BOFIT

BOFIT Weekly Review Yearbook 2023

The Bank of Finland Institute for Emerging Economies (BOFIT)

BOFIT Weekly Review
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- Russian economy likely to remain in recession throughout 2023

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- Covid surges in China, economic implications unclear
- Yuan lost ground against the dollar and euro last year; swings in the CNY-USD rate widened
- Chinese stock markets slumped last year; foreign investors offloaded Chinese bonds

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- Russia's government spending soars while war and sanctions caused various government sector revenue categories to tumble

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- Russia's economic contraction last year mitigated by government spending

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2 Jun 2023 BOFIT Weekly Review 2023/22
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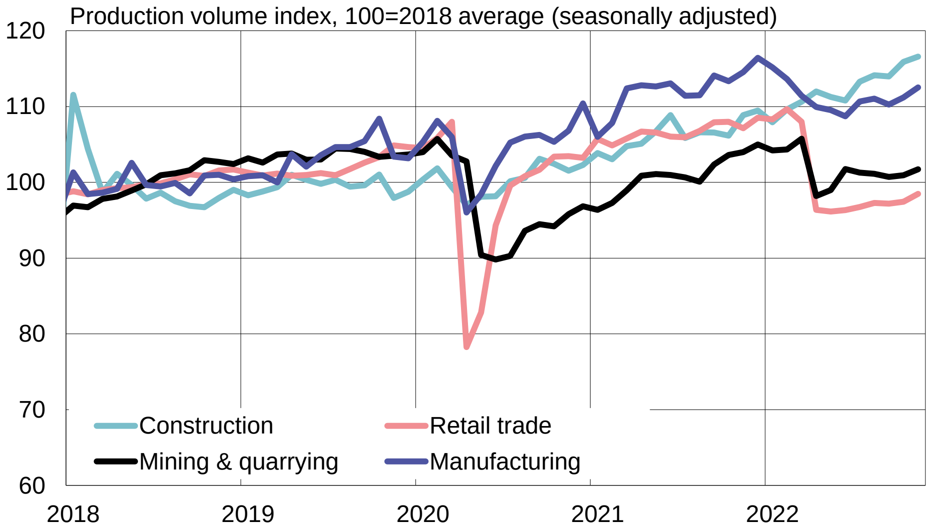
- Low oil prices due to weakened global economic prospects could weigh on Russia’s economic development next year

Russia

Russian economy likely to remain in recession throughout 2023. The Russian economy went into a tailspin in the weeks immediately following Russia's invasion of Ukraine and further escalation of Western sanctions caused by the invasion. Last spring, the Moscow Exchange experienced its largest drop ever, the ruble's exchange rate crashed to all-time lows and panic overtook the banking sector. The Central Bank of Russia (CBR) quickly responded with severe restrictions on capital and foreign currency markets to prevent a full-blown financial crisis and gradually managed to stabilize the markets. At year's end, the MICEX index was down by 43 % for the year, while the ruble's official exchange rate to the USD had appreciated 6 %.

Russian GDP began to contract last spring. In recent months, it has shrunk at a rate of 4–5 % y-o-y according to preliminary estimates from the economic development ministry. The December composite forecast of Consensus Economics, which averages the forecasts of major institutional forecasters, shows 2022 GDP dropping by 3.5 %. Growth trends varied considerably, however, depending on the branch.

Russia's economic performance remained inconsistent across core economic sectors in November



Source: CEIC, Rosstat, BOFIT.

The largest contractions were seen in the output of industrial branches that rely on imports and foreign companies (e.g. production of passenger cars was down by 79 % y-o-y in November, excavators down by 80 % and washing machines down by 60 %). Lack of export possibilities also hit certain other industrial branches in November. For example, wood processing was down by 21 % y-o-y and production of natural gas (excluding LNG) by 16 % y-o-y.

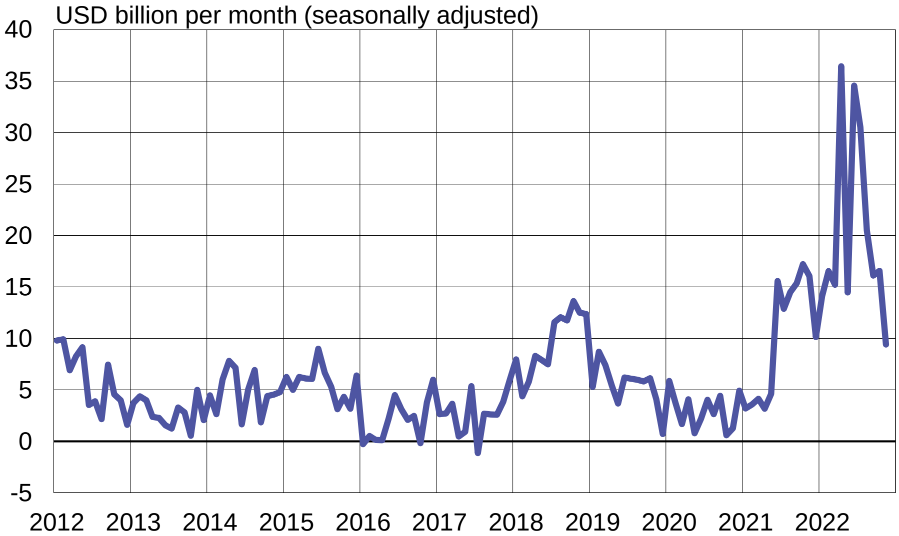
Retail sales, a good proxy for consumption trends, has contracted sharply. The volume of November retail sales was down by 8 % y-o-y. High inflation has eroded the purchasing power of Russian consumers, with consumer price inflation running at 12 % p.a. in November. Despite recession, the unemployment rate has remained low and continued to hover around 4 % in November.

