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BOFIT Weekly Review – Russia 2018

5 Jan 2018 BOFIT Weekly 2018/01
Ruble rise halted in 2017
Russia doubles oil pipeline transmission capacity to China
Uneven growth outlooks for countries in CIS region

12 Jan 2018 BOFIT Weekly 2018/02
Russia depletes its second oil fund
State gives small income hikes and tiny tax reliefs to Russians
Sistema to pay damages to Russian oil giant Rosneft in Bashneft deal

19 Jan 2018 BOFIT Weekly 2018/03
Russian foreign trade continues to recover; capital outflows up slightly
Russian currency reserves rose by 55 billion dollars last year
Concerns over Russia's regional budget deficits

26 Jan 2018 BOFIT Weekly 2018/04
Relatively slow growth outlooks for Russian economy
Improved Russian federal budget performance; deficit shrinks
Russian foreign debt turned to slight growth last year

2 Feb 2018 BOFIT Weekly 2018/05
Primary production up in Russia; manufacturing hardly at all
US refrains from imposing new sanctions on Russia, but Power Machines goes on the sanctions list
Sharp drop in births in Russia

9 Feb 2018 BOFIT Weekly 2018/06
Russian economic recovery slow last year
Role of the Russian state in banking sector continues to expand
Fast growth in household lending in 2017

16 Feb 2018 BOFIT Weekly 2018/07
CBR lowers key rate; oil, ruble and stock markets down in recent weeks
Machinery, equipment and vehicles drove the growth of Russian goods trade
Wide variations in Russian manufacturing branches last year

23 Feb 2018 BOFIT Weekly 2018/08
Russia's fiscal sector strengthened in 2017
Russian retailer Magnit sold to state-owned bank VTB
Russia loses more educated people than receives

2 Mar 2018 BOFIT Weekly 2018/09
Foreign currency sovereign credit ratings on Russia upgraded
Improvement of Russia's government sector finances at all budget levels
Strong growth in Finnish-Russian trade

9 Mar 2018 BOFIT Weekly 2018/10
Russian investments focused increasingly on oil & gas last year
CBR prepares strategy paper on improving access to banking services in 2018–2020
Gas dispute between Russia and Ukraine continues to flame

16 Mar 2018 BOFIT Weekly 2018/11
Russian oil production expected to remain at current levels also this year
Uneven development in Russian regions last year
Russia and China score low in the OECD services trade index
23 Mar 2018 BOFIT Weekly 2018/12
Putin wins Russian presidential election as expected
Russian government places two Eurobond issues
Number of people employed in Russia declined last year; labour force also shrank

29 Mar 2018 BOFIT Weekly 2018/13
Latest BOFIT Russia forecast sees gradual economic recovery continuing
Muted market reaction in Russia to expulsion of Russian diplomats
Central Bank of Russia lowers key rate by 0.25 % and signals plans to keep cutting
Russian economy started to recover again in January-February

6 Apr 2018 BOFIT Weekly 2018/14
More light on developments in the Russian economy last year
Russian central bank plans to start “bad” bank
Profits of Russian firms have supported out-of-pocket funding for investments; bank borrowing has been low

13 Apr 2018 BOFIT Weekly 2018/15
Russian markets dive after US imposes more sanctions
Russia’s import recovery slows; outflows of private capital increase slightly
Russian natural gas production grew briskly last year

20 Apr 2018 BOFIT Weekly 2018/16
Russia’s economic recovery stumbles again
Russia and the US holding off on new sanctions
IMF expects the Russian economy to grow by 1.7 % this year

27 Apr 2018 BOFIT Weekly 2018/17
Russian government receives abundant excess oil revenues
Proposal on stricter import control for Russian state-owned enterprises
Russian household consumption recovers

4 May 2018 BOFIT Weekly 2018/18
Russian central bank keeps the key rate unchanged at 7.25 % p.a.
Russian defence spending declines, but remains substantial
Russian tourism abroad up in 2017

9 May 2018 BOFIT Weekly 2018/19
Putin’s newest May Decree sets out typical government target and task list through 2024
Sale of Rosneft stake to CEFC cancelled
Foreign bank lending to Russia has declined notably

18 May 2018 BOFIT Weekly 2018/20
Price tags on Putin’s new economic initiatives revealed
Rapid growth in Russian goods trade continued in first quarter
Growth of Russia’s defence industry slowed last year

25 May 2018 BOFIT Weekly 2018/21
No large economic policy changes expected from Russia’s new cabinet
Reasonable recovery in Russian domestic demand; growth in output slower
Russian Duma approves new counter-sanctions bill
American sanctions affecting Russian firms
1 Jun 2018 BOFIT Weekly 2018/22
Russia’s government sector deficit shrinks, the reserve fund will increase
EU and Gazprom resolve long-running gas dispute
Russia to require unique identifiers for many consumer products next year

8 Jun 2018 BOFIT Weekly 2018/23
Russian fixed investment continue reasonable recovery, with further weight on oil and gas
Russia's goal of halving poverty would not require massive amounts of funds
Growth in Finnish-Russian trade cooled in 1Q18

15 Jun 2018 BOFIT Weekly 2018/24
Russian president visits China
Changes is Russia’s currency reserve composition
FDI inflows to Russia remain at low levels

21 Jun 2018 BOFIT Weekly 2018/25
CBR keeps key rate unchanged, tightens guidance
Russian government submits proposals to the Duma on raising the retirement age and VAT hike
Russian GDP forecasts cut after new US sanctions

29 Jun 2018 BOFIT Weekly 2018/26
Slow recovery in Russian consumption continues; good increases in industrial output
OPEC and Russia agree to keep production pact in place
Recent Russian market swings fairly modest compared to other emerging markets

6 Jul 2018 BOFIT Weekly 2018/27
Russian oil fund topped up with last year's oil revenues
CBR injects more money into troubled banks
Revised Rosstat figures give a significantly brighter view of recent industrial output growth

13 Jul 2018 BOFIT Weekly 2018/28
Russian import growth slows further; net flow of foreign liabilities turns negative
Russian inflation remains subdued, but inflation expectations are rising
Large hikes in revenue and spending of Russia’s preliminary budget framework

20 Jul 2018 BOFIT Weekly 2018/29
Russian economy continues mixed performance
Russian and U.S. presidents met in Helsinki
FIFA World Cup provides small boost to Russian economic growth

27 Jul 2018 BOFIT Weekly 2018/30
Russian Megafon plans to delist from London stock exchange
Russia's near-term plans for government sector finances taking shape
Changes in financing of Russian housing construction

3 Aug 2018 BOFIT Weekly 2018/31
Russian central bank still keeps key rate unchanged at 7.25 %
Oil revenues continue increasing for the Russian government
Household borrowing up in Russia

10 Aug 2018 BOFIT Weekly 2018/32
Nationwide increases of manufacturing output and retail sales in Russia
Russia approves laws establishing domestic tax havens
Russia rises to 75th place in the World Bank’s logistics performance ranking for 2018
Ruble struggles and Russian share prices slide as US adds sanctions, oil prices fall and emerging markets face problems
Higher oil prices drove growth in earnings from Russian goods exports in first half

Russian economic growth remains sluggish
Tax code revisions impact Russia's oil sector
Russia approves changes in taxation on consumption and corporations

Russia's public finances in overall balance
CBR suspends foreign currency purchases tied to the fiscal rule until the end of September
Caspian Sea states make progress in jurisdiction of territorial waters

Changes in structure of fixed investment in Russia
Russia modifies rules on repatriation of foreign trade earnings
Russian export volumes up significantly in recent years

Russian oil companies see major improvements in earnings
Russian state plays an ever-increasing role in directing investment
Russian oil production expected to increase slightly in coming years

CBR raises the key rate by 0.25 percentage points and prolongs the suspension of currency-buying under the fiscal rule through December
IMF's annual Article IV consultations with Russia stress ongoing need for reform
Russia's fourth large natural gas liquefaction unit started production

Russian industrial output and retail sales continue relatively strong growth in August
Growth in Finnish-Russian trade subsides

BOFIT forecasts low growth for the Russian economy in coming years
Russian oil production hits peak in September
Retirement age hike approved in Russia

IMF expects only modest Russian growth in coming years; decelerating growth in China
Growth in Russian imports stalls; capital outflows increase
FIFA World Cup boosted Russia's tourism exports in summer

Net exports lifted Russian economic output numbers in the second quarter; domestic demand slack
The role of the US dollar as a payment currency is under discussion in Russia
Poor health lowers Russia's ranking in human capital comparisons

Russian unemployment falls and wages continue to rise; real incomes contracted in August-September
Russia was ranked the 43th most competitive country by the World Economic Forum this year
IMF estimates that the government sector and public sector firms account for a third of Russia's GDP
2 Nov 2018 BOFIT Weekly 2018/44
Central Bank of Russia keeps key rate at 7.50 %
Higher export prices drive up industrial producer prices in Russia
Eurasian Economic Union is taking steps to harmonize external tariffs and lower internal barriers

9 Nov 2018 BOFIT Weekly 2018/45
National Welfare Fund holds 76 billion dollars; assets expected to rise before the end of the year
Wage growth varies considerably across sectors in Russia
Russia’s ranking improves slightly and China’s considerably in World Bank’s Doing Business index

16 Nov 2018 BOFIT Weekly 2018/46
As the ruble weakens, Russian import spending growth lags export earnings growth
Significant drop in oil prices could lead to new production limits
CBR’s monetary policy programme for 2019–21 sees good bank liquidity ahead

23 Nov 2018 BOFIT Weekly 2018/47
Russian economic growth slows in the third quarter, with signs of a possible pick-up in October
Price regulation disrupts Russian fuel markets
Russia and Turkey celebrate progress in Black Sea gas pipeline project

30 Nov 2018 BOFIT Weekly 2018/48
Dry summer reduces Russian harvest
Robust increase in Russian government revenues, substantial budget surpluses
A fifth of foreign debt of Russian banks and other businesses denominated in rubles

7 Dec 2018 BOFIT Weekly 2018/49
Ruble rate holds steady despite falling oil prices and Kerch Strait skirmish
Russia approves 2019 federal budget and social fund budgets

14 Dec 2018 BOFIT Weekly 2018/50
Russia and OPEC agree on new production limits
Fixed investment growth in Russia accelerated in the third quarter
The third unit of the natural gas liquefaction plant in Yamal went into operation in November

21 Dec 2018 BOFIT Weekly 2018/51–52
Modest growth in Russian industrial output continues
CBR raises key rate and announces resumption of the fiscal-rule forex buying in January
Ukraine gets new IMF programme
Yuan strengthened against the dollar and weakened against the euro in 2017
Weakness in mainland China stock markets last year relative to stock markets globally
Reduced sales tax discount on small vehicles cools car sales in 2017

China's central bank re-adjusts its exchange rate mechanism
New limits on China's financial markets
China posts moderate consumer price inflation in 2017; producer prices climb

China's latest GDP growth figures in line with expectations
New cases of fudged statistics at provincial and local levels
Growth rate in Chinese imports outstripped exports last year; trade surplus shrunk

Forecasts of major international institutions see China sustaining strong growth in coming years
Lower growth in China's debt ratio
Borrowing becomes more expensive in China

Did structural economic change in China come to a halt last year?
Rise in housing prices in China slowed last year
Yuan strongest against dollar since August 2015 mini-devaluation

China's new initiatives to protect the environment
Beijing's population growth stopped last year

China's current account surplus fell to 1.4 % of GDP last year
Market turbulence rocks China, too
China's January inflation slowdown was broad-based

Big differences in regional economic growth rates
Restrictions diminished outward FDI flows from China last year

China's financial regulator takes over the country's third largest insurance company
More joining the ranks of China's consumer class
Finnish goods exports to China rising much faster than exports generally

The official GDP growth target continues to dictate China's economic policy
Assessing true condition of China's public sector finances remains challenging
China may introduce retaliatory measures as the US goes ahead with steel and aluminium import tariffs

National People's Congress blesses party's constitutional supremacy with almost no dissent
China broadens capital tools for banks and lightens provisions for non-performing loans
Rapid growth in Chinese R&D spending
23 Mar 2018 BOFIT Weekly 2018/12
Yi Gang named PBoC governor
People’s National Congress endorses numerous high-level appointments
Chinese economy powers ahead in first two months of 2018

29 Mar 2018 BOFIT Weekly 2018/13
BOFIT China forecast sees lower GDP growth in coming years due to larger economic imbalances
US takes hard line on China trade policy
Guo Shuqing to head newly created banking and insurance regulator and serve as PBoC party secretary

6 Apr 2018 BOFIT Weekly 2018/14
Profits of China’s biggest banks surged last year
China-US trade policy dispute heats up
Every fifth international patent application now comes from China

13 Apr 2018 BOFIT Weekly 2018/15
President Xi repeats his commitment to reform and easier access to China’s markets
China launches trading of yuan-denominated oil futures on Shanghai futures exchange
China seeks to increase soy production

20 Apr 2018 BOFIT Weekly 2018/16
China continues to report implausibly stable growth
Despite a larger surplus with the US, China’s goods trade surplus contracted overall in the first quarter
China lowers its bank reserve requirement by one percentage point

27 Apr 2018 BOFIT Weekly 2018/17
Housing price rise in China’s big cities lower than national average
Despite the aim of curbing financial market risks, the Chinese continue to pile on debt
Renewed efforts to rein in local government debt in China

4 May 2018 BOFIT Weekly 2018/18
IMF GFSR: Complex corporate arrangements obscure risk assessment of China’s financial sector
Higher foreign investor quotas for Chinese stock markets
China eases operating possibilities of foreign firms in the financial sector

9 May 2018 BOFIT Weekly 2018/19
China shows large current account deficit for January-March
China-US trade dispute worsens as lists of demands lengthen
China still has a long way to go to achieve full deregulation of bank deposit and lending rates

18 May 2018 BOFIT Weekly 2018/20
Moderate slowdown in China’s economic growth continues
Chinese inflation remained modest in March and April
Robotisation of China zooms along

25 May 2018 BOFIT Weekly 2018/21
Threat of imminent US-China trade war subsides again
Chinese firms increasingly missing bond payments as financing opportunities tighten
Over 500 million Chinese have been lifted out of poverty in recent decades

1 Jun 2018 BOFIT Weekly 2018/22
Tight regulations affect income generation of China’s insurance sector
New rules require Chinese insurance companies to reveal their ownership structures
US threatens further tariffs on China
Despite underdeveloped markets, mainland China shares now included in MSCI indices
Yuan appreciation continues this year
PBoC extends range of acceptable collateral from banks in medium-term borrowing
Sluggish first-quarter growth in Finland-China trade

Slowdown in Chinese growth more broad-based in May
China further reduces import duties on consumer goods
China imported a record amount of crude oil in the first five months of this year

China and the United States back on the brink of a trade war
Rising opposition to ZTE's deal with the US
New faces on the PBoC's monetary policy committee

PBoC lowers bank reserve requirement ratios on higher economic uncertainty
Profits of European firms in China rise despite more challenging operating environment

Hardest aspects of US planned restrictions on Chinese investment fall away, but trade war still on
China's negative list cut to 48 branches restricted or banned to foreign investors
Chinese market jitters emerged in June

United States and China impose import tariffs on each other; intensification of trade dispute looms
China and Russia impose most trade and investment barriers on European firms

Official figures show Chinese economic growth slowing only marginally in the second quarter
Stock of bank lending continues to grow, even as China's shadow banking sector lending declines
Banks still the largest issuers of green bonds in China

Yuan depreciation continued in July
PBoC grants commercial banks credit to buy corporate bonds
More Chinese companies make Fortune Global 500 list

IMF wants China to continue with reforms
China concerned about slowing growth
Stakes escalate in China-US trade dispute

China's central bank seeks to cushion depreciation pressures on the yuan
Increased uncertainty halts planned issuance of CDRs in China
Local governments in China struggle with access to finance

Lower fixed investment depresses Chinese growth
China's trade surplus continues to narrow
Bank loans gain popularity as regulators have limited the access to other credit sources in China
Retail sales in China slide below GDP growth target
Stock of Chinese bank loans soars
Robust growth in Chinese commodity imports continues

Rise in Chinese housing prices moderates
Large differences among Chinese provinces in terms of living standards and economic growth

EU steps up oversight of investment inflows from China
Labour strife on the rise in China
China enjoys another year of bountiful harvests

China and the US agree to postpone tariff hikes to give negotiators time to resolve trade disputes
China and United States defend WTO reforms, but still far apart on agreement content
Markets reacted cautiously to Trump-Xi truce

Growth of China’s foreign trade slowed sharply in November; trade talks confront new problems
Rise in Chinese prices remains modest
Even with slowing growth, Hong Kong economy continues doing well

China celebrates 40 years of economic reform
China’s economic growth continues to slow
Russia

Ruble rise halted in 2017. After appreciating for a few months early last year, the ruble’s exchange rate generally slid down. While the ruble’s December average rate was up 6 % y-o-y against the US dollar, it was down against the euro by over 5 % y-o-y. The ruble’s nominal effective exchange rate (trade-weighted basket) was largely unchanged from December 2016. Relative to its 2016 lows on average, the ruble last year was up by nearly 15 % against the euro, dollar and the trading-partner currency basket. The strong recovery in Russian imports was driven by ruble appreciation.

Compared to previous years, the ruble’s exchange rate occasionally diverged more from the courses of oil prices. In the early months of 2017, a strong current account surplus supported the ruble. This is typical as imports are low in the early months. In addition, the financial account rather exceptionally showed a surplus, i.e. net inflows of capital into Russia. The final months of 2017, however, witnessed a slight drop in the ruble’s exchange rate despite rising oil prices and a current account surplus because the net outflow of private capital increased (preliminary estimate from the central bank), which observers note was due e.g. to expectations of tightening by the US Fed and the announcement of new US sanctions.

Besides these market flows, the finance ministry’s forex market purchases through the central bank were small in the total volume of forex trade, and their impact on the ruble has been considered insignificant. The new budget rule permits more forex buying if oil prices significantly exceed the rule’s basic calculation price (Urals USD 40/barrel).

Russia doubles oil pipeline transmission capacity to China. This week saw the commissioning of the expanded China extension of the Eastern Siberia–Pacific Ocean (ESPO) oil pipeline. The Russia-China leg’s transmission capacity is now at 30 million metric tons a year, but much oil is also shipped by sea to China. China and Russia last year became each other’s largest individual markets for oil. China accounted for about 20 % of Russian oil exports, but still about 60 % of Russian oil exports went to EU. Russia’s share in Chinese oil imports was about 14 %, while about 40 % of imports came from countries in the Middle East and about 20 % from Africa.

Preliminary figures suggest Russia’s total oil exports were up about 1 % last year to 257 million metric tons. Russia’s economy ministry expects exports this year to remain roughly at the 2017 level. Export growth may be restricted e.g. by Russia’s agreement with OPEC to adhere to production caps.

While no natural gas pipelines yet run from Russia to China, Gazprom reports that slightly over half of the first phase of construction of the Power of Siberia gas pipeline has been completed. Transmission of pipeline gas is slated to start in December 2019. The Yamal Peninsula LNG project that got underway last month is, however, likely to supply first LNG deliveries to China already this year.

Uneven growth outlooks for countries in CIS region. The latest IMF forecasts predict GDP growth for nearly all countries in the CIS region this year. The rates of growth, however, are expected to vary much across countries. Low oil prices in recent years have depressed growth in energy-producing countries with knock-on effects to neighbour countries. Weakness in the Russian economy, for example, has spilled over to Belarus, which trades considerably with Russia (48 % of Belarusian exports went to Russia in 2016). From other energy-producing countries in the region, particularly Azerbaijan’s economic development has been weak. Ukraine has recovered somewhat from its economic crisis. Growth has still been sluggish, especially taking into account that the level of 2016 GDP was about 14 % lower than in 2012.

Even with crude oil accounting for over half of its exports, Kazakhstan has managed in recent years to sustain a moderate GDP growth despite low oil prices. Kazakhstan has benefited from the recovery in many EU economies, China’s high growth and increased global demand for commodities. Last year about 19 % of Kazakhstan’s exports went to Italy, 12 % to China, 10 % to the Netherlands and 10 % to Russia. Central Asian countries have benefited from China’s rapid growth and more recently the recovery in Russia.

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Source: IMF WEO.
China

Yuan strengthened against the dollar and weakened against the euro in 2017. Depreciation pressures on the yuan increased in the wake of the August 2015 mini devaluation, with the yuan-dollar exchange rate weakening through late 2016. To halt the yuan’s slide and stem capital outflows, China cracked down on capital exports and stabilised the yuan’s external value. In 2017, the yuan gained 6.7% against the dollar, weakened 6.2% against the euro, and remained fairly stable against a basket of currencies of China’s main trading partners (nominal effective exchange rate or NEER). The yuan’s appreciation against the dollar reflected the general weakness of the dollar against other currencies. The stability of the yuan’s real effective exchange rate (REER) suggests that there was little change in China’s price competitiveness in 2016. On Thursday (Jan. 4), one dollar bought 6.49 yuan and one euro 7.84 yuan.

Yuan exchange rate vis-à-vis the US dollar, euro and a weighted basket of currencies of China’s main trading partners (NEER)

Weakness in mainland China stock markets last year relative to stock markets globally. In 2017, the FTSE All-World Index climbed 25%, the MSCI Asia Index (excluding Japan) soared 39% and the MSCI Emerging Market Index rose 34%. In contrast, stock exchanges in mainland China lagged the global development, with the Shanghai Composite Index ending the year up 7% and the Shenzhen Composite Index down 4%.

Share prices of large Chinese firms significantly outperformed prices of small firms last year. The CSI300 Index of the stock exchanges’ 300 largest firms rose 22%, while Shenzhen’s index of small high-growth firms, the ChiNext Index, fell by 11%. This partly reflected the convergence in prices after the bursting of the stock price bubble. Shares of Chinese companies listed outside mainland China generally fared better than shares traded on domestic exchanges. For example, the share index of mainland Chinese firms listed in Hong Kong rose by 25% last year. The shares of firms listed on both mainland China and Hong Kong exchanges, however, are still on average 30% cheaper in Hong Kong than in China. The Hang Seng, Hong Kong’s main share index was up 38% last year.

With well over 400 IPOs in mainland China last year, the pace of IPOs nearly doubled from 2016, and hundreds of firms still await listing dates.

Reduced sales tax discount on small vehicles cools car sales in 2017. China has become the world’s largest car market in recent years as Chinese have been keen to adopt the driving lifestyle. The stock of passenger cars rose from around 90 million in 2012 to 160 million in 2016. And there is still plenty of room for growth: car ownership was only 0.35 cars per urban household in 2016. For example, Finnish households own about one car per household (rural and urban areas combined).

Despite the appeal of driving, car sales slowed in 2017. Passenger car sales were up just 2% y-o-y in the January-November period (in the same period in 2016, sales were up 16%). Annual sales of new cars in China today have reached nearly 25 million passenger cars and over 4 million commercial vehicles.

Much of the high growth in 2016 car sales reflects a tax incentive in which the government temporarily halved the 10% sales tax on cars with engine volumes of less than 1.6 litres. The sales tax was then increased to 7.5% in 2017, and this year restore to 10%. Given the reinstatement of the sales tax at its old level, the outlook for car sales this year is modest at best, even if people in inland towns and cities are wealthier and financing of car purchases by loans is increasing.

Domestic car makers held on to a 43% market share in January-November 2017. China aggressively protects its domestic car industry to the detriment of foreign carmakers. Foreign carmakers face such requirements as having to enter into joint ventures with Chinese firms to be allowed to operate in China.

Sales of electric and hybrid vehicles in China last year reached 500,000, which corresponds to about half of global sales of electric and hybrid vehicles. Despite the high growth, sales of such vehicles represent only a few per cent of total passenger car sales.
Russia

Russia depletes its second oil fund. The remaining assets of the Reserve Fund, about 17 billion dollars (1 trillion rubles) were allocated in December to cover the federal budget shortfall. As decided last summer, the Reserve Fund is now closed and the National Welfare Fund remains Russia’s sole oil fund. Russia decided to divide its sovereign oil wealth fund into two funds in 2008. The Reserve Fund was intended for covering budget deficits, while the National Welfare Fund was intended to finance pensions. During 2015-2017, Russia drained roughly 90 billion dollars from the Reserve Fund to cover budget spending.

The value of the National Welfare Fund fell by 7 billion dollars last year, mostly due to financing of pensions. At the start of 2018, the Fund held assets of 65 billion dollars (3.75 trillion rubles). Nearly 40 billion dollars are liquid assets, with the rest invested in e.g. long-term deposits in state-owned banks or infrastructure projects. The Fund will be filled with last year’s higher-than-expected oil revenues of about 14 billion dollars ($4 billion rubles) according to finance minister Siluanov. Therefore Russia’s liquid oil fund assets total around 50 billion dollars (3 % of GDP).

Fund assets of about 19 billion dollars (1.1 trillion rubles) are planned be used this year to cover budget deficit, but the budget is based on a cautious oil price assumption of 44 dollars a barrel. Only a small depletion of Fund assets is planned for 2019–20.

State gives small income hikes and tiny tax reliefs to Russians. Wages and pensions paid out of government budgets at various levels fell sharply in real terms in 2014–16 on small nominal cost-of-living adjustments (COLAs) especially compared to inflation that flared up in 2015. General COLAs were reintroduced last year for pensions and most focal forms of social support. This year they and the general increase for civil servants will be closely COLA-based (projected inflation under 4 %). The increases are small relative to huge hikes of earlier election periods (2007–08 and 2011–12). After a freeze for the past four years, president Putin last spring proposed a general increase in government sector wages. Civil servants working at the federal, regional or local level received general increases on 1 January 2018. Wages for those government sector workers for whom Putin in spring 2012 ordered large and long upward adjustments will continue to rise rapidly. The general hike in the minimum wage at the start of the year also gives a boost for some budget-sector workers. The increase was over 20 % and a further hike (some 15 %) was just promised by Putin for 1 May (instead of 1 January 2019 set up to now). That will raise the minimum wage for the first time to the official subsistence minimum.

Old-age pensions were also raised already on 1 January, while the zero-hike policy for working pensioners continues. The hikes to recipients of government pensions and social pensions, irrespective of working status, come in spring. The maternity capital pack is extended to 2021. Its use in buying or building a home or paying for child care have been eased. Part of low-income families with small children will now receive monthly maternity support for up to 1.5 years per child. All pensioners will now be eligible for a revised land tax discount that applies e.g. to small home plots. Uncollectable tax arrears, their increases and fines levied on private persons for property, land or vehicle taxes incurred before 1 January 2015 will be erased from the record. The same applies to all taxes of current and former no-company individual entrepreneurs and practitioners (except excise taxes, foreign trade taxes and taxes on resource extraction), as well as their belated mandatory social taxes from before 1 January 2017.

Sistema to pay damages to Russian oil giant Rosneft in Bashneft deal. Bashneft, a mid-sized oil company was privatized at the start of the 2000s to the leaders of Bashkortostan. A few years later the company was bought by business tycoon Vladimir Yevtushenkov, owner of the Sistema conglomerate. In 2014, Bashneft’s assets were seized by the government on the premise that the privatisation was illicit. In 2016, the government decided to have a second go at privatisation of Bashneft and it was sold to state-owned Rosneft. Last spring Rosneft started court cases against Sistema for abuses during its Bashneft ownership. With support from president Putin, the companies finally reached an agreement last month with Sistema paying Rosneft 100 billion rubles (1.4 billion euros) in damages. Sistema is set to receive help to meet its obligations from the state-owned Russian Direct Investment Fund (RDIF). The RDIF and the China Investment Corporation are minority partners in Sistema’s children’s goods retailer Detsky Mir. Detsky Mir’s December share offering was cancelled due to the Sistema court case. Bashneft’s seizure was at the time seen by some to have parallels with the Yukos case and many view also the current case as a negative sign of Russia’s business climate. The current court case was actually already second related to Rosneft’s Bashneft deal. The former economy minister Alexei Ulyukayev was recently convicted for demanding a bribe from Rosneft CEO Igor Sechin for supporting the deal.
China

China’s central bank re-adjusts its exchange rate mechanism. On Tuesday (Jan. 9), the yuan dropped 0.5% against the US dollar to a level of 6.53 after the People’s Bank of China announced changes in setting the daily fixing price for the yuan-dollar rate. Under the latest PBoC guidance, banks that participate in setting the daily fixing rate no longer need to include the countercyclical factor which according to market participants has supported the yuan’s external value. The central bank refrains from intervening in forex markets as long as the yuan’s daily deviations from the fixing rate are less than 2%. The fluctuations have actually been considerably smaller.

The PBoC introduced the use of the vaguely defined countercyclical factor last May arguing it would be needed to prevent excesses by the markets. With the dollar’s depreciation over the past year and confidence returning to the yuan, the central bank saw it possible to return to its old scheme that is based more on pure of supply-and-demand conditions in the market. Of course nothing prevents the reintroduction of the countercyclical factor if conditions change.

China’s stated goals are a much freer formation of the exchange rate and deregulation of capital movements, but progress in this direction has been sporadic at best. While liberalisation of capital imports has continued, controls on capital exports have tightened. Last week, Chinese officials restricted the amount of foreign currency private individuals could annually withdraw from their domestic accounts while abroad to 100,000 yuan (USD 15,400), and just 10,000 yuan (USD 1,540) per day. Earlier limits were based on personal accounts. The total amount of currency exchange per person remains at 50,000 dollars per year, but monitoring of such transactions has also been intensified.

China’s foreign currency reserves grew last year by nearly 130 billion dollars to 3.14 trillion dollars. This was due in part to fluctuating exchange rates. In 2015–2016, China’s currency reserves shrank by over 830 billion dollars.

New limits on China’s financial markets. The China Banking Regulatory Commission (CBRC) decided at the start of this year to restrict entrusted loans, whereby banks or specialised lenders move money owned by one firm to another firm. In the worst-case abuses, the company issuing the entrusted loan just borrows from a bank to make a loan for another firm that fails the bank’s lending criteria. As the middle man is such arrangements, the bank typically pockets fees for e.g. setting up the loan and loan guarantee, but often fails to supervise the loan’s performance. The new rules prevent banks from active involvement in the entrusted loan business. Firms will no longer be allowed to purchase securities or derivatives with entrusted loans.

The new regulations are part of a crackdown on the shadow banking sector. Shadow banking is estimated to have doubled over the past ten years and now accounts for roughly 15% of private-sector financing under China’s total social financing (TSF) definition. The growth in entrusted loans has been stunning. The stock of entrusted loans is now nearly 14 trillion yuan (USD 2.1 trillion) and accounts for over half of the shadow banking sector’s TSF. The restrictions on entrusted loans extend earlier measures by the PBoC and supervisory agencies to quell off-balance-sheet lending and speculation on margin.

The new regulatory reforms rolled out this year also affect other parts of China’s financial markets. New bond-trading rules to be introduced after a one-year transition include a requirement for written contracts on all bond repo and derivative transactions as well as leverage ratio restrictions on all buyers. Off-book trading and speculation on margin are common practices in China’s roughly 67 trillion-yuan (USD 10.3 trillion) bond markets.

Reuters reports that the PBoC plans this year to limit the issuance of negotiable certificates of deposit (NCDs). Banks have been advised to obtain central-bank permission on their 2018 NCD quotas, which, combined with their interbank liabilities, may not exceed one-third of the applicant bank’s total liabilities. The value of outstanding NCDs last year reached 8 trillion yuan (USD 1.2 trillion). NCD issues are popular particularly among small lenders for financing of longer-term investments, often via the shadow banking sector.

China posts moderate consumer price inflation in 2017: producer prices climb. Consumer prices last year rose by just 1.6%, well below the government’s target ceiling of 3%. In December, the 12-month rise in consumer prices was 1.8% y-o-y. Core inflation, which omits changes in energy and food prices, was 2.2% in 2017. Upward pressure on prices last year was provided by higher prices for services and fuel. Food prices fell slightly.

Spurred by higher prices for commodities and the improved fortunes of extractive industries, producer prices rose by 6.3% last year. The 12-month rise in producer prices began to fade towards the end of the year subsiding to just 4.9% in December. The on-month rise, however, increased in every month of the second half of the year.

### Price trends in China

![Price trends in China](source:Macrobond, BOFIT)
Russia

Russian foreign trade continues to recover; capital outflows up slightly. Russian revenues from goods and services exports, as well as spending on goods and services imports were each up roughly 20% y-o-y in the final quarter of 2017. Growth in goods imports was about 20%. Russian spending on travel abroad was up by nearly 30%, matching the growth pace of previous quarters. The trade and current account surpluses of the fourth quarter were notably large on export earnings from higher oil prices.

Russian foreign trade continued to climb out of a deep two-to-three-year hole. Even with the recovery, however, levels of revenue and spending on goods and services trade in the last quarter of 2017 were still several per cent below the 2014 level and about 20% below the level of 2012–13.

Net outflow of private capital abroad was quite notable in the latter half of 2017. The corporate sector (excluding banks) received relatively little foreign direct investment. The outflow of corporate FDI from Russia continued evenly over the course of last year and was slightly larger than FDI inflows. Companies made only small repayments of their foreign debt. In the second half of 2017, other outflows of corporate capital showed an increase. Banks, in contrast, actively paid down their foreign debts throughout the year.

Russian revenues from goods and services trade in 2017 reached 23 billion dollars. Under the current monetary policy, the Central Bank of Russia abstains from intervention in forex markets and therefore direct interventions did not cause any changes in currency reserves. The CBR, however, did buy on behalf of the finance ministry last year roughly 15 billion dollars in foreign currency to soften the effects of oil price volatility on budget revenues and ruble exchange rate. Currency reserves also increased due to Russian banks’ repayments of foreign currency liquidity that the CBR provided them earlier.

At the beginning of the year, Russia’s foreign currency and gold reserves were valued at 433 billion dollars: 77 billion dollars in gold reserves, 10 billion dollars in SDR and IMF obligations and the rest 347 billion dollars in other reserves. Russia’s oil fund savings account for over 50 billion dollars of the other reserves. Most of Russia’s reserves are held in dollar- or euro-denominated assets. Chinese yuan assets represent about 0.1% of currency holdings. Based on common rules of thumb, Russia’s currency reserves appear quite solid. They are sufficient to cover about 17 months of imports or five times its short-term foreign debt.

**Concerns over Russia’s regional budget deficits.** Regional budgets (consolidated budgets of the regional and local levels) represent slightly over a third of Russia’s government-sector spending. Regional budgets are largely responsible for funding housing, education and culture as well as covering a big bulk of health care costs. Most of the government sector’s low-paid employees are on the payrolls of regional or local governments. Since 2012, defined government-sector wage hikes and other spending increases have been a considerable strain on budget balances in some regions in particular.

Rising regional indebtedness in 2013–15 reflects the fact that many regions covered their deficits with bank loans. In 2015, debt-servicing costs of regions were reduced by refinancing these bank loans with three-year loans from the federal budget. Even so, some regions have been overwhelmed by their debt-servicing costs. In October, several regions, including the Republics of Dagestan, Khakassia and Karelia, publicly requested help from the finance ministry to cover their expenses. Some of the federal budget loans maturing this year will now be turned over with extended maturities and lower interest rates.

As a whole, regional budgets are almost in balance, but there are large variations across regions. Many regions have limited opportunities to lower spending or increase revenues. About half of regional budget revenues come from corporate profit taxes and personal income taxes. Transfers from the federal government to regional budgets on average account for less than 20% of total revenues. Transfers, however, fund about 40% of regional budgets in the Far East Federal District and about 70% in regions of the North Caucasus. The two federal districts each have a number of poor regions that are completely dependent on budget transfers and budget loans.

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**Table: Main Russian balance-of-payments categories, 2015–17**

<table>
<thead>
<tr>
<th>Category</th>
<th>USD billion</th>
<th>% of GDP</th>
<th>2015 (preliminary)</th>
<th>2016 (preliminary)</th>
<th>2017 (preliminary)</th>
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<tr>
<td>Current account</td>
<td>69</td>
<td>26</td>
<td>40</td>
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<tr>
<td>- Exports (goods &amp; services)</td>
<td>393</td>
<td>332</td>
<td>412</td>
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<td>25.7</td>
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<tr>
<td>- Imports (goods &amp; services)</td>
<td>282</td>
<td>266</td>
<td>326</td>
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<td>20.5</td>
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<tr>
<td>Trade balance (goods)</td>
<td>148</td>
<td>90</td>
<td>116</td>
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<tr>
<td>- Exports (services)</td>
<td>341</td>
<td>282</td>
<td>354</td>
<td>24.9</td>
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<tr>
<td>- Imports (services)</td>
<td>193</td>
<td>192</td>
<td>238</td>
<td>14.1</td>
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<td>Services trade balance</td>
<td>-37</td>
<td>-24</td>
<td>-30</td>
<td>-2.7</td>
<td>-1.8</td>
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<tr>
<td>- Exports (other)</td>
<td>52</td>
<td>51</td>
<td>58</td>
<td>3.8</td>
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<td>- Imports (other)</td>
<td>89</td>
<td>74</td>
<td>88</td>
<td>6.5</td>
<td>5.7</td>
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<tr>
<td>Other current account</td>
<td>-43</td>
<td>-41</td>
<td>-45</td>
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<td>Financial account &amp; net errors</td>
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<td>-17</td>
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<td>13</td>
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<td>Private sector total (A+B)</td>
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<td>-20</td>
<td>-31</td>
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<td>A. Banks</td>
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<td>1</td>
<td>29</td>
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<td>B. Other private sector</td>
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<tr>
<td>- Direct investment</td>
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<td>-7</td>
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<td>- Inbound</td>
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<td>31</td>
<td>23</td>
<td>2.4</td>
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<td>- Outbound</td>
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<td>30</td>
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<td>1.6</td>
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<tr>
<td>- Portfolio investment</td>
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<td>-4</td>
<td>-11</td>
<td>-0.6</td>
<td>-0.3</td>
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<tr>
<td>- Inbound</td>
<td>-5</td>
<td>0</td>
<td>-6</td>
<td>0.0</td>
<td>0.0</td>
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<tr>
<td>- Outbound</td>
<td>3</td>
<td>4</td>
<td>5</td>
<td>0.2</td>
<td>0.3</td>
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<tr>
<td>- Foreign currency cash *</td>
<td>14</td>
<td>5</td>
<td>6</td>
<td>1.0</td>
<td>0.4</td>
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<tr>
<td>- Fictitious transactions</td>
<td>-2</td>
<td>-1</td>
<td>-1</td>
<td>-0.1</td>
<td>-0.1</td>
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<tr>
<td>- BoP net errors and omissions</td>
<td>3</td>
<td>5</td>
<td>4</td>
<td>0.2</td>
<td>0.4</td>
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<tr>
<td>- Other</td>
<td>-18</td>
<td>-28</td>
<td>6</td>
<td>-1.3</td>
<td>-2.1</td>
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</tbody>
</table>

* Positive value = decrease in the stock of foreign cash

**Source:** Central Bank of Russia.
China

China’s latest GDP growth figures in line with expectations. China’s National Bureau of Statistics reports GDP growth last year being 6.9%; 6.9% in the first two quarters of 2017, and 6.8% in the last two. GDP grew by 11.3% in nominal terms to 82.712 trillion yuan (12.2 trillion dollars).

Many economists do not take China’s official GDP growth figures at face value due to their uncanny consistency and failure to reflect business cycles, especially when other key indicators exhibit large movements. One of the most striking aspects is that significant slowdown in fixed asset investment (FAI) does not seem to have affected the GDP growth rate although investment is a major part of the aggregate demand.

New cases of fudged statistics at provincial and local levels. A year ago, news of a long-running statistical fraud in the Liaoning province emerged. It was the tip of the iceberg apparently. Three weeks ago, officials in the Inner Mongolia Autonomous Region admitted they had artificially inflated their 2016 fiscal reporting. When corrected, the figure for industrial output was 40% lower and regional tax revenues down by 26%. Two weeks ago, the city of Tianjin announced that it had revised 2016 GDP figures for the Binhai New Area down by a third. This week, officials from Inner Mongolia’s industrial city of Baotou, a relatively small city of 2.9 million, announced they had artificially inflated their 2016 fiscal reporting. When corrected, the figure for industrial output was 40% lower and regional tax revenues down by 26%. Two weeks ago, the city of Tianjin announced that it had revised 2016 GDP figures for the Binhai New Area down by a third. This week, officials from Inner Mongolia’s industrial city of Baotou, a relatively small city of 2.9 million, admitted to overstating fiscal revenue figures last year by about double.

Inner Mongolia accounted for about 3% of China’s officially reported economic output in 2016. The Binhai zone’s contribution was just over 1%. While the economic impact of these regions is marginal relative to the Chinese economy overall, there is a high probability that more statistical frauds will emerge at the local and provincial levels. Revelations of statistical fakery also reinforce scepticism about China’s national GDP figures. The latest revision of the 2016 national GDP figure was just confirmed and the recent statistical frauds appear to have no impact on the growth rate.

Growth rate in Chinese imports outstripped exports last year; trade surplus shrank. After two years of contraction, China’s goods exports measured in US dollars rose last year by 8% to roughly 2.265 trillion dollars. Driven by higher global commodity prices, the value of imports began to increase in late 2016 and continued throughout 2017. Last year’s gain was 16% to 1.84 trillion dollars. The volume of imports increased in the first eleven months of 2017 by an average of 11%, while the volume of exports rose by 7%. For all of 2017, the foreign trade surplus fell to 420 billion dollars, down by 90 billion dollars from 2016.

The rise in import volumes of key commodities continued. Highest growth last year was for pulp (up 13%) and crude oil imports (10%). Import volumes increased for coal (up 5%) and iron ore (6%), but with lower growth than in 2016. Copper was the exception; volumes were down by 5% (copper prices rose nearly 30% last year).

The EU last year increased its share of Chinese exports and imports. The value of exports to EU countries was up 13% from 2016, and the value of imports from the EU was up by 21%. Exports to the US, China’s second-largest trading partner, were up by 12%, while US imports rose by 5%.

The structural evolution of the Chinese economy is well reflected in its trade figures. Over the past ten years, the ratio of foreign trade to GDP has fallen by nearly half. In 2017, exports accounted for 19% of GDP and imports 15%. Before the global financial crisis hit in 2008, exports were at 35% and imports at 27%. Structural reform is also apparent in supply chains and processing trade, which now accounts for a reduced share of total trade. E.g., imports of goods which are meant to be processed further accounted for 29% of trade in 2017, down from nearly 50% a decade ago.

Import volumes of key commodities to China

Source: Macrobond.

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Import volumes of key commodities to China

Source: Macrobond.
Russia

Relatively slow growth outlooks for Russian economy. Updated forecasts from the IMF and World Bank expect Russian GDP growth to reach 1.7% this year. The Central Bank of Russia sees similar growth. The January Consensus Economics forecast is a bit higher. In general, major institutions have raised their outlooks from last summer by several tenths of a percent on higher oil price assumptions. The oil price climbed by about 25% last year from 2016, averaging about 53 dollars in 2017. While the IMF and World Bank expect a clearly higher average oil price this year, the CBR forecast oil price assumption is a bit more cautious. The Russian economy ministry says GDP grew by 1.4~1.8% last year.

Global economic growth is generally expected to accelerate. The forecasts see the Russian economy growing slower than nearly all other CIS countries, Europe’s advanced economies, the US, and among relatively large economies, e.g. Poland, Turkey, Brazil and Mexico.

Russian GDP growth forecasts, 2018–2019

<table>
<thead>
<tr>
<th>GDP</th>
<th>Oil price, USD</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2018</td>
</tr>
<tr>
<td>Bank of Russia (12/17)</td>
<td>1.5~2.0</td>
</tr>
<tr>
<td>IMF (1/18)</td>
<td>1.7</td>
</tr>
<tr>
<td>World Bank (1/18)</td>
<td>1.7</td>
</tr>
<tr>
<td>Consensus Economics (1/18)</td>
<td>1.9</td>
</tr>
</tbody>
</table>

Improved Russian federal budget performance; deficit shrinks. 2017 fourth-quarter budget revenues were again up significantly from Q4/16 (not including funds received in Q4/16 from the sale of a 19% stake in state oil giant Rosneft). Oil & gas tax revenues were boosted by higher oil prices, and other budget revenue streams continued to see significant gains.

For the entire year 2017, federal budget revenues increased by 18% (again, excluding the money from the 2016 sale of the Rosneft stake). Tax revenues from oil & gas were up by nearly 25%, significantly outperforming original budget projections. The additional oil revenues to be transferred to the Reserve Fund were abundant as the average price of Urals-grade crude last year climbed to 53 dollars a barrel (the initial 2017 budget assumption was 40 dollars). Other budget revenues increased by 15%, e.g. on higher VAT revenues that account for over 55% of the federal budget’s non-oil revenue streams and about a third of total federal budget revenues. Tax collection improved.

On-year growth in federal budget spending picked up in the fourth quarter (excluding the massive government repayment of bank loans taken on earlier by defence contractors, a.k.a. the OPK complex, at the end of 2016. Rather tight budget discipline was maintained last year, with spending increasing by 5% (excluding the OPK bank loan repayment), or about 1% in real terms. Defence spending fell by about 4% (or about 25% if the 2016 OPK bank debt operation is included). Spending on domestic security and law enforcement increased about 1% in nominal terms, while a lot of the spending in this category was allocated from other subcategories to Russia’s National Guard, which currently accounts for a substantial part of Russia’s domestic security forces.

Thanks to improved revenue performance, the 2017 federal budget deficit was just 1.4% of GDP, less than originally planned. In 2016, the budget deficit was nearly 3.5% of GDP. Without money from oil & gas tax revenues, the deficit contracted in 2017 to less than 8% of GDP.

Russian foreign debt turned to slight growth last year. At the end of 2017, Russia’s foreign debt was about 530 billion dollars, an increase of 3% y-o-y. Russian banks continued to pay down foreign debt, while debt of non-bank companies and government increased. At the end of 2017, the foreign debt of banks amounted to 105 billion dollars, non-bank firms 354 billion dollars and government 56 billion dollars. About 85 billion dollars in debt comes due this year.

From the peak of end-2013, the value of foreign debt has fallen by 200 billion dollars. Nearly half of the reduction, however, came from shifts in foreign exchange rates, particularly ruble depreciation (about a quarter of Russia’s foreign debt is denominated in rubles). Russian banks have reduced their foreign debt by about half since the end of 2013, while other corporates have seen their indebtedness fall only slightly. Although firms have paid down their dollar-denominated debt, their ruble- and euro-denominated debt has risen since the end of 2013.

The value of the Russian government’s total foreign debt has also shrunk from the end of 2013 largely on ruble depreciation. The government has paid down its dollar-denominated debt while increasing its ruble-denominated debt. Russia’s government debt is still quite low: at the end of 2017, foreign debt was 56 billion dollars and domestic debt 124 billion dollars, or 11% of GDP in total.
China

Forecasts of major international institutions see China sustaining strong growth in coming years. Following the World Bank’s lead earlier this month, the International Monetary Fund released its own updated global economy forecast this week. Both forecasts revised their China 2018 growth outlooks up slightly on, among other things, recovery in external demand. The medium-term risks are trending upward with the financial sector’s increasing vulnerability and rising trade barriers around the world. The IMF slightly raised its global economy forecast, and now expects growth of 3.9% p.a. in 2018 and 2019.

Other forecasting institutions generally agree that Chinese growth will remain robust in coming years and that China will make its long-term policy goal of doubling real GDP between 2010 and 2020. At the moment, this would require average growth in the range of 6.2–6.3% p.a. up to 2020. The EIU had earlier expected that China’s leaders would have already shifted their policy emphasis to getting debt under control, with growth slowing significantly in 2018–20. The new EIU forecast sees lower growth shift coming after 2020. Investment banks that monitor China expect growth to average 6.5% p.a. in 2018. Forecasts range from 5.8% to 6.9%.

Even if official figures show that China is on track to hit its GDP growth target, two international forecasting bodies, the Conference Board and Capital Economics, point out that China’s methodology for calculating GDP growth is faulty and fails to reflect true economic trends. Both forecasters release alternative estimates for the Chinese economy that suggest significantly lower growth than official estimates. The alternative indicators, in particular, diverge from official GDP growth figures in the 2015–16 period, when also many other measures of China’s growth indicated much lower readings.

<table>
<thead>
<tr>
<th>GDP growth forecasts for China, %</th>
<th>2017</th>
<th>2018</th>
<th>2019</th>
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<tr>
<td>IMF 1/2018</td>
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<td>OECD 11/2017</td>
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<td>Asian Development Bank 12/2017</td>
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<td>Conference Board (proxy) 11/2017</td>
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<td>6.5</td>
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</table>


Lower growth in China’s debt ratio. The People’s Bank of China reports that its broad measure of credit, Total Social Financing (TSF), was up 12% y-o-y in December. The TSF stock rose by a percentage point less than in December 2016. The stock of bank loans, which represents over two-thirds of TSF financing, continued to rise at the same pace as in 2016 (about 13% y-o-y). The stock of TSF credit reported for the shadow banking sector grew faster than the traditional banking sector (up 15%). Most growth came from trust and entrusted loans. Such loans are subject to new restrictions from the start of this year. Growth in corporate bond financing was lower than the TSF average.

About half of new bank lending went to households. The stock of household loans rose by about 25% over the course of last year. Fastest growth was in short-term household lending, usually in the form of unsecured credit (at year’s end the pace of growth exceeded 40% y-o-y). Such credits are partly used as bridge loans (e.g. to help meet the downpayment on an apartment purchase). Household lending has increased in recent years and now accounts for about a quarter of bank lending. The stock of corporate loans rose 13% y-o-y in December.

