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BOFIT Weekly
Yearbook 2014



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Bank of Finland, BOFIT
Institute for Economies in Transition

BOFIT Weekly
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The opinions expressed in this paper are those of the authors and do not necessarily reflect the views of the Bank of Finland.

BOFIT Weekly – Russia 2014

3.1.2014 BOFIT Weekly 1/2014

Lack of large enterprise investment depresses Russian capital investment overall.
Russia files first complaint with WTO.
Weak performance of Russian foreign trade continues.

10.1.2014 BOFIT Weekly 2/2014

Russian government admits economic stimulus measures have failed to deliver expected results.
Russian stocks and ruble exchange rate hurt last year by slightly lower oil prices and market uncertainty.

17.1.2014 BOFIT Weekly 3/2014

Russian inflation slowed slightly to 6.5 % last year.
CBR continues to move away from ruble rate steering.
Russian companies still have very few subsidiaries in Finland.

24.1.2014 BOFIT Weekly 4/2014

Russia's 2013 federal budget slightly in the red.
Russia's current account surplus contracted to 1.5 % of GDP in 2013.
Capital exports from Russia increased slightly in 2013.

31.1.2014 BOFIT Weekly 5/2014

Russian economic growth slowed sharply last year.
Ruble nosedives.
Russia seeks to attract Japanese investment in Far East agricultural sector.

7.2.2014 BOFIT Weekly 6/2014

Forecasters expect Russian economic growth to pick up this year and next.
Growth in Russian bank lending moderated last year, but households continued to pile on debt.
Clean-up of Russia's banking sector proceeds smoothly.

14.2.2014 BOFIT Weekly 7/2014

Russia's Supreme Arbitration Court handling economic disputes abolished.
Practically no growth in Russian manufacturing output last year.
Russia preparing tighter rules governing duty-free online purchases from abroad.

21.2.2014 BOFIT Weekly 8/2014

CBR expects GDP growth below 2 % in 2014-16, persistent inflation may require tighter monetary policy.
Russian foreign trade figures weaker in 2013.
Investment plans of Russian companies getting more meagre.

28.2.2014 BOFIT Weekly 9/2014

Russian insurance markets enjoyed modest growth last year.
Boom in car insurance claims spooks Russian insurers.
Ukraine stares into the financial abyss.

7.3.2014 BOFIT Weekly 10/2014

Crimean crisis accelerated ruble's decline.
Steep slowdown in government budget revenue growth.
Finland's trade with Russia contracted last year.

14.3.2014 BOFIT Weekly 11/2014

Crimea crisis hurts Russia's economic growth outlook.
Ruble's slide continues.
Large structural shifts in Russian investment in 2013.

BOFIT Weekly – Russia 2014

21.3.2014 BOFIT Weekly 12/2014

Russian markets calm.
CBR board offers dim economic outlook.
Russian ministries draft measures to finance the Crimean economy.
Gazprom's share of the European natural gas market increased last year.

28.3.2014 BOFIT Weekly 13/2014

Russian financial markets bounce back.
Latest BOFIT Russia forecast sees further growth slowdown this year.

4.4.2014 BOFIT Weekly 14/2014

After some strengthening during the past week, the ruble has again weakened.
Russian government considers economic policy options in the case of possible toughening of sanctions.
Russia's finance ministry commits to backing corporate sector if economy worsens.
Russia debates possibility of using rubles in all foreign trade.
Russia accelerates introduction of national credit card system.

11.4.2014 BOFIT Weekly 15/2014

Uncertainty on Russian markets increased this week on eastern Ukraine unrest.
Russia's foreign currency reserves down in first quarter.
Russian inflation picked up in March.
Gazprom hoists Ukraine's gas price to \$485 per thousand cubic metres.

17.4.2014 BOFIT Weekly 16/2014

Economy ministry lowers its GDP forecast.
Lower imports increase Russian current account surplus.
Considerable capital outflows from Russia continue; sharp increase in cash foreign currency holdings.

25.4.2014 BOFIT Weekly 17/2014

Distinct chill in the Russian economy.
Ministries at loggerheads over government spending and budget rule.

2.5.2014 BOFIT Weekly 18/2014

CBR raises key rate to 7.5 %.
CBR introduces three-year refinancing tool.
Standard & Poor's downgrades Russia's creditworthiness.
Russian government discusses establishing its own national-level credit rating agency.
Russian unemployment still at low levels for now.

9.5.2014 BOFIT Weekly 19/2014

IMF and OECD revise down their forecasts for Russia.
IMF approves \$17 billion support package for Ukraine.

16.5.2014 BOFIT Weekly 20/2014

Gazprom demands Ukraine pre-pay for gas deliveries.
Gazprom cuts gas price for Lithuania.
Russia requests consultation with WTO on EU energy policy.
Russian goods trade contracted in January-March.

23.5.2014 BOFIT Weekly 21/2014

Even as the Russian economy stalls, industrial output revives.
Russia shifts to domestic payment cards.
Russia and China sign major gas agreement during Putin's visit to China.

BOFIT Weekly – Russia 2014

30.5.2014 BOFIT Weekly 22/2014

Ruble weakening again; CBR permitting larger daily swings in ruble exchange rate.
Russian government approves economic forecast used in drafting medium-term budget plan.
Russian economy to be developed under state guidance.
Russian firms finding it harder to get international financing.

6.6.2014 BOFIT Weekly 23/2014

Russia, Belarus and Kazakhstan agree to form Eurasian Economic Union.
IMF gives Russian public sector financial reporting mixed review.
Finnish-Russian trade contracted in first quarter.

13.6.2014 BOFIT Weekly 24/2014

Russia government finances: higher oil revenues and defence spending.
Rosneft-BP deal lifts Russia's 2013 FDI figures.

19.6.2014 BOFIT Weekly 25/2014

Ruble's real exchange rate strengthens, drop in imports moderates.
Russia cuts gas supplies to Ukraine.

27.6.2014 BOFIT Weekly 26/2014

Russia prepares for Ukraine's EU association agreement.
Russia submits complaint to WTO on US economic sanctions.
European Union bans imports from Crimea.
Situation in Ukraine affects Russia's defence industry.
Public sector employees make up the core of Russia's middle class.

4.7.2014 BOFIT Weekly 27/2014

Interest rates in Russia climb over the past six months.
Ruble appreciated 1.6 % y-o-y in the second quarter.
Moscow share prices made strong recovery in second quarter.
Russia returns to international credit markets.

11.7.2014 BOFIT Weekly 28/2014

Ruble finds support from Russian foreign trade and calming capital flows.
Russia decides on oil sector tax reform.
TIR system gets more time again at Finnish-Russian border.

18.7.2014 BOFIT Weekly 29/2014

Russia's latest three-year budget plan calls for higher revenues and small deficits.
IEA encourages Russia to focus on energy efficiency and boost investment in the energy sector.

25.7.2014 BOFIT Weekly 30/2014

Production and demand in Russia shrank in June.
US and Canada widen sanctions against Russia, and the EU.
Banking sector reflects growth of uncertainty.

1.8.2014 BOFIT Weekly 31/2014

EU directs sanctions at core branches of the Russian economy.
Sanctions have already hit the Russian economy.
CBR hikes the reference rate as international tensions rise.
Ruble slid again.

8.8.2014 BOFIT Weekly 32/2014

Economic sanctions pose no imminent threat to Russia's banking sector.
State-owned banks continue to increase their dominance of Russia's financial sector.
Russian businesses already feeling sanction effects.

BOFIT Weekly – Russia 2014

- 15.8.2014 BOFIT Weekly 33/2014
Food import ban and Russia's food supply security.
Observers say import ban may stoke Russian inflation.
Belarus and Kazakhstan stay on the sidelines in Russia's food fight with the West.
- 22.8.2014 BOFIT Weekly 34/2014
GDP contracted in first half of 2014.
Free-floating ruble almost a reality.
Russian imports down in first half.
- 29.8.2014 BOFIT Weekly 35/2014
Russia's economy ministry lowers growth forecast for 2015.
Government budget framework 2015–2017 anticipates only slow growth in several major spending areas, save defence.
Lean times continue for regional budgets in years ahead.
- 5.9.2014 BOFIT Weekly 36/2014
Russian investments in energy and housing increased.
Finnish-Russian trade declined in first half.
Ukraine does its best to comply with the terms of the IMF support programme.
- 12.9.2014 BOFIT Weekly 37/2014
Food prices in Russia up sharply.
Experts weigh in on 2015 budget options.
CBR and economy ministry divided over monetary policy.
- 19.9.2014 BOFIT Weekly 38/2014
BOFIT forecasts slow recovery for Russian economy.
The EU and US step up economic sanctions against Russia.
Ruble down sharply.
- 26.9.2014 BOFIT Weekly 39/2014
Russia to keep tight fiscal policies in place next year.
Increasing Russia's agricultural output will take time.
Russia demands, and gets, a delay in the launch of the Ukraine-EU free-trade agreement.
- 3.10.2014 BOFIT Weekly 40/2014
Economy ministry warns capital exports could accelerate further.
CBR calms fears over possible capital control measures.
Russia depletes its oil fund savings.
- 10.10.2014 BOFIT Weekly 41/2014
Ruble facing depreciation pressures.
Structural changes for Russian government spending larger than scheduled earlier.
- 17.10.2014 BOFIT Weekly 42/2014
Falling imports support Russia's current account surplus.
Access to foreign funding for Russian banks and corporations dried up.
Russian prime minister and Chinese premier hold annual meeting in Moscow.
- 24.10.2014 BOFIT Weekly 43/2014
Transient factors supported Russian economic growth in September.
Moody's downgrades Russia's creditworthiness.
Lower crude oil prices not yet fatal for Russia's fiscal or current account balances.
Russia shifts permanently to standard time.

BOFIT Weekly – Russia 2014

31.10.2014 BOFIT Weekly 44/2014

CBR: Firms and banks able to service their foreign borrowing.
Russia reinstates authority of investigating officials to file criminal charges for tax violations independently.
Russia must increase oil drilling to preserve production at current levels.

7.11.2014 BOFIT Weekly 45/2014

Ruble hits record low – free float approaches.
CBR raises key rate.
Ukraine and Russia work out deal on winter gas supplies.
Finnish exports to Russia continue to decline.

14.11.2014 BOFIT Weekly 46/2014

CBR floats ruble ahead of schedule.
Weak outlook for Russian household income growth.
Russia and China continue gas talks at APEC summit.

21.11.2014 BOFIT Weekly 47/2014

Federal budget so far in surplus; next year's budget likely to dip slightly into the red.
Russia puts ceilings on consumer credit rates.
Russian foreign trade continues to contract.

28.11.2014 BOFIT Weekly 48/2014

CBR says zero economic growth may be ahead in 2015–2016.
Profits of foreign-registered Russian firms are aimed to get under Russian taxation.
Law changed on Russian oil sector taxation.

5.12.2014 BOFIT Weekly 49/2014

CBR intervenes in currency markets as ruble's slide hastens.
Russia approves duty on retail trade facilities.
Russia's ban on food imports causing friction among customs union partners.

12.12.2014 BOFIT Weekly 50/2014

Russian on-year inflation accelerates towards 10 %.
Russia's big firms increase their investments.
Economy ministry sees GDP contraction next year, imports to be hardest hit.

19.12.2014 BOFIT Weekly 51–52/2014

Fall of the ruble levelled off.
Putin calls for budget spending cuts already next year.

BOFIT Weekly – China 2014

3.1.2014 BOFIT Weekly 1/2014

Audit finds mounting local government debt in China.
Interest rates on the rise in China.
Shanghai A-share index falls close to its level two years ago.

10.1.2014 BOFIT Weekly 2/2014

China takes another stab at regulating grey market lending.
Few forecasters expect Chinese economic growth to pick up this year.
Concern over environmental issues on the rise in China.

17.1.2014 BOFIT Weekly 3/2014

China's inflation slowed in December.
Processing-and-assembly exports no longer increasing in China.
People's Bank of China cracks down on bitcoin trading to prevent skirting capital limits.

24.1.2014 BOFIT Weekly 4/2014

China's fourth-quarter GDP growth matches expectations.
Income growth in China slowed last year; income disparity remains high.

31.1.2014 BOFIT Weekly 5/2014

Year of the Horse enters on uncertain note.
China had record large grain harvest last year.
China's changing demographics brings challenges.

7.2.2014 BOFIT Weekly 6/2014

Yuan now ranks among top ten most-used currencies in international payment transactions.
Official figures underestimate Chinese investment in OECD countries.

14.2.2014 BOFIT Weekly 7/2014

Chinese tourists reduce global trade imbalances.
China's foreign trade grew fast in January.
China and Taiwan take a step towards increased political dialogue.

21.2.2014 BOFIT Weekly 8/2014

China's central bank drains liquidity to slow credit growth.
Profits of Chinese banks continue to soar.
Investment in China's real estate sector accelerates.

28.2.2014 BOFIT Weekly 9/2014

Yuan decline may signal move to wider trading band.
China makes it easier to start a business.
Investors' risks realizing in China's shadow banking sector.

7.3.2014 BOFIT Weekly 10/2014

China will strive to match last year's economic performance.
China gets more serious about environmental issues.
China reforms its pension system.

14.3.2014 BOFIT Weekly 11/2014

Progress in reform of China's financial markets.
China posts trade deficit in February.
Slower rise in Chinese consumer prices.

21.3.2014 BOFIT Weekly 12/2014

Yuan trading band widens as expected.
China surpasses Germany in patent applications.
China raises public spending, especially on healthcare and defence.

BOFIT Weekly – China 2014

28.3.2014 BOFIT Weekly 13/2014

Latest BOFIT forecast sees further slowing of Chinese growth, increased risks.
Losses on Chinese financial markets force investors to assess their risk exposures more carefully.

4.4.2014 BOFIT Weekly 14/2014

China announces another “mini-stimulus.”
China wants to redirect internal migrants to smaller cities.
WTO panel concludes China’s export controls on rare earth metals violate its WTO commitments.

11.4.2014 BOFIT Weekly 15/2014

China’s foreign trade remains weak.
IMF recommends China to curb lending growth.
China’s increasing clout in the global arms trade.

17.4.2014 BOFIT Weekly 16/2014

First-quarter figures show clear signs of economic slowdown.
China eases cross-border share trading as deregulation of capital movements continues.

25.4.2014 BOFIT Weekly 17/2014

First-quarter data show mounting debt levels in China.
Government aims to curb shadow-banking risks by tightening regulation and clearing path for the local government bond market.

2.5.2014 BOFIT Weekly 18/2014

China’s current account surplus shrank in first quarter.
Amendments to China’s environmental protection law give authorities more power to take on polluters.
Foreign car manufacturers increase market share in China.

9.5.2014 BOFIT Weekly 19/2014

Yuan’s international role continues to grow.
Slight improvement in Chinese foreign trade in April.
Latest ICP figures show China’s cost-of-living-adjusted GDP nearly matching the United States.

16.5.2014 BOFIT Weekly 20/2014

April’s economic figures as expected, even as worries about the real estate sector deepen.
Premier Li visits Africa amidst dip in trade.

23.5.2014 BOFIT Weekly 21/2014

China ramps up transparent financing options for local governments.
Russia becomes a new gas provider for China.
Russia accounts for just 2 % of China’s foreign trade.

30.5.2014 BOFIT Weekly 22/2014

China’s money markets calm in May, yuan exchange rate stabilises.
Territorial disputes threaten the positive development in China-Vietnam trade.
China plans to progress on structural reforms in second half of the year.

6.6.2014 BOFIT Weekly 23/2014

Company surveys indicate no big shifts in Chinese economic trends.
China becomes the world’s largest buyer of industrial robots.
Slowdown in Finnish-Chinese trade continued in first quarter.

13.6.2014 BOFIT Weekly 24/2014

Chinese exports performed well in May; trade surplus swells on weak imports.
Despite rising business uncertainty, most European firms operating in China are still profitable.

BOFIT Weekly – China 2014

- 19.6.2014 BOFIT Weekly 25/2014
China economic situation unchanged in May, progress in structural change.
China and India try to resurrect economic ties.
- 27.6.2014 BOFIT Weekly 26/2014
Falling housing prices in China?
Further progress in deposit rate liberalisation.
Weak first half for Chinese stock markets; IPO listings resume after 4-month pause.
- 4.7.2014 BOFIT Weekly 27/2014
Targeted lending breaks for select Chinese banks.
Interest rates on Chinese money markets rise a bit; no “Shibor shock” like last year.
Summer vacation season kicks off in China; foreign travel increasingly popular.
- 11.7.2014 BOFIT Weekly 28/2014
Stable inflation picture continues.
Local government indebtedness continues to rise.
Germany dominates China-EU trade.
- 18.7.2014 BOFIT Weekly 29/2014
Chinese economic growth picked up slightly in the second quarter.
Two local governments form first wave of bond issues under new policies.
China seeks to support the yuan's role in international payments.
- 25.7.2014 BOFIT Weekly 30/2014
BRICS to establish their own development bank and currency reserve arrangement.
The gap between China's foreign direct investment inflows and outflows narrows.
- 1.8.2014 BOFIT Weekly 31/2014
Yuan appreciation returns; current account surplus rises.
Summer grain harvest exceeds old record – FAO and OECD encourage China to rationalise agricultural production.
Latest WTO decisions on US-China trade disputes.
- 8.8.2014 BOFIT Weekly 32/2014
IMF board encourages China to focus on debt issues and structural reforms.
Progress in reform of hukou household registration system.
- 15.8.2014 BOFIT Weekly 33/2014
Credit growth in China slows; real economy indicators suggest more balanced growth.
China's trade surplus hits record high in July.
Foreign firms investigated under China's anti-monopoly law; EU Chamber of Commerce calls for equal treatment of all companies.
- 22.8.2014 BOFIT Weekly 34/2014
Weaker outlook for China's real estate sector.
China's financial markets see increased popularity of bonds as a means of financing.
- 29.8.2014 BOFIT Weekly 35/2014
Fossil fuels continue to dominate and govern outlook for Chinese imports from Russia.
China strives for improvements in healthcare through reduced regulation and greater public financing.
- 5.9.2014 BOFIT Weekly 36/2014
Stimulus demands unsupported by economic indicators.
China's revised budget law allows local government to borrow.
Finnish exports to China declined in first half.

BOFIT Weekly – China 2014

12.9.2014 BOFIT Weekly 37/2014

China further relaxes capital controls.
Growth of China's foreign trade slowed in August on falling commodity imports.
Modernisation of China's railways moves ahead.

19.9.2014 BOFIT Weekly 38/2014

BOFIT forecast sees smooth slowdown in Chinese economy.
China's competitiveness still based on market size and favourable macroeconomic environment.

26.9.2014 BOFIT Weekly 39/2014

Worrisome trends in China's housing markets.
Alibaba stages massive IPO.
China accounts for over half of growth in global greenhouse emissions.

3.10.2014 BOFIT Weekly 40/2014

China eases mortgage lending rules.
China launches direct yuan-euro trading, while progress in reforms across the financial sector remains spotty.
Hong Kong protests put Chinese pragmatism to the test.

10.10.2014 BOFIT Weekly 41/2014

IMF calls for further structural reforms in China.
Yuan strengthening continues.

17.10.2014 BOFIT Weekly 42/2014

China's goods trade surplus reaches record high.
Key monetary indicators suggest permanent slowdown in growth.

24.10.2014 BOFIT Weekly 43/2014

China's economic structures evolve to reflect lower growth paradigm.
Pace of growth in domestic indebtedness slows.
China to release better unemployment data.

31.10.2014 BOFIT Weekly 44/2014

Inauguration ceremonies held for China-led Asian Infrastructure Investment Bank.
Sharp increase in Chinese outward FDI flows.
Annual meeting of Chinese Communist Party Central Committee focused on problems concerning rule of law in China.

7.11.2014 BOFIT Weekly 45/2014

China posts increases in both current account surplus and financial account deficit.
China to allow competition in payment card market.
China's shadow banking sector grows rapidly.

14.11.2014 BOFIT Weekly 46/2014

Free-trade agreements top APEC agenda.
China and the United States reach deal to eliminate duties on many IT products.
China's New Silk Road vision comes closer to reality.

21.11.2014 BOFIT Weekly 47/2014

"Through Train" link of Shanghai and Hong Kong stock exchanges expands access to Chinese equities.
Trading via Shanghai and Hong Kong stock exchange link off to weaker-than-expected start.
China's economic figures reveal long-expected slowing.

BOFIT Weekly – China 2014

28.11.2014 BOFIT Weekly 48/2014

Cuts and looser rules for interest rates in China.
Chinese monetary policymakers struggle to keep up with rapid changes in the market.

5.12.2014 BOFIT Weekly 49/2014

Rollout of deposit insurance scheme proceeds in China.
Yuan use continues to increase in Chinese foreign trade.

12.12.2014 BOFIT Weekly 50/2014

Chinese inflation cools on lower food and commodities prices as well as lower economic growth.
Shanghai stock exchange volatility underscores developing state of Chinese financial markets.
China's ranking in TI Corruption Perception Index drops sharply.

19.12.2014 BOFIT Weekly 51–52/2014

Industrial output growth slowed in November; slowdown also expected in the fourth quarter.
Cheaper oil should have an overall positive affect on the Chinese economy.
Progress in reform of China's household registration system.

Russia

Lack of large enterprise investment depresses Russian capital investment overall. Fixed capital investment since last spring has most of the time been slightly below 2012 levels. Lower investment levels of large and mid-sized firms were the main reason for the reduced investment overall. In the third quarter of 2013, investment by such firms actually fell below 2012 levels even in nominal terms. Taking inflation into consideration, the real contraction in the first nine months of 2013 was remarkably severe; prices of investment goods have risen even faster than the CPI, which ran at about 6 %.

The drop in capital investment of large companies affected entire sectors. In January-September, on-year investment in oil & gas transmission pipelines was down about a third, investment in base metal production was off 20 % and investment in oil & gas production and in the electricity sector declined about 10 %. Investment in manufacturing, on the other hand, continued to rise, although at a slower pace of around 2 % y-o-y. Investment in oil refining and chemical production helped buoy growth in manufacturing investment overall.

Some of the weak investment performance reflected the completion of several pipeline megaprojects in 2012. In 2014 the willingness of large firms to jump into new investment projects is restricted by their poorer revenue growth prospects. The government last autumn decided to freeze prices of products and services of large infrastructure companies and utilities in 2014 in order to stimulate economic activity through reduced inflationary pressure. No boost for investment is expected from the public sector, either, as those investments are being cut due to tight budget constraints.

Fixed capital investment corresponds to about 20 % of Russian GDP. While this would be a normal allocation of resources for a developed economy, it is inadequate for an economy striving for rapid growth while making structural reforms. As a result, enhancing investment growth is a primary challenge for Russia's economic policymakers.

Russia files first complaint with WTO. The request for formal consultation on the EU's use of anti-dumping tariffs to certain Russian-made metal products and fertilizers was filed on December 23. The EU justifies anti-dumping tariffs by comparing the export prices of the sanctioned products to comparable pricing in third-country European domestic markets. By showing Russian export prices to be substantially lower than domestic EU prices, the EU treats these as straightforward instances of dumping.

For exports of countries granted market-economy status the comparison is normally made between exporters' domestic prices and their export prices. With regards to dump-

ing, however, the EU does not treat Russia as a market economy even if it granted Russia market-economy status in 2002.

Russia claims its low export prices reflect low domestic energy prices, so any comparison needs to be between prices on Russia's domestic market and export prices. Russia says the EU practice is violating international trade rules.

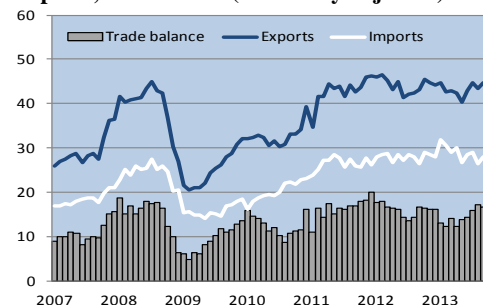
Between 1995 and 2012, the EU imposed protectionist tariffs on 17 Russian product categories.

Weak performance of Russian foreign trade continues. The value of Russian goods exports contracted 2 % y-o-y in the first ten months of 2013, amounting to \$427 billion. In October the value of exports slipped even 6 % y-o-y. The decline of the value of exports reflects lower prices as export volumes have actually increased slightly. Especially export volumes of petroleum products and natural gas have grown rapidly. Gas exports to Europe rose, while exports to CIS countries contracted. Some of the reduction in exports to CIS countries in recent months reflects the problems in Russia-Ukraine relations.

With the exception of nickel, most metal exports contracted on-year both in terms of value and volume. The Netherlands continued to be Russia's top export destination by far as it is the hopping off point for distribution of Russian oil and petroleum products to other countries. Russia's next largest export markets were Italy and Germany.

The value of goods imports grew in January-October slightly over 2 % y-o-y to \$280 billion. Growth reflected rising import prices whereas import volumes declined slightly. Imports have been falling in recent months, however. In October, the value of imports fell 4 % y-o-y and further 2 % in November according to preliminary data covering imports from non-CIS countries. The decline in the machinery, equipment and transportation vehicle category drove the drop in imports. There was a particularly sharp reduction in imports of cars and trucks. On the other hand, rapid growth occurred in imports of e.g. dairy products and pharmaceuticals. The biggest sources of imports were China, Germany and the US.

Monthly Russian goods trade surplus, goods exports and imports, USD billion (seasonally adjusted)



Sources: Central Bank of Russia, BOFIT (seasonal adjustment)

China

Audit finds mounting local government debt in China.

The National Audit Office (NAO) on Monday (Dec. 30) released its long-awaited audit of local administrations. The report found that local government debt, including loans secured by local administrations, had risen to 17.9 trillion yuan (over €1.1 trillion) as of mid-year 2013. The audit further noted that local administrations continue to pile up debt, a situation that could threaten both the sustainability of local government finances and China's overall economic growth.

Local government debt has increased by about 65 % since the end of 2010, when the NAO last released a local government audit. An NAO press release notes that any direct comparison may be misleading as the latest audit examines debt at more detailed level of government. China's multi-tiered administration complicates reliable estimation of public sector debt and how it is distributed.

Nevertheless, the audit concludes that overall public sector debt in China equals roughly 55 % of GDP. This figure is in line with most market estimates, so there was little market reaction to the audit release.

China's new leadership hopes to quell the debt splurge through economic reforms. The tax base of local governments would be expanded through changes in e.g. value-added tax and property tax. The local governments' would be permitted to issue bonds to cover maturing debt, which would bring greater transparency to their debt exposure.

Interest rates on the rise in China. The liquidity situation in the interbank market tightened again before Christmas, causing short-term rates to spike. When the widely tracked 7-day Shanghai Interbank Offered Rate (Shibor) reached nearly 9 % on December 23, the PBoC responded the next day with a reverse repo liquidity infusion. While the situation stabilised in the final days of 2013, the level of interest rates has increased since the previous rate jump in June (see chart).

Banks typically need more liquidity towards the end of the quarter, when banks report to regulators on how well they are meeting their reserve requirements (e.g. provisions). The timing of corporate tax payments, government coffer position and timing of holidays can also strain liquidity. Part of the reason for the recent tight liquidity situations has been that a number of smaller banks and other financial institutions have been relying on the interbank market for a significant share of their short-term financing.

For the architects of monetary policy, the situation has become more difficult than earlier as the number of financial market actors has increased and the selection of financial instruments has multiplied. Unfinished interest rate liberalisation and the fact that interest rate policy has not yet estab-

lished its role as a primary monetary policy tool, complicates the situation in the money market.

Shanghai A-share index falls close to its level two years ago.

China's biggest stock market continued to slide last year with share prices on the Shanghai exchange dropping nearly 7 %. Share prices were depressed by factors that included weaker growth projections for China, rising corporate indebtedness and uncertainty on financial markets. A surprise jump in interbank lending rates in June also battered share prices, and similar rate spikes were repeated in October and December (see chart).

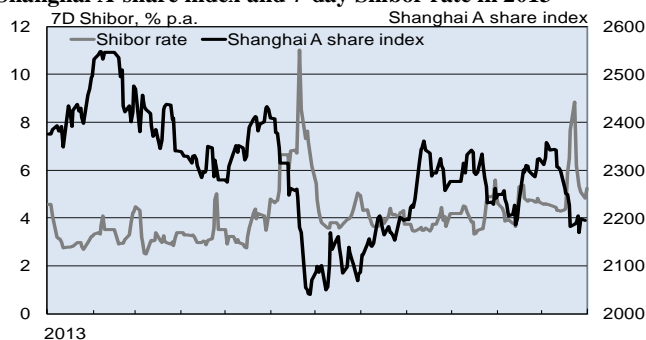
In contrast, share prices on the Shenzhen stock exchange were up about 20 % overall for 2013. The different trends of the Shanghai and Shenzhen exchanges reflect the fact that small and medium-sized firms have greater index weighting in the Shenzhen. Share prices of large companies traded on the Shanghai exchange fell about 20 % on average and shares of companies in the energy sector were down 30 %. About a third of the market capitalisation of the Shanghai stock exchange comes from share prices of large banks and financing companies. Financial-sector companies represent less than 10 % of the Shenzhen's market capitalisation.

The market capitalisation of companies listed on the Shanghai stock exchange slightly exceeds 15.1 trillion yuan (nearly €1.8 trillion), while the combined market cap of Shenzhen listings only amount to about 8.8 trillion yuan (just over €1 trillion). Share prices on the Hong Kong exchange were up 5 % for the year and the market capitalisation of listed firms amounted to about €2.2 trillion.

Economic reforms introduced during the year may have also influenced share prices. The increased emphasis on market-driven forces (in principle, at least) is seen as a way to create opportunities for small and medium-sized firms while putting pressure on large majority-held state companies to be more competitive and profitable.

The appearance of alternative investment opportunities is another significant factor in share price trends in China in recent years. Considerable assets are now channelled to the real estate sector and various asset management products that have delivered relatively high returns in recent years.

Shanghai A-share index and 7-day Shibor rate in 2013



Source: Macrobond

Russia

Russian government admits economic stimulus measures have failed to deliver expected results. Consumer demand has buoyed Russian economic growth during the last few years, but the pace of consumption growth is now expected to fade somewhat. Factors dragging down consumption growth include higher debt loads burdening households and weaker expectations of wage gains due to lower growth. Faced with a slowdown, the significance of fixed capital investment in sustaining growth should play a greater role. The government last year responded to the poor growth of investments with announcements of some individual measures for stimulation.

The economy ministry now admits the stimulus measures have so far failed to deliver desired outcomes. Andrei Belousov, former economy minister and current economic policy adviser to the president, last month also criticised the situation and demanded an accounting of implementing the stimulus measures approved in the first half of 2013 when he was still minister. The measures were aimed to lift GDP growth to around 5 % in 2013, when in fact GDP growth declined to about 1.5 %. Mainstream 2014 growth forecasts now range from the current growth rate to 3 %.

Belousov expressed disappointment that corporate borrowing has failed to increase as hoped and that Russian interest rates on lending remain stubbornly high. The economy ministry says the failure to meet growth objectives arose partly from the fact that the Central Bank of Russia decided last summer to shutter or merge struggling banks. Banks reacted by increasing their reserves and tightening lending. The ministry, however, recognised that the banking sector clean-up from sketchier banking operations was likely to improve the economy in the medium term.

The stimulus measures include subsidies for enterprises and financing. This year, they also include long-term government loans to help finance major transport infrastructure projects as well as a freeze on energy prices for companies. The measures are fairly limited and some lag is inevitable before the effects kick in even in the best cases. Moreover, freezing energy tariffs has both positive and negative effects on investments. No substantial increases in state spending are planned this year. The finance ministry estimates state spending will rise just a couple of per cent in real terms this year as the government wants to keep the overall state budget deficit at around 1 % of GDP.

Observers note that overly optimistic expectations have been placed on specific stimulus measures, and instead sustained growth mostly depends on changes in the economy overall. The need to raise labour productivity dramatically is one of Russia's most pressing issues. Despite substantial productivity gains over the last decade, Russian labour productivity is still only about 45 % of the EU aver-

age. Part of this is due to Russia's large public sector. Alfa-Bank estimates that 23 % of the employed work directly in the public sector. When employees of state-owned enterprises are included, the figure rises to 40 %.

A further challenge is reducing the government's role in the economy, which would contribute to sustained growth. However, this would require a reversal in the policy of increasing the state's role in recent years. There are few concrete signs of such a turnaround so far.

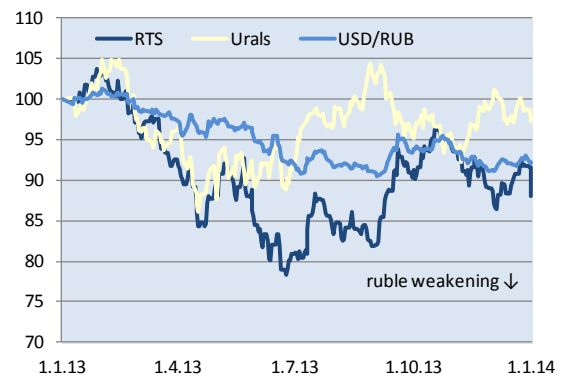
In their year-end speeches, president Vladimir Putin, first deputy prime minister Igor Shuvalov, deputy prime minister with economy portfolio Arkadi Dvorkovich and economy minister Alexei Ulyukayev reiterated the need to increase labour and capital productivity, cut costs in the enterprise and state sectors, increase competition, improve the business climate and bolster the nation's infrastructure.

Russian stocks and ruble exchange rate hurt last year by slightly lower oil prices and market uncertainty.

Although the price of Urals-grade crude oil at the start of this year was 3 % lower than a year ago, it remains at historically high levels. The average Urals price in 2013 was \$108 a barrel. The slight drop in the oil price depressed Russian stock prices, which typically track oil prices rather closely. In addition, weak metals demand, crashing metal prices and heavy debt levels pushed down share prices of metal companies. In the second half of 2013, share prices in emerging market stock exchanges including Russia experienced drops also in reaction to increased uncertainty in international financial markets.

The ruble weakened last year due to Russia's dimmed growth outlook and the drop in oil prices with weakening allowed by CBR's modified exchange rate policy to tolerate greater fluctuations in the ruble's external value. At the start of January, the ruble had lost nearly 12 % against the euro over the past 12 months and 7 % against the dollar. One euro bought 45.2 rubles and one dollar 32.8 rubles.

Price of Urals crude, RTS share index and USD/RUB exchange rate in 2013, 100 = Jan. 8, 2013



Sources: MICEX, Reuters

China

China takes another stab at regulating grey market lending. China's government has directed the central bank and financial market regulators to tighten oversight of lending that currently does not show up on bank balance sheets. While some new rules will be added to the current regulatory framework, the government considers growth of the informal lending market niche as important and does not want to disturb its development too much.

Economic deregulation has allowed grey lending to flourish, especially as officials introduced measures to restrain growth in traditional bank lending. To circumvent lending limits, traditional banks have also become actively involved in the grey market. For example, they raise money by offering depositors the possibility of investing in wealth management products (WMPs) that ostensibly give a better yield than bank deposits. They then lend the money raised to borrowers in sectors that lack access to bank loans. Banks also use money raised from the sale of WMPs to purchase loans off of their own balance sheets and then relend the money.

The new rules reportedly require banks to provide greater transparency in transactions involving WMPs, as well as restrict the pooling and use of certain types of investment products. Banks will no longer be able to use money from WMPs to purchase debt on their own balance sheets. Moreover loss provisions and capital adequacy rules may be extended to apply also to WMPs. The tighter regulations extend to other financial companies involved in the grey market.

As attempted earlier, the latest policy guidelines again call for more transparency in financial markets and elimination of high-risk financing chains. In the final analysis, however, many of the sector's problems stem from excessively low deposit rates relative to credit demand. This problem would largely vanish simply by eliminating regulation of deposit rates as it would clarify financial market structures by making it unnecessary for banks to skirt regulations.

Few forecasters expect Chinese economic growth to pick up this year. On January 20, China will release preliminary figures on realised 2013 GDP growth. Forecasters expect growth to come somewhere in the range of 7.5–8.0 %. In nearly all forecasts for 2014 GDP growth matches or falls below the 2013 level (see list). The most optimistic 2014 outlook comes from the OECD, which sees growth picking up, albeit temporarily. In 2015 and thereafter, growth is expected to slow modestly. The most pessimistic long-term outlook comes from the Conference Board (well known for its productivity assessments), which sees GDP growth averaging about 6 % p.a. in 2014–2019 and then slowing to an average pace below 4 % in 2020–2025.

Many factors contribute to China's lower economic growth, including a shrinking labour force, lower investment growth and an unavoidable decline in productivity growth.

Selection of GDP growth forecasts for China, %

	2014	2015	2016	Released
JP Morgan	7.4	7.2		1/2014
PwC	7.5	7.2		1/2014
CICC	7.6			12/2013
Standard Chartered	7.4			12/2013
OECD	8.2	7.5		11/2013
BBVA	7.6			11/2012
Mizuho Securities	7.6	7.5		11/2012
IMF	7.3	7.0	7.0	10/2013
BOFIT	7	7		9/2013

Concern over environmental issues on the rise in China.

Health impacts from air pollution in China have dominated the headlines in recent weeks. At the start of this week, the government requested people stay indoors as northeastern China was again blanketed with smog. With people growing increasingly dissatisfied with China's environmental problems, the government pledged to push local administrations to take concrete actions to reduce pollution. The *South China Morning Post* reports the central government has agreed with local administrations on reducing small particle emissions. Progress will be tracked annually.

China's extensive reliance on coal in energy production is a big reason for poor air quality. Coal use continues to rise despite the government's commitment to reduce China's coal dependence. Reuters reports that the National Development and Reform Commission (NDRC) last year approved several new coal mine projects that will boost coal production by over 100 million tons a year, a 2–3 % increase in China's current production capacity. Even so, domestic production cannot keep pace with rising demand and China increasingly imports coal from abroad.

China is by far the world's biggest coal consumer. Its heavy reliance on coal reflects the low price of coal relative to other modes of energy and China's massive domestic coal resources. According to an IEA estimate, China will account for 60 % of all growth in global coal demand over the next five years. The OECD has long encouraged China to raise pollution taxes, but any move to raise energy prices is problematic because economic growth is tied to the availability of cheap energy.

In addition to fouling the air, soil and water contamination has become a serious concern in food production and security of food and groundwater supplies. Wang Shiyuan, vice minister of land and resources, stated that over 3 million hectares of land are now too contaminated for farming. The issue is a sensitive matter; the environmental authorities last year classified a research report on soil contamination right after it was released.

Russia

Russian inflation slowed slightly to 6.5 % last year.

Although inflation fell slightly from 6.6 % in 2012 to 6.5 % last year, it still well exceeded the government's 5–6 % target range.

The rise in consumer prices accelerated slightly in the final months of 2013, driven largely by a 7.3 % y-o-y rise in food prices. Inflation was boosted in part by hikes in excise taxes, which are scheduled to continue over the next few years. Due to last year's tax hikes, prices of tobacco products rose nearly 30 % and alcoholic beverages nearly 15 %. Alcohol and tobacco make up over 6 % of Russia's consumer price index.

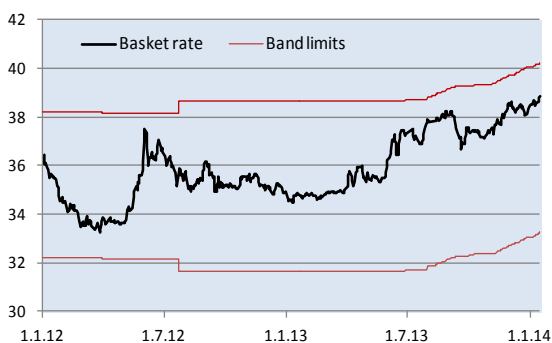
Prices of other foodstuffs rose just over 6 % last year. The largest price increases were seen for staple foods. The price of Rosstat's statistical basket of basic foodstuffs increased 10 %.

Prices of non-food goods were up 4.5 % last year, while prices of services increased 8 %. Services seeing the largest hikes were rates for energy and water, childcare, healthcare and passenger fares.

CBR continues to move away from ruble rate steering.

Technically this took place by easing the requirements for moving up or down the permitted range within which the ruble can fluctuate. Adjusting the band up or down provides the ruble with additional room to weaken or strengthen in response to market conditions.

Ruble value against currency basket, band limits, 1.1.2012–15.1.2014 (rising trend indicates ruble weakening)



Source: Central Bank of Russia

CBR exchange rate policy is based on steering the ruble's exchange rate relative to a euro-dollar currency basket. The ruble's exchange rate against the basket can move relatively freely within a seven-ruble range. Once the CBR's cumulative response to hold the ruble in its band reaches a certain level, the CBR capitulates and the band is adjusted.

The ruble's fluctuation band has been steadily shifted upwards since last summer, in response to pressures from the market. The CBR has kept the ruble's decline on a steady, but gradual, course through active intervention in the currency markets. During 2013, CBR net sales of foreign currency were about \$27 billion. At the end of November, the CBR's gold and foreign currency reserves stood at \$516 billion. Russia maintains one of the largest currency reserves in the world.

The CBR has gradually reduced its efforts to steer the ruble over the past three years and expects to adopt a free-floating ruble by 2015. A full float would allow the CBR to turn its focus to inflation targeting. The ruble is expected to weaken further this year.

Russian companies still have very few subsidiaries in Finland. The latest figures from Statistics Finland show that Russian owners held less than 40 of the approximately 3,000 foreign-owned subsidiaries operating in Finland in 2012. Subsidiaries of Russian companies operating in Finland tended to have fewer employees than subsidiaries of companies based elsewhere. The total number of persons employed by Russian subsidiaries was just 740 in 2012, about a third of the 2008 peak.

On the other hand, the net sales of Russian subsidiaries tended to be considerably higher than the average of subsidiaries of other countries. The average net sales of all foreign-owned subsidiaries operating in Finland in 2012 were €25 million, while the average for a Russian subsidiary was €100 million. The combined net sales of Russian subsidiaries in Finland exceeded €3.5 billion. The largest net sales for foreign subsidiaries in Finland were posted by Swedish companies (€6 billion) and US companies (€ billion).

Finnish companies are much more likely to set up subsidiaries in Russia than Russian companies are to set up subsidiaries in Finland. The most recent figures (2011) show that about 400 Finnish subsidiaries operated in Russia. In terms of labour force, the difference was even bigger as Finnish subsidiaries in Russia employed over 50,000 people.

Personnel employed by foreign subsidiaries (1,000 persons)



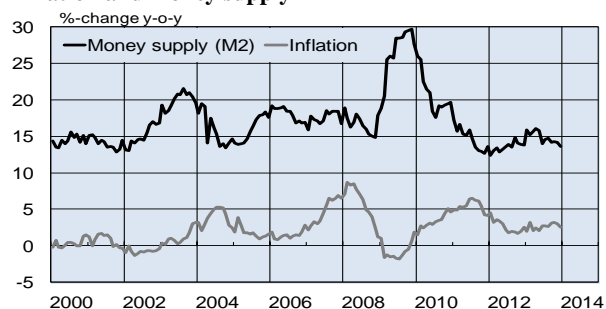
Source: Statistics Finland

China

China's inflation slowed in December. The National Bureau of Statistics reports December consumer prices were up just 2.5 % y-o-y, a rather sharp drop given 12-month inflation September-November hovered around 3 %. A notable factor was the slowdown in the rise in food prices in December relative to earlier months. Prices of non-food items remained on their long-term trend below 2 %. Inflation remained rather stable during whole last year compared to previous years. In producer prices, the long slide continued in December.

Growth in the broad money supply (M2) slowed in December to below 14 % y-o-y. The lower growth apparently reflected minor monetary tightening measures of the People's Bank of China and measures to rein in growth of the grey financial sector.

Inflation and money supply



Source: Bloomberg

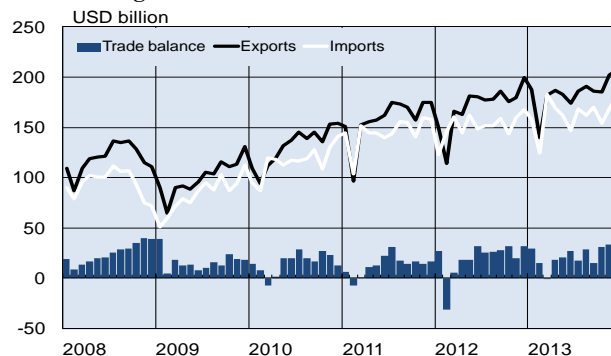
Processing-and-assembly exports no longer increasing in China. Customs officials report that the value of goods exports last year totalled \$2.21 trillion. Export growth overall remained at 8 %, but exports to ASEAN countries and elsewhere in Asia grew above that pace. Exports to Japan contracted, however. Exports to the EU and the US showed fairly low growth overall, although they picked up late in the year. Machinery and equipment, which constituted about 40 % of China's total exports, rose over 10 %.

Most of the growth in total exports came from exports of products made entirely in China. Growth in exports of products based on imported components for final processing and assembly flatlined. This reflects the fact that due to rising production costs in China, industries dependent on labour-intensive processing and assembly have moved their operations to countries with lower cost levels.

China's goods imports last year amounted to \$1.95 trillion, with import growth accelerating to 7 %. Imports from the US grew fastest (15 %), while import growth was lower from Asia (5 %) and the EU (4 %). Imports of machinery and equipment rose rapidly. Machinery and equipment constituted about 30 % of Chinese imports, while mineral prod-

ucts represented slightly over 20 %. Largely due to the drop in commodity prices globally, growth in the value of imports of mineral products remained low.

China's foreign trade 2008–2013



Source: Bloomberg

People's Bank of China cracks down on bitcoin trading to prevent skirting capital limits.

Interest in the bitcoin virtual currency spiked in China late last year, making the country the world's biggest bitcoin market. Chinese consumers and banks fell over each other trying to get in on the action. Shanghai-based BTC China, a bitcoin exchange, accounted for about a third of all bitcoin trading globally in November. BTC China is one of many bitcoin exchanges that enabled trading bitcoins in yuan.

Although bitcoin trading is still a marginal phenomenon (the entire global market is worth about €7–8 billion at the moment), the rapid increase in bitcoin transactions forced China's central bank to clarify its stance on the virtual currency. The PBoC banned banks from engaging in bitcoin transactions in early December. It then followed up by forbidding bitcoin exchanges to take yuan deposits, sending the bitcoin's value plummeting. The PBoC is wary of bitcoin trading on principle; officials have little control over cross-border transactions that could be used to circumvent capital controls. The restrictions were further motivated by the fact that bitcoins offer anonymity useful in conducting illegal drug sales and money laundering.

Most bitcoin demand growth in China, however, apparently stems from its attractiveness as an alternative investment vehicle, not its ideological charms. Regulations now prevent Chinese banks from offering yields on money-market savings above set bank deposit rates. Many still consider bitcoins a speculative investment; few firms are yet ready to accept bitcoins as a means of payment.

Most traders try to make their money off bitcoin volatility. The increase in bitcoin trading in the second half of 2013 led to skyrocketing bitcoin prices. The Bitcoin Average for December peaked at 7,000 yuan (€850) and then fell to 2,500 yuan (€300) on December 18. The bitcoin has since regained most of its lost value. The yo-yoing price reflects unstable demand and thinness of the market.

Russia

Russia's 2013 federal budget slightly in the red. The finance ministry reports the realised 2013 federal budget deficit was 0.5 % of GDP, somewhat less than originally planned.

Budget revenues last year amounted to 13.02 trillion rubles (€90 billion) and spending 13.33 trillion rubles (€96 billion). Realised revenues were slightly above and actual expenditures slightly below budget. The revenue boost came especially from higher-than-expected world crude oil prices that increased revenue under Russia's progressive oil tax regime. Other tax and fee revenue streams lagged their budget targets due to Russia's unexpectedly severe slowdown in economic growth last year.

Finance minister Anton Siluanov said he was for the most part satisfied with last year's budget performance. He said it was positive that there was no need to dip, as many had feared, into the Reserve Fund built up from oil and gas earnings to cover the budget deficit. He was disappointed, however, that only 200 billion rubles (€1.4 billion) in oil and gas revenues were allocated to the Reserve Fund last year. Siluanov said that, given the prevailing high oil prices, the Reserve Fund should have received almost a trillion rubles. Under an amendment to the law enacted a year ago, oil revenues not anticipated in the budget are no longer automatically allocated to state funds, but may be used to cover running costs of the government.

Despite the good budget picture, disconcerting trends emerged. The government has long sought to reduce its dependence on revenues from energy (mostly taxes and fees on crude oil production and oil exports). These presently account for about half of all federal budget revenues. Progress in weaning the budget off its dependence on oil is measured by calculating an alternative budget deficit that excludes state revenues from oil and gas. Siluanov noted this non-oil budget deficit should be limited to 5–6 % of GDP. Last year's non-oil deficit increased from 2012, reaching 10.2 % of GDP. The size of the non-oil deficit highlights the sensitivity of the state budget to a drop in global oil prices.

Russia's current account surplus contracted to 1.5 % of GDP in 2013. Preliminary balance-of-payments figures released by the Central Bank of Russia show a smaller current account surplus than at any time since the 1998 financial crisis. The goods trade surplus fell by 8 %, but still exceeded 8 % of GDP. The services trade deficit continued to deteriorate, as did deficits for the other current account categories such as dividend and interest payments.

Growth in export earnings halted last year. Income from goods exports fell as export earnings from crude oil and metals fell. Services exports, however, continued to rise.

Spending on imports was up around 5 % for the year, even if growth fell close to zero in the fourth quarter. Spending by Russians while on travel buoyed import growth. Other spending remained flat in on-year terms after summer.

The current account is expected to keep on shrinking this year.

Russia's balance-of-payments, main categories in 2011–2013

	USD billions			% of GDP		
	2011	2012	2013 (preliminary)	2011	2012	2013 (preliminary)
Current account	97	72	33	5.1	3.6	1.5
- exports (goods & services)	573	590	592	30.2	29.3	27.7
- imports (goods & services)	410	445	473	21.6	22.1	22.2
Trade balance (goods)	197	192	177	10.4	9.6	8.3
- exports	515	528	522	27.2	26.2	24.5
- imports	319	336	344	16.8	16.7	16.1
Services trade balance	-33	-47	-59	-1.8	-2.3	-2.8
- exports	58	62	70	3.1	3.1	3.3
- imports	92	109	129	4.8	5.4	6.1
Other items	-66	-74	-85	-3.5	-3.7	-4.0
Financial account + e & o	-85	-37	-55	-4.5	-1.8	-2.6
State (excl. central bank)	-2	16	7	-0.1	0.8	0.3
Banks	-24	19	-6	-1.3	0.9	-0.3
Other private, incl. e&o	-59	-75	-56	-3.1	-3.7	-2.6
- direct investments	-16	0	-19	-0.8	0.0	-0.9
- to Russia	50	43	78	2.6	2.1	3.7
- from Russia	66	43	97	3.5	2.1	4.5
- portfolio investments	-11	-10	-11	-0.6	-0.5	-0.5
- to Russia	-6	-8	-11	-0.3	-0.4	-0.5
- from Russia	4	2	0	0.2	0.1	0.0
- fictitious transactions	-33	-39	-27	-1.8	-1.9	-1.3
- errors and omissions (e&o)	-9	-10	-12	-0.5	-0.5	-0.5
- other items	9	-16	12	0.5	-0.8	0.6

Source: Central Bank of Russia

Capital exports from Russia increased slightly in 2013.

Net capital exports abroad amounted to €5 billion. For the first time since the 2009 recession, net capital exports were larger than the current account surplus, which devalued the ruble over the course of the year. The increase in net capital exports came mainly from the banking sector's increased capital exports (mainly in the form of deposits and credits abroad) and reduced capital imports.

On the other hand, the net capital outflows for the rest of the private sector fell last year, even if they were still substantial. Direct investment inflows into Russia increased partly, but not only, due to the huge transactions related to the TNK-BP/Rosneft ownership deal. All growth in DI outflows from Russia can be attributed to that oil deal. The increase in corporate borrowing was also largely driven by money borrowed from abroad to finance the TNK-BP/Rosneft deal.

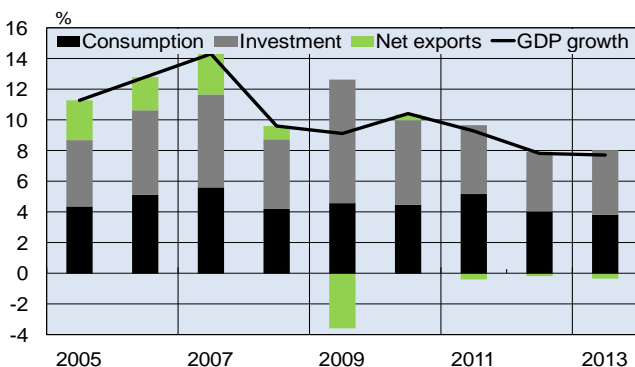
Non-resident investors continued to repatriate their earlier portfolio investments in Russia's corporate sector.

The balance-of-payments item "fictitious transactions" includes a variety of illegal activities such as transactions related to tax evasion. Capital exports created by using these transactions fell slightly last year.

China

China's fourth-quarter GDP growth matches expectations. The National Bureau of Statistics reports economic growth of 7.7 % y-o-y in the fourth quarter of 2013. Growth slowed slightly from the third quarter as the effects of the government's mini-stimulus last summer faded. GDP growth for all of 2013 was 7.7 %, the same as in 2012, i.e. it surpassed the 7.5 % bottom limit of the government's GDP growth target for last year.

GDP growth and contributions of key demand components



Source: NBS

Growth in domestic consumption slowed slightly last year on sluggish income gains, while capital investment accounted for an increasing share of economic activity. Over half of last year's growth came from investment growth supported by last summer's mini-stimulus. If official figures are credible, this suggests China made little progress last year in rebalancing its economy towards a more consumption-driven model. Indeed, the investment ratio (capital investment to GDP) rose slightly. Some observers discount the official figures, however, noting that consumption likely plays a larger role than reported. For example, firms book some of their consumption spending as investment.

Economic growth was restrained by the contraction in net exports. Nevertheless, exports remain important for China; robust exports tend to attract further investment and bolster consumption demand.

Although economic growth has slowed significantly in recent years, it has been high enough to assure high employment. Indeed, lower future economic growth is not particularly problematic in this respect as the pool of working-age people shrinks and the structure of the economy evolves. The official GDP growth target for this year has yet to be announced, but most observers expect 7.5 % or 7.0 %. Most forecasts for China anticipate a moderate deceleration in growth. For example, the IMF's forecast released this week sees growth slowing to 7.5 % in 2014 and 7.3 % in 2015.

Income growth in China slowed last year; income disparity remains high. The NBS statistics show that growth in household disposable income remained fairly strong in 2013, even if it slowed a bit from 2012. Growth in real incomes of urbanites slowed by nearly three percentage points to 7 % y-o-y. Real wages in the countryside continued to increase rapidly, reaching 9 % last year. Wages have risen faster in the countryside than in cities since 2009, although the earnings gap between town and country is still substantial. The average disposable monthly income of city-dwellers was 2,200 yuan (€270), while rural folk averaged 740 yuan (€90).

Income trends are guided to some extent by provincial minimum wage decisions. Last year, most provinces raised the minimum wage by 8–15 %. Shanghai currently has the highest monthly minimum wage – 1,620 yuan (€200). Shenzhen, however, will surpass Shanghai at the beginning of February when its minimum monthly wage goes up to 1,800 yuan (€220). The hikes largely affect labour-intensive branches such as textile manufacture.

Wage hikes promote the shift to an economic growth model driven by consumption and services. The downside is that higher labour costs depress corporate profitability. Real wages have been rising faster than productivity gains in China and producers have been unable to shift the full increase in labour unit costs to product prices (see [BOFIT Discussion Paper 3/2014](#)). This situation has somewhat depressed corporate profit margins, forcing a shift in labour-intensive industries to areas with lower labour costs. The shrinking cohort of working-age Chinese in the future and rising education levels will continue to put upward pressure on wage levels.

The official NBS calculation of China's gini coefficient, a rough indicator of income disparity, was 0.473 last year (0.474 in 2012). In other words, it seems that the income disparity in China was just about as severe as earlier. A notable shift last year, however, was that food prices rose substantially faster than other product categories. This change most strongly affects the purchasing power of low-income individuals.

Somewhat perversely, China's income disparity indicators could get some relief through flight of the rich. A recent survey from the research firm Hurun found that 64 % of the polled rich people (net worth over €1.2 million) had already moved or were planning to move abroad, preferably to the US or Europe.

The Chinese are famously avid savers, but the savings rate has reached world-beating levels in recent years. Apartments, education, health care and retirement are only some of the things that motivate Chinese saving. Last year urban households set aside about a third of their disposable income. Reducing income inequality and improving the social safety net could help reduce Chinese savings rates and accelerate structural reform of the economy.

Russia

Russian economic growth slowed sharply last year.

Growth slowed in the first half of last year, but picked up a bit in the fourth quarter. The economy ministry's preliminary estimate puts GDP growth for all of 2013 at 1.4 %.

Manufacturing, which enjoyed a strong recovery after the 2009 recession, saw practically no growth last year. It was unchanged also in the fourth quarter from 4Q2012. Extractive industry growth remained at just over 1 %, mostly a reflection of a recovery of natural gas production. Agricultural output saw strong growth thanks to a bumper grain harvest.

Growth in retail sales slowed to about 4 %. This was due mainly to the end of the boom in sales of non-food goods on lower growth of real household incomes and credit.

Growth in fixed capital investment stalled completely last year. Export volume growth recovered on higher exports of petroleum products and natural gas. Import growth slowed and was quite modest relative to recent years when imports bounced back from the 2009 recession.

Key Russia economic indicators, %-change

	2009	2010	2011	2012	2013
GDP	-7.8	4.5	4.3	3.4	1.4
Industrial production	-9.3	8.2	4.7	2.6	0.3
- extractive industries	-0.6	3.6	1.9	1.1	1.2
- crude oil	1.2	2.2	1.2	1.4	0.9
- natural gas	-12.2	11.7	3.1	-2.4	2.1
- manufacturing industries	-15.2	11.8	6.5	4.1	0.1
Agricultural production	1.4	-11.3	23.0	-4.8	6.2
Retail sales	-5.1	6.5	7.1	6.3	3.9
- food	-1.9	5.1	3.4	3.6	2.5
- non-food	-8.2	8.0	10.8	8.6	5.0
Construction	-13.2	5.0	5.1	2.4	-1.5
Fixed investments	-13.5	6.3	10.8	6.6	-0.3
Exports (goods & services)	-4.7	7.0	0.3	1.4	3.5 *
Imports (goods & services)	-30.4	25.8	20.3	8.8	3.3 *
Imports, euro value (goods & services)	-29.3	37.4	21.4	17.6	2.8

* January-September 2013

Sources: Rosstat, Ministry of Economy, CBR

Ruble nosedives. Over the first four weeks of 2014, the ruble shed about 5–6 % of its value against the euro and the dollar. For all of last year, the ruble lost about 12 % of its value against the euro and 7 % against the dollar. The ruble has not been this weak since its devaluation in early 2009 following the global financial crisis.

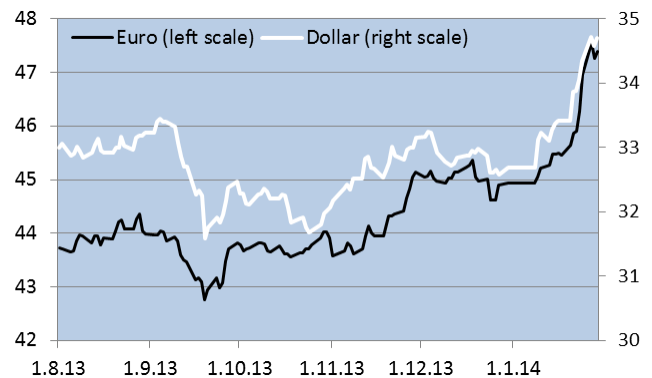
The ruble's slide picked up momentum last week as general uncertainty in emerging markets increased. That pace continued to accelerate this week. Current CBR policy allows the market more say in formation of the ruble's exchange rate, but the central bank has still intervened in the currency markets to smooth its decline. The CBR's

operations to control the ruble's descent have been exceptional in recent weeks. On Tuesday (Jan. 28), the CBR spent \$1.1 billion on buying rubles and on Wednesday another \$400 million. Indeed, before Tuesday's big sell, the CBR this month was blowing through an average of \$260 million a day.

