraded China in 2013.

The change in credit rating produced little immediate market reaction as the change was largely seen as a reminder of China’s financial issues. However, China’s ministry of finance responded immediately to Moody’s announcement, saying it saw no basis for the downgrade.

On the heels of its China decision, Moody’s also lowered the sovereign rating of the Hong Kong special administrative region – a reflection of how intertwined the Hong Kong economy is with China’s. Observers believe there is pressure to downgrade the ratings of some of China’s neighbours. While the sovereign downgrade could also ding corporate credit ratings of Chinese firms, the immediate impact should be minor as Chinese firms hold relatively little foreign debt.

Despite the lack of foreign interest, China moves to open its bond markets to the world. China’s central bank and Hong Kong’s monetary authority announced plans in May to give foreign investors the opportunity to trade bonds in mainland China’s interbank market via Hong Kong. Initially, investment will be permitted without quotas only from the Hong Kong side. Later, authorities will consider mainland China’s chance to invest in Hong Kong’s bond market. The decision initially allow only one-way investment reflects the current market situation, where Chinese officials worry about capital flight. While there is no detailed information available on how the programme will be implemented, premier Li Keqiang said already in March that he expected trading to begin this year.

Due to many uncertainty factors, the programme is unlikely to attract major foreign investor interest in the short term. Given that China’s national credit rating system diverges from international practice, it is difficult to objectively appraise the financial health of most Chinese firms. An IMF study last year found that over 90% of bonds traded in China had received excellent ratings (AA or AAA). In the United States similar high ratings were granted to less than 2% of firms. This reflects partly the fact that most issuers are linked to the government and enjoy implicit guarantees.

China’s bond market has grown rapidly to become the third largest in the world after the United States and Japan. At the end of March, the Chinese bond market had a nominal value of 66.34 trillion yuan (USD 9.6 trillion). Of that, 35% was government issued bonds, 39% financial sector bonds and 27% for the rest of the corporate sector. Foreigners held just over 1% of the bond market or about 830 billion yuan (USD 120 billion) worth of Chinese bonds. Moreover, most foreigners exclusively hold Chinese government bonds or bonds issued by Chinese state policy banks. Indeed, most foreign holders of Chinese bonds are central banks. At the end of last year, the value of yuan-denominated investments held by foreign central banks and reported to the IMF was USD 85 billion, most of which are typically invested in low-risk assets such as government bonds.

Rates of 1-year bonds on the interbank market

China’s change in exchange rate mechanism raises eyebrows. Last Friday (May 26), the People’s Bank of China announced that it was changing the way it fixes the dollar-yuan exchange rate at the start of the trading day. The new method combines earlier criteria with “countercyclical factor.” Officials said that the move was intended to deal with overreaction of markets driven by herding behaviour. To date the fixing rate has been said to be based on bids of selected banks, which in turn are based on the closing rates of the previous trading day and the supply and demand situation in forex markets.

Even with the current criteria, it is still unclear how the daily fixing rate is actually determined. Adding a vague countercyclical factor does not clarify the situation. The reform apparently increases the flexibility of currency officials to affect exchange rate trends, even if the exchange rate toolbox has been adequate to date in steering the exchange rate. Market participants, for example, see the yuan’s recent strengthening against the US dollar as a political response to Moody’s downgrade of China’s sovereign credit rating.

Source: CEIC.
Russia

Despite falling stock and oil prices, the ruble has appreciated this year. Given that over half of the weight of firms listed on the Moscow stock exchange are firms involved in the oil & gas industry, it is not surprising that the Moscow stock exchange indices rise and fall in tandem with oil prices.

The price of Urals crude has fallen 10% in dollar terms this year, while the Moscow exchange’s dollar-denominated RTS index is down 9% for the year so far. Observers attribute part of the stock market decline to profit-taking by some investors following the surge in share prices last year and loss of hope for an early lifting of US sanctions on Russia.

Similarly, the ruble’s exchange rate tends to follow oil prices. However, even with falling oil prices, the ruble this year has appreciated 8% against the dollar and 1% against the euro. Many analysts attributed the ruble’s rise to short-term “carry trade” with attempts to exploit Russia’s relatively high yields. Central Bank of Russia governor Elvira Nabiullina noted, however, that the level of carry-trade operations last December and an increased foreign investor interest in the Russian market.

Investment sluggish in Russia. Fixed investment was up 2.3% y-o-y in the first quarter. Rosstat reports that on-year growth in total fixed investment excluding small firms and those that operate in the grey economy was 0.4% and thus lagged the pace of total investment growth, like it did in previous years as well. The lion’s share of fixed investment in this category comes from large and mid-sized private firms and government investment. Estimates of seasonally adjusted fixed investment developments vary somewhat. Rosstat calculations show investment grew from the previous quarter in the second half of 2016, but remained flat in the first quarter of this year.

The first quarter brought shifts in oil & gas investment. After three years of robust growth, investment in oil & gas production fell. Investment in pipelines for transmission of oil & gas increased after five years of nearly continuous decline. The sharp drop in investment in the electricity sector continued. Investment in manufacturing dropped further too.

President Putin evaluates economic programme proposals. In late May, president Putin was presented with two economic development programmes that Putin had requested, but a decision is yet to be made of what will be the final development programme. The two proposals differ mostly in their approaches to monetary and fiscal policy. The proposal prepared by the team led by former finance minister Alexei Kudrin pushes for stable economic development based on the pursuit of moderate monetary and fiscal policies. In contrast, the “Stolypin Club” proposal would take a lighter monetary and fiscal stance and calls for large stimulus measures funded by the central bank and government budgets.

The proposals are closer to each other in terms of structural policy. Both call for e.g. measures to improve the business environment, spending on education & retraining and healthcare, as well as development of technology and the digital economy. Kudrin’s plan calls for openness in trade policy, while the Stolypin Club favours a more protectionist line.

Putin is expected to combine measures proposed in both proposals as well as in a programme prepared by the government. The president’s economic policy line has often highlighted economic stability and independence, which means e.g. restraining inflation and the government budget deficit, while encouraging import substitution. In addition, “digital economy” emerged as the term du jour at the St. Petersburg economic forum last week.

No matter what the final programme’s composition, the biggest challenge will be its implementation. The successes at implementation of earlier Russian development programmes have been modest.
China

Trade policy differences overshadow EU-China summit. The main themes at the 19th EU-China summit held in Brussels on June 1–2 were trade policy and environmental issues. However, differences between the parties prevented them from issuing a joint statement after the meeting. The EU says that China continues to give preferential treatment to its domestic firms, forcing foreign firms to submit to stricter regulation. The EU, in contrast gives Chinese firms relatively free rein in its domestic markets. China responded that the EU needs to stop withholding market-economy status now that China has completed 15 years of WTO membership. Moreover, China considers the EU’s anti-dumping tariffs imposed on Chinese steel to be protectionism. The EU and China were more closely in agreement on climate issues.

As a result, most with fairly small economies. Since 2012, China has also negotiated with Japan and South Korea on a trilateral free-trade arrangement.

Asian trade policy on hold. With the United States’ decision to withdraw from the proposed Trans-Pacific Partnership (TPP) free-trade agreement, the remaining potential TPP countries have been forced to reconsider their trade policy options. Without the US, TPP’s coverage dwindled, reducing the incentive for TPP signatories to go it alone. As a result, the Regional Comprehensive Economic Partnership (RCEP) agreement has emerged as the leading alternative to TPP. China is not participating the TPP process, choosing instead to push for the RCEP at least until the withdrawal of the US from TPP. China’s ambitions considering FTAs in the new situation remain to be seen.

The RCEP agreement, which is based on an ASEAN initiative, seeks to replace current bilateral FTAs between ASEAN’s and six other Asian countries (China, India, Japan, South Korea, Australia and New Zealand). RCEP is less comprehensive than the TPP and therefore offers fewer benefits. A number of countries were pursuing negotiations over both agreements. The countries participating in RCEP talks are a fairly heterogeneous group, which together with TPP’s shadow have made negotiations complicated.

China’s participation in the talks is eased, however, by the fact that the RCEP does not seek complete lifting of tariffs or impose strict conditions related to worker rights and environmental protection. Easier market access is also attractive to Chinese sectors suffering from overcapacity problems. For other countries, the RCEP would open further up access to the Chinese market and possibly give them better opportunities to benefit from China’s massive funding schemes such as “One Belt, One Road” (OBOR) projects. India and some other countries fear a flood of Chinese products onto their markets.

The Bank of Finland assumes no responsibility for the completeness or accuracy of the information, and opinions expressed do not necessarily reflect the views of the Bank of Finland.
Russia

Russia prepares to raise public sector wages. President Vladimir Putin recently proposed that wages funded out of public sector budgets should be raised also for those public sector workers not included in the instructions issued in May 2012 in connection to his inauguration to a third presidential term. The proposed wage hikes would consider inflation and the condition of federal and regional budgets. Putin requested that the cabinet prepare options for the wage hikes in such a schedule that the increases could be included in the 2018 budget drafting process.

Labour and social protection minister Maxim Topilin said that the new wage hikes would at least compensate for inflation for all recipients, but that the increases would not necessarily be equal for all recipients. Topilin confirmed that the May 2012 instructions on increases will be implemented implying that in the beginning of 2018 the wages of several worker groups in the social, healthcare, education and culture fields should equal 100 % or 200 % of the administrative region’s average wage. Putin acknowledged that certain regions have had trouble meeting these targets. To be able to fulfil the targets, regions will continue to be supported by transfers from federal to regional budgets as in previous years.

Putin drew attention to the fact that wages of public sector workers outside the scope of the May 2012 instructions have not been allocated additional budget money for wage increases for couple of years. High inflation and small wage increases have caused a significant decline in real wages in recent years in major branches of the public sector such as education, healthcare and civil and defence administration.

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Russia has not yet dipped into its oil funds this year. Higher-than-expected oil prices have increased Russia’s budget revenues and finance minister Anton Siluanov notes that the government has up to now been able to finance budget spending out of pocket this year without resorting to oil funds. Under the recently revised budget estimate, the plan this year still calls for withdrawing a total of about 1.7 trillion rubles to cover the federal budget deficit. The current plan sees draining the Reserve Fund entirely this year and funding most of the remaining deficit out of the National Welfare Fund. Siluanov expects the government to start dipping into fund assets sometime in the autumn.

As of end-May, the value of the Reserve Fund stood at 930 billion rubles (USD 16.5 billion), while the National Welfare Fund stood at 4.2 trillion rubles (USD 74 billion). Slightly over a third of the National Welfare Fund is invested e.g. in investment projects of Russian companies and long-term bank deposits. Thus, the total liquid assets of the oil funds correspond to about 4 % of GDP.

The budget framework for 2018–2019 calls for a large part of National Welfare Fund assets to be used to cover budget deficits in coming years. The fund is expected to hold about 2.8 trillion rubles at the end of 2019, of which 1.3 trillion rubles would be held as highly liquid assets.

Car sales revive in Russia, while other sales remain weaker. Following three years of decline, sales of new cars have begun to rise in recent months. Sales of new cars in March-May averaged 130,000 units a month, or about 10 % more than a year earlier. Sales were still, however, only about half of the levels during the last peak in car sales in 2012.

In addition to passenger cars, the sales volumes for many other durable goods such as home appliances and electronics have risen slightly. In contrast, sales of food items and clothing have declined and restrained the overall growth in goods sales because their share of sales is rather large. This year, for example, passenger cars and dairy products each accounted for just under 5 % of total retail sales. In the January-April period, the total volume of retail sales contracted by just over 1 % y-o-y. Food sales fell by 2.5 % and other goods by 0.3 %.

Russia's oil funds

Sources: Russian finance ministry, BOFIT.
China

Officials reveal falsification of statistical reporting in two Chinese provinces. The Communist Party’s corruption-fighting arm, the Central Commission for Discipline Inspection, announced that some officials in the Jilin and Inner Mongolia provinces have been charged with faking the data of local governments and businesses. No further details about the incidents have yet been released. A major fraud that had gone on for several years was uncovered in January in the Liaoning province. China’s National Statistics Bureau subsequently revised down Liaoning province’s GDP estimate by over 20%. The economic growth figures reported by several other provinces, mostly located in the northern parts of China, have also raised suspicions.

Perverse incentives are the main driving factor for local authorities to distort their data. Regional officials can become obsessed with hitting established growth targets as their career trajectories depend on reporting consistently good economic performances. Changes in the incentive system has long been discussed, but in practice no significant changes to the system have been made.

Reporting incorrect statistical data is especially problematic for China’s decision-makers, because it creates a risk that economic policy will be based on inaccurate information. The task of correcting the long-recognised problems with provincial and local figures has fallen upon the central National Bureau of Statistics, which uses its own surveys and samplings to improve the accuracy of national figures. For example, the aggregate of GDP growth figures reported by regions typically indicate much higher growth than the official national figure for GDP growth. The Liaoning incident was so extensive, however, that it casts doubt on whether the NBS’s measures to correct the figures go far enough.

China posts fairly stable growth numbers in May. NBS monthly figures show that industrial output continued to grow at over 6% y-o-y in May. However, there was a slight slowdown of growth in output from April to May. Purchasing manager indices also show a similar pattern. Retail sales, in contrast, remained strong, with real growth of about 10% y-o-y. Strong retail sales growth suggests China is making progress in structural reform of its economy.

Real growth in fixed investment descended to around 4% y-o-y. Growth in public sector investment slowed in May to around 6% y-o-y, while growth in private sector investment has remained relatively stable whole year at around 2–3%. The pace of growth in public sector investment since the start of 2016 has clearly outstripped growth in private sector investment. Even so, about 60% of total fixed investment is still made by the private sector.

In May, the rise in consumer prices accelerated slightly and inflation was 1.5% y-o-y. Price pressures, however, appear to be subdued and inflation is well below the 3% official target for this year. In contrast, the rise in producer prices slowed slightly in May to 5.5% y-o-y. The rise in producer prices should continue to slow in coming months.

Chinese foreign trade enjoyed buoyant growth in first five months of 2017. China Customs reports that the dollar value of goods exports rose 8% y-o-y the first five months of 2017. The value of goods imports in the first five months of the year was up 20% y-o-y. The last time the growth pace in January-May was this robust was in 2013. Strong export trends were supported by the yuan’s weaker exchange rate against the dollar compared to last year. The volume of foreign trade has also grown rapidly as the volume of exports grew on average 8% y-o-y and imports 13% in the first four months of the year.

The value of Chinese goods exports to both the EU and the US grew by 10% in the January-May period, and was slightly higher than the average growth of Chinese goods exports. The value of goods imports increased sharply for the United States (up 20%) and the EU (up 16%). The mirror trade figures from US and EU customs on goods trade with China largely confirm the robust growth in goods trade shown in the Chinese figures. The differences this year between the Chinese trade figures and the US and EU mirror figures have remained largely unchanged from previous years. Foreign trade can be considered as a tool to circumvent China’s capital controls, which China has been tightening since last autumn.

US and EU goods trade with China

Sources: China National Bureau of Statistics and BOFIT.
Russia

Russia’s central bank lowers key rate and revises forecast up slightly. At its regular monetary policy meeting on June 16, the Central Bank of Russia’s board decided to lower its benchmark 7-day repo rate by 25 basis points to 9 %. The CBR key rate, a major monetary policy tool, has already been trimmed three times this year for a total of 1 percentage point. Declining inflation has been the main justification for the rate cuts. This spring, inflation fell to a level close to the CBR’s 2017 target of 4 %. The monetary policy stance remains relatively tight, however, as inflation expectations are still quite high.

In conjunction with the CBR’s regular board meeting, an updated forecast was released. The rise in crude oil price assumption from 40 dollars to 50 dollars a barrel in 2017 resulted in a slight increase in this year’s growth forecast. GDP is now expected to increase by 1.3–1.7 % this year and by 1–1.5 % next year.

Despite promising signs, the basis of Russia’s economic recovery remains fragile. Growth in industrial output jumped to nearly 6 % y-o-y in May. Last month’s growth was supported by manufacturing. However, the development of manufacturing output has been quite volatile this year due to e.g. variation in the number of workdays. Manufacturing grew by less than 1 % in the January-May period, while mineral extraction industries experienced growth of nearly 3 % y-o-y. Crude oil production was up by nearly 2 % y-o-y and natural gas production by 11 %. The increased production of mineral extraction industries helped boost transport volumes by 7 %, largely on higher pipeline transmission volumes.

Retail sales also appear to be recovering at last, growing by 0.7 % y-o-y in May. Looking at Rosstat’s updated figures, retail sales achieved positive 12-month growth in April, but just barely. Retail sales were supported by rising wages and slower inflation, but the overall real disposable household incomes have continued to contract slightly.

Growth in agricultural output slowed sharply from last year to just 0.6 % y-o-y in the January-May period. In contrast, the construction sector in May posted slight growth for the first time this year, even as housing construction continued to contract.

Most of Russia’s modest recovery seems to be driven by the oil & gas sector. Rosstat reaffirmed its preliminary estimate that GDP grew 0.5 % y-o-y in the first quarter. GDP growth was largely supported by mineral extraction industries and the transport sector. This trend seems to have continued also in latest months. Recovery in other branches of the economy remains shaky, however, despite some positive signs.

US drafts changes to economic sanctions imposed on Russia. Last week the United States Senate voted near-unanimously to approve a bill making it more difficult for the US president to relax or eliminate sanctions on Russia. The package of legislative changes includes new sanctions, tightening of existing sanctions and suggestions on allowing additional new sanctions. New potential sanction targets include Russian export pipeline projects. This has created some uneasiness in Europe as it might have implications for the Russian Nordstream 2 gas pipeline project in which some European companies are participating.

The bill still needs approval from the US House of Representatives and it might be modified. It is currently unclear when the House will vote on the bill after it was sent to the Foreign Affairs Committee for a review. If the bill makes it through both houses, the president must sign it for it to become law. If he chooses to veto the bill instead, Congress can override the president with a two-thirds majority. If the bill passes, its impacts will ultimately depend on how the changes are actually applied.

On Tuesday (June 20), the US announced that it was widening its sanctions regime to include several new Russian and Ukrainian citizens and firms.
China

Chinese A-shares to be added to the MSCI EM index.
After years of discussion, MSCI Inc., which publishes a number of key global stock market indices, decided this week to include yuan-denominated A-shares listed on mainland Chinese stock markets in its MSCI Emerging Markets (EM) index. The stocks will be included in June 2018. The current plan initially would incorporate 222 large Chinese firms which A-shares can be traded through the Stock Connect programmes between Hong Kong and the Shanghai and Shenzhen exchanges, or whose H-shares are already part of MSCI EM index.

MSCI said that its decision to add mainland Chinese shares to the mix was based on the fact that institutional investors and market participants feel that access to China’s stock markets has improved. The mood change, above all, reflects the launch of the Stock Connect program and the easing of pre-approval requirements in local Chinese stock exchanges. Unlike its earlier approach, MSCI’s incorporation of Chinese shares into the EM index will occur incrementally, with increases in A-share weighting tied to China’s progress in financial market reforms and opening up. In principle, foreign investors should enjoy increased access to markets compliant with international standards, Stock Connect programmes functionality in a range of challenging conditions, an easing of daily trading limits and improved regulation of trading suspensions.

Initially, the weight of A-shares will be just 0.7% of the MSCI EM index. Currently Chinese shares listed on exchanges outside mainland China have a 29% weight in the index. In terms of market capitalisation, China’s stock markets are the world’s second largest after the United States. Thus, in the long term, the decision to include China in the index could have large implications for capital movements.

Wages in China’s public-sector last year increased faster than in the private sector. Wage data for 2016 published by China’s National Bureau of Statistics show that average wages in urban areas (including bonuses and other compensation) in non-private sector (government organisations and state-owned enterprises) rose by nearly 7% y-o-y in real terms to 5,630 yuan (770 euros) a month. Almost half of those working in urban areas were employed by the non-private sector.

The average private-sector wage was just 3,570 yuan (490 euros) a month, and private wages rose a slower pace. Real private-sector wages last year grew by 6% on average, but as recently as 2011–2014 were rising faster than public-sector wages. The average real wage of internal migrants working in cities grew by only 4% to an average wage of 3,230 yuan (440 euros) a month.

In the non-private sector, those in the IT branch saw their wages surpass state workers in the finance sector. Private-sector wages were lower than in the non-private sector in most branches, even if the relative differences varied across branches. There were also large differences in wage levels across cities.

China’s Ministry of Human Resources and Social Security finds that the number of employed people increased by 1.5 million last year to 766 million. Some 44% worked in the service sector, 28% in agriculture and 29% in industry. While the number of people working in primary production and manufacturing fell, the number of people working in the service sector last year rose by about 9 million from 2015. The number of people employed in urban areas rose by 10 million to 53% of all employed people.

Environmental problems constitute a huge burden on the Chinese economy. Air pollution puts a significant strain on China’s economy through damage to human health and reduced productivity. The recently released report State of Global Air 2017 estimates that over 1 million Chinese die prematurely each year from air pollution, while the annual amount globally is estimated to be around 4 million. The RAND Corporation estimated in 2015 that the costs of China’s air pollution over the past decade corresponded to about 6.5% of GDP, and that this cost has continued to rise as China urbanises. China has sought to reduce air pollution by e.g. closing plants, limiting car use and reducing its reliance on coal in energy production. Because many measures intended to reduce air pollution tend to lower productivity, finding a balance that allows officials to meet their economic growth targets and protect the environment has proven difficult. The official 2017 goal of reducing air pollution by 10% seems distant at the moment. The January-April air quality in Beijing, Tianjin and surrounding Hebei province was 20% worse than in spring 2016.

China’s waters are also polluted. Two-thirds of groundwater and one-third of surface water is so polluted that it is not fit for human use. In addition, 80% of the Chinese shoreline is badly polluted with waste and toxic chemicals. Then there are the climate disruption issues. A substantial portion of the Chinese population lives along the eastern coast in areas threatened by rising sea level.
Russia

Ruble exchange rate turned to drop. After a long appreciation trend, the ruble has begun to depreciate along with falling oil prices. The price of Ural-grade crude has fallen by 10% in June to below $45 a barrel and the ruble’s exchange rate has depreciated by about 4% against the dollar and euro.

The finance ministry has continued its forex purchases as announced as oil revenues have exceeded the budget forecast. Even so, the forex buying is of such limited scale that it apparently has little impact on the ruble’s exchange rate. In June, the oil price measured in rubles fell for the first time below the average oil price assumption in this year’s budget.

The ruble is still about 10% stronger in real terms against the dollar and euro compared to a year ago.

Ruble exchange rate and oil price

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Source: Reuters.

Russian bank lending turning to growth. The stock of corporate bank loans has contracted since early 2016, but in recent months the contraction seems to have halted. The corporate loan stock (corrected for exchange rate shifts) showed slight on-month growth in April and May. However, measured on-year, the stock of corporate loans continues to contract (down 2% in May). The recovery of corporate lending has been supported by factors such as improved bank earnings and declining interest rates this spring.

The share of non-performing loans (NPLs) has remained at about 7% of the total corporate loan stock throughout the past 12 months. However, the share of bad loans, which is a more comprehensive measure (including loans in categories IV and V) had increased to 11% of the total corporate credit stock at the end of March. The Central Bank of Russia says that the amount of NPLs has been raised by reassessments of the loan stocks of banks in restructuring. This year, there has been 25 banks in the restructuring process overseen by the Deposit Insurance Agency. Among the newcomers to the restructuring process was Peresvet, earlier one of Russia’s 50 largest banks.

Many NPLs involve the construction sector. As of March, over a fifth of non-performing ruble loans and 28% of all bad loans were loans to companies in the construction sector. Forex loans of construction sector companies in particular have been restructured and converted to rubles, so forex loans now only represent about 12% of construction sector borrowing (down from 25% earlier). Forex loans currently represent about 30% of the total stock of corporate borrowing. A large part of forex loans are held by companies operating in branches like mining and chemicals & petrochemicals that often have significant forex income flows.

Russia seeks to increase food supply independence through trade and agriculture policies. Russia, which has long sought to reduce its dependence on food imports, has increased its efforts in recent years with the heightening of geopolitical tensions. Russia’s agricultural ministry estimates that self-sufficiency targets have been met in production of e.g. grains, potatoes, meat and sugar, but are still lagging in production of e.g. milk and salt.

The government has actively used trade policy to support domestic producers. Food imports have been restricted by e.g. public procurement rules and import bans imposed on Western countries and Turkey. Most of the sanctions imposed on Turkey were ended as the countries mended relations, but the ban on tomato imports remains in force. In addition, food imports are hampered by technical barriers to trade such as phytosanitary and veterinary measures which are sometimes applied in a discriminatory way.

Various other policy measures like production and interest subsidies and tax breaks have also been used to boost agricultural production. The OECD estimates that the total value of Russian agricultural support measures has averaged around 13 billion dollars a year (about 1% of GDP) in recent years. The corresponding figures are 0.5% of GDP for the US, 0.7% for the EU and 2.4% for China. The biggest subsidies in Russia go to production of sugar, milk and pork.

Most Russian agricultural subsidies are supplied under the State Development Programme. In recent years, annual spending from public sector budget funds has averaged around 300 billion rubles (4.5 billion dollars). Researchers at the Gaidar Institute assess that at least the subsidized investment credit is mainly directed to a few select large corporations. Last year, for example, 90% of the subsidized investment credit in beef cattle production went to a single project of Mirtorog, Russia’s largest pork producer.

In addition to support measures, agricultural firms benefited from the sharp drop in the ruble’s external value. In 2015, the total profits of farm firms rose by nearly 50%. One of the fastest growing agricultural firms in Russia has been Agrocomplex, which is owned by the family of agriculture minister Alexander Tkachev. In recent years, it has become one of Russia’s largest producers of e.g. pork and sugar, as well as one of the country’s largest holders of farmland. After examining the issue last year, a government commission stated that this does not constitute a conflict of interest.

Consumer food prices rose by over a third in 2014–16. 38% of Russian household spending presently goes to food.
China

China’s fixed investment ratio drops slowly. Preliminary 2016 demand component figures released this month by data provider CEIC show that China is making progress in structural reform of its economy. The change has been slow, however, as fixed investment still equalled nearly 43% of GDP. In other words, the investment ratio fell by just a half percentage point from 2015. China’s fiscal policy response to the Great Recession in 2009 was to launch a massive stimulus that quickly drove up the investment rate to 45%. The purpose of the stimulus was to compensate for the huge drop in export demand, but its impact eight years later is still seen in China’s excessive investment ratio.

Private consumption accounted for 39% of total demand last year, a percentage point increase from 2015. Despite its growing share, private consumption still accounts for an exceptionally tiny fraction of GDP.

Caution should be used in interpreting China’s GDP figures. Demand-side figures, despite earlier promises to start releasing quarterly data, are only reported on yearly basis indicating various problems in data collection.

Main demand components of Chinese GDP

China’s state-owned enterprises embellish financial data while resisting capacity cuts. According to a report released last week by China’s National Audit Office, 18 out of 20 state-owned enterprises (SOEs) provided falsified financial figures to auditors. Revenues and profits were exaggerated through fictitious payments, arcane payment arrangements and manipulated financial statements. Some of the audited SOEs were among the largest businesses in China.

Media reports mention that the audit report also critiqued SOEs for violation of official Communist Party policy. Many of the audited firms failed to close down their loss-making “zombie” firms and resist dealing with their overcapacity issues. The report also criticised the backaliding of local governments on overcapacity problems and rapid increases in indebtedness.

While the overstatement of profits by the audited firms represented less than 2% of their profits overall, the financial statements show how the career paths of upper management in state firms face the same perverse incentives as local administrators. Many provinces have recently been shown to give rosier pictures of their financial development than reality warrants. Part of the problem also stems from China’s rigid growth targets in conditions where the emphasis should otherwise be on reform policy. This burdens local governments and SOEs with conflicting expectations.

