



BOFIT

BOFIT Weekly Review  
Yearbook 2019



Bank of Finland  
BOFIT – Institute for Economies in Transition

BOFIT Weekly Review  
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## BOFIT Weekly Review – Russia 2019

4 Jan 2019 BOFIT Weekly 2019/01

Continued low growth forecast for Russian economy this year  
State banks dominate Russian banking sector  
Moscow stock exchange's dollar-denominated RTS index declined 8 % last year

11 Jan 2019 BOFIT Weekly 2019/02

Rosstat released revised figures for GDP and domestic demand in 2016 and 2017  
United States moves ahead on dismantling sanctions on aluminium giant Rusal  
In Russian corporate debt increases have occurred in interfirm trade credits

18 Jan 2019 BOFIT Weekly 2019/03

Russian oil fund shrank in 2018, but central bank foreign currency reserves grew  
Consumer price inflation accelerated in Russia

25 Jan 2019 BOFIT Weekly 2019/04

Russian export earnings up significantly in 2018  
Russian foreign debt declined last year  
Topics at Moscow Gaidar Forum feature future economic growth and national projects

1 Feb 2019 BOFIT Weekly 2019/05

United States Treasury lifts sanctions on Russian aluminium giant Rusal  
Russian industrial output grew at a moderate pace last year  
Central Bank of Russia resumes forex-buying mandated by fiscal rule

8 Feb 2019 BOFIT Weekly 2019/06

Russian economy's growth rate accelerated in 2018  
Higher oil prices boost surplus of Russian federal budget  
Russian real disposable income still well below 2014 level

15 Feb 2019 BOFIT Weekly 2019/07

Russian inflation accelerates slightly in January  
Growth in Russian household borrowing accelerated in 2018  
Russia's goods trade surplus last year was larger than before

22 Feb 2019 BOFIT Weekly 2019/08

Russian government releases new guidelines for national projects  
Russia last year produced and exported more gas and oil than before  
Russian retail sales up overall, but growth has slowed in recent months

1 Mar 2019 BOFIT Weekly 2019/09

Credit rating agency Moody's upgrades Russian sovereign debt  
Russian population declines slightly in 2018 as immigration flows drop considerably  
Corruption dies hard in Russia

8 Mar 2019 BOFIT Weekly 2019/10

Russian government sector finances improved further last year  
Nord Stream 2 gas pipeline construction continues; EU reaches preliminary agreement on gas directive changes

15 Mar 2019 BOFIT Weekly 2019/11

Recovery in Russian fixed investment continued in 2018  
Finnish exports to Russia slackened last year

## BOFIT Weekly Review – Russia 2019

22 Mar 2019 BOFIT Weekly 2019/12

- BOFIT forecast sees lower growth of Russian economy ahead
- Growth in Russian industrial output revived in February
- Rapid growth in use of payment cards in Russia

29 Mar 2019 BOFIT Weekly 2019/13

- Large disparities in Russian regional economic development
- President of Kazakhstan resigns
- Russia actively engages in trade with its neighbours

5 Apr 2019 BOFIT Weekly 2019/14

- New data on last year's improved performance of Russian economy
- Russia's national ecology project addresses a range of environmental issues
- New bridges across Amur River are set to open soon

12 Apr 2019 BOFIT Weekly 2019/15

- Russian export earnings rather flat; recovery in imports continues to stall
- Russian growth in the past couple of years driven largely by extractive sector, trade and public administration
- Russia's car manufacturing industry continues to recover

18 Apr 2019 BOFIT Weekly 2019/16

- Direct investment outflows from Russia remain significantly larger than FDI inflows
- Revenue boom of Russian federal budget begins to normalise
- Russian spending on private insurance increases

26 Apr 2019 BOFIT Weekly 2019/17

- Steady rise in Russian industrial output
- Russia's foreign debt up slightly in the first quarter
- Recent restrictions on Russian trade add to challenges facing Ukraine's new leadership

3 May 2019 BOFIT Weekly 2019/18

- Russian budget surplus expected to shrink in the next few years
- Little progress in reducing poverty, even as Russian living conditions generally improve
- Russian president tours East Asia

10 May 2019 BOFIT Weekly 2019/19

- Russian defence spending large, even after declines
- Russian services trade grew last year
- Progress in two natural gas transshipment terminals in Russia's Arctic and Pacific coasts

17 May 2019 BOFIT Weekly 2019/20

- Sluggish growth in Russian foreign trade
- Dollar remains the dominant billing currency in Russian foreign trade
- Difficult to form a full picture of Russia's sizeable public sector procurements

24 May 2019 BOFIT Weekly 2019/21

- Russian first-quarter economic growth well below expectations
- Tainted oil fouls Druzhba oil pipeline
- Russia's hydrocarbon-centric energy security doctrine stresses import substitution

## BOFIT Weekly Review – Russia 2019

31 May 2019 BOFIT Weekly 2019/22

Russian industrial output growth accelerated in April  
Changes in the country structure of Russian inward and outward foreign direct investment  
Russian expenditure on travel services abroad grew slightly last year

7 Jun 2019 BOFIT Weekly 2019/23

Russian share prices up this year; substantial growth in bond markets  
Fewer sectors in Russia targeted for direct investment from abroad  
Intra-elite competition increasingly reflected in institutional behaviour in Russia and the economy more broadly

14 Jun 2019 BOFIT Weekly 2019/24

Statistical reforms provide improved picture of Russian household spending  
Chinese and Russian presidents extol good economic relations at St. Petersburg economic forum  
Kazakhstan's acting president Tokayev wins presidential election

20 Jun 2019 BOFIT Weekly 2019/25

Central Bank of Russia lowers key rate  
Rapid expansion of Russian consumer borrowing raises concerns  
Russia's labour force shrinks along with unemployment

28 Jun 2019 BOFIT Weekly 2019/26

Russian first-quarter growth supported by extractive sector and certain service-sector branches  
Russia tries to strengthen import substitution policy  
Russia suspends flights to Georgia after July 8

5 Jul 2019 BOFIT Weekly 2019/27

Russia's population declines, greys and increasingly packs into cities  
OPEC+ keeps production ceilings in place

12 Jul 2019 BOFIT Weekly 2019/28

Russian economic growth driven almost exclusively by private consumption  
Russian foreign trade contracts slightly  
Increase in outflows of private capital from Russia

19 Jul 2019 BOFIT Weekly 2019/29

Russian federal budget produces strong first half surplus  
Druzhba pipeline again operating at full capacity since July  
Russia's contribution to global oil, gas and coal production held steady last year

26 Jul 2019 BOFIT Weekly 2019/30

International Monetary Fund lowers growth forecast for Russia  
Russia posts tepid first-half growth  
Significant economic differences across Russia's cities with populations of more than one million

2 Aug 2019 BOFIT Weekly 2019/31

CBR again lowers key rate and forecasts moderate inflation  
Russia tries to promote the ruble by easing the repatriation requirement for export earnings  
Russia has a large, but relatively poor, middle class

9 Aug 2019 BOFIT Weekly 2019/32

Russia moves its large excess oil tax revenues from 2018 into the reserve fund  
Russia continues to accumulate foreign currency reserves  
Recent studies examine transport projects in Central Asia

## BOFIT Weekly Review – Russia 2019

16 Aug 2019 BOFIT Weekly 2019/33

- US imposes new sanctions on Russia
- Kremlin imposes strict economic targets on regional leaders
- IMF Article IV consultation reiterates calls for Russia to maintain economic stability and move on reforms

23 Aug 2019 BOFIT Weekly 2019/34

- Russia's economic growth remained slow
- Russia's goods trade stays rather flat
- Moderate rise in Russian government spending

30 Aug 2019 BOFIT Weekly 2019/35

- Implementation of Russia's national projects plods ahead
- UNCTAD's estimate of ultimate sources of foreign direct investment emphasises Western investment in China and Russia

6 Sep 2019 BOFIT Weekly 2019/36

- Russian fixed investment developments vary across sectors
- Russia streamlines visa rules
- Finnish-Russian trade remains sluggish

13 Sep 2019 BOFIT Weekly 2019/37

- Russia's central bank lowers key rate and revises forecasts downwards
- Ruble rate and oil prices weaker after strong performance early in the year
- Russian and Indian leaders meet to discuss economic relations

20 Sep 2019 BOFIT Weekly 2019/38

- Lower growth in Russian construction activity
- Russian competition bureau has plenty on its plate
- Russia and Belarus discuss deeper economic integration

27 Sep 2019 BOFIT Weekly 2019/39

- Russia announces ratification of the Paris climate accord
- Russia discusses how to invest government reserve fund assets
- Chinese premier talks up trade during his Russia visit

4 Oct 2019 BOFIT Weekly 2019/40

- BOFIT's latest forecast sees Russian economic growth falling to 1 % this year
- Stimulus included in Russia's 2020–2022 government sector budget framework

11 Oct 2019 BOFIT Weekly 2019/41

- Russia's foreign currency reserves swell to highest level in years
- Russia and Turkey want to increase bilateral use of their currencies
- Russia ratifies Caspian Sea accord
- Monitoring of partially completed fixed investments in Russia is difficult

18 Oct 2019 BOFIT Weekly 2019/42

- IMF lowers growth forecast for global economy
- Russian imports on the rise; modest capital flows
- Report finds that one in three Russian workers involved in informal employment

25 Oct 2019 BOFIT Weekly 2019/43

- Russian economy enjoys growth spurt
- Russia's large federal budget surplus begins to shrink
- Modest development in Russian incomes continues this year

## BOFIT Weekly Review – Russia 2019

1 Nov 2019 BOFIT Weekly 2019/44

- Central Bank of Russia lowers key rate
- Russia's foreign debt increased slightly this year
- New information about Russia's military-industrial complex and its bank debts

8 Nov 2019 BOFIT Weekly 2019/45

- Final construction permit issued for Nord Stream 2 pipeline
- CBR issues monetary policy guidelines for 2020–2022
- Russia hosts African leaders at first Russia-Africa summit

15 Nov 2019 BOFIT Weekly 2019/46

- Russian economic growth accelerated
- Russian stock exchange on the upswing
- Russian foreign trade development remains muted
- Russia prepares new measures to support firms subject to Western sanctions

22 Nov 2019 BOFIT Weekly 2019/47

- Growth in Russian government sector spending accelerates
- Capital amnesty law put to a test in Russia
- Russia brings in a hearty harvest

29 Nov 2019 BOFIT Weekly 2019/48

- Russian economic growth remained moderate in October
- Russian gas giant Gazprom share package to unknown buyer
- Global energy market trends not expected to cause big changes for Russia in near term

5 Dec 2019 BOFIT Weekly 2019/49

- Russia commences pipeline transmission of natural gas to China
- First highway bridge across the Amur river joining Russia and China is finally ready
- Small recovery in Finnish exports to Russia

13 Dec 2019 BOFIT Weekly 2019/50

- OPEC and Russia agree on further cuts in oil production
- While Russian officials wish for public spending to spur economic growth, experts remain sceptical
- Russia and China rise in World Bank rankings; unchanged in WEF rankings

20 Dec 2019 BOFIT Weekly 2019/51–52

- Bank of Russia cuts key rate again
- Recovery in Russian fixed investment remains slow
- Survey paints dreary picture of Russian business conditions

## BOFIT Weekly Review – China 2019

4 Jan 2019 BOFIT Weekly 2019/01

- China starts to the year with darkened outlook
- China's economic work conference produces no big changes in economic policies
- Slowdown in China's economic growth expected to continue in 2019

11 Jan 2019 BOFIT Weekly 2019/02

- Glimmers of hope in China-US trade talks
- China eases monetary stance
- China implements fiscal stimulus measures

18 Jan 2019 BOFIT Weekly 2019/03

- China's export and import growth turned negative in December
- Signs of deteriorating employment conditions in China
- Chinese consumer price inflation held steady at around 2 % last year

25 Jan 2019 BOFIT Weekly 2019/04

- China's economy continues to slow
- China's ratio of bank credit to GDP continues to rise
- Apartment prices in China's big cities in decline at the end of 2018

1 Feb 2019 BOFIT Weekly 2019/05

- Corporate bond issues in China up again last year
- China's markets open up to international credit ratings agencies
- Venezuela causes headaches for China and Russia

8 Feb 2019 BOFIT Weekly 2019/06

- Even as China opens its financial markets to the world, strict controls on capital exports remain in place
- China allows new debt instruments to boost bank capital adequacy and spur lending

15 Feb 2019 BOFIT Weekly 2019/07

- China's urbanising, greying and soon-to-be-shrinking population
- GDP growth in some Chinese provinces was well below target last year
- Only minor changes in value of China's currency reserves since 2016

22 Feb 2019 BOFIT Weekly 2019/08

- China's current account surplus nearly evaporated last year
- Chinese bank lending breaks records in January
- US-China trade talks continue
- EU intensifies monitoring of Chinese investment

1 Mar 2019 BOFIT Weekly 2019/09

- Trump extends time frame for US-China trade negotiations
- Chinese local government aluminium producer defaulted on off-shore bond payments
- Hong Kong economy hit by slowing growth in mainland China and trade war

8 Mar 2019 BOFIT Weekly 2019/10

- China's National People's Congress starts with warnings on economy, but new growth targets still ambitious
- Chinese tourism abroad continues to soar
- Healthy increase in Finnish exports to China last year

15 Mar 2019 BOFIT Weekly 2019/11

- EU seeks more reciprocity and balance in its China relations
- China's foreign trade contracted in January-February
- Growth in Chinese and Russian arms exports lags growth of other major arms suppliers



## BOFIT Weekly Review – China 2019

22 Mar 2019 BOFIT Weekly 2019/12

BOFIT Forecast for China: uncertainty casts shadow on Chinese growth outlook  
January-February figures show slowing Chinese economy  
NPC rushes through a new investment law

29 Mar 2019 BOFIT Weekly 2019/13

Foreign direct investment flows from China declined again last year; EU investment also down  
Chinese international patent activity almost on par with the US

5 Apr 2019 BOFIT Weekly 2019/14

China's public sector budget deficit unchanged; revenue-side a major concern  
Bloomberg Barclays index to include Chinese government and policy bank debt securities

12 Apr 2019 BOFIT Weekly 2019/15

EU gets reform commitments from China that benefit European firms  
Special audit reveals big problems in China's small rural banks  
Russia strengthens its position as China's biggest oil supplier

18 Apr 2019 BOFIT Weekly 2019/16

Despite monthly fluctuations, China's official GDP growth numbers remain remarkably steady  
China's exports revived in March, while imports continued to contract  
China's capital flows were nearly in balance last year

26 Apr 2019 BOFIT Weekly 2019/17

China moves slowly to dismantle hukou household registration system  
IMF still sees elevated risk for China's financial sector  
Last year saw fewer new apartments built for the Chinese market than in previous years

3 May 2019 BOFIT Weekly 2019/18

China tries to calm critics of Belt and Road Initiative  
China's bourses claw back last year's losses

10 May 2019 BOFIT Weekly 2019/19

Trump announcement of more tariff hikes threatens to derail US-China trade talks  
China's goods imports revive in April  
China presents new measures to help open up its financial markets

17 May 2019 BOFIT Weekly 2019/20

China-US trade war heats up with latest round of tariff hikes  
China's April economic figures weaker than expected  
Yuan drops as trade war between China and the US heats up

24 May 2019 BOFIT Weekly 2019/21

European companies want to see meaningful changes in China's business conditions  
China's current account surplus soared in the first quarter  
Conflicting price data for China's housing markets

31 May 2019 BOFIT Weekly 2019/22

Officials take over troubled Chinese bank  
China's monetary policy not particularly loose this year

## BOFIT Weekly Review – China 2019

7 Jun 2019 BOFIT Weekly 2019/23

- China intensifies anti-US rhetoric
- Another troubled Chinese bank hits the headlines
- The structure of Chinese GDP changes only slowly

14 Jun 2019 BOFIT Weekly 2019/24

- China's falling import figures signal weak domestic demand and shifts in global production chains
- More Chinese working in service jobs
- Chinese inflation accelerates slightly on higher food prices

20 Jun 2019 BOFIT Weekly 2019/25

- Chinese May industrial output growth low by historical standards
- China suspended its market economy status challenge at WTO
- Hong Kong rocked economically and politically by mainland moves

28 Jun 2019 BOFIT Weekly 2019/26

- WTO warns of rising protectionism ahead of G20 summit
- London-Shanghai Stock Connect launches

5 Jul 2019 BOFIT Weekly 2019/27

- Trade talks with the US continue; China promises to speed opening of its markets
- China holds back on additional stimulus measures
- No big changes expected in China's monetary policy

12 Jul 2019 BOFIT Weekly 2019/28

- India set to surpass China as the world's most populous country around 2027
- Coal continues to dominate China's energy palette, even as its relative contribution declines

19 Jul 2019 BOFIT Weekly 2019/29

- Slowdown in China's economic growth continued in the second quarter
- Alternative measures point to lower Chinese GDP growth than official figures suggest
- China's imports fell in the first half

26 Jul 2019 BOFIT Weekly 2019/30

- Most forecasts see China's GDP growth in line with official growth target
- Shanghai stock exchange's new technology board launches
- Yuan exchange rate has been stable for months

2 Aug 2019 BOFIT Weekly 2019/31

- Brief China-US trade talks end without much to show, Trump announces new tariffs
- SAFE releases for the first time ever information on the structure of China's forex reserves
- Record FDI flows into China in the first half of 2019, but China's FDI outflows continue to dwindle

9 Aug 2019 BOFIT Weekly 2019/32

- Impasse as China-US economic relations take a turn for the worse
- More cases of Chinese firms cooking their books
- Hong Kong protests start to hit the economy

16 Aug 2019 BOFIT Weekly 2019/33

- Third Chinese bank rescue of the summer gets underway
- China wants to speed up transfer assets of state-owned enterprises to pension funds
- China's goods imports continued to fall in July

## BOFIT Weekly Review – China 2019

23 Aug 2019 BOFIT Weekly 2019/34

Chinese economic growth continues to slow  
United States postpones September tariff hikes on some Chinese goods until December  
China introduces new reference rate for pricing bank loans

30 Aug 2019 BOFIT Weekly 2019/35

China's first-half 2019 current account surplus reached 106 billion dollars  
Expanding US-China trade war complicates already difficult situation  
China cuts subsidies on rail freight shipments to Europe

6 Sep 2019 BOFIT Weekly 2019/36

Corporate social credit system presents new challenges to firms operating in China  
Strong performance in Finnish goods exports to China in recent months

13 Sep 2019 BOFIT Weekly 2019/37

IMF sees rapid decay in China's government finances  
After strong growth from 2009 to 2015, the shadow banking sector now appears to be shrinking

20 Sep 2019 BOFIT Weekly 2019/38

Despite China's economy slowing, African swine fever causes inflation to accelerate  
China lowers bank reserve requirements  
Declining exports of foreign firms operating in China

27 Sep 2019 BOFIT Weekly 2019/39

European firms demand the elimination of preferential treatment of Chinese state-owned enterprises  
China gets rid of quotas on securities investments under QFII programmes  
Despite yuan promotion policies, international use of the currency remains modest

4 Oct 2019 BOFIT Weekly 2019/40

BOFIT forecast sees Chinese growth slowing at about one percentage point a year from 2019 to 2021  
China's fiscal revenues reduced by tax cuts

11 Oct 2019 BOFIT Weekly 2019/41

Contraction in capital flows in China's balance-of-payments reporting  
China establishes six new free-trade zones  
Growth in the number of new Chinese industrial robot installations halted in 2018

18 Oct 2019 BOFIT Weekly 2019/42

Negligible results in latest round of China-US trade talks  
China's sluggish foreign trade trend continued in September  
Pork prices drive up consumer price inflation in China; decline in producer prices accelerates  
China eases rules for foreign firms operating in the financial markets

25 Oct 2019 BOFIT Weekly 2019/43

China's economic growth continued to slow in the third quarter  
China finally changes rules to allow wider operating scope for foreign banks and insurers  
Growth in real incomes slows in China; huge income disparities persist

1 Nov 2019 BOFIT Weekly 2019/44

Chinese housing prices are rising, but huge regional differences persist  
IMF reports risk exposure of China's financial sector remains large  
No major changes in the yuan's exchange rate since August

## BOFIT Weekly Review – China 2019

8 Nov 2019 BOFIT Weekly 2019/45

China's key policy meeting offered no answers to the country's economic challenges  
Profitability and solidity of China's largest banks stable even as credit risk grows  
Hong Kong enters recession

15 Nov 2019 BOFIT Weekly 2019/46

Rising inflation limits monetary easing in China  
Chinese imports continued to contract in October  
China and 14 other Asia-Pacific nations prepare to sign RCEP trade pact next year

22 Nov 2019 BOFIT Weekly 2019/47

Growth of Chinese retail sales and industrial output slowed in October  
China enjoys good grain harvests; declining meat production boosts imports  
Lower growth in Chinese real wages

29 Nov 2019 BOFIT Weekly 2019/48

Increased risks to financial system worry China's central bank  
China's central bank plans to issue its own digital currency in the future; details still sketchy  
PBoC tightens control of bitcoin and other cryptoasset services  
Capital outflows from China continued in the third quarter

5 Dec 2019 BOFIT Weekly 2019/49

New NBS census data confirms growing importance of China's service sector  
After long hiatus, Chinese government again issues euro-denominated bonds  
Finland's trade deficit with China rises

13 Dec 2019 BOFIT Weekly 2019/50

China's foreign trade remains weak  
Companies in China find it increasingly difficult to service their debts  
Chinese teens romp in 2018 PISA scores

20 Dec 2019 BOFIT Weekly 2019/51–52

Preliminary deal in US-China trade talks avoids tariff hikes  
China's Central Economic Work Conference wraps up with little to show  
More mixed messages about the Chinese economy

## Russia

**Continued low growth forecast for Russian economy this year.** Major forecasts for Russian GDP growth this year run around 1.5 % p.a. The low pace of growth roughly matches that of realised growth during 2017 and 2018.

The forecasts differ in their assumptions about changes in global oil prices from last year (in the first eleven months of 2018, the Brent oil price averaged around 72 dollars a barrel). Several forecasts note diminished sensitivity of Russian GDP growth to oil prices since the adoption of the new fiscal rule and the floating of the ruble's exchange rate. The sensitivity to oil prices remains, however. The fiscal rule limits budget spending mainly through use of a low oil price assumption.

The recovery in household spending is expected to slow with the hike in value-added taxes at the start of this year. Growth is expected to be around 1.5 % this year and just over 2 % in 2020. Fixed investment growth is expected to recover to around 2–2.5 % in 2019 and then accelerate quickly in 2020 on increased government investment. Growth in the volume of Russian exports, which has been brisk in recent years, is expected to slow in coming years to around 2 %. The revival in Russian imports is expected to continue at a rate of a couple of per cent each year.

### Russian GDP growth forecasts, 2019–2020

	GDP		Oil price, USD	
	2019	20	2019	20
Bank of Russia (12/18)	1.2–1.7	1.8–2.3	Urals 55	55
	1.5–2.0	1.8–2.3	Urals 75	75
Ministry of Economy (11/18)	1.3	2.0	Urals 63½	60
World Bank (11/18)	1.5	1.8	71	71
OECD (11/18)	1.5	1.8	80	80
EU Commission (11/18)	1.6	1.8	80½	76½
IMF (10/18)	1.8	1.8	69	65½
Consensus forecast (12/18)	1.5		69	

**State banks dominate Russian banking sector.** A total of 499 banks operated in Russia at the end of October. Despite the high number of bank businesses, the banking sector is highly concentrated and dominated by state-owned banks. The four largest state-owned banks have over 55 % of the banking sector's total assets. In total, the assets of all state-controlled banks represent about two-thirds of the banking sector's assets. Over the last two years, the state presence in the banking sector has increased as several large private banks failed and were taken over by the central bank. Alfa Bank, Russia's largest private bank, controls about 4 % of the sector's total assets.

However, state-controlled banks are a fairly heterogeneous group. For example, Sberbank, which is majority-owned by the central bank, is in a class by itself. Over half of Russian wages and pensions are paid out through Sberbank. The bank controls nearly half of the market share for household deposits and housing loans. Despite economic recession and sanctions, Sberbank's operations have remained highly profitable.

The other three giant state-owned banks (VTB, Gazprombank and especially agriculture bank Rosselkhozbank) have seen earnings strained by their large portfolios of non-performing loans. The government each year has pumped vast amounts of capital into the agriculture bank. This year, for example, it has set aside 40 billion rubles to support Rosselkhozbank.

In addition to commercial banks, government subsidies are granted to fund state development bank VEB. VEB is a 100 % state-owned institution tasked with supporting development of the Russian economy over the long term. VEB's 3.385-trillion-ruble balance sheet is strained by non-performing loans and repayment of foreign currency loans. In the federal budgets of 2017–2019, 150 billion rubles annually have been earmarked for VEB support. Under the government's latest plan, 900 billion rubles are budgeted for VEB recapitalisation and foreign debt repayment in 2019–2024.

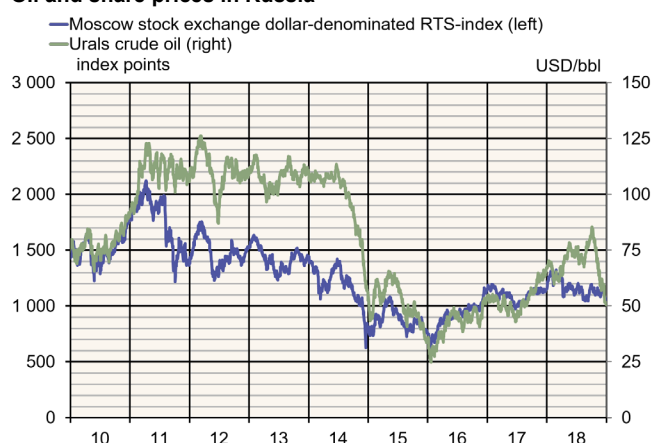
### Largest bank groups as of end-October 2018

	Total balance sheet RUB bill.	Share of banking sector balance sheet %	Share of household deposits %	Share of banking sector loan stock %
Sberbank	26896	30	45	35
VTB	13693	15	13	18
Gazprombank	6259	7	3	8
Rosselkhozbank	3231	4	4	4
Alfa Bank	3185	4	4	4

Sources: banki.ru, Central Bank of Russia, BOFIT.

**Moscow stock exchange's dollar-denominated RTS index declined 8 % last year.** With over half of the RTS general index weighting consisting of companies in the oil and gas sector, it is easy to overlook shifts in the value of companies serving Russia's domestic market. While the shares of oil and gas firms rose by 10 % last year, the prices of firms involved in consumer products and retail trade declined by 27 %. Shares of companies involved with finance were down 34 %. The prices of these shares fell sharply in April and August in reaction to US sanctions announcements. The ruble also dipped during both episodes.

### Oil and share prices in Russia



Source: Macrobond.

## China

### China starts to the year with darkened outlook.

China's economic conditions deteriorated last year as its trade war with the US heated up. Impacts were evident in falling share prices, heightened depreciation pressures on the yuan and financial market spasms. While the triggering factor for market anxiety was the US-China trade war, the roots of the worries are in China's domestic problems such as slowing growth and burgeoning debt.

Share prices on the Shanghai stock exchange fell by about 25 % last year. Overall, China's major stock exchanges lost roughly 2.4 trillion dollars in market capitalisation, an amount roughly equal to 18 % of estimated 2018 GDP. The evaporation of asset value had a knock-on effect that hurt consumer demand as households in China hold an exceptionally large portion of all shares.

The yuan's exchange rate strengthened against the dollar early last year, then began a downward spiral in April as trade tensions increased and the US central bank moved forward with interest-rate hikes. At the end of 2018, the yuan-dollar rate was down 10 % from its April level, even if the decline for all of last year was just 6 %. The yuan gained about 1 % last year against the euro.

The manufacturing purchasing managers' index (PMI) released on the cusp of this year suggests that industrial output growth came to a halt in December, when both the official and Caixin/Markit PMI readings dropped below 50. Chinese growth is increasingly dependent on services, and the services PMI readings are still above the 50 mark.

### Share prices on the Shanghai stock exchange



Source: Macrobond.

**China's economic work conference produces no big changes in economic policies.** In mid-December, mainland China's top decision-makers convened for the annual economic work conference. Reports from the meeting indicated that economic policy is likely to remain on its current course with stimulus supporting economic growth, efforts to improve the quality of growth and industrial development.

The government hopes to deal with slowing economic

growth through tax cuts, reduction in fees paid to officials and increased public spending. The biggest spending increases will go to public services such as education, child care, health care, recreation and culture. A number of large investment projects were mentioned such as construction of 5G networks, development of rural transport infrastructure and up-grading of wastewater treatment facilities.

Even if the "Made in China 2025" programme was not mentioned specifically, the government will strive to increasing the sophistication of technologies used in manufacturing and give greater support to innovation. Another goal is to shutter unprofitable "zombie" businesses, while making state firms generally bigger and stronger. For example, China plans next year to turn the state railways into public corporations. Due to massive investment, China's railways are currently struggling with trillions of yuan in debt while losing tens of billions annually. A science and technological innovation board was proposed for the Shanghai stock exchange.

There was also renewed commitment to opening up the economy to foreign investors. Direct investment by foreign firms in China will be made easier and intellectual property protections improved. Official payments related to imports will be reduced. Immediately after the meeting adjourned, China announced plans to amend the law governing foreign direct investment so that mandatory technology transfers are banned and state-owned enterprises eliminate all excess benefits. The measures as stated respond to many of the foreign grievances aired against China, but it waits to be seen what those measures look like when implemented.

### Slowdown in China's economic growth expected to continue in 2019.

The slowing in China's GDP growth is largely driven by weakening domestic demand. However, foreign demand is also expected to weaken as growth in China's export markets is slowing and no peace in the current trade war with the US is on the horizon. China is expected to press ahead with some stimulus measures though a substantial debt overhang precludes any major stimulus programme.

Bloomberg's compilation of economic forecasts see GDP growth slowing to the range of 6–6.5 % in 2019 and 6 % in 2020. The spread across forecasts is surprisingly narrow. If the forecast in economic growth materialises, China will achieve its target of doubling real 2010 GDP by 2020. Economic forecasts for China suffer from the unreliability of official GDP figures. When official GDP figures fail to reflect reality, forecasts are fundamentally flawed from the get-go.

Looking beyond the traditional business cycle, it is apparent that Chinese economic growth inevitably slows over the longer term. China's population is aging quickly and the labour force is shrinking. Productivity gains are increasingly difficult to achieve and the structural evolution to a service economy makes productivity gains even harder to achieve. Increasing growth in fixed investment is particularly challenging as the investment ratio is already excessively high. The sheer size of the Chinese economy and environmental problems also hamper possibilities for high growth.

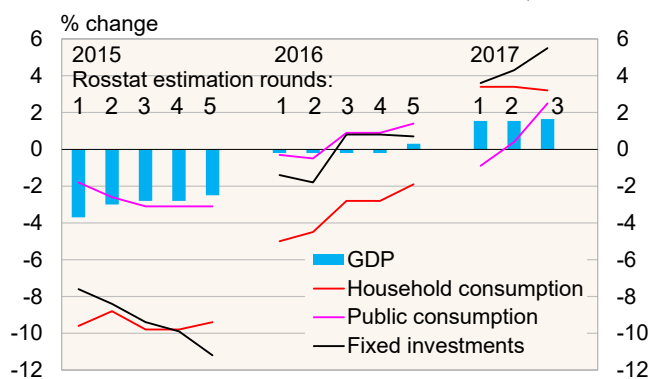
## Russia

**Rosstat released revised figures for GDP and domestic demand in 2016 and 2017.** Rosstat's revised figures for 2017 GDP released in December slightly increase reported growth from 1.5 % to 1.6 %. In the case of 2016, however, the earlier assessment of a slight contraction in GDP was revised up to 0.3 % positive growth. As the fifth revision of the 2016 figure, it should be Rosstat's final estimate under its current statistical practices.

Rosstat data on domestic demand has seen some considerable changes. For example, growth in fixed investment in 2017 was revised up at the end of 2018 to 5.5 % (the figure in last spring was around 3.5 %). Such large adjustments in fixed investment figures were earlier seen in the revision of the 2016 figures. In contrast, Rosstat data on export and import volumes in 2015–2017 has remained unchanged throughout almost all of the estimation and revision rounds.

According to Rosstat's December revision, the 2017 data were adjusted, among other things, to include more precise statistical and accounting data on company operations and the state budget. The latest adjustments in 2016 figures are based e.g. on more accurate data on the use of production inputs and outputs, as well as census of the population involved in farming, which includes some production data.

### Rosstat estimates: real GDP and domestic demand, 2015–2017



Source: Rosstat.

**United States moves ahead on dismantling sanctions on aluminium giant Rusal.** The US treasury department notified Congress on December 19 of its intent to lift sanctions on the energy company EN+, the aluminium producer Rusal and the energy company EuroSibEnergo. The latter two are partly owned by EN+. The companies were added to the US sanctions list last April due to direct or indirect ownership by Russian businessman Oleg Deripaska, who is connected to the Kremlin. The sanctions on Deripaska will not be lifted.

According to the US treasury, the targeted companies have made sufficient efforts to rearrange their ownership structures to warrant delisting. Deripaska already holds practically no direct stake in Rusal and his stake in EN+ declines

from 70 % to 45 %. The stake is to be transferred to VTB, a Russian state-owned bank, and to Deripaska's charitable organisation. Deripaska's stake in EN+ will be further diluted by a swap of Rusal shares for EN+ shares by the mining and commodities multinational Glencore.

The US House of Representatives, now controlled by the Democrats, has until January 17 to block the sanction-lifting. However, scrapping the decision would also require Senate approval, a body with a Republican majority. Democratic politicians have provided most of criticism of the decision to selectively lift sanctions as Deripaska would still be left in control of a large stake in the companies and the connection of these firms to the Kremlin would hardly be reduced. Democrats have demanded postponing the deadline from January 17 but have yet to announce whether they will try to reverse the decision.

There have been pressures to lift the sanctions, because Rusal accounts for over 5 % of primary aluminium production globally. The April sanctions initially caused world prices for aluminium to spike by 20 %, although they have come down since. This may be due to the partial postponement of the sanctions.

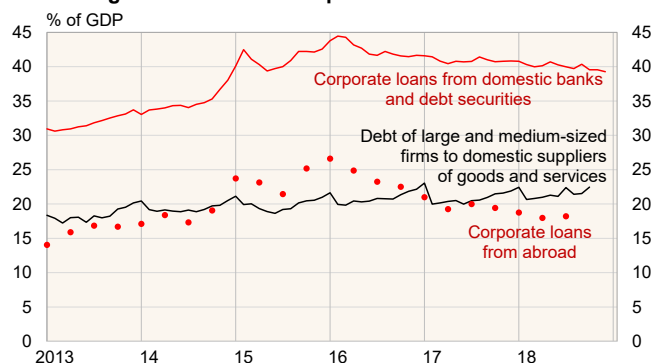
The US treasury department also added more Russian individuals and Russian firms to the sanctions list on December 19. The newcomers are accused of a range of transgressions, including interfering with US elections, poisoning the Skripals and others in the UK and assisting Deripaska.

### In Russian corporate debt increases have occurred in interfirm trade credits.

Rosstat reports that trade debt of large and medium-sized firms to domestic suppliers of goods and services has edged up gradually in recent years. Overdue payments on the trade debt have levelled off this year at around 10 %, down slightly from levels in the wake of the 2015 recession.

The volume of interfirm trade debt now exceeds total corporate foreign debt, which is partly restricted due to sanctions on foreign financing. The trade debt, however, has also increased relative to domestic corporate bank debt, even if bank liquidity is good. The situation reflects weak interest among firms to borrow to finance fixed investments.

### Main categories of Russian corporate debt



Sources: Bank of Russia and Rosstat.

## China

**Glimmers of hope in China-US trade talks.** In trade talks in Beijing held January 7–9, the two countries sought solutions to their inflamed commercial relations. The talks, originally intended to last two days, were extended a day.

No breakthrough was announced. The US reported that the talks had reviewed potential measures to create a level playing field for trade, increased reciprocity and reduced trade imbalances. Topics covered included mandatory technology transfers, intellectual property issues, various trade barriers and cybersecurity. China's propensity to not act on promises made on paper was also raised. The Chinese just said that the discussions were positive and should continue.

If the talks fail to resolve the trade impasse by early March, the US has threatened to raise the level of punitive tariffs from 10 % to 25 % on Chinese products added to the 10 % tariff list last September. The value of imports affected by the hike were worth roughly 200 billion dollars in 2017, or about 40 % of US goods imports from China. In addition, the US last summer imposed a 25 % punitive tariff on imported Chinese goods with estimated value of 50 billion dollars in 2017. China has responded to the additional tariffs by imposing its own counter-tariffs on American products.

**China eases monetary stance.** The People's Bank of China announced last Friday (Jan. 4) it was lowering bank' reserve requirements by one percentage point. The cut will be accomplished in two rounds on January 15 and 25. While the easing frees up roughly 1.5 trillion yuan (220 billion dollars) in bank reserves, only about half will be available to boost banking sector liquidity. The remainder will go to servicing repayments of maturing central bank MLF loans. The PBoC usually tries to increase liquidity ahead of the Chinese Lunar New Year celebrations.

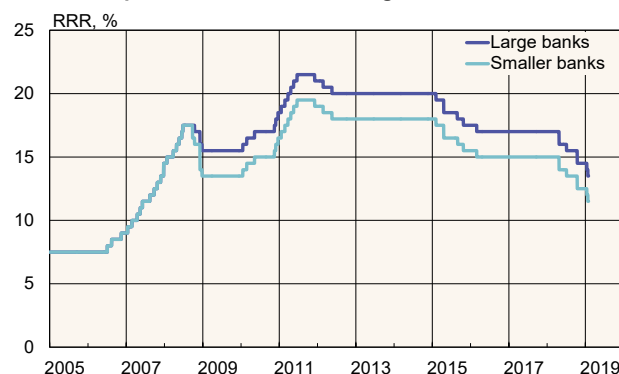
The general level of the reserve requirement ratio (RRR) for large banks falls to 13.5 % and for smaller banks to 11.5 %. China sets RRRs for each bank separately, so they can diverge from the general level. For example, banks whose loan portfolio consists a lot of so called small corporate loans are entitled to a lower RRR than other banks. At the start of this year, the PBoC changed its definition of small corporate loans to loans less than 10 million yuan (1.5 million dollars) per firm. The earlier ceiling was 5 million yuan.

China has sought to refocus monetary policy to ease the access of small firms to financing. At the end of December, the PBoC launched a new targeted credit instrument that allows large banks the seek long-term central bank financing at slightly cheaper rates. The banks entitled to cheaper financing and how much were not specified.

It is difficult to monitor Chinese monetary policy, which is implemented through a variety of targeted monetary instruments for which exact information is not released. The PBoC sought to head off any speculation of a broad-based stimulus by stressing that a drop in the reserve requirement does not

signal a shift in monetary policy, even if the measure was said to aim to support growth.

### Reserve requirements for China's large and small banks



Source: Macrobond.

**China implements fiscal stimulus measures.** The slowdown in economic growth has forced China's top decision-makers to implement further stimulus measures on the fiscal front. The budget deficit will be raised and local governments given access to additional off-budget debt financing.

According to media reports, China plans to raise this year's budget deficit target at the March meeting of the National People's Congress from last year's 2.6 % to 2.8 % of GDP. Much of the burgeoning deficit is due to increased budget spending on stimulus measures and tax cuts. Official figures for realised public sector budget deficits in recent years have been running in the range of 3–4 % of GDP, while the IMF estimates that China's actual budget deficit is somewhere around 10 % of GDP. Public sector debt is currently estimated to be around 70 % of GDP, so additional debt-fuelled stimulus carries serious risks.

As part of the stimulus programme, local governments will be allowed to increase the amount of bond issues and accelerate their timing so that construction of infrastructure projects can get underway and support economic growth. The *South China Morning Post* reports that local governments have already been granted permission to issue new bonds with a total value of 1.39 trillion yuan (200 billion dollars). The value of the total bond quota this year is estimated to rise to about 3 trillion yuan (up from 2.18 trillion yuan last year). Most of these local government bonds are "special purpose bonds," where repayment of the bond is based on revenue generated by the financed project's profits. Such projects and their financing are not included in local government budgets. The remainder of the bond quota consists bonds meant for normal budget financing.

Due to worsening debt problems, it is unclear whether commercial banks have any appetite for further increasing their local government bond portfolios. The unwillingness reflects the large number of projects financed with special bonds that have failed to generate enough revenue to pay back the bond. As economic growth slows, such problems are likely to increase.



## Russia

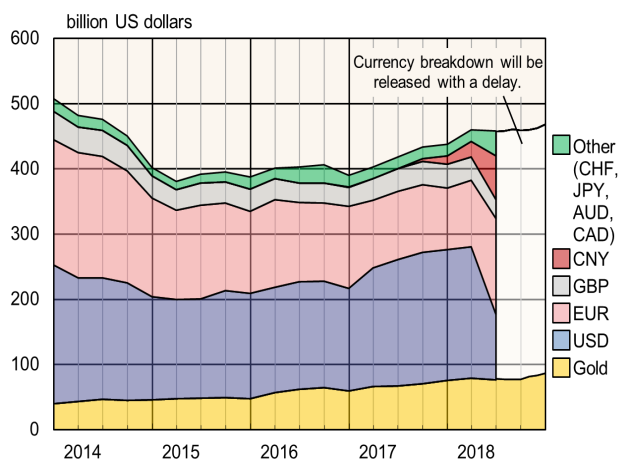
**Russian oil fund shrank in 2018, but central bank foreign currency reserves grew.** The National Welfare Fund, where the state's excess revenues from oil and gas taxes are deposited, stood at 58 billion dollars at end of 2018. The size of the Fund declined by 11 % from the end of 2017.

Last year's budget surplus will be transferred to the Fund later this year. According to preliminary figures, the Fund corresponded to just under 4 % of gross domestic product at the end of last year. Under the 2019 budget, the Fund's size should rise to around 7.5 % of GDP by the end of this year. The Fund should then continue to accumulate assets so that in 2021 it equals 12 % of GDP. The large savings should help Russia weather weaker economic performance in coming years.

Investments of the National Welfare Fund fall into two categories. The first category consists of assets that are invested in liquid, high-grade sovereign bonds of OECD countries. The second category includes deposits at the state development bank VEB, which then lends the assets forward to fund development projects. At the end of last year, 58 % of the National Welfare Fund's assets were invested in assets of the first category. Of that, 45 % was held in debt securities denominated in euros, 45 % in US dollars and 10 % in British pounds.

The Central Bank of Russia's foreign currency and gold reserves increased by 8 % last year to a value of 468 billion dollars. The share of gold in the reserves rose last year, and currently stands at about 19 % of assets. Russia's reserves are now sufficient to cover about 22 months' worth of goods imports. By this measure, Russia's reserves are substantial by international standards, especially given the small size of Russia's foreign debt. Russia's foreign currency and gold reserves are the world's fifth largest after China, Japan, Switzerland and Saudi Arabia.

### Composition of Russia's currency and gold reserves



Sources: Central Bank of Russia, BOFIT.

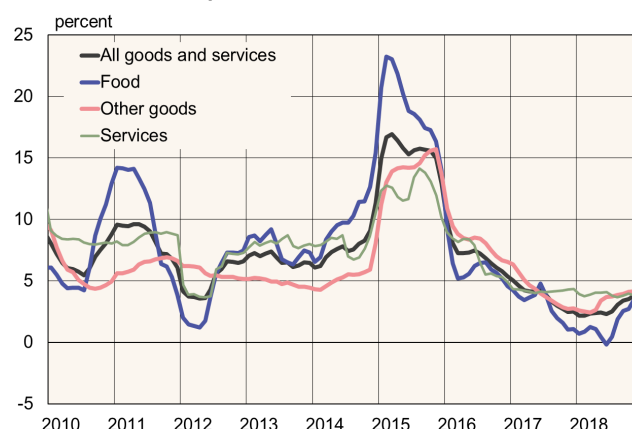
There was a notable shift in Russia's currency reserves last year. The amount of dollar assets declined sharply in the second quarter, while holdings in euro and yuan assets soared. The Central Bank sold off half of its 200 billion in dollar holdings in the second quarter. According to several analysts, the Central Bank was seeking to become better hedged against possible US sanctions. At the end of June 2018, euro made up 32 % of Russia's currency and gold reserves, dollar 22% and yuan 15 %. According to the International Monetary Fund, the average composition of global currency reserves was quite different. At the end of June 2018, dollar made up 62 % of them, euro 20 % and yuan just under 2 %.

**Consumer price inflation accelerated in Russia.** The year-on-year change in consumer prices picked up in December to 4.3 %. In early autumn, consumer price inflation was running at 3.5 % and in November was still well below 4 %. The price spike exceeded all major forecasts, which had expected inflation to stand at 4 % at the end of the year. Prices rose by 0.8 % from November to December. This was much higher than in two previous years.

Food prices saw particularly sharp increases, reaching 4.7 % y-o-y at the end of December. Excluding alcohol, food prices were up more than 5 % y-o-y in December. From November to December, they climbed 2 %. The end-of-year spike in food prices was due mainly to higher prices for fruits, greens and root vegetables, which soared by 9 % in December. This is a rather exceptional change.

The year-on-year change in the prices of non-food goods and services was about 4 % at the end of December. As in previous months, the rise in prices of non-foods and services was quite modest, suggesting that the general hike in the value-added tax from 18 % to 20 % at the start of this year had almost no impact on prices before it came into force. Rosstat reports that consumer prices were up by 0.7 % in the first two weeks of 2019, i.e. the fastest price rise since July 2015. The value-added tax hike does not apply to food, which is subject to a 10 % rate.

### Russian consumer price inflation



Source: Rosstat.

## China

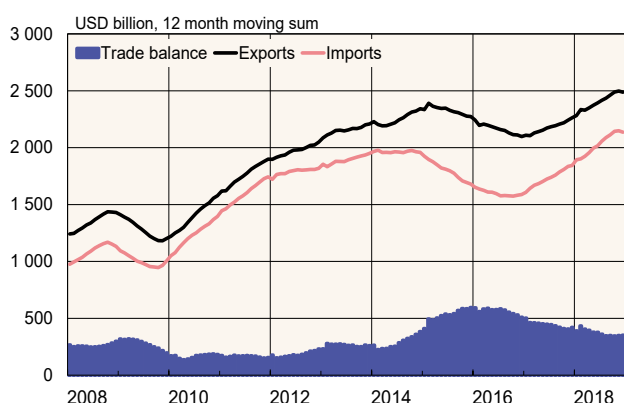
**China's export and import growth turned negative in December.** Following strong growth in the early autumn, growth of China's foreign trade slowed significantly already in November. In December, the value of goods exports measured in dollars was down 5 % y-o-y, while imports declined by nearly 8 % y-o-y. The value of exports for all of 2018, however, was still up by 10 % and the value of imports up 16 % from 2017. The goods trade surplus fell from about 420 billion dollars in 2017 to around 352 billion dollars last year.

China saw sluggish export growth in all of its main markets. Exports to the United States, which accounts for 18 % of China's exports, dropped by 4 % in December. Growth in exports to the EU (17 % share) also slowed over the past two months. December exports to the EU matched the December 2017 level. Growth in exports to Japan (6 % share) were down 1 % y-o-y, while exports to Hong Kong (12 % share), which is an important hub of re-exports, declined 25 % from its December 2017 level. The trends reflect both the impact of the US-China trade war and uncertainty in the global economy.

The sharp slowdown in import growth reflects both the general slowing of the Chinese economy and global developments. While December commodity prices were slightly lower on average than in December 2017, most of the fall in imports stemmed from other causes as imports from the US (-36 %), South Korea (-18 %) and Japan (-11 %) all declined much more than the average. Imports from the EU were down 3 % y-o-y.

Besides China's weak domestic demand, the drop in imports reflects developments in international production chains. Imports and exports related to processing trade for November and December were much weaker than average.

### Chinese foreign trade in goods



Source: CEIC.

**Signs of deteriorating employment conditions in China.** With the slowdown in economic growth, the employment situation appears to be weakening. While official unemployment figures consistently show urban unemployment just

below 5 %, other information suggest the employment situation has deteriorated substantially since summer.

China's official purchasing managers' indices (PMI), which are based on company surveys, and their sub-indices concerning employment show that the employment situation in both the manufacturing and service sectors deteriorated substantially during the autumn. Readings for both sub-indices are now around 48. Indeed, only in the construction sector the employment sub-index is still above 50. The last time the employment situation in the manufacturing and service sectors was this weak was in 2016, when China's actual economic growth is estimated to be much lower than official figures suggested.

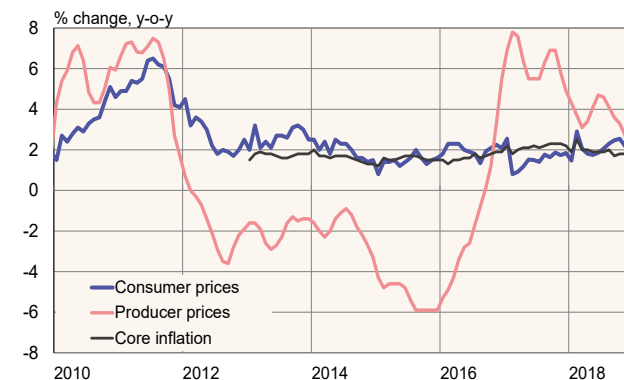
The deteriorating employment situation is further evidenced by official promises of extraordinary efforts to support employment. China's official news agency *Xinhua* reports that the government is considering cuts in social security contributions and reimbursing corporations that refrain from laying off workers. Securing employment was declared a top priority of 2019 at the Central Economic Work Conference held in Beijing in December. Media reports claim conference participants also agreed to lower this year's GDP target from last year's "about 6.5 %" to a range of 6-6.5 %.

**Chinese consumer price inflation held steady at around 2 % last year.** Consumer prices on average were up 2.1 % y-o-y in 2018, which meant that China's leadership achieved inflation below last year's target ceiling of 3 %. 12-month inflation was 1.9 % in December.

Core inflation, with excludes food and energy, was 1.8 % in December and 1.9 % for all of 2018. Prices of food, which has a 32 % weighting in the consumer basket of items used to calculate China's consumer price index, showed little variation last year.

Producer prices have fluctuated more than consumer prices. In December, the on-year rise in producer prices slowed to 0.9 %. Producer prices declined from November to December. Producer prices fell every year from 2012 to 2016. Despite a couple years of increase, the producer price index in December was at the same level as it was six years ago.

### Chinese inflation trends



Source: Macrobond.

## Russia

### Russian export earnings up significantly in 2018.

Preliminary balance-of-payments figures for the fourth quarter of 2018 show Russian revenues from exports of goods & services were up nearly 20 % y-o-y even if the growth was no longer as fast as in the previous quarter. For the entire year, export earnings were up by over 20 % as revenues from energy exports ballooned by over 30 % on strong export prices.

Russia's spending on imports of goods & services in the second half of last year was unchanged from 2H17. For all of 2018, spending on imports was up by a few per cent. The spending of Russian travellers abroad was up by about 10 % for the year although the growth stopped in the fourth quarter. The overwhelming underlying factor was ruble depreciation. Total spending on imports of goods & services in the second half of last year roughly matched 2008 and 2010 levels.

The gap between export earnings and spending on imports widened in 2018 to produce a whopping current account surplus of about 7 % of GDP – Russia's largest current account surplus since 2006.

The net capital outflow from the private sector increased substantially in 2018. The flow of direct investments from abroad into the Russian corporate sector (excl. banks) dried up almost entirely, while FDI outflows from Russia remained rather notable. Similar to 2017, banks' capital outflow abroad mostly arose from decreases in their foreign liabilities.

### Russian balance-of-payments key items, 2016–2018

	USD billion			% of GDP		
	2016	2017	2018	2016	2017	2018
			(preliminary)			(preliminary)
<b>Current account</b>	<b>25</b>	<b>33</b>	<b>115</b>	<b>1.9</b>	<b>2.1</b>	<b>7.0</b>
- Exports (goods & services)	332	411	509	25.6	26.1	31.0
- Imports (goods & services)	266	327	345	20.5	20.7	21.0
Trade balance (goods)	90	115	194	7.0	7.3	11.8
- Exports	282	354	443	21.7	22.4	27.0
- Imports	191	238	249	14.8	15.1	15.2
Services trade balance	-24	-31	-30	-1.8	-2.0	-1.8
- Exports	51	58	65	3.9	3.7	4.0
- Imports	75	89	96	5.8	5.6	5.8
Other current account items	-42	-51	-49	-3.2	-3.2	-3.0
<b>Financial account &amp; net error:</b>	<b>-16</b>	<b>10</b>	<b>-76</b>	<b>-1.2</b>	<b>-0.7</b>	<b>-4.6</b>
Government (excl. central bank)	4	12	-5	0.3	0.8	-0.3
Private sector total (A+B)	-19	-25	-68	-1.4	-1.6	-4.1
A. Banks	1	-23	-31	0.1	-1.5	-1.9
B. Other private, incl. net errors	-20	-2	-37	-1.5	-0.1	-2.2
- Direct investment	11	-9	-24	0.8	-0.6	-1.5
- to Russia	31	27	2	2.4	1.7	0.1
- from Russia	20	36	26	1.6	2.3	1.6
- Portfolio investment	-4	-10	-2	-0.3	-0.6	-0.1
- to Russia	0	-4	-1	0.0	-0.3	-0.0
- from Russia	4	5	1	0.3	0.3	0.1
- Foreign currencies in cash *	5	6	7	0.4	0.4	0.4
- Fictitious transactions	1	0	0	0.0	0.0	0.0
- BoP net errors and omissions	-5	2	1	-0.4	0.1	0.0
- Other items under B	-27	8	-19	-2.1	0.5	-1.2

\* Positive value = decrease in the stock of foreign currencies in cash

Source: Central Bank of Russia.

**Russian foreign debt declined last year.** Russians owed roughly 450 billion dollars to foreign (non-resident) entities

at the start of this year. Russia's foreign debt, measured in dollars, fell by 12 % in 2018.

While half of Russia's foreign debt is denominated in dollars and a quarter in rubles, nearly two-thirds of government foreign debt is denominated in rubles. Measured in dollars, the debt has decreased due to debt repayment and depreciation of the ruble. Foreigners have reduced their investment positions, especially in ruble-denominated government debt.

The government accounts for 10 % of the country's foreign debt, banks another 19 % and non-bank corporates nearly 70 %. Especially banks' foreign liabilities are counterbalanced by their assets held abroad and receivables from abroad.

Besides foreign debt, the stock of direct investments that have flowed from abroad into Russian firms (incl. banks) was about 520 billion dollars at the beginning of October.

### Topics at Moscow Gaidar Forum feature future economic growth and national projects.

At the annual mega-get-together for economic discussions last week, economy minister Maxim Oreshkin noted that Russian economic growth will not be driven by global growth but will rather depend on domestic measures and fixed investments. The ministry's forecast expects GDP growth to accelerate from its current pace of around 1.5 % to over 3 % in 2021, if investment growth picks up to over 7 %. The economist panel at the forum saw that the fixed investments would have to come especially from private firms. They were assessed to account for about 70 % of investments. The panel included outlooks anticipating GDP growth of some 1.5–2 % for the next few years.

Alexei Kudrin, Russia's finance minister throughout the 2000s and currently chairman of the Accounts Chamber, said that it would be extremely difficult to achieve growth above 3 %. He noted that the outlook for domestic demand was insufficient for that and stressed the need to improve the export capabilities of Russian industries. He further emphasised the need to improve business market confidence through systemic reforms such as reforming public administration, reducing the role of the government in the economy and the burden on firms caused by officials' actions as well as devolving own authority to regional administrations.

Kudrin said that such reforms are not included in the national projects launched, thus denoting that the projects will not be enough to reach the country's growth and investment goals (the 13 national projects cover areas such as infrastructure, productivity, education and health care). Kudrin pointed out the high complexity of administrative structures for national projects, programmes and target plans. In addition, finance minister Anton Siluanov noted the need to coordinate state projects at the federal and regional levels, pointing out that over half of the tasks included in the national projects is in the competence given to regional and local authorities. An amount equivalent to nearly 4 % of GDP will be channelled to national projects during 2019–2024. Of that amount, over one quarter is additional funding for projects set forth in president Putin's May inauguration Decree.

## China

**China's economy continues to slow.** Official figures show Chinese GDP growth slowed further last year to 6.6 % p.a. from the revised 2017 growth of 6.8 %. In the fourth quarter of 2018, the pace of on-year growth officially slowed to 6.4 %. China last experienced such weak growth figures in the first quarter of 2009, when the impacts from the global financial crisis hit the Chinese economy hardest. In nominal terms, GDP grew last year by 9.7 % to around 90 trillion yuan (13.6 trillion dollars, 11.5 trillion euros).

Several indicators suggest a sharper slowing in growth than the official figures imply. The weakness in fixed investment is particularly difficult to square with official GDP figures, even with the obvious litany of problems with investment figures themselves. Fixed investment officially correspond to about 40 % of Chinese GDP, while real growth in urban-area fixed asset investment (FAI, which does not correspond to fixed investment in the national accounts) last year was only about 1 %. Because the net impact of foreign trade on economic growth was even negative, it is hard to see domestic consumption alone propping up the official GDP growth figures. Retail sales, a key measure of consumer demand, increased by about 7 % last year in real terms, down from 9 % in 2017. Thus, the reported mere 0.2 percentage point slowdown in GDP growth from 2017 seems suspect.

While GDP demand figures have yet to be released, the NBS reports three-quarters of 2018 growth came from domestic consumption. Output-side figures show services slightly increased their relative share of GDP to just over 52 %, while the combined share of manufacturing and construction was 41 % and primary production 7 %.

**China's ratio of bank credit to GDP continues to rise.** China's bank lending stock rose by 13 % y-o-y in December. However, monetary easing last year failed to significantly boost bank lending and economic growth as growth in the bank credit stock has averaged 12–13 % p.a. since 2016. Still, growth was considerably higher than nominal GDP growth (10 %). As of end-2018, the bank credit stock corresponded to 152 % of GDP (137 trillion yuan, 20 trillion dollars).

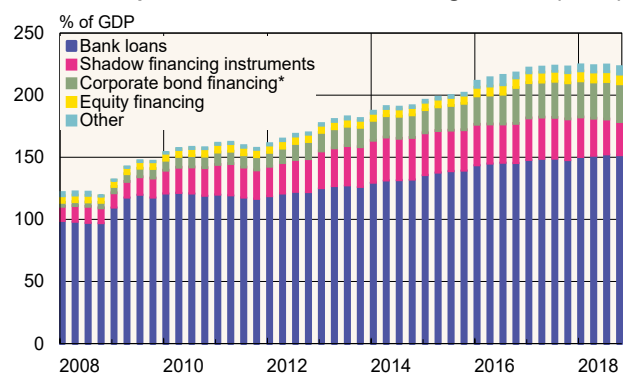
The stock of bank lending to households still grew by 20 % last year, despite deceleration due to a smaller rise in apartment prices. Household loans represented 39 % of all new bank loans issued last year and 28 % of the total bank credit stock. Excluding loans to households, the stock of bank lending rose by 11 % last year.

Central bank figures suggest that the stock of shadow-banking sector credit instruments (entrusted loans, trust loans and banker's acceptances) shrank by 11 % last year to 27 % of GDP (24 trillion yuan, 3.5 trillion dollars).

The ratio of corporate bonds to GDP was 30 %. That share does not include bonds issued by the government or banking sector, which are by far the largest bond issuers in China. Local governments have increasingly turned to issuance of so-

called special-purpose bonds to finance infrastructure projects. The central government has raised special-purpose bond quotas for local governments to allow them to reduce their off-balance-sheet financing through local government financial vehicles. Last year, the PBoC added local government special-purpose bonds to be included in its aggregate financing statistics arguing that special-purpose bonds substitute for other financing formats such as bank loans and corporate bonds. The amount of special-purpose bonds on issue has more than doubled since early 2017. They now represent over a quarter of bonds on issue.

### Non-bank corporate and household financing sources (stock)



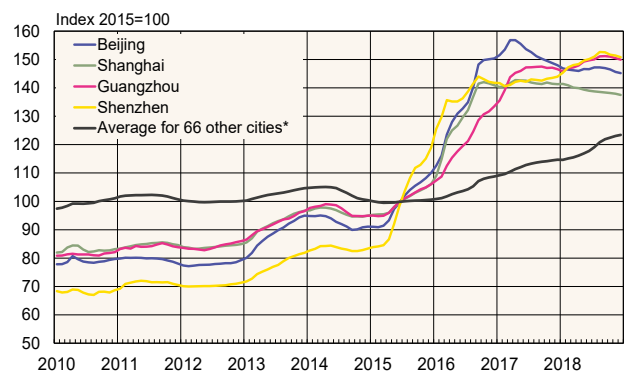
\* From 2017 onwards bond financing includes local government special bonds

Sources: PBoC, CEIC and BOFIT.

**Apartment prices in China's big cities in decline at the end of 2018.** Figures from the National Bureau of Statistics and survey data produced by the Soufun housing real estate portal show that apartment prices in Beijing, Shenzhen and Guangzhou (prices per square metre of floorspace) went into decline in the latter of 2018. Shanghai apartment prices fell all last year. Even with the price drops, apartment prices in big cities are stratospheric relative to personal incomes.

Risks to the real estate sector persist. Many construction companies are deeply in debt. A significant adjustment in housing prices would spell trouble for builders and households, and ultimately the banks that finance them.

### Average apartment prices in China's cities



\*Average weighted with each city's population in 2010.

Sources: NBS, CEIC and BOFIT.

## Russia

**United States Treasury lifts sanctions on Russian aluminium giant Rusal.** On Sunday (Jan. 27) the Treasury lifted sanctions on the energy company EN+, the aluminium producer Rusal and the energy producer EuroSibEnerg. EN+ owns large stakes in Rusal and EuroSibEnerg.

The companies were added to the sanctions regime against Russia in April because sanctioned business magnate Oleg Deripaska, who has close ties with the Kremlin, directly or indirectly held substantial stakes in all three companies. The sanctions were lifted after Deripaska's holdings in the companies were transferred to the Russian VTB Bank and other entities in order to reduce his overall holdings below 50 %. The sanctions on Deripaska himself remain in place.

Because the divestment has little effect on the Russian government's ties to these companies, some factions in the US Congress sought to oppose the lifting of sanctions. However, they were not able to gather enough support to block it.

**Russian industrial output grew at a moderate pace last year.** Industrial output in 2018 was up 2.9 % from the previous year. However, seasonally-adjusted time series have shown little indication of growth since last spring.

Output of extraction industries grew faster last year than other industries, increasing by 4.1 % from the previous year. Oil production grew strongly towards the end of the year after the Organization of the Petroleum Exporting Countries (OPEC), Russia and several other countries agreed on a looser interpretation of their production quotas. Production should decline this year, however, with the introduction of lower production ceilings.

Manufacturing growth slowed towards the end of last year. Last year, production grew 2.6 % from the previous year, but in December, it was at the same level as in previous December. Different manufacturing branches have grown quite evenly. However, pharmaceutical and forest industries have grown somewhat faster, while metals and auto industries somewhat slower.

