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BOFIT Weekly Review Yearbook 2020

The Bank of Finland Institute for Emerging Economies (BOFIT)

BOFIT Weekly Review
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BOFIT Weekly Review – Russia 2020

3 Jan 2020 BOFIT Weekly 2020/01
Russia posts sluggish 2019 growth performance
Critical reports from Accounts Chamber on economic forecast that forms basis for Russia's government budget projections generate questions about budget expenditures
Sanctions continue to overshadow Russia's relations with the West

17 Jan 2020 BOFIT Weekly 2020/03
Russian president holds annual state-of-the-nation address; government resigns unexpectedly thereafter
Ruble appreciation continues in the first two weeks of this year
Russian oil fund's assets doubled last year
Oil revenues also boost Russia's foreign currency and gold reserves
Rosstat predicts a decline in Russia's population over the next two decades

31 Jan 2020 BOFIT Weekly 2020/05
New Russian government to focus on social issues and national projects
Tepid performance for Russian foreign trade in 2019; capital flows closer to balance
Russia and Ukraine reach agreement on transit fees for natural gas

14 Feb 2020 BOFIT Weekly 2020/07
Effects of the coronavirus on the Russian economy remain limited for now
Monetary policy easing continues in Russia
Rosstat reports Russian GDP up 1.3 % in 2019; revises figures for previous years
Slightly lower growth in Russian bank lending

28 Feb 2020 BOFIT Weekly 2020/09
Central Bank of Russia to sell its controlling stake in Sberbank to the finance ministry
Sluggish trends in Russian goods trade last year
Russian crude oil production hits record levels
LNG drives growth in Russian natural gas production

13 Mar 2020 BOFIT Weekly 2020/11
Oil price collapse drives down ruble and Russian stock markets
Russia's proposed constitutional amendments allow president Putin to remain in power
Russian inflation remained moderate
Russian government sector spending increased rapidly last year; oil price drop changes outlook
Finnish-Russian trade performed modestly last year

27 Mar 2020 BOFIT Weekly 2020/13
BOFIT forecasts economic contraction in 2020 for Russia
After a selective start, Russia moves to beef up economic support
National Welfare Fund now exceeds 11 % of GDP after transfers of last year's excess oil and gas tax earnings
Oil prices, ruble and Moscow stock exchange all down; CBR holds key rate unchanged

9 Apr 2020 BOFIT Weekly 2020/15
Russia tightens measures to slow spread of coronavirus
Ruble exchange rate fluctuations in recent weeks fairly muted compared to the huge swings in oil prices
Russia's inflation tick-up may be fairly transient
Rosneft divests its holdings in Venezuela to avoid US sanctions

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24 Apr 2020 BOFIT Weekly 2020/17
New OPEC+ agreement on oil production ceilings fails to calm markets
IMF forecast sees sharp contraction in Russian economy this year followed by sluggish recovery next year
First-quarter figures show contraction in Russian foreign trade and net capital outflow
CBR sells majority stake in Sberbank to the Russian government

8 May 2020 BOFIT Weekly 2020/19
After relatively robust first-quarter performance, Russia experiences collapse of industrial output and consumption in April
CBR lowers key rate
Russia's government spending to be stretched by economic support measures
Rapid growth last year in military spending of Russia and China

22 May 2020 BOFIT Weekly 2020/21
Russian GDP grew by 1.6 % in the first quarter
Oil market price volatility calms a bit
Shifts in revenues and expenditures eat away Russia's federal budget surpluses

5 Jun 2020 BOFIT Weekly 2020/23
Prime minister Mishustin lays out Russia's road to economic recovery
After posting awful April economic numbers, Russia bounced back a bit in May
Bank lending growth slows in Russia
Finnish-Russian trade dips in first quarter

18 Jun 2020 BOFIT Weekly 2020/25
Price of Urals oil and Russian ruble continue to strengthen
CBR now publishes the RUONIA rate
Rising unemployment in Russia
While FDI inflows to Russia grew last year, they will likely contract sharply this year
Ukraine gets new 18-month IMF loan

3 Jul 2020 BOFIT Weekly 2020/27
Russia's constitutional reforms gained majority support in referendum as expected
Russian economic trends remained weak in May
CBR lowers key rate by 100 basis points
Slight downward revisions in forecasts for Russia's economy in 2020

17 Jul 2020 BOFIT Weekly 2020/29
Russian export earnings and imports decrease sharply; net capital outflow moderate
Russia's federal budget revenues declined especially in May and June, but spending climbed up
Increase in debt restructuring and postponed repayment of corporate loans in Russia
Russian firms give low marks to government agencies with respect to business environment improvement

31 Jul 2020 BOFIT Weekly 2020/31
Russian central bank again lowers its key rate
Russian economic decline started to slow in June
Russian manufacturing on the road to recovery, while extractive industries remain in a deep slump
Russian firms suffering major profitability drops this year

14 Aug 2020 BOFIT Weekly 2020/33
Sharp second-quarter contraction in Russian GDP
Signs of growth in Russian goods trade
Russia prepares to introduce new measures favouring domestic producers
Declines in industrial output vary across Russian regions; retail sales making comeback from depths

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28 Aug 2020 BOFIT Weekly 2020/35
Russian economy continued to recover in July
Russian government budget revenues decline precipitously, spending soars
Subsidy programmes and rate cuts support bank lending in Russia
State support scheme boosts demand for new housing loans in Russia

11 Sep 2020 BOFIT Weekly 2020/37
Russia's National Welfare Fund swells; CBR forex and gold reserves hit record high in August
Even with stabilisation of oil prices, the ruble has lost value in recent months
Russian government spending cushions fixed investment decline
Finnish-Russian trade plummeted in second quarter

25 Sep 2020 BOFIT Weekly 2020/39
Latest BOFIT forecast sees Russian economy returning to modest growth next year
Recovery of Russian economy moderated in August
Central Bank of Russia keeps its key rate unchanged; previews monetary policy guidelines for 2021–2023
Covid-19 crisis has increased broad unemployment and part-time employment in Russia

9 Oct 2020 BOFIT Weekly 2020/41
Rising uncertainty drove ruble depreciation in September
Covid-19 subdues private consumption in Russia
Russia to rein in government budget spending in coming years to deal with deficit
Russia to impose bans on raw wood exports

23 Oct 2020 BOFIT Weekly 2020/43
Russia's economic recovery slowed in September
Even confirmed coronavirus infections soar in Russia, officials remain cautious about imposing new restrictive measures
Signs of recovery in Russian foreign trade, capital outflows rather large

6 Nov 2020 BOFIT Weekly 2020/45
Russia-US economic relations unlikely to improve under the new US administration
Large domestic interest in Russian government bonds
Covid-19 cases continue to rise in Russia, consumers increasingly cautious
Central Bank of Russia keeps its key rate unchanged
Russian government limits the fall of household incomes with social assistance and higher wages

20 Nov 2020 BOFIT Weekly 2020/47
Russian GDP contracted by 3.6 % in the third quarter
Russian goods trade has recovered in recent months
Reduced revenues and higher spending caused Russia's government budget sector deficit to deepen
Pandemic halts growth of Russian insurance markets

4 Dec 2020 BOFIT Weekly 2020/49
Russia's economy weakened in October
Russian government support has helped move fixed investment towards recovery, outlook remains unsure
Response of Russian labour market to the economic crisis manifested through various channels
Number of confirmed covid-19 cases continues to grow; only moderate tightening of restrictions

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18 Dec 2020 BOFIT Weekly 2020/51
Russian GDP contracted in the third quarter in annual terms, but growth varied considerably across branches
Russia imposes price controls in response to rising prices on certain food items
Number of banks operating in Russia still declining, but not as fast as earlier
Russia seeks to renegotiate tax treaties

BOFIT Weekly Review – China 2020

10 Jan 2020 BOFIT Weekly 2020/02
China's central bank eases monetary policy and phases out old benchmark rates
Yuan depreciated slightly in 2019
New foreign investment law enters into force in China
85 % of China's energy needs still met with fossil fuels

24 Jan 2020 BOFIT Weekly 2020/04
As expected, China hit its economic growth target last year, but slowdown continues
Thorny issues overlooked in "Phase 1" US-China trade agreement
EU, US and Japan propose stricter WTO rules on industrial subsidies
Taiwanese economy thrives despite tense political relations with mainland China

7 Feb 2020 BOFIT Weekly 2020/06
Coronavirus epidemic having wide-ranging impacts on Chinese economy
Hard times continue for the Hong Kong economy
China's oil imports set record, but uncertainty over near-term oil demand depresses oil market
Chinese debt continued to climb last year

21 Feb 2020 BOFIT Weekly 2020/08
China's efforts to contain the coronavirus epidemic significantly affect business operations
People's Bank of China has relaxed monetary policy only moderately to deal with the coronavirus epidemic
China's 4Q19 current account surplus shows modest shrinkage
Increasing number of Chinese provinces failed to hit their growth targets last year

6 Mar 2020 BOFIT Weekly 2020/10
Early indicators suggest the coronavirus caused Chinese economic activity to collapse in February
Foreign companies operating in China report difficulties caused by the coronavirus epidemic
China posts larger-than-expected budget deficit for 2019
Finnish goods exports to China contracted by 1 % last year

20 Mar 2020 BOFIT Weekly 2020/12
China's economic output collapsed in the first two months of this year
Over-leveraged real estate developers feel the pain from China's housing market fall
Only a slight decline in Chinese goods imports in January-February
PBoC resorts to targeted monetary easing
China's loan stock growth continued steady in February

3 Apr 2020 BOFIT Weekly 2020/14
Even as the Chinese economy recovers, performance is still far below pre-coronavirus levels
China steps up stimulus measures
Coronavirus crisis hits China's banking sector
Mainland China stock markets perform relatively well, still capital is flowing from China

17 Apr 2020 BOFIT Weekly 2020/16
China's support measures accelerated lending in March; gradual relaxation of monetary stance continues
Old orders boost China's goods exports in March
Yuan's exchange rate relatively steady
China surpasses the US in volume of international patent applications

30 Apr 2020 BOFIT Weekly 2020/18
Coronavirus containment measures cause China's economy to contract for the first time in decades
Real household incomes in China decline and unemployment rises
China continues to support NEV manufacture and sales as part of corona stimulus
Chinese demand unlikely to revive global oil market over the short term

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15 May 2020 BOFIT Weekly 2020/20
Inflation in China slows, central bank promises additional stimulus
China showed current account deficit in first quarter
Chinese goods exports performed surprisingly well in April, while imports from the US contracted sharply
China's recovery policy includes investment in "new infrastructure"
Hong Kong's economic outlook remains weak even with support measures

29 May 2020 BOFIT Weekly 2020/22
National People's Congress makes exceptional decision not to declare any GDP growth target
US-China tensions intensify
New security laws darken the skies over Hong Kong
Industry drives China's recovery

12 Jun 2020 BOFIT Weekly 2020/24
China's 2020 budget deficit set to rise
Central bank announces new round of SME support
Lower commodity prices reduce value of Chinese imports in May; exports down just slightly
China drops "clean coal" to attract foreign investors to green bond markets

26 Jun 2020 BOFIT Weekly 2020/26
Across-the-board lowering of global growth forecasts; IMF still sees positive GDP growth for China this year
China's recovery uneven across sectors
Reciprocal trade and global sharing of responsibility top the agenda of the EU-China summit
Official unemployment rate understates China's true unemployment

10 Jul 2020 BOFIT Weekly 2020/28
After volatile spring, Chinese stock market indices soar in July
China has further opened its financial markets to foreign firms, still market access remains an issue
China spurs economic integration of Greater Bay Area
China-India relations on the skids

24 Jul 2020 BOFIT Weekly 2020/30
Manufacturing and fixed investment sustained China's economic growth in the second quarter
Growth of indebtedness has picked up in China, debt-to-GDP ratio soars in the first half
China's foreign trade numbers rebounded to June 2019 levels last month
China's central and local governments issue special purpose bonds to support economy

7 Aug 2020 BOFIT Weekly 2020/32
China's housing market revives, but differences across regions remain large
China's FDI outflows and FDI inflows decline slightly
China prepares to launch the world's largest emissions trading scheme
Hong Kong's dual crises: one economic, the other political

21 Aug 2020 BOFIT Weekly 2020/34
China's economic recovery stabilising
Recovery in Chinese goods exports faster than expected
US adopts even harsher policy stance towards China
China posts huge second-quarter current account surplus, capital outflows increased
PBoC's digital currency project moves ahead

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4 Sep 2020 BOFIT Weekly 2020/36
Profitability of Chinese industrial firms improved over the summer
Number of defaults of Chinese companies on dollar-denominated bonds already exceeds all of 2019
US firms operating in China remain committed to Chinese markets
Robust growth in Finnish goods imports from China

18 Sep 2020 BOFIT Weekly 2020/38
BOFIT expects positive Chinese GDP growth for the year, but structural issues and risks continue to swell
Chinese economy continued to rebound in August, even as consumer demand remained weak
Calls for speedier talks on investment agreement dominate this year's virtual EU-China summit
EU Chamber of Commerce in China worries about slowdown of opening up
Coronavirus pandemic slows signings of Silk Road investment contracts

2 Oct 2020 BOFIT Weekly 2020/40
China has lifted most restrictive measures to contain the spread of covid-19
Massive public spending on rescuing China's troubled banks
Latest round of US export restrictions even affects the electronics industry outside China
Foreign firms operating in China more cautious than earlier about their investment plans

16 Oct 2020 BOFIT Weekly 2020/42
Sales of consumer goods during China's Golden Week holiday beat 2019 numbers
Yuan strengthens against the dollar; yields attract portfolio investment to mainland China
Latest forecast revisions see China as sole driver of global growth this year
China continued last year to lead in installed new industrial robots

30 Oct 2020 BOFIT Weekly 2020/44
Recovery of Chinese economy continues to broaden
Covid stimulus causes China's debt-to-GDP ratio to soar
Chinese imports from the EU and other regions picked up in September
Revised PPP weights suggest Chinese economy is smaller than previously thought
Taiwan's covid success a boon for its economy and citizen health

13 Nov 2020 BOFIT Weekly 2020/46
China's latest five-year plan devoid of new initiatives, but still sets ambitious growth target for 2035
Outcome of US presidential election unlikely to resolve disputes with China
Chinese officials scupper Ant Group's IPO at the last minute; other new listings on mainland bourses increasing
GDP grew in all regions of China in the third quarter

27 Nov 2020 BOFIT Weekly 2020/48
Private consumption takes a higher profile in recovery of Chinese economy
China shores up regional trade relations with signing of RCEP agreement
Yuan keeps on appreciating against both the dollar and the euro
Increasing number of bond defaults by Chinese state-owned enterprises

11 Dec 2020 BOFIT Weekly 2020/50
Pork prices swing Chinese consumer price inflation into negative territory
China keeps monetary policy largely unchanged as economy bounces back from covid shock
China's overall exports boosted by global demand for technology products
United States imposes new financial market sanctions on Chinese firms

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23 Dec 2020 BOFIT Weekly 2020/52
Maintaining stability will be China’s top economic policy goal in 2021
The Chinese economy continued to grow in November; inconsistencies continue to plague fixed investment numbers
Poverty and income disparity remain big challenges for China

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Russia

Russia posts sluggish 2019 growth performance. As many analysts expected, Russian GDP growth slowed last year. In the first nine months of 2019, GDP rose by just 1.1 % y-o-y. Growth for all of 2019 is expected to have also remained close to 1 %.

Economic growth, especially in the first half, was supported by industrial output, which grew at over 2 % y-o-y in January-November. Industrial output growth lost steam in November, largely on a slowdown in manufacturing. Preliminary GDP figures and various corporate surveys suggest that much of the growth in industrial output last year reflected companies building up their inventories in anticipation of demand that never materialised, due e.g. to lower-than-expected growth in public sector spending.

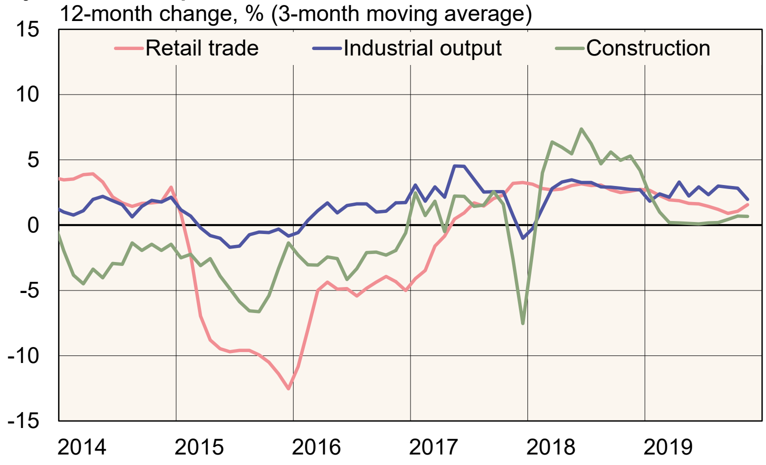
On a brighter note, growth in retail sales recovered towards the end of the year to around 2 % y-o-y, as real household incomes finally began to show positive gains again. Rosstat's revised figures for January-September show that real household incomes increased by 0.8 % y-o-y. Growth in household incomes was mainly supported by rapid wage growth and a favourable job market. At the end of 2019, Russia's unemployment rate continued to hold at historically low levels of around 4.5 %.

Preliminary figures show the drop in inflation to 3 % p.a. at the end of 2019 also helped support household purchasing power. While the hike in the value-added tax at the beginning of 2019 initially drove up consumer prices, ruble appreciation, favourable harvests and modest demand growth offset much of the inflationary effect from the VAT increase.

Moreover, largely thanks to good harvests, agricultural output grew by 4 % y-o-y in January-November. The construction and transport sectors showed practically no growth, however, and thus added nothing to economic growth.

Forward-looking indicators suggest that Russian economic growth will remain sluggish in the months ahead. Growth should begin to pick up gradually over the course of 2020, mainly on increased public sector spending. Exports should also revive slightly after last year's weaker development. The current BOFIT forecast sees Russian GDP growing by 1.7 % this year, a level well in line with the consensus range of 1.5–2 %. As usual, a decline in oil prices constitutes a key risk to Russia's short-term economic prospects. The economic strengths for the Russian economy moving forward are its set-aside funds from oil & gas earnings and the government's relatively low level of indebtedness.

Major Russian output trends



Source: Macrobond.

Critical reports from Accounts Chamber on economic forecast that forms basis for Russia's government budget projections generate questions about budget expenditures. Reports by Russia's Accounts Chamber (AC) consider optimistic the economy ministry's forecast that provides the foundation for estimates of revenues streaming to the federal budget and other government sector budgets in 2020–2022. The AC reports call for further grounds for the forecast that GDP growth will accelerate to over 3 % p.a. in 2021 and onwards. The AC gives a view that if the projected weakening cycle in Russia's foreign trade materialises, the risk would increase that GDP would grow from 2021 onwards at a pace near potential growth, which experts put at 1.5–2 % a year. This likely refers to the forecast's cautious oil price assumption (about 56 dollars per barrel of Urals-grade crude). The AC also notes that the ministry's forecast for GDP growth and many of its components align closely with the goals set forth in president Putin's inaugural decrees (May decrees), including forecasts of a growing population due to rising immigration, rather good increases in real disposable household incomes, acceleration of fixed investment growth to very high numbers and quite brisk increases in the volume of non-energy exports. The AC points out that the cohort of 15–64-year-olds will shrink, while the gradual increase in the retirement age will keep more people in the workforce. In contrast, the reports note that especially the ministry's projection of rapid growth in fixed investment is surrounded by questions which mean risks of not reaching the projected economic growth tempo.

The economy ministry's forecast and government budget estimates for 2020–2022 are practically unchanged from autumn. The finance ministry estimates that ruble-denominated nominal revenues to the consolidated budget (federal, regional, and municipal budgets, as well as state social funds) increased by 4–5 % in 2019 and a similar growth pace should continue in the next few years (the economy ministry's annual inflation forecast is 3 % for 2020 and 4 % for 2021 and 2022). Budget revenues from sources other than oil & gas taxes, however, depend on economic growth. In 2019, these non-oil revenues amounted to roughly 80 % of total consolidated budget revenues. They will provide all budget revenue growth in the next few years in the budget estimates as long as the calculations hold about weak developments in oil & gas tax revenues, based e.g. on the oil price assumption noted above. Non-oil budget revenues are projected to rise at about 6 % a year.

Consolidated budget expenditure is estimated to increase by about 6 % a year. If budget revenues are lower than projected, spending can still be maintained with funding from federal government borrowing, withdrawals from the reserve fund and the treasury's stock of cash that has become substantial. The assets in the reserve fund, i.e. the National Welfare Fund, are expected to continue to increase, and at end-2020 they are expected to equal 10 % of GDP in total with the fund's liquid assets at about 8.5 % of GDP. The finance ministry's estimate does not specify anything about the extent to which the National Welfare Fund would e.g. lend to investment projects as discussions are still ongoing. Federal domestic net borrowing is expected to come in at under 1.5 % of GDP and the issuance of new bonds just over 2 % of GDP. Federal debt rises to just over 15 % of GDP by the end of 2020.

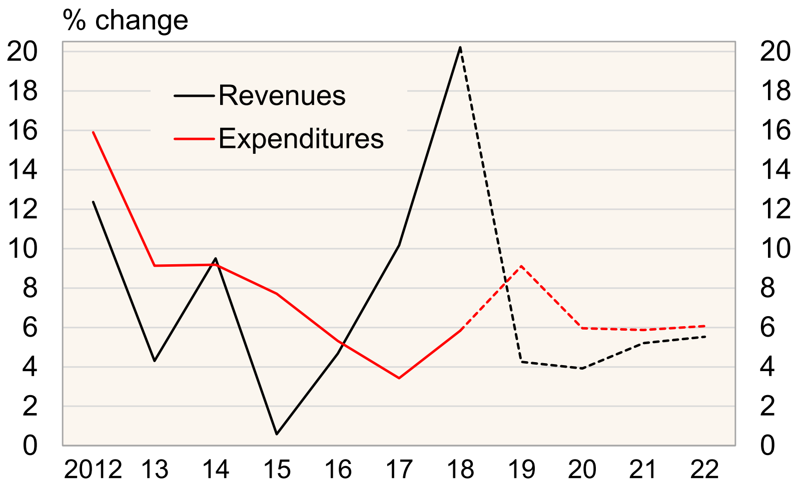
On the other hand, government budget spending is dependent on budget revenue because the federal budget is subject to a legislated fiscal rule that sets a limit on the deficit, and regional governments and state social funds have limited possibilities to borrow and are significantly reliant on transfers from the federal budget. With the projected revenues and spending, the surpluses of the federal budget and the consolidated budget would not be very large in 2020–2022 (on average about 0.5 % of GDP). Slower-than-projected growth of GDP and budget revenues together with the estimated budget expenditures would lead in the next few years towards the moderate limit on the deficit that the budget rule allows, although if really needed, relaxation of the limit that was made in 2018 is possible to repeat.

The finance ministry's assessment of the consolidated budget's expenditure structure remains essentially unchanged. If budget spending estimates would have to be cut at some point, the pressure would not spread evenly across budget spending categories. The share of spending on social support in total consolidated budget spending falls, due e.g. to the gradual increase in the retirement age, but it would still be about a third in 2022. Social support spending could be difficult to cut as the state's leaders since summer 2018 have repeatedly promised that the average old-age pension for non-working pensioners will rise in coming years by over 6 % a year. This is confirmed in the approved State Pension Fund budget for 2020–2022. Federal, regional and municipal workers have been promised a general adjustment to wages in line with projected inflation over all three years.

In addition, budget funding for the 13 national projects packed in president Putin's inaugural decree of May 7, 2018 is seen to be of paramount importance and is driven forward in a very visible process. These national projects will receive slightly more funding from the federal budget in the next few years than scheduled in the projects' initial funding plans. In light of information compiled by the Accounts Chamber last autumn on the contributions of regional budgets and state social funds to the projects (excluding transfers from the federal budget), the federal budget should provide about three quarters of all of the projects' budget funding in the next couple of years. The share of budget funding to the projects will rise in total spending both as regards the consolidated budget and the federal budget (from about 6.5 % in 2020 to about 8 % in 2022 in the consolidated budget, and from about 10 % to 12.5 %, respectively, in the federal budget).

If pressures to cut spending really arose, decisions would have to be made on how much budget funding might be shaved e.g. from homeland security and law enforcement, public administration and healthcare (each up 10–11 % a year during 2019 and 2020). The planned increases in education spending have already been set to a pace of just about 2 % above inflation, while defence spending growth is scheduled just a bit above inflation. The finance ministry expects that a lull in 2020 spending growth for various sectors of the economy will turn to increases in 2021.

Nominal revenues and expenditures of Russian consolidated budget, 2012–2018 and 2019–2022 projection



Source: Ministry of Finance.

Sanctions continue to overshadow Russia's relations with the West. In the months following Russia's annexation of the Crimean peninsula in spring 2014, the EU, US and several other Western countries joined in imposing sanctions on Russia for the Crimean occupation and Russia's actions destabilizing the situation in Ukraine. The key sanctions from the macroeconomic viewpoint deny certain Russian state-majority-owned banks, defence contractors and companies operating in the oil & gas sector access to long-term financing and ban arms trade with Russia. The sanctions also restrict exports to Russia of dual-use products and technology used in oil exploration and production. The EU reviews its sanctions every six months, and currently the sectoral sanctions are set to remain in force until the end of July. The sanctions will be lifted if Russia meets the Minsk agreement terms related to the conflict in Ukraine.

In August 2014, Russia posed import bans on several foodstuffs produced in the EU, the US and certain other countries as a counter-measure. The continuance of the bans is currently not tied to the sanctions of other countries. The import bans support Russia's longer-term aim at self-sufficiency in food production and the development of its domestic agricultural sector. The bans also align with the more general protectionist trends of Russian trade policies in recent years.

During 2016–2019, the US placed on various grounds a number of Russian individuals and firms on its Specially Designated Nationals (SDN) list, which, among other things, prevents American persons and firms from doing business with listed persons and entities. The US has also imposed other sanctions on Russia for reasons not related to the Ukraine conflict. These sanctions include prohibitions on American financial institutions from participating in new issues of Russian sovereign currency bonds. Last month, the US passed a law that threatens sanctions on companies and persons participating in the construction of the undersea Nordstream 2 gas pipeline from Russia to Germany.

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China

China's central bank eases monetary policy and phases out old benchmark rates. Effective Monday (Jan. 6), the People's Bank of China lowered the reserve requirement ratio (RRR) by 0.5 percentage points for most financial institutions. The average reserve requirement for large banks (without bank-specific exemptions) is now 12.5 %, while medium-sized banks have an average reserve requirement of 10.5 %.

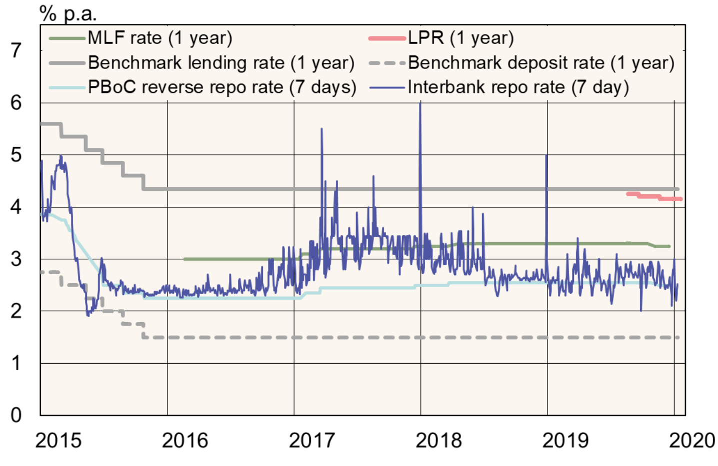
The RRR was previously lowered on a general basis in September, and was followed by further targeted cuts for regional banks in October-November. Like in September, the PBoC estimates that the January easing should free up 800 billion yuan (115 billion dollars) in liquidity from reserve deposits with the central bank. The more accommodative monetary stance is expected to lower financing costs and support economic development. The PBoC says that it expects its monetary policy this year to remain "prudent" as in previous years.

At the end of December, the central bank issued new guidelines on pricing of bank loans. From the beginning of this year, pricing based on the PBoC's old benchmark rates is no longer permitted, and the pricing of existing floating-rate loans should be changed to be based on the new loan prime rate (LPR). By the end of August 2020, floating-rate loans must be bound to the LPR and state as a difference from the LPR. While banks can freely negotiate interest rates with their customers on most lending, the interest rates on existing housing loans remain unchanged despite the benchmark rate change.

The big takeaway here is that PBoC-defined benchmark rates in bank lending are a thing of the past. Their role has long been unclear as banks have ostensibly been free since October 2015 in loan pricing. The LPR was introduced as a reference for pricing of new loans last August (BOFIT Weekly 34/2019). The PBoC reports that already 90 % of new loans are priced relative to the LPR. The reference rate reform is expected to increase the market's role in pricing and reduce interest rates on bank loans. The one-year LPR is currently 4.15 %, down from 4.25 % in August.

The central bank reduced the interest rate on its medium-term lending facility (MLF) in November. The LPR is set relative to the MLF rate. Rates of reverse repo contracts used in open market operations were cut by 5 basis points in November.

Chinese policy rates and money market rates



Sources: CEIC, PBoC and National Interbank Funding Center.

Yuan depreciated slightly in 2019. The yuan lost just over 1 % of its value against the US dollar over the course of last year, ending 2019 at a rate of 6.96. The yuan's nominal effective (trade-weighted) exchange rate, or NEER, also declined by just over 1 %. The euro-yuan exchange rate at the end of the year was about the same as at the start of the year.

The yuan-dollar rate last year moved in concert with advances and setbacks in ongoing US-China trade talks. The yuan strengthened slightly at the beginning of last year as the talks moved in a favourable direction. As the trade war heated up, however, China let the yuan depreciate to a rate above 7 yuan to the dollar in August in response to new tariff hikes imposed

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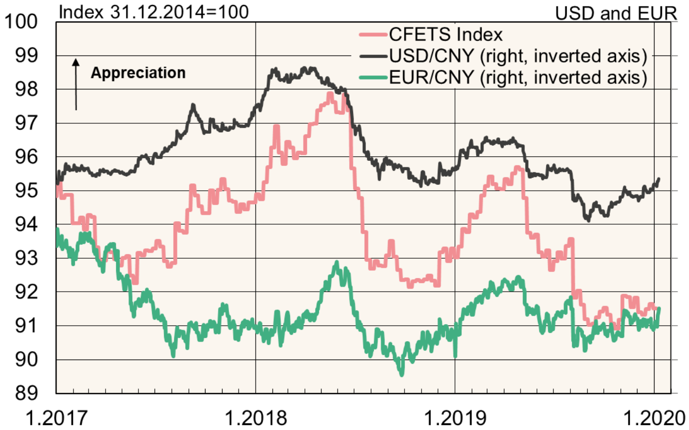
on Chinese imports by the US. When news came in December of a possible "phase 1" trade truce, the yuan appreciated slightly.

The trade-weighted China Foreign Exchange Trade System (CFETS) index, the PBoC's official currency index, weakened by about 2 % last year. CFETS, which is overseen by the central bank, updated its currency weightings from the start of the year in accordance with 2018 foreign trade data. After the update, the dollar weighting was lowered from 22.4 % to 21.6 %, while the euro weighting was increased from 16.3 % to 17.4 %.

The CFETS index was introduced at the end of 2015. It had its first update at the beginning of 2017, when a number of new currencies were added (BOFIT Weekly 01/2017). The CFETS currency basket presently comprises 24 currencies. Central bank guidelines say the index should be used e.g. by the 18 market-making commercial banks that set quotations for the yuan-dollar exchange rate the PBoC's uses in determining the daily yuan-dollar fixing rate and the upper and lower bounds (±2 %) of the exchange-rate band around the fixing rate. In practice, the CFETS index plays a minor role in currency markets as markets prefer to follow trends in the dollar's exchange rate.

Dollar-yuan and euro-yuan exchange rates; CFETS index



Sources: Macrobond and CFETS.

New foreign investment law enters into force in China. In March 2019, the National People's Congress approved a new law on foreign investment. The law entered into force at the start of this year and is intended to assure that foreign firms receive equal treatment as domestic firms. The law and its enabling clauses, however, have been criticised for vagueness and openness to interpretations.

The new investment law was hastily prepared about a year ago in an effort to stave off the emerging trade tensions with the US. The legislation streamlines previous legislation by replacing the three main laws governing foreign investments enacted during the 1970s and 1980s. The new law aims to conform international practices, following the principle of "national treatment", whereby foreign companies operate on a level playing field with domestic firms. The law protects intellectual property, guarantees access of foreign companies to Chinese public procurement processes and bans forced technology transfers. The law also affirms earlier rules on repatriation of profits and other company assets, as well as payment of fair compensation for government takings of property. The law prohibits public officials under threat of sanctions from providing to outsiders information they have obtained on foreign companies in the course of their official duties.

Foreign investment will continue to be prohibited in certain branches (negative list) and special permits will still be required to operate in some other branches. The negative list had been gradually shortened, however. Last summer, the number of branches forbidden to foreign investors was reduced to 40, down from 190 six years ago.

Although the new investment law is considered an improvement, many observers are cautious about what the new law will actually deliver. The law and its implementing regulations are not precise and leave much to interpretation. For example, eyebrows have already been raised over the exact meaning of the domestic content requirement for products supplied in public procurement contracts and the possibility for provincial authorities to provide their own interpretations of the national treatment principle. Once again, the biggest concerns relate to implementation of the new law.

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85 % of China's energy needs still met with fossil fuels. China is by far the world's biggest primary energy consumer. The latest figures from British Petroleum show that in 2018 China used about 40 % more primary energy than the United States and roughly twice as much as the EU in total. The Chinese also consumed about four times more primary energy than India, despite roughly equivalent population numbers.

Industry accounted for about 65 % of primary energy consumption in China, led by such industries as metal production, mineral processing and chemicals. Industry's share of energy consumption, however, has fallen a bit over the past decade as households (13 % share) and the transport sector (10 %) have rapidly increased their energy consumption.

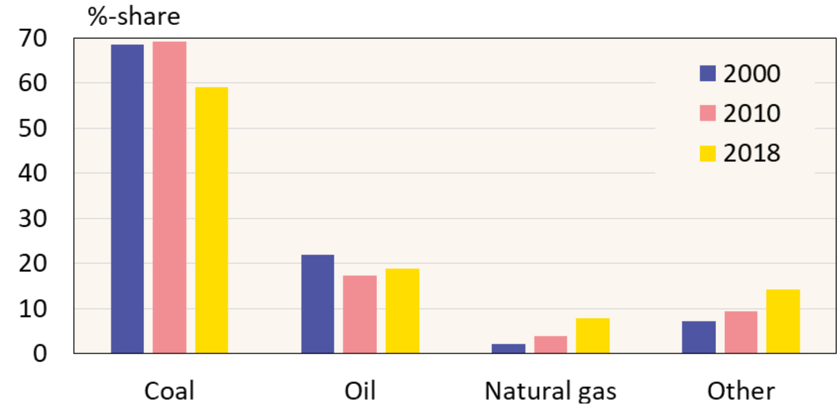
Coal remains China's main source of energy, covering almost 60 % of the country's primary energy needs. China uses as much coal as all other countries in the world combined. China's coal dependence also makes it the world's largest generator of greenhouse gasses. Coal use continues to grow and new coal-fired power plants are continually being planned and brought on stream. Nevertheless, coal's proportional contribution as an energy source has shrunk over the past decade. China has aggressively adopted several forms of renewable energy, and increased its use of gas and nuclear power. China is the global leader in generation of hydro, wind and solar power, accounting about 30 % of global power generation in each category.

Coal is an integral part of China's energy palette because it has major coal deposits. However, even if China is by far the world's biggest coal producer, it is no longer self-sufficient in coal. Over the past decade, China has had to import more and more coal from abroad, making it today the world's top coal importer. Nearly all coal is imported from Australia, Indonesia, Russia or Mongolia.

Oil is China's second-most important energy source. China's domestic oil production has been declining since 2015, and today is only sufficient to cover about 30 % of its needs. Oil imports have grown steadily at around 10 % a year. China has diversified its oil supply quite efficiently. Last year, it purchased crude oil from more than 40 countries. The biggest suppliers were Saudi Arabia (providing 17 % of China's oil imports), Russia (15 %), Iraq (10 %), Angola (9 %) and Brazil (8 %).

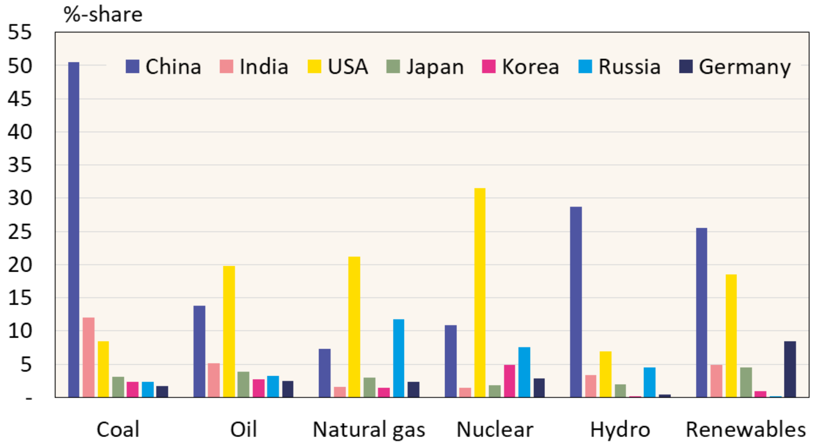
China has increased the use of natural gas rather quickly. Domestic production has doubled over the past ten years, making China today the world's sixth largest natural gas producer. Natural gas imports have also risen substantially. Gas now flows into the country via pipelines from Central Asia, Myanmar and (since December 2019) from Russia. After Japan, China is the world's number-two buyer of liquefied natural gas (LNG). About half of China's LNG comes from Australia.

Chinese energy sources by category, % of total primary energy consumption



Sources: China National Bureau of Statistics and BOFIT.

The world's top energy consuming countries in 2018, %-share of each sources' global consumption



Sources: British Petroleum Statistical Review of World Energy and BOFIT.

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Russia

Russian president holds annual state-of-the-nation address; government resigns unexpectedly thereafter. On Wednesday (Jan. 15), president Vladimir Putin delivered his annual state-of-the-nation address to a joint session of the Russian parliament. Putin first focused on Russia's poor demographic trends, and proposed increases to various family benefits to increase the birth rate and reduce poverty. The Russian president also proposed pay increases for teachers and reminded parliamentarians about fulfilment of the public sector wage hikes mandated in May 2012.

Putin reiterated his goal of raising the investment rate from 21 % of GDP at present to 25 % by 2024. Proposed measures to increase fixed investment include tax breaks and harmonisation of the regulatory framework. An economy ministry estimate finds that the costs of proposed measures to extend maternity benefits, provide child support to low-income families and tax incentives to spur fixed investment would add 300 billion rubles (4.4 billion euros) to the federal budget this year and rise later to over 600 billion rubles a year.

Putin ended his speech by proposing constitutional amendments that would, among other things, expand the role of the Duma and make official the status of the State Council, the highest advisory body to the president. The State Council was established in 2000. Immediately following the address, prime minister Dmitri Medvedev announced the resignation of his entire government. Putin proposed as new prime minister Mikhail Mishustin, head of the Federal Tax Service. The Duma approved Mishustin's nomination on Thursday (Jan. 16). The key tasks of the new government will be implementation of national projects and realisation of the numerous measures presented in Putin's speech.

Ruble appreciation continues in the first two weeks of this year. The ruble's exchange rate has appreciated gradually since its lows at the end of 2018. Over the first weeks of this year, the average dollar exchange rate has been around 62 rubles, while the euro rate has hovered around 69 rubles. The ruble has gained about 10 % against both currencies over the past 12 months. Even so, the ruble's exchange rate is still considerably weaker than at its peak in early 2018.

Rising oil prices have helped lift the ruble as they increase Russian export earnings and boost capital flows into the country. The price of Urals-grade crude in the first weeks of this year has averaged around 66 dollars a barrel, which is about 15 % higher than a year ago. The effect of oil prices is, however, restricted by the currency purchases conducted by the Central Bank of Russia for the finance ministry in accordance with the government's fiscal rule. The link between oil prices and the ruble's exchange rate seems to have weakened in recent years.

The ruble's real appreciation against the dollar and euro has been slightly more than its nominal appreciation. While inflation slowed in Russia at the end of last year, falling to just 3 % p.a. in December, it was still higher than in either the euro zone or the United States. The ruble's real effective (trade-weighted) exchange rate, or REER, rose by 8 % over the course of 2019.

The ruble's appreciation is generally not expected to continue this year, however. Most analysts expect the exchange rate to average around 65 rubles to the dollar this year. The finance ministry's forecast, the basis of the Russian budget's exchange rate assumption, expects the ruble-dollar rate to average 65.7 this year.

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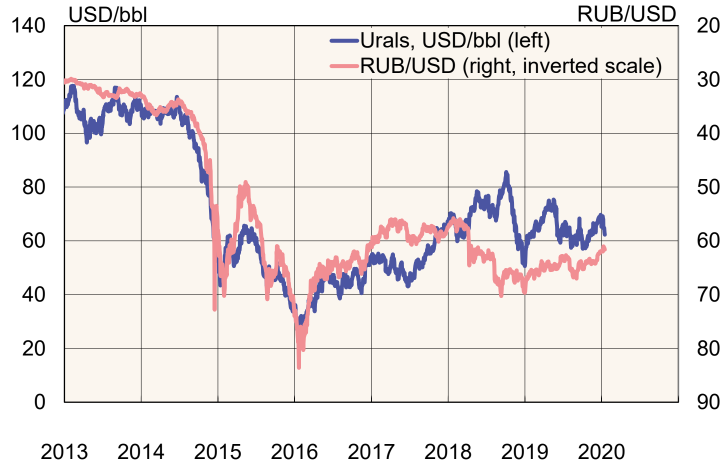
Ruble-dollar exchange rate and Urals oil price



Source: Reuters.

Russian oil fund's assets doubled last year. Higher oil prices and a stabilizing economy have created the conditions for replenishing Russia's National Welfare Fund (NWF) with oil & gas earnings. At the end of 2019, NWF assets reached 7.8 trillion rubles (126 billion dollars), which corresponded to roughly 7 % of Russian GDP.

The NWF grew by nearly 70 billion dollars last year. Much of the increase came from last summer's transfer to the fund of oil & gas revenues accumulated in 2018. A large chunk of NWF assets (6.1 trillion rubles, 99 billion dollars, or just over 5 % of GDP) is held by the CBR as part of Russia's foreign currency and gold reserves. These assets are invested in highly liquid USD, EUR or GBP-denominated assets. The remaining assets are tied up in longer term investments such as time deposits in Russian financial institutions or in bonds of infrastructure projects.

Under Russia's current fiscal rule, revenues derived from oil & gas earnings above the base price used in budget formulation (42 dollars a barrel in 2020) are to be transferred to the NWF. Russia's finance ministry predicts that the price of Urals oil will average 57 dollars a barrel this year and expects the NWF will rise to around 11 trillion rubles (9 % of GDP) by the end of 2020.

NWF assets were initially intended to finance the Russian pension system. Today, however, the main purpose of the fund is to balance cyclical fluctuations, and therefore it can be used under certain conditions to cover budget shortfalls. For example, the government dipped into the fund when oil prices collapsed in 2014. About 90 billion dollars in NWF assets were allocated during 2015–2017 to support the economy.

When the fund's liquid assets exceed 7 % of GDP, it is possible to invest the excess for supporting economic development. Under a bill pending in the Duma, up to 1 trillion rubles (16 billion dollars) could be used during 2020–2022 to provide credit finance for infrastructure projects and export credits.

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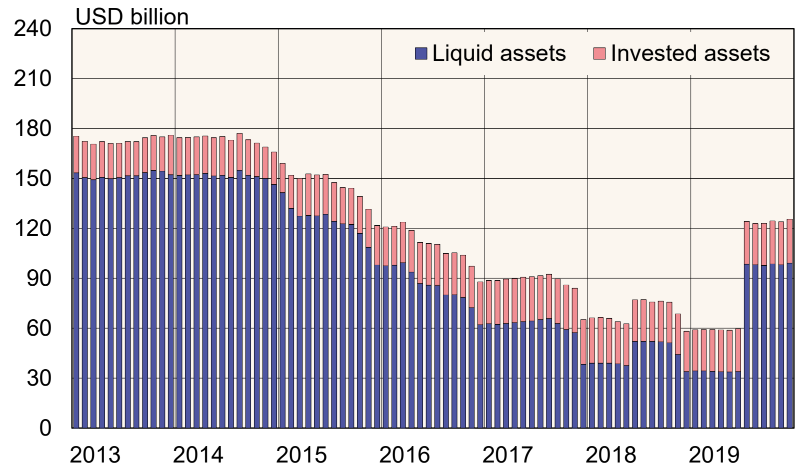
Russia's National Welfare Fund



Sources: Macrobond and Russian Ministry of Finance.

Oil revenues also boost Russia's foreign currency and gold reserves. The CBR reports that the value of its foreign currency and gold reserves at the end of last year climbed to 554 billion dollars, an 86-billion-dollar increase from the end of 2018. The increase in the reserves was mainly due to higher oil & gas revenues. The amount oil & gas revenues is reflected in the reserves due to CBR currency market operations conducted in accordance with the government's fiscal rule. The rule states that when the oil price exceeds the basic oil price (42 dollars a barrel in 2020), the CBR must purchase foreign currency from the market (or correspondingly sell forex when the oil price falls below the basic price). The purpose of these forex interventions is to reduce fluctuations in the ruble's exchange rate caused by shifting oil prices. The Ministry of Finance announces the amount of these market operations in advance every month.

The liquid assets of Russia's oil fund, the National Welfare Fund (99 billion dollars at the end of last year), are treated as a component of Russia's foreign currency reserves, even if their primary purpose is different from that of currency reserves generally. NWF assets are mainly intended to be used to smooth cyclical fluctuations in budget expenditures. Foreign currency and gold reserves, in contrast, serve largely as a buffer against unexpected shocks to foreign financing. When NWF assets are used, for example, to cover a budget deficit (i.e. ruble-denominated spending), it does not directly affect the value of the currency reserves as the central bank provides rubles for the finance ministry in exchange for the forex assets. The NWF's share of Russia's foreign currency reserves shrinks, however.

Russia's currency and gold reserves are relatively large by international standards. The currency reserves (excluding gold) are sufficient to cover more than a year's worth of imports of goods and services, or more than three times that needed to cover Russia's short-term foreign debt.

The structure of Russia's foreign currency reserves has remained fairly constant since spring 2018, when the CBR moved some of its dollar investments into yuan-denominated assets. At the end of June 2019, 30 % of Russia's reserves were in euros, 24 % in dollars and 13 % in yuan. Gold made up about 20 % of the reserves.

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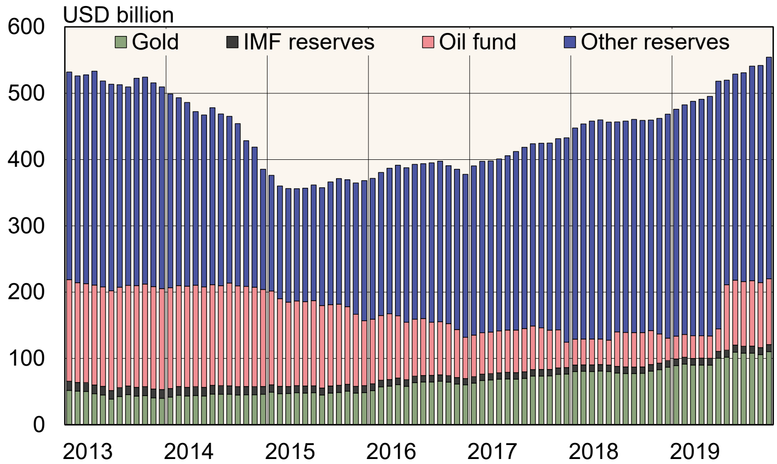
Russia's foreign currency and gold reserves



Sources: CBR and Russian Ministry of Finance.

Rosstat predicts a decline in Russia's population over the next two decades. In its latest demographic forecast, Rosstat offers three scenarios for Russian population growth through 2036. In two of these scenarios, the Russian population contracts from current levels. The forecast assumes that Russia's current population is slightly below 147 million. That figure, however, includes about 2.7 million people living on the Crimean peninsula and Sevastopol, which were illegally annexed by Russia in 2014.

Under Rosstat's basic scenario, the Russian population declines by 3 % between 2020 and 2036 to 143 million. While the birth rate remains low, Rosstat assumes that immigration to Russia remains high, with a net influx of 260,000 immigrants annually (a level quite similar to the average over the past decade). In 2018 net immigration was about 125,000 persons and in January-October 2019 it was 220,000. Over the forecast period, the annual average number of deaths would exceed the number of births by about a half million.

In the pessimistic scenario, Rosstat sees the Russian population contracting by 8 % over the forecast period to around 134 million by 2036. In this scenario, the birth rate decreases and net immigration is clearly lower, although still positive. In the optimistic scenario, immigration to Russia is so high that the Russian population increases by about 2 % over the forecast period. Even in the optimistic scenario, the number of deaths still exceeds the number of births in Russia.

The life expectancy of Russians rises in all Rosstat scenarios. In the baseline scenario, the life expectancy of men is around 75 years in 2035 (currently 68), while the life expectancy of women climbs to almost 83 years (currently 78). The increase in the Russian life expectancies reflects, for example, declines in alcohol and tobacco use.

According to the UN population forecast (BOFIT Weekly 27/2019), the Russian population is set to fall to 141 million by 2035, with a particularly swift decline in the number of working-age persons (15 to 64 years). There are major differences (e.g. estimates on net immigration) in the forecasts of the UN and Rosstat. Russia has traditionally been the destination of migrants from Central Asia and other parts of the former Soviet Union. Rising living standards in those countries could make Russia a less attractive destination, causing fewer people to immigrate. At the same time, emigration from Russia to such destinations as the EU, US and Israel continues.

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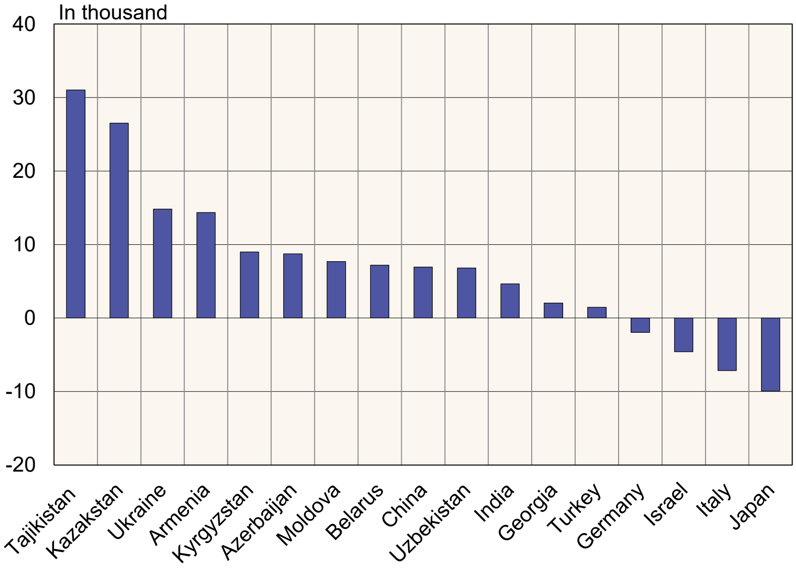
Net migration to Russia (positive value) and from Russia (negative value) for select countries, 2018



Source: Rosstat.

China

As expected, China hit its economic growth target last year, but slowdown continues. Newly released figures from China's National Bureau of Statistics (NBS) show that Chinese GDP grew by 6.1 % last year, putting growth well within the government's official 2019 target range of 6–6.5 %. On-year growth in the third and fourth quarters of 2019 was just 6 %.

The NBS also revised upwards by 0.1 percentage point its annual GDP growth estimates for the 2014 to 2018 period. The growth estimate for 2018 is now 6.7 %. Nominal GDP had already been updated at the end of last year on the basis of the newest census data (BOFIT Weekly 49/2019). The revised figures help lock in the government's politically important goal of doubling real 2010 GDP by the end of 2020. Reaching that decade-long goal still needs growth of at least 5.6 % this year. Pressure on government officials to meet the GDP growth target is one of several factors that have made Chinese GDP growth figures less than trustworthy, particularly in recent years.

Other economic indicators released by the NBS show an across-the-board slowdown in growth. Industrial output growth was just 5.7 % for all of 2019. Industrial output, however, picked up in December to a pace of 6.9 % y-o-y, likely reflecting a brief year-end recovery.

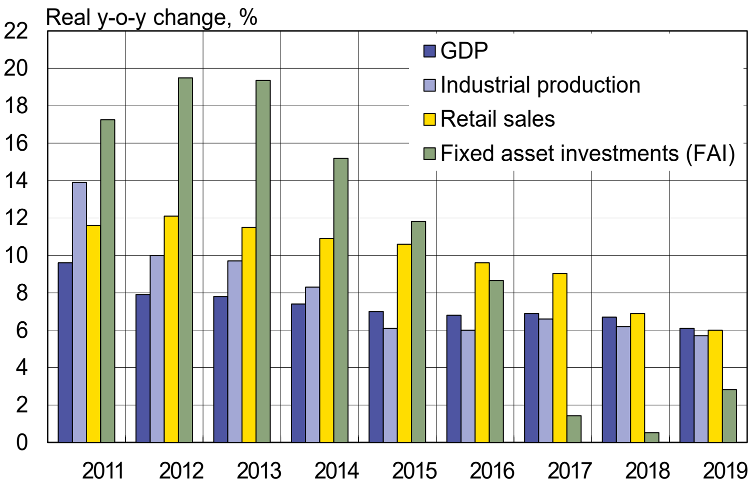
Growth in retail sales and fixed investment failed also to match the pace of GDP growth. In recent years, domestic consumption has supported China's economic growth as retail sales growth outstripped GDP growth. Last year, however, real growth in retail sales was just 6 %. Real growth in fixed asset investment (FAI) was only around 3 % last year. Public-sector investment rose faster than private-sector investment.

Household income and spending slightly lagged GDP growth last year. Real per capita disposable incomes increased by 5.8 % y-o-y, while consumer spending was up by 5.5 %. In 2018, disposable incomes increased by 6.5 % (spending up 6.2%). In urban areas, income growth last year was 5 % and median income per capita was 39,240 yuan (5,070 euros). In rural areas, the median income was 14,390 yuan (1,860 euros).

Surveys suggest the urban unemployment rate at the end of December was 5.2 %, up from 4.9 % in December 2018. Chinese unemployment figures show remarkably tiny variation from 5 %, and few observers believe they reflect actual labour market conditions. Even with slowing economic growth, there has, however, been little mention in the news of extensive layoffs. On the other hand, protests over belated salaries are quite common.

The rise in consumer prices in December matched the November pace of 4.5 % y-o-y. Inflation was pushed up by soaring pork prices, which alone contributed 2.3 percentage points to consumer price inflation. Producer price deflation eased in December, with producer prices declining by just 0.5 % y-o-y (down 1.4 % in November). Consumer prices were up 2.9 % for all of 2019, just below the government's 3 % target ceiling.

Real on-year growth in GDP, industrial output, retail sales and fixed asset investment



Sources: CEIC and NBS. BOFIT estimates when official figures are otherwise unavailable.

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Thorny issues overlooked in "Phase 1" US-China trade agreement. Last week (Jan. 15), representatives of China and the United States met in Washington DC to sign the Phase 1 trade agreement set to go into effect within 30 days of signing. The heart of the deal involves increasing the level of US imports to China. Most terms of the agreement, however, just reiterate reforms that have already been largely implemented or announced by China. Changes include such general measures as opening up markets to American companies and enhancing copyright protection. Tough trade issues such as Chinese government subsidies, industrial policy and cybersecurity are not covered in Phase 1.

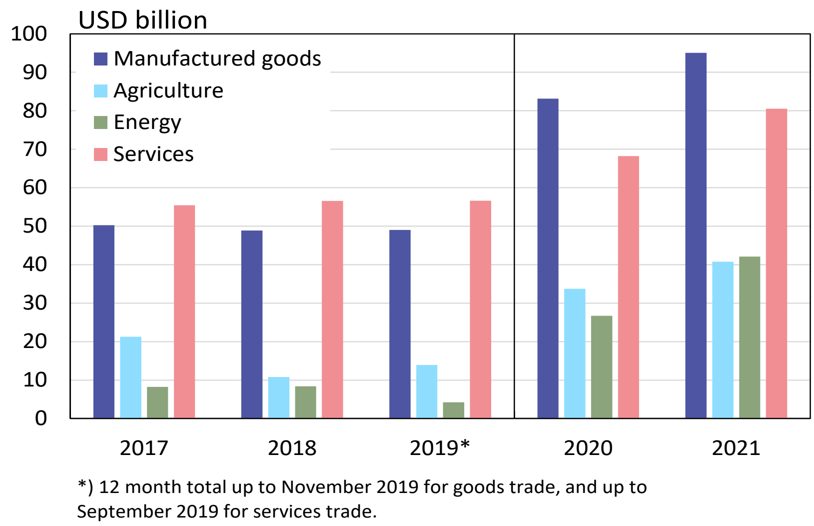
China promises that during 2020 and 2021 it will purchase goods and services worth at least 200 billion dollars in excess of the value of its purchases in 2017 before the trade war started (US figures for 2017 show that trade in the affected categories was worth 135 billion dollars). The product categories covered in the agreement accounted about 60 % of US goods exports to China in 2017 and practically all services exports.

The Chinese have committed to substantial purchases from US producers. The total value of Chinese goods imports last year was about 2.1 trillion dollars, of which 122 billion represented imports from the US. Under the agreement, China promises to increase from 2019 levels its purchases of agricultural products by 130 %, energy by 550 %, finished goods by nearly 70 %, and services by 20 %. Many observers point out that the agreement violates both countries' WTO commitments and likely distorts international markets. A fresh estimate published by the Kiel Institute for the World Economy suggests that quota purchases from the US under the deal would reduce EU exports to China in 2021 by more than 10 billion dollars and exports to China from the rest of the world by 50 billion dollars.

The agreement demands little from the US in return. As a symbolic gesture ahead of signing, the US abandoned its claim that China is a currency manipulator. The US also dropped its scheduled imposition of additional tariffs in December 2019 and will reduce by half the 15 % punitive tariffs imposed in September 2019.

The countries agreed to have high-level meetings on implementation and other issues that might arise under Phase 1. Many observers expect that China-US tensions to flare at some point as the agreement does nothing to rein in China's controversial practices. President Donald Trump said that he expects Phase 2 talks to get underway shortly.

Affected US product categories under Phase 1 trade agreement with US export quotas for 2020 and 2021



Sources: US Census Bureau, Phase 1 of the US-China trade agreement and BOFIT.

EU, US and Japan propose stricter WTO rules on industrial subsidies. Just ahead of the signing of the "Phase 1" US-China trade pact, the US, EU and Japan issued a joint statement calling for action on WTO rules on industrial subsidies, forced technology transfers and other market-distorting issues. In the view of the three trading superpowers, the current list of subsidies prohibited under WTO rules is insufficient to curb subsidy practices in some jurisdictions that distort markets and trade.

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The joint statement calls for extending the list of prohibited state subsidies, improvements in national subsidy reporting requirements, revision of subsidy calculation methods and other refinements. Although China was not named in the statement, the proposed changes seemed particularly applicable to China. As the US has been highly critical of the WTO, it will be interesting to see whether any actual progress on the rule changes called for in the statement is achieved.

Taiwanese economy thrives despite tense political relations with mainland China. Taiwan's current president since 2016, Tsai Ing-wen was re-elected this month to a second term. Tsai, the member of the Democratic Progressive Party (DPP), won with 57 % of the vote. Her platform stressing the right of Taiwan to sovereign independence and democracy was well-received by voters, boosted by the fact that the same themes have topped the political agenda in Hong Kong since protests began last summer. The election result was seen as a defeat for China's leadership, especially president Xi Jinping, who has stepped up his demands for reunification of Taiwan and its 24 million inhabitants with the People's Republic of China.

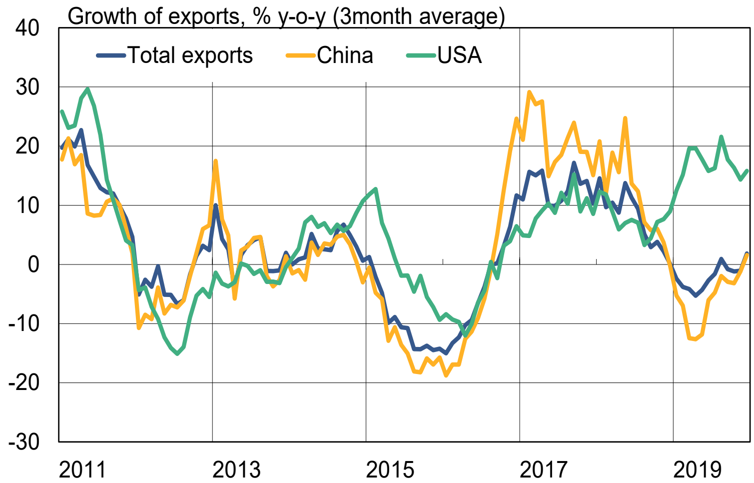
Political disputes are also reflected in economic relations between Taiwan (Republic of China) and the mainland (People's Republic of China). In the midst of the Taiwanese presidential election campaigns last August, mainland China denied private tourist visas for Taiwan. As a result, the number of Chinese tourists dwindled from around 300,000 a month before the visa halt to around 100,000 a month by November. The number of Chinese tourists also dropped sharply in 2016 when Tsai was first elected president. Some of the decline in the number of Chinese tourists in Taiwan has been offset by increased numbers of tourists from Japan, South Korea and Southeast Asia.

Besides political tensions, economic relations between the two countries have been affected by China's slowing growth and the US-China trade war. In 2019, the value of Taiwan's goods exports in US dollar terms declined by more than 1 %, while exports to China fell by 5 %. At the same time, Taiwan's exports to the US grew by 17 %. The trade war has forced restructuring of production chains as many companies operating in China have moved some of their production to Taiwan.

The Taiwanese economy is highly dependent on foreign trade. The ratio of exports of goods and services to GDP is currently around 65 %. Even with the political tensions with the mainland, China is still Taiwan's top trading partner. Last year, 28 % of Taiwanese exports went to China, followed by the US, which accounted for 14 % of exports.

Taiwan's export industries, fixed investment (23 % of GDP), and economy generally have benefitted from the partial transfer of production from the mainland to Taiwan. Taiwanese GDP rose by 2.7 % y-o-y in 2019, roughly the same pace as in 2017 and 2018. The country also produced a strong current account surplus last year (over 10 % of GDP) and a smallish budget deficit (about 1 % of GDP). Taiwan's government debt (32 % of GDP) is modest by international standards, inflation (1 % p.a.) is low and the exchange rate of the new Taiwan dollar has been relatively stable. Taiwan's economic growth this year is expected to be about the same as last year.

Change in US dollar value of Taiwan's goods exports, %



Sources: Macrobond and BOFIT.

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Russia

New Russian government to focus on social issues and national projects. Russia's new cabinet is led by prime minister Mikhail Mishustin, former director of the Federal Tax Service. Anton Siluanov, a proponent of tight fiscal policy, remains at the finance minister post. Perm regional governor Maxim Reshetnikov heads up the economic development ministry. Presidential economic adviser Andrei Belousov takes over as first deputy prime minister in charge of e.g. economic issues. A number of former cabinet ministers, including former economic development minister Maxim Oreshkin, have moved over to positions in the Presidential Executive Office.

Despite the snap cabinet shake-up, market reactions to the new government were quite mild. The new cabinet is not expected to push any major economic policy changes, although the state's purse strings are expected to loosen slightly. In line with the priorities laid out in president Vladimir Putin's January speech, prime minister Mishustin has raised improving social conditions and promoting national projects as key tasks of the new government. Both Putin and Mishustin have emphasized, however, that stability and building up financial buffers to deal with shocks remain essential economic policy goals as they have in recent years.

The finance ministry estimates that the cost of planned socio-economic support measures this year will amount to around 400 billion rubles (nearly 6 billion euros or about 0.4 % of GDP) and then increase gradually but notably through 2024. It is still unclear what amount of this translates into actual increases in budget spending. Russia can afford to increase federal government spending a bit as the budget framework for the next few years is been designed to generate small surpluses. Moreover, some allocated budget spending of previous years has not been used, so some retained funds are available. The large increase in the National Welfare Fund over the past couple of years has also eased the need to set money aside.

The planned spending increases should support slightly higher economic growth in Russia in coming years. The new government, however, is not generally expected to move ahead with significant structural reforms that would promote long-term economic growth. A key limiting factor on Russian economic growth is its economic system that is based on weak institutions. No significant changes in the current economic system are on the horizon.

Tepid performance for Russian foreign trade in 2019; capital flows closer to balance. Preliminary balance-of-payments figures from the Central Bank of Russia show that revenues from exports of goods and services fell 5 % last year in dollar terms (unchanged in euro terms). The decrease in revenues that began in the second quarter steepened towards the end of the year. Export prices fell slightly last year after rising in 2017–2018, when export revenues climbed up by over 20 % a year. Significantly lower energy prices last year were reflected in lower revenues from energy exports that drove down the export revenues overall. Revenues from exports of non-energy goods and services experienced feeble growth after two years of brisk increases.

Imports of goods and services to Russia collapsed in 2015 after a slide in oil prices, lower export earnings and a decline in the ruble's exchange rate. The subsequent recovery in imports still came to a halt in autumn 2018 until imports began to revive again in the second half of 2019, when on-year growth in spending on imported goods and services rose by well over 10 % in euro terms. The revival reflected a stronger ruble. In the fourth quarter of 2019, the ruble's real exchange rate was up by 10 % y-o-y against the euro and up over 6 % against the Bank of Russia trade-weighted currency basket.

Spending on imports rose by 8 % in euro terms in 2019, up from just 1 % in 2018 (in dollars, up 3 % in 2019 and 5 % in 2018). Spending on imports of both goods and services increased at a roughly similar pace. Services imports include spending on travel, which grew slightly faster. In euro terms, the value of imports was still less than in 2012 or 2013.

Russia's goods trade surplus contracted in 2019 as a result of the drop in the value of exports and the increase of imports. The deficits in other current account categories continued to deteriorate, reducing the overall current account surplus from around 7 % of GDP in 2018 to slightly over 4 % last year.

The net outflow of capital from the private sector decreased in 2019, largely due to higher inflows of direct investment (FDI) from abroad to Russia's corporate sector (banks not included). FDI to Russia only amounted, however, to about one-and-a-half percent of GDP. The outward FDI of Russian firms roughly equalled inward FDI to Russia. The outbound capital flows of banks declined reflecting banks' efforts to reduce their foreign debt in previous years. Russia's entire financial account was roughly in balance as the private capital deficit was offset by government net capital imports as foreign investors make substantial purchases of federal bonds on secondary markets.

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Main items in Russian balance of payments, 2017−2019

	USD billion 2017	2018	2019 (preliminary)	% of GDP 2017	2018	2019 (preliminary)
Current account	**32**	**113**	**71**	**2.1**	**6.9**	**4.2**
Trade balance, goods & services	83	164	128	5.3	9.9	7.6
- Exports of goods & services	411	508	482	26.0	30.7	28.5
- Imports of goods & services	327	343	353	20.7	20.8	20.9
Trade balance, goods	115	194	163	7.3	11.8	9.7
- Exports of goods	353	443	418	22.4	26.8	24.8
- Imports of goods	238	249	255	15.1	15.0	15.1
Trade balance, services	-31	-30	-35	-2.0	-1.8	-2.1
- Exports of services	58	65	64	3.7	3.9	3.8
- Imports of services	89	95	98	5.6	5.7	5.8
Other current account items	-51	-51	-58	-3.2	-3.1	-3.4
- income on investments and credit	42	49	49	2.7	2.9	2.9
- expenditure on investments and credit	82	87	93	5.2	5.3	5.5
- other items, net	-11	-12	-13	-0.7	-0.8	-0.8
Financial account & net errors	**-10**	**-74**	**-4**	**-0.6**	**-4.5**	**-0.2**
Government (excl. central bank)	12	-7	23	0.8	-0.4	1.4
Private sector total (A+B)	-24	-63	-27	-1.5	-3.8	-1.6
A. Banks	-23	-33	-22	-1.5	-2.0	-1.3
B. Other private sector, incl. net errors	-1	-30	-5	-0.1	-1.8	-0.3
- Direct investment	-9	-24	1	-0.6	-1.4	0.0
- to Russia	27	6	27	1.7	0.4	1.6
- from Russia	36	30	26	2.3	1.8	1.6
- Portfolio investment	-10	-2	-5	-0.6	-0.1	-0.3
- to Russia	-5	-1	-3	-0.3	0.0	-0.2
- from Russia	5	1	2	0.3	0.1	0.1
- Foreign currencies in cash *	6	7	8	0.4	0.4	0.5
- BoP net errors and omissions	3	2	-5	0.2	0.1	-0.3
- Other items under B. Other private sector	9	-14	-3	0.6	-0.9	-0.2

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

Source: Central Bank of Russia.

Russia and Ukraine reach agreement on transit fees for natural gas. Slightly less than half (roughly 70 billion m³ per year) of Russia's natural gas exports to EU countries is transmitted to customers via pipelines running through Ukraine. Russia's other pipeline exports to Europe transit Belarus (Yamal-Europe pipeline), travel under the Baltic Sea from Russia to Germany via Nord Stream 1 pipeline, or are piped directly to countries that share a border with Russia. As transit fees represent an important revenue source for the Ukrainian government, the EU and US are concerned about the future of gas transmission from Russia via third countries. The nearly complete Nord Stream 2 pipeline, which parallels Nord Stream 1, could reduce Ukraine's transit fee income to a fraction of its current level. Partly because of this and partly because of America's interest in growing its domestic liquefied natural gas (LNG) industry, the US issued targeted sanctions on companies involved in construction of the Nord Stream 2 pipeline. The move has halted construction work on the pipeline and it appears that Gazprom must finish the project on its own.

Russia and Ukraine reached a new agreement on gas transit at the end of December just as the old agreement was expiring. Under the new agreement, Gazprom commits to transmit via Ukraine at least 65 billion m³ of gas this year and at least 40 billion m³ of gas a year during 2021—2024. Before Gazprom and Naftogaz reached the agreement, they had to settle their disputes on earlier transit agreements. In late December, Gazprom finally payed Naftogaz 2.9 billion dollars in damages for its breach of the previous agreement. Naftogaz in return committed to not pursuing further claims on transit fees.

The Turk Stream pipeline, which runs under the Black Sea from Russia to Turkey, was completed late last year and officially commissioned at the beginning of January. The pipeline supplies gas to the Turkish market, but potentially could also supply customers in Southeast and Central Europe. The Nord Stream 2 and Turk Stream pipelines do not open new markets for Gazprom, and their commissioning will not lead to any net increase in Russian gas exports.

Russia gained direct access to China's growing natural gas market with the official inauguration in early December of the Power of Siberia gas pipeline. Russia's pipeline exports were earlier entirely dependent on trends in European and Turkish

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markets. Initially the volumes piped to China will be small, and it is difficult to judge the overall profitability of the pipeline. Once the pipeline reaches its full capacity of 38 billion m^3 a year, the amount of Russian gas shipped by pipeline to China will be roughly on par with the amount of gas Turkmenistan ships to China.

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China

Coronavirus epidemic having wide-ranging impacts on Chinese economy. The coronavirus outbreak, first reported at the end of last year from Wuhan, the capital and largest city in Hubei province in Central China, has now spread to all provinces of China. Isolated cases have also been reported in over two dozen countries. The vast majority of the cases are in Hubei province, which has a population of 60 million people and accounts for about 5 % of China's GDP. Wuhan and other cities in the province have been under quarantine for weeks.

There are also extensive measures elsewhere in China to prevent the spread of the epidemic, as well as limits on travel. China's week-long Lunar New Year holiday was extended by three days throughout the country to February 2. In most provinces, non-critical production facilities have remained closed this week. The affected provinces and metropolises (including Guangdong, Beijing and Shanghai) account for about 80 % of China's economic activity and 90 % of exports. Many internal migrant workers who travelled during the holiday season have been unable to return to the cities or towns where they work. Schools remain closed throughout the country. Tourist destinations are also shuttered and group tours have been suspended.

The economic impacts have been significant, especially for the service sector, because the epidemic struck during the Chinese New Year holidays. The National Development and Reform Commission reports that the number of New Year's travellers fell from 421 million last year to just 190 million this year. The transportation ministry reports that, in comparison to the 2019 New Year's holiday, the number of riders on trains and buses declined this year by around 70 %, while domestic air travel was off by almost 60 %. Businesses that profit during the holidays had to close. By some estimates restaurant and retail sales were off by about half from pre-coronavirus projections.

Financial markets plunged at their opening on Monday (Feb. 3). Most shares listed on the mainland China stock exchanges fell by 10 %, the limit at which trading in that share is suspended for the day. The yuan's exchange rate also declined. As the week wore on, however, currency and share prices recovered part of the Monday's drop. Media reports say that state-backed actors have been requested to support the markets as needed.

Several provincial governments have announced plans to support firms that have lost business due to the epidemic, offering such breaks as reduced or postponed tax payments and financial support to firms that do not lay off workers. Officials have instructed financial firms to support the economy by easing access to financing and lowering loan costs. At the beginning of the week, the PBoC increased market liquidity through its open market operations. The yields on reverse repo agreements used in the central bank's liquidity operations were cut by 10 basis points. Further monetary and fiscal policy easing measures are expected.

The economic impacts of the coronavirus are still difficult to judge due to the unknown extent of measures to limit the virus' spread or the duration of the epidemic. Most international forecasting institutions expect the coronavirus epidemic to cause a further slowing in China's GDP growth this year on the order of 0.5 percentage points, assuming the epidemic is brought under control within a few months. First-quarter growth is expected to decline by 1–2 percentage points and recover thereafter.

The situation is reminiscent of the another coronavirus outbreak, the SARS (severe acute respiratory syndrome) epidemic of 2003, which saw on-year growth in China's GDP and retail sales slow briefly by few percentage points and then recover quickly. The current epidemic is expected to have a larger impact, as the importance of the service sector (accounting for 59 % of GDP growth today compared to 39 % in 2003) and final consumption expenditure (58 % of GDP growth today vs. 35 % in 2003) in the economy have grown since 2003. Traditional stimulus measures such as investments in infrastructure have lost their potency as a means to reviving growth. Should the epidemic continue for a longer time, there is the danger that the already deteriorated economic and financial conditions of many firms could set off a vicious downward spiral.

The coronavirus epidemic is presently expected to cut 0.1–0.3 percentage points off global economic growth this year. In addition to the slowdown in Chinese demand and the resulting impacts on global commodity and financial markets, prolonged shutdown of manufacturing facilities in China disrupts international production chains that may further drag down global economic activity.

Chinese economic policy, which is dominated by growth targets, has long been accommodative. Even if the impacts on growth from the epidemic are short-lived, stimulus measures will be costly. From the stimulus standpoint, however, the situation is not comparable to the SARS epidemic. China today is in the midst of an economic slowdown and government debt is considerably larger.

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BOFIT

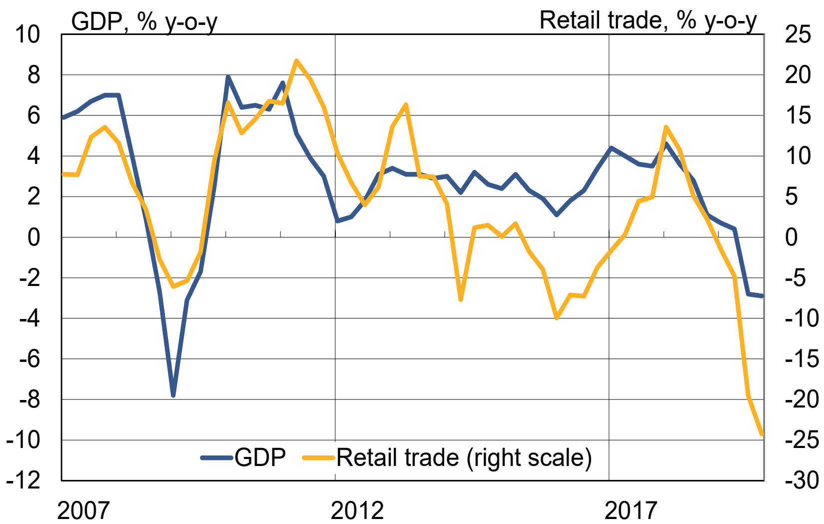
Hard times continue for the Hong Kong economy. GDP of the Hong Kong special administrative region (SAR) last year fell by 1.2 % y-o-y. GDP growth was down 2.9 % y-o-y in the fourth quarter as GDP fell for the third consecutive quarter. Hong Kong's growth has slowed for two years, hit by the flaring of trade tensions between China and the US in spring 2018, the slowdown in mainland China's growth and last summer's pro-democracy demonstrations. The outbreak of the coronavirus epidemic in China has only made things tougher for Hong Kong.

The uncertainty from political tensions last year weighed heavily on the Hong Kong services sector, which accounted for 88 % of total GDP in 2018. In particular, tourism and related retail activity suffered major losses with a 50 % decline in tourist numbers. An average of 5.9 million tourists a month visited Hong Kong during January-May 2019. Of that number, 4.7 million tourists a month came from mainland China. During the September-December period, the number of tourists averaged just 3 million a month, of which mainland visitors averaged around 2.3 million. Hotel occupancy rates fell from about 90 % to just 61 % in December. In the final quarter of the year, retail sales were down by 25 % y-o-y.

Targeted stimulus measures have substantially increased public spending, while private consumption, and particularly fixed investment, was down from a year earlier. Despite the inauspicious economic situation, Hong Kong's financial markets have remained calm and the Hong Kong currency board system, a de facto pegging of the Hong Kong dollar to the US dollar, has kept the exchange rate stable at around USD 1 = HKD 7.76 (Feb. 2). Hong Kong also continues to maintain robust currency reserves. The unemployment rate rose from 2.8 % in June to 3.3 % in December.

Hong Kong's economic situation remain precarious. The January reading of manufacturing and service industry purchasing managers' index (46.8) indicates an ongoing decline in production, even if the latest index reading was the highest since June. The coronavirus epidemic is putting an additional dent in tourism and the Hong Kong economy. The Hong Kong SAR closed most border-crossing points with mainland China after protests from health workers. Schools in Hong Kong remain closed and many bank branches have decided to keep their doors shut. Moreover, the outlook continues to be overshadowed by the general slowdown of the Chinese economy, political uncertainty, as well as tensions between China and the US, which continue despite the Phase 1 trade truce signed in January.

Hong Kong's real GDP and retail sales.



Source: Macrobond, BOFIT.

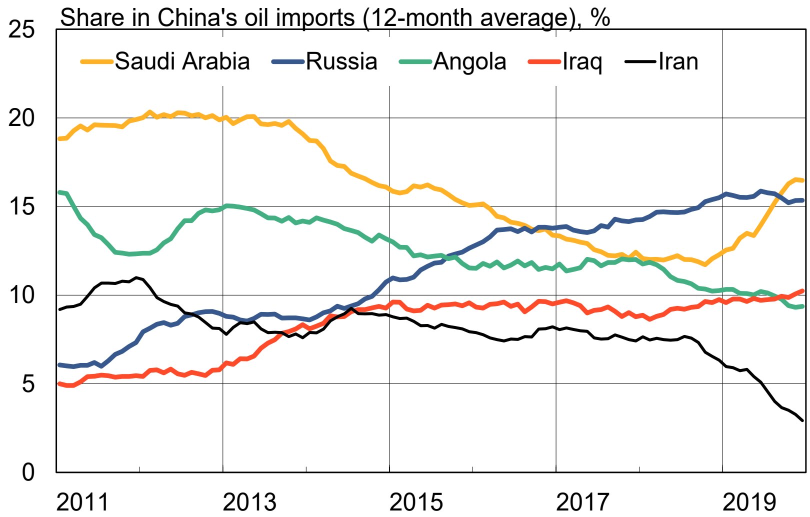
China's oil imports set record, but uncertainty over near-term oil demand depresses oil market. China imported 506 million metric tons of crude oil last year, a 9.5 % increase from 2018. China's oil imports has risen in recent years steadily by about 10 %. China's domestic crude production peaked in the middle of last decade at 215 million tons a year before declining to an annual level of around 190 million tons over the past three years. As the world's largest crude oil importer, China plays a key role in the global oil market.

China has effectively diversified its oil sourcing. Saudi Arabia last year re-established itself as China's top oil supplier with a share just over 16 %, while Russia held onto second place, supplying over 15 % of China's oil imports. The next largest suppliers were Iraq and Angola, each with shares around 10 %. Official Chinese figures show that imports of Iranian oil have fallen sharply since April 2019, when the US tightened its sanctions on Iran crude oil exports. Iran's share of China's crude imports fell by half to roughly 3 % last year. As recently as early 2018, Venezuela provided about 5 % of China's oil imports, but in the final months of 2019 China imported no oil from Venezuela. Some crude oil has been brought also from the US over the past couple years. Imports from the US last year fell by half to 6 million tons, or just 1 % of China's total oil imports.

Some of the recent increase in oil imports reflects new refineries coming on stream in China. They add to over-capacity in the branch and boost the volumes of refined petroleum product exported from China. China has rapidly emerged as the fourth-largest exporter of petroleum products in Asia after South Korea, Japan and India. China's overcapacity could cause new trade policy disputes.

Disruptions in production and transport flows caused by the coronavirus epidemic are expected to reduce Chinese oil demand over the short term. Uncertainty about China largely explains the recent major price swings on global oil markets.

Contributions of China's main oil suppliers relative to China's total crude oil imports

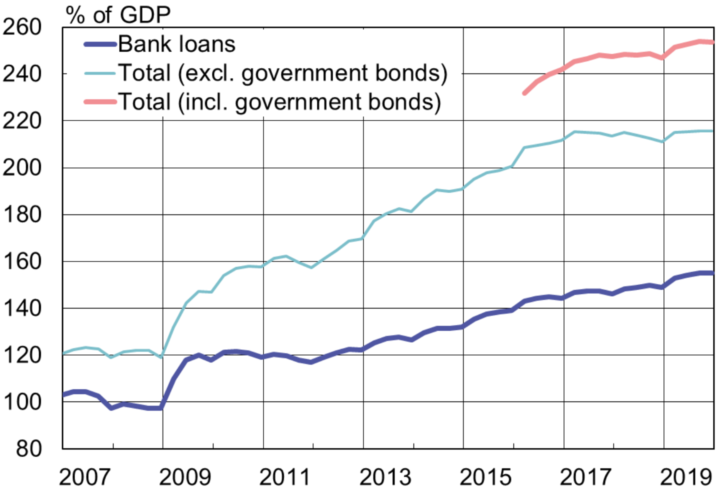


Source: CEIC, BOFIT.

Chinese debt continued to climb last year. The size of China's bank loan stock increased by over 12 % in 2019, even as nominal GDP growth remained below 8 %. The bank loan stock last year reached the equivalent of 155 % of GDP (148 % as of end-2018).

At the end of last year, the People's Bank of China changed the definition of its broadest credit measure Aggregate Financing to the Real Economy (AFRE, previously Total Social Financing), adding in from 2016 onwards the debt portfolios of central and local governments (38 % of GDP as of end-2019). The AFRE also includes the bank credit stock (155 % of GDP), select shadow-banking instruments (entrusted and trust loans, as well as undiscounted bankers' acceptances, amounting to 22 % of GDP), net corporate bond financing (24 % of GDP) and non-financial corporates equity financing (7 % of GDP). AFRE grew by 11 % last year to 254 % of GDP (up from 247 % at the end of 2018). The stock of shadow-banking instruments declined last year by 7 %, while the stocks of corporate and government bond issues rose by 13–14 %.

Ratios of domestic bank credit stock-to-GDP and debt-to-GDP (with and without government bonds)



Sources: People's Bank of China, CEIC and BOFIT.

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Russia

Effects of the coronavirus on the Russian economy remain limited for now. As there is still large uncertainty on the duration and extent of the coronavirus epidemic, the potential impact on the Russian economy is difficult to evaluate. Current information suggests the overall economic impact will remain low. However, if the epidemic widens, it poses significant risks to Russia's economic development amidst deteriorating global economic conditions.

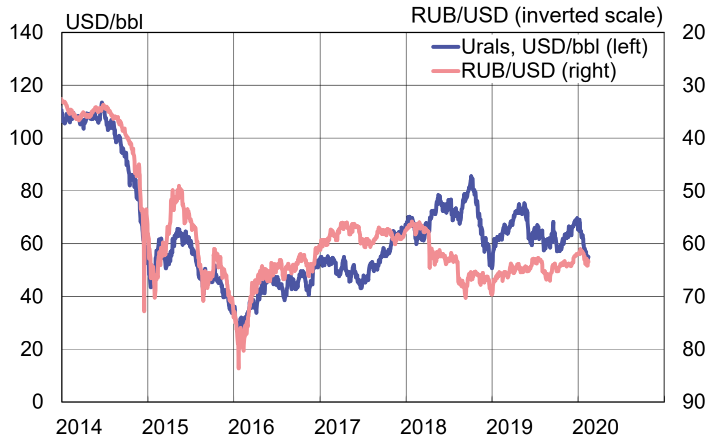
Russia has experienced two confirmed coronavirus cases. Both are Chinese nationals. Both made full recoveries and have been released from hospital. Measures to prevent the spread of the coronavirus in Russia include restricting passenger traffic at China-Russia border crossings, limiting flights between Russia and China, and suspending visa-free travel for Chinese tourist groups.

While the coronavirus has caused uncertainty on international markets in recent weeks, the reaction on Russian markets has been subdued. The ruble has lost about 4 % of its value against the dollar and the RTS stock index is down about 1 % from the start of the year.

Commodity markets, however, have seen the price of Ural-grade crude plummet by 20 % since the start of the year. Prices of many metals have fallen as well. The value of Russian exports of oil, natural gas and metals accounted for approximately 17 % of GDP last year. On the basis of the latest oil futures, the average price of oil should reach about 55 dollars a barrel this year. Russia's 2020 budget is set to show a slight surplus with Urals oil price of 42 dollars a barrel in accordance with the government's fiscal rule.

Russia's tourism sector is already feeling the effects of the virus with a drop in Chinese tourists. The Chinese are among the top tourist groups in Russia. Russia's Association of tourism industry says the industry could lose 40–50 million dollars a month if Chinese group tours scheduled for February and March continue to cancel. Russia's total tourism earnings amounted to 11 billion dollars last year (0.6 % of GDP). In addition to the tourism industry, the epidemic has complicated component deliveries to Russian car factories, as well as disrupted retail chain supplies of fruits and vegetables imported from China.

This year started with falling oil prices and ruble depreciation



Source: Reuters.

Monetary policy easing continues in Russia. At its February meeting, the board of the Central Bank of Russia decided to reduce the key rate by another 25 basis points to 6 % p.a. Consumer prices increased 2.4 % y-o-y in January. Inflation has slowed in recent months more than the CBR had earlier forecast due to Russia's sluggish economic growth and ruble appreciation. The base effect from last year's hike in the value-added tax also drags down inflation this year.

