



BOFIT

BOFIT Weekly
Yearbook 2016



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 2016

8.1.2016 BOFIT Weekly 1/2016

Lower oil prices hurting values of ruble and other CIS currencies.
Russia's national payments card system moves ahead.
Russia's banking sector weakens.

15.1.2016 BOFIT Weekly 2/2016

Russian inflation surged to heights last year.
Russian stock market performance reflects low oil prices and ruble slide.
Russia and Ukraine implement further trade sanctions against each other.

22.1.2016 BOFIT Weekly 3/2016

Russian exports and imports sink below 2010 levels.
Capital flows between Russia and the rest of the world remarkably small.
Russia's Reserve Fund shrank last year substantially.

29.1.2016 BOFIT Weekly 4/2016

Ruble struggles back from record low.
Russian economy continued to contract in December.
Russian federal budget revenues declined last year, while defence spending soared.

5.2.2016 BOFIT Weekly 5/2016

CBR keeps rates unchanged, but adjusts guidance.
Measured in dollars, Russia's average wage declined over 30 % last year.
Tight budgets and uncertainty currently dominate Russian economic policy.

12.2.2016 BOFIT Weekly 6/2016

New calculation of statistics increases size of Russian economy.
Profitability of Russia's banking sector weakens.
Minor shifts in the structure of Russian foreign trade.

19.2.2016 BOFIT Weekly 7/2016

Russian government deficit soared in 2015.
Russian foreign debt declined last year.
Russia's disputes with neighbours complicate road transport.

26.2.2016 BOFIT Weekly 8/2016

Russia discusses caps on oil production.
Russian manufacturing shrank 5 % last year.
Asia top destination for Russian arms exports.

4.3.2016 BOFIT Weekly 9/2016

Russia approves 2016 anti-crisis economic programme.
Inflation in Russia moderates.
Finland's trade with Russia declined sharply last year.

11.3.2016 BOFIT Weekly 10/2016

Russia's fixed investment structure continued to shift last year.
Growth of housing production slowed.
Consumption down across Russia in 2015.

18.3.2016 BOFIT Weekly 11/2016

CBR calls for better supervision of microlenders.
High demand for Russia's Deposit Insurance Agency funds.
Protests lead to concessions in Russia's new road fee system.

BOFIT Weekly – Russia 2016

24.3.2016 BOFIT Weekly 12/2016

Latest BOFIT forecast for Russia sees economy and imports still contracting further this year.
CBR keeps key rate at 11 %.
Russian firms seek financing from China.

1.4.2016 BOFIT Weekly 13/2016

Russia's banking laws now meet Basel III criteria.
Russian companies having problems in payments.
Russia's working-age population continues to decline despite immigration.

8.4.2016 BOFIT Weekly 14/2016

Higher oil prices lift ruble's exchange rate.
Russia's finance ministry issues 250 billion rubles worth of domestic bonds in first quarter.
Revised figures show some shifts in Russian GDP components in the past few years.

15.4.2016 BOFIT Weekly 15/2016

IMF lowers its forecast for Russian GDP.
Russian export earnings and import spending continue to fall.
Capital flows between Russia and the rest of the world remain small.
Accounts Chamber of Russia criticizes special economic zones.

22.4.2016 BOFIT Weekly 16/2016

Russian economy has shrunk considerably from early 2015.
Russia and other major oil producers fail to reach agreement on oil production freeze.
No revisiting of Russian budget in Duma spring session.

29.4.2016 BOFIT Weekly 17/2016

Little overall change in foreign debt of Russian firms and banks.
Net FDI inflow to Russia falls to lowest level in over a decade.
Russia's services trade shrinks sharply.

4.5.2016 BOFIT Weekly 18/2016

CBR keeps key rate unchanged at 11 %.
Russia's defence industry still enjoying strong growth.
Pressure on Russian government finances continues to increase.

13.5.2016 BOFIT Weekly 19/2016

Russia dips into the Reserve Fund to cover the budget deficit.
Russia's import substitution commission reviews progress.
Russia's recession has slightly reduced income differences.

20.5.2016 BOFIT Weekly 20/2016

Contraction of the Russian economy slowed this year.
Fall in Russian imports begins to moderate.
Russia signs on to OECD's Automatic Exchange of Information initiative.

27.5.2016 BOFIT Weekly 21/2016

Russia's finance ministry issued a new eurobond.
Russian demand remained slack in April.
Russian and ASEAN leaders meet in Sochi.

3.6.2016 BOFIT Weekly 22/2016

Russia pension terms will tighten gradually for certain government workers.
Rosneft completes sale of 15 % stake in Vankorneft to the Indian ONGC.
Finnish exports to Russia may be closing the bottom.

BOFIT Weekly – Russia 2016

10.6.2016 BOFIT Weekly 23/2016

Rise in Russian consumer prices slowed in January-May.
Russia dips further into its reserve funds.
Declining ruble exchange rate has sharply lowered external value of wages in all branches.

17.6.2016 BOFIT Weekly 24/2016

Russian central bank lowers key interest rate.
Ruble strengthening on higher oil prices.
Liquidity in Russian banking sector recovers.

23.6.2016 BOFIT Weekly 25/2016

Russia posts weak economic figures for May.
President Putin hits familiar themes in address to St. Petersburg Economic Forum.
Russia debates course of economic policy.

1.7.2016 BOFIT Weekly 26/2016

Brexit result has had only minor impact on Russian economy so far.
Despite unprecedented budget-cutting, Russia posts large government deficits.
Shanghai Cooperation Organization meets in Tashkent.

8.7.2016 BOFIT Weekly 27/2016

Russian oil production growth slows.
Debate on oil taxation continues in Russia.
EU and Russia decide to keep sanctions in place.

15.7.2016 BOFIT Weekly 28/2016

Contraction in Russian foreign trade and capital outflow slowed down.
Russian state reduces stake in diamond giant Alrosa.
Russia seeks ways to reduce grey pay.

22.7.2016 BOFIT Weekly 29/2016

Russian producers feel hints of recovery, though consumption continues to fall.
IMF emphasises fiscal policy and banking sector reform in latest Article IV consultation with Russia.
Russia's foreign currency reserves grew in the first half of the year.

29.7.2016 BOFIT Weekly 30/2016

Forecasts see smaller slide for Russian economy than earlier.
Russia prepares for serious budget tightening.
Increase in profits of Russian firms supports capital flows abroad and to banks.

5.8.2016 BOFIT Weekly 31/2016

CBR keeps key rate unchanged.
Oil price down sharply in July, ruble follows.
Russia has yet to see clear upturn in business cycle.

12.8.2016 BOFIT Weekly 32/2016

Presidents of Russia and Turkey try to repair economic relations.
Russia's public sector planning a shift to domestic software.
Russia's share of global investment falls sharply.
Corruption, bad institutions and lack of openness dog Russian competitiveness.

19.8.2016 BOFIT Weekly 33/2016

Russian consumption and output declined in July.
WTO panel confirms Russian import duty violations.
Russian farm production growing gradually.

BOFIT Weekly – Russia 2016

- 26.8.2016 BOFIT Weekly 34/2016
Russian goods imports near bottoming out.
Further tightening of Russian regional budgets.
Russians increasing domestic travelling.
- 2.9.2016 BOFIT Weekly 35/2016
Fixed investment in Russia increasingly goes to oil & gas production.
Russian pensioners get one-time payment and a return to inflation-indexed pensions.
Finnish-Russian trade continues to shrink.
- 9.9.2016 BOFIT Weekly 36/2016
Budget deficits drain Russia's Reserve Fund.
More Russian firms added to US sanctions list.
CBR registers new national credit-rating agency ACRA.
Putin visits Uzbekistan.
- 16.9.2016 BOFIT Weekly 37/2016
Russian firms issuing more eurobonds.
Economic contraction has slowed down in Russia's regions.
IMF disburses new loan tranche to Ukraine.
- 23.9.2016 BOFIT Weekly 38/2016
Consumption continued to fall in Russia in August; production picked up slightly.
CBR lowers key rate; no further interest rate cuts expected this year.
Duma elections produce few surprises.
- 30.9.2016 BOFIT Weekly 39/2016
BOFIT Russia forecast sees slow recoveries for the economy and imports.
Russia imposes new procurement restrictions on the public sector and state enterprises.
- 7.10.2016 BOFIT Weekly 40/2016
Still waiting for Russia's economic recovery.
CBR announced organisational changes to improve banking supervision.
Firms with foreign ownership cutting back operations in Russia.
- 14.10.2016 BOFIT Weekly 41/2016
Russian cabinet decides to increase spending this year, abandons last spring's budget framework.
Russian imports recover to nearly same level as a year ago.
Russian government sells Bashneft to Rosneft.
- 21.10.2016 BOFIT Weekly 42/2016
Russian industrial output contracted in September.
Russia and India agree on new arms sales, but overall trade between the countries continues to shrink.
Government subsidies keep Russia's inefficient car producers on life support.
- 28.10.2016 BOFIT Weekly 43/2016
Bleak outlook for Russia's government finances.
Russia drops slightly in the Doing Business 2017 rankings.
Unpredictability of administrative regulation diminishes corporate investment appetite in Russia.
- 4.11.2016 BOFIT Weekly 44/2016
CBR leaves key rate unchanged.
Russia's special supplement to defence spending also affects next year.
Russia's middle class hit by recession.

BOFIT Weekly – Russia 2016

11.11.2016 BOFIT Weekly 45/2016

Immediate impacts of US election results on the Russian economy appear minimal.
Russian economy projected to see gradual recovery next year.
Russia plans to increase government revenues in the next few years without hikes in large general taxes.

18.11.2016 BOFIT Weekly 46/2016

Russian imports finally on the rise.
Russia's economy minister arrested.
Gazprom-EU dispute unresolved after four years.

25.11.2016 BOFIT Weekly 47/2016

BOFIT 25th Anniversary Conference examines evolutionary paths of Russia and other post-communist systems.
Russia's economic recovery still uncertain.
Russia on track for record grain harvest.

2.12.2016 BOFIT Weekly 48/2016

Oil & gas sector still dominates Russian business.
Russian government takes on wage arrears problem.
Finland's exports to Russia shrank further.

9.12.2016 BOFIT Weekly 49/2016

Few surprises in Putin's state-of-the-nation address.
Gas sector drives growth in fixed investment.
Growth of Russia's banking sector has stalled.

16.12.2016 BOFIT Weekly 50/2016

Russian state reduces stake in Rosneft.
Russia and OPEC agree to reduce oil output.
Duma and Federation Council approve federal budget and state social fund budgets.

23.12.2016 BOFIT Weekly 51–52/2016

Russian industrial output increased, consumption still falling.
CBR leaves key rate unchanged.
President Putin visits Japan.

BOFIT Weekly – China 2016

8.1.2016 BOFIT Weekly 1/2016

Chinese stock markets nosedive.
Volatility of yuan exchange rate increases as system overhaul proceeds.

15.1.2016 BOFIT Weekly 2/2016

Chinese markets remain restless.
New secretariat to coordinate administrative affairs of Chinese financial supervision bodies.
Foreign trade figures and price trends indicate no unusual weakness in the Chinese economy.
China seeks long-term economic growth through innovation processes.

22.1.2016 BOFIT Weekly 3/2016

China's economy grew 6.9 % last year.
Chinese growth expected to slow moderately.
Taiwan elects government with hard-line stance on mainland China.

29.1.2016 BOFIT Weekly 4/2016

Indebtedness continued to rise last year in China.
China's labour markets dealing well with lower economic growth.
China strengthens its Silk Road strategy in the Middle East.

5.2.2016 BOFIT Weekly 5/2016

Reforms to Chinese exchange rate policy expected.
Chinese wage growth remains robust.
Chinese P2P lender proves to be pyramid scheme.

12.2.2016 BOFIT Weekly 6/2016

China's current account surplus grew last year.
Chinese apartment prices continue to rise.
As domestic demand wanes, Chinese steel exports rise.

19.2.2016 BOFIT Weekly 7/2016

China's lending soars, while share of nonperforming loans increases.
Decline in Chinese foreign trade continued in January.
PBoC reiterates commitment to opening Chinese economy.

26.2.2016 BOFIT Weekly 8/2016

Chinese officials promise economic stimulus and structural reforms.
China's overcapacity problems increase.
Chinese direct investment in Europe continues to rise.
China's arms exports grow rapidly.

4.3.2016 BOFIT Weekly 9/2016

China relaxes monetary policy.
China's service sector increasingly shouldering growth burden.
China increased its share of Finnish foreign trade last year.

11.3.2016 BOFIT Weekly 10/2016

China targets growth of 6.5–7 % this year.
China opens its bond markets to foreign investors.
Rising food prices drive Chinese inflation higher.
Pricing factors depress Chinese foreign trade.

18.3.2016 BOFIT Weekly 11/2016

January-February sees lower industrial output growth and pick-up in apartment sales in China.
China's largest provinces have economies similar in size to mid-sized emerging economies.
Delays in wage payments ignite wave of protests in China's problem industries.

BOFIT Weekly – China 2016

24.3.2016 BOFIT Weekly 12/2016

BOFIT sees continued modest slowdown in growth for China.
China's role in international patent activity continues to increase rapidly.

1.4.2016 BOFIT Weekly 13/2016

Chinese firms struggle with late payments and debt.
Low population growth affecting China's economic growth.
No big changes in China's fiscal policy in 2016.

8.4.2016 BOFIT Weekly 14/2016

Housing prices soar in China's big cities.
Profits at China's biggest banks show little change.
China and Russia see Panama Papers as Western attempt to destabilise their political systems.

15.4.2016 BOFIT Weekly 15/2016

International financial institutions expect Chinese growth to slow only slightly.
China's foreign trade stumbles in first quarter.
Is Chinese producer price deflation finally abating
As China and Russia boost military spending, so do their neighbours.

22.4.2016 BOFIT Weekly 16/2016

Fixed investment sustained China's first-quarter growth.
Capital inflows to China diminished last year, while capital outflows increased.
China increased its share of EU foreign trade in 2015.

29.4.2016 BOFIT Weekly 17/2016

IMF concerned about state of Chinese businesses.
China's programme to lower corporate debt levels and reduce bank NPLs moves ahead.
China eliminates foreign trade subsidies that violated its WTO commitments.

4.5.2016 BOFIT Weekly 18/2016

China shifts main service branches into VAT sphere as key tax reform proceeds.
Chinese direct investment on the rise also in Finland.

13.5.2016 BOFIT Weekly 19/2016

Wider discussion of economic policy in China.
Regional neighbours and commodity producers likely to suffer most from Chinese slowdown.
China's inflation largely unchanged in April.

20.5.2016 BOFIT Weekly 20/2016

April's economic numbers confirm China's ongoing slowdown.
Swings in yuan-dollar exchange rate get larger.
Boom in Chinese foreign travel continues.

27.5.2016 BOFIT Weekly 21/2016

Chinese officials take on restructuring of problematic state enterprises.
Apartment prices in China's big cities are soaring again.
Chinese steel production on the rise.

3.6.2016 BOFIT Weekly 22/2016

People's Bank of China increases open market operations as monetary policy seeks new direction.
Chinese share prices stable.

BOFIT Weekly – China 2016

10.6.2016 BOFIT Weekly 23/2016

Surveys show Chinese firms hiring less.
Exchange rate depreciation and poor foreign trade performance reduce international yuan use.
China's foreign trade performance remains tepid.

17.6.2016 BOFIT Weekly 24/2016

Foreign investors still face too many hurdles in accessing mainland China stock markets.
Fixed investment in China loses steam.
Weaker outlook for European firms operating in China.

23.6.2016 BOFIT Weekly 25/2016

Rapid lending growth in China continues.
Familiar themes get most play at annual China-US strategic and economic dialogue meeting.

1.7.2016 BOFIT Weekly 26/2016

Chinese economy faces little immediate fallout from Brexit vote.
Yuan weakens against the dollar.
Chinese presence in energy projects in Russian Far East set to increase.

8.7.2016 BOFIT Weekly 27/2016

Rapid rise in Chinese wages continues.
Annual report of China's central bank stresses need to keep on with financial reforms.
China's NBS updates GDP calculation methods.

15.7.2016 BOFIT Weekly 28/2016

China's foreign trade continued to falter in first half.
International court finds no historical basis for Chinese territorial claims over the South China Sea.
China strengthens its position as the world's largest market for industrial robots.

22.7.2016 BOFIT Weekly 29/2016

China's shows steady growth in second quarter.
Chinese inflation down a bit.
Foreign banks pulled back on their China lending last year.

29.7.2016 BOFIT Weekly 30/2016

Forecasters largely agree on trends in China's economy.
Market-economy status and steel on the table at the EU-China summit.
Slight bump in Chinese share prices.

5.8.2016 BOFIT Weekly 31/2016

Chinese decision-makers struggle with conflicting policy goals.
Revised GDP methodology helps only little with China's 2020 growth target.
China's bond markets show strong growth.

12.8.2016 BOFIT Weekly 32/2016

China's central bank tightens the control of capital flows.
Value of Chinese foreign trade declines, volume increases.
Change in method of calculating Chinese GDP only marginally eases path to 2020 growth targets.

19.8.2016 BOFIT Weekly 33/2016

China's credit expansion creating less and less economic growth.
Sharp slowdown in Chinese investment growth.
Slight uptick in Chinese housing construction; price trends uneven across cities.
China gives go-ahead to Shenzhen-Hong Kong Stock Connect.

BOFIT Weekly – China 2016

26.8.2016 BOFIT Weekly 34/2016

IMF calls for decisive action from China to tackle rising vulnerabilities.
IMF encourages China to shift to monetary policy based on inflation targeting and floating exchange rate.
Relatively slow growth in fixed capital formation hastens speed of structural reform of Chinese economy.

2.9.2016 BOFIT Weekly 35/2016

Reform of China's public sector moves ahead.
China seeks to rein in online P2P lending market through increased regulation.
First-half trends in Finnish-Chinese trade slightly more upbeat than Finnish foreign trade overall.

9.9.2016 BOFIT Weekly 36/2016

Chinese yuan is now the most used emerging economy currency in foreign exchange trading.
China's G20 summit in Hangzhou finishes up.
More free-trade zones for China.
European firms fear state's role in the economy is increasing in China.

16.9.2016 BOFIT Weekly 37/2016

No big changes in Chinese economic trends over the past months.
Outlook for Chinese banks gets bleaker.

23.9.2016 BOFIT Weekly 38/2016

Yuan interest rates spike again in Hong Kong; mainland China money markets remain calm.
Rapid increase in indebtedness in China continues on many fronts.

30.9.2016 BOFIT Weekly 39/2016

BOFIT forecast for China sees lower economic growth, rising risks.
Chinese tourists help reduce trade imbalance.
China establishes new fund to assist with reform of state-owned enterprises.

7.10.2016 BOFIT Weekly 40/2016

Yuan becomes part of IMF's SDR currency basket.
China's soaring housing prices again causing concern.
Capital outflows from China strengthen.

14.10.2016 BOFIT Weekly 41/2016

China's structural shift and economic slowdown profoundly impact global economy.
Yuan's exchange rate volatility increases after addition to SDR basket.
China's competitiveness unchanged relative to other countries.

21.10.2016 BOFIT Weekly 42/2016

China once again releases GDP growth figure in line with official target.
Producer prices in China finally start to rise.
Value of China's foreign trade declines even as trade volume increases.

28.10.2016 BOFIT Weekly 43/2016

Chinese government pushes to get debt restructurings going for troubled state-owned firms.
Second-child births keep China's maternity wards busy.
Mainland China stock markets await investment of pension savings and foreign investors.

4.11.2016 BOFIT Weekly 44/2016

China tightens measures to deal with overheating of the housing market.
China reaps good grain harvests this year.
President Xi Jinping increases his power as party leader.

BOFIT Weekly – China 2016

11.11.2016 BOFIT Weekly 45/2016

Trump presidential victory increases uncertainty also in China.
China's current account surplus insufficient to cover capital outflows; currency reserves fall.
China's banking sector continues to weaken.

18.11.2016 BOFIT Weekly 46/2016

Foreign firms concerned about China's new cybersecurity law.
Retail sales growth slows in China; popularity of online shopping remains strong.
China's rapidly growing middle class is now also the world's largest.

25.11.2016 BOFIT Weekly 47/2016

BOFIT 25th Anniversary Conference raises insights into China's structural adjustments and growth outlook.
Payment delays on the rise in China.
Yuan loses ground on dollar appreciation.

2.12.2016 BOFIT Weekly 48/2016

China's State Council issues contingency guidelines on local government debt problems.
Over a million patent applications filed last year in China.
Finnish exports to China outperform Finnish exports generally.

9.12.2016 BOFIT Weekly 49/2016

China tightens capital controls to reduce depreciation pressure on yuan.
Foreign investors gain new trading link to Shenzhen exchange.

16.12.2016 BOFIT Weekly 50/2016

Chinese producer price inflation accelerates, other economic indicators unchanged.
Market interest rates on the rise in China.
China takes market economy status issue to the WTO.

23.12.2016 BOFIT Weekly 51–52/2016

China's leaders sketch out areas of economic policy focus for 2017.
Is the rise in housing prices in China's big cities abating?
Chinese 15-year-olds lead emerging economies in latest PISA rankings.

Russia

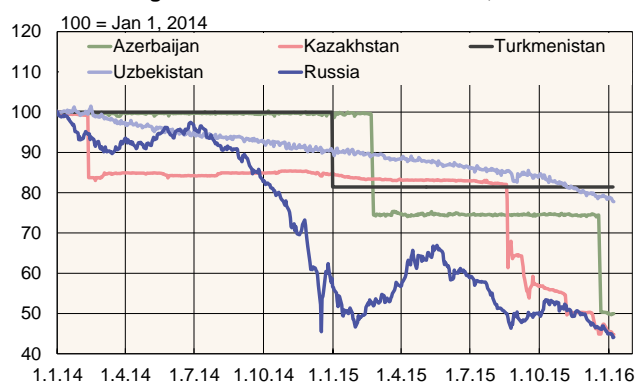
Lower oil prices hurting values of ruble and other CIS currencies.

At end-December, ruble hit new lows for the year pulled by declining oil prices. The ruble has renewed its slide in recent days as oil prices have tested lows not seen in over a decade. Yesterday the USD/RUB rate closed at 75 and EUR/RUB rate at 82 rubles.

Low oil prices have socked not just the ruble, but the currencies of other CIS energy-exporting countries. Oil and natural gas (the price of which tends to follow oil price changes with a lag) account for 60–95 % of exports of Azerbaijan, Kazakhstan and Turkmenistan. Natural gas is an important source of export earnings also for Uzbekistan. The currencies of these countries have been long de facto pegged to the US dollar, but in 2014–15 they experienced significant devaluations.

Besides putting pressure on exchange rates, the drop in oil prices severely hurts budget revenues in these countries, creating pressure to cut public spending. Fortunately, most CIS energy-producing countries built up large funds during years of strong oil and gas revenues and still expect positive economic growth (with the exception of Russia) despite slow-downs. With elderly leaders in Kazakhstan and Uzbekistan approaching retirement, the prospect of bumpy power transitions could add to economic uncertainty.

Dollar exchange rates for select CIS currencies, 2014–2015



Source: Macrobond.

Russia's national payments card system moves ahead.

Under amendments to the payments system act in spring 2014, all card payments made in Russia need to be settled through a national payments clearing system. As a result of the change, Visa and MasterCard, which dominate the Russian credit and debit card markets, have moved to settling payments made in Russia using the national settlement system, which is owned by the Central Bank of Russia. The driver of the change has been the desire of Russian officials to bolster the country's economic independence and

support financial institutions that have been targeted with sanctions by Western countries. The national payments card system will also feature Russia's own Mir payment card.

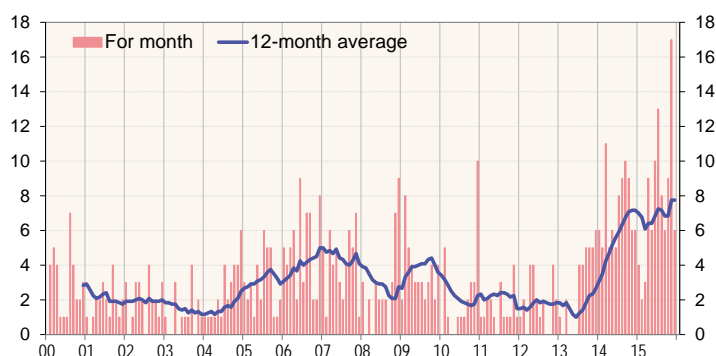
On December 15, Bank Rossii, which was targeted with Western sanctions in summer 2014, became the first bank to issue a Mir payments card. At the same time, six other banks were announced to issue their own Mir cards. Among the 35 Russian banks currently participating in the Mir system are giant state bank Sberbank and VTB24. Officials expect national use of Mir cards to ramp up during this year. Use of the Mir card in international payments, on the other hand, may remain limited.

Russia's banking sector weakens. The troubles of the real economy are beginning to manifest in banking sector performance. While banks overall are still profitable, the number of loss-making banks rose notably in the first eleven months of 2015, with nearly 30 % of banks operating in the red. Growth in delinquent payments and credit losses are one factor in this shift. The volume of delinquent loan payments rose by almost 50 % in January–November 2015. At the start of December, delinquent payments of Russian firms and households reached 2.63 trillion rubles, or to nearly 7 % of the stock of granted credit. So-called problem loans, which represented less than 7 % of the total loan stock at the start of the year, exceeded 8 % by the beginning of November.

Boosted by considerable government support, the average ratio of bank's own capital to total assets in the banking sector has risen to 13 %. There are large variations, however. At the beginning of November, 129 banks had equity ratios below 12 %. Large deficiencies in calculating the capital have come to light in several bank insolvencies.

The CBR has increased its efforts to clean up the banking sector. Since June 2013, over 200 credit institutions have lost their licenses (93 in 2015). Most of the banks have been covered by the deposit insurance scheme. Consolidation of the banking sector continues, and today Russia's 20 largest banks hold about 75 % of all banking sector assets. At the beginning of December, 740 banks operated in Russia.

Number of banking licence cancellations in Russia, 2000–2015



Source: Banki.ru.

China

Chinese stock markets nose dive. On Monday (Jan. 4), the first trading day this year, share prices fell 7 % on mainland China stock markets. The new automated trading circuit-breaker mechanism kicked in on its first day in use, causing share trading to be suspended in the afternoon. The circuit breaker again shut down trading on Thursday (Jan. 7), just a half hour into morning trading. For the day, share prices were down 12 % in Shanghai and 15 % in Shenzhen from December 31. Share prices on the Hong Kong stock exchange were also down 7 % from the start of the year. Late Thursday evening, the China Securities Regulatory Commission (CSRC) suspended for now use of the circuit breaker.

The circuit breaker was introduced at the start of the year to halt share and derivatives trading in Shanghai and Shenzhen for 15 minutes whenever the CSI 300 index rises or falls more than 5 % during intraday trading. Trading is suspended for the rest of the day if the shift exceeds 7 %. The brake mechanism was introduced to promote healthy market development, but on Thursday the CSRC said it had not achieved the expected effect and rather amplified market volatility. Some observers have claimed that the threshold for the circuit breaker is just too low. Last summer alone, trading would have been suspended 20 times had the circuit breaker been in place. Indeed, the introduction of the circuit breaker may have added to market volatility; the threat of trading disruption forces investors to speed up their trades.

The market jitters this week were partly due to the expiration of a six-month ban on selling shares imposed on major shareholders after last summer's market plunge. The CSRC announced yesterday that it would keep the sales ban partly in place and limit share sales of major shareholders to 1 % of a company's shares. Media reports also claim that state financial firms have again been purchasing shares to prop up prices as they did last summer. Some observers have commented that December's weak purchasing managers' index (PMI) reading may have contributed to the collapse in share prices. On the other hand, nothing about the PMI reading was very surprising. Yet again, any real economy links to the share price meltdown are hard to identify.

Trends in mainland China's main stock market indices



Source: Macrobond.

Volatility of yuan exchange rate increases as system overhaul proceeds. Nervousness this week also seized the foreign exchange markets. On Thursday (Jan. 7), the yuan-dollar rate was down 1.5 % from the start of the year in Shanghai and down 1.7 % on Hong Kong's forex market. Since the mini-devaluation last August, the yuan has stayed consistently weaker in Hong Kong than in mainland China, suggesting that depreciation pressure on the yuan has increased considerably since August.

While the main reason for the weakening pressure is the uncertainty stemming from the slowdown in economic growth, the trend on the forex market also reflects changes in the foreign exchange rate system itself. Last August, in connection with the yuan's mini-devaluation, the People's Bank of China announced that its calculation of the daily dollar-fixing rate would be adjusted to better reflect actual market conditions. In December, the PBoC published 13 core currency partners in its composite CFETS currency index, designed to give a wider insight into the yuan's trend than the dollar-yuan rate alone. While publication of the index carries the possibility that volatility in the yuan-dollar rate could increase, its role in actual policy making is still unclear. The latest change came this week as the opening times of China's forex markets was extended so that trading in Shanghai concludes at 11.30 pm instead of 4.30 pm as earlier. The change is expected to smooth yuan trading on Chinese and European markets.

Although the recent weakening of the yuan has shaken markets, increased yuan exchange rate volatility is part of a normal system adjustment and a sign that China is developing in the direction of advanced economies. The Chinese economy has evolved to such an extent that its relatively tight foreign exchange rate policy would be too costly to pursue and, hence, more flexible rates are needed. The shift is not straightforward, however, as the country will occasionally revert to traditional methods in rate setting. Late last year, for example, some foreign banks were temporarily forbidden to make certain forex operations to prevent arbitrage of exchange rate differences on the Shanghai and Hong Kong yuan markets.

Mainland and Hong Kong (offshore) yuan-dollar rates



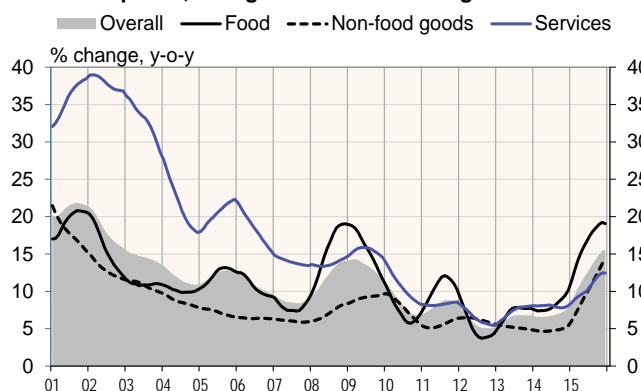
Source: Macrobond.

Russia

Russian inflation surged to heights last year. The one-month rise in consumer prices in December, as in November, outpaced the last significant rise in November-December 2010 – not counting the record inflation spike at the end of 2014, the biggest since the 1998 financial crisis. Leading the high inflation numbers was the continued increase in food prices, but the increase for non-food goods also went on. The ruble's slide, which worsened dramatically in December as the ruble lost 10 % of its external value, has been a crucial factor in fuelling inflation. Ruble's slide episodes readily create expectations in the import trade chain and among households of further exchange rate slide and continuing high inflation. Russian import restrictions on Turkish food items likely added to inflation pressures somewhat.

December 2015 consumer prices were up 12.9 % y-o-y (11.4 % at the end of 2014). Due to the inflation burst a year ago, for 2015 overall inflation was up on average 15.5 % over 2014. The high inflation tells about the extent of the loss of household purchasing power and reduced consumption. The annual average indicates that consumer prices rose faster than at any time since 2002. Episodes of high food price inflation as seen in 2015 were last experienced in 2008 and 2001. No similar episode of run-away non-food goods price inflation has been seen since 2001. The last similar rise in prices of services was in the early months of 2010.

Consumer prices, change of 12-month average



Source: Rosstat.

Russian stock market performance reflects low oil prices and ruble slide. Russia's main RTS share index, calculated in dollars, fell 4 % last year on the drop in oil prices and the ruble's weak exchange rate. The decline in the RTS index last year remained modest, however, as it had already fallen 45 % in 2014. The index largely follows the price of oil, as companies in the oil & gas sector account for about half of weight of the index. While the total market capitalisation of companies included in the RTS index has slumped about

50 % from peak years, it was still above \$100 billion last year. That amount is about double the RTS market cap during the 2009 financial crisis.

In contrast, the Moscow exchange's MICEX index, calculated in rubles, rose 23 % last year. Although the price of oil has fallen below 2009 levels, the impact on the ruble-denominated index has been softened by the adjustment of the ruble's exchange rate. The ruble's weakening has supported the profitability of export firms despite falling prices for oil and other commodities. Revenues of export firms are mainly denominated in foreign currencies, while most of their spending is in rubles. Moreover, the sub-index for state-owned enterprises was up 31 % last year, beating the MICEX overall. Finance was an above-average-performing category, while metals clearly underperformed the MICEX average.

The year's trading volume on the Moscow stock exchange contracted slightly last year to 9.4 trillion rubles, about half the peak level of 2011, but still above the 2013 nadir.

Russia's main share indices and the oil price



Source: Macrobond.

Russia and Ukraine implement further trade sanctions against each other. With the entry into force of the free-trade agreement between Ukraine and the EU at the start of this year, Russia set its free-trade agreement with Ukraine to expire at the same time. Russia also took steps to expand earlier food import bans against the EU to include Ukraine, while significantly curtailing transshipment of Ukrainian goods via Russia. In response, Ukraine banned the import of various products from Russia, including certain foods, chemical products and locomotives. The value of such exports from Russia to Ukraine was about \$200 million last year.

Russia has also clarified its new *Turkey* sanctions. From the start of this year, Turkish citizens and firms owned by Turkish citizens are prohibited from engaging in business in Russia in the following sectors: construction, architecture and engineering services, travel bureau services, hotels, wood processing and public procurements. The ban does not affect existing contracts, such as those for construction projects granted to Turkish firms involving the 2018 FIFA World Cup in Russia.

China

Chinese markets remain restless. Just four days into the first week of trading this year, Chinese regulatory officials abandoned use of a new automatic circuit-breaker mechanism to deal with excessive intraday volatility after it was found to increase rather than decrease market volatility. In recent days, officials have resorted to older approaches such as limits on share trading to calm the markets. Such measures have done little, however, to dispel stock market uncertainty, and large daily gyrations in share prices can be expected to continue in the near future.

To calm forex markets and reduce depreciation pressure on the yuan, the People's Bank of China employed the fairly heavy-handed measure of squeezing the availability of offshore yuan (Hong Kong, CNH), thereby driving down the difference in offshore and onshore (Shanghai, CNY) yuan-dollar exchange rates. The measure initially caused offshore yuan market rates to soar at the start of this week (CNH Hibor7D reaching 33 %). While the CNH interest rate fell after Wednesday's session and the situation on forex markets calmed, China's slowing growth, deregulation of currency movements and shifting exchange rate policies will keep markets on edge.

New secretariat to coordinate administrative affairs of Chinese financial supervision bodies. Although volatility in China's stock and forex markets is to be expected as the country's massive systemic reforms continue, officials' interventions and poor communication have made matters worse than need be. The online economic news service *Caixin*, reported Thursday (Jan. 13) that the government plans to establish a new secretariat to coordinate the administrative actions and messaging among the central bank and the three authorities overseeing securities trading, banking and insurance markets. Many problems on China's financial markets and the creation of a new coordinating body indicate just how far reforms of China's markets have come and how difficult it is for officials accustomed to old regulatory system to change their approaches.

Foreign trade figures and price trends indicate no unusual weakness in the Chinese economy. The value of China's December exports in dollar terms was up 1 % from a year earlier. Imports contracted 8 % y-o-y on the fall in global commodity prices. As a result, the trade surplus continued to rise. For 2015 overall, the goods trade surplus rose to \$595 billion. China's huge foreign trade surplus balance depreciation pressure on the yuan.

The December price trend was unremarkable: consumer price inflation held at 1.6 % y-o-y, while producer prices continued to decline nearly 6 % y-o-y. Although producer price inflation suggests persisting excess capacity problems and deflationary pressure, there was nothing immediately

new or disconcerting in the latest data, making it hard to interpret or explain recent market uncertainty.

China seeks long-term economic growth through innovation processes. OECD estimates show China's R&D investment rose from \$33 billion in 2000 to \$336 billion in 2013. Innovation activity has focused on traditional industries and emerging IT branches. The Boston Consulting Group's 2015 list of the world's 50 most innovative companies includes three Chinese IT firms: Internet giant Tencent (12th), telecom network solutions provider Huawei (45th) and computer technology specialist Lenovo (50th).

Products of high-tech firms last year constituted the largest category of Chinese exports, accounting for about 30 % of China's industrial product exports. In 1990, over half of exports consisted of low-tech products. The rise of Chinese technology in Asia is stunning. China accounted for 9 % of Asian high-tech exports in 2000, but 44 % in 2015.

The Global Innovation Index (GII) 2015, published jointly by Cornell University, INSEAD and the World Intellectual Property Organization (WIPO), compares the innovation activities of 149 countries using several indicators. China was ranked 29th in the survey and the top performer among upper middle-income countries. China has invested heavily in innovation since the 2008 recession, and succeeded in improving the quality and efficiency of its innovations. In 2015, China ranked 18th for quality of innovations and 6th by innovation efficiency. To improve the efficiency of innovation activity, China needs particularly to improve its political, regulatory and business environments. The country's GII rankings could further rise in coming years as the 2016–2020 five-year plan sees innovation as a source of growth.

China's innovation policy, however, has been criticised for being protectionist. The US-based think tank, the Information Technology and Innovation Foundation (ITIF), reports that China's "innovation mercantilism" strengthened last year. The ITIF defines innovation mercantilism as a national strategy where technology exports are promoted through protectionist measures.

Other BRIC countries posted much lower GII scores than China. Russia ranked 48, followed by Brazil at 70th place and India at 81st. Even if Russia slightly boosted spending on innovation activity after the financial crisis, its ranking has been stable in recent years. The ITIF also accused Russia of engaging in innovation mercantilism. Brazil and India also climbed in the country rankings in 2011–2015, but not nearly as fast as China.

Finland ranked sixth in the 2015 GII, down two places from 2014. Finland's investment in innovation was particularly impressive (3rd out of 149), even if investment in innovation activity had not returned to the pre-2008-crisis levels. Finland came out on top in the survey in the "institutions" and "human capital and research" sub-categories. There was room for improvement in the innovation output (10th) and efficiency (41st) categories.

Russia

Russian exports and imports sink below 2010 levels.

Preliminary 2015 balance-of-payments figures released by the Central Bank of Russia show that the 2010 level was hit in the third quarter in both revenues from exports of goods and services and spending on imported goods and services. Just in 2013, imports and exports were at all-time highs. Export earnings last year contracted by more than 30 % in dollars and 17 % in euro terms. Spending on imports last year fell 35 % in dollars and 22 % in euros, and the pace of on-year decline almost matched those numbers in the fourth quarter. The current account surplus increased slightly last year, and much more relative to GDP, as the value of GDP in foreign currencies contracted sharply on the ruble's slide. The goods trade surplus shrank, whereas the services trade deficit contracted. The deficit for the rest of the current account also shrank, especially due to reduced earnings on foreigners' direct investments in Russia.

Export earnings from oil and petroleum products showed a particularly sharp drop, but revenues from natural gas and other exports were also down. Spending on imported goods fell slightly more than the overall spending on imports. Spending of Russian travellers abroad was down more than 30 % in dollar terms and 17 % in euro terms.

Key balance-of-payments items for Russia, 2013–2015

	USD billion			% of GDP		
	2013	2014	2015 (preliminary)	2013	2014	2015 (preliminary)
Current account	35	58	66	1.7	3.1	5.4
- Exports (goods & services)	593	564	389	28.6	30.0	31.8
- Imports (goods & services)	470	429	281	22.6	22.8	23.0
Trade balance (goods)	182	190	146	8.8	10.1	11.9
- Exports	523	498	340	25.2	26.5	27.8
- Imports	341	308	194	16.4	16.4	15.9
Services trade balance	-58	-55	-37	-2.8	-2.9	-3.0
- Exports	70	66	50	3.4	3.5	4.1
- Imports	128	121	87	6.2	6.4	7.1
Other current account	-89	-76	-43	-4.3	-4.0	-3.5
Financial account & net error:	-57	-124	-64	-2.7	-6.6	-5.3
Government (excl. central bank)	5	30	-9	0.3	1.6	-0.7
Private sector total (A+B)	-63	-152	-57	-3.0	-8.1	-4.7
A. Banks	-17	-86	-33	-0.8	-4.6	-2.7
B. Other private sector	-45	-66	-24	-2.2	-3.5	-1.9
- Direct investment	-25	-36	-14	-1.2	-1.9	-1.1
- Inbound	60	18	7	2.9	1.0	0.5
- Outbound	85	54	21	4.1	2.9	1.7
- Portfolio investment	-13	-18	-6	-0.6	-0.9	-0.4
- Inbound	-11	-12	-4	-0.5	-0.7	-0.3
- Outbound	2	6	1.5	0.1	0.3	0.1
- Foreign currency cash*	10	9	13	0.5	0.5	1.1
- Fictitious transactions	-27	-9	-1	-1.3	-0.5	-0.1
- BoP net errors and omissions	-10	6	-3	-0.5	0.3	-0.3
- Other	30	-9	0	1.4	-0.5	0.0

* Negative value = increase in the stock of foreign cash

Source: Bank of Russia.

Capital flows between Russia and the rest of the world remarkably small.

Preliminary balance-of-payments figures show that the net outflow of private capital fell in 2015. This was despite banks paying down large amounts

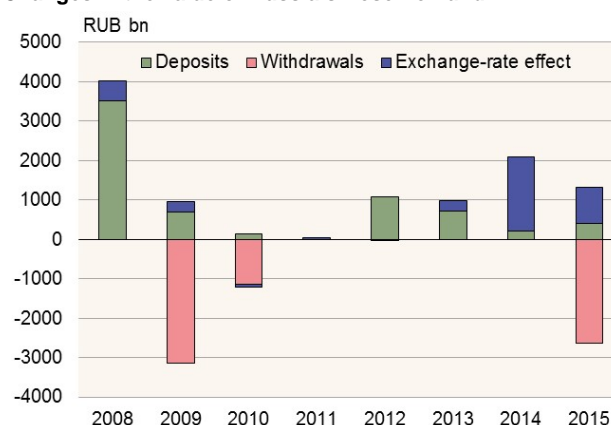
of foreign debt. Unlike in previous years, banks also reduced their foreign assets. On the other hand, companies, as in 2014, managed to pay down only a little of their debt. The inflow of direct investment to Russia fell to a trickle, while out-bound FDI contracted as well. The outflow of grey capital remained small. Foreign currency cash held outside banks continued to decline, despite on-going instability in the ruble's exchange rate during last year.

Russia's Reserve Fund shrank last year substantially. Russia established its Reserve Fund to cover possible fiscal deficits in the event of economic weakness. The money is invested in liquid foreign-currency assets. For the first time since 2010, the government last year dipped into the Reserve Fund to cover budget expenses. As a result, the value of the Reserve Fund shrank last year by nearly \$40 billion, standing at around \$50 billion at year's end.

The depreciation of the ruble, however, supported the value of the Reserve Fund in ruble terms and hence the purchasing power of the assets as most budget spending is denominated in rubles. At end-December, the Reserve Fund held 3.6 trillion rubles (nearly 5 % of GDP). This year's budget act dedicates 2.1 trillion rubles in Reserve Fund assets to covering the deficit. The average \$50-a-barrel oil price assumed in the 2016 budget, however, is about double the current oil price. Preliminary estimates from Russia's finance ministry suggest the Reserve Fund could be drained by the end of this year if spending is not cut further.

Russia's other big rainy-day fund, the National Welfare Fund, is meant to fund the pension system, but during crisis periods has been used to support domestic banks and firms through e.g. deposits and bond purchases. The stated value of the National Welfare Fund is unaffected by such measures as use of its assets in this way are treated as investment. Thus, nearly all changes in the National Welfare Fund's valuation come from exchange rate shifts. At end-2015, the Reserve Fund stood at \$72 billion. Of that, \$48 billion (3.5 trillion rubles) was in liquid foreign-currency assets.

Changes in the value of Russia's Reserve Fund



Source: Russian Ministry of Finance.

China

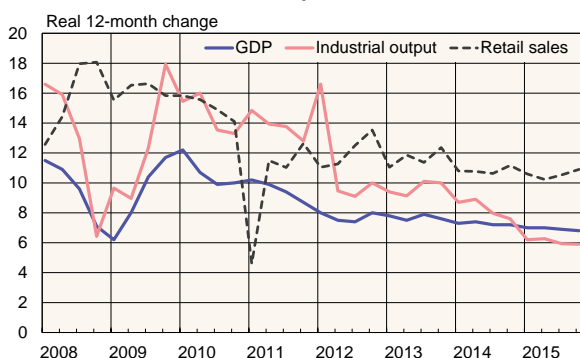
China's economy grew 6.9 % last year. GDP growth last year slowed slightly from previous year's 7.3 % as expected. In the final quarter of 2015, GDP grew 6.8 % y-o-y. Seasonally adjusted quarterly growth slowed from 1.8 % in 3Q15 to 1.6 % in 4Q15. Nominal GDP growth was 6 % y-o-y in the fourth quarter and 6.4 % for all of 2015.

2015 saw progress in the economy's structural change. For the first time ever, the service sector accounted for over half of the economy, while manufacturing and construction accounted for about 40 % and primary production 9 %. Manufacturing and construction were up 6 % y-o-y in real terms, while real growth in the service sector exceeded 8 %. Finance (up 16 %) was the fastest growing branch within the service sector, in itself responsible for about 20 % of last year's GDP growth. Nearly 90 % of nominal GDP growth came from services, as industrial prices kept falling.

December's headline economic figures held few surprises. Industrial output growth slowed to 5.9 % y-o-y (6.1 % overall in 2015 and 8.3 % in 2014). Growth in retail sales remained at 11 %. Online sales were up 33 % last year, with 12 % of all goods transactions occurring online. Average per capita disposable income increased last year to 22,000 yuan (€3,100), an increase of 7 % from 2014 in real terms.

Fixed investment growth slowed from 16 % in 2014 to 10 % last year. The pace of slowdown in manufacturing growth and structural change has picked up speed. For example, the volume of steel production in 2015 was down 2 % y-o-y, while the volume of steel exports rose 20 %. The fall in domestic steel demand reflects a slowdown in construction. New building construction, measured in terms of floorspace, fell 14 % y-o-y. Production of electricity and cement were also down slightly from their 2014 levels.

Growth in GDP, industrial output and retail sales, %



Source: Macrobond

Chinese growth expected to slow moderately. The latest batch of economic forecasts for China shows general agreement on trends in the Chinese economy over the next few years. Most major forecasters expect economic growth to slow gradually this year and next, but still remain in the range

of 6–7 %. While there have been no major changes in the forecasts in recent months, downside risks continue to emerge and increased uncertainty has made the economy much more difficult to manage. Amidst the new low-growth environment, economic structures still need balancing, indebtedness is increasing and state institutions are failing in many respects to keep up with market developments.

As fears about a possible “hard landing” of the Chinese economy rise, a number of forecasters have tried to estimate the effects of such a slowdown on the rest of the world. Most expect the hardest hit countries to be China's neighbours, who constitute important export markets. Commodity-producing countries would also suffer from further weakness in demand and lower prices. The World Bank forecast suggests that a one percentage point slowdown in Chinese economic growth cuts one percentage point off GDP growth in Hong Kong and Singapore over the next two years and about 0.4 percentage point off growth in Indonesia, Malaysia and Thailand. UBS Bank calculates that a slowdown in China's growth this year to 4 % would drive many countries in Eastern and Southeast Asia into recession.

Economic growth forecasts for China, %

	2016	2017	Released
IMF	6.3	6.0	1/2016
World Bank	6.7	6.5	1/2016
Citigroup	6.3	6.0	1/2016
Deutsche Bank	6.7	6.7	1/2016
JP Morgan	6.6	6.4	1/2016
UBS	6.2	5.8	12/2015
OECD	6.5	6.2	11/2015
BOFIT	6	6	9/2015

Taiwan elects government with hard-line stance on mainland China. Taiwan's presidential election went as expected on Tuesday with Tsai Ing-wen winning the presidency. Tsai is head of the Democratic Progressive Party (DPP), which also rolled to victory in parliamentary elections held at the same time. The election result put Beijing on its toes. In recent years with the Kuomintang party in charge, relations between the mainland and Taiwan improved substantially. The DPP, in contrast, has traditionally pushed for Taiwan's independence. Tsai immediately sought to defuse tensions after the election by indicating that she will not push for independence, but instead seek to preserve the status quo.

Tsai and the DPP have won the right to preside over Taiwan in tough economic times. GDP contracts, and is still below its level at the onset of the 2008 financial crisis. And it is likely that economic conditions will further deteriorate if tensions between mainland China and Taiwan worsen significantly. Mainland China is a major market for Taiwan's export-driven economy. About 40 % of Taiwanese goods exports go to China (including Hong Kong), Taiwanese firms have vast investments in mainland China and tourism of mainland Chinese has exploded in recent years, bringing significant amounts of money to the island.

Russia

Ruble struggles back from record low. The ruble's exchange rate hit an all-time low January 21 after the price of Urals-grade crude oil fell below \$25 a barrel. At bottom, one euro bought 93 rubles and one dollar 85 rubles. The oil price has since recovered a bit. On Wednesday (Jan. 27), Urals crude was going for about \$29 a barrel. Higher oil prices have supported the ruble's external value, which has again recovered in recent days.

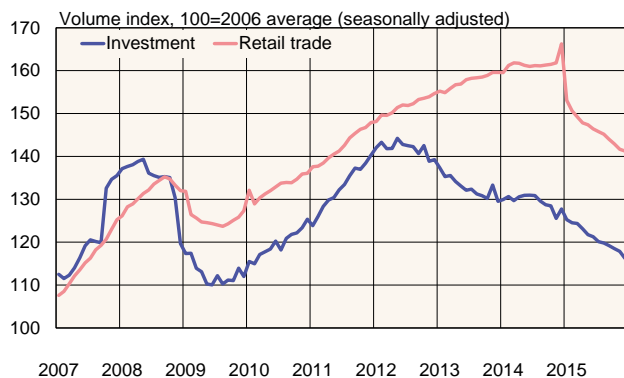
Central Bank of Russia governor Elvira Nabiullina stated on January 20 that the central bank would refrain from intervening to prop up the ruble unless financial stability risks warranted. Nabiullina later noted that the CBR always stands ready to act during a major market disturbance.

Russian economy continued to contract in December. Rosstat reports that industrial output and retail sales both continued to slide in December. In annual terms, retail sales were down 15 %, a fall amplified by its referencing to the December 2014 shopping spree caused by the sharp ruble depreciation. Fixed capital investment was down nearly 9 % y-o-y in December, while industrial output fell almost 5 %.

Russia's economy last year contracted for the first time since the 2009 economic crisis (GDP down 3.7 %), but growth was already slowing earlier due to structural problems. The current situation is somewhat different from the 2009 crisis, however. Household incomes and consumption have contracted much more violently, due e.g. to more modest public sector support as an increasing share of budget spending has been directed to the defence sector. Real wages declined last year nearly 10 %, while unemployment rose to just under 6 %. Retail sales fell 10 % last year.

Fixed investment fell just over 8 % last year. While the contraction in investment was slower than during the 2009 crisis, it has gone on for several years due to Russia's poor business environment, lack of access to financing and increased uncertainty. Poor investment development also restricts future growth potential of Russian economy.

Trends in Russian fixed investment and retail sales



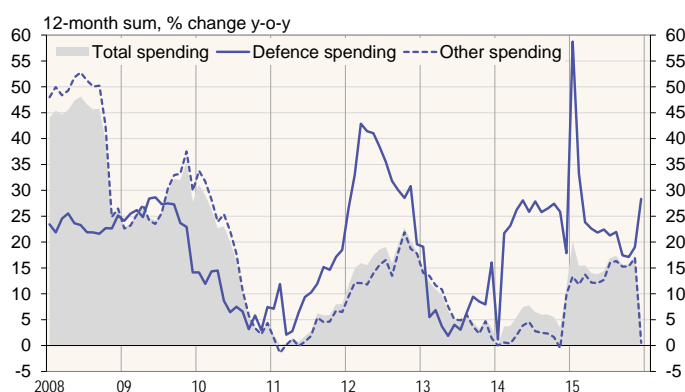
Sources: Rosstat and BOFIT.

Given weak demand, industrial output last year contracted 3 % and construction activity fell 7 %. The mineral extractive sector (includes oil & gas) remained unchanged. Growth was only posted in the food industry (up 2 %) and the chemicals industry (up 6 %). The weak ruble caused imports to shrink substantially and gave a slight boost to some domestic producers. The government has also sought to support domestic producers through measures limiting imports. The effectiveness of these measures has been questionable and especially in longer term import substitution policies rather restrain economic growth by e.g. restricting competition.

Russian federal budget revenues declined last year, while defence spending soared. In nominal ruble terms, federal budget revenues last year contracted 6 %. In real terms (i.e. taking inflation into consideration), they were down about one fifth. Revenues from taxes on oil & gas (i.e. production taxes and export duties) going entirely to the federal budget fell by one fifth even in nominal rubles. The finance ministry's forecast from last spring was slightly exceeded, mainly because more oil than expected was exported. Other budget revenues increased 10 % (again, more than forecast) as value-added tax revenues, the budget's single largest revenue item, increased and revenues from federal property, assets and services were up by one half.

Federal budget expenditures rose 5 % in nominal terms and contracted substantially in real terms. Expenditures slightly exceeded the original spending estimate, even if that plan was cut last spring. After increasing at an average rate of 18 % a year during 2007–2014, defence spending increased 28 % last year. Defence spending as a share of GDP increased a percentage point to 4.3 %. The last time this share was so large was in 1994. The Stockholm International Peace Research Institute (SIPRI) estimates that the defence share of GDP already reached 4.5 % in 2014. In contrast, non-defence expenditures last year rose just 0.5 %. The budget deficit was 1.9 % of GDP with interest payments on debt excluded. With the interest payments included, the deficit was 2.6 % of GDP, which was still much less than had been expected in last spring's finance ministry estimate.

Federal budget expenditure growth in rubles, %



Source: Ministry of Finance.

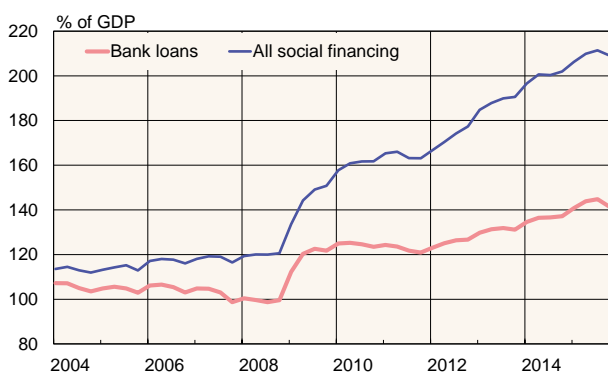
China

Indebtedness continued to rise last year in China. Total social financing (TSF), a broad measure of private debt in China's economy, grew 12 % y-o-y last year to around 210 % of GDP at the end of December. TSF growth slowed slightly, however, as local governments substituted off-budget debt included in TSF with bonds not counted in TSF calculations. Official figures for central and local government debts are not included in TSF, but off-budget debts are. According to IMF estimates, China's public sector debt currently stands at around 40 % of GDP (not including off-budget debts of local governments), and continues to rise. Foreign debt (public and private) amounts to about 10 % of GDP, so the total credit stock is about 260 % of GDP.

Two factors underlie the explosion in Chinese indebtedness. First, it has long been cheap to borrow money in China, a situation created by the country's earlier obsession with investment-driven growth. Even with deregulation of banks' lending rates, there have been no big shifts in interest rates. Financing remains relatively inexpensive (for state enterprises, at least). The second factor is the massive stimulus programme implemented by the government during the 2008 financial crisis. Stimulus measures involved shoving loans out the doors of state banks to finance investment projects.

As lending has soared, the risk of funding unprofitable ventures has grown substantially. The stock of non-performing loans held by commercial banks, despite growth, remains fairly small, averaging less than 2 % of the overall loan stock. Many observers say the actual share is significantly larger. As the government moving to close excess production capacity in numerous industries, the volume of non-performing loans is expected to continue to rise.

Private sector domestic debt



Sources: Macrobond, PBoC and BOFIT.

China has considerably higher debt levels than most emerging economies, and the increase in indebtedness growth has been rapid since 2008. In many countries, similar booms in lending growth have resulted in financial sector crashes and sharp drops in economic growth. Compared to

other countries, however, China has exceptionally large buffers. The state holds massive amounts of assets (e.g. state-owned enterprises), the reserve ratio requirement for banks is high and it still has huge currency reserves to protect the country from external risks.

China's labour markets dealing well with lower economic growth. About 13 million new jobs were created last year in urban areas. That number well exceeded the government's target of 10 million urban jobs a year set for recent years. The rate of new job creation has remained roughly stable since 2013.

Urban private-sector service businesses is the key to the sustained high employment rate. The service sector is the only part of the economy where labour force has steadily increased. In contrast, the number of workers involved in primary production (mostly farming) plunged in 2013–2014, while the manufacturing workforce showed a slight decline. Primary production and manufacturing each now employ slightly less than 30 % of the Chinese labour force, while services account for over 40 %. Last year's purchasing managers' index (PMI) readings repeatedly showed service firms continued to take on new staff, while manufacturing shed jobs. The rapid growth of the service sector is critical also in the years ahead. By some estimates, about 10 million people work in overcapacity industries, where about 3 million jobs are to be cut.

China has begun to sporadically release findings of its 31-city survey on unemployment. The survey shows that unemployment rate is about 5 %, and it has budged very little over the past two years. While this may indicate continuing problems with unemployment statistics, it also tells about the extreme flexibility of Chinese labour markets. If an internal migrant to the city fails to find work, he or she just returns to the home village to farm the family plot. Such cases are not captured in the unemployment figures. Only one in ten migrant workers are covered by unemployment insurance.

China strengthens its Silk Road strategy in the Middle East. President Xi Jinping last week toured Saudi Arabia, Egypt and Iran to promote Chinese economic relations. His first Middle-East visit also emphasised China's growing international role in the region where the political and security situation is extremely complicated and difficult.

While the Middle East is clearly critical to Chinese energy security, Saudi Arabia and Iran (which has just seen international trade sanctions lifted) are also enticing export markets. The visits resulted in the signing of numerous deals on energy supplies and infrastructure projects.

Last year, Saudi Arabia accounted for about 1 % of China's total exports, Iran 0.8 % and Egypt 0.5 %. Saudi Arabia accounted for about 2 % of China's total imports and Iran 1 %. China imported almost nothing from Egypt. Saudi Arabia is China's number-one oil supplier, accounting for 15 % of all Chinese oil imports. Iran's share of Chinese oil imports is 8 %.

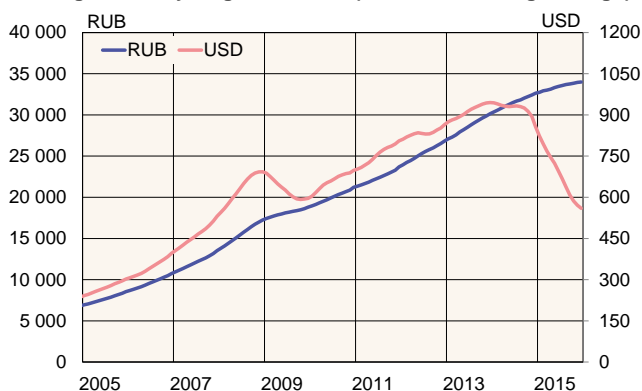
Russia

CBR keeps rates unchanged, but adjusts guidance. At its scheduled meeting last Friday (Jan. 29), the Central Bank of Russia's board decided to leave the key rate unchanged at 11 %, the same level it has been at since August 2015. The CBR estimated that annual consumer price inflation was 10 % in January, which meant that real interest rates have turned positive for the first time in a year. The central bank expects inflation to slow further to less than 7 % by January 2017 and to reach the 4 % inflation target by the end of 2017. The CBR noted, however, that risks to deviating from the target at end-2017 have increased. The CBR indicated that the oil price is a key risk to price stability, because a drop in the oil price causes the ruble to weaken and fuels inflation expectations.

The CBR's reference to the possibility of tightening monetary policy slightly surprised the markets. In December, the central bank signalled that it would begin gradual lowering of rates if inflation moderated in line with its forecast. The latest CBR announcement pointed to the possibility of monetary tightening in coming months if inflation risks further amplify. It further noted that the oil price is likely to be lower than in its December baseline forecast of \$50 a barrel in 2016–2017, so Russia's GDP development is expected to be even weaker than earlier predicted. In December, the central bank forecasted that GDP would still contract 0.5-1 % this year and return to modest growth in 2017. The CBR board's next meeting on interest rates is set for March 18.

Measured in dollars, Russia's average wage declined over 30 % last year. Preliminary data show the average monthly wage in Russia in 2015 was 34,000 rubles (\$560, €500). Nominal wages increased 4.5 % on average, while high inflation and ruble depreciation eroded the purchasing power of wage earners. Real wages contracted over 10 %, and measured in dollar terms, the average monthly wage was down more than 30 % from 2014.

Average monthly wage in Russia (12-month moving average)



Sources: Macrobond, BOFIT.

Wages remained highest in the oil & gas and fishing industries, but average nominal wages range widely across industries. The average monthly wage in the oil refining industry was nearly 2.5 times higher than the average wage nationally, and about half the average in the textile industry.

Based on ILO methodology, Russian December unemployment was 5.8 %. Although the total unemployment has increased only slightly, the regional variations are large. The unemployment rate in the Central Federal District has remained below 4 %, while unemployment has risen to 12 % in the North Caucasus region. In the Republic of Ingushetia, the unemployment rate exceeds 30 %. Unemployment is especially a problem for the young. About 20 % of Russian 20–24-year-olds were unemployed in December 2015.

While wage arrears rose significantly in the past year, the level is still low.

Tight budgets and uncertainty currently dominate Russian economic policy. Persistent low oil prices and the weak economy have forced Russian policymakers to balance between budget cuts and stimulus measures. Public sector cuts will require painful, unpopular measures, so implementation has been resisted as long as possible. Recent statements from Russian leaders on the country's economic situation and outlook exude a puzzling optimism, given that GDP last year contracted nearly 4 % and the oil price in January was down about 40 % from a year earlier.

Spending cuts are currently under preparation led by the finance ministry, but a large part of budget spending is ruled out from cuts. On the other hand, the economy ministry is drafting an economic support programme for this year. The programme seems to be largely cosmetic, however, as few additional funds are expected to be allocated to finance it.