Output has even increased in certain branches. For example, fabrication of metal products grew in November by 16 % y-o-y and production of special-purpose clothing more than doubled. The construction sector, supported by government infrastructure investment, has also experienced brisk growth.

Russia's overall economic development continued to be supported by the all-important oil industry. Oil production rose in January-November by 2 % y-o-y. A large share of production goes to exports. The volume of Russian crude oil exports only began to shrink in the final months of last year. While the EU's ban on imports of Russian crude oil took effect in December, the import ban on petroleum products only enters into force at the beginning of February. Russia sought out new oil export markets last year, most notably India.

While high commodity prices drove Russia's export revenues to historical highs, imports started to contract sharply last spring due to sanctions and the collapse of the ruble's exchange rate. Limits on capital flows and economic sanctions have reduced capital flight from Russia, so Russia's record-high export earnings largely remain in Russia. This initially led to sharp ruble appreciation, but recently these trends have reversed. Preliminary data suggest the volume of Russian oil exports declined in December and export prices fell. The drop in export revenues has led to a decline in Russia's current account surplus and depreciation of the ruble.

Russia's current account surplus continued to shrink in November



Sources: Macrobond, Central Bank of Russia, BOFIT.

The weakening of oil exports and economic recession are reflected in Russian government finances. Finance minister Anton Siluanov recently evaluated that the federal budget deficit in 2022 would be much higher than previously expected, reaching 2 % of GDP. The government piled on debt in the form of domestic bond issues in the final months of 2022 to finance the widening deficit. Windfall taxes imposed on some of Russia's biggest commodity producers – most notably gas giant Gazprom – helped generate substantial revenues for the government at the end of last year.

The outlook is bleak as the Russian economy enters 2023 in recession, and recent key forecasts see Russian GDP contracting by 3–4 % this year. Exports should decline sharply as sanctions begin to bite. According to this year's federal budget, government spending is set to remain flat. This implies a decline in real terms since most forecasts expect Russian inflation to average 4–6 % in 2023. Even with flat expenditure, the federal budget deficit is expected to reach at least 2 % of GDP in 2023. The risks of even weaker performance remain large, however, as long as Russia continues to conduct its war in Ukraine.

Format update: The format of the BOFIT Weekly Review will change slightly this year. Each month will include general overviews of the macroeconomic situation in Russia and China. Two other issues every month will delve into specific economic topics related to Russia, China or other emerging economies.

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China

Covid surges in China, economic implications unclear. Chinese policymakers abruptly abandoned their strict zero-covid policy in early December as the futility of an all-out suppression strategy at preventing the spread of aggressive new omicron strains became evident. China's public health officials currently expect the national infection rate to peak by the end of January, but some observers suggest the infection wave may have already crested or is just passing. With official mass-testing ended, it is impossible to give a reliable assessment of total infections or recoveries in China.