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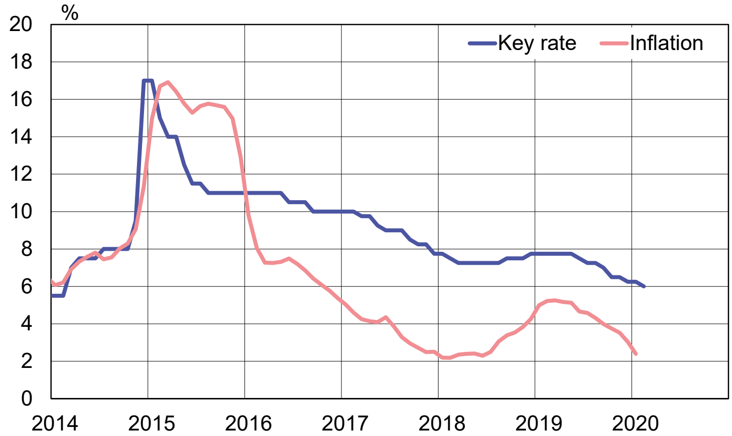
Governor Elvira Nabiullina gave a clear signal that the CBR's accommodative monetary stance would continue. She indicated that a further rate cut is probable at the next meeting, implying a shift from a neutral monetary policy stance to a stimulative one. The CBR left untouched both its GDP growth forecast for this year (1.5–2 %) and its inflation forecast (3.5–4 %). The CBR's inflation target is 4 %.

A downward trend in Russia's key rate has continued practically the past five years. In late 2014 the CBR had to hike the rate notably in the wake of a collapse in oil prices and geopolitical uncertainty. The key rate is currently at its lowest level since Russia annexed the Crimean peninsula. Credit interest rates have also dropped to historically low levels. The average interest rate on ruble-denominated corporate loans of over a year fell below 9 % in November.

In light of Russia's muted economic growth of recent years, the economy ministry, which is responsible for presenting the cabinet with policies that promote growth, has criticized the CBR for too slow monetary easing. Andrei Belousov, Russia's new first deputy prime minister and responsible for economic issues, has also advocated for looser monetary policy. The critics view lower financing costs would boost Russia's modest investment levels, whereas the CBR underlines the role of structural factors as obstacles to growing fixed investment in Russia.

President Vladimir Putin has been supportive of the CBR's monetary policy framework, remarking also in his January state-of-the-nation speech on the contribution of moderate inflation for economic stability. Inflation also shows up repeatedly among the top issues of economic concern in surveys of the general public. The CBR's monetary discipline has supported the reduction of Russia's consumer price inflation to the historic lows in recent years.

Russian inflation and key rate near historical lows



Source: Macrobond.

Rosstat reports Russian GDP up 1.3 % in 2019; revises figures for previous years. Last year, Russian GDP grew at its slowest pace in three years as growth averaged slightly over 2 % a year in 2017–2018. The recovery of imports slowed a bit to just over 2 %. Household consumption, by far the largest demand component, was even more the main driver of growth than earlier, although its growth slowed considerably to 2.3 %. Growth in public consumption gained notably. Even if fixed investment was up just 1.4 % in 2019, it was still an improvement from zero growth in 2018. In contrast, the volume of exports fell by 2 %, after rising every year since 2010.

Russian real GDP was nearly 4 % larger than its 2014 level, the year preceding the previous dip. The same applies to public consumption. The export volume was 16 % higher than in 2014, however. Household consumption and fixed investment were more than 3 % below their 2014 levels, while the import volume was down 11 % from 2014.

Revised Rosstat data for 2014–2018 show that GDP grew slightly more during three years in the period than shown by last autumn's data. The change reflected better-than-reported increases in household and public consumption. In contrast, growth in fixed investment fell to virtually zero in 2018. The new data also show that the ratio of fixed investment to GDP was just 20.5 % in 2018 and slightly over 21 % in 2019.

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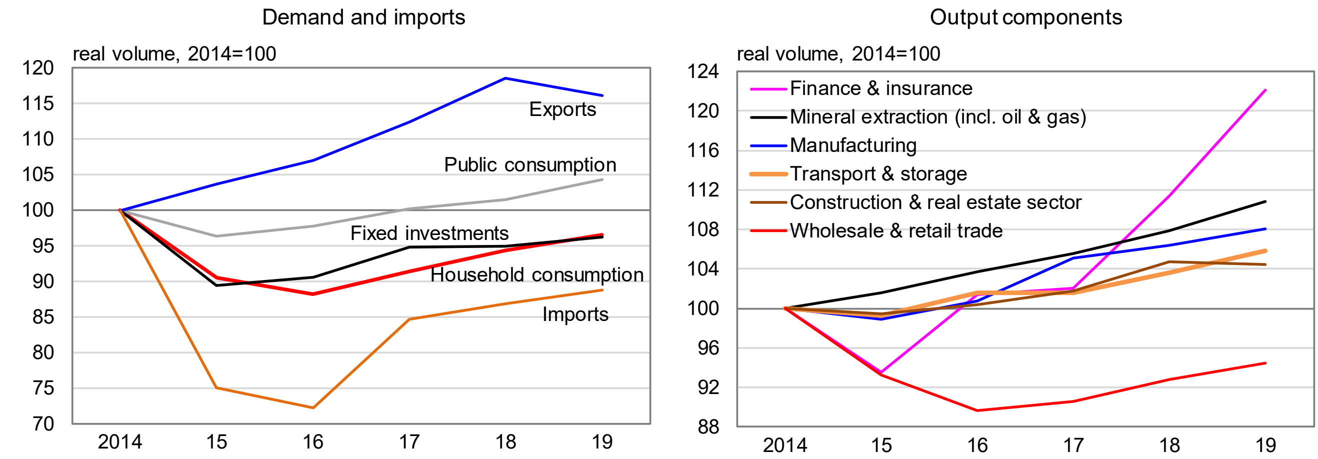
GDP growth in 2019 was largely driven by the same sectors as in 2018. The financial sector, trade and extractive industries, led by natural gas, continued to grow rapidly. After two years of value-added growth in the real estate sector, growth halted. Growth of value-added in manufacturing remained relatively slow.

Big differences in trends of Russian GDP components; gradual recovery in imports



Source: Rosstat.

Slightly lower growth in Russian bank lending. The credit stock of Russian banks grew by 6 % in nominal terms last year, down from 12 % growth in 2018. The most notable slowdown was seen in corporate borrowing, which increased by just 1 % y-o-y. Since approximately a quarter of corporate bank loans are issued in foreign currencies, shifts in the ruble's exchange rate affect the value of the corporate credit stock reported in rubles. Overlooking exchange rate changes, corporate borrowing from banks was up by 4 % in 2019 (up 5 % in 2018). The low growth in corporate borrowing was caused by low investment demand and rapid growth in the corporate bond market. The stock of corporate bonds on issue rose by about 15 % in 2019.

The weak demand for large-scale corporate borrowing has forced many banks to get more involved in retail banking. This is reflected in the rapid growth of housing loans and consumer credit. Despite slowing growth, the stock of household credit grew by over 18 % in 2019. The growth in unsecured consumer credit continued at a worrying pace (up 20 %), although slowing down from 2018.

About half of Russia's bank lending consists of corporate loans, while household loans account for another quarter. Russia's banking sector is highly dependent on customer depositors, and about half of the deposits come from households. Even with declining interest rates, household bank deposits grew by 10 % last year.

The CBR reports that banking sector profits, when adjusted for comparison, contracted last year by about 10 %. Russia had 442 operating banks at the end of 2019.

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China

China's efforts to contain the coronavirus epidemic significantly affect business operations. The Chinese are gradually returning to work outside Hubei province, but workplaces in Hubei will remain closed at least for the rest of the week. The resumption of production in most Chinese provinces gradually got underway last week (Feb. 10). Restarting production plants has been complicated, however, by the need for inspections, permits and issuance of protective gear. The conditions and guidance provided by local authorities varies considerably across provinces.

Travel restrictions and quarantines prevented China's internal migrant workers from returning to the workplace after their Lunar New Year's holidays. China's Ministry of Transport reports that only about a quarter of the scheduled 300 million holiday return journeys occurred last week. About a third of migrant workers are unable to return to work until March. About half of China's 1.4 billion population are currently subject to some restrictions on movement. Passenger numbers (road, rail, air and ship) within China are down 80 % from a year ago. Overseas airlines have suspended their China flights until the end of March or April. The suspensions also apply to cargo shipments.

The drop in economic activity is reflected in roughly 40 % lower coal consumption at large energy plants. A survey of China's main ports found that capacity utilization rate at China's large ports was off by 20–50 % from normal times.

The situation has also significantly impacted foreign companies operating in China. The American Chamber of Commerce in Shanghai surveyed its members during February 11–14. The responses by their member companies in the city and surrounding areas provides interesting insights into the effects of the epidemic. Almost half of responding companies said the coronavirus epidemic has already disrupted their international production chains. 78 % of respondents said they were suffering from labour shortages. Many companies also reported a lack of personal protective equipment for their employees.

Another survey performed between February 7 and 14 by Business Finland, the Finnish government's trade promotion agency, asked about the impact of the coronavirus epidemic on Finnish companies. 39 % of responding companies said they expect a negative impact on net sales over the next six months. About a fifth of respondents said they have already felt shortages of raw materials or components. Although the vast majority of respondents were small businesses, a quarter said they had already made or planned to make changes in their supplier networks.

The crisis has awakened awareness at many companies and in many industries as to the extent of their China dependence, and has forced them to consider diversifying their production chains. Some branches have long been involved in moving production chains outside China due to rising production costs and this trend was accelerated by the punitive tariffs imposed amidst the China-US trade war.

People's Bank of China has relaxed monetary policy only moderately to deal with the coronavirus epidemic. On Monday (Feb. 17), the People's Bank of China issued commercial banks 200 billion yuan (29 billion dollars) in one-year medium-term lending facility (MLF) credits. The credit was provided at a rate of 3.15 %, a 10-basis-point reduction. The one-year loan prime rate (LPR), the new reference for bank lending, was also cut 10 basis points in February to 4.05 %.

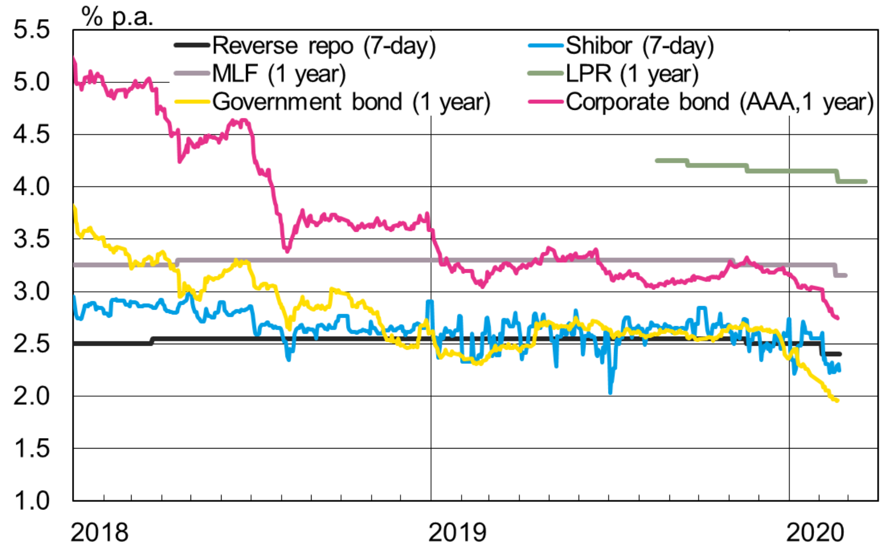
A total of 500 billion yuan in MLF loans have been granted this year. In addition, PBoC has granted 241 billion yuan in targeted financing (TMLF), a lending facility introduced at the beginning of 2019 and intended for lending to small businesses. The value of TMLF loans maturing in January amounted to 258 billion yuan. Market liquidity this year has been increased via MLF and TMLF by a total of 483 billion yuan (69 billion dollars).

The PBoC also used open market operations to boost liquidity when the financial markets opened after the extended Lunar New Year holiday. On February 3 and 4, net liquidity was increased through 7- and 14-day reverse repo contracts by a total of 1.35 trillion yuan. They also included a 10-basis-point reduction in the interest rate (e.g. the rate on the 7-day reverse repo was 2.4 %). Since then, more reverse repo contracts have matured than have been issued. So far this year, the net liquidity impact of the PBoC's open market operations has been -300 billion yuan. Interbank market liquidity has been sufficient, however, and the situation remains calm according to the PBoC. Interest rates on the interbank market have fallen.

In order to alleviate the short-term effects of the coronavirus epidemic, the PBoC has allocated 300 billion yuan (43 billion dollars) in "special central bank lending." The funds will go to designated national and regional banks that will use them to fund measures for dealing with the epidemic in the worst-affected areas. Central and local governments have compiled a list of key companies, involved in the production and distribution of medical equipment and daily necessities, that the money should be lent. Commercial banks are required to grant the loans at rates at least 100 basis points below the LPR, and preferably more. The finance ministry will compensate companies for half the interest costs of these loans, which means that the interest rate paid by the companies would be below 1.6 %.

The markets were expecting an across-the-board monetary easing, including cuts in bank reserve requirements. However, the African swine fever virus that has driven pork prices through the roof has cause inflation to flare and thus limits the chance of a broad monetary policy easing. Consumer prices in January were up 5.4 % y-o-y (core inflation, which does not include food and energy prices, was 1.5 %). The coronavirus epidemic could raise food prices further as transport restrictions have hampered distribution. Monetary easing at this point could also lead to hard-to-manage capital outflows and a deteriorating exchange rate (although there are no signs of extensive capital flight at the moment). The yuan's exchange rate fell by over 1 % against the dollar at the market open on February 3, but has since remained stable at around 7 yuan to the dollar. The value China's gold and currency reserves increased in January by 11 billion dollars to 3.234 trillion dollars.

Interest rates have fallen on China's money and credit markets



Sources: CEIC and Macrobond.

China's 4Q19 current account surplus shows modest shrinkage. Balance-of-payments data released by the State Administration of Foreign Exchange (SAFE) show that China's current account surplus fell to 40 billion dollars in the October-December period, a level lower than in any of the previous three quarters. Despite the smaller fourth-quarter surplus, China's overall 2019 current account surplus reached 178 billion dollars, well above the 2018 surplus (49 billion dollars). The ratio of current account surplus to GDP last year was 1.2 %, up from 0.4 % in 2018.

SAFE will later release detailed information on capital movements, but the current balance-of-payments information already shows that foreign direct investment inflows to China declined last year to 157 billion dollars from 203 billion dollars in 2018. The outward FDI of Chinese firms to other countries amounted to 98 billion dollars, essentially unchanged from the previous year. For comparison, China's commerce ministry reports that FDI inflows to China rose slightly last year to 138 billion dollars (the commerce ministry figures exclude financial sector investment, which has accounted for a few percent of total investment in recent years). Outbound FDI last year declined to 117 billion dollars from 143 billion dollars in 2018.

Using available balance-of-payments data, the net capital outflow from China last year was just under 200 billion dollars. The current account surplus largely compensated for net capital outflows, however, so changes in China's foreign reserves were negligible. As of end-2019, China's foreign currency and gold reserves amounted to 3.223 trillion dollars.

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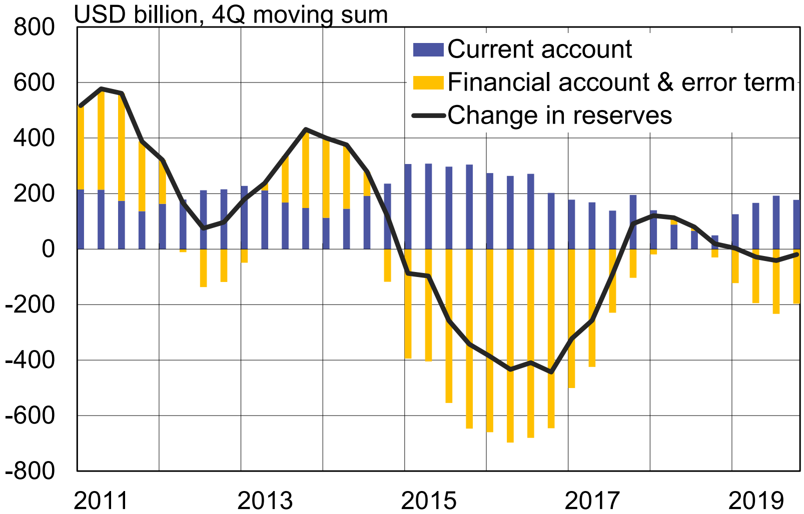
Main items in China's balance-of–payments



Source: Macrobond and BOFIT.

Increasing number of Chinese provinces failed to hit their growth targets last year. The National Bureau of Statistics reports that seven of China's 31 provinces missed their GDP growth targets by at least one percentage point, and that another five provinces undershot their GDP growth targets by lesser amount. The remaining 19 regions submitted output numbers in line with their growth targets, with except of Xinjiang, which claimed to have growth slightly above target. Cumulative weighted real regional GDP growth (6.5 %) again exceeded the NBS national GDP growth figure (6.1 %).

Observers have long recognised that officials in China's regions are motivated to embellish statistical reporting as hitting numerical targets is important for career advancement. The fact that so much target-missing appears in the latest figures reflects both the current economic struggles of regions and pressure from the central government to report more realistic figures. Several provinces have experienced major data-falsification scandals in recent years.

Recent revisions to regional GDP numbers, reflecting the findings of the economic census conducted at the beginning of 2019, provide a picture of extensive problems with provincial statistical reporting. Based on the survey data, the NBS revised downward total 2018 provincial GDP by over 1 trillion yuan (140 billion euros). The revised aggregate provincial GDP figure is now lower than the national GDP figure.

The biggest monetary adjustment was for Shandong province, which saw its GDP reduced by nearly 1 trillion yuan. In relation to the size of regional economy, however, the size of the Tianjin economy was reduced the most (a 30 % cut). Several provinces saw upward adjustments of their 2018 GDP numbers. The largest correction in percentage terms was 17 % boost in GDP figures for Yunnan province.

Substantial reduction in the size of many provincial economies means that their debt-to-GDP ratios clearly exceed previous estimates. Although the actual amounts of provincial debt exposure are vague, many regions, including Tianjin and Jilin, are known for high indebtedness. The tough situation facing provinces has not been helped by the central government's decision last year to cut taxes while increasing expenditures to provide economic stimulus.

China's central leadership has adopted policies in recent years that have put provincial policymakers between a rock and a hard place. The top leadership has called for deleveraging while stubbornly pushing hard growth targets only achievable through increased debt. Regions currently have the thankless task of balancing between ramping up production and containment of the spread of the coronavirus.

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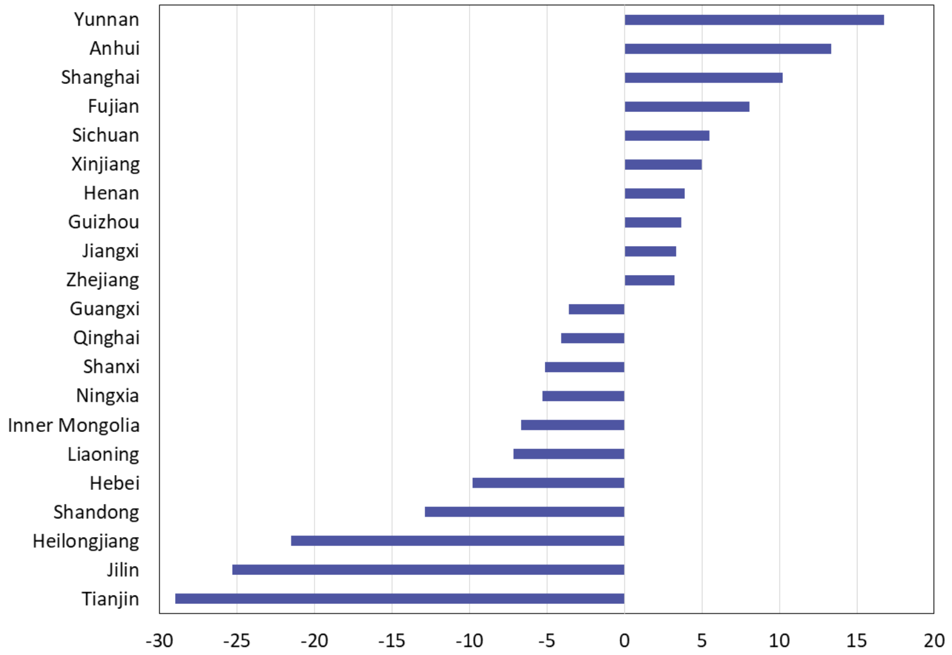
Largest NBS revisions for 2018 provincial GDP, % change



Sources: NBS and BOFIT.

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BOFIT

Russia

Central Bank of Russia to sell its controlling stake in Sberbank to the finance ministry. About half of the shares of Sberbank, which is listed on the Moscow Stock Exchange, are currently held by the Central Bank of Russia. Given that the CBR is also in charge of banking supervision, the ownership arrangement has raised concerns. The government now proposes that the CBR sells its shares to the Ministry of Finance. This is no small move as Sberbank is the largest bank in Russia, controlling about 30 % of the total assets of the Russian banking sector.

The proposed legislation enabling the transfer of Sberbank's ownership was submitted to the Duma on February 17. While bill readings have yet to be scheduled, passage seems certain. The new law authorises the finance ministry to acquire Sberbank shares now held by the CBR over next two years. Estimates for the potential sale price have been approximately 40 billion dollars. The finance ministry would pay for the share purchase with money from the National Welfare Fund, which already holds stakes in Russia's other major banks (VTB, Rosselkhozbank and Gazprombank).

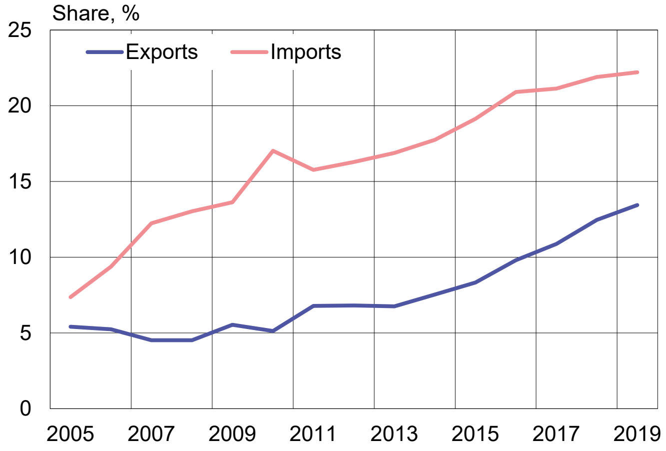
Proceeds from the sale will increase CBR profits, most of which are transferred to the state. Under the draft bill, the CBR will transfer the proceeds in instalments during 2020–2023. These revenues will increase non-oil revenues of the federal budget, i.e. they are not subject to the fiscal rule. Therefore, proceeds from the sale could be used to finance increased budget spending in the coming years.

Sluggish trends in Russian goods trade last year. Rosstat's preliminary breakdown of GDP categories indicates that the overall volume of Russian exports of goods and services decreased by about 2 % last year. It was the first such drop in a decade. The statistics on goods trade suggest that most of the export decline reflects notable decreases in export volumes of iron and steel products as well as cereals. These products together account for approximately 10 % of Russian goods exports. Russia's exports are still dominated by oil and gas, which accounted for over 60 % of Russian exports last year. The total export volume of crude oil and petroleum products remained nearly at the same level as a year earlier. The volume of natural gas exports rose by almost 6 %, mostly on growth in Russia's liquefied natural gas (LNG) industry. The value of goods exports slid by 6 % to 425 billion dollars. The value of exports was dragged down by drops in commodity prices and declining volumes.

A breakdown of Russia's GDP figures shows that the volume of goods and services imports to Russia increased by 2 % last year. Ruble appreciation helped boost import demand; the ruble's real effective (trade-weighted) exchange rate was up 2.5 % last year. Within trade in goods, imports in the machinery, equipment & vehicle sub-category remained unchanged and constituted about half of imports. The volume of chemical products, metal products and textiles was up 5–8 %. The value of goods imports was approximately 250 billion dollars, an increase of nearly 3 % y-o-y.

The geographical structure of Russian goods trade in 2019 followed the trends prevailing in previous years. The EU was still Russia's largest trading partner, accounting for 45 % of exports and 36 % of imports, but the EU's share remained on a slight declining trend as the share of Asian countries increased a bit. Russia's most important single trading partner was China, which last year accounted for 13 % of Russian goods exports and 22 % of goods imports. China's share of Russian goods exports has more than doubled in the 2000s, while the share of goods imports has tripled.

China's role in Russian goods trade has increased notably in past decade



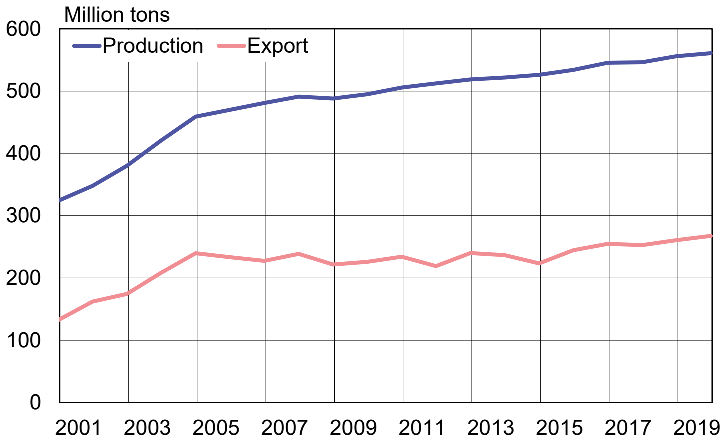
Source: CEIC.

Russian crude oil production hits record levels. Russian crude oil production (including gas condensates) last year edged up by a percent. The output was 560 million tons (11.3 million barrels a day) reaching its highest level in the post-Soviet era. The International Energy Agency (IEA) ranked Russia last year as the world's second largest producer of crude oil after the United States.

Most forecasts expect Russian oil production to remain nearly unchanged this year. Production growth is restricted e.g. by Russia's agreement with the OPEC+ that was renewed in December. OPEC+ includes OPEC members and nine other oil-producing countries. Russia is in talks with OPEC on further production cuts to deal with the negative demand shock from the coronavirus epidemic. Even if the February forecasts of the International Energy Agency (IEA) and OPEC factor in the negative impact of the coronavirus on crude demand, both still see global oil demand rising by nearly 1 % this year.

About 270 million tons (5.4 million barrels a day), or almost half of Russia's crude oil output was exported last year. The export volume increased by almost 3 %, despite the contamination of the Druzhba oil pipeline in April that restricted supplies for several weeks. January-September figures show that just over half of Russian crude oil exports last year went to the EU, while over a quarter went to China. The value of Russian oil exports last year was about 120 billion dollars, and exports of petroleum products 70 billion dollars (together 11 % of Russian GDP). In its February forecast update, Russia's finance ministry said it expects the volume of crude oil exports to increase by nearly 2 % this year, but then decline slightly in following years.

Russian crude output hit new highs last year



Sources: CEIC, Rosstat.

LNG drives growth in Russian natural gas production. The volume of Russian natural gas production (excluding "associated" gas from oil wells) grew by 3 % to the highest output ever – almost 690 billion cubic metres. Production of liquefied natural gas (LNG) increased by nearly 50 % as LNG operations on the Yamal peninsula reached full capacity. Russia produced approximately 40 billion m³ (29.5 million tons) of LNG last year, about 6 % of the country's total gas production. Other natural gas production rose by about 1 %.

Most forecasts show the volume of Russian natural gas production rising by 1–2 % a year over the next few years. Gas production is largely constrained by moderate demand outlook. Russian gas production has traditionally focused on the Yamal-Nenets autonomous region in western Siberia, which features the traditional huge gas deposits. Production growth focus is shifting to the Yamal peninsula and eastern Siberia. On the Yamal peninsula, Novatek is starting a new LNG project (Arctic LNG 2), while Gazprom is developing the Kovykta gas deposit in eastern Siberia.

About a third (250 billion m³) of Russia's gas production went to exports last year. Exports grew by nearly 6 % in 2019 on a doubling of LNG exports. The volume of gas exported by pipeline was unchanged for a year earlier. Most of Russia's LNG production is exported, with LNG accounting for 15 % of total gas exports last year. Figures for January-September show that nearly 70 % of Russian gas exports went to EU countries, while about 15 % flowed to CIS countries. China represented less than 1 % of Russia's gas exports. The total value of Russian gas exports last year was 50 billion dollars (3 % of GDP).

The February forecast of Russia's finance ministry envisions an increase in gas export volume of a few percent in coming years. Transmitted gas volumes to China are being ramped up gradually with the opening of the Power of Siberia pipeline in December. Current planning calls for the pipeline to supply China with around 5 billion m³ of gas this year and 10 billion m³ next year. The coronavirus epidemic could, however, depress gas demand in China.

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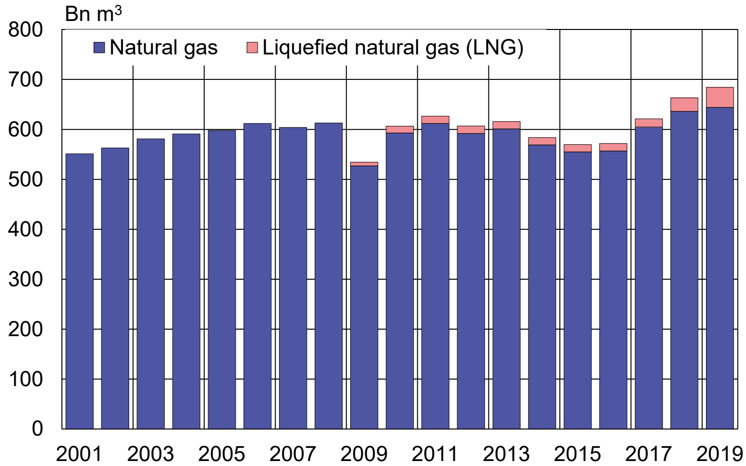
LNG led growth in Russian natural gas production last year



Sources: Rosstat, BOFIT.

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BOFIT

China

Early indicators suggest the coronavirus caused Chinese economic activity to collapse in February. The February reading of China's official Manufacturing Purchasing Managers' Index (PMI) fell from a growth-neutral reading of 50 in January to 35.7. The official PMI for the service sector plunged from 54.1 points in December to just 29.6 in February. The severity of this shift is underlined by the fact that there has never before been a reading of the services PMI below 50 points.

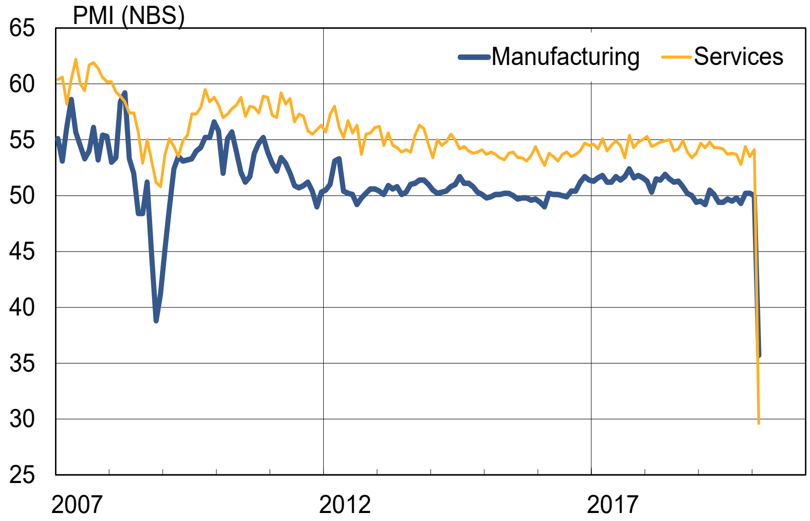
The PMIs are based on how firms see their economic situation in the current month relative to the previous month. A reading below 50 indicates declining prospects, while a value over 50 indicates an improving situation. The indices produced by the private business analytics firm IHS Markit also showed deep drops in their February manufacturing PMI (down from a January reading of 51.1 to 40.3) and a February services reading of 26.5 (down from 51.8).

China releases its January-February output and foreign trade data later in March. Even as it appears the government began to get a handle on the spread of the coronavirus, the daily data show only minor improvements in energy use, passenger and freight transport or commodity prices in February. News reports claimed an 80 % drop in car sales in February (down more than 40 % y-o-y in January-February). The only foreign trade information available for February so far concerns South Korea's foreign trade with China. For January-February of this year, the value of South Korean exports to China was down 9 % y-o-y. South Korea saw its exports to China plummet 16 % last year.

In March, the economic situation will improve, even if there are various obstacles to recovery. Part of the problem is that mending the gaps in production chains across provinces and sectors will be a heavy task. The cautiousness and coronavirus fears of people, combined with delayed wage payments, depress the demand side. The spread of the coronavirus to other countries is likely to slow China's recovery further.

Given the way PMIs are calculated, it is evident that their readings will improve in March from February lows. A more interesting issue in coming months, however, is whether the readings recover to stable levels above 50 as that would signify China's return to a growth path and a making-up of lost production.

February saw record low readings in China's official purchasing manager indices



Sources: Macrobond and BOFIT.

Foreign companies operating in China report difficulties caused by the coronavirus epidemic. The chambers of commerce in China for the US, UK and EU all published at the end of February the results of their member surveys made about a week earlier. All surveys found foreign firms operating in China suffering from problems caused by the coronavirus epidemic. These included restrictions on travel and logistical problems, increased costs, reduced productivity, financing issues, as well as restricted supply of intermediate goods and diminished demand for finished products.

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Not only do firms expect significant economic losses in the first half of this year, but huge uncertainty still overshadows the rest of the year. Uncertainty has forced companies to postpone their investment decisions and other planned operations. Many companies have had to cut costs and revise their budgets for this year. Most companies have also shifted extensively to telecommuting, which has increase the need for IT support.

To ease the situation, the bulk of foreign companies operating in China would like to see Chinese government support such as tax incentives. Foreign companies further stress the importance of clear, consistent and transparent policies in China. Many foreign companies have supported Chinese organisations in their fight against the coronavirus by providing charitable donations, technical support and medical supplies. American companies also wish having the US relax its heightened entry restrictions imposed on travellers from China to the US.

Two weeks ago, about half of companies surveyed expected the situation to normalise by the end of March.

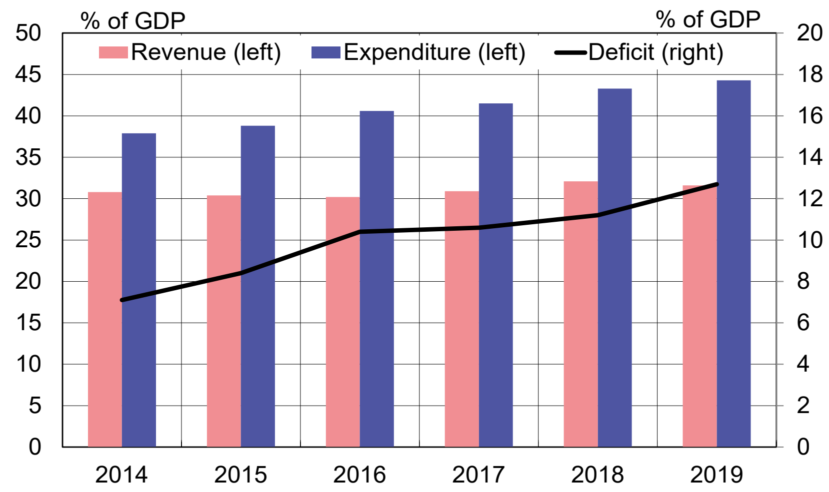
China posts larger-than-expected budget deficit for 2019. The original 2019 budget approved a year ago anticipated an increase of just over 5 % in central and local government revenues from the previous year. However, the revenue growth turned out to be below 4 %. Especially local governments fell behind in the budget. When the budget was adopted a year ago, the finance ministry already noted that the revenue-side budget will be hard to meet. Last year's expenditures, in contrast, slightly overshot their budget targets, raising the government's current official budget deficit estimate to nearly 5 % of GDP.

China's budget figures do not give a complete picture of what is happening in the public finances. Local governments, in particular, engage in extensive off-budget operations. For example, they channel investments through local government financing vehicles, earn money selling land rights and issue special purpose bonds to finance projects. The IMF calculates estimates for China's general government finances, which take into account off-budget activities. The figures show that the public-sector deficit has exceeded 10 % of GDP in recent years – and has been growing. The IMF estimates China's total public debt-to-GDP ratio to be currently around 70 %.

The coronavirus crisis has exacerbated in particular the distress of provincial economies. Restrictions on movement, widespread production shutdowns or operations limited to skeleton crews will be a huge blow to their revenues, but at the same time there is need to increase expenditures as the government must somehow revive economic growth and help companies make it through trying times. Moreover, China's leadership remains stubbornly fixated on meeting the growth targets set for this year, which would require increasing stimulus heavily.

China's budgets are typically approved annually at the National People's Congress in early March. This year's NPC will not be convened as usual due to the coronavirus epidemic, so there is no information available on this year's budget. No new date for the NPC has yet been announced.

China's public-sector spending, revenues and deficit based on IMF estimates



*) estimate for 2019.

Sources: IMF Article IV consultations (2019), own calculations and BOFIT.

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Finnish goods exports to China contracted by 1 % last year. Finland's goods exports to China last year were worth 3.5 billion euros. Finland's imports from China increased by 5 % to 4.9 billion euros. The value of Finnish goods exports overall grew by 2 %, while the value of imports decreased by 1 %.

Pulp accounted for 25 % of Finnish exports to China last year, with other wood products making up another 6 %. The value of pulp and wood exports declined slightly from 2018. Over 20 % of all Finnish pulp and wood exports went to China last year. The value of machinery & equipment exports remained at the 2018 level. Machinery and electronic equipment accounted for 30 % of Finland's exports to China. Optical and medical devices, which accounted for another 7 % of exports, saw their value increase by 7 % last year. The value of exports of furs (4 % of total exports to China last year) and nickel ores and concentrates (5 % of exports) also rose. Some 46 % of Finland's total fur exports and 88 % of nickel exports went to China last year.

Machinery and electronic equipment constituted over half of Finnish imports from China. The value of these imports increased slightly last year. Clothing, accessories and footwear accounted for 14 % of imports from China, furniture 5 % and toys 4 %. Finnish customs also collects industrial-specific goods trade data for each trading-partner country. Last year, wholesale and retail trade accounted for 60 % of Finland's imports from China. As regards Finland's domestic industries, Chinese imports are essential particularly to those involved in clothing manufacture, telecommunications and software services.

Key industries in Finland-China goods trade, 2019

	Imports			Exports		
	Imports, EUR m	Share of branch total imports, %	Share of China imports, %	Exports, EUR m	Share of branch total exports, %	Share of China exports, %
Wholesale trade	1,821	8.8	37.2	452	5.2	12.9
Retail trade	1,096	25.3	22.4	2	0.7	0.1
Manufacture of computers and electronics	269	17.9	5.5	388	15.3	11.1
Manufacture of electrical equipment	194	13.3	4.0	127	4.5	3.6
Manufacture of other machinery and eq.	193	8,0	3,9	622	7,4	17,8
Telecommunications	161	43.0	3.3	0.2	2.0	0.0
Manufacture of wearing apparel	105	45.5	2.1	1	0.5	0.0
Computer programming and consultancy	84	36.9	1.7	6	5.8	0.2
Manufacture of fabricated metal products	76	7.0	1.6	22	1.0	0.6
Scientific research and development	72	29.5	1.5	7	6.2	0.2
Manufacture of basic metals	59	1.6	1.2	249	4.4	7.1
Manufacture of chemicals and products	48	2.5	1.0	133	4.6	3.8
Manufacture of paper and paper products	27	2.3	0.5	1,036	10.0	29.7
Publishing activities	21	36.2	0.4	6	26.8	0.2
...						
Total	**4,897**	**7.5**	**100.0**	**3,493**	**5.4**	**100.0**

Source: Finnish Customs.

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Russia

Oil price collapse drives down ruble and Russian stock markets. The slow decline in oil prices seen in the first two months of this year accelerated at the end of last week. On Monday (Mar. 9) oil prices collapsed. By Thursday (Mar. 12) the price of Urals-grade crude oil had fallen to just $29.84 a barrel, down over 50 % from the start of January.

The precipitous fall in oil prices reflects the inability of Russia and OPEC's top producer, Saudi Arabia, to renew their voluntary production-ceiling agreement and negotiate further cuts in production. Russia, OPEC and a number of other oil-producing states (OPEC+) agreed in 2016 to coordinate production, but adhering to the production ceilings has been difficult at times. At talks last week, Russia refused to accept further production cuts, causing Saudi Arabia to blow off the negotiations.

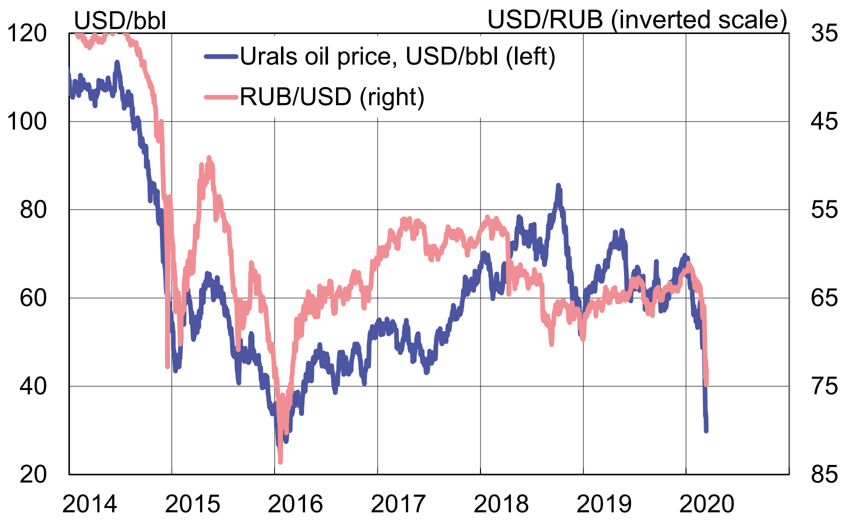
The negotiations on production ceilings among OPEC+ members have been complicated by the rise of shale oil production in the United States. American officials report that the US is the world's largest crude oil producer (19 % of total global output), with Saudi Arabia dropping to second place (15 %) and Russia to third (13 %). Of the three countries, Saudi Arabia has the best capacity to ramp up production quickly if it sees the need to do so.

As usual, the shift in oil prices was reflected in the ruble's exchange rate. The ruble lost significant ground at the start of this week. On Friday noon (Mar. 13), one dollar bought about 73 rubles. The ruble is currently about 15 % weaker against the dollar and 17 % down against the euro from the start of this year. Ruble depreciation does not completely reflect the fall in oil prices, however, so oil prices in recent weeks have fallen significantly also in ruble terms. Lower oil prices hurt the government's tax earnings from oil in ruble terms and degrade Russia's fiscal situation, even if some of the impact of low oil prices can be blunted with National Welfare Fund assets.

The Central Bank of Russia announced on Tuesday (Mar. 10) that it was resuming ruble purchases from the currency markets along the lines of the government's fiscal rule. Until recently, the fiscal rule has largely induced the CBR to sell rubles and buy forex, causing Russia's forex reserves to rise to around 570 billion dollars in February. Russia has the world's fourth-largest gold and currency reserves after China, Japan and Switzerland.

Russia was not spared in the collapse of oil prices or the stock market crashes. On Thursday (Mar. 12), Moscow's dollar-denominated RTS index was down 37 % from the start of this year. The share prices of energy companies were particularly hard hit, with the RTS oil & gas sector sub-index off 44 % for the year to date.

The ruble-dollar exchange rate has been dragged down by falling oil prices



Source: Reuters.

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Russia's proposed constitutional amendments allow president Putin to remain in power. Revisions prepared for the Russian constitution in past weeks have now been approved by both the Duma and upper-house Federation Council. April 22, the date of the national referendum on the new constitution, has been declared a national holiday.

The current Russian constitution only allows a person to serve two terms as president. Under a last-minute amendment to the new constitution text, only terms after the new constitution enters into force would count. As a result, even Russia's sitting president would be free to serve another two terms under the new constitution. President Vladimir Putin has given his blessing to the amendment on the condition that the constitutional court approves the change.

The revisions to the constitution also include changes that address certain social issues, i.e. the minimum wage should not be lower than the official subsistence minimum, as well as a requirement that pensions and other social entitlements be indexed. The draft constitution also provides changes in power-sharing arrangements among institutions, certain requirements on persons serving in political office, as well as immunity and life-time seats on the Federation Council granted to former presidents.

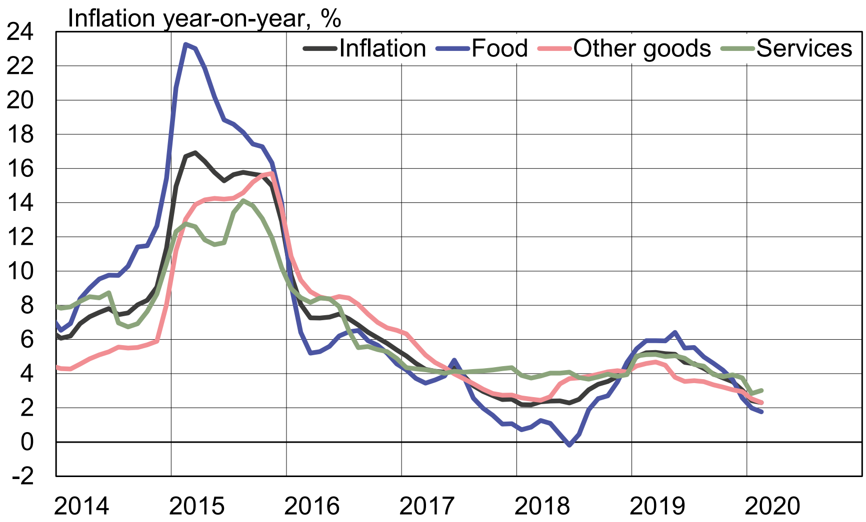
Russian inflation remained moderate. February consumer prices were up by 2.3 % y-o-y. Inflation slowed slightly from the January pace of 2.4 %. Much of the drop can be attributed to low growth in food prices (1.8 %) and other goods prices (2.1 %).

Since the start of 2019 the rise in consumer prices has slowed, mainly as a result of low economic growth and ruble appreciation. The CBR has responded to falling inflation with monetary easing. Its key rate (currently 6 %) has now been lowered six times in a row. After its February key rate meeting, the CBR signalled that it intended to maintain an accommodative monetary stance (BOFIT Weekly 7/2020).

The recent substantial drop in the ruble's exchange rate in turbulent markets should result in higher import prices and thus somewhat accelerate inflation in the coming months. Persisting market uncertainty makes it challenging to fine-tune monetary policy. If the ruble remains weak, higher prices for imported goods likely pass through more to consumer prices, while ongoing troubles in the oil markets may further depress Russian economic growth, which would lower inflation.

Consumer price inflation is currently running below the CBR's target of 4 % p.a. Its forecast for this year calls for inflation in the range of 3.5–4 %. The CBR's next regularly scheduled rate meeting will be on March 20.

Russian consumer price inflation has remained moderate



Source: Macrobond, BOFIT.

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BOFIT

Russian government sector spending increased rapidly last year; oil price drop changes outlook. Growth in revenues to the consolidated budget (federal, regional and municipal budgets plus state social funds) slowed in 2019 to around 6 %. Growth in budget spending quickened to nearly 10 %, its fastest pace in many years. The budget surplus shrank somewhat, but still amounted to about 2 % of GDP (nearly 3 % of GDP in 2018).

The slowing growth in revenues was due to an over 10 % decline in revenues from oil & gas taxes. Oil & gas taxes accounted for a fifth of total consolidated budget revenues, i.e. a decline to the 2015–2017 levels. Growth in other budget revenue streams exceeded 10 %, even if the pace slowed slightly. VAT revenues again increased rapidly (up 18 %), accounting for an increased share of 18 % of consolidated budget revenues. Growth subsided for revenues from social taxes based on wages, but they still accounted for a fifth of total budget revenues. Revenues from corporate profit taxes and labour income taxes increased by 10 %, but grew less rapidly than in 2018.

The fastest growing consolidated budget spending categories (each up well over 15 %) last year were the housing sector and various branches of the economy. The brisk rises of 2018 continued for spending on healthcare (up 14 %) and education (up 10 %). Spending on government administration rose by nearly 10 % for the second consecutive year. Growth returned to spending on defence and domestic security & public order, but stayed at 6 %. Growth remained rather moderate for spending on social entitlements, both with respect to pensions and other forms of social support.

The Duma approved changes to the federal budget and the state pension fund budget for 2020–2022 partly in response to president Putin's promise to add to social support in his January speech to the Russian parliament. If regional and municipal revenue projections still are at the level of estimates made last autumn, consolidated budget revenues should rise by roughly 3 % this year on the above-mentioned changes and about 6 % a year during 2021–2022. Large part of the increase in revenue estimates for 2021 and 2022 derives from an increase in the CBR's annual transfer from its surplus to the federal budget stemming from the government's recent decision to buy the CBR's majority stake in Sberbank to the government. The move is to be financed with assets from the National Welfare Fund. Consolidated budget spending should increase with the above-mentioned changes and last autumn's regional budget spending projections slightly faster than expected late last year, i.e. 6.5 % annually in 2020–2022.

Based on the revenue and spending estimates, the view of a slight surplus in the consolidated budget is preserved (the federal budget surplus this year would be 0.8 % of GDP). The revenue projections, however, are based on an economic scenario criticised already earlier for being overly rosy (GDP growth of nearly 2 % this year and over 3 % from 2021 onwards). Moreover, the recent collapse in oil prices casts shadow over the budget's oil price assumption, which this year is just under $58 a barrel (Urals crude). The slide in the ruble's exchange rate caused by the drop in oil prices will soften the impact to the budget from the contraction in dollar-denominated oil & gas tax revenues, but it will still be insufficient to compensate for the negative impact of the drop in oil prices on the real economy. At an average price of $50 a barrel this year, the budget would go slightly into deficit under current spending projections. On the other hand, Russia already has a prodigious liquid asset buffer in the National Welfare Fund, as well as additional accrued oil tax revenues waiting to be transferred into the Fund. These assets altogether amount to over 9 % of GDP.

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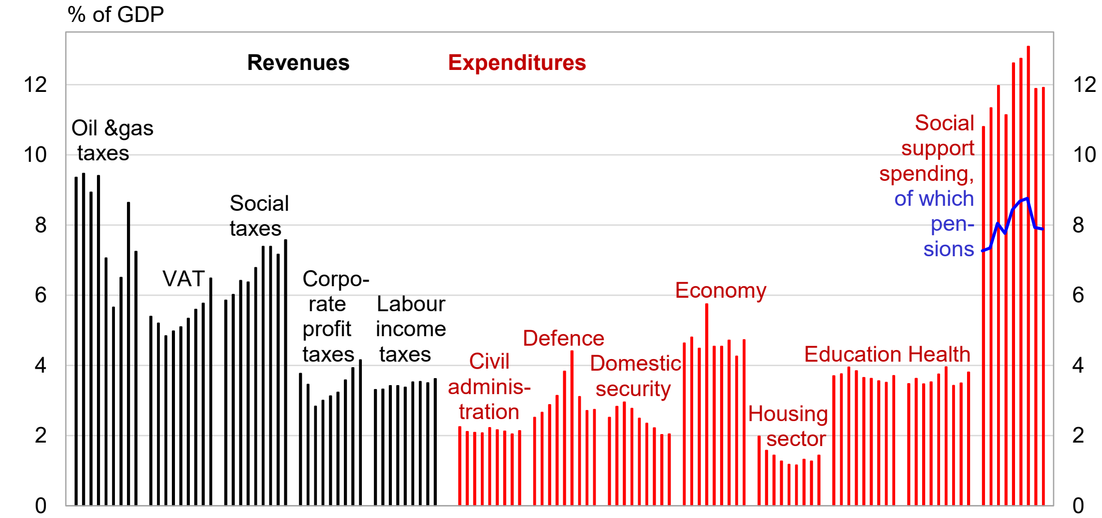
Largest revenue and spending categories in Russia's consolidated government budget, 2011−2019



Source: Russian Ministry of Finance.

Finnish-Russian trade performed modestly last year. Finnish goods exports to Russia increased last year by 10 % to 3.6 billion euros. Much of the export growth, however, reflected one-time supplies for construction of the Nord Stream 2 gas pipeline. Pipeline sections that were made in Russia and brought to Finland for coating were earlier recorded as part of Finland's imports from Russia and last year correspondingly as Finnish exports to Russia.

Without the gas pipeline deliveries, Finnish exports to Russia grew only by about 1 % last year. Export trends vary considerably across branches. Exports of machinery & equipment, foodstuffs and forest industry products were up 3–6 %, while exports of chemical products and textiles experienced contractions. Finnish exports lagged market trends as Russia's total goods imports grew last year by 8 % in euro terms supported by ruble appreciation.

Machinery & equipment remained the cornerstone of Finland's goods exports to Russia, accounting for about a third of total exports. Chemical products represented about 20 % of exports to Russia. Other important goods categories included forest industry products and metals. The export share of foodstuffs has declined in recent years to around 3 % due to import restrictions imposed by Russia.

Finnish imports of Russian goods contracted by 3 % to 9 billion euros. Most of the contraction in imports came from the Nord Stream 2 pipeline project. When the pipeline project is excluded, the value of imports was unchanged from the previous year. About 70 % of Finnish imports from Russia in recent years have consisted of oil & gas. Other important imports include metals and chemical products, each of which accounted for about 10 % of imports.

Russia accounted for almost 6 % of Finnish goods exports last year, making it Finland's fifth-most important export market. From sector perspective, Russia was an important export market in particular for the sectors of retail trade and manufacture of metal products. Russia also accounted for nearly 14 % of Finland's goods imports, making it Finland's second-largest import provider. In sector terms, Russia is important e.g. to Finland's forest and metal industries as a source of raw materials.

The sectoral breakdown of Finnish imports from Russia is not complete (see table). Information in some branches is confidential due to small number of importing companies. For this reason, such items as energy imports are not fully reflected in the detailed breakdown of goods imports by branch, but rather included in the "other sectors" category.

Russia's share of Finland's goods exports and imports by branch in 2019

	EXPORT			IMPORT		
	Value of exports, EUR million	Russia's share in sector's exports, %	Sector's share in exports to Russia, %	Value of imports, EUR million	Russia's share in sector's imports, %	Sector's share in imports to Russia, %
Manufacture of machinery & equip.	707.0	8.4	19.4	8.5	0.4	0.1
Wholesale trade	495.6	5.7	13.6	1 302.9	6.3	14.5
Manufacture of paper	441.6	4.3	12.1	270.5	23.4	3.0
Manufacture of metal products	355.0	15.9	9.7	62.7	5.7	0.7
Manufacture of chemical products	207.4	7.2	5.7	288.8	15.4	3.2
Manufacture of plastic & rubber	119.1	8.3	3.3	95.8	10.5	1.1
Manufacture of electronic equip.	101.7	3.6	2.8	81.9	5.6	0.9
Manufacture of basic metals	94.8	1.7	2.6	978.6	27.1	10.9

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Source: Finnish Customs.

China

China's economic output collapsed in the first two months of this year. The January-February figures published by China's National Bureau of Statistics on industrial output, retail sales and fixed investment all displayed the sharpest drops seen since China adopted its current statistical methodologies. Economic activity came to a standstill as the government imposed measures to deal with the coronavirus epidemic. Those measures largely remained in place throughout February.

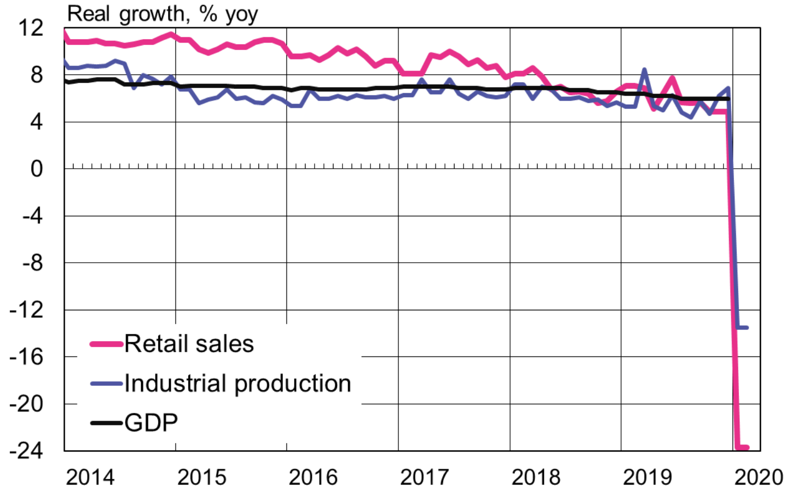
Industrial output contracted by 14 % y-o-y in the first two months of the year. Production fell by 20 % at privately-held companies, a larger drop than for state-owned enterprises. Manufacturing output decreased by 16 %. Car production plunged by 46 % and production of mobile phones was off by 34 %. The monthly indicator of fixed asset investment (FAI) was down by about 25 % y-o-y in January-February. Investment in infrastructure slid by around 30 %, with investment in manufacturing falling slightly more.

Retail sales declined by 24 % y-o-y. Catering services sales dropped by 43 %. While the total value of e-commerce fell 3 %, online goods shopping rose on higher food sales (up 26 %). The China Association of Automobile Manufacturers (CAAM) reports that the number of cars sold in January-February was down by 42 % y-o-y. There was a similar drop in the volume of mobile phones sales (44 % y-o-y).

Although economic activity has been up in March from January-February, the first-quarter economic contraction will be substantial. Most of China's big firms are again up and running, but travel restrictions and quarantines have caused labour shortages. Besides the reduction in domestic demand, the coronavirus pandemic and the implementation of crisis measures in countries around the world are only beginning to impact external demand for Chinese goods and services.

The rise in unemployment in February gives some insight into the pain experience by many companies. China's survey based urban unemployment rate rose from 5.3 % in January to 6.2 % in February. The NBS reports that the average weekly working time decreased by 6.5 hours from January to 40 hours in February.

Industrial output and retail sales contracted significantly in January and February



Sources: CEIC and Macrobond.

Over-leveraged real estate developers feel the pain from China's housing market fall. China's NBS reports that the volume of apartment sales volumes, measured in square metres of liveable floorspace, fell by 39 % y-o-y in January-February. At the same time, the long-standing decline in the stock of unsold apartment came to halt and even increased slightly. New apartment building starts at the beginning of the year were down 44 % from a year earlier. The slowdown in the apartment sales hurt developers' cash flows and hit an economically important, but already heavily indebted, real estate sector.

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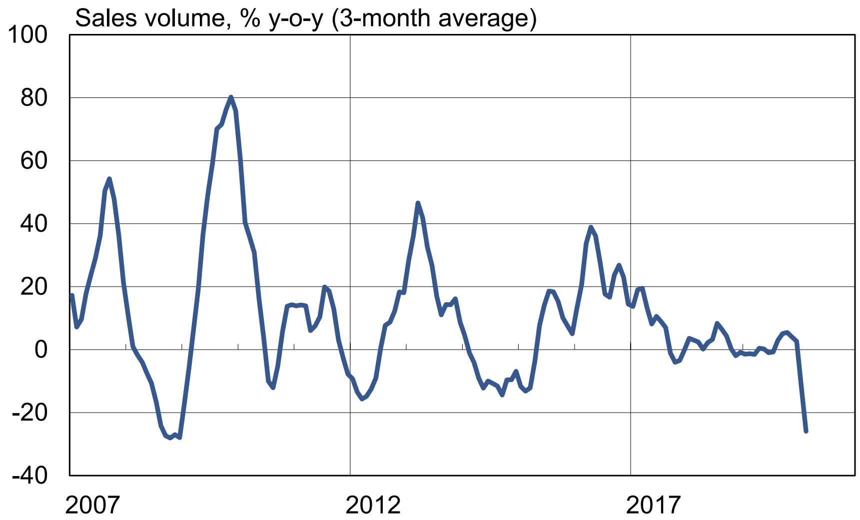
There is no reliable statistical data on apartment price trends as news reports suggest that even in major cities only very few apartment sales were conducted in February. One of China's largest developers, China Evergrande, offered its new apartments at a 25 % discount last month, and were still were offering a 22 % discount this month. Other developers also sought to unload their stock of apartments through discounts, indicating the severity of the downward pressure on apartment prices.

By using discount campaigns, real estate developers seek to raise money to deal with their debts. The largest construction companies still have access to credit even with massive debt, while small and medium-sized developers face significant financing problems. Much of China's foreign corporate debt is owed by construction companies.

International credit rating agencies S&P and Moody's expect apartment sales in China will decline overall this year. The real estate sector is expected to see many mergers, acquisitions and bankruptcies. While fewer than 500 companies went belly up last year, already roughly 100 construction companies sought bankruptcy in the first two months of this year. There is an abundance of real estate companies in the sector, however. Bloomberg notes that just in Hubei province, ground zero of the coronavirus epidemic, there are around 4,300 real estate developers.

Volume of Chinese apartment sales (measured in floorspace) collapsed in the first two months of this year



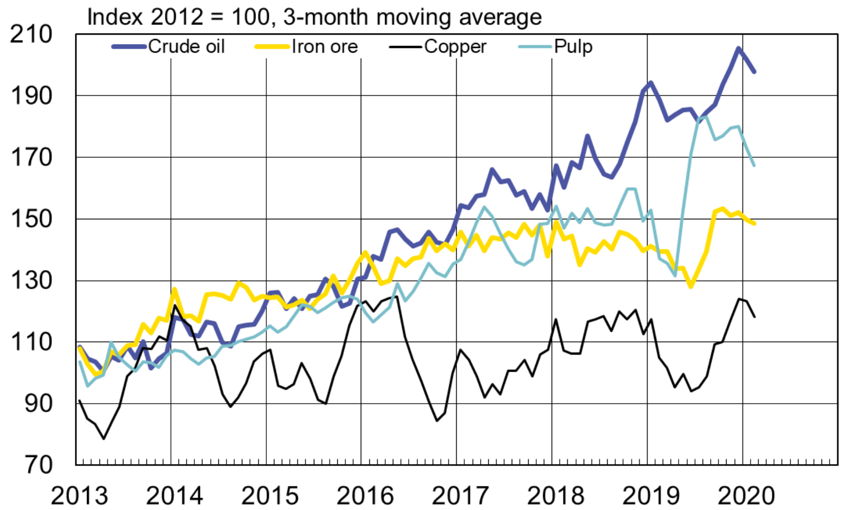
Sources: Macrobond and BOFIT.

Only a slight decline in Chinese goods imports in January-February. China Customs reports that the value of goods imports decreased by 4 % y-o-y in January-February, while imports of key commodities such as crude oil, despite a small dip, were up slightly on-year. The coronavirus crisis is likely to have a delayed impact on imports as many of China's import orders were already shipped when the crisis broke out. It takes sea cargo from Europe or the Americas roughly a month to reach China. In addition, deliveries, like certain commodities, may be based on long-term supply contracts that can be difficult to modify quickly. As the drop in production markedly outstripped the decline in imports, inventories in China built up.

Goods import trends varied from country to country. Imports from the EU fell by 19 %, from Japan by 9 % and from Korea by 8 %, while imports from ASEAN countries in Southeast Asia rose by 8 %. While imports from the US rose by 2 %, the value of imports from the US fell short of the amount agreed in "phase 1" trade agreement between China and the US. Under the agreement, China commits to buy every month this year US goods an average of a bit over 5 billion dollars more than in in 2017. To reach this would have required 34 billion dollars in goods imports in January-February, when the actual value of imports was less than 18 billion dollars. It is difficult to see how China manages to meet its agreed purchases this year.

Chinese exports contracted by 17 % y-o-y in January-February and goods trade showed an exceptional deficit of a few billion dollars. China's export outlook remains bleak. The February purchasing managers index (PMI) showed a collapse in export orders. Since then, the coronavirus crisis has spread to all of China's main export markets.

Volumes of select commodity imports to China



Sources: China Customs, Macrobond and BOFIT.

PBoC resorts to targeted monetary easing. On Monday (Mar. 16), the People's Bank of China lowered the reserve requirement ratio (RRR) by 50 to 100 basis points for commercial banks whose lending included a sufficiently large share of inclusive financing, e.g. student loans, low-income consumption loans, and lending to farmers, self-employed and small businesses.

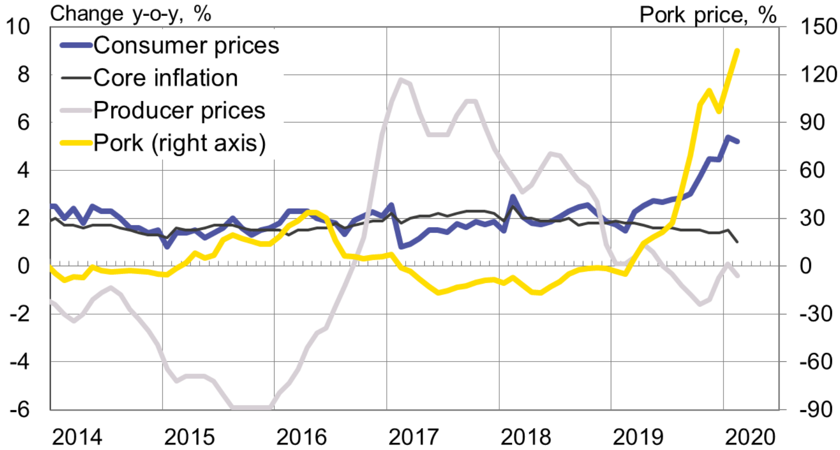
The move was part of the PBoC's annual review of its reserve requirement ratios (RRRs). In addition, joint-stock banks which are entitled to a 50-basis-point RRR reduction will be granted a further 100-basis-point cut. The PBoC, however, did not reveal which banks were eligible for RRR reductions. The RRR was previously lowered by 50 basis points for all banks in January (800 billion yuan in liquidity) before the coronavirus outbreak (see BOFIT Weekly 2/2020). The liquidity effect was smaller than in the previous operation, however. According to the central bank, the operation freed up 550 billion yuan (79 billion dollars) in bank funds.

On Monday (Mar. 16), the central bank also offered one-year financing to commercial banks through its medium-term lending facility (MLF) for a total of 100 billion yuan (14 billion dollars). The interest rate on MLF lending remained unchanged from the February level of 3.15 %. This indicates the PBoC currently has no plans to significantly cut rates. In March the loan prime rate (LPR), new benchmark for bank lending, remained also unchanged (at 4.05 % for one year loans). A total of 500 billion yuan in one-year MLF credit was granted in January-February and a total of 3.69 trillion yuan for all of last year.

As a broad stimulus could fuel inflation and capital outflows, the PBoC, unlike other major central banks in recent weeks, has kept its monetary stimulus measures more targeted. Driven by soaring food prices, consumer prices rose by 5.2 % y-o-y in February. Skyrocketing pork prices (up 135 %) alone raised consumer prices by 3.2 percentage points. Core inflation, which does not include food and energy prices, slowed to just 1.0 %.

Despite market swings and stunningly weak economic figures, the yuan-dollar exchange rate has weakened by less than 2 % from the start of the year. On Friday (Mar. 20), one dollar bought 7.1 yuan. The value of China's currency reserves (including gold), has remained virtually unchanged this year, and stood at 3.23 trillion dollars as of end-February.

Rising inflation limits room for monetary stimulus



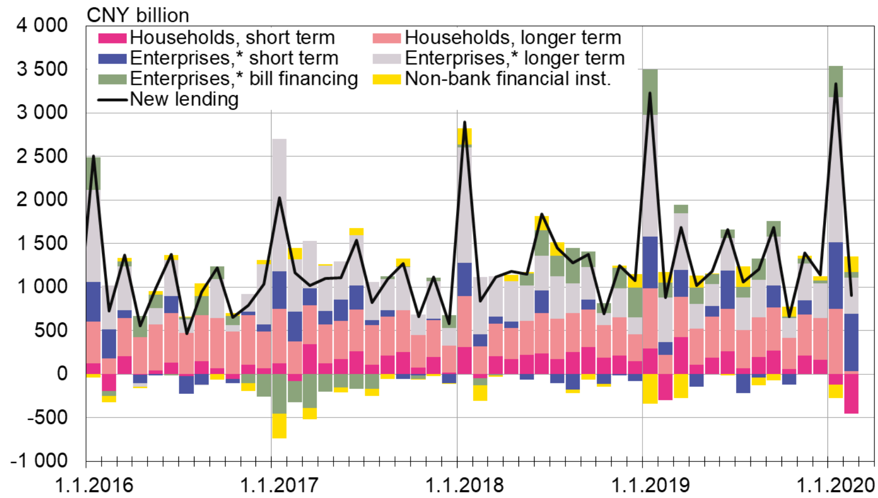
Sources: CEIC and Macrobond.

China's loan stock growth continued steady in February. PBoC figures show that growth in the Chinese bank credit stock remained at 12 % y-o-y and the broadest financing measure, aggregate financing to the real economy (AFRE), grew by 11 %. The value of new loans granted in February was 910 billion yuan (130 billion dollars), or about the same as a year ago.

The structure of new borrowing changed, however. Most borrowing was now in the form of corporate loans (1.13 trillion), particularly short-term credits (650 billion yuan). Less "bill financing," typically linked to trade financing, was granted this year. The stock of household loans shrank by 410 billion yuan, with the stock of short-term household loans decreasing by 450 billion yuan. With the housing market in limbo, banks granted also exceptionally few new long-term loans.

Local governments have been authorised to issue bonds to deal with the rapid increase in spending needs created by the coronavirus epidemic. New local bond issues in January-February amounted to 1,220 billion yuan (up from 680 billion yuan in the same period in 2019). Nearly 80 % of the new funding is in the form of "special purpose bonds" for financing infrastructure projects that should be paid back from income generated by such projects. In February, the stock of bonds issued by local governments increased by 18 % y-o-y (stock of special purpose bonds +35 %) to the equivalent of 23 % of GDP.

New bank lending by borrower group



** Non-financial enterprises and government agencies*

Sources: PBoC and CEIC.

Russia

BOFIT forecasts economic contraction in 2020 for Russia. Our latest outlook for the Russian economy is far gloomier than our previous forecast from last October, due to the recent collapse in oil prices and the impacts of the coronavirus pandemic. When the new forecast was compiled, markets expected an average price of Urals-grade crude oil of around $39 a barrel this year, which is 40 % below the 2019 average. Most observers have also sharply lowered their forecasts for the global economy due to the coronavirus pandemic.

The newest Forecast for Russia 2020–2022 sees Russian GDP contracting by 1 % this year and returning to modest growth next year. Increased public sector spending supports the economy. In the current highly uncertain situation, risks related to the forecast are exceptionally high. Russia's economic performance could be much worse if the coronavirus pandemic persists and oil prices drop further.

Government spending should rise 6–7 % a year in nominal terms during the 2020–2022 forecast period under Russia's approved budget framework. Even with lower oil prices, the Russian government is expected to hold the line on budget spending. Under the current oil price assumption, Russia's public economy will turn to deficit this year, but the deficit can be covered with oil & gas earnings retained in the National Welfare Fund.

Private consumption is expected to contract this year on weak economic activity and impacts related to the coronavirus. Recent ruble depreciation can accelerate inflation and thus reduce purchasing power. Consumption is expected to revive next year. Private fixed investment should contract sharply this year on low oil prices and a degraded economic outlook.

Exports also will decline this year on the weak global outlook, but improve gradually next year as demand returns. Imports are expected to contract substantially this year due to ruble depreciation and weaker demand. Russia will still show a slight current account surplus this year, even if it is significantly smaller than last year's surplus.

BOFIT expects Russian GDP to contract this year, then return to growth. ("E" = Estimate; "F" = Forecast)

	2017	2018	2019E	2020F	2021F	2022F
GDP	**1.8**	**2.5**	**1.3**	**-1.0**	**1.5**	**1.8**
Consumption	3.4	2.8	2.4	-0.9	2.0	2.2
Fixed investment	4.7	0.1	1.4	-6.5	2.0	2.5
Exports	5.0	5.5	-2.1	-5.0	2.0	1.0
Imports	17.3	2.6	2.2	-10.0	4.0	3.0

Sources: Rosstat and BOFIT Forecast for Russia 2020–2022.

After a selective start, Russia moves to beef up economic support. Russia's approved federal budget calls for brisk increases in spending this year. The government has announced it remains committed to those spending plans despite the budget's turn into a clear deficit due to current low oil prices. No new state spending initiatives have been envisioned, while president Vladimir Putin mentioned in his speech on Wednesday (Mar. 25) certain budget measures which could change the situation somewhat.

Within the frame of approved total budget expenditures, some reallocation of spending is under preparation. An example is the creation of an economic support fund. To improve budget flexibility, the government will expand the rights of federal, regional and municipal authorities to apply no-competitive-bid procurements and reduce penalties for at least minor departures in procurement contracts. Certain social supports will be increased slightly, and persons affected by the coronavirus will have their sickness payments based on at least the minimum wage. The government is also prepared to issue more credit guarantees.

The government is oriented to increasing transfers from the federal budget to regional budgets if needed. The consolidated budget has initially been outlined to provide for spending increases that would be faster than inflation, but this may be hard to maintain with decreasing revenues to the federal, regional and municipal budgets, as well as social funds. Regions and social funds cannot make up for the revenue losses by taking on more debt. Instead, they are dependent on transfers from the federal budget. A pick-up in inflation will also erode spending developments in real terms.

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The government's concrete decisions for supporting the economy have so far have focused on a few segments. For example, air travel and tourism firms that operate in public-owned premises will be entitled to breaks on paying their rent. Troubled firms in these branches can get adjustments to bankruptcy procedures to help them avoid bankruptcy. Creditors would be prohibited from initiating bankruptcy proceedings against any troubled firm. Tax payments of small and medium-sized firms (SMEs) will be postponed excluding the VAT and wage-based social taxes which will be reduced from 30 % to 15 % for some substantial period. Micro-sized firms will get a break also on social taxes. Restrictions on exports will be increased and import duties eliminated on certain medicines, medical products and food items. Monitoring of prices will be enhanced. On-site inspections by government officials will cease temporarily with the exception of e.g. health inspections.

Given the experiences from the 2009 and 2015–2016 recessions, employment is given high priority. The government has charged authorities as well as regional and municipal leaders with preventing layoffs or dismissals considered unfounded. In this and support measures, special attention is attached to over 600 firms deemed "systemically" important to the economy, as well as company towns (monogorods). Still, the ceiling on unemployment benefits, which is low, will be raised by 50 %. To fight against the coronavirus, all workers will get a paid leave to stay at home from March 28 to April 5 with the exception of essential personnel working in healthcare, shops, banks, transportation, and public administration.

In the banking sector, the liquidity situation is relatively good as a whole thanks to abundant amounts of deposits of households and non-financial firms. For the time being at least, neither the Central Bank of Russia nor the government have resorted to sizeable measures as in the previous two recessions. For the time being, the CBR's limited portions of liquidity provision have been sufficient. Banks have been given general reliefs on certain asset classes on their balance sheets such as booking the value of debt securities and equities. In order to support access to credit and debt restructuring for companies in the air travel, tourism, pharmaceutical and medical branches, as well as SMEs, banks will be granted interest subsidies as well as looser rules regarding e.g. loan quality, solvency ratios and booking loss provisions. The same applies to housing loans carried by households that slide into problems. In order to widen reliefs on debt-servicing, Putin proposed a break on servicing all housing loans and consumer credit, as well as bank debts owed by private entrepreneurs and SMEs.

A 13 % tax will be imposed on individuals for their interest income from large bank deposits, as well as income from extensive holdings of debt securities. A 15 % tax is scheduled for introduction on 1 January 2021 on interest income and dividends, excluding interest on various important categories of debt securities, transferred from Russia to certain foreign destinations.

National Welfare Fund now exceeds 11 % of GDP after transfers of last year's excess oil and gas tax earnings. On March 19, Russia's finance ministry reported that it had completed the final transfer of last year's excess oil and gas earnings to the National Welfare Fund (NWF). In total, the NWF's assets amount now to roughly 12.2 trillion rubles, about 157.2 billion dollars at last week's average exchange rate. At the end of 2019, NWF assets totalled 125.6 billion dollars.

The NWF currently corresponds to slightly over 11 % of Russian GDP. Some 10.5 trillion billion rubles (9.6 % of GDP) is invested in highly liquid securities. This provides Russia with an economic buffer in a situation where the oil price has dropped precipitously and the economic impacts of the coronavirus are still hard to predict.

The transfer of Sberbank's shares from the CBR to the government should also increase government revenues (BOFIT Weekly 2020/09). In February, the CBR and the finance ministry agreed that the CBR would divest its holdings (a 50 % stake plus one share) in Russia's largest bank to the finance ministry. The arrangement will increase the CBR's income which then goes to the state. Under Russia's fiscal rule, such income can be used to cover supplemental spending, even if the price of oil exceeds the roughly $42/bbl. assumption in the fiscal rule. The sale has been postponed due to the recent stock market crash and rebound, but many observers still believe the deal will go through.

Part of Russia's macroeconomic strategy has included the building-up of foreign currency reserves, so that high oil prices would not drive an over-appreciation of the ruble's external value. Under the government's fiscal rule, the CBR purchases forex from the market with rubles. On March 13, Russia's foreign currency and gold reserves amounted to 581 billion dollars, its highest level since August 2008. The CBR has now started to sell forex from its reserves in order to prevent rapid swings in the ruble's exchange rate. For example, in the first part of this week the CBR sold about 75 million dollars in forex daily.

As part of its currency and gold reserve management duties, the CBR oversees the liquid assets of the NWF (BOFIT Policy Brief 2/2015). When the finance ministry needs NWF funds, it withdraws money from the CBR in the form of rubles, so the size of Russia's currency reserves remains unchanged.

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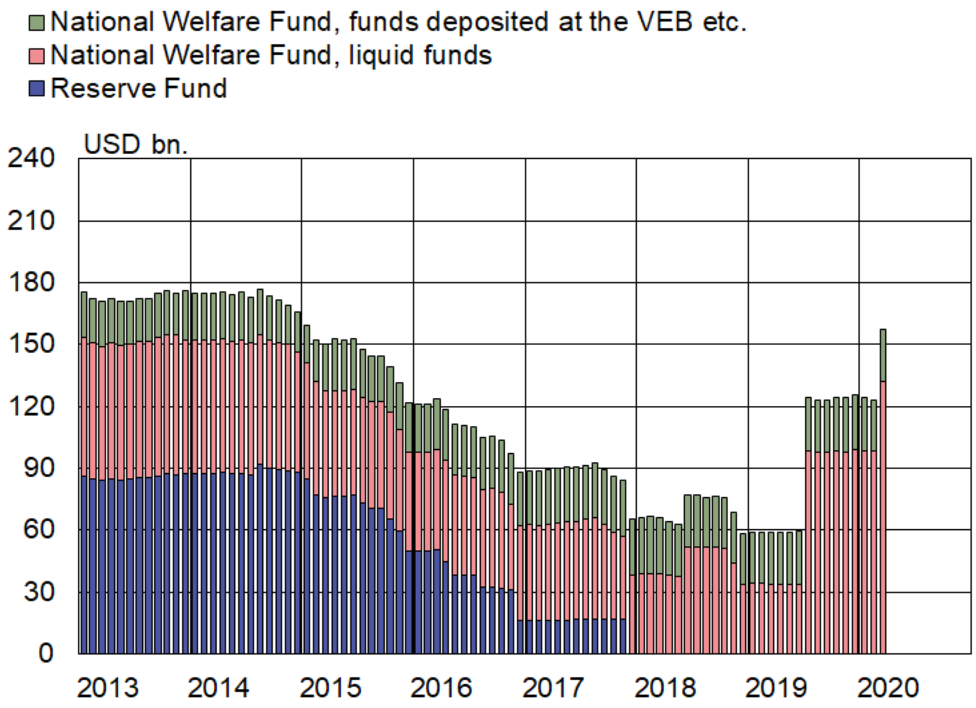
Russia's reserve funds, 2013–2020



Sources: Russian Ministry of Finance and BOFIT.

Oil prices, ruble and Moscow stock exchange all down; CBR holds key rate unchanged. Global oil prices continued to slump in the wake of their March 9 collapse. The export price of Urals-grade crude averaged $21 a barrel this week, meaning that the Urals price is down 34 % after the March collapse and 67 % since the start of the year.

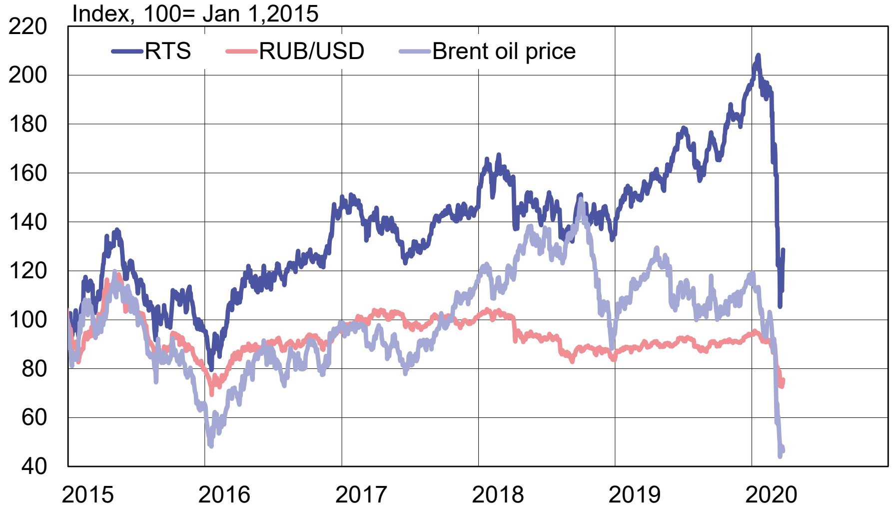
Oil prices face both demand and supply pressures. The coronavirus pandemic has depressed oil demand around the world, while excess supply issues have been triggered by an impasse among OPEC+ countries on renewing a voluntary agreement on production ceilings. If the coronavirus pandemic worsens or the large producer countries in OPEC+ fail to agree on production caps, oil prices can remain at their current levels or fall even further. In Russia's case, this situation would show up as below-forecast economic growth.

The ruble's exchange rate has mirrored the drop in oil prices. The Russian currency has weakened by 20 % against the dollar since the start of the year, and another 4 % after the March collapse. The ruble-dollar exchange rate averaged 79 rubles this week. The CBR has supported the ruble's exchange rate by selling forex, so the ruble's drop has not been as sharp as the fall in oil prices.

Russia was not spared in the global stock market crash. On Thursday (Mar. 26), the Moscow Stock Exchange's dollar-denominated RTS index was down 34 % from the start of the year. Share prices of energy and financial firms were hit particularly hard: the oil & gas sector sub-index was down 41 % from the start of the year, while the financial sector sub-index was off by 39 %.

At its regular meeting on March 20, the CBR board decided to keep its key rate at 6 % as expected by market analysts. Among other things, the CBR noted the differing effects of the decline in oil prices and the depreciation in ruble with respect to inflationary pressures. In addition to holding the key rate unchanged, the CBR approved support measures to households, small and medium-sized firms and financial institutions. The CBR noted that inflation could temporarily exceed its 4 % inflation target this year, but expects inflation to return to the target level next year.

Oil prices, ruble exchange rate and Russian stock exchange hit major downdraft.



Sources: Macrobond and BOFIT.

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China

Even as the Chinese economy recovers, performance is still far below pre-coronavirus levels. China's official Purchasing Managers Index (PMI) for manufacturing returned to positive territory in March with a reading of 52.0 (up from 35.7 in February). The March PMI for services and construction was 52.3 (29.6 in February). When a PMI reading exceeds 50, it suggests that, on average, company purchasing managers see their business improving from the previous month. A value below 50, in contrast, means business conditions are getting worse. The jump in the PMI was expected as the government lifted or relaxed many restrictions on movement and other activities, thereby allowing most companies to gradually resume normal operations in March after a horrendous February. Despite the rise in PMI indices, many companies are still struggling to resume normal production. The production figures set to be released in a couple of weeks are expected to show that output in March, as in January and February, was lower than in the same months last year.

The manufacturing PMI shows the employment in the manufacturing sector improved slightly from February to March. In contrast, the employment situation in the services and construction sectors continued to deteriorate, albeit at a slower rate than in February. Even the official unemployment rate of urban areas rose unprecedentedly in February by almost one percentage point to the level of 6.2 %. The faltering global economy is now restraining China's recovery. The March PMI showed that over half of responding companies had fewer export orders on their books than in February.

Economic activity is reviving as reflected in the daily indicators for transport, energy use and air pollution. After hitting bottom of February, sales picked up in the important housing market as builders have reopened their sales offices and substantial discounts tempt to dismantle pent-up demand for housing. The situation, however, varies by branch and province.

In Hubei province, ground zero of the coronavirus epidemic, recovery has been slower than elsewhere. Officials nevertheless report that even in Hubei nearly all industrial companies were back in operation by the end of March, although on average 30 % of workers had yet to return to work. In addition to the labour market situation, there are other obstacles to normalising economic conditions, including the lack of demand and gaps in production chains. A survey conducted by the American Chamber of Commerce in China in mid-March found that 35 % of companies were operating normally and 23 % expected their situation would return to normal by the end of April. Thus, it will take time for a large proportion of American companies to recover even if China would be spared a possible second wave of the coronavirus epidemic.

Despite general downward revisions in China's growth forecasts, there is little consensus on of the size of the first-quarter drop in GDP, the pace of recovery and therefore GDP growth for all of 2020. Under the World Bank's base scenario forecast published this week, Chinese growth would slow to 2.3 % this year. In its pessimistic scenario, growth remains at zero. In our latest BOFIT Forecast for China, published two weeks ago, we estimate China's GDP this year will be slightly lower than last year even with a relatively strong recovery.

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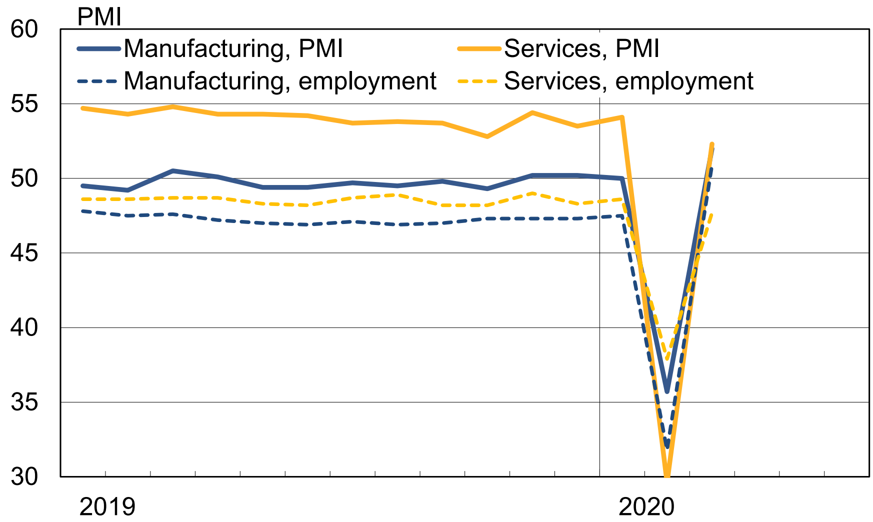
China's official manufacturing and services purchasing manager indices (PMIs) and employment sub-indices



Sources: NBS, Macrobond and BOFIT.