The notion of raising money for the budget through privatisation of state-owned enterprises is back on the agenda. Privatisation plans have been under preparation for years, but the actual privatisation sales of large firms have been postponed due to market weakness. The situation is unlikely to improve this year. The terms that president Putin has imposed on privatisation sales further limit the pool of potential buyers. Even in the best case, the impact of privatisation sales on the budget would be limited and temporary.

The reluctance to tackle difficult reforms can also be seen in the government's long-term plans. Russia's structural economic problems have been long recognised and e.g. the list of economic goals of the recent national security strategy again includes improving the investment climate and business environment, as well as increasing productivity. In practice, these goals have remained secondary, with the emphasis instead on import substitution and other measures restricting business operations.

China

Reforms to Chinese exchange rate policy expected.

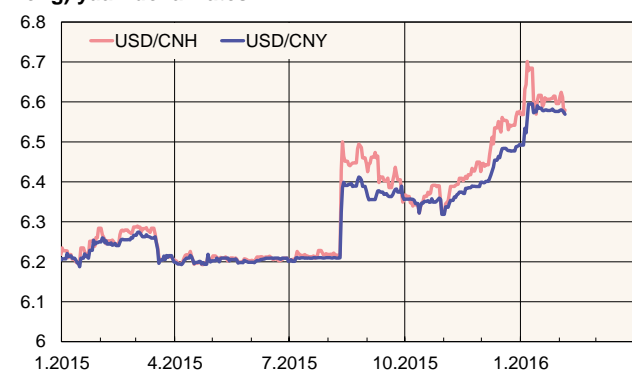
The yuan started the year by weakening almost 2 % against the dollar, but since then the People's Bank of China has kept the yuan-dollar rate fairly stable. In past two weeks, off-shore yuan trading in Hong Kong (CNH) saw the yuan weaken against the dollar widening the gap between the CNH and on-shore mainland yuan (CNY). On Thursday (4th of Feb), the gap almost closed pointing again to an intervention by the Chinese authorities.

The government has employed stricter capital controls to contain capital outflows from the country. Press reports say PBoC measures include limiting the sale of bonds by foreign institutions on the interbank market and urging commercial banks to limit customer attempts at moving yuan assets out of the country. Additionally, the granting of new foreign investment quotas for qualified domestic institutional investor (QDII) and renminbi qualified domestic investor (RQDII) programmes have been on hold since March 15.

Since January 25, the reserve requirement have been applied also to deposits in Hong Kong and other yuan trading centres, thereby increasing costs of yuan trading. As the possibility of investing in yuan-denominated assets outside mainland China is limited, foreign banks often simply deposit their yuan in mainland China banks. Mainland China banks operating in Hong Kong have also been instructed to cease offering off-shore interbank loans, rising interest rates substantially in Hong Kong at times.

Some economists have recently recommended stricter limits on capital movements as a cure for the falling yuan exchange rate. China's economy and financial system, however, have opened to such an extent that restricting capital outflows is now difficult and contradicts the country's strategy of opening up. In lieu of stricter capital controls, China needs to find a way to shift to a more flexible approach to exchange rate formation. A more flexible exchange rate would allow deregulation of capital movements to continue, but would also demand clearer domestic monetary policy.

On-shore CNY (Mainland China) and Off-shore CHN (Hong Kong) yuan-dollar rates



Source: Macrobond

Chinese wage growth remains robust. The National Bureau of Statistics reports that the per capita monthly disposable income in China at the end of 2015 was about 1,870 yuan (\$280). Incomes were up nearly 9 % y-o-y in nominal terms and 7 % in real terms. The income difference between urban and rural Chinese are still huge; urban workers made nearly three times more than their rural colleagues.

Data from the household income survey show that wage earnings account for about 61 % of urban disposable incomes, and 44 % for rural incomes. Business earnings in cities represented 10 % of total income, while in the countryside, they accounted for a third of total income. Income transfers accounted for 17 % of urban income and 19 % in rural income. Property income was noteworthy mainly for city-dwellers.

The household income survey further found that urban wages in December were up nearly 8 % y-o-y. Based on this, the average monthly wage in the public sector and government-owned businesses was about 6,100 yuan (\$930). The official wage data for 2015 have yet to be released.

While official figures for private sector wages are unavailable, they are typically lower than public sector wages. The average wage reported in December for migrant workers was 3,070 yuan (\$470). According to press reports, the entry-level wage at an electronics assembly plant in Guangdong province is 2,100 yuan (\$320) a month and later rises with overtime to 3,200–4,500 yuan (\$480–680). Guangdong's regional minimum wage is just under 1,900 yuan (\$290). According to the *China Labour Bulletin*, minimum wages in mainland China are about half minimum wage levels in Taiwan or Hong Kong, but substantially higher than in other Asian emerging economies.

Chinese P2P lender proves to be pyramid scheme.

Prior to its collapse last week, the peer-to-peer (P2P) lending service Ezubao, which was only founded in summer 2014, managed to accumulate assets worth 50 billion yuan (€7 billion) from nearly a million Chinese investors on the promise of 9–15 % returns. As in a classic Ponzi scheme, there were almost no real investment targets. Money from late investors was used to pay early investors and the company's founder and other key personnel took their share of the money raised. Government investigators have yet to determine how much money has been permanently swindled from investors and how much can be recovered.

The availability of P2P lending services exploded last year. An investor survey found that P2P loans, due to their "guaranteed" high returns, were the number-three favourite form of investment in China. By some estimates, the P2P lending market rose last year to nearly 1 trillion yuan (€140 billion) or about four times the 2014 amount. Regulations for the P2P lending industry are still in drafting phase.

As the number of loosely or not at all regulated financial vehicles has soared in recent years, the number of financial abuses has grown and new fraud cases will surface.

Russia

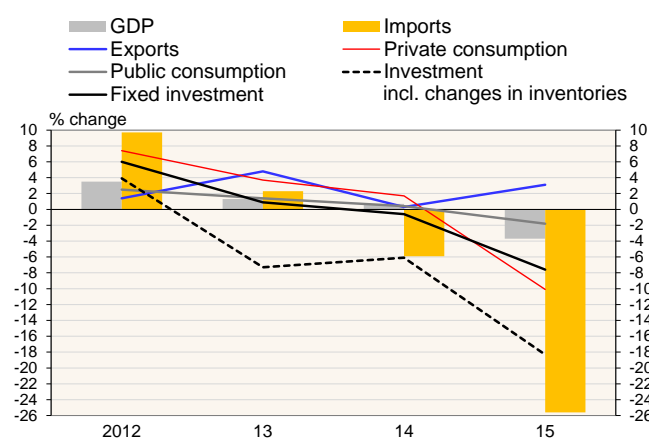
New calculation of statistics increases size of Russian economy. Applying international accounting standards of 1993 and 2008 for calculating GDP, Rosstat has adjusted Russia's 2014 GDP measured in rubles up by 9 %. The GDP figures for 2011–2013 were also raised by about 7 %. Russian 2015 GDP under the new approach is estimated at around 80.4 trillion rubles. 2015 GDP measured in euros (1,190 billion) or dollars (1,320 billion) showed a decline, however, due to the ruble's fall. GDP per capita in 2015 was just over €8,000 (€10,500 in 2014).

The new GDP figures include estimates of gains from living in one's own home, labour employed by households, capital consumption based on the market value of capital, as well as revised estimates of grey wages. The reassessed GDP 2014 data also provide wider coverage of R&D activity and defence spending.

While the biggest upward impact to the new 2014 GDP estimate came from a revised private consumption figure, the largest relative increase occurred in the value of fixed capital investment. Fixed investment accounted for over 21 % of GDP in 2014 and 22 % in 2015. On the supply side, the real estate branch's added-value had the largest impact as it soared by 50 %. State administration and defence sector lumped together were also up 45 %.

Real GDP growth figures for 2012–2014 only changed slightly. On the other hand, practically all GDP categories (consumption, fixed investment, exports and imports, as well as production branches) saw adjustments of growth rates to a varying degree. It is unclear whether inclusion of Crimea data impacted the 2014 growth figures. Crimea accounts for about half of a per cent of Russian GDP.

Changes in supply and demand components 2012–2015



Source: Rosstat.

Profitability of Russia's banking sector weakens. Growth of Russia's banking system largely stopped last year and profitability fell significantly. The Central Bank of Russia

reports the banking sector's total assets increased by about 7 % last year, but due to exchange rate shifts, total assets of the sector were down 2 % from the end of 2014. The contraction reflects a stoppage of growth of the credit stock and growth in loan-loss reserves. The stock of credit granted to households contracted sharply (-7 %), while the stock of corporate credit grew by about 3 %. The share of forex credits grew slightly. Forex loans at the end of December accounted for just under 3 % of the household credit stock but about 40 % of corporate credit stock.

Total banking sector profits in 2015 contracted to 192 billion rubles (€2.6 billion), about a third of the 2014 level. When the profits of Sberbank, Russia's largest bank, are excluded, the sector showed virtually zero profits last year. Bank solvency ratios are still generally healthy, though with huge variations among individual banks. Weak results of banks raise expectations that consolidation in the sector and CBR revocation of banking licences will remain strong this year.

Minor shifts in the structure of Russian foreign trade. Measured in US dollars, the value of both goods exports and goods imports contracted by 30 % y-o-y in the fourth quarter of 2015. The rate of contraction for both imports and exports, however, slowed slightly as the end of the year approached. Most of the drop in the value of exports reflected low commodity prices. The fall in imports came mainly from lower import volumes.

For 2015 overall, Russian goods exports contracted a bit over 30 % and had a value of about \$340 billion. Crude oil, oil products and natural gas accounted for 64 % of total goods exports (a slight drop from earlier due to the sharp decline in oil prices). The volume of crude oil exports rose 9 %, oil products 4 % and natural gas 8 %. Export volumes were also up for certain metals, fertilisers and wood products. Metals accounted for nearly 10 % of exports, while chemical products and machinery & equipment each accounted for over 7 % of exports.

The value of goods imports was \$190 billion, down nearly 40 % y-o-y. Again, the largest import category (45 %) was machinery, equipment and transport equipment, even if imports in this category have fallen dramatically for a while due to weak investment demand (e.g. the volume of imported passenger cars fell by half last year). As a result, pharmaceuticals became the largest single import category, and chemical products overall accounted for nearly a fifth of all imports. Foodstuffs rose slightly to nearly 15 % of imports.

EU countries saw their share of Russian foreign trade shrink slightly last year. Just under half of Russian exports went to the EU and just under 40 % of imports came from the EU. Asian countries, in contrast, saw slight increases to nearly 20 % of exports and 30 % of imports. China accounted for over 8 % of Russian exports and nearly 20 % of imports. The shares of Eurasian Economic Union countries rose slightly (due in part to the accession of Kyrgyzstan) to about 8 % for both exports and imports.

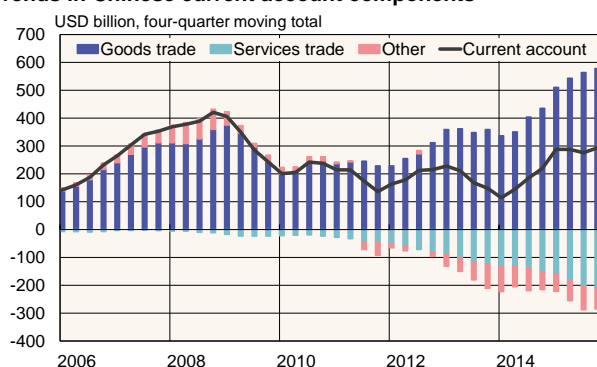
China

China's current account surplus grew last year. Preliminary balance-of-payments figures show China's 2015 current account surplus amounted to \$293 billion, or 2.7 % of GDP. The goods trade surplus of \$578 billion was partly offset by deficits in the services trade balance and income transfers. The services trade deficit of \$209 billion was generated almost entirely by Chinese travellers, who spent \$253 billion abroad last year compared to \$165 billion in 2014.

The counterpart of the current account in balance of payments includes the capital account, financial account and the net errors and omissions term. Taken as a whole, they indicate that net capital outflows continued last year through both official and unofficial channels. Preliminary figures do not break out the net errors and omissions term from the rest of the financial account balance, however. Some capital outflows reflect normal business activity such as Chinese direct and portfolio investment abroad. Moreover, firms worried about currency risk and yuan depreciation seem to have accelerated payments on principal of their loans denominated in foreign currencies.

The value of China's foreign currency reserves shrank by \$513 billion last year. Some \$170 billion of that reflected shifts in exchange rates and asset valuations. The value of currency reserves fell \$99 billion last month to \$3.231 trillion. Total reserves (including gold, SDRs and reserves held by the IMF) were worth \$3.308 trillion as of end-January.

Trends in Chinese current account components



Source: Macrobond.

Chinese apartment prices continue to rise. Based on private real estate portal SouFun's tracking of average apartment prices in 99 Chinese cities, the price of square meter rose by more than 4 % y-o-y in January. The average apartment price has risen from last spring and currently stands at 11,030 yuan per square metre of floorspace (\$1,670/m²).

In January, SouFun tracking found apartment prices still falling from a previous month in 36 of its cities, while the figure was over 70 cities in late 2014. The price development is uneven even within provinces. For example, January housing prices were down slightly in Guangzhou, but up significantly

on-year in Shenzhen. The price of a square meter of apartment floorspace was up 15 % y-o-y in Shanghai and 8 % in Beijing. In certain cities, prices were down 10 % y-o-y.

The overall situation for real estate construction remains problematic. The volume of new construction starts measured in floorspace is still showing a distinct downward trend, and the situation is unlikely to be resolved quickly as the stock of unsold apartments continues to rise. Besides heavily indebted construction firms, local governments are also struggling. The biggest buyers of land rights are building companies and land right sales of local governments last year were down nearly a third from 2014.

Growth in volume of new apartment building construction



Sources: Macrobond and BOFIT.

As domestic demand wanes, Chinese steel exports rise. China last year produced 800 million metric tons of steel, or about half the world's steel output. As the construction industry is one of the biggest steel consumers, demand for steel falls when the volume of new construction declines. Last year, China produced 2 % less steel than in 2014. With the domestic steel prices nose-diving, China's top-100 steel producers last year posted collective losses of 65 billion yuan (\$10 billion).

In reaction, steel producers have sought out demand in foreign markets. Cheap Chinese steel has succeeded in gaining market share elsewhere, with steel exports nearly doubling over past two years. The rest of the world's producers have accused the Chinese of dumping. The EU, United States and Japan have all imposed protectionist tariffs on certain Chinese steels within the framework of their WTO commitments. The EU and the US are currently considering expanding their anti-dumping tariffs to cover additional Chinese steel products.

China's steel production capacity is about 1.170 billion tons a year and new capacity is still coming on stream. At the same time, demand for steel is expected to decline as services increasingly become the main economic engine. The government has repeatedly said that it intends to shutter mills until the industry's overcapacity problems are under control. The current target calls for cutting output by 100–150 million tons by 2020. China's central government has declared similar initiatives many times before with little effect because local governments fiercely defend their producers.

Russia

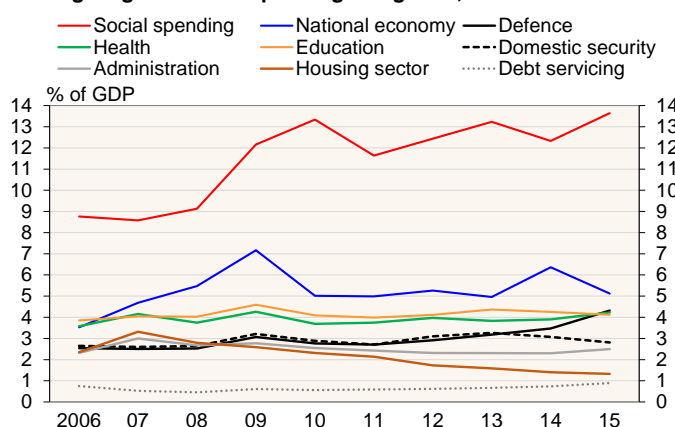
Russian government deficit soared in 2015. Revenues to the consolidated government budget (federal, regional and municipal budgets, plus state social funds) declined 1 % in nominal rubles, while expenditures increased by over 6 %. Using GDP data determined by Rosstat's old methodology (i.e. before the recent adoption of broader definitions), revenues declined to 36 % of GDP, while expenditures climbed to nearly 40 % of GDP. The consolidated government deficit, which corresponded to 3.9 % of GDP in the old GDP system, was just under 3.6 % of GDP using the new system.

The large hole created by the drop in government revenues from oil & gas taxes was partly filled with considerably increased revenues from social taxes as part of the health insurance financial reform. Revenues from corporate profit taxes were up as company profits in the oil sector and among exporters involved in basic manufacturing saw significant gains from the ruble's collapse at the beginning of the year. VAT revenues were also up in nominal ruble terms.

While defence spending continued to soar last year, increases in government spending otherwise averaged about 4–5 % in nominal ruble terms. Among major government spending categories, a notable spending increase was seen in public administration, although it is difficult to say where the increase went as it arose mainly from spending on unspecified international relations. In contrast, spending on domestic security and law & order contracted in 2014–2015.

Social spending is by far the government's biggest spending category, and most social spending goes to pensions. Social spending increased rapidly last year. Financial reform of health insurance also lifted healthcare spending by well over 10 %. The low spending growth for education in 2014 dropped further last year, failing to increase even in nominal ruble terms. With the exception of day-care facilities, zero budget growth fell on education at all levels.

Largest government spending categories, 2006–2015



Source: Ministry of Finance.

Spending on the housing sector continued to decline. Budget spending on the economy fell, which was due to December 2014 recording of a very large one-time support sum granted later to banks. Budget spending was raised for the energy sector and, following a notable drop last year, also for agriculture. Spending on road network construction and maintenance showed virtually no increase in 2014–2015. Debt servicing costs (interest payments) rose last year by over 25 %.

Russian foreign debt declined last year. Preliminary figures from the Central Bank of Russia put the country's foreign debt at \$515 billion at the end of 2015. Foreign debt fell in 4Q15 by just over \$20 billion as banks and firms paid down debt. During the whole 2015, the value of foreign debt decreased by over \$80 billion. Some of the reduction reflects the depreciation of the ruble's exchange rate. About one-fifth of Russian foreign debt is denominated in rubles. Foreign ruble debt appears to have in fact even increased last year.

Russian government foreign debt amounts to about \$30 billion (2 % of GDP according to the new GDP figures). If the debt of the CBR and state-majority enterprises and banks are included, the public sector's total share of Russian foreign debt is about half. Firms operating outside the banking sector hold most private sector foreign debt. However, over a third of that is debt in the form of intra-group liabilities.

Russia holds about \$50 billion in short-term foreign debt. The CBR estimates that just under \$30 billion of that comes due in the first half of 2016. Russia's foreign currency reserves stood at \$370 billion at the end of January. So for the Russian economy as a whole, paying down debt should not cause problems to forex liquidity. Individual firms, however, could have trouble settling their debts.

Russia's disputes with neighbours complicate road transport. With the closure of routes through Ukraine and Poland, Russian lorries have currently practically no land connection to Central Europe. Russia and Ukraine this week declared reciprocal blockades on Ukrainian and Russian lorries seeking to cross their borders. Russia said it was blocking traffic in response to recent interference of Ukrainian protesters seeking to prohibit movement of Russian lorries through Ukraine. Ukraine responded with its own border shutdown. At the start of January, Russia imposed restrictions on Ukrainian road freight transiting Russia to Kazakhstan.

The situation is made more problematic for Russia by the fact that it already has a similar blockade in force with Poland. That bilateral transport agreement expired at the start of this month and negotiations on a new agreement have stalled over transport permit quotas. While economic effects of the transport feuds are likely to remain limited for Russia as a whole, the transport sector faces extra costs as do some firms that have to revise their logistics chains.

China

China's lending soars, while share of nonperforming loans increases. Some 2.5 trillion yuan (\$380 billion) in new yuan-denominated loans were granted in January – more than in any single month ever. The amount was comparable to the combined value of lending last year in both January and February. The corporate sector (including public-sector businesses) borrowed 1.94 trillion yuan, an increase of 85 % from January 2015. New lending to households in January amounted to 610 billion yuan (up 43 % y-o-y). The total credit stock grew 15 % y-o-y in January.

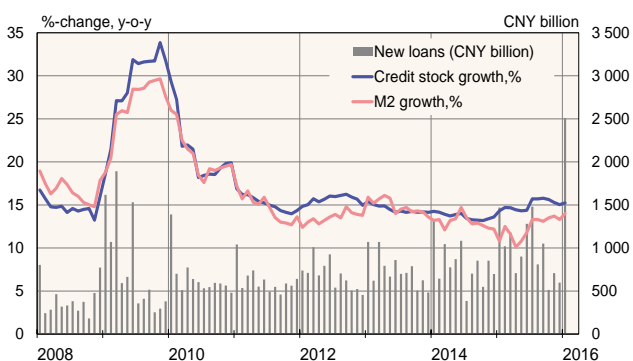
Lending usually surges at the start of the year due to high seasonal demand for money around the Chinese New Year's holiday week. This year, the growth in demand for yuan-denominated credit also reflects a fall in demand for foreign-currency loans and efforts to pay off foreign-currency debt. In January, the People's Bank of China stepped up its money supply expansion efforts through open-market operations and the use of targeted lending. Growth in the broad money supply (M2) accelerated to 14 % y-o-y in January.

Consumer price inflation accelerated to 1.8 % in January. Core inflation (excludes prices of food and energy) remained at 1.5 %, while producer price deflation reached 5.3 % in January.

The volume of non-performing loans (NPLs) on bank balance sheets rose in 2015. The banking sector's NPL stock amounted to 1.3 trillion yuan. When 'special mention loans' (a high likelihood of default) are included, the total amount rises to 4.2 trillion yuan (\$650 billion), an increase of 41 % y-o-y. NPLs and special mention loans combined represented on average 5.5 % of the banking sector's total credit stock.

Loan-loss provisions on bank balance sheets amounted to 2.3 trillion yuan (up 18 %) at the end of 2015 – an amount sufficient to cover 180 % of total NPLs. Under current regulatory rules, bank need to hold loan-loss reserves equivalent to at least 150 % of their NPL stock. Media reports say a cut of loan-loss provision requirement is under consideration to help banks improve their profitability.

Growth in credit stock and money supply (M2), new yuan loans

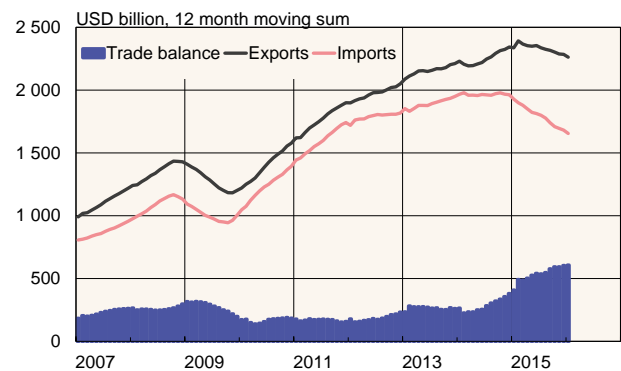


Sources: Macrobond, Bloomberg.

Decline in Chinese foreign trade continued in January. Measured in US dollars, the value of January goods exports fell 11 % y-o-y, while the value of good imports was down by 19 %. The contraction in exports was broad-based across trade partners and commodities. The contraction in the value of imports accelerated on further declines in world commodity prices, even if the volumes of many commodity imports increased. The goods trade surplus boomed in January to a record \$63 billion.

The foreign trade numbers reflect weak demand in China and its key exports markets as well as exchange-rate shifts. Looking at the mirror trade data, the value of US's and Eurozone's exports to China fell 5–6 % last year measured in dollars and euros, respectively. Moreover, due to China's capital controls firms disguise capital movements as foreign trade transactions, which complicates interpretation of Chinese foreign trade figures.

Trends in Chinese foreign trade



Source: Bloomberg.

PBoC reiterates commitment to opening Chinese economy. People's Bank of China governor Zhou Xiaochuan commented on trends in Chinese exchange rate policy in an interview with the Chinese economics journal *Caixin* on February 13. In Zhou's view, China's massive current account surplus indicates that there is no basis for yuan depreciation. He further noted that China plans to gradually shift its exchange-rate policy to a system where one of the criteria will be to establish a relatively stable yuan against a yet-to-be-decided currency basket. Zhou said that increasing international use of the yuan and the dismantling of capital controls proceeds, but that the rate of progress depends on the amount of uncertainty in the markets.

It was somewhat surprising how strongly the interview emphasized the role of speculators in the PBoC's communication strategy, as messaging intended to influence speculative behaviour easily leads to overall confusing signalling. The views on the article on exchange-rate policy and capital movements did little to clarify the short-term outlook, but strongly suggested that China plans to stick with its opening up strategy.

Russia

Russia discusses caps on oil production. The energy ministers of Russia and Saudi Arabia, the world's two largest crude exporters, met last week with representatives from Kuwait and Venezuela. They agreed on freezing crude oil production at the January 2016 level if other OPEC members agree to the deal. That has not happened so far.

The potential cap on production volumes is seen as a way to influence oil prices. It is easy for Russia to stick with January's production volumes; Russia's energy ministry says Russian crude oil production hit a record level of more than 46 million tons in January. If output holds at this level for all of 2016, Russian oil production would climb almost 3.5 % this year from last year. This seems unlikely as many observers see that Russia is already at its oil production ceiling.

With old fields drying up and new investment hard to come by, oil production in Russia is expected to decline in coming years. The October forecast of Russia's economy ministry predicts oil production will contract by about 0.5 % in 2016 and 2017. The latest report of the International Energy Agency (IEA) sees Russian oil production falling in coming years by nearly 1 % a year. Saudi Arabia lacks production constraints similar to Russia's.

Russian manufacturing shrank 5 % last year. The production of basic necessities seems to be performing best among manufacturing branches. The ruble's devaluation has boosted prices of imported goods, forcing consumers to switch to domestic products. Food industry output was up by 2 %, and was further supported by earlier investment and import bans. In contrast, the textile industry has seen little benefit from the ruble's devaluation or import restrictions on state procurement. The textile industry's production fell by 12 % last year.

Pharmaceutical production was also up 9 %. There are, however, increasing concerns in Russia about the availability of some of the cheapest medicines. Their prices are controlled by the state, which reduces incentives for companies to produce them. The chemical industry overall grew by 6 %. The chemical industry's robust growth might have also been partly due to the notable increase in defence spending last year, supporting e.g. production of explosives.

Increased exports helped oil refining record slight growth. Due to weak domestic demand for petroleum products, 60 % of refined products went to export last year. Export volumes of many metals and wood products increased on the weak ruble, even if output of metal industry contracted nearly 7 % and the forest industry about 5 %. Global price drops have, however, hit the sales value of metal producers.

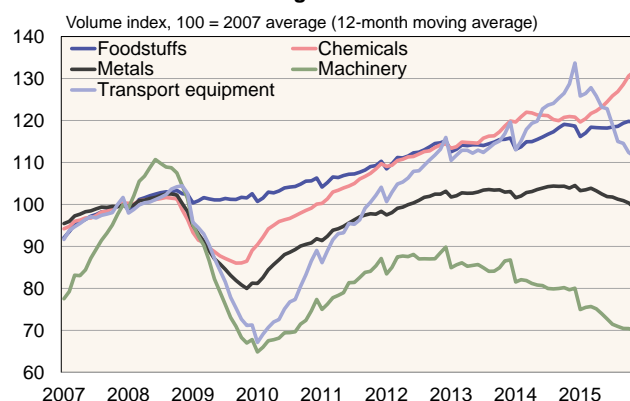
Branches that rely mostly on domestic investment demand are suffering at the moment. Production of construction materials contracted 8 % last year, while manufacturing

of machinery, equipment and transport vehicles was down 10 %. The production of transport equipment has been dragged by the shrinking car sales in Russia as they were down already third year in a row. Last year's drop was intensified due to the record-high production level in 2014, which was fuelled by a significant increase in defence spending.

The manufacturing outlook for this year is hardly rosy. Domestic demand remains weak and rapid inflation erodes the price competitiveness brought by the weaker ruble. The ruble devaluation has also hurt the profitability of some firms as prices of imported components have risen notably. The lack of investment could suppress production growth for a long time. Manufacturing investment in Russia in recent years has only corresponded to about 2.5 % of GDP.

Russian industry remains heavily focused on oil & gas production, and no signs of diversification in the production structure has been seen in recent years. Also within the manufacturing sector, oil refining is the largest branch. Other manufacturing production accounts for about 10 % of Russian GDP. The next-biggest branches are foodstuffs, machinery, equipment and transport vehicles, as well as the metals industry.

Trends in some manufacturing branches in Russia



Sources: Rosstat, BOFIT.

Asia top destination for Russian arms exports. The Stockholm International Peace Research Institute (SIPRI) reports that the volume of international arms sales increased by 14 % in 2011–2015 compared to the 2006–2010 period. In the first five years of this decade, the US has accounted for 33 % of global arms exports and Russia 25 %. The next closest were China and France, each with shares below 6 %.

In 2011–2015, the volume of Russian arms exports was up 28 % compared to 2006–2010. However, in 2014 and 2015, export volumes had subsided to the 2006–2010 level. SIPRI reports that Russia supplies arms to 50 countries, as well as Ukrainian rebels. Over two-thirds of Russian arms exports go to Asia. 35 % of Russian arms exports go to India, 11 % to China and 11 % to Vietnam. Russia's exports to Azerbaijan have soared over the past five years, increasing four percentage points to 5 % of Russia's total arms exports.

China

Chinese officials promise economic stimulus and structural reforms. China's officials this month have assured they can calm turbulent markets, hit their growth targets and move forward with reform. Eight top officials posted a declaration on the central bank's website to express their commitment to increasing financial support to industrial branches impacted by structural reforms. The declaration further promised support to Chinese investment abroad. Insolvent "zombie" firms will be wound down. Earlier this month, to speed up structural change the government promised tax relief to high-tech service firms. At a meeting of the reform policy steering group this week, president Xi Jinping stressed that it was essential to continue with reforms at all levels. In February, the head of China's securities regulatory commission was sacked.

The latest economic policy declarations emphasise the role of debt-finance to promote structural reforms and growth. This will worsen China's debt problems. The biggest headache for officials still seems to be figuring out how to achieve the current 6.5–7 % growth target. There seems to be no room to consider that employment goals might be achieved with slightly lower growth and less indebtedness. Some official comments optimistically assert that the recent uncertainty is only temporary and reforms can be postponed to more appropriate times. Yesterday (Feb. 25), the markets expressed their view on uncertainty with share indexes in China dropping by more than 6 %.

Further discussion on the course of economic policy is expected next month when the People's Congress (China's parliament) convenes to approve this year's budget and the revised goals for the 2016–2020 five-year plan.

China's overcapacity problems increase. Overcapacity is most apparent in businesses supplying the construction sector (e.g. steel, concrete and glass), aluminium production, papermaking, coal mining and shipbuilding. While overcapacity has been acknowledged for years, the problem has snowballed as the economy has evolved. Excess shipbuilding capacity derives from a 2007 government decision to become the world's biggest shipbuilder.

A just-released [report](#) from the EU Chamber of Commerce in China recommends over two dozen measures to deal with these issues. Investment in overcapacity sectors need to be reined in, direct subsidies from local government to businesses need to be cut, and prices of electricity, gas and water need to be more market-based. The Chamber further proposes hikes in environmental fees in order to encourage decommissioning of the worst-polluting production facilities. Moreover, state enterprises should be required to pay dividends rather than invest in additional production capacity. China's leadership has recently embraced several initiatives to shutter plants in overcapacity branches, but the results to date have been modest.

Chinese direct investment in Europe continues to rise. The US-based Heritage Foundation and the American Enterprise Institute's China Global Investment Tracker database indicate that the new large overseas investments (over \$100 million) of Chinese firms last year reached \$111 billion (up from \$96 billion in 2014).

Nearly a third (\$33 billion) of large investments of Chinese firms abroad last year went to Europe. About a fifth (\$22 billion) went to the United States. Investment in Europe has increased in recent years, while investment in e.g. Africa has declined. Some of this shift reflects changes in the branches receiving the most investment. Investments in the energy and metal sectors, for example have fallen, while investment in transportation, finance and the tech sector are on the rise. Investment by branch and geographic region, however, fluctuates from year to year.

Last year, transportation and finance were the main target areas for Chinese firms in Europe. The largest investments came from state-owned ChemChina (nearly \$8 billion in the Italian Pirelli), the HNA Group (nearly \$3 billion for acquisitions of aerospace firms in Switzerland and Ireland), and China Minsheng Investment (over \$2 billion for the Swedish reinsurer Sirius). ChemChina last month announced plans to buy the Swiss agriculture company Syngenta for \$43 billion, which would make it the largest foreign investment ever of a Chinese firm.

China's arms exports grow rapidly. According to the new data by the Stockholm International Peace Research Institute (SIPRI), China has established itself as the world's third-largest arms exporter, after the US and Russia. China's arms exports increased by 88 % from 2006–2010 to 2011–2015. The country's share of international arms exports grew from about 4 % in the latter half of the previous decade to about 6 % in the first half of this decade. Some 35 % of China's weapon exports go to Pakistan, 20 % to Bangladesh and 16 % to Myanmar.

With China increasing its own arms production capabilities, the volume of arms imports fell by about 25 % in 2011–2015 compared to the previous five-year period. Although the country's share of global arms imports has declined below 5 %, it is still the world's third-biggest weapons buyer after India (14 %) and Saudi Arabia (7 %). China is still dependent on foreign technology for air defence, helicopters and cargo aircraft, as well as aircraft and ship engines. Engines accounted for about a third of arms imports.

Last year, China agreed to buy from Russia sophisticated air-defence missile systems and 24 Su-35 fighters – the first international sale of these fighters. The fighter sale is valued at \$2 billion. SIPRI reports that despite a long-term decreasing trend, Russia still supplies 59 % of China's arms imports, while France accounts for 15 % and Ukraine 14 %.

Russia

Russia approves 2016 anti-crisis economic programme. Over its several weeks of planning, the anti-crisis programme has seen its price tag repeatedly reduced as Russia's fiscal outlook faltered. Funding decisions were made for only some measures of the approved plan, though the sources are still partly unclear. The fate of other measures (including support for the troubled VEB state development bank) will depend on economic trends in the first half of this year.

The total value of the package amounts to just under 700 billion rubles (€8 billion). However, most of the measures inked in the programme are already included in this year's federal budget. The additional funding needs are put at 160 billion rubles. This corresponds to 0.2 % of GDP, so the impact on the economy is likely to be limited. It is also still unclear where the additional funding will come from.

Some 60 % of the total 700-billion-ruble package will go to regions and social spending, a bit more than a third will go to supporting industry and rest to help small and medium-sized enterprises (about half in the form of government guarantees). Over 70 % of the 160-billion-ruble additional funding is marked for industry, with the remainder going to regions and social spending. Carmakers are the big winners; they are set to receive support worth 140 billion rubles.

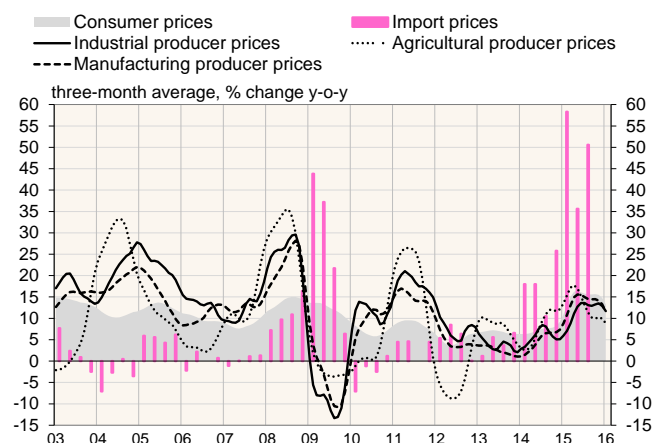
The programme also includes a long list of structural reforms. These cover a broad spectrum of various measures like regulatory reforms and improved oversight of state firms.

Inflation in Russia moderates. Consumer and producer price inflation have slowed recently. Industrial producer prices were in fact down clearly on-month in December-January. In on-year terms industrial producer prices and consumer prices were still up 8–10 % in January. A similar 12-month rise in industrial producer prices was last seen in 2012 (not counting the 2015 spike).

Inflation picked up when the ruble's slide steepened in spring 2014 with the Ukraine conflict and the following summer on foreign sanctions and Russia's retaliatory import bans on food and agricultural products. Inflation picked up sharply last winter as the ruble crashed and import prices soared in ruble terms (up 75 % in just six months), more than even in the 2008–2009 ruble crisis. Imports have had a large share in the economy, e.g. spending on imported consumer goods and spending by Russian travellers on goods and services abroad equalled about 15 % of private consumption, while imported investment goods represented a fifth of total investment.

This winter, the ruble's slide has been much milder compared to last winter. Central Bank of Russia governor Elvira Nabiullina noted that the effect of the ruble's slide on prices has also been weaker than a year ago. The CBR reports this is due to weak demand and the fact that there has been no rush to buy goods, unlike last winter. The CBR expects consumer price inflation to slow to 7–8 % y-o-y by the end of this year.

Changes in consumer, producer and import prices, 2003–2016



Source: Rosstat.

Finland's trade with Russia declined sharply last year. The contraction reflects mainly lower oil prices, weak Russian demand and the ruble's devaluation. EU-imposed sanctions on trade with Russia have apparently had only modest impact on trade. The food import bans imposed by Russia reduced Finnish food exports. The value of goods exports was €3.2 billion and goods imports €6 billion. Exports and imports shrank by nearly a third to levels well below the troughs of the 2009 recession. Russia accounted for 6 % of Finnish goods exports and 11 % of imports.

The structure of exports has scarcely changed in recent years. Some 34 % of exports last year consisted of machinery and equipment, 26 % of chemical products and 14 % of wood and paper products. Foodstuffs fell slightly to 4 %. In 2009, the share of machinery, equipment and transport vehicles contracted sharply, largely on the collapse of re-exports of mobile phones and passenger cars, which have not recovered much since. Finnish customs says re-exports (i.e. exports of goods manufactured in a third country) accounted for 22 % of Finland's exports to Russia in 2014. Re-exports currently include e.g. some machinery and pharmaceuticals.

The structure of imports has also showed little change. Last year mineral fuels (mainly crude oil) still accounted for over 70 % of imports, so the fall in imports was largely due to lower oil prices. Chemical products were 13 % of imports, wood products 6 % and metal products 3 %.

Russian tourism in Finland also declined sharply last year. Slightly over 9 million people crossed Finland's eastern border, a decline of about 20 % from 2014. Tax-free sales fell roughly the same measured by the number of purchases. Overnight stays of Russian travellers declined by over 40 %. Nevertheless, Russians were still the single largest foreign tourist group visiting Finland last year.

Transit transport from Finland to Russia contracted about 40 % last year. It was the fourth consecutive year of contraction and the value of transit freight was just €8 billion (down from €30 billion in peak years).

China

China relaxes monetary policy. China this week lowered by a half percentage point the reserve requirement on bank deposits. Since March 1, large banks must place 17 % of their deposits with the People's Bank of China, while small and mid-sized banks must give 15 %. The cut should free up about \$100 billion in yuan deposits for lending. Reserve requirement ratio was last lowered in October.

Besides lowering reserve requirement to boost lending, the PBoC injects short-term liquidity into the system through open market operations by buying securities from banks with a promise to sell them back (reverse repo). The central bank also has other monetary tools to help banks meet their liquidity needs and target lending, including the standing lending facility (SLF), medium-term lending facility (MLF) and pledged supplementary lending (PSL).

Strong credit and money supply growth in January point to relaxed monetary policy stance. Short-term money-market rates (7-day), however, have remained at around 2.5 % since last summer and lowered reserve requirement appears to have had no immediate effect on interest rates. China's monetary policy framework remains complex, which complicates the assessment of the monetary policy stance.

Environment for monetary policy is challenging. On the other hand, monetary policy is expected to support the government's growth target, yet labour markets, price trends and the economy's structural shift argue for embracing a lower growth path. Furthermore, China's mounting debt problems, capital outflows and the depreciation pressure of yuan are not making it easier for the policymakers.

China's service sector increasingly shouldering growth burden. China's service sector grew by over 8 % in real terms last year, while industrial and construction output was up 6 % and primary production (mainly agriculture) just 4 %. Fuelled by high growth, the service sector last year contributed its highest share of economic activity ever, accounting for 50 % of GDP. Even so, China's service sector is relatively small. While smaller shares can be found from African countries and petrostates, the service sector in advanced economies typically generates 70–80 % of GDP.

Structure of China's service sector and real growth in 2015

	Growth, %	Share, %
Accommodation and catering	6	4
Transport and storage	5	9
Real estate	4	12
Finance and insurance	16	17
Wholesale and retail trade	6	19
"Other"	9	39
Total service sector	8	100

Source: China National Bureau of Statistics.

Finance and insurance have been the fastest growing branches within the service sector in recent years. In contrast, growth slowed last year in trade, transport, and accommodation and catering services. The "other" services category, which encompasses about 40 % of China's service sector, has enjoyed robust growth and suggests a rapid expansion of public services. The most recent available figures from 2012 show about 60 % of "other" services are generated by public administration, education, health care and research activity.

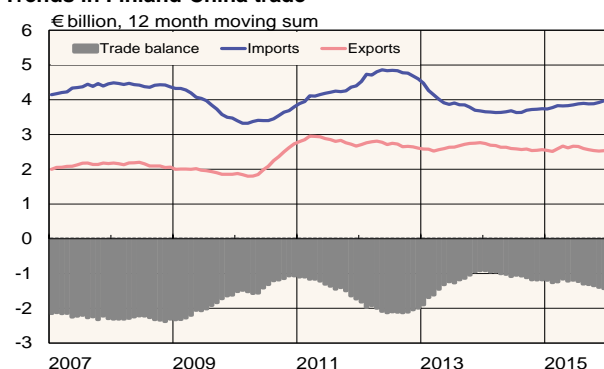
China increased its share of Finnish foreign trade last year. Although the value of Finnish goods exports to China fell 1 % last year to €2.5 billion, the value of imports rose 6 % y-o-y to €4.0 billion. The total value of Finnish goods exports last year fell by 4 %, while the value of imports declined some 6 %. China is Finland's fifth-largest trading partner with a 6 % trade share.

The value of Finnish raw-material exports to China exceeded the value of exports in the machinery and equipment category. Raw materials last year accounted for 40 % of all Finnish exports to China. The largest groups were pulp (19 % of total exports) and furs (11 % of exports). The machinery and equipment category, in contrast, shrank to 38 % of exports to China. Chemical products had a 7 % share.

Finland's imports from China consisted largely of machinery and equipment (52 % of imports) and variety of other finished goods (45 % of imports). Imports of machinery and equipment mainly consisted of consumer electronics. Phones last year accounted for 13 % of Finland's imports from China and computer equipment 10 %. Finland imports a wide range of Chinese consumer goods. The share of clothing and footwear declined last year slightly to 15 %.

Chinese travellers last year had 182,000 overnight stays in Finnish hotels and inns, an increase of 53,000 overnight stays from 2014. Overnight stays of all foreign travellers in Finland declined slightly. The number of visitors from China last year exceeded the number of Japanese visitors for the first time. However, the Japanese tended to stay longer and thus had more overnight stays than the Chinese. The number of Chinese travellers in Finland doubled in just three years. Today, 5 % of all visitors to Finland are Chinese.

Trends in Finland-China trade



Source: Finnish Customs.

Russia

Russia's fixed investment structure continued to shift last year. After declining 1.5 % in 2014, the volume of fixed capital investment in the Russian economy declined by over 8 % last year. Rosstat estimates that investment of small firms and grey economy contracted for the first time since the 2009 recession (down by a few per cent). Other fixed investment was down about 10 %, accelerating the slide that began in 2013.

Increases of investment in core economic sectors came virtually only from oil & gas production (up 11 %) and other extractive activities. In this respect, 2015 was similar to 2014. Investment in branches operating extensive infrastructure continued to plummet. The electrical power generation, transmission and distribution sector saw a drop of 32 %, oil & gas pipeline transmission was off 11 % and railway investment slumped 19 %. Investment in oil refining, which soared earlier in this decade, contracted well over 10 %. Investment in other manufacturing branches was also down several per cent.

The slump in construction activity worsened last year, falling 7 %. The biggest factors were drops in production of commercial and industrial buildings. Using data in nominal rubles (only nominal data is available), investment spending in machinery, equipment and transport vehicles was flat in 2015, following a considerable drop in 2014. Thus, the 2015 drop was also quite severe in real terms.

After falling drastically in 2014 when federal, regional and municipal governments sharply cut back on investment spending, their fixed investment spending last year rose slightly. Firms fully or partly owned by foreigners, and, according to the preliminary figures, privately held Russian firms, increased their investment spending slightly last year after a decline in 2014. Even so, the increase in 2015 was clearly outstripped by the rise of prices of investment goods.

As in 2014, firms continued to rely increasingly on out-of-pocket financing to finance fixed investments. Along with the lame financing from the state budgets, financing from other sources, e.g. borrowing, declined virtually across the board.

Growth of housing production slowed. Housing construction contracted slightly last year. Rosstat reports that the total volume of new apartments completed in Russia last year amounted to 84 million m² (measured in liveable floorspace), which was nearly the same volume as in 2014. Construction of detached and semi-detached housing, however, fell clearly, while state-supported housing production was up slightly. As a result, Moscow, for example, last year saw completion of a record volume of new apartments (17 million m² in liveable floorspace).

The slight decline in average apartment prices reflected growth in supply and the lack of eligible buyers. The nominal

price of new apartments in rubles fell 2 % y-o-y, while prices of older apartments sank about 4 %. The price variations and shifts across regions were considerable, however.

Even with housing prices propped up in part by government-subsidised interest rates for new housing loans, the value of apartment loans granted by banks was down 35 % last year. The interest subsidy programme, earlier set for phase-out at the end of March, has now been extended to the end of 2016. About 40 % of apartment loans issued last year qualified for interest subsidies. While the role of bank loans in financing purchases of apartments has increased, less than a quarter of apartment purchases in Russia are financed with bank loans.

Consumption down across Russia in 2015. Retail sales volumes fell 8–13 % in six of Russia's federal districts, a significantly larger drop than in the 2009 recession. Of Russia's 83 administrative regions, 27 experienced declines in retail sales of 10–15 % and five saw drops of 15–20 %.

Fixed investment fell most in the Southern and Siberian Federal Districts. The Northwestern Federal District also experienced a large decrease, for the third year in a row. There were huge differences across administrative regions. 39 regions saw fixed investment slump at least by 10 %, including 15 regions with drops of 20–30 % and six regions with drops of 30–40 %. Investment rose by over 5 % in six regions.

Production in extractive industries (including oil & gas as its major part) largely avoided very significant decreases in major production areas as well as regions where extractive industries constitute a large share of the economy. Manufacturing output was down most in the Far Eastern Federal District and the Northwestern Federal District. With respect to the largest regions in terms of their share of manufacturing in Russia, tangible production declines were only seen in Moscow and St. Petersburg. In smaller manufacturing regions, nine saw manufacturing production contract about 8 % and twelve regions saw declines of over 10 %.

Real growth in core economic indicators for seven federal districts and Russia's main urban centres, 2009 and 2013–2015

	2009	13	14	15	2009	13	14	15	2009	13	14	15
	Retail sales % change				Fixed investments % change				Manufacturing % change			
All Russia	-5	4	3	-10	-14	1	-2	-8	-15	1	2	-5
Central	-4	4	4	-11	-20	5	-1	-4	-9	2	2	-2
Moscow City	-3	4	2	-14	-22	7	0	2	-7	-4	-1	-5
Moscow Region	-8	2	8	-6	-37	6	-4	-8	-15	6	4	1
Northwestern	-6	3	3	-10	-19	-9	-8	-9	-13	0	-3	-6
St. Petersburg	-5	3	3	-12	-21	27	2	-11	-21	-1	-7	-7
Southern	-5	5	4	-8	-2	15	-17	-18	-13	4	5	10
Volga	-5	6	3	-13	-18	7	-1	-8	-12	2	4	-4
Ural	-10	5	-1	-12	-14	1	1	-4	-19	4	4	-1
Siberian	-11	3	-1	-12	-14	-6	-4	-17	-9	3	3	-3
Far Eastern	1	6	5	-1	30	-17	-5	-3	-2	5	3	-10

Source: Rosstat

China

China targets growth of 6.5–7% this year. Premier Li Keqiang revealed the growth target in his opening address to the National People's Congress (NPC) last Saturday (Mar. 5). The NPC also reviews and approves the 2016–2020 five-year plan in which China seeks average annual GDP growth of at least 6.5%. For those who had hoped China was finally ready to abandon rigid growth targets and accept slightly lower growth, the ambitious growth targets were a disappointment. The fear is that high growth targets imply soaring indebtedness and postponement of needed economic reforms. Amid the wide-spread concerns over a rapid deceleration in China's growth, premier Li said that this year's target is set high also to guide market expectations.

While premier Li's assessment hit familiar themes such as financial market reform, overhaul of state-owned enterprises and reducing overcapacity, it offered little in the way of concrete actions. Li said that China this year intends to improve the yuan exchange-rate mechanism and keep the yuan's exchange rate "basically stable." Increased innovation activity was proposed as a general cure for the economic slowdown. The 2016–2020 plan calls for an increase in R&D spending to 2.5% of GDP, while energy efficiency will be improved and emissions reduced.

Achieving the growth target requires monetary and fiscal stimulus measures. Budget spending is planned to rise 7% this year, which will boost the budget deficit. There is room to manoeuvre in monetary policy, as this year's inflation target has been set at 3%, while the broad money supply (M2) and broad credit measure (total social financing) each have growth targets of 13%. Indebtedness is likely to rise swiftly if these targets are met; the expansion of credit is roughly double the rate of nominal GDP growth.

China opens its bond markets to foreign investors.

Late last month, the People's Bank of China announced it was eliminating quotas imposed on foreign commercial banks, insurance companies, pension funds and asset management companies participating in China's interbank bond markets. Foreign investor quotas were eliminated already last summer from central banks and state investment companies. Of the institutional investors, only foreign hedge funds' investment to Chinese bond market remain limited by quotas. Market observers see the reform as a major step towards opening up of China's financial markets.

Valued at about \$7.3 trillion, China's bond market is the world's third largest after the US and Japan. The main bond issuers in China earlier were the state and various public sector entities. In recent years, however, financial and non-financial corporate bond issues have become commonplace. Trading in Chinese bonds focuses largely on the interbank market. Foreign investors currently account for less than 2% of the market.

With interest rates in advanced economies generally low, Chinese debt securities offer higher yields that will tempt foreign investors to put their money in Chinese bonds. However, disconcerting trends in China's economy have emerged and recently capital has been flowing out of the country. Media comments suggest that institutional investors are closely monitoring the situation and have assumed a cautious stance on China investment.

The opening up of bond markets to foreign entities is a natural step in advancing China's domestic financial markets, deregulation of capital movements and internationalisation of the yuan. Moreover, the bond market deregulation seems timely in light of the net outflow of capital from China and devaluation pressures on the yuan.

Rising food prices drive Chinese inflation higher.

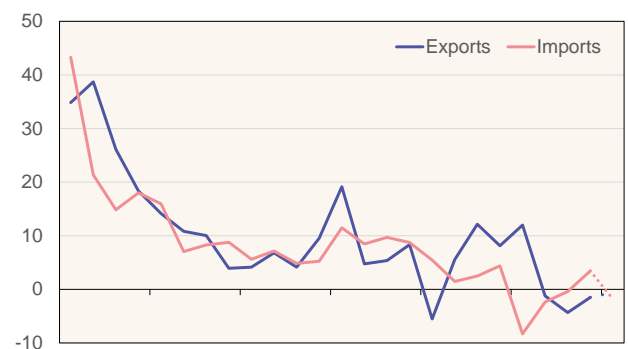
Consumer prices rose 2.3% y-o-y in February, up from 1.8% in January. Notably, core inflation (food and energy prices omitted) slowed slightly to 1.3% y-o-y. The long slide in producer prices continued in February, when producer prices were down 4.9% y-o-y. However, the slide has been slowing down in recent months.

Pricing factors depress Chinese foreign trade.

Measured in US dollars, China's goods exports fell 18% and imports 17% in the first two months of this year. The foreign trade surplus for the period came to \$96 billion. While the foreign trade trend points to weakening demand in China's domestic and export markets, it also reflects large adjustments in prices. Prices of China's export and import goods overall have been declining and the yuan's exchange rate has been about 5% weaker against the dollar compared to a year ago. Measured in volume, China's foreign trade showed a modest contraction in January: exports were down 1% and imports 2% y-o-y.

Trends in the value of exports and imports are also distorted by companies disguising capital movements in import and export declarations given to China Customs. Changes in such avoidance of capital controls will have direct impact in trends of the value-based China's foreign trade figures.

Foreign trade volume quarterly 2010–2015 and January 2016, %-change y-o-y



Sources: China Customs and CEIC.

Russia

CBR calls for better supervision of microlenders. Although lending of commercial banks to households has declined, the growth of providers of small loans at high interest is booming. Some 3,000 registered microlenders now operate in Russia and it is estimated that there is also a large number of illegal loan-sharking operators. The Central Bank of Russia reports declaring 430 illegal microlenders in 2015, and that cancellations of licences have become more frequent. At the beginning of March, the CBR cancelled the licences of 34 registered microlenders. With increased online surveillance, the number of cancellations is expected to rise significantly this year.

Russia's credit information registry shows that the stock of microloans is currently about 70 billion rubles (€875 million), or less than 1 % of the value of the stock of commercial bank loans to households. Over half of all microcredits are consumer loans granted to private individuals and the rest consists of loans to tiny firms or sole proprietorships. Payday loans, i.e. small loans with maturities of up to 30 days and daily interest charges of about 2.5 % are the fastest growing product line. According to media reports, significantly higher rates and illegal collection practices are not uncommon. At the end of this month, an amendment will enter into force limiting the interest rate charged on microcredit to no more than 400 % p.a. (the CBR had requested a 200 % ceiling). In addition, the CBR has suggested restrictions on the number of loans for a single borrower.

Supervision of other financial market participants is also tightening. The CBR has suggested mandatory stress tests for private pension funds and stricter competence requirements for fund managers. Any firm offering financial market services must be a member of one of the seven approved associations in the financial field. The reforms are intended to reinforce the branch's transparency and stability.

High demand for Russia's Deposit Insurance Agency funds. Some 838 banks currently participate in Russia's deposit insurance scheme. The arrangement covers the deposits of a private individual up to 1.4 million rubles (about €17,500). Every bank participating in the deposit insurance scheme pays a quarterly insurance premium equal to 0.1 % of their total household deposits. Russia's largest deposit-taking bank, state-owned Sberbank, generates nearly half of the total amount of insurance payments.

During 2015, a total of 93 financial institutions lost their operating licences. Of those, 77 were participants in the deposit insurance scheme. Russia's Deposit Insurance Agency (DIA) last year paid out a total of 369 billion rubles (€4.6 billion) on deposits of bank customers. The DIA had to pay out so much that it turned to the CBR for additional funds. The CBR granted the agency two loans for a total of 250 billion

rubles (€3.1 billion) last year. Deputy finance minister Alexei Moiseyev said he expects the DIA to soon request a new CBR loan of 170 billion rubles (€2.1 billion).

The DIA also participates in bank restructurings, on which it last year spent about 490 billion rubles (€6 billion). The number of banks experiencing restructurings has been on the rise. At the beginning of February, the DIA had 30 banks under restructuring. In addition, the DIA assumed responsibility in December 2014 over a programme for recapitalisation of large banks. Under that programme, the capitalisations of 25 banks have been boosted by a total of approximately 800 billion rubles (€10 billion). Restructurings and bank recapitalisations are financed with support from the CBR and the government.

Protests lead to concessions in Russia's new road fee system. Russia last November introduced its Platon system of fees for heavy vehicles using federal-level highways. Platon's purpose is to collect revenues for the building and maintenance of highways. The basic fee of 1.53 rubles (2 euros) per kilometre was set to double at the beginning of March, and road use fees were expected to raise about 40 billion rubles (€0.5 billion) additional funding for road construction this year. Some road projects were already planned to receive part of their financing from these funds.

The road fee provoked a strong backlash from road transport operators and led to major demonstrations by long-haul lorry drivers. The government has now decided to freeze the fee at its initial level for the time being and give tax concessions to transport firms for compensation of the road fees. As a result of these decisions, the net revenue from road fees is likely to be rather modest, especially since the company operating the system charges the government 10 billion rubles a year. In the first four months of operation, the road fee raised nearly 5 billion rubles.

The road fee dust-up exemplifies the difficulties the administration faces in implementing even smaller unpopular reforms, especially in a recession with elections approaching. For the moment at least, the unrest has been limited to private actions protesting specific government measures such as road fees. Recent surveys have found nothing to suggest that widespread protests are in the wings, despite Russia's poor economic situation. For example, the survey findings of the independent Levada research institute released this week show that only a quarter of Russian respondents regard protests related to the economic situation as possible. A similar survey in summer 2009 found that 40 % thought protests might be possible, but no major protests occurred during the 2009 economic crisis.

The international transit routes used by Russian road freight firms in Ukraine and Poland are again functional. According to Russia's transport ministry, transit traffic in Ukraine restarted at the end of February. Poland and Russia, on the other hand, have agreed to a temporary transport permit quota that will stay in force until mid-April.

China

January-February sees lower industrial output growth and pick-up in apartment sales in China.

Industrial output growth slowed to 5 % y-o-y in January-February, continuing a trend of steady decline in recent years that has largely been due to the falling heavy industry production. For example, production of metals, cement and glass all fell in the first two months of this year. In contrast, the production volumes of consumer goods such as cars and mobile phones were up. Retail sales growth remained relatively strong, increasing 10 % y-o-y in January-February.

Fixed investment climbed 10 % y-o-y in January-February. Private sector investment grew 7 %, while investment of the government and state-owned enterprises rose 20 %. Investment in infrastructure and the energy branch rose sharply. Investment in housing recovered a bit, and was up 3 % y-o-y in the same period.

Apartment sales picked up considerably in January-February compared to the first two months of 2015. Measured in terms of liveable floorspace, apartment sales in January-February were up 28 % y-o-y. Measured by value, apartment sales rose 44 %. New apartment starts, measured by floorspace, were up 14 % y-o-y.

China's largest provinces have economies similar in size to mid-sized emerging economies.

The relative size of China's provincial economies has increased dramatically in recent years due to economic growth well above that of many countries and the appreciation of yuan. Measured by nominal gross domestic product, China's largest province Guangdong has an economy roughly equivalent in size to Mexico's and only slightly smaller than the Russian economy (which has seen its GDP in dollars fall substantially on recession and the ruble's collapse). China's second and third largest provinces, Jiangsu and Shandong, each boast economies larger than that of Indonesia's. Three largest provinces, however, are in a class of their own in Chinese terms and the differences across other provinces are huge. In terms of GDP, Tibet has the smallest and poorest economy. It is only about 1 % of the size of the Guangdong economy.

The fastest economic growth in recent years has been posted by the Chongqing, Tibet and Guizhou provinces (all posted annual economic gains above 10 % last year). In contrast, growth has slowed significantly in provinces traditionally known for heavy industry. The Shanxi and Liaoning provinces posted the lowest growth last year, just 3 %. Their futures are hardly rosy either. Both have major production in overcapacity industries, which the central government is planning to close in coming years. Understandably, provincial governments vigorously oppose shuttering plants.

Chinese provincial-level statistical data should be treated with the great caution. Even if provinces have lowered their growth targets, very few have actually managed to achieve

their growth targets in recent years. Moreover, most provinces likely fudge their figures, because economic performance remains a determinant of career advancement for provincial leaders. For this reason, the National Bureau of Statistics conducts its own studies to determine the extent of error in the data reported by provincial authorities in order to adjust national figures accordingly. Based on province-level data, for example, the Chinese economy last year grew by about 8 %, or 1 percentage point more than reported in the national figures. The size of the Chinese economy based on the figures provided by the 31 regions would have also been 7 % larger than GDP as reported by the NBS.

China's ten largest provinces in 2015

	GDP, USD billion	GDP, real % change	Population, 2014, millions
Guangdong	1,159	8.0	107
Jiangsu	1,117	8.5	80
Shandong	1,003	8.0	98
Zhejiang	683	8.0	55
Henan	589	8.3	94
Sichuan	479	7.9	81
Hebei	475	6.8	74
Hubei	471	8.9	58
Hunan	463	8.6	67
Liaoning	458	3.0	44

Sources: CEIC and China National Bureau of Statistics

Delays in wage payments ignite wave of protests in China's problem industries.

Protests last weekend by coal miners in China's northeastern Heilongjiang province symbolises problems likely to be encountered as structural reforms proceed. The immediate cause of the demonstration was that the holding company Longmay that operates a local government-owned mine had failed to pay its workers in a timely manner. The decline in demand for coal and falling coal prices, as well as inefficient production methods, have conspired to make Longmay a money-loser. Its coal production per worker is less than half the national average for mining companies in China. Longmay employs 240,000 people. In addition to paying their wages, the company is also liable for the pensions of some 180,000 former workers. The company plans to lay off tens of thousands of workers, so the protest is also a jobs issue.

Longmay's problems are typical for many publicly owned firms that operate in industries suffering from overcapacity. By official estimates, China's coal and steel industries will have to lay off 1.8 million workers in coming years. According to some estimates, total of 5–6 million jobs will disappear from industries suffering from overcapacity in coming years. Structural reforms will hit particularly hard heavy industry clusters such as the one found in Heilongjiang.

The *China Labour Bulletin* reports that the number of worker protests has increased and that about 90 % of these protests involve unpaid wages. Over half of recent demonstrations have involved the construction industry, nearly a quarter manufacturing, and about 6 % mine operators.