The stock of TSF credit stood at 211% of GDP at the end of 2017. Nominal GDP growth accelerated slightly (up 11%), and growth in the debt ratio slowed to a crawl. The debt ratio was only up by 2 percentage points from December 2016, even if it has averaged growth of over 10 percentage points a year over the past five years. The BIS cited its own evidence that growth in the debt-to-GDP ratio has slowed. The total indebtedness of Chinese firms, households and the public sector at the end of June 2017 was 256% of GDP, four percentage points higher than in June 2016, when the debt ratio had grown by nearly 20 percentage points over 12 months.

Trends in TSF growth and China’s debt ratio

Borrowing becomes more expensive in China. The PBoC’s slight tightening of monetary policy during 2017 was reflected in interbank market as higher SHIBOR rates and demands for higher yields on new issues of government and corporate bonds. The interest rate on China’s 10-year government bond rose by nearly 100 basis points last year to 3.9%. The yield on corporate bonds rose even more last year. Higher financing costs were also reflected in the price of bank loans in the first three quarters of 2017. As of end-September, the nominal rate on the average bank loan was 5.8%, while apartment loans were slightly cheaper (5%). Both average rates were about 50 basis points higher than a year earlier. Respectively real interest rates (4.2% and 3.4%) rose even more due to modest inflation. Even so, they were considerably lower than at the beginning of 2015.
Russia

Primary production up in Russia; manufacturing hardly at all. At the end of last year, a nearly six-month slide in seasonally-adjusted industrial output stopped. For 2017 overall, industrial output was up 1%. The score was dragged down especially by manufacturing, which, due to a weak late part of the year, saw growth fall to almost zero for the entire last year. Late in the year, the electricity and heating sector saw growth fall to almost zero for the entire last year. Production of extractive industries rose by 2%. Growth was limited by a decrease in oil production in autumn to levels below highs reached a year earlier. The decrease reflects implementation of production limits agreed with OPEC countries and other oil-producing nations. The role of oil production was relatively small in causing the industry total’s weak performance towards the end of the year.

Agricultural output increased by 2.4% last year, a slower rise than in previous years. The growth in vegetation output subsided to slightly over 2%. While the grain harvests hit a record, harvests of other crops were mostly smaller than in 2016. The growth in livestock production rose to nearly 3%. The slow decline in construction activity continued throughout 2017 (down 1.4% for the year). Growth in the volume of transported goods accelerated over 5% due to increased freight haulage by rail and pipeline transmission.

Retail sales recovered gradually last year, with the volume of sales up more than 1% from 2016. The average real wage rose by 3.4%, but other sources of household income showed weak development. Thus, real household incomes were still slightly lower than in 2016.

In recent years, primary production based on natural resources has grown – especially farm output but also mineral extraction. Goods transport has also increased. 2017 manufacturing output, in contrast, was slightly lower than in 2014. Construction and retail sales, which were hit hard by the recession, were 10% smaller than in 2013.

Real-term trends in Russia’s core economic sectors, 2014–17

Source: Rosstat.

US refrains from imposing new sanctions on Russia, but Power Machines goes on the sanctions list. Last week, the US added the names of 30 persons and firms to its SDN sanctions list imposed on Russia in response to the Ukraine conflict. New additions to the list included global power engineering company Power Machines, which is owned by business tycoon Alexei Mordashov. The sanctioning was related to supplying turbines to Crimea. Americans are generally forbidden from doing business with companies on the SDN sanctions list and the US assets of those on the list are frozen.

The mandated report on the Countering America’s Adversaries Through Sanctions Act, or CAATSA, which was passed last summer, was presented to Congress on January 29. The public part lists 114 representatives of administration and state-owned firms as well as 96 oligarchs being part of the president’s inner circle. The report’s classified part should include an assessment of parastatal entities and the impacts of possible sanctions imposed on Russian government debt. No new sanctions are currently targeted at the listed persons and parastatal entities, unless they are already subject to earlier sanctions. US treasury secretary Steve Mnuchin says new measures are planned for the coming months, however.

Under CAATSA, the US could have imposed sanctions also on companies that work with the Russian defence contractors designated last autumn. According to the administration, sanctions are not considered necessary at the moment and the threat of sanctions is sufficient.

The possibility of new sanctions has given rise to worries in Russia and thinking about how to mitigate their impact. For example, an amnesty for those who repatriate assets hidden abroad, nondisclosure of information for companies working with public procurement and companies subject to sanctions as well as repurposing the failed Promsvyazbank to create bank to serve defence contractors have been proposed.

Sharp drop in births in Russia. There were fewer than 1.7 million live births in Russia last year, a drop of 200,000 births from 2016. Last time such a drop in births was seen in early 1990s after the collapse of the USSR. The drop was fairly consistent nationwide, with the number of births falling last in all Russian regions except Chechnya.

Much of the drop reflects a long-term demographic trend with the number of women of childbearing age falling for over a decade and also the number of births for several years. Last year also the birth rate dropped, however, particularly sharply, possibly due e.g. to the weak economy. Real disposable household incomes have fallen for four years in a row.

Preliminary figures, however, show net migration caused Russia’s total population to increase slightly also last year. Rosstat estimates that Russia’s population at the start of this year was 146.9 million people. The figure includes nearly 2.4 million residents of Crimea, an area that Russia annexed in violation of international law. Under Rosstat’s base scenario, the number of births will continue to decline until 2030 and natural population growth will remain negative.
China

Did structural economic change in China come to a halt last year? Preliminary demand-side GDP figures show that private consumption accounted for 39 % of total demand last year, slightly less than in 2016. The share of public consumption, still low by international standards, rose slightly to almost 15 % of GDP. The share of investment remained at 43 % of GDP, so at least by official figures there was no progress in restructuring the economy last year. However, statistical deficiencies make it difficult to evaluate true trends.

The National Bureau of Statistics reports that over half of China’s 6.9 % growth last year came from consumption growth. Investment demand growth slowed to account for less than a third of GDP growth. Net exports accounted for a small part of China’s GDP (2 %), and its contribution to growth was 0.6 percentage points.

The service sector’s share of GDP last year remained at the previous year’s level (52 %), while industrial production accounted for a 40 % share. As recently as 2012, the sectors were equal in size but the subsequent rapid structural evolution slowed down last year. Service sector output (up 8 %) grew faster than industrial output (up 6 %). From the supply-side perspective, the service sector accounted for well over half of last year’s economic growth. The contribution of industrial production to GDP growth was just over a third, a low level for China. Agricultural production generated 8 % of GDP last year but employed over a quarter of the Chinese workforce. The sector’s impact on economic growth was marginal.

Structure of Chinese GDP, 1985–2017

Rise in housing prices in China slowed last year. Housing market tracker SouFun reports that apartment prices generally rose in 2017, but with considerably slower pace than a year ago. SouFun’s 99-city sample showed that the average price of a square metre of living space in December reached 14,000 yuan ($2,400), rising 7 % y-o-y. The price of a square metre of apartment varied from 4,500 yuan ($770) in Yingkou to 54,000 yuan ($9,300) in Shenzhen. The rise in prices was more broad-based than earlier. In January 2017 prices were still falling in 27 cities, but in December 2017 only five cities experienced price drops. In Beijing, prices continued to fell slightly in December and price increases also in other large cities were generally modest.

Growth in apartment sales slowed towards the end of last year. The volume of apartment sales, measured in square metres, was up about 5 % y-o-y, down from over 20 % the previous year. The volume of completed housing last year, measured in liveable floorspace, was down 15 % y-o-y and the aggregate floorspace of unsold apartments was down 25 % y-o-y. On the other hand, purchases of land rights for construction in the first eleven months of the year were up by over 40 % y-o-y, while new construction starts were up by 8 %.

The central government has sought to rein in soaring prices, tightening conditions for housing loans and making apartment rental more appealing. Officials also want to boost production of rental housing in big cities and rural villages by e.g. allocating a portion of lots with building rights to rental housing and granting cheap credit to builders and renters.

Yuan strongest against dollar since August 2015 mini-devaluation. The yuan strengthened by 3.5 % in January. At month’s end, one dollar bought 6.29 yuan. Much of the recent trend reflects general dollar weakness. The yuan-euro exchange rate has been relatively stable over the past six months. One euro bought 7.83 yuan at the end of January.

Yuan rates vis-à-vis the dollar, euro and currency basket (NEER)
Russia

Russian economic recovery slow last year. Preliminary figures from Rosstat show that Russian GDP grew by 1.5% in 2017, slightly less than nearly all forecasters had expected. Recovery was relatively slow given that the oil price rose by over 25% from 2016. On-year GDP growth fell below 1.5% in the fourth quarter.

The rise in GDP was partly stymied by imports, which soared 17%. The growth of imports relative to GDP growth was exceptionally fast. The rise in imports reflected the extremely low level of imports in 2016, a 25% rise in Russian export earnings and real ruble appreciation of 16% from 2016. Import growth cooled a bit in the fourth quarter, but was still 15% y-o-y.

Most of the economy’s demand categories rose in a good tempo last year. Growth in the volume of Russia’s exports accelerated, reaching 5.4%. Domestic demand increased by over 3.5%. That was the pace of growth also in private consumption, which was reflected in rising domestic retail sales and sales of services as well as the spending of Russians when travelling abroad. Public consumption further declined slightly.

Fixed investments rose over 3.5%. The Central Bank of Russia estimates that most of the growth in investments came from one-off government investments and construction of the Power of Siberia natural gas pipeline. Growth in inventories made an unusually large contribution to growth in domestic demand. The figures for GDP components in 2017 may see even substantial revisions later on as suggested by the large entry for “statistical discrepancy” in the preliminary figures.

GDP last year returned to its 2013 level. Consumption and fixed investments were still below the levels where they were half a decade ago, however. Imports were about 10% below their 2011 level.

Role of the Russian state in banking sector continues to expand. Three systemically important banks were placed under central bank administration last year. Additionally, a total of 63 credit institutions had their licences revoked. Most of the banks losing their licences were relatively small players, so their departure from the market had little impact. The Deposit Insurance Agency reimbursed private individuals with accounts at these banks as planned.

Otkritie Bank and B&N Bank (Binbank), two of Russia’s top 10 banks in terms of total assets, failed late last summer. Both were placed under central bank administration. After a rash of rumours about impending collapse of a third large bank, Promsvyaz Bank, the CBR stepped in and took over in mid-December. Market reaction has been muted as the central bank interventions were largely anticipated. After the take-overs, seven of Russia’s ten largest banks are state-owned. Collectively, they represent 60% of the banking sector’s total assets.

The CBR now plans to merge the operations of Otkritie and Binbank. The goal is to create a competitive universal bank that could eventually be privatised. Finding interested private buyers in the near future looks challenging, however. The restructuring of Promsvyaz will likely focus on creating a bank specialised in serving military-industrial complex and state procurement.

While the departure of small boutique banks is likely to improve banking sector efficiency and financial intermediation, the total collapse of three major banks has raised eyebrows. Despite strict banking supervision, even large banks have managed to conceal their risk exposures. During 2017, total assets of the banking sector rose by 6.4%, slightly outpacing inflation. If banks that lost their licences are not included, the growth in bank balance sheets was around 8%. At the start of 2018, 561 banks operated in Russia and the total assets of the banking sector equalled 92% of 2017 GDP.

Fast growth in household lending in 2017. The CBR reports that the bank credit stock rise by 3.5% when exchange rate shifts are included. The stock of corporate loans was largely unchanged, while household lending soared. The stock of household lending grew by 13% last year, and stood at 12 trillion rubles ($200 billion) at year’s end. According to various credit bureaus, the total amount of new lending last year reached 5.7 trillion rubles, an increase of about 40% from 2016. Highest growth was registered for unsecured credit card debt and housing loans. The microcredit industry also expanded rapidly. Such speedy growth has raised concerns about over-indebtedness. Even with rising wages, the real incomes of Russians fell by 1.7% last year.

Small banks only account for a tiny share of household lending. Russia’s 50 largest banks hold about 90% of all household loans. While only about half of Russian banks are registered in Moscow, over 90% of household credit is granted by Moscow-based banks. About a third of borrowers live in Moscow or the surrounding Central Federal District.
China

China’s new initiatives to protect the environment. Official rhetoric on improving the environment in China has been backed up with deeds in recent months. In addition to a new environmental protection tax, the government has banned the import of problematic waste and announced the implementation of an emissions trading scheme. Defying expectations, tighter environmental regulation resulted in an improvement in Beijing’s air quality last year. Greenpeace reports that air pollution values were down by over 30% in the last quarter of 2017, which offset the poor air quality trend of the first three quarters. Progress nationwide, however, was not as impressive, with the least progress in improving air quality in years. Part of the problem was that industrial production growth appears to have accelerated from the low growth of previous years, even if it is difficult to discern any fluctuations in growth from official GDP figures.

The new environment protection tax, which entered into force at the beginning of January, replaces an arrangement in place since 1979, whereby polluters paid an emissions fee to the environmental regulators. The shifting of collection responsibilities to tax officials should make it more difficult to evade payment, a fairly common activity in the past. The tax rate varies according to pollutant and province. Local governments have been granted the authority to impose taxes as long as they are within the range set forth by the central government. Implementation of the environmental protection tax has been criticised for giving local governments too much freedom in setting rates. Many local governments have decided to set the rates close to the lower limits, even if they retain the taxes collected. For example, under the upper and lower limits set by the central government, an air pollutant tax could be set anywhere in the range of 1.2 to 12 yuan per 0.95 kilograms of nitrogen or sulphur dioxide emissions. China’s biggest coal-producing region, Shanxi province, has imposed an air pollution tax of just 1.8 yuan. A similar move was taken by Guangdong province, a hub of high-tech production. Critics point out that it is not at all certain that officials are capable of gathering reliable data on the amount and nature of pollution generated by firms. There are also worries that companies will try to circumvent emission taxes.

An import ban on problematic waste was imposed in conjunction with the environmental protection tax. The ban applies to 24 types of problematic waste such as household plastics and unsorted paper. The ban has global implications. Many countries, particularly developed Western nations, send their waste abroad for processing. China has been the world’s leading waste importer for decades. In 2017, for example, China imported about 40 million metric tons of plastic, paper and metal waste worth roughly $22 billion.

The government also announced at the end of December that a pilot emissions trading scheme was being rolled out nationwide. While only power plants are initially required to participate in the trading scheme, the goal is to eventually expand the programme to include other polluters.

Beijing’s population growth stopped last year. Last year, for the first time this millennium, the population of Beijing showed no increase. The population of Beijing was 12.6 million people in 1999, and 21.7 million in 2016. The city’s official population last year declined by 22,000 people. Part of this reflected local government efforts to limit pollution, traffic congestion and internal migration. The shantytowns of migrant workers have been torn down and the operation of small business restricted. Factories, logistics centres, schools and hospitals have been forced outside the city limits. A cap on Beijing’s permanent resident population has been set at 23 million until 2020. In Shanghai, China’s largest city, the goal is to cap the population at 25 million by 2035 (the population was about 24.2 million in recent years).

The UN projects that China’s population will peak at 1.43 billion about ten years from now, and thereafter begin to decline. While the one-child policy was replaced two years ago with a two-child policy, it appears that the change has done little to increase childbirths to the extent hoped for by policymakers. The new policy targeted annual births of 20 million. The actual number of children born in China in 2016 was 17.9 million. Last year’s number was 17.3 million.

With lower birth rates and people living longer, China’s dependency ratio is deteriorating rapidly. According to a UN forecast, by 2050 there will be nearly 70 dependents (children under 15 or adults over 64) per 100 working-age persons. In 2015, the number of dependents per 100 workers was just 37. Finland’s dependency ratio in the same timeframe is expected to rise from 58 to 71. The measurement technique, however, underestimates China’s true dependency ratio, because the retirement age is well below 64 years. Women typically retire between 50 and 55, while men retire at 60. The predicted shift in China’s demographic structure increases the pressure on the central government to institute reforms, particularly in the areas of pensions and family policy.

Trends in China’s population and dependency ratio

Sources: UN and Macrobond.
Russia

CBR lowers key rate; oil, ruble and stock markets down in recent weeks. The Central Bank of Russia continued monetary easing at its first board meeting of the year, lowering the key rate by 25 basis points. Effective from February 12, the key rate is 7.5 %. The key rate was last cut by 50 basis points on December 15.

The CBR explained the rate cut was chiefly justified by low inflation and reduced inflation risks over the near term. At the end of January, consumer price inflation was 2.2 %. The central bank noted that permanent factors may have more impact on inflation than previously estimated, adding that it seems less likely the official 4 % inflation target (12-month average) will be exceeded this year. Near-term inflation risks have abated, but still prevail over the medium term. Overall risks have shifted towards economic growth factors. In this environment the CBR will continue to reduce the key rate.

Stock exchange indices around the world see-sawed over the past two weeks. Over half of the Moscow exchange’s main share index is weighted to oil and gas companies, so share prices tend to track closely oil prices. Since the beginning of February, however, the price of Urals-grade oil, measured in dollars, declined 12 % while the Moscow exchange’s dollar-denominated RTS index dropped 5 %. The ruble-dollar rate has weakened by nearly 3 % (ruble-euro by under 2 %). Last year, the ruble’s exchange rate occasionally diverged noticeably from changes of the oil price.

Machinery, equipment and vehicles drove the growth of Russian goods trade. The value of both goods exports and goods imports rose by about 25 % in dollar terms in 2017. The value of goods exports amounted to 350 billion dollars and goods imports 240 billion dollars.

The rise in exports was due to both price and volume changes. Prices of oil and metals rose, while the export volume of oil and oil products contracted by 5 % and the export volume of metals remained flat. Natural gas export volume, in contrast, rose by about 5 %. The volume of exports of machinery, equipment & vehicles grew by 24 %, although presumably partly due to one-off deliveries. The volume of food exports grew by 22 %, mainly on last year’s record grain harvest. Most of Russia’s exports consisted, as usual, of oil, petroleum products and natural gas. They accounted for nearly 60 % of total exports last year. The preliminary estimate of the Russian officials of the value of arms exports last year was around 15 billion dollars, or about 4 % of goods exports.

All goods imports categories showed fairly brisk growth. Growth in the value of imports was led by machinery, equipment & vehicles (up 28 %), buoyed by a moderate recovery in investment demand. The value of imports of chemical products was up 17 % and foodstuffs 16 %. Imports in several food categories were also up slightly in volume terms.

The structure of goods trade by country remained practically unchanged. EU countries continued to account for over 40 % of Russia’s trade turnover, Asian countries just under 30 %, countries in the Eurasian Economic Union 9 % and the US 4 %. China was Russia’s largest single trading partner in terms of both exports (11 %) and imports (21 %).

Wide variations in Russian manufacturing branches last year. Total manufacturing output recovered only slightly last year. After two weak years, output in 2017 was still slightly below the 2014 level. Growth in the food industries, one of the largest categories in manufacturing, continued at 2–3 % pace as the rise in foodstuffs production accelerated. Growth of the chemical industry remained high, especially in pharmaceuticals but also e.g. plastic products.

Production of oil products increased by 1 % to the 2014 level. Forest industry growth was also further up to several per cent, mainly on higher production of paper products. Production of construction materials increased after two years of deep decline, while the metal industry slid substantially.

Growth in the machinery & equipment category (six branches) continued at about 1.5 %. Especially the car industry showed recovery. The boom in other vehicle production and electronics halted, likely due to a decline in defence industry orders. Services involving repair and installation of machinery & equipment continued to decline.

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<th>Total imports</th>
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Source: Rosstat.

Trends in main manufacturing branches 2014–17

Source: Rosstat.
China’s current account surplus fell to 1.4 % of GDP last year. Preliminary balance-of-payments figures from the People’s Bank of China show that the goods trade surplus fell slightly last year from 2016 to a level of 476 billion dollars, while the services trade deficit increased to 261 billion dollars. The total current account surplus fell from 196 billion dollars in 2016 to 172 billion dollars last year (1.4 % of GDP).

China’s large services trade deficit reflects trends in tourism. While Chinese tourist spending abroad last year (tourism imports) did not increase, foreign tourists visiting China declined slightly (tourism exports). Thus, the tourism deficit rose to 221 billion dollars. The rest of the services trade deficit was explained by a 56 billion-dollar deficit in transport services. While other services trade categories are small, they were overall in surplus.

The flow of direct investment shown on the financial account turned positive again, i.e. more investment flowed into China (USD 165 billion) than out of the country (USD 101 billion). The change reflected China’s implementation of stricter limits on capital exports. The flow of direct investment turned negative for the first time in 2016.

China’s foreign exchange reserves started to increase again last year. The balance-of-payments figures show the rise in currency reserves was USD 92 billion. In the national accounts, currency reserves last year were up USD 138 billion indicating that a third of the value increase in reserves came from exchange rates and other valuation changes. The value of currency reserves in January (incl. gold, SDRs and IMF reserve funds) rose by USD 25 billion to USD 3.261 trillion.

China customs data show that January’s trade surplus was just USD 20 billion as the value of goods imports rose to USD 180 billion. The value of goods exports was USD 201 billion. The timing of the Chinese Lunar New Year holiday impacts January and February economic figures. This year, the week-long celebrations began February 15.

China’s January inflation slowdown was broad-based. Consumer price inflation in January fell to 1.5 %, three-tenths of a percentage point lower than in December. Core inflation, which omits food and energy prices, fell also by three-tenths of a per cent to 1.9 %. The dampening of consumer price inflation was most affect by price trends in certain recreational services as well as in transport and telecom services. At least part of this is explained by the timing of the Chinese Lunar New Year holiday. Prices of certain consumer items typically rise during the holiday. Last year’s celebration kicked off in January and this year in February, which had weakening effect on on-year price growth in January this year. Conversely, the later holiday this year may boost February’s inflation figures.

The slowdown in producer price inflation that began last year continued in January. On-year growth in producer prices fell from 4.9 % in December to 4.3 % in January. Price cooling was strongest in industries and services related to production of coal and iron ore.

Market turbulence rocks China, too. Stock markets nose-dived globally as unexpectedly strong economic figures lifted interest rates and increased expectations of accelerating inflation in the United States. The rise in volatility put share prices in free-fall and spread to all major exchanges. The reactions on Chinese exchanges were especially strong. Both Hong Kong’s general Hang Seng Index, and mainland China’s Shanghai Composite Index declined by over 10 % in the first two weeks of February. The Shanghai drop erased all of last year’s gains on the Shanghai Index, which returned to the same level as at the start of 2017. The climb in Hong Kong share prices had been steeper, so after the correction the Hang Seng was still up by over 30 % from the start of 2017. Share prices have recovered somewhat in recent days. Just before the New Year holiday, the yuan depreciated somewhat against the euro, the dollar and a trade-weighted basket of major currencies. The rise in US interest rates has narrowed the gap with Chinese interest rates and is expected to dampen appreciation pressures on the yuan.
Russia

Russia’s fiscal sector strengthened in 2017. Consolidated budget revenues (federal, regional and municipal, plus social funds) increased by over 13% y-o-y. However, 2016 was a low base year whether the funds received from the sale of a stake in the Rosneft oil company are included or not (here not included). Higher oil prices helped increase revenues via oil & gas tax income (up 23%) whose share rose to close to a fifth of total budget revenues.

Other budget revenues rose by over 10%, which is rapid even if the data was adjusted for inflation. Revenues from corporate profit taxes and goods excise taxes rose especially fast. Value-added tax revenues provided 17% of total budget revenues and were up by well over 10%, reflecting both economic recovery and improved tax collection. Mandatory social taxes on worker wages, which represent 22–23% of budget revenues, still showed notably strong growth.

Growth in consolidated budget spending accelerated last year to over 6% (here 2016 spending does not include the large sum granted to defence industry to pay off their bank loans). The growth in social security spending rose to over 10% and the share increased to over 36% of total budget spending. Spending on various sectors of the economy increased by over 10% as spending on transport rose fast. Spending on space activity appears to have tripled and the sub-category of other spending on the economy grew quickly (these two lack further itemisations). After a long decline, spending on the housing sector jumped, mainly on big spending on housing by the City of Moscow.

Spending on education turned to growth, while health care expenditures defied expectations by showing a fall. Spending on public administration rose slightly faster than inflation, excluding a hefty increase in spending on international cooperation. Spending on internal security and order remained flat, while the defence spending category declined.

Largest expenditure items in Russia’s consolidated budget, 2011–17

The revenue bump helped reduce the consolidated budget deficit to around 1.5% of GDP.

Russian retailer Magnit sold to state-owned bank VTB. Last week businessman Sergei Galitski announced he was selling nearly all his holdings in the company he founded, the retail and supermarket chain Magnit to VTB. Magnit, one of Russia’s largest retail chains, has suffered in recent years from the notable contraction in household purchasing power. With its purchase of a 29.1% stake, VTB will become the company’s largest shareholder by far, as majority of the shares are on free float. The reported price of the share package, 138 billion rubles (2 billion euros), implied a small discount. The news surprised the markets, and Magnit’s share price fell after the announcement, but have recovered lately.

VTB’s purchase decision has caused some head-scratching. Some observers think that VTB may be considering exploiting Magnit’s extensive outlet network for its banking services. By some estimates, the purchase of Magnit, which targets lower-income customers, could even be an effort to support government social policy. VTB has also earlier acquired companies outside its core business and it still has a significant stake e.g. in St. Petersburg’s Pulkovo International Airport and teleoperator Tele2.

The acquisition has also raised concerns that the government’s extensive role in the economy is only getting larger. Unlike in many other branches, the share of state ownership has been small in the Russian retail sector.

Russia loses more educated people than receives. The Gaidar Institute recently published a review on migration of educated people in Russia. Researchers relied on e.g. foreign statistics and survey data as they do not believe Rosstat figures provide a comprehensive picture of the situation. The review does not cover illegal guest workers in the country.

Researchers estimate that roughly 100,000 Russians a year have emigrated to the West in recent years. Some 40% of them have higher education. Most have left Russia in the face of decaying economic and labour market conditions. The main motive for about a quarter of emigrants, however, is the country’s political situation: in particular the geopolitical events of 2014, but also disappointment with the 2012 presidential election. A third of emigrants say they will not return to Russia, while roughly a half are open to the option of returning and the rest are actively planning to move back.

Researchers found that the educational level of people moving to Russia has declined in past decades, and on average immigrants are now less educated than the Russian population. According to survey results only 13–17% of immigrants had higher or incomplete higher education. Even these people had trouble finding work corresponding to their education in Russia. Russia has tried to attract high-skilled workers through preferences, but after six years of implementation of the law Russia has received only 150,000 high-skilled immigrants.
China

**Big differences in regional economic growth rates.** Regional 2017 GDP growth figures for China’s provinces range from a decline of 14% in Inner Mongolia to a rise of nearly 16% in Shanxi province. In addition to Inner Mongolia (which was revealed to fake its statistics), weakest growth provinces included north-eastern province of Heilongjiang, which is characterized by the agrarian economic structure and low annual household incomes, as well as China’s second-least-populous province Qinghai, which is dependent on heavy industry and oil & gas production. Most provinces, however, saw GDP growth above the national average (6.9%). Highest growth was posted in central provinces. Resource rich Shanxi and Guizhou, industrial Anhui and Shanxi all saw annual GDP growth above 14%.

Nominal GDP of Tibet, China’s smallest provincial economy, reached 130 billion yuan ($20 billion), roughly the GDP equivalent of Iceland or Cyprus. Some of China’s coastal provinces posted huge GDP figures: nearly 9 trillion yuan ($1.4 trillion) for Guangdong and 8.5 trillion yuan ($1.3 trillion) for Jiangsu, putting them on par with economies like South Korea or Russia.

Chinese provincial data should be viewed with some scepticism. Statistical malfeasance has continued to come to light in recent months (BOFIT Weekly 3/2018), indicating that regional administrations are still fudging numbers to meet their hard growth targets. Reported regional GDP in aggregate has typically exceeded the National Bureau of Statistics national GDP figure. However, some regional governments recently lowered their growth targets for 2018. Even if most GDP adjustments are marginal, some are considerable. The port city of Tianjin east of Beijing, for example, conceded it manipulated its data and then lowered its growth target from last year’s nearly 16% to 5% in 2018.

**Northeast China: home to low-growth provinces.**

Restrictions diminished outward FDI flows from China last year. China’s commerce ministry reports that outbound foreign direct investment from China (excluding the financial sector) fell by a third from 2016 to $120 billion. The commerce ministry figures also showed that inward FDI to China (excl. financial sector) amounted to $131 billion, a slight increase from 2016. Official balance-of-payments figures, which are based on different reporting, however, show outward FDI last year fell by over 50%.

The drop in FDI outflows from China stems from the crackdown on capital exports that began in late 2016. Guidance published last August (BOFIT Weekly 35/2017) limits investment in branches such as real estate, hotels and entertainment. Another factor is the harsher scrutiny in approval processes for Chinese investment in target countries. As approvals drag on, some Chinese investors give up and go home.

China’s official figures fail to give a comprehensive picture of the breakdown of foreign investment by country or by branch. For this reason, several organisations compile their own figures on Chinese investment. These figures, too, note a drop in investment of Chinese firms abroad, especially when ChemChina’s massive $43 billion acquisition of the Swiss Syngenta late last year is not included. The investment decline is evident from the Heritage Foundation’s China Global Investment Tracker (CGIT) dataset. It suggests that nearly all of last year’s drop can be attributed to a decline in Chinese investment in the US. The value of Chinese FDI in the US fell by over 50% last year compared to 2016. Setting aside the Syngenta deal, Chinese investment in Europe fell by over 10%. With the Syngenta deal, FDI in Europe rose by 60%.

The new guidelines give preference to investments under the umbrella of the Belt & Road Initiative (BRI). The trade ministry notes that BRI-related investments in all 65 countries aboard in the Silk Road Project, remained at previous year’s level in 2017. This is also evident from the CGIT dataset, where BRI investments remain at the $30 billion level of 2016. CGIT data show the largest BRI investments last year went to Singapore and India and that Chinese SOEs are largely responsible for investment. According to the Economist Intelligence Unit, some 50 state enterprises invested in over 1,700 BRI projects in 2014–17.

**China’s inward and outward FDI flows**

Sources: NBS, Macrobond, Power BI and BOFIT.
Russia

Foreign currency sovereign credit ratings on Russia upgraded. Standard & Poor’s last week raised its rating of Russian sovereign foreign bonds to investment grade (BBB-). The earlier junk-grade rating of BB+ lasted for three years. The rating of Russia’s local currency government bonds were also upgraded by one notch to BBB. S&P Global Ratings noted that Russia’s macroeconomic policy has allowed the economy to adjust to lower commodity prices and international sanctions. The outlook for the Russian economy is stable. S&P’s rating for Russian sovereign foreign bonds now matches that of Fitch, while Moody’s continues to apply a junk rating (Ba1).

The S&P upgrade means that two of the big three international credit ratings agencies now give investment grade on Russia’s foreign bonds. Demand for the bonds may increase as this status allows large international institutional investors again hold them. The Russian government currently faces no compelling need to borrow from abroad as the current fiscal mandate, but the rate of growth is likely lower than last year. The deficit of the funds already shrunk in 2016, and last year turned into a small surplus thanks to improved revenues and the federal transfers.

Improvement of Russia’s government sector finances at all budget levels. Last year saw large gains in federal budget revenues (up 18%), while tax revenues flowing directly to state social funds also increased by 8% after rapid growth in 2016 as well. Annual inflation was below 4%. Federal transfers to social funds increased abundantly after a one-year pause. Spending of social funds increased by 6%. The deficit of the funds already shrank in 2016, and last year turned into a small surplus thanks to improved revenues and the federal transfers.

Government levels of Russia’s consolidated budget, 2011–17

After contracting in most of the previous years, transfers from the federal budget to regional and local budgets increased by over 8%. Tax revenues and payments flowing directly to these budgets maintained growth above 8%. Revenue streams from corporate profit taxes and labour income taxes rose well. Expenditures of regional and local budgets increased by 9%, due e.g. to spending on the economy, particularly the transportation sector.

The combined deficit of regional and local budgets nearly evaporated in 2016 and increased only slightly last year. The differences across regions, however, remained large when measured e.g. with the deficit relative to tax revenues flowing to the regional budget. Regions and localities over the past two years have as a whole managed to pay down their bank debts slightly. Last year the federal government in net terms hardly had to grant them any credit.

Strong growth in Finnish-Russian trade. The value of goods exports rose by 15% last year to 3.4 billion euros. Strongest growth was in the machinery & equipment category, with the value of exports rising by over 25% y-o-y. Otherwise, export development varied. From core export product groups e.g. foodstuffs grew by 5%, while exports of chemical products and metal contracts slightly. Russia’s share of Finnish goods exports was still below 6%.

Until last year, the value of goods exports to Russia declined four years in a row and hit bottom in 2016 with the value of exports less than half of the 2008 peak. At that time, however, nearly 40% of exports consisted of re-exports, i.e. goods not made in Finland. For example, re-exports of passenger cars and mobile phones have nearly ceased. In recent years, re-exports have comprised about a quarter of Finland’s exports to Russia, consisting mainly of pharmaceuticals and products in the machinery & equipment category.

Finland’s services exports to Russia also revived last year, driven in part by services related to tourism. Overnight stays by Russian travellers in Finland increased by 16% last year. In January-September, Finland’s total service exports to Russia increased by 20% y-o-y. Growth in goods and services exports should continue this year on recovering Russian demand, but the rate of growth is likely lower than last year.

The value of Finnish goods imports from Russia grew by a third last year to 8.2 billion euros. The rapid growth mainly reflects higher oil prices and one-time supplies of gas pipes. Russia accounted for 13% of Finland’s goods imports.
China

China’s financial regulator takes over the country’s third largest insurance company. The China Insurance Regulatory Commission (CIRC) announced last Friday (Feb. 23) it had seized private insurer Anbang to prevent its collapse into insolvency, protect clients from losing coverage and shield investors from loss. Anbang’s founder and key shareholder Wu Xiaohui, who was arrested last June for improprieties, now faces formal charges for financial crimes. Officials said their stabilisation plan for the next 1–2 years would require recapitalisation of the firm and bringing in new partners. CIRC has also expressed concerns about abuses by other insurers.

In terms of total assets (USD 310 billion), Anbang ranks 139th on the Global Fortune 500. The company, which aggressively expanded its operations this decade domestically and internationally, strayed into businesses unrelated to insurance such as financing, real estate and hotels. The aggressive expansion model was built on novel insurance products and financing from the shadow banking sector. Regulatory changes and tighter enforcement aimed at the insurance and shadow banking nexus, however, squeezed Anbang’s revenue. Chinese officials have also been tracking the company’s foreign investments. With the company struggling with solvency problems, it has begun to sell off assets.

The Anbang seizure captures in microcosm the risks facing China’s financial system, where many firms have funded their expansions with debt. Besides Anbang, firms such as Fosun, HNA, Wanda and CEFC have got a lot of publicity during the last twelve months due to their possible debt and business model problems.

More joining the ranks of China’s consumer class.

Measured in dollar terms, China became the world’s largest retail market two years ago, surpassing the valuation of the United States in domestic retail sales.

The average annual per capita disposable income of China’s nearly 1.4 billion citizens last year reached about 26,000 yuan (USD 4,000). The annual disposable income of urban residents was about CNY 36,000 (USD 5,600), or roughly two-and-a-half times rural disposable incomes. Nearly 60% of the Chinese population lived in cities at the end of 2017. While the share has risen rapidly, the extent of urbanisation could still increase further, and thereby sustain growth in incomes and consumption. For comparison, 83% of South Koreans and 94% of Japanese live in cities.

As the middle class grows and acquires more wealth, economic dynamics shift. This evolving structure of consumer demand also affects the trade flows to China. For example, the share of consumer goods and vehicles in total imports has risen faster than other types of imports. 24 million new cars were sold in China in 2017, while just over 17 million new cars were sold in the US.

Finnish goods exports to China rising much faster than exports generally.

Finnish Customs reports that, while Finnish goods exports overall increased by less than 15% last year, the value of Finnish goods going to China rose by 27% to 3.4 billion euros. China’s share of goods exports increased by half a percentage point to just under 6%. Imports from China rose 12% to 4.5 billion euros, accounting for roughly 7% of Finland’s total imports. Finland’s trade deficit with China contracted by 16% to 1.1 billion euros, but still accounted for nearly half of Finland’s total goods trade deficit of 2.5 billion euros.

Finnish Customs noted that over a fifth of Finnish exports to China in 2016 were re-exports, i.e. goods produced in a third country. In 2016, re-exports rose by 17%, making China Finland’s third largest destination for re-exports after Sweden and Russia. The largest re-export category was electrical machinery & equipment.

Statistics Finland’s figures show that Chinese accounted for 7% of the over 3 million foreign travellers visiting Finland last year. These foreign travellers recorded nearly 6.6 million overnight stays in paid lodgings, or 14% more than in 2016. Overnight stays of Chinese tourists increased by 34%, more than for any other nationality. Russians, Germans, Swedish and British tourists had more overnight stays than the Chinese, who posted 311,000 overnight stays in Finland last year.

Finnish goods exports to China by category in 2017

Source: Finnish Customs.

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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.
Russia

Russian investments focused increasingly on oil & gas last year. After years of contraction, Russia’s total fixed investment grew by 4.4% in 2017. The fresh Rosstat figures show, however, that the recovery in the first nine months of the year was more tepid than earlier figures suggested, and that strong growth was concentrated in the fourth quarter. Despite the come-back, fixed investment was still down by nearly 8% from 2013, and on par with the 2008 or 2011 levels.

Fixed investment of large and medium-sized companies (LMEs) and the state sector increased by over 4%. Rosstat regularly tracks these investments in its fresh investment statistics, and its figures show they have represented about 75% of all fixed investment in the past few years. Rosstat estimates that other fixed investment (by small firms, households and grey economy) rose roughly 5% last year.

After growing briskly in previous years, LME and state investment in oil & gas production increased by 13% last year. Investment in pipeline transmission rose by 12% after two years of contraction. Over half of LME and state investment growth came from investment in oil & gas production or pipeline transmission. After two years of decline, investment in production of oil products rose slightly. Fixed investment in the electrical power sector contracted for the fifth consecutive year. The combined share of the four energy blocks increased to 30% of all fixed investment.

The two-year decline in investment in manufacturing industries (excl. oil products) moderated. Last year’s contraction was due to the decline in investment in metal industries. The chemical industry, the other large investment branch in manufacturing, saw an investment drop after several years of growth.

Shares of oil & gas, electricity and manufacturing in total fixed investment of large and medium-sized companies and the state

CBR prepares strategy paper on improving access to banking services in 2018–2020. While access to banking services in Russia overall is quite satisfactory by international standards, disparities across regions and various population groups are large. Many pensioners, for example, have poor access to banking services, and about a third of them do not even have bank accounts. The key goals of the strategy draft paper concern access to high-quality financial services outside big cities and development of online banking services. These goals necessarily overlap, as web and mobile services are seen as critical in bringing banking and other financial services to households even in small localities and sparsely populated areas. Digitalisation of financial services and financial supervision are also supported in the central bank’s 2018–2020 Fintech programme.

Besides technical solutions, expansion of access to financial services requires greater financial awareness. Survey studies in recent years have found that the average Russian’s level of financial literacy is quite rudimentary. In particular, understanding of basic economic concepts such as inflation and interest rates is feeble. In October 2017, the government approved a strategy developed by the finance ministry and CBR to promote financial literacy during 2017–2023. The financial literacy campaign seeks, among other things, to introduce new teaching materials, both online and printed, laying out fundamental economic concepts to be integrated into regular school curricula.

Gas dispute between Russia and Ukraine continues to flame. The Stockholm arbitration court ruled last week (Feb. 28) on gas transit fees as part of the Gazprom–Naftogaz dispute. The court said Gazprom should pay Naftogaz $4.56 billion in lost transit fees. The court also found that the contract obliges Gazprom to pay transit fees for the expected 110 billion cubic metres of gas to be transmitted via Ukrainian pipelines through to the end of 2019.

In the arbitration court’s ruling in December 2017 on gas supplies to Ukraine, Naftogaz was ordered to pay Gazprom $2 billion for its unpaid gas bills. Naftogaz’s take-or-pay purchases were limited to 5 billion cubic metres per year in the 2018–2019 contract period. In practice, Ukraine has not imported any gas from Russia since 2015. Following the decision, the companies agreed to resume gas deliveries in early March.

Gazprom, however, rejected last week’s arbitration court decision, noting it would not abide by the transit or take-or-pay findings. Consequently, Gazprom also rejected the agreement on resuming gas supplies to Ukraine, forcing Naftogaz to cover its gas needs with imports from Poland and elsewhere. If negotiations continue to drag on, it is possible that the matter will not be resolved before the current contract term expires at the end of 2019.
China

The official GDP growth target continues to dictate China’s economic policy. In his opening address to the 3,000 delegates at National People’s Congress (NPC) on Monday (Mar. 5), premier Li Keqiang laid out this year’s growth targets. He said the country would seek GDP growth of “about 6.5%” and the same inflation ceiling as last year, i.e. 3%. Unlike earlier, no targets were announced for growth in the money supply or credit stock. New goals included the creation of 11 million jobs in cities and reducing the number of rural poor by 10 million.

Economists have long wished that China would abandon numeric GDP targets, because such targets in China’s current situation leads to distortionary economic policies. Even so, China continues to adhere doggedly to its goal of doubling 2010 GDP by 2020, a goal that requires growth above 6% p.a. over the next three years. The pursuit of this goal will likely exacerbate difficult debt issues and increase risk to the stability of the financial system.

For the first time ever, China has set an unemployment target based on surveys of urban areas. This year’s target level is less than 5.5% for this survey-based unemployment rate, which includes, among other things, migrant workers. The National Bureau of Statistics has published a survey-based unemployment rate for 31 cities since 2016. The rate has remained steadily in the range of 4.8–5.1%. The NBS also compiles a survey-based nationwide unemployment figure, but that figure is only released sporadically. A comprehensive unemployment figure will be important for setting policy if officials want to reduce their reliance on GDP targets.

The NPC meeting will adjourn in the latter half of this month. Several major appointments and constitutional amendments are expected, including an end to presidential term limits.

Assessing true condition of China’s public sector finances remains challenging. Under the draft proposal presented to the NPC, the combined deficit of China’s central and local government budgets this year will amount to 2.6% of GDP. Last year’s 3% deficit target was exceeded by about one percentage point, as actual spending exceeded budget.

This year’s budget reflects the policy lines formulated in the autumn. Spending will be boosted for poverty eradication and environmental protection. Defence spending and the larger spending category of domestic security will increase faster than the budget overall. Budget revenues should match nominal GDP growth (9%), while spending will lag slightly.

The IMF notes that China’s local governments have been burdened with some of the world’s heaviest spending obligations – without much possibility to influence revenue streams. Partly for this reason, local governments have had to constantly increase their debt loads, only part of which is visible in official budget statements. A reform plan published in 2016 was intended specifically to address this revenue and spending imbalance.

Whatever is happening China’s public sector finances is difficult for outsiders to decipher. Chinese budget figures are not comparable to those of other large economies. The IMF’s own estimate of public sector finances in 2016 was: 28% of GDP for revenue, 32% of GDP for spending and nearly 4% of GDP for deficit. When off-budget activities of local governments are included, the IMF, using a wider definition of deficit, finds that the 2016 deficit was as high as 12% of GDP.

China may introduce retaliatory measures as the US goes ahead with steel and aluminium import tariffs. On Thursday (Mar. 8), president Donald Trump made good on his blunt protectionist threat to apply general import tariffs on steel (25%) and aluminium (10%). However, it is still unclear whether “allies” will be exempted, and thus the question of possible countermeasures remains open. Canada is by far the most important supplier of these products to the US.

China is not a major provider of steel and aluminium products to the US nor do the exports of affected products ($2 billion per year) play a big role in Chinese exports. The tariffs are unlikely to reduce the US trade deficit with China. The value of affected Russian metal products sent to the US is about the same as for China, but the US aluminium market is important to Russia.

China has been a popular whipping-boy of Trump-era trade policy. First major tariff hikes were introduced in January, when 20–50% punitive tariffs were placed on Chinese solar panels and washing machines. Last month, the US also decided on anti-dumping tariffs on Chinese aluminium foil.

The politburo’s top economic advisor Liu He last week travelled to Washington DC to discuss China-US economic relations. The talks were confidential, but the countries promised to continue discussion of trade policy disputes in Beijing. China has threatened a response to the tariff hikes, but to ease tensions, it has also repeated its commitment to opening up its markets to the world.

China’s overproduction and subsidising of steel have fuelled of a long-running dispute also with the EU. The EU imposed a 17–28% anti-dumping tariff on Chinese corrosion-resistant steel last month. This week the EU announced it would also continue its antidumping tariffs on steel pipe.

<table>
<thead>
<tr>
<th>Combined central and local government budget, % of GDP</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
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<tr>
<td>Expenditures</td>
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<td>23*</td>
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<tr>
<td>Deficit</td>
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<td>2.6*</td>
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<td>Expanded deficit **</td>
<td>10</td>
<td>10</td>
<td>12</td>
<td>13</td>
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</table>

* China’s Ministry of Finance budget proposal, nominal GDP expected to rise 9% p.a. in 2018.
** IMF estimate based on augmented budget definitions.

Russia

Russian oil production expected to remain at current levels also this year. Russia last year produced crude oil about 546 million metric tons or 11 million barrels a day (gas condensates included). Production levels were about the same as in 2016. Russia is one of the world’s largest oil producers, accounting for about 11% of global production. Most of Russia’s oil still comes from its traditional production areas in the Ural and Volga federal districts. The share of the Ural Federal District, however, has contracted in recent years as new oil fields have come on stream in Eastern Siberia and the Far East. Several forecasts see Russian oil production remaining at current levels this year due to Russia’s voluntary production ceiling agreement with OPEC. In 2019 and 2020, Russian oil production is expected to rise at 1–2% a year.

Crude oil and oil products are still by far Russia’s top export products. Last year they accounted for over 40% of Russia’s goods export income, or just over $150 billion. The volume of crude oil exports, however, declined by 1% and oil products by nearly 5%. Russia’s economy ministry expects the total export volume of oil and oil products to increase by less than 1% a year in 2018-2020. Most Russian exports of crude oil and oil products still go to EU countries, but last year China became Russia’s largest single crude oil customer, accounting for over 20% of Russian oil exports.

Uneven development in Russian regions last year. While Russian industrial output and retail sales overall grew by about 1% last year, industrial output growth across federal districts (FD) ranged between 1–3%. Retail sales increased by about 1% last year, industrial output growth across federal districts, fixed investment contracted by 4% in the Volga Federal District, however, fixed investment and construction fell by 12% in the Northwestern FD on weak demand. Industrial output and retail sales in Moscow increased near the average pace, while growth in St. Petersburg was somewhat higher. Variations in fixed investment and construction were greater. Nationally, fixed investment increased by 4%, while construction activity decreased by just over 1%. Supported by e.g. the Power of Siberia pipeline project, fixed investment in the Far East FD soared by 17% and construction by 9%. Growth was also strong in the illegally annexed Crimea, due largely to the construction of the federal budget funded Kerch Bridge. About 13% of all federal budget fixed investment last year went to Crimea and Sevastopol, whereas only about 9% of investment went to the North Caucasian FD, 6% to the Far East FD and 4% to Arctic regions. In contrast to other federal districts, fixed investment contracted by 4% in the Volga FD and construction fell by 12% in the Northwestern FD on weak trends in St. Petersburg and the Komi Republic. In other regions of the Northwestern FD, however, fixed investment and construction grew rapidly. Regional variation within all federal districts was again large.

The economic recession of recent years has overall been reflected unevenly in the economic performances of Russia’s regions. While Russian GDP overall contracted by about 3% in 2015–2016, GDP growth across Russia’s over 80 regions ranged from a contraction of 12% to growth above 20%. While there seems to be no clear geographical patterns, growth regions included e.g. northern oil and gas producer regions (Nenets and Yamalo-Nenets autonomous okrugs), the Republic of Chechnya (which relies heavily on federal budget funding) and the Tula region (which has benefitted e.g. from heavy defence spending in recent years).

Income levels also vary widely across regions. In terms of purchasing power, Russia’s richest regions include Moscow and St. Petersburg, while the poorest regions are found in ethnic minority-dominated republics in southern and southeastern Russia such as Ingushetia, Tuva and Kalmykia.

2017 retail trade and investment growth in selected regions, %

Source: Rosstat.

Russia and China score low in the OECD services trade index. The OECD’s Services Trade Restrictiveness Index (STRI), published annually, compares regulatory environment of services trade across 44 countries and 22 service sectors. The STRI considers e.g. restrictions on foreign entry, restrictions on movement of people, barriers to competition and regulatory transparency.

The just-released STRI reading for 2017 places Russia and China near the bottom, with India occupying the cellar. Most of the numerous service-sector restrictions in these countries focus on market entry of foreign firms. Especially Russia’s weak performance, however, reflects largely general problems with its business environment, not just restrictions related to its service sector.