China steps up stimulus measures. President Xi Jinping announced at the end of last week that the budget deficit will be increased this year. Moreover, the finance ministry will be issuing special bonds and the quota of special purpose bonds for local governments will be further raised. In addition, premier Li Keqiang said this week that the central bank's support to small and medium-sized enterprises (SMEs) would increase from 500 billion yuan to 1.5 trillion yuan (roughly 210 billion dollars), along with a number of other support funding measures for companies aimed at preventing a wave of bankruptcies and higher unemployment. Targeted additional reductions in bank reserve requirements are also planned. Provincial governments have launched their own support measures. In recent weeks, a number of provinces distributed vouchers to encourage residents to increase consumption.

China's stimulus response has been more subdued than in many countries. The IMF estimates that the fiscal policy measures before the latest batch only amount to around 1.2 % of GDP. A revised budget for this year has yet to be announced. The budget deficit is set to increase this year even without increasing expenditure because slowing economic growth will reduce government revenues. The IMF estimates that even before the coronavirus crisis the government's budget deficit already exceeded 10 % of GDP and central government debt amounted to roughly 70 % of GDP.

Monetary policy measures have been restrained. The People's Bank of China has eased monetary policy during the coronavirus crisis by lowering reserve requirements and boosting market liquidity. In addition standard policy funding, commercial banks have also been granted access to special funding to increase their lending to companies in those provinces hardest hit by the epidemic. Interest rates have only been lowered slightly. MLF and LPR rates were cut by 10 basis points in February, while the PBoC's reverse repo rate was cut by 10 basis points in February and 20 basis points in March.

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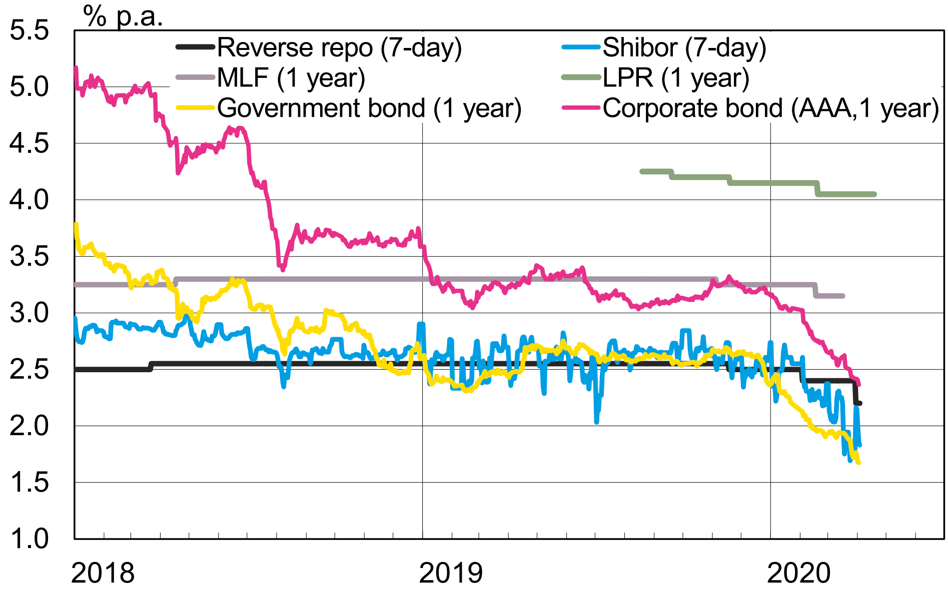
Chinese interest rates continue to fall



Sources: CEIC, Macrobond and BOFIT.

Coronavirus crisis hits China's banking sector. Even as China's big banks have been reporting juicy profits for 2019, international credit ratings agencies are warning of heightened risks to the banking sector, as the coronavirus crisis is eroding the quality of bank loan portfolios. The heavily leveraged corporate sector, faced with the additional burden of shutting down and restarting operations, is finding it even harder to service debt. In addition, banks have been ordered to help especially the SME sector through these hard times banks are expected to play a critical role in getting economic growth back on track.

While the true figure for the Chinese banking sector's non-performing loans remains a matter of speculation, it is known to be an amount much greater than that reported by banks (e.g. BOFIT Discussion Paper 2/2020). Estimates before the coronavirus epidemic were in the range of 5–20 % of the total loan stock. Last autumn, the PBoC published stress test results showing that a slowdown in economic growth to just over 5 % p.a. would significantly increase the amount of non-performing loans of large and mid-sized banks, while a slowdown in GDP growth to 4 % p.a. would create a situation where many banks could no longer meet minimum prudential capital requirements. China's current economic growth is well below anything envisioned in the stress tests.

Even before the coronavirus pandemic, small and mid-sized banks were having problems. Last May, officials seized Baoshang Bank and later last year launched bailouts of at least three other banks. In the March, one the banks (Bank of Jinzhou) was restructured. Close to a 40 % stake in the bank ended up in the PBoC control, while another 7 % stake went to the provincial government. The state is wiping 150 billion yuan (nearly 20 billion euros) of assets from the bank's balance sheet and providing an additional 75 billion yuan in long-term credit. Moreover, a listed trust company Anxin also is also being restructured. Media reports suggest that Anxin will end up in Bank of China's control.

Mainland China stock markets perform relatively well, still capital is flowing from China. Despite the significant economic impact from the coronavirus crisis, Chinese stock markets have lately been outperforming most other major stock markets. On Friday (Apr. 3), the Shanghai Composite Index was down by 9 % from the beginning of the year, while the Shenzhen Composite Index was off by just 2 %. The Shenzhen exchange's ChiNext index of growth companies has performed remarkably well of late and it is 6 % higher than in the start of January. In contrast, most global stock markets have seen large collapses in recent weeks. The US S&P 500 index, for example, is down by 22 % from the start of the year, while the MSCI Emerging Markets index is down by 25 %.

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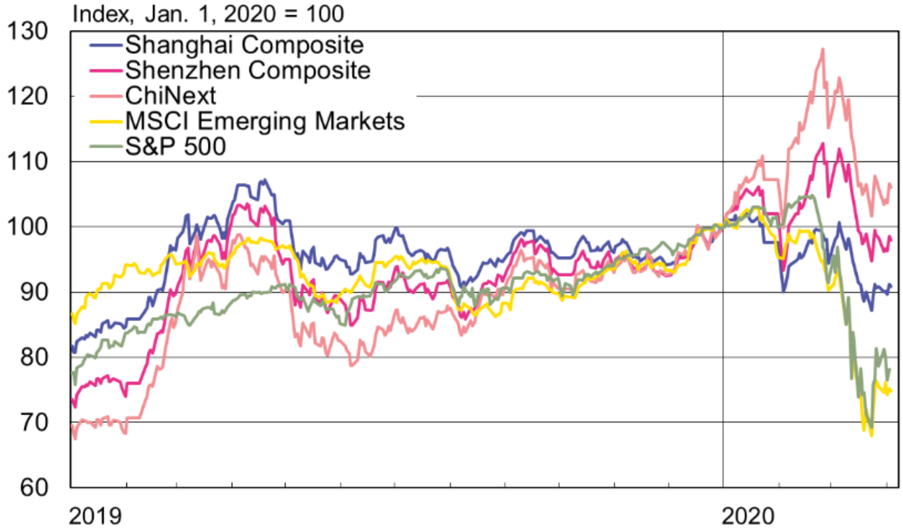
Trends in mainland China stock markets usually do not reflect the real economy outlook. Because market stability is a cornerstone of government policy, state-controlled operators can be ordered to support stock prices or at least refrain from selling shares at a time when share prices are plummeting. In addition, trading is dominated by small investors, which often display herd behaviour. Stock prices declined when traders returned from the extended Lunar New Year's holidays on February 3. After, during the three worst weeks of the coronavirus crisis, share prices rebounded by 10–20 %. As demand in real economy collapsed, some of the money injected appears to have flowed into the stock market. Stock prices fell again in March.

Shares on the Hong Kong Stock Exchange, which is open to foreign investors, have fallen more than shares listed on mainland China. On April 3, the Hong Kong exchange's main Hang Seng Index was off by 17 % from the start of the year. The index of Mainland Chinese firms listed on Hong Kong was off 15 %. The prices of shares of companies listed on both mainland and Hong Kong exchanges have been significantly cheaper in Hong Kong for years, and are currently on average 28 % cheaper. According to media reports, shares of all these 119 dual-listed companies are currently cheaper in Hong Kong, some several times cheaper.

Foreign investors can trade on stocks in mainland China exchanges through the Stock Connect arrangements with the Hong Kong Stock Exchange. The outflow of capital through this channel has accelerated in recent weeks. In March, foreign investors sold more shares than they bought through Stock Connect. The net value of purchases (purchases minus sales) was -68 billion yuan (a drop of 10 billion dollars). In 2019, net purchases amounted to 349 billion yuan. Capital has also flowed out of China under the Stock Connect arrangement as Chinese investors have increased their holdings in Hong Kong shares. In March alone, Chinese investors' net purchases in Hong Kong amounted 135 billion yuan (19 billion dollars). For all of last year, they totalled 246 billion yuan.

According to Dealogic data, the value of IPOs in mainland China in the first three months of this year amounted to roughly 11 billion dollars, more than in any other country. The biggest IPO (nearly 5 billion dollars) was the listing of the state-owned Beijing-Shanghai high-speed railway company on the Shanghai exchange at the beginning of January.

Stock market indices, 1.1.2019–3.4.2020



Sources: Macrobond and BOFIT.

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BOFIT

Russia

Russia tightens measures to slow spread of coronavirus. Russia's restrictions were moderate still in March but have been now tightened considerably with the rise in COVID-19 cases. President Vladimir Putin declared that April will be a paid holiday for most workers as much of the country's economic activity will be locked down. The restrictions do not apply to all sectors, however, and vary from region to region depending on the spread of the epidemic. The containment measures are expected to hurt especially service industries and small and medium-sized enterprises (SMEs).

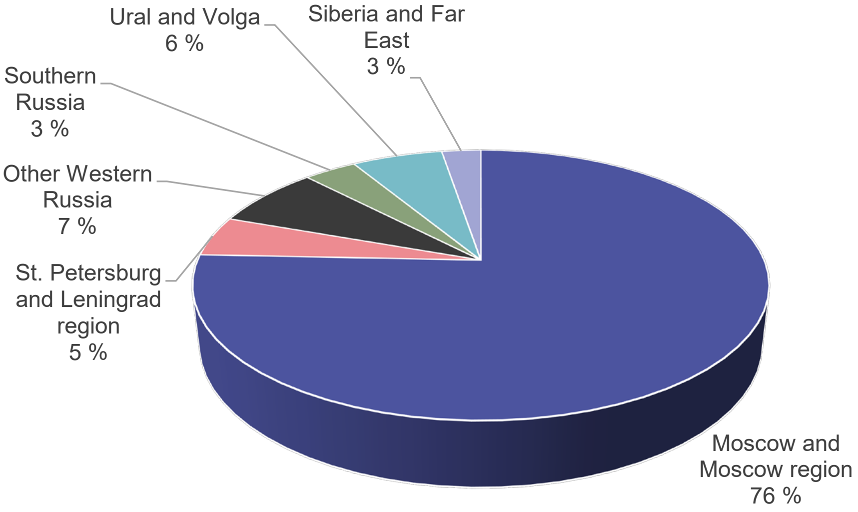
Russian GDP is expected to decline significantly in April due to the containment measures. Current estimates find that a shock from one month of restrictions reduces Russian GDP by 1–3 % this year. If the restrictions are extended, the loss of GDP could be considerably higher. A recent BOFIT Policy Brief illustrates that trade and certain other service branches will have largest contributions to GDP decline.

At the beginning of this week, Russia reported that it had roughly 7 500 confirmed cases of coronavirus and nearly 60 COVID-19-related deaths. Variations across regions were huge. 75 % of all reported infections were in Moscow city and region, while just over 30 cases were reported in regions along the Chinese border. Virus testing varies considerably across regions. President Putin has ordered regional governments to determine the scope of restrictive measures required for their regions. The goal is to limit the spread of the virus without impairing economic activity more than necessary. The shift of decision-making powers to the regions implies that the regional authorities also largely bear the responsibility for managing the crisis.

The presidential decree calls for paid leave throughout April. This could support the household income development over the short term. According to survey information, however, many companies have already dismissed employees or cut pay. Moreover, the average Russian household real income never recovered from the slump caused by the 2014–2015 economic crisis. Most households have little savings and their indebtedness has risen in recent years. Current government support measures for household include some increases e.g. in unemployment benefits and child allowances.

The Russian government has yet to announce any significant measures to support the business sector directly. Most support measures for business have targeted specific branches and consist mainly of postponement of tax payments, deferred payment of loan principal or easier access to credit. The government has, however, identified nearly 650 large enterprises as critical to the functioning of the economy that will get more sizable support if needed.

Most of Russia's reported coronavirus cases are still located in or around Moscow



Sources: Russian government and BOFIT.

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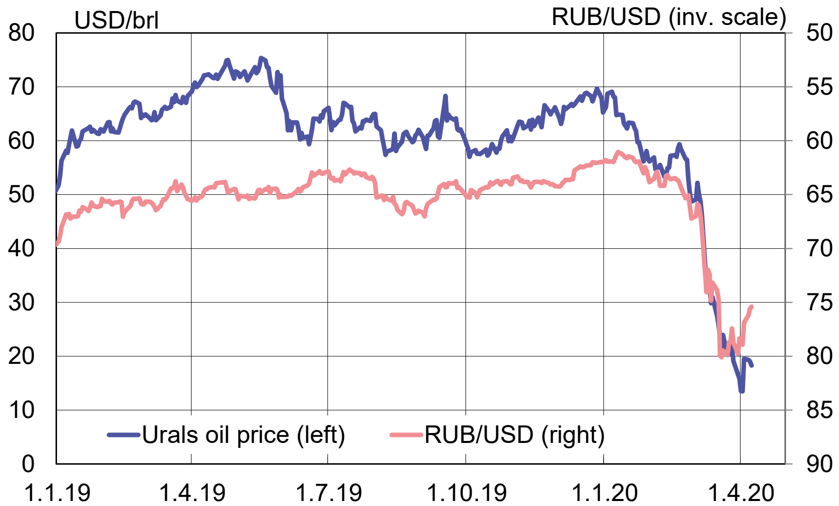
Ruble exchange rate fluctuations in recent weeks fairly muted compared to the huge swings in oil prices. Recent weeks have seen large daily moves in oil prices. For example, the price of Urals-grade crude oil fell by 15 % on April 1 to a record low of $13.50 a barrel, only to rebound by 45 % on April 3. The seesawing prices reflect supply and demand instability and the extreme uncertainty in global markets.

Economic growth has collapsed in many countries as a result of societal efforts to constrain the coronavirus pandemic. Demand for oil has decreased while inventories have soared. As the depth and duration of the economic downturn caused by the coronavirus crisis is difficult to assess, the market continues to experience large daily fluctuations in oil prices. Concerns about additional oil supplies flooding the market have increased of late by the impasse in negotiation of voluntary production ceilings among the OPEC+ group of oil producers. The group's largest non-OPEC member, Russia, and OPEC's largest producer, Saudi Arabia, have been unable to agree on how to proceed since the previous agreement expired at the end of March and the need for further cuts has grown dire.

The recent collapse in oil prices seems to have dispelled the reluctance of Russia and Saudi Arabia to resume talks. US president Donald Trump commented last Friday (Apr. 3) that Russia and Saudi Arabia were close to agreement on a new round of production cuts, triggering a sharp rebound in global oil prices. The US and Canada are also discussing the possibility of imposing tariffs on Russian and Saudi oil if the two countries fail to limit production. The OPEC+ group countries (OPEC and a half dozen other oil producers, including Russia) were scheduled to resume negotiations on April 6, only to postpone until at least April 9 over a dispute as to whether countries that are not in OPEC+ will also take part in to the agreement. Even if key oil-producing countries agree on new production restrictions, the impact of production ceilings on oil prices in the midst of a pandemic is unclear.

Declining oil prices pulled down the ruble's exchange rate in the first quarter of this year. However, the ruble-dollar rate (down 20 % since the start of the year) has weakened considerably less and fluctuations have been much smaller than in the Urals prices, which have declined in dollars 70 % since the start of the year. Since mid-March, the CBR has sold currency in the markets on behalf of the finance ministry which has mitigated ruble exchange rate movements.

Both oil prices and the Russian ruble's exchange rate dropped as the COVID-19 crisis exploded



Sources: Reuters and BOFIT.

Russia's inflation tick-up may be fairly transient. In March, 12-month consumer price inflation remained rather moderate at 2.5 %. However, the month-on-month inflation accelerated to 0.6 %. Especially food prices rose briskly in March (up 1 % m-o-m). It seems likely that prices for foodstuffs and household items were driven up by stocking up by households in anticipation of coronavirus times. Both Sberbank and Romir household payments monitoring report that household consumption spending increased strongly just after mid-March, but declined significantly either in the final week of March or the first week of April. This suggests an easing in acute price pressures.

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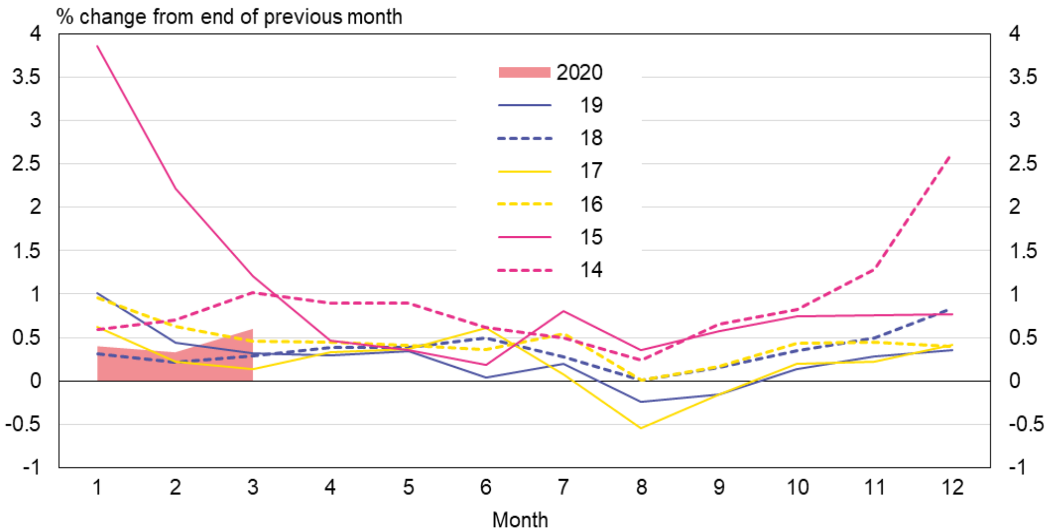
The collapse of the ruble's exchange rate seems to have had no large impact on consumer prices. The fastest increases in food prices in March mostly involved domestically produced foods. Imported foodstuffs account for a reasonable quarter of food retail sales. Increase in prices of non-food goods was more subdued, even if imported non-food goods account for about half of such retail sales. The weak ruble is expected to have a relatively moderate impact on prices, even if expectations are subject to unusual uncertainty. Russia's economic and consumption outlook for the nearby periods has been severely downgraded, increasing the uncertainty of whether consumer price inflation will stay around the Central Bank of Russia's 4 % inflation target.

Authorities have expanded their actions on the price front. Price controls have been stepped up, particularly for medicines and basic foodstuffs (prices of the most important medicines have already been regulated for a decade). The export of certain medicines, medical equipment and personal virus protection equipment is prohibited. Part of such items are exempt from value-added tax, and imports of selected items are both import duty free and VAT free. The government has set a ceiling on grain exports and the state can intervene by selling grain if their prices exceed the upper limits set for them.

Even more unusual measures have appeared. For example, a major retail chain announced it would start selling socially critical necessities at cost (i.e. purchase price), and invited other retail chains to join in. Russia's Federal Antimonopoly Service (FAS) has determined that this practice does not violate the Competition Law. In mid-March, the FAS also requested that all institutions, businesses and experts abstain from price forecasts. The FAS said that price forecasts were unacceptable because they could lead to violations of the Competition Law through e.g. high price gouging.

The rise in consumer prices accelerated in March



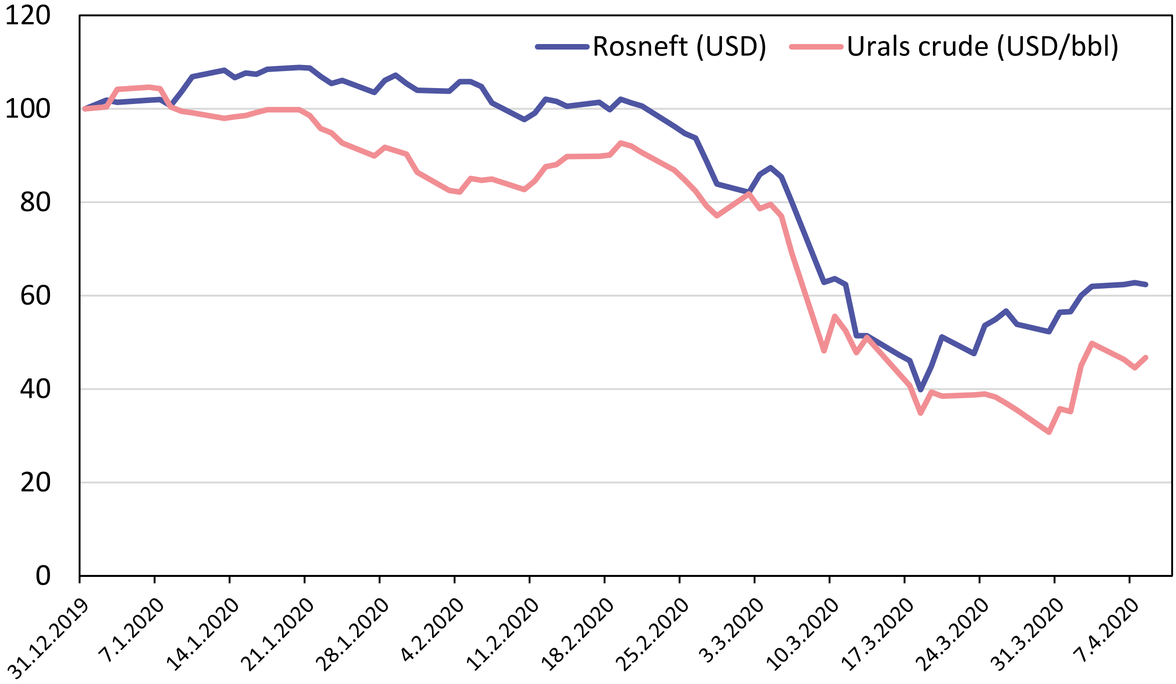
Sources: Rosstat and BOFIT.

Rosneft divests its holdings in Venezuela to avoid US sanctions. On March 28, Russia's largest oil company, Rosneft, announced that it had sold off all its operations in Venezuela to another Russian company, Roszarubezhneft, a state-owned entity created to shield Rosneft from additional US sanctions.

In February, the US imposed sanctions on Rosneft's two Swiss subsidiaries because of their involvement in Venezuela. The US claims that the companies were assisting the efforts of the Maduro regime at evading US sanctions. The concern was that current and future sanctions on the Swiss subsidiaries might affect the activities of the parent company. Rosneft has been subject to EU and US sanctions since 2014 for Russia's efforts at undermining Ukraine's sovereignty (see e.g. BOFIT Policy Brief 2/2019).

Rosneft accounts for about 40 % of Russia's oil production. Along with divesting the Venezuela operations, some additional measures further affect Rosneft's ownership structure. As payment for the divested firms, Rosneft is to receive 9.6 % of its own shares. While technically it appears the Russian state will cease to be the majority owner of Rosneft, the actual fate of this stake remains unclear. Rosneft's next largest shareholders are the energy giant BP with a 19.75 % stake and the Qatar Investment Authority with an 18.93 % stake.

Rosneft's share price has closely tracked the slide in oil prices, Dec. 31, 2019 = 100



Sources: Macrobond and BOFIT.

China

China's support measures accelerated lending in March; gradual relaxation of monetary stance continues. Figures released by the People's Bank of China show that 2.85 trillion yuan in new yuan-denominated loans were originated by banks in March, substantially more than a year ago (1.69 trillion yuan). Annual growth of the bank credit stock accelerated to 13 %. Households accounted for 990 billion yuan in new bank loans, including 510 billion yuan in short-term credit. The stock of outstanding corporate loans (including governmental organisations) grew by 2.05 trillion yuan (up 12 % y-o-y), while the credit stock of non-bank financing firms contracted by 200 billion yuan. Net corporate bond issues in March hit a record high of 980 billion yuan.

The PBoC is providing financing to commercial banks in order to support the corporate sector in its struggles with the coronavirus crisis. In late January, the central bank allocated 300 billion yuan in special central bank financing to companies critical to efforts in fighting the epidemic and production of crucial supplies. As of end-March, 229 billion yuan (32 billion dollars) in such credit had been granted. Another 500 billion yuan in funding for more general support to firms was also announced in late February, of which 277 billion yuan had already been released as of end-March. In late March, the amount of this additional funding was increased by 1 trillion yuan. China's policy banks were also provided a separate allotment of 350 billion yuan for lending to small businesses. Banks are required to provide the financing at below-market rates.

The central bank relaxed monetary policy this month with a 20 basis-point cut in the one-year medium-term lending facility (MLF) financing rate to 2.95 %. This rate cut is likely to be extended to the LPR rate used as the reference rate for bank lending. As of end-March, the average lending rate for general loans was 5.48 %, about 25 basis points lower than at the end of 2019.

In line with the government's earlier announcement, the PBoC also lowered its reserve requirement ratio for small and medium-sized banks by one percentage point. The decrease, which takes place in two steps (April 15 and May 15), should, according the central bank, have an overall liquidity effect of 400 billion yuan (56 billion dollars). After the May cut, the reserve requirement will be 6 % for small banks and at 9.5 % for mid-sized banks, while large banks without bank-specific dispensations will be subject to a 12.5 % reserve requirement. To encourage banks to lend, the PBoC also reduced the interest rate on voluntary excess reserves from 0.72 % to 0.35 %. The annual rate paid on mandatory reserves held by the central bank is 1.62 %.

Growth in consumer prices slowed from 5.2 % in February to 4.3 % in March as the strong rise in pork prices began to abate. Core inflation, which excludes food and energy prices, was up by 1.2 %. Producer prices fell further in March (down by 1.5 % y-o-y). The decline reflects mainly lower energy and commodity prices, but also weak demand.

The opening of the economy has accelerated after lifting of the corona lockdown. The final major restrictions on movement in Wuhan ended on April 8. Schools have already been reopened in some provinces, while in e.g. Beijing and Shanghai, the reopening of schools is set to take place in stages beginning in late April. Companies have been exhorted to ramp up production as quickly as possible. The average citizen is being asked to consume again. In early April, however, various indicators still showed levels of production were significantly lower than in the same period last year. The restarting of the economy seems to be taking much longer than many had predicted.

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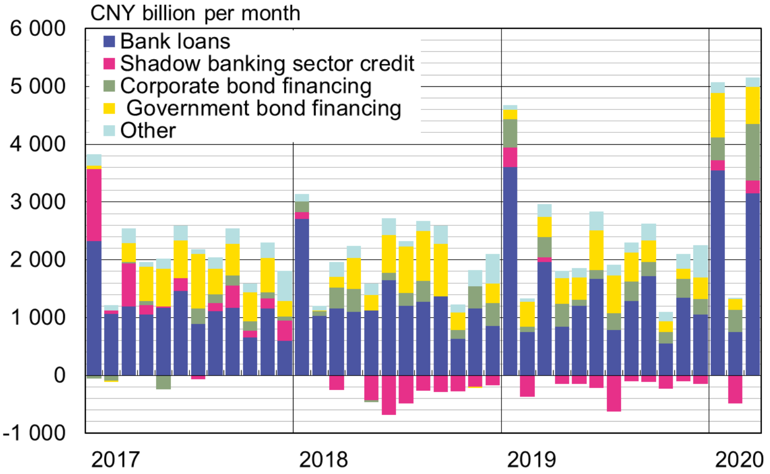
Breakdown of net new domestic financing, monthly



Sources: PBoC, CEIC and BOFIT.

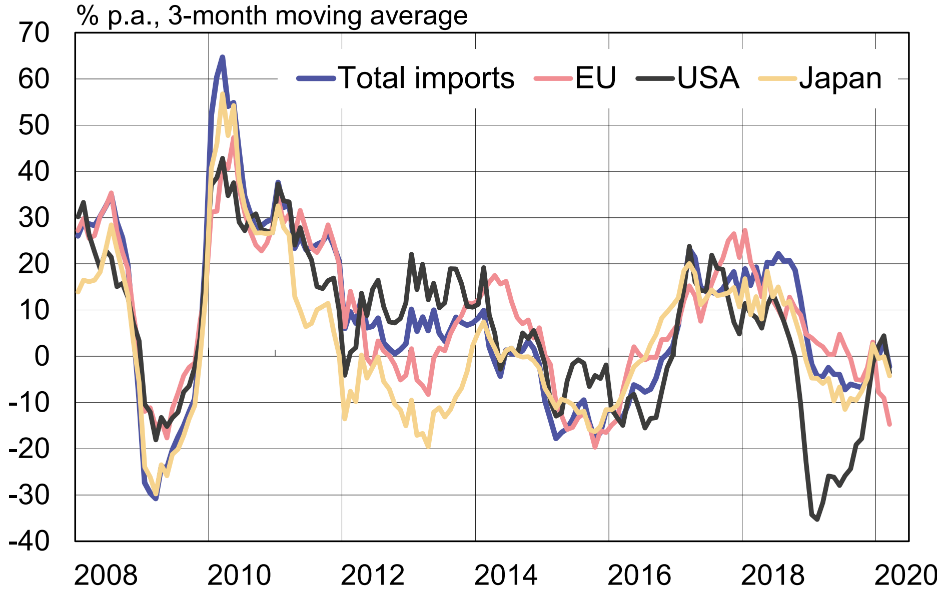
Old orders boost China's goods exports in March. China's foreign trade first suffered from the domestic shocks from dealing with the emerging COVID-19 crisis, only to then face external shocks as the virus spread to the rest of the world and rocked the global economy. Figures from China Customs show that after a 17 % y-o-y decline in January and February dollar-denominated goods exports fell only by 7 % in March. March's relative improvement in exports likely reflects the fulfilment of old orders that Chinese companies were unable to ship during the national shutdown from the epidemic. Some observers note that order cancellations only began to rise sharply in the second half of March.

The value of goods exports in the first quarter dropped by 13 % y-o-y, while the value of goods imports sank by 3 %. China's exports to the EU declined by 16 % y-o-y, while imports decreased by 7 %. In contrast, China's imports from ASEAN countries were up by 9 % from the previous year. Imports from the US increased slightly between January and February, but contracted by 12 % y-o-y in March. It is difficult to see how China will be able to buy enough US goods to fulfil its commitments in the "phase 1" trade agreement.

With COVID-19 cases in everywhere in the world, China's export outlook is bleak. China's official purchasing managers' index shows that the volume of new export orders collapsed in February and weakness continued in March. The struggles of other countries are expected to impact Chinese exports full power directly in the second quarter.

The World Trade Organization (WTO) expects the contract of 13–32 % in global trade this year to be followed by a fairly strong recovery next year. The trends in global trade will depend, however, on the duration of the pandemic and extent to which production chains remain intact to facilitate a post-crisis recovery.

China's imports contracted in the first quarter



Sources: China Customs and BOFIT.

Yuan's exchange rate relatively steady. Global concerns and uncertainty generated by the COVID-19 crisis have led to capital flight and currency depreciation in some emerging economies. For the moment, China appears to have been spared from these headaches. On Thursday (Apr. 16), one dollar bought 7.07 yuan and the yuan-dollar exchange rate has weakened only by bit over 1 % from the start of the year. As the yuan has appreciated slightly against many other currencies such as the euro, yuan's nominal effective (trade-weighted) exchange rate (NEER) has strengthened by around 3 % since the start of the year.

The maintaining of a relatively stable exchange rate is an important goal for Chinese policymakers in good times, and it takes on particular importance in times of trouble. In the 2008–2009 global financial crisis, China pegged the yuan to the US dollar. During the capital flight episode of 2015–2016, the PBoC supported the yuan through massive forex market interventions and tighter capital controls. It is unclear how much the PBoC has done to support the yuan during the current pandemic. In the first three months of this year, China's foreign exchange reserves remained virtually unchanged, suggesting that the central bank had directly done little, if anything, to support the yuan's exchange rate through forex sales. There has not been mentions about tightening of capital controls either. However, other exchange-rate-stabilising measures might be in place. For example, officials might have given instructions to the large state banks, which are important actors in fixing the yuan's exchange rate.

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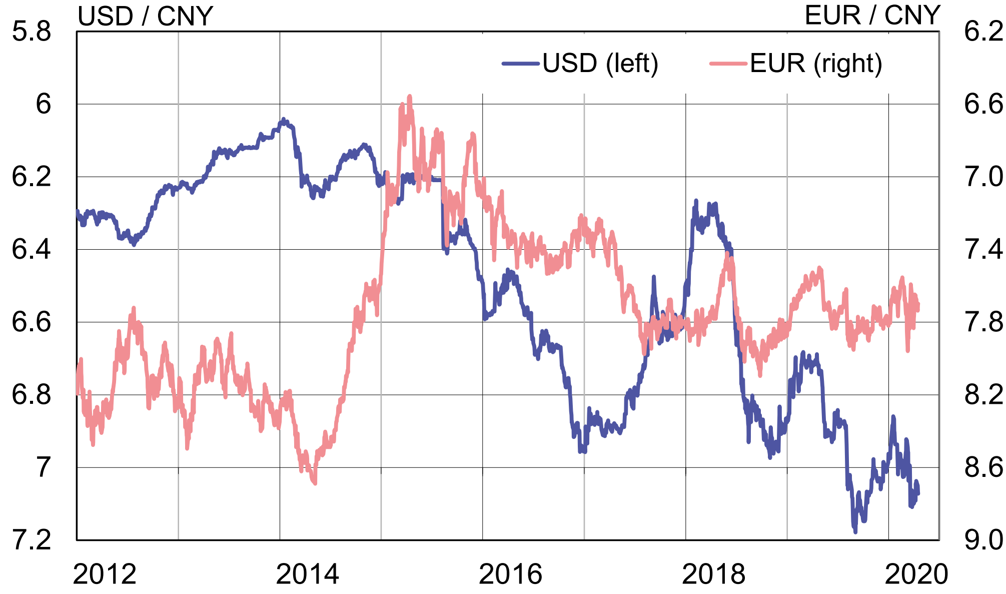
Dollar-yuan and euro-yuan exchange rates



Sources: Reuters, ECB and BOFIT.

China surpasses the US in volume of international patent applications. 2019 figures just released by the World Intellectual Property Organization (WIPO), a specialised UN agency, show that a total of 265,800 international patent applications were filed under the Patent Cooperation Treaty (PCT). The three largest filing nations were China (22.2 % of all applications), the United States (21.7 %) and Japan (19.8 %). It was the first time the US was unseated from the top spot since the PCT system was established in 1978.

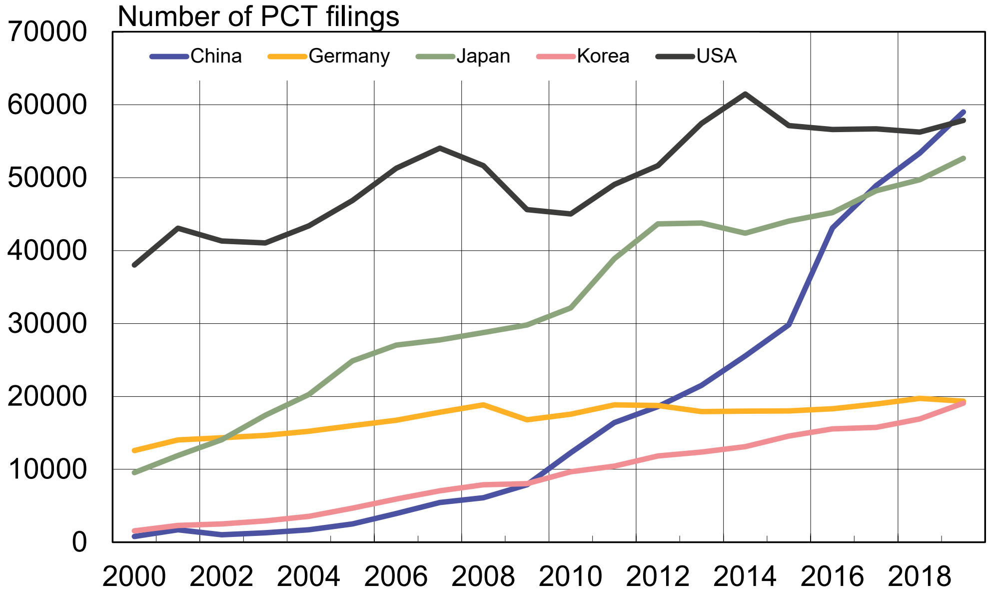
East Asia's role in international innovation continues to grow. With the sharp increases in the number of PCT applications from China, Japan and South Korea, these countries together accounted for around half of all PCT applications last year. The total European share of applications fell to 23 % as the number of applications from Germany, Europe's most active patent filer, decreased slightly and there was no significant increase in applications from other European countries.

Although China's Huawei filed about a thousand less patent applications than in 2018, the company continued to dominate as the most eager filer with 4,400 international patent applications. Next came the Japanese Mitsubishi Electric (2,700 filings), the Korean Samsung (2,300) and the American Qualcomm (2,100). Other top-ten filers included China's smartphone maker OPPO (5th place), display-maker BOE (6th place), and debuting in the top ten at 8th place, Ping An Technology, a company that develops AI solutions among other things. The two European firms making the top ten were Swedish telecom giant Ericsson and the German Bosch.

Other BRIC countries filed far fewer patent applications than China, and not a single company in these countries made it into the top 50 in terms of patent application filings. The number of patent applications from India increased by 27 % y-o-y in 2018, but only rose by around 2 % last year. The roughly 2,000 patent applications filed by India in 2019 represented just 0.8 % of patent applications filings globally. Notably, Finland continued to file more patent applications (1,655) than Russia (1,218) or Brazil (644).

The PCT system is administrated by WIPO, but patents are granted by national or regional patent offices. A single PCT patent application request can seek rights in all of the over 150 PCT member countries. Patent-seekers must still file, however, with each national or regional patent office.

Countries most active in PCT patent application filings



Sources: World Intellectual Property Organization (WIPO) and BOFIT.

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BOFIT

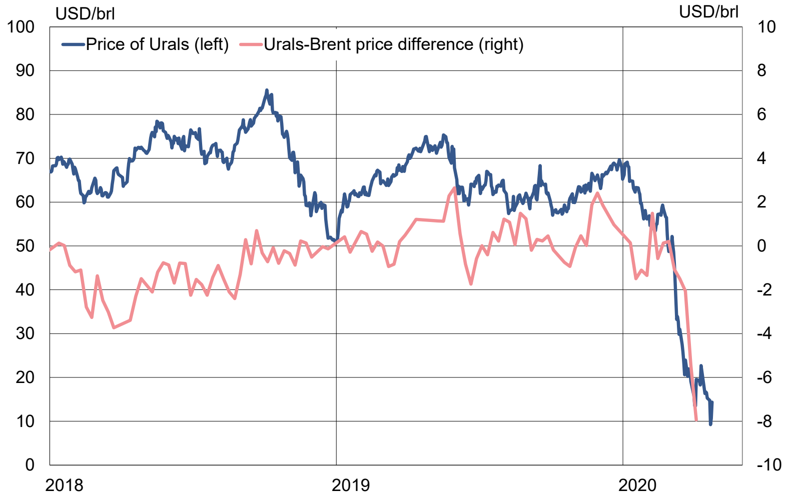
Russia

New OPEC+ agreement on oil production ceilings fails to calm markets. At a meeting on Monday (Apr. 12) of the OPEC+ group of oil-producing countries (led by Saudi Arabia and Russia), the parties agreed to cap crude oil production until April 2022 to support oil prices. The agreement calls for reducing production by almost 10 million barrels a day (mbd) in May and June, and then by roughly 8 mbd for the rest of the year. From 2021 to the end of the agreement period, the production cut will amount to nearly 6 mbd. The combined output of OPEC members and Russia last year was about 40 mbd, or about 40 % of world crude production. The production ceilings are set to reduce the output of countries by up to 25 % in May-June and by about 20 % for the rest of the year.

According to various media reports, Russia committed to cut 2.5 mbd for May-June and around 2 mbd for the rest of the year (which would correspond to a nearly 20 % cut for the May-December period). The agreed cuts, the largest ever, present a challenge for Russia. Oil companies warn that production in sub-arctic conditions and geological factors make it technically difficult to adjust production volumes. Indeed, the cuts are so large that mid-sized, privately-held producers will also be called upon to do their part. This has apparently ignited a heated debate on burden-sharing among producers.

The OPEC+ pledges of massive production cuts did little to calm oil markets. The spot price of West Texas Intermediate (WTI) crude turned negative on Monday as inventories have grown and demand fallen further. Recent weeks have seen an historical widening in the price gap between North Sea Brent crude and Russian Urals-grade crude. On Tuesday (Apr. 21), the price of Urals crude briefly fell below $10 a barrel.

Oil prices have declined by about 70 % since the start of the year



Sources: Reuters, Bloomberg and BOFIT.

IMF forecast sees sharp contraction in Russian economy this year followed by sluggish recovery next year. The latest IMF [World Economic Outlook](), released last week, forecasts a sharp three-percent contraction in global GDP this year followed by a strong recovery of 5.8 percent next year. The Russian economy has been hit hard by the corona pandemic shutdown of the economy and the collapse in crude oil prices. Russian GDP is expected to fall this year by 5.5 % and then grow by just 3.5 % next year. As a result, overall GDP will be less in 2021 than in 2018.

While most forecasting institutions expect a contraction in Russian GDP this year, the forecast figures depend to a large extent on how long Russia is assumed to keep relatively strict lockdown measures in place. For example, the IMF base scenario assumes that most COVID-19-related restrictions will be lifted after the second quarter, and that recovery from the pandemic will begin already in the second half of this year. In Russia's case, also assumptions about oil price trends have a huge impact on the growth outlook.

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Europe's other emerging economies, including Ukraine and Turkey, should also experience similar economic weakness this year. Notably, the Turkish economy should bounce back strongly next year. The IMF expects economic trends in Asia to be better than elsewhere this year, and that many emerging economies in the region will manage positive growth numbers.

Short-horizon developments in the Russian economy, as elsewhere, are monitored by such daily and weekly indicators as traffic volumes, energy consumption as well as retail sales. Restrictive measures in the early weeks of the lockdown, for example, reduced overall energy consumption by 3–5 % y-o-y. By some estimates, a change of this magnitude implies a drop of roughly 10 % of GDP. Payment card data reported by Alfa Bank show that household consumption in the first two weeks of April declined by about 30 % from the end of March.

Russia had been enjoying relatively strong economic growth in the months before the COVID-19 pandemic. Industrial output was up 1.5 % y-o-y in in the first quarter (up 0.3 % in March), with manufacturing up by 3.8 % y-o-y (2.6 % in March).

GDP forecasts published in April

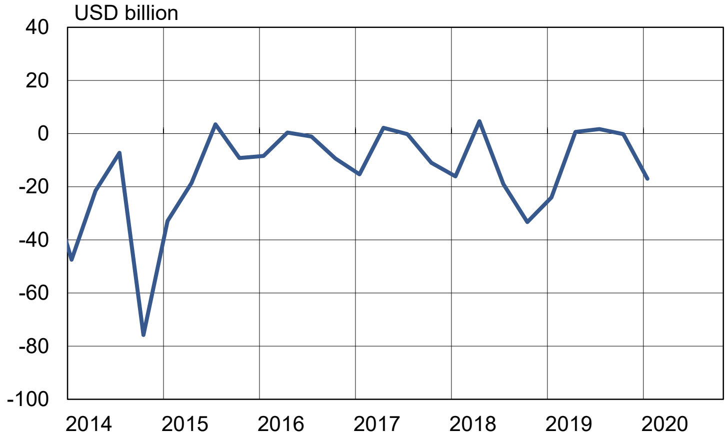
	IMF		World Bank		ADB	
	2020	2021	2020	2021	2020	2021
Russia	−5.5 %	3.5 %	−1.0 %	1.6 %		
Ukraine	−7.7 %	3.6 %	−3.5 %	3.0 %		
Kazakhstan	−2.5 %	4.1 %	−0.8 %	3.0 %	1.8 %	3.6 %
Turkey	−5.0 %	5.0 %	0.5 %	4.0 %		
China	1.2 %	9.2 %	2.3 %	7.7 %	2.3 %	7.3 %
India	1.9 %	7.4 %	2.8 %	5.0 %	4.0 %	6.2 %
Indonesia	0.5 %	8.2 %	2.1 %	5.6 %	2.5 %	5.0 %
Vietnam	2.7 %	7.0 %	4.9 %	7.5 %	4.8 %	6.8 %

Sources: International Monetary Fund, World Bank, Asian Development Bank and BOFIT.

First-quarter figures show contraction in Russian foreign trade and net capital outflow. Preliminary balance-of-payments figures show that the value of Russian exports of goods and services amounted to 100 billion dollars in January-March, a 13 % y-o-y decline. Oil & gas exports slid by 25 % y-o-y in the wake of steep drop in price and declining demand. The value of other goods exports increased by 2 % y-o-y. Exports of services decreased due to COVID-19-related travel restrictions that reduced exports of travel services by 27 % y-o-y. The value of imports of goods and services amounted to 74 billion dollars, a decline of just over 1 % y-o-y. Imports of travel services fell by 16 %, while goods imports remained unchanged from a year earlier. The first-quarter current account surplus fell significantly on year, amounting to 22 billion dollars. The overall current account surplus for the past four quarters corresponded to approximately 3 % of GDP.

Looking at the financial account, there was again a corresponding net outflow of capital. Foreign investors sold their Russian sovereign bonds and repatriated portfolio investments from the non-banking corporate sector. The net flow of foreign direct investment into Russia also fell to nearly zero, and Russian banks continued pay down foreign debt. On the other hand, the first-quarter capital outflow was lower than in 1Q19 as Russian banks and companies made fewer investments abroad. The net capital outflow of the private sector amounted 17 billion dollars in the first quarter.

Net capital flow of Russian private sector



Sources: Macrobond and BOFIT.

CBR sells majority stake in Sberbank to the Russian government. The sale, announced last February (BOFIT Weekly 13/2020), took place last Friday (April 10). The transaction was originally set to take place in several tranches, rather than all at once, and the price of stake (50 % plus one share) was expected to be around 2.5 trillion rubles. However, with the general decline in share prices, the final price of the acquisition was just 2.139 trillion rubles (about 28.5 billion dollars). Sberbank, Russia's largest bank, accounts for about a third of Russia's entire banking sector.

The transaction resolves the Central Bank of Russia's long-running potential conflict of interest in holding the controlling interest in Russia's largest bank. For the government, the greatest value of the transaction is the huge boost it gives to the CBR's distributable funds. The CBR is obliged to surrender its profits to the government, which can then spend the money unfettered by the current fiscal rule. Sberbank's stake was acquired with assets from the National Welfare Fund, which in turn saw a decrease in its assets invested in highly liquid securities. The value of transaction corresponds to roughly 2 % of Russia's 2019 GDP.

China

Coronavirus containment measures cause China’s economy to contract for the first time in decades. China’s National Bureau of Statistics (NBS) reports a severe contraction in first-quarter GDP (6.8 % y-o-y and 9.8 % q-o-q). It was the first contractionary episode reported since the NBS began to publish quarterly data in 1992. The last on-year contraction in Chinese GDP was recorded in 1976. No official growth target has been set for this year as the coronavirus epidemic has led to the postponing of the National People’s Congress, which is traditional held in March. The NPC is scheduled to start on May 22.

Official figures show that 4.4 percentage points of the contraction in GDP came from reduced consumption expenditure, 1.5 percentage points from lower investment and one percentage point from the drop in net exports. On the supply side, manufacturing and construction (which accounted for 39 % of GDP in 2019) shrank by 10 % in the first quarter. Production of services (54 % of GDP) was off by 5 %.

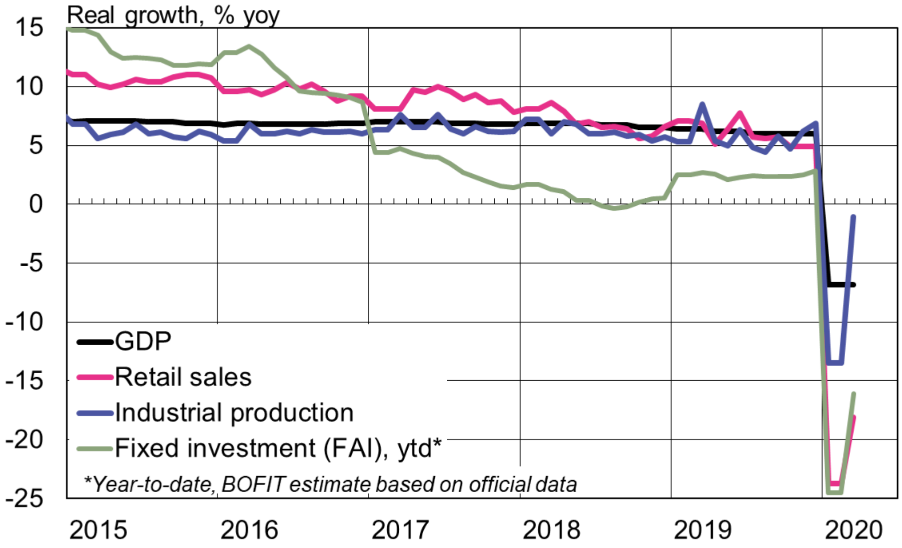
While industrial output, retail sales and fixed asset investment (FAI) all increased in March from February, they all saw on-year declines. For the first quarter, retail sales were down by about 22 %, industrial production by 8 % and FAI by about 16 %. The index of service production published by the NBS also decreased by 12 %. Given these numbers, a contraction in services of 5 % seems rather modest. China’s GDP data are quite opaque and the reported figures do not give a realistic picture of economic trends. It is quite likely that the first-quarter GDP contraction was more severe than reported. Revised Bank of Finland estimates (see BOFIT discussion paper), for example, show that the economy contracted by nearly 10 % y-o-y in the first quarter of 2020.

Economic forecasts have been dramatically lowered in recent weeks in response to the COVID-19 pandemic. The latest IMF forecast sees the Chinese economy growing by just over 1 % this year. Some institutions have yet to update their forecasts to reflect the deepening corona crisis. For example, FocusEconomics's May consensus forecast for China’s growth this year sits at 1.9 % (within a range of -1.5 % to 4 %), which is nearly two percentage points lower than a month earlier. The restart of the economy after the corona lockdown has been more challenging than many expected, and the impacts will no doubt extend well beyond the first quarter. The contraction in the Chinese economy projected in our latest BOFIT forecast, published in March, now seems increasingly likely.

The economic recovery has slowed in recent weeks. While official restrictions on movement and gathering have been largely lifted, consumer demand remains weak due to falling incomes, reduced employment and fears about COVID-19. Research firm Trivium estimates that economic activity, which initially roared back from a dead stop in mid-February to around 68 % of normal by mid-March, is now recovering more slowly and reaching about 83 % of normal as of mid-April.

According to daily activity indicators, some industrial sectors have already ramped up production to levels approaching those of last year. For example, coal consumption at power plants has matched the same level as last April on some days. However, the intensity of night lights in industrial plants is still down by about 20 % from last year’s levels. The real estate business has revived from a full stop in early February, but is still only at around 75–80 % of last year’s activity. Private car use has increased, but the number of people using public transport is only about half the level of last year. Most leisure-time service providers such as movie theatres remain closed.

Monthly indicators showed larger contraction than GDP in the first-quarter



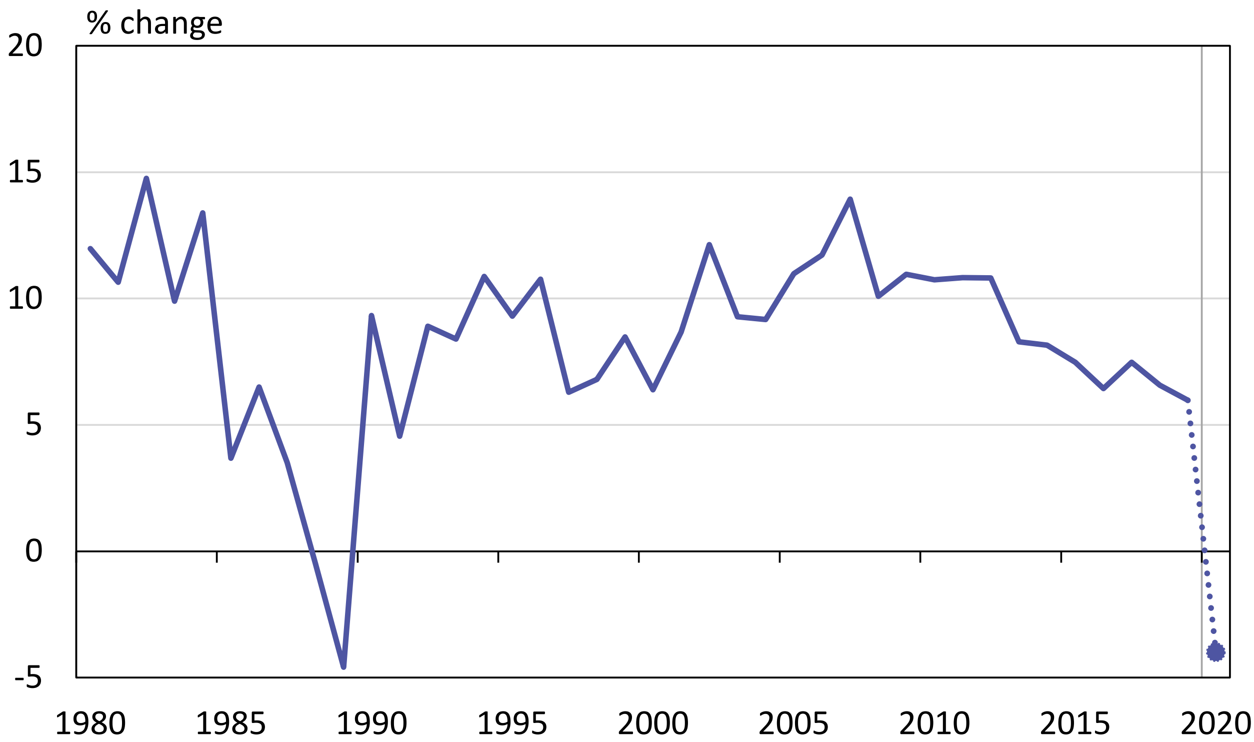
Sources: China Bureau of Statistics, CEIC, Macrobond and BOFIT.

Real household incomes in China decline and unemployment rises. The NBS reports that real per capita household income fell by 4 % y-o-y in the first quarter. NBS figures also show that real income last slumped in 1989. The decline was about the same for rural and urban areas. The average per capita monthly income in urban areas averaged 3,900 yuan (510 euros) and 1,550 yuan (200 euros) in rural areas.

Unemployment has increased. While official survey based figures indicate that the unemployment rate has risen from 5 % to 6 %, the data coverage is spotty at best. Unemployment is estimated to be much more commonplace. Small and medium-sized firms, which have been hit hard by the crisis, collectively account for most of the country's employment. Media reports suggest that roughly a half million companies (about 1 % of all companies) ceased to operate in the first quarter and that many companies operates below capacity. The Chinese Zhongtai Securities last week estimated that 70 million people had lost their jobs and that the true unemployment rate is likely around 20 %. Estimates in the same ball park have been presented by other observers as well.

As increasing prosperity of individuals has long been a cornerstone of Communist Party rule, the decline in real incomes and rising unemployment are particularly sensitive issues. China lacks a robust social safety net (e.g. unemployment insurance), and protections are often non-existent in the case of migrant workers. In April, the Party established up a new high-level task force to uphold social stability and safeguard the Party's position.

Change in real per capita household disposable income in China, 1980–2019 and 1Q 2020



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

China continues to support NEV manufacture and sales as part of corona stimulus. Car sales in China, which were already declining last year, plunged with the emergence of the coronavirus epidemic. The China Association of Automobile Manufacturers (CAAM) reports that both car production and car sales declined by about 80 % y-o-y in February. Although the lock-in-restrictions and factory close downs were released in March and car production was restarted, both production and sales were still down by over 40 % from March 2019. As part of the stimulus arrangement, the government extended subsidies on production of new energy vehicles (NEVs) to 2023. The NEV subsidies were originally set to expire this year.

While China is both the world's largest car producer and the world's largest market for car sales (including NEVs), Chinese cars have not yet found much demand outside China. Of China's production of about 25 million cars a year, just over 1 million are exported, with most of those going to developing countries or other emerging economies. Chinese consumers themselves prefer foreign makes which in total account for about 60 % of car sales. Volkswagen, the most popular make in China, accounts for about 15 % of all sales. All of the world's largest car manufacturers have plants in China.

China has relied on knowledge transfers from abroad to develop its domestic car industry. Often the proprietary skills and knowledge have been gained through acquisition (e.g. Volvo) and by forcing foreign manufacturers into joint ventures with domestic manufacturers. In spring 2018, the government announced plans to phase out gradually its joint venture requirement. A change governing the NEV industry was implemented already the same year, allowing Tesla to break ground on its new plant in Shanghai in 2018. Tesla launched production at the facility last year. NEVs are also part of the "Made in China 2025" programme, which seeks to develop China's manufacturing presence in emerging high-tech fields. The China's investment in production of domestic electric and hybrid vehicles is expected to improve the image of Chinese cars at home and abroad –and hopefully make China a major NEV exporter. China's M-Byte all-electric SUV will hit markets in the west late this year. In a fairly short period, China has also become a leading manufacturer of lithium batteries for electric vehicles.

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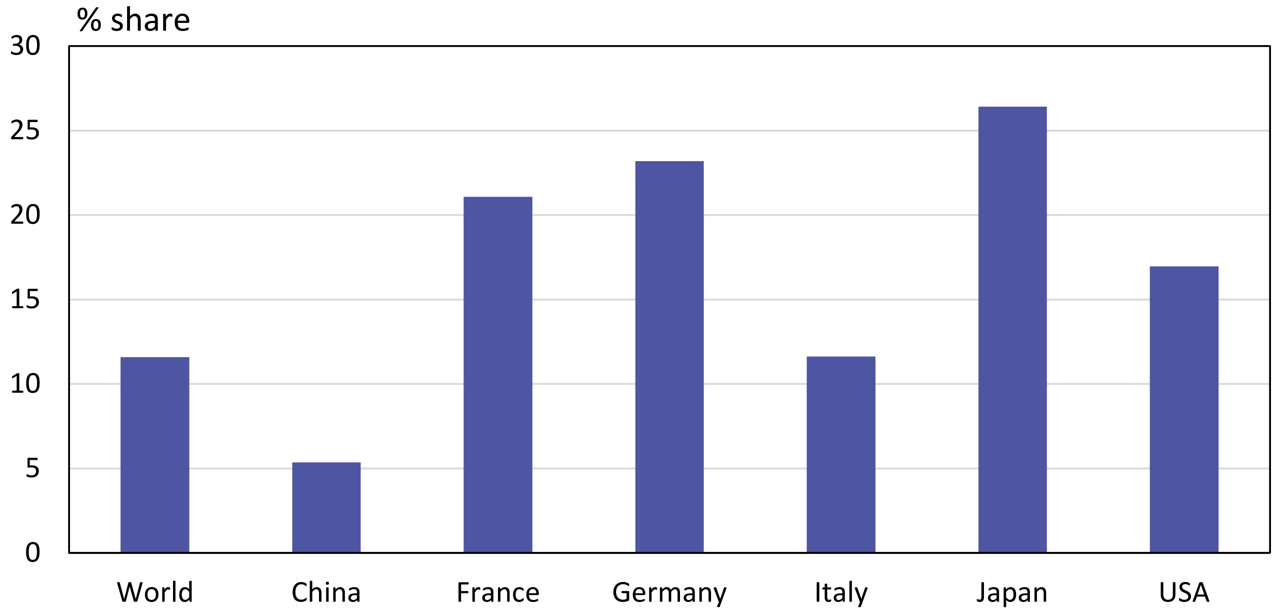
Vehicles as a share of the value of goods exports to select countries, 2018



Sources: WTO and BOFIT.

Chinese demand unlikely to revive global oil market over the short term. The volume of crude oil imports to China over the first three months of this year increased by 5 % y-o-y (value up by 8 % measured in US dollars), suggesting import volumes and prices had yet to feel the full impact of the corona crisis. By March, however, the collapse in domestic demand was well reflected in decreased oil refining activity and building up of inventories became an important driver of crude imports.

While domestic refining decreased by 7 % in March, crude oil imports rose by nearly 5 % due to existing import agreements and government and commercial operators taking advantage of low prices and replenishing stocks. By some estimates, nearly all of China's storage capacity for crude oil and petroleum products has been utilised, causing a rush to build new storage capacity. As elsewhere, oil tankers have been leased to store some of the purchases. The AP reports the government claimed China's national strategic oil reserves were adequate to meet 80 days of consumption as of last September. Now the government is likely increasing also these reserves.

Thanks to new refining capacity, China's net exports of petroleum products have rapidly increased to 40 million metric tons a year. This, in turn, has driven increased imports of crude oil. The corona pandemic, however, has decreased demand for petroleum products elsewhere in Asia. This situation could depress Chinese oil refining and crude oil imports in coming months. Reuters reports that China lowered domestic prices on gasoline and diesel fuel in March by a record 14–16 % using the pricing mechanism in place since 2013. Authorities have noted, however, that fuel prices would not be lowered further if the price of oil fell below $40 a barrel. These factors, together with full inventories, limit the likelihood that a recovery in Chinese demand will bring rapid relief to the global oil market.

China's top oil suppliers are Saudi Arabia (which accounts for 17 % of China's annual imports) and Russia (16 %). Otherwise, China has distributed its international oil sourcing quite broadly. In light of current geopolitical and trade tensions, it is notable that China's reliance on Iranian oil has evaporated (now under 2 %) and that Chinese official figures show that it has not imported any oil from Venezuela since last September. Moreover, China has imported no crude oil from the US this year, despite the fact that it has committed to significant increases in imports of energy products under the "phase 1" trade agreement signed in January.

China has the world's second-largest demand for crude oil after the US. Imports now satisfy over 70 % of domestic oil demand, making China the world's largest importer of crude oil (about a fifth of international oil trade). While China is a key player in the global oil market, its reluctance about releasing information on its oil reserves make it difficult to assess the market situation.

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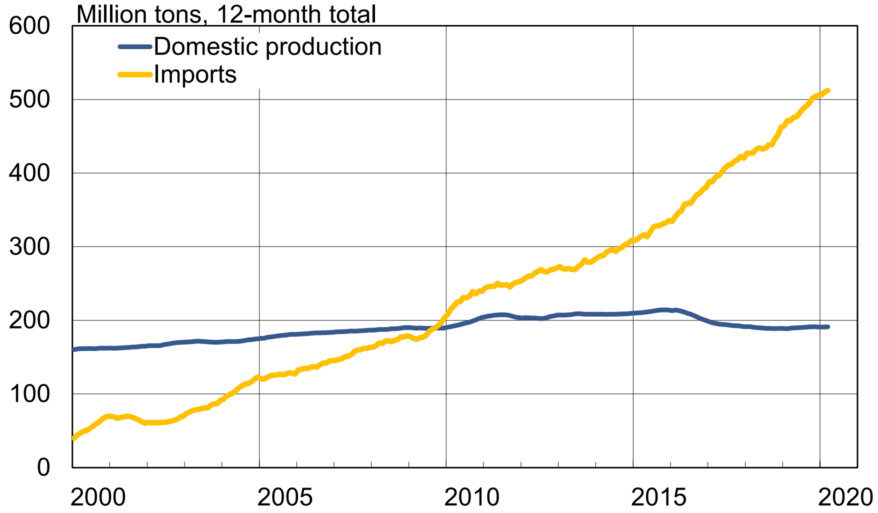
China's domestic production of crude oil and its oil imports in 2000–2020



Sources: CEIC and BOFIT.

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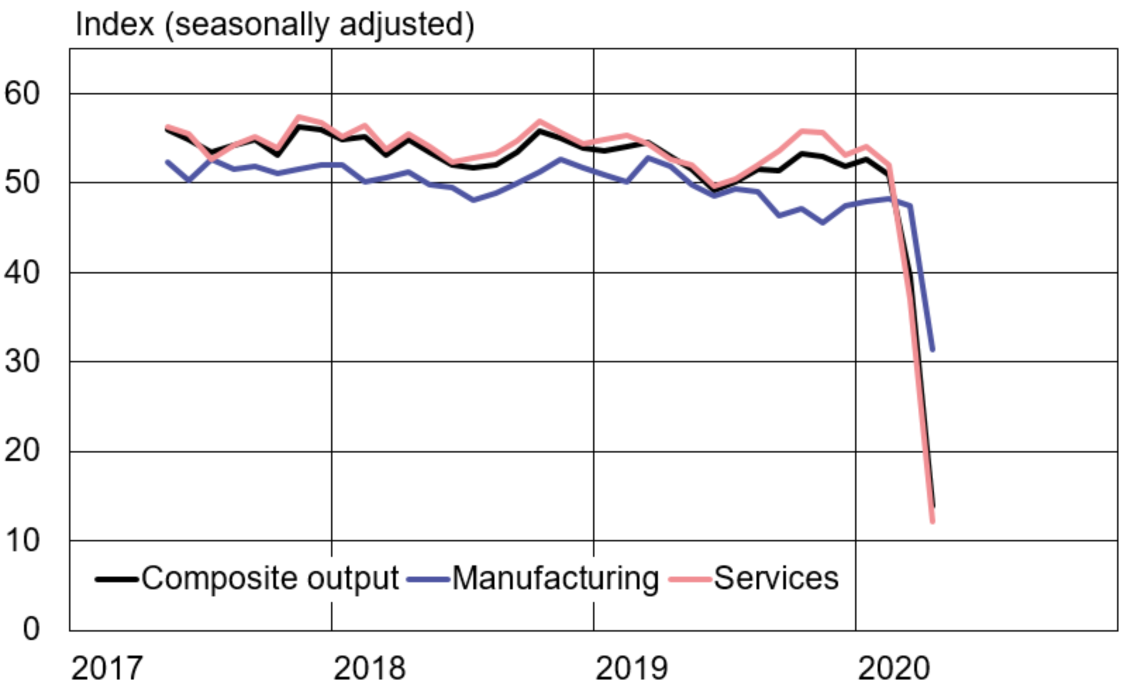
Russia

After relatively robust first-quarter performance, Russia experiences collapse of industrial output and consumption in April. Rosstat reports that Russia's industrial output climbed by 1.5 % y-o-y in the first three months of this year. While growth was strong in January and February, in the latter part of March industrial output suffered as the impacts from the coronavirus pandemic began to be felt. Retail sales grew briskly throughout March (up 5.6 % y-o-y). Some of the increase in retail sales reflected hoarding of certain products by households before the corona shutdown entered into force in late March. Retail sales were up 4.3 % for the entire first quarter, indicating that private consumption was quite strong prior to the epidemic. However, real disposable household income decreased by 0.2 % y-o-y in the first quarter, which suggests that the increase in consumption is unsustainable.

The lockdown measures imposed in April to deal with the corona outbreak and the general reticence of households to spend have sharply reduced economic activity in Russia. The Central Bank of Russia, which monitors the payments system, notes that payment activity in April was about 20 % below normal. The April readings of purchasing manager indices for manufacturing and services revealed plummeting production and a poor outlook for the future. The Composite Output Index, an indicator of total economic output, plunged to just 13.9, suggesting that an overwhelming majority of companies slashed their production after March. New orders decreased in all sectors, and the demand forecasts for coming months were quite bleak.

Purchasing manager indices showed a collapse in output in April (a neutral reading of 50 indicates no change from previous month)



Sources: Markit, Macrobond and BOFIT.

CBR lowers key rate. The Central Bank of Russia lowered its key rate by 50 basis points to 5.5 % on April 24. The CBR further signalled that it would consider another rate cut at its next meeting if conditions warrant. The CBR's rate-setting decisions at recent meetings have been made challenging by countervailing inflationary pressures and exceptional levels of economic uncertainty.

Consumer inflation accelerated to 3 % y-o-y in April. The acceleration in the inflation rate reflected ruble depreciation and a retail demand spike in late March as Russians stocked up in anticipation of the lockdown. According to the research

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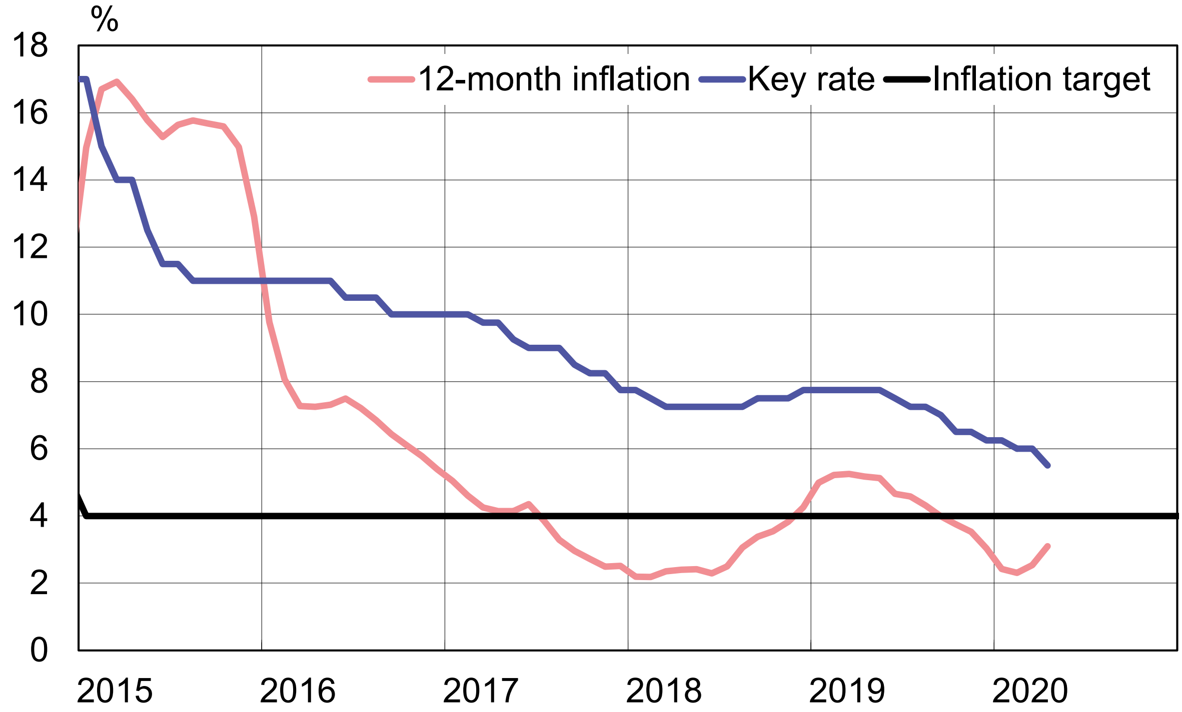
literature, a 10 % depreciation in the ruble's exchange rate translates roughly to an increase in Russian consumer price inflation of about one percentage point within three months. In March, the nominal effective (trade-weighted) exchange rate of the ruble deteriorated by 12 %. The CBR views the recent pick-up in inflation to be fairly short-lived and expects inflation to hover near the CBR's official 4 % inflation target both this year and next on average.

The CBR's latest economic forecast sees Russian GDP contracting by 4–6 % this year, and rising by 3–5 % next year. The price of Urals oil is assumed to average $27 a barrel this year (i.e. an average of $20 between May and December this year) and $35 a barrel next year. The CBR expects a sharp decline in both exports and fixed investment. The volume of imports is expected to decrease slightly less than exports. The CBR forecast sees Russia's current account surplus turning to deficit for the first time this century.

CBR lowered the key rate again in April



Sources: Central Bank of Russia, Macrobond and BOFIT.

Russia's government spending to be stretched by economic support measures. Finance minister Anton Siluanov indicates that federal budget expenditure would rise this year by roughly one percent (or possibly even closer to two percent) of GDP from the spending planned so far even in environments with declining budget revenues. Spending reallocations continue to evolve at the same time. More federal money will be targeted to the economy, particularly the small and medium-sized enterprise (SME) sector. SMEs in branches hard-hit by the corona impacts are eligible for money to cover payroll and other running costs if they e.g. commit themselves to retaining employees (at least 90 % of March level). The hard-hit list identifies over 70 branches suffering from corona impacts.

More funds will also be devoted to social assistance. Families with children will be eligible for a new form of support and those who became unemployed and registered for unemployment after the beginning of March will receive the maximum unemployment benefit. More funds will be made available for healthcare and corona fight including special wage supplements (combat pay). On the other hand, some investment projects and state wage reforms have been postponed. Several of president Putin's national projects would see some of the funding delayed, basically on those parts of the projects that have yet to begin.

Other government budget sector sections, i.e. state social funds and regional budgets, will receive additional transfers from the federal budget to, among other things, cover lost revenues. The deficit ceilings on regional budgets will also be relaxed. Scheduled debt repayments of regions to the federal government will be postponed for 2021–2029, and inter-regional lending will be permitted.

The state social funds will lose revenues as wage-based social taxes of employers will be halved to 15 % for SMEs. The move will give businesses relief this year in an amount equivalent to slightly less than 0.3 % of GDP. No other major tax changes are planned for now. However, several tax payments will be deferred for three to six months, excluding value-added taxes, excise taxes and natural resource extraction taxes (as well as export tariffs which are not actually defined as taxes). The deferrals are available for SMEs and firms in hard-hit sectors, as well as large enterprises that have experienced drops in revenues greater than 10 %. The payment deferrals do not apply in all respects to foreign-owned enterprises. Special oversight will be applied to firms considered systemically important for the nation. Over 1,100 companies have been placed on the list of systemically important firms based on recently revised criteria. Regions have also made their own lists of critical firms.

Federal, regional and municipal government real estate landlords are postponing rental payments for all SMEs and larger firms in hard-hit branches. Private landlords renting commercial real estate (other than residential properties) have been obligated to defer payments of tenants in hard-hit branches. To help participating private landlords, regions are to grant them relief from property taxes. Undercapitalisation (net assets below capital) of joint stock companies and other limited liability corporations will not be taken into account when assessing sufficiency of capital. New bankruptcy proceedings are mostly frozen.

Banks are allowed to retain on their balance sheets the valuations of shares, debt securities and foreign currency items as at the beginning of March. The general loosening of regulatory rules applicable by banks also covers e.g. loss reserves, credit quality and related collateral for a very large part of corporate and household loans granted, as well as their possible restructurings. Authorities have also set up separate deferral programmes for bank debt repayments that are supported by regulatory easing, government interest-rate subsidies and low-interest CBR loans to banks. Deferral programmes are available for households that have suffered income losses of more than 30 %, as well as SMEs and enterprises in hard-hit sectors. A separate deferral programme is also under consideration for large corporations.

Several programmes to provide inexpensive bank loans have been established that provide support through the three ways mentioned above, as well as via loan guarantees from the government or state-owned Vneshekonombank. The purpose of these programmes is to foster lending for housing or provide credit to SMEs. In addition, firms in the hard-hit branches and firms listed as systemically important are eligible for loans to cover payroll and other running costs.

Rapid growth last year in military spending of Russia and China. Data compiled by the Stockholm Peace Research Institute (SIPRI) show that total military expenditure by national governments last year amounted to 1.92 trillion dollars, a nearly 4 % increase in real terms from 2018 and up by over 7 % from 2010. Spending growth was strong in almost all major countries: United States (up 5.3 %), China (5.1 %), India (6.8 %) and Russia (4.5 %). The world's biggest military spenders in recent years have been the US, China, India, Russia and Saudi Arabia. Together they account for about two-thirds of global military spending. The United States, unquestionably the world's biggest military spender last year (732 billion dollars), was followed by China (261 billion dollars). China's military spending is roughly on par with the total military spending of all EU countries combined.

SIPRI figures show Russian military spending declined sharply between 2016 and 2017, but grew rapidly last year back to 2013 levels (61 billion dollars). The ratio of Russian military spending to GDP (3.9 %) was significantly higher last year than in any other European country, China or the US. About half of Russian military spending in recent years has gone to procurement of equipment and weapons systems, a level high by international standards.

SIPRI compares national military expenditure by converting reported amounts to dollars at current exchange rates. Differences in price levels likely lead to underestimation of the real level of military expenditure in e.g. Russia and China relative to the US. Nevertheless, even if purchasing power parity (PPP) index for military goods existed, the order of the countries in terms of real spending would remain unchanged. Using the overall PPP index for GDP, Russia's military spending still was less than a quarter of US military spending last year.

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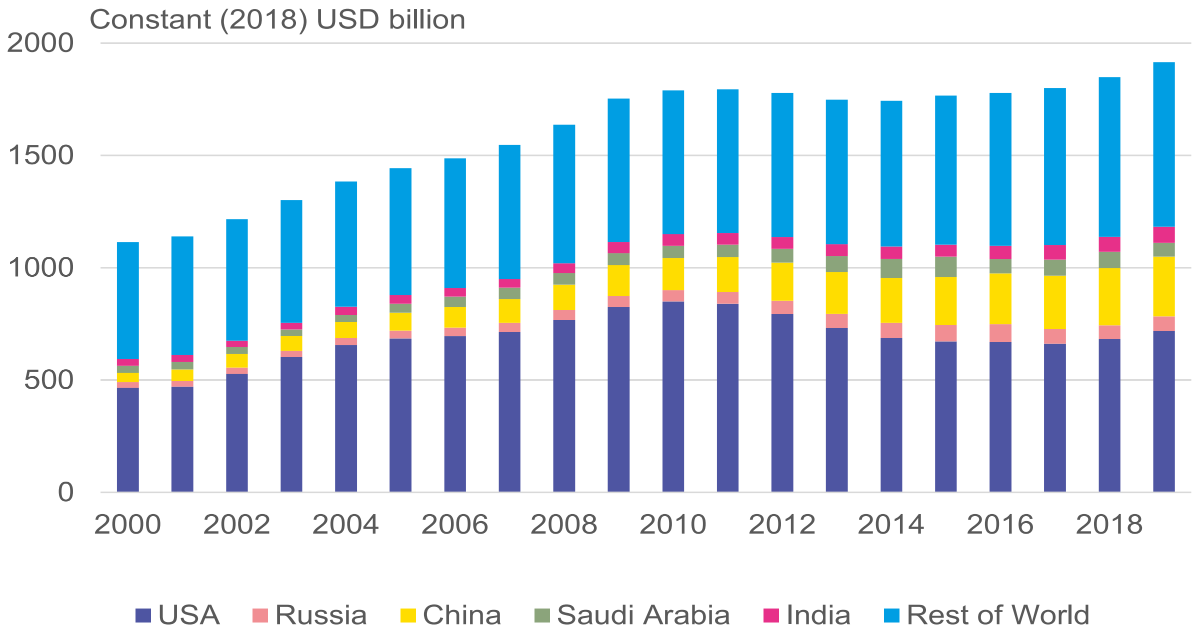
Global military spending continues to rise



Sources: SIPRI and BOFIT.

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China

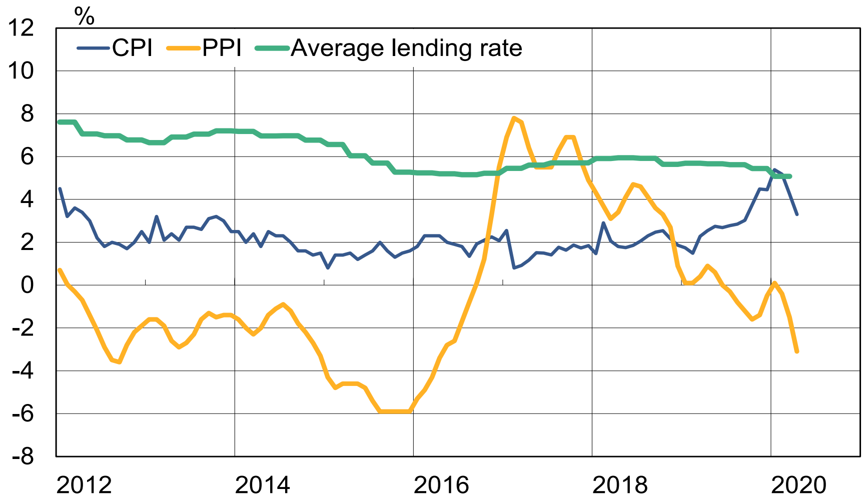
Inflation in China slows, central bank promises additional stimulus. Consumer price inflation in China fell by a percentage point to 3.3 % in April, while producer price deflation accelerated to 3.1 %. The slowdown in consumer price inflation largely reflects improved supply of many food products (particularly pork), which has lowered food prices in the recent months. The worsening of producer price deflation reflects reduced demand caused by the COVID-19 crisis. In addition to lower revenues, deflation makes it difficult for firms to service their debts due to higher real interest rates.

With China facing persistently challenging economic conditions, the People's Bank of China promised further monetary easing when it released its first-quarter monetary policy report on May 10. It did not, however, specify what sort of stimulus measures were envisioned. The PBoC has made monetary policy more accommodative this year through the granting of special credits, lowering the reserve requirement ratios for banks and adjusting its medium-term lending facility (MLF) rates, which it uses to fine-tune longer-term liquidity (3-, 6-, and 12-month loans) and which guide commercial bank lending rate policy. The one-year MLF rate is currently 2.95 %. The PBoC's monetary policy report further noted that it had lowered the short-term lending facility (SLF) used to guide short-term rates (overnight, 7-day and 1-month) by 30 basis points on April 10. The rate on the 7-day SLF credit, which sets the ceiling for central bank interest rate corridor, is now at 3.2 %. Monetary easing was also seen in April with the lowering of the rate paid on non-required commercial bank deposits (excess reserves) with the central bank which forms the lower bound of interest rate corridor (it was the first change in this rate since November 2008). In January-March, the weighted average interest rate charged by banks to customers fell by about 50 basis points from the previous quarter to around 5 %.

As in March, April credit growth exceeded market expectations. Growth in the bank credit stock accelerated to around 13 % y-o-y, which, in combination with strong growth in corporate and local government bonds, ensured continued growth in aggregate financing to the real economy, even as lending in the shadow banking sector continued to decline. The rapid growth of the credit stock and collapse of nominal GDP in the first quarter caused a significant increase in the debt-to-GDP ratios.

China's indebtedness issues have made the PBoC wary of appearing overly eager to apply strong monetary stimulus measures. In any case, it is challenging for an outsider to assess China's actual monetary policy stance. In addition to interest rates, various reserve requirements and macro-prudential measures, officials orchestrate bank behaviour through "window guidance" orders that are not disclosed to the public. The difficulties to assess the monetary policy stance is illustrated by the latest cut in the SLF rate (a key monetary policy instrument) in early April, which was revealed only a month later.

Consumer and producer prices and weighted average of bank lending rates in China



Sources: China National Bureau of Statistics, People's Bank of China, Macrobond and BOFIT.

China showed current account deficit in first quarter. Just-released figures from the State Administration of Foreign Exchange (SAFE) reveal a current account deficit of 30 billion dollars for the first three months of this year. In 1Q19,

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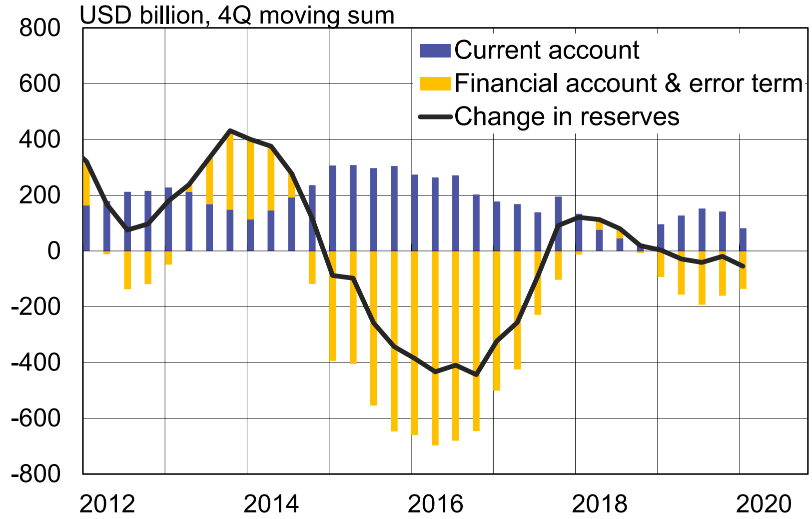
China showed a surplus of roughly similar magnitude. The main cause of the deficit was a reduction in the goods trade surplus to just 26 billion dollars, or about 50 billion dollars less than in 1Q19. The current account surplus fell on year to just over 80 billion dollars (0.6 % of GDP).

While detailed information on capital movements has yet to be released, the available data show that capital flows were quite balanced, as China's foreign currency reserves shrank by 25 billion dollars in January-March. The net flow of capital in every quarter of 2019 was clearly outbound from China. Balance-of-payments figures show that direct foreign investment in China in the first quarter of this year amounted to only 33 billion dollars, a significant drop from 1Q19. Outward FDI from China was 19 billion dollars, only slightly less than in 1Q19. Some observers suggest that the balancing of net capital flows at the beginning of the year may reflect more foreign portfolio investments into China as yields there were higher than in most major markets. The impact of the global corona crisis on investor behaviour and investment in China should become apparent in coming quarters.

To attract portfolio investment, the PBoC announced this month that quotas for QFII and RQFII programmes for foreign institutional investors would be phased out and that repatriation of investments made under the programmes would be facilitated. The practical significance of the decision, which enters into force in June, should to be limited, however, as the current quotas have long been underexploited as foreign investors have found other ways to invest in China.

Monthly data show that China's goods trade surplus last month soared and that its currency reserves rose to nearly 3.22 trillion dollars as of end-April.

Main items in China's balance-of-payments



Sources: SAFE, Macrobond and BOFIT.