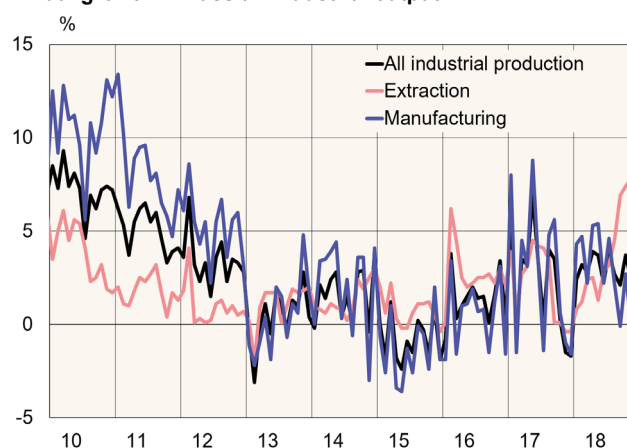
Construction activity statistics have been revised by the Russian Statistics Service to an exceptional degree. December figures showed that construction activity last year was roughly on the same level as the previous year. Revised figures released in January show construction had grown by 5.3 %. Especially the figures for northern regions involved in oil and gas production were revised sharply upwards. Explanations for the revision have been mostly general in nature.

The volume of goods transport last year was 2.9 % larger than in previous year. Almost half of transports go through pipelines and almost half on rail. Transit freight is not significant enough to much affect the growth figures. The Power of Siberia natural gas pipeline will not increase the overall pipeline transmission volumes until next year.

Agricultural output was down 0.8 % from 2017. Grain harvests were 16.7 % lower than in 2017, but still at a level well

above the average of the past decade. Wheat accounts for two-thirds of the grain harvest. Because Russia exports quite a lot of wheat, the smaller crop is likely to affect global wheat prices. For many countries in the Middle East, the fertile southern steppes of Russia are a major wheat source. It was still unclear last autumn whether Russia would limit grain exports to hold down domestic prices. It now seems that idea is off the table for now.

**Annual growth in Russian industrial output**



Sources: Rosstat, Macrobond.

**Central Bank of Russia resumes forex-buying mandated by fiscal rule.** On January 15, the Central Bank restarted its foreign currency buying tied to the government's fiscal rule after a five month hiatus (for more, see BOFIT Weekly [2018/35](#) and [2018/38](#)). Last Friday (Jan. 25), the CBR announced it would today (Feb. 1) commence its foreign currency purchases under the fiscal rule that were postponed in last fall.

Since the beginning of 2017, the CBR has purchased under the fiscal rule daily a pre-announced amount of foreign exchange on behalf of the finance ministry. During the period from January 15 to February 6 this year, the finance ministry is using, on average, 15.6 billion rubles (240 million dollars) a day for the forex buys, which in total corresponds to about 265 billion rubles (4 billion dollars). The finance ministry has yet to announce the schedule for the next forex buy.

The CBR will make up for its postponed foreign currency purchases under the fiscal rule gradually over the 36 months. These purchases will increase daily forex purchases under the fiscal rule by 2.8 billion rubles. The CBR may temporarily halt the purchase programme as needed.

Market observers note that the currency-buying in line with the fiscal rule could cause a slight depreciation of the ruble. Large impacts are not expected, however, as the daily forex-buying under the fiscal rule accounts for a small fraction of the forex market's daily turnover. Since the resumption of forex buying, the ruble's exchange rate against the dollar and euro has appreciated just over 1 % (as of February 1, USD 1= RUB 65.5; EUR 1= RUB 75.0).

## China

### Corporate bond issues in China up again last year.

People's Bank of China figures show that at the end of 2018, the stock of bonds on issue in the country totalled 86 trillion yuan (12.5 trillion dollars, equivalent to 96 % of GDP). The stock of bonds on issue increased last year by 16 % y-o-y. Bond issues were up 7 % y-o-y. New corporate bond issues increased last year by nearly 40 %, after contracting more than 30 % in 2017.

Banks account for 38 % of the bonds on issue (including policy banks), non-bank corporations 24 %, local governments 21 % and the central government 17 %. The stock of bonds issued by foreign institutions in mainland China grew by over 50 % last year, but was still just 155 billion yuan (23 billion dollars). At the end of September 2018, mainland China bonds held by foreign investors amounted to 1.75 trillion yuan. The volume rose by 58 % y-o-y, but was still just 2 % of China's bond market overall.

China has started to allow bond defaults in recent years, though the authorities still try to use various arrangements to avoid open defaults of troubled firms. The credit rating company Fitch reports that the number of bond payment defaults in mainland China rose from 25 in 2017 to 117 last year. The total value of payment defaults of 45 firms last year was 111 billion yuan (16 billion dollars). The amount includes four state-owned enterprises. The payment defaults have shed light on China's complex financing arrangements and brazen misrepresentation of company finances.

According to Fitch, rising risk pushed investors last year to prefer government bonds or bonds of firms with high-quality credit ratings. This was also seen in the widening interest rate gap between the bonds of firms with poor and good credit ratings. On Tuesday (Jan. 29), the interest rate on the one-year government bond was 2.4 %, the yield on the highest rated corporate bond (AAA+) was 3.2 % and the lowest high-quality corporate bond (AA-) 5.7 %.

**China's markets open up to international credit ratings agencies.** At the end of January, the People's Bank of China granted American credit rating agency S&P Global a licence to begin rating the creditworthiness of bonds traded on China's interbank markets. The ratings agencies Moody's and Fitch are likely to follow.

The government hopes that the presence of international ratings agencies will encourage competition, bring credibility to the credit assessments of Chinese firms and create a new wave of foreign investors in China. Local credit assessment agencies are currently seen as handing out excessively high credit scores to their clientele. Some of the pressure to let the major players onto the Chinese market also comes from the current trade war and China's growing need to finally deliver on its commitments to open its markets to the world.

The Chinese operating environment is difficult for credit ratings agencies. In recent months, for example, there have

been several situations where companies that appeared solvent on paper could not service even minor debts.

### Venezuela causes headaches for China and Russia.

Amidst Venezuela's catastrophic economic crisis and political impasse, opposition leader Juan Guaidó declared himself interim president on January 23. The move occurred just weeks after president Nicolas Maduro was inaugurated to his second term. The United States and several Latin American countries immediately recognised Guaidó, while China and Russia said they backed the Maduro administration. Venezuela offers both China and Russia a strategic foothold in the Western Hemisphere, an opportunity both countries have pursued through lavish financing to Venezuela.

Several sources report that since 2008 China has lent Venezuela roughly 60–70 billion dollars to fund infrastructure and oil projects. Repayment of these loans is tied largely to oil supply contracts. Just last September, China granted Venezuela a 5-billion-dollar loan. Venezuela is currently thought to owe China something the range of 20–25 billion dollars. Venezuela earlier was China's seventh largest oil supplier, accounting for about 5 % of China's oil imports. China's imports from Venezuela declined by nearly a quarter last year, lowering Venezuela's share of Chinese oil imports to just 3.6 %.

While China's financing to Venezuela dwarfs the Russian input, the Russian government and the state-owned oil company Rosneft have granted credit to Venezuela since 2006 amounting to at least 17 billion dollars in total. Most of this credit is likely tied to oil supplies. Last November, the government continued to provide financing to Venezuela by agreeing to reschedule a loan for more the 3 billion dollars. So, this is the minimum outstanding amount Venezuela currently owes to Russia. By its own reports last autumn, Rosneft's claims on the Venezuelan government exceeded 3 billion dollars. Russia and China also hold stakes in the Venezuelan oil industry.

Figures from the Stockholm International Peace Research Institute (SIPRI) show Russia and China began exporting arms to Venezuela in 2006. During 2006–2016, Russia accounted for 74 % of arms sales to Venezuela. China, with an 11 % share, was the second largest supplier of arms to the country. Venezuela's arms imports appear, however, to have collapsed around 2015.

Venezuela's actual debt situation is very confused and the country no longer has the ability to service its debts. Reuters puts Venezuela's foreign debt at about 140 billion dollars, of which 60 billion dollars are government sovereign bonds or bonds issued by the state-owned oil company PDVSA. The remainders are credits granted by foreign governments and international institutions. Even if the country has the largest oil reserves in the world, its situation has deteriorated with the decline of oil prices in dollars, decreased production and the collapse of the bolivar. The situation also complicates debt repayment to China and Russia. The US sanctions imposed on Venezuela's oil industry and oil exports on Monday (Jan. 28) will only aggravate debt crisis of the Maduro administration.

## Russia

### Russian economy's growth rate accelerated in 2018.

Rosstat's first GDP growth estimate for all of 2018, released on Monday (Feb. 4), surprised both Russian and foreign analysts. Rosstat estimates Russian GDP last year grew by 2.3 %. Preliminary figures for the first nine months of 2018 indicated GDP growth of 1.6 %, and available monthly data indicated no significant pick-up in growth.

One factor in the higher-than-expected growth figure was a significant revision of the construction activity data. It appears that a large share of construction work at the massive LNG facility on the Yamal peninsula was only booked in the end of 2018.

Despite the positive surprise, the acceleration in growth has not been broad-based. Growth in private consumption last year slowed to 2.2 % (3.2 % in 2017) and growth in public consumption remained at just 0.9 % (2.5 %). Preliminary figures indicate that fixed investment rose last year by only 2.3 % (5.5 %). The positive surprise in GDP growth in 2018 was largely due to increase in net exports. The growth in the volume of exports rose last year to 6.8 % (5.0 % in 2017), while growth in the volume of imports slowed to 3.8 % (17.4 %). First estimates of GDP are, however, still subject to several rounds of revisions.

### Higher oil prices boost surplus of Russian federal budget.

2018 budget revenues were up 29 % last year. Much of the gain came from higher revenues from oil & gas taxes, which saw a boom especially in autumn. The price of Urals-grade crude oil in early autumn hit 78–79 dollars a barrel, while weakening of the ruble's exchange rate raised the ruble-denominated oil price to an all-time high. Revenues from oil & gas revenues accounted for 46 % of all federal budget revenues in 2018, with the ratio of revenues from energy products to GDP rising to nearly 9 %. During the 2011–2014 peak period, the ratio was only slightly higher (9.3 %).

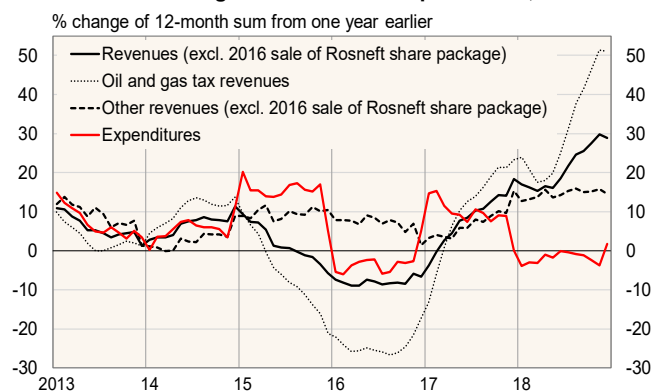
Growth in other budget revenues accelerated to over 14 % last year mainly thanks to a 17 % increase in value-added tax revenues. VAT revenues accounted for 58 % revenues of other than oil & gas revenues. VAT's share of other revenues has not been this high in roughly one and a half decade. Revenues from corporate profit taxes and dividends from state-owned enterprises also increased substantially.

Federal budget spending rose in nominal terms by just 2 % in 2018. Defence spending declined slightly. Spending on domestic security saw large increases to the agencies responsible for security, prosecutorial and investigatory functions. The federal budget covers nearly all of these spending items.

The federal budget surplus rose in 2018 to a level equal to 2.7 % of GDP. The last time the federal budget showed such a large surplus was in 2011. Federal cash reserves also rose significantly in the second half, finishing the year at nearly 10 % of GDP. The sum includes liquid reserve fund assets (i.e. National Welfare Fund). The boost in assets was partly driven by

oil prices well in excess of the basic calculation price defined under the fiscal rule (last year's calculation price was just under 41 dollars a barrel). The Russian Federation last year issued ruble bonds equivalent to roughly 1 % of GDP. Repayments of ruble-denominated bonds corresponded to 0.5 % of GDP.

### Russian federal budget revenues and expenditures, 2013–2018



Source: Russian Ministry of Finance

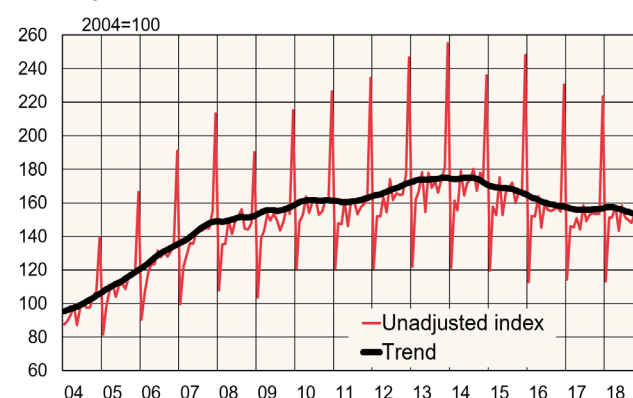
### Russian real disposable income still well below 2014 level.

Russian real disposable household incomes last year were essentially unchanged from 2017. Revenues initially showed gains in the first half of the year, only to decline in the second half. In the post-Soviet era, the peak in real incomes was reached in 2014. At the end of 2018, real disposable incomes were about 13 % below the 2014 level.

Although disposable incomes have generally been on a downward trend over the past four years, real wages started growing already at the beginning of 2016. In addition to wages, disposable income also includes a variety of social entitlements such as pensions, as well as capital income and an assessment by the Russian Statistics Service of wages paid under the table.

The nominal average monthly wage in Russia last year was 43,400 rubles, up 11 % from 2017. In euro terms, this makes 585 euros, a decrease of over 1 % from 2017.

### Real disposable income of Russians, 2004–2018



Sources: Rosstat, BOFIT.

## China

**Even as China opens its financial markets to the world, strict controls on capital exports remain in place.** At the end of January, the China Security Regulatory Commission (CSRC) published draft legislation geared to increasing foreign investment in Chinese securities. The proposal calls for consolidating the current investment quota system, streamlining permitting of foreign agents and offering a wider selection of investment instruments.

The draft bill would integrate the qualified foreign institutional investor (QFII) and renminbi qualified foreign institutional investor (RQFII) programmes and simplify the permitting processes. In addition to publicly listed shares and bonds, it would also let existing qualified investors invest in a broader range of financial instruments such as financial and commodity market derivatives.

The QFII programme, launched in 2002, was complemented in 2011 with the RQFII programme, which allows investment of yuan acquired outside mainland China in Chinese securities. These programmes have long served as the main conduit to China's stock and bond markets for foreign investors. In mid-January, the QFII programme quota was doubled to 300 billion dollars, even if only about 100 billion dollars of the old quota was employed. The new RQFII programme quota is 1.94 trillion yuan (USD 280 billion), and again, less than 650 billion yuan (nearly USD 100 billion) of it has been used. Since 2015, the stock and bond trading connections between mainland China and Hong Kong exchanges, as well other deregulation, have reduced the relative significance of the QFII and RQFII programmes as vehicles for bringing foreign capital into China.

While China's equities and debt security markets are the world's third largest after the United States and Japan, foreign investors only account for about 2–3 % of Chinese market participation. The attractiveness of China to foreign investors is likely to be enhanced, however, once western credit rating agencies gain access to Chinese markets. Indeed, S&P Global was last month granted permission to begin providing credit ratings for bonds in China's interbank market. International interest should also be boosted by the gradual introduction of Chinese securities to international financial market indices. Last June, share index producer MSCI started introducing with a tiny weighting of mainland Chinese shares into its global indices. Bloomberg recently announced that starting in April it will gradually add Chinese government and policy bank bonds to the Bloomberg Barclays Global Aggregate index. The move is a first step in incorporating Chinese debt securities into international benchmark indices. Other index producers have announced similar plans.

China's efforts to open up its financial markets have focused on attracting investment into China. Portfolio investment outflows from China are still tightly regulated, however. Aside from the Stock Connect programme, Chinese can invest in

foreign securities in Hong Kong and China under the 2015 reciprocal Mutual Recognition of Funds (MRF) arrangement. Fewer than two dozen funds, however, currently are licenced to market themselves to Chinese investors, while in Hong Kong foreigners have been able to invest in roughly 50 Chinese funds. After a long permitting process, JPMorgan Asset Management last week won approval to market for two funds directed at Chinese investors under the MRF framework.

**China allows new debt instruments to boost bank capital adequacy and spur lending.** The central bank and The China Banking and Insurance Regulatory Commission (CBIRC) gave the green light last month to the issuance of "perpetual bonds" by commercial banks. The first issue of perpetual bonds by the Bank of China on January 25 was valued at 40 billion yuan (USD 6 billion).

The issuance of perpetual bonds should help recapitalise banks (additional Tier 1), and thereby help them increase lending. The government's main motivation is concern over banking sector stability as particularly some smaller Chinese banks are barely able to meet their minimum reserve requirements. The reduction in the use of off-balance sheet shadow banking sector instruments has boosted traditional bank balance sheets, which also necessitate further reinforcement of capital buffers. In its latest financial stability review, the IMF urged China to increase capitalisation of its banking sector.

Like many other bonds with good credit ratings, commercial banks can use perpetual loans as collateral with the central bank. To boost demand, the CBIRC will also allow insurance companies to invest in perpetual bonds issued by banks. Further, the People's Bank of China has introduced a new policy instrument that allows financial companies to swap perpetual loans issued by solid banks for PBoC bonds for up to three years at a time. The central bank bonds acquired in such swaps cannot be traded, but can be used as collateral for PBoC credit facilities.

The purpose of promoting this complicated swap arrangement is ultimately to support recapitalisation of banks. Swap operations are not a reflection of an easing of the monetary stance. The PBoC will not purchase the perpetual bonds of commercial banks, but only swaps them temporarily for its own bonds which are, at least for the time being, believed to be more attractive to investors than initial perpetual bonds.

In the recent public discussion of China's economic predicament, the inability of loose monetary policy to promote high growth has been one of the topical issues. According to media reports, the PBoC recently directed commercial banks to maintain their leading growth and volume of new lending at least at the same level as in the same period last year. While the PBoC has offered the banking sector substantial liquidity, the economic slowdown has depressed corporate borrowing demand and the willingness of banks to lend to riskier corporate borrowers. In such case, excess liquidity tends to flow elsewhere than the real economy.



## Russia

### Russian inflation accelerates slightly in January.

Consumer price inflation rose 5.0 % y-o-y in January. In particular, higher food prices since last summer appear to be driving inflation. Rosstat reports that core inflation, which excludes prices of food, energy and administratively regulated prices, was up 4.1 % in January.

The hike in the value-added tax (VAT) at the start of this year from 18 % to 20 % had a lower-than-expected impact on consumer price inflation in January. It seems that the effects of the VAT hike will gradually pass-through to consumer prices over coming months.

As 12-month inflation is currently running near the lower bound of the Central Bank of Russia's (CBR) inflation forecast for this year (5–5.5 % at the end of this year), the CBR left the key rate unchanged (7.75 %) at its rate review meeting on February 8. The CBR expects annual inflation to settle back to its target level of 4 % in the first half of 2020. However, real interest rates in Russia are still rather high as the nominal average rate for corporate loans for over 12 months hit 9.2 % in December.

### Interest rates and inflation in Russia



Sources: Macrobond, Central Bank of Russia.

### Growth in Russian household borrowing accelerated in 2018.

The Central Bank of Russia reports that the household credit stock increased during the past two years. Growth accelerated substantially last year, lifting the total household credit stock to 14.9 trillion rubles (220 billion dollars) at the end of 2018 – an increase of 22 % y-o-y. During Russia's last credit boom in 2011–2013, annual growth in credit exceeded 30 %.

While the volume of housing loans grew especially fast last year, growth in unsecured consumer credit was also brisk. Credit stock growth was highest in the Moscow region, St. Petersburg and some regions in the Volga Federal District. In all these places, high growth was generated mainly by housing

loans. Due to the housing loan growth in recent years, housing loans now constitute 43 % of all household borrowing. Less than 1 % of household credit is denominated in foreign currencies.

The increase in credit demand partly reflects a slight drop in interest rates. The average rate on a ruble-denominated household loan for more than one year was 12.5 % in December. In December 2017, the similar average rate was 13.5 %. The corporate credit stock also grew rapidly, but the rate of growth (11 % y-o-y) was well below the growth in household borrowing.

**Russia's goods trade surplus last year was larger than before.** Russian customs reports that in 2018 the country's goods trade surplus climbed to 212 billion dollars, or roughly 12 % of GDP.

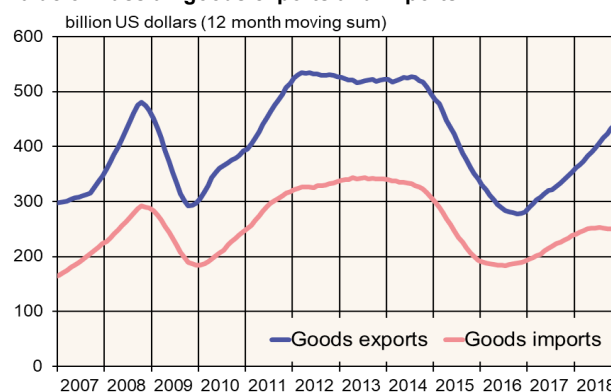
Russian goods exports rose by 26 % from previous year. This reflects changes in both quantities and prices. Some of these may prove to be temporary. Energy prices are a major driver of fluctuations in Russia's case.

The EU accounted for 46 % of Russian exports, while 12 % went to China. Two-thirds of earnings from goods exports came from fossil fuels. The combination of a slight increase in oil and gas export volumes and higher world prices raised export earnings by a third. In addition to fossil fuels, there were also significant increases in exports of metals and grains. With the bumper crop of autumn 2017, 2018 wheat exports were up by a third from 2017. Russia produces about 10 % of the world's wheat. In recent years, about half of Russia's wheat production has gone to exports.

The trend in exports last year was not reflected in imports. Russians spent only 5 % more on imported goods in 2018 than in the previous year. Import growth was depressed by ruble depreciation of more than 10 % against the dollar and euro.

About 37 % of Russia's goods imports last year came from the EU and 22 % from China. While half of imports consisted of machinery, equipment and vehicles, growth in the category was modest. Pharmaceuticals and foodstuffs were also important import good categories.

### Value of Russian goods exports and imports



Source: Federal Customs Service of Russia.

## China

**China's urbanising, greying and soon-to-be-shrinking population.** China National Bureau of Statistics reports that the Chinese population reached 1.395 billion at the end of December. The population increased by a mere 0.4 % from 2017, or about 5.3 million people. The rate of population rise was the slowest since the famine years of the early 1960s.

Populations in urban areas increased by a total of 18 million people to 831 million. The rural population correspondingly decreased by 13 million. Some of the growth in urban areas, however, reflects extension of city limits. Areas once zoned rural are now classified as urban areas. The worsening employment situation in cities was reflected last year in the number of internal migrants (people who move from rural areas to urban areas for work). The number of internal migrant workers increased by just 1.8 million to 288 million. Growth in the number of internal migrants has slowed steadily since 2010.

The working-age population (16–59 years) has been shrinking for years, falling to 897 million last year (a decrease of 5 million from 2017). The number of persons over 60 years of age increased by 9 million to 249 million.

Last year saw the birth of 15.2 million children, the lowest number of births since China began to abandon the one-child policy in 2013. Although China officially switched to a two-child policy in 2016, the policy relaxation has not been reflected in the birth rate as hoped. China's birth rate last year was just 10.94 per 1,000 inhabitants, down from 12.43 births per 1,000 in 2017. The Chinese Academy of Social Sciences (CASS) recently estimated that China's population will go into decline in 2027. Under the current estimate, the population will fall to 1.17 billion by 2065.

China's rate of population growth is lowest among all of the world's most populous nations. The World Bank expects the population of India to exceed the population of China as soon as 2022. The current share of China's working-age population (using the World Bank definition of 15–64 years) to total population was the highest among all of the world's most populous nations (over 71 %) last year. The World Bank expects this ratio to fall below 60 % by 2050, when the working-age population ratio in China will be even lower than in e.g. the US.

**GDP growth in some Chinese provinces was well below target last year.** The NBS released new data that show real GDP growth was more than one percentage point below the official growth targets set for Inner Mongolia, Liaoning, Jilin, Hainan and Chongqing provinces. Official figures show economic growth in these areas running at 4–6 % p.a. In most provinces, GDP growth was roughly in line with the target. GDP figures have yet to be released for Heilongjiang and Tibet provinces.

In about a dozen provinces, GDP grew by 6–7 % in real terms, and in another dozen 7–9 %. The highest GDP growth,

around 9%, was posted by Yunnan and Guizhou provinces. Both are among the poorest economies in China.

The economies of China's larger provinces match those of major countries. For example, the GDP of Guangdong and Jiangsu in dollar terms last year corresponded to that of Spain or Australia. 19 of mainland China's 31 provinces have economies larger than that of Finland.

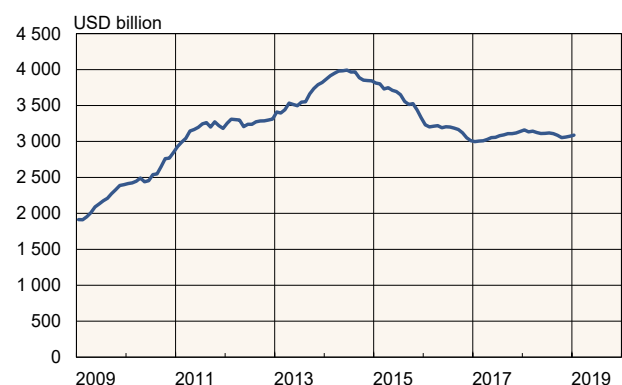
The reliability of provincial-level GDP figures has long been dubious. Hitting growth targets is a major consideration in evaluating the performance of provincial officials. Such targets put pressure on them to set economic growth figures exceeding the party's national GDP growth target. As a result, the aggregate growth reported by regions without exception exceeds the official GDP growth figures released by the NBS. Several provinces have been caught up in scandals over jiggered growth figures.

**Only minor changes in value of China's currency reserves since 2016.** At the end of January, the value of the People's Bank of China's total official foreign reserve assets was 3.186 trillion dollars. Some 97 % of the reserves were held as foreign-currency assets, typically debt securities such as treasury bills in major currencies. Gold made up over 2 % of China's reserves, with other assets constituting less than 1 % of China's holdings. China does not reveal the composition of its foreign currency reserves.

China by far has the world's largest foreign currency and gold reserves. Although gold constitutes a small fraction of the PBoC's reserves, it still amounts to about 1,870 tons, making it the sixth largest gold hoard of any central bank. The 8,100 tons of gold held by the US Federal Reserve are by far the world's largest, with gold accounting for 75 % of the Fed's forex and gold reserves. The next largest gold reserves are held by the central banks of Germany, Italy, France and Russia, in all of which the share of gold is quite large relative to total reserves.

After a two-year pause, the PBoC again boosted its gold reserves slightly in January. Russia, for its part, has firmly increased its gold reserves to 2,115 tons (19 % of the value of its total reserves currently) over the past decade.

### China's foreign currency reserves



Source: Macrobond.

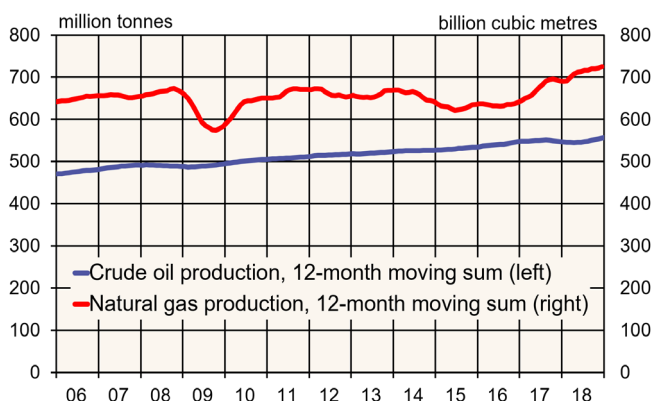
## Russia

**Russian government releases new guidelines for national projects.** As part of his inaugural decrees in May 2018, president Putin set forth twelve national priority areas and a handful of infrastructure modernisation programmes to be implemented during 2019–2024. The twelve national priority areas comprise 69 federal-level projects. The costs of implementing the projects is currently put at 26 trillion rubles or about 4.3 trillion rubles (65 billion dollars) annually, an amount that corresponds to approximately 4.5 % of 2018 GDP. While 70 % of funding is supposed to come from budget, it is still unclear how much of an increase in budget spending, if any, will be required to cover the costs.

The biggest ruble spending will go to implementation of infrastructure, road and demography programs. Each federal-level project in the programme has its own detailed set of goals. Often there are hundreds of benchmarks for hitting these goals. Some project targets are quite simplistic (e.g. the average housing loan interest rate will be 7.9 % in 2024), while some are expansive and general (e.g. the share of persons younger than 40 among academic researchers will grow). The mass of specific performance criteria for the wide-ranging projects creates a benchmark jungle that is difficult to oversee and possibly counterproductive to project implementation.

**Russia last year produced and exported more gas and oil than before.** Russia extracted 556 million metric tons of crude oil and associated gas in 2018. Average daily crude production exceeded 11 million barrels a day last year. This is 2 % more than in the previous year. Thanks to a reinterpretation of the agreement on voluntary production restrictions among a group of oil-producing countries in June, Russia's daily output increased by 4 % during the second half of 2018. However, new restrictions will likely reduce production in coming months. Also natural gas production grew last year. Production reached 725 billion cubic metres. This is 5 % more than in the previous year.

**Russian crude oil and natural gas output**



Source: CDU TEK.

Most of Russia's oil and gas production still takes place near the Urals mountain range in the Perm, Komi, Nenets and Khanty-Mansi regions. Other fields are found in the Far East, lower Volga and Caucasus regions. About two-thirds of Russian oil production and one-third of gas production goes to exports, mostly to Europe. The combination of increased oil and gas export volumes from higher production and higher oil and gas prices lifted export earnings of the energy sector by a third.

Natural gas has traditionally been transmitted via large pipeline grids, but liquefaction makes cargo shipments possible, too. The recent phased start-up for the liquefied natural gas (LNG) facility on the Yamal peninsula has facilitated gas exports. At the end of last year, about 10 % of Russia's natural gas exports were already being shipped in liquid form. In addition to new gas export pipelines to China and Germany under construction, new LNG facilities are planned.

**Russian retail sales up overall, but growth has slowed in recent months.**

The volume of retail sales last year grew by 2.6 % y-o-y. The pace of growth varied during the year, however, slowing to 2.3 % y-o-y in December. After several years of contraction, Rosstat reports that the volume of retail sales increased by roughly 5 % in the time period of 2017–2018.

The volume of food sales rose by 1.7 % last year. The volume of retail sales increased despite lower household disposable incomes ([BOFIT Weekly 2019/06](#)). This may be partly explained by the rise in sales of inexpensive goods as well as a distinct increase in household borrowing. The stock of household borrowing increased by 22 % last year. However, most of the increased borrowing came from housing loans ([BOFIT Weekly 2019/07](#)).

In January 2019, retail sales volume growth was dragged down by a general increase in the value-added tax (VAT) rate from 18 % to 20 %. January retail sales volumes rose by 1.6 % y-o-y, while growth in sales of non-food goods slowed sharply to just 1.2 %. The VAT rate on food was unchanged, however, and growth in food sales picked up slightly last month.

**Annual growth in Russian retail sales**



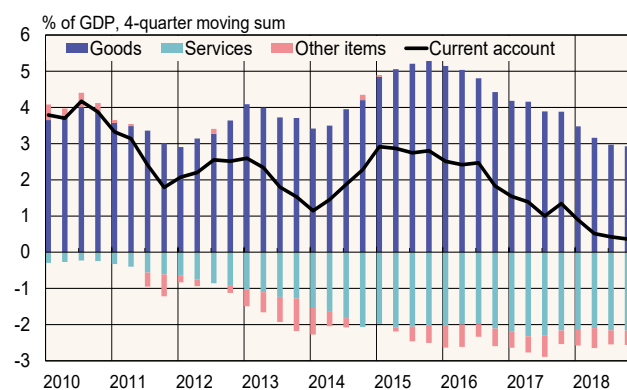
Source: Rosstat.

## China

**China's current account surplus nearly evaporated last year.** China's current account surplus last year fell to just 0.4 % of GDP, down from 1.3 % in 2017. In monetary terms, the 2018 current account surplus amounted to a mere 50 billion dollars. The goods trade surplus of roughly 400 billion dollars was largely offset by a services trade deficit of about 300 billion dollars and a deficit in net income and transfer payments totalling another 50 billion dollars.

Besides the reduction in the goods trade surplus, the current account surplus has been curtailed by increased purchases of foreign services. Tourism, in particular, has caused large outflows of money from China. Chinese tourists abroad last year spent 240 billion dollars more than foreign tourists spent on visits to China.

### China's current account, % of GDP



Sources: SAFE, Macrobond and BOFIT.

**Chinese bank lending breaks records in January.** The People's Bank of China reports that the stock of yuan bank loans increased to 3.23 trillion yuan (480 billion dollars) in January, an increase of 13.4 % y-o-y. January bank lending activity is typically brisker than in the final months of the year. The PBoC this year has been actively encouraging commercial banks to increase their lending.

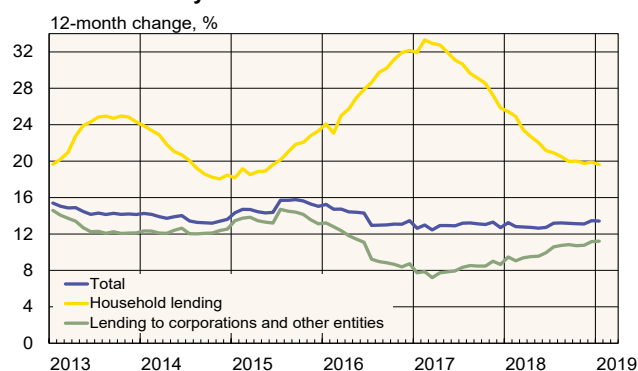
The stock of lending to households increased by 990 billion yuan in January. About a third of that was short-term lending. Lending to non-financial companies and state organisations increased by 2.58 trillion yuan. Nearly half was in the form of short-term loans (e.g. bill financing), suggesting that demand for financing of real investment is relatively weak.

The PBoC reports that the average 12-month interest rate on bank loans was 5.9 % at the end of September. At the end of January, the stock of yuan-denominated bank loans was 139.53 trillion yuan (155 % of GDP). Thus, if the average interest rate is applied to the entire credit stock, the interest costs alone would be about 690 billion yuan (100 billion dollars) a month. A big part of new corporate sector borrowing likely goes to paying down debt and interest.

Besides bank loans, firms sought financing in January through the net issue of 500 billion yuan in corporate bonds and another 340 billion yuan's worth of shadow banking sector instruments. While the stock of shadow banking instruments was up again in January, it is still 10 % smaller than a year ago.

The stock of yuan bank deposits increased by 7.6 % y-o-y. Growth has slowed over the past two years, and new deposits were down on-year in January. At the end of January, the stock of yuan deposits was 180.79 trillion yuan (201 % of GDP).

### Growth in stock of yuan-denominated bank loans



Sources: PBoC, CEIC and BOFIT.

**US-China trade talks continue.** On February 14–15 in Beijing, China's vice premier Liu He and US trade representative Robert Lighthizer prepared a memorandum of understanding to serve as a basis for an eventual trade agreement to be signed by the presidents of both countries. Both parties acknowledged progress in the talks, but no concrete results were mentioned. Talks resumed this week in Washington, DC.

**EU intensifies monitoring of Chinese investment.** On February 14, the EU parliament approved by a large majority new rules on screening investments and acquisitions of third-country companies seeking to make inroads into strategic EU sectors. The new rules enter into force in October 2020.

The new system gives the European Commission opportunities to investigate and comment on third-country investments in EU strategic branches. The purpose of the legislation is to assure that foreign state-owned enterprises are unable to threaten fundamental EU interests such as security and public order. While China was not specifically named, the investment activities of Chinese state enterprises appear to have provided impetus for the legislation.

Even with the European Commission's new authority, the power to permit or prevent foreign investment remains with EU member states. The new system calls for better exchanges of investment information among member states, but does not require every state to have its own monitoring regime. About half of EU states have third-country investment monitoring schemes in place.

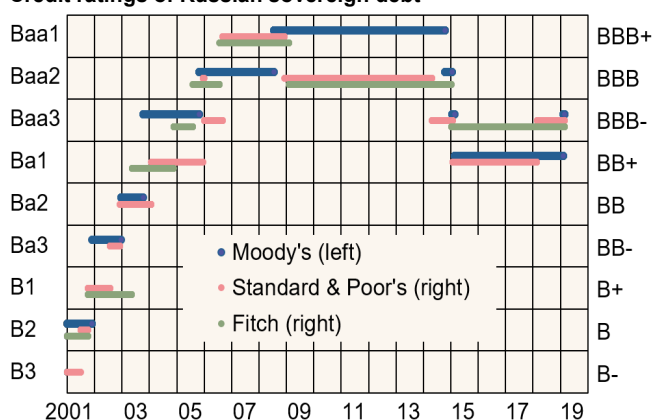
## Russia

**Credit rating agency Moody's upgrades Russian sovereign debt.** On February 8, Moody's upgraded Russia's credit rating score by a notch from Ba1 to Baa3, its tenth-best rating score. Bonds in the top-ten ratings categories are generally considered "investment grade," while those below are considered "junk." The assessments of all the big three international ratings agencies are now consistent. Standard & Poor's made a similar upgrade to its rating of Russian sovereign bonds in February 2018, while Fitch never dropped its rating as far, preferring to keep with its BBB- rating in recent years.

According to Moody's, the Russian government has implemented prudent fiscal policies during recent years. At the core of these policies is the accumulation of foreign currency into the National Welfare Fund. In addition, the Russian government has relatively little debt, and the amount of debt owed to foreigners has decreased. Moody's notes that the fiscal policies have contributed to the government's ability to weather both a major slump in oil prices and the pressures of sanctions. On the other hand, Moody's observed that the government's heavy involvement in the economy drags down growth.

There are other indications that the financial situation of state entities may be changing to some extent. The state-owned gas giant Gazprom plans to return to issuing dollar-denominated bonds. However, the debt may include the same unusual clause that Gazprom used already in November when it issued euro-denominated debt. Apparently to hedge against further sanctions, Gazprom reserved the right to pay back the debt in a currency other than euros if, for some reason beyond its control, it was unable to repay in euros. The Russian government also used a similar clause last year.

**Credit ratings of Russian sovereign debt**



Sources: Moody's, Standard & Poor's, and Fitch.

**Russian population declines slightly in 2018 as immigration flows drop considerably.** According to Rosstat, Russia's population was 146.8 million at the end of the year. However, the figure includes the 2.3 million people of the Crimean Peninsula, which Russia illegally annexed in 2014. The Russian population shrank by 0.1% last year. There were 1.6 million births and 1.8 million deaths. Russia's population shrank continuously from the mid-1990s to 2009, when the population began to grow again. 2018 was the first year since 2009 that the Russian population declined. In this decade, population growth has been driven by an increase in immigration and life expectancy. The World Health Organization reports that the current average life expectancy of a Russian woman is 77.2 years and a Russian man 66.4 years.

Russia's birth rate has also declined over the past two years. In 2017, the total fertility rate was 1.62, which is typical also for EU countries and China. At the end of 2018, Rosstat forecasted that Russia's population will continue to decline slowly. By their projection, the Russian population would be 144 million in 2036.

Last year, net immigration was no longer sufficient to make up for the gap between births and deaths. Rosstat says that net immigration was only about 125,000 persons, down from about 210,000 in 2017. Following the established pattern, many immigrants and emigrants are from former Soviet countries. Last year, the largest sources of net immigration to Russia were Tajikistan and Kazakhstan.

**Corruption dies hard in Russia.** Russia has performed equally worse in Transparency International's (TI) Corruption Perception Index rankings during recent years. Russia's overall point score has hardly changed since 2012.

The 2018 index placed Russia 138<sup>th</sup> out of the 180 countries surveyed, on par with Iran, Papua New Guinea, Mexico and Lebanon. Countries at the low end of the TI rankings have typically weak economic and political institutions such as judiciary, media, civil society and public administration. Denmark, New Zealand and Finland have held the top positions in TI's rankings in recent years.

**Public sector corruption 2012–2018**

	Score 2018	Rank 2018	Score 2015	Rank 2015	Score 2012	Rank 2012
Belarus	44	70/180	31	106/168	31	123/176
India	40	78/180	38	76/168	36	94/176
China	39	87/180	37	83/168	39	80/176
Brazil	35	105/180	38	76/168	43	69/176
Armenia	35	105/180	35	95/168	34	105/176
Moldova	33	117/180	33	102/168	36	94/176
Kazakhstan	31	124/180	28	123/168	28	133/176
Kyrgyzstan	29	132/180	28	123/168	24	154/176
Russia	28	138/180	29	119/168	28	133/176
Azerbaijan	25	152/180	29	119/168	27	139/176
Tajikistan	25	152/180	26	136/168	22	157/176
Uzbekistan	23	158/180	19	153/168	17	170/176

Source: Transparency International.

## China

**Trump extends time frame for US-China trade negotiations.** The lead negotiators for China and the United States met again last week in Washington, DC, to work on pressing bilateral trade issues. Talks between lower-level team officials continued this week. President Donald Trump approved the idea of giving negotiators more time to work out a deal and promised to refrain from imposing additional tariffs in early March as threatened. No new deadline for the negotiations has been announced.

Despite advances in the talks, few concrete or specific points of agreement have emerged. From the beginning, it was clear that trade talks would be quite challenging, given that cuts in government subsidies and elimination of the special privileges of state enterprises strike at the heart of China's political and economic system. Easing market access, protecting intellectual property rights and increasing China's purchases of US agricultural products and energy are areas where it is probably easier for the Chinese and the Americans to find common ground.

Monitoring of compliance with the agreement terms has also raised thorny issues. The parties appear to have arrived initially at an arrangement in which official at the ministry-level would engage monthly, deputy minister-level quarterly and minister-level twice a year to resolve issues, raised by e.g. firms, in implementing the agreement. American negotiators have reserved the right to raise tariffs if consultations fail to resolve observed implementation problems.

Part of a trade deal with the Trump administration requires that China transparently conduct forex market interventions and refrain from yuan devaluations for competitive advantage. While details have yet to be released, the American team claims the matter is already resolved to some extent. Suggestion to refrain from beggar-thy-neighbour devaluations to improve price competitiveness is included in the recently revised NAFTA agreement as well as in an earlier G20 declaration that also China has committed to.

The inclusion of a yuan-dollar rate in the trade agreement could cause huge problems in interpretation. China's vast structural changes and decelerating growth will inevitably be reflected in the exchange rate. Things are complicated by the fact that China needs to adopt a more flexible exchange rate regime as a part of financial market reforms and the lifting of capital controls.

**Chinese local government aluminium producer defaulted on off-shore bond payments.** Last Friday (Feb. 22), Qinghai Provincial Investment Group (QPIG) defaulted on 11 million dollars in interest payments on a 300-million-dollar bond. The company is majority-owned by the government of the Qinghai province in western China. The notion of a state-owned enterprise being allowed to default on its foreign bonds is very exceptional for China and reflects the country's changing conditions.

For the time being, it has been widely held that the Chinese government would intervene to bail out struggling state-owned firms despite the fact that several state companies had been allowed to default on domestic bond issues in recent years. QPIG, which ran into insolvency problems already last year, was also believed to be bailed-out by the government.

**Hong Kong economy hit by slowing growth in mainland China and trade war.** Hong Kong's relatively small, open economy is highly dependent on mainland China. It saw GDP growth slow dramatically in the fourth quarter of 2018 to just 1.3 % p.a. GDP growth was still just under 3 % in 3Q18 and exceeded 4 % in 2H18. Growth averaged 3 % last year.

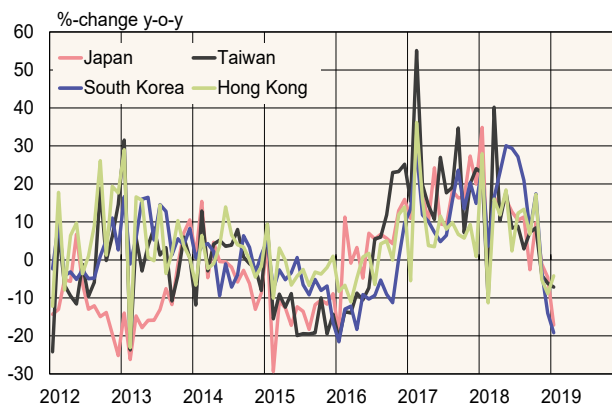
Despite the weakening in private consumption demand, it rose in the fourth quarter still over 3 % y-o-y. At the same time, fixed investment fell by more than 5 % y-o-y in real terms. This reflects a much-degraded outlook for Hong Kong firms. Fixed investment last year corresponded to roughly 20 % of Hong Kong's GDP.

The value of goods transiting Hong Kong to and from China increased sharply in the first three quarters of 2018, only to fall in the fourth quarter and in January. The movement of goods is critical for the success of the Hong Kong economy. Both the value of Hong Kong's goods imports and the value of goods exports exceeds 150 % of the special administrative region's GDP. The Port of Hong Kong's container terminals are still among the busiest on earth, despite the rapid development of mainland China's own ports.

While exports of goods produced in Hong Kong are tiny in relative terms, exports to China were up at the end of last year. In particular, the amount of jewellery sold to mainland Chinese has soared in recent months. Some observers speculate that the fascination with Hong Kong jewellery reflects Chinese propensities for skirting capital controls and seeking secure ways to preserve wealth.

Exports to China from neighbouring countries have been on the wane recently. In dollar terms, goods exports to China from South Korea, Japan and Taiwan contracted on year in January, the third consecutive month of decline.

**Exports of neighbour countries to China**



Sources: Macrobond and BOFIT.

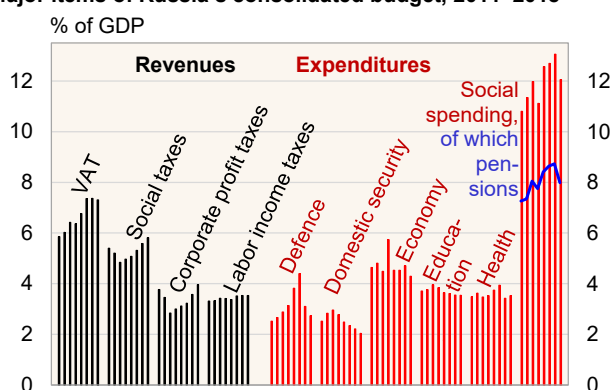
## Russia

**Russian government sector finances improved further last year.** Revenues to the consolidated budget (federal, regional and municipal budgets plus state social funds) increased by about 20 % in 2018. The ratio of revenues to GDP climbed to over 35 % – the highest level in ten years. Nearly half of the increase in revenues came from oil & gas tax earnings ([BOFIT Weekly 2019/06](#)), which now account for almost a quarter of total consolidated budget revenues. The share hit 28 % in peak oil price years.

Other budget revenues were up by nearly 14 %. Revenues from corporate profit taxes and value-added taxes rose most swiftly and at the fastest rate since 2011. Other key categories, particularly revenues from mandatory payroll social contributions and labour income taxes, showed substantial increases. This reflects further improvements in tax collection.

After a few lean years, consolidated budget spending was up by about 6 % last year, i.e. a couple of percentage points higher than inflation. The ratio of spending to GDP fell to around 33 %, about the same level as in the early years of the current decade. The biggest spending increases were seen in health care (18 %) and education (12 %). Much of the higher spending came as these sectors received large wage increases last year based on earlier state decisions. The increases in education spending were focused on preschool, primary education and vocational training. The rise in spending on civil administration accelerated to nearly 10 %, focused, among others, on funding tax, customs and financial market supervisory authorities. Spending on the economy increased only slightly, although brisk spending increases on roads continued.

**Major items of Russia's consolidated budget, 2011–2018**



Sources: Ministry of Finance and BOFIT.

Housing sector spending rose last year on housing-related infrastructure, whereas spending on housing specifically again turned to decline with the slowdown in the boost of major projects in Moscow and continued drops in housing construction almost throughout the country. Growth in social spending, including pensions, slowed to a couple of per cent reflecting targets set for coming years. Spending on domestic

security continued to increase rather slowly, while defence spending contracted slightly even in nominal terms.

After running a deficit for years, Russia's consolidated budget showed a surplus equivalent to as much as about 3 % of GDP last year. The most recent consolidated budget surplus before that was in 2012.

**Nord Stream 2 gas pipeline construction continues; EU reaches preliminary agreement on gas directive changes.**

The first Nord Stream natural gas pipeline was completed in 2012. The Nord Stream 2 pipeline largely parallels the existing one and runs from Russia to Greifswald on the German coast. Like its older counterpart, the Nord Stream 2 will have an annual transmission capacity of 55 billion m<sup>3</sup>. Over 800 kilometres of the 1,220-km pipeline have now been laid beneath the Baltic sea bottom. The pipeline is scheduled for commissioning at the end of this year.

The Nord Stream 2 pipeline venture was initially owned by Russia's Gazprom and five European energy companies. Due particularly to opposition from the Polish competition authority, the European companies pulled out of the venture as stakeholders in August 2016, although they continued as financial investors of the project. Uniper, Wintershall, Shell, OMV and Engie each have committed to provide 10 % of the project's estimated 9.5-billion-euro funding.

While the participating energy companies seek an economically efficient import route that runs directly to their core markets, the pipeline has met opposition for environmental reasons (increased import capacity may increase hydrocarbon use) and geopolitical reasons (increased pipeline capacity may increase dependence on Russia). The new pipeline is also likely to substantially reduce the flow of gas to Europe coming through Ukraine, and thereby reduce Ukraine's income from transit fees.

The United States has several times threatened to impose sanctions on the company building Nord Stream 2 to block construction. EU countries have sought to agree on how regulations of EU gas markets should be applied to new gas pipelines from outside the EU area. A provisional political agreement on new rules was reached on February 12. The agreement calls for amending the EU gas directive so that its key elements (tariff regulation, transparency, third-party access and unbundling ownership of production and distribution functions) affect also Nord Stream 2. Once the European Parliament and Council approve the proposal, member countries need to integrate the rules into their own legislative frameworks. National authorities are responsible for implementing the directive. It is still too early to judge the practical implications of the new rules on future pipeline use.

In the event both Nord Stream pipelines can be operated at full capacity in the next decade, over half of the gas imported from Russia to EU countries could flow via the under-sea Baltic route. Slightly over 40 % of the gas imported by EU countries comes from Russia, with another third from Norway and about 10 % from Algeria. LNG accounted for 14 % of EU gas imports from outside the EU in 2017.

## China

**China's National People's Congress starts with warnings on economy, but new growth targets still ambitious.** At the opening of the National People's Congress (NPC) on Tuesday (Mar. 5), premier Li Keqiang presented the governmental work report and goals for this year to the nearly 3,000 NPC representatives. Li noted that, while economic conditions were challenging, the government was still committed to an ambitious GDP growth target of 6.0–6.5 %. The NPC delegates should formally approve the target with little debate.

To help the government reach its growth targets, the easing of fiscal and monetary policy will continue. Taxes and fees are planned to be cut by nearly 2 trillion yuan (300 billion dollars). The cuts include a reduction in the VAT rate from 16 % to 13 % for manufacturing firms, a cut in the VAT rate from 10 % to 9 % for construction and transport firms, as well as lower employer contributions to social security and lower rates for electricity and data transmission. Despite significantly larger revenue cuts than last year, the government still expects the budget deficit to only amount to 2.8 % of GDP.

To finance infrastructure projects, local governments have been granted permission to issue 2.15 trillion yuan (320 billion dollars) in special purpose bonds. Last year's budget capped special purpose bond issuance at 1.35 trillion yuan. China does not treat special purpose bonds as public debt because the projects as planned should be self-financing. Media reports say the working agenda mentions possible reductions in interest rates and reserve requirements, as well as significant increases in bank lending, especially to small firms.

As in last year, the government expects inflation to be 3 %, while urban unemployment holds at about 5.5 %. In addition, one of the goals is to raise another 10 million Chinese out of poverty as in earlier years.

While governmental work agenda's remarks on the difficult economic situation are hard to dispute, the targets set for economic growth, budget and gaining control over indebtedness raise serious doubts. China continues to obsess on GDP growth targets that lead to fabrication of statistical data and excessive debt levels. Despite a 2018 budget deficit target of 2.6 % of GDP, the realised official budget deficit exceeded 4 %. Many observers believe the actual deficit was at least double that. If the deterioration of economic conditions this year, large revenue cuts and large spending increases are included, it seems certain that the budget deficit will rise. In addition, plans to increase corporate borrowing regardless the risks will further aggravate the debt problem.

Official growth targets have distorted economic policy throughout the current decade, increasing the country's vulnerability to economic shocks. The current economic policies hardly match the image of China as a country with a strong long-term strategic view.

**Chinese tourism abroad continues to soar.** According to China's culture and tourism ministry, Chinese last year made 150 million trips abroad, a 15 % increase from 2017. Balance-of-payments figures show Chinese tourists spent 277 billion dollars on their travels, an upsurge of 8 % y-o-y.

The Chinese are now the world's biggest tourist group. Top destinations include nearby Hong Kong, Macao, Taiwan, Thailand, Singapore and other Asian neighbours. The Hong Kong Tourism Board reports that mainland Chinese made 51 million visits to Hong Kong last year, an increase of 15 % y-o-y. Most visits were day trips.

Statistics Finland reports that 203,000 Chinese travellers spent at least one night in a Finnish inn or hotel last year, a 3 % decline from 2017. However, Chinese tourist total overnight stays increased by 6 %, while total overnight stays of foreign visitors were up just 1 %. 6 % of all foreign visitors staying in Finnish inns & hotels were Chinese. The number of Chinese tourists and overnight stays this January grew rapidly.

**Healthy increase in Finnish exports to China last year.** Finnish Customs values Finland's goods exports to China last year at 3.5 billion euros, an increase of 4 % from 2017. Exports set a nearly 6 % growth trend in the first 11 months of the year, only to stumble badly in December (down 15 % y-o-y). Nearly all of the drop was in pulp exports. Some 5.5 % of Finnish exports went to China last year, making it Finland's fifth-most-important export market after Germany, Sweden, the US and the Netherlands. Goods imports totalled 4.6 billion euros (up 1 %). China supplied 7 % of Finnish goods imports, making it the number-four import source after Germany, Russia and Sweden.

Finnish exports to China consisted mainly of pulp, machinery & equipment, refined metals, ores and wood products. Despite China granting of an ever-increasing number of import permits to Finnish food companies, they only represented slightly more than 1 % of Finnish exports to China. Finland's main Chinese imports were machinery & equipment, clothing, footwear, textiles and metals.

Finland's roughly 1-billion-euro goods trade deficit with China was partly offset by a large services trade surplus. Statistics Finland reports that services exported to China in the first nine months of 2018 were worth roughly 1 billion euros, while Finland bought about 600 million euros in services from China. Most of the services earnings came in the form of IPR, telecommunications, data technology and data services royalties or payments. Chinese tourism, however, has also become a major income source for Finland. Most of the services Finns bought from China involved R&D services.

In December, the OECD published its updated value-added-based figures for output and trade. The figures show that in 2015 China was fourth-largest consumer of Finnish value added. The US was clearly the largest followed by Sweden. Germany only placed slightly ahead of China. Value-added-based figures include value added from goods and services, including value added passing through third countries.



## Russia

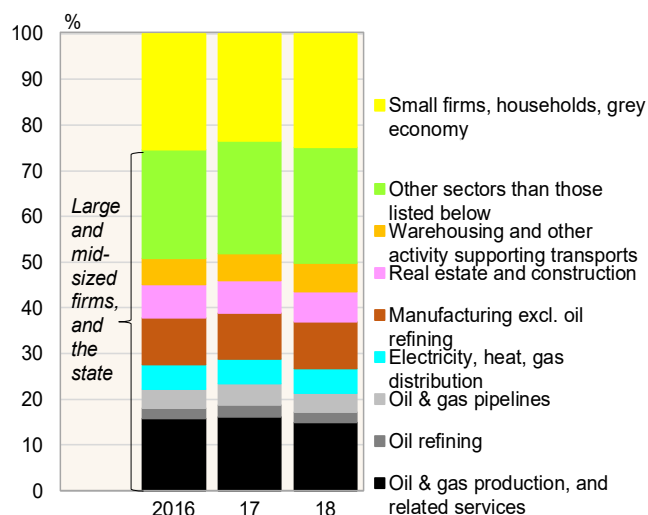
### Recovery in Russian fixed investment continued in 2018.

Fixed investment rose by 4.3 % last year (4.8 % in 2017, with Rosstat's latest round of revision raising the figure a bit). The level of fixed investment was no longer more than about 3.5 % below its 2013 peak. Investment growth dropped below 3 % y-o-y in the fourth quarter of 2018, but the figure for the first nine months of the year was revised up. Together with the earlier upwardly revised growth figures for the construction sector this reaffirms the setup where the surprisingly strong GDP growth in 2018 figures rest partly on improved data for January-September (revised quarterly GDP data will be released in early April).

The pace of investment last year was typical of nearly all years in this decade, when investment of large and mid-sized firms, as well as the government, increased slower than total investments (just over 2 %). Instead, other investment such as small firms and households, Rosstat says, rose some 10 %.

Investment of large and mid-sized manufacturing firms (excluding oil refining) rose briskly. The increase was led by further growth in the chemical industry and a recovery of investment in the car industry after deep slump. The chemical industry makes the most investment in manufacturing industries by far. Investment in crude oil production declined last year, after increasing in 2017. Growth in investment in natural gas production soared due to the Yamal LNG project (the Yamalo-Nenets autonomous region accounted for about two-thirds of all Russian natural gas production investment in 2017 and 2018). Investment figures for large and mid-sized firms indicate a slight decline from previous years in the share of the energy sector (oil, oil products, natural gas and electricity) from about 30 % of total fixed investments, while manufacturing (excluding oil refining) rose to 12 %.

### Main categories of fixed investments, 2016–2018



Source: Rosstat.

**Finnish exports to Russia slackened last year.** The trend in Finnish-Russian trade last year reflected Russian foreign trade generally. Due in part to ruble depreciation, Russians cut back on their purchases of foreign goods and services abroad. The value of Russian goods exports was lifted by higher oil prices.

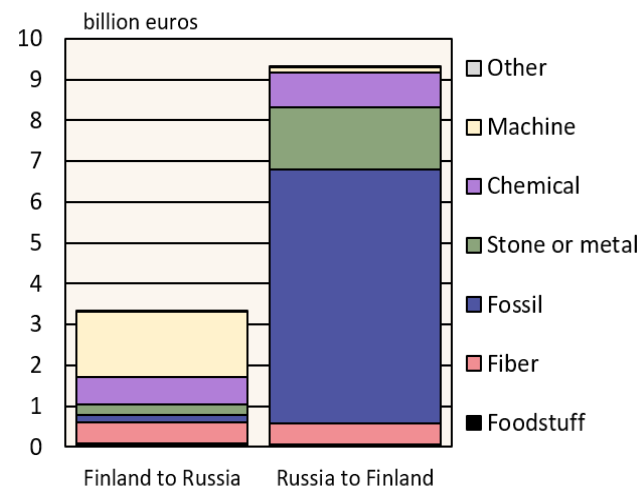
According to Finnish Customs, goods exports from Finland to Russia totalled 3.3 billion euros last year, or 3 % less than in the previous year. Russia accounted for 5 % of the value of Finland's total goods exports. Russia's share has diminished considerably during recent years. In 2013, nearly 10 % of Finnish exports went to Russia. Finland's main export goods include machines and paper.

Finland last year imported from Russia goods worth 9.3 billion euros, or 13 % more than in the previous year. Russia's share of Finland's good imports was 14 %. The value has grown mainly due to higher oil prices as fossil fuels represent two-thirds of Finland's goods imports from Russia. However, it is noteworthy that a significant share of the oil that Finland imports is exported after refinement. Finland also imports a considerable amount of wood, metals and chemicals from Russia.

According to Statistics Finland, Finns annually produce just under 1.5 billion euros in services for Russians. While the value has increased over the past two years, it depends to a large extent on Russians' willingness to travel. That in turn is affected by the ruble's exchange rate, and the ruble fell about 10 % against the euro during last year. Around the New Year holiday period Russians spent about 10 % fewer nights in Finland than a year earlier. During last year, Russian travellers accounted for 12 % of overnight stays by foreigners. About 5 % of all Finnish services provided to foreigners went to Russians.

Russians annually provide Finns with services worth nearly 1 billion euros. Russia accounts for 3 % of Finland's service imports. Transportation services represent about half of the services Russians produce for Finns.

### Finland-Russia goods trade in 2018



Sources: Finnish Customs, BOFIT.

## China

**EU seeks more reciprocity and balance in its China relations.** On Tuesday (Mar. 12), the European Commission released a joint communication entitled “EU-China – A strategic outlook.” The document reflects the strong pressures to strengthen the EU’s China policies. Proposals involving foreign trade and economic issues in many respects overlap with current US demands set out in the current trade negotiations with China.

The EU Commission, in addition to emphasising greater cooperation with China in many issues like climate policy, seeks more balanced and reciprocal economic relationship. This means the EU should closely monitor China’s compliance with its EU agreements and commitments. Needed actions include reforming the WTO (including reducing subsidies and forced technology transfers), as well as approval by 2020 of long-negotiated bilateral agreements on investment. Government procurements should stress reciprocity and make it easier for European firms to compete in China.

In addition to its demands on China, the European Commission also presented a number of actions EU could take to amend laws and their implementation in ways that reduce distortions in competition. These include the operation of third-country state-owned firms in the internal market as well as compliance with labour and environmental standards in government procurements. The joint communication directly mentioned the security risks associated with 5G telecom networks and foreign investment. Member countries were advised to implement the foreign investment screening mechanism agreed last month. The European Commission also stressed the importance of the EU’s own need to adapt to changing realities and reject protectionist urges in EU policy.

China will figure prominently in the EU agenda this spring. The upcoming meeting of European Council will take up the Commissions joint communication on March 21. The annual EU-China summit will be held on April 9. European business groups are also refining their China positions.

**China’s foreign trade contracted in January-February.** China Customs valued the country’s goods exports in January-February at 350 billion dollars, a 5 % decrease from the first two months of 2018. Imports contracted by nearly 3 % y-o-y to 310 billion dollars. The foreign trade surplus shrank by 10 billion dollars from a year earlier and stood at 40 billion dollars. Both exports and imports measured in yuan were about the same in January-February as a year ago.

Measured in dollars, the value of exports to the US in the first two months of the year declined by nearly 15 % y-o-y. Exports to the EU and ASEAN countries still grew slightly, but the pace of growth slowed noticeably. In terms of product categories, the largest contractions in exports were seen in phones (down 24 %), clothing (down 15 %) and footwear (down 11 %). Exports of electronic devices other than phones

also contracted. Exports of microchips and refined oil products increased by roughly 20 %.

In January-February, China imported 35 % less goods from the United States than a year earlier. Imports contracted sharply also from ASEAN countries (down 10 %) and South Korea (down 14 %). Imports from the EU increased by a few per cent. Imports from many commodity-producing countries, including Russia, showed robust growth.

The manufacturing purchasing manager index for February reflected shrinking export orders, an indication of a deteriorating export outlook in the months ahead.

**Growth in Chinese and Russian arms exports lags growth of other major arms suppliers.** The latest report on global arms transfers from the Stockholm International Peace Research Institute (SIPRI) shows that, during the latest five-year study period (2014–2018), arms transfers rose 8 % from the previous period (2009–2013). Three-quarters of global arms transfers involved the United States (36 %), Russia (21 %), France (7 %), Germany (6 %) and China (5 %).

The volume of China’s arms transfers in 2014–2018 rose by less than 3 % from the 2009–2013 period. The figures suggest growth in China’s arms exports has slowed radically from the boom years at the start of this decade. The number of customer countries, however, increased from the previous five-year period from 41 to 53 countries, even if arms supplies continued to focus on Pakistan (37 % share), Bangladesh (16 %) and Algeria (11 %). China’s arms export possibilities are limited by political reluctance in many countries to purchase Chinese arms. SIPRI notes that, among the world’s top 10 arms importers, India, Australia, South Korea and Vietnam do not buy any arms from China. Asia and Oceania account for 70 % of Chinese arms exports, Africa 20 % and the Middle East 6 %.