Russia

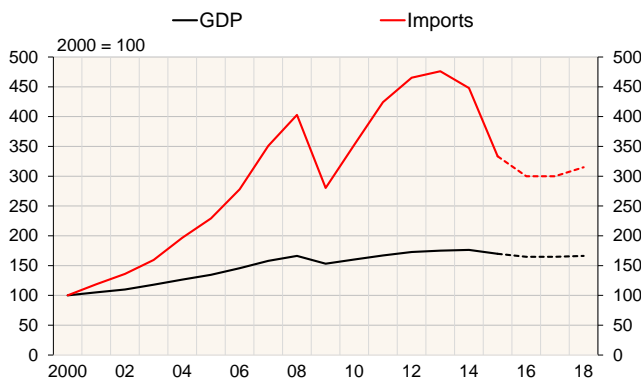
Latest BOFIT forecast for Russia sees economy and imports still contracting further this year. With the price of oil down by about 50 % in the second half of 2014, domestic demand, including private consumption, slid 10 % last year. Russian GDP contracted 3.7 %, even if oil sector exports displayed strong growth and defence spending rose at record pace. Imports fell by 25 % (down 6 % in 2014) on Russia's falling export earnings and the weak ruble.

The oil price slipped again in the second half of 2015. The latest [BOFIT Forecast for Russia](#) for 2016–2018 assumes the oil price recovering only slowly, to an average price this year slightly above \$40 a barrel (23 % less than in 2015) and \$49 a barrel in 2018. We assume no change in geopolitical tensions or economic sanctions. Due to the previous export price shocks and also the oil price assumption, we see Russian GDP contracting about 3 % this year and then remaining around zero in 2017 before returning to low growth. Russian growth should remain low thereafter due to uncertainties and the poor quality of the business environment.

Because the economy will contract and Russian export earnings fall, Russian imports are expected to contract this year yet another 10 %. The volume of imports would be about 37 % below their 2013 level. With recoveries in the economy and export earnings, we expect imports to return to modest growth towards the end of the forecast period. The ruble's real exchange rate will appreciate gradually as inflation remains higher in Russia than in its main trading partners.

The substantial further decrease in domestic demand this year will be driven by several factors, including still rather high inflation that continues to eat away at purchasing power in the private and public sectors. Private consumption will also be restrained by modest growth in private and public sector wages, as well as small pension hikes. Fixed investment is expected to continue to decline. The volume of exports will rise only slowly as growth in oil sector exports will fade.

Russian GDP and import volumes



Sources: Rosstat and BOFIT Forecast for 2016–2018.

Even without targeted cuts, real government spending is set to decline notably this year. The oil price drop has reduced the government's real revenues sharply, so the government also this year faces a rather large budget deficit.

The oil price is a central risk to the forecast, as it could go up or down from our assumption. Geopolitical tensions could change, and there is continuously the risk of other events that would increase capital flows from Russia and cause the ruble and imports to deteriorate further. Despite the government's aims to cut spending, the government could add to spending as the September 2016 Duma elections and March 2018 presidential election are approaching.

CBR keeps key rate at 11 %. The importance of pursuing cautious monetary policy was emphasised in the Central Bank of Russia's statements on the rate decision. Inflation has slowed in past months on e.g. weak domestic demand and recent ruble appreciation. In February, consumer prices were up 8 % y-o-y. The CBR still regards, however, inflation risks high and noted that moderately tight monetary policy could remain in place longer than previously planned. The CBR expects to reach its inflation target of 4 % in late 2017. Inflation risks include development of oil and other commodity prices, high inflation expectations caused by the ruble's previous collapse and uncertainty related to fiscal policy. The CBR noted that this year's planned budget deficit and its funding mostly out of the Reserve Fund can slightly ease monetary conditions. Loosening fiscal policy further could fuel inflation and decrease room for monetary easing.

Russian firms seek financing from China. In response to sanctions imposed on Russia by Western countries that have limited access to financing, Russian firms have stepped up talks with the Chinese to find new sources of financing. Progress has been stiff for the most part.

Chinese investors are interested in Russia's natural resources and local market potential, but they see also many weaknesses and risks in Russia. E.g. an Ernst & Young survey last year found that Chinese firms see Russia's regulatory environment and infrastructure as weaknesses. Biggest obstacles to investment relate to legislation, uncertain economy, the lack of investment guarantees and sanctions.

Some projects have moved forward recently. The Silk Road Fund has sealed the purchase of a 10 % stake in Novatek's LNG project on the Yamal peninsula (CNPC already owns a 20 % stake). Sinopec has agreed to purchase a 9.9 % stake in the petrochemical company Sibur. Both Russian firms are involved in major investment projects that have received funding also from Russia's National Welfare Fund. Gazprom has also taken sizable loans from Chinese banks. Gazprom needs funding for e.g. construction of the Power of Siberia natural gas pipeline to China and bringing gas production on stream in order to supply the pipeline. The Chinese have, however, also sold stakes in Russian enterprises (e.g. a stake in the Moscow stock exchange).

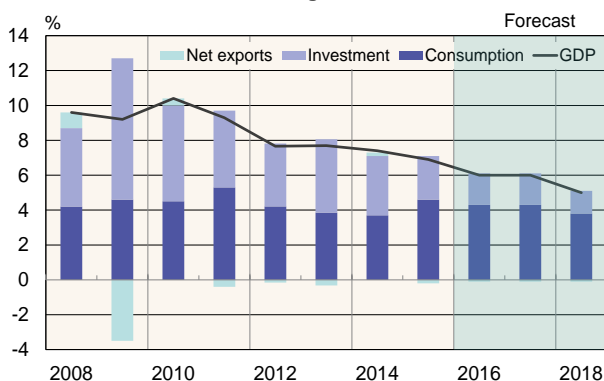
China

BOFIT sees continued modest slowdown in growth for China. Despite market fluctuations, our latest [BOFIT Forecast for China](#) sees China's development in coming years conforming largely to our earlier forecasts. Thus, we expect the Chinese economy to grow at around 6 % p.a. in 2016 and 2017, and then slow to around 5 % in 2018.

The rate of structural change accelerated last year and Chinese economy seems to be even more clearly following dual tracks. Growth in the service sector remains brisk, contributing to the relatively bright outlook for employment. In contrast, heavy industry production declines and branches suffering from overcapacity will be forced to reduce output. In coming years, growth in fixed investment will moderate and China's domestic consumption will increasingly drive economic growth.

A controlled slowdown in economic growth and a smooth progress in structural change is by no means a given. With the opening of China's markets to the world and an already high level of indebtedness, the economy is increasingly susceptible to a range of economic disruptors. China's overall debt-to-GDP ratio is estimated to be around 250 % of GDP, which is exceptionally high for countries at a similar level of development. If the high GDP growth targets under the current five-year plan are adhered to, China will be left with little room to work on reducing debt. The risk of allowing problems to build up is that progress in needed reforms will take a back seat as decision makers are tempted to increase regulation and leverage to prop up existing economic structures and non-competitive heavy industry, especially at the regional level. Indeed, some signs of tighter regulatory policies that are ill-suited to economic reform efforts have recently begun to appear.

Structure of China's economic growth and BOFIT forecast



Sources: China National Bureau of Statistics and BOFIT

The opening up of the Chinese economy brings with it new risks that will have to be met with well-defined policy measures and transparency. Deregulation of capital movements and the freeing of the yuan's exchange rate should

proceed at a deliberate pace to take advantage of the relatively favourable conditions at the moment. Postponing reforms could leave policymakers in a position where they must push through tough reforms in the midst of a crisis.

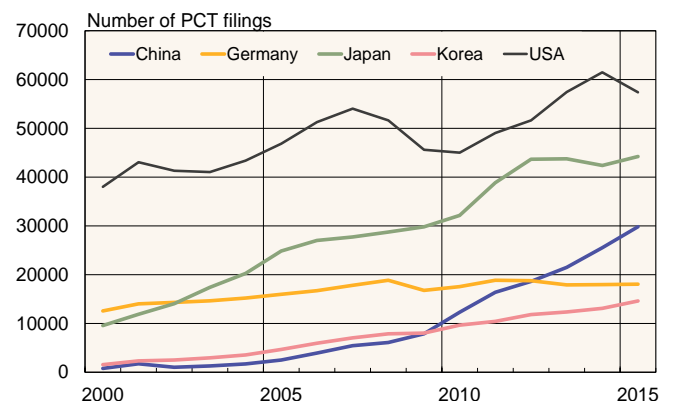
China's role in international patent activity continues to increase rapidly. The latest figures from the World Intellectual Property Organization (WIPO) show that the volume of patent applications filed under the international Patent Cooperation Treaty (PCT) increased by less than 2 % last year to 218,000. The number of patents filed by Chinese firms increased by 17 %. Chinese entities accounted for 14 % of all PCT patent filings, cementing China's position as the world's third-most-active international patent seeker. The United States led with most patents filed last year, accounting for over 25 % of all PCT filings. Japan's accounted for about a fifth of PCT filings. Most of the growth in the number of PCT patent applications came from China, Japan and Korea, indicating that the global centre of gravity in technological innovation continues to shift to Asia.

As in previous years, Chinese telecom giants Huawei and ZTE ranked number one and number three on the list of top filers of international patents. Second place went to the American electronics giant Qualcomm. The Top 50 list of patent filers included six Chinese firms, which together represented about a third of all Chinese PCT patent filings. China's innovation activity covers a broad front.

The large number of patent application does not tell the full story, however, as the quality and significance of the innovation of Chinese companies is often lower than that shown in the filings of companies in more advanced countries. Nevertheless, China's emergence as a technological powerhouse is indisputable. For example, China already accounts for 44 % of all high-tech exports from Asia.

Other BRIC countries lagged far behind China in patent activity. In 2015, India filed just over 1,400 patent applications (about the same as in 2014), Russia about 800 (-16 %) and Brazil about 550 (-6 %). Finnish firms in 2015 filed about 1,600 international patent applications, a drop of 12 % from 2014.

Countries filing the most PCT patent applications



Source: WIPO

Russia

Russia's banking laws now meet Basel III criteria.

The Basel Committee for Banking Supervision, which operates under the Bank for International Settlements, reports that Russia is compliant with the Basel III capital and liquidity standards. Some features of Russia's national requirements are even stricter than those of the Basel III framework. Over the past two years, the Central Bank of Russia has implemented significant improvements to its bank supervision standards. The Duma approved the final cornerstone piece of Basel III legislation in December 2015.

The CBR will apply the new capital standards to all credit institutions regardless of size, while the Basel III liquidity requirements effective from the start of this year apply only to Russia's ten largest, systemically important, banks (i.e. Unicredit, Gazprombank, VTB Bank, Alfa-Bank, Sberbank, Otkritie, Rosbank, Promsvyazbank, Raiffeisenbank and Rosselkhozbank). Russia's Deposit Insurance Agency and state development bank VEB are considered public sector entities that are exempt from bank regulation. The Basel Committee's report on Russia noted that implementation of the Basel III rules has only just begun and evaluation of their efficacy will take time.

Russian companies having problems in payments.

Rosstat finds that the ratio of overdue payments in corporate payments has gradually risen over the past two years. The overdue rate exceeded 6 % of the total stock of payments at the end of last year. During the 2009 financial crisis, the rate of overdue payments climbed to around 8 %. Invoice payment time of companies has also increased over the past year. Based on data gathered by the business news and analysis provider Interfax, companies were paying nearly a quarter of their bills over 60 days past the due date at the end of last year. A year earlier, only 14 % of payments were as belated.

On the collections side, power utility companies in particular have complained that accumulating non-paid customer bills already cause problems for them to finance investments and pay for fuel. Gazprom has conceded that its stock of overdue outstanding payments last year rose 20 %, mainly on belated payments from power utilities and households. Overdue payments relate especially to customers that by law cannot be cut off from services even when they are seriously delinquent in paying their bills. Power utilities report e.g. that many organisations that are funded out of government budgets have ceased to pay their electricity and heating bills. The situation does not appear to have improved even with a recent amendment that allows companies to now charge higher late payment interest.

Corporate wage arrears also began to climb sharply at the beginning of 2015, although their share of the total wage payment is still less than 1 % and the volume of arrears has been even at its highest only half of what it was at the peak of the

2009 financial crisis. At the end of February, wage arrears concerned 72,000 employees with an average of about 1.5 months salary unpaid.

Russia's working-age population continues to decline despite immigration. Rosstat estimates that Russia's population at the start of 2016 was 146.5 million people. This includes the addition of the 2.3 million residents of Crimea that Russia annexed in spring 2014. Rosstat estimates that the Russian population (not including Crimea) has recorded a meagre, on average 0.2 % growth past years.

Most population growth comes from migration from other CIS countries to Russia. Net immigration, however, has been falling and e.g. last year the net flow of Uzbek migrants was negative, unlike in previous years. The recorded annual migrant flows to and from Russia have averaged several hundred thousand people in recent years, but estimates of unrecorded flows are significantly larger.

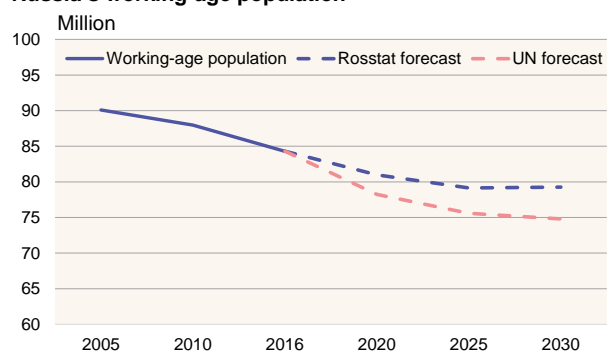
Russia's working-age population has shrunk for nearly a decade and will continue to do so in coming years. Under Rosstat's basic forecast scenario, the working-age population should decrease on average 0.5 % a year. The UN projections for 2016–2030 see a contraction of 0.9 % a year. A shrinking working-age population limits the possibilities for economic growth and weakens the dependency ratio.

The ratio of pension-aged Russians to the general population is increasing. Life expectancy has risen to 77 years for women and 66 years for men, although the life expectancy of a Russian man is still fairly low (e.g. the life expectancy of a Chinese man, who is much poorer on average than his Russian counterpart, is considerably higher). An aging population means higher pension costs. Russia's pension system is in dire need of reform; its financing is already problematic.

After a sharp drop in the 1990s, Russia's birth rate has recovered. In recent years, it has just exceeded the mortality rate. With a birth rate of 1.8, Russia is now in the same class as other countries with similar levels of GDP per capita.

About three-quarters of Russia's population live west of the Urals. That share has increased slightly in recent years due to internal migration to large city surroundings and birth rates of southern regions above the national average.

Russia's working-age population



Sources: Rosstat, UN.

China

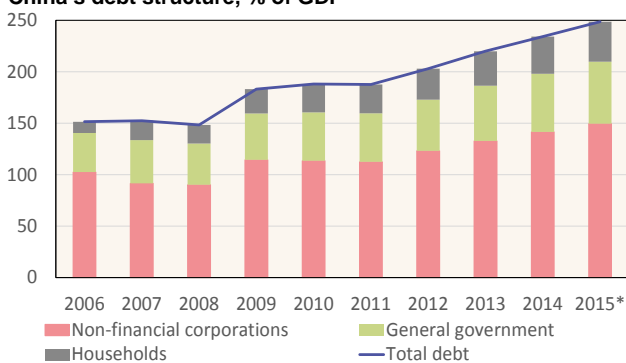
Chinese firms struggle with late payments and debt.

Bloomberg News reports that Chinese firms are waiting longer for their customers to pay their bills. The median time for getting the money after sales has risen by a month in five years to 83 days, an average delay in payments not seen since the late 1990s. The slowest payers by sector are found in industry, where the median time to receive payment is 131 days after the sale.

The extended delay in payments, along with weaker profitability and outlook, has raised concerns about the ability of companies to service debt in a timely manner. Banks have seen an increase in nonperforming loans and in recent weeks, also central bank governor Zhou Xiaochuan has begun to warn of a debt problem. The Bank for International Settlements (BIS) reports that Chinese firms have taken on exceptionally large amounts of debt compared to companies in any other countries.

To reduce corporate debt burdens, premier Li Keqiang has proposed that companies having trouble paying their loans could pay them with their shares. Banks have low enthusiasm for the proposal, however, because it would make them owners of their debtors' problems. In any case, the issue is no longer hypothetical: struggling shipbuilder Huarong Energy last month swapped \$2.7 billion in debt for its shares. The company's creditors now own a 90 % stake in a company that in 2014 lost over a billion dollars in an industry struggling with overcapacity. When the equity-for-debt swap was last used to mop up the effects of the Asian financial crisis, commercial banks were generously recapitalised by the government.

China's debt structure, % of GDP



Sources: BIS and IMF. Public sector debt includes local government off-budget investment vehicles. * BOFIT estimate

Low population growth affecting China's economic growth.

National Bureau of Statistics reports that the country's population grew by 7 million last year to 1.375 billion, with 56 % of the people now living in cities and 44 % in rural areas. Urbanisation supports economic growth as cities offer people a wide variety of jobs and greater opportunities for

productivity gains. The urbanisation process also drives construction, as urban infrastructure must be build for about 20 million people every year.

China's shifting age structure, however, puts a damper on high economic growth and strain public finances. The working-age population (16–59 years of age) began to shrink in 2012. Referring to recent Chinese estimates, *Global Times* suggests that the share of the working-age population relative to the total population will fall from 66 % in 2015 to 57 % in 2030. At the same time, the percentage of pensioners in the population will rise from 16 % to 25 %.

With this rapid deterioration in the dependency ratio, the government is likely to announce higher retirement ages next year. The official retirement age is currently 60 years for men and 50–55 years for women, depending on the nature of the job. The average Chinese life expectancy has increased by more than ten years since 1978 to 77 years for women and 74 years for men.

No big changes in China's fiscal policy in 2016.

Growth in government spending overall (central and local level) should nearly match GDP growth this year and reach 18 trillion yuan. Growth in government revenues, in contrast, looks to grow just 3 % this year. Part of the reduced revenue stream reflects expansion of a value-added tax pilot programme that allows firms to deduct more taxes than earlier. The consolidated government budget deficit this year should be about 2.2 trillion yuan, or roughly 3 % of GDP.

Although China has sought to improve public sector reporting, the latest budget report to parliament leaves open many questions about the structure and trends from revenues and spending. The report itemises various areas of priority, but says little about how budgeted assets will actually be spent. In any case, the plan seems to be rise spending quite evenly across the board of public sector activity.

China's budget practices do not follow international standards and local governments, in particular, operate extensively off-budget. To get a clearer picture of Chinese conditions, the IMF has begun to release its own figures on China's public economy that includes off-budget activity. The IMF figures suggest the annual public sector deficit has been running at about 10 % of GDP since 2009 and is on track to show a similar deficit this year. The IMF further estimates that more broadly defined public-sector debt is already about 60 % of GDP.

China's public sector finances (central and local governments), % of GDP

	2013	2014	2015	2016
Revenues	23	22	23	22*
Expenditures	25	24	26	25*
Deficit	2	2	3	3*
IMF-defined deficit	11	10	10**	10**
IMF-defined debt ratio	54	57	60**	64**

* Nominal GDP projected to rise 6 % this year. ** IMF estimate.

Sources: CEIC, China's budget report and IMF.

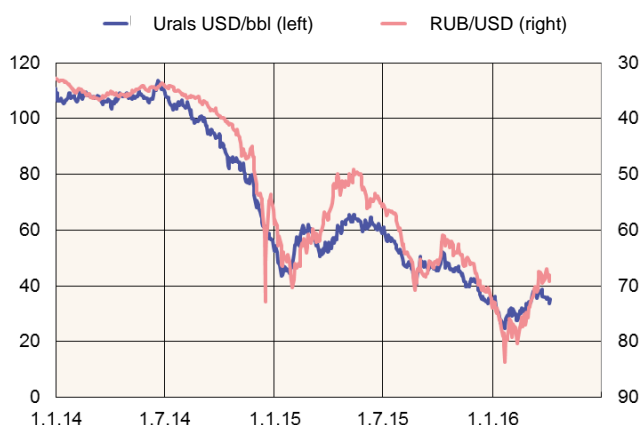
Russia

Higher oil prices lift ruble's exchange rate. The rising price of Urals-grade crude oil since January has also boosted the ruble's exchange rate. On Thursday (Apr. 7) the price of Urals crude was \$36.5 a barrel (Brent \$38.7). Since hitting this year's low on January 21, the price of Urals crude has rebounded by 48 %. In the same period, the ruble has appreciated 23 % against the dollar. The ruble's appreciation has been further supported by the usual first-quarter effect of the large amount of corporate taxes coming due at the end of March. On Thursday (Apr. 7), one dollar bought 67.9 rubles and one euro 77.4 rubles.

Since July 2015, the Central Bank of Russia has avoided direct interventions in the currency market to influence the ruble's external value. The value of the CBR's gold and foreign currency reserves also climbed in January-March from \$368 billion to \$387 billion, mostly on the increase in the value of the CBR's gold reserves from \$49 billion to \$58 billion. The value of the CBR's foreign currency reserves also rose from \$320 billion to \$329 billion.

12-month consumer price inflation slowed to 7.3 % in March, due e.g. to the ruble's appreciation and the fact that March 2015 provided a high base level.

Urals oil price and ruble-dollar exchange rate



Source: Reuters.

Russia's finance ministry issues 250 billion rubles worth of domestic bonds in first quarter. For the first time since 2011, the latest government domestic bond issues have been almost fully subscribed. The popularity of bond issues at the moment reflects the rebound in oil prices, expectations of falling interest rates and significant improvement in the liquidity situation of Russia's commercial banks. The finance ministry says it now plans to issue 270 billion rubles (\$4 billion) in new paper during the second quarter of this year.

With about 150 billion rubles in old bonds maturing in the first quarter, the government raised about 100 billion rubles in net terms from the domestic market. For the remainder of the year, some 290 billion rubles in earlier bond issues come due. An annual average of about 550 billion rubles (\$8 billion at the current exchange rate) in government bonds are expected to come due during 2017–2019.

Federal domestic, ruble-denominated debt totals 7.24 trillion rubles, or nearly 10 % of GDP. Of that, 1.67 trillion rubles represents guarantees from the state, while about 1 trillion rubles consists of state bonds issued in December 2014 as part of an operation to inject capital into Russian banks. The 2016 budget projects net domestic borrowing of just 300 billion rubles.

Foreign investors hold about 20 % of outstanding ruble-denominated government bonds. When bonds issued to re-capitalise banks are not counted, that share rises to slightly over a quarter of domestic bond holdings.

Revised figures show some shifts in Russian GDP components in the past few years.

Rosstat's revised annual data found no change in the GDP growth figures in 2012–2015. Compared to the previous data released early February, the import numbers have moved up and down for 2013–2014, although the reduction in the level of imports in 2015 was less than 1 %. Compared to earlier figures, private consumption showed a larger 2013 increase and a slightly smaller 2015 decrease. Revised fixed investments in 2014 fell considerably more than previously reported, lowering the level of investments by 2 %. The volume of exports increased in 2014–2015 slightly more than under the previous data.

Rosstat for the first time also now released revised quarterly GDP figures calculated according to newer international standards. In the fourth quarter of 2015, GDP contracted 3.8 % y-o-y, a drop very similar to that of the third quarter. The on-year drop of more than 12 % in private consumption was more severe than in the previous quarters. In contrast, the volume of exports in the fourth quarter rose 10 % y-o-y, due to large volumes of crude oil exports and a strong recovery in gas exports.

The latest growth figures may contain uncertainties as the work on revision of GDP data continues to move gradually backward in time (BOFIT Weekly Review 6/2016).

Changes in Russian GDP, imports and demand components, %

	2012	13	14	15
GDP	3.5	1.3	0.7	-3.7
Imports	9.7	3.6	-7.6	-25.7
Private consumption	7.4	4.4	1.5	-9.6
Public consumption	2.5	1.4	0.2	1.8
Fixed investments	6.0	0.9	-2.6	-7.6
Exports	1.4	4.6	0.6	3.6

Source: Rosstat.

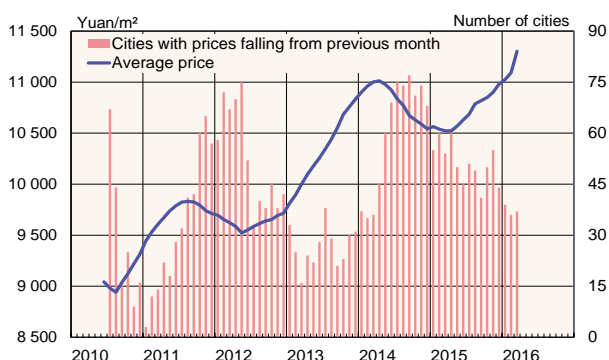
China

Housing prices soar in China's big cities. The National Bureau of Statistics reports that prices of new apartments in February were up an average of 13 % y-o-y in Beijing, 21 % in Shanghai and 57 % in Shenzhen. The strong rise in prices in big cities has pulled up national housing market trends. The volume of new apartment buildings under construction increased 10 % y-o-y in the first two months of this year. On the other hand, the diverging trend between large and small cities has become sharper. There are still many unsold apartments in small cities and prices are falling or rising only slightly. The March figures of the real estate portal SouFun, which tracks average apartment prices in 98 cities, saw on-month declines in 37 cities. Compared with March 2015, prices were lower in 55 cities.

The government intervened with a variety of measures last year to prop up the real estate market, including a reduction in the downpayment requirements. Downpayment requirements have been further lowered this year in most cities, as well as certain taxes related to apartment purchases have been reduced. Shanghai and Shenzhen, however, in an effort to dampen the rise in apartment prices, have tightened rules on apartment buyers and raised the downpayment requirements. The revival of the housing market partly reflects the increased use of borrowed money to meet the downpayment requirement. Downpayment loans are provided e.g. by some housing developers or through a peer-to-peer lender.

Living costs in China's large cities have also risen rapidly. The latest survey of 133 cities of the Economist Intelligence Unit (EIU), found that all the eight cities in mainland China included (Beijing, Dalian, Guangzhou, Qingdao, Shanghai, Shenzhen, Suzhou and Tianjin) were among the world's 60 most expensive cities. The EIU survey looks at prices of over 160 goods and services. Living costs are measured in relation to New York, so the dollar's appreciation lifted US and Chinese cities in the rankings. The highest living costs were in Singapore, Hong Kong and Zürich. Shanghai was the priciest Chinese city, sharing 11th place with Tokyo. Shenzhen ranked 16th, making it slightly more expensive than Helsinki (17th).

Trends in Chinese apartment prices (98-city survey)



Sources: SouFun, Macrobond

Profits at China's biggest banks show little change.

The world's four largest banks (Industrial and Commercial Bank, ICBC; China Construction Bank, CCB; Bank of China BoC; and Agricultural Bank of China, ABC) released their 2015 financial results at the end of last month. While the profits of the four banks last year totalled about 900 billion yuan (\$140 billion), profitability growth was extremely thin. The interest margin (difference between interest rate paid on deposits and rate charged on loans), narrowed for all four banks. The average interest rate on loans fell to around 5 %. While banks said the reduced interest margin was mainly the result of loose monetary policy, ICBC and CCB noted increased rate competition since interest rate deregulation.

Despite hundreds of billions of yuan in profits, the big banks find themselves in a precarious situation. As they are largely state owned, they must participate in economic policy measures. The annual reports of these banks mention a range of government programmes, including the "One Belt, One Road" and the "Going Global". At the same time, the banks lack adequate risk-management mechanisms. Their log of non-performing loans is growing, even if they claim that NPLs only represent about 2 % of the loan stock. If loans likely to become NPLs are considered, the share of bad loans rises to 7 % according to the CBRC. Even higher figures have been suggested. In any case, the NPL stock is expected to increase as the government closes plants in its efforts to reduce overcapacity.

To cover potential losses, Chinese regulations require that banks set aside reserves equal to at least 150 % of their NPL stock. Previously actual provisions were much higher but last year the loan-loss reserve ratio for three big banks (ICBC, CCB and BoC) only barely exceeded the minimum requirement. Press reports indicate the government is considering lowering loan-loss provision requirement to 120 %.

China and Russia see Panama Papers as Western attempt to destabilise their political systems.

The unprecedentedly large data leak on offshore companies released last week by the International Consortium of Investigative Journalists (ICIJ) revealed that people close to the Chinese and Russian presidents had used the services of a Panamanian law firm to set up firms in tax heavens. The Chinese government has tried to censor news and discussion concerning the involvement of China's leadership. The *Global Times*, which serves an international readership, suggested that the leaks were part of a Western disinformation campaign, noting that Western elites have gone largely unscathed. The paper highlighted suspicions concerning president Putin's inner circle, but did not mention suspicions on China's leadership. The Kremlin's press officer said the leak was an attempt to destabilise Russia before upcoming parliamentary elections.

The Panama Papers story has received considerable attention in the West. While setting up an offshore corporation in a tax haven is not illegal per se, it may be used to avoid taxes or hide illegally obtained assets and bribes.

Russia

IMF lowers its forecast for Russian GDP. The IMF's newest *World Economic Outlook* projects a nearly one-percentage point deeper contraction in Russian GDP in 2016 than in its January forecast. The IMF still expects the Russian economy to return to low growth next year.

The World Bank came out with a similar projection last week, but sees a slightly stronger recovery path than the IMF forecast. Most forecast risks, however, are on the downside. The combined effects of US and EU sanctions, as well as Russian countersanctions are weakening the economy's development. The World Bank's forecast sees Russian economic growth accelerating in 2017 to 2 % if general uncertainty abated and sanctions were lifted.

Forecasts of Russian GDP growth, % change

	2016	2017
Bank of Russia (3/16)	-1.5 – -1.3	-0.5 – 0.5
IMF (4/16)	-1.8	0.8
World Bank (4/16)	-1.9	1.1
BOFIT (3/16)	-3	0
Consensus (3/16)	-1.5	1.1

Russian export earnings and import spending continue to fall. Preliminary balance-of-payments figures from the Central Bank of Russia show export earnings from goods and services fell by a third in the first quarter from 1Q15 (and they were not very much larger than at the bottom of 1Q09). The on-year drops in earnings on exports of crude oil, oil products and natural gas exceeded 40 %. Earnings on other goods exports slumped more than 20 %. In both energy and non-energy categories, export earnings were depressed mainly by low commodity prices. Service export earnings also contracted further (down nearly 20 % y-o-y).

Russian export earnings and import spending (EUR), % change y-o-y



Source: CBR.

First-quarter spending on imported goods and services was down nearly 20 % y-o-y, scoring the same amount as in

1Q10. Spending on goods imports was no longer down more than about 15 % y-o-y, while spending on services imports was off almost 30 % due to a pullback in spending of Russian travellers abroad (down well over 40 %).

Due to the huge drop in export earnings, the goods trade surplus was the smallest it has been since the 2009 slump. That, in turn, reduced the current account surplus to an unusually low level (less than \$12 billion) despite smaller deficits in services trade and other current account items.

Capital flows between Russia and the rest of the world remain small. Especially in light of seasonal variations, the net flow of private capital abroad was very small in the first quarter. Like last year, banks continued to pay down foreign debt (even if there was less to pay than last year) while repatriating their assets from abroad in the same amount.

In the corporate sector, the net capital outflow dwindled to a trickle as there was little to pay back on outstanding loans. The outflow of direct investments still contracted slightly and was quite modest. Continuing the earlier trend, FDI inflows to Russia were even smaller. The outflow of grey capital from Russia was still marginal. Following the trend of recent years, there was a slight decrease in the stock of foreign currency cash held outside banks.

Accounts Chamber of Russia criticizes special economic zones. An investigation by the Accounts Chamber of Russia (ACR) finds that special economic zones (SEZs) have given only little support to the economy. The administration in the SEZs has often been inflexible and irresponsible, and budget monies to SEZs have been used inefficiently or misapplied. Over the past decade, 520 billion rubles (€7 billion at the current exchange rate) of budget funds have been dispensed for SEZs and construction of related infrastructure. The ACR further found that SEZs have created only about 18,000 new jobs.

The first Russian SEZs based on the current model were launched in 2006. They were supposed to attract investment through reduced tariffs and tax breaks, less red tape and ready infrastructure. There are now 33 SEZs specialised in industrial activity, technology manufacture and development, port operations or tourism.

The ACR also noted a boom in SEZ-like regional development policy instruments, like technology parks and innovation clusters. The ACR said the current approach is overbroad and the most ineffective measures should be ended.

Last year saw the creation of "territories of accelerated development" (TORs) aimed at boosting development mainly in Russia's Far East. TORs are now also touted as a solution to Russia's "company town" problem, where everybody suffers if the local business falters. The car-making city Tolyatti, for example, is establishing a TOR that its city elders hope will generate 24,000 jobs over the next decade. According to the ACR report, Tolyatti's existing SEZ that was established in 2010, has created fewer than 300 jobs.

China

International financial institutions expect Chinese growth to slow only slightly. The IMF's April *World Economic Outlook* projects 3.2 % baseline growth of the global economy this year and 3.5 % in 2017. The IMF raised China's GDP growth forecast slightly, and thanks to stimulus policies, now expects growth to be 6.5 % this year. The forecast matches the lower boundary of the growth target range set by the Chinese government for this year. As China makes progress in structural rebalancing, the IMF expects growth to slow to 6 % in 2018, a level at which growth should remain at least through the end of this decade. The IMF pointed out, however, that China's structural reforms may prove to be more difficult than anticipated, which could hurt economic growth. A more-severe-than-forecast slowdown in China would also hurt growth of the world economy.

The March forecast of the Asian Development Bank (ADB) predicts a growth trend for China in 2016–2017 that essentially matches the IMF's forecast. The World Bank (WB), in contrast, expects the Chinese economy to grow at a pace of 6.5 % a year through 2018.

Forecasters at the IMF, WB and ADB all expect India to maintain robust economic growth. India, partly due to its very low average income level, is set to enjoy the highest growth among the world's large economies. Despite slower-than-hoped progress in economic reforms, India benefits e.g. from declines in energy prices.

GDP growth forecasts for China and India, %

	2015	2016	2017
China			
IMF (4/16)	6.9	6.5	6.2
WB (4/16)	6.9	6.7	6.5
ADB (3/16)	6.9	6.5	6.3
India*			
IMF (4/16)	7.3	7.5	7.5
WB (4/16)	7.3	7.5	7.7
ADB (3/16)	7.3	7.4	7.8

* 2015 figures for India are estimates.

Sources: IMF, WB and ADB forecasts.

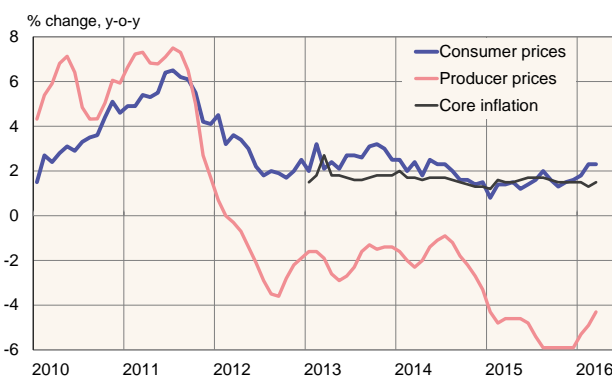
China's foreign trade stumbles in first quarter. The value of China's goods exports fell 10 % y-o-y to \$464 billion in the first three months of this year. Exports to all of China's main markets declined. Exports to the US were down 10 %, 5 % to the EU and 3 % to Japan. The value of goods imports slid 13 % y-o-y in the first quarter to \$339 billion. The drop was largely due to lower prices. Import volumes of many commodities were actually up in the first quarter.

While the March value of exported goods rose 12 % y-o-y in US dollars, most of the increase in exports reflects the relatively low comparison figure for March 2015. The drop in goods imports slowed as imports in dollars last month fell 8 % y-o-y. Dollar appreciation hurt trade figures. In March,

the central bank's reference yuan-dollar rate was 6 % weaker than in March 2015.

Is Chinese producer price deflation finally abating? March consumer price inflation was unchanged from February at 2.3 % y-o-y. Core inflation (excluding food and energy prices) accelerated slightly to 1.5 %. A visible shift, however, seems to be occurring in the producer price trend. Producer prices were down nearly 6 % y-o-y at the end of last year, but down only 4.3 % in March. Moreover, while the on-year price change was still negative, producer prices in March rose from February. It was the first time an on-month rise had been seen since September 2013. If the new trend becomes established, it may dissipate many policy concerns related to the deflationary trend even at the global level.

Chinese price trends



Source: Macrobond

As China and Russia boost military spending, so do their neighbours. New data compiled by the Stockholm International Peace Research Institute (SIPRI) show that military spending of governments increased 1 % last year, corresponding to about 2.3 % of world GDP. Measured in dollar terms, the United States accounted for 36 % of total military spending, China 13 %, Saudi Arabia 5 % and Russia 4 %. The weak ruble was the main reason Saudi Arabia overtook Russia in the rankings.

Military spending declined last year from 2014 in most parts of the world, but China, Russia and Saudi Arabia posted increases of 6–8 % y-o-y in constant dollars. The growth in military spending was even higher in countries in Central Europe and the Baltic region that share borders with Russia or Ukraine. The rise of tensions in the South China Sea was also reflected in sharp spikes in military spending in the Philippines, Indonesia and Vietnam.

Russia's military spending climbed last year to 5.4 % of GDP, driven up by Russia's economic recession and the intense military modernisation. Rapid economic growth in China has helped hold the relative share of increased military spending to a level of around 2 % of GDP. The ratio of military spending to GDP in the United States fell to 3.3 % last year.

Russia

Russian economy has shrunk considerably from early 2015. Seasonally adjusted figures show a substantial recovery in industrial output in the first three months of this year. Extractive industries, particularly oil production, drove that growth with production in the extractive sector rising nearly 3.5 % y-o-y. Seasonally adjusted manufacturing output remained rather flat in the first quarter with output down more than 3 % y-o-y. The economy ministry estimates GDP declined slightly less than 2 % y-o-y in 1Q16. Adjusting for the February 29 “leap day,” the fall was closer to 2.5 %.

The seasonally adjusted volume of retail sales slid further. Sales were down 5.5 % from a year earlier and down 12 % from two years ago. Real household incomes contracted nearly 4 % y-o-y. Driven by private sector wage hikes, nominal wages rose 6 % y-o-y, just a couple of percentage points less than the pace of 12-month inflation.

Retail sales and industrial output volumes, 2009–2016

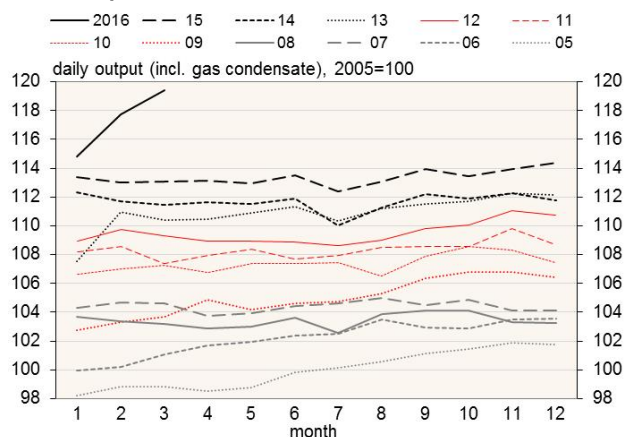


Source: Rosstat.

Russia and other major oil producers fail to reach agreement on oil production freeze. Last weekend, Russia and a number of other non-OPEC countries resumed talks with several OPEC members. In February, Russia and three OPEC producers agreed in principle to freeze their oil production at the January 2016 level if all OPEC countries went along with the deal. Some OPEC countries wanted to keep out while others were unwilling to accept that during the latest round of talks. Negotiations could resume in June.

Russian crude oil output was up in January-March by 4.5 % y-o-y to record levels. Under Russia’s interpretation of the proposed production freeze to January levels, it could increase oil output this year by 1.5–2 %. The energy ministry just recently estimated that growth of output this year would only reach 0.5–1 %, which is quite in line with the latest estimate of the International Energy Agency (IEA). However, Russia’s energy ministry expects Russian oil exports to increase 4–6 % this year as domestic oil consumption falls.

Crude oil production in Russia, 2005–2016



Source: Rosstat.

No revisiting of Russian budget in Duma spring session.

Prime minister Dmitri Medvedev announced in his annual speech to the lower-house Duma that the government has no plans to modify this year’s federal budget during the current Duma term, which runs until September. This year’s federal budget is based on average oil price of \$50 a barrel. It entails a deficit of 3 % of GDP (2.4 trillion rubles) according to president Vladimir Putin’s instructions. The average price of Urals-grade crude oil to date has only averaged \$33 a barrel this year. By various estimates, the federal budget deficit could reach 4–5 % of GDP if the price of oil stays in the range of \$35–40 a barrel and the budget remains unadjusted. The first-quarter budget deficit equalled 3.7 % of GDP. Earnings from oil and gas fell visibly below budget projections, but other revenue and spending performance went approximately as planned.

The finance ministry has compiled a revised version of the budget that assumes an average oil price of \$40. The deficit would be squeezed to around 3 % of GDP by e.g. spending cuts and increasing income from privatisation sales. Such measures, however, now seem to be off the table at least until next autumn. Some extra income will come from the recent amendment requiring state-owned enterprises to give at least half of their last year’s profits to the state. The move is expected to bring 100 billion rubles of additional budget revenue this year.

The current plan is to cover most of the federal budget deficit with money from the Reserve Fund, which held 3.4 trillion rubles (\$50 billion, 4% of GDP) at the end of March. Russia also has the National Welfare Fund, which currently stands at around 5 trillion rubles (about two-thirds is in the form of highly liquid assets).

Russia’s government debt corresponds to about 14 % of GDP. This year the state has issued roughly 250 billion rubles in domestic bonds. Issuance of bonds abroad has been under consideration, but there has been difficulties in finding banks willing to arrange issues due to economic sanctions.

China

Fixed investment sustained China's first-quarter growth. On-year GDP growth in January-March was 6.7 %. Seasonally adjusted quarterly growth, however, was 1.1 %, which translates to on-year growth of just 4.5 %. Nominal GDP growth of 7.1 % exceeded real GDP growth, signalling a pick-up in inflation. Nominal growth in 2015 overall was lower than real growth.

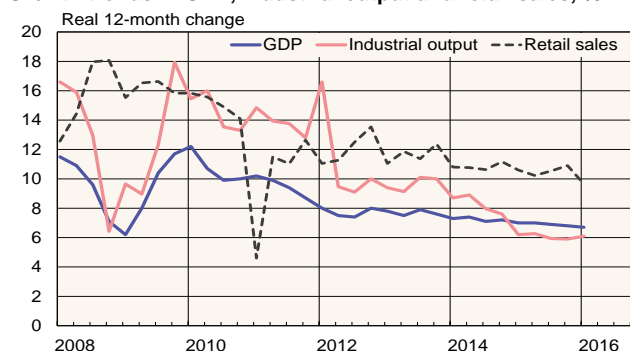
Looking at 1Q16 GDP supply items, industrial output (33 % of 1Q16 GDP) was up 6 % y-o-y, while construction activity (5 % of GDP) and the service sector overall (57 % of GDP) showed growth of 8 %. Of the services, growth in financial sector (10 % of GDP) slowed from 16 % y-o-y in 1Q15 to 8 % in 1Q16 and growth of real estate services (7 % of GDP) accelerated to 9 %.

Fixed investment towered over other demand-side components in the first quarter, climbing 14 % y-o-y in real terms. Investment in infrastructure notably increased 20 %. Public investment was the big driver of higher investment growth with investment of government and state-owned enterprises up over 23 % y-o-y in nominal terms. Public investment accounted for 34 % of fixed investment in 1Q16 (up from 30 % in 1Q15).

Borrowing to finance investment remained brisk in January-March with growth in the loan stock continuing to climb at around 15 % y-o-y. It appears that China has reverted to the traditional approach for hitting the annual official growth target (6.5–7 % this year) – bank-financed investment. The risk with this strategy is that it leaves no space to subdue the growth of indebtedness.

Growth in retail sales, an indicator of private consumption trends, remained at 10 % in the first quarter. Real per capita incomes grew at an on-year pace of 7 %. The National Bureau of Statistics also hinted that the unemployment rate in March was 5.2 %, even if the bureau hasn't yet published the survey-based unemployment statistics.

Growth trends in GDP, industrial output and retail sales, %



Source: Macrobond

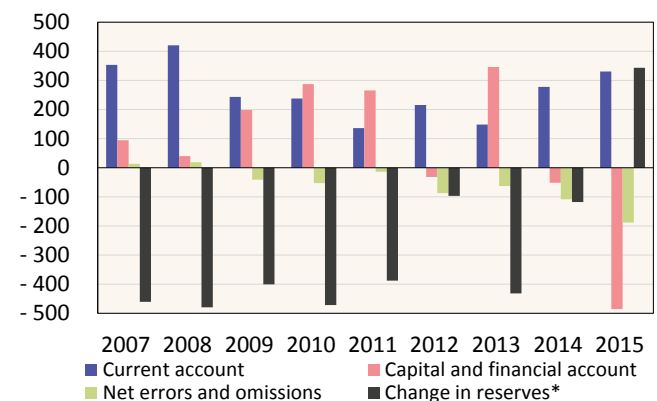
Capital inflows to China diminished last year, while capital outflows increased. Three weeks ago, China released complete balance-of-payments figures for 2015. The fi-

nancial account showed that last year less capital flowed in and more capital flowed out of China than in recent years. Foreign portfolio investment flows to China fell sharply, and the Chinese increased purchases of securities abroad compared to earlier years. Depositors also took money out of China and foreign loans were paid back. Deregulation, China's economic slowdown and the weaker growth outlook were the biggest factors in changes in capital flows.

The "net errors and omissions" item in the balance-of-payment ledger indicates capital movements not captured by official figures were larger than ever last year, with some \$190 billion in unrecorded capital flowing out of the country. The estimate suggests the extent of efforts to circumvent capital controls. The flows of capital out of China clearly exceeded the current account surplus. This created depreciation pressure on the yuan's exchange rate, which the People's Bank of China offset with interventions in the forex market reducing China's foreign exchange reserves by \$340 billion.

The yuan's exchange rate has seen little turbulence in recent months and China's foreign currency reserves have remained basically unchanged. This indicates that the yuan no longer faces the same depreciation pressures as it did last autumn. China has also begun to publish more data than previously on the structure of its foreign currency reserves. It revealed, for example, its forex derivative position, which in net terms was relatively small at the end of February.

China's balance-of-payments items, USD billion



Source: SAFE, *) A negative figure indicates net purchases of foreign currency and an increase in currency reserves.

China increased its share of EU foreign trade in 2015.

The EU28's goods imports from China last year rose 16 % y-o-y to €350 billion. The value of total non-EU goods imports increased 2 %. The value of goods exports to China grew 4 % y-o-y, slightly slower than other exports, to €170 billion. The EU28's trade deficit with China rose to €180 billion.

About a fifth of non-EU imports to the EU28 come from China. About 10 % of EU28 exports went to China. The United States was the EU's most important trading partner with an 18 % share. Russia accounted for 6 % of trade with the EU28 last year, with the value of Russian trade decreasing by 27 %.

Russia

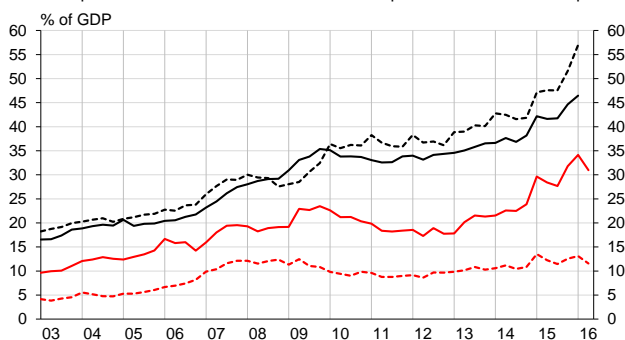
Little overall change in foreign debt of Russian firms and banks. The debts have gradually subsided since summer 2014, when foreign financial sanctions were imposed. The reduction tapered off in the first quarter, so that as of end-March the debt stood at \$475 billion (under the recently applied GDP methodology over 35 % GDP; or over 40 % of GDP under the old method). Of that, corporate debt stood at \$346 billion (over 25 % of GDP). In contrast to 2014 and 2015, the ruble's exchange rate has had little impact on dollar value of the ruble-denominated part of foreign debt this year.

Repayment of foreign debt by Russian banks has gradually fallen. In the first quarter of this year, the repayments amounted to not much more than a few billion dollars. Banks have paid off their loans as earlier in amounts not very far from their scheduled payments. Their foreign receivables have also diminished. On January 1, they amounted to \$222 billion (of which \$91 billion were short-term receivables). For over a year now, the repayment capability of banks has been bolstered by growth in domestic deposits.

As earlier, firms managed in the first quarter to keep their foreign debt repayments at a minimum. The foreign receivables of Russian firms remained at over \$200 billion (of which about \$70 billion were short-term receivables). Due to the small amount of foreign debt repayments, the need for companies to offset foreign debt with domestic borrowing has remained small.

Foreign and domestic debt of corporations and banks

— Corporate foreign debt - - - Banks' foreign debt
— Corporate domestic bank debt - - - Corporate and household deposits



Source: Central Bank of Russia

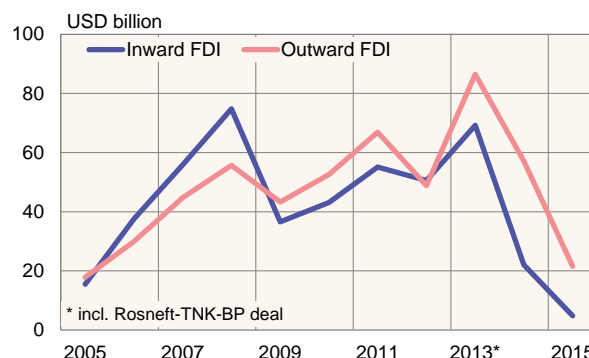
Net FDI inflow to Russia falls to lowest level in over a decade.

The net inflow of foreign direct investment into Russia last year was less than \$5 billion and remained positive only due to reinvested profits. New equity investment did flow into Russia, but slightly more old equity investment was repatriated. As earlier, the bulk of FDI flows consisted of intra-group credit. The net inflow to Russia of intra-group credit was also slightly negative as firms paid down more old debt than acquired through new borrowing.

Net outbound FDI flows from Russia also contracted sharply last year to \$22 billion. Equity investment of banks increased substantially, quite the opposite of non-bank firms. Non-bank firms, however, granted more intragroup credit abroad than ever, even as they also received much repayments of old debts.

The total value of the stock of Russian inward and outward FDI has shrunk dramatically over the past two years. As of end-2015, the values of inward and outward FDI stocks were about \$340 billion each. The reduction in the value of the overall FDI stock primarily reflects changes in exchange rates and valuations. On-year, the net FDI flows have remained positive. Both in Russia's inbound and outbound FDI the share of various intermediate countries, like Cyprus, is still about 60–70 %. A large part of these investments is believed to be of Russian origin, but have taken a circuitous international route to e.g. avoid taxes.

Russia's net FDI flows



Source: Central Bank of Russia

Russia's services trade shrinks sharply. The value of Russian services exports last year was \$52 billion and services imports \$88 billion. Services accounted for about 13 % of total exports and nearly a third of imports. Russian services trade contracted last year some 25 % y-o-y, a faster contraction than has been seen since the start of the millennium.

The EU is by far Russia's largest trading partner both in services and goods. The EU accounted for nearly 40 % of Russia's services exports last year and nearly half of services imports. The services trade is partly related to FDI, which is why one of Russia's main trading partners is Cyprus. The share of Asian countries and especially China, is notably smaller in Russian services trade than goods trade, only about 10 %. The Eurasian Customs Union countries accounted for 8 % of Russian services exports and 3 % of services imports.

Russia's top export services are transportation services and miscellaneous business services such as consulting and engineering services. The largest import category by far is travel services, but the share of miscellaneous business services is also significant. Russian imports of travel services contracted by nearly a third last year to \$35 billion.

China

IMF concerned about state of Chinese businesses.

The IMF's April 2016 edition of its [Global Financial Stability Report](#) finds that at the end of last year nearly 16 % of Chinese companies borrowing from commercial banks had less revenue than their interest costs. The IMF puts the amount of potentially at risk bank loans to corporations at \$1.3 trillion or 12 % of GDP. That amount rises to about \$2 trillion or 18 % of GDP, when loans channelled through the shadow banking sector, policy banks and the off-budget financing vehicles of local governments are included. Not all at-risk loans end up as bank losses, of course, because corporate profitability may recover or the shortfall made up by e.g. selling off company assets. The rapid growth and sheer volume of potentially at risk loans, however, has triggered alarms regarding the state of China's business sector.

There are other signs of the weakened condition of Chinese businesses. The average time of it takes to settle inter-company payments has soared in the past year, and the practice of companies using their own shares as collateral for bank loans has become widespread. The IMF says that the value of equity used to secure bank loans was \$460 billion at end-2015, a 30 % increase from July 2015. Moreover, the report notes that the use of equity as collateral is among the financial measures companies use as the last resort.

The origins of the current struggles of Chinese businesses can be traced to the provision of cheap loans in particular to state-owned enterprises to finance unprofitable projects. As company profits have declined, it has become harder for these companies to service their loans. Problems have emerged in real estate, manufacturing, mining, steel production, as well as in the retail and wholesale trade sectors.

Despite rising debt, the IMF says China has sufficient buffers to handle the situation. Banks are still showing healthy profitability and have sizeable reserves. If needed, the central government can afford to help resolve banking sector problems. The IMF emphasised, however, that officials must take prompt action now to break China's debt spiral before the situation gets out of hand. The IMF would most like to see improvements in risk management practices and banking efficiency, whereby reasonably priced lending is directed to healthy firms for viable projects. It also suggests banks should write down their loan losses sooner and called for an end to market-distorting implicit government guarantees to state-owned enterprises.

China's programme to lower corporate debt levels and reduce bank NPLs moves ahead. Chinese officials this spring have been formulating a programme to ease corporate debt problems and reduce the stock of non-performing loans (NPLs) held by banks. The arrangement lets companies swap their equity for bank loans and banks could also bundle the NPLs for sale at a discount. Similar arrangements were made in the wake of the Asian crisis. The programme's

contents have yet to be specified, but media reports suggest some of China's big banks are experimenting with the bundling and sale of NPLs. Media reports suggest that the ceiling of the equity-debt conversion programme will be 1 trillion yuan (\$650 billion). The first swap took place in March, when the Hong-Kong-exchange-listed shipbuilder Huarong Energy announced it had reached deal with its creditors on restructuring \$2.7 billion in debt.

This week, three IMF economists released a [technical note](#) on the debt-equity conversion and NPL securitisation programme. In their view, the programme needs to be carefully designed due to the real danger that debt restructuring will simply give non-viable "zombie" firms extended time to fail and increase the overall cost to the state. This insight specifically concerns the restructuring of inefficient state-owned enterprises. The authors further note that banks generally lack the competence to turn around money-losing businesses and that bank involvement in non-bank businesses involves moral hazard issues. The IMF economists propose that firms be carefully vetted before admission to the programme, banks retain the right to replace corporate managers and directors as necessary, debt-equity conversions be based on actual market price of the shares, and that the percentage of a bank's stake in a participating firm be limited and temporary. In addition, the regulatory framework should be geared to improving bank risk management and require banks to report their problem loans in greater detail.

China eliminates foreign trade subsidies that violated its WTO commitments. The United States a year ago filed a dispute with the World Trade Organization that claimed China's central and local administrations were subsidising export firms in 179 industrial branches through under-pricing of services and monetary incentives in violation of its WTO commitments. The claim included products ranging from agriculture and textiles to the pharmaceutical industry. In mid-April, China made a bilateral agreement with the US on elimination of these subsidies. The deal benefits China's other trade partners as well, including the EU, which joined the US's WTO dispute at a later stage.

The export subsidies mandated for elimination have relatively little economic significance and do nothing to ease China's burning trade policy issues. The agreement highlights how vague and impractical China's subsidy system is also from China's own development viewpoint. Moreover, it suggests that efforts to clear China's subsidy jungle would not proceed efficiently without outside pressure.

The China-US agreement on cutting export subsidies that violate WTO commitments supports China's integration with the global economy and systemic adjustment. It is also important from China's perspective to show that the country is ready to operate by market-economy rules. At the end of the year, the EU and US will decide on whether to grant China market-economy status. If granted, it would become more difficult for China's trading partners to impose anti-dumping tariffs on products imported from China.

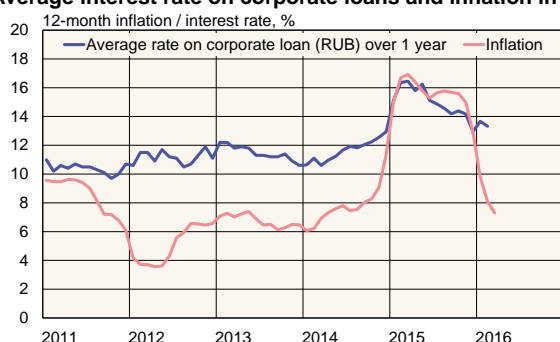
Russia

CBR keeps key rate unchanged at 11 %. The Central Bank of Russia stated that inflation has slowed down in recent months, but inflation risks remain elevated. Hence, the CBR board of directors decided to keep the key rate at 11 %. The CBR estimates that 12-month inflation at the end of April was 7.3 %, unchanged from the March reading. The board said it expects to reach its declared 4 % inflation target in late 2017.

The CBR noted that uncertainty associated with government budgets was among the biggest inflation risks. In addition, it expects market interest rates to fall even without a cut in the key rate as the budget deficit and financing the shortfall out of the Reserve fund will increase liquidity in the banking sector. Lending rates have been falling gradually during the past year, but real interest rates have turned clearly positive this year due to the significant drop in inflation.

The CBR said it will resume a gradual lowering of the key rate in the near future if inflation risks subside sufficiently. The board's next meeting on rates is set for June 10.

Average interest rate on corporate loans and inflation in Russia



Source: Macrobond.

Russia's defence industry still enjoying strong growth. Information collected from multiple sources indicates that Russia's defence industry production rose about 13 % in 2012 and nearly 20 % a year in 2014 and 2015. While precise figures on how much the defence industry contributes to total Russian industrial output is unavailable, experts estimate defence industry accounts for around 5 % of total industrial output and about a third of Russian machine building. Defence ministry procurements also represent a large share in the production of transport vehicles and electrical devices.

The goal of Russia's 2011–2020 state armament programme approved in 2010 was to substantially upgrade weaponry and capabilities of all branches of the military and special forces under the defence ministry. While programme details remain classified, a number of sources have put total planned spending on the programme at around 20 trillion rubles, or 2 trillion rubles a year. Media reports indicate the

programme has been fully implemented in recent years, and defence spending has soared since 2011. Federal budget spending on defence in 2015 rose 28 % to around 3.1 trillion rubles (€46 billion, slightly over 4 % of GDP).

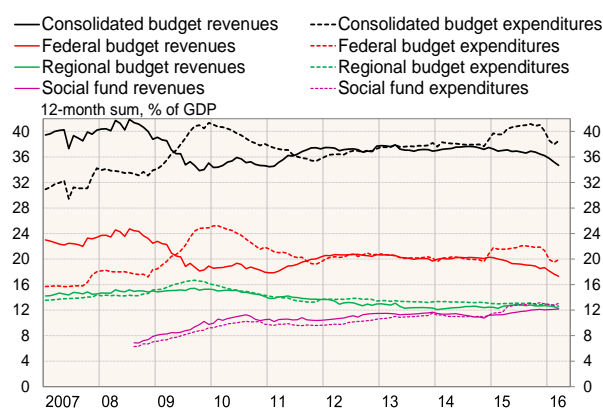
Russian industrial output contracted about 5 % last year. Without the demand spike from the military build-up, however, it appears industrial output would have already begun to fall in 2013. According to the approved federal budget, total defence spending will not grow this year. If the armament programme stays to schedule, large acquisitions still lie ahead in the 2016–2018 period, after which demand for government defence procurements goes flat. Defence contractors and suppliers have been encouraged to develop products for the civilian market and to seek new export markets abroad.

Pressure on Russian government finances continues to increase. First-quarter revenues to the consolidated budget (federal, regional and municipal budgets plus state social funds) were down about 3 % from 1Q15. As inflation remained fairly high, the contraction in government revenues in real terms that began in 2015 persisted.

As in 2015, the revenue drop reflected lower oil & gas tax revenues, which were down 36 % y-o-y in the first quarter (down over 20 % for 2015 overall). Other revenues increased 8.5 % in nominal terms, basically matching the pace of inflation. Nominal spending declined slightly. The government deficit amounted to 2.8 % of GDP.

Federal budget revenues fell 15 % y-o-y even in nominal terms on the lower oil & gas tax revenues and weakness in other revenue streams. As regional budget revenues were essentially unchanged on-year in nominal terms, the real fall in revenues continued. Asset transfers from the federal level to regions continued to dwindle, while other regional revenues performed weakly. Federal budget expenditures fell sharply, due in part to a spending spree in early 2015. Regional budget spending has fallen in real terms since 2013, while growth of revenues of state social funds and their expenditures accelerated to over 20 % y-o-y in nominal terms.

Government revenues and expenditures



Source: Ministry of Finance.

China

China shifts main service branches into VAT sphere as key tax reform proceeds. China further expanded its value-added taxation (VAT) reform on May 1 to major service branches, including construction, real estate, finance, insurance and a variety of consumer services. These industries were earlier subject to the Business Tax (BT), a tax based on each firm's gross revenues. The shift to VAT in service branches began in 2012. Initially, the pilot programmes only involved certain cities and branches. The VAT trial has been expanded nationally since 2013 to include e.g. logistics, postal and telecommunication services.

Most financial services are now subject to a 6 % VAT rate. These include income from interest on consumer and business loans; gains made from trading equities, debt securities and foreign currency; fees for financial services and insurance premia. VAT exemptions will include deposit interest, interest commercial banks pay to the central bank, interbank loans and public and local government debt.

The basic VAT rate for real estate services and construction is 11 %. Small businesses are eligible for a simplified tax scheme with a lower tax rate, but are then not entitled to tax deductions. VAT applies in real estate deals and the sale, purchase or rental of properties by firms or private individuals. VAT generally will not be collected from private individuals selling an apartment that they have owned for over two years, but sales of expensive apartments in big cities will still involve some amount of VAT. A reduced 5 % tax rate of the sale price is applied to other private apartment sales.

The basic VAT rate is 6 % for consumer services such as tourism, hotels, the hospitality, food & beverage branch, training, healthcare, cultural events and entertainment. There are exceptions, however. Tax exemptions have been granted e.g. to healthcare services, elder care, child care and training provided by approved agencies and up to certain levels of accreditation.

Companies have had only a short time to prepare for the tax reform as premier Li Keqiang announced only at the National People's Congress in March that the expanded VAT reform would enter into force at the beginning of May. VAT revenues will be shared between the central government and local governments. BT revenues earlier went directly to the local government and accounted for about 40 % of local government revenues. Officials say the tax reform this year will reduce the overall tax burden on companies by more than 500 billion yuan (€70 billion), which, in turn, will reduce revenues to local governments. The shortfall has been factored into this year's central government budget.