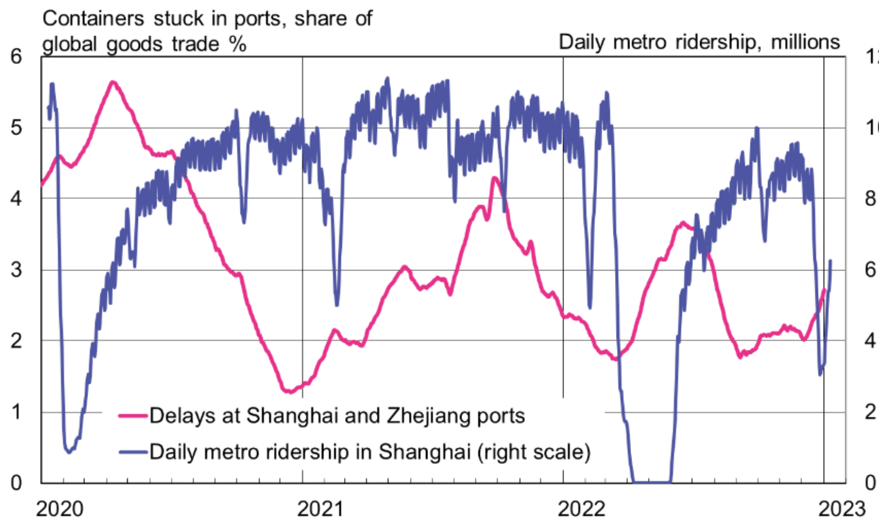
Daily metro ridership figures suggest the latest covid wave has already peaked at least in larger cities. Daily metro ridership has been a fairly reliable indicator of rising or waning infection rates and the intensity of lockdown measures. Ridership declined in the second week of December immediately after the government's about-face on covid policy. The pace of recovery has varied from city to city, however. For example, the rise in metro ridership in Beijing and Guangzhou began in late December, while Shanghai followed about a week later. As of the second week in January, Shanghai metro ridership was still down by about 20 % from its highest levels during the COVID-19 pandemic, and down by over 30 % from 2019 levels. The lifting of domestic travel restrictions coincides with the traditional travel surge associated with the Chinese Lunar New Year season. After years of lockdowns and restrictions, Chinese can finally freely travel to meet friends and relatives in their home districts. Domestic air travel demand increased significantly in December, as did ticket prices.

The December readings of China's official purchasing manager indices were somewhat lower than at the peak of the previous covid wave in April 2022. The manufacturing PMI fell to a below-neutral reading of 47, while the service sector reading dropped to 39. The PMI compiled by Markit Economics, which places a stronger emphasis on private firms and export firms, showed that economic activity for those firms also contracted. The cautious revival of mobility inside cities as well as domestic travel should foster a gradual recovery of private consumer demand and services in the coming months. However, the latest covid wave is unlikely to be the last.

China's pandemic struggles are also echoed in port congestion. For example, the backlog of container ships stacked up outside Shanghai ports or the numbers of container ships forced to divert have repercussions for global production chains. The Kiel Institute, which tracks the number of container ships waiting outside e.g. the Shanghai and Zhejiang ports, estimates the global share of container goods tied up in logistical limbo hit its peak of 5.5 % in early 2020 during the first wave of the COVID-19 pandemic. In December 2022, that percentage of stuck goods rose again with the explosion in omicron-variant infections. Notably, the shift coincided with a sharp downturn in metro ridership. The recent recoveries in metro ridership likely augurs improving conditions at Chinese ports in coming weeks.

China's lengthy quarantine requirements, which effectively prevented foreign visitors from entering the country, were lifted on January 8. Visitors are now only required to produce a negative covid test taken within the past 48 hours.

Metro ridership in Shanghai has recently increased, portending relief for the logjam of container ships



Sources: Metro Shanghai, Kiel Institute, Macrobond and BOFIT.

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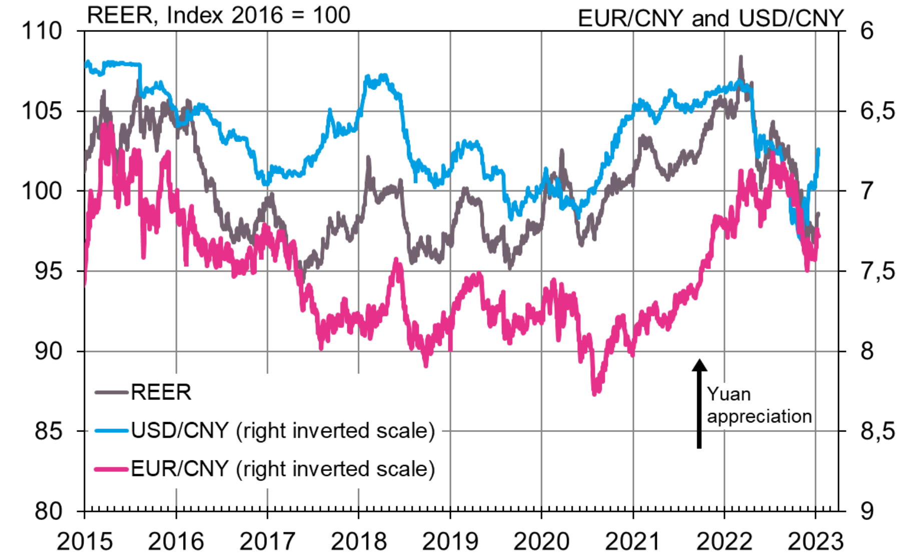
Yuan lost ground against the dollar and euro last year; swings in the CNY-USD rate widened. The yuan's real effective (trade-weighted) exchange rate, or REER, declined by 8 % last year. At the end of 2022, the yuan was down by 9 % against the dollar and 2 % against the euro from the start of the year. On December 31, one dollar bought 6.9 yuan, and one euro 7.4 yuan.