China is the world’s largest exporter of drones for military use. Part of the reason is that the United States and Israel restrict the sale of their military drones to others.

Even with own arms production capabilities, China was the world’s sixth largest importer of arms in the 2014–2018 period after Saudi Arabia, India, Egypt, Australia and Algeria, accounting for just over 4 % of global imports. Although the volume of imports fell (down 7 % from the previous five-year period), China is still dependent on imports of e.g. engines for fighter jets and ships, and air defence missiles. Russia accounts for 70 % of Chinese arms imports, France 10 % and Ukraine 9 %.

The volume of Russian arms exports dropped by 17 % during the 2014–2018 period relative to the previous five-year period. SIPRI reports that much of the decline came from a 42 % drop in exports to India and a total collapse in exports to Venezuela. Even so, India is still Russia’s top arms customer with 27 % share, followed by China (14 %) and Algeria (14 %). Russia exports arms to 55 countries. Asia and Oceania account for 60 % of exports, Africa 17 %, the Middle East 16 %, Europe 6 % and Americas just over 1 %. Russian arms imports are insignificant at the moment.

## Russia

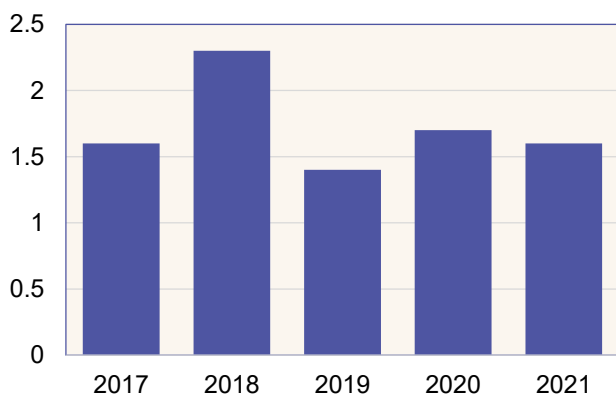
**BOFIT forecast sees lower growth of Russian economy ahead.** While Rosstat's 2.3 % initial estimate for Russian 2018 GDP growth clearly exceeded expectations, our latest [BOFIT Forecast for Russia 2019–2021](#) sees growth slowing this year. Lower growth in public sector wages and a modest pick-up in inflation bode lower real wage growth. Growth in private consumption will be curtailed by a two-percentage-point increase in value-added taxes at the start of the year. Growth in household borrowing, a bulwark of private consumption over the past two years, should remain high, even if higher on-year growth is unlikely.

If oil prices remain at current levels, the public-sector budget should remain in surplus. The rise in budget revenues will slow and the government's fiscal rule should limit growth in public consumption. Private consumption in Russia corresponds to roughly half of GDP, while public consumption accounts for just under 20 %.

Numerous investment programmes associated with the state-lead national projects are set to get underway in 2020 and 2021. The project spending should slightly boost economic growth, especially in 2020. In contrast, there are no signs of a broad-based recovery in private investment. The government hopes to attract investment through such measures as subsidising domestic production, increasing domestic-content requirements and guiding large firms to participate in the financing of national projects. The business environment remains burdened by uncertainty and structural problems with the economy. The pick-up in investment growth is likely to be temporary and the economy's investment rate should remain at just over 20 % of GDP.

Substantially higher growth in export volumes relative to import volumes supported economic growth last year. During the forecast period, this gap between export and import growth will narrow. Growth in the state's overall presence in the economy and lack of market reforms depress the growth outlook in the years ahead.

Realised Russian GDP growth and forecast for 2019–2021, %



Sources: Rosstat, BOFIT Forecast for Russia 2019–2021.

**Growth in Russian industrial output revived in February.** Industrial output growth rose to 2.6 % y-o-y in January-February. The figure moved up towards the growth figure for all of 2018. Extractive industries led growth, with production increasing by nearly 5 %, up from an annual growth pace below 3 % over the past three years. Growth of crude oil production was up, while natural gas production increased rapidly for the third consecutive year. As in previous years, the volume of services related to their production grew at such a pace that the services also now had a major impact on extractive sector growth. The weight in terms of the value of these services in extractive sector production figures is slightly larger than the weight of natural gas output.

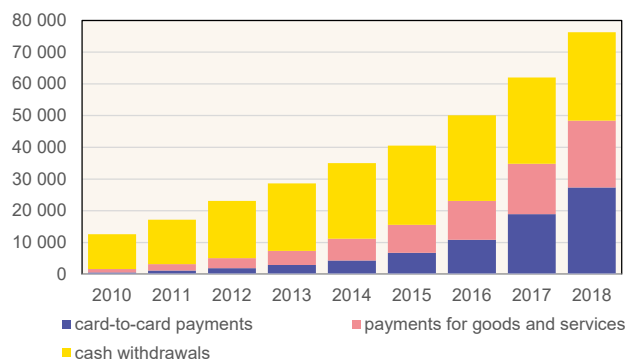
Having been around 2.5 % y-o-y for the previous three years, manufacturing output growth was under 2 % in January-February. Years of rapid growth in the food industry continued. Growth also strengthened in some of the other large branches such as oil refining and metal industries, while production performance weakened in the chemical industry and in the machinery & equipment category.

**Rapid growth in use of payment cards in Russia.** The use of new forms of electronic payments has increased rapidly in Russia, and the Central Bank of Russia has clearly indicated its intention to participate in this trend. The CBR aims to create safe payments systems that are independent from foreign banks and financial institutions. With this goal in mind, since 2014 Russia has built e.g. CBR-owned national payment systems, and the national payment card Mir.

At the beginning of this month the CBR launched its own fast payment system SBP, designed to allow for immediate transfer of funds between client accounts. Although a group of 40 banks has signed up to participate in the system, Sberbank, Russia's biggest bank and the unchallenged market leader in card payments, has yet to join.

A sizable chunk of retail payments in Russia are made with the card-to-card payment systems mostly based on Visa and Mastercard. The authorities may hope the CBR's SBP system will move at least some payment traffic to domestic platforms.

Use of payment cards 2010–2018 (RUB billion)



Source: Central Bank of Russia.

## China

**BOFIT Forecast for China: uncertainty casts shadow on Chinese growth outlook.** China's economic growth, which witnessed a slowdown last year, continues to slow this year. While uncertainties that include the current trade war with the United States, domestic indebtedness and unreliable statistical data make it hard to judge China's true economic circumstances, our latest [BOFIT Forecast for China 2019-2021](#) nevertheless sees an ongoing slowdown in annual GDP growth towards around 4 % by the end of the forecast period.

The drag on Chinese economic growth comes largely from structural factors. The population is ageing rapidly. The working-age population (15–64 years) has been shrinking since 2014, and the absolute number of people in the workforce declined last year for the first time in the modern era. The dependency ratio continues to deteriorate at a rapid pace. The structural evolution towards a services-driven economy also limits opportunities for productivity gains. It is difficult to boost investment growth much as the investment rate is already the highest among all large economies. The need to address China's environmental problems also depresses the country's growth outlook.

China has stubbornly clung to the political goal of doubling real 2010 GDP by 2020. The need to constantly apply stimulus to reach the growth targets has caused the country's indebtedness to soar. Moreover, statistics have been falsified in order to meet targets increasing uncertainty and complicating decision making at all levels.

Room to manoeuvre in economic policy is limited. As long as the fiscal policy stance remains extremely accommodative, the sustainability of local government indebtedness is highly problematic. In the corporate sector, further debt-driven stimulus is also difficult to justify in the face of rising defaults and bankruptcies. Moreover, debt financing beyond a certain point has diminishing returns as new borrowing goes to paying off old debt. Any increase in stimulus measures exacerbates the likelihood of sudden economic decline.

The government's focus on supporting economic growth has pushed needed structural reforms to the back burner, but the trade war brought them back to the fore. However, measures to consolidate the party's power and increase control over society conflict with economic reforms.

The likelihood of a sudden slump in economic growth has increased. In countries that have gone rapidly into debt like China, it is common to see the episode end with a sharp drop in GDP and a crisis in the financial sector. The current astronomical apartment prices relative to incomes poses a clear risk. A correction in housing prices would not just cause problems for households but for heavily indebted companies in the construction sector as well. In the banking sector, small and mid-sized banks are most vulnerable. Even if the trade war is resolved amicably, the US and China will continue to compete for global dominance, which will stoke trade and geopolitical tensions also in the coming years.

**January-February figures show slowing Chinese economy.** The National Bureau of Statistics reports industrial output growth slowed to 5.3 % y-o-y in the first two months of 2019 (over 7 % in the same period in 2018).

Retail sales rose by 7.1 % y-o-y in real terms during January-February. Although growth in online sales slowed, the value of goods and services sold online rose by 14 % y-o-y (37 % y-o-y in January-February 2018). Car sales, which represent about 10 % of retail sales, continued to contract as part of a trend that began last year. Apartment sales also slowed. Measured in terms of liveable floorspace, apartment sales in January-February declined by 4 % y-o-y.

The unemployment rate rose from 5.1 % in January to 5.3 % in February (4.9 % in December). The shift is significant by Chinese standards; since January 2017, the official survey-based urban unemployment rate has held solidly in the 4.8–5.4 % range.

Growth in the stock of bank lending continued to rise in January and February at 13 % y-o-y. Local governments accelerated their borrowing plans this year. In the January-February period, local government issued bonds worth 782 billion yuan (117 billion dollars).

Real growth in fixed asset investment (FAI) for January-February was estimated at about 2–3 %. Growth in infrastructure investment slowed significantly from the first two months of 2018. This slowdown was also apparent in construction. The NBS reports that new building starts rose by 3 % y-o-y in January-February, the lowest pace of growth since the series was first released in 2004. Chinese investment figures should be taken with a large grain of salt, however, as many series published at the moment only indicate nominal cumulative (year-to-date) growth. Yuan-denominated series have been discontinued. The FAI figures are also odds with China's national accounts figures.

**NPC rushes through a new investment law.** Last Friday (Mar. 15), the National People's Congress passed a new Foreign Investment Law designed to protect commercial secrets of foreign firms, ban forced technology transfers and assure foreign firms equal access to China's domestic markets. The new law will enter into force at the start of 2020.

A further revision to the bill added last week says that officials who pass information provided by foreign firms to third parties can be punished. The law complements earlier regulations such as those on free repatriation of corporate profits and other corporate assets. The new law has been criticised for its hasty 12-week preparation and its resulting vagueness. The financial website Caixin reports that the new law will likely be clarified through lower-level regulations and guidelines. Implementation of the law and its monitoring has already become a major trade policy issue.

The new law responds to the current trade war and US demands, and replaces three laws enacted during the 1970s and 1980s.

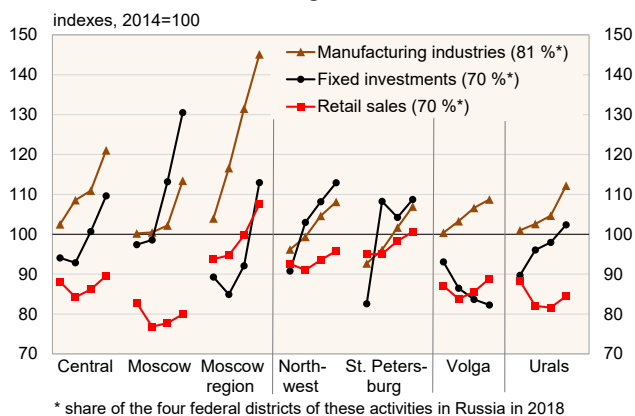
## Russia

**Large disparities in Russian regional economic development.** Apart from the Siberia and Far East federal districts, manufacturing output has risen over the past 3–4 years continuously in Russia's other six federal districts. Rapid growth in the Central Federal District reflects diverse manufacturing operations in the Moscow region surrounding the City of Moscow, the region enjoying manufacturing growth surpassing 10 % p.a. for the past three years. The mega concentration of the City and the region accounted for over 15 % of all national manufacturing output (excluding oil refining). Manufacturing in the Northwest, Volga and Ural federal districts has also shown good growth.

Fixed investments recovered rapidly over the past two years in the Central Federal District, buoyed by investments in a number of sectors based in Moscow and the Moscow region. In the Northwest Federal District, investments also rose briskly over the past couple of years, due in large part to sharp increases in transportation sector investments in the Leningrad region surrounding St. Petersburg. Investments in the Central and Northwest federal districts last year exceeded the pre-plummet 2014 level by roughly 10 %. Both federal districts continued to raise their shares of fixed investments in Russia over the past two years. In 2018, they together accounted for nearly 40 % of all fixed investments in Russia.

Since the deep slump in 2015, retail sales have recovered to their previous level in only a few of Russia's more than 80 administrative regions. The Moscow region led the rise, due in part to shifts where retail trade has been moving to the region from the City of Moscow. The Moscow region continues to account for an increasing share of national retail sales, which, together with the City, was nearly 23 % of the country's retail sales in 2018. Retail sales in the City of St. Petersburg and the Leningrad region have recovered to 2014 levels. In five federal districts, however, retail sales last year were still at levels 10–15 % below those of 2014.

### Real change in manufacturing, investments and retail sales in 4 federal districts and the 2 largest urban centres, 2015–2018



Source: Rosstat.

**President of Kazakhstan resigns.** 78-year-old Nursultan Nazarbayev, Kazakhstan's leader since the break-up of the Soviet Union, announced his resignation on March 19. The speaker of the upper house of parliament Kassym-Jomart Tokayev will serve as acting president until Nazarbayev's current term expires next year. Rather than going into full retirement, however, Nazarbayev will continue as head of the Security Council and as chairman of his Nur Otan party. Nazarbayev's new informal position was further evidenced when Tokayev, upon assuming office, changed the name of the capital city from Astana to Nursultan.

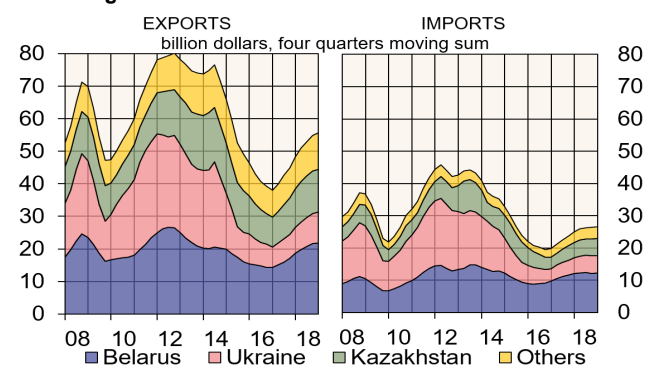
As most of Kazakhstan is arid land, most of its 18 million population live either in the relatively verdant steppe of the north or the mountain foothills of the south. Over half of the country's inhabitants are ethnic Kazakhs, but the northern plains are also home to millions of ethnic Russians. Partly owing to its wealth of natural resources, Kazakhstan has been able to sustain living standards close to those of Russia. Its Central Asian neighbours are rather less affluent. Kazakhstan is a member of the Eurasian Economic Union, which includes Russia, Belarus, Armenia and Kyrgyzstan.

### Russia actively engages in trade with its neighbours.

Although the significance and number of members of the Commonwealth of Independent States (CIS) have declined, the eleven former Soviet republics that formed it with Russia remain an important group of trading partners for Russia. These countries have economic significance also as transit countries since they lie between Russia, the European Union, the Middle East and China. In 2018, these countries accounted for about 11 % of Russian goods exports and imports. Exports volumes are reported to have grown by about 10 % from 2017 to 2018, while imports grew much more modestly.

Russia exports significant volumes of fossil fuels to Belarus and Ukraine, whereas many countries in the Caucasus and Central Asia have their own fossil fuel reserves. In addition to fuels, Russia exports machinery, vehicles and metal goods to these neighbour countries. Russian food is also exported to Central Asia. Russia imports machinery from Belarus and Ukraine, ore and metals from Ukraine and Kazakhstan, and foodstuffs from Belarus and the Caucasus.

### Russia's goods trade with current or former CIS members

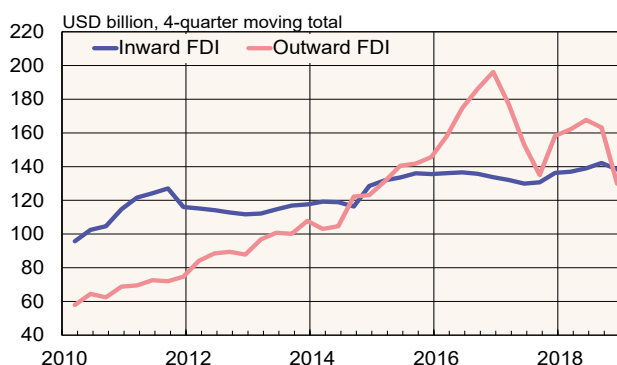


Source: Russian customs.

## China

**Foreign direct investment flows from China declined again last year; EU investment also down.** China's Ministry of Commerce reports that foreign direct investment outflows from China amounted to 130 billion dollars last year, a decline of 18 % from 2017. Outward FDI was slightly less than inward FDI to China, which was valued at 138 billion dollars.

### Inward and outward FDI flows for China



Sources: China Ministry of Commerce and CEIC.

China Global Investment Tracker (CGIT) also reported a sharp decline in investment from 2016–2017. CGIT reports that 40 % of Chinese investment last year went to Europe, while Asia, North America and Africa each accounted for roughly 15 %. Chinese investment in Africa soared after a slump of several years. CGIT shows that nearly 40 % of Chinese investment last year went to the metals and energy sectors, compared to less than 15 % in 2017. Investment in other branches fell sharply.

A recent [report](#) from MERICS and the Rhodium Group finds that the flow of Chinese FDI to EU countries last year fell to just 17 billion euros, a 40 % drop from 2017 and the lowest level of FDI since 2014. The UK, Germany and France together accounted for nearly half of Chinese FDI to EU countries, down from more than 70 % in 2017. Investment in Sweden, however, soared after Volvo-owner Geely pumped in 3 billion euros in new capital. As recently as the start of this decade, Chinese state-owned enterprises accounted for 80–90 % of Chinese FDI to the EU. The Rhodium Group estimates that the share was just over 40 % last year.

FDI outflows from China have fallen since 2017 after China implemented tighter guidance on investment abroad and narrower access of Chinese firms to financing. A number of firms struggling with debt last year were forced to sell a part of their foreign assets. MERICS/Rhodium Group estimate that Chinese firms divested at least a total of 4 billion euros in EU assets last year.

The stricter regulatory environments in FDI receiver countries has also affected Chinese foreign investment. In recent years, several Western countries have tightened their screening of foreign investment. The EU also recently approved new

rules on investment screening for third countries (see [BOFIT Weekly 7/2019](#)). Equitable treatment of foreign investors and a level competitive playing field were again on the agenda during president Xi Jinping's visit to Europe this week.

**Chinese international patent activity almost on par with the US.** The World Intellectual Property Organization (WIPO), which operates under the auspices of the UN, reports that a total of 253,000 international patent applications covered by the Patent Cooperation Treaty (PCT) were filed last year, an increase of 4 % from 2017. Even with a minor decline, the number of PCT patent applications from the US was the highest, accounting for just over 22 % of total PCT applications. The number of Chinese PCT patent applications rose by 9 % last year to a total share of 21 %.

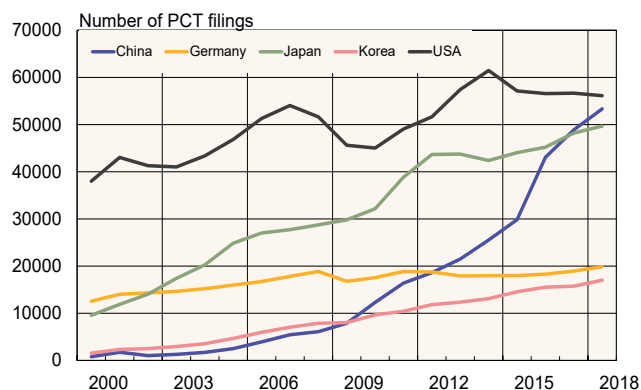
Asia's push on the innovation and patent front was bolstered by number-three Japan (20 % of all patent applications) and fifth-place South Korea (7 % share). They bracket number-four Germany with its 8 % share. Six of the top 10 PCT patent application countries were located in Western Europe. For the first time, Asian countries accounted for half of all applications, while Europe represented just over 24 % and North America 23 %.

Asia's push into the technology frontier was also evidenced in the rankings of firms filing the most PCT patent applications. The Chinese Huawei topped the global list with over 5,400 patent applications last year. Next was the Japanese Mitsubishi Electric with about 2,800 applications. The number 3 and 4 spots went to the American Intel and Qualcomm, respectively. The top 10 also included two other Chinese firms, two Korean firms, a Swedish firm and a German firm.

BRIC countries other than China are far less active in their patent application activity. Although the number of patents submitted from India increased by 27 %, it still represented only about 2,000 applications, which is less than 1 % of all applications. Russians submitted less than 1,000 patent applications, while Brazilians had just over 600 applications.

The number of PCT patent applications from Finland rose by 15 % last year to just over 1,800, putting Finland 15<sup>th</sup> in the rankings just after India and Israel.

### PCT patent applications in leading countries



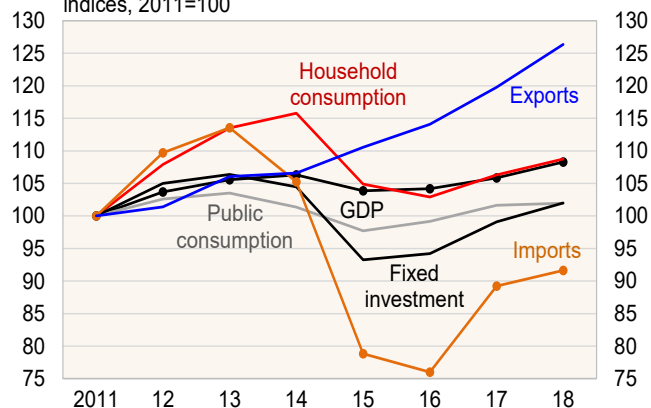
Source: WIPO.

## Russia

**New data on last year's improved performance of Russian economy.** Rosstat's fresh figures reinforce their first-round estimate that 2018 GDP growth at 2.3 % clearly beat out the 2017 performance (1.6 %). GDP growth in the first nine months of last year was adjusted upward to over 2 % (previous estimate 1.6 %). Mainly household consumption helped boost growth in the fourth quarter to 2.7 %.

The updated figures modify earlier views on the evolution of the main GDP components last year. Import growth was revised downward to just 2.7 %. The economy was still led by export growth, even if the new data show export volumes boomed (5.5 %) less than earlier announced. Fixed investment growth was revised up to nearly 3 %, while growth in public consumption was lowered to close to zero.

**Real GDP, imports and demand components, 2012–2018**  
indices, 2011=100



Source: Rosstat.

**Russia's national ecology project addresses a range of environmental issues.** One of the twelve programmes included in president Putin's inaugural May Decrees of 2018 ([BOFIT Weekly 08/2019](#)) seeks to improve the environment. The programme in principle deals with all environmental problems, but waste management is given a rather prominent place in it. Dumps constitute a contentious issue in Russia as citizens have started to pay more attention to the problems involved with it. In contrast, climate emissions play a small role in this programme.

While the cost estimate has fluctuated since May 2018, the plan released in February calls for 4.041 trillion rubles or a bit more than 50 billion euros during 2019–2024. This corresponds to about half a percent of gross domestic product. Polluting firms are expected to finance up to three-quarters of the national project, while the state will subsidise interest payments on loans taken for this purpose. The firms are expected to raise funds by issuing special green bonds. Money raised by these kinds of bonds is earmarked for environmental investments. Russia's first green bonds were issued in December on the Moscow Exchange.

**Funding of the national ecology project, 2019–2024**

	mrd.	RUB	EUR*
<b>Sources</b>		<b>4 041.1</b>	<b>54.0</b>
1 Federal budget		701.2	9.4
2 Budgets of the federal subjects		133.8	1.8
3 Other funds		3 206.1	42.8
<b>Expenditures</b>		<b>4 041.0</b>	<b>54.0</b>
1 Clean land		124.2	1.7
2 Management of municipal solid waste		296.2	4.0
3 Management of hazardous waste		36.4	0.5
4 Clean air		500.1	6.7
5 Clean water		245.0	3.3
6 Improvement of the Volga River		205.4	2.7
7 Protection of the Baikal Lake		33.9	0.5
8 Protection of unique bodies of water		15.2	0.2
9 Protection of biodiversity and development of nature travel		6.3	0.1
10 Protection of forests		151.0	2.0
11 Adoption of best available technologies		2 427.3	32.4

\* Converted at the average exchange rate of the first quarter of 2019 (74.7 RUB = 1 EUR).

Source: Russian government.

However, the principles for calculating the costs may not be straightforward. The figures may include already-funded public works, and the companies might have planned to make some of the investments even without the project. According to the finance ministry's estimate, the programme doubles direct federal spending on environmental protection.

The programme has evoked contentment as well as contempt. While the plan mentions several concrete actionable measures to be taken at the worst polluted sites, it falls short of giving a precise description of a general tightening of environmental regulation. For example, World Wildlife Fund (WWF) Russia has pushed for greater focus e.g. on recycling, modernisation of production methods and improving the market environment for small waste management firms.

### New bridges across Amur River are set to open soon.

The Amur River, that flows into the Pacific Ocean, and its tributaries form the roughly 4,000-kilometre long border between Russia and China in the Far East. To improve the lack of bridges across the Amur, China and Russia began building a rail bridge in 2014. China finished its part of the bridge in 2016, but the Russian part was connected to the Chinese side only in March 2019. The bridge is set to open later this year. In 2016, the countries began to construct a trans-border road traffic bridge that should be completed next year.

The new rail bridge is located near the small Chinese city of Tongjiang at the confluence of the Songhua River. This spot is connected by rail to the large Chinese city of Harbin and to the Russian Trans-Siberia railroad. It was already possible earlier to use the Trans-Manchurian line running through Harbin to reach the Trans-Siberian line in Vladivostok to the east and Chita to the west. Additionally, there is a rail connection from Beijing through Mongolia to Russia's Ulan-Ude. It seems that an important use of the new bridge will be to facilitate iron ore transport from mines on the Russian side of the border to China. The new road traffic bridge is located at the confluence of the Zeya River, allowing crossing between Blagoveshchensk on the Russian side and Heihe on the Chinese side. A freeway runs directly from Heihe to Harbin.

## China

**China's public sector budget deficit unchanged; revenue-side a major concern.** Last month's National People's Congress approved the finance ministry's proposed 2019 budget. With total revenues to central and local governments of 19.25 trillion yuan (2.5 trillion euros, or nearly 20 % of GDP) and expenditures of 23.52 trillion yuan (estimated at 24 % of GDP), the deficit would be 4.27 trillion yuan, or 4.3 % of GDP. The budget deficit as a share of GDP is slightly larger than the realised 2018 deficit. Figures do not include budgeted withdrawals from state funds.

The finance ministry's budget report indicates concern over the government's ability to realise the budget, particularly in light of the bleak revenue outlook. While budget revenues are projected to climb 5 % this year, economic growth is slowing and the government has committed to 2 trillion yuan (300 billion dollars) in stimulative cuts to taxes (including VAT and income taxes) and fees. This does not include earlier agreed cuts that will further reduce revenues.

The need to spend to prop up economic growth and commitments to earlier public projects provide strong incentives for officials to spend beyond their budgets. While spending will increase 6 %, greater effort must be made to target spending effectively. The finance ministry has called for spending cuts at all administrative levels and placed strict controls on officials in their foreign travel, car use and business-related entertaining. The finance ministry plans to cut its own spending by at least 5 %. *Caixin* reports that about 50 central government ministries and agencies had already committed to spending cuts by early April. However, a similar number of ministries and agencies have increased budget expenditures.

The budget report notes many fiscal ailments in China's public sector. Some cities are struggling to provide basic services, conduct other normal activities and even make payroll. Such basic government spending is hard to cut, even when revenue prospects are shaky. Nearly 40 % of provincial budget revenues consist of income transfers from the central government. A nearly as large share of revenues is derived from the sale of land-use rights. Sales of land-use rights declined in the first three months of this year. The finance ministry also points out that excessive commitments by provincial administrations have endangered the sustainability of their finances. Provincial governments continue to guarantee credit or lend against the rules, making it even harder to assess debt risk.

By official estimates, China's public-sector debt is less than 40 % of GDP. Local governments, however, hold large amounts of off-budget "hidden" debt. Last summer, the IMF estimated that China's actual government debt was 70 % of GDP. This week Zhang Xiaojing, a deputy director of the Institute of Economics at the Chinese Academy of Social Sciences (CASS), valued China's current government debt at more than 90 % of GDP. Media have recently run stories about the debt problems of several city governments.

**Bloomberg Barclays index to include Chinese government and policy bank debt securities.** On April 1, Bloomberg Barclays added yuan-denominated bonds issued in mainland China to its Global Aggregate Index. The weighting of Chinese bonds in the index will rise incrementally over the next 20 months to 6 %. Yuan bonds were also added to two other Bloomberg Barclay bond indices. Mainland Chinese bonds have never before been included in any major global index.

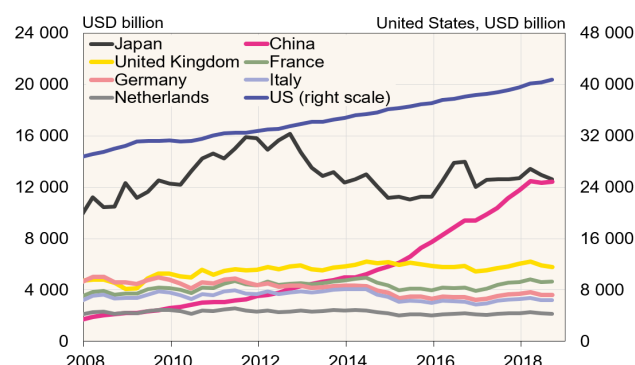
The rapid growth of China's bond markets since 2015 is largely a reflection of growth in local-government indebtedness. Foreign investor ownership in mainland China is, however, concentrated almost entirely in sovereign debt or bonds issued by the three state policy banks. FTSE Russell, one of the biggest index producers, is also considering adding Chinese bonds to its main index next autumn. J.P. Morgan, too, is contemplating the move, but has yet to include Chinese bonds.

The Bloomberg Barclays Global Aggregate Index is followed by about 2.5 trillion dollars in managed assets. Many investment banks assume that investors are reluctant to immediately shift investments to China as a passive tracking of the index would suggest. Even so, the credibility from index inclusion should bring in over 100 billion dollars in investment to China over coming years. That amount would increase if other central indices also include mainland Chinese bonds.

Index inclusion reflects the opening up of China's financial markets to the world, but there is still plenty of room for improvement. Foreign investors can presently only participate in China's bond markets through special programmes. Moreover, the availability of financial instruments to hedge interest-rate or currency risk is limited. Shifting investment assets to China is further restricted by the relatively low liquidity of Chinese markets and the fact that it is difficult to anticipate or defend against official regulatory changes.

Foreign ownership on China's bond markets grew last year by about 75 billion dollars to 250 billion dollars, which still was just over 2 % of the market. Foreign participation grew by about 50 billion dollars in 2017. Last year's developments are notable in that a large share of the increase in foreign ownership possibly came from Russia. The Central Bank of Russia reports that it last year shifted about 55 billion dollars of its currency reserves into yuan assets.

**Bond market size in select countries (USD billion)**



Source: BIS.



## Russia

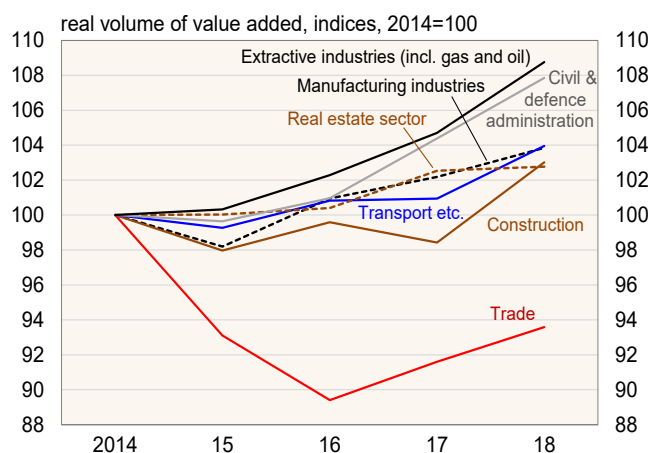
**Russian export earnings rather flat; recovery in imports continues to stall.** Central Bank of Russia balance-of-payments figures show that earnings from exports of goods and services, which had recovered fast in 2017–2018, were essentially unchanged in the first quarter from the same period a year earlier. This concerned both the energy category, which had seen a hefty rise in export prices, other exports of goods, as well as exports of services. Spending on imports of goods and services were unchanged on-year for the third quarter in a row. This has been the situation in goods imports for the past three quarters and Russians' travel spending abroad for the last half year.

The current account surplus was still large in the first quarter, rising to more than 7 % of GDP. The net private capital flow out from Russia climbed, increasing to 4.5 % of GDP for the past four quarters.

**Russian growth in the past couple of years driven largely by extractive sector, trade and public administration.** New GDP data show that among the largest sectors output of extractive industries and related services, as well as civil service and defence administration have been the fastest drivers of real growth over the past three years. The trade sector, as well as transport and warehousing also recovered gradually over the past two years and construction over the past year. After showing good growth a couple of years back, manufacturing saw a slowdown. In GDP statistics, output is measured by value-added produced in each sector.

Health care and social services stand out among the weakest sectors and have seen their value-added decline in real terms slightly in recent years. Increases in government budget spending on health care have largely focused on wage increases (especially last year) for workers in the sector. In practice, the rise in wages has mainly been reflected as higher prices in health care.

**Real growth of the economy's largest sectors, 2015–2018**



Source: Rosstat.

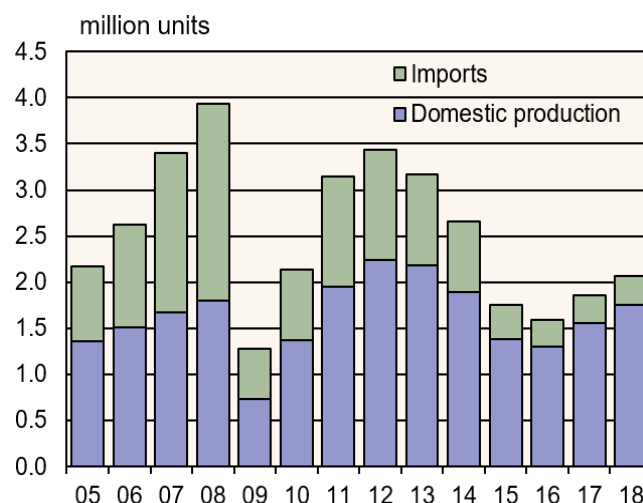
**Russia's car manufacturing industry continues to recover.** Rosstat reports that Russian car production rose by 13.3 % from 2017 to 2018. A total of 1.8 million passenger vehicles, busses and lorries were built in Russia, with another 300,000 vehicles imported. Russia currently has about 50 million cars on the road. Russia's domestic production has gradually recovered in recent years from a dip in 2014–2016, but this winter the recovery has been slower.

The role of foreign brands in the Russian car market has fluctuated over the past three decades. Domestic production declined during the 1990s, and over half of the flow of cars into the market were imports by 2008. Since then, however, domestic production has made a comeback as foreign car-makers moved their assembly work to facilities in Russia.

Russian partners are often involved in plant projects of foreign automakers. Such joint ventures, for example, have allowed AvtoVAZ, known for its production of the Lada, to preserve significant market share. The popularity of German, American, Japanese and Korean cars has remained, but today four out of five cars that come to the Russian market are assembled in domestic plants. In recent years, foreign companies operating in the Russian market have shut down some of their production lines. Ford Sollers, the joint venture of the American Ford and Russian Sollers (formerly Severstal-Avto), announced in March that they were ceasing passenger car production and focusing on other light vehicles.

The core manufacturing centres of Russia's car industry are located along the banks of the Volga River between Samara and Yaroslavl. Foreign manufacturers have also been attracted through various incentive arrangements to establish production in Kaluga, the Kaliningrad enclave and St. Petersburg. Lower car sales can have significant local impacts in smaller municipalities. For example, the city of Togliatti, with a population of about 700,000 people, is home to the AvtoVAZ plant. Even after major layoffs, the plant still employs 37,000 people.

**Flow of cars into the Russian market, 2005–2018**



Source: Rosstat.

## China

**EU gets reform commitments from China that benefit European firms.** At the 21<sup>st</sup> annual EU-China summit held on Tuesday (Apr. 9) in Brussels, the parties signed a joint statement that said that they were committed to, among other things, supporting multilateral rule-based world trade and WTO reform including rules on government subsidies. Both the EU and China unequivocally rejected forced technology transfer policies.

Progress has been slow in negotiations on the EU-China Comprehensive Investment Protection Agreement which began in 2013. Now the joint statement affirms that the EU and China are committed to accelerate the process so that the agreement could be signed as soon as next year. The agreement would assure improved market access, elimination of discriminatory demands and practices on foreign investors and establish a balanced investment protection network. The EU considers approval of the investment protection agreement a precondition to starting free-trade talks. The parties also pledged to foster China's accession to the WTO's Government Procurement Agreement.

Both sides agreed that steel overcapacity and dealing with government supported export credit were global challenges. The parties will also seek to create synergy between the EU strategies on Connecting Europe and EU Trans-European Transport Networks and China's Belt and Road Initiative in order to improve connections between Asia and Europe.

The EU has lately [honed](#) its China policies. This was clearly expressed in the strategy paper released by the European Commission last month (*EU-China – A strategic outlook*). This week it seemed that the EU might walk away from the joint statement if China failed to commit to concrete steps to solve long-standing trade-policy problems. While the nature of problems suggests they cannot be dealt with quickly, this time the parties managed to agree on tracking mechanisms to monitor progress in meeting their commitments.

**Special audit reveals big problems in China's small rural banks.** China's National Audit Office late last week submitted a special audit report on rural banks in Henan province. Of 42 banks inspected, a dozen were found to hold non-performing loans (NPLs) in excess of 20 % of their loan stocks. Several had NPL ratios above 40 %.

At the end of 2018, Henan banks reported NPL ratios of around 2.5 % on average, which was still above the nationally reported average of 1.9 %. However, Chinese banks are famously reluctant to report or write down bad loans, so it is evident that similar problems of mischaracterisation of loan status found in Henan are fairly widespread. Banks allow non-performing receivables to accumulate after funding unprofitable projects under political pressure. Chinese banking rules require banks to hold reserves to cover such bad loans, but if NPLs were reported honestly, their reserve buffers

would have to be increased dramatically to meet official requirements.

The situation for China's banking sector overall was relatively stable last year. Lending grew steadily and banks managed to slightly widen the interest rate spread between loans and deposits from which banks derive most of their earnings. Banks also managed to boost solvency ratios. Profitability measures (ROE, ROA) remain quite low, though. Overall, the situation within the banking sector remains one in which large banks perform much better than small banks by just about any performance measure.

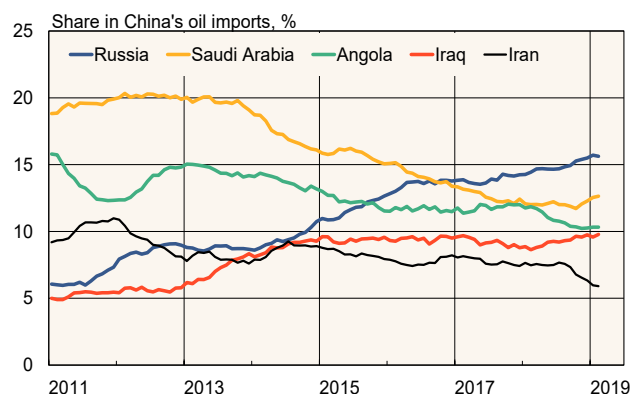
Most banks consider the current operating environment challenging. In addition to external uncertainties, growth of China's domestic economy is slowing, thereby increasing problems with loan repayments and competitive pressures from the large financial technology (FinTech) firms.

**Russia strengthens its position as China's biggest oil supplier.** China imported 462 million metric tons of crude oil last year, an increase of 10 % from 2017. China's domestic oil production witnessed a third consecutive year of decline from a peak of 215 million tons to just 189 million tons last year. The country's dependence on oil imports continues to rise (71 % of crude oil consumed in China is now imported).

China has been quite strategic in distributing its sources of foreign oil. In recent years, Russia (16 % of China's oil imports) has surpassed Saudi Arabia as China's most important oil supplier. The shift reflects the completion in early 2011 of the China branch of the Eastern Siberia Pacific Ocean (ESPO) pipeline, as well as the inauguration of an additional pipeline section to China in January 2018. China's oil imports from Russia rose by about 20 % last year to 72 million tons, of which about half was transmitted via the ESPO pipeline's China branches. About a quarter of Russian crude oil exports now go to China.

Iran, long a major supplier for China, saw a sharp decline in the volume of oil exports to China last autumn. The drop likely reflects harsher US sanctions on Iran. Venezuela, which only a year ago accounted for over 5 % of China's oil imports, has recently seen its share fall below 4 %.

### China's top crude oil suppliers



Source: CEIC.

## Russia

**Direct investment outflows from Russia remain significantly larger than FDI inflows.** Flows of direct investment to and from Russia's non-bank corporate sector have been smaller over the past five years than earlier. This concerns inbound FDI to Russia especially, even though they rose temporarily due to two individual relatively massive investment operations in the period (the ownership restructuring of the TNK-BP joint venture between the Russian state oil giant Rosneft and BP in 2013, and the sale of a large stake in Rosneft to foreign investors in 2016). FDI flows into Russia's corporate sector over the past decade have almost continuously been smaller than FDI outflows from the Russian corporate sector.

As in previous years, most 2018 FDI inflows to Russia's corporate sector were reinvested profits. Intragroup credit between parent and subsidiary companies became a popular practice a decade ago to bring capital into Russia but that has shifted in recent years to a slight drain of capital out of the country. Owning more equity in Russia has not been quite appealing: net inflows of inward share capital (excluding Rosneft arrangements) have been small over the past ten years. Last year even saw the situation where that net flow was an exceptionally large negative. This could also be seen in the fact that, for the past couple of years, foreign companies launched fewer new firms in Russia than earlier and the number of closures of established foreign firms in Russia rose.

The types of finance in Russia's corporate sector FDI outflows, in contrast, remained quite diverse. Reinvestment of profits has stayed popular, while investment in share capital and lending by Russian parent companies to their foreign subsidiaries also retained their roles.

The direction of the small FDI flows involving the banking sector have almost constantly been into Russia rather than out. FDI inflows to the Russian banking sector for many years have almost entirely consisted of reinvested profits. Most FDI outflows from the Russian banking sector have been made in the form of share capital.

### Inward and outward direct investment flows, 2007–2018



Source: Rosstat.

**Revenue boom of Russian federal budget begins to normalise.** After climbing by nearly 30 % last year in nominal terms, budget revenues rose another 13 % y-o-y in the first quarter of this year. Revenues from oil & gas taxes increased by 7 % after rising by about 50 % last year. Other budget revenues increased at about the earlier rate of over 15 %. A similar pace of growth was seen in VAT revenues. The impact on budget revenues from the VAT increases of January 1, 2019 is still ahead as VAT is paid with a quarter's delay.

Growth in federal budget spending accelerated from last year to over 8 %, which is the pace budgeted for this year. Defence spending increased by 13 % y-o-y in the first quarter. The budget surplus for the last twelve months still corresponded to 2.8 % of GDP.

### Russian spending on private insurance increases.

The Central Bank of Russia reports that in 2018 Russians paid a total of 1.48 trillion rubles (20 billion euros) for various types insurance (excluding mandatory insurance policies for healthcare and pensions), which works out to about 10,000 rubles (140 euros) per capita. The insurance market saw nominal overall growth of 16 % between 2017 and 2018. Growth has been rapid even if we take into account inflation of about 5 % a year. Even so, Russia's insurance market is still rather small relative to most advanced economies.

About 30 % of insurance payments go to life insurance. Health, accident and prescription drug insurance account for another 20 % combined, while car insurance is about 30 %. The rise of life insurance in recent years has made up for the downturn in premia paid on other types of policies (though other insurance categories also grew last year). Russia's pension system and healthcare system are funded through mandatory contributions, so the role of private insurance is supplemental. Private life insurance policies represent a small share of pension insurance, and only a small slice of the Russian population purchases supplemental health insurance.

Life insurance has been the strongest growth category in the insurance sector. During 2016 and 2017, the total amount of life insurance premia collected increased at a pace of over 50 % a year, and last year grew by yet another 30 %. The central bank, which is responsible for supervision of Russia's financial markets, also intervened this year to regulate the life insurance business. New guidance that entered into force this month requires insurance companies to better inform their clients of the terms of life insurance policies and ensure that the policies fit the needs of their clients. The Central Bank pays special attention to the clarity of payout conditions and amounts.

At the end of 2018, there were 275 companies operating in Russia's insurance markets. About 200 were companies, 12 mutual insurance groups and the rest insurance brokers. The number of operating licences declined, but the drop was due more to voluntary relinquishing of operating licences than official action. In contrast, the Central Bank has had few qualms about revoking banking licences lately. It has been responsible for oversight of insurance companies since 2014.

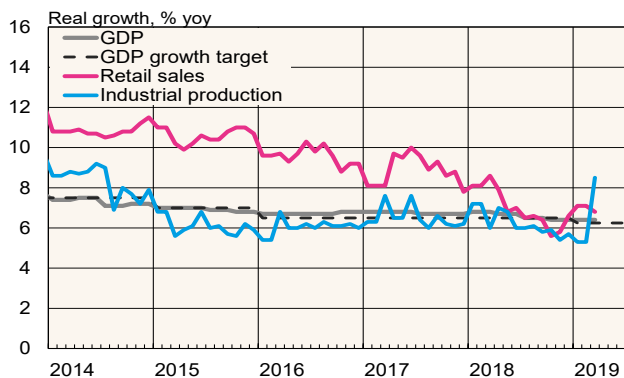
## China

**Despite monthly fluctuations, China's official GDP growth numbers remain remarkably steady.** China's National Bureau of Statistics reports that economic output increased by 6.4 % y-o-y in the first quarter of 2019, matching the growth pace of the previous quarter. The official GDP growth figure was higher than expected in light of weak indicator readings in January and February, and despite the anticipated growth gains of March. The extreme consistency of official GDP growth is less a reflection of actual economic trends than a showing that official growth targets are met.

The NBS also reports that March industrial output grew by 8.5 % y-o-y, well outpacing growth just over 5 % in January and February. While the revival in industrial output was broad-based, stand-out growth performances were seen in export branches such as equipment manufacture, electronics and textiles. The revival was not reflected in domestic consumption. Retail sales in real terms in March grew by less than 7 % y-o-y.

Consumer price inflation accelerated from 1.5 % in February to 2.3 % in March, mainly on higher food prices. The rise in producer prices also picked up from 0.1 % in January and February to 0.4 % in March.

### GDP, retail sales and industrial output



Sources: Macrobond, CEIC and BOFIT.

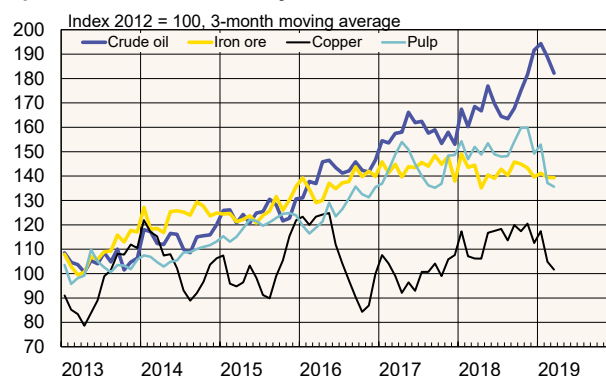
**China's exports revived in March, while imports continued to contract.** The value of Chinese exports in the first three months of this year (USD 552 bn) represented an increase of just over 1 % from a year earlier, even if on-year growth in March accelerated to 14 %. The value of imports (USD 475 bn) declined in 1Q19 by 5 % y-o-y. March imports were down by nearly 8 %. The first-quarter goods trade surplus was 76 billion dollars, up from 45 billion dollars in 1Q2018.

The revival of on-year growth in exports in March was driven by demand in EU markets (up 24 %), but strong growth was also registered elsewhere. Exports to the US in March were up 4 % y-o-y.

China's slack demand for imports reflects persisting weakness in domestic demand. In March, imports from the EU fell by 5 % y-o-y while imports from the US were down by more

than 25 %. Also imports from Japan, South Korea and Taiwan plunged. In addition to imports of finished goods from above mentioned countries, the volume of many key commodity imports have recently been in decline.

### Import volumes of select key commodities to China



Source: CEIC.

### China's capital flows were nearly in balance last year.

Balance-of-payments figures for 2018 show a small current account surplus and a surplus in the financial account. FDI inflows to China amounted to 204 billion dollars, while outflows from China were 97 billion dollars. Foreign portfolio investment in China was up sharply from 2016 and 2017, while Chinese portfolio investment abroad declined significantly.

Market reforms in recent years have largely sought to attract financing to China. Regulation of direct investment of Chinese firms abroad has been tightened and possibilities for portfolio investment outside China has been restricted. For example, only the investment channel to mainland China has been opened for bond investment under the Bond Connect programme launched in 2017. The channel for Chinese investors to invest in the Hong Kong bond market remains closed.

However, the negative number in the "net errors and omissions" item suggests larger capital outflows than the recorded flows indicate. The net errors item, which has been negative for the past decade, mainly reflects unspecified capital flows. When the net errors item is included, China's balance of payments was roughly in balance last year and its foreign currency reserves increased only by 19 billion dollars.

### China's balance-of-payments highlights, USD billion

	2015	2016	2017	2018
Current account	304	202	195	49
Goods trade	576	489	476	395
Services trade	-218	-233	-259	-292
Other items	-54	-54	-22	-54
Capital and financial account	-434	-416	109	130
Direct investment	68	-42	28	107
Portfolio investment	-66	-52	29	107
Other items	-436	-322	52	-84
Net errors & omissions	-213	-229	-213	-160
Change in reserves	-343	-444	92	19

Source: SAFE.

## Russia

**Steady rise in Russian industrial output.** According to Russian Statistics Service, the volume of industrial output rose by 2.1 % y-o-y in the first quarter of 2019.

The output volume for mineral extractive industries was up 4.7 % y-o-y. This reflects to some extent changes in the production ceiling agreement reached among a group of oil-producing countries. Last June, Russia and other countries interpreted earlier agreements in such a way that they could increase oil output. As a result, Russia's oil production grew by 4 % from June to October. In December, a new agreement was reached and Russia committed to cutting back on production by about 2 % ([BOFIT Weekly 50/2018](#)). The cuts are to be made during the first half of this year. Russian oil output declined by 1 % from December to March.

Manufacturing production volumes grew by 1.3 % y-o-y in the first quarter. Production of foodstuffs, beverages and paper were among the fastest growing branches. The clothing and textile industries were among the weakest performers.

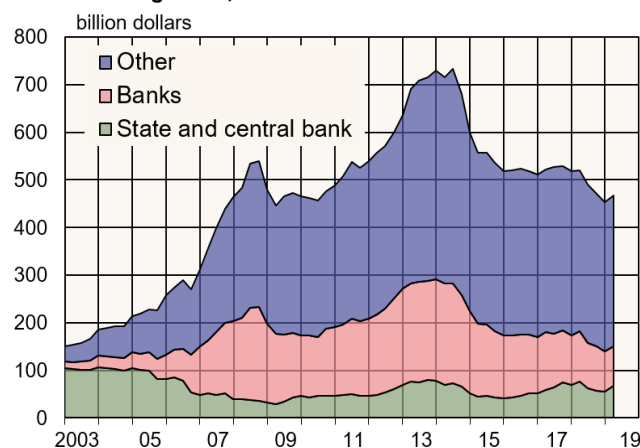
Construction activity rose by 0.2 % y-o-y in the first quarter. However, there are still grave concerns about the reliability of these numbers. The revised numbers released at the start of the year lifted the construction activity sharply to show a 5.3 % y-o-y increase in 2018. At least part of the revision seemed to be due to late recording of oil and gas projects in northern Russia. Given that the most intensive phase of construction on the Arctic coast is ending, construction activity can be expected to cool in the year ahead.

**Russia's foreign debt up slightly in the first quarter.** Growth in Russia's foreign debt basically came from government foreign debt. Russia's foreign debt is held mainly by non-bank corporations, banks and the government. Foreign debt has declined from a mid-2014 peak of about 733 billion dollars to around 468 billion dollars at the end of March.

Russians have reduced their foreign debt since the 2014 peak, mainly by paying down debt, due to sanctions and Russia's weak economic performance. Russians also paid down foreign debt during the 2009 financial crisis. However, the level of indebtedness at that time recovered rapidly after the crisis. The impact of sanctions is most evident in the continuous reduction of foreign debt of Russian banks. Russia's largest banks, which include giant Sberbank and VTB, are not able to get any new long-term financing from EU countries or the US.

At the end of March, the Russian government's foreign debt amounted to little over 53 billion dollars (11 % of total foreign debt). Banks owed over 82 billion dollars (18 %). Other sectors, mainly corporates outside the financial sector, owed about 318 billion dollars (68 %) to lenders abroad. Of that, 142 billion dollars was intragroup debt, i.e. debt owed between parent and subsidiary companies of the same corporate group.

Russia's foreign debt, 2003–2019



Source: Central Bank of Russia.

**Recent restrictions on Russian trade add to challenges facing Ukraine's new leadership.** The serious issues in Russia-Ukraine relations since the annexation of Crimea have been amplified by the latest rounds of trade restrictions. Russian economy minister Maxim Oreshkin estimates the restrictions imposed by Russia on Ukrainian goods affect nearly 30 % (4.3 billion dollars) of bilateral trade.

Russian president Vladimir Putin ordered his government last autumn to move ahead with new special economic measures on Ukraine in response to Ukrainian measures on Russian firms and individuals. In December, the government imposed new import bans on select Ukrainian goods. At the end of 2018, Ukraine extended its import bans of 2016 to the end of 2019. Russia last week widened its list of import bans and placed export bans and licencing processes on exports to Ukraine. Commodities subject to export licences include coal, coke, gasoline and diesel oil. Ukraine imported from Russia 3.5–4 billion dollars of these commodities in 2018.

Early this month, a WTO dispute settlement panel issued a first-time conclusion regarding the grounds for Russian transit bans imposed on Ukrainian goods, particularly in January 2016. Russia argued that the measures were necessary to protect "essential security interests" in an "emergency in international relations". Against Russia's view, the panel saw it had jurisdiction to review the matter. In the panel's view, Russia's basis for its bans comply with WTO rules. A focus was on deterioration of Russia-Ukraine relations to such a point that they constituted an international emergency. The panel saw evidence in a reference to armed conflict in a UN General Assembly Resolution on the Crimean situation, and third-country sanctions imposed on Russia. The panel stressed that in the absence of this international emergency the transit bans would appear to be inconsistent with WTO rules. The parties have 60 days to appeal.

In the second round of Ukraine's presidential election, Volodymyr Zelenskyi beat the incumbent Petro Poroshenko by gaining more than 73 % of votes against Poroshenko's just over 24 %. Voter turnout was 62 %.

## China

**China moves slowly to dismantle hukou household registration system.** The National Development and Reform Commission (NDRC) last week announced that this year all cities with populations of 1 to 3 million shall grant *hukou* status to anyone requesting it. For cities of 3–5 million inhabitants, the rules on petitioning for hukou status will be eased. For cities with populations of more than 5 million, the requirements for obtaining household registration shall be clarified so that more people have the opportunity to obtain hukou rights.

China has moved slowly in dismantling the hukou system. The latest reforms are part of a broader package approved already in autumn 2013 and an implementation plan published in spring 2014 ([BOFIT Weekly 14/2014](#)). Ending the hukou system is a critical reform as it makes it easier to move around and increases the equality between the rural and urban population. The government hopes it will accelerate urbanisation and sustain economic growth. As of end-2018, about 60 % of the Chinese lived in cities.

Hukou status is determined by place of birth. Changing status to another jurisdiction is difficult, especially if a person wants to move from the countryside to a city. Hukou complicates access of internal migrants to public services such as healthcare and education for their children because the services are tied to hukou status. Services, however, can usually be accessed today by paying additional fees. Some cities have arranged services specifically for the migrant community.

Even if the hukou system complicates moving around the country, it hasn't prevented people from moving to places with better job prospects. The National Bureau of Statistics reports that China had 288 million internal migrants in 2018. The average age of an internal migrant is 40 and about two-thirds are men. Roughly speaking, half of China's migrant workforce find jobs in the service sector, 30 % in manufacturing and 20 % in construction.

**IMF still sees elevated risk for China's financial sector.** In the latest *Global Financial Stability Report* released this month, IMF finds that China's tightened financial sector supervision and regulation has partly slowed the growth in bank balance sheets and risks, but further notes that the financial sector still has major vulnerabilities.

Distortions in how funds get distributed constitute a problem for the entire financial sector. As the government is expected to support real estate prices in troubled times and as financing is raised commonly by an entity assumed to have full government backing, banks continue to provide cheaper financing for real estate and infrastructure projects than for other branches. In recent years, such favourable lending has increased faster than other lending, increasing the already high land and real estate prices. Infrastructure projects may also lack sufficient cash flow to pay back loans, with the result that such loans end up on the public ledger.

The IMF noted specific problems facing China's small and mid-sized banks. Many of these banks have weak balance sheets, low profitability and are barely able to meet capital requirements. The IMF recommended that these banks cut back on lending to bolster their balance sheets.

The IMF sees that easing of monetary and credit policies to stimulate the economy could only exacerbate the financial sector vulnerabilities and at the end it might risk the financial stability.

**Last year saw fewer new apartments built for the Chinese market than in previous years.** According to the NBS, the volume of completed building area (measured in terms of floorspace) in 2017 and 2018 declined relative to previous years and that the drop continues this year. The volume of real estate sales has been quite steady, however, and the inventory of unsold real estate has declined.

The volume of new buildings completed in the first three months of this year fell by 11 % from the same period in 2018 to 185 million m<sup>2</sup> of floorspace. Of that, 130 million m<sup>2</sup> was residential buildings. In contrast, building starts measured in floorspace were up by 12 % y-o-y in the first quarter.

The total floorspace of buildings sold in January–March was 298 million m<sup>2</sup>, of which residential apartments were 260 million m<sup>2</sup>. Both declined slightly from the same period last year. Sales have risen steadily overall at the national level, and last year apartment sales measured by floorspace were up by 2 % from 2017. There are huge regional differences in sales trends, however. For example, apartment sales in Beijing recovered considerably in the first quarter from last year's decline, while apartment sales in Guangdong, one of China's largest provinces, saw its decline in apartment sales continue.

Chinese regulations on buying and selling apartments are city-specific, so sales volume and price trends vary considerably. In many small or mid-sized cities, prices are rising at 10–20 % y-o-y. Most of the decline in prices take place in China's big cities. Housing-market tracker SouFun found that in March average prices were lower than year ago in 5 of its 99 cities surveyed. The weighted average price per square metre of apartment floorspace rose by 4 % y-o-y. The price levels in Beijing, Shanghai and Shenzhen are now the same as in March 2018.

**Average apartment prices in select cities**



Sources: SouFun and Macrobond.

## Russia

**Russian budget surplus expected to shrink in the next few years.** The consolidated budget forecast released in April sees budget revenues increasing this year at about 3 % p.a. and at around 4 % p.a. in 2020–2021. That is slightly below inflation. The forecast, which comprises federal, regional & local budgets and state social funds, extends to 2036.

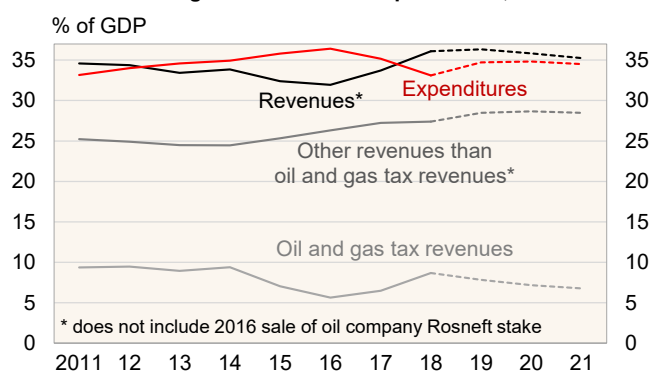
Revenues from oil & gas taxes substantially weigh on the revenue outlook. They rose hugely in 2018. This year they are expected to decline tangibly and then stay over 10 % smaller than last year. The estimate for the level of oil & gas tax revenues is unchanged from last autumn's forecast, as is the budget assumption about the price for Urals crude: over 63 dollars in 2019 and 58 dollars in 2021.

The GDP growth forecast for 2019–2021 also remains unchanged from last autumn, i.e. an acceleration in growth (1.3 % this year, 2 % in 2020 and over 3 % in 2021). The estimated level of other consolidated budget revenue streams than oil & gas tax revenues has risen a bit following last year's rapid rise that was also much faster than forecast (particularly profit tax and VAT revenues). They are expected to increase by 6–7 % this year and by about 6 % p.a. in 2020–2021 (the latter about the same pace as in last autumn's forecast).

The levels of consolidated budget spending estimates for 2019–2021 have been raised slightly after spending increased faster than forecast in 2018. The pace of spending growth remains very much the same as in last autumn's forecast at around 6 % p.a. or 1.5–2 % higher than inflation. Funding of national projects ordered in president Putin's May 2018 inaugural Decree is included in spending estimates.

The budget surplus will shrink this year to about 1.5 % of GDP and to 1 % of GDP next year. The calculational budget deficit at the fiscal rule's low oil price for the next few years is about 1.5 % of GDP. The rule mechanism will replenish the National Welfare Fund so that its liquid assets exceed 10 % of GDP in 2021 if no additional monies from the Fund are committed by e.g. granting loans for projects. This savings part of the rule forces the government to borrow to cover spending. The government debt will rise to 15.5 % of GDP in 2021.

### Consolidated budget revenues and expenditures, 2011–2021



Sources: Finance ministry and BOFIT.

**Little progress in reducing poverty, even as Russian living conditions generally improve.** Every two years, Rosstat conducts a large nationwide household survey that covers widely living conditions, incomes, housing and health. The results of the latest survey, conducted in autumn 2018, were released at the end of March. The survey includes responses from 60,000 households across Russia.

The survey indicates economic hardship has diminished slightly for most households. In autumn 2018, half of responding households said they had sufficient assets to afford a one-week vacation away from home, up from 43 % of respondents two years ago. Two-thirds of households reported that they could afford at least two pairs of shoes for every family member each year, up from half of respondents in 2016.

Only slight inroads have been made in reducing extreme poverty, with 15 % of respondents reporting struggles to meet necessary expenses. Confirming this are Rosstat's latest income data, which show that 13 % of the population (19 million people) last year got by on incomes below the official subsistence minimum. Despite economic growth and hikes in minimum wages, however, the share of the population living in poverty has remained unchanged in the last few years. The survey questions also touched on problems related to living in neighbourhoods and districts. The most frequent sources of dissatisfaction were the poor quality of the road system and traffic safety. Lack of access to services or their poor quality was clearly less of an issue for the respondents.

**Russian president tours East Asia.** On April 25, Vladimir Putin hosted North Korea's leader Kim Jong-un in Vladivostok. He then continued to Beijing to participate in the Belt and Road Forum which is a meeting of countries who participate in the initiative led by China.