VAT was already applied before the extension to manufacturing and trade. The newly implemented tax reform harmonises tax practices for goods and services and allows

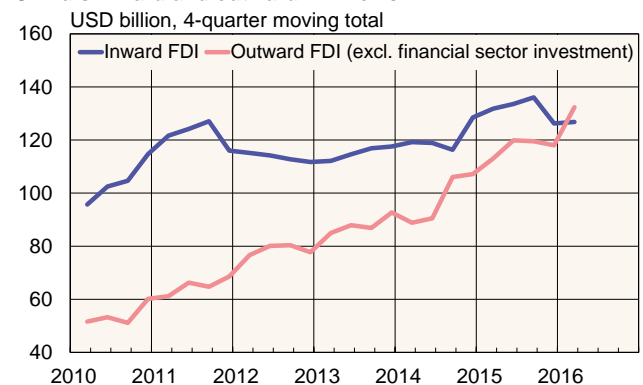
tax deduction for semi-finished goods and procurement of services across branches. Several VAT rates are currently applied in China and the Chinese tax system is still quite complicated. VAT rates typically range between 3 % and 17 %. In 2014, for example, the average VAT rate in OECD countries was 19 %. China's VAT system is set for further reforms until in practice there are only two tax rates in use.

Chinese direct investment on the rise also in Finland. Foreign direct investment outflows from China have enjoyed strong growth for over ten years, but the investment pace this year seems to have kicked into high gear. China's commerce ministry reports that outward FDI flow in the first quarter of 2016 was up over 50 % y-o-y. Media coverage of planned acquisitions indicates that the trend will continue. China's government supports companies through such measures as providing financing for acquisition of foreign firms.

Chinese investors earlier generally paid little attention to Finland, but over the past year interest in Finnish companies has soared. The Chinese National Silicon Industry Group is acquiring the Finnish silicon wafer maker Okmetic for about €150 million. JOT Automation, a company focused on production automation and testing, was bought by the Chinese Wuxi Lead Intelligent Equipment for €74 million. The Chinese HNA Tourism Group announced last week it was purchasing Carlson Hotels and the deal includes the multinational Radisson Hotel chain, which operates in Finland. The Chinese Kaidi, which is specialised in environmentally friendly power facilities, is designing the Kemi biofuel power plant, currently contemplated as a €1 billion project.

Earlier large investment projects that remain active include Huawei's Finnish research and development centre for mobile device technologies and Finnish commercial ship designer Deltamarin, which has been Chinese-owned since 2012. Both investments are on the order of tens of millions of euros. The Chinese companies have also made many smaller investments and Chinese representative offices have been opened in Finland.

China's inward and outward FDI flows



Source: China Ministry of Commerce

Russia

Russia dips into the Reserve Fund to cover the budget deficit. Russia waited until April to tap the Reserve Fund this year, withdrawing a total of 390 billion rubles (\$6 billion). At the end of April, the Reserve Fund held assets worth 2.9 trillion rubles (\$45 billion). The plan this year is to withdraw a total of 2.1 trillion rubles to cover the budget deficit, but more money might be needed if oil prices remain flat and budget is not amended. Some 1.3 trillion rubles were withdrawn from the Reserve Fund last year.

The National Welfare Fund held assets of 4.8 trillion rubles (\$74 billion) at end-April. About a third of that was held in less liquid assets like long-term bank deposits or debt securities of Russian firms, while the rest consisted of highly liquid foreign-currency securities. The National Welfare Fund was originally established to fund the pension system, not budget deficits. In recent economic discussions and the economy ministry's latest forecast, however, both funds are lumped together as a source for financing budget shortfalls.

Russia's import substitution commission reviews progress. At the import substitution commission meeting at the end of April, the commission's chairman, prime minister Dmitri Medvedev, noted that by now the goals of Russia's import substitution programme are defined and the main processes for import substitution outlined. The means for supporting import substitution include such measures as import restrictions and provision of state financing. Medvedev noted that the share of imports in consumption has fallen in many branches, although mostly due to the ruble's devaluation.

Most of Russia's import restrictions currently apply to public procurements, but there are plans to extend them also to state-owned enterprises. Public procurements are currently subject to *import bans* (97 products in the branches of defence and national security, machine-building, light industry and software), *import restrictions* (46 products involving the medical technology and pharmaceuticals branches) and *preferential treatment* for domestic products (278 products enjoy a 15 % price advantage if originating in the Eurasian Economic Union). In addition, Russian countersanctions restrict all food imports.

State financing has been granted to support import substitute producers. The government last year handed out over 70 billion rubles (€1 billion) in financing and this year a similar amount is planned. Russia's total fixed investment in 2015 was about 17.7 trillion rubles.

The import substitution commission emphasised the need for supporting demand for import substituting production. Measures mentioned include coordination of branch- and region-specific import substitution plans and the procurement plans of state-owned enterprises, as well as setting of new national standards. Various agencies continuously come up with their own proposals to support new domestic production

with varying success. These include e.g. a value-added tax to foreign firms providing services online (a "Google tax") currently under discussion in the Duma and a "mandatory surrender" of certain foreign medicine licences.

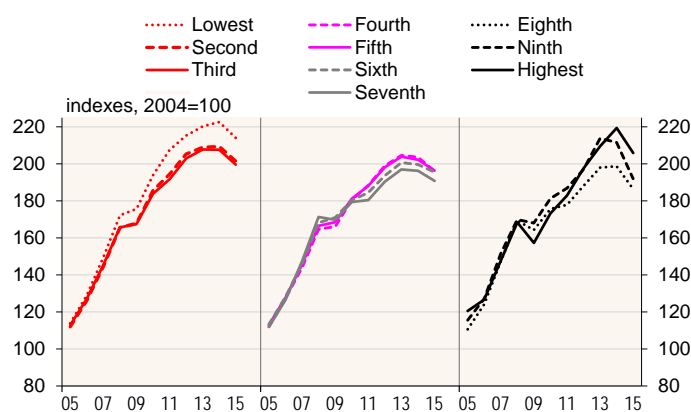
Import substitution policy has been criticised in Russia as it hurts competition and supports some domestic firms at the cost of the rest of the economy. Consumers and firms needing imported inputs must settle for narrower selections and lower quality products, while paying higher prices. Russia's economy ministry estimates the cost of public procurements has risen 40 % due to import substitution policies. The economy ministry would like to see a reduction in import restrictions, while the industry ministry wants more.

Russia's recession has slightly reduced income differences. Rosstat reports a narrowing of income disparity a bit similar to that seen in the 2009 recession. Nominal incomes in 2015 per family member rose in the three highest income deciles by 5–8 % and in the other deciles by about 12 % (a decile contains 10 % of the population). Incomes have risen fastest in recent years in high-income groups, but over the past ten years low-income groups have seen the overall fastest rise. This was due, in particular, to large hikes in pensions and public sector wages in certain earlier years.

A decline of the Gini index, an overall measure of income disparity, shows that income disparity in Russia has slightly shrunk over the past eight years. In 2007–2010, Russia's Gini index reading exceeded 42 and in 2015 it was 41.2, which was still higher than in the early 2000s (under 40). The figure roughly matches the US. It is lower than in countries showing very high income disparity, e.g. Brazil (about 53), but considerably higher than in the EU countries.

Russian real household incomes have in the past decade increased slightly more in lowest and highest income deciles than in middle deciles. The relative status of lower deciles, however, has not improved as much as nominal incomes suggest. Lower deciles spend much more on food, and food prices have risen faster than prices of non-food goods.

Change in real household incomes by income decile



Sources: Rosstat and BOFIT.

China

Wider discussion of economic policy in China. On Monday (May 9), the *People's Daily*, the main paper of China's Communist Party, carried on its front page an interview with an "authoritative person" that commented with rare frankness and openness on key economic issues and criticized sensibility of debt-fuelled stimulus. The authoritative person is believed to be a senior economic policymaker. The next day the paper followed up with a summary of a speech by president Xi Jinping, who gave his own views on the Chinese economic situation that echoed the authoritative person's comments. Both stressed the importance of proceeding with reforms and structural adjustments of the world's second-largest economy.

The authoritative person bluntly stated that there is nothing on the horizon to suggest a revival in growth, but rather that China's pace of growth would inevitably have to slow. Given the thorny problems that may arise from a real estate bubble, industrial overcapacity, non-performing bank loans and the indebtedness of local governments, the authoritative person said the government needs to keep its focus on reducing indebtedness, moving ahead with reforms and stop whipping up hopes of stimulus relief. The article also stated that stock markets, forex markets and real estate markets need to return to their original purpose and not be manipulated to sustain artificially high growth.

This year, official comments on economy have emphasised the need to hit established growth targets meaning debt-fuelled stimulus and leaving reforms partly on the back burner. Thus, Monday's mysterious interview is a welcome call for maintaining long-term economic perspective, acknowledging the dangers of debt-driven stimulus and the importance of pursuing reforms. It may also indicate internal differences in the party over economic policy.

Regional neighbours and commodity producers likely to suffer most from Chinese slowdown. The May issue of the IMF's *Regional Economic Outlook* sees Asian growth slowing to 5.3 % p.a. for 2016 and 2017. Strong domestic demand should continue to counterbalance the weak trends in the global economy and lower Chinese growth. The IMF sees China's GDP growth slowing from 6.9 % last year to 6.5 % this year and 6.2 % in 2017.

China's significance for other countries has increased rapidly as its share of the global export market has risen from 3 % in 2000 to 9 % last year. Over the same decade-and-a-half, China's share of Asian countries' exports has increased from 9 % to 22 %. In addition to the direct impacts of trade, the IMF survey noted the indirect impacts through commodity prices and financial markets.

The survey reports estimates of the impacts of China's structural shifts and slowdown suggest that a drop of 1 percentage point in China's GDP reduces GDP of its Asian neighbours by 0.15–0.30 percentage points over the short run. The

size of the impact depends on the nature of the affected country's exposure to China. Countries dependent on Chinese investment (e.g. Taiwan, South Korea) will suffer more in the short run from China's structural change and slowing growth than countries focused on serving Chinese consumers (e.g. New Zealand, India). Commodity producers have been hit by falling prices which, however, are mainly due to other factors than China. Indeed, only a few commodity-producing countries have seen significant declines in volumes of exports to China.

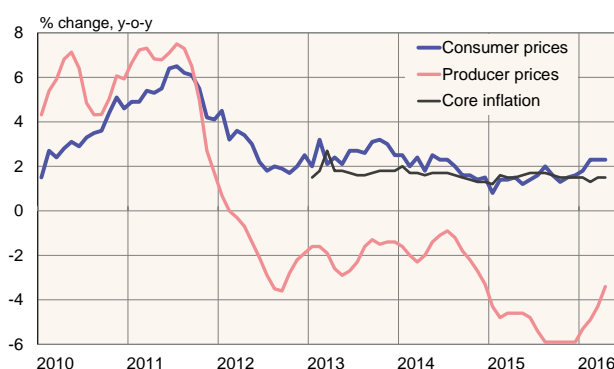
The impacts of China's structural changes and slowing growth on countries outside the Asian region and countries not dependent on commodity exports will naturally depend also on how much their value-added production is linked to Chinese consumption and investment. The average impacts, however, are smaller than for Asian countries. China's adjustments will also alter international production chains as it gradually replaces intermediate products manufactured elsewhere with its own production.

The IMF stressed, however, China must adopt a sustainable growth model. Over the long run, successful structural reforms will add to regional and global growth.

China's inflation largely unchanged in April. China's National Statistics Bureau reports that consumer prices rose 2.3 % y-o-y in April and that 12-month core inflation (not including food and energy prices) was 1.5 %. China's inflation rate has remained modest and quite steady in recent months, even if food prices climbed 7 % y-o-y. The slide in producer prices has moderated in recent months.

In earlier years, changes in food prices had a significantly larger impact on consumer prices. At the start of the year, the NBS revised the contents of its consumer basket on which it bases the consumer price index. The weighting of food in the basket has been reduced substantially, while housing, transport and healthcare services were given larger weights. Financial services were among the new items making their debut in the current basket formulation. The NBS adjusts its consumer basket every five years to reflect consumer habits. As households grow wealthier, it is typical that households devote a smaller share of their income to food.

Price trends in China



Sources: China National Bureau of Statistics and Macrobond.

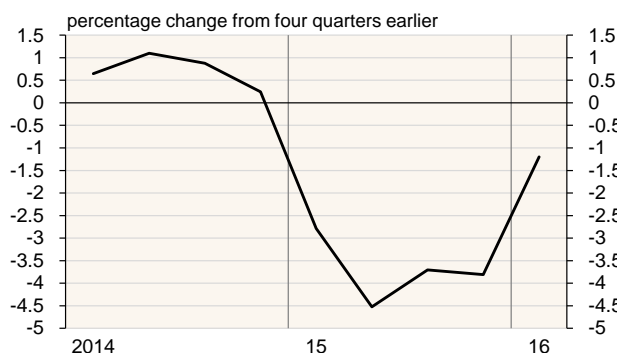
Russia

Contraction of the Russian economy slowed this year. Rosstat reports that GDP fell 1.2 % y-o-y in the first quarter. Russia's economy ministry noted that the impact of leap year blunted the drop. The ministry's estimate meant that without the leap-year effect, the first quarter fall in GDP would have been about 2 % y-o-y. Moreover, the GDP figure got a small boost from an exceptional increase in Russian crude oil output in the first quarter. However, fresh estimates of Russian oil production this year by Russian and international energy authorities see growth in oil production slowing during the remainder of the year.

After the release of Rosstat's GDP figure for the first quarter, Russia's economy ministry estimated that seasonally adjusted GDP contracted 0.2 % q-o-q in the first quarter. Portraying figures reliably is hard, however, due to the fragmentation of Rosstat's GDP time series. This is because Rosstat is recalculating its GDP statistics moving back through time from the present. The recalculations use methodologies that are based on more updated international recommendations than those applied earlier.

Most of the latest forecasts estimate Russian GDP will shrink 1.2–1.3 % this year. The economy ministry's projection of a contraction of 0.2 % is among the most favourable.

Russian GDP growth



Source: Rosstat.

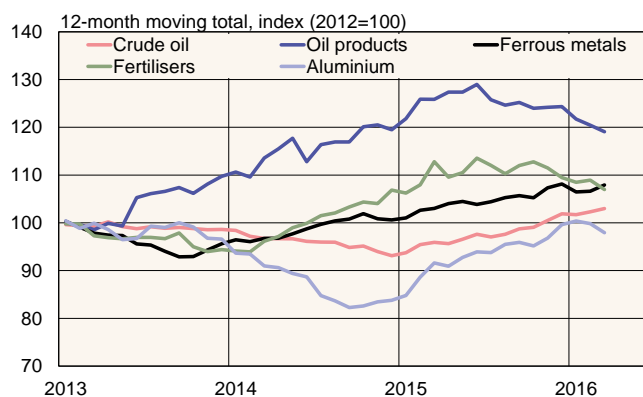
Fall in Russian imports begins to moderate. The value of goods imports in January-March contracted 15 % y-o-y to just under \$40 billion. The contraction in imports slowed considerably in all main product categories, and Russia's Federal Customs Service noted that import volumes of certain products even recorded growth. The EU's share of Russian imports rose slightly to nearly 40 %. Russian imports from e.g. France and Estonia were up nearly 20 %. Russian imports from China contracted 12 % y-o-y, but China, which accounted for over 20 % of Russia's imports, was still the single most important import provider by far. Imports from Turkey were down 60 % y-o-y, partly due to Russia's decision at

the end of last year to ban imports of many Turkish food products.

The value of Russian goods exports contracted in January-March by about a third to \$60 billion due largely to lower export prices. The average price of Urals-grade crude oil was \$32 a barrel for the period, down from \$53 a barrel a year earlier. In addition, the growth in export volumes of major commodities slowed or went into decline. Growth in crude oil exports slowed to 4 % y-o-y and the export volumes of oil products shrank by 16 %.

Among key metal products, export volumes of ferrous metals and aluminium went into slight decline, whereas in exports of copper and nickel growth slowed visibly. The ruble's real effective (trade-weighted) exchange rate in 1Q16 was still 5 % lower than a year earlier.

Export volume trends of select Russian export commodities



Sources: Macrobond / Federal Customs Service of Russia.

Russia signs on to OECD's Automatic Exchange of Information initiative. The OECD and G20 countries have developed the Automatic Exchange of Information (AEOI) standard procedure as a way to increase international cooperation among tax officials and thereby reduce tax evasion. Under the AEOI, tax officials in participating countries agree to automatic annual exchange of information about the asset-holdings of citizens. Currently, there are 82 signatory countries to the agreement, including a number of tax havens such as the British Virgin Islands. Russia's participation is set to commence in September 2018, but bilateral agreements still need to be signed.

The AEOI is expected to support implementation of new tax laws developed in recent years to reduce hiding capital assets abroad. These include a ban on foreign assets of individuals in government service and stricter taxation of Russian income originating abroad. Increased taxation of offshore capital has been sought also by an amnesty law enacted last summer. The law allows Russians to avoid possible punishments related to offshore assets through voluntary disclosure. The law so far has resulted only in a couple hundred voluntary asset declarations and will remain in force until end-June.

China

April's economic numbers confirm China's ongoing slowdown. After slight improvements in key economic indicators in March, April's figures were weaker than most observers had expected. Growth in industrial output last month slowed to 6 % y-o-y and retail sales were up about 9 %. Growth in fixed investment slowed a bit, but differences across sectors were huge. For January-April, public sector investment was up 24 % y-o-y, while growth in private sector investment remained at 5 % y-o-y.

Chinese exports in January-April were down 8 % y-o-y in dollar terms. The drop moderated last month, however, to an on-year fall of just a couple per cent. The value of imports was down again last month by over 10 %, a trend that has persisted all year. The drop largely reflects low commodity prices – import volumes of many important commodities actually increased. In January-April, import volumes were up 19 % for crude oil, 29 % for copper and 8 % for iron ore.

China's financial markets have been relatively calm since February and capital outflows from the country have been modest. As in recent months, the value of China's currency reserves hovered around \$3.2 trillion. Current government challenges include a worsening debt problems and partial overheating in the housing market. The general fall in housing prices in many cities ended a year ago and prices today are soaring in many large cities. SouFun's survey of 99 major cities shows that the average apartment sale price in April was up 9 % y-o-y. Price trends ranged widely across cities.

Swings in yuan-dollar exchange rate get larger. Last August's foreign exchange overhaul was designed to allow larger swings in the yuan-dollar exchange rate. The People's Bank of China has accomplished this goal to some extent as the volatility in both the yuan-dollar exchange rate fixing and the USD/CNY market exchange rate has increased significantly since August. At the same time, yuan volatility against multi-currency indexes has decreased.

The PBoC began last December to publish three multi-currency exchange rate indexes (the CFETS index, which comprises 13 currencies; the IMF's SDR index based on four major currencies; and the BIS index of 40 currencies). Commercial banks that submit price proposals on which the central bank bases its daily dollar-yuan "fixing" rate have been instructed to take into account market price at the end of the previous day's trading and the yuan's trend against all three main indexes. This request is impractical in many respects as the proposed dollar reference exchange rate submitted by reporting commercial banks would have to take into account the yuan's movements against all index currencies. Yuan's dollar fixing rate has closely followed the market exchange rate since the reform was introduced.

Despite the PBoC's goal of broadening market perspective on yuan exchange rate, forex markets remain largely focused

on the yuan-dollar exchange rate. Some of this is natural; e.g. the vast share of yuan trading is conducted in relation to the dollar. Moreover, the central bank's CFETS index is an arbitrary construct with no other practical application.

The needs of a country with a large, rapidly developing economy that is opening up and deregulating capital movements are best served by a flexible exchange rate regime. China has declared its plans of shifting to a freer exchange rate regime, so recent improvements in flexibility are welcome. The current situation still allows for managed increases in flexibility.

Yuan-dollar rate with CFETS and SDR multi-currency indexes



Sources: Macrobond and BOFIT

Boom in Chinese foreign travel continues. Chinese foreign travel has soared in recent years. Compared to 2010, the number of trips abroad doubled last year and the amount spent abroad was six times larger. China's National Tourism Administration reports that Chinese made nearly 130 million trips abroad last year. PBoC balance-of-payments figures further show Chinese travellers abroad spent a total of approximately \$300 billion in 2015 (the equivalent of about 3 % of GDP). The UN's World Tourism Organization (UNWTO) reports that both the number of tourists and the money spent per traveller have increased so much that Chinese are now the world's most significant tourist group. American tourists were the second-biggest spenders abroad last year (\$120 billion). Russian travellers spent \$35 billion.

The top destinations for Chinese are countries in East and Southeast Asia, Europe and North America. The Chinese typically travel in groups and often purchase luxury products. Chinese are expected to travel even more in coming years as the country grows more affluent.

Finland's national tourism promotion board "Visit Finland" reports that the number of Chinese visitors arriving in Finland last year exceeded 500,000, or about a third more than in 2014. The Chinese were the fourth largest tourist group after Russians, Swedes and Estonians, and the second biggest spenders after Russians. Chinese arriving in Finland as transfer passengers at the airport make up a third of Chinese tourists, but the number of overnight stays by Chinese travellers also increased some 40 % last year.

Russia

Russia's finance ministry issued a new eurobond.

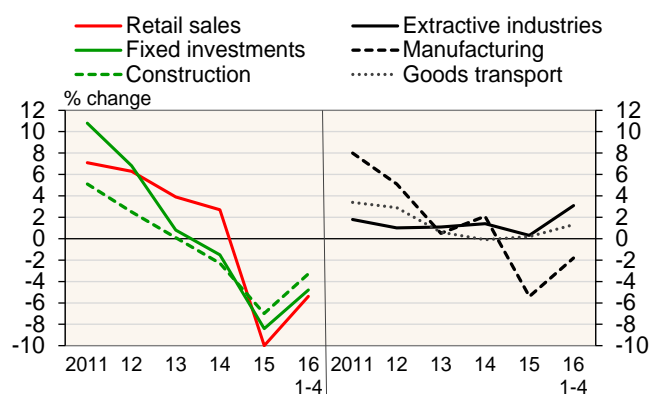
This week Russia issued sovereign dollar-denominated eurobonds for the first time since 2013. The bond offering was seen as a means to feel out investor sentiment and to support pricing in Russian dollar-denominated debt securities. Furthermore, the liquidity situation of Russian banks has improved significantly this spring, and strong demand was expected for new instruments denominated in foreign currencies. The final eurobond placement remained relatively small (\$1.75 billion), even though the yield of 4.75 % is quite high.

In February, the finance ministry approached numerous foreign banks asking of their wish to arrange a \$3 billion Eurobond issue. At the time, no willing banks could be found and the offering was postponed. The issue placed this week was arranged exclusively by VTB Capital, the investment branch of Russia's state-owned VTB Bank, which is currently subject to international sanctions. Uncertainty over the interpretation of sanctions and over secondary markets of the bond limited the participation of major foreign investors.

During the first four months of this year, the finance ministry has issued about 400 billion rubles (\$5.9 billion) worth of new ruble-denominated debt. The government's budgeted net borrowing this year is 300 billion rubles (\$4.5 billion) from domestic markets and \$3 billion in foreign bond issues.

Russian demand remained slack in April. The volume of seasonally adjusted retail sales continued to fall last month, declining about 5 % from April 2015. Household real incomes dipped from March, and the high on-year inflation kept real incomes in April 7 % below the level of April 2015. The first data this year on fixed investment became available (since the start of the year, the figures are released only on a quarterly basis). Investment in the first quarter was down nearly 5 % from a year ago and 12 % from three years ago.

Indicators of Russian economic performance, 2011–2016



Source: Rosstat.

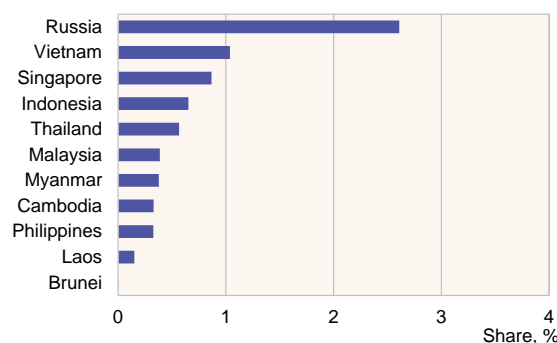
The situation for Russian production has been slightly better. In the extractive industries, which includes hydrocarbon production, the April production was clearly larger than a year earlier, although the crude oil production boom in the previous months of this year subsided. Seasonally adjusted manufacturing output increased slightly, rising about 0.5 % y-o-y. Economy minister Alexei Ulyukayev noted that the ministry estimated the GDP fell only 0.7 % y-o-y in April.

Russian and ASEAN leaders meet in Sochi. Russia has been a full dialog partner with the Association of Southeast Asian Nations (ASEAN) since 1996. Last week, the third joint summit was held in Sochi. At the meeting was signed a new cooperation programme running through 2020 describing general measures for developing relations between the countries. The participant countries were particularly interested in joint projects in the energy sector, arms sales and infrastructure projects. Russia-ASEAN cooperation also strives to counterbalance China's dominant role in the region.

Current economic cooperation between Russia and most ASEAN members is quite modest. Russian goods exports to ASEAN countries in 2015 totalled just \$6 billion and imports \$7 billion. ASEAN countries last year accounted for 2 % of Russian exports and 4 % of imports. Russia's share of the total ASEAN exports and imports is less than 1 %. Arms sales are the exception as Russia and Vietnam are key partners. The Stockholm International Peace Research Institute (SIPRI) estimates that nearly all of Vietnam's arms imports in recent years have come from Russia.

Russian officials said that there were also discussions with several countries on possible free-trade agreements with the Eurasian Economic Union. Russia launched free-trade talks with Vietnam already in 2009 and last year Vietnam became the first country to sign a free-trade agreement with the Eurasian Economic Union. That agreement should soon enter into force. The average duty level in bilateral trade should fall from a current average of around 10 % to 1–2 % within a decade. Russian firms are interested in e.g. getting Vietnam to gradually lower its high import duties on cars.

ASEAN countries' share of Russian goods trade and Russia's share of ASEAN goods trade (exports + imports) in 2015



Source: IMF DOTS.

China

Chinese officials take on restructuring of problematic state enterprises. China's state media report the State Council decided at its May meeting to restructure 345 state-owned "zombie" companies which are distressed subsidiaries of 106 of key state-owned enterprises (SOEs) owned by the central government. The restructuring will be done over the next three years. Job cuts at these firms seem unavoidable as restructuring involves flattening organizational hierarchies from their current five to nine layers to four at maximum.

Making SOEs efficient and profitable is widely welcomed as they constitute a major drag on the economy and prevent more efficient use of resources. The restructurings announced this month only affect a small number of SOEs, however. If companies owned by local governments and all subsidiaries are included, China has roughly 150,000 SOEs in total. Indeed, some of the thorniest problems are believed to lie with firms owned by local governments. Local government officials are reluctant to restructure distressed firms due to production cuts and the loss of jobs that would ensue.

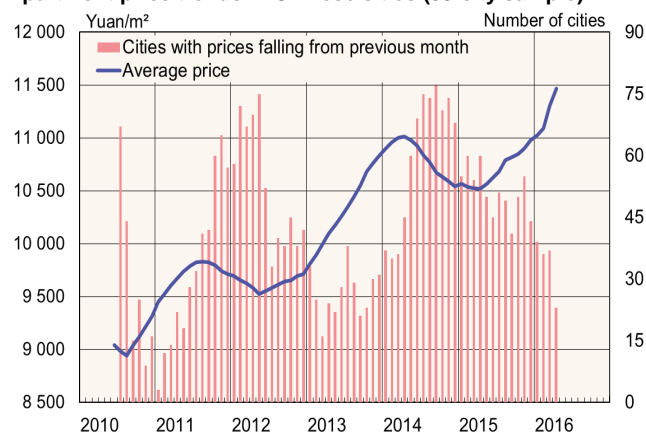
Apartment prices in China's big cities are soaring again. The situation in China's housing market has changed dramatically from a year ago, when housing prices overall were still falling. Urban real estate markets today are hot. The real estate portal SouFun's survey of 99 cities showed that in April the average apartment price was 9 % higher than a year earlier. Moreover, average price drops from the previous month were now registered in less than a quarter of the cities surveyed. The most spectacular gains have been in China's dynamic metropolises. April apartment prices were up 60 % y-o-y in Shenzhen, 21 % in Shanghai and 12 % in Beijing.

In addition to rising apartment prices, the volume of apartment sales (measured in square metres of liveable floor-space) increased 39 % y-o-y in the first four months of this year. During the same period, the volume of new housing construction starts (in terms of floorspace) was up by nearly a fifth from a year ago. Although the volume of unsold new apartments has fallen since the start of the year, the stock of unsold apartments remained high relative to sales volumes and previous years. This situation poses a risk to a sustained recovery in the housing market.

A recovery in housing markets would normally be welcome news, but the sharp spike in prices seems to be fuelled largely by increased borrowing. Higher debt boosts the exposure of real estate developers and banks to any downturn in housing prices. Reuters calculates that 40 % of the loan portfolios of China's five biggest banks at the end of 2015 were either tied to real estate or mortgages, up from 26 % seven years ago. It also appears that the indebtedness of households relative to the value of apartments has risen rapidly, a trend fuelled by reduction of the downpayment requirement. Apartment buyers even seem to be borrowing the required

downpayment amount from the shadow banking market to qualify for standard bank loans.

Apartment price trends in Chinese cities (99-city sample)



Sources: SouFun, Macrobond and BOFIT.

Chinese steel production on the rise. With the recovery in construction, steel prices have risen rapidly on China's domestic market. Even with this month's moderation in the rise in prices, China's steel price index last week was still up 30 % from the start of the year. Crude steel production recovered from its around a year-long decline (up 2 % y-o-y in March-April). The production is expected to continue to grow in coming months, as several steelmakers have announced plans to reactivate closed mills due to higher prices. Chinese observers expect about 50 million tonnes of additional production capacity to come back on stream. Chinese steel production in 2015 was about 800 million tonnes, or about half of global production.

The Chinese export considerable amounts of steel. In January-April, the export volumes of Chinese steel products were up about 8 % y-o-y, which was lower growth rate than in recent years. About 70 % of Chinese steel exports goes to Asia, which also accounted for most export growth. Exports to the EU were up about 7 % y-o-y, while exports the US fell by 65 %. The US has imposed a range of import duties on Chinese steel, charging that Chinese steel is sold at prices below actual production cost. In recent weeks, the US has stepped up its anti-dumping campaign, imposing duties as high as 500 % on certain Chinese steel products. Many other countries have also imposed anti-dumping duties on Chinese steel.

As China's economy slows and evolves towards a more consumption- and service-driven paradigm, its steel overproduction is offloaded onto global markets. This situation is particularly disconcerting for steelmakers elsewhere, and the matter is on agenda at this week's G7 meeting in Ise-Shima, Japan. China's government has pledged to reduce its annual capacity in the sector by 100–150 million tonnes by 2020, but observers hold out little hope for the project's success. China has attempted similar measures before with meagre results.

Russia

Russia pension terms will tighten gradually for certain government workers. A recent change in the law affects those with official posts mainly in administration at federal, regional and municipal levels. Authorities report their number is over one million of about 18 million workers employed by federal, regional and municipal governments. Their entitlement age for an old-age pension will begin to rise from next year at a rate of six months a year, so that the pension age increases to 65 years for men by 2026 and 63 years for women by 2032. Currently, these civil servants qualify for full pensions under the general rules in Russia, at 55 years for women and 60 years for men.

In addition, eligibility for pensions based on years of service begins to rise by six-month increments each year from the start of 2017. The current required number of years of service for federal office holders is 15. There are no other unified requirements, and regions and municipalities can presently decide their requirements with a range of 10–20 years of service. For all levels, the minimum requirement will be 15.5 at the start of next year and will rise to 20 years by 2026.

The changes are part of the emerging reform of the pension system, which has become increasingly necessary as government pension spending has gradually risen to almost 9 % of GDP and a quarter of total government budget spending. Moreover, budget revenues have fallen substantially on lower oil prices and economic recession. Several high officials have indicated, however, that no decision on a general increase in the pension age is expected before 2018.

With the government facing tight budgets, other decisions affecting pensions have also been made. Accumulation of budget revenues to the savings pot of the state pension fund has been skipped since 2014 (a sum equalling 0.4 % of GDP annually). Increases in Russian pensions were lowered to just 4 % this year, well below 7 % headline inflation. Pensioners who work got no increase this year (the official data is that 40 % of about 35 million people receiving old-age pensions in Russia are working). The value of pensions will fall tangibly this year in real terms after dropping nearly 4 % last year. It was the first decline in real pensions since 1999. The average pension in recent years has been about 33–35 % of the average wage; the target set in connection with declaring sharp pension hikes nearly a decade ago was 40 %.

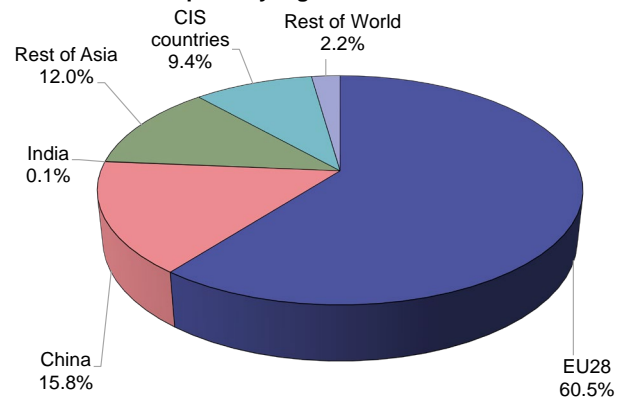
Rosneft completes sale of 15 % stake in Vankorneft to the Indian ONGC. The Indian state energy company ONGC Videsh this week acquired a 15 % stake in Rosneft subsidiary Vankorneft for \$1.3 billion. The deal was preliminarily agreed last autumn after Rosneft's long search for a foreign partner for Vankorneft among e.g. Chinese companies. The deal may have been accelerated due to Rosneft's tightened financial situation caused by low oil prices and sanctions. Rosneft is also in talks with Indian companies on other possible acquisitions

that could raise their stake in Vankorneft to nearly 50 %. ONGC already holds a 20 % stake in the Sakhalin 1 project.

Vankorneft operates the giant Vankor oil field in Eastern Siberia that produced 4 % of Russia's oil last year. All the oil fields located in Russia's Far East and East Siberia represented 12 % of total oil output in Russia. Production is growing fastest in these regions, while it has been declining for years in the mature oil fields of Western Siberia.

The shift of oil demand growth to Asia (particularly to China, and lately increasingly to India), has supported development of fields in the Far East and Eastern Siberia. Nearly 30 % of Russia's crude oil exports last year went to Asia. China accounted for 16 % of Russia's oil exports, while the volume of exports to India was marginal.

Russian crude oil exports by regional market in 2015



Source: Federal Customs Service of Russia.

Finnish exports to Russia may be closing the bottom.

The value of goods exports in January-March was €600 million, or 14 % less than in the same period a year earlier. Exports were at their lowest quarterly level in 15 years. The contraction in exports has been slowing, however. Exports were down just 6 % y-o-y in March. Product categories such as foodstuffs and metals, which have experienced the worst declines in recent years, even saw growth in March. In 1Q16, Russia was Finland's fifth largest export market, on par with China which also accounted for about 5 % of exports.

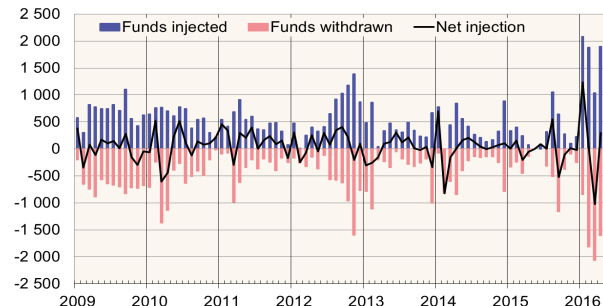
The decline in travel and tourism exports to Russia also seems to have slowed in the first quarter. The number of border crossings was still down by 8 % y-o-y and overnight stays of Russians contracted by 18 %. Last year, Finland's income from Russian tourists fell by nearly 40 % to under €600 million. Statistics Finland's preliminary figures, however, show that the combined value of most other Finnish services exports to Russia actually rose last year.

The value of goods imports shrank on-year in 1Q16 by a third to €1.2 billion. Much of the contraction was due to lower oil prices and reduced crude oil import volumes. In contrast, import volumes increased for e.g. many metals and raw timber. Russia accounted for 9 % of Finnish goods imports and was Finland's third most important import provider.

China

People's Bank of China increases open market operations as monetary policy seeks new direction. Since Chinese New Year ended in February, the People's Bank of China has engaged in open market operations on a daily basis. Previously, it had conducted them twice a week. The volume of open market operations has also increased. In recent months, the instrument of choice has been the reverse repo (buying debt securities from banks with agreement to sell them back). The impacts of the PBoC's monetary policy measures are apparent in the interbank money markets, where both repo and Shibor rates have remained steady since last summer.

Monthly volume of PBoC market operations (CNY billion)



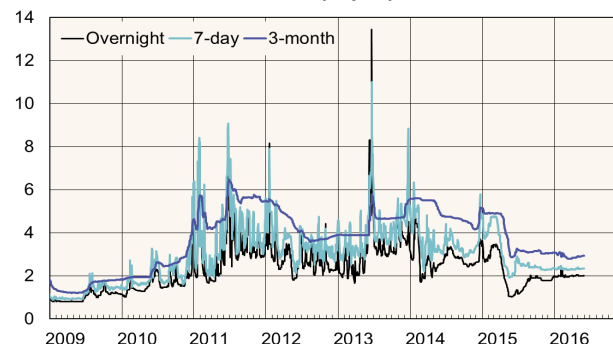
Source: CEIC

The PBoC has also sought to boost liquidity through various lending programmes. Under the medium-term lending facility (MLF), the central bank offers commercial banks 3–12-month secured financing. Some 1.74 trillion yuan was lent under the MLF during January–April, while MLF repayments amounted to 910 billion yuan. The PBoC channelled 310 billion yuan to the country's policy banks under its pledged supplementary lending (PSL) programme in January–April. The combined lending stock of the two programmes amounted to 2.9 trillion yuan (€400 billion) at the end of April. This year short-term (1–7 day) market liquidity has been boosted through the PBoC's standing lending facility (SLF). Interest rates under PSL, MLF and SLF programmes have also been reduced. For example, the interest rate on a 3-month MLF loan in April was 2.75 % p.a.

Since the deregulation of interest rates last autumn, the Chinese monetary policy measures and its direction have become harder to deduce. The most important monetary policy tool of the moment seems to be the reserve requirement ratios (RRRs) for banks, which the PBoC employs e.g. to provide lending guidance and as a macroprudential tool. The RRRs for individual banks, however, may differ from the general level of the banking sector. Recently the PBoC seems to have been cautious in relaxing of the monetary stance through lowering of RRRs and reference rates, which are closely followed by the markets. Broad-based policy easing could stoke capital outflows from the country and add to yuan

depreciation pressures. The central bank has eased domestic financial conditions mainly through focused measures.

Shibor interbank market rates (% p.a.)

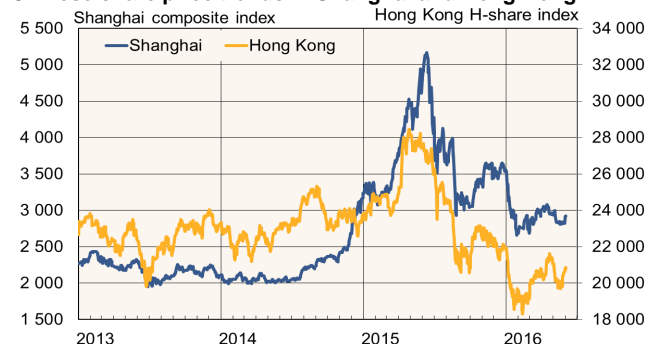


Source: Macrobond

Chinese share prices stable. During last summer's stock market crash, state measures to support share prices included encouraging market participants to buy copious amounts of shares with the requirement that they hold them for at least six months. As the ban on selling began to expire around the start of the year, share prices started to plunge again and officials decided to extend the ban on selling for large shareholders by limiting divestment of a firm's shares to 1 % per quarter. After the measure, share prices have remained relatively stable for the past four months.

In the view of many investors, arbitrary and prolonged interruptions to share trading have become a big problem. China's stock exchanges announced new rules in May that make it harder for firms to suspend trading and to limit trading breaks to defined periods, which are up to 3 months. The change coincides with the upcoming decision of Morgan Stanley Capital International on whether to include Chinese A-shares in its emerging market index (MSCI EM), which currently only includes shares of Chinese companies listed on the Hong Kong stock exchange. MSCI will announce its decision within the next two weeks. If A-shares are included, foreign ownership of China's stock exchanges will probably increase, as it is mandatory for funds that track the MSCI EM index to purchase A-shares. Foreign investment in Chinese stock exchanges is currently only a few per cent.

Chinese share price trends in Shanghai and Hong Kong



Source: Macrobond

Russia

Rise in Russian consumer prices slowed in January-May. May consumer prices were up less than 3 % from December, whereas the comparative figure in 2015 was well over 8 %. As in the previous two months, May consumer prices were up 7.3 % y-o-y. The last time such a relatively lower 12-month inflation score was seen in April 2014.

Food prices have been the strong mover in consumer prices in recent years. The fall of the ruble at the end of 2014 and Russia's countersanctions in August 2014 that brought import bans of certain foods, sent food prices to a level 19 % higher on average in 2015 than in 2014. This year, food prices have risen considerably slower in on-year terms than prices of other consumer goods and services. Part of this reflects an increase in domestic food production and a partial shift of demand from imported food items to cheaper domestic products. Food prices were up 5.6 % y-o-y in May, while prices of services and non-food goods were up 8.4 % y-o-y.

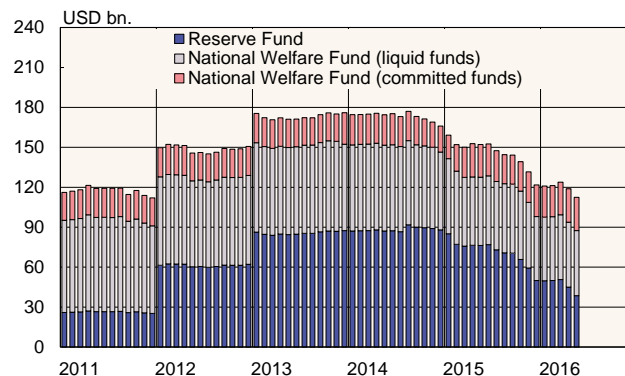
Consumer price inflation in recent months has been 3.7 percentage points lower than the CBR's key rate (at 11 % since August 2015), making the key rate clearly positive in real terms. Central Bank of Russia forecast has consumer prices up 6–7 % y-o-y at the end of this year, and the Bank expects to reach the 4 % inflation target by the end of 2017.

Russia dips further into its reserve funds. Another 390 billion rubles (\$6 billion) was lifted from the Reserve Fund in May to cover the budget deficit. The Reserve Fund at the end of May was valued at 2.55 trillion rubles (\$39 billion or 3 % of GDP). So far this year, about 800 billion rubles has been withdrawn from the Fund, and budget plans call for a further draining of 1.3 trillion rubles by year's end. While the federal budget assumes an average oil price of \$50 (3,165 rubles) a barrel, the actual average price of Urals-grade crude in January-May was \$36 (2,560 rubles).

The value of the National Welfare Fund stood at 4.8 trillion rubles (\$73 billion or 6 % of GDP) as of end-May. So far this year, about 7 billion rubles (\$100 million) has been used to cover pension expenditure.

The entire Reserve Fund and about two-thirds of the National Welfare Fund are counted as part of Russia's foreign currency reserves. The CBR oversees these assets and invests them in low-risk, highly liquid currency-denominated securities as it does with the rest of the nation's currency reserves. The value of Russia's foreign currency reserves does not automatically fall when money is withdrawn from the reserve funds. When the funds are used to cover expenses in rubles, the central bank exchanges foreign currency for rubles and the currency reserves remain unchanged. The value of Russia's foreign currency reserves, which has risen slightly this year, stood at €388 billion at end-May.

Value of Russian oil funds



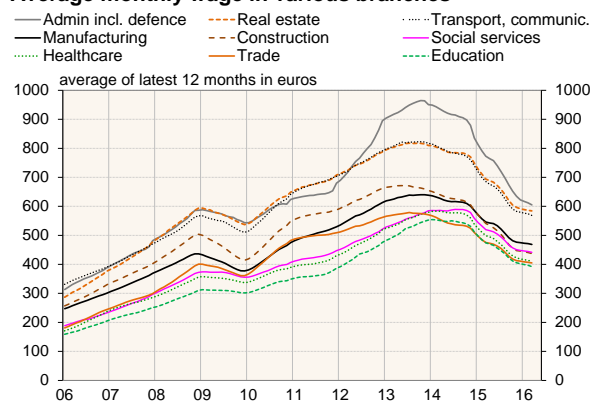
Sources: Macrobond, Russian Ministry of Finance and BOFIT.

Declining ruble exchange rate has sharply lowered external value of wages in all branches. The average monthly Russian wage between April 2015 and March 2016 was €500. In manufacturing, it was about €470, lower than in China (roughly €600), and if compared to EU countries with lowest incomes, lower than in Romania (€550) but still higher than in Bulgaria (about €400). Russian manufacturing wages vary tangibly. The low-income branches are textiles and clothing with €240 and woodworking with slightly over €300. High-income branches comprise basic metals and chemicals where the average is around €600 a month.

The best-paying fields overall are oil refining (€1,300 a month), oil & gas production, pipeline transmission and finance (each around €1,000 a month). Russia's low-paid fields include trade, education and the health services branch (about €400 a month), and construction (€440). Public administration jobs, including administration in social services and defence paid around €600 a month.

Estimates say unrecorded wages account for about 15 % of the average pay package. Rosstat estimates of unrecorded production connote the share of unrecorded wages varies very much across branches. In particular, pay in the construction and trade branches is better than official figures indicate.

Average monthly wage in various branches



Source: Rosstat.

China

Surveys show Chinese firms hiring less. For over a year, purchasing manager indexes compiled by various organizations have been indicating that firms in both the industrial and service sectors have not been hiring at the same pace as earlier. The international staffing company Manpower repeated a similar theme in its latest survey. The number of firms planning to employ additional workers has fallen for years, and today is almost as low as during the roughest part of the 2009 financial crisis. The drop in hiring applies to all sectors, including finance, manufacturing, construction and mining, services, transport and trade.

The findings of employee surveys also comport with business surveys. For example, the People's Bank of China's quarterly survey of bank depositors notes that the employment expectations of depositors have weakened since last autumn.

The expectations of continued slowdown in the Chinese economy, lower corporate profitability and higher wage costs (a driver of increased production automation and the shifting of labour-intensive production to countries with cheaper labour costs) are just a few of the many factors shaping company hiring prospects. In coming years, many jobs will vanish as production is planned to be reduced in sectors plagued with overcapacity, certain state-owned enterprises are restructured and the number of people serving in China's military is reduced.

The quality of Chinese official labour market statistics has room for improvement, not to mention how actual unemployment or labour supply and demand are assessed. Survey-based figures indicate overall employment trends but fail to specify e.g. in the number of workers on payroll. It is particularly disconcerting from the government's standpoint that firms in the service sector are increasingly reluctant to hire new personnel. A cornerstone assumption of economic restructuring policies is that service sector will take up much of the slack as workers are forced out of downsized heavy industry and other branches.

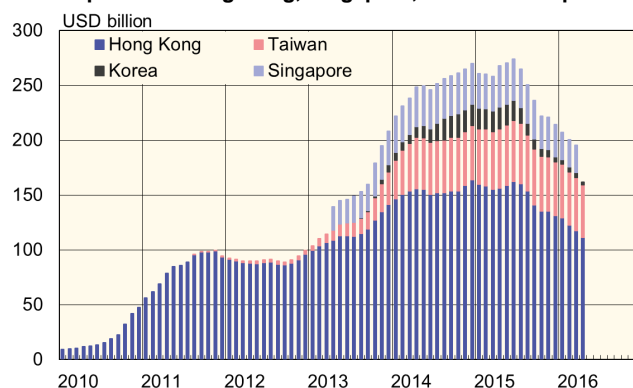
Official figures show that China's registered unemployment rate has hovered around 4 % for over a decade. Many people have little incentive to seek assistance or report themselves as unemployed, however. Another official unemployment survey, which the government only started to publish in 2013, looks at urban unemployment rates in 31 major cities. By this alternative measure, unemployment has remained at just over 5 % over the past three years. As official data only include the urban residents, there is virtually no information on unemployment and underemployment in rural areas or concerning internal migrants (i.e. the most flexible and mobile participants in the Chinese labour market). At the beginning of June, the consulting firm Fathom said overall unemployment in China's economy could reach 12 % this year, up from 10 % in 2015 and around 5 % in 2013. Unemployment is a delicate subject for China's leadership.

Exchange rate depreciation and poor foreign trade performance reduce international yuan use. SWIFT, the Society for Worldwide Interbank Financial Telecommunication, reports that in April the yuan was used in 1.8 % of all international payments by value. The yuan was the world's sixth-most-used payment currency, just behind the Canadian dollar. Last summer the yuan climbed to fourth place among the most-used payments currencies. Moreover, yuan's use in Chinese foreign trade has diminished. In March-April, only 17 % of China's foreign trade was conducted in yuan. The corresponding figure last year exceeded 25 %.

With the yuan's falling exchange rate, yuan deposits in designated yuan trading and clearing centres outside mainland China (offshore yuan) have diminished. This trend partly reflects the PBoC's decision last January to impose reserve requirement ratios (RRRs) on offshore yuan deposits in order to calm currency speculation. The PBoC also announced last week that as of July 15, RRRs will be based on average deposits for the quarter rather than deposits at the end of the quarter. By some estimates, the move will further reduce yuan deposits at offshore centres.

The overall readiness of firms and financial institutions to conduct business in yuan has nevertheless improved in recent years. SWIFT figures show that over 1,100 foreign financial institutions (37 % of all financial institutions with payments traffic in China or Hong Kong) already use the yuan.

Yuan deposits in Hong Kong, Singapore, Seoul and Taipei



Sources: Macrobond, BIS, national central banks and BOFIT (*Singapore data available on a quarterly basis up to 2016Q1)

China's foreign trade performance remains tepid. China's customs figures show May goods exports, measured in dollars, contracted at 5 % y-o-y, the same rate as the average of the previous four months of this year. After contracting by more than 10 % y-o-y in the first four months of this year, May imports remained at the same level as a year earlier. China's trade performance is strongly influenced by fluctuations in exchange rates and commodity prices. When goods trade is considered in terms of trade volumes, both export and import volumes increased an average of 2 % y-o-y in January-April. Moreover, especially foreign trade value figures are muddled up by the changes in trade flows in which the participants are circumventing China's capital controls.

Russia

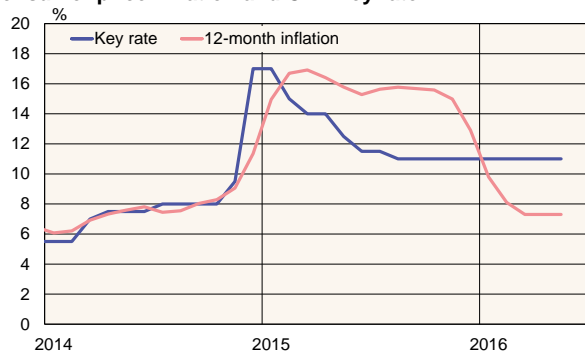
Russian central bank lowers key interest rate. At its monthly meeting last Friday (June 10), the Central Bank of Russia's board of directors voted to lower the key rate by 50 basis points to 10.5 %. The CBR last lowered the key rate in August 2015.

The board based its decision to reduce the key rate on more benign inflation development and outlook. 12-month consumer price inflation was below forecast, stabilising at 7.3 % in past months and inflation expectations have continued to decline. The board noted that inflation risks have subsided, although remain elevated due to e.g. the stickiness of inflation expectations and uncertainty related to fiscal policy.

The CBR also announced its reduced inflation outlook for this year in conjunction with the meeting. The earlier projection that 12-month inflation would end the year at around 6–7 % was revised down to 5–6 %. The CBR expects the economy to come out of recession at latest in the second half of this year. Economic growth is, however, expected to remain slow next years and therefore not accompanied by higher inflation pressures. The CBR expects to hit its 4 % inflation target by the end of 2017.

The board added that it would consider further rate cuts if inflation risks abate and inflation continues to drop as expected. The next board meeting is set for July 29.

Consumer price inflation and CBR key rate



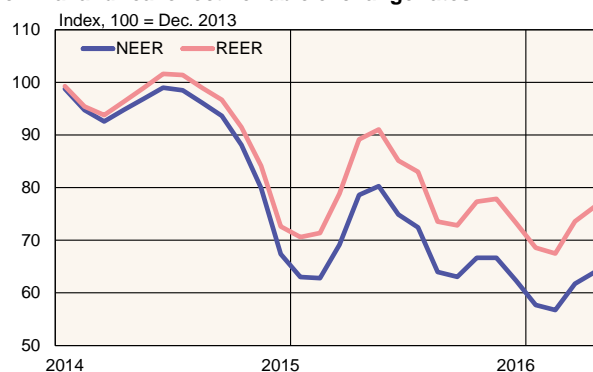
Source: Macrobond.

Ruble strengthening on higher oil prices. This week the ruble-dollar exchange rate hovered around 66 RUB, while the euro-ruble rate held around 74 RUB. The ruble has appreciated more than 20 % against the dollar and euro after hitting this year's bottom in late January. Since the CBR floated the ruble in November 2014, the ruble's exchange rate has closely tracked oil prices because the bulk of Russian forex earnings comes from oil and related exports. Depreciation pressures on the ruble have also subsided due to a sharp slowdown in capital outflows. The CBR estimated that the net outflow of private sector capital in the first five months of 2016 amounted to \$13 billion, down from \$50 billion in the same period in 2015.

Due to higher inflation rate in Russia than in most of its trading partners, the ruble has strengthened even more in real than nominal terms, although its value is still far below pre-collapse levels. The ruble's real effective (trade-weighted) exchange rate in May was 22 % below end-2013.

Many Russian firms are satisfied with the ruble's strengthening. A recent survey committed by the CBR found that over 60 % of responding firms want a stronger ruble because it would support their investment in imported machinery and equipment and reduce production costs as imported inputs would become cheaper. Firms in nearly all branches favoured ruble appreciation regardless of whether they serve the domestic market or are involved in exports.

Nominal and real effective ruble exchange rates



Sources: Central Bank of Russia, BOFIT.

Liquidity in Russian banking sector recovers. Poor economic performance, fluctuations in the ruble's exchange rate, the drop in foreign financing and increase in household savings rate have affected the banking sector in multiple ways. Measured in nominal terms, bank loan portfolios grew just 8 % in 2015 and contracted by 4 % in the first four months of this year. About 30 % of bank lending is denominated in foreign currencies. Adjusting for shifts in exchange rates, bank loan portfolios have seen no growth for over a year. Especially lending to households has fallen dramatically.

Households have responded to economic uncertainty by saving more. Adjusting for exchange rate shifts, households increased their bank deposits 17 % last year and another 1 % in the first months of this year. Deposits by households and corporations now account for 60 % of total banking sector liabilities. With growth in domestic deposits, borrowing from the central bank has fallen sharply. At its peak in early 2015, CBR funding accounted for nearly 12 % of banking sector liabilities, but as of April that share had fallen below 4 %.

Even with bank profits affected by hikes in loan-loss reserves and reduced lending, banking sector liquidity improved this spring and interbank overnight rates trended below the CBR key rate. The CBR is monitoring the situation and prepared to intervene as needed. The minimum reserve requirement for forex deposits rises to 6.25 % on July 1.

China

Foreign investors still face too many hurdles in accessing mainland China stock markets. The international indices and analytics producer MSCI yet again decided not to include mainland China's yuan-denominated A-shares in its emerging markets (MSCI EM) index. Despite significant reforms, China's stock markets still do not fully meet international standards. In its annual review of market classifications, MSCI noted that in recent months Chinese officials have improved the rules on beneficial owners, improved quota allocation under the qualified foreign institutional investor (QFII) programme, eased capital mobility restrictions and enhanced regulation on voluntary trading suspension policies. Because the reforms have been implemented so recently, however, China has yet to establish a track record on the effectiveness of the changes.

A significant barrier to inclusion of Chinese A-shares in the MSCI EM index appears to be repatriation limits for invested assets and pre-approval restrictions imposed by Chinese stock exchanges on releasing international investment products containing A-shares. The thorniest problem for investors seems to be the 20 % repatriation limit, i.e. only a fifth of previous year's net value of QFII investments can be repatriated in a given month, which means it takes about five months to close out a position. MSCI EM index currently includes Chinese shares listed on the Hong Kong or US exchanges, and the shares have about 20 % weight in the index.

The fundamental barrier to access to Chinese stock markets is that international investors can only invest through special programmes with imposed quotas. As an example of this market access constraint, share prices for the same firm currently average about 35 % more on the Shanghai and Shenzhen exchanges than in Hong Kong. The linking of the Shenzhen and Hong Kong exchanges is set to begin shortly. Even if this improves access of international investors to the Chinese market, however, China's hoped-for inflows of foreign capital and investor knowhow into its financial markets have remained meagre since the Shanghai-Hong Kong process began in late 2014.

A- and H-share prices on Shanghai and Hong Kong exchanges



Source: Macrobond.

Fixed investment in China loses steam. Fixed investment growth accelerated a bit in early spring as the public sector ramped up infrastructure construction. Now it appears fixed investment growth has again slowed. Nominal growth in fixed asset investment (FAI) fell below 10 % y-o-y in January-May as growth in both public and private investment faded. Growth in private investment, which accounted for slightly more than 60 % of all FAI in the first five months of the year, slowed in May to around 1 %. Heavy industry investment fell rapidly in the northern parts of the country.

Production trends in May were in line with previous months. Industrial output growth has long remained around 6 % and the growth of retail sales this year has remained below 10 % in real terms, which reflects slowdown in average disposable income to 6.5 % y-o-y in 1Q16.

May price trends held few surprises. Consumer price inflation slowed to 2 %, and there was a slight rise in the core inflation rate (food and energy excluded). Although May producer prices were still lower than a year earlier, prices on a monthly level have risen for three months in a row.

Weaker outlook for European firms operating in China. The European Chamber of Commerce in China last week published its annual survey of member companies in China. The survey, conducted in February and March, drew responses from over 500 European firms operating in China. The firms reported that China's business environment had become increasingly hostile and that firms were more pessimistic about their prospects than earlier. In 2011, nearly 80 % of firms surveyed still expected their businesses in China to grow over the next two years. Last year, that share fell to 58 % and this year it was just 44 %. In addition, firms increasingly report that profit growth has stalled and that only 20 % of surveyed firms expect their profitability to improve over the next two years. Given the degraded outlook, fewer companies are considering expanding their operations in China and more are moving to slash costs.

About 70 % of responding firms said they were in China to serve the domestic market. The largest concern by far for firms remained the slowdown in growth of China's economy. The next biggest worries were rising production costs and slowing growth of the global economy. A large and still growing share of firms feel operationally challenged due to unpredictable regulatory shifts. Nearly 60 % of firms noted that tight Internet controls complicate their business. Notably, firms felt that China's anti-corruption efforts were successful and the share of firms still seeing corruption as a significant problem has become smaller.

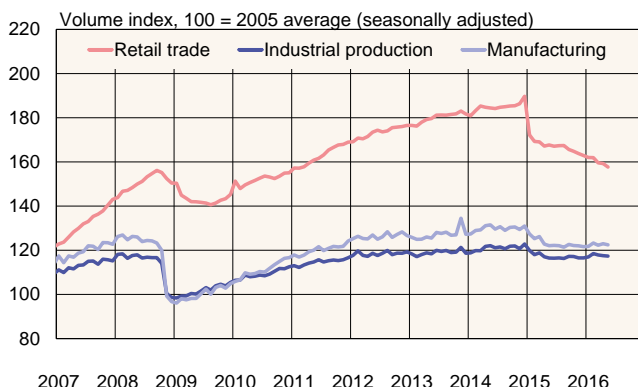
European industrial firms also suffer from China's overcapacity problems. The capacity utilisation rates in most industrial branches have fallen and 45 % of the surveyed firms remarked on significant overcapacity problems in their field. The firms felt that market-driven change and a level playing field with Chinese SOEs were the best ways to deal with overcapacity problems.

Russia

Russia posts weak economic figures for May. Several short-term economic indicators suggest growth has not yet returned to Russia. While May industrial output was up 0.7 % y-o-y overall and manufacturing 0.3 %, both showed seasonally adjusted contractions from April. Growth of extractive industries continued to slow in May, falling to 1.5 % y-o-y. Construction activity declined more sharply in May than in previous months and was down 9 % y-o-y.

The contraction in retail sales accelerated in May, with the volume of retail sales down 6 % y-o-y. Retail sales declined also in seasonally adjusted terms from April. Retail trade development largely reflects a contraction in real incomes. The average nominal Russian monthly wage in May was 36,600 rubles (€490), an increase of 6 % y-o-y. With inflation outpacing wage growth, real wages fell about 1 % and real disposable income (including pensions and various income transfers) was down nearly 6 %. May unemployment was 5.6 %, the same as the May 2015 figure.

Trends in retail sales, industrial production and manufacturing



Sources: Macrobond, Rosstat, BOFIT.

President Putin hits familiar themes in address to St. Petersburg Economic Forum. Among the priority themes of current economic policy, Putin stressed his vision of the Eurasian Economic Union as the driver of broad-based Eurasian integration. He noted also again the importance of import substitution policy and stated that the modernisation of Russian industry would be accelerated through legally requiring that from 2019 major manufacturers use only best-available technologies that meet the strictest environmental standards.

Most other themes of the speech were drawn from both of the main programmes for growth presented recently (see below). Putin stressed reducing the budget deficit and budget dependency on oil revenues. He set the long-term economic growth target of Russia to 4 % a year. This could be achieved, he noted, through e.g. increased labour productivity and a

better business environment. These themes have been reiterated for several years now, indicating Russia's leadership is well aware of the country's economic problems but still lacks practical answers to deal with them. Putin announced that he was establishing a presidential council on strategic development and priority projects to make reforms more effective and seeing that major projects get implemented.