After weakening by 15 % between April and November last year, the yuan has recovered against the dollar. Much of the yuan's depreciation last year was a reflection of dollar strength. The US dollar spot index (DXY) gained about 8 % last year, and 14 % between April and early November. The dollar has weakened in recent months, however. The People's Bank of China once carefully managed the yuan-dollar rate, but recently the central bank has tolerated larger fluctuations. The PBoC regulates the exchange rate by publishing a daily "fixing" rate, around which the yuan-dollar rate can diverge by up to 2 % in either direction in Chinese markets. In addition, PBoC officials can order the country's commercial banks to purchase or sell foreign currency to stabilise the yuan's exchange rate. Direct central bank currency interventions have been less common in recent years.

The yuan's international use increased slightly last year. The yuan remained the fifth-most-used currency in international payments made via the SWIFT system, accounting 2.4 % of total international payment traffic in November (2.1 % in November 2021). The allocation of central bank reserves as reported to the IMF show that the yuan accounted for 2.8 % of central bank allocated currency reserves globally in September (2.7 % in September 2021).

The yuan depreciated against both the dollar and euro last year



Sources: Macrobond and BOFIT.

Chinese stock markets slumped last year; foreign investors offloaded Chinese bonds. As elsewhere in the world, stock markets in China ended the year on down note. Uncertainty in China's markets was fuelled by the government's zero-covid policies and uncertainty about how long the policy would last, as well as the increased risks of policy and regulatory shifts. The Shanghai Composite Index was down by 15 % at year's end, while the Shenzhen Composite Index ended down by 22 % for the year. The Hong Kong Stock Exchange's Hang Seng Index fell by 18 % last year. The index of the largest traded firms on the Shanghai and Shenzhen stock exchanges (CSI 300) declined by 22 %, while the average price of growth firms included in the Shenzhen Stock Exchange's ChiNext Index were off by 29 %. China's market trends are in line with emerging market exchanges in Asia (the MSCI Emerging Asia Index fell by 23 % last year), whereas the overall performance of the world's exchanges was only slightly better (e.g. the FTSE All World index fell by 17 % last year).

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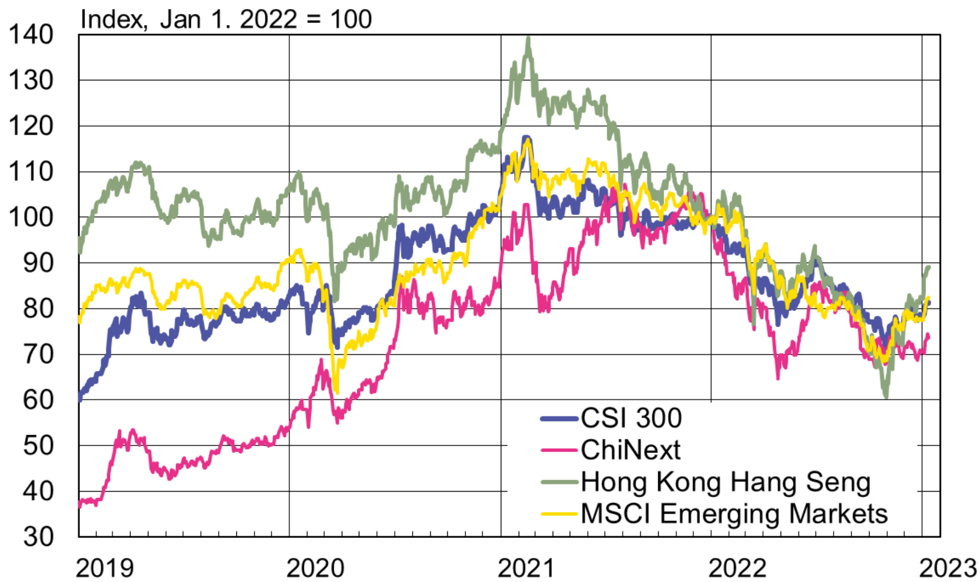
Emerging market stock indices fell last year. The trend was reflected on exchanges in mainland China and Hong Kong