On the other hand, the CBR has not reacted to the exchange-rate drop by adjusting steering rates. Interbank market rates have also held steady. The Moscow Exchange has been on a downward trend lately, but share prices are nowhere near last year's lows.

The ruble's decline has largely domestic roots, reflecting the bleak growth outlook for the Russian economy. However, it has been given an extra tailwind from the agitated state of emerging markets. The CBR's adoption of a more liberal exchange rate policy has permitted this trend.

Euro-ruble, dollar-ruble exchange rates, 1.8.2013–29.1.2014 (rising line indicates ruble weakening)



Source: Central Bank of Russia

Russia seeks to attract Japanese investment in Far East agricultural sector. Deputy agriculture minister Oleg Savelev says plans to apply the special economic zone concept to farming in the Russian Far East are under consideration. Farms within special economic zones would enjoy a variety of tax breaks and other incentives. The Japanese Hokkaido Bank has expressed interest in the initiative and is currently putting together an investor group to discuss the creation of special economic zones in the Khabarovsk and Primorsk regions. The Japanese would like to farm such row crops as buckwheat, soybeans, and feed corn in Russia. The first trial plantings are already completed.

Even without special economic zone status, a number of Chinese and a few Korean agricultural firms already farm in the Russian Far East. The Chinese firms operate as tenant farmers, leasing or otherwise occupying at least 600,000 hectares of farmland. The firms also employ local residents.

Increasing exports to Asia is important for farming in Russia's Far East. It is not economical to ship produce across seven time zones to the European side of Russia.

China

Year of the Horse enters on uncertain note. Starting today (Jan. 31), China's financial markets will be closed until February 6 for the Lunar New Year holiday. Markets have been jittery in recent weeks, not least on concerns about losses on trust and wealth management products. A coal company defaulted at the end of January on 3 billion yuan (€360 million) in trust loans. Although development of China's financial sector would need increasing market discipline and reduced moral hazard, it seems that trust product investors were once again bailed out with only minor interest income losses. The trust product in question promised a 10 % return. Details of the bailout and which organisations are involved are still matters of speculation.

A second contributor to the late-January angst was the tightening of liquidity on money markets. Demand for cash always increases ahead of Chinese New Year's holiday and this time around the People's Bank of China was prepared. It boosted the money supply and the spike in short-term money market rates was short-lived. The rate rise was smaller than during the liquidity tightening last December.

The yuan continues to face appreciation pressures. After appreciating in December, the yuan has stayed consistently around 6.05–6.06 yuan to the dollar, i.e. close to the strong-end of its narrow fluctuation band. At their lowest, January share prices on the Shanghai exchange were down as much as 12 % from their early December highs. Chinese stock markets have performed poorly already for a long time and recently have been battered on expectations of higher interest rates.

Uncertainty from emerging economies such as Turkey and Argentina has not been directly reflected on Chinese markets. Instead, China's cooling economy and financial market distress have contributed, along with the US Federal Reserve's decision to cut back on QEIII bond purchases, to the overall uncertainty afflicting many emerging economies. After an already bumpy Year of the Snake, investors are preparing for quite a ride in the Year of the Horse.

China had record large grain harvest last year. The total grain harvest last year exceeded 602 million metric tons, up from 590 million tons in 2012. Following a sharp drop in harvests in the early 2000s, China's grain harvests have risen each of the past ten years, averaging about 3 % per year. The growth reflects a larger amount of land area under cultivation and efficiency gains in production. Increased use of irrigation, artificial fertilizers and pesticides, as well as the adoption of advanced farm equipment and high-yield plant strains have boosted grain output per hectare on average about 20 % from a decade ago.

China seeks to be largely self-sufficient in key agricultural products. Domestic production, however, has failed to

keep up with rising demand and changes in consumer preferences. In recent years, China has had to increase imports of agricultural products from abroad. In particular, imports of grains, soybeans, vegetable oils and sugar have risen substantially. At the same time, less and less farm produce has been available for export, so export volumes of agricultural products have been on the decline with the exceptions of a few vegetables, soy oil, honey and tea.

China's changing demographics brings challenges. The National Bureau of Statistics reports that China's population grew 0.5 % last year to 1.361 billion people. Population growth has held steadily at around 0.5 % for several years now. The one-child policy introduced in the 1970s is the main reason for the depressed birth rate. However, rising wealth in recent years appears to be further depressing population growth. As a result of low replacement rates and longer lifespans, the Chinese population is now aging rapidly. An older population is a challenge for the Chinese economy in that its shrinking labour force reduces the country's output potential. Sustained economic growth now must come through higher productivity gains instead.

The retirement age in China is 60, so the working-age population is typically measured according to the number of 15- to 59-year-olds. The cohort of 15- to 59-year-olds started to contract in 2012. During 2013, the pool of working-age people declined by 2.5 million, down about two percentage points to just over 67 % of the total population. The UN estimates that 15- to 59-year-olds will account for less than 60 % of the Chinese population within 20 years. The decline in the working-age population increases pressure to raise the retirement age.

At the same time, the share of the population over 65 has been rising rapidly and is approaching 10 %. The aging of the population has forced China's leadership to consider ways to improve the pension scheme in order to secure basic income for the elderly. Many consider the current pension arrangement unfair and underfunded.

In response to the distorted age structure of the population, China's leadership late last year offered concessions on the one-child policy. A couple would have the right to have a second child if at least one of the parents is an only child. It is unclear how much the reform will affect the birth rate and it will take years for impacts to be felt. The policy change might have an impact on gender imbalance at birth. China's gender imbalance remained unchanged last year with roughly 118 boys born for every 100 girls.

The rate of urbanization has slowed in recent years, but the general trend of people moving to cities remains strong. The share of the population living in cities grew more than a percentage point to 54 % last year. Urbanisation improves labour availability and delays the impacts on companies caused by the demographic shift.

Russia

Forecasters expect Russian economic growth to pick up this year and next. The latest Rosstat figures show GDP grew 1.3 % last year. Most 2014 GDP growth forecasts fall into the 2–2.5 % range, although they vary from 1 % to 3 %. Growth is expected to accelerate slightly in 2015 and 2016.

Economic growth would still be based to a large extent on private consumption. The growth in consumption is expected to slow from 4.7 % last year but most forecasters see consumption rising still 3.5–4 % this year.

Uncertainty about developments internationally and in Russia has meant that fixed capital investment forecasts are quite varied. After last year's zero growth, fixed investment this year is generally expected to grow a couple of per cent. Some forecasting institutions, however, expect investment will stagnate also this year. Investment growth would improve in 2015.

Selection of Russian GDP growth forecasts, % change

	2014	2015	2016	Released
IMF	2.0	2.5		1/14
World Bank	2.2	2.7		1/14
OECD	2.3	2.9		1/14
UN/DESA	2.9	3.6		1/14
EBRD	2.5			1/14
Citibank	2.6	2.7	2.9	1/14
Consensus Economics	2.2	2.6		1/14
Interfax Consensus	1.3	2.3		1/14
J.P.Morgan	1.8	2.5		1/14
Alfa Bank	1.0	1.4		1/14
Sberbank Investment Research	2.3			1/14
Danske Bank	2.6			1/14
Russian economy ministry	2.5	2.8		12/13
VTB Capital	1.3			12/13
Central Bank of Russia	2.0	2.5	3.0	11/13

Growth in Russian bank lending moderated last year, but households continued to pile on debt. Corporate borrowing rose 13 % last year, matching the 2012 pace. Growth in the stock of household credit slowed from nearly 40 % in 2012 to 29 %.

Corporate borrowing last year was reined in by the economic slowdown and stagnating investment.

The Central Bank of Russia has become quite concerned about the rapid build-up in household debt, particularly the increase in unsecured loans. Unsecured credit now accounts for over 60 % of household borrowing. Unsecured loans carry larger risk than secured loans.

With households taking on heavier debt burdens and slowing income growth, the stock of non-performing loans in bank portfolios has begun to rise. Households with loans

devoted on average nearly 25 % of their income to debt servicing last year.

To calm the credit boom, the Central Bank of Russia last year increased the reserve requirements concerning household loans with further hikes planned this year. The requirements target unsecured loans.

The CBR is also investigating high interest rates charged on some loans. At the end of 2013, the average rate charged on a household consumer loan for over a year was around 18 %, while inflation was 6.5 %. Interest rates on unsecured loans are particularly high. The new consumer credit law, which will come into force at the beginning of July, grants the CBR authority to restrict rates charged on consumer loans.

Clean-up of Russia's banking sector proceeds smoothly.

Last autumn, the CBR launched a clean-up of the banking sector to shut down banks with shaky finances and those involved in shady activities. Last year licenses were withdrawn from 29 banks and reorganization required on another two banks. As of end-December, 923 banks operated in Russia.

Most of the banks that have lost their licences are small or mid-sized, and their shutdown has not significantly affected the banking sector. However, depositors have become wary, with some smaller banks facing difficulties as depositors tried to empty their accounts. Some of the panic has come from unsubstantiated online warnings about impending bank licence withdrawals. As has happened in similar situations earlier, competing banks are often responsible for spreading the false information, but this time around the CBR took a proactive stance by publicly dismissing the rumours.

Russia's deposit insurance agency last year paid out a record 110 billion rubles (€1.4 billion) in compensation, depleting the deposit insurance fund by half. The deposit insurance agency, nevertheless, estimates that it will have sufficient funding this year to cover its obligations without having to hike fund contributions of banks. From the start of this year, also sole proprietorships are eligible to compensation from the deposit insurance fund in addition to households.

Although Russia's deposit insurance scheme covers deposits in nearly all banks, the uncertain situation in the banking sector has benefited state-owned banks and other large banks as people move their deposits to them. Russia's five largest banks are state-owned. Their combined share in the total assets of the banking sector increased last year by over two percentage points to nearly 53 %.

At the beginning of 2014, the CBR adopted capital adequacy requirements in accordance with Basel III banking supervision standards. The CBR next year will stage a gradual rollout of Basel III liquidity requirements that significantly tighten liquidity demands on Russian banks.

China

Yuan now ranks among top ten most-used currencies in international payment transactions. According to the Society for World Interbank Financial Communication (SWIFT), the Chinese currency in December accounted for 1.12 % of international payments, making it the world's eighth most-used payment currency. Although the share of yuan use will likely decline temporarily in January and February due to the Chinese New Year holidays, it is clear that the yuan has established itself as a major payment currency. The two top payment currencies by far are the US dollar and the euro, followed by the British pound and the Japanese yen. The Canadian dollar (1.90 %), Australian dollar (1.89 %) and Swiss franc (1.29 %) still had larger payments market shares than the yuan in December.

Three-quarters of yuan payments occurred in Hong Kong, but use of the yuan soared also at other offshore yuan trading centres in London, Singapore and Taiwan. The growing international role of the yuan is also apparent in the on-going rise in yuan-denominated deposits in Hong Kong. Yuan deposits in the Hong Kong special administrative region were up 43 % y-o-y in December.

Chinese statistical data show yuan use in Chinese foreign trade continued to increase in the second half of 2013 after a short pause. As of December, 15 % of Chinese foreign trade was conducted in yuan, up from 10 % in August.

Official figures underestimate Chinese investment in OECD countries. The expansion of Chinese businesses in the international arena has further secured China's increasing role in the global economy. The phenomenon has attracted considerable attention in the media and has struck a note of concern among policymakers. Part of the nervousness reflects the fact that many large Chinese enterprises are state-controlled and not always subject to market forces. This feature of Chinese corporate ownership has been at the heart of recent disputes in Europe and the US in e.g. the telecommunications sector.

While the magnitude of FDI flowing into developed economies appears relatively modest, China's official figures likely underestimate outbound investment. The official statistical data only reflect investments that are approved by China's commerce ministry. According to these numbers, FDI outflows from China (excluding financial sector investments) exceeded \$90 billion last year, up 16 % from 2012. Total financial sector FDI outflows amounted to \$10 billion in 2012.

Although the commerce ministry has recently improved its practices and formally committed to complying with international standards, many still believe that the official

figures underestimate the true numbers. International standards call for the use of surveys to get investment figures. In China's case, official figures are still compiled from data collected in the course of the investment approval process. Particularly small and private enterprises tend to under-report investments.

A second cause of the statistical distortion is the practice of "round-tripping" investments through tax havens. Investments pass through the tax haven to be reinvested in China or third countries. Such transactions go undetected as the Chinese practice only registers the first leg of the investment outflow from China, not the country where the money eventually ends up. Official figures show about 70 % of Chinese foreign investment goes to Hong Kong, the Cayman Islands or the Virgin Islands. The final destination of this investment usually goes undisclosed.

A new [China Global Investment Tracker](#) database from the Heritage Foundation registers investments of Chinese firms exceeding \$100 million. The database confirms that OECD countries receive considerably more Chinese FDI than official Chinese figures indicate. OECD countries, especially Australia, the US, Canada and the UK attracted a much larger share of Chinese investment than official figures show. The database also reveals that nearly half of all Chinese investment outflows go to the energy sector and about a fifth to the mining sector. The database mentions numerous investment projects that have been abandoned or failed for some reason or another. Most of these projects are related to the energy or mining sectors.

January was a busy month for Chinese firms investing abroad. Many firms seek to increase their international reach and acquire technological capabilities through corporate acquisitions. For example, technology giant Lenovo agreed to buy the business operations of mobile phone maker Motorola from Google for \$2.9 billion. Lenovo, which saw its international growth take off in 2005 with its acquisition of IBM's personal computer business, bought IBM's server business last month for \$2.3 billion. In addition, banking giant ICBC agreed to acquire a controlling stake in Standard Bank's London-based markets unit for nearly \$800 million.

Rhodium Consulting reports that Chinese investment in the US doubled in 2013, mostly on large corporate acquisitions. UNCTAD further confirms that the value of corporate acquisitions by emerging market enterprises in North America (NAFTA countries only) grew 63 % y-o-y in 2013 to \$37 billion. UNCTAD's assessment expects more FDI outflows from China also to emerging markets, particularly Southeast Asia. They are often geared to infrastructure development or financial and production sectors. China has recently been active in negotiations to protect and increase foreign investment. The EU and China agreed in December to enter into talks on a bilateral investment treaty.

Russia

Russia's Supreme Arbitration Court handling economic disputes abolished. On February 6, president Vladimir Putin signed into law a package of court reform legislation. The reform, based on a presidential initiative, combines the functions of Russia's two highest courts – the Supreme Arbitration Court, which handles economic disputes, and the Supreme Court, which handles all other types of disputes. Most of the reforms will come into force in August.

The operational model of Russia's arbitration courts stems from legislation adopted in the 1990s when Russia's current court system was just being created. Arbitration courts were created to resolve economic disputes. These courts have generally been considered more impartial and competent than the general courts. For example, over 60 % of corporate claims filed with arbitration courts in recent years have succeeded in overturning decisions by the tax authorities and other official agencies. In contrast, it is quite rare for regular courts in Russia to overturn any official decisions. Commercial arbitration courts are considerably more transparent as nearly every ruling is posted online.

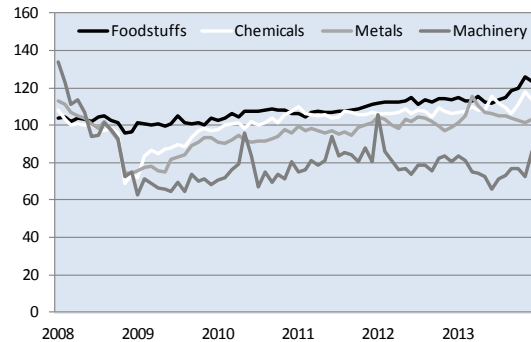
The fusion of Russia's supreme courts is justified by an aim to streamline the legal process. In some cases, the decisions of the Supreme Arbitration Court and the Supreme Court have contradicted each other. It is unclear whether elimination of the Supreme Arbitration Court threatens the existence of the arbitration court system overall.

Representatives of the business community and experts have voiced strong public criticism of the decision to merge the functions of the Supreme Arbitration Court with Russia's other supreme court. The big fear is that the merger will erode the independence of arbitration courts and make rulings on commercial disputes resemble more practices of the general judicial system. This would further degrade conditions of doing business in Russia.

Practically no growth in Russian manufacturing output last year. There were big variations, however, across sectors. Among the largest sectors, production in the chemicals branch (up 5 % y-o-y) and the foodstuffs branch (up over 2 %) were supported by continuing growth in consumer demand. Oil refining also rose 2 %.

The worst-performing branches were found in industries related to capital investment. Machine-building contracted 8 % y-o-y and metals over 2 %. Many metals industry companies have found themselves struggling under mountains of debt on falling demand for their products and declining prices. Since the end of last year, some firms have sought state assistance to help deal with their debts. Also the outlook for metal and machinery manufacturers in January was the bleakest among sectors compared to the situation a year ago.

Volume indices for select manufacturing branches, 100 = 2007 average (seasonally adjusted)



Sources: Rosstat, BOFIT

Russia preparing tighter rules governing duty-free online purchases from abroad. While there has been no official decision on the matter, the most often mentioned amendment is to lower the ceiling of duty-free purchases to €150 per imported order. On orders valued at more than €150, the purchaser should pay a duty equivalent to 30 % of the good's valuation. Russians can currently purchase up to €1,000 worth of goods from online sources outside the country each month without having to pay any import duty.

Rapid growth in Russian online shopping recent years has given a push to the officials for more regulation in the sector. In 2012, imports constituted about 10 % of Russia's total online shopping market which was estimated at about \$10 billion.

Officials justify the move as a way to weed out shady import schemes. The change should also boost revenues to the federal treasury. Even the use of additional revenue is already thought of as president Putin mentioned in his December address to the Federal Assembly that the money could be spent on building up housing infrastructure.

Russian online sellers also want the changes. They point out the current arrangement incentivises buyers to use sellers located outside Russia as long as they avoid the customs charges on foreign purchases. Opponents of the change say the change favours domestic online sellers at the consumer's expense. Many observers note that the change is likely to have little impact in the end as most Russian purchases from abroad are below the planned €150 ceiling. Larger purchases could also be transhipped via Kazakhstan to avoid customs duties.

As a rule, the Finnish ceiling on duty-free online goods orders from outside the EU is €150 per order. Value-added tax usually applies to orders valued at over €2.

Foreign electronic commerce has faced also other problems in Russia recently. In January, several of the international express delivery services temporarily suspended deliveries to private individuals in Russia, complaining that the increased paperwork demanded by Russian customs excessively prolonged delivery times.

China

Chinese tourists reduce global trade imbalances. China's current account surplus last year amounted to \$190 billion, about the same as in 2012. Given China's high GDP growth, the current account surplus fell to just 2 % of GDP last year. Before the global financial crisis China's current account surpluses were running at around 10 % of GDP and economists and policymakers were engaged in a brisk debate on impact of large trade imbalances on the global economy. In recent years, some of the major forecasting institutions, including the IMF, continue to warn that China's current account surpluses may again start rising. BOFIT has considered this as unlikely as rising imports should further diminish China's current account surpluses.

China again posted a large goods trade surplus last year, as well as a substantial services trade deficit. The services trade deficit has continued to widen on a steady rise in Chinese purchases with purchases of transport services and rapid increase in Chinese tourism. It seems China's emerging middle class is off to see the world. Tourist visits of mainland Chinese to Hong Kong last year increase by about 6 million from the previous year and some 7 million Chinese tourists more than in 2012 travelled long haul. Moreover, Chinese tourists are big spenders. When visiting Finland, for example, they spend more than any other tourist on average. Chinese balance-of-payments figures show that last year \$130 billion flowed out of China with Chinese tourists, nearly \$30 billion more than in 2012.

The financial account was well in the black as capital inflows to China exceeded capital outflows. The structural data for the financial account have yet to be released.

Balance-of-payments highlights for China, US\$ billion

	2010	2011	2012	2013
Current account	238	136	193	189
Goods account	254	244	322	360
Services account	-31	-62	-90	-122
Income account	-26	-70	-42	-41
Net transfers	41	25	3	-9
Financial account	282	260	-21	243*
Net errors and omissions	-53	-14	-80	
Change in currency reserves	467	382	92	431

*) Includes net errors and omissions. Sources: CEIC and SAFE

China's foreign trade grew fast in January. The value of exports in January rose 11 % y-o-y and imports were up 10 %. The trade surplus increased to nearly \$32 billion. Strong upticks were seen in exports to the EU (up 19 % y-o-y), the US (11 %) and ASEAN countries (18 %). The big increases in imports came mostly from the EU and the US.

The modest improvement in outlook for developed economies might be reflected in Chinese foreign trade

figures. However, it would be unwise to jump to conclusions based on January's numbers alone because it is unclear whether they represent an actual pick-up in economic activity. The Chinese Lunar New Year fell 10 days earlier than last year, jumbling available trade figures. For example, firms may have accelerated their export deliveries and advanced their import orders in January ahead of the New Year's holiday. Foreign trade data has yet again sparked concern over manipulated export figures. However, exports to Hong Kong showed a contraction of about 20 % in January relative to January 2013, which could indicate that distortions are being addressed at least to a certain extent.

China and Taiwan take a step towards increased political dialogue.

In a move of major political rapprochement, top-level officials met for China-Taiwan bilateral talks this week in Nanjing, China. Minister of Taiwan affairs, Zhang Zhijun, led the Chinese delegation. Minister for mainland affairs, Wang Yu-chin, led the Taiwanese delegation. It was the first such high-level meeting since 1949. On Tuesday (Feb. 11), the parties agreed to opening up a regular dialogue on cross-strait relations. The meeting laid the basis for deeper cooperation on the political front, but concrete results have yet to be seen.

The intensity of Taiwan-China relations stem from the fact that China considers Taiwan to be a province of China and takes a very dim view of the island's efforts to declare political independence. Taiwan, on the other hand, holds tightly to its right to self-governance. Bloomberg, for example, reports that 80 % of Taiwanese oppose reunification with China. US arms deliveries to Taiwan have also kept the question current in superpower relations.

Two camps dominate Taiwan's domestic policy debate: The Democratic Progressive Party, which is pushing for Taiwan's full independence and the more moderate centre-right Kuomintang (National People's Party). China-Taiwan relations have improved in recent years with governments led by the more mainland-friendly Kuomintang. China and Taiwan have signed numerous agreements promoting trade and freedom of travel since 2008, when Kuomintang chairman Ma Ying-jeou was elected president.

With the lifting of economic barriers, China-Taiwan trade has boomed. China is today by far the biggest trade partner for Taiwan. The Taiwanese finance ministry reports that nearly 40 % of Taiwan's exports last year went to the mainland or Hong Kong. China's relatively rapid growth has also boosted the Taiwanese economy. Taiwan's GDP grew nearly 4 % last year.

Greater freedom of cross-strait travel and direct air and sea connections have vastly increased the number of mainland China tourists visiting Taiwan over the past five years. A third of all tourists to Taiwan now come from the mainland. That share was below 10 % in 2008.

Russia

CBR expects GDP growth below 2 % in 2014-16, persistent inflation may require tighter monetary policy. At last Friday's (Feb. 14) board meeting, the Central Bank of Russia decided to keep its "key rate" at 5.5 %. The CBR aims to get inflation down from slightly above 6 % at the moment to 5 % by the end of this year. Factors that should restrain inflation include weak demand and restrictions on hikes in administratively set energy and utility rates. The central bank estimates the ruble's devaluation over the past few months contributes up to 0.5 percentage points to the inflation rate. The central bank stated that it is ready to tighten its monetary stance if inflation accelerates above targets e.g. due to heightened inflation expectations.

The CBR's fresh economic forecast lowers its earlier prediction of Russian GDP growth this year to a range of 1.5–1.8 %. Growth is now expected to pick up a bit in 2015–2016, but still remain at around 1.7–2.0 %. The CBR expects growth in private consumption to slow this year to just above 3 %, while fixed capital investment should recover to around 1.5 % growth. The volume of Russian exports is expected to rise 2 % at most on a relatively slow recovery in global demand. The CBR expects imports to rise 4 % at most this year. Import growth is restrained e.g. by the ruble's weaker real exchange rate.

Russian foreign trade figures weaker in 2013. The value of goods exports in 2013 contracted by 1 % y-o-y to \$523 billion. The reduction in exports reflected drops in export volumes and prices of crude oil and metals, as well as a contraction in exports to CIS countries. Exports to Belarus fell 20 % y-o-y on economic weakness. The 13 % drop in exports to Ukraine reflected largely political tensions. In contrast, exports of petroleum products and natural gas to non-CIS countries grew briskly. Export volume of gasoline increased by more than 50 %, while natural gas exports were up over 20 % from a year earlier. Gazprom reports its share of the European market increased last year to a record 30 %.

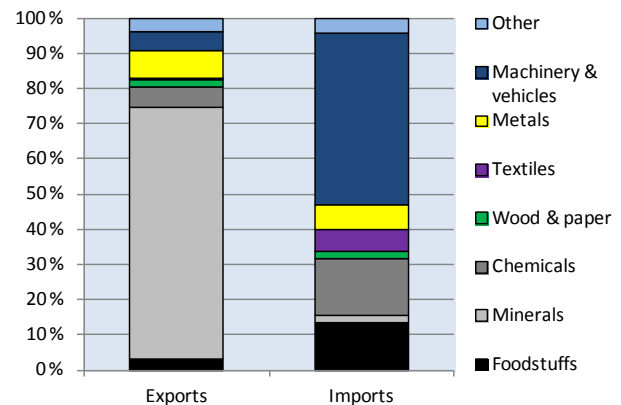
Over 70 % of Russian goods exports last year consisted of oil, petroleum products and natural gas. Metals and chemicals were the next largest export good categories. Even machinery & equipment accounted for over 5 % of total goods exports last year. The top export destinations were the Netherlands, Italy and Germany. EU countries took over half of all exports, while Russia's customs union partners Kazakhstan and Belarus, accounted for 7 %.

Growth in the value of goods imports slowed last year to below 3 % y-o-y with the level of imports reaching \$344 billion. Chemical products and foodstuffs continued to drive import growth, even as imports of machinery,

equipment and vehicles declined slightly. Looking at individual product categories, there was a drop of nearly 20 % in imports of passenger cars, while imports of milk more than doubled.

About half of imports still consisted of machinery, equipment and vehicles. Chemical products and foodstuffs were other major import categories. China continued to be Russia's top source of imports, accounting for 17 % of Russia's total imports last year. EU countries accounted for just over 40 % of imports to Russia, whereas the share of the customs union partners Belarus and Kazakhstan in Russian imports was 7 %.

Structure of Russian foreign trade in 2013, %



Source: Russian customs

Investment plans of Russian companies getting more meagre. Rosstat's annual investment survey finds that just 49 % of firms responding (compared to 56–60 % in the previous three years) are planning to increase their fixed capital investments this year. Companies planning to reduce their investments increased to 31 % from 23–26 % during the previous three years. The survey polled over 10,000 firms, including 6,400 large and mid-sized companies.

The investment plans of companies surveyed apparently reflect largely investment of privately held companies, suggesting that growth in private company investment could slow down a bit this year. Economy minister Alexei Ulyukayev reported investment of private firms increased by 7 % last year. However, state-owned enterprises account for a large share of capital investment in Russia. Ulyukayev noted that the 20 % cut in investment of state enterprises last year was the main reason the investment growth overall dropped to zero last year.

The survey found that the biggest factor limiting investment was again the lack of available out-of-pocket funds (nearly 60 % of firms). Other most commonly cited reasons for not investing were still the high cost of credit, risks associated with investment, uncertainty about the Russian economy (26–27 % of firms) and lack of demand for a company's products (just over 20 % of firms).

China

China's central bank drains liquidity to slow credit growth. Over two days this week, the People's Bank of China sold a total of \$18 billion in 14-day forward repurchase contracts (repos) to sop up excess yuan liquidity in the money market. It was the first time in nearly eight months that the PBoC stepped in with repo sales to drain liquidity from the banking system. The key 7-day rate on the inter-bank market fell to 3.6 % at the end of the week.

January's rapid credit expansion, a drop in market rates after the Lunar New Year holidays and yuan weakening against the dollar in recent weeks are all behind the PBoC response. China's central bank is increasingly concerned about the indebtedness of Chinese firms and local administrations. Thus, despite moderate inflationary pressures, the central bank is not pleased with recent financial market developments. Consumer price inflation remained at 2.5 % in January and producer prices continued their nearly two-year slide, falling to 1.6 %.

From the standpoint of monetary policy and reform policy it was interesting that growth in traditional bank deposits appears to have slowed substantially. Growth in the deposit stock slowed from 14 % y-o-y in December to 11 % in January. Growth in bank lending, however, continued to grow at a 14 % pace. Even if the quality of the figures is suspect, the overarching reason for the reduction in deposits (beyond seasonal factors) may be that private individuals and companies alike seek forms of investment in the shadow banking sector that pay better yields than traditional bank deposits. Online companies offering investment opportunities have seen a rapid growth in their popularity.

The situation concerning China's monetary and macroprudential policies remain quite byzantine and intractable, which is why China's monetary policymakers may be more and more eager to move ahead with liberalisation of deposit interest rates and let the market play a greater role in determining the yuan's exchange rate. The changes would provide Chinese policymakers with more effective interest-rate policy. The economic conditions for making the shift could hardly be more favourable than now.

Profits of Chinese banks continue to soar. The China Banking Regulatory Commission (CBRC) reports banking sector profits increased last year by about 15 % to 1.4 trillion yuan (€170 billion or the equivalent of 2.5 % of GDP). While the rate of rising profitability has slowed from year to year, it remains impressive. Banks make most of their profits from providing basic banking services, i.e. they make money on the spread between what they pay out for deposition and what they charge for loans. Although China ended regulation of lending interest rates last summer, interest-rate margins of banks have remained roughly unchanged. China

still tightly regulates deposit interest rates, which diminishes competition between banks.

It has been expected that the amount of non-performing loans on the books of commercial banks could take off as projects financed with money from the massive 2009–2010 stimulus go belly up. While the stock of non-performing loans grew slightly last year, they remained at around 1 % of the entire loan stock. By many estimates, however, the actual stock of non-performing loans is far larger. The problem is that banks are reluctant to admit that loans are non-performing.

China's banking sector continues to be dominated by four largely state-owned banks: Industrial and Commercial Bank of China, China Construction Bank, Agricultural Bank of China and Bank of China. Together they hold slightly less than half of total assets of China's banking sector. Their share of the banking market has been shrinking lately, however, as a number of mid-sized Chinese banks have shown rapid growth. China's four large state banks rank among the world's 20 largest banks by just about any metric.

Investment in China's real estate sector accelerates. The National Bureau of Statistics reports that investment in real estate development last year totalled 8.6 trillion yuan (€1 trillion), or 20 % more than in 2012. Over half of investment took place in the eastern part of the country, but investment in the western part of the country has been rising faster. The importance of construction to the Chinese economy has steadily increased in recent years. Real estate development exceeded 15 % of GDP last year. It was under 10 % of GDP just five years ago.

Construction activity has picked up from a year ago. The volume of new residential floorspace was up 15 % y-o-y in December. China's building craze is largely driven by rising housing prices, which have been favourable for builders since late 2012. The NBS reports prices of new apartments in 70 of China's large and mid-size cities rose on average by 9 % last year. In the major metropolises, the rise in housing prices has been even steeper. Growth in the stock of housing loans accelerated to 20 % (up from 12 % in 2012), further fuelling demand. China still regulates the interest rates charged on housing loans to limit demand and prevent overheating of the housing market.

According to a Standard Chartered Bank survey released at the end of January, real estate companies expect the sector to remain in growth mode. Even so, the urge to build has declined from the last survey six months ago, a reflection of such factors as tighter financing conditions. Most of the companies responding to the survey said it had become harder to get bank loans in recent months, which could force companies, especially the smaller developers, to seek financing from the grey lending market. If construction companies turn to grey-market financing, it will increase their financing costs and make them less capable of weathering a period of flat or falling housing prices.

Russia

Russian insurance markets enjoyed modest growth last year. Total premium payments to Russian insurance companies increased 11 % in 2013, while claim disbursements were up 13 %. With inflation last year running at over 6 %, real growth was about half the nominal rates. Standard & Poor's Rating Services expects growth in Russia's property and casualty insurance markets continues to slow a bit this year.

Fastest revenue growth last year was seen in the life insurance, casualty insurance and voluntary-contribution pension plans. While these types of insurance are still fairly rare in Russia, they are expected to rise dramatically in coming years as the economy grows and the Russian insurance market gains sophistication.

The relative size of insurance markets in various countries can roughly be judged by the ratio of insurance premia paid relative to GDP. Russian insurance premia last year only amount to 1.4 % of GDP. The figure for most developed economies exceeds 4 %.

Boom in car insurance claims spooks Russian insurers.

One reason for the increase in compensation payments was a Russian supreme court ruling from last July that extended consumer protection regulations to cover also insurance business. After the change, courts handling insurance claim disputes have in almost all cases decided in favour of the client. Before the change, the great majority of court decisions were in favour of the insurance company.

The biggest headaches are generated by mandatory traffic insurance; rates for such insurance are set administratively. Insurance companies have begged officials for relief.

The rising amount of claims paid out has caused many insurers to limit or cease offering mandatory traffic insurance. The companies are also using various tricks to increase their premium income or escape claims. Certain insurance companies have begun to demand that their car insurance clients also purchase at least one other insurance policy such as life insurance. The Federal Antimonopoly Service (FAS) disapproves of this business approach and is looking into it. Insurers are also trying to duck insurance claims by locating their collision claims inspection offices in remote locations that are difficult to reach. The FAS has sought to correct the situation by proposing that all traffic insurance providers accept claims and inspections even if they come from people that bought their mandatory traffic insurance from a different insurer.

Vladimir Tchistyuhin, deputy head of the Financial Market Service of the Central Bank of Russia that supervises insurance markets, says the problems now facing insurance companies are due in part to the fact that the companies themselves continue to violate the rights of

insurance buyers, fail to pay claims and use unclear contract language in their insurance documents. The FAS has decided to deal with this by establishing a consumer protection unit.

Ukraine stares into the financial abyss. The current political upheaval and uncertainty cast a shadow over Ukraine's short-to-mid-term economic prospects. The Ukrainian hryvnia has lost around 30 % of its value against the dollar this year and hit all-time lows. The central bank has imposed limits on capital movements.

The National Bank of Ukraine held foreign currency and gold reserves worth \$17.8 billion as of end-January. The sum is only enough to cover just over two months of imports. The internationally recommended minimum is enough money to cover at least three months of imports. Ukraine's financial situation has become even more desperate as the government has to this year pay a total of \$8.2 billion on principal and debt servicing of foreign loans and domestic forex loans.

The IMF reports that Ukraine's total public sector deficit last year amounted to around \$10.5 billion, or 7.7 % of GDP. A substantial part of the deficit was generated by subsidies paid to Ukraine's state gas monopoly Naftogaz. The subsidies hold down rates paid by households and industrial enterprises.

The IMF and EU have promised bridge loans to help Ukraine get through its current financial distress. The main condition for such lending, however, is that Ukraine installs a functional government with whom it is possible to agree on preconditions for the financing. The IMF prematurely suspended Ukraine's access to its credit facilities at the end of 2012, when Ukraine failed to comply with borrowing conditions such as ending gas-sector subsidies.

Russia says that Ukraine's \$15 billion loan package announced in December will remain on ice until the country installs a new government. Russia already disbursed to Ukraine \$3 billion in December and had planned to pay out the remaining \$12 billion by the end of this year.

Servicing of Ukraine government foreign debt and domestic forex bonds, US\$ million

	2013	2014	2015	2016	2017	2018
Principal	7,069	5,378	7,131	2,837	4,222	532
Bilateral loans	190	103	111	111	423	13
Multilateral loans	5,879	4,276	2,056	476	499	519
Other	0	0	696	1,000	0	0
Foreign bonds	1,000	1,000	4,268	1,250	3,300	0
Interest	1,513	1,338	1,259	1,137	1,030	736
Total	8,582	6,716	8,390	3,974	5,252	1,268
Domestic forex loans	2,100	1,500	1,500	1,400	0	0

Sources: National Bank of Ukraine, Ukraine finance ministry, Fitch Ratings

China

Yuan decline may signal move to wider trading band.

The drop in the external value of the yuan against the US dollar in late January and early this month caught the market off guard. Most actors were expecting the yuan to continue its slow but steady rise. Even with increased uncertainty in China's financial markets, the depreciation of the yuan is striking in light of January data that show a rising foreign trade surplus and increased capital imports. By most accounts, there should have been little downward pressure on the yuan. Indeed, market interest rates had been falling in China in recent weeks, the opposite of what would be expected from a market shaken by increased uncertainty.

Indeed, many observers speculate that the yuan's decline has been engineered by China's central bank to disabuse market participants of their slavish reliance on yuan appreciation. Before this week, the yuan's market exchange rate had been stronger than the daily parity rate (fixing) for nearly 18 months, knocking frequently the border of a fairly tight 1 % trading band. The central bank has long indicated its plans to widen the band and allow greater exchange-rate volatility. In this respect, recent events are omens of an impending widening of the trading band, which was last broadened in April 2012 from 0.5 % to 1.0 %.

Dollar-yuan exchange rate and PBoC fixing rate



Source: Macrobond

China makes it easier to start a business. The government just announced it is eliminating the minimum capital requirement for new firms altogether. The change makes it easier to set up a new business in China.

The minimum capital requirement before the change depended on the type of business. For example, the minimum capitalisation for joint stock companies was 5 million yuan (€620,000). The reforms do not apply to 27 financial sector branches.

China also phases out annual mandatory inspections of all firms and instead allows them to submit their annual reports online. Officials then perform spot audits to determine how businesses are performing.

The changes are part of the reform package announced by the Central Committee last autumn, which aims to create a more business-friendly environment that encourages entrepreneurship and economic dynamism. The rise of privately held firms should also motivate state-owned enterprises to step up their game if they want to stay competitive. State-owned enterprises still hold the upper hand as they enjoy for example access to substantially cheaper financing.

The number of firms operating in China has exploded. In 2012, the number grew by 1 million to 8.3 million firms. There was a notable uptick in formation in of privately held corporations, which now account for 80 % of all firms in China. However, it's hard to distinguish between private and public firms as many private firms are closely involved with the public sector.

Investors' risks realizing in China's shadow banking sector.

The discussion of financing arrangements outside the formal banking system has dominated the headlines in Chinese business media for the past two months. In January, an over-indebted coal company defaulted on its trust loan. Trust companies collect funds from private individuals and firms via commercial banks and lend the money forwards as trust-loans. In this case, the losses of investors were covered by an unknown third party. It is highly likely that the government was involved in the last minute arrangement. The episode has raised a profound discussion on moral hazard and the realization of risks of investor liabilities in the shadow banking sector. Investors have so far avoided significant losses on trust-products. This has led to insufficient risk assessment and degraded market discipline due to investor reliance on the notion that a third party like a bank or public official will provide a bail out.

Recently, a second heavily debt-burdened coal company went insolvent after it failed to make its payments on trust products coming due on February 8. Investors of Jilin Trust, which manages the loan to the coal company, could face losses if officials decide to take a hard line. Ultimately, these investor losses will be settled later after the company restructuring later on. It would mark the first case where investors absorb significant losses on their trust investments. Credit losses in the shadow banking sector are likely to rise in any case as solvency ratios have decayed rapidly in recent months, especially in industrial sectors suffering from over-capacity. A record amount of loans issued by the shadow banking sector are slated to mature this year.

The proportion of trust products in China's total credit stock has risen rapidly. Banks use trust products to circumvent lending quotas, and investors snap them up because they offer better returns than bank deposit rates. The total stock of trust products increased 46 % last year and now represents about a quarter of all new credit issues. Trust products have become an important financial vehicle for private firms that lack access to bank credits.

Russia

Crimean crisis accelerated ruble's decline. Political uncertainty increased the outflow of foreign currency from Russia early this week. The ruble hit an all-time low of 50.15 rubles to the euro, while the MICEX fell over 10 %.

The Central Bank of Russia responded on Monday (Mar. 3) by hiking its “key” rate by 1.5 percentage points to 7 %, noting the hike would restrain inflation and stabilise markets.

The CBR also changed the rules on the ruble's trading band so that the central bank will more aggressively intervene in the market to stabilise the ruble. The shift is seen by many as a deviation from the CBR's commitment to reducing the steering of the ruble's exchange rate and gradually shifting to a free-floating ruble.

On Tuesday, the CBR sold over \$11 billion in currency to prop up the ruble. The CBR's forex selling had previously averaged about \$400 million a day.

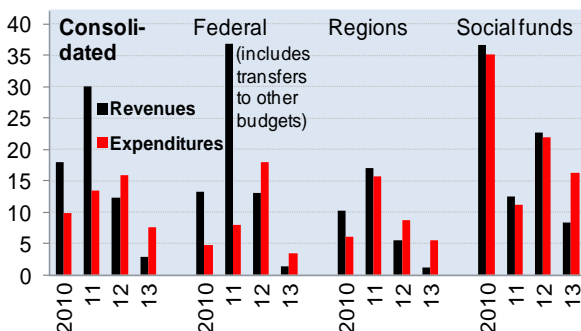
The markets calmed soon, and on Thursday (Mar. 6), the CBR again sold just \$400 million in forex. The ruble began to appreciate, and on Friday the rate was 49.59 rubles to the euro and 36.13 rubles to the dollar. Share prices have also clawed back some of their lost value.

Steep slowdown in government budget revenue growth.

Revenues to the *consolidated* budget (combined federal, regional and local government budgets, plus state social funds) increased just 3 % in nominal terms last year, i.e. declined in real terms. Spending growth slowed to below 8 %, an increase of only about 1.5 % in real terms. The government budget deficit rose to 1.3 % of GDP. Budget income fell to 36 % of GDP (down from 38 % in 2012). Spending, meanwhile, remained above 37 %.

Federal budget revenues increased just 1 %, while expenditures climbed 3 to 4 %. *Regional and local* budget revenues also rose only about 1 %. Regions and municipalities get about a fifth of their revenues from the federal budget as transfers and subsidies.

Government budget revenues and expenditures, 2010–2013, (%-change y-o-y)



Source: Ministry of Finance

Government budget revenues from taxes and duties on production and export of oil, petroleum products and natural gas recovered strongly after the 2009 recession. Last year, however, growth in these revenue streams virtually halted despite an increase in the gas production tax. The share of these streams in consolidated budget revenues shrank slightly, but was still 27 %. Their share in federal budget revenues remained at 50 %. Tax revenues from corporate profits fell sharply on lower company earnings. Growth in VAT revenues halted. Income tax, mandatory social security contributions and hikes in excise taxes helped support budget revenues.

The fastest-growing item in state spending was still pension costs (up nearly 20 %), as well as spending on defence and national security (up 14 %). Spending on education was increased notably. The growth in healthcare spending essentially plateaued. So did the growth in spending on the economy, too, although spending on roads continued to increase rapidly.

Russia's relatively modest government debt is a trump card. As of end-2013, federal debt (including guarantees) was just over 11 % of GDP. The debt of regions and municipalities was only about 2.5 % of GDP. Moreover, the value of sovereign moneys that the state has set aside in two funds amounted to 8.5 % of GDP. However, some of the money will be invested as long-term loans to finance a few transport megaprojects. The ultimate return on these investments remains uncertain.

Finland's trade with Russia contracted last year. The value of goods exported from Finland to Russia last year was just under €5.4 billion, or nearly 6 % less than in 2012. The value of exports was dragged down by contractions in some of the biggest export categories. Exports of machinery & equipment shrank 9 %, while chemical products fell nearly 12 %. In contrast, exports of consumer goods such as food and textiles continued to enjoy mild growth. Russia was Finland's third largest export market last year with a nearly 10 % share of total goods exports.

The value of Finnish goods imports from Russia contracted by nearly 1 % to €10.5 billion. The contraction mainly reflected a slight drop in prices of mineral products (over 80 % of imports consisted of “mineral products,” i.e. oil, petroleum products and natural gas). Russia provided nearly 90 % of the crude oil imported by Finland last year, and Finland gets just about all of its natural gas from Russia. From other major import products, metals imports saw sharp declines, whereas raw timber imports surged. Even so, import volumes of raw timber were still less than half the amounts seen in the peak years of early 2000s.

The number of tourists coming from Russia to Finland continued to rise, albeit at a significantly slower pace. Russian border-crossings and overnight stays rose by nearly 10 % last year. Growth in 2012 was nearly twice as fast.

China

China will strive to match last year's economic performance. In his opening speech to the National People's Congress, premier Li Keqiang announced China's GDP growth target of about 7.5 % for this year, similar as last year. Also unchanged were the inflation target (around 3.5 % for this year) and the broad money supply target (M2 at 13 %). The budget foresees a public sector deficit of 2.1 %; again, about the same as the budgeted 2013 deficit. None of the announced targets were unexpected. For example, many of the released GDP forecasts of observer institutions are also around 7.5 %. BOFIT publishes its China growth forecast at the end of this month.

In addition to the quantitative targets for economic performance, Li presented a long list of proposed reforms. Most were already green-lighted at the plenary session of the Communist Party's Central Committee last autumn. The reform direction includes further opening of the economy, improving the business climate for private firms, strengthening of market economy, increased public sector transparency, improved quality of economic growth, promoting structural reform of the economy and improving general well-being.

The National People's Congress comprises nearly 3,000 members and is officially the country's highest decision-making body. Its actual function, however, is largely to rubber-stamp proposals brought before it, e.g. key nominations, new legislation, state budgets and action plans. The People's Congress convened on March 5 and adjourns March 13.

China gets more serious about environmental issues.

Premier Li Keqiang said China will commence wide-ranging measures to deal with pollution. Air pollution will be reduced through many approaches, including improvement in energy efficiency. Sulphur, nitrogen and dust emissions from coal-fired power plants will be cut and small coal plants phased out. Taking 6 million old vehicles off the road will help to reduce vehicle emissions.

China is also taking on protection of its groundwater resources, which may be a greater challenge than cleaning up the sky. Although the details of the new action plan have yet to be released, it is clear that strong measures will be needed to protect remaining sources of potable water and improve wastewater treatment. When officials sampled groundwater at 5,000 sites in 2012, they found that about 3,000 of the sites tested were severely polluted. By some estimates, 200 million rural residents lack access to *any* potable water.

While the slavish reliance of local governments on a single measure of performance – economic growth – has been a huge driver of pollution, the system is being changed with the adoption of additional performance indicators. Moreover, the central government has begun to offer local ad-

ministrations direct incentives to tackle pollution. In February, officials announced they would distribute a total of 10 billion yuan (€1.2 billion) in bonuses to cities and regions that make significant progress in improving air quality this year.

China reforms its pension system. In February, the government announced a plan to merge China's rural and urban pension systems. The reform aims to reduce the income gap between rural residents and city-dwellers, and systematise China's fragmented pension scheme. The *South China Morning Post* reports the reform will allow rural pensioners to get an annual increase in their pension payments. News agency Xinhua also claims that migrant workers will be able to receive pensions regardless of their current domicile under the household registration system (*hukou*). The change encourages labour mobility and urbanisation. It is estimated that the basic pension ranges from 100 yuan (€12) to 2,000 yuan (€240) a year.

China's leadership has also undertaken social reforms to maintain internal stability. China's current pension system is viewed as highly inequitable. Even with reform, many problems with China's pension arrangements will remain unsolved. Pensions not only reflect China's large income disparities but also differ between public and private sectors and across regions. Civil servants receive generous pensions despite the fact that they are excused from contributing anything to their pensions. A report from the University of Chicago's Paulson Institute finds significant variations in pensions for working individuals, reflecting differences in local practices and principles. The report notes that different pension practices inhibit labour mobility as moving earned benefits from one place to another is challenging.

The coverage of China's mandatory pension scheme has been expanded in recent years. An OECD report released late last year found that some 28 % of the working-age population was covered by the pension system (OECD member country average 65 %, India 10 %), while just two years ago that share was below 20 %. Around 2010, rural residents were given the option of making voluntary pension contributions. Since then, figures from the ministry of human resources and social security show the number of rural people receiving pensions has risen rapidly.

Central and local administrations subsidise the pension system by paying a part of pensions. Xinhua reports the reform will create additional financing needs because underdeveloped provinces need support to meet their pension commitments. In addition to this, the cohort of working-age people began to decline in 2012. China's changing demographics will challenge the financial sustainability of any pension arrangement. The OECD estimates that China's dependency ratio will fall from about 8.4 per pensioner at present to 2.4 by 2052. The dwindling dependency ratio adds to pressures for higher retirement ages. The current pension age is 60 years for men and 55 for women.

Russia

Crimea crisis hurts Russia's economic growth outlook.

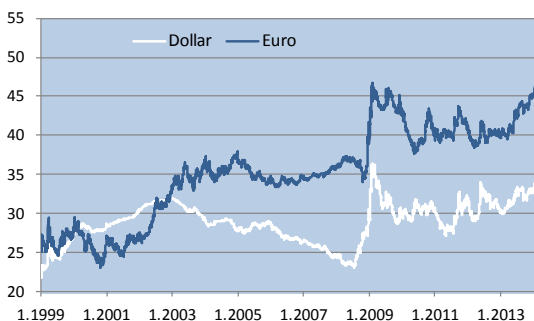
The Crimea crisis has forced many international and Russian financial institutions to trim their 2014 forecasts for the Russian economy. The new forecasts for this year now run at around 1–1.5 %, about a percentage point lower than earlier. Some observers even expect zero growth for the Russian economy this year.

The dimmed outlook largely reflects weakened prospects for investment, which, in turn, are the product of increased uncertainty. Fixed capital investment is not expected to pick up this year, and some observers now anticipate a decline of several per cent. The latest forecasts do not take into consideration the impact of proposed economic sanctions against Russia by the West.

Ruble's slide continues. On Friday (Mar. 14), the dollar-ruble exchange rate fell to 36.46 and the euro-ruble rate hit 50.81. Both were record lows for the ruble. After the massive forex sale of \$11.3 billion to support the ruble on March 4, the Central Bank of Russia's daily interventions were \$400 million, a pace of operations similar to the daily average in the first two months of this year. On March 13, however, CBR forex sales increased to \$1.7 billion.

Given the already weak outlook for Russian economic growth, the political and economic uncertainty generated by the Crimea crisis makes the outlook for the ruble rather bleak. Most observers have lowered their targets for the ruble's exchange rate in the coming nine months. For example, Citibank and the Russian Alfa Bank expect the ruble's exchange rate to end this year at around 38 rubles to the dollar.

Dollar-ruble, euro-ruble exchange rates, 1.1.1999–13.3.2014 (rising trend indicates ruble depreciation)



Source: Reuters

Liquidity has tightened on Russian money markets in March and interbank rates are up. After averaging 6 % in January and February, the one-day credit rate (MIACR) hit 7.9 % on Wednesday (Mar. 12).

Prices of Russian sovereign bonds have come down on international financial markets. The major international credit ratings agencies have left the creditworthiness of Russian sovereigns unchanged for the time being. Moody's and Fitch, however, have both warned about possible rating downgrades for Russia if the Crimea crisis escalates into a shooting war or the West moves ahead with economic sanctions on Russia. Despite heightened market risk, Moody's noted it remains quite unlikely that the Russian government would default on its international obligations.

Large structural shifts in Russian investment in 2013.

Although fixed capital investment did not increase overall last year, investment of small firms and investment in the grey economy increased considerably.

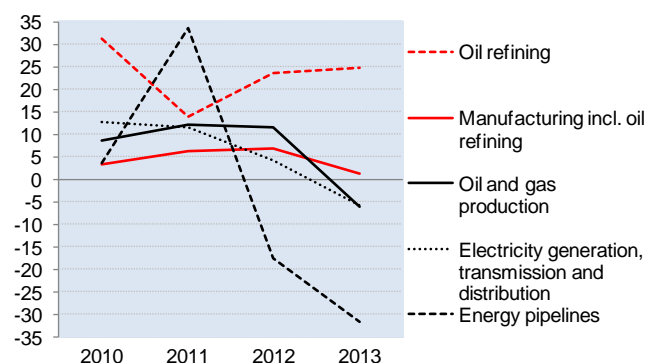
Investment in other parts of the economy declined nearly 6 %. For example, investment of large energy-sector firms fell substantially on the completion of a number of large projects. Investment in oil & gas production was also down 6 %, as was investment in the electrical power sector. Investment in oil and gas pipelines was off by about a third.

Manufacturing investment rose slightly. However, that growth was due to a boom in investment in oil refining capacity.

Government leaders are particularly distraught by the precipitous drop in investment of large state enterprises. Some observers claim the drop has been caused by the government's decision to freeze for this year wholesale prices of goods and services provided by state-owned enterprises. The price freeze is intended to restrain inflation, and concerns e.g. rates of energy and rail shipping.

At president Putin's behest, the government is using "manual steering" to incentivise investments by state enterprises. The government wants to improve their efficiency and get a better volume from money invested. It is also imposing savings targets on state-owned enterprises. One approach is to limit price-setting by firms that supply goods and services to state enterprises.

Investments in various focal branches, % change



Source: Rosstat

China

Progress in reform of China's financial markets. In the press conference after yesterday's (Mar. 13) final session of the 9-day National People's Congress (NPC), premier Li Keqiang made it clear that significant reforms are planned this year for the financial sector. They include the roll-out of a deposit insurance scheme this year. Last December, officials hinted that the planned deposit insurance scheme would cover deposits of up to 500,000 yuan (€60,000). The ceiling on deposit coverage in the EU is €100,000. The deposit insurance scheme would prevent bank runs when the public's confidence in a certain commercial bank is shaken.

Also during the NPC, central bank governor Zhou Xiaochuan announced plans to free deposit rates within two years. The People's Bank of China still sets a ceiling on deposit interest rates (e.g. the one-year time deposit rate is currently 3.3 %). Deposit rates on the interbank market were already deregulated in December and lending interest rates were deregulated last summer.

The desire of depositors for better returns on their savings has driven a considerable amount of capital into the informal banking sector, which offers far higher interest rates to depositors. The rapid growth of China's shadow banking sector might force the government to compress its timetable for deposit-rate deregulation into a much shorter period.

The China Banking Regulatory Commission (CBRC) reports that China is planning to establish five new private banks. Two existing large companies will jointly own each bank. These companies include China's two top online retailers, Alibaba and Tencent, as well as large corporations in various branches. Alibaba and Tencent already offer a range of online financial services and investment products. China currently has only a few domestic private banks, the largest being Minsheng Bank.

Premier Li reported that China has adopted a timetable for the introduction of tighter capital and solvency requirements under Basel III. The timetable, however, has yet to be published. In the EU and the US, Basel III capital requirements are being gradually adopted during 2014–2019.

The proposed reforms are important steps in developing China's domestic financial markets and also advance China's goals to free capital movement and increase the international use of the yuan.

China posts trade deficit in February. The value of goods exports shrank by nearly 20 % in February to around \$114 billion. The combined value of January and February exports fell by 2 %, despite a surprisingly high increase in January exports. The 10 % y-o-y growth in imports in January held steady in February as well. The drop in exports and rising imports produced an overall trade deficit of \$23 billion.

It would be unwise to jump to any profound conclusions about the global competitiveness of Chinese exporters or international demand based on the drop in exports, however.

For starters, export figures in the early months of the year are always all over the map because of the shifting dates for the Chinese Lunar New Year holidays. This year's week-long New Year holiday occurred at the start of February, a week earlier than last year. The timing likely caused deliveries of export orders to be advanced to January.

Additionally, the rapid growth in exports at the start of last year partly reflects Chinese companies reporting higher-than-actual export invoicing as they evaded controls on capital imports (see [BOFIT Weekly 20/2013](#)). Exports to Hong Kong surged 74 % in the first quarter of 2013 partly as a result of over-invoicing. The magnitude of the distortion can be inferred by comparing official Chinese figures for exports to Hong Kong against Hong Kong's official figures for imports from China. The statistical discrepancy at the monthly level reached \$28 billion last March. In January this year, the discrepancy was \$5 billion, or about half of what it was in January 2013. It seems that the problem still persists, but at a smaller scale.

China's exports to Hong Kong contracted in the first two months of the year by about a third, but growth in exports to the EU, ASEAN countries and the US made up for the loss.

The official index of manufacturing purchasing managers (PMI) indicates that the number of new export orders in the first two months of this year have continued to decrease. It suggests that the hard times for Chinese exporters will continue.

Slower rise in Chinese consumer prices. The National Bureau of Statistics reports that consumer price inflation slowed from 2.5 % in January to 2 % in February. Most of the rise was driven by food prices. Food prices in February were up 2.7 % y-o-y, a percentage point less than in January. While prices of vegetables and pork were lower than a year earlier, beef prices skyrocketed. In other food categories, price rose steadily at 1.6 %. Prices of services and non-food consumer items rose modestly.

After a slight acceleration in 12-month inflation last autumn, inflation has stabilised at around 2 %. A long episode of yuan appreciation has kept the rise in import prices at bay. China's inflation target this year is around 3.5 %, the same as last year. It appears that the country's leadership does not have to worry much about inflation kicking up, which means that they will have some leeway to relax monetary policy if needed. The easing of monetary policy, however, is constrained as the government also wants to simultaneously restrain the excess build-up of credit.

Producer prices fell 2 % y-o-y, pulled down especially by prices of coal and other commodities. Producer prices have slid every month for the past two years. Overcapacity in many industrial branches will continue to depress prices.

Russia

Russian markets calm. The Central Bank of Russia intervened actively to support the ruble at the end of last week and early this week, selling an average of \$2.9 billion of its currency reserves daily. The price of interventions to stabilise the currency have averaged around \$400 million a day earlier this year. The CBR spent about \$500 million on Tuesday and Wednesday (Mar. 18 and 19) propping up the ruble, and they are finally seeing some ruble appreciation. Yesterday (Mar. 20), one euro bought 49.97 rubles and one dollar 36.12 rubles.

The Moscow stock exchange has settled down a bit during this week with the RTS index recovering some of last week's losses. While the RTS is still down about 12 % from the start of the month and 22 % from the start of the year, share prices in Russia are still well above their 2009 nadir (see chart).

Moscow RTS index (January 1, 2009 – March 20, 2014)



Source: Reuters

Rising uncertainty has boosted capital exports from Russia. The economy ministry estimates net capital exports from Russia in January and February totalled \$35 billion. Observers expect net capital exports in the first quarter to reach \$50–70 billion. Net capital exports for 2013 overall amounted to \$63 billion (\$28 billion in 1Q2013).

CBR board offers dim economic outlook. At its March 14 meeting, the CBR board decided to hold its key rate at 7 %. The key rate had already been raised two weeks earlier. The CBR stated in its press release that ruble depreciation had increased the likelihood of higher inflation. The CBR now expects inflation to exceed its own year-end target of 5 %. In such circumstances, the board stressed that the central bank's primary task must be to restrain inflation. The bank also noted its duty to assure stability of financial markets, especially in the face of rising uncertainty in the international operating environment.

The CBR believes Russia's economic outlook has deteriorated substantially over the past month. It said it was highly likely that sluggish growth, economic uncertainty,

tepid corporate profitability and tightening bank lending will hurt investment. Moreover, the CBR now expects lower real wage growth and reduced consumer confidence will diminish consumer demand. The board noted that any boost in economic growth from the ruble's recent devaluation was insufficient to offset these negative impacts.

Russian ministries draft measures to finance the Crimean economy. Unofficial government sources say the Russian government faces annual funding costs of about \$3 billion (€2.2 billion) to finance the Crimean economy. The cost includes budget transfers to lift Crimean income levels to Russian standards and major investments in construction and maintenance of infrastructure.

Crimea is quite poor relative to Russian regions and consistently posts budget deficits. The average income per inhabitant last year was a mere 10,800 rubles, or less than a third the Russian average (37,000 rubles). Public sector wages, pensions and social entitlements in Crimea are also considerably lower than in Russia. President Putin has promised to raise them promptly as part of Crimea's integration. The Crimean social sector's annual financing needs are estimated to be at least 50 billion rubles (€1 billion).