The service industries with least restrictions in Russia are legal and accounting services, whereas the most restricted ones are logistics and warehousing services. The OECD reports that restrictions on services in Russia have increased in recent years e.g. with the new law on storing personal information. In China, the least restrictions are imposed on architectural and engineering services, and the most on courier services and the media branch. According to OECD, China has reduced barriers to services trade in recent years, particularly with regard to rail freight.
China

National People’s Congress blesses party’s constitutional supremacy with almost no dissent. On Sunday (Mar. 11), the National People’s Congress (NPC) voted near unanimously for a package of constitutional amendments that bolster the power of the Communist Party of China (CPC) and blur the boundaries between the CPC and state. The most debated of the 21 amendments has been the elimination of presidential term limits. In practice, presidency of the state is entitled to the CPC secretary general, who also serves as commander-in-chief of the military. The terms of the latter two posts were never limited to definite periods. Xi became the first living Chinese leader since Mao to have his name inscribed in the party articles, and on Sunday his personal ideology “Xi Jinping Thought” was incorporated into the preamble of the Chinese constitution.

The NPC also approved the party’s proposed broad administrative reforms of state institutions. Parts of old ministries and agencies will be eliminated and merged, while new ones will be created, raising the total number of ministries and commissions by one to 26. For example, the banking and insurance supervisory commissions will be combined, while the pursuit of macroeconomic stability will shift in part to the central bank. The market regulatory authority will occupy the field in such areas as corporate antitrust and competition regulation as well as product safety. The new national health commission will now focus on the challenges presented by an aging population. The Ministry of Environmental Protection will be bolstered by the integration of activities currently performed in several other ministries and agencies. Appointment to top leadership positions will be made before the NPC adjourns next Tuesday (Mar. 20).

The constitution was amended to include a newly created National Supervisory Commission. It comprehensively oversees the country’s internal monitoring, anti-corruption activities, ideology and political work on behalf of the party.

Accepted constitutional amendments enable CPC to take a firmer grip on society. Although the NPC has never rejected a proposed amendment from the party, open opposition now appears to be rarer than before. The constitutional amendments were approved in a vote of 2,958 to 2. After the changes enter into force, the CPC will be China’s sole governing authority under the constitution. Official addresses to the NPC will be made by the CPC secretary general, who also serves as commander-in-chief of the military, The terms of the latter two posts were never limited to definite periods. Xi became the first living Chinese leader since Mao to have his name inscribed in the party articles, and on Sunday his personal ideology “Xi Jinping Thought” was incorporated into the preamble of the Chinese constitution.

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**Russia**

**Putin wins Russian presidential election as expected.** Russia’s sitting president garnered 77% of the national vote last Sunday (Mar. 18), while his regional performances ranged from 65% in Russia’s Far East regions to over 90% in the republics of Southern Russia. Putin took 71% of the vote in Moscow and 75% in St. Petersburg. Voter turnout was nearly 68%, slightly higher than in the 2012 presidential election.

No major changes are expected for the main lines of economic policy as a result of the election. In principle, the results give the president a strong mandate that could enable realization of difficult, but badly needed, structural reforms of the Russian economy. In reality, most observers expect the administration to interpret the election results as an endorsement of current policies and thus allowing to ignore the reform agenda. The composition of the new government should be announced in early May after Putin’s inauguration ceremony.

After the election results became clear, Putin proclaimed that the central issues of his next term would be economic growth and securing the country’s defence capabilities. The comments were in line with his platform speech earlier this month. Putin called already last week on the presidential administration to prepare new executive decrees on national goals for the upcoming six years. These included, e.g., reducing poverty by half and making Russia the world’s fifth-largest economy. Putin issued similar decrees in the beginning of his current term, but most of those goals (e.g., substantial productivity gains and increased job-creation in high-technology sectors) have failed to materialize.

**Russian government places two Eurobond issues.** Last week the finance ministry placed 11-year and 30-year Eurobond issues worth a total of 4 billion dollars. The 11-year bond carries an initial yield of 4.63% p.a. while the 30-year bond pays 5.25%. Most of the money raised from the issue will go to buying back 3.2 billion dollars of state sovereign bonds set to come due in 2030 and carrying a hefty coupon of 7.5%.

Demand for the new bonds was about double the supply. Finance minister Anton Siluanov said that foreign investors bought most of the debt. The heavy demand for Russian bonds reflects, among other things, their high real yields relative to most sovereign bonds at the moment and the fact that the Russian economy began to revive from recession last year, Rosstat reports that its labour force survey of people aged 15 to 72 years found the number of people employed in Russia declined last year: labour force also shrank. Even as the Russian economy began to revive from recession last year, Rosstat reports that its labour force survey of people aged 15 to 72 years found the number of employed people declined slightly. Their number last year averaged around 72.1 million.

A mild drop in employment is fairly unusual during periods of economic growth, even if the same thing happened also during two years in the past. Moreover, the number of unemployed persons fell slightly last year to just under 4 million people, a record low. The unemployment rate was 5.2% in the labour force formed by 15–72-year-olds (according to Russia’s regularly conducted labour survey based on the International Labour Organization’s methodology).

Rosstat’s monitoring suggests that the decline in the number of employed people may in part stem from the fact that large and mid-sized firms employed more effectively their part-time and temporarily laid-off workers. In a couple of years earlier, the number of part-time workers and those temporarily laid-off increased. Last year their number contracted considerably, while the number of hours worked per worker increased in an exceptional pace. In addition, a slightly larger number than usual of Russia’s well over 10 million working pensioners may have ceased working. Since 2016, working pensioners have no longer been eligible for a general inflation adjustment to their pensions if they continue to work.

The reductions in the numbers of both employed and unemployed persons meant a sizeable drop in the labour force last year. While pensioners ending their work naturally exit the labour force, the biggest factor is demography, whereby the working-age population has shrunk continually since around 2005. The employment rate for the working-age population is increasingly harder to raise. Despite the contraction in employment last year, their employment rate was still above 76%.

**Number of people employed in Russia declined last year; labour force also shrunk.**

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**Working-age populations, labour force and number of employed, 2003–2017**

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Source: Rosstat
China

Yi Gang named PBoC governor. Yi’s appointment was announced at the end of the People’s National Congress this week. Outgoing People’s Bank of China governor Zhou Xiaochuan (70), who was appointed to the central bank governor position in 2012, will now retire. His replacement, Yi (60), has worked at the PBoC since 1997 and served as deputy governor under Zhou for the past ten years. He also led the State Agency of Foreign Exchange (SAFE) in 2009–2016, during which time capital controls were relaxed and the yuan’s role as an international currency was strongly promoted. Yi took his PhD in economics at the University of Illinois before moving on to an academic career in the US and elsewhere.

Yi is expected to continue Zhou’s reform-minded approach. It should also keep the PBoC at the forefront in implementation of China’s economic reforms. Yi has already promised a number new reforms in the near future.

Yi will face numerous challenges during his term as governor. He should use monetary policy to deal with increasing financial market risk and to lower China’s indebtedness while he is also expected to provide cheap credit in order to sustain high economic growth. The situation is further complicated by the fact that interest rates should start rising in many countries. China’s central bank is moving to an interest-rate-based monetary policy, but interest rates currently only augment the PBoC’s otherwise diverse policy toolbox. These tools are applied on a case-by-case basis depending on the particular policy objective and make the whole system quite opaque.

While China says that it is committed to the eventual adoption of a free-floating currency regime and deregulation of capital movements, it still has a long way to go. While China’s central bank functions as a part of government and lacks independence, the departing Zhou nevertheless succeeded in gradually opening the Chinese economy to the world and pursued reforms that led to the yuan’s incorporation into the IMF’s SDR currency basket in 2016. China’s enthusiasm for market reform remains foreign affairs minister, while He Lifeng (63) remains foreign affairs minister, while He Lifeng (63) reprises his role as head of the National Development and Reform Commission. Wei Fenghe (63), a general in the People’s Liberation Army, becomes national defence minister. Han Changfu (63) continues as agricultural minister. Environment minister Li Ganjie (53) and natural resources minister Lu Hao (50) represent the young cadre.

Chinese economy powers ahead in first two months of 2018. Real industrial output rose by 7.2 % y-o-y in January-February – the highest January-February industrial output figure since 2014. Fixed asset investment (FAI) in urban areas rose about 8 % y-o-y in nominal terms in January-February, or one percentage point less than in the same period in 2017. On-year real FAI growth was around 2 %, assuming that inflation’s impact on January-February investment was slightly lower than in the Q417. Retail sales grew by nearly 10 % y-o-y in nominal terms in the first two months of this year. Online sales were up 37 % y-o-y, with online now accounting for about 15 % of all retail sales of consumer goods. While the nominal growth in retail sales was slightly higher than in the first two months of 2017, higher inflation held real growth to about 8 %.

The rise in consumer prices accelerated in February to 2.9 %, while the January figure was 1.5 %. The Chinese Lunar New Year fell this year in February, causing a rise in prices of certain consumer products. The February core inflation reading, which excludes food and energy prices, rose by 0.5 percentage points from January to 2.5 %. Producer price inflation continued to cool, falling from 4.3 % in January to 3.7 % in February. On-year growth in producer prices slightly exceeded 6 % on average for months in 2017.

People’s National Congress endorses numerous high-level appointments. Wang Qishan (69), who has spearheaded president Xi Jinping’s anti-corruption campaign and has long experience in US-China relations, was elevated to vice president. Premier Li Keqiang (62) was appointed to a second term, while Han Zheng (63), the long-serving party secretary from Shanghai, becomes first vice premier. Other appointees to vice premier posts are Sun Chunlan (67), a former leader of an organisation that aims to increase the influence of the Communist Party in China and elsewhere; Hu Chunhua (54), earlier seen as Xi’s possible successor (at least before the abolition of term limits on the Chinese presidency); and Liu He (66), China’s “economic architect” and president Xi’s chief advisor.

Liu Kun (61), former head of the commission for budget affairs, was named finance minister. Yang Xiadou (64) will head the newly created National Supervision Commission and becomes national anticorruption minister. Wang Yi (64) remains foreign affairs minister, while He Lifeng (63) reprises his role as head of the National Development and Reform Commission. Wei Fenghe (63), a general in the People’s Liberation Army, becomes national defence minister. Han Changfu (63) continues as agricultural minister. Environment minister Li Ganjie (53) and natural resources minister Lu Hao (50) represent the young cadre.

Chinese industrial output, retail sales and fixed investment*.

<table>
<thead>
<tr>
<th>Year</th>
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<tr>
<td>2018</td>
<td>2.9</td>
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* January-February 2018 investment trend based on price estimate. Sources: Macrobond, CEIC, BOFIT.
Russia

Latest BOFIT Russia forecast sees gradual economic recovery continuing. The economy recovered last year, with GDP rising 1.5%. Relative to the swings in global oil prices, the recession was mild and recovery slow as the rouble’s floating exchange rate significantly dampened the swings.

BOFIT Forecast for Russia expects GDP to rise by nearly 2% this year and slightly exceed its 2014 peak. In 2019-2020, annual GDP growth should average about 1.5% as long as the oil price remains near its current level and as proper reforms that would support growth are not in sight.

Household consumption continues its moderate recovery. General increases in government sector wages and pensions still this year are rather meagre in real terms, but should then increase. Corporate sector wages should rise reasonably compared to productivity gains. Consumption is supported by relatively low inflation.

The revival in fixed investment will continue as the worn-out capital stock requires replacement and its high utilisation calls for investment in new capacity. High growth is not expected as the major investment phases of large projects are becoming past and appetite for new investment is limited, especially by the defective business environment.

Government expenditures are set to rise slowly as the new budget rule frames spending. It limits the deficit and defines computational oil & gas tax revenues. Other revenues should no longer increase rapidly with the projected GDP growth.

Growth in Russia’s export volume should slow as the rouble is relatively strong and energy exports only rise slowly. The recovery in Russia’s imports will slow this year from last year’s big rebound and a bit further thereafter on fading growth of export earnings. Even so, imports will grow rather briskly, but only climb close to the 2012 level in 2020.

Risks to the forecast include possible deviations from the expected oil price, impairment of the good global economic growth outlook and developments in international incidents. The growth of Russia’s export volume could exceed anticipations, although production capital could pose a tighter-than-expected constraint on exports and also more broadly on domestic production. A tax reform envisaged in Russia could slow consumption growth and support domestic production.

Muted market reaction in Russia to expulsion of Russian diplomats. Early this week, nearly 30 countries followed the UK in expelling over 100 Russian diplomats from their countries. Many countries assess Russia to be responsible for the nerve agent attack in England in early March. While the coordinated expulsion of diplomats sent a powerful political signal, Russian market reactions were limited. The ruble-dollar rate depreciated by 0.4% in the beginning of this week and the Moscow exchange’s RTS index fell by about 1%. Despite the modest market reactions, heightened political tensions will elevate also economic uncertainty.

Central Bank of Russia lowers key rate by 0.25% and signals plans to keep cutting. With the February 12-month inflation reading unchanged at 2.2%, the CBR board decided to cut the key rate to 7.25%. It said that it now considers the low-inflation environment sustainable and evaluated that inflation expectations have continued to fall. If the current environment prevails, it stated it will continue cutting the rate this year until reaching the level that is neutral with respect to inflation (which according to the current CBR estimate is 6–7%). At the end of this year, the central bank expects inflation to be at 3–4%, or near the CBR’s official 4% target. From inflation risks, the CBR now brought up for the first time a concern related to the tightening of labour market that might lead wages to rise faster than productivity.

Russian economy started to recover again in January-February. Following weaker performance at the end of last year, the Russian economy appeared to get back to the track of slow growth in the first two months of this year. The engine of recovery seems to have shifted from last year’s primary production to a broader base, but the development is still shaky.

Retail sales rose by 2% y-o-y in January-February. This represented a slight slowdown from the end of last year, even if real wages rose by over 10% y-o-y. The spurt appears to have come largely from certain public sector wage hikes prescribed by president Putin back in 2012. Real incomes, however, still contracted by nearly 1% y-o-y, although the last year’s point of reference is raised by the 5,000 rouble one-time pay-outs to most pensioners (if the pay-out is ignored, real incomes rose by 2.5% y-o-y).

In contrast, growth in industrial output accelerated in the first two months of the year, mainly thanks to support from manufacturing. Manufacturing recovered briskly in January-February, rising 3% y-o-y. Metal fabrication and the car industry were among the main growth drivers. Growth in output of extractive industries slowed to under 1%, with oil & gas production levels declining from a year earlier. Pipeline transmission volumes also fell, weighing on growth of the entire transport sector. Construction activity remained unchanged from a year earlier in January-February, mainly on strong growth in housing construction.
China

BOFIT China forecast sees lower GDP growth in coming years due to larger economic imbalances. Despite the upswing in the business cycle, our latest BOFIT Forecast for China is darker than the previous forecast six months ago. Expected market reforms in our previous forecasts have yet to be implemented and the government has failed to bring debt under control. As China’s economic policy continues to rely on high numeric growth targets, we have slightly boosted our 2018 growth projection, putting it on par with the government’s official target of 6.5%.

However, sustained high growth is becoming ever harder to achieve. The government has to deal with financial market risks and the country’s massive pollution problems in the years ahead, not to mention the impact of the ageing population and shift to a services-based economy on growth. We thus expect growth to slow to a more sustainable level of about 5.5% in 2019 and around 5% in 2020, which means the government will slightly undershoot its rate of doubling real 2010 GDP by 2020. In any case, China’s growth figures should be taken with a grain of salt; growth targets incentivise officials to manipulate the numbers, so official GDP figures are not trustworthy.

During the forecast period, China’s monetary policy officials face the unenviable task of reconciling the goals of maintaining an accommodative stance to support economic growth while reining in debt and stemming the increase in financial market risk. The situation is further complicated by the general rise in interest rates globally. The PBoC responded to the US Federal Reserve’s latest rate hike last week by raising its 7-day repo (open market operations) rate by 5 basis points. The hike was largely symbolic.

Rising debt levels have increased the risk of a serious disruption in financial markets that could lead to a rapid slowdown in economic growth. The risks of trade disputes have materialised with the US now threatening China with new import tariffs. The party’s role in the economy has also increased worryingly. The concentration of power in fewer hands increases the likelihood of errors in policy planning.

US takes hard line on China trade policy. The Trump administration announced plans last Thursday (Mar. 22) to impose a 25% tariff on certain high-technology products from China in response to China’s alleged intellectual property infringements. As part of the move, the US filed a complaint with the WTO against China’s discriminatory technology licensing practices, which the Trump administration says prevents foreign firms from competing on Chinese markets.

The list of tech products subject to tariffs should be released by early April, after which begins a month-long series of hearings before the tariffs enter into force. Products under scrutiny are part of China’s “Made in China 2025” industrial policy programme, which Western business organisations have criticised as protectionist. Imports of products subject to the new tariffs are estimated to be worth some $50–60 billion dollars, or about 10% of US imports from China.

While the new tariffs raise the threat of a trade war, they also put pressure on the US and Chinese to get to the bargaining table to discuss opening up China’s markets and improving conditions for American firms operating on Chinese markets. US negotiators seek faster liberalisation of financial markets, reduced subsidies to state-owned enterprises, lower duties on imported cars, a more transparent regulatory system and abolishing the practice of making American firms partner with a Chinese firm to conduct business in certain branches in the Chinese markets.

China has emphasised its desire for negotiated solutions and indicated a willingness to speed up implementation of certain reforms. But it has also stated its readiness to implement retaliatory measures. Immediately after Trump’s tariff threat last week, China imposed retaliatory import duties on e.g. US pork products and fruits, as well as on steel pipe in response to the US announcement earlier this month to place new tariffs on steel and aluminium. US steel and aluminium tariffs, as well as China’s just-announced retaliatory measures, only marginally impact US-China bilateral trade.

Guo Shuqing to head newly created banking and insurance regulator and serve as PBoC party secretary. The People’s National Congress just approved merging China’s banking and insurance regulatory agencies into the new China Banking and Insurance Regulatory Commission (CBIRC). It will be led by Guo Shuqing, former head of the banking regulatory commission. To the surprise of many, Guo was also appointed the central bank’s party secretary. Former PBoC governor Zhou Xiaochuan, who retired this month, held both the governor and party secretary posts, so the new appointment aroused discussion about the extent of the authority of new governor Yi Gang. Guo is a member of the CPC’s 205-member central committee; Yi is not.

The PBoC signals that governor Yi will manage “all aspects of work at the central bank” and that Yi and Guo will deputize each other for the governor and party secretary posts. Otherwise governor Yi is expected to focus on monetary policy, while party secretary Guo monitors administrative and strategic issues.

China’s realised GDP growth and BOFIT forecast 2018-20

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Sources: China National Bureau of Statistics and BOFIT.
Russia

More light on developments in the Russian economy last year. Rosstat reports that seasonally adjusted GDP grew briskly from the final months of 2016 to mid-2017. The revival then came to a halt in the autumn and GDP contracted in the fourth quarter. From four quarters back, GDP grew by slightly under 1 % after the on-year growth in the second and third quarters had been 2.2–2.5 %. This year has seen some improvement. The economy ministry tentatively estimates that GDP grew on-year by around 1.7 % in January-February.

The rise in GDP slowed on easing fixed investment growth towards the end of the year. Fixed investment growth rose to a very rapid pace last spring, which assessments note was supported to a large degree by progress in various major infrastructure projects. Rosstat further reported growing inventories faced a notable turn downwards in the final quarter. In contrast, the recovery in household consumption accelerated in the second half to over 4 % y-o-y and growth of the export volume climbed to about 5 %.

On the production side, the economy’s recovery towards the end of the year was hurt especially by a steepening of the decline in industrial output that eventually stabilised this year. Growth in imports slowed in the second half of last year, but was still running above 15 % y-o-y in the fourth quarter. As usual, Rosstat’s release of past year’s quarterly data also brought some revisions to figures for the entire year, mostly concerning certain demand-side GDP items. The new data revised the earlier-reported decline in public consumption to slight growth. The pace of recovery in fixed investments increased to over 4 % y-o-y, while the volume of exports grew slightly slower than earlier reported, but still above 5 %. Other focal growth figures remained unchanged. GDP last year grew by 1.5 %, household consumption by nearly 3.5 % and imports by 17 %.

Seasonally adjusted Russian GDP

Net flow of funds from firms to banks and abroad

Russian central bank plans to start “bad” bank. Central Bank of Russia deputy governor Vasily Pozdyshev said Monday (Apr. 2) that problem loans and certain other assets of the banks that are under control of the central bank will be placed in a new “bad” bank. Three major privately held Russian banks went under the control of the CBR last year: Otkrytie, Binbank (B&N Bank) and Promsvyazbank. They all had earlier taken on other problematic banks for restructuring. The bad bank will be built on the basis of Trust bank that was under restructuring by Otkrytie. It will be used to marshal bad loans and certain other assets also from Binbank and Promsvyazbank worth a total of 1.1 trillion rubles (16 billion euros), or just over 1 % of the total assets of the Russian banking sector. Pozdyshev estimates that 40–60 % of the bad loans could be recovered, but many observers of the Russian banking sector see this statement as overly optimistic. The CBR will not capitalise the bad bank directly, but rather fund it through low-interest loans.

Pozdyshev reports that the CBR has currently spent a total of nearly 630 billion rubles (9 billion euros) for capitalization of Otkrytie Bank, Binbank and Promsvyazbank. He estimates that Promsvyazbank still needs an additional injection of 130 billion rubles (nearly 2 billion euros). The current plan is to sell Otkrytie and Binbank to private investors once their distressed loans are transferred to the bad bank. Promsvyazbank, in turn, would become a state-owned bank focused on providing finance to defence contractors.

Profits of Russian firms have supported out-of-pocket funding for investments; bank borrowing has been low. Rosstat reports that the net profits of large and medium-sized firms (excluding the financial sector) dropped last year in both nominal terms and relative to company turnover. The net profits, nevertheless, were still quite good, equal to over 8 % of turnover and 11 % of GDP.

Profits over the past couple of years have allowed firms to increase their out-of-pocket investments. As total fixed investments contracted until last year, the share of fixed investments financed from other sources has shrunk, including domestic bank loans that already earlier had a small share. The balance of financing between firms and domestic banks has also shifted. Although the flow of funds from firms to banks has decreased over the past couple of years, borrowing by firms from banks has declined to such an extent that the net flow of funds, unlike in previous years, has been going from firms to banks. Partly this situation is also due to drops in the net outflow of funds from firms to outside Russia.
China

Profits of China’s biggest banks surged last year. China’s five biggest banks released their 2017 financial reports in late March. The largely state-owned banks include Commercial Bank of China, China Construction Bank, Agricultural Bank of China, Bank of China and Bank of Communications. The combined net profit of the Big Five banks rose by over 3% y-o-y, even if capital yield declined slightly. The net interest margin, which reflects the profitability of traditional banking operations, rose at four of the five banks (BoComm was the exception).

The Big Five control the vast majority of retail deposits, which forces smaller banks to resort to funding mainly from the interbank market. Thus, the big banks can exploit a general rise in interest rates when lending their surplus assets to other banks. Non-performing loans (NPLs) fell to just 1.5-1.8% of the total credit stock, but many observers believe the lower limit for some banks declining to as low as 1% (BOFIT Weekly 11/2018). The actual figures are considerably larger. Last year, banks were required to set aside provisions 150% of their NPL aggregates, a requirement all the Big Five passed. NPL provisions this year will be decided on a case-by-case basis, with the lower limit for some banks declining to as low as 120% (BOFIT Weekly 11/2018). Officials want to make sure banks are adequately capitalised as tighter regulation of the shadow banking sector shifts lending back to the balance sheets of mainstream banks.

The China Banking Association (CBA) and financial consultants PwC annually survey a group of nearly 2,000 Chinese bankers. The latest survey found that the surveyed bankers highlighted credit risk as the biggest source of uncertainty facing banking operations. Credit risk has risen as economic conditions have deteriorated in certain geographic areas and business branches. It has also become more difficult for banks to dispose NPLs. Over 90% of respondents said that regulation of banking operations had become stricter. Nevertheless, the near future looks bright as bankers believe the stock of NPLs should shrink further over the next three years and profits should rise even faster than last year.

China-US trade policy dispute heats up. In late March, US president Donald Trump announced plans to impose a 25% import tariff on certain Chinese goods if China refused to open its markets and continued to infringe on intellectual property rights. That threat materialised on Tuesday (April 3), when, as expected, the US issued a list of over 1,300 Chinese imports subject to the additional tariff. The value of affected goods imported from China to the US last year was roughly $50 billion dollars (about 10% of the total US imports from China). The list includes a range of pharmaceuticals, hospital equipment, machinery, electronics and other goods. The Trump administration says that the tariffs are a targeted response to China’s protectionist industrial policies.

China’s response was swift. On Wednesday (April 4), China issued its own list of 106 American imports that would be subject to a 25% additional tariff. Like the US, China’s retaliatory measures targeted specific imports with an annual value of about $50 billion (32% of China’s imports from the US). The list includes soybeans, commercial aircraft and cars.

While the situation seems to be trending in a dangerous direction, there remains hope of a negotiated solution. The US tariff hikes and Chinese retaliatory measures would only enter into force in late May at the earliest after a mandatory hearing process. China has long given lip-service to reforms the US now seeks (and others hope for), thereby providing a basis for resolving the matter amicably. However, already on Thursday (April 5), president Trump responded with a further threat of additional tariffs targeted at another $100 billion in Chinese imports.

Every fifth international patent application now comes from China. The latest annual report from the World Intellectual Property Organization (WIPO) notes that globally 243,500 patent applications under the Patent Cooperation Treaty (PCT) were filed in 2017, an increase of 4.5% over 2016. Patent applications in China have risen at a rate of over 10% a year since 2003. China last year overtook Japan as the world’s second-most active patent-seeking country.

In 2017, the five biggest countries in international patents were the United States, China, Japan, Germany and South Korea. India ranked 16th with 1,603 patent applications, just ahead of Finland with 1,595 applications. The number of patent applications from Russia (ranked 23rd) increased by nearly 23% to 1,097.

Chinese telecom giants Huawei and ZTE are the world’s biggest patent seekers, accounting for 3% of all PCT patent filings last year. The top ten patent-seeking companies include seven from Asia, two from the US and one from Sweden. The biggest group of PCT filings in China and South Korea related to digital data transfer, while they tended to focus on electrical machinery in Japan, computer technology in the US and transport technology in Germany.

China rising: PCT patent applications, 2000–2017

Source: WIPO.
Russia

Russian markets dive after US imposes more sanctions. On April 6, the United States added 24 Russian businessmen and public officials, along with 15 Russian companies, to its sanctions list. Half of the blacklisted firms (including Rusal, one of the world’s largest aluminium producers) are owned by Russian oligarch Oleg Deripaska, who now finds himself also on the list. Entities subject to the sanctions face freezing of their assets in the US and Americans are now generally prohibited from dealings with them. Non-US persons could also face sanctions if they knowingly facilitate significant transactions of listed entities.

The initial market reactions in Russia were strong with the Moscow exchange’s RTS index falling 12% in the beginning of the week and the ruble losing about 10% of its value against both the dollar and the euro, but yesterday there was a visible correction upwards. The biggest losers have been listed firms hit directly by sanctions, but also many other Russian firms, e.g. metal producers and banks, saw their stock prices tumble. In addition to last week’s new round of sanctions, markets were spooked by a proposed US bill to sanction Russian sovereign debt and heightened tensions between Russia and the US in the Syrian conflict. Market jitters should continue in the coming days, but calm gradually if further complications do not arise.

Russia’s import recovery slows; outflows of private capital increase slightly. Measured in US dollars, the official currency for reporting the value of Russian foreign trade and balance-of-payments data, imports of goods and services rose by 20% y-o-y in the first quarter. Measured in euros, however, spending on imports increased by only about 4%, as the euro’s exchange rate has appreciated against the dollar by an exceptional amount over the past year. Growth in goods imports was slightly lower than growth in services imports, which included growth of Russian travel spending abroad slowing down but still increasing by 14% (in euro terms).

Russia’s earnings on exports of goods and services rose by 20% in dollars, but by only a few per cent in euros. At this pace, earnings rose from goods exports both overall and separately for energy and non-energy. For the past four quarters, the current account surplus was up to about 2.5% of GDP.

After growing slightly in the second half of 2017, the net outflow of capital from the corporate sector abroad increased further in the first quarter. Apart from foreign direct investments into Russia, there were net capital outflows in all major foreign debt and receivable categories of the corporate sector.

Russian natural gas production grew briskly last year. After declining three years in a row, Russian natural gas production increased 8% last year reaching 690 billion cubic metres (including associated natural gas production). Due to limited storage possibilities, gas production trends are largely dictated by demand. Last year demand was supported by domestic economic recovery and brisk export growth. Russia’s economy ministry expects gas production to decline slightly this year and increase by around 1–2% a year in 2019 and 2020.

Russia, which accounts for nearly a fifth of total global production, is the world’s second largest natural gas producer after the United States. About 90% of Russian gas is produced in the Yamal-Nenets Autonomous Okrug, which large part of Russian gas reserves are also located. Liquefied natural gas (LNG) is produced on the Sakhalin Island and the Yamal Peninsula with the total production capacity currently standing at about 15 million metric tons (20 billion m³), or about 5% of global LNG production.

About a third of Russian natural gas production is exported. While natural gas is an important export commodity for Russia, it is not nearly as important as oil. Export earnings on gas amounted to just over 40 billion dollars last year (compared to over 150 billion dollars on oil and oil products), or about 11% of Russia’s total earnings on goods exports.

Most Russian natural gas exports are still transmitted by pipeline, with about two-thirds going to EU countries. Other major markets include Turkey and Belarus. Practically all of Russia’s LNG production currently goes to East Asian countries, which are not yet served by Russian pipelines. Completion of the first phase of the Power of Siberia gas pipeline from Russia to China is set for late 2019.
President Xi repeats his commitment to reform and easier access to China’s markets. In his speech to the Boao Forum for Asia on Tuesday (Apr. 10), president Xi Jinping reaffirmed his commitment to gradually opening of China’s economy to the world. He noted China and other countries have benefited from decades of China’s ongoing opening process and continuation of the process will remain important in the future. While Xi did not mention the deterioration in US-China trade relations, he implied that China is responding to concerns raised by the Trump administration.

Xi, for example, promised that this year China would implement measures to open up its financial services markets as promised last November. The moves include elimination of foreign ownership restrictions on banks and financial services firms. Deregulation of foreign insurance companies will also be accelerated. In industrial fields, China plans to ease rules “as fast as possible” for foreign-owned car manufacturers, the aerospace industry and shipbuilders. These are fields in which foreign firms are currently required to form joint ventures with Chinese firms to gain access to the Chinese market. China also plans to lower import tariffs on certain goods – most notably cars, which currently are subject to a 25% import tariff.

Investing in China should become easier once the government revives its “negative list,” which specifies those branches in which foreign investment is restricted and requires special government permission. Other investments will be treated like domestic investments and not require government clearance beforehand.

Violation of intellectual property rights has topped the US litany of complaints in the current trade dispute. China is addressing these concerns by reopening the state intellectual property office and increasing punishments for violators. China will also seek to accelerate its compliance with the WTO Government Procurement Agreement, which it committed to as part of its WTO accession in 2001.

Several of the reforms presented by president Xi have been earlier proposed but never made it to the implementation stage. The US said it was encouraged by Xi’s message, but would still like to see words backed with action. The EU Chamber of Commerce in China has wishes similar to the US, but would still like to see words backed with action. The EU Chamber of Commerce in China has wishes similar to the US, but would still like to see words backed with action.

China launches trading of yuan-denominated oil futures on Shanghai futures exchange. China last year surpassed the United States to become the world’s largest oil importer. Decade-planned trading in yuan-denominated oil futures finally launched on the Shanghai futures exchange on March 26. The oil futures are the first Chinese derivative contracts in which international investors may freely trade.

Oil sold on global markets is traditionally priced in US dollars, with trading fundamentals set by the price of the benchmark West Texas Intermediate (WTI) grade in New York and Brent oil in London. The new yuan-denominated futures provide an opportunity to establish an Asian benchmark grade based on one of the grades most used by Asian oil refiners. The derivative instruments will help Chinese firms manage costs and hedge from price swings. At the same time, the move should help strengthen the yuan’s role in international commerce. Reuters reports that the futures trade is also a first step in China’s efforts to internationalise the yuan’s use as a viable payment currency for the oil trade alongside the dollar.

The first wave of trading included Chinese investors and international players from e.g. Switzerland and the US. The appeal of yuan-denominated oil futures depends to a great extent on international use of the yuan, which will require a toning down of China’s capital controls. Up to now, complex trading rules and barriers to capital movements have effectively prevented foreign investors from participating in Chinese securities markets.

China seeks to increase soy production. China buys two-thirds of the soybeans sold on the global market. Soy meets large share of the protein feed input in Chinese meat production. China’s domestic production can only cover a small fraction of soy demand, however. China’s current 2016-2020 five-year plan calls for reduction the country’s dependence on imported soy by encouraging farmers replace maize with soybeans. By 2020, the area under cultivation for maize should decline to 13% below the 2015 level, while soybean acreage should rise by 40% from that level.

Overproduction of maize has been a problem in China. The subsidised guaranteed maize price was earlier so high that it encouraged farmers to grow maize whether or not there was any demand for it. Chinese soybean farming is today largely supported through farm subsidies. Also soy import tariffs are speculated to be another way of encouraging soy farming as it would raise prices for domestic producers. Over a third of China’s soybean imports come from the United States. With trade tensions flaring, China has threatened to impose 25% tariffs on US-produced soybeans. Import restrictions imposed on soybeans, however, would impact Chinese meat production and fuel inflation. Moreover, this huge soy amount would be difficult to cover with imports from other countries. Chinese firms, not multinationals, are today the main soy importers to China.

Soybean production rose by 12% in 2017, while maize production declined by about 2%. The volume of soybean imports, however, grew by about 14%, while maize imports declined by nearly 11%. The threat of a trade war has confused the outlook of the year and is likely to affect prices of soybeans and maize.

While most guaranteed prices for agricultural products have been abolished, they remain in place for wheat and rice.
Russia

Russia’s economic recovery stumbles again. The Russian economy performed at least slightly better in the first quarter of this year overall compared to the halt of growth in the second half of 2017. The economy ministry estimates first-quarter GDP grew by more than 1 % y-o-y, up from less than 1 % in 4Q17.

Seasonally adjusted industrial output, however, fell again in February and grew only slightly in March. Even if on-year growth in the first quarter was nearly 2 %, March industrial output was lower than in spring and summer 2017. Output of mineral extraction industries was up this year after hitting bottom late last year, rising by about 1 % y-o-y in the first quarter. Manufacturing output has remained unchanged this year, while from a dip in 1Q17 output has increased by over 2 %.

Seasonally adjusted retail sales have continued to recover this year, albeit slowly. Retail sales in the first quarter were up by over 2 % y-o-y. A gradual recovery in real household incomes has supported consumption. Real incomes were up in the first quarter by 3 % y-o-y (if the one-time pay-out to pensioners early last year is excluded). Public sector wages rose rapidly.

Construction activity has continued to shrink this year, declining by 4 % y-o-y in the first quarter. The volume of goods transport rose by well over 3 % y-o-y in the first quarter on strong growth in pipeline transmission in March.

Real growth of core sectors of the Russian economy, 2015–18

% change from four quarters earlier

Source: Rosstat.

Russia and the US holding off on new sanctions. Russia has extended the process of handling a draft law that would impose new sanctions on the United States and possibly other countries. The lower-house Duma is not expected to take up the matter until mid-May, and the proposal has already raised criticism among several Russian firms and many experts. The bill’s proposed menu of sanction options includes restrictions on imports, exports and public procurements. The Russian president would then decide which measures, if any, to implement. Some of the proposed measures would have little effect as they are already in place as earlier sanctions or have been introduced as import substitution efforts (for example, several food items subject to import restrictions).

The US was also expected to again announce new sanctions on Russia at the beginning of the week, which would now be related to Russian support for the Syrian government. Thereafter, the US administration said that it was still only considering new sanctions.

With new sanctions at least postponed by both sides, the nervousness on Russian markets subsided a bit in recent days. The Moscow exchange’s RTS index recovered and the ruble’s exchange rate climbed slightly from last week’s lows. The finance ministry’s daily forex purchases, however, have ceased temporarily in order to lessen depreciation pressures on the ruble’s exchange rate.

Russia is also considering measures to support firms directly targeted by previous US sanctions. One proposal calls for setting up Russian special economic zones similar to tax havens elsewhere. Firms subject to sanctions would be allowed to transfer their operations and capital from foreign tax havens. It has also been envisaged that firms could be supported through e.g. public procurements and a new bank that is in the process of being established to meet the needs of the defence industry.

IMF expects the Russian economy to grow by 1.7 % this year. The IMF’s latest World Economic Outlook sees Russian GDP growth slowing next year to 1.5 %, which is in line with the IMF’s estimate of Russia’s long-term growth potential. According to the IMF forecast, Russia and South Africa will experience some of the lowest growth this year and next among economies that have been generally regarded as emerging economies. The IMF forecasts China’s economy will grow by 6.6 % this year and 6.4 % next year. The Indian economy is expected to grow by 7.4 % this year and 7.8 % in 2019.

The IMF expects that the global economy will grow by 3.9 % this year and next. Thus, Russia’s share in the global economy will continue to diminish. Using market exchange rates, Russia’s share of global GDP is just 2 % this year, well down from its peak share of about 3 % in 2012–2013.

The IMF reports that per capita GDP adjusted for purchasing power parity (PPP) was about $27,800 in Russia last year, or e.g. 63 % of Finnish per capita GDP. Russian living standards soared before the 2008 global financial crisis, but since then have converged on higher-income economies at a much slower pace. In recent years, the gap in living standards has actually widened, for example, with EU countries.
China continues to report implausibly stable growth. China’s National Bureau of Statistics reports that first-quarter GDP grew at 6.8 % y-o-y – exactly the same pace as in the previous two quarters. Official figures paint a picture of remarkable consistency in Chinese economic growth over recent years which is hardly a credible description of a transition economy that experiences major changes.

Despite the challenges of interpreting Chinese GDP figures, economic growth apparently has remained robust thanks to strong domestic consumer demand. However, many of the monthly indicators of economic performance (e.g. industrial output, fixed asset investment, electricity generation) suggest economic growth is slowing. In addition to the structural deceleration of growth, heightened US-China trade tensions and the severity of the debt problem pose extra risks to the future growth prospects.

Nominal and real Chinese GDP growth (official version)

Despite a larger surplus with the US, China’s goods trade surplus contracted overall in the first quarter. The value of China’s first-quarter goods exports amounted to $454 billion, an increase of 14 % y-o-y. The value of imports was up by 19 % to nearly $500 billion. This year the overall trade surplus contracted to $49 billion. While the overall trade surplus contracted, China’s surplus with the United States rose by 18 % y-o-y in January-March to $58 billion. China’s $14 billion surplus with the rest of the world (except the US) in 1Q2017 turned to a $9 billion trade deficit in 1Q2018.

China’s growing trade surplus with the US only exacerbates tensions between the two countries. On April 13, the US treasury department released its semi-annual trade report. The treasury department expressed serious concerns about the US trade deficit with China and China’s unfair trade practices, but refrained from calling China a currency manipulator. China, in fact, has recently supported the yuan’s value. On Monday (Apr. 16), the US commerce department imposed a seven-year ban on component sales of US firms to the Chinese telecom giant ZTE. Officially, the ban was declared because of ZTE’s business dealings with Iran and North-Korea.

US-based Qualcomm, however, could lose one of its most important customers as its microchips are found in nearly half of all the phones ZTE produces. On Tuesday (Apr. 17), China, for its part, imposed a temporary 179 % antidumping fee (in the form of obligatory deposit) on US sorghum. China imported about $1 billion worth of US sorghum last year.

China lowers its bank reserve requirement by one percentage point. The People’s Bank of China cut its reserve requirement ratio (RRR) for small and mid-sized banks from 15 % to 14 %, and for large banks from 17 % to 16 %. The changes will enter into force next Wednesday (Apr. 25). Banks should use most of the freed-up cash to pay back their maturing medium-term lending facility (MLF) loans to the PBoC. Thus, the drop in the RRR should only mildly affect the situation in the money markets. Nevertheless, the move supports banks’ profitability by allowing them to pay back their MLF loans (the current rate on new one-year MLF issues is 3.3 %) from their reserves which carry a lower interest rate (1.6 %).

A total of 891 billion yuan ($140 billion) in MLF loans will come due by the beginning of June. The central bank this year has granted 1.591 trillion yuan in new one-year MLF loans to commercial banks. In contrast, the use of the PBoC’s short-term lending facility (SLF loans), which banks use to meet their short-term (1–30 days) borrowing needs, has been depressed compared to last year. The PBoC also regulates banking sector liquidity with its open market operations. As a result of these operations, about 800 billion yuan in liquidity has been mopped up from the markets this year. Moreover, the PBoC supports the liquidity of the financial system by providing pledged supplementary lending (PSL loans) to its policy banks. At the end of March, the stock of PSL loans was nearly 3 trillion yuan; a net gain this year of 304 billion yuan.

Determining China’s actual monetary policy stance is difficult. The use of interest rates in guiding policy has yet to gain the same status in China as in advanced economies. Interest rates offered on financing to commercial banks through the PBoC’s short-term lending facility (MLF) and 1-day repo operations have been kept low. The PBoC supports the liquidity of the financial system by providing pledged supplementary lending (PSL loans) to its policy banks. At the end of March, the stock of PSL loans was nearly 3 trillion yuan; a net gain this year of 304 billion yuan.

Chinese trade balances by country/region

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Russia

Russian government receives abundant excess oil revenues. Revenues to the federal budget continued to climb up rapidly in the first quarter of this year, rising by well over 10 % from a year earlier. Most of the revenue increase came from higher oil and gas tax revenues, which were up by over 20 % y-o-y. Rising revenues from value-added taxes provided an increase in non-oil revenues.

“Additional” budget revenues from oil and gas taxes in the first quarter corresponded to a whopping 3 % of GDP. Under the federal budget rule, additional revenues from oil and gas taxes are those resulting from an oil price above the “basic price” set in the rule (that price is applied to define budget expenditures). For this year, the budget rule sets a basic Urals oil price of slightly below $41 a barrel. The revenue projection of the approved federal budget assumes a price of just $44. In fact, the realised average Urals price in the first quarter was $65. The rule requires additional oil revenues to be set aside. Last year’s excess oil earnings amounted to almost 1 % of GDP. The income set aside may be used later to cover budget deficits.

The past four quarters have seen the federal budget deficit decline to under 1 % of GDP. Under the approved 2018 federal budget, spending hardly rises at all even in nominal ruble terms this year. As a result, first-quarter spending declined from a year earlier. Defence spending increased a bit and domestic security spending more tangibly. Other spending fell quite sharply.

Oil & gas tax revenues in the Russian federal budget, 2016–2018

![Graph of oil & gas tax revenues in the Russian federal budget, 2016–2018]

Proposal on stricter import control for Russian state-owned enterprises. The proposal is related to an amendment approved at the end of 2017 that will enter into force at the beginning of July. Under that law, state-owned enterprises and their subsidiaries must seek approval from the government commission on import substitution for certain imported procurements. The law also applies to investment projects receiving state support. The current proposal details which products and services will need permission.

The law was initially planned to concern mainly ship and aircraft procurements. The newest list from the ministry of industry and trade incorporates over 200 additional products and services that extend to e.g. textiles, cement, industrial machinery and construction services. For most of the listed goods and services, the bill proposes that approval of import substitution commission would be needed for imports worth over 50 million rubles (€700,000) annually. The proposal is considered strict, but some observers expect its impact to be blunted by shortening the final list or raising the minimum ruble value on imports requiring approval.

The legislative amendment is part of the government’s import substitution policy that has been accentuated in recent years. The policy seeks to reduce the country’s dependence on imported goods by replacing them with domestic products. The government has sought to promote import substitution especially by imposing procurement rules on the government sector and state-owned enterprises. However, these policies have so far yielded meagre results.

Russian household consumption recovers. Private consumption began to recover last year, increasing in real terms by about 3.5 % y-o-y after declining by a total of 12 % over the previous two years. Household consumption last year was slightly lower than in 2012, but still up around 25 % from a decade ago.

All the main categories of household consumption have started to revive. The strongest recovery last year occurred in spending of Russian travellers abroad on goods and services. On the other hand, consumption in all core categories last year was still far below the pre-recession peaks of several years back. Imports of consumer goods last year were still even below the 2008 level.

Domestic online sales and imports of goods ordered from foreign online sellers are still significantly smaller categories at present. After contracting during the recession two years ago, online sales have recovered. Over several years, there has been strong growth in online purchases especially from foreign sellers.

Segments related to household consumption, 2008–2017

![Graph of segments related to household consumption, 2008–2017]
China

Housing price rise in China’s big cities lower than national average. Real estate portal operator SouFun reports the deceleration in the average rise in housing prices continued in the first quarter of this year. Chinese housing prices in March 2017 averaged a rise of 17% y-o-y in SouFun’s survey of 99 cities. Housing prices this March were up just over 6% y-o-y. Price growth in large cities has been considerably lower than the national average. SouFun reports that the average price of new apartments in March in its surveyed cities was 14,100 yuan ($1,800) per square metre of liveable floorspace. For example in Shanghai, apartments were going for 47,000 yuan ($6,100) per square metre.

The volume of apartment sales in the first three months of this year (measured in terms of floorspace) was up 3% from a year ago. Because the volume of apartment building completions was down 14% y-o-y in the first quarter, the volume of pending sales of apartments fell 25% y-o-y. New building starts, however, were up sharply in the first quarter, with new projects up by nearly 40% y-o-y. Most of the new starts were apartment buildings.

Despite the moderation in price growth, rising indebtedness, overbuilding and receding affordability relative to income levels cause concern. Part of the overheating of China’s housing markets also reflects efforts by local governments to raise money through the sale of land use rights. Purchasing an apartment in China on average now consumes nearly 30 years of household income. Apartment affordability is even worse in big cities.

Officials hope the long-planned property tax based on assessed value will make it easier for local government budgeting, reduce speculation in housing markets and increase the popularity of renting apartments. At the National People’s Congress last month, Premier Li Keqiang announced that the government will steadily push forward legislation on property tax, but no specific timetable on its roll-out was mentioned.

Renewed efforts to rein in local government debt in China. The massive accumulation of debt by local governments has become a primary concern for Chinese economic policy. Over the past two months, officials have announced a number of new measures to bring the situation under control. As an initial measure, local administrations were ordered to implement by August a debt-swap programme that was initially approved in summer 2015. The programme calls for conversion of debt (mostly bank loans) of local governments to bonds. Officials hope the debt swap will make it easier to assess the debt situation of local governments and reduce their debt-servicing costs. Additionally, state-owned financial institutions are now banned from lending to local governments in any manner other than purchasing their bonds. Granting of new bank loans to off-budget local government financial vehicles (LGFVs) is also prohibited.

Despite the aim of curbing financial market risks, the Chinese continue to pile on debt. As of end-March, the People’s Bank of China’s broad measure of credit (total social financing or TSF), which includes corporate and household borrowing, stood at 179.9 trillion yuan, or 213% of GDP. While acceleration in nominal GDP growth caused the TSF-based debt-to-GDP ratio to fall slightly in the final three quarters of 2017, China’s debt-to-GDP ratio began to head back up in the first quarter of this year.

Rapid growth in bank lending continued with the total stock of bank lending rising to a record high of nearly 150% of GDP. The stock of bank loans granted to households in March was up 23% y-o-y, while the total stock of yuan-denominated loans rose by 13%. 26% of yuan loans went to households. The stock of trust loans continued to swell (up 23% y-o-y), while the stock of entrusted loans, another major product of the shadow banking sector, fell year-on-year for the first time ever. Regulation of entrusted loans was increased significantly this year.

Domestic private sector borrowing (stock of TSF)

Sources: PBoC, Macrobond and BOFIT.

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Russia

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

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

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

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

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

SIPRI reports that US defence spending continued to fall in real terms in 2017, but otherwise spending in Russia’s vast neighbourhoods continued to rise. During 2015–17, China and India increased their defence spending by 5.5–6 % a year. Annual spending growth in eastern central Europe and the Balkans was nearly 8 %, while spending of the Baltic countries rose at 20 % a year. Defence spending in western Europe rose 2 % a year. Turkey increased its spending by nearly 10 % a year, while Ukraine’s spending, despite slight dips, was up 5.3 % from the 2014 level.

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

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

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

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

Russian travel abroad and average monthly income

Sources: CEIC and Rosstat.
China

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

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

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

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

The increased quotas reflect last year’s decision by share index publisher MSCI Inc. to include mainland China shares in its indices from the start of June (BOFIT Weekly 25/2017). Even if a large share of the China-weighting in indices will still be realized China’s decision to create a unified financial regulator (China Banking and Insurance Regulatory Commission, CBIRC), and expects it to bring about much-needed cooperation. The GFSR notes, however, that assessment of financial sector risk is complicated by opaque cross-holding arrangements and leverage structures, as well as a lack of clarity on the actual risk of investment products.

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

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

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

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

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

Putin’s newest May Decree sets out typical government target and task list through 2024. As with Putin’s third inauguration in 2012, he laid out on Monday (May 7) a new to-do list for the cabinet during his fourth six-year term. General goals include population growth and rising living standards, including cutting by half the number of Russians living in poverty and improving housing conditions, a rate of economic growth above the global average, technological advancement (e.g. innovation and digitalisation) and a high-productivity export sector. The list mentions nothing regarding foreign or domestic security, foreign policy or the recent years’ theme of import substitution.