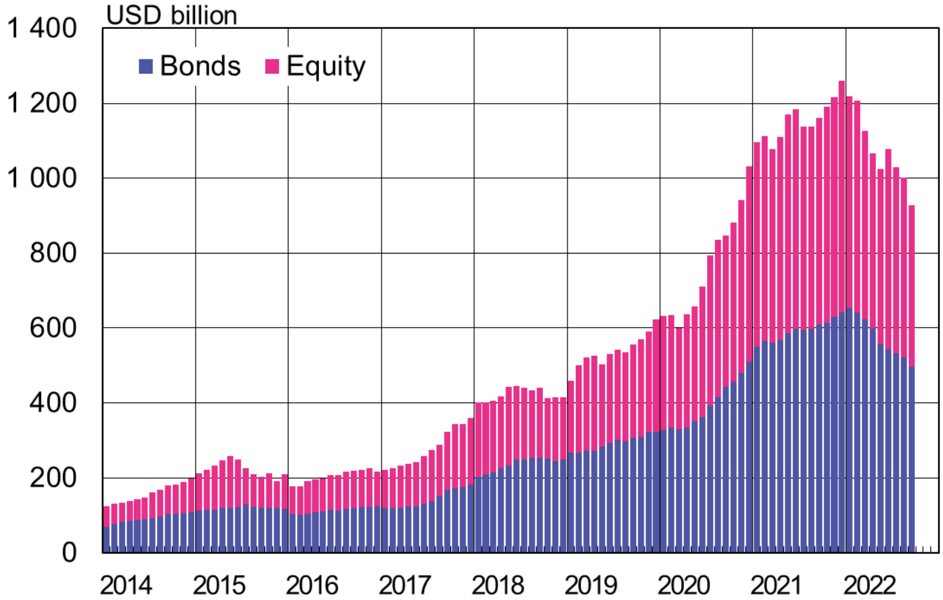
Sources: Macrobond and BOFIT.

Chinese share prices have rebounded in the first two weeks of this year on investor expectations of an economy reinvigorated by the government's surprise decision to abandon covid restrictions and regulatory roll-backs. The policy shift immediately brightened investor sentiment. The central bank's deputy governor said last week that the government was ending its over-two-year regulatory crackdown on internet firms, which started with the last-minute scrapping of the Ant Group's initial public offering in November 2020. The China Securities Regulatory Commission (CSRC) also announced at the end of November that it was ending its 12-year ban on new share sales by property developers. The money raised from new share sales must still be used for specific purposes such as paying down debt or corporate acquisitions. The move allows developers to raise money without increasing their indebtedness. Developer IPOs were banned by the officials in 2010 in an effort to stem soaring apartment prices and reduce speculation in land-use rights. The risk of Chinese firms being delisted on US exchanges has also subsided since China seems have granted permission to share the auditing reports of US-listed Chinese firms with American officials (BOFIT Weekly 52/2022). In the United States, the share prices of Chinese firms have risen by nearly 20 % since the start of this year (situation as of Jan. 12).

Over 400 IPOs were staged on the Shanghai and Shenzhen bourses last year. Also 80 firms listed last year on the recently established Beijing Stock Exchange (BOFIT Weekly 48/2021). By the end of 2022, 162 firms were listed on the Beijing Stock Exchange. The combined market capitalisation of those firms was 210 billion yuan (30 billion dollars). The Beijing Exchange's market cap is miniscule, however, compared to the market cap of the Shanghai Exchange at 46 trillion yuan (6.7 trillion dollars) or the Shenzhen Exchange at 32 trillion yuan (4.7 trillion dollars). Beijing's daily trading volumes have also remained modest. China regulates the IPOs of firms in order to support certain sectors. The *Financial Times* reported this week that the CSRC is banning firms operating in certain fields from new listings on the Shanghai and Shenzhen main boards. These categories include food & beverage chains, firms providing education services, firms involved in covid prevention and funeral firms. The goal is to direct financing flows to branches currently championed by the government (e.g. tech firms), where the present economic condition of the firm carries less importance.

The value of foreign bond and equity holdings in mainland China has decreased. The value of shares acquired by foreign investors on the Shanghai and Shenzhen exchanges via the Stock Connect programme with the Hong Kong bourse last year corresponded to roughly the same value of total shares sold last year. The decline in share prices, however, lowered the value of their shareholdings. On the other hand, the participation of foreign investors on China's bond markets declined every month last year after February. The state-owned China Central Depository & Clearing Co. reports that foreign investor bond holdings in January-November fell by nearly 600 billion yuan (147 billion dollars) and as of end-November stood at 3.1 trillion yuan (430 billion dollars). The latest available central bank figures on foreign investor holdings in stock and bond markets are from the end of September. In the first three quarters of 2022, the value of Chinese listed shares in foreign investor portfolios fell by 187 billion dollars, while the value of their bond holdings dropped by 147 billion dollars. The relative share of foreign investor holdings also declined. Foreign investors currently hold about 4 % of traded shares and control about 3 % of the market value of the interbank bond market. Foreign investors in China almost exclusively keep their investment in central government bonds or bonds issued by policy banks. As of end-November, 9 % of government bonds and 3.5 % of policy bank bonds were held by foreign investors. At the beginning of the year, new regulations on foreign institutional investors bond investment holdings entered into force. The new rules, which are intended to smooth and encourage investment, permit e.g. the transfer of assets between different types of accounts and foreign investor participation in forex derivatives trading to allow for hedging against exchange rate risk.