The biggest spending allocation for Russia, however, will go to upgrading Crimea's poor infrastructure and integrating the Black Sea enclave with e.g. Russia's energy and transportation grids.

Russia's federal budget spending this year will reach nearly 14 trillion rubles (about €280 billion). Crimea-related costs in the federal budget, however, represent less than 1 % of total federal budget expenditures.

Gazprom's share of the European natural gas market increased last year. Although EU natural gas consumption declined about 1 % overall in 2013, Gazprom figures show its gas exports to the EU and Balkan countries increased 19 % to a total of 139 billion m³. Gazprom controlled nearly 29 % of the EU gas market – its highest market share since 2008. The boost in market share reflects such factors as Gazprom's recent willingness to lower prices and higher LNG spot prices in Europe.

Gazprom has been compelled to follow the lead of Norway's Statoil and allow gas spot prices a greater role in price formation in a number of contracts renegotiated with European buyers over the last few years. Pricing in long-term supply contracts was earlier based almost solely on global oil prices. Observers note that Gazprom's average price for gas supplied to its European customers last year was already close to European spot prices.

Gazprom is currently again negotiating gas prices with certain European buyers. Buyers continue to insist that Gazprom drop its contract term requiring buyers to pay for a preset minimum amount of gas even when they have no need for it.

China

Yuan trading band widens as expected. The People's Bank of China announced last Saturday (Mar. 15) that it was widening the yuan's trading band to allow market forces a greater role in setting the Chinese currency's external value. The yuan can now appreciate or depreciate up to 2 % against the PBoC's daily fixing against the US dollar. Prior to the change on Monday (Mar. 17), the permitted maximum fluctuation was 1 %. The widening of the trading band did not come as a surprise. The PBoC had issued numerous statements and made preparations anticipating the shift. The fluctuation band was last widened in April 2012.

Even with the band widening, the PBoC still holds considerable power in steering the yuan's exchange rate. For example, it decides the daily exchange rate fixing that sets the average rate from which the currency may diverge. When there is pressure for the exchange rate to exceed its 2 % appreciation or depreciation limit, the central bank intervenes by buying or selling foreign currency to keep the yuan within the trading band.

Yuan-dollar exchange rate (black); trading band limits (grey)



Sources: Macrobond, PBoC and BOFIT

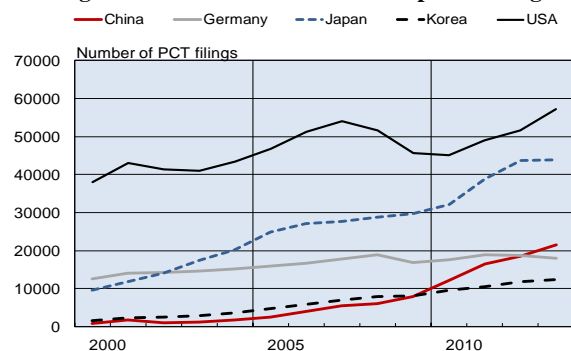
China surpasses Germany in patent applications. The World Intellectual Property Organization (WIPO) reports that about 205,000 cross-border patent applications were submitted last year under the Patent Cooperation Treaty (PCT) it oversees. The number of international patent filings was up overall by about 5 % from 2012. The US and Japan together accounted for nearly half of all patent applications. The number of Chinese patent filings continued to rise fast last year, giving China a share of over 10 % of total patent applications. China surpassed Germany as the third-most active patent-seeker.

The innovation and value contents in Chinese patents are likely less than in filings of leading industrialised countries, so WIPO figures probably exaggerate China's innovation abilities. Nevertheless, China's surge in patent activity suggests it is following the path to technological advancement blazed by Japan and South Korea.

Japan's Panasonic this year beat out China's ZTE, which had topped the leader board the previous two years for companies with most patent applications filed. Third place last year went to another Chinese telecom giant Huawei, last year's runner-up.

With over 21,000 patent applications last year, China stands head and shoulders over fellow BRICs India and Russia. Indian firms increased slightly their number of submitted patent applications to almost 1,400. Russia had just under 1,100 filings, about the same as in 2012. Finnish firms submitted 2,100 international patent applications, about 200 fewer than in 2012.

Leading countries in international PCT patent filings



Source: WIPO

China raises public spending, especially on healthcare and defence.

The National People's Congress last week approved the proposed 2014 budget and realised 2013 budget. Public sector spending will increase this year nearly 10 % to 15.3 trillion yuan (€1.8 trillion). At 14 trillion yuan (€1.7 trillion), revenues should rise several percentage points less than spending. The budgeted public sector deficit will be 2 % of GDP. Last year's budget also forecasted a 2 % shortfall, but the actual deficit was slightly less due to higher-than-expected economic growth. Spending on public administration has increased faster than revenues in recent years.

The growth in healthcare spending will increase by about 15 % this year. The biggest increases will go to expanding rural healthcare services. Pensions and other social spending will also rise as China's population ages. Improvements in the social safety net will help reduce the Chinese compulsion of saving for a rainy day. Defence spending will increase 12 % to nearly €100 billion.

It is difficult to assess China's public sector finances in light of the large gaps in budget reporting and lack of transparency. However, the public sector deficit is larger than stated as local governments' substantial off-budget activities are not included. Off-budget debt has increased rapidly and is officially estimated at 32 % of GDP. Local administration revenues and expenditures are not itemised in the budget, so it is impossible e.g. to tell if there are any changes in spending allocation at the local level.

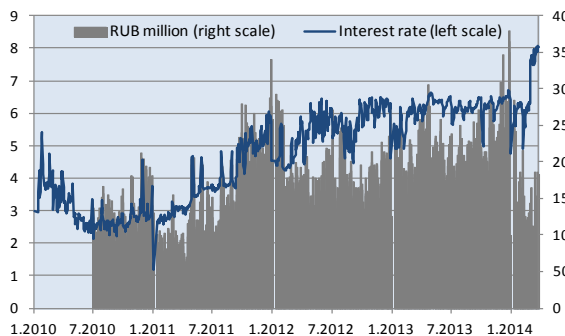
Russia

Russian financial markets bounce back. Russia's financial markets calmed this week as the Crimean crisis settled into a holding pattern and sanctions directed at Russia so far appear to have little economic effect. The ruble has strengthened for more than a week now and in recent days the appreciation trend has intensified. On Friday (Mar. 2), a dollar bought 35.58 rubles and a euro 49.05 rubles. The ruble's exchange rate is now back at the same level as at the end of February before the Crimean crisis broke out. The Central Bank of Russia continues to buy rubles to prop up the currency's value, but its daily ruble purchases now average just some \$280 million a day.

The Moscow Exchange's RTS index has also recovered in recent days to early March levels.

Liquidity remains tight on Russian money markets, however. The interbank lending rate soared at the start of the Crimean crisis, when also the CBR raised its key rate. When the crisis hit, the most important interbank rate, the one-day credit rate, jumped 130 basis points from 6.3 % to 7.6 %. On Wednesday (Mar. 26) the one-day Moscow Interbank Actual Credit Rate (MIACR) was 8.0 %.

One-day MIACR, lending volumes (1H2010 not included)



Source: Central Bank of Russia

Rising economic uncertainty has made banks cautious about risk taking and forced many to cut back on their services offered, including trade financing. Banks are also wary about lending to each other, which means that smaller banks, in particular, find it difficult to access credit on the interbank market. This situation, in turn, limits the corporate and household lending of banks, hindering economic growth.

Latest BOFIT Russia forecast sees further growth slow-down this year. Russia's GDP growth of 1.3 % last year undershot forecasts. The main reasons for the slowdown were a steep decline in fixed capital investments of state enterprises and the state as well as a slowdown of consumption growth. Export prices have not risen at all in the past two years and their impact on growth has faded.

BOFIT forecasts GDP growth will slow further this year to around 0.5 %, and then recover in 2015 and 2016 to around 1.5 % p.a. While the recovery in the global economy will support growth, we expect the oil price to decline slightly over the forecast period. These impacts, however, pale in comparison to the effects of the economic and political uncertainty caused by the Crimean crisis even with relatively contained market reactions and sanctions.

While events in Crimea will postpone private-sector investments this year, the contraction in total investments should remain moderate as long as the drop in investments of state enterprises and the state can be brought to a halt. Investment growth should begin a gradual recovery next year. The slow recovery in investments, however, will hamper growth in the capital stock and limit productivity gains. This, in turn, could restrain output growth. Although growth in private consumption will slow substantially, it will still be moderate. Sluggish export growth is expected as Russia's outlook for energy exports remains weak.

The volume of Russian imports grew 6 % last year. Imports this year will contract a couple of per cent due to the recent deep slide of the ruble. In 2015 and 2016, import growth will recover to a couple of per cent per annum.

Imports will revive because the ruble's real exchange rate is not expected to depreciate substantially as Russian inflation is running well above the inflation rates of its main trading partners. The ruble's nominal exchange rate will gradually decline as the current account surplus evaporates and net capital flows remain outbound.

Russia's leaders have so far had no enthusiasm for launching a broad-based stimulus. Low budget revenue growth will depress spending growth as long as the government is committed to its budget rule of keeping the deficit to around 1 % of GDP. There is also no appetite for monetary stimulus as inflation still exceeds the pace desired and the impacts of monetary stimulus on borrowing from banks are uncertain. However, the government is currently drafting new measures to support businesses.

There are exceptional downside risks with the current forecast, due especially to the potential effects of the Crimean crisis. Investments could be weaker than expected, as could growth of the global economy and public sector revenues; especially the latter could reduce consumption growth. Strong depreciation episodes of the ruble would fuel inflation and depress consumption and import demand. On the other hand, disruptions in the global oil market could raise oil prices. Russia's leadership could respond to weak growth through increasing state spending by taking on debt or boosting credit to companies and households via the banking system.

Over the longer term and under more peaceful conditions, we see GDP growth staying near a 2 % p.a. trend as long as the country does not move ahead faster and on a broader basis with systemic economic reforms than it has in recent years.

China

Latest BOFIT forecast sees further slowing of Chinese growth, increased risks. BOFIT's [Forecast for China](#), released this week, predicts the Chinese economy will still grow at around 7 % p.a. in 2014 and 2015, but slow in 2016 to about 6 %. Of course, even at 6–7 %, Chinese economic growth remains impressive by any measure.

Many factors explain China's decelerating growth. The number of working-age people has begun to decline. Moreover, after sustaining over three decades of rapid economic growth, urbanisation and catching up, Chinese productivity can no longer be expected to keep rising as fast. Growth will also be constrained by the limited availability of natural resources and immense environmental problems that are forcing China to adopt a growth model that puts sustainability ahead of high growth. One factor immediately depressing growth is China's rapid increase in indebtedness. It forces the government to take relatively strict fiscal and monetary policy stances, which is likely to constrain investment by the public sector and the business community.

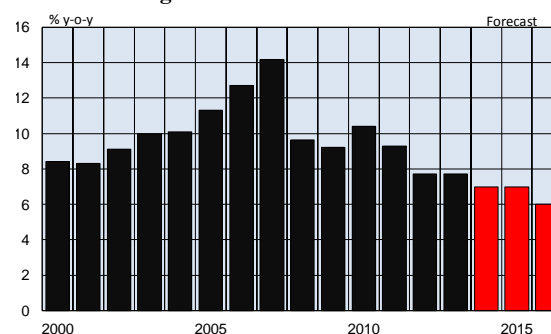
Certain conditions for favourable economic development are in place as the reform policies announced late last year suggest China's leaders are committed to deep and far-reaching reforms. The view that reforms are likely to be implemented is further supported by the fact that market conditions demand reforms to bring emerging systemic risks under control. The reform agenda includes implementation of a deposit insurance scheme, liberalisation of deposit rates and capital movements, as well as increasing the role of interest-rate policy. China's healthy employment situation and an inflation rate holding at 2–3 % also give the leadership an opportunity to focus on reforms.

The gradual liberalisation and diversification of financial markets, poor supervision of shadow banking activity and considerable amount of debt have increased uncertainty in financial markets. This uncertainty is expressed through occasional tightening on financial markets and the general rise in interest rates. It is clear that progress in market reforms will bring with it the realisation of losses and bankruptcies in financial sector. Our basic forecast assumes the financial buffers of banks and other firms, and ultimately the government's ability to bail out troubled banks and businesses, are sufficient to prevent widespread contagion. This view is bolstered by the fact that the Chinese public sector controls vast assets it can sell to raise money and the fact that Chinese firms have not borrowed extensively on international markets. Rapid economic growth continues to be a prerequisite to China's ability to deal with its emerging problems.

Because the role of fixed capital investment is so large in the Chinese economy, any difficulties in financing could undercut investment plans and lead to sharp reduction in

economic growth that could not be offset through boosting consumption and exports. Given the nature of these problems, there is a far greater risk that growth will fall below our forecast than exceed it. This view draws on experiences elsewhere with credit bubbles and financial market liberalisation causing excesses. A number of these symptomatic financial trends are already well established in China.

Realised GDP growth and BOFIT forecast for 2014–2016



Sources: NBS and BOFIT

Losses on Chinese financial markets force investors to assess their risk exposures more carefully. Certain investors and banks have recently had to swallow losses on insolvencies of a construction company and a solar panel manufacturer, which has heightened uncertainty in Chinese financial markets. Unlike earlier, the government did not bail out the troubled firms, signalling that China's capital markets are moving to a more market-based financial system.

Developer Zhejiang Xingrun Real Estate Co. this month defaulted on 3.5 billion yuan (€20 million) in bank loans. The magnitude of the default has raised concerns over the Chinese construction sector's financial sustainability. Many companies depend on the availability of credit, which means that they are exposed to considerable risk of default if housing prices decline or interest rates go up.

Just two weeks earlier, China saw its first-ever corporate bond default, when solar panel maker Chaori Solar failed to pay 90 million yuan (€1 million) interest payments. While the fact that investors could lose their money on a corporate bond issue is unprecedented in the Chinese experience, it has long been known that the solar panel business suffers from significant overcapacity.

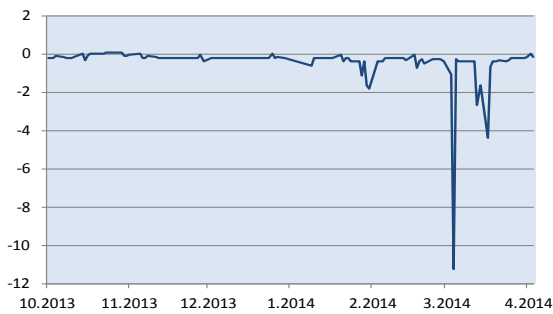
In a statement issued Tuesday (Mar. 25), the State Council reiterated its commitment to reforms that promote transparency of capital markets and improve the ability of investors to manage risk. The Xinhua news agency reports rules on share issues will be reassessed and the bond market diversified by allowing the sale of a wider variety of debt securities to investors. Derivatives markets will be further developed. The goal is to diversify capital markets by expanding investment opportunities. While no timetable has been given, China's booming shadow banking sector puts pressure on the leadership to move ahead with reforms.

Russia

After some strengthening during the past week, the ruble has again weakened. The strengthening at the end of the first quarter was mainly caused by increased demand for rubles, due e.g. to scheduled corporate tax payments. After that, the ruble started to weaken again. The ruble is now more than 7 % weaker than at the start of the year.

Over the past week, the Central Bank of Russia has gradually cut down on its ruble-buying. On Wednesday (Apr. 2), the CBR spent no currency on interventions, but returned to the market on Thursday.

CBR daily forex market interventions, USD billion, 1.10.2013–2.4.2014



Source: Central Bank of Russia

Russian government considers economic policy options in the case of possible toughening of sanctions. According to the government and CBR, the current monetary stance and foreign exchange policy will remain in place, along with the commitment to allow a free-float of the ruble at the beginning of 2015.

The government is split, however, on fiscal policy. Finance minister Anton Siluanov rejected the proposal of economy minister Alexei Ulyukayev to loosen budget policy rules so that the amount of money transferred to the reserve fund from oil & gas revenues would be more dependent on the prevalent economic situation. The change would allow budget expenditures to be increased this year.

The finance ministry says a change in the budget policy amidst the current uncertainty could damage the economy by increasing investor skittishness about Russia's future. Siluanov said that stimulating demand by increasing budget spending would only fuel inflation. In his view, an economic crisis should launch fundamental reforms that would improve the investment climate and make businesses more efficient.

Russia's finance ministry commits to backing corporate sector if economy worsens. Finance minister Anton Siluanov announced at a meeting of the Russian Union of Industrialists and Entrepreneurs (RSPP) that companies will be eligible for subsidies if economic conditions worsen.

However, the amount of support available is likely to be less than after the 2008 financial crisis.

Observers have criticised Russia's 2009 stimulus policies, which focused on bailing out big industries. They note that the bailouts allowed inefficient firms to continue with business as usual without implementing needed structural changes or efficiency measures. During 2009–2010, nearly 1.5 trillion rubles (€35 billion) in subsidies and supports were paid out of the federal budget. In addition, over 1.0 trillion rubles (€24 billion) of public money was used in investments and loans to prop up the financial system.

Siluanov said that this time around the cabinet will focus on supporting companies themselves rather than bailing out owners. Measures include providing financing to retrain workers and cover moving costs as well as promotion of small business. To make it easier for firms to borrow, the state loan guarantee system would be expanded. To get banks to increase lending, banks need higher capitalisation. Siluanov suggested that investments in state banks in 2009 be transmuted into capital. Economy minister Ulyukayev suggested that banks be required to lend for large investment projects at low interest rates to be eligible for refinancing from the CBR.

Russia debates possibility of using rubles in all foreign trade. Andrei Kostin, head of VTB Bank, Russia's second largest bank, first proposed universal ruble use.

Kostin argues that large energy exporters like Gazprom and Rosneft, as well as arms exporter Rosoboroneksport, should be the first to shift to all ruble payments. The firms affected, however, are not hot on the idea. They say it is difficult to get buyers to agree to payment in rubles. Moreover, few Russian companies are willing to give up their foreign currency earnings, without which most would e.g. find it harder to borrow on international markets.

The economy ministry says the cabinet is exploring the possibility of shifting to ruble use in foreign trade but no concrete plans have yet been made.

Russia accelerates introduction of national credit card system. Russia has been planning its own credit card system for years, but implementation has been thwarted by sophisticated technical demands and high costs, as Russia also wanted to use credit cards for other purposes such as personal identification.

The Russian credit card project got a reboot after Visa and MasterCard two weeks ago declined to accept credit cards of some Russian banks. The CBR and finance ministry then called upon banks to discuss the new system, only to be met with an array of opinions. President Putin will make the final decision on the payment system.

Officials note that Russia will have to continue cooperation with international credit card companies in any case if e.g. Russian travellers want to be able to use their credit cards abroad.

China

China announces another “mini-stimulus.” With relatively sluggish economic growth in the first three months of this year, many have been questioning whether China will actually hit its official GDP growth target of “around” 7.5 % this year. Also China’s leadership seems to be concerned about the slowdown. Premier Li Keqiang last month remarked that slightly lower growth would be acceptable. With the increased likelihood China might not even meet a loosened target, the government on Wednesday (Apr. 2) declared it was initiating measures to support growth.

This latest small-scale or “mini-stimulus” will feature directed tax cuts and a boost in public spending. Small businesses will get a tax break that reduces their income tax obligation by half. On the spending side, China will take on another 150 billion yuan in debt (about €18 billion or 0.3 % of GDP) to speed up railway projects in progress or planned. Moreover, China Development Bank was ordered to finance low-income housing projects. An immediate goal this year is to replace about five million dwellings in shantytowns with affordable apartments.

A similar mini-stimulus was applied last summer. If growth fails to pick up sufficiently, further measures, especially to maintain employment, are expected.

China wants to redirect internal migrants to smaller cities. The government last month released its urbanisation plan, including urbanisation targets through 2020. The plan follows the decisions made at the Central Committee’s plenary session last November, and recognises the outline for policies that encourage urbanisation such as land use regulations and gradually dismantling of the *hukou* household registration system. China also hopes to avoid the big pitfalls of rapid urbanisation such as increased inequality, environmental degradation and soaring housing prices. The government aims to boost the share of the population living in cities from under 54 % at the moment to 60 % over the next six years. The increase calls for approximately 90 million rural-dwellers to pack up and move to cities. As the desire of the rural population to move to big cities is already high, China hopes to channel this latest influx of new urbanites to small and mid-sized cities.

The government is moving ahead with its efforts to dismantle restrictions of the *hukou* system in smaller cities. *Hukou* is used to control the migration flows as it defines the social benefits to which everybody, including internal migrants, are entitled. The restrictions on migrants seeking a place in China’s megalopolises will stay in place, however. For example, applicants seeking residence in Beijing will still have to meet the age limit on eligibility as well as other

requirements such as completing a university degree. To improve rural dwellers’ financial possibilities for moving, the government is easing the selling and leasing of rural land. The mini-stimulus announced on Wednesday helps the government meet its urbanisation goals with such measures as supporting construction of low-income housing.

With the cohort of working-age people shrinking, China’s leadership is focusing on urbanisation to maintain the supply of cheap labour. The leadership has also long emphasised the role of urbanisation in moving to a consumption-based model for growth as it increases e.g. demand for services.

In addition to housing construction, urbanisation requires massive investment in health care, public transport and infrastructure. Many local administrations are heavily in debt, so further public investment means the government must give local administrations more access to financing. Dismantling of the *hukou* system will increase demand for public services even further and thereby increase the need for a sustainable basis for funding public administration.

A [World Bank report](#) released last week says China needs to build cities smarter and denser to reduce infrastructure expenses and mitigate pollution. The report estimates better urban planning could save China as much as \$1.4 trillion. Improvements could be achieved, for example, by changing the method for pricing plots of land. The current pricing of land on outskirts encourages expansion of urban areas. Traffic congestion as well as air and water pollution increase when the cities expand far from the centre. The World Bank calls China to evaluate local administrations based on efficient and sustainable urban planning.

WTO panel concludes China’s export controls on rare earth metals violate its WTO commitments. China in 2010 imposed export quotas and raised export tariffs on rare earth elements (REEs), arguing that quotas were needed to protect the nation’s natural resources. China produces about 90 % of the world’s REE supply. REEs are critical in many high-tech applications including electronic devices, permanent magnets and alternative energy production. After China imposed the REE export ban, world prices soared. The resulting outcry led affected countries to file a complaint with the WTO in spring 2012. At the end of March 2014, an expert panel set up by the WTO found that China’s export restrictions violate its WTO commitments. The plaintiffs included the United States, EU, Japan and 16 other countries. Under the ruling, China must present its plans to comply with its commitments, and if approved by the panel, implement them within a reasonable time. China has the possibility to appeal the ruling.

Trade disputes over export restrictions are extremely rare. Most trade disputes involve import restrictions.

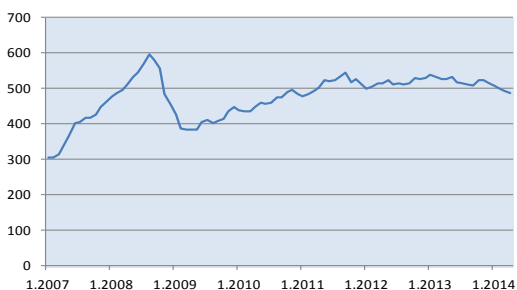
Russia

Uncertainty on Russian markets increased this week on eastern Ukraine unrest. The ruble again weakened, provoking the Central Bank of Russia to sell an average of \$180 million a day of its foreign currency reserves. On Friday (Apr. 11), one dollar bought 35.62 rubles and one euro 49.50 rubles.

Russia's foreign currency reserves down in first quarter. The CBR's foreign currency reserves (including gold), which have steadily dwindled since November, stood at \$486 billion at the end of March. The shrinking reserves reflect increased capital exports from Russia and the CBR's on-going sales of foreign currency to prop up the ruble's exchange rate.

Russia's foreign currency reserves are substantial, however. At the moment, they are sufficient to cover the value of over a year's worth of imports of goods and services, well above the internationally recognised minimum of three months' worth of imports. Russia's foreign currency reserves are the world's fifth largest after China, Japan, Saudi Arabia and Switzerland.

Russia's foreign currency reserves, USD billion



Source: Central Bank of Russia

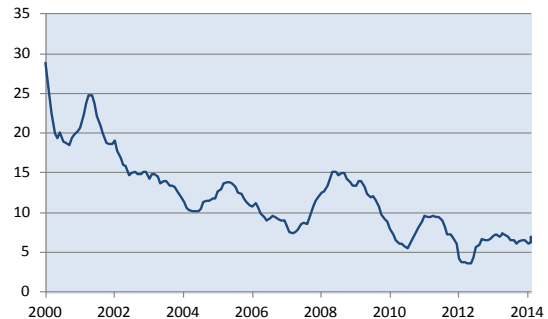
Russian inflation picked up in March. March consumer prices rose 1 % m-o-m. In March 2012, on-month inflation was 0.3 %. 12-month inflation was 6.9 %.

The slide in the ruble's value has fuelled inflation. March food prices were up 1.8 % m-o-m, rising four times faster than in March 2013. Prices for non-food goods increased 0.7 % m-o-m, nearly double the rate of rise in March 2013. Over the past 12 months, food prices were up 8.4 % and non-foods 4.6 %.

The largest price rises over the year, however, have affected utility rates. Gas rates are up 15 % y-o-y, electricity 13 % and heating 11 %, following sharp hikes last summer.

Observers expect the ruble's devaluation to keep prices rising until summer. The likelihood that the government will hit its inflation target of 5 % at the end of the year seems increasingly remote.

12-month consumer price inflation in Russia, %



Source: Rosstat

Gazprom hoists Ukraine's gas price to \$485 per thousand cubic metres. Gazprom last week revoked discounts granted earlier to Ukraine's national gas company Naftogaz, which is \$2.2 billion in arrears to Gazprom. The price Ukraine now must pay is considerably higher than what Gazprom charges its most EU customers. For example, German gas buyers have been paying this year an average of about \$380 per thousand cubic metres of gas. Traditionally, the price Ukraine has paid for its gas to Gazprom has been largely determined in political negotiations with Russia, not by transparent market pricing.

Ukraine openly admits that it cannot pay its gas bills at the moment without outside help. Russian gas covers about 60 % of Ukraine's gas consumption and 20 % of the country's total energy needs. Most other gas Ukraine produces domestically, mainly in the Kharkiv and Poltava regions in eastern Ukraine. Ukraine fears Russia might again cut off gas supplies like in the 2006 and 2009 pricing disputes, as already implicated by president Putin.

However, a heavy-handed approach could hurt Gazprom as well; Ukraine is one of its biggest customers. A number of analysts have warned that the current price hike could crush Ukrainian demand for Russian gas, and ultimately reduce the overall value of Gazprom sales to Ukraine. If Gazprom would halt gas sales to Ukraine, it could create problems for Gazprom deliveries to the EU and Turkey via pipelines running through Ukraine. About a third of Gazprom's sales by volume and about half by revenues come from exports to the EU and Turkey.

Nearly half of all Russian gas exports to the EU are piped via Ukraine. This amount corresponds to a few per cent of total EU primary energy consumption, but in many countries in Central and Eastern Europe, reliance on Russian gas is substantially higher. Experts say temporary supply disruptions are unlikely to cause severe problems for the EU at the moment. Its gas reserves are still half full and gas consumption is falling as the home heating season comes to an end.

Russia also supplies gas to EU countries via Belarus and via the Baltic Sea with the Nordstream pipeline.

China

China's foreign trade remains weak. The value of goods exports fell in March for the second month in a row, sliding nearly 7 % y-o-y to \$170 billion. Imports were down 11 % y-o-y. First-quarter trade figures were tepid. In the first three months of this year, exports declined 3.5 % and imports climbed only 2 %. The trade surplus fell sharply from a year earlier to just \$17 billion.

In part the lower growth numbers reflect last year's rife over reporting of export prices, which allowed Chinese firms to circumvent capital controls and bring capital to China to take advantage of yuan appreciation. The bulk of the pricing distortions involved trade with Hong Kong. Based on monthly figures, the level of distortion seems to have peaked in March 2013. When the Hong Kong numbers are excluded from the rest of the trade figures, China's exports grew in January-March over 3 % y-o-y, while import growth held at 2 %. The figures likely give a more realistic idea of Chinese trade, but do not alter the fact that China is experiencing weaker foreign trade growth.

First-quarter export performance to the EU and Southeast Asia was better than the average. Exports to the US were basically unchanged from a year ago. Strongest import growth was with the EU, US and Australia.

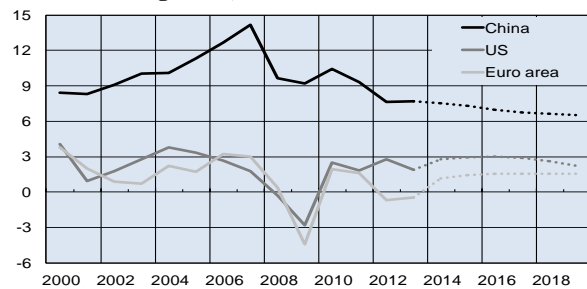
IMF recommends China to curb lending growth. The International Monetary Fund's [World Economic Outlook](#) released this week sees uneven global growth ahead. The IMF says two-thirds of growth in the global economy will come from emerging economies in coming years. The biggest engines of growth will be China and other emerging economies in Asia. The IMF sees China's GDP growth slowing from 7.5 % p.a. this year to 6.5 % in 2019. The forecast assumes economic reforms will be implemented as planned.

The IMF's warnings for China mainly pertain to financial markets. Lending has boomed in recent years and a considerable amount of money has been poured into unprofitable investments. The IMF says China needs to cool the credit growth and curb indebtedness of local governments, especially off-budget borrowing. The IMF emphasised the need to liberalise interest rates to assure risk is better priced into loans than at present.

The IMF regards China's financial sector problems as a risk to the global economy. China's economic growth is still heavily tied to fixed capital investment, so officials might be reluctant to act in timely fashion to deal with emerging problems in investment financing. If the problems get out of hand, the IMF notes, it could lead quickly to a severe slowdown in economic growth with broad implications for the global economy. The IMF, however, stressed this scenario is

unlikely at the moment and the financial sector's problems are manageable as long as regulators take proper measures.

Chinese GDP growth, % (IMF)



Source: IMF World Economic Outlook

China's increasing clout in the global arms trade. The Swedish Stockholm International Peace Research Institute (SIPRI) reports that China's arms exports in 2013 increased 8 % from a year earlier, climbing to nearly 10 % of the international arms trade. Over the past five years, China has become the world's third largest arms-seller, surpassing France, Germany and the United Kingdom. The value of China's global arms sales, however, represents only about a fifth that of US or Russian sales at the moment.

Most of China arms go to low and middle-income countries. About 40 % of all China's arms exports go to Pakistan, which buys most of its armaments from China. Other major customers include Myanmar and Bangladesh. China's weapons production has diversified and includes tanks, missiles, radar systems and fighter jets. SIPRI notes that China also recently received orders from such countries as Turkey, Morocco and Indonesia, which reflects China's rapidly developing military technology as also Russia and the US competed for the same orders.

China's military spending grew at over 10 % a year throughout the 2000s. At the moment, military spending corresponds to about 2 % of GDP. However, Chinese military spending this year is likely to exceed economic growth, thereby increasing its relative share of GDP. Russia and the US, for example, spend over 4 % of GDP on military.

Arms sales to China, in contrast, have shrunk considerably, an indication that China has become much more self-sufficient in arms technology than earlier. During the 2009–2013 period, China imported about half of the arms it had imported in the previous five years. Russia has traditionally been China's largest arms supplier. China has developed much of its own arms production capacity based on Russian technology, which has reduced China's need for imports. In part due to this copying, Russia has refused to sell its most advanced weapons technology to China.

China and Russia have not signed the international Arms Trade Treaty, which bans the arms sales to conflict zones in certain instances. Russia has provided explosives and air defence missiles to the Syrian government during the civil war as well as helicopters to Egypt amid the political unrest.

Russia

Economy ministry lowers its GDP forecast. The economy ministry's forecast for Russian growth this year was yet again revised down on the anticipation that e.g. capital outflow would rise and growth in demand for Russian natural gas would flatten to zero for EU countries and demand would contract in the case of Ukraine.

Deputy economy minister Andrei Klepach says the ministry now expects GDP growth this year to reach 1.1 % at best. The forecast assumes federal budget spending will increase more than planned up to now. The ministry wants an increase in budget spending this year of 350–700 billion rubles, or €7–14 billion (0.5–1 % of GDP). Part of the extra spending will go to Crimean development. The ministry foresees net capital outflow from Russia will reach \$100 billion this year. Private capital net exports for all of last year amounted to \$60 billion.

GDP growth will stay at 0.5 % without increased budget spending. In this case, fixed capital investment will decline and consumption growth will slow strongly. Finance minister Anton Siluanov this week said the current GDP growth estimate for 2014 was still 0.5 %, but growth could also fall to around zero.

The economy ministry also mentioned a darker, but less likely, development path that sees a GDP contraction fuelled e.g. by higher capital exports (\$150 billion).

The ministry's previous forecast, released in December, projected GDP growth of 2.5 % this year.

The IMF World Economic Outlook published last week also cut the IMF's earlier growth estimate for Russia this year from 2 % to 1.3 %. The World Bank estimated last month that Russian GDP would grow just over 1 % this year, cautioning that GDP could contract nearly 2 % if the effects of the Crimean situation were worse than assumed.

Lower imports increase Russian current account surplus. The Central Bank of Russia's preliminary balance-of-payments first-quarter figures show the current account surplus was slightly larger than in 1Q2013. The current account surplus for the past four quarters, however, was still well below 2 % of GDP. The goods trade surplus rose slightly and for the past four quarters amounted to nearly 9 % of GDP. On the other hand, deficits in the services trade balance and other current-account components deepened a bit, to 7 % of GDP.

Earnings from Russian exports of goods and services fell in the first quarter a couple of per cent y-o-y. Export earnings have been falling for over a year now. Export earnings on services continued to increase. Export earnings from goods exports contracted overall, as well as with respect to exports of crude oil, petroleum products, natural gas, and other goods. The export volume of crude oil fell strongly early this year, and petroleum products took a dip.

Export prices for oil, petroleum products and gas were also slightly lower than a year ago.

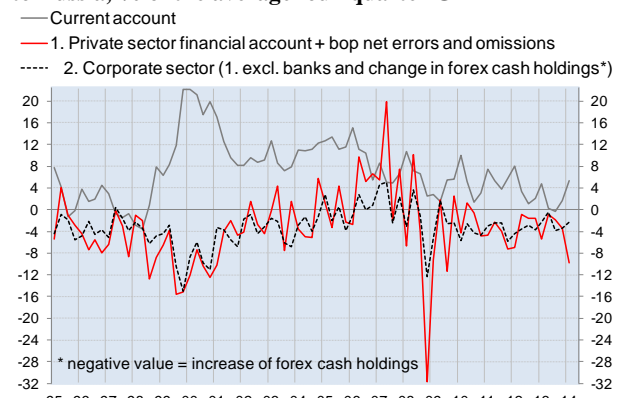
The value of goods and services imported to Russia in the first quarter was down considerably from 1Q2013. The value of goods imports contracted by nearly 10 %. Spending on services imports was still slightly larger than a year earlier. This was due almost entirely to Russian travellers spending abroad, even if annual growth in spending during foreign travel slowed to less than 10 %.

Considerable capital outflows from Russia continue; sharp increase in cash foreign currency holdings. Preliminary balance-of-payments figures from the CBR show a continuing net outflow of capital from Russia's private sector and sharp growth in the amount of foreign currency cash held by the economy's non-bank sector, basically households. These two flows combined rose to over \$50 billion in the first quarter. Of this, nearly \$20 billion came from hoarding cash in foreign currencies. Russians bought foreign currency cash both with money withdrawn from banks and rubles held as cash. Foreign currency cash holdings have not shown such a spike since the final months of 2008 when the financial crisis struck. During the last four quarters, the above-mentioned two capital flows combined equalled 4 % of GDP, the highest since autumn 2012.

The net flow of private capital abroad in the first quarter was about the same as in 1Q2012 and 1Q2013 (about \$30 billion). Banks increased their net capital exports substantially (to almost \$20 billion) to balance their forex positions as domestic forex deposits with banks increased sharply.

Capital flows between Russia's corporate sector (excl. banks) and the outside world remained relatively small. Direct investment flows from abroad to the corporate sector stayed at just over 2 % of GDP while DI outflows from Russia's corporate sector were a bit larger. Despite a small uptick, corporate borrowing from abroad remained rather mild. The comparisons exclude the massive DI and foreign borrowing impacts from the TNK-BP ownership deal a year ago. The CBR estimates grey capital exports declined.

Current account surplus and private sector net capital inflows to Russia, % of the average four-quarter GDP



Source: Central Bank of Russia

China

First-quarter figures show clear signs of economic slowdown. The National Bureau of Statistics reports that real GDP grew 7.4 % y-o-y in the first quarter of this year. As expected the data suggest China's economy is now definitely slowing. On-year growth was still 7.7 % in the fourth quarter of 2013. The slowdown is even more evident in the quarterly growth figures. First-quarter growth of 1.4 % q-o-q translates to on-year growth below 6 %.

12-month GDP growth in China, %



Source: China National Bureau of Statistics

Most economic indicators point to a slowdown. Although China has yet to release quarterly figures for demand-side GDP components, the foreign trade data show flagging export demand in the first quarter. Further, the pace of growth in fixed capital investment decelerated; real investment growth (excluding rural households) declined to 16 % y-o-y, down three percentage points from 1Q2013.

Lower growth in China is also an indication of structural adjustment in the economy. Services contribute an increasing share of output, while the pace of industrial growth consistently lags growth in retail sales. Household demand is sustained by steady income gains; real disposable incomes per capita were up nearly 9 % y-o-y in the first quarter. On the other hand, increased indebtedness and financial market problems have dampened investment growth.

The slowdown in growth in China has been long anticipated and largely reflects a shift to a more sustainable growth model. The facts that growth still looks quite robust by international standards, incomes continue to rise and the situation concerning employment and inflation (2.4 % in March) remains stable do not imply that China should change its basic macro policy stance. Rather the situation should be welcomed by decision-makers as it provides them with a window of opportunity to deal with problems brewing in the financial markets and move ahead on scheduled reforms.

China eases cross-border share trading as deregulation of capital movements continues. The official agencies regulating securities trading in China and Hong Kong, the CSRC and SFC, last week announced a joint programme to facilitate mutual stock market access on the Hong Kong and Shanghai stock exchanges. Under the proposed “through train” scheme, shares of Chinese companies listed in Shanghai could be bought or sold via the Hong Kong exchange. The scheme would give foreign investors direct access to Chinese capital markets. Similarly, investors in mainland China could buy and sell shares listed on the Hong Kong exchange via the Shanghai exchange. This would make it easier for Chinese investors to put their money outside mainland China. Officials hope to launch the scheme before the end of this year. A similar cross-border arrangement, initially proposed in 2007, was shelved at that time in light of turmoil in global financial markets.

The cross-border share trading will be restricted under a quota system, a familiar first-step approach of Chinese officials in implementing reforms. Quotas prevent large swings in the markets and allow officials to implement reforms incrementally. The quotas limit the flow of funds from Hong Kong to Shanghai exchange to 300 billion yuan (€36 billion), or about 10 % of the market capitalisation of the Shanghai stock exchange. The total daily value of trades cannot exceed 13 billion yuan (€1.2 billion), or 10–15 % of the Shanghai exchange's daily trading volume. Chinese investment in Hong Kong will be limited to 250 billion yuan (€30 billion) overall, and 10 billion yuan daily. Investments from Shanghai to Hong Kong will only be allowed for institutional investors and wealthy individuals.

Cross-border securities trading must currently take place within official schemes that use quotas and limit participation of approved investors. The Qualified Foreign Institutional Investor (QFII) programme applies to investment in mainland China with foreign currencies and the Renminbi Qualified Foreign Institutional Investor (RQFII) programme for yuan based investment. The Qualified Domestic Institutional Investor (QDII) programme allows Chinese investors to invest abroad. The “through train” scheme appears to allow investments outside of these programmes.

The reforms bolster Hong Kong's status as an international hub for yuan trading as shares listed in yuan can be purchased directly from local brokers. Hong Kong has historically played an important role in Chinese pilot programmes. For example, the Hong Kong exchange was the first to be approved as a QDII destination.

At the moment, there can be disparities in prices of shares of companies listed on both the Hong Kong (H-shares) and Shanghai (A-shares) exchanges. The current differences are due largely to capital controls and should narrow with freer capital movements.

Russia

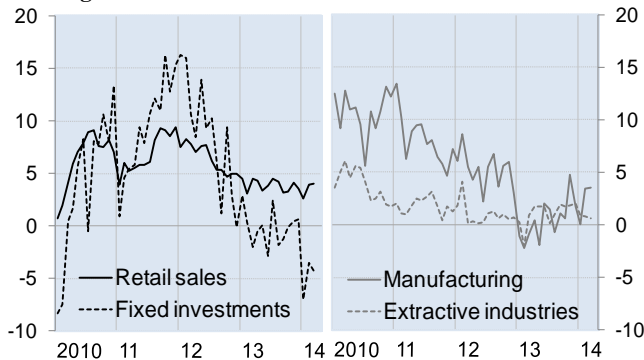
Distinct chill in the Russian economy. Preliminary economy ministry estimate shows GDP grew by 0.8 % y-o-y in the first quarter and seasonally adjusted first quarter GDP contracted 0.5 % q-o-q. Rosstat reported a revision of its GDP growth figures for 2013. The new figures indicate GDP growth picked up over the year, reaching 2 % y-o-y in the fourth quarter. Earlier figures showed a second-quarter dip in growth.

The 1 % y-o-y pace of industrial output growth in the first quarter was essentially unchanged from 4Q2013. The recovery in manufacturing that began late last autumn continued with growth holding at just under 2.5 % y-o-y. Most manufacturing growth came from brisk growth in the oil refining and chemical industries. Production of mineral extraction industries was up less than 1 %, or slightly lower growth than last year. Crude oil production increased by over 0.5 %, while natural gas production slid about 1.5 %.

Retail sales growth remained fairly brisk, with sales rising 3.5 % y-o-y. Russia, however, experienced a burst in sales of non-food goods in the first quarter. Observers believe there was a rush to buy things which came in response to higher prices and inflation expectations caused by the sharp drop in the value of the ruble.

Growth in consumer demand is constrained by real disposable incomes of households which fell over 2 % in the first quarter. The decline was partly due to increasing interest payments on household bank loans. The decline in household borrowing continued. Households drew down their bank accounts to an exceptional extent in the first quarter to finance goods purchases and hoard foreign currency cash.

Russian domestic demand and industrial output, 12-month % change



Source: Rosstat

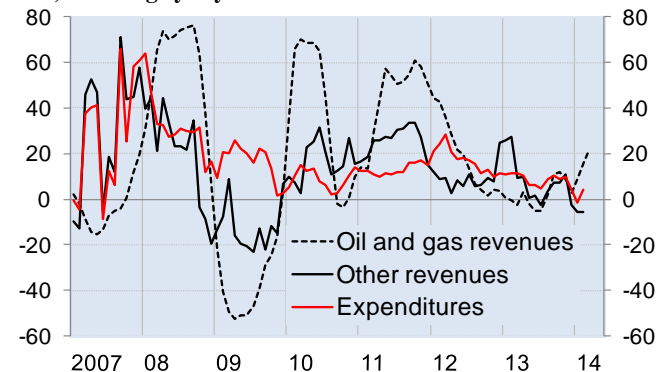
Fixed capital investment and construction activity both declined, 5 and 3.6 % y-o-y, respectively. The contractions in building and investment were already underway before the Crimean situation added to economic uncertainty.

Ministries at loggerheads over government spending and budget rule. The policy wrangle between the ministries of economy and finance ratcheted up this week and last. After the economy ministry's latest economic forecast included a recommendation to increase state spending, the finance ministry noted the economy ministry overstated the impacts of higher spending on economic growth.

The finance ministry does not want to deviate from the agreed budget rule limiting the size of the budget deficit to 1 % of GDP. The finance ministry argues that higher spending will lead to more imports and increased capital outflows, accelerate inflation, and together with more borrowing will lead to higher interest rates and degrade the investment climate. The finance ministry also noted that violation of the budget rule during the current geopolitical risks would be undesirable even with the new state spending on Crimean development. The finance ministry further explained that temporary boosts in spending do not secure sustained economic growth. The finance ministry is even suggesting tightening of the budget rule so that the basis for determining state spending would take into account the oil price and, instead of the budget deficit relative to GDP, an estimate of the state's access to financing. Prime minister Dmitri Medvedev has commented on a deviation from the budget rule by way of reserve.

In the economy ministry's view, higher spending would be supported by state oil and gas revenues, which are denominated in dollars and in ruble terms will exceed this year's budget revenue projection by over 1 % of GDP. The finance ministry dismisses this argument, noting that other budget revenues and state financing (including refinancing of debt) through borrowing and privatisation sales will be considerably lower than expected. Government revenues from production taxes and export duties on the oil & gas sector increased over 20 % y-o-y in the first quarter. Growth in other revenue streams, however, failed to match inflation.

Russian government revenues and expenditures, 3-month sum, % change y-o-y



Source: Finance ministry

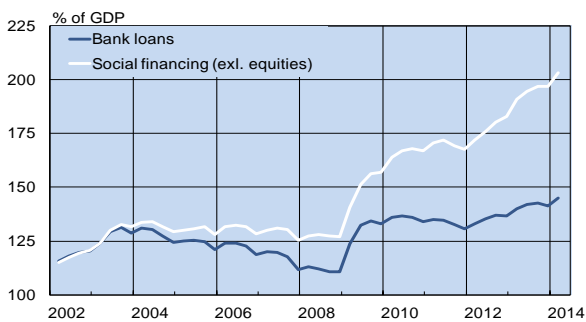
China

First-quarter data show mounting debt levels in China.

China's pace of economic growth slowed in the first three months of the year, partly on lower growth in investment demand. The slowdown in growth was also reflected in credit stock growth. Using a broader definition that includes social financing arrangements but not equity, credit stock growth slowed in the first quarter. March on-year growth slowed one percentage point to 16 %. Diminished credit growth could be seen in both formal bank lending and financing granted by the shadow-banking sector. Broad money supply growth (M2), which consists of cash and bank deposits, slowed by over a percentage point to around 12 %, a record low for Chinese money supply growth in recent decades.

Despite the slowdown, the growth in the credit stock exceeded nominal GDP growth. As a result, indebtedness relative to GDP increased in the first quarter. China's total credit stock now exceeds 200 % of GDP.

Overall credit stock and bank lending stock relative to GDP



Sources: *Macrobond, BOFIT*

China's slowing economic growth has fuelled a debate over the need for further stimulus measures. The government has already lowered capital adequacy requirements of rural banks by 0.5–2.0 percentage points to 13–15 %. The move is mainly intended to support agriculture; due to a small size of rural banks, the step is not expected to have specific liquidity or interest-rate effects. The government will also support small-business employment through modest tax breaks, commission new infrastructure projects and ease restrictions on real estate markets to sustain activity.

The debt loads on enterprise sector and local administrations, however, are now so large that they must be considered in economic policy. Reducing debt growth under the current circumstances could yield greater benefits for the Chinese economy than stimulus measures as long as the job market shows no signs of weakening.

Government aims to curb shadow-banking risks by tightening regulation and clearing path for the local government bond market. China's Banking Regulatory Commission (CBRC) announced this month new measures designed to rein in risks arising from financing activity outside the formal banking system. The new regulations target trust companies operating in financial markets. Trust companies collect funds from private individuals and firms via commercial banks, and lend the collected funds forward as trust loans. Reuters reports the new regulations will prevent trust companies from issuing new trust products to fund repayments to investors on maturing loans. Under the reform, trust products must also specify the underlying assets of the investment, which allow investors to understand their risk exposure better. The details and timetable for the rollout of the new rules has yet to be announced.

The new regulations require trust companies to clarify their operational procedures and demonstrate access to adequate financing (e.g. from company owners) in the event of financial market tightening. Because financial companies outside the formal banking system lack access to the central bank's emergency financing arrangements, officials are paying particular attention to the liquidity management of shadow banks.

By banning trust companies from issuing new debt to pay off old debt, officials hope to avoid situations where investors' risks are prevented from realising as it only postpones and piles up problems. A big issue for many companies financed by shadow banks is that they rely on access to financing because they have financed long-term projects with short-term loans. New measures aim to prevent these maturity-mismatches in the future to reduce liquidity risks.

Individual investors will also be banned from using borrowed funds to invest in trust products. The regulatory measures are designed to stave off a build-up of problems and the emergence of systemic risks.

The shadow-banking sector has defaulted on repayments for certain wealth management products this year, but so far investors have been bailed out. The bailouts, in turn, have raised questions about investor liability and moral hazard. In several recent events, investors have assumed seller banks were responsible for reimbursement for trust product losses, suggesting that liability issues still need clarification.

China is going to speed up the rollout of local administration bond markets. Standard Chartered Bank estimates 20–30 % of assets raised from shadow-banking sector's wealth management products have been loaned to local administrations. The introduction of bond financing is hoped to improve transparency of the accounting practices and debt of local administrations.

Russia

CBR raises key rate to 7.5 %. Ahead its decision last week (Apr. 25), the Central Bank of Russia's key rate, i.e. the 7-day repo credit rate, was 7.0 %. In its press release, the CBR said the hike reflected faster-than-expected inflation caused by the slide in the ruble's exchange rate. The economic slowdown, the central bank noted, was unlikely to quell inflation as most of the slowdown in growth is due to structural reasons.

The CBR last increased its key rate in March to ease market uncertainty caused by the Crimean crisis. The decision to raise the repo credit rate came as a surprise to the markets, which widely expected the central bank to keep the key rate unchanged. Many observers note that the rate hike supports the markets now that the uncertainty caused by international developments has again heightened. Deputy economy minister Andrei Klepach criticised the rate hike. In his opinion, the move further weakened conditions for economic recovery.

The announcement of new sanctions imposed on Russia this week by the US and EU have had minimal impact on Russian financial markets.

CBR introduces three-year refinancing tool. At the start of last week, the CBR announced that it would begin to grant banks a new three-year refinancing instrument. The loans can be used to secure bank loans for investment projects. The refinancing rate is fixed at 6.5 %.

The new refinancing tool should increase the supply of long-term investment financing, something Russia's financial markets generally lack at the moment. The initiative for a refinancing tool came from the corporate sector, and the government and the central bank have been working on the arrangement for a while.

Only large banks with capitalisations of at least 50 billion rubles (just over €1 billion) are eligible for the refinancing deal. This group comprises fewer than 20 banks. Investment loans are eligible for refinancing if the project meets the same criteria that are required in order to get a state guarantee for a loan.

Standard & Poor's downgrades Russia's creditworthiness. Last Friday (Apr. 25), S&P announced a downgrade of Russian sovereign foreign currency debt to BBB-, the lowest of investor-grade rating. Ratings below this are considered junk, i.e. too risky for prudent institutional investors. Moody's and Fitch, the other major international credit rating agencies, are keeping their sovereign ratings for Russia unchanged for the time being, even if both warned of possible downgrades in March.

S&P said its decision to downgrade Russia reflected large capital exports, which can even increase if the politi-

cal situation worsens. Government creditworthiness is hurt by capital exports as they erode economic growth possibilities.

Russia's downgrade will have little impact on day-to-day activities of the Russian government, at least in the short run. With its public finances in relatively good shape, Russia has no acute financing problems at the moment. Russian firms, on the other hand, could be affected by further limiting of their access to international financing and higher financing costs. However, international corporate borrowing has already been hit by heightened international political tensions.

Russian government discusses establishing its own national-level credit rating agency. There is a need for a national rating agency, as according to the first deputy prime minister Igor Shuvalov, Western governments can currently influence the three leading international credit rating agencies' evaluations.

Russian market participants, on the other hand, are loathe to the idea of one national credit rating agency. Instead, Russia's already functioning domestic rating agencies' evaluations should be used in the country in the same way as evaluations of the international credit rating agencies. However, such a move would require the development of world-class rating proficiency that does not exist in Russia at the moment. In any case, e.g. the finance ministry has no plans to stop relying on the ratings on the big three international credit ratings agencies any time soon as without them it would be impossible to market Russian government debt.

Russian unemployment still at low levels for now. The economic downturn has yet to be reflected in the labour market. The first-quarter unemployment rate fell to a historically low national average of 5.5 %. In recent months, however, both official data and company surveys hint at weakness in the labour market. For example, downsizing is now slightly more often reported as the reason for terminating employment. In addition, the number of advertised open positions is lower than a year ago.

The differences in unemployment rates across regions are still large. In Moscow and St. Petersburg, the unemployment rate was under 2 %, while it was nearly 10 % in the Karelian republic and almost 40 % in the restless North Caucasus regions. Unemployment has already risen or threatens to rise substantially in many *monograts* (single-industry cities), where the core industry struggles with a weak economy.

Official figures show that only around 2 % of Russians work outside the region where they live, even if that share has grown gradually in recent years. There are plans to provide public funds to support resettlement from areas hardest hit by unemployment, specifically *monograts*.

China

China's current account surplus shrank in first quarter.

China's January-March current account surplus was just \$7 billion, down from \$48 billion a year earlier and the smallest since 1Q2011. The current account surplus fell to 1.5 % of GDP.

Although the current account surplus fell substantially, net capital inflows into China remained strong. China's foreign currency reserves rose by nearly \$130 billion in the first quarter to \$3.95 trillion.

The yuan's exchange rate continued to slide in April, falling to 6.25 yuan to the dollar. The exchange rate has remained at the weak end of the 2 % fluctuation band for the daily fixing rate set by the People's Bank of China.

Although the rebalancing of foreign trade removes some appreciation pressure on the yuan, it also indicates that the yuan's decline in the midst of fairly robust economic conditions in the first quarter, large capital inflows and growth in China's foreign currency reserves has not been entirely market driven. A similar weakening episode occurred in 2012, after which the yuan returned to its long-term appreciation trend. With China's shrinking current account surplus, lower economic growth and recoveries underway in some of its main trading partners, the current situation is more in balance than earlier.

Ratio of current account surplus to GDP, four-quarter moving average



Source: Macrobond

Amendments to China's environmental protection law give authorities more power to take on polluters.

The National People's Congress last week approved an amendment expanding the scope of environmental regulation and permitting harsher measures to mitigate pollution. The law will give officials the power to impose larger sanctions on firms violating environmental laws. The current ceiling on penalties will be eliminated when the amendments come into force at the start of 2015. The regulatory changes were the first to China's environmental protection law since it

was enacted in 1989. Although the law has always sought to limit soil, air and water pollution, its implementation to date has been rather toothless.

Current punishments for violating the environmental protection law are inadequate as firms find it cheaper to pay fines for their excessive emissions than to implement environmentally friendly production technology. Under the current rules, polluting firms get off with a single fine. China's official news agency Xinhua reports that the new law will allow authorities to impose fines that accumulate daily during the period when the violator is out of compliance. It remains to be seen whether environmental protection officials will actually exercise their new powers to take on violators. If they do, it should increase demand for clean technologies in China.

The reforms also tighten emission-reporting requirements of firms. Companies will have to reveal more detailed information about the environmental impacts of their production. Non-governmental organisations that fulfil certain criteria can bring a lawsuit against a polluting company. This means that, in principle at least, citizens have a channel to seek legal action in challenging China's worsening pollution problems. The level of dissatisfaction of average Chinese with the country's pollution problems has soared in recent years.

The amendment provides hard evidence that China's leadership is taking climate and environment issues seriously. The leadership is starting to implement policy measures and provide more information on these issues. In April, the Ministry of Environmental Protection (MEP) published a research report on soil contamination after it was classified as a state secret a year ago. The MEP report notes that about a fifth of China's farmland is contaminated with heavy metals such as lead, arsenic and cadmium. China has also begun to post its own official air quality index along side the US embassy's air quality measures. Air quality has long been an extremely sensitive topic for Chinese politicians.

Foreign car manufacturers increase market share in

China. The 13th Beijing International Automobile Exhibition Show, which ended on Tuesday (Apr. 29), brought Chinese carmakers and nearly all major Western car manufacturers to town. Car sales in China have increased more than ten-fold over the past 13 years the annual event has been held. China has surpassed the US as the world's biggest market for passenger cars and new car sales rose 14 % to 22 million cars last year.

In the first quarter of this year, nearly 6 million cars were sold in China, a gain of 9 % y-o-y. However, sales of Chinese brands shrank by over 1 % in the same period. Consequently the market share of foreign brands exceeded 60 %, a five-percentage-point gain from last year. German brands, in particular, have seen their popularity rise.

Russia

IMF and OECD revise down their forecasts for Russia.

The IMF cut its earlier forecast for Russian GDP growth this year from over 1 % to 0.2 %. The OECD also revised its earlier forecast for Russian GDP growth down to 0.5 %. Both forecasts were lowered on the expectation of a contraction in fixed capital investment from uncertainty surrounding the Ukraine situation. Both organisations see GDP growth recovering in 2015 as investment picks up. The IMF sees growth of about 1 % next year and the OECD 1.8 %.

Notably, both organisations took notice of trends in Russia's public sector finances. Government revenues from dollar-denominated duties and fees collected from the oil and gas sector should increase this year significantly more than earlier estimated due to ruble depreciation. The OECD would like to see the revenues used to avoid spending cuts and support the economy, especially through funding education, innovation and labour market programmes. The OECD notes, however, that this kind of temporary deviation in budget policy should be reversed when the economy picks up. The IMF also hinted that if the economic downturn would be deep and prolonged, a temporary increase in spending could be considered as long as it is executed in a focused and conscientious manner. The IMF emphasised that sticking to the government's approved budget rule, which limits the deficit to around 1 % of GDP, is crucial under the current uncertainty to preserving credibility. In addition, the IMF reiterated the need to continue reform of the pension system and pointed to the possibility of raising the retirement age.

IMF approves \$17 billion support package for Ukraine.

At its April 30 meeting, the IMF board approved a two-year reform programme for Ukraine. The loan package requires Ukraine to implement agreed economic reforms for the full \$17 billion to be disbursed over this year and next. With the first measures already implemented, the first disbursement of over \$3 billion has been released.

The IMF estimates that Ukraine's need for financing from external public institutional lenders in 2014 and 2015 totals \$22.5 billion (nearly 8 % of Ukraine's GDP in 2014 and 2015). Of this amount, the IMF's net lending would come to nearly \$11 billion, while financing from other institutional sources such as the World Bank, EU, EBRD and EIB, would amount to nearly \$12 billion.

The IMF programme seeks to stabilise Ukraine's economy by returning sustainability of public finances and current account as well as by reinitiating the implementation of a broad package of economic reforms neglected during the crisis. After this year's fall in output the IMF expects Ukraine to achieve positive GDP growth next year if the measures agreed on in the programme are implemented.

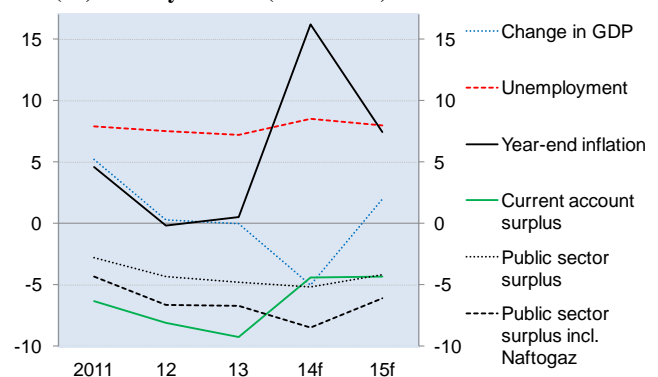
The programme seeks to keep the hryvnia's exchange rate flexible in order to support economic competitiveness and external balance. The deep public sector deficit will contract gradually through restrained public spending (nearly half of GDP over the past two years) and higher government revenues. The agreed spending limits are comprehensive and cover e.g. public sector wages, pensions, public procurements and the energy subsidies that have been a heavy burden on government budget and the state-owned gas company Naftogaz.