Mainland China exchanges shrug off MSCI index inclusion; foreign investors in wait-and-see mode. MSCI Inc., publisher of the Emerging Markets (EM) Index, decided on June 20 to include mainland China shares in its MSCI EM Index (BOFIT Weekly 25/2017). The decision had little immediate impact on share prices. The biggest effects were seen in the share prices of large firms, i.e. those to be included in the MSCI EM Index next year. The CSI300 Index of 300 firms listed on the Shanghai and Shenzhen stock exchanges and the SSE180 Index of 180 firms listed on the Shanghai exchange have both risen 3% since MSCI’s decision to include Chinese shares.

Although mainland Chinese stock indices have been relatively stable this year, Chinese shares listed on foreign exchanges have done better. MSCI’s China index is up over 20% and the Hong Kong stock exchange’s China Enterprise Index is up 10%. However, shares of Chinese firms in Hong Kong are over 20% cheaper than shares of the same firm listed on a mainland China stock exchange.

Foreign investments in mainland Chinese stock markets do not seem to have increased significantly in the immediate wake of the MSCI decision. The average volume of stock trading via the Stock Connect programme with Hong Kong has seen a slight increase since early summer, while the total transaction value of shares only represent 3% of the Shanghai exchange’s turnover and just 2% of Shenzhen’s turnover.

Qualified foreign investors can also trade on mainland-China’s stock markets under the QFII and RQFII programmes. As of end-March, foreign investors held shares traded only in mainland China worth 780 billion yuan (113 billion dollars). That amount corresponds to 1.4% of the market capitalisation of all Chinese stock markets. MSCI estimates that the implementation of its expanded EM Index next year will boost foreign holdings of mainland Chinese share immediately by about 17 billion dollars.

The inclusion of mainland Chinese firms will take place in two steps in May and August 2018. The EM Index will initially include 222 Chinese firms with more to be added later. Over two-thirds of the included firms are owned by the state or local governments, which has aroused suspicions concerning e.g. the actual power of shareholders to influence corporate decisions. The state still plays a huge role in stock markets, so any further increase in the weight of mainland Chinese shares in the MSCI EM Index will require further stock market reforms.
Russia

EU and Russia extend sanctions. The EU Commission decided on June 28 to keep economic sanctions targeting specific sectors in place until January 31, 2018. The sanctions, imposed on Russia for its actions in the Ukraine conflict, were extended for the lack of full implementation of the Minsk agreements. The EU sanctions limit the access of certain Russian firms to financing and restrict exports of technology related to oil production and dual-use goods from EU to Russia. In addition, the sanctions prohibit arms trade with Russia.

On June 30, president Putin signed a decree extending Russian countersanctions on certain Western foods to the end of 2018.

Russia’s finance ministry proposes continuing the pension funding practice of last years. Russia has planned for years to reform its chronically underfunded pension scheme. Pensions have accounted for over 20 % of public sector spending in Russia in recent years. Over 60 % of pension spending has been covered since the pension insurance contributions of the current workers. The rest (about 2.4 trillion rubles) has come mostly out of the federal budget.

Under the current model applying to most employees, a mandatory pension contribution of 22 % of the worker’s pay is paid by the employer. Of that, 16 percentage points goes to the pay-as-you-go system, i.e. for pension payments to current retirees, while the remaining 6 percentage points is set aside to fund future pension obligations. With the tightening fiscal situation in recent years, however, the government has used the funded part for covering running costs (including pensions). The finance ministry recently gave the government a proposal that in principle formalises the practices of recent years. Under the proposal, the entire 22 % mandatory contribution would be channelled to the pay-as-you-go pension system. In addition, workers could choose their level of voluntary contribution for personal pension savings, which would range from 0 to 6 % of their wages. The voluntary pension savings would be encouraged with e.g. tax breaks.

The shift, which would relieve immediate budget pressures, is feared to further undermine the long-term sustainability of the pension scheme. Only 7 % of workers participated in voluntary pension savings plans last year. Funding the pensions entirely from the current contributions is becoming even more difficult with Russia’s aging population and rising dependency ratio. The finance ministry has also proposed raising the retirement age, but no decisions are expected at least until next spring’s presidential election.

Critics of the financing model reform fear that it will also gut the pension funds. One of the reasons for the shift to a partly funded scheme in 2002 was the ability of pension funds to provide long-term financing for the markets. Pension funds last year held a total of 5.2 trillion rubles (6 % of GDP). 40 % of that was under the control of state development bank VEB, with rest held by private pension funds.

Russia last year had about 45 million people receiving pension benefits. The average monthly pension payment was 12,400 rubles (185 dollars), or about a third of the average monthly wage. About a third of people receiving pensions were still working.

Life expectancies in Russia up sharply, but gap between men and women remains huge. Rosstat reports that the life expectancy of girls born in Russia last year rose to 77.1 years, while that for boys rose to 66.5 years. Life expectancies of Russians have increased notably from the late-1990s, when the life expectancy for men was still well below 60. Life expectancies have increased with improvements in healthcare resources and lifestyle changes. Cardiovascular disease, however, remains a major cause of death in Russia.

OECD countries and many middle-income countries boast longer life expectancies than Russian men. In addition, in Russia the difference in life expectancy is particularly pronounced between men and women. In 2015, Japanese women had the longest life expectancies for OECD countries – 87.1 years. Iceland boasted the longest expected lifespan for men – 81.1 years. Numerous countries poorer than Russia had higher life expectancies, highlighting the generally poor condition of Russia’s national healthcare system. For example, the average expected lifespan in China was 77.3 years for women and 74.3 years for men. The life expectancies of men were also higher than those of Russia in Brazil (70.7 years) and India (66.6 years).

The life expectancies especially for men in Russia are expected to rise further in coming years, tracking trends in most developed countries. Therefore, Rosstat’s latest demographic forecast expects the number of pensioners to increase significantly. The middle variant of Rosstat’s three forecast scenarios sees the number of working age people falling by the end of 2035 by slightly over 4 % to 78.7 million people. In the UN’s latest demographic forecast, the number of Russians between the ages of 15 and 60 will decline even more, by about 5 %.

In Rosstat’s forecast the labour force will be bolstered by net immigration adding 300,000 people a year to the workforce through 2035.

Life expectancies in selected countries in 2015

<table>
<thead>
<tr>
<th>Country</th>
<th>Women</th>
<th>Men</th>
</tr>
</thead>
<tbody>
<tr>
<td>Japan</td>
<td>87.1</td>
<td>81.1</td>
</tr>
<tr>
<td>Finland</td>
<td>82.6</td>
<td>76.8</td>
</tr>
<tr>
<td>Iceland</td>
<td>80.7</td>
<td>75.7</td>
</tr>
<tr>
<td>Estonia</td>
<td>76.9</td>
<td>70.8</td>
</tr>
<tr>
<td>Poland</td>
<td>75.5</td>
<td>69.3</td>
</tr>
<tr>
<td>Brazil</td>
<td>72.8</td>
<td>67.0</td>
</tr>
<tr>
<td>China</td>
<td>74.3</td>
<td>66.5</td>
</tr>
<tr>
<td>Russia</td>
<td>74.3</td>
<td>66.5</td>
</tr>
<tr>
<td>India</td>
<td>66.6</td>
<td>60.5</td>
</tr>
<tr>
<td>South Africa</td>
<td>65.0</td>
<td>62.0</td>
</tr>
</tbody>
</table>

Sources: Rosstat and OECD.

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China

20th anniversary of Hong Kong’s handover to China; integration with mainland continues. July 1 marked the 20th anniversary of Great Britain’s return of the Hong Kong special administrative region (SAR) to China. Since then, the Hong Kong economy has become increasingly intertwined with the mainland economy. Territory’s importance has diminished, however, as China has an increasing number of cities with over one million that now compete with Hong Kong. In 1997, Hong Kong’s GDP was equivalent to about 20% of China’s GDP. It is just 3% today.

Nevertheless, Hong Kong remains the main economic link between mainland China and the rest of the world. The Hong Kong economy is dominated by logistics and finance, and in both areas mainland is the main counterpart. A quarter of all China’s exports went through Hong Kong 20 years ago, and today still over 10% of Chinese exports pass through Hong Kong. The territory’s role with China increasingly involves provision of financial services. Hong Kong provides foreign entities controlled access to mainland China’s financial markets and China uses Hong Kong as a test lab for economic reforms and to encourage international use of the yuan. China has tightened capital controls in recent years, causing yuan deposits in Hong Kong to fall by 50% between January 2015 and March 2017. The share of the yuan in bilateral trade payments between mainland and the SAR has also declined.

The integration of Hong Kong with China continues. Credit ratings giant Moody’s characterises Hong Kong’s economic, financial and political connections with the mainland as “close and tightening.” Not surprisingly, China’s credit downgrade in May led to a similar downgrade in Hong Kong’s credit rating immediately. The Hong Kong Monetary Authority estimated in March 2017 that 28% of Hong Kong borrowing originated from China and 26% of loans granted by Hong Kong banks to foreigners went to mainland Chinese entities. Shares listed on the Shanghai or Shenzhen stocks exchanges can now be traded via the Hong Kong stock exchange as part of the Stock Connect arrangement.

The business environment for foreign firms in Hong Kong has recently suffered from political uncertainty, particularly China’s efforts to interfere with its politically independent judiciary. The Heritage Foundation has continuously listed Hong Kong as the freest place in the world to do business after the SAR return to China. The erosion of judicial independence, however, has made firms wary. Young people in Hong Kong also have become more hostile in their views of mainland China, which is reflected in the growing popularity of democracy and independence movements.

Foreign institutional investors can now invest in mainland China bond markets via Hong Kong. This week’s anniversary celebrations of the UK’s return of Hong Kong to China included the launch of the Bond Connect programme on Monday (July 3) that was approved in May (BOFIT Weekly 22/2017). The programme permits foreign institutional investors to invest in bonds traded on China’s interbank market. China last year broadened opportunities for these investors to trade in the interbank bond market from mainland China. The Bond Connect now eliminates the requirement that investors hold a separate Chinese trading account, allowing investments to be made using Hong Kong accounts without quotas or preapprovals.

Roughly 130 institutional investors had registered with the Bond Connect as of Monday, the first trading day, when the value of trading under the programme totalled 7 billion yuan. As the trading rules are not fully clear, it seems unlikely that the Bond Connect will significantly increase foreign holdings in China’s bond markets in the short term. Citigroup and Bloomberg this year introduced mainland China debt securities into some of their narrower indices. Mainland Chinese bonds, however, are not yet included in the major international indices.

Despite recent efforts to restrict capital outflows from China, the bond programme is a step forward in the opening up of China’s capital markets to the world. The Bond Connect differs from the Stock Connect programmes in that Chinese investors are still denied access to Hong Kong’s bond markets. The central bank says that this policy is not yet ripe for review.

About 90% of China’s bond trade is conducted on the interbank market, where Chinese commercial banks and investment firms account for most of the trading. Bonds can also be traded on China’s stock exchanges. The interbank bond market was valued at around 46 trillion yuan (about USD 7 trillion) at the end of June, when China’s total bond market was worth close to 70 trillion yuan. Foreigners hold less than 2% of bonds traded on the interbank market.

With the start of the Bond Connect, the People’s Bank of China announced rules to allow foreign credit rating agencies to operate in China. From the foreign investor’s perspective, the allowing of international credit ratings agencies to rate Chinese firms is an important step in getting beyond China’s tendency to overrate corporate creditworthiness. Currently, it is difficult for foreign investors to evaluate actual corporate risk, so nearly all foreign investments have been made to government bonds or policy bank bonds.

Interbank bond issues by issuer class

![Interbank bond issues by issuer class](chart.png)

Source: CEIC.
Russia

Recovery in Russian export earnings and imports continued in second quarter. Balance of payments figures from the Central Bank of Russia (CBR) show Russian earnings on exports of goods and services rose by over 20% y-o-y in 2Q17. The good performance resembled the strong rebound in the first quarter, but both quarters measure their on-year growth against very low levels in the first part of last year. Earnings were up for exports of both energy and other goods, which also in the second quarter were driven to a significant degree by increases in export prices. Exports earnings on services also continued to rise.

Russian spending on imports of goods and services was up about 25% y-o-y in both the first and second quarters. Spending on goods imports was up about 30% y-o-y. In euro terms, spending on imports was about the same as in 2011 for both total imports and goods imports. Service imports increased more slowly, but within the category, imports of travel services (i.e. purchases of goods and services by Russian travelers abroad) were up about 30%.

Following a common pattern, the Russian goods trade balance in the second quarter was strongly in surplus and the services balance was in deficit. The rest of the current account, however, was slightly more in deficit than usual. Much of the higher deficit reflected outward dividend and interest payments on investments made from abroad in Russia’s corporate sector. The current account balance overall was slightly in the red.

The net flow of capital to Russia’s corporate sector (excluding banks) was notably positive. This was due mainly to direct investment flows both into and out of Russia. In the second quarter and the first half overall, foreign direct investment flow into the corporate sector was up slightly from recent years (if the sale of a large stake in Rosneft oil company, which greatly boosted the 4Q16 FDI figures, is omitted). On the other hand, FDI inflows in the first half only equalled about 2% of Russia’s half-year GDP. Russian firms, in turn, made considerably less direct investments abroad in the second quarter than in previous years.

Second-quarter capital outflows from Russia’s banking sector were rather hefty as banks continued to pay down their foreign debts at a brisk pace.

Russia’s deposit insurance agency is given the administration of Yugra Bank. In terms of total assets, Yugra is Russia’s 30th largest bank. It has been placed under temporary administration by Russia’s Deposit Insurance Agency (DIA), with its payments frozen for three months. During the period of temporary administration, the DIA will decide whether to restructure the bank or wind it down. Yugra Bank grew quickly in recent years through aggressive pursuit of deposits from the general public and channelling them to lending to companies. The bank’s main owner is a company registered in Switzerland that is itself owned by Russian businessmen.

In May, the Duma approved a bill that shifts the burden of financial restoration of troubled banks and restructurings from the DIA to the CBR. A separate fund created with CBR assets was established to finance restructuring efforts. The new system will be introduced not until end of this month, which could make Yugra Bank its first client.

The DIA financial restoration programmes covered 25 banks in the early part of this year. In addition, the DIA is responsible for winding down banks that have lost their licences. The number of banks undergoing bankruptcy proceedings increased in both 2015 and 2016 by almost 30%, reaching 295 by the end of last year. The DIA has found it increasingly difficult to deal with these processes in a smooth manner, and the time spent on winding down banks and the costs of the processes have risen substantially.

The prime mission of the DIA is to guarantee the deposits of private individuals up to 1.4 million rubles when a bank loses its license. The number of deposit insurance claims has increased almost as fast as the pace of bank licence cancellations. Banks that lost their licences last year included several mid-sized deposit banks, and the DIA received 11 insurance claims costing a total of more than 10 billion rubles each. For all of 2016, a total of 564 billion rubles (7.6 billion euros) was paid out of the deposit insurance fund. The fund’s assets were insufficient to handle all the payments, so the DIA was granted cheap credit from the central bank to cover the difference.
China

**Consumer price inflation holds steady in China.** As in May, June consumer price inflation was 1.5 % y-o-y. Core inflation, which excludes food and energy prices, also remained steady. This year’s official inflation target is 3 %, so price trends at the moment do not restrict macro-level policy.

Producer prices have fallen each month since April, but 12-month producer price inflation in June was still up 5.5 %. Producer prices track energy and commodity prices, so a slowdown in the on-year rise in producer prices is expected.

**Price trends in China, percentage change, y-o-y**

![Graph showing price trends in China](source: Macrobond)

**Yuan use as a reserve currency unchanged; use in international payments declines.** Fresh IMF figures show that the value of yuan-denominated currency reserves globally at the end of March was 83 billion dollars. This is slightly more than in December 2016, when the IMF first published information on the yuan as a reserve currency. At that time, yuan assets worth of 79 billion dollars was reported by COFER respondents that separately account RMB holdings. The yuan’s share of allocated foreign currency reserves fell slightly, however, to 0.93 %. When also other than currency reserves are included, the yuan’s share of official reserve assets rose slightly from the December figure to 0.76 %.

The European Central Bank said last month that it had made the yuan a reserve currency in the first half of this year. The value of the ECB’s yuan investments is only 500 million euros, or 1 % of the value of its foreign currency reserves, making the yuan addition a largely symbolic gesture.

**SWIFT, the global association for secure interbank financial transfers, notes** that yuan payments accounted for 1.6 % of international transfers in May, or about the same share as the Swiss franc. In late 2015, the yuan was used in 2.3 % of international payments. In the first six months of this year, less than 13 % of China’s foreign trade was conducted in yuan, down from 19 % in 1H16 and 26 % in all of 2015.

**Funding deficit threatens pension system; China must move ahead with reforms.** China’s pension system needs reform to put its funding on a sustainable footing. China’s population has been aging rapidly due to the one-child policy introduced in 1979 and rising life expectancy. The World Bank notes that China’s old-age dependency ratio in 2016 rose to 14 persons aged 64 and above per 100 working-age persons (Finland 34). The measurement method overlooks the fact that retirement ages in China are well below 64. While currently the situation is still manageable, the greying of China gives reformers little opportunity for delay. The UN forecasts that China’s old-age dependency ratio will hit 44 by 2050 (i.e. 44 people over 65 for every 100 working-age persons).

China’s pension system consists of the state pension system, corporate pensions and voluntary worker pension savings arrangements. Payment into the government pension system is mandatory for urban workers. An urban-dweller pays a mandatory work pension payment equal to 8 % of his or her gross wage into a personal pension account. The employer then contributes an amount equal to 20 % of the gross wage to the pension fund. The pension is paid in part from the pension account and in part from the pension fund. All people who have paid into the pension system for at least 15 years are entitled to a pension. Large, wealthy firms also pay into a corporate pension scheme. In rural areas, government pensions are small and contribution to the system is not compulsory. For this reason, most people do not pay into the pension system and do not receive pensions.

Without reform, the current system will suffer from a severe financing deficits as the numbers of elderly Chinese grow. China’s human resources and social security ministry reports that pension fund spending in 2015 rose faster (up 20 %) than revenues (up 17 %). The same year, China announced the elimination of the public-sector exemption from pension contributions. Last year, pension funds gained the right to invest in equities. Both measures are intended to increase pension fund revenue streams. In January-May 2017, fund revenues increased slightly faster than expenditures. Investment of pension fund assets in domestic shares is problematic in terms of system sustainability due to the high risk of speculative stock market bubbles in China.

China’s low retirement age poses a huge challenge. Women are generally eligible for retirement between 50 and 55. The retirement age for men is usually 60. By one estimate, raising the retirement age by one year increases annual pension revenues by 4 billion yuan and reduces pension costs by 16 billion yuan. An increase in the pension age would ease the financing deficit, which by some estimates could be as much as 1.2 trillion yuan (155 billion euros) by 2019.

Progress in reform is slow. The government is expected to issue information on pension reform this year, even if preliminary reports suggest that implementation would not begin until 2022, after which the retirement age would be gradually increased over the next 30 years. At that time, the pension age would reach 65 for men and 60 for women. A planned hike in the pension age for women threatens to further lower China’s already low birth rate and labour force participation rate of females. Chinese families have traditionally relied on grandparents to provide child care as there are few possibilities for getting children into organised daycare.
Russia

New Russian budget rule frames government spending; sovereign funds to be combined. The Duma this week passed legislation designed to keep budget expenditures within a limit imposed by relatively low oil prices. Under the new rule, federal budget spending (excluding government debt interest payments) cannot exceed estimated budget revenues. The estimate will be based on revenues from oil & gas taxes calculated at a base oil price and a projected ruble-dollar exchange rate, while non-oil & gas revenues will be those estimated in the budget. Thus, the budget’s primary balance (i.e. the balance before interest payments) must be zero or positive with the calculated revenues. The base price of Urals crude is defined to average $40 a barrel this year and will be raised by 2 % per year starting in 2018. A transition will take place in 2018, when the primary balance is allowed to show a deficit of 1 % of GDP. The permitted budget deficit overall would be slightly larger, as interest payments from the federal budget in 2016 equalled 0.7 % of GDP.

In its recent annual Article IV consultations with Russia, the IMF considered the new fiscal rule to be generally appropriate. The IMF suggested that a more flexible base price for oil would smooth budget spending responses to changes in oil prices and reduce the need to suspend the rule in the event of large changes in the oil price. The IMF also proposed that the budget rule should seek to produce budget surpluses to generate more government savings.

In the new legislation, the government’s two reserve funds will be merged. The Reserve Fund will be terminated by February 1, 2018 and any remaining assets will be moved to the National Welfare Fund. Any oil & gas revenues exceeding this year’s budget estimate will also be transferred to the National Welfare Fund before October 1, 2018.

Later, extra oil & gas revenues will be used to increase the National Welfare Fund, while the Fund may be used to cover a budget deficit up to the amount of a shortfall in oil & gas revenues. The extra revenues and the shortfall will be determined as the difference between the oil & gas revenues calculated at the oil price projected for the budget year, or actual oil & gas revenues, and the oil & gas revenues calculated using the base oil price. If the Fund’s assets at the central bank (i.e. liquid assets) are less than 5 % of GDP, annual use of the Fund is allowed up to the oil & gas revenue shortfall or an amount equal to 1 % of GDP. Fund assets can be invested elsewhere than the central bank as long as the assets at the central bank do not fall below 7 % of GDP. This will not apply to infrastructure projects or Vneshekonombank projects already financed from the Fund and started before 2018.

This year’s IMF Article IV consultation provides important recommendations to Russia. The IMF kept its forecast for Russia’s GDP growth in 2017 unchanged at 1.4 % assuming an average oil price (Brent) of $53 a barrel. Medium-term potential GDP growth is estimated at 1.5 % p.a. assuming no reforms are made. The IMF noted that the current effort to reduce government budget deficits is appropriate for adjusting to persistently lower oil prices. The IMF said expenditure measures should be durable and better targeted (e.g. in social spending) and include pension system reform in order to safeguard growth-enhancing spending on e.g. infrastructure (for Russia’s new budget rule, see previous item).

The IMF saw Russia’s current monetary policy stance as tight and recommended further easing although gradually as it is possible disinflation may reverse. It also encouraged Russia to elaborate on its inflation target frame beyond 2017 and communicate it to the public. Regarding problem banks, the IMF said bank reforms should make owners to shoulder more recapitalisation, remove obstacles that discourage investors from acquiring assets and liabilities from bank owners, replace central bank financing with federal funding, and otherwise, to tighten rules on related-party lending and strengthen efforts to deal with money laundering.

The IMF noted Russia had taken just some steps of economic reforms in the past year and advocated setting priorities on e.g. property rights, privatisation, labour markets, innovative business environment and stronger trade relations.

Russian federal budget revenues and spending recover, but are still at a low level. Second-quarter revenues were up substantially from a year earlier, like in Q1. First-half revenues were up by over 20 %, well outpacing inflation (consumer prices were up 4.4 %). Revenues from oil and gas taxes rose by over a third. Other budget revenue streams overall grew nearly 13 %, including a rapid rise in VAT revenues.

Budget spending under tighter budget policies increased by just over 4 % y-o-y in the first half. Defence spending fell by 5 %. The budget deficit contracted to 1.2 % of GDP, leading towards this year’s deficit target of 2.1 % of GDP, even if the deficit is typically larger in the second half.

In real terms, the revenues and spending in the federal budget are still low due to high inflation in recent years. Largely due to lower oil & gas tax revenues, real first-half revenues were notably lower than in 2011. First-half spending in real terms exceeded the level of 1H11.

Federal budget revenues & expenditures, inflation, 2011–2017

Sources: Ministry of Finance and Rosstat.
China

China’s second-quarter economic growth still robust. The National Bureau of Statistics (NBS) reports that the Chinese economy maintained its first-quarter GDP growth pace of 6.9% p.a. in the second quarter. Quarterly growth picked up in April-June to 1.7% q-o-q. This year’s growth target of “about 6.5%” appears quite achievable, even if the officially reported growth slows slightly in 2H17.

Higher domestic and foreign demand lifted industrial output, resulting in higher GDP growth. National accounts data show industrial growth accelerated in the first half to 6.5% y-o-y (6% in 2016), while growth of the service sector remained at about 8%. Monthly indicators support this view. Growth in industrial output accelerated in June to nearly 8% y-o-y and retail sales grew by 10%. After falling in 2016, China Customs figures show export freight volumes recovered this year.

With growth in fixed investment slowing, economic growth has become increasingly reliant on consumption demand. Second-quarter real growth in fixed asset investment (FAI) slowed to 4% y-o-y, while private investment growth was 2%. Public investments are supported by infrastructure investments, which increased in real terms by 17% y-o-y in the first half. They now account for a fifth of all FAI. Domestic consumption was supported by relatively good growth in incomes. The NBS notes that real income growth exceeded 7% y-o-y in the first half, one percentage point higher than in 2016.

Trends in major economic indicators for China

![Graph of major economic indicators]

Sources: Macrobond, CEIC and BOFIT.

China’s National Financial Work Conference raises debt issue to top-priority status. The National Financial Work Conference met in Beijing last weekend. The conference, which is held every five years, was led by President Xi Jinping. Contrary to previous times, Xi’s speech shoved reforms and financial sector opening to the back burner and instead focused on the financial sector’s risks and capital market’s role as a servant of the real economy. Some analysts see the president’s comments as evidence that China’s rising debt problem has become the leadership’s top concern. Xi concentrated his criticism on rapid increase of the shadow bank lending and on the state-owned enterprises, many of which are so called zombie firms kept on life support with cheap loans.

The conference had less to offer when it came to economic reforms. It celebrated the creation of a Financial Stability and Development Committee, which will operate under the State Council. It seeks to coordinating in a broad manner with the three main regulatory bodies overseeing China’s banking, securities, and insurance sectors, as well as the People’s Bank of China. Competition between these regulators has caused regulatory gaps and heightened market risk and indebtedness. The central bank will play a key role in the committee’s work, but no detailed information has yet been released on the committee’s organisation or tasks.

Several major international bodies that monitor China consider the rapid rise in indebtedness to be the top risk to its economy. The Communist Party leadership has recently adopted a harder line on corporate indebtedness. Tighter regulation should slow China’s economic growth from a brisk first half.

Chinese debt levels continue to rise; households piling on debt. PBoC figures show that the stock of domestic bank lending in China was up 13% y-o-y at the end of June, with stock of bank loans exceeding 150% of GDP. Similar to last year, about half of new bank loans in January-June went to households (mostly housing loans). While households in China carry relatively little debt, they are currently taking on debt much faster than the corporate sector. The stock of bank loans granted to households in June increased by 31% y-o-y to 24% of the total credit stock.

Under China’s broader debt concept of Total Social Financing (TSF), the credit stock (financing to households and non-financial businesses) in June was up 13% y-o-y. Lending by the shadow banking sector (bank’s acceptances, trust and entrusted loans) has continued to increase again this year. In June, the shadow lending stock was up 16% y-o-y. In contrast, corporations have cooled from last year on new financing with stock and bond issues. Growth in the debt-to-GDP ratio has slowed this year, as nominal on-year GDP growth in the first half was over 11%, compared to 7% in 1H16.

Domestic debt-to-GDP (excl. central and local governments)
Russia

Russian economy gradually recovers. After rising throughout the spring, seasonally and workday-adjusted industrial output contracted slightly in June. In on-year terms, industrial output was up in June by 5.5% and by 2% in the entire first half of the year. Mineral extraction industries (includes oil & gas) have grown through the past one-year period, and were up over 3% y-o-y in the first half of this year. Natural gas production has climbed 13%, while crude oil production was up by nearly 2%. Manufacturing growth turned down in June, and first-half growth was less than 1% y-o-y.

The volume of seasonally adjusted retail sales increased slightly further in June, with retail sales up in the May-June period by about 1% y-o-y. Household consumption this year has recovered slightly faster than the retail sales figures indicate, because Russian shopping abroad has recovered quite sharply. Real household disposable incomes have risen in recent months, recovering to the same level as in May-June 2016. The revival in private consumption has been stronger than income growth, reflecting the fact that households have been saving less and borrowing more than last year.

Growth in agricultural output has remained slack all this year, up just 0.2% y-o-y in the first half. Construction, in contrast, picked up in May-June after a lengthy period of decline. Construction activity was up 4–5% y-o-y. Goods transports have been a boom sector of the economy showing robust growth due to increased rail transport and pipeline transmission of oil & gas. The volume of goods transportation was up by over 7% y-o-y in the H1.