The dollar value of foreign-held securities on China's stock and bond markets declined by over 25 % in January-September 2022



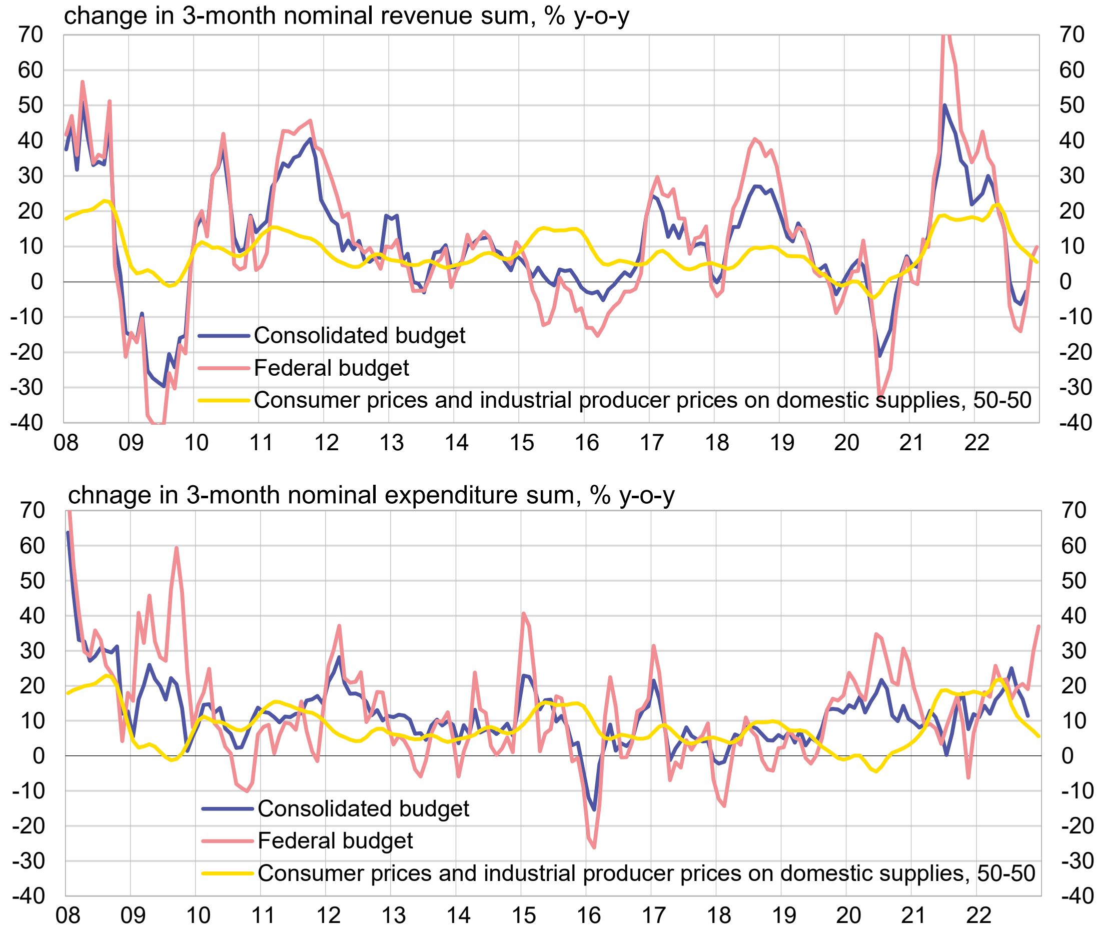
Sources: People's Bank of China, CEIC and BOFIT.

Russia

Russia’s government spending soars while war and sanctions caused various government sector revenue categories to tumble. Russia’s downward slides in the economy and imports since its delusional invasion of Ukraine eleven months ago have substantially depressed Russia’s government revenues. The consolidated budget, which comprises federal, regional and local municipal budgets plus state social fund budgets, has seen nominal revenues decline significantly on-year since mid-summer 2022 (consolidated budget information is only available through October 2022). The same applies to federal budget revenues, which account for over half of consolidated budget revenues. In the final months of last year, the federal budget got a boost from a huge production tax imposed on state-owned Gazprom. As a result, nominal federal budget revenues briefly exceeded 2021 levels. Without the Gazprom windfall, revenues would have continued to slide.

In terms of real purchasing power, revenues to both the consolidated and federal budgets headed downward since late last spring, when spiking inflation outpaced the nominal rise in revenues (measured broadly as an even split between the change in consumer prices and industrial producer prices for domestic supplies as spending on government wages and social supports constitute about half of consolidated budget spending). While inflation slowed significantly in the second half of 2022, consolidated budget revenues were still down in real terms by 10–15 % y-o-y in autumn and federal budget revenues were off by 15–20 %. Indeed, without the Gazprom money, the downward (albeit less severe) trend would have continued in the fourth quarter. Earlier Russian recessions have caused similar real declines in government revenues.