Russia debates course of economic policy. The economic council led by the president is set to prepare over the next year a new economic policy programme for Russia that will extend through 2025. The work began at the end of May when two main expert-drafted proposals on restarting economic growth were presented to the president at the council meeting. While both programmes seek to increase the investment rate, their views on the roles of monetary and fiscal policy in supporting change are diametrically different.

The programme espoused by Alexei Kudrin, former finance minister and current deputy chairman of the economic council, calls for moderate monetary and fiscal policies. Kudrin said that Russia needs a stable macroeconomic environment to attract investment, which would be best achieved by balancing government finances and keeping inflation relatively low and stable. In the current policy framework, the central bank and the finance ministry are closest to this view.

The Stolypin club offered a completely different approach, which has been prepared under the lead of the club's chairman, business ombudsman Boris Titov. In addition, the part concerning monetary policy seems to reflect largely the views of president's advisor Sergei Glazyev. Under the proposal, investment would be supported through increased government spending and pumping central bank money into the economy. The goal of exchange rate policy would be to target a steadily depreciating ruble exchange rate, with limits, if needed, on currency exchange to prevent excessive depreciation. In the current administration, the economy ministry supports looser monetary and fiscal policy, but its views are much more moderate than those of the Stolypin club.

Both programmes are quite unanimous on the needed major structural reforms, despite some differences in emphasis. Both programmes call for improving the business environment, reducing the government's role in the economy, diversifying the production structure and increasing international openness. The import substitution policy currently popular with the leadership receives no support under either proposal.

The president has yet to take an official stance on the proposals and the discussion of the economic policy framework will continue at future council meetings. It has yet to be seen how much of an effect the programmes will have on actual economic policy. Recently, at least, economic policy has been overshadowed by domestic and foreign policy issues, as well as aspirations of economic independence. Policy choices important for re-establishing economic growth have taken a back seat.

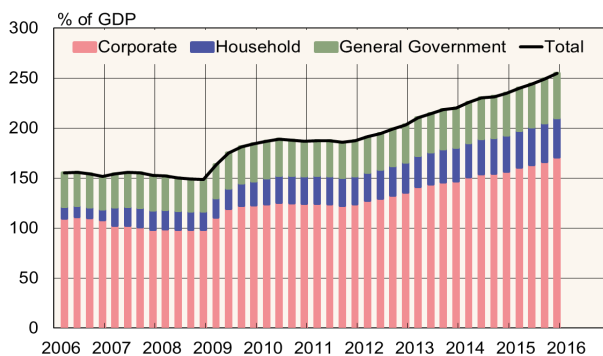
China

Rapid lending growth in China continues. China's own broad credit stock measure, total social financing (TSF), grew 13 % y-o-y in May. Credit growth remained stable throughout the first five months of this year, rising about twice as fast as nominal economic growth. Yuan-denominated bank loans, the largest of TSF's subsets, were up 14 % y-o-y. Lending of the shadow banking sector (trust and entrusted loans) showed high growth. The stock of forex-denominated loans continued to shrink, as yuan weakness and uncertainty over future exchange rate trends reduced borrower interest in new forex loans, and borrowers increasingly paid down debts in foreign currencies.

China adopted the TSF measure in 2011 to capture the rapid growth in non-traditional financing activity (i.e. the use of credit forms other than bank loans). Lately, however, doubt has been cast on the TSF indicator's ability to capture credit creation. Analysts at Goldman Sachs estimated at the beginning of this month that the volume of credit creation last year was about 30 % higher than the TSF figure.

The Bank for International Settlements (BIS) reports that China's total debt at the end of 2015 was equivalent to about 255 % of GDP, a level far higher than is typical for emerging economies. The ratio of corporate debt to GDP was 171 %, public sector debt 44 % and household debt 40 %. Because the state is also an active participant in the corporate sector, it is difficult to differentiate public-sector and corporate debt. The IMF, for example, puts China's public sector debt at around 60 % of GDP. Given the strong rise in borrowing in the first five months of this year, the debt ratio already likely exceeds 260 % of GDP.

China's debt structure



Source: BIS.

Despite years of incessant debt rise, China has made limited progress on tackling the issue. The IMF last week warned that China's government needs to promptly get a handle on already high – and rising – corporate debt to avoid serious problems. The IMF would like to see China move ahead with measures such as stricter budget constraints for state-owned enterprises, restructuring or closing down problem firms and

preparing to deal with the ensuing social costs. The experiences of other countries suggest that sustained rapid rises in credit growth are likely to end in financial market meltdowns and severe economic slowdowns or even economic contractions. The good news in China's case is that it may still manage to deal with its debt problems as nearly all debt is denominated in yuan and the state controls large financial buffers that it can deploy to avoid a systemic crisis.

Familiar themes get most play at annual China-US strategic and economic dialogue meeting. At the start of Barack Obama's presidency, China and the United States agreed on extending the ministry-level strategic dialogue of the two countries to include other pressing issues in addition to economic matters. At the latest meeting in Beijing this month, many of the topics discussed were the same as eight years ago. The tone of the final communiqué showed that discussions were between two major global powers.

In principle, the two countries share common views on what China needs to do to strengthen the role of the market in its economy. China confirmed its plans to increase the role of markets in determining the yuan's exchange rate and conceded that production needs to be cut in the steel industry and other industries suffering from overcapacity. This will be helped by China's commitment to ongoing deregulation of energy prices. China will continue to improve the quality of its economic statistical data collection and communication on economic policy. The problems with corporate cybersecurity continued to be on the agenda. Many of the issues mentioned during dialogue have already been addressed or at least noted in China's own programmes or at international meetings, so emphasis was mainly on strengthening reform policies rather than launching new initiatives.

China promised this spring to ease foreign investment to China by introducing a "negative list" that limits or bans outright the access of foreign firms to certain sectors. The Americans suggested that further reduction of the negative list is a threshold issue to finalising the key bilateral investment protection agreement. China last week delivered a whittled-down list, which Reuters reports still contained 35–40 sectors off-limits to foreigners (down from about 80 sectors earlier). Given the relative freedom Chinese firms enjoy in investing in the US, the Americans still feel the list is too long.

The US is about to revisit the issue of whether China finally fulfils the criteria for market-economy status. The common view is, however, that the status will not be granted. The status would make it more difficult to impose anti-dumping duties on Chinese products sold below their producing costs to the US markets. Just last spring, the US imposed, in line with its WTO commitments, very high additional tariffs on certain Chinese steel products. China wants its market status classification conferred automatically at the end of 2016 as it completes its 15th year of WTO membership. The EU Commission will review its assessment of China's market-economy status in July.

Russia

Brexit result has had only minor impact on Russian economy so far. The immediate effects of the UK EU referendum on the Russian economy are quite marginal at this point. Oil prices fell, the ruble lost ground a little, and Moscow share prices dropped slightly on news of the vote outcome last Friday (June 24). They all recovered this week. President Vladimir Putin and his top cabinet ministers commented the effects mainly by noting they expected the initial market reaction to pass within a few days, although e.g. economy minister Alexei Ulyukayev said heightened uncertainty from the Brexit vote will continue.

The impacts via real economy channels will only emerge gradually along with the Brexit process. The direct impact from Russia's trade with the UK will be small, given that the UK only accounts for around 2–3 % of Russian foreign trade. A much larger issue for Russia is how Brexit will affect economic growth in EU countries. The indirect effects of Brexit on the Russian economy and markets are hard to estimate in light of the great economic and political uncertainty surrounding the UK's departure from the EU.

Despite unprecedented budget-cutting, Russia posts large government deficits. Revenues to the consolidated government budget (includes federal, regional and municipal budgets plus state social funds) fell 3 % y-o-y in nominal ruble terms in the first five months of this year after having been essentially flat in 2015. Government spending has begun to adjust to the reduction in revenues. Expenditures measured in nominal rubles fell about 1 % y-o-y in January-May. The consolidated budget deficit amounted to 3 % of GDP, a deficit equal to that posted in January-May 2015. Given Russia's established pattern of increasing government spending towards the end of the year, this presages a larger consolidated budget deficit for 2016 as a whole unless the federal government and regions take additional budget-cutting measures. For all of 2015, the deficit was 3.8 % of GDP.

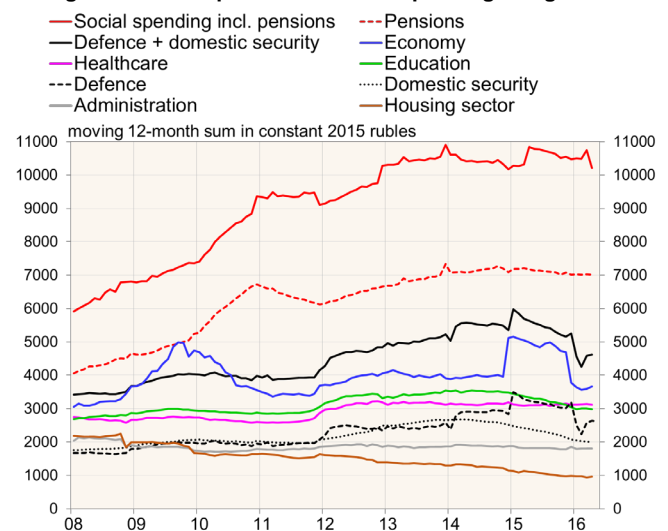
Despite a clear slowdown, inflation remains quite high and continues to erode purchasing power. For government spending, the most important figures were the 8 % y-o-y rise in consumer prices in January-May and 3.5 % y-o-y increase in industrial producer prices. The figures for all of 2015 were slightly over 15 % and slightly over 12 %, respectively. Therefore, government spending contracted substantially in real terms already last year. Over the past twelve months, spending has been around the spring 2012 level. This was the first decline in spending in real terms since 1999.

Government spending has not contracted in real terms in all main categories, however. In large social spending outlays, such as pensions, the exceptionally meagre increases of the benefits this year are only now beginning to show. The ongoing health insurance reform has sustained healthcare spend-

ing. For the moment, spending on government administration has also contracted a relatively small amount.

In contrast, the earlier upward trajectory of defence spending has turned sharply downward this year, reflecting what was decided when the federal budget was approved. Spending on domestic security and order have continued to diminish and are back to 2011 levels. Spending on education has been squeezed quite strongly, and in a few other main spending categories some of the heaviest spending cuts have been borne by research and development budgets. Russia's government spending has not provided economic stimulus comparable to the 2009 recession (with the exception of the large lump of bank support disbursed from the federal budget in December 2014).

Real government expenditure in main spending categories



Sources: Ministry of Finance, Rosstat, BOFIT.

Shanghai Cooperation Organization meets in Tashkent. The Shanghai Cooperation Organization (SCO), founded in 2001, consists of Russia, China and four Central Asian countries (Uzbekistan, Kazakhstan, Kyrgyzstan and Tajikistan). The heads of the six member countries gathered for the annual SCO summit last week in the Uzbek capital of Tashkent. Ahead of the summit, many observers expected the SCO to grant full member status to India and Pakistan. The final summit communiqué, however, only noted that terms of membership had been agreed. Countries with observer status include India, Pakistan, Afghanistan, Iran, Mongolia and Belarus. The summit also recognised Azerbaijan, Armenia, Cambodia and Nepal as cooperation partners. The official languages of the SCO are Chinese and Russian.

The goal of the SCO is to promote inter-state cooperation in the political, economic and security spheres. The tangible achievements of the SCO to date have been quite modest. China's focus is on deepening economic and energy cooperation, while Russia has sought to promote more the fight against terrorism and security issues.

China

Chinese economy faces little immediate fallout from Brexit vote. China's currency markets seem to have been most affected by the outcome of June 23 UK referendum on the EU. Unlike the world's major stock exchanges, stock market reaction to the vote was quite modest in China. The largest immediate impact of the vote has been a general increase in uncertainty in global markets. Last Friday (June 24), the People's Bank of China issued a short statement noting that it had measures in place to deal with a possible Brexit shock to the markets. It is expected that the short-term negative effects of Brexit to China will be smaller than for other large economies. In coming months, Chinese consumers and investors could even benefit from the weak pound as the costs of travel to Britain and prices of British investment assets may fall.

Over the longer term, the biggest impacts on the Chinese economy will likely relate to how Brexit affects economic growth and export demand in Europe. The EU is China's most important trading partner, accounting for nearly 15 % of the value of Chinese goods trade. The UK accounts for about 16 % of Chinese goods exports to the EU and about 3 % of China's total exports.

China's relations with the UK are generally regarded to be stronger than its relations with most EU countries. The UK has provided a channel for Chinese firms seeking to penetrate European markets. Chinese firms have also invested heavily in the UK. Chinese figures show that a fifth of all FDI flows to Europe in 2010–2014 went to the UK. London is Europe's yuan-trading centre and has played an important role in promoting international acceptance of the yuan. The impacts of the possible split with the EU on the UK's position has yet to be seen.

In a big picture, China has unquestionably been a net beneficiary of globalisation trends. Some observers have expressed worries that the referendum outcome may reverse the globalisation trend and cause countries to turn inward and increase the use of protectionist measures.

Yuan weakens against the dollar. The PBoC has allowed the yuan to depreciate fairly swiftly over the past three months. The yuan has lost 3 % of its value against the dollar since end-March, and currently is plying levels not seen since 2010. On Monday (June 27), with the dust from the UK Brexit referendum beginning to settle, the PBoC set its daily average dollar fixing rate about 1 % weaker than its Friday posting. On Thursday (June 30), the market exchange rate in mainland China (onshore yuan or CNY) was 1 % weaker than a week ago and one dollar bought 6.64 yuan. Some market participants believe that the central bank intervened in the forex markets over the past week to stabilise the yuan's exchange rate. The movements of the Hong Kong offshore exchange rate (CNH) this week have been slightly larger, but the CNH rate is also down about 1 % from last week.

The underlying causes of the yuan's depreciation are the strong dollar and the PBoC's gradual shift to the use of a multi-currency basket to track the yuan's external valuation. Following the announcement of the Brexit result, the central bank said that it planned to keep the yuan's exchange rate "basically stable." While exchange rate stability is a fairly loose term, it is clear that yuan exchange rate flexibility will increase with the opening up of China's financial markets to the world. Increased exchange rate volatility in this case is a positive signal that China is progressing towards a floating yuan. The trend also increases China's need to enhance communication of its exchange rate policy.

Yuan-dollar onshore and offshore exchange rates: CNY (Shanghai) and CNH (Hong Kong)



Source: Macrobond

Chinese presence in energy projects in Russian Far East set to increase. As before, during president Vladimir Putin's official state visit to China on Saturday (June 25) dozens of agreements for various areas were signed and the leaders stressed the importance of bilateral economic cooperation and strategic partnership. Energy projects dominated the economic dialogue. Russian state oil company Rosneft penned a crude oil supply contract and framework agreements on including Chinese firms in energy projects in Russia's Far East. Rosneft agreed to get China National Chemical Corporation (ChemChina) involved with 40 % stake in a planned project to build a multi-billion-dollar petrochemical complex in Russia's Far East.

Despite the many economic agreements signed during state visits and their high collective value, many projects have either stumbled or never been realised. As a result of falling oil prices, Russian firms have found it increasingly difficult to finance necessary capital investments, which has helped Chinese firms insinuate themselves into Russian projects with partial equity ownership. For example, the Russians for some time now have been trying to sell a combined 20 % stake in Rosneft to Chinese and Indian oil companies.

Talks continue on a bullet train project spanning a 770-kilometre route between Moscow and Kazan. The Chinese want to play a central role in construction and financing of the project as China needs a successful bullet train project overseas to showcase its capabilities. Its bullet train projects in Mexico, the US and Indonesia are cancelled or on ice.

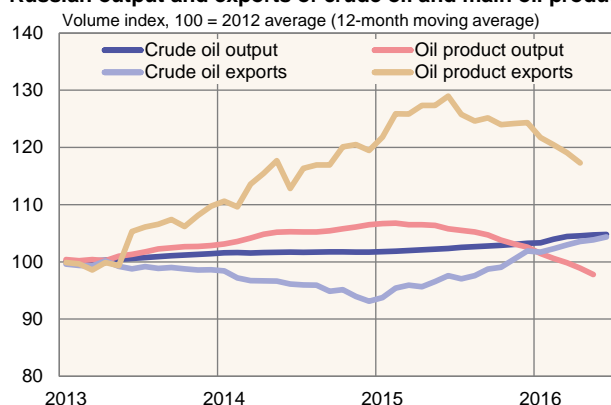
Russia

Russian oil production growth slows. Preliminary figures from Russia's energy ministry show oil output (incl. gas condensates) grew 2 % y-o-y in the first half of 2016. Output growth has slowed in recent months, with June on-year growth slightly above 1 %. Most forecasts expect Russian oil output to rise about 1 % this year.

Production growth has come largely from smaller oil companies such as Tatneft and Bashneft. Although it only accounts for a small share of Russian oil production, the oil output of gas producer Novatek has soared this year with the opening of a new field. Output has declined for Russia's biggest oil producers Rosneft and Lukoil.

Crude oil exports have also increased this year, but the pace has been slowing slightly. The energy ministry estimates that the volume of crude oil exports was still up 7 % y-o-y in the first half of 2016. In contrast, exports of oil products have declined sharply this year due to e.g. duty hikes.

Russian output and exports of crude oil and main oil products



Sources: Rosstat, Ministry of Energy, Russian customs

Debate on oil taxation continues in Russia. The finance ministry has prepared a proposal that calls for shifting the emphasis from taxing production and exports to taxing oil company profits. The approach has long been recommended to Russia as it would encourage greater investment in production than the current tax model. The finance ministry estimates that the tax model would lead to a slight reduction in oil company tax burden and lower budget revenues. Changes in oil taxation have been under discussion all year, but no decisions are expected before autumn at the earliest.

The previous overhaul of oil taxation took place at the end of 2014, when it was decided to gradually shift the tax emphasis from exports to production. High export duties on crude oil were considered to result in artificially low crude prices for domestic and Belarussian oil refiners (export duties are not applied to trade within the Eurasian Economic Union). The government also decided to direct export duties more on less refined oil products in order to discourage their exports.

Most Russian oil tax earnings come from the mineral extraction tax (MET) and export duties. The MET consists of a base rate on produced tonnage and multiplier factors derived from world market oil prices, the ruble-dollar exchange rate and certain factors related to production site characteristics. Crude oil export duties also include a base rate and a variable component that depends on the world market price of oil. Export duties on oil products are based on the crude oil export duty (this year they range from 40 % to 82 % of the crude oil export duty depending on the product). Under the 2014 tax revision, the government decided to gradually raise the MET and lower most export duties. This year's planned reduction in the crude oil export duty was abandoned, however, due to lower-than-anticipated budget revenues.

Oil companies, of course, also pay general taxes like profit tax and excise taxes. It has been estimated that as much as 90 % of oil company profits go to taxes. The collapse in oil prices, however, has reduced the relative contribution of oil & gas revenues to the federal budget. In the first five months of this year, they accounted for 36 % of budget revenues. In 2014, oil & gas still provided over half of revenues.

Some tax rates on Russian crude oil and oil products

	2014	2015	2016	2017
MET base rate, RUB/t	493	766	857	919
Crude oil export duty, % of oil price in excess of \$25/bbl (on top of the base rate of \$4/bbl)	59	42	42	30
Export duties on select oil products, % of crude oil export duty				
Light oils	65	48	40	30
Gasoline	90	78	61	30
Fuel oils	66	76	82	100

Sources: Ministry of Finance, Rosneft

EU and Russia decide to keep sanctions in place. The EU last week decided to continue sanctions on Russia through January 31, 2017. These sanctions were first imposed on August 1, 2014 in response to Russia's involvement in Ukraine. The sanctions restrict access of certain Russian firms and banks to financing, ban arms trade, as well as limit exports of dual-use goods and oil-production-related products and services. The EU has announced it will lift the sanctions when the conditions of the Minsk accord are in place.

For its part, Russia will continue bans of food imports from e.g. the EU, US, Norway and Ukraine through December 31, 2017. In addition, Russia has extended its restrictions on transit transport from Ukraine to Kazakhstan and Kyrgyzstan. Ukraine this week said it would keep in place its Russia sanctions to the end of 2017 and that it plans to react also on the extended transport restrictions.

Russia has lifted its ban on arranging tours to Turkey and said it will review the possibility of lifting other sanctions on Turkey as president Erdogan has apologised for the shooting down of a Russian fighter jet last November.

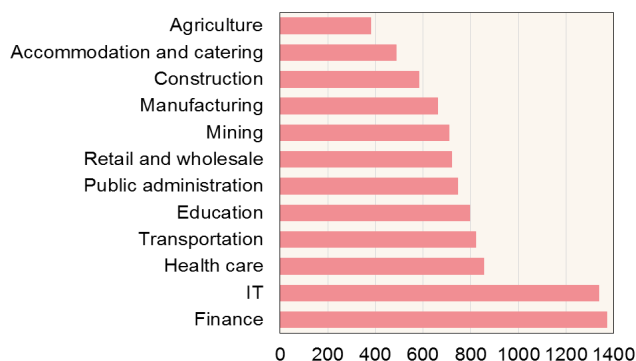
China

Rapid rise in Chinese wages continues. China's National Bureau of Statistics (NBS) reports that the average monthly wage in urban areas rose about 10 % last year to 5,170 yuan (€740). The rise in nominal wages picked up slightly. Mainly due to falling inflation, the rise in real wages accelerated to nearly 9 %. Wage trends varied considerably across branches. The fastest wage rises were seen in education (18 %) and public administration (17 %), while average wages fell 4 % in the mining sector. Highest average wages by far continued to be paid in the financial and IT sectors. Rural wage growth last year was slightly higher than in cities, but the average rural wage is still well below the average urban wage.

The acceleration in nominal wage growth has raised doubts about the reliability of Chinese wage data. Household survey data suggest that nominal wage growth has slowed to 8 %. Even with problems stemming from incomplete coverage and inaccurate reporting, it seems clear that wage growth remained strong last year. Wage growth this year is expected to hold at about the same pace as last year.

Minimum wage adjustments across China also reflect the rapid rise in wages. Over the past five years, the average minimum wage has gone up about 12 % a year, about one percentage point faster than the rise in the average urban wage. Minimum wages vary considerably across provinces and even within provinces. The highest minimum wage is in Shanghai (2,190 yuan a month; 21 yuan an hour) and the lowest in certain prefectural-level cities in Guangxi province (1,000 yuan a month; 9.5 yuan an hour). Regions set minimum wages on their own, but government rules require wage levels must be reviewed at least every two years. Many regions adjust their minimum wage every year.

Average urban-area monthly wages by sector in 2015, in euros



Sources: CEIC, NBS

Compared to other countries, the rise in wages and average wage levels in China has been brisk. For example, wages in many industrial branches already exceed those of most countries in Southeast Asia. Office worker wages have also

made substantial gains. The consulting firm Willis Towers Watson (WTS) noted last spring that white-collar workers earn considerably more in China than in emerging economies in Southeast Asia. WTS estimates that the entry-level wage for a white-collar worker in China is about 30 % of the US level and that top management pay in China is nearly on par with the US.

Annual report of China's central bank stresses need to keep on with financial reforms. The People's Bank of China's 2015 annual report released last month emphasises reforms to further open up China's capital markets and increase yuan convertibility. Initiatives include the QDII2 programme that would give qualified individual Chinese investors an opportunity to invest directly in international markets. Existing investment programmes are directed towards institutional investors and private investors are limited to investing overseas via fund management companies or banks. The exchange-rate mechanism will also be improved and markets are given a bigger role in setting interest rates.

The PBoC aroused international attention when it said it was considering the possibility of allowing trading of foreign firm shares in China. Qualified foreign firms would be permitted to issue depository receipts (a standard way for firms to issue shares outside their home countries). The central bank did not, however, give further details or a time frame for the reform plan.

The PBoC said that monetary policy will become more flexible, but more targeted this year. The PBoC characterises its monetary stance as "prudent," a term it has used since 2011. The central bank also promised to improve communication to increase policy transparency.

China's NBS updates GDP calculation methods. Under the new method of GDP reckoning, corporate spending on research & development activities is treated as gross fixed capital formation rather than consumption. Following the change, China's gross domestic product is about one per cent larger than earlier stated. The NBS said that the impact on GDP growth is marginal. Last year's growth figure remained at 6.9 %, and 1Q16 annual growth at 6.7 %. The NBS this week announced the change and published revised annual GDP figures going back to 1952. Following the change, 2015 GDP increased from 67.671 trillion yuan to 68.551 trillion yuan. The change also slightly reduced the share of domestic consumption in the economy. At this stage, the new accounting method applies only to national, not regional, GDP figures.

Under the revised system, R&D activity is recorded following the newer international SNA 2008 standard. China's national GDP accounting is not fully compliant with many of the newer standards. It is estimated that it still e.g. underestimates the contribution of services to the economy. The NBS recently said it was looking at ways to improve national accounting to better incorporate "new economy" branches such as biotechnology, online retail and robotics.

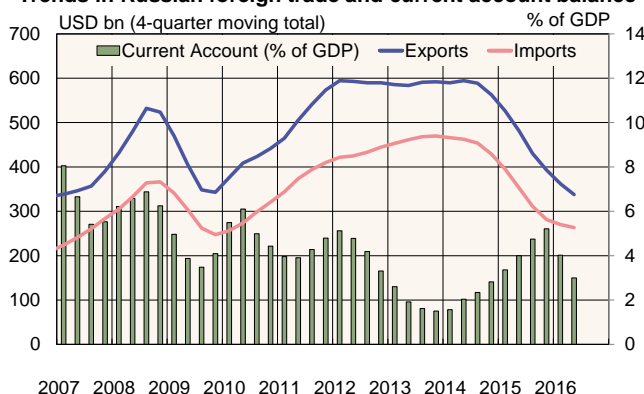
Russia

Contraction in Russian foreign trade and capital outflow slowed down.

Preliminary balance-of-payments figures show the value of Russian imports shrank 10 % y-o-y in dollar terms during April-June. Goods imports were down 5 % y-o-y, while services imports plunged by over 20 %. Among the hardest hit were travel services, which were still down by more than a third in 2Q16. Largely due to low oil prices, the dollar value of Russian exports contracted on-year by a quarter in April-June. Oil & gas exports declined by about a third on-year, while other exports were off by about 15 %. With a more substantial decline in exports than imports, Russia's current account surplus contracted in the first six months of the year to \$16 billion, a level on par with 2009.

Mainly as a result of Russia's falling foreign debt, the net outflow of private sector capital continued to slow in April-May. Banks continued to pay down their foreign currency debts and repatriate assets from abroad. For other firms, both direct investment inflows and outflows were up slightly, but the levels were quite modest – just over \$6 billion. Total private sector net capital outflow in 1H16 was just over \$10 billion compared to over \$50 billion a year ago. The Central Bank of Russia expects the private sector net capital outflow to reach \$25 billion by the end of the year.

Trends in Russian foreign trade and current account balance



Sources: Macrobond, CBR, BOFIT.

Russian state reduces stake in diamond giant Alrosa.

In a secondary public offering (SPO), the government sold off mostly to Russian and European investors a 10.9 % stake in the diamond company. After the sale, the Russian state owns a third of Alrosa, the regional and local administration of Sakha Republic a third, with the remainder now freely traded. The divestment sale raised 52 billion rubles (€700 million) for the state coffers.

Alrosa has been on the privatisation list for years, i.e. a state-owned company in which the government plans to reduce its participation. Implementation of privatisation sales has been repeatedly postponed in recent years due to unfavourable market conditions.

This year's tight budget, however, seems to have speeded up the sales. Russia's government estimates that selling off its stakes in various enterprises this year could provide as much as 1 trillion rubles to cover the budget deficit. In 2014 and 2015, income from privatisation sales amounted to a modest 7–8 billion rubles, as the government was reluctant to sell stakes in any large firms.

Deputy prime minister Shuvalov noted that this year's planned sale of a 10.9 % stake in VTB Bank, at least, would still be postponed to next year. The decision to hold off on the sale may reflect the fact that VTB remains subject to EU and US financial sanctions. Shuvalov stated that the state plans this year sell off stakes in shipping company Sovkomflot and oil company Bashneft. The sale of a stake in Rosneft is also under discussion. The government is interested in finding strategic investors and Shuvalov does not rule out the possibility of selling Bashneft shares to Rosneft. The privatisation programme approved for 2014–2016 also seeks reductions in state participation in such firms as state airline Aeroflot, rail company RZD and pipeline operator Transneft, but they have not appeared much in sales discussions this year.

The role of state-owned enterprises in the Russian economy is significant and has even increased in recent years. SOEs provide about 30 % of all jobs and account for 40 % of the net sales of the country's 600 largest firms.

Russia seeks ways to reduce grey pay. Facing budgetary shortfalls, the government is trying to increase revenues also by improving tax collection. Finance minister Siluanov has noted that grey wages cause a huge loss of tax revenue, perhaps as much as 1.5-2 trillion rubles (2 % of GDP) a year. The finance ministry and tax administration are now considering ways to get a handle on undeclared income, including reviews of financial sources of large household purchases such as real estate. Earlier a limit to cash transactions was also proposed, but that seems to be dropped. Russia's 13 % flat income tax applies to wages and most other forms of household income.

Some 15 to 30 million Russians (20–40 % of employed persons) are estimated to work in the grey economy. Rosstat estimates that 13–14 million people work solely and another 1-2 million partly in the unofficial sector. Corresponding estimates of Russia's Presidential Academy of National Economy are 9 and 20 million. Surveys of the Academy of National Economy and VTSIOM found that in recent years about 10–15 % of workers received all of their wages under the table, while about 15–20 % has a portion of their wages paid under the table. Half of Russians said they had paid for services or work under the table.

Rosstat GDP figures include an estimate of the grey economy i.e. legal, but unrecorded, economic activity. The estimate does not include criminal activity such as trafficking in illegal drugs. In the first part of 2000s, Rosstat estimated that Russia's grey economy accounted for 20–25 % of GDP and that in recent years that share has declined to around 15 % of GDP. Statistics Finland's estimate for Finland is 1–2 %.

China

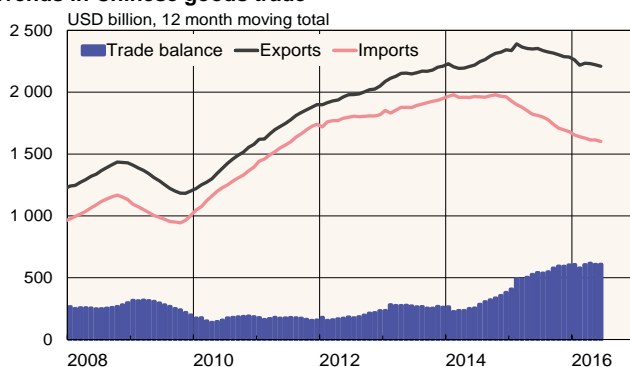
China's foreign trade continued to falter in first half.

China's general administration of customs reports the dollar-value of goods exports fell 8 % y-o-y in the first half of 2016 and that the value of goods imports was down 10 % y-o-y. The value of foreign trade in June remained at the May level, but exports were still down 5 % y-o-y and imports 8 %.

Contradiction in trade value stemmed largely from low commodity prices and a decline in the yuan's exchange rate. The value of exports in yuan terms fell 1 % and the value of imports 4 % in the first half of the year. The volume of goods trade did not contract, however. Chinese official January-May figures show the volumes of exports and imports on-year were up by a few per cent. Import volumes of many major commodities were up in the first half, including crude oil (rising 19 % y-o-y), copper (26 %), coal (11 %) and iron ore (10 %).

With expectations of yuan depreciation, foreign trade pricing schemes, whereby companies exaggerate import invoices to ship capital out of the country, have again come to the fore as a means of circumventing capital controls in the first half. Chinese official statistics report a value for imports from Hong Kong during January-May that is 2.5 times higher than a year ago. In the same period, Hong Kong figures show the value of exports to China fell. Imports from Hong Kong account for about 1 % of the total value of China's imports.

Trends in Chinese goods trade



Source: Bloomberg

International court finds no historical basis for Chinese territorial claims over the South China Sea. In 2013, the Philippines took China to international arbitration court in the Hague over violations of the United Nations Convention on the Law of the Sea (UNCLOS). On Tuesday (July 12), the 5-member UN arbitration panel ruled in favour of the Philippines. China asserts that its "nine-dash line" demarcation of an area covering most of the South China Sea is based on historical rights. The tribunal, however, said it could find no legal basis for the claim. The panel further noted that none of the features claimed by China in the Spratly Islands met the definition of an island under UNCLOS, giving no right to claim an exclusive economic zone that gives rights to extract

natural resources from the surrounding sea and seabed. The ruling is binding, but the tribunal has no power to enforce it.

It was the first time a court took a position on a territorial dispute in the South China Sea. China did not participate in the proceedings, claiming the arbitration panel lacked jurisdiction over the matter. China announced already before the ruling that it would not give credence to any ruling of the panel. It would rather like to seek to resolve differences on a bilateral basis. Besides the Philippines, Brunei, Malaysia, Taiwan and Vietnam also have territorial claims in the region that partly overlap China's. The South China Sea has some of the world's busiest shipping routes, as well as significant fishing waters and large oil & gas potential.

China strengthens its position as the world's largest market for industrial robots.

The International Federation of Robotics (IFR) reports that about 248,000 industrial robots were sold globally last year, an increase of 12 % from 2014. China has led the global robot market since 2013. New robot sales climbed to 67,000 last year (an increase of 17 % y-o-y) and China's share of the global industrial robot market rose to 27 %. Asian technological status is reflected in the fact that after China the next biggest markets for robot sales are South Korea (15 % globally) and Japan (14 %). The US accounts for 11 % of the industrial robot sales and Germany 8 %. In 2015, industrial robot sales to China exceeded the sales to all of Europe, even if European sales rose 10 % to about 50,000 units.

Car manufacturers have led the push for industrial automation globally. They accounted last year for 38 % of robot sales, but the volume of growth in robot sales today is slow. While the number of robots working in China's car industry has risen rapidly, vast growth potential remains. The IFR reports that in 2014 there were just over 300 robots per 10,000 workers at Chinese carmakers, while carmakers in Japan had over 1,400 robots per 10,000 workers.

China has also risen rapidly among global robot manufacturers. Nearly a third of all industrial robots sold last year in China were manufactured locally. Although Chinese robot makers still mainly produce systems for fairly simple application, they aspire to advanced robotic capabilities. China's home appliance giant Midea this week announced it was acquiring a 50 % stake in the German Kuka, the world's largest manufacturer of industrial robots. The deal will increase its stake in Kuka to 64 %. Reuters reported last month that China's largest industrial robot maker Siasun is looking to acquire firms in Europe. In June, a Chinese-European investment fund purchased an Italian robot manufacturer.

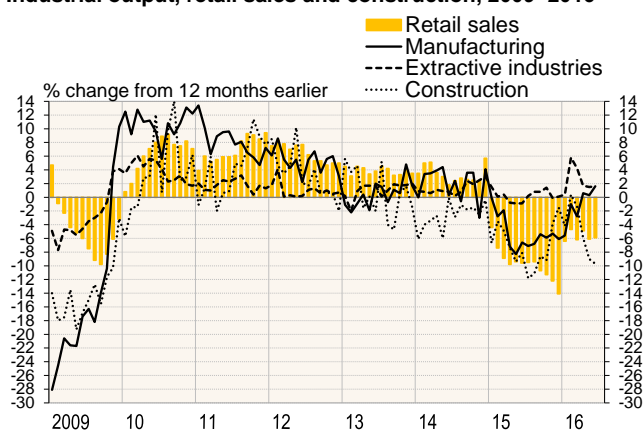
China's rapid and continuous technological advancement was also evident last month when Chinese supercomputer Sunway TaihuLight took first place in the TOP500 supercomputer speed rankings. The Chinese already held the top position, but the latest breakthrough involved switching out traditional Intel processors with locally developed ShenWei processors. The new processors, however, slightly restrict the range of TaihuLight application areas compared to competing models.

Russia

Russian producers feel hints of recovery, though consumption continues to fall. Seasonally adjusted industrial output increased 0.3 % in June from May. Industrial output has bobbed up and down this year, and was up 0.4 % from December mainly on the June gain. Whether a solid recovery is underway will become clear in the coming months. Industrial output was up 1.7 % from June 2015, with most of the increase coming from higher crude oil production. Oil production gains were especially strong in early months of this year, but slowed as summer approached. In contrast, output in manufacturing and the electricity sector recovered with the onset of summer. Manufacturing has gained especially from food processing and chemical production both of which continued to grow. Goods transport, including pipeline transmission of oil & gas, has increased since last summer.

The volume of seasonally adjusted retail sales fell further from May to June, the 18th consecutive month of sales volume declines. Retail sales for May-June were down 6 % y-o-y and down as much as 15 % from two years ago. The drop has been very similar for food sales and non-food retail sales, even if some observers have argued for some time that a slightly larger share of food sales now goes unrecorded in statistical data. Statistical uncertainty is around as about half of the data on value-added from agricultural production is assembled by means of other type of entry methods than direct statistical reporting. Real household incomes fell again in June as inflation remained rather brisk, with consumer prices up 7.5 % y-o-y. Construction activity continued a decline that started about three years ago.

Industrial output, retail sales and construction, 2009–2016



Source: Rosstat

IMF emphasises fiscal policy and banking sector reform in latest Article IV consultation with Russia. In its latest [country report for Russia](#) based on the annual Article IV consultation, the IMF emphasised the importance of balancing government budgets in the next few years. Still, it

noted that Russia's current fiscal consolidation may be too steep and hoped for better targeting of spending cuts. IMF experts recommend that Russia rely more on borrowing to finance its budget deficits in order to preserve more assets in the Reserve Fund to deal with unanticipated liquidity crises. The IMF further encouraged Russia to reinstate its three-year budget framework and a budget rule, and stressed that pension system reform was inevitable to creating balanced budgets.

On the monetary policy side, the IMF noted that the Central Bank of Russia could proceed with gradual easing as inflation risks subside, but should proceed prudently.

Among its recommendations for the banking system, the IMF would like to see enhancements in stress testing of banks, a review of banks' asset quality, as well as further development of banking supervision and bank regulation. In particular, the operations of state development bank VEB deserve improvement. The IMF estimates that capital support needed to prop up the Russian banking system could reach 0.5–1 % of GDP at oil prices broadly around \$50 a barrel. If the oil price falls to \$20–\$30 a barrel, it could push, according to IMF stress tests, that requirement to 4.5 % of GDP. In addition, the support needed for VEB could reach 2 % of GDP in coming years.

The IMF repeated its call that structural reforms are inevitable to support future growth and encouraged e.g. to reduce unwarranted administrative pressures on businesses, strengthen property protections, improve education and sustain infrastructure investment.

Russian authorities were largely in agreement with the IMF when it comes to balancing budgets, pension system reforms and the importance of structural reforms.

Russia's foreign currency reserves grew in the first half of the year. The value of Russian foreign currency reserves as of end-June stood at \$393 billion, an increase of nearly \$25 billion from end-December 2015. Most of the growth came from exchange rate changes and banks' repayments of forex repo contracts to the central bank. The CBR has made no direct buy or sell interventions in the forex markets since July 2015.

At the end of last year, the CBR's foreign currency and gold reserves held about \$50 billion in gold. Some 43 % of the other reserves were dollar-denominated assets, 40 % euro assets and 11 % British pound assets. The remaining 6 % of assets were in other currencies e.g. Canadian dollars. The share of euro-denominated assets fell notably last year, to below the level two years ago. Conversely the share of dollar-denominated assets rose almost the same amount. Some 83 % of currency reserves was invested in sovereign bonds of other countries, mainly the US, France and Germany. As earlier, about 23 % of all investment was in high-grade (AAA) assets, and 67 % in AA-grade assets (72 % at the end of 2013). The remaining 10 % was in A-grade or ungraded assets (a little over 4 % two years ago).

China

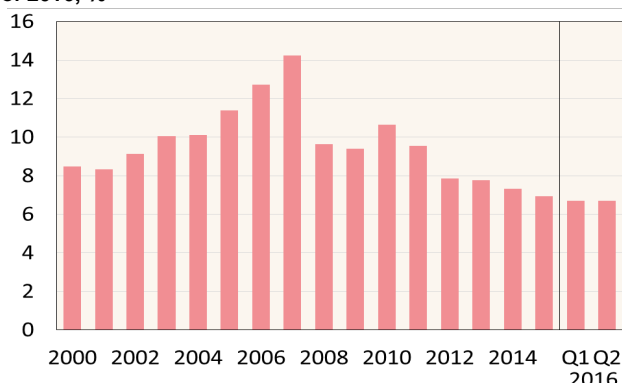
China's shows steady growth in second quarter.

China's National Bureau of Statistics reports that GDP grew 6.7 % y-o-y in real terms in the second quarter, a growth pace identical to the first quarter. Given the challenges China faces in its domestic and foreign markets, many observers had expected growth to slow. Thus, the announced figures slightly exceeded forecaster expectations. China's GDP growth target is 6.5–7 % for all of 2016.

There are strong indications that a structural shift in the Chinese economy is taking place. Service sector 2Q growth was again clearly higher than growth in the manufacturing and construction sectors, and services generated 54 % of economic activity. Strong domestic consumer demand was reflected in stable 10 % y-o-y real growth in retail sales, which is supported by robust, continued wage growth. In particular, online shopping is increasingly popular among consumers.

Real growth in fixed investment this year has increased by about 10 % y-o-y, a clearly slower pace than in recent years. Moreover, investment growth has been sustained mainly through public sector spending on fixed assets, which has risen a brisk 20 % y-o-y. Especially spending on infrastructure projects has grown rapidly. Growth in private investment, on the other hand, has slowed all year and in June real growth was only about 2 % y-o-y. The slow pace in private investment growth likely stems from several factors, including cautious expectations about the domestic economy, weak export demand, overcapacity problems in many industries and the need for indebted companies to tackle their debt problems.

Real growth in Chinese GDP, 2000–2015 plus first two quarters of 2016, %

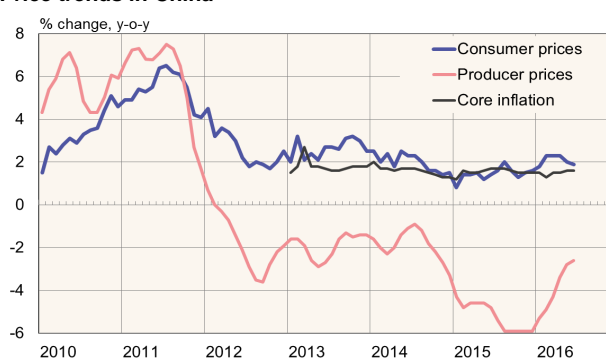


Sources: China National Bureau of Statistics and CEIC

Chinese inflation down a bit. The NBS reports consumer prices rose 1.9 % y-o-y in June. Inflation has slowed slightly during the past few months. Most price movements have come from food prices (e.g. meat prices are up about 20 % y-o-y in June), while the core inflation (inflation excluding

prices of food and energy) has remained rather stable at around 1.6 % since the first half of 2015. Producer prices, in contrast, have witnessed a slight abating of the deflationary spiral that began in 2012. Given that inflation is well below the official government 3.5 % target, certain circles have suggested that now is the time for monetary easing. For monetary policy-setters, however, the challenge is balancing inflation-fighting gains against the many other goals of Chinese monetary policy.

Price trends in China



Sources: China National Bureau of Statistics and Macrobond

Foreign banks pulled back on their China lending last year.

The Bank for International Settlements (BIS) reports that cross-border lending to China declined by \$250 billion last year, down about 25 % from 2014. At the end of 2015, the stock of lending of foreign banks to Chinese entities amounted to \$760 billion. Cross-border lending globally fell by 3 % last year. The decline in China's cross-border lending was influenced by China's weak growth outlook and increased downside risk. Moreover, the drop in global commodity prices and weak foreign trade performance, which directly affected the volume of foreign trade financing.

In conjunction with the [BIS Quarterly Report, June 2016](#), BIS for the first time released information on the international activities of Chinese banks. The statistical data cover all commercial and investment banks located in China (including subsidiaries of foreign banks), as well as intra-group liabilities. The figures show that banks located in China are net borrowers on international markets. As of end-2015, banks had foreign liabilities of \$940 billion and foreign assets of \$720 billion. Part of this is explained by the fact that many Chinese banks are listed on foreign exchanges (including Hong Kong), where their market capitalisations on those exchanges are counted as foreign debt. In addition, foreign debt includes offshore yuan deposits held in Chinese banks (roughly \$440 billion at the end of 2015).

Even if the significance of Chinese banks as an international provider of credit has increased, only 3 % of all cross-border lending in 2015 originated from banks in China. Banks in China mainly make foreign loans in dollars (nearly 75 % of foreign lending as of end-2015).

Russia

Forecasts see smaller slide for Russian economy than earlier. Both the IMF World Economic Outlook update released this month and the July consensus forecast of various major forecasters see Russian GDP contracting around 1 % this year. Forecasts published in late spring and early summer were somewhat cooler, although the Central Bank of Russia already at that time projected the GDP would only drop about a half a per cent, and the economy ministry drew up an even milder outlook. Several forecasts expect the volume of Russian imports to contract 4–7 % this year.

A major factor behind the improved outlooks is an almost across-the-board upward revision of the oil price assumption. Forecasts now put the average price of oil this year in the range of \$40 to \$45 a barrel, with the price climbing to \$45–50 in 2017. Notably, Russia's economy ministry and the central bank are offering a slightly more cautious assumption of \$40 a barrel.

In addition, economy ministry estimates show Russian GDP this year fell only 0.9 % y-o-y in January-June, which was less than previous forecasts. Economic contraction was smaller on brisk growth in oil output, but it seems the GDP slide was mitigated especially by a milder fall of inventories, after inventories had declined strongly for a couple of years. This picture emerges from the first quarter GDP data and the wholesale sector that recovered through last spring.

Forecasts for Russian GDP growth in 2016 and 2017, %

	2016	2017
Russian economy ministry (5/16)	-0.2	0.8
Central Bank of Russia (6/16)	-0.7 – -0.3	1.1 – 1.4
IMF (7/16)	-1.2	1.0
World Bank (6/16)	-1.2	1.4
OECD (5/16)	-1.7	0.5
EU Commission (5/16)	-1.9	0.5
EBRD (5/16)	-1.2	1.0
Consensus forecast (7/16)	-0.8	1.2

Russia prepares for serious budget tightening. The government earlier this month gave its initial approval to the 2017–19 federal budget framework. Finance minister Anton Siluanov said the budget revenue forecast was based on a fairly cautious assumption of \$40 a barrel for Urals-grade crude oil and 2017 revenues would drop slightly even in nominal terms.

The federal budget deficit next year would be limited to slightly over 3 % of GDP (about the same as estimated for this year). Thereafter, following instructions by president Vladimir Putin, the target is the deficit would shrink by one percentage point of GDP annually.

Siluanov noted that the starting point for federal budget spending is this year's targeted nominal sum, after cuts from the budget approved last winter, which would remain the

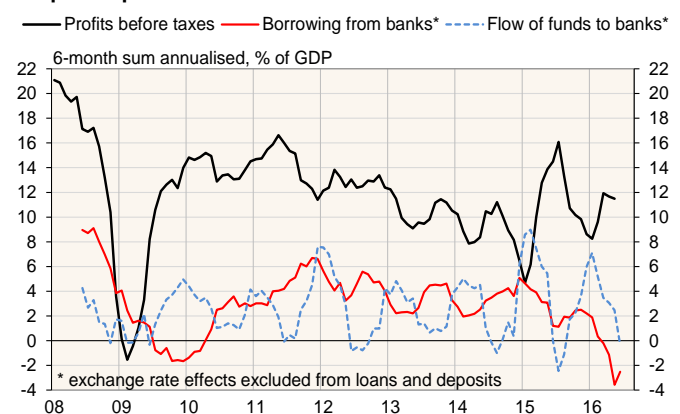
same in coming years. This would mean a further downward slide of government spending in real terms, even if spending has already declined by roughly 10 % over the past year and a half. Siluanov added that the government is set to safeguarding entitlements related to pensions and other social benefits, as well as public sector wages. He expects cutting budget spending in other categories will be an exceptionally challenging task.

Increase in profits of Russian firms supports capital flows abroad and to banks. Despite a recessionary economy, profits of Russian companies were up again in January-May relative e.g. to companies' business turnover and GDP. Profit data is based on Rosstat figures that aggregate firm-level numbers determined according to Russian bookkeeping standards. By that measure, profits have risen to levels not seen since 2012–13. The surge in profit this year reflects another slide in the ruble's exchange rate. The ruble fell rather continuously from summer 2015 to early 2016, which fuelled profits of export firms, in particular. The largest sums of profits were seen in almost all of the same branches as in early 2015, i.e. oil production, metal refining, chemical production and wholesale activities. Food industry profits were also up. Not surprisingly, these fields are also among the most profitable in Russia.

Higher corporate profits have yet to induce a recovery in domestic investment. Even if far less than in previous years, flows of outbound corporate sector assets have remained quite notable this year and last. Outbound flows have consisted mainly of direct investment and granted credit.

Otherwise, companies have shifted a couple of times the focus of their assets allocation to financial activities during this recession. In the first half of 2015, firms concentrated on paying down foreign debt. In the second half of 2015, the focus was on restoring their funds at banks. The theme of the first half of 2016 was reducing indebtedness to domestic banks. Reminiscent of the behaviour of households last year, companies became net lenders to banks.

Corporate profits and flows of their bank assets and credit



Sources: Rosstat, Central Bank of Russia and BOFIT.

China

Forecasters largely agree on trends in China's economy. The latest forecasts of major international institutions and commercial banks see the Chinese economy growing about 6.5 % this year, a level of growth well in line with the government's official GDP growth target. The lion's share of forecasters see growth slowing to around 6–6.5 % next year. Most forecasts this year have seen little adjustment. In fact, the current figures almost exactly match those of January.

Although it is expected that China's growth to remain strong in the near-term, all forecast bodies emphasise that uncertainty has been increasing. Growth this year has been supported with the usual means such as increasing government spending on infrastructure projects. Government led growth funded with borrowed money, however, only aggravates economic imbalances, which might unwind in a manner that causes disruption to the economy and leads to a sharp slowdown in growth. Forecasters also are in near-universal agreement on China's long-term growth outlook. They expect economic growth to slow as China's labour force begins to shrink, economic structures evolve and productivity gain become harder to come by as the country approaches the technology frontier. BOFIT releases its next forecast for China in September.

Select GDP growth forecasts for China, 2016–2017, %

	2016	2017	Released
BOFIT	6	6	3/2016
BBVA	6.4	5.8	7/2016
OECD	6.5	6.2	6/2016
Asian Development Bank	6.5	6.3	7/2016
IMF	6.6	6.2	7/2016
Deutsche Bank	6.6	6.5	7/2016
JP Morgan	6.7	6.4	7/2016
World Bank	6.7	6.5	6/2016

Market-economy status and steel on the table at the EU-China summit. Beijing hosted the 18th EU-China summit in mid-July. Top-level discussions touched on e.g. Brexit impacts and tensions in the South China Sea, but the hottest topic was perhaps if the EU would finally get around to granting China market-economy status. The decision is expected later this year. China claims that during its WTO membership talks, the parties agreed that market-economy status would be conferred automatically when China completed its 15th year of WTO membership in December 2016. On the EU side, however, a common view has not yet formed, whether to grant the status or not. The view is mixed both between the EU countries and between the EU institutions. The granting of such status would be a political recognition, but in practice the granting of market-economy status to China would make it more difficult to impose anti-dumping sanctions on Chinese exports to Europe.

After the meeting, European Commission president Jean-Claude Juncker linked the discussion of granting market-economy status to China's domestic steel overcapacity problems. The EU and China decided to create a joint working group on steel to allow frank discussion on overcapacity problems as well as monitor Chinese measures to resolve its steel issues. China accounts for about half of global steel production. At a time when its economic structures are changing, domestic steel demand is expected to fall and many fear that the country will try to dump even more steel onto the global market. The EU has already imposed anti-dumping tariffs on Chinese steel, claiming that China has been selling steel at prices below production cost in Europe. A week after the meeting, China decided to impose anti-dumping tariffs on certain types of steel imported from the EU, Japan and South Korea.

Slight bump in Chinese share prices. Even with the fall on Wednesday, stock indexes in Shanghai and Shenzhen are few percent up over the two months, but are still considerably lower than at the start of the year. Media reports suggest that new large institutional investors are coming to the Chinese stock market, as China's pension funds are finally starting their investment in shares, decided last year. Pension funds hold assets of about 2 trillion yuan (€270 billion), but only a fraction of that will be invested in local equity markets. The investment will be made over several years via the national social security fund. A goal of reinvesting pension assets is to improve the return on fund investments. China's undeveloped stock markets have been volatile in recent years, seeing far more than the economic development would suggest. One possible explanation is the lack of large institutional investors to anchor the markets. The entry of pension funds into the market might slightly calm share price volatility.

Predicting profit of listed Chinese firms has proven a non-trivial task. A recent Bloomberg assessment found that per-share earnings of Chinese listed companies have been running about a third less than market analysts had forecast. Many of China's largest listed firms are involved in heavy industry. While China seeks to transform its economy to a more consumer-oriented, service-driven economy, firms in industrial branches suffering from overcapacity have seen their profitability weaken much more than analysts expected.

Main stock index performance in China and Hong Kong



Sources: Macrobond and BOFIT.

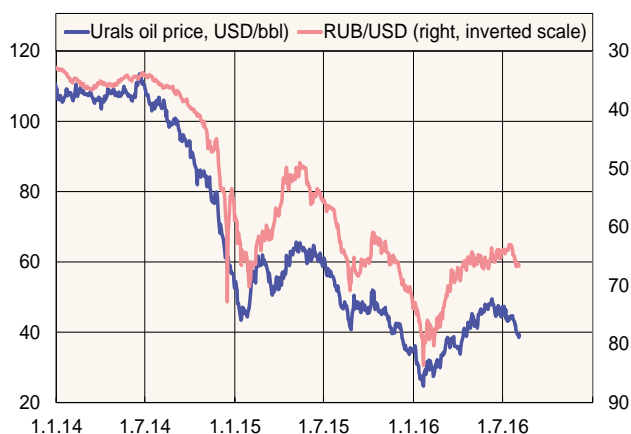
Russia

CBR keeps key rate unchanged. At the regular meeting last Friday (July 29), the board of the Central Bank of Russia decided to keep the key rate unchanged. The 10.5 % key rate has been in place since June 14. The CBR board noted that inflation expectations had not subsided enough to justify further rate cuts. July consumer prices were up 7.2 % y-o-y. The next regular rate review meeting of the CBR is set for September 16.

Oil price down sharply in July, ruble follows. Global crude oil prices hit their peak this year early in June, when the price of Urals-grade crude approached the \$50-a-barrel mark. The oil price has since fallen, and in July the decline accelerated. Over the past month, the price of oil fell by more than 15 % and the current price of Urals-grade crude is slightly below \$40/bbl. Oil futures suggest the price should rise by around \$3/bbl by the end of the year. Urals hit a low this year of about \$25/bbl in January.

Changes in the oil price are rapidly reflected in the ruble's external value. When oil prices rose this spring and early summer, the ruble's exchange rate strengthened. When the price of oil fell in July, the ruble shed about 4 % of its value against the US dollar.

Urals oil price and ruble-dollar exchange rate



Source: Reuters

A crucial issue for Russia's public finances is the oil price *in rubles*. As a rule, ruble depreciation cushions the budget impacts of a drop in the dollar price of oil. In recent weeks, however, the crude oil price in rubles has fallen sharply, because ruble depreciation has been less than the drop in oil prices in dollars. At the moment, a barrel of Urals-grade crude oil costs approximately 2,600 rubles. This year's budget assumes an average oil price in 2016 of 3,165 rubles a barrel. At that price, the public sector deficit this year would be about 3 % of GDP.

Russia has yet to see clear upturn in business cycle.

Key economic indicators for June and July failed to show a distinct uptick in the Russian economy, even if positive growth is clearly taking hold in certain branches. The economy ministry's figures show total output fell in May by 0.6 % y-o-y and was down another 0.5 % in June. The seasonally-adjusted total economic output indicator was the same in June as in May.

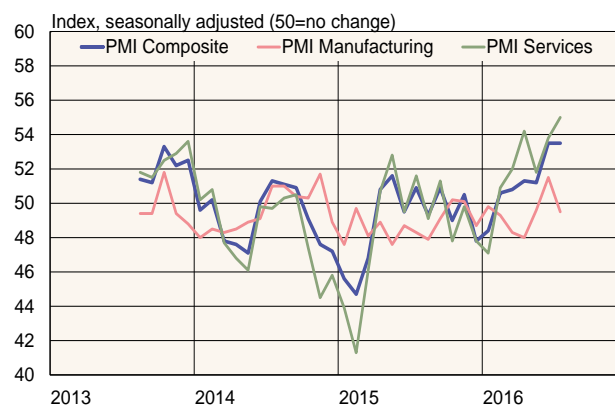
Broken down by core production sectors, in June industrial output rose 1.7 % y-o-y, agriculture 2.1 % and transportation 1.8 %, while the volume of retail sales declined 5.9 % and construction activity fell 9.7 %.

The economy ministry estimates that GDP contracted 0.6 % y-o-y in the second quarter. The CBR offered a slightly smaller figure for GDP shrinkage in the same period. Somewhat disconcerting for the prospects for Russian growth was the CBR's finding that fixed investment continued to contract in the second quarter, falling by over 3 % y-o-y. The CBR's estimate noted ongoing declines in construction activity and production of investment goods. Fixed investment in Russia has fallen since 2013.

Various confidence indices also give conflicting perspectives for Russia's near-term economic trends. The July PMI index reading for manufacturing activity, for example, was 49.5, suggesting a contraction. The June reading was 51.5. While July manufacturing output increased overall slightly, the volume of new orders fell. On the other hand, the services PMI index reading rose to 55, its highest level in over three years. The volume of new orders for services increased substantially.

Rosstat also makes a quarterly survey of consumer confidence. Its consumer confidence reading for the second quarter was -26, a slight improvement from -30 in the first quarter. Consumer confidence, however, was weaker than in Q2 last year and well below the long-term average.

Russia's Purchasing Managers' Indices (PMIs)



Sources: Markit, Macrobond

China

Chinese decision-makers struggle with conflicting policy goals. Reaching an official 6.5 % growth target, slowing the rising tide of indebtedness and moving forward with structural reforms needed for sustainable growth are part of an economic policy package that is hardly possible to carry out without a compromise on some of targets. The difficulties were apparent at last month's meeting of the Communist Party Politburo, as top decision-makers debated over the economic outlook and policy challenges for the rest of the year. The official statement mentioned pressures for lower growth and raised demands on more proactive fiscal policies, as well the need for "prudent" monetary policy to sustain the current pace of economic growth. The release also stressed accurate targeting of credit to assure development of the real economy. Prominent mention went to problems arising from industrial overcapacity and debt, implying serious reform of large state-owned enterprises is needed. The politburo sees the current strong trend to urbanisation of China's population as a partial solution to existing problems. The leaders at the meeting defended the need for a stable yuan exchange rate and noted the need to prevent financial market bubbles. To dampen rising costs, China's leaders expressed willingness to lower taxes and allow greater labour market flexibility.

The general phrasing of meeting findings and lack of distinct economic policy priorities and clarity of action suggest that China's leaders themselves are not unanimous on how to proceed. Differences over the economic policy framework emerged in May, when a member of China's senior leadership anonymously criticised debt-financed stimulus and failure at implementing needed reforms. Differences over policy were subsequently seen, for example, in last month's statement by a People's Bank of China representative calling for stimulus through fiscal policy rather than monetary policy. This week the influential National Development and Reform Commission (NDRC) demanded additional monetary stimulus through lower interest rates and bank reserve requirements in order to halt the current slowdown in investment.

Some observers, however, believe the politburo meeting has improved the position of decision-makers who question debt-financed stimulus measures and push the reform agenda. There is also a sense, however, that tough reforms of state-owned enterprises, which could impede short-term economic growth, are unlikely to be implemented before the 19th National Communist Party Congress in autumn 2017, when major personnel changes will occur.

China's economic conditions have remained stable this summer. According to the Purchasing Managers' Indices (PMI), problems in heavy industry worsened in July, while small firms saw distinct improvements in their activity. Both the official PMI index and the private Caixin/Markit PMI registered service-sector growth in July.

Revised GDP methodology helps only little with China's 2020 growth target. In 2012, president Hu Jintao declared that by 2020 Chinese GDP and per capita incomes would be double that of 2010. These goals still seem unrealistic and even unwise from the standpoint of sustainable economic policy. With the change in GDP calculation methodology at the start of July, these goals are not much closer. Annual real GDP growth in 2016–2020 still needs to be on average around 6.5 % to push real GDP across the "doubling" finish line in 2020. The doubling of per capita income also requires continued rapid growth.

The notion of setting growth targets is a legacy from command economy times. As China's economy has embraced market elements, the wisdom of pursuing numeric growth targets has become questionable. Strict adherence to growth targets and linking them to career advancement in high posts leads to perverse incentives that drive inefficient expansion plans and waste national resources, which in turn creates economic imbalances and other problems.

China's bond markets show strong growth. Chinese bond markets this year have grown at about 30 % y-o-y. Since the rules on bond-issuing have been loosened, local governments have been particularly keen to issue bonds. China's bond market is valued at around \$8 trillion, making it the world's third largest after the United States and Japan. The stock of issued bonds can be divided roughly into three categories of the same size: bonds of financial institutions, corporate bonds and government (state and local) bonds. With a few exceptions, all bonds issued in mainland China are denominated in yuan. Media reports indicate that when the yuan is incorporated into the IMF's SDR currency basket this autumn, several other institutions (including the World Bank) plan to issue SDR-denominated bonds in China.

While there is still relatively little foreign investment in China's markets, foreign investment has increased significantly this year for three main reasons: China has relaxed its regulations on foreign investment, yields are quite low in developed economies and investors have moved their biggest concerns over Chinese economic growth to the back burner.

As growth of the Chinese economy slows and economic structures evolve, an increasing number of Chinese firms are expected to face difficulties servicing their bond debt. This year, at least 17 firms have defaulted on either interest or principal payments. The number of defaulting firms is nearly as high as for all of 2015 and the defaults include multi-billion-yuan bond issues. Heavily indebted firms involved in overcapacity branches such as steelmaking and shipbuilding seem to be in the worst shape. Programmes to convert bond debt into company shares have generally been met with low enthusiasm in the bondholder community.