Real growth in core sectors of Russian economy, 2011–2017

The pace of real annual GDP growth now rose by 0.4 percentage points for 2012–13, as growth of private consumption was revised up by 0.7 percentage points. In contrast, annual growth in fixed capital formation weakened by 0.7 percentage points for 2012–14.

Russia releases 2011–13 GDP figures produced with new methodology. GDP and its components for the years 2011–16 have now all been revised in accordance with a unified SNA 2008 methodology. As Rosstat has been working backwards, the revised figures for 2014–15 were released in early 2016, together with partly improved data for 2011–13 based on a temporary methodology. The newest 2011–13 figures for fixed capital formation (fixed investment), which impact the GDP figures, now include acquisition of large weapons systems as well as economically beneficial R&D activities.

In the latest round, the value of fixed capital formation during 2011–13 was increased by roughly 10% from the earlier figures (the previous revision already boosted the value of private consumption by about 10%). The value of GDP in the years 2011, 2012 and 2013 rose 1–3%. In the previous temporary revision, the rise in the value of GDP for the period was about 7% from the old figures.

The pace of real annual GDP growth now rose by 0.4 percentage points for 2012–13, because growth of private consumption was revised up by 0.7 percentage points. In contrast, annual growth in fixed capital formation weakened by 0.7 percentage points for 2012–14.
China

Most recent GDP growth forecasts agree with China’s official growth targets. The IMF this week released its updated outlook for the global economy. The IMF expects Chinese growth to reach 6.7% p.a. this year and fall to 6.4% next year (slightly higher than its earlier forecast). Several other major institutions have also upgraded their forecasts recently, with the consensus now around 6.5% (see table). China’s official goal of doubling GDP between 2010 and 2020 requires average GDP growth of about 6.5% p.a.

Most of the forecasters, including the IMF, note that the risks associated with China’s debt-fuelled high-growth strategy continue to accumulate. Without the government propping up the growth, the natural pace of growth of the Chinese economy would be slowing due to such factors as a contracting workforce, ongoing structural reform of the economy and the fact that most of the easy productivity gains have already been taken.

Selected GDP forecasts for China, %

<table>
<thead>
<tr>
<th></th>
<th>2017</th>
<th>2018</th>
<th>2019</th>
<th>Release</th>
</tr>
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<td>6.4</td>
<td></td>
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<td>JP Morgan</td>
<td>6.8</td>
<td>6.4</td>
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<td>OECD</td>
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<td>BOFIT</td>
<td>6</td>
<td>5</td>
<td>5</td>
<td>March</td>
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China drops FDI restrictions; European Chamber wants more market access. At the end of June, China’s Ministry of Commerce (MoFCom) and the National Development and Reform Commission (NDRC) released their latest Foreign Investment Industrial Guidance Catalogue, which sets out incentives and restrictions applicable to foreign direct investments in coming years. The new catalogue took effect today (July 28).

The catalogue lists those branches where incentives are available to foreign firms, as well as branches that are on the “negative list”, i.e. where access by foreign investors is constrained. The catalogue divides branches on the negative list into two groups: those subject to a complete FDI ban and those subject to conditions (such as formation of a joint enterprise with a Chinese partner and ownership restrictions). While foreign firms receive nominally neutral treatment in relation to Chinese firms in branches not mentioned in the FDI catalogue, foreign firms report facing discrimination.

Officials report that the new catalogue reduces the number of restricted branches to 63 compared to 93 in the previous catalogue. Instead of 36 branches previously, only 28 of the 63 branches are still fully off-limits to foreign investors. The most extensive deregulation targets the service sector as well as the manufacturing and mineral extraction sectors. For example, motorcycle manufacturing or road passenger transport services are now free of foreign investment restrictions.

The EU Chamber of Commerce in China released a less sanguine assessment of the new catalogue. The Chamber noted that, even if 30 branches are supposedly open to foreign investment, only 18 of the branches are actually available to foreign investors. The remaining 12 branches were listed as off limits to both domestic and foreign actors in the 2016 Market Access Negative List, which has priority over the FDI catalogue. The Chamber also strives for transparent, simple FDI regulation. The Chamber above all is concerned about equal market access, noting that the new catalogue does nothing concrete to rectify the matter. The access of European firms to the Chinese market is still very restricted, while Chinese firms enjoy largely unfettered licence to operate within the EU.

Foreign direct investment from China and to China contract. Measures introduced by the central government to stifle capital outflows from China have effected investment flows in the first half of 2017. Since last December, officials have paid special attention to outbound direct investment (ODI). Last week, the government announced that the intensified scrutiny would continue. In particular, real estate, hotels, the film industry and sports investment have received closest scrutiny. China’s Ministry of Commerce notes that ODI (excl. financial sector) fell to around 48 billion dollars in the first half, down by 46% from 1H16.

Inward foreign direct investment (FDI) also fell to 66 billion dollars in the first half, a decline of 5% from 1H16. In yuan terms, the value of inbound FDI remained at the 2016 level as the yuan has weakened against the dollar. As usual, Hong Kong’s dominance as an FDI source continued with the share of investment (including investment routed via tax havens) rising to 74%. The EU accounted of the 8% of FDI inflows to China.

China’s inward and outward FDI flows

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Russia

Russian central bank keeps key rate unchanged. Last Friday (July 28), the governing board of the Central Bank of Russia decided to hold its key rate at 9 %. The board noted that inflation is currently running close to the 4 % target and that the economic recovery continues. Even if rates were not adjusted at the July meeting, the CBR stated that a rate cut before the end of the year remains possible. The press release also noted the economic growth is now approaching potential and that certain branches are even showing signs of looming labour shortages.

Number of employed all-time high in Russia. Rosstat reports that the number of people employed in the Russian economy reached around 72.4 million people in June, a slight increase from a year earlier. At the same time, the number of unemployed people decreased slightly. According to preliminary data, the unemployment rate based on ILO methodology was 5.2 % in June. Variations across regions, however, were substantial. The unemployment rate in Moscow was a mere 1.4 % and in St. Petersburg 1.6 % while several republics in the North Caucasus region posted unemployment rates well above 10 %.

Russia has experienced a decline in unemployment that has continued since the start of the millennium; most labour market adjustment has occurred instead through wage flexibility. Much of this dynamic reflects a decline in the size of the working-age population, which peaked in 2005 at 90 million. The working-age population stood at 83 million at the end of 2016. The number of people entering the working-age cohort over the next 15 years will be smaller than the number leaving, so a change in the downward trend is not to be expected anytime soon. Raising retirement ages has been proposed as a way to maintain the size of the labour pool. This, however, would also have a limited impact as a significant share of pensioners already work after they reach retirement age. Over the past 15 years, Russia’s labour force participation rate has risen back to levels well above the OECD average.

Trump signs new Russian sanctions bill. The “Countering America’s Adversaries Through Sanctions Act” tightens some of existing sanctions on Russia, creates the possibility for imposing new sanctions and makes it harder for the US president to lift or ease them. Europeans reacted most to the act’s threatened extension to projects involving the maintenance, expansion and construction of Russia’s oil & gas export pipelines. The new law could affect e.g. several major gas pipelines including the Power of Siberia, NordStream2 and TurkishStream, and hence might impact also the operations of some major European energy companies.

Monitoring for compliance with economic sanctions is difficult and sometimes subject to discussion. Recent examples include the case of the oil giant Exxon that has stated it would appeal its two-million-dollar fine, which was levied after Rosneft made a deal with Exxon in 2014. The US Treasury Department claims the deal violated the sanctions regime in force at the time. Similarly, the German Siemens conceded that its joint venture partner in St. Petersburg violated sanctions imposed by the EU by sending gas turbines to a power plant project in Crimea.

After Congress passed the bill, Russia announced it was limiting the number of US embassy personnel in Russia to 445 people and denying access of personnel at the US embassy to their summer estate outside Moscow. The measures are at least partly responses to measures announced by the US in December 2016 that forced Russia to surrender two major estates near New York and outside Washington DC.

Increase in area of land classed as Russian arctic – with much less budget funding. At end-June, the northern and northeastern parts of the Karelian Autonomous Republic were recognized, after a long effort by local officials, as a part of the Russian arctic region through a presidential decree. The law defining the area of the arctic region and its status is yet to be approved, however.

An economic development programme until 2020 for the arctic region was laid out already in spring 2014, but many of the programme’s specifics as well as its funding from the federal budget are still open. At the start of 2017, it was planned to allocate just over 200 billion rubles (3 billion euros) in budget funds for the programme, but the most recent media reports suggest that that amount has fallen to around 12 billion rubles. Rosstat reports that the Russian arctic is home to about 2.4 million people and generated about 5 % of Russian GDP in 2015.

About 10 % of Russian investment last year went to arctic areas. Most of that went to the massive LNG project on the Yamal peninsula, the first phase of which should be completed this year. The role of public investment is small in the most energy-rich arctic regions, but e.g. in the Murmansk region and Chukotka Autonomous Okrug over 40 % of investment was financed from budget funds last year.

Sources: Rosstat, OECD and CEIC.
China

Housing prices continue to rise in China. The National Bureau of Statistics reports that prices of existing apartments in 70 large cities saw an average rise of 10% y-o-y in June with no signs of an overall slowdown in the rate of price increase. Several major metropolises that had earlier witnessed soaring apartment prices, however, saw some levelling off. For example, official figures show the rise in prices came to a halt in Shanghai and Shenzhen in late 2016, even if June apartment prices were still up 10% y-o-y in Shanghai and 4% in Shenzhen. Apartment prices in Beijing fell in June, but were still 16% higher than in June 2016. In Guangzhou, where housing prices are up over 20% from a year ago, prices continue to rise rapidly. The NBS sampling from 66 other large cities shows the rise in housing prices overall continues at about 9% a year.

Many Chinese cities over the past year have sought to restrict apartment sales to cool their overheated housing markets. The new restrictions have hit many apartment buyers and led to minor demonstrations in Beijing, Shanghai and elsewhere. Several cities have already abandoned some of the restrictions.

Prices of existing apartments in large Chinese cities

<table>
<thead>
<tr>
<th>Year</th>
<th>Beijing</th>
<th>Shanghai</th>
<th>Guangzhou</th>
<th>Shenzhen</th>
<th>Average of 66 other cities*</th>
</tr>
</thead>
<tbody>
<tr>
<td>2010</td>
<td>100</td>
<td>120</td>
<td>130</td>
<td>140</td>
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<td>2011</td>
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</tr>
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<td>2017</td>
<td>170</td>
<td>190</td>
<td>200</td>
<td>210</td>
<td>190</td>
</tr>
</tbody>
</table>

Sources: NBS, CEIC, BOFIT.

Small steps forward in reform of Chinese state-owned enterprises. China’s leaders in December included partial privatisation of state-owned enterprises (SOEs) on their 2017 reform agenda. According to the official media sources, in the first half of the year about 50 SOEs had sold off stakes to private investors to raise a total equal to roughly 1.5 billion euros. This year’s first big privatisation sale – a stake in China Unicom, one of China’s three largest telecommunications operators, has yet to occur. Reuters reports that the yet-to-be-finalised plan involves offering shares of China Unicom listed on the Shanghai stock exchange and that the company expects to raise some 10–15 billion euros from the sale. Reuters expects the biggest investors to include internet-based Chinese firms Tencent, Alibaba, Baidu and JD.com.

As part of efforts to support partial privatisation, the Chinese government ordered at the end of July that all companies administered by the central government (other than those in the financial and culture sectors) be converted to limited liability or joint stock corporations by the end of this year. To encourage enterprises to make the switch, the government is offering a five-year exemption from fees of land-use right transfers and reliefs in their value-added taxation. The State-owned Assets Supervision and Administration Commission (SASAC), which oversees enterprises owned by the central government, currently manages 101 conglomerates, which include roughly 50,000 smaller enterprises. The government says that about 3,200 of these firms will be converted to limited liability or joint stock corporations. Over 100,000 firms controlled by local governments are unaffected by the move.

A second, longer-term project involving SOEs is the creation of “national champions” though mergers to create larger and powerful corporations. A decade ago, the Chinese state owned about 150 conglomerates. SASAC plans to take the current 101 conglomerates down to around 80.

Money raised from partial privatisation sales will help SOEs struggling under mountains of debt. Privatisation is also hoped to improve corporate governance in SOEs and increase their efficiency. As the state retains a majority stake in most cases, however, it is unclear how much power private investors will be granted in managing corporate affairs. Most observers find little to be optimistic about. On the whole, the state’s role in the Chinese economy seems to be growing rather than getting smaller.

Despite orders to cut overcapacity in steel production, China’s first-half output increases anyway. New NBS figures show Chinese production of steel and aluminium climbed to a monthly record in June. For the first half of this year, production was up across the board for steel (up 5% y-o-y), coal (up 5%) and aluminium (up 9%). China’s overproduction creates problems on the international trade front, impedes the structural shift in the economy to higher productivity branches and hurs efforts to deal with air, water and soil pollution issues.

Winding down overcapacity is hindered by fears of social unrest. In 2016, it was estimated that capacity reductions would result to 1.8 million workers losing their jobs in the coal and steel industries. Officials put the number of actual job losses last year in these industries at 726,000 people. In any case, production has increased, as a lot of capacity has been idle. Construction activity supported by local governments and higher commodity prices for steel and coal have helped boost production. Unauthorised production has also increased with rising prices.

Greenpeace reports that only 24% (20 million metric tons) of 2016 cuts in steel production capacity focused on capacity that was in use, while 60 million tons of new capacity was added through restarted mills or brand new mills.
Russia

Brisk growth in Russian goods trade continues. The dollar value of goods exports and imports rose by nearly 30 % y-o-y in the first six months of 2016. In the second quarter, import growth accelerated slightly and export growth slowed. Despite high growth, the levels of exports and imports were well below peak levels of earlier years.

Driven largely by higher export prices, the value of goods exports continued to rise in the second quarter. Total export volumes also appear to have increased slightly. Export volumes of e.g. natural gas, iron ore, coal, wheat and copper increased, whereas export volumes of crude oil and oil products contracted relative to 2Q16.

The value of goods imports grew by double digits in the second quarter in most product categories. Imports of metal goods grew – both in terms of volume and value – by roughly 50 % y-o-y. The value of imports of machinery, equipment & transport vehicles increased by over a third.

The country structure of goods trade has remained largely unchanged this year. EU countries accounted for 44 % of Russia’s trade, Asian countries 27 %, Eurasian Economic Union member countries 9 % and the United States 4 %.

Growth in value of select categories of Russian imports, 1H17

Source: Russian customs.

Russia has the most barriers to trade for European exporters. The European Commission published its latest report on barriers to trade in June. The report, which is based on information from European firms, identifies 372 barriers to trade currently in use, with the largest stock of barriers (33) imposed by Russia. Brazil, China and India each had stocks of 23 barriers against European firms.

Russia accounted for six of the 36 new barriers introduced in 2016. These measures included restrictions on imports and regulations to favour domestic firms in procurements by state-owned enterprises, new certification requirements for cement and pharmaceuticals, as well as restrictions on transit. Russia also announced plans for introducing requirements for psychological and educational safety of toys that would be unique in international practice.

Industrial output in Russian regions rises, while consumption gradually recovers. Industrial output growth continued in the first half of this year in all of Russia’s eight federal districts (each district comprising several administrative regions). Production rose by 1.5–2 % y-o-y in the Northwest, Central and Volga Federal Districts, as well as in the mega area of Moscow City and the surrounding Moscow region. In other major federal districts and Saint Petersburg industrial output continued to rise at a 3–4 % pace.

Over the past couple of years, neither industrial output overall nor manufacturing overall has not contracted in any of Russia’s federal districts. Industrial output has even increased briskly in 2015–16 and this year in the Southern Federal District due to high growth in manufacturing and in the Far East Federal District driven by growth in the mineral extraction industries.

Retail sales have turned to growth, albeit slowly, in six federal districts. In Russia’s Northwest and Central Federal Districts, for example, the volume of retail sales in the first six months of this year rose by just a little over 0.5 % y-o-y. After collapsing in 2015–16, retail sales volumes this year have been similar to levels seen in 2010–12 in the Central, Northwestern, Southern and Volga Federal Districts. The retail sales volumes in the Siberia and especially the Ural Federal Districts are at even earlier and lower levels.

Of Russia’s over 80 administrative regions, about a dozen in recent years witnessed no contraction or only slight contractions in retail sales to 2013–14 levels. Most regions have experienced a fall in retail sales to roughly the same levels that prevailed in the early years of this decade. The retail sales volumes in nearly 20 administrative regions both overall and per capita have sunk to levels similar to those last seen in 2005–08. Among them, Moscow is rather specific as considerable parts of retail sales and also industrial production have over many years moved out of Moscow City to the surrounding Moscow region.

Real on-year change in industrial output and retail sales in Russia’s federal districts and major metropolises, 2015–2017

Source: Rosstat.
China

Tightened capital controls dampen Chinese capital exports, but fail to fix true problems. Driven by goods exports, China’s current account surplus rose in the second quarter to 53 billion dollars. The first-half current account surplus this year reached 71 billion dollars, compared to 110 billion dollars in 2016. The 12-month current account surplus shrank to 1.4 % of GDP, or about a percentage point less than a year ago.

Although a detailed breakdown of the financial account figures is still forthcoming, it is clear that the net capital outflow from China has slowed significantly from 2015 and 2016. In the first half of 2016, the financial account and the “net errors and omissions” term, which together indicate the net outflow of capital from China, reached nearly 270 billion dollars. In 1H17, the net capital outflow was just 40 billion dollars. At the same time, the depletion of foreign currency reserves halted and even recovered slightly. Monthly figures show that China’s foreign currency reserves last month rose by 24 billion dollars to 3.08 trillion dollars. Most of this increase likely reflects appreciation of the euro and other major reserve currencies against the dollar.

Main categories in China’s balance-of-payments figures*

![Graph showing China's balance-of-payments figures](image)

* 2Q17 financial account includes “net errors and omissions” term. Sources: Macrobond, BOFIT.

In order to stem capital outflows, falling currency reserves and depreciation pressures on the yuan, Chinese officials have substantially tightened capital controls and regulatory oversight. One major focus of the recent tightening has been on foreign investments of Chinese firms. Balance-of-payments figures show that outbound foreign direct investment of Chinese firms in 1H17 amounted to just 40 billion dollars, down from 124 billion dollars in 1H16. Despite efforts to encourage capital imports, first-half FDI inflows to China fell from 75 billion dollars a year earlier to 55 billion dollars.

While the payments balance has levelled off, efforts to correct imbalances through administrative decree are unlikely to put China on a sustainable footing. Circumvention of regulations is common. Indeed, some of the reduction in the current account surplus comes from an explosion in tourism spending that many suspect includes substantial amounts of illicit capital exports. Officials are responding to the situation by increasing the monitoring of use of payment cards by travellers abroad starting from September. The current round of regulatory tightening, however, does not tackle the natural need of Chinese firms and households to diversify their operations and investments. The need for diversification goes up when domestic uncertainty and risks are heightened by rising mountains of debt, the emergence of asset bubbles and political foot-dragging on needed reforms.

Robust growth in Chinese foreign trade. Growth in Chinese foreign trade has recovered significantly after a weak development seen in recent years. China customs reports that the dollar value of goods exports has grown this year by nearly 10 % y-o-y and goods imports by close to 26 %. Rapid growth in imports in particular reflects higher commodity prices than last year, but the rise in the volumes of exports and imports has been rapid too, both increasing nearly 10 % y-o-y in 1H17. The resurgence of foreign trade has been quite broad-based both by commodity group and by country. Trade figures of customs authorities in other countries confirm the strong growth in China’s trade, and tend to dispel suspicions that the sudden rise in goods trade involves greater evasion of capital controls than earlier. The suspicions initially arose when the recovery in imports began last year at the same time China cracked down on capital movements.

The recovery of exports has been promoted by weakening of the yuan’s real effective (trade-weighted) exchange rate (REER) over the past year and a half, which has bolstered the price competitiveness of China’s exports. The REER is now about 10 % weaker than at the start of 2016. The pick-up in Chinese export growth has also boosted imports, as China still continues to import a relatively large share of components for assembly or further processing before they are exported further along the production chain. This "process trade" currently represents a third of all Chinese exports.
Russia

**Russian growth accelerates.** Rosstat preliminarily estimates Russian GDP grew by 2.5 % y-o-y in Q2 2017, up from 0.5 % growth in the first quarter. The strong GDP acceleration is not surprising, since growth slowed down again in coming months. For the first half of the year, GDP grew at a rate of 1.5 % y-o-y. BOFIT’s most recent forecasts (spring 2017) sees GDP rising by 1.5 % this year overall.

Several forecasters have slightly upped their predictions on Russian GDP growth during this year. The most recent forecasts see Russian GDP rising by 1–2 % this and next year if the oil price remains around 50 dollars a barrel. Most recoveries in domestic demand and exports should fuel gradual growth. Forecasts for import growth range more widely: 2–10 % real growth this year and 2–4 % next year.

**Moscow launches ambitious housing programme.** At the beginning of August, Moscow mayor Sergei Sobyanin confirmed the list of apartment buildings to be included under an ambitious programme of resettlement and urban renewal. Most buildings on the demolition list are crumbling five-storey Khrushchyovka apartment blocks constructed in the 1950s and 1960s. The residents will be replaced mainly to new apartment buildings constructed under the programme. The massive project, far larger than the resettlement programs of recent years, covers more than 350,000 apartments and total liveable floorspace of over 16 million m². The programme is planned to be finished by 2032 and Moscow’s deputy mayor Marat Khusnullin estimates the total costs of the programme at 3–3.5 trillion rubles (40–45 billion euros).

Some residents in apartment buildings slated for demolition organised protests this spring and summer against the programme on fears they may be getting a raw deal. To pacify their concerns, guarantees about e.g. the location and size of the new apartments have been written into law and the residents have had the possibility to vote on opting out or into the city’s apartment building programme.

Moscow’s plan is quite large even at the national scale. In recent years, housing built under resettlement programs outside Moscow and St. Petersburg has annually amounted to about 2.5–3 million m² according to the state corporation for housing and communal services. The corporation estimates that there are still over 650,000 people living in uninhabitable housing outside Moscow.

Looking at the impact on Russian housing construction overall, the Moscow programme would account for about 1 % of annual housing production volume nationally. Housing production increased at a rate of about 8 % a year during 2011–15, but contracted by 6 % in 2016 and 11 % y-o-y in the first half of this year.

**Wages in Russian industry recover to pre-recession top levels.** Between 2014 and mid-2016, wages in Russian industry declined relative to many countries on the ruble’s sharp devaluation. In the manufacturing sector, the average monthly wage relative to European countries was so far at its highest in 2013–14, when it was about 650 euros (gross wage before income taxes). By summer 2016, the Russian wage had fallen by about a third to around 450 euros.

More recently, Russian manufacturing wages have come back strongly, recovering close to their 2013–14 levels. In nominal terms, ruble wages continued to rise at around 8 % a year even in the recession years of 2015–16. In the first five months of 2017, they were further up about 9 % y-o-y. Adding to the increase, the ruble has appreciated rapidly since early 2016, roughly 30 % against the euro.

Russian manufacturing wages this spring exceeded 600 euros a month, putting them again broadly on par or slightly above average manufacturing wages in the lowest-income EU countries. Even with the recovery, Russian manufacturing wages are still lower than in the other of the eleven countries that have joined the EU since 2004. In 2016, the average monthly manufacturing wage was about 620 euros in China and about 560 euros in Brazil.

**Average gross manufacturing wage, 2012–2017**

**Source:** National statistics agencies.
China

After a strong first half, China’s economic numbers dip in July. Figures just released by China’s National Bureau of Statistics show on-year growth in industrial output, retail sales and fixed investment slowed last month. July industrial output growth fell in real terms by over a percentage point to 6.4%, while real growth in retail sales slowed to 9.6%. Growth in on-line commerce remained brisk.

The long-term declining trend in real growth in fixed asset investment (FAI) in urban areas continued with July growth barely surpassing 2%. As private investment has long languished, the reduction in public investment was the biggest driver in last month’s slowdown. The level of private investment in July remained at the same level as in July 2016. While the concept of urban FAI does not correspond the standard notion of fixed investment in China’s national accounts, decline in FAI has been a good predictor of slowdown in fixed investment growth in this decade.

Consumer price inflation slowed in July to 1.4%. Producer price inflation was 5.5% for the third month in a row.

China seeks to be the world leader in artificial intelligence. China’s State Council last month released an ambitious national development guideline on pushing the frontiers of artificial intelligence (AI). The development of AI technologies is to be promoted through legislative policy, including tax breaks. The State Council has also encouraged Chinese firms to gain AI expertise from abroad through mergers or acquisition. AI refers to machines and devices (e.g. smart cars and robots), as well as software that mimic human reasoning.

The AI directive has a three-step goal. First, make China a global player in AI by 2020 by reaching the level of leading countries in AI technologies and their utilization. Second, become a world leader in AI by 2025. Finally, make China the global centre of AI innovation by 2030.

AI offers the Chinese economy remarkable economic opportunities. For example, the McKinsey Global Institute notes that about half of jobs now performed in China could be fully automated. McKinsey and others point out that AI could significantly boost Chinese economic growth. So, China’s political leaders want to make AI the new engine of economic growth.

Artificial intelligence has applications outside manufacturing and commerce that crosses many disciplines from psychology and medicine to military technology and social control. Global interest has recently been piqued by the Chinese planners’ intension to construct an Orwellian-sounding “social credit system,” whereby every citizen would be scored for social reliability based on his or her online and other behaviour.

China’s recently tightened censorship rules are directly at odds with the freedom demanded by an innovation economy. For example, president Xi Jinping’s calls for tighter ideological controls at universities are unlikely to promote free thought or effective use of research time. In practice, the push for ideological purity limits the access of Chinese researchers to studies in related fields by their colleagues abroad. In recent weeks, China has initiated a crackdown on virtual private networks (VPNs) that are used to circumvent online censorship. Apple recently had to pull over 60 VPN apps from its Chinese App Store. Media reports also claim Amazon has been pressured to remove VPN apps from its Chinese cloud servers.

CPC tries to elevate its role in China’s state-owned enterprises. Media reports claim the recent campaign by the Communist Party of China (CPC) to increase the state’s role in corporate operations is increasingly apparent even for Chinese state-owned enterprises (SOEs) listed on the Hong Kong stock exchange. The Wall Street Journal reports that at least 32 Chinese firms listed on the Hong Kong exchange have amended their corporate articles of incorporation since 2016 to give a CPC committee an advisory role in board decisions. Most of these changes have occurred in recent months. The Financial Times noted that the articles of association in roughly 100 SOEs held by the central government and administered by the SASAC had been amended to increase the party’s role in firm governance.

It is unclear why there is now a need to elevate the role of party committees and how the campaign pertains to planned reforms designed to make SOEs more efficient. An important part of corporate reforms is incremental privatisation of SOEs to increase the efficiency of their governance and operations. It is difficult to see how the strengthening of party committees would help to reach these goals particularly as the pool of competent people for such committees remains limited.

The efforts of the CPC to increase power in governance of listed SOEs is at odds with promised market reforms and quite off-putting to foreign investors. The matter could even affect current policy debates in Europe and North America on restricting Chinese investment and corporate acquisitions.

Headline indicators of Chinese economic performance

Sources: Macrobond, CEIC, BOFIT.

China's political leaders want to make AI the new engine of economic growth. So, China’s political leaders want to make AI the new engine of economic growth. So, China’s political leaders want to make AI the new engine of economic growth. So, China’s political leaders want to make AI the new engine of economic growth.
Russia

Russia’s industrial output recovery varied boldly in recent months. Rosstat reports that seasonally and workday-adjusted industrial output, which posted robust increases throughout the spring, declined on-month in both June and July. The on-month contraction in July was as large as about 1%. Compared to July 2016, July industrial output was up by 1%.