The government was tasked with creating or modifying national projects and programmes covering twelve sectors. The demography programme will seek to improve the birth rate and ease the entry of mothers to working life. The healthcare project seeks to reduce mortality of working-age individuals and infants, eliminate Russia’s healthcare labour shortage, improve access to first aid and define tariffs for care. The education project will seek to improve the quality of general education through the adoption of new teaching methods and modernise vocational training to make it more oriented and flexible to practical demands. The housing and urban environment project is to increase annual home construction volume by 50 % through different financing modes (including a mortgage interest rate ceiling), subsidies for standard construction, reduced regulation on housing construction and efficient land usage for mass construction.

The employment programme has links to child and education policies. Tax incentives and less red tape are to improve labour productivity. The goal of raising productivity by 5 % a year will apply to at least 10,000 mid-sized and large companies operating in basic industries outside the resource extraction sector. The project for small and medium-sized firms and private entrepreneurs seeks strong growth in the numbers of people employed by them through simplified tax reporting, beneficial credit and public procurements. The export development programme seeks to boost Russian exports beyond basic commodities. Measures include reduced regulation, export support, improvements in logistics and border-crossings. The only trading partners mentioned are members of the Eurasian economic union, along with targets for the trade volume within the union and final common market objectives.

R&D spending will rise under the science project. Digital economy’s own programme includes rapid spending increases and IT performance & security enhancement based primarily on domestic designs. Digitalisation is also emphasised in various other projects.

The road project seeks e.g. to reduce traffic deaths, and impose heavier punishments for traffic violations. There is a separate agenda for large national traffic corridors and electricity projects. The Decree also has environmental focuses. The project extends to waste handling and waste dumps, air pollution in large industrial centres, drinking water quality, and clean-ups of Russia’s various lakes, rivers and shorelines. The culture programme stresses stronger national identity.

Sale of Rosneft stake to CEFC cancelled. The deal that was announced last autumn involved the Chinese CEFCS acquisition of a 14 % stake in Rosneft from a consortium of Glencore and the Qatar Investment Authority (QIA). A Glencore press release last week said the deal had been cancelled. The consortium will also be dissolved and the stake meant for CEFC will go to a QIA subsidiary. Under the new arrangement, QIA will own 18.9 % of Rosneft and Glencore 0.6 %.

CEFC failed to raise the money to finance the deal after its chairman was detained by Chinese officials. China’s state-owned investment company Citic Group has bought out CEFCS assets in the Czech Republic, but not foreign assets elsewhere nor the option on Rosneft stake. CEFC participated last autumn in the IPO of the Russian energy company En+. En+ last month was placed on the US SDN sanctions list.

Foreign bank lending to Russia has declined notably. The Bank for International Settlements (BIS) reports that the total lending of foreign banks to Russia at the end of 2017 amounted to $122 billion. The figure includes lending of all foreign bank units to Russian borrowers. The lending stock has declined by a bit more than 50 % since the end of 2013, apparently on weak trends of the Russian economy and impacts of sanctions on long-term borrowing of certain companies. Lending recovered only slightly in 2017.

Among reporting countries, France was Russia’s biggest lender ($27 billion), followed by Italy ($22 billion), Austria ($14 billion) and the US ($13 billion). All these countries have bank operations in Russia.

Foreign bank lending to many other emerging economies only fell slightly or even grew during the same period. For example, lending to India and Indonesia rose by nearly 20 % in the period. Foreign banks’ lending to China fell by 7 % during the whole period, but last year it returned to brisk growth.

Foreign bank lending to select emerging economies

Source: BIS.
China shows large current account deficit for January-March. This year’s $28 billion first-quarter current account deficit set a historical record for China. It partly reflects the typical dip in the first-quarter goods trade surplus and China’s growing services trade deficit. In the first three months of this year, spending of Chinese tourists abroad increased by 14 % y-o-y to a record $74 billion. Tourist spending in China, in contrast, remained at the 1Q17 level and the travel services trade deficit was $64 billion. Overall, there was a record services trade deficit of $76 billion. The value of goods exports was up 11 % y-o-y and the value of imports was up by 21 %, narrowing the goods trade surplus to $53 billion.

The goods trade surplus has traditionally kept China’s current account in the black. Over the past 25 years, the current account only briefly dipped into negative territory in 2001. China’s current account is still in the black on year, but the overall surplus has shrunk to just 1 % of GDP. The current account surplus is expected to shrink in coming years as China shifts to a service economy, rapid growth in household consumption cuts into the goods trade surplus and the tourism deficit rises along with Chinese living standards.

China’s main current account categories relative to GDP

China-US trade dispute worsens as lists of demands lengthen. On May 3 and 4, president Trump’s trade policy delegation, led by US treasury secretary Steve Mnuchin, visited Beijing to assuage tensions in the current bilateral trade dispute. The main takeaway from the meetings was that the parties agreed to keep talking. In some respects, trade relations between the two countries seemed to take a turn for the worse, with the Americans presenting additional demands and China responding with its own new demands.

The US now wants to reduce its annual bilateral goods and services trade deficit with China by $200 billion a year by 2020. The Trump administration had earlier asked for a reduction by $100 billion a year within 12 months. The request is not small – the 2017 imbalance was $337 billion. Bloomberg reports that the US also reiterated earlier demands that China open up its markets and cut tariffs, that Chinese firms desist from further IP violations and that China drop the subsidy elements of its “Made in China 2025” industrial policy.

China said US firms would only get to enjoy opening of its markets if the US, among other things, ends restrictions aimed at Chinese technology firms, refrains from raising tariffs and grants China market economy status in the WTO.

The lengthening lists of demands from both sides highlights the seriousness of the situation. The US decision to focus on direct and immediate reduction of its trade deficit with China is both unworkable and counterproductive. Indeed, it endangers the legitimate goals of accelerating China’s opening and eliminating existing protectionist schemes. One of the biggest threats from the current situation is that the countries go through with customs duty hikes and launch into a full-blown trade war.

Bilateral talks will continue in Washington DC next week, when a delegation led by Chinese vice-premier Liu He arrives.

China still has a long way to go to achieve full deregulation of bank deposit and lending rates. China’s last remaining interest rate limits were officially dropped in October 2015 (see BOFIT Weekly 44/2015). While it has been ostensibly left to commercial banks to set their own interest rates on loans and deposits, the reality is that the People’s Bank of China continues to determine the price ranges of banks through its “window guidance” policy. At PBoC and commercial banks meetings, the central bank can extend lending limits and objectives, as well as provide guidance on pricing of loans and deposits. The central bank additionally continues to issue reference rates for loans and deposits, even if they have not been adjusted since interest rates were deregulated.

Commercial banks also agree among themselves on pricing of loans and deposit rates. China Daily reported in April that commercial banks had discussed in their meetings the possibility of raising deposit interest rate range to 140–150 % of the PBoC reference rate. The current range is 130–140 % of the reference rate. In addition, since the deregulation of rates, lending rates have closely tracked reference rates. According to PBoC figures, over two-thirds of new bank loans are priced at 90–130 % of the reference rate. The average interest rate on new bank loan at the end of 2017 was 5.7 % p.a., and the one-year reference lending rate was 4.35 %.

New central bank governor Yi Gang has stated that China will continue transition to a market-based interest-rate regime and end the current dual-rate market. Money markets are currently free to set interest rates, but the retail rates are still in the control of the central bank. News agency Caixin reported in April that the PBoC had decided to let commercial banks set higher interest rates on certificates of deposit, but the decision did not extend to bank deposits. For example, large commercial banks can now offer interest rates on their deposit certificates at up to 150 % of the reference rate. The previous ceiling was 140 %.
Russia

Price tags on Putin’s new economic initiatives revealed. Prime minister Dmitri Medvedev’s initial assessment of president Putin’s May Decree is that implementation over the next six years will cost about 25 trillion rubles (€360 billion). The bulk of this spending is already incorporated into federal budget planning, but Medvedev estimated that supplemental spending of around 8 trillion rubles is still needed (a nearly 10 % increase in the estimated total federal budget expenditures over the next six years). In other words, extra annual spending would average 1.3 trillion rubles (an increase of €19 billion or about 1 % of GDP).

The daily business paper Kommersant reports that the finance and economy ministries have sketched the costs for the 13 national projects to be created for implementing the May Decree. The largest expenditures would go to roads (an average of 1.4 trillion rubles a year), demography (600 billion rubles), infrastructure (300 billion rubles) and digital economy (220 billion rubles). The biggest annual spending increases are planned for healthcare (220 billion rubles a year), roads (210 billion) and digitalisation (170 billion). The May Decree did not mention defence, but spending under the recently accepted 2018–2027 armaments programme is estimated at 19 trillion rubles, or an average of 1.9 trillion rubles a year.

It is still unclear where the money for supplemental spending on national projects will come from. In principle, money should be raised by increasing either non-oil revenues or cutting spending in other budget categories, since under the new budget rule all revenues from oil price exceeding the target of just over $40 a barrel should be set aside as savings. Additional revenues are hoped to be raised e.g. through higher economic growth or improved tax collection. Raising the retirement age has been suggested as one way to save in spending.

Rapid growth in Russian goods trade continued in first quarter. The value of goods exports in the first quarter slightly exceeded $100 billion, an increase of over 20 % y-o-y. Rising oil prices boosted exports, with the average price of Urals crude up about 25 % y-o-y. On the other hand, the total volume of exports of crude oil and oil products contracted by about 1 % y-o-y. In contrast, many other major goods saw brisk increases in export volumes, including natural gas, most metals and wheat. About half of goods exports went to EU countries, more than a fifth to Asia and about 9 % to countries in the Eurasian economic union. China accounted for 12 % of exports.

Food imports also rose briskly despite Russian import bans and efforts to encourage import substitution. In the category of dairy products, in particular, domestic producers have been unable to provide adequate supply. As a result, dairy import volumes climbed by 20 %. Nearly 40 % of Russian imports came from EU countries, over a third from Asia (from China 22 %) and 8 % from the Eurasian economic union.

**Russian goods trade and the oil price**

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<th>Change, % y/y</th>
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<tr>
<td>Exports</td>
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<td>Imports</td>
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<td>Urals price</td>
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Sources: Central Bank of Russia, Reuters.

Growth of Russia’s defence industry slowed last year. Production of the military-industrial complex (obo-ronno-promyshlenyi kompleks or OPK) increased last year by over 3 %, reaching a record level after growing at 10−15 % a year in the four previous years. Over 80 % of production in OPK was production for defence, about the same share as in 2016. The share rose to this height in the boom of OPK defence production during 2012–2016. Civil production, however, is planned to gradually begin to account for a larger share of OPK after 2020 and rise to around 30 % by 2025.

OPK is part of Russia’s manufacturing industries whose production overall remained virtually flat over the past three years. Manufacturing overall rose by just 0.2 % last year. Taking into account the rise of defence production in OPK, civil production in manufacturing industries as a whole has clearly declined. Depending on the way of calculation, OPK employs 15−20 % of Russia’s manufacturing workers.

**Real growth in production of Russian military-industrial complex and total manufacturing output**

Sources: Industry ministry, Federalnyi spravochnik and Rosstat.
China

Moderate slowdown in China’s economic growth continues. Private consumption has sustained China’s growth in recent years. Retail sales, a common measure of private consumption, slowed in April slightly in real terms to just under 8%. Growth in fixed asset investment (FAI) has also been slowing for a while. Nominal FAI growth in April slowed to just 6% y-o-y. Even with a moderate inflation estimate of investments, FAI real growth is assumed to be close to zero. Growth in property sales have also slowed this year. In terms of floor space, sales of residential and commercial properties have fallen from last year.

Industrial output growth accelerated slightly to 7% y-o-y in April. Some observers see the pick-up as temporary, however, as the spurt includes the March lifting of winter restrictions on atmospheric emissions and the subsequent increase in heavy industry activity.

Imports grew faster than exports again in April. In the first four months of the year, the dollar value of imports rose by 20%, while the value of exports was up by 14% y-o-y. During the same period, the yuan appreciated over 8% against the dollar. This resulted in a more modest growth in foreign trade when measured in yuan (exports grew by 6% and imports by 12%).

The value of China’s foreign currency reserves fell in April by USD 18 billion to USD 3.125 trillion, partly due to exchange rate movements.

Chinese inflation remained modest in March and April. 12-month consumer price inflation was 2.1% in March and 1.8% in April. Core inflation, which excludes food and energy prices, remained at 2%. Prices for services rose by 2.1% y-o-y in April, clearly exceeding the rise in goods prices (1.3% y-o-y). Healthcare-related services saw the fastest rise in prices. Inflation overall slowed a bit on low food price inflation (0.7%), mainly a reflection of a large drop in pork prices (down 16.1%). April producer price inflation was 3.4%.

Robotisation of China zooms along. China has been the world’s largest market for industrial robots since 2013, and accounted for 30% of global industrial robot sales in 2016. The International Federation of Robotics (IFR) reports that China’s share rises further in a couple of years to around 40%. Robot density in China’s industrial sector in 2016 (68 robots per 10,000 employees) nearly tripled in a few years’ time to approach the global average of 74. The highest robot density in the world was in South Korea (631), while Russia, the Philippines and India (3 each) had the lowest robot densities. In 2016, a total of 87,000 new industrial robots were purchased in China, or more than double the number purchased in South Korea or Japan, the next largest markets. The annual number of units sold in China approaches the combined sales volume for North America, South America and Europe (97,300).

In 2016, over a million industrial robots were in use in Asia, with about a third located in China. The total number of industrial robots that year was around 460,000 in Europe and about 300,000 in North and South America. The number of industrial robots in China is expected to reach 1 million units within the next two years, when 2 million industrial robots are expected to be in use in Asia.

With over 30,000 units purchased in 2016, relatively more “service” robots are sold in North and South America than elsewhere. That same year, about 16,000 service robots were sold in Europe and 11,000 in Asia. Most service robots used in businesses are involved with logistics, national defence, hospitals or agriculture. Growth in the use of service robots by firms is expected to grow at 20–25% a year in coming years. Private household robots are also included in the service robot category. Nearly 3 million domestic units were sold in Asia and the Americas in 2016, while sales in Europe were less than 1 million. Europe led in the number of service robot manufacturers (293), however, followed by North America (242) and Asia (134).

Estimated numbers of industrial robots by region, 2015–2020

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Russia

No large economic policy changes expected from Russia’s new cabinet. On May 18 president Vladimir Putin approved the new cabinet proposed by prime minister Medvedev, consisting of 10 deputy prime ministers and 22 ministers. There were few surprises in the cabinet reshuffle and even most of the ministers coming outside the cabinet have long careers in government administration.

Anton Siluanov was named as the first deputy prime minister responsible for e.g. economic matters, but continues as finance minister as well. There were no changes in the ministers for economic development, industry & trade and energy. Dmitri Patrushev, head of Rosselhozbank, was appointed as the agriculture minister. His father, Nikolai Patrushev, is secretary of the Security Council of Russia.

Numerous observers have characterised the new cabinet as conservative and technocratic, so hopes of major economic reforms are not very high. Alexei Kudrin, a father figure for reforms, did not make it to the cabinet but was named chairman of the Accounts Chamber of Russia.

Reasonable recovery in Russian domestic demand; growth in output slower. The recovery in seasonally adjusted retail sales continued in April. From twelve months earlier retail sales were up nearly 2.5%. Real household incomes also rose by several per cent in on-year terms in the first four months of the year. The recovery in fixed investment slowed a bit from last year. Fixed investment in the first quarter was up 3.5% y-o-y. After a long period of decline, construction activity also revived in April.

As in previous recoveries, the revivals of domestic demand increased imports, even if import growth has slowed in recent months. Domestic production has grown much more slowly. Rosstat reports that first-quarter GDP grew by 1.3% y-o-y.

Retail sales and industrial output in Russia, 2014–18

Signs of industrial recovery are still unclear. While seasonally adjusted industrial output has increased in recent months, April industrial output was still on par with the level of early summer 2017. In the first four months of this year, on-year growth of industrial output was less than 2%. In extractive industries, which include oil and gas, on-year growth was just over 1%. Manufacturing in the period was up 2% y-o-y, but in recent months manufacturing output has remained essentially flat.

Russian Duma approves new counter-sanctions bill. The bill was introduced last month after the US added new Russian entities and persons to its SDN sanctions list. The version of the bill approved in its third reading to the Duma on May 22, however, was formulated in notably more general terms than the original bill. Under the final version, the Russian president can, as needed, impose restrictions on unfriendly countries and firms operating under their jurisdiction. Possible counter-sanctions mentioned include import and export bans.

The Duma is also considering a bill that would criminalise enforcement of foreign sanctions in Russia, but it is still under discussion due to wide opposition.

American sanctions affecting Russian firms. The latest round of sanctions announced by the US Treasury Department on April 6 have significantly impacted targeted Russian firms, most notably one of the world’s largest aluminium producers Rusal and its main stakeholder Oleg Deripaska. Rusal’s global production activities have been severely impaired by the move, forcing its customers and investors to get determinations e.g. on how fast they need to cease their business relations with the sanctioned giant. US officials have been willing to show flexibility in Rusal’s case e.g. on arrangements in corporate structures, partly because the mere threat of disrupting the company’s production caused global aluminium prices to spike by about a third. This week global aluminium prices were up about 15% from the start of April.

Deripaska owns Rusal via the energy-focused EN+ Group. He has promised to reduce his ownership stake in Rusal from 70% to below 50%. Following the sanctions announcement, Rusal’s share price plummeted by over 50%. Its share price is currently down about 65% from the beginning of this year.

The US sanctions list also includes Viktor Vekselberg and his Renova Group conglomerate. Renova owns, among other things, several machine-building firms and a stake in Rusal. Vekselberg says Renova paid off about 1 billion Swiss francs worth of loans to Western banks before sanctions took effect. Renova says the loans were paid off out of pocket and through borrowing arrangements. A press release from the Russian finance ministry noted that Renova also obtained a loan from Promsvyazbank. The government plans to make Promsvyazbank a major lender to Russian defence industry to make sure that other Russian banks are not burdened with the risk of sanctions that could arise if they loaned money to companies subject to financial sanctions.
China

Over 500 million Chinese have been lifted out of poverty in recent decades. The World Bank defines the international poverty threshold as disposable income of USD 1.90 a day (PPP-adjusted). Under that definition, 88% of the Chinese population lived below the poverty line in the early 1980s. That ratio had fallen to just 2% by 2013, when the number of persons living in poverty was just 25 million. The global Multidimensional Poverty Index (MPI), which was developed at Oxford University and has been embraced by the UN, assesses poverty more broadly in such terms as years of education, nutrition, child mortality, access to necessities, healthcare and living standards. Under the MPI, 12.5% of Chinese were poor in 2002, but just 4% (56 million people) in 2014. Gains in poverty reduction mainly reflect better access to education and improvements in hygiene and public health.

China’s official national poverty line is an annual income of 2,300 yuan a year (about USD 350 a year). Under this poverty definition, there were roughly 56 million impoverished Chinese in 2015. The government notes, however, that the number has fallen steadily by about 10 million people a year. Last year, the number of persons living in poverty was about 30 million.

President Xi Jinping would like to see all extreme poverty eliminated by 2020. The elimination of poverty is one of three pillars in the current five-year plan. The other main themes are reducing pollution and financial risks to the economy. The government also wants to relocate 100 million rural inhabitants to cities by 2020 and another 150 million by 2026. This goal integrates the most difficult phase in elimination of poverty, which involves bringing those in extremely rural areas into economic life and modern living standards. People are moved to cities or surround areas, or into newly built villages. Poverty reduction and urbanisation reinforce consumption and economic growth.

America and Environmental Technology, which is listed on the Shanghai exchange, defaulted this month on its US $1 billion (USD 2 billion) and interest. The company’s largest owner (about 30%) is Sunshine Kaidi New Energy, which is also the parent of Kaidi Finland, which is planning to build a biofuel refinery in Kemi. CEFX Shanghai International, a subsidiary of CEFX China Energy that run earlier into financial problems and withdrew from the Rosneft deal, missed this week over 2 billion yuan in scheduled bond payments.

Missing bond payments is still quite rare in China, and even fewer firms have been allowed to go bankrupt. The fact that news of such events is now making it into the public sphere suggests a changing situation and increased difficulties for firms in getting financing. It has long been hard to assess the true economic condition of Chinese firms, especially as debt payments could often be covered by simply borrowing more money. Regulatory oversight of shadow banking instruments, in particular, has been stepped up this year. This has made it harder for firms to get financing and refinance existing debt.

While China is shifting to a more market-based financial system, actual corporate risk is still not necessarily reflected in the pricing of credit, especially when investors assume the government provides an implicit guarantee. The threat of actual default has sobered investors to some extent. The government allowed the first bond default in 2014, and in recent years the number of bond defaults has risen to several dozen a year.
Russia

Russia’s government sector deficit shrinks, the reserve fund will increase. In the first quarter of this year, revenues to the consolidated budget (federal, regional and local budgets plus state social funds) were up by more than 10% from a year earlier. The rise in revenues was nearly as fast as last year.

Budget oil revenues increased by well over 20% y-o-y, which was about the same pace as last year. The oil revenues comprise five categories: taxes on production of crude oil and natural gas, and export duties on oil, oil products and natural gas. Export duties on oil and oil products, as well as the taxes on crude oil production are partly determined by export prices, which have been substantially higher this year than last year. Oil revenues in the first quarter increased their share to nearly 25% of total consolidated budget revenues. The share has not been this high since 2015.

Other revenues to the consolidated budget continued to rise by nearly 8% y-o-y in the first quarter, even if revenues from excise taxes plunged as the tobacco industry’s output fell sharply last year. The biggest revenue streams (mandatory corporate social taxes, value-added taxes, corporate profit taxes, income tax) all increased by roughly 15% y-o-y. This suggests that tax collection has improved further, as there have been no increases in these taxes. Value-added tax revenues have also grown due to imports which continued to recover rather briskly still early this year.

Consolidated budget spending continued to rise slowly in the first quarter, just 3% y-o-y. Spending on healthcare and education, as well as spending on general administration increased remarkably fast. Spending on defence, domestic security and law enforcement, as well as various economic sectors, grew rather slowly.

Major revenue streams in Russia’s consolidated budget, 2008–2018

The consolidated budget deficit has contracted over the last twelve months to less than 1% of GDP. Under the new federal budget rule, “excess” oil revenues are to be saved and transferred to the single reserve fund that Russia maintains since the start of this year, i.e. the National Welfare Fund, by autumn of the following year. Excess oil revenues arise when the realised oil price exceeds the annual base calculation price set in the rule. Both this year and last year have seen large inflows of excess oil revenues. The reserve fund holds liquid assets equivalent to more than 2% of GDP, but last year’s excess oil revenues have yet to be transferred to the fund. Overall, the Russian federal government had assets in the central bank equivalent to more than 6% of GDP at the end of March.

EU and Gazprom resolve long-running gas dispute. An investigation by the European Commission launched in autumn 2012 found that Gazprom broke the EU’s competition regulations in many central and eastern European member countries. Commission findings on the matter were delivered to Gazprom in April 2015. Gazprom delivered its response in spring 2017. Last week (May 24), the Commission issued its final ruling in the matter. The ruling mandates that Gazprom, under threat of a fine, modify its contract practices within the EU. Among other things, Gazprom must allow the sale of gas to third parties, commit to upholding market pricing and ease gas deliveries to the four EU member countries dependent on Gazprom pipeline supplies. Observers note that Gazprom has already modified most of its operational practices to conform with EU standards and that the company has promised to abide by the Commission’s decision.

Gazprom last year accounted for about 43% of EU gas imports. About 44% of natural gas from Russia reached the EU via Ukraine, 24% via Belarus, and about 30% via the Nord-Stream gas pipeline, which runs under the Baltic Sea.

Russia to require unique identifiers for many consumer products next year. At the end of 2017, the Duma approved a law on unique identifier codes for products sold in Russia. At the moment, the unique product identifiers are being used in a few pilot projects, e.g. fur products. Under a cabinet decision made in early May, the first wave of unique identifiers will become mandatory next year for products that include tobacco products, clothing, footwear, perfumes and automobile tyres. The system of mandatory unique identifiers is planned to be extended later to include other products such as pharmaceuticals.

The identifier must include information e.g. on the product classification and its origin as well as give the item its unique identity. The unique identifier system is to be based on Russian encryption technology and should be implemented by a company partly owned by Rostec, a massive conglomerate operating e.g. in the defence sector. The identifier system is hoped to reduce smuggling, the grey economy and counterfeit goods. Many firms, especially SMEs, fear that this system will increase costs and force them to raise prices.
China

Tighter regulations affect income generation of China’s insurance sector. The size of China’s insurance sector (total balance sheet assets) grew in the first quarter of this year by 6.5% y-o-y to just over 17 trillion yuan ($2.7 trillion). The size of China’s insurance sector is now nearly eight times larger than it was a decade ago. Insurance premia fell by 16% y-o-y in the first quarter. The biggest drop was in life insurance, which accounts for over 60% of all insurance payments. Investment income rose in the first quarter by more than 15%.

Some insurance companies have strongly bolstered their growth in recent years through the sale of “wealth management products.” These universal insurance products differ from traditional insurance by promising investors high and guaranteed rates of return. Companies have been expanding abroad and outside their core business. Last year, however, measures targeting the insurance and shadow banking sectors have tightened the income generation of insurers, especially regarding the wealth management products. Growth has slowed and some insurance companies have been forced to sell their assets. In particular, unlisted firms struggle to pay promised returns to investors. The government has promised better access of foreign entities to Chinese markets, which should even increase the competition. Regulation is also being tightened (see below).

Anbang Insurance provides a telling example of the insurance sector’s current problems. Anbang expanded rapidly and was China’s third largest insurance company in the first half of 2017. It controlled directly or indirectly nearly 60 firms when encountered with severe financial difficulties and was taken over by government. In April, the government spent 61 billion yuan ($10 billion) re-capitalising Anbang. In May, Anbang founder Wu Xiaohui was convicted of financial crimes and sentenced to 18 years in prison.

New rules require Chinese insurance companies to reveal their ownership structures. The newly merged banking and insurance regulator CBIRC released new rules in May that substantially increase the disclosure obligations of insurers. Insurance companies must now provide detailed information about their ownership structures, main business activities and risk management practices. The new rules enter into force on July 1.

Complex webs of ownership and corporate arrangements in China’s financial sector have increased stability risks. The new rules require insurance companies, among other things, to report all entities that hold more than 5% of a company’s shares, as well as declare who actually holds decision-making powers in the firm. For the first time, insurance companies must reveal information about their liabilities, assessments of balance sheet items and future cash flows.

US threatens further tariffs on China. On Tuesday (May 29), the White House announced that it was imposing 25% import tariffs on certain Chinese goods totalling about $50 billion a year. The new tariffs reflect on-going disputes over intellectual property protection. The White House has promised a detailed list by June 15, and that the tariffs would come into effect “soon thereafter”. Bilateral trade talks are nevertheless set to continue during June 2–4, when US commerce secretary Wilbur Ross visits Beijing.

Despite underdeveloped markets, mainland China shares now included in MSCI indices. Starting today (June 1), share index producer MSCI includes some 233 A-shares listed on mainland Chinese exchanges in its international indices. The decision was taken last summer. Only 5% of the adjusted market capitalisation of the Chinese shares are included, indicating the large remaining barriers to market access and market-based trading on Chinese exchanges. The index update will take place in two phases. Half of the Chinese share weighting will be included now and the other half at the beginning of September. For example, after the update, the MSCI Emerging Market index’s 31% China weighting still only contains 0.8 percentage points from mainland China A-shares. The weighting of Chinese A-shares in the MSCI All Country World Index will only be about 0.1%.

Mainland China’s stock markets are the world’s second largest after the United States. International indices have traditionally taken their China weighting from shares listed in Hong Kong and outside mainland China. Foreign holding of Chinese shares concentrates on these shares. China’s stock markets differ from Western stock markets in their lack of institutional investors. Furthermore, the state is heavily involved and intervenes actively in trading. MSCI has warned of the risks associated with Chinese markets such as the volatility caused by the market structure and poor social, environmental and corporate governance.

Thus, the inclusion of Chinese A-shares in international indices is largely a symbolic gesture, an expression of Western hopes that China will continue to open up its markets to the world and adopt market-based reforms. Several observers say that it is unlikely that the index update will immediately significantly increase capital inflows from abroad. Foreign shareholding under the joint Stock Connect programmes of the Hong Kong stock exchange and the Shanghai and Shenzhen bourses is currently about $73 billion. All in all, foreign ownership in China’s stock markets is about $190 billion, or 2% of the total market capitalisation.

China is updating its rules on trading in China depositary receipts (CDR) in mainland China, which would give large foreign listed Chinese firms the possibility to issue such certificates also on domestic markets. The issuance of CDRs would help to facilitate the planned cooperation between the Shanghai and London exchanges. Central bank governor Yi Gang said in April that trading under the cooperation programme could begin already this year.
Russia

Russian fixed investment continue reasonable recovery, with further weight on oil and gas. The volume of fixed investment in the first quarter, which rose by 3.6% from the same period last year, was still about 5% below the level of Q112. After falling severely for three years, investment last year revived and rose by 4.4%.

Fixed investment of large and medium-sized firms as well as government sector fell about 1% y-o-y in the first quarter. It implies that Rosstat found other investment rose very rapidly. The multi-year growth in investment in oil & gas production continued. Investment in manufacturing also returned to growth after a three-year decline.

Russia’s goal of halving poverty would not require massive amounts of funds. President Putin’s inauguration Decree, issued on May 7, includes a goal of cutting Russian poverty in half by 2024. The Decree did not specify how to achieve this goal or how to estimate fulfilment of the target.

Definitions of poverty vary. In Russia, over 19 million people or 13% of the population lived below the official subsistence minimum in 2017. The share was highest, about a fifth, among youths under the age of 16. The share of all those living below the minimum has shrunk considerably since 2000, although it rose in 2015 when inflation peaked. The subsistence minimum, which is a “minimum basket of consumer items”, stood at a monthly income of just over 10,000 rubles in 2017 (less than 140 euros). For the entire population on average, the minimum basket last year contained over 45% of food, with other goods and services each accounting for about a quarter.

Halving the number of poor would not appear very difficult as the share of people earning less than the subsistence minimum, but still more than 7,000 rubles a month, was over 7,5% of the entire population last year. Lifting this group to the minimum would cost a couple of decimals of a percent of GDP or just over half a cent of government consolidated budget spending (with several assumptions about the average income in the income groups). According to Rosstat’s annual calculation, the cost of lifting all people living below the subsistence minimum to the minimum would have cost 0.8% of GDP last year, or slightly over 2% of government spending.

With Putin in the lead, action was already taken before the May Decree by e.g. raising the minimum wage during the first quarter depending on the category. The information is compiled and edited from a variety of sources.

Growth in Finnish-Russian trade cooled in 1Q18. Finnish goods exports to Russia in the first quarter remained at roughly the same level as in 1Q17. The export trend was in line with Russian goods imports overall, with the euro value of imports rising by just 3% y-o-y. Following strong growth in Russian import volumes last year, there has been a significant slowdown this year due e.g. to the weaker ruble. The development in euro terms has also been affected by euro appreciation against the USD from a year earlier.

Performance of Finnish goods exports to Russia varied significantly in the first quarter depending on the category. Exports of machinery, metals and paper rose, while exports of textiles, foodstuffs and chemical products fell.

Growth in Finnish services exports also appears to have slowed in the first quarter, as Russian overnight stays in Finnish inns and hotels increased only by 4% y-o-y. Total Finnish services exports to Russia rose by 17% last year.

The value of Finnish goods imports from Russia fell by 3% y-o-y in 1Q18. Most of the contraction reflects last year’s high reference point caused by a large one-off gas pipeline delivery. Finland’s main imports from Russia – oil & gas – were up largely due to higher prices.

Russian total goods imports and Finnish goods exports to Russia (in euros)

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China

Yuan appreciation continues this year. As of the first week of June, the yuan’s nominal effective (trade-weighted) exchange rate, or NEER, had increased about 3% in value since the start of the year. The appreciating trend now extends for over a year, during which time the yuan’s NEER has climbed by nearly 6%.

The US dollar has appreciated about 4% in trade-weighted terms (NEER) since mid-April. In some emerging economies the strengthening dollar and rising interest rates in the US have hurt the domestic currency, fuelled inflation and added to capital flight pressures. In China’s case, however, the yuan has remained relatively stable against the dollar, depreciating since mid-April by just over 1%.

On the other hand, the weakening of the euro, especially on Italy’s attempt to form a government, lifted the yuan-euro rate at the end of May by nearly 4% from its mid-April level. In all, the yuan barely showed any overall appreciation in NEER terms in May.

PBoC extends range of acceptable collateral from banks in medium-term borrowing. In reaction to increased uncertainty in China’s bond markets, the People’s Bank of China moved last week to allow corporate loans and bonds carrying lower credit scores to be used as collateral to banks using its medium-term lending facility (MLF). Many firms have recently found it difficult to find buyers for their debt. The MLF funding earlier required central government, local government, policy bank or domestically AAA-rated corporate bonds as collateral. The PBoC says it will now accept collateral such as corporate bonds rated AA or higher, green bonds and high-quality small- and micro-enterprise loans.

The move is intended specifically to improve small firms’ access to finance and improve the access of smaller banks, which typically hold less high-grade collateral, to central bank lending. The interest rate spread between high-grade and lower-grade corporate bonds has widened since April. In China, bonds rated AA– are already treated as speculative grade in most cases.

On Wednesday (June 6), the PBoC lent commercial banks 463 billion yuan (USD 72 billion) in one-year MLF loans at a rate of 3.3% p.a. The issuance compensated the 260 billion yuan of maturing MLF credits.

Interbank yields on one-year Chinese bonds

Sluggish first-quarter growth in Finland-China trade. Finnish Customs figures show that Finland exported roughly 850 million euros worth of goods to China in the first quarter of this year. Finland imported 1.1 billion euros of goods from China. The value of goods trade in 1Q18 was only slightly larger than in 1Q17, with imports up just 1% and exports 2%. The growth of trade with China was also sluggish compared to growth in Finnish trade overall (exports up 7%, imports up 5% y-o-y in 1Q18). Finland’s trade deficit with China fell by 4% to 250 million euros. Finland’s overall goods trade deficit was 670 million euros.

Paper pulp, ore, scrap metal and specialised machinery for various branches accounted for half of Finnish exports to China. All of these exports groups continue to gain share. The much-traded goods categories suffering share losses were sawn timber and electrical machinery & equipment. As in 1Q17, the dominant good categories for imports from China in 1Q18 were telephone and radio equipment, office equipment, other electrical devices and clothing. The imports of telephone and radio equipment noticeably increased, while imports of office equipment fell.

According to Visit Finland records, nearly 67,000 Chinese tourists visited Finland during the first three months of this year, giving the Chinese a 9% share of all foreign visitors to Finland. The number of Chinese tourists and overnight stays increased by more than 20% y-o-y in January-March.

Statistics Finland figures for 2017 show that Finland’s total services exports rose by 8% and imports by 3% y-o-y. Services exports to China fell by 4%, while services imports dropped by 16%. With the larger contraction in imports, Finland’s services account surplus with China rose to 480 million euros in 2017 (up 26% y-o-y). Large fluctuations in the bilateral services trade of China and Finland are normal.
Russia

**Russian president visits China.** President Putin met with Chinese president Xi and attended the Shanghai Cooperation Organisation summit last week. As usual, during the presidents’ meeting was signed a raft of various cooperation announcements and some business deals e.g. on nuclear power.

Russia-China economic cooperation has increased gradually in recent years, but nowhere near the most optimistic hopes in Russia. Last year, bilateral trade returned to brisk growth after weaker development. Russian goods exports to China in 2017 were worth about $40 billion and imports from China nearly $50 billion. China was Russia’s single most important trading partner, accounting for more than 10 % of Russian exports and 20 % of imports. Russia only accounted for about 2 % of China’s total foreign goods trade. Russia exports to China mainly crude oil and imports consumer goods.

Services trade has a smaller role. While the value of bilateral services exports and imports was just over $2 billion last year, China was one of Russia’s top trade partners in tourism.

Despite a few high-profile projects, investment between countries remains rather modest. The stock of recorded Chinese FDI in Russia last year was $4.5 billion, while the stock of Russian FDI in China was about $200 million. Determining country origins of FDI is, however, challenging particularly in the cases of Russia and China, where pass-through countries are often involved.

**Changes in Russia’s currency reserve composition.** Russia’s gold and foreign currency reserves have grown notably since early 2017. They stood at nearly $460 billion at the end of May. Some of the gains reflect forex purchases by the Central Bank of Russia on behalf of the finance ministry, while other gains came mainly from the rise in value of certain reserve assets. The forex purchases have added about $30 billion to the reserves since they began in February 2017.

The structure of Russia’s reserves has also evolved gradually over time. Gold’s share has more than tripled in this decade as the CBR has built up its gold reserves. Gold accounted for nearly 18 % of the value of reserves at end-May.

The share of assets denominated in Chinese yuan has also grown significantly, standing at nearly 3 % of total reserves at the end of 2017. Nevertheless, most of Russia’s currency reserves is still held in dollar- or euro-denominated assets.

Russia’s foreign currency reserves also include the liquid forex assets of Russia’s oil fund, which currently are worth about $40 billion. Their share in currency reserves has diminished notably in recent years as fund assets have been used to finance budget spending. The currency reserves have not diminished, however, because the finance ministry has sold the forex-denominated assets to the CBR in exchange for rubles.

Russia’s currency reserves provide a quite strong buffer in the event of an external financial shock. At the moment, the reserves are sufficient to cover e.g. about 17 months of imports or 140 % of Russia’s short-term foreign debt.

**FDI inflows to Russia remain at low levels.** The net flow of inward foreign direct investment to Russia contracted slightly last year to $28 billion. In 2016, FDI numbers were boosted by the sale of a minority stake in Rosneft to foreign investors. FDI flows are still far below levels at the beginning of this decade. Over the past two years, however, new FDI has again begun to flow into Russia, whereas in 2014–15 recession most FDI consisted of reinvested profits.

Russia’s total inward FDI stock stood at $535 billion (34 % of GDP) at the end of 2017. Nearly 70 % of that came from countries typically considered as pass-through countries or tax havens such as Cyprus and Bermuda. Much of these investments is considered to be of Russian origin.

Breaking down the inward FDI stock by sectors, the largest recipient (over 20 %) has been the extractive sector, which includes oil and gas. The shares of manufacturing, retail trade and financial sector have also been about 15-20 % each. In recent years, extractive industry has again risen as the largest FDI recipient sector, while retail and finance were the top sectors at the start of the decade.

The net outward flow of FDI from Russia last year amounted to $39 billion, or nearly double the amount in 2016. The stock of Russian FDI abroad at the end of 2017 was $470 billion. Over 70 % of that amount was invested in pass-through countries or tax havens and much of it has probably returned to Russia.

Russia’s gold and foreign currency reserves

FDI inflows to Russia remain at low levels

Russia’s inward and outward FDI flows

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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.
China

Slowdown in Chinese growth more broad-based in May. Monthly indicators released by the National Statistics Bureau show that the nominal increase in fixed asset investment (FAI) in May was below 4%. Even with modest price assumptions, real growth in FAI was negative due to the contraction in public investment. In the first five months of 2017, public investment still rose faster than private investment.

The slowdown in growth of fixed investment is a long-term trend as Chinese economic growth becomes increasingly dependent on consumption demand. Growth in retail sales, a rough measure of consumption, fell to below 7% y-o-y in May in real terms. Industrial output grew by nearly 7% y-o-y.

As in April, May consumer-price inflation hovered at 1.8% p.a. Producer price inflation accelerated slightly to 4.1% p.a.

China imported a record amount of crude oil in the first five months of this year. China’s imports of crude oil rose by 8% y-o-y in the first five months of this year. The period included several months of historical record highs in monthly oil import volumes. A total of 190 million metric tons of crude was imported in the January-May period, which translates to an average of about 9.3 million barrels a day. For January-May 2017, the average was 8.6 million barrels a day. China’s domestic oil production continues to decline, so it has to import more oil and has become the world’s largest oil importer. The volume of crude oil imported from abroad already exceeded the volume of China’s domestic crude oil production in 2009.

Demand for imported crude oil certainly exists. Refineries increasingly depend on imported crude as China’s domestic production has steadily declined since the second half of 2015. The causes of the production drop include ageing production facilities, high production costs and the depletion of some domestic oil deposits. In March 2018, China produced about 3.7 million barrels a day, the same amount as a decade earlier. Still three years ago, daily production exceeded 4.3 million barrels. Besides oil, the import volumes of other key commodities increased in the first five months of the year, particularly copper imports (up 17%).

The overall value of Chinese goods imports in the first five months of the year amounted to nearly USD 860 billion, an increase of 21% y-o-y. The value of goods exports was up 12% to USD 960 billion. The trade surplus shrank in January-May by nearly a third from the same period a year earlier. Measured in yuan, imports grew by 11% and exports 3%. China Customs estimates that the volume of imports increased by 7.5% y-o-y in the first quarter of this year, while the volume of imports grew by 8.5%.

The reductions in import duties brings China’s customs duties on Chinese goods average 11.9% for agricultural products and 4.5% for other products. On the flip side, China extracted duties on goods from the EU and the US to the tune of about 15% for agricultural products and 9% for the rest.

China further reduces import duties on consumer goods. From July 1, import duties in China will fall from an average of 15.7% to 6.9% in 1,449 consumer goods categories. For example, the average import duties on clothing, footwear, kitchenware, and ready-to-eat food items will be reduced by about half to 7%, while the import duties on some fresh foods and foodstuffs fall by twenty percentage points to around 5%. Import duties on washing machines and refrigerators will fall from over 20% to 8%. Import duties on cosmetics and health products will fall from over 8% to 3%, while import duties of medicines will be eliminated completely. The measures are a follow-up from the latest round of import duty reductions for consumer goods implemented in December 2017 (see Weekly 48/2017).

The reductions in import duties brings China’s customs level closer to that of developed economies, even if the differences are still considerable. The WTO reports that in 2016 the average import duties in China were 9.9%, compared e.g. to 5.2% for the EU and 3.5% for the US. In 2016, Chinese products encountered US import duties averaging 4%. EU import
Inflation planned tax increases. Current circumstances require a slower transition to a neutral rate, as the CBR was still lowering its key rate and gave guidance. The government has already decided to cut the excise tax on gasoline at the start of July to rein in the price growth. Price inflation has nearly stopped in recent months, while the inflation of non-food goods has accelerated led by gasoline. As recently as March, the CBR’s outlook for inflation and interest rate policy have shifted notably in recent months. As recently as March, the CBR was still lowering its key rate and gave guidance on a continuing trend to lower rates. Now the CBR observed that current circumstances require a slower transition to a neutral monetary policy stance. The change reflects increased inflation pressures caused by e.g. ruble depreciation and the planned tax increases.

Russia's key rate and consumer price inflation

For now, inflation has remained moderate, as consumer prices were up just 2.4 % y-o-y in May, the same as in April. Price trends are diverging by product groups, however. Food price inflation has nearly stopped in recent months, while the inflation of non-food goods has accelerated led by gasoline. The government has already decided to cut the excise tax on gasoline at the start of July to rein in the price growth.

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Russian GDP forecasts cut after new US sanctions.

Despite higher oil prices, Russian GDP forecasts have been revised down by many institutions lately. E.g. the World Bank’s recent Russia forecast lowers its GDP growth outlook for this year by 0.2 percentage points. In addition to a weaker-than-expected growth in the early months of this year, the downward revision reflects the latest round of sanctions imposed by the US at the beginning of April. They are expected to increase uncertainty about the Russian economy.

Alexei Kudrin, chairman of Russia’s Accounts Chamber and former finance minister, said in a recent interview that sanctions could impede growth by 0.2–0.3 percentage points. Several international banks also cut their 2018 Russian forecasts last month. The CBR’s latest GDP growth forecast, however, was unchanged from March, even if the central bank slightly lowered its outlook for fixed investment growth.

Forecasts of Russian GDP growth, %

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Last year just over 36 million Russians, or about a quarter of the population, received old-age pensions. Rosstat reports 24 % of them were also working. The number of such individuals, however, seems to have fallen dramatically in recent years with the elimination of annual cost-of-living adjustments for pensioners who choose to keep working.

The government also submitted to the Duma a proposal to raise the VAT rate from 18 % to 20 % from the start of 2019. Socially important items, like food and medicine, would continue enjoying reduced tax rates. The government estimates that the VAT increase will annually bring in an additional 620 billion rubles (9 billion euros) to the federal budget. Most of the funds raised by the changes are set to go to funding expenditures for fulfilling president Putin’s May decree. The cabinet discussed also several other measures to fund the May decree and compensate the tax hike, but they have so far not proceeded to the Duma.

While Russian economy experts have taken the proposed increase in the retirement age in general positively, they have criticized the VAT hike on its depressing effects for economic growth. In contrast, raising the retirement age goes down badly with average citizens. A recent survey found that 92 % of respondents were opposed to the government’s proposed increase in the retirement age and an online petition by labour unions opposing the change has already gathered over one million signatures. Some political researchers believe the government deliberately came out with a harsh proposal to leave room for softening the conditions later.

Russian government submits proposals to the Duma on raising the retirement age and VAT hike. Last week the government finally agreed on a long-discussed move to raise the retirement age. As proposed, the retirement age would be increased annually in six-month increments until the new target ages were reached. Although certain groups would be exempted, the retirement age would generally rise from the current 60 to 65 for men and 55 to 63 for women.

Pension expenses already consume about a quarter of Russian public spending. They have increased due e.g. to higher life expectancy (currently 67 years for men and 77 for women), even if pensions have only increased modestly. Last year, the average monthly old-age pension was about 14,000 rubles (200 euros).

Forecasts of Russian GDP growth,
China

China and the United States back on the brink of a trade war. Last Friday (June 15), the United States released a list of 818 Chinese products to be slapped with a 25% punitive import duty. Imports of affected products amount to about 34 billion dollars a year. The duties are scheduled to take effect on July 6. Following the public hearings process, the list could be expanded by another 284 products (16 billion dollars in imports annually). The duties target China's strategically important sectors such as information technology, industrial robotics and aerospace.

Immediately after the US announced the latest round of imports tariffs, China countered with its own 25% import duties on US goods worth 34 billion dollars a year. Duties on China’s 545-product list, including agricultural products, automobiles and seafood, would also go into effect on July 6. Another 16 billion dollars of additions to the list are planned, including imports of US coal, crude oil, and chemicals.

After promising to make good on its earlier threats to respond if China countered to new sanctions, President Donald Trump said on Monday (June 18) that he would hit China with a new round of 10% duties on Chinese imports worth roughly 200 billion dollars a year. These duties take effect if China refuses to amend its practices in such areas as intellectual property protection and actually goes through with its threatened 25% import duties. Trump’s Monday evening threat on import duties on Chinese imports could add yet another 200 billion dollars in imports affected, amounting to nearly the entire value of China’s goods exports to the US.

China’s goods exports to the US last year totalled about 500 billion dollars and goods imports 130 billion dollars.

Rising opposition to ZTE’s deal with the US. The problems of Chinese telecom giant ZTE began in March 2017, when it admitted to exporting US technology to Iran and North Korea in violation of US trade sanctions. ZTE is highly dependent on American technology. For example, over a quarter of its smartphone components are of US origin. ZTE was fined 1.2 billion dollars for violating trade sanctions. It got permission to continue working with US firms on condition that it punished employees who violated the sanctions. After it emerged that ZTE broke its promise, the US commerce department on April 16 imposed a seven-year ban sales of US components to ZTE.

Due to the ban on component sales, ZTE announced it was halting production. Trading in the company’s shares was also halted on April 17. When trade negotiations at the beginning of May hit a favourable patch, President Trump announced that he was lifting the ban on component sales to ZTE. A deal was reached and ZTE announced on June 12 that it had agreed to the terms laid down by the US commerce department. ZTE would pay a one-billion-dollar fine and place 400 million dollars in escrow for possible future violations. Additionally, all board members must be replaced within a 30-day period that began on June 8 both in ZTE and in its wholly-owned subsidiary ZTE Kangxun Telecom.

The matter continues to simmer in the US, however. On Monday (Jun. 18) the US Senate, which is controlled by a Republican majority, passed the National Defence Authorization Act, which includes language repudiating the ZTE deal. For the NDAA to become law, it still requires reconciliation with the earlier-passed House version of the bill, which did not contain any reference to ZTE. Although trade relations between the US and China are less than optimal, the Trump administration seems determined to remove the ZTE language from the bill.

After trading of ZTE shares was restarted last Wednesday (June 13) prices nose-dived. Even after bouncing back slightly on the Hong Kong exchange on Wednesday (June 20) ahead of Trump’s meeting with Republican senators, ZTE had lost over 50% of its market capitalisation in Hong Kong and 40% in Shenzhen.

Price of ZTE shares on Shenzhen and Hong Kong exchanges

Source: Macrobond.

New faces on the PBoC’s monetary policy committee. In mid-June, central bank governor Yi Gang was named chairman of the 14-member policy panel. He replaces former PBoC governor, Zhou Xiaochuan, who retired in March. In addition to including the governor and two deputy governors of the PBoC, the committee comprises representatives from the government, the finance ministry, financial supervisory agencies, several other state agencies and China’s banking association. The committee also includes three representatives from academia. The academics include Liu Shijin, deputy chairman of the government think tank China Development Research Foundation; Liu Wei, president of Renmin University; and Ma Jun, former PBoC chief economist and now a professor at Tsinghua University. The previous academic members were Fan Gang, Huang Yiping and Bai Chongen.