Putin discussed security issues and economic relations with Kim, although compliance with international sanction policy against North Korea restricts cooperation between the two countries. Even so, a large number of North Koreans are reportedly already employed in the Russian Far East, especially at construction sites. In addition, by controlling a piece of land between its neighbours, North Korea has some regional economic leverage. Possible rail and gas pipeline connections between Vladivostok and South Korea would have to cross its territory. Natural gas is already shipped by sea from Russia's Sakhalin Island to South Korea, but this requires liquefaction and regasification and is more expensive. However, pipes or tracks are unlikely to be built in the near future.

In connection with the Beijing forum, the Russian energy company Novatek announced that two Chinese state-owned oil companies, CNODC and CNOOC, would each be taking a 10 % stake in its planned Arctic LNG 2 gas liquefaction facility. The French energy company Total also committed earlier this year to a 10 % stake. According to the current plan, the facility would be built on the coast of the Gulf of Ob at the Arctic Sea and begin production in 2023. Novatek's new Yamal LNG facility has already started production on the opposite side of the gulf.

## China

### China tries to calm critics of Belt and Road Initiative.

President Xi Jinping announced the Belt and Road Initiative (BRI or New Silk Road) in 2013. The second BRI Forum was held last weekend in Beijing. Participants included presidents or prime ministers from 36 countries among a total of approximately 5,000 delegates. China's official BRI website claims the initiative embraces 130 countries. China reiterated its long-standing theme that the purpose of the BRI is to increase investment in infrastructure and promote international cooperation. The BRI has expanded in multiple directions over the years, so nowadays the Chinese even speak of an "Arctic Silk Road" or "Agricultural Silk Road" projects.

During the forum, president Xi announced the signing of new BRI contracts worth a total of 64 billion dollars. The figure seems quite high given that China's National Development and Reform Commission (NDRC) announced just before the forum that Chinese firms invested a total of 90 billion dollars in BRI countries during 2013–2018 and that Chinese banks have lent BRI countries roughly 200–300 billion dollars. Financial market data provider Refinitiv puts the total value of BRI projects globally at 3.67 trillion dollars.

The project has been criticised as neo-colonialism and that the aggressive lending to participating countries effectively ties them to China's apron strings. Criticism of BRI projects has increased recently, as have efforts of partner countries to review the value they receive from such projects. For example, a Malaysian BRI project involving the purchase of construction services for a Chinese rail line was put on ice in January until the parties agreed in April to reduce the project price tag by a third.

Beijing sharply disputes the criticism, so assuaging these fears were the major themes at the forum. In his opening address, president Xi emphasised the advantages of BRI projects for all parties, including their permanent nature, environmental friendliness and reasonable pricing. Mr. Xi also said that he would not tolerate corruption in any BRI project and called for transparency. A big problem with BRI loans has been that the loan terms, usually negotiated in secret, may confer exceptional remedies to the lender (China) in the event of default (e.g. seizure of all project assets). Chinese officials are also accused of bribing loan counterparties to assure smooth signing of the project documents.

This week the independent think tank Rhodium Group released a [note](#) on the renegotiations of Chinese debt granted to other countries. The note found that 40 Chinese loans to a total of 24 countries have been renegotiated. Nearly all of the loans were issued during this decade and went to countries participating in BRI projects. The Chinese typically reschedule or forgive some of the troubled loan. The forgiven amount is usually tiny relative to the size of the loan, however. According to the note, asset seizures are actually a rare occurrence. China in total has forgiven about 50 billion dollars in loans.

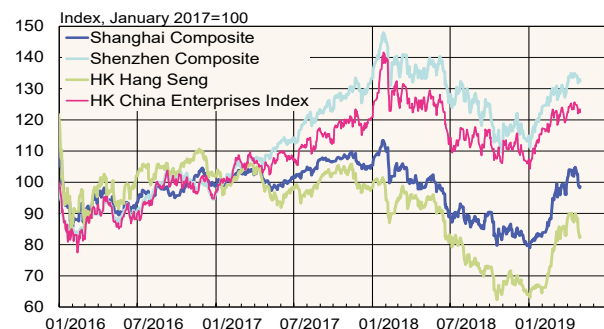
**China's bourses claw back last year's losses.** Share prices in China have been buoyed recently by expectations of continuing economic stimulus policies. Surprisingly strong GDP numbers, however, have dampened hopes for additional stimulus. Since the GDP figure was released on April 17, China's main share indices have declined, dropping by 6 % in Shanghai and 8 % in Shenzhen. For all of 2019, share prices are still up 23 % in Shanghai and 29 % in Shenzhen.

Stock index producer MSCI announced in February that it was gradually increasing the weighting of mainland Chinese shares in its indices starting in May. An initial weighting of 5 % of the market capitalisation of mainland Chinese shares was included in certain MSCI indices last June. This year weighting will quadruple in three phases to 20 %. MSCI is also introducing shares of smaller Chinese firms. The weighting of listed mainland Chinese stocks in the MSCI Emerging Markets Index should reach about 3.3 % of the index by the end of this year. The weighting of mainland Chinese stocks listed off-shore will rise to 28.6 %. Index producer FTSE Russell will also include a mainland Chinese stock component beginning next month. By March 2020, FTSE Russell expects the weighting of Chinese A-shares to reach 5.5 % of its FTSE Emerging Markets Index and 0.6 % of the FTSE Global All Cap Index.

Trading of foreign investors on mainland bourses via Stock Connect arrangements with Hong Kong has increased significantly in recent months in conjunction with increased trading activity in China. Nevertheless, the share of Stock Connect transactions relative to overall trading volumes has changed little and only accounts about 8 % of the daily trading volume in Shanghai and just 6 % in Shenzhen. At the end of last year, foreign ownership in mainland China stock markets was about 2.6 % of the total market cap. The value of foreign holdings fell late last year along with the fall in stock prices.

Shanghai is currently establishing a new Sci-Tech Innovation Board, which is scheduled to begin operations in June. The listing process under the new arrangement should be faster and easier than at present, and will not require e.g. that firms demonstrate a track record of profitability or place strict limits on listing prices. China's rules have forced the largest Chinese IPOs in recent years to be staged in Hong Kong or New York. The goal of the new listing process is to encourage Chinese tech giants to stage their IPOs in China.

### Share prices in mainland China and Hong Kong



Sources: Macrobond and BOFIT.



## Russia

### Russian defence spending large, even after declines.

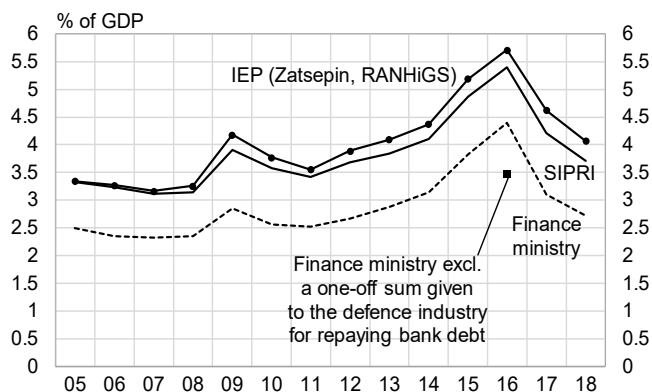
Russian government defence spending fell slightly in nominal ruble terms last year. In real terms, defence spending is down, but reminiscent of earlier years, still sizeable.

Developments in Russian defence spending are very similar in figures compiled by the Ministry of Finance (MinFin), the Stockholm International Peace Research Institute (SIPRI) for its global defence spending assessment and the Russian Presidential Academy of National Economy and Public Administration (RANEPa), which has its calculations published by the Gaidar Institute for Economic Policy (IEP). In real terms, adjusted for increases in domestic producer prices and wages, Russia's 2018 defence spending was about the same as the augmented level in 2014. The ratio of defence spending to GDP was also about the same as in 2013 (MinFin 2.7 %, SIPRI 3.7 % and IEP just over 4 %). Defence spending still accounts for a large share of total government sector spending (MinFin over 8 %, SIPRI and IEP 11–12 %, i.e. slightly more than spending on education or healthcare).

Added to the MinFin data for defence spending, the figures published by SIPRI and IEP include notable items from other budget spending categories. The biggest items added are military pensions, spending on domestic security as regards the national guard and border control, and classified budget spending on the economy. In the past two years, these additional spending items accounted for 27 % of total defence spending in SIPRI's figures and 33 % in the IEP figures. The IEP also publishes RANEPa figures for bank credit to defence industry. Repayment of bank loans exceeded new borrowing in the past few years by a sum equalling 0.2–0.3 % of GDP.

SIPRI reports defence spending by Russia's neighbours has increased sharply in real terms in recent years. From 2013, spending in eastern Central Europe and the Baltic countries was up an average of 45 %, Ukraine 53 %, Turkey 60 % and China 36 %. Nominal 2018 defence spending in Russia was 61 billion dollars, 250 billion in China, 266 billion in Western Europe and 649 billion dollars in the US.

### Ratio of Russian defence spending to GDP, 2005–2018



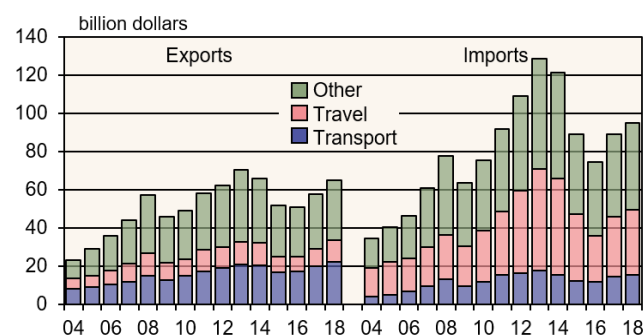
Sources: Finance ministry, SIPRI, IEP, Rosstat and BOFIT.

**Russian services trade grew last year.** The Central Bank of Russia reports that services exports last year rose by 12 % and service imports by 7 %. Thanks to some extent to the FIFA World Cup, travel service exports were up by 28 %.

In 2018, foreigners purchased Russian services worth a total of 65 billion dollars. Of that, 18 % consisted of tourism services, while 34 % was transport services. Air transport accounted for the bulk of spending on transport services. Of service exports, 11 % went to countries in the Commonwealth of Independent States (CIS), 45 % to Europe and 5 % to China.

Russians last year purchased services from abroad worth a total of 94 billion dollars. Of that, 36 % is due to tourism services and 16 % to transport services. Of service imports, 6 % came from CIS countries, 51 % from Europe and 3 % from China. Turkey, a favourite holiday destination for Russians, accounted for 7 % of service imports. Egypt, once a popular vacation destination, lost its position after a terrorist attack on a Russian charter plane in 2015 and Russia's ban on package tours to Egypt. Although the ban was lifted last year, charter flights to Egypt have yet to resume.

### Russian services trade, 2004–2018



Source: Central Bank of Russia.

### Progress in two natural gas transshipment terminals in Russia's Arctic and Pacific coasts.

In March, Russian officials granted permits to the Russian gas company Novatek for siting a liquefied natural gas (LNG) storage and transshipment terminal in Avacha Bay on the Kamchatka Peninsula on the Pacific Ocean coast. In April, officials followed up with permits for construction of similar terminal in Ura Bay on the Kola Peninsula on the Arctic Sea coast. Once these ports are completed, expensive shipping vessels with ice-breaking capability will focus on transporting natural gas from Novatek's facilities at the Arctic Sea in the Gulf of Ob to these ice-free ports, where cheaper vessels without ice-breaking capability will transport the gas further. The approach substantially reduces transport costs.

The French oil and gas company Total announced plans in April to acquire 10 % stakes in both ports. Total is a minority shareholder in Novatek and has invested directly in the Yamal LNG plant and the planned Arctic LNG 2 plant. The sites of these plants are located on opposite shores of the Gulf of Ob.

## China

**Trump announcement of more tariff hikes threatens to derail US-China trade talks.** The Office of the United States Trade Representative announced on Wednesday (May 8) it was moving ahead with raising the current 10% punitive tariff imposed last September on Chinese goods to 25 %, effective today (May 10). The tariffs apply to a wide range of Chinese imports with an annual worth of about 200 billion dollars. China promised to take countermeasures. There was apparently little progress in the talks when lead negotiators adjourned on Thursday night (May 9) in Washington, DC. With the tariff deadline now passed, talks continue today.

The impending failure of trade negotiations came as a surprise to many as the parties on both sides earlier reported progress, last when the trade teams met on May 1 in Beijing. Despite apparent progress, president Trump said on Sunday (May 5) that the US would proceed with tariff hikes on Chinese goods. Besides his 25 % hike declared on Sunday, Trump said he also considers imposing tariffs on some 300 billion dollars in Chinese imports currently not subject to tariffs.

The US defended the hikes, claiming China had backed off from commitments it made in the previous rounds of talks. A central issue appears to be China's unwillingness to change its laws to reflect agreed rule changes. China instead wants to implement changes through administrative measures. Leaving implementation to administrators, however, makes US oversight difficult and unlikely to produce the desired changes in practice at the provincial level.

Little concrete information about the negotiations has been made public, causing additional uncertainty in world stock markets. Media reports up to early May implied that understandings had been reached on topics such as ending forced technology transfers, enforcement of copyright protection and cybersecurity. Even breakthroughs in certain areas of opening up access to China's markets were mentioned. Among the more difficult unresolved issues are the timetable for lifting current tariffs, free movement of information and allowing access of American cloud services providers to China. Particularly thorny issues are posed by the competitive distortions by preferred government treatment of Chinese state-owned enterprises and government subsidies. Now it also emerged that the earlier-claimed consensus on oversight of agreement implementation evaporated with China's reluctance to change its legislation to suit American wishes.

One of the main reasons for the current trade dispute is China's failure to deliver on promises that were part of its WTO accession in 2001, i.e. allowing access to its markets and the ending of unfair trade and investment practices. As such reforms would deeply impact China's current economic system, it was clear from the beginning that the trade negotiations would be difficult. Moreover, as the trade disputes are a part of wider great power competition, even a positive outcome this week would only provide temporary respite from ongoing trade tensions and uncertainty.

**China's goods imports revive in April.** China Customs valued April goods imports at 180 billion dollars. After shrinking by nearly 5 % in the first three months of the year, import growth recovered to 4 % y-o-y last month. The value of key commodity imports rose by 15 % y-o-y in April, while the value of other goods imports was up by 1 %. Imports of machinery & equipment (over 40 % of Chinese imports) contracted much less in April (-3 %) than in the January-March period (-8 %).

Trade with the United States continued to shrink. During January-April, imports of US goods to China fell by 30 % from a year earlier, while exports declined by 10 %. The April figures were similar to those of the first quarter. The EU showed the strongest rebound in Chinese imports from advanced economies (up 4 % in April).

Shifts in exchange rates also affected foreign trade trends in the first four months of this year. In dollar terms, the value of exports showed no growth in January-April (in April -3 %), while imports contracted by about 2 %. In yuan terms, exports rose by nearly 6 % y-o-y and imports were up almost 3 %.

**China presents new measures to help open up its financial markets.** Guo Shuqing, chairman of the China Banking and Insurance Regulatory Commission (CBIRC), announced a dozen measures at the beginning of May intended to open up access to Chinese markets. Ownership limits in the banking sector and foreign firm size requirements would be dropped, while foreign banks would no longer need to petition for permission to engage in yuan-based operations.

The measures include elimination of certain qualification requirements for foreign insurance groups, including ceilings on ownership shares and provision of a 30-year operating history. In addition, the government will make it easier to set up consumer financing firms. CBIRC says that the new rules for foreign banks and insurance companies will soon be published. The measures, which respond to China's promises to open up access to its financial markets, are intended to help with US trade talks.

Some foreign firms were recently granted licences to expand operations in China. They include the Swiss UBS, which increased its stake in its Chinese joint venture UBS Securities to 51 %; the German insurer Allianz, which got the go-ahead to found the first foreign-held insurance company in China; and American ratings giant Standard and Poor's, which can now operate as a credit ratings agency in China. The Dutch ING Group, which has a joint venture with the Bank of Beijing, seeks dominant shareholder status. If the regulators approve the joint venture, it would create the first Chinese bank in which a foreign entity holds the majority stake. Credit card issuer American Express finalised its licencing process November, gaining the right to operate in China under the form of a joint venture with a local entity. According to media reports, Visa and Mastercard have long sought operating licences. Mastercard is reportedly establishing a joint venture with a Chinese partner to ease its licencing process.

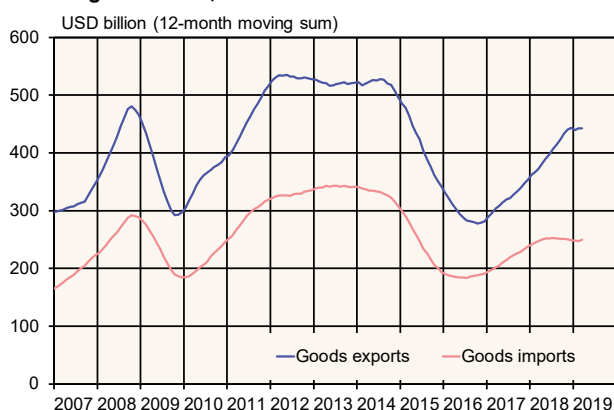
## Russia

**Sluggish growth in Russian foreign trade.** Russian customs reports that Russia's goods exports, measured in dollar terms, rose a mere 1.4 % y-o-y in the first quarter of this year (they rose by 25 % in 2018). The dollar value of goods imports fell by 2.4 % (up 4 % in 2018).

While ruble weakness has depressed Russian spending on imports, part of this poor picture of Russian import developments stems from the use of the dollar as a unit of measurement. Measured in euros, goods imports to Russia rose over 5 %. About half of Russia's imports comes from Europe.

The volume of exported crude oil increased by 7 % y-o-y (compared to 3 % growth in 2018), while the volume of oil products shipped fell by 7 % (exports were virtually flat in 2018). Growth in natural gas exports stopped, but exports of liquefied natural gas (LNG) continued to rise. The value of energy exports overall increased by 3.6 %.

### Russian goods trade, 2007–2019



Source: Russian customs.

**Dollar remains the dominant billing currency in Russian foreign trade.** The Central Bank of Russia reports that 67 % of invoicing on exports last year was in dollars, 17 % in euros and 14 % in rubles. The dollar's share of foreign trade invoicing has slowly declined since 2013, while the euro and ruble have gained slightly. The dollar has traditionally represented about 40 % of Russia's invoice currency for imports, while the euro and ruble have each accounted for about 30 %. These shares have remained quite stable over recent years.

The ruble is the top invoice currency in trade with the countries that formed the CIS, especially with the Eurasian Economic Union. In other markets, the ruble's share in Russian export invoicing is below 10 %. The exception is India, where that share rose to more than a third in 2018.

The dollar holds a commanding status in Russia's trade with China. Almost 90 % of Russian exports to China are invoiced in dollars, although that share fell sharply in the second half of 2018. In 4Q18, the dollar's share was just 65 %, while the euro's share rose to almost 25 %. While the dollar's

use as an invoice currency for imports from China has declined, its share is still over 70 %. In 2018, about 20 % of imports from China were not invoiced in dollars, euros or rubles. This most likely reflects increasing use of Chinese yuan.

**Difficult to form a full picture of Russia's sizeable public sector procurements.** Russia's finance ministry reports that public sector contracts made last year under procurement oversight were worth about 24 trillion rubles (about 320 billion euros). Most of the contracts were made by public agencies or government-owned firms.

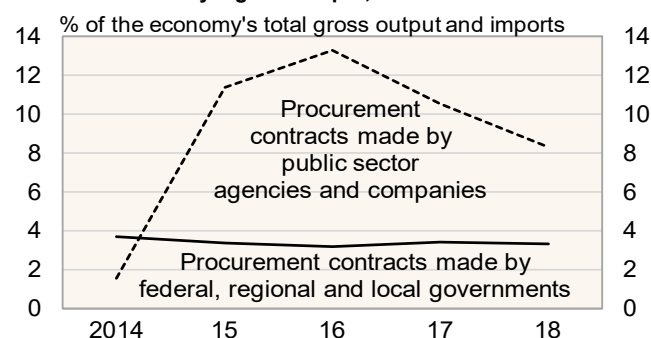
Federal, regional and local governments last year made procurement contracts worth 6.9 trillion rubles, or over 90 billion euros. In ruble terms, growth in procurements slowed to about 8 % y-o-y. The federal government level last year sealed contracts worth 32 billion euros, regions 42 billion euros and municipalities 19 billion euros.

Public agencies and firms in which the state holds a stake of over 50 % made contracts under procurement oversight worth 17.2 trillion rubles, or 230 billion euros. Oversight of this category has declined. Largely due to this, the amount of reported contracts fell significantly (even in nominal ruble terms) for the second year in a row. The reporting requirement has been dropped for e.g. real estate sales and rentals, as well as services related to bank loans and deposits. The ten largest buyers made contracts worth 75 billion euros, led by Gazprom and its subsidiaries (33 billion euros), Russian Railways (22 billion euros) and Rosneft (16 billion euros).

Not all procurements are subject to oversight, and annual oversight reports do not try to estimate oversight coverage. Comparison to government sector budget figures suggests the oversight covers federal, regional and municipal procurements rather well. Oversight of public agencies and state-owned firms may be less than half of their total, even assuming the supply contracts are for not longer than a year.

Online auctions accounted in 2018 for 64 % of the value of federal, regional and municipal procurement contracts, as in 2017, while no-competition contracts with single suppliers accounted for 23 %. The latter method accounted for close to half in contracts made by state agencies and state-owned firms. Methods reported as unidentified were very common.

### Russian public sector procurements subject to oversight relative to the economy's gross output, 2014–2018



Sources: Ministry of Finance and Rosstat.

## China

**China-US trade war heats up with latest round of tariff hikes.** On Monday (May 13), China announced new tariff increases on imports from the United States. The action was taken in response to the US announcement last Friday (May 10) of further tariff increases on Chinese goods. While both trade negotiation teams denied that talks had been suspended, the situation is getting worse as president Donald Trump has threaten to impose additional tariffs on Chinese goods so far exempt from the hikes.

China's tariff hikes, which are set to go into effect at the beginning of June, largely apply to the same categories of products on which China imposed 5 % or 10 % retaliatory additional tariffs last September in response to US tariff hikes at that time. About half of products subject to additional tariffs will now have the 25 % rate, with the rest subject to rates ranging from 5–20 %. The most recent tariff increases apply to annual imports worth about 60 billion dollars. If the 25 % tariff hikes of last summer imposed on 50 billion dollars in imported goods is included, the total added tariffs on US imports to China now stands at about 110 billion dollars (as estimated last year). Ahead of the tariff hikes of March 2018, China's goods imports from the US were around 160 billion dollars a year. Today, that value has fallen to about 140 billion dollars (the respective exports to China reported by the US are USD 130 billion in 2017 and USD 114 billion currently).

The US last week raised the tariff to 25 % on those select goods on which 10 % rate was imposed in September. Chinese imports now subject to the 25 % rate have had an annual value of about 250 billion dollars (estimated last year). The US is now considering imposing tariffs on practically all Chinese imports. Before the tariff is imposed, product must go through a public hearing process. Thus, the wider tariff regime could enter into force as soon as late June or early July. Annual US goods imports from China are still currently at about the same level as before the tariff hikes were imposed, i.e. about 520 billion dollars (China reports its annual exports to the US were about USD 430 billion in 2017 and are currently just under 470 billion dollars).

The views expressed by the parties on the issues at hand differ considerably. The situation got even murkier on Wednesday (May 15) after the US decided to block American cooperation with Chinese telecom giant Huawei. It is still up in air whether trade talks proceed or the late-June Xi-Trump one-on-one meeting at the Osaka G20 conference takes place.

**China's April economic figures weaker than expected.** China National Bureau of Statistics figures show that real industrial output grew by 5.4 % y-o-y last month, a drop of three percentage points from March. Real growth in retail sales slowed to 5.1 % y-o-y. Official real growth in retail sales was last this low in May 2003.

The ongoing slump in car sales depressed figures for both industrial output and retail sales. Carmakers reported that

passenger car production fell by 17 % y-o-y in April, while car sales were down by 18 %.

From the standpoint of Chinese economic growth, the tracking of core investment trends is difficult with the available statistical data. The NBS, however, reports that fixed asset investment (FAI) growth in urban areas reached 6.1 % y-o-y in the first four months of this year. Prices of investment goods rose by more than 3 % in the same period, suggesting that real investment growth undershot official growth targets.

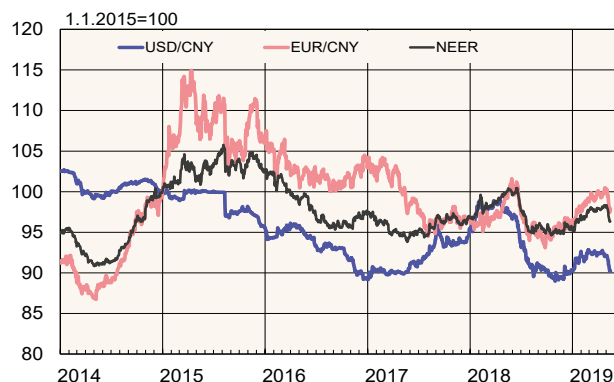
The weak economic figures and heating up of the trade war have increased speculations on further stimulus. On Wednesday (May 15), the People's Bank of China lowered the deposit reserve requirement for rural commercial banks to 8 % to help increase lending and spur growth.

**Yuan drops as trade war between China and the US heats up.** Even as trade talks with the US seemed to take a turn for the worse last Friday (May 10), the yuan's exchange rate fluctuated without establishing a clear direction. However, the yuan lost ground quickly after the opening of Chinese markets on Monday (May 13). By closing, it had fallen to a rate of 6.86 yuan to the dollar. On Hong Kong's less-regulated yuan market, one dollar bought 6.91 yuan. On Friday (17.5.), yuan fell further to 6.90 per dollar (CNY/CNH 6.93).

The exchange rate shift on Monday was more a matter of yuan weakening than dollar strengthening as the euro-yuan exchange rate followed a quite similar path. In addition to the trade war, yuan depreciation pressures currently include the weak new economic figures and monetary policy stimulus measures designed to keep interest rates low. The PBoC is strongly involved in guiding the yuan's exchange rate.

International stock markets initially fell on news of trade-war tensions. Chinese share prices have also fallen considerably since their April highs. Last Friday (May 10), however, share prices rose amidst major salvos in the trade war. Possible reasons for the rise include direct government intervention in the markets and expectations of further easing in monetary policy. This Friday (May 17), Chinese equity prices (CSI300) were again down 2.5 %.

**Yuan-dollar, yuan-euro rates and NEER\*, 2014–2019**



\* NEER= nominal effective (trade-weighted) exchange rate  
Source: Reuters.

## Russia

**Russian first-quarter economic growth well below expectations.** Preliminary Rosstat figures show Russian GDP growth in the first three months of the year was just 0.5 % y-o-y, a figure clearly lower than anticipated by most forecasts. At the end of 2018, the Central Bank of Russia forecast growth in the range of 1–1.5 %, while the responses of analysts interviewed by *Bloomberg* averaged 1.2 %. Even Russia's economic development ministry, which updates its forecast monthly, expected 0.8 % growth.

The Russian economy last grew as slowly in the fourth quarter of 2017. The slowdown in growth from 4Q18 (2.7 %) was, however, expected due to low growth in domestic demand. The value-added tax increase introduced at the beginning of January appears to have boosted wholesale trade at the end of last year in anticipation of higher VAT rates. Wholesale activity in the first quarter of this year contracted by 7.4 % y-o-y, even as retail sales rose by 1.8 %. Besides the larger-than-expected impact from the VAT hike, observers also point to weak economic development relative to previous years due to a reduction in defence materials orders and a milder-than-usual winter that reduced energy consumption and gas exports.

Inflation (5.3 %) negatively impacts general income levels. Rosstat estimates that real incomes fell by 2.3 % y-o-y in the first quarter. Industrial output rose by 2.1 %.

The CBR and the business press believe the growth slowdown is temporary. In the most hopeful scenarios, the launch of large state investments in national infrastructure, healthcare and education at the end of the year will spur higher economic growth next year.

**Tainted oil fouls Druzhba oil pipeline.** On April 19, Belarus reported detecting a large quantity of organic chlorides in the crude oil moving through the Druzhba (Friendship) pipeline. Pipeline transmission from Russia was suspended for several days, and subsequent efforts to re-establish flow were sporadic. Many European customers turned to their own stores and suspended payment to Russia until disputes over damages are resolved.

As even small quantities of organic chlorides, which are used in oil drilling, can foul refinery processes, contaminated oil must be kept away from refinery equipment. In this case, the concentration of organic chlorides appears to be rather high. While the problem seems to have been traced to a small private oil refinery in the Samara region, details of the events leading to the contamination have yet to be released.

The fouled pipeline is a major artery for oil flows from Russia to Europe. Crude oil streams from various Russian oil fields are blended before they are placed in the pipeline, which starts in Tatarstan, 1,000 kilometres east of Moscow. A mix of crude oil from Urals, Siberian and Kazakh fields enter the pipeline to be pumped west to Belarus. From there the

pipeline forks, with the northern fork crossing Poland to Germany, and the southern fork traversing Ukraine, Slovakia, Czech Republic, Hungary and Croatia. The pipeline is also linked to Russia's Ust-Luga oil port on shores of the Gulf of Finland. About a third of all crude oil exported from Russia goes through the Druzhba pipeline. Oil going to customers in Western Europe can alternatively be shipped via Baltic and Black Sea ports. Even with these alternatives, Russia has had to lower output somewhat to accommodate the decreased flow of oil. Profitability of refineries in Central and Eastern Europe is dependent on oil coming through the pipeline, even if they can procure oil supplies via oil tanker or use their own stockpiles.

The contaminated oil has been found almost throughout the entire length of the pipeline. Estimates put the amount of spoiled oil at more than one million metric tons, a half-billion dollars in oil at current prices. The fouled oil may be salvaged by diluting it with untainted crude and selling it at a discount. As these measures apply to the entire length of the pipeline, oil will have to also be shipped by rail to the oil ports. At least some Chinese companies seem to be keen on purchasing the cheap oil. Despite these measures, cleaning of the pipeline, disposal of the tainted oil, identification of the culprits and recovery of damages could take months or years.

**Russia's hydrocarbon-centric energy security doctrine stresses import substitution.** President Vladimir Putin last week (May 13) approved Russia's updated energy security doctrine. The document includes a list of general challenges and threats to Russia's national energy security, as well as desirable policy measures. Energy security is interpreted to comprise of both uninterrupted domestic energy distribution as well as smooth flow of energy exports. Energy security in Russia's case is an inextricable part of its foreign, fiscal and national security policies.

While the energy security doctrine notes that the global shift to renewable energy poses challenges for Russia, the proposed response is to increase support for the oil & gas sector rather than fund development of renewable energy sources or new technology. The policy of import substitution has particular prominence, and import substitution was strongly evident already in the economic security strategy approved in May 2017. The energy security doctrine takes a positive view of international efforts to mitigate climate change as long as they do not interfere with Russia's national interests. The document gives only scarce consideration for domestic security threats such as mismanagement and corruption, which may partly explain events like the contamination of the Druzhba oil pipeline.

Energy sector development goals will be tackled in detail in a separate energy strategy. The current energy strategy, which extends to 2030, was approved in 2009. The updating of the strategy has taken years. Its most recent cabinet discussions was postponed from April to December this year. The energy strategy update (ES-2035) was supposed to be approved already in 2014.

## China

**European companies want to see meaningful changes in China's business conditions.** European companies doing business in China say the gap between words and practice is huge when it comes to Chinese reforms of the business environment. For example, a substantial share of companies engaged in high value-added production still are forced to surrender know-how to their Chinese counterparts, even if China officially claims to have ended the practice of mandatory technology transfers. Only a handful of responding firms felt that the discriminatory treatment they receive from China's regulators will improve in coming years.

This week, the EU Chamber of Commerce in China released its [Business Confidence Survey 2019](#) conducted in January and February. The top three concerns expressed by the 585 of its 1,326 members were China's slowing growth, the slowdown in the global economy and the rapid rise in wage costs in China. The US-China trade war only ranked as the fourth biggest concern, possibly because direct fallout from the dispute has been less than feared though it has heavily worsened business sentiment. The EU Chamber blamed the "reform gap" (the government's slow-walking of reform even as the economy matures and grows rapidly) as the main cause for the trade war and lack of reciprocity in economic relations with the rest of the world.

While firms in many branches reported easier market access, EU Chamber is concerned about new barriers faced by law and ICT firms that serve businesses in many branches. European firms are increasingly united in seeking a level playing field and consistent treatment from regulators. About 70 % of European firms reported that Chinese state-owned firms do business in their fields and receive preferential treatment in e.g. public procurements, financing and licencing.

Despite the obstacles, over 60 % of respondent firms ranked China among their top-three investment countries. In the response to the survey's innovation question last year, the number of firms saying they considered Chinese firms at least as innovative as European firms exceeded half for the first time. This year, 62 % of firms considered Chinese inventiveness to be at least on par with European firms. Most EU firms saw this trend as a positive development also for them.

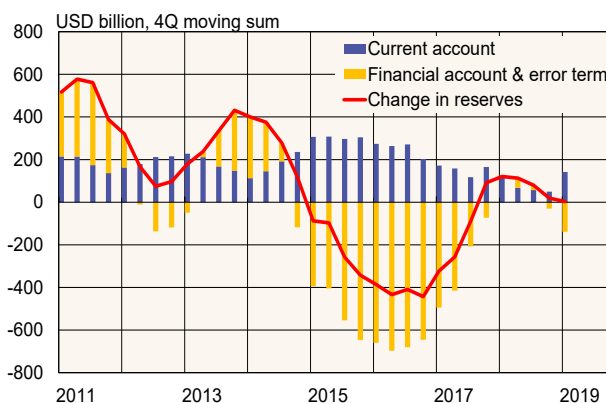
This week, also the American Chamber of Commerce in China (AmCham China) and its partner AmCham Shanghai released a [joint survey](#) of their members. Three-quarters of the nearly 250 member firms surveyed said that they had suffered under the US and Chinese tariff hikes. Slightly fewer than half of responding firms said they had also been subject to Chinese non-tariff retaliatory measures such as increased inspections, foot-dragging by customs authorities and delays in licencing processes. To get around tariffs, many firms have shifted their focus to buying and selling primarily in the Chinese market. About 40 % of firms said they were considering moving or had already shifted production away from China to other countries, especially Southeast Asia or Mexico.

**China's current account surplus soared in the first quarter.** China's current account surplus in January-March rose to 59 billion dollars. In the same period last year, the current account showed an exceptional deficit of 34 billion dollars. On annual basis, the current account surplus was 142 billion dollars, or 1 % of GDP (0.4 % in 4Q 2018).

The biggest factor growing the current account surplus was the rising goods trade surplus. Export revenues rose and import spending declined relative to 1Q 2018. The services trade deficit also contracted, due largely to a drop in Chinese spending on tourism abroad (down 10 % y-o-y).

Financial account data will be released later. Based on published data, it can be calculated that the net outflow of capital (including the net errors & omissions term) was slightly less than the current account surplus, indicating a small uptick in China's foreign currency reserves after slight declines in the previous two quarters. Monthly figures show China's foreign currency reserves (including gold) slightly exceeded 3.19 trillion dollars at the end of April.

### Main items of China's balance-of-payments



Source: Macrobond.

### Conflicting price data for China's housing markets.

According to the 70-city sample used by China's National Bureau of Statistics (NBS), the weighted average price for new apartments increased last month by about 7 % y-o-y. Price changes in the four most important cities were still quite minor. Based on other sources, the rise in housing prices has been faster.

Business portal *Caixin* cited the E-House Real Estate Research Institute's survey of 100 cities, which claims apartment prices rose an average of 13 % y-o-y in the first quarter. In nearly a quarter of cities the annual price increase exceeded 20 %, and in China's four major cities, prices were up by 19 %. In the NBS 70-city sample, only Hohhot reported a price rise of 20 %. Data from real estate tracker *SouFun* also indicate a faster rise in prices than reported by the NBS.

It is difficult to draw a clear overall picture of housing price trends. Recent warnings on housing markets issued by China's decision-makers imply, however, that the situation may be more disconcerting than the NBS figures suggest.

## Russia

**Russian industrial output growth accelerated in April.** After three months of lower growth this year, industrial output growth accelerated in April to 4.6 % y-o-y. For the January-April period, industrial output grew by 2.8 % y-o-y.

Growth in mineral extraction industries has slowed slightly from the strong performance of 2H18, but on-year growth during the first months of this year was still close to 5 %. Production of crude oil and natural gas rose by 3.5 % in January-April.

Growth in manufacturing output accelerated in April, even if on-year growth in January-April was just 2.2 %, less than half the growth pace of the mineral extractive sector. The outcome of the first four months of the year was quite weak in the machinery & equipment category, likely due to a substantial cut in government procurement spending. In contrast, rapid growth continued in many industries producing consumer goods, including food and pharmaceuticals.

The rise in nominal wage growth has slowed this year. In January-April, wages were up 6.6 % y-o-y. On-year growth in real wages in the first four months of the year was 1.4 %. Even so, the contraction in real disposable incomes continued.

**Changes in the country structure of Russian inward and outward foreign direct investment.** Flows of foreign direct investment, especially inbound FDI flows to Russia, have continued to decrease in recent years. The role of EU countries other than Cyprus as immediate sources or recipients of the FDI increased. The shares of large EU economies, however, are relatively small.

When considering the ultimate source or recipient countries of FDI flows in Russia's case (no published overall data), it is important to remember that Russian investors move large amounts to countries that provide favourable treatment and then repatriate the money to Russia as direct investment. The FDI inflows to Russia from foreign firms also often move indirectly via third countries.

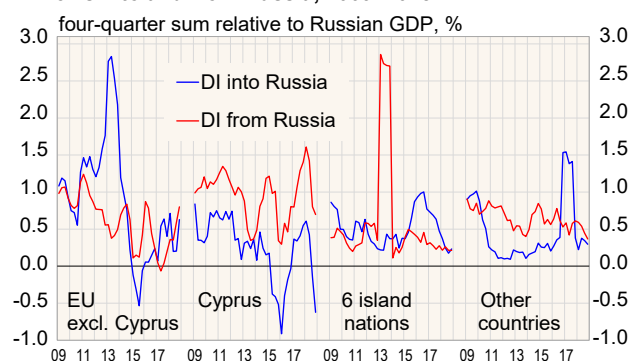
As regards the pattern of recent years for EU countries other than Cyprus, most FDI inflows to Russia came from the UK and Luxemburg, while outbound FDI from Russia went especially to Austria and also the UK. Russians have pulled out significant amounts of their FDI from the Netherlands. The FDI flow from Russia to Cyprus remains substantial. Cyprus is still overwhelmingly the largest FDI recipient from Russia. In turn, FDI made earlier from Cyprus to Russia have been wound down (negative flows) in recent years.

Somewhat reminiscent of Cyprus, several other small island states have received considerable amounts of Russian FDI. While FDI flows between them and Russia overall have declined clearly in recent years, the roles of certain island havens such as the Bahamas, Jersey, British Virgin Islands and Bermuda continue to create a notable share of business. The popularity of Gibraltar, as well as Saint Kitts and Nevis islands, was short-lived in the early years of this decade.

The role of other countries as immediate FDI sources or recipients has remained more stable. The top of these countries for Russia are Singapore and Switzerland. The shares of e.g. the US, Japan and China remain much smaller.

The two big peaks in FDI flows in this decade basically reflect ownership changes related to state oil giant Rosneft.

**FDI flows into and from Russia, 2009–2018**



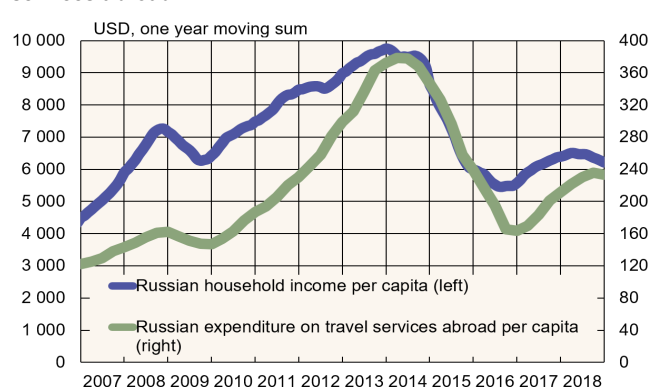
Sources: Central Bank of Russia, Rosstat and BOFIT

**Russian expenditure on travel services abroad grew slightly last year.** The Central Bank of Russia reports that Russians last year spent 34 billion dollars on travel services abroad, a 9 % increase from 2017.

Turkey, Germany, Spain, Thailand and Italy topped the list of countries in Russian travel spending. Russian tourism abroad is highly dependent on the purchasing power of income earned in Russia. In 2014–2016, the ruble's external value declined along with the collapse in oil prices, but since then it has remained rather stable. As nominal wages have grown, Russian wage-earners have seen a slight improvement in their foreign purchasing power.

Foreign visitors last year spent 12 billion dollars on Russian travel services, a 27 % increase from 2017. Earnings on tourism services were boosted last summer by Russia's hosting of the FIFA World Cup championships.

**Russian household income and Russian expenditure on travel services abroad**



Sources: Rosstat, Central Bank of Russia and BOFIT

## China

**Officials take over troubled Chinese bank.** Faced with insurmountable financial difficulties, Baoshang Bank, which operates mainly in Inner Mongolia, was taken over last Friday (May 24) by the China Banking and Insurance Regulatory Commission (CBIRC) and the People's Bank of China. Officials explained the takeover was justified by the need to protect the interests of small depositors and other customers.

Baoshang's day-to-day operations have been farmed out to state-owned China Construction Bank. The central bank also announced it will give liquidity support for the troubled bank. Baoshang's most recent annual financial statement was filed in 2016.

Excessive credit risk, a high-growth strategy and overreliance on funding from the interbank market sealed Baoshang Bank's fate. The bank's solvency has been weaker than that of most rivals, and has been declining for years. On paper (according to the latest available figures), the bank still enjoyed decent profitability, but the decline in the quality of its lending portfolio is not necessarily reflected in profits. The share of non-performing receivables on the balance sheet increased, but the bank only reported a modest less-than 2 % share at the end of 2016.

Baoshang experienced rapid growth this decade. During 2013–2017, its total assets more than doubled and lending to the public nearly tripled. Deposits, however, failed to keep up with the lending spree, making Baoshang extremely dependent on borrowing from other banks. The bank's debts to other banks nearly quadrupled during 2013–2017.

Baoshang is small enough that its collapse will probably not have major systemic implications. Yet it still ranks among China's top 50 banks and employs a staff of about 8,000. The size of the bank's balance sheet is only a couple per cent larger than that of ICBC. However, the incident could have wider implications, if it weakens public confidence in other small regional banks. China's banking system is mostly in government hands, but Baoshang's majority owner was a private entity called Tomorrow Holding Group.

China has a number of small and mid-sized banks whose growth has been similar to Baoshang's in recent years. However, they generally seem to have better solvency ratios and they have not expanded as fast as Baoshang.

According to the CBIRC statistics, there are about 4,000 banks currently operating in China. The five largest commercial banks control about 40 % of the banking sector's total assets. China's twelve joint-stock banks represent about 20 % of sector assets. There are around 130 city commercial banks that control just over 10 % of sector assets, as well as three policy banks that have a combined 10 % share. Other banks, mostly rural banks and the postal bank, account for about 20 % of banking sector assets. In recent years, small and mid-sized banks have rapidly expanded their balance sheets.

**China's monetary policy not particularly loose this year.** While the PBoC has lowered reserve requirements for banks this year, the net effect of its applications of various monetary instruments has been to reduce net liquidity in the system. In China, a broad range of policy instruments is used to adjust the monetary policy, so the overall monetary stance has to be evaluated as the combined effect of all tools.

Reserve requirement ratios (RRRs) were lowered twice in January, which was estimated to add about 1.5 trillion yuan in liquidity to the system. In May, the central bank announced a targeted RRR cut affect about 1,000 rural banks (implemented in three phases between May 15 and July 15.), which is expected to increase the liquidity by CNY 280 billion.

The net impact of open market operations (OMOs) this year (as of May 28) has been to reduce liquidity by about CNY 610 billion. The PBoC has granted commercial banks CNY 400 billion in medium-term lending facility (MLF) funding this year, considerably less than maturing MLF debt (CNY 1.73 trillion).

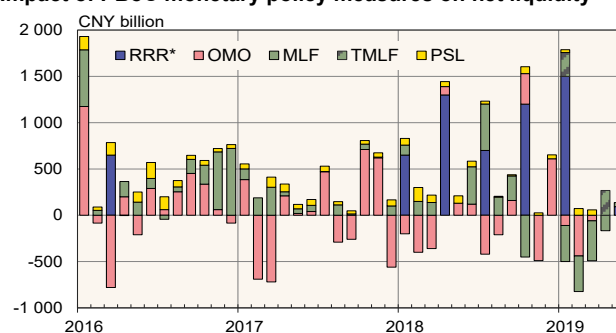
Since the beginning of the year, the central bank has used its new targeted medium-term lending facility (TMLF) to provide banks funding at slightly lower rates for small business lending. At total of CNY 520 billion in TMLF credit was issued in the first four months of this year.

The overall impact on liquidity in January-May from the monetary policy measures has been fairly modest (estimated at about CNY 200 billion or USD 30 billion). In the same period last year, increase was clearly higher (estimated at CNY 1.6 trillion or USD 240 billion). The figures do not include pledged supplementary lending (PSL) provided to three policy banks.

The PBoC has kept interest rates unchanged this year. For example, the rate on the one-year MLF credit is 3.3 % (TMLF credit at 3.15 %) and the rate on the 7-day reverse repo used in open market operations is 2.55 %. Other central bank rates have also remained unchanged. This week, PBoC governor Yi Gang said that the central bank could finally waive the announcement of loan reference rates. Restrictions on interest rate pricing of commercial banks were lifted, at least nominally, already in 2015.

The decrease in central bank funding may reflect lower financing demand from commercial banks. A cautious monetary stance that resists easing might also reflect increased devaluation pressure on the yuan due to the intensified trade war.

**Impact of PBoC monetary policy measures on net liquidity**



\* Estimate based on PBoC announcements (omits bank-specific changes)

Sources: PBoC, CEIC and BOFIT.



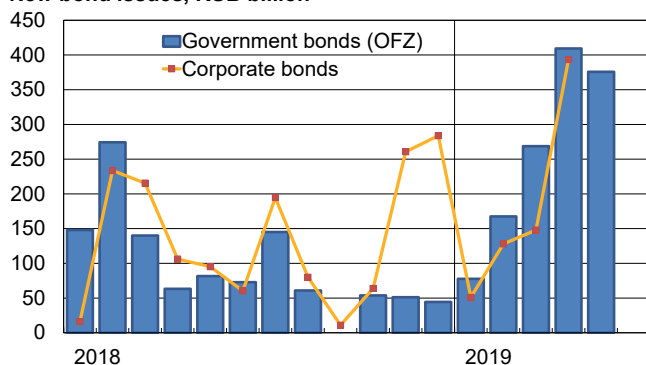
## Russia

**Russian share prices up this year; substantial growth in bond markets.** The revival of investor interest in emerging markets has been apparent in Russia's financial markets. Share prices this year have also been buoyed by rising global oil prices and expectations of juicy dividends from Russia's biggest corporations. The Moscow Stock Exchange's RTSI index is up about 15 % from the start of this year, and now matches levels reached in early 2018. The improved market conditions have raised interest in ruble-denominated corporate debt securities and government treasuries.

During the first five months of the year, the finance ministry issued government bonds worth roughly 1.3 trillion rubles (18 billion euros), an amount greater than all issues in 2018. A monthly record of 404 billion rubles (5.6 billion euros) in new debt was sold in April. Government treasury issues remained brisk in May with the sale of 376 billion rubles in new issues. While the Russian government has no big need to issue debt, the current favourable market conditions have motivated the government to move up scheduled debt issues. The Central Bank of Russia reports that foreign investors purchased 45 % of treasury issues in April. Foreign investors currently hold about 27 % of all government ruble-denominated debt securities. Although the share has increased sharply in recent months, it is still smaller than in early 2018. Increased demand has reduced yields and the yield on e.g. the 10-year OFZ treasury bill is now below 7.9 %. The CBR's key rate is currently 7.75 %.

Investor appetite for corporate bonds has increased substantially. In the first four months of this year, 720 billion rubles (10 billion euros) in new corporate debt securities were issued. The lop-sided structure of the Russian economy is well-reflected in the bond market. About 40 % of corporate debt securities have been issued by financial institutions and about 31 % by oil & gas companies.

### New bond issues, RUB billion



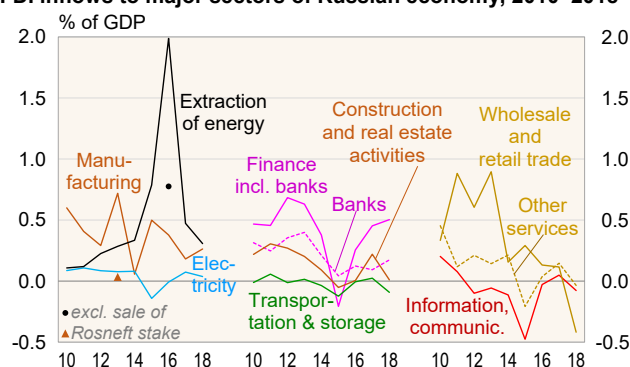
Source: Cbonds.

**Fewer sectors in Russia targeted for direct investment from abroad.** In recent years, FDI inflows have overwhelmingly focused on the financial sector, the energy sector

(basically oil & gas production) and manufacturing. The amounts of FDI inflows to the oil & gas and manufacturing sectors have fallen notably, however, in the past two years.

The amounts of FDI flowing to the banking sector, as well as the construction and real estate branches, have diminished significantly from the years early this decade. An even more severe contraction in inward FDI has hit the trade branch, which witnessed a net pull-out of inward FDI last year. The allure of various service branches (mainly corporate services) has faded.

### FDI inflows to major sectors of Russian economy, 2010–2018



Sources: Central Bank of Russia and Rosstat.

**Intra-elite competition increasingly reflected in institutional behaviour in Russia and the economy more broadly.** Observers note that the Duma's increasingly proactive role in legislating and the rise of competition among security services and state-owned companies exemplify Russia's shifting domestic internal power balance. It reflects behind-the-scenes jockeying for position among Russia's elites and preparations for the end of president Putin's fourth term in 2024.

As the latest example of the confusion created by the dispersed political landscape, experts cite the March arrests of Michael Calvey, CEO of the private equity firm Baring Vostok, along with five other businessmen. While Calvey was accused of embezzling billions of rubles, he atypically avoided being held in custody while the case was investigated and granted house arrest while awaiting trial. Kremlin spokesman Dmitry Peshkov said this week that he hoped that Calvey and the other accused would be vindicated. Observers say the inconsistent treatment shows a lack of official coordination.

President Putin's long-term goal has been to create a tightly concentrated vertical power hierarchy. Observers say current system relies too heavily on micromanagement from the top, i.e. everything that is not specifically permitted is forbidden. Inverting this power hierarchy means that the Kremlin relaxes its grip on guidance of other institutions. Doing so, however, reduces the predictability of official measures. Some observers claim the Security Council is emerging as the principal body of power, where the top members of the power elite meet to decide on national security and economic issues.

## China

**China intensifies anti-US rhetoric.** China released a white paper last Sunday (Jun. 2) accusing the US of walking away from the current round of trade negotiations and making unreasonable demands on China. In response to the hikes in US import tariffs that went into effect on May 10, the Chinese raised countermeasure tariffs on US imports, effective June 1 (see [BOFIT Weekly 20/2019](#)). Over the past weeks, exchanges between the two countries have heated up and moved from targeting goods to specific businesses.

It remains unclear as to whether the countries plan to resume talks when their presidents meet at the G-20 summit at the end of the month. The negotiation stakes have risen since president Donald Trump in mid-May banned US firms from using telecom equipment that posed a threat to national security. In practice, the ban was directed at Chinese technology giant Huawei. Furthermore, the US commerce department banned firms from doing business with Huawei without first obtaining a special permit. While this effectively halts deliveries to Huawei of critical components and systems, products already in existence have been given a 90-day extension as of May 20.

China's commerce ministry plans to release its own list of "unreliable firms and persons" and national development and reform commission (NDRC) suggested the country may consider export restrictions on rare earth metals if products made from them are used against China. In addition, officials have asked Chinese tourists and students planning to go to the US to reassess carefully the risks involved, and warned Chinese companies operating in the US to prepare for increased harassment from law enforcement officials. Moreover, Chinese news coverage has recently grown critical of the US.

**Another troubled Chinese bank hits the headlines.** Bank of Jinzhou's announcement last Friday (May 31) that it was changing its auditors precipitated a strong reaction from China's bond markets. Ernst & Young's auditing team quit after differences arose with the bank's management.

The auditors said the bank failed to provide the requisite information and documentation on credit reviews of loan recipients, which raised suspicions that some corporate clients were using their credit for purposes outside the loan agreements. The bank's 2018 financial statement have yet to be published or ratified. Bank of Jinzhou's total assets (about 110 billion dollars) make it slightly larger than Baoshang Bank, which officials recently took over (see [BOFIT Weekly 22/2019](#)). One of the main indicators of Baoshang's distress was the refusal of its management to release the financial statement.

Like Baoshang, Bank of Jinzhou expanded rapidly in recent years. Its balance sheet grew by nearly 50 % in 2016 and over 30 % in 2017. In particular, lending to industrial firms grew quickly. Jinzhou Bank is mostly owned by private Chinese investors. It has a very broad ownership base. Jinzhou shares are listed in Hong Kong. Trading in Jinzhou shares

was suspended in April on the delayed release of the bank's financial statement. However, there is still a market for Bank of Jinzhou's debt instruments (AT1 instruments), which will be first in line to cover the losses of weakened solvency of the bank. The market price for Bank of Jinzhou AT1's on Monday (Jun. 3), was about 78 % of their nominal value.

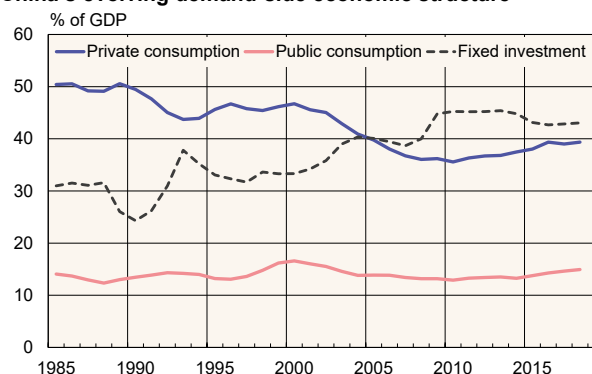
With the severe troubles of two privately held banks within two weeks, wider concerns have arisen about the condition of the Chinese banking sector, particularly small and mid-sized banks and the correctness of financial statements. Small banks are especially dependent on funding from the interbank market, so increased uncertainty can cause their financial health to degrade quickly. The People's Bank of China attempted to calm markets last weekend by declaring that it had no plans to take over any more banks.

**The structure of Chinese GDP changes only slowly.** At the end of May, National Bureau of Statistics published the demand structure of GDP for 2018. China's evolution towards a consumption-driven economy seems to be making slow, if any, progress. Fixed investment, which corresponded to an astronomical 43 % of GDP last year, grew slightly. Both private consumption (39 % of GDP) and public consumption (15 %) also increased their shares of GDP slightly. The GDP share of net exports of goods and services fell below 1 %.

China's ratio of fixed investment to GDP is remarkable by any measure. Similar ratios are only temporarily seen in small developing countries and more persistently in unusual economies like Bhutan. During Japan's rapid development in 1960–1990, the ratio of fixed investment to GDP averaged slightly more than 30 %, reaching a peak of just over 36 % in the 1970s.

The size of an economy is usually measured roughly speaking either by figuring out the amount of goods and services produced (supply measure) or determining the amount of goods and services used (demand measure). China has traditionally measured the supply, while Western economies typically primarily measure the demand. Notably, the two measures of Chinese nominal GDP have begun to diverge in recent years. China's supply-measure GDP for 2018 is 1.6 trillion yuan (nearly 2 %) larger than the demand measure, even if in principle they should be equal.

**China's evolving demand-side economic structure**



Sources: China National Bureau of Statistics, CEIC and BOFIT.

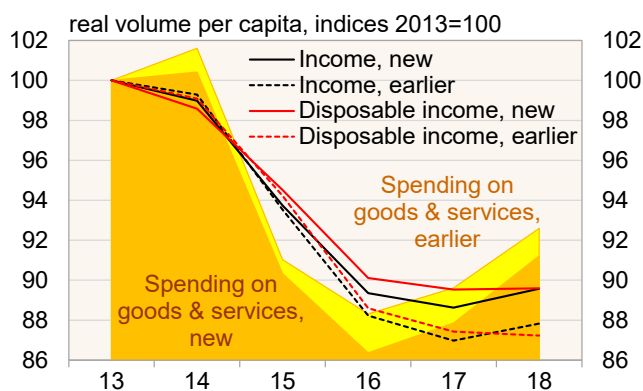
## Russia

**Statistical reforms provide improved picture of Russian household spending.** New figures show that the large contraction in real household incomes of recent years was a little milder than reported earlier. They also show that the real trend in spending on goods and services improved slightly. Data on *nominal* spending on the purchases in 2013–2018, however, jumped 7 %, which may eventually lead to an upward revision in figures for the nominal levels of household consumption and GDP.

Rosstat has yet to release new figures on sub-categories of household spending on purchases based on its new statistical methodology. Changes made to the methodology suggest that the rise in the level of spending is due to more comprehensive inclusion of data on e.g. Russian spending on tourism abroad and online purchases from foreign websites.

In addition to the higher level of spending on purchases, as the level of other household expenses and payments also increased remarkably, the picture of household savings declined sharply. The other payments should now cover better the gratuitous money transfers that Russians send abroad.

### Real per capita income and spending of Russian households, 2014–2018



Sources: Rosstat and BOFIT.

### Chinese and Russian presidents extol good economic relations at St. Petersburg economic forum.

President Vladimir Putin voiced strong criticism of the latest US trade policy measures against China, specifically citing sanctions against telecom giant Huawei as an example of economic egoism. Putin warned that the breakdown of the global order based on free trade not only threatened growth of the global economy but geopolitical stability as well. In his turn at the podium, China's president Xi Jinping said Russia and China had reached consensus on some of the questions related to the harmonization between the Belt & Road Initiative and the Eurasian Economic Union.

The original mission of the St. Petersburg International Economic Forum was to attract Western investment to Russia, but since the war in Ukraine and annexation of Crimea,

most large firms in the West have stayed away from the event. China's unprecedented delegation this year of more than a thousand people was interpreted by Russian state media as a signal that the Russian economy is destined to be increasingly eastward-facing.

Critical assessments of the outlook for the Russian economy were offered at some side events. Alexei Kudrin, current chairman of the Accounts Chamber and former finance minister, said that Russian economic growth would remain below 2 % p.a. in coming years unless the country moves ahead with structural reforms, particularly development of an independent judiciary. Kudrin said that a survey of the Federal Security Service found that over 55 % of the firms do not trust the judiciary and 70 % consider doing business to be dangerous.

### Kazakhstan's acting president Tokayev wins presidential election.

The tallied results from the presidential elections held last Sunday (June 9) show Kassym-Jomart Tokayev garnered 71 % of the vote. The election was moved up a year after Kazakhstan's leader, Nursultan Nazarbayev, announced in March his decision to step down from the post he had held for 30 years. Tokayev, who previously served as upper-house speaker, stepped in immediately three months ago as acting president until elections could be held.

The election result was expected as the 78-year-old Nazarbayev had already designated the 66-year-old Tokayev as his successor. Despite the changes at the top, Nazarbayev is expected to continue wielding power. Major policy shifts are not expected to be made in the near future. Observers from the Organisation for Security and Cooperation in Europe reported that the election failed to meet the criteria of free and fair election, specifically noting the limits put on standing for office, campaign assemblies and expressions of opinion.

Partially thanks to its natural resource endowments, Kazakhstan is a rather wealthy country in the Central Asian region. The World Bank reports that Kazakhstan's purchasing-power-adjusted GDP per capita in 2017 was 26,000 dollars. Thus measured, living standards are roughly on par with Russia and about half that of Germany. With a population of just under 20 million, Kazakhstan is a significant regional trading partner for Russia, which has a population of about 145 million. Along with Russia and Belarus, Kazakhstan was a founding member of the Eurasian Economic Union. While this union was in principle founded to advance the integration of member-state economies, there is also a geopolitical aspect to it.

Russia and Kazakhstan are both major global exporters of hydrocarbons and metals and significant importers of machinery and chemicals, but they also trade fairly extensively with each other. Russia last year accounted for 8 % of Kazakhstan's goods exports and 38 % of goods imports. From Russia's side, Kazakhstan accounts for 3 % of goods exports and 2 % of goods imports. For Russia as a whole Kazakhstan is thus only a minor trading partner, but for the Siberian regions close to the border Kazakhstan is an important market.

## China

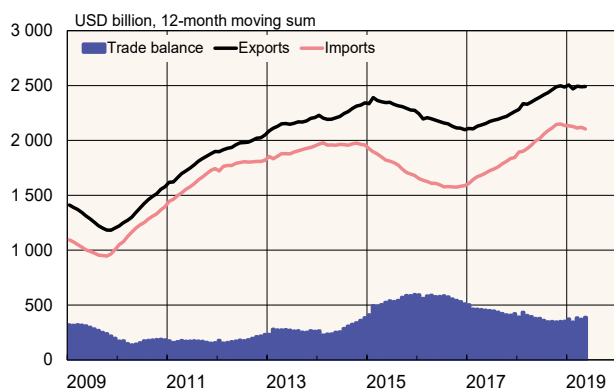
**China's falling import figures signal weak domestic demand and shifts in global production chains.** In dollar terms, the value of Chinese goods exports in May was up 1 % y-o-y. However, the value of imports was down by nearly 9 % y-o-y. For the January-May period, the level of exports remained roughly unchanged from the first five months of 2018, while imports contracted by nearly 4 %. China's goods trade surplus in the period hit 130 billion dollars, up from 94 billion dollars a year earlier.

With China's other major export markets showing declines or weakness in recent months, export growth is currently driven by gains in EU markets (up 6 % y-o-y). Exports to the US continued a string of down months, falling by 4 % y-o-y in May.

The weakening import trend suggests deeper problems with domestic demand. While the value of EU imports in May was still up by 2 % y-o-y, the value of imports from other major markets declined substantially. Imports from the US continued to slump as in previous months, dropping by about 25 % from a year ago. Imports from neighbouring Asian countries also continued to slide.

The complexity of the situation can be seen in the fact that exports and imports tied to international production chains have performed worse than the rest of China's foreign trade.

### Chinese foreign trade (goods) in 2009–2019



Source: CEIC.

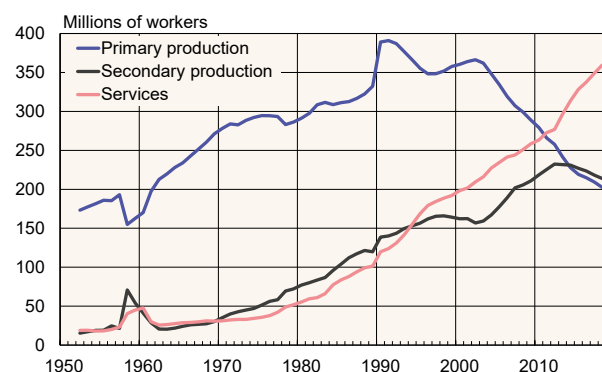
**More Chinese working in service jobs.** While official figures show that the structure of Chinese GDP has hardly budged in recent years towards a more consumption-driven economy (BOFIT Weekly 23/2019), the structural evolution of China's labour market, which consists of nearly 780 million people, shows a strong shift to the service sector.