The slide in industrial output in June and July was driven by declines in manufacturing, which in July made output nearly 1% lower than even in July 2016. Notably, however, the entire manufacturing output drop in July and part of the good performance in spring were due to transport vehicle production (excluding automobiles). In mineral extraction industries, the long stretch of seasonally-adjusted growth in output plateaued in July.

The recovery in construction activity that began last spring, continued in July. Construction was up by a whopping 7% y-o-y.

As in previous months, seasonally-adjusted volume of retail sales rose slightly in July, but growth was still very slow. The volume of retail sales in June and July exceeded the level of a year earlier by about 1%. Real disposable household incomes in July performed slightly more weakly than in previous months, however. The small recovery in consumption has still been largely dependent on a decline in the household savings rate and a gradual recovery of borrowing.

Industrial output (seasonally and workday-adjusted), 2016–17

2014=100

Source: Rosstat.

Recovery of Russian government budget revenues has brought rebalance. Rebound of revenues on the consolidated budget (federal, regional and municipal budgets plus state social funds) continued in the second quarter of this year. For the first half of 2017, revenues were up 16% y-o-y in nominal rubles. Revenues from oil & gas taxes rose by 37% from the lows of 1H16, while other budget revenues increased by nearly 12% (well above Russia’s 4.4% inflation rate). Even if growth in revenues from excise taxes and corporate profit taxes slowed in the spring, both revenue items in the first half of the year were nearly 20% higher than in 1H16. Revenue streams from social taxes and value-added taxes, which form the consolidated budget’s two largest revenue streams, as well as revenues from property taxes, continued to experience strong growth, rising by 11–12% in the first half of the year. Labour income taxes also generated clearly higher revenues than a year ago.

Thanks to higher revenue flows, the first-half consolidated budget showed a slight surplus. Budget spending increased by over 6% y-o-y, which meant real growth was rather moderate. Social spending, however, increased by about 10%, even when omitting the one-time pay-out to pensioners at the start of the year. Budget spending in the housing sector as well as in different sectors of the economy turned to notable growth after some years of decline. Even with a slightly less severe restraint, the spending track on education remained weak, while spending on healthcare declined. The zero-growth line on administration spending seen last year remained in place. After a string of boom years, defence spending declined by 8%. Spending on domestic security continued to decline as it has for about three preceding years.

Real developments in consolidated budget spending, 2008–17

Sources: Finance ministry, Rosstat and BOFIT.

Russia’s regional budgets and social funds benefit most from recovery in government budget revenues. Federal budget revenues rose by over 20% y-o-y in the first half of this year due to higher oil & gas tax earnings. Transfers to state social funds represented the fastest-growing spending category, while transfers to regional budgets also rose after two consecutive years of declines. Even in nominal ruble terms, other federal budget expenditures were unchanged when omitting the one-time payment to pensioners at the start of the year. Budget spending in the administration sector remained in place. After a string of boom years, defence spending declined by 8%. Spending on domestic security continued to decline as it has for about three preceding years.

Regional and local budget revenue growth accelerated to around 10% y-o-y. Regional spending rose by over 6% y-o-y, while regional budget surpluses as a total were unusually large. Revenues and spending of state social funds rose by about 9%.
China

IMF warns debt driven high growth raises risk of hard landing for the Chinese economy. In its annual Article IV consultation country report for China, the IMF team sees government efforts to cling to high growth targets as harmful to the Chinese economy. The IMF expects China to use all means possible in achieving its target of real doubling of 2010 GDP by 2020. Achieving this goal calls for extensive debt-fuelled fiscal stimulus policies and increased public investment that thwart efforts to rebalance the economy away from investment-driven growth to increased emphasis on consumption and services. Holding tightly to specific target numbers has fuelled a rapid increase in public and private borrowing, which in turn exposes many sectors to increased levels of risk. China’s debt-to-GDP ratio is expected to rise another 60 percentage points by 2022.

The IMF would like to see China move from numerical growth targets to committing to economic reforms as it is the only way to sustain relatively robust economic growth over the long term. Growth needs to be supported through productivity gains, which would require rapid implementation of major reforms. Critical elements in reform of the corporate sector include decommissioning of unprofitable zombie firms, reform of state-owned enterprises that are less efficient than their private-sector counterparts and reduction of over-capacity. While these painful measures will lower growth over the short term, the IMF believes China can get growth on a sustainable basis over the long term. Other major areas for economic reform mentioned by the IMF include increasing the role of markets in the economy to improve resource allocation and levelling the playing field between private (including foreign) firms and state-owned or state-associated firms.

In the monetary policy sphere, the IMF sees the current stance of monetary policy accommodative and exchange rate broadly in line with fundamentals. The authorities have recently cracked down on capital outflows and increased administrative controls over the exchange rate, which are moves away from the needed shift to a market-based and ultimately floating exchange rate regime. While more flexible exchange rate, financial market stability and more effective price-based monetary policy framework would allow further relaxation of capital controls, the IMF cautions China to carefully sequence reforms in the current circumstances.

The emphasis in fiscal policy needs to shift from overinvestment to policies that support private consumption, including increased income transfers, progressive income taxes and government spending on education and healthcare. With such changes, households would be able to devote a larger share of their income to consumption rather than saving. China’s very high savings rate helps sustain excessive domestic fixed investment that erodes productivity and sustains global imbalances. China’s ratio of private consumption to GDP is still below 40% (world average around 60%), reflecting the high household savings rate (23% of GDP, world average 8%).

China’s augmented public sector deficit stays around 10% of GDP. China’s official figures show that the deficit of the public sector (central and local governments combined) has been running at 2–3% of GDP in recent years. These official public sector figures, however, are not comparable with countries using accepted international standards and Chinese numbers, for example, omit the extensive off-budget activities of local governments. As in earlier years, the IMF has evaluated in its latest Article IV consultation the condition of China’s public sector under internationally comparable standards taking off-budget financing into consideration. The IMF notes that China’s augmented public sector deficit last year likely exceeded 10% of GDP and is unlikely to shrink this year.

Due to the large deficits, the IMF’s revised projection of public debt now rises to nearly 70% of GDP by the end of this year. About a third of that debt is owed by the central government, with the rest held by local governments. While the ratio of central government debt to GDP has long remained stable, local government debt levels have soared.

Local governments were granted the right to issue bonds in 2015. Previously, all local governments were required to have balanced budgets, making debt acquisition out of the question. This rule was widely circumvented through the creation of off-budget “local government financing vehicles” (LGFVs). Under a programme launched in 2015, local governments and provinces were encouraged to issue their own bonds and use the money raised to pay down off-budget debt. In reality, LGFVs have continued to pile up debt. At the start of 2016, local administrations were granted the possibility to implement investment projects by including private financiers – the so-called Public Private Partnership (PPP) model. In practice, a “private partner” in China is typically a firm owned by either the state or a local government. The model has gained increasing popularity, especially this year. The IMF noted that the distinction between the LGFV and PPP models seems to be minor. China’s finance ministry recently conceded that local governments use PPP financing models to disguise their borrowing. Observers note that risks in PPP projects are usually borne by the government, while private partners are guaranteed fixed returns on their investment.

IMF estimate of augmented public sector deficit and debt, % of GDP

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Source: IMF. * forecast.
Russia

Central Bank of Russia takes over Otkritie Bank. The CBR announced on Tuesday (Aug. 29) that it had taken over administration of Otkritie Bank, Russia’s eighth largest bank and second-largest privately held bank after Alpha Bank. The banking group’s total assets at the end of 2016 amounted to 2.703 trillion rubles (about 43 billion euros).

Otkritie becomes the first Russian bank to enter receivership under new bank restructuring laws. The funding committed to the operation from a dedicated CBR Fund makes the Fund at least a 75 % stakeholder in Otkritie. The CBR says that Otkritie Bank will continue to meet all its obligations and that none of the bank’s debt instruments will be converted to shares. Otkritie Bank suffered a large run on deposits all summer. In July alone, depositors withdrew over 6 billion euros worth of deposits.

Otkritie Bank in recent years pursued a very aggressive expansion strategy, acquiring the Rosgosstrakh insurance company and taking charge of restructuring National Bank Trust. Otkritie’s balance sheet almost tripled in just a couple of years. The shift to public ownership of Otkritie Bank further increases the state’s role in Russia’s banking sector.

Market reactions so far have been subdued. The CBR has provided banks with additional liquidity to prevent problems in the interbank markets.

Recovery in Russian fixed investment. The volume of fixed investment rose by well over 6 % y-o-y in the second quarter. For the first half, growth was nearly 5 % y-o-y. Fixed investment was still down by 10 % from the first half levels in 2012 to 2014.

Rosstat reports that investments covered by within-year statistical recording increased by about 2.5 % y-o-y in the first half. These investments come basically from large and mid-sized firms and the state, which altogether account for three quarters of total investments. Instead, Rosstat estimated that other investments, which include those of small firms, grey-economy operators and most household investments, rose by more than 10 %. This is similar to the years of recovery and growth in the wake of 2009 recession, when these investment categories also experienced significantly higher growth than the core statistically recorded investments.

Regarding the investments by large and mid-sized firms and the state, investment in oil & gas production, after rising in the past couple of years, contracted in the first half by about 1 % y-o-y. Investment in oil refining remained at the same low level as in 2016. Investment in pipeline transmission of oil & gas, however, increased by 25 % after several years of decline. Investment in the electricity sector fell strongly for the fifth consecutive year. Manufacturing investment (excluding oil refining) contracted for the third year in a row.

The brisk recovery in fixed investment, especially in the second quarter, has drawn observer attention to the impact of investment waves caused by relatively one-time expenditures on large projects. The CBR, for example, noted spending on the Power of Siberia natural gas pipeline running in eastern Russia and to China, construction of Kerch Strait road-rail bridge to Crimea, and the 1 July deadline for companies to complete investments in new cash registers and related systems.

Among Russia’s eight governmental areal subdivisions (Federal Districts), fixed investment recovered fastest in the Far East Federal District (up 20 %), as well as in the Central Federal District (15 %), e.g. in Moscow. In contrast, fixed investment continued to decline in the Volga and Siberia Federal Districts. In Russia’s more than 80 administrative regions, investments in 36 regions increased substantially, while investment continued to decline in over half of the regions. Investment revival in Moscow contributed significantly to the recovery in Russian investment overall, as did investment in the commodity-producing regions of Tyumen, Sakha-Yakutia and Amur. Russian investment in Crimea, which rose by over 250 %, was largely financed with state budget funds and had a large impact on the statistical growth figure of Russia’s total fixed investment. The increase in investment in these areas partly reflects the above-mentioned large projects.

Russia lowers import duties under its WTO commitments, while devising new barriers to imports. After years of negotiations, Russia became a WTO member in August 2012. Even if membership and free trade were largely seen in Russia to threaten domestic producers, Russia was not willing to remain outside the global organisation. In its first five years of membership, Russia has largely kept to its WTO commitments, but introduced other barriers to foreign trade to protect the most sensitive branches.

Soon after Russia’s WTO accession, the country implemented e.g. an automobile recycling fee where only domestic producers are eligible of compensation, as well as restrictions on pork imports based on Russian veterinary and phytosanitary regulations. The WTO is still investigating the recycling fees, but the pork import restrictions have been deemed to violate WTO rules. Food imports to Russia are currently restricted mainly by Russian counterasanctions. Russia has also introduced numerous measures that either restrict imports or favour domestic producers in public sector and state-enterprise procurements. Russia has not signed the WTO agreement on public procurements, but only committed to enter into talks on joining the agreement.

Russia’s WTO membership terms commit it to gradually lowering its average import duties from 10 % to under 8 %. Most of the remaining duty reductions enter into force today (Sept. 1). Russia has also committed e.g. to opening up of some service branches to foreign firms, as well as restricting agricultural and industrial subsidies. During its membership, Russia has faced seven complaints against it for violation of the WTO framework, as well as filed six complaints of its own against other WTO members.
China

China’s housing markets may be cooling. Many cities have sought since last autumn to rein in soaring housing prices through various restraints on apartment sales, including limiting the number of apartments private investors can own, changed rules on resale, increased downpayment requirements and tougher rules on house loans. Even so, the National Bureau of Statistics reports that July prices in 70 cities surveyed rose at 9 % y-o-y, matching the June pace of growth. The skyrocketing prices of China’s biggest cities showed signs of cooling, however.

The volume of housing sales also slowed significantly. In terms of liveable floorspace, the volume of housing sales rose 12 % y-o-y in the first seven months of the year. Sales during summer 2016 were up 27 %. Officials have sought to calm housing markets also by increasing supply. In January-July, the volume of new housing construction starts, again measured in m² of floorspace, rose by 12 %. Sales of rights to land use zoned for construction were up 9 %. While supply by these measures rose at least as fast as a year ago, the volume of completed apartments in January-July was only about the same level as in the same period in 2016. Over 80 % of building construction involved residential housing. Less commercial data make it difficult to get a clear picture of what is happening in Chinese housing markets.

Chinese firms get new guidelines on investment abroad. China’s government updated in August its catalogue on guidance in outbound foreign direct investments. Investment is classed into three categories: “encouraged,” “restricted” and “prohibited.” FDI in infrastructure projects that are somehow associated with president Xi’s One Belt, One Road initiative are “encouraged.” Other types of FDI abroad likely to get green-lighted are those directed at high-tech industries, agriculture or the energy sector.

Firms investing in the restricted category (e.g. real estate, hotels, entertainment and sport) need special permission from officials. Officials say that these industries have suffered in recent years from “irrational” investments which are directed outside of the firm’s core business area and used as a means to move money out of the country. Concerns over the financial wisdom and risk involved have also increased in recent years, and in practice officials have already cracked down on such investment by late last year. In particular, large private firms have faced heavy scrutiny over their overseas dealings, with some foreign acquisition projects abandoned altogether.

The prohibited are e.g. investment in the gambling industry and projects that may compromise national security.

Figures from China’s commerce ministry show that outbound FDI (excl. finance sector) fell in the first seven months of the year by over 40 % from the same time in 2016, when a record amount of foreign investment occurred. The Rhodium Group analysis shows that this year state-owned enterprises, unlike last year, accounted for the majority of foreign acquisitions. ChemChina, which embarked on its acquisition of the Swiss firm Syngenta in 2016, completed the deal in July. ChemChina now controls over 98 % of the company’s share capital. The deal, valued at about 43 billion dollars, accounts for about a quarter of all Chinese FDI abroad last year. It is still unclear how the Syngenta FDI flows are allocated in official statistics, but the deal definitely has a large impact on FDI flows. If the investment is allocated to 2017, China’s overall FDI outflows have not fallen from the 2016 level.

Summer harvest of China’s grain crops better than last year. The summer harvest this year was about 1 % larger than last year’s harvest, which was about 1 % smaller than the record 2015 harvest. The summer harvest, which typically accounts for less than a quarter of China’s annual crop harvest, consists largely of rice, maize, wheat, beans and root vegetables such as potatoes. The summer harvest was larger than in 2016 even with the smallest area of land under cultivation since 2009. Accordingly, yields per hectare hit an all-time high.

China began to increase subsidies to domestic farm production in 2003. Yields of summer crops have since increased by nearly 40 % per hectare and the size of the annual harvest by about 45 %. Besides increased use of fertilisers and irrigation, the government set guaranteed support prices at which it promised to purchase crops for its reserve stocks to assure national food security. The price guarantees were originally intended to stabilise producer incomes, but reserve stock purchases gradually evolved into the main sales channel for selling agricultural produce. As world commodity prices have declined in recent years, China’s higher guaranteed prices have caused reserve stocks to balloon at great cost to the state, especially when those stocks eventually spoil or have to be sold at a loss. High support prices erode production competitiveness. For example, the price floor for maize led to lower consumption of domestic maize and increased imports.

First efforts to address the problem included the phasing out of the support price for cotton, soybeans and maize during 2014–16. Price guarantees still apply to wheat and rice, despite speculation this summer that these guarantees might also end. Wheat is a particularly thorny issue. Forecasters suggest that ratio of wheat reserves, which includes the portion unusable due to spoilage, to China’s annual consumption should climb next year to around 110 % (the global average is about 20 %). China’s wheat supply (reserve stock and production) accounts for about half of the wheat available on global markets. Other countries are concerned that China’s decision to end price guarantees will cause more of China’s overproduction to flood onto the world market, inducing sharp price declines. For the time being, however, China’s decision to deregulate prices of maize and cotton has had barely any impact on their exports, which remain minuscule on a global scale.
Russia

Corporate profits in Russia decline to more conventional levels. Based on its recurring business survey, Rosstat reports that net profits of companies in its pool of 48,000 firms were down by 10% in the first half from H116. In 2015 and 2016, net profits had soared, propelled largely by higher profits of export firms profiting from the ruble exchange rate’s relative weakness. On the other hand, net profits relative to the amount of business activity in the first half of 2017 largely matched the also good levels of earlier years.

Declining corporate profits have aroused assessments of the possible depressive effects on investment. This view is supported by the fact that Russian companies typically finance roughly half of their investment out of pocket. Rosstat’s investment survey also shows that insufficiency of a firm’s own funds to finance investment is a significant barrier for firms to make investments. Lack of cash on hand is not a decisive factor constraining investment, however. In listing other factors that may depress investment, survey respondents also cited economic uncertainty in Russia as one of the significant problems. The reduction in profits this year has also been relatively mild and firms still hold considerable funds in domestic banks. Profits are largest in firms involved in energy or metals, and such firms typically have easier access to credit than other businesses.

Changes in area and country structure of Russian goods imports show some stabilisation. Russian customs figures show that the share of imports from EU countries inclined down to 38% in the first half of this year, a slight drop from H115 and H116. The share of imports from China and other emerging economies in southern and south-eastern Asia rose to more than 26%, with China accounting for about 20% of imports to Russia and these emerging economies exceeding 6%, largely on growth in imports from Vietnam, Indonesia and India. South Korea’s and Japan’s share rose to 7% as South Korea’s share of imports increased. The US remained almost unchanged with less than 6% of imports. CIS countries held on to an 11% stake as e. g. the decline in Ukraine’s share eased. The relative shares shown in Russian import figures should be taken with a recall that the corresponding export figures of trading partners give a partly different picture. For example, the export figures compiled by international agencies suggest that the share of EU countries is clearly larger in Russian imports than indicated by Russia’s import figures.

The country structure of Russian imports has seen tangible changes in recent years. The decline of the share of EU countries in imports to Russia in 2014–16 mainly came from the machinery, equipment & vehicle category. This category, which includes both investment goods and consumer durables, has been affected, besides the sharp drop in the ruble’s exchange rate, by a strong fall in fixed investment and consumption with their accompanying structural changes in Russia, globalisation of production chains for finished products and factors affecting the competitiveness of suppliers.

The rest of the tapering off of the EU countries’ share in Russia’s imports mainly reflects the impact of Russian counteractions that were imposed in 2014. The restrictions focus on imports of agricultural products and foodstuffs. The restrictions for their part have helped Asia’s emerging economies and China increase their market shares and have also propelled a notable increase in Belarus’ share of Russia’s imports.

Rapid growth in Finland-Russia trade. The value of Finnish goods exports to Russia in the second quarter rose 13% y-o-y. Export growth faded in the spring, but picked up steam in May and June. For the first half of 2017, goods exports jumped by nearly 20% y-o-y. Export gains were seen in almost all of major goods categories, but highest growth was seen in exports of machinery and equipment. Exports were still well off their peak levels of recent years. Russia accounts for just over 5% of Finland’s goods exports. After falling for several years in a row, services exports to Russia have also begun to recover this year. The value of services exports was up by nearly 9% y-o-y in 1Q17. Growth of travel service exports seems to have continued also in the second quarter, with overnight stays of Russians in Finnish inns and hotels up by over 20%.

The value of goods imports from Russia rose by 27% y-o-y in the second quarter. The increase largely reflected higher oil prices. Import growth slowed down notably from the exceptional peak at the start of the year which was largely due to a one-time delivery of gas pipelines. In H1H7, Russia was Finland’s second-largest import market after Germany, with an over 14% share.
China

China’s key party congress set to kick off on October.

At the end of August, government officials announced that the 19th National People’s Congress of the Communist Party of China (NPC) will begin on October 18. The NPC, which convenes every five years, will be attended by roughly 2,300 delegates tasked with choosing a new Central Committee, which in turn installs the party leadership, politburo and the politburo’s 7-member standing committee. President Xi Jinping’s selection as party leader for a new five-year term and a reshuffling of people in key party posts should help Xi consolidate his power base.

Economic policy has recently focused on supporting growth and preventative measures to deal with emerging problems in order to secure stable conditions across the board going into the NPC. The economic policies that emerge from the conference are of key interest to China and the world. While Xi has spoken on many occasions about the importance of market reforms and getting China’s debt problems under control, the government has cracked down with e.g. increased censorship and increased exercise of party power that bode poorly for market reforms.

Finland-China trade soared in the first half.

Finnish Customs reports the goods trade between Finland and China grew by 20 % y-o-y in the first half of this year. Growth exceeded that of Finnish foreign trade overall (up 15 %). Finland’s imports from China swelled by 13 %, in line with overall import growth of 14 %. Exports to China rose by 31 % from the previous year (total exports up 15 %). Finland’s trade deficit with China contracted in the first six months of the year to 470 million euros (630 million euros in H116). Trade with Hong Kong also grew by about 20 %.

Exports of raw materials (up 39 %) as well as machinery, equipment & transport vehicles (27 %) surged. Both categories remained the top two most important categories for Finnish exports to China. Pulp continued to constitute about a fifth of Finnish exports to China. Nickel exports skyrocketed to over 6 % of total Finnish exports to China. Furs and pelts remained at around 4 % of China exports. About half of the goods that Finland imports from China fall into the machinery, equipment & vehicles category. Such imports were up 20 % from the same period a year earlier.

China surpassed Russia in goods trade during the first half, making it Finland’s fifth-most important export destination. China now accounts for about 6 % of Finland’s total exports. China was Finland’s fourth-most important import provider, accounting for 7 % of imports.

Statistics Finland reports that trade in services between Finland and China rose by 17 % y-o-y in 1Q17 (exports up 16 %, imports 19 %). The value of services exports last year reached 1.1 billion euros, or about 30 % of Finland’s total China exports. In this year’s first quarter the share dropped to less than 25 %.

Statistics Finland reports that the number of Chinese travellers spending at least one night in Finland increased by about 50 % y-o-y in the first half. The Chinese accounted for 5 % of all overnight stays of foreign visitors to Finland.

Trade with North Korea has little economic significance for China and Russia.

US president Donald Trump last weekend threatened to cut trade relations with countries that do business with North Korea. According to the Comtrade database maintained by the UN, China is essentially North Korea’s sole trading partner, with China accounted for about 90 % of all of North Korean goods exports and imports in 2016. Russia’s share of North Korean imports was 2 % and exports even less.

With goods exports to North Korea valued at just 2.8 billion dollars last year, the country has only minor economic significance to China (0.1 % of China’s total exports in 2016). Imports were valued at 2.5 billion dollars (less than 0.2 % of total imports). Broken down by category, China’s exports to North Korea were quite diverse. The leading categories of goods exports in 2016 were machinery & equipment (27 % share of exports), textiles (17 %), various food products (7 %), clothing (6 %) as well as oil and refined oil products (4 %). Imports were dominated by coal (47 % of imports), clothing (22 %), ores (9 %) and shellfish (7 %). Due to the sanctions agreed with the UN, China last month banned imports of coal, iron ore, iron, lead, fish and shellfish from North Korea.

Russian goods trade with North Korea is also quite modest. Only 0.02 % of Russian exports (68 million dollars in 2016) went to North Korea. Imports were just 9 million dollars, or practically non-existent. Oil and oil products constituted 80 % of Russian exports to North Korea. While the emphasis had been on refined products in recent years, North Korea this year boosted its orders for crude oil. Other exports consisted mainly of grain products, fish and transport vehicles. The biggest import goods category was fish, which accounted for about a third of imports.

Figures on North Korean foreign trade vary depending on the source. The country itself releases no statistical data. A big part of business activities is likely never recorded.
Russia

Chinese CEFC to acquire 14 % stake in Russian oil giant Rosneft. The deal is valued at around 7.5 billion euros. The Russian state retains its majority position in Rosneft even if the deal materialises, as CEFC buys the stake from a joint venture of the Qatar Investment Authority and Glencore. The deal with CEFC surprised many as the joint venture bought a 19.5 % stake in Rosneft from the Russian state just last December for 10.2 billion euros. Some observers regarded the motivations for the original deal and its financing arrangements as unclear.

CEFC is reportedly a private company focusing on oil trading and finance. It has no record of investment in Russia. The Chinese energy firm Sinopec owns a stake in Rosneft subsidiary Udmurtneft. CNPC also acquired a few per cent stake in Rosneft last decade, but negotiations to increase the stake have not progressed. If approved, the CEFC deal will be the biggest Chinese investment in Russia so far. Over the past decade, China has become Russia’s largest export market of crude oil and Russia is China’s largest foreign oil supplier.

Problems surrounding Rosneft’s acquisition of a majority stake from the state last autumn in the Bashneft oil company have also received attention recently. Alexei Ulyukayev, who served as economy minister at the time of the deal, is currently on trial for demanding related bribes from Rosneft CEO Igor Sechin. Multibusiness corporation Sistema, which owned the majority of Bashneft before the state seized it, was recently ordered by the court to pay Rosneft 136 billion rubles (2 billion euros) for stripping assets from Bashneft.

Russia introducing new import restrictions on public sector and SOE procurements. Russia’s import restrictions in recent years have been aimed at supporting domestic producers under an import substitution policy. Current import restrictions on public sector procurements already range from pharmaceuticals and food to software. A new government decree prohibits public sector purchases of select imported furniture and wooden veneers from December 1. The ban applies to imports from outside the Eurasian Economic Union and lasts for two years.

The Duma also received a bill to tighten oversight of procurement of imported goods and services in state-owned companies and companies receiving state support. At the moment, procurement rules e.g. grant domestic producers a 15 % price advantage. Large investments in imported machinery also require approval from the import substitution commission. The bill calls for expanding the list of procurements needing commission approval to include e.g. ships and aircraft in order to protect the interests of domestic producers. In addition, the requirements for state-owned enterprises are to be extended to apply also to their subsidiaries.

Impact of support measures for Russian monoton towns hard to determine. From 2009 to 2016, support to single-company towns, or monoton towns, were arranged on the basis of presidential or government decrees. The development programme for monoton towns was only approved in late 2016. A study by the Federal Accounts Chamber (FAC) found the programme lacking in terms of comprehensive scope, concrete measures and long-term objectives. FAC noted overlapping functions and insufficient coordination. At the federal level, the programme involves e.g. 12 ministries and 9 lenders (including 4 large state banks). Monitoring statistics are compiled by 4 federal authorities without unification. Several relevant monitoring indicators were only decided early this year. Information on the companies forming a town is often partly confidential.

The FAC said it was not possible to sort out the results of support measures, noting that no federal executive authority has reliable information even on the amount of support granted. Transfers from other government budgets to monoton towns equalled 0.6 % of total consolidated government budget spending in 2010–16. Of that, 30 % went to the 8 largest monoton towns. Besides budget money, support has been provided in the form of credit and tax reliefs. Monoton towns have made agreements on co-financing infrastructure projects and have established zones of accelerated economic development.

The number of towns officially listed as monoton towns has declined slightly since the 2009 recession, and now stands at 319. A town is defined as a monoton if it has over 3,000 inhabitants and one industrial firm (excluding oil & gas production) accounts for at least 20 % of employment in the town during five years before the listing. The monoton town distress ranking uses such criteria as termination of a town company, the number of lay-offs planned by a town company, prospects for a town company’s industry, the local unemployment rate and town residents’ assessments of local conditions compiled in official surveys. 100 monoton towns are currently ranked as problem towns (75 in 2013). Nearly 150 are classed as having a risk of deterioration, and over 70 are classed as stable. The FAC says the list needs updating.