The PBoC’s monetary policy committee meets every three months. It can offer recommendations, but has no real decision-making power over China’s monetary policy directions. Even China’s central bank lacks independence; all major monetary policy decisions have to be approved by the government.
Russia

Slow recovery in Russian consumption continues; good increases in industrial output. Despite its slow revival pace, the recovery in seasonally-adjusted retail sales plodded forward in May. The sales were about 2.5 % larger than in May last year. Retail sales have been climbing out of a deep slump for nearly a year and half but are still down about a tenth from their 2014 level.

Seasonally-adjusted industrial output as a whole has grown nicely in almost every month of this year, driven especially by manufacturing. Rosstat’s revised figures show that in April-May industrial output had grown nearly 4 % from one year earlier, while manufacturing output had climbed by well over 5 %.

OPEC and Russia agree to keep production pact in place. At the end of 2016, Russia agreed with OPEC and a number of other oil-producing countries on a regime of voluntary production ceilings to support higher crude oil prices. The original deal called for limiting production by a total of 1.8 million barrels a day. Unlike earlier voluntary pacts, the countries have scrupulously upheld the deal and last year agreed to extend the agreement to the end of 2018. OPEC figures show Russia’s total oil production (including gas condensates) rose by 0.2 % last year to 11.1 million barrels a day. Russia’s energy ministry reports that 2017 production totalled 564 million metric tons, a 0.1 % decline from 2016.

OPEC production (particularly Venezuela) has fallen well below the agreed ceilings, which in turn has bolstered oil prices. Last Friday (June 22), OPEC’s council of ministers affirmed the arrangement would remain in place as earlier agreed. Producer countries were given the opportunity to increase output to reach the initially agreed production ceiling. In practice this is likely to indicate that Russia and Saudi Arabia could increase their combined production by about 1 million barrels a day. Russian energy minister Alexander Novak said that Russia could increase its oil output in the second half of this year by about 200,000 bpd.

Recent Russian market swings fairly modest compared to other emerging markets. In recent months, foreign investors have been selling their assets in emerging economies. Some of the sell-offs have been driven by rising expectations of currency depreciations. Investor global jitters, in turn, have exacerbated market swings. In emerging economies such as Turkey, Venezuela and Argentina, also domestic economic and political challenges have amplified market turbulence. Foreign investors in the Russian market began to reduce their exposures in early April after the US added Russian businessmen, public officials and companies to its Specially Designated Nationals and Blocked Persons List (SDN) sanctions. Recently market swings in Russia have, however, been fairly moderate.

The ruble-dollar exchange rate at the start of this year was around 56–58. Immediately after the imposition of the SDN sanctions, the ruble lost about 9 % of its value. It then has stabilised around a level of 62–63 rubles to the dollar.

Trends on the Moscow stock exchange typically track the oil price because Russian share indices are heavily weighted with oil and gas companies. Brent crude hit a high of close to $80 a barrel at the end of May, only to retreat to its current level of around $75. The oil price has risen about 12 % since the start of the year.

After SDN sanctions were announced, Russia’s dollar-denominated RTS index fell about 12 %. Since then, however, it seems to have again followed the developments of oil prices. In recent days, the RTS has hovered in the range of 1110–1125, or about 9 % below its level before SDN sanctions. Since mid-April, foreign investors have sold off roughly $1.1 billion in Russian equities. The moderate recent reactions among foreign investors have been regarded to reflect Russia’s current account surplus, fiscal policy (e.g. budget discipline and low level of government debt) and high oil prices.

RTS index, ruble rate and Brent oil price, 1 Jan 2015–28 Jun 2018
China

PBoC lowers bank reserve requirement ratios on higher economic uncertainty. Last Sunday (June 24), the People’s Bank of China announced it would lower its reserve requirement ratio (RRR) for most banks by a half percentage point effective July 5. Large banks are currently required to deposit an amount equal to 16% of their deposits with the central bank. The RRR for mid-sized and small banks is 14%. This latest drop in the reserve requirement increases the amount of money available for bank lending by about 700 billion yuan ($108 billion).

The reserve requirement was previously lowered by one percentage point in April, when banks were ordered to use most of their freed-up assets to pay back their medium-term lending facility (MLF) loans to the PBoC. The latest RRR cut is geared to helping firms and the real economy. The easing is a response to May’s slowdown in domestic demand (fixed investment, retail sales) and the threat to foreign demand caused by a looming trade war. The increase in uncertainty has been reflected in continued declines in share prices on Chinese stock markets. The PBoC has let the yuan depreciate against the dollar, with the yuan-dollar rate now clearly lower than at the start of the year. On June 29, one US dollar bought 6.61 yuan.

Shifting reserve requirements, fluctuating interest rate levels, the use of multiple lending schemes and dictation of policy directly to banks (window guidance) have made it difficult to gauge China’s monetary policy stance. This challenge is made even harder as PBoC measures often come with conditions. Now, for example, large banks are expected to use their freed-up assets from the RRR cut to deal with over-indebted firms (e.g. debt-equity swaps). China has been hoped to replace manual steering with market-based and transparent interest-rate policies. China’s current problems in signalling monetary policy are further complicated by the government’s own contradictory economic policy goals. As China’s central bank lacks independence, it must reconcile the near-impossible simultaneous goals of bolstering economic growth and reducing financial risk by restricting access to credit.

Profits of European firms in China rise despite more challenging operating environment. The European Union Chamber of Commerce in China (EUCCC) last week released its annual business confidence survey of European firms operating in China. The report finds that doing business has gotten harder due to increased regulation, barriers to market access and discriminatory treatment of foreign firms. Despite the challenging business environment, however, European firms last year saw a clear increase in profitability. The percentage of European firms whose Chinese operations showed positive earnings before interest and taxes last year (77%) was the highest since 2005. The most successful firms were those involved with pharmaceuticals, transport & logistics, and car manufacture. The majority of surveyed European firms said they were planning to expand their operations in China in 2018. Pessimistic readings of the near-term outlook were also lower than last year.

Expressing a new set of concerns, over half of respondents said that the innovation capabilities of Chinese firms today match or exceed those of European firms. The investments in product development and improved production quality have raised the competitiveness of Chinese firms. This change furthers evident in the fact that the profitability of European firms, particularly those in the IT and data communications branches, have declined substantially in recent years.

As Chinese firms strengthen their technical capacity and penetrate international markets, the pressure to protect Chinese intellectual property rights has also grown within China. In a stark change from earlier surveys, 34% of respondents said that China has been doing an adequate job in implementing intellectual property protections. There is still room for improvement; over half of respondents still considered Chinese IP protections inadequate.

Stiffer competition has increased demands for a level playing field. This demand is nothing new; EUCCC surveys have hammered on the issue of unfair treatment of foreign firms for years. The latest survey reports that nearly half of European firms said that regulations hamstringing their business activities and believe that the regulatory environment will only become harsher in the years ahead, with small and mid-sized European firms bearing the brunt of this squeeze.

Chinese policy rates (reverse repo, SLF, MLF), interbank (Shibor) and reserve requirement ratio (RRR) for large banks

Profits of European firms operating in China

How did your business’s total revenue in Mainland China last year evolve compared to the previous year?

- Increased substantially (>20%)
- Increased (5-20%)
- Remained the same (+/-5%)
- Decreased (5-20%)
- Decreased substantially (>20%)

% of respondents

Source: European Union Chamber of Commerce in China.

Source: Macrobond.
Russia

Russian oil fund topped up with last year’s oil revenues. In June, the National Welfare Fund received a 900-billion-ruble boost (14 billion USD) from oil income saved last year, i.e. budget revenues from higher-than-anticipated oil & gas tax revenues. Under the current budget rule, revenues from oil & gas taxes in excess of the threshold average Urals oil price (about 40 USD a barrel) received to the federal budget must be set aside in the fund.

As of end-June, the National Welfare Fund held assets worth a total of 4.8 trillion rubles (77 billion USD or about 5 % of GDP). About two-thirds of them were liquid (i.e. easily converted to cash) currency-denominated assets and counted as part of Russia’s foreign currency reserves. The remainder is invested e.g. in long-term deposits in state-owned banks and for financing infrastructure projects of domestic companies.

With the changes for this year’s budget law approved at the end of June, Russia’s federal budget is now expected to record a surplus of 480 billion rubles on higher oil prices instead of deficit as anticipated before. Thus, fund assets should not be needed to cover budget expenditures, but the fund could be further replenished. Russia’s other fund for oil tax revenues, the Reserve Fund, was drained last year and closed.

Russia’s oil funds

![Graph showing Russia’s oil funds](image)

Sources: Macrobond, Russian Ministry of Finance.

CBR injects more money into troubled banks. The Central Bank of Russia last year had to take over three large private banks – Otkritie, B&N Bank and Promsvyazbank – to ensure their continued operations. The CBR announced last week that it was investing another 43 billion rubles to capitalise Otkritie Bank. The bank will immediately be forced to use most of the infusion to cover losses in its pension funds that result, among other things, from the drop in the value of shares in its Rosgosstrakh insurance company.

The CBR also made 3-5 year temporary deposits totalling 174 billion rubles in a number of banks undergoing restructuring. These deposits are set to be used for reorganizing and concentrating weak assets in troubled banks and companies owned by them onto balance sheets of select troubled banks.

Finally, the select banks are planned to be merged under an asset management company established on the basis of Trust bank, into which all the weaker assets of the troubled banks will be marshalled. The current plan is to restore Otkritie Bank to health and sell it to private investors.

The CBR is now using a total of 217 billion rubles (3.5 billion USD) in extra funds to support banks it has taken over. CBR governor Elvira Nabiullina stated in early June that the central bank had thus far spent 760 billion rubles (12 billion USD) on recapitalising troubled banks. It had also provided troubled banks 1.86 trillion rubles (30 billion USD) as deposits. Thus, the CBR to date has used over 45 billion USD (about 3 % of 2017 GDP) in supporting the three banks that it took over last year. Some of this amount, however, should be recovered when assets in banks acquired by the CBR are sold off as well as in the planned privatisations of the banks.

Revised Rosstat figures give a significantly brighter view of recent industrial output growth. Revised 2016−17 data show that Russian industrial output, rather than the 2.3 % reported earlier, grew by 4.3 % over the two-year period. The adjustment was due almost entirely to large improvements in performance of manufacturing firms. Instead of the earlier-reported 0.7 %, manufacturing output in 2016−17 rose by 5.2 %. Some of the biggest improvements were seen e.g. in the chemicals, metal products and machinery & equipment categories.

Rosstat said the changes were due largely to revised figures received from the companies this year and last year which replaced the earlier preliminary monthly data. In addition, estimates of the production of small firms are replaced by data gathered on a quarterly or yearly basis. Revised figures were previously published once a year. Rosstat now plans to publish revised figures on a quarterly basis.

Due to the higher industrial output assessment, Rosstat revised upwards also its 2016−17 growth indicator for the output of five core sectors of the economy by roughly one percentage point. The CBR has evaluated that the GDP growth output for 2016 and 2017 might be revised up by 0.2−0.3 of a percentage point.

Total industrial output and core sector output, 2016−17

![Graph showing total industrial output and core sector output](image)

Source: Rosstat.
China

Hardest aspects of US planned restrictions on Chinese investment fall away, but trade war still on. President Donald Trump last week rescinded his threat to impose major restrictions on Chinese investment in the United States. Instead of pushing for specific restrictions on Chinese investment, Trump expressed support for a bill expanding the existing evaluation process of all foreign investments. Nevertheless, the US today (July 6) went ahead with the 25 % tariffs on certain Chinese imports announced in June. China has said it will respond with countermeasures.

Foreign investors currently need US government permission to operate in any branch considered critical to national security. Permits are granted by the inter-agency Committee on Foreign Investment in the United States (CFIUS). Last November, an overhaul of CFIUS’s mission was proposed under the Foreign Investment Risk Review Modernization Act of 2018 (FIRMA), which sought to expand widely the type of entities subject to CFIUS scrutiny. A proposition that keeps strengthened CFIUS oversight of outgoing investment and operation of US firms abroad is winning acceptance. To be rejected, a foreign investment in the US would no longer need to pose a threat to national security. Congress could give final approval to FIRMA this summer.

The US seeks to restrict Chinese investment, particularly the sectors set to benefit from China’s industrial policy flagship “Made in China 2025.” China wants to use the programme as a springboard to technological leadership in fields such as aerospace, IT, artificial intelligence and pharmaceuticals. China has financially supported high-tech firms in their international expansion, as well as in acquisition of firms possessing high-tech capabilities. While Chinese investment and acquisitions of foreign firms has exploded, China still seeks to restrict inward foreign investment both with official and unofficial means.

While difficult to glean bilateral investment from official figures, the Rhodium Group claims 2016 was a record year for Chinese FDI flows to the US ($47 billion). The volume of new investment dipped in 2017 to $30 billion. In the first half of this year, the US received less than $2 billion in Chinese FDI.

China’s negative list cut to 48 branches restricted or banned to foreign investors. Chinese officials last week released an updated version of the “negative list,” which identifies branches where foreign ownership is restricted or banned. The current list whittles the list from 63 branches last year to just 48. The new list takes effect on July 28. The list reaffirms government pledges to eliminate the ceiling on foreign ownership in certain fields of finance in 2021 and restrictions on vehicle manufacture by 2022. Branches considered strategically important remain on the list. These include mining and refining of rare earth metals, cloud computing and the oil & gas sectors.

The official announcement of the new negative list followed president Trump’s announcement that he was backing off from an earlier plan to restrict Chinese investment in the US. Shortening the negative list was among the demands that the US presented in May on the current trade dispute. Having a branch deleted from negative list does not automatically translate to convenient market access for foreign firms. Foreign firms repeatedly point out that they are subject to stricter reporting and regulatory requirements than comparable domestic firms in several branches.

Chinese market jitters emerged in June. Over the course of June, the yuan’s exchange rate dropped 3 % against the US dollar, its deepest low in six months. The trade-weighted yuan is worth 2 % less than at the start of June. On July 2, one dollar bought nearly 6.7 yuan. After slightly appreciating, the yuan dropped again today (July 6). Stock indices have fallen continuously since the slide began in early June. Mainland China’s Shanghai Composite Index is down 11 % from early June. Hong Kong’s Hang Seng general index has fallen 8 % and the China Company Index by 11 %.

Market reactions were triggered by renewed tensions in trade policies and increased concerns about China’s domestic demand. May investments and private demand were both weaker than expected. At the beginning of July, the Standing Committee of the National People’s Congress presented a plan for wide-ranging income tax cuts. The tax reform, intended to spur private consumption, would enter into force in October.

Chinese share prices and yuan plunged in June

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.

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0 5 10 15 20 25 30 35 40 45 50

FDI flow, USD billion
US investment in China
Chinese investment in US

Index June 1, 2018 = 100

Source: Rhodium Group.

Source: Macrobond.

CNY/USD

Shanghai Composite (Mainland)
Hang Seng (Hong Kong)
CNY/USD (right)

6.1
6.2
6.3
6.4
6.5
6.6
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6.8

110 115 120
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Index June 1, 2018 = 100

Source: Macrobond.

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30 25 20 15 10 5 0

Index June 1, 2018 = 100

Source: Macrobond.
Russia

Russian import growth slows further; net flow of foreign liabilities turns negative. Preliminary balance-of-payments figures show the dollar-value of Russian goods and services exports rose in 2Q18 by nearly 30 % y-o-y. Much of the growth acceleration came from higher oil prices, as growth in other exports slowed slightly. The brisk export development was not reflected in imports, however. On-year growth of goods and services imports slowed further, with 2Q growth of just 9 % measured in dollar terms. With the euro’s substantial strengthening w.r.t. USD compared to a year earlier, the rise in imports was just 1 % y-o-y in euro terms. The current account continued on hefty surplus amounting in annual terms to about 4 % of GDP.

Looking at the financial account, the net flow of Russia’s liabilities abroad was $17 billion negative. The situation likely reflects the impacts of uncertainty created by the additional US sanctions imposed in April. Such large net outflows were last seen in 2014–15. Foreign debt of the public sector and banks showed particularly large declines in 2Q18. Russian banks were also much more active in repatriating foreign investments than in making new investments.

Net flow of Russia’s foreign liabilities

![Graph showing net flow of Russia's foreign liabilities from 2014 to 2018](Image)

Source: Central Bank of Russia.

Russian inflation remains subdued, but inflation expectations are rising. June consumer price inflation slowed slightly from 2.4 % y-o-y in May to 2.3 %. Much of the slowdown came from lower food prices, which declined by 0.2 % y-o-y. The drop largely reflects the high fruit & vegetable prices of early summer last year. Prices of non-food goods rose by 3.7 %, while prices for services were up 4.1 %. The ruble’s weakening in April may have been behind some of the price increases, at least with regard to goods.

The Central Bank of Russia’s June household survey found inflation expectations rising for the first time since early 2017. Household inflation expectations seem to be driven especially by higher fuel prices. Inflation expectations are among the factors that the CBR takes into account when setting monetary policy. The CBR executive board’s next interest rate policy meeting is set for July 27.

The CBR’s inflation target is 4 % at the end of this year. The draft 2019 budget includes a hike in the value-added tax from 18 % to 20 %. The finance ministry estimates it would accelerate inflation by 1.3 percentage points in 2019, while the CBR’s estimate is about one percentage point.

Large hikes in revenue and spending of Russia’s preliminary budget framework. In its presentation of the first draft of the three-year budget framework, the finance ministry raised its revenue estimate for 2019 and 2020 by about 4 trillion rubles ($63 billion or 3–4 % of GDP) above those defined under the current budget law. The massive revenue increase largely reflects a higher oil price assumption leading to higher budget revenues from taxes on oil & gas earnings. Under the new framework, the average price of Urals-grade crude oil during 2019–2021 is assumed to be around $60 a barrel. The current budget law assumes a price around $40. Another large source of additional revenues is the proposed hike in the value-added tax that is currently in the duma. It is estimated to raise annual budget revenues by 600-700 billion rubles.

The new three-year framework calls for increased spending of about 10 % in 2019–2020 compared to the current budget law. Most of the additional spending, about 1.2 trillion rubles ($19 billion) in 2019 and 2020, will be directed at financing president Putin’s latest May Decree (details of how the money will be spent have yet to be released). The finance ministry has also proposed establishing a Development Fund within the federal budget to finance large infrastructure projects. The value of the Development Fund would amount to 3.5 trillion rubles during 2019–24 and would be financed mainly by government borrowing.

Higher revenues in the new framework will also raise public finances on surplus contrary to earlier expectations. Next year’s budget surplus is estimated at nearly 2 % of GDP. The federal budget structural deficit calculated according to the oil price defined in the budget rule ($42–43 a barrel) would, however, remain at around 0.5 % of GDP in coming years, even if the budget rule states it should be at least in balance. The discussion on the new framework continues in the Duma.

Russia's federal budget spending in the current law (Law) and new framework (New)

<table>
<thead>
<tr>
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</thead>
<tbody>
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<td>17.9</td>
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<tr>
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<td>Social policy</td>
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<td>4.9</td>
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<tr>
<td>Economy &amp; general administration</td>
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<tr>
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<td>-</td>
<td>1.2</td>
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<tr>
<td>Other</td>
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<td>2.2</td>
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<td></td>
<td>2.5</td>
<td>2.8</td>
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</tbody>
</table>

Source: Russian Ministry of Finance.
China

United States and China impose import tariffs on each other; intensification of trade dispute looms.

The United States implemented its first wave of tariffs targeted solely on Chinese imports last Friday (July 6). The 25% hikes in import tariffs affect products with an annual import value of about $34 billion. Immediately after the tariffs were implemented, China imposed corresponding tariff hikes on certain imported US products. China also filed a complaint with the WTO objecting to the new US tariffs.

The American tariff hikes are a response to China’s protectionist industrial policies. Most of the over 800 items listed are technology products such as vehicles, machinery, equipment, and related components. Some observers estimate that the US tariff hikes most affect the manufacturing of multinationals in China, affecting international production chains above all.

Chinese tariffs target just under 550 US products, mainly basic food commodities (including soybeans) and certain cars. Over half of US soybean production goes to exports, and about 60% of that goes to China. Soybeans last year accounted for nearly 10% of US’s goods exports to China. Soybean prices on US commodity markets have collapsed since the trade disputes intensified. China’s tariff hikes, which focus on agriculture, are estimated to hit American producers hardest in states where support for Donald Trump is strong.

The tariff hikes that entered into force last Friday are only part of the $50 billion in Chinese imports targeted by the 25% tariff hike announced by president Trump in June. The remainder, a list containing nearly 300 product designations, will be affirmed after a hearing process, and the tariff increases are expected to go into effect in August. China has reiterated its plans to respond in kind, producing its own list of designated import value of $16 billion.

President Trump this week raised the stakes in the Chinese trade dispute, with the US publishing a listing of new targeted products with an import value of $200 billion. These products would be subject to an additional 10% import tariff. Most of the listed items are materials, components or consumer goods. The list is open for comments and finalisation of the new tariff hikes would be completed by September at the earliest. If all the hikes go through, it would affect about half of the US imports from China, which last year were worth $526 billion. The corresponding value of China’s goods imports from the US was $155 billion. The US business community has been shaken by the tariff hikes, creating fears that they could dampen investment and raise consumer prices.

The direct impacts of current tariffs in force are expected to have little impact on China’s economic growth. If the trade disputes escalate, the bigger impacts are coming from increased economic uncertainty that reduces the willingness of firms to invest in longer-term projects and disruptions in global production chains.

China and Russia impose most trade and investment barriers on European firms. The European Commission’s Annual Report on Trade and Investment Barriers notes that the wave of protectionism that began after the global financial crisis still continued last year. At the end of 2017, the European Commission said it was aware of 396 barriers created through trade and investment policy that were substantially harmful to European firms. While the EU managed to eliminate 45 obstacles, the number of barriers in force rose by a couple dozen from 2016.

Russia and China top the list of countries setting up the most barriers to trade and investment. China reportedly last year erected the highest number of new barriers (10) to European firms doing business in the country, while Russia came second adding six new barriers. The EU subsequently managed to get China to drop seven of its barriers, but only managed to get Russia to cancel one.

Last year European firms were most concerned about China’s enactment and implementation of a cyber security law that entered in to force in summer and threaten the ability of firms to operate in China. In Russia, new regulations of state enterprise procurements that overwhelming favour domestic firms were seen the most disconcerting making it harder to do business there. European car manufacturers report unfair treatment in both countries.

A large part of the reported barriers to trade are “behind the border measures,” i.e. restrictions that apply to services, fixed investment, public procurements, intellectual property rights and technical regulations. The more traditional trade barriers, “border measures,” include tariffs, quotas, phytosanitary & health regulations, import licences and direct bans on trade.

In recent years, China has been the WTO member with the most claims of unfair trade practices raised against it. WTO figures show during the 2008–2017 period every G20 member had filed – by far – most of their initiations for antidumping & countervailing duty investigations against China. The number of antidumping & countervailing duty investigations against China vary considerably, however, with over 100 filed by the US and India, over 60 by the EU, 10 by Russia and just one by Saudi Arabia. The US has been the most frequent target of China’s antidumping & countervailing duty claims.

Number of trade and investment barriers imposed on EU firms

<table>
<thead>
<tr>
<th>Country</th>
<th>Number of barriers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Russia</td>
<td>23</td>
</tr>
<tr>
<td>China</td>
<td>21</td>
</tr>
<tr>
<td>Indonesia</td>
<td>9</td>
</tr>
<tr>
<td>India</td>
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<tr>
<td>Brazil</td>
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<td>South Korea</td>
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<td>Turkey</td>
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<td>USA</td>
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<td>Australia</td>
<td>3</td>
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<td>Thailand</td>
<td>3</td>
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</table>

Source: EU Commission Market Access Database.
Russia

Russian economy continues mixed performance. June economic growth was mostly driven by private consumption. After perking up in the spring months, the trend in investment-driven branches weakened. Despite mixed performances, the Russian economy generally appears to be on a modest growth track in line with earlier expectations.

On-year growth in retail sales accelerated slightly in June to 3%. Factors supporting growth included growth in household borrowing and the FIFA World Cup soccer matches that began in mid-June. Real household incomes, in contrast, showed nearly zero growth. Real wage growth slowed slightly, but was still up 7% y-o-y.

On-year growth in industrial output slowed in June to around 2%. On-month seasonally adjusted industrial output volume even contracted a bit last month. Most of the slowing came from lower manufacturing growth. The extractive sector saw gains on increased oil & gas production. The spring growth spurt in construction activity ended in June with construction down over 1% from a year earlier.

In their latest estimates, the Central Bank of Russia and economy ministry find that Russian GDP growth accelerated from 1.3% p.a. in the 1Q18 to close to 2% in the 2Q18.

Trends in core sectors of the Russian economy

Russia and U.S. presidents met in Helsinki. At the Helsinki summit last Monday (July 16), discussions focused on foreign and security policy, but also economic relations were touched upon. Putin said he had agreed with Trump e.g. on the creation of a high-level business working group on developing bilateral economic relations.

Neither country is a particularly important partner for the other in economic terms and bilateral economic relations have developed poorly in past years given Russia’s weak economy and ongoing political tensions between the two countries. The value of US-Russia bilateral goods trade last year was about $25 billion. The US accounted for 4% of Russian goods trade, while Russia’s share was less than 1% in the case of the US. Russia mostly exports fuels and metals to the US and imports machinery & equipment and chemicals.

Even if direct investment figures should be viewed with caution, they show the stock of American foreign direct investment in Russia last year was only about $3 billion, less than 1% of Russia’s total FDI stock. The stock of Russian investment in the US was about $7 billion, which is also a miniscule share of the total US FDI stock. Russia this year has also significantly reduced its holdings of US treasuries that according to some views could be related to sanctions risks.

For the moment, US sectoral sanctions have restricted access to financing and exports of oil exploration technology to certain Russian firms. Additionally, several Russian firms and persons have been placed on the Specially Designated Nationals (SDN) sanctions list, which calls e.g. for freezing of assets. Further measures are under discussion from time to time, including a proposal this week to sanction the Nord-Stream 2 undersea gas pipeline. Russia has restricted food imports also from the US, among other countries, with Putin last week extending the sanction up to the end of 2019.

New tariffs also complicate trade this year. Russia’s economy ministry reports that US import duties levied on steel and aluminium products this spring incur on Russia costs of $540 million. Russia recently imposed retaliatory tariff hikes on certain US imports such as technology used in construction and oil drilling. Russia has also joined a number of countries in a complaint to the WTO about US tariff policies.

FIFA World Cup provides small boost to Russian economic growth. Russia’s FIFA World Cup Local Organising Committee (LOC) reports that the soccer tournament drew nearly 600,000 foreign spectators to the matches and a total of 5 million foreign tourists from June 14 to July 15. Sberbank estimates that foreign tourists spent a total of $1.5 billion during the games, double the amount of the same period last year.

Official figures report that Russia spent about 680 billion rubles ($13 billion) in preparation to host the World Cup, which is estimated to have made it the most expensive World Cup in history. Most of the money went to construction or refurbishing of sports venues and transportation infrastructure (270 and 230 billion rubles, respectively). Financing was largely provided from the federal budget.

Russia’s LOC estimates a positive effect to the Russian economy of $870 billion rubles ($17 billion) during 2013–18, with most of the benefits coming from investments in infrastructure and increased tourism. The LOC said that in 2017–18 the tournament added a quarter of a percentage point to GDP growth. Most other estimates put the growth benefit of the games in the range of 0.1-0.2 percentage point this year.

The LOC expects the event to add 150–200 billion rubles a year to the economy over the medium term, assuming full advantage is taken of opportunities created by the new investment. Other estimates are more pessimistic, as e.g. most of the new stadiums are considered unprofitable investments.
China

Official figures show Chinese economic growth slowing only marginally in the second quarter. China’s National Bureau of Statistics reports that GDP grew at 6.7 % y-o-y in the second quarter, a slight slowing from the 6.8 % pace of the previous three quarters. China’s eerily consistent GDP growth figures do not reflect the severe slowdown in the monthly figures for fixed asset investment (FAI). Fixed asset investment data indicate an-year drop in second-quarter public sector investment, which is also reflected in a significant slowdown in growth of infrastructure investment.

The NBS further noted that final consumption expenditure contributed to nearly 80 % of April-June GDP growth. NBS figures, however, show slowdowns in both retail sales and income growth. Real disposable income per capita rose by 6.7 % y-o-y in real terms in the first half of 2018 (7.3 % growth in 2017). Growth in retail sales slowed in the second quarter with real on-year growth falling to 7 % in June.

Consumer price inflation held steady at 1.9 % in June, while producer price inflation sped up a bit to 4.7 %.

The shrinking debt-to-GDP ratio may be short-lived, however. To preserve growth amid market uncertainties, the monetary policy stance has been made more accommodative and China may also need to relax its stiff stance on curbing shadow bank lending to reduce financial market risk. Media reports note, for example, that implementation of tighter regulation of wealth management products has been delayed.

Banks still the largest issuers of green bonds in China. Bonds intended to finance environmental protection projects such as waste-water treatment facilities or climate-saving technology such as solar power arrays are referred to as green bonds. The international expert organisation Climate Bonds Initiative (CBI) reports that last year the amount of green bonds meeting international standards reached $156 billion globally. Of these, 25 % were issued in the US, 15 % in France and 15 % in China. The largest green bond in 2017 was issued by the French government ($11 billion), followed by the China Development Bank bond ($5 billion). In the first six months of this year, Chinese issuers launched 22 new green bonds worth over $3 billion in total.

While a total of $36 billion in green bonds were issued in China last year (an increase of 5 % y-o-y), a large share (38 %) only qualified as green under China’s own criteria. Banks, which dominate the green bond market, accounted for 74 % of last year’s issues. Although the banks’ share has fallen, it is still substantially larger than the global average of 25 %.

Unlike international green bond standards, China includes projects involving e.g. clean coal, improvements in coal-burning efficiency and efficiency optimization of fossil fuel power plants. Moreover, international standards require that in practice all funds raised through the issue to be dedicated to green projects, while Chinese standards allow up to a half of the money to be used, for example, for servicing banks loans or augmenting corporate capital.

The People’s Bank of China say the county would need to spend about 2–4 trillion yuan ($320–640 billion) a year on environmental protection and measures to mitigate climate disruption. The various policy measures used to promote green bonds were recently bolstered by including them as acceptable collateral in central bank financing.

Stock of bank lending continues to grow, even as China’s shadow banking sector lending declines. The broad descriptor of domestic private sector credit (total social financing or TSF) corresponded to 212 % of GDP in end-June. The figure indicated a slight drop in the debt-to-GDP ratio that stemmed from a crackdown on lending outside the official banking sector. The TSF aggregate includes some type of shadow banking sector instruments such as trust loans, entrusted loans and bank acceptance bills (a kind of IOU). This unofficial lending component, which equals roughly 30 % of GDP, shrank for the first time, falling by 5 % between December 2017 and June 2018. Bank lending grew by over 12 % y-o-y and now exceeds 150 % of GDP.

The TSF aggregate describes private sector financing. The Bank of International Settlements reports that the total Chinese credit stock (including government debt, but excluding financial sector debt) was 256 % of GDP last year. BIS figures show that China’s debt-to-GDP ratio declined in the fourth quarter of 2017 for the first time since 2011.

Chinese economic indicators

<table>
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<th>Year</th>
<th>GDP</th>
<th>Industrial output</th>
<th>Retail sales</th>
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<td>2018</td>
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<td>5</td>
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</table>

Sources: CEIC, Macrobond and BOFIT.
Russia

Russian Megafon plans to delist from London stock exchange. Under a plan released on July 16, one of Russia’s largest mobile phone operators, Megafon, will offer to buy out the shares of minority shareholders for a total of about $1.3 billion. About 80% of the company’s shares are held by billionaire Alisher Usmanov and Gazprombank. Megafon stated that in the future it will be more oriented to building up digital services in Russia which may require high-risk investment and close cooperation with state-owned enterprises.

Megafon announced in May that it was partnering with Gazprombank and state-owned Rostec in a joint venture to produce digital services and blockchain-based solutions for Russian corporate clients. The decision to delist reflects a change in corporate strategy, but probably also concerns about publicity issues relating to information on state enterprises and a possible widening of sanctions. Usmanov has been gradually shifting his assets to Russia.

Russia’s near-term plans for government sector finances taking shape. The finance ministry’s government sector budget framework for 2019–21 foresees that rapid growth in revenues of the consolidated budget (federal and regional budgets, and state social funds) will continue still in 2019. Federal budget revenues are expected to rise substantially faster (about 15% p.a.) this year and next compared to revenue streams to the other budget categories thanks to relatively high oil prices and a hike in the value-added tax. All oil tax revenues and VAT revenues will continue to go to the federal budget.

Revenue growth of regional budgets is expected to keep going at about 2% faster than inflation. Part of this growth would come from letting regions retain gradually increasing shares of certain excise tax revenues. This dovetails with plans to start reducing transfers from the federal budget to regional budgets. Social fund revenue growth is also expected to outpace inflation, while federal transfers to the Pension Fund should remain roughly at current levels. Rates of social taxes going to the funds will generally stay unchanged, at a total of 30% of workplace wages. The finance ministry notes some of the increase in government sector budget revenues will come from improved tax collection based e.g. on ongoing digitalisation. Collection of VAT, labour income taxes and social taxes has improved over the past couple of years.

The proposed framework assumes growth of about 2% above inflation in government sector spending. Highest growth is seen in federal budget spending (excl. transfers to other budgets), but estimates of regional budgets do not yet include (at least fully) funding of the national projects listed in president Vladimir Putin’s May inauguration Decree. This could lead to regional changes in taxation and budget transfers. Government sector wage increases are generally speaking outlined to match inflation.

Increases in social fund spending from next year onwards are expected only to roughly match inflation. Both the finance ministry and the labour and social affairs ministry say that the proposed gradual increase in the retirement age in a bill currently before the Duma could also produce budget savings to an extent that pensions for retirees who do not work could possibly be increased in coming years by an average of 6–7% a year.

Russia’s near-term plans for government sector finances taking shape.

Changes in financing of Russian housing construction. Under a change in the law since July 1, construction firms may no longer finance their construction activity by selling unfinished apartments directly to consumers. This buy-early approach has long been popular in Russia because it lowered the sales price for the apartment-buyer while providing builders with a source of cheap financing. The drawback of this approach is that it has been very difficult for the buyers to recover their money if the apartment is never finished for some reason. Russia’s ministry of construction, housing and utilities reports that there are currently over 80,000 such problem cases (the actual number may be more than double that according to some experts).

The amendment requires buyers to deposit the payment for the future apartment in a separate bank account linked to a specific building permit. The money can only be released to the construction company upon completion of the apartment, but the deposit makes it easier for companies to borrow to cover construction costs. Buyer deposits are covered by banks’ deposit insurance up to 10 million rubles (140,000 euros). The law also tightens up e.g. other financing and solidity requirements for builders.

The change in the law is expected to improve the legal protection of apartment buyers and drive unscrupulous building companies out of the market. On the downside, the arrangement may reduce construction activity and drive up the apartment prices as financing becomes more expensive for many builders. The total volume of residential apartment production in Russia last year was about 80 million m². One of the goals of president Putin’s May Decree is to raise the volume of housing production to 120 million m² a year.

Sources: Ministry of Finance, Ministry of Economy and Rosstat.
China

**Yuan depreciation continued in July.** The dollar-yuan rate saw last week its largest monthly shift after the ending of the de facto pegging of the yuan to the dollar in 2005. As of today (July 27), the yuan was down 6 % from the start of June. Over the same period, the dollar’s trade-weighted exchange rate has remained essentially unchanged. The yuan has lost 6 % also against the euro since the start of June. The yuan’s nominal effective exchange rate (NEER) is about where it was at the start of this year.

Chinese exchange rate moves are still relatively modest. This year the yuan’s average daily fluctuation against the dollar has been only 0.2 %, compared to e.g. fluctuations of 0.4 % for the yen and euro and 0.6 % for the rouble against the dollar.

The yuan depreciation has also tightened tensions in trade policy talks. US president Donald Trump last week accused the Chinese of artificially devaluing their currency to support exports. China’s foreign ministry says the drop is due to market factors, and China does not intend to devalue its currency to stimulate exports.

The exchange rate trend also reflects dollar strength and conditions on China’s domestic market. The US Federal Reserve moves to higher interest rates, whereas China’s monetary stance is becoming more accommodative to boost growth in the presence of market uncertainties.

Even so, officials seem to be refraining from intervening as they did after the mini-devaluation of the yuan in summer 2015. The State Administration of Foreign Exchange (SAFE) reports that pressure to move capital out of the country today is considerably lower than three years ago. China has a range of measures available if needed to prop up the yuan.

**In other words, PBoC is not buying corporate bonds directly to hold on its balance sheet, and commercial banks carry the risks. Collateral accepted for MLF loans was expanded in June to include corporate bonds with ratings of AA to AAA- (see BOFIT Weekly 22/2018).**

**Media reports say that the PBoC exercised its window guidance policy last week in requesting that commercial banks provide estimates of their planned corporate bond purchases for July. On Monday (July 23), the central bank granted 502 billion yuan ($74 billion) in new one-year MLF loans that Caixin claims were allocated for this purpose. Earlier this month, 189 billion yuan in MLF loans were issued to fund rollovers of maturing loans.**

The rate on a one-year MLF loan is currently 3.3 %. On Monday, one-year AAA+ corporate bonds traded on the interbank market paid 4.0 %, and riskier AA- bonds 6.7 %.

Risks have emerged this year in the non-bank corporate sector with the increase in corporate bond defaults. The defaults have made investors particularly skittish about investing in high-risk bonds. At the same time, the yield spread for high and low quality bonds has increased. Companies are also finding it harder to access credit as the shadow banking sector has come under increased official scrutiny. China’s Banking and Insurance Regulatory Commission (CBIRC) last week issued guidance to banks on “actively lowering” financing costs for small firms and improving access to financing. Large banks were requested to take the lead on this.

**More Chinese companies make Fortune Global 500 list.** This year’s Fortune Global 500 (largest 500 firms in the world measured by total revenue converted to dollars) contains 111 Chinese firms (includes companies headquartered in Hong Kong). Nine Taiwanese firms made the list, along with seven Brazilian firms, seven Indian firms and four Russian firms. In 2000, only ten Chinese companies made the list. By 2017, that number had reached 109. 126 US firms made this year’s list, along with 52 Japanese firms. The rankings are based on revenue and profits from the most recent financial year ending March 31 or earlier.

US retail giant Walmart continued to hold the top spot with annual revenues exceeding $500 billion. As in 2017, the second-, third- and fourth-place rankings went to China’s state-owned energy giants State Grid, Sinopec Group and China National Petroleum, with revenues in the range of $326–349 billion. Of the 22 Chinese firms making it into the top 100, only Huawei (at the 72nd spot) is privately-held. Privately-held Anbang, CEFIC, HNA and Wanda that last year were included in the Global 500, were left out this year. Despite high-enough revenues to make it to the list, Fortune said the firms were removed due to e.g. operational difficulties, and some of them being under legal or regulatory investigation.

US-based Apple, with profits over $48 billion, was the most profitable firm on the list. All big four of China’s state banks (ICBC, CCB, ABC and BOC) made the top 10 most-profitable list.

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PBoC grants commercial banks credit to buy corporate bonds. Media reports assert that the People’s Bank of China is using its medium-term lending facility (MLF) to provide collateralised loans to banks to be invested in bonds of non-financial corporations. Economics & finance magazine Caixin reports 1-to-1 MLF credit is available for purchase of bonds rated AA+ and higher and 2-to-1 for lower-grade bonds.
Russia

Russian central bank still keeps key rate unchanged at 7.25 %. The press release from the Central Bank of Russia’s July board meeting on interest rates reads largely like the June release. The CBR said that it is highly likely that its monetary policy stance will shift to neutral next year. The CBR has earlier determined that the neutral key rate level is 6–7 % and further specified that the level has risen closer to the upper bound of this range in recent months.

The CBR expects inflation to rise from its current rate of around 2.5 % to at least somewhere near its target rate of 4 % by the end of this year. In addition to the direct effects of forthcoming tax changes on inflation, uncertainty persists over the strength of their impact on inflation expectations. Expectations of slightly higher inflation are further supported e.g. by the likelihood of a smaller harvest than the bumper harvest of 2017.

Oil revenues continue increasing for the Russian government. The second-quarter rise in federal budget revenues was so substantial that first-half revenues were up by over 20 % y-o-y. Most of the revenue boost came from oil & gas tax revenues, which increased by more than 35 %. Oil & gas revenues of the past 12 months were equivalent to over 7 % of GDP, which is the highest level of these revenues since autumn 2015. Other budget revenues continued to rise well, driven almost entirely by increased value-added tax revenues.

While federal budget spending climbed sharply in the second quarter of this year, it was only up 3 % y-o-y for the entire first half. Defence spending increased by 10 % and spending on domestic security, order and law enforcement by over 6 %. Other spending grew by less than 1 %. The federal budget deficit has shrunk considerably as a result of surging revenues. The federal deficit during the past 12 months was less than 0.1 % of GDP.

Federal budget revenues and expenditures, 2014–2018

Household borrowing up in Russia. Bank lending overall saw a slow recovery in the first half of the year. CBR figures show Russia’s credit stock was up 3.4 % y-o-y at the end of June. Corporate lending grew slowly, with the stock of corporate loans rising by just 1.9 % in January–June (accounting for exchange rate changes). Initial figures show high lending growth in the construction sector, which could foreshadow a recovery in construction activity. In contrast, lending to manufacturers rose by just 1 % in the first five months of the year.

The rapid growth in household borrowing that began last summer continued throughout the first half of this year. The household credit stock was up 19 % y-o-y in June. Strong growth was registered in both consumer credit and housing loans, but particularly the rapid growth in unsecured consumer credit has created concerns about over-indebtedness. The CBR has responded to the situation by raising its risk-weightings for high-interest consumer credit to slow growth in this area.

Banking sector earnings overall in the first half of 2018 amounted to 634 billion rubles (8.7 billion euros), a slight drop from 1H17. In particular, profitability was dragged down by losses of banks undergoing the central bank’s restructuring programmes. 145 banks declared losses in the first half of this year.

Under new regulations that entered into force at the start of the year, small banks may apply for a “basic” licence rather than the usual general banking licence. The basic licence permits limited banking activity and is only subject to limited supervision requirements. The basic licence has generated little enthusiasm so far. In the first half of this year, only six banks were granted basic licences.

The decline in the number of banks has continued, albeit at a slower pace than in previous years. In the first six months of 2018, the central bank cancelled the licences of 31 banks for regulatory violations. Another six banks merged with other banks. Most banks that lost their licences are small, controlling only a tiny fraction of the market. Russia’s 50 largest banks account for about 90 % of total banking sector assets. At the end of June, 524 credit institutions operated in Russia, down from 589 a year earlier.
**China**

**IMF wants China to continue with reforms.** The IMF’s 2018 Article IV Consultation praises China for its recent reform progress. It especially welcomes the actions taken tackling vulnerabilities facing the financial system as well as the risks to stability posed by China’s large shadow banking sector and its links to the formal banking sector. While credit growth has slowed, it is still high, so the IMF repeated its earlier warnings on the dangers of excessive indebtedness. While reining in credit growth inevitably restrains economic growth over the short run, it lays the foundations for sustainable long-term growth.

Now that China has 40 years of reform under its belt, the IMF encouraged its leaders to continue the shift in monetary policy away from money supply instruments to interest-rate based guidance. Measures should be actively developed to help the yuan achieve a free-floating exchange rate regime. The IMF team expressed hope that China would hold to its commitment to opening up its economy and allowing markets to play an increasing role. While there has been some incremental progress in removing barriers to foreign trade and investment, China is still far more closed to foreign direct investment and services trade than typical emerging economies. Despite restrictions imposed in branches suffering from overcapacity, the IMF said the sustainable answer is to let unprofitable “zombie” businesses fail. It also said the government has generally dragged its feet in reforms of state-owned enterprises.

Due to tightened financial market regulation and abatement of foreign demand, the IMF estimates that growth of Chinese GDP will slow slightly to 6.6% this year and to 5.5% by 2023. Although the impact of import duties currently imposed on China by the US will have little impact on economic growth, the IMF believes that embracing protectionist policies may represent one of the biggest challenges to growth. The IMF wants China to soothe its strained trade relations through negotiated settlement that emphasise free trade and support international and regional cooperation.

**Stakes escalate in China-US trade dispute.** The US this week announced $113 million in investments in emerging Asian economies. US Secretary of State Mike Pompeo described the gesture as a “downpayment on a new era of US economic commitment to the Indo-Pacific region.” The investment will focus on energy, technology and infrastructure. Pompeo said the US seeks an independent and open Asia, where no single country dominates. The initiative is a response to the Silk Road project and China’s growing regional influence.

One of Trump’s earliest acts as president was to issue an executive order to withdraw from the Trans-Pacific Partnership (TPP). Last April, Trump said the US was considering rejoining the trade pact.
Russia

Nationwide increases of manufacturing output and retail sales in Russia. Manufacturing output continued to rise in the first half of this year in almost all federal districts, even if the pace of growth varied somewhat. Manufacturing growth in the Central Federal District hit 10% y-o-y, followed by growth in the range of 5–7% in the Northwest, Urals and Southern federal districts. Manufacturing output has risen in federal districts through the general 2015–16 recession, with the exceptions of brief dips in the Siberia and Far East federal districts.

Retail sales, which began to recover last year, continued to improve in the first half of this year in nearly every federal district (up 2–4% y-o-y). As a consequence of recession declines, however, the volume of retail sales in almost all federal districts has yet to reach pre-recession levels. For example, the volume of retail sales in almost all federal districts, however, the volume of retail sales in almost all federal districts has yet to reach pre-recession levels. For example, the volume of retail sales in almost all federal districts, however, the volume of retail sales in almost all federal districts has yet to reach pre-recession levels. For example, the volume of retail sales in almost all federal districts, however, the volume of retail sales in almost all federal districts has yet to reach pre-recession levels. For example, the volume of retail sales in almost all federal districts, however, the volume of retail sales in almost all federal districts has yet to reach pre-recession levels.

The gradual shift in retail sales from the City of Moscow to its surrounding Moscow region in the Central Federal District has continued for years. Retail sales in the Moscow region well exceeded the pre-recession level in the first half of this year. Moscow and the Moscow region constitute a mega centre of retail activity, with a third of all retail sales in that mega concentration taking place in the Moscow region.

Retail sales in St. Petersburg have recovered slightly better than elsewhere in the Northwest Federal District. Overall, the retail sales slump in St. Petersburg was notably smaller than elsewhere, with the city’s retail sales in the first half of this year reaching the pre-recession level. St. Petersburg’s share of retail sales in the Northwest Federal District has gradually risen to more than 45%. Trends in retail sales in the Moscow mega concentration and St. Petersburg partly reflect their continuously growing populations. Populations of both have been increasing by about 1% a year during this decade.

Real developments of retail sales in Russian federal districts and major urban centres, 2015–18

Source: Rosstat.

Russia approves laws establishing domestic tax havens. Under a package of new laws, Russia will establish special administrative zones on Russky Island next to Vladivostok and on Oktyabrysky Island, which is part of the Kaliningrad enclave. Both sites have been designated as offshore centres where foreign-registered firms owned by Russians that meet compliance standards will be eligible for “redomiciliation” of their business. Companies that transfer their operations to one of the zones will enjoy notable advantages with respect to taxation e.g. of their profits, dividend income and different types of property, as well as the looser currency regulations applied to non-residents. Excluded from registration on the islands are banks, financing companies and companies providing payment services.

The legislative package is part of measures planned in Russia that seek to alleviate the impact of economic sanctions. Business daily Kommersant reports that a plan drafted by the finance ministry combines the new legislation with measures to reduce the dollar’s role in foreign trade payments, support access to financing of Russian firms affected by sanctions, limit “unfair competition” by foreign states (i.e. imports), as well as restrict access to information on firms potentially affected by sanctions. The measures will be prepared over the next two months.

Russia rises to 75th place in the World Bank’s logistics performance ranking for 2018. The survey-based Logistics Performance Index (LPI) covered 160 countries this year. Russia’s score places it in the mid-range of former Eastern Bloc countries - lower than current EU member states but higher than Central Asian countries except for Kazakhstan. China’s ranking (26) put it ahead of some Western countries.

LPI scores are compiled from six sub-indicator scores. Russia’s relative strengths were in infrastructure (61st), timeliness of delivery (66th) and logistics competence (71st). Russia performed worse in the areas of customs procedures (97th), tracking & tracing of consignments (97th) and arranging international shipments (96th).

Since the LPI was launched in 2007, Russia’s highest overall ranking has been 90th and its lowest ranking 99th. The country has recently made progress in the area of customs procedures, where it still ranked 141st in 2016. The shift towards electronic customs documentation in recent years may have improved its score.

Russia’s ranking has been rising also in other comparisons that measure similar institutions and features. Over the past decade, it has risen from 65th to 35th position in the infrastructure dimension of the Global Competitiveness Index published by the World Economic Forum. Notably, Russia’s rail network has risen to 23rd place, while its road network still fails to make even the top 100. The trade across borders category of the World Bank’s Doing Business survey ranked Russia 100th in 2018.
China

China’s central bank seeks to cushion depreciation pressures on the yuan. Recent weakening of the Chinese currency has forced the People’s Bank of China to reinstate its reserve requirement for financial institutions trading foreign-exchange forwards, effective August 6. The 20% forex reserve requirement was first introduced in October 2015 to deal with another yuan depreciation episode. The requirement was lifted in September 2017.