China National Bureau of Statistics reports that the service sector had nearly 360 million workers in 2018, with the number of employees rising by over 10 million from 2017. The service sector has emerged this decade as the largest employer in the Chinese economy. Last year, 46 % of all workers were employed in service jobs.

The number of workers in primary production (mainly agriculture), has dropped precipitously since the turn of the millennium. China's accession to the WTO in 2001 strengthened its course to become the global hub of manufacturing and assembly, which in turn caused a massive influx of workers from the countryside to cities. Some 366 million people worked in the primary production sector in 2002, but that number declined to just 203 million by 2018. During the same period, the share of workers employed in primary production fell from 50 % to 26 %.

The number of workers employed in secondary production (industry and construction), has fallen since 2012. 214 million people last year worked in secondary production (28 % of the workforce). The decline partly reflects rising labour costs that have forced companies to automate or move labour-intensive production to cheaper countries.

### Number of workers by sector (in millions)

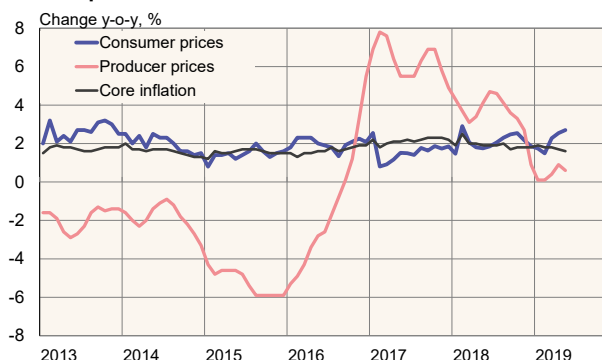


Sources: China National Bureau of Statistics, CEIC.

**Chinese inflation accelerates slightly on higher food prices.** The NBS reports May consumer prices were up 2.7 % y-o-y, slightly higher than the 2.5 % rise registered in April. The pick-up in inflation was mainly due to sharp increases in prices of fruit and pork products (the spread of African swine fever virus has caused pork prices to jump in China). Food prices overall were up 7.7 % last month.

Producer price inflation slowed to 0.6 %, which puts pressure on corporate earnings and profitability.

### Chinese price trends



Source: Macrobond.

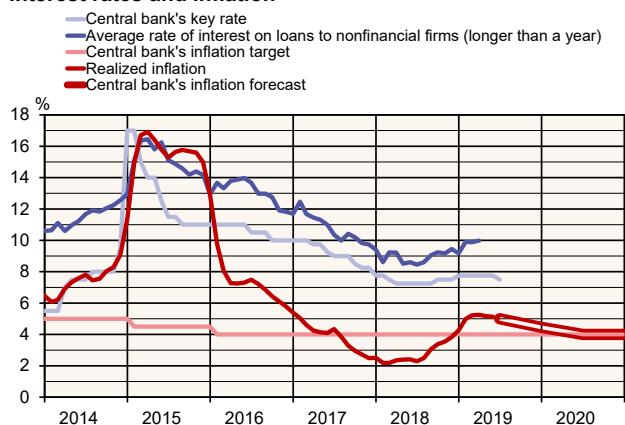
## Russia

**Central Bank of Russia lowers key rate.** On June 14, the Central Bank of Russia, as markets anticipated, lowered the key rate by 25 basis points. The key rate is now 7.5 %. The CBR said their decision reflected slowing annual inflation and tepid economic growth in the first half of the year.

Annual inflation peaked in March at a rate of 5.3 %, and annual consumer price growth reached an estimated 5 % at the beginning of June. Ruble appreciation (up 8 % against the dollar since the start of the year) and slowing growth in retail sales contributed to slowing inflation. The CBR also noted that the pass-through of the VAT hike at the start of the year has been transferred to consumer prices. The central bank now forecasts 12-month inflation slowing further to a range of 4.2–4.7 % (reduced from the earlier forecast of 4.7–5.2 %) at the end of 2019. In 2020 and 2021, annual inflation is expected to remain close to 4 %.

The weaker-than-expected economic data early in the year ([BOFIT Weekly 21/2019](#)) also have caused the CBR to slightly cut its GDP growth forecast for this year. The updated forecast reduces the growth outlook from a range of 1.2–1.7 % to 1–1.5 %. Government investment projects, however, might return growth to a level of 2–3 % in 2021. The CBR did not rule out the possibility of a further rate cut at one of the upcoming board of directors' meetings.

### Interest rates and inflation



Source: Macrobond.

**Rapid expansion of Russian consumer borrowing raises concerns.** Preliminary data released by the CBR show that on-year growth in the stock of credit granted to households accelerated in the first four months of this year. The credit stock, which grew at less than 20 % y-o-y in spring 2018, increased by 24 % y-o-y this April.

The acceleration in growth of unsecured consumer credit to its current pace of over 25 % y-o-y is seen as a particular cause for concern. Nominal wages in Russia are only rising at about 7 % y-o-y and real incomes continue to shrink. Consumer loans represent about half of household borrowing.

The CBR has sought to moderate credit growth by e.g. though several hikes in the risk ratio buffers for unsecured credit and by announcing its willingness to increase requirements further if needed. From the beginning of October, banks granting new loans will have to determine the debt burden ratio on each loan applicant (ratio of total credit-servicing costs to the previous year's average monthly earnings).

The growth in housing loans is seen as less of a cause for worry than that of consumer loans, but the increasing loan-to-value ratios (ratio of mortgage amount to appraised value of property) have raised some questions. At the beginning of January, the CBR increased risk ratio buffers for highest-risk housing loans (loan-to-value ratios above 80 %), thereby slightly increasing interest rate on these loans. The loan-to-value ratio for about 40 % of housing loans granted during the first months of this year exceeded 80 %. At the same time, the average size of a housing loan has risen. Approximately 400,000 new housing loans were granted in January-April, which was slightly fewer than in the same period in 2018. The average interest rate on new housing loans is currently just under 10 %.

Less than 1 % of household loans are denominated in foreign currency. About 20 % of household deposits are in foreign currency.

### Household borrowing and deposits

	3/2019	3/2018	3/2019
	RUB billion	12-month change, %	
Loan stock	15846	17 %	24 %
Housing loans	6909	3 %	21 %
Consumer loans	7702	15 %	24 %
Deposits	28810	10 %	8 %

Source: Central Bank of Russia.

**Russia's labour force shrinks along with unemployment.** Rosstat's latest labour market survey, which is based on the methodology of the International Labour Organization (ILO), finds that the employed population (aged 15–72 years) fell by about 1 % y-o-y in the first quarter of this year. The contraction in the number of unemployed is now in its third year.

In the four-quarter period from April 2018 to March 2019, the employed population averaged just over 72 million, while number of unemployed averaged 3.6 million. After several years of increase, the employment rate fell slightly this year to 65.4 %. The unemployment rate fell to 4.7 %.

The size of Russia's total labour force, which includes both employed and unemployed workers, witnessed an unusually large decline this year. At the same time, the number of persons outside the labour force increased. The increase is due almost entirely to the over 1 million persons in potential labour force, i.e. not actively seeking work, but who would like to have a job.

## China

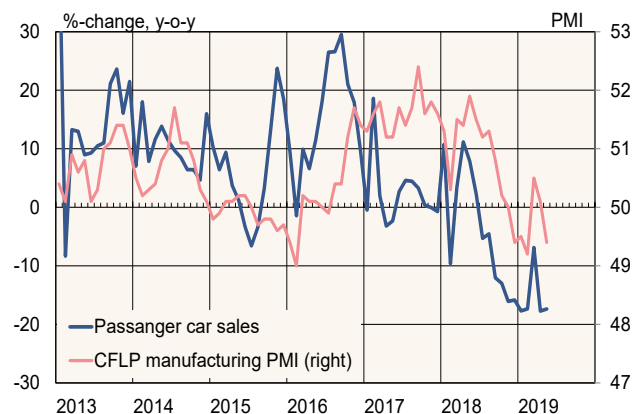
**Chinese May industrial output growth low by historical standards.** The China National Bureau of Statistics reports that the country's on-year growth in real industrial output slowed from 5.4 % y-o-y in April to 5 % in May. If the exceptional figures occasionally posted during the January-February Lunar New Year festivities are excluded, China has not officially announced such low growth since the early 1990s.

While China's official figures leave much to be desired, it is notable that industrial output growth in the first five months of this year averaged just 5.9 %, which was about 1 percentage point lower than a year ago. According to the main purchasing manager indices (PMI), industrial output in May was essentially unchanged from April.

China's car industry, once a major driver of economic growth, has seen its value-added trend decline in recent months (down by 5 % in May). The China Association of Automobile Manufacturers reports that over the past 12 months fewer than 22 million passenger cars have been built domestically, a decline of 13 % from last year. May output was down 24 % from May 2018. There is no quick fix for the car industry. The leading finance magazine *Caixin* reports that the central government does not intend to provide special subsidies to carmakers as earlier planned. Manufacturers also have to unload 3 million cars in inventory built to old emission standards before the new standards enter into force next summer.

Chinese growth continues to rely increasingly on growth in the service sector. Real growth in retail sales picked up from 5.1 % in April to 6.4 % in May. Real growth in retail sales in the first five months of this year was just 6.4 %, however, down from over 8 % in the same period a year earlier. The various purchasing manager indices showed that production of services continued to enjoy robust growth, but indicated no further acceleration in growth.

Monthly car sales and manufacturing PMI readings in China



Sources: CEIC, CAAM, CFLP.

**China suspended its market economy status challenge at WTO.** This month, the World Trade Organization (WTO) approved China's request submitted in May to suspend its complaint in a dispute raised with the EU over how import prices of Chinese products were determined in dumping cases. In practice, the complaint was intended to force the WTO to determine whether China meets the criteria for recognition as a market economy.

China asserts that its 2001 WTO accession agreement automatically conferred market-economy status after 15 years of WTO membership. Such status affects how and whether anti-dumping tariffs can be imposed on Chinese products. The dispute has been pending at the WTO since 2016.

The EU and the US dispute the Chinese interpretation. They say that the low pricing of many Chinese products continues to be based on large public subsidies, so the EU and US have used pricing in third countries with efficient markets to reveal evidence of price dumping in Chinese products. This evidence has been used by the EU and US to impose anti-dumping tariffs on Chinese products, and thereby supported the price competitiveness of their own companies.

A number of different sources report that China has requested that petition be withdrawn after it became apparent that the WTO was ready to issue a negative ruling. China's similar claim against the US is also expected to be dropped.

**Hong Kong rocked economically and politically by mainland moves.** The Hong Kong Census and Statistics Department reports that the special administrative region's GDP grew by just 0.6 % y-o-y in the first quarter of this year, the lowest growth pace since the 2009 financial crisis. Growth in private consumption was negligible, while investment in construction and machinery & equipment contracted. Foreign trade goods exports began to fall and growth in services exports slowed to around 1 % y-o-y. Imports of goods and services also contracted. Economic trends remained generally weak in April.

For Hong Kong, a small open economy, mainland China has huge economic importance. The movement of goods, services, people and money between the special administrative region and the mainland is quite lively. The slowdown in Hong Kong's economic growth also reflects weakness in the mainland China economy. Trade war, heightened protectionism and slowing growth in world trade also have diminished the region's economic growth.

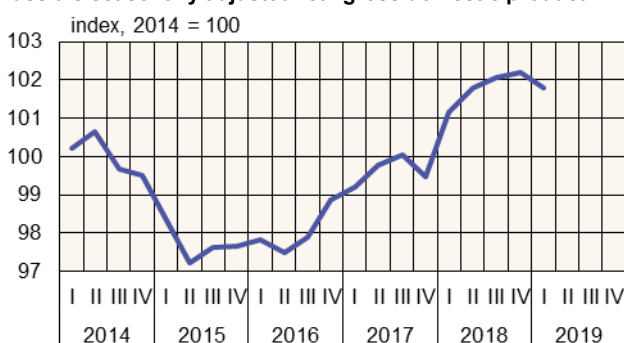
When the UK surrendered control over Hong Kong to China in 1997, the parties agreed, among other things, that Hong Kong's economic system and constitution would remain in place until at least 2047. In recent years, however, China has tightened its grip on Hong Kong. The mass protests of recent weeks reflect dissatisfaction with this trend. The regional government postponed a change in the law that would make it easier to extradite a person accused of a crime to mainland China, but protestors continue to demand that the proposed law never be enacted and that Hong Kong's chief executive Carrie Lam step down.

## Russia

**Russian first-quarter growth supported by extractive sector and certain service-sector branches.** The latest Rosstat figures show Russia's seasonally adjusted gross domestic product in the first quarter contracted by 0.4 % from the previous quarter. Prior to that, seasonally adjusted GDP had grown almost uninterrupted since mid-2016. Russian GDP in the first quarter of this year was 1.8 % larger than it was in 2014.

Russian GDP rose by 0.5 % y-o-y in the first quarter of this year. Growth was supported in particular by high growth in the extractive sector (4.6 %), even if the pace of growth slowed from late 2018. There was also high growth in some service branches. Financial services increased by 7.6 % y-o-y, while tourism was up by 4.8 %. Both fields have experienced strong growth since 2017. Manufacturing growth in the first quarter was up by just 0.6 % y-o-y. There was virtually no growth in the construction sector.

### Russia's seasonally adjusted real gross domestic product



Source: Rosstat.

**Russia tries to strengthen import substitution policy.** In February, Russia's ministry of industry and trade released a draft decree which would limit public procurement. The decree would require government agencies to purchase computer, communications equipment and household appliances from domestic producers if suppliers selling the requisite goods are available. Domestic producer is defined as a firm that is at least 50 % Russian-owned.

The legislation is part of Russia's import substitution policy. Russian industry is currently heavily dependent on imported machinery. In particular, the market shares of Russian companies in quality product categories are quite small. Officially, restrictions on imports are intended to reduce dependence on foreign countries and diversify the domestic production structure. Usually these measures target the location of end-product assembly or the ownership of the firm doing it rather than the production of added value along the entire production chain. In practice, the import substitution policy can be influenced by special interest groups such as the stakeholders of a large factory in a particular city. To the extent

that the measures protect special interests and preserve existing business structures, they hardly promote the goals of reducing dependency and diversifying Russian production.

Russia already has several measures favouring domestic manufacturers. In 2014, Russia restricted imports of certain foods from the West in response to Western sanctions on Russia for annexation of Crimea and war in eastern Ukraine. In addition, favouring of domestically produced goods and services has been seen in the pharmaceutical, transport vehicle, telecom and software industries. The effectiveness of these measures is limited as Russia cannot offer serious domestic alternatives.

Russia has traditionally had high barriers to imports. Since joining the WTO in 2012, Russia has incrementally lowered its import duties, but barriers to imports are still quite high. The UN reports that Russia's average trade-weighted most-favoured-nation customs duty in 2017 was about 5 % of the value of the goods. Thus, the average duty was not particularly high, but duties varied depending on the trade partner and the product category. In addition, Russia's regulatory environment presents a major obstacle to trade.

**Russia suspends flights to Georgia after July 8.** Last Friday (Jun. 21), President Vladimir Putin signed a decree suspending direct flights between Russia and Georgia citing heightened security concerns. Thousands of protesters took to the streets in the Georgian capital of Tbilisi last week after a representative of the Russian Duma addressed the Georgian parliament as part of a meeting of the Interparliamentary Assembly on Orthodoxy. Relations between Georgia and Russia have stayed tense since the August 2008 war between the two countries. While they have not restored diplomatic ties, tourism and trade have remained brisk.

About a million Russian tourists visited Georgia last year. Given that Russians constitute the largest tourist group, observers estimate that Georgia's loss in revenues due to the ban on flights could go as high as 300 million euros this year. Russia's food safety agency (Federal Service for Veterinary and Phytosanitary Surveillance) has also blocked specific wine shipments from Georgia. Russia banned imports of Georgian wines altogether from 2006 to 2013. Russia last year accounted for 13 % of Georgia's total exports, about a quarter of which was wine.

The ban on flights to Georgia is not the first instance of Russia imposing restrictions on tourism abroad. Russia halted all flights to Egypt in 2015 after a suspected luggage bomb brought down a charter flight from the Red Sea resort town of Sharm el-Sheikh to St. Petersburg. Before the bombing, over 2 million Russians visited Egypt each year. Since then, official figures show the number of Russian tourists visiting Egypt has fallen to less than a thousand annually. Tourist numbers to Egypt failed to recover, even after scheduled direct flights between Cairo and Moscow were re-established last autumn, and there are plans to reinstate charter flights later this year.

## China

**WTO warns of rising protectionism ahead of G20 summit.** On Monday (Jun. 24), the World Trade Organization released its 21<sup>st</sup> [Monitoring Report on G20 trade measures](#). New measures to restrict imports have been introduced at a record pace in recent year. In the latest monitoring period (October 16, 2018–May 15, 2019), the WTO estimates that the coverage of new restrictions targeting imports amounts to around 336 billion dollars a year, an amount that corresponds to some 2.5 % of the imports of G20 countries.

Shifts in trade policy can be seen in the increase in trade coverage of import-restrictive measures, which was only larger in the immediately preceding monitoring period in 2018, when new restrictive measures covered 3.5 % of G20 imports. The WTO has made estimates of the coverage of import restrictions since 2012. Before 2018, however, the coverage of new imports subject to restrictions was only 0.1–0.6 %. Most of the recent increase reflects tariff hikes. The number of new import restrictions, however, were fewer than in the previous monitoring periods. The value of new measures to facilitate imports also hit a record level.

While the monitoring report technically catalogues trade policy measures implemented by G20 countries during the period, it also reveals simmering tensions within the WTO and in global trade. The WTO Secretariat hopes that the G20 countries will provide, among other things, clear rules on reporting of government subsidies. The report also notes that in services trade, while most new measures have facilitated trade, policies in several branches such as telecommunications and online services as well as investment in strategic fields have become more restrictive.

The WTO report avoids naming specific countries. It is not hard to guess, however, that a significant part of the reported new import restrictions is due to the trade war between China and the US. The report also shows that imports from China have overwhelmingly been the most usual target of anti-dumping and countervailing initiations by other G20 members (including Russia). Overall, the product groups hit hardest by these retaliatory measures have been metals, chemical products and plastics.

The WTO should be reformed in order to make its rules and operations to reflect changes in the global economy. However, the trade dispute between the United States and China will again overshadow the G20 summit in Japan on June 28–29, as well as any progress in reforming the WTO. Besides tariffs, the opening up of China's markets and the controversies surrounding Huawei, a new stumbling block to trade negotiations is posed by US allegations concerning the involvement of three Chinese banks in a scheme to circumvent sanctions against North Korea. Revelations this week in the *Washington Post* have only added to uncertainty surrounding the trade negotiations between the US and China.

**London-Shanghai Stock Connect launches.** On June 17, China's financial markets took a small step towards internationalisation as the London Stock Exchange opened trading in depository receipts of Chinese firms. At the moment, however, foreign investors in London can only use the arrangement to trade in the depository receipts of a single Chinese company.

Unlike the Stock Connect programme that links the Hong Kong Stock Exchange with the Shanghai exchange, the London-Shanghai Stock Connect scheme relies on Global Depository Receipts (GDRs) issued by Chinese firms, while the listings of firms on the London exchange are based on Chinese Depository Receipts (CDRs) on the Shanghai bourse. The depository receipts represent ownership of ordinary shares of a foreign corporation and can be traded like regular shares. The custodian bank issues the depository receipts against the actual shares of the firm in its possession. The advantage of trading in depository receipts is that it removes the need for direct trading infrastructure between exchanges and eliminates such issues as time differences. The trading is subject to the rules of both exchanges. In Shanghai, trading is denominated in yuan and in London in dollars, pounds or yuan.

To launch the London-Shanghai Stock Connect, the Chinese brokerage Huatai Securities raised 1.5 billion dollars (about 9 % of the company's share capital) through the issue of depository receipts on the London exchange. No firm listed on the London exchange has yet issued depository receipts in Shanghai.

The Stock Connect rules are strict, so only a small number of exchange-listed firms are qualified to participate. For this reason, the arrangement is not expected to do much to increase the prospects of Chinese firms seeking foreign financing. Trading in both directions is subject to quotas and private Chinese investors cannot participate in the scheme without a large enough investment capital. Trading activity is expected to remain relatively modest, and the programme could end up being mostly a symbolic gesture.

### Share price trends in mainland China, Hong Kong and London



Sources: Macrobond and BOFIT.



## Russia

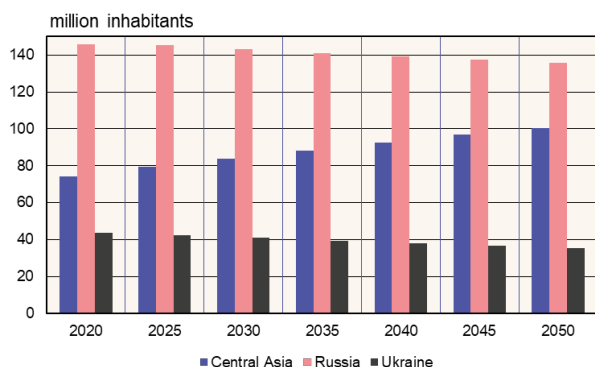
**Russia's population declines, greys and increasingly packs into cities.** The UN's latest population forecast shows the Russian population falling from its current 146 million to 135 million by 2050. The forecast extends to 2100, but the margin for error for the out years is significant. With that caveat, the forecast estimates the Russian population go down to 126 million people in 2100.

The average life expectancy of Russians and their living standards have risen steadily since the start of the millennium. Consumption of tobacco and alcohol products has also declined. The birth rate remains low, however, so Russians on average are getting older and the age dependency ratio continues to deteriorate even if immigration from countries close to Russia somewhat offsets the decline in population. In the 2010–2018 period, immigration to Russia was 2.2 million more than people moving out of the country. Russia's current dependency ratio of 63 means that for every 100 persons of working age, there are 63 minor children or persons over the age of 65. The corresponding figure for Western Europe is 72. Russia's dependency ratio will climb to 77 in 2030 and 83 in 2050. The ratios for Western Europe at those times will be 83 and 94, respectively.

The Russian population is becoming concentrated in cities. The populations of Moscow and St. Petersburg are expected to rise by 3–4 % by 2035, while the populations in Russia's other 13 cities with populations of more than a million will increase by about 2 % during the same period.

The differences in trends in Eastern Europe and Central Asia are striking. The populations of Russia, Belarus, Ukraine, Moldova, Armenia and Georgia are ageing and shrinking. The biggest drop is expected in Ukraine, which should fall from the current 43.7 million to 35.2 million by 2050. The total population of Central Asia (Kazakhstan, Kyrgyzstan, Uzbekistan, Tajikistan and Turkmenistan) is expected to rise from the current 74.3 million to 100 million by mid-century. At that time, the most populous country of Central Asia will be Uzbekistan (up from 33.5 million today to 43 million in 2050).

UN population forecasts, 2020–2050



Source: United Nations.

**OPEC+ keeps production ceilings in place.** At the start of this week, the so-called OPEC+ league of oil producing countries reached agreement on extending production ceilings of its members by nine months. The agreement is non-binding.

The agreement reaffirms the cuts that were agreed on last December. Then participating countries agreed to cut their daily output by 1.2 million barrels or about 3 % from the October 2018 level. Official figures show that OPEC+ met its overall target this spring. Even with the production ceilings, the oil price has remained at about 60 dollars a barrel.

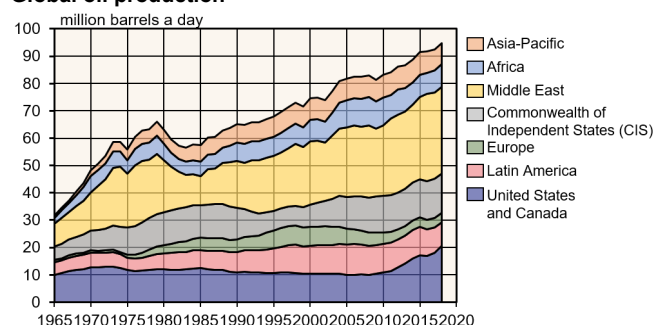
The parties to the agreement include the 14 members of the Organization of Petroleum Exporting Countries (OPEC) and ten other oil-producing countries. The lead duo are Saudi Arabia and Russia. With a few exemptions, the parties control African, Middle Eastern, Central Asian, Uralian, Siberian, Malaysian, Mexican and Venezuelan oil fields. That said, production in Venezuela and Libya has already collapsed due to domestic strife. Figures released by British Petroleum for 2018 show that OPEC accounted for 42 % of global oil output, Russia 12 % and other nine OPEC+ members 7 %.

The OPEC+ group first agreed to production ceilings in October 2016. The agreement has since seen evolving interpretations and restrictions lifted occasionally. The agreement is seen as the response of Saudi Arabia and Russia to increased North American shale oil production. With advances in shale oil extraction methods, US oil production has doubled over the past decade. The US and Canada accounted for 22 % of global oil output last year.

Although Iran has earlier refrained from committing to cuts, it in principle supports the agreement. However, it is displeased about the bilateral cooperation of Saudi Arabia and Russia. Iran says the alliance conflicts with the common goals of OPEC. Russia's activity could also be seen as part of Russia's general efforts to develop deeper economic relations with Middle Eastern countries.

Russia had little trouble complying with the production ceilings after the contamination in April of the Druzhba oil pipeline, which brings oil from the Urals to Central Europe ([BOFIT Weekly 21/2019](#)). The fouling required temporary production cuts. Many Russian oil companies are unhappy with the production ceilings. State-owned oil giant Rosneft said it does not plan to postpone new projects.

Global oil production



Source: British Petroleum.

## China

**Trade talks with the US continue; China promises to speed opening of its markets.** Presidents Xi Jinping and Donald Trump met on the sidelines of the G20 summit in Osaka last Saturday (Jun. 29). The US trade delegation said no further tariff hikes on Chinese imports were envisioned in the near future as the negotiations continue. China committed to buying more US farm products.

The current punitive and retaliatory tariffs imposed by the two countries on each other will remain in force, but after declaring a continuation in the talks, the US has abandoned its plans to impose further tariff hikes that would have applied to nearly all Chinese imports yet to be subject to higher tariffs. Trump also softened his position on Chinese telecom giant Huawei, announcing at a press conference that American companies could continue to sell to Huawei as long as it poses no threat to national security.

There is no information yet on the length of the truce in talks. Large issues underlie the US-China dispute, including China's policies that discriminate against foreign firms, compel technology transfers and fail to protect intellectual property rights. It is unlikely that any of these problem areas will be permanently sorted out soon.

On Sunday (Jun. 30), China's National Development and Reform Commission (NDRC) issued a press release that said the list of branches off-limits to foreign firms (the negative list) will be cut from 48 branches to 40. Foreign ownership will be allowed in branches such as oil & gas exploration, gas and heat pipelines in larger cities, movie theatres, as well as broader access to the agricultural sector and mining of certain metals. The shortened list enters into force on July 30. The negative list was last trimmed a year ago ([BOFIT Weekly 27/2018](#)).

In his speech to the G20 summit participants, Xi proposed a number of measures to open up China's markets to the rest of the world, including reduced tariffs and lowering of other trade barriers, creation of new free-trade zones, and progress in an EU-China investment protection agreement as well as the free-trade agreement between China, Japan and South Korea. On Tuesday (Jul. 2), premier Li Keqiang told participants at the World Economic Forum in Dalian that China would open its markets to foreign investors and accelerate the planned phase-out to end restrictions on foreign ownership in the financial sector from 2021 to next year.

**China holds back on additional stimulus measures.** Although Chinese economic growth is slowing, the government has announced only very modest new measures to support the growth recently. To counteract a sharp slowdown in car sales, the government eliminated restrictions on car purchases (excluding gasoline & diesel vehicles). No new subsidies were granted, however. Instead, the NDRC encouraged provincial governments to support car and home appliance sales if they happen to have extra money available.

In line with plans announced in winter, China has relaxed its fiscal policy throughout the spring. In April, VAT for manufacturing firms was lowered from 16 % to 13 %, and VAT on construction and transport from 10 % to 9 %. All firms will have greater possibilities to make deductions on their VAT, and firms with monthly sales less than 100,000 yuan (12,900 euros) are exempted entirely from the VAT requirement (earlier the ceiling was 30,000 yuan). At the beginning of May, mandatory corporate contributions for pension, unemployment and accident insurance were lowered. Income taxes, already reduced last autumn, were also granted more exemptions from the start of January.

The tax cuts have led to a clear slowdown in the growth of government budget revenues. Even so, budget revenues and spending for the January-May period were on track to meet this year's budget released in March.

To encourage investment in infrastructure projects, local governments have been allowed to issue more special purpose bonds than earlier. Thanks to this policy, a growth in public-sector investment has picked up somewhat. However, real growth in fixed asset investment overall (including private investment) has remained modest, at around 2 % a year.

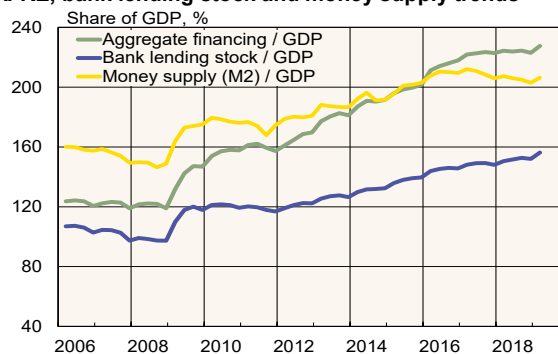
### No big changes expected in China's monetary policy.

On Monday (Jul. 1) at a monetary policy conference arranged by the Bank of Finland, China's central bank governor Yi Gang spoke on his nation's economic conditions and monetary policy. Yi acknowledged the downward pressures on the Chinese economy, but said that the current monetary stance of "neither too loose nor too tight" will remain in place.

The monetary policy stance this year has not been eased much ([BOFIT Weekly 22/2019](#)). For several years now, the PBoC has sought to improve access to finance and lower the costs of financing for small firms. It will continue these efforts through the use of various monetary policy instruments. Opening of China's financial sector will also continue.

China's monetary policymakers seek to hold growth in the broad money supply (M2), loan stock and aggregate financing to the real economy (AFRE) to the same pace as nominal GDP growth. China earlier talked about reducing its debt-to-GDP ratio, but current policy is aimed at just maintaining that ratio. In recent years, the stock of bank lending has grown a bit faster than official nominal GDP.

**AFRE, bank lending stock and money supply trends**



Sources: CEIC and BOFIT.

## Russia

**Russian economic growth driven almost exclusively by private consumption.** Newly released Rosstat figures show that the slowdown in GDP growth to just 0.5 % y-o-y in the first quarter was due to simultaneous weakening performance of both domestic demand and exports. The value-added tax hike at the start of the year had a one-time impact on domestic demand.

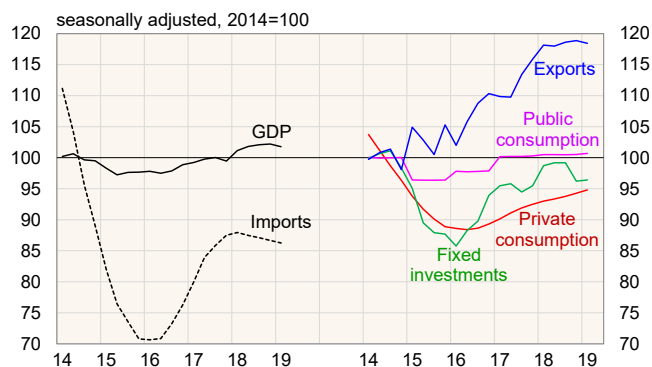
After several years of significant growth, the volume of exports stabilised last year and showed a small decline in the first quarter of this year. For the first time in three years, the volume of exports was slightly lower than in the same quarter a year earlier, but it was still up almost 20 % from the 2014 level.

Following a precipitous drop in 2015, private consumption gradually recuperated over the following two years. While continuing this year, the pace of recovery slowed in the first quarter. The slower growth picture for retail sales in recent months suggests that recovery in consumption may have cooled further. Private consumption in the first quarter was up about 1.5 % y-o-y, but still about 5 % below the level of 2014. Growth in public consumption in the first quarter remained at last year's very slow pace.

Fixed investments recovered for about two years after their 2015 collapse, but last year growth flattened. Even with some growth in the first quarter of this year, the very weak investment performance in the final months of 2018 meant investments in 1Q19 were lower than in 1Q18, which was the first on-year drop in three years. Investments were also a few per cent lower than in 2014.

Imports of goods and services to Russia have contracted slightly in several recent quarters. In volume terms, imports were down slightly on-year in the first quarter and off by about 14 % from 2014.

### Performance of real GDP, imports and demand, 2014–2019



Source: Rosstat.

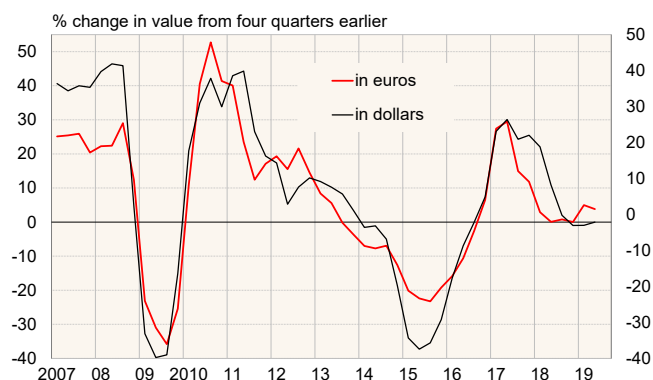
**Russian foreign trade contracts slightly.** Preliminary balance-of-payments figures released by the Central Bank of

Russia show that Russian earnings from exports of goods and services fell in the second quarter of this year by a couple of per cent in on-year terms. The last such on-year drop was seen in autumn 2016. The contraction in export earnings arose mainly from developments in the energy sector, where export prices were lower than in 2Q18.

Russian spending on imports of goods and services, which since last summer has been running at about the same level as four quarters earlier, remained in the no-growth situation in the second quarter of this year. While this feeble track mainly concerned goods imports, growth has also been slow in imports of services such as Russian spending on tourism abroad.

Even if the slight drop in export revenues in the second quarter diminished Russia's current account surplus, the weak import performance meant that the current account surplus over the last four quarters still continued rumbling at nearly 7 % of GDP.

### Russian spending on imports in euros and dollars, 2007–2019



Source: Central Bank of Russia.

### Increase in outflows of private capital from Russia.

Preliminary balance-of-payments figures show that Russia's net private-sector capital outflow went on in the second quarter. The net outflow from the private sector increased over the past four quarters to nearly 5 % of GDP. This was due mainly to capital outflows from the banking sector, while the net outflow of capital from the corporate sector remained at around the equivalent of 2 % of GDP.

The inbound flow of foreign direct investment from abroad to Russia's corporate sector has remained very small over the past four quarters (about 0.5 % of GDP). Although the figure for the outflow of capital from Russia's corporate sector in the form of outbound FDI has shrunk a bit, the four-quarter ratio was still about 1.5 % of GDP.

The other relatively significant capital flows for the corporate sector have involved foreign borrowing and lending. Russian firms generally have continued to pay down their foreign debt at a fairly steady pace, including the second quarter, while reducing their receivables related to foreign trade rather notably.

## China

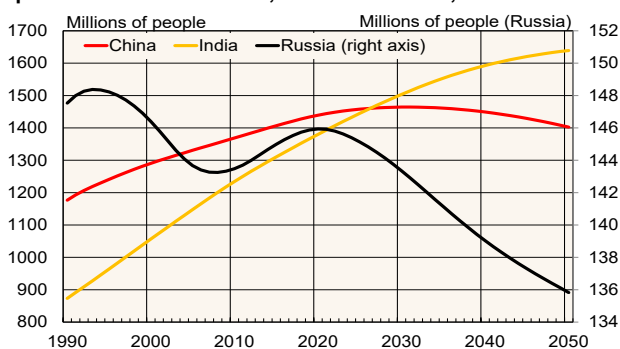
**India set to surpass China as the world's most populous country around 2027.** The UN's new population outlook, [World Population Prospects 2019](#), released last month expects the global population to rise from its current 7.7 billion to 8.5 billion by 2030. The world population should approach 10 billion by 2050, but population trends will continue to vary radically across regions.

In coming decades, population increase in absolute terms will be largest in India, Nigeria and Pakistan. The UN estimates that India will surpass China as the world's most populous nation in 2027. At that time, China's population will peak at 1.46 billion people. China's population should begin to decline in the first half of the 2030s. The UN estimates that just over 1.43 billion people currently live in China and that just under 1.37 billion live in India. The UN estimates are higher than those of the national statistical agencies of those countries (1.395 billion at the end of 2018 for China, and 1.332 billion for India as of end-March 2019). The IMF's population estimate, which is based on national figures, has India's population exceeding China's already in 2023.

While the US population, currently 329 million, is expected to keep growing throughout this century, it will lose its third-largest status to Nigeria sometime around mid-century. Russia currently has the world's ninth-largest population, but is expected to drop out of the top ten in less than two decades.

Both China and Russia face huge social challenges from low birth rates and ageing populations. The dependency ratios (ratio of persons not of working age to those of working age) is rising rapidly in both countries. The pension and social security systems and their funding require reform in both countries.

**Population trends for China, India and Russia, 1990–2050**



Source: UN World Population Prospects 2019.

**Coal continues to dominate China's energy palette, even as its relative contribution declines.** At the end of June, oil giant British Petroleum released its annual [Statistical Review of World Energy](#) (production, consumption and trade flows). The BP figures show that China continued to increase its role as the world's biggest energy consumer in 2018.

China accounted for a third of total growth in global energy consumption last year. About a quarter of the growth in Chinese consumption was satisfied with oil, another quarter with natural gas and another quarter with renewables. The final quarter of growth was covered by increased use of coal, nuclear power and hydropower.

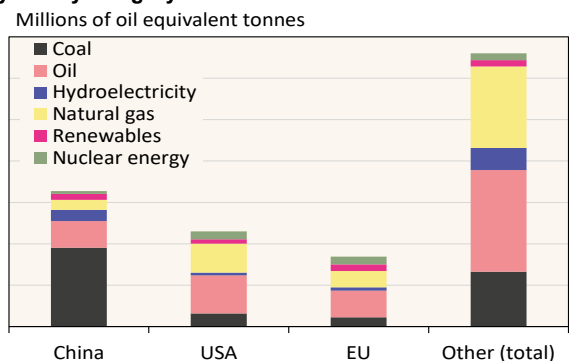
Coal remains China's single largest source of energy by far. China last year burned about as much coal as the rest of the planet. Even if new coal-fired power plants are still coming on line, the importance of coal is slowly waning. Coal-burning, which satisfied 72 % of China's energy demand in 2008, accounted for just 58 % last year. However, coal-burning is still the basis for two-thirds of China's electricity production. A big reason for China's coal dependence is that the country has large coal deposits. Despite an abundant resource base, however, China began to import more coal over the past decade. Even if the amount of imported coal is relatively small compared to domestic production (net imports were 7 % of 2018 production), China has become the world's biggest coal importer.

China is still the world's eighth-largest oil producer, even if its output has been declining since 2015. Oil consumption has increased rapidly, which has driven China to import large quantities of oil from abroad ([BOFIT Weekly 15/2019](#)). Domestic natural gas production doubled from 2008 to 2018, making China last year the world's sixth-largest gas producer. In 2008, China still produced about as much as gas as it used, but consumption has since far outstripped production growth and China is one of the largest gas importers. During the past two years, liquefied natural gas (LNG) imports have outstripped pipeline imports. Much of the LNG is imported from Australia, while most pipeline gas is brought in from Turkmenistan.

China is the biggest consumer of hydropower (using nearly 30 % of the world's hydropower) and renewable energy (25 % of world's consumption). It continues to rapidly roll out new wind and solar power capacity. Nearly half of all global growth in renewable energy production last year came from China.

While nuclear energy production has quadrupled in China over the past ten years, it still plays a fairly minor role. Nuclear accounts for 4 % of electricity production, as for example renewables already generate 9 % of China's electricity.

**Energy use by category in 2018**



Sources: BP Statistical Review of World Energy 2019 and BOFIT.

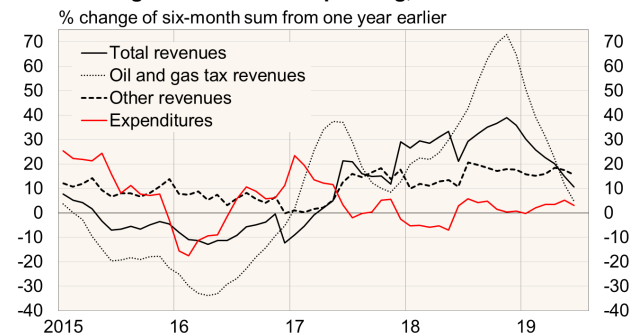
## Russia

**Russian federal budget produces strong first half surplus.** Budget revenues in the first half of 2019 climbed 10 % y-o-y in nominal rubles, even when the high pace of growth that boosted tax revenues from oil & gas exports has settled. Oil & gas-related revenues in January-June increased by just 5 % y-o-y. Other budget revenues, however, climbed by 14 %, supported in part by the inclusion of revenues from the VAT increase at the start of the year in the second quarter budget.

Federal budget spending was up just 3 % y-o-y in nominal terms in January-June, i.e. lower than inflation. Defence spending declined slightly. The pace of budget spending is expected to pick up in the second half as the national projects delineated by president Vladimir Putin in May 2018 move further into the implementation stage. Total projected budget spending for this year includes a recently approved small supplemental budget and should raise spending growth to about 10 % from last year. Defence spending should rise by 3–4 %.

While growth in federal budget revenues was brisk in the first half, growth in spending this year has been slow. The disparity has created a booming budget surplus that as a sum over the past 12 months has exceeded 3 % of GDP in recent months. For all of 2019, however, the finance ministry only expects a surplus of 1.7 % of GDP as long as the price of Urals crude averages just over 63 dollars a barrel (Urals averaged 66 dollars a barrel in January-June).

### Federal budget revenues and spending, 2015–2019



Source: Finance ministry.

**Druzhba pipeline again operating at full capacity since July.** Refinery-fouling oil was inadvertently mixed with other oil in the Druzhba pipeline in early April. The oil was contaminated with potassium chloride and other chemicals used in oil drilling ([BOFIT Weekly 21/2019](#)).

Pipeline operator Transneft estimates that oil exports transmitted by the Druzhba pipeline declined by 4.4 million metric tons in the first four months of this year compared to the same period last year. Nevertheless, Russia's total oil exports in the period were up by 2.9 million tons, thanks to an increase in exports via oil harbours of 6.5 million tons from the same period last year. While Transneft has promised to compensate its customers for their losses, no details on the damage settlements have yet been released.

**Russia's contribution to global oil, gas and coal production held steady last year.** British Petroleum's (BP) latest issue of its [Statistical Review of Global Energy](#) finds that Russia accounted for 13 % of world oil production, 17 % of natural gas production and 6 % of coal production in 2018.

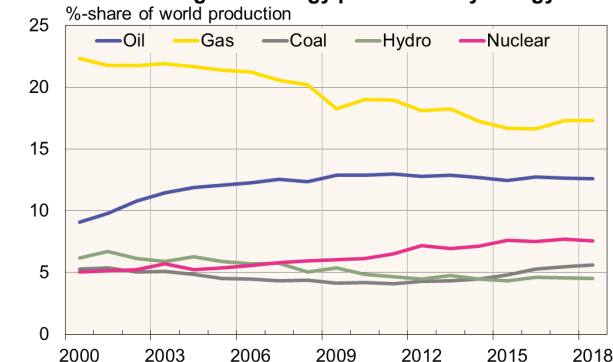
The volume of Russian oil & gas production has increased by about 10 % from the level in 2010, while hydropower production has grown by about 15 %, nuclear power 20 % and coal production 45 %. The rates of growth are roughly in line with average global growth in production, as Russia's share of the global production has remained roughly the same in recent years (see chart). Russia accounted for just 0.1 % of global renewable energy production last year.

Some 40 % of Russian energy production (oil equivalent) last year was in the form of natural gas, 39 % oil, and 15 % coal, with hydropower and nuclear power contributing 3 % each. Despite rapid growth, renewable energy production only accounted for a tiny fraction of Russian energy production.

In recent years, Russian natural gas companies have invested heavily in gas liquefaction facilities. There is high demand for LNG in East Asia, particularly Japan, China and South Korea. According to BP, Russia's share of global LNG exports was 6 % in 2018. However, Russian gas producers want to increase LNG production dramatically over the next decade. Around 70 % of Russian LNG exports went to markets in Asia and majority of the rest to Europe. UK and France together accounted for around half of the European exports. The first LNG shipment from the liquefaction plant on the Arctic Yamal peninsula via the Northeast passage to the Pacific Ocean departed on June 29. LNG carrier ships with ice-breaking ability can make the journey without the need for accompanying ice-breaker vessels. The Northeast passage is still only traversable in summer.

Russia accounted for 5.2 % of the world's primary energy consumption in 2018 and 4.6 % of carbon dioxide emissions. An average Russian consumed 210 gigajoules of primary energy last year. In per capita terms, it matches that of the average consumer in the West. 54 % of the energy used came from natural gas, 21 % from oil, 12 % from coal and 6 % from nuclear power. Russians get a disproportionate amount of their primary energy from natural gas. In most of Europe, gas accounts for about a quarter of primary energy consumption.

### Russia's share of global energy production by energy form



Source: British Petroleum.

## China

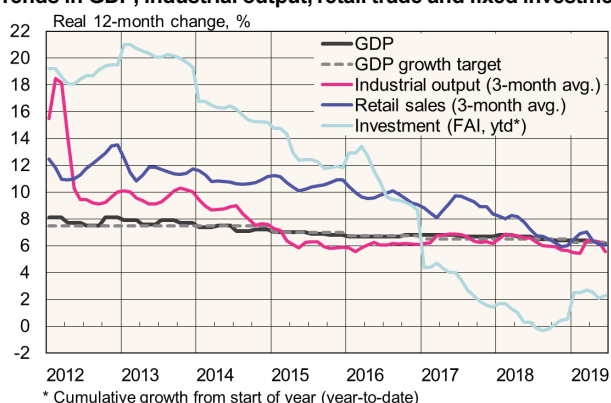
**Slowdown in China's economic growth continued in the second quarter.** Official figures show GDP growth holding at 6.2 % y-o-y, down from first quarter growth of 6.4 %. China's National Bureau of Statistics (NBS) attributes the continued strength in growth to the trend in net exports, which contributed by around 20 % of the growth. In the first half, average real disposable incomes were up 6.5 % y-o-y, slightly outpacing GDP growth.

Growth in retail sales and industrial output accelerated in June with both growth measures exceeding 6 % y-o-y in real terms. NBS retail sales figures show that value of car sales rebounded by 17 % y-o-y in June after declining in January-May. The pick-up in car sales may be explained by a change in emission standards in many provinces that forced dealers to reduce stocks by offering cars at substantial discounts ahead of the change. However, the China Association of Automobile Manufacturers (CAAM) observed that the volume of car sales was still down by 10 % y-o-y in June. CAAM said that car sales were down 12 % y-o-y in the first half.

Growth in fixed investment has revived a bit this year on increased public investment. While monthly figures for China's investment trends only give a rough idea of what is actually happening, the real increase in fixed asset investment (FAI) in the first half was around 2 %. Investment of state-owned enterprises has risen this year by about 3 % y-o-y in real terms. In the 1H18, FAI of state companies declined.

The rise in food prices continues to be driven by the African swine fever virus. Even so, consumer price inflation in June was unchanged from the May reading of 2.7 %. Core inflation (food and energy prices excluded) remained at 1.6 %. Producer price inflation fell to zero in June.

### Trends in GDP, industrial output, retail trade and fixed investment



Sources: Macrobond, CEIC and BOFIT.

**Alternative measures point to lower Chinese GDP growth than official figures suggest.** The pace of GDP growth carries huge political gravitas in China. The growth target this year, 6–6.5 %, is fulfilling president Xi Jinping's goal of doubling real 2010 GDP by 2020.

Official GDP growth has been remarkably steady, hitting annual growth targets even as other measures of economic activity suggest the deteriorating economic conditions in recent years, not to mention the increase in economic uncertainty from e.g. trade disputes. Official figures also fail to reflect normal business-cycle fluctuations.

The deficiencies in China's GDP statistics and criticism of China's reported growth figures is hardly new. Alternative indicators that might provide a more honest picture of growth have been suggested for years. Many of these other measures suggest that growth is currently lower than official figures. For example, the US-based Conference Board releases its own alternative GDP growth estimates for China. According to it, Chinese growth in recent years has been lower on average by about 2.5 percentage points from the official figures. The Conference Board put 2018 GDP growth at 4 % and sees it falling to 3.8 % this year.

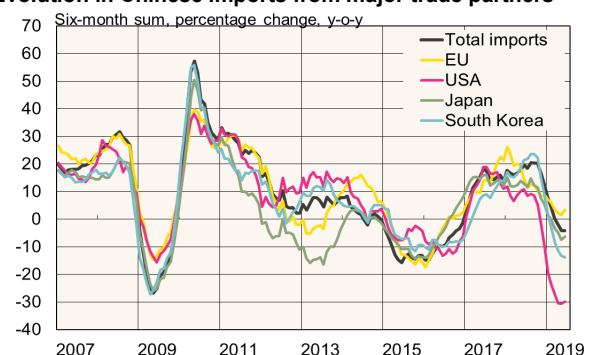
A [BOFIT Discussion Paper](#) released last December also noted that actual Chinese GDP growth has run on average at more than 1 % below the official numbers since 2014. The assessment considers alternative methods of estimating the GDP deflator. China does not disclose the deflator it uses to describe price trends in determining real GDP growth. Specifically, the deflated real growth figures in official statistics are astonishingly consistent. The use of an alternative deflator also reveals business-cycle variations as one might expect to see. Using the average alternative deflator from the study, GDP growth in the first quarter was below 5 %.

**China's imports fell in the first half.** China customs reports that the value of goods imports measured in US dollars fell by 4 % y-o-y in the first six months of this year. The value of imports fell by 7 % in June. Imports were down for all of China's key markets, except the EU. The value of imports from the US was down by 30 % y-o-y in the first half.

The dollar-value of goods exports in 1H19 was unchanged from 1H18 and fell by 1 % y-o-y in June. Exports to the US fell by 9 % in the first half, while the value of exports to the EU rose by 5 %. The first-half goods trade surplus overall climbed to 181 billion dollars. The trade surplus with the US increased to 140 billion dollars, up from 134 billion dollars in 1H18.

In yuan terms, China's foreign trade rose slightly in January-June, with the value of imports up 1 % and exports 6 %.

### Evolution in Chinese imports from major trade partners



Source: Macrobond.

## Russia

**International Monetary Fund lowers growth forecast for Russia.** The IMF's July update to its [World Economic Outlook](#) revise the forecast for Russia's projected 2019 growth down from 1.6 % in April to 1.2 % currently. The updated growth forecast for 2020 is 1.9 %.

The Fund, as well as all major institutions, expect Russian growth to accelerate slightly next year on higher public spending. The European Bank for Reconstruction and Development (EBRD) notes that growth this year has been restrained by such factors as the hike in value-added tax rates at the start of the year.

The IMF's July update lowers the growth projections for China and India in 2019 and 2020. The global growth outlook was also reduced a bit.

### GDP growth forecasts

		2019	2020
RUSSIA	IMF (7/19)	1.2 %	1.9 %
	Consensus Economics (7/19)	1.1 %	1.9 %
	World Bank (6/19)	1.2 %	1.8 %
	EBRD (5/19)	1.5 %	1.8 %
UKRAINE	World Bank (6/19)	2.7 %	3.4 %
	EBRD (5/19)	2.5 %	3.0 %
TURKEY	Consensus Economics (7/19)	-1.5 %	2.3 %
	World Bank (6/19)	-1.0 %	3.0 %
	EBRD (5/19)	-1.0 %	2.5 %
INDIA	IMF (7/19)	7.0 %	7.2 %
	World Bank (6/19)	7.5 %	7.5 %
	Asian Development Bank (4/19)	7.2 %	7.3 %

**Russia posts tepid first-half growth.** Although Russian GDP grew by over 2 % last year, the pace of growth slowed to just 0.5 % in the first quarter of this year ([BOFIT Weekly 21/2019](#)). New data for June show manufacturing growth picked up in the second quarter to 3 %, while other sectors of the economy showed virtually no growth gains.

There was no on-year growth in construction in the first half, and growth in services was negligible. Growth in both goods transport and retail sales slowed in the second quarter to under 2 %. The volume of services to households contracted by well over 1 % from 1H18.

The rise in real wages was also slower in the first half than in the same period last year. In June, real wages were 2.3 % higher than in June 2018. The real disposable incomes of Russians in 1H19 contracted by more than 1 % y-o-y. Household borrowing, in particular, helped fuel growth in retail sales. The household credit stock was up 23 % y-o-y in June. Notably, the rise in consumer credit has aroused concerns about excessive indebtedness ([BOFIT Weekly 25/2019](#)).

Part of Russia's sluggish economic performance reflects a slowdown in the global economy, which, in turn, reflects the contraction in Russian exports. The latest balance-of-payments figures show that the value of exports and imports

contracted in January-June by about 3 % y-o-y. Exports, in particular, took a nose-dive in the second quarter. Economic growth is expected to revive a bit in the second half of this year as the effects from planned public sector spending begin to kick in.

**Significant economic differences across Russia's cities with populations of more than one million.** Russia has 16 cities with more than a million inhabitants. The five biggest cities after Moscow and St. Petersburg are Novosibirsk, Yekaterinburg, Nizhny Novgorod, Kazan and Chelyabinsk. About 34.5 million people (24 % of Russia's total population) live in cities with at least a million people. Of that, 16.5 million live in cities other than Moscow or St. Petersburg.

The Russian consulting firm Strelka's latest [survey of cities over 1 million](#) shows that Russia's largest population centres contribute about a third of Russian gross domestic product. The large megalopolises of Moscow and St. Petersburg account for about 70 % of all the GDP generated by cities with populations over a million. The leading regional urban areas from an economic standpoint are Krasnodar, Yekaterinburg and Samara. Moscow's nominal GDP per capita is about double that of the richest regional cities with populations over a million such as Krasnodar and Yekaterinburg, and over three times greater than that of the poorest cities surveyed (Omsk and Voronezh). Differences in price levels across cities suggest that actual differences in living standards are smaller. Real wages in regional cities with more than a million are about 30 % lower than in Moscow on average.

The pace of economic development in regional cities with over a million people varies considerably. For example, the GDP of Kazan, Nizhny Novgorod, Novosibirsk, Samara and Ufa grew by more than 25 % in 2010–2017, while economic growth was negligible in Perm and Chelyabinsk. In Novosibirsk and Ufa, small and medium-sized firms were the main engines of economic growth. Growth was driven by large enterprises in Kazan and Samara.

Compared to the St. Petersburg and Moscow metropolises, Russia's regional cities with more than a million people constitute minor economic units and are quite sensitive to business-cycle fluctuations. These cities grew faster than Moscow or St. Petersburg at the start of the decade, only to contract more violently after Russia went into recession in 2015. Fixed investment in these regional cities with a million people fell much more than in Moscow or St. Petersburg.

The differences in living standards can also be seen in the [quality-of-the-urban-environment index](#), which is jointly produced and maintained by Russia's Ministry of Construction, Housing and Utilities, Strelka and Dom.rf. The index captures urban quality of life generally, and is based on sub-indices that track e.g. housing quality, availability of public services and infrastructure. According to the index, the quality of life in Moscow is good (214/300) and satisfactory in St. Petersburg (181), but mediocre (135) on average for other Russian cities with populations above one million.

## China

**Most forecasts see China's GDP growth in line with official growth target.** Major institutional forecasts are largely in agreement that China's economy will grow by 6.2–6.4 % this year. China's official figures show GDP grew by 6.3 % in the first half. Most forecasters base their forecasts on China's official figures, and thus also the global growth outlooks reflect China's reported development. Some alternative estimates indicate China's actual growth likely being somewhat lower than official figures ([BOFIT Weekly 29/2019](#)).

The updated IMF July forecast cuts China's economic growth this year from the 6.3 % April number to 6.2 %, while the global 2019 growth reading ticks down from April's 3.3 % to 3.2 %. The forecasted development would mean that China would still account for well over a third of all global growth (with purchasing power parity weights). The recently updated outlooks see China's slowdown in growth be a bit faster than earlier expected due to uncertainty caused by the trade war with the US and lower growth of the global economy. The baseline scenarios of the IMF and World Bank both assume that trade tensions between the US and China will not escalate further, but the imposed punitive and retaliatory tariffs will remain in place.

**GDP growth forecasts for China, 2019–2021 (%)**

	2019	2020	2021
IMF (7/19)	6.2	6.0	6.0
World Bank (6/19)	6.2	6.1	6.0
Asian Development Bank (4/19)	6.3	6.1	
OECD (5/19)	6.2	6.0	
European Commission (5/19)	6.2	6.0	
Citi Research (6/19)	6.4	6.0	5.8
J.P. Morgan (7/19)	6.2	6.1	
Capital Economics (7/19)	6.3	6.0	5.8
Oxford Economics (7/19)	6.2	5.9	5.7

**Shanghai stock exchange's new technology board launches.** The Shanghai Stock Exchange rolled out its new Star Market on Monday (Jul. 22). The new board enables technology and science companies to list on the exchange with less strict requirements on e.g. firm profitability than the main boards at the Shanghai and Shenzhen exchanges. Star Market listing also does not require government approval, making listing faster and easier. Market makers price the firm and the Shanghai exchange approves each listing.

Trading launched with 25 firms on the list and over 100 firms are on the waiting list. Restrictions on trading and limits on daily price swings are more relaxed than for other markets in mainland China. For example, short-selling of shares on the new board is permitted, where in the main boards it is usually restricted. However, only investors with e.g. a trading history of at least two years and over 500,000 yuan (65,000 euros) in investment capital may trade on the Star Market. The requirement is designed to diminish the number of naïve speculators in the market. Despite this, Star Market shares

were up on average 140 % on the first day of trading. IPOs were wildly oversubscribed. Only officially qualified foreign institutional investors (QFIIs) can trade in Star Market listings.

In particular, China would like to attract its own tech giants to the new list as many of them currently list offshore. The Star Market also allows Chinese firms listed abroad to raise capital by issuing Chinese Depository Receipts (CDRs). Investor interest in the new market has yet to be established. Response to the Shenzhen exchange's ChiNext tech board, which launched in 2009, has been underwhelming.

The new list's market value climbed to 529 billion yuan (77 billion dollars) in its first day of trading, and was 537 billion yuan on Thursday (Jul. 25). The Shanghai exchange will release an index tracking the Star Market price developments later. The key exchange indexes were relatively stable despite the release of a new market. Prices on mainland China stock markets have been fairly stable since May.

**Key indices on mainland China and Hong Kong stock markets**



Source: Macrobond.

**Yuan exchange rate has been stable for months.** Since the latest round of US tariff hikes against China that entered into force on May 10, the yuan's exchange rate has held at a rate of about 6.9 yuan to the dollar. Yuan's dollar exchange rate is about the same as it was at the start of the year, but has gained about 2 % against the euro over the same period.

BIS figures show that the yuan's real effective (trade-weighted) exchange rate (REER) in June was down 1 % from the end of 2018 and off 3 % from a year earlier.

**Yuan REER, dollar-yuan, euro-yuan exchange rates**



Sources: BIS and Macrobond.



## Russia

**CBR again lowers key rate and forecasts moderate inflation.** Last Friday (Jul. 26), the Board of Directors of the Central Bank of Russia, as generally expected, decided to lower the key rate by 25 basis points to 7.25 % (effective July 29). Prior to CBR's previous rate cut in June, the board had left the rate unchanged since the rate hikes in the latter half of 2018.

Like with its previous cut, the CBR noted that the move reflected slowing inflation and lower economic growth than expected. The CBR predicts consumer price inflation will slow from 4.6 % at the start of last week to 4 % in early 2020. If developments continue as the CBR forecasts, the CBR said it sees possible cutting the key rate further.

The CBR noted diminished inflation risks especially due to weak domestic and international demand. However, as earlier, the central bank paid attention to elevated inflation expectations, noting that increased government sector spending in the second half of this year could exacerbate inflation risks.

**Russia tries to promote the ruble by easing the repatriation requirement for export earnings.** The fresh law amendment applies to ruble-denominated export contracts, where the contracts also call for payment of export deals in rubles.

The repatriation requirement will be gradually phased out between the start of 2020 and start of 2024 for Russia's principal exports (commodities such as crude oil, petroleum products, natural gas, coal, as well as waste and scrap metal). The repatriation requirement for other ruble-denominated export earnings will be dropped completely in one go from the start of 2020. The explanatory note to the law amendment says that due to the large amount of criminal activity associated with the export of raw timber and raw timber materials, the law maintains complete repatriation requirements for that branch.

All export earnings are currently subject to the repatriation requirement regardless of the currency used in the export contract. However, Russia long ago did away with the requirement of converting export earnings into rubles.

The purpose for eliminating the repatriation requirement is to encourage the use of the ruble in e.g. Russian exports where the share of the ruble has seen no gains in recent years. The euro's share in Russian export contracts has doubled. Last winter, the euro's share exceeded 20 %.

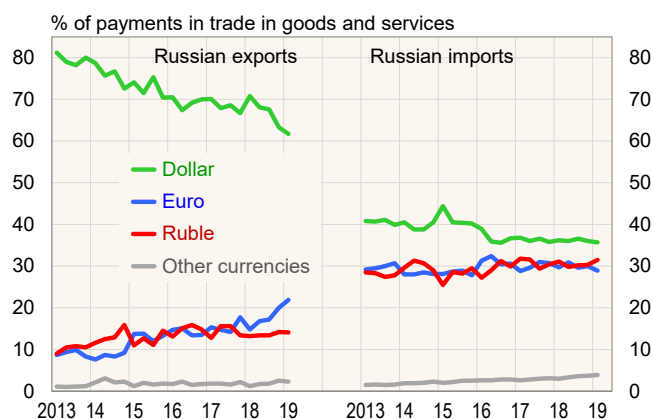
**Russia has a large, but relatively poor, middle class.** Alfa Bank, Russia's largest private commercial bank, has released a [study](#) claiming that 30 % of the Russian population, about 43 million people, are "middle class." The middle-class reached its apex in 2014 at 37 %.

Estimating the size of a middle class is a non-trivial exercise. Depending on the methods used, a substantial majority or tiny minority of persons may be considered middle class. A recent Sberbank [survey](#) found that 47 % of Russians claim to belong to the middle class, while the same survey in 2014 found that 60 % of respondents claimed to be middle class. Under the Credit Suisse definition, the middle class consists of persons with savings amounting to at least double their annual earnings. By this definition, only 4 % of Russians could call themselves middle class, when the equivalent numbers for Germany are 42 % and 38 % for the United States. The OECD defines a member of the middle class as someone whose annual income is within the 75–200 % range around the national median income. For Russia, that range is 26,000–70,000 rubles (370–1000 euros) a month. By this measure, 53 % of Russians belong to the middle class. Alfa Bank uses the OECD definition of income, but limits its middle-class definition to those deciles in which at least half of the members own a car.

The consuming habits of Russia's middle class suggest relatively nonaffluent lives. They spend about 27 % of their income on food, which is a much larger share than in other industrialised nations. The middle classes in the US and Germany, for example, spend about 10 % of their incomes on food, while the middle classes in Poland and China spend about 15 %. In 2017, 26 % of Russia's middle class worked in the commerce and transportation branches, while 20 % in mining or industry. 15 % of the Russian middle class consisted of officials and members of the armed forces (up from 10 % in 2003).