61 of Russia’s over 80 administrative regions have monoton towns. In over 200, and in over 70 problem towns, the town company’s industry is machinery, equipment & transport vehicles, metals, mineral extraction or forest industry. The officially listed monoton towns had 13.6 million inhabitants or 9.3 % of the Russian population at the start of 2017. Monoton towns stood for 8.5 % of the employed and 11 % of the unemployed nationally. The town companies represent 5–6 % of goods supplied nationally and they employ one million workers, or 1.5 % of the employed. Almost 3 % of the Russian population lives in the problem towns. Three monoton towns have populations in excess of 500,000, of which two are problem cities. FAC’s own separate survey found that 70 % of monoton town residents find the living conditions unacceptably or barely tolerable and that 60 % would like to move elsewhere. Under 8 % found the measures of local officials adequate. The FAC reports that the population of monoton towns has decreased in recent years and the real volume of goods supplied by the town companies shrank by about 6 % during 2015–16.
China

Yuan appreciated substantially against the dollar. The yuan strengthened 4% against the dollar between late July and early September. While some of the appreciation reflected dollar weakness (the dollar’s nominal effective, or trade-weighted, exchange rate fell by 2%), the yuan appreciated also against the currencies of other major trading partners. The PBoC’s CFETS index climbed nearly 3% and the yuan-euro rate was up by 1%. On Friday (Sept. 15), the yuan-dollar rate was still 6% higher from December 31, while the yuan has lost about 6% against the euro this year.

The mechanism for setting the yuan’s daily trading rate has incorporated a countercyclical factor since early summer (see BOFIT Weekly 22/2017). The new feature appears to provide an additional means for the PBoC to influence the yuan-dollar exchange rate in a desired manner.

The yuan lost ground slightly this week after the PBoC on Monday (Sept. 11) dropped its 20% reserve requirement on forex forward transactions and on yuan-denominated deposits in Hong Kong and other clearing centres abroad. The PBoC imposed the reserve requirements in late 2015 and early 2016 in response to yuan weakness and high capital outflows. Ending the reserve requirement reduces the forex trading costs and makes it cheaper to cover against rate shifts.

Although the value of yuan deposits in Hong Kong fell by half during 2015–16, the stronger yuan has slightly revived them. The freely set Hong Kong offshore yuan rate (CNH) is often used to measure adjustment pressures on the yuan. However, when there was strong depreciation pressure on the yuan in 2016, China manipulated also the CNH rate. The difference between the mainland China onshore rate (CNY) and the offshore CNH rate this year, however, has been negligible.

Exchange rate appreciation and the state’s tighter measures have calmed capital outflows from China. The value of China’s foreign currency reserves has risen by 81 billion dollars this year, standing at 3.092 trillion dollars as of end-August. Some of the valuation increase comes from exchange rates changes. When gold, SDR and IMF reserve components are included, the value of total reserve assets rises to 3.188 trillion dollars.

Margins of China’s big banks narrow. China’s four largest banks recently released their financial reports for the first half of this year. The total profits of these banks increased by 3% y-o-y to 510 billion yuan (70 billion euros). Compared to last year, however, their headline profitability indicators generally continued to weaken and their margins shrank. The large banks noted, however, that their profitability levels have stabilised. The average lending rate of banks fell by about 0.3 percentage points from a year earlier to a level of 3.9–4.2%. Average rates fell for both short-term loans of less than a year and longer term loans. People’s Bank of China figures show lending rates in the banking sector overall have risen slightly.

All banks claimed to be devoting heightened attention to risk management. They had raised reserves to deal with non-performing loans (NPLs), even if banks reported that their NPL ratios relative to the overall loan stock was still at low levels (1.5–2.5%). The bulk of nonperforming loans were held by companies involved in extractive industries, manufacturing or retail. Banks are widely seen as reluctant to declare a loan nonperforming. In addition, banks report that 3–4% of their current loans are likely to become NPLs at some point. The share of such loans declined slightly.

Among the large banks, only ICBC mentioned banking challenges. It noted that financial sector risks were becoming increasingly complex, which complicated banks’ efforts to manage risk exposure. With the ending of regulated interest rates, competitive pressure has forced banks to accept smaller margins. Competition has also stiffened with the appearance of online peer-to-peer credit providers.

The situation of small and mid-sized banks differs from that of large banks. When large banks suck up large amounts of the deposit business, small banks are forced to seek out assets on money markets. This limit them mostly to short-maturity lending activities. Interbank market rates have risen this year, which has made it more expensive to resort to the interbank market for funds. Interest rates also face upward pressure if China moves ahead with measures to bring the debt problem under control. Indeed, financing-associated risk alone was enough for the international credit ratings agency Moody’s to last week lower its credit rating of Bank of Communications, China’s fifth largest bank.

Chinese inflation accelerated in August. Consumer price inflation rose to 1.8% p.a. in August, up from about 1.5% in the previous three months. The surge in prices was driven by higher prices for food and fuel. Core inflation, which omits food and energy, only picked up slightly to 2.2%. The general rise in prices does not yet cause concerns for policymakers and no sudden changes in conditions are expected. This year’s official inflation target is 3%.

Producer price inflation in August accelerated to 6.3% up from 5.5% in the previous three months. The pick-up in price inflation was highest in energy and other extractive industries, where higher prices have improved the firms’ profitability and eased their debt situation.
Russia

Russian economy showing more signs of recovery. Following a weak spell in June and July, Rosstat reports that seasonally and workday-adjusted industrial output increased slightly in August from July. The rise was 1.5% y-o-y and reached nearly 2% y-o-y for the January-August period. Manufacturing output increased a bit in August, raising January-August output to nearly 1% y-o-y. Mineral extraction industries saw an on-month contraction in output in July and August, but August as well as January-August output was still up by about 3% y-o-y. Several sub-categories within the extractive sector other than oil production had experienced booms this spring and summer, but most of them witnessed distinct slowdowns in recent months.

A weak performance in the early summer, agricultural output revived significantly in August as delayed harvesting got underway and worked towards normal rhythms. Recovery in other major sectors of the economy continued. Construction increased for the fifth month in a row, and the volume of construction activity in August remained at 6% y-o-y. Growth in goods transport has increased also in recent months. For the January-August period, they were up by over 7% y-o-y.

The volume of seasonally adjusted retail sales increased slightly in August. Sales have recovered gradually over the past half-year. They climbed to nearly 2% y-o-y in August. Food sales clearly picked up in August, while sales of non-food goods continued a gradual rise that started in spring.

B&N Bank now under CBR administration. On Thursday (Sept. 21), the Central Bank of Russia announced it would become the largest shareholder in troubled B&N Bank (Binbank), which is privately owned and Russia’s twelfth-largest bank by asset value. The bank’s operations will continue normally, with no moratorium on payments will be imposed and bail-in terms will not be applied. The measures also cover Rost Bank, which has been under resolution by Binbank. CBR deputy governor Vasily Pozdyshev estimated the recapitalization need of Binbank at 250–350 billion rubles (4.5–5.5 billion euros).

Following in the wake of Otkritie and Yugra banks, Binbank is the third large bank to fail in recent months. The CBR last week confirmed its resolution plan for Otkritie Bank which includes e.g. recapitalisation from the CBR. An earlier estimate by Pozdyshev put Otkritie’s recapitalisation need at 250–400 billion rubles. The CBR filed Yugra for bankruptcy in August.

While market reaction to bank problems have been generally limited during past months, rumours concerning certain individual banks has put pressure on these banks. These banks suffered from deposit outflow in August and they needed liquidity financing from the CBR. Most of the liquidity financing went to Otkritie Bank, which as of end-August had nearly 11 trillion rubles (16 billion euros) of CBR credits on its balance sheet. However, the total stock of deposits held by the banking sector in August remained practically unchanged and interest rates on the interbank market were still relatively low. The CBR has e.g. implemented a supplementary liquidity financing facility and extended its list of systemically important banks. Recent problems are largely seen to reflect the activities of the individual banks, like excessive related-party lending and aggressive expansion through M&A, e.g. buying up banks in resolution.

In recent years, tighter banking supervision has forced many banks in Russia to close or submit to restructuring. Most failing banks tend to be small and are often involved in shady dealings and them CBR has tried to weed out systematically. A number of larger banks has, however, also fallen into trouble. The Deposit Insurance Agency, which had dealt with problem banks until this summer, has doled out about 2.3 trillion rubles (33 billion euros) on refunds to depositors for their losses or recapitalisation of failed banks since the beginning of 2014. A new Bank of Finland blog discusses Russian banking sector in more detail.

CBR lowers key rate; announces around 4% inflation target for coming years. At its regular monetary policy meeting last Friday (Sept. 15), the CBR board decided to lower the CBR key rate by 0.5 percentage points to 8.5%. It was the fourth rate cut this year. At the start of 2017, the rate was 11%. The CBR still sees a further cut in the key rate possible during the remainder of this year.

The central bank said its last Friday’s rate-cut decision was made largely on the grounds that inflation has been close to its 4% target for the end of this year. Inflation fell in August from 3.3% to 3.1%. In June, inflation was still running at 4.4%. August’s low score, however, was caused mainly by drops in fruit and vegetable prices, which saw unusually large seasonal declines (July-August prices have only experienced greater drops in four of the past 16 years). The CBR noted that one of the inflation risks comes from fluctuations of food prices and that overall the risk of inflation overshooting the target is larger than the risk of a downward deviation from the target. The CBR noted inflationary risks coming also from swings in prices on global markets, wage increases, declines in the household savings rate and a powerful rise in consumption. It stressed that even if inflation expectations had (based on a survey it regularly orders) fallen to historically low levels, they were still not anchored at any low level and remain sensitive to price movements or changes in the ruble’s exchange rate.

The CBR said it has specified its inflation target at around 4% in the years ahead. The CBR did not set a fluctuation range for inflation, even if the possibility was discussed. Deviations of inflation from the target would only trigger a CBR response if they create a threat of longer-term departure e.g. via impacting inflation expectations. The CBR sees this summer’s differences in inflation as a fluctuation within its inflation target rather than a deviation.
China

Fixed investment subdues Chinese economic growth. Figures released by China’s National Bureau of Statistics suggest lower economic growth in August. Real growth in retail sales fell to 0% y-o-y, while industrial output growth decelerated to 6%. The sharpest slowdown was registered for fixed asset investment (FAI), which, even with cautious inflation estimates, contracted in real terms in August. Private investment growth, in particular, was sluggish, while also public investment barely topped 1%.

Looking at core sectors of the economy, on-year contractions in real investment in the industrial and construction sectors have been registered every month this year. The sharpest drop has been in investment in extractive industries. Investment in the service sector, in contrast, continued to rise, but growth has slowed significantly and investment in retail and wholesale has been shrinking. Some observers believe the weak investment trend may reflect company efforts to reduce debt. People’s Bank of China figures, however, show that indebtedness continues to soar.

Key real economy indicators for China, %

<table>
<thead>
<tr>
<th>Year</th>
<th>Industrial production</th>
<th>Fixed asset investment</th>
<th>Retail sales</th>
<th>GDP</th>
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<td>6.2</td>
<td>7.3</td>
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<tr>
<td>2017</td>
<td>6.7</td>
<td>6.9</td>
<td>7.1</td>
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Sources: NBS and BOFIT.

EU Commission proposal for increased oversight of corporate acquisitions gets mixed reception. In mid-September, Jean-Claude Juncker, president of the European Commission, suggested that the EU create a new framework for overseeing acquisition activity of non-EU firms inside the EU area. The European Commission is particularly concerned about foreign firms taking over companies involved with advanced technology, logistics, data communications, energy or other businesses in strategic sectors. The European Commission said it would begin to analyse extra-EU direct investment and create a coordinating group of member-state representatives to discuss concerns and solutions to issues in the area of foreign direct investments.

A significant increase in Chinese investment in Europe is a key factor behind the European Commission’s proposal. Twelve member states, however, already have national foreign investment screening systems in place that allow these countries to restrict foreign access to strategic technologies and critical sectors. Thus, while French president Emmanuel Macron called upon the EU to act on the matter this summer, many member states consider their national screening systems as sufficient and fear implementing the European Commission’s proposal would only increase bureaucracy.

Unsurprisingly, China condemned the EU plan and claimed it supports free flow of trade and investment. OECD monitoring, however, finds China to be one of the most vigorous limiters of foreign investment, while EU members tend to be among the most easy-going. This contradiction increases pressures in the EU to limit the activities of Chinese firms.

China shuts down cryptocurrency-related activities. Chinese officials announced at the start of the month the banning of all fund-raising schemes offering tokens in exchange for investments in virtual coins (a practice known as Initial Coin Offerings or ICOs). ICO campaigns seek to raise capital from the public in exchange for virtual coinage such as Bitcoin or Ethereum coins in order to launch a business or project. In exchange, investors receive tokens that entitle them to an ownership stake in the firm or to a certain amount of the firm’s future products and services.

Last week the central bank declared a complete end to trading on virtual currency markets in China. China’s three largest bitcoin exchanges announced the suspension of trading in yuan would occur at latest in October. After the announcement Bitcoin, by far the most popular virtual currency, plunged from about 4,000 dollars to around 3,000 dollars before rebounding close to the earlier level.

ICO campaigns in China have intensified this year and the amount of money raised from such campaigns has exploded. In the first half of 2017, ICO campaigns raised an amount equivalent to 400 million dollars in cryptocurrencies from roughly 100,000 investors. ICO campaigns are beyond the scope of official regulation, which has created additional risks for Chinese financial markets. Due to the anonymous nature of virtual coins, ICO campaigns are ideal vehicles for financial scams and money laundering.

Trading in digital currencies had been quite lively up until February 2017, when officials announced that bitcoin exchanges had to monitor transactions. Moreover, the loading of cryptocurrency into the digital wallets of customers, i.e. the final step needed to allow them to use digital currency in normal payments, was frozen for four months. At the end of 2016, when transaction volumes had reached their peak, over 90% of global trade in virtual currencies was conducted in yuan. Since the freeze, the amount of global transactions, all currencies combined, has plummeted to about 3% of the December 2016 level. The Chinese have been quite astute at using cryptocurrencies to e.g. ferry capital out of the country.

Even with the recent crackdown on the use of digital money, the PBoC is apparently contemplating its own virtual currency. Besides the cost savings in payment handling, an official cryptocurrency would provide better tracing of financial transactions.
Russia

BOFIT sees Russian economy continuing moderate growth in coming years. Lifted by higher oil prices, Russian GDP has returned to positive growth this year as anticipated. BOFIT’s latest Forecast for Russia sees GDP rising by 1.5 % p.a. through 2019 on the assumption that oil prices remain roughly at their current levels.

Growth will be driven by domestic private demand, which has gradually recovered this year. Household consumption is supported by increasing real wages and reviving household borrowing. Fixed investment is also expected to continue moderate growth as Russian industry already operates near full capacity. Further growth of fixed investment is limited, however, especially by the difficult business environment and uncertain economic outlook.

Government spending is not expected to increase in real terms this year and the preliminary budget framework anticipates even harsher spending discipline in coming years. Inflation has slowed down close to the Central Bank of Russia’s 4 % target and the CBR has signalled that it will continue to cut interest rates if inflation pressures permit.

Despite brisk export growth, the volume of Russian export growth should slow as e.g. oil & gas export levels are already historically high. After three years of contraction, the volume of imports has increased strongly this year supported by recovering demand and appreciation of the ruble. This year’s import growth forecast has been raised substantially, but growth should slow gradually in coming years.

Forecast uncertainty is caused by oil price trends, which impact the Russian economy rapidly. The approaching presidential election could add pressure to increase public spending and temporarily raise growth. Growth could also be helped this year if demand is oriented more towards domestic production than imports for the latter part of the year.

Russia’s economy is expected to continue moderate 1.5 % growth in coming years. With the economy at near-capacity, higher sustainable growth would require structural reforms that are currently not in sight.

Russia has plenty of college graduates, but spends little on education. Education at a Glance 2017, the latest publication of the education database kept by the Organisation of Economic Cooperation and Development (OECD) broadly assesses the school systems of many countries, their spending on education and outcomes. The survey also covers several non-OECD members, including Russia and China.

Figures from 2015 show nearly 60 % of Russians in the 25–34 age group had completed tertiary (i.e. college-level) degrees, putting them on par with the South Koreans and the Japanese, but well above the OECD average of 42 %. Only 18 % of this age group in China had completed tertiary education, and just 14 % in India. Russia’s high tertiary education figures partly reflect the fact that in the Russian system students enter and graduate university at relatively young ages. Most degree-holders have something less than a master’s degree (short-cycle tertiary or bachelor’s degree). The phenomenon is not new as also about 55 % of Russians between the ages of 25 and 64 have college degrees.

Tertiary education in Russia currently focuses heavily on business, administration and law. Some 38 % of degrees granted in 2015 went to students majoring in one of these three fields. The average for OECD countries was 24 %. In addition, 24 % of Russian students took degrees in natural sciences, engineering or math, compared to an OECD average of 20 %. The share in Germany was 32 %. Russia graduates relatively fewer professionals with degrees in education or healthcare than other OECD countries.

Russia currently devotes relatively few resources to education by international standards. In 2014, Russia’s education spending was just 3.4 % of GDP, the lowest for any country in the report except Indonesia. The OECD average was 5.2 %. The picture is similar when comparing cumulative spending per student. Regional differences in education spending in Russia are, however, huge.

Education spending and PISA reading scores

Education expenditure per student (ages 6 to 15) in purchasing power-adjusted (PPP) dollars.

Sources: OECD and BOFIT.

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China

BOFIT expects China’s growth to slow; financial market worries on the rise. China’s GDP growth accelerated to 6.9 % p.a. in the first half of this year. The pick-up is not likely to last, however. BOFIT’s latest *Forecast for China* sees growth slowing towards the end of the year, with GDP expected to grow by about 6.5 % this year, 6 % next year and 5 % in 2019. Even with lower growth, China’s growth is high and closing the gap with advanced-world living standards. Growth will continue to be driven by the domestic market. Consumer demand and investment growth are supported by strong wage growth, urbanisation and productivity gains.

A growth slowdown in China is a natural development as major structural factors like the huge size of the economy, ageing population with fewer working-age people and environmental problems reduce growth. Moreover, the structure of the economy is changing as evidenced by lower fixed investment growth and the rising importance of domestic consumer demand and services. Productivity growth has slowed with the easy productivity-enhancing measures already taken and services account for an ever-increasing share of economic output.

In 2012, China set the goal of doubling its 2010 real GDP by 2020. The government has had to apply heavy stimulus to achieve the high GDP growth needed to hit that target. It also seems that officials have felt pressure to fudge their growth figures. At the same time, China’s debt has soared. The experiences of other countries with extended episodes of rapid indebtedness end almost without exception in crisis. As a result, financial sector stability has become a major theme of China’s leadership. Nevertheless, no significant measures to rein in credit growth have been implemented. The possibility of a financial market crisis and sharp reduction in economic growth during the forecast period cannot be ruled out.

The 19th Party Congress next month could be a turning point for policy, but the government’s recent focus on excessive stability and increasing the role of the party in the economy have diminished hopes for serious market reform.

China’s realised GDP growth and BOFIT forecast 2017–2019

Sources: China National Bureau of Statistics and BOFIT.

China’s indebtedness still continues to rise. China’s bank lending stock rose in August by 13 % y-o-y. While growth in lending to households has slowed slightly in recent months, the stock of household credit has increased faster than the credit stock overall (up 30 % y-o-y in August). In the first eight months of this year, over half of new lending went to households, mostly in the form of housing loans. The bank lending stock equals roughly 150 % of GDP, a quarter of which is household borrowing.

Bank lending to corporations, government and to non-bank financial companies has slowed this year to around 8 %, while non-traditional financing sources have become increasingly important for firms. Growth in China’s broadly defined stock of total social financing (TSF) rose in August by 13 % y-o-y. Shadow bank lending has accelerated recently and firms have also resorted to new non-TSF financial arrangements.

Growth of M2, the broader measure of the money supply, has slowed this year, rising by just 9 % y-o-y in August. Slowdown reflects things such as faster pace of financial transactions rather than slower credit growth. In its latest monetary policy report, the People’s Bank of China said it was reducing M2’s role as a gauge of monetary policy due to its weakened link to economic development.

The rise in China’s debt-to-GDP ratio has slowed. On-year growth of both TSF and the stock of bank lending averaged 13 % in the first eight months of the year, while nominal GDP grew by slightly over 11 % in January-June. BIS figures put China’s debt-to-GDP ratio at 258 % at the end of March, an increase of over 7 percentage points from a year earlier.

**Growth of China’s credit stock and total social financing (TSF)**

Sources: CEIC, PBoC and BOFIT.

S&P lowers China’s credit rating. On September 20, China’s sovereign credit rating was lowered one step from AA- to A+, S&P’s fifth-highest rating category. China had held its AA- rating since 2010. S&P said the downgrade reflected China’s rapidly increasing debt and the increased risk it imposed on the financial sector and economy. In May, Moody’s lowered China’s rating one notch to A1, its fifth-highest score. Fitch has maintained its fifth-highest rating, A+, for China since 2007. S&P also cut ratings for Hong Kong, several Chinese firms (including banks and state-owned enterprises), as well as some international banks operating in China.
Russia

Russia's public sector finances recover this year; tightening expected next year. The finance ministry predicts revenues to this year's consolidated budget (federal, regional and municipal budgets plus state social funds) to increase by over 10% in nominal rubles (when the income received from the sale of a stake in state oil giant Rosneft is not included in 2016 revenues). Most revenue improvement comes from an over 20% increase in oil & gas related taxes, duties and fees. The finance ministry expects Urals-grade crude oil to average slightly less than 50 dollars a barrel this year, which is well above the 2016 average price. Revenues have also been boosted by changes in oil & gas taxation. Other budget revenue streams are expected to increase by 9% this year. Spending should increase by over 6% (omits costs of large 2016 financing package to help defence contractors pay off bank loans). Thus, the consolidated budget deficit would be 2.3% of GDP.

In its newest version of the 2018–20 budget framework, the finance ministry expects consolidated budget revenues to increase by about 6% next year, over 2% higher than inflation, and in the following years at about the pace of inflation. As in previous years, revenues are estimated to reach 32–33% of GDP. Oil & gas tax revenues will shrink next year if the average price of Urals oil falls as expected to below 44 dollars a barrel. Other revenue streams should keep growing next year at 9% and at a robust pace also in the following years. Estimates of other revenue growth assume the economy ministry's forecasted annual GDP growth above 2% mainly driven by the oil sector, the volume of imports grew by over 20%. Growth in exports, which supports domestic production, slowed considerably from the first quarter. Both the Central Bank of Russia and the economy ministry estimate that GDP growth slowed to around 2% y-o-y in 3Q17.

Much of Russia's GDP growth spurt last spring came from inventories. Russian GDP grew in April-June by 2.5% y-o-y. According to fresh GDP figures, however, much of the growth came from a build-up in inventories, suggesting that growth is still on a rather fragile base. Other domestic demand also recovered as household consumption grew by 3% y-o-y and fixed investment rose by 6%. The growth in demand was, however, largely directed to imports rather than domestic production, as the volume of imports grew by over 20%. Growth in exports, which supports domestic production, slowed considerably from the first quarter. Both the Central Bank of Russia and the economy ministry estimate that GDP growth slowed to around 2% y-o-y in 3Q17.

CIS countries have had to relax foreign exchange policies in recent years. The currencies of countries in the Commonwealth of Independent States have had to endure severe devaluation pressures, due e.g. to the conflict in Ukraine, sliding oil prices and Russian economic problems that feed through to other CIS economies. This has forced many CIS countries to loosen their currency-steering approaches.

Under the IMF classification, CIS countries with de facto floating exchange rate regimes include Armenia, Georgia, Kazakhstan, Moldova, Russia and Ukraine. Russia is the only one classed as having a free-floating exchange rate (the CBR has refrained from any forex market interventions since summer 2015). The central banks of the other countries occasionally intervene to mitigate high exchange rate volatility, but do not target a specific exchange rate and they publish information about their interventions. In early September, Uzbekistan also allowed its currency, the som, to float.

The currencies of Azerbaijan, Belarus, Kyrgyzstan and Tajikistan are not linked to any specific level, but the central banks of these countries seek to smooth fluctuations through interventions. So their regimes are not considered fully floating nor pegs and IMF groups such foreign exchange arrangements under the “other managed arrangement” category. Only Turkmenistan still pursues a pegged exchange rate policy. The Turkmenistani manat is pegged to the US dollar and has held its value stable since devaluation at the end of 2014.

Consolidated budget revenues and expenditures, inflation rate 2012–20 (2017–20 finance ministry estimate)

Source: Finance ministry.

Exchange rates for certain CIS currencies w.r.t. USD

Source: Macrobond.

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China

European Union Chamber of Commerce in China wants to see promised reforms implemented. The European Union Chamber of Commerce in China released its annual position paper last month. The European Chamber expressed satisfaction with the comments of China’s leaders with respect to increased openness and the government’s calls last January for policies that make it easier for foreign firms to invest in China, offering new incentives for foreign investment, as well as taking steps to create a competitive environment that is fair to both domestic and foreign firms. Despite speeches and policy goals, however, little has been done to translate words into action. The European Chamber’s Business Confidence Survey 2017, released this summer, found that only 15% of its member companies expected regulatory barriers to operation in China to decrease over the next five years. The recent OECD survey of openness to foreign investment also ranked China 59th out of 62 countries surveyed.

The European Chamber found that China has reversed direction from opening up its economy in some areas, and expressed concern that the foreign firms are being closed out of certain branches. Among other things, China has introduced rules that favour domestic firms or domestic production, as well as increased trade barriers (e.g. the October tightening of permit requirements for agricultural products and food imports). The government has also purposefully enlarged state-owned firms, which has reduced room for private actors to participate in certain markets. Moreover, China introduced a cybersecurity law in June that has complicated the ability of foreign firms to do business.

While China has offered temporary advantages in selected special economic zones to attract foreign direct investment, the most important changes sought by European firms involve concrete implementation of reforms that improve basic conditions such as predictability of the regulatory environment, transparency and rule of law.

China has the most industrial robots. Data published by the International Federation of Robotics (IFR) at the end of September show that China has surpassed Japan for the top global spot in terms of numbers of industrial robots in service. At the end of 2016, China had 340,000 robots, or nearly a fifth of the world’s industrial robots in use.

China has been the world’s largest market for new industrial robots since 2013. Last year saw the sale of 87,000 robots, or 30% of global industrial robot sales. Robot sales increased in China by 27% y-o-y last year, while robot sales rose by 16% globally. China’s industrial robot market is roughly the same size as that of Europe and North America combined. As a result of extremely rapid industrialisation, the electronics industry now rivals the automobile industry in terms of robot purchase, both globally and in China.

China’s position for the industrial robot market will only increase in coming years, since China still lags well behind the leading countries (South Korea, Singapore, Germany and Japan) in terms using robots to augment labour. The IFR reports that China’s manufacturers are experiencing a rapid shift in terms of the number of robots used per 10,000 workers. For China, that number is only 68 at the moment, compared 631 in Korea and over 300 in Germany and Japan. Use of robots in the car industry everywhere is significantly more extensive than in any other major industrial branch.

Notably, China’s significance also is increasing as it develops its own robot production capability. About a third of the robots purchased last year by China’s electronics industry came from Chinese robot-makers. China’s car industry, in contrast, only bought 13% of its robots from domestic producers. Chinese firms have ambitions to increase their technical sophistication and market share, which is reflected in acquisitions of foreign robot manufacturers.

China, South Korea, Japan, the US and Germany account for 74% of the global market for industrial robots. The IFR estimates that global sales of industrial robots will grow at least 18% this year and by about 15% a year in 2018–2020.

Chinese tourism continues to grow rapidly; emphasis shifting to domestic tourism. Chinese made 2.5 billion domestic vacation journeys and 60 million holiday trips abroad in the first half of the year. Domestic holiday travel grew by 13% y-o-y. After years of soaring growth, foreign holiday travel grew by just 5%, because, even as traveller numbers soar, it is natural that growth in percentage terms slows. Moreover, lower wage growth favours cheaper in-country holidays, but there are also other factors such as fear of terrorism, which have reduced the growth in foreign travel.