The forex reserve requirement makes currency trading more expensive, thereby discouraging speculation on yuan depreciation. Since the beginning of June, the yuan had lost about 6% of its value against the dollar. Since its peak in the end of March this year, the yuan has lost nearly 9% of its value. The latest round of yuan depreciation reflects both the relative strength of the dollar and the narrowing of the interest-rate spread between the United States and China. While US interest rates are rising, the Chinese government has moved ahead with policy stimulus measures in the face of increased uncertainty. The yuan’s real effective (trade-weighted) exchange rate is down by about 4.5% since the beginning of June.

China’s currency reserves grew in July by 6 billion dollars to 3.12 trillion dollars. Yet, even with net increases in both June and July, China’s currency reserves are down by 22 billion dollars for the year.

Increased uncertainty halts planned issuance of CDRs in China. The plan to issue Chinese depositary receipts or CDRs has been shelved. The initial issue of the smartphone manufacturer, Xiaomi, was supposed to take place in July. Xiaomi indefinitely postponed its CDR offering in late June and July, China’s currency reserves are down by 22 billion dollars for the year.

Local governments in China struggle with access to finance. Local government bond issues are currently on the decline. China’s finance ministry reports that local governments last year issued bonds worth a total of 4.4 trillion yuan, a decrease of 28% from 2016. In the first six months of this year, new bond issues amounted to just 1.4 trillion yuan, nearly 25% less than in the same period a year earlier. The volume of bond issues is only a fraction of what local governments are permitted to issue this year. Moreover, only a quarter of bond issues in the first half represented actual new debt. Most new debt goes to rolling over old bonds or paying off high-interest loans of local government financial vehicles (LGFVs).

China earlier required local governments to have balanced budgets, a requirement that forced many local governments to seek outside sources for additional funding. Off-budget LGFs were created to acquire short-term, high-interest loans, mostly provided by the shadow banking sector (i.e. financing arrangements outside the realm of official regulation). Bond quotas for local governments have gradually been increased since 2011. At the start of 2015, the law was amended to allow local governments to show budget deficits.

Under a three-year programme launched in summer 2015, local governments were required to swap out pricier debt for bonds. The goal was to reduce the debt-servicing costs of local governments, introduce market discipline and make it easier to get a handle on local governments’ indebtedness through greater transparency. China Chengxin Credit Rating reports that, as of end-June this year, local governments still held 860 billion yuan (130 billion dollars) in debt commitments that should be swapped for bonds before the swap programme ends this month.

Growth in infrastructure investment has slowed substantially as many local governments have postponed or cancelled their investment plans. In fact, negative public investment growth was registered for the March-June period. The central government has been forced to motivate local governments to fulfil their financing needs so that justified current projects at least are completed. The central government has increased its quota of “special bonds” tied to specific projects from 800 billion yuan last year to 1.35 trillion yuan (about 200 billion dollars) this year. Such special bonds may be used to finance projects such as subway construction or construction of toll roads. Instead of being paid out of the local government budget, investors are paid off from the revenue stream generated by the project.

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.
Russia

Ruble struggles and Russian share prices slide as US adds sanctions, oil prices fall and emerging markets face problems. Since the end of July, the Russian ruble has lost about 6% of its value and Moscow’s RTS stock index, which is denominated in dollars, has sunk 8%. While multiple factors underlie the ruble’s depreciation and declining share prices, the single most important reason is probably US sanctions. A new round of US sanctions was announced on August 8, and a US Senate draft bill on additional sanction legislation came to light.

The new sanctions come in response to the Skripal poisoning incident. They include restrictions on the export of certain electronic devices and dual-use devices to Russia. While these restrictions as such have a minor impact, the US is prepared to expand the restrictions in 90 days if Russia brushes them off. For that, Russia is required to assure that it will refrain from using banned chemical weapons and permit inspections of facilities where such weapons are allegedly under development. The next round of sanctions would grant the US government authority to suspend e.g. all Aeroflot flights to the US and ban a large swath of Russia-US bilateral trade. The draft bill includes even more significant measures such as restrictions on the ability of the Russian state and Russian companies to acquire funding and carry out money transactions.

A plan to significantly increase taxation of firms in Russia also emerged from the Kremlin last week. The proposal drafted by the president’s office mentioned 14 major firms and caused an immediate drop in their share prices. Russia’s financial markets were already roiled by declining oil prices. Oil prices have fallen as forecasts of global growth have been lowered and oil-producing countries have boosted production. The price of Urals-grade crude oil is down about 5% from the end of July.

Ruble rate, Urals oil price, Russian stock indices in 2018

General uncertainty about emerging economies, particularly Turkey, also dragged down Russian markets. Turkey is an important trading partner for Russia. In the first half of this year, 5.3% of Russian goods exports went to Turkey. The bulk of the exports were natural gas and oil, but Russia also exports metals and metal products to Turkey.

Russia’s largest bank, Sberbank, also acquired the Turkish Denizbank in 2012 for 3.6 billion dollars, making it Sberbank’s largest stake in any foreign bank. Denizbank has operations in countries neighbouring Turkey as well. In May, Sberbank announced it was selling its stake in Denizbank to Emirates NDB for 3.2 billion dollars. The deal is pending until official approvals are completed.

Higher oil prices drove growth in earnings from Russian goods exports in first half. The value of goods exports (measured in dollars) was up by 27% in the first half of this year compared to 1H17. On-year growth was 23% in the first quarter and 30% in the second quarter.

Mineral fuels accounted for 64% of goods exports in the first six months of this year. The volume of oil exports was down slightly, while the volume of gas exports rose. Although the volume of fuel exports overall rose only about 3%, higher prices meant their value was up by 24% y-o-y in the first quarter and 37% in the second quarter. Metals and metal products accounted for 11% of goods exports and their value in 1H18 increased by 32% y-o-y. The increase reflected higher prices and a 15% increase in export volumes.

The value of imports in dollars was up about 13% y-o-y in the first half, while in euros it was up just 2%. Growth in the first quarter was 20% y-o-y in dollar terms, but only 8% in the second quarter.

There was little change in the structure of imports. Machinery, equipment & transport vehicles accounted for 48% of imports in the first half. Imports in this category slowed significantly (in dollars, growth was 24% in the first quarter, and 6% in the second quarter). Growth of imports of chemical products (18% of total goods imports) remained fairly good in the second quarter. Spending on food and raw material imports (12% of total goods imports) rose slightly.

Both revenues from goods exports and spending on goods imports was still down by about one fifth from 2014 levels.
China

Lower fixed investment depresses Chinese growth. China’s most important economic indicators suggest that the economy slowed more in July than the markets had anticipated. Real growth in retail sales fell well below 7% y-o-y and industrial output growth was 6% – also below market expectations.

Perhaps the most interesting July figure was the slack in fixed investment. Even using a cautious measure for price developments, the volume of fixed asset investment (FAI) was again well in the red. While real growth in private investment rose slightly, the volume of public investment fell in July well over 10% y-o-y. Official figures show that fixed investment last year equalled 43% of GDP and thus continues to play a large role in Chinese economic growth. It is hard to get a clear picture of the actual state of investment in China, however, as FAI figures do not correspond to the national accounting for fixed investment. The two indicators, which earlier moved in sync, seem to be diverging since last year.

There were few surprises in July price trends. Consumer prices were up 2.1% y-o-y and producer prices rose by 4.6%. The survey of urban unemployment, now in use for a couple years, showed the urban unemployment rate surging from 4.8% in June to 5.1% in July. For China, this is a big shift in unemployment numbers. China’s unemployment figures, however, should be regarded with suspicion.

Indicators of Chinese economic growth

![Graph of Indicators of Chinese economic growth]

China’s trade surplus continues to narrow. For the first seven months of the year, the value of Chinese goods exports rose to 1.39 trillion dollars (up 13% from the same period in 2017). The value of imports increased to 1.22 trillion dollars (up 21%). The trade surplus from the same period last year contracted by about 25%.

China’s bilateral trade surplus with the US continued to grow, however, reaching 162 billion dollars in the January-July period, and increase of 13% y-o-y. Exports to the US in the first seven months of the year grew by 12% y-o-y, while imports rose by 11% (clearly lower than import growth overall). The US share of China’s imports has been decreasing during the past year. The US now stands in fifth place after the EU, South Korea, Japan and Taiwan.

Some of the growth in exports and imports reflects exchange rate fluctuations. Despite the yuan’s recent weakening, its average value in January-July was still 6% higher than in the same period last year. The yuan-dollar exchange rate in July was roughly at the same level as in July 2017. Total exports in yuan terms grew by 6% y-o-y in the January-July period, while imports were up by 14%.

Bank loans gain popularity as regulators have limited the access to other credit sources in China. People’s Bank of China figures show that Chinese banks granted 1.45 trillion in yuan denominated new lending in July (210 billion dollars). Growth in the stock of bank loans rose to 13.2% y-o-y. For the first seven months of this year, the value of new bank lending reached 10.48 trillion yuan, an increase of 19% from the same period in 2017.

In June and July, half of new bank loans went to companies and state organisations. Household borrowing accounted for about 40% of new loans, down from well over 50% a year ago. Financial institutions outside the banking sector have also increased their borrowing. For the first seven months of this year their stock of bank loans increased by 390 billion yuan, while in the same period last year it fell by 330 billion yuan.

Lending by small banks has grown faster than the lending of big banks. In the first half, small and mid-sized banks granted 25% more new loans than in 1H17. The volume of new lending by large state-owned banks increased by 12%. In the first half, large state-owned banks originated 39% of all new loans, down from over half at the start of the decade.

The central bank has eased its monetary policy and officials are encouraging banks to increase their lending in response to a regulatory crack-down on shadow bank instruments. The PBoC reports that the average interest rate on bank loans has only risen modestly, standing at 6% as of end-June.
Russia

Russian economic growth remains sluggish. GDP growth edged up from 1.3 % y-o-y in the first quarter to 1.8 % in the second quarter. Growth in the entire first half was 1.6 % y-o-y.

Industrial output growth climbed from slightly over 3 % in the second quarter to nearly 4 % y-o-y in July. Manufacturing output grew by 4.6 % y-o-y in July, or slightly faster than in the second quarter. Growth in extractive industries accelerated to over 3 %. Judging by Rosstat's previous data revisions, the industrial output data for recent months could later be revised even higher, especially manufacturing output.

Fixed investment in the first half was up by over 3 % y-o-y. Fixed investment growth slowed in the second quarter to under 3 %. Construction activity remained depressed, contracting about 1 % y-o-y in the June-July period.

Officially reported real wage information continued to show significant gains in July, up 8 % y-o-y. The rise of household disposable real income, on the other hand, remained at a bit in July, however.

Growth in household disposable income is expected to be in line with growth in real wages, as meagre gains in non-wage household income.

Retail sales growth, which quite naturally tracks real income trends, was 2.5 % y-o-y in July, the same pace as in the first half of this year. Seasonally adjusted retail sales dipped a bit in July, however.

The increases in the mineral extraction tax will raise the domestic price of crude oil. To compensate for the resulting losses on profitability of domestic refineries, the excise tax on petroleum products will also be adjusted. A share of excise tax revenues will go to supporting domestic refineries after the transition period. The level of support to refineries will depend on e.g. refinery location and the refinery's product range. Refineries are also promised favourable excise tax treatment if they are affected by Western sanctions. Numerous uncertainties surround the actual implementation of the revised approach to excise taxes.

Russia will continue to sell crude oil to Belarusian refineries at domestic prices, but due to the replacement of export tariffs with the higher mineral extraction tax, the price Belarusian refineries pay will be higher. Eliminating such structural boons may have been one of the goals of the tax reform.

Russia approves changes in taxation on consumption and corporations. The changes to the tax laws signed by president Putin early this month enter into force at the beginning of 2019. Although the value-added tax will generally rise from 18 % to 20 %, it will remain at 10 % for certain foods, children's goods, printed publications and pharmaceuticals. The economy ministry notes the full VAT rate applies to about three-quarters of goods and services. A zero VAT rate will be extended to cover domestic flights to and from the Russian Far East.

Excise taxes on alcoholic spirits and beer will remain unchanged next year, while the tobacco tax goes up by 10 %. Excise taxes on alcohol and tobacco will be adjusted in 2020–21 to keep up with the projected inflation rate, i.e. 4 % p.a., while taxes on tobacco products will go up slightly faster. Excise taxes on passenger cars will be adjusted for inflation. Taxes on motor fuels rise by 10 % next year from their level in the first half of this year (they have been reduced for the rest of this year to contain price increases). After 2019 they will be adjusted to roughly keep pace with inflation. Taxes on lower-grade gasolines, however, will remain unchanged in 2019–20 and the tax on heavy fuels used e.g. by cargo ships will stay at 0 % during 2019–21.

The revisions of tax laws keep the combined rate (based on wages) for mandatory social contributions at 30 % as the component going to the Pension Fund will remain at 22 %. Regional budgets will get some relief as regions will no longer have to pay social taxes into the health insurance fund for designated special groups of non-working people.

The tax on the physical capital of companies, which was limited to a maximum of about 2 %, will no longer apply to moveable assets (the tax will remain e.g. for buildings). As the tax has partly covered even relatively new production capital, it has been deemed to burden production while not doing very much to encourage investment. Unified principles will be applied to define the tax bases for taxes on real estate and the land tax.

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China

Rise in Chinese apartment prices moderates. Chinese housing-market tracker SouFun reports that apartment prices in Chinese cities have generally risen this year, but at a slower pace than last year. SouFun’s 99-city survey of apartment prices shows that the average price for one square metre of apartment floorspace in July was 14,400 yuan (1,800 euros), an increase of just over 5 % y-o-y. In the four biggest cities in the survey, the average square-metre price in July was 5,100 euros, unchanged from the start of the year.

New apartment construction starts in the first seven months of the year were up by more than 25 % from the same time last year. In the same period, construction starts on new office buildings and commercial space ran at the same pace as a year earlier. In the January-July period, the volume of apartment sales measured in terms of liveable floorspace increased by about 3 % y-o-y. The volume of completed apartment (m² of floorspace) declined by 18 % from a year earlier, and, consequently, the volume of pending sales of apartment also deteriorated steadily.

![Graph of apartment prices in Chinese cities](image)

Sources: SouFun, NBS and Macrobond.

Big trouble for China’s P2P platforms. About 250 online peer-to-peer lending platforms went insolvent during recent months, as investors withdrew from China’s P2P lending market. The collapse started as the government is tightening its regulatory grip on the P2P sector, thereby raising fears among investors that P2P platforms will face new problems. The industry was already struggling to shake the damage from numerous fraud cases (e.g. Ponzi schemes). Investors who have lost their money tried to organise demonstrations to show their displeasure, only to be blocked by officials.

P2P platforms intermediate loans from private individuals or firms to borrowers who otherwise lack access to credit. Due to the increased risk involved, the lending rates and yields are significantly higher than bank loans or bank deposits. While the P2P market limits the size of a single corporate loan to 1 million yuan (145,000 dollars) and a total of 5 million yuan in P2P loans per borrower, the amounts lost in a single platform collapse can be prodigious. Reuters’ sources estimate the Chinese P2P loan stock at close to 220 billion dollars, an amount greater than all of the P2P lending market in the rest of the world. While over 1,800 platforms in China are still standing since the first waves of platform collapses, most are not expected to survive under tightened regulatory conditions.

Reuters reports that financial supervision officials have turned to the government’s largest asset management companies (bad banks) for assistance in cleaning up the P2P sector mess.

China want to make the Pearl River Delta a world-class urban centre. Last week, a high-level working group held its initial meeting in Beijing to discuss development plans of the Pearl River Delta Greater Bay Area initiative. The initiative seeks to blur borders through creation an economically integrated region that grows the roles of mainland China cities of the Guangdong province (particularly Shenzhen and Guangzhou) through enhanced cooperation with the Hong Kong and Macao special administrative regions. While Guangdong’s nine major cities cover less than 1 % of China’s land area, they contain about 4 % of China’s population and generate nearly 10 % of China’s GDP.

The initiative seeks to build on the strengths of each area, while increasing the mobility of people, goods and capital within the region. Hong Kong will focus on financial markets, Macao on entertainment services and tourism, and cities in mainland China on services and high-technology sectors. Guangdong’s provincial government announced in August plans to invest 450 billion yuan (65 billion dollars) over the next three years in high technology, while encouraging local officials to attract more electronics firms and car manufacturers to the region.

An infrastructure goal is to improve travel within the Pearl River Delta. This year will see the opening of the world’s longest highway bridge (55 kilometres). It will link Hong Kong, Zhuhai and Macao. A bullet train connection linking Hong Kong, Shenzhen and Guangzhou also opens this year. Improvements are planned for numerous tunnels, ferry terminals and highway networks. Starting in September, residents of Hong Kong, Macao and Taiwan can apply for a Chinese personal ID that will give them access to a range of public services in mainland China, including education and housing services.

A goal of regional development is to ease Hong Kong’s lack of land for building by enabling those who work in Hong Kong to live also outside the city. Naturally, the project has also caused apartment prices in the mainland China side to soar. Apartment prices in some cities of the Pearl River Delta region have risen by over 70 % since 2015. The regional population is expected to reach 120–140 million by 2040.
Russia

Russia’s public finances in overall balance. Revenues to the consolidated budget (federal, regional and local budgets plus state social fund budgets) increased by over 15% y-o-y in the first half of the year. The rise of oil & gas tax revenues from higher oil prices accounted for nearly half of the revenue increase. The revenues stood for about a quarter of total consolidated budget revenues.

Other budget revenues increased by about 10% y-o-y, with the top four revenue streams rising by 12–15%. While the share of the top four sources in total revenues decreased slightly, the share was still nearly 60%. The top four breakdown is led by the mandatory social contributions by firms (20%), value-added taxes (17%), corporate profit taxes and personal income taxes (each roughly 10%).

Consolidated budget spending increased in the first half of this year by well over 5% y-o-y, driven by a clear pick-up in spending in the second quarter. Spending on healthcare and education increased fastest (about 15% y-o-y), in line with the Russian leadership’s current guidelines on raising budget spending in these categories. Spending on civil administration rose well over 10%, while revised figures show spending on defence, domestic security and law enforcement increased by 6%. Spending on social security rose by just 4%, due e.g. to the fact that general increases in old-age pensions were limited this year to levels slightly above the inflation rate.

The government sector deficit contracted last year and in the first half of this year. Over the 12-month-period ending in June, the budget showed a slight surplus of 0.1% of GDP.

CBR suspends foreign currency purchases tied to the fiscal rule until the end of September. Since the beginning of 2017, the Central Bank of Russia has purchased daily a pre-announced amount of foreign exchange on behalf of the finance ministry. Under the government’s current fiscal rule, excess tax revenues from oil & gas going to the federal budget (this year excess revenues will accrue when Urals crude is above $40.80 a barrel) will be transferred to the National Welfare Fund. As a rule, the liquid assets of the National Welfare Fund are invested in forex assets. As rising oil prices and ruble depreciation have increased budget revenues, the daily amounts CBR has been buying on behalf of the finance ministry have increased.

Earlier CBR buying suspensions have only lasted a few days. The current announcement calls for an exceptionally long suspension till the end of September. The CBR says the measure is intended to dampen increased volatility on financial markets and enhance the predictability of monetary authorities’ actions. Finance ministry representatives, however, assert the fiscal rule will be strictly followed and the CBR will continue to provide the agreed amount of forex from its own reserves.

Some market observers have noted that the measure could slightly support the ruble’s exchange rate, although any large impact is unlikely. The ruble-dollar rate has fallen about 8% since the beginning of August.

Caspian Sea states make progress in jurisdiction of territorial waters. On August 12, the five littoral states surrounding the Caspian Sea (Azerbaijan, Iran, Kazakhstan, Turkmenistan and Russia) signed a convention on administration of rights to the water resources and territorial bounds, easing construction of underwater oil & gas pipelines crossing the territorial zones and banning access of non-littoral military forces to the area. The convention makes the parties committed to protecting the Caspian Sea’s rich biodiversity, for which some areas are already seriously polluted.

The long-awaited agreement, over 20 years in the making, still leaves open critical questions about rights to natural resources underlying the vast seabed. The Caspian basin’s huge oil & gas potential has long been recognised and is already partly utilised. For example, the Kashagan oil field on Kazakhstan’s coast was discovered in 2000. It accounts about 10% of the country’s oil production at present, and that share is expected to keep growing. Jurisdiction over some Caspian Sea oil & gas deposits is disputed, and the new agreement does not reconcile the situation.

Under the new treaty, construction of oil & gas pipelines only requires permission from those countries through which the pipeline runs, and not all littoral countries as earlier. Concerns have been raised, however, about the effectiveness of eased permissions if other littoral countries can use environmental laws to dispute oil & gas pipelines located in the area. The issue is especially important for Turkmenistan, which has long planned a pipeline from its Caspian Sea oil & gas fields to Azerbaijan and further to European markets. Kazakhstan is also planning to connect its oil field pipeline to Europe via Azerbaijan. Russia and Iran, which look askance at competition on Europe’s energy markets, earlier used environmental protection rules to block pipeline projects proposed by others. Discussions among the parties to the convention are expected to continue to resolve outstanding issues.
China

US-China trade talks produce no results; new round of import tariffs takes effect. Trade talks between mid-level officials from China and the United States continued in Washington, DC on August 22–23, but failed to deliver results. On the second day of meetings, the US imposed its earlier threatened 25 percentage-point round of tariff increases on $16 billion worth of Chinese imports. China responded immediately by imposing similar import duties on the same dollar amount of select imports from the US.

If trade tensions further escalate, the US says it will go ahead with import tariff hikes on another $200 billion worth of Chinese imports. Public hearings by the US Trade Representative’s office, currently underway to finalise the list of targeted products, should be wrapped up on September 5. If the tariff hikes on the list are implemented later in September as planned, China has promised another round to tariff hikes affecting $60 billion worth of US imports.

China has held the line on further yuan devaluation amidst the trade policy wrangling. The yuan has actually rebounded by about 2 % against the dollar since hitting a low in mid-August. At the start of this month, the People’s Bank of China reinstated use of a “counter-cyclical factor” in determining the yuan’s appropriate reference exchange rate, thereby helping prevent further devaluation. On Friday (Aug. 31), one dollar bought 6.83 yuan.

EU could remove its import restrictions on Chinese solar panels. Chinese solar panel producers have been required by the EU for the past five years to sell their products within the EU-area at prevailing prices, or at least a minimum price defined by the European Commission. If the price went below the official floor, Chinese imports were subject to heavy import duties. Over the years, the price floor has been lowered gradually. The temporary import restrictions have been extended through a series of expiry reviews, with the latest period ending at the beginning of September. Reuters reports that the European Commission now plans to let the anti-dumping import duty scheme expire on its own and allow solar panel producers to set whatever prices they wish.

China’s solar energy sector has grown briskly thanks to generous state support. Last year, for example, China added 53 gigawatts of solar power production capacity. The increase accounted for over half of the increase in solar power production capacity globally, and was roughly equivalent to the generation capacity of 30 Finnish Olkiluoto nuclear power plants. China’s total installed solar power base in 2017 had a production capacity of 130 gigawatts, or about a third of installed solar capacity globally, placing China well ahead of its closest competitors, Japan (49 GW) and the US (43 GW).

Some solar power generated in China goes to waste due to inadequate demand, a lack of storage capacity and transmission grid limitations. Concerns over inefficient investment and overcapacity have arisen recently. Government support has been implemented through bank sector financing, which has allowed some solar firms to expand by taking on massive debt. At the beginning of June, Chinese officials announced an immediate end to subsidies for new solar power projects and the elimination of all production incentives. The decision was generally seen as a shot in the arm to sector as it forces companies to produce efficiently and invest wisely. The reduction in state support has long been a prerequisite to lifting of anti-dumping tariffs in export markets.

Countries with most solar power production

<table>
<thead>
<tr>
<th>Solar power, gigawatts</th>
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</thead>
<tbody>
<tr>
<td>2016 production capacity</td>
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<tr>
<td>2017 added capacity</td>
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<td>China</td>
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Sources: BP, Macrobond.

Higher rents yet to appear in China’s official inflation numbers. Various market operatives report that rents, particularly in China’s biggest cities, soared over the summer. A study by Chinese real estate brokers further shows that July rental prices in Beijing were up on average over 20 % y-o-y. Rents climbed by nearly 40 % in some areas.

China’s rental markets are generally considered underdeveloped. Most people own their own apartment. Soaring rental prices have pushed the government in recent years to make renting more attractive. Beijing’s rental market is currently dominated by a handful of brokers and tenant rights are inadequate e.g. in resisting capricious rent hikes.

As of mid-August, rental brokerages in Beijing agreed jointly to constrain the rise in rents by offering 120,000 new apartments on the rental market and refrain from cynical bidding wars. Media reports claim that rental brokers have lately promised apartment owners high rental prices to capture apartments to their own listings. Beijing rents are the highest in China, currently an average of about 92 yuan (13 euros) per square metre.

The higher rents have yet to show up in official inflation statistics. The rental expenditure category of the consumer price index shows rents even in big cities rising at a steady pace of 2–3 % a year in recent years. In the worst case, the failure of the government’s methodology for calculating inflation in capturing large increases in rents or housing prices leads to improper dimensioning or timing of policy actions.
Russia

Changes in structure of fixed investment in Russia. Fixed investment rose by over 3% y-o-y in the first half of this year, even if investments of large and mid-sized firms and the state, which are in the core of statistical recording of fixed investment, fell by 1%. Thus, Rosstat figures imply an unusually large increase (well above 10%) in fixed investment activity by small firms, firms operating in the grey economy and households.

Fixed investment by large and mid-sized corporations was drawn down by all significant categories of the energy sector. The multi-year decline in investment in the electricity sector continued, while investment in pipelines for the oil & gas sector dipped. Investment in oil production and oil refining turned downwards. The large investment wave in services related to gas production and transportation on the Yamal Peninsula came to a near complete halt. Manufacturing investment (excluding fixed investment in oil refining) rebounded strongly after a three-year decline. Much of the recovery reflects investment in the chemical industry and manufacturing of transport vehicles.

Looking at investment in various types of physical capital, growth of investment in machinery and equipment has remained brisk this year. In contrast, investment in various kinds of structures has declined, supporting the picture that the peak in various large investment projects, some of them government-led, has now passed.

Structure of fixed investment of large and mid-sized corporations

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Russia modifies rules on repatriation of foreign trade earnings. Russia’s finance ministry has sought this year to ease the foreign repatriation demands on companies involved in foreign trade, with several proposals turned down. At the end of July, however, an amendment eliminating the repatriation mandate for companies affected by Western sanctions was approved. Proposals to ease the repatriation requirement on all companies e.g. on ruble-denominated foreign trade earnings are still under consideration.

Under current legislation, firms are required to repatriate their foreign trade revenues. It is not required, however, that firms convert their earnings to rubles. This partly explains why about 30% of corporate bank deposits in Russia are denominated in foreign currencies. CBR figures show that the largest export firms have typically converted over 50% of foreign earnings to rubles in order to pay e.g. wages and taxes. The rise in the export price of oil has increased export revenues, which are typically denominated in dollars, as well as ruble-denominated taxes and tariffs going to the budget. The finance ministry reconverts any surplus budget revenues back into foreign currencies before they are transferred to the National Welfare Fund.

Russian export volumes up significantly in recent years. Unlike other demand-side categories, the real volume of exports of goods and services grew overall at an average rate of 4% a year in 2015-17. This year’s growth has been even higher. Exports correspond to over a quarter of GDP. The pace of export volume growth in recent years has directly added about one positive percentage point a year to changes in GDP.

Most export growth over the past couple of years has come from non-energy exports. Led by grain exports that have tripled over this decade, exports of agricultural products have soared in recent years. Chemical exports have increased steadily for many years, mostly from traditional chemical exports such as fertilisers. Metal exports have also risen substantially this year, particularly ferrous metals and copper. Exports of services have increased significantly over the past year-and-a-half, not just in the core categories of transport and tourism, but other services as well.

Energy items in recent years accounted for about half of Russia’s total earnings from exports of goods and services, while other goods accounted for over one third and services 14-15%.

Volume growth of non-energy goods exports

Source: Rosstat.

Source: Russian customs.
China

China’s official statistics getting more suspect. The Hong Kong daily South China Morning Post (SCMP) last week reported potential new cases of anomalous statistical reporting by Chinese officials. The SCMP article found evidence to question recently published data from the China National Bureau of Statistics (NBS) on the profitability of large industrial firms, retail sales, electricity consumption and coal output. SCMP reporters assert that officially reported July industrial profit growth was seriously overstated compared with growth figures calculated from absolute yuan figures. The NBS explained that the difference reflects annual changes in the size of the corporate sample. The NBS sample is limited to firms with revenues above 20 million yuan. Some experts interviewed think that the NBS may, for example, deliberately adjust the sample size to make the numbers look better and meet official growth targets.

Last month, Chinese media reported that the housing expenditure component of the consumer price index failed to reflect actual trends in housing costs.

The poor reliability of official Chinese figures has been discussed for years, but in recent years the problem seems to have grown worse. The remarkable stability of reported GDP growth figures is not credible. Moreover, it has been found that, for example, in the Liaoning and Inner Mongolia provinces and Tianjin’s Binhai special zone official data have been significantly manipulated. Many suspect part of the statistical reporting problem is related to the China’s ambitious official target of doubling real 2010 GDP by 2020. The goal may have forced officials to cheat in meeting their mandated targets.

Data discrepancies are always problematic. They can distort assessments of the economic situation leading to inappropriate economic policies and bad business decisions.

China cuts income taxes. The Standing Committee of the National People’s Congress last week announced an income tax reduction, with the largest cuts going to low- and middle-income individuals. Under the income tax tables coming in October, individuals earning less than 5,000 yuan (EUR 630) a month pay no income tax (earlier 3,500 yuan). The three lowest income tax brackets for individuals (3 %, 10 %, 20 %) were adjusted so that e.g. the income ceiling in the third-lowest (20 %) rises from 9,000 yuan a month to 25,000 yuan. Other tax bracket definitions remain unchanged. China’s highest income tax rate (45 %) applies to individuals with monthly earnings exceeding 80,000 yuan (EUR 10,000).

The reform also provides more opportunities for income tax deductions. For example, larger shares of the costs of education, care for serious illness or injury, housing and elder care can now be deducted. The government plans to give more detailed deduction rules during the autumn. Those rules come into force at the start of 2019. The comment period on proposed tax changes ran through July. Media reports note that hardly any of the over 100,000 comments resulted in changes to the government’s original proposal.

The government hopes the tax cuts will boost consumption to support economic growth. China’s finance ministry estimates that the cuts will increase the average urban-dweller’s consumption by about 300 yuan (EUR 40) a month. The impact of the tax change on public sector revenues is expected to be small, however. Unlike the US, where income taxes account for half of the tax take or Finland with over 60 %, they only accounted for about 8 % of total government revenues in China last year. Value-added tax is China’s largest tax revenue stream, accounting for 39 % of last year’s tax take. Corporate taxation generated 22 % of the tax take.

Local governments in China encouraged to boost growth. At the end of July, the central government leadership encouraged local administrators to increase their borrowing, especially to fund infrastructure projects. The message seems to have taken hold. In July and August, local governments issued 1.64 trillion yuan (240 billion dollars) in new debt. Local governments this year have issued bonds worth over 3 trillion yuan, while the value of maturing bonds this year has been less than 400 billion yuan.

A quarter of the new borrowing involves “special-purpose” bonds that local governments may use for acquisition of land or financing road projects. These bonds are to be paid back from revenues from the completed project. The finance ministry this year significantly increased its special-purpose bond quota for local governments to 1.35 trillion yuan (200 billion dollars), while the ceiling on new standard local government bonds was limited to 830 billion yuan. Local governments, under orders from the finance ministry to use their quotas, are rushing to find land acquisition and road construction projects. The finance ministry wants local governments to use 80 % of this year’s special-purpose bond quota by the end of September and the rest by the end of October. China’s large state-owned banks have already announced plans to increase their investments in local government bonds, most of which are already held by Chinese banks.

China’s leadership made reducing indebtedness a main goal of the current five-year plan. In the second half of 2017, infrastructure investment projects already started were put on ice and new projects approvals halted on worries over rising indebtedness and potential project insolvencies. Somewhat ironically, the policy stance has reversed and many new local government infrastructure projects re-authorised.

The exhortations to finance investment projects and support economic growth come in the face of rising uncertainty over rising local government indebtedness. There is no comprehensive estimate of local government debt loads, but China’s own estimate puts official debt at about 20 % of GDP as of end-2017. The IMF estimates that local government off-budget financing vehicles amounted to indirect debt obligations at the end of 2017 equal to 24 % of GDP, which put total local government debt at around 45 % of GDP.
Russia

Russian oil companies see major improvements in earnings. Despite a global rise in crude oil prices, the ruble has lost about 16% of its value against the US dollar this year. Geopolitical factors account for most of the headwinds battering the ruble. Global markets reacted negatively and swiftly in early April after the US broadened its sanctions roster to include a number of major Russian enterprises and private individuals. August brought additional uncertainty due to the US announcement it might go ahead with further sanctions, heightened tensions between the US and Russia over Syria and Iran and the novel sanctions imposed after findings of the UK's Skripal poisoning investigation.

While the price of Urals crude oil reached 76 dollars a barrel at the end of August (up 13% since the start of January this year), the rise in oil prices has been significantly larger in ruble terms. At the beginning of this year, a barrel of Urals went for about 3,900 rubles. By the end of August, its price had climbed 33% to 5,200 rubles. Higher oil prices in dollars coupled with the ruble's devaluation are shown in the first half year earnings of Russian oil companies.

Rosstat statistics, for example, show total pre-tax net profits of oil companies were up by over 140% y-o-y in the first half of this year. Russia's largest oil company Rosneft announced that its first-half result (EBITDA) improved close to 50% y-o-y. Similarly, Lukoil earnings were up about 30% in the first half. Thanks to higher earnings, the companies have announced major share buy-back programmes. Rosneft plans to spend 2 billion dollars buying back its own shares, while Lukoil expects to spend 3 billion dollars on its shares. Both Rosneft and Lukoil report paying down considerable amounts of debt in the first half of 2018.

Russian state plays an ever-increasing role in directing investment. President Putin's 2018 May Decree included the goal of raising the investment-to-GDP ratio to 25% by 2024. Deputy finance minister Andrei Ivanov has since clarified that Russia needs about 21 trillion rubles (300 billion dollars) in investment, and that companies should contribute about 8 trillion rubles of that amount. A wide variety of proposals have been made concerning the funding and targeting of this additional investment. Last month saw the publication of “Belousov’s list” of 14 large industrial firms to be taxed on windfall profits totalling about 500 billion rubles. The government ultimately balked on capture of those profits, however, and instead the listed firms agreed to invest in projects that benefit society. The identification of such projects will involve the joint cooperation of the finance ministry, the presidential administration, the contributing firms and the Russian Union of Industrialists and Entrepreneurs (RSPP).

Production and exports of Russian crude oil

Production and exports of Russian crude oil have increased slightly in coming years. According to the July forecast by Russia’s economic development ministry, Russia will this year produce 549 million tons of crude oil (about 11 million barrels a day), which is about half a percent more than last year. Crude exports are expected to total about 250 million tons and exports of domestically refined products about 150 million tons. The ministry forecasts that both output and exports will grow by about 1% a year over the next two years and plateau thereafter. According to several estimates, Russian oil output will begin to decline sometime within the next ten years. However, forecasters have been continually pushing the date of Russian peak oil further into the future.

New fields are being brought on stream in both Russia’s traditional oil production areas on both sides of the Urals as well as in the Yamal region and Eastern Siberia. As in many other countries, the advent of hydraulic fracking has made it possible to exploit a considerable amount of previously intractable deposits. Sanctions, however, complicate to some extent adoption of the latest technologies as well as upgrading current equipment and facilities.

Russia has no shortage of potential investment targets. Media reports note, for example, that the price tag for Russia’s revised national digitalisation programme for 2019–2024 has climbed to around 1.2 trillion rubles and that cost of the economic development ministry’s infrastructure programme now stands at around 7 trillion rubles. Officials hope that both efforts will be partly funded out of the federal budget and partly by corporations, including those in the private sector. In addition, firms face added costs in complying with new rules on ID coding of goods and data storage in compliance with the Yarovaya anti-terrorism amendments.

The finance ministry has proposed encouraging private investment through e.g. development of various financing instruments and reforming investment agreement practices. Under the latest proposal, large investment projects requiring joint commitments from the parties would be allowed to lock in their tax treatment for up to 12 years.
China

China’s goods trade surplus with the US widened in August. China customs reports that growth in goods trade last month was roughly the same as in previous months. One-year growth in the value of exported goods remained at around 10 % y-o-y, while the value of goods imports rose by about 20 %. Growth in the volume of imports has been double that of exports. Robust import growth has reduced China’s overall trade surplus. However, there is much variation in bilateral trade balances as illustrated in the chart below.

China customs adds that growth in goods exports to the United States remained strong last month, outpacing growth in exports to both Japan and Europe. As a result, China’s trade surplus with the US hit an all-time high in August. US customs figures back up the growing imbalance in trade with China. US imports have accelerated on strong growth of the US economy, creating strong import demand with countries other than China as well. Moreover, imports from China have picked up as firms operating in the US have moved up scheduled shipments from China in anticipation of higher tariffs.

China’s trade war with the US continues to escalate. The US last week completed hearings on raising import tariffs on rebates on nearly 300 products. Trump announced the US could move ahead rapidly in conclusion of the hearing period, US president Donald Trump announced the US could move ahead rapidly in conclusion of the hearing period, US president Donald Trump announced the US could move ahead rapidly in conclusion of the hearing period, US president Donald Trump announced the US could move ahead rapidly in conclusion of the hearing period. To ease the distress of its struggling export industries, the US economy, creating strong import demand with countries other than China as well. Moreover, imports from China have picked up as firms operating in the US have moved up scheduled shipments from China in anticipation of higher tariffs.

China has announced it is ready to impose its own new tariffs. To ease the distress of its struggling export industries, China’s finance ministry announced increases in export tax rebates on nearly 300 products.

Falling prices make foreign investors wary about mainland China stock markets. As scheduled, the weight of Mainland Chinese shares was increased in the MSCI Emerging Markets Index at the beginning of September (BOFIT Weekly 22/2018). However, their weighting in the index is still quite small. Despite the fact that China represents a roughly 30 % weighting in the MSCI Emerging Markets Index, only 0.8 percentage point comes from mainland China A-shares. This amount is miniscule considering that Hong Kong-listed Chinese Tencent represent alone nearly 5 % of the MSCI EM weighting, or that, Alibaba, a heavy on the New York Stock Exchange, has a nearly 4 % weighting. Index provider FTSE Russell is expected to follow suit with MSCI by including mainland Chinese shares in its flagship indexes.

Share prices have slumped in mainland China this year. The slide accelerated at the beginning of June on rising fears about a trade war, China’s own deteriorating domestic economic conditions and increased risk facing financial markets. On Wednesday, the Shanghai Composite Index was down 20 % from the start of the year, while the Shenzhen Composite Index was off by 26 %.

As expected, MSCI’s move of giving more weight to mainland shares in its emerging markets index has had little impact on foreign holdings of mainland shares. Foreign holdings of Chinese shares increased by 125 billion yuan (18 billion dollars) in May, but fell by 45 billion yuan in June along with a fall in equity prices. Foreign investors owned 1.275 trillion yuan (190 billion dollars) of mainland China shares at the end of June, about 2.5 % of the Chinese stock exchanges’ market capitalisation. Foreign investor trading on the Shanghai and Shenzhen stock exchanges via the Stock Connect arrangement with the Hong Kong stock exchange also showed almost no reaction to the decision to include mainland shares in major emerging market indices.

The Chinese government has taken steps to enhance the appeal of Chinese stocks to foreign investors. To show good faith in current trade dispute talks, China announced an easing of foreign ownership rules and extended shareholding possibilities to such critical sectors as car manufacturing and finance. In June, the restrictions on participants in the QFII and RQFII programmes for qualified foreign institutional investors were relaxed by abolishing monthly repatriation limit of 20 % of net value of the portfolio in the previous year.

Starting Monday, China will attempt to attract new investors to the market by allowing qualified foreigners operating in China to trade directly on mainland stock exchanges. This pool of potential investors is estimated to contain nearly a million people. At the same time, firms listed on stock exchanges in mainland China will be permitted to offer stock incentives also to their foreign employees.

Mainland China and Hong Kong stock exchange indexes

Sources: China customs and Macrobond.
Russia

CBR raises the key rate by 0.25 percentage points and prolongs the suspension of currency-buying under the fiscal rule through December. On September 14, the Central Bank of Russia’s key rate went up to 7.5%, the first hike in the key rate since December 2014. The CBR said its decision takes into account a rising inflation forecast and increased inflation risks. The updated forecast on inflation is mainly driven by the approaching VAT hike from 18% to 20% on January 1, 2019, as well as ruble weakness arising from geopolitical tensions and emerging market volatility. The forecast sees inflation at the end of this year running at around 4% (previous forecast 3.5-4%) and 5-5.5% (previously slightly above 4%) at the end of 2019. In 1H2019, the VAT increase could temporarily boost the inflation rate as high as 6%, but the CBR expects inflation to subside to 4% in 2020. Main inflation risks stem from highly uncertain external conditions and their impact on financial markets.

The CBR also decided to prolong the suspension of foreign currency purchases under the fiscal rule until year’s end. The CBR earlier said the purchase pause would last through September (see BOFIT Weekly 35/2018). The move is intended to stabilise ruble volatility and its influence on inflation. The CBR decision to resume foreign currency purchases under the fiscal rule will be made based on financial market conditions.

IMF’s annual Article IV consultations with Russia stress ongoing need for reform. The IMF expects Russian GDP to grow by 1.7% this year and 1.5% next year if the oil price remains roughly around $72 a barrel. Largest risks comprise geopolitical tensions, weak growth in developed economies, lack of economic reforms in Russia and weaknesses in its banking system.

The IMF noted its outlook could change due to additional state spending arising from president Putin’s May inaugural Decree. Extra spending on infrastructure, healthcare and education could amount to more than 1% of GDP per year during 2019-24, raising GDP growth in the next few years to 2%. However, the impacts e.g. on the economy’s growth potential and inflation cannot be estimated based on available information. Growth in the outer years could become quite slow.

The IMF considers Russia’s general policy of monetary easing correct, but also referred to a possible pick-up in inflation, persisting inflation expectations and risks to the inflation outlook stemming e.g. from the government budget sector. The IMF noted that refining monetary policy communication was important in lowering inflation expectations.

Concerning the banking sector, the IMF paid attention to last year’s failures of several large banks. The IMF emphasised the need to improve supervision of risks, especially as regards related-party lending and the accuracy of financial statements. The IMF noted rehabilitated banks should be returned to private hands in an open way. Privatisation of state-owned banks appears difficult in current conditions.

The IMF stressed that the lack of necessary economic reforms means that Russia’s economic convergence to higher levels is stalled. The IMF staff estimate that the Russian government and state-owned enterprises contribute about a third of GDP. Reducing the role of the state in the economy should start from increasing competition by e.g. lowering barriers to entry and exit, using market-friendly public procurements and inducing changes in how state-owned enterprises operate. Challenges also include excessive regulation and customs operations. The IMF said barriers to foreign trade and FDI need to be reduced.

Russia’s fourth large natural gas liquefaction unit started production. In August, the first cargoes were offloaded from the second unit (liquefied natural gas (LNG) train in professional terms) of the plant in the Yamal Peninsula on the shores of the Arctic Sea. The third and last large unit is to be completed next year. Two more units are located on the Sakhalin Island in the Pacific Ocean. Each of these five large units is capable of condensing annually about 7 billion m³ of natural gas into about 5 million metric tons (the capacity of about 70 vessels) of LNG. These units account for almost all of Russia’s production. Smaller facilities in the Baltic region produce much smaller amounts used e.g. as ship fuel. In liquid form, Russian natural gas can be delivered beyond the reach of pipelines. Most of the LNG produced so far has been delivered by sea to Asia. After the completion of the plant in the Yamal Peninsula, nearly 15% of Russia’s natural gas exports may be delivered in liquid form. Russia’s share of global LNG production capacity will rise to over 5%. Russia would still be far below the levels of Qatar or Australia.

New projects are under consideration, but none has reached the construction phase. They would be operational several years from now at the earliest. In addition to the expansion of the Pacific Ocean and Arctic Sea plants, there is a plan to build a large plant in the port of Ust-Luga at the Gulf of Finland. Instead of being close to a gas field, this plant would be fed through the pipeline grid. The route of Nord Stream 2 gas pipeline also happens to start near Ust-Luga.

Destinations of natural gas produced in Russia

Sources: Rosstat, Russian customs and economy ministry (forecast).
China

US-China trade war escalates; American firms operating in China suffer. On Monday (Sept. 17), United States president Donald Trump unveiled a new round of tariffs on imported Chinese products with a combined value of $200 billion a year. The additional 10% tariffs entered into force on September 24 and rise to 25% at the start of next year unless US-China talks manage to resolve the intensifying dispute. The US had already imposed import tariffs on China worth $34 billion a year at the beginning of July, as well as additional tariffs on another $16 billion worth of Chinese imports in August. US tariffs announced so far apply to about half of US goods imported from China.

As in the previous instances, China retaliated immediately to the US measures by imposing additional tariffs on American goods. China’s additional tariffs, 5% and 10% depending on the product, apply to US goods imports worth $60 billion a year. They enter into force on the same day as the newest round of US tariffs. Trump has indicated that the US is prepared apply additional tariffs to practically all goods imports from China if China continues to rebuke US measures. No high-level trade talks have been announced.

While the American Chamber of Commerce in China notes that trade wars only produce losers, they do not believe the dispute will be resolved quickly. According to its survey made during the August-September cusp, the before and newly imposed additional tariffs harm 75% of American firms operating in China. Nearly half of the 430 firms responding said the tariffs imposed by the US have a “strongly negative effect” on their operations, and just a handful of firms saw themselves as benefitting from Trump’s tariff policies. Tariffs have driven up production costs for American firms, reduced demand for their products and increased prices to end consumers. About half of the responding firms expected their profits to shrink. The trade war is also apparent in the fact that firms have postponed or cancelled their investment plans and are seeking to restructure their supply chains. For example, 31% of American firms operating in China reported that they are trying to reduce their purchases of US-made parts or component assembly operations in the US. Very few firms said they were considering moving their production back to the US. Respondents also noted that, in addition to the burdens from new tariffs, Chinese bureaucrats have complicated their lives through increased inspections and oversight, as well as slowing goods handling at customs.

The latest annual survey of the European Union Chamber of Commerce in China (EUCCC) asks about the impacts of higher tariffs on European firms operating in China. It finds that roughly half of firms see tariff increases as harmful to their businesses, while the rest see a neutral impact. Most European firms were taking a wait-and-see position and they have yet to take any measures to respond to the tariff hikes.

Even with China’s leaders trying to portray the country as a beacon of free trade, the EUCCC asserts that the roots of the trade war originate with China’s foot-dragging on market-economy reforms and slowness in opening its economy to the world. The EUCCC reports that domestic Chinese firms still face far fewer barriers and operate far more freely than foreign firms in China. Already for years, American and European firms have called for China to open its markets and assure foreign firms of a level competitive playing field.

Large Chinese banks report improved profitability. The semi-annual financial reporting of China’s Big Four banks (Agricultural Bank of China, Bank of China, China Construction Bank and Industrial and Commercial Bank of China) shows all increased their margins and profits during the January-June period. Most of the earnings growth came from a widening spread between lending and deposit rates. The situation has improved for these banks since 2015 and 2016, when the tough competitive environment dramatically shrank margins. Other profitability indicators like various return on capital ratios also suggest higher bank profitability. The Big Four appear to have benefitted from recent campaigns by the country’s leadership on lowering debt levels and tighter regulation. Concerns about banking system stability are primarily focused on small and mid-sized banks.

There has long been a cloud surrounding the reliability of economic reports published by Chinese banks. The solidity of Chinese banks, which are famously reluctant to for example report non-performing loans, is generally seen as weaker than represented. During the past few years, Big Four financial reports increasingly portray themselves as enthusiastic participants in the government’s economic development campaigns and initiatives.

No evidence of an impact from recent stimulus measures in China’s July-August investment figures. China’s official economic figures for August show no large changes in economic circumstances relative to previous months. However, while monthly figures show little fluctuation, it seems third-quarter GDP growth will fall well below the growth pace of 3Q17.

Retail sales, a widely-used indicator of services output and consumption, rose in real terms by 6.6% y-o-y in July-August. The corresponding growth in July-August 2017 was 9.3%. Figures for goods freight indicate an even sharper slowdown in growth. Industrial output growth appears to have slowed only marginally since July-August 2017, but the lack of almost any fluctuations in official figures over the past three years has also been astonishingly consistent – especially in light of changes in other indictors tied to industrial output. Real on-year growth in fixed asset investment (FAI) has been around zero for over a year. Despite stimulus measures to boost growth, there were no signs yet in July and August of an increase in FAI.