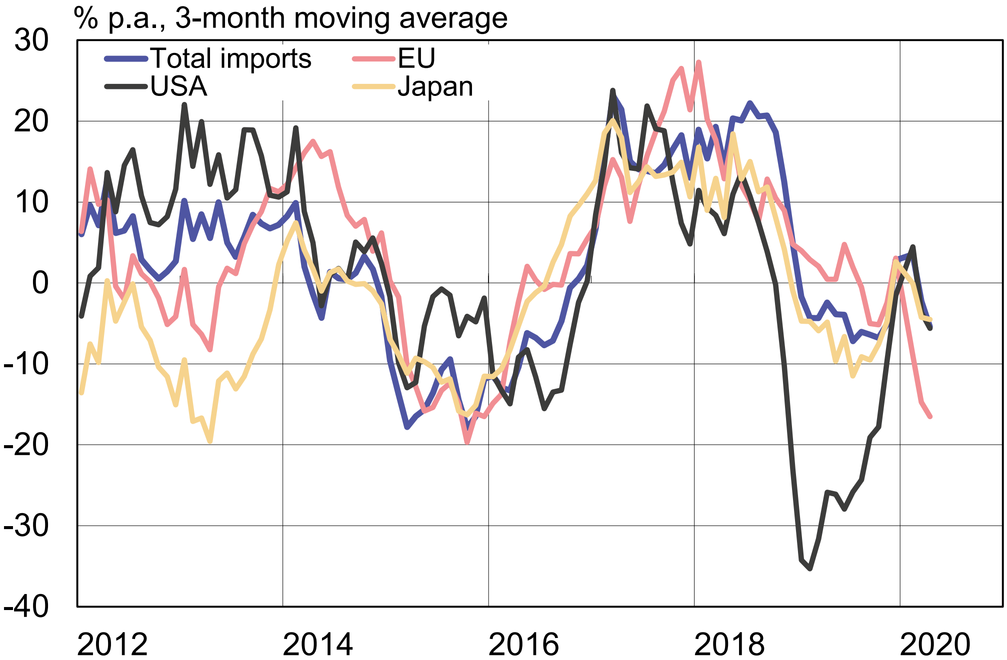
Chinese goods exports performed surprisingly well in April, while imports from the US contracted sharply. Somewhat surprisingly, China Customs reports that the dollar-value of goods exports increased by 3 % y-o-y in April. The value of goods exports had decreased by 13 % y-o-y in the first three months of the year. April witnessed booming growth in exports of COVID-19 related personal protective equipment as well intermediate products for their production and surgical and medical equipment. Observers also noted that exports were likely driven by efforts to fill pre-crisis orders that companies had been unable to meet during the corona lockdown in January and February. Company surveys (e.g. PMI readings) indicate new export orders have decreased rapidly and exports are expected to decline in coming months.

Chinese exports to neighbouring countries such as Japan, South Korea and other ASEAN countries were up sharply in April. Exports to the United States also grew a few percent on-year. While exports to the European Union decreased by 5 %, there were large differences across countries. For example, Chinese exports to Germany were up by 20 %.

The value of Chinese goods imports decreased by 14 % in April. The drop in crude oil imports in itself accounted for an estimated 5 percentage points of the contraction, with lower prices for other forms of energy and unprocessed plastics accounting for another percentage point of the decline. The value of imports in China's top import category, machinery & equipment, fell by only a few percent. China's imports contracted from almost all countries.

Tensions between China and the US have increased in recent weeks. Bilateral trade is again central in the discussion as Chinese goods imports from the US continued to decline in April (down 11 % y-o-y). Both the US and China have signalled that China is still committed to "phase one" of the US-China trade agreement signed in January. The agreement requires that China purchase at least 144 billion dollars of specified goods from the US this year. US export figures show that the value of such products exported to China in January-March amounted to less than 15 billion dollars. In order to achieve the agreed quota, China needs to buy the same amount of goods in in each remaining month of this year as it did in the first three months in total. To boost imports, China announced that it would abolish additional tariffs on 79 American products next week. It is hard to see how China manages to meet its agreed purchase quota.

China's goods imports by country



Sources: China Customs, Macrobond and BOFIT.

China's recovery policy includes investment in "new infrastructure". Nominal on-year growth in Chinese fixed investment slowed over the past decade from over 30 % to just 5.4 % last year as profitable investments became harder to identify and old projects remained mired in debt. The big collapse, however, only arrived in the first two months of this year, when fixed investment contracted by 25 % y-o-y (manufacturing was off by nearly 33 %). The situation improved a bit in March and more in April, so that the contraction in fixed investment for first four months was on estimate around 10 % y-o-y in real terms.

Although recovery measures after the first wave of the coronavirus epidemic have focused of normalising consumption, fixed investment has also been supported through monetary and fiscal measures. Key interest rates have been lowered and banks have been encouraged to lend to firms. The quotas for regional specialty bond issues have been increased to promote infrastructure investment.

China's economic structure is gradually evolving to more service and consumer-oriented. At the same time, fixed investment is increasingly directed to high technology and "new infrastructure" of which 5G network has been a good example for a few years already. China is now rushing 5G network construction to help with recovery from the COVID-19 pandemic. The new network not only adds speed and capacity to mobile communications, but facilitates e.g. the Internet of Things, virtual reality and self-driving vehicles.

The Ministry of Industry and Information Technology reports that there were 198,000 5G base stations in China at the end of March this year, and that China's current goal is to add over 600,000 more base stations around the country by the end of this year. The ministry estimates that the cost of building a 5G network during 2020–2025 to achieve near-complete national coverage will cost roughly 1.2 trillion yuan. The benefits from having a national 5G network are increased by about threefold sum of support to production chains and other business related to 5G.

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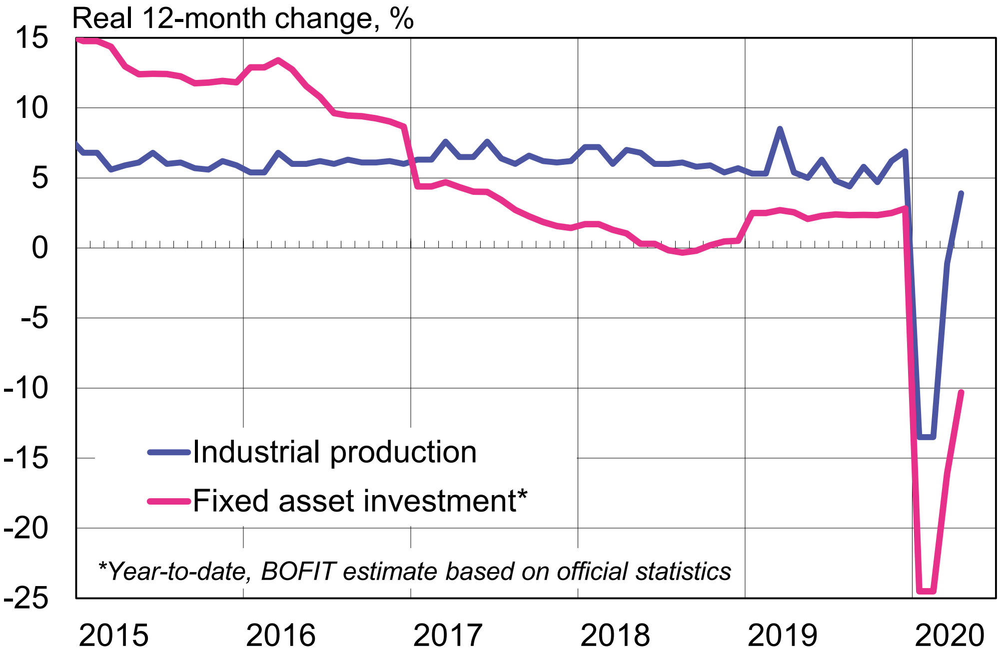
Estimates of the short-term economic impacts of the 5G project are wide-ranging. The official view is that the stimulus benefits are substantial (over 10 trillion yuan directly over five years and almost 25 trillion yuan indirectly in the same period). In contrast, researchers at Gavekal Dragonomics claim that short-term economic impact of the 5G networks will be limited and 5G should be treated as a political objective. China has declared its intention of becoming a major player in information and communication technologies.

The coronavirus pandemic hit Chinese fixed investment harder than it hit industrial output



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

Hong Kong's economic outlook remains weak even with support measures. Preliminary figures show that Hong Kong's GDP fell by 8.9 % y-o-y in the first quarter, the sharpest drop since figures began to be kept in 1974. The increase in public consumption (up 8 % y-o-y) was insufficient to offset the declines in private consumption (down 10 %) and fixed investment (down 14 %). In late April, Hong Kong's financial secretary Paul Chan said that GDP could contract by as much as 7 % this year. The IMF's April forecast expected a contraction of less than 5 %. The Hong Kong economy shrank by 1 % last year.

The flow of tourists to Hong Kong came to an almost complete halt with the global coronavirus outbreak and imposition travel restrictions in February-March. The number of tourists arriving in March from mainland China (about 80% of all tourists) was just 30,000 (compared to 4.5 million in March 2019). Retail sales suffered from the collapse in tourism, driving March retail volume down by 44 % from a year earlier (down 47 % y-o-y in February). National accounts show that goods exports in the first quarter fell by 10 % y-o-y (imports down by 11 %). Due to the collapse of tourism, the decline in services trade was even steeper with 38 % y-o-y decrease in exports and 25 % in imports. The value of goods exports to mainland China decreased by more than 20 % y-o-y in January, but grew by 10 % in February and March.

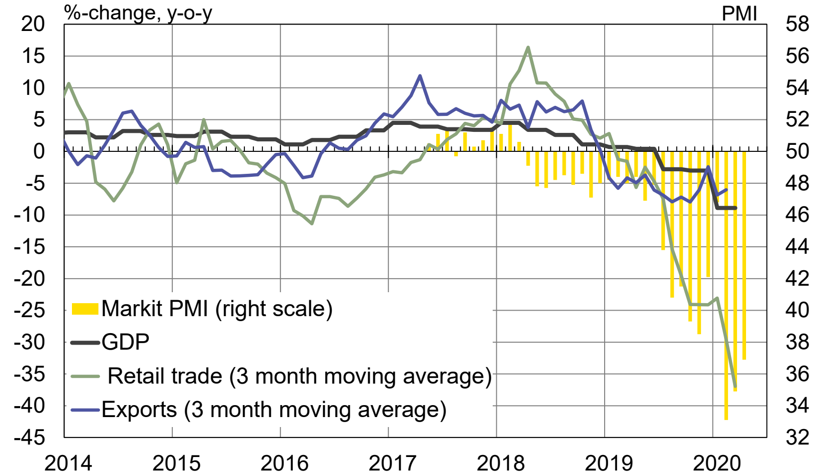
Hong Kong has unveiled a massive recovery package, which the IMF reckons to equal roughly 10 % of GDP. Measures include a 10,000 HK dollar (1,200 euros) cash subsidy to all adults permanently residing in Hong Kong (cost: 2.5 % of GDP), establishment of a support fund for restaurants, shopkeeper and tourism-related businesses (cost: 1 % of GDP), business employment subsidies covering up to half of wage costs for six months (cost: about 3 % of GDP), as well as various tax cuts and relaxation of payment schedules. Efforts have also been made to improve liquidity in the banking sector. Corporate loan payments have been extended and state-guaranteed loans have been made available to small firms.

Mainland China's political grip on Hong Kong has tightened recently, leading to increased local dissatisfaction with official treatment of the special administrative region. Together with the US-China trade war, they have already dented the region's economy for couple of years. The Markit PMI last showed a positive growth reading (i.e. a reading above 50) in March

2018. Global financial market volatility and unrest have hurt the outlook for Hong Kong's financial sector, although there are no signs of a large capital outflows at the moment.

Lockdown measures to control spread of the coronavirus have been relaxed in May. Since the end of last week, bars and cinemas have been permitted to open and number of persons allowed to congregate has been raised to four to eight. Schools are set to open at the end of May and workers are gradually returning to their offices. Pro-democracy demonstrations have also increased in recent weeks along greater intensity in government retaliation. As tensions increase and the incomes of mainland Chinese consumers decrease, it is unlikely that Chinese tourists will provide quick relief to Hong Kong's struggling economy – even after the lifting of corona restrictions.

Hong Kong's economy continued to contract in the first quarter of 2020



Sources: Hong Kong Census and Statistics Office, Macrobond and BOFIT.

Russia

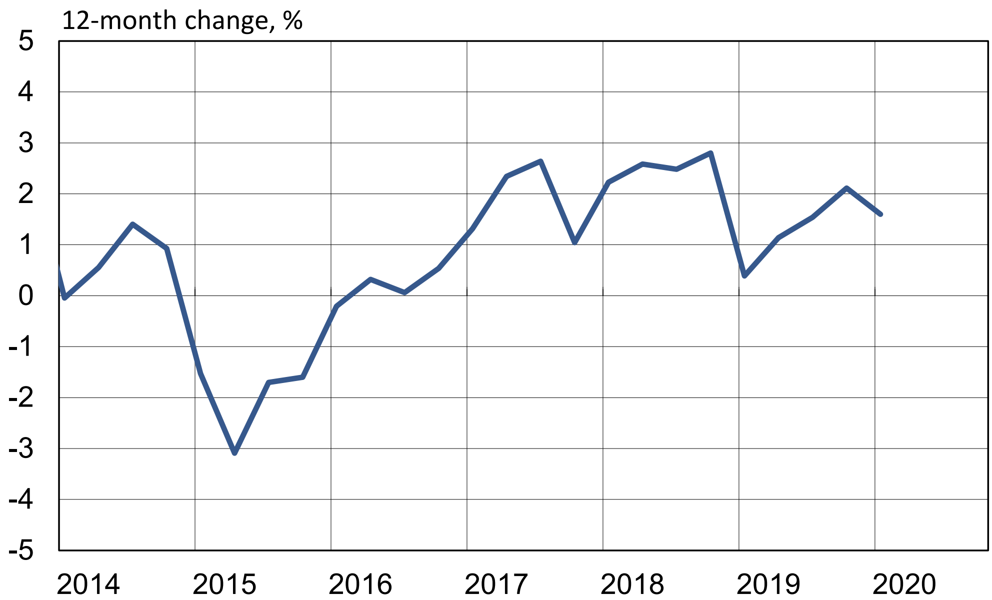
Russian GDP grew by 1.6 % in the first quarter. While growth slowed slightly from 2.1 % y-o-y in the fourth quarter of 2019, it was a relatively good performance on the cusp of the COVID-19 pandemic.

Russia's statistical agency, Rosstat, has revised GDP's quarterly growth numbers extending back several years. However, new quarterly growth paths have not led to revisions of the annual GDP growth figures, but aggregate demand components for 2019 have been revised. Revisions have been quite modest (BOFIT Weekly 7/2020), though. Private consumption growth slowed from 3.3 % in 2018 to 2.5 % last year. Fixed investment was up by 1.5 % last year, and the volume of exports decreased by 2.3 %.

The news pages of the Moscow-based RBC media group report that, according to finance ministry information, nominal GDP contracted in April by 28 % y-o-y, an amount that corresponds to a loss of 20 % of real GDP.

The Central Bank of Russia also released detailed statistical information on operation of the payments system. In April, payments made through the system ran at about 20 % below normal, but changes in payment activity varied tremendously across branches. For example, payment volumes in many industrial branches rebounded to levels close to previous years by early May. In contrast, payments in service branches ran well below normal. Restaurants and tourism-related businesses were among the hardest hit.

Russian GDP growth had been making a comeback before the coronavirus pandemic struck



Sources: Rosstat, Macrobond and BOFIT.

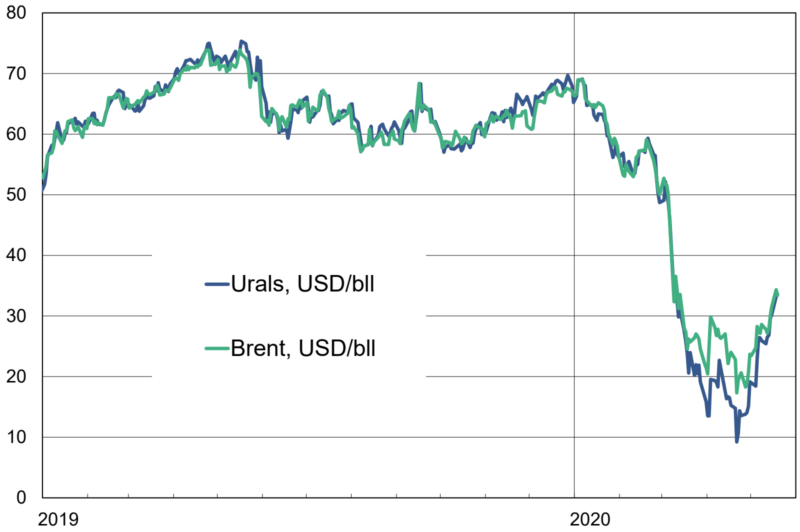
Oil market price volatility calms a bit. In just a month, the price of Brent crude rose from around $20 a barrel to nearly $35. The current price is now on par with levels in early March, but still about 50 % lower than at the start of the year. The price of Urals crude, Russia's slightly heavier export grade, has also returned to early-March levels. The price difference between the traditionally slightly cheaper Urals grade and Brent blend has narrowed to almost nothing.

Prices fell sharply in March and April as COVID-19 reached pandemic status. Lockdown measures and the sudden halt in economic growth resulted in an unprecedented reduction in global oil demand. Uncertainty spiked and financial markets grew volatile. Moreover, the crisis hit when oil production was at historically high levels and there was a shortage of storage capacity in many places.

The new OPEC+ production control agreement in force since the beginning of May (BOFIT Weekly 17/2020) appears to have significantly reduced production. Saudi Arabia, for example, has announced that it will reduce its production to levels significantly below the agreement ceiling. The world's largest crude oil producer, the United States, is expected to see a large decline in output as several major oil companies have announced production cuts. The International Energy Agency (IEA) estimates that US crude oil production will be at the end of this year 20 % below the level of end-2019.

Oil markets have buoyed in recent weeks by a slightly less gloomy outlook for global oil demand. The recovery of the Chinese economy is fitfully underway, and many countries are gradually easing restrictions to curb the spread of the coronavirus. Nevertheless, there is little reason for great optimism among oil producers. The IEA sees oil consumption declining by about 20 % in the second quarter, and by almost 10 % y-o-y for all of 2020.

Brent and Urals crude prices are having a tough year



Sources: BOFIT, Reuters and Bloomberg.

Shifts in revenues and expenditures eat away Russia's federal budget surpluses. As in 2015 and 2016, federal budget revenues from the production taxes and export tariffs of the oil and gas sector have plummeted. In the first four months of this year these revenues were down by almost 20 % y-o-y. The on-year decline in April was 40 %. The revenues are closely linked to USD-denominated export prices for crude oil, petroleum products and natural gas.

The price of Urals crude was off by more than 35 % y-o-y during the first four months of this year. Oil prices collapsed in March, and the Urals cost around $18 a barrel in April which was 70–75 % lower than in April 2019 and January this year. Although the ruble's depreciation against the US dollar slightly dampened the oil price decline, the Urals price in rubles was still about 65 % lower in April than 12 months earlier. The situation is different from previous deep drop in oil prices in 2015, when much of the impact on federal budget revenues was softened by ruble depreciation.

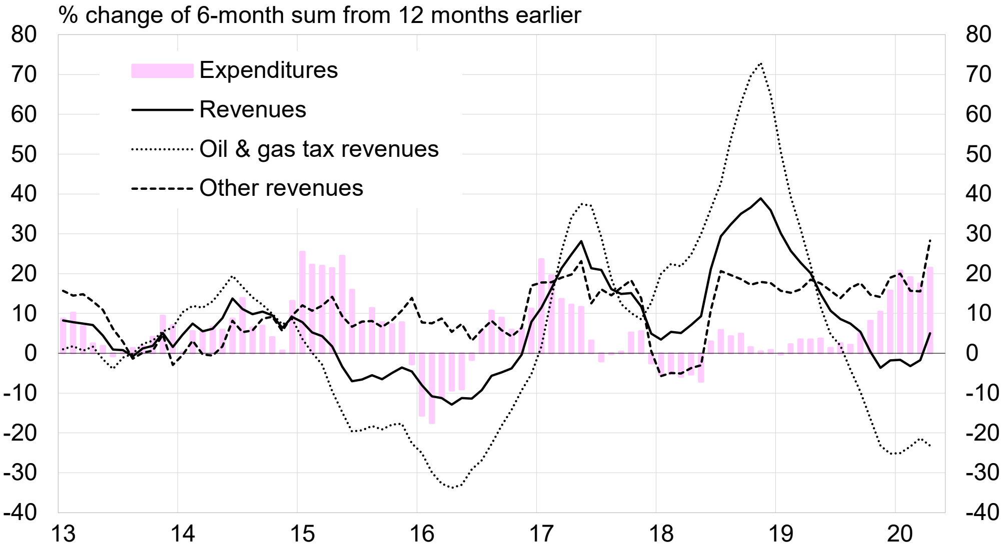
In January–March, non-oil revenues to the federal budget were up by 13 % y-o-y. They rose so steeply in April that their growth in January–April exceeded 30 % y-o-y. The jump in April came from a huge leap (about 1 % of GDP) in a category that includes revenues from the central bank (CBR). The CBR apparently handed over virtually all of the payments planned for this year from the operating surplus that is derived from the sale of its majority ownership stake in Sberbank to the government (BOFIT Weekly 17/2020). The funds for the purchase were taken from the National Welfare Fund, the state's reserve fund. By linking the purchase of Sberbank shares to these payments from the CBR's surplus, National Welfare Fund assets were converted into budget revenues that the government will use to finance budget spending.

Without the one-time transfer from the CBR, non-oil & gas tax revenues in January-April were largely unchanged from a year earlier. VAT revenues this year are so far on par with oil & gas tax revenues. Anyhow, VAT revenues fell by 15 % y-o-y in April and were about the same in the four months of this year as in January-April 2019.

When the CBR payment is included, total federal budget revenues in the first four months of this year were up 10 % y-o-y. When it is excluded, January–April revenues were down by 7–8 %. Budget expenditures in the first four months of this year were up by a bold 24 % y-o-y. The large increase in spending reduced the budget surplus for the previous 12 months to just over 1 % of GDP in April. Without the revenues from the Sberbank arrangement, the 12-month budget balance was only slightly in surplus.

Finance minister Anton Siluanov says the ministry expects this year's federal budget revenues to shrink by a fifth from 2019 and this year's original revenue estimate if the price of Urals oil averages $30 a barrel and GDP declines by 5 %. The loss in budget revenues amounts to roughly 4 % of GDP. Siluanov expects additional federal spending to be authorised this year and the federal budget deficit to come in at around 4 % of GDP.

Growth in Russian federal budget revenues has stopped on lower oil prices, while spending has risen rapidly



Sources: Russian Ministry of Finance and BOFIT.

China

National People's Congress makes exceptional decision not to declare any GDP growth target. The decision not to set a growth target, even if only temporary and in the midst of a global pandemic, is a welcomed policy change. The fixation on numerical growth targets have long been criticised for incentivising inappropriate economic policies, fuelling indebtedness and maintaining unprofitable "dinosaur" businesses. An abbreviated and postponed version of the annual National People's Congress was held in Beijing on May 22 to 28.

The government's work report presented by premier Li Keqiang listed a number of objectives to guide economic development this year. The report reveals that the government is foreseeing a clearly positive GDP growth for this year. Nevertheless, the long-standing target of doubling the real GDP from 2010 by the end of this year, i.e. the end of the current 5-year plan, will not be achieved. According to president Xi Jinping, the GDP target would have been set at around 6 % without the corona shock.

The corona crisis has highlighted the importance of maintaining employment. China's survey-based urban unemployment rate this year should be held to around 6 % (last year's target was around 5.5 %). Just over 9 million new jobs should be created, which is well below last year's target of 11 million and the realised creation of 13.5 million new jobs. Since the number of new jobs is a gross target, it does not take into account lost jobs and tells little about the actual situation in labour markets. The urban employment growth has slowed for years, increasing by just 8 million last year. In the first four months of this year, 3.5 million new jobs were created according to official statistics. Many estimates suggest that tens of millions of Chinese lost jobs at the same time. Therefore the objective of creating 9 million new jobs does not appear particularly optimistic.

China's planned fiscal stimulus seems quite modest compared to other major economies. Maintaining high growth targets has long required accommodative fiscal policies that has caused the public deficit to skyrocket. The official budget deficit target has been raised from 2.8 % of GDP last year to 3.6 % this year. The calculation of the Chinese budget deficit, however, does not correspond to international practices and fails to reflect the true state of public finances as a large amount of spending occurs off-budget. Off-budget local government spending will rise this year with the authorisation of an increased quota for special bonds local governments may issue (to 3.75 trillion yuan this year from of 2.150 trillion in 2019). In addition, the central government will issue 1 trillion yuan in rarely utilised special bonds. Combined with the announced tax and fee cuts, this year's fiscal easing is estimated to be around 4 % of GDP.

Chinese fiscal policy has long been focused on channelling money and resources to fixed investment. The role of social spending is marginal, even if this year's political objectives include the complete eradication of poverty. Personal incomes are expected to grow at the same pace as the economy, i.e. well below the last year's growth. Although the premier's speech mentioned "new infrastructure" such as 5G networks and electric vehicles, the need for rapid recovery will likely emphasise more traditional infrastructure investments. With long continued infrastructure boom, however, infrastructure-driven stimulus may provide poor returns and do little to boost future growth potential.

Although efforts have been made in recent years to keep debt growth "roughly" in line with nominal GDP growth, such efforts appear to have been set aside. In 2019, the aggregate financing stock increased by 11 %, while the broad measure of money supply (M2) increased by 9 %. This year, both metrics are expected to grow "much faster than last year," which, together with the collapse of economic growth, will significantly boost the debt-to-GDP ratio. Inflation will be allowed to accelerate slightly. The inflation target has been raised from around 3 % last year to around 3.5 %. The inflation target in China, however, is largely seen as a ceiling for consumer price growth, not an explicit monetary policy target.

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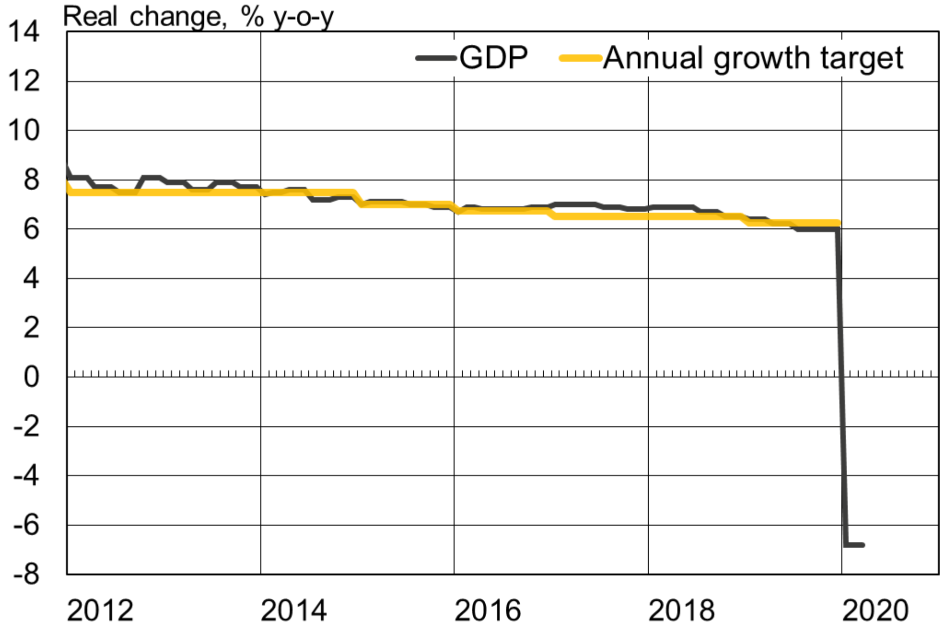
China's GDP growth and annual growth targets, 2012–2019



Sources: Chinese government, China National Bureau of Statistics, Macrobond and BOFIT.

US-China tensions intensify. Relations between the US and China have grown tense with the ongoing harm from COVID-19, uncertainty about implementation of the US-China trade agreement, China's plans to impose security laws on Hong Kong, and new restrictions on American companies working with Chinese partners. The impending US presidential election in November has added its own political dimension.

The "phase one" of a US-China trade agreement in January was initially seen as a signal of thawing relations. China committed under the agreement to increase imports heavily from the US (BOFIT Weekly 04/2020). China's total imports of US goods, however, contracted by nearly 6 % in January-April. While premier Li Keqiang offered assurances last week that China still plans to fulfil its commitments, achievement of the target seems unrealistic (BOFIT Blog 19.5.2020).

The uncertainty created by the coronavirus and the threat that the trade agreement falls apart have heightened the Trump administration's China rhetoric. Among other things, US president Donald Trump has threatened to pull out of the deal and even cut off relations entirely with China. The US has also lately the tightened restrictions on technology sales to Huawei based on national security grounds. Last week the US Department of Commerce announced plans to blacklist 33 Chinese tech companies which it considers to be involved in the crackdown on Uighurs in Xinjiang province.

The situation with Hong Kong and Taiwan creates security- and value-based tensions between China and the US. China's efforts to impose new security laws on Hong Kong have raised widespread opposition in the US and president Trump has promised countermeasures soon. US Secretary of State Mike Pompeo's show of support for the recently re-elected Taiwanese president Tsai Ing-wen and Taiwan's democracy, as well as the possible sale of US torpedoes to Taiwan, have irritated the Chinese regime. China considers both Hong Kong and Taiwan part of its domestic policy.

Since April, when the Chinese coffeehouse chain Luckin Coffee was caught cooking its books and threatened with expulsion from the New York Nasdaq, the accounting practices of China's exchange-listed firms have come under greater scrutiny in the US. Moreover, a US federal government pension fund was ordered not to invest in Chinese companies. The US Senate passed on a bill that obliges foreign companies listed on US stock exchange companies to open their accounts to US authorities. According to the Chinese business media company Caixin, 95 % of listed companies whose financial accounts cannot be reviewed by US authorities use Chinese or Hong Kong auditors.

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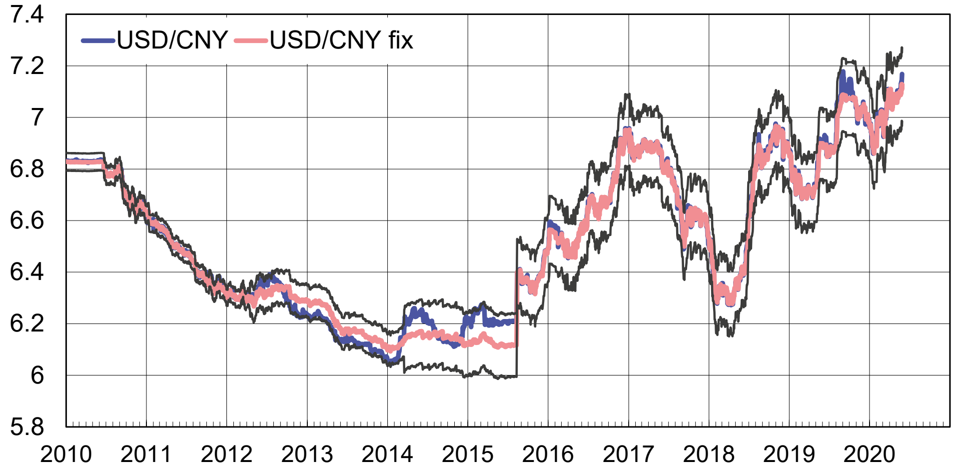
China has allowed the yuan's exchange rate to depreciate gradually against the dollar throughout the spring. This week, however, saw a sudden deterioration with in yuan plunging to its lowest level in 12 years. The exchange rate has been the subject of long-running feud between the US and China.

China policy is a theme in the approaching US presidential election. Candidates Trump and Joe Biden have accused each other of having a soft spot for China, although both have strict China policies in their platforms. There is also a political logic driving the debate. Politico, an online US magazine, commissioned a survey that found 31 % of Americans consider China to be the enemy, up from 20 % in January.

The yuan has weakened against the dollar this year



Sources: People's Bank of China, Macrobond and BOFIT.

New security laws darken the skies over Hong Kong. In the name of national security, mainland China has decided to make a set of laws on Hong Kong banning revolutionary movements and foreign influence in the special administrative region. China's intentions have led to large-scale demonstrations in Hong Kong. The US is considering more sanctions for China and said that Hong Kong does not have high degree of autonomy from China anymore. President Trump is giving a press conference on the issue later today. The EU has called on China to respect Hong Kong's autonomy. The Chinese and Hong Kong governments have tried to play down the meaning of new laws.

The notion of legislating Hong Kong law from Beijing is a violation of the independence of Hong's Kong's legal system. An independent legal system has been one of the corner stones in helping Hong Kong become a major international financial centre. There are fears that China's tightening grasp and possibly following US actions will force an exodus of capital and send foreign companies important to Hong Kong to destinations elsewhere in Asia. So far, the reactions on the Hong Kong Stock Exchange have been rather moderate.

The Hong Kong economy has been in recession since the middle of last year. Factors hurting growth include the slow-down in growth of the Chinese economy, the trade war, wide-spread anti-China demonstrations and the coronavirus pan-demic (BOFIT Weekly 20/2020).

Stock market trends in Hong Kong and Shanghai, 2016–2020

Sources: Hong Kong and Shanghai exchanges, Macrobond and BOFIT.

Industry drives China's recovery. China has gradually eased its coronavirus-related restrictions on movement and activities, declaring the entire country as low-risk for contraction of COVID-19. Companies began to restart operations in mid-March, but the "return to normal" progresses at different paces across provinces and sectors. Regions most affected by the pandemic are experiencing the slowest recoveries.

Industrial firms were the first to start normalisation of operations, so April industrial output rose by 3.6 % y-o-y. Growth was also apparent in the increases in freight volumes, traffic congestion and air pollution. Large state-owned industrial enterprises seem to have recovered faster than small and medium-sized enterprises. In May, the volume of coal consumption at power plants have exceeded last year's volume by almost 10 % which suggests that growth in industrial output continued in May.

Fixed asset investment (FAI) in April was down just 10% y-o-y in nominal terms, a reflection of available capacity and persisting uncertainty about the economic outlook. The strongest recovery was seen in construction-related investment, a sector of the economy targeted for recovery stimulus.

Domestic consumer demand has recovered slowly. After contracting by 20 % y-o-y in January-March, April retail sales were down 9 % y-o-y in real terms. A recent study based on UnionPay payments data found that consumption in the first four months of this year was down by around 27 % y-o-y. Online sales have been affected significantly less than traditional retail. Consumers are shopping again, but they are still reticent about using services. As of end-April, spending in restaurants was still down by 40 % from a year earlier. Shopping malls in China operated at about two-thirds of normal in April. Service businesses are affected by some remaining precautions like testing mask use and social distancing.

The arrival of the early May holiday season marked a turning point in attitudes to intercity travel. The government has even begun to encourage domestic tourism. Long-distance travel (by road, rail or air) is still down by about half normal levels. People clearly avoid public transport, even local transport. The number of metro passengers in China's nine largest cities is up a bit, but still 80 % below the ridership levels of 2019. Traffic congestion, on the other hand, reached an average May level, highlighting the popularity of using private cars.

The frail economic recovery has been hampered by weak export demand and prudence on the part of consumers and investors. With the rapid recovery of industrial production, the structural shift from industry and investment dominated economic growth to more consumption and service based growth is delayed.

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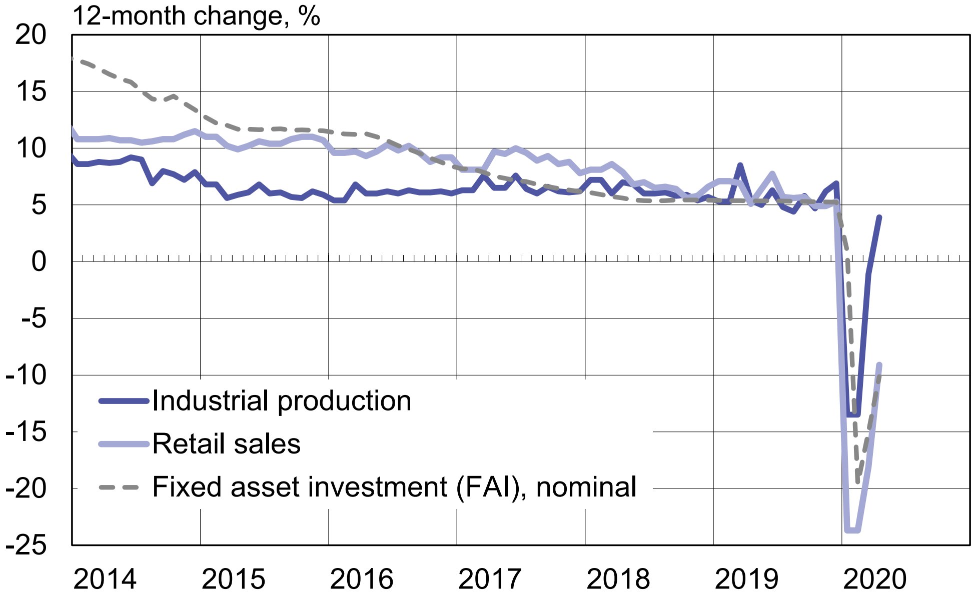
Industrial output, retail sales and investment trends in China



Sources: NBS, CEIC and BOFIT.

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Russia

Prime minister Mishustin lays out Russia's road to economic recovery. Mikhail Mishustin's economic recovery plan hopes to reach a sustainable long-term growth path by the end of 2021. Over the next year and a half, the government would also strive to bring employment at small and medium-sized enterprises back to pre-crisis levels, while reducing unemployment and poverty generally.

Mishustin noted that his plan includes around 500 measures and carries a price tag of 5 trillion rubles (about 5% of GDP) for 2020–2021. As details of the plan have yet to be released, it is unclear what kind of measures the costs actually include and how the implementation of the plan will affect the government budget in practice.

Media reports suggest that most of the programme consists of previously agreed support measures and budget spending already included in the current budget framework (e.g. public procurements and national projects). The release of some previously planned budget spending seems to be, however, accelerated slightly. In addition, the plan proposes changes that should improve efficiency of Russia's social security system, increase labour market flexibility, promote a digital economy and limit imports in procurements by the public sector or state-owned enterprises.

President Vladimir Putin said that the plan provides a foundation, but government must continue working on the plan before launching specific actions at the beginning of July. Putin also ordered the government to prepare proposals on adjustments in implementation of national projects required under the current economic circumstances.

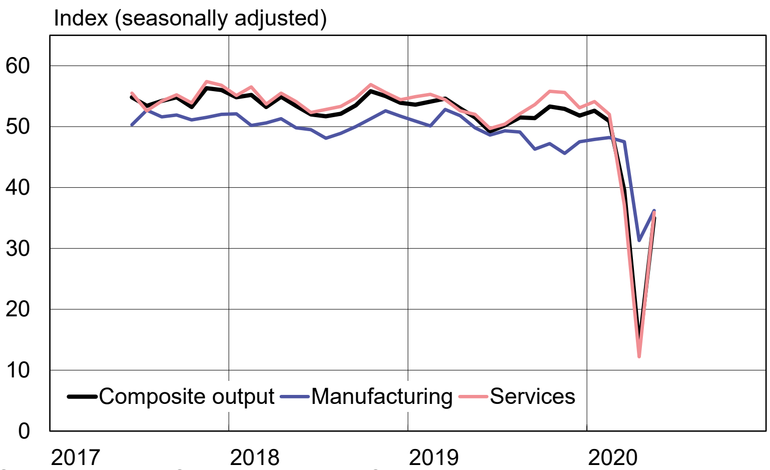
After posting awful April economic numbers, Russia bounced back a bit in May. By practically all metrics, Russian economic activity collapsed in April. The economy ministry estimates that GDP was down by 12 % y-o-y in April. Industrial output decreased by 6.6 % y-o-y, while manufacturing was down by 10 %.

Restrictions on movement were most evident in retail trade, which decreased by 23 % y-o-y in April. The largest drop in consumption was seen in non-food products (down 37 %). Food sales decreased by 9 %. Although certain movement restrictions were eased or lifted in May, the on-year contraction in production and consumption likely continued.

Forward-looking economic indicators bounced a bit back in May from the April trough. The manufacturing purchasing managers index (PMI) had a reading of 36 in May (31 in April), while the services PMI had a reading of 36 (12 in April). Despite some improvement, the May PMI readings for both manufacturing and services remained well below the neutral reading of 50, the level that portends a stable outlook.

The Central Bank of Russia publishes detailed statistics on the operation of the national payments system. During the first three weeks of May, economic activity recovered in many sectors, even if it was still lower than in previous years. Sectoral differences remained large. In some industries, payments have already returned to normal levels. Production of pharmaceuticals and health care equipment is well ahead of previous years. In service industries, in contrast, the recovery has been distinctly more sluggish. For example, there was still no recovery in tourism as of mid-May.

Russia's purchasing manager indices recovered a bit in May



Sources: Markit IHS, Macrobond and BOFIT.

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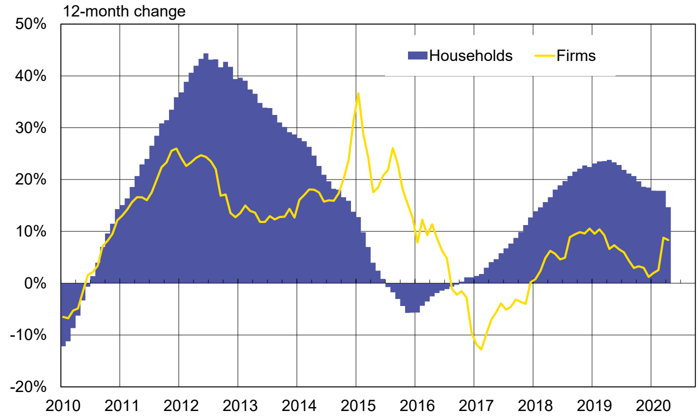
Bank lending growth slows in Russia. In 2019, banks' lending to the corporate sector slowed down and the nominal value of the loan stock, calculated in rubles, increased by just 1.2 %. About a fifth of corporate lending was denominated in foreign currencies. When adjusted for changes in foreign exchange rates, the value of outstanding loans increased by 4.5 % last year, or slightly less than in 2018 (5.8 %). The growth in household lending slowed slightly last year, with the outstanding amount of household loans increasing by just 18.5 % (down from 22.5 % in 2018). Household deposits, the banking sector's main source of financing, increased by about 10 %.

At the beginning of this year, the slight slowdown in growth of the lending stock continued, but the collapse of economic activity and the increase in uncertainty in March-April were clearly reflected in bank lending. The annual growth rate of loans to households was still brisk, but compared to March, the loan stock declined for the first time since 2015. Market participants report that new lending in April was only about half the March level. The volume of new consumer credit declined sharply, and the volume of new mortgage lending was also lower than in previous months.

At the end of March, lending to non-financial corporations increased sharply, suggesting that companies were girding themselves for impending difficulties, for example, by activating their lines of credit. Growth in corporate lending slowed slightly from March to April.

Growth in outstanding bank loans slows a bit



Sources: CBR and BOFIT.

Finnish-Russian trade dips in first quarter. The value of Finland's goods exports to Russia in the first three months of this year decreased by 5 % y-o-y to 722 million euros. Export trends varied widely from product category to category. Decreases were seen in machinery & equipment and chemical products, both major export categories, while exports in numerous other product categories were up on year. Preliminary data show that the value of Finland's exports of services to Russia increased by 5 % in the first quarter to 377 million euros. The trade figures for April and May are expected to be weaker than in the first three months of the year. In a survey conducted by the Finnish-Russian Chamber of Commerce in April and May, over 60 % of responding companies reported that the coronavirus had hurt trade with Russia. The effects only became apparent in April and May.

The value of Finland's goods imports from Russia fell by 18 % y-o-y to 1.8 billion euros. The decline in import was driven by the lower value of minerals (including oil & gas), a major category of import, following the recent collapse in oil prices. Preliminary figures show that imports of services from Russia decreased in the first quarter by 21 % y-o-y to 147 million euros.

In January-March, Russia's share of Finland's goods exports was unchanged from a year earlier at 5 %. In the first quarter of this year, Russia's share of goods imports was 12 %, a 2 percentage-point decline from a year earlier, but Russia still remained Finland's second most important source of imports.

In January-March, Finland's exports of goods to China decreased by 14 % y-o-y to 695 million euros. The decrease in exports was mainly due to contraction of the Chinese economy in the first quarter. Exports of forest industry products, a major component of Finnish exports, decreased by 36 %. However, exports of machinery & equipment were up by 8 % y-o-y.

Finland's goods imports from China increased by 5 % y-o-y in the first quarter to 1.1 billion euros. Imports in the machinery & equipment category rose by 9 %, while other products (including categories such as games, gaming equipment, sports equipment as well as furniture and lamps) were up 15 % y-o-y. Preliminary figures show exports of Finnish services to China and service imports from China decreased by 8 % y-o-y.

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Finnish-Russian trade broken by product categories, January-March 2020

	Exports (1–3/2020)		**Imports (1–3/2020)**	
	Value of exports, EUR million	Change from previous year (1-3/2019)	Value of imports, EUR million	Change from previous year (1-3/2019)
Machinery & equipment	258	-32 %	20	-8 %
Minerals (incl. oil & gas)	55	+28 %	1 180	-27 %
Chemical products	139	-4 %	197	+3 %
Forest industry products	112	+14 %	124	+9 %
Metals and metal products	111	+131 %	292	+10 %
Total goods exports/imports	722	- 5 %	1 840	- 18 %
Exports/imports of services (preliminary figures)	377	+5 %	147	-21 %

Sources: Finnish Customs, Statistics Finland and BOFIT.

China

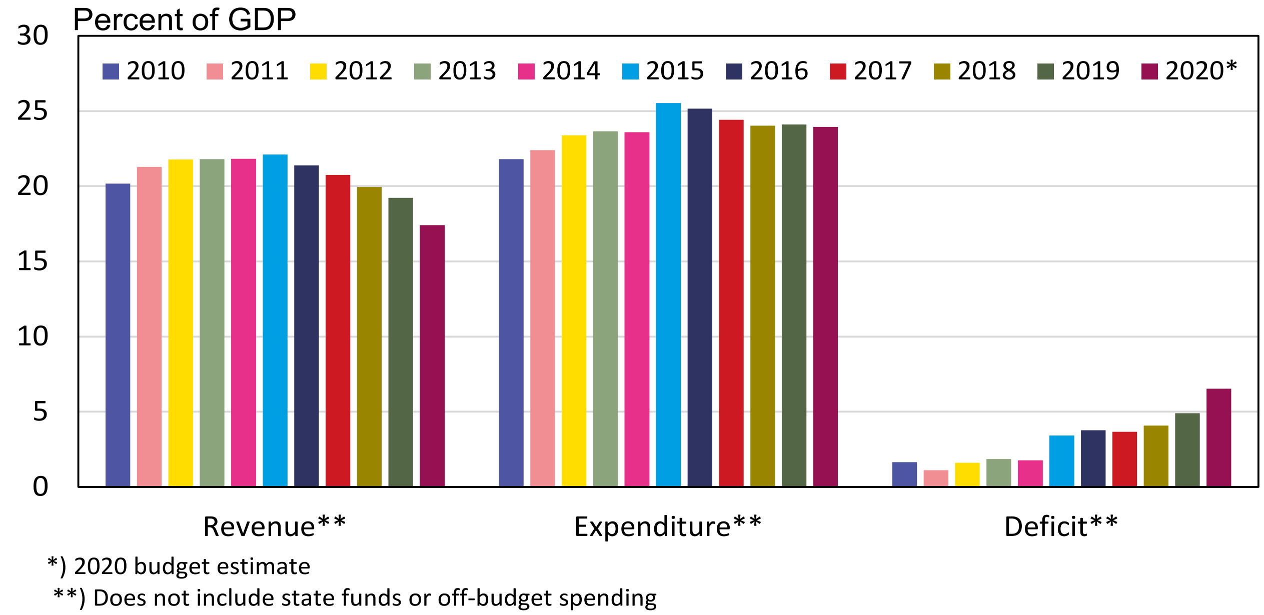
China's 2020 budget deficit set to rise. The finance ministry's budget report anticipates that central and local government spending will increase this year by approximately 1 trillion yuan to just under 24.8 trillion yuan. At the same time, revenues should decrease by around 1 trillion yuan to just over 18 trillion yuan, leaving a budget deficit of 6.8 trillion yuan or around 6.5 % of GDP. The deficit will be partly covered with 3 trillion yuan in transfers from other sources, resulting in an official budget deficit of 3.8 % of GDP.

Realised spending and deficits have consistently overshot budget projections in recent years. Also this year's budget seems to be rather optimistic. While raising the deficit, stimulating the economy and supporting employment, the finance ministry is also calling on government administrators to tighten their belts and consider carefully how funds are spent. General expenses should be drastically reduced and spending should be slashed for such activities as hospitability, travel, training and vehicle acquisition. Construction of new administrative buildings is strictly forbidden.

Given that the Chinese public sector operates extensively off-budget, official public budget figures fail to provide a comprehensive picture of public expenditure and revenue. This year, special "off-budget" bonds will provide an important source of financing. The central government plans to issue 1 trillion yuan in special "corona" bonds. The funds raised will be channelled to local governments for crisis management and economic support measures. In addition, the quota for special purpose bond issues for local governments has been increased to 1.6 trillion yuan. Typically, provinces have used these special purpose bonds to finance infrastructure projects and other investments considered capable of generating sufficient cash flow to pay for themselves. The ministry reports that these funds may now also be channelled to promote social welfare and support consumer demand.

The IMF releases annually fiscal assessment for China which includes an estimate off-budget activity. According to the most recent estimate published in the summer of 2019, the general government deficit has exceeded 10 % of GDP in recent years and public debt was estimated at 80 % of GDP at the end of 2019 (see BOFIT Weekly 10/2020). The IMF estimates updated last week suggest that the fiscal stimulus measures announced by China to deal with COVID-19 pandemic will amount to around 3.6 trillion yuan this year (3.5 % of GDP). Thus, the general government deficit will likely exceed 15 % of GDP this year.

Realised budget expenditures, revenues and deficits of China's central and local governments (2020 estimate included)



Sources: Ministry of Finance, CEIC and BOFIT.

Central bank announces new round of SME support. At the beginning of June, the People's Bank of China unveiled two new programmes to alleviate the financial distress of small firms due to the coronavirus crisis. Access to new lending and repayment extensions are conditioned on borrower commitment to retaining staff. The programmes are directed to smaller regional banks, whose financial standing authorities also want to improve.

Small and medium-sized enterprises (SMEs) account for about 80 % of urban payrolls and generate close to 60 % of GDP. Even so, most SMEs find it difficult to obtain bank loans. The PBoC reports that the stock of small business loans at the end of last year amounted to just 11.6 trillion yuan or 8 % of China's total 153 trillion yuan bank credit stock.

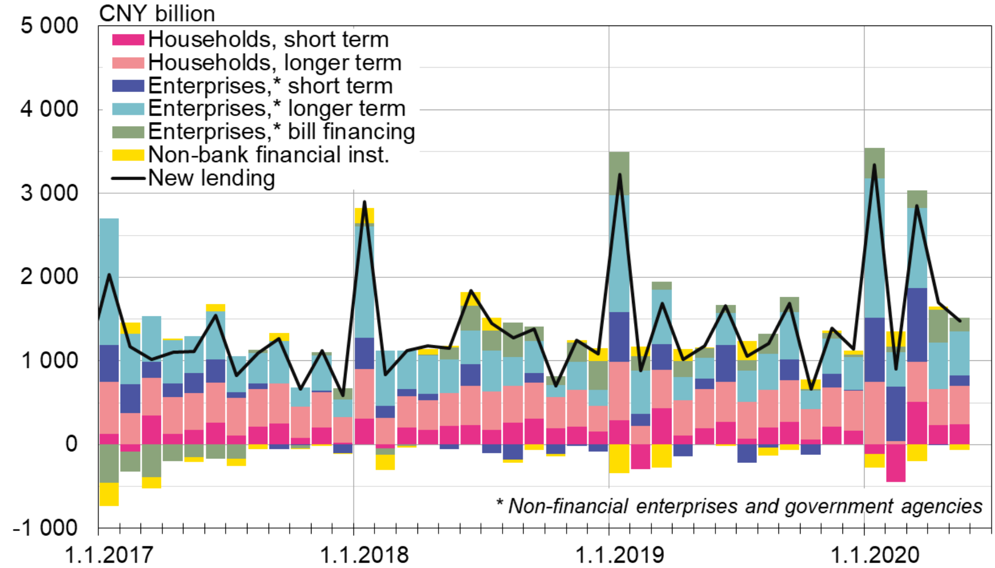
In the first programme, the PBoC provides zero-interest loans to smaller regional commercial banks for the purpose of financing SMEs. The arrangement involves setting up a special purpose vehicle which buys from suitable commercial banks up to 40 % of new unsecured SME loans with maturities longer than 6 months. For this programme, 400 billion yuan has been set aside with the goal of increasing lending to small businesses by 1 trillion yuan. Banks keep the interest income on the loans, but also bear all the risk of default. Commercial banks need to repurchase loans from the vehicle at the selling price at the end of a one-year period. As providing adequate collateral is a common obstacle for small businesses seeking loans in China, the programme emphasises the granting of unsecured loans. Observers make the point that commercial banks might not be interested in the programme, as the high risk of default is a reason they are so reluctant to grant loans to SMEs.

Under the second programme, 40 billion yuan has been allocated to support bank income losses resulting from extensions on small business loans. At the belated May session of the National People's Congress, premier Li Keqiang announced that small businesses could postpone repayments and interest on loans due this year until the end of March 2021. A bank is eligible to receive the equivalent of 1 % of capital of postponed loans to cover the losses. The PBoC considers any company with a credit line less than 10 million yuan (approximately 1.4 million dollars) to be a small firm.

China's monetary policy has long been guided by various targeted actions. The economic fallout from the coronavirus epidemic has increased the range of instruments used by the PBoC. The two new programmes are small, however. Earlier this year, the PBoC launched two financing programmes worth a total of 1.8 trillion yuan (approximately 250 billion dollars) to deal with the corona epidemic and support businesses. Central bank governor Yi Gang reports that a total of 752 billion yuan under the programmes had been doled out as of end-May.

As in April, the stock of bank lending in May increased by just over 13 % y-o-y. New lending totalled 1.48 trillion yuan (210 billion dollars), which was slightly less than in March and April. Growth in the PBoC's total financial stock accelerated to almost 13 % y-o-y as both government and corporate bond financing soared.

Monthly volumes of new bank lending by loan type



Sources: PBoC, CEIC and BOFIT.

Lower commodity prices reduce value of Chinese imports in May; exports down just slightly. China Customs reports that the value of goods imports, measured in US dollars, fell by 16 % y-o-y in May, while exports decreased by just 3 %. As a result, China's trade surplus hit a near-record monthly high of 63 billion dollars.

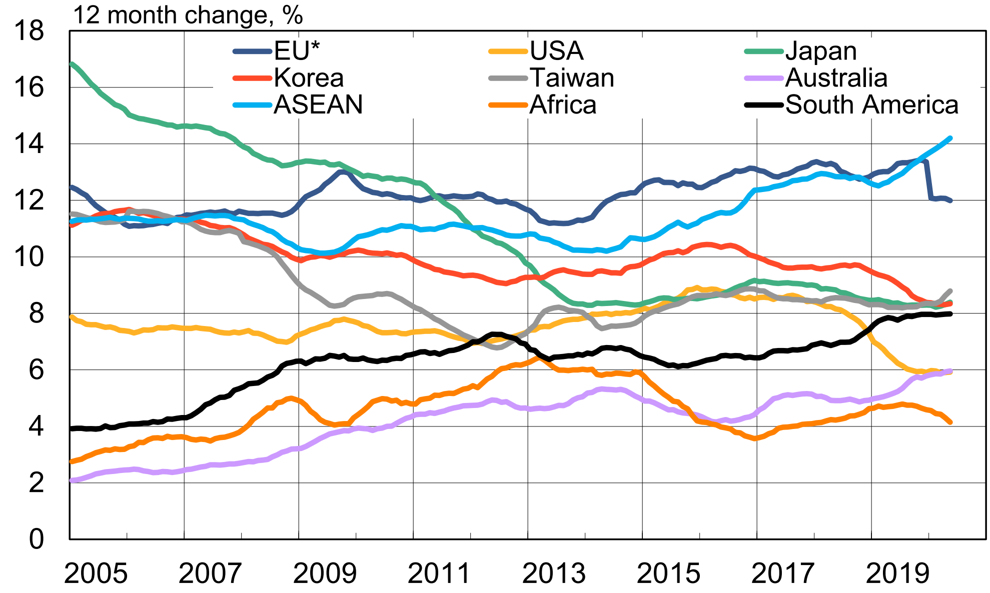
Much of the decrease in the value of imports was due to lower global commodity prices. Volume-wise, imports of many raw materials actually increased from a year earlier. For example, China imported a record amount of crude oil in May, but the cost of the oil was about 15 billion dollars less than it would have been in May 2019.

Under phase 1 of its new trade agreement with the US, China committed to a significant increase in US imports. In May, however, China continued to miss its agreed import targets as imports from the US were down by 14 % y-o-y. Imports were also lower for almost every other region as well. For example, imports from the EU-27 fell by 22 %, when Brexit is taken into account. Imports from ASEAN countries and Japan decreased by 5–6 %. The biggest percentage regional drop in imports was for Africa, which saw the value of imports down by 52 %. African countries account for a small share of Chinese trade and China's imports from there are mostly basic commodities.

The 3 % decrease in total exports again was lower than expected. The decline was softened by exports of health care equipment and personal protective equipment (PPE), which continued to boom in May. Exports to the EU-27 were up by 15 % (Brexit-corrected), Japan by 11 % and the United States about 1 %. On the other hand, the coronavirus significantly depressed exports to India (down 51 %) and Brazil (down 26 %).

The outlook for Chinese exports have been hurt by the global economic recession. A similar story is revealed in readings of purchasing manager indices (PMIs), which suggest that new export orders are contracting rapidly.

12-month change in shares of China's goods imports (select regions and countries)



*) From 2020 EU-27 (Brexit)

Sources: China Customs, Macrobond and BOFIT.

China drops "clean coal" to attract foreign investors to green bond markets. With environmental friendliness part of China's official growth strategy, the state has been actively developing and supporting green funding. In 2015, the PBoC announced guidelines for green financing schemes, which defined also criteria for green bond financing. These criteria were recently revised first time.

China used to have different criteria than those internationally accepted for green bonds. Notably, China initially classified investment in "clean coal" as a green funding category. China still produces the bulk of its primary energy from coal, and in its reluctance to leave coal has chosen instead to invest in technologies that reduce carbon emissions of coal use. International investors, in contrast, see no place for coal in the green bond space and consider talk of "clean coal" to be green-washing or an excuse for foot-dragging on clean forms of energy.

Chinese green bonds have mainly been sold to domestic investors, but now China wants to attract foreign investment as well. On May 29, the PBoC announced revised criteria for green bonds that specifically excluded coal-fired power plant projects. The move clarifies the situation and places China more in line with international practice.

There are as yet no uniform global standards for green bonds. One major international authority is the International Capital Markets Association (ICMA). Its committee on green bond principles includes representatives from for example the

World Bank, the European Investment Bank and the European Bank for Reconstruction and Development (EBRD). Another key standards-setter and important source of statistical data is the Climate Bonds Initiative, an informal, non-profit organisation of investors. It certifies that green bonds conform to the goals of the Paris climate accord and their own criteria for issuance processes. There are also a number of regional standards. The IMF has called for uniform criteria that make it possible for investors to compare products and ensure that green bonds actually are used to finance projects that legitimately benefit the environment.

The Climate Bonds Initiative reports that last year China issued more than 30 billion dollars in green bonds, the second highest issuance amount in the world after the US. Less than half of the Chinese issues met international criteria. For those green bonds not conforming to international criteria, the majority were disqualified by the fact that more than 5 % of the money went to overhead unrelated to the project itself. For over a quarter of non-complying projects, the problem was non-greenness (e.g. related to coal-fired power plants).

The vast majority of China's green bonds have only been issued domestically (85 % in the first half of 2019). The largest issuers are financial corporations, with the public sector only accounting for small fractions and that coming mainly from the local level. In the first half of 2019, more than a third of funding went to transport, more than a quarter to energy and about a fifth to water supply. With the May reforms to appease foreign investors, these ratios might change.

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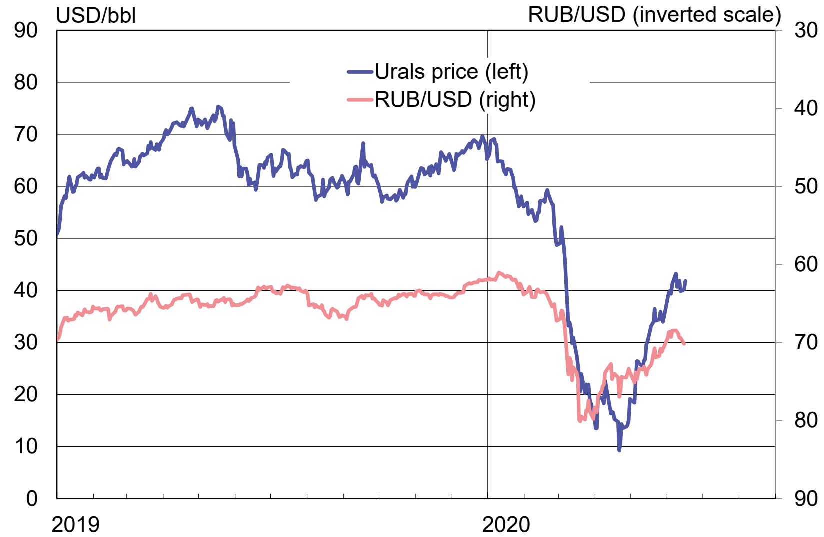
Russia

Price of Urals oil and Russian ruble continue to strengthen. The price of a barrel of Urals-grade crude oil has risen over the past month from just over $30 to around $40. The price has now recovered to levels similar to early March, but still is about 40 % below the price at the start of the year. The Urals price has quite exceptionally exceeded the price of North Sea Brent grade in June.

Global crude oil prices have recovered from record lows with the new OPEC+ production ceiling agreement (BOFIT Weekly 17/2020). The agreement went into force at the beginning of May and will continue until April 2022. The oil price has been further boosted by decisions of several OPEC+ countries, most notably Saudi Arabia, to cut production even more than the agreement requires, as well as a contraction of production in other oil-producing countries such as the US. The International Energy Agency (IEA) estimates that global crude oil production contracted in May by about 12 million barrels a day. While oil production in Russia declined by 14.5 % y-o-y in May, it was only down 2.3 % for the January-May period. At the beginning of June, the OPEC+ countries agreed to extend the May-June cuts through the end of July. Oil prices have also been lifted by a slightly improved demand outlook with the reopening of many economies from corona shutdowns. Nevertheless, the IEA expects global oil demand to fall this year by about 8 million barrels a day and to remain below 2019 levels in 2021 by over 2 million barrels a day.

Higher oil prices are reflected in the ruble's exchange rate. Although the ruble has appreciated roughly 5 % against the dollar and about 1 % against the euro over the past month, the ruble-dollar and ruble-euro rates are still about 12 % weaker than they were at the start of the year.

Urals price and ruble-dollar exchange rate have climbed from the recent low.



Sources: BOFIT and Reuters.

CBR now publishes the RUONIA rate. The weighted average interest rate on unsecured overnight interbank ruble loans, or Ruonia (Ruble Overnight Index Average) is a key reference rate for Russian money markets. The Ruonia rate, which has been calculated since 2010, was previously administered by market participants. On May 21, responsibility for administering the rate was transferred to the Central Bank of Russia. The CBR is now fully in charge of the methodology, calculation and publication of this benchmark rate. The change was driven by changes in international practice, the EU regulation, as well as the need for operational continuity.

The Ruonia rate is based on data provided to the CBR by the largest banks active in the interbank market. It is used as a benchmark in pricing of loans and bonds, and even is used in setting rate for certain finance ministry instruments. The CBR uses Ruonia rate as one of the indicators in assessing monetary policy transmission and money market liquidity.

Another fixing rate, which coexists with the Ruonia rate, is the traditional MosPrime (Moscow Prime Offered Rate), which is administered by the National Foreign Exchange Association. It is based on the ruble offer rates of eight major contributor banks. While the significance of the MosPrime rate has declined in recent years, it still plays a central role in

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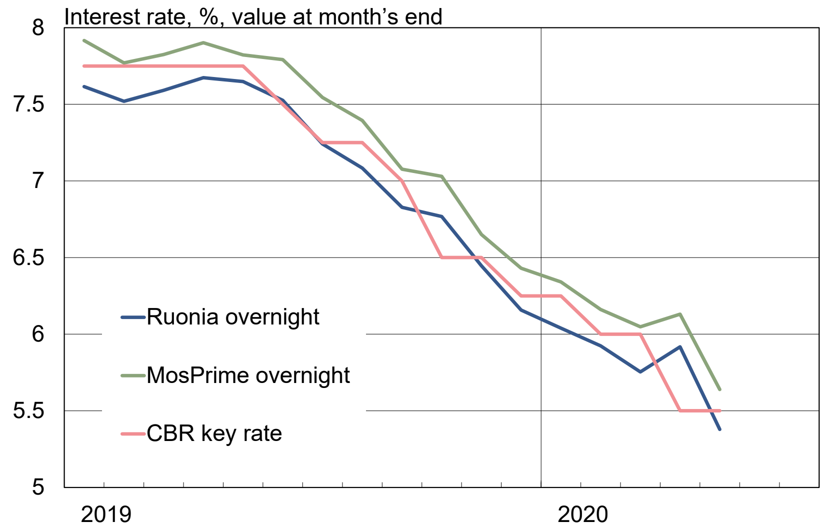
derivatives trading. For example, the MosPrime rate is used in fixing the rates of most ruble interest rate swaps. The CBR continues to publish also MIACR interbank lending rates, which are based on actual rates in the whole banking sector.

Interbank rates have closely tracked the decline in the CBR's key rate.



Sources: CBR, CEIC and BOFIT.

Rising unemployment in Russia. The number of registered unemployed jumped from 1.3 million at the end of April to 2.1 million at the end of May. Anton Kotyakov, Russia's minister of labour and social protection, said that new unemployment claims have been averaging about 150,000 a week in June, bringing the total in mid-June to around 2.4 million. The number of registered unemployed has traditionally been much lower than in Rosstat's survey-based estimate. Registering for unemployment in Russia is a laborious process and the benefit paid out is quite small. With the government's significant increase in the unemployment benefit during the corona pandemic, unemployed workers have greater incentive to register.

Rosstat's survey-based estimate shows that Russia had 4.3 million unemployed persons in April, and increase of about 800,000 from March. The unemployment rate rose in April to 5.8 %, a level not seen since 2015–2016. Unemployment typically remains fairly subdued in Russian recessions as the labour market tends to adjust via pay cuts or fewer hours rather than lay-offs. In the current situation, however, unemployment likely continued to rise in May. Based on a survey conducted in late May, researchers at Moscow's Higher School of Economics found that 10 % of respondents reported that they had lost their jobs, and nearly a third said they knew somebody in their immediate circle who had been furloughed. 40 % of respondents said their wages were lower than before the pandemic. Labour incomes declined most for workers involved in construction and in service branches. The statistical data on wage trends in April and May have yet to be released.

While FDI inflows to Russia grew last year, they will likely contract sharply this year. The net inflow of foreign direct investment into Russia last year was $32 billion, a huge jump from the previous year's exceptionally weak numbers. Last year saw also new equity investment instead of just reinvested profits. In contrast, the net outward FDI flow from Russia shrank last year to $23 billion. UNCTAD's latest World Investment Report expects FDI flows, both globally and in the specific case of Russia, to contract by 30–40 % this year due to the corona pandemic.

The stock of FDI in Russia at the end of last year amounted to around $590 billion (35 % of GDP). Broken down by branch, the most investment (23 %) went to mineral extraction industries (includes oil & gas), manufacturing (20 %), finance (17 %) and trade (15 %). The stock of Russian FDI abroad amounted to nearly $410 billion.

While FDI is often considered an important indicator of the degree to which a country is integrated with the global economy, phantom investment flows may blur the picture. Phantom investment refers to flows that are conducted via third countries for such purposes as tax planning. According to a working paper published by the IMF last year, phantom investments could account for as much as 40 % of global FDI flows. In the article, it is estimated that in Russia's case about a quarter of FDI inflows to Russia are actually of domestic origin. Only in China the share of FDI inflows with domestic origin

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is slightly larger. UNCTAD's 2017 estimate found that Russia's main providers of FDI (with third-country effects removed) were the US, UK and Germany.

The net inflow of FDI to Russia grew notably last year.

Sources: CBR and BOFIT.

Ukraine gets new 18-month IMF loan. The IMF's executive board signed off on a new Stand-By Arrangement (SBA) for Ukraine last week. The programme runs for 18 months, allowing Ukraine to tap into a $5.5 billion credit line. While the first disbursement to Ukraine of $2.1 billion was released immediately to help the country stabilise its economy during the COVID-19 pandemic, release of four other tranches require that Ukraine continues to adhere to its SBA conditions.

Ukraine is also seeking a $1 billion loan from the World Bank. Other international financial institutions traditionally require a valid IMF program before lending to a country. The IMF SBA should also facilitate new EU lending to Ukraine.

As is standard with IMF loan programs, Ukraine had to implement a number of policy measures before the loan was granted. Measures requested by the IMF included changes in the tax code and revision of customs regulations. Ukraine's banking laws also had to be amended to make sure that the restructuring of the Ukrainian banking sector remains on track.

Ukraine was still enjoying relatively favourable economic trends last year, with GDP increasing by 3.2 % and the general government deficit falling to just 2 % of GDP. The IMF expects Ukraine's GDP to decline by 8.2 % this year and forecasts a slow recovery in coming years: just 1.1 % GDP growth in 2021 and 3.0 % in 2022.

As of end-2019, Ukraine's general government debt was $78 billion, or about 50 % of GDP. The county's liabilities to international financial institutions (including the IMF) amounted to about $10.3 billion.

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The Ukrainian hryvnia has depreciated against the euro this year, UAH/EUR rate.

Sources: National Bank of Ukraine and BOFIT.

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China

Across-the-board lowering of global growth forecasts; IMF still sees positive GDP growth for China this year. Despite a global recession, the IMF's June World Economic Outlook Update still expects China's economy to grow by 1 % this year. A resurgence of economic activity should bring growth up to over 8 % next year. Managing the COVID-19 crisis is expected to scar China's economic growth relatively little. Indeed, the IMF expects that China's GDP will be only less than 3 % smaller at the end of 2021 than it would have been according to its growth projection in last October's WEO forecast. The latest World Bank assessment of Global Economic Prospects offers a similar outlook for China.

The OECD's June Economic Outlook sees China falling into recession this year. The OECD forecast presents two scenarios judged equally likely: one with no second COVID-19 wave and one in which a second outbreak that occurs towards the end of this year. China's economy contracts by 3.7 % this year under the second-wave scenario, while it contracts by about a percentage point less under the no-new-wave scenario. Chinese economy in this latest outlook is expected to be 7–11 % smaller at the end of 2021 than the expectation published in the OECD's previous November forecast.

Some investment banks and other forecasting institutions have raised China's growth outlook in their latest updates on the assumption of a stronger-than-expected recovery in economic activity. Even so, forecasts are lower than few months ago. The June consensus forecast for China from FocusEconomics sees a 1.6 % increase in GDP this year. There is a huge disparity in the forecasts underlying the consensus, however. They range from -4 % to +4 % this year. The consensus forecast for next year is 7.5 %.

The growth outlook for the global economy has been revised downward sharply in all forecasts. The IMF expects the world economy to contract by 4.9 % this year and grow by 5.4 % next year. The IMF expects the COVID-19 pandemic a 7 % drop in global economic performance in 2020–2021 compared to the last October's WEO. The IMF also sees the global volume of trade in goods and services contracting by 12 % this year. The OECD's milder scenario anticipates that the world economy will shrink by 6 % this year and grow by 5.2 % next year. Under its second-wave scenario, the economy contracts by 7.6 % this year and grows by 2.8 % next year. Compared to its pre-corona forecast from November 2019, the OECD sees global economic output to be 7–12 % lower at the end of 2021.

Latest GDP growth forecasts for China, %

	2020	2021	Released
IMF	1.0	8.2	06/2020
OECD (no 2nd wave)	-2.6	6.8	06/2020
OECD (2nd wave)	-3.7	4.5	06/2020
World Bank	1.0	6.9	06/2020
Asian Development Bank	1.8	7.4	06/2020
Capital Economics	2.0	10.0	06/2020
Moody's	1.0	7.1	06/2020
Citibank	2.4	8.2	06/2020
J.P. Morgan	2.0	8.6	06/2020
ING	-1.5	4.3	06/2020
Fitch	0.7	7.9	05/2020

China's recovery uneven across sectors. The National Bureau of Statistics reports that retail sales are slowly returning to normal levels, with retail volumes in May only down by about 4 % y-o-y. Restaurant sales, still off by about 20 % y-o-y, strongly reflect coronavirus restrictions and changes in consumer behaviour.

In contrast, industrial output, has recovered rapidly. May industrial output was up by 4 % y-o-y. Nevertheless, there was wide variation across sectors. Industries involved in production of personal protective equipment (PPE) saw strong growth. Production of industrial robots, microchips and computers has also increased by over 20 % y-o-y in recent months. Moreover, growth has been robust in many construction-related industries. For example, production of steel and cement have reached record levels. Production of earthmoving equipment such as excavators, as well as elevators has also grown rapidly.

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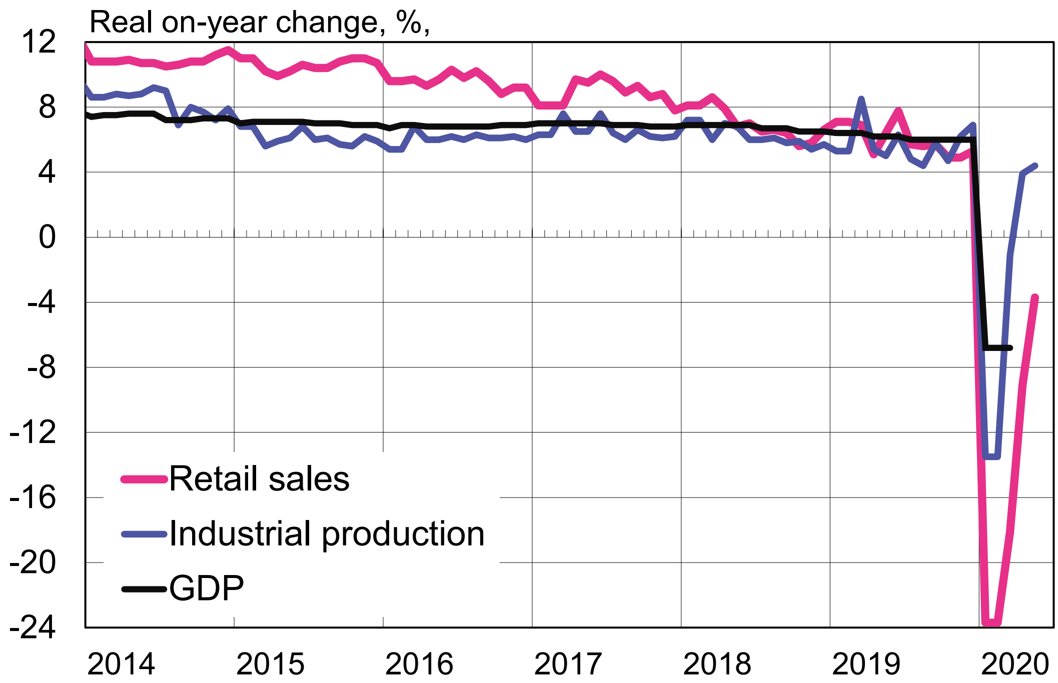
The resurgence of industrial output has also led to increased electricity consumption. Due to China's heavy reliance on coal, air pollution has also returned to pre-corona levels.

Increased production of construction materials suggest a pick-up in building activity. Official figures point to a recovery in fixed investment after a near halt in February, but it is unclear whether fixed investment in May matched or remained below the May 2019 level. China's data on fixed investment leaves much to be desired. The stock of aggregate financing to the real economy (AFRE) has picked up only slightly in recent months and was up by 12.5 % y-o-y in May. Last year, AFRE grew by just under 11 %.

Analytics firm Trivium China estimates that Chinese firms were operating near 90 % of normal levels at the beginning of June. Weekly and daily figures for June also suggest economic activity has continued recover. Power-plant coal consumption is at or above levels of a year ago. Night lighting at industrial parks is almost on par with 2019 levels. Restaurant orders continue to rise. Apartment sales are roughly at 2019 levels. A big difference in Chinese behaviour is that people still avoid using public transportation, preferring their own cars instead.

Beijing has registered over 250 new coronavirus cases in recent weeks, but the situation seems to be under control at the moment and economic consequences for the country will likely be relatively minor despite school closures, flight cancellations and stricter quarantine rules.

While industrial output has bounced back to positive growth, retail sales continue to lag.



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

Reciprocal trade and global sharing of responsibility top the agenda of the EU-China summit. On Monday (Jun. 22), the EU and China held their annual summit via video. The EU's tone has grown harsher with respect to China, even if the EU's stance remains largely unchanged from its strategy outlook for China released last year (BOFIT Weekly 11/2019), i.e. China remains important partner for the EU in terms of trade, climate, technology and multilateral cooperation. The EU expressed the hope that China would take a larger role in resolving global issues, but also regretted that China is challenging the EU at the systemic level.

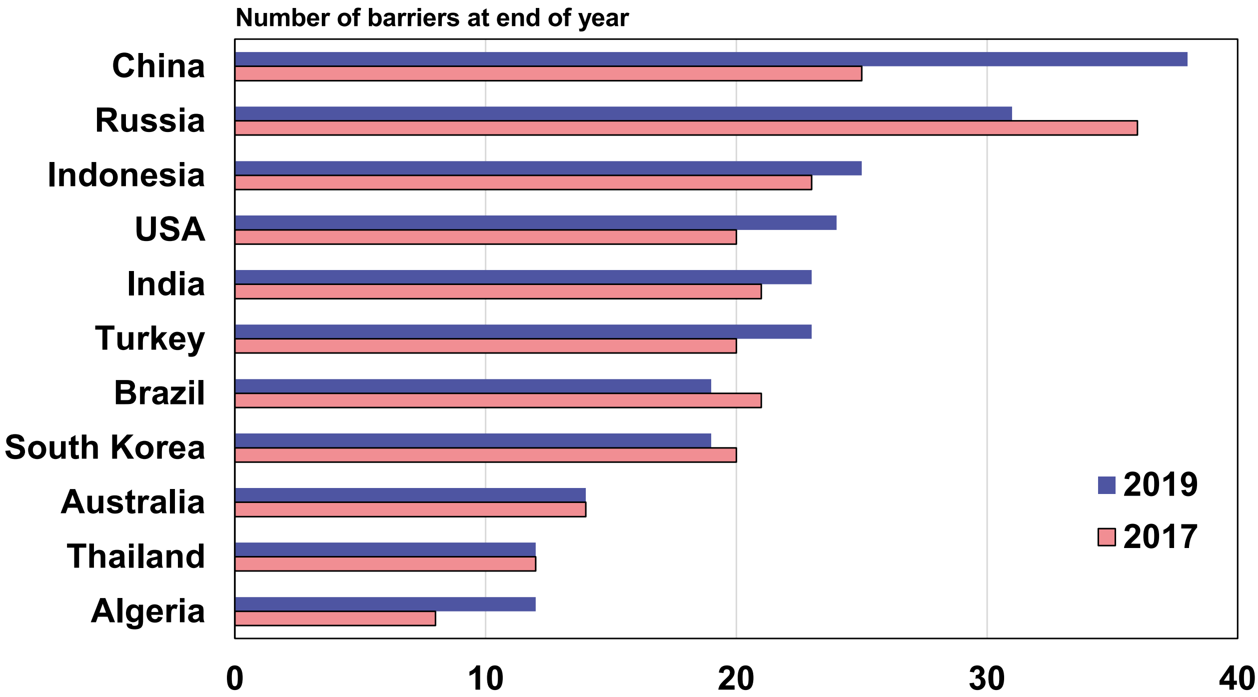
In their statements, representatives of the EU and China expressed their desires to sign a joint investment agreement sometime this year. In the meantime, the EU wants China to improve its practices on e.g. state subsidies, state-owned enterprises and forced technology transfers that hurt the competitiveness of EU companies in the Chinese market. The EU representatives also said that the EU and China would sign the Agreement on Geographical Indications in the coming weeks. The agreement guarantees name protection for certain agricultural products, foodstuffs and alcoholic beverages on the basis of their geographic origin. It is particularly beneficial for European products sold in China.

Other potential agreements discussed relate to the EU's efforts to improve the reciprocity and balance in the EU-China trade relationship. According to a recent EU report, EU companies as of end-2019 faced the most trade and investment barriers in China. The EU has sought to address these trade issues through the WTO and its own legislative projects. In other respects, the EU has remained on the sidelines in the trade and technology disputes between the United States and China.

EU representatives would like to see China play a more active role in multilateral cooperation, particularly in mitigating climate change, in promoting peace and security, and in the global recovery from the coronavirus pandemic. In addition, the EU raised the issue of human rights and democracy. The EU-China human rights dialogue traditionally organised in conjunction with the summit was postponed due to the pandemic.

The EU Chamber of Commerce in China and on-line media site Politico noted that the concrete results from the summit were rather slim. The European Chamber would have liked to see greater commitment from China on promoting market access. Many observers were baffled by the failure of the parties to issue a joint statement, as well as the inconsistencies among EU representatives on their goals in relations with China.

Number of barriers to trade and investment faced by EU companies in select countries



Sources: European Commission and BOFIT.

Official unemployment rate understates China’s true unemployment. China's labour market was severely disrupted by restrictions of movement and layoffs caused by the COVID-19 pandemic. Yet, even as most of the economy stalled for a couple months, official surveyed unemployment increased only slightly from 5 % to 6 %. Informal estimates put the unemployment rate at around 20 %.

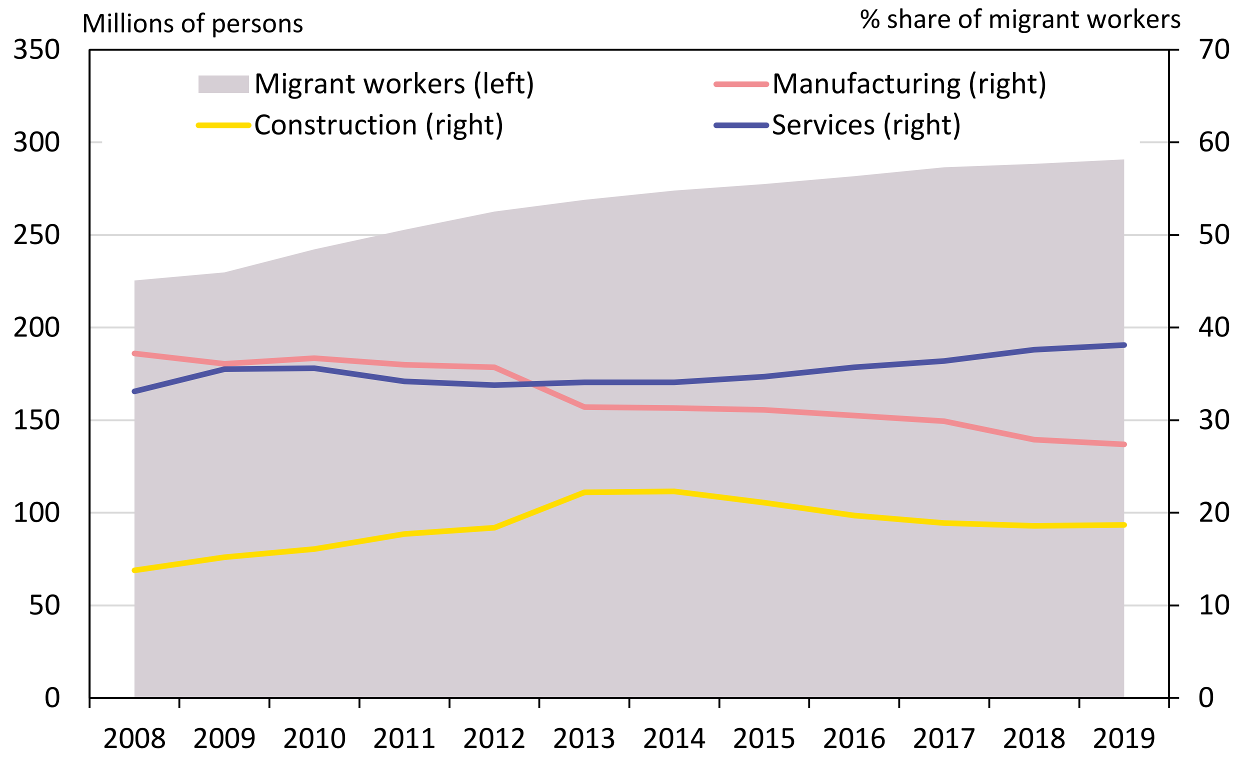
Besides being a politically sensitive issue, China’s official unemployment figures exclude three large worker groups of China’s total labour force of 810 million. The first excluded group, migrant workers, consists of 170 to 280 million people depending on the calculation method used. They and the second group, rural workers, are excluded as they are considered available for farm work as needed in their home districts. Finally, China's roughly 150 million self-employed persons do not get counted when they have no work.

China began its lock down and impose of restrictions on movement during the Chinese Lunar New Year holiday season, a time when most migrant workers return to their home districts. In April, it was estimated that only about two-thirds of migrant workers had managed to return to their jobs, leaving tens of millions of migrant workers unemployed. The unemployment benefits of migrant workers are marginal at best, and non-existent as a rule.

In the early stage of the corona pandemic, the employment picture deteriorated rapidly in all sectors of China. Today, unemployment in many service sectors remains weak, with the restaurant and tourism industries hit particularly hard as consumers remain cautious. UBS reports that in April roughly 50–60 million people in the service sector have either lost their jobs or are still unable to return to work. The corresponding combined figure for the affected in manufacturing and construction sectors was about 20 million. The employment prospects for export sectors appear weak as many countries have fallen into recession. Chinese exports employ directly or indirectly an estimated 112 million people.

China's policymakers, who are clearly concerned about unemployment, have implemented a range of economic support measures aimed at preserving jobs or improving employment prospects. The fear among China's leaders is that higher unemployment could lead to social unrest.

China's internal migrant workers are increasingly employed in the service sector.



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

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Russia

Russia's constitutional reforms gained majority support in referendum as expected. Russia postponed its referendum on constitutional changes from late April to last Wednesday (July 1) due to the coronavirus epidemic. Preliminary returns show that 78 % of voters supported the constitutional changes. The measure failed to garner majority support only in the Nenets Autonomous Okrug. Nationally, voter turnout was 68 %. According to the Central Election Commission, this implies that 53 % of all Russians entitled to vote supported the changes. The vast majority of voters cast their ballots before the actual election day as Russia introduced early voting in response to the coronavirus.

The constitutional amendments adopted in the vote include a reset provision that would allow Vladimir Putin to continue as president for another two six-year terms after his current term expires in 2024. There are also number of other changes made in the constitution. According to a survey conducted by VCIOM at the end of May, the provisions considered most topical by Russian voters included guarantees of state-provided health care, indexation of pensions and other social benefits, as well as the protection of historical truth and national sovereignty. While the referendum was non-binding, the Russian administration views the vote as an endorsement of the current system's legitimacy.

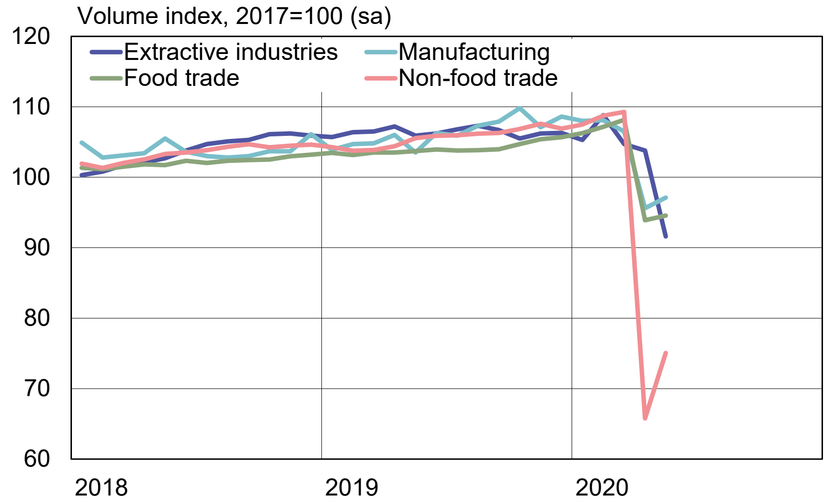
Russian economic trends remained weak in May. In many industries, on-year production continued to decline significantly. The nadir of the corona crisis, however, seems to have been reached in April. Most sector output showed slight (seasonally adjusted) increases in May from April.