Household rate increases for gas and district heating are a cornerstone of Ukraine's energy sector reform. These rates are presently the lowest in Europe; nominally just 11–25 % of rates paid in other gas importing countries in the region. Gas rates were increased at the beginning of May by 56 % and district heating rates will go up 40 % at the start of July. During 2015–2017, rates are expected to double to bring them up to a level where they would cover gas sector costs. Rate hikes will be offset for the most vulnerable household by extending the social support for energy costs. After the reforms, it is expected that over a quarter of households will be covered by the support.

The IMF noted that implementation of the reform package involves significant, wide-ranging risks that include the Ukraine-Russia bilateral trade relationship (e.g. full realisation of the significant hike in the gas price for Ukraine demanded by Russia), Ukraine's geopolitical situation, tensions in eastern Ukraine, the country's political uncertainty, as well as potential problems exposed by the coming investigation of Ukraine's banking sector. The IMF noted that the reform package enjoys support in Ukraine also beyond the current leadership. Supporters include the leading presidential candidates, the key political parties and many NGO representatives.

Given the flood of conflicting information, the IMF reform package offers a clear and comprehensive anchor for Ukraine's stable development.

Ukraine's GDP growth (%), unemployment ratio (%), inflation (%) and key deficits (% of GDP)



Source: IMF

China

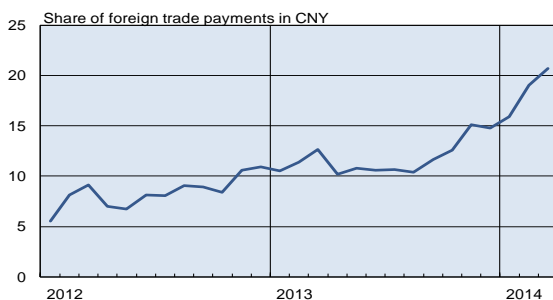
Yuan's international role continues to grow. SWIFT, the global provider of bank information services, reports that the yuan climbed again in its rankings in March to become the world's seventh-most-used international payments currency (1.6 % global share). Singapore in recent months also surpassed London as the top offshore yuan trading centre after Hong Kong.

Assuming no dramatic downturn in the Chinese economy and that the country continues to lift capital controls, the yuan is on track to overtake the Canadian dollar (current global share 1.8 %) and the Australian dollar (1.8 %) to challenge the fourth-place Japanese yen (currently 2.5 %). The US dollar (40.2 %) and the euro (31.8 %) dominate international payments, with the British pound coming in a distant third (9.2 %).

Contrary to the intentions of Russia's leadership, SWIFT payments figures show the ruble losing ground as an international payments currency. As recently as February 2013, the ruble was ranked 13th ahead of the yuan. SWIFT's March 2014 list put the ruble in 18th position.

The increased international acceptance of the yuan can be seen in other indicators, too. For example, yuan deposits this year in Hong Kong have continued to grow and the share of Chinese foreign trade invoiced in yuan has increased to 20 %.

Share of Chinese foreign trade conducted in yuan, %



Source: Macrobond

Slight improvement in Chinese foreign trade in April.

After two consecutive months of decline, the value of goods exports saw modest growth in April. The value of exports rose by nearly 1 % y-o-y to \$190 billion for the month. After dropping in March, the value of imports also grew nearly 1 % in April. The revival in exports drove the trade surplus to \$18 billion, over double the March surplus. Total exports in the first four months of the year contracted by over 2 % on poor February and March numbers.

Interpreting Chinese foreign trade data has this spring been problematic due to problems with last year figures. In the first half of 2013, Chinese firms tended to exaggerate

their export prices to circumvent capital controls and repatriate earnings to take advantage of yuan appreciation. Even if the exaggeration effect on growth figures has declined from previous months, it was still significant in April. Since most of the skewed trade figures pertain to Hong Kong trade, it is hardly surprising that the value of exports to Hong Kong nose-dived this year after the introduction of stricter reporting rules. Excluding the Hong Kong figures, China's exports rose by nearly 10 % in April and over 5 % in the first four months of the year. The distorting impact of Hong Kong on import figures has been less severe.

April exports showed sharp gains to EU countries (up 15 %), the US (12 %), South Korea (14 %) and Vietnam (22 %).

Latest ICP figures show China's cost-of-living-adjusted GDP nearly matching the United States. The International Comparison Program (ICP), which is hosted by the World Bank, last week released its latest country-specific GDP estimates adjusted for purchasing power parity (PPP). The ICP calculates that China's real PPP-adjusted GDP in 2011 was 87 % of the US level. With China experiencing far higher GDP growth than the US over the past three years and the current forecasts for GDP growth this year, China is on track to overtake the US economy in the terms of purchasing power some time during 2014. The news has received considerable attention in the global media as it has been interpreted as a milestone in world economic development. Chinese per capita income, on the other hand, lags the US by a long distance under any measure.

The ICP figures show that China's share of global output was about 15 % in PPP-adjusted terms in 2011. Based on nominal GDP, the share was just over 10 %. The GDP share of emerging economies increases in PPP-adjusted figures due to their relatively low price levels. For example, India beat out Japan in ICP figures as the world's third largest economy, even if its nominal GDP figure suggests a much smaller economy than Japan's. By taking price differences into consideration, the ICP seeks to make GDP statistics more meaningful, by making the valuing of non-tradable goods and services more comparable.

One should be cautious about reading too much into PPP-adjusted figures, given that the methodology is fraught with pitfalls. Defining price levels starts with an assumption that people across countries consume the same basket of goods and services. Yet it is obvious that even within China itself consumer habits vary widely. Critics also point out that customs and skills in computing GDP vary across countries. The ICP concedes that the greater the differences between countries surveyed, the more problematic it is to interpret the data. For example, much of China's growth is driven by fixed investment, which itself is hard to estimate due to many special features of the Chinese economic system.

Russia

Gazprom demands Ukraine pre-pay for gas deliveries.

After Ukraine failed to come up with the \$1.3 billion Gazprom had demanded by its May 7 deadline for gas supplied in April, Gazprom said that as of June 2 it would only supply gas to Ukraine on a prepayment basis.

Ukraine refuses to pay the new hiked rate of \$485 per 1,000 cubic metres that Gazprom introduced at the beginning of April. Ukraine says that if Gazprom does not back off on pricing, it will take the matter to the international arbitration court in Stockholm (Arbitration Institute).

Ukraine also refuses to pay Gazprom for earlier gas deliveries until the new price is agreed. Ukraine stopped paying its gas bills last autumn. According to Gazprom, Ukraine now owes it a total of \$3.5 billion (including April deliveries). Ukraine claims it owes less.

At the end of April, the IMF granted Ukraine a \$17 billion credit facility. The IMF last week released the first \$3.2 billion tranche of the support programme to Ukraine. The money can be used for such purposes as debt servicing.

The Ukraine-Russia price dispute could affect the supply of gas piped to Europe via Ukraine. Representatives of Ukraine, Russia and the EU are still discussing the situation.

Gazprom cuts gas price for Lithuania. Lithuanian officials late last week announced that a gas price deal extending to the end of 2015 had been reached. Lithuanian prime minister Algirdas Butkevicius implied the discount amounts to at least 20 % off on Lithuania's current rate for Russian gas of \$465 per 1,000 m³. Butkevicius said the new rate roughly corresponds to the price Lithuania's neighbours are paying for Russian gas.

Now that the deal has been reached, Lithuania will most probably withdraw its filing with the arbitration court in Stockholm (Arbitration Institute) accusing Gazprom of discriminatory pricing policies.

Russia requests consultation with WTO on EU energy policy. Russia's complaint focuses on how the EU's Third Energy Package treats Russian energy infrastructure within the EU. Under the Third Energy Package rules, an energy supplier cannot own distribution infrastructure. The EU says the rule is intended to increase competition within the EU energy market.

In Russia's view, the Third Energy Package conflicts with the EU's own WTO commitments as it violates the principles of equal treatment and market access. The rules directly affect Gazprom's operations in Europe, including the planned South Stream pipeline that would bring gas to Europe via the Black Sea.

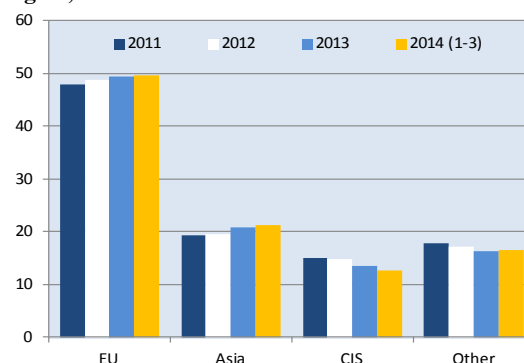
For its part, the EU Commission is investigating Gazprom's possible price manipulation and competition rule violation in the EU market. The EU Commission notes that Gazprom charges its European customers widely varying and often unreasonably high prices for the same product. The Commission launched an official investigation two years ago and is expected to present its findings within a few weeks.

Russian goods trade contracted in January-March. The first-quarter contraction in the value of imports of 7 % y-o-y reflects Russia's current economic slowdown and the ruble's slide. The value of goods imports from CIS countries dropped 20 % in the first quarter while the volume of these imports fell as much as over 40 % in January-February only. CIS countries, however, accounted for just over 10 % of Russian imports. EU countries supplied over 40 % of imports and Asian countries nearly 30 %. Foodstuffs were the only major import category to show growth in value terms in the first quarter. The value of imports in other major categories, i.e. machinery & equipment and chemical products declined sharply.

The value of goods exports contracted 2 % y-o-y in the first quarter. The export prices of nearly all Russia's major export commodities (crude oil, petroleum products, natural gas and metals) were slightly lower than a year earlier. Export volumes of crude oil and aluminium contracted sharply. Export volumes of natural gas and raw timber increased. Over half of Russian goods exports go to the EU. Asia's share is just under 20 % and CIS countries' a bit over 10 %. The value of exports was nearly double that of imports, driving the goods trade surplus to over \$50 billion in the first quarter.

Russia's services trade increased slightly in January-March from a year earlier. Services represent nearly 30 % of total imports and just over 10 % of total exports. Russia's services trade deficit was \$10 billion. The EU accounts for over 40 % of Russia's trade in services. Turkey is Russia's largest single services trade partner.

Breakdown of Russian goods trade (imports + exports) by region, %.



Source: Russian customs

China

April's economic figures as expected, even as worries about the real estate sector deepen. April's industrial output growth of nearly 9 % y-o-y matched the March figure. Growth in retail sales remained at around 10 %. The readings of key purchasing manager indices (PMIs) released earlier also signalled no significant changes in industrial or service sector conditions in April from previous months. GDP growth was 7.4 % y-o-y in the first quarter.

While economic output appeared stable overall, trends in the housing sector and construction activity are raising concerns. The situation varies across provinces, but a number of key indicators suggest a distinct cooling in the housing market. During the January-April period, the volume of new housing starts was down 25 % y-o-y, while the value of housing sales was off by 10 %. The stock of unsold apartments continued to rise and the decline in housing prices spread to more cities.

Real estate sector difficulties are driving the slowdown in construction activity, which has led to a deceleration in annual growth of cement production to below 4 % and steel output to around 5 %. The slowdown in the housing market partly explains the first-quarter slowdown in fixed capital investment growth. Real estate investment last year accounted for a quarter of total fixed capital investment. Because capital investment represents such a large share of GDP in China, the housing slowdown has a profound impact on the headline growth figure.

The slowdown in growth and problems in the real estate market are naturally reflected in the financial sector, where growth in lending continued to slow in April. Despite the slowdown, bank lending and other credit provision showed strong growth as a share of GDP in January-March, and rising debt levels remained on an unsustainable course.

Ultimately, the biggest headaches for China's economic policymakers are how to maintain high levels of employment and keep inflation low. 12-month inflation has remained around 2–3 % over the past two years, and the inflation outlook remains subdued in light of April's figure of 1.8 %. No reliable unemployment figures are available for China, but labour market signals do not seem to indicate any erosion of the employment situation.

If the employment situation remains good despite lower economic growth, the government will not have to resort to special measures to stimulate growth. From the standpoint of sustainable growth, curbing rising debt and focusing on reforms are more important than obsessing on meeting growth targets which may no longer even correspond to the needs of the labour market or the environment. Providing reliable unemployment data would increase transparency of Chinese economic policy.

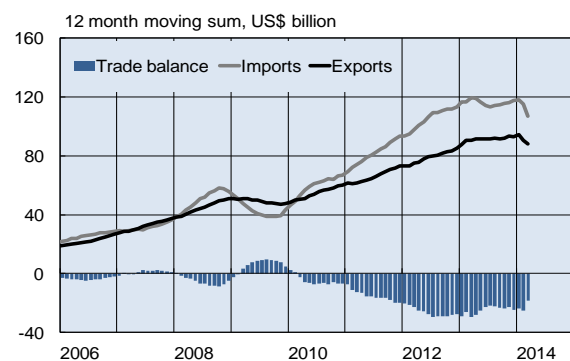
Premier Li visits Africa amidst dip in trade. During his eight-day, four-country tour of Africa last week, China's premier Li Keqiang met with leaders in Angola, Kenya, Nigeria and at African Union headquarters in Ethiopia. During the visit ending Sunday (May 11), China increased its promised concessional loans from \$20 billion to \$30 billion and announced it would provide nearly \$4 billion in funding for construction of a railway line from Nairobi to Mombasa.

China's official news agency Xinhua noted the main purpose of the visit was to support Africa's development beyond cooperation only in exploiting the region's natural resources. This might be a way to address some of the criticism that China has faced over its activities in Africa, including charges that Chinese companies engage with corrupt governments, have poor environmental track records and mistreat workers.

China is Africa's most important single trading partner country, due largely to China's voracious demand for raw material inputs. For the same reason, China runs a huge trade deficit with Africa. As the supply of raw materials varies across countries, China's imports are concentrated in only a few African states. South Africa and Angola last year accounted for nearly 70 % of China's imports from Africa. Angola is China's second largest oil supplier after Saudi Arabia. Nearly 45 % of Angolan exports go to China. Most Chinese exports to Africa went to wealthier countries such as South Africa (18 % of exports to Africa), Nigeria (13 %) and Egypt (9 %). Chinese exports to Africa are mainly consumer electronics or investment goods.

Although China-Africa trade has boomed over the last decade, Africa's share in Chinese foreign trade remains modest. Exports to Africa last year amounted to around \$90 billion, just 4 % of China's total exports. The value of imports was \$120 billion, about 6 % of China's entire imports. The value of imports increased last year by less than 4 %, which was clearly lower than in previous years. Causes of the slowdown include the drop in world commodity prices and China's slowing economy. China's imports from Africa were down nearly a third in the first quarter.

China's trade with African countries



Source: Macrobond

Russia

Even as the Russian economy stalls, industrial output revives. Rosstat's first assessment of Russian first-quarter economic growth was a mere 0.9 % y-o-y. However, seasonally adjusted GDP contracted in the first quarter (according e.g. to the calculations of the economy ministry). These preliminary data are subject to later revision.

In contrast, growth in seasonally adjusted manufacturing output recovered in the first four months of the year. January-April manufacturing output was up nearly 3 % y-o-y. April manufacturing output climbed nearly 4 % y-o-y. Observers say some of the (perhaps temporary) improvement in the industrial output figures may be due to a boost in defence spending that has enhanced defence industry activity. The ruble, which has been losing ground for about a year, may have also helped demand for domestic goods. The ruble's drop makes imports relatively more expensive. There were additionally signs that inventories have started to fill up after a period of contraction.

Russia shifts to domestic payment cards. Amendments to the Law on the National Payment System were approved in rapid order in late April and early May. The revised law enters into force on July 1.

The fundamental goal of the amendments is to assure all payment card transactions in Russia are processed via data centres located inside Russia. International payment card companies operating in Russia would have to establish their own data centres within the country. This would avoid payment freezes from outside interventions such as economic sanctions.

To promote wide acceptance of a national payment card system, all pension payments, social benefits and public sector wages must be paid to bank accounts tied to a domestic payment card.

Visa and MasterCard look to be hardest hit by the new law. They currently handle the lion's share of Russian card transactions. The new law requires international card issuers operating in Russia to deposit with the Central Bank of Russia a guarantee equalling two day's worth of their Russian turnover. Visa and MasterCard, along with most experts in the field, consider the deposit requirement excessive as it exceeds the value of their annual net sales in Russia. Visa has already announced that it is considering pulling out of the Russian market at the beginning of July if concessions are not forthcoming.

Finance minister Anton Siluanov observed that Russia needs the international card companies as they process a large share of payment transactions. Officials are currently trying to resolve the impasse with the big card companies, and there are signs that the amount of the guarantee deposit required from foreign card issuers may be reduced.

Use of national cards outside Russia would be limited. If the international card issuers pull out from Russia, it would complicate life for Russian tourists abroad and on-line shoppers making international purchases.

The setting up of the national payment card system is just getting underway. A CBR-owned corporation is to be established, but most practical aspects of the system have yet to be dealt with.

Russia and China sign major gas agreement during Putin's visit to China. The gas deal, representing over ten years of tough negotiations, was the crowning event of president Putin's visit to China this week, and was extremely important for the Russian side. The issues in the lengthy negotiations concerned the routing of the new Russia-China pipeline, China's financial participation in the project and the ultimate price of the gas supplied (an issue that remained open right up to the last minute).

The haggling over pricing was intense, continuing even after Putin's arrival. As a last minute solution, Putin suggested that Russia could excuse gas supplied to China from the usual resource extraction tax in exchange for China dropping its import duty on gas. While the parties never released the agreed gas price, observers put the price in the range of \$370–390 per 1,000 m³. Observers consider the price to be slightly on the low side.

Some of the issues included in the contract were left open for further negotiations. These include the mutual tax and duty exemptions for gas.

The 30-year contract calls for annual gas deliveries of 38 billion m³. Gas deliveries will ramp up gradually, starting as soon as 2018. Just a year ago, the project's annual transmission capacity target was 70 billion m³ a year.

China's interest in Russian gas exports has diminished over the years as other global supply sources became available. China's hand was further strengthened by Russia's efforts to find buyers for its gas outside Europe.

The presidents signed a number of other trade and cooperation agreements during the meetings. Some of the deals had actually been signed earlier, so the occasion was used as a formal commemoration.

China has long been one of Russia's top trading partners, especially with regard to imports. China has this year supplied 18 % of Russian imports and 8 % of exports. Russia has recently run substantial trade deficits with China.

About half of Russia's imports from China fall into the machinery & equipment category, but textiles are also an important product category. Russian exports to China are mainly oil and other basic commodities such as industrial minerals, metal and timber.

The Russian and Chinese presidents pledged to raise the level of bilateral trade from just under \$90 billion this year to \$100 billion by 2015.

China

China ramps up transparent financing options for local governments. This week the finance ministry said it would move ahead with a plan to allow ten local administrations issue their own bonds. The ministry is permitting local governments this year to sell bonds with a combined value of up to 400 billion yuan (€47 billion). The project involves wealthy east coast provinces and cities, including Beijing, Shanghai, Guangdong and Qingdao. The project stems from a 2011 pilot programme that allowed several local governments to issue bonds totalling 23 billion yuan (€2.6 billion).

The project should enhance financial transparency; local governments must open their books to investors to assess issuer creditworthiness. Beijing further hopes to improve market discipline by requiring local government bonds to be rated by an independent credit rating agency. The requirements should replace earlier incentives that encouraged local governments to take on debt in order to boost their output figures without paying attention to the sustainability of their financial position. It remains to be seen how investors will actually price local government credit risk in the bond market. Market discipline will not be achieved if investors believe the central government will always intervene to bail out a local government default. The central government has previously issued bonds on behalf of local administrations, which has further added uncertainty about the responsibilities of various levels of government.

The rapid growth in local government indebtedness is forcing China's leaders to move swiftly on reforms related to local government financing. Rapid debt accumulation demonstrates the need for a broader local government tax base and transparent financing channels. The reason why local governments need more transparency in their financing stems from a balanced-budget requirement imposed on local governments in 1994. To circumvent the rule, local governments have turned to off-budget borrowing. By some estimates, half of all local government debt is held under off-budget financing vehicles.

It is further estimated that about a fifth of the lending of the shadow banking sector goes to local administrations, mostly in the form of short-term loans. China's leaders hope that shifting to a stable municipal bond market will lengthen average debt maturity and thus reduce liquidity risks. The bonds will carry maturities of 5, 7 and 10 years.

Russia becomes a new gas provider for China. A deal to supply gas from Siberian gas fields to China crowned president Vladimir Putin's state visit to China this week (May 19–20). The negotiations on the pipeline from Siberian gas fields to China have lasted over a decade. Under the agreement, Russia will supply China with 38 billion cubic metres

of gas a year for a 30-year period. If no new barriers to the deal are raised and the massive investment needed is mobilised promptly, gas deliveries could begin as soon as 2018.

Although China gets just 4 % of its energy from natural gas at the moment, the need to wean itself from its environmentally disastrous reliance on coal suggests a rapid increase in the use of gas. Over 50 billion m³ of China's total gas consumption of 170 billion m³ last year was imported. Imports from Turkmenistan accounted for about half of the imports. The supply from Turkmenistan is expected to rise to 65 billion m³ a year by 2020. China last year inaugurated a gas pipeline (12 billion m³ annual capacity) running from Myanmar to China. China also imports liquefied natural gas (LNG), mainly from Qatar and Australia.

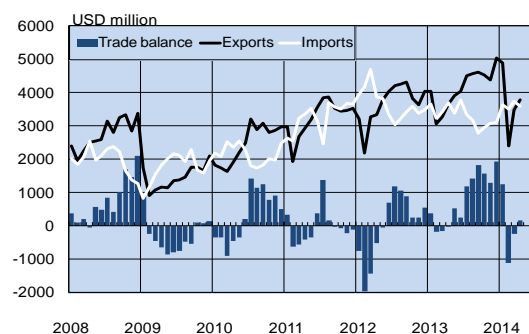
The Russian gas deal fits nicely with China's goal of diversifying its import sources and making its suppliers compete on price and supply terms. Russia was supposedly forced to make pricing concessions as the Ukraine crisis bolstered China's negotiating position. The new gas agreement was the result of a long, difficult process for both sides. In this sense, the deal signals no major shift in China-Russia relations.

Russia accounts for just 2 % of China's foreign trade.

China's oil imports from Russia have been rising since the first Russia-China oil pipeline came on stream in 2011. China currently imports about 27 million tons of crude oil a year from Russia, or about 10 % of China's total oil imports. Oil constitutes over half of the value of China's imports from Russia. However, beside some other raw materials, Russia is overall not a significant supplier for China. While nearly all China's imports from Russia are basic commodities, China's exports to Russia comprise a diverse range of goods. Recently, China has run a large annual trade surplus with Russia.

With the slowdown in the Chinese and Russian economies, growth of bilateral trade has tapered off. In January–April, China's exports to Russia and imports from Russia were up about 3–4 %. Russia has long accounted for just over 2 % of China's imports and exports.

China-Russia bilateral trade

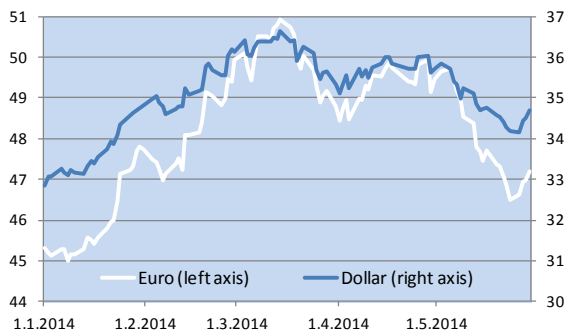


Source: CEIC

Russia

Ruble weakening again; CBR permitting larger daily swings in ruble exchange rate. In May the ruble clawed back some of its losses since the start of the year. This week the ruble, however, has again declined on news of violent clashes in east Ukraine. The Central Bank of Russia ended interventions to prop up the ruble in mid-May and has since turned its focus to building up currency reserves.

Euro-ruble, dollar-ruble exchange rates, Jan. 1–May 29, 2014 (falling trend indicates ruble appreciation)



Source: Reuters

The CBR last week gave notice that it has diminished the amount of foreign currency used for interventions when the ruble's external value comes close to the boundaries of its prescribed fluctuation band, which means greater volatility in daily swings. The move is another step in achieving the CBR's ultimate goal of a free-floating ruble.

Russian government approves economic forecast used in drafting medium-term budget plan. Differences over budget policy made approval of the forecast particularly challenging this time around as the amount of state support for the economy is seen to be one of the decisive factors affecting economic growth.

In the end it was decided to stick to the stringent budget policy line. Hence, the low-growth scenario was approved as the basic forecast with GDP expected to rise 0.5 % this year and 2 % next year.

Russian economy to be developed under state guidance. At last week's annual St. Petersburg Economic Forum, president Vladimir Putin expressed his concerns about Russian growth falling below the global average.

In his address, Putin laid out a number of measures to restore growth. The structure of Russian exports must be rapidly altered so that the share of non-energy products in Russian exports will rise 6 % a year. At the same time, Russia must actively develop production to replace imports in fields where it is possible to gain a competitive edge.

Putin said Russian industry now needs a fundamental overhaul of its production technology. The changes will be attained by improving access of companies to low-cost financing for their capital investments, making it easier to get government loan guarantees and providing tax breaks for greenfield investment. Punitive taxes and tax breaks will be used to encourage producers to replace out-dated equipment with modern, green production technologies.

In order to reduce imports Putin asked proposals by next autumn on products for public procurement that could be bought solely from domestic companies or suppliers within the customs union. For example, supply of Russian radio-electronics, computer software, textiles and food products can all be increased through modernisation of production methods and investment. Putin promised that fields identified as competitive would be eligible for various types of support.

Putin asked the cabinet to make sure that there would be sufficient funding in the 2015–2017 budgets for the proposed measures.

Russian firms finding it harder to get international financing. CBR figures show that the foreign debt stock of Russia's corporate sector at the end of March was just over \$430 billion. Some 62 % of foreign financing had been provided in the form of bank loans, 35 % as loans provided through direct investment and 2 % as bonds and other paper. Until recently, corporate borrowing had risen steadily as Russian firms borrowed actively from international markets. The borrowers as a rule are Russia's large, well-known companies.

International tensions have forced foreign banks and investors to pull back on lending to Russian firms to reduce their exposure to Russian risk. In some cases, loan talks have been terminated or more stringent conditions imposed on new loans. Companies are also finding it harder to roll over old loans. So far this year, Russian companies have had significantly fewer international bond issues than last year. Observers say this situation could continue the rest of the year.

The possibilities of domestic financial markets are limited. If corporate borrowers turn more to the domestic market, it may become difficult for banks to meet the 10 % capital adequacy requirement even if they now meet it with ease. Putin promised at the St. Petersburg Economic Forum that the state would support additional capital injections for the banking system and that the cabinet is currently looking a ways to do this. The CBR's new long-term, low-priced credit instrument should bring relief to the situation as it makes it easier for banks to offer refinancing for capital investment projects.

Observers note that Russia's problem is not so much the lack of financing as the lack of profitable projects in which to invest.

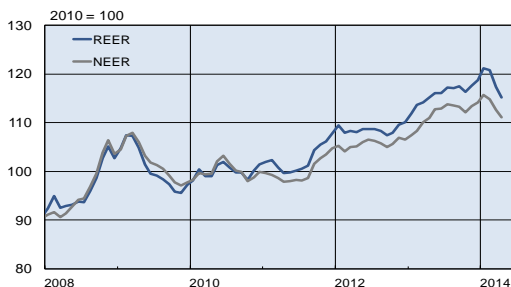
China

China's money markets calm in May, yuan exchange rate stabilises. The situation in the interbank money market has been stable in recent weeks, with the benchmark 7-day Shibor (Shanghai Interbank Offered Rate) hovering in the range of 3.1–3.6 % throughout May. The situation contrasts starkly with last year's interest rate hikes following the liquidity tightening in May 2013. The interbank repo rate eventually hit 11 % in June, after which the People's Bank of China intervened and stabilised the market. Companies and banks face a wave of scheduled tax and other mandatory payments next month, but this time the PBoC is not expected to allow similar market turbulence as last year.

With 12-month inflation settling to 1.8 % in April, officials have little motivation to tinker with the current monetary policy stance.

While the yuan lost 3 % of its value against the dollar during February–April, it stabilised in May at a rate of 6.2 to the dollar. The yuan's drop can be seen in both its real and nominal effective (trade-weighted) exchange rates (REER and NEER). The REER is down 5 % from its January high, while the NEER is off about 4 %.

Real and nominal effective exchange rates (REER and NEER)



Source: BIS

Territorial disputes threaten the positive development in China-Vietnam trade. Territorial disputes in the South China Sea flared at the start of May, when state-owned China National Offshore Oil Corporation (CNOOC) anchored an oil-drilling platform in a disputed sea area east of Vietnam's Ly Son Island and south of China's Hainan Island. Anti-China demonstrations erupted throughout Vietnam in response to the action. A number of Chinese-owned manufacturing facilities were shuttered as a precaution to the inflamed atmosphere. The Vietnamese response resembles the Chinese reaction to Japan's attempt to nationalise control of two tiny islands in the East China Sea in 2012. At that time, Chinese protestors sought to disrupt operations of Japanese-owned firms in China.

Potential offshore oil and gas deposits in the South China Sea largely drive the territorial dispute. Tensions over the

islands last erupted in 2011, when Vietnam claimed that China damaged its oil and gas exploration in the area.

Escalation could cost both sides. In 2013, the value of China-Vietnam trade increased by nearly a third to \$50 billion, or about 1.2 % of China's total foreign trade. China runs a huge trade surplus with Vietnam, thanks in part to Vietnam's rising wealth. China's top exports to Vietnam include electronics, machinery & equipment and base metals. A substantial share of China's imports from Vietnam is made up by electronics; many foreign consumer electronics firms, including Samsung, have production in Vietnam.

China is Vietnam's biggest trading partner. Imports from China account for nearly 30 % of the value of Vietnam's total imports, and 10 % of its total exports.

China plans to progress on structural reforms in second half of the year. On May 17, China's influential National Development and Reform Commission (NDRC) released a report on economic reforms planned for the second half of 2014. The report includes no big surprises as it builds on the policy guidelines laid down at the plenary session of the Central Committee last November. The report, however, can be seen as a signal that the country's leaders remain committed to implementing announced reforms in the following months. The emphasis is to increase the role for the private sector.

The NDRC report reiterates the State Council's demand for more competition in sectors dominated by state-owned enterprises. In the remainder of the year, China plans to move ahead with measures that include eliminating barriers to market entry, reducing bureaucracy and boosting the competitiveness of SOEs. The aim to increase competition should also imply cuts in subsidies and other benefits that state firms now receive. However, this is politically difficult as the heads of SOEs are a politically powerful group.

The NDRC report stresses financial sector reform. The share of private capital will be increased in investment projects. The NDRC also announced last week that it would permit private investment in projects earlier off limits. For example, private investors can now participate in many rail and energy projects. China's closed banking sector is also gradually being opened up to private operators. Banking regulators earlier this year gave the go-ahead on establishment of five private banks.

Deregulation of deposit rates constitutes a major capital market reform. In its latest monetary policy report, the PBoC notes that commercial banks can now offer certificates of deposit to the public at rates above official regulated rates. Sales of certificates of deposit were earlier limited to the interbank market. It appears that China is following the example of other countries in deregulation of its capital markets. In March, PBoC governor Zhou Xiaochuan said regulation of deposit rates would be phased out over the next two years.

Russia

Russia, Belarus and Kazakhstan agree to form Eurasian Economic Union. May 29 saw the signing of a treaty on the creation of the Eurasian Economic Union (EEU), set to launch January 1, 2015. The treaty lays a basis for a common market with unrestricted movement of goods, services, labour and capital.

The free movement of goods was included already in the agreement on the customs union made up of Russia, Belarus and Kazakhstan that started in 2010. The customs union arrangement, however, exempted several major goods categories, including oil, gas, electricity, pharmaceuticals and automobiles. Many administrative barriers also were left in place. The countries nevertheless moved ahead with the creation of a Single Economic Space in 2012 to allow free movement of labour, services and capital. The goals of this second stage also remain largely unrealised.

The Eurasian Economic Union hopes to push ahead with all these earlier objectives over the coming years. For example, the countries will begin to coordinate their economic policies under several common criteria: annual budget deficits may not exceed 3 % of GDP, public sector debt may not exceed 50 % of GDP and consumer price inflation cannot exceed the lowest inflation rate within the EEU by more than five percentage points. 2025 should see the inauguration of a unified market for oil and gas, as well as integration of national financial markets. Plans also call for a common system of agricultural subsidies by 2016 and creation of a common electricity market by 2019.

Negotiations on the establishment of a Eurasian Economic Union have been contentious with each country aggressively pursuing its own interests. However, compromise was finally reached even on one of the thorniest issues – the pricing mechanism for Russian crude oil supplied to Belarus. The Belarusian economy is highly dependent on cheap supplies of oil from Russia.

IMF gives Russian public sector financial reporting mixed review. At the request of Russia's finance ministry, the IMF evaluated the country's fiscal reporting, budgetary and forecasting methods and risk management practices. The report [Russian Federation: Fiscal Transparency Evaluation](#) was released on May 26.

The IMF states that Russia's budgeting arrangements and fiscal reporting now comply to a large extent with IMF standards for good budgetary practices. Fiscal risk management has improved considerably and recent budget legislation defines clear accounting rules for every level of government. Routine public reporting has also increased at all levels. The IMF notes that adopting a medium-term

budgetary framework has improved fiscal policy planning and centralized strict oversight has put limits on public borrowing at all levels.

The IMF, however, criticised Russia for using a too-narrow definition of the public sector that excludes more than 30,000 government-controlled enterprises. This leads to exclusion of a large share of liabilities (including loans) that would be categorized as public under international standards. The IMF recommends that Russia include organisations operating on non-market basis in general government statistics and prepare consistent statistics on other state-owned enterprises. This would provide a much more comprehensive overview of the state's role in the economy.

The IMF further criticised the fact that 14 % of Russia's federal budget spending is classified "secret" as a matter of national security. The share is exceptionally large relative to most countries.

Finnish-Russian trade contracted in first quarter. Finnish Customs reports that the value of goods imports from Russia in the first quarter fell by nearly 20 % from a year earlier. Much of the drop came from the largest product group, mineral fuels (over 80 % of total imports), particularly imports of crude oil. Nevertheless, the total value of goods imports still exceeded €2.3 billion, making Russia Finland's largest import supplier.

The value of goods exports contracted 16 % y-o-y in the first quarter to just under €1.1 billion. Reduced demand and ruble weakness caused declines in all major export product categories. The value of exports in the machinery & equipment and chemical products categories, which together represent about half of Finnish exports to Russia, declined by nearly 20 %.

A significant share of Finnish exports to Russia still involves re-exports, i.e. goods produced in a third country but exported from Finland to Russia. While mobile phones and cars earlier dominated Finland's re-exports to Russia, they have now all but dried up. The top re-export categories these days are e.g. pharmaceuticals, hand tools and petroleum products. The latest assessment from Finnish Customs finds that re-exports last year constituted 24 % of Finland's exports to Russia. Last year re-exporting activity contracted notably more than Finnish exports to Russia overall.

The erosion of Russian consumers' purchasing power and increased economic uncertainty has hurt Russian tourism in Finland. For the first quarter, overnight stays by Russians in Finnish hotels and inns were down 6 % y-o-y and Finland-Russia border crossings were off 4 %.

Transshipping of goods via Finland into Russia contracted some 20 % y-o-y in the first quarter. The road transit freight may suffer further when TIR agreements are ended at the Finnish-Russian border from the start of July. Less than 10 % of Russia's imports now enter via Finland, down from a third a decade ago.

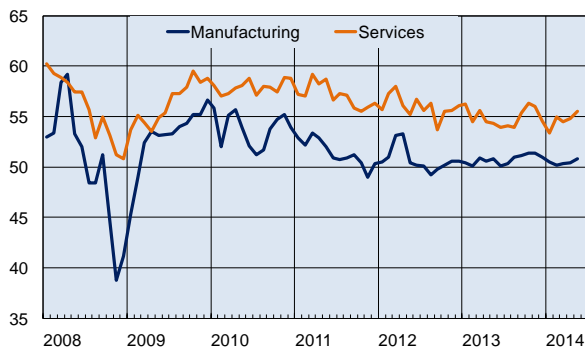
China

Company surveys indicate no big shifts in Chinese economic trends. The latest readings of China's official purchasing manager indices (PMI) for the manufacturing and service sectors reinforce the earlier view that Chinese economic growth remains stable and that the slowdown in the first four months of the year has not foreshadowed a substantial downturn. The official manufacturing PMI strengthened 0.4 points in May to 50.8, while the reading for the services PMI rose 0.7 points to 55.8. The unofficial HSBC manufacturing PMI (includes smaller firms than the official PMI) rose in May to 49.4 points, while the HSBC services PMI declined to a four-month low of 50.7. A value below 50 indicates a weakening economic outlook.

The positive survey responses reflect growing domestic order books. Moreover, the employment situation in China appears stable with the service sector absorbing workers leaving the manufacturing sector. Prevailing labour market conditions in China have been largely unchanged for two years with no significant shifts yet appearing on the horizon. China's refocusing on growth driven by services and domestic consumer demand appears to be proceeding.

The recent PMI readings reflect the fact that China's economic growth is smoothly slowing down to a permanently lower level. No big changes in the economic outlook or PMI readings are expected in the near term. In light of available economic indicators, there seems to be no need for a wide-ranging fiscal and monetary stimulus at this point. Thus, China's leadership has an opportunity to focus on reining in rising debt and move ahead with structural reforms.

Official PMI readings for manufacturing and services



Source: Macrobond

China becomes the world's largest buyer of industrial robots. China last year purchased nearly 37,000 industrial robots, in increase of 60 % from 2012. Thanks to the rapid increase in robot acquisition, China last year surpassed Ja-

pan as the world's top purchaser of industrial robots. A *Financial Times* story notes that figures from the International Federation of Robotics (IFR) show Japan last year bought approximately 26,000 industrial robots, while US manufacturers bought nearly 24,000. Roughly 168,000 industrial robots were purchased globally last year, an increase of 5 % from 2012.

Carmakers, who lead the push in industrial automation, account for about 60 % of Chinese robot demand. Although demand for industrial robots has been rising for years in China, there is still plenty of room to grow. China's car industry in 2012 had 213 robots per 10,000 workers. In other industries, the ratio averaged just 11 robots per 10,000 workers. Japan, the world leader in industrial automation, had 2012 ratios of 1,562 per 10,000 workers for its car industry and 219 for other industries.

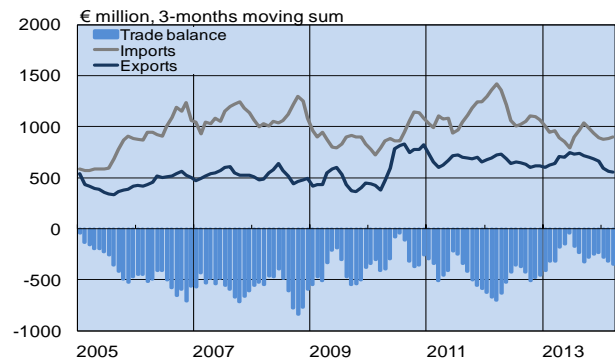
The IFR estimates that about half of the world's more than 1.2 million industrial robots at the end of 2012 were located in Asia. In terms of absolute robot numbers, China ranked fifth after Japan, the US, Germany and South Korea.

Slowdown in Finnish-Chinese trade continued in first quarter.

Finnish exports to China nosedived in the first quarter of this year. Finnish Customs reports that the value of exports to China in the first quarter declined 14 % y-o-y. The fall in machinery & equipment accounted for a large share of the decline. The category saw exports off by 24 % from a year earlier. Machinery & equipment account for about 40 % of all Finnish exports to China. A drop in earlier booming exports of furs and pelts added to the overall slide in exports. Furs and pelts last year accounted for about 14 % of the value of Finnish exports to China. The same figure for the first quarter was below 3 %.

Finnish imports from China also declined in the first quarter, with the value of imports down by 6 % y-o-y. Most of Finland's imports from China consist of machinery & equipment and finished goods such as clothing. China accounts for about 5 % of Finland's foreign trade.

Finland-China trade, 3-month moving total, € million



Source: Finnish Customs

Russia

Russia government finances: higher oil revenues and defence spending. Russian defence expenditures were up about 40 % y-o-y in the first five months of this year. At least some of the increase can be attributed to this year's abnormally front-weighted defence spending (54 % of 2014 defence budget took place in the first five months). There is no indication yet of changes in overall defence spending this year, however. In its proposed supplemental federal budget bill presently before the Duma, the cabinet requests only a slight hike in defence spending. A small part of total budget spending would be reallocated, but the overall level of spending would remain unchanged.

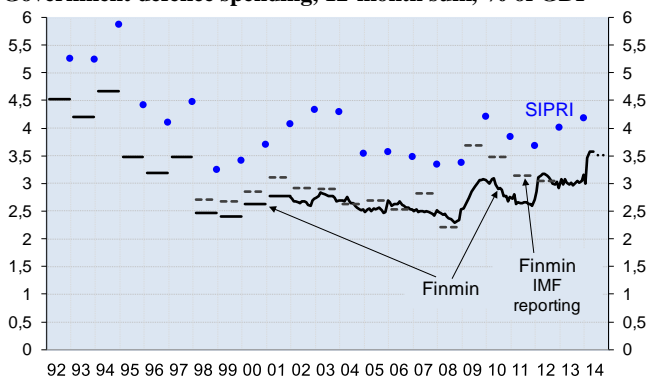
Defence spending (including the supplemental budget) will grow by 20 % this year. It will account for some 9–9.5 % of government spending and 3.5 % of GDP. The last time defence spending reached such levels was nearly 20 years ago. The Stockholm International Peace Research Institute (SIPRI), however, puts Russian defence spending last year at over 4 % of GDP.

Total government spending increased in the first quarter by 6 %, lagging inflation. Non-defence spending was about the same as last year in nominal terms as social spending was down sharply. The finance ministry expects social spending also to increase for the year.

Government revenues rose 10 % y-o-y in the first quarter as the ruble's slide boosted the take on dollar-based tax revenues from oil and gas. Under the supplemental budget, oil and gas revenues will approach earlier highs, rising 15 % this year to over 10 % of GDP. This assumes the price of Urals-grade crude oil holds at \$104 a barrel and the ruble's exchange rate remains around its current level (35.5 rubles to the dollar, or about 10 % less than in 2013). With the stalling Russian economy, other government revenues increased by just 6 % y-o-y in the first quarter.

With higher actual oil and gas revenues, the federal budget at least should show a small surplus this year.

Government defence spending, 12-month sum, % of GDP



Sources: Finance ministry (2014 supplemental federal budget), IMF, SIPRI

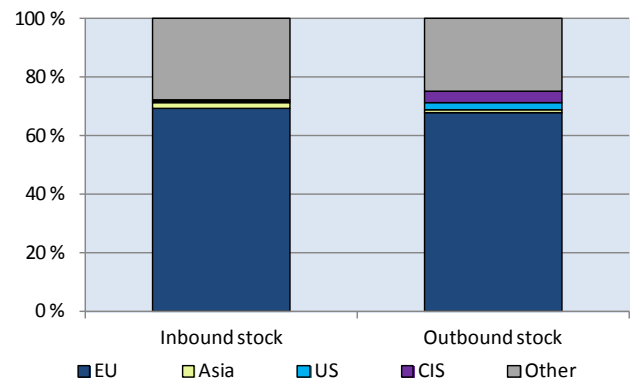
Rosneft-BP deal lifts Russia's 2013 FDI figures. Flows of foreign direct investment into Russia reached \$80 billion in 2013. FDI outflows from Russia amounted to \$95 billion. Although FDI inflows were significantly higher than in 2012, the growth was largely due to the buyout of BP's stake in its joint venture with Rosneft (TNK-BP).

The deal made the British Virgin Islands Russia's top destination for FDI outflows last year because TNK-BP was domiciled there. The British Virgin Islands has long been, along with Cyprus and the Netherlands, one of the most popular destinations and sources of Russian FDI. The three countries account for over half of Russia's total inward and outward FDI stocks. Most of the assets moving between Russia and these countries are likely Russian capital moving through foreign-registered firms back to Russia due to e.g. taxation issues. The BP-Rosneft deal also boosted Russian FDI inflows to the oil sector as part of the buyout was paid for with Rosneft shares.

Even without the TNK-BP deal, FDI inflows to Russia were up last year. Cyprus restored its position as the largest source of investment flows after a dramatic drop in 2012. As in previous years, other large FDI inflows came from e.g. Luxembourg and Ireland. Growth in French FDI was rapid, while the Swedes focused on repatriation of assets, especially in the second half of the year. In recent years, service branches have been the top recipients of FDI in Russia. Over half of FDI inflows last year went to trade or financial services.

In contrast, FDI outflows from Russia actually fell if the TNK-BP deal is excluded. FDI outflows to Cyprus fell to half last year in the wake of the Cypriot financial crisis. In addition, the net FDI flow to the Netherlands turned negative as Russians' repatriated asset flows exceeded new investment. FDI outflows to Austria and Switzerland rose significantly. Russian FDI outflows typically originate from Moscow, which accounted for about 80 % of total FDI outflows last year. Some 8 % of FDI outflows came from the oil-and-gas-producing region of Tyumen and 4 % from St. Petersburg.

Geographical breakdown of Russian FDI stocks in 2012, %



Source: Central Bank of Russia

China

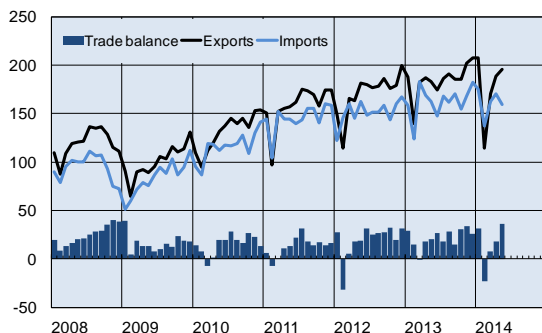
Chinese exports performed well in May; trade surplus swells on weak imports. The value of goods exports rose 7 % y-o-y in May to over \$195 billion. Imports contracted by nearly 2 % to \$160 billion. Strong exports and lower imports drove the trade surplus to a record high level of \$36 billion in May.

The slight economic uptick in the EU area was reflected in May's trade figures. Exports to EU countries were up overall 13 % y-o-y, led by higher exports to Italy (up 22 %) and the UK (up 20 %). Despite the on-going East China Sea territorial dispute, exports to Vietnam rose by nearly 25 %. Exports to the US climbed 6 % y-o-y, a slight drop from the first quarter of the year. The unofficial manufacturing purchasing manager index compiled by the HSBC Bank showed that the level of new export orders climbed in May, raising the index to 53.2. A reading higher than 50 indicates that exports should continue to grow. In comparison, the unofficial PMI also showed that the level of new orders overall, including booked domestic orders, remained largely unchanged from earlier months.

The import trend suggests weaker domestic demand. For example, commodity imports failed to rise in May as in previous months. Growth in import volumes of oil, copper and iron ore slowed sharply from April. Import volumes of coal and pulp were down from last year.

Interpreting export growth figures in the first months of this year has been difficult because of the distortions in 2013 export figures. Chinese firms tended to exaggerate their export prices to Hong Kong in the first half of 2013 to circumvent capital controls. This created a large discrepancy between China's official figures for exports to Hong Kong and Hong Kong's reported imports from China. The gap was evidently narrower in May 2013 compared to the earlier months of the year, so the May export figures should give a more realistic picture of Chinese foreign trade than earlier this year.

Trends in Chinese foreign trade, US\$ billion



Source: CEIC

Despite rising business uncertainty, most European firms operating in China are still profitable. Over 60 % of European firms operating in China report they were profitable last year, even if the costs of doing business in China have risen and competition has intensified in many industries. Profitability generally has been declining. About 75 % of European firms reported profits in 2010. Over half said they were struggling with rising costs and recruitment problems. The findings are part of the [Business Confidence Survey](#) released by the European Union Chamber of Commerce in China late last month. Most of the over 500 firms responding have operated in China for at least ten years.

The economic slowdown in China has curbed the incentive for European companies to expand operations in China, and fewer firms succeeded in increasing their sales volumes in China last year. There were huge differences in performance across branches, however. For example, car manufacturers and companies in the healthcare branch were far more likely to see increases in sales than companies in the financial or energy fields. The EU Chamber of Commerce in China remarked that there are European firms operating in heavily regulated fields or branches suffering from overcapacity, which limits opportunities for expansion.

The rise in the costs of doing business is reflected in the willingness of firms to invest. Some of the investments that would have earlier gone to China are now channelled to countries with lower costs. Rising labour costs increase pressure to increase productivity, raise added-value in production and boost demand for process automation.

European firms report that labour does not always meet company needs. Firms also have trouble enticing expatriate workers to China, largely on perceptions of poor air quality.

A greater share of the surveyed firms consider state-owned firms to be their biggest rival. In other words, it appears that the role of state-owned firms has not diminished, even if the country's leaders have promised to increase market based reforms by addressing the status of state-owned enterprises. The survey results show that over half of European firms see themselves in a weaker position than local firms. The IMF also reminded China in last week's Article IV consultations that pricing of factors of production, including financing, should be equal for all parties.

European firms are suspicious of China's promised reforms and only about half of firms believe that China can implement meaningful reforms over the next two years.

In its survey published earlier this year, the American Chamber of Commerce in China (AmCham China) also mentions many similar themes: profit growth of American firms has slowed and investment uncertainty has increased. Vague legislation increases business challenges. For example, about 70 % of American firms feel China's patent laws are ineffective. American firms were also sceptical of many reforms. For example, only a third of firms believed the Shanghai Free Trade Zone would have a positive impact.

Russia

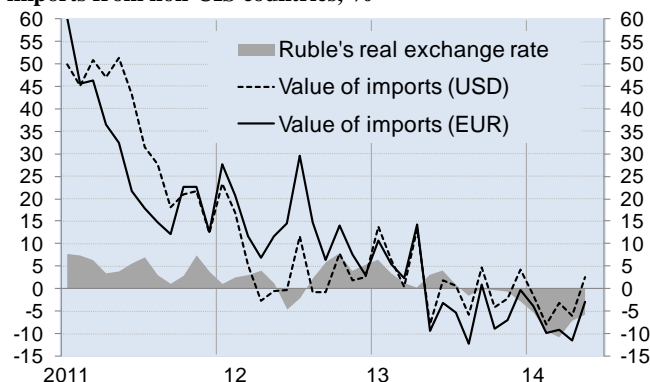
Ruble's real exchange rate strengthens, drop in imports moderates.

The ruble's nominal exchange rate, which had weakened since spring 2013, began to appreciate last April. During April and May, it gained over 4.5 % in value relative to its trade-weighted currency basket. The stronger exchange rate has been boosted by both trade and capital flows. The contraction in imports drove up the trade surplus to seasonal highs not seen since the 2009 recession. Central Bank of Russia governor Elvira Nabiullina reports that net private-sector capital outflows from Russia and various ruble-denominated asset groups shrank in April and May to levels less than half of the first quarter of this year.

The ruble's real exchange rate strengthened in April-May by nearly 5.5 % against the currency basket, because inflation in Russia continued to run well above that of Russia's main trading partners (the inflation disparity was around four percentage points in 12-month terms). Although it was still 10 % weaker y-o-y against the euro in May, the ruble's real exchange rate against the currency basket was down less than 6 % y-o-y. Forecasters expect the ruble's real exchange rate to fall only slightly this year or perhaps even stabilise. If the real exchange rate remains at its May level, it would end this year down just 1 % y-o-y.

Real ruble appreciation should help calm inflation pressures, while supporting consumption and imports. The value of Russian goods imports in May was at the level of May 2013, after having contracted at around 10 % y-o-y in the first four months of this year. On the other hand, imports had already dropped considerably in May 2013. Moreover, the recovery in imports this May partly reflects a huge jump in imports of aircraft and ships. For the time being, the forecasts remain unchanged and still foresee a rather small drop in imports this year compared to the large decline in the early part of the year. Russia's economy ministry last month forecast imports would contract just less than 3 % before next year's expected recovery.

12-month change in ruble's real exchange rate and goods imports from non-CIS countries, %



Sources: CBR, Russian customs

Stabilisation of the ruble's exchange rate, a lower inflation outlook and recoveries in consumption and imports naturally could be shaken by events (e.g. relating to the situation in eastern Ukraine) that might aggravate the shortage of trust lingering in the markets.

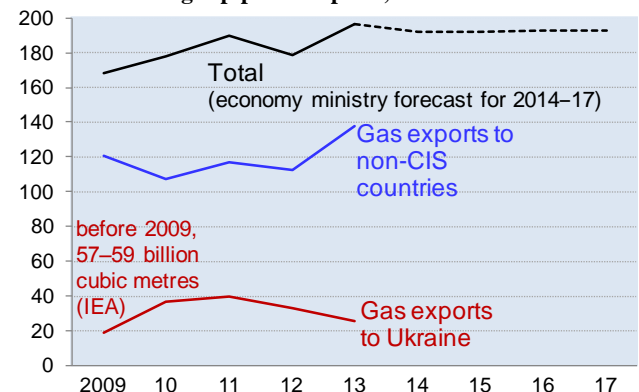
Russia cuts gas supplies to Ukraine. After agreeing in talks mediated by the EU Commission to postpone its deadline for switching to pre-payment of gas supply and referring to its 2009 supply contract with Ukraine's Naftogaz, Gazprom introduced its pre-payment demand on June 16. Ukraine has refrained from pre-paying.

Gazprom also filed a claim with the Arbitration Institute of the Stockholm Chamber of Commerce this week to recover \$4.5 billion from Naftogaz for non-payment on earlier gas deliveries. Naftogaz filed its claim with the same court stating Gazprom has overcharged \$6 billion for earlier supplies e.g. through excessive prices. Resolution of the claims should take at least several months.

The latest round in a series of EU-mediated talks between Ukraine and Russia, centred especially on the price of gas and also Naftogaz's unpaid bills, finished during last week without a result. The parties could not agree on the price, after tabling \$385 per 1,000 m³ (Russia's price after waiving the export duty) and \$285 per 1,000 m³ (Ukraine's position), and despite the EU Commission's mediator package proposals. Ukraine says it can get "turn-around" gas from Eastern European countries at the price of around \$300. Ukraine further distrusts Russia's proposed price decision model alleging it gives Russia the power to raise the gas price unilaterally. The EU Commission has invited Ukraine and Russia to resume their negotiations next week.

Gas imports from Russia cover about 55 % of Ukraine's total gas consumption and over 35 % of its total energy consumption. Ukraine is expected to muddle through in the warmer part of the year with its own gas reserves, "turn-around" gas imports from Eastern Europe and its domestic gas production. The issue is not insignificant to Russia either. Russian revenues from gas exports to Ukraine were about \$10 billion in 2013, roughly 0.5 % of Russian GDP.

Russian natural gas pipeline exports, billions of cubic metres



Sources: Russian customs, CBR and economy ministry, IEA

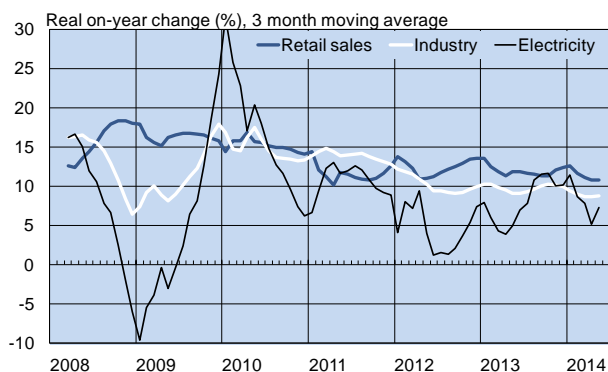
China

China economic situation unchanged in May, progress in structural change. China's National Bureau of Statistics reports that industrial output continued to rise at a steady pace of 9 % y-o-y in May. Growth in the service sector was also largely unchanged as retail sales continued to rise at nearly 11 % y-o-y. Although electricity production is not a perfect indicator of overall performance of the economy, it does not indicate any serious worsening of the Chinese economy at the moment. The output figures released last week also comport with the purchasing manager indexes (PMI) readings for May released earlier.

The fact that China's overall growth remains so robust is somewhat remarkable in light of the distinct slowdown in real estate, one of the key drivers of growth. The number of new housing starts is considerably smaller than earlier, and the slowdown is well reflected in output growth for construction materials (e.g. cement, iron and steel, window glass), all of which are well below average industrial output growth. Growth appears to be buoyed by services, production of durable goods, production of consumer goods and related industries. For example, production of passenger cars was up nearly 17 % y-o-y in May. Growth in output of the pharmaceutical industry also far outstripped the average rate of industrial output growth.

Other signs of structural shifts in the Chinese economy were clear from changes in investment patterns. Fixed asset investment (FAI) grew just 17 % y-o-y in January-May, while a year ago their growth was over 20 % y-o-y. Service sector investment rose 19 %, while industrial investment growth was 14 %. The service sector accounted for 56 % of total investment.

12-month change in industrial, services and electricity output, %



Source: Macrobond

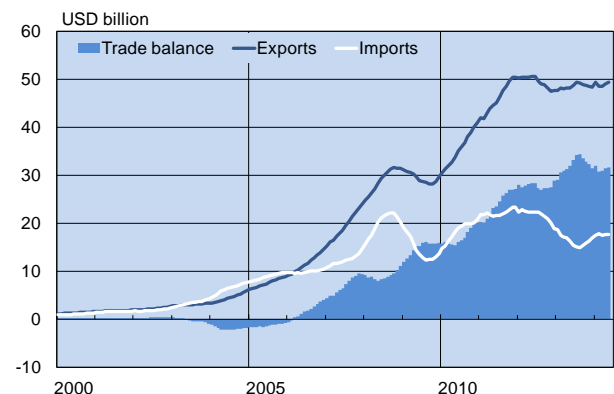
China and India try to resurrect economic ties. China's foreign minister Wang Yi visited India this month to meet the country's new leadership, including new prime minister Narendra Modi. As with several other neighbouring countries, border disputes have long chafed China-India relations. The main border disputes involve the northern India states of Jammu and Kashmir, as well as the northeastern state of Arunachal Pradesh. In his recent election campaign rhetoric, Modi took harder line on border disputes than his predecessors. Neither China nor India, however, seem willing to let the border disputes affect a *rapprochement* in economic relations. China is already India's most important trading partner. Moreover, China's leadership seemed hopeful that a resolution to border issues could be found and that the economic relations of the two countries could improve.

During the visit, the parties engaged in talks on ways to increase Chinese investment, especially in Indian infrastructure (including a high-speed rail network) and manufacturing industries. According to media reports, foreign minister Wang told his Indian hosts that China is ready for new investment if regulations are relaxed. The countries also agreed on easing visa rules to increase tourism.

The value of bilateral China-India trade last year was \$66 billion, with China's trade surplus reaching \$31 billion. China accounts for nearly 10 % of India's foreign trade. India mainly imports machinery & equipment, electronics, and chemical products such as pharmaceuticals. Nearly half of India's imported electronic equipment and nearly a third of its imported machinery come from China.

China mainly imports commodities from India, notably cotton, iron ore and certain metals such as copper. India accounts for a relatively small share of China's foreign trade. In recent years the value of China's trade with India has been on par with that of Russia, Thailand and Singapore.

China-India trade, 12-month moving total, USD billion



Source: Macrobond

Russia

Russia prepares for Ukraine's EU association agreement. Ukraine's president Petro Poroshenko is expected today (June 27) to sign a free-trade agreement with the EU. The free-trade deal completes Ukraine's EU association agreement. The political part of the accord was signed in March. The agreement will ultimately eliminate most duties on EU-Ukraine trade, although it will take several years of gradual phase-out of duties on some products.