Inflation has largely outpaced growth in Russia’s government budget revenues since late last spring, real spending has risen



Sources: Russian Ministry of Finance and BOFIT.

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The basket of consolidated budget revenue streams other than those from special taxes on the oil & gas sector, which account for about 80 % of total revenues, went into decline on-year last summer. In the federal budget the shortfall emerged already late last spring. While war and sanctions depressed output, spiking Russian inflation (also due to war) fuelled a rapid rise in nominal GDP (the highest since 2011 not counting 2021). This raised revenues from value-added and excise taxes on domestic producers (an over 13 % share of consolidated budget revenues in 2021) during the entire year. Tax collection seemed relatively strong as the ratio of VAT revenues to GDP stayed close to its 2021 peak.

Despite recession, the economy's wage sum rose at a comfortable pace, lifting labour income tax revenues (10 % share of consolidated budget revenue). Revenues from social taxes on wage payments (a 19 % share), however, were down markedly on-year after an extension on paying them. The situation began to stabilise in autumn. Revenues from corporate profit taxes (13 % share) fell sharply went into freefall around mid-summer.

War and sanctions have been particularly hard on revenues from VAT on imported goods and import duties (10 % share), which already by late spring were down by 40–45 % y-o-y. Figures in the autumn still showed an on-year decrease of about 25 %. The last time Russia experienced a similar drop in VAT on imports and import duties was during the harsh recession of 2009.

Revenues from production taxes and export duties on the oil & gas sector, which together account for about a fifth of consolidated budget revenues and about 40 % of federal budget revenues, were down significantly on-year around mid-summer. Decisions by Western firms to reduce their Russian oil imports compelled Russia to large discounts on Urals blend crude oil as early as March, even if the Urals price underscored the level of 12 months earlier only in early autumn. On the other hand, the value of oil & gas taxes, which are denominated in dollars, declined in ruble terms as a very large current account surplus and stringent currency controls drove up the ruble exchange rate sustaining from late spring until virtually end-2022. A slight increase in oil output lifted the share of oil production tax revenues in all oil & gas tax revenues to over 72 %, while Gazprom's extra production tax payment raised the share of natural gas production tax revenues.

With the acceleration of consolidated budget spending growth in the spring and slowing inflation, spending increased at a considerable pace in real terms after mid-summer, due e.g. to a sharp increase in spending on fixed investment (information on other spending categories has not been released since April figures). Federal budget spending already accelerated in the months around the invasion of Ukraine and was boosted in the final months of 2022 to about 40 % y-o-y. The dramatic increase in spending on fixed investment points to a sharp rise in defence spending (which was already up by nearly 40 % y-o-y in January-April). The real increase in total government spending, however, has yet to exceed the tempos seen in some of the previous recessions.

With fading revenues and increased spending, the small federal budget surplus (0.4 % of GDP) in 2021 transformed in 2022 in a larger-than-expected deficit (2.3 % of GDP – even with Gazprom's tax boost equivalent to nearly 1 % of GDP). This situation should characterise roughly the overall government sector deficit as regional and municipal budgets and the budgets of state social funds can hardly finance any deficits. In early autumn, the government still contemplated covering the federal budget deficit with significant drawings from the reserve fund (National Wealth Fund). However, in late autumn it resorted to financing the deficit almost entirely through massive domestic bond issues.

In early autumn, the finance ministry drew up revenue estimates based on a relatively optimistic economic forecast, issued in a government budget policy framework. It also presented a very modest increase in consolidated budget spending that only slightly exceeded forecast inflation. Federal and state social fund spending approved by the Duma in December did not exceed the autumn estimates even if the allocation of federal budget spending (at least at that stage of the game) pulled back on the huge spending increase planned for domestic security and law enforcement and added some spending on sectors of the economy struggling with the current recession. The large and fast excess in federal budget spending last year from what was expected already indicates that existing spending plans and schedules presented in public may see rapid additions this year in circumstances of war and recession.

The current government goal to rein in spending growth is based on limiting the federal budget deficit this year to 2 % GDP. The limit could be exceeded, however, given the overly favourable revenue estimates and extra spending growth. The increase in the budget deficit could be financed from the National Wealth Fund and from large state-owned banks (to which the central bank, in turn, could provide liquidity support as needed) if direct financing from the central bank appeared too unattractive.