The service sector, in particular, continued to suffer from the effects of Russia's coronavirus lockdown. Even if Russia began to gradually relax restrictions to prevent spread of the virus in May, retail sales were still down by 19 % y-o-y. Industrial output continued to decline, down by 10 % y-o-y in May. Much of the fall in output reflects drops in oil & gas production. Russian crude oil production was down by almost 15 % y-o-y in May after the new OPEC+ production ceiling agreement entered into force at the beginning of the month. Construction activity was down by 3 % y-o-y.

Unemployment also continued to rise in May. At the end of the month, Russia had 4.5 million unemployed persons, about 6 % of the labour force. During April-May, the number of unemployed grew by about a million persons. Wages have also started to decline. Real wages in April were down by 2 % y-o-y.

Russia's economy ministry estimates that Russian GDP contracted by about 11 % y-o-y in April-May. Forward-looking indicators suggest that the economy bounced back somewhat in June.

Industrial output and retail sales were still weak in May



Sources: CEIC, Rosstat and BOFIT.

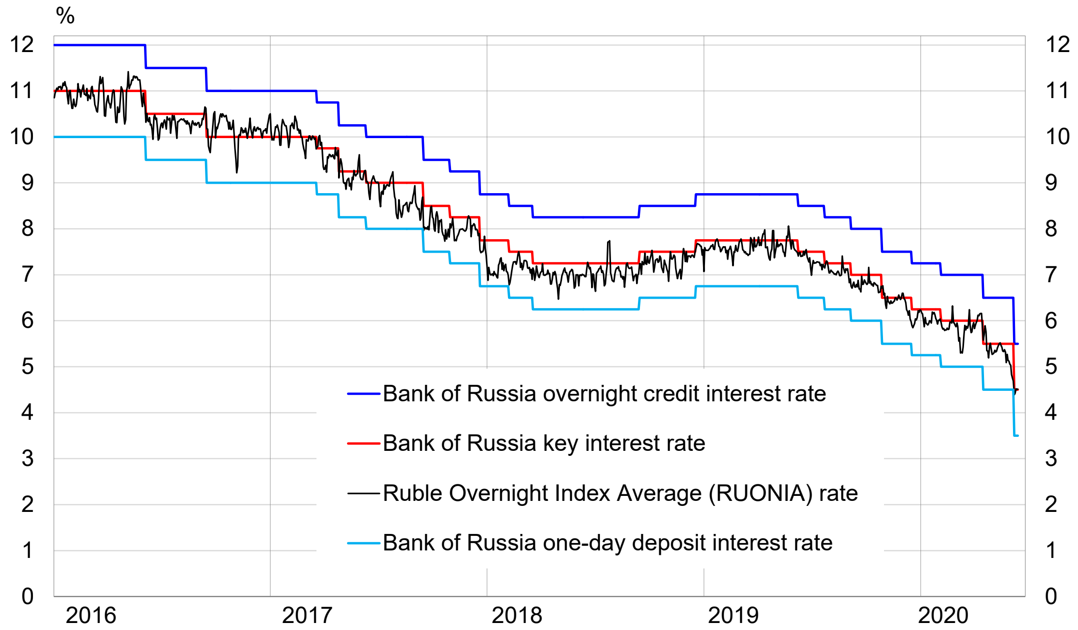
CBR lowers key rate by 100 basis points. On June 19, the Central Bank of Russia lowered its key rate by a full percentage point, dropping it to 4.5 %. The CBR executive board based its decision to cut heavily, among others, on factors that have slowed down the inflation rate more than expected.

The CBR noted in particular that restrictions to deal with the COVID-19 pandemic in both Russia and abroad had lasted longer than initially expected, and thus also prolonged their negative impacts on demand and economic activity in general. Risks to Russia's financial stability stemming from the situation in international financial markets have diminished and inflation expectations among households and businesses have abated. In the CBR's view, uncertainties relating to the pandemic and the economic impacts from restrictive measures as well as the unwinding of restrictions and national economic recoveries mostly create downward inflation risks.

At the same time, the impact of inflation-supporting factors such as the sharp decline in the ruble's exchange rate in March and a short-lived spike in domestic demand have already been absorbed. Moreover, the ruble's exchange rate strengthened in May and June with the stabilisation of international financial markets and higher oil prices. Nevertheless, the CBR noted that inflation could be supported by disruptions in logistics chains due to corona restrictions, the added costs of protecting workers and consumers, as well as possible volatile episodes in international financial markets.

The on-year increase in consumer prices was 3.1 % as of mid-June. The central bank expects inflation to pick up slightly this year. By lowering the key rate, the CBR aims at reducing the risk that inflation could this year fall even significantly below its inflation target of 4 %. As in the case of several previous key rate cuts, the CBR stated that it would rather soon consider whether further cuts in the key interest rate were appropriate.

The CBR's main steering rates and money market rate



Source: Central Bank of Russia.

Slight downward revisions in forecasts for Russia's economy in 2020. Outlooks for the Russian economy of major international economic and financial organisations have been revised further down from previous forecasts for this year. Forecasts released in May and June predict that Russian GDP will contract by 4.5–8 % this year. Latest consensus forecasts see the Russian economy contracting by around 4.5–5 % this year. The wide range of forecasts still in late spring and early summer reflects very high short-term uncertainty.

GDP next year is expected to recover by around 3–4 % from this year's slump. The annual crude oil price assumptions in forecasts of international organisations for this year run between $30 and $38 a barrel. The average oil price is expected to rise to around $38–40 next year. CBR governor Elvira Nabiullina recently noted that the central bank's forecast so far remains unchanged. GDP should thus contract this year by 4–6 % if the price of Urals crude averages $27 a barrel, and even if, as Nabiullina pointed out, the on-year contraction of the GDP in the second quarter of this year may have been deeper than the roughly -8 % expected earlier. The CBR sees GDP recovering to the 2019 level in the first half of 2022.

Some forecasts, besides addressing falling oil prices and the coronavirus pandemic, lockdowns and other restrictive measures that have knocked down demand domestically and internationally, also consider how cooperation among OPEC members, Russia and other oil-producing countries plays out. On one hand, they note that the latest OPEC+ agreement on production cuts will press down Russian GDP. On the other hand, the cuts are considered insufficient compared to the low global demand of oil in order to properly support oil prices.

The GDP projections for some other large emerging economies were also downgraded for 2020. This especially concerns Turkey, India and Brazil.

GDP forecasts for 2020−2021

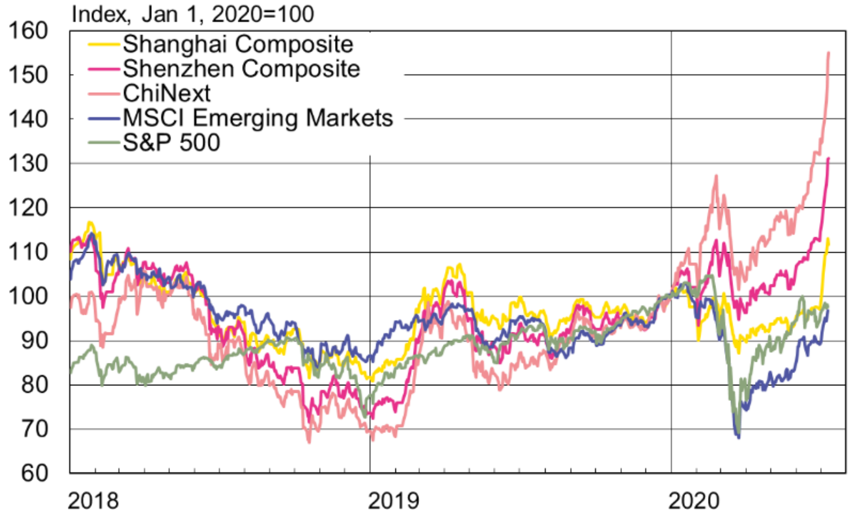
		Russia	Ukraine	Turkey	China	India	Brazil
		% change	% change	% change	% change	% change	% change
IMF, June	2020	-6.6		-5.0	1.0	-4.5	-9.1
	21	4.1		5.0	8.2	6.0	3.6
World Bank, June	2020	-6.0	-3.5	-3.8	1.0	-3.2	-8.0
	21	2.7	3.0	5.0	6.9	3.1	2.2
OECD, June	2020	-8.0		-4.8	-2.6	-3.7	-7.4
	21	6.0		4.3	6.8	7.9	4.2
EU Commission, June	2020	-5.0		-5.4	1.0	1.1	-5.2
	21	1.6		4.4	7.8	6.7	1.9
EBRD, May	2020	-4.5	-4.5	-3.5			
	21	4.0	5.0	6.0			

China

After volatile spring, Chinese stock market indices soar in July. Amid the coronavirus pandemic, mainland China stock markets have performed better than most exchanges around the world in recent months. Share prices have been buoyed by accommodative monetary policy and hopes of massive government stimulus measures. Chinese share prices fell as elsewhere during the global market collapse in March, but have recovered since. On Thursday (July 9), the Shanghai Composite index was up 13 % from the start of the year, while the Shenzhen index was 31 % higher for same period. Notably, shares included in ChiNext, the Shenzhen stock exchange's index of growth companies, were up over 50 % from the start of the year. The turbulence in Hong Kong and China's new security law for Hong Kong that went into effect at the end of June have yet to significantly affect stock market performance. On Thursday, Hong Kong's Hang Seng index was up 11 % from the end of June and 3 % from the end of 2019.

Over the past week, share prices on mainland China stock exchanges have climbed by over 10 %. While some of the rise in share prices reflects economic recovery, the uphill charge has been spurred by official media hyping for people to invest in shares of domestic firms. Analysts add that stricter regulation of other forms of investment and lower interest rates have driven investors into stocks. Some worry that relaxed access to financing is driving speculative investment in equities rather than investment in the real economy. As during the 2015 stock market bubble, leveraged buying of stocks has surged in recent days. Media reports show that small investors are again increasingly opening new trading accounts. Since April, international investment assets have flowed into mainland China's stock markets via Hong Kong's stock connect arrangements. In March, capital flowed out of China.

Mainland China stock exchange indices have outperformed the MSCI Emerging Markets and S&P 500 indices.



Sources: Macrobond and BOFIT.

China has further opened its financial markets to foreign firms, still market access remains an issue. Since April, foreign-owned firms have been allowed to seek permission to engage in securities and fund management as well as investment banking in mainland China. The accelerated roll-out of the legislative change (originally slated for the end of this year) was announced in January in conjunction with the signing of phase one of the US-China trade agreement. China has sought to move trade negotiations along in recent years with promises of China's financial market opening. At the beginning of January, limits were removed on foreign ownership of firms involved in futures trading and life insurance.

Operations of foreign firms in China's financial markets were earlier only possible through joint ventures. In March, Goldman Sachs and Morgan Stanley were authorised by the China Securities Regulatory Commission (CSRC) to increase their stakes in their securities trading joint venture with their Chinese partners to 51 %. Credit Suisse was granted similar permission in April. Prior to March, UBS, JPMorgan Chase and Nomura held dominant positions thanks to their joint ventures. At the end of last year, the French asset management company Amundi received approval of plans to set up a wealth management company with a Chinese partner in which Amundi would retain the controlling interest.

After buying out their Chinese joint venture partners, the CSRC last month approved JPMorgan Chase's application to operate on China's futures markets. JPMorgan is the first fully foreign-owned firm to operate in Chinese futures business. With the April changes in the law, JPMorgan Chase further announced its intention to acquire all shares in its China-based asset management company. In addition, the American investment managers Blackrock and Neuberger Berman Group have applied for permission to establish fully-controlled mutual funds in China.

To increase competition and stimulate business in the banking sector, China is considering giving the green light to domestic commercial banks to engage in investment banking and securities trading, according to media reports. Official are considering a pilot programme that initially would only apply to the giant state-owned banks. Although domestic commercial banks are not allowed to provide securities services, many already do so through their Hong Kong subsidiaries.

China has made reforms to open its financial sector in recent years, but it often takes a considerable amount of time before the announced reforms are put into practice. The Chinese business environment is perceived to be plagued by bureaucracy, strict regulation of foreign companies and an entirely distinct set of market mechanisms. An example is the processing and clearing of yuan payments by foreign credit card companies. While the opening of such operations to foreign companies was announced already in 2014, guidelines on how to apply for permission to engage in such activities were not published until 2017. In 2018, American Express was given permission as the first foreign card company to operate in China by establishing a joint venture with a Chinese partner. However, it was only in June this year that the joint venture obtained its licence from the central bank to initiate card-clearing services. In February, the People's Bank of China approved a joint venture of Mastercard and a Chinese partner to start preparing for operations in China. Permits were granted last year to the credit ratings agency S&P Global, while its competitor Fitch was given authorisation in May this year to offer credit ratings of issuers and products in China's interbank markets. The opening of China's credit rating industry to foreign firms was announced in 2017.

In June, China updated its foreign investment negative list, lowering from 40 to 33 the number of branches in which the operations of foreign firms is restricted or altogether banned. The latest of the negative list takes into consideration financial market reforms implemented this year. Other updates are relatively minor. The list is updated annually, with the latest version of the list taking effect on July 23. China's new foreign investment law entered into force at the beginning of this year (BOFIT Weekly 02/2020).

China spurs economic integration of Greater Bay Area. The Pearl River Delta Greater Bay Area initiative seeks to integrate the Hong Kong and Macao special administrative regions and nine cities located in Guangdong province into a single economic zone (BOFIT Weekly 34/2018). The practical goals involve increasing regulatory cooperation and developing infrastructure to promote the flows of people and goods within the area.

The recent measures are driven by China's efforts to bring in capital and labour, especially from Hong Kong, to the mainland. For example, in late June new financial market measures were announced to facilitate the provision of wealth management services between special administrative regions and the mainland. While the details are still vague, the programme would operate much in the same way as the equity and bond market cooperation programmes between mainland China and Hong Kong. Furthermore, as of July, foreign professionals living in Guangdong province will be able to apply under certain conditions for tax subsidies to compensate for the tax gap between the mainland and Hong Kong. The Hong Kong national security law, which is seen as significantly undermining Hong Kong's autonomy, entered into force at the same time.

The most ambitious infrastructure project of Greater Bay Area initiative so far has been the construction of a 55-kilometer bridge connecting Hong Kong, Macao and Zhuhai. The bridge, which opened in October 2018, saw lower-than-expected traffic volumes in its first year of operation. Another bridge under construction is a 24-kilometer span running from Shenzhen to Zhongshan. It is scheduled to open in 2024.

Guangdong province has developed over recent decades into one of China's most important economic areas. The city of Shenzhen, in particular, has become the country's technology hub. Measured in US dollars, the GDP figures for Shenzhen and Guangzhou have matched Hong Kong over the past two decades. While GDP per capita in Guangdong (USD 13,700 in 2019) is higher than the Chinese average (USD 10,300), living standards are well below those of Hong Kong, which had a GDP per capita of USD 48,800 in 2019.

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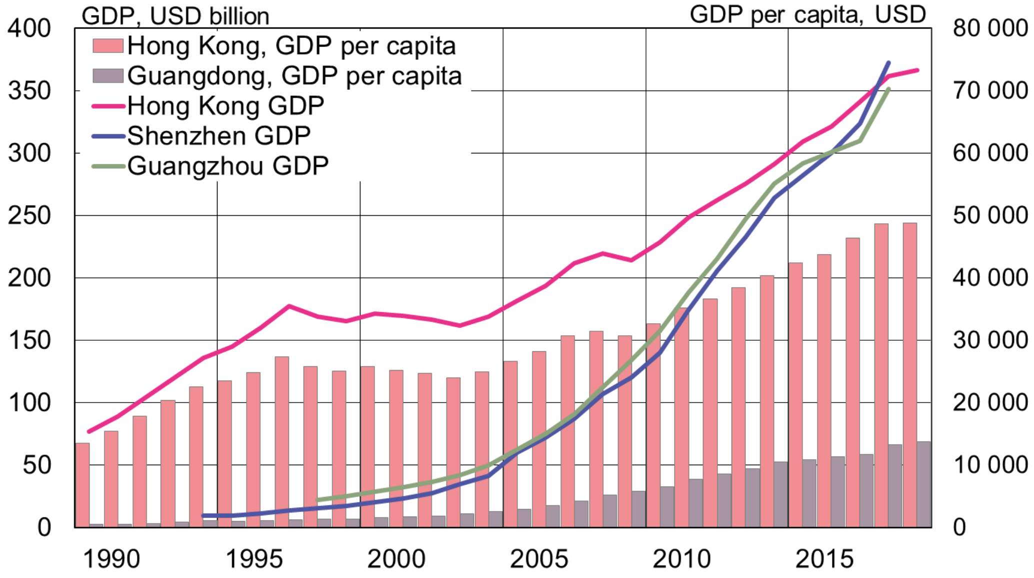
The Greater Bay Area development plan was published in February 2019, and has been integrated into China's national urbanisation effort. The purpose of the national plan is to intensify cooperation on integration of urban centres and the creation of vigorous metropolitan areas. Besides the Pearl River Delta, large expectations have been placed on development projects around Beijing and Shanghai.

Shenzhen and Guangzhou have experienced strong economic growth over the past two decades.



Sources: Macrobond and BOFIT.

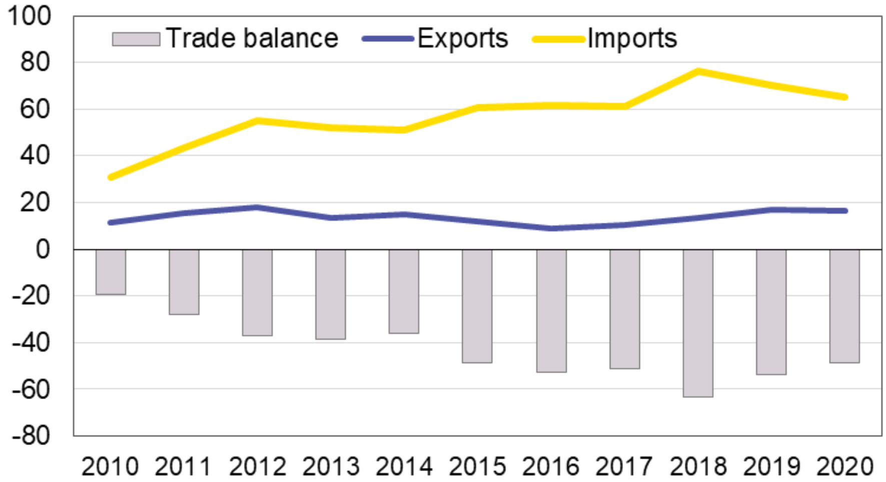
China-India relations on the skids. Relations between Asia's two giants have become tense with the border squabbles of recent months that have claimed several lives. Even as the military posturing has cooled, tensions continue on other fronts, particularly trade policy. India, for example, has imposed special reviews of Chinese foreign direct investment, limited the interactions of Indian state-owned companies with Chinese firms and imposed bans on the use of certain Chinese software.

As the clear underdog, India has long been concerned with its China trade relations. Figures for the most recent statistical year (April 2019–March 2020) show that India's goods trade deficit with China amounted to around USD 50 billion and accounted for about a third of India's entire trade deficit. The structure of China trade is strongly unfavourable to India, which mainly imports consumer goods and capital goods from China, while exporting mainly lower-grade intermediate goods and commodities. Like many countries, India is dependent on imports from China over the short-term in key sectors such as the pharmaceutical industry.

Concerns about being disadvantaged in trade with China and other countries in the region are an important reason for India's withdrawal last November from the Regional Comprehensive Economic Partnership of 15 Asian countries. India's trade negotiations with Europe and the United States have also been challenging. India seems to be responding to its trade issues by retreating to protectionist measures. Such a short-sighted approach could slow India's commercial development and reinforce its underdog status relative to China and other countries. Like many of China's neighbours, India, in light of recent events, is forced to reassess its role in the global economy and international politics.

The heightened tensions between India and China come against the backdrop of India's struggling economy. Many Indians want to open up their economy even as the number of COVID-19 infections climb. India's economic recovery has also been hobbled by an ongoing banking crisis and fragile public finances. The latest IMF forecast sees India's economy contracting by 4.5 % this year.

India's trade deficit with China (statistical year begins in April and ends in March).



Sources: CEIC, India Ministry of Commerce and Industry, BOFIT.

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BOFIT

Russia

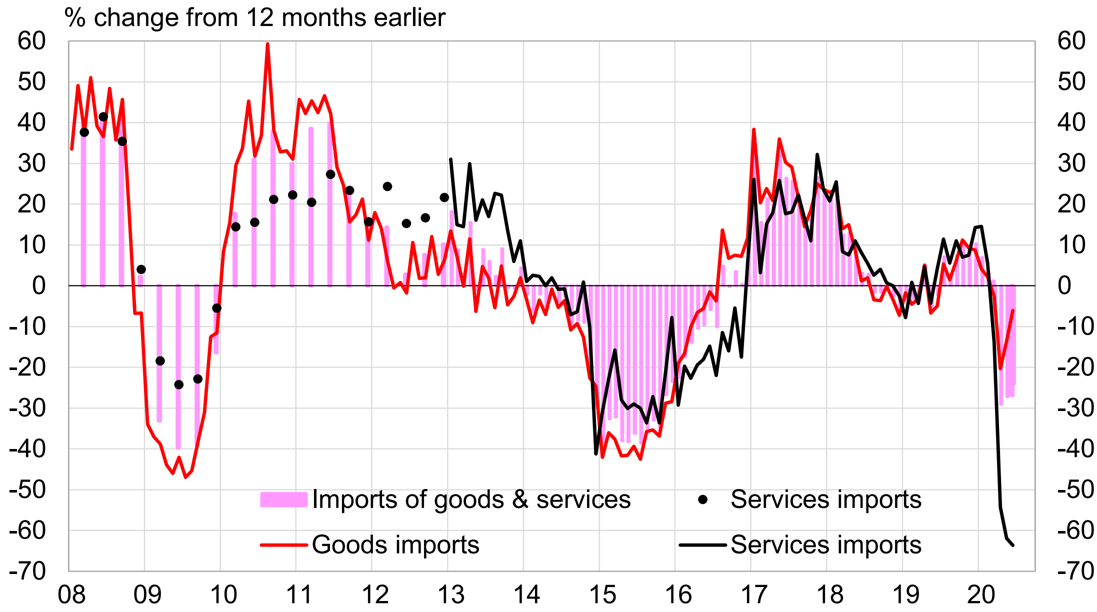
Russian export earnings and imports decrease sharply; net capital outflow moderate. Preliminary balance-of-payments figures released by the Central Bank of Russia show that the country's revenues from exports of goods and services fell by 35 % y-o-y in the second quarter. The on-year fall of revenues from goods exports deepened and was roughly a third, mainly due to a 50 % y-o-y drop in earnings on exports of crude oil, petroleum products and natural gas. Declines in other goods exports were considerably smaller, only about 7 % on average. Revenues from services exports were down to roughly 50 % y-o-y in the second quarter.

Russian spending on imports of goods and services in 2Q20 fell by about 25 % y-o-y, although preliminary data show that the June decline was slightly less than in the previous two months. The 2Q20 contraction in spending on imports of goods was no more than about 13 % y-o-y, and the June decline was just 6–7 %. Notably, the reduction in spending on goods imports so far has been much less than in the 2009 or 2015 recessions, which saw drops in imports of 30–40%. However, spending on services imports fell by 60 % y-o-y in the second quarter as Russian travel spending abroad essentially ceased (down 95 % y-o-y) due to travel restrictions from the coronavirus pandemic. Transport services also witnessed dramatic declines.

Russia's current account surplus shrank to an unusually low level in the second quarter, although the current account surplus of the last four quarters was still almost 3 % of GDP in 2Q20.

Preliminary balance-of-payments figures show that the net flow of private capital out of Russia has been slightly higher this year than in previous years, but was still well below the outflow seen during the oil price slumps of 2009 and 2014–2015. Foreign liabilities of banks continued to shrink. While the net outflow of capital from the corporate sector appears moderate, the corporate sector has shifted to moving clearly more money abroad as portfolio investment. Since last year, foreign investors have also been reducing their corporate portfolio investment exposure in Russia.

The slump in import expenditures has been so far milder than in the 2009 and 2015 recessions



Sources: Central Bank of Russia and BOFIT.

Russia's federal budget revenues declined especially in May and June, but spending climbed up. For the May-June period, federal budget revenues from oil & gas production taxes and export duties on oil, gas and oil products hit a record low, down almost 70 % y-o-y. In the 2009 and 2015 recessions, oil & gas revenues were off by 40–50 % at most. World oil prices hit bottom in April, seriously reducing oil & gas tax revenues for May-June as the delayed impact from the price drop hit budget revenues. Oil prices in the second quarter were down by more than 50 % y-o-y. The relatively slight depreciation of the ruble's exchange rate cushioned to a rather small degree the fall of the oil price in rubles that came at 50 % from a year earlier.

Other than oil & gas federal budget revenues declined by 15 % y-o-y in the second quarter, but were roughly unchanged on-year for the first half if we exclude the CBR's large transfer (to the federal budget) of this year's part of the surplus the CBR gained from the government's payment for the majority of Sberbank shares. With the CBR transfer, first-half growth in revenues other than from oil & gas taxes was nearly 20 % y-o-y. Value-added tax revenues took a notably small hit in the second quarter, dropping by 5 % y-o-y, and were essentially unchanged in the first half compared to 1H19. VAT, which currently provides the federal budget's single largest revenue stream, has seen its share in total revenues rise to around 40 % this year.

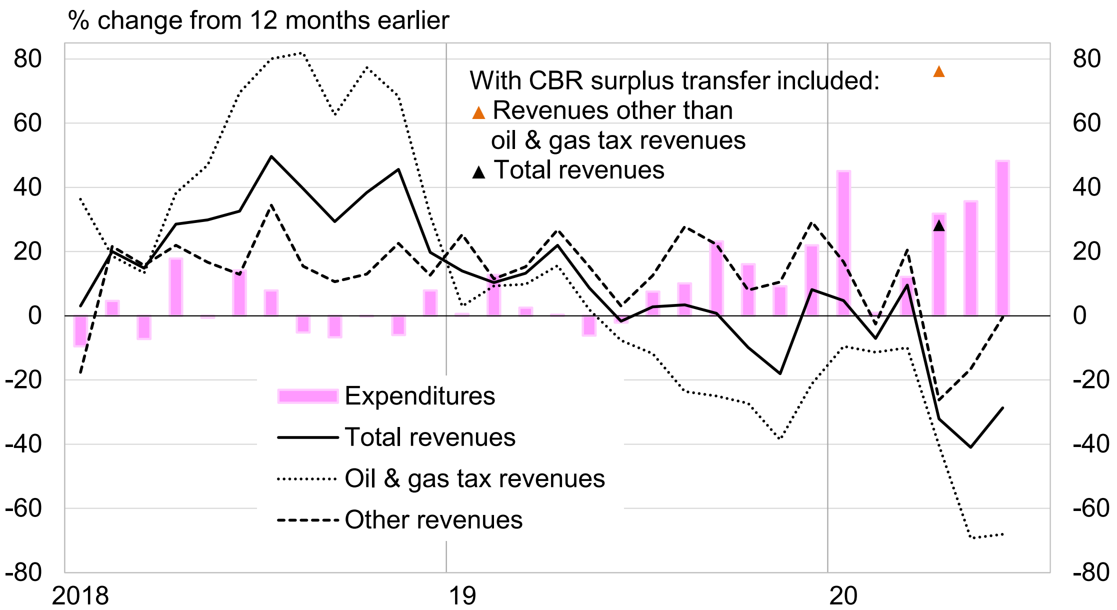
Total federal budget revenues without the CBR's Sberbank surplus transfer were down roughly 15 % y-o-y in the first half. In the second quarter, however, the on-year decline was around 33 %. The CBR transfer softened the decreases numbers to about 5 % and 10 %, respectively.

Budget spending, on the other hand, has soared. Expenditure growth reached almost 40 % y-o-y in 2Q20, raising the growth rate for the first half of the year to almost 30 %. Defence expenditure rose by nearly 20 % y-o-y, while other spending was up by 30 %. The federal budget adopted for this year foresees an increase of expenditures by 8 % from 2019. Actual spending in 1H20 was already more than half of the budget expenditure estimate for the year (the overwhelming majority of budget spending in Russia typically takes place in the latter half of the year).

If spending this year will be increased further to the degree suggested by prime minister Mikhail Mishustin early this month, the spending growth estimate this year rises to near 20 %. President Putin, on the other hand, said this week that there was cause to stretch the timetable for national projects announced in spring 2018 from 2024 perhaps even into the next decade. This retreat on government spending on national projects only helps to a relatively limited extent in adjusting government spending. For example, the spending on national projects in the first half of this year corresponded to less than 8 % of total federal budget spending.

The federal budget has gone from surplus to deficit. The 12-month deficit as of June was around 0.6–0.7 % of GDP. Without the CBR's Sberbank surplus transfer the deficit would have deepened to about 1.7 % of GDP. During the remainder of 2020, the deficit will increase due to feeble revenue streams caused by low oil prices and economic contraction, and rising government expenditures.

Russian federal budget spending up, even as revenues this year fall significantly



Sources: Russian Ministry of Finance and BOFIT.

Increase in debt restructuring and postponed repayment of corporate loans in Russia. The stock of bank lending to non-financial corporations increased rapidly in late March and early April. In May, however, there was no growth in the loan stock compared to the previous month. Preliminary figures show that growth recovered slightly in June (up

0.5 %). The share of non-performing loans (NPLs) was relatively stable throughout the early part of the year, accounting for 6.8 % of the corporate loan stock at the end of May. However, the number of debtors applying for various restructuring arrangements has increased rapidly. During this spring the Russian authorities introduced various anti-crisis measures to help debtors hit by the corona recession. The measures include e.g. direct interest subsidies, provision of cheap financing to banks for lending programmes and temporary easing of bank capital requirements.

Information collected by the CBR (CBR bulletin) indicates that more than 2.3 trillion rubles, or over 7 % of the corporate loan stock has been restructured since March. Many of the support measures announced by the Russian government this spring have focused on small and medium-sized enterprises (SMEs) in distressed sectors of the economy. About a third of all firms in these sectors are covered by loan restructurings. As of end-June, over 90,000 SMEs were able to restructure their borrowings of around 670 billion rubles, corresponding to over 13 % of the total lending to the SME sector. About half of the restructured SME loans were granted to firms operating in commerce, 17 % to firms in the transportation sector and 10 % to firms in the restaurant and tourism branches. CBR governor Elvira Nabiullina noted that the total amount of restructured loans is about 4.3 trillion rubles (close to 7 % of the credit stock).

In addition, government-sponsored loan repayment holidays affected about 55,000 borrowers in the SME sector (total 120 billion rubles) as of end-June. According to information released by the economy ministry last Friday (July 10), banks have granted about 500 billion rubles in loans with government-subsidised interest in order to help businesses survive the corona recession.

Russian firms give low marks to government agencies with respect to business environment improvement. Problems in public administration present a long-standing barrier to improving the business environment in Russia. Problem areas include shortcomings of the judiciary, abuses by law enforcement, as well as complex regulatory rules and supervision of business activities. The latest annual review by the presidential ombudsman for business shows that these problems are highly relevant, and have gotten worse in some cases.

The latest review found that 94 % of firms surveyed felt that they lack protection from baseless criminal charges. Allegations of corporate economic malfeasance are often made by law enforcement officials with personal interests at stake or based on initiatives from a competing firm. A large part of investigations never results in judicial action, however, due to the failure of investigators to show cause. Even so, investigations may be very burdensome for targeted firms as documents are confiscated and assets frozen. Indeed, 74 % of respondents said that the Russian justice system was neither independent nor objective. About a quarter of respondents felt that corruption has increased over the past year.

The review also looked at the regulation and monitoring of business activities such as fire safety and compliance with environmental requirements. Companies said that many of legal requirements, particularly numerous inspections, were difficult and costly. The authorities can also use inspections and fines as a way to squeeze out revenues for the state treasury or their own pockets. The report noted that the number of inspections imposed on companies has decreased considerably in recent years, but penalties on companies for violations have increased. Last year, on average, one in four companies in Russia was sanctioned for regulatory violations. Almost half of companies surveyed said that the likelihood of successfully overturning state officials in court were miniscule at best.

Russia, however, often lacks the effective monitoring needed to prevent industrial accidents. Even president Putin has commented on this problem recently in addressing the massive fuel spill in May at the Norilsk Nickel facilities. Russian oversight authorities estimate that the environmental damage caused by the spill will likely exceed 150 billion rubles (nearly 2 billion euros). The Russian government says that total costs from industrial and other such accidents in 2015 amounted to about 600 billion rubles.

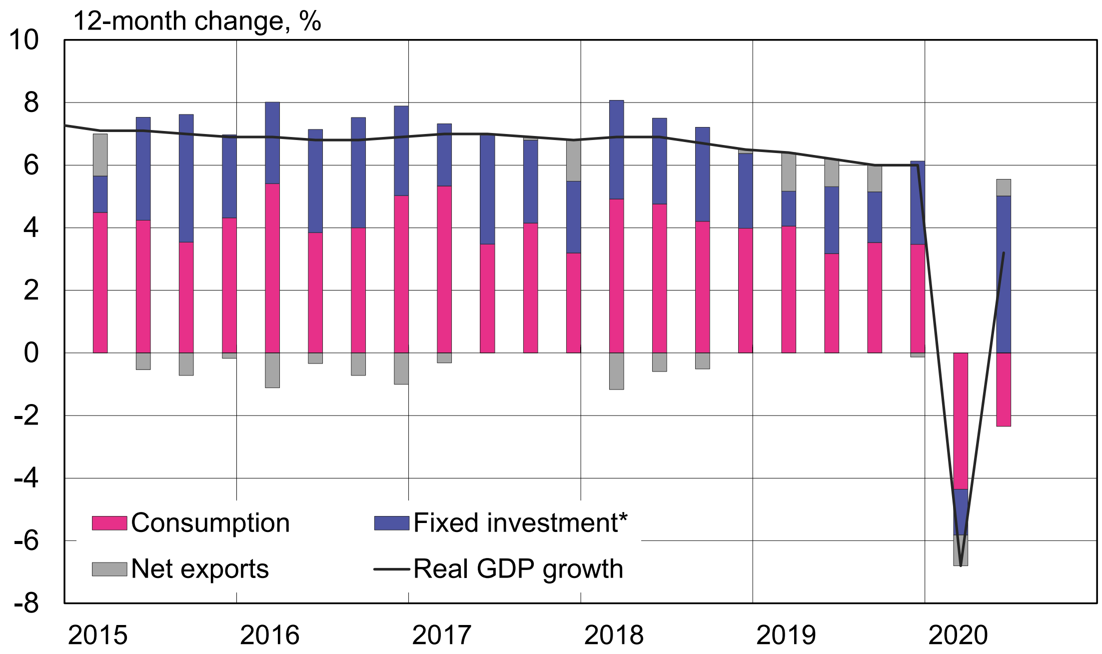
In late 2016, Russia launched a major project to reform regulatory and supervisory activities. The reforms seek to reduce accidents and their resulting financial losses, while simultaneously diminishing the regulatory and inspection burdens on businesses. The project is scheduled to be ready by 2025.

China

Manufacturing and fixed investment sustained China's economic growth in the second quarter. The National Bureau of Statistics reports a rapid recovery of the Chinese economy in the second quarter. After a real GDP contraction of 6.8 % in the first quarter, GDP grew by 3.2 % y-o-y. The recovery is expected to continue for the rest of this year. Most forecasts see 2020 GDP growth coming in at around 1–2 % (BOFIT Weekly 26/2020).

The Chinese recovery is best described as mixed. China seems to have again turned to debt-fuelled fixed investment to stimulate growth. As a result, industrial output and construction have picked up rapidly in recent months, along with an acceleration of indebtedness. In contrast, growth is restrained by declined real disposable household income, weak consumer demand and reduced activity in the services sector from last year. The structure of China's economy has in recent years shifted slowly from one dominated by industrial activity and fixed investment towards a model led by services and consumption. This development is now backtracking significantly.

Fixed investment was the big driver of GDP growth in the second quarter.



*) Includes changes in inventories.

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

Growth of indebtedness has picked up in China, debt-to-GDP ratio soars in the first half. The People's Bank of China says that domestic aggregate financing to the real economy (AFRE) rose by nearly 13 % y-o-y in June. The growth in financing has accelerated this year by two percentage points as China has poured on the stimulus to deal with the coronavirus crisis. Bank lending accounts for the bulk of credit (60 % of AFRE), followed by corporate and public sector bond issues (25 %) and financing from the shadow banking sector (10 %). The strongest growth in credit markets this year has come from bond issues. Financing provided by the shadow banking sector continues to dwindle, albeit at a slower pace than last year.

The Chinese economy contracted sharply in the immediate aftermath of the first wave of the coronavirus outbreak. The contraction of the economy together with the pick-up in growth of indebtedness due to stimulus policies, has sent the debt-to-GDP ratio skywards. The stock of total financing at the end of June was around 275 % of GDP. The debt ratio started this year at 254 % of GDP.

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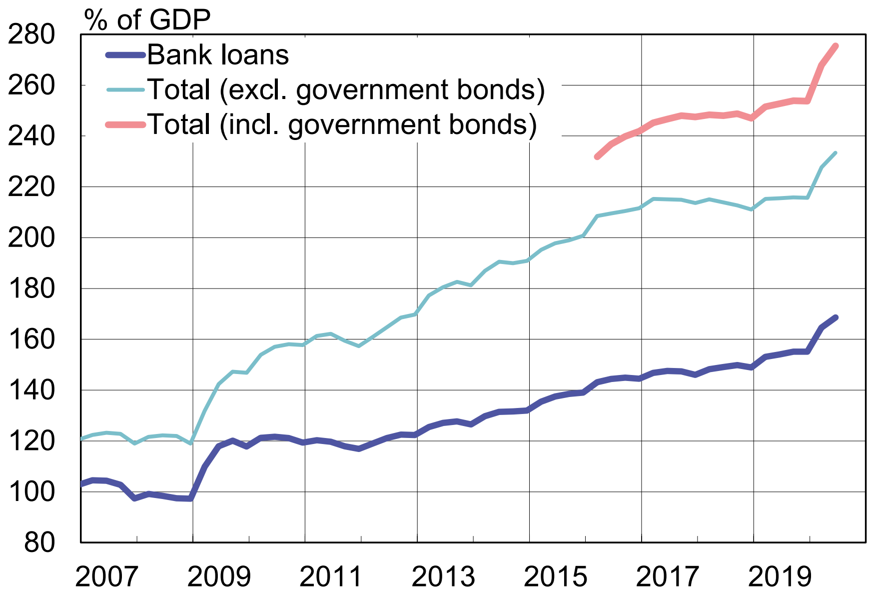
The covid-19 crisis has exacerbated China's long-worrisome debt urges. Companies, in particular, have piled on debt and now their capacity to service debt is clearly diminished. A quarter of industrial firms, for example, posted losses in May and their total losses for this year have increased sharply. Officials' efforts to help companies in distress include allowing small and medium-sized enterprises (SMEs) to postpone repayment of loan principal and interest until next year. Companies struggling with loan payments quickly show up on bank balance sheets. Even before the pandemic, the number of troubled small and medium-sized banks was rising.

China's debt-to-GDP ratio increased sharply in the first half of 2020.



**) Official public debt estimate, about 40 % of GDP. Official statistics reports some private sector liabilities as government liabilities. The IMF's broad estimate of public sector debt was around 70 % of GDP in 2019.*
Sources: PBoC, CEIC and BOFIT.

China's foreign trade numbers rebounded to June 2019 levels last month. China Customs reports that the dollar-value of goods imports climbed by 3 % y-o-y in June, while goods exports returned to positive growth territory (up 0.5 % y-o-y). Foreign trade picked up considerably in the spring, reflecting overall stabilisation of China and the global economy in the wake of the coronavirus shock. In January-June, Chinese exports and imports were both down by about 6 % y-o-y.

China's exports fell dramatically in the first quarter of this year, while second-quarter exports matched the level year ago. In contrast, imports shrank in the second quarter by 9 % y-o-y, largely on low global commodity prices. The price of crude oil has been rising, boosting the value of China's imports somewhat in June. The volume of raw material imports in May was already higher than a year earlier. June import volumes were notably up for crude oil, iron ore and copper. Part of this growth reflects China's emphasis on infrastructure-building in part of its stimulus efforts.

China's foreign trade in June returned to growth with a number of countries. Even so, growth was spotty across regions. June export figures were about the same as a year ago, but there were significant changes in import numbers. China's imports from Africa continued to decline (down 36 % y-o-y), while imports from Asia grew by 17 % for ASEAN countries, and 9 % for Japan and South Korea. China's trade with Asia in January-June was about the same level as last year. In contrast, US-China trade has shrunk (China's goods imports from the US were down by 4 % y-o-y and exports to the US down by 11 %).

Brexit-adjusted imports from the EU were up by about 1 % y-o-y in June. However, revised figures for the first half showed imports contracting by 10 % y-o-y. Chinese second-quarter exports to the EU were up 12 % y-o-y, with the result that exports over the January-June were about the same as year ago.

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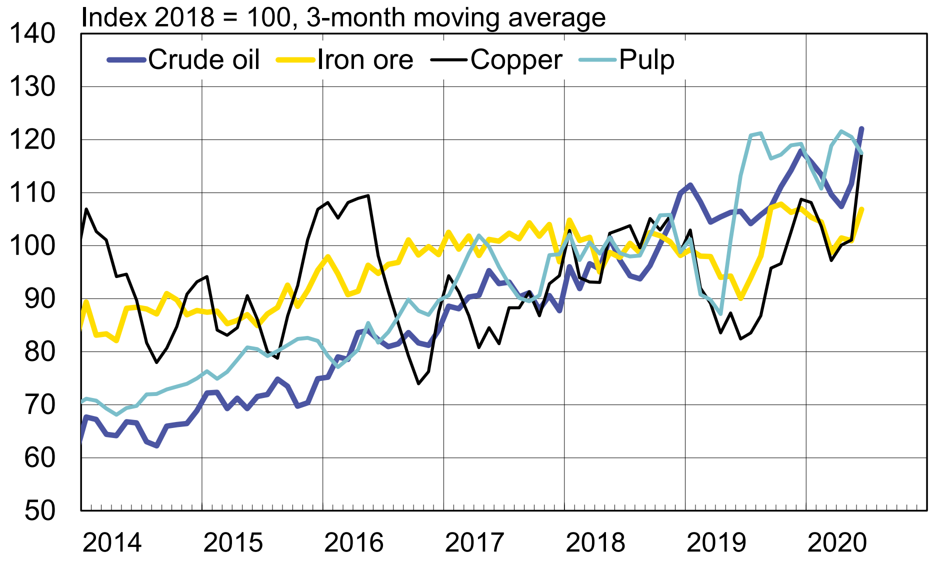
While China's first-half foreign trade performance was better than expected, its third-quarter performance will depend largely on economic and coronavirus trends in China and globally.

Volumes of commodity imports increased sharply in May and June.



Sources: China Customs, Macrobond and BOFIT.

China's central and local governments issue special purpose bonds to support economy. Most of China's fiscal stimulus policy measures in dealing with the coronavirus pandemic have involved increasing financing of public projects through the issuance of "special purpose bonds."

In the first six months of this year, local governments issued bonds worth a total of 3.49 trillion yuan (500 billion dollars), of which some 2.37 trillion yuan were special purpose bonds. The finance ministry reports that the average maturity on local government bond issues this year has been 15 years with an average yield of 3.33 %. Local governments have a bond quota this year of 4.73 trillion yuan, including 3.75 trillion yuan in special purpose bonds.

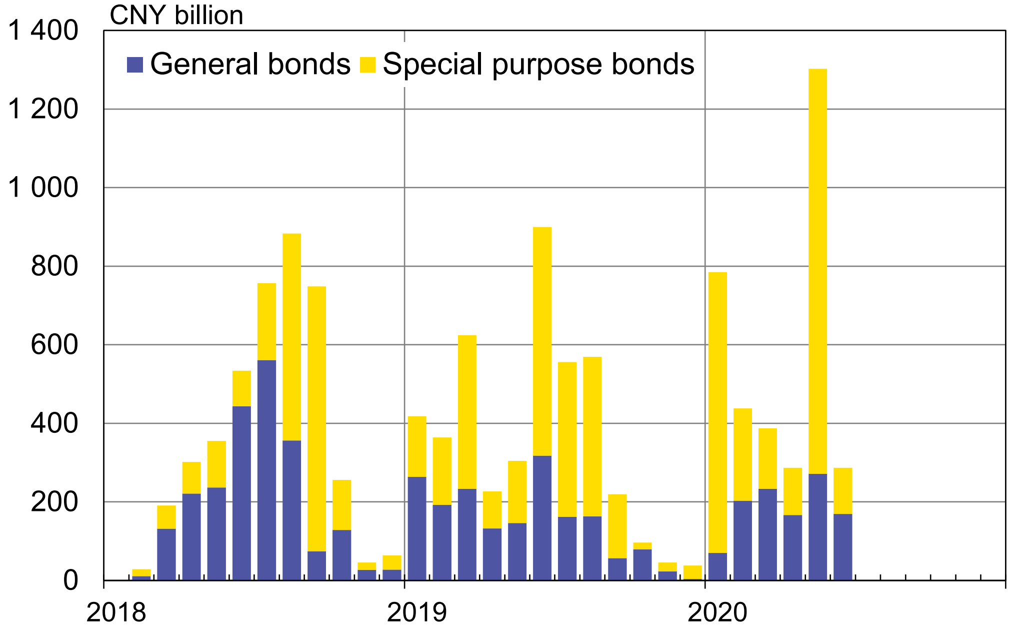
Special purpose bonds provide an off-budget source of financing for local government projects. Typically, such bonds were used to finance infrastructure projects to be paid off with cash flow from the project. The range of reasons for issuing special purpose bonds has been widened recently to include for example supporting consumption demand. At the beginning of July, the government announced that part the money raised from issuing special purpose bonds could be used to recapitalise small and mid-sized banks. Local governments replenish the capital of local banks by purchasing their convertible bonds.

The government has so far issued 1 trillion yuan in special purpose bonds to finance its coronavirus pandemic efforts. As of mid-July a total of 240 billion yuan in bonds had been issued. The remaining part of the quota must be issued by the end of July. Special purpose bonds are currently available with maturities of 5, 7 and 10 years. The average yield on a 10-year bond in July is 2.77 %. The central government has resorted to the issuance of special purpose bonds on two previous occasions, i.e. when the government recapitalised state-owned banks in 1997, and when the government established the China Investment Corporation in 2007.

Excluding corona bonds, central-government-issued debt in January-May amounted to 540 trillion yuan, increasing the credit stock to about 17 trillion yuan (18 % of GDP). At the end of June, local governments had bonds on issue worth a total of 24 trillion yuan (24 % of GDP). Local governments also engage extensively in off-budget borrowing.

Government bonds yields have risen since spring. On Wednesday (July 22), the rate on a one-year treasury was 2.24 %, up one percentage point from end-April. Rates on corporate bonds have also increased, due in part to the flood of the large amount of government paper onto the market. Chinese government bonds are considered to be risk free by investors.

Monthly bond issuances of Chinese local governments.



Sources: China's Ministry of Finance, CEIC and BOFIT.

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BOFIT

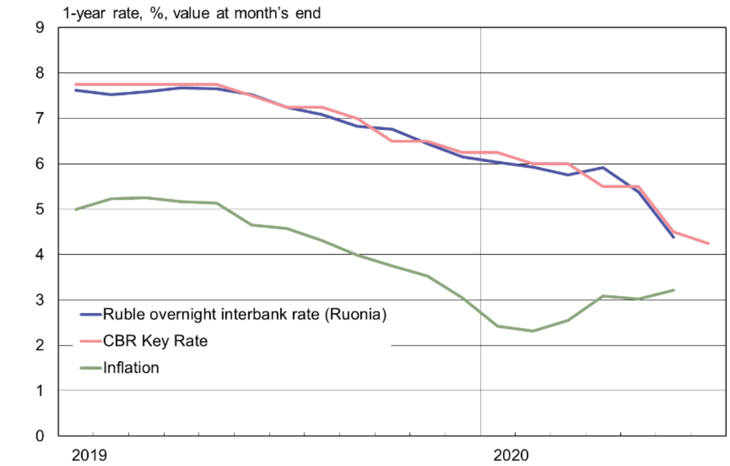
Russia

Russian central bank again lowers its key rate. Last Friday (July 24), the Central Bank of Russia's board of directors decided to lower the key rate by 25 basis points to 4.25 %. It was the fourth rate cut this year. The CBR has continuously relaxed the monetary policy stance since summer last year, and the key rate is now 300 basis points lower than year ago. Economic uncertainty this year had held consumer price inflation well below the CBR's 4 % inflation target. In June, consumer prices increased by just 3.2 % y-o-y. The CBR board said it expects inflation to pick up slightly towards the end of this year, but should remain between 3.3 % and 4 % next year. This could give room for further rate cut decisions at upcoming CBR monetary policy meetings.

The CBR notes that although monetary conditions have generally eased since the previous board meeting in June, the sudden halt in economic activity caused by a nine-week lockdown and increased uncertainty have tightened access to credit in certain segments. In addition to interest rate cuts, the CBR has e.g. temporarily relaxed solvency requirements of banks in order to support lending. Last Friday, the risk weights were lowered for certain housing credits, systemically important firms, export firms and companies in the pharmaceutical industry.

The CBR board now expects GDP to decline between 4.5 % and 5.5 % this year, which is slightly less than its previous forecast. Even if Russian exports decline sharply this year as expected, the current account should nevertheless remain in surplus. Both domestic and foreign demand are expected to remain weak for most of next year. GDP is forecasted not to return to 2019 levels until early 2022.

Disinflation has provided the CBR with rate-cut opportunities



Sources: CBR, CEIC and BOFIT.

Russian economic decline started to slow in June. The economy ministry estimates that the 12-month drop in GDP was no longer more grave than 6.5 % from June 2019, following the roughly 11 % y-o-y declines posted in April and May. The easing of coronavirus restrictions contributed to economic recovery.

June household demand recovered from the May level as people returned to work. June retail sales volumes were still down by 7.7 % y-o-y, an improvement from the 20 % drops in April and May. Rosstat estimates that seasonally-adjusted sales volumes were up by around 20 % in June from April, signalling a relatively rapid bounce-back. Even so, retail sales were still down by almost 10 % from the start of the year. The country has a rather long way to go before pre-coronavirus conditions are reached. Food sales saw the strongest recovery, and were only down 3.7 % y-o-y in June. Sales volumes of non-food goods were down by about 11 % y-o-y.

The economic recovery could also be seen in construction activity, which last month recovered to the same level as in June 2019. The contraction in industrial output also eased slightly, but was still down by 9.4 % from a year earlier. The persistence of low oil production levels was reflected in reduced levels of pipeline transmission, which were down by almost 15 % y-o-y in June. Rail freight transport in June was also down by over 4 % y-o-y.

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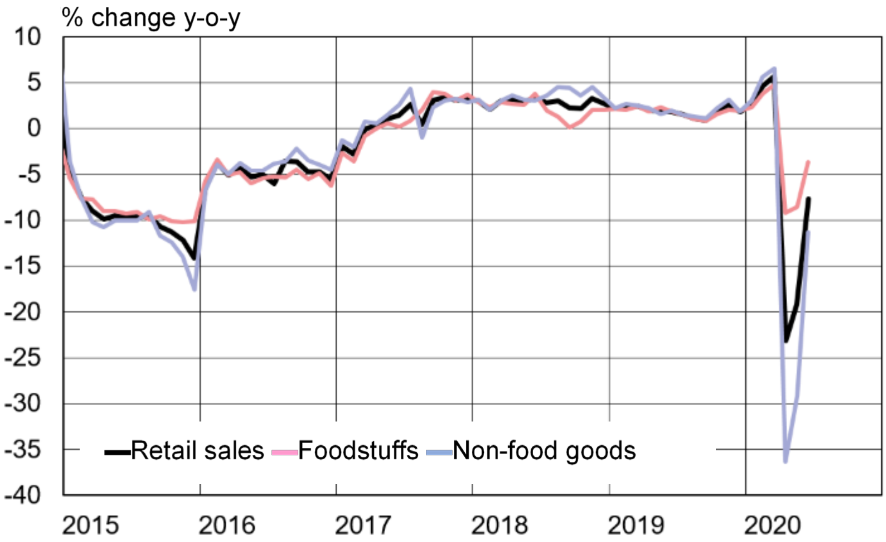
The tough times in the Russian labour market and falling household incomes speak to the depth of the economic crisis wrought by the covid-19 pandemic. Real disposable income in the second quarter decreased by 8 % y-o-y, hitting their lowest level in over a decade. Even if economic activity and household incomes recover in coming quarters, Russian income levels prior to the corona crisis were still below the 2014 level. As incomes have decreased, households have borrowed more to maintain consumption. In the second quarter of this year, lending to households increased by 12.6 % y-o-y.

Russian retail sales in June continued a come-back from their spring low



Sources: Rosstat, Macrobond and BOFIT.

Russian manufacturing on the road to recovery, while extractive industries remain in a deep slump. Industrial output was in June down almost as much in on-year terms as in May, with the output drop in both months holding at roughly 9.5 % y-o-y. Industrial output decreased by 8.5 % y-o-y in the entire second quarter.

Drops in output have been seen especially in the mineral extraction sector. Crude oil & natural gas production and related services account for 75–80 % of the extractive sector's value of deliveries (crude oil production alone counts for over half of all the deliveries). As in May, production of crude oil was down over 15 % y-o-y, due in part to the OPEC+ production ceiling agreement and a large drop in demand for oil, particularly on the domestic market. Natural gas production had been significantly curtailed for several months already. After years of growth, coal production has also contracted considerably this year.

Manufacturing output continued to recover in June, albeit slightly, but was still down by 6.5 % y-o-y. Differences across manufacturing industries were very large, however. Among major branches food processing saw exceptionally high growth in the first quarter due to growth in exports, settling back to more normal growth of 3–3.5 % in the second quarter. Output growth of the chemical industry has remained strong throughout this year without a dip, and production in the pharmaceutical industry has shown fast growth due to the health crisis.

Production of petroleum products increased briskly in the early months of the year, but declined in May-June in an atypical way to 5–6 % y-o-y. Production of construction materials and metals fell sharply in the second quarter, declining by 8–9 % y-o-y. In the machinery & equipment category, where most parts have been on a growth path in recent years, there was a sharp drop in production in the second quarter, including a decline in installation and maintenance of machinery & equipment. On average, production of companies in the machinery & equipment category was down by about 25 % y-o-y in the second quarter.

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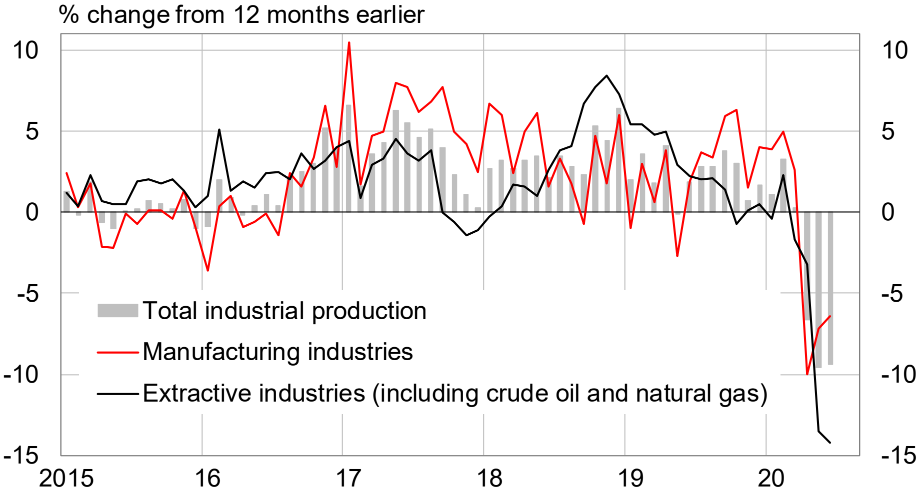
Manufacturing output on recovery path in May and June



Sources: Rosstat and BOFIT.

Russian firms suffering major profitability drops this year. Rosstat figures show that the net profit of the corporate sector, i.e. combined profits and losses of Russian firms, fell by half in the first four months of this year. In March, companies on balance posted more losses than profits. In April-May, the net profit was down by about 40 % from a year earlier. The last time net profit of the sector fell below zero was at the beginning of 2015. On the other hand, the net profit of the corporate sector in 2018 and 2019 was quite good relative to sales. This year's drop in profits is also nowhere near the profitability collapse experienced in 2009.

Among individual branches, the net profit of the corporate sector was mostly driven down by fuel wholesale which saw a sharp drop in net profits. Net profit of crude oil production and related services was down considerably, and profits in oil refining and chemical industry evaporated altogether. In the metal industry, profits were down by more than half.

Profitability in all these sectors has been hit by lower export prices and for the oil sector, a sharp drop in domestic prices. The ruble has also depreciated notably less this year than in the 2015 recession, so now profitability in the export sectors has not received a ruble boost of the same magnitude.

Amidst the corona recession, only some branches have experienced higher profits. These very few segments include retail food sales and the pharmaceuticals industry.

Despite lower profitability, the number of companies officially terminating their activity is down considerably this year. Existence of companies has been propped by the government restrictions on corporate bankruptcies introduced with the advent of the corona crisis. The restrictions on bankruptcies are an additional element to various government support measures aimed at preserving stability in the country.

The coronavirus downturn has affected profitability of Russian firms

Sources: Rosstat and BOFIT.

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BOFIT

China

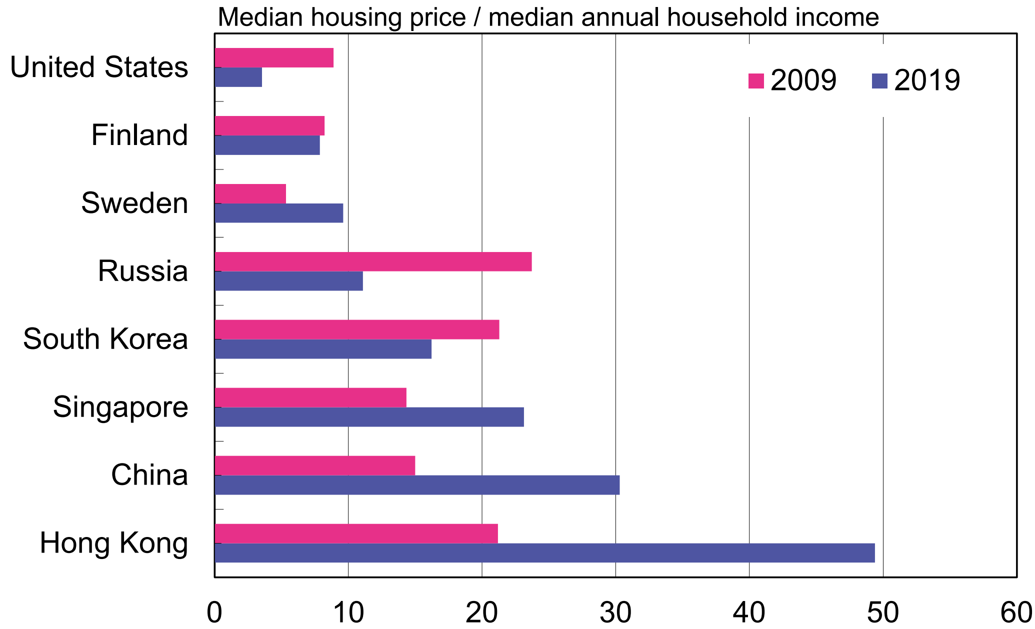
China's housing market revives, but differences across regions remain large. The housing market in China slowed to a virtual standstill in late January and early February with the spread of the coronavirus and subsequent lockdown and mitigation measures. Housing sales came back to life fairly quickly, however. China's National Bureau of Statistics reports that in May and June, apartment sales volumes in China were up 6 % y-o-y measured in terms of square metres of liveable floorspace. Moreover, the People's Bank of China noted that the number of newly granted housing loans was exceptionally high, climbing 15 % y-o-y in May and June. The volume of housing construction also picked up in June, with a 10 % y-o-y increase in new apartment building starts.

Regional differences within the housing market remain sizable. In Hubei province, home to the coronavirus pandemic, apartment sales were down over 30 % y-o-y in May and June. Even in Beijing, there were about 20 % less housing sales. In contrast, sales were up sharply in some western provinces. Also Shanghai and its neighbouring provinces saw sales increases of about 20 %. Sales in Hebei province, which surrounds Beijing, have witnessed brisk housing sales lately.

NBS tracking shows apartment prices per square metre were also up an average of 5 % y-o-y in June. Price trends vary considerable from city to city, however, a common phenomenon in recent years. The fastest rises in housing prices (up 15 % y-o-y) were seen in Shenzhen, which lies to the north of Hong Kong, and Tangshan, a city just east of Beijing. In order to calm the Shenzhen housing boom, officials already tightened rules who can purchase apartments from Shenzhen.

Relative to household incomes, housing prices in China are exceptionally high. China's top leadership, among many others, have been concerned about high prices, as a housing bubble collapse would have costly consequences. This issue seems to have been on the minds of policymakers when they designed policy stimulus measures to deal with coronavirus impacts. For example, measures to assist apartment-buyers such as reducing the size of the downpayment requirement are notably absent from policy measures, despite the fact that housing construction is one of the sectors of the economy. China's leadership this summer have continued to reiterate the message that apartments are for living not speculation.

Chinese housing prices are extremely high relative to median household income levels.



Sources: Numbeo, Macrobond and BOFIT.

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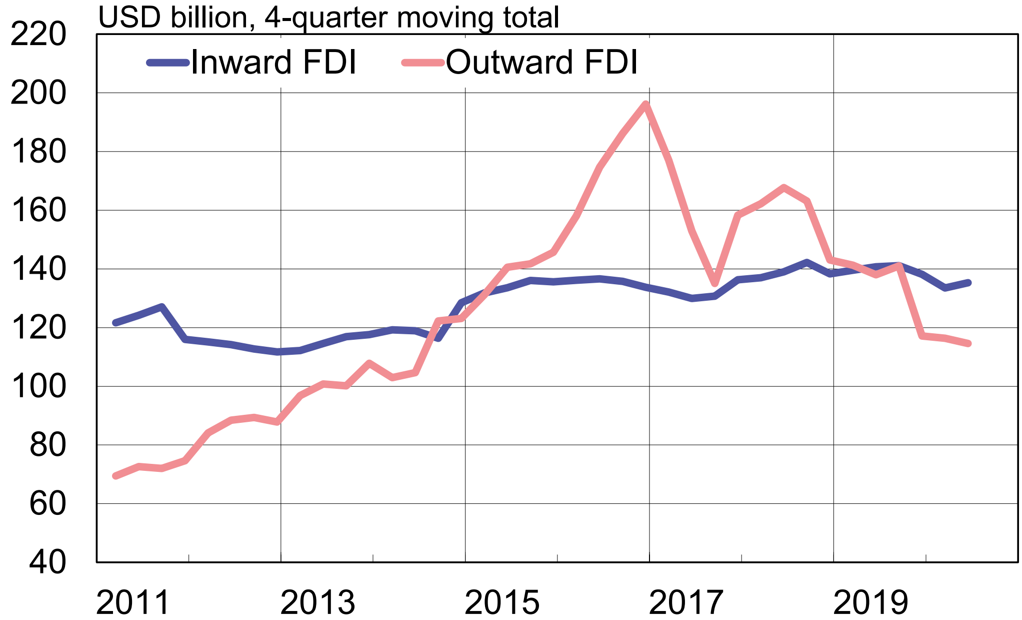
China's FDI outflows and FDI inflows decline slightly. Commerce ministry figures show that foreign direct investment (FDI) in January-June, both outflows from China and inflows to China, fell by 4 % y-o-y. Inward investment to China totalled 68 billion dollars, while outbound FDI amounted to 55 billion dollars. Given the current global economic conditions, the decline in official FDI figures was surprisingly modest.

Figures from [China Global Investment Tracker], a public database that follows Chinese firms' FDI transactions greater than 100 million dollars, show that in January-June Chinese outward FDI fell by about 70 % y-o-y. While the figures are sensitive to when individual investments are recorded, the general reduction in investment is indisputable and significant relative to previous years. FDI has fallen in every major geographic region and has concentrated largely on the tech, metal and transport sectors. FDI outflows from China have been on the decline since 2017. The reductions reflect tighter restrictions on Chinese investment abroad, geopolitical tensions and the globally challenging conditions for trade and investment policy.

The UN agency UNCTAD reports that as of end-2019 FDI stocks in China accounted for almost 5 % of all global FDI, while China's FDI in other countries made up 6 % of global FDI stock. In its June FDI report, UNCTAD forecasted that global FDI flows would fall by 40 % from the 2019 level during 2020 and 2021. The main cause was the impact of the coronavirus, as the lockdowns delayed projects just getting underway, as well as heightened uncertainty and recession expectations that caused investments to be postponed or reduced in scope. UNCTAD also sees localisation of value chains and direct investment in the years ahead as exposure to external shocks and supply security have become central issues for businesses.

China's foreign direct investment inflows and outflows.



Sources: China Ministry of Commerce, CEIC and BOFIT.

China prepares to launch the world's largest emissions trading scheme China is the world's biggest climate polluter, accounting for 29 % of all carbon dioxide emissions last year. China's emissions have exceeded the combined carbon emissions of the US and EU for several years now. Indeed, in an era when OECD carbon emissions have been falling, Chinese emissions continue to rise, up 3.4 % y-o-y in 2019.

The International Energy Agency (IEA) reports that about 80 % of China's CO2 emissions are produced from burning coal, and that coal remains the country's largest primary energy source. China's 13th five-year plan called for reducing coal's share of the country's energy consumption to 58 % by 2020, a target that was in fact achieved already last year. The share is still massive share and the country continues to open up new coal mines and coal-fired power plants. Coal remains a cornerstone for China's energy independence. This year, China's National Energy Administration eased rules on approving opening of new coal plants and the government's coronavirus stimulus response includes large investments in both renewable energy

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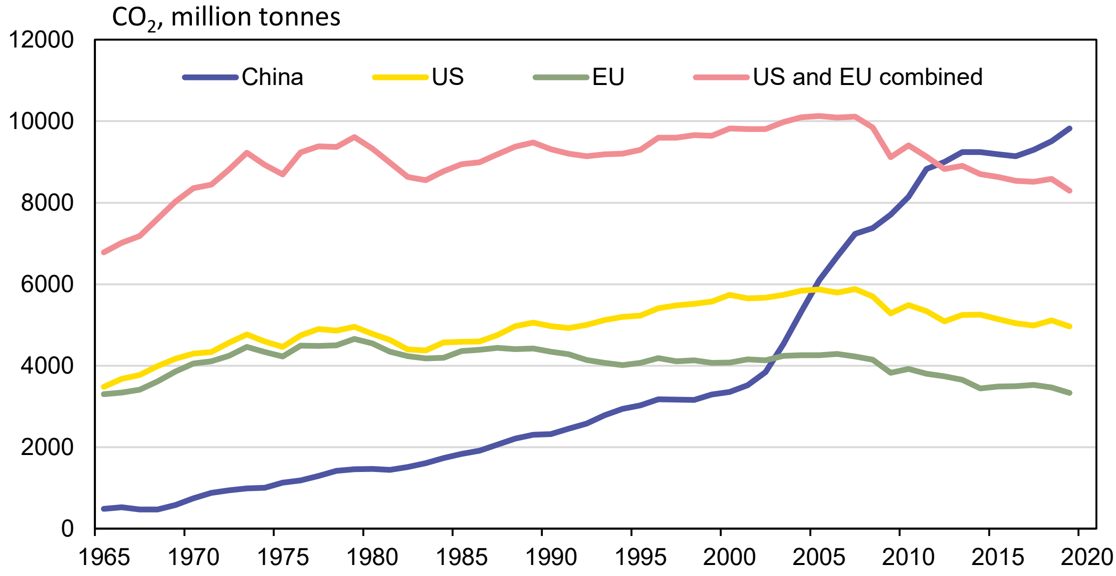
and coal. Regarding coal, the government seeks to phase out old heavily polluting coal-fired power plants and construct new efficient facilities that pollute less. In other words, China's thinking on fighting climate change diverges significantly from the West, which long ago abandoned China's modernisation strategy and the notion of "clean coal." Indeed, China had to drop coal projects altogether from its green bond portfolios (BOFIT Weekly 24/2020).

The IEA also reports that China's second largest primary energy source, oil, accounts for about 14 % of the country's CO2 emissions. China remains a major oil producer, but its production is declining. Last year, domestic production was only sufficient to meet 30 % of the nation's needs. As a result, China has become the world's largest crude oil importer. China has also become a major petrochemical refiner, exporting considerable quantities of petrochemical products. Like many of the world's large oil companies, PetroChina Co. is seeking to secure its future through investing on environmentally friendly energy. When some of PetroChina's oil and gas pipeline and storage facilities are transferred to the newly created PipeChina corporation, PetroChina announced it would use some of the proceeds from the sale on environmentally friendly energy production. The goal is to reduce oil consumption for example by increasing the number of electric vehicles on the road. Overall, the move will have a relatively small climate impact as road transport vehicles only generate about 10 % of the country's emissions. Moreover, some of the environmental gains from electric cars are lost when coal is used to produce the electricity for charging.

China has committed to the Paris climate accord to the extent that it will cease to increase its greenhouse gas emissions after 2030. China's plan is to increase the use of renewable energy (mainly wind and solar) to reduce its reliance on fossil fuels over the long run. Renewables currently account for just 5 % of China's primary energy production. A more effective approach would be to adopt an efficient mechanism for pricing carbon emissions such as the one used by the EU.

In 2017, China decided it would implement a national carbon trading scheme by 2020. The scheme now is expected to be operational by the end of this year or early next year. The *Financial Times* reports that participation will initially be limited to companies in the energy sector. Such companies account for about half of China's carbon emissions. The scheme will later be extended to energy-intense industries (particularly steelmaking and cement), at which point the scheme will cover about 80 % of emissions. Regional trials have been underway since 2011, and the experience gained has been used to develop the scheme. Regional participants in the trial phase of recent years include Beijing, Shanghai, Chongqing, Guangdong, Hubei, Shenzhen and Tianjin. Preparations for implementation at the national level has required such measures as developing a regulatory framework and familiarising firms with the scheme. Official climate policy and emissions trading should be clarified during the upcoming 2021–2025 five-year plan.

China's carbon dioxide emissions continue to rise.



Sources: BP Statistical Review of World Energy 2020, Macrobond and BOFIT.

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Hong Kong's dual crises: one economic, the other political. Hit simultaneously with decaying relations between China and the United States, COVID-19 and a new security law imposed by Beijing, the Hong Kong economy continued to stumble in the first half of this year. In the second quarter, GDP contracted by 9 % y-o-y, matching the same downward trend of the first quarter. Private consumption decreased by almost 15 % y-o-y, while fixed investment fell by more than 20 %. In foreign trade, the difference between goods exports (down 2 % y-o-y) and service exports (down 47 %) was particularly striking. Although the recovery of the Chinese economy has supported Hong Kong's goods exports, travel restrictions have badly hurt tourism, an industry critical to the Hong Kong economy. The lack of tourists is reflected in both service exports and consumption. To support the economy, the government has applied fiscal stimulus that accelerated the growth of public consumption to 10 % y-o-y in the first half.

During a ten-day period in the second half of July the number of new coronavirus infections in Hong Kong topped 100 a day. While that infection rate is low for a city with over 7 million residents, the numbers are big relative to Hong Kong's first-wave cases in January and the second-wave cases in late March. In response, Hong Kong has imposed strict guidelines on mask-wearing and limited gatherings to just two people. The numbers of daily new infections have dropped slightly since the beginning of August.

On September 6, elections for the Legislative Council of Hong Kong (the special administrative region's "parliamentary" elections) should select half of the council's 70 representatives. At the end of July, however, officials announced that the elections would be postponed for a year. The coronavirus situation was cited as the reason for the delay as elections involve large gatherings and create serious risk of infection, particularly for the elderly. Additionally, the government said that some voters living in mainland China would be unable to travel to Hong Kong to vote due to restrictions. The justification for postponing the elections to prevent COVID-19 infections are seen to overstate the challenges of holding the election, and the real reasons for the delay are considered likely political. Suspicions that this was indeed the case were bolstered when several pro-democracy politicians were banned from standing in the election. The BBC reports that opposition representatives have pointed out that delaying a scheduled election for more than 14 days violates the Hong Kong constitution.

China in June moved to impose a new national security act in Hong Kong. The act, which entered into force in early July, gives the authorities significant powers over local and foreign persons and corporations. The official justification from Beijing was a desire to combat terrorism and anti-government actions. The main underlying reason is Hong Kong's ongoing anti-Beijing demonstrations. The new security act allows a person charged with anti-government activity to be transferred to the mainland for trial, where they face potential sentences up to life imprisonment. Some demonstrators have already been arrested under the new law.

Hong Kong's GDP has been contracting since last summer.

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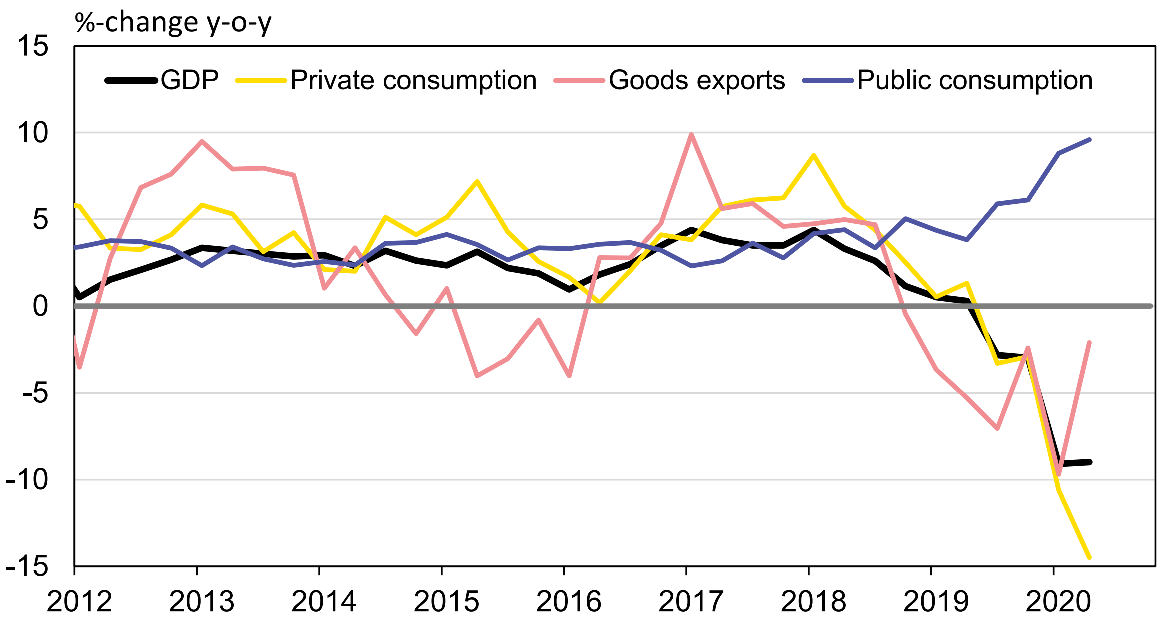

Sources: Hong Kong Census and Statistics Department, Macrobond and BOFIT.

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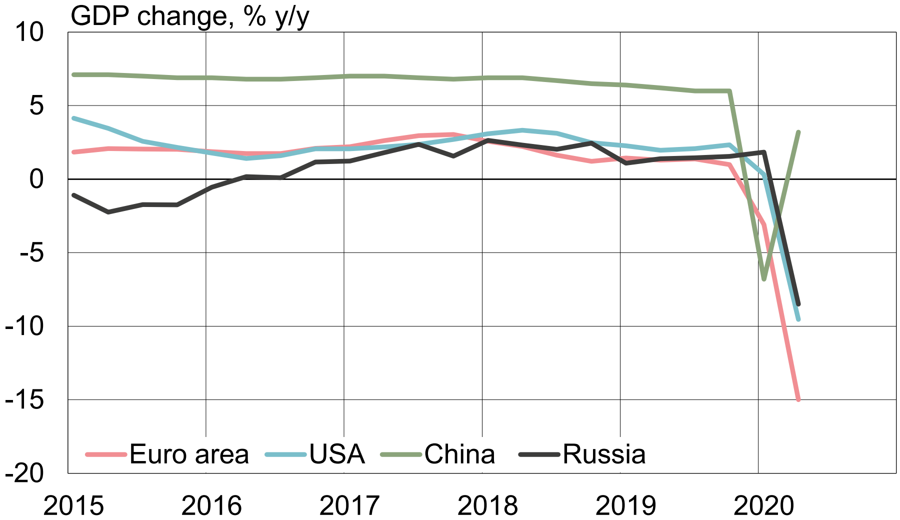
Russia

Sharp second-quarter contraction in Russian GDP. Preliminary Rosstat data show the country's GDP fell by 8.5 % y-o-y in the second quarter of 2020. The drop was slightly less than many forecasters had expected, and more modest than recorded in 2009 following the global financial crisis. Main contribution to the decline appears to have come from a sharp reduction in consumption due to the corona lockdown and other restrictive measures that continued well into June. Consumption was also depressed by weak trends in household incomes and rising unemployment.

For the April-June period, the Russian GDP decline was slightly less than that experienced in the United States or the euro area and GDP contractions in the US and euro area both commenced earlier than in Russia. China experienced a major economic contraction in the first quarter of this year, and official figures suggest that Chinese GDP growth already turned positive in the second quarter.

In Russia's case, forward-looking indicators initially pointed to a strong recovery in the summer, but some signs of fading have now crept in. Most forecasts at the moment see Russian GDP declining by 5–8 % this year and rising by 3–4 % next year.

Russian GDP contracted slightly less in the second quarter than in the US or the euro area.



Sources: Macrobond, Rosstat and BOFIT.

Signs of growth in Russian goods trade. In the April-June period, the value of Russian goods exports was down by 30 % y-o-y, mostly on a drop in export commodity prices. The volume of exports, in contrast, saw small increases for some major export items despite the coronavirus pandemic. Crude oil exports were up 4 % y-o-y, while petroleum products climbed by 13 %. Export volumes of iron and steel products increased slightly, while natural gas exports decreased.

The value of Russian goods imports fell by 13 % in the second quarter, a significantly smaller drop than in previous economic crises. Car imports decreased sharply, while imports of machinery & equipment fell less than the general drop in goods imports. Imports of certain foodstuffs increased from a year earlier.

Measured in terms of value, Russian goods exports fell sharply in nearly all major markets during the second quarter. Russia's exports to Europe, however, were down more than exports to Asia or countries in the Eurasian Economic Union. The exception was Russian exports to the UK, which saw their value nearly double in the first half led by exports of precious gems and metals. There was greater variation in goods import trends among Russian's main trading partners. Imports from EU countries and countries in the Eurasian Economic Union were down by nearly 20 % y-o-y, while imports from China, Turkey and the US were up a bit.

Russia's main goods trade markets in January-June 2020.

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Exports	Percentage share	Imports	Percentage share
EU-27	36.8	EU-27	33.7
China	14.8	China	23.1
UK	5.4	US	6.5
Turkey	4.8	Belarus	5.4
Belarus	4.3	Japan	3.3
Kazakhstan	4.0	South Korea	2.8
South Korea	3.9	Kazakhstan	2.1
US	3.4	Turkey	2.1
Other	22.6	Other	21.0

Sources: Russian Customs and BOFIT.

Russia prepares to introduce new measures favouring domestic producers. At the end of July, president Vladimir Putin approved a law that gives the government the power to designate minimum domestic content in procurements of the public sector and state-owned enterprises (SOEs). The domestic-content rules had been on the table for a while as a part of Russia's import substitution policies. The new law increases the opportunities for the government to favour domestic producers. Certain imported products are already banned for public procurements under earlier legislation and domestically produced products already enjoy a competitive edge in SOE procurement.

It is still unclear which branches are affected or how much domestic content will be required. Deputy prime minister Yuri Borisov mentioned that the domestic-content for public sector and SOE procurements currently averages around 30 %. Sergei Chemezov, CEO of the state-owned conglomerate Rostech, estimates that the domestic content of high-tech procurements for SOEs is currently only around 3–5 %. The total value of public sector and SOE procurements last year was about 30 trillion rubles (400 billion euros), which corresponds to nearly 30 % of GDP.

Some observers see the domestic content quotas as largely an effort to support Russia's electronics and IT sector, the segment of the economy where Russia has one of the most broad-ranging and ambitious import substitution goals. In recent years, the ministry of industry and trade has drawn up a series of proposals on ways to support the sector. This spring, a proposition was introduced whereby organisations that manage "critical information infrastructure" (e.g. government administration, financial sector and energy industry) would be compelled to migrate to domestically produced software by the start of 2021 and domestically produced hardware by the start of 2022. Companies in the financial sector have demanded at least a longer transition period. In order to support the electronics and IT sector, the government recently decided to grant tax breaks to firms and reduce their mandatory social contributions.

Declines in industrial output vary across Russian regions; retail sales making comeback from depths. Total industrial output, which comprises extractive industries and manufacturing, recovered in Russia's Central Federal District in June to the same level as in June last year. The Central Federal District includes Moscow, where production has recovered to levels well above a year ago. In nearly all other federal districts as well as the City of St. Petersburg, industrial output has shrunk more, by about 10 % y-o-y, with neither May nor June bringing much respite.

In extractive industries, which include oil & gas production as well as support services, industrial output was down in Russia in May-June by 15 % y-o-y. The decline was about the same in the Tyumen region, which is part of the Ural Federal District and accounts for more than a third of Russia's extractive industry activity. Production also fell tangibly in several other fairly significant regions of mineral extraction, including Tatarstan and the Orenburg region in the Volga Federal District, the Krasnoyarsk region in the Siberia Federal District and the Sakhalin island in the Far East Federal District.

Manufacturing output has declined widely across Russia, falling in about 60 of the country's more than 80 administrative regions during April-June. Due to recoveries, manufacturing output in June was down on-year in no more than about 40 regions. Large drops were seen in the Northwestern Federal District due to a deep dive in output in the City of St. Petersburg, along with the Volga and Far East Federal Districts. Clear output recoveries were also seen in the Northwestern and Volga Federal Districts.

Besides the broad-based downturn in manufacturing, the output figures for several regions and even Russia's national manufacturing figure, have been impacted notably by reduced production in several hubs of certain large manufacturing branches. First, car production collapsed in spring in five significant regions, i.e. the City of St. Petersburg, and the regions of Nizhni Novgorod, Samara, Kaluga and Kaliningrad. Second, production of petroleum products declined precipitously in four

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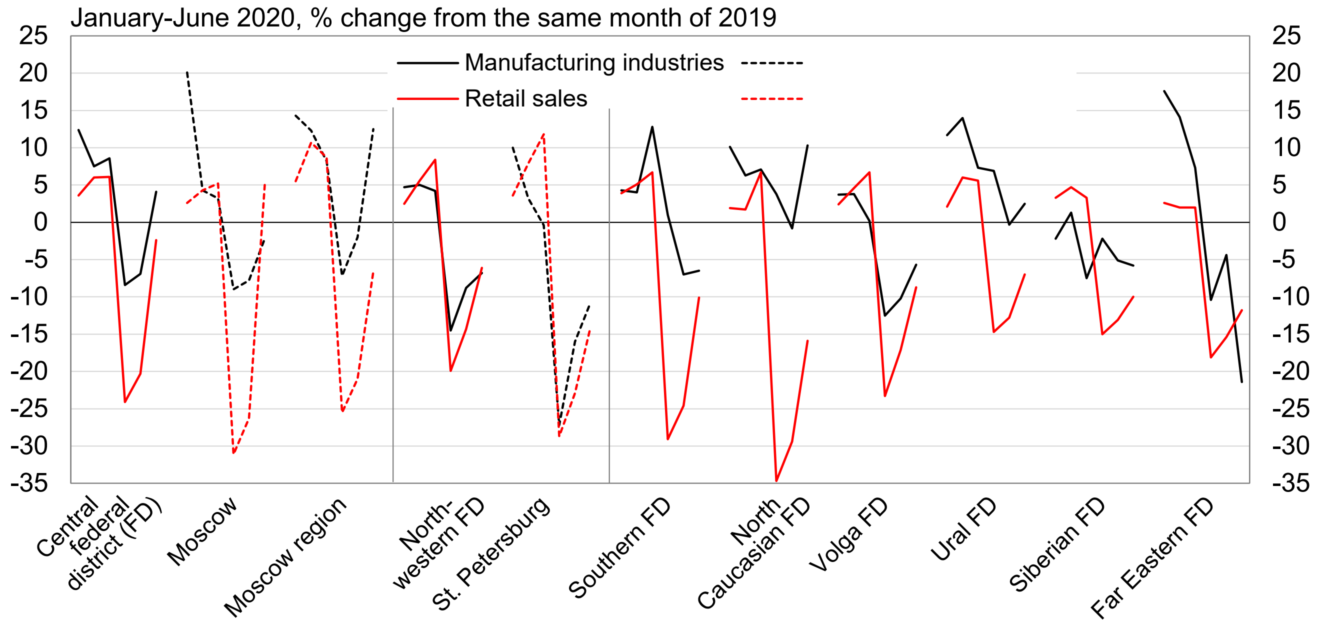
important regions: Nizhni Novgorod, Omsk, Bashkiria and Moscow. Third, metal production contracted considerably in three regions: in the Chelyabinsk, Krasnoyarsk and Sverdlovsk regions.

Only one of Russia's over 80 regions avoided a sharp drop in retail sales in spring after the imposition of restrictions during the government's initial response to the coronavirus pandemic. In June, retail sales in just 14 regions had recovered to the same levels as in June 2019. Most of the recovery seen in the Central Federal District in June was driven by the resurgence of retail sales in Moscow. In six other federal districts, June retail sales were down by 6–12 % y-o-y.

Manufacturing and retail sales have recovered in most of Russia's federal districts and largest urban concentrations.



Sources: Rosstat and BOFIT.