Russia

Presidents of Russia and Turkey try to repair economic relations. Russia-Turkey relations cooled substantially last November after Turkey shot down a Russian fighter jet. Russia's retaliatory measures included restrictions on food imports, tourism and operations of Turkish construction companies in Russia. In late June, Turkish president Recep Tayyip Erdogan apologised for the downing of the Russian plane and Russian president Vladimir Putin cancelled the restrictions on Russians' traveling to Turkey and ordered the other sanctions under reconsideration. At the presidents' meeting in St. Petersburg at the start of the week, Putin said the sanctions on Turkey would be lifted gradually, but gave no specific timetable.

Putin and Erdogan also discussed joint energy projects such as the Turkish Stream gas pipeline and the Akkuyu nuclear power plant. Work on the Turkish Stream project came to a halt last summer, due e.g. to delay in issuing required permits in Turkey. Now Russia's energy minister stated that next negotiations are planned for October. The Akkuyu project was launched in 2010, but has made little progress due to legislative delays in amending Turkish law.

Russia's public sector planning a shift to domestic software. At the end of July, prime minister Dmitri Medvedev approved a plan aiming at the federal administration renounce foreign computer software and switch to domestic software by the end of 2018. Under the plan, the practice would be extended to include other administrative levels and state businesses by the end of 2020.

Software for public procurement was already earlier subject to import restrictions as part of Russia's import substitution policies. Other product categories subject to restrictions include e.g. pharmaceuticals and textiles. The economy ministry estimates that Russia's public procurement amounts to about 8 trillion rubles (€120 billion, 10 % of GDP) a year. Of that, about 1 trillion rubles was last year subject to import restrictions and preferential treatment for domestic producers. The economy ministry estimates that these policies have increased the prices of public procurements. The average price of public procurements subject to these policies rose 40 % last year, whereas the average price of all public procurements fell nearly 20 %. There has been discussion on extending import restrictions to cover also the purchases of enterprises owned by the public sector, but nothing concrete has materialised so far. The economy ministry put the 2015 value of these purchases at 23 trillion rubles or 30 % of GDP.

Russia's share of global investment falls sharply. The latest report from the UN agency UNCTAD finds that the flow of foreign direct investment into Russia last year slowed substantially to just \$10 billion, about a third of levels in recent

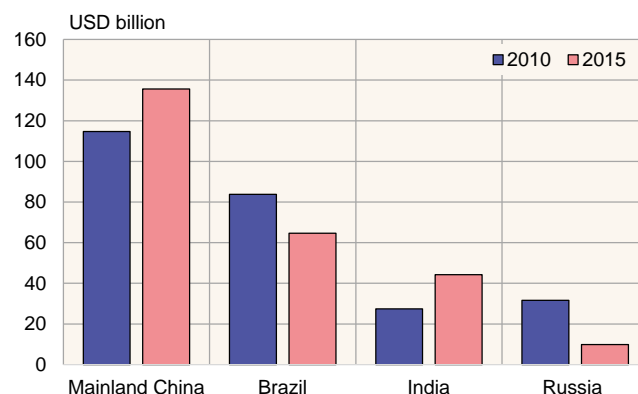
years. Most of last year's inflows consisted of re-invested earnings. The flow of new investment was very small.

Falling oil prices and geopolitical tensions, as well as additional restrictions on foreign media ownership, have dampened interest in new investment in Russia and caused some firms to pull back on investment (e.g. General Motors and Raiffeisen Bank) or pull out from the Russian market altogether (e.g. ConocoPhillips and Axel Springer).

The global flow of direct investment rose nearly 40 % last year. Only 0.6 % of global direct investment went to Russia. Russia's share in earlier years was about 2 %. The outflow of FDI from Russia to other countries was \$27 billion last year, less than half the outbound FDI of 2014.

FDI flows to Kazakhstan fell last year by nearly half of the 2014 level. FDI flows to Ukraine, however, increased substantially from the previous year, when they hit a record low.

Foreign direct investment flows to BRIC countries in 2010, 2015



Source: UNCTAD WIR 2016.

Corruption, bad institutions and lack of openness dog Russian competitiveness. The World Economic Forum (WEF) global competitiveness index last year ranked Russia 45th among 140 countries surveyed. Russia had little success in institution-building, financial market development and commodity market efficiency. Corruption was the biggest obstacle to doing business. Russia's ranking actually improved slightly over the past decade: the WEF's 2005 survey ranked Russia 53rd of 117 countries surveyed.

Transparency International's Corruption Perception Index (CPI) measures perceived corruption of public sector agencies. The 2015 CPI ranked Russia at 119th of 168 surveyed, putting it on par with Azerbaijan, Guyana and Sierra Leone. TI noted that conditions that promote civil society development and press freedom have weakened in Russia. Such factors are considered important in fighting corruption. Russia ranked 126th of 153 countries in the 2005 survey.

The Heritage Foundation's 2016 Index of Economic Freedom ranks Russia 153rd out of 178 surveyed. Russia got low marks for rule of law (e.g. property rights and fighting corruption) and market openness (investment). The 2008 IEF ranked Russia 134th of 157 countries surveyed.

China

China's central bank tightens the control of capital flows. The yuan's slide this year has provided Chinese investors with motivation to take advantage of existing possibilities as well as invent new ways to sneak capital out of the country. In response, the People's Bank of China has tightened enforcement of capital controls and imposed new rules on commercial banks that limit large transfers of capital out of the country. The PBoC has considerable say in the operational aspects of commercial banking in China and lately "window guidance" policy has been used to control outbound capital flows. Media reports assert that commercial banks are now required to provide much more details of their clients' forex trading. Certain banks apparently are now also required to alert officials in advance of large forex purchases and some banks have had to limit repayment of forex loans ahead of payment schedule.

Private individuals are allowed under current law to purchase up to \$50,000 in foreign currency each year, so many schemes have been devised to circumvent this rule. For example, Chinese customers have shown recent appetite for pricey Hong Kong insurance policies that pay out claims in dollars and are accepted as collateral for dollar loans. In February, China's State Administration of Foreign Exchange (SAFE) imposed a \$5,000 ceiling on single UnionPay credit card purchases of financial products. UnionPay is China's national credit card company. The planned QDII2 programme to expand foreign investment opportunities for private Chinese investors has been put on ice and SAFE has not granted domestic institutional investors new foreign investment quotas since March 2015.

Yuan-dollar exchange rate onshore (mainland China, CNY) and offshore (Hong Kong, CNH).



Source: Macrobond

The capital outflow pressure also effects China's monetary policy. In its June quarterly report released last week, the PBoC warned that any lowering of the general reserve requirement would increase liquidity in the market, which

might lead to increased depreciation pressure on the exchange rate and fuel speculative trading. These policy goals partly explain the PBoC's reliance on targeted lending programmes (e.g. MLF, PSL) at the moment. These have become key instruments of implementing monetary policy.

Capital outflows appear to have slowed this year compared to the second half of 2015 and China's foreign currency reserves have remained at around \$3.2 trillion since January. This week the yuan gained slightly against the dollar. On Friday (Aug. 12), one dollar bought 6.64 yuan. The yuan has lost about 5 % against the dollar after last August's implementation of a revised exchange rate mechanism and a surprise 2 % devaluation.

Value of Chinese foreign trade declines, volume increases. The value of Chinese goods imports and exports measured in dollars has declined 7–10 % this year. Much of the decline reflects exchange rate shifts. The yuan was down about 7 % y-o-y against the dollar in July. As a result, a better perspective on foreign trade might be offered by volume trends. Volumes of both exports and imports have risen about 3 % y-o-y this year. Export growth accelerated slightly in the second quarter.

Export volumes rose in nearly all sub-categories. Export volumes in machinery & equipment, the largest sub-category, have increased on average about 1 % y-o-y over the first six months of this year. Exports growth was highest for coal, crude oil, gas and refined oil products. In a notable bifurcation of import trends, import volumes of commodities and foodstuffs have increased, while import volumes of industrial products have fallen from a year ago.

While the weak yuan has boosted price competitiveness of Chinese products, export gains have been fairly slim. Moreover, a rapid rise in Chinese labour costs that has offsets at least partly gains in price competitiveness. Company surveys give a contradictory picture as to whether the export outlook has improved over the course of this year or not. The impact of yuan depreciation to Chinese exports is also diminished by the fact that it also means higher import prices. About 35 % of Chinese exports still consists of "processing trade," that is, export activities that involve assembly of imported components or processing of semi-finished imported products. In recent years, the share of processing trade in China's overall trade has dwindled and is expected to continue to fall in coming years.

Change in method of calculating Chinese GDP only marginally eases path to 2020 growth targets. China is targeting to double the GDP from 2010 level by 2020. Reaching this goal requires real GDP growth of nearly 6.5 % a year. Last month's change in the methodology for calculating GDP should make it only slightly easier for China to hit its growth targets. Many experts feel that the growth target is unreasonably ambitious and distorts economic policy.

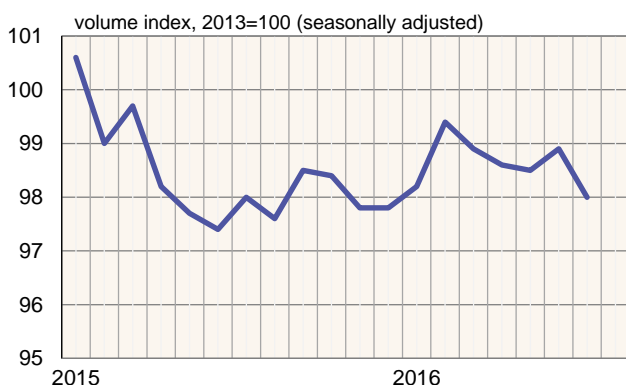
Russia

Russian consumption and output declined in July.

The volume of retail sales (seasonally adjusted) contracted further last month and was 5 % smaller than in July 2015. The decline from a year ago was slightly smaller than in the second quarter of this year. Household real disposable income also continued to fall, to a level 7 % below July 2015, even if real wages were up slightly. Fixed investment, for which only quarterly reporting is published after last year, declined roughly 4 % y-o-y in the second quarter. The drop was nearly 5 % in the first quarter.

Seasonally adjusted industrial output declined by almost 1 % from June to July. Most of the drop was due to a reversal in manufacturing output, which was down 1.5 % y-o-y. Output of extractive industries, in contrast, showed slightly higher on-year growth (1.8 %) compared to previous months. Most of the increase came from crude oil production, which was up 1.7 % y-o-y in July (1.3 % in 2Q2016).

Russian industrial output 2015–2016



Source: Rosstat

WTO panel confirms Russian import duty violations.

A WTO panel last week agreed with the EU's claim, filed at the end of 2014, that Russia has levied excessive import duties on certain goods. The panel confirmed that Russian import duties on certain paper and paper board products, palm oil and refrigerators exceeded WTO "bound" rates. The panel rejected the EU's claim of systematic application of higher duties targeting numerous products due to insufficient evidence. The panel's ruling becomes binding if neither party files an appeal within 60 days. At that point, Russia would have to bring its import duties into compliance with WTO rules as soon as possible. Failure to comply with the ruling could lead to compensation or retaliation measures. Russia has, however, brought its customs practices into compliance for some of the products concerned already in the course of the panel proceedings.

Other EU complaints about Russia still pending with the WTO include automobile recycling fees and bans on imported pork. The EU also recently introduced anti-dumping duties on some Russian and Chinese steel products.

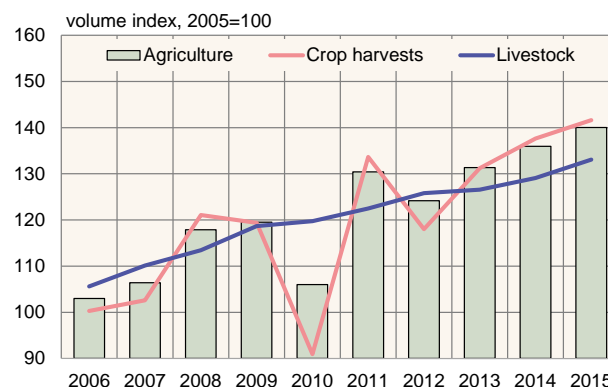
Russian farm production growing gradually. Bans on imports of certain foods and policies favouring domestic producers have had only minor impact on production volumes of domestic farmers. Russian production of grains and livestock has grown a few per cent a year in recent years. The value of total agricultural output as well as livestock production in 2015 grew 3 % in real terms and has continued to increase at the same pace in 2016. Grain harvest was last year approximately on the previous year's level. However, production of certain other crops such as sugar beets and soybeans grew rapidly last year. This year's grain harvest is expected to be considerably larger than last year's.

Production of meat and poultry was up 4 % last year and about 6 % y-o-y in the first months of 2016. While dairy production has shown virtually no growth overall, production of certain dairy products has increased. Highest growth has been in cheese production, which was up 17 % last year. Growth in cheese production appears to have levelled off, however, at around 2 % growth in the first half of this year. This year, especially production of certain vegetables has grown rapidly. Food production overall rose 2 % in 2015 and 3 % y-o-y in 1H16.

Retail food sales continue to diminish, but reduced foreign competition has allowed domestic producers to increase their market shares. The absence of competition has allowed price increases, which has enhanced profits of both farmers and the food industry. Even so, there are no signs of increased investment in the sector. In 2015, investment in farming and livestock fell 13 %.

With the contraction in real incomes and rapidly rising prices for many food items, food represents an increasingly large share of household consumption. At the end of 2015, food accounted for about 30 % of the consumer spending of Russian households.

Russian agricultural output 2006–2015



Sources: Rosstat, BOFIT.

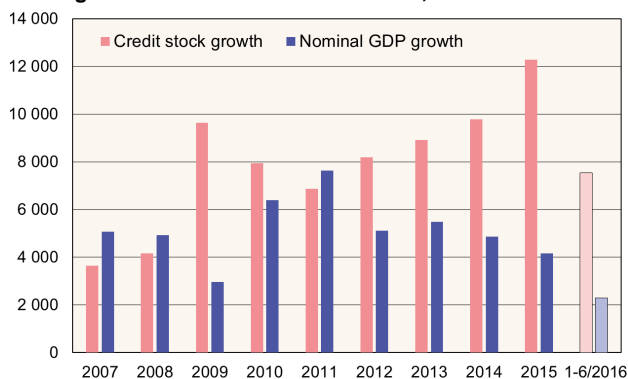
China

China's credit expansion creating less and less economic growth. Financial circles are increasingly worried about China's soaring indebtedness in the face of faltering economic growth. China's credit stock grew 15 % y-o-y the first half of this year, then slowed slightly to 13 % y-o-y last month. At the end of July, the value of yuan bank loans in China climbed to 102 trillion yuan, or about 144 % of GDP.

Using the Chinese central bank's broadest credit measure (total social financing, TSF), the credit stock in July was up 12 % y-o-y to an equivalent of about 210 % of GDP. Indicators of activity in the shadow banking sector suggest that the use of banker's acceptance bills has fallen significantly this year, while the stock of trust and entrusted loans has increased (up 17 % y-o-y in July). Among the various TSF categories, the stock of corporate bonds grew fastest (up 30 % y-o-y at the end of July). The money raised by companies through equity issues has also increased rapidly this year.

A highly disconcerting aspect of China's rising indebtedness is the fact that companies are devoting an ever-increasing share of new borrowing to servicing existing debt. There are also signs that borrowed money is going elsewhere than investment in production in hope of quicker returns. Last year, the stock of yuan-denominated loans grew by 12 trillion yuan, which was roughly three times more than the growth of nominal GDP. The ratio has persisted this year as well.

Annual growth of credit and GDP in China, CNY billion



Sources: Bloomberg, CEIC & BOFIT

Sharp slowdown in Chinese investment growth.

Growth in private investment, which accounts for over 60 % of all Chinese investment, has slowed sharply since the second half of 2015. Private investment last month dipped below the July 2015 level. The pace of public investment also slowed sharply in July compared to the first half of the year. Consequently, real growth in fixed asset investment (FAI) fell below 5 % y-o-y last month.

FAI figures reported on a monthly basis do not correspond directly to the quarterly national accounting figures for

fixed capital formation. However, also real growth in capital formation fell to just over 5 % in the first half (down from over 6 % growth in 1H15). Capital formation represented 45 % of total demand last year, highlighting the potentially significant impact of shrinking investment on GDP growth. Domestic consumer demand, in turn, becomes much more critical than earlier in sustaining rapid growth.

July output growth slowed slightly from June. Industrial output grew 6 % y-o-y, while growth in retail sales, which reflects both service sector and consumption activity, fell to slightly below 10 % in real terms.

Slight uptick in Chinese housing construction; price trends uneven across cities.

Following a downturn in production last year, housing construction revived strongly in the first seven months of this year. Measured in terms of square metres of liveable floorspace, there was a 20 % increase in completions of new apartment buildings and a 13 % jump in new apartment building starts. The rate of new building starts, however, faded a bit with the onset of summer. Compared with previous years, builders are also buying less land use rights for building lots, a trend that suggests only moderate growth in housing construction lies ahead.

The uptick in construction reflects the recovery in apartment sales, which were up sharply in the first half of this year, both in terms of liveable floorspace and value of sales. Private real estate portal SouFun's latest survey of around 100 cities found that the average price of a square meter of floorspace in July was 12,000 yuan (€1,600), an increase of 12 % y-o-y. The growth of average housing prices accelerated from June. From the standpoint of emerging risks, it should be noted that on-year growth in the stock of housing loans accelerated in the second quarter to 31 %.

Housing markets in China are quite heterogeneous. Average apartment prices (CNY/m²) runs from about 4,000 yuan (€540) in Baoji in Central China to 53,000 yuan (€7,200) in Shenzhen. While the fastest rise in apartment prices has been in the big cities, the number of smaller cities witnessing on-month overall price declines started to rise in July. SouFun found that apartment prices were falling in almost a third of cities surveyed.

China gives go-ahead to Shenzhen-Hong Kong Stock Connect.

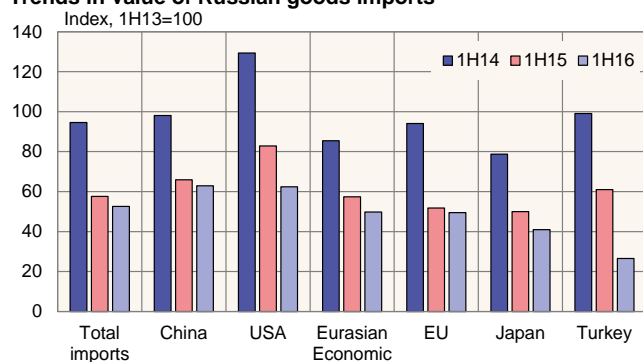
On Tuesday (Aug. 16), the State Council approved linking of Hong Kong and Shenzhen stock trading without giving a specific start day. A Hong Kong stock exchange press release said that trading was expected to begin within four months. The Shenzhen-Hong Kong Stock Connect project follows the Shanghai-Hong Kong Stock Connect programme launched in November 2014. As with the sister Stock Connect programme, trading in shares on the Shenzhen exchange via the Hong Kong exchange (and vice versa) are subject to daily quotas. An innovation is that there will be no overall quotas, and they have now been abolished for Shanghai-Hong Kong trading as well.

Russia

Russian goods imports near bottoming out. The value of goods imports contracted 9 % y-o-y to \$84 billion in the first half of this year. The value of imports fell in all major goods categories. The contraction in imports has slowed and the June imports were only slightly more than 1 % smaller than a year earlier. The value of imports of machinery, equipment & transport vehicles even rose in June for the first time in two years, up 7 % y-o-y. The contraction in imports of chemical products has nearly ceased, while the slide in food imports has accelerated in previous months. The EU's share of Russian imports increased slightly from 1H15 and was nearly 40 %. About a third of imports came from Asia, with China the largest import provider (nearly 20 %). Imports from Turkey were down over 50 % y-o-y in 1H16.

The value of goods exports in the first half was just under \$130 billion, a decline of nearly 30 % y-o-y. The drop in the value of exports has slowed slightly in recent months on higher commodity prices. Export volume development has been varying. Measured on-year, export volumes of crude oil, natural gas, ferrous metals, timber and grain were up in the first half, while export volumes of oil products contracted substantially along with decreases in volumes of fertilisers, aluminium and copper. Less than half of exports went to EU countries (down from a year earlier), and about a fifth of exports went to Asia. Exports to most countries still shrank, but exports increased to e.g. Iran and Egypt.

Trends in value of Russian goods imports



Source: Federal Customs Service of Russia.

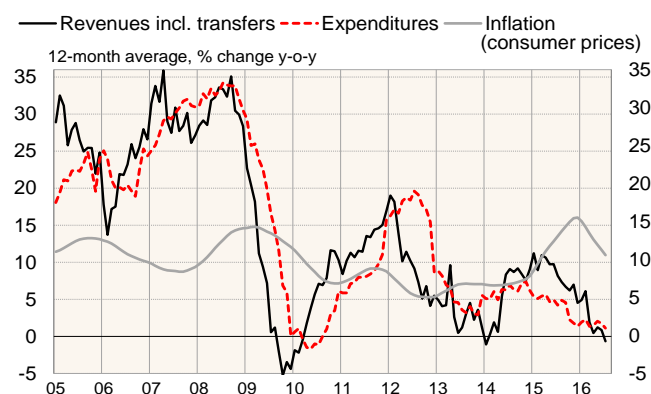
Further tightening of Russian regional budgets.

Nominal regional budget revenues in January-July 2016 were unchanged from January-July 2015. Transfers from the federal budget to regional budgets fell sharply, even after contracting in most previous years. However, it was covered up by an increase in other revenues in nominal terms, but similar to last year, the increase was quite a bit below inflation.

Regional budget spending in the first seven months of this year rose a couple of per cent in nominal terms from the same period in 2015. Overall spending growth has failed to keep up

with inflation for three and half years in a row. Like revenues, spending this year is down in real terms well over 15 % from 2012-13. Among the biggest spending categories, education and healthcare have seen funding develop weakly in 2015 and 2016. Spending in the housing sector has seen the same for several years. Spending on the economy (roads, transport and agriculture) has experienced the greatest relative gains.

Revenues and spending of regional budgets, 2005-2016



Source: Russia's Ministry of Finance.

Russians increasing domestic travelling. Tourism abroad has fallen sharply over the past two years due to the weak ruble and falling real disposable incomes. Imports of travel services last year amounted only to \$35 billion, a decline of over 30 % from 2014. The number of tourist trips abroad and the number of passengers on international flights fell nearly 20 % last year. This year, the slide has accelerated due e.g. to restrictions imposed at the end of 2015 on travel to Egypt and Turkey. In the first half of this year, imports of travel services fell nearly 40 % and the number of passengers on international flights declined almost 30 % y-o-y.

Russians have partly replaced trips abroad with domestic trips. The number of domestic travellers in Russian accommodation facilities last year increased 25 % (excluding the impact of Crimea) and the number of passengers on domestic flights rose 14 %. The growth in domestic travelling is expected to continue this year, but at a slower pace. In 1H16, the number of passengers on domestic flights rose 8 % and the volume of accommodation services was up 9 % y-o-y.

The tough economy and rising prices constrain Russian spending also on domestic tourism. Recent surveys found that the share of Russians planning to take no vacation at all or not go anywhere during their vacation is the highest in a decade. The average amount set aside for vacation this year was only slightly more than in 2015, even if prices of tourist services were up 8 % y-o-y in 1H16.

Russia's tourism sector employs 1.3 million people. 2015 turnover for the sector was around 3 trillion rubles (\$50 billion, 2 % of the total turnover of all companies). Russian tourism sector largely relies on domestic tourists, with foreigners representing only 14 % of travellers in hotel accommodations.

China

IMF calls for decisive action from China to tackle rising vulnerabilities. In its annual [Article IV consultation](#), IMF staff recognises China's advances in shifting to a growth model increasingly driven by consumption and its progress in certain areas of structural reform. Nevertheless, the report puts emphasis on increasing economic vulnerabilities and a distinct lack of progress in many critical reforms. In particular, soft budget constraints on state-owned enterprises (SOEs) means cheap money gets channelled to inefficient projects and corporate indebtedness balloons. The ability of firms to service existing debt burdens has faltered with the declining profitability of industrial firms. This includes a growing group of firms with insufficient profits to cover even loan interest.

As firms have piled on debt, financial sector has swelled in size and the links between banks and nonbanks have expanded rapidly. Growth of the shadow banking sector and development of novel financial instruments has made the sector opaque and officials overseeing it find risk assessment increasingly difficult. Moreover, interconnections of the sector increase the risk of spill-overs, which will fuel further problems.

As corporate indebtedness continues to rise, the likelihood of the emergence of disruptive adjustment keeps growing, which could lead to banking crisis and cause a rapid slowdown in economic growth as has happened elsewhere in similar circumstances. For this reason, the IMF hopes for decisive action from China to reduce the vulnerabilities, even if it means lower growth in the near term. SOE indebtedness must be curbed, heavily indebted firms must be restructured or liquidated, and losses need to be recognized and shared among firms, banks and creditors. The state should also be prepared to participate in clean-up costs and help find work for the displaced and make it easier to start new firms. The financial sector should also be better prepared to take such measures as bolstering bank asset buffers, writing down bad loans as credit losses and reducing risks associated with the shadow banking sector. Officials need to intensify their supervision efforts and get crisis management plans in place.

IMF encourages China to shift to monetary policy based on inflation targeting and floating exchange rate. The latest IMF's Article IV Consultation praises China's formal deregulation of interest rates and adoption of a new exchange rate mechanism as steps towards an increasingly market-based policy regime. The IMF staff assessment found that it would be beneficial for China to introduce a floating exchange rate as rapidly as possible, preferably already by 2018. They further recommended widening the fluctuation band for current the trade-weighted exchange rate as a policy transmission mechanism, noting that a more flexible exchange rate would protect the economy from external shocks and confer monetary policy independence as access to capital markets opens up. The yuan's current valuation is now largely in line with fundamentals according to the IMF.

The IMF would like to see Chinese monetary policy adopt a system where the government sets an explicit medium-term inflation target for policy guidance and gives the central bank operational independence over achieving the target. The IMF said the 7-day repo rate could be used as the new policy rate, providing a basis for the central bank's earlier proposed interest rate corridor (see [BOFIT Weekly Review 48/2015](#)). The shift to market-based monetary policy should be accompanied by an increase in exchange rate flexibility. The IMF would also like to see consistent, clearly communicated monetary policy to improve its efficiency.

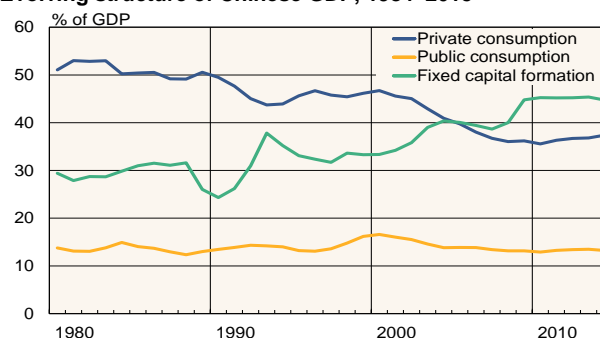
Unlike many market observers, the IMF sees China's current accommodative monetary stance as appropriate. The staff noted that economic fundamentals suggest that real interest rates could even be higher. The IMF expects a pick-up in inflation, so interest rates should rise accordingly. Slightly higher interest rates would help quell the incessant build-up in indebtedness, particularly borrowing outside the official bank sector, which is beyond most of the regulatory controls.

In contrast, the IMF took a cautious view on China's efforts to lift capital controls. The opening up of capital account should only proceed after China's financial system and corporate governance are improved and exchange rate flexibility has increased.

Relatively slow growth in fixed capital formation hastens speed of structural reform of Chinese economy. Consumption generated 52 % of Chinese GDP last year, with private consumption contributing about three-quarters of that. Fixed capital formation accounted for 43 % of GDP. National accounts data show real consumption grew 8 % y-o-y last year, while investment growth slowed to 6 %. Consumption contributed about 60 % of GDP growth last year.

China's National Bureau of Statistics updated its GDP calculation methodology in July. Although the revised figures slightly increased the share of fixed capital formation in GDP, it did not disturb the overall shift in the structure of the Chinese economy; the ratio of fixed capital formation to GDP still fell gradually and the ratio of consumption to GDP continued to rise. China's calculation methods for GDP still fail to fully capture activity in China's service sector, and thus the actual contribution of consumption to GDP is believed to be higher.

Evolving structure of Chinese GDP, 1984–2015



Source: CEIC.

Russia

Fixed investment in Russia increasingly goes to oil & gas production. The total volume of fixed investment fell over 4 % y-o-y in the first half of this year (down over 8 % in 2015). Rosstat estimates that small firms and grey economy investment fell well over 10 %, which is about the same as in the 2009 recession. The three-year drop in other investment moderated considerably, with the decline in the first half only amounting to about 1 % y-o-y.

In core branches, the developments largely resemble those of previous years. Growth in fixed investment in oil & gas production remained strong for the third year in a row. However, in other parts of the energy sector, i.e. oil & gas pipeline transmission and electrical power generation and distribution, last year's large drop in investment persisted quite strong. The slide in oil refining investment that began last year became considerably steeper. In other manufacturing, the drop in investment of last year stabilised; the investment remained roughly at the same level as last year.

Russian pensioners get one-time payment and a return to inflation-indexed pensions. The government announced last week that every pensioner will receive a one-time payment of 5,000 rubles (about €70) next January. The sum corresponds to over 3 % of an average annual pension. In addition, the government said it would return (at least for next year) to traditional inflation indexing of pensions as set forth in the law. That indexation means the annual pension increase, which usually occurs in February, is based on the rate of consumer price inflation at the end of the previous year. At the start of this year, however, the government introduced a new rule that pensioners who keep working will no longer be eligible for inflation adjustments. Official figures show that about 35 % of Russia's over 45 million people receiving different government pensions are still working. The most recent forecasts expect inflation to be running at about 6–6.5 % at the end of this year.

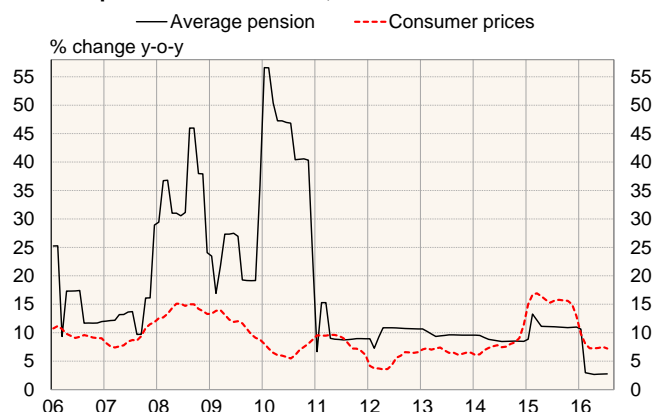
The typical cost-of-living adjustment to cope with inflation was not granted this year. Despite the fact that inflation was running at nearly 13 % at the end of 2015, pensions were only increased by 4 % in February. At that time of the feeble adjustment, the government said a second increase would be possible in the second half if economic conditions allowed.

Russian pensions this year and last year fell in real terms for the first time since 1999 – and the drop has been stunning. At a meeting of cabinet ministers on pensions, prime minister Dmitri Medvedev last week noted that the government's fresh decision to hike pensions was based on both social and political considerations. Many observers had expected for some while the government to raise pensions with the approach of the national Duma election on September 18.

Low oil prices, economic contraction, and the ensuing drop in budget revenue, have made the government rein in

cost-of-living adjustments of pensions. Pension spending has risen to a quarter of total government spending, and about 9 % of GDP.

Russian pensions and inflation, 2006–2016



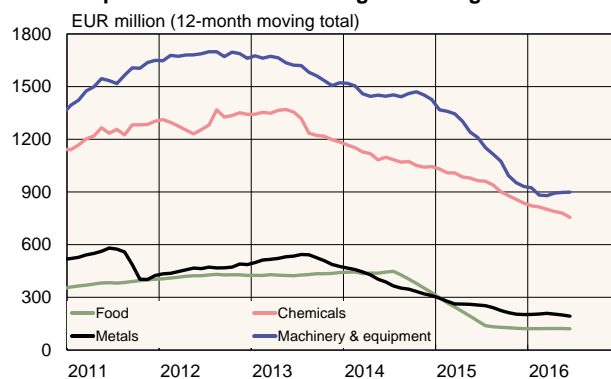
Source: Rosstat.

Finnish-Russian trade continues to shrink. The value of Finland's goods exports to Russia fell 11 % y-o-y in the first half of the year to €1.3 billion. The slide in exports slowed in the spring, but accelerated in recent months on lower sales of e.g. chemical and metal products. Figures also suggest that the decline in exports of machinery & equipment, food products and mineral fuels has hit bottom and stabilised in recent months. However, there were few signs of real recovery. Russia accounted for 5 % of Finland's total goods exports.

The value of goods imports in the first half was €2.7 billion. Imports contracted 8 % y-o-y, but in recent months there has been a return to growth on higher world prices for commodities and increasing import volumes of many goods.

In addition, exports of tourist services to Russia continued to contract. In the first six months of the year, the number of Russian overnight stays in Finnish hotels and inns fell by about 20 % y-o-y. Border-crossings on the eastern border were also down 7 % in the same period.

Finnish exports to Russia in select goods categories



Source: Finnish customs, BOFIT.

China

Reform of China's public sector moves ahead. China's government announced last week that it was launching a reform to clarify the division of duties and reduce overlaps in them between the central government and local governments, as well as shift some local government tasks to the central government. The reform, which seeks more effective use of public funds, will proceed stepwise and it should be fully implemented in 2020. The need for public administration reform has long been apparent. The current system, introduced in 1994, dedicates 85 % of public spending to provincial and municipal levels, even if these tiers only collect slightly more than 50 % of public revenues. Even if the imbalance is largely covered by massive transfers of central government funds to provinces and municipalities, sale of land use rights has become a major revenue source for local administrations. Many see that imbalance between revenues and spending has fuelled the current indebtedness of local governments through creation of off-budget investment vehicles.

The last big public finance reform in 2014 involved letting provinces and municipalities issue their own bonds with central government approval. The change was supposed to subdue off-budget activity of local governments and improve transparency. While the 2014 changes have yet to be fully implemented, regional bond issues have increased substantially. Off-budget activity, however, remains substantial.

Official figures show that China's public sector revenues and expenditures have been around 20–25 % of GDP in recent years, with deficits around 2–3 % of GDP. The IMF notes that when off-budget liabilities of local governments are included, revenues are slightly larger than official estimates and spending considerably higher. The IMF calculates the public sector deficit has been running at around 10 % of GDP in recent years and that China's public sector debt as of end-2015 was close to 60 % of GDP. The IMF expects the public sector debt ratio to grow further in coming years.

China seeks to rein in online P2P lending market through increased regulation. In the latter half of August, Chinese officials released regulations on direct online peer-to-peer (P2P) lending. An individual is now permitted to borrow no more than 200,000 yuan from a P2P lender or platform and the total value an individual's P2P borrowing may not exceed 1 million yuan (\$150,000) at any time. The limits on corporate borrowing are five times higher. Moreover, P2P firms that conduct most of their business online are now banned from engaging in activities such as taking deposits from the general public, sale of asset management products or giving loans guarantees.

The crackdown had been planned since last spring, after the Ezubao P2P platform, which was set up in 2014, turned out to be a 50 billion yuan (\$6 billion) pyramid scheme. Bloomberg and the Yingcan Group, which tracks P2P lending, report that the volume of P2P loans last year rose to 1 trillion

yuan (\$150 billion). As of July, P2P firms had matched 3.4 million investors with 1.2 million borrowers. Credit offerings vary from consumer loans to high-risk corporate loans. The average interest rate on P2P loans this summer was 10.3 %.

Even if the volumes of P2P lending and the numbers of investors and borrowers are minuscule relative to China's financial markets overall, the concern is the explosive growth and fraud opportunities in online shadow banking activities and the possible spillover effects. For example, the Ezubao scam directly affected 900,000 investors.

First-half trends in Finnish-Chinese trade slightly more upbeat than Finnish foreign trade overall.

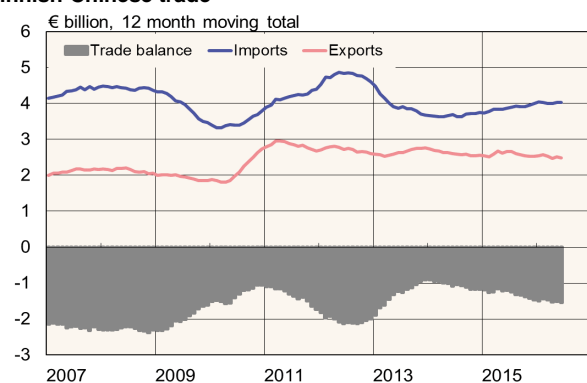
Finnish Customs figures put the value of goods exports to China in the first six months of the year at €1.27 billion, a decrease of 4 % y-o-y. The overall value of goods exports fell by 5 %. Imports from China increased 1 % y-o-y to €1.9 billion, while the overall value of imports fell by 1 %. China is Finland's fifth most important trading partner, accounting for 5 % of Finnish goods exports and 7 % of goods imports.

The structure of exports to China has remained largely unchanged in that machinery & equipment account for over a third of exports. Pulp was the single largest export item in 1H16, accounting of nearly a fifth of the value of Finnish exports to China. Exports of wood and wooden products increased sharply, accounting for about 10 % of the value of Finnish exports. Exports of furskins, in contrast, declined rapidly and their share of total exports fell from 15 % in 1H15 to 5 % this year. About 30 % of Finland's exports of pulp and nearly half of its fur exports go to China.

About half of Finland's imports from China consists of machinery & equipment, and their imports have followed the trend of overall imports. Imports of clothing and footwear rose 6 % y-o-y in 1H16, accounting for 15 % of imports overall. A third of Finland's clothing and footwear imports come from China. Other imports consist of a diverse mix of goods.

The number of Chinese travellers visiting Finland has increased rapidly. In the first half of the year, Finnish hotel and inn accommodations served over 60,000 Chinese guests, an increase of 39 % y-o-y. Chinese guests accounted for 5 % of foreign guests staying in Finnish accommodation establishments.

Finnish-Chinese trade



Source: Finnish Customs

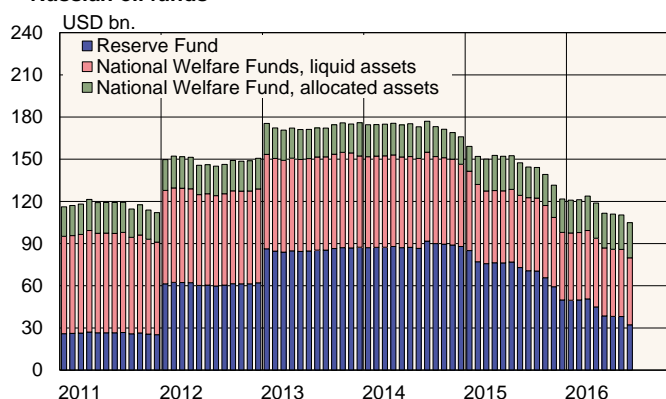
Russia

Budget deficits drain Russia's Reserve Fund. In August, the government withdrew 390 billion rubles (\$6 billion) in assets to cover the federal budget deficit. Even so, the Reserve Fund still held at month's end about 2.1 trillion rubles (\$32 billion, or nearly 3 % of GDP). This year the government has withdrawn 1.2 trillion rubles to cover budget expenses and plans to use another 900 billion rubles by the end of the year. The 2016 budget assumes an average price of \$50 (3,165 rubles) a barrel for Urals-grade crude oil, but the real-ised average for January-August was only \$40 (2,690 rubles).

The value of Russia's other oil fund, the National Welfare Fund, was 4.7 trillion rubles (\$73 billion) at end-August. Russia's finance ministry has stated that the National Welfare Fund could be tapped to fund budget deficits, even if such use deviates from the fund's original purpose. About a third of that fund is already tied up in e.g. long-term bank deposits and corporate bonds. So, Russian oil funds in total currently hold liquid assets worth about 5.2 trillion rubles (\$80 billion, 7 % of GDP). Last year's spending as well as this year's budgeted use of the funds amounts to 2.1 trillion rubles.

Foreign currency and gold reserves are not directly connected to the budget discussion as their primary purpose is to provide liquidity to cover foreign obligations in the event of a severe sudden shock. The liquid assets of Russia's oil funds are included in the forex reserves, because the Central Bank of Russia administers these assets under the same principles as the other forex reserves. Notably, when oil earnings are used to cover ruble-denominated expenditures, the value of Russia's forex reserves does not change. At the end of August, the value of Russia's foreign currency and gold reserves stood at \$393 billion, an increase of \$25 billion from January.

Russian oil funds



Sources: Macrobond, Russian Ministry of Finance, BOFIT

More Russian firms added to US sanctions list. On September 1, the US Treasury Department announced an extension of sanctions on Russia for occupation of Crimea. Several Russian firms were added to the sanctions list mostly due

to doing business in Crimea. These include firms related to the construction of the Kerch bridge between Russia and Crimea, like Mostotrest, one of Russia's biggest construction companies. Other additions to the blacklist include defence and maritime firms active in Crimea.

Russia lifted its ban on charter flights to Turkey at the start of this month. Sanctions that remain in place include bans on food imports from Turkey and restrictions on Turkish business activity in Russia.

CBR registers new national credit-rating agency ACRA. Under Russia's credit-rating companies act of June 2015, all credit-rating agencies giving national ratings must register with the CBR by January 1, 2017. Registration requires that the credit-rating institution be domiciled in Russia and, among other things, that it commits to complying with Russian legislation and remains free of geopolitical influence. The change in the law reflects Russia's disappointment with the downgrades of international credit-ratings agencies after its economy faltered in 2014–2015, as well as desire to build up national arrangements in e.g. payment cards and payment clearing systems ([BOFIT Weekly 1/2016](#)).

In late 2015, at president Putin's bequest, a new Analytical Credit Ratings Agency (ACRA) was established. The CBR registered ACRA on August 25, allowing it to officially begin operations. The CBR said it was also considering the applications of several other ratings agencies.

The new law has made it challenging for the big three international credit-ratings agencies to operate in Russia. Credit ratings agency Moody's announced earlier this spring that it was pulling out of Russia.

Putin visits Uzbekistan. President Vladimir Putin visited Uzbekistan this week to extend his condolences for the death of the country's long-time president Islam Karimov and to meet with Uzbekistan's prime minister Shavkat Mirziyoyev. The successor of Karimov is not yet designated and some observers have expressed concerns about a possible behind-the-scenes power struggle in the Central Asian country. Mirziyoyev is considered a top contender for the president's post.

Throughout the Karimov era, Uzbekistan emphasised its independence and largely shunned regional cooperation projects such as the Eurasian Economic Union. Unlike other Central Asian countries, Uzbekistan has had less extensive economic relations also with China, choosing instead to balance between its large neighbours in relative isolation. Uzbekistan has a fairly closed economy and holds only minor economic significance for Russia and China. Uzbekistan accounts for just 0.5 % of Russian foreign trade and even less of China's foreign trade. Russian and Chinese firms have invested in some oil & gas projects in Uzbekistan. Repatriation of guest worker earnings from Russia last year accounted for nearly 5 % of Uzbekistan's GDP.

China

Chinese yuan is now the most used emerging economy currency in foreign exchange trading. The latest currency market survey from the Bank for International Settlements (BIS) found that the yuan was involved on one side in 4% of all forex trading in April 2016. The yuan now ranks as the eighth most traded currency, up from eleventh place in 2013. The yuan surpassed the Mexican peso, making it now the most traded emerging-market currency. BIS noted that the daily volume of forex markets was \$5.1 trillion in April. The US dollar was used in 88 % of actual trades, while the euro's share fell a couple percentage points from the previous survey to 33 % (as the method used tracks both sides of the transaction, the total percentage adds up to 200 %).

The Society for Worldwide Interbank Financial Telecommunication (SWIFT) reports monthly on the use of currencies in international payments. The July report found that 2 % of cross-border payments globally were conducted in yuan, placing it in fifth place just behind the Japanese yen among world's most important currencies in international payments. The rankings were led by the US dollar (41 %), euro (31 %), British pound (8 %) and Japanese yen (3 %).

The role of the Russian ruble in forex trading and in international payments has declined in recent years. BIS reports that the ruble today is involved in only 1 % of forex trades and that its ranking has declined from 12th place three years ago to 18th place at present. The ruble has failed to make it into the SWIFT top 20 currencies since spring 2015.

China's G20 summit in Hangzhou finishes up. The 9-page communiqué from the G20 summit (September 4–5) in Hangzhou referred in vague terms to supporting economic growth in a challenging global environment. Themes of cooperation expressed in the “Hangzhou Consensus” included opposing protectionism and reviving international trade. The G20 members committed to refraining from deliberately weakening of their currencies to improve their price competitiveness.

The summit naturally put heavy emphasis on international cooperation and the institutions that facilitate it. G20 praised China's cooperation with the Paris Club of creditors in restructuring public debt. It was hoped that China would join the Paris Club in light of the large debt receivables by China from many developing countries. The touchy issue of China's steel production overcapacity was moved to a working group backed by the OECD.

Only hours before the summit, China and the US, which together account for 38 % of global greenhouse emissions, announced they have ratified the Paris agreement on climate change. The move put pressure on other G20 members that have yet to ratify the agreement. The climate agreement, finalised last December, requires ratification of at least 55 countries that collectively account for 55 % of global greenhouse emissions to enter into force. With the addition of

China and the US, 26 countries have now ratified the agreement. The Paris agreement calls for holding the average global temperature to less than 2 degrees Celsius above pre-industrial times and requires signatory countries to publish their emissions targets and data. In spite of some pressure, the G20 summit participants failed to agree on a timetable for phasing out subsidies on fossil fuels.

More free-trade zones for China. At the end of August, the Chinese government approved the establishment of new free-trade zones (FTZs) in seven inland provinces. China's first FTZ was established in Shanghai in autumn 2013 and it was followed in December 2014 with FTZs in Fujian, Guangdong and Tianjin. With seven new FTZs, the number then rises to eleven and they now expand from the coast to inland provinces. The nature and roll-out schedules of the latest round of FTZ pilot programmes have yet to be specified. Despite mixed reactions to FTZ trials, the new FTZs will increase pressure for business deregulation throughout China.

European firms fear state's role in the economy is increasing in China. At the beginning of this month, the European Union Chamber of Commerce in China (EUCCC) released its latest [position paper](#) on China's current five-year plan (2016–2020). The EUCCC said the plan actually increases the state's role in the economy, and thus runs counter to many of China's professed economic goals and its long-term opening strategy, which imply reducing the state's role.

The Chamber said that increased government involvement could be seen in current plans to develop state-owned enterprises (SOEs). China's SOEs already enjoy preferred status relative to other firms operating in China, yet, according to the EUCCC, many of the targets in the current five-year plan seek to further strengthen their position. The Chamber added that new SOEs continue to be formed and that old SOEs continue to establish major new subsidiaries. Political involvement in SOEs has increased as party committees operating in SOEs have been granted greater authority. The state's over-involvement is further evidenced by its dealing with overcapacity issue. Instead of dealing with the access of SOEs to cheap credit, reckless borrowing behaviour and wasteful investment, the government has chosen instead to get involved in regulating SOEs directly and determining the amount of capacity to be taken off stream. The EUCCC also pointed out that China uses heavy-handed measures to guide the operations of private firms through e.g. subsidy policy, which does not result in the best outcomes for the Chinese economy.

The Chamber called for reciprocity in opening up to foreign investment, pointing out that Chinese firms can operate rather freely in Europe compared to the operating possibilities of European firms in China. The Chamber also demanded a speed-up in the current EU-China investment agreement talks so that a deal could be finalised within a year at the latest.

Russia

Russian firms issuing more eurobonds. Financial institutions and non-financial corporations have issued 1.1 trillion rubles (\$17 billion) in new domestic bonds this year, which is slightly less than year ago. The share of public offerings in debt issuances continued to decline, however, with just over half of bonds issues public in January-August. State development bank VEB, for example, issued \$600 million in domestic bonds in July, which was sold mainly to domestic banks. An increasing share of Russian debt issues lack international credit ratings, which could be due to the growth in use of asset-secured bonds. Russia's new law on pledged securities entered in force in July 2014, making it easier to issue also other asset-backed than mortgage-backed securities.

At the same time, the appetite and opportunities of large corporations to issue Eurobonds seem to have grown. In January-August, Russian banks and corporations issued \$7.1 billion in eurobonds, up from \$1.8 billion in the same period last year. E.g. steelmakers Evraz and NLMK issued in June Eurobonds of \$500 million and \$700 million, respectively.

The Moscow stock exchange's ruble-based share index is up 14 % this year and hit new highs in line with a mild recovery in oil prices. Share trading overall, however, remains as sluggish as last year. The index of corporate bond market is up 9 % and trading in debt securities has risen sharply this year. Growth in the domestic bond market has been supported by the improved liquidity situation of banks and government borrowing. The finance ministry has this year issued new sovereign debt according to schedule totalling 519 billion rubles.

Economic contraction has slowed down in Russia's regions. An on-year drop in retail sales was seen in nearly all of Russia's federal districts in the first half (but less than in January-June 2015). In the greater Moscow area (City of Moscow plus surrounding Moscow oblast) and the Ural Federal District, the volume of retail sales was still down 7–9 % y-o-y. In nearly all other federal districts and St. Petersburg the slid was about 2–4 %.

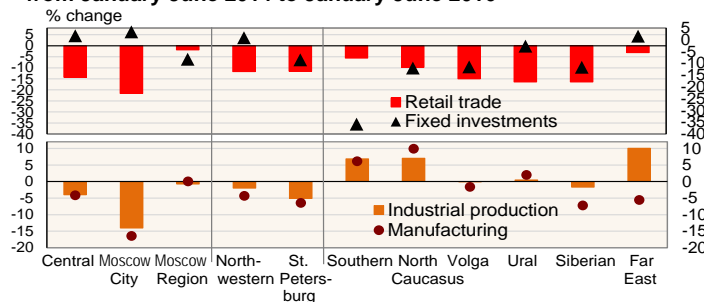
Fixed investment in the first half was slightly up on year in the greater Moscow area, in the Central Federal District and St. Petersburg and even substantially up in other parts of the Northwestern Federal District as well as Ural Federal Districts. In the Southern and Volga Federal Districts, investment still showed severe declines.

Industrial output (manufacturing and mineral extraction) in the first half grew significantly on year in greater Moscow, the Central Federal District, St. Petersburg and especially in the Southern Federal District. Most other federal districts were unchanged from a year earlier.

Russia's economic development deteriorated visibly in 2014 and the development has been quite variable across regions during past years (see chart below). Retail sales have

contracted throughout the country, and are down over 20 % in Moscow. The investment trend also has been quite uneven. In some federal districts, investment has been flat or growing slightly, while the investment volume dropped 36 % in Southern Federal District over the past two years. Industrial output has fallen in western Russia, but grown in the Southern and Far East Federal Districts.

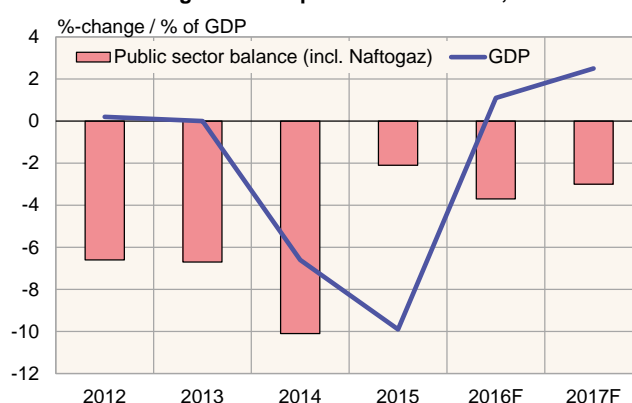
Real change in core sectors for federal districts and major cities from January-June 2014 to January-June 2016



Source: Rosstat.

IMF disburses new loan tranche to Ukraine. At its meeting on Wednesday (Sept. 14), the executive board of the International Monetary Fund voted to grant Ukraine the third tranche of its four-year \$17.5 billion Extended Fund Facility (EFF) agreed in March 2015. The current tranche is worth about \$1 billion. During 2015, Ukraine received about \$6.7 billion from its EFF. The release of the third tranche was delayed considerably from the original schedule. As required by the conditions of Ukraine's EFF, the country has e.g. increased regulated energy rates, decreased public sector deficit and improved stability of the banking system. The IMF is however, worried on the course of Ukraine's fiscal policy and its progress in fighting corruption. Several international financial institutions, including the World Bank, are conditioning their lending to Ukraine in part on the IMF's continuation of its EFF with Ukraine. Ukraine's GDP growth is expected to reach 1.5 % this year and 2.5 % next year.

Ukraine's GDP growth and public sector deficit, 2012–2017



Sources: Ukraine statistics officials and Consensus Economics.

China

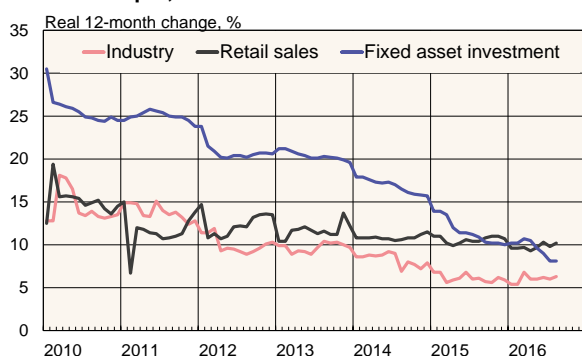
No big changes in Chinese economic trends over the past months. Industrial output growth accelerated slightly in August to over 6 % y-o-y, with retail sales growth climbing above 10 % y-o-y, an increase from July. The rapid slowdown in fixed asset investment (FAI) that had raised concerns in recent months moderated in August; private and public investment growth were both up from July. Infrastructure and real estate construction received the most investment. Monitoring investment developments is, however, getting even fuzzier than before. Apparently, due to the government campaign last year to buy huge amounts of shares to prop up stock prices, a large group of previously privately controlled shareholding firms are now classified as public, which distorts the picture concerning the development of both private and public investments.

The value of China's imports rose 2 % y-o-y in August, the first positive growth figure since autumn 2014. The long-term drop in the value of imports reflects the decline in global commodity prices as Chinese figures show that import volumes rose 3 % y-o-y in the first seven months of the year. While the value of exports was down 3 % y-o-y in August, the volume of exports in January-July was up by 3 %.

Price trends are not a cause for concern for policy makers. Consumer price inflation slowed a bit in August to 1.3 % while producer prices, which have fallen for 54 months in a row, were down less than 1 % y-o-y in August. On month, however, producer prices have begun to rise.

Even if growth in electrical power production accelerated to nearly 8 %, which should suggest an improving economic outlook, the overall economic picture remained decidedly mixed. Figures on freight and passenger traffic suggest a substantial slowdown has occurred this year. A People's Bank of China company survey found that corporate confidence in the economy and their view on the business climate have fallen this year to levels lower than measured in 2008–2009. Moreover, even part of the pickup in industrial output was due to transient factors such as the halving of the sales tax on small cars. The tax cut expires at the end of this year.

Industrial output, retail sales and fixed investment in China



Source: Macrobond

Outlook for Chinese banks gets bleaker. Chinese banks have released their financial statements for the first half of this year. The overall condition of Chinese banks has deteriorated by several measures and large banks expect their condition to worsen in the near future. Provision of basic banking services remains the main generator of bank earnings. For large banks, the interest rate spread between loans and deposits continued to narrow in the first half. The average credit interest rate was 3.8 %, while the average deposit rate was 1.7 %, causing on-year profit growth of large banks to essentially cease. However, their profits were still rather hefty, totalling nearly 500 billion yuan (\$75 billion) for the period.

The slowing economy and structural change are particularly worrisome for banks as they erode the ability of borrowers to pay back their loans. Even if banks this year have accelerated their write-downs of non-performing loans (NPL) compared to earlier years, the NPL stocks of China's four largest banks have grown rapidly, reaching approximately 750 billion yuan (\$110 billion) at the end of June. The declared NPL ratio remains relatively low (1.5–2.5 %), but the true amount of NPLs is likely substantially larger given the traditional reluctance of banks to recognise NPLs and preferring instead to roll over bad loans. The IMF estimates that 15 % of the borrowing of China's exchange-listed firms is likely to end up classes as NPLs. In addition, there has been an increase in overdue payments beyond 90 days. The economic condition of smaller banks is reportedly even more challenging than that of the larger banks.

China's banking regulations require that banks hold reserves equal to at least 150 % of their NPL portfolio. Regarding the largest banks, the NPL provisions of ICBC in June fell to 143 %, while the reserves of CCB and BoC were still slightly more than the minimum requirement. It is unclear whether China's main bank regulator, the CBRC, will intervene on rule violations. Already at the start of the year, officials were suggesting that the requirement could be lowered to 120 %. Although no decision on the issue has been published, market participants speculate that regulation are not being strictly enforced at the moment.

Despite the headwind facing banks, China's Postal Savings Bank is preparing for an IPO listing on the Hong Kong stock exchange. The emission, currently valued at \$7–8 billion, would be the largest IPO listing this year globally in terms of market capitalisation. The IPO is believed to offer a 15 % stake in the bank's shares and with the largest buyers expected to be the state-owned China Shipbuilding Industry corporation and Shanghai International Port Group, which both have committed to purchase slightly over \$2 billion in shares. China Post Group will continue to be the bank's largest owner after the IPO. China's Postal Savings Bank at the end of last year was the world's 22nd largest commercial bank measured by total assets and its network of 40,000 branch offices was the largest in China.

Russia

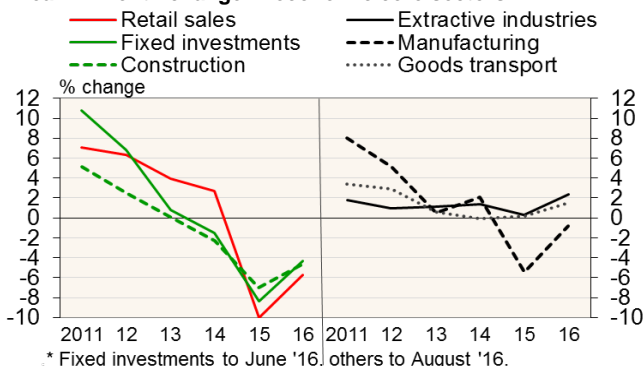
Consumption continued to fall in Russia in August; production picked up slightly. The volume of retail sales (seasonally and workday-adjusted) has fallen for 20 consecutive months. Retail sales were down 5 % y-o-y in August, or about the same as in July and slightly less than in the first and second quarters (down 6 % y-o-y). From the beginning of spring the drop has been approximately the same for sales volumes of both food and non-food goods. Real household incomes continued to decline in August (incomes have been in decline since late autumn 2014).

In contrast, seasonally and workday-adjusted industrial output increased on-month in August – the third month of growth this year. Industrial output was about the same as in March and April, and up 0.7 % from August 2015. The mining and mineral extraction sector (which includes oil & gas) saw a slowdown, with output up less than 2 % y-o-y. The downturn largely reflects a drop in crude oil production for the first time this year to a level about the same as a year ago (production growth had been strong this year up to July). Natural gas production in August was up for the first time this year.

Following a weak performance in July, manufacturing output increased significantly in August, with production climbing back to the same level as August 2015. Among the most important manufacturing branches, output of foodstuffs, chemicals and rubber and plastics products experienced accelerating growth.

The slide in construction began to level off as summer progressed. July-August construction activity was only down about 3 % y-o-y. Growth in farm output picked up towards the end of the summer. Production growth was up 5–6 % y-o-y in July-August. Much of the increase came from larger grain harvests – grain harvests at the beginning of September were about 25 % higher than at the same point in 2015.

Real 12-month change in economic core sectors



Source: Rosstat.

CBR lowers key rate; no further interest rate cuts expected this year. At its regular meeting on September 16, the Central Bank of Russia executive board dropped the key

rate by 0.5 percentage points to 10.0 %. The CBR board, which last lowered rates on June 14, said its rate-cut decision reflected favourable inflation trends. Inflation expectations were down in August and annual inflation slowed to 6.6 % at the beginning of September.

The CBR also made clear in its announcement that no further rate cuts should be expected this year. The next rate cut at the earliest would come in the first half of 2017 and would require that inflation risks calm further and the inflation rate slows as expected. The central bank expects inflation to fall to around 5.5–6 % at the end of this year and says it is still on track to meet its 4 % inflation target at the end of 2017. CBR governor Elvira Nabiullina said that real interest rates should be 2.5–3 % as long as inflation and inflation expectations exceed the central bank's target.

The CBR also revised downward its projection for economic growth next year. GDP is now forecast to grow in 2017 in the range of 0.5–1 % (earlier 1.1–1.4 %). Growth is also now expected to remain tepid in 2018–2019 (1.5–2 %). The CBR also announced plans to issue short-term OBR bonds as part of an expansion of the monetary toolkit for regulating bank liquidity. Liquidity has recently surged through such measures as draining the state Reserve Fund to finance budget deficits.

Despite the CBR rate cut and the recent decline in oil prices, the ruble's exchange rate has been rather stable in September. The ruble-dollar exchange rate has been about 64–65 and the ruble-euro rate about 72–73. Diminished capital outflows have helped support the ruble's exchange rate. The CBR estimates that the net outflow of private sector capital in the first eight months of this year amounted to about \$10 billion, down from \$13 billion in January-May. Net capital inflows in August amounted to about \$1 billion. Such reversals are rather rare, but were also seen in June this year and August-September 2015. The next regular CBR board meeting is set for October 28.

Duma elections produce few surprises. Russians went to the polls last Sunday (Sept. 18) to vote for lower-house Duma representatives. As expected, the party of power United Russia dominated, taking 54 % of the overall vote. As a result, United Russia will gain a constitutional majority in the new Duma. The election's most notable feature was the record-low voter turnout. Only 48 % of registered voters bothered to cast a ballot. Voter turnout in the last Duma elections in December 2011 had a voter turnout of 60 %. Voter turnout was particularly low in Russia's big cities. Only a third of registered voters in Moscow and St. Petersburg voted. Voter participation and support for United Russia was high-est in the North Caucasus republics.

Russians also voted last Sunday on regional governorships in nine regions, regional parliaments in 38 regions, as well as municipal dumas in ten regions. United Russia was the largest party in all of these elections as well.