Russia opposes the Ukraine-EU free-trade agreement, claiming it conflicts with the CIS free-trade agreement to which Ukraine acceded in 2012. For example, different rules apply in animal- and phyto-sanitary regulations and technical standards. Russia further worries that a freeing up of Ukraine's trade with the EU will allow EU goods to flow duty-free into Russia, allowing EU firms to steal market share from domestic producers.

Retaliatory measures to protect their markets were taken up at the meeting of the Russia-Belarus-Kazakhstan customs union on June 23. Russia noted that it can cancel its free-trade agreement with Ukraine so that imports from Ukraine would carry duties in line with Russia's WTO commitments. The average level of such duties is just over 7 %. Russia says that the two other members of the customs union may decide independently on their trade policies with Ukraine.

Russia announced it can also resort to other measures in restricting Ukraine imports. For example, Rosselkhoz nadzor, the agency responsible for food safety, has already decided that animal-based food products imported from Ukraine must carry much more detailed documentation on origin and production from June 30 onwards.

Russia submits complaint to WTO on US economic sanctions. According to Russian prime minister Dmitri Medvedev, the sanctions e.g. breach the WTO rule on most-favoured-nation status extending equally to all trading partners. He added that the fate of the complaint is uncertain due to the authority the US commands in the WTO.

Russia's complaint suggests that economic sanctions hurt Russia far more than what is generally thought. This has already been seen e.g. in increased financing costs for Russian businesses due to rising uncertainty.

European Union bans imports from Crimea. On Monday (June 23), the EU decided to ban products of Crimean origin in response to Russia's annexation of the Crimea. The EU is following the same protocol as it does with other areas it does not recognise. According to EU sources, further restrictions are expected, including visa policy and EU transport connections with Crimea.

Crimean officials say that the region will not be hurt by the sanctions as the lion's share of Crimean exports goes to Russia or other CIS countries.

Situation in Ukraine affects Russia's defence industry. Certain parts of the Russian defence industry depend to a great extent on Ukrainian suppliers and subcontractors. For example, Russia imports nearly all helicopter engines and turbines for certain types of vessels from Ukraine.

Russia's plans for equipping its armed forces would be jeopardised should Ukraine officials ban exports to Russia of the military components. For Russia, increasing domestic production capacity in many cases will require large investments that take years to complete. President Putin has asked state-owned enterprises to find ways to replace Ukrainian products by Russian ones.

Public sector employees make up the core of Russia's middle class. An extensive study by the Institute of Sociology, Russian Academy of Sciences finds that some 42 % of Russia's population, about 60 million persons, now qualify as "middle class". The Institute of Sociology's 2003 study found that just 29 % of Russians were middle class. Middle class here is defined on the basis of income, wealth, quality of work and the individual's own perception of his or her station in life. Given the peculiarities of Russian society, the survey criteria differ from practices in Western countries that place greater emphasis on social and cultural factors. Under Western criteria, about 20–30 % of Russians would be categorised as middle class.

The study further found that over half of Russia's middle class members are civil servants, other public-sector employees or employees of a state-owned enterprise. The large share of public sector employees in the middle class ranks reflects the fact that in Russia the public sector employs relatively more people than in Western countries. Public sector wages have also risen substantially in recent years.

A middle-class family's income is just over €800 a month per household member. About 65 % of the Russian middle class holds higher degrees. In cities with populations of at least one million, slightly over half qualify as middle class under the survey criteria.

A notable feature of the Russian middle class is that only about 15 % make an effort to develop professionally. Moreover, that share has shrunk by about half over the past ten years and is significantly smaller than in Western economies. Part of this reflects a lack of motivation. In recent years, opportunities for professional advancement through further education and training have become quite scarce. Motivation is further hurt by the fact that workers, especially those in leadership positions, have seen a significant erosion of their ability to effect change in the workplace.

China

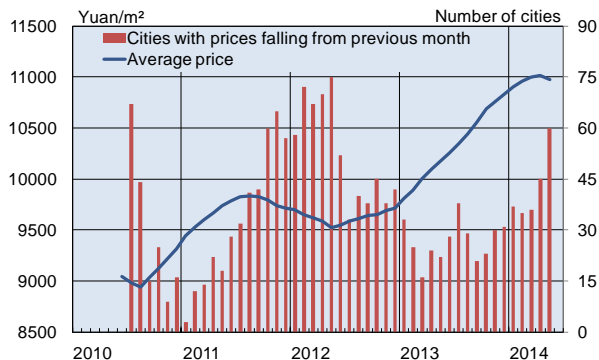
Falling housing prices in China? The weak performance of China's real estate sector in the first half has raised concerns inside and outside China. New housing starts (measured in square metres of floorspace) were down 22 % in January-May compared to the same period in 2013. Although construction activity picked up slightly in May from earlier months, housing prices appear to have peaked.

SouFun, a private portal service that tracks China's real estate markets, reports housing prices declined on average 0.3 % m-o-m in May. SouFun's survey is based on housing sales data for 100 sample cities. The survey found declining housing prices in 60 sample cities in May, compared to declines in 45 cities in April. The National Bureau of Statistics also reported a significant May increase in cities experiencing drops in housing prices from April. Housing market conditions are somewhat similar to autumn 2011, when housing price declines were last seen.

According to the SouFun figures, the average apartment price (price per liveable square meter of floorspace) was about 11,000 yuan (€1,300/m²) in May. In the pricey metropolises of Beijing and Shanghai, the average price was around 33,000 yuan (nearly €4,000/m²). While prices were still up in Beijing, they fell in Shanghai. It is difficult to generalise about overall conditions in the housing market or the nature of a housing bubble given the large price variations across provinces.

Officials earlier tried to rein in rising housing prices through restrictions on various types of construction and tighter terms for housing loans. These restrictions have now been relaxed in many regions. However, the high debt burdens of firms and local administrations are limiting the scope for stimulus policies. This makes the situation more dire than in spring 2012.

Average apartment prices and the number of cities (out of a sample of 100 cities) where prices fell from the previous month



Sources: SouFun, CREIS and Macrobond

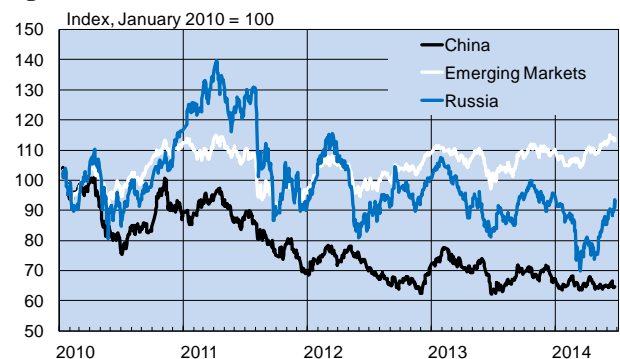
Further progress in deposit rate liberalisation. The People's Bank of China announced that as of today (June 27) it will no longer regulate interest rates on certain corporate foreign-currency deposits in the Shanghai region. The decision initially only applies to accounts with deposits less than \$3 million. While the trial is limited relative to China's overall deposit market, it signals deregulation of deposit rates is on-going and not limited to free-trade zones.

Weak first half for Chinese stock markets; IPO listings resume after 4-month pause. Share prices have remained fairly flat in the first half of the year. The Shanghai Composite Index, for example, is down 4 % from the start of the year. In comparison, share prices in Russia are also off about 4 % since the end of 2013, while share prices in emerging markets overall are up about 3 % this year.

After a four-month suspension, initial public offerings have resumed on the Shanghai and Shenzhen stock exchanges. Given the general lacklustre performance of listed shares, regulators are worried about overpricing of debutant listers. Fewer than 50 firms have been allowed to list on mainland China stock exchanges during the first two months of the year after an earlier listing suspension that lasted over a year. New IPO emissions were again halted in February. The China Securities Regulatory Commission (CSRC) expects about 100 IPOs to get go-aheads this year. About 600 firms are awaiting exchange-listing approval.

Chinese stock market listing involves a complicated application process. Officials look at such criteria as the applicant's operations and profit potential. Despite the proposed market-based changes in the application procedure, officials still heavily control the IPO process. The move reflects larger changes in capital controls and development of cross-border share trading (see [BOFIT Weekly 16/2014](#)). The "through train" scheme to allow limited foreign investment on the Shanghai exchange via the Hong Kong exchange and Chinese investment in shares listed on the Hong Kong exchange is currently slated to launch in October.

Key share price indices for Shanghai (SE Composite), Emerging Markets (MSCI EM) and Russia (RTS)



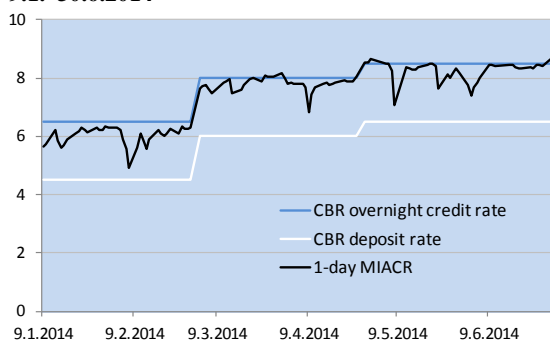
Source: Bloomberg

Russia

Interest rates in Russia climb over the past six months.

The one-day Moscow Interbank Actual Credit Rate (MIACR) reached 8.6 % at the end of June, up from 5.6 % at the start of this year. The rise in interest rates largely reflects hikes of the Central Bank of Russia's key rate in March and April, as well as a drying up of money-market liquidity on increased capital outflows from Russia. The CBR tightened liquidity further with currency-selling interventions to prop up the ruble (i.e. buying rubles from the markets), especially when market uncertainty was at its highest in March.

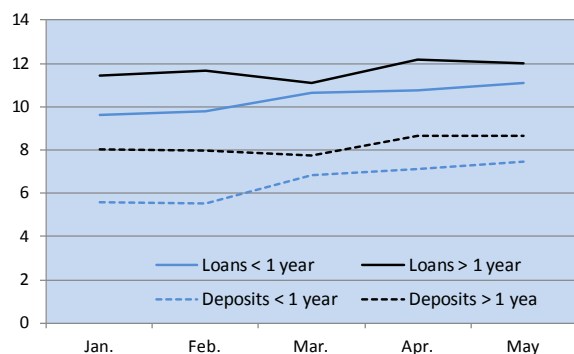
One-day Moscow Interbank Actual Credit Rate (MIACR), 9.1.–30.6.2014



Source: Central Bank of Russia

The CBR's tight monetary stance has made banks to increase their lending rates. Banks, however, have not widened their margin between deposit and credit rates, which may indicate that the uncertainty of banks over economic development has peaked.

Average rates for bank-issued ruble-denominated corporate loans and deposit rates, January-May 2014



Source: Central Bank of Russia

Preliminary figures show 12-month inflation further accelerated in June to 7.7 %. Inflation is expected to slow, however, towards the end of the year.

Ruble appreciated 1.6 % y-o-y in the second quarter.

After losing 5.7 % of its value in the first quarter, the ruble gained 1.6 % in the second quarter. Today (July 4), one euro bought 46.7 rubles and one dollar 34.2 rubles. As of end-June, the ruble had recovered to its January level relative to the CBR's dual dollar-euro currency basket, a key indicator used in setting exchange-rate policy.

Ruble strengthening was due to a settling of market reactions to the Ukraine crisis and the tight monetary stance pursued by the CBR. The central bank raised its key rate two percentage points during the spring. The ruble should get some support in coming months from stable oil prices and high domestic interest rates. Conditions could shift quickly, however, if e.g. the Ukraine situation flares.

In the long run, the ruble faces devaluation pressures from the meagre growth prospects of the Russian economy, due e.g. to reduced investment demand.

Moscow share prices made strong recovery in second quarter.

The drop in the Moscow stock exchange's RTS index ended in May as the market uncertainty caused by the Ukraine crisis settled. By the end of June, the RTS index was up 30 % from its March low. The RTS is currently down just over 5 % for the year.

RTS index, 1.1.2013–1.7.2014



Source: Reuters

Russia returns to international credit markets.

Sberbank and Gazprombank successfully sold one billion euros worth of Eurobonds in June. The sales marked Russia's return to international bond markets after Russia's annexation of the Crimea in March. Investment banks note that while the market currently gives Russia bonds a thumbs-up, things could turn around quickly should the political situation worsen again.

Yields on Russian sovereign bonds issued on international markets have fallen in recent months. At the peak of the Ukraine crisis in the spring, the 30-year credit rate hit a high of over 6 %. At the start of July, the rate had fallen to around 5.5 %.

China

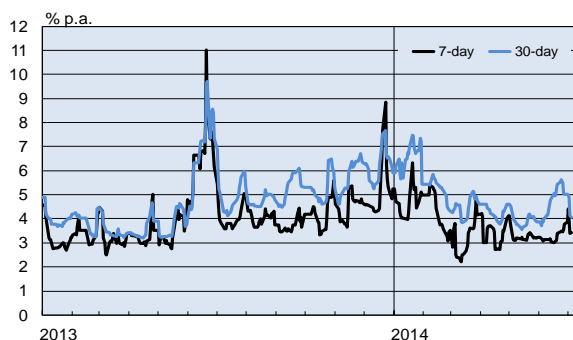
Targeted lending breaks for select Chinese banks. Effective from July 1, the China Banking Regulatory Commission (CBRC) has altered its method for calculating the loan-to-deposit ratios of Chinese banks. The change does not affect the legal requirement that outstanding bank loans may not exceed 75 % of deposits. Rather a definition change that excludes targeted loans from the ratio and adds some new deposit items will let banks increase their lending volumes and still remain within the credit ratio limit.

While the loan-to-deposit ratio in China's banking sector averaged 66 % at the end of March, certain large banks were already close to the 75 % limit.

The People's Bank of China recently reduced the reserve requirements for certain commercial banks to stimulate lending. The 0.5 percentage point drop in reserve requirements targeted credit institutions that focus on lending to small businesses or the agricultural sector. The reserve requirements for rural banks were already lowered in April. The reduction in reserve requirements, however, was not extended to China's largest banks. By these measures officials try to improve credit access of small businesses and the agricultural sector without affecting the general monetary policy stance.

Interest rates on Chinese money markets rise a bit; no "Shibor shock" like last year. Interbank money markets remained fairly subdued in June, avoiding a repeat of last summer's interest-rate spike. Cash demand typically increases at the end of every quarter, while banks must build reserves to prepare to the end of the reporting period.

Interbank Shibor rates



Source: Macrobond

The PBoC eased market liquidity conditions by postponing its sale of repurchase agreements scheduled for the end of June to the beginning of July. The central bank soaks up market liquidity by selling repos at its weekly open market operations. At the beginning of the week, the 7-day Shang-

hai Interbank Offered Rate (Shibor) was up over a percentage point from the start of June. The 30-day Shibor rate spiked nearly two percentage points in June, only to fall back at the end of the month.

Summer vacation season kicks off in China; foreign travel increasingly popular. The Chinese summer vacation season begins in July as the school year ends for most students. Many working Chinese schedule their vacations during the July-September period and are eager to travel during their time off. Although the vast bulk of vacation travel takes place domestically, the share of foreign travel continues to enjoy steady growth. Chinese tourism officials say that the volume of foreign travel increased last year by 18 % to nearly 100 million. In comparison, Beijing alone had 250 million visitors in 2013.

The lion's share of foreign travel involved trips to China's special administrative regions (Hong Kong and Macao), which count as foreign destinations in the official figures. Hong Kong accounts for approximately 40 % of foreign travel and Macao 25 %. Most trips to Hong Kong are for shopping, while trips to Macao tend to focus on gambling in the casinos. In recent years, Taiwan has overtaken Japan to become tied for third with South Korea as a travel destination. Some 3 million mainland Chinese visited Taiwan last year. Taiwan seeks to further boost tourism by relaxing visa requirements for mainland Chinese.

Europe and the United States together account for roughly 5 % of Chinese foreign travel. The US share especially has been on the rise in recent years. The Chinese are also a growing group in Russia, where they were the largest tourist group in the first quarter, beating out both the Germans and the Turks.

The share of Chinese tourists staying at Finnish hotels increased slightly at the start of the year. Statistics Finland reports that Chinese stays at Finnish accommodations in the first four months of the year totalled 23,000 overnight stays, an increase of 15 % y-o-y. The figure is still relatively modest compared to e.g. Japanese tourists, who registered about 60,000 overnight stays in Finland in the period.

The UNWTO World Tourism Organization reports that Chinese tourists spent about \$130 billion internationally – more than any other country – during their travels abroad last year. Next came the Americans and Germans, who each spent about \$85 billion. Chinese spending abroad outstrips the spending tourism brings into the country and is a central cause of China's large services deficit. A slight drop in the popularity of China as a tourist destination has further increased the size of the deficit.

Oxford Economics estimates that currently about 110 million Chinese households can afford foreign travel, and that this number will double over the next decade. Oxford Economics expects the Chinese to lead global tourism growth in coming years.

Russia

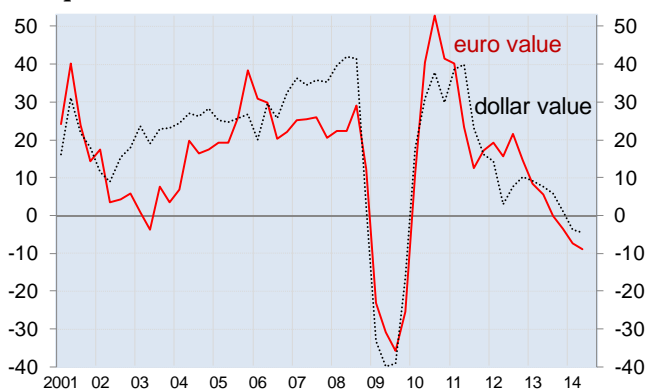
Ruble finds support from Russian foreign trade and calming capital flows. Preliminary balance-of-payments figures from the Central Bank of Russia show revenues from exports of goods and services in the second quarter rose slightly from a year earlier, largely on higher earnings from energy exports. At the same time, however, earnings on other goods exports continued to shrink and earnings on services exports, particularly tourism, went into decline.

Russian spending on imports in 2Q2014 was still down from a year earlier. In value terms, goods imports were off 7–8 % y-o-y. There was no longer growth in spending of Russian travellers abroad. Overall, slightly higher export earnings and lower spending on imports lifted the current account surplus, which for the past four quarters equalled 2.5 % of GDP.

With most critical tensions subsiding in the second quarter, capital outflows from Russia and the ruble partly cooled off. While the flight to foreign-currency cash diminished sharply and the CBR estimated grey capital exports contracted substantially, capital outflows from banks remained large as their foreign debt declined to an exceptional degree. Russian corporate borrowing internationally was minimal. Foreign direct investment flows into Russia and DI outflows from Russia were largely unchanged with outflows continuing to slightly outpace inflows.

The current account surplus and calming of capital flows have supported the ruble. The ruble's nominal exchange rate against its trade-weighted currency basket rose 7 % in the second quarter. Since the ruble's slide ended, the cost advantage for Russia has narrowed significantly with the ruble's real effective exchange rate in June just 4 % below early 2013, when it hit its all-time peak.

Russian imports of goods and services, % change from four quarters earlier



Sources: Rosstat, CBR

Russia decides on oil sector tax reform. The government has spent past months preparing changes to tax policies for oil production and oil exports. Although cabinet members hold diverging views, the finance and energy ministries struck a deal late June on tax reform in the sector that also won the blessing of state oil giant Rosneft, a critic of the reform initiative. The new policies shift the tax emphasis by lowering export duties and raising production taxes.

The new rules will begin to be rolled out at the start of 2015 and gradually implemented over the next three years. The export duty on crude oil will fall from 59 % at the moment to 30 % by the end of 2017. Export duties on refined petroleum products will also go down. At the same time, resource extraction taxes will nearly double.

The Eurasian Economic Union, which currently includes Russia, Belarus and Kazakhstan, has been a major reason for the reforms. When the EEU was created in May, the founding countries agreed on gradual integration of their energy markets. By keeping its existing tax regime in place, Russia stood to lose significant amounts of budget revenue from the elimination of export duties to EEU member states. Russia currently subsidises the Belarus economy by exempting some oil exports from the duties. The shift away from export duties to taxing production will reduce the support Belarus now enjoys. Oil exports from Kazakhstan currently carry a lower duty than Russian oil. If Russia did not cut its export duties, Russian oil companies could start to export oil at lower cost via Kazakhstan.

Unlike most oil-exporting countries, taxation on Russia's oil sector focuses on the value of an oil company's production rather than its financial performance. The value of production is defined according to world oil prices. While experts in Russia and elsewhere have long called on Russia to move to a system based on taxing corporate profits, the latest reforms still balk at such a shift.

TIR system gets more time again at Finnish-Russian border. Russian customs had planned to phase out the expedited customs formalities under TIR (Transports Internationaux Routiers or International Road Transport) procedures at Finnish-Russian border crossings at the beginning of July. In late June, however, Russian customs announced that transports carrying TIR carnets would be recognised until the beginning of December. Russia initially planned to end TIR procedures altogether already last August. Russian officials, however, have postponed the implementation date several times, particularly at Finnish-Russian border crossings, where the bulk of TIR freight crosses into Russia.

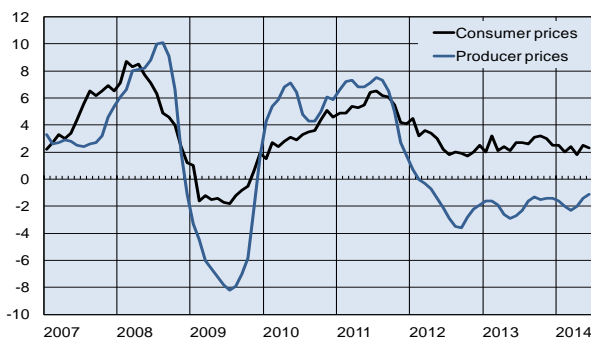
Many fear the termination of TIR procedures will slow road freight and increase costs of foreign trade. There is anecdotal evidence some Russian road freight has already shifted to routes via Belarus, where the TIR system will remain in place. Belarus is also a member of the customs union with Russia and Kazakhstan.

China

Stable inflation picture continues. June consumer prices were up 2.3 % from a year earlier. March consumer prices, in contrast, rose just 1.8 % y-o-y. Much of the increase in inflation reflects rising food prices, which were up 3.7 % in June. Prices of non-food goods rose 1.7 %, unchanged from its long-standing trend. The decline in producer prices slowed from 1.4 % in May to 1.1 % in June.

With the exception of real estate prices, prices in China have been quite stable over the past two years. The inflation outlook remains subdued, which means inflation is not a top concern for monetary policymakers at the moment.

Consumer and producer prices in China, %- change y-o-y



Source: Macrobond

Local government indebtedness continues to rise. A press release from China's National Audit Office (NAO) in late June claimed that the indebtedness of local administrations has continued to climb since last June, but appears to be slowing. In a monitoring sample consisting of nine local administrations and city governments, debt levels rose about 4 % between June 2013 and March 2014, a sharp slowdown in the piling-on of debt seen earlier. Higher revenues from land sales have helped local governments avoid higher borrowing. The NAO press release did not specify which local governments were included in the sample, making it difficult to judge how it reflects the overall financial conditions of local governments.

Officials are unable to offer precise figures on local government debt after June 2013 as determining indebtedness at the various levels of government is a demanding and time consuming process. The NAO's latest comprehensive debt survey, published last December, showed indebtedness of Chinese local administrations increased briskly after 2010, reaching 17.9 trillion yuan (€2.1 trillion) in June 2013.

Chinese figures also point out that about 2.4 trillion yuan (€300 billion) in local government debt is set to mature over the present year. Many local governments may have to borrow more just to service their existing debts.

Germany dominates China-EU trade. German chancellor Angela Merkel wound up her three-day visit to China on Tuesday (July 8). The visit was important from an economic standpoint; Germany is China's top European trade partner, accounting for about 30 % of China's foreign trade with the EU and 4 % of China's total foreign trade.

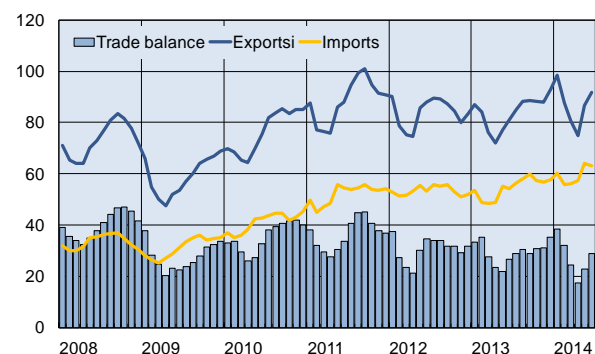
During the visit, China and Germany signed a number of deals, including a roughly €2 billion commitment from German carmaker Volkswagen to build two new plants. Volkswagen and General Motors dominate in China, which has the world's largest car market at the moment. Promoting international use of the yuan was also high on the agenda. German investors were granted an 80 billion yuan (€9.5 billion) quota under China's Qualified Foreign Institutional Investor (QFII) programme that allows foreign investors to participate on the Shanghai and Shenzhen stock exchanges.

The EU is China's largest trading partner, and Germany is China's fourth largest trading partner after the United States, Japan and South Korea. About 43 % of China's EU imports last year came from Germany. Some 20 % China's exports to the EU went to Germany. The largest share of China's foreign car imports came from Germany, accounting for about a third of all passenger car imports and nearly a fifth of all German imports.

China mainly exports to Germany goods in the electronics and machinery & equipment categories. Over half of the solar panels imported to Germany come from China, but last year's solar-panel tariff dispute reduced EU solar-panel imports from China. During 2010 and 2011, nearly 10 % of imports from China were solar panels. That share fell to 2 % last year.

Chinese foreign trade figures show China has long run a trade deficit with Germany. Imports last year exceeded exports by about \$27 billion. The EU overall runs a trade deficit with China, however. German figures do not reflect the Chinese view. German figures show its imports from China exceed exports. The discrepancies in trade figures reflect differences in such areas as recording practices and treatment of complex global production chains.

China-EU trade, three-month totals, USD billion



Source: Macrobond

Russia

Russia's latest three-year budget plan calls for higher revenues and small deficits. The government approved the 2015–2017 budget policy framework in early July as a basis for further refinement. The finance ministry sees total government budget (federal and regional budgets, and social funds) revenues increasing at 6–6.5 % a year, which is slightly higher than the economy ministry's forecast for inflation. In this prospect, the ratio of revenue to GDP will fall gradually towards 35 % (36.5 % in 2013). Government revenues from oil & gas production taxes and export duties will climb this year and then level off as long as the price of Urals-grade crude holds at around \$100 a barrel. It is also expected that some production and exports in the sector will remain unchanged while others decline.

Various measures will be applied to boost growth in other revenue to 8–9 % a year. VAT revenues to the federal budget should rise strongly on improved collection. Among other taxes, the tobacco excise tax will go up by 50 % from this year, and an excise tax will be levied on gas exports to Turkey. Regional budgets will continue to receive less transfers, while hikes in excise taxes will support their revenues. The government is also considering whether to allow regions to launch sales taxes. Transfers to social funds will be boosted, along with a rise of the social tax revenues thanks to improved collection and hikes in certain categories of mandatory employer's social contributions.

The finance ministry expects the government deficit to only rise slightly to around 1.5–2 % of GDP, mainly due to tight set-ups in regions. The government aims to hold the federal budget deficit at around 0.5 % of GDP, which is well below the 1 % ceiling called for in the budget rule.

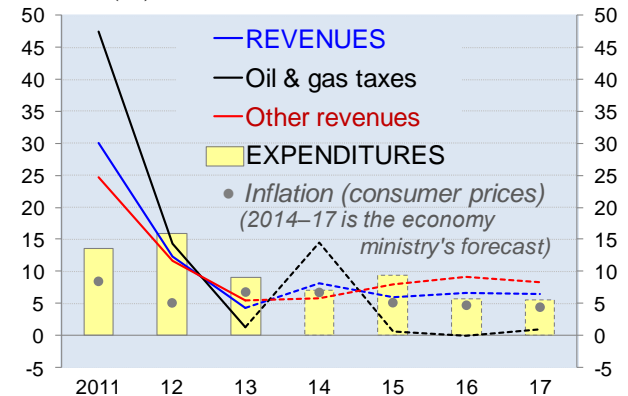
While government expenditures will rise notably next year, particularly spending on pensions, spending growth will then remain slightly lower than inflation. From 2016, spending as a share of GDP will fall gradually to under 37 % (38 % in 2013), although so far only the 2015 expenditure figures include spending on Crimean investment. The three-year budget plan may imply a tangible reduction in government spending in real terms because prices for public consumption and investment have for years risen clearly faster than consumer prices.

The tight spending situation will be eased slightly by the state using long-term loans from the National Welfare Fund to part-finance big transport infrastructure projects. Based on current government decisions, lending for such projects would accumulate by end-2017 to about a quarter of the National Welfare Fund and correspond to 1 % of GDP.

The framework for government budget policy sees federal debt (including government guarantees) rising towards

15 % of GDP by end-2017. Debt alone would be about 10 % of GDP. The finance ministry expects the assets of the Reserve Fund to increase slightly. The combined value of the two funds would remain below 10 % of GDP.

Government revenues and expenditures (% change) and inflation (%)



Sources: Finance ministry, Rosstat, economy ministry

IEA encourages Russia to focus on energy efficiency and boost investment in the energy sector. The International Energy Agency (IEA) last month released its [broad survey](#) of Russian energy policy. The IEA noted that Russia's energy sector has experienced remarkable changes since its last survey in 2002, citing among the most positive ones the massive reform of the electricity sector, progress in liberalizing natural gas markets, as well as bringing undeveloped oil and gas deposits in East Siberia into production.

The IEA said improving energy efficiency and infrastructure investment should be the focus of Russian energy policy. Progress in these areas requires increased competition and liberalization, particularly for pricing household energy supplies. The phase-out of regulated household tariffs and the shift to consumption-based energy invoicing would give utility companies incentives to make long-needed investment in infrastructure for household electricity and heating. The negative effects of higher tariffs could be offset through social transfers to the poorest households.

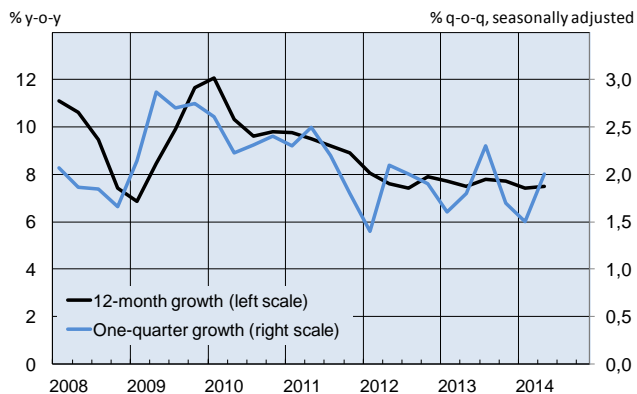
The IEA forecasts Russian oil exports will decline in coming years as domestic demand rises and production plateaus. Natural gas production, however, is perceived to suffer from oversupply. Russian domestic demand is expected to rise only slowly, if at all, while growth in export demand is limited by greater competition and economic weakness in Europe, Russia's biggest gas customer. The IEA recommends that Russia become more efficient in its oil use and replace oil e.g. by shifting to vehicles powered by natural gas. The shift in energy consumption patterns would increase Russia's oil export possibilities.

While the government's latest energy strategy, which extends to 2030, largely comports with IEA recommendations, the IEA emphasizes its proper implementation.

China

Chinese economic growth picked up slightly in the second quarter. China's National Bureau of Statistics reports the Chinese economy grew at a rate of 7.5 % y-o-y over the April-June period. Economic growth strengthened from 7.4 % in the first quarter. Seasonally adjusted GDP growth hit 2 % q-o-q in the second quarter, up from the revised 1.5 % for the first quarter.

Real GDP growth from the previous quarter (q-o-q) and four quarters previous (y-o-y), %



Sources: NBS and BOFIT

Some of the pick-up in growth came from public investment, particularly infrastructure projects, public housing production and rules to ease bank lending. These measures have all injected liquidity into the economy. Growth in the broad measure of money supply (M2) accelerated in June relative to the first five months of the year, while the loan stock grew 14 % y-o-y, slightly higher than in April and May.

Public project spending helped boost investment towards the end of the quarter. Real growth in investment (not including rural households) in the first half of the year was 16 % (down from 20 % in 1H2013). Growth in real estate investment slowed to 13 % y-o-y, down from 20 % in 1H2013. Construction starts in the first half fell 16 % y-o-y in terms of floorspace production. Real estate sales also declined.

Real per capita disposable income increased about 8 % in 1H2014, slightly outpacing overall economic growth. The volume of retail sales grew 11 %, about the same as in 1H2013. The pace of growth in the service sector slightly exceeded economic growth overall, which meant that the contribution of services to overall output continued to increase.

Two local governments form first wave of bond issues under new policies. The southern province of Guangdong and the northern Shandong province have together issued 30 billion yuan in bonds this summer. The bond issues are part of the Ministry of Finance's pilot program that allows local governments and municipalities to sell bonds (see [BOFIT Weekly 21/2014](#)). Finance minister Lou Jiwei hopes that eventually the possibility of selling bonds will extend to a larger assemblage of local governments.

While local governments sold their own municipal bonds earlier, the central government has always been liable for debt repayment. Under the new arrangement, local governments are responsible for keeping their commitment to pay back the bonds. To participate in the new bond market, investors should be more aware of the credit risks of issuers.

The yield on Guangdong's 5–10-year bonds settled around 4 % p.a., which is rather close to the yield on Chinese sovereign bonds issued by the Ministry of Finance. It thus appears that investors are not pricing provincial credit risk into their bond purchases. Many investors may still assume the central government will step in and bail them out if a local government defaults. The 3.9 % yield on Shanghai bonds is even lower than the Guangdong product.

Finance ministry rules require local governments to be evaluated by an independent credit rating agency before issuing bonds. Guangdong received the top credit rating from a Shanghai-based ratings agency. Observers note, however, that the Guangdong economy relies heavily on real-estate construction.

China seeks to support the yuan's role in international payments. China's central bank has granted two large Chinese banks the right to clear offshore yuan transactions in Europe. The Frankfurt branch of the Bank of China and the China Construction Bank's subsidiary office in London have been named as official clearing banks. The presence of clearing hubs in Europe should speed up the yuan payments clearing process. At the moment, the yuan's limited availability outside mainland China impedes payment processing. Similar clearing bank arrangements are already operational in Singapore, Taiwan and Hong Kong.

The measures are designed to facilitate faster cross-border payments. When a European firm earlier wished to pay a Chinese firm in yuan, it had to use a clearing bank located inside China to convert, say, euros to yuan.

While over 20 % of China's foreign trade was transacted in yuan in March, the share has retreated to around the 15 % level in subsequent months. SWIFT, the Society for Worldwide Interbank Financial Telecommunication, reports the yuan accounted for around 1.5 % of all international payments traffic in May.

Russia

Production and demand in Russia shrank in June.

Economy ministry estimates GDP growth in the second quarter was 1.2 % y-o-y, a slight improvement from 0.9 % in the first quarter.

Most of the improvement in GDP growth came from industry. However, in June seasonally adjusted industrial production contracted notably, to just slightly above the level of December 2013. In particular, manufacturing growth slowed steeply after a spring recovery (observers have noted that transitory factors boosted growth in spring, such as the advantage conferred on certain industrial branches from the drop of the ruble and sharp growth in defence spending.) Manufacturing was up 2.6 % y-o-y in the first half and 0.3 % y-o-y in June.

Growth of seasonally adjusted resource extraction industries remained at zero for three months in a row. In y-o-y terms, output growth in June and for the entire first half came in at slightly below 1 %. Crude oil output increased 1.5 % y-o-y in the first half, while natural gas production declined 2 % y-o-y.

Seasonally adjusted retail sales contracted in the last three months, after a revival in late winter. Back then, people accelerated their purchases as the ruble slid and inflation rose. Although retail sales grew 2.7 % y-o-y in the first half, they were up just 0.7 % y-o-y in June. Households' real disposable income declined slightly in 1H2014 from 1H2013, e.g. due to their increasing debt servicing.

Investments fell almost 3 % y-o-y in the first half on weakness in the first quarter of the year. June investment, however, was up slightly from a year earlier. Some of this gain can be attributed to the low base of June 2013. Completed housing projects in June, on the other hand, continued at the record pace set in the first half. In terms of floor space, the volume of finished housing was up one third from a year earlier both in the entire first half and June.

US and Canada widen sanctions against Russia, and the EU. The annexation of Crimea and the on-going crisis in eastern Ukraine has pushed the US, the EU and a number of other countries (including Canada, Australia and Japan) to impose economic sanctions on Russia during spring and this summer. As a rule, the sanctions have mainly been applied to individuals or specific firms. The initial US sanctions froze the assets and imposed travel bans on 45 individuals and 30 firms. The EU's respective list has 72 private persons and two companies operating in Crimea.

On July 16, the US imposed considerable new sanctions on Russia. The sanctions list saw the addition of four Russians (including Oleg Savelyev, minister for Crimean af-

fairs) and eight armaments firms (including Almaz-Antez, maker of the BUK ground-to-air missile system). State oil giant Rosneft, Russia's largest private gas producer Novatek, and two major state-owned banks (VEB and Gazprombank), saw their access to US debt markets restricted. The new sanctions decision forbids US persons from transacting in, providing financing for, or otherwise dealing in new debt of over 90 days maturity for them, and of new equity for the banks. The sanctions also extend e.g. to majority-owned subsidiaries of those listed. Trading e.g. in existing debt securities, short-term funding, payment transactions and other commercial activities are still permitted.

In practice, the new US sanctions block the named firms from access to long-term dollar-based borrowing. Rosneft and Novatek have relied actively on foreign borrowing to finance investments and refinance their debt. The lack of access to dollar-based financing will force these firms to turn to domestic financing sources or Mideastern and Asian financial markets. Availability of funds may not necessarily become a problem, but financing costs will increase.

On July 24, Canada imposed identical sanctions, among others, on VEB, Gazprombank and Novatek. Moreover, on July 25, the EU decided to add several further persons and entities to its list of those subject e.g. to an asset freeze. The list is to be published today.

Banking sector reflects growth of uncertainty. Growth in household deposits came to a standstill in early this year on uncertainty caused by ruble weakness and tensions from the conflict in Ukraine. The deposit stock shrank by 0.4 % in nominal terms from January to June. During 1H2013, the deposit stock still grew about 10 %. In March and April in particular, households changed bank deposits into foreign currency cash and moved up planned purchases. Foreign currency deposits at end-June amounted to over 18 % of all household deposits, about one percentage point higher than a year earlier.

The ratio of household deposits to total assets of the banking sector fell by two percentage points during the first half to 28 %. The shares of central bank financing and state deposits (including the finance ministry) as well as inter-bank lending have all grown. The share of central bank financing has nearly doubled over the past year; it now accounts for about 9 % of banking sector total assets, while it reached 12 % in early 2009, the crisis year.

Growth of corporate credit stock was 16 % y-o-y at end-June, slightly faster than a year earlier. The acceleration in growth of the credit stock may reflect increased difficulties in foreign borrowing. On-year growth of the stock of household credit slowed from 34 % at end-June 2013 to 21 % at end-June 2014. A driving factor was the central bank's earlier measures (see [BOFIT Weekly 6/2014](#)). The bulk of new household borrowing is however going to servicing existing loans.

China

BRICS to establish their own development bank and currency reserve arrangement. Leaders of the world's biggest emerging economies, the BRICS (China, India, Brazil, Russia and South Africa), met last week at the BRICS-UNASUR summit in Brazil and took a considerable step towards concrete cooperation by setting up a New Development Bank (NDB). The initial mission of the NDB will be to provide financing for public and private infrastructure projects in emerging and developing countries. The bank will grant project loans, provide loan guarantees and offer capital financing. The headquarters will be located in Shanghai, a reflection of China's political and economic clout in the initiative. Other countries outside the founding members could also eventually join the NDB.

Under current plans, the NDB's initial subscribed capital will rise over the next seven years to \$50 billion. The NDB can also raise additional capital by issuing \$50 billion in shares that will be available for subscription to founding members and new members. The initial capitalisation plan gives all founding members equal voting shares, but acquisitions of new shares will allow individual members to increase their voting power. With further capital infusions, the bank capitalisation could rise to \$100 billion. For example, the World Bank's subscribed capital is \$230 billion.

The diverse characters and geographic disparities of the member countries make it difficult to predict the type of projects that will be the NDB's focus. Most of the member countries have their own national development banks already overseeing their national interests. For example, China's National Development Bank agreed this week to grant new loans to Venezuela in exchange for oil shipments. Regional development banks such as the Asian Development Bank (ADB) and the Inter-American Development Bank for Latin America are currently major lenders in projects geared to regional development.

Several observers have noted that the NDB is part of an effort to diminish the current dominance of first world countries in international organisations. For example, the United States and Japan play key decision-making roles in the IMF and ADB. Also the fact that the reforms to voting power in the IMF have not been enforced has further disillusioned several emerging economies.

In addition to the NDB, the BRICS agreed to form \$100 billion "Contingent Reserve Arrangement" meant to function as a risk management mechanism. It could, for example, provide short-term liquidity or help support the exchange rate of an individual member country. The arrangement is based on member financial commitments, whereby funds are not pooled into a currency reserve. China's contribution would amount to \$41 billion. The currency

arrangement is not economically significant in China's case as its own foreign currency reserves neared the \$4 trillion mark in June.

The gap between China's foreign direct investment inflows and outflows narrows. China's commerce ministry reports that direct investment outflows from China rose 8 % y-o-y in the second quarter of this year. On the contrary, foreign direct investment inflows to China were down 1 % from the same period a year earlier. In the first six months of this year, FDI from China (not including the financial sector) amounted to \$43 billion, down 5 % y-o-y due to a weak first quarter. FDI inflows to China amounted to \$63 billion (up 2 % from 1H2013).

Over the longer term, the difference in direct investment flows into and out of China has been shrinking. FDI outflows from China (not including the financial sector) increased 16 %, while investment inflows into the country grew 5 %. UNCTAD estimates that China's direct investment abroad will exceed FDI inflows within the next couple of years. UNCTAD figures differ from the commerce ministry figures as the data collected by the commerce ministry occurs in conjunction with its investment approval process, which is why the reported deal values can differ from the actual numbers. Nevertheless, the overall image of investment flows is undisputed for both agencies.

The commerce ministry figures reveal that FDI inflows to China's manufacturing sector have dwindled in recent years. In the first half of this year, FDI going to manufacturing was down 14 % y-o-y. Nevertheless, a third of China's incoming direct investment still goes to manufacturing. Growth in real estate sector investment remained brisk (up 31 % y-o-y in 1H2014). The real estate sector received nearly 30 % of FDI inflows to China. FDI to China from South Korea, in particular, jumped in the first half, while FDI from Japan fell significantly.

According to the China Global Investment Tracker database, a large share of large outbound investments (over \$100 million each) by Chinese firms in the first half went to resource extraction industries and the energy sector. Investment in resource extraction was boosted in the first half by a nearly \$6 billion copper mine investment in Peru. This year has seen increased technology investment coming from Lenovo's deals with IBM and Motorola, each of which worth over \$2 billion.

UNCTAD reports that China was the world's third largest source of FDI last year after the United States and Japan. Given the size of its economy, the total FDI stock from China is relatively small by international standards. The stock of FDI from China last year corresponded to 7 % of GDP, compared to 24 % for Russia, 18 % for South Korea and 15 % for Thailand.

Russia

EU directs sanctions at core branches of the Russian economy. On Tuesday (Jul. 29), the EU decided to implement further sanctions against Russia. The new measures take effect today (Aug. 1). The most significant sanctions relate to key parts of the economy, particularly the financial sector and oil production. EU exports of certain oil exploration technology and drilling equipment to Russia are now banned. The defence sector, which Russia has developed intensively in recent years, is also subject to sanctions. Russia will not be permitted to import weapons systems or dual-use items for military purposes.

The sanctions on the financial sector affect all Russia's large state-majority banks. While equity and debt issues of these banks are now banned on European markets, the EU still allows Russian banks to take loans with maturities less than three months. The US extended on Tuesday its sanctions agreed upon a few weeks ago and now a total of five state banks are off limits for loans longer than three months. Unlike the EU sanctions, the US sanctions do not target the biggest Russian state bank, Sberbank.

Some of Russia's largest state banks have traditionally played important roles in brokering loans from international capital markets to meet domestic market needs. In the short-term, the constraints on access to financing are unlikely to have serious impacts as banks can still raise funds elsewhere (e.g. Asian markets). However, financing costs for Russia will likely go up in all markets due to Russia's heightened country risk and poorer prospects for economic growth caused by the sanctions. According to observer estimates, the relatively strong fiscal position of the Russian state and ample sovereign oil funds make it possible for banks to be financed from domestic sources for about a year.

As reciprocal sanctions, Russia has so far considered import restrictions on certain foodstuffs from the EU and the US. These goods can be rather quickly replaced with similar imports from elsewhere. The constraints on imports are hoped to provide domestic firms with an opportunity to increase production. However, higher prices are an obvious consequence of the measure. Russia's food safety agency banned from today imports of many Polish fruit and vegetables due to certification infractions and health risks from contaminated products.

Sanctions have already hit the Russian economy. The impacts of the latest sanctions will depend on how long they remain in place. The EU sanctions are set for one year, but the situation will be reviewed every three months.

Russia's economic development and long-term economic outlook have already for months suffered from the EU and US sanctions – and in particular from the uncer-

tainty over possible further sanctions. While sanctions have until now been fairly limited, they have increased uncertainty at home and abroad about the Russian economy in general. Furthermore, Russia's actions in Ukraine have in itself been a major source of uncertainty.

Uncertainty has reduced Russia's access to financing, increased borrowing costs, caused capital exports to soar and decreased corporate willingness to invest. The latest round of sanctions further amplifies that uncertainty.

Even the modest growth of the Russian economy appears to have slowed to anaemic levels. The IMF last week confirmed their April prognosis; Russia's economy remains on track to grow just 0.2 % this year. The IMF expects Russia's economy to grow about 1 % next year.

CBR hikes the reference rate as international tensions rise. Last Friday (Jul. 25), the Central Bank of Russia raised its key rate by a half percentage point to 8 %. It was the third such hike since March.

The CBR noted its decision to raise the rate reflects increased risks of ruble's weakening and higher inflation caused by the international political tensions. The CBR also referred to domestic fiscal policies, i.e. hikes in tax rates and tariffs that are under preparation in the government for next year.

The central bank noted that the reasons for slow economic growth are structural in nature. Growth is restrained by the high rate of capacity utilisation particularly in sectors producing competitive products, near-full employment conditions and slow productivity growth. The CBR further noted that economic growth is depressed by the tense international political climate, which increases uncertainty over entrepreneurial ventures, limits access to long-term financing and depresses investment demand. Under such conditions, the possibilities of monetary policy to promote growth are limited.

The CBR's end-year inflation target range is 6.0–6.5 %. As of mid-July, the central bank estimated 12-month inflation was still running at 7.5 %.

The rate hike came as surprise to most analysts. They now believe that the main motivation for the CBR's action was the concern about rising capital exports if the international political situation continues to deteriorate. Analysts also see the CBR's rate hike as an effort to convey its concern about the possible relaxation of fiscal policy.

Ruble slid again. Despite last Friday's rate hike, the ruble dropped early this week, but started to rise again towards the end of the week. The CBR did not intervene to prop up the currency.

As of August 1, the ruble-euro rate was 47.8 and the ruble-dollar rate was 35.7. The ruble has lost over 5 % of its value against the euro and nearly 8 % against the dollar since the start of the year. The ruble's weakest point this year occurred when the Crimean crisis flared in March.

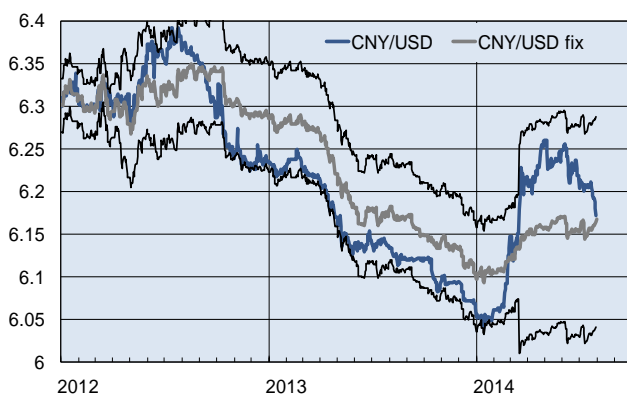
China

Yuan appreciation returns; current account surplus rises. The yuan's exchange rate relative to the US dollar weakened significantly in the beginning of this year in response to the People's Bank of China's deliberate policy of frustrating appreciation pressures from one-sided speculation urges. The "policy package" also included a widening of the yuan's daily fluctuation band. Since mid-March, the yuan has been allowed to rise or fall 2 % in value against the PBoC's daily reference exchange rate.

The yuan's exchange rate stabilised at a level of 6.23–6.25 to the dollar in late spring. The PBoC has since allowed the exchange rate to strengthen. One dollar bought 6.17 yuan at the end of July. The appreciation has been supported throughout the summer by economic data that suggest a stable growth outlook for the economy. The second quarter also saw a return to growth in the current account surplus. The moving 12-month current account surplus climbed to 1.7 % of GDP in the second quarter, up from 1.5 % in the first quarter. At the end of June last year, the moving 12-month current account surplus was still about 2.6 % of GDP.

The yuan's real effective (trade-weighted) exchange rate in June was 4 % lower than at the end of 2013. In a publication released this week, the IMF estimates that the yuan's exchange rate is still 5–10 % undervalued in light of economic fundamentals and policy needs. A number of investment banks anticipate modest yuan appreciation.

Yuan-dollar rate, PBoC reference rate and fluctuation band



Sources: Macrobond, BOFIT

Summer grain harvest exceeds old record – FAO and OECD encourage China to rationalise agricultural production. China's National Bureau of Statistics reports that the summer grain harvest increased by 5 million metric tons from last summer's total to 137 million tons. The summer crop accounts for about a fifth of China's total annual grain harvest. The long-trending gains in China's agricultural

output reflect, e.g. more efficient land use and farm subsidies. Farmers are subsidised for procurement of fertilisers and pesticides, and the use of fertilisers has been an important factor in boosting agricultural output. China subsidises domestic farming in order to guarantee 95 % self-sufficiency in key staples such as wheat and rice.

The [OECD-FAO Agricultural Outlook 2014](#) released in July suggests that China's agricultural output is unsustainable as chemical overuse is causing farmland degradation. The report recommends that China should boost agricultural productivity by rationalising farming instead of escalating fertiliser use. The government could also replace many input subsidies with income transfers to farmers.

The jointly compiled report notes that farm production could be made much more efficient by consolidation of smaller farms into large units. China's current farming economy, which is based on small farmers, makes the efficient use of modern farm equipment difficult. Improved land rights for farmers would encourage larger farms and mechanised production. The aging population and urbanisation continue to increase pressures to mechanize farming further.

According to OECD and FAO, China needs to stress efficient use of irrigation water. Adjusting the pricing of irrigation water would encourage farmers shift away from water-intensive plant varieties. Currently a number of provinces suffer from water shortages that are already starting to affect food production. However, it appears that China is moving ahead with concrete measures to remedy the situation. Reuters reported last week that seven provinces have been granted permission to host pilot markets to trade water rights in a scheme to bring water to wherever it is most needed. Officials have yet to decide if the rights will be granted to private firms or local authorities.

Modernisation and development of agriculture is important for social reasons. The FAO and OECD note that currently 11 % of Chinese suffer from malnutrition and that the lack of food is concentrated in the areas where living is based on small-scale farming.

Latest WTO decisions on US-China trade disputes. A World Trade Organization arbitration panel found that countervailing duties levied by the US on 17 products manufactured by Chinese state-owned companies violate WTO rules. The US claimed the public companies were in fact public bodies that enjoy state subsidies and distort competition. The WTO concluded that state-ownership per se does not necessarily mean that a company is a public body under the WTO definition. The US can still appeal the decision.

In May, a WTO expert group found in favour of the United States in a dispute where the US claimed China's import duties on certain large engine vehicles violated its WTO commitments. The decision was largely symbolic as China had already abolished the disputed duties.

Russia

Economic sanctions pose no imminent threat to Russia's banking sector. Five of Russia's six largest banks are now on the US sanctions list after its update last week. They include rapidly growing Vneshtorgbank (VTB) which concentrates on corporate financing and VTB24 specialised in providing household services; Gazprom-owned Gazprombank; Bank Moskovy, which was acquired from the City of Moscow in 2011 by the VTB Group; and Russian Agriculture Bank (Rosselkhozbank). The state holds majority stakes in all five banks. The sanctions list also includes state development bank VEB. The EU also released its own sanctions list last week. In addition to the five above-mentioned banks, Russia's largest bank, savings bank Sberbank was included in the list. The Central Bank of Russia is Sberbank's largest shareholder.

The US has banned the listed banks from issuing equities and bonds as well as getting loans with maturities over 90 days on US financial markets. The EU ban concerns issuing bonds and equity on European markets.

Although the sanctions are directed solely at the named banks, the knock-on effects feed also to other Russian banks and firms which financing costs have increased and access to international financing has reduced. The impacts on the banking sector as a whole remain limited for the moment.

Russia's banking sector carries relatively little foreign debt – only about \$180 billion or 10 % of the sector's total assets. About \$50 billion of that debt matures in the second half of this year or next year. Of that, state-owned banks have to pay up about \$10 billion this year and \$20 billion next year.

Repayment should not be a problem. The liquidity positions of most banks are quite good thanks in part to financing provided by the central bank. In addition, the deposits of banks in the CBR exceed the minimum reserve requirements. Moreover, foreign assets exceed foreign debts, so the overall situation of the banking sector seems to be relatively good.

If problems do emerge, the CBR has declared it stands ready to provide support to banks as needed. The CBR has increased its repo financing to banks this year, as well as financing using non-marketable assets as collateral. At the moment, the CBR can grant credit to banks for up to twelve months. The government is currently considering other measures to support the banking sector.

During the 2008–2009 financial crisis, the Russian government and the central bank provided subordinated loans to large banks, including Sberbank, VTB, Gazprombank and Alfa. The Duma last month approved a law that allows the conversion of these subordinated loans into preferred

shares in order to increase bank capital. This increases the capability of banks to provide credit for domestic companies if their access to foreign financing is further reduced.

There is currently wide discussion in Russia on the possibilities of access to foreign credit on Asian markets. However, most also concede that the high uncertainty enveloping Russia is driving up borrowing costs everywhere. Moreover, any credit extended is likely to come with less favourable conditions than earlier.

State-owned banks continue to increase their dominance of Russia's financial sector. Although there are still over 900 banks operating in Russia, the banking sector is quite concentrated. A special feature of the sector is the dominant role of state-owned banks. The state or the central bank holds the majority of shares in Russia's six largest banks (combined assets amounting to 56 % of total banking sector assets). These six banks account for over 60 % of both household deposits and corporate credit in Russia.

Rankings 7 through 10 include three privately held domestic banks (Alfa, Otkritie and Promsvyazbank) and one foreign-owned bank (Italy-based UniCredit). Their overall impact on the sector is significantly lower than the top six banks. Together they represent just 7 % of total banking sector assets.

The market share of banks in which the state or central bank have majority ownership has increased in recent years due in part to the withdrawal of licences of a number of small private banks by the CBR. The CBR actions reflect a general clean-up of the banking sector to remove shady operations and banks that routinely violated banking regulations. State-owned banks have also increased their dominance in the banking sector through take-overs of troubled private banks.

Russian businesses already feeling sanction effects. Economic sanctions imposed on Russia by the EU and US have made many companies in the West cautious about investing in Russia. The French energy company Total last month suspended its planned acquisition of additional shares in Russia's largest private natural gas producer Novatek. Total, which currently holds just over 18 % of Novatek's shares, had planned to increase its stake gradually to 19.4 %. Novatek is now on the US economic sanctions list.

The US sanctions list also includes Rosneft, Russia's giant state oil company. Rosneft CEO Igor Sechin last week announced his company might have to postpone some planned projects due to the sanctions.

Several Western banks have limited their lending to Russian firms. In the second quarter, lending of foreign banks to Russia declined 42 % y-o-y. Bloomberg reports that no Russian firms were able to secure dollar, euro, or Swiss franc loans from international markets in July. It was the first such shut-out in at least five years.

China

IMF board encourages China to focus on debt issues and structural reforms. The International Monetary Fund last week published its annual Article IV report on China, which offers a comprehensive view on recent economic development and policy issues. The Fund predicts 7.4 % GDP growth this year and 7.1 % next year. Despite slowing GDP growth from 7.7 % in 2013, the unemployment situation has not deteriorated. 12-month inflation is also expected to remain around 2–3 % this year and next.

The IMF forecasts China's current account surplus will hold at around 2 % of GDP and estimates the yuan's real exchange rate (despite appreciating in recent years) still remains 5–10 % undervalued from a rate supported by economic fundamentals and optimal economic policy.

The IMF noted that the drop in investment efficiency, rising levels of indebtedness, income inequality and environmental problems continue to cloud China's growth outlook. Moreover, it warned that these factors could be interpreted as further reason to abandon the traditional investment-driven growth model and move to a model driven mainly by private consumption. The IMF board stresses that if China hopes to avoid a "hard landing" it needs to redouble its efforts to rein in debt and avoid fiscal stimulus measures unless confronted with a truly substantial slowdown in economic growth. The board further suggests a GDP growth target range of 6.5–7.0 % or even less would be fully appropriate for China at this point.

Although the IMF expects the Chinese government to hold its indebtedness risks in check over the short term, ongoing debt accumulation at the current pace threatens the country's economic prospects. Examining the last half century for analogues to China's current situation and drawing on the data for 43 countries, the IMF staff found only four instances of credit growth as high as growth of China's broadest definition of credit ("total social financing" or TSF) in recent years. In all four cases, the debt-bingeing countries succumbed to major banking crises within three years of their credit booms.

As a result, the IMF board encourages China's leaders to implement their ambitious reform plan introduced last autumn to get credit risk under control and adopt new drivers for growth. Reform of the financial sector includes a strengthened regulatory environment and supervision, freeing up deposit interest rates, increasing reliance on interest rates as an instrument of monetary policy and the elimination of implicit guarantees to various actors across the financial and corporate landscape. Reforms of state-owned enterprises, fiscal policy and social security are central themes of current reform policies.

Good statistical data are critical to monitoring economic developments and setting appropriate economic policy. Here, the IMF notes, China has plenty of room for improvement. The methodology for determining GDP volume is unclear and officials have yet to introduce the currently lacking quarterly GDP by expenditure figures. Statistical updates often appear without adjusting the earlier data series. Budget figures are particularly sketchy, making it difficult to make honest assessments of the public economy or debt levels.

Progress in reform of *hukou* household registration system. China's government last week issued a press release detailing some of the coming reforms to the household registration system (*hukou*). While the general outline of *hukou* reform was approved at last November's plenary session of the Central Committee, few details emerged thereafter.

A major thrust of the reform is to ease requirements for gaining urban *hukou* rights. Under the reform plan, migrant workers would get access to many benefits including healthcare and education. *Hukou* restrictions will be eliminated altogether for small cities (population under 500,000). In mid-sized cities (0.5–1 million inhabitants), the applicant for *hukou* rights must demonstrate that they have an apartment and a permanent job. In larger cities (1–3 million inhabitants), officials may demand further proof of domicile intent such as length of service with current employer. Officials could modify requirements in response to migration pressures in the jurisdiction. The goal of such rule-making is to balance migration trends to small and large cities.

The *hukou* rules for China's largest cities (over 5 million population) will remain quite strict. To earn *hukou* rights in a big city, the applicant must achieve a certain score based on overall suitability. The point scheme favours highly educated professionals with international experience.

Many local administrations oppose the reforms, which they say will increase their budget spending. Their responsibilities will increase due to additional investments in e.g. healthcare and educational services. Many local administrations are already deeply in debt, so implementation of further investment would require local administrations to broaden their financial bases further.