The economic impacts of Chinese foreign travel are substantial. Chinese tourists have been the biggest holiday spenders abroad since 2012 compared to tourist groups of other nationalities. The World Tourism Organization reports that Chinese tourists spent 260 billion dollars abroad in 2016, well ahead of the second-place Americans, who spend 120 billion dollars on their travels abroad. A big influence on Chinese spending patterns is that 60% of foreign travellers fall into the 18–34 age group, and China’s younger generations carry fewer stigmas about consuming than their elders. China’s tourism spending abroad accounts for nearly 60% of the annual current account’s spending on services. This spending has significantly reduced the country’s current account surplus.

This week Chinese spend their annual Golden Week holidays. Some 710 million Chinese (up 10% from last year) are expected to take holiday trips somewhere inside China. Another 6 million will journey abroad. The record number of travellers has huge economic impacts. Domestic spending on tourism this week is expected to reach 89 billion dollars.

The growth of Chinese visitors to Finland has been staggering. Statistics Finland reports that overnight stays of Chinese tourists in Finnish inns and hotels reached nearly 180,000 in the first seven months of this year, a 46% increase from the same period in 2016.
Russia

Russian export earnings and imports continue to recover rapidly, even if the fastest pace has slowed. Preliminary balance-of-payments figures for the third quarter show revenues from exports of goods and services rose by about 15% y-o-y. For the first three quarters, on-year growth was about 25%. The rise in oil prices has slowed from the first half of the year, however. Growth in the services exports also slowed.

Growth in Russian spending on imported goods and services slackened in the third quarter, but growth was still well above 15% y-o-y. For the first three quarters growth was 23% y-o-y. The slowdown in the very rapid recovery concerned imports of both goods and services, including spending abroad by Russian travellers. In euro terms, total third quarter spending on imports was about the same as in 2011.

The current account surplus for the first nine months of the year hit 27 billion dollars, which was more than last year in the same period but clearly smaller than in normal years. As usual, the goods trade surplus of 80 billion dollars was the element maintaining the overall current account surplus. The deficits in the services trade and other categories in the current account (mainly dividend and interest payments) were approximately the same as in the previous year or two.

Moderate net outflow of private capital from Russia.

During the first three quarters of this year, the net outflow of private capital from Russia amounted to 21 billion dollars, which was more than in the same period last year, but less than in previous years. The outflow largely reflects repayments by banks of their foreign debts.

The net outflow of capital in the non-banking corporate sector was small in the three quarters. Capital flows consisted largely of direct investments, which flowed into Russia in a notable amount after a low of a couple of years. Russia’s outbound direct investments rose by about the same amount, and possibly reflected a channelling of Russian investments via foreign countries back to Russia. Grey capital flows from Russia have raised their head for the first time since 2013.

Russian GDP forecasts increased in recent months. The IMF’s latest World Economic Outlook (WEO) sees Russian GDP rising by 1.8% this year and 1.6% next year. Forecasts for both years were slightly higher compared to July. Most Russian and international forecasters expect Russian GDP to increase by 1.5–2% p.a. in 2017 and 2018. At the start of the year, most forecasters only expected growth of 1–1.5%.

There are much larger differences in the outlook for imports this year. Several international institutions, including the IMF, expect imports to rise by about 5% this year, while Russian forecasters expect roughly double that and thus a considerably smaller current account surplus. For 2018, most forecasters expect import growth of a few per cent.

The longer-term outlook for Russia, however, remains largely unchanged. The IMF estimates that Russia’s potential growth is still about 1.5% a year. The Central Bank of Russia predicts that growth should be about 1.5–2% p.a. during 2019 and 2020, regardless whether the oil price averages 40 or 60 dollars a barrel. The base forecast of the economy ministry foresees growth slightly above 2% in 2019–20. The ministry estimates that an increase of 5 dollars a barrel in the oil price adds 0.1–0.2 percentage points to economic growth.

Recent forecasts of Russian GDP growth (%)

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Russian inflation hits historical lows. Consumer prices rose by 3% y-o-y in September, which was Russia’s smallest on-year increase in inflation in the entire post-Soviet era. Inflation expectations have also fallen to their lowest level ever. The continuing decline in Russian inflation this year reflects the current low-growth economic environment, the CBR’s relatively tight monetary policy and ruble appreciation. The CBR estimates that a 1% change in the ruble’s exchange rate results in a change in the inflation rate of 0.1–0.15 percentage points within a few months.

For the first time, inflation has also fallen below the CBR’s inflation target of 4%, but the CBR views this to mainly reflect transitory factors. In recent months, inflation has been stemmed by a seasonal drop in prices for fruits and vegetables boosted by good crops this year. In September food prices rose by 2% y-o-y, non-food goods by 3% and services by 4%.

Most forecasts see inflation hovering around 3–4% this year and next. This should allow the CBR to continue to lower the key rate, which currently stands at 8.5%. The CBR estimates that the longer-term level of key rate compatible with its 4% inflation target is 6.5–7%.
China

Central bank governor wants to speed up the opening of Chinese economy. The business magazine Caijing this week published a wide-ranging interview with the outgoing governor of the People’s Bank of China, Zhou Xiaochuan. Mr. Zhou made a strong case for China moving forward with reforms in order to open up its economy. Zhou hoped, in particular, for exchange rates set by the market and a reduction in capital account controls. He said that now is the appropriate time to move ahead with reforms as later it will be costlier.

The interview was released just days ahead of the National People’s Congress. China’s central bank, traditionally been a proponent of economic reforms, nevertheless lacks independence and must cope with the fact that reform policies are largely political matters. Progress in reforms has recently ground to a halt as Chinese officials have taken their pursuance of stability into extremes.

Zhou has been at the helm of the PBoC since December 2002. His 15-year term, exceptionally long for China, has witness the pushing through of major reforms on the monetary policy front. Interest-rate regulation ended, the yuan’s peg to the US dollar loosened and capital movements deregulated. Indeed, reform progress was so substantial that the IMF last year decided to include it in its SDR basket. Unlike the experiences of many emerging economies, Chinese inflation has remained stable over the last decade and a half. Zhou is expected to retire in the near future.

China to lower bank reserve requirements in January. The People’s Bank of China announced on September 29 a 50 to 150 basis-point reduction in the reserve requirement ratio (RRR) for commercial banks from January 1 next year. The PBoC said the requirement cuts were based on how well banks meet needed requirements. Nearly all commercial banks are eligible for a 50 basis-point cut, but only a small group of banks are entitled to larger reductions. The PBoC hopes the reduction of RRR will encourage lending to small firms and farming operations, but it is difficult to see how the measure works without other incentives or actions.

The RRR defines the portion of a bank’s customer deposits it must keep at the central bank. The money cannot be lent ahead and the PBoC only pays marginal interest on it. After the cut, the average reserve ratio in China will be about 16 %, which is still high by international standards.

It is exceptional for the PBoC to announce a reserve requirement ratio adjustment three months in advance. The typical heads-up has been about a week. Consequently, some market participants speculate that the move has more to do with the upcoming changes in macro-prudential assessment of commercial banks at the start of next year than a change in lending policy or monetary easing. The PBoC itself noted that the lowering of the RRR does not signal a change in monetary policy.

IMF raises its growth forecast for China, but warns of rising debt problems. In its World Economic Outlook (WEO) released this month, the IMF has slightly raised its projected growth for the Chinese economy. IMF analysts now expect China’s GDP to grow by 6.8 % this year and 6.5 % next year. The revised forecast reflects higher-than-expected growth in the first half of this year and strength in China’s export markets. The 2018 forecast assumes that the Chinese government will continue to support economic growth, especially through public investment in order to meet the government’s target of doubling real GDP between 2010–2020. Achieving of the GDP growth target, which was set by the party leadership in 2012, requires that GDP growth average about 6.5 % p.a. in coming years.

The increase in the IMF’s growth prognosis is not so much an indication of strong economic conditions, but a foreshadowing of increased economic problems in coming years. Debt-fuelled stimulus policies partly account China’s recent high growth. This has eroded room to manoeuvre in the fiscal policy sphere and slowed progress in structural reform of the economy. In conjunction with the WEO’s release, the IMF issued a longer-term projection that sees Chinese GDP growth slowing very gradually while public-sector debt as a share of GDP rises from the current level of 48 % to over 60 % in 2022. However, China’s public-sector liabilities are actually even greater than that.

The IMF would like to see China shift its policy focus from annual GDP growth targets to reforms that support sustainable growth and tuning of fiscal policy so that the broadly defined budget deficit (about 10 % of GDP) is gradually reduced to stabilise the debt-to-GDP ratio. The monetary stance should be gradually tightened. Monetary policy could be made more effective by phasing out monetary targets, increasing exchange rate flexibility and improving communications. China could also strengthen its financial market supervision and impose measures to make banks deal with non-performing loans. Expanding the role of markets in the economy should be a central priority. This means, for example, opening of China’s tightly closed service sector and allowing state-owned enterprises to face harder budget constraints.

As earlier, the IMF warned of postponing efforts to restrain mounting indebtedness and structural reforms as it could lead to a sharp slowdown in the economy. A crisis could be triggered by a sudden drying up of access to financing on the interbank market or the wealth management product market, barriers to trade imposed by trading partners or increased pressure to move capital out of the country due e.g. to a faster-than-expected rise in US interest rates.

A rapid slowdown in Chinese economic growth would also be reflected in the volume of trade with other nations, a drop in global commodity prices and uncertainty over global growth prospects. The latest WEO notes that China accounts for over half of the world demand for metals. A tightening of China’s lending policies or a substantial reduction its overcapacity in metals production could have profound downward or upward price implications in global commodity markets.
Russia

Russia posts uneven economic performance in September. On the consumption side, the recovery seemed to strengthen, with retail sales rising 3 % y-o-y in September. Retail sales growth accelerated sharply, even with meagre income development. In other words, most consumption growth was funded by credit or savings. Real wages were up less than 3 % and real incomes continued to contract slightly despite historically low inflation.

On the production side, third-quarter growth was supported by agriculture, which saw output increase by nearly 9 % y-o-y in September. The high growth partly reflects a later harvest than in 2016, but the overall harvest this year is expected to be even larger than last year’s bumper yield.

The extractive sector and related transport, which led growth of the economy in the first half, lost steam in September as well as in the entire third quarter. With the decline in oil production in September, total mineral extraction remained unchanged from a year earlier. Growth in the transport sector slowed significantly as pipeline transmission volumes plateaued. Manufacturing output increased by 1 % y-o-y, but that increase was partly supported by an output spike in the highly volatile transport equipment branch.

Rosstat’s revision of its earlier published growth figures meant that the outlook for the construction sector darkened considerably in September. The new numbers suggest that construction only achieved faint positive growth very recently. For the first nine months of the year, construction activity fell by 2 % y-o-y.

Changes planned for Russian public sector spending structure already next year. The finance ministry’s consolidated public sector budget for 2018–20 (federal, regional and municipal budgets plus social funds) sees spending increasing at 3.7 % a year, or slightly less than forecasted inflation. Spending will be boosted e.g. by public sector wage increases. President Putin recently proposed that inflation adjustments to wages would be granted also to public sector workers who were excluded from the spring 2012 round of wage hikes. In addition, the minimum wage should be increased to the official subsistence minimum by the start of 2019. Wage costs account for over a quarter of consolidated budget spending.

Social spending, which accounts for 35 % of total spending, would increase by about 3 % y-o-y in nominal terms and contract in real terms. The reinstatement this year of inflation-indexing of pensions no longer applies to pensioners who remain in the workforce (official figures say about 35 % of pensioners still work).

The wage hikes will cause a brisk increase in spending next year on healthcare, education and administration. Healthcare spending will be further lifted by the continuing development of the new health insurance system. Healthcare spending should rise to nearly 12 % of total budget spending.

Spending in various sectors of the economy should increase at over 3 % a year, while spending on internal security and law enforcement will rise 2 % a year. Defence spending is planned to be reduced sharply next year, but it will still remain on the heightened level of 2012–13 even in real terms.

The 2019–20 spending estimates only serve as guideposts and are subject to change. In addition, the budget still has a relatively large amount of unallocated spending.

Russia wants to spur e-commerce. The Russian administration has recently been enthused over digital economy and compiled related development programmes, most recently for electronic commerce. Developing effective online shopping seems sensible for Russian circumstances given that internet penetration is extensive and physical distances are huge. Yet the goals for this modern branch bring to mind the traditions of the planned economy. For example, it declares that by 2025 e-commerce should account for 20 % of retail sales in Russia, that Russia should account for 10 % of global online sales and that over 80 % of persons 13 and older will have made online purchases.

Estimates on the size of Russian online retail sales in 2016 vary between 1–2 trillion rubles (14–27 billion euros), or 3–4 % of total retail sales. The value of online purchases from foreign vendors last year amounted to about 300 billion rubles (4 billion euros), of which about half came from China. Russia accounts for about 1 % of global e-commerce. While total retail sales and imports have contracted sharply in recent years, online retail has continued to grow. About 30 million Russians, roughly a quarter of the adult population, have bought something online at some point.

The programme to boost e-commerce includes proposals to liberalize online sales of food, alcoholic beverages and pharmaceuticals. While no specific barriers to foreign retail sales are proposed, vendors should specify that their goods are not certified to Russian standards. The Eurasian Economic Union is currently discussing a proposal on reduction in the monthly duty exemption for online shopping from the current 1,000 euros to 200 euros by 2020. The duty on purchases above the limit is 30 %.

Main categories of Russian public sector spending, 2011–20

Source: Finance ministry

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The information is compiled and edited from a variety of sources. The Bank of Finland assumes no responsibility for the completeness or accuracy of the information, and opinions expressed do not necessarily reflect the views of the Bank of Finland.
Global prominence, domestic development and long-range market reforms.

China convened its 19th National Congress on Wednesday (Oct. 18). Party chairman and president Xi Jinping’s delivered a wide-ranging address that touched on China’s rising global prominence, domestic development and long-range goals. He invoked the phrase new era into which “socialism with Chinese characteristics” is now entering.

Xi proclaimed that, under established party goals, the country is on track to becoming a “moderately prosperous society” by 2020. He added a new goal of becoming a fully developed and leading global power by 2050, measured both in terms of soft power and military might. As a mid-range goal, China will seek to become a modern socialist state by 2035, with a large middle class and a narrower income gap.

To meet the 2020, 2035 and 2050 targets requires Chinese industry to produce more efficiently and move up international value chains. Xi pointed out that China does not seek isolation, but continues with the process of opening up to the world and market reforms (e.g. opening up the services sector). Liberalisation of exchange rates and interest rates will continue, as will strengthening of state-owned enterprises, dealing with over-capacity branches (“supply-side” reforms) and reining in rising indebtedness.

Xi’s speech elevated the roles of ideology and the party. Nothing should be allowed to challenge the party’s authority. Democracy, rule of law and equality would be defined in terms of China’s “socialist democracy.” Corruption was seen as the largest threat to the party’s legitimacy, so the struggle against corruption would continue.

Apart from the 2035 and 2050 targets, Xi’s speech did not offer any new elements to economic policy that might be interpreted as a shift in economic policy stance or the near-term outlook. Even if the speech emphasised the quality of economic growth, Xi was unclear as to whether the party would scrap hard annual growth targets altogether in order to phase out current trend of piling on debt and put growth on a more sustainable basis. In any case, commitment to the “moderately prosperous society” goal for 2020 implies a doubling of economic growth, Xi was unclear as to whether the party would scrap hard annual growth targets altogether in order to phase out current trend of piling on debt and put growth on a more sustainable basis.

In dollar terms, the value of Chinese goods exports rose by 8 % y-o-y in September, the same average rate of growth for the first eight months of the year. January-September export volumes were up 8 % y-o-y. The value of exports in September was nearly 200 billion dollars. The fastest growth in exports this year has been to North and South America (10–12 %), while exports to Africa have contracted slightly.

As a result of high import growth, China’s goods trade surplus fell significantly. For January-September 2017, the surplus was just 300 billion dollars, or 100 billion dollars less than in the first nine months of 2016.

Sources: China Customs, Bloomberg and BOFIT.

Chinese foreign trade, 2008–17 (in billions of US dollars)

Rise in Chinese producer prices accelerates. September producer prices were up 6.9 % y-o-y (up 1 % m-o-m). Rising prices of raw material inputs, as well as prices in the extractive and metals industries, drove the pick-up in inflation. In contrast, the prices of consumer goods production rose by less than 1 % y-o-y. The rise in producer prices increases the nominal income of firms, thus providing a modicum of relief to indebted firms to service their debts.

September consumer price inflation slowed from 1.8 % in August to 1.6 % in September due to lower food prices. Core inflation, which excludes food and energy, accelerated moderately in September to 2.3 %.
Russia

Ruble strengthening returns. After a couple of months of weakening, the ruble’s exchange rate recovered in September and has since remained around 58 rubles to the dollar and 68 to the euro. Rising oil prices have supported the ruble’s ascent as they have increased Russia’s export earnings and the trade surplus (especially with slowing growth in imports). Although the net capital flow has in recent months turned again outward from the country, the amount has remained modest.

There are no large upward or downward pressures on the ruble’s exchange rate on the near horizon as markets expect oil prices to remain near their current level in coming months. Capital outflows could accelerate slightly in December, which traditionally sees a spike in paying down foreign debt. Most debt has in earlier years been rolled over, however.

The ruble’s nominal and real effective (trade-weighted) exchange rates in January-September were about 20% higher than in the same period in 2016.

Ruble exchange rate and oil price

[Graph showing the relationship between the ruble exchange rate and oil price]

Russian budget revenues expected to rise on favourable economic forecast and planned tax hikes. The finance ministry expects consolidated budget revenues to rise slightly faster than inflation in coming years, even if oil & gas revenues are seen to decline under a cautious assumption about the oil price (Urals crude price of 42–44 dollars a barrel). Other revenue streams should be boosted to brisk growth by the GDP growth forecast above 2% per year and the expected expansion of the tax base by exposing a larger part of the shadow economy to taxation.

VAT revenues will contribute significantly to growth in other revenues based on the forecasted GDP growth and wider tax base estimate. Higher VAT revenues should be supported also by robust growth in imports and expected depreciation of the ruble (about 8% against the dollar) mostly next year.

As Russia’s leaders have promised, a general increase in the tax burden of firms not operating in the oil & gas sector is not planned, although certain taxes and payments are to be increased. The finance ministry estimates that the proposed tax hikes will boost budget revenues over the coming years by an amount accounting to over 2% of total budget revenues or nearly 1% of GDP.

A significant revenue boost should come from an increase in the dividend requirement of large state-owned enterprises to pay out 50% of profits. The government has negotiated with state-owned enterprises on this issue already for few years. Higher excise taxes on e.g. tobacco, alcohol and fuels should also produce a moderate increase in budget revenues. In addition, a hefty hike in health insurance payments is planned for next year.

Another way to boost revenues that has been brought up is cutting tax breaks. However, it is extremely difficult to scrap previously granted breaks, especially as some of them are permanent. The finance ministry estimates that the losses from tax breaks correspond to over 8% of public sector revenues in 2014–20.

Russian public sector main revenue streams (consolidated budget, 2017–20 finance ministry estimates)

[Graph showing the distribution of revenue streams]

Russians moving to mobile banking. With a shrinking number of local bank branch offices and fewer ATMs, households are turning to netbanking services. A recent Central Bank of Russia survey found that over a third of the adult population uses an online banking service or a mobile banking app. This share has clearly increased over the past two years. The survey also reviewed the wider use of banking services. Nearly 80% of Russian adults have at least one bank account and about 45% actively use at least one account. Many Russians have several bank accounts. Private individuals together had over 544 million bank accounts at the start of the year (about 4.6 accounts per capita). The use of debit and credit cards has also expanded rapidly. About half of adults have some sort of payment card, and in addition to this about 30% of Russians have a bank card related solely to wage payments.

Despite rising household indebtedness, only about a third of the population has borrowed from a bank or other credit institution. Bank customers are typically middle-class urban-dwellers, while the customer base for the microcredit sector tends to be low-income individuals.
China

China’s new communist party line-up takes shape. The 19th National Congress of the Communist Party of China (CPC) has been brought into conclusion with the main posts in the party hierarchy filled. The CPC’s highest decision-making body, the politburo standing committee, continues to be led by party secretary Xi Jinping (president) and also Li Keqiang (premier) maintained his seat at the standing committee. They are joined by five new members: Li Zhanshu, Wang Yang, Wang Huning, Zhao Leji and Han Zheng.

Perhaps the most striking feature of the new permanent committee members is that they will all be too old to qualify for the top job at the next national congress if age rules are enforced. Thus, the top party organ contains no heir apparent. The two leading prospects for top spots going into the party congress were Chen Miner and Hu Chunhua. Both had to settle for seats in the politburo, the second-tier of CPC leadership. Moreover, it is still not clear whether president Xi will continue for an exceptional third term or will successors be promoted to the standing committee at later stage. This time the informal pension rule was enforced. Ahead of the congress, it was expected that the influential Wang Qishan, even at the age of 69, would be allowed to continue in the inner circle since he is an important ally of Xi and he has long headed the anticorruption programme. However, he was not selected even into the 205-member CPC central committee.

The party congress for the most part proceeded as expected. Xi Jinping’s position was reinforced and his name was added to the party’s constitution. The act places Xi in the pantheon of the greatest leaders of the modern era, on par with Mao Zedong and Deng Xiaoping. No big changes in economic policy are expected. Freedom and openness were emphasised, even as the roles of the party and the state in the economy are expected to increase.

China’s top central banker lays out risks to the economy. At the press conference arranged during the party congress, central bank governor Zhou Xiaochuan fielded questions from the media on the condition of China’s financial sector. He noted that, at the general level, bubbles can develop in asset prices such as apartments, shadow banking sector or derivatives markets. In addition, a special problem for transition economies is the poor condition of the banking sector due to a large stock of non-performing loans, as well as regulation and supervision that lags behind a rapidly evolving economy. Asset bubbles, he noted, will grow if there are too many pro-cyclical polices in place and over-optimistic expectations of economic agents. This, at some point, could trigger a sharp correction in asset prices. Zhou said this is the key risk we want to prevent. While the bubble-collapse scenario was presented as a general hypothetical, the parallels with the current Chinese economy are apparent.

On indebtedness, Zhou noted that greater attention should be paid to the rapid increase in indebtedness of Chinese households and the true liabilities of local administrations. International institutions have long been concerned about China’s soaring indebtedness and financial sector fragility. This was echoed in the IMF’s latest Global Financial Stability Report, released early this month.

The central bank governor has recently been active in publicly sharing his views. In an interview released this month, Zhou came out as a proponent for opening of the economy, exchange rate flexibility and dismantling capital controls. Governor Zhou says he expects to retire soon.

Chinese GDP growth remains steady. China’s National Bureau of Statistics reports that third-quarter real GDP growth was 6.8 %, barely changed from 6.9 % in the first half. Prices this year have risen faster than in previous years; nominal GDP was up over 11 % in the first nine months of 2017. China’s very consistent GDP growth figures fail to capture business cycle fluctuations, and therefore their evaluation re-quires alternative indicators.

Urban areas report monthly fixed asset investment (FAI), which real growth turned negative in August-September. The 12-month growth figure has been around 2 % for the year to date. Private investment showed practically no real on-year growth in January-September. The rate of growth of public investment has slowed and this year has been around 5 %. Despite this, the national accounts show investment growth remained relatively high, and investment accounted for a third of economic growth in the first nine months.

Real growth in retail sales remained at 9 % in September, supported by the strong earnings growth. The NBS reports that real disposable incomes grew by nearly 8 % in January-September. The national accounts show that the contributions of private and public consumption to economic growth in January-September was 4.5 percentage points. The NBS says that per capita consumption expenditure grew by 6 % y-o-y in real terms. Online goods sales have grown this year at a rate of nearly 30 % y-o-y. In January-September, 16 % of NBS registered goods trade was conducted online. Online sales of services grew even faster.

Indicators of China’s real economy performance

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Russia

Russian central bank continues accommodating monetary policy. At its regular meeting last week, the Central Bank of Russia’s board again lowered the key rate. The 25-basis-point cut to 8.25 % took effect on October 30. The central bank board noted that, while the slowdown in 12-month inflation continued in October with inflation dropping below 3 %, it was due mainly to transient factors. In addition, the CBR said that the fall in inflation expectations is not yet sufficiently large, sustainable and broad-based to justify more robust rate cuts.

The rate cut was in line with market expectations. The latest cut included a slight change in the CBR’s forward guidance. Earlier cuts were accompanied with messaging about the need to maintain a moderately tight monetary stance, but now the CBR referred to a gradual shift from the moderately tight stance to neutral monetary policy. In addition, the CBR noted further rate cuts are possible in the next meetings instead of the earlier six-month horizon. Many market analysts viewed the guidance as an indication of a faster relaxation in the policy stance, even if specific interpretations vary somewhat.

At the September rate meeting, governor Elvira Nabiullina emphasised that making the current 4 % inflation target sustainable would require a further reduction in inflation expectations and an anchoring of those expectations at a lower level. She noted that the level of key rate in the range of 6.5 - 7 % that is compatible with the inflation target might be achieved in 2019.

The pace of Russian inflation has slowed in recent months to record lows – so low in fact that some Russian government officials have called for even more accommodative monetary policy. President Vladimir Putin, however, recently expressed strong support to the CBR’s cautious policy approach.

CBR key rate and 12-month inflation

Nearly a fifth of Russian workers classed as working poor. A new study from the government’s Analytical Center finds that roughly 17 % of the working population, about 12.1 million Russians, must scrape by on inadequate incomes. The working poor are defined as individuals whose incomes are insufficient to cover the minimum needed to support a family. Many working poor households rely on microcredit, payday loans or consumer credit. This is reflected in rising indebtedness among Russia’s poorest households.

Low wages are a particular problem in public-sector fields dominated by female labour. Rosstat figures show that 7 % of wage-earners on average are paid wages below the monthly subsistence minimum. Over 17 % of people working in the education sector or various municipal services earn below-substantive wages. The regional variation in the economic structure and the public sector’s role are reflected in the regional variations in working poor numbers. For example, in many regions of the North Caucasus Federal District over a fifth of workers are paid wages below the subsistence minimum.

Raising the minimum wage to the level required by the law, i.e. the subsistence minimum, has been discussed for years and is now set to be achieved by 2019. The minimum wage was raised twice in 2016, and at the beginning of July 2017 the monthly minimum wage was increased to 7,800 rubles (115 euros). The official minimum wage is now about 60 % of the average subsistence minimum and about 20 % of the average monthly wage, which is quite low by international standards. The minimum wage in most OECD countries is about 40 % of the average wage.

United States revises its economic sanctions regime for Russia. The US treasury department published an amended version of one of its sanction directives on October 30. The amendment concerns the ban of providing goods, services and technologies to certain Russian companies (including Rosneft and Gazprom) for projects to explore or produce oil in deepwater, Arctic offshore and shale deposits. The ban earlier only applied to oil projects in Russian areas, but now will cover any oil venture launched after January 28, 2018 in which the Russian firms subject to this measure hold at least a one-third stake or majority of voting shares.

In September, the US tightened financial sector sanctions on certain Russian firms shortening further maturities of allowed financing.

The US treasury department recently also released a list of entities related to the defence and intelligence sectors of the Russian government as required by the Countering American Adversaries through Sanctions Act approved in August. Further sanctions are not imposed for the listed entities at the moment, but possible additional measures will be announced separately. Some of the listed entities are already subject to existing sanctions. The list includes a total of 39 entities, including aerospace, arms-makers and shipbuilding companies, as well as the Federal Security Service (FSB).

Media reports claim that Rosneft recently decided to postpone exploration and development of an offshore deposit in the Black Sea, due in part to the impacts of Western sanctions.
China

First time since 2004, Chinese government issued a small amount of sovereign dollar debt. China's finance ministry last week issued in Hong Kong a total of 2 billion dollars in five- and ten-year notes. Demand for the bonds exceeded supply by more than ten times. The five-year bond carried a coupon of 2.125 % and the ten-year 2.625 % (just 15 and 25 basis points, respectively, above the rates on the corresponding US treasuries).

The small issuance was largely intended to help set a reference rate for pricing increasingly popular corporate dollar bond issues. Bloomberg reports that Chinese firms this year have issued dollar-denominated notes worth approximately of 150 billion dollars, a 78 % increase from the same period last year.