China

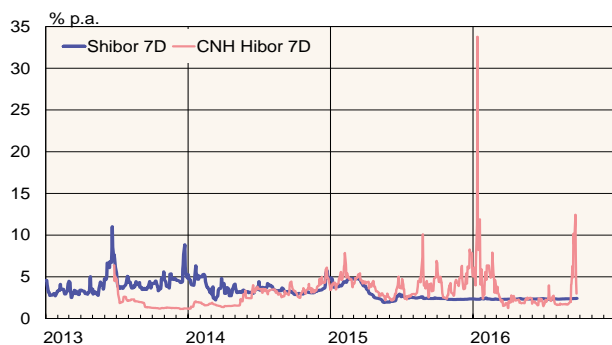
Yuan interest rates spike again in Hong Kong; mainland China money markets remain calm. It became again expensive to hold yuan outside mainland China with the second spike this year in the Hong Kong interbank off-shore yuan rate. On Monday (Sept. 19), the overnight borrowing rate climbed to 24 %, falling back to 1.5 % on Thursday (Sept. 22). While normal seasonal fluctuations in money demand drove part of the increase, observers speculate that in order to reduce depreciation pressures on the yuan, the People's Bank of China instructed China's large state-controlled banks to reduce offshore market liquidity to make it more costly to speculate with weakening of the yuan.

An even more dramatic throttling of liquidity occurred last January, when interest rates on overnight yuan loans soared above 60 %. The PBoC then also sought to reduce offshore liquidity to alleviate depreciation pressures on the yuan and narrow the gap between the onshore (CNY) and offshore (CNH) rates to stave off capital outflows caused by plunging stock markets. Despite efforts of officials to plug certain outflow channels, the outflow of capital from China has continued, albeit at a significantly more moderate pace than in the first half of the year. China's foreign currency reserves fell in August by \$16 billion to \$3.19 trillion.

The yuan-dollar exchange rate has remained below 6.70 in both mainland China and Hong Kong market. Since February, the CNY/CNH gap has been almost non-existent. Some market participants expect the yuan to remain fairly steady until October 1 (when the IMF adds the yuan to its SDR basket), and then weaken somewhat for the rest of the year. Depreciation expectations have also driven the drop in demand for yuan in Hong Kong. At end-July, yuan deposits in Hong Kong were only about two-thirds the level of a year ago. Issues of yuan-denominated dim sum bonds have also fallen.

In contrast, mainland China money markets have been stable with interbank rates unchanged at about 2 %. The PBoC has increased market liquidity through open-market operations. Along with overnight and 7-day operations, it is also providing banks with access to long-term financing.

Yuan interest rates on interbank markets in mainland China (Shibor) and Hong Kong (CNH Hibor) (% p.a.)



Source: Macrobond

Rapid increase in indebtedness in China continues on many fronts. China's booming credit growth shows no signs of abating. The stock of yuan loans grew 13 % y-o-y in August. With slowing corporate investment, households account for an ever larger share of borrowing, particularly in the form of housing loans. In June-August, the on-year growth in household loan stock averaged 20 %, while the stock of loans granted to firms and government administrations grew 9 %. Three-quarters of new loans issued in June-August went to households, mainly in the form of housing loans. In the first eight months of this year, sales of apartments, measured in terms of liveable floorspace, rose 26 % y-o-y. Average apartment prices in urban areas were up 14 % y-o-y in August.

In response to concerns over rising indebtedness and capital outflows, the PBoC has refrained from further broad-based monetary easing. Given the rapid slowdown in fixed investment, there is, however, increased pressures for more policy stimulus. The central bank has continued to dole out targeted loan support. For example, the stock of MLF (medium-term lending facility) loans to designated commercial banks (sometimes for a set purpose), has risen this year to over 1 trillion yuan (€130 billion). The central bank has also lent nearly 800 billion yuan this year to three state policy banks (China Development Bank, Export-Import Bank and Agricultural Development Bank) under the PSL (pledged supplementary lending) programme.

China's policy banks have also issued bonds worth over 2.5 trillion yuan in January-August. Bloomberg reports that policy banks this year have raised over 2 trillion yuan (€270 billion, 3 % of GDP) in new funding to be used to finance designated projects. The lending programme is also expected to have a multiplier effect as firms may use their granted credit as collateral for new loans or deposit part of the money temporarily in commercial banks. At the end of August, the total assets of policy banks amounted to 10 % of total banking sector assets.

International institutions have regularly expressed concern over China's rapid growth of indebtedness. Last week the Bank for International Settlements (BIS) took up the matter in their quarterly report. BIS said that China's debt-to-GDP ratio in March departed 30 % from the long-term trend, which it uses as an indicator of risk levels. The distortion is higher than in any other country and widely seen as a signal of an impending banking crisis. Historical data show that even a departure of 10 % from the long-term trend suggests a high likelihood of a banking crisis within three years. BIS figures put China's debt-to-GDP ratio at the end of March at 255 %. The reality of risks associated with Chinese corporate debt hit home again this week as the first Chinese firm issuing bonds on the interbank market (state-owned Guangxi Nonferrous Metals Group) filed for bankruptcy.

Russia

BOFIT Russia forecast sees slow recoveries for the economy and imports. The GDP contraction in the first half was mild (less than 1 % y-o-y), given that the oil price was 30 % lower than in 1H15 and over 60 % lower than in 1H14. The decline has been softened by a rise in oil prices this year and a large fall in imports caused by a weak ruble. As in 2014–2015, this year's decline in imports has been very steep relative to the drop in GDP.

Our latest [Forecast for Russia](#) for 2016–2018 assumes an average oil price this year below \$45 a barrel (17 % below 2015) that gradually rises to \$55 in 2018. The GDP is projected to shrink 1 % this year, while imports will fall about 7 %. Rising oil prices will gradually revive the GDP in 2017, but growth will be slow, due e.g. to underinvestment now and in the next few years at least. A decisive lift in growth could result if Russia refocused its policy emphasis to market-friendly systemic reforms and away from the currently creeping restrictions that erode the functioning of markets.

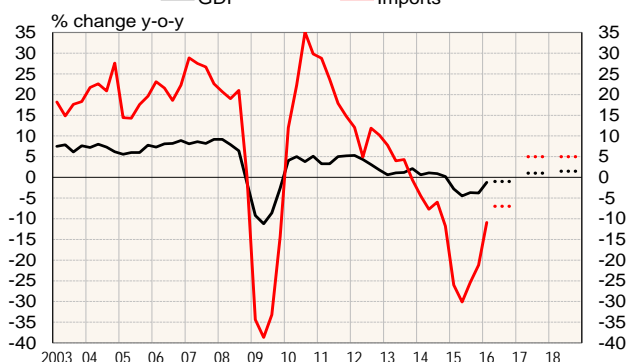
Imports start to revive in 2016–2017 as the economy recovers, the rise of oil prices lifts Russia's export earnings, and the ruble's real exchange rate gradually rises. However, imports will grow moderately. Their share in the economy still now is as large as it was in 2013 before the slide began.

The gradual slowdown in inflation will support a recovery in private consumption. On the other hand, consumption growth will be limited by modest productivity gains that only permit small wage hikes, and by the continuance of current strict policies on public sector wages and pensions. The volume of Russian exports will recover but grow slowly, if the expected mild contraction in oil sector exports materialises. As with other investments, the investments of export firms remain limited by uncertainty over the economy and the poor business environment.

The weak outlook for government finances will also retard economic recovery. Budget revenues are expected to rise only slightly faster than the inflation rate. The downward slide of spending in real terms should moderate from this year, but will continue if the leadership sticks to its announced targets to shrink the budget deficit. The possibilities for relaxing monetary policy seem limited in light of the set inflation target. It is also unclear how strongly monetary easing would affect real interest rates or corporate borrowing due to economic uncertainty.

Large risks to the forecast persist. They mostly relate to the oil price and geopolitical tensions, and consequently the ruble's exchange rate, inflation, imports and government finances. The recovery in imports could be more rapid than our forecast (as occurred after Russia's previous recessions). On the other hand, Russia could impose further restrictions on imports. Given the drop in living standards the people have endured, and with political pressures possibly sprouting, budget policies might be relaxed.

Real change in Russian GDP and imports



Sources: Rosstat, BOFIT Forecast for Russia 2016–2018

Russia imposes new procurement restrictions on the public sector and state enterprises. Most public sector food procurement (including fish, meat, milk and rice) must now favour domestic producers (Eurasian Economic Union members are considered as domestic here). Existing import restrictions on public sector procurements already cover e.g. some machinery products, medicines, clothing and software. A 15 % price advantage is also applied to domestic producers. The restrictions on public procurements have been extended this year to cover state and municipal unitary enterprises such as Russian Post. At the moment, the law on public procurements affects roughly 260,000 organisations whose purchases this year so far amount to 3.3 trillion rubles (€45 billion). The value of public procurements in recent years has averaged around 9 % of GDP.

The 15 % price advantage granted to domestic producers in public procurement will be extended at the start of next year to apply also for the purchases of SOEs carried out through competitive bidding. The actual impact of the law remains unclear, because according to the economy ministry only 5 % of SOE procurements this year have been subject to competitive bidding. The law on procurements of state-owned enterprises does not precisely specify those cases where procurements should be subject to competitive bidding. SOEs were already earlier subject to certain domestic content requirements in the case of large investment projects. The overall value of SOE procurements in recent years has corresponded to about 30 % of GDP.

The restrictions on procurements of the public sector and SOEs are part of Russia's import substitution policy. Unsurprisingly for many observers, prime minister Dmitri Medvedev stated in his recent article that import substitution will remain a focal point of Russian economic policy in coming years, regardless of geopolitical conditions or sanctions.

Russia has also extended its food counter-sanctions to a ban on salt imports from November 1. The salt ban affects the same group of countries (e.g. the US, EU, Norway and Ukraine) and will remain in force with earlier import bans until the end of 2017. The ban mostly affects Ukraine, which last year provided half of Russia's salt imports.

China

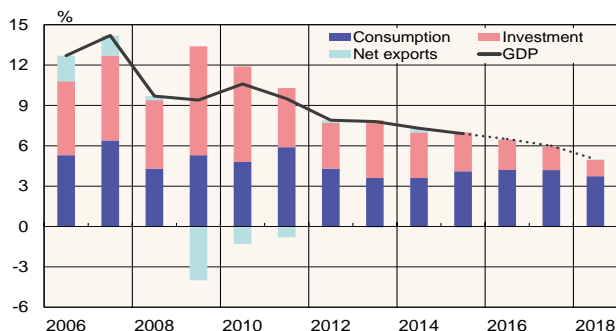
BOFIT forecast for China sees lower economic growth, rising risks. We have just released our latest [Forecast for China](#). With GDP growth receiving a boost from government stimulus policies this year, we now expect 2016 GDP to grow at 6.5 % p.a. (up from 6 % in our March forecast). Otherwise, the outlook for growth remains unchanged from our previous forecasts. The natural slowing of economic growth is expected to continue in coming years, reaching 6 % in 2017 and falling to 5 % in 2018. Several structural factors underlie the slowdown in growth. The sheer size of China's economy makes it increasingly difficult to sustain high growth. Demographic trends are also unfavourable and productivity gains have become harder to achieve.

Progress in the shift to a consumption-driven growth will continue. Rapid growth in disposable incomes will sustain strong growth in domestic consumer demand, and growth in fixed investment will slow. However, this year's trend in investment has been disconcerting. Investment has been largely state-led, while on-year growth of real investment of private firms has been tepid. The contribution of net exports to economic growth in coming years should remain tiny.

Concerns have also increased over the state of the financial sector. Debt-to-GDP ratio is judged to be around 260 %, and indebtedness continues to rise swiftly. Countries that have experienced similar increases in their debt-to-GDP ratios have typically experienced banking crises and rapid economic slowdowns. In China, private firms in particular have piled on debt, even as lower growth and structural shift of the economy has impaired corporate earnings. The weakened state of businesses spills over to the banking sector. Non-performing loans are up and bank buffers have shrunk. The situation for banks will get harder in coming years.

China's economic development depends on political choices. At the moment, policies of opening up the economy on one hand, and tighter internal controls on the other (e.g. increased censorship and more restrictions) are on a collision course. Moreover, it seems that there is wide disagreements over the direction economic policy among party leaders, which increases the uncertainty.

Chinese GDP and contributions to growth (actual and forecast)

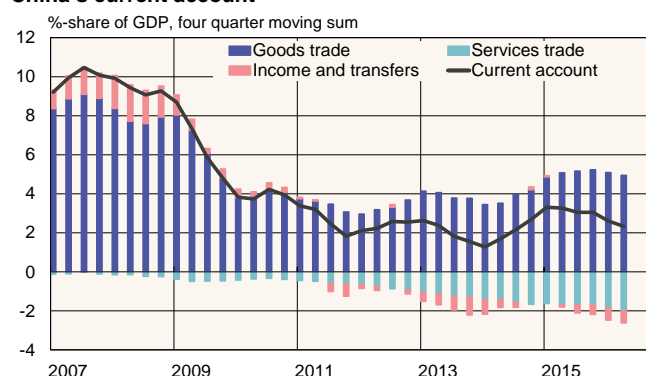


Sources: China National Bureau of Statistics, CEIC and BOFIT

Chinese tourists help reduce trade imbalance. China's current account surplus in the first half of this year amounted to \$99 billion (2 % of GDP). The massive \$229 billion surplus in goods trade was offset by a \$117 billion services trade deficit. Other current account categories (factor income and current transfers) showed a deficit of \$13 billion.

The total goods trade surplus for the past twelve months was \$544 billion in August and the services trade deficit \$227 billion. Nearly all of the services trade deficit (\$211 billion) was generated by travel abroad. In the past 12-months, Chinese travellers spent \$319 billion (up 35 % y-o-y) outside the country. International travellers visiting China spent \$108 billion. However, questions have been raised whether travel spending has become a way to circumvent capital controls, i.e. part of increase in Chinese spending abroad is just capital outflows. According to China's tourism administration, the number of Chinese travelling abroad increased 4 % y-o-y in 1H16.

China's current account



Source: Macrobond

China establishes new fund to assist with reform of state-owned enterprises. While reform of China's large, inefficient state-owned enterprises (SOEs) is one of the most critical reforms on the agenda, it is also a one of the most difficult reform and progress has been slow. This week a new fund was established to support SOE reforms. The fund will eventually grow to 350 billion yuan (\$52 billion), and its assets will go to restructuring, improving competitiveness and financing foreign acquisitions of firms in strategic branches. The fund will be administered by the State-owned Assets Supervision and Administration Committee (SASAC), which is presently responsible for oversight of 106 large central government SOEs.

Smaller funds have previously been established to support SOE reforms, but their overall impact has been marginal. Corporate bankruptcies, winding down of failing subsidiaries or divisions, and corporate mergers have all gradually become part of efforts to return the sector to health, even if serious conflicts of interest have thwarted progress. Mergers are expected to reduce the number of SASAC-administered firms to under 100 by the end of this year.

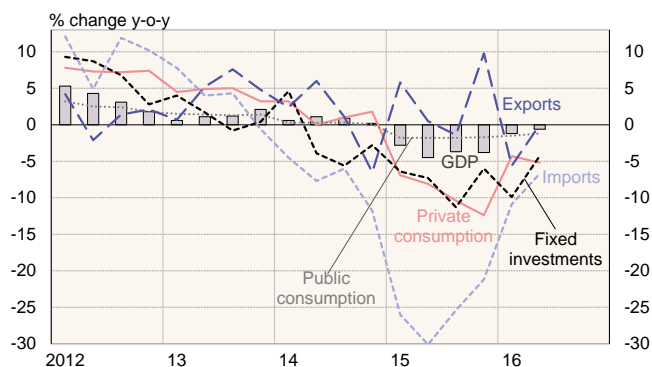
Russia

Still waiting for Russia's economic recovery. The latest Rosstat figures on GDP demand components and imports show that the volume of Russian exports of goods and services recovered from a first-quarter slump in the second quarter, with exports rising to a level on par with 2Q15. The decline in imports of goods and services also began to level off, with the volume of imports down less than 7 % y-o-y in 2Q16 compared to nearly 9 % for the first half overall.

The foundations for economic recovery look still rather shaky, with private consumption decline deepening to 5 % y-o-y in 2Q16. The drop in fixed investment slowed considerably, however, but was still over 4 % y-o-y. As in 1Q16, decline of the overall GDP was in 2Q16 cushioned by the considerably milder inventory adjustment than a year earlier.

CBR preliminary estimates for the third quarter indicate the economy's 3Q performance was much like in the first half. Consumption and investment on-year were down a few per cent, but GDP overall was down just about 0.5 % y-o-y thanks to stabilising inventories and bumper harvest. The CBR estimates that seasonally adjusted GDP remained largely unchanged from the second quarter.

Change in Russia's real GDP, imports and demand components



Source: Rosstat.

CBR announced organisational changes to improve banking supervision. In recent years, the Central Bank of Russia has worked determinedly to clean up the banking sector from financial institutions that fail to comply with legal requirements. At the beginning of this week, CBR governor Elvira Nabiullina announced that solving the problems accumulated in Russian banking sector requires a profound rearrangement of banking supervision. Some board members currently responsible for banking supervision will shift to new duties, while first deputy governor Dmitri Tulin, who earlier was responsible for conducting monetary policy, will be in charge of banking regulation and supervision. Monetary policy is now directly under Nabiullina's purview.

The process of culling bad banks over the past three years has resulted in roughly 280 financial organizations losing

their licences. Some of them were merged with other banks, some restructured and others declared insolvent and wound down. Most of the culled banks have been tiny, but some mid-sized banks have also run into trouble recently.

With a rising backlog of sick banks to deal with, criticism has turned to the agency charged with resolving bank insolvencies, the Deposit Insurance Agency (DIA). As of June 2016, the DIA had 271 insolvency cases still open. Insolvency processes take a long time and case processing has slowed lately. In the first half of 2016, the DIA only managed to finalize the insolvency process for eleven banks. Not only are DIA claim costs up as the condition of sick banks entering receivership is worse than earlier, but Russia's complex banking insolvency rules and lengthy procedural requirements invite abuse. To make resolution procedures more effective, the CBR has proposed that it would directly oversee resolution of failed banks, but the proposal has received a reserved reception from the DIA and the economy ministry.

Most insolvent banks are covered by the deposit insurance scheme, which guarantees each depositor 100 % coverage on deposits up to 1.4 million rubles (€20,000) for each bank where the depositor has accounts. In 1H16, DIA coverage extended to deposits of 44 banks (218 billion rubles). In 2015, the insurance scheme covered 77 banks and about 435 billion ruble in deposits.

At the beginning of September, Russia had 659 operating banks, the lion's share of which were still extremely small. The fifty largest bank held nearly 90 % of total banking sector assets at the beginning of September. State-controlled banks held over half of total assets.

Firms with foreign ownership cutting back operations in Russia. Large and mid-sized firms with at least some share of foreign ownership reduced their personnel more than other firms over the past year-and-a-half by a few per cent to the 2011 level. Firms with foreign participation employ about 5 % of the Russian workforce, and nearly 15 % of workers in manufacturing industries.

The turnover of large and medium-sized firms with foreign ownership have fallen in real terms for several years. Nominal growth in sales has been lower than for purely domestic firms, with their share of total corporate sales falling to just over 20 %. When small firms are included, the 2015 share rises to over 35 %, and to 45 % in manufacturing. Some 35–40 % of the turnover of firms with foreign participation comes from the retail and wholesale trade, and a third from manufacturing, which have a high ratio of sales per worker.

Firms with foreign participation have accounted for 14 % of Russia's total fixed investment in recent years. In the manufacturing sector, they account for 28 % of investment and in the trade sector for about a quarter. Majority foreign-owned firms accounted for over 7 % of the country's total fixed investment. These firms have cut back sharply on investment since the 2011–12 boom.

China

Yuan becomes part of IMF's SDR currency basket.

The addition of the yuan to the IMF's Special Drawing Rights (SDR) currency basket last Saturday (Oct. 1) went smoothly and generated little market reaction this week. The IMF announced its decision to make the yuan an SDR currency in November 2015. Addition to the currency basket is a largely symbolic recognition of the opening up of China's financial markets to the world and increased international yuan acceptance. In China's domestic policy, SDR status has helped in the push for key domestic financial market reforms. The yuan has an 11 % weighting in the revised currency basket, which is significantly more than the yuan's current use in international payments. The yuan plays an important role in Asia, however. SWIFT figures show the yuan is used in 45 % of international payments in Asia and the Pacific region that involve China (includes Hong Kong). In Europe, the share of yuan in China transactions already exceeds 30 %, while in Americas it is still less than 5 %.

The SDR is the IMF's reserve asset and accounting unit, which value is based on a basket of currencies. The SDR is used in lending of the IMF and a small part of member state currency reserves is in SDRs. The interest rate charged on IMF loans and SDR deposits are based on average national interest rates of SDR currencies.

Economy size, use in cross-border payments and weight in SDR basket, %

	Share of global economy (2015 market prices)	Share in international payments (August 2016)	Weighting in SDR basket
US	24.5	42.5	41.7
Eurozone	15.8	30.2	30.9
China	15.0	1.9	10.9
Japan	5.6	3.4	8.3
UK	3.9	7.5	8.1
Total	64.8	85.5	100

Sources: IMF and SWIFT.

China's soaring housing prices again causing concern.

Just over a year ago, average apartment prices in China began to climb again. The rate of climb has been increasing ever since. The real estate portal SouFun, which tracks housing prices in nearly 100 Chinese cities, found that the average price of one square meter of liveable floorspace surpassed 12,600 yuan (€1,700) in September, a 17 % increase from September 2015. Price rises were largest in China's main metropolises. September prices were up 19 % y-o-y in Beijing, 27 % in Shanghai and 42 % in Shenzhen. SouFun's sampling found average apartment prices fell in only 17 cities, suggesting that the recent price rise is exceptionally broad-based.

Following a brief pickup in spring, the rate of housing construction has subsided. In August 2016, new housing starts were up less than 4 % y-o-y. In spring 2015, new starts were up 20–25 % y-o-y. The pace of building growth could

remain moderate in the future as purchases of building rights on lots has fallen sharply since the building boom peaked a couple years ago. In July-August, the volume of lots purchased by companies were down by about 20 % y-o-y.

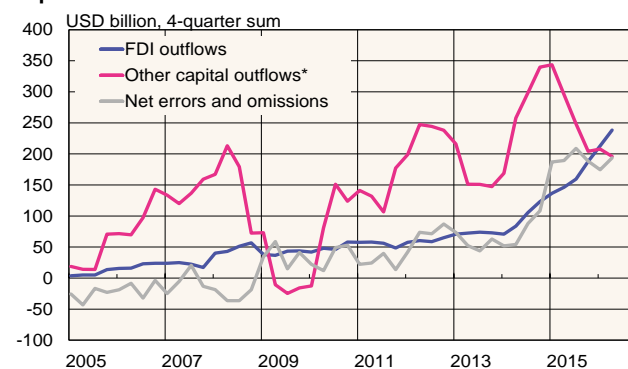
From the economic policy perspective, the housing market situation is problematic. Some of loans intended to stimulate economic output have gone instead to housing investment, further fuelling the rise in housing prices. A housing bubble, in turn, makes it more difficult to deal with the debt problem. Local governments have tried to deal with the price rise by tightening city-specific rules on apartment purchases and loan conditions, as well as encouraging real estate developers to move ahead with new construction projects. At the moment, these measures have had little effect and the situation continues to degrade.

Capital outflows from China strengthen. Balance-of-payments data for the first half of 2016 show capital outflows from China amounted to \$236 billion, while capital inflows were just \$64 billion. Thus, the financial account deficit (changes in currency reserves not included) was \$172 billion. In contrast, the current account still showed a strong surplus, but the PBoC, especially in January, still had to sell currency from its reserves to calm forex market worries about yuan devaluation.

In the first half, about half of capital outflows from China were direct investment or comparable capital flows (e.g. intragroup corporate financial arrangements). Chinese also actively lent to borrowers abroad and increased other receivables from abroad. The net errors and omissions term in the balance-of-payments figures, which indicates unreported cross-border money transfers, suggests heavy capital outflows.

The increase in capital outflows from China reflects several factors. The lift of capital controls in China has allowed capital flows to increase. Measures to increase international use of the yuan through the creation of offshore trading centres have supported these outflows. In addition, the slowdown in economic growth and increased risk have made investment abroad more attractive to Chinese investors.

Capital outflows from China



*) Portfolio investments, derivatives, deposits, loans, trade credits and other receivables.
Sources: Macrobond and BOFIT.

Russia

Russian cabinet decides to increase spending this year, abandons last spring's budget framework. The Russian government this week submitted to the Duma a proposed amendment to this year's federal budget act that increases budget spending by 0.3-0.4 % of GDP compared to this year's approved budget. This differs visibly from the policy goals underlined last spring, when leading policymakers stated on numerous occasions that spending cuts this year were essential to reining in the federal budget deficit. In the spring the cabinet decided, however, to postpone any spending cuts to this autumn.

Under the amendment and according to prime minister Dmitri Medvedev, spending rises and redirection of existing spending will allocate more money to the National Pension Fund and other priority spending areas. The proposal apparently includes a substantial increase in defence spending.

Lower-than-expected oil prices have reduced federal budget revenues. This year's budget initially assumed that the price of Urals-grade crude oil would average \$50 a barrel this year. The average price this year has been about \$40. The spending increase means that the federal budget deficit will widen this year to 3 trillion rubles (€43 billion), or 3.7 % of GDP (original deficit ceiling 3 %). The deficit increase is planned to be covered through e.g. increasing domestic debt and divestment of stakes in state-owned enterprises. Most of the budget deficit, of course, will be funded out of the Reserve Fund, but in the amendment there are no propositions to increase the amount of planned withdrawals this year.

Russian imports recover to nearly same level as a year ago. Preliminary balance-of-payments figures released by the Central Bank of Russia show that Russia's spending on imports of goods and services in the third quarter was only a few per cent below the level of 3Q15. Spending on goods imports was, however, already up on-year by several per cent. Russian spending on travel service imports was still in a deep slump, down 35 % y-o-y. Revenues from exports of goods and services were also still down 10 % y-o-y. The 3Q16 current account remained slightly in surplus, but the surplus was among the smallest in three years.

In the first nine months of the year, Russia's cumulative current account surplus was just \$16 billion, down from \$54 billion a year earlier. The shrinking surplus mainly reflects the larger drop in exports than imports. In the last four quarters, the cumulative current account surplus has amounted to less than 3 % of GDP.

In the third quarter, the net flow of private capital on the financial account turned again slightly negative. This was due mainly to banks paying down slightly more foreign debt than in the second quarter. In addition, other firms also paid off their foreign debt while increasing their accounts receivable from abroad.

The private sector net capital outflow in the first nine months of this year amounted to \$10 billion, down from nearly \$50 billion in the same period last year. Underlying the shift was the contraction in foreign debt payments of banks and an increase in repatriations of foreign receivables. The net inflows of direct investment and portfolio investment to other sectors also increased, even if they were still rather modest.

Change in Russian spending on imported goods and services



Source: Central Bank of Russia.

Russian government sells Bashneft to Rosneft. The state's 50.08 % stake in the Bashneft oil company has been on this year's privatization list. Russian government decided this week to sell the stake directly to oil company Rosneft in which state also has majority ownership. The stake was sold for 330 billion rubles (€4.7 billion), which was slightly higher than analysts expected. The money from the sale will go to covering this year's budget deficit. The government is also still planning to sell this year a 19.5 % stake in Rosneft to cover the budget deficit. Chinese and Indian oil companies are among those interested in acquiring Rosneft stakes. Rosneft also recently said it might be willing to buy back its own shares.

There has recently been considerable criticism in Russia of the state's disproportionately large role and the lack of competition in the economy. Russia's Federal Antimonopoly Service has found that the share of economic activity involving state or state-owned enterprises has increased substantially over the past decade, seriously impairing competition and hampering the operations of private companies. The CBR says that high level of monopolisation across many industries materially complicates the use of monetary policy channel in managing inflation. The finance ministry has stated that reducing the role of state companies in the economy should be a central policy goal in coming years, noting that state-owned firms consume economic resources inefficiently and crowd out private firms in financial and labour markets.

China

China's structural shift and economic slowdown profoundly impact global economy. The International Monetary Fund's semi-annual World Economic Outlook (WEO) report was released last week. The IMF lowered slightly its forecast for global growth this year to 3.1 %, mainly on an unexpectedly weak performance of the US economy in the first half. Global economic growth is expected to accelerate next year to 3.4 %. While growth in developing economies is still expected to slow this year to 1.6 %, growth in emerging market economies, after years of continuous slowing, should accelerate to 4.2 %. Emerging market economies now account for about three-fourths of all global economic growth.

The WEO took special note of the impacts of China's structural change and slowing growth on other countries. China is among the ten most important export markets for over 100 countries, so the slowing in Chinese growth and shifts in its growth model are strongly reflected in the global economy. Referring to earlier research, WEO reports, for example, that a 1 % negative shock to China's final demand lowers world GDP by about 0.25 %.

Most impacts are transmitted via the foreign trade channel and depend to a large extent on the country's export structure vis-à-vis China. As a rule, a change in the structure of Chinese demand benefits exporters of consumer goods and weakens the relative position of producers of investment goods. For energy and commodities producers, changes in Chinese demand are seen via changes in prices, but also China's oversupply in some sectors causes price disturbances. The IMF said that the spillover effects to financial markets from changes in China, while limited at the moment, are growing. Turbulence in China's financial markets has already increased volatility in international markets.

The slowdown in China's growth and structural adjustments creates pressures at all levels and the road ahead will not be smooth. The IMF stressed that, managed properly, changes in China will put it on a more sustainable development path, a trend that is in the world's interest.

Yuan's exchange rate volatility increases after addition to SDR basket. The yuan lost about 1 % of its value against the dollar when the markets reopened this week after the week-long National Day celebrations. In September, the yuan was relatively stable and its inclusion in the IMF's SDR basket on October 1 went without a hitch. Capital outflows from China have continued as the yuan has weakened. The country's foreign currency reserves this year have shed \$164 billion and at the end of September stood at \$3.166 trillion.

An increase in yuan exchange rate volatility reflects the policy goal of a free-floating currency. The yuan's average daily variation against the dollar has been 0.12 % over the past year. It was 0.07 % prior to the exchange rate reform of summer 2015. Even with the yuan's higher exchange rate volatility, it still fluctuates considerably less than free-floating

currencies. The euro's daily average fluctuation this year has been 0.41 % and the yen's 0.52 % against the dollar. The average change in offshore yuan (CNH) against the dollar has also been larger (0.17 %) than for the onshore CNY rate. The largest single daily change in the yuan's exchange rate – 1.8 % – occurred in August 2015 in connection with the exchange rate reform. For comparison, on the day after the Brexit vote, the euro lost 2.1 % and the yen appreciated 3.4 %.

Onshore vs. offshore rates: CNY and CNH (HK) against USD



Source: Macrobond

China's competitiveness unchanged relative to other countries. The World Economic Forum (WEF) Global Competitiveness Index (GCI) rankings of 140 countries put China this year in 28th place. China has held its 28th position in the rankings for three years in a row. The GCI considers 114 indicators that matter for country's productivity and long-term prosperity. The indicators are grouped under 12 pillars that include institutions, infrastructure, macroeconomic environment, health and primary education, higher education and training, goods market efficiency, labour market efficiency, financial market development, technological readiness, market size, business sophistication and innovation. The comparison does not take into account national differences in, e.g. price competitiveness.

China consistently fell into the upper-middle group for most indicators. Notable virtues of China were the exceptional size of its economy, price stability, savings levels, opportunities for air travel, share of students starting primary education, and rates of HIV and malaria. In all these categories, China was the best or among the best. China performed poorly relative to other countries in e.g. investor protection, which have gotten worse in recent years, and corporate taxation, which has become more severe. Establishing a new business is still more difficult than in many other countries and corporate governance is weak. Moreover, the broadband capacity per user is still relatively small.

Switzerland topped the GCI rankings this year. Hong Kong ranked 9th, Finland 10th and Taiwan 14th. Russia climbed in the ratings to 43rd place, up from 67th five years ago. The WEF noted Russia's improvements in institutions, overall education level, innovation capacity and business environment. The conclusion raises questions about the reliability of the GCI indicators in capturing actual development.

Russia

Russian industrial output contracted in September.

Total seasonally and workday-adjusted industrial output contracted slightly in September from August. The volume of production was down 0.8 % y-o-y. The production is currently close to the levels seen in 2011.

September manufacturing witnessed a stronger contraction, down 1.6 % y-o-y. Although a turnaround in manufacturing has been expected for months, any signs of recovery have remained faint. The differences across branches, however, were significant. Production of foodstuffs and chemical industry products showed a distinct rise, while falling production continued in production of many petrochemicals and construction materials.

Extractive industry output fell slightly from August to September, but was still up 2.1 % y-o-y. Growth has however, slowed down from the beginning of the year when crude oil production increased strongly.

The contraction in retail sales continued in September, but at a more moderate pace than earlier this year. The volume of retail sales was down 3.4 % y-o-y. Retail sales were supported, however, by a halt in the contraction in private sector real wages. Real disposable incomes overall contracted by nearly 3 % y-o-y.

Russia and India agree on new arms sales, but overall trade between the countries continues to shrink.

During the BRICS summit in Goa last week, India revealed it was buying new weapons systems from Russia. In recent years, India has been Russia's most important arms customer. The Stockholm International Peace Research Institute (SIPRI) estimates that about 40 % of Russian arms exports went to India during 2011–2015.

Under the current deal, India will buy, among other things, an S-400 air defence system. The deal, which will take several years to perform, is valued at about \$5 billion. In addition, India and Russia agreed on local assembly of certain equipment such as Kamov military helicopters in India. The deal also included purchase of two frigates capable of launching cruise missiles, with India later producing two similar frigates in its own shipyards. Russia continues work on the two nuclear reactors at the Kudankulam power station in Tamil Nadu. The first Russian-built reactor was commissioned in October 2013 and the second last week.

In conjunction with the BRICS summit, Russia's state-owned oil company Rosneft announced that it was involved with a group of international investors in the joint acquisition of the Indian oil company Essar Oil. Rosneft will take a 49 % ownership stake. The deal, valued at \$13 billion, should be finalised by the end of the year. Rosneft is also preparing to sell a further 11 % stake in its Vankorneft subsidiary to the Indian ONGC Videsh. After the acquisition, Indian oil companies will control 49.9 % of Vankorneft.

With the Russian economic recession and the ruble's depreciation, Russia's trade with India has declined in recent years. Russian exports to India in the first eight months of this year were worth about \$3 billion and imports from India about \$1.5 billion. The dominant product categories for Russian imports from India were pharmaceuticals (nearly a third) and electronic equipment (slightly over 10 %). In Russian exports to India precious gems accounted for nearly 20 % and machinery & equipment for slightly over 10 % of exports.

Neither India nor Russia are very important to each other as trading partners. India accounts for only 1–1.5 % of Russian exports and Russia about 0.5 % of Indian exports.

Government subsidies keep Russia's inefficient car producers on life support.

The economy ministry last week released a study that found that Russia's car industry received state subsidies of about 400 billion rubles (nearly €9 billion adjusted to annual average exchange rates) from 2009 to 2015. Last year, one in three cars in Russia was purchased with state support. The report stated that the subsidies have prevented large reductions in production capacity but allowed non-competitive carmakers to remain in the market. The economy ministry estimates that in the coming years as much as a third of the Russian car industry's annual production capacity of 3.3 million vehicles will be idle. Most of this production is not competitive in export markets and domestic demand is only expected to recover slowly. Even so, the economy ministry is not advising to cancel subsidies to carmakers, but rather redesign the support to be more efficient. The car industry accounts for about 0.5 % of Russian GDP and directly employs about 500,000 people.

About 1.5 million new passenger cars were sold last year in Russia which is about half of the peak levels before the current crisis. Car sales have declined already for three years and in the first nine months of 2016 were down 15 % y-o-y.

Last year, 1.2 million cars were produced in Russia, and another 350,000 cars were imported. Imports as a share of consumption have declined notably over the past decade as the result of foreign car makers putting up assembly plants in Russia. Majority of Russian production today is assembly work. The average degree of localisation is only about half, however, because local component production simply does not exist. Imports have also been reduced by high import duties that Russia must gradually lower in coming years under its WTO commitments. Russia also introduced a vehicle recycling fee in a 2012 which has been contested in WTO.

Russia last year exported about 100,000 passenger cars. Car exports have fallen for two years and in the first half of 2016, they fell further 30 % y-o-y. Demand has been weak in Russia's main export markets, the CIS countries. Exports to Kazakhstan this year collapsed with the introduction of vehicle recycling fees. Russian brands are mostly not competitive outside the CIS and the export competitiveness of Russian assembly production is hampered e.g. by high logistics costs.

China

China once again releases GDP growth figure in line with official target. Third-quarter economic performance figures from China's National Bureau of Statistics show GDP growth held steady at a 6.7 % y-o-y for the third quarter in a row. Quarterly GDP growth was 1.8 % q-o-q, which corresponds to an annualized growth rate of 7.4 %. The underlying economic development behind the unconvincingly stable GDP growth figures, however, has been quite mixed. Nominal on-year GDP growth accelerated slightly in 3Q16 to 8 %.

Industrial output rose 6 % y-o-y in September, while retail sales were up nearly 10 %. Growth in fixed investment accelerated slightly, climbing 9 % y-o-y in September. The investments of state and state-owned enterprises have risen considerably faster (up 21 % in January-September) than private investment (up 3 %).

A disconcerting aspect of China's high growth is the quality of the growth. The growth has been supported by government stimulus measures financed with ever-increasing debt. Growth has also been boosted by the overheated real estate sector and increased borrowing for apartment purchases. Looking at the GDP components, the real estate sector's growth accelerated from below 4 % last year to 9 % in the first nine months of this year. Measured by liveable floorspace, apartment sales were up 27 % y-o-y in the first three quarters. The rapid rise in real estate prices has not ignited a construction boom, however. New construction starts, again measured by floorspace, increased 7 % in January-September, even as sales of the land rights for housing construction fell 6 %. Several cities have tightened apartment purchase conditions and downpayment requirements, so that the impacts of the real estate boom are likely to be quite transient.

The September figures give a two-track picture of progress in economic structural reforms. On the demand side, growth has largely been consumption-driven – in the first three quarters of this year, 71 % of GDP growth came from consumption. On the supply side, the service sector has grown to account for 53 % of economic output, while service sector growth has slowed and its contribution to economic growth has fallen slightly to 60 % of GDP growth. A standout feature of the new figures is the rapid slowing in income growth. In January-September, average disposable incomes grew 6 % y-o-y in real terms, down from 8 % growth a year earlier. Especially growth in migrant worker incomes has slowed fast.

Producer prices in China finally start to rise. After 54 consecutive months of decline, producer prices in September rose 0.1 % y-o-y, bringing to an end an unprecedented producer price deflation episode that began in March 2012. The protracted period of falling producer prices reflected both the drop in global commodity prices and China's overcapacity problems. The rise in prices has mostly been caused by the recovery in global commodity prices. Prices of liquid fuels, coal and metals all began to rise. Prices of almost all other

products have generally held at roughly the same level as a year ago. An increase in producer prices creates upward pressure on China's export prices and possibly global producer prices as well.

The rise in consumer prices accelerated from 1.3 % in August to 1.9 % last month. Food prices were up sharply. Core inflation (excludes food and energy prices) has remained stable and below 2 % for over three years.

Price trends in China



Source: Macrobond and BOFIT.

Value of China's foreign trade declines even as trade volume increases. The fall in the value of China's exports since spring 2015 accelerated in September. Dollar-denominated exports were down 10 % y-o-y. After falling since autumn 2014, the value of imports rebounded slightly in August, only to sink again by 2 % y-o-y in September. With the yuan down nearly 5 % y-o-y against the dollar last month, the drop in the value of foreign trade was more modest in yuan terms. The September foreign trade surplus fell to \$42 billion.

The value of trade was depressed by drops in export and import prices, while the volume of exports in June-August was up 5 % y-o-y and the volume of imports up 3 %. Also foreign trade cargo figures from China's ports suggest a slightly stronger trend in volume growth than last year. Import volumes of many critical commodities have been rising. For example, China continues to build up its strategic oil reserves, with crude oil imports rising 15 % this year.

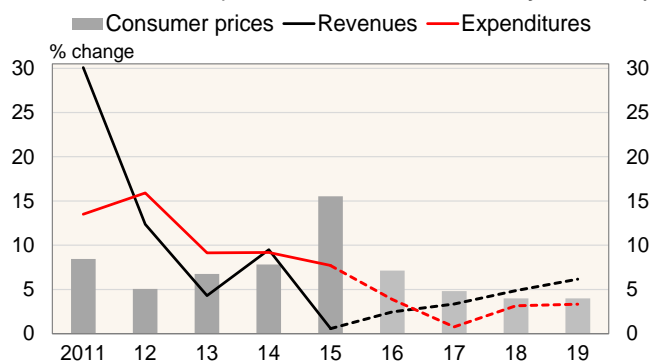
The IMF's latest World Economic Outlook (WEO) notes that the slowdown in growth of global trade arise from depressed global economic growth and slowdown in fixed investment growth in particular. Moreover, the growth in international trade has also been dampened by increased protectionism and decreased importance of international production chains. These factors are likely to underlie the slowdown also in the growth of Chinese foreign trade. Chinese statistical data show that the share of processing trade has fallen from about 55 % ten years ago to around 40 % today, and that this declining trend is apparently set to continue. Production-chain-related imports have also fallen in the past decade from about 50 % to just over 30 %, and have remained at that level for several years now.

Russia

Bleak outlook for Russia's government finances. In its fresh budget policy framework for 2017–2019, the finance ministry sees revenues to the consolidated budget (federal, regional and municipal budgets, and government social funds) still failing to keep up with inflation next year. The estimate cautiously assumes a price of Urals-grade crude oil of \$40 a barrel for the whole period, which equals the average of January-September of this year. The ruble's exchange rate, which also affects tax revenue from oil, is assumed to weaken slightly. Other revenues are expected to slightly outpace inflation next year. To mend the revenue side, the government plans to treat the income (nearly 0.9 % of GDP) raised from the sale of a 19.5 % stake in state oil giant Rosneft as budget revenue, although by nature that income is a financing item to cover the budget deficit. It would be channelled to the budget as dividend income from the state-owned firm selling the Rosneft stake. The sale could be completed this year.

The ministry expects low government spending growth in coming years as targets have been set to shrink the deficit. The 2017 growth figure is also depressed by this year's abrupt spending boomlet caused by the 2016 supplementary federal budget (currently in the Duma) that boosts defence spending by a whopping 0.9 % of GDP. The ministry now estimates the government budget deficit will reach 4 % of GDP this year even if the Rosneft deal goes through, and 4.8 % of GDP without the deal. Next year's targeted deficit is 3 % of GDP.

Changes in government revenues and expenditures, and inflation rate, 2011–2019 (2016–2019 are finance ministry estimates)



Source: Ministry of Finance.

Russia drops slightly in the *Doing Business* 2017 rankings. The World Bank's latest business environment survey ranks Russia 40th out of 190 countries. Russia's current ranking puts it on par with Bulgaria, Hungary and Belgium. China rose slightly in the rankings to 78th position.

Longer term developments are harder to figure out from the data due to major methodological changes especially in recent years. For example, Russia ranked 36th or 51st last year depending on the methodology applied.

While *Doing Business* is the widest and best-known international business climate comparison, it has its limits. By concentrating on narrowly defined sample cases, the results cannot necessarily be generalised to the broader business environment. It does not take into account e.g. corruption or the cost of inspections by officials, which are often quite substantial in Russia. Prime minister Dmitri Medvedev recently noted that the inefficiencies caused by officials' inspections cost firms around 5 % of GDP. In addition, the regional business climate survey used by the Russian administration showed that last year the worst declines were in indicators of official oversight and administrative coercion for firms.

The narrowness of *Doing Business* survey criteria is also reflected in the fact that some of its results differ markedly from the findings of other surveys. In the *Doing Business* comparison Russia ranks high in sub-indicator topics such as registering property (9th) and enforcing contracts (12th). In contrast, the WEF competitiveness rankings give Russia significantly lower marks in similar topic categories, e.g. property right enforcement (123rd) and judicial efficiency in dispute resolution (82nd).

Moreover, the *Doing Business* survey only looks at big cities, i.e. Moscow and St. Petersburg in Russia's case. However, the differences in business climates across Russia's regions are large. Russia's ranking in the survey showed greatest improvement in the sub-indicator for ease of starting a business, which considers, among other things, how long it takes to set up a company. The reported average time was less than 10 days. A survey of the Russian Union of Industrialists and Entrepreneurs (RSPP) found that last year it took less than 10 days to set up a business in only 18 % of Russian regions.

Unpredictability of administrative regulation diminishes corporate investment appetite in Russia. The World Bank recently published a study (Levina & al. 2016) that examines how informal administrative regulation is related to the eagerness of firms to invest in Russian regions. Most of the data are based on the Russian Firms in the Global Economy survey conducted in autumn 2014. The data set has been supplemented with regional variables, BEEPS survey material on corruption factors and the NGO "Companies Against Corruption" information on hostile takeovers. The sample covers about 1,500 Russian companies in 35 regions.

The findings show companies adjust to the level of administrative corruption in a region if corruption is a predictable and foreseeable component in an investment decision. If, however, the firm's experience with administrative corruption in the region varies greatly, the unpredictability of corruption diminishes the company's appetite for investment. Corporate eagerness to invest is also hurt by inconsistent enforcement of property rights and the possibility of unexpected hostile takeovers. While the study makes no policy recommendations, it reinforces earlier views that the uncertainty in the business environment discourages investment, which then impedes economic recovery in Russia.

China

Chinese government pushes to get debt restructurings going for troubled state-owned firms. China has been preparing a programme since last spring to ease the massive debt choking state-owned enterprises and stop the mounting level of banks' non-performing loan portfolios. Early this month, the State Council posted guidelines for reducing corporate debt. It made clear that the arrangement only applies to high-quality firms with good chances of long-term survival. The government emphasized that the arrangement does not apply to unviable "zombie" firms, many of which operate in branches suffering from overcapacity.

The guidelines seek to avoid the problems that arose after debt-equity swaps at the end of the 1990s. They also draw on expert advice on the dangers of keeping unviable businesses on life support and the inability of banks to step in as an owner and manage troubled firms. For these reasons, the government emphasises the role of market forces in debt restructurings. In practise, debt-for-equity swaps would be performed by asset-management companies owned by banks or third parties, and the exchange of debt and shares would take place at market prices. Although the government states that it will not answer for the loans of over-indebted SOEs, it has promised extra funding to viable companies that move ahead with restructuring. The government also hopes that mergers, acquisitions, and bankruptcy actions will restore the debt-burdened corporate sector to sound basis.

While restructuring and winding down of state-owned enterprises has been slow and painful, something is happening. Earlier this month, the court approved the bankruptcy plan of state-owned Dongbei Special Steel Group after large state banks refused to swap junk bonds for shares despite pressure from the Liaoning provincial government. While the incident shows financiers that state-owned companies can also go bankrupt, it is still unclear what will be left of Dongbei after it emerges from bankruptcy and how much steel production capacity will eventually be taken off the market.

Second-child births keep China's maternity wards busy. Late last year, China announced it was abandoning its long-standing one-child policy, replacing it with a new general two-child limit. Official estimates now see a net increase of 3 million births a year over the next five years as a result of the policy change. Even with the change, the population is on track to peak at 1.45 billion in 2029, and thereafter begin to shrink. Many urban maternity clinics now face a rush as families apparently decided as soon as the policy change was announced to go for number two. In Beijing, for instance, some 360,000 babies will be born this year, over 100,000 more than in 2015. Facilities and staff are stretched to the limit, even if more maternity beds have been set up.

Even with numerous exceptions granted since China

adopted the one-child policy in the late 1970s, China's demographics have become distorted. China's dependency ratio is rising rapidly, with large age cohorts reaching pension age and much smaller cohorts entering the labour force. More boys than girls continue to be born. The imbalance is the world's most severe, even if it has fallen a bit in recent years. In 2015, 114 boys were born for every 100 girls. Such imbalance could lead to social tensions if young people are unable to find a suitable match.

The one-child policy also affects care of the elderly, a job that has traditionally fallen on the shoulders of the children. A Peking University nationwide survey of 20,000 over-45-year-olds found that over half of China's elderly already live without the assistance and support of their children. The need for public and private elder care has increased.

Mainland China stock markets await investment of pension savings and foreign investors. Prices on mainland China stock markets have remained relatively stable this year and trading has calmed considerably from last year's boom. New possibilities to invest in the stock exchange are increasing. A change in the law approved last year now allows pension funds to invest in equities and debt securities. According to press reports, China's local governments are beginning to invest pension assets in publicly traded stocks this year, which could bring 200–400 billion yuan to the market before the end of the year. The amount is less than 1 % of the market capitalisation of mainland China stock exchanges. Local pension funds will be transferred to China's national social security fund, which will administer the invested assets.

The long-awaited Shenzhen-Hong Kong Stock Connect project has reached its technical phase, with trading expected to begin in late November. Investor interest in the Shanghai-Hong Kong Stock Connect project that launched in November 2014 has been relatively modest and inter-exchange trading under Stock Connect still accounts for less than 2 % of the Shanghai stock exchange's daily turnover. The programme has also failed to close the price gap between Shanghai and Hong Kong, even if it has narrowed slightly in recent months. Prices of Chinese company shares in Shanghai on average are still 22 % higher than the same shares in Hong Kong.

Trends in Chinese stock markets



Sources: Macrobond and BOFIT.

Russia

CBR leaves key rate unchanged. On October 28, the board of the Central Bank of Russia decided to keep its key rate at 10 %, where it has been since September 19. The CBR reiterated that no further rate cuts should be expected this year, but the key rate can thereafter fall if there are signs that inflation is cooling as expected and inflation risks are abating.

The CBR said 12-month inflation slowed to 6.2 % at end-October, but noted that much of the slowdown reflects transient factors such as this year's good harvest. The ruble's exchange rate has also appreciated and inflation expectations are rather high. The CBR said holding the key rate unchanged should reduce inflation expectations and encourage saving.

The recovery in output is unstable and has been uneven across branches and regions. The CBR said most barriers to growth are structural, so a moderately tight monetary stance should not prevent economic recovery.

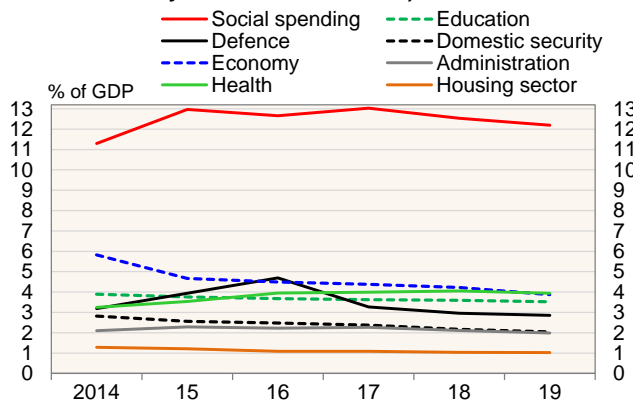
The CBR's inflation target is still 4 % at the end of 2017, but possible risks to reaching that figure include inertia of inflation expectations, lower household savings, higher real wages, pending decisions on mid-term fiscal policies, and volatility in commodities and financial markets. The CBR's next regular board meeting is set for December 16.

Russia's special supplement to defence spending also affects next year. In the budget policy framework for 2017–2019, the finance ministry foresees that defence spending will decrease sharply after this year's large increase. The draft of this year's supplemental federal budget, currently before the Duma, sees defence spending rising to its highest level in over 20 years to 4.7 % of GDP. Defence accounts for over 13 % of consolidated budget government spending this year. Spending on domestic security is 6.7 %. The respective shares of federal budget spending are nearly 24 % and 12 %, or almost 36 % combined. There is no reason to add any so-called secret spending of approved budgets to the above draft budget figures as in draft budgets the sum of all main categories adds up to total spending. The Stockholm International Peace Research Institute (SIPRI) estimates that defence spending has for years been roughly one percentage point of GDP higher than presented in official budget data.

The massive supplement to this year's defence spending is a very special measure. The additional money will go to paying off defence industry bank debts that are guaranteed by the state. Finance minister Anton Siluanov said this enables new borrowing by the companies to facilitate e.g. implementation of the armament programme. For new borrowing, the ceiling on state guarantees for 2016 will increase sharply.

The ministry estimates that social spending will rise to 36 % of total consolidated budget spending. That share would rise even higher without the earlier decision that pensioners who are working no longer receive inflation adjustments to their pensions.

Main categories of government spending (consolidated budget, finance ministry estimates for 2016–19)



Source: Ministry of Finance.

Russia's middle class hit by recession. A new Sberbank survey finds that the number of Russians that see themselves as middle class has declined sharply over the past two years. A study from the Institute of Sociology of the Russian Academy of Sciences (ISRAS) finds that the "core" middle class has suffered relatively more than lower income households.

It is difficult to evaluate trends or the size of the middle class in any country, because there is no clear agreement as to what constitutes middle class. In Russia, the middle class is a concept dealt with widely in studies of the Russian Academy of National Economy and Public Administration (RANEPA) and ISRAS. In these studies, the concept of middle class incorporates factors such as income, property, education, profession and personal experience. Some 10–20 % of the total population has been estimated to form the core middle class in recent years. Under broader definitions, the size of the middle class expands to 20–40 % of the population. RANEPA estimates that the percentage of households that would rank as middle class has remained largely stable throughout the past decade and a half. ISRAS found that it had grown from 30 % to 40 % over the past decade.

Due to data availability, international comparisons typically focus on income or wealth. A popular approach is to define a middle-class household by daily income: in the range of \$10–20 for middle class and \$20–50 for upper middle class (adjusted for purchasing power and household size). Using this definition, the Pew Research Center, for example, finds the Russian middle class increased from 28 % in 2001 to 37 % in 2011 and the upper middle class from 9 % to 36 %. In 2011, 18 % of the Chinese population was middle class and 4 % upper middle class; the figures for the US were 7 % and 32 %. When wealth is compared, the middle class typically is smaller, because wealth is more unevenly distributed. A Credit Suisse survey classifies a household as middle class or higher if it has assets of at least \$50,000 (PPP). Under this criterion, 4 % of the Russian population were middle class in 2015 and 0.5 % above that. In China, the share of middle class was 11 % and in the U.S. 38 %.

China

China tightens measures to deal with overheating of the housing market. Access of real estate developers to external funding has been severely restricted since the past month. The financial magazine *Caixin* reports that the National Development and Reform Commission (NDRC) has cancelled bond issues by builders in mainland China and Hong Kong. The China Securities Regulatory Commission (CSRC) is withholding permission from mainland construction companies seeking to stage IPOs on the Hong Kong exchange. Officials are also in the process of drafting stricter guidelines for construction company bond issues. Without bond financing, it becomes harder to purchase land use rights, the prices of which have soared recently. By stricter rules, the government may also be trying to better shield investors from the increased risk in the branch and costly bailouts.

The new restrictions follow ad hoc attempts to deal with the overheating problem in dozens of cities. Measures such as higher downpayment requirements and limits on the number of apartments private persons could own were insufficient to stem the rise in prices. These measures are reminiscent of actions after the stock market collapse in summer 2015, when the state intervened heavily in the market.

The government's measures are geared to slowing the rise in apartment prices, which in China's big cities were still up on average 17 % y-o-y in September. The National Bureau of Statistics last week took the unusual step of releasing mid-month price figures for October. They showed a slowdown in price growth in urban apartment prices from September.

The housing price boom has been fuelled by easy access to housing loans. The stock of housing loans held by the banking sector at the end of September stood at 18 trillion yuan (25 % of GDP), an increase of 33 % y-o-y. In the third quarter, 70 % of new bank lending went to households, mostly in the form of housing loans. The People's Bank of China has attempted to quiet the rapid growth in housing loans through use of its suasive policy tool known as "window guidance." Media report that the PBoC last month invited representatives of the largest commercial banks to a meeting in Beijing, at which banks were encouraged to tighten their housing loan criteria and improve monitoring of loan performance.

PBoC figures show that the average interest rate on a housing loan was 4.6 % p.a. in June, about one percentage point lower than in summer 2015. Notably, many apartment buyers have borrowed their downpayment money from peer-to-peer lenders or used other financial arrangements provided by the shadow banking sector, where interest rates are considerably higher than those of regular banks.

China reaps good grain harvests this year. The National Bureau of Statistics reports that China has enjoyed bountiful grain harvests this year, even if the summer harvest was 2 million tons less than in 2015. The summer harvest, only represents about a fifth of the annual harvest, however.

Harvests overall have increased substantially in recent years. China produced 621 million tons of grain in 2015, compared to 546 million tons in 2010. The larger harvests reflect increased land area under cultivation and adoption of more efficient farming practices (e.g. new cultivar varieties, acquisition of modern farm equipment, wide use of irrigation systems and targeted fertiliser use).

China's obsession with staple crop production reflects the national self-sufficiency policy. In practice, soy beans are only staple China has to import in large quantities. The rapid growth in harvest size and the state subsidy arrangements have led to massive inventories in the state's grain stores. For example, China's maize (corn) reserves now represent about half of all global reserves. The government this year has tried to auction off maize stored from previous years, abandoned its generous system of price guarantees and reportedly ceased to buy maize harvested this autumn. The price of maize in China, which still exceeds world prices, is now falling and expected to decline further. Many foreign producers worry that Chinese maize will flood onto the global market and depress the world price.

Domestic meat production is down from last year, while meat imports from abroad are increasing. China will apparently become the world's largest pork importer (it has long been by far the world's largest pork producer and consumer).

President Xi Jinping increases his power as party leader. The final communique from last week's four-day plenum of the Central Committee of the Chinese Communist Party said that Xi Jinping had been elevated to the status of "core" party leader. While the new status is informal, political scientists say the move grants Xi unconditional authority within the party and the right to veto party decisions. Xi's predecessor, Hu Jintao, was never granted core status, but his predecessor, Jiang Zemin was. As a result, some interpret Xi's elevated status as a drop in Jiang's post-presidency influence.

From the standpoint of badly needed economic reforms, the developments on the political front are quite interesting. President Xi openly praised an anonymous letter from an "authoritative" person that was published on the front page of *China Daily*, the party's main paper. The letter strongly criticised debt-fuelled growth policies and demanded comprehensive economic reforms. The emerging economic policy framework depends, however, on the outcome of the party conference to be held in the latter part of 2017. At that time, in addition to other changes in party posts, there will be the membership rotation of the Politburo's seven-member Standing Committee. Xi's status upgrade should give him more personal discretion on who gets picked.

The prospects for comprehensive market reforms, however, are overshadowed by the fact that domestic surveillance has increased under Xi's leadership, leading to greater censorship, a variety of morality campaigns and changes in the business environment that directly conflict with development of a market economy. Moreover, in spite of Xi's increased clout, ongoing differences within the party over the direction of economic policy and its implementation will persist.

Russia

Immediate impacts of US election results on the Russian economy appear minimal. The immediate fallout from announcement on Wednesday (Nov. 9) morning of Republican presidential candidate Donald J. Trump's victory increased uncertainty on global financial and commodity markets. Russian markets for commodities, forex and equities all fell at their openings, but recovered as the morning progressed. Over the longer term, the current uncertainty surrounding the Trump administration's economic and foreign policies makes it difficult to foresee impacts on the Russian economy. During the campaign, the discussions covered, among other things, free-trade agreements, new customs barriers, cutting taxes, European security, sanctions on Russia and geopolitical tensions.

Crude oil prices and the ruble's exchange rate have depreciated in recent weeks. The price of Brent crude oil, which peaked at \$51.60 a barrel on October 10, saw its subsequent drop accelerate already before the race was called for Trump. This morning (Nov. 11), the price of Brent crude was close to \$46 a barrel, a decline of about 9 % from a month ago. The price of Brent oil has risen by more than 70 % since it hit a low of \$28.70 on January 19.

The ruble's external value tracks oil prices. The fall in the Brent price over the past month has been reflected in a 3–4 % weakening in the ruble's exchange rate. This morning (Nov. 11), the ruble-dollar rate was about 65 and the euro-ruble rate about 71. The ruble has strengthened about 30 % against the dollar and euro since its record lows in late January.

Russian economy projected to see gradual recovery next year. Key forecasts see a GDP contraction of 0.5–1 % this year. Russia's economy ministry and the Central Bank of Russia see GDP growing by more than 0.5 % next year, cautiously assuming the average price of Urals-grade crude remains at \$40 a barrel. Other forecasts (IMF, World Bank, EU Commission, EBRD and Consensus forecast) assume a moderate increase in oil prices. Nearly all forecasts see GDP rising 1–1.5 % next year.

Private consumption is expected to increase in 2017 by about 0.5–1 %, i.e. a slow recovery from the current deep recess. The uncertain investment outlook is reflected in forecast estimates of fixed investment growth that vary from virtually no growth to nearly 2 %.

Russia plans to increase government revenues in the next few years without hikes in large general taxes. In the draft 2017–2019 federal budget submitted to the Duma, the finance ministry computed that the tax changes concerning the federal budget, which are to be finalised during the current budget round, will raise additional government revenues to the tune of 0.7 % of GDP each year.

The revenue increases (compared to taxation decisions currently in force) result almost entirely from tax changes in two revenue categories. A focal reform in taxation of the oil sector, prepared and mulled for quite a while, will be completed next year. Under the renovation, the crude oil production tax goes up, while export duties on oil and petroleum products for the most part go down. A revised method of calculating the tax base for the production tax on natural gas produced by Gazprom will also enhance the state's tax take.

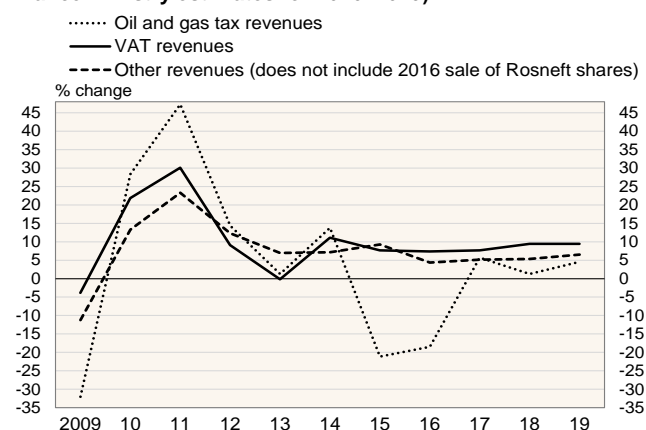
For the second category, state-owned enterprises (SOEs) will be required to pay larger dividends to the state (50 % of profits). The finance ministry anticipates a handful of large SOEs will tangibly increase the budget's dividend revenues. There will also be a small addition to budget revenues next year with Sberbank's main owner, the CBR, paying its dividends received from Sberbank further to the federal budget.