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China

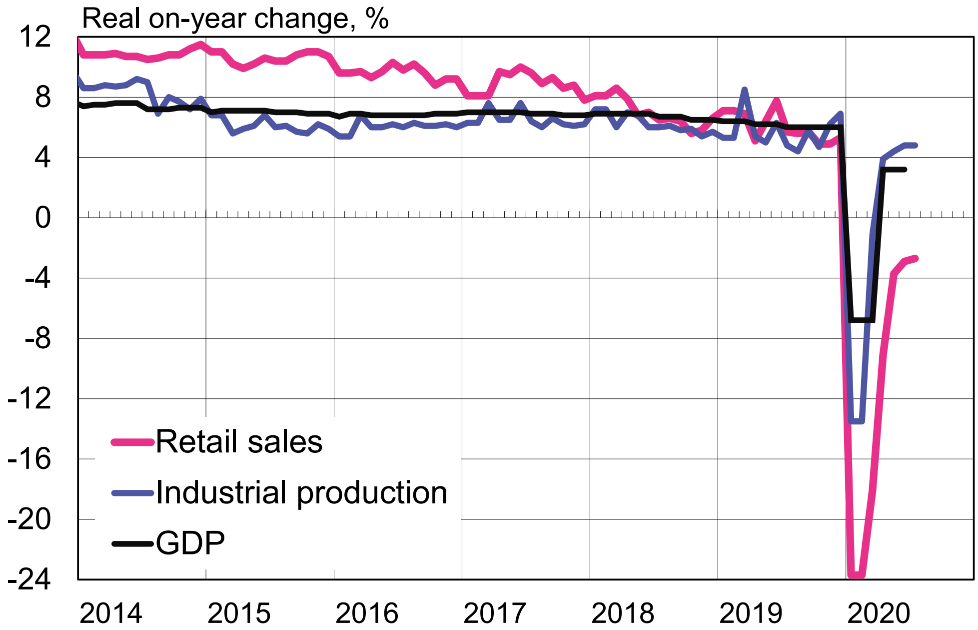
China's economic recovery stabilising. The Chinese economy has so far staged a remarkably robust recovery since hitting bottom in January-February. However, the impacts of the coronavirus and extent of recovery vary considerably across sectors. The National Bureau of Statistics reports that the overall pace of recovery has slowed in recent months in industry, retail sales and fixed investment.

On-year industrial output growth figures have hovered around 5 % in recent months. Notably, manufacturing has bounced back nicely. The manufacture of computers, smartphones, cars and a wide range of home appliances has soared in recent months. This reflects changes in demand brought on by the covid-19 pandemic as people switch to working remotely from home, spend on home appliances and prefer private vehicles to public transport.

Domestic consumer demand continues to contract. In recent months, retail sales have been down by about 3 % y-o-y in real terms. Unemployment is also still above normal and household disposable incomes have shrunk. In some branches, measures to deal with covid-19 still restrain consumption. For example, the reopening of movie theatres began only in late July.

Growth in fixed investment appears to be moderating, but these figures come with huge uncertainty. Growth this year has been largely driven by investment in infrastructure and real estate, while investment in productive capital assets at factories has decreased.

The recoveries in industrial output and retail sales slowed in recent months with growth remaining below pre-corona levels.



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

Recovery in Chinese goods exports faster than expected. The value of Chinese goods exports measured in US dollars climbed by 7 % y-o-y in July. Exports recovered from the impacts of the coronavirus epidemic, thanks mainly to China's successful suppression of the first wave of the virus and the fortunate positioning of Chinese firms to take advantage of global demand for medical supplies and personal protective equipment, as well as equipment related to remote working, especially electronic products. Overall, the export volume trend has lagged the export value trend in recent months. A significant exception, however, is petroleum products, where the value of exports has fallen due to a roughly one-third drop in oil prices from a year ago.

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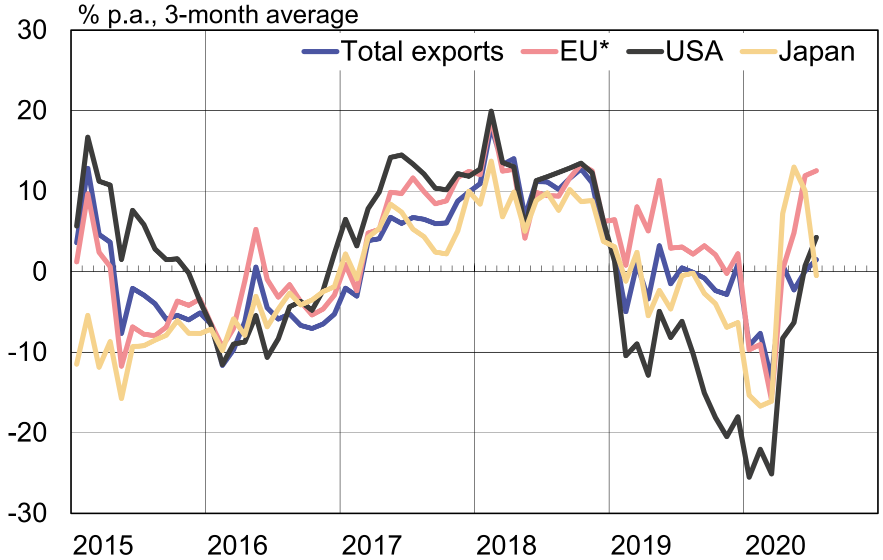
Chinese exports have increased in recent months, especially exports to the United States, ASEAN countries, the EU and Australia. Rail freight from China to Europe has also grown significantly. According to China State Railway, the country shipped 68 % more freight to Europe last month than it did in July 2019 – and the trains have gotten longer. The shift to rail freight reflects the impacts of coronavirus restrictions on air and sea freight.

Chinese exports face a number of uncertainties, not least of which is the duration and extent of the coronavirus pandemic, as well as its impacts on the global economy. In April, the WTO forecasted that global trade could contract this year by 13–24 %. At the end of July, the WTO revised its outlook to suggest a less severe economic contraction and improved odds for its most optimistic scenario.

The value of imports in July was 1 % less than a year earlier. The value of imports has fallen on the drop in global commodity prices, even as the import volumes of many commodities have risen substantially, particularly commodity inputs that bolster industrial output or reflect fixed investment stimulus. The volume of copper imports has risen by roughly 70 % y-o-y in recent months, and crude oil imports are up by about 25 %. The overall recovery in imports has been restrained, however, by weak domestic consumption due to the poor employment situation and low income growth.

The strongest on-year imports growth in recent months has concentrated on Latin America, Taiwan, the US, Japan and South Korea. In July, the biggest on-month changes were seen in imports from Africa and Australia. Imports from the EU have contracted on-year in recent months, but recorded slight on-month growth in July.

Development of Chinese goods exports measured in US dollars



**) Brexit corrected.*
Sources: China Customs, Macrobond and BOFIT.

US adopts even harsher policy stance towards China. This summer saw the United States impose a number of measures on China that provoked China to respond with its own measures. US-China relations have long been tense, but the US presidential election has caused the bad situation to unravel further.

The severest economic measures imposed the US were directed at the technology sector. In early August, the Trump administration expanded its Clean Network initiative, which is designed to exclude China from most technological ecosystems for security reasons. The focus remains on telecom giant Huawei, which the US government has accused, among other things, of stealing proprietary technologies and endangering national security. Deliveries of American-made microchips to Huawei have been significantly limited, putting the firm in a tough position. Indeed, Chinese companies generally remain heavily dependent on the US semiconductor industry. In addition, the US has threatened to ban Chinese apps such as Tik Tok and WeChat over data security concerns.

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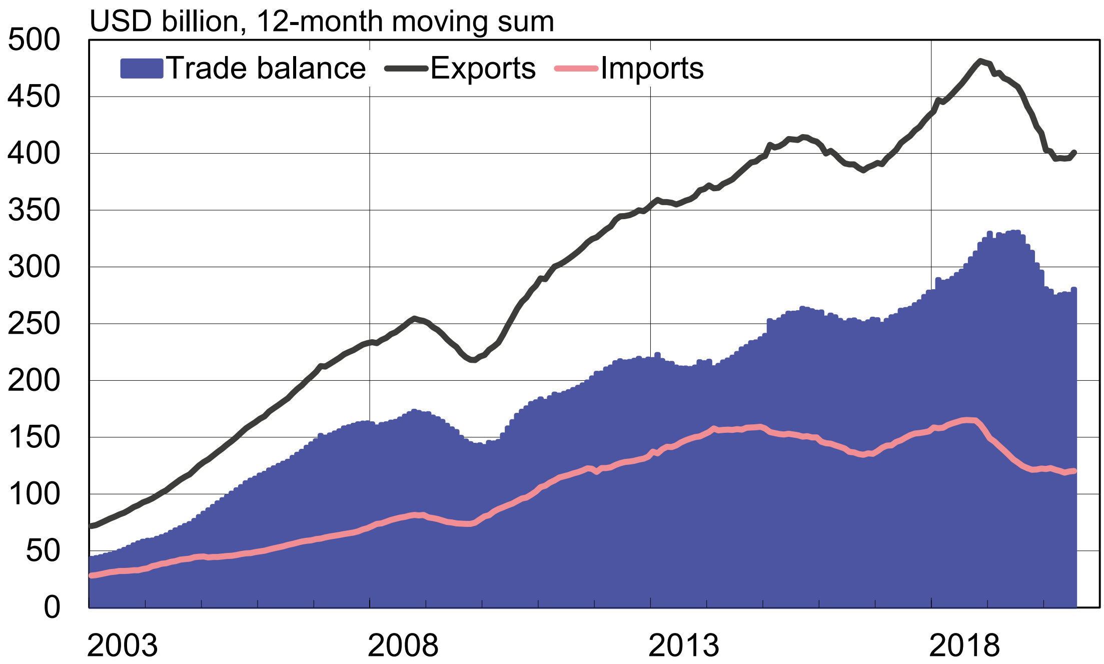
The US has targeted China with a number of diplomatic and political measures. Diplomatic relations have been strained, e.g. by the closing of the Chinese consulate in Houston, as well as the classification of Chinese media and actors as a “foreign mission”. The US has imposed sanctions on officials in Xinjiang and Hong Kong, and revoked Hong Kong’s special status. China responded to these measures by shutting down the US consulate in Chengdu and announcing further countersanctions.

Trade relations continue outside these disputed areas, however, even if China has failed to meet its obligations to purchase US goods under phase 1 of the current US-China trade agreement. Import levels are well below those called for under the agreement, and it seems impossible that China could meet its commitments under the arrangement. Trump personally declared an end to talks with China and no future talks are scheduled. The intermediate review of phase 1 has been delayed from this month.

No matter what the outcome of the US presidential election in November, tensions are unlikely to ease. China’s rise as an economic and technological superpower, as well as its ever-increasing prominence in geopolitics, are likely to sustain tensions over the long term.

China’s trade surplus with the US increased over the past decade.



Sources: China Customs, Macrobond and BOFIT.

China posts huge second-quarter current account surplus, capital outflows increased. Preliminary balance-of-payments figures suggest that China’s current account surplus in the second quarter reached 120 billion dollars, rebounding from a current account deficit of 34 billion dollars in the first quarter. The goods trade surplus reached a record 161 billion dollars in the second quarter. At the same time, the services trade deficit shrank significantly with the drying up of Chinese travel abroad.

The balance-of-payments figures show net positive inflows of foreign direct investment into China in both the first and second quarters. Despite a massive current account surplus and small FDI surplus, the change in China’s reserve assets in the second quarter was only slightly positive (19 billion dollars). The figure implies that more capital flowed out of China either on record on the financial account or off the record under the “net errors and omissions” term. In any case, capital outflows from China are still much smaller than in 2015 and 2016. Detailed financial account figures will be released later along with revised current account figures.

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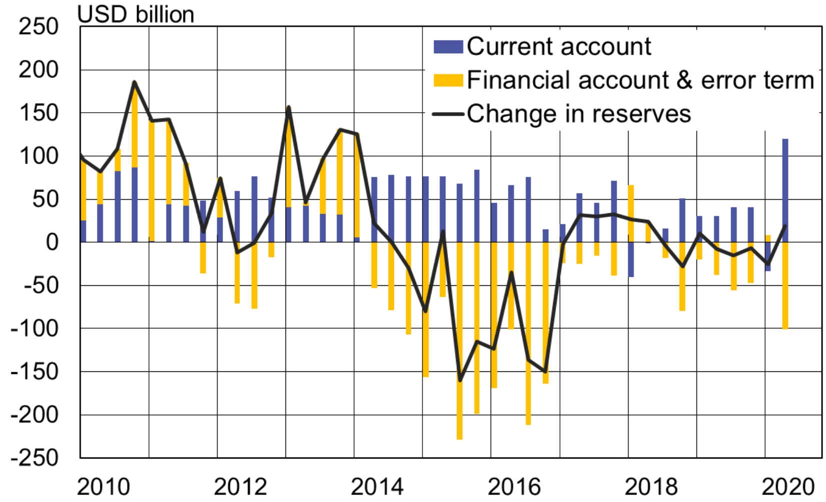
The value of China's foreign currency reserves, taking into account valuation changes, has increased by 75 billion dollars since the start of this year. As of end-July the value of China's reserves stood at 3.3 trillion dollars (includes gold, SDRs and IMF reserves). While the People's Bank of China has in recent years officially intervened only very little in the forex markets, state-backed entities such as China's giant commercial banks can still influence exchange rates indirectly. The yuan's exchange rate has appreciated by about 3 % against the US dollar since late May. At the same time, the yuan has lost about 3 % against the euro. On Friday (Aug. 21), one dollar bought 6.91 yuan and one euro 8.20 yuan.

Main categories in China's balance-of-payments reporting and changes in reserves, quarterly figures.



Sources: SAFE, Macrobond and BOFIT

PBoC's digital currency project moves ahead. With advances in digital trading and cryptocurrencies, central banks around the world have had to consider whether they should issue their own digital currency alongside traditional cash or simply phase out cash altogether. As in many countries, the use of physical cash has declined rapidly in China, where an increasing share of payment transactions are conducted with mobile apps such as Alipay or WeChatPay.

China, the birthplace of paper money, is clearly committed to be in frontline of development of digital central bank money. The PBoC began it plan the introduction of digital currency already back in 2014. The initial use of digital currency was tested in April in four urban centres (Shenzhen, Suzhou, Chengdu and the Xiong'an New Area).

During the summer, the central bank also announced cooperation with select firms (including the ride-share firm Didi and food delivery giant Meituan) in the introduction of China's digital currency. The next set of trials will cover the Beijing-Tianjin-Hebei region, Shanghai and its surroundings, as well as Guangdong, Hong Kong and Macao.

So far the PBoC has been tight-lipped about the technical details of its digital currency. PBoC governor Yi Gang has revealed that the plan calls of replacing physical cash with more traceable digital currency, stressing that it is not intended to replace digital funds held as bank deposits or compete with popular commercial payment applications.

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Russia

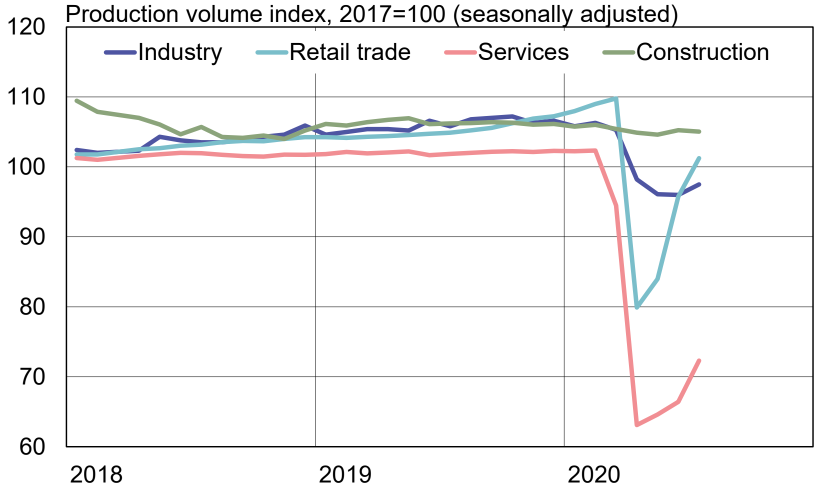
Russian economy continued to recover in July. The covid-19 pandemic hit Russia hard this spring, but the impacts were uneven. It now appears that even most of hard-hit sectors are beginning to climb up from their spring lows. Compared to a year earlier, however, output in nearly all sectors was still down in July. The economy ministry estimates that GDP contracted by nearly 5 % y-o-y in July and around 4 % y-o-y in the first seven months of the year.

Consumption-driven service branches experienced sharp declines in the spring. Retail sales in particular have seen a brisk recovery in recent months with the gradual relaxation of coronavirus-related restrictions. July retail sales were only off by 2 % from a year earlier, and new car sales in July recorded even growth from the year earlier. The recovery in several other service branches, however, has been much more modest. Other services were still down by 25 % y-o-y in July. Relatively favourable wage trends have supported the revival of consumer-driven branches as the average wages held nearly stable throughout the second quarter. Unemployment climbed sharply, however, with the unemployment rate reaching 6.3 % in July.

Manufacturing also recovered further in July, while extractive industries remained in the doldrums. Development in manufacturing has varied tremendously across branches, however. For example, production of foodstuffs and pharmaceuticals enjoyed strong growth throughout January-July, while car production dropped substantially. The weak development of extractive industries largely reflects reduced crude oil output due to large cuts in oil production agreed to by OPEC+ countries that were still in force in July. This month, however, Russia is permitted under the arrangement to increase output slightly. Russian natural gas output has also contracted significantly this year.

The coronavirus pandemic seems to have spared agricultural production, which grew at a steady 3 % y-o-y pace throughout January-July. Construction output barely contracted during the crisis period, and in July was just below its level at the start of the year. Residential housing construction, however, declined by 12 % y-o-y in January-July.

Signs of recovery in core sectors of the Russian economy



Sources: Rosstat and BOFIT.

Russian government budget revenues decline precipitously, spending soars. Revenue streams to the consolidated budget, an aggregate of federal, regional and local budgets plus state social funds, decreased by 13 % y-o-y in the second quarter and by about 4 % in the first half of the year. The decrease was mitigated by a large one-time payment from Central Bank of Russia's additional surplus to the federal budget in April, which resulted from the sale of the central bank's majority stake in Sberbank to the government (BOFIT Weekly 17/2020). Without the CBR payment, consolidated budget revenues were down by 23 % y-o-y in the second quarter and 9 % in the first half.

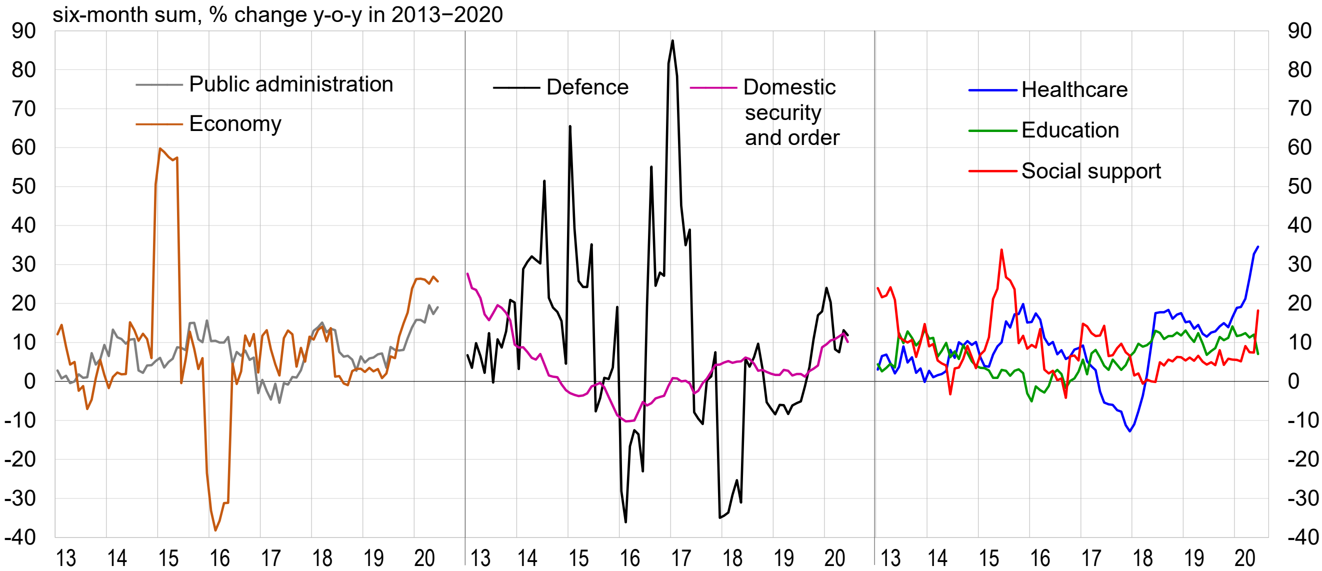
Consolidated budget spending has increased. Spending in both the first and second quarters was up by about 17 % y-o-y. Budget spending has provided stimulus to the economy as it has increased significantly even in real terms. The effectiveness of the stimulus has been helped considerably by fairly moderate rises in consumer prices and fixed investment prices, as well as a decline in producer prices of industrial goods supplied to the domestic markets (for more on developments in Russian budget expenditures and revenues in real terms see our just released BOFIT Policy Brief 10/2020).

After two years of surplus, the reduction in revenues and higher spending this year have turned the consolidated budget to deficit. The 12-month deficit for the period ending in June corresponded to 1.3 % of GDP (without the CBR's one-time payment, the deficit would have exceeded 2 % of GDP).

Nearly all revenue categories of the consolidated budget have decreased substantially this year. Smaller revenues from oil & gas taxes lowered their share of total budget revenues to 15 % in the first half. Other budget revenues in the first half of the year were up 5 %, while remaining unchanged on-year in the second quarter. Again, without the CBR's one-time transfer, revenues would have fallen in the second quarter by 13 % y-o-y. Revenues from corporate taxes fell sharply in the second quarter (down 30 %), creating a large hole in the budget. The decline in budget revenues from property taxes and special taxes on entrepreneurs, as well as the drying up of dividends from state-owned enterprises also had notable impacts. Revenues from labour income taxes fell much less (down just 10 %). Value-added-tax revenues and mandatory social contributions based on wage earnings were only down by 5 %. The reductions in some revenue streams were not due only to the economy's dive in the second quarter but also the government's spring decisions to grant tax reductions and extensions on tax payments.

Increased budget spending has focused especially on healthcare due partly to the coronavirus pandemic (up 35 % y-o-y in the first half) and the economy (up 26 %), mainly transportation and roads. The spending boosts for health and the economy were reflected in goods & services, corporate subsidies and fixed investment with unusually rapid increases of expenditures. In addition, the budget's biggest spending category by far – spending on social support – grew briskly, mostly on near-doubling of support to families. Amidst the covid-19 crisis, spending on public administration as well as domestic security and order also increased notably faster than in previous years. The rise in defence spending accelerated in the second quarter.

Main spending categories of the Russian government budget sector (consolidated budget) show considerable increases this year



Sources: Russian Ministry of Finance and BOFIT.

Subsidy programmes and rate cuts support bank lending in Russia. The corporate loan stock experienced robust growth in the first quarter of the year as companies prepared (for example, by securing lines of credit) for impending coronavirus restrictions and lockdown. In the second quarter, the growth of the loan stock slowed, but in July the stock of corporate loans increased by 1.6 % m-o-m. The growth in lending mostly reflected credit granted to a few large companies and funds channelled through various state support schemes. As of end-July, corporate loans granted by credit institutions amounted to 42.9 trillion rubles, with annual growth in the loan stock accelerating to 9 % y-o-y in July. Lending to the small and medium-sized enterprises (SMEs), boosted by various state support schemes, grew slightly faster. However, loans to SMEs only account for around 12 % of the corporate loan stock. Interest rates on ruble-denominated loans have fallen significantly this year. The average interest rate on loans for less than a year was 6.9 % in June, almost two percentage points lower than a year earlier.

At the end of July, the stock of household loans amounted to 18.7 trillion rubles, an increase of 13 % y-o-y. Growth in the loan stock slowed from last year, and increasingly relied on strong growth in housing loans. About 45 % (8.2 trillion rubles) of all household loans at the end of June were housing loans.

The decline in interest rates could also be seen in deposit rates. In June, the rate paid on household deposits of less than a year fell below 4 % p.a., which is below the CBR's key rate. Lower interest rates have spurred interest in other investments. In April-June, nearly a million new small investors entered the securities markets. The value of assets held in investment accounts of private individuals grew by 14 % y-o-y, clearly outperforming bank deposits.

Loans to households and corporates, as well as bank deposits, increased over the past year

	1.8.2019	1.1.2020	1.7.2020	1.8.2020	% change y-o-y in July
Loans to households, stock	16 527	17 651	18 388	18 703	13,2
-of which housing loans	7 213	7 705	8 182		
Loans to corporations, stock	37 986	39 004	41 714	42 898	9
- of which SME loans	4 585	4 666	5 092		
Household deposits, stock	29 054	30 549	31 693	32 108	7,4
On year change excludes valuation changes and information on banks that ceased operations.					

Sources: CBR and BOFIT.

State support scheme boosts demand for new housing loans in Russia. Issuance of new housing loans cratered in April and May due to the coronavirus lockdown. The volume of new housing loans issued in May was down by about 30 % from February and March. In June, the lending decline reversed, with 270 billion rubles in new housing loans granted, i.e. about the same amount of lending as in February and March. Data provided by Russia's largest banks show growth in housing lending continued in July with significantly more housing loans issued than in June.

During May-July, 270 billion rubles in subsidised interest loans were granted under a new housing loan scheme that provides loans at rate of 6.5 % p.a. in accordance with a government decision. The support scheme and CBR rate cuts have lowered interest rates on all housing loans. In June, the average rate for new housing loan was 7.5 % p.a., down from 10.3 % a year earlier. The average interest rate on loans granted for the purchase of new apartments using an escrow account fell below 6 %. The use of escrow accounts in housing financing is gradually increasing in Russia, and at present just over a third of apartments under construction are sold through escrow account arrangements.

The average length of housing loans granted in June was 18 years with an average size of 2.3 million rubles (28,000 euros). Annual growth in the stock of housing loans declined to under 14 % y-o-y in June. A year ago, the annual growth in housing loans was 22 %. The growth of the housing loan stock has been sustained by increased borrowing and active use of deferred principal payments and other loan restructuring arrangements offered during the pandemic.

Demand for housing loans remains fairly strong

Sources: Central Bank of Russia, CEIC and BOFIT.

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BOFIT

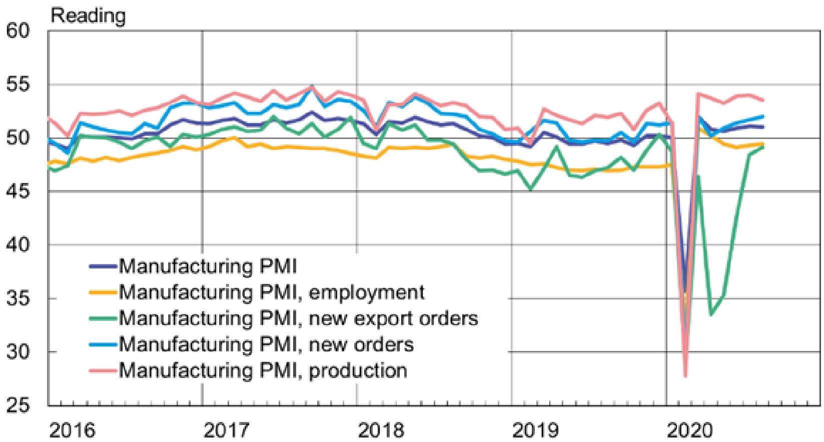
China

Profitability of Chinese industrial firms improved over the summer. With the Chinese economy recovering, the plight of industrial firms has also improved. July was the third month in a row that industrial firms reported on-year increases in profits. However, with the coronavirus pandemic dragging down profits in the early part of the year, profits for the first seven months of 2020 were still down by 8 % y-o-y. The recovery in profitability of privately-held industrial enterprises (down 5 % y-o-y in January-July) has fared significantly better since February than state-owned enterprises (down 24 %).

The coronavirus crisis is reflected in diverse profit trends across industrial sectors. In particular, profit increases in January-July were led by manufacturers of computers and communications technology (up 29 %). Profits increased also for manufacturers of instruments, machinery and special equipment. The profits of pharmaceutical companies rose by 5 % y-o-y. Reflecting a common trend in commodity prices, profits in the mining industry were down (e.g. coal industry profits declined by 33 % y-o-y), energy production (e.g. oil & natural gas down by 72 %) and chemicals (down 28 %). Profits of clothing and furniture manufacturers were well below last year's levels (down 26 %).

China's official composite NBS Manufacturing Purchasing Managers' Index (PMI) remained at a slightly positive reading of 51.0, or about the same as July's reading of 51.1. The production sub-category of the manufacturing PMI has recovered especially fast from February's massive drop. Among the manufacturing PMI sub-categories, only new export orders experienced a second drop in April and May as measures to suppress the spread of the coronavirus caused many countries around the world to close their borders. In August, however, the reading for new export orders surpassed the July number, putting it above the average for all of 2019, even if the reading was still below 50 points, level that reflects growth in economic activity. Markit's Caixin General Manufacturing PMI rose by several tenths of a percentage point in August to 53.1 points.

China's official manufacturing PMI and sub-categories



Sources: CFLP, Macrobond and BOFIT.

Number of defaults of Chinese companies on dollar-denominated bonds already exceeds all of 2019. The international credit rating agency Fitch reports that nine Chinese companies as of end-July had defaulted on their foreign currency bonds (total $4.5 billion), topping the amount of the six companies that defaulted on roughly $3.3 billion in all of last year. More payment defaults are likely as $54 billion in bond repayments come due by the end of this year.

Even with an impending lockdown due to the coronavirus, Chinese companies issued over $20 billion in new US dollar bonds in January and February, over double the amount issued in January-February 2019. As the pandemic chewed through markets, however, Chinese international bond issues diminished. As of July, only $37 billion new dollar-denominated corporate bonds had been issued for the year compared to $59 billion issued a year ago. The total stock of dollar-denominated bonds issued by Chinese companies is currently around $257 billion. Chinese companies have only issued a small number of bonds internationally in currencies other than the dollar.

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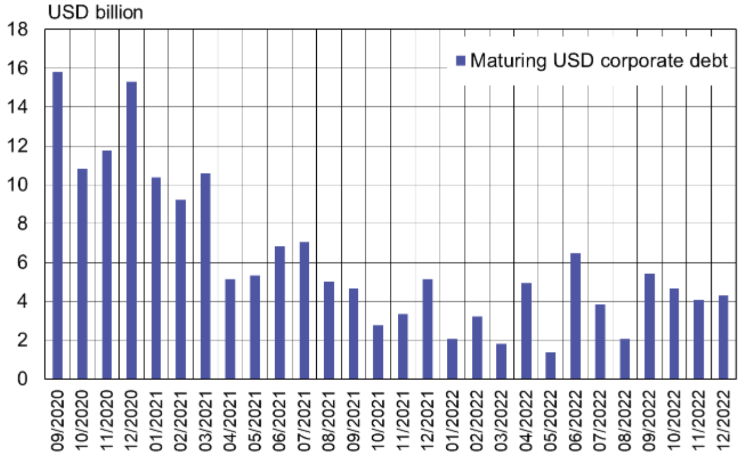
China's domestic bond market, which is dominated by yuan-denominated corporate bonds, is valued at over 28 trillion yuan ($4.1 trillion), or about 16 times higher than amount of dollar bonds issued by Chinese companies. On the domestic market, bonds issue activity is up significantly from last year. Issues have been accelerated by monetary stimulus policies such as rate cuts in the spring as well as relaxion of rules on bond issuing. Interest rates on debt securities have been lower than bank loan interest rates, making them an attractive way for businesses to raise money. Tighter regulation in the shadow banking sector has also motivated companies to move out of trust loans to bonds. Over 90 % of new issues came from state-owned enterprises (SOEs) and local government financing vehicles (LGFVs).

Fitch reports that 18 private companies and a SOE had experienced payment problems on the domestic market this year as of end-July. Troubles in holding to set bond repayment schedules applied to bonds totalling approximately 60 billion yuan ($8.7 billion). Over the course of last year, more than 50 companies had payment problems amounting to over 120 billion yuan. Given the size of the Chinese bond market, the proportion of defaults is still negligible. However, reported defaults do not give a realistic picture of the Chinese corporate liquidity. Companies may have agreed on extending payments directly with investors or exchanged maturing bonds for new ones. Even enfeebled companies have managed to pay off maturing bonds with new credit. Fitch observed that some companies have managed to issue bonds on the domestic market to pay off their maturing dollar bonds. Nevertheless, payment defaults are expected to increase towards the end of the year on the domestic market. Bloomberg reports that bonds worth 3.65 trillion yuan – more than double the amount maturing in the first half of this year –will come due by the end of December. Of that amount, over 360 billion yuan is owed by private companies with low credit scores.

Chinese firms have $54 billion in dollar-denominated bond debt coming due by the end of this year (situation as of Sept. 1, 2020).



Sources: Bloomberg and Bank of Finland.

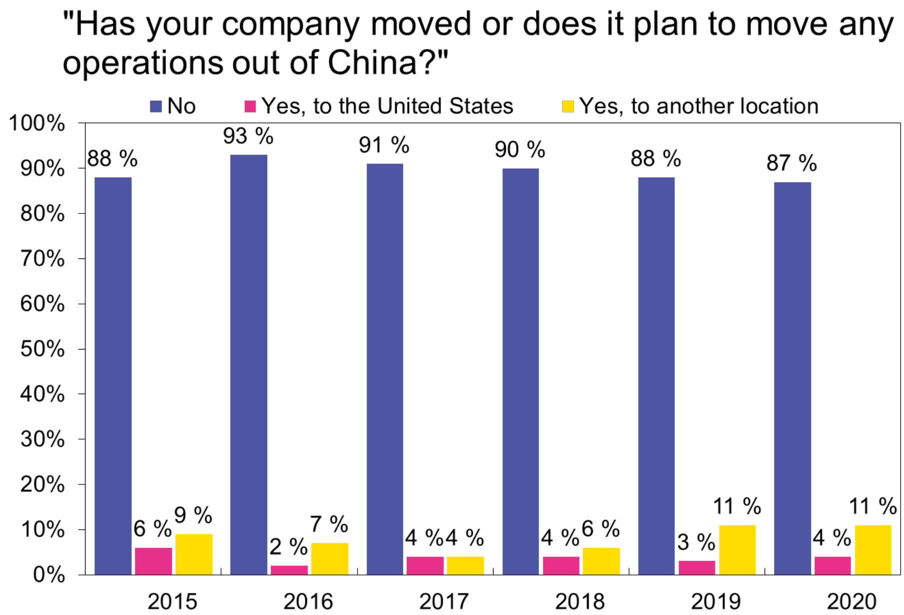
US firms operating in China remain committed to Chinese markets. A new member survey from the US-China Business Council (USCBC) reveals that firms consider US-China tensions and fallout from the coronavirus pandemic the biggest challenges affecting their abilities to operate in China. The survey, conducted in May and June, is based on the responses of more than 100 USCBC member companies doing business in China.

Some 86 % of companies reported that the increased tensions between China and the United States had affected their business in China. They said that frayed diplomacy had created uncertainty in their business relationships, which has made business more difficult with Chinese parties. The tariffs and counter-tariffs imposed by China and the US have also hampered business. Phase 1 of the new US-China trade agreement, on the other hand, was seen to have had a stabilising impact on superpower relations and was viewed very positively.

The survey shows that most companies considered their prospects good in China's current business environment. More than 80 % of companies said China was an important part of their global strategy, and 90 % reported that their Chinese businesses were profitable. A clear majority said that their business, fixed investment plans and wages would remain unchanged or increase this year. However, heightened geopolitical tensions and the coronavirus pandemic have increased uncertainty about the near future. Fewer respondents said they had plans to expand their businesses or raise wages, and only 30 % of companies predicted revenue growth in 2020. Despite this, the interest of companies in moving operation out of China has not increased since last year. Only 4 % of companies said they had considered or were planning to move their operations back to the US, and 11 % said that they were moving operations elsewhere.

Many US companies pointed to the challenges of competing with Chinese companies, especially SOEs. The majority of companies responding to the survey expressed awareness or suspicions that Chinese SOEs receive favoured treatment from the Chinese state with respect to e.g. financing, licencing and public procurements. The respondents noted an improvement in China's industrial policy and a greater willingness to enforce intellectual property right protections. China's cybersecurity concerns were raised by the effects of superpower relations and restrictions on international data flows. Some 13 % of respondents said they had been asked to transfer technology, an increase of 8 percentage points from 2019.

Interest of US firms in moving their business operations out of China has not increased in recent years.



Sources: US-China Business Council and BOFIT.

Robust growth in Finnish goods imports from China. Finnish Customs reports that the value of goods imported from China in January-June was 2.5 billion euros, an increase of more than 10 % y-o-y. A driver of imports growth has been the shift to online work, as well as strong demand for personal protective equipment (PPE) such as face masks to deal with Covid-19 risks. While Finnish imports from other parts of the world have declined markedly this year, China's share of Finnish imports has increased rapidly. That share climbed to roughly 10 % in the second quarter (7.5 % in 2019).

Finnish exports to China declined at the same rate as exports to the rest of the world (down 17 % y-o-y). Volumes of many important Finnish exports such as pulp, metals and timber decreased, as did export prices for many commodities. Exports to China totalled 1.5 billion euros in January-June. Rapidly increasing imports and declining exports boosted the goods trade deficit of goods to around 1 billion euros for the first half of this year.

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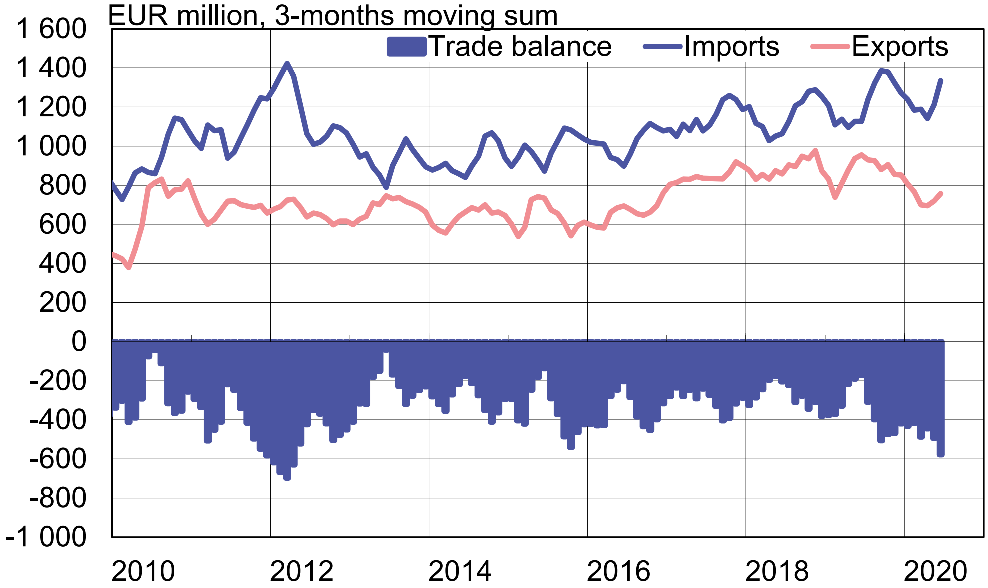
Steady growth in Finnish imports from China.



Sources: Finnish Customs and BOFIT.

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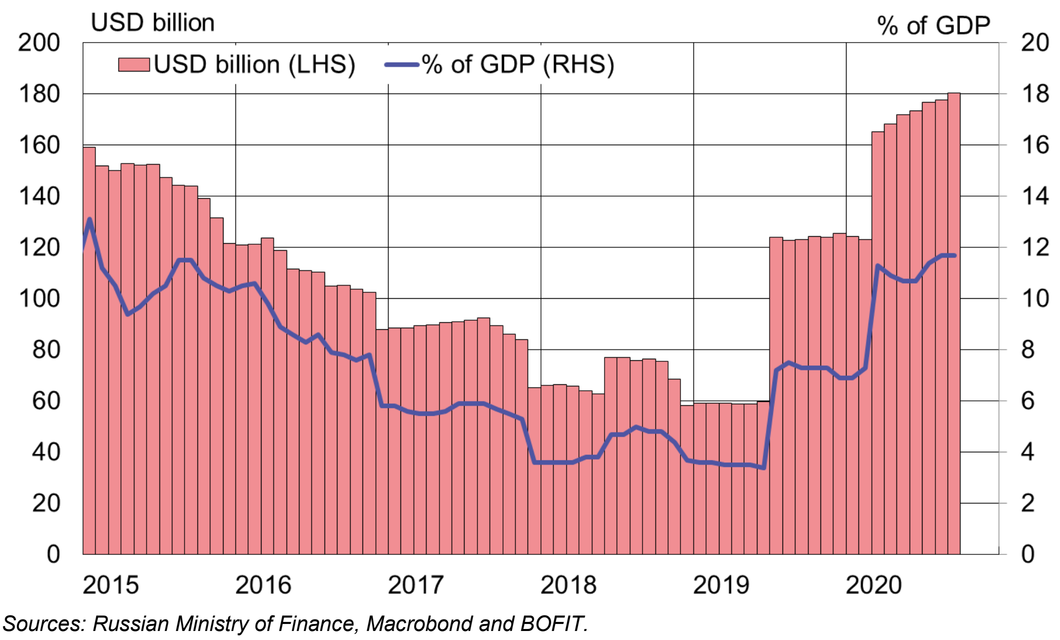
Russia

Russia's National Welfare Fund swells; CBR forex and gold reserves hit record high in August. At the end of August, the National Welfare Fund (NWF), which has been built up from taxing the energy sector, reached $180 billion, or 11.7 % of forecasted 2020 GDP. The NWF has increased by about 45 % this year in dollar terms. The tax revenues set aside from oil and gas earnings last year were transferred to the fund in March (BOFIT Weekly 2020/13). In addition, appreciation of the euro against the US dollar has helped increased the value of the NWF in dollars. Smaller amounts have been withdrawn from the NWF this year to cover budget shortfalls caused by the Russian government's fiscal deficit. The value of assets in the NWF last surpassed such heights in late 2008 and first half of 2009, when the value peaked at $225 billion.

Slightly over $119 billion of the NWF are invested in highly liquid bonds of countries with high credit ratings. The remainder is invested in such forms as deposits in Russia's state development bank VEB ($7.8 billion) or other Russian entities designated by the government. Majority stake in Sberbank that was bought from the Central Bank of Russia ($34.9 billion) represents the largest single investment (BOFIT Weekly 2020/17). These assets are part of the national investment strategy of enhancing the long-term growth prospects of the Russian economy.

The CBR's foreign currency and gold reserves have also surged this year, even if they have been growing since early 2017. The value of the forex and gold reserves briefly topped $600 billion last month, and stood at $594 billion as of end-August. The previous peak was in August 2008, when the value of the forex and gold reserves reached $598 billion. The growth in reserves was boosted, among other things, by higher gold prices. Gold made up 24 % of CBR reserves at the end of August. Russia has the world's fourth largest foreign currency and gold reserves after China ($3.308 trillion at end-August), Japan ($1.399 trillion) and Switzerland ($1.014 trillion).

The National Welfare Fund has seen large gains this year.



Sources: Russian Ministry of Finance, Macrobond and BOFIT.

Even with stabilisation of oil prices, the ruble has lost value in recent months. The external value of the ruble has traditionally tracked – almost slavishly – changes in world crude oil prices. Since early June, however, the ruble has lost significant value without a corresponding drop in crude oil prices. This week, the price of crude oil fell rapidly again, with the price of Urals-grade crude falling below $40 a barrel for the first time since June.

Since the beginning of June, the ruble has lost 8 % of its value against the US dollar and 15 % of its value against the euro. At the same time, the price of a barrel of Urals crude has risen slightly more than 2 %. Market analysts report that exchange rates have been under pressure from general uncertainty about conditions in emerging economies and the impact of the Covid-19 pandemic. In addition, the situation in Belarus in recent weeks and the poisoning of opposition leader Alexei

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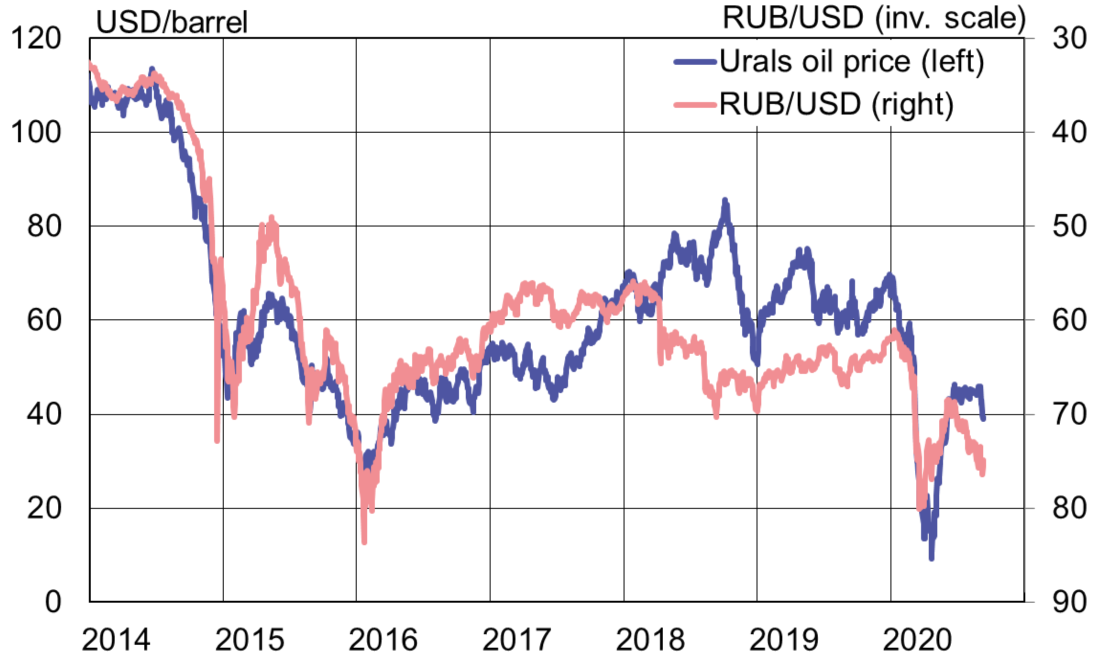
Navalny have increased the likelihood of new sanctions against Russian persons and entities. Moreover, the fate of the just-renewed production cut agreement of OPEC+ countries, which takes about 10 million barrels of daily production off the market, looks uncertain. Previous versions of the voluntary agreement succeeded in compelling major oil-producing nations to restrict output.

The ruble-dollar rate has dropped in recent months.



Sources: Central Bank of Russia, Reuters and BOFIT.

Russian government spending cushions fixed investment decline. In Russia, the real volume of fixed investment declined in the second quarter by about 7.5 % y-o-y. The drop was less steep than those experienced during the recessions in 2009 and 2014–2015. In those slumps, fixed investment dropped by over 10 %. After the latter slump, fixed investment has recovered, but still last year reached only levels that corresponded to those of 2012–2014.

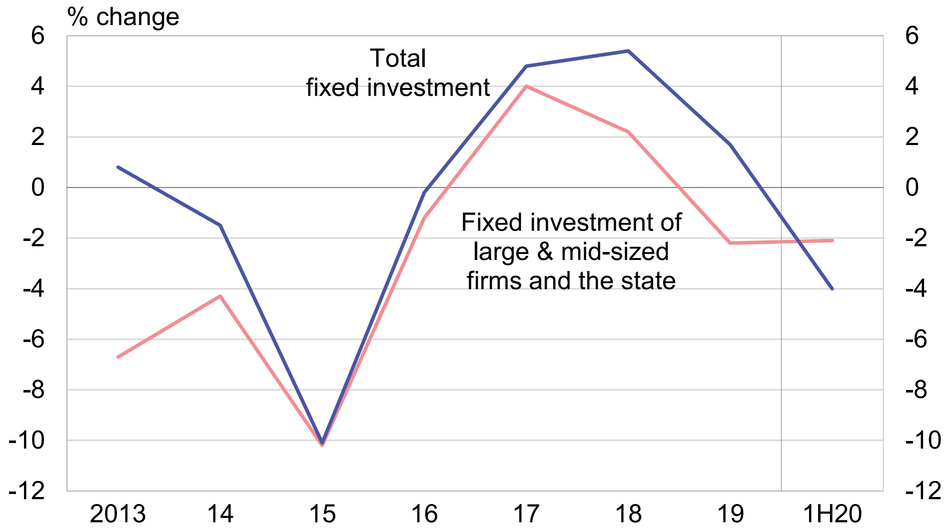
Rosstat within-year structural investment statistics cover only fixed investment of large and mid-sized enterprises, as well as government investment, which together account for about three-quarters of total fixed investment. Breaking from the usual pattern, these fixed investments have contracted slightly less this year than other fixed investment. The decline was moderated by two sectors. In the energy sector, fixed investment in natural gas production and oil refining continued to experience rapid increases.

Second, investments in major sectors governed by the state, i.e. healthcare and education, have seen strong increases in investment, similar to the past couple of years. In addition, investment in government administration has climbed briskly this year, which is also reflected in investment financing. Funding from federal, regional and municipal budgets began to rise considerably already last year after a hiatus of several years. Budget funding this year has accounted for an unusually large amount of the increase of total investment funding, particularly in the second quarter.

Thanks to sustained strong growth in a couple of core branches such as foodstuffs and the metals industry, investment in manufacturing (not including oil refining) dipped by just about 3 % y-o-y in the first and second quarters of this year. In several other manufacturing branches, the on-year decline in investment in the first quarter was already notable before steepening in the second quarter. In particular, large contractions have been witnessed in manufacturing of metal products, certain branches of machinery & equipment, as well as automobile production. Among non-industrial sectors, declines in the first half of this year in investments in oil & gas pipelines, as well telecommunications equipment and networks, have significantly contributed to the fall of total investments.

On fixed investments of the state and large or mid-sized enterprises in different technical modes of capital data are only available in value terms. Fixed investments in production systems and infrastructure, the largest spending category, have partly recovered from last year's slump. The increase of spending was fairly brisk compared to the rise in prices of investments. Much of this year's increase reflects investment in the gas sector and some growth in investment in crude oil production, which at least for the time being has not been hit by low oil prices or the OPEC+ agreement on production cuts. Increased spending on machinery & equipment, the second-largest category, in the second quarter roughly matched price increases on machinery & equipment going to fixed investment. Spending on transportation vehicles and construction of non-residential buildings saw sharp contractions in the second quarter.

Real volume of fixed investment in Russia declined.



Sources: Rosstat and BOFIT.

Finnish-Russian trade plummeted in second quarter. The value of Finland's goods exports to Russia decreased by 32 % y-o-y in the second quarter. Exports were dragged down by the sudden contraction in Russian demand caused by the coronavirus pandemic lockdown and restrictions, turbulence in global oil markets, as well as ruble depreciation. The plunge in exports was amplified by the relatively high reference point last year due to one-off gas pipeline deliveries. Pipes used in the Nord Stream 2 project were coated in Finland and thus recorded in the Finnish customs statistics first as imports from Russia and later as exports to Russia. Excluding the pipelines, the value of goods exports to Russia from Finland contracted by about 20 % y-o-y in April-June, i.e. the same amount of decline as the rest of Finland's goods exports. There were two-digit drops in Finnish exports to Russia in all major product categories in the second quarter. In recent months, however, Finnish exports to Russia appear to be experiencing a gradual recovery. Russia this year has accounted for 5 % of Finnish goods exports, making it Finland's sixth most important export market.

Finnish services exports to Russia also appeared to contract sharply in the second quarter, mainly on a slump in tourist services. In order to curb the spread of Covid-19, tourism in both Finland and Russia has been extremely restricted. As a result, the number of crossings of Finland's eastern border with Russia crashed and overnight stays by Russians were almost non-existent last spring. In recent years, tourism has accounted for about half of all of Finland's services exports to Russia.

The value of Finland's goods imports from Russia contracted in the second quarter by about half from a year earlier. While much of the collapse in the value of imports can be attributed to plunging crude oil prices, the volume of crude oil imports also declined sharply. The drop in imports, however, appears to have plateaued in recent months as oil prices have rebounded. Russia accounted for about 10 % of goods imports to Finland this year, and Russia is Finland's third most important import provider.

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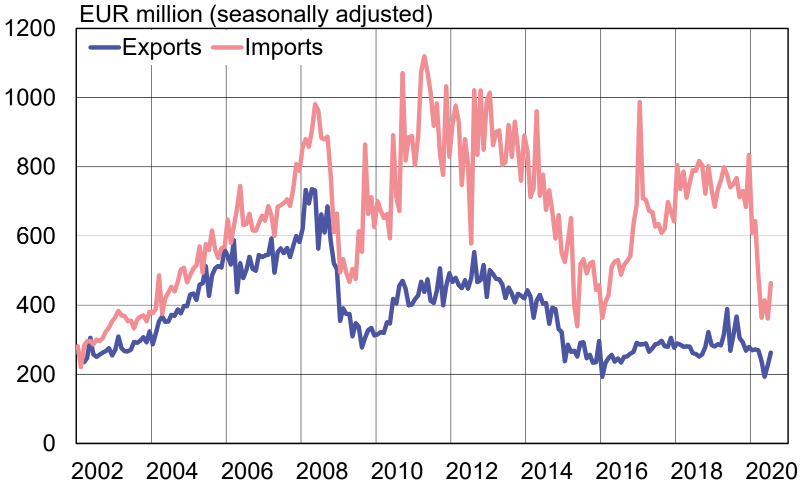
The value of Finland's goods trade with Russia, especially imports, has declined this year.



Note: July 2020 figures based on preliminary data.
Sources: Finnish Customs and BOFIT.

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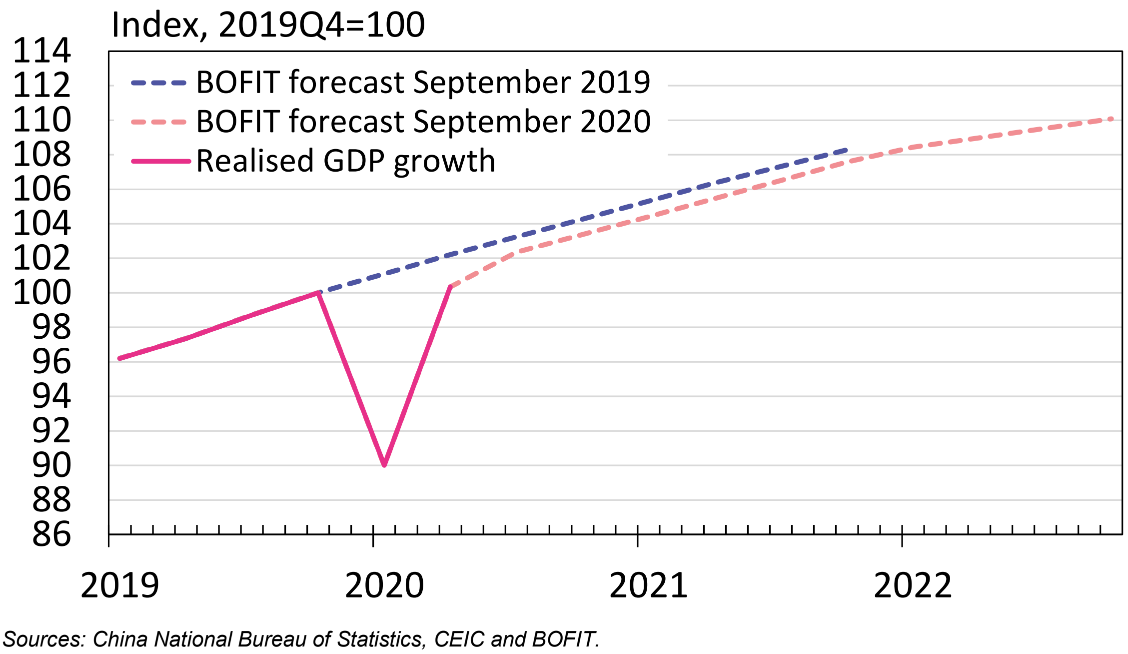
China

BOFIT expects positive Chinese GDP growth for the year, but structural issues and risks continue to swell. Our latest BOFIT Forecast for China was released yesterday (Sept. 17). The Chinese economy has bounced back from the Covid-19 crisis faster than predicted in our March forecast. We now expect China's GDP to increase slightly this year (about 1 %). In coming years, economic growth will be restrained increasingly by ageing population and shrinking working-age demographic. The need to balance public sector finances has also become more critical, as public-sector deficit will approach 20 % of GDP this year and government debt will near 100 % of GDP. Due to stimulus measures, spending on infrastructure and construction projects is strong despite concerns on cost-effectiveness of China's huge annual investments. Slow progress in reforms will keep productivity gains modest. Even with all these factors, 2021 on-year GDP growth should be impressive (about 7 %), thanks to the exceptionally low reference figures for 2020. GDP growth will slide back to around 3 % in 2022.

Uncertainty has increased due to heightened tensions between China and other countries. China has become more aggressive on its borders and beyond, and has imposed stricter controls on citizens domestically and in Hong Kong. Relations with the US are likely to continue to degenerate and decoupling is expected to proceed, which will cloud the growth outlook for China.

The large risks lurk in the financial sector. Overall indebtedness has re-accelerated and businesses in many branches have seen their ability to serve debt eroded by Covid-19 crisis impacts. Many countries that have embarked on similar long-running borrowing binges have eventually found themselves in financial crisis. The risk of a major disturbance in financial markets has grown. A new broad-based wave of Covid-19 infections in China would slow economic growth and significantly increase financial market risks.

Even with a rapid recovery from the first-wave Covid-19 shock, Chinese GDP growth will undershoot pre-crisis forecasts.



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

Chinese economy continued to rebound in August, even as consumer demand remained weak. The National Bureau of Statistics reports that manufacturing led a nearly 6 % y-o-y rise in industrial output in August. Fixed investments are also on a rise in monthly terms, even if the nominal value of fixed investment reported in January-August is still less than in the same period in 2019.

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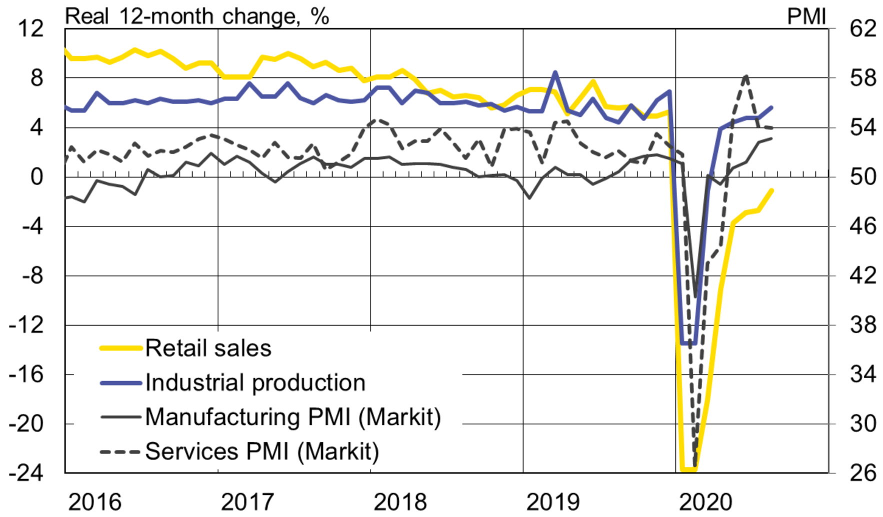
Retail sales, a rough measure of domestic consumption, were still down by about 1 % y-o-y in August. The level of retail sales is about 5 % smaller than at end of 2019. Sales of certain non-necessity goods such as cars, consumer electronics, jewellery and cosmetics, rose faster than retail sales generally. This likely reflects changes in consumer demand due to the epidemic, postponed consumption from earlier this year and loss of foreign travel possibilities. The value of sales of restaurant services in August was still down by 7 % y-o-y, however. The drop in restaurant sales was 44 % y-o-y for January-March.

Industrial output has been boosted by soaring international demand in certain export categories such as medical and protective equipment (mask, gloves, etc.), as well as electronic devices. The total value of exports measured in dollars rose by 10 % y-o-y in August, while the value of imports fell by 2 %. The strong export trend and low global commodity prices have caused China's goods trade surplus to increase rapidly. Despite a record goods trade deficit in February due to the coronavirus lockdown, the cumulative January-August surplus ($289 billion) exceeded the surplus for the same period a year earlier.

The improved demand for industrial sector has eased producer price deflation. In August, producer prices were down by 2 % y-o-y (-2.4 % in July). 12-month consumer price inflation slowed slightly in August to 2.4 % (2.7 % in July). Core inflation (food and energy prices excluded) remained at 0.5 %.

China's economic recovery continues on two tracks.



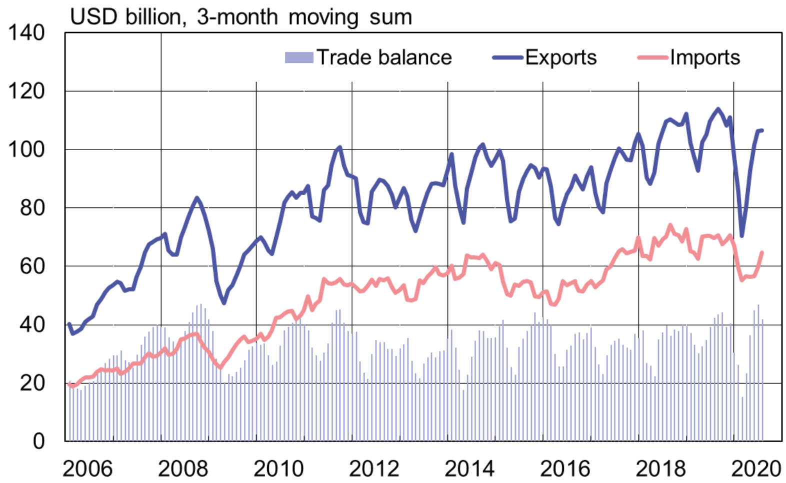
Sources: China National Bureau of Statistics, Markit, CEIC and Macrobond.

Calls for speedier talks on investment agreement dominate this year's virtual EU-China summit. The September 14 EU-China summit was originally planned to be held in Leipzig with the participation of all EU leaders. In recent months, however, the coronavirus forced organisers to shift to a videoconference format that only included Chinese president Xi Jinping, German chancellor Angela Merkel (currently chairing the EU presidency), president of the European Council Charles Michel and president of the European Commission Ursula von der Leyen. The summit addressed issues that included trade and investment, climate change, the Covid-19 crisis, tensions in the South China Sea and human rights.

The parties discussed progress in the EU-China Comprehensive Investment Agreement, which was first proposed in 2013. The agreement seeks to allow EU companies to invest in the Chinese market under the same rules governing Chinese firms, and vice versa. Despite some progress in talks, EU leaders stressed that big issues of the agreement remain open. Among other things, China still has to credibly commit to increasing access to its market. The aim is to finalise the agreement by the end of the year.

A separate EU-China Agreement on Geographical Indications (GIs) was signed ahead of the summit. China and the EU have held talks on the GI agreement since 2011. It provides a framework of traceability to protect over 100 food and agricultural items with unique geographic origins in Europe and in China from counterfeiting or misrepresentation. The GI agreement would enter into force at the start of next year if ratification proceeds according to schedule. China was the EU's third-largest market for agricultural exports last year.

China goods trade (exports, imports and trade balance) with EU, 2006–2020.



Sources: China Customs, Macrobond and BOFIT.

EU Chamber of Commerce in China worries about slowdown of opening up. This week, the European Union Chamber of Commerce in China (European Chamber) released a Position Paper 2020/21 that makes hundreds of recommendations on corrective measures for various branches in order to improve the operating environment in China. The recommendations focus on removing barriers to doing business and creating a level playing field for companies where nationality or ownership structure would play no role in how firms are treated.

The opening up of Chinese markets to international firms has slowed in recent years. The European Chamber asserts that European firms operating in China must deal with a two-tier system. The first tier is characterised by no-go parts of the economy that operate entirely under government guidance. In these branches, the role of state-owned firms is enhanced, and foreign investment in such areas as renewable energy or high-tech industry is actively discouraged. Companies operating on the second tier experience a fairly level playing field and find regulation is applied consistently to domestic and foreign firms alike. Here, opening up of access continues and European investment is welcomed. The automobile industry is cited as a model example of an industry in which European firms have been granted a foothold.

On the other hand, opening in some branches has been largely illusory. For example, the "opening up" of the financial sector has dragged on so long that domestic players have occupied the market and actual competition is impossible. Access to the few remaining potential market niches is blocked through complex licencing and approval processes. European banks estimate that the already nearly non-existent market share of foreign banks will continue to dwindle. The report notes that the words of Chinese officials diverge increasingly from practice. Doing business has become politicised, which makes it harder to anticipate or cope with the operating environment.

Coronavirus pandemic slows signings of Silk Road investment contracts. Chinese officials themselves estimate that about 20 % of Silk Road (a.k.a. Belt and Road Initiative or BRI) projects currently under construction have been hamstrung by the Covid-19 pandemic. Projects have had to be delayed, interrupted or scrubbed altogether. In addition, fewer new projects are being green-lighted. According to official figures from Ministry of Commerce, the value of new projects approved in the first seven months of this year was about 7 % less than in the same period a year earlier. Many questions dog the statistical reporting on BRI projects, however. Refinitiv, a global provider of financial data, news and analysis, says that new projects in the first quarter declined much faster than figures show. In the two years preceding the Covid-19 pandemic, Silk Road projects have had headwind as China's growth slowed, lending policies tightened and Silk Road projects faced criticism from all sides – at home, in borrower countries and in the West.

The BRI has provided project funding for certain poor countries otherwise unable to raise money from the markets due to their low creditworthiness. Refinitiv reports that since 2013 China has loaned roughly $280 billion to 44 countries with bad

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The information is compiled and edited from a variety of sources.
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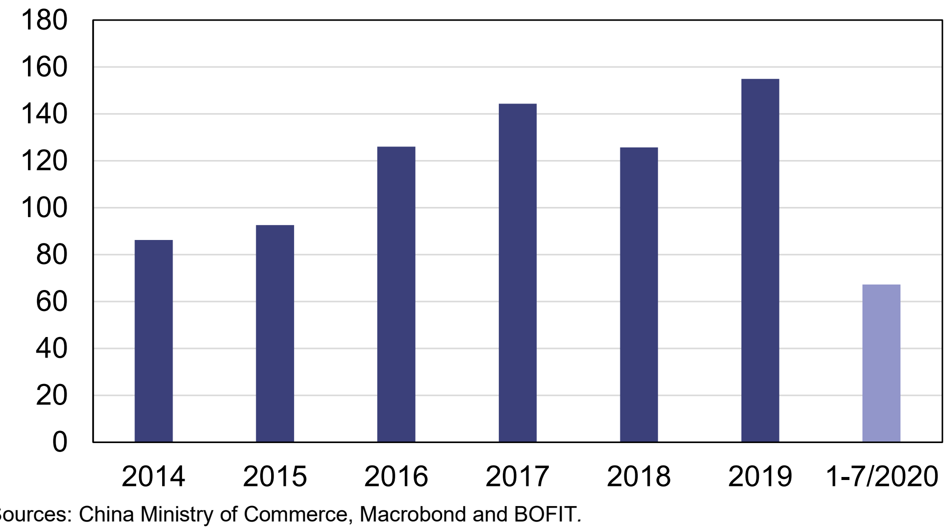
credit ratings, while it estimates that the total value of BRI project investments is about $1.9 trillion. While the project funding is generally welcomed by recipient countries, China is accused of "debt-trap diplomacy" with poor nations. Worries on the risks related to these loans have been expressed for years in both debtor countries and China, and some loans have already had to be restructured. Payment defaults this year have increased rapidly as the coronavirus pandemic has made debt-servicing challenging for many recipient countries. Most of the five-year loans granted during the 2015–2016 lending peak will come due this year or next year.

Within the context of a debt forgiveness programme for poor nations agreed among the G20 members, China included its own forgiveness effort for loans to poor countries. China's participation in the G20 joint operation is appreciated as China has traditionally sought to hold private bilateral talks with debtors. The earlier approach raised suspicions that China was holding debtors to stricter repayment rules than other G20 members.

China's state policy banks such as China Development Bank, the Export-Import Bank of China (Eximbank) and other large state-owned banks, as well as certain government ministries and the state-owned Silk Road Fund (for which the People's Bank of China provided the bulk of its initial capitalisation and oversees), have provided most financing for BRI projects. China's risks are heightened by the fact that most loans are granted in dollars. China has tried to promote international use of the yuan, but borrowers want dollars.

The independent research firm Rhodium Group says China will be able to maintain BRI lending roughly at current levels, but is unlikely to increase lending. Instead, China will attempt to diversify the lender base, including attracting financing from privately-held entities. China would also like to reduce the government's extensive involvement in project implementation. Refinitiv claims that over half of projects are spearheaded by government entities such as state-owned enterprises and that less than a third are led by private-sector entities. BRI projects are likely to be smaller in the future and more focused on emerging areas such as digitalisation, healthcare delivery and environmental remediation. There is also a push to make Silk Road projects more cost-effective. A study released by Chatham House last month rejects the view that China has a malevolently motivated BRI plan, but rather that many BRI projects are not only bad ideas at inception, but tend to be poorly planned, ineffectively implemented and hard to justify from an economic standpoint. In fairness, the authors argue that blame for these failures needs to be apportioned between China and recipient countries.

Value of new Belt & Road agreements as officially reported by China, USD billion.



Sources: China Ministry of Commerce, Macrobond and BOFIT.

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Russia

Latest BOFIT forecast sees Russian economy returning to modest growth next year. The coronavirus pandemic and turbulence in the global oil markets have battered the Russian economy this year. Preliminary data suggest GDP contracted by 8 % y-o-y in the second quarter. In recent months, however, the economy has begun to claw its way back. Recovery is now expected to continue for the rest of this year, albeit slower than the initial sharp rebound. Due to the sharp drop in output last spring, our latest BOFIT Forecast for Russia, which was released last week, sees GDP contracting by 4 % this year and growing by slightly over 2 % p.a. in the next two years. The possibility of weaker economic performance remains large, however, as there is still much uncertainty related to the outlook for covid-19 and the oil markets.

Private consumption in Russia shrank sharply due to strict measures to control the spread of the coronavirus pandemic, sharp drop in incomes and increased unemployment. Consumption has recovered briskly in latest months as covid-related restrictions have been lifted. Fixed investment has declined and new fixed investment is supressed by uncertainty over economic trends and a massive drop in corporate profits. Russia has resorted to public sector support to blunt the impacts from the covid shock. Public sector spending should increase sharply this year, but next year the supportive effect of public spending will fade.

Russia's foreign trade has experienced a substantial contraction this year. The export volumes of certain key products, however, started to increase already in the spring, thanks in part to rapid recovery of the Chinese economy. Russian imports have been hurt by weak demand and ruble depreciation. Both exports and imports are expected to show modest growth next year with reviving demand domestically and globally.

BOFIT expects a modest recovery to begin next year: realised and forecast (f) figures.

Change, %	2019	2020f	2021f	2022f
GDP	1.3	-4.0	2.4	2.2
Consumption	2.4	-4.4	2.9	2.5
Investment	1.5	-6.5	2.5	2.5
Exports	-2.3	-6.0	2.5	2.0
Imports	3.4	-10.0	4.0	3.0

Sources: Rosstat and BOFIT Forecast for Russia.

Recovery of Russian economy moderated in August. The recovery in consumption-driven branches began to fade slightly in August, while primary production supported the overall economy. Although the Russian economy has recovered somewhat from its spring lows, output in most branches remains well below pre-covid levels. Preliminary economy ministry estimate suggests that the 12-month change in Russian GDP was 4.3 % in August. For the first eight months of this year, GDP contracted by 3.6 % y-o-y.

After an initial rapid recovery, the resurgence in retail sales petered out in August, which, led by food trade, contracted 3 % y-o-y. Recovery slowed down also in trade of non-food goods and other branches of the service sector. Manufacturing output also weakened, dropping by 4 % y-o-y. Unemployment rose slightly, with the unemployment rate reaching 6.4 % in August.

Extractive industries, in contrast, finally began to recover in August. The shift largely reflects a slight easing in the severe cuts in oil production according to the lines agreed in the most recent OPEC+ agreement on production ceilings. Russian oil output last month was still 13 % below its August 2019 level, however. Besides extractive industry production, Russian economic growth has been supported by agriculture, which saw August output increase again by 4 % y-o-y.

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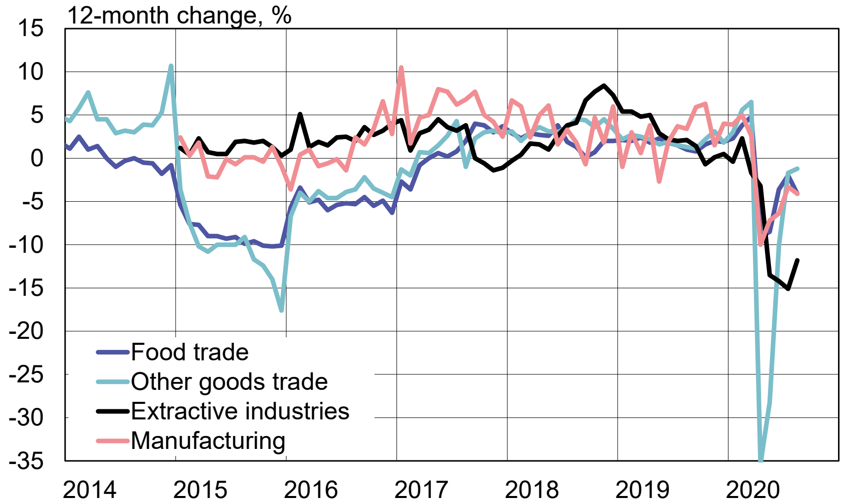
August witnessed a divergence in Russian trade and industry trends.



Sources: Rosstat, Macrobond and BOFIT.

Central Bank of Russia keeps its key rate unchanged; previews monetary policy guidelines for 2021–2023. At its scheduled meeting on September 18, the CBR decided to leave the key rate unchanged at 4.25 %. The CBR said the decision not to touch the key rate at this time largely reflected the recent higher than expected increase in consumer prices. 12-month inflation was running at 3.4 % in July, but had climbed to 3.7 % by mid-September. The CBR's annual inflation target is 4 %.

Over the short term, inflation has been increased by the recovery of the Russian economy with the gradual lifting of coronavirus restrictions (BOFIT Weekly 35/2020). Moreover, ruble's depreciation in recent months has caused prices to rise (BOFIT Weekly 37/2020). However, over the medium term there seen disinflationary risks as e.g. Russia's output is less than potential.

The CBR has lowered the key rate by a total of 275 basis points since last September. This is also reflected in market rates. The average rate on ruble-denominated corporate loans of over one year was 7.42 % in July, while loans to private individuals averaged 10.85 % (i.e. both were about 200 basis points lower than a year ago). In its forward guidance, the CBR did not rule out the possibility of a further rate cut at its next meetings. However, CBR governor Elvira Nabiullina noted that the monetary stance will remain accommodative next year, even if most monetary easing had already been implemented.

On September 10, the CBR released a draft version of its monetary policy guidelines for 2021–2023. The report sets out monetary policy goals, principles and methods that will steer CBR monetary policy for the next three years. Among the monetary policy principles – and similar to many central banks – are the public inflation target, a steering rate, transparent communication and forecast-based decision-making. The draft version has been submitted to the president and cabinet for comment. The final version of the report should be sent to the Duma at the end of this month.

The CBR's economic forecast for 2021–2023 has an updated format in the draft version. The central bank earlier prepared the forecast around assumptions related to trends in crude oil prices. Now the baseline scenario is augmented with three alternate scenarios (risk scenario, disinflationary scenario and pro-inflationary scenario) that mainly diverge in assuming on how well the Russian economy is expected to recover from the covid crisis. The view is underpinned by the fact that the Russian economy, due to the government's fiscal rule and a floating exchange rate, is today less dependent than earlier on crude oil prices. Another visible change in the draft version is the effort on the part of the CBR to expand its communication, particularly through e.g. publication of information and analyses on regional economic development and provision of more detailed information about its economic forecasts.

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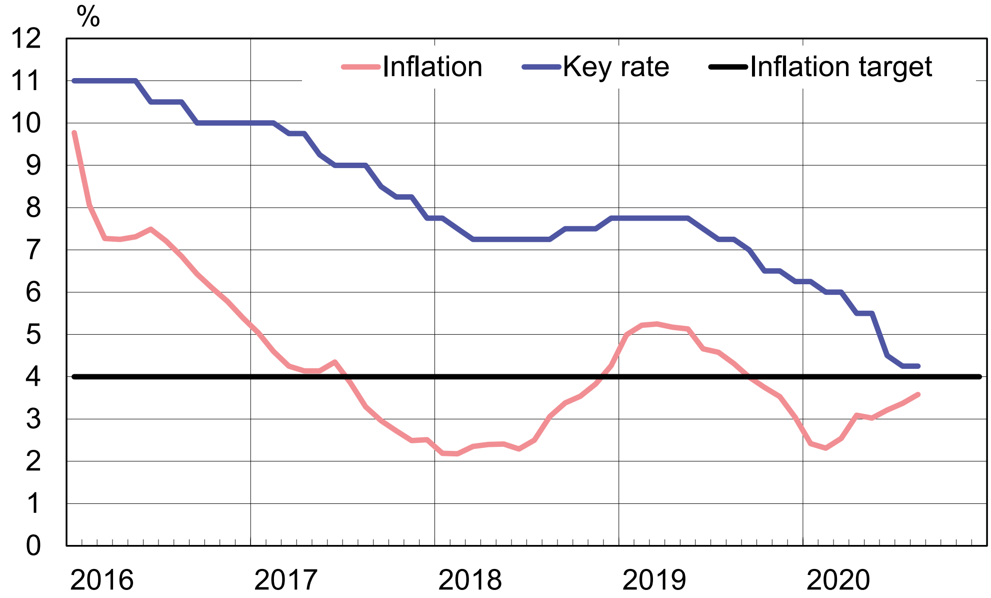
Russian key rate, consumer price inflation and inflation target.



Sources: Central Bank of Russia, Rosstat, Macrobond and BOFIT.

Covid-19 crisis has increased broad unemployment and part-time employment in Russia. Using the methodology of the International Labour Organization (ILO), Rosstat's latest survey of the labour force reminded that the numbers of 15 to 72-year-olds employed and unemployed have been shrinking since 2017. This year's economic recession and coronavirus restrictions have pressed the number of persons employed to a downslide almost as deep as seen during the 2009 slump.

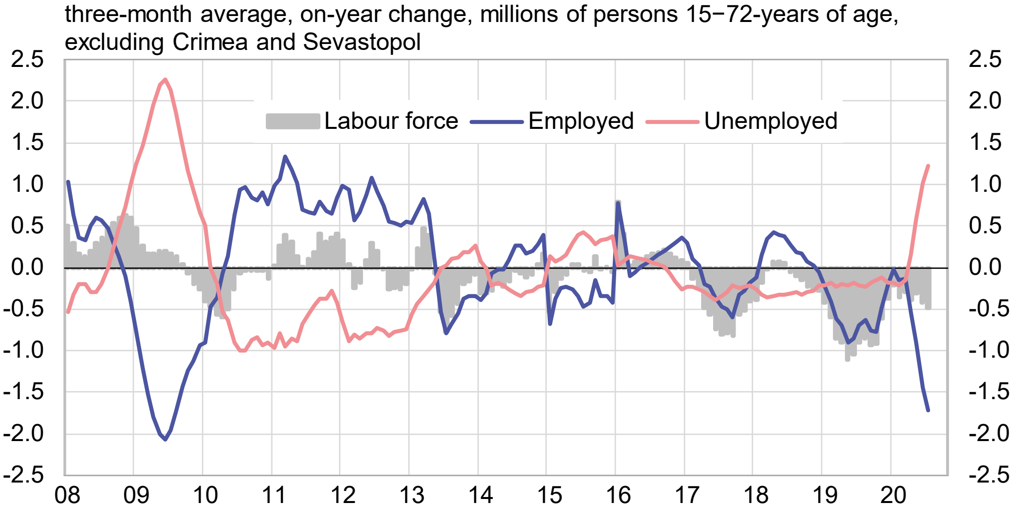
Unemployment increased rapidly in spring, and continued to rise slightly in summer. In July and August, slightly less than 6.5 % of the Russian workforce was officially unemployed, i.e. well above the historical low of less than 4.5 % about a year ago. With economic recovery, the economy ministry now expects the unemployment rate to subside and average 5.7 % for 2020 overall. The number of persons registering as unemployed with the employment offices has risen to a record two-thirds of the unemployed. Part of the surge reflects an increase in spring in the maximum unemployment benefit by one half, even if the maximum monthly compensation is still not higher than about 140 euros. Even if only slightly more than 30 % of unemployed people use the employment office services for job searches, the reliance on job searches at the offices has clearly increased.

The decline in employment is also reflected in groups that share similarities with the unemployed but are classified according to the labour survey criteria to be outside labour force. The number of such persons grew substantially last year and in the first half of this year. Persons ready for work but not seeking a job already earlier constituted a group equivalent to about 2 % of the workforce. That number rose to 2.5 % this summer. Rosstat includes this group as the overwhelming part in potential labour force. Using the ILO methodology, the broader unemployment rate including that potential was about 8.5 % this summer. In addition, the number of persons desiring to work but not ready to start working has been running around 3.5–4 % as a ratio to the labour force since last year.

The corona restrictions last spring fuelled layoffs and caused part-time work to soar. The labour survey found that over a fifth of workers was temporarily furloughed during April-May. The situation turned back in June towards normal levels of a couple of percent of workers. The share of persons with maximum 30-hour work weeks increased in the spring to about 7–8 %, up from the 5 % normal.

Lower employment has hurt real household incomes, which fell by about 8 % y-o-y in the second quarter. The percentage of the population earning less than the official subsistence minimum increased to 13.5 % of the total population in the second quarter, a roughly one percentage point increase from last year's readings.

The spring economic pothole caused sharp moves in the numbers of employed and unemployed persons.



Sources: Rosstat and BOFIT.

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China

China has lifted most restrictive measures to contain the spread of covid-19. China has reported around a dozen of new infections daily over recent weeks, all of which are said to have originated from abroad. No new covid-related deaths have been reported since May. Perhaps more significant than the official infection figures sign of low infection rates is the fact that China's has exceedingly relaxed the strict covid restriction measures put in place earlier this year.

Extensive testing and targeted measures to deal with local clusters of infection have allowed economic activity to return to near normal levels. Corona restrictions were imposed and are lifted depending on the local situation. The government remains ready to clamp down at the slightest sign of a local covid outbreak. Cities with infected person are classified as risk zones and subject to specific public health measures. Two weeks ago, for example, a lockdown was briefly imposed on a small city in Yunnan province to deal with a local outbreak.

More stringent measures to restrict the spread of the outbreak have either been significantly relaxed or eliminated altogether. Protective measures and restrictions on capacity restrictions are still in place, and citizens are required to use a corona-tracking app on their phones. Schools began to reopen in some provinces as early as March. At the start of the autumn semester, students across the country have returned to class. Cinemas, as well as some other attractions, were permitted to reopen in most parts of the country in July. In mid-September, theatre occupancy rates were increased to 75 % of capacity.

Domestic travel has largely returned to normal, with the number of domestic flights rising steadily. The number of passengers on domestic flights in August was just 16 % below the number a year ago. (The number of passengers on international flights, however was still down by 97 % in August). The epidemic has caused many to prefer their own private vehicles over public transport. September metro passenger volumes in China's largest cities, however, were already close to last year's level. The Golden Week national holiday (Oct. 1–7) is expected to revive domestic travel. Media reports suggest that trips will still be down by about a fifth from last year's Golden Week.

The biggest remaining restrictions apply to international travel. China cancelled practically all arrivals of foreigners at the end of March. The toughest restrictions have been relaxed in recent weeks. Since the end of September, foreign nationals with valid residence permits have been allowed to enter the country. Prior to that it was required to have a special visa to enter the country. Foreign tourism is still extremely limited as, among other things, all persons arriving from abroad must quarantine for 14 days. During this holiday week, China's foreign ministry has requested that all citizens refrain from taking trips abroad.

Covid-19 continues to spread quickly outside China. Many countries have imposed new lockdowns or other restrictions to deal with the pandemic. Oxford University's Covid-19 Government Response Stringency Index considers e.g. the impacts of school and workplace closing, as well as restrictions on movement and group gatherings. The index shows extensive relaxation in China in recent weeks.

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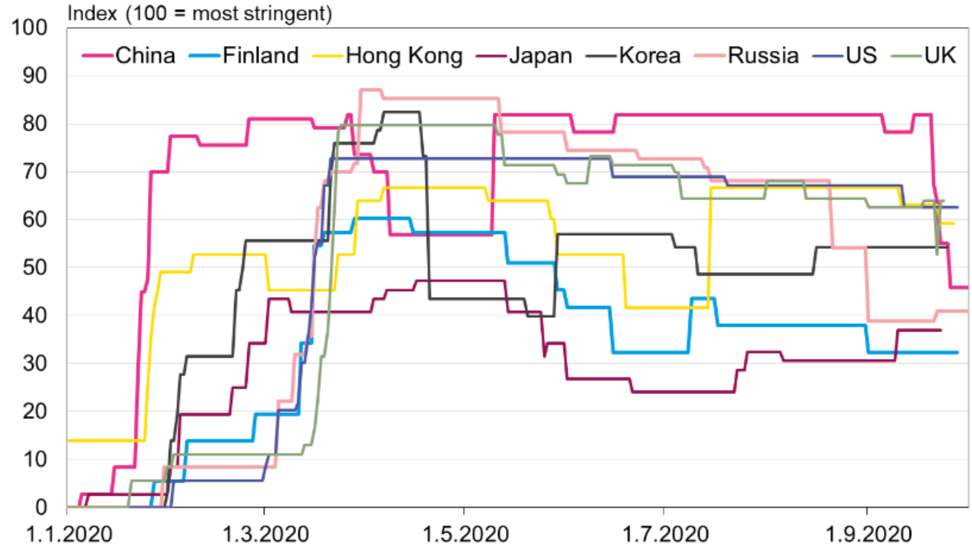
Stringency of government covid-19 responses in China and other select countries.



Scale: 0 (no measures) – 100 (most stringent).
Sources: Oxford COVID-19 Government Response Tracker (Stringency Index) and BOFIT.

Massive public spending on rescuing China's troubled banks. Policy measures adopted to deal with the coronavirus pandemic, debtor problems in servicing loans and banks bracing for a rise in non-performing loans (NPLs) reduced bank profits by about 25 % y-o-y in second quarter. Most bank earnings were generated through normal banking functions. The narrowing of the loan-deposit interest rate margin by about 10 basis points from last year to 2.1 % ate directly into bank profits. Although banking supervisors have warned in recent months of a significant NPL build-up, banks have reported only a slight increase in them. However, the actual amount of non-performing receivables is estimated substantially larger than what banks report. Banks expect difficult conditions to continue at least through the end of the year.

While China's largest banks seem to be in fairly good shape, the condition of small and mid-sized banks, many of which have grown quite rapidly, is troubling. Many of these banks has relied on funding from the interbank market and taken on too much risk in their lending. A number of small and mid-sized banks were already in trouble well before the coronavirus pandemic. In May 2019, officials took over the regional *Baoshang Bank*. The rescue operation took around a year and, according to the Caixin news agency, required 170 billion yuan (about 21 billion euros) in public assets. The deposit insurance fund, set up and operated by the PBoC, was the main source of funding for the operation. Baoshang was allowed to go bankrupt this summer after some parts of the bank were sold off to *Huishang Bank* in spring and the rest of Baoshang operations were transferred in May 2020 to the newly created *Mengshang Bank*. In August, the government had to use nearly 10 billion yuan from the deposit insurance fund to prop up Huishang Bank.