Just over 1 % (about 18 billion dollars) of China’s government debt was foreign debt at the end of last year. Of this, 85 % was denominated in yuan. The last time the Chinese government issued dollar notes was in 2004.

The rate for both the five-year and ten-year mainland China bonds was 3.9 % at the start of November, or 30 basis points higher than a month earlier and over 100 basis points higher than a year ago.

Slight acceleration in pace of Chinese wage growth this year. China’s National Bureau of Statistics reports that real average disposable household incomes per capita have risen this year by 6.6 % in urban areas and 7.5 % in the countryside, which is roughly the same rate as GDP growth. Income growth has picked up this year by about one percentage point from last year. While income growth in rural areas has long been higher than in cities, the income differences between cities and the rural areas are still substantial. Disposable monthly incomes for city-dwellers in January-September averaged 3,050 yuan (400 euros) and in the countryside 1,090 yuan (140 euros).

In contrast, figures released by the Korn Ferry Hay Group (KFH), an international consultancy specialising in business management services, give no signs of accelerating wage growth. According to figures updated in May, KFH clients operating in China had raised wages by 6 % over the previous 12 months and expect future wage increases to continue at the same pace.

Even if it is difficult to evaluate conditions in Chinese labour markets due to the lack of reliable statistical data, enhanced employment conditions may explain the acceleration in the rise of average incomes. Official figures for registered unemployed people are considered unreliable, as jobless people have very few incentives to register themselves as unemployed. Despite this, a slight reduction in registered unemployed this year could indicate improvement in the labour market. Moreover, household confidence surveys indicate stable and healthy employment conditions and prospects.

China’s fight against air pollution intensifies, bringing new problems for industry and growth targets. The central government plans to enforce strict measures this winter season in areas suffering from poor air quality, especially in China’s northern provinces. Officials are paying particular attention to reducing coal-burning and cutting production of polluting industries. This year is the deadline for meeting the 2013 air quality target, which calls for reducing small particulates (PM2.5) in China’s most important metropolitan areas by 15–25 % from 2012 levels. The central government also recently issued city-level targets for this winter for Beijing and other northern cities. These cities must reduce their PM2.5 levels by at least 25 % compared to last year. According to the environment ministry, city leaders will be held personally responsible for failing to hit their air quality targets. However, achieving the 2013 goals appears unlikely as the environment ministry says that in the first eight months of this year, the air quality in 338 of China’s largest cities was worse than in the same period in 2016. Greenpeace also reports that air quality has become worse in about a third of Chinese cities. Air pollution is estimated to cause the premature deaths of 1.8 million Chinese every year.

Officials would like to replace coal with natural gas in heating and electrical power generation. Reuters reports that during a recent six-month campaign, heating systems of over 1 million households have been replaced. The impacts of the campaign became visible in June-August, when natural gas consumption in mainland China rose by nearly 30 % instead of 5–10 % as in previous summers. Analysts say that much of a significant increase in natural gas demand will cause supply interruption to industry this winter as gas supplies are inadequate to satisfy the increased demand. Households have higher priority to gas deliveries than industry.

The reduction of air pollution is difficult to implement in conjunction with an ambitious GDP growth target. Due to the growth target, the growth has been heavily supported by various stimulus measures to e.g. the construction industry. The construction industry relies on many of the products of heavy industry such as steel and cement, which are very dirty industries. Stimulus measures are partly to blame for the decrease in air quality in Beijing and its surroundings this year, even if air quality had improved somewhat earlier. Official are now cracking down on polluters, including temporary closures in recent months of tens of thousands of plants that have broken environmental laws. Furthermore, production limits have been imposed for the November-March period in many cities that rely on heavy industry. Reuters reports that Tangshan, China’s leading steel city (which produces more steel than the entire United States), plans to cut steel output by half this winter season.

China’s official industrial purchasing managers’ index went into decline in October, which may partly reflect harsher application of environmental protection policies.
Russia

Brisk rise in Russian industrial producer prices. Prices of industrial products delivered domestically were up by nearly 8% y-o-y this year so far. The rise matched last year’s pace, even if it has moderated in recent months. The brisk pace was basically due to an acceleration of increases in extractive industry prices to 15% y-o-y. The rise in manufacturing producer prices slowed slightly from last year’s pace and in recent months has been running at around 6% y-o-y.

The rise in producer prices in both extractive industries and manufacturing came focally from oil, oil products and the metal industry that have heavy weights in the industrial producer price basket. As in previous years, their domestic producer prices have tracked the rise in export prices in these branches. In various manufacturing branches with longer processing chains, the increases in domestic producer prices this year have been considerably more moderate.

Changes in world market prices of oil, oil products and metals feed more broadly into inflation in Russia via their domestic producer prices that track the export prices. Higher producer prices in these three basic commodity groups affect costs in other manufacturing branches and generate price pressures that roll further on into consumer prices. The impact on Russian prices via this channel is tangible. The three commodity branches account for nearly 15% of the total domestic delivery volume of goods and services. True, consumer prices are also affected by imports, particularly when ruble exchange rate fluctuations are large. However, in periods when the ruble’s exchange rate is fairly stable the role of imports is limited as import prices change only modestly, even if imports of goods and services equal over a fifth of Russia’s domestic demand.

Russia ranks higher in World Bank Doing Business survey than in most comparisons. The World Bank’s latest Doing Business international comparison of regulatory environments ranks Russia 35th out of 190 countries surveyed. Russia came in just behind Japan and a few notches above Ruanda. China ranked 78th. Among the survey’s 10 topic indicators, Russia scored high marks e.g. in property registration (12th) and getting credit (29th). Property registration was, however, seen in the report considerably easier in e.g. Ruanda and Kyrgyzstan than in Russia, while getting credit was substantially easier in e.g. Zambia and Nigeria.

To maximise international comparability of the Doing Business results, the survey focuses on very narrowly defined example cases that may not necessarily be applicable to the business environment generally. Moreover, the comparison does not take e.g. corruption into consideration. In other international comparisons, Russia ranks lower. For example, Transparency International’s latest Corruption Perceptions Index ranks Russia 131st of 176 countries surveyed. In the World Economic Forum Competitiveness report’s institutional pillar Russia ranks 83rd of 137 countries surveyed.

CEFC China Energy actively investing in Russia, but goods trade remains the focus of economic relations. An under-the-radar Chinese firm, CEFC China Energy, which had never invested earlier in Russia, has in recent months been preparing several corporate acquisitions in relation to a few Russian and international actors. CEFC announced in August plans to purchase a 14% stake in Rosneft, part of a stake that had been acquired at end-2016 by a joint venture of the Swiss Glencore and the Qatar Investment Agency (QIA). Last week, CEFC participated in the IPO of Russian power and aluminium producer En+, as did the QIA. The Russian VTB might lend CEFC much of the money needed to finance these acquisitions. VTB earlier provided credit to Glencore and QIA in the initial Rosneft deal. In addition, VTB is a minority stakeholder in En+ and its major creditor. Glencore will also get a stake in En+ through a share swap. According to media reports, both CEFC and QIA have also negotiated about acquisitions or joint ventures with the NNK oil company, which is owned by Rosneft’s former CEO Eduard Khudainatov. Both Rosneft and NNK are subject to certain US economic sanctions. The total value of CEFC’s planned purchases is estimated to exceed 12 billion dollars.

Otherwise, Russia-China economic relations continue to be dominated by goods trade. Russian exports to China last year were worth approximately 30 billion dollars, while the value of imports from China was about 40 billion dollars. China has been Russia’s biggest provider of goods imports for several years, accounting for over 20% of goods imports. This year China also became Russia’s top goods export destination, accounting for 11% of Russian goods exports in January-August. Oil represents the lion’s share of Russia’s exports to China. Natural gas exports are expected to start in coming months as the massive Yamal peninsula LNG project, which includes Chinese investors, becomes operative. Pipeline transmission of natural gas is scheduled to begin in December 2019. Services trade between the two countries is much more modest than goods trade, but has been supported e.g. by the recent boom in Chinese tourism. Nearly 1.3 million Chinese tourists visited Russia last year, making them Russia’s fourth largest tourist group.

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China

Few surprises emerge from Trump-Xi meetings. The first official visit of United States president Donald Trump to China on Wednesday and Thursday (Nov. 8–9) was a part of his 10-day Asia tour. Going into the China visit, the two countries faced next to impossible challenges to resolving tensions with North Korea and reducing the large imbalances in US-China trade.

Based on released comments on Thursday, progress in resolving these issues was indeed modest. Even though it was claimed that US firms had signed deals with Chinese counterparts worth a total of 250 billion dollars, most of them were just letters of intent or deals that had been agreed earlier. Trump blamed the current trade deficit problems on policies of previous US administrations. American firms said they would like to see more concrete measures to open Chinese markets and assurances of fair treatment. North Korea figured heavily in the headline addresses, but no new initiatives to resolve tensions were announced.

Trade between China and the United States has grown in recent years. According to Chinese figures, China’s goods exports to the US rose 11% in dollar terms in the first ten months of this year, while imports were up 17% y-o-y. Even if import growth has been faster than export growth, China’s trade surplus with the US in the January-October period increased to 225 billion dollars from 209 billion dollars in the same period last year. Trump’s has repeatedly talked about the trade imbalance, even if bilateral imbalance is hard to address from a policy standpoint in the current global economy. According to US figures, the trade deficit with China in the first nine months of this year exceeded 274 billion dollars, or nearly half of the entire US trade deficit.

China and the US are important trading partners for each other. The US accounts for about 20% of Chinese exports and it is China’s largest single export market. Although the EU is China’s biggest import market, the US accounts for 7% of Chinese imports and is about as large a trading partner with China as Japan, South Korea or Taiwan. China purchases 8% of US exports and provides 21% of all imports to the US. In terms of imports, China is by far America’s largest trading partner. In exports, only exports to Canada and Mexico are greater.

Both countries invest heavily in each other. According to foreign direct investment figures compiled by the Rhodium Group, the cumulative FDI of American firms in China at the end of 2016 exceeded 240 billion dollars, while the stock of Chinese FDI in the US amounted to roughly 110 billion dollars. Chinese investment in the US soared in recent years, but this year investment has slowed due to the clamp-down on capital exports from China. In any case, the US accounts for a significant share of outward Chinese FDI, which has even raised a discussion in the US over the wisdom of restricting Chinese investment.

China’s current account surplus shrinks; foreign currency reserves increase. New balance-of-payments data show that China’s current account surplus for the first nine months of this year was about 106 billion dollars. The goods trade surplus fell to 335 billion dollars, while the services trade deficit, driven by a tourism deficit of 172 billion dollars, expanded to 203 billion dollars. On-year, the current account surplus fell to 1.0% of GDP.

Balance-of-payments figures also highlighted the fact that FDI outflows from China in the first nine months of the year amounted to 65 billion dollars, while FDI inflows to China were 86 billion dollars. After having been 47 billion dollars in the red last year, net FDI flows turned positive. Other items in the financial account showed that capital outflows from China slowed significantly in the first half compared to last year. Some observers argue that this trend continued in the third quarter, but official third-quarter figures have yet to be published.

China’s currency reserves at end-October were 3.109 trillion dollars. China’s currency reserves have increased by 99 billion dollars this year. In 2015–2016, they fell by 833 billion dollars. With gold and other assets included, China’s reserves totalled 3.204 trillion dollars at the end of October.

China’s current account trends relative to GDP, %

Source: Macrobond.
**Russia**

**Russian GDP growth slows.** According to preliminary Rosstat estimates, Russian third-quarter GDP rose by 1.8 % y-o-y, down from 2.5 % in the second quarter. Growth appeared to slow on moderating export and investment demand, which was reflected on the production side e.g. in slowing growth in oil output. Sentiment surveys and other forward-looking indicators also offered little promise of higher growth in the last months of this year.

Russian GDP grew by 1.6 % y-o-y in the first nine months of this year. The trend relatively closely matches BOFIT’s 1.5 % GDP growth forecast for 2017.

![Russian GDP graph](image)

Source: Rosstat.

**Slowing growth in Russian foreign trade.** Even with the slowdown, the value of goods exports and goods imports increased in 3Q17 still by about 20 % y-o-y in dollar terms. The higher value of exports was supported largely by higher oil prices, while export volumes of several major commodities were down from a year ago. The export volume of crude oil and oil products was only down a fraction, while export volumes of e.g. metals and fertilizers were down more pronouncedly. Lower growth in investment-led imports such as machinery and equipment, as well as metals, slowed the growth of goods imports in 3Q17. However, import growth remained in double digits in all major goods categories.

For January-September, the value of Russian goods exports was 250 billion dollars. The value of exports was up by 26 % y-o-y, which was the same as the increase in the price of Urals-grade crude oil. Lifted by rising prices, the share of oil & gas in goods exports is back above 7 %, down from 11 % in the second quarter. Growth in machinery, equipment and transport vehicles was 26 % y-o-y, which was reflected on the production side e.g. in rising output of automobiles and other goods.

Meanwhile, the ruble’s real effective (trade-weighted) exchange rate (REER) appreciated 21 %. The import breakdown by category was led by machinery, equipment and transport vehicles with 48 %, followed by chemical products with 18 % and foodstuffs with 13 %. About 38 % of imported goods came from the EU, 33 % from Asia and 8 % from the Eurasian Economic Union. China, again the most important individual import country by far, accounted for over 20 % of imports.

**State enterprises and the state may generate around 40 % of Russian GDP.** Rosstat reports that in recent years 11–12 % of revenues of all firms and organisations (excluding funding received from government budgets) have been generated by firms or organisations that have at least some direct ownership by the federal government or a regional government (at least about 30,000 entities). Their revenues are highly concentrated. Surveys by the Russian Presidential Academy of National Economy and Public Administration (RANEPA) show that just 54 large state-owned enterprises (SOEs) account for 8 % of revenues. When 20 indirectly state-owned firms are added the share rises to 12 %. The business magazine Ekspert arrived at the 11 % figure by combining revenues of all SOEs on its “Ekspert 400” list of Russia’s biggest companies. Gazprom and Rosneft together already account for over 4 % of total revenues.

Any statistics on the GDP produced by SOEs has not been published. Based on the financial accounts of Gazprom and Rosneft, RANEPA researchers estimate that the share of those two in Russian GDP has clearly exceeded 10 % in recent years. If the ratios between earnings and GDP produced in other SOEs are similar to that of Gazprom and Rosneft, RANEPA reports the SOEs account for around 25–30 % of GDP. A couple of similar estimates exist. The share could also be somewhat smaller as profitability that reflects the relationship between GDP produced and earnings has been notably better in the oil & gas sector than in other sectors.

Rosstat records that the share of the government sector (includes federal, regional and local governments) in GDP produced has slightly exceeded 13 % in recent years. When the above estimates of the SOEs’ share are added, the share of the entire public sector would be around 40 %. The European Bank for Reconstruction and Development (EBRD) earlier put the share at around 35 %, but EBRD stopped publishing that piece of information in 2010.

In any case, the share of Russian GDP produced by the government sector and SOEs is far less than 70 %, a figure floating around for the past couple of years. The 70 % figure actually refers to the ratio of gross earnings or spending of government budgets and SOEs to GDP (which despite the term “gross” measures net flows of goods and services).

However, SOEs in Russia account for a much larger share of the economy than in e.g. Turkey or Brazil. Public ownership may be a drag on firm efficiency and may limit competition, and the state’s role in the economy is naturally a much broader issue than mere shares of GDP.
China

China opens up financial sector to foreign entities. Last Friday (Nov. 10), China announced it was eliminating restrictions on foreign ownership in the financial sector. First, China will scrap the rules that foreign ownership in a Chinese bank is limited to 25% while a single foreign investor can own no more than 20%. Second, under the new rules foreign entities can now take a controlling 51% stake in a Chinese fund or securities company and in three years’ time the cap will be removed completely. Before the change, the cap on foreign ownership was 49%. Moreover, the ownership cap on foreign owners of life insurance companies also rises to 51% during the next three years and ownership restrictions will be abolished entirely after five years.

The measures were received positively as they signal that China continues to implement reforms aimed at opening its economy to the world. Greater opening of the financial sector has long been wished for, since the presence of foreign entities in China’s financial sector remains marginal. Following the announcement, a number of international companies announced plans to increase their holdings in Chinese firms in the financial sector.

Many observers, however, stress that in spite of recent reforms swift changes in the role of foreign entities in Chinese financial markets are unlikely. Competition is fierce, China’s domestic players are strong and state firms are tightly networked with each other. Moreover, other regulations and requirements imposed on foreign entities could make expansion problematic. It has, for example, been theoretically possible since 2006 for a bank founded in China by a foreign bank to operate freely. Today, such banks account for less than 1% of China’s banking sector – and that share has been falling in recent years. Another example involves restrictions on foreign credit card issuers. China announced in 2014 that it would permit foreign credit card companies to set up clearing firms in China to settle transactions. The People’s Bank of China, however, only issued guidelines on such settlements this summer. At least two credit card companies have applied for licences to operate in China, but officials claim their applications are inadequate.

China’s economic growth slowed as expected in October. Indicators of China’s economic activity suggest that the economic growth overall slowed in October. In real terms, industrial output growth decelerated to around 6% y-o-y, while growth in retail sales fell well below 9%. After averaging around 5% in previous months, growth in electricity production fell to below 3% last month.

The sharp slowdown in fixed asset investment (FAI) deserves special note. Even with cautious investment price estimates, October investment growth was clearly in the red. In the previous years, changes in FAI have followed trends in fixed investment recorded in the national accounts.

Consumer price inflation accelerated from 1.6% in September to 1.9% in October. As in September, October producer prices were up 6.9% y-o-y.

Rapid growth in Chinese goods imports continued in October. The value of goods imports in October was 170 billion dollars, while the value of good exports was 198 billion dollars (about the same as in September). The value of imports measured in dollars rose by 17% y-o-y, while exports were up by 7%. The value of imports in January-October increased by 18% and the value of exports by 6%. The trade surplus contracted to 333 billion dollars, down from 465 billion dollars in the same period a year ago.

Risen commodity prices, among other things, resulted in higher import prices from a year ago. September prices were up by 9% y-o-y. September price inflation for exports was 3%. Goods import volumes rose by about 11% in the first nine months of the year, while the volume of goods exports was up by about 8%.

Overall, import volumes of commodities have increased this year. In the first ten months of this year, China imported 12% more crude oil and coal than in the same period last year. Pulp imports grew by 13%, while copper imports declined. Crude oil import volumes, however, fell from their March record high, when China imported 39 million tons (34 million tons in September and October). Pulp imports also peaked last March.
Russia

Recovery in Russian output stalls. The Russian economy performed poorly in October. After already contracting for a couple of previous months, workday- and seasonally-adjusted industrial output fell again in a tiny bit last month. Output was lower than in the spring and summer, and unchanged from a year earlier. The contraction in output of extractive industries (including oil & gas) halted with October and September output on par with a year earlier. Crude oil production in September-October was smaller than a year earlier, and the boom in natural gas production earlier this year has subsided. Seasonally-adjusted manufacturing output has remained largely flat in recent months, and in October output was unchanged from a year earlier. Manufacturing output was pressed down by the metal industries and oil refining.

Following good growth in August and September, October agricultural output was down from a year earlier. The continued slight slide in construction last month brought a substantial on-year drop. In contrast, the volume of goods transport still in October was considerably higher than a year earlier.

The recovery in retail sales continued in October. As in September, the volume of retail sales was up 3 % y-o-y. The high fixed investment growth of the second quarter faded to a couple of per cent in the third quarter.

Proposed changes to Russian legislation could reduce economic transparency. The government this week submitted to the Duma draft legislation that modifies rules on public disclosure of certain financial information. Provisions from disclosure were earlier limited to state secrets. Under the bill, the government can define also other special cases for which it can restrict disclosure of financial information.

For corporations, the changes would affect e.g. financial reporting and auditing. Information related to the special cases determined by the government could not be published with financial reporting. If this information is impossible to decouple from other business activities, effectively all financial reporting could not be published. The same principle would apply to auditing as well. The government could define also for public procurements special cases for which information would not be publicly disclosed. Under current legislation, open tenders on internet must be arranged for most public procurements. In addition, the list and selection criteria for banks allowed to perform financial operations related to government defence orders would no longer be public.

The explanatory note for the draft proposal refers e.g. to national security and securing defence capabilities. Many observers see the proposal as a response to the threat of widened US sanctions against Russia. Anatoly Aksakov, chairman of the Duma’s financial markets committee, said the bill would primarily concern companies operating in the defence industry, and possibly some other strategic companies. Some observers worry that the changes would promote abuses in public procurements and reduce transparency in business.

The proposal will be taken up by the Duma next month. The government is expected to prepare the specifying decrees for the bill by mid-December.

While the share of farm cooperatives, farming corporations and similar organisations has gradually declined, they still produce over 70 % of grains and other grain staple crops. Private career farmers (Russian fermeri) have gradually increased their share towards 30 % of all those crops. Small home plots continuously account for nearly 80 % of potato production and about two-thirds of vegetable production.

Russia posts record grain harvests. By the conclusion of the harvest season on November 1, over 135 million metric tons of grains and other grain staples had been harvested – an all-time record for Russia. The harvest was 13 % larger than last year’s and 45 % larger than the annual average harvest over the previous decade. The record harvest was entirely due to a strong improvement in crop yields. This and previous years have no longer seen increases in the area of land under cultivation. Harvests of other important staples, i.e. potatoes, sunflowers, sugar beets and vegetables were lower than last year, but the brisk growth of previous years meant that the harvests were still fairly large.

Grain and grain staple harvests in Russia, 1990–2017

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China

Chinese debt levels continue to rise. The People’s Bank of China reports that its broad measure of private-sector borrowing (total social financing or TSF) rose by 13 % y-o-y in October. Growth has continued at roughly the same pace over the past three years. 70 % of the total credit stock now consists of bank loans, 15 % of shadow-banking sector credit (trust loans, entrusted loans and bank bills) and 15 % as corporate bonds and equities. Flows of credit via the shadow-banking sector have witnessed a sharp increase this year, with the stock of shadow-banking credit up 19 % y-o-y in October. In contrast, growth in corporate bond issues slowed to 5 % y-o-y as interest rates on bond markets have risen and the costs of bond financing for firms has increased.

Chinese indebtedness has caught global attention as such rapid increases in debt have earlier ended in financial crisis in many countries. Even China’s own leaders have begun to stress the need to rein in or mitigate financial market risks and do something about the current debt craze. While the growth in credit overall has accelerated with the pick-up in price inflation. This trend has significantly slowed growth in the debt-to-GDP ratio. The PBoC’s TSF measure suggests that the debt-to-GDP ratio fell slightly in the second and third quarters. Seasonal variation in the total credit stock, however, is quite large. When seasonal swings are taken into consideration, the debt-to-GDP ratio is likely rising.

Figures from the Bank for International Settlements (BIS) show that the structure of Chinese debt has shifted slightly. The ratio of corporate debt to GDP has seen a marginal decline, while indebtedness of households and the public sector has increased rapidly. The BIS reports that China’s debt-to-GDP ratio was 258 % at the end of March.

China tightens regulation of asset management products. In a joint statement released last week, the People’s Bank of China and banking, insurance, securities and foreign exchange regulators announced new unified regulations on asset management products. The rules not only bring consistency to regulation of products and providers, but clarify the properties of investment products. The new rules also seek to rein in banks’ efforts to circumvent financial regulation through the use of asset management products. Seller can no longer promise fixed or guaranteed returns. Firms must also set aside 10 % of their fees collected from investors to offset investment losses. The comment period on the proposed regulations runs until mid-December, and the period of transition to the new regime extends through June 2019.

Demand for asset management products in China has soared on the promise that such products offer much higher returns than bank deposits. Even with a vast range of investment options, large investment losses are seldom reported as the asset product sellers prefer to cover investor losses out of their own pockets. Investors also assume asset management products to be implicitly backed by the government.

Outward FDI growth of Chinese firms stalls this year. To deal with outflows of foreign currencies, declining forex reserves and depreciation pressure on the yuan, China over the past year has significantly tightened its rules on limiting and monitoring capital exports. The stricter rules also affect foreign direct investment (FDI) of Chinese firms. Difficulties in keeping track of outward Chinese FDI mean that estimates vary widely. For instance, China Global Investment Tracker (CGIT), which is run by the American Enterprise Institute, tries to monitor all investments of Chinese firms that exceed 100 million dollars. CGIT indicates the outward FDI of Chinese firms last year amounted to 171 billion dollars.

Chinese FDI abroad last year exceeded China’s FDI inflows for the first time. The trend has now reversed. The commerce ministry valued Chinese outward FDI (excluding financial sector) in the first ten months of this year at 86 billion dollars (-40 % y-o-y), while inward FDI to China was valued at 101 billion dollars (-3 %). It is unclear whether China’s own figures will include the Syngenta deal.

Direct investment abroad by Chinese firms, % change, y-o-y*

* 2017 data refer to the situation in September or June (CGIT).
Sources: CGIT, CEIC, BOFIT.
Russia

Recovery in fixed investment in Russia slows. Fixed investment grew by over 3 % y-o-y in the third quarter, down from growth above 6 % in the second quarter. Investment was up by 4.2 % y-o-y in the first nine months of 2017.

Especially the recovery in fixed investment of large and medium-sized firms, as well as government investment, slowed in the third quarter. In the first nine months of the year, the growth was just around 1.5 % y-o-y. Within-year statistics mainly cover these investments. In turn, Rosstat estimates investments by other entities such as small firms, grey economy actors and households. Rosstat says that the recovery of the estimated investments remained fast, holding at a pace of around 12 % y-o-y in January-September.

The recovery in the statistically recorded investment, however, has a narrow basis. After a couple years of decline, investment in pipeline transmission increased by over 25 % in January-September. Without this growth, recorded investment would have shown no increase, and total investment growth would have been about 5 %.

The electricity sector has been a major drag on the recovery in investment with the sector’s recorded investment falling in January-September by nearly 10 %. Manufacturing (excluding oil refining) also saw investment fall by about 6 %. Sharp drops in fixed investment were registered in a few large manufacturing branches, most notably metal industries. Investment in oil & gas production contracted by 1 %. Third-quarter investment in oil refining showed a sharp increase after a couple years of steep decline.

Due to the transport sector the investment recovery has had regional focuses. In the first nine months of the year, well over half of the increase in investment came from the City of Moscow (much of that were investments in land transport projects). Additionally, about 30 % of investment growth was generated in the Amur region (Power of Siberia gas pipeline) and Crimea (Kerch Strait Bridge).

Russian FDI on the rise. The net flow of foreign direct investment into Russia from abroad in the first half of this year amounted to 17 billion dollars, which was clearly more than in the previous two years. Outward FDI flows from Russia increased slightly from 1H16, with a net outflow of 16 billion dollars. The total FDI stock in Russia was 405 billion dollars, while the Russian FDI stock abroad was 435 billion dollars (about 30 % of GDP).

While Russia’s economic problems in recent years have reduced direct investment, the impacts have generally been limited. Most Russian FDI flows are, however, Russian capital that has been recycled through e.g. Cyprus or the Bahamas and invested back into Russia. The reasons for this recycling include e.g. Russia’s own institutional weaknesses and a quest for more favourable tax treatment. The government has tried in recent years to diminish capital recycling and make Russian firms to repatriate their operations.

There are many challenges in compiling FDI figures in general and individual corporate acquisitions can cause huge swings in investment numbers over the short run. For example, at the end of 2016, there was a massive spike in Singaporean FDI flows into Russia after the sale of a stake in Rosneft to a Singapore-registered joint venture of the Qatar Investment Fund and the Swiss Glencore. On the other hand, this year the equity FDI flow from Russia to Singapore jumped.

Net flows of foreign direct investment to and from Russia

Source: Central Bank of Russia.