The Alfa Bank study found that real incomes of Russia's middle class declined slightly during 2008–2018. For the top earnings decile, real incomes climbed 11 %, while those with small incomes rose by 4 %. The declining real earnings of Russia's middle class are reflected in its attitudes. Borrowing of the middle class and Russia's richest decile fell sharply as Russia experienced recession in 2015, but only borrowing of the top decile recovered after the economy emerged from recession. Russian risk aversion accounts in part for the negative perception of entrepreneurship. The study refers to a 2017 survey by the Levada Center that found 12 % of Russians wanted to start their own business (57 % in the US).

Major currencies in Russian exports and imports, 2013–2019



Source: Central Bank of Russia.

## China

**Brief China-US trade talks end without much to show, Trump announces new tariffs.** Little specific information has been forthcoming about the half-day talks held in Shanghai on Wednesday (Jul. 31) between the lead negotiators for China and the United States. Discussions apparently focused on boosting Chinese purchases of American farm products and the concessions from the US needed to make that happen. The parties said the next round of talks would take place in the US in September.

The same themes were front and centre at the side-line talks between China and the US at the Osaka G20 summit in June. At that time, president Donald Trump promised to refrain from imposing further tariffs on Chinese goods as long as talks continued. While the parties returned to the negotiation table after breaking off talks in May due to new tariff hikes, the situation is difficult. This is evidenced by the fact that the latest talks focused on very narrow aspects of trade relations, even if the US claimed that also such major topics as forced technology transfers, intellectual property protections and technical barriers to trade were discussed.

Given the bitter public exchanges between the Trump and Xi administrations during the talks, the prospects of quick resolution of trade differences seem unlikely. The uncertainty surrounding the talks has not been helped by the approaching US presidential election.

President Trump's [announcement](#) of more tariffs by tweet on Thursday (Aug. 1) have further muddied the waters. A 10 % tariff on rest of imports from China (300 billion dollars) is scheduled to go into effect on September 1.

**SAFE releases for the first time ever information on the structure of China's forex reserves.** In its just-released annual report for 2018, China's State Administration of Foreign Exchange (SAFE) said the dollar component of its currency holdings declined from 79 % in 1995 to 58 % at the end of 2014. From 2005 to 2014, the yield on China's forex holdings averaged 3.7 % p.a. SAFE did not reveal the share of other currencies in its forex reserves nor more up-to-date information.

The composition of China's forex reserves has traditionally been a closely guarded secret. The *Caixin Global* online financial magazine reports that China's forex reserves are likely composed of over 30 currencies, a broader holding assortment than in most countries. The IMF estimates that the dollar presently accounts on average for about 62 % of forex holdings of all central banks.

China's large current account surpluses in earlier years helped grow China's forex reserves into the largest reserves in the world. China's currency reserves peaked at 4 trillion dollars in mid-2014, only to decline rapidly until late 2016 when they levelled off at their current level. At the end of June

2019, China's currency reserves amounted to roughly 3.2 trillion dollars, which was still nearly 2.5 times larger than Japan's currency reserves (the second-largest reserves in the world). China's current account surplus has fallen to around 1 % of GDP, so it no longer fuels growth of China's reserves as it once did.

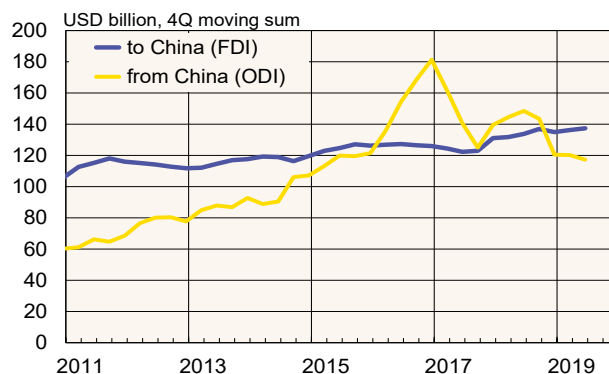
**Record FDI flows into China in the first half of 2019, but China's FDI outflows continue to dwindle.** China's commerce ministry reports that, despite uncertainty from the trade war, first-half foreign direct investment inflows into China (not including the financial sector) were bigger than ever – 71 billion dollars (up 4 % y-o-y). China's outward FDI fell by 6 % y-o-y to 54 billion dollars. The ministry's figures do not include financial-sector investments, which have corresponded to about a tenth of China's outward FDI investment in recent years, and just a few per cent of FDI inflows to China.

Private western databases on Chinese outbound FDI confirm the decline in investment. According to the *China Global Investment Tracker* database, Chinese corporate FDI in the first half (27 billion dollars) was down by 50 % from the same period in 2018. Investment in Asia increased by nearly 50 %, while investment in all other regions declined. The value of investment flows to Europe were a tiny fraction compared to last year. The regional growth figures are sensitive to the timing of when large investments are recorded.

A joint survey of the Rhodium Group and the multinational law firm Baker McKenzie finds that Chinese FDI fell by 60 % y-o-y in the first half to about 20 billion dollars. Chinese investments in Finland were the largest of all European and North American countries as the exchange-listed Finnish firm Amer was acquired by Anta Sports for over 5 billion dollars the start of the year. In the first half of this year, Chinese corporate FDI flows to Europe fell to 9 billion dollars (-26 % y-o-y), but rose to 3 billion dollars to North America (19 %).

UNCTAD figures show that at the end of 2018, the stock of FDI in China amounted to 1.63 trillion dollars (5 % of global FDI). China's global FDI stock amounted to about 1.94 trillion dollars (6 % of the global FDI stock). China last year accounted for 13 % of outward FDI flows globally.

### China's inward and outward FDI flows (excl. financial sector)



Sources: China's Ministry of Commerce, CEIC.

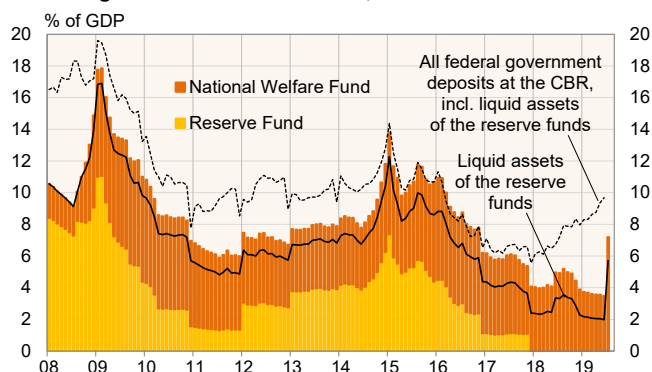
## Russia

**Russia moves its large excess oil tax revenues from 2018 into the reserve fund.** The finance ministry deposited over 65 billion dollars (equal to about 4 % of GDP) in the National Welfare Fund in July. As of August 1, the Fund's assets stood at 124 billion dollars (over 7 % of GDP). Of that, almost 99 billion dollars (5.7 % of GDP) were liquid assets that are held at the central bank in forex. The other assets of the Fund are tied up in e.g. investment project financing.

Each year, the excess oil tax revenues from the previous year must be transferred to the Fund by October 1. The federal budget rule defines that such excess revenues arise when the actual world market price for oil exceeds the rule's reference oil price for the year. The reference price for Urals-grade crude oil rises 2 % every year and was 40.8 dollars a barrel last year, while the actual outcome was almost 70 dollars. "Oil tax" revenues consist of taxes on oil and gas production, as well as export tariffs on oil, gas and petroleum products.

The Fund's reserves can be used on e.g. new investment projects when its liquid assets exceed 7 % of GDP. That sum has accrued because excess oil tax revenues in January-July this year amounted to well over 1.5 % of annual GDP. These excess funds will eventually be moved to the Fund but are until then waiting on other government accounts at the CBR.

### Russian government reserve funds, 2008–2019



Source: Russian Ministry of Finance.

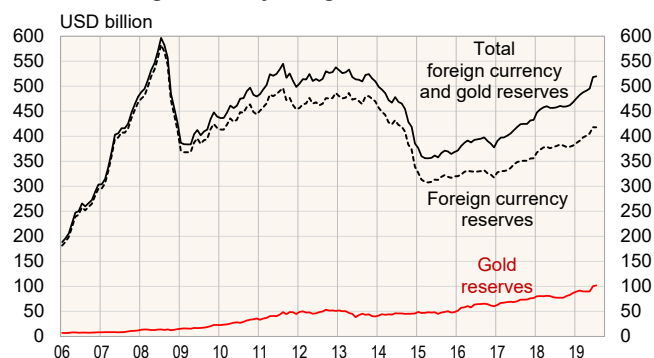
**Russia continues to accumulate foreign currency reserves.** The CBR's foreign currency and gold reserves have grown quickly this year. As of August 1, the reserves stood at about 520 billion dollars, an amount sufficient to cover about 18 months of imports of goods and services.

The increase in forex and gold reserves largely reflects the forex purchases that have continued from 2017 and 2018. The CBR makes them on the domestic currency market for the finance ministry. The finance ministry orders forex from the central bank at the pace that excess oil revenues flow to the federal budget.

The CBR's reserves have also been augmented by purchases of gold, which this year have nearly sustained the brisk pace of 2017 and 2018. The spike in gold prices in June gave

a notable increase to the value of the CBR's reserves. Gold makes up about 20 % of the reserves. The CBR holds the fifth largest gold reserves of any central bank in the world.

### Russia's foreign currency and gold reserves, 2006–2019



Source: Central Bank of Russia.

### Recent studies examine transport projects in Central Asia.

A recent [report](#) from the OECD's International Transport Forum (ITF) examines the potential for countries in Central Asia to become a major hub on the Eurasian continent. A World Bank [report](#) takes a different tack, considering the overall economic argument for China's Belt and Road Initiative. Both reports conclude that better land connections and logistics, while important, will not be transformative.

The geographic isolation of Central Asia (Kazakhstan, Kyrgyzstan, Uzbekistan, Tajikistan and Turkmenistan) is hard to overcome. Improved land connections would not necessarily transform economies based on commodity exports, but would widen the potential customer base for these countries. Even so, other factors such as unpredictable customs practices are likely to ward off international trade.

A recent [transition report](#) from the EBRD finds that if all planned transport corridors are built by 2040, it would increase real incomes in Uzbekistan by 6 % and in Kazakhstan by 4.5 %. These projects have a long journey from planning to implementation. The World Bank's assessment finds a direct impact on Central Asian real incomes of about 1 % after roads are built under China's Belt and Road plan. The biggest gains flow to the 300-km long Fergana Valley, which spans Uzbekistan, Kyrgyzstan and Tajikistan. The fewest benefits accrue to Turkmenistan. Streamlining of documentation and border inspection practices would deliver more benefits than Belt-and-Road connections per se.

Even with the challenges, Central Asian nations have come up with functional solutions. Rail freight transport between China and Europe moving through Kazakhstan usually keeps to schedule without unreasonable delays. Depending on destination, rail shipments from China to Europe only take about 15 days (transport by ship takes about 30 days). Despite the large investment, the value of goods freight moving by rail between China and Europe is worth only 2–3 % of the total value of goods flow. The sea and air freight dominate flows when measured in value of transported goods.

## China

### **Impasse as China-US economic relations take a turn for the worse.**

On August 1, in the wake of brief, unproductive trade talks, president Donald Trump announced a new round of tariffs. Chinese officials responded this week by forbidding Chinese firms from buying American agricultural products. Noting US protectionism and more tariffs hikes, the People's Bank of China on Monday (Aug. 5) let the yuan depreciate and pass the psychological limit of 7 yuan per dollar. On Tuesday (Aug. 6) the US officially designated China as a "currency manipulator." Global markets have reacted strongly to the increased uncertainty.

Trump unleashed the first round of punitive tariffs in the US-China trade war in July 2018. Since the start of June 2019, the US has applied additional 25 % tariffs to Chinese imports worth earlier about 250 billion dollars a year. The latest round of US tariff hikes, which go into effect on September 1, will add a 10 % tariff to all previously unaffected Chinese imports (worth earlier roughly 300 billion dollars a year). For its part, China has slapped (mostly 25 %) tariffs on American imports worth earlier about 110 billion dollars a year. US figures show that imports from China over the past 12 months were worth 509 billion dollars (down 4 % y-o-y), while US exports to China in the same period were worth 108 billion dollars (down 20 % y-o-y). The trade deficit, however, is about the same as a year earlier (400 billion dollars).

China's decision on Monday (Aug. 5) to allow the yuan to depreciate to a level of 7.05 to the dollar hardly came as a surprise, especially with few other forms of direct reprisal available given the massive trade imbalance between the two countries. The yuan has not broken the 7-yuan line since spring 2008, so the psychological impact on markets was huge (even if the yuan's drop was just 1.6 % from its Friday level). Besides the trade war, the downward pressure on the yuan's exchange rate from the slowing Chinese economy and rising indebtedness made it easier for the government to allow the yuan to weaken. Depreciation is by no means a cure-all; it drives capital flight, which, if it worsens, could force the government to tighten already strict currency controls. It also hits private consumption.

The US has inexplicably chosen to label China a "currency manipulator" for the first time since 1994. The move is especially odd given that it is very likely the yuan would have fallen further if it was allowed to float freely. In any case, the label is fairly meaningless as the US, under its own legislation, must engage a "currency manipulator" nation in talks. The US and China have already been in trade talks for over a year and half.

Thus, the US and China find themselves at an impasse from which it is impossible for either side to extricate themselves with current approaches. Continuing down this road only increases uncertainty in the markets and reduces economic growth for all.

**More cases of Chinese firms cooking their books.** Billions of dollars in fraudulent bookkeeping of Chinese firms has come to light this year. Many firms caught up in the revelations have been unable to repay their debts, even if their financial statements show excellent cash positions. Several accounting firms have been swept up in the scandals.

The latest round of accounting firm problems started when officials launched an investigation into the practices of the Chinese accounting firm GP in May. Last month, Ruihua, one of China's largest domestic accounting firms, was also targeted for investigation. That investigation implicated a number of Ruihua's clients as many of them have had to freeze their plans to get new funding.

At the end of May, the auditors of Jinzhou Bank, which is listed on the Hong Kong stock exchange, quit after the bank refused to provide additional information about its lending activities. To bail out the troubled bank, state-owned ICBC, Cinda and Great Wall announced in July that they would inject billions of yuan into the bank.

There is a long history of reporting on the bookkeeping problems and scandals surrounding Chinese firms, but slowing economic growth seems likely to expose more troubles. Chinese firms have long felt comfortable cooking the books as they faced only relatively small punishment if caught. Officials routinely threaten harsher punishments, but very little has actually happened.

**Hong Kong protests start to hit the economy.** The waves of demonstrations that began in June show no signs of abating. Indeed, the protests have been backed by strike action that has caused, for instance, stoppage of most of Hong Kong's public transport. A substantial deterioration in economic conditions would complicate resolution of the special administrative region's already messy political problems.

While the economic impacts from strikes and protests are hard to quantify, it is clear that strikes immediately affect production and add to political uncertainty and instability that drive away potential investors and tourists.

Hong Kong's on-year GDP growth fell to 0.6 % y-o-y already in the first and second quarters of this year. More recent data show Hong Kong's Hang Seng index fell by nearly 10 % last 30 days. There were no similar declines on any other major stock exchanges. Retail sales and real estate shares, which are highly dependent on condition of the Hong Kong economy, have been hit hardest. The share prices of Chinese firms listed on the Hong Kong stock exchange have also tanked. The slowdown in mainland China's economic growth is a major factor in Hong Kong slowing growth.

The Hong Kong Monetary Authority (HKMA) has pegged the Hong Kong dollar to the US dollar for decades with fixed exchange rate (currency board). Possible loss of confidence in the HK dollar would call the HKMA to intervene to prop up the HK dollar which would show up in the money market. So far, the situation seems to be stable and interest rates show no particular stress. The recent increase in forex reserves helps the HKMA defend the currency peg.

## Russia

**US imposes new sanctions on Russia.** At the beginning of August, president Donald Trump signed an executive order preventing United States financial institutions from participating in new issues of Russian sovereign foreign currency bonds, effective August 26. The executive order also calls the US Treasury to oppose any new lending to Russia by international financial institutions (such as the World Bank). The actions are based on US code pertaining to international violations in the use of chemical and biological weapons. Russia is alleged to have poisoned several persons with Novichok nerve agent in Salisbury, England in March 2018.

The impacts from the latest round of sanctions are likely to be minor as the Russian government has little need to borrow on international markets at the moment. Virtually all of its new bond issues are in rubles. At the end of July, foreign investors held about 30 % of government-issued ruble-denominated paper and slightly over half of Russia's euro-denominated government bonds.

**Kremlin imposes strict economic targets on regional leaders.** Under a new rule introduced this spring, regional leaders are now evaluated according to 14 different criteria. The main measures of regional economic performance are private-sector job creation, number of small and medium-sized enterprises in the regions and labour productivity.

Russia has a total of 85 federal regions (including the unlawfully annexed territories of Crimea and Sevastopol). Most are led by regional governors. Every region now has specific targets they should meet. The targets are intended to supplement the national investment projects. For example, the annual volume of investment in Moscow and St. Petersburg needs to grow at over 6 % to achieve the national target of a 25 % investment ratio (fixed investment to GDP) by 2024. Regions are also expected by then to halve the number of people living below the poverty line and increase labour productivity by 5 %. Observers have criticised the evaluation criteria released in July for their narrow perspective. Rather than strive for general improvement of economic conditions, leaders must concentrate on boosting readings of specific metrics.

The target regime places trust in the central government (including the president) as the core metric, which shows that political stability and loyalty to central power remain most important. Constitutionally Russia is a federation, but its power structure is actually centralised. Since elections of regional governors were restored in 2012, the Kremlin has effectively diminished regional authority by removing unfavourable governors from office prior to elections and replacing them with favoured candidates whose victory is effectively guaranteed.

**IMF Article IV consultation reiterates calls for Russia to maintain economic stability and move on reforms.** The International Monetary Fund (IMF) [reports](#) that

Russian GDP grew by 0.5 % a year during 2014–2018, while in the same period other emerging economies in the G20 and eleven EU new member countries on the averages of the two groups saw growth exceeding 3 % a year. The IMF estimates that foreign sanctions reduced Russian GDP growth in those years by 0.2 percentage points a year, while the fall in oil prices knocked off 0.6 percentage points a year.

The IMF expects Russia's 13 national projects to lift GDP growth in the next few years to 2 % a year through increased government spending. The projects focus on such areas as transport infrastructure, education and health care. The IMF also estimates that the national projects, if properly targeted and effectively implemented, could together with a gradual increase in the retirement age increase Russia's potential economic growth from the earlier-estimated 1.5 % a year to 1.6–2 % by 2024 that marks the end of the period reviewed.

The IMF recommended that the central bank stays the course with its policy of gradual relaxation of the monetary stance. Improving communications on factors affecting monetary policy will also help, which should focus on the central bank's view of the outlook for the economy and inflation.

The IMF encouraged Russia to keep to its fiscal rule (e.g. refrain from measures like the relaxation already made as regards the deficit limit for the 2019–2024 budgets). In the IMF's view, the assets of the National Welfare Fund (NWF) should not be used in a quasi-fiscal manner of e.g. lending for such purposes as project financing even after the liquid assets in the NWF reach the required level of 7 % of GDP, which is likely to happen next year.

Regarding government finances, the IMF also recommended lowering the high wage-based social taxes, which could then be offset by cutting back on various tax benefits. Oil taxation needs to be simplified, especially given that after a promising start of the reform in this area the taxation became more complex. Subsidisation of domestic oil consumption should be phased out gradually, and the classification of budget spending as secret should decrease. Due to the lack of reform, early retirement provisions remain overly generous, and social support policies have not been overhauled to better meet the needs of people and reduce poverty.

The IMF offered several recommendations for the banking sector, including the introduction of regulations to prevent a bank's related parties from receiving more favourable treatment from the bank, as well as reaffirming the independence and professional competency of external auditors. The Duma remains reluctant to pass legislation that would give central bank supervisors the necessary legal protection when exercising professional judgement in supervision tasks.

Looking at broader economic reforms, the IMF noted that the lack of competition and the related government's involvement in the economy remain core problems for Russia. Oversight of state-owned enterprises needs to improve, which in turn requires proper standardised economic reporting. Regarding barriers to trade, the IMF noted that the domestic content requirements applied in Russia are the third highest among the G20 countries.

## China

**Third Chinese bank rescue of the summer gets underway.** *Caixin* business media reports that Hengfeng Bank, headquartered in Shandong province, is on track to receive funding of 30 billion yuan (4.3 billion dollars) from the provincial government. In addition, the state-owned Central Huijin Investment is expected to acquire a stake in the bank.

The capitalisation of the bank is unsurprising given that Hengfeng Bank's troubles have been long recognised. The bank has not released a financial statement since 2016. Based on the latest available information, Hengfeng is somewhere in the neighbourhood of China's 20<sup>th</sup> largest bank in terms of total assets, or roughly the same size as the combined assets of the Baoshang and Jinzhou banks rescued earlier this summer. One of the largest banks in Southeast Asia, Singapore-based UOB, holds a 13 % stake in Hengfeng Bank. UOB has tried to divest its stake in recent years, but has found no buyers.

Regulators have taken a different approach in the rescue operations of Hengfeng Bank and Jinzhou Bank announced in late July than they used in the Baoshang Bank case in May. In the Baoshang takeover, officials announced that large stakeholders would have to accept some of the bank's losses. This measure led to a reassessment of counterparty risk on the interbank market and made access to funding for small and medium-sized banks more challenging. In contrast, when the government decided to recapitalise Hengfeng and Jinzhou with public funds, the market reactions have been fairly subdued. Of course, simply pumping money into a troubled bank is a temporary solution that can only be effective if the bank changes its practices.

**China wants to speed up transfer assets of state-owned enterprises to pension funds.** China decided in 2017 to transfer a handful of 10 % stakes in state-owned enterprises to pension funds. Later, the list of enterprises was broadened to 600.

Lou Jiwei, head of the national social security fund, said in spring that the 10 % stakes of just five state firms had been transferred in full to the pension funds. In July, the government announced it wanted to accelerate the transfers and further broaden the list of firms.

Pension funds are in dire need of additional assets as their current levels are inadequate to meet future obligations. China's population is ageing rapidly, while the number of pensioners is growing and the dependency ratio is soaring. The China Academy of Social Sciences (CASS) estimated last spring that the pension funds will be exhausted around 2035 without reform. The government has given assurances that pensions will be paid in full also in future.

Raising the retirement age is seen as a critical reform. Men currently retire at 60 and women at 55 or 50 depending on the nature of their work. At the same time, the average life expectancy in China has risen to 76 years. While authorities

have from time to time called for raising the pension age, lately the subject has largely fallen pretty much off the radar.

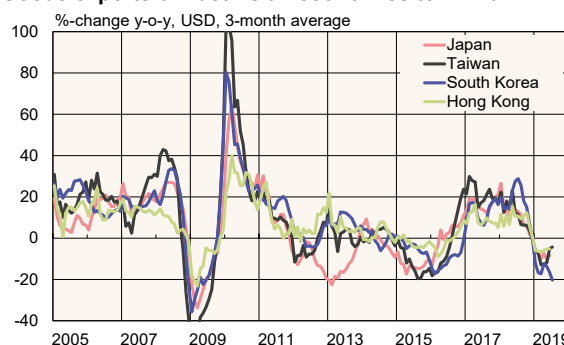
China's pension system needs reform. Presently, provinces have their own funds. The pensions of migrant workers are paid into the provincial fund where the worker is employed. Pensions must be paid out, however, from the migrant labourer's home province if the worker has not worked long enough in another province. As a result, there are huge differences across provincial funds. Provinces in Northeast China in particular have seen their pension funds drained, while provinces that attract migrant labour enjoy burgeoning pension funds and have even granted companies reductions in their mandatory pension contributions.

For years, China has been expanding the number of persons covered by the pension system. Officials say that as of the end of 2018 about 940 million people were covered under some kind of pension scheme. Some pension, however, are rather meagre. China's finance ministry says that the average monthly pension was just 120 yuan (16 euros) in 2016 for rural residents and individuals in cities who had not worked at a wage-paying job. This system covers over 520 million Chinese. Persons who have performed wage labour for their entire career in a firm or as a bureaucrat were paid on average just under 2,400 yuan (325 euros) a month in 2016. The government has sought to encourage citizens to participate in various private pension savings plans geared to the individual, but participation has been modest. Children have traditionally provided for their elderly parents in China.

**China's goods imports continued to fall in July.** China Customs reports that goods imports in July fell by 6 % y-o-y in dollar terms, the same rate of contraction as in previous months. The biggest drop was seen in imports from the United States, but there were also major declines in imports from East Asian economies. The value of imports from the EU, Southeast Asia and Africa has risen slightly this year.

China's goods exports are running at the same level this year as in 2018. With contracting imports and stable export levels, the goods trade surplus increased by 60 billion dollars from year earlier to 226 billion dollars for the January-July period.

### Goods exports of East Asian economies to China



Sources: Macrobond, national customs and statistics authorities, and BOFIT.

## Russia

**Russia's economic growth remained slow.** The preliminary Rosstat figure shows Russian second-quarter GDP growth was 0.9 % y-o-y. When combined with first-quarter GDP growth of 0.5 %, first-half growth was 0.7 %.

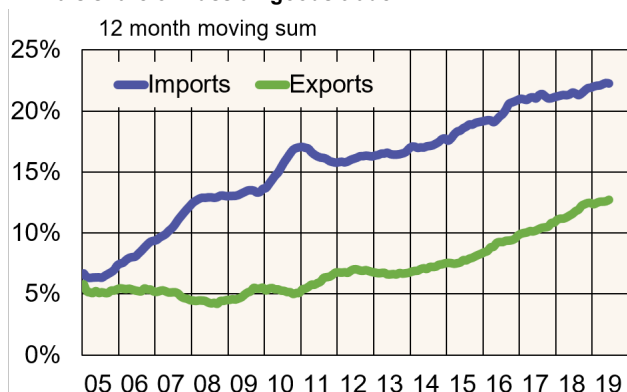
Growth in domestic demand has gone fairly sluggish. Retail sales in May-June were up 1.4 % y-o-y and by just 1 % in July. Fixed investment growth increased slightly from 0.5 % y-o-y in the first quarter, but just to a mild 0.7 % in the second quarter.

Manufacturing output growth rose to about 3 % y-o-y in June-July, while growth in mineral extractive industries (includes oil & gas) slowed to around 2.5–3 %. After a couple of years of brisk growth, growth in the volume of goods transported has slowed notably this year. Growth fell to 1.3 % y-o-y in the entire January-July period and further to around zero in the May-July period.

**Russia's goods trade stays rather flat.** According to Russian customs service, the dollar value of Russian goods imports in the second quarter declined by 3 % y-o-y. The earlier sharp increase in imports began to level off already last year. The value of Russian goods exports in dollars was down by 9 % in the same period.

As the euro weakened slightly against the dollar between the second quarter of 2018 and the second quarter of 2019, the value of Russian imports measured in euros did not fall but rather remained roughly at the same level. As nearly half of goods imported to Russia come from the euro zone, the euro-dollar exchange rate has a major impact on the trade figures. The decline in the value of exports can be attributed to some extent to a decline in oil prices.

**China's share of Russian goods trade**



Source: Russian Federal Customs Service.

China continues to gain importance as a major trading partner with Russia. For the 12-month period ending in June, 22 % of all Russian goods imports came from China, while 13 % of Russian goods exports went to China. In recent years, China's share in both imports and exports has risen by about

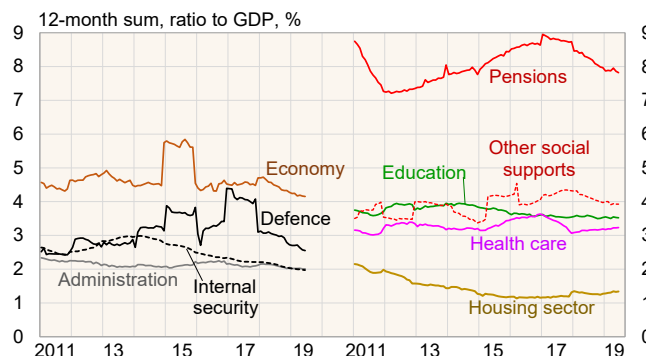
one percentage point a year. Oil, gas and coal account for about three-quarters of Russian goods exports to China. Other major export goods include wood, metals and fish. About half of Russia's goods imports from China consist of machinery and equipment. Other goods include various intermediate products and consumer goods such as shoes, clothing, toys and furniture. Russia trades similar goods with other countries and the composition of Russian-Chinese trade has not changed considerably during recent years.

**Moderate rise in Russian government spending.** Revenues to Russia's consolidated budget (federal, regional and municipal budgets plus state social funds) in the first half of this year were up by over 10 % y-o-y. Growth in consolidated budget spending held at roughly the same pace as in the previous three years, i.e. around 5 % y-o-y, or slightly higher than headline inflation. The rapid growth in revenues combined with the relatively slow growth in spending so far this year has boosted the overall budget surplus. In June, the 12-month consolidated budget surplus amounted to nearly 4 % of GDP.

Budget revenues from sources other than oil and gas taxes increased by 13 %, i.e. the same swift pace as last year. They accounted for 78 % of all revenues to the consolidated budget. In particular, revenues from corporate profit taxes continued to climb fast (by 20 %), while VAT revenues, thanks in part to the VAT increase at the start of the year, were up by 18 %. Revenues from income taxes and wage-based mandatory social taxes continued to show fairly strong growth (up 9 %).

As last year, spending increases largely went to health care, education and the housing sector. Spending on pensions and other social supports continued to show moderate rises that roughly matched the inflation rate. Spending on administration, domestic security and the economy rose by just a couple of per cent, while defence spending shrank. The ratio of spending-to-GDP has declined for many spending categories due to their low rates of increase. However, growth in budget spending overall is expected to pick up in the second half of this year to the extent that implementation of national projects set forth in president Putin's 2018 May decree gets underway more properly.

**Government sector main spending categories, 2011–2019**



Source: Russian Ministry of Finance.

## China

**Chinese economic growth continues to slow.** While the unreliability of official statistical data makes it difficult to assess actual economic conditions in China, numerous measures, including official figures, reveal a slowing trend in economic growth. In July, nearly all main indicators showed deteriorating conditions in China. The export figures of China's neighbours also indicate weakening conditions in the region.

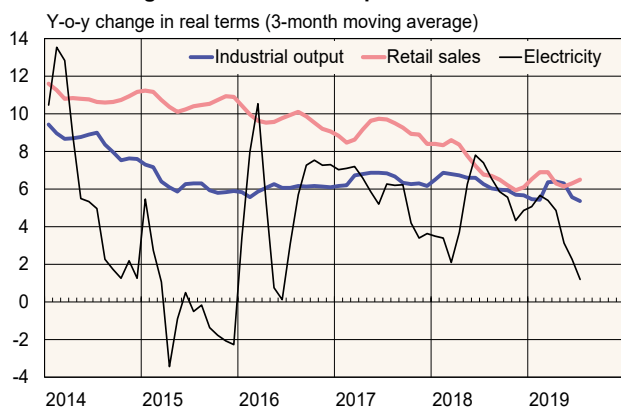
On-year growth in Chinese industrial output slowed from over 6 % in June to below 5 % in July. Notably, on-year growth in car manufacturing has been negative in every month for over a year according to the China Association of Automobile Manufacturers (CAAM). Manufacture of passenger cars was down 18 % y-o-y in July. Real growth in retail sales slowed over one percentage point to below 6 %.

The two main purchasing manager indices (PMIs) confirmed slowing growth. Both the official and private (Markit) manufacturing PMIs remained below the 50-point mark, which signifies the approach of industrial downturn. This year, the official PMI has climbed above the 50-point mark (i.e. rising production) only in March and April. While the services PMIs for both index producers fell from June to July, they were both still well above the 50-point mark.

Producers face the challenge of producer price deflation. In July, after a long slowdown, producer prices contracted by 0.3 %. It was the first time since August 2016 that there was an on-year decline in producer prices. Lower prices hurt corporate bottom lines, which in turn makes firms reluctant to invest. Consumer price inflation (2.8 %) was practically unchanged from the previous months.

China's economic slowdown, combined with the negative impacts of the trade war on international production chains were evident in the value of exports to China from its neighbouring countries. In January-July, China exports were down sharply for Japan (down 9 % y-o-y), South Korea (down 17 %) and Taiwan (down 8 %).

### Official NBS figures for Chinese output indicators



Source: Macrobond, BOFIT.

**United States postpones September tariff hikes on some Chinese goods until December.** On August 13, the US announced it would delay until December 15 the 10 % tariff hike on some of the nearly 300 billion dollars in goods that would otherwise have gone into force on September 1. The deferral applies to over 500 products (e.g. smart phones, chemical products, clothing and footwear) that represent some 155 billion dollars in imports annually. President Donald Trump said the delay was needed to protect retailers and consumers in the upcoming Christmas shopping season.

Even so, the US will go ahead at the beginning of September with the earlier-announced additional 10 % tariff on Chinese imports worth about 130 billion dollars a year. From the beginning of June, about 250 billion dollars in Chinese goods have been subject to punitive 25 % tariffs. After the December hike goes into effect, essentially all Chinese goods imported to the US will be subject to punitive tariffs.

American firms were also granted a 90-day extension this week to supply equipment and software updates to Chinese telecom giant Huawei. The countries will continue to talk by phone before the tariff hikes kicks in next month. While a fact-to-face meeting is set for September, few observers hold out hope that the two sides will resolve their differences.

**China introduces new reference rate for pricing bank loans.** Last Friday (Aug. 16), the People's Bank of China announced that commercial banks should price their new lending according to a "loan prime rate" (LPR) published by the National Interbank Funding Center (NIFC). The LPR is based on rate quotes by a panel of 18 banks offered to their most creditworthy customers. The LPR is published on the 20<sup>th</sup> day of each month.

The new LPR is defined so that the panel banks announce their rates relative to the rate of central bank financing (primarily medium-term lending facility (MLF) rate). Panel banks' quotes were previously linked to the PBoC's benchmark rate. Now the LPR can be more flexible fine-tuned to reflect changes in the monetary policy stance. The rate reform also includes quoting of a longer maturity (5 years and over) LPR.

Banks earlier based their loan pricing on the PBoC's benchmark rates. The mechanism was unclear after the nominal deregulation of rates in 2015 that gave, in principle, commercial banks autonomy to price their loans. Introduction of the new reference rate is seen as further progress in deregulation of interest rates and a shift to more market-based pricing. An important motive is also the need to lower corporate borrowing costs in uncertain economic times.

The one-year LPR rate in August is 4.25 %, while the PBoC's benchmark rate is 4.35 %. The five-year LPR is 4.85 %. According to some sources, most of the benefits of lower interest rates could go to large state-owned enterprises and loan prices for smaller firms may remain high even with the reform. The new reference rate will not have an immediate effect on corporate debt-servicing costs as most of current loans remain tied to the PBoC's benchmark rate, which has remained unchanged since 2015. The dynamics of the new LPR have yet to be established.



## Russia

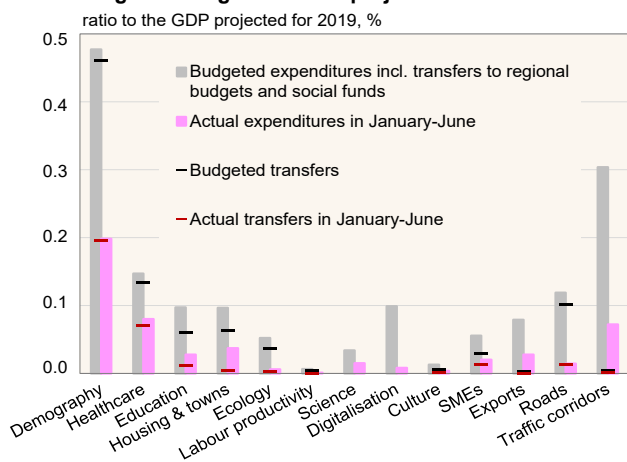
**Implementation of Russia's national projects plods ahead.** Total funding for the 13 national projects is scheduled to exceed 3 % of forecast GDP during 2019–2024. This includes the roughly 1 % of GDP ordered when the national projects were laid out in president Putin's inauguration decree (*ukaz*)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

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

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

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

### Federal budget funding of national projects in 2019



Sources: Finance ministry and Accounts Chamber of Russia.

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

### Estimated ultimate ownership of inward foreign direct investment stock in 2017

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

Sources: UNCTAD, CBR and PBoC.

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

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

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

## China

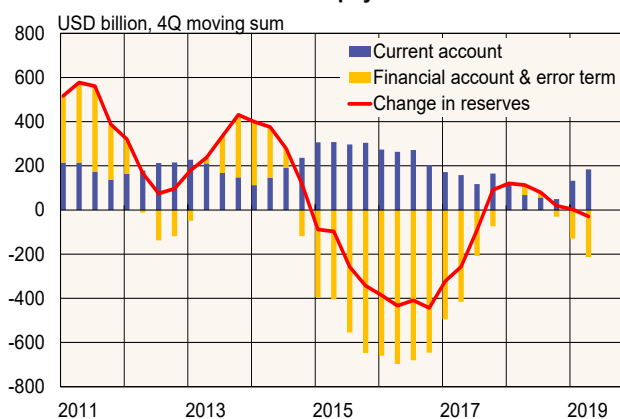
**China's first-half 2019 current account surplus reached 106 billion dollars.** China's current account showed a deficit in the first half of 2018, but finished the year with a surplus of 49 billion dollars. The 12-month current account surplus in the second quarter of this year rose to the equivalent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

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

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

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

### Main items in China's balance of payments



Sources: Macrobond, BOFIT.

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

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

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

### China cuts subsidies on rail freight shipments to Europe.

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

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

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

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

## Russia

**Russian fixed investment developments vary across sectors.** Growth in fixed investments in the first half of this year cooled off to 0.6 % y-o-y, the slowest pace since growth remained at a halt in 2016. Fixed investments by large & medium-sized firms and the government fell by about 1 %. In 2017–18, investment growth in these categories also clearly lagged growth in fixed investments in other categories.

Fixed investments of large & medium-sized companies and the government account for about three-quarters of all fixed investments in Russia. The pace of growth in these investments has varied considerably across sectors. In the first half of this year, investments in natural gas production and liquefaction roughly doubled in their real volume, while investments in telecommunications were up by one half. These leaps provided a large boost to growth figures for total fixed investments. On the other hand, investments in crude oil production continued to fall as they had in 2018. Investments in oil refining were up notably after last year's drop. Investments in other manufacturing branches declined after two years of strong growth.

First-half growth remained brisk for fixed investments by entities other than large & medium-sized firms and the government, scoring a pace of 5–6 % y-o-y even after rapid growth in 2016–18. Most of these investments consist of housing and machinery & equipment in various sectors. The data on this category of other fixed investments are based, especially within a year, on Rosstat's estimates of fixed investments by small firms, entrepreneurs, households and the grey economy.

Data on the rapid rise in the real volume of these other fixed investments carry a special feature as regards price increases. Comparison of the volume data to data on the value of these other fixed investments indicates that the rise of prices in these investments for many years has considerably lagged the price increases in fixed investments by large & medium-sized firms and the government, or even declined, like they did last year. It appears that in some years a partial cause of the slower price increases was a moderate rise in housing construction prices.

**Russia streamlines visa rules.** Starting on October 1, foreign visitors to Russia can get cleared for their visit to St. Petersburg or the surrounding Leningrad region simply by filling in data online and downloading an electronic visa at no cost. It is not clear yet whether the new e-visa will also apply travellers entering Russia via Finnish-Russian rail services. The list of nationalities eligible for e-visas has also yet to be released.

Citizens of 53 countries (e.g. all EU countries, India and China) have been able to visit the Kaliningrad enclave on an

e-visa since July. Citizens of China, India and 15 other (predominantly Asian) countries have been able to visit the Russia's Far East Federal District on an e-visa since 2017.

CIS countries have generally relaxed their visa practices. In order to attract visitors, some CIS countries over the past couple of years have introduced e-visas or increased the number of countries exempt from the visa requirement. This year, Uzbekistan removed the visa requirement for 45 nationalities. The countries of Central Asia are also planning to introduce a joint Silk Road Visa that would allow travel in any Central Asian country with the exception of Turkmenistan.

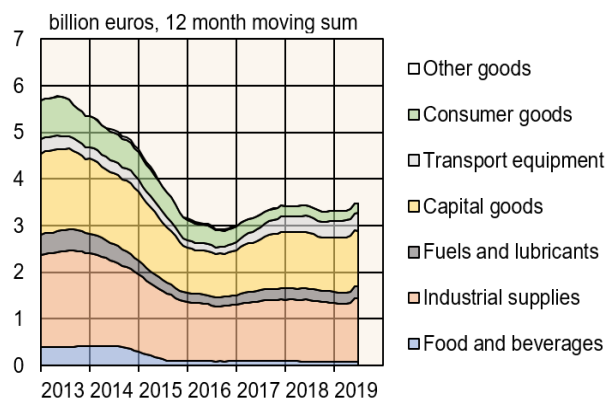
EU citizens can now visit a number of CIS countries without visas, including Armenia, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Ukraine and Uzbekistan. E-visa travel is available for Azerbaijan and Tajikistan. Limited visa-free travel is available for Russia and Belarus. Of all CIS countries, only Turkmenistan retains the traditional visa requirement.

**Finnish-Russian trade remains sluggish.** Finnish Customs reports that in the first half of 2019 the value of goods exports from Finland to Russia (1.8 billion euros) increased by 10 % and the value of goods imported from Russia to Finland (4.5 billion euros) was down by 1 % compared to the first half of 2018. However, a significant share of export revenues this year have derived from one-time gas pipeline deliveries to the Nordstream 2 pipeline that spans the Baltic Sea. Other exports declined slightly.

The total value of the goods flow from Finland to Russia remains at about half of its level prior to the start of the global financial crisis in 2008. Over the past decade, Russia's share of Finnish exports has dropped from 11 % to 5 %.

In the first half of 2019, Russians made 2 % fewer trips to Finland than in the same period last year and had 4 % fewer overnight stays in Finland. In particular, there were much fewer Russian overnight stays in January, which includes the Russian Christmas holiday season. On a yearly basis, Russians account for 4 % of overnight stays in Finland, but in January their share was 9 %.

### Finnish goods exports to Russia



Source: Finnish Customs (BEC classifications).

## China

**Corporate social credit system presents new challenges to firms operating in China.** While China's development of a social credit system (SCS) for individuals has received wide press, the fast-approaching inauguration of China's Corporate SCS has obtained much less attention. Last week, the European Union Chamber of Commerce in China, in cooperation with the German consulting firm Sinolytics, released a [report](#) entitled *The Digital Hand: How China's Corporate Social Credit System Conditions Market Actors*. Its main message is that China's Corporate SCS poses large challenges for companies operating in China.

Building on unprecedented computer power in gathering, integrating and processing data, the government hopes to use the Corporate SCS as a sophisticated rating and governance tool. A good score may reward a firm with preferential treatment such as lower tax rates, cheaper financing, easy access to markets and opportunities to participate in government procurements. A low score exposes the firm to increased official scrutiny, exclusion from government procurements or public blaming and shaming. If the proposed scheme is enacted in its present form, firms might even face black-listing.

The EU Chamber wants firms to prepare themselves in three areas. First, they should be ready for *compliance challenges* as Corporate SCS places strong emphasis on compliance with laws and regulations. While such compliance should not be a problem for most firms, the system's rigidity, comprehensiveness and cross-cutting interdependence may create compliance gaps caused by even minor mistakes. The monitoring burden is relatively greater for small firms than large ones. Second, the rating system creates *strategic challenges* relating to the trustworthiness of suppliers and business partners as their SCS ratings may affect scores of the firm. The system also provides a loose framework for sanctioning foreign firms, e.g. as part of a bilateral trade policy dispute. Third, officials mandate that firms *surrender massive amounts of data*, i.e. even more than the large quantities required at present. The integration and manipulation of otherwise mundane firm data, as well as sensitive information on personnel and proprietary technologies, permits to develop a concise picture of corporate operations that may threaten the firm's competitive position.

The report notes that the Corporate SCS is part of China's efforts at opening up its economy to the world. In the new system, formal barriers to market access such as domestic partner requirements will be replaced with an automated approach in which officials still retain control over a firm's activities. The Corporate SCS already exists to some extent. In the next phase, the government will work with domestic tech giants (Taiji Computer, Huawei, Alibaba, Tencent, Vision-Vera) in building a massive database (the National "Internet+Monitoring" System) which integrates information from public and private sources. The database should be rolled out by the end of this year. The EU Chamber notes that firms need

to prepare for a rapid launch of Corporate SCS next year.

Wider issues extend beyond the practical implementation challenges of the Corporate SCS. While the system nominally claims to treat all firms equitably, the SCS in China's opaque and authoritarian regime offers authorities a lot of possibilities to treat firms as they see fit, making the system vulnerable to e.g. corruption. It could even aggravate trade tensions in coming years.

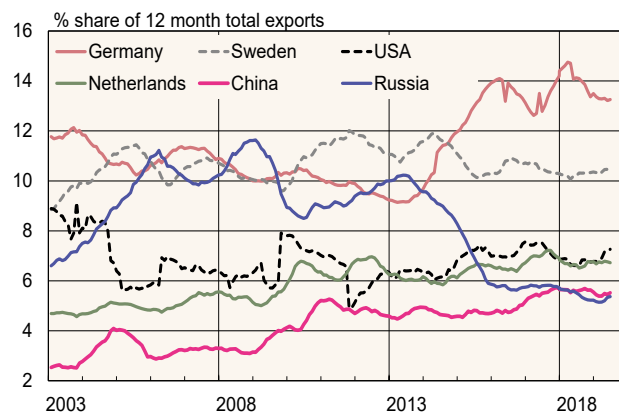
**Strong performance in Finnish goods exports to China in recent months.** Finnish Customs reports that the value of Finnish goods exports to China increased in the second quarter by slightly over 10 % y-o-y. In the first quarter, goods exports fell by 5 % y-o-y. For the first six months of this year, China exports were up about 3 % or roughly the same increase as Finnish exports generally.

For 2Q19, the biggest export growth was seen in pulp exports (up 16 % y-o-y), certain types of machinery & equipment (up 10 %) and wood products (up 40 %). Media attention focused also on the rapid growth in meat exports to China after the granting of import licences to Finnish meat producers. The value of meat exports in the first half tripled from 1H18. Despite the rapid growth, meat and meat products only made up about 0.5 % of Finnish exports to China.

Finnish imports from China have increased steadily this year at a roughly a 4 % y-o-y rate, slightly outpacing growth in Finnish exports to China. For this reason, Finland's trade deficit with China rose by 40 million euros in the first half to around 500 million euros.

Finland typically runs a services trade surplus with China, and last year that surplus amounted to nearly 500 million euros. 2018 services exports to China were roughly 1.4 billion euros, while goods exports were valued at 3.5 billion euros. Chinese tourism in Finland accounted for 14 % of services exports in 2017. Chinese tourism in Finland continues to enjoy strong growth. Statistics Finland reports that in the first seven months of this year, 133,000 Chinese tourists visited Finland (up 14 % y-o-y) and that they spent a total of 217,000 nights in Finnish hotels or inns (up 17 %).

### Main markets of Finnish goods exports



Sources: Finnish Customs, Macrobond and BOFIT.

## Russia

**Russia's central bank lowers key rate and revises forecasts downwards.** On September 6, the Central Bank of Russia's board of directors again lowered the key rate by 0.25 percentage points. It was the third cut since mid-June. The move was expected by the markets, and from Monday (Sept. 9) onwards the key rate is 7 %.

The CBR noted that inflation had slowed to 4.3 % p.a. at the end of August. Moreover, economic growth was continuously lower than the CBR had expected. The Bank said it would consider whether further rate cuts will be necessary if its baseline forecasts for inflation and economic growth materialise. The CBR currently estimates that the targeted neutral level of its key rate is in a range of 6–7 % in nominal terms and 2–3 % in real terms.

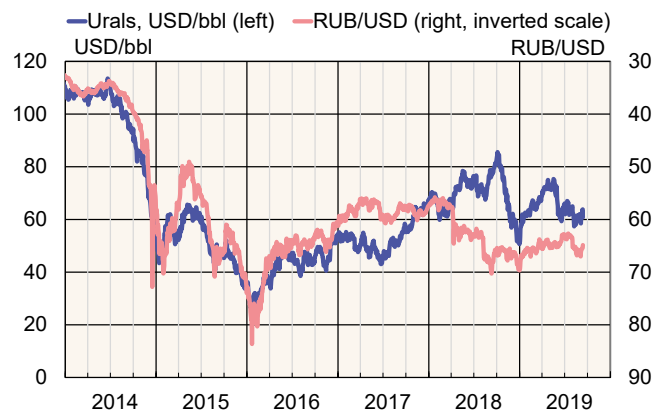
The CBR lowered its inflation forecast and expects inflation at the end of this year to be running in the range of 4–4.5 % before settling to close to 4 %. It also lowered the economic growth outlook. The CBR expects GDP growth of 0.8–1.3 % this year and 1.5–2 % next year if the price of Urals crude oil falls so that next year's average is 55 dollars a barrel. In accordance with its June forecast, the CBR continues to expect the real volume of household consumption to grow this year by 1–1.5 %. At the same time, the outlook for fixed investment growth was lowered to 0–1 %, while the outlook for growth in export and import volumes fell to around zero.

**Ruble rate and oil prices weaker after strong performance early in the year.** The ruble's exchange rate and oil prices strengthened in the early part of 2019. While both have been on a downward track in recent months, the ruble-dollar rate is still up 6 % from the start of the year and the dollar price of Urals oil up by 23 %.

As in previous years, developments in the ruble's exchange rate has occasionally diverged from the oil price. The price of Urals crude in dollars around the end of May was up by slightly over 40 % since the start of the year, while the ruble was up only about 7 % against the dollar. Despite the large drop in oil prices in June on market concerns about slowing global growth, the ruble held its value. It only dropped to its current level (around 65 rubles to the dollar) in early August on the US announcement of more sanctions against Russia. The price of a barrel of Urals crude also dropped slightly when the sanctions were announced, but has now recovered to its late July level of around 63 dollars a barrel.

Foreign investors supported the ruble's exchange rate in the first five months of this year by increasing their share of ruble-denominated treasury bonds (OFZs) from 25 % to 30 %. The government's rather tight fiscal policies have also supported the ruble. CBR forex purchases under the finance ministry's fiscal rule are not expected to cause much weakening of the ruble's exchange rate as the purchases are a small part of market activity (on September 13, the dollar-ruble rate was 64.8 and the euro-ruble rate 71.7).

Ruble's exchange rate and Urals oil



Source: Reuters.

**Russian and Indian leaders meet to discuss economic relations.** Russian president Putin hosted the leaders of India, Japan, Mongolia and Malaysia at the Eastern Economic Forum on September 4–6 in Vladivostok on Russia's Pacific coast. The bilateral discussions of Russian host Vladimir Putin and Indian Prime Minister Narendra Modi focused on increased economic cooperation. A number of bilateral agreements were signed.

The countries already cooperate on a few strategic and technical fronts. There are a few Russian nuclear reactors in India, and more may be built. For years, Russia has been supplying arms and other military equipment to India, but recently Russian companies have made efforts to start producing them in India as well. India is a partner in the Sakhalin-1 project to exploit oil and gas fields in the Sakhalin Island. The American Exxon holds a 30 % stake in the venture, the Japanese Sodeco 30 %, the Russian Rosneft 20 % and India's state-owned oil company ONGC Videsh 20 %. Rosneft CEO Igor Sechin announced at the economic forum in Vladivostok that the venture partners had agreed on construction of a gas liquefaction plant at Russia's De-Kastri seaport on the coast of the Sea of Japan. Oil and gas are already flowing through pipelines from Sakhalin Island to the mainland.

Despite these ventures, Russia-India trade is fairly modest. Russian customs values last year's Russian goods exports to India at around 7 billion dollars, while goods imports from India were worth about 3 billion dollars. India accounts for just 1.7 % of Russian goods exports and 1.4 % of goods imports. Russian exports to India include oil, fertilizers, paper, diamonds, machinery and sea vessels. The Stockholm International Peace Research Institute (SIPRI) reports that Russia last year exported at least \$1 billion in military equipment to India. Russia imports pharmaceuticals, tea, electrical equipment and clothing from India. The statements released in the context of Putin-Modi meeting envision a manifold increase in Russia-India trade in coming years. However, there is no free-trade agreement between the Eurasian Economic Union and India at the moment.

## China

**IMF sees rapid decay in China's government finances.** The IMF last month released its annual [Article IV consultation](#) on trends in the Chinese economy. China's public sector deficit and indebtedness continue to rise when borrowing by off-budget local governments and other debt is included (augmented debt). This year's fiscal policy stimulus through tax cuts and investment by local governments in infrastructure projects will boost the augmented deficit by 1.5 percentage points to 13 % of GDP (11 % in 2018). Stimulus measures should support growth this year by 0.8 percentage point.

Both public debt and China's total debt-to-GDP ratio are expected to rise until 2024. China's augmented public sector debt should rise from 73 % last year to over 80 % this year (official public sector debt 38 % of GDP in 2018) and exceed 100 % of GDP in 2024. China's overall debt-to-GDP ratio is expected to rise this year by nearly 10 percentage points to 266 %.

Rising public sector debt poses a threat to the sustainability of China's indebtedness. To lower public sector debt, the IMF recommends limiting off-budget borrowing by local governments to finance infrastructure investment, as well as a shift to progressive and pro-rebalancing taxation that rewards structural adjustments (e.g. carbon tax). The credit growth of state-owned enterprises (SOEs) is of particular concern as debt ratios are rising, productivity remains generally weak and about a third of SOEs now operate at a loss. SOE debt represents a fast-growing share of total debt, highlighting how state firms are favoured by banks at the expense of private firms.

The state's extensive involvement in the economy interferes with efficient allocation of resources. The situation will only worsen if China continues to pile on debt to hit official growth targets. Administration of an ever-more complex economy requires an overhaul of policy, improvements in governance and a shift to more market-based and transparent frameworks. Rather than focus on rigid growth targets, fiscal policy resources should be used to mitigate the problems arising from critical structural reforms.

At the time of the consultation, roughly half of US imports from China were subject to punitive tariffs. Under the adverse scenario proposed by the IMF, whereby the US applies a 25 % tariff to all remaining Chinese imports, China's growth would slow by about 0.8 percentage point over the next 12 months relative to the baseline scenario. With the increased tensions in the trade war in August, the assumptions of the adverse scenario have largely come to pass.

The IMF recommended increasing fiscal stimulus to mitigate some of the impacts of the current trade war, noting that funding for such stimulus has to come from central government budget funds, that the stimulus must support structural reforms of the economy and be targeted at low-income households to amplify the impacts of stimulus as much as possible. These include hikes in pensions and unemployment benefits, as well as increased spending on education and health care. At

the same time, however, public debt is rising faster than in the report's baseline scenario. The IMF does not recommend monetary stimulus; monetary policy should be focused on inflation.

With regards to exchange rate policy, the IMF encouraged China to move to a freer exchange-rate formation regime as it would help soften the impacts of external shocks on the economy. China also should work to improve the quality of its statistical data and eliminate gaps in its data.

**After strong growth from 2009 to 2015, the shadow banking sector now appears to be shrinking.** Shadow banking in China got its start after the partial deregulation of financial markets and restrictions on bank lending. Recently, however, the size of the shadow banking sector has shrunk.

In its latest Article IV report (see above), the IMF notes that regulatory measures to curb shadow banking have largely succeeded, with sector assets shrinking to just over 20 trillion yuan (2.8 trillion dollars). The IMF, however, wants further measures to force informal financing into the formal banking sector. Unlike in the US and Europe, in China the shadow banking sector is focused on lending to firms rather than households for e.g. housing.

Chinese shadow banking features several different contractual and lending arrangements. All involve marshalling investor assets for lending while avoiding the need for a bank to stand formally as creditor, serving instead as a mere intermediary (a role non-banks can also perform). While there is no precise definition of shadow banking, certain modes of financing deserve mention.

*Wealth management products* are based on agreements, whereby the investor agrees to place assets in an uninsured account and allow the bank to lend or invest those assets on behalf of the client in the hope of a high return. The assets are not included on the bank's balance sheet and the bank is not otherwise obligated to the investor. Typically, the money is not invested in securities, but loaned to debtors under a standard lending contract. Such investments are often thought to have the bank's implicit guarantee, so they are considered safe investments. Officials are currently promulgating new rules banning such implicit guarantees. These rules should be fully in force by the end of 2020.

*Entrusted loans* also rely on an agent bank relationship. The bank negotiates and intermediates the loan between two parties, handing the loan documents, but not assuming liability for failed performance of the loan parties. The parties are typically firms, but the bank has occasionally later purchased the debt note for itself. The firm placing the assets to be lent has some say as to whom their money is lent.

*Trust loans* are arranged by various trust companies, which also take in investments from banks. Such loans are granted to debtors with lower creditworthiness that may disqualify them from eligibility for a regular bank loan.

*Peer-to-peer lending (P2P)* typically is done online. It allows private individuals to lend to each other via a platform provided by a third party. With the collapse of several platforms, officials have sought to restrict growth of P2P lending.

## Russia

**Lower growth in Russian construction activity.** According to Rosstat, annual real growth in construction activity in 2018 was still 5.3 %. This year, growth has been non-existent. The volume of construction rose by just 0.2 % y-o-y in January-August.

However, the total floor area of residential buildings that were completed during January-August was more than 7 % greater than in the same period last year. That said, last year's base level is rather low as construction declined from 2017 to 2018 by 4.5 %. The long-running rise in housing prices levelled off slightly in the first half of this year, and in some regions prices of older apartments even declined a bit. Housing prices vary tremendously across regions.

Housing construction activity may continue to slow due to a legal amendment that entered into force in July. It forbids construction companies from using up-front payments received from a customer to fund their other construction sites not connected to the customer. With the ban, a larger share of building costs will have to be financed through bank loans taken by the builder. The change is expected to drive small and low-profit builders out of the market.

**Russian competition bureau has plenty on its plate.**

As part of the release of the 13<sup>th</sup> annual report of Russia's competition agency, the Federal Anti-Monopoly Service (FAS), agency head Igor Artemyev briefed the government on the report's contents. It covers a range of topics, including government and state-owned enterprise procurements, access to services provided by natural monopolies, agreements that limit competition, commodity exchanges, administratively regulated prices, national projects, 18 sectors as well as a state of the art review of the FAS 2018–2020 plan to promote competition. The plan has further been processed into goals and measures for Russia's regions and municipalities.

Artemyev said that all major competition laws currently in process and agreed in the government are being reviewed further because they have received negative appraisals from the state-legal directorate of the Presidential Administration. A draft law, which prohibits the establishment of state unitary enterprises in competitive markets, was eventually submitted to the Duma despite resisting lobbying efforts of several regional leaders and only via consent of the prime minister and the president. Another proposed law submitted to the government would prohibit federal, regional and municipal government entities from acquiring shares in firms doing business in markets deemed subject to competition.

The FAS report finds that the target in government procurements with regards to the share of small firms has already been nearly achieved, but the targeted share of small and medium-sized firms in state-owned enterprise procurements has a way to go. Work continues in order to tackle discriminatory practices with regards to user access especially to gas and heating grids, as well as rail and port services. The

non-discrimination policy approach also applies to rights to extract natural resources and sales of property confiscated by the state, for which Artemyev characterised the current practices as closed or half-closed.

Development of commodity exchanges continues, making trade of basic commodities such as natural gas, coal, oil products, grain, and various primary chemical products easier and less discriminatory. Besides the exchanges, various databases are providing more open price information also for medicines, construction and government contracts.

For administratively regulated prices such as electricity, water, gas and rail transport, the FAS legislative draft seeks to establish clear and more unified criteria in the setting of tariffs and to prevent regions from implementing rate hikes that vastly exceed federal limits. It also seeks to eliminate huge rate variations that have appeared even within regions. A further goal is to shift to 5–10 year plans in which rate hikes are held slightly below the inflation rate.

Regarding cartels and other agreements to restrict competition, the FAS has pursued numerous cases especially in road construction and pharmaceuticals. Reported competition violations by state agencies have overall declined steeply in recent years whereas their participation in agreements to limit competition rose sharply last year.

The FAS notes that implementation of national projects requires greater government budget spending, yet they contain no prerequisites for applying competition practices. The FAS sees that this may lead to limitations on competition. The same assessment also applies to promoting investments through special investment agreements between individual industrial firms and state authorities.

**Russia and Belarus discuss deeper economic integration.**

At the beginning of September, Russian Prime Minister Medvedev and Belarusian Prime Minister Rumas signed an action plan on creating a road map for economic integration. The integration program should be ready for presidential signing in December.

While no plan has been officially released, the Russian business daily Kommersant describes it in detail. The plan envisions integration of tax regulation, foreign trade policy, economic legislation, bank supervision and regulation of energy markets. On the other hand, discussion of issues like shared government structures and common currency are postponed. The integration process should begin in 2021.

Officially, Russia and Belarus have been in a rather close state union for two decades. In practice, however, the relationship has been strained e.g. by disagreements over oil and gas supplies and foreign policy. Furthermore, the relevance of the union became less clear in 2010 as Russia, Belarus and Kazakhstan established the Eurasian Customs Union which was later renamed Eurasian Economic Union (Armenia and Kyrgyzstan also joined it). This union of five states has similar goals as the bilateral union of Russia and Belarus. The new plan by Russia and Belarus may further complicate integration process within the Eurasian Union.

## China

**Despite China's economy slowing, African swine fever causes inflation to accelerate.** All common economic indicators for China point to a further slowdown in growth in August. Industrial output growth fell to 4.4 % y-o-y, its lowest level in two decades. Even as the severe drop in passenger car production appeared to stabilise last month, passenger car sales were still down by 7 % y-o-y. Hence, real growth in retail sales fell slightly to 5.6 % y-o-y in August.

Given the poor Chinese statistical data, it is particularly difficult to assess investment demand which is still a key component of the Chinese economy. According to available data, real growth in fixed asset investment (FAI) appears, however, to have been at most 2–3 % y-o-y in January-August.

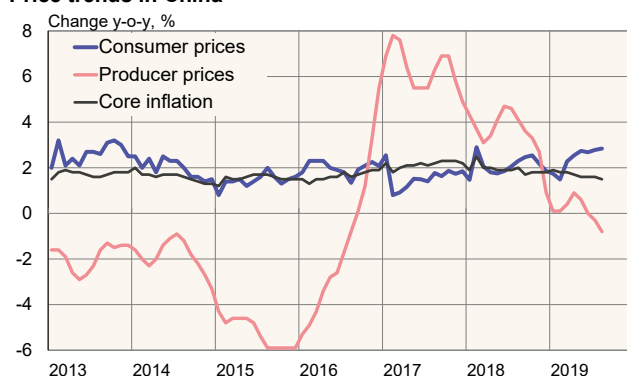
Negative growth in producer price inflation (down 0.8 % in August), which erodes corporate profitability and diminishes corporate appetite for investment, is seen as further evidence of weakening economic conditions.

The most important factor in price trends at the moment has been food prices. Consumer price inflation accelerated to 2.8 % in August on higher prices for food and, in particular, pork. Pork prices shot up 47 % y-o-y in August as domestic pork supplies have fallen to a ten-year low. Since the African Swine Fever (ASF) outbreak a year ago, about a third of pigs in China has died or been slaughtered. China has increased pork imports. This week, ahead of the 70<sup>th</sup> National Day holiday in early October, the government released pork supplies from its strategic food reserves.

China accounts for about half of global demand for pork products. As domestic supply keeps declining and prices keep rising, the situation has significant impacts also on global markets for meat products and animal feed.