Several decisions, which had made last year to restore the health of certain troubled banks, were implemented this spring. *Hengfeng Bank* was recapitalised with a 100 billion yuan private placement to state and private investors. Of that, 60 billion yuan in shares went to Central Huijin Corporation, which is administered by the finance ministry. Another 36 billion yuan in shares went to the Shandong local government administration. The placement made Central Huijin the bank's largest owner with a 54 % stake. In spring, the Chengfang Huida Corporation, which is administered by the People's Bank of China, became the largest shareholder in *Bank of Jinzhou*, with a 5 billion yuan private placement. At the same time, Chengfang Huida used 45 billion yuan to clean up Jinzhou's balance sheet by acquiring the bank's loan portfolio with a nominal value of 150 billion yuan. Also this spring, the *Bank of Gansu* announced that it was strengthening its balance sheet with a private placement to several entities tied to local governments. The measures received approval from officials and the shareholders' meeting, but the actual placement has yet to take place. The ownership structure of *Bank of Harbin* was also revised last year so that major share of ownership was transferred to the local government.

In addition to the above mentioned bailouts, the government decided in July to earmark 200 billion yuan in financing for small and mid-sized banks from local governments to use special bonds issue this year. In total, at least 500 billion yuan (approximately 60 billion euros, the equivalent of 0.5 % of GDP) in public assets have been earmarked for or spent on bank bailouts. Additionally, some small banks have suffered deposit runs, but it is unknown whether the central government or local governments have had to rescue these banks. In addition, there suspicions that not all government support to banks have come to the public's attention. Financial entities other than banks have had to be bailed out as well.

Latest round of US export restrictions even affects the electronics industry outside China. In 2019, the United States prohibited American microchip manufacturers from supplying components or technology to Huawei or any of its subsidies on the assertion that Huawei posed a threat to national security. The restrictions were extended in August 2020 to ban the transfers of all US software, operating systems and related technology that might be used by foreign electronics companies anywhere in the world that could end up with Huawei or its subsidiaries. For example, the South Korean Samsung and LG decided in September to end deliveries of displays to Huawei. Media reports at the end of September claimed that the US was adding names to its entity list, including Chinese microchip maker SMIC. The US Department of Commerce has yet to officially confirm the addition.

In practice, the bans mean that US technology cannot be sold to firms on the entity list without special permission. Companies can seek an exemption from the export ban, and some exemptions have already been granted. Exemptions are decided on a case-by-case basis, however, which has created uncertainty about the rules for getting an exemption. The Peterson Institute for International Economics (PIIE) estimates that the restrictions could substantially reduce global demand for US electronics components. Chinese firms not on the entity list and foreign companies they do business with could shift their supply chains away from the US to assure continuity.

As part of anti-Chinese technology bans, the US government is seeking to forbid use of the social media apps TikTok and WeChat in the US. TikTok, through complex ownership arrangements with the US-based software giant Oracle and retail behemoth Walmart, has sought to avoid the ban, but the outcome is still unsure. A California court issued an injunction in late September that delays the justice department's imposition of a WeChat ban in the US. The commerce department's order to remove the app from app stores also has yet to be implemented. China has responded with new restrictive measures by announcing that it will establish its own entity list of suspect firms to be excluded from the Chinese market. There has been no lack of speculation as to which firms might end up on the list, but no names have yet been released.

American electronics components this year have been the sole category in which trade between China and US has met the target established under the phase one bilateral trade agreement. Total Chinese imports from the US, however, still dramatically lag the targets agreed in February as part of the phase one trade deal. The value of US imports to China in 2020 as of end-August was just 56 billion dollars. China is committed under the trade agreement to boost its imports from the US by 64 billion dollars (based on 2017 trade flows) to 173 billion dollars this year. It is likely that imports this year will come nowhere near the target levels. The US-China phase one tracker maintained by PIIE shows that China has most severely missed its agreed targets in the energy sphere. As of end-August, China had only imported from the US energy products worth 3.5 billion dollars. This year's goal is 25 billion dollars. Agricultural products at end-August had reached 11 billion dollars, when this year's target is just under 37 billion dollars.

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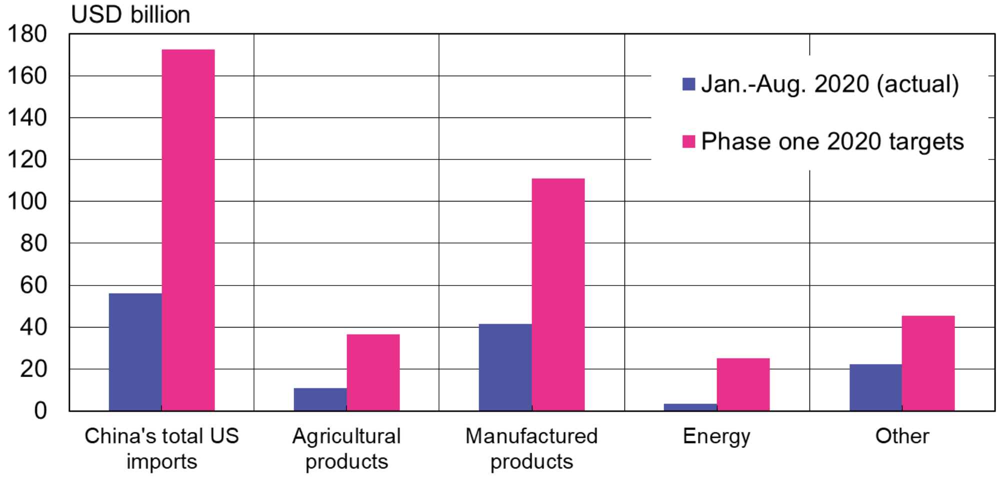
China's US imports in January-August lagged far behind the targets set in the phase one trade agreement.



Sources: PIIE and BOFIT.

Foreign firms operating in China more cautious than earlier about their investment plans. During late August and early September, the American Chamber of Commerce in South China conducted a survey of 178 firms operating in the region. Nearly 40 % of American firms said that they expected to reduce capital investment in the second half of this year, while nearly 20 % expected to increase investment. In June and July, the American Chamber of Commerce in Shanghai conducted its own survey of 346 US firms operating in China. AmCham Shanghai reports that the number of companies planning it increase investment in China has dropped significantly from a year ago. Firms would like to disperse production and suppliers to reduce the risk of damage from any further escalation of the US-China trade war. This trend was reinforced by the covid-19 epidemic, which has exposed major structural problems in concentrating supply chains too much in one country. Nevertheless, over 90 % of companies responding to the survey said that they would like to remain in China. Only very few said that they were ready to completely abandon China. Similar trends are also found in surveys of European firms operating in China.

Both Japan and South Korea have actively sought to encourage their companies to leave China. Japan is supporting such companies with a 2.3 billion dollar package to cover the costs of reform of production chains and repatriating production from China to Japan or moving production elsewhere is Southeast Asia. These measures are a response to the sudden breakdown of international production chains last spring. The Japanese Chamber of Commerce and Industry in China surveyed 942 Japanese firms operating in China during late June and early July. The survey found that Japanese firms were concerned about being swept up in US-China trade and technology disputes. Uncertainty facing Japanese firms was further accentuated by e.g. China's new list of "unreliable" firms. The lack of transparency has also made firms cautious.

South Korea is encouraging its firms to repatriate from China as a way of supporting the domestic economy and promoting recovery from the covid-19 crisis. Returning firms receive tax breaks, subsidies, as well as funding for R&D and product development, especially in fields that benefit from increased factory automation based on robots and artificial intelligence. However, Financial Times reports that a survey by KBIZ, an organisation representing the interests of small and medium-sized Korean companies, found that Korean firms were generally unwilling to abandon China. The survey, based on responses from 200 firms operating in China and Vietnam, found that just 8 % of firms wanted to move their operations back to South Korea. Last year, foreign direct investment outflows from South Korea were nearly five times larger than FDI inflows to South Korea. Not even US and Chinese protectionist measures could intimidate South Korean firms into pulling out of China. Firms explained that their desire to remain in China reflected such factors as lower wage levels and China's vast market. Companies were reluctant to sacrifice such potential for a few tax breaks.

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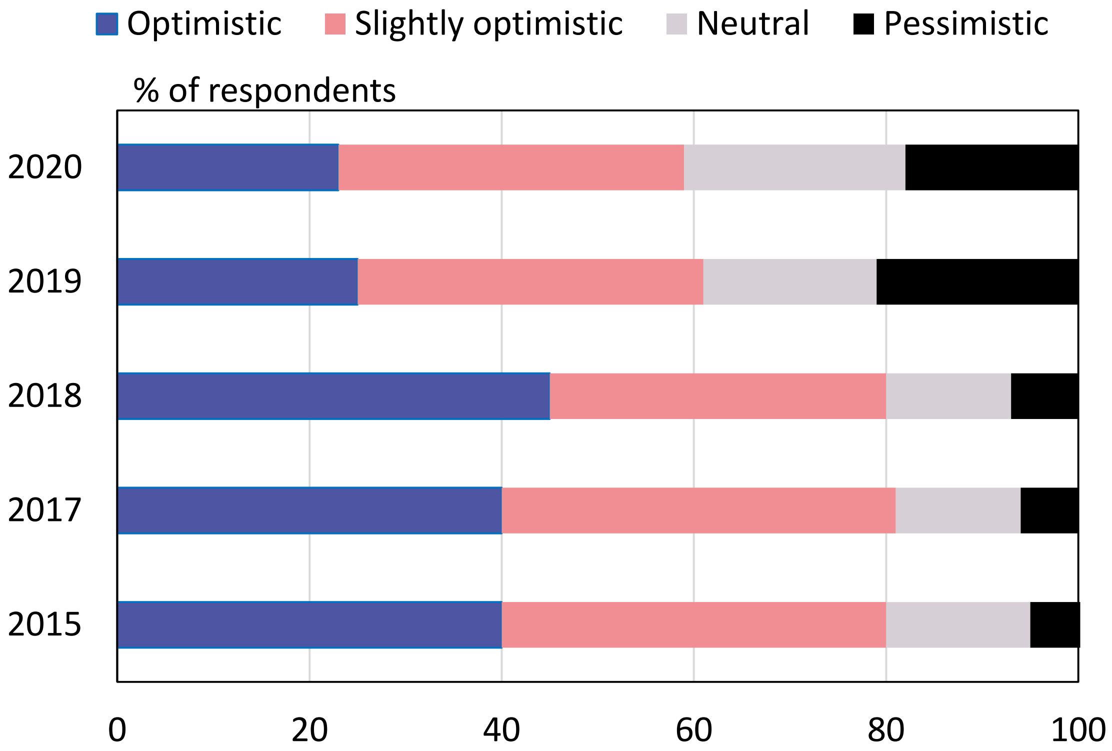
The majority of American firms operating in the Shanghai environment remain optimistic or mildly optimistic about their business development over the next five years.



Sources: AmCham Shanghai and BOFIT.

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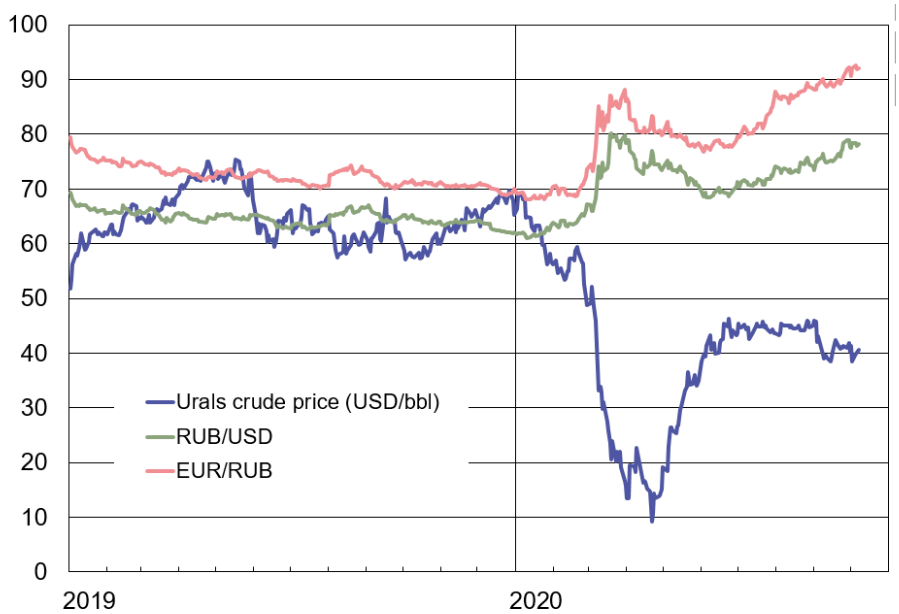
Russia

Rising uncertainty drove ruble depreciation in September. Although the world market price of crude oil remained relatively stable this summer, the prevailing uncertainty surrounding emerging economies placed pressure on the external value of the ruble (BOFIT Weekly 37/2020). Last month, the ruble's exchange rate came under additional pressure from declining crude oil prices and numerous geopolitical concerns. The unrest in Belarus and the poisoning of opposition leader Alexei Navalny increased the likelihood of new sanctions against Russian entities or persons. The thawing of the frozen Nagorno-Karabakh conflict between Armenia and Azerbaijan and recent unrest in the wake of the Kyrgyzstan presidential election have further increased uncertainty throughout the region, threatening Russia's economic prospects. All this comes before the US election next month, as well as the upcoming Tajikistan and Moldova presidential elections and Georgia's parliamentary elections.

At the end of September, the ruble-dollar exchange rate weakened to nearly 80 and the ruble-euro rate to a record level over 90. To ease the depreciation pressure, the CBR announced on September 29 that it would sell 185 billion rubles worth of foreign currency between October and December. The forex operation is related to the CBR's sale of its majority stake in Sberbank to government in April. In addition, several state-owned enterprises such as diamond giant Alrosa and oil major Rosneft have apparently been instructed by the government to reduce their forex positions to October 2018 levels. The government last ordered SOEs to sell currency to prop up the ruble in late 2014. Following the announcements, the ruble-dollar rate has remained relatively steady in recent days.

The ruble has lost even more value against the euro than the US dollar this year (rising trend = depreciation).



Sources: Central Bank of Russia, Reuters and BOFIT.

Covid-19 subdues private consumption in Russia. Although Russian GDP still grew by 1.6 % y-o-y in the first quarter of this year, it contracted by 8.0 % in the second quarter as the coronavirus epidemic and restrictions sharply depressed domestic demand. Private consumption fell by a whopping 22 % y-o-y and fixed investment was down by 12 %.

Russian GDP (seasonally adjusted) contracted by 3.2 % q-o-q in the second quarter. Notably, Russian GDP dropped by only 4.1 % during the first half of this year – a remarkably moderate hit relative to most economies. No European country experienced such a small drop in GDP in the first half of this year. Finland and Lithuania, among Europe's least impacted economies from the covid pandemic, still saw GDP contractions of more than 5 % in the first half. The Russian economy has a favourable structure in this respect. Small services providers and tourism play a less significant role than in most countries. The current drop in Russian GDP was also smaller than during the 2009 crisis.

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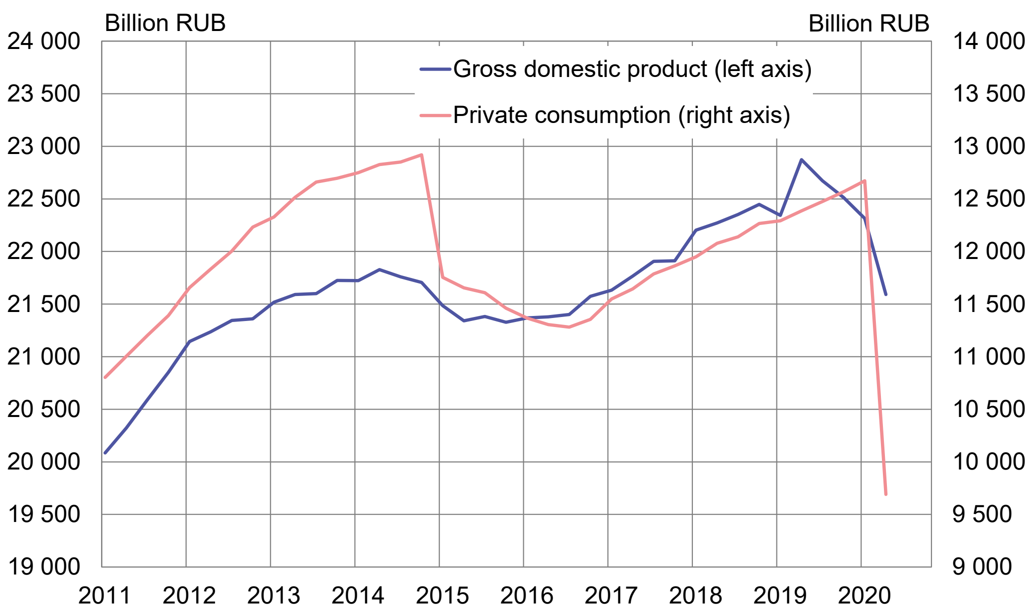
Russian GDP growth was largely supported in the second quarter by a collapse in imports, i.e. net exports increased. Seasonally-adjusted GDP, in contrast, has contracted continuously since the second quarter of 2019. In other words, the Russian economy had gone flaccid well before the coronavirus epidemic struck.

The purchasing manager index (PMI) reading for September suggests an uneven economic recovery. While the September PMI reading for manufacturing was 48.9, a decline into pessimistic sentiment from August, the PMI services reading was still above the 50-point threshold (i.e. positive), with a September reading of 53.7 (even though clearly below 58.2 in August). The low rise in prices of services in September at 2.5 % y-o-y also refers to weak demand.

The coronavirus epidemic caused private consumption in Russia to plummet to levels not seen in over a decade (seasonally-adjusted GDP in billions of 2016 rubles).



Sources: Rosstat and BOFIT.

Russia to rein in government budget spending in coming years to deal with deficit. The finance ministry just released its government sector finances framework for 2021–2023. The plan covers the entire consolidated budget (federal, regional and municipal budgets, plus the budgets for the state's three social funds). At the end of September, the cabinet submitted to the Duma its suggestions for the federal budget and social fund budgets.

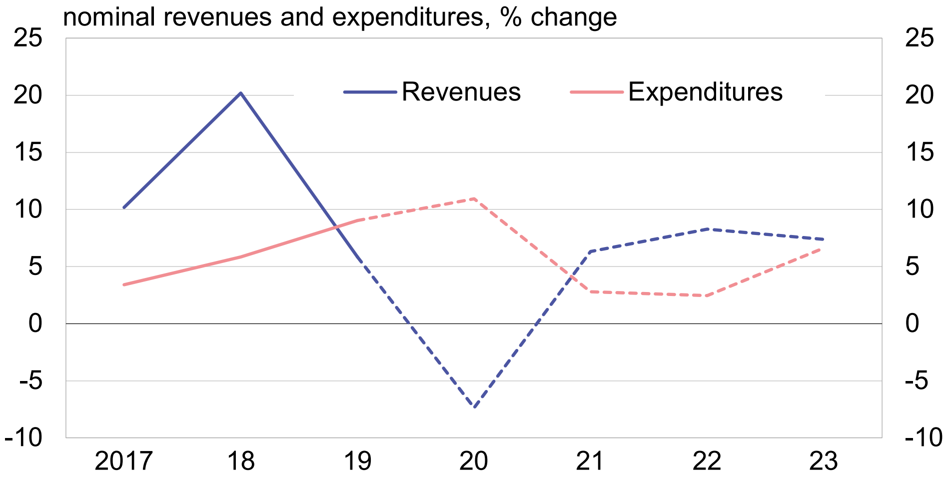
The framework sees nominal government sector revenues contracting by more than 7 % this year. The revenue drop would have been even larger (about 10 %) without the CBR's one-time payment from the sale of its majority stake in Sberbank to the government. Tax revenues from oil & gas tax revenues are expected to fall by a third, while, thanks to the Sberbank infusion, other revenue streams should remain largely unchanged. Spending is expected to rise by more than 10 %, even with growth expected to ebb in the final months of this year. On the other hand, the government has prepared for a possible greater rise in spending. In a rare move, a large sum from the state coffers is marked for a possible shift to a separate government fund that would allow the government to target expenditures quickly, especially when it involves supporting parts of the economy or fighting the coronavirus. The government sector surplus in 2019, which corresponded to nearly 2 % of GDP, has turned this year to deficit, which is foreseen to reach about 4.5 % of GDP if the government refrains from the special dipping into its separate fund.

The Russian economy is forecast to recover next year to 3.3 % growth, and that pace is expected to remain almost the same in following years. The export price of Urals crude is assumed to rise from this year and remain at a level of around $45–47 a barrel. Oil & gas production and exports are also expected to increase. As a result, revenues from oil & gas taxes would rise by more than 15 % per year during 2021–2022. Other budget revenues are anticipated to increase at about 7 % a year. VAT revenues, the government sector's biggest revenue stream (nearly a fifth of total revenues) should continue to rise at a brisk pace reminding of previous years.

The government hopes to bring down growth in nominal public sector expenditures during 2021–2022 to a couple of per cent a year, i.e. below the forecast inflation rate of slightly less than 4 %. With increased revenues and spending in check, the deficit should fall to 3 % of GDP in 2021 and below 1.5 % of GDP in 2022. Government sector wage increases will be frozen next year, and increases will only keep pace with inflation in the following two years. Under a decision from 2018, pensioners who do not work will receive an increase in their pensions of about 6 % a year. For the functional sectors, the target for next year is to lower the growth in spending in the healthcare and social support categories to very low paces. After rising last year and this year, defence spending is set to decline. Spending on the various branches of the economy, as well as domestic security and law enforcement, is to increase by around 5 % next year. The education category, which was in the shadow of other sectors this year, will also get a 5 % rise next year.

This year's expanding deficit will be financed almost entirely by issuing domestic debt. Starting next year, the government plans to take on even more debt than the deficit, mainly because oil & gas tax revenues will accordance with the fiscal rule anew begin to flow aside for further transfer to the National Welfare Fund (NWF). Government debt will continue to rise, but the ratio of government debt to GDP is expected to rise no higher than to about 21.5 % by the end of 2023. The ratio of NWF total assets to GDP is expected to remain rather steady during 2021–2023 at about 10–11 %. NWF liquid assets are scheduled to stay at about 7 % of GDP.

Russia plans to curb growth in government sector budget spending over the next two years.



Sources: Russian Ministry of Finance and BOFIT.

Russia to impose bans on raw wood exports. At the end of September, president Vladimir Putin stated that raw wood exports of softwoods (conifers) and valuable hardwoods (oak, birch and ash) should be banned. The ban is set to go into effect at the start of 2022, but details have yet to be released. The goal of the export ban is to reduce illegal logging and grey-market wood sales. Putin blames this illicit activity for Russia's large loss of market share in the global wood trade. The ban also seeks to increase the value-added in Russia's domestic forest industry production.

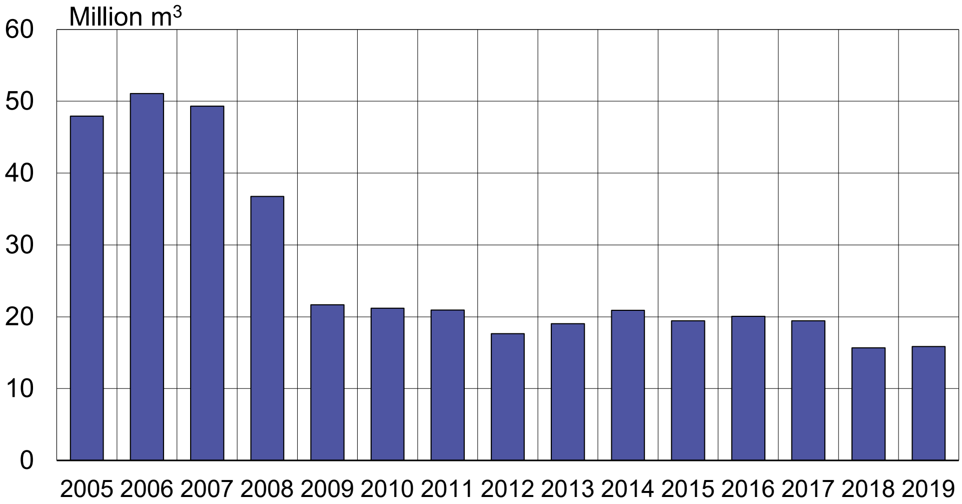
Russia has long strived for these goals by restricting raw wood exports. Raw wood exports were put under tariffs already in 2005 and the tariffs were hiked incrementally in 2007 and 2008. At that time, Russia already considered raising tariffs so high as to make exports unprofitable. When Russia became a member of the WTO in 2012, certain export tariffs on raw wood were lowered. However, quantitative quotas were imposed on softwood exports and the tariffs on exports outside the quota were not bind in the WTO agreement. Exports outside the quotas have experienced sharp increases in export tariffs in recent years. A partial or total ban on raw wood exports has also been discussed on several occasions in Russia in recent years.

In the peak years of 2005 to 2007, Russia exported about 50 million m^3 of raw wood a year. In 2008–2009, exports fell by about half. Thereafter, exports settled at around 20 million m^3 a year. In recent years, however, exports have begun to decline further. The value of raw wood exports in 2019 was $1.1 billion or 0.3 % of Russian goods exports. Of that, about 75 % was softwood and hardwoods set to fall under the ban. While raw wood exports have fallen, exports of sawn wood have grown. Most of these exports consist, however, of lumber that has only been marginally processed to avoid the export tariffs.

Russia's biggest raw wood export markets are China and Finland. China accounted for 71 % of Russian raw wood exports last year, while Finland had a 21 % share. The structure of raw wood exports to China and Finland are quite different. About 80 % of exports to China consist of softwood, while birch accounts for 70 % of exports to Finland. As a result, the ban on softwood exports seems to concern mainly raw wood exports to China. Most illegal logging in Russia is thought to occur in Siberia or the Far East near the Chinese border.

Russia is a major supplier of raw wood for both China and Finland, but its importance has declined. In 2005–2007, Russia still accounted for nearly 70 % of the volume of China's raw wood imports. In recent years, that share has dropped to around 20 %. Russia today is China's second-most important raw wood supplier. Russia is still by far Finland's largest supplier of raw wood, with a roughly 70 % share. However, the significance of Russian imports to Finland's forest industry has fallen over the past decade. In 2005–2006, it accounted for 20 % of the roundwood and fibrewood inputs for Finland's forest industry. In recent years, that share has dropped to 7–8 %. As Finland mainly imports birch from Russia, the export ban should have a significantly smaller impact.

Russian raw wood exports have been declining.



Sources: Comtrade, Russian Customs and BOFIT.

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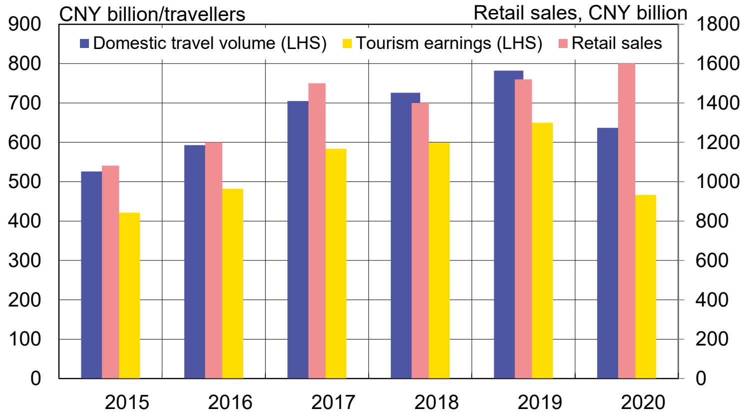
China

Sales of consumer goods during China's Golden Week holiday beat 2019 numbers. China's Golden Week autumn holiday (Oct. 1–8) kicked off with National Day on October 1. For two decades now, the festivities have extended for 7 or 8 days. Golden Week is particularly important to retailers and the service sector as Chinese typically travel to destinations elsewhere in the country to celebrate.

The retail story is important because much of the recovery in China since the first wave of the coronavirus epidemic has been driven by manufacturing, exports and infrastructure investment. Recent monthly data show that retail sales still shrank by roughly 1 % y-o-y in August. The Golden Week retail sales number released by China's commerce ministry suggests modest growth in consumption. Sales of consumer goods during Golden Week grew to 1.6 trillion yuan (over 200 billion euros), a roughly 5 % nominal increase from 2019 Golden Week. Part of the reason for higher domestic consumption this year is the fact that foreign travel was not an option.

Even domestic travel this year was lower than in 2019. During Golden Week, just under 640 million Chinese journeyed somewhere in China. Last year, the number of domestic travellers was about a fifth higher at just over 780 million. Earnings on this autumn travel season were also lower than last year. Golden Week earnings related to domestic tourism last year amounted to 650 billion yuan (80 billion euros). This year's figure was about a third lower, just 470 billion yuan.

Domestic journeys, tourism earnings and retail sales during the Golden Week holidays, 2015–2020.



Sources: China Ministry of Commerce, China Ministry of Culture and Tourism, CEIC and BOFIT.

Yuan strengthens against the dollar; yields attract portfolio investment to mainland China. Since the conclusion of the week-long national holiday on October 8, the yuan has gained over 1 % against the euro and the dollar. On Friday (Oct. 16), one dollar bought 6.72 yuan. In August, the exchange rate was about 7. Since the end of last year, the yuan has appreciated roughly 3 % against the dollar and lost about 1 % against the euro. Much of the gain against the dollar reflects dollar weakness (the DXY dollar index has declined by 3 % since the end of 2019).

The People's Bank of China reacted to the last week's yuan appreciation by lowering the reserve ratio for forward foreign exchange sales to zero as of October 12. The elimination of the FX forward trading reserve requirement decreases the cost of yuan sales and therefore should decrease appreciation pressures on the yuan. The FX forward reserve requirement was set at 20 % in August 2018 to deal with depreciation pressure on the yuan (BOFIT Weekly 31/2018).

Since late-spring, interest rates have largely returned to pre-corona levels, which makes them clearly higher than current rates in the US or other advanced economies. For example, the yield on China's one-year government bond is currently 2.7 %, compared to just 0.1 % on a US one-year treasury bill. Chinese stock markets have also generally outperformed the rest of the world. Share prices on mainland China's CSI 300 are up by 17 % from the start of the year as of Thursday (Oct. 15). The American S&P 500, in contrast, was up by 8 %, the MSCI EM by 1 % and the world average (FTSE All World) about 2 %.

Foreign ownership on the Chinese bond market has risen by 34 % this year (120 billion dollars), bringing the value of total holdings at the end of September to 2.94 trillion yuan (430 billion dollars). That share, however, is still less than 3 % of the market. Since 2017, foreign investors have been able to participate in mainland China's interbank bond market via the Bond Connect with Hong Kong (BOFIT Weekly 27/2017). Bond Connect trading volume in January-September was more than double compared to the same time last year.

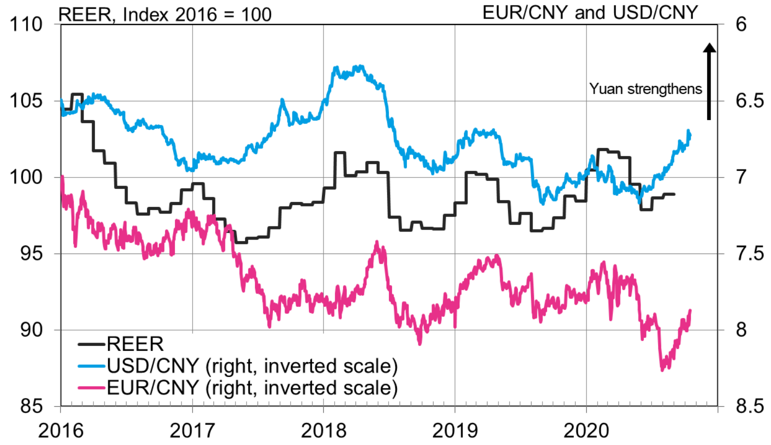
At the end of September, index provider FTSE Russell announced that it was including government bonds issued in mainland China in its World Government Bond Index. The decision should be confirmed next spring and enter into force in

October 2021. Analysts estimate the index update to bring in over 100 billion dollars in foreign investment to mainland China. Bloomberg Barclays added mainland China bond issues to its bond index in April 2019. J.P. Morgan followed this year by taking Chinese government bonds into its Emerging Markets Bond Index in February.

The inclusion of mainland Chinese shares in international indexes has also brought foreign assets to Chinese stock exchanges. FTSE Russell concluded the first phases of index expansion this summer. Mainland China A-shares are now included with a 25 % market-value weighting, and correspond to about 6 % of the FTSE Emerging Market Index and 0.7 % of the FTSE Global All Cap Index. The MSCI and S&P Dow Jones have also included A-shares in their indexes in recent years.

Trading by foreign investors on mainland China stock exchanges via the Stock Connect arrangement with the Hong Kong stock exchange has increased, and currently already accounts for about a tenth of the trading volume on the Shanghai and Shenzhen exchanges. The holdings of foreign investors via the Stock Connect programmes has increased slightly this year (by around 130 billion yuan or 19 billion dollars). About 4 % of stock market capitalisation in mainland China are held by foreign entities. While efforts have been made through market reforms in recent years to increase the trading possibilities of foreign investors in mainland Chinese equities and debt securities via different programmes, the possibilities for Chinese investors to invest abroad remain quite limited.

Yuan gained against the dollar this year, while the trade-weighted exchange rate (REER) in August was similar to end-2019.



Sources: BIS, Macrobond and BOFIT.

Latest forecast revisions see China as sole driver of global growth this year. The revised autumn forecasts of the OECD, World Bank, Asian Development Bank (ADB) and IMF all agree that Chinese GDP will grow by about 2 % this year even with an over 4 % decline in global GDP. Indeed, China is the only G20 country expected to see positive growth this year.

Just a few months ago, the prospects on the Chinese recovery were still uncertain. The OECD, for example, still expected in June that Chinese GDP would contract this year. The second-quarter data, however, suggested that the country dealt with the coronavirus better than most expected. While covid-19 spread globally, China could already start to lift restrictions and reopen its production facilities. Exports in recent months have been surprisingly strong and fixed investment has added to the corona stimulus. Nevertheless, the World Bank warns that the allocation of the stimulus is short-sighted which can weaken the country's economic prospects over the longer term. In particular, the government's overemphasis on stimulus measures focused on fixed investment rather than consumption are likely to delay structural reforms needed to shift the Chinese economy away from its industrial-based model to a more services-oriented paradigm.

The IMF has raised its economic forecast for China this year to nearly 2 % (up from 1 % growth in its June forecast). The outlook for next year still calls for robust growth of 8 % p.a., a figure well in line with other major forecasting institutions. In the coming years, the IMF sees China's growth to slow only very little, and expects the growth to normalise at around 5.5 % p.a. in 2025. As in most countries, conditions in China's public sector finances are likely to deteriorate sharply this year.

Both the OECD and IMF stress that their forecasts are subject to an exceptionally large number of uncertainty factors. How the coronavirus pandemic develops, the timelines for development and rollouts of various vaccines, and the introduction of new therapeutics and treatments are all determinative of how quickly and how completely the service sector returns to normal and how well consumer and corporate confidence returns. The consistent application of stimulus and the financial sector's ability to withstand strains from the coronavirus crisis are also determinative of how the economy performs.

The outlook for most other emerging economies is still weak. In many of them, income from tourism is important. Disruption of the tourism business damages the economy. Many emerging economies also rely on transfers from abroad, e.g. their citizens working abroad sending payments home to family members. India saw the biggest adjustment in the IMF's outlook for emerging economies. India's GDP is expected to contract by over 10 % this year. This June, the forecast was

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just -4.5 %. India, which is among the countries hit hardest by the pandemic, is still struggling to get covid-19 under control. Even so, India's economy is expected to bounce back rather briskly. While current forecasts for Russia and Brazil have been modified to show smaller contractions in GDP this year, the growth prospects for both countries next year have also been lowered.

China's growth forecasts this year diverge considerably from the outlooks of other emerging economies.

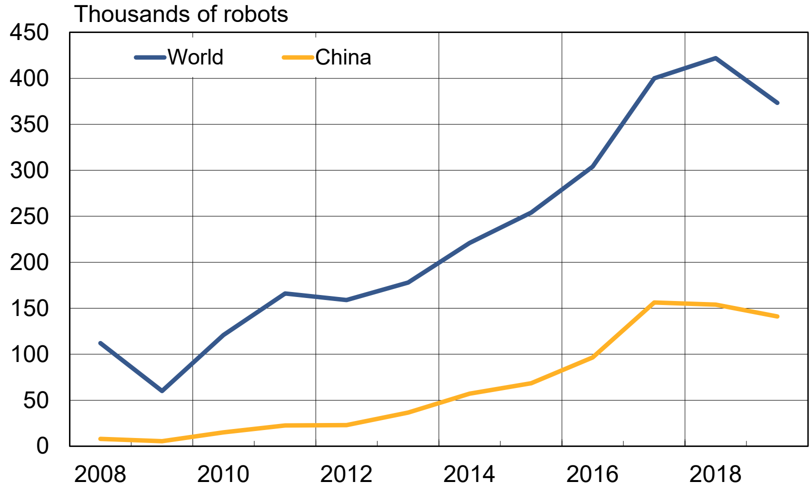
		2019	2020	2021	2025
China	ADB (Sept.)		1.8	7.7	
	OECD (Sept.)	6.1	1.8	8.0	
	World Bank (Oct.)		2.0	7.9	
	IMF (Oct.)	6.1	1.9	8.2	5.5
Russia	ADB (Sept.)				
	OECD (Sept.)	1.4	-7.3	5.0	
	World Bank (Oct.)				
	IMF (Oct.)	1.3	-4.1	2.8	1.8
India	ADB (Sept.)		-9.0	8.0	
	OECD (Sept.)	4.2	-10.2	10.7	
	World Bank (Oct.)				
	IMF (Oct.)	4.2	-10.3	8.8	7.2
Brazil	ADB (Sept.)				
	OECD (Sept.)	1.1	-6.5	3.6	
	World Bank (Oct.)				
	IMF (Oct.)	1.1	-5.8	2.8	2.2
Indonesia	ADB (Sept.)		-1.0	5.3	
	OECD (Sept.)	5.0	-3.3	5.3	
	World Bank (Oct.)		-1.6	4.4	
	IMF (Oct.)	5.0	-1.5	6.1	5.1
World	ADB (Sept.)				
	OECD (Sept.)	2.6	-4.5	5.0	
	World Bank (Oct.)				
	IMF (Oct.)	2.8	-4.4	5.2	3.5

China continued last year to lead in installed new industrial robots. The International Federation of Robotics (IFR) reports that 370,000 industrial robots were installed globally last year. Of that, 140,000 new robots were sited in China. China has accounted for about 40 % of new robot installations for several years now. The IFR says that the installed base of industrial robots in China last year was close to 800,000, or roughly 30 % of the global installed base.

The world's other leading robot markets are Japan, South Korea, Germany and the United States. These five nations together accounted for over 70 % of all robot installations globally last year. The biggest application branches for industrial robots, car and electronics manufacturing, account for over half of all robot demand. Fewer robots were installed last year than in 2018, however. The IFR estimates that the number of new robot installations is likely to decline further this year, largely due to the coronavirus epidemic.

Robotic automation of production in China has been spurred by rising labour costs that have made the shift to robots economically attractive. Chinese industrial policy supports this trend. Robotics is one of the initiatives in the *Made in China 2025* industrial programme. Beyond construction and development of robots, some regions have even offered subsidies to help firms acquire robots.

China has been the world's most active country in recent years when it comes to adding industrial robots.



Sources: International Federation of Robotics and BOFIT.

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Russia

Russia's economic recovery slowed in September. The service sector and primary production were still propping up the Russian economy. Other core sectors showed signs of slowing in September. Preliminary estimates from Russia's economy ministry suggest that Russian GDP contracted by 3.8 % in the third quarter. For the first nine months of the year, the decline was 3.5 % y-o-y.

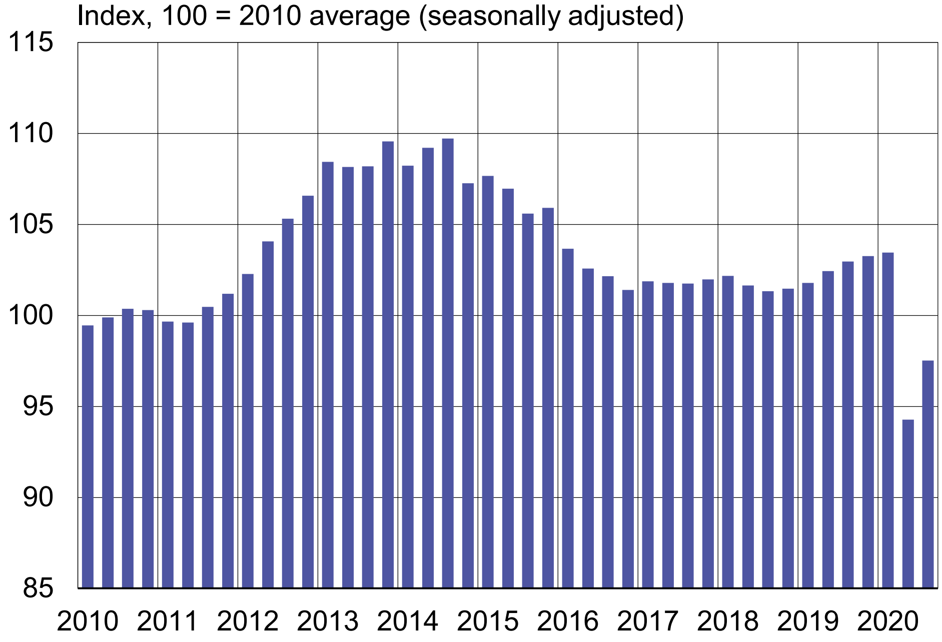
Looking at consumption-driven indicators, September retail sales stagnated and were still off by 3 % y-o-y. The exception was new car sales, which increased by 3 % y-o-y. Other service sector branches continued to recover, albeit at a slower pace than in previous months. Services output in September was still down by 12 % y-o-y.

The recovery in industrial output halted in September, dragged by manufacturing. In the mineral extraction branch, which includes oil & gas production, recovery continued at a more subdued pace than up to now. However, the figures for industrial output were revised significantly upward in September for both his year and last year. According to the revised numbers, industrial output contracted by just 3 % y-o-y in the first nine months of 2020, or nearly two percentage points less than previously estimated. In particular, production of machinery, equipment & transport vehicles declined less than recorded in the earlier estimate. This large revision can slightly raise GDP for the first half of the year.

Agricultural output continued to rise in September as it had for all of this year, although more slowly at 1 % y-o-y. Construction output still remained at the same level as a year earlier. In recent months, the engine in construction activity has shifted to residential housing, which, after a sharp drop in the spring, grew by 6 % y-o-y in the third quarter.

Labour market developments were varied. Unemployment went into a slight decline in September, bringing the unemployment rate to 6.3 %. In contrast, growth in real wages stagnated already in August, the last month for which figures are available. Real disposable household incomes fell by 5 % y-o-y in the third quarter. The income figures were also revised in September slightly downwards for this year so far. The purchasing power of Russian households even today is still lower than it was a decade ago.

Real disposable incomes of Russian households fell dramatically this year.



Sources: Rosstat, CEIC and BOFIT.

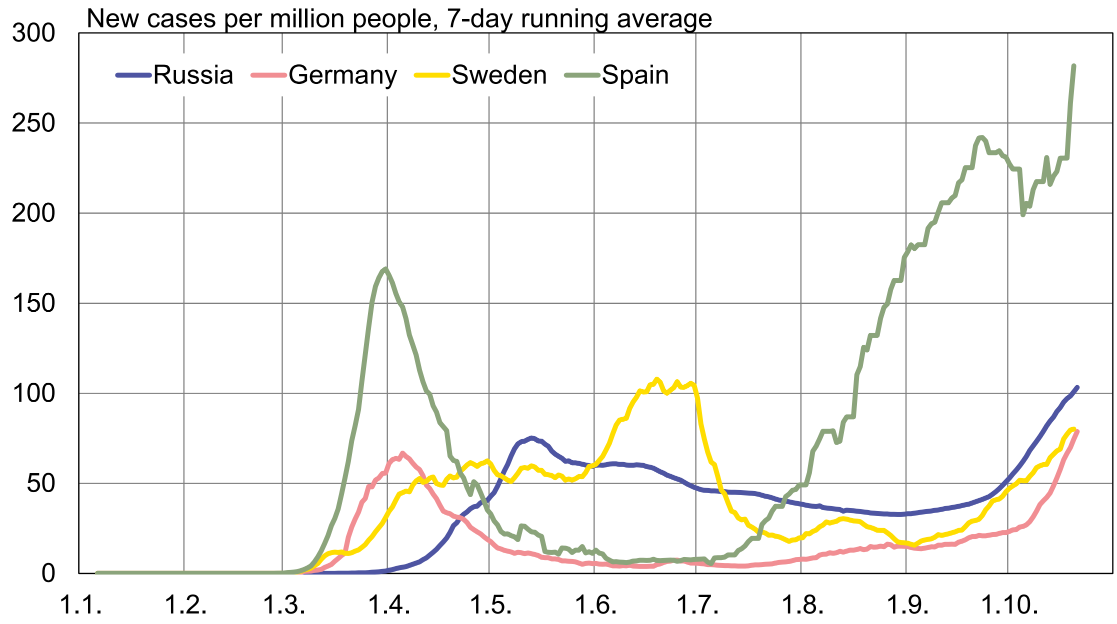
Even confirmed coronavirus infections soar in Russia, officials remain cautious about imposing new restrictive measures. The number of new confirmed covid-19 infections in Russia has risen clearly since early September. Yesterday, the daily recorded number of new cases exceeded 17,000, while during the first wave of infection in April-May, the number of confirmed cases ranged from 10,000 to 11,000 a day. The number of registered deaths from the coronavirus has risen to new heights, and presently exceed 200 a day.

With the increase in confirmed cases, Russia finds itself in a situation similar to many countries in Europe. On the other hand, there has so far been no large appetite for extensive measures as now seen in Europe that would curtail business or people's freedom of movement.

Instead of nationwide restrictions, local officials have taken targeted approaches to dealing with local situations. Mask use is mandatory in many public spaces and on public transport. The autumn break for Moscow schools has been extended, and when the break is over, upper-grade students continue to take their classes online. In St. Petersburg, where restaurants must now close by 11 pm, every customer in principle must provide their contact information to the restaurant. Such measures are hoped to be sufficient to slow the spread of the epidemic until vaccines become available on the markets.

A recent survey of small and medium-sized firms by Magram Market Research and Promsvyazbank found that a third of responding firms said that they would go out of business if Russia declared significant restrictions on movement lasting longer than three months. This at least partly explains the unwillingness of officials to impose excessive measures. It is worth remembering that this year Russian GDP has contracted the least of any European county (BOFIT Weekly 2020/41), a reflection of the Russian economy's structural resilience in the midst of a pandemic.

The 7-day average of confirmed covid-19 infections continues to rise in many European countries.



Sources: Worldometer and BOFIT.

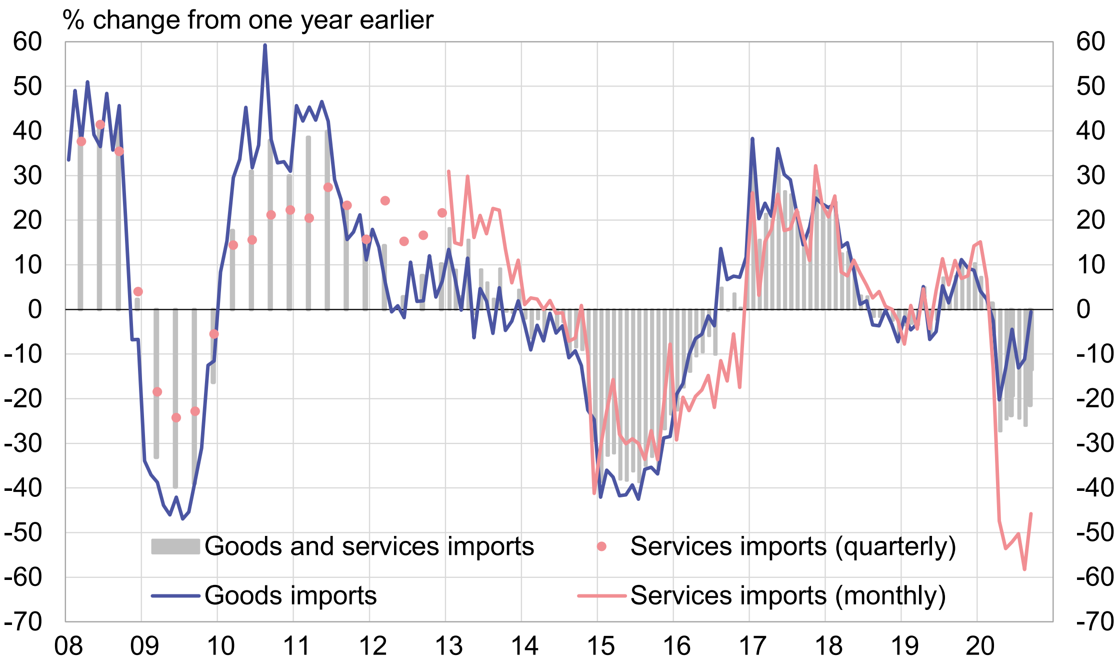
Signs of recovery in Russian foreign trade, capital outflows rather large. Preliminary Central Bank of Russia balance-of-payments figures show that Russian earnings on exports of goods and services were down by nearly 30 % y-o-y still in the third quarter. The figure of decline was slightly smaller than in the second quarter. Revenues from exports of oil, petroleum products and natural gas were still down by almost half from what they were a year earlier. Revenues on exports of other goods, in contrast, have declined just a few percent this year overall, and were fairly close to where they were in the third quarter of 2019. Earnings on services exports have contracted by almost 40 %, especially on the collapse in tourism revenues.

Russian spending on imports of goods and services in the third quarter was still nearly 25 % less than year ago. Goods imports, however, edged towards recovery, and were in September 2020 already close to the September 2019 level. Services imports in the third quarter remained down by more than half from a year earlier, and even September's performance did not bring much relief to the situation. Russian spending on travel abroad (more than one-third of services imports in 2019) was still down by 90 % y-o-y and imports of other services were down by nearly 25 %.

As export earnings have dropped substantially more than spending on imports, Russia's current account surplus has been exceptionally small for the past six months. The four-quarter surplus shrank in the third quarter of this year to less than 2.5 % of GDP.

The financial account balance between Russia and the rest of the world has been distinctly in deficit this year, which has caused the ruble's exchange rate to depreciate. Unlike domestic sources to finance the government's budget deficit, investments coming from abroad to Russian government bonds diminished greatly in 2019. The net outflow of private capital from Russia has been considerable. The foreign liabilities of banks, which currently consist mainly of foreign deposits and bank accounts, continued to decline in the third quarter as they have for years (excluding impacts from changes in the ruble's exchange rate). Banks have also reduced their foreign receivables. The net capital outflow from the Russian corporate sector increased in the third quarter to the extent that the four-quarter net outflow amounted to nearly 2.5 % of GDP – the largest outflow recorded in five years. Much of this was driven by the retreat of inbound portfolio investments in the Russian corporate sector and notable outbound flows of portfolio investments from Russia's corporate sector. Inflows of direct investments from abroad to the Russian corporate sector have declined to a trickle this year. After years of brisk activity, outbound direct investments from Russia's corporate sector this year have become almost non-existent.

Goods imports to Russia on the road to recovery, while services imports remain down.



Sources: Central Bank of Russia and BOFIT.

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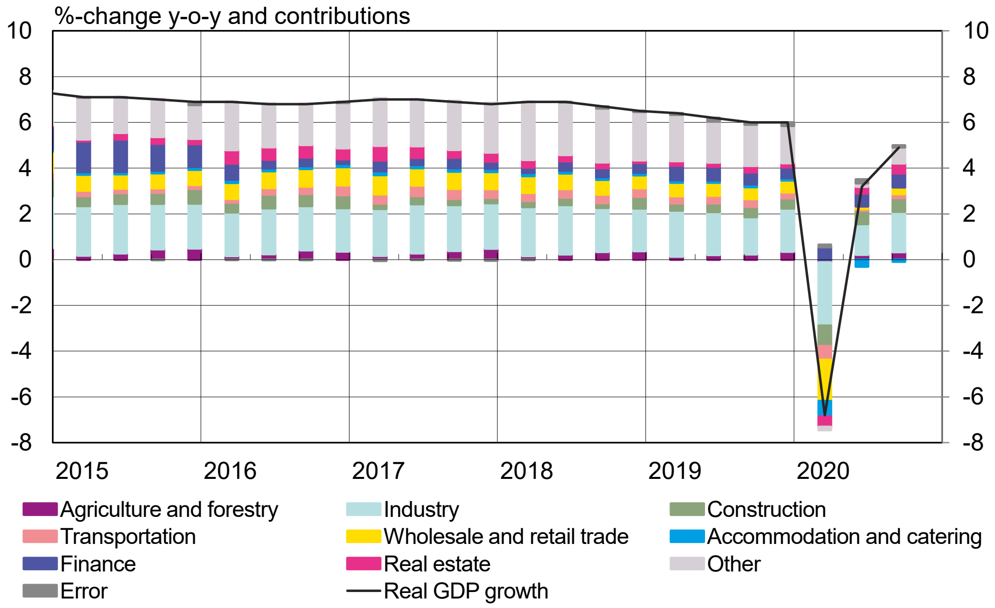
China

Recovery of Chinese economy continues to broaden. China's National Bureau of Statistics reports that GDP growth accelerated in the third quarter to an annual pace of 4.9 %. Even if there continues to be uncertainty about the exact figure, many other economic indicators and alternative calculations for measuring growth confirm the view that China's economy has bounced back quickly. The economy is again humming with covid infections in check and many restrictions have been lifted. Investment demand, supported by central and local government stimulus measures, has been unleashed. Moreover, Chinese industry has successfully pivoted in reaction to the demand shifts caused by the covid pandemic by e.g. increasing production of personal protective equipment and telecommuting equipment, which have seen demand soar in many countries, not just China.

Looking at core sectors of the economy, industrial output and fixed investment both recovered quickly from the covid crisis, but in recent months their pace of growth has stabilised. Official figures show that utilisation of industrial capacity increased in the third quarter already to pre-crisis levels. However, lately recoveries in consumer demand and the service sector have become stronger. In the third quarter, consumption demand made a positive contribution to GDP growth, while after contracting in all previous months of this year, September retail sales grew by 2 % y-o-y in real terms. Recoveries in some of the large service sector branches such as the hotels and restaurants have proceeded slowly, with output remaining lower than a year ago.

Chinese GDP trend with supply-side contributions.



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

Covid stimulus causes China's debt-to-GDP ratio to soar. Aggregate financing to the real economy (AFRE), the broadest measure of domestic debt used by the People's Bank of China, stood at 280 % of GDP as of end-September. This broad debt-to-GDP ratio has risen by 26 percentage points this year. AFRE includes traditional bank lending, shadow banking sector financing instruments, as well as funds raised from issues of bonds and equities.

The stock of domestic bank lending increased by 13 % y-o-y, rising to 170 % of GDP. The stock of corporate lending grew by nearly 13 % y-o-y, while the stock of household loans rose by nearly 14 %. Relative to last year, growth of the corporate credit stock has accelerated while growth in household credit has slowed. Debt financing of corporations, as well central and local governments, has grown at a roughly 20 % p.a. rate.

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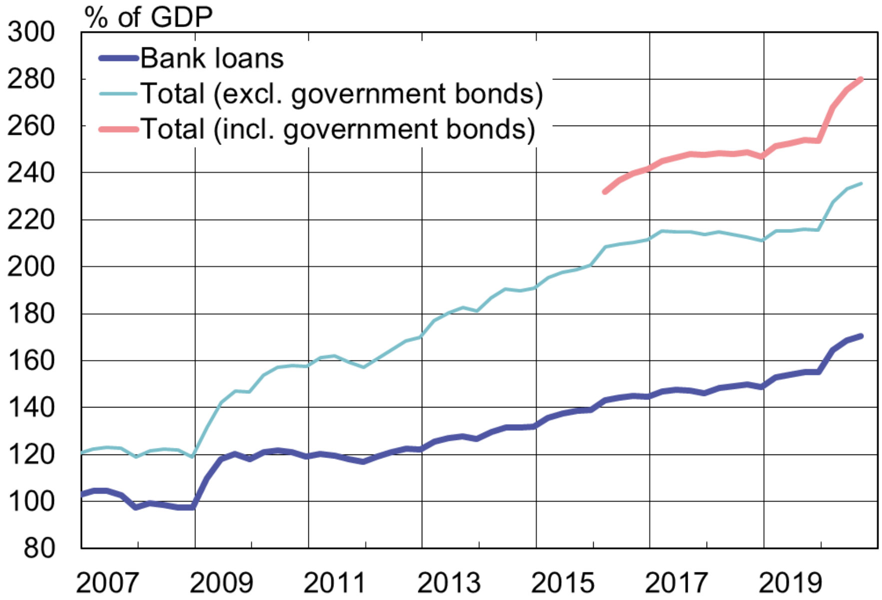
At the end of June, China's State Administration of Foreign Exchange (SAFE) reported that China's foreign debt totalled $2.13 trillion, or 15 % of GDP. The most foreign debt was owed by the banking sector ($990 billion). Government foreign debt amounted to $290 billion (2 % of GDP). Some 52 % of foreign debt was denominated in dollars, 38 % in yuan and 4 % in euros. Foreign debt stock in June was 6 % bigger than a year earlier. Yuan-denominated debt grew 19 % y-o-y and dollar-denominated debt 2 % y-o-y.

China's total domestic debt has increased rapidly this year.



Sources: PBoC, CEIC and BOFIT.

Chinese imports from the EU and other regions picked up in September. China Customs reports strong goods exports in September, with the value of exports measured in US dollars rising by 10 % y-o-y and matching the pace of growth in August. For the first nine months of this year, however, the value of exports was still about 1 % less than during the same period last year.

The dollar-value of goods imports, which was still contracting in August, grew by 14 % y-o-y in September. While some of this rapid reversal merely reflects the relatively low comparison basis, domestic demand also appears to be reviving. The value of goods imports in the first nine months of this year was down by 3 % y-o-y from the same period in 2019.

The value of imports from EU27 countries climbed by 22 % y-o-y in September, but was still down by 3 % y-o-y for the first nine months of the year. In September, imports increased in all major goods categories and for all large EU countries. The value of imports of machinery & equipment (37 % of China's imports from the EU) grew by 12 %, the value of vehicle imports (18 % of imports) by 29 % and the value of food imports (7 % of imports) by 45 %.

The value of imports in September also grew for most of China's major import providers: Taiwan (up 36 % y-o-y), Japan (up 13 %), South Korea (up 17 %) and the United States (up 25 %). The notable exception was Australia, which has seen its trade with China decline –partly for political reasons. Among other things, China has imposed anti-dumping and anti-subsidy tariffs on Australian barley and banned imports of Australian beef from certain meat-processing facilities. Media reports indicate that China this month reimposed its ban on importing Australian coal by state-owned enterprises.

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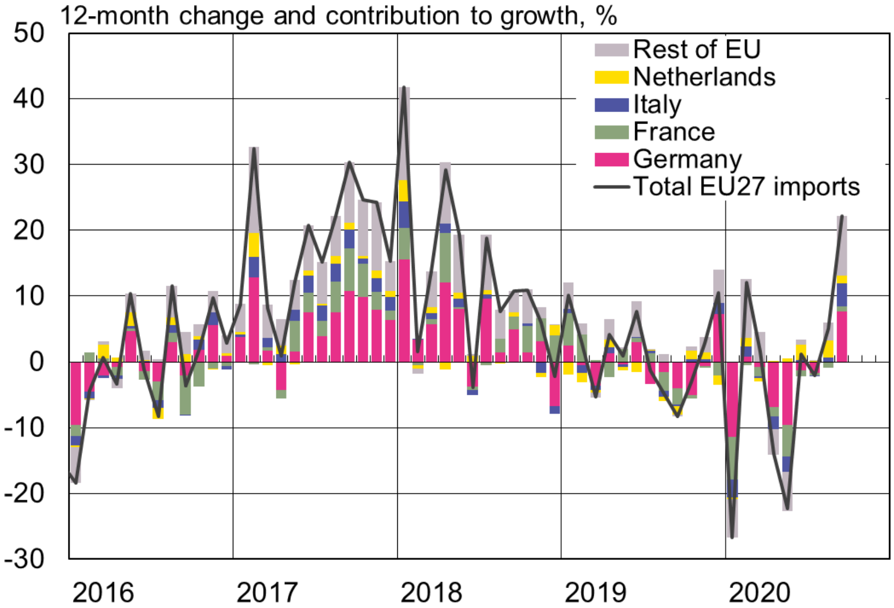
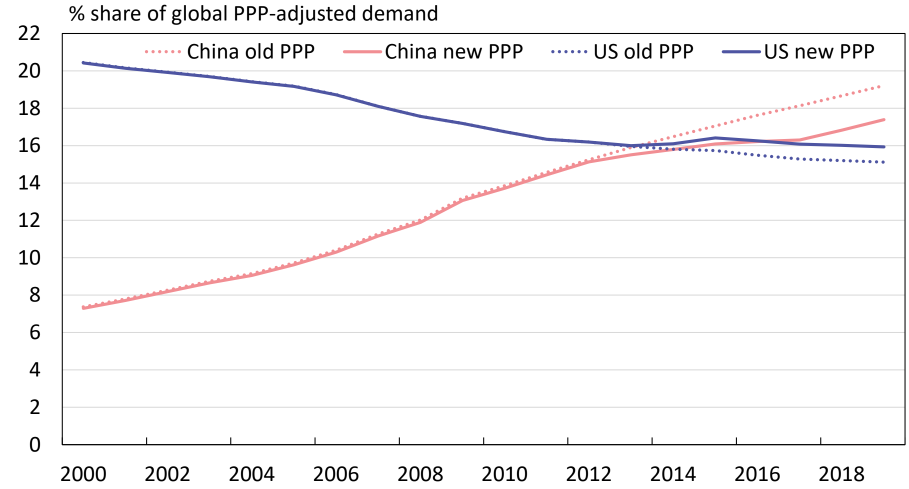
Value of Chinese goods imports in September increased for all large EU economies.



Sources: China Customs, CEIC and BOFIT.

Revised PPP weights suggest Chinese economy is smaller than previously thought. The International Comparison Program, in which many major international organisations and statistical offices around the world participate, readjusted the weights for purchasing power parity (PPP) during the summer to improve comparison among 176 countries. The weights take into account differences in price levels and exchange rates of the assessed countries. The new weights are based on 2017 figures (the previous weights were taken from 2011 data). Applying the revised weights, the IMF finds that China's PPP-adjusted GDP represented 17.4 % of the global economy in 2019, down from 19.2 % using previous PPP weights. Nevertheless, China has been the world's largest economy in PPP-adjusted terms since 2018, when it overtook the US. The new weights have caused shrinkage in the relative size of several emerging economies, including India. Russia's share of global GDP last year remained unchanged at 3.1 %. The new weights have also caused the size of many developed economies to increase slightly. Measured purely in dollar terms, the US economy is still larger than the Chinese economy.

Even with the new weights, China remains the world's largest economy in PPP-adjusted terms.



Sources: IMF and BOFIT.

Taiwan's covid success a boon for its economy and citizen health. Taiwan to date has just 550 reported coronavirus cases, of which only seven have ended in death. On a per capita basis, the country has one of the lowest covid infection rates in the world. Taiwan's readiness to deal with emerging epidemics was bolstered significantly in the wake of the 2003 SARS outbreak. Early in January, Taiwan moved swiftly with a range of measures that included mandatory quarantines for all persons entering the country, exploiting new technologies to identify infected individuals and a comprehensive system of testing and tracing. People's readiness to use masks was high from the start, and many people at their own initiative avoided collective exposure at restaurants and bars. As a result, officials never had to mandate extensive business closures or severe restrictions on movement.

In both the first and second quarters of this year, Taiwan's GDP contracted by only about 1 % y-o-y. Most of the contraction was due to consumers' reluctance to spend caused by fears of contracting or spreading the virus. Retail sales fell by 15 % q-o-q in the first quarter or 3 % y-o-y. In the third quarter the economy rebounded with GDP growing 3.3 % y-o-y and growth is expected to continue in the fourth quarter. Taiwanese manufacturing returned to growth already in the second quarter of this year. Surveys indicate that business confidence has continued to strengthen. Retail sales grew in the third quarter by over 4 % y-o-y, the largest growth gain in many years. Taiwan's goods exports rose by more than 6 % y-o-y in the third quarter. The improvement largely represents recovery from the lower second-quarter basis and a return to pre-corona growth rates. Because the Taiwanese economy is highly dependent on exports, the country has benefited from the early recovery of the mainland Chinese economy. China and Hong Kong together account for about 40 % of Taiwan's exports. On the other hand, demand for Taiwanese exports has been hurt by the economic contractions in Europe and the United States.

The Taiwanese economy also appears to have weathered the economic fallout from the covid-19 pandemic better than other similar economies in the region. The IMF sees Taiwan's GDP growth accelerating next year to over 3 %, and thereafter stabilising at around 2 %. Unemployment in coming years is forecasted to remain just under 4 % p.a. as at present. Taiwan's public finances, which had been relatively balanced in recent years, are expected to show a deficit of nearly 5 % this year, with the government debt-to-GDP ratio rising to around 35 %. By international standards, however, Taiwanese government indebtedness is still relatively low.

Taiwan's otherwise bright economic outlook has been clouded by increased foreign policy tensions, mainly with mainland China. In mid-October, the Trump administration greenlighted the sale of $1.8 billion in arms sales to Taiwan. Following the US decision, China imposed sanctions on the US arms sellers, but the measures are expected to have little significance.

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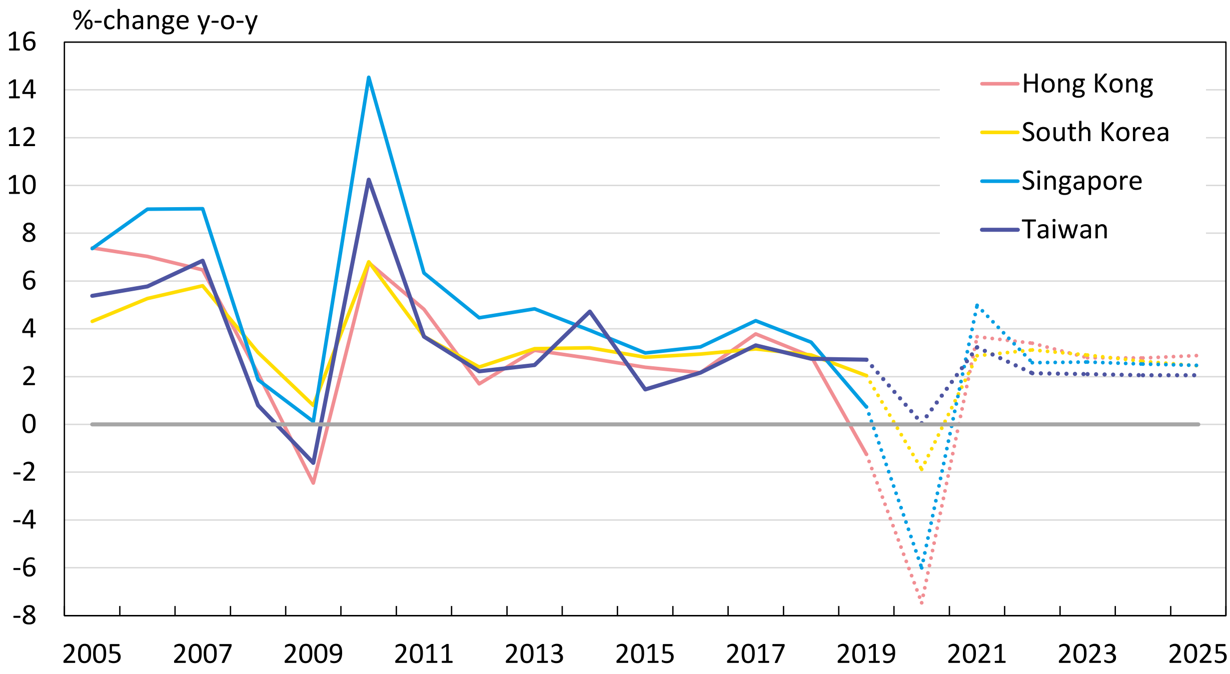
Taiwan on track to become the best-performing “Asian tiger” this year; IMF forecast for 2020–2025.



Sources: IMF World Economic Outlook and BOFIT.

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Russia

Russia-US economic relations unlikely to improve under the new US administration. The long-prevailing modest state of economic relations between Russia and the United States has been further clouded in recent years by political tensions, economic sanctions and increased competition on international energy markets. The US is a considerably more important economic partner for Russia than vice versa. While Russia has sought to reduce its reliance on the US dollar in recent years, the dollar remains important for Russian transactions.

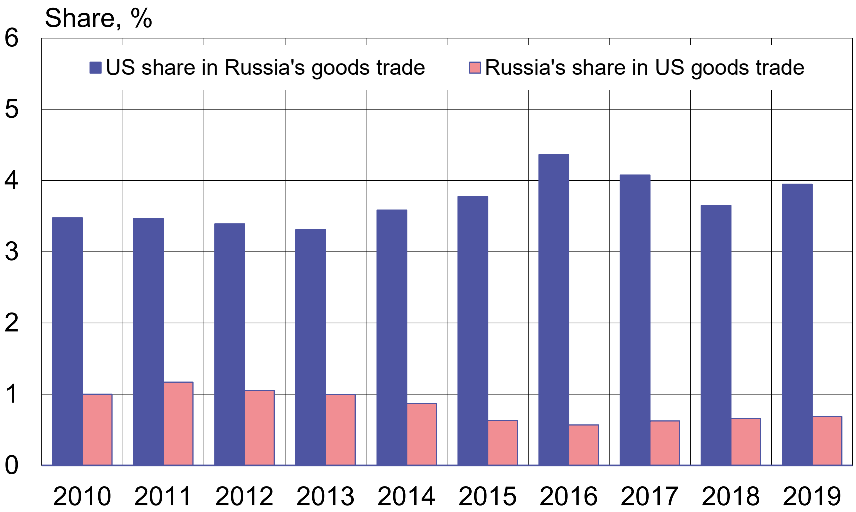
Russia-US goods trade last year was worth about 30 billion dollars. In recent years, the US has accounted for approximately 4 % of Russia's goods trade, while Russia has represented only about 0.7 % of US goods trade. Russia mainly exports oil, petroleum products, metals and fertilizers to the US. It mainly imports US machinery & equipment, as well as pharmaceuticals. The value of US-Russia bilateral goods trade this year has contracted by about 10 %. The UN Conference on Trade and Development (UNCTAD) has evaluated that the US is the single largest provider of foreign direct investment to Russia once third-country pass-throughs are taken into account.

Russia-US economic relations have been clouded by various economic sanctions imposed on Russia in response to e.g. the annexation of Crimea and Russian interference in US elections and the threat of further sanctions has increased uncertainty on the economic relations. Sectoral sanctions include banning arms sales, limiting exports to Russia of technologies critical to oil exploration and production, as well as restrictions on the access of certain Russian firms and the Russian state to international financing. Other economic sanctions focus on specific individuals or firms. Russia has banned imports of several foodstuffs from the US as part of its countersanctions.

US-Russian competition in global energy markets has intensified in recent years as the US has ramped up production of shale oil and liquefied natural gas (LNG). The US has seen its oil and LNG exports soar in recent years to around a 10 % of total global exports. The abundance of US supplies has depressed global crude oil prices and pushed Russia to production ceiling agreement with OPEC. American LNG also constitutes a potential competitor for Russia's pipeline gas to Europe.

In recent years, Russia has sought to reduce its dependence on the US dollar. While the dollar's share in Russian debt, assets and trade has contracted, it is still significant. The use of the dollar in Russian foreign trade and foreign debt has diminished in recent years from well over 60 % to about 50 %. The share of dollar-denominated assets in Russia's foreign reserves has decreased from 45 % to around 30 %. As recently as 2017, Russia was still among the largest holders of US sovereign debt. Today, Russia holds less US sovereign debt than Egypt or Peru. The heightened tensions with western countries have also increased Russia's aspirations for tighter economic relations with China.

The US is a more important trading partner for Russia than Russia is for the US.

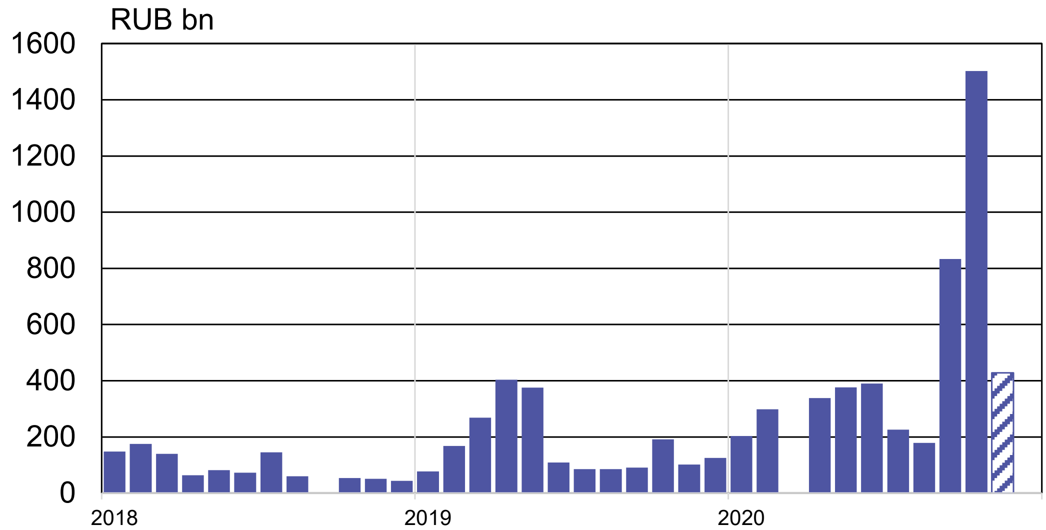


Sources: UN Comtrade and BOFIT.

Large domestic interest in Russian government bonds. As a consequence of the economic recession caused by the coronavirus pandemic, Russia's government sector surplus has turned to deficit. This year's deficit is expected to reach about 4.5 % of GDP. Most of the deficit will be covered by domestic government borrowing. In recent months, the finance ministry has successfully placed huge issues of ruble-denominated bonds. There has been strong demand for new government bonds, especially by Russian banks. Consequently, the share of foreign investors in Russian government bond markets has diminished slightly.

On October 28, the finance ministry successfully issued a historically large (430 billion rubles) 9-year variable-rate bond. On November 3, the government issued a nearly-as-large 10-year variable-rate bond. Issues of fixed-rate long-term bonds, which have been much smaller, have seen their yields rise above 6 %. Future bond issues for the rest of this year are expected to be much smaller as the 4Q borrowing target of 2 trillion rubles has essentially been reached. At the end of September, domestic debt of the government amounted to about 12 trillion rubles, which is about 25 % more than a year earlier. Government foreign debt at the end of September was valued at around 60 billion dollars (about 4.8 trillion rubles). The Russian government's debt burden is modest by international standards. Despite ongoing borrowing, Russia's government debt-to-GDP ratio under the finance ministry's guidelines in not expected to exceed 22 % in coming years.

Government ruble-denominated debt issues have soared to record levels in recent months.*



**) The November 2020 column shows value of debt issues as of November 5.*
Sources: Russian Ministry of Finance and BOFIT.

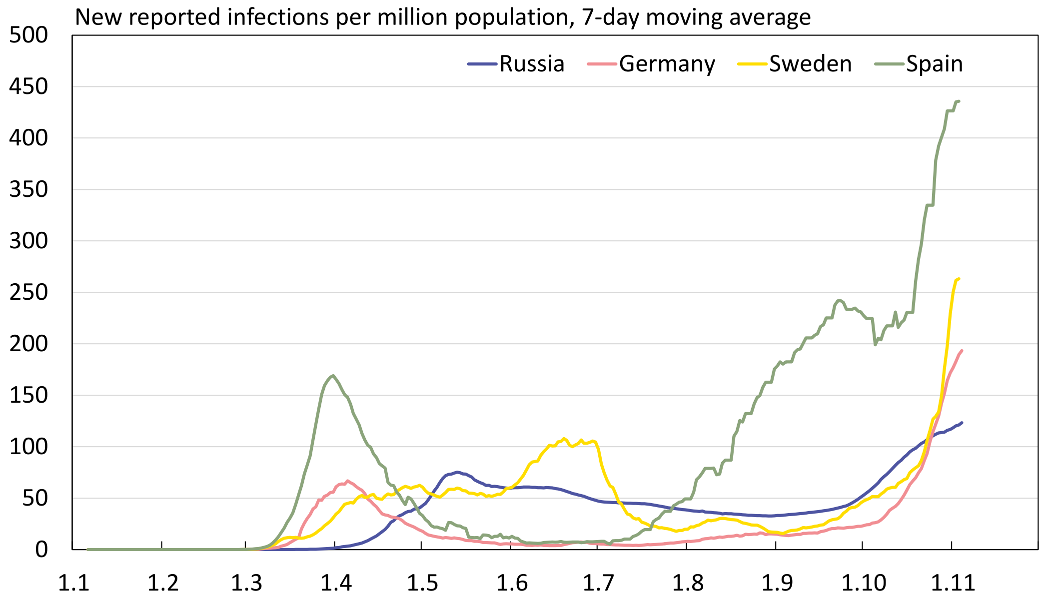
Covid-19 cases continue to rise in Russia, consumers increasingly cautious. The number of confirmed coronavirus cases in Russia has climbed steadily since early September. In the first days of November, the number of reported cases already exceeded 20,000. At the end of August, the number of daily cases was still less than 5,000. Notably, the number of reported covid cases has increased significantly faster in many other European countries. The Russian healthcare system has been stretched by the rise in cases requiring hospitalisation and ICU care. In many Russian regions, the quality and availability of medical services was already quite poor. Daily death tolls this week have approached 400.

The willingness of Russia's political class to expose themselves to covid is a remarkable aspect of Russia's handling of the pandemic. As of end-October, at least 91 of the 450 Duma deputies had contracted covid. About a third of regional governors have also come down with covid. The infected-politician phenomenon has been particularly common in regions east of the Urals. Even prime minister Mikhail Mishustin had covid in May.

While officials have not significantly tightened covid restrictions in recent weeks, Russians have voluntarily restricted their movements and consumption habits in response to the increased numbers of covid cases. Payments data from Sberbank suggest that consumption was down by about 10 % y-o-y in the final week of October. In the previous week, the on-year drop was just 0.9 %. In particular, consumption of services contracted by about third from a year earlier. Payment transaction figures released by CBR show that the volume of payments in industrial branches had recovered to the level of previous years at the end of October. In recent weeks, however, economic activity has again slowed in many service branches.

Among industrial branches, the performance of oil production and refining have been quite unusual, which is partly a reflection of depressed oil prices and partly due to production cuts under the OPEC+ agreement.

Numbers of reported covid-19 cases have soared in many European countries.



Sources: Worldometer and BOFIT.

Central Bank of Russia keeps its key rate unchanged. At its meeting on October 23, the CBR decided to keep the key rate unchanged at 4.25 %. The decision was in line with market analyst expectations. In its press release, the CBR noted that inflation was developing in accordance with its inflation forecast. The CBR did not rule out the possibility of a rate cut at upcoming meetings.

Annual inflation picked up to 3.7 % in September. The uptick was driven by weakening of the ruble's exchange rate in recent months (BOFIT Weekly 37/2020). The ruble-dollar rate momentarily breached the 80-ruble level this week. At the same time, the euro-ruble rate briefly approached the 94-ruble level. The ruble has lost 14 % against the US dollar and 17 % against the euro since the beginning of June. Ruble depreciation has fuelled inflation expectations, which might lead to increases in prices of goods and services in the months ahead. On the other hand, inflation pressures have been weakened since summer due to falling domestic demand (BOFIT Weekly 43/2020). The Russian economy's activity below its potential output level could also restrain inflation.

The CBR estimates that 12-month inflation will be running in the range of 3.9–4.2 % at year's end. It now forecasts inflation in the range of 3.5–4 % next year. In subsequent years, inflation should stabilise close to 4 %. The CBR's annual inflation target is 4 %.

The CBR also updated its GDP forecasts for the Russian economy for 2020 and 2021. The economy should contract by 4–5 % this year, i.e. half a percentage point less than the previous forecast. The revised outlook is mainly explained by better export performance in this spring. Economic growth next year should diminish to around 3–4 %, or about half a percentage point less than the previous forecast. The reduced growth outlook is affected by the surging covid pandemic in Russia and elsewhere. The CBR did not revise its growth projections for 2022 (2.5–3.5 %) and 2023 (2–3 %).

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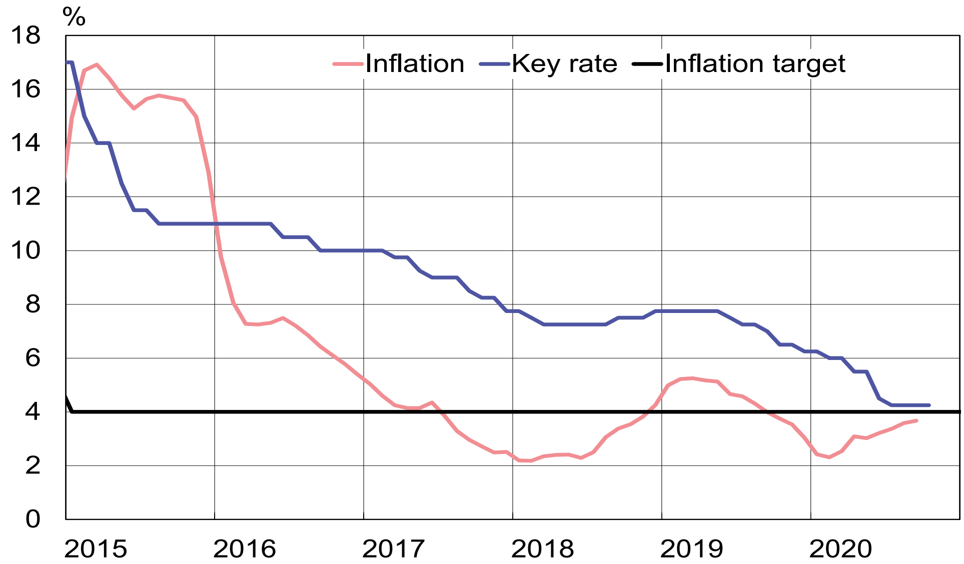
Russian key rate, annual inflation and the CBR's inflation target.



Sources: Central Bank of Russia, Rosstat, Macrobond and BOFIT.

Russian government limits the fall of household incomes with social assistance and higher wages. Real household incomes fell by over 8 % y-o-y in the second quarter. In the third quarter, the on-year drop was still nearly 5 %. The fall is the deepest since 2015–2016, when high inflation significantly eroded nominal income gains. The 3–3.5 % consumer price inflation experienced this year has also for its part held down the growth in real incomes. Additionally, the covid restrictions affected the second quarter which saw an exceptional slide also in nominal incomes.

An even steeper decline in household incomes this year has been avoided thanks to substantial increases in social support paid out from state social funds' budgets. That action is part of the government support measures called for by president Vladimir Putin early last spring. In this respect, the actions resemble the 2009–2010 stimulus, but the hikes in social supports this time have not focused on pensions but rather other forms of social assistance to e.g. families with children. Rosstat figures for household incomes show that social supports accounted for nearly 20 % of total household income in 2019.

Other sources of household income have shrunk. Notably, household non-wage earnings (including entrepreneur earnings, dividends and interest income) have dropped in a rarely precipitous way. The sum of household wages (including estimated grey-economy earnings), which represents roughly 60 % of household incomes, has also declined in real terms.

Part of the wage sum slide is due to a drop in the number of employed, which has occurred even slightly more severely than in big recession of 2009. In addition, layoffs and shifts to part-time work have increased. According to Rosstat's labour force survey, this year's decline in the number of persons employed has taken place especially in the grey economy, a pattern similar to earlier economic downturns. In contrast, there has been rather small decline in employment as a whole in the non-grey parts of the economy (for which much better data is available). In these fields, the average wage has risen even in real terms in the current recession, which is different from the recession-plus-inflation years of 2009 and 2015. The differences across branches are very large, however. Real wages of the private sector in core sectors of the economy such as industry and trade have fallen, while wages in large public-sector branches such as state administration and education – and health care in particular – have been adjusted upwards at a rapid pace.

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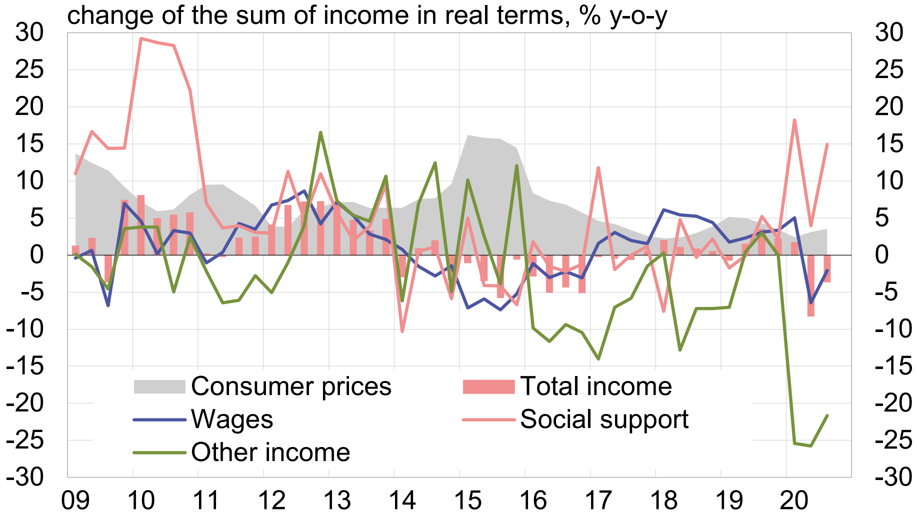
Social supports are the only components of Russian household income that increased this year.



Sources: Rosstat and BOFIT.

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China

China's latest five-year plan devoid of new initiatives, but still sets ambitious growth target for 2035. When the Central Committee of the Communist Party of China (CPC) wound up its 5th plenary session on October 30, it announced the outline of the latest version of the next five-year plan (2021–2025), as well as the CPC's long-term objectives through 2035. The 14th five-year plan showcases familiar themes such as economic prosperity, self-sufficiency and technological advancement but is devoid of significant new initiatives. Particularly notable was the lack of emphasis on environmental issues, especially since president Xi Jinping announced in September that China will seek to be carbon neutral by 2060. Final approval of the plan will take place at the National People's Congress next spring.

The themes highlighted in the 5-year plan to some extent reflect the deterioration of US-China relations. In recent months, China's leadership has stressed the importance of self-sufficiency in the face of US export restrictions on high technology products such as microchips that China cannot produce. In addition, there is a strong emphasis on research & development and innovations in the plan, which reflects also China's aims to take leadership roles in select technology fields involving genetics, nanotechnology, artificial intelligence and robotics, targets set in 2015 with the launch of the *Made in China 2025* programme. As a leading country, China can no longer copy from others, but must develop new technologies on its own.

Besides the rollout of the 5-year plan, China's leadership also announced a further details on 2035 targets as outlined by president Xi in 2017. China seeks to be a "moderately developed" economy within the next 15 years. President Xi this week reiterated that long-term numerical GDP growth targets is not set, but noted that it is "completely possible" that China can double real GDP between 2020 and 2035. Such a doubling would require an average GDP growth rate of just under 5 % a year to bring GDP per capita into line with living standards of Poland by 2035. To meet exceptionally ambitious growth target, China will need to continue to keep its economic policy very accommodative and continue piling on debt. The target is conflicted as China's stated goals prioritise quality of growth over quantity of growth.