China’s quarterly reporting of on-year GDP growth has fluctuated a mere 0.1 percentage point around the 6.8% level during the past three years. Third-quarter GDP figures will be released on October 19.
Russia

Russian industrial output and retail sales continue relatively strong growth in August. Industrial output in August rose by 2.7% from a year earlier, whereas in July it grew by 3.9%. The level of industrial output is now about 8% higher than at the end of 2015.

The August industrial output figures were boosted mainly by activity in extractive industries, where output increased by 4.5% y-o-y. Information from Russia’s energy ministry shows a distinct increase in oil production in July and August, approaching the highest levels of output recorded in the post-Soviet era. Manufacturing industries have grown faster than extractive industries for most of this year. They grew slower only in August, when y-o-y growth dropped to 2.2%. Notably, the August production of motor vehicles grew by 12.2% and that of paper by 11.9% from last year. In contrast, electronics production has declined over the past year.

Economic recovery is also visible in retail sales, which grew in real terms by 2.8% y-o-y in August. The y-o-y growth of retail sales has fluctuated this year between two and three percent. Volumes of retail sales and domestic consumption (as calculated in national accounts) have grown since early 2017. Growth in private consumption has been supported by growth in real wages. They were up by 7% y-o-y in August.

Increased borrowing is also driving higher household consumption. Households piled on debt in the years before the 2014-2015 economic crisis. Much of that debt was used to buy consumer goods such as cars. The volume of new lending to households has been rising since the beginning of 2016, and growth this year has accelerated. Nominal y-o-y growth in ruble-denominated loans reached 37% in July.

Growth in Finnish-Russian trade subsides. Ruble depreciation has had a dampening effect on the growth of Finnish exports to Russia this year. While the value of Finland’s imports from Russia has grown, this is mostly due to higher oil prices.

In the first six months of this year, Russians purchased in euro terms roughly the same amount of Finnish goods as in the same period last year. The annual value of Finnish goods exports to Russia is over 3 billion euros. Machinery and equipment account for about a third. Other significant export products include paper and chemical products.

Russians spent 5% more on Finnish services in euro terms in the first half of this year than they did in the same period last year. Annually more than 1 billion euros are spent, with about half related to travel. Other important service export categories include construction, transportation and data services.

Fins purchased about 3% more Russian goods in euro terms in the first half than in the same period last year. Due to the one-off delivery of a gas pipeline last year, the reference point is quite high. Without it, Finnish imports from Russia increased by over 10%. Finns annually buy about 8 billion euros worth of Russian goods. About two-thirds of it comes in the form of fossil fuels, while the rest is mostly metal or wood products. Russia supplies Finland annually with roughly 10 million metric tons of crude oil, which corresponds to 2% of Russia’s crude oil production and accounts for about 90% of Finland’s crude oil imports. Finland also imports refined petroleum products and natural gas from Russia. At current prices, the value of Finland’s annual fossil fuel imports is roughly six billion euros. However, this is not solely net imports, as a large share of crude oil is used as an input to make various export goods.

Fins spent about 10% more euros on Russian services in the first half than in the same period of last year. Of the nearly 1 billion euros used annually on Russian services, about two-thirds goes to transportation services. Travel services account for about 10%.

**Trends in real wages and real disposable income in Russia**

![Graph showing trends in real wages and real disposable income in Russia](Source: Rosstat.)

**Finnish goods exports to Russia**

![Graph showing Finnish goods exports to Russia](Source: Finnish Customs.)
China

US-China interest rate spread narrows. At a time when China is applying economic stimulus through monetary easing, the United States continues to tighten its monetary stance. The US Federal Reserve raised rates yet again on Wednesday (Sept. 26). Thus, the interest rate spread between China and the US has practically vanished.

While China continues to apply stimulus measures on worries over slowing growth, monetary easing fuels China’s debt problems and adds to capital flight and yuan’s depreciation pressures.

Despite the rapid increase in mobile payments in China, growth remains robust also in its payment card markets. In January-June, the value of card payments grew by 37 % y-o-y. In addition to payment cards, China had 628 million credit cards on issue. At the end of June, credit card debt was up about 33 % y-o-y to 6.3 trillion yuan (USD 950 billion).

Finnish first-half goods trade deficit with China balanced by services trade surplus. While Finnish Customs reports that Finland’s overall goods trade turnover grew at an average pace of 6 % y-o-y in January-June, Finnish trade with China hardly grew at all. Finnish goods exports to China amounted to 4.71 billion euros (up 2 %), while imports were valued at 2.16 billion euros (down 1 %). The overall goods trade deficit was 450 million euros, which was smaller than the H17 deficit.

In the first half of this year, 5.4 % of Finnish goods exports were destined for China, while 6.6 % of goods imports came from China. China is thus Finland’s fifth-most-important export market after Germany, Sweden, the US and the Netherlands, and Finland’s fourth-largest import provider after Germany, Russia and Sweden.

Finnish imports from China declined slightly or remained unchanged in the main broad categories (machinery & equipment, basic and other manufactured articles) compared to H17. There was more volatility in exports, however. The value of exports of Finnish machinery & equipment, as well as chemicals, declined substantially, while exports of raw materials and basic and other manufactured articles were up.

The services trade balance between China and Finland has been positive since 2016. Statistics Finland reports that the value of services exports to China in H18 was 650 million euros against services imports of 420 million euros (resulting in a surplus of 230 million euros). While Statistics Finland does not publish a breakdown of the structure of services trade by country monthly or quarterly, its figures for tourism show clear declines in the numbers of Chinese arriving in Finland and spending the night in Finnish lodgings during the May-July period compared to a year earlier. Last year tourism accounted for 14 % of Finland’s services exports to China.

Sources: Finnish Customs and BOFIT.

UnionPay launches European expansion; foreign card issuers still find access to the Chinese market difficult. China’s state-controlled payment card company UnionPay is launching its initial foray into European markets by providing electronic mobile payment cards to corporate customers in the UK who plan to visit Asia. As the rollout progresses, UnionPay also plans to offer its credit cards in Europe through third parties such as banks. UnionPay has in recent years expanded internationally mainly in Asia as well as developing markets outside Asia.

Over 7 billion UnionPay payment cards have been issued, making UnionPay the world’s largest payment card issuer. Nearly all of its cardholders live in mainland China.

China announced already in 2014 that it was opening its credit card market to foreign companies and would permit them to establish their own clearing companies. Guidelines to credit card companies on applying for operating licences were published only last year after China promised to open its financial sector to foreigners as part of negotiations with the US. Not one foreign payment card issuer has yet been granted permission to operate independently in China. The Wall Street Journal last spring reported that American Express will be the first foreign card company to receive an operating licence from the People’s Bank of China. A licence was granted to a joint venture that includes Chinese mobile payments provider Lianlian Group.

3-month rates of various Chinese bonds and US treasuries

Finnish goods trade with China
Russia

BOFIT forecasts low growth for the Russian economy in coming years. Our latest BOFIT forecast for Russia, which covers the 2018–2020 period, sees GDP growth this year remaining below 2%, with growth slowing next year to around 1.5% as long as the oil price (Brent crude) stays reasonably close to its current level of about $75 a barrel. Growth will remain slow in coming years as there is little indication that Russia will move ahead with market-friendly systemic reforms that are necessary to foster higher growth.

The recovery of Russian imports from a deep slump in 2014–2016 slowed this spring, dragged down by ruble depreciation (first-half import growth this year was 6% y-o-y). Imports are expected to recover at roughly 5% pace in the next few years as the ruble’s real effective exchange rate (REER) is assumed to remain rather stable. The rapid growth in Russian export volumes (mainly non-energy goods and services) is expected to slow, even if the relatively low REER supports export growth. The outlook for growth in Russian energy exports is tame.

The recovery in household consumption should remain rather slow. The increase in the value-added tax from 18% to 20% at the start of January 2019 will lift up consumer prices and hit purchasing power. Real pensions will rise slowly, and the state has not promised increases in government budget sector wages. Recently increases in corporate wages have been higher than productivity gains. The gradual increase in retirement ages starting next year means slightly fewer people than expected will be leaving their workplaces.

Fixed investment will continue to recover slowly, even with aging and worn existing capital and peak utilisation of industrial capacity. The state has started guiding investments made by state-owned and large private firms to the national ports. Russian oil production at present is already higher than the former agreed ceiling by 400,000 barrels a day. OPEC agreed in 2016 on voluntary limits to oil production, a scheme that since succeeded in substantially raising oil prices. For example, the price of Urals-grade oil, slightly over $50 a barrel at the start of 2017, now stands at over $80 a barrel. Russia and OPEC agreed in June to get rid of production ceilings. Russian oil output currently exceeds the former agreed ceiling by 400,000 barrels a day. OPEC countries have also boosted their production.

Russian oil production hits peak in September. Russia’s energy ministry reports that Russian crude oil production in September exceeded by a small margin its previous peak in the post-Soviet era. Russia’s average daily production in August rose by 1.3% y-o-y to 11.4 million barrels. Russia and OPEC agreed in 2016 on voluntary limits to oil production, a scheme that since succeeded in substantially raising oil prices. For example, the price of Urals-grade oil, slightly over $50 a barrel at the start of 2017, now stands at over $80 a barrel. Russia and OPEC agreed in June to get rid of production ceilings. Russian oil output currently exceeds the former agreed ceiling by 400,000 barrels a day. OPEC countries have also boosted their production.

Russian oil production at present is already higher than the economy ministry’s latest forecast for 2019 (see BOFIT Weekly 37/2018). The ministry expects production to rise further in 2020–21 by about 1% a year, and then ease into a slow decline. It is therefore unclear how long the current production level can be sustained without new investment.

Retirement age hike approved in Russia. On September 27, the Duma, the lower house of the parliament, approved the third reading of a bill to raise the general retirement age by five years. After approval by the Federation Council, the upper house, president Putin signed the bill into law on October 3. Starting January 1, 2019, the retirement age will rise by six months every year, from 60 to 65 for men and from 55 to 60 for women. Numerous special groups will still be entitled to lower retirement ages.

Government sector spending will increase in real terms this year, and will continue to rise next year to implement projects in Putin’s May Decree. Higher inflation will reduce real spending growth. The added spending will be funded by the VAT hike and by lowering the federal budget surplus. Even so, the federal budget, which assumes the Urals oil price at about $60 a barrel, and the entire consolidated budget are expected to show notable surpluses in the next few years.

Important risks to the forecast continuously include a large shift in oil prices and weaker-than-expected developments in the global economy and international relations. Increased government spending could drive higher-than-expected GDP growth in the forecast period.
China

Latest BOFIT forecast sees China’s slowing growth exacerbating economic problems. The outlook for China’s economy has become increasingly uncertain this year. As in our March 2018–2020 forecast, the baseline forecast in our latest BOFIT Forecast for China sees growth remaining strong, but slowing to around 5% p.a. in 2020. The risk of lower growth, however, has increased.

An external driver of uncertainty has been the intensifying trade war with the United States already manifested in plunging share prices on Chinese stock exchanges and yuan deprecation. The main cause of China’s deteriorating situation, however, stems from its own problems, particularly the economic slowdown and rising indebtedness.

Over the longer term, China’s growth will be drawn down by demographic trends, environmental issues and the rise of a services-based economy. Unreliability of official figures makes clear assessment of current economic conditions difficult, but many indicators suggest growth is weakening. The slowdown in growth is also evidenced by the government’s robust stimulus policies designed to blunt the effects of the trade war and help the country meet official growth targets.

China’s current official GDP growth targets and accompanying stimulus policies stand in stark contrast to the country’s worsening indebtedness. Stimulus policies sustain old structures and unprofitable activities which, along with the lack of serious economic reforms, are an important source of the current trade policy battles. The credibility of reform policies has been further eroded by the government’s robust stimulus policies designed to blunt the effects of the trade war and help the country meet official growth targets.

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Debt-to-GDP ratios for China, Euro Area and the US (% of GDP)

Sources: BIS, Macrobond.

Chinese indebtedness relatively higher than in the Euro Area or the United States. New figures released by the Bank for International Settlements (BIS) show that China’s total debt-to-GDP ratio rose by 5 percentage points in the first quarter of this year to 261% of GDP. China’s debt ratio, is slightly higher than that of the US or the Euro Area, and significantly higher than that of other emerging market economies tracked by the BIS.

Total debt includes debt of public-sector entities, household and firms (excl. banks). Unlike most other countries, Chinese debt is concentrated with firms (164% of GDP). The indebtedness of households (49% of GDP) and public-sector entities (48% of GDP) are relatively small. On the other hand, the distinction between firm and public-sector entity is blurred in China, making them hard to tell apart. The IMF puts public-sector entity debt at almost 70% of GDP.

The monthly reporting of the People’s Bank of China of total domestic lending to the private sector suggests that the rising debt-to-GDP ratio continued in the second and third quarters. Although on-year growth in the stock of total lending slowed in August to 10% (down from an average of 13% last year), growth has still outstripped the pace of nominal GDP growth. The shadow banking sector is largely responsible for the slowdown in the rise in overall lending. Tighter regulation has reduced the stock of financing provided via the shadow banking sector in recent months. Growth in the stock of bank loans has continued at about the same pace as last year.

Most of China’s debt is domestically held. While foreign debt has grown rapidly for more than a year, it was still just 14% of GDP at the end of June. About half of foreign debt is denominated in dollars and about a third in yuan.

Years of soaring debt have raised fears in many quarters. Debt explosions like China’s have, almost without exception, led to lower growth and crisis. Chinese authorities understand the problem and have managed to rein it in partly, but escalation of trade disputes has again shifted the emphasis of economic policy in a more stimulatory direction.
GDP growth forecasts, 2018–2020, %

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Sources: IMF, ADB, BOFIT, CBR, National Bank of Ukraine.

Growth in Russian imports stalls; capital outflows increase. Preliminary balance-of-payments figures show that the value of Russian exports of goods and services increased by nearly 30% y-o-y in the third quarter of this year. Higher oil prices were the main driver of higher export earnings. In contrast, on-year growth in spending on imports of goods and services came to a halt in July–September, with growth for the first nine months only reaching 5%.

The IMF sees Russian growth remaining slightly below 2% p.a. in coming years. Next two years’ slight acceleration in growth was attributed to sharply higher oil prices and fiscal stimulus policies. Over the longer term, the IMF sees Russian growth slowing to around 1.2%, and forecasts that economic growth of the region’s other major oil producer, Kazakhstan, will remain significantly higher than Russia’s for years to come.

Under the Central Bank of Russia’s basic forecast scenario, economic growth begins to accelerate in 2020 as the effects of structural reforms and targeted public spending begin to kick in. In the CBR’s basic scenario, the oil price falls to $55 a barrel by 2020, when growth accelerates regardless of an oil price decline. The slight pick-up in growth is expected to continue in 2021.

The IMF sees China’s economic growth slowing next year. The September forecast of the Asian Development Bank (ADB) is quite similar in this respect for China. Both the IMF and ADB expect India’s growth to start accelerating this year. The country should be the fastest growing G20 country in the years ahead.

The large current account surplus was due to Russia’s traditional goods trade surplus. The services trade deficit was identical to a year earlier. Russia posted a large January-September current account surplus of 76 billion dollars. The total surplus from the last four quarters amounted to about 5.5% of GDP.

A net 19 billion dollars in private capital flowed out of the country in the third quarter, bringing the value of net capital outflows for the first nine months of the year to 32 billion dollars (the annual outflows in 2016 and 2017 averaged slightly over 20 billion dollars). In January–September, foreign direct investment inflows to the corporate sector (excl. banks) were exceptionally modest, a mere 2.4 billion dollars. Russian FDI outflows amounted to 17 billion dollars, roughly the same amount as in previous years. The foreign debt of banks has shrunk this year yet again slightly faster than non-bank corporate debt. At the mid-year mark, the foreign debt of Russian banks amounted to 95 billion dollars. The last time Russian banks had so little foreign debt was in 2006.

FIFA World Cup boosted Russia’s tourism exports in summer. During summer tourist season, which runs from April to September, foreign visitors spent about 8 billion dollars (an increase of 45% y-o-y) on Russian travel services. In dollar terms, the value of Russian travel service exports has in any case been recovering at about 15% a year since a low in 2015.

The World Cup is reflected in tourist numbers mostly as a change in the composition of nationalities. The share of tourists from more distant lands increased, while the share of visitors from neighbour countries declined. Total number of tourists in early summer was similar to last summer during which 15 million tourists visited Russia. In the winter season, which runs from October to March, foreigners made 10 million tourist trips to Russia and spent 4 billion dollars. The trend of winter travel to Russia has been waning.

Russians spent 21 billion dollars (11% more than a year earlier) during the summer season on travel services abroad. In early summer, Russians made 7% more trips abroad than in the same period last year. Last year, 24 million trips abroad were made during the entire summer. The beachside towns of the Black Sea or Eastern Mediterranean have traditionally been popular summer destinations. A fifth of summer trips in early summer were to Turkey. Egypt used to be popular tourist destination until a Russian charter jet crashed in the Sinai in 2015 and Russia temporarily banned flights to Egypt. The flight ban was lifted this spring, but charter flights did not yet resume in summer.

In the winter season, Russians made 16 million trips abroad, or 15% more than in previous winter, and used 14 billion dollars, or 30% more than in previous winter. Travel plans for this winter season depend to a large extent on the ruble’s exchange rate and its impact on the international purchasing power of Russians. In real terms, the ruble is currently about 10% weaker than a year ago.
**China**

**Trade dispute gives impetus to long-stalled economic reforms in China.** Chinese officials this summer implemented reforms aimed at easing access of foreign firms to China’s markets. Measures include relaxing investment rules and lowering import tariffs.

An updated version of the “negative list” limiting or banning foreign ownership in certain branches entered into force at the end of July. It trims the original 63 restricted branches to 48. Officials announced in August that ownership restrictions would be lifted on foreign banks and financing companies, and that such firms would now be treated the same as their domestic counterparts. Media reports that ownership limits have been lifted from car-manufacturing, ship-building and aerospace industries as well.

The reform policies are supported by local efforts, as provinces and cities facing lower export growth have decided to approach foreign investors on their own. For example, the *South China Morning Post* reported last month that the Guangdong province, a hub for many export industries, had eliminated restrictions on foreign ownership in several high-tech industries and was promising its own incentives.

The escalating trade war between the US and China has put pressure on China to move ahead with long-postponed reforms. While the Chinese tout the decision to open up their markets, Western firms operating in China note that Chinese officials recently have moved on other fronts to complicate markets, Western firms operating in China note that Chinese officials recently have moved on other fronts to complicate their ability to do business. Moreover, there is still little consensus in China on elimination of special advantages enjoyed by China’s state-owned enterprises. This is a key question of reform policy and relates directly to current trade disputes.

**China’s central bank continues monetary easing.** The People’s Bank of China has decided to lower the reserve requirement ratio (RRR) by one percentage point, effective October 15. The reserve requirement ratio has been cut three times this year.

For large banks, the RRR falls to 14.5% of deposits. The RRR level varies depending on each bank’s risk exposure and loan portfolio. Some 450 billion yuan of the freed-up reserves will be available to pay off maturing PBoC medium-term lending facility (MLF) credits. The lowering of the RRR will have a liquidity effect of 750 billion yuan (110 billion dollars).

As before, the PBoC stressed that the RRR cut does not imply a change in its monetary stance. The PBoC must be cautious in its messaging as the monetary easing could be seen as conceding economic weakness and puts depreciation pressure on the yuan. This week, the yuan weakened further against the dollar. Interest rates on domestic money markets declined slightly.

Interest rates in Hong Kong’s offshore-yuan (CNH) market rose this week, making it more expensive to speculate on yuan depreciation. The PBoC last month signed an agreement with the Hong Kong Monetary Authority, whereby the PBoC will be allowed to issue its own bonds on the Hong Kong market to influence yuan liquidity. Chinese commercial banks will also assist as needed in steering offshore yuan liquidity.

The Hong Kong Monetary Authority has hiked Hong Kong dollar (HKD) interest rates in line with US rate increases.

**Yuan interbank interest rates in mainland China (Shibor) and Hong Kong (CNH Hibor), and yuan-dollar exchange rate**

![Chart showing the relationship between Shibor 7D, CNH Hibor 7D, and CNY/USD exchange rate.](chart.png)

**Chinese active in filing patent applications, even if few have much commercial value.** The World Intellectual Property Organization (WIPO) reports that China now annually grants the most patents by far of any country in the world. WIPO says that in 2016 there were 1.3 million patent filings in China, and over 400,000 patents granted.

Observers have long been sceptical about the quality of Chinese patents. *Bloomberg* reported last month that most patents granted in China were so worthless that the patent owner ceased to pay the annual upkeep fees within five years, allowing the patent to expire. *Bloomberg* notes that US patent owners, for example continue to pay upkeep fees for much longer time.

In China, patenting activity is supported with public funds in the form of e.g. tax breaks and direct subsidies. This is seen both in the quality of patents and types of patents filed. Half of the patents approved last year by China’s patent office were utility models and a quarter design patents. Such patents get less scrutiny and have shorter processing times than invention patents.

Even with the issues related to patenting, China’s R&D activity is nevertheless very strong and the country has made remarkable technological gains.
Russia

Net exports lifted Russian economic output numbers in the second quarter; domestic demand slack. Russian GDP grew by 1.9 % y-o-y in the second quarter of this year, with seasonally-adjusted GDP rising 0.9 % from the previous quarter. In the second quarter, private and public consumption, as well as fixed investment, grew by 0.2 % q-o-q. The volume of exports grew by 1.3 % while imports contracted by 0.7 % q-o-q.

Growth in Russian domestic demand was quite modest in the second quarter, while net exports experienced robust growth. Import volumes have traditionally fluctuated strongly with the business cycle in Russia. Since mid-2016, import growth has been quite fast due to the recoveries of the ruble and domestic demand. However, the current ruble depreciation has reduced nominal growth in imports, which in principle boosts GDP.

Seasonally-adjusted growth in fixed investment has been positive since the start of 2016, albeit quite low. Investment is still nearly 10 % below its level at the start of 2013. Notably, fixed investment already began to contract in the first half of 2013 – already before the drop in oil prices or imposition of Western sanctions. This is a clear sign of challenges in Russia’s business environment.

The year-on-year change in industrial output was 2.1 % in September (2.7 % in August). Mineral extraction (includes oil) was up 6.9 %. In contrast, manufacturing output contracted by 0.1 %. Third-quarter industrial output increased by 2.9 % y-o-y, with manufacturing up 2.2 %. Manufacturing growth has slowed considerably from the first half of the year. Figures on industrial output and developments in various branches suggest that GDP growth slowed in the third quarter.

Fixed investment growth in emerging economies

The role of the US dollar as a payment currency is under discussion in Russia. According to finance minister Anton Siluanov, the cabinet has taken up discussion of a de-dollarisation programme that would reduce the role of the dollar in the Russian economy. In practice, the government would try to incentivize companies to switch to rubles as the payment currency in their foreign trade. A measure under consideration is the elimination of repatriation regulations on ruble-denominated foreign trade earnings by 2024. At the moment, the dollar has an overwhelming dominant status in foreign trade payments, foreign loans and the central bank’s foreign currency reserves.

Discussions about reduction of dollar use has come up from time to time. This time around, the discussion is driven by concern over the possibility of new US sanctions. Dollar-denominated payments are typically routed via a US bank, so sanctions imposed by the US could interfere with the dollar-denominated payment traffic of Russian firms and banks. An advantage of using the dollar, however, is its liquidity on world markets. Additionally, pricing of many of Russia’s important export products such as crude oil is done in dollars. For these reasons, the planned measures seek to strengthen the role of the ruble, rather than ban the use of the dollar.

Poor health lowers Russia’s ranking in human capital comparisons. Russia’s “human capital” (the knowledge, skills, talents and capabilities of its population) can be evaluated by different methods. Methods based on educational achievement and health measures are common, since an educated and healthy worker produces more and makes a longer career. Another approach is to value the population’s expected labour output at world market prices.

The World Bank’s Human Capital Project and the World Economic Forum’s Human Capital Report are both based on education and health measures. A study published in The Lancet, a journal of medical science, also featured a similar assessment. Over 140 countries are covered in each of these comparisons. Russia’s highest ranking was 28th and lowest 49th, putting it among the lower half of European countries. China’s highest ranking was 44th and lowest 71st place.

Because health measures are given greater emphasis, The Lancet study even places China ahead of Russia. In health comparisons, Russia performs quite poorly: mortality of the working-age population is particularly high. On the other hand, Russia tends to be often ranked quite high based on the quality of education and level of education. All education yardsticks are not comparable, however. For example, the share of population with tertiary education (college, university, etc.) does not reflect the quality of such education.

An economic progress measurement approach is also used by the World Bank in its national wealth comparison. It gives similar results as other comparisons. Russia’s human capital wealth in 2014 was valued 91,000 dollars per capita, putting the country in 45th place. China, with an average of 63,000 dollars came in at 51st place. The average in OECD countries is 499,000 dollars.
China

Rise in global oil prices erodes China’s foreign trade surplus. China customs reports a foreign trade surplus of 220 billion dollars for the first nine months of this year. The surplus has declined considerably since 2016, due largely to higher prices for commodities, particularly oil. When primary commodities are excluded from goods trade, China’s surplus have been relatively stable in recent years.

In September, the value of Chinese exports and imports rose by 14 % y-o-y. Exports to the United States were still robust in September, buoyed by the strong US economy and corporate preparations for escalation of the trade war. In contrast, Chinese imports from the US saw no on-year growth, causing China’s trade surplus with the US ballooning to record levels in September.

With no progress in US-China trade talks, the possibility of any quick resolution continues to recede. Both sides are exploring the possibility of a meeting between president Xi Jinping and Donald Trump on the sidelines at the G20 summit at the end of November.

China’s stock markets plunge increases financial market risk. The slide in Chinese stock markets accelerated last week as in other stock exchanges around the world. The market value of shares listed on mainland China exchanges has dwindled this year by over 14 trillion yuan (2 trillion dollars). As in 2015, investors are demanding that the government intervenes to stabilise share prices.

The Shanghai Composite Index today (Oct. 19) was down 23 % from the start of the year, while the Shenzhen Composite Index was down by 34 %. Chinese share prices are now at lower level than in 2015, when the government introduced massive support measures for the stock markets. Hong Kong’s Hang Seng Index has fallen by 17 % this year and the index for mainland Chinese firms listed in Hong Kong is down by 12 %. There are roughly 3,500 A-share listings on the Shanghai and Shenzhen exchanges. Trading in the shares of over a thousand firms was halted on October 11, when their daily value declines exceeded the exchange’s 10 % limit.

To support its tanking stock markets, the Chinese government has announced share buy-back programmes to support their share prices.

The risk created by declining share prices is amplified by the fact that shares are increasingly used as loan collateral in China. When share prices fall, so falls the value of the collateral. This can lead to forced sales of shares and accelerate stock market declines. Bloomberg estimates that roughly 4.24 trillion yuan of shares are pledged as collateral for loans, which translates to about 10 % of the total market capitalisation of Chinese stock exchanges.

On local level, state-owned entities have assembled funds to support the region’s privately-held listed firms. The Caixin business publication notes, for example, that the city of Shenzhen plans support packages for local exchange-listed firms. According to the publication, well over 100 of the nearly 300 firms listed on the Shenzhen exchange have posted over 20 % of their shares as collateral.

China eases air pollution measures. China’s environment ministry announced in October a watered-down version of an earlier plan to clean up urban skies during the coming winter months. The government also backed off from similar production cuts on heavy industry imposed last year.

China wants to reduce the volume of the most health-harmful PM2.5 airborne particulates in northern cities by 3 % a year, a more modest goal than the previous planned target of 5 % a year. Companies in heavy industry and construction that meet the emission requirement will also be exempt from production restrictions. Decisions on production restrictions will be delegated from the ministry to the local level.

The government lowered its emission targets on fears of flagging economic growth and last winter’s widespread issues with apartment heating. By some estimates, even the less ambitious emission targets may be hard to achieve. Due to last year’s winter emission limits and favourable weather conditions, the basis for comparison this year is already a much-improved relative to earlier years. People are also worried that the emission targets might be missed when local governments are able to decide on production restrictions.

China’s carbon dioxide emissions are larger than the combined CO2 emissions of the EU and US. The less time it takes for Chinese emissions to actually start falling, the better for meeting global climate targets.

Sources: China customs, CEIC and BOFIT.
Russia

Russian unemployment falls and wages continue to rise; real incomes contracted in August-September.

Using the methodology of the International Labour Organization (ILO), Russia’s unemployment rate continued to decline this year, falling to just 4.5% in September. The national unemployment rate in September 2017 was 5%. The unemployment rate in both Moscow and St. Petersburg was below 2%.

The average nominal monthly wage in September was up by 11% y-o-y to 42,200 rubles (530 euros). The decline in unemployment and emergence of labour shortages in some growth centres have supported strong wage growth, but the largest single driver continued to be the large wage hikes for public service workers. These hikes derive from a decree given by Putin after he was inaugurated as president in May 2012. The last of the decreed wage hikes in education, healthcare and culture sectors were implemented in early 2018, before the end of that six-year term in office.

In the first half, the rise in wages was sufficient to make up for the lower growth in other income streams (pensions, wealth transfers, capital income and entrepreneur income). After four years of contraction, real disposable household incomes increased slightly in the first half of this year relative to the same period last year. The slight slowdown in the pace of wage increases from January-March brought real income growth to a halt. Real incomes in the third quarter were unchanged from a year earlier. The weak trend in real incomes partly accounts for the low growth in retail sales. The average nominal wage in September was up 11% y-o-y, while the volume of retail sales grew by only 2.2% y-o-y.

Russia was ranked the 43th most competitive country by the World Economic Forum this year. The annual Global Competitiveness Report released last week included 140 countries. Russia’s ranking has risen slightly over the past decade. While it trailed wealthy Western countries, it was close to the top among former socialist countries.

The ranking combines 90 indicators, most of which have been developed by other institutions. Their purpose is to describe a country’s ability to succeed in global markets. The measures evaluate, for example, basic institutions, infrastructure, financial system, research, health and education.

In interpreting these results, it is important to note that not all indicators are adjusted to the size of the country. The size of the economy gets directly a 1/12 weighting and certain quality measures favour countries with large populations. For example, when counting the number of academic articles published and number of research institutes – even if quality is accounted for to some extent – large countries receive a high score rather easily. In this way, countries with large populations rank higher than they would if only the workings of their economies were evaluated as such.

According to the report, Russia’s relative strengths include, among other things, market size (6th), quality of research institutions (12th), efficiency of train services (15th), airport connectivity (18th), scientific publications (22nd) and the adoption of information technology (25th).

Russia’s weak areas include public health, financial system and institutions. Some of the biggest challenges from the competitiveness perspective are high labour tax rate (133rd), restrictions on the freedom of the press (121st), banks’ regulatory capital ratio (114th), public sector corruption (113th), weak protection of property rights (112th), impediments to imports due to local regulations (113th), complexity of tariffs (110th) and low quality of roads (104th).

China ranked 28st in this year’s report. Its strengths and weaknesses were similar to Russia’s. However, China substantially outscored Russia in infrastructure comparisons.

IMF estimates that the government sector and public sector firms account for a third of Russia’s GDP. The International Monetary Fund seeks to clarify the interpretation of the figure of 70% it published in 2014. That is the ratio of the income of the government sector and public sector firms to GDP. This is not the same thing as their share of GDP, as it is often misinterpreted.

The IMF has now calculated their share of GDP to be one-third. In the economy’s market-based block, the estimate is based on their share of income. In blocks where the income formation of firms and organisations is not market-based, it is based on their share of workers. The calculation includes the subsidiaries of the 20 largest state-owned enterprises (excl. banks) in Russia. The one-third share is estimated for 2016, but according to the calculations it was practically the same in 2012.

The IMF emphasises that the negative effects of public sector firms within the economy can be wider than suggested by their nominal GDP share, e.g. through excessive concentration and the lack of competition in some branches, lack of transparency in procurements of the government or SOEs, as well as preferred treatment through easier access to financing.

Researchers at the Russian Academy of National Economy and Public Administration and the Gaidar Institute published their own assessments of the public sector’s contribution to GDP earlier this year. The government sector’s share of GDP appears in Rosstat’s GDP figures as just under 20%, and this applies to this entire decade. SOEs are not included in Russia’s GDP figures. The rough estimates of researchers put the share of GDP of SOEs and a few state corporations and the government’s largest commercial institutions at over a quarter of GDP. This is based on a two-step calculation. In the first step, over 100 SOEs and the above-mentioned state corporations and businesses are found to generate about 12% of the corporate sector’s revenues. The second step assumes rather boldly that the ratio of value added to income estimated using the financial statements of Gazprom and Rosneft is equally applicable to all other SOEs.
China

Officials in China seek to calm markets spooked by slowing growth. China’s National Bureau of Statistics reports that real on-year GDP growth was 6.7% in the first nine months of this year and that third-quarter growth slowed to 6.5% y-o-y. Some of the lower growth reflects the rising contribution of services to output. In the last 12 months, services accounted for 52% of total output, while the contribution of industry and construction combined was less than 41%, and primary production (mostly agriculture) just over 7%.

While acknowledging the low reliability of official Chinese statistical data, even they show growth slowing. Indeed, all three of China’s most-tracked growth indicators showed on-year growth below 6.5% in September. While real growth in retail sales fell only slightly below the 6.5% level, industrial output growth dropped below 6%, and real growth in fixed investment remained around zero, as it has for a long time.

The combination of the slowdown in growth, China’s debt problems and uncertainty over trade policy has made markets nervous. To calm the markets, China’s government again promised measures to improve access of privately held firms to financing and clarified regulation related to wealth management products sold by investment funds. Due to the nature and breadth of the problems, however, calming markets with such individual promises is difficult. Market disturbances are an inevitable part of China’s development. Chinese markets this week also felt pressure from global stock prices.

Little progress in core reform of China’s state enterprises. In recent years, China has implemented various programmes and subsidies to make state-owned enterprises (SOEs) bigger and stronger while limiting options for companies in the private sector. The share of industrial assets of SOEs have slightly increased this year after falling earlier.

As economic growth has slowed, concerns over future growth has increased and international criticism of China’s SOEs has grown, China’s leaders have responded by talking more about the importance of the private sector. A letter by president Xi Jinping published last weekend stressed the importance of the private sector. Vice premier Liu He has recently also come out as an ardent advocate for the private sector.

The most critical move in helping the private sector would be to create a level playing field. Most of China’s financial sector is in state hands and bank lending policies tend to favour state companies no matter what their financial condition or whether their projects make any financial sense. Banks assume SOEs enjoy implicit state guarantees that will protect them when risk materialises. This distorts the pricing of risk, which has allowed many SOEs to become over-indebted. Allowing firms to go on reckless borrowing sprees means that banks likely hold large stocks of bad loans. Chinese government has long been urged to end implicit state guarantees to SOEs to end this distortionary effect.

Even if modernisation of SOEs is a central tenet of structural reform, little progress has been made on this front. A campaign was launched some years ago to sell partial stakes in SOEs to private investors (mixed-ownership reform), but the results to date have been modest. In some cases, SOEs have been sold to active management.

A big problem in pushing through reforms is that they may conflict with the interests of the decision-makers themselves. SOEs have tight connections with political decision-makers, with corporate leaders typically tapped by the party elite. This creates a system that cycles the same people through executive ranks of state-owned firms, top positions at decision-making bodies in public administration and high regulatory posts. Decision-makers also use SOEs as instruments for implementing economic policy in order to guarantee that they meet politically defined growth targets. Giving up of such direct tools is difficult. Connections to SOEs are often important in personal career advancement within the party hierarchy and wealth accumulation.

Currently, 96 conglomerates operate under the auspices of the State-owned Assets Supervision and Administration Commission (SASAC), which works directly under the central government. The government has reduced the number of such conglomerates through mergers. The OECD reports that when the number of subsidiary corporations within conglomerates and other firms directly under central government administration are included, there were about 50,000 such firms at the end of 2015 employing 20 million people. When local-level firms and their subsidiaries are included, some 160,000 SOEs operated in China at the end of 2015. 25,000 of these firms were involved in industry, 15,000 in the real estate sector, 13,000 in primary production and 10,000 in the transport sector. The OECD reports that these firms employ a total of 40 million people, with 11 million engaged in primary production, 7 million in industry and 5 million in the transport sector. By some official estimates, Chinese SOEs employ around 60 million people. In any case, SOEs employ a relatively small part of the Chinese workforce (770 million), but enjoy a disproportionate share of many other resources.
Russia

Central Bank of Russia keeps key rate at 7.50 %. At the monetary policy meeting on October 26, the CBR noted that short-term inflation risks remained elevated. The annual rate of consumer price inflation was 3.4 % in September. The CBR also said it expected the inflation rate to climb to around 4 % p.a. by the end of this year and slightly exceed 5 % by the end of 2019. One-off factors such as the VAT hike at the start of next year may accelerate inflation. Under the CBR’s forecast, inflation should subside to the long-term target level of 4 % in the first half of 2020.

The overnight interbank market rate (MIACR) closely tracks the CBR’s key rate. The rate on ruble-denominated loans to corporations granted by banks (excluding Sberbank) averaged about 170 basis points above the CBR’s key rate in January-August. The average rate on corporate loans in August was slightly below 9 % (slightly below 6 % in real terms).

Higher export prices drive up industrial producer prices in Russia. The rise in producer prices for supplies to domestic customers has accelerated this year, exceeding 14 % y-o-y in September. Extractive industries (includes oil & gas) have seen prices for their products score 30–40 % y-o-y in recent months.

As in the two previous years, the price of crude oil supplied to domestic users has risen sharply with the export price. However, domestic prices of crude oil stay quite a bit lower due to export tariffs. In recent years, the domestic tax-free producer price has been about two-thirds of the export price.

The domestic oil price and export prices for refined oil products have caused prices of oil products to rise inside Russia. Oil and oil products represent about a quarter in the domestic industrial producer price index. Hikes in gasoline prices in the distribution chain last spring were quick, inducing the government to reduce the excise tax on gasoline until December.

Eurasian Economic Union is taking steps to harmonize external tariffs and lower internal barriers. The union has evolved on top of earlier economic cooperation agreements among former Soviet republics. Upon the breakup of the Soviet Union, twelve of its 15 members (all except the Baltics) established the Commonwealth of Independent States (CIS). Free trade relations were established among the countries, but there was no deeper integration. Consequently, Russia, Belarus, Kazakhstan, Kyrgyzstan and Tajikistan founded the Eurasian Economic Community in 2000. As integration stalled also under this new framework, Russia, Belarus and Kazakhstan established the Eurasian Customs Union (EACU) in 2010 and the Eurasian Economic Union (EAEU) in 2015. Armenia and Kyrgyzstan acceded in 2015.

The Union’s basic idea and governing structure largely mimic the European Union, but its functions have been limited to supporting economic integration. According to the founding treaty, the Union’s mission is to incrementally implement the free movement of goods, services, labour and capital. Further goals include macroeconomic policy harmonization and perhaps a currency union. A fairly ambitious schedule has been set for market unification: a common electricity market by 2019, oil by 2024, natural gas by 2025 and finance by 2025. Implementation of all plans, however, requires the conciliation of differing views and interests among the member states.

To date, the Union has made progress mainly on making border crossings easier. Customs inspections on internal borders have nearly ceased, and customs procedures and payments on external borders have been to some extent harmonized. The adoption of a common customs code at the start of this year has facilitated trade across the Union’s external borders. The electronic customs declaration system also helps to monitor shipments through the Union territory. Without oversight, it would be difficult for the Union to make free trade agreements with other countries and unions because such agreements typically apply only to goods manufactured in the countries that are parties to the agreement. In addition to unified customs rules, the Eurasian Economic Commission seeks to eliminate some individual barriers to competition. Among other things, it has begun promoting reciprocal recognition of academic degrees, more open public procurements and open waterways for member country vessels.

While former Soviet states are the focus of expansion, the Union’s name intentionally does not rule out membership of any country on the Eurasian continent. The Union also seeks to improve its external trade relations. It has signed a free-trade agreement with Vietnam and looser cooperation agreements with China, Egypt and Iran. The Union’s effort to seek closer economic relations with countries in Western and Southern Asia partly overlaps with China’s Belt and Road Initiative, even if cooperation of these projects was officially agreed upon in 2015.

Domestic producer prices have also risen along with export prices in the chemical, metal and forest industries. In these branches, domestic prices have been up in recent months by around 10–15 % from a year ago.

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As in the two previous years, the price of crude oil supplied to domestic users has risen sharply with the export price. However, domestic prices of crude oil stay quite a bit lower due to export tariffs. In recent years, the domestic tax-free producer price has been about two-thirds of the export price.

The domestic oil price and export prices for refined oil products have caused prices of oil products to rise inside Russia. Oil and oil products represent about a quarter in the domestic industrial producer price index. Hikes in gasoline prices in the distribution chain last spring were quick, inducing the government to reduce the excise tax on gasoline until December.

Eurasian Economic Union is taking steps to harmonize external tariffs and lower internal barriers. The union has evolved on top of earlier economic cooperation agreements among former Soviet republics. Upon the breakup of the Soviet Union, twelve of its 15 members (all except the Baltics) established the Commonwealth of Independent States (CIS). Free trade relations were established among the countries, but there was no deeper integration. Consequently, Russia, Belarus, Kazakhstan, Kyrgyzstan and Tajikistan founded the Eurasian Economic Community in 2000. As integration stalled also under this new framework, Russia, Belarus and Kazakhstan established the Eurasian Customs Union (EACU) in 2010 and the Eurasian Economic Union (EAEU) in 2015. Armenia and Kyrgyzstan acceded in 2015.

The Union’s basic idea and governing structure largely mimic the European Union, but its functions have been limited to supporting economic integration. According to the founding treaty, the Union’s mission is to incrementally implement the free movement of goods, services, labour and capital. Further goals include macroeconomic policy harmonization and perhaps a currency union. A fairly ambitious schedule has been set for market unification: a common electricity market by 2019, oil by 2024, natural gas by 2025 and finance by 2025. Implementation of all plans, however, requires the conciliation of differing views and interests among the member states.

To date, the Union has made progress mainly on making border crossings easier. Customs inspections on internal borders have nearly ceased, and customs procedures and payments on external borders have been to some extent harmonized. The adoption of a common customs code at the start of this year has facilitated trade across the Union’s external borders. The electronic customs declaration system also helps to monitor shipments through the Union territory. Without oversight, it would be difficult for the Union to make free trade agreements with other countries and unions because such agreements typically apply only to goods manufactured in the countries that are parties to the agreement. In addition to unified customs rules, the Eurasian Economic Commission seeks to eliminate some individual barriers to competition. Among other things, it has begun promoting reciprocal recognition of academic degrees, more open public procurements and open waterways for member country vessels.

While former Soviet states are the focus of expansion, the Union’s name intentionally does not rule out membership of any country on the Eurasian continent. The Union also seeks to improve its external trade relations. It has signed a free-trade agreement with Vietnam and looser cooperation agreements with China, Egypt and Iran. The Union’s effort to seek closer economic relations with countries in Western and Southern Asia partly overlaps with China’s Belt and Road Initiative, even if cooperation of these projects was officially agreed upon in 2015.

Domestic producer prices have also risen along with export prices in the chemical, metal and forest industries. In these branches, domestic prices have been up in recent months by around 10–15 % from a year ago.
China

Growth in Chinese car sales stalls. Sales figures for China’s automobile industry indicate that passenger car sales in the third quarter declined compared to a year earlier. Sales were down by 12 % y-o-y in September. At the same time, profits of car manufacturers has also fallen sharply.

China is the world’s largest car market. Sales currently are running at about 25 million new cars a year. Sales in the number-two US are about 17 million cars a year. Chinese sales growth has been sluggish this year, however, with total sales over the past twelve months in September on par with a year earlier. Foreign makes, which are mainly produced and assembled in China, account for 60 % of domestic car sales.

Car production growth also has plateaued. Some 25 million cars are manufactured in China each year, with about 700,000 vehicles exported. China imports about 1 million cars a year.

The flagging car sales trend reflects changes in household demand in China. Moreover, different kinds of fixed-term subsidy schemes for car buyers and changes in taxation have caused fluctuations to car sales. Recent news reports say the government is planning to lower the tax on car purchases to account for about 5 % of new cars sold in China.

Plug-in hybrids. In the third quarter, plug-in electric vehicles global sales of plug-in electric vehicles (fully electric and plug-in hybrids) has risen rapidly. China accounts for about half of worldwide demand in China. Moreover, different kinds of fixed-term subsidy schemes for car buyers and changes in taxation have caused fluctuations to car sales. Recent news reports say the government is planning to lower the tax on car purchases to support car producers and economic growth.

Despite the slowdown in car sales, growth in sales of electrical cars has risen rapidly. China accounts for about half of global sales of plug-in electric vehicles (fully electric and plug-in hybrids). In the third quarter, plug-in electric vehicles accounted for about 5 % of new cars sold in China.

FDI outflows of Chinese firms still below 2016 level. Even as China’s trade war with the US escalated, foreign direct investment flows into China increased in the first nine months of this year compared to the same period in 2017. Also Chinese outbound FDI also increased. The picture of investment trends, however, show some variation depending on the statistical data used.

China’s commerce ministry (MOC) reports that FDI flows into China (excluding the financial sector) amounted to 98 billion dollars in January-September, an increase of 6 % from the same period last year. However, China’s balance-of-payments figures diverge considerably from the number offered by the commerce ministry. According to the first-half balance-of-payments figures, 126 billion dollars in foreign investment flowed into China – more than double the amount of H17.

Compiling FDI statistics is notoriously difficult in every country and interpreting them even more so, as in the current globalized world investments may not originate from the investor’s home country. Commerce ministry figures show that Hong Kong accounts for 65 % of inward FDI to China. Other Asian countries and certain tax havens also provide considerable amounts of FDI. The EU accounts for around 9 % of investment flows into China, while the US contributes just 2 %. As part of its trade negotiations, China has opened up certain branches such as the car industry and finance to more extensive foreign ownership in an effort to encourage more FDI inflows. The trade war itself has forced many foreign firms to consider pulling their production out of China altogether.

Commerce ministry figures show the flow of outward FDI of Chinese firms in the first nine months of this year amounted to 89 billion dollars, an increase of 6 % y-o-y. Outward FDI growth was quite strong in the first half, but turned negative in the third quarter. China’s balance-of-payments figures show outward FDI roughly following a similar trend to that shown in the commerce ministry figures. The value of investment in January-June (46 billion dollars) was up 12 % y-o-y.

According to the China Global Investment Tracker (CGIT) database compiled by the American Enterprise Institute and Heritage Foundation, foreign investment of Chinese firms abroad fell in the first half relative to H17. In the January-June period, large FDI expenditures of Chinese firms (FDI of more than 100 million dollars) amounted to only 56 billion dollars, down from 101 billion dollars in the same period last year. Last year’s figures, however, got a huge boost from the June 2017 purchase of the Swiss agribusiness giant Syngenta for 43 billion dollars. CGIT reports that in the first half of this year, 35 % of investments went to Europe and 10 % to the US. These shares were slightly smaller than in the first half of 2017.
Russia

National Welfare Fund holds 76 billion dollars; assets expected to rise before the end of the year. According to the budget rule, a share of oil tax revenue will be transferred to the fund if the price of oil stays above 40 dollars a barrel. As this is the case, it is expected that the fund will be soon refilled on top of the funds already accumulated by October 31. The first addition to the fund this year was made in June. Nearly 15 billion dollars were added then.

The Fund currently corresponds to 5.1 % of GDP. Under the finance ministry’s current plans, the Fund will increase in size over the coming years. In 2021, its size would reach 216 billion dollars, or 12 % of GDP. Russia’s reserve funds last reached such magnitude in 2009. The government wants to use a part of the increase in tax revenues brought about by higher oil prices to build up Russia’s financial buffers.

Also the central bank’s foreign currency reserves have grown slightly this year. As of the end of October, the value of foreign exchange reserves (including gold) stood at 461 billion dollars, which is 6 % more than at the end of last year. The reserves are sufficient to cover the cost of nearly two years of goods imports, which is very much by international comparison. Russia’s foreign debt stood at 467 billion dollars at the end of September.

Russia’s reserve funds

Wage growth varies considerably across sectors in Russia. While the reported average wage has risen briskly, it appears that wage income has actually been rising even faster. According to Rosstat’s labour survey, the number of people working in the grey economy increased by a few percent this year from 2017. Rosstat estimates that almost a fifth of the working population works exclusively within the grey economy.

The rise in average wages in the government budget sector subsided in the spring as the last of the long-term increases decreed by Putin had been implemented. In recent months, however, that rise has again accelerated. In January-August, the average wage in the healthcare and social services sector rose by 26 % y-o-y, and in the education sector by 16 %. According to the survey, the number of employees in these sectors did not decline this year.

In the corporate sector, wages have continued to rise nearly 10 % a year. Among sectors that are large by number of employees, wages in the trade sector rose by 7 % a year. Wages in manufacturing continue to rise as in previous years at 8–9 % a year. Real wages continue to rise much faster than productivity per worker. During the current decade, this has been the case especially in the past couple of years. On the other hand, the weakening of the ruble has increased the competitiveness of domestic producers.

Russia’s ranking improves slightly and China’s considerably in World Bank’s Doing Business index. Russia rose from 35th place last year to 31st place this year, and China jumped from 78th to 46th place. The 190-country comparison assesses among other things trade across borders, permitting, regulation, contract enforcement, paying taxes, access to credit and getting electricity.