Russia’s 2018–20 monetary policy guidelines stress the role of inflation expectations. The Central Bank of Russia reaffirmed its inflation target of “close to 4 %” a year on average. The CBR underlined that for its rate decisions it is important to see lower inflation expectations and their lower volatility. The CBR reminded of the sensitivity of food prices (nearly 40 % of the consumer price basket) to variations in harvests and world market prices as well as government mandates to set rates for services in the housing sector (6 % of the basket). The CBR aims e.g. at broadening the circle of interbank market, lowering the market costs and phasing out its special refinancing credits.
China

China’s Silk Road Project targets countries of Central and Eastern Europe (CEE). At the 16-country CEE summit with China (16+1) this week in Hungary, last three CEE countries completed their signing of memoranda of understanding concerning China’s Silk Road Project. A dozen other deals were also signed at the get-together, mainly in the areas of transportation, investment cooperation, infrastructure and financing. Chinese sources claim China has already invested about 9 billion dollars in the CEE area. The deals made at the summit add another 3 billion dollars in new investment commitments.

The 16+1 group, first convened in 2012, is a Chinese initiative to bolster cooperation with eleven EU member states and five non-EU states in the Balkans. China has prioritised three areas for cooperation: infrastructure, advanced technology and environmental technology.

The 16+1 group, which long operated under the radar, now finds itself in the media spotlight. Part of the reason for the change is soaring Chinese foreign investment and the overall attention this raises in Europe. Moreover, some circles in the EU worry that inundation of Chinese FDI may result that China gains too much influence in the CEE region which in turn may indirectly shape EU-China policy. These suspicions have only increased with EU’s problems with certain CEE countries. In the end, however, the financing assistance offered by China is small compared, for example, to EU structural funds available to CEE countries.

China lowers import duties on consumer goods. China’s finance ministry announced last week that import duties on 187 consumer goods will be reduced starting from today (Dec 1). Import duties drop on average from 17 % to under 8 %. The wide-ranging list of consumer products includes seafood, cheeses, nuts, mineral water, alcoholic beverages, pharmaceuticals, perfumes, cosmetics, hygiene products, clothing, home appliances, household devices and baby diapers. Many products on the list are considered luxury items.

The WTO reports that the average import duty on non-agricultural products in China was 9 % in 2015, a level that is relatively low compared to other emerging economies (duties range from 6 to 60 %), but is clearly higher that in developed economies (2–4 %).

Even if the duty cuts are substantial, many observers expect their impact to be minor. The last round of duty reduction in 2015 had relatively marginal effects. Instead, the main goal of the measure seems to be levelling the playing field for online retailers and brick-and-mortar outlets. Online purchases from foreign sellers are duty-free in China if they are worth less than 2,000 yuan (250 euros). During the year, a buyer can make duty-free purchases of foreign goods up to 20,000 yuan (2,500 euros). In addition, online retailers can offer much lower value-added tax and consumption tax rates than brick-and-mortar shops.

Coal will still account for over half of Chinese power generation in 2030. China remains heavily dependent on coal. The IEA’s latest World Energy Outlook reports that coal accounted for 73 % of domestic energy production in 2016 and 65 % of energy consumption (production and imports). With its current production and consumption structure, China accounts for half of global coal demand, even if it only accounts for roughly a quarter of total global energy demand. Air-pollution problems caused by coal largely drive China’s efforts to reduce coal use.

The IEA expects Chinese energy demand to increase by 21 % between 2016 and 2030 if existing plans move forward and announced intentions are fulfilled. Growth is clearly lower than in the 2000–16 period, when demand rose by 180 %. The IEA forecast sees energy demand rising as much as 31 % without effective reforms. Sustainable development would require demand to grow by just 5 %. The report predicts that China’s own energy production will increase by just 17 % by 2030, which means the country becomes more dependent on energy imports and remains the world’s largest net importer of energy. China’s self-sufficiency in oil and natural gas is low and further increases in demand lower China’s energy self-sufficiency overall. By 2030, the IEA expects more energy demand to be covered by natural gas (10 %), various forms of renewable energy (13 %) and nuclear energy (6 %). Coal-based production, however, will still satisfy 52 % of energy demand.

Structural reforms of the energy sector require considerable investment, which IEA estimates to reach 200 billion dollars a year by 2025. On top of that, most currently operating coal-fired plants are fairly new (70 % of coal capacity consists of plants commissioned in 2005 or later) and taking them off-stream might mean abandoning of otherwise usable power infrastructure worth roughly 90 billion dollars by 2030.
Russia

Russia reaches agreement with OPEC and other oil-producing countries on keeping cuts in place. The countries collectively decided at the end of 2016 to limit their oil output by 1.8 million barrels a day. The agreement was extended for the second time on November 30 to end-2018. The agreement will be reviewed again next summer.

OPEC has often had trouble enforcing agreed production ceilings on its members, but compliance with the current arrangement seems to have been quite good. Rising oil prices, up about 25 % y-o-y in January-November, have been to a degree supported by the deal. The Brent oil price in early December has been around 63 dollars a barrel.

The fastest recovery phase for Russia’s government budgets is over. The recovery of revenues to the consolidated budget (combined budgets of federal, regional, municipal governments and state social funds) slowed in the third quarter of 2017 to 10 % y-o-y after soaring early in the year. On-year growth in the first nine months of the year was 14 %. Oil and natural gas revenues rose by 24 %, while the rapid increase in oil prices that characterised the first half of the year was no longer there to boost budget revenues. The 10 % growth in other budget revenues continued to outpace inflation. This applied to all large tax categories such as value-added tax and mandatory social taxes, and suggests that the tax bases have broadened somewhat.

Consolidated budget revenues and expenditures, 2008–2017

Consolidated budget spending rose in January-September by 6 % y-o-y. Several spending categories posted growth quite far from estimates for the year. Especially social security spending (up 13 %) has increased faster than scheduled. Spending was lower, however, for defence (down 8 %) and healthcare (down 7 %), while homeland security saw no increase, leading to performances well below estimates in these categories. Bursts of spending in these categories can be expected at year’s end when total budget spending also typically soars. The finance ministry’s 2017 spending growth estimates for the federal budget and social funds including supplementary budgets have risen to 8–9 %.

The consolidated budget for the first nine months of the year showed a slight surplus (0.6 % of GDP). The performance augurs a relatively small deficit for this year overall.

Finland at 100: Finnish-Russian trade recovering, while Russia’s share of exports is low compared to history. Finnish goods exports to Russia grew in January-September by 18 % y-o-y. While growth has slowed in recent months, it has remained brisk. Growth was led by machinery & equipment, but e.g. food exports also made a rather brisk recovery. The value of goods imports from Russia was up 45 % y-o-y in in January-September on higher oil prices and large gas pipeline deliveries in the first half. Still, the level of bilateral goods trade was well below peak levels of 2012–13. In January-September, Russia accounted for nearly 6 % of Finnish goods exports and under 14 % of imports.

During Finland’s 100 years of independence, Russia and the USSR accounted on average for about 10 % of Finnish goods exports and imports. The share fell to zero during WWII and then soared to 30 % in the first years of Finland’s war reparations to the USSR. The share again reached a new high during the oil price spike of the early 1980s. Since the 1960s, the trade has followed the price of oil, which largely determines Russia’s export earnings and import demand. For decades, the bulk of Finland’s imports from Russia have consisted of various forms of fossil fuels.

From 1861 to 1917, Russia accounted on average for 40 % of imports and exports of the Grand Duchy of Finland (Finland was then part of Russia).

The structure of Finland’s exports to Russia has evolved and diversified notably over past decades from raw timber to metals, textiles and ships and further to today’s emphasis on machinery & equipment and chemicals. The emphasis in services exports has shifted from construction projects to tourism. The significance of direct investments has also increased over the past two decades in parallel with trade.

Share of Russia / the Soviet Union in Finland’s goods trade since Finland’s independence

Source: Finnish National Board of Customs.  
*January-September
China

Finland at 100: China’s significance as a trading partner continues to rise. China is currently Finland’s sixth top export destination and fourth largest provider of imports. Throughout the past century of Finnish independence, the importance of trade with China has grown – especially in the past decade. Prior to the 2000s, China never made the top-10 list of Finland’s main trading partners. But Finnish exports to China soared in recent years, with the value of exports to China in January-September reaching 2.5 billion euros, nearly 6% of Finland’s total exports. In that period, the value of exports climbed 30%, while total Finnish goods exports rose 15%. The value of Chinese imports to Finland in January-September was 3.4 billion euros (up 13% y-o-y).

Relations with the Republic of China (1912–1949) never amounted to much in the decades following Finland’s independence in 1917. Finland, however, was among the first Western countries to recognise the People’s Republic of China in 1950. Because the PRC emphasised self-sufficiency in its early years, relations remained modest. With the advent of major economic reforms in the 1980s, however, the importance of trade with China emerged. In the 1990s, Finland consistently ran goods trade surpluses with China. China’s accession to the WTO in 2001 cemented its position as a global trade power. As trade increased, Finland began to run goods trade deficits with China. This is partly offset today by Finland’s services trade surpluses with China.

For many years in the past decade, electronics accounted for at least half of Finnish imports from China. The current share is less than a third. The share of electronics in exports has fallen from almost 40% in 2005 to 14% in January-September this year. Machinery & equipment’s share of total exports has fallen by half over the past decade and now account for less than 20%. Pulp (19% of exports in the first nine months of 2017) and wood (10%) account for an increasing share of Finnish exports to China, while paper exports have declined. Exports of furs to China peaked in 2013, accounting for 14% of total exports. This year furs accounted for just 5% of exports. About 40% of Finland’s fur exports go to China.

Trade policy disputes impair China’s relations with the West. China claims that during its World Trade Organization accession talks, Western countries agreed that it would automatically be granted market-economy status 15 years from accession in December 2016. The US and EU, however, oppose the automatic grant of market-economy status with the expiry of its accession protocol. In their view, the state’s pervasive role in the Chinese economy still distorts prices. China petitioned the WTO to resolve the matter. As the parties were unable to settle it among themselves, the dispute with the EU has already been moved before a panel selected by the WTO. The US last week submitted a brief from its trade representative to the WTO, laying out the case for not automatically granting China market-economy status.

For China, market-economy status would mean political acknowledgement of its progress in market reforms. It also governs how anti-dumping duties are imposed on imports. Without market-economy status, it is easier for WTO countries to impose higher duties on imports. Market-economy status also means that existing anti-dumping duties against goods produced in China would be changed.

As the market-economy dispute has smouldered, the EU has worked to update its own anti-dumping rules. The latest rules approved by the EU parliament in November imply that the EU can continue to use its old method of determining whether Chinese imports will be subject to retaliatory duties. The European Council has yet to approve the new rules.

Over the past five years, the global average for anti-dumping duties has been about 160 a year. The biggest duty-imposers are India and Brazil, but last year saw the US quite active as well. The hard US line is also highlighted by the fact that for the first time since the early 1990s, a US administration unilaterally launched an investigation into dumping of aluminium sheet produced in China. Generally, such clarifications are initiated at the request of the industrial branch.

China has also been active, imposing 11 anti-dumping duties last year and even more this year. The WTO said that China had already imposed 10 anti-dumping duties during the first half of the year. China’s commerce ministry reports the country has since added a number of new duties.

Number of anti-dumping tariffs imposed by country, 2007–2016

![Number of anti-dumping tariffs imposed by country, 2007–2016](chart)

Source: WTO.
Russia

Strict 2018 spending rules approved for Russia’s federal budget and pension fund. Federal budget spending is set to contract slightly next year in nominal ruble terms, which means a real decline of several per cent. The budget assumes inflation will average just under 4 % next year. Transfers to the pension fund (20 % of federal budget expenditures) will fall considerably from this year’s peak. Transfers to regional budgets, which have increased in recent years, will remain unchanged in nominal rubles (10 % of expenditures). Other federal budget spending will remain about the same. Spending marked for defence will drop sharply from current levels. Homeland security spending will see a slight increase.

Federal budget revenues are expected to increase at the pace of projected 2018 inflation. Oil & gas tax revenues, however, should fall notably if the price of Urals-grade crude remains at the assumed average of slightly below 44 dollars a barrel. Other budget revenues should continue to rise briskly. For that, the budget assumptions include projected GDP growth of over 2 %, growth in the tax base higher than GDP growth, improved tax collection, some tax increases in smaller tax categories, and also increased dividend requirements for state-owned enterprises (50 % of profits), which, however, are subject to case-by-case negotiations that will continue next year.

Federal budget spending for next year is set following the new budget rule in force from Jan. 1, 2018. Starting next year, oil & gas tax revenues calculated for that purpose are based on the Urals price of 40 dollars a barrel and other budget revenues are those in the budget’s estimate. The budget rule limits the budget deficit before interest payments on debt to 1 % of GDP next year. The actual overall budget deficit is to contract to around 1.3 % of GDP, which is within the budget rule framework.

The deficit will be financed with domestic debt and withdrawals from the government’s reserve fund, i.e. the National Wealth Fund (the two current funds will be combined on Jan. 1, 2018). The fund will be replenished with oil & gas tax revenues exceeding the calculated revenues. The fund’s liquid assets should correspond to about 2 % of GDP at the end of next year. State debt is expected to reach about 15 % of GDP. The actual overall budget deficit is to contract to around 1.3 % of GDP, which is within the budget rule framework.

Yamal peninsula LNG production comes on stream. Novatek’s massive liquefied natural gas (LNG) project includes e.g. gas production, liquefaction plants and a harbour for shipping LNG. The first phase of the project, a production “train” unit with capacity to produce 5.5 million tons of LNG annually, was commissioned last week. The ultimate capacity of 16.5 million tons should be reached by 2019.

The Yamal-Nenets Autonomous Okrug is classed as part of Russia’s Arctic Region and has long been Russia’s main natural gas production area. But with Novatek’s liquefaction plant it will be possible for the first time to transport the gas by sea via the Northeast Passage instead of pipelines. Shipping makes it possible for Russia to export gas e.g. to Asia, to which there is currently no pipelines from Russia.

The gas from Russia’s so far only LNG facility on Sakhalin Island has also been supplied to Asia. Inaugurated in 2009, the Sakhalin plant last year produced nearly 11 million tons of LNG, or about 8 % of total Russian gas exports. With the first phase of the Yamal project completed, Russia can export a total of about 16 million tons of LNG (22 billion m3 of gas). The total volume of global LNG exports last year corresponded to about 350 billion m3 of gas.

The French Total and the Chinese CNPC are the largest minority stakeholders in the Novatek project. China’s Silk Road Fund also bought a stake in the project after Novatek became subject to US financial sanctions. The project is expected to cost around 27 billion dollars. It has received financing e.g. from Russia’s National Welfare Fund (about 2.5 billion dollars), loans from Chinese (about 12 billion dollars) and Russian state banks (about 4 billion dollars). Russia has granted tax breaks to the project and LNG is exempt from export duties (gas transmitted by pipeline is subject to a 30 % export duty).

CBR becomes sole owner of Otkritie Bank. On Monday (Dec. 11), the Central Bank of Russia announced it had taken control of a 99.9 % stake in the troubled Otkritie Bank. The CBR last week estimated that bailout of the Otkritie Bank Group will require some 456 billion rubles (6.6 billion euros) in additional capital, an amount considerably higher than any previous bailout in Russia. The restructuring and integration of Bank Moskvy, originally owned by the City of Moscow, cost roughly 300 billion rubles.

At the beginning of 2017, the total assets of Otkritie Bank amounted 2.817 trillion rubles (44 billion euros), making it the country’s largest private bank. Last summer Otkritie suffered a massive run on deposits, and the CBR placed the bank under administration at the end of August. By early November, the bank’s total assets had shrunk to 2.109 trillion rubles (31 billion euros).

Today (Dec 15) CBR announced it has taken over another large private lender, Promsvyazbank. At the moment, half of Russia’s 20 largest banks are either state owned or subject to central bank restructuring programs.

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China

IMF sees complexity and opacity of China’s financial system as threats to financial stability. The IMF this month released its comprehensive Financial System Stability Assessment (FSSA) for China, which is based on the Financial Sector Assessment Program (FSAP) of the IMF and World Bank. Since the last report published in 2011, China’s financial sector has grown rapidly and increasingly embraced shadow banking sector instruments that increase systemic complexity and reduce transparency. The size of the banking sector is 310% of GDP and the overall financial sector 470% of GDP.

The FSSA notes that under-pricing of risk in China has led to excessive borrowing and that low bank deposit interest rates have encouraged flight to riskier investment vehicles. The rapid growth in popularity of such financial instruments as wealth management products and short-term wholesale funding is due in part to regulatory arbitrage, where regulation of novel financial instruments is not as comprehensive as in the case of bank lending. Non-bank financial sector operators such as trust, insurance, securities and wealth management firms have grown faster than the banking sector. Even so, such firms have inextricable hidden connections to the banking sector.

The report praised financial market reforms introduced since 2011, in particular the implementation of Basel III standards and a deposit insurance scheme, deregulation of interest rates and improvements in macroprudential supervision. The IMF welcomed China’s improved financial sector regulation and monitoring for systemic risks. The current challenge is making sure policy signals on the importance of reducing financial market risk reach provincial and local levels, where obsessions with maintaining high growth still prevail. China today by and large complies with international financial regulatory and supervision standards, but its regulators face limited independence, inadequate resources and insufficient coordination among regulatory bodies.

China’s large banks are better capitalised than other banks, with the greatest risk allocated to smaller banks that have grown rapidly in recent years. The banking sector’s generally low ratios of non-performing loans (NPLs) to total loans evidently overstate the quality of loans as an increasing share of bank lending is made with novel financial instruments. Most of this lending goes to sectors with low profitability and branches with regulatory limits to bank credit (e.g. branches suffering from overcapacity, real estate and construction). Thus, even if China’s banking system meets the minimal Basel III requirements, the FSSA recommends targeted increases in bank capital as risks may be larger than estimated.

The implicit guarantee is a special feature of Chinese financial markets. It increases moral hazard and excessive risk-taking. Because financial companies face a loss of reputation from sour deals, investor losses rarely materialise. Moreover, the state is assumed to guarantee the borrowing of state-owned enterprises and the debts of local governments. The state also intervenes to prevent losses in falling stock and bond markets. Credit is extended to unviable businesses. State ownership and control dominates the financial system, making it difficult to price risk when the state is both the owner and the regulator. Consequently, the IMF warns that financial market corrections can be huge in such conditions. China, however, still has substantial buffers and plenty of administrative tools to deal with a possible crisis.

The IMF said that lower growth in indebtedness and more effective credit monitoring will require reform of state enterprises and the winding down of unprofitable businesses. State guarantees either should be phased out or made explicit. Financial sector reforms should be sequenced to minimise the risks from dismantling moral hazards and implicit guarantees. The quality and comprehensiveness of statistical data should be improved to help the reform process.

China’s new financial market regulator begins operations. The Financial Stability and Development Committee (FSDC) created last July at the National Financial Work Conference, launched its operations in November. The committee is expected to coordinate monetary policy and financial markets regulation among China’s three main market supervisory agencies and the central bank. The committee will also oversee financial sector reform programmes and develop ways to manage financial market risk. The committee is headed by vice premier Ma Kai and it operates under the State Council.

The IMF welcomed the new committee in its latest FSSA. It would also like to see the FSDC establish a separate financial stability committee that would focus solely on maintaining financial stability and regularly monitor for systemic risk as well as to make recommendations on macroprudential policy actions. The IMF recommends a more broad-based approach to monitoring for systemic risk to replace the current sector-based approach.

European Union, United States and Japan align their China trade policy. At 11th Ministerial Conference of the WTO this week, the EU, Japan and the US announced plans for closer cooperation on the trade policy front to deal with trade-distorting policies of certain countries. Their joint communique stated that the function of global trade was harmed by state-subsidized overcapacity and large subsidies to state and private firms. The three condemned mandatory technology transfers and demands that a percentage of a given product is produced locally. The alliance announced it would seek cooperation in eliminating the unfair conditions mentioned above as well as other distortionary and protections models.

While the communique did not name countries, it was clear China was the main culprit. Advanced economies are unhappy with China’s failure to modify its bad behaviour despite negotiations. Notably, media reports suggest the cooperation came at Japan’s initiative. Through cooperation, the parties hope to command greater authority and reduce the risk of unilateral action by the US.
**Russia**

**Russian industrial output decreased; consumption continues to make a comeback.** After relatively mild industrial output declines in previous months, seasonally- and workday-adjusted industrial output fell sharply in November. Industrial output was down by about 3.5 % y-o-y, and the level of output was roughly the same as the 2014 average.

Manufacturing output suffered a particularly large drop, to a level nearly 5 % lower than in November 2016. Part of this drop was due to a high point of that reference period. Compared to the 2014 average, November manufacturing output was down about 3 %. Much of the weak performance in recent months has focused on a few branches. The slump in metal industry output has dragged down manufacturing overall. In November especially, the decline was also driven in part by the negative impacts from certain branches producing machinery & equipment.

Output of mineral extractive industries (including gas & oil) shrank in November for the fifth month in a row, and was clearly lower than twelve months earlier. As was the case in September and October, the reason was lower crude oil production. The overall reduction in industrial output in November was also due in part to a reduction in electricity production due to mild weather. Construction posted another slight decline.

Retail sales provided November’s bright spot. Retail volumes have gradually recovered all this year. November retail sales were up 2.7 % y-o-y, and over 3 % in September and October. Sales were largely boosted by the increased reliance of households on bank credit. Real household disposable incomes, in contrast, continued to perform weakly in November – even if real wages have risen substantially since the beginning of the year. Some commentators in Russia have estimated that the rise in statistically recorded wages could largely reflect successes of efforts by tax authorities to bring under-the-table wage payments into the sphere of taxed income.

**Another cut in the key rate from the CBR.** At its final interest-rate meeting of the year, the CBR board decided to keep easing monetary policy and cut the key rate by 50 basis points. Since last Monday (Dec. 18), the key rate has been 7.75 %. The CBR cut the key rate 25 basis points in October.

The markets generally expected a rate cut of 25 basis points. The CBR said its larger-than-expected rate cut was justified by lower 12-month inflation and the decision by oil-producing countries to extend their production restraint agreement to the end of this year. The CBR noted that the current low rate of inflation, around 2.5 % p.a., still largely reflects transient factors. While the agreement on holding down oil output internationally should reduce inflation risks over the next twelve months, the CBR noted that medium-term inflation risks are still on the upside.

With the annual inflation target set close to 4 %, the CBR now believes convergence to that level of inflation should be achieved within the second half of 2018. The CBR will continue its gradual transition from a moderately tight to neutral monetary stance during the first half of 2018, with a possibility of further cuts in the key rate. The next interest-rate meeting is scheduled for February 9.

**CBR takes over Promsvyazbank.** Last Friday (Dec. 15), the CBR announced it would start measures to prevent the bankruptcy of Promsvyazbank, the country’s ninth largest bank and also one of the banks considered systemically important.

The bank’s troubles have long been suspected, so market reactions were limited. Promsvyazbank is one of four large Russian private banks that have been enveloped in speculation during this year. Of them, Otkritie Bank was bailed out in August and Binbank in September. Moscow Credit Bank received additional capital in October from a share issue and long-term deposits from Rosneft. In recent years, these banks have expanded aggressively by e.g. participating in the resolution of other banks and providing currency financing for Russian firms affected by Western sanctions.

The systemic impact of these troubled banks should remain modest, however, as each only holds about 2–3 % of the banking sector’s total assets. Preliminary CBR estimates suggest that that the recapitalisation of the three above-mentioned banks will require about 1 trillion rubles (14 billion euros). Russia’s banking sector is dominated by large state-owned banks and many of them have also received government support in recent years amidst a weak economy.

Alexei Ulyukayev, Russia’s former economy minister, convicted of soliciting bribes. Ulyukayev was arrested in November 2016 for demanding a 2-million-dollar bribe from Rosneft CEO Igor Sechin for supporting Rosneft’s acquisition of state-owned oil company Bashneft. Last Friday (Dec. 15), Ulyukayev was sentenced to eight years in a prison colony and fined 130 million rubles (nearly 2 million euros). The muddled trial drew mixed reactions and many Russian observers say the case was politically motivated.
China

People’s Bank of China tightens monetary stance a bit. The US Federal Reserve (Fed) raised its main reference rates last week by 25 basis points to a target level of 1.25–1.50%. The People’s Bank of China (PBoC) followed by raising its reverse repo rates, i.e. the rates it uses to signal the monetary policy stance, by 5 basis points. The 7-day reverse repo rate climbed to 2.5%. On the interbank market, there was no indication of higher repo rates, however, and short-term Shibor rates remained in the range of 2.7–2.8%. Reverse repo operations are mainly used to cover the regular liquidity needs of banks. Looking at the PBoC’s short-term and medium-term lending facilities (SLF and MLF) to banks, at least the one-year MLF rate was raised by 5 basis points.

The PBoC last raised rates in March just after the Fed raised rates. However, the PBoC did not follow the Fed in June to raise rates. China’s exceptionally cautious interest-rate policy reflects the difficult choices confronting monetary policymakers at the moment. On one hand, China needs to hold rates sufficiently higher than US rates to prevent pressures on capital flight and weakening of the yuan. A tighter monetary stance with higher rates would also help calm the growth in indebtedness. The actual rise in market rates already reflects these concerns. On the other hand, policymakers face pressure to meet tough official economic growth targets. A rate increase may also be a cause of concern from a financial stability point of view by further impeding loan re-payments and limiting the access to credit of firms already struggling with solvency issues. A modest inflation rate of just under 2% and a stable inflation outlook provides a modicum of relief to the challenges facing policymakers.

It is difficult to give a clear appraisal of Chinese monetary policy due to its multiple goals and shifting monetary policy framework. In order to bring clarity and to emphasise the in-policy due to its multiple goals and shifting monetary policy of relief to the challenges facing policymakers.

China’s leaders lay out areas of economic emphasis for next three years. The annual Central Economic Work Conference, held in Beijing this week, determined that upcoming economic policy will concentrate especially on financial sector risks, pollution and poverty. While the conference themes certainly reflected topical Chinese issues, releases from the conference suggested few concrete measures to deal with these problems. As previously, the meeting participants stressed quality of growth, yet failed to announce the official end to numeric growth targets. The familiar themes of “pro-active” fiscal policy and “prudent” monetary policy were reiterated, making it hard to say where economic policy is headed.

Chinese taking on more debt to buy apartments; housing prices flat. The PBoC reports that the average household debt burden has soared this year, up about 30% y-o-y. While growth has slowed slightly in recent months, it is still somewhere above 6%. The debt of Chinese households corresponds to less than 50% of GDP, which is still rather modest by international standards. About 75% of the debt consists of housing loans.

While most Chinese own the apartment in which they live, purchasing an apartment with a bank loan and mortgage is a relatively new trend in China. Buyers earlier paid cash for apartments, and part of that cash was borrowed from parents or extended family members. The vibrant growth in apartment loans, however, has made banks and households increasingly exposed to a possible decline in housing prices. Apartment buyers are known to use consumer loans and other short-term financing to cover their downpayment requirement (30% of the apartment’s price, for example, in Shanghai). Other credit channels – even illegal ones – are also used to circumvent the downpayment requirement.

The rise in housing prices in recent years reflects the rapid growth in housing loans. In China’s largest cities, housing prices are among the highest in the world when adjusted to local income levels. China’s top leaders have long worried about expensive housing. To calm the situation, many cities have tightened the rules on apartment sales by e.g. further increasing the downpayment requirement or making a rule that buyers cannot resell their apartment for two, three or even five years from the date of purchase. Banking supervisors are also expected to have increased scrutiny of housing loans.

The National Bureau of Statistics reports housing prices in big cities remained largely unchanged during the summer and autumn in big cities. In smaller cities, however, the increase in apartment prices continued, albeit at a more modest pace. Variations in housing markets across regions are huge, and can even vary wildly from city to city or neighbourhood to neighbourhood.

The slowing of housing price growth is reflected in construction activity. Growth in housing construction activity slowed substantially in late summer and autumn, but revived in November. Purchases of land use rights for lots zoned for construction have also picked up sharply since summer.

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China’s interest rate “corridor” and interbank rates

<table>
<thead>
<tr>
<th>Year</th>
<th>MLF 1Y</th>
<th>MLF 7D</th>
<th>SLF 7D</th>
<th>Shibor 7D</th>
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Sources: Macrobond, BOFIT.