The ASF crisis has become a major political headache for Beijing as pork is a central part of the Chinese diet and even symbolic of rising living standards to many people. The situation is aggravated by the fact that the crisis has revealed serious systemic and political problems (e.g. downplaying of risks and problems, cover-ups, corruption and failures in government regulation).

### Price trends in China



Source: Macrobond.

**China lowers bank reserve requirements.** An across-the-board 0.5 percentage-point cut in the bank reserve requirements ratio (RRR) came into force on Monday (Sep. 16). The average RRR (not including bank-specific exemptions) now stand at 13 % for large banks, 11 % for mid-sized banks and 7.5 % for small banks.

The RRR for smaller regional banks will also drop by a total of 1 percentage point in two steps (October 15 and November 15). The action should support growth in the real economy by reducing financing costs and improve access to financing for smaller firms. A goal of the recent reference rate reform is also to lower bank lending rates ([BOFIT Weekly 34/2019](#)).

Reserve requirements were lowered several times since April 2018, when the RRR for large banks was 17 %. China's monetary policy stance otherwise remains unchanged. For example, the central bank's rates in its open market and lending operations are untouched. No significant changes have been reported in money-market rates.

Setting monetary policy in China involves balancing the demands of domestic pressures to support economic growth and external pressures to combat exchange-rate depreciation and capital outflows from the country. Monetary easing also fuels indebtedness, which has already reached levels that threaten China's economic development. The People's Bank of China reports that it now uses targeted monetary stimulus rather than broad measures.

**Declining exports of foreign firms operating in China.** China Customs reports that goods trade in August sustained the downward trend of previous months. Imports continued to contract and exports were at the same level as in August 2018, with the result that the trade surplus increased. Although there was now a contraction in imports from the EU, August foreign trade trends with individual countries were generally unchanged from earlier months.

Export trends for domestic and foreign firms have been diverging this year. Growth in goods exports by Chinese firms has remained fairly brisk (up 4 % y-o-y in January-July), while exports of foreign firms (including joint ventures) were off by 5 % in the same period. In the first seven months of this year, the share of exports produced by Chinese firms rose to 60 % and exports by foreign firms operating in China declined to 40 %. Many foreign firms have announced that they have moved their export-oriented production elsewhere due to the trade war.

The trade war is also reflected in China's processing trade. Figures from China Customs show that exports based on foreign parts and assembly contracted by 7 % y-o-y in January-August, while conventional exports increased by 3 %. Some 29 % of goods exports this year have come from the processing trade, down from 32 % last year. At its peak, ahead of the global financial crisis, processing trade accounted for 55 % of exports. Rising production costs have driven manufacturing out of China to other countries, while some parts of production chains have been shifted entirely to China.



## Russia

**Russia announces ratification of the Paris climate accord.** Russia is the world's fourth-largest emitter of greenhouse gases (GHGs) after China, the United States and India. Russia signed on to the Paris climate accord in 2015, but dragged its feet on legislative ratification. This week, the government finally announced it will ratify the agreement. The additional legislation supporting the Paris accord could be debated in the Duma even before the end of this year.

Russia's targets include an unimpressive 25 % reduction in GHG emissions from 1990 levels (1990, the year before Soviet industry collapsed, is used as the base year for Russian emissions). Russian emissions have since fallen so far that the country can actually increase its emissions through 2030 and still hit the 25 % reduction target – even overlooking the carbon sinks of its forests (LULUCF activities). The ratification and formulation of national legislation should be integrated into Russia's "Ecology" national project.

**Russia discusses how to invest government reserve fund assets.** The discussion has focused on investing liquid assets in the National Welfare Fund (NWF) when the liquid assets exceed a targeted limit. Budget legislation says that when NWF liquid assets surpass 7 % of GDP, the excess can be invested in such purposes as lending to domestic investment projects, but not to cover budget spending.

Part of NWF assets have already earlier been tied e.g. through project lending, so while the fund's total assets presently amount to 7.5 % of GDP, the liquid assets are about 6 % of GDP. The 7 % liquid asset limit should be met next year as finance ministry accounts already hold a more than sufficient amount of sc. excess oil & gas tax revenues that have piled up this year and are waiting to be transferred to the NWF. Under the rules of the NWF, the excess oil tax earnings of each year must be deposited in the NWF no later than October 1 of the following year. In 2018 and 2019, the transfers were made in summer. The federal budget rule says that excess oil tax revenues are generated when the actual price for Urals crude exceeds the computational (base) price set by the rule. The base price increases automatically at 2 % a year, so this year's base price is over 42 dollars a barrel.

The Central Bank of Russia has assessed the economic impacts from a couple of options for investment of NWF assets. In addition to investment in domestic projects, the assessments cover lending to foreign entities that would then commit to using the money to purchase Russian products. The options, however, do not represent any CBR view on the matter. CBR governor Elvira Nabiullina recently noted that a clearer choice would be to raise the budget rule's base price of oil and thereby impact the flow of excess revenues channelled to the NWF.

The finance ministry stressed there are no plans to modify the budget rule, noting that moneys invested from the NWF are to be paid back to the fund. Related to that, the NWF

should invest together with other financiers. One co-investor could be the Russian Direct Investment Fund. Its operations have raised the possibility that foreign sovereign state funds might be interested in participating in Russian project financing if Russia's own reserve fund (NWF) took part.

Economy minister Maxim Oreshkin said the economy ministry would like to see NWF assets lent for the purpose of expanding exports of Russian firms. Russia's Union of Industrialists and Entrepreneurs (RSPP) has also proposed that option in such a way that NWF assets be deposited with banks who would lend the funds onward to support exports.

**Chinese premier talks up trade during his Russia visit.** The Chinese premier Li Keqiang visited Russia on September 16–18. Russian and Chinese prime ministers envisioned doubling the value of mutual trade to 200 billion dollars a year over the next five years. The countries see opportunities for trade and cooperation in agriculture, energy and military technology. Currently, most Russian exports to China are basic commodities, while most Chinese exports to Russia consist of machinery or consumer goods.

Regarding food supplies, particular emphasis has been put on basic crops. China's trade war has radically reduced soybean imports from the United States, making it a natural topic of discussion. The Chinese have sought soy sources elsewhere, especially South America, but soy is being produced closer to home as well. China's soy-growing areas are located in the northeastern parts of the country, and the climate band where soy cultivation is optimal extends into Russia. However, the border currently complicates shipping of Russian-grown soybeans to Chinese markets. In any case, Russia cannot match American soy production as the current amount of land in Russia dedicated to soy can only meet a tiny fraction of Chinese demand and there is not much uncultivated arable land left in Russia. Large-scale conversion of land used for cultivating other crops into soy production also seems unreasonable.

The countries are investing in energy trade. The Power of Siberia gas pipeline, which runs from Siberia to China, is set to be completed by the end of this year. In addition, China has invested in gas liquefaction facilities in Russia. Asia is the most important market for liquefied natural gas.

In recent years, China and Russia have criticised the dominant role of the dollar in the international financial system. While politicians in both countries have talked of harmonising payment systems, no big changes have happened. In spring 2018, the Central Bank of Russia shifted 15 % of its currency reserves into Chinese yuan.

Russia and China also engage in military cooperation. In conjunction with Li's visit, China participated in military exercises in Russia's southern regions. Other participants in the military exercises included India, Pakistan, Kazakhstan, Kyrgyzstan, Uzbekistan and Tajikistan. In the 1990s, China emerged as one of Russia's most important arms buyers. The arms trade with China has since diminished as China has increased its own arms production.

## China

### **European firms demand the elimination of preferential treatment of Chinese state-owned enterprises.**

The European Union Chamber of Commerce in China this week released its [Position Paper 2019/2020](#) with its views regarding problems of China's business environment and potential solutions. The competition-distorting advantages enjoyed by state firms were seen as the most pressing problem.

The latest annual corporate survey conducted by the European Chamber found that 70 % of responding European firms said they operated in fields that compete directly with Chinese state-owned enterprises (SOEs). Some 18 % of firms reported that Chinese SOEs controlled over half the market in their field. About 40 % of respondents believed that the status of SOEs will be bolstered at the expense of privately held firms over the next two years. Just a fifth of respondents saw the situation moving in favour of private firms.

The Position Paper notes that the increased advantage of SOEs in this decade is particularly evident in access to credit. As the share of lending to private firms has decreased, the share of lending to state firms has risen. The exceptionally long payment periods demanded by SOEs further tighten private firms' financing position. SOEs also enjoy monopoly status, looser permitting rules, preference in public procurements and direct connections to regulators and policymakers.

While SOE reform has been long discussed, the European Chamber notes that the push for reform has gone in the wrong direction in recent years. The report says that the government pursues "SOE reform with Chinese characteristics" where the authorities actually do not even try to restrict the size or status of state firms. In the words of president Xi Jinping, the goal is simply to make SOEs "stronger, better and bigger."

The European Chamber concurs with IMF recommendations that the government restrict SOE access to credit, tighten rules on dividend payments, abolish implicit guarantees, wind down unprofitable firms, open up non-strategic sectors to private firms and foreign firms, as well as improve corporate governance.

The European Chamber puts its hope on the principle of "competitive neutrality", noting that the term has recently been adopted by several major Chinese economic decision-makers. Current policy trends that aim to reinforce the Communist Party's role may, however, refute such hopes.

### **China gets rid of quotas on securities investments under QFII programmes.**

China's State Administration of Foreign Exchange (SAFE) announced this month that it was scrapping investment quotas under its qualified foreign institutional investor (QFII) and renminbi qualified foreign institutional investor (RQFII) programmes. The move is largely symbolic as the quota limits were rarely approached and effectively had little impact on investment flows. Otherwise, the programmes will continue in their current form, i.e. qualified

foreign institutional investors can still use them to invest in China's financial markets.

China's opening of new avenues of investment has reduced foreign investor dependence on the QFII schemes. The stock and bond market connections between mainland China and Hong Kong, in particular, have replaced use of QFII schemes, although volumes still remain limited.

China has made inbound investment easier in recent years, but possibilities to make securities investments from China abroad have not been deregulated equally. This arrangement has been used to support the yuan's exchange rate.

### **Despite yuan promotion policies, international use of the currency remains modest.**

The yuan (CNY), which is still not freely convertible due to China's strict currency controls, has yet to establish itself as a credible alternative in international payments and investment. As a result, the yuan has failed to establish itself as an international currency proportional to the size of the Chinese economy.

China has sought for years to increase international use of the yuan. In 2010, Chinese importers were granted permission to make payments in yuan via "offshore" banks in Hong Kong and foreigners were permitted to open yuan bank accounts in Hong Kong. Issuance of yuan-denominated bonds in Hong Kong also soared. Along with other objectives, the rationale for reduction in interest-rate regulation and slight relaxation of exchange-rate policy have been to promote international yuan use. To encourage Chinese exports and the international use of the yuan, the People's Bank of China has agreed with over 30 central banks on a system of bilateral currency swaps to develop a reciprocal credit line in participant currencies.

The Bank for International Settlements (BIS) recently released its breakdown of the volume of foreign currencies traded on forex markets during April 2019. The yuan was only the eighth-most-converted currency and its share of the global OTC currency exchange has grown slowly. Only 4 % of forex trades involve the yuan as a converted currency. The Russian ruble was on the other side in 1 % of currency trades.

The Society for Worldwide International Financial Telecommunication (SWIFT) collects information about the use of various currencies in international payments. 2.2 % of all international payments traffic last August was in yuan, raising the yuan back to fifth place among the most-used payments currencies. Yuan-denominated customer payments made and received outside China occurred above all in Hong Kong. The next largest yuan-clearing centres were in the UK and Singapore.

The IMF reports that the yuan accounts for 1.8 % of global currency reserves. In Russia, however, yuan accounted for 14 % of total reserves in December 2018. In 2016, the yuan was added to the IMF's SDR currency basket with a weighting of just under 11 %. With the pace of China's reforms slowing, the use of the yuan has disappointed the expectations.

## Russia

**BOFIT's latest forecast sees Russian economic growth falling to 1 % this year.** The acceleration of Russian economic growth to 2.3 % last year was largely driven by transient factors. Growth was expected to subside to a lower level this year. Rosstat's first-round estimate of growth in the first half of this year (0.7 %) suggests the slowdown has been more rapid than expected.

Rosstat's just-released figures for the second quarter show growth in private consumption remained fairly brisk, while the performance in exports was exceptionally weak. Following episodes of very strong growth in export volumes since 2016 and a plateauing of growth towards the end of 2018, the volume in exports contracted in the first half of 2019. While a lower rate of export growth was largely expected, the actual declines in volumes in many core export industries came as a surprise. Part of the decline in export volumes can be attributed to last year's poor grain harvest compared to 2017, the agreement among OPEC+ countries to limit crude oil production and the contamination and interruption in operations of the Druzhba pipeline (one of Russian's main oil export pipelines) last spring. Underpinning these developments are slowing global economic growth and a bleaker outlook for global growth.

Fixed investment growth is also expected to remain very modest this year. In the first half of 2019, the volume of fixed investment was smaller than in the same period in 2018. Growth in government-sector spending may slightly raise the economy's growth rate in the second half, but overall the GDP growth is expected to stay at around 1 % this year.

The fresh [BOFIT Forecast for Russia](#) sees the economy's growth rising slightly next year on higher public consumption and government-sector investment. The state's growing role and meagreness of market-friendly reforms, however, will limit growth in private investment. While private consumption remains important to economic growth, negligible growth in real household incomes and slower growth of household borrowing will dampen consumption growth.

**Stimulus included in Russia's 2020–2022 government sector budget framework.** The finance ministry's three-year fiscal framework covers the entire consolidated budget. That includes the federal budget and the budgets of the state's three social funds, for which (all four) the government has just submitted drafts to the Duma, and also projections for regional and municipal budgets.

In nominal terms, government-sector revenues are expected to increase annually by 4–5 % this year and in the next coming years. The role of the government budget sector in the economy overall is stimulative. The estimated growth in spending could still accelerate this year to a degree that growth for the entire year would reach about 8 %. Growth will average around 6 % a year in the closest years ahead, i.e. about two percentage points above the projected inflation rate. The consolidated budget surplus, which was almost 3 % of GDP in 2018, is expected to fall below 2 % of GDP this year and go down to 0.7 % of GDP next year.

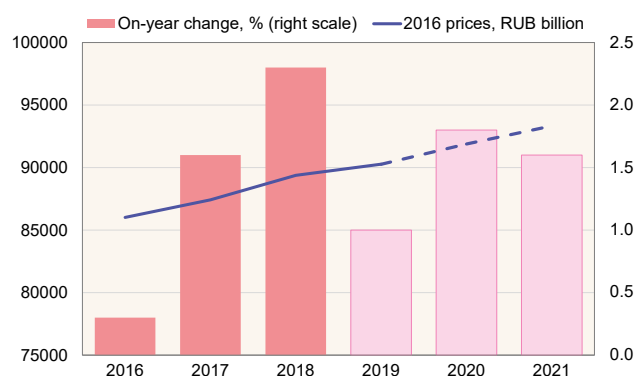
The consolidated budget revenues are constrained by the assumption of a moderate drop in the price of Urals crude oil from its current level to around 56 dollars a barrel for the next few years. In that case, oil & gas tax revenues would decline substantially this year and next year before levelling off in 2021. On the other hand, the estimate of the budget's other revenues is based on the economy ministry's forecast that GDP growth accelerates from about 1.5 % this year and next year to over 3 % from 2021 onwards. Thus, the growth of other revenues, which has remained high for the past two years, will continue in the next few years at 6–7 % a year.

Other revenues are expected to increase at about that pace for the federal, regional and social fund budgets. VAT revenues to the federal budget will rise well, and dividend payouts from state-owned companies are expected to increase notably. The flow of money to social funds will be due to revenue increases from mandated social taxes from wages. Regional budget revenue estimates are not broken out.

Consolidated budget spending on healthcare and public order and domestic security will grow this year and next by over 10 %. Public administration will also receive tangible increases. After increases this year, the various branches of the economy and the housing sector must wait at least a year for new budget impulses. The education sector will have to wait longer. Increases of spending on social benefits and defence are to slightly outpace inflation in the next coming years. General increases in government-sector wages are scheduled roughly in line with inflation. Pension increases are to exceed 6 % a year based on the decision of summer 2018.

As the base oil price set under the federal budget rule is low compared to the oil price assumption of the revenue calculations in the federal budget, the National Welfare Fund (NWF), which serves as the government's reserve fund, is expected to swell by the end of next year to a level corresponding to 10 % of GDP. The finance ministry's technical assumption is that NWF assets will not be invested in anything other than central bank accounts. Thus, the NWF's liquid assets at the end of next year would amount to 8.5 % of GDP.

### Realised Russian GDP growth and BOFIT forecast 2019–2021



Source: BOFIT Forecast for Russia 2019–2021.

## China

**BOFIT forecast sees Chinese growth slowing at about one percentage point a year from 2019 to 2021.** Growth of over 6 % p.a. is required for China to meet its declared goal of doubling 2010 real GDP by 2020. Like before, our latest [BOFIT Forecast for China](#), however, expects growth to fall faster than official projections perhaps to around 4 % p.a. at the end of the forecast period in 2021.

Unreliable official figures that fail to capture economic trends make it more challenging than ever to get an accurate picture of China's economic situation, let alone to produce solid forecasts. Official figures report an extremely modest drop in growth, but a review of a broad range of economic indicators and anecdotal evidence suggest that the current economic situation is clearly worse than in early 2018.

Domestic factors are largely the cause of the economic slowdown, and structural factors alone already pose a significant drag on the economy. Escalation of trade tensions has made matters worse. Several institutions (including the Bank of Finland, IMF and OECD) estimate that the tariff increases reduce China's growth by about one percentage point a year if 25 % additional customs tariffs are applied to all trade between the US and China. As the causes of the trade war are deeply rooted in China's current system, we expect tensions to continue. Their resolution requires China to address system-level issues.

Productivity-enhancing reforms would be essential to sustaining growth potential, but major reforms have been postponed years. Capital allocation is increasingly inefficient as an ever-larger share of financing goes to low- or negative-profitability state-owned enterprises and role of the Party in the economy surges. The concentration of power in the hands of a party leadership reluctant to move ahead with reforms increases the danger of economic policy missteps.

China has increased fiscal stimulus to support growth, even as the room for stimulus has become more limited. The actual public-sector deficit is rising rapidly. The IMF estimates that general government debt is approaching 80 % of GDP. If the current policy to support unsustainable pace of growth continues, it will distinctly erode government finances during the forecast period.

As growth is sustained by debt-fuelled stimulus, China's debt ratio has soared to a disturbing level of around 260 % of GDP. Banking crises are often associated with countries that experience such rapid increases in their debt-to-GDP ratios. Corporate access to financing has become tighter, which, in combination with the slowdown in domestic growth, has severely reduced outward FDI flows of Chinese firms.

The relentless pursuit of economic stability through stimulus in the current, still relatively benign, economic conditions diminishes economic buffers and further delays the implementation of reforms crucial to locking in long-term growth. This, along with the weakening of corporate finances and increased financial market risk, heighten the danger of a serious recession.

**China's fiscal revenues reduced by tax cuts.** Tax cuts implemented over the past twelve months (i.e. cuts in the income tax, value-added tax, as well as larger tax refunds for exporters) have hurt growth in budget revenues. The finance ministry reports that the combined budget revenues of the central and local governments increased by 3 % y-o-y in the first eight months of 2019. Revenue growth was the lowest since 2009, a period marked by the international financial crisis and roll-out of a massive economic stimulus.

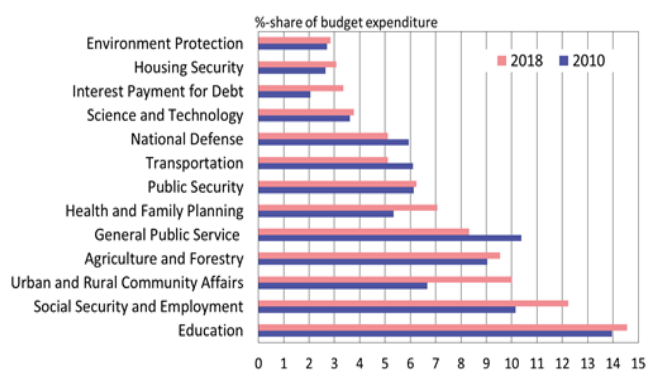
The slow increase in revenues, however, was anticipated in the budget released last spring. In January-August, received revenues were running at 71 % of the forecast revenues for the year, about the same level as in previous years. Last year's budget revenue totalled 18.3 trillion yuan (2.35 trillion euros or 20 % of GDP), of which 85 % came from taxes and 15 % from other revenue streams. The biggest source of tax revenues was the VAT (40 % of total tax revenues) and the corporate tax (23 %).

Public-sector spending in the first eight months of this year increased by 9 % y-o-y, slightly below the budget forecast. It is unclear whether spending is timed for later in the year or whether financial difficulties are involved. Less debt was issued in the first eight months of this year to fill in budget cracks than in 2018. Last year's budget spending amounted to 21 trillion yuan (2.7 trillion euros or 23 % of GDP). The official budget deficit was about 3 % of GDP.

Revenue collection last year divided roughly equally between the central government and provincial and local governments. The central government then distributed most of its revenues to provinces and cities. Last year, about 85 % of all public spending occurred at the local and provincial levels.

A major obstacle to analysis of China's public sector is that a considerable amount of spending takes place off-budget. China's budget fails to mention various social security funds or the amounts of money made from sale of land-use rights. Adding in funds, sales of land-use rights and investment projects funded by local government bonds and local government financing vehicles (LGFVs), the IMF puts public-sector spending in 2018 at 43 % of GDP, revenues at 32 % of GDP and the budget deficit at 11 % of GDP.

### China's largest public-sector spending categories (central and local governments) in 2010 and 2018



Sources: China's finance ministry, CEIC and BOFIT.

## Russia

**Russia's foreign currency reserves swell to highest level in years.** As of end-September, the value of Russia's foreign currency and gold reserves reached 531 billion dollars, its highest level since 2013. This year's gain of over 60 billion dollars has been largely due to Central Bank of Russia's forex buying on behalf of the finance ministry. Higher prices for gold, which constitutes about 20 % of Russia's reserves, have also helped.

First-quarter figures suggest the composition of Russia's forex holdings has remained largely unchanged this year. As of end-March, some 30 % of Russia's forex reserves were held in euros, 24 % in dollars, 14 % in yuan and 7 % in British pounds. During 2017–2018, Russia dramatically reduced the dollar component of its reserves, switching instead to euro and yuan assets. The change was apparently done in response to US sanctions.

**Russia and Turkey want to increase bilateral use of their currencies.** At the beginning of this month, Russia and Turkey signed an agreement that seeks, among other things, to increase the use of national currencies in their bilateral trade, expand possibilities to use the Russian MIR payment card in Turkey and connect Turkish banks with Russia's national SPFS payment system.

Use of the Russian ruble is currently mainly limited to CIS countries, which denominate over 60 % of their trade with Russia in rubles. Use of the ruble has increased in recent years in Russia's trade with India and China. About a third of Russia-India trade last year was denominated in rubles, and about 6 % of Russia-China trade. In addition, apparently over 10 % of Russia-China trade was denominated in yuan.

Three foreign banks, all based in the CIS region, currently participate in Russia's national SPFS payment system. The MIR payment card can now be used outside Russia in a few CIS countries and Turkey.

**Russia ratifies Caspian Sea accord.** The five littoral states of the Caspian Sea (Russia, Kazakhstan, Turkmenistan, Iran and Azerbaijan) negotiated for two decades on territorial demarcation and sharing of the natural resources of the Caspian Sea. In August 2018, the heads of the littoral states [signed a convention](#) on these issues. The Russian parliament ratified the convention by law on September 19 and Russian president signed the law into effect on October 1. Iran is the only state yet to ratify the convention.

The convention establishes that territorial waters extend to 15 miles from shore and fishing rights to 25 miles. The area in the middle of the sea is to be divided into sectors. These are to be determined with agreements among neighbouring countries. Russia, Kazakhstan and Azerbaijan have already earlier agreed on sector boundaries in the northern part of the Caspian. Azerbaijan, Iran and Turkmenistan still continue

negotiations on the division of the southern end. These countries have asserted overlapping claims on a number of hydrocarbon deposits.

In addition to exploiting natural resources, the convention gives each state the right to construct gas pipelines running along the seabed in their own sector. While this has raised hopes for the proposed Trans-Caspian gas pipeline running from Turkmenistan to Azerbaijan, the matter is still far from settled. Both Russia and Iran oppose the plan and may still contest the pipeline on environmental grounds.

**Monitoring of partially completed fixed investments in Russia is difficult.** A recent study of Russia's Accounts Chamber notes that information about partially implemented fixed investment projects is collected by a variety of public agencies. Rosstat compiles comprehensive information on them for the national accounts, but announced that it has stopped processing this information as decided in spring 2018. Rosstat data suggests that the ratio of the value of investments in progress relative to the value of Russia's total stock of fixed capital has held steady throughout this decade (Rosstat adjusts both stock values each year to reflect changes e.g. in prices). The value of investments relative to the capital stock at the end of 2016 was 6–7 %.

The Accounts Chamber assessment of unfinished projects focuses on those that are financed from federal, regional or municipal budgets. Despite various information systems, comprehensive investment figures appear only in budget information. These data provide the basis for the Account Chamber's estimate of public sector investment projects in progress, i.e. an amount equal to just over 10 % of the public sector's capital stock. Nearly 30 % of investments in progress have been under construction for over five years, halted or abandoned.

The Accounts Chamber finds that data collection is generally adequate only for the Federal Targeted Investment Programme (FAIP). According to a presidential decree, there should have been an inventory of all federal projects by the beginning of 2016 and all regional projects by the beginning of 2017. The software for reporting and data management are still not ready, however, and data collection to date has been spotty. The reporting forms for the main reporting system were only provided to regions this year.

To reduce the number of unfinished investment projects, the government gave local and regional governments a two-month deadline at the beginning of 2017 to provide development plans. As of this summer, most recipients of federal funds had submitted their plans, but only 23 of Russia's 80 regions. The Accounts Chamber gave recommendations on data collection and drafting of plans. It also recommended improving related laws and regulations, determining the responsible regional authorities, as well as providing technical assessments of the projects in order to decide on their continuation.

## China

**Contraction in capital flows in China's balance-of-payments reporting.** The financial account (excluding foreign currency reserves) in January-June showed a 45-billion-dollar surplus, down from the 1H18 surplus of 129 billion dollars. However, the "net errors and omissions term" implied an overall net capital outflow from China. Revised first-half figures for the current account were lowered slightly to 88 billion dollars ([BOFIT Weekly 35/2019](#)).

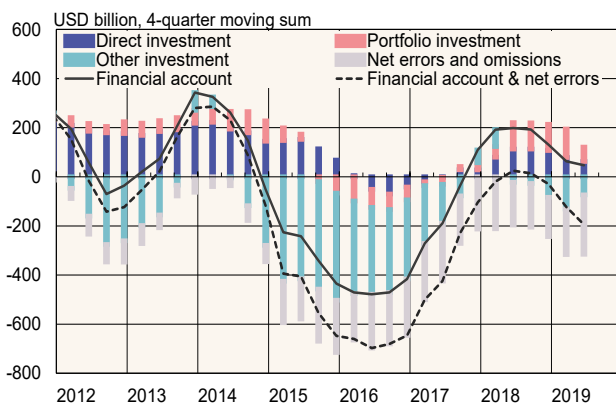
Two-thirds of the statistically recorded capital flows in 1H19 consisted of foreign direct investment. The net flow, however, was rather small as the flows of FDI into China recorded in the balance of payments contracted and the outward flow from China remained at last year's level. Portfolio investment in China was down considerably from 1H18, while portfolio investment flows out of China were unchanged.

Unlike the recorded flows in the financial account, the net errors and omissions term provides a ball-park figure for unrecorded forex flows. It suggests that the net capital outflow from China accelerated this year. The errors and omissions term for 1H19 suggests that 131 billion dollars in capital outflows circumvented official scrutiny (50 billion dollars in 1H18).

Using China's balance-of-payments methodology, foreign currency and gold reserves rose by 2 billion dollars in the first half (changes in valuations raised the final figure for China's reserves). The value of China's reserves slipped a bit in the third quarter, standing at 3.092 trillion dollars as of end-September.

China's net foreign asset position at the end of June was 2.025 trillion dollars, a 2 % decline from a year earlier. China had gross foreign assets of 7.443 trillion dollars (up 2 % y-o-y) and gross foreign liabilities of 5.417 trillion dollars (up 4 %). A quarter of gross receivables were FDI and over 40 % currency reserves. Over half of gross liabilities was FDI and nearly a quarter portfolio investment. The net foreign asset position weakened in 1H19 by 105 billion dollars as a result of capital flows and changes in exchange rates and prices.

### Financial account net flows (excl. changes in reserves)



Sources: SAFE and Macrobond.

**China establishes six new free-trade zones.** New free-trade zones (FTZs) will be established in the Heilongjiang, Guangxi, Hebei, Jiangsu, Shandong and Yunnan provinces. The new FTZs have various branch-specific and geography-related emphases. For example, the northern Heilongjiang FTZ focuses on Russian trade and wood processing industries.

Companies in FTZs are subject to looser rules. They may get special foreign trade incentives, relaxed customs procedures, fewer barriers to currency exchange and establishing a business, lower joint-venture requirements, the possibility to recruitment foreign workers and reduced taxes and fees.

China has good experiences with its special economic zones established in the 1980s and 1990s. Many of these were used as pilot experiments for reforms that were eventually adopted nationwide. China has established more special economic zones than any other country. UNCTAD reports that China has over 2,500 special economic zones, which is more than half of all such zones globally. China only established its first true FTZ, however, in Shanghai in 2013. With the six new additions, China now has a total of 18 FTZs.

Special economic zones earlier served a useful pilot role, but in the current decade they are likely to provide little extra value and can perhaps be seen mainly as holdovers from the past. Now China should promote national-level reforms rather than increase the number of new local pilot projects.

### Growth in the number of new Chinese industrial robot installations halted in 2018.

The International Federation of Robotics (IFR) reports that about 154,000 new industrial robots were put into service in China last year, which was about 1 % fewer than the number of robots put into service in 2017. The country's continuing pre-eminence in the robotics market can, however, be seen in the fact that just 131,000 new robots were taken into service last year for all of Europe and the Americas combined.

China has been the world's biggest robot market since 2013. A decade ago the country accounted for less than 10 % of robot purchase globally but last year its share was 37 % (and 40 % in 2017). The IFR estimates that there are 649,000 industrial robots currently in use in China, i.e. 27 % of the global robot stock.

With the China's rapid adoption of robots, its robot density (140 robots per 10,000 workers) clearly surpasses the global average (99 robots) and is comparable to Finland's robot density. China still has a way to go to reach the level of the top users of robots, however. In terms of robot density, the leading countries are Singapore (831), South Korea (774), Germany (338) and Japan (327). US robot density is 217.

Last year about 422,000 new robots were installed at industrial facilities around the world, a 6 % increase from 2017. The stock of robots in use rose to 2.44 million units. Asia accounted for 68 % of new robot installations globally last year, followed by Europe with 18 % and North and South America with a combined total of 14 %.

## Russia

**IMF lowers growth forecast for global economy.** The latest [World Economic Outlook](#) from the International Monetary Fund (IMF) sees growth of the global economy slowing this year to 3 % and then accelerating next year to 3.4 %. The 2020 pick-up in growth should come from EU countries and accelerating growth in certain emerging economies such as India and Brazil. This suggests that the trough of slowdown in global growth should be seen this year. Global growth is forecast to hold at around 3.6 % p.a. from 2021 to 2024.

The IMF expects that Russian economic growth will accelerate in 2020, before stabilising at or just below 2 % a year through 2024. Also the latest [BOFIT forecast](#) sees growth of the Russian economy to accelerate from around 1 % p.a. this year to 1.8 % in 2020, mainly due to increased public investment. In the following years, however, growth subsides to around 1.5 %, which is close to what most observers consider Russia's long-term growth potential. The World Bank's latest forecast for the economies of Central and Eastern Europe expects Russian economic growth of 1.7 % next year and 1.8 % in 2021. Forecasters hold differing views on how long the phase of faster growth in Russian public investment will last.

IMF estimates that Russia's GDP per capita adjusted for purchasing power parity (PPP) is about 28,800 dollars this year. The average for EU member states is 43,200 dollars, while it is e.g. 32,000 dollars for Poland, 32,400 dollars for Portugal and 34,200 dollars for Estonia. Among Eastern European countries, the comparable GDP per capita is 9,300 dollars for Ukraine and 7,300 dollars for Moldova.

### IMF GDP growth forecasts for select economies, %

	2018	2019F	2020F	2021F
Global economy (PPP-weights)	3.6	3.0	3.4	3.6
Russia	2.3	1.1	1.9	2.0
Ukraine	3.3	3.0	3.0	3.1
Turkey	2.8	0.2	3.0	3.0
China	6.6	6.1	5.8	5.9
India	6.8	6.1	7.0	7.4
Brazil	1.1	0.9	2.0	2.4

Source: IMF.

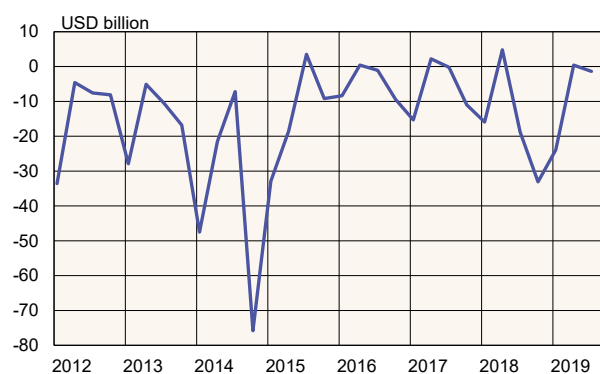
### Russian imports on the rise; modest capital flows.

Preliminary balance-of-payments figures from the Central Bank of Russia show that the value of Russian imports of goods and services in dollars rose in the third quarter by 4 % y-o-y. In the first half of this year, the value of imports still contracted slightly. The value of exports of goods and services shrank slightly in the third quarter by 7 % y-o-y on lower oil prices. This caused the current account surplus to contract on-year in the same period. The total current account surplus for the latest four-quarter period was 96 billion dollars (nearly 6 % of GDP).

The net flow of private sector capital turned slightly negative in the third quarter, amounting to just 1.4 billion dollars.

Most capital outflows came from the banking sector as Russian banks e.g. further trimmed their foreign debt. For the rest of the private sector, the net flow of capital was positive, supported in part by inward FDI flows. The net outflow of private sector capital in January–September amounted to 25 billion dollars declining to some extent from the same period in 2018.

### Quarterly net flow of Russian private sector capital, 2012–2019



Source: Central Bank of Russia.

### Report finds that one in three Russian workers involved in informal employment.

A just-released survey from the Russian Presidential Academy of National Economy finds that about 25 million Russians participate in the grey labour market (i.e. work without an official labour contract, receive part of their salary under the table or moonlight). The survey finds that the share of persons participating in the grey labour market contracted sharply over the past two years, largely because of a decline in moonlighting. Russians now engage much less in off-the-books extra work as the opportunities for such arrangements have become scarcer. Due to country's modest economic development past years, Russian households have needed to cut also from buying informal work and services. In contrast, the number of people who work full-time in the informal market has hardly changed in recent years. Moreover, the survey suggests that the attitude of Russians towards moonlighting has become more positive.

A World Bank report published this summer found that the share of Russians working without an official contract has risen steadily throughout the 2000s. The share is estimated to be in the range of 15–20 % of the employed. This percentage is not particularly high compared to other countries with similar income levels. Growth in informal employment in Russia's case is driven largely by the fact that there has been almost no net job creation in Russia's formal sector for the last decade. The report said that grey labour markets could be reduced through such measures as easing labour mobility between regions, relaxing labour market regulations and raising the education level of the workforce.

## China

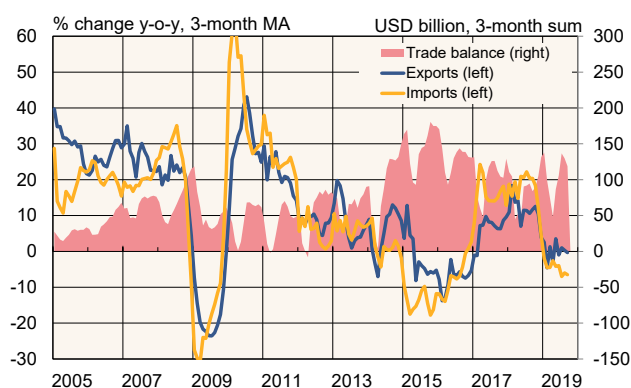
**Negligible results in latest round of China-US trade talks.** Face-to-face trade negotiations between China and the United States took place on October 10–11 in Washington, DC. The parties said they had reached agreement in principle on a temporary arrangement (“phase one”), but the details of the deal remain open. Nothing was signed and there was no clarity on how the talks would proceed. Most of the thorny issues remain unresolved or have been intentionally excluded from the negotiations.

One concrete achievement of the latest round of talks was a promise from China to annually purchase 40–50 billion dollars in agricultural products from the US. The parties have apparently also reached agreement on dispute resolution and implementation mechanisms. The resumption of talks was sufficient for the US to call off its planned tariff hikes set to go into effect in mid-October. Trade negotiations, however, are still clouded by, among other things, US tariff hikes scheduled for December.

**China’s sluggish foreign trade trend continued in September.** China Customs reports that the value of goods imports in September contracted by 9 % y-o-y, while exports were down by 3 %. The goods trade surplus rose to 40 billion dollars in September, bringing the surplus for this year to 300 billion dollars, an increase of 80 billion dollars for the year.

Due to the trade war, goods imports from the United States contracted by 26 % y-o-y in the first nine months of this year. In recent months, imports from the EU and Africa have also started to decline. Chinese imports from Australia have increased, averaging growth of 25 % y-o-y in recent months. China mainly buys commodities from Australia.

### Chinese goods trade and trade balance



Sources: China Customs, CEIC and BOFIT.

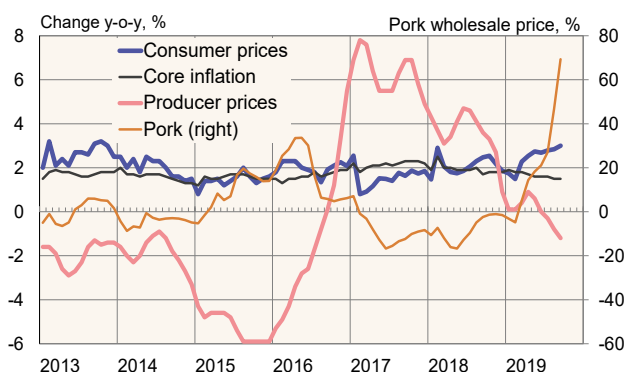
**Pork prices drive up consumer price inflation in China; decline in producer prices accelerates.** Chinese consumer prices in September rose by 3.0 % y-o-y, up from 2.8 % in August. The acceleration in inflation was driven by a nearly 70 % jump in pork prices from September 2018.

Core inflation, which excludes food and energy prices, remained at 1.5 % as in previous months.

Even if inflation has yet to exceed the government’s target ceiling of “about” 3 %, soaring pork prices are a major headache for decision-makers. Just over a year ago, China suffered an outbreak of African swine fever virus that spread more quickly than elsewhere due, at least partly, to systemic and policy errors on China’s part. Pork is a key component of the traditional Chinese diet. To make up for the shortfall, imports have climbed 70–110 % in recent months. The impacts have been far reaching, with pork prices spiking in Europe and elsewhere. Despite increased imports, the rise in pork prices in China continues. On Friday (Oct. 18), wholesale pork prices were up 24 % from the end of September.

China’s producer price inflation sank deeper into negative territory in September, falling by 1.2 % y-o-y. Declining prices erode corporate profitability and make companies reluctant to invest.

### Price trends in China



Sources: CEIC and Macrobond.

**China eases rules for foreign firms operating in the financial markets.** The China Securities Regulatory Commission (CSRC) announced last week (Oct. 11) that limits on foreign ownership in mainland-based futures firms, mutual fund companies and securities firms would be phased out during 2020. The decision allows completely foreign-owned companies to operate in these branches of the finance sector.

While China already earlier promised to scrap ownership restrictions, the trade war with the US seems to have provided incentive to accelerate the process and declare a clear timetable for implementation. The restrictions on futures firms will end next year on January 1, those on mutual fund companies on April 1 and those on securities firms on December 1.

For the moment, foreign firms must still be part of a joint venture with a Chinese partner to operate in the above-mentioned branches. Given the deregulation over the past couple of years, some foreign giants in the financial sector have already acquired majority stakes in their joint ventures. Western firms, however, represent only a tiny share of the Chinese market, and that share is not expected to increase rapidly despite huge interest of Western players in China.



## Russia

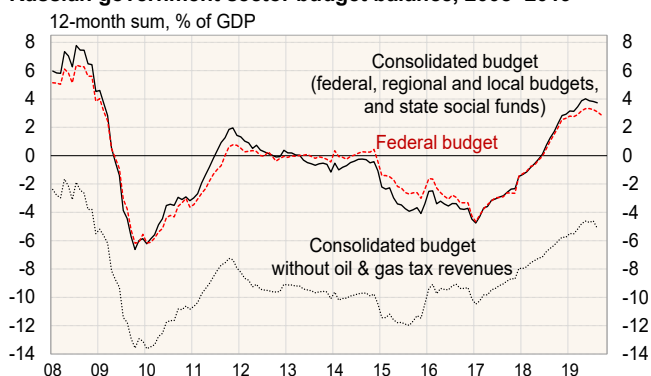
**Russian economy enjoys growth spurt.** Russia's third quarter economic performance was surprisingly strong, but further gains are likely to be short-lived. Growth was driven by industrial production (up 3 %) and agricultural production (up 5 %). Forward-looking indicators, however, suggest that the outlook for industrial output is not rosy. For example, inventories have reached historical highs. Construction and transport activity were about the same as a year earlier.

Consumer demand remains modest. Despite the fastest rise in real incomes in years, on-year growth in retail sales slowed in July-September to below 1 %. Some observers suspect that the recorded 3 % growth in real incomes is overestimated. They are critical of the statistical methods used in determining income trends.

After posting growth in the first half of this year below 1 %, Russia's economy ministry estimates that GDP grew at a nearly 2 % on-year pace in the third quarter. The ministry noted, however, that growth was largely based on transient factors such as inventory build-up and expects growth to slow in the fourth quarter of this year.

**Russia's large federal budget surplus begins to shrink.** Despite the third-quarter reversal, the federal budget surplus for the last 12-month period still amounted to nearly 3 % of GDP. The turn reflects shifts in both revenues and expenditures. After having risen by 10 % in the first half of the year in nominal terms, budget revenues now rose by just about 2 % y-o-y. On-year growth in spending accelerated as expected to 16 % y-o-y in the third quarter, after scoring about 1 % in the first half.

### Russian government sector budget balance, 2008–2019



Source: Ministry of Finance.

Budget revenues from oil & gas taxes went into a tailspin in the third quarter (down 20 % y-o-y) after posting large gains in numerous previous quarters. It was the first decline in oil & gas tax revenues since autumn 2016. Growth in other revenues accelerated and rose to 17 % y-o-y for January-September. More of the gains came from improved tax collection rather than the impact from the VAT hike on January 1, 2019.

Defence expenditures, the sole government budget sector spending category funded entirely from the federal budget, fluctuates considerably within each year. Defence spending turned to sharp rise in the third quarter, lifting spending growth to about 5 % y-o-y for January-September.

**Modest development in Russian incomes continues this year.** While real disposable income of Russians has increased marginally this year, the weak development in previous years puts it on par with the 2011 level. The average Russian income is about 35,000 rubles (500 euros) a month, while the average monthly wage is 45,000 rubles (640 euros) and average monthly pension is 14,200 rubles (200 euros).

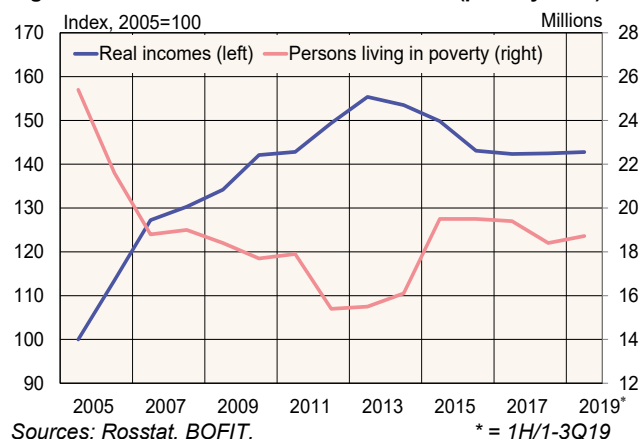
Wealth trends appear similar as income trends. The recent assessment from Credit Suisse finds that the median wealth of Russian adults this year was about 3,700 dollars (3,400 euros), or about the same as in 2012.

Poverty has increased in recent years, but seems to have stabilised at levels last seen about a decade ago. Nearly 20 million Russians (about 14 % of the population) live below the official subsistence minimum. The official subsistence minimum this year is about 11,000 rubles (160 euros) a month per person. A recent survey from the non-governmental Levada Center found that Russians themselves define the poverty level as about 12,500 rubles a month.

The distribution of income and wealth in Russia has not changed notably in recent years. The Gini coefficient, a rough indicator of income disparity, was 0.41 last year. The World Bank finds that income equality is roughly the same as in the United States. Relatively high income equality is found in the Nordic countries (Gini coefficient below 0.3), while the greatest income inequality is typically found in certain countries of Latin America and Africa (Gini coefficient above 0.5).

Russian wealth distribution, however, is among the most skewed in the world. Credit Suisse estimates that the Gini coefficient for wealth distribution in Russia is 0.88, the highest disparity of about 200 countries surveyed. Russia's richest 1 % own nearly 60 % of the country's wealth. In most countries, the share is below 50 %.

### Real disposable incomes of Russians and number of people living below the official subsistence minimum (poverty level)



Sources: Rosstat, BOFIT.

\* = 1H/1-3Q19

## China

**China's economic growth continued to slow in the third quarter.** The National Bureau of Statistics reports that GDP grew by 6 % y-o-y. The growth slowdown has been extremely even: down to 6.4 % in Q1 and 6.2 % in Q2. So, growth has remained within the official government target range of 6-6.5 % this year.

The role of fixed investment as an engine of growth has diminished. In the first nine months of the year, about a fifth of economic growth came from increased fixed investment. In the same period in 2018, fixed investment accounted for over a third of growth. The economic boost from rising consumer demand also waned. Consumer demand accounted for about 60 % of growth this year, down from 80 % in the same period last year. Growth in consumption of services grew faster than other forms of consumption. The NBS reported that services accounted for over half of household consumption demand. Net exports of goods and services have been a positive contributor to growth this year, accounting for about 20 % of first-half GDP growth.

Retail sales grew in the first nine months of this year by 6.4 % in real terms. Weakness in car sales slowed retail sales growth overall. Car sales account for roughly 10 % of retail sales of goods and services. The value of car sales in the official retail sales figures fell by 1 % in January-September. The China Association of Automobile Manufacturers (CAAM) reports that 10 % fewer cars were sold in January-September than in the same period last year. Industrial output growth revived in September, rising to 5.8 % y-o-y.

**China finally changes rules to allow wider operating scope for foreign banks and insurers.** In mid-October, the Chinese government announced rule changes that eliminate or ease restrictions on foreign financial institutions. In principle, the reforms take effect immediately, so the bank and insurance regulator (CBIRC) has promised to expedite guidelines on implementation of the new rules. In the past, however, officials have often used permitting processes to delay implementation of reforms.

In addition to joint ventures with Chinese banks, foreign banks can now open wholly owned subsidiaries and branches under the new rules. Rules on working capital and fields of operation have also been relaxed. The potential customer base of banks has been broadened by halving the required amount of individual time deposit to 500,000 yuan (70,000 dollars). In addition to eliminating ownership restrictions on insurance companies, the government has ended the requirement that firms have 30 year of experience in the insurance business and that they have had a representative office in China for at least two years.

When China joined the World Trade Organization in 2001, it committed to deregulation of financial institutions over the next five years. In fact, the opening up of China's financial sector has proceeded at a snail's pace. The latest

liberalisation measures in banking and insurance make good on promises announced by the government in [November 2017](#) and [April 2018](#). The trade war with the US and the weakening of the economy have increased the urgency to move ahead with reforms. China this year has opened its markets to international [credit ratings agencies](#). In October, China announced that it was eliminating foreign ownership rules on companies involved in [futures trading, mutual funds and securities trade](#) by 2020.

Despite extremely limited opportunities, dozens of foreign financial firms already operate in China. Their impact on the Chinese financial sectors is minimal, however. Foreign firms represent just 1.6 % of the total assets of the Chinese banking sector, and 6.4 % of the Chinese insurance sector.

**Growth in real incomes slows in China; huge income disparities persist.** The NBS reports that the real disposable incomes of households in urban areas have risen at just over 5 % y-o-y this year. Growth in real incomes in 2019 is likely to be lower than at any time in the 2000s.

The slowdown is largely due to higher inflation. The rise in nominal disposable incomes has held steady at 8 % y-o-y for several years now, and will continue to do so this year. The cut in income taxes about a year ago and increased income tax deductions at the beginning of this year have had some impact on income developments. The average monthly income per capita in January-September was 3,550 yuan (460 euros) a month in urban areas and 1,290 yuan (167 euros) a month in rural areas.

The income gaps in China are vast. China's official estimate of the Gini coefficient for income disparity is 0.47, which is already extremely high by international standards. However, the official figure does not include a large chunk of China's top earners. When they are included, the UN's World Institute for Development Economics Research (WIDER) finds that China has some of the largest income differences on the planet (Gini index 0.65).

The rise in incomes and asset prices (particularly housing prices) have boosted Chinese wealth. Credit Suisse's just-released [global wealth report](#) finds that the median wealth of a Chinese adult rose from 9,000 dollars in 2010 to nearly 21,000 dollars at the end of June 2019. That puts Chinese wealth on par with Poland or just over a third of Finnish per capita wealth (56,000 dollars).

Even with large income differences, Credit Swiss finds that the wealth disparities in China are notably smaller than the global average. Nearly a billion Chinese have wealth of less than 100,000 dollars. Over 4 million Chinese are millionaires. Only the US has more millionaires than China.

Due to the long continuous rise in wages and other production costs, China is no longer considered a cheap country for manufacturing. Manufacturing wages are significantly higher than in many other counties in South Asia or South-east Asia. Thus, labour-intensive production has shifted away from China. The current trade war has accelerated the shifting of production elsewhere.

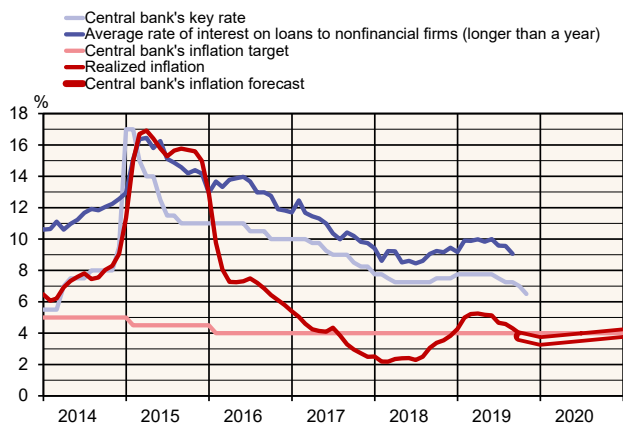
## Russia

**Central Bank of Russia lowers key rate.** Last Friday (Oct. 25), the Central Bank of Russia lowered its key rate by 50 basis points. The new key rate is 6.5 %. The CBR board noted that 12-month inflation has slowed faster than forecasted. The rate cut was fourth in this year. The board also pointed out that the key rate could be cut further at one of the upcoming meetings.

12-month inflation slowed in September to 4 %, and the CBR estimated that it has further decelerated in October. Underlying the slowing inflation are such factors as rather weak economy, ruble appreciation against the dollar (up about 9 % from the start of the year) and a good harvest. The CBR now expects 12-month inflation to slow to a range of 3.2–3.7 % (previously 4.0–4.5 %) at the end of the year, around 3.5–4.0 % at the end of 2020 (previously 4 %) and thereafter remain close to the CBR's 4 % inflation target.

Market rates have declined following the CBR's key rate cuts. In August, the average rate on ruble-denominated corporate loans of more than one year was around 9 %. Ruble-denominated household loans of more than one year averaged around 13 %.

### Russian interest rates and inflation



Sources: Macrobond, CEIC.

**Russia's foreign debt increased slightly this year.** At the end of September, Russia's foreign debt amounted to 470 billion dollars, including about 60 billion dollars in short-term debt. This year Russia's foreign debt has increased by 17 billion dollars, mostly due to rising government-sector borrowing. Non-bank corporate sector debt also rose, while banks continued to pay down debt.

The Russian government's foreign debt at the end of September amounted to 65 billion dollars, its highest level in over a decade. Most of this year's 20-billion-dollar increase in foreign debt came from ruble-denominated debt held by foreign investors. The Russian government has also issued roughly 6 billion dollars in eurobonds this year. Government borrowing is not essential; the federal budget continues to

show large surpluses and excess earnings from oil have been set aside in the reserve fund. In the future, however, the issuance of foreign-currency debt by the government will be complicated by the US sanctions that went into effect at the end of August. The Russian government continues to hold little foreign debt, as it currently corresponds to about 4 % of GDP.

At the end of September, Russian banks still owed 74 billion dollars in foreign debt. However, banks have been actively reducing their bank debt since the 2013 peak of 214 billion dollars. Western sanctions are a key reason for banks paying down foreign debt so aggressively. The foreign debt of the non-bank corporate sector has increased slightly this year, standing at 322 billion dollars at the end of September.

### New information about Russia's military-industrial complex and its bank debts.

Russia's military industrial complex (*Oboronno-promyshlennyi kompleks*, OPK), which comprises over 1,300 firms, accounts for roughly 3 % of Russia's GDP according to analysts at Promsvyazbank, which was formed specifically to provide OPK financing. The OPK revenues of 65 billion euros last year correspond roughly to 2 % of total revenues of all Russian firms and organisations. The OPK provides nearly 2 % of Russian jobs.

Nearly half of OPK revenues in 2018 came from government defence orders, while another fifth came from civilian products and about 30 % from exports of defence products. For meeting the goal set to increase the share of civilian products to 30 % by 2025 requires increased financing from company revenues and banks.

Russia's OPK is currently quite heavily indebted, with its domestic bank debt at 2 % of GDP. OPK debts account for about 5 % of loans extended to the entire corporate sector by the domestic banking sector, but for significantly much more of the bank debt of the manufacturing sector. The ratio of bank debt to revenues in OPK is about 40 %, which is much higher than in the rest of the manufacturing industries. About 3–4 % of OPK revenues go to paying interest on bank loans.

According to deputy prime minister Yuri Borisov, who was raised to his new post last spring, about a third of OPK bank loans need to be restructured, an amount that corresponds to over 0.5 % of GDP. The situation resembles that of late 2016, when the government doled out from the federal budget in one go an amount corresponding to nearly 1 % of GDP in order to help OPK firms repay their bank loans.

OPK bank debts (including problem loans) are largely held by three big state-owned banks, i.e. Sberbank, VTB and Gazprombank. Part of their OPK loans have been transferred to Promsvyazbank, which currently holds about 20 % of OPK bank loans.

President Putin has asked all concerned to find solutions to OPK financing problems. Now the plan is to combine several approaches to deal with the problem loans. The government and creditor banks are considering the proportions to be used in combining remedies such as e.g. extensions of repayment times, recapitalisation of OPK firms with government budget funds and debt forgiveness.

## China

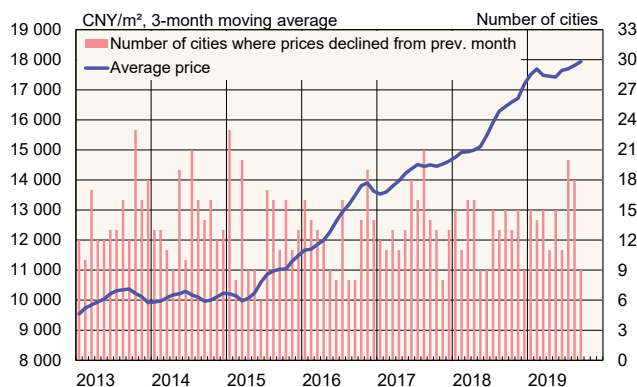
**Chinese housing prices are rising, but huge regional differences persist.** Based on the National Bureau of Statistics (NBS) 70-city sample, prices of existing apartments were up by 5 % y-o-y on average in September, while prices of new apartments rose by 9 % y-o-y. NBS figures indicate that price trends over the past two years have been quite stable and differences between cities range from drops of several per cent to increases of nearly 20 %. Other information, however, suggests that price changes and regional differences in price trends are actually much larger.

SouFun, a major real estate portal that tracks apartment prices, reported that average prices of new and existing apartments in its 31-city sample were up by 11 % y-o-y in September. SouFun's reported differences across cities are larger than those reported by the NBS, with price trends ranging from a 10 % drop in some cities to dozens of percent increases in many others. Prices were down in September from August in nine of the 31 cities in the sample. There were 18–20 cities showing declines in July and August.

SouFun's figures show that apartment prices (measured in liveable floorspace) in September were up on average by 14 % y-o-y in Beijing, 10 % in Shanghai, 12 % in Guangzhou and 6 % in Shenzhen. Among these cities, prices for a square metre of apartment ranged from 57,500 yuan (7,300 euros) in Shenzhen down to 29,200 yuan (3,700 euros) in Guangzhou. The average price in the total 31-city sample was 18,300 yuan (2,300 euros) per m<sup>2</sup>. Housing prices in China, when disposable household incomes are noted, are among the highest in the world.

Housing construction is a fundamental driver of the Chinese economy. While new housing starts in terms of floorspace were still up in the third quarter by 6 % from 3Q18, growth in the volume of new starts faded. In 3Q18, new apartment starts were up by 27 % y-o-y. Construction companies have acquired rights to far fewer lots than a year ago.

### Apartment prices (CNY/m<sup>2</sup>) and number of cities where prices fell from the previous month (31-city sample)



Sources: SouFun-CREIS, Macrobond.

**IMF reports risk exposure of China's financial sector remains large.** The IMF's latest *Global Financial Stability Review* notes that while financial conditions in China are relatively stable, the risks confronting the financial sector are daunting. Problems concern almost all actors in the financial sector, i.e. banks, other financial entities, the non-bank corporate sector and households.

In the latest stability report, the IMF focuses specifically on risks facing the corporate sector where most Chinese debt is concentrated and where there is great uncertainty about the ability of borrowers to service their loans. The IMF estimates that the debt of companies where debt-servicing costs exceed earnings now corresponds to about 35 % of GDP. Such debt is expected to soar to around 70 % of GDP if China experiences a rapid economic slowdown and financing dries up. When corporate revenue is inadequate to service debt, the problems are likely to be manifested in the banking sector.

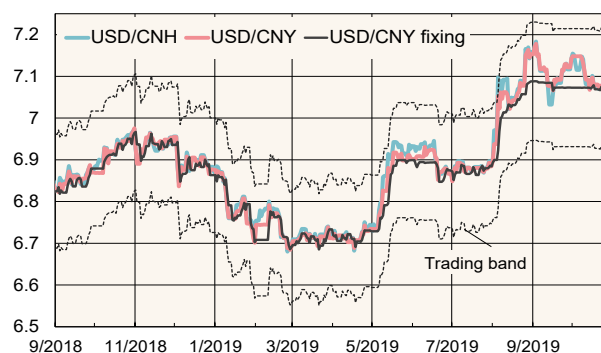
The IMF also called attention to last summer's bailouts of three banks (Baoshang, Jinzhou and Hengfeng) as they highlight the challenges facing small and mid-sized banks. The IMF said it was critical for China to rapidly establish a bank resolution system along with other financial market reforms.

**No major changes in the yuan's exchange rate since August.** In response to the US announcement at the beginning of August of new tariff increases, the yuan's exchange rate weakened to a rate of over 7 yuan to the dollar. At the end of August, the yuan weakened further with the US announcement of new tariff increases, even if they were not implemented after further talks. The yuan has since recovered somewhat. The US has kept its exchange rate concerns, however, at the top of the negotiating agenda in the current bilateral trade talks.

In recent months, central bank's daily yuan-dollar fixing rate has typically been stronger than the market rate. On the markets, the onshore USD/CNY rate is allowed to diverge by up to 2 % from the daily fixing rate. The CNH rate in Hong Kong, which in theory floats freely without limits on its fluctuations, closely tracked the CNY rate throughout October. The rates sometimes diverged during August and September.

The yuan-dollar rate at end of October was 2 % weaker than at the start of the year (the euro rate was unchanged).

### Yuan-dollar rates in mainland China (CNY) and Hong Kong (CNH)



Source: Macrobond.

## Russia

**Final construction permit issued for Nord Stream 2 pipeline.** The Danish Energy Agency last week granted a construction permit for Gazprom's Nord Stream 2 gas pipeline. If the permit goes uncontested, Gazprom can begin laying pipe next month in the waters of Denmark's exclusive economic zone. About 150 kilometres of the 1,230-km pipeline runs through the Danish exclusive economic zone. The pipeline has already been laid in the Russian, Finnish and Swedish zones, and work continues in the southern Baltic Sea. Under the original schedule, the pipeline was to have been completed by the end of 2019. The capacity of Nord Stream 2 of 55 billion cubic meters a year is identical to the capacity of its twin, the Nord Stream 1 pipeline, which was commissioned in 2012.

Great uncertainty still surrounds commissioning of the pipeline. Under the EU's internal gas market rules, individual gas suppliers are limited to using no more than 50 % of the capacity of trunk pipelines. The Nord Stream pipelines come ashore in Greifswald, Germany, from where gas is transmitted southward via the OPAL trunk pipeline. A 2016 decree gave Gazprom the right to use the full capacity of the OPAL pipeline if no other suppliers needed to use it. At the beginning of September, an EU court ruled that Gazprom's exemption on trunk pipeline use was invalid. If the ruling goes uncontested, Gazprom has to supply about 12 billion cubic metres of natural gas to its customers by alternative means. According to Poland, which had sought the ruling, Gazprom will have to import that gas into the EU via Ukraine. Ukraine, the EU and Russia last held talks on gas transiting Ukraine at the end of October, but adjourned without reaching an agreement. The current transit agreement expires at the end of December.

In April 2019, the Council of the EU approved changes in the EU gas market directive. At the start of next year, the EU internal gas market rules shall apply to gas transmission lines between a member state and a third country, up to the member state's territorial borders. It is still unclear how the rules will be interpreted with regard to the Nord Stream 2 pipeline.

**CBR issues monetary policy guidelines for 2020–2022.** Maintaining price stability will remain the top monetary policy priority for the Central Bank of Russia in coming years. This means, in practice, the active pursuit of an inflation target of around 4 % p.a. The main monetary steering instrument remains the CBR key rate (7-day repo rate).

The basic mechanism for implementing monetary policy also remains the same. The CBR will try to keep overnight lending rates on the interbank market close to the CBR's key rate. Money market rates will be guided by absorbing or injecting liquidity into the banking system. In recent years, the CBR has dealt with excess liquidity largely through deposit auctions and the issuance of Bank of Russia bonds. The CBR plans to retain this approach.

Overnight standing facilities that banks can use on a daily basis are used to restrict fluctuations in money market rates. The rates of the overnight standing facilities for absorbing and providing liquidity define the interest rate corridor of the CBR (it has been key rate  $\pm 1$  % for the key rate's entire existence). This steering mechanism has remained in place since end-2013. The CBR notes that steering mechanisms do not require quantitative targets for monetary aggregates.