Although China’s rank changed considerably, such a change is not uncommon in this comparison. This is due to the peculiar features of the scoring system. First, only the number one or two economic centres of each country are designated as representative of the whole country. Russia is represented by Moscow and St. Petersburg, and China by Shanghai and Beijing. Second, instead of using a comprehensive and representative set of measures, points are allocated based on narrowly-defined standard cases. For example, in assessing ease of trading across borders, the survey focuses on importation of car parts. In assessing ease of getting a building permit, only warehouse construction is evaluated. Third, in place of actual practice, the evaluation focuses on official procedures, giving considerable weight to the content of laws and regulations.

This approach has been chosen because of its lower demands in data collection and comparison. The peculiarity of this approach is indicated by the results. Georgia and Macedonia FYR make it to the top ten, but Netherlands and Switzerland fall behind Rwanda and Russia. This order differs dramatically from similar comparisons performed by other institutions.

Due to the narrowness of the measures, countries can rapidly improve their rankings through precisely targeted reforms. For example, president Putin decreed in 2012 that Russia’s Doing Business ranking be raised from 120th place to 20th place by 2018. During the next three years, Russia’s score on getting electricity, paying taxes and receiving building permits rose sharply. Even though there are real reforms behind these point gains, they do not reflect the general pace of reforms in Russia.

In addition to China, also India and Turkey rose considerably, albeit more modestly, in the ranking. China’s point gains came mainly from streamlined of tax payments, property registration and building permits.
China

**Slowing growth in Chinese purchasing power.** China’s National Bureau of Statistics reports that disposable incomes in urban areas rose by 8 % y-o-y in the first nine months of this year. Income gains have held steady for several years now. Gains in real incomes dropped below 6 % y-o-y. Wages, the most important income category, witnessed increases in line with overall income gains.

The NBS also found that household consumer spending in urban areas distinctly lagging wage gains. Household consumption rose by just 4 % y-o-y in January-September, and was reflected in lower retail sales growth. Chinese households are legendary savers, so bank deposits have seen healthy growth again this year. On the other hand, household debt-servicing costs have also climbed rapidly as households have taken on substantial debt in this decade.

In addition to the income divide between cities and rural areas, income differences vary considerably among cities. In the first nine months of this year, the monthly disposable incomes of city-dwellers averaged 3,300 yuan (420 euros), while rural incomes averaged about a third of that. Shanghai posted the highest average urban income level (5,000 yuan a month), while Gansu was at the bottom (2,000 yuan). Price levels also vary considerably across China.

Some cautious estimates of wage trends contrast with the rosy official picture. Zhaopin, a company that matches jobseekers and employers online, reports very modest increases in wages for white-collar workers. Its third-quarter figures show an average rise in real wages of 1 % y-o-y.

**China posts current account deficit for January-September; currency reserves decline.** Just-released balance-of-payments figures show China with a current account deficit of 13 billion dollars for the first nine months of this year. During the same period last year, the country produced a 103-billion-dollar surplus. Small surpluses in the second and third quarters were inadequate to erase the first-quarter deficit.

Higher prices for commodities helped reduce the goods trade surplus from the same period last year. About 80 % of the services trade deficit this year came from tourism. On an annual basis, the current account is still in surplus though just below 0.4 % of GDP.

The financial account shows that considerably more capital this year flowed into China in the form of direct investment than last year. The direct investment balance in January-September showed an 81-billion-dollar surplus. Other balance-of-payments figures will be published later. Other measures, however, suggest a slight increase in capital outflows this year.

The value of China’s foreign currency reserves has fallen by 87 billion dollars this year. Balance-of-payments figures show that China’s currency reserves increased in the first half, indicating that the decline in separately published reserves was due to exchange rate shifts and other valuation changes. In the third quarter of this year, the contraction in reserves also appears in the balance of payments, indicating that the central bank was using the forex reserves to make up for the capital outflows or support the yuan’s exchange rate. The People’s Bank of China does not release information about its foreign currency interventions. In October, the value of the foreign currency reserves fell by 34 billion dollars to 3.053 trillion dollars.

**PBoC issues yuan bonds in Hong Kong.** Despite increased volatility in the yuan’s exchange rate, the State Administration of Foreign Exchange still plays a visible role in steering the yuan’s external value. In the markets, exchange rate expectations are influenced by the spread between the offshore yuan rate quoted in Hong Kong (CNH) and the mainland China onshore yuan rate (CNY).

The PBoC this week issued its first yuan-denominated bonds in Hong Kong. The new instruments offer the possibility to directly influence yuan liquidity in the special administrative region and thereby the CNH rate. Previously, the PBoC apparently relied on large state-owned banks operating in the region to adjust CNH liquidity and steer the exchange rate. The market players hope that the central bank bonds will provide transparency in the key yuan offshore market. Additionally, they may offer a new reference rate for yuan-denominated financial products outside mainland China.

**Yuan-dollar exchange rate in Shanghai and Hong Kong**

*Source: Reuters.*
Russia

As the ruble weakens, Russian import spending growth lags export earnings growth. In the third quarter of this year, the total value of Russian goods exports in dollar terms was 31% larger than in the same period last year, but the value of imported goods was 2% smaller.

Export earnings were driven by sharp increases in oil prices. In volume terms, oil exports have remained rather stable. The impact of oil prices on Russia’s export earnings is huge, because fossil fuels account for about two-thirds of the country’s earnings on goods exports.

Until recently, Russian spending on imports has closely tracked the trends in export earnings, since higher oil prices have boosted the ruble’s external value and thus Russians’ purchasing power. This year, however, growth in spending on imports has faded even as oil prices have kept on rising. This is largely due to partial delinking of the oil price and the ruble’s value. From March 2018, the ruble has depreciated by one-tenth against the CBR’s basket of currencies both in real and nominal terms. The latest rounds of US sanctions are the most important reason for this depreciation.

In value terms, about half of Russian imports consists of machinery, equipment and vehicles. The EU supplies about 40% of Russian goods imports, China about 20% and the US about 10%.

Significant drop in oil prices could lead to new production limits. The price of Urals-grade crude slightly exceeded 85 dollars a barrel in early October, its highest level this year. The Urals price has since fallen 22% to around 67 dollars a barrel. The ruble-dollar exchange rate, however, only declined 3% from the beginning of October (down 1% against the euro) over the same period, i.e. the linkage between the oil price and ruble’s exchange rate has been modest during last weeks.

Substantial declines in crude oil prices may indicate concerns about a global glut or possible decline in overall demand. Russia, OPEC and a few other oil-producing countries met last Sunday (Nov. 11) to discuss, among other things, new production limits. While the parties did not make decisions about new production limits, Saudi Arabia announced that it would unilaterally reduce its oil exports by 500,000 barrels a day in December. Russian crude oil production is currently at a post-Soviet record level (BOFIT Weekly 2018/40). According to energy minister Alexander Novak, however, Russia is not ruling out the possibility of new production caps if the parties reach a consensus. By some estimates, the producer countries could reach an agreement on new production limits at their next meeting in a couple of weeks. The current agreement expires at the end of this year.

CBR’s monetary policy programme for 2019–21 sees good bank liquidity ahead. The Central Bank of Russia notes that its operative monetary policy goal is to hold interbank money market overnight rates near its own key rate. To achieve this, the CBR has absorbed bank liquidity after liquidity in banks has increased over the past couple of years. For over a year the CBR has relied mainly on deposit auctions to soak up excess liquidity, but also on issuing its own debt securities especially from last spring onwards.

The CBR, based on its own economic forecast and the finance ministry’s budget forecast, expects good bank liquidity in the next three years. It also plans to continue with its liquidity absorption operations.

The CBR notes bank liquidity will be partly supported by the CBR’s foreign purchases on Russia’s domestic currency markets. The CBR makes the purchases using its discretion based on the finance ministry’s long-standing order for steady forex supplies. The ministry wants to convert extra oil tax earnings from the relatively high oil price into forex. The CBR underlines that in its liquidity forecast the assumption about its forex purchases in no way signals any decision to resume forex buying, which it earlier suspended for the September-December period.
China

Retail sales in China slide below GDP growth target. Retail sales, considered the most important indicator of private consumption in China, grew by less than 6 % y-o-y in real terms in October. The growth figure includes the booming online shopping trade, which now accounts for over 17 % of all sales of consumer goods. A year ago, growth in retail sales was close to 9 % y-o-y.

On-year growth in fixed asset investment (FAI) in urban areas instead accelerated on revived growth in public and private investment. This is partly the result of orders from the central government that local governments complete unfinished infrastructure projects. The apparent recovery also reflects the modest basis for comparison at the end of last year.

FAI and retail sales are the most important indicators of current domestic consumption available as the National Bureau of Statistics publishes figures on fixed investment and consumer demand consistent with its GDP methodology only on the annual level. According to official figures, Chinese GDP grew in July-September 6.5 % y-o-y. Notably, slowing growth in both FAI and consumer demand appear to be running lower than GDP growth. Moreover, the shrinking of the foreign trade surplus suggests that net exports depress rather than fuel growth at the moment.

China’s official GDP figures seem not to be troubled by movements in the core demand indicators, however. They merely track growth targets laid out by the party.

China’s GDP and major demand indicators

Stock of Chinese bank loans soars. The stock of yuan-denominated loans increased in October by 13.1 % y-o-y. In the first ten months of this year, new bank lending valued at 13.8 trillion yuan (2 trillion dollars) was issued, up from 11.8 trillion yuan in the same period in 2017. Foreign-currency-denominated lending represented only about 4 % of China’s total new bank lending.

Official efforts to improve corporate access to financing this year are only evidenced in bank lending figures in the explosive growth in “bill financing.” In January-October, banks granted nearly 1.3 trillion yuan in this form of short-term credit. Bill financing is usually used for trade financing, so its risks are more limited than traditional bank loans. Such lending can easily be used to boost overall lending when authorities ask banks to do so. In the first ten months of this year, the volume (5.1 trillion yuan) of new long-term lending to firms and state organisations contracted by 12 % from last year and the volume (600 billion yuan) of other forms of new short-term credit than bill financing was less than half that granted in the same period last year. In addition, the stock of lending off bank balance sheets, i.e. shadow banking sector instruments (trust and entrusted loans, or banker’s acceptances) has decreased this year.

While the growth of new loans granted to households this year has decelerated, the stock of loans continues to grow at 18 % a year. The popularity of short-term loans has increased this year, while long-term lending (mostly housing loans) to households has declined from last year. In the January-October period, households accounted for 45 % of new bank lending.

Robust growth in Chinese commodity imports continues. China customs reports that the country’s foreign trade continued to grow briskly in October, with the value of goods exported climbing by 16 % y-o-y and goods imports by 21 %. Both growth rates are at roughly the same levels as in previous months. Roughly half of the growth in value of imports and exports reflects price changes, while the other half reflects increased volumes.

Measured in terms of volume, China imported 8 % more crude oil, 11 % more coal, 7 % more pulp and 17 % more copper in the first ten months of this year than in the same period in 2017. While the volume of iron ore held steady, steel output continued to rise despite a campaign to reduce overcapacity in the industry.

Unlike many other indicators, the relatively stable growth in commodity imports does not suggest weakening economic conditions. This view is possibly distorted by the fact that China does not report its commodity inventories. Moreover, reduced imports of recycled metals due to restriction on such imports have had to be substituted with other imports.

Volumes of select Chinese commodity imports

Source: China customs, Macrobond and BOFIT.
Russia

Russian economic growth slows in the third quarter, with signs of a possible pick-up in October. Preliminary figures show Russian GDP grew by 1.3% y-o-y in the third quarter, down from 1.9% in the second quarter. It seems likely, however, that seasonally-adjusted GDP was unchanged from the second quarter. In the first nine months of this year, GDP growth has averaged 1.5% y-o-y.

Production figures for October indicate a re-acceleration of Russian economic growth. The change in industrial output was 3.7% y-o-y, driven largely by strong on-year growth in extractive industries (7.4%). The sharp rise in oil prices in early autumn caused some oil-producing countries, including Russia, to boost production which is already reflected in monthly production figures. If the recent slide in oil prices leads to new agreements on production cuts, production of Russia’s extractive industries could begin to contract.

Manufacturing output in October grew by 2.7% y-o-y. In the third quarter, on-year growth was 2.2%. Construction appears poised to re-enter positive growth territory. Construction volumes rose by 2.9% y-o-y in October, having contracted on-year almost continuously for several years.

The main demand-side indicators were more modest than those on the supply side. The volume of retail sales, which increased by just 1.9% in October, continued a slowing trend. Wage growth and growth in bank credit granted to households also slowed.

12-month change in industrial output and retail sales

Price regulation disrupts Russian fuel markets. While the official policy of the Russian government is to refrain from price-setting, this measure was carried out in the beginning of November through agreements between the Federal Antimonopoly Service (FAS) and Russia’s big oil companies. As a result, wholesale prices for fuel were lowered. To prevent shortages, the oil companies were at the same time obliged to provide adequate supplies for the domestic market.

The government justify these measures by claiming that fuel prices have risen unreasonably high. Rising global oil prices and ruble depreciation have led the ruble-price for crude oil to nearly double between summer 2017 and last summer. It has, though, fallen again in recent weeks.

Oil companies quickly found ways to circumvent the narrowly targeted price agreement. As the regulation applies to nominal prices, oil refiners have eliminated other advantageous terms in their supply contracts such as discount schemes. Moreover, as the deal only applies to wholesale prices, fuel producers are channelling more of their production to their own filling stations.

Independent fuel retailers that buy from the big oil companies now find themselves in difficulties. The amount of fuel available on the St. Petersburg commodities exchange has shrunk, and delivery delays have been reported. The situation in Siberia and Crimea seems to be most problematic, since the share of independent fuel retailers is large in these regions.

Discussion of the problem is made more difficult by Russia’s already inflamed debate on market competition. The big oil companies accuse independent retailers of abusing their local dominant market positions. Independent retailers accuse the big oil companies of using their market positions to compete unfairly. According to some retailers, the price agreements reached with the FAS grant an advantage to the big companies.

Russia and Turkey celebrate progress in Black Sea gas pipeline project. The new Black Sea gas pipeline土耳其 Stream (TurkStream) runs under the sea bottom from Krasnodar to west of Istanbul. On Sunday (Nov. 19), presidents Vladimir Putin and Recep Tayyip Erdogan met in Istanbul to celebrate the completion of TurkStream’s off-shore section. Construction continues on the Turkish side, with pipeline commissioning now expected in late 2019.

Turkey annually purchases roughly 30 billion m³ of natural gas from Gazprom. About half of that is currently supplied directly to Turkey via the Blue Stream pipeline. The rest is supplied by pipelines that cross Ukraine, Romania and Bulgaria. In its initial phase of operation, TurkStream will have an annual capacity of 17 billion m³.

Gazprom is currently constructing two other major pipelines for gas exports: the eastern leg of the Power of Siberia pipeline and Nord Stream 2, which parallels its predecessor under the Baltic Sea. The go-ahead decision on construction of the Power of Siberia, which encompasses approximately 3,000 km of pipeline, was made in 2014. Completion of the pipeline is expected late next year. Gas supplies to China should begin flowing in 2020. The new pipeline, with a transmission capacity of 38 billion m³ a year, opens the Chinese market for Russian gas.

Nord Stream 2 will double the current Nord Stream transmission capacity of 55 billion m³ a year. Laying of pipe along the Baltic seabed commenced in September. Commissioning is planned for late 2019. The simultaneous completion of these three pipelines would enable a significant shift of Russian gas export routes during 2020.
China

Rise in Chinese housing prices moderates. Real estate market tracker SouFun reports that the average city apartment price in China in recent months has hovered around 16,600 yuan (EUR 1,800) per square meter of liveable floor-space, a 5 % increase from last year. Price increases have been quite modest this year, however, in China’s four biggest cities. The average square-metre price for apartments in Beijing was 42,500 yuan (EUR 6,000) in October.

Housing price trends vary widely from city to city. SouFun’s 99-city sample reveals that in some cities average prices are slightly lower than a year ago, while prices in some other cities are up by as much as 20 % y-o-y. Some of the deviation reflect regional differences in rules governing real estate sales. When officials tighten regulations, speculative buyers shift their buying to other cities.

Growth in apartment sales volume (measured by floor-space) has slowed to around 2 %, while the volume of new construction has soared to levels not seen since the start of the decade. Lower demand growth could put downward pressure on prices. Falling prices, in turn, create a danger that sold, but unoccupied, apartments end up back on the market.

Large differences among Chinese provinces in terms of living standards and economic growth. Real on-year GDP growth in China’s 31 regions (provinces, first-tier municipalities and autonomous regions) during January-September ranged from 9.1 % in Yunnan to 3.5 % in Tianjin. GDP growth nationally in the period was 6.7 % p.a.

Nominal GDP growth varies even more than real growth across regions. In January-September, the GDP of Inner Mongolia was over 10 % smaller than in the same period last year. In contrast, Ningxia’s GDP grew by nearly 14 %. Comparisons of nominal growth overlook regional price trends, which can be significant due to e.g. production structures. Variations in consumer prices, however, were marginal.

Standards of living vary considerably within China. Last year, GDP per capita in northwest China’s Gansu province was just 28,500 yuan (USD 4,100), a level comparable to per capita GDP in Algeria or Georgia (not purchasing power adjusted). GDP per capita last year was 129,000 yuan in Beijing and 127,000 yuan in Shanghai. These GDP per capita levels of USD 18–19,000 are similar than those of Greece or Slovakia.

Regional GDP figures should be viewed with great caution, however. Several major instances of regional authorities falsifying statistical data have emerged in recent years (e.g. Inner Mongolia, Liaoning and Tianjin). Moreover, cumulative regional GDP figures does not give the same GDP figure as the official national figure. This discrepancy has been shrinking, however. Combined regional GDP in the first nine months of this year was only 0.5 % higher than the official national GDP figure. The NBS will next year begin to produce its own regional GDP assessments rather than rely on local officials.

Regional GDP growth, consumer price inflation and GDP/capita

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<td>Beijing</td>
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Sources: China National Bureau of Statistics, CEIC and BOFIT.

Variations in consumer prices, however, were marginal. Comparisons of nominal growth overlook regional price trends, which can be significant due to e.g. production structures. Variations in consumer prices, however, were marginal.

Standards of living vary considerably within China. Last year, GDP per capita in northwest China’s Gansu province was just 28,500 yuan (USD 4,100), a level comparable to per capita GDP in Algeria or Georgia (not purchasing power adjusted). GDP per capita last year was 129,000 yuan in Beijing and 127,000 yuan in Shanghai. These GDP per capita levels of USD 18–19,000 are similar than those of Greece or Slovakia.

Regional GDP figures should be viewed with great caution, however. Several major instances of regional authorities falsifying statistical data have emerged in recent years (e.g. Inner Mongolia, Liaoning and Tianjin). Moreover, cumulative regional GDP figures does not give the same GDP figure as the official national figure. This discrepancy has been shrinking, however. Combined regional GDP in the first nine months of this year was only 0.5 % higher than the official national GDP figure. The NBS will next year begin to produce its own regional GDP assessments rather than rely on local officials.

Regional GDP growth, consumer price inflation and GDP/capita
Russia

Dry summer reduces Russian harvest. Data from the beginning of November show Russia’s grain harvest this year was about 15% smaller than last year. Last year’s harvest, however, was exceptionally large due to favourable summer grain-growing conditions. Compared to 2016, this year’s harvest was only a few per cent smaller. The sugar beet crop was about 10% smaller than last year, while potato and other vegetable crops matched 2017 levels.

The area of land under cultivation has expanded in recent years, but arable land is unevenly distributed across Russia. Wheat and sugar beet cultivation is concentrated in the steppe that stretches from the Black Sea to Siberia, while potato and rye cultivation succeeds at more northern latitudes. Also crop composition has changed since the breakup of the Soviet Union with the traditional rye and buckwheat crops replaced increasingly by maize and wheat. In terms of weight, two-thirds of Russia’s grain crop is now wheat. Wheat is exported especially to countries in the Middle East.

The size of harvests impacts food prices and thus the general price level. Foodstuffs represent 37% of Russia’s consumer goods basket used for price indexing. Compared to many other countries, this is a large share. Thus, the large harvest last autumn slowed down slightly the rise in consumer prices during last winter and spring. Accordingly, this year’s smaller autumn harvest can be expected to slightly accelerate inflation over coming months.

Robust increase in Russian government revenues, substantial budget surpluses. Revenues to the consolidated budget (federal, regional and local budgets, plus government social funds) in the first nine months of this year were up 20% from the same period in 2017. Oil & gas tax revenues were up by nearly 50%, and rose even faster in the third quarter on quite high oil prices.

Other revenue streams to the consolidated budget rose by 13% y-o-y in January-September. While value-added taxes and corporate profit taxes boosted budget revenues remarkably, revenue streams from mandatory social taxes of employers and labour income taxes were up well over 10%.

Budget expenditures, in contrast, have only risen modestly, up by just 6% y-o-y in January-September. Healthcare spending topped the increase, rising by nearly 20%, followed by education at more than 10%. The increases mainly reflect substantial hikes in wages in these sectors. Spending on administration turned to hefty increase, while spending on domestic security was up by a few percent. Growth in defence spending strengthened to over 7%. Budget categories this year seeing increases of only about 1% (i.e. real declines) include the economy’s various sectors, and pensions and other forms of social support.

The rapid growth in revenues has turned Russia’s government finances to surpluses. The 12-month surplus of the consolidated budget exceeded 1.5% of GDP in September. The finance ministry expects the federal budget surplus to end up at about this level for the whole of this year even if the newly-approved supplemental budget spending (rather small) for this year will materialize and the large remaining amounts of last year’s budget funds will all be used.

A fifth of foreign debt of Russian banks and other businesses denominated in rubles. The Central Bank of Russia reports that the total foreign debt of Russian banks and other Russian corporations stood at around 428 billion dollars as of end-June. Some 21% of that debt was denominated in rubles, 57% in dollars and about 20% in euros.

The banking sector’s foreign debt has contracted continuously since spring 2014. Bank foreign debt, which declined by 114 billion dollars over the past four years, stood at 95 billion dollars as of end-June. The foreign debt of state-owned banks, in particular, contracted dramatically. Some of the debt reduction reflects exchange rate fluctuations, but differences between banking groups are also substantial. About 30% of the foreign debt of private banks is denominated in rubles. In contrast, only about 15% of the foreign debt of large state-owned banks is in rubles. The foreign receivables of banks have also fallen, but still considerably exceed bank debt loads.

The foreign debt of non-financial corporations has contracted over the past four years. At the same time, the share of debt liabilities to direct investors in corporate sector’s total foreign debt has constantly increased. In June the share was over 40%. About a third of corporate credit stock (103 billion dollars) was large state-owned enterprise debt. When liabilities to direct investors are excluded, only 5% of foreign borrowing of state-owned enterprises is denominated in rubles. In contrast, about 30% of the foreign borrowing of private firms is in rubles. Not counting the debt and receivables associated with direct investment, the value of the foreign net assets of the non-banking corporate sector was close to zero.

Total foreign debt of banks and other firms, USD billion

Source: Central Bank of Russia.

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.
China

EU steps up oversight of investment inflows from China. The EU Parliament, the Council and the Commission last week (Nov. 20) reached agreement on monitoring mechanisms for foreign direct investment flows into the EU. The EU wants to assure that FDI in critical infrastructure and technology do not imperil the EU’s internal or external security.

The EU has sought tighter supervision of direct investment for years. While the new EU policy does not mention China specifically, the accord has been driven by fears that Chinese state-owned enterprises could target European firms involved in infrastructure and technology. Concerns over possible media ownership and influence over domestic policies have been also expressed.

The new regulations, which still require formal approval by EU bodies, are expected to enter into force in 2020. Half of the EU’s 28 member states currently have some sort of FDI monitoring arrangements to assess possible security threats. The new arrangement does not move decision-making on FDI away from the national level, but rather seeks to increase oversight of FDI through coordination and information-sharing among member states. It also gives the European Commission the possibility voicing its position on major investment projects that are important for the Union.

While the views of the member states on Chinese investments differ, the general attitude also in Europe has become more critical. The German government, for example, last summer in practice torpedoed an effort by the Chinese Yantai Bus Group to purchase German machine tool maker Leifeld.

US scepticism towards FDI, particularly deals involving the Chinese, has garnered far more attention than in the EU. The Committee on Foreign Investment in the United States (CFIUS) recently expanded its mandate to assess possible security threats. The new arrangement does not move decision-making on FDI away from the national level, but rather seeks to increase oversight of FDI through coordination and information-sharing among member states. It also gives the European Commission the possibility voicing its position on major investment projects that are important for the Union.

Labour strife on the rise in China. The Hong Kong-based China Labour Bulletin (CLB), an NGO that tracks the worker’s movement in China, reports a sharp increase in labour disputes this year. Most protests have involved wage arrears.

According to the register maintained by CLB, about 1,150 protests over wage arrears were staged in the first ten months of this year. There were 813 protests in the same period last year. The record year was 2016, when 1,700 workplace disputes were registered over wage arrears.

As in previous years, the bulk of protests have been in the construction sector, which typically uses internal migrant workers from rural areas. Teachers, however, have staged the largest demonstration this year. Over 10,000 teachers took to the streets in Harbin in northeastern China to demand better pension payments.

Labour action has also been supported by Chinese universities, which students have helped to organise labour protests on behalf of workers. Media reports claim that the police have this year arrested dozens of student activists from China’s top-tier universities. Officials monitor student movements extremely closely, well aware of the lessons from the 1989 Tiananmen protests.

China enjoys another year of bountiful harvests. China’s National Bureau of Statistics reports that this year’s summer harvests (139 million metric tons) roughly match the scale of last year’s bumper harvests. The summer harvests represent about a fifth of China’s total harvests for the year. Although the autumn harvest figures have yet to be published, they are expected to be similar to last year’s harvest numbers.

China’s annual grain harvest in recent years has hovered around 660 million tons. After the 2003 crop failure, harvests grew quickly to current levels. Much of the improvement reflects higher productivity, but the area of land under cultivation has also increased. Production efficiency has been boosted through improvements in irrigation and fertiliser use, as well as a shift to higher-yield cultivars. The use of modern farm equipment has also increased.

Like other statistical data in China, agricultural figures should be viewed critically. A good example is the NBS’ large upwards revisions this autumn of its figures for grain harvests and land under cultivation for the period 2007–2017. New figures show maize production last year exceeded previous estimates by whopping 43 million tons. The revision is huge; it boosts Chinese maize production by 20 % and global production by 4 %. The sizes of the wheat and rice harvests were also overstated by several million tons.

China strives for self-sufficiency in certain major crops. It supports producers of critical crops through such measures as price guarantees. In the case of maize, a very costly price-guarantee subsidy was dropped in 2016. In 2017–18, the self-off of state maize reserves purchased at the guaranteed price is estimated to have cost the government nearly 30 billion dollars. Rice and wheat still enjoy price guarantees.

Chinese grain harvests (millions of tons)

Sources: China National Bureau of Statistics, CEIC and BOFIT.
**Russia**

**Rouble rate holds steady despite falling oil prices and Kerch Strait skirmish.** The price of Urals-grade crude oil declined by 30% in October and November, from above 85 dollars a barrel to under 60 dollars, but there was hardly any change in the rouble’s exchange rate. Similarly, the naval incident on November 25 in the Kerch Strait had virtually no impact on the rouble’s exchange rate. There is no unambiguous explanation for rouble’s unusual behaviour.

However, the weakening of the link between rouble and oil can be partly explained by currency purchases by the Central Bank of Russia. Since the start of 2017, the Ministry of Finance has been accumulating foreign currency to the National Welfare Fund. Currency purchases have been made daily on the market by the Central Bank. According to the government’s fiscal rule, the higher the price of oil is, the more foreign currency is accumulated. While such forex buying has a depreciating effect on the rouble’s value, the effect’s magnitude is not simple to quantify. However, the connection between the rouble’s exchange rate and the oil price has diminished substantially during the forex-buying programme. In August, the Central Bank suspended the forex-buying programme until the end of the year. This may have supported the rouble’s value during autumn.

In an indirect manner, the longer-term effect of sanctions may also account for the rouble’s stability in recent months. After the declaration of new sanction packages in April and early August, the rouble fell steeply, but it has had a slight tendency to rebound to some extent during the following months. Thus, recovery from the initial sanction effect may have partly cancelled the effect of oil price on the rouble’s exchange rate. However, such an explanation remains rather speculative in lack of direct evidence.

The rouble’s exchange rate could also be getting some support from Russia’s monetary policy and relatively benign fiscal environment. Public sector finances are in surplus and government debt is quite low relative to most countries. In addition, emerging-market currencies have generally bounced back from their lows earlier this year.

**Russia approves 2019 federal budget and social fund budgets.** The finance ministry expects federal budget revenues to increase next year by about 5% relative to this year’s expected revenues. Oil and gas tax revenues are expected to decline by a few percent, if the price of Urals-grade crude oil falls according to the assumptions of this year’s supplementary budget. The price is expected to average 70 dollars a barrel this year and 63.4 dollars a barrel next year. In contrast, other revenue streams will rise by 15%. Nearly a third of the gains will come from the increase in value-added tax at the beginning of 2019. Another third is related to increases in value-added tax revenue for other reasons. Dividend income from state-owned enterprises is expected to soar as well.

Federal budget spending will rise next year by a few percent from this year’s forecasted expenditures. Federal budget expenditures excluding transfers to regional budgets and state social funds will correspond to 12% of GDP. In nominal terms, defence spending next year will be roughly the same as in 2017 and 2018.

The 2019 federal budget is expected to produce a surplus equal to 1.8% of GDP. However, the Russian government will take on new debt. This is because under the calculated low price of oil in the budget rule a large share of oil tax revenues must go into the National Welfare Fund. The total value of the assets in the Fund is expected to correspond to 7.5% of GDP at the end of next year.

State social funds are a significant part of Russia’s public finances, as the expenditures of these funds equal to 11% of GDP. Tax revenue received by the funds consists almost entirely of mandatory social contributions collected from corporations. According to the budget, revenues to the Pension Fund, which is the biggest fund by far, will grow next year so well that transfers from the federal budget to the fund will remain unchanged. The fund’s expenditures will increase only slightly as the general retirement ages begin to rise next year. In line with the guidelines set forth by the government through 2024, pensions will go up by 7% at the beginning of next year. However, pensioners who continue to work are no longer entitled to such across-the-board pension rises. Rapid growth in revenues and spending of health insurance fund will continue.

**Urals oil price and rouble exchange rate**

![Graph showing Urals oil price and rouble exchange rate](Source: Reuters)

**Federal budget (FB) and social fund (SF) revenues and expenditures**

![Graph showing Federal budget (FB) and social fund (SF) revenues and expenditures](Source: Russian Ministry of Finance)
China

China and the US agree to postpone tariff hikes to give negotiators time to resolve trade disputes. Presidents Donald Trump and Xi Jinping held high-level bilateral talks during the G20 summit in Buenos Aires last weekend. The US and China agreed to work together in resolving their current trade impasse over the next three months, during which time the United States promised to refrain from imposing further tariff hikes.

The US had earlier threatened to raise the 10% tariff imposed in September on 200 billion dollars’ worth of Chinese imports to 25% at the start of 2019 unless China committed to trade policy reforms demanded by the US. The US said that the tariff increases would go into effect in March if the two countries failed to reach an agreement within 90 days. China has consistently responded to US tariff hikes with retaliatory counter-tariffs.

The stated goals of the trade talks are quite ambitious. The US says the talks will address “structural changes” to such issues as forced technology transfers, protection of intellectual property, non-tariff barriers to trade, various cyber-threats, services and agriculture. China was vague on the goals of the bilateral talks and only confirmed that both countries were committed to necessary reforms of the WTO to improve its operation. China’s development and exploitation of the system. A good sign is that the member states committed to necessary reforms of the WTO are behind developed-economy countries confirmed a promise from China to increase its imports of energy, agricultural and industrial products from the US to reduce the trade imbalance.

The United States insists that China make real changes, not simply show good intentions. The appointment of China-critic Robert Lighthizer as US trade representative illustrates the US hard-line stance.

It will be difficult for the US to negotiate on “structural changes” as many go directly to the core of China’s economic and political system. Reaching a meaningful outcome is complicated by the intricate and sensitive matters involved, the brief period for negotiation and the fact that trade policy disputes are just part of the broader power struggle between the world’s leading economies. By stoking uncertainty in global markets, the ongoing US-China trade dispute has become quite toxic for global business communities.

China and the US defend WTO reforms, but still far apart on agreement content. The Argentina G20 summit produced a fairly thin final communiqué in which the member states committed to necessary reforms of the WTO to improve its operation. China’s development and its economic policy practices are behind developed-economy calls for WTO reform.

The United States has been the sharpest critic of the WTO and China’s exploitation of the system. A good sign is that the US now promises to continue discussions on trade policy on a multilateral basis. As regards China’s commitment to WTO reforms, it is important that China itself participates in determining the rules-based international trading order. However, it will be very difficult to find a common premise for reform, given that member views on the matter are so divergent with to the substance of reform. No concrete initiatives on WTO reforms were announced in Buenos Aires.

The biggest challenge to WTO reform from the Chinese standpoint involves Western demands for elimination of public subsidies and other market-distorting practices. These are particularly sensitive issues for China and other emerging economies. As one of the world’s trading superpowers, China can no longer hide behind its developing economy status and demand special treatment or concessions.

The WTO and the multilateral trade policy system are facing their deepest crisis in decades. The US-China trade disputes are at the centre of current problems. How the US and China succeed in their bilateral talks during the next three months may also indicate whether reforms of the WTO are possible at all or whether the crisis around it deepens further.

Markets reacted cautiously to Trump-Xi truce. Given the low expectations going into the G20 summit that the US and China would make progress on resolving their trade differences, the 90-day postponing of further sanctions was enough for both sides to put a positive spin on their meeting. Market reactions in China and the US, initially positive, grew more pessimistic as the week progressed, partly with news of the US-ordered arrest in Canada of Huawei CFO, Wanzhou Meng on December 1.

In the wake of the summit on Monday (Dec. 3), prices on the Shanghai stock exchange rallied nearly 3% from their Friday levels, only to fall slightly later in week. Chinese stock performances this year have generally been weak, so the hoped-for injection of optimism gave way on Tuesday (Dec. 4) to uncertainty over the feasibility of resolving complex trade issues in a brief period. On forex markets, the yuan was up over 1% against the dollar, only to weaken again to around 6.88 by Friday (Nov. 7).

Last week’s publication of the official purchasing managers’ index indicated that industrial output growth halted in November, adding to market jitters.

Mainland China and Hong Kong share indices
Russia and OPEC agree on new production limits. Russia, OPEC and a few other oil-producing countries announced last Friday (Dec. 7) that they were cutting back crude oil production by a total of 1.2 million barrels a day from the start of 2019. OPEC members will reduce their production by a total of 800,000 barrels a day, while non-OPEC countries commit to cutting back by a total of 400,000 barrels a day. Soon after the agreement was announced, the price of a barrel of Brent crude rose by about 5 % to over 63 dollars. This week it slid back to a level of around 61 dollars.

The agreement of production cuts will stay in place for six months, and according to the agreement producer countries reduce their production by over 2 % from the October 2018 level. Russian energy minister Alexander Novak said that Russia plans to reduce its daily output gradually over the next few months for an overall reduction of 228,000 barrels a day. Novak further noted that production cuts in January 2019 would be at least 50,000–60,000 barrels a day. In addition to the production cut deal, Russia, OPEC and a few other oil-producing countries are now preparing a separate cooperation agreement to be signed in the first quarter of 2019.

In late 2016, OPEC and Russia announced they had voluntarily agreed to a cut of nearly 1.8 million barrels a day. Russia’s cut amounted to 300,000 barrels a day, a reduction it gradually implemented in the first half of 2017. The agreement on production cuts was extended twice in 2017. In June this year, OPEC and Russia announced that they were abandoning the production cuts. During last months, Russian oil output has been at an all-time high for the post-Soviet period. Russia’s energy ministry reports that output in September-November averaged 11.4 million barrels a day, i.e. over 400,000 barrels a day above the previously agreed production ceiling, and over 4 % higher than in the same period in 2017.

Fixed investment growth in Russia accelerated in the third quarter. Fixed investment was up by over 5 % y-o-y in the third quarter of this year. In the first six months, on-year growth exceeded 3 %. For the entire January-September period, growth was slightly over 4 %.

Fixed investment by large and mid-sized firms, as well as the state, rose in the first nine months of the year by 1.4 % y-o-y. Rosstat estimates that other fixed investment, including investment by small firms, was up by well over 10 %, almost the same increase as in the first half of the year.

After two years of growth, fixed investment by large and mid-sized firms in crude oil production declined by a couple of per cent in January-September. In contrast, fixed investment in natural gas production increased by nearly 50 %, even if investment growth in the branch was already brisk in the previous two years. Last year’s notable recovery in natural gas pipeline investments has continued this year. Large and mid-sized manufacturing firms markedly increased their investment, although the level of investment was still low in light of a steep three-year slump.

Share of investment of large firms, mid-sized firms and the Russian state in total fixed investment

![Graph showing the share of investment of large firms, mid-sized firms and the Russian state in total fixed investment from 2011 to 2018.](source: Rosstat)

The third unit of the natural gas liquefaction plant in Yamal went into operation in November. The plant is located on the coast of the Arctic Ocean. It brought its first unit, or train, on stream a year ago, and the fourth and final unit is to be commissioned next year. However, the fourth unit is significantly smaller than the first three. Somewhat unusually, the project is about a year ahead of its original schedule.

Russia’s total natural gas liquefaction capacity now exceeds 25 million tons a year, which is equal to about 6 % of global capacity. Liquefaction, shipping and regasification are an alternative way to deliver gas to customers beyond the reach of pipelines. The largest demand is in Asia, which lacks a sufficient number of gas pipelines from production areas.

There are two large liquefaction plants in Russia. The other is on Sakhalin Island on the coast of the Pacific Ocean. From there, gas is shipped directly to Asian markets. In contrast, most of the Yamal gas is shipped towards the Atlantic due to difficult ice conditions. Even though the gas is transported by a fleet of icebreaker cargo ships, shipments towards the Pacific Ocean are possible only in summer. Most often these special ships are used to transport the gas to ice-free waters, where it is then transferred to other vessels. Such transfers are made, for example, in the Norwegian Sea or in Western European ports. The gas then continues its journey with market prices determining the final destination. Some of it goes to Asia.

The Yamal facility is majority-owned by the Russian gas company Novatek. The minority stakes are owned by the French Total, China National Petroleum Corporation and China’s Silk Road Fund. Novatek has been in talks with French, Chinese, Japanese, Korean and Saudi entities about building yet another plant near the Yamal plant. Decisions are due next year. In addition, Novatek has announced its ambition to build yet more large facilities during the next decade.
China

Growth of China’s foreign trade slowed sharply in November; trade talks confront new problems. China customs reports that the value of goods exports in November rose by 5 % y-o-y, while the value of imports was up by just 3 %. For the January-October period, exports climbed by more than 10 % and imports by over 20 %. The rapid slowdown in import growth was not due only to declining commodity prices on the global market, but rather from the evaporation of growth in imports of machinery, equipment and related components.

Growth of Chinese goods exports to the US in November remained strong. In contrast, goods imports from the US declined by 25 % y-o-y. As a result, China’s trade surplus with the US soared in November. Exports to the US were driven by strong economic growth in the US and anticipatory stocking-up on fears of impending tariff increases. United States customs figures show that goods imports from China already declined for those goods affected by the first round of additional tariffs in July and August.

China and the United States are still trying to negotiate a solution to their differences and end the trade war. China promised to buy even more American products and get rid of the additional tariffs imposed on American cars in July. Moreover, media reports claim China is even planning changes to its “Made in China 2025” industrial policy programme. It is hard to imagine, however, any quick fix to the situation as most of the reforms required take a while to implement even with the political will needed.

Already struggling trade negotiations were not helped last week by the US-ordered arrest of Huawei CFO Meng Wanzhou in Canada. The US accuses Meng of misleading banks about prohibited trade with Iran in violation of US sanctions. Meng was freed on bail in Vancouver, British Columbia about prohibited trade with Iran in violation of US sanctions.

The US accuses Meng of misleading banks about prohibited trade with Iran in violation of US sanctions, but China considers the arrest a political stunt, condemning it in the strongest terms. The Chinese government this week arrested two Canadians “on suspicion of engaging in activities that harm China’s state security.”

Rise in Chinese prices remains modest. According to China’s National Bureau of Statistics, consumer price inflation has remained modest and remarkably stable for years. 12-month consumer price inflation slowed to 2.2 % in November. Core inflation (food and energy prices excluded) has long remained at around the 2 % level.

The pace of producer price growth continued to slow in November. Producer prices were up 2.7 % y-o-y, but were down slightly from October due to drops in energy and commodity prices.

China’s methodology for calculating consumer price inflation has been suspected for years to underestimate particularly housing costs. Even with the massive rent hikes recently in many cities, the consumer price index has only risen 2–3 %, even in China’s tier-one cities.

Price trends in China

Sources: Macrobond and BOFIT.

Even with slowing growth, Hong Kong economy continues doing well. On-year GDP growth in the special administrative region slowed from 3.5 % in the second quarter to 2.9 % in the third quarter. In the first nine months of the year, GDP grew by 3.7 % y-o-y. The average on-year growth in Hong Kong since 2000 has been just under 3.0 %.

Hong Kong’s economic growth this year has been broad based. Retail sales have provided an important engine of growth. Thanks to a strong first half, retail sales were up by over 10 % this year. Industrial output, exports and tourism earnings all made positive gains. Thanks to a strong economy, the unemployment rate fell from 3.0 % at the end of 2017 to 2.8 % in October. In recent months, Hong Kong’s inflation rate has climbed to 2.7 %.

Business confidence indicators released by the NBS suggest that economic growth will continue to slow in the coming quarter. The growth outlook is clouded over the near and medium term by the slowdown in growth in mainland China, the US-China trade war and rising interest rates in the US. Shifts in American monetary policy impact Hong Kong instantly as the value of the Hong Kong dollar is pegged to the US dollar.
Russia

Modest growth in Russian industrial output continues. The volume of industrial output rose by 2.4% y-o-y in November. The pace of growth was in line with the industrial output trend of several years. Output growth remained quite unbalanced, however, with the output volume of extractive industries rising 7.8% y-o-y, while the volume of other manufacturing output was unchanged from a year earlier. The multi-year decrease in construction turned into growth in October. November construction activity was up 4.3% y-o-y.

Real disposable household incomes have shrunk in recent years. In November, they were down by nearly 3% from a year earlier. Retail sales, in contrast, grew y-o-y by 3%. However, they were still 10% lower than in summer 2014 just before the collapse of oil prices and the ruble’s exchange rate.

Industrial output and retail sales

![chart of industrial output and retail sales](source: Rosstat, BOFIT)

CBR raises key rate and announces resumption of the fiscal-rule forex buying in January. The Central Bank of Russia decided to raise the key rate by 25 basis points to 7.75%. The increase went into effect on Monday (Dec. 17). The CBR last raised the key rate in September. The CBR also announced that on January 15, 2019 it would resume foreign-currency purchases, which were on halt in fall, in accordance with the fiscal rule on behalf of the finance ministry.

The CBR said its decision was driven largely by inflation risks that have remained elevated over the short term. The CBR estimates that on December consumer price inflation was running at 3.9% y-o-y. It pointed, however, to the upcoming increase in the value-added tax from 18% to 20% at the start of next year and the ruble’s depreciation this year of about 15% against the US dollar (and about 10% against the euro) as factors that will fuel inflation next year. The CBR expects inflation to be in the range of 5–5.5% at the end of next year, potentially spiking temporarily in the first half to as high as 6%. Under the forecast, inflation settles back to the CBR’s 4% target level in the first half of 2020. Capital outflows from emerging economies and geopolitical factors were mentioned by the CBR as some of the external inflation risks. In addition, the CBR noted the increased risk of a glut in global oil supplies next year.

The CBR’s rate on interbank overnight deposits moved up to 6.75% after the key rate decision. Overnight interbank money market rates (MIACR and RUONIA) stood at about 7.6% at the start of the week. For ruble corporate loans from banks (not including Sberbank) with maturities over one year, the average lending rate in October was 9.2%.

CBR key rate and 12-month inflation

![chart of CBR key rate and 12-month inflation](source: Macrobond)

Ukraine gets new IMF programme. At its meeting this Tuesday (Dec. 18), the executive board of the International Monetary Fund (IMF) voted to grant Ukraine a new Stand-By Arrangement (SBA). The 3.9-billion-dollar SBA will run for 14 months. It replaces Ukraine’s Extended Fund Facility approved in 2015 that was set to expire in March 2019. Under the new SBA, Ukraine gets immediate access to credit worth 1.4 billion dollars.

According to preliminary information, the other loan tranches will be released to Ukraine in May and November next year. The World Bank has also granted Ukraine 750 million dollars in loan guarantees. Ukraine last month received a 500-million-euro loan from the European Union after preliminary agreement was reached on the IMF’s SBA.

The SBA required Ukrainian authorities to accept a number of loan conditions. For example, regulated energy prices had to be increased to levels close to actual producer costs. The 2019 budget approved by Ukraine foresees a deficit corresponding to 2.3% of GDP.

Before the new SBA was approved, Ukraine had 9.9 billion dollars in outstanding loans from the IMF. Ukraine’s 2019 debt-servicing costs to the IMF will be about 1.9 billion dollars. In total, nearly 5 billion dollars in Ukraine government foreign debt comes due next year.
China

China celebrates 40 years of economic reform. The milestone was celebrated on Tuesday (18.8.) in the high level meeting in Beijing. The meeting, however, offered nothing new concerning the future of reforms.

In 1978, the Chinese economy was in bad condition when party leader Deng Xiaoping announced that the country was embarking on reforms. The command economy used resources so inefficiently that it had become an obstacle to the country’s economic development. In terms of GDP per capita, China ranked with some of the world’s poorest countries, including Burundi, Guinea-Bissau and Malawi.

From the beginning, Deng’s reforms focused on improving productivity by giving workers and firms new operating possibilities and by opening the Chinese economy to the rest of the world. Under the “household responsibility system”, farmers were allowed to farm their own plots of land and after making their quota to the local collective allowed to sell whatever was left. Agricultural output rose rapidly. In the business world, the 1980s saw the government grant small firms incentives to stimulate economic growth. The first “special economic zone” was established. Within these zones the business rules were distinctly more flexible than elsewhere in China. The Chinese economy was further strengthened by the fact that decision-making power was devolved from the central government to provinces in the mid-1980s and local decision-makers were given incentives to stimulate economic growth.

The 1980s saw the introduction of a two-tier pricing system that allowed firms to sell production above their quota at market prices. The pricing reform was extended in the 1990s and markets were allowed to play an increasing role in price-setting. In 1994, China unified its dual exchange rates. Two years later, the yuan became fully convertible under the current account. State-owned enterprises were also reformed extensively during the 1990s. Restructuring of the weak banking-sector started and continued well into the 2000s.

China's opening up to the rest of the world began in the 1980s. In order to strengthen the economy, it was necessary that domestic firms got modern machinery and production methods from abroad. Foreign direct investment was allowed in certain fields. China's opening to the world was further boosted by the country’s accession to the World Trade Organization (WTO) in 2001. Globalisation got a huge boost as hundreds of millions of Chinese workers were integrated into global production chains. By the end of the decade, China had become the world’s largest goods exporter.

Efforts to reform the economy began, however, to wane. As a result, many of the reforms launched over the past ten years in the spheres of monetary policy and financial markets have only been partially implemented. Although the People’s Bank of China officially ended interest rate regulation in 2015, commercial banks today still do not compete on rates. The fixed peg of the yuan to the US dollar was abandoned in 2005, but in practice the PBoC still plays a key role in guiding the yuan rate to desired levels. Half-finished reforms have created a messy hybrid system in which participants seek to exploit the advantages of the old and new systems, with a variety of unintended consequences.

Decades of rapid economic growth have lifted hundreds of millions of Chinese out of poverty. China is the world’s second largest economy after the United States. In 2017, China’s GDP per capita was on par with Mexico and ranked in the same class of upper middle income countries as Russia.

China’s economic growth continues to slow. Figures from the National Bureau of Statistics show industrial output growth slowed in November to around 5% y-o-y, while retail sales remained under 6% for the second month in a row. Despite a slight pick-up in fixed investment last month to 5% y-o-y, weak import and export trends reinforced the perception of a substantial slowdown in China’s economic growth.

The situation of the car industry is interesting as the performance of carmakers extends to many other industries and is widely seen as a measure of consumer sentiment. Car sales fell 16% y-o-y in November, the fifth consecutive month of decline. For the first time in several decades, it appears that growth in car sales will be negative for the entire year. Regarding other consumer goods, mobile phone sales and production seem to have declined which has caused a drop, for example, in the sales of some industrial robots. Some of this has to do with the maturation of China’s mobile phone market, uncertainty caused by the trade war with the US and problems in export markets.

China’s official statistics, long criticised for their failure to provide a reliable basis for realistic appraisal of economic conditions, are unlikely to improve much over the near term. The central government this week forbade Guangdong province from releasing its own manufacturing purchasing managers’ index. The move only added to suspicions that the Chinese economy is in weaker shape than official numbers suggest.

Official monthly core indicators for Chinese economy

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<tr>
<th>Year</th>
<th>Industrial production</th>
<th>Retail sales</th>
<th>Fixed asset investment (FAI)</th>
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Source: Macrobond.