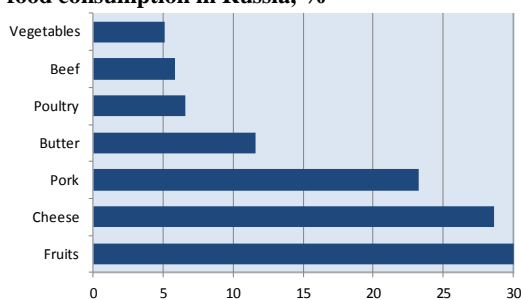
The current household registration system has not prevented rural Chinese from leaving their homes to seek jobs in the cities. Over half of the Chinese population now lives in cities, but only a third has *hukou* rights to live in a city. By current estimates, 250 million urban-dwellers are excluded from healthcare services and social benefits. Many are forced to save most of their income for future expenses, which, in turn, likely hampers progress in structural changes needed to transition China to growth model driven by private consumption (see [BOFIT Discussion Paper 7/2014](#)). Reform of the *hukou* household registration system would encourage private consumption.

Russia

Food import ban and Russia's food supply security. On August 6, President Vladimir Putin imposed a ban on imports of farm produce and foodstuffs from the EU, US, Norway, Canada and Australia. The ban includes poultry, pork, beef, fish, dairy products, fruits, vegetables and some processed foods. The ban is initially set to last for a year, but the government may revise its duration depending on the situation. The import ban does not apply to baby foods or food imports for private consumption. Under Russian customs rules, a private person may bring in goods duty-free up to €1,500 in value or a total weight of 50 kilograms.

The value of imported food items falling under the ban last year amounted to over \$9 billion, about 7 % of Russia's goods imports. Russia plans to replace the banned import foodstuffs with imports from other countries and increased domestic production. Substitution of certain products will be challenging – banned imports account for as much as 30 % of Russian consumption in certain product categories.

Contribution of banned imports by category relative to total food consumption in Russia, %



Sources: Rosstat, UN Comtrade

Proposals to modify the list of banned imports are already under consideration. Vice premier Arkady Dvorkovich says products for special diets (e.g. lactose-free milk) and basic inputs (e.g. seed potatoes) could be removed from the list in a few days as the domestic supply of such products is inadequate. There are also demands for new additions to the list. Russian fish producers, for example, would like to see canned fish on the banned product list.

Russia has long sought to boost its food self-sufficiency through measures such as its national food security programme. A report published this year by an economic research institute under the presidential administration noted that domestic grain and potato production already exceed domestic consumption. The report further found that, while self-sufficiency in meat production improved in recent years, it is still well below the government's 85 % goal. Dairy production, which remains well below the official 90 % self-sufficiency target, has seen the share of imports even increase slightly in recent years.

Observers say import ban may stoke Russian inflation.

Temporary shortages of certain food items on the Russian market and higher costs of transport and finding alternative suppliers are likely to have an inflationary impact. A number of research institutions have already raised their inflation target for Russia, with the consensus outlook now averaging 7–7.5 % for this year. Next year's inflation is now expected to remain at the 2014 level, or even accelerate in response to higher taxes, planned increases in utility rates and rail freight fees, possible further weakening of the ruble and the ban on agricultural imports. The CBR and government have yet to modify their official inflation target ranges of 6–6.5 % this year and 4.5 % next year.

The government has launched a monitoring of prices in 40 food categories. Food chains are required to report their prices to regional officials on a regular basis, and inspectors must conduct on-site checks in stores and at outdoor marketplaces. The ministries of agriculture and industry and commerce as well as the Federal Antimonopoly Service will coordinate food price oversight. They are tasked with affecting market conditions through regular discussions with producers and retailer/wholesaler representatives.

Belarus and Kazakhstan stay on the sidelines in Russia's food fight with the West.

On August 7, Russian president Vladimir Putin discussed with Belarus president Alexander Lukashenko and Kazakhstan president Nursultan Nazarbayev the possibilities of coordinating their trade policies with Russia's ban on food imports. Lukashenko and Nazarbayev declined participation in the import ban. Both countries are also continuing to trade with Ukraine under their free-trade agreement, despite Russia's June imposition of duties on Ukrainian trade in response to Ukraine's EU association agreement and its request that Belarus and Kazakhstan revoke their free-trade agreement with Ukraine. Members of the Russia-Belarus-Kazakhstan customs union are committed in principle to harmonising their trade policies.

Lukashenko assured Putin no goods subject to the import ban would be permitted to transit Belarus to Russia. Belarus is an important supplier of farm produce to Russia, and will likely benefit from the import ban. Current ministry-level talks between the two countries are aimed at raising quotas on agricultural products imported from Belarus. Belarus can still sell food products in Russia even if ingredients imported from the West are used, while Russian firms may not import raw ingredients from the West.

Belarus farm subsidies are the highest in the customs union. This has aroused dissatisfaction among Russian producers, leading Russia in some cases to impose restrictions on imports based on health and food safety risks. Under the constitution of the Eurasian Economic Union, which comes into force next year, Belarus commits to reducing agricultural subsidies to 10 % of the value of its agricultural output by 2016.

China

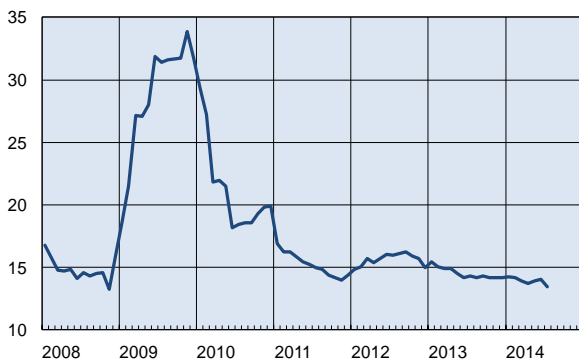
Credit growth in China slows; real economy indicators suggest more balanced growth. July credit stock growth amounted to 385 billion yuan (€47 billion), and the volume of new bank loans in July fell to its lowest level since 2009. The credit stock increased just 0.5 % for the month, with on-year growth slowing to 13.4 %. Growth of the broad money supply (M2) decelerated in July to 13.5 % y-o-y. Lower borrowing demand reflects in particular the slowdown in the real estate sector. The People's Bank of China was quick to comment that July's weak credit demand was not the result of changes in monetary policy, and that the volume of new loans issued had picked up in the first week of August.

The July economic figures indicated more balanced growth. Industrial output increased 9 % y-o-y, down from 9.2 % in June. Consumer demand remained at the same level as in previous months, with the value of retail sales increasing 12.2 % in July. While the manufacturing purchasing manager index (PMI) suggested an improving growth outlook for new domestic and foreign export orders, the outlook for service companies is deteriorating. Construction firms also expect lower growth than in the first half.

Investment growth seems to be slowing. Fixed capital investment (not including rural households) remained at 17 % y-o-y in the first seven months of the year, down from over 20 % in the same period last year. The biggest slowdown was seen in growth of real estate investment.

Price inflation held steady in July, with consumer prices rising at 2.3 % y-o-y and producer price deflation slowing slightly to 0.9 % y-o-y. Consumer price inflation has remained below the government's official target ceiling of 3.5 % this year. While low inflation provides China's monetary authorities with an opportunity for policy relaxation, the rising indebtedness of firms and local governments puts severe limits the range of available measures.

12-month growth in credit stock, %



Source: Bloomberg

China's trade surplus hits record high in July. Goods exports staged remarkable gains in July, amounting \$213 billion (up 15 % y-o-y). At the same time, the value of goods imports contracted 2 % to \$166 billion. Driven by record export demand, China's trade surplus hit \$47 billion.

Major gains in exports to the EU (up 17 % y-o-y) and the US (up 12 %) were seen in July. Import growth was dragged down by the demand for raw material inputs, particularly oil and coal. Foreign trade trends overall have been more balanced in 2014. The value of exports in January-July increased 3 % y-o-y and the value of imports 1 %.

Foreign firms investigated under China's anti-monopoly law; EU Chamber of Commerce calls for equal treatment of all companies. China's competition authorities have launched a number of investigations of foreign firms across China under the auspices of the Anti-Monopoly Law (AML). Officials suspect targeted firms of AML violations such as abuse of dominant market position and price gouging. While the EU Chamber of Commerce in China has repeatedly called for Chinese officials to effectively enforce the AML, Chinese authorities have only applied AML rules sporadically since it went into force in 2008.

In a [press release](#) published Wednesday (Aug. 13), the EU Chamber of Commerce in China insisted on fair and consistent implementation of the AML, noting that Chinese officials have not targeted domestic firms in a similar manner. The Chamber said that in certain joint ventures involving a foreign and a domestic partner, *only* the foreign partner has been investigated. Although there have been investigations of Chinese firms since the AML was enacted, the special status and benefits enjoyed by state-owned enterprises have remained largely unchallenged.

China's commerce ministry denies that it discriminates against foreign firms and assures that the same rules apply to Chinese and foreign firms. Commerce ministry officials say the investigations have been motivated largely by needs to protect consumer interests and promote fair competition.

Among the investigation targets, China's competition authorities have focused on foreign carmakers for price gouging practices. They say that many of these manufacturers' products and spare parts are priced higher in China than elsewhere. The EU Chamber of Commerce in China responds that taxation and distribution chains, among other things, add to costs in China. In response to the investigations, some carmakers have lowered their prices to avoid sanctions for AML violations.

Foreign firms have long found the Chinese regulatory environment problematic. The latest American Chamber of Commerce in China survey found that companies list regulatory uncertainty among the biggest challenges in doing business in China. The latest round of official investigations could further increase such uncertainty.

Russia

GDP contracted in first half of 2014. Rosstat's preliminary estimate for GDP growth in the second quarter of this year is 0.8 % y-o-y. Comparable growth in the first quarter was 0.9 %. Nevertheless, development has weakened from last year, with seasonally adjusted GDP now estimated to have been slightly lower in the first half of this year than at the end of 2013.

Output of the five core sectors of the Russian economy (industry, agriculture, construction, retail sales and transport) in the first and second quarters increased just 0.3–0.4 % y-o-y. GDP growth has thus largely been driven by other sectors such as services, real estate and certain public sector branches.

Change in the volume of GDP and output of five core sectors, % y-o-y



Source: Rosstat

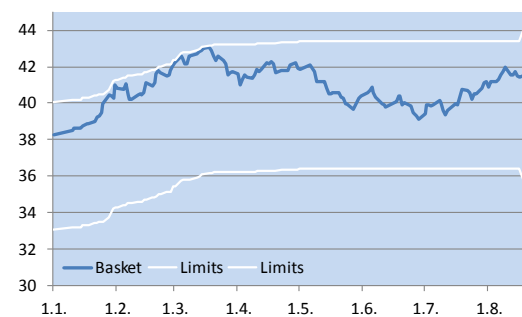
Free-floating ruble almost a reality. The Central Bank of Russia further relaxed its ruble exchange rate steering mechanism on Monday (Aug. 18). Steering is based on reacting to fluctuations in the exchange rate relative to a dollar-euro currency basket. The first change is that the fluctuation band limits governing the CBR response has been widened from two to nine rubles. Second, as long as the currency basket rate is within the allowed fluctuation range, the CBR will now abstain entirely from market operations to affect the ruble rate. (The central bank earlier also intervened to some extent within the fluctuation band). Third, less appreciation or depreciation pressure on the ruble will now be sufficient to move the entire band up or down. The measures will further increase the ruble's freedom of movement.

The changes are in line with the CBR policy of past couple of years to shift incrementally to floating ruble. The CBR confirmed it will cease steering the ruble's exchange rate by the end of this year, which will enable it to focus on achieving its inflation target. A floating exchange rate also allows the central bank better possibilities to influence financial market liquidity through interest-rate policy.

While the markets have doubted the CBR's commitment to free-float of the ruble amidst the current political and economic turbulence, the latest changes have largely erased this scepticism. The CBR has stated, however, that it still may support the ruble in exceptional circumstances.

When the Crimean crisis flared in March, the CBR intervened extensively in the currency markets, selling more than \$26 billion of its currency reserves in a month to prop up the ruble. Although the currency reserves have declined this year, they remain substantial. They stood at \$479 billion at the end of July, down from \$510 billion at the start of the year. The CBR has stayed out of the market entirely since late June, i.e. the ruble has *de facto* floated freely for the past eight weeks.

Ruble/currency-basket rate and fluctuation band limits, Jan. 1–Aug. 21, 2014 (rising trend indicates weaker ruble)



Source: Central Bank of Russia

Russian imports down in first half. The value of goods imports in the first half fell to \$153 billion, a drop of about 5 % y-o-y. Imports contracted in nearly all product groups on sluggish demand, ruble weakness and tighter credit markets. About half of Russia's imports consisted of machinery, equipment and transport vehicles, with the volume of imports from non-CIS countries contracting by 10 % y-o-y and even more sharply from the CIS countries mainly due to the Ukraine conflict. Metal imports also plummeted. The value of Russia's food imports in January-June was unchanged from 1H2013. Considerably less pork meat was imported than a year ago from both CIS and non-CIS countries. Imports of milk and dairy products rose substantially.

The value of Russian good exports increased just over 1 % y-o-y to \$256 billion. The bulk of export growth came from major increases in exports of petroleum products such as gasoline. Crude oil exports declined from a year earlier.

The EU accounted for half of Russian goods trade, APEC countries about a quarter and the CIS countries 13 %. The biggest drop in Russian trade volume was registered with the CIS countries.

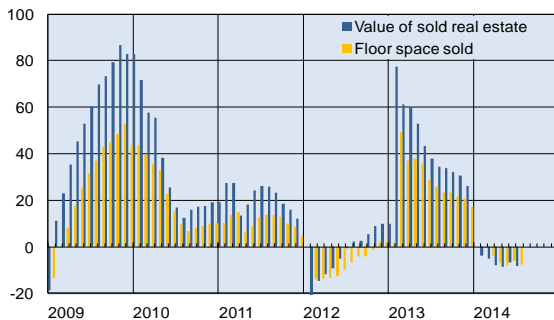
The Russian government informed on Wednesday (Aug. 20) on products taken off the banned import list. Following to proposals brought up last week, e.g. non-lactose dairy products and seed potatoes were removed from the list.

China

Weaker outlook for China's real estate sector. China's property markets have cooled significantly in recent months. The National Bureau of Statistics reports the real estate sector posted 14 % y-o-y growth in the first six months of the year, down from over 20 % growth in 2013. The number of new real estate ventures has fallen sharply on market sluggishness. The volume of new housing starts measured in terms of floorspace was down 13 % y-o-y in January-July.

Uncertainty over housing price trends has driven investors to the sidelines. The NBS index shows prices of new and existing apartments fell on average about 1 % m-o-m in July. Many local governments have rushed to deal with the price drop e.g. by relaxing restrictions on apartment ownership to bolster housing demand and construction activity. With both builders and buyers gripped with uncertainty, the number of finalised apartment sales dropped throughout the first seven months of this year.

12-month change in real estate sales, %



Source: Macrobond

The regional differences in real estate trends are substantial. Real estate sales in western and central provinces are largely unchanged from last year in terms of floorspace sold. In the eastern parts of the country, real estate sales have plunged (down 15 % y-o-y in July). The goal of China's urbanisation strategy to channel the influx of population from the countryside to smaller cities further shapes regional trends in the future.

A recent Standard Chartered Bank survey found that real estate developers' confidence towards future housing demand has deteriorated. Moreover, the majority of firms responding to the survey reported that their financing costs have risen and that they now have greater difficulty in acquiring loans.

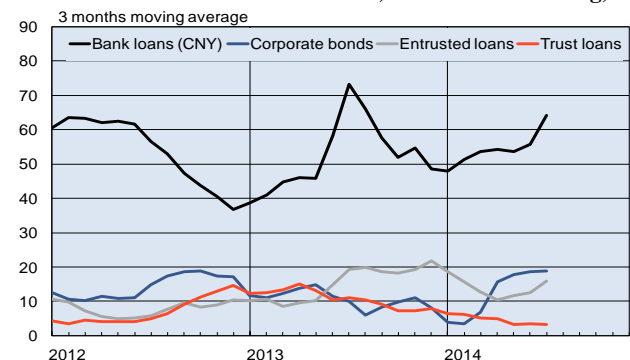
With many property holding companies carrying great amounts of debt, falling housing prices and higher credit costs could deliver great stress to the entire sector.

Small firms, in particular, lack access to cheap credit, so even a modest dip in cash flow may create large problems. Such a situation was seen earlier this year when the construction firm Zhejiang Xingrun defaulted on its scheduled bank loan payments.

China's financial markets see increased popularity of bonds as a means of financing. People's Bank of China figures show bond financing gained share in China's financial markets over the current year. Bonds now account for nearly 20 % of new credit issues, up from about 10 % a year ago. The share of bank loans has again started to rise since the beginning of the year, with the current ratio standing at about 60 % of new loans to corporations and households.

Official figures suggest that the role of China's shadow banking (off-balance-sheet financing activity and financing outside the formal banking sector) has shrunk over the past year. The share of new lending originated from trust companies has halved this year to slightly over 3 %. Trust loans are funded by collecting funds from firms and private individuals via commercial banks. Last spring, the China Banking Regulatory Commission (CBRC) tightened its rules for trust company asset management products. The move was designed to reduce risks arising from such off-balance-sheet lending. Problems in China's real estate sector may also explain some of the drop in demand for trust loans. Some real estate developers report that their access to trust loans has become more difficult recently.

Bank loans and other credit formats, share of new lending, %



Source: Macrobond

Regulation will play a central role in development of China's financial markets. Officials this year have given the go-ahead on issuance of various types of debt securities, which may explain some of the increased popularity of bonds among investors. The trend follows a familiar pattern seen in previous years, i.e. new, less regulated financing modalities take off as officials attempt to limit the growth in traditional bank lending. Put simply, regulation in one sphere channels demand to alternative forms of finance.

Russia

Russia's economy ministry lowers growth forecast for 2015. While the ministry reiterated its forecast of 0.5 % GDP growth for 2014, it lowered the growth projection for next year to 1 %, a considerable reduction from its previous forecast. Growth in retail sales next year is foreseen to slow to about 0.5 %, while fixed investments would increase by 1.5 % on a recovery from this year's dip of a couple of per cent. The economy ministry expects a nearly 8 % contraction in Russia's imports this year – deeper than earlier forecast – and a rebound of less than 1 % next year. The inflation outlook, on the other hand, has been raised to over 7 % at year's end and 6.5 % at the end of 2015.

Government budget framework 2015–2017 anticipates only slow growth in several major spending areas, save defence. Total government spending (federal and regional budgets, plus state social funds) under the cabinet-approved policy framework, which forms the basis for further annual budgeting processes, is projected – after next year's surge – to increase with only a pace that matches consumer price inflation. In fact, spending overall and spending in several major categories could decrease in *real terms* as consumer prices to date have been rising notably more slowly than prices of public consumption and capital investment. At the same time, there are larger differences among the various spending categories than in previous years.

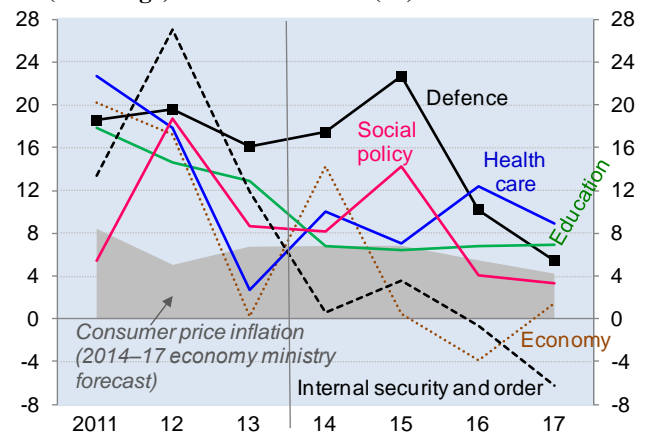
Defence spending, which has risen swiftly in recent years, shows accelerated growth this year and next. Defence spending will rise to nearly 11 % of total government spending or about 4 % of GDP. Spending on internal security and order will decline in real terms already this year following large increases in recent years, especially wage hikes. Social spending will climb briskly next year, mainly on higher expenditure on pensions. Pensions and other forms of social security will continuously consume about a third of all government spending and equal some 12 % of GDP.

The finance ministry expects increases in healthcare spending to improve in 2016–2017 after relatively slow growth in 2013–2015. Growth in spending on education will remain more modest. Combined spending on healthcare and education will increase slightly as a share of total government spending, staying above 20 %, and correspond to just over 8 % of GDP.

Government spending on various sectors of the economy will decrease a lot in real terms, including categories such as roads and other transport. The downslide will be offset slightly by long-term loans from the National Welfare Fund to finance major transportation infrastructure projects. There is also an effort to increase government guarantees mainly granted for loans from state banks to state-owned

enterprises, such as the defence industry. In addition, Russia's ban on imports of many foodstuffs and agricultural inputs is bolstering efforts to achieve food self-sufficiency, and assessments circulating e.g. in government circles suggest government funding will be needed for that purpose.

Actual and forecast government spending in major categories (% change) and inflation rate (%)



Sources: Finance ministry, Rosstat, economy ministry

Lean times continue for regional budgets in years ahead. The finance ministry's assessment in the government budget policy framework for 2015–2017 sees revenues to federal and regional budgets (including transfers from the federal budget) will barely keep up with inflation. Growth in regional budget revenues declined to the inflation rate in 2012, and revenues to both federal and regional budget levels grew far slower than inflation last year. The federal budget this year has gotten some temporary respite through dollar-denominated taxes and export duties on oil as the ruble has been weak compared to last year. Regional budget revenues, however, will grow at rates well below inflation even this year.

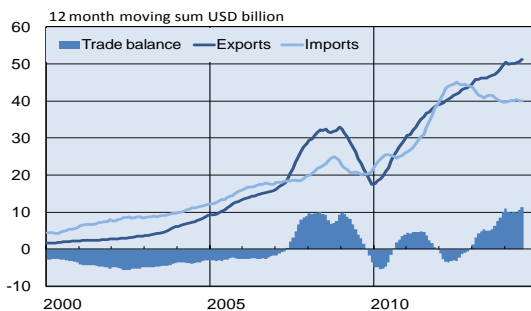
In the next few years, growth in regional budget revenues will be partly constrained by reduced transfers from the federal budget. Instead, the federal government will increase contributions to the Pension Fund. Other federal spending growth will only keep pace with inflation.

The finance ministry expects regional budget spending will grow even a bit more weakly than federal spending while regional budget deficits increase slightly to just over 1 % of GDP. The finance ministry also expressed concerns about the problems for regional budgets under the policy framework. It plans actions to reduce regional budget deficits to around 0.5 % of GDP. Besides possibly allowing regions to impose a sales tax, the ministry proposes restrictions on public sector wage hikes and regional administrative spending, as well as granting regions the right to limit social entitlements on the basis of need. The finance ministry also wants tighter limits on regional and municipal indebtedness, borrowing volumes and debt servicing costs.

China

Fossil fuels continue to dominate and govern outlook for Chinese imports from Russia. While China's exports to Russia have enjoyed robust gains, China's imports from Russia have been flat in recent years. In keeping with this trend, the value of China's exports to Russia increased about 6 % y-o-y in the first seven months of 2014, while imports from Russia increased less than 2 %. Russia accounts for just over 2 % of China's total exports and imports. Although Russia has gained in its share of China's exports a bit, Russia's share of China's total imports has decreased slightly.

China-Russia trade 2000–2014, USD billion



Source: CEIC

Imports from Russia remain driven by increasing import volumes of Russian crude oil. In the first seven months of this year, China's oil imports from Russia were up about 20 % y-o-y. China currently imports about 27 million metric tons of crude oil a year from Russia, or about 10 % of China's total oil imports. Crude oil and petroleum products accounted for over 70 % of China's imports from Russia and raw timber and other primary forest industry products nearly 10 %. When base metals and other goods with low degrees of processing are included, such commodities represent over 90 % share of what Russia sends to China. Goods in the machinery & equipment and transport vehicle categories together represented just 1 % of China's imports from Russia.

China's exports to Russia, in contrast, represent a great diversity of goods. Some 30 % of exports to Russia from China come from the machinery & equipment category. Textiles, clothing and footwear made up over a quarter of exports. Base metal products and plastic products both constituted over 5 % of China's exports to Russia. Transport vehicles now account for nearly 6 % of exports to Russia. China exports about 60,000 passenger cars a year to Russia, which represents about 15 % of China's total car exports.

Russia's trade with China is structurally similar to that of Russia's other main trading partners – raw materials are imported from Russia and finished goods exported to Rus-

sia. Under last year's Rosneft-CNPC long-term crude oil supply deal, the volume of China's oil imports from Russia should increase substantially in years ahead. A China-Russia gas deal signed in May opens an import route for Russian gas to China by the end of the decade. There are no indications of any further diversification of Russian exports to China.

While Asia and China provide natural export markets for Russian commodities, there are no signs of deeper integration. Russia's inward looking, statist and highly protectionist policies have made it almost impossible for Russia to adjust its production structure and integrate into the global economy. Asian markets have not offered and will not offer Russia concessions in the ground rules of global trade and economic integration.

China strives for improvements in healthcare through reduced regulation and greater public financing.

The commerce ministry reports China will permit 100 % foreign-owned hospitals in seven trial areas, including Beijing, Shanghai and Tianjin. As a general rule, foreigners are not allowed to own more than 70 % of a hospital. The pilot programme is designed to increase hospital access in larger metropolitan areas with long wait-times for medical attention. Chinese officials also hope that less regulation will increase competition between the private and public sector, and encourage technology transfer to China.

Commerce ministry figures show that while only a very modest amount of foreign investment goes to the healthcare sector, the rate of growth of foreign investment has taken off. A recent survey by the EU Chamber of Commerce in China noted that European firms involved in healthcare delivery have been relatively successful in China. This might arouse further investor interest in the future.

China's rising wealth and aging population make higher public healthcare spending inevitable. The urbanisation process also drives demand for more services by bringing more people closer to healthcare services. The finance ministry reports that China spent 550 billion yuan during January-July on public healthcare, a 20 % increase from the same period a year ago. Healthcare now accounts for 7 % of public sector spending.

OECD figures show China's private and public healthcare spending in 2012 equalled 5.4 % of GDP (OECD average 9.3 %). The health ministry says China should boost spending on healthcare to 7 % of GDP by 2020. Additional investment is needed, however, as the country has relatively few doctors per capita by international standards; about 1.6 doctors per 1,000 persons (OECD average 3.2).

There is room of improving efficiency in healthcare delivery. According to some estimates the occupancy rates of hospital beds in smaller townships are often below 50 %, while there is a huge lack of bed space in larger cities. Better use of healthcare resources is a primary reason China wants to direct internal migrants to smaller cities.

Russia

Russian investments in energy and housing increased.

The decline of a couple of per cent in total investments during the first six months of this year was due to investments by small businesses and the grey economy. Investments of large and mid-sized firms, households and the government, as reported together, increased by nearly 3 %, even if government investments continued on the same downward track as last year. This situation differs from 2012 and 2013, when investments of large firms stumbled.

Investments of large energy firms, in particular, revived from last year's slump. Improvements were seen across the board in oil and gas production, pipeline transmission and the electrical power sector.

As in 2012 and 2013, investments in oil refining continued to boom (up about a quarter from a year earlier), boosting overall growth in manufacturing investments. Among the large branches, investments in manufacturing of transport vehicles and food processing also experienced strong growth.

Growth of real estate investments gained speed largely due to an exceptional increase in housing construction activity. New apartments completed in January-June, measured both in terms of the number of apartments completed and new floor space, was about a third greater than in 1H2013. Defying the general slowdown in household borrowing, demand for housing loans remained strong in the first half. Observers suggest that households drained their savings accounts to buy apartments in response to higher inflation. Construction of other private housing was also up sharply.

However, the contraction in investments in machinery and equipment, which began last year, continued in the first half. This does not bode well for the prospects for economic growth.

Finnish-Russian trade declined in first half. The value of Finnish goods exports to Russia in the first six months of this year amounted to €2.3 billion, a 12 % drop from 1H2013. Exports contracted substantially in the beginning of the year due to a weaker ruble, but in the spring months the pace of contraction slowed down. Russia remained Finland's third largest export market, even if its share of Finland's total goods exports shrank to 8 %.

Increased uncertainty over economic trends and tighter financial situation strongly impacted demand for investment goods and durable goods in Russia. This was reflected in Finnish exports to Russia; in the biggest export product categories, metals and machinery exports contracted most severely. On the bright side, the value of exports of electrical equipment increased some 20 % y-o-y and the value of foodstuffs over 1 %.

Russia's feeble growth has also carved into road freight transit from third countries passing through Finland to Russia. Transit road freight fell by about 20 % y-o-y in the first half. The biggest drops were registered in transit shipping of machinery & equipment and automobiles.

The lack of gains in disposable income of Russian households and the ruble's slide have placed a damper on the travel plans of Russians. The number of Russian travellers spending the night at Finnish inns and hotels fell 13 % y-o-y in the first half.

The value of Finland's goods imports from Russia contracted in January-June by 10 % y-o-y to just under €4.7 billion. The main cause of the decline was the lower value of mineral fuel imports (mostly oil). Russia, however, was still clearly Finland's largest provider of goods imports (16 %).

Ukraine does its best to comply with the terms of the IMF support programme. Prior to release of its second loan tranche to Ukraine, the IMF board last week concluded a review of the country's on-going recovery programme. The IMF conceded that two of the major downside risks to the programme's success had materialised. The crisis in eastern Ukraine has deepened, and following an impasse in negotiations between Naftogaz and Gazprom, gas supplies were shut down by Gazprom in June. The IMF said the planned releases of funding under the programme (provided by the IMF and other international partners) should be sufficient to cover the country's needs for the next twelve months. The IMF further noted that if the Ukraine conflict does not subside in coming months as assumed, more funding would be needed.

Ukraine was granted waivers for non-observance of the combined deficit ceiling for the public sector (includes state gas company Naftogaz) as well as the central bank's currency reserve target. The IMF board decided to ease certain targets for this year somewhat given commitments by Ukraine to take additional measures to reduce its public sector deficit next year to below 6 % of GDP (down from the forecast 10 % this year). For this purpose, Ukraine will step up collection of Naftogaz gas bills domestically and reduce spending on public sector wages and pensions (both wages and pensions could shrink by over 10 % in real terms).

The IMF expects Ukraine's GDP to shrink 6.5 % this year on lower private consumption, capital investments and exports. GDP in eastern Ukraine is forecast to fall by 15–20 %. Fixed capital investments will amount to just 8 % of GDP. Inflation is forecast to reach nearly 20 % by the end of this year, due in part to depreciation of the hryvnia's exchange rate. The IMF sees the hryvnia falling 20 % in real terms this year. Ukraine's current account deficit will only amount to a couple of per cent of GDP, as imports will fall about one fifth. The net outflow of capital from Ukraine would exceed previous forecasts.

China

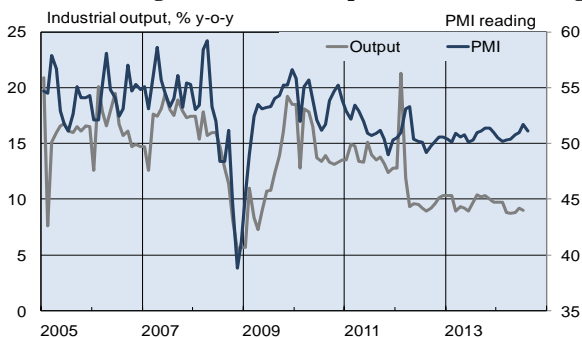
Stimulus demands unsupported by economic indicators.

Despite headlines calling for stimulus measures and usual market reactions, the manufacturing and services purchasing manager indices released early this week suggest no marked changes in China's economic situation. China's economy remained on a steady keel in August with the manufacturing PMI for the month dipping slightly to 51.1 and the services PMI nudging up a bit to 54.4. A PMI value above 50 indicates a perceived expansion in seasonally adjusted output in the survey month relative to the previous month.

China's manufacturing and services PMIs have been in their current levels since 2012. At the same time, output growth has slowed modestly without any indication of increasing unemployment (see figure). It may be that the current levels of PMIs simply illustrate a natural slowdown of economic growth is underway and that there is no reason to expect a "rebound" in these indicators or the real economy as many still assume.

If the current pace of growth is sufficient to sustain employment, there is no need for stimulus that would increase debt levels. Instead of stimulus, the present situation allows the government to focus on further debt accumulation and move ahead with structural reforms.

12-month change in industrial output and manufacturing PMI



Source: Macrobond

China's revised budget law allows local government to borrow. Last Saturday (Aug. 30), the Standing Committee of the National People's Congress approved amendments to the budget law that included granting local governments the power to issue bonds. The revised law abolishes the balanced budget requirement under the 1994 budget law that drove many local governments to engage in off-balance sheet borrowing. The central government retains authority to monitor debt acquired by local governments, and local bond issues still must be approved by the State Council. The move extends a finance ministry trial programme that allowed select local administrations to issue debt securities. The revised budget law enters into force in January.

The balanced budget requirement drove many local governments to use off-budget financing entities. When the central government tried to rein in the local government borrowing through these financing entities, locals turned to the less regulated shadow-banking sector for loans. By some estimates, about a quarter of assets raised from the shadow-banking sector are lent to local governments. Access to credit through official channels under the new law should lower the borrowing costs of local governments.

Beyond improved transparency of local government finances, the revised law strives for greater market discipline. The ability of investors to appraise the creditworthiness of local governments remains unclear, however.

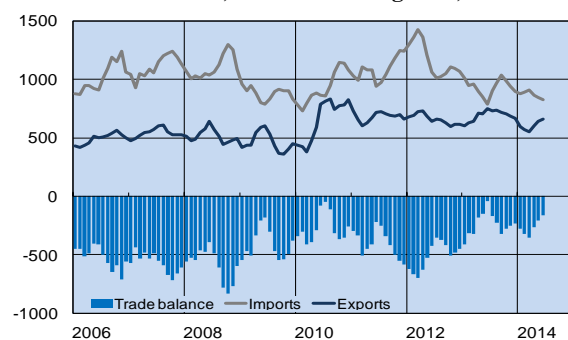
Finnish exports to China declined in first half. Finnish Customs reports that goods exports from Finland to China in the first six months of 2014 were worth €1.2 billion, a 12 % drop from 1H2013. Lower prices sharply reduced the value of fur exports in the first half to €103 million, down by €128 million from 1H2013. Exports of paper machines and related equipment fell 70 % to just €47 million.

Imports from China returned to growth in the second quarter, but the first half total of €1.7 billion in imports was slightly less than for 1H2013. Clothing and footwear imports (16 % of all imports) fell 5 % y-o-y in the first half. Imports of phones (12 % of imports) and computers (10 % of imports) fell about 10 %.

The slowdown in exports boosted Finland's trade deficit with China to €513 million in the first half. Chinese customs authorities report a trade surplus with Finland of \$421 million (€310 million) for the period. The discrepancy however has narrowed in June at the month-to-month level. China's figures for early 2014 show some months in balance and even deficits with Finland, while the Finnish figures show China running a surplus every month.

The number of Chinese tourists coming to Finland continued its steady rise, even though Chinese only comprise a small share of visitors to Finland. Chinese tourists racked up 51,000 overnight stays in Finnish inns or hotels in the first half, about 2 % of foreigners' overnight stays in Finland.

Finland-China trade, 3-month moving total, EUR million



Source: Finnish Customs

Russia

Food prices in Russia up sharply. Although August consumer price inflation only picked up slightly from July to 7.6 % y-o-y, food prices climbed 10.3 %. Prices of non-food goods were up just 5.5 % y-o-y and services 6.7 %.

Prices of most food items rose, and in some cases extremely fast. Indeed, the surge in food prices was only constrained by the seasonal drop in prices of fruits and vegetables. The largest price gains were posted for meat and fish. Meat prices were up 2.5 % y-o-y and fish 1.4 %. Meat and fish prices have risen rapidly for some months already. The rise in meat prices is due in part to Russia's ban in January on pork products of EU origin. The reduced supply on the Russian market has driven up pork prices, as well as other meat alternatives such as chicken. There was also a sharp rise in prices of milk and dairy products in August.

The ban on food imports imposed last month has yet to cause shortages of products in the banned categories, with the exception of unprocessed fish. Therefore, the direct effect of the ban on inflation has been limited. The ban has, however, boosted inflation indirectly by e.g. encouraging domestic producers, merchants and foreign supplies unaffected by the ban to raise their prices. In the future, the ban is expected have a bigger inflationary impact. There were already signs in the first week of September that inflation was running significantly higher than in August.

Officials regularly review retail prices to prevent price gouging. The Federal Antimonopoly Service (FAS) has opened a hot line that allows people to report on food prices. The FAS is currently investigating sharp hikes in fish and poultry prices.

Experts weigh in on 2015 budget options. The government is currently reviewing next year's federal budget draft. Although the basic budget framework has been agreed upon in principle, the challenges of matching revenues with ever-increasing spending needs has fostered conflict. Prime minister Dmitri Medvedev last week summoned together Russia's leading economists and cabinet ministers involved with economic issues to discuss the available fiscal policy options.

The prime minister wanted to hear the economists' take on the economy ministry's assertion that fiscal policy needs to be relaxed under the current circumstances. The proposal would require the government to abandon its budget rule, which places a ceiling on the federal budget deficit of 1 % of GDP. The economy ministry says that allowing a larger budget deficit would make available budget assets that could be spent on stimulating economic activity. Nearly all experts present said it would be better to stick to the budget rule as it forms the basis of public sector stability.

The invited experts were divided on Medvedev's question as to whether tax hikes were in order. One group felt that taxes should not be raised, noting that the government has committed publicly to holding the line on the overall tax burden. Others felt that tax hikes were necessary in the current situation to cover rising expenditures, but the tax hikes should be smaller than the government initially proposed. The economists were united in their opposition to the proposed new sales tax. They said it would be wiser to slightly raise the value-added tax.

A number of experts said the preferred option would be to keep the budget rule and tax rates in place, and instead make efforts to rationalise budget spending. Savings could be garnered, for example, by making public-sector operations more efficient, including reducing fringe benefits and wage hikes and improving administration of public procurements. The cabinet is currently preparing plans to make investments especially in food production and weapons development in order to enhance domestic production to substitute for imports. The experts warned that such investment should not raise budget spending, but should be funded though redirected spending.

CBR and economy ministry divided over monetary policy. The economy ministry's criticism of the central bank intensified this summer after the CBR raised its key rate in July by a half percentage point to 8 %. Hackles were further raised by the fact that the CBR raised rates without first consulting the government. The CBR justified the rate hike, citing the inflationary pressures created by e.g. the tense international climate and the government's planned tax hikes next year.

CBR first deputy chairman Ksenia Yudayeva remarked that the government should pay attention to the inflationary impacts of any decisions regarding taxes. Yudayeva said that if the government decision on taxes leads to higher inflation, the CBR would have to assume a tighter monetary stance, even if it negatively impacted economic growth.

The economy ministry responded that a more relaxed monetary stance is needed to promote economic recovery. Economy minister Alexei Ulyukayev proposed to president Putin that the economy ministry, finance ministry and CBR jointly decide the inflation target. Putin accepted Ulyukayev's proposal at the end of August. The economy ministry and finance ministry are already heard by the central bank when it prepares its policies as both ministries have consultative representation at the CBR board.

It remains to be seen whether the new approach will influence CBR monetary policy. The CBR has a fixed medium-term inflation target of 4 % with a 1.5 percentage point deviation up and down. The economy ministry wants the inflation target to be adjusted in response to changes in economic circumstances.

China

China further relaxes capital controls. China's commerce ministry has announced an easing of the rules for Chinese firms investing abroad from the beginning of October. Capital investment projects of \$100 million or more will be freed altogether from the permitting process, and the ministry will only require permits for investments in countries subject to UN export restrictions or from companies involved in businesses subject to government export restrictions.

Both the commerce ministry and the influential National Development and Reform Commission (NDRC) regulate foreign investment of Chinese firms. Under new NDRC rules set forth last April, foreign investments of under \$1 billion only need to be declared, while investments of \$1–2 billion require NDRC clearance and all investment above \$2 billion must be approved by the Chinese government.

The volume of capital flows in October will be further boosted by "Shanghai Hong Kong Connect," an arrangement that lets foreign investors trade in yuan-denominated A-shares on the Shanghai stock exchange via the Hong Kong stock exchange. The mechanism also permits investors in mainland China to trade in H-shares of Chinese companies denominated in Hong Kong dollars (HKD) on the Hong Kong exchange. It provides a new channel for investment in parallel with current qualified institutional investor programmes (QFII, RQFII, QDII), even if share-trading under the arrangement is restricted by quotas.

Growth of China's foreign trade slowed in August on falling commodity imports. Goods imports declined in August by 2 % y-o-y to \$159 billion. Imports from Japan fell 5 %, while imports from the US were off 3 %. Imports from EU countries rose by 4 %. Imports from Germany, in particular, remained strong (up 11 %).

The value of August exports exceeded \$208 billion. Although export growth slowed in July, they were still up 9 % y-o-y. As a result of declining imports and rising exports, China's trade surplus hit a monthly record of nearly \$50 billion. Exports remained robust for the EU (up 12 % y-o-y) and the US (up 11 %). Exports to Russia were also up 27 % y-o-y in August, although exports to Russia still only accounted for 3 % of China's goods exports overall.

The slowdown in investment (e.g. lower housing construction activity) depressed domestic demand. Commodity imports fell in August. Import volumes of coal declined 27 % y-o-y, copper 12 % and aluminium 38 %. The drop in world market prices further lowered the value of commodity imports.

Falling commodity prices, overcapacity in some industries and the slow rise in housing costs all contributed to

August's lower inflation figure. 12-month consumer price inflation fell from 2.3 % in July to 2 % in August, while producer price *deflation* accelerated from 0.9 % in July to 1.2 %.

Modernisation of China's railways moves ahead. Railways were jammed last weekend as people travelled to their home districts for the mid-autumn festival holiday on Monday (Sept. 8). On average, there are over six million train journeys taken every day in China, accounting for 10 % of all passenger traffic. China massively invests in its railway network, particularly bullet train corridors in eastern and central China. No other country comes close to matching China's 11,000-km high-speed rail (HSR) network – and HSR projects in progress should double the length of track in service. HSR lines presently account for about 10 % of the whole railway network.

Rail projects will play an important role in sustaining investment levels if activity in the real estate sector continues to drag. The China Railways Corporation (CRC) plans this year to invest at total of 800 billion yuan (€10 billion), of which about half had been spent by the end of August. The investment target has been raised by 170 billion yuan this year. The measures are used to boost GDP growth to its target level this year.

CRC has funded most of its investments by borrowing. As a result, the company is currently carrying over 3 trillion yuan (€360 billion) in debt. CRC operations were deeply in the red in the first half of this year. Premier Li Keqiang wants to see more private capital going to rail investment. The NDRC announced this summer that it was opening investment in rail projects to private investors. The central government is also looking into ways to support profitability of the rail companies.

A World Bank report released in July found that the Chinese take a fairly cost-effective approach to construction of high-speed rail connections. A kilometre of HSR in China can be built on average for about \$20 million, when the same kilometre costs over \$30 million in Europe. The World Bank said the keys to Chinese cost-efficiency were standardisation of railway components and processes. The massive projects also enjoy scale advantages.

Cost-efficiency is a key feature of China's competitiveness for international rail projects. CRC currently has projects under construction in Africa, Latin America and Southeast Asia. Last month, Thailand approved a partnership of a \$20 billion project to build a transnational railway linking Singapore to China's rail network.

China has gone head-to-head with Japan in competing for major projects (e.g. in India). Chinese companies have won bids for major infrastructure projects internationally by demonstrating technical proficiency and offering sufficient capital.

Russia

BOFIT forecasts slow recovery for Russian economy.

Russian economic growth slowed to a crawl in the first half of 2014, even if transient factors supported domestic output and consumption. Temporary factors included the sharp increase in defence spending and a jump in retail sales as households accelerated purchases in the late winter and spring in anticipation of higher inflation.

The latest [BOFIT Forecast for Russia](#) 2014–2016 sees virtually no GDP growth this year as the Ukraine crisis continues to stoke uncertainty that has been particularly hard on private investment. The Russian economy will begin to recover gradually as growth in global trade and the world economy picks up – even with the oil price falling slightly over the forecast period as we believe. This benign scenario of slow recovery assumes that financial market responses to the heightened uncertainty from the Ukraine crisis are limited and no further escalation or prolongation of sanctions takes place. If so, investment should start to recover at the end of the forecast period. Growth in private consumption will slow this year on e.g. relatively modest real gains in wages and pensions due to higher inflation. Overall export growth should be sluggish as energy exports decline slightly in coming years. The finance ministry expects zero real government spending growth.

Russian imports have already contracted substantially due to the depreciation of the ruble. Imports are expected to stabilise next year and then begin to recover as long as the ruble's exchange rate remains relatively steady. The ruble's real exchange rate will strengthen gradually as Russia's inflation rate is likely to remain higher than that of its main trading partners. Net capital exports from Russia will continue, but their influence on the ruble's nominal exchange rate will be offset to some extent by the current account surplus driven by reduced imports.

The downside risks associated with this forecast are quite substantial. They relate largely to the situation in Ukraine and Russian uncertainties, which, in turn, affect both Russian investment decisions and imports. Private investment could be postponed to a much greater extent than in our basic forecast. Net capital outflows could also well exceed expectations, in which case the ruble's slide continues and imports drop even more than forecast. The limited possibilities for further employment gains and the lack of investment could impose surprisingly large constraints on Russian output growth.

Economic growth could also revive faster than we forecast if Russia decides to move ahead with a wider economic stimulus that involves higher government spending or channelling central bank money into the economy via the banking system. Russian leaders could also substantially increase the investment levels of large state enterprises.

Over the long term, the conditions for growth and development will be weakened as private investment projects are delayed and the government prioritises spending on defence over the next few years. Russia will also be hurt by the current push to increase self-sufficiency in production and to move further away from market reforms and promotion of open competition.

The EU and US step up economic sanctions against Russia. Last Friday (Sept. 12), the EU and US tightened last summer's sanctions on the financial sector. The new measures bar Russia's largest banks as well as oil and defence companies from receiving loans with maturities of more than 30 days, down from 90 days earlier.

Export restrictions were also widened. The EU forbids exports of dual-use military equipment to more Russian firms. European companies were now also banned from providing Russia with certain services in addition to previous restrictions on some technologies for deep-sea and Arctic oil exploration and production, as well as shale oil production. The US imposed similar oil-sector bans on state-owned Gazprom and privately held Lukoil.

Many Russian companies hit by financial sanctions are asking for state compensation. The restrictions on technology and services exports for the oil sector could limit the development of the sector in longer term.

Ruble down sharply. According to the Central Bank of Russia's official daily rate today (Sept. 19), one euro bought 49.5 rubles and one dollar 38.4 rubles. The ruble has this week been at an all-time low against the CBR's dual-currency basket. Nevertheless, the CBR has refrained from market interventions under its stated policy to intervene only when ruble goes outside its permitted fluctuation band relative to its currency basket rate.

The ruble's slide has been driven by increased uncertainty concerning the Russian economy, caused by the latest round of EU and US sanctions. In addition, the world market price for crude oil, a key number for the Russian economy, has declined since mid-summer. The export price of Urals-grade crude fell below \$100 a barrel at the end of August, hovering in recent days at around \$95 a barrel. The ruble's slide has been strongest against the dollar. The ruble, like the currencies of many emerging economies, has been hurt by expectations of monetary tightening in the US.

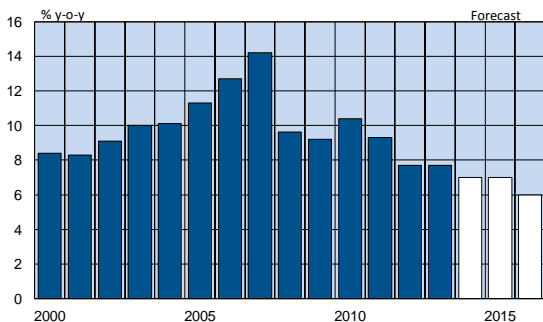
Russian financial markets have for some time suffered from foreign currency drought. To increase liquidity, the CBR announced Tuesday (Sept. 16) the start of foreign exchange (FX) swap auctions, whereby it sells dollars at a fixed interest rate to commercial banks and then buys them back the next day. The reverse FX swap (central bank sells rubles for dollars) is a standard CBR monetary policy tool.

The CBR decided to keep the key rate at 8.0 % at its monthly meeting on Tuesday. Interest rates will be revisited at the next meeting at the end of October.

China

BOFIT forecast sees smooth slowdown in Chinese economy. On-year GDP growth slowed to 7.7 % in 2013, and to around 7.5 % in the first half of 2014. Our latest [BOFIT Forecast for China](#) predicts the slowdown in growth to continue. In line with our March forecast, we still see GDP growth of around 7 % this year and next, and then falling to around 6 % in 2016.

Realised GDP growth and BOFIT forecast 2014–2016



Sources: NBSC and BOFIT

The slowdown in growth is quite natural given the size of the Chinese economy, its resource demands and its increased level of development, but there are many other factors contributing to the slowdown. Following a decade-long investment boom, new investment no longer delivers the same “bang for the buck” as earlier. The aging population reduces labour input, and vast environmental degradation comes with hefty social costs that are already eroding growth. Short-term economic growth will also be subdued by the rapid rise the indebtedness of local governments and businesses that will limit the government’s room to manoeuvre in the fiscal and monetary policy.

Perhaps the clearest signs of waning economic growth can be seen in fixed-asset investment in urban areas (FAI), which slowed from 20 % y-o-y in 1H2013 to 16 % in the first half of this year. The volumes of goods exports and imports faded in January–July to around 2–3 % (goods trade increased about 10 % last year in the same seven-month period). Figures for industrial output and credit growth in July and August confirm the view that growth continues to slow in the third quarter. Indicative data do not show any increase in unemployment (admitting, of course, the general difficulties in getting reliable employment data).

A controlled “soft landing” for economic growth is by no means a given at this point. Remaining on an appropriate glide path will require strong economic and reform policies. Rising indebtedness of firms and local governments remains a top challenge for China’s multi-tiered economic policy matrix. Darkening the outlook further is an impending correction in the real estate sector. Reducing risk exposure and

reinforcing new engines of growth will require far-reaching reforms of China’s financial markets, state enterprises, the public sector and social security. China’s eagerness to move ahead with reforms will be on display at the fourth plenum of the Communist Party next month.

Given the nature of China’s challenges, comprehensive management of economic policy is becoming increasingly difficult. Consequently, there are significant downside risks associated with this forecast. Even in a best-case scenario, it is unlikely China avoids occasional market disruptions. The knock-on effects seen in recent years in financial markets offer a hint of things to come.

China’s competitiveness still based on market size and favourable macroeconomic environment. This year’s World Economic Forum (WEF) [Global Competitiveness Report](#) ranks China 28th out of the 144 countries surveyed. China was the most competitive of the BRICS, followed by Russia (53rd), South Africa (56th), Brazil (57th) and India (71st). Switzerland remained in the top spot for global competitiveness, while Finland ranked fourth.

In the 12-category survey, China’s competitiveness was sustained by the large size of its market (second out of 144) and a favourable macroeconomic environment (10th) that reflects e.g. a high savings rate and low state debt. A number of development indicators, however, still show China lagging far from the leader pack. Low marks that dragged down China’s overall ranking include higher education and training (65th), efficiency of commodity markets (56th), financial market development (54th) and technological readiness (83rd). The WEF report noted that China is no longer a centre for cheap labour-intensive production. To retain its competitive advantage, the country must develop high value-added businesses.

Russia this year rose eleven places in the rankings to 53rd position. The improvement particularly reflects gains in commodity market efficiency (e.g. increased competition), innovation and business development. Russia outperforms China in the areas of higher education and training, infrastructure development and technological readiness. Russia’s competitive weaknesses stem largely from its inefficient institutional environment (97th), and underdeveloped commodity (99th) and financial markets (110th). Data in the report are from last year. The escalation of the Ukraine crisis is seen as a risk to Russian competitiveness that rests largely on publicly funded education and innovation.

Chinese business leaders interviewed for the report identified difficulties in access to finance, corruption and tax regulation as the biggest barriers to doing business. The biggest barriers in Russia were corruption, high corporate taxation and poor access to financing.

Hong Kong ranked seventh and Taiwan 14th. Hong Kong’s infrastructure and financial market sophistication put it among the world’s best. It still had room for improvement in education, research and innovation.

Russia

Russia to keep tight fiscal policies in place next year.

The draft federal budget approved by the cabinet last week (Sept. 18), upholds the budget rule adopted in 2012 that says the deficit may not exceed 1 % of GDP. In the face of heavy pressure to spend, the government limited the overall real rise in budget expenditures to a few per cent, (i.e. after inflation is taken into account). Finance minister Anton Siluanov said holding to agreed principles in both fiscal and monetary policy forms a foundation of certainty for the Russian economy on which economic actors must be able to rely.

The structure of budget spending has been aggressively modified to allow higher spending in such areas as defence and national security, as well as to boost certain sectors of the economy. Much of the spending in the final category will go to building new production or expand existing capacity to substitute for imports, especially in the defence and agriculture sectors. The measures are part of Russia's new emphasis on economic self-sufficiency. Redirected financing will also go to developing the Crimea and the Far East region, as well as funding large infrastructure projects such as Moscow's new ring road. The government sees giant state-funded infrastructure projects as a way to revive economic growth. The total proposed budget is 15.5 trillion rubles, or slightly over €310 billion.

Notably, the government refrained from any major tax hikes and did not even mention its much-derided sales tax proposal. The value-added tax will remain at its current 18 % rate.

The budget proposal, however, includes a controversial decision to increase budget revenues without raising taxes by transferring to the federal budget pension contributions collected next year for the funded part of the pension system. The arrangement was first introduced in this year's budget and has been heavily criticised. Observers note that it ruins the 2002 pension reform, which transitioned the Russian pension scheme from a pure pay-as-you-go system to a partially funded system. Under the system, one part of the collected pension contributions are used to pay out current pension obligations, while the other part is invested in long-term instruments to fund the future pensions of current workers. The feasibility of the partly funded pension system has been put under question since last year, when it was first decided to use pension contributions for funding budget outlays.

The final decisions on the budget in the Duma are slated for October. As the Duma is also considering government revisions to the tax code, changes in tax rules are to be expected in the future. The draft tax code proposal includes changes in taxation of oil production and oil exports, as well as dividend income. The Duma is also considering a

bill to hike taxes on primary housing and other residential real estate e.g. by bringing appraised property values closer to market valuations.

Increasing Russia's agricultural output will take time.

Russia has made boosting agricultural output and national food self-sufficiency top priorities since imposing a ban on imports of certain Western farm produce and processed foods. Official Russian statements on the ban characterise it as a tremendous opportunity to increase domestic farm production now that competing imports are off the market.

The agriculture ministry proposed in August that annual agricultural production subsidies be increased 50 % from the current 200 billion rubles (€4.2 billion). Funding needs next year are most acute for certain crops, especially potatoes and other major cultivars. In capital-intensive meat production, the bulk of new subsidies would be needed as interest support for investment loans. The draft 2015 budget just approved by the cabinet provides 20 billion rubles, far less than the requested 100 billion rubles.

In any case, subsidies would not transform Russian agriculture overnight. Increasing farm output will take time; anywhere from two to six years depending on the product. If Russia's import bans are lifted after a year as currently planned, it is not worthwhile for producers to invest in boosting output due to uncertainty about future demand.

Russia, like a number of countries in the northern hemisphere, is expecting a bumper grain harvest this year. The cereals harvest is estimated to be around 104–106 million metric tons, which would nearly match the all-time record set in 2008 of 108 million tons. Russia's annual grain harvest over the last ten years has averaged 84 million tons.

Russia demands, and gets, a delay in the launch of the Ukraine-EU free-trade agreement. On September 16, the EU and Ukraine ratified their earlier-approved association and free-trade agreements. Before ratification, representatives of the EU, Ukraine and Russia held talks on the possible impacts of the agreements. Russia noted that the free-trade deal is not compatible with the CIS countries' free-trade agreement, in which Ukraine is a member. As a result, Russia insisted that the launch of the free-trade agreement be delayed from November this year to the end of 2015.

Russia's biggest fear about the EU-Ukraine free-trade agreement is that it would allow EU goods to flow into Russia via Ukraine duty-free. At the beginning of the week, the Russian government published a decree to impose import duties on Ukraine trade if Ukraine went ahead with the launch of its EU free-trade agreement before the end of 2015. Russia also said it would take retaliatory measures if Ukraine adopts standards or regulations that harmonise trade practices with EU requirements.

Despite the delay in the implementation of the free-trade agreement, the EU will unilaterally keep in place the reduced import duty rates granted to Ukraine in May.

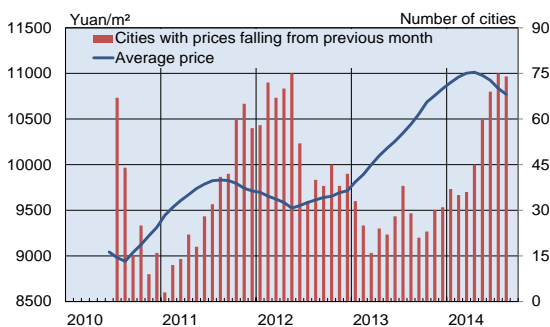
China

Worrisome trends in China's housing markets. SouFun's independent property research arm, which produces data on China's private real estate markets, reports that in August the average apartment price in China had fallen about 2 % from its April peak. In August, on-month prices fell in about three-quarters of the 98 cities surveyed by SouFun. Regional differences are huge, however, as the average August apartment price (price per square metre of liveable floorspace) for the country as a whole was under 10,800 yuan/m² (€1,360/m²), compared to the Beijing average of about 32,700 yuan/m² (€4,140/m²). Prices also declined in Beijing, Shanghai and Guangzhou.

Official figures support the notion that China's housing markets have cooled. In addition to an overall drop in apartment prices, housing sales measured both in terms of total floor space and value fell in January-August over 10 % from the same period a year earlier.

Over the past few years, officials have tightened borrowing requirements on builders and limited housing purchases by raising the required minimum down payment amount in response to the boom in real estate markets. The practice of buying several apartments was also discouraged. With economic growth now slowing, provincial and municipal governments are rolling back these restrictions. Real estate investment accounts for 10–15 % of GDP, and the budgets of many provincial and local governments rely on the sale of land use rights for a substantial share of their budget revenues.

Average housing prices and number of surveyed cities (98-city sample) where housing prices fell from the previous month



Sources: SouFun, Macrobond

Alibaba stages massive IPO. Last Friday (Sept. 19) saw the debut listing of Chinese Internet retailer on the New York Stock Exchange. On its first day out, Alibaba raised a total of \$25 billion from investors, making it the largest IPO in history. After the IPO, Alibaba's founder and former English teacher, Jack Ma, became China's richest person.

China's rising role as a driver of growth in the global economy can be seen in the fact that two previous IPO records were set by Chinese state banks, ABC in 2010 and ICBC in 2006.

The price of Alibaba shares rose 38 % on their first day of trading. At the closing bell, the company market capitalisation stood at around \$230 billion. In terms of market cap, Alibaba whizzed by its main competitor, web-seller Amazon. Unlike other Internet retailers, Alibaba provides sellers with a platform for both selling and handling payment transactions. Alibaba's revenues derive mainly from advertising and service charges.

Investor enthusiasm for owning American depositary shares (ADRs) of Chinese firms listed on US exchanges has remained largely undaunted by Chinese scandals in recent years involving accounting fraud, improper company valuations and other abuses. In Alibaba's business sector, Chinese officials limit the ownership rights of foreigners, which can only access the underlying shares through Variable Interest Entities (VIEs). Observers warn, however, of risks inherent to VIE arrangements. Any disputes between Chinese and foreign investors, for example, may have to be resolved in Chinese courts. Moreover, Alibaba's new shareholders have no voting rights in corporate matters; they merely have the right to receive dividends.