Based on the CBR's forecast, banks in coming years are likely to experience an increase in their structural liquidity surplus that will boost their deposits in the CBR considerably. Some of this increase will be due to the CBR's daily forex purchases on the domestic forex market. These purchases are fulfilment of forex orders from the finance ministry. According to the government's fiscal rule, it needs to convert the excess earnings from oil taxes into foreign currencies that then go into the reserve fund.

At the same time, the CBR expects its foreign currency and gold reserves to increase quite substantially. In addition to forex buying, the CBR plans to purchase to the reserves more gold, which already makes up about a fifth of its reserves.

The CBR noted that besides monetary policy also other factors can occasionally cause price fluctuations. These factors include changes in food prices, the ruble's exchange rate and official decisions concerning administratively regulated utility rates.

**Russia hosts African leaders at first Russia-Africa summit.** On October 23–24, Russia hosted the Africa-Russia Economic Forum in the Black Sea coastal city of Sochi. Egypt, the current chairman of the African Union acted as co-host. In addition to forum discussions, bilateral meetings between countries took place.

At the forum, experts discussed the possibility for Russia-Africa economic cooperation and Russian officials and corporations showcased Russian expertise, products and services. While Russia does not have large amounts of capital to invest, it has some interesting goods and services to offer to African states. These mainly involve arms, energy production, raw material extraction and food production.

Russia-Africa trade is quite modest, but Russia is not starting from zero. The forum is part of an effort to revive relationships that were formed during the Soviet era.

Egypt is Russia's top trading partner on the African continent. Russian customs reports that last year Egypt accounted for 1.6 % of Russian goods exports and 0.2 % of goods imports. Other African nations accounted for considerably less. In earlier years, Egypt was a major beach vacation destination for Russian tourists. As part of Egypt's plans to develop the Suez Canal area, it is establishing a special industrial zone for Russian firms. China is also involved in developing the same area.

## China

**China's key policy meeting offered no answers to the country's economic challenges.** The Communist Party of China's 19th Central Committee concluded its fourth plenary session at the end of October. In addition to discussing the work report submitted by president Xi, the session focused on modernisation of the current system and improving capacity for governance. The final communique from the meeting, however, consisted largely of antiquated party hype and failed to offer concrete plans for tackling the country's wide-ranging economic issues.

The communique, which otherwise barely mentioned current problems, addressed the unrest in Hong Kong by stressing the importance of the "one country, two system" principle, as well the need to guarantee national security in special administrative regions. Possible changes in the law or other measures contemplated by the party elite for Hong Kong were not clarified.

The plenary session, which plays an important role in the party's decision-making, was postponed for one year without any explanation. The lack of proper information from the session and the empty content of the communique contradict the meeting theme of modernizing the current system.

**Profitability and solidity of China's largest banks stable even as credit risk grows.** A third-quarter reviews of China's biggest banks show that profits at each of the country's four giant banks grew by 5–6 % from 3Q 2018. While the return on equity (ROE) in the banking industry declined slightly overall, annualised returns held steady at just over 10 % at the big banks. The ROE of the banking sector overall in 2015 still exceeded 20 %.

Over half of earnings at the big banks was generated by interest margins, i.e. differences between rates on deposits and lending. Other earnings mostly came from fees. The revenues from securities and forex-related businesses were still a relatively small for banks operating in China.

The total assets of the four biggest banks grew by 5–10 % y-o-y (about the same pace as the nominal GDP). In terms of assets and liabilities, the largest of the four big banks was Industrial and Commercial Bank of China, with total assets about 30.4 trillion yuan (3.9 trillion euros) at the end of September. The other big banks had total asset of just over 20 trillion yuan.

China's big banks appear to be quite solvent. At the end of September, the Common Equity Tier 1 (CET1) readings for all big banks were unchanged from a year earlier. (CET1 is the highest quality of regulatory capital, such as common shares and retained earnings). Readings ranged from 11.2 % to 14.0 %. The international standard Basel III regulatory framework requires a level of 4.5 % at minimum, if other capital requirements are not included.

Bank profits have been dragged down by the growth in non-performing loans (NPLs), which now total 2.2 trillion

yuan for the sector. The situation is the worst in 15 years. International observers claim that the amount of NPLs is actually much larger. The future of the NPL situation is highly dependent on macroeconomic trends in China.

Despite China's implementation of a deposit insurance scheme in 2015, bank runs have been seen in some smaller banks this year, with depositors emptying their accounts at banks they no longer trust. The latest runs hit the Yichuan Rural Commercial Bank and Yingkou Coastal Bank.

**Hong Kong enters recession.** Preliminary figures indicate that Hong Kong's seasonally adjusted GDP fell in July-September by 3.2 % from the previous quarter. As second-quarter growth was also negative (down 0.5 % q-o-q), Hong Kong is now technically in recession. Third-quarter GDP was down by 2.9 % y-o-y. Last year, the special administrative region (SAR) still experienced growth of 3 % y-o-y.

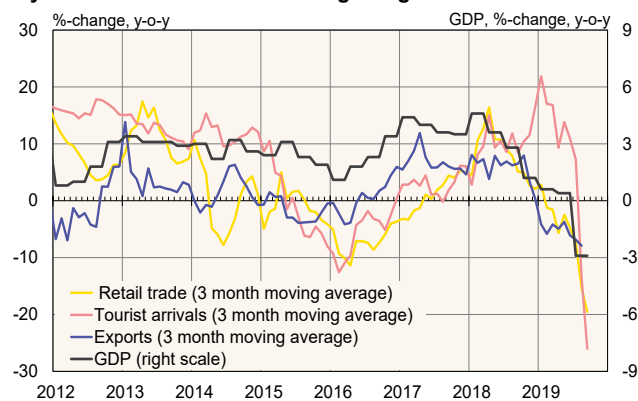
Hong Kong's economy is quite sensitive to shifts in tourism, trade and finance. Indeed, 55 % of the SAR's economy comes from just four branches: financial services, trade & logistics, tourism and professional services. Pro-democracy demonstrations have strongly impacted tourism, of which about 80 % comes from mainland China. Tourism flows began to decline in July and collapsed in August and September. The number of tourists arriving from mainland China fell by about 40 % y-o-y in August-September and the number of tourists coming from elsewhere fell by nearly 30 %. The lack of tourists has hurt retail sales.

The slowing Chinese economy also affects Hong Kong as roughly half of goods trade is conducted with mainland China. The volume of Hong Kong imports in August-September fell by about 10 % y-o-y, while exports were off 7 %.

The provision of financial services for foreign firms operating in China, as well as Chinese firms engaged in international expansion, are critical industries for the Hong Kong economy. Moreover, mainland Chinese have invested heavily in the local real estate market. However, there are currently no signs of major capital flight from Hong Kong.

The Markit purchasing manager index plunged from a slightly negative reading of 48 in June to 39 in October.

### Key economic indicators for Hong Kong



Source: Macrobond.

## Russia

**Russian economic growth accelerated.** Rosstat's preliminary estimate puts third-quarter GDP growth at 1.7 % y-o-y, well above the 0.7 % rate for the first six months of this year. The acceleration in GDP growth apparently reflects higher export volumes and inventories, as there have been few signs of any revival in domestic demand. Retail sales growth in the third quarter slowed to just 0.8 % y-o-y, a decline from the 1.8 % pace set in the first half of this year. Construction has remained practically flat for the entire year. Our latest *BOFIT Forecast for Russia* expects GDP growth of around 1 % this year.

**Russian stock exchange on the upswing.** In recent weeks, the RTS (Russian Trading System) index, Russia's core dollar-denominated stock index, has climbed to levels not seen since 2013. The rise in share prices has been driven by oil & gas companies, which account for about half of the RTS index weighting. The sub-index for companies in the oil & gas sector has risen to its highest levels in over a decade. The trends in other sectors have been more modest. Weak private consumer demand in recent years has hurt the performance of companies in the consumer sector. The financial sector sub-index has been depressed by such factors as Western sanctions and problems at certain banks.

The Russian media conglomerate RBK recently compiled a list of Russia's fastest growing companies. Oil & gas companies are the most numerous in the list. The top ten also include companies involved in building infrastructure for the energy sector, metal ore mining, as well as firms involved in agriculture and the gaming industry. A similar list produced by the *Financial Times* for fast-growing firms in Europe is dominated by technology and e-commerce firms.

### Russia's RTS stock index and some sectoral sub-indices



Source: Macrobond.

### Russian foreign trade development remains muted.

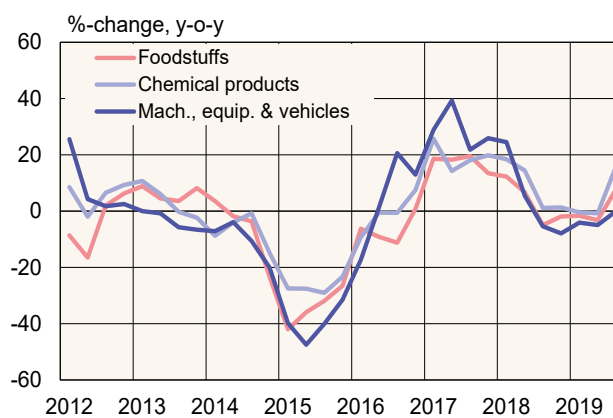
The value of Russian goods exports contracted by 5 % y-o-y in the first nine months of this year to a level of 390 billion

dollars. The contraction mainly reflected lower oil prices. Combined export volume of crude oil and oil products grew by 1 % y-o-y. While the volume of natural gas exports through pipelines declined slightly, exports of liquefied natural gas (LNG) soared with the ramping up of production on the Yamal peninsula this year. Oil & gas still accounted for nearly two-thirds of Russia's exports. Other important export products include metals (9% share) and chemical products (6 %). While metal exports have contracted this year, exports of chemical products have grown slightly.

The value of Russian goods imports in January-September was essentially unchanged from a year earlier, holding at around 175 billion dollars. While growth in imports of chemical products and metals was modest, imports of machinery, equipment & transport vehicles contracted slightly. Machinery, equipment & transport vehicles accounted for nearly half of imports. Other major import categories included chemical products (19 %) and foodstuffs (12 %).

The EU accounted for 45 % Russian goods exports and 36 % of goods imports. China was Russia's largest individual trading partner, accounting for 13 % of exports and 22 % of imports. Countries in the Eurasian Economic Union accounted for just under 10 % of both exports and imports.

### Change in value of Russian imports in select product categories



Sources: CEIC and BOFIT.

### Russia prepares new measures to support firms subject to Western sanctions.

In order to systematise subsidies, Russia's finance ministry has proposed a legal distinction for firms subject to Western sanctions. While the relevant subsidies have yet to be defined, suggestions include looser forex rules and the possibility of not disclosing certain economic information. The finance ministry is even contemplating the establishment of a separate stock exchange for sanctioned firms to help them raise financing. Russia's ministry of industry and trade has proposed favouring firms subject to Western sanctions in public procurements.

The proposed measures are feared to further reduce competition, weaken transparency in the economy and increase opportunities for various abuses.

## China

### Rising inflation limits monetary easing in China.

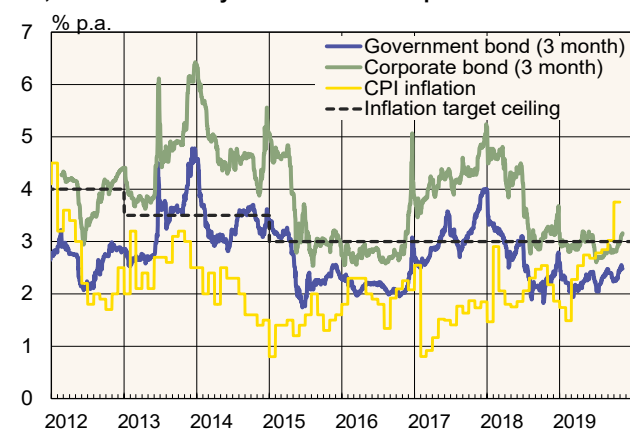
Consumer prices rose 3.8 % y-o-y in October, outpacing the government's target ceiling of 3 %. Inflation target in China is, however, not as critical a component of monetary policy as in many other countries. The setting of the inflation target occurs at the National People's Congress in March along with setting of many other key figures used to provide economic guidance.

The National Bureau of Statistics reports that higher prices of pork boosted consumer price inflation by 2.4 percentage points in October, when wholesale and retail pork prices were up more than 100 % y-o-y. Core inflation, which excludes food and energy prices, has held at 1.5 % since August. Producer prices fell by 1.6 % y-o-y in October.

Given the difficult economic situation, China's decision-makers must reconcile many contradictory pressures when setting monetary policy. The People's Bank of China this month slightly lowered the rate on its one-year medium-term lending facility (MLF) for commercial banks from 3.3 % (the rate set in April 2018) to 3.25 %. In August, the PBoC introduced a new reference rate for the pricing of bank loans based on the MLF rate ([BOFIT Weekly 34/2019](#)). Money market rates have remained fairly stable this year.

The stock of bank loans continued to grow at a rate of 12 % y-o-y in October. Growth has remained at around 12–13 % for over three years. The use of financial instruments in China's shadow banking sector, however, has been on the decline for more than a year.

### CPI, 3-month treasury bond and AAA corporate bond rates



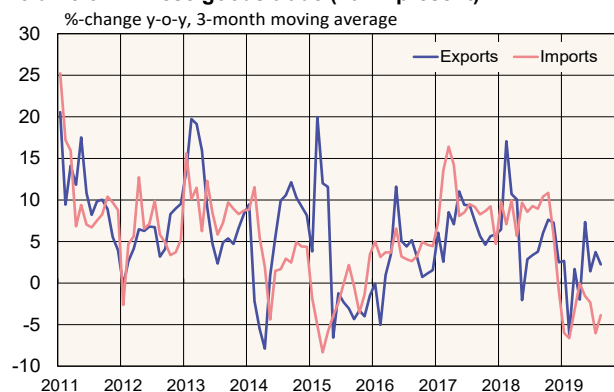
Source: Macrobond.

### Chinese imports continued to contract in October.

China Customs reports that the value of goods imports measured in dollars contracted by 6 % y-o-y in October. Exports were down by 1 %. In the first ten months of the year, imports were down 5 % y-o-y. Exports remained unchanged, however, so China's foreign trade surplus increased. For the January-October period, the trade surplus amounted to 340 billion dollars, close to the value of the entire 2018 surplus.

While price and exchange-rate shifts explain some import trends, the decline in imports largely reflects lower import volumes. During the first eight months of this year, monthly goods import volumes were off about 3 % y-o-y on average. For example, the import volume of machinery & equipment was down 5 % on average, while vehicles were off by over 10 %. In contrast, the volume of exports increased by a couple per cent. The net impact from foreign trade has been to support real economic growth.

### Volume of Chinese goods trade (2011–present)



Sources: China Customs, CEIC and BOFIT.

### China and 14 other Asia-Pacific nations prepare to sign RCEP trade pact next year.

At a summit in Bangkok, Thailand early this month, the representatives of ten ASEAN countries, plus South Korea, Japan, China, Australia and New Zealand, announced they had reached agreement on the terms of the Regional Comprehensive Economic Partnership (RCEP). The trade agreement will be signed next year if no problems emerge in the review phase.

While details of the agreement have yet to be revealed, it is clear that the agreement is less ambitious than the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) free-trade agreement that partly entered into force at the end of last year. Seven CPTPP countries are also part of the RCEP agreement. Media reports note that the RCEP agreement focuses on goods trade and mainly unifies bilateral tariff arrangements of its members. Customs tariffs will decline in many fields. Some observers note that the agreed unification of rules of origin may be even more important than lower tariffs as it promotes production chains within the region.

Countries acceding to the RCEP trade pact represent almost 30 % of the world's population and global GDP (in nominal dollar terms). The agreement's economic impacts are expected to be relatively modest, however, and further diminished by the long transition periods.

China, which accounts for 62 % of the population in the RCEP area and 54 % of its nominal GDP, strongly supports the trade agreement. India withdrew from the agreement after it failed to gain concessions for its agricultural sector. India also feared that its participation in RCEP would lead to a flood of Chinese products onto its market.



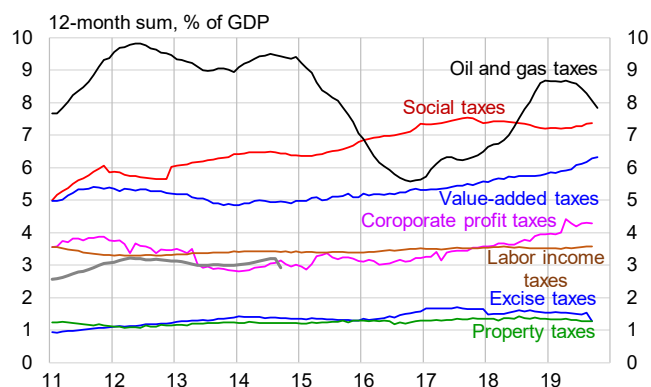
## Russia

**Growth in Russian government sector spending accelerates.** Expenditures of the consolidated budget (federal, regional and municipal budgets, plus state social funds) increased in the third quarter by 13 % y-o-y, pushing growth for January-September to over 7 % y-o-y, which became quite close to the finance ministry's forecast for all of 2019. Despite a sharp drop in revenues from oil & gas taxes, third-quarter growth of total budget revenues matched the first-half pace, scoring 13 % y-o-y. While the 12-month consolidated budget surplus shrank from its 4 % of GDP peak in May, it still equalled 3.3 % of GDP in September.

Spending growth accelerated in the third quarter in nearly all major categories. For the January-September period, the housing sector's budget spending rose by about 25 %. The rapid growth in healthcare spending that began last year continued (nearly 13 %), as did growth in education spending (about 10 %). Growth of spending allocated to various sectors of the economy rose to 8 % in the first nine months of the year, while spending on social support, administration and defence was up 5–6 %.

Increases in tax revenues other than those from oil & gas taxes remained brisk in the third quarter. The hike in the value-added tax at the beginning of this year helped sustain VAT revenue growth at a nearly 20 % pace. The share of VAT revenues rose to 18 % of total budget revenues in January-September, approaching the same scale as the revenue streams from mandatory employer social taxes and oil & gas taxes (20–21 %).

### Major government sector revenues in Russia, 2011–2019



Source: Russian Ministry of Finance.

**Capital amnesty law put to a test in Russia.** With many Russians believed to have moved assets out of the country to avoid taxes or hide wealth from the authorities, the government introduced a capital amnesty programme intended to encourage individuals or corporations to declare their foreign assets and repatriate their wealth to Russia. Under the capital amnesty law, anyone declaring assets abroad is not required

to specify the origin of their foreign wealth and their declarations are immune from further legal or administrative consequences.

The first round of capital amnesty (originally planned to be a one-time affair) took place in 2015–16. The second round was organized in 2018–19. The finance ministry reports that during the first two rounds a total of 19,000 declarations on assets worth about 35 billion euros have been filed.

The third round of amnesty, which lasts through February, requires that any declared assets held in foreign banks be transferred to Russian banks. Additionally, companies registered abroad must either be shut down or registered in one of Russia's two domestic "tax havens" (i.e. the special administrative regions, SARs, created just over a year ago in Kaliningrad and Vladivostok). About a dozen firms have so far registered in the SARs. Most of these companies are connected to the oligarch Oleg Deripaska, who is on the US sanctions list.

Capital amnesty documents confiscated by Russia's federal security service, the FSB, have been used this autumn as evidence in an ongoing court case against businessman Valery Izrailit on illegal money transfers abroad in connection with the construction of the Ust Luga port. The legality of using amnesty documents has since been contested in several court instances. The case was also brought to the attention of president Vladimir Putin, who emphasized when the law went into force that the information from amnesty filings should not be abused by officials. The Supreme Court of Russia has now ruled that information provided under capital amnesty act cannot be used as evidence. Similar internal contradictions of the Russian system were on display in last spring's Baring Vostok case ([BOFIT Weekly 23/2019](#)).

**Russia brings in a hearty harvest.** Two years ago weather conditions were very good, but last year heat and drought reduced the harvest. This year weather was again rather favourable. Harvests in the first ten months of this year were up 7 % y-o-y for grains and pulses, 20 % for sunflowers and 24 % for sugar beets. The harvests of potatoes and other vegetables were roughly similar to those of 2018.

Food prices tend to react to the size of the harvest. They were pushed down by bumper harvest in 2017 and pushed up by meagre harvest last year. This year's fairly good harvest has again stemmed the rise in food prices. Whereas from last October to this October overall consumer prices rose by 3.7 %, food prices grew by 4.2 %.

Over the past decade, cultivation of sunflowers, rapeseed and soybeans has soared, with about 15 % of cultivated land now dedicated to their cultivation. About half of cultivated land is dedicated to growing grain and about 20 % to fodder crops.

Animal husbandry has experienced a gradual evolution over the past decade. The number of cattle in Russia has been declining at 1 % a year, the number of pigs and chickens has risen at 4 % a year, and the number of goats and sheep seems quite stable. These trends have generally held from year to year, but the increase in chicken numbers has slowed.

## China

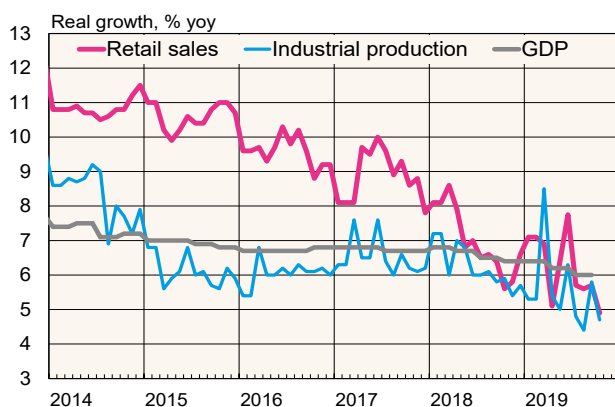
**Growth of Chinese retail sales and industrial output slowed in October.** China's National Bureau of Statistics reports that real growth in retail sales in October was just 4.9 % y-o-y, down from 6.4 % in the first nine months of this year. Industrial output growth slowed from 5.6 % in January-September to 4.7 % in October.

Slow car sales continued to drag down growth in retail sales in October. The value of online sales of goods and services was up by over 16 % y-o-y in the January-October period. Nominal growth, however, slowed considerably from 26 % in January-October 2018.

Mobile phone sales have been on a long downward trajectory in China, dropping to just 323 million units sold domestically in the first ten months of this year, a decline of 6 % y-o-y. The number of new phone sales peaked in 2013, when 478 million phones were sold in the same period. Chinese makes accounted for 91 % of new phone sales this year.

Nominal growth in fixed asset investment (FAI) in the first ten months of this year was just over 5 %, so estimated real growth was just over 2 %. Investment of government and government-owned enterprises rose by over 7 % in nominal terms, while private investment growth remained at 4 %. Thus, the situation has reversed from last year, when private firms still drove investment growth. Nominal growth of infrastructure investment in January-October was only around 4 %. Growth in real estate investment, on the other hand, continued to rise at over 10 % y-o-y. Measured in terms of floorspace, new construction starts in the first ten months of this year were up 10 % y-o-y. Real estate sales, measured by floorspace, were unchanged from a year ago.

### Retail sales, industrial output and GDP growth



Sources: Macrobond and BOFIT.

**China enjoys good grain harvests; declining meat production boosts imports.** Nearly all of the wheat and maize crops have been gathered, along with the bulk of the rice crop. Based on October estimates, China's agriculture ministry reports that the grain harvest this year should ex-

ceed 650 million metric tons, putting it on par with other harvests of recent years. FAO figures show that China is the world's largest producer of rice (28 % of global production) and wheat (17 %), as well as the second-largest producer of maize (23 %) and fourth-largest soybean producer (4 %).

Bumper harvests have diminished China's food imports and increased its exports. China is mainly a net importer of soybeans and barley (it imports also small amounts of wheat and maize relative to its own production). Rice is China's main export crop. Chinese policy calls for self-sufficiency in staple grains.

Meat production contracted by 8 % y-o-y in January-September. The African swine fever virus has decimated pork production, causing pork prices to skyrocket. Poultry, beef and lamb prices have also risen sharply, with production increasing by 2–10 % y-o-y. China is the world's largest producer of pork (46 % of global production), as well as lamb & mutton (25 % global share). It is also the world's third-largest producer of chicken (12 %) and beef (10 %).

With the contraction in pork production and higher meat prices, China has turned to buying more meat from abroad. China imported 35 % more meat in the first nine months of this year than in the same period last year. At the same time, meat exports have fallen. The trend impacts all types of meat. The sharpest increases in meat imports were seen in beef (up 53 %), chicken (48 %) and pork (44 %).

**Lower growth in Chinese real wages.** The *2020 Global Salary Forecast* from the American consulting firm, Korn Ferry, sees average global real-wage increases to accelerate to 2.1 % next year. Growth remains highest in Asia, where on-year growth in real wages should accelerate to 3.1 %. The slowdown in Chinese real-wage growth, however, is expected to continue next year.

Korn Ferry's assessments are based on wage forecasts provided by their client organisations in surveyed countries. Nominal wages in China are expected to rise by 6 % next year, effectively matching this year's wage forecast. However, with inflation picking up, real-wage growth in China should decline from 3.2 % this year to 2.9 % next year. While these are merely forecast figures, they indicate a general slowdown in real-wage growth. In Korn Ferry's client organisations at least, wage-increase expectations appear to be much lower than official output growth figures.

NBS on-year figures show that the 2018 nominal average monthly wage in public organisations in urban areas was 6,870 yuan (880 euros), a 10.9 % increase from 2017. The average wage in 2018 rose by 8.8 % in real terms. The average private-sector wage was just over 4,100 yuan (530 euros).

Official figures indicate that last year the average wage at a public-sector-owned manufacturing firm was around 6,000 yuan (770 euros) a month. According to media reports, the basic wage at a privately held electronic assembly plant is currently on the order of 3,000 yuan (380 euros) a month. With overtime, monthly earnings rise to 4,500–5,500 yuan (580–700 euros) a month.

## Russia

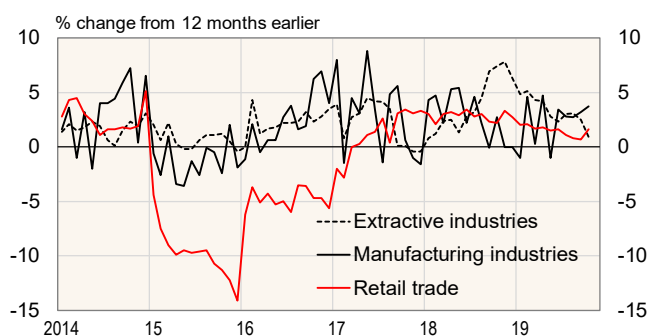
**Russian economic growth remained moderate in October.** Russian manufacturing growth in October accelerated to above 3.5 % y-o-y (growth averaged just over 2 % in the first nine months of this year). The higher growth in October largely reflected a jump in oil refining output, a branch that experienced fairly weak growth in the previous six months. Growth in extractive industries, however, fell to an unusually low level of less than 1 % with simultaneous contractions in oil and gas production, a situation not seen in two years.

Agricultural production continued to show robust growth, and the nearly 4 % growth in January-October points to similar figures for the whole year. Construction activity rose in October by 1 % y-o-y, which was somewhat better than the below 0.5 % pace of January-October. Like in the third quarter, the volume of goods transported fell slightly in October, but still diverged sharply from the strong growth seen in previous years and in the first half of this year.

Growth in fixed investment improved slightly in the third quarter, but was still below 1 % y-o-y. Growth was just 0.7 % y-o-y in the first nine months of 2019.

Retail sales growth recovered from its slow pace late this summer to over 1.5 % y-o-y in October, the pace for the January-October period. Growth in real household incomes strengthened in the third quarter. Consumer credit continued to support the recovery in consumption, even if that credit support impulse has been lower than in 2018. The growth of consumer borrowing flow has been lower this year than in previous years, even if it still outpaced inflation.

### Real growth in Russian industrial output and retail sales



Source: Rosstat.

**Russian gas giant Gazprom share package to unknown buyer.** Gazprom, one of Russia's largest listed companies, sold 3.6 % of its shares via the Moscow Exchange last week. The offered shares had been held by a Gazprom subsidiary, and the offering was valued at around 190 billion rubles (2.7 billion euros) as the shares sold at an 11 % discount to the closing price preceding the placement.

A similar type of sale took place last July, when Gazprom subsidiaries sold a 2.9 % stake in parent-company shares. The offering at that time was valued at around 140 billion rubles (2 billion euros) and the shares were also sold at a small discount. In both rounds, all offered shares were purchased by a single unidentified investor.

Even with the offerings, the majority of Gazprom shares continue to be held by the Russian government. Gazprom estimates that its free float has now risen to 49.6 % of the share capital. Gazprom has a 15 % free-float weighting in the Moscow Exchange's RTS index, which is calculated in dollars.

**Global energy market trends not expected to cause big changes for Russia in near term.** The base scenario used in this year's *World Energy Outlook* from the International Energy Agency (IEA) foresees slow growth in global demand for oil & gas in the years ahead, with the oil price climbing gradually to around 80 dollars a barrel by 2025. The emphasis in demand growth should shift increasingly to Asia.

In the IEA's base scenario, global oil demand grows at 1 % a year until 2025, with most demand growth coming from Asia, particularly China and India. EU oil consumption is expected to fall by just over 1 % a year. Growth in oil production should come mainly from the US. Russian oil production will remain close to current levels as it is restrained by a voluntary production ceiling agreement with OPEC and the depletion of current fields under production. High costs and Western sanctions complicate Russian efforts to bring new oil fields on stream.

The IEA expects growth in global demand for natural gas to average slightly less than 2 % a year until 2025. Again, most growth in demand will come from Asia, mainly China. No growth is expected in EU gas demand. The IEA estimates that Russian natural gas output will rise at just under 2 % a year on average until 2025.

While the IEA's base scenario "Stated Policies" takes into account the energy policies announced by various countries, the report also offers two alternative scenarios. In the first alternative scenario, current policies continue and oil & gas demand rise slightly faster than in the base scenario. The Sustainable Development scenario is aligned with the Paris climate accord. Global oil demand begins to decline in the near future, while gas demand up to 2025 grows at only about half the rate of the base scenario.

Crude oil, oil products and natural gas remain major export products for Russia. Their aggregate export value last year amounted to 260 billion dollars (16 % of GDP), accounting for 45 % of Russia's total exports of goods and services. While the EU is Russia's largest export market for oil & gas, its share of exports will likely decline in coming years as the focus of demand growth continues to shift to Asia. China accounted for over 25 % of Russian oil exports last year, while its share in gas exports was small. China is set to become a more important export market for Russia also in gas, however, with the launch of LNG production on the Yamal peninsula and the commissioning of the Power of Siberia pipeline.

## China

**Increased risks to financial system worry China's central bank.** The *Financial Stability Report* released by the People's Bank of China this week warns of considerable risks accumulating in the financial sector due to the ongoing slowdown in economic growth and structural economic problems it exposes. The report notes, however, that risks related to key actors have no more increased.

The PBoC performed stress tests on 30 large and mid-sized banks. The tests revealed that the quality of loan portfolios held by the sampled banks would rapidly degrade in the event of an economic slowdown. Even in the rather benign scenario, where real GDP growth falls to 5.3 % p.a., the stock of non-performing loans rises from 1.5 % to 5.4 % of all loans, while capital adequacy ratios fall from 14.5 % to 13.5 %, a level the PBoC still considers satisfactory.

Based on its risk assessment, the central bank divides into ten categories the various financial sector entities subject to banking supervision (e.g. all banks, corporate financial institutions, car finance companies, consumer finance companies and finance leasing companies). Risk is small for most large banks, but some carry mid-level risk level. In contrast, 586 actors out of 4,355 small and mid-sized financial institutions fall into the high-risk category. The PBoC says private and foreign financial companies typically receive good scores, while many rural banks belong in the high-risk category.

Indeed, the government has had to bail out some small and mid-sized domestic banks this year. At the end of May, officials took over Baoshang Bank. In July and August, public funds were expended on recapitalising the Jinzhou and Hengfeng banks. In November, the government bought out the stakes of six private shareholders in Harbin Bank. October and November also brought runs on the small Yingkou and Yichuan banks. The runs occurred despite the fact that Chinese deposit insurance fully covers deposits up to 500,000 yuan (nearly 65,000 euros). Increased uncertainty has driven up financing costs for small banks, forcing them to raise their deposit rates to attract new depositors and retain long-term depositors.

**China's central bank plans to issue its own digital currency in the future; details still sketchy.** The People's Bank of China hopes to implement an electronic form of yuan to complement, rather than compete with, traditional yuan notes. The innovation is unlikely to have an immediate impact on bank deposits. As planned, households and small firms would be able to store and use the new electronic money in common types of payment transactions.

None of the technical solutions employed or the launch dates for this new kind of money have yet been announced. Rumours on these details circulating in the media seem often to be baseless speculation.

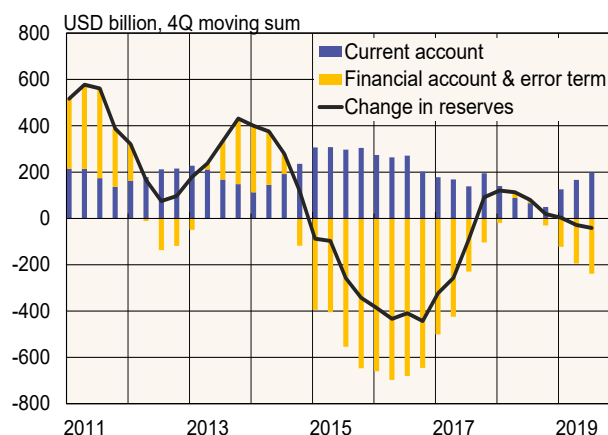
**PBoC tightens control of bitcoin and other cryptoasset services.** Activities involving cryptoassets in China are strictly regulated or banned. When initial coin offerings (ICOs) were forbidden in 2017, the government also cracked down on trading in cryptoassets, forcing crypto exchanges out of business. Banks are not allowed to get involved in any form of cryptoasset services. Even a ban on the "mining" of cryptoassets was briefly considered.

Despite the bans, interest in cryptoassets flourishes. Last week, the Shanghai division of the PBoC shut down several illegal cryptoasset operations. Inspections in Shenzhen also turned up similar illegal activities. As a lot of Chinese evidently still use virtual assets, stricter policies may affect prices of virtual currencies such as bitcoin.

**Capital outflows from China continued in the third quarter.** Preliminary balance-of-payments figures show a current account surplus of 59 billion dollars in the July-September period. The 12-month current account surplus has increased to about 1.4 % of GDP. Much of the increase was caused by lower value of goods import and a reduction in the services trade deficit. The change in currency reserves this year has been small. Overall, this translates into an increase in net capital outflows, which is measured as the sum of the financial account and the "net errors and omissions" term in the balance-of-payments accounting.

Later revisions of balance-of-payments data could alter the view on how much capital actually flowed out of the country. Revisions for the first two quarters of 2019 have produced reductions in the current account surplus by nearly 30 % from preliminary estimates. Using the new estimates, the amount of the net capital outflows diminished slightly. In the first half of this year, the outflow of capital was in fact "unclassified" and showed up in the net errors and omissions term which was clearly negative. The combined recorded figures for the capital and financial accounts indicated a small surplus.

Trends in China's balance-of-payments, 2011–2019



Sources: Macrobond, SAFE and BOFIT.

## Russia

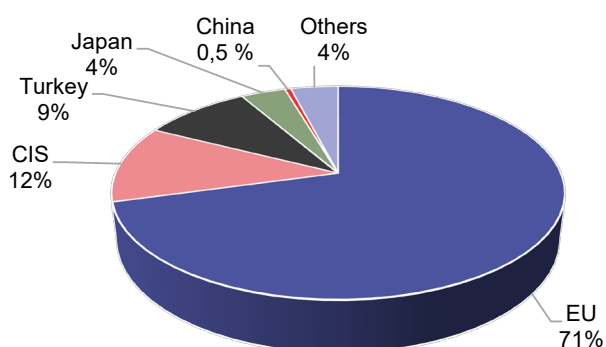
**Russia commences pipeline transmission of natural gas to China.** On Monday (Dec. 2), presidents Vladimir Putin and Xi Jinping celebrated the commissioning of the Power of Siberia natural gas pipeline. Gas transmission will ramp up gradually. In 2020, the volume of gas transmitted should reach 5 billion m<sup>3</sup>. Full capacity of 38 billion m<sup>3</sup> a year should be achieved in 2024.

Russia and China reached an agreement on construction of the pipeline and gas supplies after years of talks that culminated in spring 2014. At that time, the parties signed a 30-year agreement on annual shipments of 38 billion m<sup>3</sup> of pipeline gas per year from Russia to China. To meet the contract terms, Russia's state-majority-owned gas giant Gazprom needs to develop two new gas deposits in Eastern Siberia and build the 3,000-kilometre pipeline for transporting gas to the Chinese border.

The first leg that was now commissioned runs for 2,200 km from the newly developed Chayandinskoye field in Yakutia to the border city of Blagoveshchensk. From there, gas is piped under the Amur river to China. The pipeline is the sole transmission connection of the Chayandinskoye field and therefore gas can be exported from there only to China. By 2022, the Power of Siberia pipeline should be extended another 800 km west to connect with the Kovyktinskoye gas field that is under construction.

Russia's total natural gas exports amounted to nearly 250 billion m<sup>3</sup> last year. About 175 billion m<sup>3</sup> of that went to EU countries. China's share of exports was less than 1 %. The start of pipeline gas exports to China has no direct impact on Russia's gas business with EU customers. Pipeline gas exported to China comes from a newly developed gas field and that gas cannot be shipped to another foreign market.

Russian natural gas exports by region, 2018



Source: BP.

China last year imported roughly 120 billion m<sup>3</sup> of natural gas. The International Energy Agency (IEA) expects imports to reach nearly 290 billion m<sup>3</sup> by 2030. China's most im-

portant gas suppliers last year were Turkmenistan and Australia, each providing China with just over 30 billion m<sup>3</sup> of gas. Russia accounted for only about 1 % of Chinese gas imports in 2018.

**First highway bridge across the Amur river joining Russia and China is finally ready.** China and Russia signed an initial agreement on construction of the Amur road bridge in 1995. Construction halted almost immediately due to the lack of financing. A second agreement was penned 20 years later, with construction getting underway in earnest in December 2016 with financing from a Chinese bank.

The thousand-metre bridge over the Amur links the city of Blagoveshensk in Russia's Far East with Heihe in Northeastern China. Russia and China were each responsible for building half of the bridge. China completed its portion in autumn 2018 at an estimated cost of about 5 billion rubles (70 million euros). Russia completed its section in late November this year at a price of nearly 14 billion rubles (200 million euros). The bridge is set to open to goods traffic next spring, and passenger traffic is expected to begin in mid-2021 once Russia builds border-crossing infrastructure.

China is a key economic partner for Russian Amur region. China last year accounted for over 90 % of the region's exports and nearly 75 % of its imports. The stock of Chinese FDI in the region was about 60 million dollars at the end of last year. China is the region's second-most important FDI provider after Cyprus (Russian investors often cycle investment via Cyprus). A recent BBC investigation found that at least 10 % of land under cultivation in the Amur region was controlled by Chinese entities.

**Small recovery in Finnish exports to Russia.** Finnish goods exports to Russia rose by 28 % y-o-y in 3Q19. Much of the growth came from gas pipeline deliveries to the Nord Stream 2 project. The pipe sections were brought from Russia to Finland for coating, meaning that they were initially recorded as imports to Finland from Russia, then treated as exports from Finland to Russia. Even when gas pipeline activity is omitted, the pace of growth in Finnish exports to Russia accelerated after the first half of the year, rising at about 7 % y-o-y in 3Q19. The fastest growth was seen in exports of foodstuffs and paper products. Russia was Finland's fourth-largest export market, accounting for nearly 6 % of Finnish exports.

The latest survey from the Finnish-Russian Chamber of Commerce suggests export growth could continue. The survey covers over 200 Finnish firms involved in trade with Russia and 40 % of respondents expected their exports to Russia to increase at least to some extent over the next six months.

The value of Finnish goods imports from Russia contracted by 9 % y-o-y in the 3Q19. The value of imports was mainly dragged down by lower oil prices, but imports contracted in all major product categories. After Germany, Russia was Finland's second most important import provider, accounting for nearly 14 % of Finland's imports.

## China

**New NBS census data confirms growing importance of China's service sector.** The results from the census, which was conducted by the National Bureau of Statistics in 2018 and shows the situation at the end of last year, were released last month. The previous census was conducted in 2013. Over the following five years, the number of entities (mainly corporations) operating in the industrial or service sectors doubled to nearly 22 million. The number of employees rose by 7.6 % to 383 million. The survey did not cover the agriculture sector.

About 18.6 million of the organisations surveyed were corporations, up from 8.2 million in the 2013 census. Of the 18.3 million domestic firms in this group, 72,000 were state-owned enterprises (113,000 in 2013). The census found 103,000 foreign firms (106,000 in 2013) and 119,000 (97,000) firms from Hong Kong, Macao or Taiwan. The census also looked at 1.1 million state institutions, 305,000 social organisations and 1.8 million other legal entities.

38 % of the 383 million persons employed in the industrial and service branches were women. The number of industrial employees declined by 20 million from 2013 (down 10 %), while the number of employees in service branches rose by 47 million (up 29 %). The number of self-employed units rose to 63 million (33 million in 2013) and they employed 149 million persons (90 million in 2013), of which 46 % were women.

The census data have been used, among other things, to update last year's nominal GDP estimate, which was boosted 2.1 % to 91.93 trillion yuan (13.9 trillion dollars). The value of services output was adjusted up by 4.3 %, with the service sector accounting for 53.3 % of GDP and the industrial sector 39.7 %. Revised real GDP figures have yet to be released.

### Number of firms and employees by branch in 2018

Thousands	Firms*	Firm's employees *	Employees of self-employed
<b>Industry</b> , of which	4 630	172 558	26 111
- mining	70	5 960	85
- manufacturing	3 270	104 713	16 374
- construction	1 218	58 091	9 503
<b>Services</b> , of which	17 159	210 677	123 201
- commerce	6 499	40 085	64 432
- hotels and restaurants	431	7 069	22 353
- IT and software	920	10 107	448
- finance	138	18 316	-
- real estate	745	12 689	1 717
- business services	2 551	22 901	2 993
- public admin. & social security	1 597	25 087	-
<b>Total</b>	<b>21 789</b>	<b>383 236</b>	<b>149 312</b>

Sources: NBS and BOFIT. \*Corporations and other legal entities.

**After long hiatus, Chinese government again issues euro-denominated bonds.** Last month, China's finance ministry issued euro-denominated debt for the first time in 15 years. The 4-billion-euro issue carried maturities of 7, 12

and 20 years. The 7-year eurobond yields 0.2 % and the 20-year eurobond 1.1 %.

The finance ministry also issued 6 billion dollars in dollar bonds last month with yields 0.35–0.7 percentage points higher than similar yields on US treasuries. After a 13-year pause, China has issued dollar-denominated debt for the past three years. The debt issued by the Chinese government is a key benchmark for corporate foreign-currency debt.

The foreign debt of Chinese businesses at the end of June totalled about 2 trillion dollars (14 % of GDP). About half of that was debt of banks, just over 10 % of finance ministry and central bank, with the remaining 40 % of other actors. Dollar debt (55 % share) dominated foreign debt. Yuan-denominated foreign debt was 34 %, and euro-debt a mere 5 %.

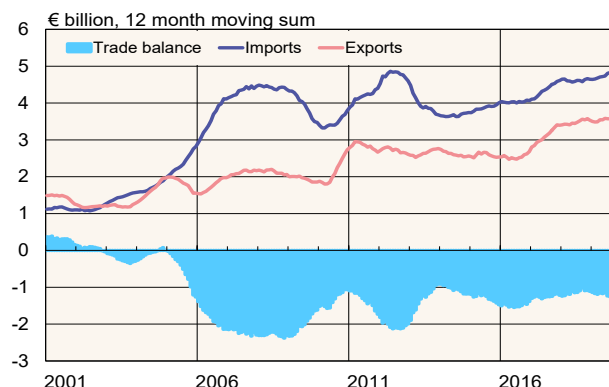
**Finland's trade deficit with China rises.** Finland's goods exports with China contracted in January-September by about 1 % y-o-y. Finnish imports from China grew by 7 % in the same period. On a yearly basis, Finnish exports to China amounted to 3.5 billion euros and imports 4.9 billion euros. The trade deficit in recent months widened to around 1.4 billion euros. China accounted for 5.4 % of Finnish exports and 7.4 % of imports.

The bulk (44 %) of Finnish exports to China were basic commodities. Pulp alone was 25 %. Industrial machinery, a second important export product group, constituted nearly a third of goods exports. Exports of meat products has grown quickly, even if food was still just 2 % of exports.

During the first nine months of this year, 53 % of goods imports consisted of electronics and other machinery & equipment. The remainder was other manufactured goods. Clothing had a 10 % share.

The latest services trade data are from the second quarter of this year. The 12-month period ending in June showed Finnish services exports to China were 1.6 billion euros and imports 1.0 billion euros, and thereby slightly offsetting the goods trade deficit. Licencing fees were the top services export category last year (28 % share). Tourism accounted for 16 % of services exports. Finns purchased business services (56 % share) and transport services (24 %) from China.

### Finland's goods trade with China, 2001–2019



Source: Finnish customs.

## Russia

**OPEC and Russia agree on further cuts in oil production.** Over the past three years, Russia has worked closely with OPEC members in a number of voluntary agreements to restrain crude oil production and stabilise prices. Partly as a result of the increased cooperation between Russia and Saudi Arabia, oil-producing countries in recent years have managed, at least to some extent, to hold to the agreed production ceilings in order to support oil prices. The combined crude oil production of Russia and OPEC represents roughly half of global oil output.

At the beginning of 2017, OPEC members, Russia and several other non-OPEC producer countries (a group sometimes referred to as “OPEC+”) agreed to voluntarily reduce their combined output by about 1.7 million barrels a day. Under the deal, Russia was obliged to cut its daily production by 0.3 million barrels. The agreement was later extended several times through June 2018. Russian oil production rose to a record-high level in autumn 2018, but the countries met again and agreed to reinstate roughly 1.2 million barrels in cuts from the start of 2019.

At last week’s (Dec. 6) OPEC and Non-OPEC Ministerial Meeting, the parties agreed to new production cuts until the end of March 2020. Overall, the parties agreed to cut production by roughly 1.7 million barrels in 1Q2020. In addition, Saudi Arabia committed unilaterally to reduce its own production by about 0.4 million barrels a day. As in its previous agreements, Russia committed to cuts of about 0.3 million barrels a day. The required cuts are, however, smaller than earlier, as gas condensate production will no longer be included in Russia’s production quota. Energy minister Alexander Novak noted that under the new calculation method, which excludes gas condensates, Russia would have more than exceeded its reduction targets in November 2019, even if it only achieved 85 % of its agreed cuts under the old system.

**While Russian officials wish for public spending to spur economic growth, experts remain sceptical.** Many Russian officials hope that the elixir to cure Russia’s malaise of low economic growth would be found from the national projects and spending money from the National Welfare Fund. Most economic experts, however, point out that the impacts of these public-sector measures are likely to be limited and transitory. Economic growth driven by public spending could even come at a fairly high cost as one ruble of public spending does not even come close to producing corresponding increase in GDP.

The national projects announced by president Vladimir Putin last year call for a total of roughly 18 trillion rubles (260 billion euros) in budget funding during 2019–2024. This year’s budget allocates 1.8 trillion rubles for national projects. Government officials have been criticised for moving too slowly in applying allocated funds. At the start of November, only 70 % of this year’s funds had been disbursed.

Deputy prime minister Konstantin Chuychenko said slow spending was preferred to avoid misuse of funds.

Use of assets from the National Welfare Fund to support the economy has also been discussed, because the Fund has grown substantially in recent years. Under the fiscal rule, the government can access the Fund to support the economy when its liquid part exceeds 7 % of GDP. A pending bill allows spending up to 1 trillion rubles during 2020–2022 on investments in domestic infrastructure and provision of export credit. Funding requests have already been submitted by e.g. Russia’s postal service and state railways RZD, as well as fertilizer giant Uralkali for construction of a plant in Angola.

International and Russian domestic research institutions estimate that national projects could accelerate Russian economic growth by 0.1–0.3 percentage points a year in 2020 and 2021. Even with the national projects, total expenditures of Russia’s public sector will grow slowly in real terms in the coming years. Spending from the National Welfare Fund would increase public spending. Moscow’s Higher School of Economics (HSE) estimates that spending of 300 billion rubles from the Fund next year could speed up economic growth by 0.2–0.3 percentage points depending on the use.

**Russia and China rise in World Bank rankings; unchanged in WEF rankings.** Both annual comparisons were released in October. The World Bank’s survey of 190 economies in [Doing Business 2020](#) shows Russia rising from 31<sup>st</sup> place last year to 28<sup>th</sup> this year, while China climbs from 46<sup>th</sup> to 31<sup>st</sup> in the rankings. Among the 141 economies covered in the World Economic Forum’s (WEF) [Global Competitiveness 2019](#), no changes in the rankings are reported for Russia, which remains at the 43<sup>rd</sup> spot, while China holds at 28<sup>th</sup>.

The World Bank’s business-friendliness assessment looks at factors such as official practices, regulation and judicial system. Indicators are illustrated through case examples. For instance, “trading across borders” is evaluated in terms of the ease of importing auto parts, while “dealing with construction permits” considers the time, cost and ease of building a warehouse. The assessments concern each country’s largest or two largest cities. The World Bank claims that this practice makes its comparison studies feasible. On the other hand, the cases do not provide a comprehensive assessment of the business environment. The comparison also ignores e.g. corruption. Countries can improve their score by making small, targeted reforms. The report notes Russia’s reform of its tax-payment system. China wins praise for easing registration and permitting burdens, as well as simplifying tax payments.

The WEF competitiveness study considers such factors as institutions, infrastructure and market functionality. Larger economies benefit from the fact that size of the economy is weighted in the index. Russia failed to make it into the top 90 economies in such categories as security, independence of the judiciary, corruption, press freedom, property rights, openness to foreign trade and financial market stability. China performed poorly in such sub-categories as social capital, press freedom, adult internet use and financial system stability.

## China

**China's foreign trade remains weak.** The dollar value of China's goods exports in the first eleven months of this year was unchanged from the same period last year (but down 1 % y-o-y for November). The value of imports fell in January–November by 5 % y-o-y, but there was no change in November from a year earlier. The trade surplus for the first eleven months of this year rose to nearly 380 billion dollars, up by over 80 billion dollars from a year earlier.

Demand in China's main export markets have weakened over the past year. Exports to the EU and South Korea were still growing in the first half of this year, but in the past three months they have gone flat and the decline in exports to the US and Japan has become steeper. In contrast, exports to the ten-country ASEAN market have grown rapidly. In November, the value of Chinese exports to the ASEAN region were as large as exports to the EU or the US. Strong export growth to countries such as Vietnam are believed to be partly related to the trade war and companies' efforts to circumvent US punitive tariffs. Export weakness affects a broad swath of China's main export products.

While growth in China's imports from the EU in the past three months remained slightly in negative territory, the decline in imports from Japan and the United States slowed. Chinese goods imports from South Korea in September–November were down 18 % y-o-y. Imports from ASEAN countries, which have reached a level on par with China's imports from the EU, were up 5 %. The import volumes for many commodities have increased since summer, which might indicate stimulus-driven revival in Chinese domestic construction.

### Trends in Chinese goods exports and imports



Sources: China Customs and Macrobond.

**Companies in China find it increasingly difficult to service their debts.** This year over 50 Chinese firms have defaulted on their bonds, while last year just over 40 firms defaulted. The amount defaulted has also increased from last year, reaching 120 billion yuan (15 billion euros) as of end-November. Given the size of the Chinese market, the amounts are still relatively small. Most defaults on the bond market

concern private firms, but some state-owned enterprises have also defaulted.

Companies involved in public administration are generally seen as safe investments in China as investors believe the government will step in as payer of last resort to cover their debts. It is therefore notable that this month public administration related firms have had difficulties to service their bonds. Specifically, Inner Mongolia's Hohhot Economic & Technological Development Zone Investment Development Group, a local government financial vehicle (LGFV), defaulted on a 1-billion-yuan (140-million-euro) 5-year privately placed note. While the LGFV managed to pay off part of its debts a few days later and declared that the balance would be paid early next year, the default was only the second ever in recent history. In the other instance, a company largely owned by Peking University went into default this month when it failed to make payment on its 2-billion-yuan (250-million-euro) bond.

While a rise in payment defaults can indicate weakening economic conditions, such defaults are also a natural part of financial system development as they force lenders to consider carefully their actual risk exposure.

**Chinese teens romp in 2018 PISA scores.** Participating students in Shanghai, Beijing, Jiangsu and Zhejiang snagged top scores in all three of PISA's major categories (reading, mathematics and natural sciences). The Chinese students posted particularly high scores in mathematics and natural sciences. Only 2 % of the students scored poorly in math, the smallest percentage of any PISA participant country.

Notably, China does not PISA-test at the national level. Instead, the OECD uses an abbreviation for the major cities involved in the study with the moniker S-P-J-Z (China). While the population covered in the S-P-J-Z cities totals 180 million, it is unclear how well the performance in these relatively wealthy areas are applicable to the country as a whole. The quality of teaching varies considerably within China. In assessing the effectiveness of school systems, PISA researchers also determine time spent on school work. Chinese students spent about 57 hours a week studying, which was the second highest number of hours for any country. Finnish students, in contrast, spent about 37 hours a week studying, the lowest amount of time for any of the countries surveyed.

Students in Hong Kong and Macao also posted strong scores. Student scores have traditionally been excellent in developed Asian countries such as Singapore, Japan and South Korea. Estonia and Finland were Europe's top-scoring countries. Russian students posted scores slightly below the OECD average in all three categories.

Every three years, the OECD conducts its internationally coordinated PISA testing of 15–16-year-olds. Not all of the 80 survey participant countries are OECD members, and not all students in the age cohort are tested. Instead a sample of schools is chosen. Schools can opt out of the sample and not all students in participating schools necessarily take part in the test.



## Russia

**Bank of Russia cuts key rate again.** Last Friday (Dec. 13), the Central Bank of Russia board of directors decided to cut the CBR key rate by 25 basis points to 6.25 %. The CBR said the cut was appropriate, largely due to a sharper-than-expected slowdown in inflation. The rate cut was the fifth this year. The CBR mentioned that the key rate could be lowered further in the first half of 2020.

The on-year rise in consumer prices slowed in November to just 3.5 %. The slowdown in inflation reflects factors such as the ruble's appreciation since the start of this year, weak economic growth and a good harvest. The central bank's updated inflation forecast now sees on-year inflation in the range of 2.9–3.2 % at the end of this year (down from 3.2–3.7 % earlier). The CBR expects the inflation to rise to a range of 3.5–4.0 % by the end of 2020 and thereafter remain near the official 4 % inflation target.

The average market rate on ruble-denominated corporate loans over one year was 9.3 % in October. The average rate on household ruble loans over one year was 12.7 % in October.

### Recovery in Russian fixed investment remains slow.

The real volume of fixed investment in the third quarter of this year was up only 0.8 % y-o-y. Growth in the first half was even a little lower, just 0.6 %. After a sharp drop in fixed investment in 2015, it recovered rather well in 2017–2018. However, this year's slow recovery means that fixed investment for the entire year will still remain a couple of per cent below the 2012–2013 level.

Fixed investment of large and mid-sized firms, as well as fixed investment by the state, which statistical reporting covers in the course of a year, appears to have developed more weakly than total fixed investment again this year. In fact, in the first nine months of 2019, fixed investment in these categories as a whole declined by over 2 % y-o-y. In other words, the Rosstat figures suggest that fixed investment in other categories (small firms, households and the grey economy) have been estimated to have continued their rapid growth further this year. These categories together account for about a quarter of total fixed investment.

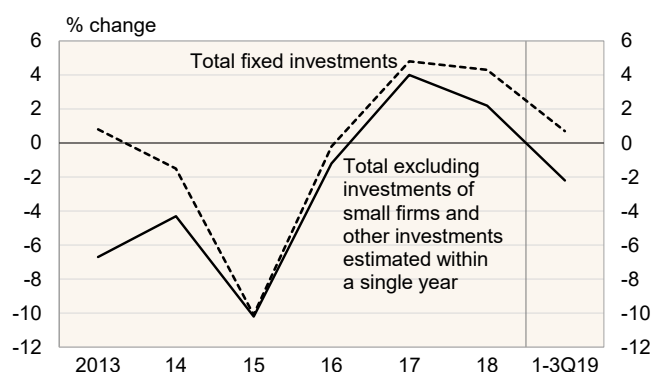
As in previous years, behind the average number of change in fixed investment there are large disparities in investment developments at the sectoral level. For those sectors where the investment of large and mid-sized firms is sizeable and thereby has a significant impact on the general track of fixed investment, three branches emerge as the biggest areas of growth this year. First, investment growth in natural gas production this year has well surpassed even last year's sharp increase. Second, after a substantial decline last year, investment in oil refining has risen fast. Third, following strong growth in 2018, the pace of investment in telecommunications has only accelerated this year.

On the other hand, after fairly tame growth in recent years, investment in the electricity sector has dropped steeply

this year. After two stronger years of investment, a similar sharp decline in pipeline investment has also occurred.

This year has not been promising from the standpoint of diversification of Russia's production base. After recovering nicely in 2017–2018 from a very sharp drop in 2015–2016, fixed investment in manufacturing other than oil refining has grown just very slightly this year.

**Changes in real fixed investment in Russia, 2013–2019**



Source: Rosstat.

### Survey paints dreary picture of Russian business conditions.

This autumn, the consulting firm PWC conducted a [survey](#) based on interviews with corporate representatives to get some notion of how Russia's business environment has changed since the early 1990s. The "fathers and sons" survey comprises the views of 1,000 representatives of various-sized firms across Russia. The study specifically looked at the generational differences between younger respondents (born 1980–1991) and older respondents (born 1957–1963).

About half of respondents said doing business in Russia had become harder than three decades ago. Business was complicated by factors such as administrative and regulatory barriers. Government control and inspection, as well as corruption, are also viewed to limit growth opportunities in the corporate sector. Nearly 70 % of respondents (and 80 % of "fathers") reported that corruption has worsened or remained about the same in recent decades. Most acknowledged improvements in such areas as competition, ease of starting a business and access to credit.

The survey also found that the risks facing entrepreneurs have changed in recent decades. In the early 1990s, most respondents said that the core business risks were getting murdered, physically assaulted or threats to family. The biggest fears today are damage to business reputation, imprisonment or forced emigration.

Only about half of all respondents believe that Russia's corporate sector will develop in a positive direction over the next 30 years. The younger generation, however, was slightly more optimistic. The most favourable outlooks were for the IT sector, energy production and trade. Sundowner branches included agriculture, healthcare and scientific research.

## China

**Preliminary deal in US-China trade talks avoids tariff hikes.** Last Friday (Dec. 13), United States trade negotiators announced they had agreed with China on “phase one” trade treaty. While the text of the agreement was not released, the US trade representative’s office said the agreement covers intellectual property, technology transfers, agriculture, financial services, exchange rates, commitments to increased trade and dispute resolution. The agreement must still be finalised. No signing date has been announced and there are many uncertainties associated with the arrangement.

US negotiators said that China committed to purchasing US goods and services (industrial, agricultural, foodstuff and energy products) over the next two years in a total amount that exceeds China’s annual level of imports for those goods and services in 2017 by no less than \$200 billion. China confirmed that the parties had reached an agreement, but had no comment on details nor on the additional purchases.

The immediate effect of the announcement was to head off more tariff hikes and further escalation in the trade war. The US had threatened another round of 15 % tariff hikes on December 15 that would apply to nearly all Chinese imports still not subject to punitive tariffs. China also refrained from implementing its earlier-announced punitive tariffs.

The US further declared that, on the basis of the agreement, it was reducing from 15 % to 7.5 % the punitive tariffs on Chinese goods imposed on September 1. The tariffs affect about a fifth (110 billion dollars) in US imports from China. If the agreement is signed immediately in January, the lower tariff rates could be in force at the earliest in February. Other punitive tariffs on Chinese goods and services, however, would remain in place at their current levels. Punitive tariffs will still apply to nearly 70 % of US imports from China. This share has been stable since September 1. With the possible tariff cuts in February, the US-based Peterson Institute for International Economics (PIIE) estimates that the average US tariff rate on Chinese goods will be 19 %, down from the current 21 %. Prior to the trade war, the average tariff was 3 %.

About 60 % of China’s US imports are subject to punitive tariffs. PIIE figures that China’s average import tariff on US goods is 21 %, up from 8 % before the trade war.

**China’s Central Economic Work Conference wraps up with little to show.** The three-day Central Economic Work Conference of China’s top leadership took place last week in Beijing to set out next year’s economic policy framework and goals. The final statements from what is typically one of the year’s most important economic policy meetings was unusually vague: economic development should continue on the same fronts in the same manner as in previous years and stability is the central focus of economic policy.

Although China has yet to affirm an official GDP growth target for next year, some sources report that meeting participants settled on a target of around 6 % for 2020. If that target

is realised, China would hit its major policy target, set forth in 2012, of doubling real 2010 GDP by 2020.

In addition to the economic work conference, the meeting of the Central Committee in late October also had little to say about the economy. Given that China’s decision-makers are well aware of the need to reform the economy and better times for reforms cannot be expected due to worsening economic situation, the lack of guidance from party leadership is confusing. In light of China’s tightly closed decision-making system, one can only speculate as to whether this lack of direction reflects colliding differences among the leadership or that leaders are at a loss as to how to proceed due to the complexity of the challenges they face.

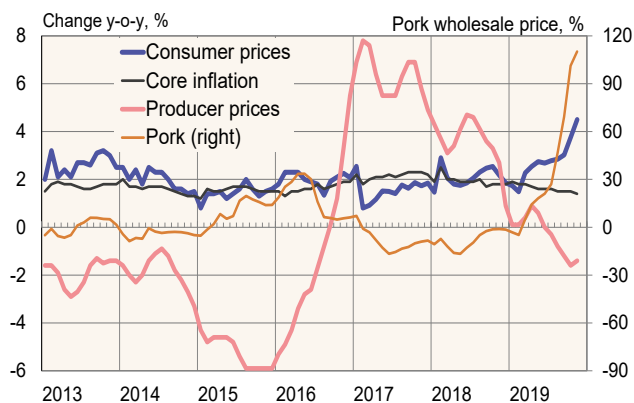
### More mixed messages about the Chinese economy.

China’s National Bureau of Statistics reports industrial output growth rose from 4.7 % y-o-y in October to 6.2 % in November. The improved readings in the manufacturing purchasing manager indices affirmed the recovery. Passenger car production was slightly positive for the first time since June 2018. The readings of the services purchasing manager indices also suggested that conditions in November had improved from the previous month. The demand-side indicators, however, showed no corresponding strengthening in November.

While the purchasing manager indices suggest improvement in the service sector, there has been no sign of stronger growth in retail sales. Real growth in retail sales was 4.9 % in November (unchanged from October). Passenger car sales were down by more than 5 % y-o-y. November investment demand was unchanged from October. Estimates based on official figures show real on-year fixed investment growth in January–November was 2–3 %. Growth in electricity production and consumption has been below 5 % in recent months.

Accelerating inflation, which erodes household purchasing power, was a big contributor to the slowdown in retail sales. November consumer price inflation picked up from 3.8 % in October to 4.5 % in November as reduced pork supplies caused meat prices to soar. Producer prices, on the other hand, have been declining for five months.

### Price trends in China



Sources: Macrobond and CEIC.