Outcome of US presidential election unlikely to resolve disputes with China. The results of the national election in the United States last week are unlikely to affect the current disputes with China. Neither country has budged on the central issues, which centre around China's use of government subsidies, industrial policy and cybersecurity. In addition, both the Democratic and Republican parties in the US strongly support actions taken against China.

US-China bilateral trade has suffered for more than two years. As of end-2019, the US accounted for 15 % of China's imports, while China represented 6 % of US imports. In 2017, before the imposition of punitive tariffs, the US provided more than 20 % of China's imports and China accounted for 10 % of US imports. The signing of phase one of the trade agreement in January 2020 has done little to assuage the situation. Many of the targets in the agreement will not come close to being achieved this year, even if China's imports from the US in recent months have grown swiftly. China's imports from the US rose by 22 % y-o-y in October, while the country's imports overall increased by 11 %. At the same time, exports to the US (up 33 %) performed much better than Chinese exports overall (up 5 %).

The value of goods imports from the US covered under phase one of the US-China bilateral trade agreement amounted to $65 billion for the first nine months of this year. The 2020 target is more than $170 billion. Some goods import activity this year has suffered from production interruptions caused by covid-19 pandemic as well as shifts in demand. In addition, the sharp drop in oil prices in early March made it particularly difficult to reach import targets in the energy sector as the agreed targets are specified in dollars.

In addition to tariffs on goods, the US has taken a hard line on China's technology sector in recent years. Among other things, the US has restricted sales of US technology and components to China's tech giants on the basis of national security. The US has also sought to prevent the use of Chinese software in the US. Besides the technology dispute, relations have been strained by the US shuttering of China's Houston consulate, the imposition of sanctions on officials in mainland China and Hong Kong, as well as the ending of Hong Kong's special status.

Even when Joe Biden assumes the presidency in late January, the tensions between China and the US will continue. US China policy next year is nevertheless likely to become less capricious and more predictable. The incoming administration is more open to multilateral cooperation and traditional diplomacy. In particular, the US could coordinate its China policy with

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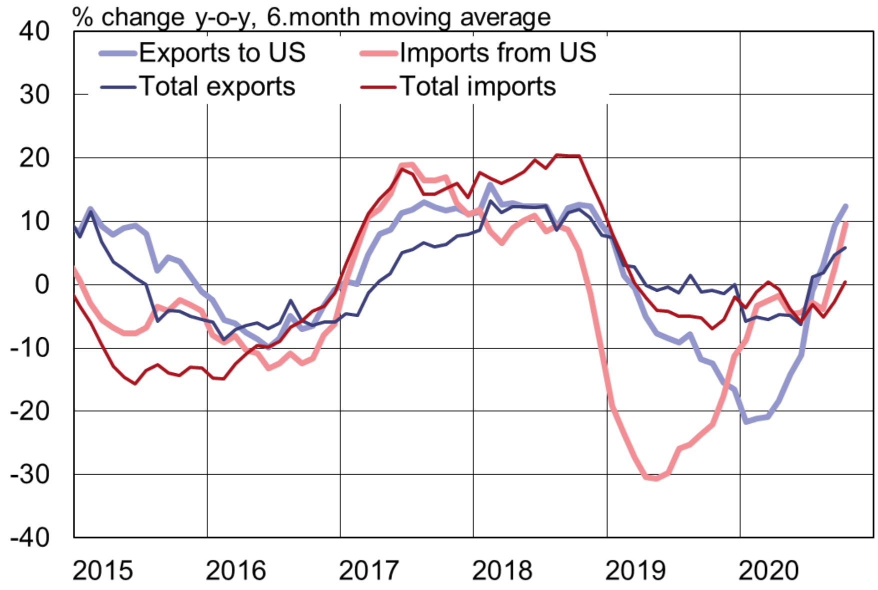
other western countries in order to actually compel China to change behaviour. Stronger commitment to rule-based cooperation, opening up of markets and a fair treatment of foreign firms would be the first steps towards easing trade disputes.

Chinese goods trade with the US.



Sources: China Customs, CEIC and BOFIT.

Chinese officials scupper Ant Group's IPO at the last minute; other new listings on mainland bourses increasing. The IPO of the Ant Group, Alibaba's payment services subsidiary, was set for simultaneous listings this month on the Shanghai stock exchange's Star Market list and the Hong Kong stock exchange. The $36 billion IPO would have been the largest ever, pushing the market capitalisation of the Ant Group north of $300 billion, even higher than that of state-owned ICBC, the world's largest bank in terms of total assets. The Shanghai exchange, however, called off the IPO two days before its scheduled date. Listing plans were cancelled on the Hong Kong exchange as well. Alibaba, Ant Group's parent, listed on the New York Stock Exchange in 2014 that was the world's largest IPO at the time. A year ago, Alibaba also listed its shares on the Hong Kong exchange.

On November 3, China issued a draft of stricter rules for online microlenders. It is not yet known when the new rules will be finalised or implemented. The reforms seek to limit the size of individual loans, place limits on microlender's indebtedness and define that online platforms would need to fund a significantly larger share of loans instead of relying on partner banks for financing. On the same day, Ant Group representatives were summoned to meet with regulators. The Shanghai stock exchange (SSE) said the reason for suspending the IPO had to do with the interview with regulators and change in the regulatory environment. Officials said the SSE's decision was necessary to protect investors and financial market stability. Observers think that the cancellation may have had other reasons as well. Ant Group and other fintech firms have emerged as serious challengers to traditional state-owned banks in that they can offer payment and financing services while being more loosely regulated than banks. The last-minute cancellation of the IPO, which had earlier been green-lighted by officials, is unlikely to improve investor views on the predictability of Chinese financial markets or regulatory transparency.

Despite to scrubbing of the Ant Group IPO, listings on mainland China bourses continue to rise. Consulting and accounting firm EY reports that there were 295 IPO listings on the Shanghai and Shenzhen exchanges during the January-September period. The listings represent about third of all IPOs globally during the period and correspond to over 30 % of the total value of new IPOs. Over the same time, the Hong Kong stock exchange witnessed 99 IPOs (17 % of the value of all IPOs globally). US exchanges (NYSE and NASDAQ) saw 150 IPOs (34 % of the value of global IPOs).

Since Shanghai's Science and Technology Innovation Board (Star Market) was launched last year, a significant number of listings have been added to the list. The Star Market encourages China's biggest tech innovators to list domestically (BOFIT

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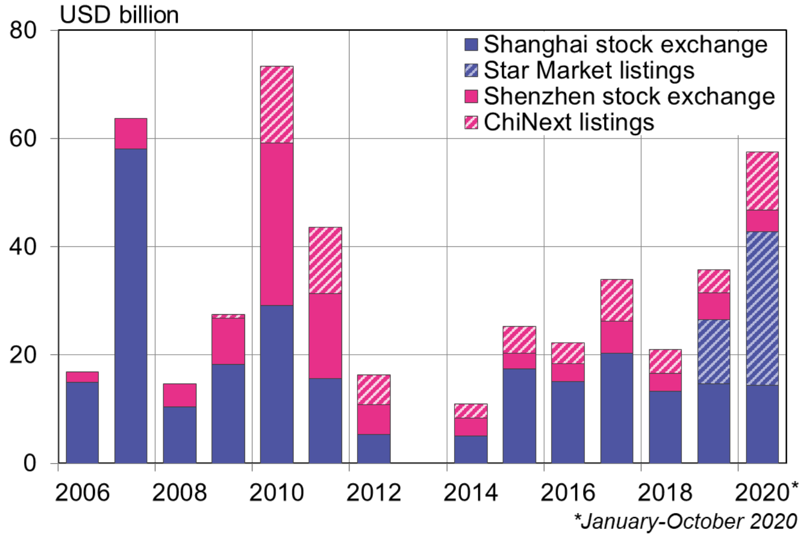
Weekly 30/2019). The Star Market list presently includes over 190 firms. The Shenzhen stock exchange has its own list of growth firms, the ChiNext list, which contains over 870 firms. Listing practices on ChiNext were eased this year to conform with Star Market rules. China is aiming to extend the registration-based IPO reform to all listings in both exchanges. One motivation for the reform is to accommodate home listings of US-listed Chinese companies in the event they are forced to leave the US market.

Value of IPOs on mainland China exchanges with Star Market and ChiNext listings specified, annually and in January-October 2020.



Sources: Shanghai and Shenzhen stock exchanges, CEIC and BOFIT.

GDP grew in all regions of China in the third quarter. China suffered most from the first wave of the covid-19 pandemic in the first quarter, when GDP contracted in nearly every province in mainland China. About a third of China's provinces, (including autonomous regions and directly-administered municipalities) continued to experience on-year contractions in GDP in the second quarter. A distinct turn for the better occurred in the third quarter, when GDP rose in all parts of mainland China (and quite strong growth in a number of provinces). Some of the growth burst can be attributed to the government's stimulus efforts.

Hubei province, which is situated in the Central China, remains worst-affected by the covid crisis. About 80 % of all confirmed covid cases in China have been registered in the province. The provincial capital, Wuhan, was in strict lockdown for 2½ months. Nearly all of the rest of Hubei was locked down for about two months starting from January 23. Hubei province's real GDP contracted by over 37 % y-o-y in the first quarter. Despite stimulus, Hubei's real GDP for January-September was still down by 10 % y-o-y. The other provinces of Central China, in contrast, managed to get through the first wave of covid-19 in remarkably good shape. Central China's (excl. Hubei) GDP growth in the second quarter was 4 %, which was better than most of the country.

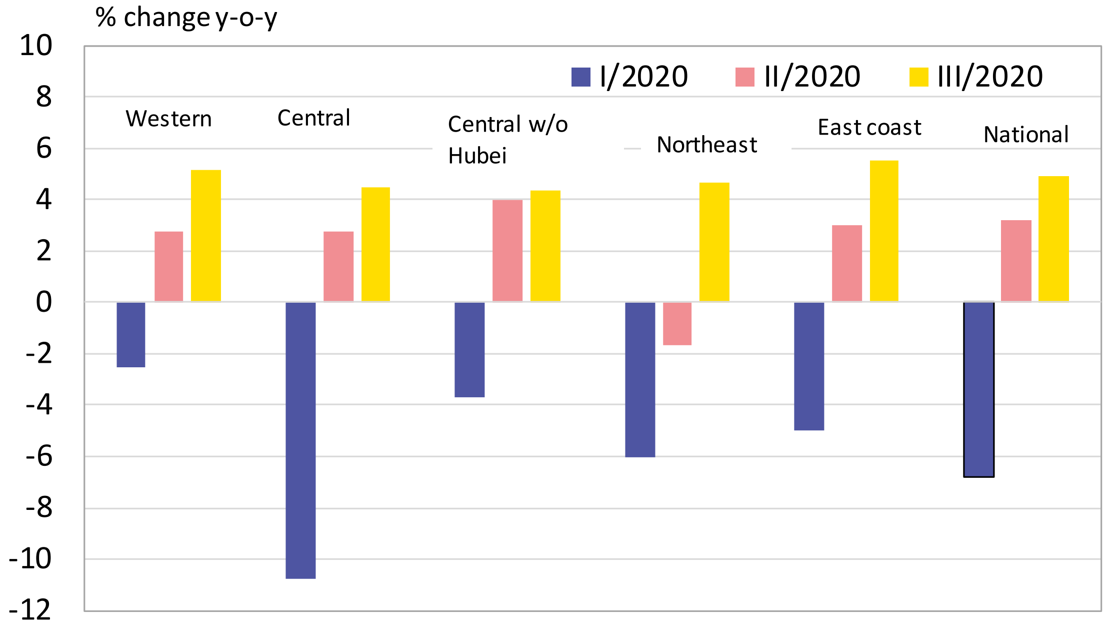
GDP contracted sharply in all three provinces of Northeast China due to covid-19. In April, Heilongjiang province was forced to further tighten its lockdown measures when the rate of new covid infections spiked. The impact of the hard lockdown was reflected in provincial GDP, which contracted by 6 % y-o-y in the second quarter, the biggest decline in output for any province in China.

The smallest declines in GDP were registered in Western China, where the number of confirmed covid cases per capita remained lower than anywhere else in the country. For example, official figures indicate that Tibet has so far been almost completely spared of coronavirus infections. GDP growth in Tibet has been strong for years, and the impacts of covid have done little to curb that growth. Growth in the Xinjiang province was strong in the first quarter despite the coronavirus epidemic.

In the wealthy provinces of China's East Coast, GDP declined by about 5 % y-o-y in the first quarter, and recovered in the second quarter by about 3 %. Growth was even stronger in the third quarter. Tourism and other services branches suffered most in China's large cities. The East Coast, which is rich in export-related industries, saw its collapse in output in the first quarter of this year followed by a brisk recovery.

Over the short term, China's GDP growth figures conceal huge trend differences across provinces. In the wealthy self-governing megalopolises of Beijing and Shanghai, total output per capita is five times higher than in the poorest provinces. The covid crisis is expected to exacerbate regional economic differences as well as tensions between people living in cities and rural citizens.

Third-quarter economic growth was positive in all regions, quarterly change y-o-y in real GDP.*



) Quarterly real GDP is weighted average of real changes in provincial GDP calculated by deflating nominal provincial changes with their average implicit GDP deflator for January-September 2020. **Western Region: Inner Mongolia, Guangxi, Chongqing, Sichuan, Guizhou, Yunnan, Tibet, Shaanxi, Gansu, Qinghai, Ningxia and Xinjiang. **Central Region:** Shanxi, Anhui, Jiangxi, Henan, Hubei and Hunan. **Northeast Region**: Liaoning, Jilin and Heilongjiang. **East Coast Region**: Beijing, Tianjin, Hebei, Shanghai, Jiangsu, Zhejiang, Fujian, Shandong, Guangdong and Hainan.*

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

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Russia

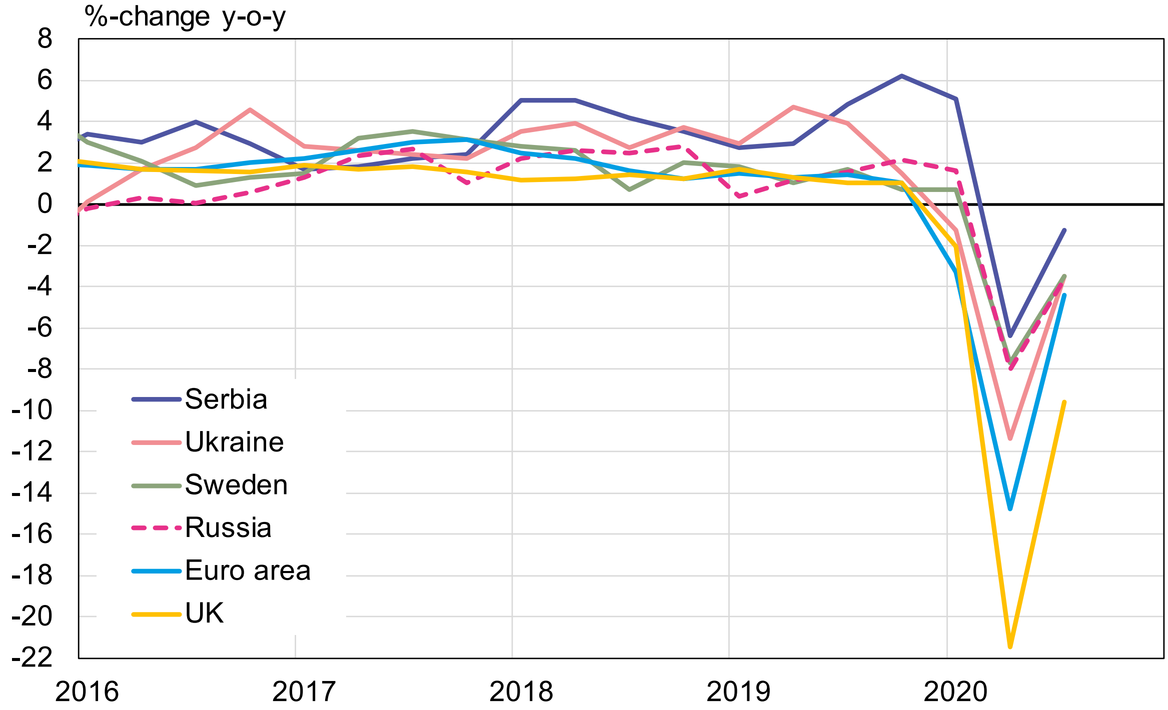
Russian GDP contracted by 3.6 % in the third quarter. Russia experienced an 8.0 % y-o-y drop in GDP in the second quarter as its economy struggled with the covid-19 pandemic and lockdowns. Even so, Russia's economy is less hard-hit by coronavirus than most European countries. GDP in the euro area witnessed a nearly 15 % y-o-y contraction in the second quarter, but only a 4.4 % drop in the third quarter. GDP in the United Kingdom shrank by nearly 22 % in the second quarter. The structure of Russia's economy has provided hidden benefits in dealing with covid shocks. For example, the contribution of services (particularly tourism) to overall output and employment is smaller in Russia than in many other countries.

The third-quarter output contractions were less severe in all branches than in the previous quarter. Manufacturing contracted by just 0.4 % y-o-y, while wholesale activity actually grew by 1.1 %. Services contracted by nearly 20 % y-o-y, a substantial improvement over the 36 % drop of the second quarter.

However, while industrial output declined by less than 4 % y-o-y in September, it fell by 6 % in October. The level of industrial output (seasonally adjusted) matched the September number after increasing for four consecutive months, and the level is now only about 6 % below its pre-covid level of late 2019.

Manufacturing output, a component of industrial output, was down by 6 % y-o-y in October. In September, the decline was less than 4 %. For example, the bump in the pharmaceuticals and medical supplies seems to be over. Output of mineral extractive industries was down by nearly 9 % y-o-y, which was largely a reflection of Russia's adherence to oil production ceilings under its OPEC+ agreement. The current rise in confirmed covid-19 cases is likely to hurt Russia's economic performance in the months ahead.

Russian GDP has contracted less this year than in most European countries.



Sources: National statistical agencies, Macrobond and BOFIT.

Russian goods trade has recovered in recent months. With the recovery in demand, Russia's imports of goods have quickly rebounded from last spring's nadir. The value of imports in September was only 3 % less than a year earlier. The strongest import category has been machinery & equipment, which was up 9 % y-o-y in September. Imports of food and textiles were also up slightly. While import trends vary, Russia has reduced its imports from most countries this year. However, among Russia's larger trading partners, imports from China and Turkey have grown slightly. Regarding minor trading partners, Russia's imports from e.g. Iran have increased strongly in latest months.

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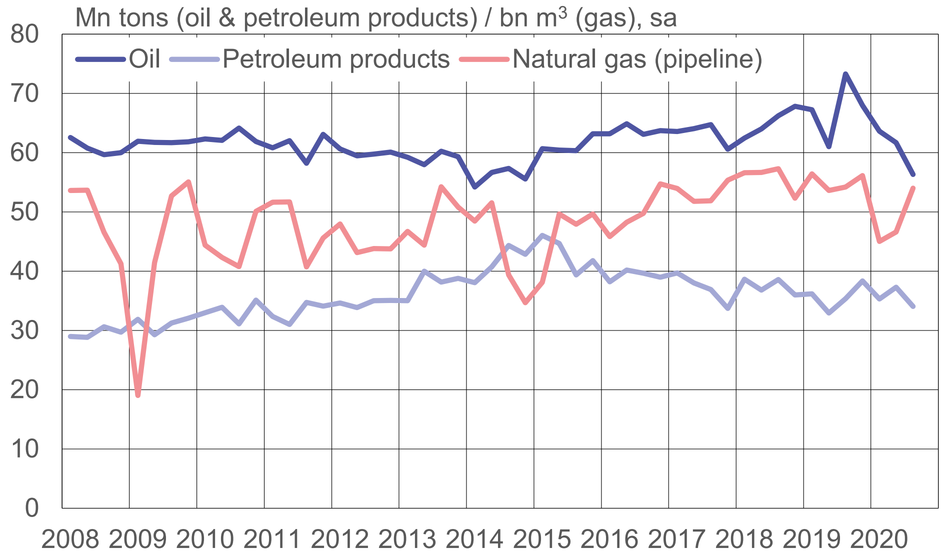
While the value of Russian goods exports has gradually increased from spring lows thanks to rising oil prices, it was still down by 14 % y-o-y in September. In contrast, the volume of oil exports has declined in recent months after a more favourable development in the spring. The volume of crude oil exports contracted by 23 % in the third quarter, while exports of petroleum products were down by 5 % y-o-y. Russia's crude oil export volumes have not been this low since 2014. The volume of crude oil exports contracted by 10 % y-o-y in the first nine months of this year, while exports of petroleum products grew by 2 %. In recent months, the volumes of natural gas exports have begun to rise, led by exports of liquefied natural gas (LNG). In the January-September period, however, natural gas exports still contracted in annual terms due to the weak development of pipeline gas exports.

Russia's export performance this year has been supported by exports of gold and precious gemstones. The value of such exports has doubled over the past 12 months. In the third quarter, gold and precious gemstones accounted for 11 % of Russia's goods exports. They were the second largest export product group after mineral fuels. Exports of gold and precious gemstones to the UK have increased significantly, making it one of the few countries which has increased its purchases of Russian exports this year.

The volume of Russian crude oil exports declined sharply in the third quarter.



Sources: Central Bank of Russia, Russian Customs and BOFIT.

Reduced revenues and higher spending caused Russia's government budget sector deficit to deepen. Revenues to the consolidated budget (federal, regional and municipal budgets, plus state social fund budgets) were down by 14 % y-o-y in the third quarter. The on-year drop in revenues in the third quarter was less severe than in the second quarter when revenues fell by 23 % – that is without the one-time budget windfall in April involving the payment by the central bank from its extra surplus created by the transfer of Sberbank's ownership from the central bank to the government.

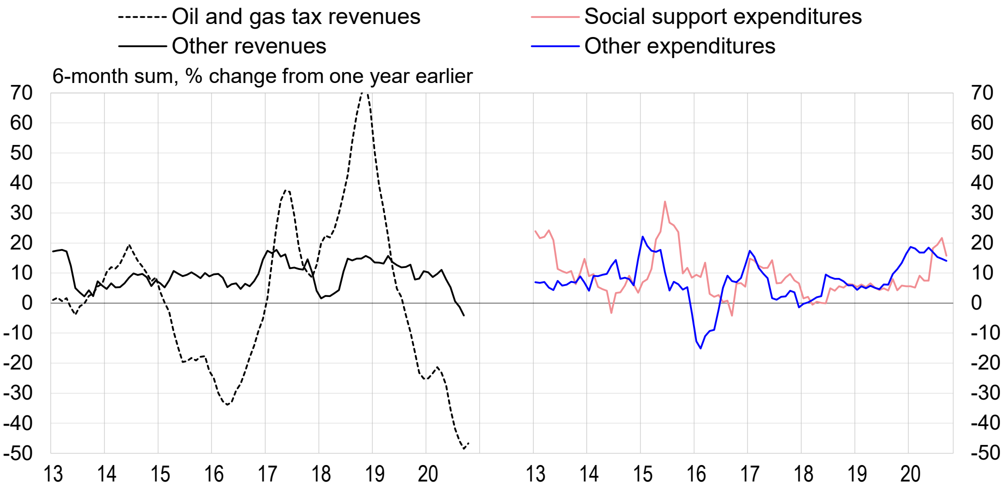
The increase in consolidated budget expenditures that already began last year has continued throughout this year. Spending was up by nearly 12 % y-o-y in the third quarter, even if the on-year growth figure was smaller than in the previous two quarters (17–18 %). The spending growth also in the third quarter has provided a factor limiting the economy's contraction as inflation has remained relatively slow.

The opposing movements in revenues and expenditures have increased the consolidated budget deficit. The past 12-month deficit in September corresponded to about 3.5 % of GDP, putting the state on track to post the deficit estimated for this year at about 4.5 % (not counting the Sberbank payment the 12-month deficit would have been about 4.5 % of GDP in September). The government last spring was covering its burgeoning budget deficit by a combination of using liquid funds on its accounts and borrowing. In late summer and autumn, however, the government has relied increasingly on borrowing.

The consolidated budget's collapse in oil & gas tax revenues moderated in the third quarter, but these revenues were still down by 37 % y-o-y. Other budget revenues declined by more than 8 % y-o-y, which was also less severe than in the second quarter (down by 14 % y-o-y if April's Sberbank payment is not included). On the other hand, the dwindling of budget revenues was still that large as taxes are paid to the budget later than taxable incomes accrue to taxpayers. In addition, the government's tax rebates and payment extensions granted last spring are in force. Revenues from corporate profit taxes, in particular, were still quite deep down in the third quarter while value-added tax revenues declined further (VAT, the largest budget revenue stream, accounts for a fifth of total budget revenues). The bright spot in this otherwise dismal budget revenue picture was a slight improvement on the wage front. The mild decline in revenues from employers' wages-based social taxes ceased and revenues from labour income taxes recovered.

Growth in budget spending on social supports slowed in the third quarter, but was still 13 % y-o-y (18 % growth in January-June). The pace of other spending growth slowed from 17 % in the first half to 10 % in the third quarter. Their growth also slowed in real terms as the pace of inflation stayed rather unchanged. Healthcare has clearly led the fast rise in budget spending throughout this year due to covid-19 crisis. Healthcare spending was up about 33 % y-o-y in the first nine months. Budget spending on subsidies and fixed investments in different branches of the economy continued to rise briskly in the third quarter, and was up by over 20 % y-o-y in the January-September period. In addition, spending on public administration increased by 14 % y-o-y in January-September, while spending growth on domestic security and order exceeded 10 %. Education spending grew by under 7 % in the period, while defence spending rose by 4 %. Defence spending declined in the third quarter after a peak last spring.

Russia's government sector revenues have dropped precipitously while spending has increased rapidly.



Sources: Russian Ministry of Finance and BOFIT.

Pandemic halts growth of Russian insurance markets. Russia's insurance markets grew by over 10 % per year in 2016 to 2018. Last year, however, growth was essentially non-existent, due in part to a regulatory crackdown. Sales of insurance, particularly life insurance, boomed in the early months of this year, but lockdown and restrictions on movement in the second quarter, along with the economic recession, diminished demand for insurance. For the year to date, growth has essentially remained at zero. In the same period, however, the amount of payments on accident insurance claims has declined, keeping insurer profitability relatively strong. Forecasters for the branch expect the covid-19 pandemic to increase demand for voluntary health insurance in coming years.

Legally mandated insurance is uncommon in Russia, and accounts for less than 20 % of all premia payments. Mandatory vehicle insurance (OCAGO) accounts for the lion's share of such payments. Life insurance, which is not mandatory, is the most significant form of insurance, accounting for about 25 % of premia revenue. The low real interest rates paid on bank deposits partly explain the eagerness of Russians to purchase life insurance policies.

Despite brisk growth in the past decade, Russia's insurance markets are still relatively small. The aggregate balance sheet of the insurance branch as of end-June was roughly 3.6 trillion rubles, or about 3 % of GDP. For comparison, the aggregate balance sheet (total assets) of the banking sector corresponded to around 95 % of GDP. CBR figures indicate that about a quarter of insurer assets are invested in corporate bonds, 18 % in government debt securities, and 12 % in bank deposits.

Russia's largest insurer is Sogaz, a company founded by gas giant Gazprom. Measured in terms of premia income, Sogaz controls about a quarter of the domestic insurance market. The number-two and -three insurers are subsidiaries of Sberbank and Alfa Bank, each with a market share of roughly 12 %. According to official figures, 169 insurers operated in Russia at the end of June, a decrease of 20 companies from June 2019. The consolidation of Russia's insurance sector is expected to continue this year. The ten largest insurance companies account for over 70 % of all insurance premia payments.

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China

Private consumption takes a higher profile in recovery of Chinese economy. While the rest of the world suffers economic contraction from the covid-19 pandemic, China's economy is recovering with accelerating speed. The nature of the pandemic and the government's emphasis on stimulus have caused various parts of the economy to recover at different rates. Since the first quarter's Covid-19 induced crisis, growth has been led mostly by fixed investment and net exports to a lesser extent. Consumption revived to the point that it supported GDP growth in the third quarter.

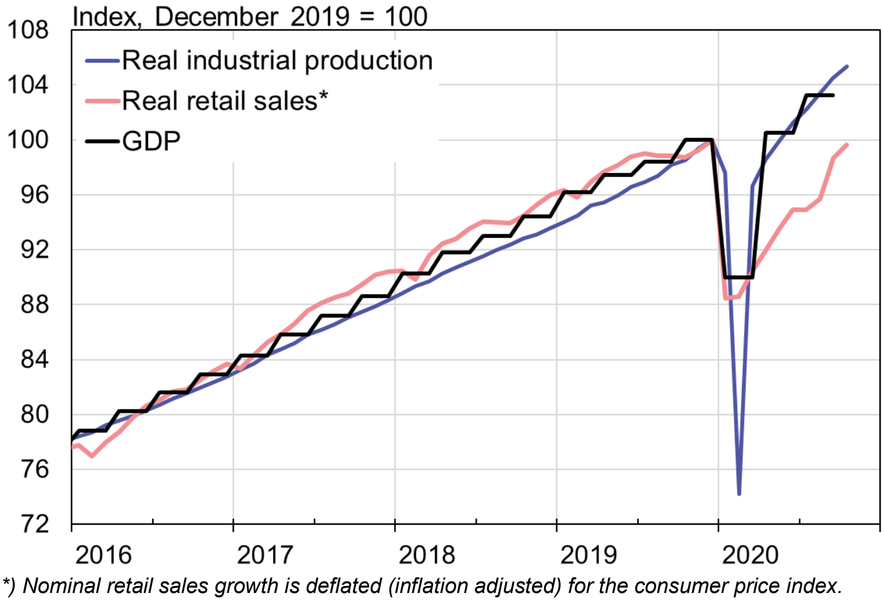
After returning to growth in September, real growth in retail sales accelerated in October to close to 5 % y-o-y. November retail sales growth is also expected to remain strong. Online retail giants like Alibaba and JD.com report that sales on Single's Day were up substantially from last year. The return to normalcy and positive consumer sentiment is also evidenced in the October rise in restaurant sales of nearly 1 % y-o-y. The reading of the official services purchasing manager index (services PMI) in October was a robust 56.2, a modest improvement from September.

Strong growth in industrial output has continued for several months (up 7 % y-o-y in both September and October). The official industrial PMI reading for October was in line with previous months, while the Caixin industrial PMI showed a slight improvement from the September reading. Industrial output has been supported largely by strong export demand and stimulus measures focused on infrastructure investment.

Goods exports climbed by over 11 % y-o-y in October. Imports rose in October by nearly 5 % y-o-y for the second month in a row. Imports from the United States grew by 3 % y-o-y in January-October, while exports to the US were up by 2 %.

The inflation rate in China continues to be affected by the disruption in meat production due to the African swine fever virus epidemic. Consumer price inflation slowed in October to its lowest pace in eleven years (0.5 % y-o-y) after pork prices declined for the first time in 20 months on news that the African swine fever virus was under control. The producer price index fell by 2.1 % y-o-y in October.

While China's industrial output has recovered quickly, retail sales have lagged.



**) Nominal retail sales growth is deflated (inflation adjusted) for the consumer price index.*
Sources: China National Bureau of Statistics, CEIC and BOFIT.

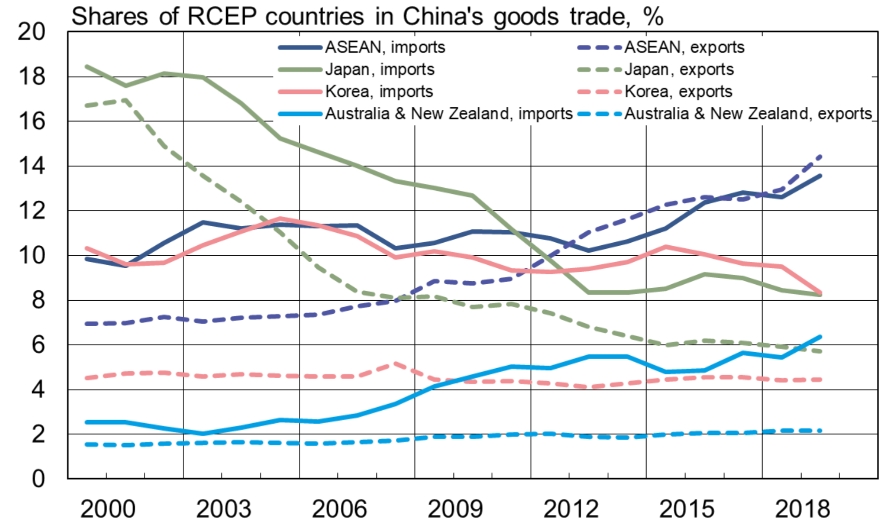
China shores up regional trade relations with signing of RCEP agreement. On November 15, China, Japan, South Korea, Australia and New Zealand together with ten ASEAN countries (Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam) signed an agreement to create one of the world's largest free-trade pacts. The signatory countries of the Regional Comprehensive Economic Partnership (RCEP) account for nearly a third of global GDP and population. India participated in the talks until last year, but withdrew at the last minute. RCEP talks stretched over eight years.

While the details of the agreement have yet to be published, RCEP should slightly reduce tariffs among members and simplify trade procedures e.g. with common rules of origin (i.e. how much of a product has to be produced within the region to qualify for duty-free status). The RCEP pact includes goods trade, the service sector and to some degree intellectual property rights (copyrights, patents and trademarks). Because member countries differ extensively from each other not least in the level of economic development, the agreement includes many exemptions and breaks for participating countries. This naturally weakens the overall comprehensiveness of the RCEP.

Many RCEP signatories already have bilateral free-trade agreements with each other, which decreases the overall impact of the pact. ASEAN members have trade *and* investment agreements with each other. In addition, China, Japan, South Korea, Australia and New Zealand have their own trade agreements with ASEAN countries. On the other hand, this is the first trade agreement between China and Japan and between Japan and South Korea. In a Peterson Institute working paper last June, two researchers estimated that Japan and South Korea would gain the largest economic benefits from the agreement.

Only a few days after the signing of the RCEP, president Xi Jinping announced China's intent to join the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) of 2018. CPTPP was agreed on by eleven countries (Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore and Vietnam) as they continued negotiations after the US pulled out of the original TPP agreement in 2016. The CPTPP agreement is fairly evolved. Accession would require China to open up its service sector to foreign companies, as well as make steep reductions in tariff levels and concessions in such areas as state-owned enterprises and labour unions. China is currently also in trilateral trade negotiations with Japan and South Korea. Talks of a markedly more comprehensive trade deal than the RCEP began in 2012.

Shares of RCEP countries in China's goods trade.



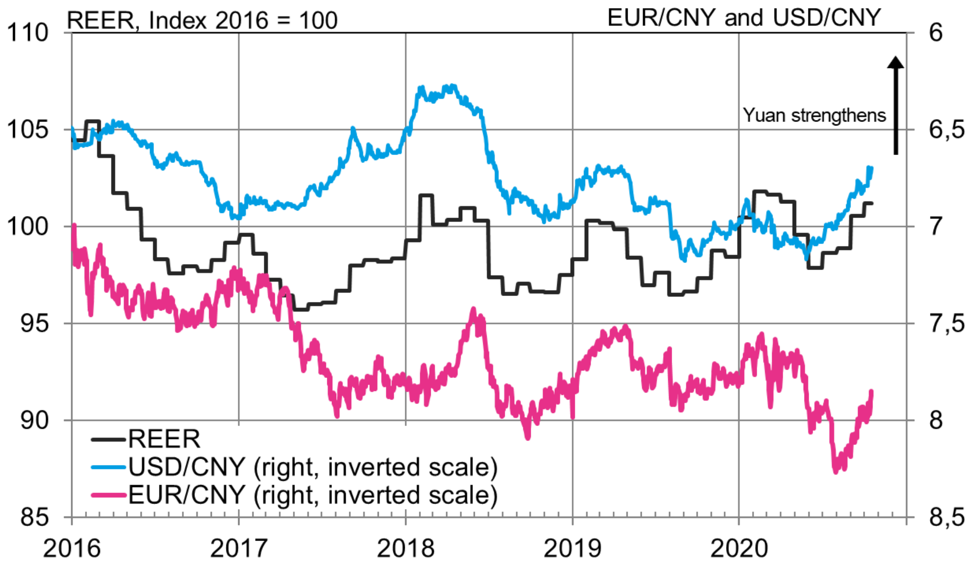
Sources: China Customs, CEIC and BOFIT.

Yuan keeps on appreciating against both the dollar and the euro. The yuan's exchange rate has strengthened by 8 % against the dollar since the start of June and 5 % against the euro since early August. On Thursday (Nov. 26), one dollar bought 6.58 yuan and one euro 7.83 yuan. The yuan was last this strong against the dollar in spring 2019. In contrast, the yuan is still weaker against the euro than it was at the start of this year. The yuan's real effective (trade-weighted) exchange rate (REER) has also gained in recent months. The yuan's appreciation reflects the good performance of the Chinese economy relative to the rest of the world as China seems to have emerged from the covid-19 crisis. China has posted an exceptionally large current account surplus, and the recovery together with the widened interest rate differential between China and the rest of the world has attracted capital inflows.

For the moment at least, the People's Bank of China has showed no urgency to directly intervene in the currency markets to stem yuan appreciation. China's currency reserves have remained relatively stable this year when valuation changes are taken into account. The PBoC has used other measures, however. For example, its reduction of the FX forward reserve requirement to zero on October 12 was seen as a measure to slow yuan appreciation slightly (BOFIT Weekly 42/2020).

At the end of October, China adjusted the mechanism for setting the exchange rate by abandoning the "countercyclical factor" introduced in 2017. Commercial banks have used the factor when they determine the value of yuan which they report to the central bank to be used in setting the official daily yuan opening rate. Use of the factor, which was seen as peculiar from its introduction, was already relaxed in 2018. The mechanism, not known to have been used in any other country, apparently served as a brake on yuan depreciation.

The yuan appreciated against the euro and dollar in recent months (REER = real effective exchange rate.)



Sources: PBoC, BIS, Macrobond and BOFIT.

Increasing number of bond defaults by Chinese state-owned enterprises. The recent increase in bond defaults has been seen as a sign that economic conditions are normalising. In other words, stimulus is being withdrawn and the monetary stance is tightening. During the first ten months of this year, 29 firms defaulted a total of 90 bonds. The value of the defaults was 94 billion yuan ($14 billion), a 10 % increase from the January-October period last year. Payment defaults increased further in November. They are still rare, however. Default rate is well under 1 % of outstanding bonds.

In recent years, the government has begun to tolerate bond defaults of state-owned enterprises (SOEs) and their number have increased this year. Financial media house Caixin reports that SOEs account for 40 % of bond defaults. At least ten SOEs this year have defaulted, including firms thought to be quite solvent such as microchip maker Tsinghua Unigroup, which is controlled by Tsinghua University, as well as Brilliance Auto, the parent company of BMW's Chinese joint-venture partner.

Markets were stunned in November when Yongcheng Coal & Electricity, a wholly state-owned company in Henan, defaulted on repayment of its 1 billion yuan short-term loan, even though according to its financial statements should have had more than enough money to service its debts. The default provoked some investors to sell their SOE bonds and caused other SOEs to postpone new bond issues. Yongcheng later managed to negotiate an extension on its bond payments and thereby avoided defaults on further bonds coming due.

The government's increased toleration for bond defaults and unwinding of implicit guarantees are generally seen as a welcome trend. It increases the role of market forces and improves the allocation of capital. Nevertheless, the pricing of risk is still challenging as Chinese credit ratings do not reflect the true financial condition of firms. Most bonds are given the highest or next-to-highest credit rating. In addition, firms' ownership, financing and shareholding structures are often

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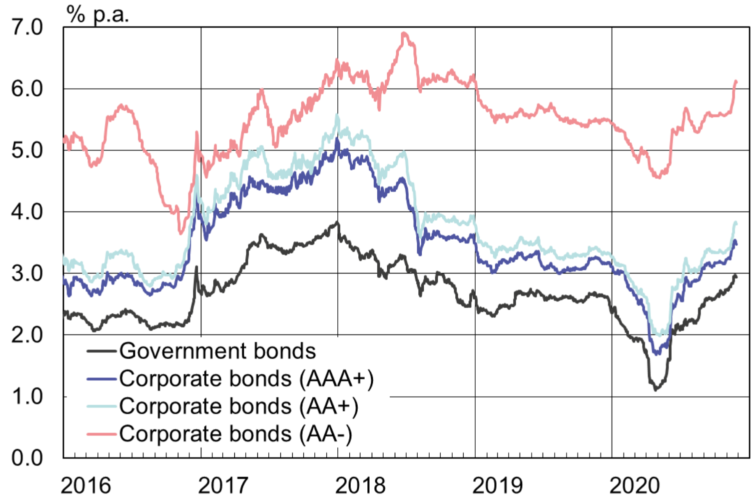
opaque. The most recent defaults sparked also market fears on suspicions that certain firms had deliberately transferred assets to other firms. Financial regulators announced in November that they would crack down on rule violations and fraud that threatened investor protection.

Bond interest rates on the interbank market have risen this month, but the increase in defaults seem not to have caused significant market disruption. Restructuring of debt is a common practice that usually results in the creditors recovering their belated payments. What is new, however, is that some provinces seem increasingly reluctant to support their SOEs. This trend could reduce investor trust in implicit government guarantees and increase the spread in interest rate among SOEs.

1-year interbank bond market rates have risen in recent months.



Sources: National Interbank Funding Center, CEIC and BOFIT.

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Russia

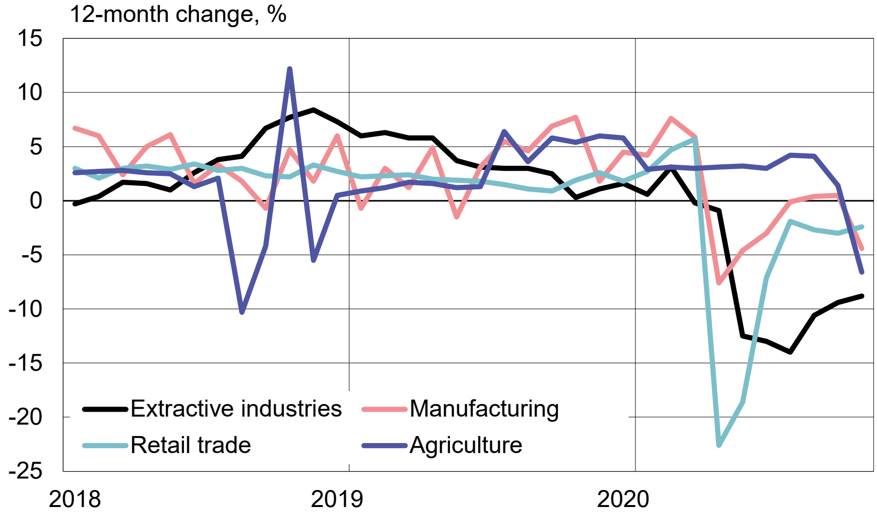
Russia's economy weakened in October. Russian economic growth has slackened since the summer's brisk recovery, with volatile development across branches. Manufacturing and agriculture weighed on the total output in October, while retail sales perked up. The preliminary estimate from Russia's economy ministry shows GDP contracting by 4.7 % y-o-y in October and 3.6 % for the first ten months of this year.

After a couple of weaker months, retail sales revived slightly in October. New car sales were up 7 % y-o-y, even if retail sales overall were still down by 2 %. The recovery in retail sales is expected to be short-lived, however. Much like last spring, it likely reflects demand driven by expectations of further ruble depreciation and a worsening covid situation. Recovery of other services chilled in October, due e.g. to tightening of covid restrictions.

October industrial output remained unchanged from previous months, even if the performances of core sectors diverged. The spotty recovery in extractive industry production continued, but it was still down 9 % y-o-y in October. Oil production remained quelled by Russia's production ceiling agreement with OPEC+ states. The arrangement prohibits further increases in Russian oil production this year. In addition, OPEC+ countries just agreed to moderate the allowed production increases for January 2021 in light of the darker covid outlook. The performance of Russian manufacturing worsened notably in October with production falling by 4 % y-o-y.

Agriculture was also a drag on growth in October with farm production contracting for the first time in two years (down 7 % y-o-y). The decline largely reflected smaller sunflower seed and sugar beet crops compared to last year's record harvests. Construction output in October remained at about the same level as it has for the past two years. Construction statistics suffer from uncertainty, however, and could be revised later.

Manufacturing and agriculture dragged down Russia's economic recovery in October



Sources: Rosstat and BOFIT.

Russian government support has helped move fixed investment towards recovery, outlook remains unsure. After shrinking by 7.5 % y-o-y in the second quarter, real fixed investment contracted by over 4 % y-o-y in the third quarter. Fixed investment has turned much faster to the recovery path than it did during the recessions of 2009 and 2015 (recovery took over a year in both cases).

Fixed investment was down by about 4 % y-o-y for the first nine months of this year. Rosstat only gathers within-year data for large and mid-sized firms as well as government sector investment, which together represent about three-quarters of total fixed investment, and estimates the rest. Fixed investment for the monitored category declined by less than 2 % y-o-y in January-September. Thus, Rosstat estimates that the covid pandemic and depression of the economy pressed down other fixed investment by about one tenth.

The overall decline of fixed investment of large and mid-sized was led especially by a sharp drop of investment in oil & gas pipelines as well as by service providers for oil & gas production. The downhill slide of manufacturing investment (not

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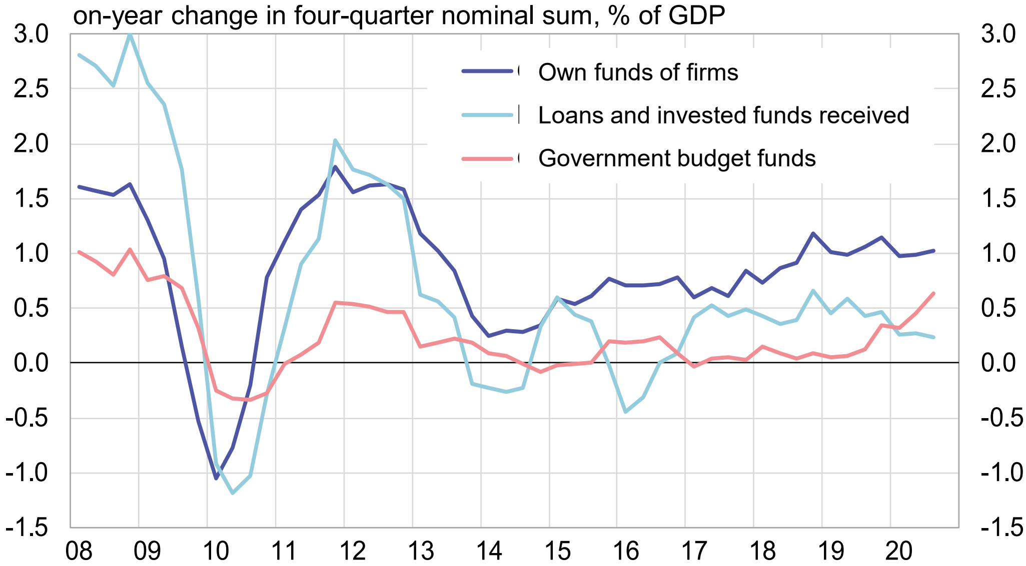
including production of petroleum products) became slightly steeper in the third quarter. Fixed investment in Russia's two large and capital-intensive branches of manufacturing –petroleum products and metals – has instead increased substantially. A larger reduction in total fixed investment, however, has been offset by a strong rise in investment in health care, public administration and also the education sector.

Increased investment in government budget sectors is reflected in fixed investment financing. The government budget sector administrative levels, mainly federal and regional governments, have increased investment financing most strongly in a decade. Moreover, the out-of-pocket investment of large and mid-sized firms has remained stable and continued to be the largest funding source. This has been helped to some extent by government support measures, including corporate subsidies paid out from the government budgets. Overall, corporate funds at banks have increased further this year.

Investment outlook is uncertain for the coming months. Rosstat monitoring finds that industrial capacity use is at its lowest level in ten years. The Central Bank of Russia notes that investment outlook might be weak as so far investors have had limited possibilities to change their ongoing investment programmes.

The government has played an increasing role in financing fixed investment during this year's recession (large and mid-sized firms, as well as government fixed investment)



Sources: Rosstat and BOFIT.

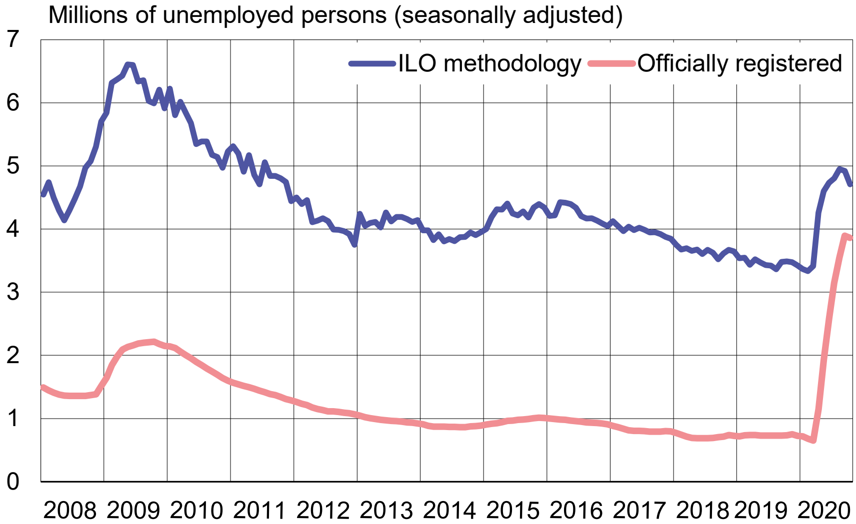
Response of Russian labour market to the economic crisis manifested through various channels. The covid-19 epidemic has shaken Russia's labour market with declining employment, rising unemployment, wages cuts and shorter working hours. While economic recovery has helped the labour market situation stabilise in recent months, the worsening covid situation now overshadows hopes of improvement in the labour market.

During the covid pandemic, the unemployment rate in Russia (based on the ILO methodology) has increased by about two percentage points. Unemployment ceased to rise in September, and the unemployment rate in September and October remained steady at 6.3 %. Russia's unemployment rate is the highest in a decade, but still lower than during the 2009 recession. The number of persons officially registered as unemployed has skyrocketed to record levels. Traditionally, only a small number of unemployed persons in Russia bothered to register as unemployed because unemployment benefits were meagre and application for such benefits burdensome. Last spring, the amount of benefits paid to unemployed individuals was sharply increased and the application process simplified. Half of those now registered as unemployed did not participate in the official labour force earlier. The enhancements to unemployment benefits, however, are only temporary, and many of them expired at the beginning of October. The number of persons officially registered as unemployed declined slightly in October. In addition to greater numbers of unemployed persons, the number of persons who have left the labour force has increased.

As in earlier economic crises, the Russian labour market has adjusted through channels other than higher unemployment. The average monthly wage in the spring contracted sharply for a brief period. In various surveys up to 40 % of respondents reported that their wages had been reduced. The number of hours worked also fell sharply last spring as many workers were put on involuntary holiday or saw their working hours reduced.

The covid pandemic is also reflected in the grey labour market and in migrant labour, even if the exact impacts are difficult to determine. Rosstat estimates that the number of people working in the informal labour market declined sharply last spring. Covid has particularly affected the service sector, where grey labour is more common. It is easy for an employer to sack informal workers. On the other hand, there are signs that some workers have sought out jobs in the informal sector in order to make money while drawing unemployment benefits. A large part of Russia's migrant labour force (possibly as much as 40 % in Moscow) appear to have lost their jobs last spring and some of them returned to their home countries. Covid restrictions have caused the number of migrant workers entering Russia to decline sharply this year. There are indications that this has caused even labour shortages this autumn in certain regions and branches.

Covid and hikes in unemployment benefits have caused the numbers of ILO-defined and officially registered unemployed to spike



Sources: Rosstat and BOFIT.

Number of confirmed covid-19 cases continues to grow; only moderate tightening of restrictions. The daily number of new confirmed cases of covid-19 in Russia has exceeded 25,000 for the past two weeks. The number of reported cases, however, has fluctuated widely in recent days with no apparent direction. Moreover, strong suspicions have been voiced that Russian statistics ignore some covid-related deaths (and possibly infections as well). Official figures report just over 41,000 covid-related deaths in Russia.

While officials have tightened restrictions in the face of rising covid infections, they remain reluctant to impose severe lockdowns on movement and business as last spring. Mask use is now mandatory in public spaces and on public transport in many cities. In St. Petersburg, for example, restaurant hours will be restricted throughout December and the New Year's holidays. The hope is that these measures will be adequate to stem the rapid rise in new cases.

Russia announced administration of its own "Sputnik V" vaccine will begin next week. President Vladimir Putin said the Sputnik V vaccine was ready for distribution, with nearly 2 million doses already manufactured. Given Russia's population of nearly 146 million, production still needs to ramp up substantially. Putin said that the first groups to receive vaccinations would be healthcare workers and teachers. Vaccination of Russian military personnel is already underway. Russia has several other vaccines in various stages of development. It has also participated in trials of several foreign-developed vaccines. Widespread fears about vaccines could cause problems for Russia's vaccination efforts. Several public opinion surveys conducted this autumn found that perhaps half of Russians are reluctant to get a covid vaccine jab.

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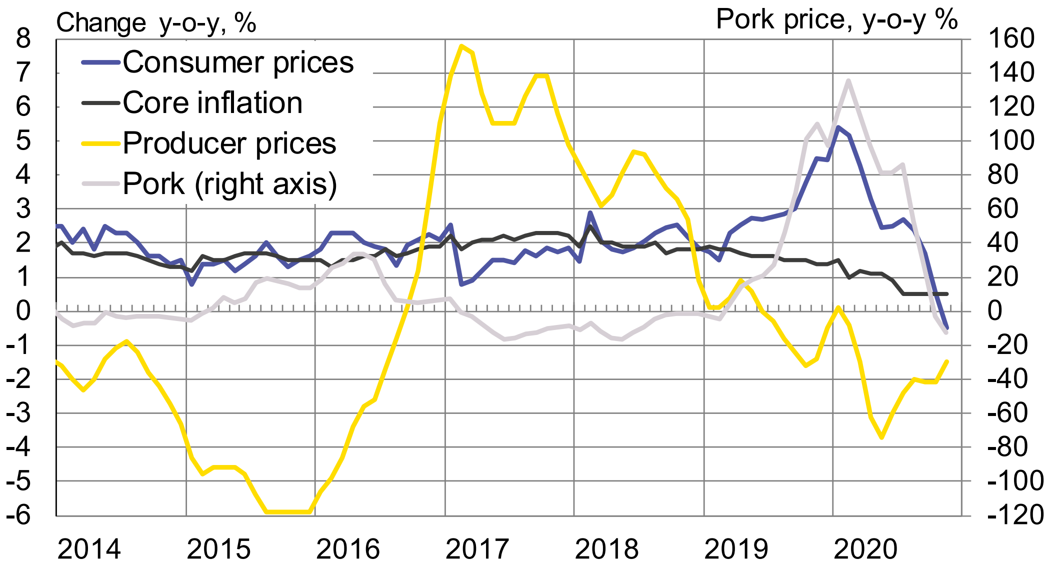
China

Pork prices swing Chinese consumer price inflation into negative territory. Consumer prices slid by 0.5 % y-o-y in November. The drop was led by a 13 % y-o-y drop in the price of pork, a major component of China's average consumer shopping basket. Energy prices also were down on year. In contrast, core inflation, which excludes food and energy prices, continued to rise in November. It was the fifth month in a row that core inflation growth held at the 0.5 % level. Consumer price declines are rare in China. The last negative CPI reading was posted was in 2009 during the international financial crisis.

The decline in consumer prices was to be expected. In the second half of 2019, the African swine fever virus caused pork prices to double after a mass culling of infected pigs. While China's commercial pig stocks and production have recovered somewhat this year and pork prices have started to decline, prices are still very steep compared to before the swine fever outbreak. The expected slow settling down of pork prices will dampen inflation for many months to come. Pork is central to the Chinese diet. China not only consumes about half of all global pork production, it is also the world's largest pork producer by far.

November saw a decline in consumer prices, while the deflation of producer prices continued.



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

China keeps monetary policy largely unchanged as economy bounces back from covid shock. Despite a rapid recovery of the Chinese economy in recent months, the People's Bank of China has kept its main policy rates unchanged since spring. Financing conditions have become tighter, however, and money market rates have risen with the phase-out of the coronavirus stimulus last spring.

The PBoC implements monetary policy with a diverse monetary toolkit. The PBoC's medium-term facility (MLF), targeted medium-term lending facility (TMLF) and pledged supplementary lending (PSL) provided to commercial banks saw more loans come due than were issued during the April-November period. Interest rates under these lending programmes have been steady since April, including the benchmark 12-month MLF rate (2.95 %). Furthermore, the central bank's open market operations (OMO) in January-November caused a net reduction in market liquidity. PBoC market operations are carried out by issuing reverse repo contracts. Their rates have been kept unchanged since March (2.2 % on a 7-day reverse repo).

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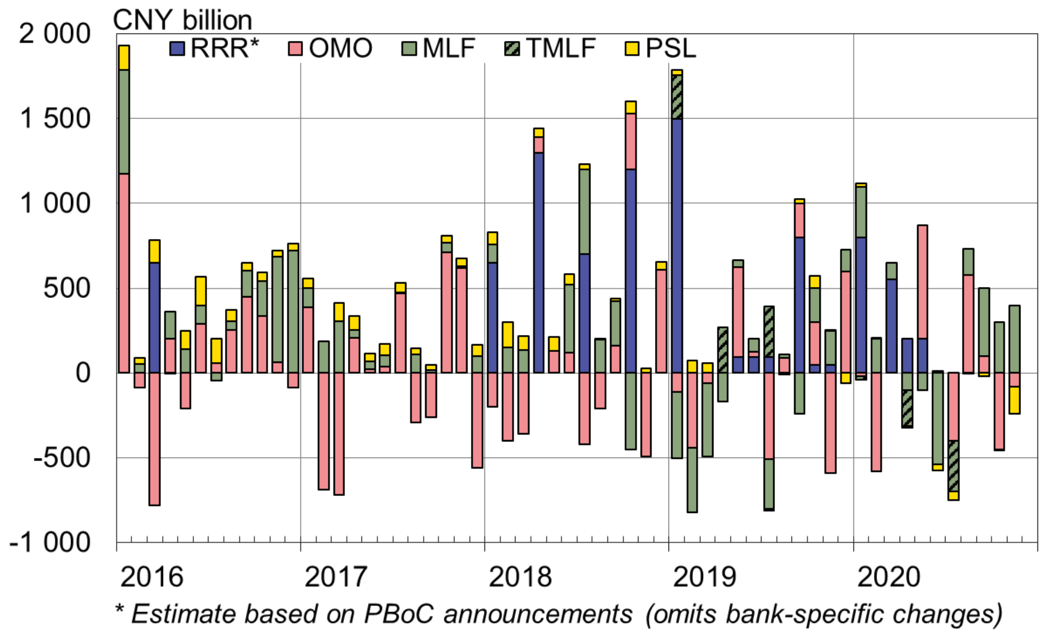
The reserve requirement ratio (RRR) was lowered for all banks in January and further for some banks in March-May. Since then, however, the general RRR levels have remained untouched. The reserve requirement changes, open market operations and lending programmes have led to an increase in market liquidity over the first eleven months of this year of about 1.9 trillion yuan, which is only slightly more than the 1.8-trillion-yuan increase in the same period last year. In addition to these measures, earlier this year the PBoC granted a total of 1.8 trillion yuan in lending and discount quotas to help pandemic containment and support firms (BOFIT Weekly 16/2020), as well as financing aimed at supporting small businesses. Loans to small businesses that were coming due this year have been granted extensions to end-March 2021.

The loan prime rate (LPR), the reference rate on bank loans based on the MLF rate, has remained unchanged since April (3.85 % on a 12-month loan). The PBoC reports on a quarterly basis the average rate on bank loans, which has hovered around 5.1 % this year.

Fall in consumer prices is not expected to affect the monetary policy stance, as the current inflation drop mainly reflects swings in pork prices, and not a general weakness in demand. The official inflation target (3.5 % this year), which is set annually along with other economic targets, largely serves as a desired ceiling for price growth rather than an actual monetary target. China's core inflation rate has remained below the inflation target value for years and the CPI inflation has been above last year's target (3 %) and currently is significantly below the target.

Rising financial market risk from soaring indebtedness is more of a concern for PBoC. Even if the growth in bank lending slowed marginally in November from previous months, the stock of bank loans still increased by 13 % y-o-y. The PBoC measure of total financing (aggregate financing to the real economy) was up by nearly 14 %. Observers generally do not expect any further hikes in policy rates this year. Moreover, the PBoC has tried to calm markets by announcing that it will not act hastily on signs of economic recovery, but rather seek to keep monetary policy "normal" as long as possible. The interest rate gap between China and the rest of the world has widened, causing the yuan's exchange rate to appreciate.

Since the spring, the PBoC's monetary policy measures have decreased market liquidity on net basis.



Sources: PBoC, CEIC and BOFIT.

China's overall exports boosted by global demand for technology products. In dollar terms, the value of China's November exports increased by 21 % y-o-y. Growth rate has now accelerated for six consecutive months. November trade balance grew to $75 billion. In relative terms, exports to the US grew most (up 46 % y-o-y). The value of goods exported to the European Union in November rose by 9 % y-o-y.

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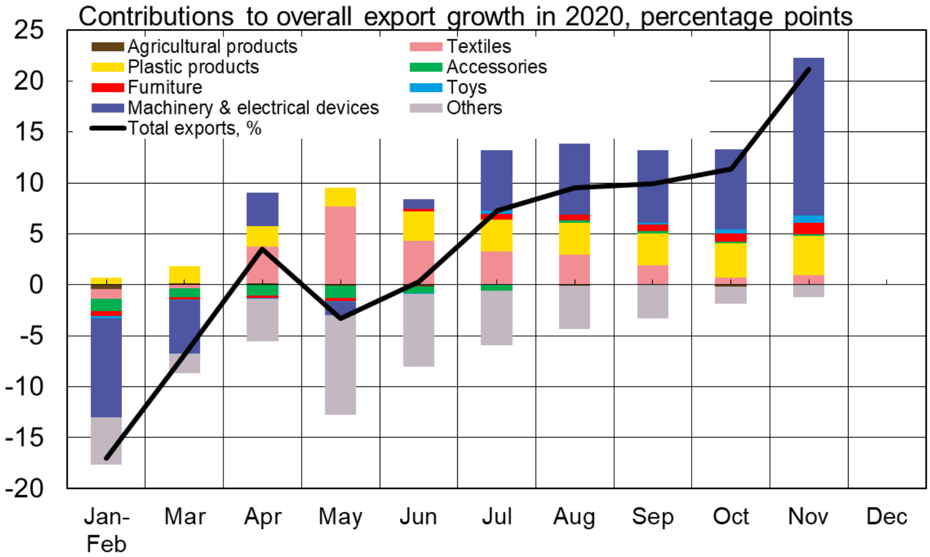
Total exports grew most in China's largest export category, machinery & electrical devices, which saw November exports climb by 25 % y-o-y. The value of exports was boosted particularly by computers and related components (up 34 %), mobile phones (up 29 %) and electronic circuits (up 26 %). Exports of high-tech products rose by a total of 21 %. Export growth in such categories as furniture (up by 42 %), toys (up 50 %) and sports equipment (up 67 %) suggested a revival in consumer demand despite the global covid pandemic.

Import growth remained at 5 % y-o-y in November. Growth in China's imports was strongest for the US, which saw goods imports increase to $15 billion dollars, a 33 % y-o-y jump in November. The return of production to normal levels, which has happened quickly since early spring, is well reflected in China's commodity imports. During the first eleven months of this year, the value of imports of iron ore and pulp were up by over 10 % y-o-y in dollar terms, while copper imports climbed by nearly 40 %. While oil imports were up by about 10 % y-o-y, coal imports were down by nearly 10 %.

Chinese exports have recently been boosted by rising demand for machinery & equipment.



Sources: China Customs, CEIC and BOFIT.

United States imposes new financial market sanctions on Chinese firms. At the beginning of December, the US House of Representatives unanimously approved the Holding Foreign Companies Accountable Act, paving the way for delisting from American stock exchanges any foreign firm that fails to comply with US accounting rules. The act was unanimously passed in May by the US Senate, and now moves to the desk of president Donald Trump for signing.

Even if written with Chinese firms in mind due to years of various accounting scandals, the act applies in principle to any foreign firm. The law requires firms to submit to audits by the US Public Company Accounting Oversight Board (PCAOB). Firms will also have a duty to report whether they are owned by a foreign power or if a foreign power holds a controlling stake in the business. If a firm has been out of compliance for three years in a row, it will be delisted from all US stock exchanges. The law includes a three-year transition period.

China has generally frowned on the idea of external audits, citing national security as the concern. The US Congress reports that as of October, US stock exchanges listed 217 firms that are domiciled in China. The market capitalisation of such firms was $2.2 trillion, or about 6 % of the total market cap of US exchange-traded firms.

In November, president Trump also signed an executive order forbidding ownership or trading in the shares of firms involved with the Chinese military. The order currently affects 35 firms that appear on lists published by the US Defense Department over the year. These listed firms are considered to be involved in the development and modernisation of the Chinese military and thereby pose a direct threat to US national security.

When the order goes into effect on January 11, 2021, investors will have ten months to divest completely of their shares in companies on the list. The order will also cause changes for global stock exchange indices that include the listed Chinese

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firms. Global index provider MSCI announced it would begin to establish the necessary steps to remove them, while FTSE Russell said it would just drop the listed Chinese firms from its own indices on December 21, 2020.

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Russia

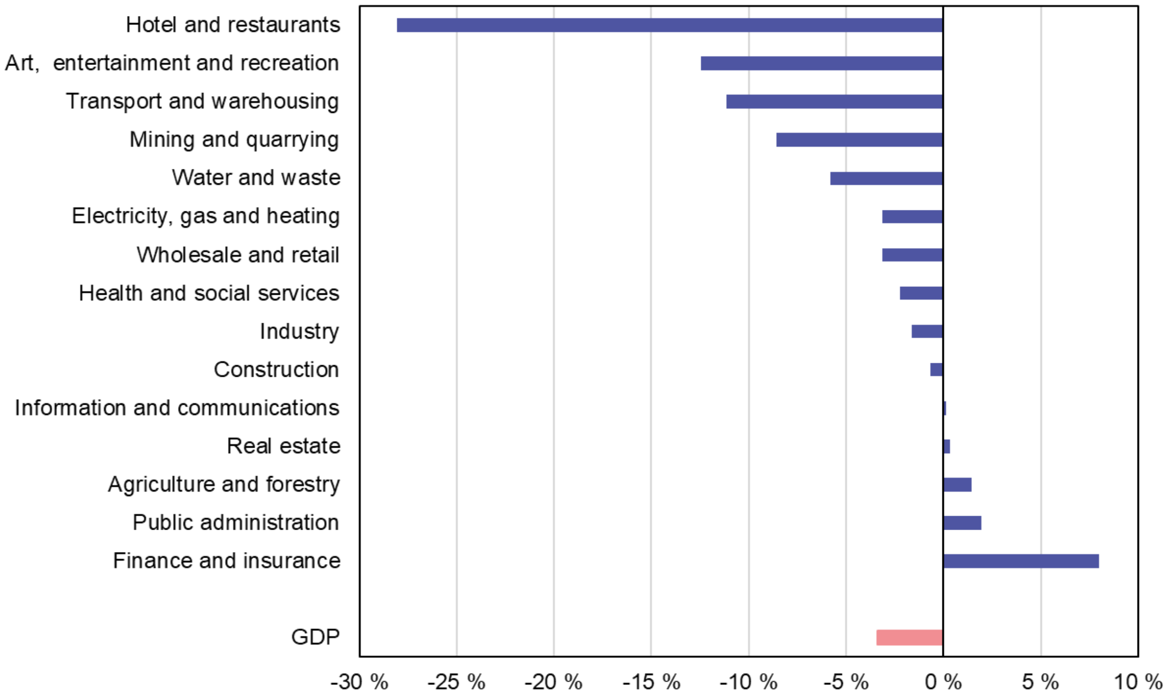
Russian GDP contracted in the third quarter in annual terms, but growth varied considerably across branches. Revised figures for Russian gross domestic product show a 3.4 % y-o-y contraction in the third quarter. For the first three quarters of this year, Russian GDP also shrank by 3.4 % y-o-y in seasonally adjusted terms. The quarter-on-quarter growth, however, climbed to positive territory in the third quarter, as seasonally adjusted GDP grew by 0.7 % q-o-q. Russian economy's performance was already faltering before covid-19 struck, as the peak of seasonally adjusted GDP was already in second quarter of 2019.

As elsewhere, many of Russia's service branches have been clobbered by the pandemic and accompanying lockdowns and restrictions. Large drops were seen in such categories as hotels and restaurants, and entertainment events. In contrast, the third-quarter value-added of industrial branches was almost identical to that of third quarter in 2019. Rapid growth in the financial sector provided a bright spot in the services category.

One special feature of this year has been the OPEC+ agreement, under which Russia and other major oil producers commit to ceilings on crude oil production to keep global oil prices from declining excessively. Due to the agreement, Russia saw mineral extraction activity, which includes oil & gas production, contract strongly (-12 % y-o-y in the third quarter).

While Russian industrial output declined by 2.6 % y-o-y in November, it was less than October's 5.5 % drop. Mineral extraction output fell by 7 % due to the OPEC+ agreement, while manufacturing output rose by 1 %. The pharmaceuticals industry saw a sharp gain in output (up 36 % y-o-y). Rapid growth was also posted by the textile (17 %) and chemical (10 %) industries.

Development has varied widely across branches in Jan-Sep 2020, real on-year %-change in seasonally adjusted value-added



Sources: Rosstat and BOFIT.

Russia imposes price controls in response to rising prices on certain food items. The month-on-month rise in consumer prices accelerated significantly in October and especially in November. The rise was considerably faster than in previous years, with November's pace largest since 2015. In on-year terms, the increase in the CPI also gained pace in November and was 4.4 %. In particular, food prices rose quite sharply. A larger November jump in food prices last occurred

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in 2014 in the wake of sharp depreciation of the ruble that raised import prices. Food prices last month were nearly 6 % higher than 12 months earlier.

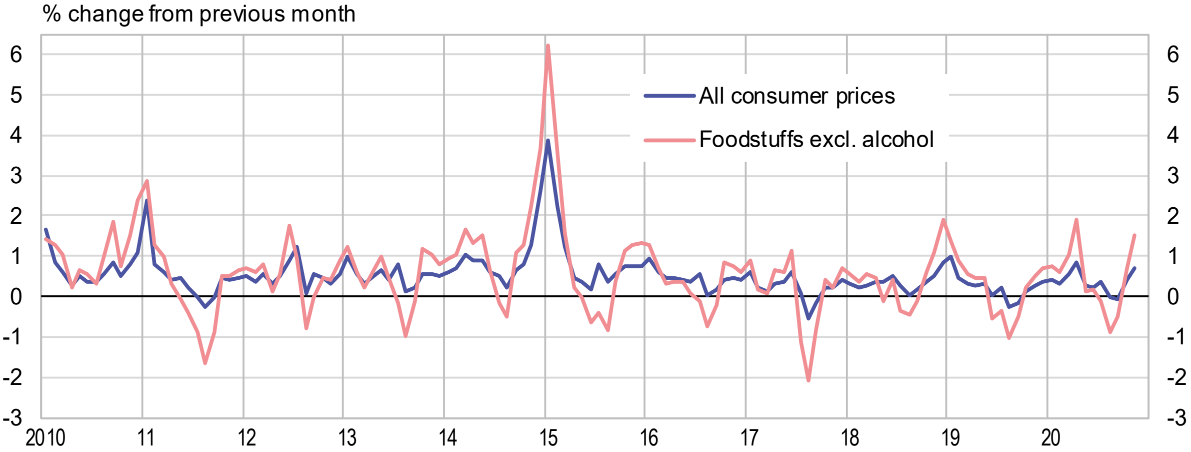
Some of the November price rise reflects the normal seasonal movement for fruits and vegetables, but this year their price increases were notably higher than in previous years. Official attention has focused on certain other staple items such as sugar, which jumped by nearly 30 % on average nationally in October-November and as much as 35–40 % in several regions. Sunflower oil prices increased by 15 % on average and as much as 25 % in some regions. Authorities also spotlighted prices of bread and other baked goods, along with flour prices, which have all gradually risen over the past two years. In some regions, those two-year increases have been as much as 25–30 %. While the increases in sugar and sunflower oil prices largely reflect poor domestic harvests of sugar beets and sunflower seed this year, world prices for these commodities have also increased somewhat.

President Vladimir Putin publicly announced price measures last week, whereupon the government acted swiftly in dealing with the high prices of these staples. Sugar and sunflower oil producers, along with large retail chains, have been directed to sign price control agreements with the government (represented by the industry and trade ministry and the agriculture ministry). Under the price control agreements, which run until April 1 next year, producers and sellers agree to markedly lower their prices of these items still this month and keep them stable in the following months. In return, the government promises to provide support. Sugar producers will be granted low-interest loans to purchase sugar beets. Flour producers will receive subsidies for purchasing wheat, and bakers will receive support in flour procurement. Such price control agreements between firms and the state have been used previously in Russia for other commodities deemed critical, particularly gasoline and fertilisers.

Authorities are also improving readiness for tighter price controls that will rather naturally require a regional emphasis. Under a law enacted in 2008, the government can impose price controls on socially significant staples in individual administrative regions if the price of the staple in the region rises by at least 30 % in a given month. The triggering increase will now drop to 10 % during a one- or two-month period (excluding seasonal fluctuations in prices).

Grain exports will be subject to quotas from February to mid-2021. Wheat exports within the quota will be subject to a roughly 10 % export duty. The grain exports that exceed their quotas, including wheat, will face a 50 % export duty. Increases of export duties on sunflower seed and rapeseed to high levels have already been approved and will remain in force from January to mid-2021. An export tariff on sunflower oil will also be applied in case there are violations of the price control agreements.

Food prices in Russia this year have risen faster than in most recent years.



Sources: Rosstat and BOFIT.

Number of banks operating in Russia still declining, but not as fast as earlier. Central Bank of Russia governor Elvira Nabiullina declared that the purging of unhealthy banks from the sector is essentially complete. Thanks to a consistent policy push since 2013, the number of banks operating in Russia contracted by over half during the following six years. Most affected banks lost their licences due to violations of prudential regulations or money laundering rules. Bank mergers are still relatively rare in Russia. As of beginning December, 371 banks and 40 other credit institutions operated in Russia.

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This year 33 smallish banks have seen their licences pulled, including two banks just last week. While government interest subsidies and loan restructurings have brought relief to the banking sector this year, the recession could still cause havoc for small financial institutions. The November bank health forecast from economic journal Expert RA anticipates that 35 small banks will struggle next year.

Despite Russia's relatively large number of banks even today, banking has always been fairly concentrated. Sberbank, the country's largest bank, accounts for nearly a third of the banking sector's total assets and holds about a third of all deposits. The twelve large banks classified as systemically important represent about 75 % of the Russian banking sector's total assets. The remaining top-100 largest banks account for another 20 % of total assets. That leaves about 250 tiny banks that together represent about 5 % of the banking sector's total assets. About half of these small banks operate under a "basic licence" that restricts the scope of banking and financial services they can offer their customers.

Half of Russia's systemically important banks are either directly state-owned or owned by state enterprises. The state's role in the banking sector sharply increased in 2017–2019, when several small and mid-sized banks were seized by the central bank, deposit insurance agency or a state enterprise. The state currently controls, either directly or indirectly, roughly 65 % of the banking sector's total assets. The CBR is currently seeking private owners for two troubled banks it seized in recent years (Otkritie and ATB), but finding suitable buyers has not been easy.

The number of banks in Russia has declined over the past two decades.

Sources: CBR and BOFIT.

Russia seeks to renegotiate tax treaties. Russia has bilateral tax treaties with roughly 80 countries. These treaties spell out the rules that governments must follow on taxing income transfers between their countries. For example, taxes paid in Russia on income generated in Russia can be credited to the tax liability that might be imposed on that income when it is received in the other signatory country. Last spring, president Vladimir Putin ordered Russia to modify its tax treaties with certain countries, since within the treaties capital income transferred abroad is taxed at substantially lower rates than in Russia. Russia seeks to both increase its tax take and reduce capital flight.

A recent IMF Working Paper estimates that 50 % of foreign direct investment from Russia abroad goes to phantom companies that conduct no actual business. Nearly 60 % of all foreign direct investment inflows to Russia come from phantom companies. Russian firms circulate capital in particular through Cyprus and the Netherlands. Russia's finance ministry estimates that in 2018 and 2019, a total of roughly $50 billion was transferred from Russia in dividends and interest income to Cyprus and over $10 billion to the Netherlands.

So far, Russia has managed to renegotiate its bilateral tax treaties with Cyprus, Malta and Luxembourg. Under the revised agreements, Russia can collect a 15 % tax on dividend and interest income transferred from Russia to these countries instead of the previous typical tax rates of 0–5 %. There are still several exceptions to the agreements (e.g. institutional investors) to which the new higher tax rates are not applied. The new agreements enter into force at the beginning of 2021. Russia has tried to negotiate similar changes with the Netherlands, but the countries have not reached an agreement and Russia has started preparing measures for abandoning the bilateral tax treaty with the Netherlands altogether. Initiating talks with Switzerland and Hong Kong has also been on the table in Russia.

To make it worthwhile to keep capital at home, Russia is also planning to reduce taxation on dividends and interest income in domestic "tax havens". Russia established two special administrative regions in 2018 in Kaliningrad and in Primorsky Krai with a view to getting especially Russian-owned firms registered abroad to repatriate to Russia. Firms registered in these regions receive tax benefits and other preferential treatment. Even so, firms have shown less interest in the regions than officials had hoped. To date, only 40 firms have registered in these special regions.

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China

Maintaining stability will be China's top economic policy goal in 2021. China's top economic policymakers gathered last week (Dec. 16–18) for Beijing's economic work conference to decide Chinese economic policy priorities for 2021 and set relevant targets as China enters its 14th five-year plan. The key message was essentially the same as from last year's conference (BOFIT Weekly 51/2019). Rather than any major adjustments in the economic policy framework, the stress will remain on continuity and stability.

Even if the 2021 GDP growth target has yet to be announced, media sources suggest a target of around 8 % p.a. Approval of the target will take place at the National People's Congress which is normally held in March. The 8 % target also comports with international forecasts, as given this year's exceptionally low basis reference, on-year GDP growth next year should be brisk. Monetary targets include keeping the debt-to-GDP ratio stable, which means that the government will try to rein in growth in indebtedness by keeping debt growth at the same level as nominal GDP growth. In addition, interest rate reforms will be deepened, bank capital will be reinforced and funding of technological innovation will improve.

The work conference identified eight main policy emphases for next year that align both with the coming five-year plan and China's longer-term goals. The emphases are: strengthening technological innovation in strategic fields; enhancing production chains; bolstering domestic demand though e.g. higher employment; reforms and opening up of the economy; improving food supply chains; increasing competition; as well as tackling housing issues in big cities by e.g. increasing production of affordable housing and improving renter protections. The final emphasis will be on climate emissions, including formulating an action plan to assure China's carbon dioxide emissions peak by 2030.

The Chinese economy continued to grow in November; inconsistencies continue to plague fixed investment numbers. Retail sales, measured in real terms, strengthened from below 5 % y-o-y in October to 6 % in November. It was the third month in a row of rising on-year retail sales, an indicator of consumer goods demand. Some of the support for real growth in retail sales, however, reflects the fact that the consumer prices were declining in November (for more on inflation, see BOFIT Weekly 50/2020).

Industrial output growth has plateaued, as in November the growth was the same 7 % y-o-y pace as in the previous two months. The robust recovery in industrial output has been driven by rising export demand. Thanks especially to soaring demand for technology products, export growth accelerated in November to 21 % y-o-y (for more on November foreign trade figures, see BOFIT Weekly 50/2020).

China's National Bureau of Statistics reports that fixed asset investment (FAI) in the first eleven months of this year was up by 3 % from the same period in 2019. Official time series for investment, however, should be viewed with caution. Revisions of the time series and inconsistencies have been ongoing this year. The result from calculating on-year growth in FAI from the official monthly yuan-denominated series now rarely agrees with the official growth figure. In the official growth rate series, FAI was higher this year in the first nine months (January-September) compared to the same period a year earlier. The corresponding growth rate calculated from the yuan-denominated time series, however, indicates that FAI in January-November was still 6 % smaller than in the same period last year. The ending of publication of fixed investment price indices has further complicated the ability of observers to assess the development of fixed investments in real terms.

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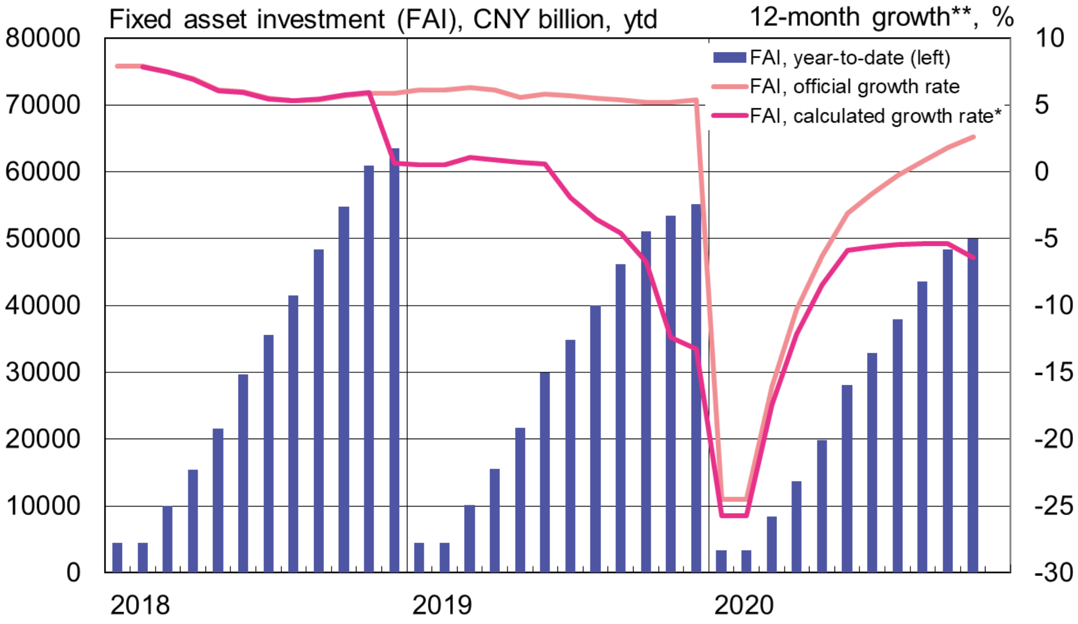
Inconsistencies in the official time series for nominal fixed asset investment (FAI) are a problem



* Calculated from yuan-denominated time series (blue bars).
** Investments made from the beginning of the year compared the same time period in the previous year.

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

Poverty and income disparity remain big challenges for China. China has spent recent years “battling” poverty, specifically elimination of “absolute poverty” by the end of 2020. The government’s specific goal has been to lift the average per capita income in all of China’s 2,851 counties above 4,000 yuan a year (about 500 euros). In certain wealthy provinces, the target was set a bit higher (e.g. Jiangsu 6,000 yuan or 750 euros). China’s National Bureau of Statistics announced in November that every county had average incomes exceeding the poverty threshold, and in December, President Xi Jinping declared a major victory on eradication of poverty.

China’s average county-level poverty definition diverges radically from internationally accepted definitions based on individual income levels, however. The average conceals much of individual extreme poverty, as income disparities also within counties are large. The widely used World Bank definition on extreme poverty is people living on less income than $1.90 per day, which makes around 4,800 yuan per year (660 euros), 800 yuan more than China’s county average target.

A variety of measures have been used to lift the average income levels in the counties, which had average income less than 4,000. Some direct support has been given to these counties, but local authorities have sometimes resorted to measures less welcomed by the poor. For example, officials have moved destitute persons from poor counties to richer areas, which has the immediate effect of raising the average income level of everybody else remaining in the county. The long-term sustainability of such measures has been widely questioned. Criticism has also arisen from the fact that efforts to eliminate poverty in China have focused solely on the poorest counties rather than dealing with poor people throughout China.

In any case, China’s rising affluence and improved living standards are indisputable. For example, China has made significant gains in the UN’s Human Development Index (HDI) over the past 30 years. The HDI considers such factors as life expectancy at birth, expected and actual years of schooling, as well as living standards, i.e. purchasing-power-adjusted gross national income (GNI) per capita. In the latest HDI assessment, China ranked 85th out of the 189 countries surveyed. China performed well with respect to average in life expectancy (77 years). However, while China’s average living standard fits well with the country’s ranking, it conceals massive income disparities. The World Bank estimates that Chinese income differences using the rough Gini coefficient measure are larger than in either Russia or India – and the World Bank’s estimate for China is even more modest than China’s own official estimate.

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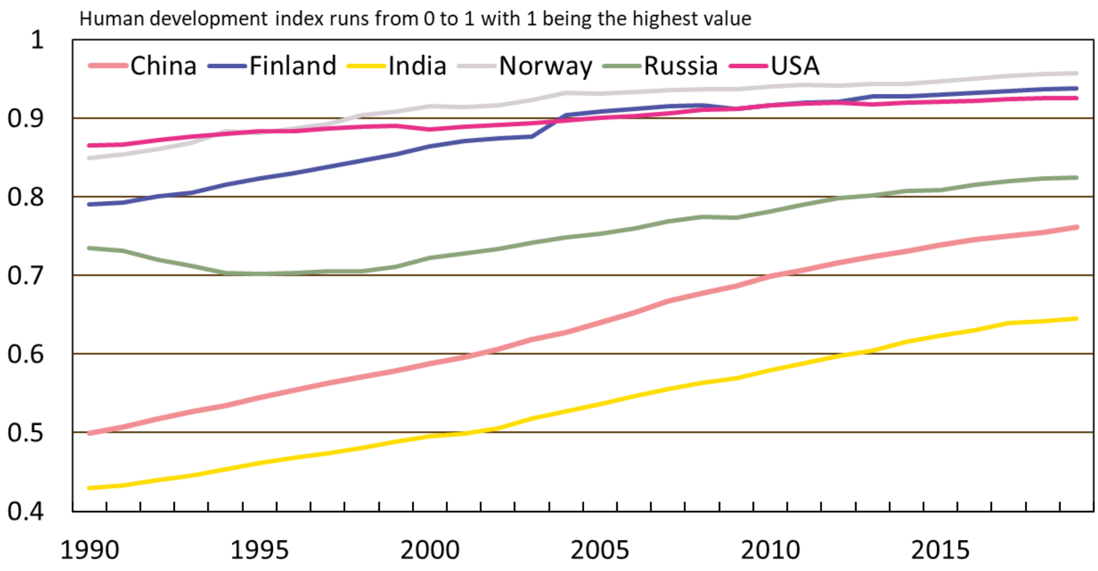
China has narrowed the gap with developed countries in the UN's Human Development Index (HDI) values during the past 30 years



Sources: UN and BOFIT.

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