China accounts for over half of growth in global greenhouse emissions. The UN climate summit got underway on Tuesday (Sept. 23) with headlines decrying the rapid rise in Chinese greenhouse gas emissions. According to a report of the Global Carbon Project, China last year accounted for 28 % of global CO₂ emissions. Second place went to the United States (14 %), followed by EU (10 %), India (7 %) and Russia (5 %). Global emissions rose 2 % in 2013. Emissions growth was highest in emerging economies such as China (up 4 %) and India (up 5 %). US emissions rose 3 %, while EU emissions fell 2 %. In per capita terms, China's CO₂ emissions surpassed the EU for the first time last year. On a per capita basis, US emissions are still 2.3 times higher than China's, and Russia 1.8 times higher than China's.

China's 2020 carbon intensity target calls for a reduction of carbon per unit of GDP, narrowly defined to include only emissions from energy consumption and industrial activity, to about 50 % of 2005 levels. This target would not, however, result in an overall reduction in China's carbon emissions. A large share of Chinese emissions still comes from coal. China says it will phase out the use of the dirtiest forms of coal, as well as limit emissions in the steel and cement industries. China also hopes to ramp up sustainable energy production. While consumption of renewable energy rose nearly 30 % last year, renewable energy only accounts for a small share of China's overall energy picture. Over 90 % of the energy consumed in China last year came from combustion of coal, oil or natural gas.

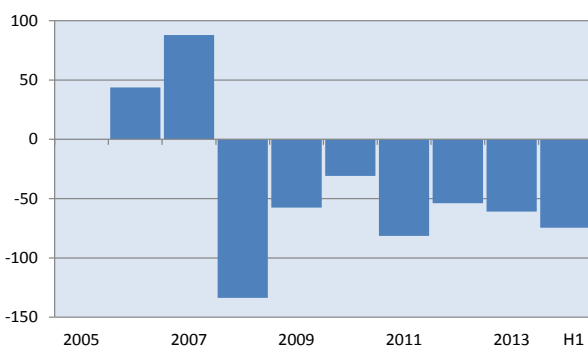
Russia

Economy ministry warns capital exports could accelerate further. Deputy economy minister Alexei Vedev said last week that net private sector capital exports, driven by domestic and foreign political tensions, could reach as much as \$120 billion this year, or double the \$61 billion recorded last year. Vedev made specific reference to the recent fate of the Sistema conglomerate, where top management has been charged with financial abuses in their acquisition of the majority stake in the Bashneft oil company. After an arbitration court last week ordered the confiscation of Sistema's Bashneft shares, the share prices of both Sistema and Bashneft plummeted.

The Central Bank of Russia, however, says that the lion's share of capital exports driven by uncertainty in the business environment took place already in March, when Russia annexed Crimea. March capital exports were about \$35 billion, or nearly half of the \$74 billion in capital exports recorded the first six months of this year. As the flow of capital exports has subsided, the CBR now expects second-half outflows to be relatively modest compared to the first half.

The CBR term "capital exports" includes not just transfer of assets abroad, but assets of firms, banks and households converted from rubles to foreign currencies (even if that currency never leaves Russia). The CBR notes that most of March's "capital flight" was various actors moving into forex. E.g. households are quick to dump rubles for foreign cash when faced with economic uncertainty.

Net private sector capital exports from Russia 2005 – 1H14, USD billion



Source: Central Bank of Russia

CBR calms fears over possible capital control measures. On Tuesday (Sept. 30), rumours circulated in the markets that the CBR was considering imposition of capital controls to dampen capital flight. The CBR overrode the rumours with a press release, but the ruble's exchange rate sank momentarily. On Friday (Oct. 3), the euro-ruble exchange rate

reached 49.95 rubles, while the dollar-ruble rate was 39.55 rubles.

Free movement of capital is a fundamental element of Russian economic policy, as well as key to upholding the CBR's credibility and confidence in the ruble.

Russia depletes its oil fund savings. Russia's weak economy, foreign trade sanctions and budget imbalances have placed tremendous pressure on the government to use assets of the National Welfare Fund to cover budget shortfalls.

Several banks and large companies expect financing. For example, state oil company Rosneft and the privately held gas company Novatek want National Welfare Fund money to finance their projects now that they have been cut off from foreign credit due to financial sanctions. Some Fund money is also slated for use in large construction projects to stimulate economic activity (e.g. the modernisation of Baikal-Amur and Siberian railways).

At the end of August, the National Welfare Fund held assets of \$85 billion (3.15 trillion rubles), an amount equal to 4.4 % of GDP. Under the Fund's new rules, 40 % of assets can be invested in domestic infrastructure projects or deposits with domestic financial institutions, 10 % with the State Direct Investment Fund for financing domestic projects and 10 % in Rosatom projects. The government has already given the green light for e.g. Rosatom Oversea's 1,200 MW Hanhikivi 1 nuclear power plant in Finland.

The government has yet to decide where it will invest Fund assets besides in Rosatom projects and the State Direct Investment Fund. It is clear, however, that Welfare Fund assets are insufficient to cover all funding requests.

The predecessor to the National Welfare Fund, the Stability Fund, was established in 2004 to deal with state windfall revenues from soaring crude oil prices. Each year, a share of revenues from export duties, taxes and production fees were diverted to the Stability Fund. The Stability Fund was split in 2008 into a National Welfare Fund and a Reserve Fund that continue to be augmented according to earlier rules. The Reserve Fund is to be used as a rainy-day fund to cover future federal budget deficits. At the end of August, the Reserve Fund held assets of \$92 billion.

The purpose of the National Welfare Fund has been to collect money to fund future obligations of the pension scheme as they arise. Under its original rules, Fund assets were to be invested in high-grade foreign securities to preserve asset values as much as possible. In 2009, Fund assets were for the first time invested domestically to bolster bank balance sheets and stimulate lending during the recession.

Assets of the National Welfare Fund are supposed to secure the government's ability to deal with rising pension obligations. If assets are invested mainly in domestic projects where risks are high and the potential return is low (or non-existent in the case of certain infrastructure projects), Russia will lose a key enabling element of responsible fiscal policy.

China

China eases mortgage lending rules. With the slowdown in housing markets across the country and declining apartment prices, the People's Bank of China issued on Tuesday (Sept. 30) new rules that make it easier for buyers to qualify for a mortgage and potentially lower loan costs. According to the new rules, individuals seeking to purchase a second apartment could get a mortgage on the same terms as first-apartment buyers if they had already paid off the mortgage on their first apartment. In practice, this means such buyers avoid the earlier 60 % down-payment requirement and only have to pony up 30 % of the purchase price with cash. They will even qualify for a cheap mortgage rate set at 30 % below the PBoC's mortgage reference rate. Since 2011, buyers other than first-apartment buyers have paid mortgage rates above the central bank's reference rate. Moreover, owners of more than two apartments will be eligible for mortgages on new apartments as long as all previous mortgages have been paid off. Such mortgage arrangements were strictly forbidden earlier.

A relaxation of mortgage lending rules to stimulate apartment buying has not been seen at the national level since 2010, when the policy tightening in the real estate sector started. A number of cities have already eased local lending restrictions to stimulate activity in the real estate sector.

Central government authorities moved to relax mortgage rules on fears that the weak housing market might endanger the growth outlook. Economic growth slowed as summer wore on, and the indices of purchasing managers (PMIs) released at the start of October did not change the picture. The official manufacturing PMI reading was 50.1 (same as in August) and services PMI 54.0 (54.4).

China launches direct yuan-euro trading, while progress in reforms across the financial sector remains spotty. The PBoC announced this week that as of Tuesday (Sept. 30) it would allow direct trading in euros and yuan in the domestic interbank market. Thus, banks will no longer have to use the dollar as an intermediary currency in such trading. The euro joins seven other direct-trade currencies: the US dollar, Australian dollar, New Zealand dollar, Japanese yen, British pound, Russian ruble and Malaysian ringgit. While direct trading should be cheaper in principle than dollar-intermediated trading, the actual benefits are only realised at higher trading volumes. The euro offers high potential for savings and, consequently, direct trading will support economic cooperation between China and Europe.

China's track record remains spotty on efforts to open up foreign currency markets and financial deregulation. The much-hyped Shanghai Free-trade Zone (STZ) pilot project launched last year has been a major disappointment. Even if

bureaucratic red tape has been reduced and certain branches have been allowed to operate more freely, the ultimate "experiments" with liberalisation measures for the financial markets and capital movements, in particular, have been disappointingly modest. Deregulation of deposit interest rates, seen by many as a key reform, only applies to forex deposits in the STZ.

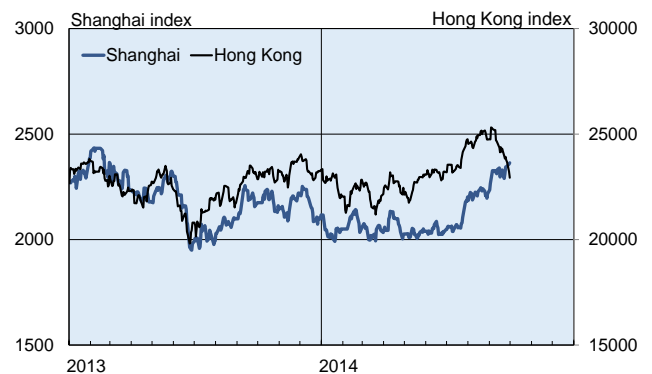
Although yuan use in international payments has increased rapidly, the expectations set by China's leaders for its international status will not be realised without further opening of the domestic financial sector. However, despite years of planning, the government has yet to disclose what progress is expected in implementation of, e.g., its deposit insurance scheme or deregulation of deposit interest rates.

Hong Kong protests put Chinese pragmatism to the test. This week's protests in Hong Kong continued to demand democracy and oppose Beijing's end-August decision to limit candidacies in Hong Kong's administrative leadership elections in 2017.

The scale and nature of the protests, as well as the potential blowback from mainland China have naturally raised concerns also among the business community. In Hong Kong, many firms have already prepared to continue their core functions in the outskirts of the city in the event the protests continue and make operations at their downtown offices too difficult. Prices on the Hong Kong stock exchange declined throughout September, with the key index down 7 % for the month. In contrast, share prices in Shanghai continued to rise ahead of National Day (Oct. 1), the start of a week-long holiday.

The events in Hong Kong have raised discussion about a diverse range of threats, and there is true potential for prolongation or further enflaming of the situation. Fortunately, it is not out of the question that a practical solution will be found to Hong Kong's election arrangement that serves the best interests of China's reform policies.

Hong Kong and Shanghai share prices, 2013–2014



Source: Macrobond

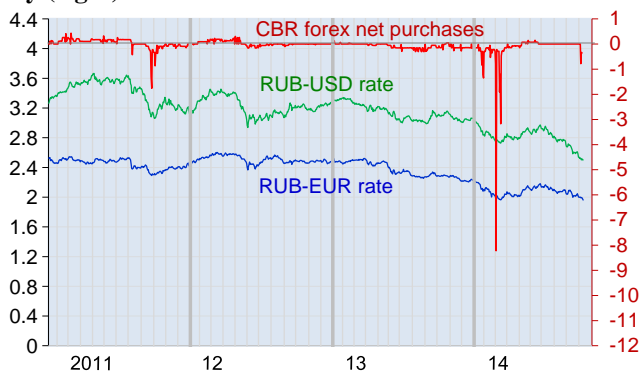
Russia

Ruble facing depreciation pressures. The ruble's exchange rate has declined about 4 % over the past two weeks and over 10 % since the end of June. Responding to the ruble's on-going slide, Bank of Russia (CBR) this week lowered the floor of the ruble's fluctuation range and following its policy aimed at a flexible exchange rate widened the fluctuation band.

On the other hand, the CBR also bought rubles on domestic forex markets for the first time since midsummer and started currency swaps to help banks meet their overnight currency liquidity demands. CBR chairwoman Elvira Nabiullina reports the central bank further plans to provide foreign-currency repo credits of one to four weeks to help banks with their currency liquidity.

The immediate devaluation pressures on the ruble's exchange rate are caused by the long-standing trend of more capital flowing out of Russia than into Russia. The situation has been made more difficult now that access of Russian banks and corporations to foreign lenders has diminished very significantly due to uncertainties relating to Russia, which, in turn, has made it even harder to service their existing loans.

Ruble exchange rate in US cents and euro cents (left) and CBR forex market interventions in EUR billion per day (right)



Source: Bank of Russia

Structural changes for Russian government spending larger than scheduled earlier. The government last week submitted to the Duma its drafts of the federal budget and state social funds for 2015, along with the budget frameworks for 2016–2017 as well as the finance ministry's projection of consolidated government budget revenue and spending (including regional budgets). The finance ministry sees consolidated government spending rising over 11 % in nominal terms next year, slightly faster than its previous estimate this summer. The ministry also expects a slight rise

in revenue growth to over 7 %. The deficit forecast remains at over 2 % of GDP.

Defence spending, of which virtually all comes from the federal budget, will rise next year to even higher levels than planned earlier. In nominal terms, spending will rise 33 % from this year, will constitute 11 % of overall government spending and correspond to over 4 % of GDP. As another change to earlier plans, however, the finance ministry now foresees that defence spending will fall considerably after 2015.

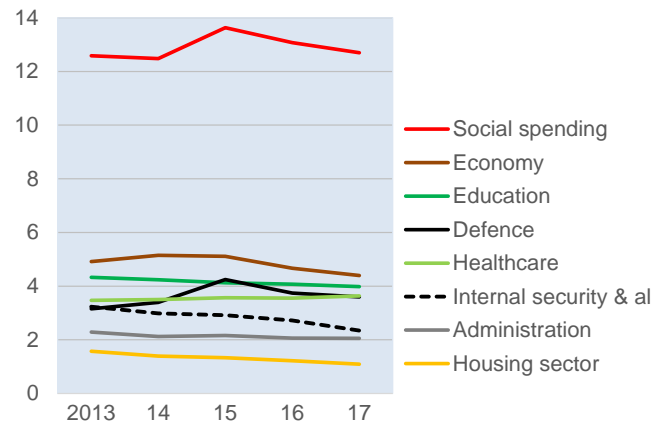
Government spending policies have also been adjusted to reflect the fact that the estimated spending on the various sectors of the economy will be notably larger in 2015–2017 than estimated this summer – even if the growth in spending will remain much below the projected rate of inflation. The biggest spending increases have to do with the transport sector and spending on the road network (e.g. Crimea projects).

The finance ministry also expects spending on pensions and other social entitlements to increase faster in coming years than foreseen in the summer plan. Spending should rise fairly sharply next year (16 %). On the other hand, much of the increase is due to pension savings included in the social spending figures. A return to this pension savings scheme policy begins next year. Running social costs will grow at a more modest rate (next year about 10 %). Social spending will rise to about 35 % of government spending and to over 13 % of GDP.

The finance ministry sees other core government spending areas slightly more squeezed in the years ahead than earlier. Growth in spending on education will at best match the predicted inflation rate. Spending on healthcare will grow a couple of percentage points faster than the inflation rate.

To ease the situation in the country's different regions, the government will break from earlier plans by increasing transfers of federal budget funds to regional budgets, starting already this year.

Main areas of government spending, % of GDP



Source: Russian Ministry of Finance

China

IMF calls for further structural reforms in China. The IMF's just-released [World Economic Outlook \(WEO\)](#) sees China's economic output growing 7.4 % this year and 7.1 % next year. The slowdown remains steady; GDP growth in 2013 was 7.7 %. The projections for this year and next have been revised down slightly from the WEO released in April.

Lower future growth for China reflects the slowdown in housing investment and a deliberate shift away from investment in fixed assets to a more sustainable consumption-driven growth model. In its basic forecast, the IMF expects China will continue to rein in credit growth and indebtedness of local governments to secure a stable financial system. Moderation of credit growth will support structural change in the Chinese economy.

Even though the geopolitical risks and a potential prolonging of low growth in the Euro Area will affect China as well, China's biggest challenges come from domestic trends. The most immediate threat is a sharper than expected cooling in the real estate sector, since real estate investment has been a major engine of economic growth. Problems would be aggravated due to the potential for contagion; the banking sector (official and shadow) provides the bulk of lending to the real estate sector and relies on real estate values in collateralising loans. Problems in the real estate sector could also hurt local government revenues; many are dependent on the sale of land use rights as an important source of income.

Over the medium term, the IMF sees indebtedness and overcapacity in many branches as major causes for concern particularly as growth still seems to rely largely on capital investments and additional debt. From the economic policy point of view, it is difficult to balance between growth targets and structural reforms, but continuing with the old growth model would increase the risk of major financial market disruptions and a sharp slowdown in growth. If this dark scenario materialises, the impact would be felt throughout the global economy.

Thus, the WEO calls on China's leaders to implement previously agreed structural reforms to sustain growth. Reforms include strengthening of financial market supervision, reduction of indirect subsidies, deregulation of deposit interest rates and shifting monetary policy to emphasise market-based interest-rate-setting. The IMF supports China's efforts to increase exchange rate flexibility, which, together with other reforms, will help to narrow global imbalances. The IMF also mentioned state enterprises, local governments and the social security system as key targets for reform.

The October WEO report projects that the world economy will grow 3.3 % this year and 3.8 % next year. The IMF warns, however, that the risks to growth have also increased since its April forecast.

IMF 2014 and 2015 growth projections, %

	2013	f2014	f2015
World output	3.3	3.3	3.8
Advanced economies	1.4	1.8	2.3
United States	2.2	2.2	3.1
Euro Area	-0.4	0.8	1.3
Japan	1.5	0.9	0.8
Emerging economies	4.7	4.4	5.0
China	7.7	7.4	7.1
India	5.0	5.6	6.4
Russia	1.3	0.2	0.5

Source: IMF World Economic Outlook, October 2014

Yuan strengthening continues. The People's Bank of China intervened in the currency markets in the first half of the year to deliberately weaken yuan and provide a wakeup call to market participants that yuan appreciation was not inevitable. In mid-March, the PBoC also widened the permitted fluctuation of the yuan from its daily fixing of the yuan-dollar exchange rate from 1 % to 2 %. The changes herald central bank efforts at preparing the markets for a more volatile yuan exchange rate, even if no specific timeline for deregulation of the yuan's exchange rate has yet been announced.

The yuan's exchange rate started again to strengthen in the summer in terms of its trade-weighted real effective exchange rate or REER (which takes into account inflation-rate differences with China's main trading partners) and the yuan's nominal effective exchange rate (NEER). The yuan hit its weakest point against the US dollar this year at the end of May and early June, when it was down over 3 % from the beginning of the year. Since then the yuan has strengthened and the dollar exchange rate is currently slightly more than 1 % below its level at the start of the year. On Friday (Oct. 10), one dollar bought 6.13 yuan. The yuan-euro rate stood at 7.79, which means the yuan has gained 7 % against the euro since the start of the year.

Yuan real and nominal effective exchange rates



Source: BIS

Russia

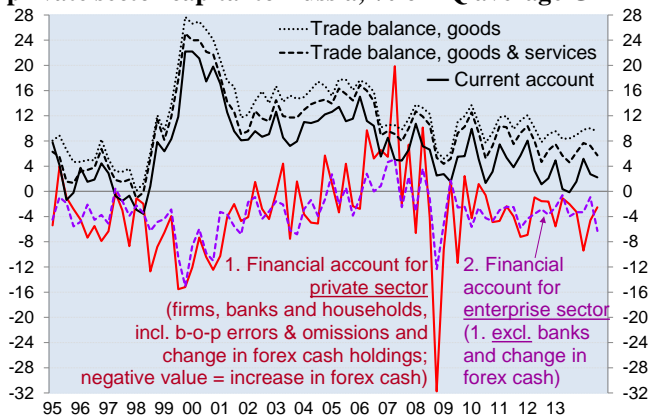
Falling imports support Russia's current account surplus. Preliminary Central Bank of Russia balance-of-payments figures show a third-quarter current account surplus again rivalling the quarterly surpluses of the previous two years. For the past four quarters, the current account surplus rose to nearly 3 % of GDP and the goods trade surplus continued to hold at nearly 10 % of GDP.

Russia's earnings from exports of goods and services fell slightly y-o-y in both the third quarter and the first three quarters of this year. Growth in export earnings has remained virtually flat for the past two-and-a-half years.

Russia's recent notable trade and current account surpluses reflect a contraction in Russian imports. The value of imports of goods and services (including spending of Russian travellers abroad) was down 6–7 % y-o-y in both the third quarter and the first nine months of the year. The corresponding drop in goods imports only was about 8 %. Regarding services imports, both traveller spending abroad and imports of other services contracted just a couple of percentage points and only during the past six months.

Access to foreign funding for Russian banks and corporations dried up. Preliminary CBR balance-of-payments figures indicate Russia's net private sector capital outflow fell in the third quarter. Banks repatriated a record high amount of their assets from abroad in order to balance their forex positions as Russian firms and households reduced their domestic forex deposit accounts with Russian banks. In addition, observers note that Russia's large state banks repatriated assets from abroad also in case there was an asset freeze. Net borrowing of banks from abroad was strongly, and to an unusual degree, negative.

Trade and current account surpluses, and net inflow of private sector capital to Russia, % of 4Q average GDP



Source: Central Bank of Russia

The net capital outflow from Russia's *enterprise sector* (non-bank corporations) increased substantially in the third

quarter (up to more than 6 % of GDP of the four previous quarters). While corporate asset outflows remained largely unchanged, e.g. with respect to direct investments, corporate liability flows turned negative – a very exceptional situation. FDI in the corporate sector ground nearly to a standstill and firms paid down existing foreign debt in considerably larger amounts than what they received in new loans.

Russian prime minister and Chinese premier hold annual meeting in Moscow. With increased tension in Russia's relations with Europe and the US, Russia has stepped up its efforts to expand economic cooperation with China in order to develop alternative export markets and sources of international financing. The current situation has strengthened China's negotiation hand in defining the terms of cooperation. As in earlier meetings, most of the leaders' signing activities involved general memoranda on cooperation and policy frameworks concerning the energy sector.

Li Keqiang and Dmitri Medvedev also finalised the massive natural gas supply agreement that the two countries agreed on in May. The 30-year deal calls for Russia to export 38 billion m³ of natural gas a year to China from 2018 onwards. State enterprises Gazprom and CNPC have commenced construction of the "Power of Siberia" gas transmission pipeline. Gazprom, which is responsible for pipeline construction on the Russian side, has requested a \$25 billion downpayment from the Chinese, but says the pipeline can also be built without the downpayment.

Other Russian firms are also trying to get Chinese loans now that access to credit in Europe and the US has dried up. For the moment, Chinese banks appear rather cautious in lending to Russian companies, mostly granting financing to projects that include a Chinese partner. Press reports suggest that combined lending of China's largest banks to Russian businesses only amounts to around \$1 billion, whereas the total foreign debt of Russia's private sector is about \$615 billion.

The central banks of Russia and China also signed a currency exchange deal. The swap agreement, which allows up to 150 billion yuan (\$25 billion) in foreign currency swaps, will remain in force for three years. China has made similar swap deals with a number of central banks in recent years to boost international use of the yuan.

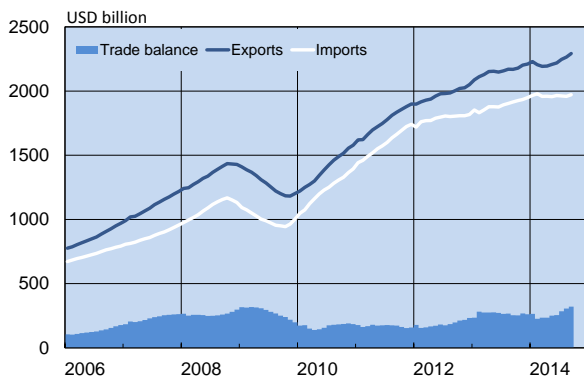
Medvedev announced the goal of doubling bilateral trade to a level of \$200 billion a year by 2020. Russia mainly exports oil and other commodities to China and imports mostly consumer goods from China. China is already Russia's largest supplier of imports (17 % overall), and e.g. over half of Russia's clothing imports and over a third of electronics come from China. Medvedev particularly hoped for increased trade in high technology. High-tech products currently account for about 1 % of Russia's total exports and a quarter of China's total exports. Chinese high-tech exports typically include a high third-country value-added component.

China

China's goods trade surplus reaches record high. The value of Chinese exports in September clearly exceeded market expectations, surging 15 % y-o-y. Seasonally adjusted export figures show strengthening growth for several consecutive months. The top markets for Chinese exports, Europe and the United States, were up 15 % and 11 %, respectively. Exports to Japan, however, declined 5 %.

While conditions in China's export markets were generally favourable in the third quarter, September exports were boosted by a couple of transient factors. Phone exports exploded with the release of Apple's iPhone 6 and exports to Hong Kong rose by over a third. The Hong Kong numbers, however, were called into question, as mainland companies may have reported far more exports to Hong Kong than Hong Kong figures will later probably indicate as imports from mainland China. Observers suggest there might have been a relapse to phoney invoicing schemes for avoiding capital import controls. Even excluding Hong Kong, however, the rest of China's exports were still up 12 % y-o-y in September.

China's foreign trade, 12-month moving total



Source: Bloomberg

The 7 % rise in imports (measured by value) also beat market expectations. However, import growth was driven entirely by a sharp increase in inputs for assembly industries. Imports associated with assembly production, which is determined by demand outside China, rose 30 % y-o-y in September. The value of Chinese imports for the country's own consumption declined about 2 % y-o-y. Drops in energy and commodity prices slowed the rise in the value of imports. Imports from Europe were up 9 %, from the United States 13 % and from Japan 4 %.

China has apparently increased its market share in Russia due to the current tense relations between Russia and the West. While Russian imports are down almost 10 % overall,

Chinese goods exports to Russia in January-September rose 11 % y-o-y. In the August-September period, growth exceeded 20 %. Despite falling commodity prices, the value of China's imports from Russia were up 3 % in the first nine months of 2014, largely on higher crude oil import volumes.

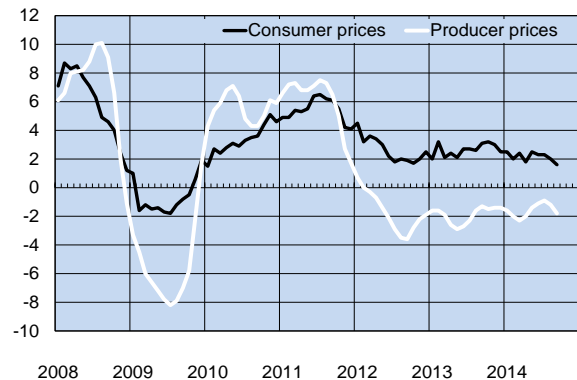
Even if China's September goods trade surplus was less than in August, the 12-month trade surplus surged to a record of slightly over \$320 billion. The overall foreign trade picture was balanced by China's rising services trade deficit, which is largely driven by a huge increase in Chinese international tourism. As a result, the current account surplus should continue to hold at around 2 % of GDP.

Key monetary indicators suggest permanent slowdown in growth. Over the past two years, the rise in Chinese consumer prices has remained in the range of 2–3 % a year, but 12-month inflation now fell from 2 % in August to 1.6 % in September. Such a low inflation was last seen in January 2010. Stable or falling food and fuel prices have been major drivers slowing Chinese inflation. Lower growth in housing expenses has also helped dampen inflation.

In addition to lower consumer price inflation, the decline in producer prices steepened from a fall of 1.2 % y-o-y in August to a slide of 1.8 % in September. Producer prices have now fallen in every month since March 2012. The drop in producer prices reflects lower global commodity prices, as well as China's own problems with excess supply. Many branches in China, and notably the coal and steel industries, for example, have long suffered from overcapacity issues.

In addition to low inflation, indicators on the supply of credit and money reflect a cooling economy. Growth in bank lending slowed a bit to 12.4 % y-o-y, while growth of entrusted and trust loans' stock outside the regular banking sector slowed to 26 %. The volume of trust loans, the most problematic of these shadow-banking products, actually declined in recent months. The broad money supply measure (M2) continued to rise at 12.9 % y-o-y, even if growth in bank deposits appears to have slowed substantially.

Consumer price and producer price inflation in China, %



Source: Bloomberg

Russia

Transient factors supported Russian economic growth in September. Manufacturing output was up nearly 4 % y-o-y in September, partly due to rising oil refining activity. Some observers relate the acceleration also to the ruble's recent slide that has helped increase output in certain industrial branches. Others emphasise Russia's soaring defence spending, up 33 % y-o-y in the first nine months of this year. Agricultural output also increased dramatically on record harvests.

Although food sales since May have been down slightly from a year earlier, retail sales growth picked up to 1.7 % y-o-y in September. Non-food sales were up 3.5 % y-o-y, even if household wages fell in real terms for the first time in many years. Ruble depreciation and higher inflation have spurred households to accelerate their spending and reduce their bank accounts.

The on-year drop in fixed capital investment has been a couple of per cent over the past two months, thanks to distinctly better development in investment of large energy and transport enterprises than other investment. The housing construction boom of the first half of the year has cooled in recent months.

The economy ministry estimates GDP growth was 0.7 % y-o-y in January–September, decelerating slightly during the past couple of months.

Moody's downgrades Russia's creditworthiness. Russia's sovereign credit rating was downgraded last Friday (Oct. 17) to Baa2, Moody's second lowest investment grade rating, i.e. the agency still believes the country can service debt in the face of poor growth prospects, but is more susceptible to capital flight and external shocks in changing circumstances. A sovereign investment-grade rating indicates that a country's debt securities are relatively safe investments, and may be mandatory in the case of institutional investors such as pension funds. Speculative grade bonds (i.e. debt securities with ratings below investment grade) are only recommended for "well-informed" investors willing and able to assume high risks.

Standard & Poor's reduced its rating of Russian foreign-currency sovereign debt last April to BBB- as the Ukraine crisis developed. Fitch, the other Big Three ratings agency, has held its rating on Russian unsecured foreign and local currency sovereigns at BBB, its second lowest investment grade, since 2009. All three credit ratings agencies have published negative outlooks for Russia in the years ahead.

Moody's based its downgrade on the weak growth outlook for the Russian economy, shrinking foreign currency reserves, the increased difficulties Russian firms face in accessing international credit markets and the decline in crude oil prices.

Lower crude oil prices not yet fatal for Russia's fiscal or current account balances. World crude oil prices have fallen to their lowest level since October 2010. The price of Urals-grade crude oil is currently around \$85 a barrel, about 25 % lower than its June peak this year.

Price of Urals-grade crude, USD/barrel, 1.1.2000–23.10.2014



Source: Reuters

If the price of crude oil holds at the \$85–95 level for a longer time, Russian growth will be much slower than current consensus forecasts predict. For example, BOFIT's 2014–2016 forecast for Russia released in September, assuming an average oil price of around \$100, expected the economy to grow 0.5 % next year and 1.5 % in 2016.

Russia's 2015 federal budget also assumes an average oil price of \$100 next year, producing a budget deficit of 0.5 % of GDP. The impact of a lower oil price on Russia's fiscal balance will still be manageable; the nominal increase in budget revenues from ruble depreciation will in part offset losses. Prof. Sergei Guriyev estimates public sector finances could withstand an oil price of \$80–90 for a couple of years thanks to reserve funds and the weak ruble.

Sberbank's research department has calculated that the current account will remain in surplus next year even if the oil price holds at \$85. Export revenues will fall, but also imports will decline substantially on e.g. the weak ruble and impacts from economic sanctions.

Russia shifts permanently to standard time. After years of public discussion, the Duma passed a law in July abolishing daylight savings time in Russia. This Sunday (Oct. 26), Russia shifts to year-round standard ("winter") time. Russia adopted daylight savings time in 1981. In 2011, then-president Dmitri Medvedev launched an initiative to move to daylight savings time year round, only to have his proposal widely condemned. Daylight savings time in some regions of Russia has meant significant departures from their natural geographic time zones.

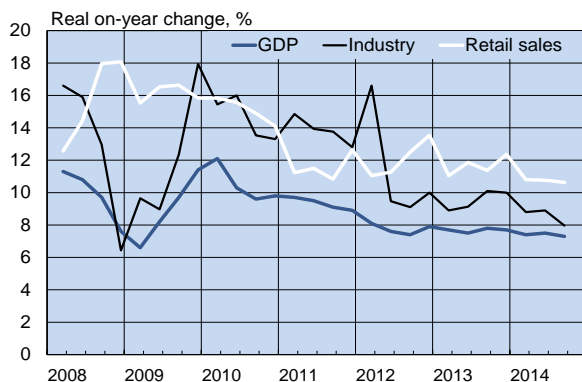
Russian regions have had their say in the proposed changes. For example, the northeastern regions of Kamchatka and Chukotka will keep daylight savings time (Moscow time plus nine hours). Most regions west of the Urals will use Moscow standard time (UTC +3).

China

China's economic structures evolve to reflect lower growth paradigm. China's GDP figures released this week show growth of 7.3 % y-o-y in the third quarter, down from 7.5 % in the second quarter. Seasonally adjusted figures show third-quarter GDP growth increased 1.9 % q-o-q. Second-quarter GDP growth was 2.0 % q-o-q.

GDP rose 7.4 % y-o-y in January-September. Much of the growth slowdown reflected evaporating domestic investment demand caused by cooling of the housing market. Some 3.0 percentage points of growth came from fixed capital investment, while domestic consumption demand accounted for 3.6 percentage points and net exports 0.8 percentage points. Given that investment was still a bigger driver of growth last year than consumption, it appears the long-awaited effects of structural reforms are finally kicking in. The third-quarter uptick in export growth helped spur GDP growth as the rise in import volumes remained modest.

Growth in GDP, industrial output and retail sales for China



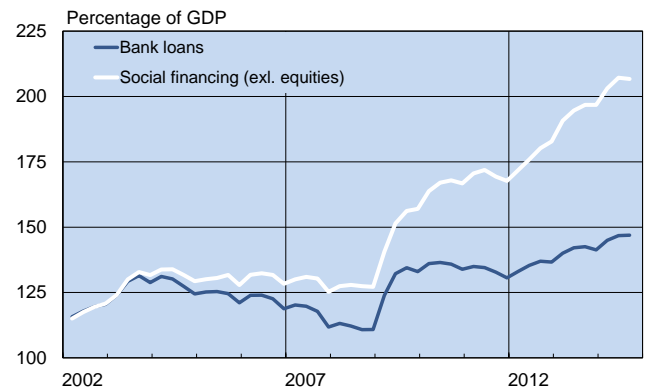
Sources: Macrobond, BOFIT

The structural evolution of the economy was further reflected in output. Service sector output increased faster in January-September than industrial, agricultural and forest sector output. Services generated 47 % of GDP in the first nine months of the year, while industry and construction accounted for 44 %. The contributions of agriculture and other primary production shrank to 9 % of GDP.

The slowdown in growth comes as no surprise, and many observers expect the pace of economic growth in the final months of this year to plateau at the current level or fall. Officials report that labour market conditions, however, remain strong, giving decision-makers an opportunity to focus on implementing agreed reforms. Indeed, from the reformer's standpoint, the situation will hardly change for better in the foreseeable future.

Pace of growth in domestic indebtedness slows. Measured with the broad concept of credit (total social financing), on-year growth in China's credit stock slowed in the third quarter to below 15 %, and the ratio of the credit stock to 12-month GDP at the end of September was unchanged from the end-June figure of 210 %. A similar slowdown occurred at the end of 2013, after which credit growth relative to GDP again accelerated. Notably, the volume of poorly regulated trust loan issuances has fallen in recent months and growth in the shadow-banking sector overall has slowed considerably. The ratio of the stock of bank loans to GDP remained practically unchanged in the third quarter.

Credit stock as percentage of Chinese GDP



Sources: Macrobond, BOFIT

China to release better unemployment data. *Bloomberg News* reports China's National Bureau of Statistics will "very soon" start releasing monthly survey-based indicators of unemployment levels produced in accordance with ILO methods.

A new indicator would be welcome, as official quarterly "urban registered" unemployment figures are basically unusable. Registered figures show the urban unemployment rate over the past decade hovering steadily in the range of 4.0–4.3 %. The undisclosed unemployment figures long used by decision-makers in setting policy are rumoured to have put the June unemployment rate at around 5 %.

In the absence of reliable unemployment data, economic policy debates have tended to focus on meeting growth targets. Unfortunately, even if growth targets earlier provided useful economic policy guidance, focus on targets today could be deceptive for all parties. It is nearly impossible at the moment to predefine sustainable growth targets that optimise employment. The most practical solution, perhaps, is to align fiscal and monetary policy with actual price and employment trends.

Russia

CBR: Firms and banks able to service their foreign borrowing. The Central Bank of Russia reports that non-bank corporations and banks have sufficient assets to service their debts at least to the end of 2015, even if shut off altogether from international financial markets.

A just-released CBR Financial Stability Survey finds that, as of end-September, non-bank firms and banks (including state-majority-held) owed \$614 billion (30 % of GDP) to foreign creditors: \$422 billion by corporations and \$192 billion by banks. By the end of this year, corporations must pay down \$39 billion in foreign debt (including interest) and banks \$414 billion. Corporations next year must make payments on principal and interest of \$77 billion and banks \$42 billion.

The foreign loans of *non-bank enterprises* broke down into 22 % Eurobonds, 29 % syndicated loans and 49 % bilateral loans.

Oil and gas companies accounted for the bulk non-bank enterprise sector loans (64 % of all loans). Some 35 % of foreign loans taken by these companies mature before 2016, while the loan due dates of firms in other branches is divided more evenly. Large export earnings denominated in dollars should help ease the burden in the oil and gas sector. The CBR pointed out that the sector nevertheless could be forced to reduce or postpone investment to service debt.

Moody's estimates that a significant part of large corporations will be able to service their debts e.g. out of substantial cash reserves at least this year and next. Many companies have anticipated coming foreign payments, e.g. by actively purchasing forex during the first half of this year (which boosted recorded capital exports). Debt servicing, however, has become challenging for some firms due to the lack of new financing from abroad. Moving ahead, firms must borrow from domestic sources with higher costs to service their debts.

The foreign debt of *banks* consisted of 62 % state-bank debt, 24 % private bank debt and 14 % foreign-owned bank debt. Most bank debt is long term, and will mature more than three years from now. A survey carried out by the CBR in September on Russia's 30 largest banks found banks generally capable of servicing their foreign debt at least through the end of 2015, even if certain banks could run into trouble from maturity mismatches with forex revenues and expenditures.

Russia reinstates authority of investigating officials to file criminal charges for tax violations independently.

The changes president Putin signed into law on October 22 were effective immediately and abolish the 2011 reform introduced during the Medvedev administration. Under the 2011 reform, criminal charges for tax violations could only

be laid by tax authorities. The amended law allows investigators (e.g. police) to press charges after requesting a statement from tax officials. Charges can be pressed even if the tax authority finds no evidence of tax code violations.

The 2011 reform was part of a general liberalisation of the Criminal Code aimed at reducing the powers of officials to exert pressure on firms. Other reforms included limits on the time the accused can be held during a criminal investigation and easing criminal penalties.

The business community saw the 2011 reforms as extremely important in reducing opportunities for authorities to harass companies. The number of criminal charges filed against companies for tax violations was reduced significantly. According to officials, however, the reform made it more difficult to investigate tax crimes.

Putin submitted his proposal on stiffening the law to the Duma last autumn, raising a long-running controversy thereafter. Not only have representatives of the business community declared their opposition to the move; prime minister Medvedev and several ministries also came out against it. Opponents say the change will again worsen the operating environment for firms. Indeed, companies have perceived deterioration in their operating environment in many ways over the past couple of years.

Russia must increase oil drilling to preserve production at current levels. Energy minister Viktor Novak said that oil drilling needs to increase 5–7 % a year to hold production at current levels, a challenge made all the more difficult with Western drilling companies leaving the country. Russia would have to build up its own state-of-the-art oil drilling capacity, yet investment is limited at the moment by low oil prices and lack of access to international lenders.

Oil production has already peaked at oil fields in the European parts of Russia and begun to decline in Western Siberia. Novak said production at the newer fields in Eastern Siberia is unable to make up for the loss of production elsewhere, nor are there enough new projects on the horizon to ease the situation.

The production emphasis is shifting to ever more remote or challenging areas for resource extraction and requires new technology (e.g. shale oil production). Russia lacks the necessary know-how and technology; development of new deposits was planned to a large extent to be based on collaboration with Western companies now subject to sanctions. If sanctions continue much longer, they will impact Russia's future oil production capabilities.

ExxonMobil pulled out of its arctic cooperation with Rosneft in September after the companies identified a promising deposit during exploratory drilling in the Kara Sea. Shortly thereafter, the French Total announced it was cancelling a planned joint shale oil venture with Lukoil. Shell also suspended its cooperation plans in shale oil extraction with Gazprom Neft.

China

Inauguration ceremonies held for China-led Asian Infrastructure Investment Bank. China and 20 other Asian and Middle Eastern countries gathered last Friday (Oct. 24) in Beijing to sign the founding articles for the Asian Infrastructure Investment Bank (AIIB). Other large Asian countries involved in the project include India, Thailand and Malaysia. Indonesia, South Korea, Japan and several other invited countries have decided not to participate at this point.

The bank's initial capitalisation will be \$50 billion, with China the largest contributor. Further rounds of AIIB capitalisation are planned, however, and more countries can join in to become stakeholders. AIIB's starting capital is the same as that of the BRICS countries' New Development Bank (NBD), established last July. The capitalisation of the region's longest operating development bank, the Asian Development Bank (ADB), is currently \$175 billion, with Japan and the United States holding the largest stakes (31% combined). China holds a 6% stake in ADB. China has been a proponent for new multinational development banks as they could provide alternatives for investing the country's foreign currency reserves and to use the new banks to create export markets for its infrastructure-building expertise.

The AIIB is scheduled to open its doors at the end of next year. Several developed economies and other international lenders have expressed concern over AIIB shortcomings in such areas as project transparency and issues related to environmental protection and labour rules. In any case, Asia has a huge infrastructure deficit. The ADB estimates, for example, that the regional investment demand for infrastructure development in 2010–2020 exceeds \$8 trillion. The World Bank adds that rectifying India's infrastructure gap alone will cost nearly \$2 trillion.

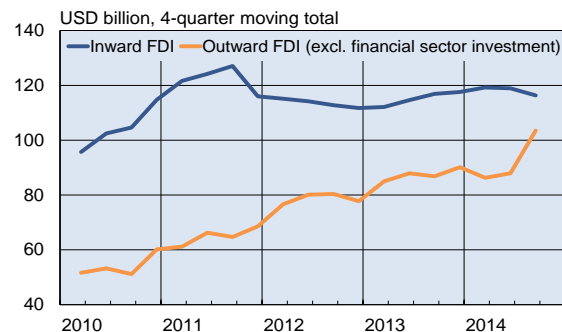
Sharp increase in Chinese outward FDI flows. China's commerce ministry reports Chinese foreign direct investment outflows in the third quarter amounted to about \$31 billion, a 97% increase from 3Q2013. Chinese FDI outflows in the first nine months of this year amounted to \$75 billion, a 22% increase from the same period last year.

China's outward FDI flows have grown rapidly in recent years. UNCTAD says China's outward FDI flows in 2013 (\$101 billion) moved the country into the world's top-three FDI providers, which it now shares with the United States (\$338 billion) and Japan (\$136 billion). A number of Chinese reforms have aimed at boosting the volume of outward FDI. China relaxed its rules at the beginning of September so that most firms are now able to make direct foreign investments by simply reporting it to the officials. All foreign investment earlier involved the often-lengthy process of getting an official permit. Officials say the change affects the bulk of investment flows. However, commerce ministry approval is still required for investment in certain countries

and branches.

Inward FDI flows to China fell to \$24 billion in the third quarter, a drop of 10% y-o-y. Inward FDI was last this low in 2010. The reduction in investment reflects not only the slowdown in the Chinese and global economies, but also uncertainties surrounding the regulation of foreign firms. Inward FDI flows amounted to \$87 billion during the first nine months of 2014, about the same as a year before. For the first time third-quarter inward FDI flows were less than China's outward FDI flows.

Chinese inward and outward FDI flows, 4-quarter total



Source: CEIC

Annual meeting of Chinese Communist Party Central Committee focused on problems concerning rule of law in China. The theme of finding ways to improve rule of law in China made its debut at the plenum of the Central Committee. The final session on October 23 was accompanied with a communiqué emphasising the need to govern in accordance with the Constitution; creating a stronger system to assure implementation of Constitution and oversight in accordance with it; safeguard the legitimacy of government actions; promote transparency in government affairs; attach liability to officials that break the law; and strengthen the internal rules and mechanisms of the Communist Party. Contrary to expectations, the meeting offered no new information on progress in economic reforms.

The latest plenum themes highlight the extent of problems at each level of China's justice system. The emphasis on enforcing discipline and measures to maintain law and order were also in keeping with the anti-corruption campaign launched last year. While initiatives at the party congress included limiting the influence of regional leaders in relation to local courts, there was little concrete information on planned reforms of the court system.

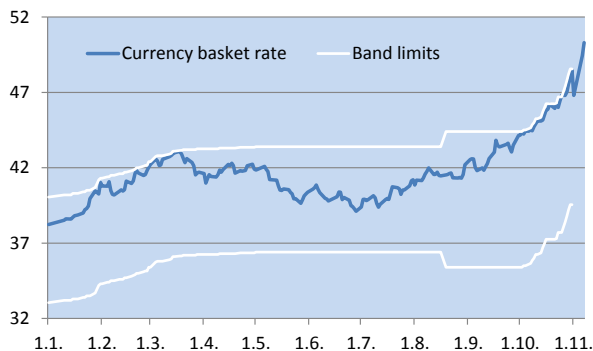
Anti-corruption campaigns cannot, in any case, solve systemic problems over the long term. In the worst case, the administration might find itself paralysed by such campaigns due to lack of clear procedures and rules. Many already suspect China is headed in this direction. The goal of the meeting was "the socialist rule of law with Chinese characteristics," not the most encouraging phraseology for launching efforts to secure "transparent rule of law."

Russia

Ruble hits record low – free float approaches. Since the start of September, the ruble has weakened about 15 % against its dollar-euro currency basket. The Central Bank of Russia again returned to the currency markets last month to smooth the ruble's slide, burning through nearly \$30 billion in its foreign currency reserves. By month's end, CBR currency reserves stood at \$428 billion. Even if Russia's foreign currency reserves are still prodigious by international standards, the last time they were so low was in autumn 2009.

Apparently reacting to the rising market uncertainty in recent days, the CBR unexpectedly imposed an upper limit on daily market interventions of \$350 million (there was no ceiling earlier). With the change, the ruble's exchange rate can at times exceed its fluctuation band limits. In practical terms, much of the functional significance of the band has been lost. The change is seen as a major step towards a free-floating ruble. The CBR has gradually liberalised the ruble regime during recent years, and the transition should be finalised at the start of 2015.

Ruble-currency basket rates and trading band limits, (Jan. 1–Nov. 7, 2014)



Source: CBR

CBR raises key rate. On Wednesday (Nov. 5), the CBR hiked its key rate 1.5 percentage points to 9.5 %. The central bank said the move was needed as a response to higher inflation and rising inflation expectations, which are affected in particular by ruble weakness and the ban on food imports. Ruble weakness, for its part, is mainly due to lower crude oil prices and economic sanctions. The boost in the key rate is also seen as part of efforts to slow ruble devaluation.

Consumer prices were up 8.3 % y-o-y in October. Food prices rose 11.5 % and non-food goods 5.7 %. The CBR expects 12-month inflation to stay above 8 % at least in the first months of 2015. The CBR said lower economic growth

has so far not decelerated inflation as the growth slowdown is due to structural factors such as capacity constraints.

While the hike in the key rate was not unexpected, its size surprised most observers. The move is generally considered appropriate in fighting inflation and securing financial sector stability amidst the current uncertainty. The rate hike, however, will also likely depress Russia's prospects for economic growth.

Ukraine and Russia work out deal on winter gas supplies. At EU-sponsored talks last week, Russia and Ukraine reached agreement on natural gas supplies for the next five months. Gas supplies had been interrupted since last June. Moving ahead, Gazprom will transmit only prepaid gas to Ukraine's state gas company Naftogaz. The gas price of approximately \$480 per 1,000 cubic meters is based on a 2009 agreement. With Russia's export duty discount included, Naftogaz will pay about \$380/1,000 m³. Even with the duty reduction, Ukraine will still pay a somewhat higher price than e.g. the average price Germany pays on Russian gas imports.

Ukraine plans a 4-billion m³ gas purchase for the rest of the year, which amounts to a prepayment of \$1.2 billion. Naftogaz also committed to pay \$3.1 billion by the end of the year to cover last winter's unpaid gas bills.

It has been left to a Stockholm arbitration court to hear complaints and cross-complaints of Naftogaz and Gazprom with regard to gas pricing, delivery conditions and Ukraine's unpaid gas bills.

Finnish exports to Russia continue to decline. The value of goods exports fell 13 % y-o-y in the January-August period on the ruble's severe weakening and weaker demand. Exports were down over 20 % y-o-y in August, reflecting partly Russia's imposition of import bans on certain foodstuffs. Finland's food exports to Russia fell to half of their last year's level as a result of the ban.

Finnish firms have gloomy expectations also on the near-term outlook for exports to Russia. A just-released Finnish-Russian Chamber of Commerce survey notes that export prospects have not been as weak since January 2009. Firms see political tension and the collapse of the ruble as the main problems for exports. An earlier survey of the Finland's Central Chamber of Commerce found that about 1 % of its member firms are subject to the EU export bans to Russia or the Russian import bans.

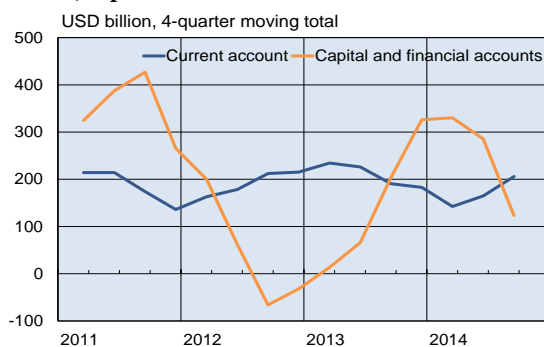
The numbers for Russian tourist visits to Finland have continued to slide in recent months. Both crossings at the Finnish-Russian border and overnight stays of Russian tourists in Finnish hotels and inns were down about 10 % from a year earlier. A survey by the Finnish Commerce Federation found the share of short day trips has increased this year in Russian tourism. Russians also spend less than previously on goods and services in Finland.

China

China posts increases in both current account surplus and financial account deficit. Preliminary balance-of-payments figures show China's current account surplus continued to rise in the third quarter of 2014. The September current account surplus was \$82 billion (\$40 billion in September 2013). The cumulative current account surplus for the first nine months of this year was \$162 billion, up 17 % from the same period in 2013. The four-quarter moving surplus was \$206 billion, or 2 % of GDP. A record goods trade surplus (driven in part by falling import prices) boosted the current account surplus. Signs of waning export demand emerged in late October with the release of the latest manufacturing purchasing manager index (PMI). The data is not yet reflected in balance-of-payments figures, however.

The combined capital account and financial account total, an indicator of capital transfers and investment of the current account surplus abroad, turned negative in the second quarter of this year. The third quarter deficit was \$82 billion. The shift over the past twelve months has been quite dramatic; last year in the same period the combined capital and financial account surplus was about \$81 billion. Capital inflows to China continued to diminish in the third quarter, while capital exports increased as the current account surplus was invested abroad. The capital account deficit since the start of 2014 amounted to \$4 billion. The last time China was a net capital exporter was in 2012.

Current, capital and financial account balances



Source: CEIC

China to allow competition in payment card market. The Chinese government last week announced that domestic and foreign firms that meet authorities' requirements can open their own clearing companies for processing card transactions in China. As the Chinese UnionPay is the only provider of yuan-denominated transaction clearing for bank and credit-card payments at the moment, foreign card companies have to rely on UnionPay for clearing yuan transactions. Details about qualification criteria for card-clearing

operators or a timetable for the rollout of the competitive arrangement have yet to be released. Two years ago, the World Trade Organization (WTO) found that China discriminated against foreign payment card companies by granting UnionPay a monopoly on clearing yuan payment card transactions.

Card-based payments are on the rise in China. The People's Bank of China reports UnionPay last year processed over 15 billion card-based transactions. In 2013, card-based payments rose 48 % y-o-y to over 32 trillion yuan (€3.8 trillion). The number of bank and credit cards in use has doubled over the past four years. A total of 4.5 billion cards has been issued.

China's shadow banking sector grows rapidly. The annual [Global Shadow Banking Monitoring Report 2014](#) of the Financial Stability Board (FSB) ranked China's shadow banking sector as the world's third largest at the end of 2013, with a size of \$2.7 trillion. The United States had the largest shadow banking sector (\$14 trillion), followed by the United Kingdom (\$4.7 trillion). According to the report, Russia's shadow banking sector, like its financial sector overall, was relatively tiny (\$80 billion). The FSB shadow banking asset comparison considered 23 jurisdictions.

China's shadow banking sector grew 38 % in 2013, only outpaced by Argentina in the FSB comparison. Many observers find the rapid growth of China's shadow credit industry disconcerting. Growth in the US was 1 %, while the sector contracted in the UK. Shadow banking overall increased 2 % globally last year.

The report also examines development of a wider concept that covers all financing outside the regular banking system (excluding insurance companies, pension funds and public financial institutions). The extent of these forms of financing reflects financial market sophistication and the variety of investment instruments available. The rapid rise of the wider non-bank credit intermediation in e.g. China is worrisome as it could outpace the ability of financial supervision authorities and regulatory framework to keep up.

China accounted last year for 4 % (\$3 trillion) of the \$75 trillion in non-bank credit intermediation in the G20 and euro area as a whole. Relative to its economy, China's non-bank financing was modest, just 31 % of GDP (survey average 120 % of GDP). However, the growth of non-bank financial assets for China has been quite rapid. Growth last year was 34 %, far surpassing the 7 % average of the countries surveyed.

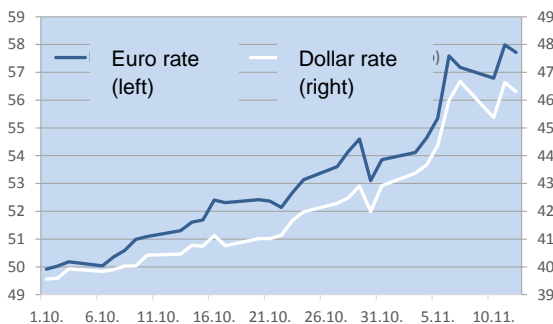
Assets relating to the non-bank credit intermediation represented 9 % of China's entire financial sector assets at the end of 2013. In comparison, the average ratio in the FSB report was significantly higher, 25 %. Banks hold 72 % of financial assets in China, compared to the survey average of 46 %. Insurance and pension assets in China represented just 4 % of financial assets. The survey average was 18 %.

Russia

CBR floats ruble ahead of schedule. The Central Bank of Russia announced in 2010 it would gradually move away from trying to steer the ruble's exchange rate. In 2012, it confirmed further that it would have measures in place to allow a free-floating ruble by the end of 2014. The float should allow it to focus on fighting inflation through interest-rate policy instead of ruble steering.

Recent market instability and a steep drop in the ruble's exchange rate forced the CBR late last week to accelerate the float date. Since Monday (Nov. 10), the CBR no longer seeks to restrain the exchange rate within a trading band by buying and selling currency.

Euro-ruble, dollar-ruble rates, Oct. 1 – Nov. 12, 2014 (rising line indicates ruble weakening)



Source: Bank of Russia

In addition to phasing out the trading band based on the performance of the ruble relative to a dollar-euro currency basket, the CBR will also abandon rule-based market interventions. Naturally, the CBR retains the option of market intervention if it sees that the stability of the financial sector is threatened. Making the timing of interventions less predictable reduces opportunities for ruble speculation.

In lieu of rule-based interventions, the CBR will now offer banks euro or dollar credit if market demand for forex increases. The CBR in October introduced auctions of 7-day and 28-day forex repo contracts. Later this year it will also initiate auctions for one-year forex repo contracts. Repo contracts allow banks to borrow foreign currency from the central bank against approved collateral. The CBR says it will regularly arrange forex repo auctions as long as Russian banks lack access to international credit markets.

Weak outlook for Russian household income growth.

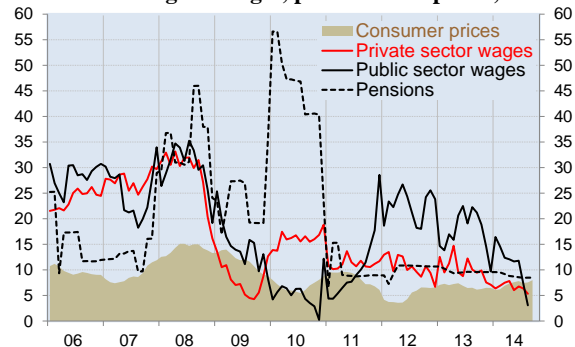
Disposable real incomes of households have shrunk in recent months compared to a year earlier e.g. due to debt-servicing. The government September forecast sees real incomes growing very slowly in coming years. Since then, the outlook for household income has deteriorated further.

Rise of private sector wages has been gradually dampened by lower economic growth and deteriorating corporate profitability. The average wage rise of recent months has barely kept up with inflation, i.e. real wages are stagnant.

Real wage growth in the public sector has also slowed sharply in recent years and even lagged inflation in recent months. Also for next year the federal budget sees wage increases at a rate below inflation. This means that the promised wage growth by president Putin in his 2012 inauguration decrees will not happen.

The rise in pensions has also been close to inflation. The government will next year seek to raise pensions more sharply than planned earlier. After that, pensions should rise at about the same rate as inflation.

12-month change in wages, pensions and prices, %



Source: Rosstat and BOFIT

Russia and China continue gas talks at APEC summit.

Last Sunday, executives of Gazprom and the Chinese CNPC signed a framework agreement on the "western route" for natural gas supplies from Russia to China. After years of talks, the parties now agreed on a schedule for next steps in the talks and basic precepts. These include the annual supply volume of 30 billion m³ which would be transported via the yet-to-be-constructed Altai pipeline. The Altai pipeline route and the gas price have yet to be specified.

Russia has been pushing the western route in order to take advantage of existing transmission infrastructure. It also provides a strategic alternative market for Western Siberian gas, which currently is only exported to Europe. China, on the other hand, is more interested in the eastern route because it is closer to end-users. China already has several pipeline gas suppliers on its western borders.

After several years of price talks, China and Russia agreed earlier this year on eastern-route gas supplies. Under the deal, Russia will annually pipe to China 38 billion m³ of gas starting in 2018. In order to fulfil the deal, Russia should bring new gas fields in Eastern Siberia on stream, as well as construct the 4,000-km "Power of Siberia" pipeline.

If both Russia-China gas pipeline projects are realised according to plan, Russia could annually export to China nearly 70 billion m³ of gas annually in the next decade. Russia's total gas exports to Europe last year amounted to 170 billion m³.

China

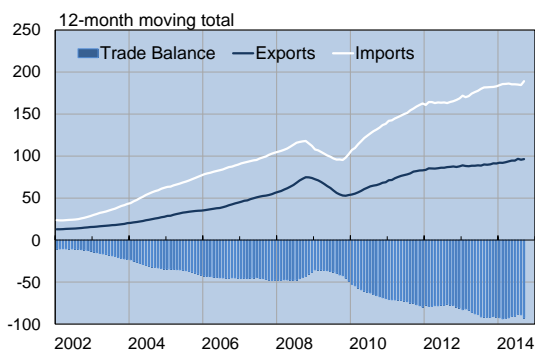
Free-trade agreements top APEC agenda. China hosted the Asia-Pacific Economic Cooperation (APEC) summit in Beijing during the first two weeks of November. Notably, China and South Korea (which has run trade surpluses with China for over two decades) announced they had concluded a free-trade deal. While both countries still must ratify the agreement, local media reported that China had committed over the next 20 years to eliminating tariffs on 85 % of imports from South Korea by value and that South Korea would cut tariffs on about 90 % of Chinese imports by value. The agreement, however, omits important goods categories such as agricultural and automotive products, and appears to be narrower in scope than, say, the South Korea-EU free-trade agreement.