While there will be large hikes in excise taxes, particularly for tobacco products and automobile fuels, the overall impact on budget revenues will be small. The overall rate for mandatory social contributions (30 % of the gross wage up to a specified limit) will remain in place, with the exception that the percentage of each worker's contribution to the health insurance fund will increase in 2019. On the other hand, the upper limit, which imposes a 10 % additional charge on the excess part of the wage in contributions to the Pension Fund, will rise gradually.

Plans for better tax collection are continuously present. Partly based on expectations of improvement in collection, the finance ministry sees value-added tax revenues growing rather briskly relative to other government revenue streams. Efforts to improve tax collection will also focus on social contributions, customs duties and alcohol excise taxes.

In summer, the finance ministry presented its thoughts and calculations on raising general taxes, i.e. mandatory social contributions, VAT, labour income tax, as well as the corporate profit tax and property taxes. The envisioned increases, however, did not get support from the state's leaders.

Main categories of government revenues (consolidated budget, finance ministry estimates for 2016–2019)



Source: Ministry of Finance.

China

Trump presidential victory increases uncertainty also in China. Even with an election outcome that largely defied opinion polls, initial market reactions in China and globally suggest a wait-and-see approach to the coming Trump presidency. After Trump's electoral triumph, the offshore yuan-dollar exchange rate in Hong Kong (CNH) fell by 0.5 % on Wednesday (Nov. 9) and the onshore rate in mainland China (CNY) remained roughly at the previous day's level. After Wednesday, both exchange rates have weakened a bit. Interest rates remained fairly stable and changes in stock markets were moderate.

Donald J. Trump and his administration will assume office on January 20, 2017. Thereafter, the extent to which Trump acts on his campaign rhetoric should gradually become evident. For example, Trump talked against free trade in Asia and criticized arrangements with China, even if the US and American firms have huge stakes in the region, the engine of global growth. An immediate issue for the incoming administration will be the fate of the already-signed Trans-Pacific Partnership (TPP) agreement. A collapse of the yet-to-be-ratified TPP agreement could have unpredictable effects on development of global trade and international trade rules.

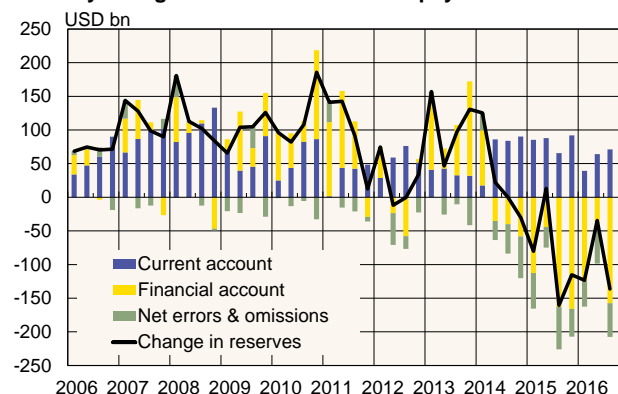
China's current account surplus insufficient to cover capital outflows; currency reserves fall. Preliminary third-quarter balance-of-payments figures show that China's current account surplus corresponded to 2.4 % of GDP, down from about 3 % in 3Q15. In dollar terms, the current account was slightly larger than in the second quarter, but the outflow of capital in net terms accelerated. For the past two years, the current account surplus has been inadequate to cover the deficit created by capital outflows. In the third quarter, China's foreign currency reserves fell by \$136 billion. Of that, over \$30 billion represented a deficit in foreign direct investments. Capital outflow is also characterised by the fact that a big part of it is difficult to categorise, which is reflected in an increase in the net errors and omissions term.

The balance-of-payments situation in October seems to show little change from previous months, with goods trade still sluggish. The value of exports fell 7 % in dollar terms, while imports were down 1 % from a year earlier. The October goods trade surplus rose slightly from the previous month to nearly \$50 billion. While data on October services trade is still unavailable, the services trade deficit seems to be roughly unchanged based on the spending of travellers abroad, and thus should offset the goods trade surplus by about half. China remained a net exporter of capital last month as its currency reserves fell by \$45 billion to \$3.121 trillion. However, the drop was partly due to exchange rate fluctuations.

To defend the yuan's exchange rate, Chinese officials have attempted for some time now to restrict forex flows out of the country through such measures as tighter enforcement of existing rules and plugging loopholes with new regulations.

Foreign trade pricing, forex purchases of Chinese tourists, buying insurance policies in Hong Kong and bitcoin transactions have all been mentioned as ways of circumventing current regulations.

Quarterly changes in China's balance-of-payments accounts*



*3Q 2016 "net errors and omissions" term assumed to match the previous quarter

Source: Macrobond.

China's banking sector continues to weaken. Listed Chinese banks have recently released their third-quarter financial reports. The spread between deposit and lending rates of big banks continued to narrow and earnings continued to shrink. Banks responded to falling income by cutting expenses e.g. laying off staff. Most banks have also reduced their buffers in an effort to boost profits. In spite of that, profits grew only modestly (0–2 % y-o-y) in third quarter. Similar trends are also seen in the listed medium-sized banks.

The portfolios of non-performing loans (NPLs) held by large banks generally continued to rise last quarter. The exception was China Construction Bank (CCB), which announced a slight reduction in its NPL portfolio. However, junk loans represent just 1.5–2.4 % of the loan portfolios of the four large state banks. The actual figures are suspect, however; banks are reluctant to indicate a loan as non-performing and prefer to roll over the bad loan.

Banking rules in China require that banks maintain provisions equal to 150 % of their NPL portfolio. Among the large banks, only Agricultural Bank of China (ABC) clearly exceeds the requirement (173 %). Bank of China's NPL reserves are currently at 157 %. CCB's reserve ratio has fallen to 149 % and Industrial and Commercial Bank of China's (ICBC) had declined already to 136 %. The consequences, if any, from the violations of CCB and ICBC are still unknown, but officials seem to be leaning towards relaxing the rules rather than punishing the banks. Mid-size listed banks have higher NPL provisions, but also report suspiciously low NPL portfolios.

Large Chinese banks, which have significantly increased their foreign presence over the past ten years, have found international expansion challenging at times. In November, New York state officials issued an over \$200 million fine to ABC for violating anti-money-laundering rules.

Russia

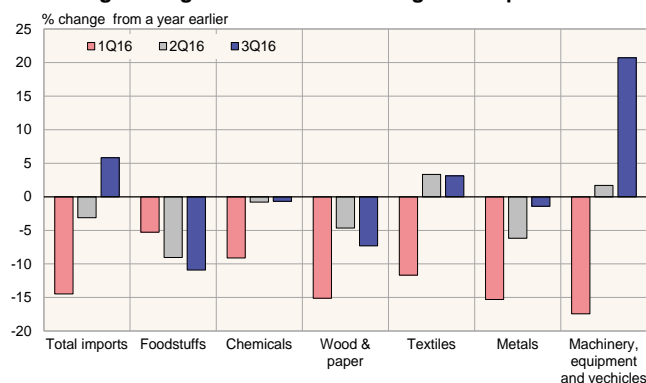
Russian imports finally on the rise. Measured in US dollars, the value of imported goods rose at a rate of nearly 6 % y-o-y in the third quarter. In the on-year terms, it was the first increase in imports in three years. Growth was driven by higher imports of machinery, equipment and transport vehicles, which were up 20 % y-o-y. Some of the invigorated growth reflected demand from large investment projects such as the LNG liquefaction plant and shipping terminal under construction on the Yamal peninsula. Textile imports were also up slightly, but other major goods import categories continued to decline.

Import demand has also been supported by the ruble's appreciation this year. The ruble's real trade-weighted exchange rate was up 5 % y-o-y in the third quarter. A Gaidar Institute report noted that the ruble's strengthening is yet another blow to already previously weak attempts aimed at import substitution. Imports began to recapture market share of consumption in numerous categories this year. Moreover, many imported products gained market share even when the ruble was declining as there are no comparable domestic products available.

The contraction in Russian goods exports slowed further in the third quarter, but its value was still 9 % less than a year earlier, due mainly to lower oil prices. The average price of Urals-grade crude oil in July-September was \$44 a barrel compared to \$50 a barrel in 3Q15. The value of exports excluding oil & gas returned to modest growth. Trends in the export volumes remained spotty, however. The volume of Russia's top export, crude oil, was up 4 % y-o-y and the long decline in exports of oil products ended.

For the first nine months of the year, the value of Russian goods imports was \$136 billion, a decline of 4 % from the same period in 2015. The value of goods exports contracted by nearly 25 % y-o-y to \$200 billion. Nearly 40 % of imports came from the EU, a third from Asia and just over 10 % from CIS countries. The EU accounted for nearly half of exports, Asia roughly 20 % and CIS countries 13 %.

Percentage change in value of Russian goods imports



Sources: Russian customs, BOFIT.

Russia's economy minister arrested. Russia's Federal Investigative Committee announced very early Tuesday morning (Nov. 15) that economy minister Alexei Ulyukayev had been detained. It was further noted that Ulyukayev had been "caught red-handed" taking a \$2 million bribe and had also been charged with extortion. The Investigative Committee operates under the auspices of the Russian president. The Committee said that Ulyukayev had demanded payment from state oil giant Rosneft for his support in a deal to acquire slightly over half of the shares of the state-owned Bashneft oil company. The Committee's press release noted that Ulyukayev had also threatened to complicate Rosneft's operations, and that Rosneft reported the \$2 million bribe to the police.

The arrest was met in Russia with surprise and raised suspicions about the motives of the arrest e.g. among key characters in the business community. Prime minister Dmitri Medvedev said the arrest was hard news, even if he called for equal treatment of all before the law. No matter what the facts are in the matter, the arrest yet again tells about uncertainty and the pitfalls of operating in Russia.

Ulyukayev has enjoyed a prominent career, serving as first deputy finance minister (2000–2004), CBR first deputy governor in charge of monetary policy (2004–2013) and economy minister (summer 2013 onwards).

Gazprom-EU dispute unresolved after four years.

A probe by the European Commission found that Gazprom's operations violate EU competition rules in many member states of Central and Eastern Europe. The European Commission launched its investigation in September 2012 and its official notice (statement of objections) was submitted to Gazprom in April 2015. The Commission found that Gazprom was engaged in restricting competition, unfair pricing and linking supplies to control of distribution grids in two EU member countries. Observers say that Gazprom may offer to change its pricing practices and supply conditions to avoid possible fines imposed by the European Commission. The matter is still pending, and Gazprom has yet to respond.

At the end of October, the European Commission, however, gave its go-ahead for making it easier for Gazprom to use the Nord Stream 1 twin gas pipeline system. The pipelines run along the Baltic seafloor to Greifswald, Germany. From there, gas is transmitted either to the south to the German-Czech border via the OPAL pipeline or via the NEL pipeline towards Hamburg. The Commission had previously limited Gazprom to using half of OPAL's capacity to avoid an excessively dominant market position, particularly in the Czech market. The ruling essentially limited the use of the entire Nord Stream 1. Under the new ruling, Gazprom can use up to 80 % of OPAL's capacity under certain conditions, thereby increasing the utilisation of Nord Stream overall. Nord Stream utilisation this year has risen to 75–84 %. A Gazprom-led consortium is currently planning a new twin Baltic Sea pipeline. The Nord Stream 2 would follow the Nord Stream 1 route and double annual transmission capacity from 55 to 110 billion m³.

China

Foreign firms concerned about China's new cybersecurity law. China this month approved a new cybersecurity law set to take effect at the beginning of June 2017. Under the new law, firms operating in China are obliged to help officials fight crime and threats to China's national security. The law requires that firms store certain data on servers in China, get official approval on IT equipment and systems they use and agree to government inspections of their data systems.

Dozens of business organisations around the world have been criticising the bill since summer. They have expressed concerns that the threat of vague IT security inspections and burdensome data storage requirements would ultimately hurt international trade. Even so, the draft law was not significantly revised before its final reading this month. The EU Chamber of Commerce in China is especially unhappy with the strict data storage requirements and restrictions on cross-border data transfer. It says that the law is unclear in its terminology and fails to specify how inspections will be conducted, all of which only add to uncertainty. The US Chamber of Commerce in China says the restrictions on cross-border data transfer will inhibit innovation activity.

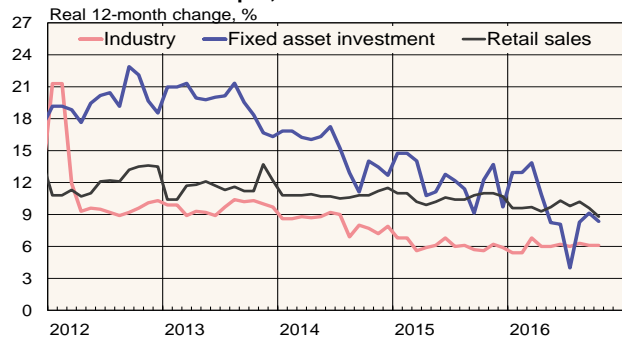
Some observers note that it is impossible to avoid current cyber-threats by simply erecting barriers as the law assumes. Officials instead need to focus on international cooperation to deal with these threats. The law is also seen as protectionist, as in practice it is expected to block foreign firms from operating in many parts of China's technology sector. Some NGOs worry that the law increases China's online censorship.

Retail sales growth slows in China; popularity of online shopping remains strong. The growth in retail sales, a fundamental support for economic growth, has slowed this year. Real on-year growth in retail sales in October was less than 9%. The slowdown in growth partly reflects lower growth in disposable incomes. On-year growth in urban household incomes fell to below 6% in September. The retail sales figures collected by the National Bureau of Statistics, however, are not a direct measure of private consumption, because they include procurements of government agencies (including the military) and state-owned enterprises.

NBS retail sales figures for the first ten months of the year show that 12% of retail trade was conducted online. Even if the growth in online retail has slowed, it still rose at a pace of 26% y-o-y. During the "Single's Day" shopping rush on November 11, China's 16 largest online retailers posted sales of 180 billion yuan (up 44% from last year) of which net retailer Alibaba group reported sales of 121 billion yuan. The figure, however, includes transactions that were never completed. China Post estimates that November 11 sales generated deliveries for the post and courier firms of over 1 billion packages.

Otherwise, October economic data contained few surprises. Consumer price inflation accelerated slightly to 2.1% and producer prices were up 1.2% y-o-y.

Trends in industrial output, fixed investment and retail sales



Sources: Macrobond, BOFIT.

China's rapidly growing middle class is now also the world's largest. As there is not an agreed definition of "middle class," estimates of the size of China's middle class necessarily vary. The *Pew Research Institute*, for example, finds that the middle-class segment of the population increased from 3% in 2001 to 18% in 2011, when middle class is defined as a purchasing-power adjusted (PPP) income of \$10–20 a day. Based on Pew's assessment, China is home to 30% of the world's middle class. During the same 2001–2011 period, the segment of the population classified as poor declined from 41% to 12%, and the share of the population living above the poverty line, but still not middle class, rose from 57% to 66%. Alternatively, the *Economist Intelligence Unit* (EIU) defines middle class quite broadly (individuals with annual incomes of 13,000–200,000 yuan, or \$2,000–30,000). The middle class share of the population is expected to rise from the current 60% to 75% by 2030.

China's middle class is also the world's largest in terms of wealth. *Credit Suisse* defines middle class as an adult with net assets (PPP-adjusted) of at least \$50,000. In 2015, 109 million Chinese (11% of the adult population) met this definition of middle class. By this measure, 16% of the world's middle class are Chinese.

China's middle class is still largely concentrated in larger cities, but most growth in the middle class will come from smaller cities. *Boston Consulting Group* estimates that over 40% of urban households are now middle class. In addition, 80% of urban dwellers own their own apartments, but only 30% invest in shares. Besides a growing middle class, China has substantial low-income population, which is largely composed of people living in the countryside.

China's consumer market is the world's second largest and the growing middle class means the market will continue to grow. By some estimates, China is already the world's largest market for luxury goods, and the audit and consulting firm *PwC* believes that China's movie theatre market next year will surpass the United States as the world's largest. Similarly, China's online market is now estimated to be as large as the European and American markets combined. In terms of PPP-adjusted GDP per capita, the EIU estimates that the average purchasing power of a Chinese consumer in 2030 will be the same as a consumer today in South Korea or an American in 2000.

Russia

BOFIT 25th Anniversary Conference examines evolutionary paths of Russia and other post-communist systems.

The first keynote address, delivered by Professor Gerárd Roland (University of California, Berkeley) discussed the evolution of post-communist economies towards democratic market economies. The transition in Central and Eastern Europe began when their increasingly complex economies had become impossible to centrally operate. This translated to a gradual shift in power, especially to corporate bosses. As the old system lost its grip, the process accelerated. The change of system resulted in an increase in corruption and strengthening of unholy alliances of political and economic forces in many of these countries. For some, this problem continues to this day and partly explains their poor economic performances during the 1990s and thereafter. In some of the countries, however, strong civil society helped push back against these forces. In addition, institutional development was much stronger in those countries of Central and Eastern Europe that joined the EU in the 2000s. The perspective of EU membership encouraged many countries to make substantial reforms, especially prior to accession.

The conference programme and links to presentations are available [here](#).

Russia's economic recovery still uncertain. October figures for seasonally and workday-adjusted industrial output showed slight improvement from September, even if they were roughly unchanged from the final months of 2015 and last spring. Russia has experienced spurts and lulls in industrial output growth since February 2015, but the level has remained nearly unchanged. In the case of extractive industries, output declined slightly in October, while manufacturing output rose slightly. The on-year trends for both output categories have displayed some weakening in recent months.

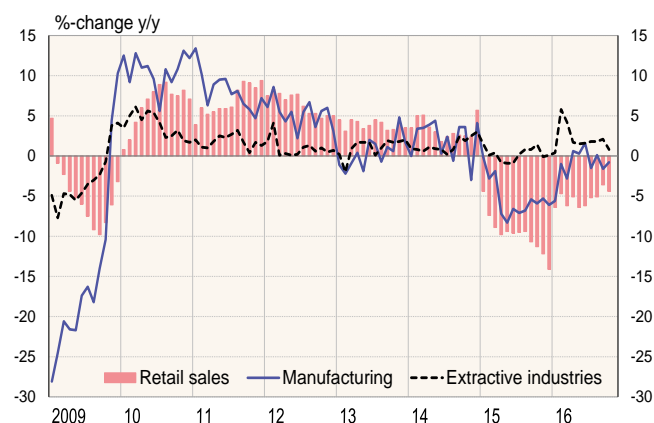
Russia's domestic demand has shown a two-track trend in recent months. The volume of retail sales (seasonally adjusted) continued to fall slightly in October, continuing a slide of 22 consecutive months. The volume of trade was down 4.4 % y-o-y, and 15 % below the October 2014 level. Real household disposable incomes contracted, falling nearly 5 % y-o-y in October. The trends in household borrowing and bank deposits have provided little support for consumption.

The on-quarter slide in fixed investment eased in the third quarter, and was even slightly up from a year earlier, when investment plummeted. For the first nine months of the year, fixed investment was down 2.3 % y-o-y.

The first official Rosstat figures for Russian 3Q GDP suggest a contraction of 0.4 % y-o-y. For the first nine months of the year, the contraction was 0.7 % y-o-y. The Central Bank of Russia and the economy ministry estimate that seasonally adjusted GDP in 3Q was roughly at the same level as in the

previous quarter. The 3Q GDP was boosted by Russia's bumper harvests.

Development of Russian retail sales and industrial output



Source: Rosstat.

Russia on track for record grain harvest. Preliminary figures suggest the grain harvest this year will exceed 123 million metric tons, and increase of about 15 % over last year. Thanks to good weather, the wheat harvest will be nearly 20 % larger than in 2015. Last year's wheat harvest was about 65 million metric tons, of which about 26 million tons went to export. Wheat exports this year are expected to rise to over 30 million tons, which would make Russia the world's largest wheat exporter. Good harvests for most of the world's wheat producers have lowered the wheat price to its lowest level in a decade. The decline in export prices and ruble appreciation threaten the profitability of many farm operations. To ease the strain on farmers, the government decided in September to temporarily eliminate wheat export tariffs.

Russia's agricultural land amounts to about 385 million hectares (ha), of which about half is arable land. Last year about 140 million ha of arable land was in agricultural use, of which about 80 million ha were under cultivation. Rosstat reports that about 47 million ha was devoted to grain crops, and about half of that was wheat. Some 17 million ha was allocated for fodder crops (e.g. hay, alfalfa) and about 12 million ha to vegetable oil crops (e.g. rapeseed, sunflower).

There has been a strong concentration of farmland holdings in recent years. Farms of private homesteaders average about 240 ha, while farmland held by an average large agricultural business is about 12,100 ha. A list compiled by the consulting firm BEFL shows that Russia has at least 43 firms with land holdings of more than 100,000 hectares (1,000 square kilometres). The six largest holders of farmland together control about 3.5 million ha of farmland. Family members of agriculture minister Alexander Tkachev own the dairy producer Agrokomplex, which controls about 456,000 ha. The average field area of a Finnish farm is about 44 ha.

China

BOFIT 25th Anniversary Conference raises insights into China's structural adjustments and growth outlook.

The first keynote address was delivered by professor Gérard Roland (University of California, Berkeley), who provided an overview of the transition in post-communist economies in Eastern Europe and China. Notably, the reasoning behind the transition in China and post-communist regimes in Europe was fundamentally different. In the European context, economic transition can be regarded as part of the dissolution of communist regimes, while in China market reforms were launched to preserve the power of the Communist Party of China. Reforms have strengthened the party apparatus, and it continues to be essential in implementing the reforms. Roland noted that the CPC is now probably the world's most powerful organisation. Under market economy conditions, old ideology and corrupt behaviours are an issue. In China's case, however, Roland said the sustainability of current system should not be underestimated. Roland saw only few hopes for any major political reforms.

The second keynote address was delivered by professor Justin Yifu Lin (Peking University), who analysed China's current economic situation and opportunities for growth over the medium and long term. Unlike most observers, Lin does not ascribe the slowdown in Chinese economic growth in recent years to China's structural issues, but rather that the slowdown largely reflects external business cycle factors related to the global financial crisis. Lin said the slowdown in growth was also evident in many other countries, so there was little reason to ascribe the slowdown to structural problems that would restrain China's future growth.

Lin said China still has a way to go before it reaches the technology frontier of advanced economies, so it can still enjoy the catch-up advantage as Japan and South Korea did decades ago. Chinese per capita income is currently about a quarter of the US per capita income. If China follows the path of its Asian neighbours, Lin believes China could still enjoy GDP growth potential as high as 8 % p.a. until 2028. China's current growth is supported by urbanisation, fixed investment, technological advances and economic reforms. Thus, China should have little trouble in achieving the government's current 6.5 % p.a. growth target over the next four years.

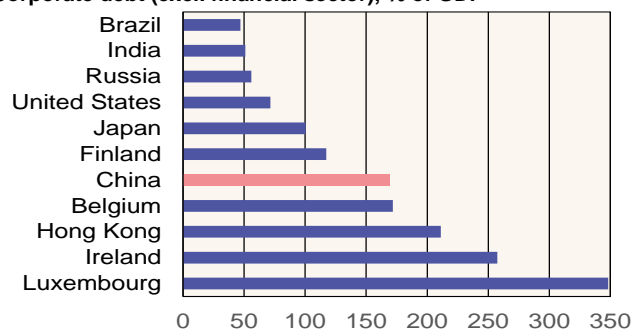
Unlike professor Lin, most forecasters expect China's growth to remain at its current level or slow in the final years of this decade.

Payment delays on the rise in China. It now takes exchange-listed firms over 90 days on average to receive payment from their customers. In 2011, the average payment time was under 60 days. Since then, the average payment delay has increased by about one week each year. The last time the belated payment situation was this bad was after the Asian financial crisis of the late 1990s. The industrial sector has the longest payment times.

The late payment problem has forced many Chinese firms to sell their invoices to third-party finance firms or banks. In exchange for quick cash, the firms surrender a portion of the invoice to the factoring firm. For example, construction equipment manufacturer Sany has reportedly sold payments receivable to factoring firms for 9 % below their face value.

Figures from the Bank for International Settlements (BIS) show that the debt burden on Chinese firms is among the highest on earth relative to the size of the economy. Drawn-out payment times, decelerating economic growth and the ongoing structural change make it more difficult for many firms to service their debts. Non-performing bank loans (NPLs) are on the rise, even if banks claim the problem is small. Many observers note that the actual NPL problem is much more serious than banks are willing to admit.

Corporate debt (excl. financial sector), % of GDP



Source: BIS.

Yuan loses ground on dollar appreciation. The yuan has lost about 2 % of its value against the dollar since the end of October. At the same time, the dollar index (DXY) has strengthened by over 3 %. The yuan has appreciated nearly 2 % against the euro, and its trade-weighted effective exchange rate has strengthened by 1 %. The People's Bank of China seems to tolerate a more volatile dollar exchange rate and put more weight on yuan's stability relative to a multi-currency basket. The markets appear to have no difficulties to live with the current situation as there have been no major reactions from the interbank or equity markets. The exchange-rate difference between mainland China and Hong Kong has also remained relatively small.

Yuan-dollar and yuan-euro exchange rates



Sources: Reuters, ECB.

Russia

Oil & gas sector still dominates Russian business. The Russian business weekly *Expert* finds that firms operating in the oil & gas sector continued to dominate in its annual list of Russia's 400 largest companies. The 21 companies in the oil & gas sector making the Expert-400 list together accounted for nearly a third of net sales and nearly two-thirds of earnings. Profitability in the sector was supported by ruble depreciation that softened the impacts of falling oil prices.

Total net sales of Russia's largest firms rose 13 % last year to 61 trillion rubles (\$1 trillion). Net sales were up most in the chemicals industry (up nearly 30 %) and most sluggish in the machine-building industry (up just over 2 %). Machine-building also had the only money-losing firms, which were mainly in Russia's struggling car industry.

The overall share of state-owned enterprises in the Expert-400 fell slightly to just under 40 % in terms of net sales. Foreign firms accounted for just over 10 % of large firm net sales. Most large foreign-owned firms operated in consumer sectors such as telecommunications and retail trade.

Russia's largest firms in 2015

	Net sales (USD billion)	Branch	Owner
Gazprom	96.0	Oil & gas	state
Lukoil	84.9	Oil & gas	private
Rosneft	67.6	Oil & gas	state
Sberbank	43.7	Banking	state
RZD	24.8	Transport	state
VTB	19.7	Banking	state
Surgutneftegaz	16.4	Oil & gas	private
Magnit	15.6	Commerce	private
Transneft	13.4	Transport	state
X5	13.3	Commerce	private

Source: *Expert*.

Russian government takes on wage arrears problem.

Prime minister Dmitri Medvedev told a cabinet-level meeting on wage arrears last week that total wage arrears were less than 1 % of the total monthly payroll sum of the firms monitored. At the beginning of November, some 70,000 people, or less than 1 % of the workers in monitored firms, were owed delinquent wages. During the current downturn, wage arrears have seen a relatively mild increase. About half are concentrated in the manufacturing sector. Nearly 30 % of the arrears were owed by firms that had filed for bankruptcy.

Olga Golodets, deputy prime minister with social affairs portfolio, said that in the course of a month wage arrears sometimes increase to over four times the amount reported in the official end-month monitoring statistics. She noted that the official labour agencies on the average deal with almost 800,000 wage payment cases each month.

The government would like to see a more permanent solution to this problem. Medvedev referred to raising the fines

on employers in wage arrears and increasing compensation paid to the workers as well as the interest rate charged on the late wages. Golodets noted a proposal was under consideration to establish the right to recover wages before taxes in bankruptcy proceedings.

Medvedev recalled the hard times in the 1990s and the prolonged times it took to settle wage arrears. For example in 2004, wage arrears were roughly a tenth of company monthly payrolls monitored, and about 4 million workers at slow-paying firms were affected. During the 2009 recession, wage arrears rose to around 2 % of total payrolls and the number of workers affected by wage arrears reached 500,000.

Finland's exports to Russia shrank further. The value of Finnish goods exports to Russia was down 8 % y-o-y in 3Q16, and down 3 % y-o-y for September. Machinery & equipment and chemicals form the majority of exports. Exports continued contracting in nearly all main product categories mainly due to reduced Russian demand and the weak ruble. The direct impact of EU export restrictions is limited, as they concern just 0.5 % of exports. The share of food items subject to Russia's import bans was about 5 % of exports to Russia before the ban, but now exports of such food items have nearly ended. President Putin recently said that the import bans should be kept in place as long as possible.

There are small signs of recovery in exports of tourist services, with the number of overnight hotel and inn stays of Russian visitors to Finland showing annual growth in September – the first rise in nearly three years. The number of border crossings to Finland via the eastern border, however, has continued to fall slightly. For the second quarter, total services exports to Russia were still down over 30 % y-o-y.

Latest survey by the Finnish-Russian Chamber of Commerce finds that 40 % of Finnish companies that operate in or export to Russia expect their sales in Russia to increase over the next six months. Only 10 % said they anticipate a further contraction. Especially exporting firms but also firms operating in Russia consider the ruble as their main problem.

The latest Team Finland survey reports that Finnish firms are encountering trade barriers most often in Russia. The number of obstacles reported for Russia was more than twice higher than for China, which had the second highest reporting of trade barriers. Russia's share of trade barriers has also grown (partly due to sanctions). Problems with customs procedures were the most cited trade barriers for Russia.

The value of Finnish goods imports from Russia contracted in the first nine months of 2016 by 2 % y-o-y. In September, it was at the same level as a year ago. Crude oil accounted for the bulk of imports. Services imports in 2Q16 were at about the same level as a year earlier.

Finnish goods exports to Russia in 2015 were €3.3 billion and services exports €1.2 billion. Both contracted 30 % y-o-y. Goods imports from Russia amounted to €5.6 billion and services imports €0.6 billion. Russia represented nearly 6 % of Finnish goods and services exports and 8 % of imports.

China

China's State Council issues contingency guidelines on local government debt problems. The contingency guidelines require local governments to report risky borrowing, placing them in one of four "debt risk" categories. The State Council repeated its stance that the central government would not bail out indebted local governments, and that they must instead manage the debt themselves. If a local government is unable to handle its debts, the State Council said it expects them to refrain from new investment projects, suspend on-going projects or sell off assets. In addition, other public expenses could be cut and staff laid off. Local governments have been encouraged to think about beforehand how to pay off loans they take. The new guidelines are intended to help reveal risks, create response plans for crisis situations and improve risk awareness of local government financiers.

The IMF estimates that the indebtedness and other liabilities of local governments totalled roughly 40 % of GDP at the end of 2015. Local governments this year have issued about two times more bonds than a year ago. Some of these assets have been used to pay off more expensive bank loans. The debt situation varies considerably across provinces, however. A finance ministry official interviewed by the Caixin news agency in November said that debt levels of some local governments were alarmingly high, along with a degraded ability to service that debt. Despite the risks, the yields on local government bonds are nearly the same as government bonds, and the government's latest measures did little to change the situation. If local governments find themselves in great difficulties, the central government might be forced to bail them out, even if it had given repeated warnings that it would not.

Over a million patent applications filed last year in China. The latest survey from the UN's World Intellectual Property Organization (WIPO) notes that over 1.1 million patent applications were submitted to China's patent office in 2015. While the number of patent applications globally rose over 8 %, they were up 19 % in China. China's growing significance on the R&D front was evident in the fact that the number of submitted patents to China's patent office equalled the number of the next three countries combined (United States, Japan and Korea). China's patent office also received the most applications for trademark and industrial design protections.

Last year over 1.2 million patents were granted globally, an increase of 5 % from 2014. Most of the increase came from China. China's patent office granted nearly 360,000 patents last year, making it the largest patent office in the world, surpassing the United States. WIPO estimated that there were 10.6 million patents in force last year, of which 25 % were in the United States, 18 % in Japan and 14 % in China.

China's central and local governments strongly support patent activity, which has led to an emphasis on quantity, rather than quality, of patent applications submitted. Moreover, the Chinese still mostly seek protection under domestic

patents. The number of international patent applications severely lags e.g. the US, Japan and Germany. Nevertheless, it seems that China is developing rapidly both in terms of patent quality and international applicability. The Chinese telecom giants Huawei and ZTE have for years been ranked among the three largest international patent seekers (PCT).

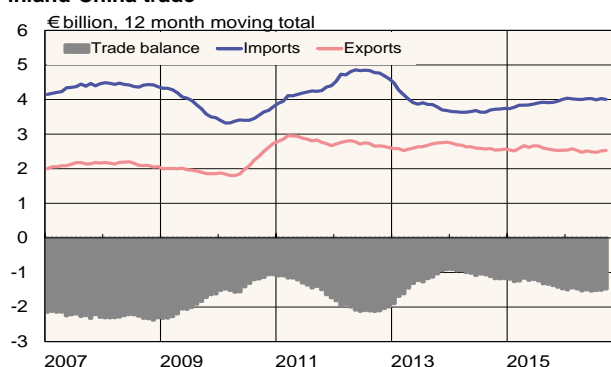
Chinese R&D spending amounted to 2.1 % of GDP last year. In the US, R&D spending is 2.7 % of GDP and the OECD average is about 2.4 % of GDP.

Finnish exports to China outperform Finnish exports generally. The value of goods exports to China in the first nine months of this year matched their 2015 performance, while Finnish exports overall were down about 5 %. Goods imports from China, like good imports generally, were at about the same level as in 2015. Exports to China of timber (up 56 % y-o-y) and paper pulp (up 12 %) increased, while fur exports declined (down 59 %). In January-September, 30 % of Finland's pulp exports and 43 % of fur exports went to China. Nickel exports to China increased by nearly 20 times from the previous year, and represented 1 % of the value of total exports to China. There was little change in the structure of imports. Finland mostly imports machinery and equipment (about half of imports from China), as well as clothing and footwear (16 % of imports). China accounted for 5 % of Finnish goods exports and 7 % of imports.

Finnish services exports to China rose to 11 % in the first half of 2016, while the total services exports held at the 2015 level. Services exports to China on-year amounted to nearly €1 billion, or about 40 % of the value of total goods exports to China and 4 % of Finland's total services exports. The value of services imports from China exceeded €800 million, or roughly 4 % of Finland's total services imports.

In the first nine months of the year, the number of overnight stays of Chinese travellers in Finnish hotels increased 20 % y-o-y, but still only represented about 4 % of all overnight stays of foreign visitors. Overnight stays of foreign visitors overall increased by 2 %. Figures from international tax-free shopping specialist Global Blue show that Chinese travellers accounted for 31 % of Finnish tax-free sales in the first nine months of this year, and were second only to Russians.

Finland-China trade



Source: Finnish customs.

Russia

Few surprises in Putin's state-of-the-nation address.

President Putin delivered his annual state-of-the-nation address last week at the Kremlin to a packed audience of Duma deputies, Federation Council members and invited guests. Breaking from recent years, the Russian president focused on domestic policy. Education, health care and preconditions for economic growth were some of the main themes.

In discussing the economy, Putin noted that domestic, not external, factors were largely responsible for restraining growth. He said Russia must resolve at least some of its structural issues or economic growth may remain sluggish for years to come. Among the specific challenges mentioned were harmonisation of inconsistent regional legislation, improving the effectiveness of regulators and continuing the fight against corruption. He also stressed the importance of having a healthy, well-supervised banking sector to assure financial intermediation and financing of investment in Russia. The address ended with a hat-tip to Russia's new science and technology strategy, which involves support for young scientists and a digital leap forward for the Russian economy.

Putin offered no new initiatives and no concrete proposals in dealing with long-acknowledged economic problems highlighted in his annual address.

Gas sector drives growth in fixed investment. Newly released Rosstat figures show a small recovery in seasonally adjusted fixed investment happened earlier than what the figures showed in late summer. The fresh figures suggest fixed investment returned to growth in the first half of this year. Fixed investment was up 0.3 % y-o-y in the third quarter.

Rosstat estimates that fixed investment of small firms and those operating in the grey economy continued to experience an unusually strong reduction in investment that began last year. In contrast, other fixed investment, which is mainly investment by large and mid-sized firms, experienced modest growth.

However, increase in fixed investment rests on a very narrow basis. In fact, all growth of total investment came from investment in producing and shipping liquefied natural gas (LNG) – an area where investment has multiplied this year. Observers note that this burst basically reflects massive investment on the Yamal gas production peninsula.

Fixed investment declined from last year for all other branches when taken together. Investment in oil production contracted significantly, and the steep decline in investment in the electricity sector and pipeline transmission capacity continued. In the manufacturing sector (excluding oil refining), fixed investment continued to slide, even if the drop was less steep than last year. The biggest drops in manufacturing investment were in the machinery, equipment and transport

vehicles category. Investment in the chemicals industry continued to rise. The metallurgy branch returned to growth after three years of contraction.

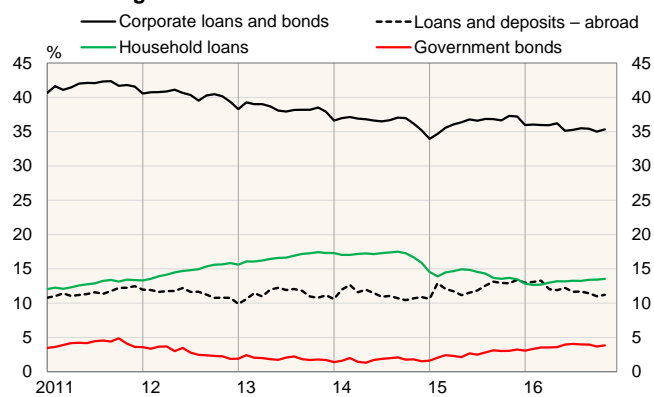
Growth of Russia's banking sector has stalled. Household deposits held by banks increased at a brisk pace last year and the early months of 2016. More recently, however, the stream of household deposits to banks has subsided. A more striking change has been the unusually rapid draining of corporate bank accounts over the past six months. As a result, growth of banking sector total assets this year has come to an exceptional standstill. In addition, the value of forex-denominated items converted to rubles and thereby the balance sheet total in rubles has shrunk considerably with the ruble's appreciation.

The growth in receivables on the banking sector balance sheet has been limited by weakness of lending, especially corporate lending. The stock of domestic corporate loans granted by banks has shrunk considerably this year. Part of this is due to ruble appreciation, but another equally large reason is that the corporate sector has paid down bank loans faster than it has taken new loans. The drop in corporate borrowing from banks has been slightly offset by banks increasingly acquiring corporate bonds. In contrast, borrowing of Russian households has recovered a bit this year, even if households have been cautious about new borrowing compared to the pre-recession period from 2011 to 2014.

The modest borrowing of the private sector has created an opportunity at least for the time being for the government to fund part of the federal budget deficit through the sale of bonds to domestic banks. If private borrowing does not recover significantly, the state should have no great difficulty in increasing domestic borrowing under the budget deficit financing plan as presented.

Bank receivables from companies based abroad, as well as from non-resident banks and foreign governments have declined this year. In addition to ruble appreciation, banks in Russia have reduced their deposits in foreign banks.

Share of main balance sheet receivables in total assets of Russia's banking sector



Source: Bank of Russia.

China

China tightens capital controls to reduce depreciation pressure on yuan. China has recently tightened considerably its capital controls. At the start of this month, the State Administration of Foreign Exchange (SAFE), which operates under the People's Bank of China, announced that any transaction exceeding \$5 million must be declared to its vetting. The previous limit was \$50 million. The chambers of commerce in China of the United States and the EU reacted quickly, noting that the new rule imposes a burden on foreign businesses operating in China. European firms said this week that they have recently been unable to repatriate dividends from China. Dividends are included in the current account, and under China's international commitments, it should not restrict them.

China has also clamped down on oversight of capital movements to and from the Shanghai Free-Trade Zone, as well as tightened the rules on purchasing gold from abroad. Moreover, Reuters reports that corporate lending from China in yuan to foreign units must be reported to SAFE, which has imposed a ceiling on such lending based on the size of the firm. Thus, firms will no longer be able to transfer yuan abroad and then convert the money to other currencies. Media reports that additional measures are planned. More measures are expected to be introduced in coming months. The State Council, for example, is discussing a requirement that all "extra-large" investments abroad, i.e. exceeding \$10 billion, will require top-level approval. Property investments of more than \$1 billion by SOEs and direct investment projects outside the firm's core business will also be scrutinised.

Officials have shown increasing willingness to go after attempts to circumvent capital controls when they suspect illegal activities are involved. For example, several illegal banks operating mostly in southern China were recently raided. Officials claim that the banks arranged unreported cross-border transfers worth tens of billions of dollars.

The tightened restrictions are designed to reduce capital flows out of China and diminish depreciation pressure on the yuan. The yuan's exchange rate has weakened 3 % against the dollar since the end of September, but has strengthened nearly 1 % against the euro over the same period. China's foreign currency reserves fell by \$114 billion during October and November.

It is difficult to predict the impact of the new measures. Starting next month, private persons will be subject to a reset \$50,000 annual forex quota. This might temporarily raise forex demand. Overall, at this stage of China's development, it is difficult to use direct restrictions to stem capital outflows. Even if capital controls would temporarily reduce depreciation pressure on the yuan, they are at odds with China's strategy of opening its markets to the world and promoting the yuan's use in international trade. In the final analysis, these factors determine China's economic success.

Foreign investors gain new trading link to Shenzhen exchange. The gradual opening of China's stock exchanges to the world continues, even with new restrictions on capital movements. The long-awaited Shenzhen-Hong Kong Stock Connect trading link launched operations on Monday (Dec. 5), giving foreign investors the ability to invest via Hong Kong in 678 firms on the Shenzhen exchange's main and SME boards. Brokers and institutional investors can also now invest in 203 firms on the tech-heavy ChiNext board. Many of the 1,850 firms listed on the Shenzhen exchange are "high growth." The average P/E ratio for Shenzhen-listed firms is 44, compared to 16 for firms on the Shanghai exchange.

Large mainland Chinese investors (investments over 500,000 yuan, approx. €70,000) have access to shares of 417 companies traded on the Hong Kong stock exchange. The amount includes shares of about 100 new (mostly small) firms, while the rest are the same as in the Shanghai-Hong Kong Stock Connect link, which opened two years ago. As with the Shanghai link, the net daily quota for foreign investors (buying minus selling) is 13 billion yuan (€2 billion). The daily quota for mainland Chinese investing in Hong Kong via the Shenzhen exchange is 10.5 billion yuan.

The first day's trading after the launch of Stock Connect was subdued. The average daily trading volume of foreign investors on the Shenzhen exchange was around 2.2 billion yuan (1 % of the exchange's daily turnover). Investors from mainland China on average bought shares worth nearly 600 million yuan in Hong Kong. The Shanghai-Hong Kong Stock Connect link accounts for about 1 % of the Shanghai exchange's daily turnover and 3 % of Hong Kong's turnover.

Stock markets in mainland China have picked up since the doldrums of summer. The main indexes of the Shanghai and Shenzhen exchanges are up 8 % from the end of July. Shares of companies listed in mainland China are still on average over 20 % more expensive than the same shares listed in Hong Kong, but the price gap has narrowed. The new Stock Connect link is not expected to significantly reduce the price difference as share prices on the mainland China and Hong Kong exchanges are affected by different factors. In addition, intraday trading and short sales via Stock Connect are impractical, reducing opportunities for arbitrage.

Main indexes: Shanghai, Shenzhen and Hong Kong exchanges



Sources: Macrobond and BOFIT.

Russia

Russian state reduces stake in Rosneft. The sale of almost a fifth of the state-majority controlled Rosneft oil company is a part of Russia's privatisation plan. Given the pressures from western sanctions and low oil prices, the sale of Rosneft shares to foreign investors, announced on December 7, came as a surprise to many. Preliminary reports said the buyer is a joint venture of the Qatar Investment Authority (QIA) and the world's second largest oil trader, Swiss-based Glencore (in which QIA is the largest shareholder). The joint venture buys 19.5 % stake in Rosneft. The deal, worth around €10.5 billion, has already been included in this year's federal budget income figures.

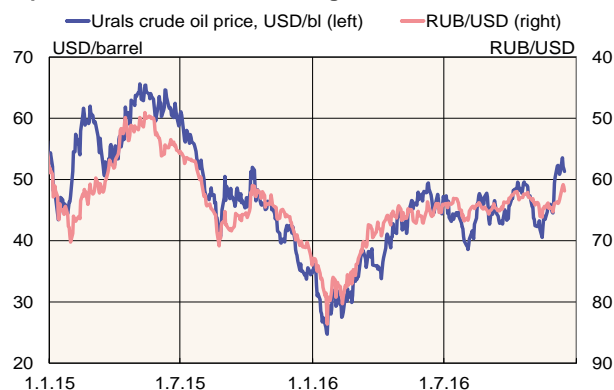
Implementation of Russia's privatisation programme has been repeatedly postponed due to unfavourable market conditions. Pressure to restart the programme was given impetus from low oil prices and rising federal budget deficits. The government earlier this year sold for example its majority stake in the Bashneft oil company to Rosneft, as well as its 10.9 % stake in diamond giant Alrosa to private investors. In all sales, the federal government, a regional government or a state-owned enterprise continues to have majority control. The Russian state still has a 50 % stake in Rosneft.

Russia and OPEC agree to reduce oil output. The Organization of Petroleum Exporting Countries, OPEC, announced on November 30 that it had reached agreement with its member countries on reducing crude oil production by 1.2 million barrels a day, effective January 2017. The agreement to cut oil output is conditional on non-OPEC countries' participation. On the same day, Russia's energy minister Alexander Novak said his country would gradually reduce crude oil production by 0.3 million barrels a day during the first half of 2017 as long as OPEC members hold to the agreement. On December 10, Russia and ten other non-OPEC countries announced that collectively they would reduce production by 0.5 million barrels a day. Russia reaffirmed that its contribution to the cuts would be 0.3 million barrels a day.

Crude oil prices rose on world markets after the OPEC announcement. The price of Urals-grade crude was up about 16 % in dollar terms to around \$52 a barrel. Higher oil prices have lifted the ruble's exchange rate about 6 % against the dollar and the euro. The exchange rate now stands at about 61 rubles to the dollar and 65 rubles to the euro.

Many observers do not expect the agreed production cuts to hold, as OPEC members have not stuck to earlier agreements after oil prices have increased after cuts announced. The production cuts also come at a time when oil production is hitting historical highs. In November, Russian output was 11.2 million barrels a day, a post-Soviet record. A deal among OPEC members, Russia and other non-OPEC members is exceptional to the extent that it holds.

Oil price and ruble-dollar exchange rate



Source: Reuters

Duma and Federation Council approve federal budget and state social fund budgets. Russia's lower and upper houses of parliament accepted the government's proposals for 2017–2019 federal budget total revenues and expenditures. The federal budget accounts for roughly a half of all general government revenues and spending (consolidated budget). If the relatively cautious budget assumption of \$40 a barrel for Urals crude holds, budget revenues over the next three years would stay at slightly over 15 % of GDP, i.e. at the low level of this year (does not include the proceeds from Rosneft share sale).

Federal budget spending would contract slightly even in nominal terms, with its share of GDP falling below 19 % next year. With this, the budget deficit begins shrinking notably from this year and should fall to around 3.2 % of GDP next year. Two-thirds of next year's deficit would be funded out of the Reserve Fund and the National Welfare Fund. Over half of the deficit in 2018 would be covered from the National Welfare Fund.

If the oil price exceeds the assumed price by \$10, it would add roughly 1.5 percentage points of GDP to revenues. If conditions permit, finance minister Anton Siluanov said, the federal spending could be increased next year through e.g. higher subsidies to the economy.

Government defence spending is covered entirely by the federal budget. It should shrink even in nominal terms from 2015–2016, although much room has been created for the defence industry to take on government-guaranteed bank loans. The current plan also calls for cuts in spending on domestic security and order (currently 95 % funded out of the federal budget).

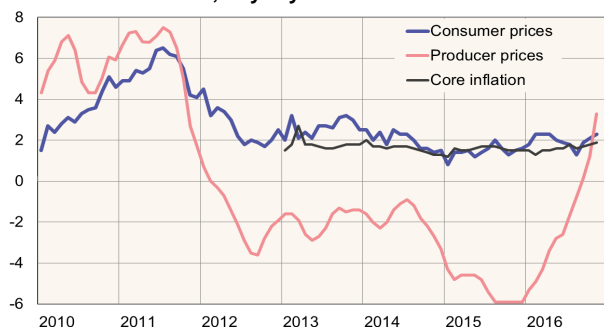
After the defence spending boom of past several years, transfers to the Pension Fund will again become the largest single federal budget spending category by far – nearly a quarter of all spending, even if the rise has been quelled by working pensioners remaining without inflation adjustments. Spending from the Pension Fund and other social funds will, especially next year, rise notably faster than general government spending overall.

China

Chinese producer price inflation accelerates, other economic indicators unchanged. Producer prices, which started rising on-month already last spring, have since seen an acceleration in the increase. November producer prices were up 1.5 % m-o-m. The on-year deflation trend ended this autumn, and producer price inflation reached 3.3 % y-o-y growth in November. Most of the increase in producer prices reflects higher prices in mineral extraction industries and other commodities. Consumer price inflation rose slightly in November to 2.3 % y-o-y.

There were few surprises in November's real economy indicators. Industrial output continued to grow at 6 % y-o-y, while real growth of retail sales remained at 9 %. Real growth of fixed investment was about 8 %. Private sector investment has revived since summer.

Price trends in China, % y-o-y



Source: Macrobond.

Market interest rates on the rise in China. Short-term market interest rates (e.g. Shibor 7D) were up about 0.2 percentage points in the first half of December compared to mid-July. Along with tighter restrictions on cross-border capital movements, higher rates dampen currency outflows and support the yuan's exchange rate against other currencies. Yuan interest rates in Hong Kong have risen more sharply than in mainland China. Interbank rates (e.g. CNH Hibor 7D), which were below 2 % in August, have been on average 7 % in December. Rising interest rates in Hong Kong have helped keep the yuan off-shore rate near mainland China's on-shore rate.

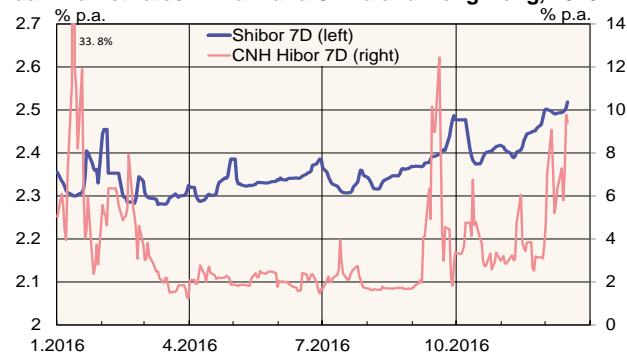
The People's Bank of China have kept unchanged its reference rates for deposits and credit, as well as its deposit reserve requirements. Nevertheless, the PBoC's liquidity operations have recently focused on long-term lending which could have caused nominal interest rates to rise. Behind the interest rate rise might also be the PBoC's window guidance policy. However, the recent pick-up in inflation means real interest rates have fallen in recent months. The rapid growth in lending in November also suggests that the monetary policy tightening has only been marginal at most.

Many companies have resorted to short-term credit to roll-over their old debts. If interest rates continue to rise, it could affect their financial stability. Moreover, if real interest

rates begin to rise meaningfully, it would be harder for China's leaders to reach their 6.5 % GDP long-term annual growth target. However, rising interest rates should restrain rising indebtedness and strengthen economic fundamentals.

Many expectations and pressures afflict China's forex and financial markets. Administrative regulation and tighter currency controls imposed this autumn do not resolve the basic causes of market distress, and instead create uncertainty over the direction of policies. The stated goal of China's market reforms is to shift to interest-rate based monetary policy and allow greater exchange rate flexibility. Given the current circumstances, it may be time to take steps in that direction. The situation on financial markets underscores how a pursuit of a numeric GDP growth target complicates efforts to formulate and implement appropriate economic policies.

Yuan market rates in mainland China and Hong Kong, 2016



Source: Macrobond.

China takes market economy status issue to the WTO. Last Sunday (Dec. 11), China celebrated its 15th anniversary since joining the World Trade Organization. In China's view, other countries agreed during its accession negotiations that it would be treated initially as a non-market economy and would be granted market-economy status automatically after 15 year of membership. The largest advanced economies, i.e. the US, EU and Japan, however, have yet to grant China such status. The US, in particular, has stressed China's failure to make sufficient progress in market reforms. On Monday (Dec. 12), China filed a complaint to WTO and announced its request to engage consultations with the US and EU to resolve the matter. If the parties fail to agree, the dispute would move to the WTO for resolution. If so, the decision would likely be handed down in spring 2018. The parties could still resolve the dispute among themselves earlier.

The granting of market-economy status to China is largely a political gesture to recognise the country's progress in market-economy reforms. In practical terms, market-economy status means little as it applies only to anti-dumping measures. It is easier to impose anti-dumping measures on countries with non-market-economy status. Japan and the US are keeping their anti-dumping procedures unchanged, while the EU is changing its practices so that market-economy status will no longer have any affect how import duties are imposed.

Russia

Russian industrial output increased, consumption still falling. November seasonally and workday-adjusted industrial output increased substantially from October. Revised Rosstat figures show that industrial output rose by over 1 % in the course of October and November, and 2.7 % y-o-y for November.

Seasonally adjusted output of extractive industries was unchanged in November compared to the previous month, but was notably higher than in the weak November 2015. Crude oil production, which is part of extractive industries, reached record-high levels again in early autumn. For the October–November period, production continued to rise further, and was up over 3 % y-o-y. Natural gas production also showed unusually strong gains in November.

Manufacturing output in November increased at its fastest rate in a long while, and the growth reached 2.5 % y-o-y. As earlier this year, manufacturing output in recent months was led by the same well-performing branches, i.e. chemicals, rubber & plastics. In contrast, production of metals and construction materials remained sluggish even in recent months.

The decline in the volume of seasonally adjusted retail sales continued in November, with the volume remaining 4 % smaller than a year earlier. Real household disposable incomes also fell further.

Three primary production sectors appear to have been largely untouched by Russia's year-and-a-half recession. Mineral extraction only saw a slight drop in output for a couple of spring months in 2015, and has been resurgent this year. Electrical power production also increased this year. Agricultural production was up both in 2015 and this year. This view was affirmed by the latest GDP production component figures, which show on-year growth in the first three quarters and in the third quarter came mainly from agriculture, mineral extraction and electrical power generation and distribution.

CBR leaves key rate unchanged. The Central Bank of Russia's regular board meeting on December 16 decided to keep the key rate at 10 %, where it has remained since September. As of end-November, 12-month inflation had fallen to 5.8 %. The CBR estimated that inflation continued to decline slightly in the first two weeks of December and noted that its inflation and economic growth forecasts were on track. The CBR conceded that some of the slowing was due to transient events such as the record grain harvest. While the inflation risks have abated somewhat, inflation expectations remain elevated.

The CBR repeated its previous announcement that it was considering a rate cut in the first half of 2017 if inflation slowed as expected. CBR Governor Elvira Nabiullina said it

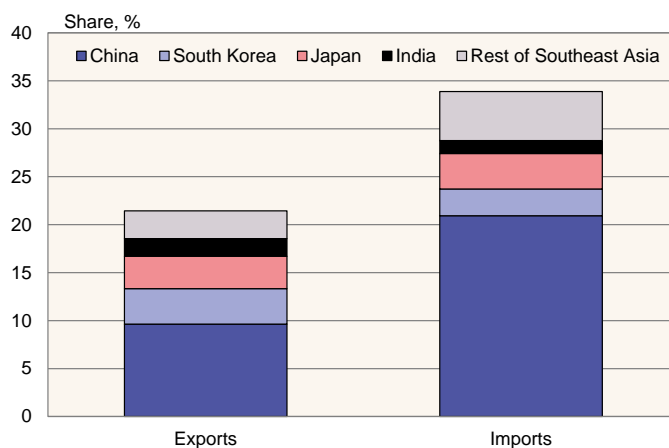
was now more likely that the rate cut would come in the second, rather than the first, quarter. The CBR's next regular board meeting is slated for February 3.

President Putin visits Japan. Russian president Vladimir Putin made a two-day visit to Japan last week that included the familiar signings of memoranda of understanding and framework agreements. Putin and Japan's prime minister Shinzo Abe also discussed the long-running territorial dispute over the Kuril Islands. While little progress was made towards resolution of the dispute, the leaders produced a joint communique stating a common pursuit to develop economic cooperation on the islands.

Russia and Japan are not each other's key economic partners. In Asia, China is the most important economic partner for both of them. Thus, the interest in developing mutual economic relations partly reflects efforts at counterbalancing China's increasing economic power in the region. Japan currently participates in the economic sanctions regime Western countries have imposed on Russia, but Russia's countersanctions on food imports do not apply to Japan. In any case, Japan exports very little food.

In recent years, Japan has accounted for about 4 % of Russian goods trade, while Russia has accounted for a slightly smaller share of Japan's goods trade. The value of Russia–Japan bilateral trade has contracted sharply in recent years due to falling oil prices, ruble depreciation and Russia's weak economy. Russia mainly exports oil & gas to Japan and imports cars. Japan last year accounted for about 6 % of Russia's oil & gas exports. Russia currently has one natural gas liquefaction facility on the Sakhalin island. Most of its LNG goes to Japan, and Japanese firms are minority participants in the venture. Japanese carmakers also assemble cars in Russia. For example, Nissan is part-owner of Avtovaz, Russia's largest car manufacturer.

Share of Southeast Asian countries in Russian goods trade, January–September 2016



Source: Russian customs service.

China

China's leaders sketch out areas of economic policy focus for 2017. The communique from the mid-December Central Economic Work Conference highlighted the usual themes of maintaining stability and moving ahead with reforms. News agency Xinhua reported that the economic work conference warned of excess capacity in certain branches and mounting problems in the financial sector. To bring these issues under control, conference stressed reining in overcapacity, reducing inventories, bringing down debt levels and lowering business costs. More concrete proposals included partial privatisation of state-owned firms, seen as a way to improve efficiency of state-owned enterprises operating in such sectors as electrical power generation, oil & gas, railways, airlines, telecommunications and military industry.

Statements on economic policy suggest that expansionary fiscal policy continues, while monetary policy was vaguely characterised as “stable and neutral.” The government, however, expressed concerns about potential bubbles in the housing and finance markets, as well rising debt problems, which limit the room to stimulate the economy. Current capital outflow and depreciation pressure of the yuan highlighted the contradictory stances presented at the conference, as emphasis was put on exchange rate stability, while promising greater exchange rate flexibility. Decision-makers seemed split on how to proceed under current circumstances.

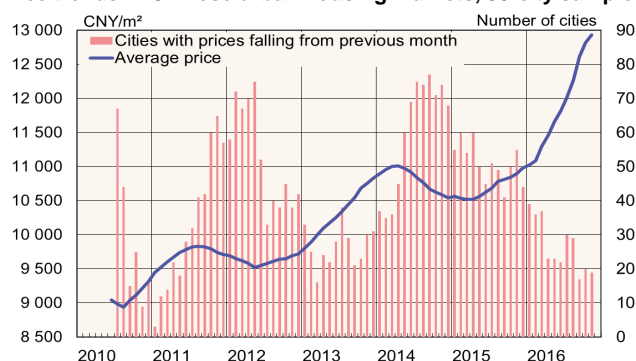
Many observers expect no major changes in economic and reform policies before the party congress next autumn. Among matters to be decided at the congress are the nominations of persons to replace outgoing members of the party's seven-member politburo standing committee.

Is the rise in housing prices in China's big cities abating? SouFun, a private real estate portal that tracks apartment prices in China, reports that apartment prices in its survey of 99 Chinese cities showed an average 12-month increase of 19 % in November. The rise in apartment prices in big cities has become more broad-based: 87 of the 99 cities surveyed showed price increases over the past twelve months. Housing market trends vary considerably across provinces, however. Price increases have been greatest in China's major cities largely due to investors piling into these markets.

The rise in prices moderated from October to November in large cities, which could be a harbinger of the end to this period of soaring prices. The National Bureau of Statistics reports that average apartment prices in some major metropolises (including Beijing, Shanghai and Shenzhen) in mid-November were at slightly lower levels than in October. Prices in these cities are still almost 30 % higher than they were a year ago. Rising real estate prices are considered a major risk to China's economic stability, and the local and central governments have tried to curb price growth in many ways.

Growth in real estate sales slowed in November. Measured by floorspace, apartment sales increased 8 % y-o-y. Apartment sales were still rising an average pace of 30 % y-o-y in the first half of this year. Growth in apartment construction has also slowed from the first half of the year. Measured by floorspace, the volume of completed apartments rose 6 % y-o-y in the first eleven months of the year and new construction starts were up 8 %. The volume of apartments for sale measured in floorspace fell on-year in January-November.

Price trends in Chinese urban housing markets, 99-city sample



Sources: SouFun, BOFIT.

Chinese 15-year-olds lead emerging economies in latest PISA rankings. The latest round of the OECD's PISA tests included over 500,000 15-year-olds in 72 countries last year. The provincial level cities of Beijing and Shanghai participated, as well as students in the Guangdong and Jiangsu provinces. Chinese students ranked 6th in mathematics, 10th in sciences and 27th in reading comprehension. In the 2009 and 2012 testing rounds, Shanghai was the sole Chinese participant and Shanghai students posted the highest scores in all testing areas.

China's neighbours performed also well in the PISA testing. Looking at combined scores (sciences, mathematics and reading comprehension), Singapore's youngsters crushed the test. The PISA top ten overall also included Hong Kong, Macao, Taiwan, Japan and South Korea. Finland, Estonia and Canada also made the top ten. Considering emerging economies, not too far below China (10th) was Vietnam (22nd place), which had a remarkably strong showing in sciences. Russian students posted consistent performances in all categories, placing 28th in the overall rankings. Brazil occupied the cellar at 66th. India was not a PISA participant.

Student scores in China have come exclusively from wealthy areas, so expansion of PISA testing to interior provinces would likely lower China's overall scores. Nevertheless, education traditionally has been highly valued in China and regarded as a path to higher socioeconomic status. Teachers are also greatly respected. Chinese children are effectively required to attend nine years of basic education, and nearly all continue their education thereafter. UNESCO figures show that 43 % of Chinese students went on to university or some other college-level studies in 2015, up from just 20 % in 2005.