China's General Administration of Customs reports that in September South Korea surpassed Japan as China's third main trading partner after the EU and US. Trade between the two countries last year was valued at \$274 billion, about 7 % of China's foreign trade. China is South Korea's most important trading partner, with a quarter of its exports going to China.

Ten years of talks on a bilateral free-trade deal between China and Australia also appeared to be in the home stretch. China is Australia's biggest trading partner. Bilateral trade last year reached \$136 billion, or about 3 % of China's foreign trade. In addition to South Korea and Australia, China has six FTA agreements under negotiation. China has twelve free-trade agreements in force at the moment.

Given the intricacies of free-trade arrangements within the 21-member APEC, China is pushing for creation of a regional "Free-Trade Area of the Asia-Pacific" (FTAAP). The summit's final communiqué mentions establishment of a study group to scope out possibilities towards FTAAP realization. The US supports creation of a more restricted Trans-Pacific Partnership (TPP) that does not include China.

Chinese trade with South Korea, USD billion



Source: Macrobond

China and the United States reach deal to eliminate duties on many IT products. The WTO's Information Technology Agreement (ITA) got a huge boost this week when China and the United States agreed to expand the agreement and completely eliminate duties on over 200 IT products ranging from smartphones to medical equipment and game consoles. The expansion would eliminate tariffs on globally traded goods with an estimated value of \$800 billion to \$1.4 trillion a year. China is the world's largest exporter of IT products.

The ITA trade pact that entered into force in 1997 sought to end tariffs on high-tech products. It has lagged technological advance from the start. Although the need for a treaty expansion has been apparent for 17 years, agreement still seemed in doubt last year as the US and China suspended ITA talks several times. The treaty includes 80 WTO members and covers 97 % of globally traded IT products.

China's New Silk Road vision comes closer to reality.

President Xi Jinping last year proposed creating a modern version of the ancient Silk Road trade route running from China to Europe. The ambitious New Silk Road (NSR) project took a big step forward last week when Xi announced that China would create a \$40 billion NSR fund to provide financing for infrastructure projects and economic cooperation among countries along the route. The project is part of China's regional cooperation strategy and is connected to the establishment of several new development banks. It is, however, still unclear how the new fund will operate.

The NSR plan has land and maritime aspects. The NSR involves rail lines connecting Central Asia with regional economies, as well as sea routes running from Southeast Asia to Europe. The NSR plan calls for large-scale construction of railways, road infrastructure, seaports and airports. The land route would traverse southwest China, several countries in Central Asia and the Middle East, as well as Turkey before reaching Europe. The sea routes would run from China's southern coast to Southeast Asia, India, East Africa, then on via the Suez Canal to the Mediterranean Sea.

China hopes the plan will promote regional cooperation, boost foreign direct investment abroad and increase international use of the yuan. The huge project would also create demand for Chinese heavy industry, which is suffering at the moment from overcapacity in several branches.

The lion's share of freight between China and Europe presently moves by sea. China is linked to Europe via rail lines running through Kazakhstan, Russia and Belarus. While maritime shipping offers greater freight capacity and lower transport costs, land shipping is attractive where speed or reliable timing of delivery are issues. Overland shipping from China to Europe would take half the time of sea shipping. Given the heightened tensions between Russia and Europe at the moment, the NSR could seek alternative (i.e. non-Russian) land routes to China for European exports.

Russia

Federal budget so far in surplus; next year's budget likely to dip slightly into the red. Preliminary finance ministry figures show a January-October federal budget surplus of 1.9 % of GDP. Although the decline in world crude oil prices in recent months has reduced Russia's dollar-denominated export earnings, the collapse of the ruble has largely offset the drop. Measured in rubles, budget revenues from taxes on oil production, as well as export duties on oil, have largely matched their budget targets. Other budget revenue categories have felt a modest boost from the pick-up in inflation.

The end-year surplus is likely to be largely wiped out as government agencies try to spend their full budget allotments before the end of the year. As a result, this year's budget should be nearly in balance by the end of December. The federal budget this year was earlier expected to show a deficit of around 0.5 % of GDP.

On November 14, the Duma approved the critical second reading of next year's budget act. The proposed budget would have a deficit of 0.6 % of GDP. Fees and duties from oil set aside in the Reserve Fund would be used to cover the deficit. The budget calculations assume an average Urals oil price in 2015 of \$100 a barrel and an average exchange rate of 34 rubles to the dollar. Both assumptions are already outdated. According to the finance ministry, the situation will, however, be improved by ruble weakness, which will increase oil income in ruble terms compared with earlier calculations.

Russia puts ceilings on consumer credit rates. Last year the Duma passed an amendment giving the central bank the authority to set ceilings on consumer credit charges (combined total of interest and other fees converted to a per annum interest rate). The move sought to rein in the often sky-high costs of consumer credit in Russia.

The Central Bank of Russia has for the first time released figures on the average costs of consumer loans. The data cover the third quarter of 2014. Based on the information, the CBR has issued guidance that the total cost of a consumer loan granted in the first quarter of 2015 may not exceed by more than 33 % the average total cost of consumer loans granted in 3Q14. The allowed quarterly maximum costs are categorised according to lender and credit type.

Hence, credit institutions can in 1Q15 collect costs and interest on e.g. unsecured loans of less than 30,000 rubles (€10) at up to 46.8 % p.a. Organisations making unsecured loans of less than 30,000 rubles for periods of one month or less may not charge a rate equivalent higher than 914.8 % p.a.

Growth in bank lending to households has slowed steadily since 2013. One reason is that banks have tightened their lending rules to comply with CBR guidelines. CBR guidelines, in turn, have been shaped to reduce the exposure of banks to credit risk from consumer loans. Credit risk related to unsecured loans, in particular, has increased sharply.

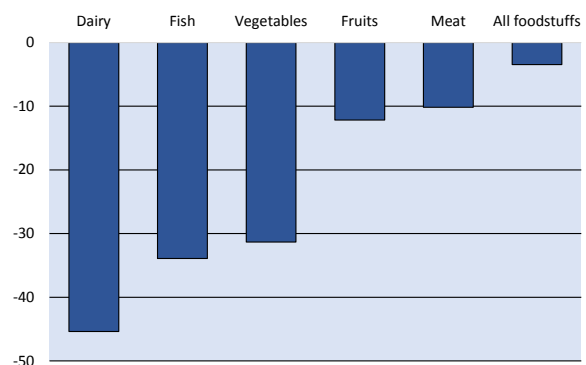
Russian foreign trade continues to contract. The value of Russian goods exports in the first nine months of the year was just over \$380 billion and the value of goods imports was just under \$220 billion. The value of exports shrank 1 % y-o-y, while the value of imports fell 6 % y-o-y.

The value of third-quarter goods exports fell 4 % from a year earlier, due in large part to lower oil prices and contractions in volumes of both crude oil and natural gas exports. Crude oil exports to non-CIS countries fell by 5 % y-o-y, while gas exports to non-CIS countries decreased by more than 25 %. In contrast, exports of refined petroleum products grew briskly. Gas exports to CIS countries plunged over 50 %, mainly on a sharp decline in gas exports to Ukraine. EU countries account for over half of Russia's total exports.

Driven largely by the fall in the ruble exchange rate, the value of goods imports contracted in the third quarter by nearly 7 % y-o-y. While imports contracted in nearly all product categories, the biggest drop (12 %) among the most important ones was seen in machinery, equipment and transport vehicles, which account for about half of Russian goods imports.

Impact of the import ban on select food items that Russia imposed in August was visible in imports. Food represents 13–14 % of Russia's total goods imports; the ban targets about three percentage points of that slice of imports. Imports of products in categories affected by the ban fell by nearly 25 % y-o-y (in both value and volume terms) in the August-September period. Imports of dairy products and fish have been hardest for Russians to replace as their imports have contracted most.

Change in value of main categories of food imports affected by Russia's ban and total food imports, Aug.-Sept. 2014, % y-o-y



Sources: BOFIT, Russian customs

China

“Through Train” link of Shanghai and Hong Kong stock exchanges expands access to Chinese equities. The opening of China’s capital markets took a great leap forward on Monday (Nov. 17) with the launch of linked trading on mainland China and Hong Kong stock exchanges. The arrangement allows foreign investors to trade shares on the Shanghai Stock Exchange (SSE) via the Hong Kong Stock Exchange (SEHK), and Chinese on the SEHK via the SSE.

The joint programme permits trading in shares included in the SSE 180 and SSE 380 indices, shares in the SEHK’s Hang Seng Composite LargeCap and MidCap indices, as well as shares of companies listed on both the SSE and SEHK. Currently the programme covers 568 SSE-listed shares and 268 SEHK-listed shares.

The cap on foreign investor net purchases is 300 billion yuan (€39 billion) for the Shanghai exchange, less than 2 % of the SSE’s market capitalisation. Net purchases of Chinese investors trading on the SEHK are capped at 250 billion yuan, less than 1 % of the SEHK’s market capitalisation. Trade flows are also subject to daily limits: the SSE maximum daily net buys are 13 billion yuan (€1.7 billion), while the maximum net buys for the SEHK are 10.5 billion yuan. Investment in China is further limited by restrictions on foreign ownership. A single foreign investor may not hold more than 10 % of a Chinese firm and no more than a total of 30 % of a Chinese firm’s shares may be in foreign hands.

Access to Chinese stock markets was earlier limited to investors with Qualified Foreign Institutional Investor (QFII) or Renminbi Qualified Foreign Institutional Investor (RQFII) status. Now any Hong Kong resident or foreign investor can trade on the Shanghai exchange. Mainland institutional investors and private investors with assets of at least 500,000 yuan (€65,000) can trade on the Hong Kong exchange. The arrangement lets mainland Chinese invest in some of China’s largest SEHK-listed firms, including Tencent, Lenovo and China Mobile.

As all trading is in yuan, the “Stock Connect” experiment is hoped to increase international yuan demand and reinforce Hong Kong’s position as a yuan-trading centre. As a symbolic gesture, the Chinese have also lifted the 20,000-yuan daily conversion limit on Hong Kong residents.

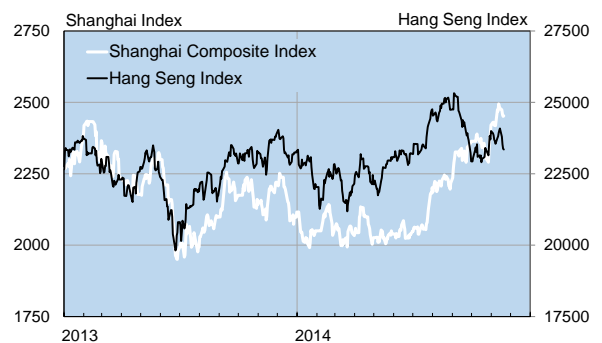
Trading via Shanghai and Hong Kong stock exchange link off to weaker-than-expected start. Although the start of linked trading on Monday (Nov. 17) appeared to reach the 13-billion-yuan daily buy quota for the Shanghai stock exchange, some trades were later cancelled. The total value of buy orders on the SSE via the link was 12.1 billion yuan. Link trading cooled sharply on Tuesday and Wednesday, bringing the total value of share purchases in the first three days of trading to 19.7 billion yuan (€2.6 billion). Foreign

owners sold 400 million yuan (€52 million) in shares purchased on previous days. Intraday trading on the Shanghai stock exchange is prohibited.

Over the first three trading days, mainland Chinese purchased shares valued at 2.9 billion yuan (€382 million) on the SEHK. The value of sold shares was about 300 million yuan (€39 million). Chinese share buyers were put off by the relative priciness of Hong Kong shares, even if Hong Kong share prices have fallen in recent months. Prices on the Shanghai exchange are up 16 % from the start of the year, while Hong Kong share prices on average are about where they were at the start of the year. In the first three days of linked trading, share prices fell on both exchanges.

Thus far the Through Train arrangement has had little impact on daily trading volumes on either the SEHK or SSE. Trading under the programme during the first three days represented less than 4 % of the daily trading volume on the SSE and less than 2 % on the SEHK.

Hong Kong and Shanghai stock indices, 1.1.2013–19.11.2014



Source: Macrobond

China’s economic figures reveal long-expected slowing. China’s October inflation and other headline economic figures were somewhat lower than expected and reinforced the view that economic growth has settled into a long-term slowing trend. The 12-month change in consumer prices in October of 1.6 % was unchanged from September, and inflation remained at its lowest level since 2010. Producer prices continued to drop, down 2.2 % y-o-y in October. On-year growth in October in the loan stock, money supply and fixed capital investment slowed from September. Growth in lending by the shadow-banking sector showed an even more pronounced slowing than growth in the formal banking sector. Industrial output rose 7.7 % in October, a slight drop from 8 % in September. Growth in the value of exports and imports also slowed.

The slowdown in economic growth matches expectations, and GDP growth is expected to remain around the 7 % level. In recent months, the People’s Bank of China has provided banks with short-term financing to increase market liquidity. Broader easing measures by the central bank might put at risk efforts to manage rising indebtedness in China.

Russia

CBR says zero economic growth may be ahead in 2015–2016. The Central Bank of Russia released its annual guidelines for monetary policy, including various scenarios for the economy of the country. In the basic scenario, GDP does not grow in 2015 and 2016. This assumes OPEC countries cut oil production and the average price of Russian Urals-grade oil rises from its current level of less than \$80 a barrel to \$94–95. The forecast further assumes that current trade and financial sanctions will remain in place until 2017, when GDP is expected to increase by about 2 % p.a. If next year's oil price is \$84 (i.e. still higher than currently), the CBR expects GDP to shrink by about 0.5 %. An increase in the oil price to \$105 next year would bring a GDP growth of about 0.5 %.

In the basic scenario, private consumption grows only slightly during 2015–2016. Fixed capital investment is expected to decline slightly next year and in 2016. While the global economy recovers gradually in all scenarios, in most of them the volume of Russian exports remains at its current level next year and increases only slightly in 2016. Under the basic scenario, Russian imports further contract slightly next year and only begin to recover in 2017.

Economy minister Alexei Ulyukayev this week confirmed that his ministry's economic forecast was unchanged by noting that next year's projection still calls for GDP growth above 1 % and 2016 growth over 2 %.

The CBR forecasts GDP growth this year of 0.3 %, while the economy ministry says 0.5 %. Observers note that the transient factors that sustained better growth in January–September (0.8 % y-o-y) also impacted in October. The weak ruble and a soaring increase in defence spending in the early autumn fuelled growth in certain manufacturing branches, and consumers continued to accelerate big purchases amidst higher inflation and inflation expectations.

Profits of foreign-registered Russian firms are aimed to get under Russian taxation. The Duma last week approved tax law changes designed to restrict the common practice of offshoring profits of Russian companies by sending e.g. dividends and loan interest to companies in countries with low tax rates. The long-recognised problem has recently faced more vocal demands to promptly rectify the situation, including from president Putin himself.

The amendments require Russian firms and private individuals to pay taxes in Russia on the profits of their foreign-registered corporations if they own at least 50 % of the company. Starting in 2016, the minimum ownership cap falls to 25 %. Amendments include also some more detailed conditions, like that the foreign tax jurisdiction will still be recognised in certain circumstances, e.g. when at least 80 %

of the earnings of the foreign-registered company are generated through business activities in the local economy.

The finance ministry and business groups, which have been preparing the bill for a couple of years, have been criticised on their slow progress. The finance ministry would have wanted to relax some of the draft bill's harshest rules ahead of the Duma's decisive second reading. The Duma, however, wanted the changes to be effective as soon as possible and chose to pass the law in its original form. In the view of both the finance ministry and some Duma deputies, the revised law is impossible to implement in its current form. They aim at amending it in the spring session of the Duma. Because the issue concerns relaxing regulations, deputy finance minister Sergei Shatalov said it should be possible to implement the needed changes retroactively.

For the law to work in practice, Russian officials must still gain access to the necessary information from those countries where Russian-controlled firms are registered.

Deputy finance minister Shatalov said the reforms would add about 20 billion rubles (€360 million) a year to the federal budget. Next year's federal budget revenue estimate was about 15.1 trillion rubles (€270 billion).

Law changed on Russian oil sector taxation. In mid-November, the Duma approved major revisions of the tax and duty scheme for crude oil and petroleum products. The amendment shifts the taxation emphasis from exports to production.

The changes will come into force gradually over the next three years. During that time, export duties on crude oil, diesel fuel and gasoline will go down 70 %. The mineral extraction tax on crude oil production correspondingly will go up 70 %, and there will be an over 500 % increase in the extraction fee for byproduct gas condensate generated from oil drilling. One of the aims of the changes is to increase federal budget revenues. It is estimated that the reform should boost budget revenues by about 250 billion rubles (€4.5 billion) a year starting in 2016.

The tax structure reform will reduce earnings of oil refiners, because the domestic price they pay for crude oil will rise as a consequence of higher mineral extraction fees. The losses to refiners will be offset, however, through the corresponding drop in export duties on petroleum products. Igor Sechin, CEO of state-owned Rosneft, strongly opposes the reform, which he fears will endanger e.g. Rosneft's planned Nakhodka oil refinery.

Russia severely taxes the oil sector, and taxes are based on the global price of crude oil. It is estimated that about 70 % of the oil export price goes to the federal budget through various fees, duties and taxes. The system does not encourage companies to modernise their production facilities or make new investments. Russia has been encouraged to adopt international practices, i.e. taxation based on corporate earnings instead of the value of production.

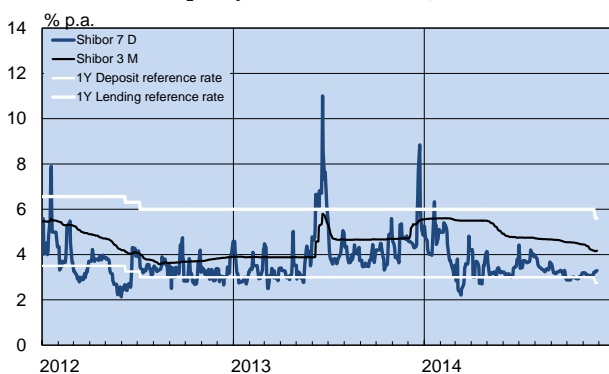
China

Cuts and looser rules for interest rates in China. In a surprise move after hours last Friday (Nov. 21), the People's Bank of China announced it was cutting the benchmark loan and deposit rates banks charge from their customers. The benchmark one-year credit rate was lowered by 0.4 percentage point to 5.6 % and the one-year benchmark bank deposit rate was lowered by 0.25 percentage point to 2.75 %. Reference rates were last adjusted in July 2012. The rate cuts mainly help the housing market, where housing loans are still subject to interest-rate regulation. Otherwise cuts are unlikely to have much impact on bank lending or economic growth as bank lending rates for the most part have been deregulated since July 2013.

More important than rate cuts as such is perhaps that the latest measures signal progress in deposit rate liberalisation. In connection with the rate cut, the PBoC also granted more flexibility to banks in setting deposit rates. Instead of the earlier ceiling of 10 %, banks can now offer up to 20 % above the benchmark rate on deposits. In practice, the ceiling for one-year deposit rate remains unchanged at 3.3 %. Reference bank deposit rates for longer maturities were also consolidated to reduce the overall number of reference rates.

Importantly, the rate cuts do not erode the competitiveness of formal banks relative to deposit rates and yields on investments offered on shadow markets. Banks now have less incentive to circumvent interest-rate rules, which in turn reduces their incentives in the hard-to-monitor shadow banking sector to develop alternative financial products. The PBoC also stressed that the main function of the rate cuts is to improve interest-rate transmission in the economy, not to change the current monetary policy stance.

Trends in Chinese policy and market rates, 2012–2014



Source: Macrobond

There was mixed, but modest, reaction to the rate drop on money markets with some rates rising and others falling.

On Monday (Nov. 24), the yuan-dollar exchange rate declined only 0.3 % in the wake of the announcement.

Chinese monetary policymakers struggle to keep up with rapid changes in the market. Although China has only partially liberalised its financial markets at the moment, market structures and operations continue to evolve rapidly. The pace of market change, however, is not sufficiently reflected in the central bank's efforts to overhaul its monetary policy toolkit. As a consequence, Chinese monetary policy remains fairly opaque.

This year, the PBoC has tried to influence money markets and economic growth through offering credit directly to targeted banks. This policy approach has been criticised for lack of both fairness and transparency. The central bank has also cut the 14-day repo rate four times this year (including another cut this week), but the role of such cutting to the overall implementation of monetary policy remains unclear. As regards the latest cuts in benchmark credit and deposit rates, even the PBoC itself does not seem all that convinced that the lower reference rates will translate automatically to lower bank lending rates. By its acknowledgement, the PBoC will also resort to putting informal pressure on banks to pass on the lower lending rates to businesses. Market observers note that financial entities find it difficult to distinguish between measures by the PBoC merely to balance bank liquidity and more long-term measures that signal a tightening or loosening of the monetary stance.

It is obvious that the current monetary guidance does not work well, and many observers think that the central bank's most important monetary policy instrument is still the reserve requirement ratio (RRR). The RRR has been kept unchanged at a relatively high level from May 2012. This summer, however, the central bank announced that smaller banks focusing on lending to small businesses and the agriculture sector were entitled to a reduction in their RRR. Even in this case, it however remains somewhat unclear which banks actually benefitted from the move.

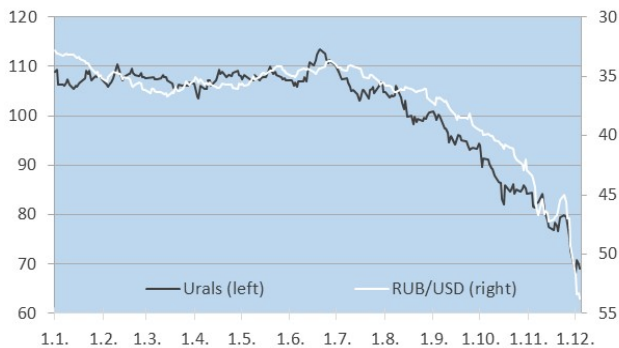
Many aspects of Chinese monetary policy adhere to the old ways. The PBoC still operates under the government, and thus lacks independence in its monetary policy decisions. For example, the government has recently sought to improve access to credit for small businesses and the agricultural sector as a way to boost economic growth, while the PBoC has emphasised cautious monetary policy due to e.g. the rise of non-performing loans in the banking sector. This has created contradictory policy messaging and the introduction of new monetary policy instruments that has resulted in even less transparency.

In recent years, the central bank has pushed reforms of the banking sector, as well as interest rate and currency policy. Recent trends and the PBoC's own messaging suggest, however, that the central bank's move to an interest-rate-based monetary policy regime is inevitable.

Russia

CBR intervenes in currency markets as ruble's slide hastens. The ruble's slide accelerated this week with the sharp drop in world oil prices. The trend has been affected also by recent cuts in economic growth forecasts of ministries. In just eight days, the ruble lost about 14 % of its value against the euro and dollar. As of December 5, the dollar-ruble rate was 52.7 and the euro-ruble rate 64.8.

Price of Urals crude (USD/ barrel) and dollar-ruble exchange rate, Jan.1–Dec. 4, 2014 (decline indicates ruble weakening)



Source: Thomson Reuters

The CBR spent \$700 million of its reserves during its December 2 intervention, explaining the ruble's exchange rate had diverged substantially from an exchange rate justified by Russia's economic fundamentals. The central bank noted that the plunging exchange rate and its large fluctuations increase the risks of degrading the stability of the banking sector and reinforcing inflation expectations. Yesterday (Dec. 4), the CBR lowered its interest rate on forex repo credits to increase liquidity on the forex market.

The CBR last intervened in the market to support the ruble on November 10, after which it announced the ruble would be allowed to float freely. It reserved the right to intervene to support the ruble in extreme circumstances.

Russia approves duty on retail trade facilities. As of July 2015, changes in the tax code will enter into force in three "federal level" cities (Moscow, St. Petersburg and Sevastopol on the Crimea), allowing them to apply a new trade duty (*torgovyi nalog*) to retailers. Other Russian regions would eventually also be able to apply the trade duty with further changes in the tax code.

Revenues from the trade duty go directly to municipal budgets and municipal officials have a certain degree of flexibility in setting the amount of the duty. The duty is based on shop floorspace. For example, Moscow retailer with floorspace of over 50 square meters would pay a trade duty of 1,200 rubles (about €20) per square meter per year.

Given resistance to hikes in value-added tax rate during next year's budget preparations this autumn, the plan was to

introduce a municipal sales tax on all goods. The tax was intended to boost revenue of municipalities struggling with budget deficits. After municipal sales tax found little support, a "business" tax was proposed instead. The business tax would have applied to over 20 categories of service-sector activities and all Russian municipalities could impose the tax.

The business tax bill encountered vigorous opposition when it was published last month without discussions with the business community. During its November reading in the Duma, the business tax was whittled down to the more modest trade duty. President Putin said the trade duty was needed because many large retail chains in Moscow pay no taxes at all. Large Moscow retail chains quickly disputed the president's claim.

According to officials, the trade duty would affect only companies evading taxes, since the trade duty can be deducted from other taxes paid by the retailer.

Russia's ban on food imports causing friction among customs union partners. Russia's Federal Service for Veterinary and Phytosanitary Surveillance (Rosselkhozadzor) claims that banned products are continuously being brought into Russia through Belarus. A common ruse is to disguise cargo as transit freight headed for Kazakhstan. As there are no customs inspections on the internal borders of the Russia-Belarus-Kazakhstan customs union, movement of goods is difficult to monitor within the union. To prevent illegal imports, Rosselkhozadzor announced at the end of November that all transit freight coming from Belarus would be inspected at the Russian border – a rule that violates customs union principles. Despite the announcement, customs union members are aiming at deepening economic integration at the start of next year, when the customs union will become the Eurasian Economic Union.

Still in August, Russia planned to substitute many of the items covered under the food import ban with products from Belarus. For example, the customs union doubled Belarus' quota for meats imported from outside the customs union in order to assure an adequate supply of raw material for preparation of meat products destined for the Russian market. Rosselkhozadzor has, however, in past months reported a number of veterinary and phytosanitary rule violations in Belarus meat products and other foods. In response, the agency imposed temporary import restrictions on numerous Belarus food exporters at the end of November. Belarus president Alexander Lukashenko strongly criticised Russia's actions.

Rosselkhozadzor head Sergei Dankvert says even more rigorous food security inspections lie ahead, noting that even if the August ban on food imports is lifted, food imports will still be subject to greater scrutiny. Officials are currently drafting new rules forbidding public-sector entities from purchasing food items prepared outside the customs union. The new regulations are to be introduced at the start of 2015.

China

Rollout of deposit insurance scheme proceeds in China.

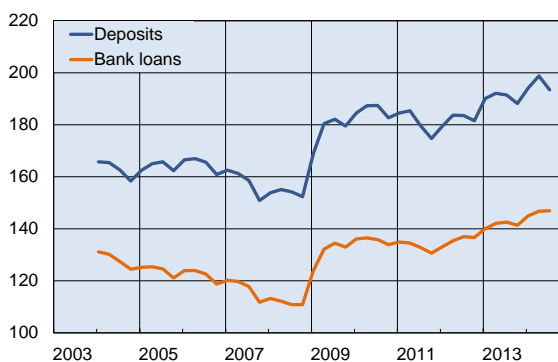
The People's Bank of China has released a draft of its proposed deposit insurance scheme, saying it expects initial comments on the plan by the end of the year. The PBoC said the deposit insurance scheme could be in place as early as next year. The current proposal calls for fully insuring all deposit accounts up to 500,000 yuan (about €65,000). The current deposit insurance coverage in the EU, for example, has been €100,000 per deposit account since 2010.

Deposit insurance is an important stabilising factor for financial markets as interbank competition is increased through deregulation of deposit interest rates and the lifting of capital controls. The PBoC last month raised the ceiling on bank deposit interest rates to allow more flexible interest rate pricing. Commercial banks can now offer higher deposit rates relative to the PBoC's reference rate. The introduction of a deposit insurance scheme would also permit ending interest rate regulation altogether.

If a bank becomes insolvent, its depositors would be reimbursed from a fund to be built up from insurance contributions collected from financial institutions. China has never had a deposit insurance scheme, but the state has in practice guaranteed deposits by preventing bank collapses and providing capital infusions to stave off bank runs. Deposit insurance would also balance out competition in the banking sector and in principle allow failed banks to go bankrupt.

The PBoC reports the proposed ceiling of 500,000 yuan per account would cover over 99 % of individual deposit accounts and about half of total deposits in Chinese banks under the proposed deposit insurance scheme. China's deposit stock is one of the world's largest. At the end of October, the deposit stock was about 112 trillion yuan (about €14 trillion), about half of which was household deposits. Chinese deposits are also substantial – nearly 200 % of GDP.

Bank deposits and loans, % of GDP (4-quarter moving total)

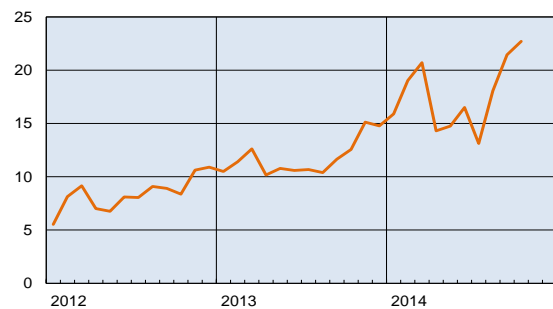


Sources: CEIC, Macrobond

Yuan use continues to increase in Chinese foreign trade.

In October, 23 % of Chinese foreign trade payments were denominated in yuan, a sharp increase from just 5 % in 2012. And the yuan's importance in international payments continues to rise. SWIFT, an organisation to promote secure international financial messaging services, reports the yuan was the world's seventh most-used currency in international payments in September with a 1.7 % share.

Share of yuan payments in China's goods trade, %



Source: Macrobond

China has signed bilateral currency swap agreements and established yuan clearing banks to make it easier to conduct business in yuan. Currency swap deals have already been signed with nearly 30 countries. The PBoC increasingly sets the yuan exchange rate directly for many currencies. Direct currency exchange of the yuan and Singapore dollar was introduced at the end of October, and direct dealing in yuan and the South Korean won began this week. The yuan-euro exchange rate has been set directly since September. The significance of direct currency trade, however, is marginal at least as concerns the smallest countries due to low volumes.

China last month announced the establishment of a number of new clearing banks around the world. The PBoC has designated two state banks as yuan clearing banks: ICBC for Toronto and Doha, and the Bank of China for Sydney and Kuala Lumpur. The ICBC has also set up a yuan-clearing bank in Los Angeles. Clearing banks are also important in the development of yuan-denominated financial instruments. The linking of the Hong Kong and Shanghai stock exchanges should also somewhat increase demand for yuan and yuan-based financial instruments.

China seeks to increase the use of the yuan as a reserve currency in order to facilitate borrowing from international financial markets. The PBoC reports that the yuan is currently the world's seventh largest reserve currency. The British government, for example, issued a loan of 3 billion yuan (€390 million) in yuan-denominated bonds in October in order to add yuan in its currency reserves. The yuan's significance as a reserve currency is still, however, minor. Most of the world's currency reserves are in dollars and euros. If yen and British pound are included, the four currencies make up 93 % of the international currency reserves.

Russia

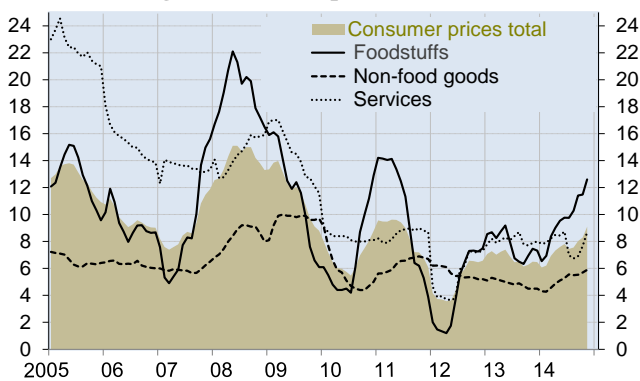
Russian on-year inflation accelerates towards 10 %. The rise in consumer prices picked up throughout 2014, with 12-month inflation running above 9 % at the end of November. In particular, November food prices were up 12.6 % y-o-y. Inflation for non-food goods also rose to nearly 6 %.

At his meeting this week with the cabinet, president Vladimir Putin said it was clear that higher prices for imported goods, due to the weakened ruble, and Russia's ban on imports of certain foodstuffs were fuelling inflation. Economy minister Alexei Ulyukayev further clarified that about 4 percentage points of the rise in food prices came from the ruble's fall and about 2.5 percentage points from the import bans. Deputy economy minister Alexei Vedev said the overall impact of the ruble's weakening this year would be 2.4 percentage points to the consumer price inflation rate.

The Central Bank of Russia, the economy ministry and the finance ministry currently expect 12-month inflation to accelerate to nearly 10 % this winter. Inflation should begin to subside during the second quarter of 2015.

The ruble has lost almost 9 % of its value against its currency basket since the start of December. The CBR has staved off a deeper drop in the ruble by buying rubles in the currency market on six days this month, spending a total of €1.1 billion. The CBR also granted banks over €0.5 billion in additional forex repo credits (mostly 28-day repos).

12-month change in consumer prices, %



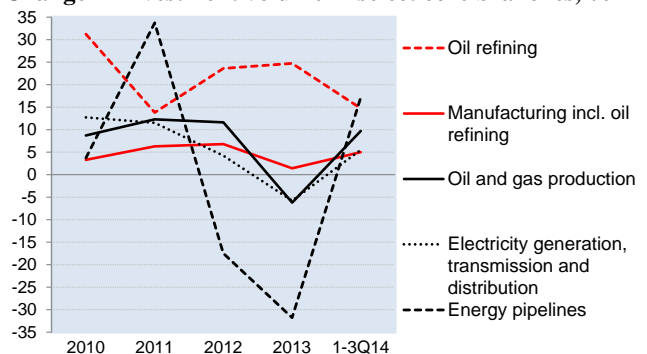
Source: Rosstat

Russia's big firms increase their investments. Total fixed capital investments fell a couple of per cent in both the January-September period and the third quarter of the year. The drop in investments was considerably smaller than what has been projected in forecasts. As in the first half of the year, investments of small firms and the grey economy contracted substantially. In contrast, investments by others (mainly large and medium-sized firms) increased by a couple of per cent in January-September.

Since last year's drop, investments of large companies in the energy sector have recovered rapidly. Although growth in investments in oil refining slowed, it remained rapid and accounted for the lion's share of total investment growth in the manufacturing sector. Investment growth also remained good in the food industry. Particularly fast growth was posted by the transport vehicle industry, which may reflect a boost from the sharp growth of defence spending. Moreover, the contraction in total investments in machinery & equipment of large and medium-sized firms came to an end in the third quarter. Growth in housing construction remained brisk.

Growth in investments of large firms reflects the government's goal, reinforced at the start of this year, of getting large state-owned enterprises to increase investments despite the hard times. The economy ministry indicated in November that investments of so-called natural monopolies, which represent some of the biggest state-owned enterprises, will grow even more notably next year.

Change in investment volume in select core branches, %



Source: Rosstat

Economy ministry sees GDP contraction next year, imports to be hardest hit. In its revised forecast prepared last week, the economy ministry now sees GDP contracting next year by 0.8 %, assuming the price of Urals oil averages \$80 a barrel. The ministry expects private consumption and fixed investment to fall about 3.5–4 % next year. The ruble should recover slightly from its current low (around 55 rubles to the dollar) to 49 rubles to the dollar – a level still about 25 % below this year's average exchange rate. The economy ministry further estimates that good imports to Russia will decline in value terms about 10 % this year and as much as 15 % next year. The cabinet has yet to review the forecast.

Maxim Oreshkin, head of the finance ministry's department for strategic planning, said the ministry largely agreed with the economy ministry GDP forecast. However, the ministry expected the ruble's exchange rate next year to average around 45 rubles to the dollar. Finance minister Anton Siluanov noted the largely shared views of the finance ministry and the central bank with respect to the situation in the domestic currency markets.

China

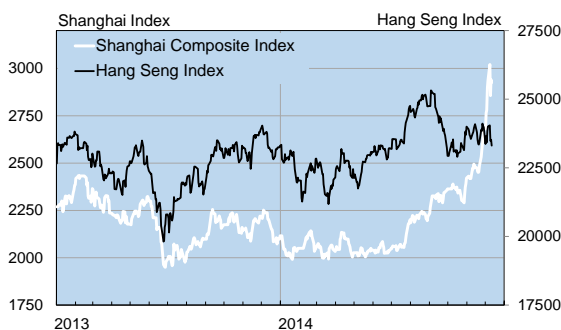
Chinese inflation cools on lower food and commodities prices as well as lower economic growth. Consumer price inflation in China slowed from 1.6 % y-o-y in October to 1.4 % in November. Producer prices continued their third consecutive year of decline, with the rate of fall increasing from 2.2 % in October to 2.7 % last month. Drops in prices of various foodstuffs, energy, and commodity prices have driven much of the recent overall slowdown in inflation. Moreover, overcapacity in many branches is a major driver of the slide in producer prices.

Lower economic growth has fuelled fears of a deflationary spiral. Expectations of a looser monetary policy stance are reflected in the yuan exchange rate. The yuan has lost nearly 1 % of its value against the US dollar over the past month. On Friday (Dec. 12), one dollar bought 6.19 yuan.

Shanghai stock exchange volatility underscores developing state of Chinese financial markets. On Monday (Dec. 8), the Shanghai stock index soared to its highest point in four years. The next day witnessed a major pullback, the biggest drop since 2009 when officials imposed collateral requirements for traders buying on margin. The sharp rise in share prices of recent months may come from increased investing appetite among private investors; a view backed by the sharp increase in the number of new stock trading accounts opened this autumn. Investors seem to be betting continued government willingness to provide economic stimulus and relax monetary policy further. Falling real estate prices have also forced investors to seek better returns in equities.

The recent share price volatility highlights the dependence of China's stock markets on exceptional factors created by economic reforms. The unsophistication of Chinese financial markets was also on display during the recent stampede to buy shares, driving share prices of certain Chinese firms on the Shanghai exchange considerably higher than prices of the same shares on the Hong Kong exchange.

Shanghai Composite Index and Hong Kong Hang Seng Index



Source: Macrobond

China's ranking in TI Corruption Perception Index drops sharply. China fell from 20th place to 100th in Transparency International's rankings of 175 countries and territories in this year's [Corruption Perceptions Index](#). As a country's score rises in the Corruption Perceptions Index (CPI), the amount of perceived corruption falls. The country with the highest CPI score is thus seen as the "cleanest" or least corrupt by its own residents and the rest of the world.

The Nordic countries and New Zealand again topped the CPI rankings as least corrupt in the world. There was also little change in the worst performers, with Somalia, North Korea and Sudan retaining their places as the most corrupt countries surveyed. China's overall CPI score fell four points, the second-largest drop of all countries surveyed (Turkey suffered a five-point decline). Russia fell nearly ten notches to 136th place. The rankings of Ukraine and Belarus were roughly unchanged from 2013. Notably, India and Kazakhstan made substantial gains in the rankings. Ivory Coast and Egypt posted the biggest improvements.

The index is based on the combined scores from twelve distinct surveys. The data are compiled from country-level surveys of experiences and views of corruption. As it would be challenging to determine corruption in absolute terms, the most reasonable approach is to measure relative differences through multiple studies. In the case of China, findings of eight studies were used. Respondents to all studies in China noted the overall increase in perceived corruption.

China's severe drop in the rankings provoked officials to comment on TI's findings and cast doubt on their reliability. The decline was surprising given that president Xi Jinping has actively pursued an anti-corruption campaign launched last year. The campaign has enjoyed a high profile in the media and rule of law was the central theme at this year's party congress. Corruption investigations have concerned a high number of officials. Several high-level bureaucrats, protégés of previous leaders, have been charged with corruption. The way the campaign has raised awareness of corruption may well have affected survey respondent perceptions on corruption in China.

Select countries from TI 2014 corruption perception rankings

Country	CPI score (0-100)	Ranking 2014	2013
Denmark	92	1	1
Finland	89	3	3
United States	74	17	19
Turkey	45	64	53
India	38	85	94
China	36	100	80
Belarus	31	119	123
Kazakhstan	29	126	140
Russia	27	136	127
Ukraine	26	142	144

Source: Transparency International

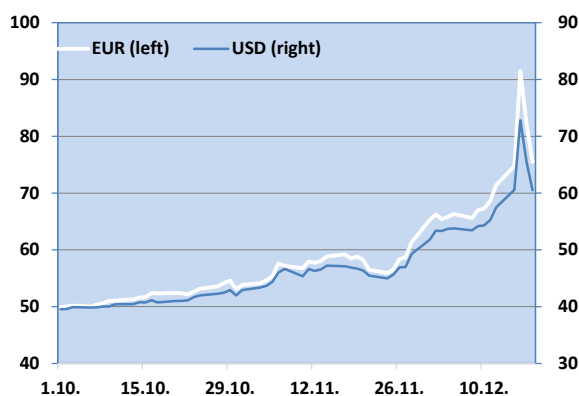
Russia

Fall of the ruble levelled off. After already raising its key rate by one percentage point last week, the Central Bank of Russia board held an emergency meeting on Monday evening (Dec. 15), where it decided to boost the key rate another 6.5 percentage points to 17 %. The measures failed to stave off a further collapse of the ruble, however. On Tuesday (Dec. 16), the ruble slid nearly 20 % against the euro and dollar. On Wednesday (Dec. 17), the ruble began to claw back some of its losses with the CBR's announcement of further measures to stabilise the markets. CBR actions to boost confidence in the financial sector included temporary relaxing of rules on prudential requirements and levels of permitted credit and interest-rate risk, as well as increasing the amount of forex-denominated credit available to banks. The CBR and government began preparations for recapitalising banks next year. The value of the ruble against the euro and dollar was yesterday about 5 % lower than at the end of last week.

Russia's currency markets are very sensitive at the moment and react easily to rumours in the market. Recent uncertainty has been heightened by speculation that capital controls could be imposed. The CBR, however, says such measures are off the table. Instead of capital control measures, the government has discussed with large state-owned exporters and recommended them to repatriate their forex earnings and convert them to rubles.

Russian households are traditionally quite alert to economic signals. Whenever risks of faster inflation or devaluation begin to emerge, they easily convert ruble cash or bank deposits into foreign currencies. The same alertness has been seen recently. If the households would further increase withdrawing their deposits en masse from banks, it would weaken the banking sector.

Dollar-ruble, euro-ruble rates, Oct. 1– Dec. 18, 2014 (rising line indicates ruble depreciation)



Source: Thomson Reuters

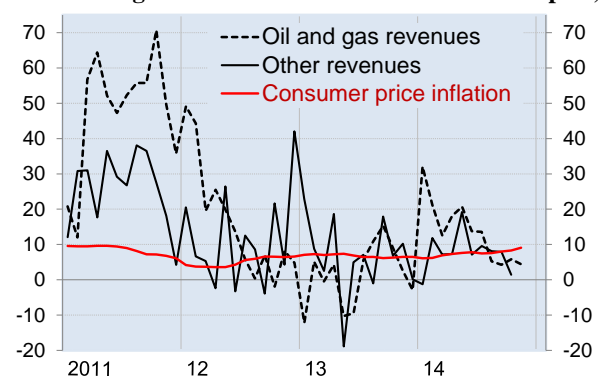
The ruble began to lose ground against other major currencies in spring 2013 as Russia's economic outlook deteriorated due to internal problems. The ruble's collapse accelerated this spring with the Crimean crisis. It has worsened since this summer as the oil price has started to go down and sanctions have accelerated ruble slide even further. The steep fall in the ruble's external value this week reflects the nervousness in the market.

Putin calls for budget spending cuts already next year. President Vladimir Putin directed the government to reduce federal budget expenditures in real terms by 5 % a year during 2015–2017, implying that the 2015 budget law passed by the Duma in November needs to be amended. Cuts are planned for all budget areas except defence, national security and reportedly the social sector. Recently released information suggests the government next year plans to cut spending as much as 10 % in nominal terms, which, at the current 12-month inflation rate of over 9 %, translates to a reduction in real spending of nearly 10 % from this year. The current 2015 budget notes public sector wage hikes averaging 5.5 % and is based on an earlier 2015 inflation forecast. According to new estimates, inflation next year is expected to exceed 10 %, implying a substantial decline in real wages. A decline in real public sector wages is a major deviation from recent years as wage hikes have consistently exceeded the inflation rate.

The budget cuts reflect falling budget revenues from lower oil prices and an expected GDP contraction. Even so, the budget will get some respite from the ruble's depreciation on a nominal spike in oil tax revenues, which are calculated in dollars but paid to the treasury in rubles. Maxim Oreshkin, head of the finance ministry's long-term strategic planning department, emphasized that this is only a transient benefit as a weak ruble fuels inflation, which creates added pressure to increase budget spending.

Growth in government revenues has fallen below the pace of consumer price inflation in recent months, i.e. revenues are down in real terms. Moreover, prices for goods and services procured with state money usually increase even stronger than consumer prices.

Growth in government revenues from 12 months past, %



Source: Ministry of Finance

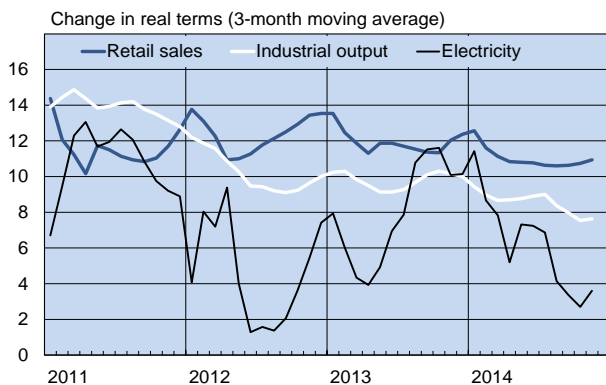
China

Industrial output growth slowed in November; slowdown also expected in the fourth quarter. Industrial output fell from 8 % y-o-y in October to 7 % in November. Lower growth in export demand and plant closures in northern China to reduce air pollution during the November APEC summit were among the factors driving the slowdown in growth. The shutdowns of China's dirtiest mining operations and steel mills led to a drop in iron ore production. Heavy industry has long suffered from excess capacity and falling demand. On-year growth in electrical power generation slowed in November to around 2 %.

Fixed capital investment, which still grew by nearly 16 % y-o-y, fell to its lowest level in nearly 13 years. The slowdown partly reflects structural change and the shrinking contribution of fixed capital investment to economic growth overall. The slowdown in real estate investment has long been the biggest drag on growth in capital investment. Real estate investment in the first eleven months of the year was up 12 % y-o-y (20 % in January–November 2013). Consumer demand, on the other hand, remained robust, with retail sales up 11 % y-o-y.

The unofficial manufacturing purchasing manager index (PMI) released by Hong-Kong-based HSBC showed a preliminary estimate of 49.5 for December, a slight drop from a reading of 50 in November. Index values below 50 indicate contraction relative to the previous month. The preliminary estimate for new orders also dipped below the 50-point mark.

On-year change in retail sales as well as industrial and electricity output, %



Source: Macrobond

Cheaper oil should have an overall positive affect on the Chinese economy. While the economic slowdown in China, which has depressed demand of the world's top oil importer, has been partly blamed for the recent fall in world oil prices,

the impacts of cheaper oil for China's economy are largely positive. The trade surplus continues to climb as the value of imports diminishes and lower commodity prices boost industrial profitability. The government regulates fuel prices in China, but the regulated price reflects the oil price, which means that lower prices also boost the disposable incomes of consumers. Cheaper oil has allowed the government to raise fuel taxes, which increases government revenues and may even have positive environmental impacts.

Cheaper oil could also boost Chinese GDP growth. The Asian Development Bank estimates that the current oil price will increase the region's economic growth next year by about half a percentage point. The IMF also says that, if the oil price remains at its current level, it would add about a half percentage point to global economic growth.

Cheaper oil is not a blessing for every province in China. China is the world's fourth largest oil producer, so falling oil prices hurt domestic producers just as much as producers elsewhere. Most of China's oil industry is located in interior provinces, which are already struggling with deflation caused by the collapse of other commodity prices. A drop in the oil price could exacerbate economic struggles in inland provinces that are much poorer than provinces on the coast.

Progress in reform of China's household registration system. Four Chinese provinces recently announced they were abandoning the *hukou* household registration system altogether, and the government published at the beginning of December a draft proposal on reforming *hukou* nationwide. The biggest change would be that migrants to cities would be allowed to apply for permanent resident status. Up to now, migrants could only apply for temporary residence permits. Many social services such as education, health care and elderly care are reserved exclusively for city-dwellers with permanent *hukou* entitlements. Under the government's plan, the *hukou* system would be gradually phased out in smaller cities, and only remain in place in the largest cities.

The *hukou* system discourages internal migration from the countryside to cities, and thereby divides the population into urbanites and rural-dwellers. Because *hukou* governs access to social services, migrants from the countryside moving to the cities find themselves with second-class status. The *hukou* system has been in place since the late 1950s. It has long been understood that *hukou* not only confers distinct status on households, but erodes the growth potential of the economy by impeding labour mobility.

Efforts to pursue *hukou* reforms continued throughout the past decade, but change came slowly. Up to now, local administrators have had to shoulder most of the costs of *hukou* reform. Given their current levels of indebtedness, most local governments have been reluctant to proceed further with *hukou* reform. However, it now appears the central administration is more serious than earlier about actively implementing *hukou* reform.

Central Bank of Russia / Exchange rates 2014

http://www.cbr.ru/eng/currency_base/dynamics.aspx

Date	USD	EUR
1.1.2014	32.6587	45.0559
10.1.2014	33.1547	45.0672
11.1.2014	33.2062	45.2069
14.1.2014	33.1204	45.2855
15.1.2014	33.2386	45.4139
16.1.2014	33.3562	45.4878
17.1.2014	33.4013	45.4926
18.1.2014	33.4343	45.5175
21.1.2014	33.6429	45.5424
22.1.2014	33.8161	45.8242
23.1.2014	33.8688	45.9125
24.1.2014	34.0334	46.105
25.1.2014	34.26	46.8985
28.1.2014	34.7093	47.4962
29.1.2014	34.625	47.3739
30.1.2014	34.5633	47.2238
31.1.2014	35.2448	48.0951
1.2.2014	35.18	47.6408
4.2.2014	35.2347	47.5351
5.2.2014	35.4502	47.9535
6.2.2014	34.9592	47.2159
7.2.2014	34.7287	46.9497
8.2.2014	34.6044	47.0205
11.2.2014	34.7636	47.3758
12.2.2014	34.7964	47.5319
13.2.2014	34.7595	47.4154
14.2.2014	34.8611	47.4913
15.2.2014	35.2559	48.2618
18.2.2014	35.0976	48.1188
19.2.2014	35.2386	48.3086
20.2.2014	35.5857	48.973
21.2.2014	35.767	49.1975
22.2.2014	35.6828	48.9497
25.2.2014	35.5112	48.7959
26.2.2014	35.5669	48.8654
27.2.2014	35.7872	49.1823
28.2.2014	36.0501	49.3454
1.3.2014	36.1847	49.5839
4.3.2014	36.3784	50.1513
5.3.2014	36.3208	49.952
6.3.2014	36.0849	49.5446
7.3.2014	36.1251	49.5925
8.3.2014	36.2618	50.2625
12.3.2014	36.4015	50.4707

Central Bank of Russia / Exchange rates 2014

http://www.cbr.ru/eng/currency_base/dynamics.aspx

Date	USD	EUR
13.3.2014	36.4865	50.5593
14.3.2014	36.4566	50.8096
15.3.2014	36.6391	50.7635
18.3.2014	36.6505	50.9442
19.3.2014	36.4487	50.7621
20.3.2014	36.207	50.4146
21.3.2014	36.1081	49.9628
22.3.2014	36.4022	50.1804
25.3.2014	36.1663	49.9167
26.3.2014	35.9316	49.7042
27.3.2014	35.4494	48.9521
28.3.2014	35.581	49.0484
29.3.2014	35.6871	49.0519
1.4.2014	35.6053	48.968
2.4.2014	35.024	48.2596
3.4.2014	35.2517	48.6826
4.4.2014	35.5154	48.8834
5.4.2014	35.501	48.6435
8.4.2014	35.4679	48.6159
9.4.2014	35.5475	48.86
10.4.2014	35.7493	49.2911
11.4.2014	35.5581	49.2266
12.4.2014	35.6239	49.4994
15.4.2014	35.989	49.8232
16.4.2014	35.9635	49.6836
17.4.2014	36.0813	49.886
18.4.2014	35.9287	49.7289
19.4.2014	35.5389	49.1041
22.4.2014	35.6688	49.2978
23.4.2014	35.6785	49.2185
24.4.2014	35.6625	49.282
25.4.2014	35.683	49.3175
26.4.2014	35.9289	49.6969
29.4.2014	36.0245	49.8219
30.4.2014	35.6983	49.5064
1.5.2014	35.7227	49.3188
6.5.2014	35.8381	49.7361
7.5.2014	35.655	49.507
8.5.2014	35.4971	49.412
9.5.2014	35.0343	48.7642
13.5.2014	35.2091	48.4759
14.5.2014	34.8789	48.0073
15.5.2014	34.709	47.6173
16.5.2014	34.7005	47.5674

Central Bank of Russia / Exchange rates 2014

http://www.cbr.ru/eng/currency_base/dynamics.aspx

Date	USD	EUR
17.5.2014	34.7794	47.6999
20.5.2014	34.7394	47.6416
21.5.2014	34.6007	47.3995
22.5.2014	34.5078	47.3171
23.5.2014	34.2802	46.8507
24.5.2014	34.3139	46.835
27.5.2014	34.0771	46.4266
28.5.2014	34.2571	46.7712
29.5.2014	34.4895	47.0161
30.5.2014	34.6481	47.1145
31.5.2014	34.7352	47.2677
3.6.2014	34.8887	47.5463
4.6.2014	35.0115	47.6296
5.6.2014	35.1398	47.8253
6.6.2014	34.9043	47.4908
7.6.2014	34.6573	47.3211
10.6.2014	34.3303	46.8746
11.6.2014	34.3681	46.7269
12.6.2014	34.3227	46.4764
17.6.2014	34.5654	46.8085
18.6.2014	34.8095	47.2121
19.6.2014	34.8232	47.1715
20.6.2014	34.3025	46.696
21.6.2014	34.419	46.8821
24.6.2014	34.2797	46.6478
25.6.2014	33.9812	46.2212
26.6.2014	33.907	46.1576
27.6.2014	33.7508	46.0226
28.6.2014	33.6306	45.8251
1.7.2014	33.8434	46.1827
2.7.2014	34.2275	46.8335
3.7.2014	34.2496	46.8398
4.7.2014	34.1949	46.6863
5.7.2014	34.3236	46.687
8.7.2014	34.5691	46.9448
9.7.2014	34.4258	46.8122
10.7.2014	34.0758	46.4146
11.7.2014	33.8353	46.1649
12.7.2014	34.0582	46.3328
15.7.2014	34.3135	46.6835
16.7.2014	34.3723	46.791
17.7.2014	34.3853	46.6299
18.7.2014	34.7998	47.0702
19.7.2014	35.1627	47.5505

Central Bank of Russia / Exchange rates 2014

http://www.cbr.ru/eng/currency_base/dynamics.aspx

Date	USD	EUR
22.7.2014	35.09	47.5048
23.7.2014	35.0387	47.3758
24.7.2014	34.8101	46.8718
25.7.2014	35.0786	47.1702
26.7.2014	35.0535	47.2206
29.7.2014	35.3457	47.4799
30.7.2014	35.6339	47.8635
31.7.2014	35.7271	47.8958
1.8.2014	35.4438	47.4699
2.8.2014	35.7272	47.8244
5.8.2014	35.6605	47.8671
6.8.2014	35.7987	48.049
7.8.2014	36.1102	48.2432
8.8.2014	36.2496	48.4947
9.8.2014	36.4461	48.7722
12.8.2014	36.0475	48.2856
13.8.2014	36.089	48.2402
14.8.2014	36.2222	48.411
15.8.2014	36.0395	48.1416
16.8.2014	36.0014	48.1231
19.8.2014	36.0294	48.2398
20.8.2014	36.1094	48.2133
21.8.2014	36.224	48.1924
22.8.2014	36.3317	48.1686
23.8.2014	36.0027	47.8548
26.8.2014	36.1201	47.6641
27.8.2014	36.1358	47.7282
28.8.2014	36.1397	47.6177
29.8.2014	36.3053	47.952
30.8.2014	36.9316	48.6315
2.9.2014	37.2945	48.9677
3.9.2014	37.348	49.0193
4.9.2014	37.3183	49.0213
5.9.2014	36.8038	48.3786
6.9.2014	36.9219	47.7806
9.9.2014	37.0866	47.9789
10.9.2014	37.0261	47.7118
11.9.2014	37.1693	48.0636
12.9.2014	37.3758	48.2484
13.9.2014	37.6545	48.6647
16.9.2014	37.9861	49.1958
17.9.2014	38.7058	50.0582
18.9.2014	38.3724	49.6923
19.9.2014	38.4209	49.4592

Central Bank of Russia / Exchange rates 2014

http://www.cbr.ru/eng/currency_base/dynamics.aspx

Date	USD	EUR
20.9.2014	38.4134	49.5379
23.9.2014	38.5782	49.6193
24.9.2014	38.6672	49.6912
25.9.2014	38.383	49.3145
26.9.2014	38.3007	48.8449
27.9.2014	38.7243	49.3386
30.9.2014	39.3866	49.954
1.10.2014	39.3836	49.9817
2.10.2014	39.6604	50.0554
3.10.2014	39.5474	49.9484
4.10.2014	39.698	50.2021
7.10.2014	39.982	50.0775
8.10.2014	39.7417	50.2017
9.10.2014	39.9819	50.5091
10.10.2014	39.98	50.9585
11.10.2014	40.2125	51.0538
14.10.2014	40.3251	51.0798
15.10.2014	40.5304	51.5141
16.10.2014	40.9416	51.7829
17.10.2014	40.7457	52.1504
18.10.2014	41.045	52.5253
21.10.2014	40.8815	52.1198
22.10.2014	41.0501	52.6468
23.10.2014	40.9671	52.1388
24.10.2014	41.4958	52.4424
25.10.2014	41.8101	52.9065
28.10.2014	41.9497	53.2342
29.10.2014	42.3934	53.8693
30.10.2014	42.6525	54.3393
31.10.2014	43.3943	54.6378
1.11.2014	41.9627	52.7219
6.11.2014	44.3993	55.6234
7.11.2014	45.1854	56.545
8.11.2014	47.8774	59.3153
11.11.2014	45.8926	57.2418
12.11.2014	45.952	57.0494
13.11.2014	46.3379	57.8575
14.11.2014	46.1233	57.4235
15.11.2014	47.392	58.9793
18.11.2014	47.3329	59.3081
19.11.2014	46.9797	58.6448
20.11.2014	47.0294	58.909
21.11.2014	46.7047	58.5817
22.11.2014	45.7926	57.4377

Central Bank of Russia / Exchange rates 2014

http://www.cbr.ru/eng/currency_base/dynamics.aspx

Date	USD	EUR
25.11.2014	44.7852	55.5336
26.11.2014	44.9758	55.8779
27.11.2014	46.4244	57.9052
28.11.2014	47.6629	59.6215
29.11.2014	49.322	61.4108
2.12.2014	51.8068	64.4425
4.12.2014	54.3821	67.2652
5.12.2014	52.6932	64.8443
6.12.2014	53.1088	65.7168
9.12.2014	53.3079	65.4248
10.12.2014	54.2116	66.8809
11.12.2014	54.2758	67.1989
12.12.2014	54.7932	68.2942
13.12.2014	56.8919	70.5289
16.12.2014	58.3461	72.6642
17.12.2014	61.1512	76.1516
18.12.2014	67.7851	84.589
19.12.2014	59.6029	73.3414
20.12.2014	60.6825	74.5727
23.12.2014	56.494	69.2503
24.12.2014	54.5687	66.7539
25.12.2014	54.4913	66.4031
26.12.2014	52.6159	64.3177
27.12.2014	52.0343	63.5131
30.12.2014	56.6801	69.059
31.12.2014	56.2584	68.3427