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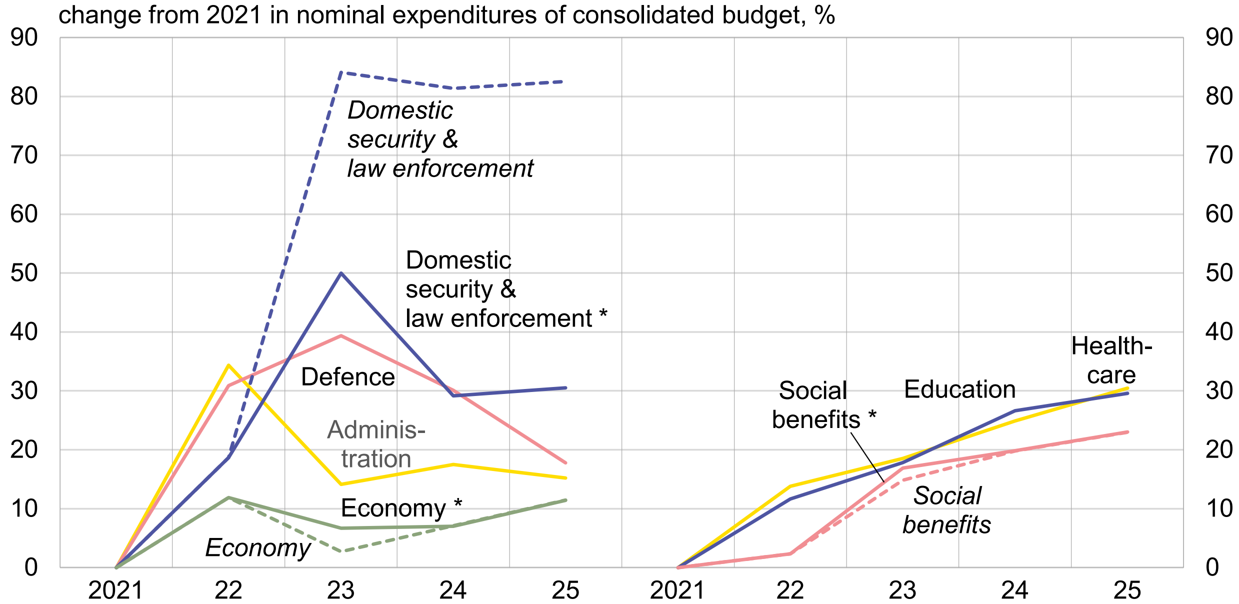
Structures of Russia's government spending have been partly revised since September 2022



* estimates in consolidated budget guidelines of September 2022 amended with figures in federal budget approved in December 2022; no information is available on possible changes in regional budgets after the guidelines

Sources: Russian Ministry of Finance and BOFIT.

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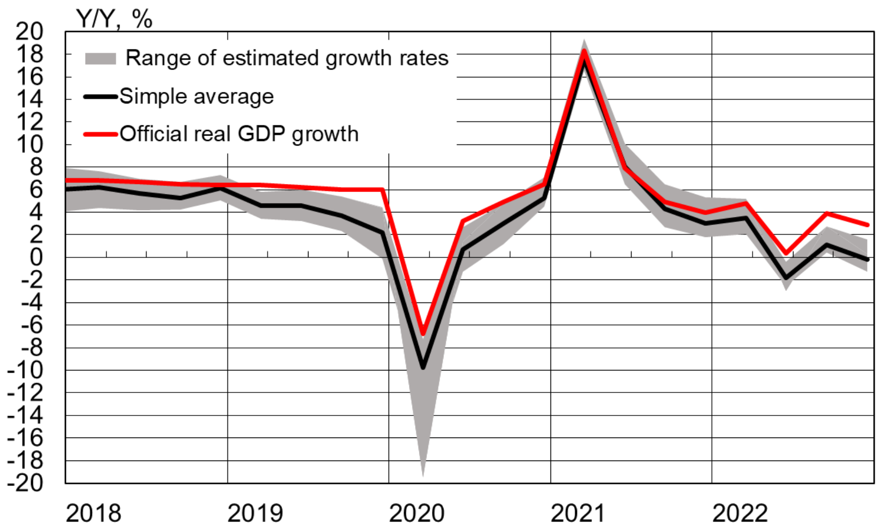
China

Chinese economy struggled last year. China's National Bureau of Statistics reports that GDP grew in the fourth quarter by 2.9 % y-o-y. The 3.0 % GDP growth for all of 2022 was also well below the around 5.5 % growth target announced at the National People's Congress in March last year. Economic development faltered twice last year, first in late spring and then in the final months of the year as the country experienced its large wave of covid infections and massive lockdown measures. Consumer demand, in particular, was subdued by covid waves. In 4Q22, retail sales contracted in real terms by 4–5 % y-o-y. With real growth in disposable income of around 3 %, households turned to building up their savings. Another factor dragging down growth was the demise of the construction sector, which continued to decline throughout the year. Real estate sales contracted by 30 % y-o-y in the fourth quarter of last year, while building volume saw a drop of 50 % in terms of floorspace under construction. The weak growth of the Chinese economy dragged the volume of goods imports to decline throughout the year. Robust exports, the bright spot in the first half of the year, plummeted at the end of last year on slowing global growth. The volume of exports contracted by over 10 % y-o-y in the fourth quarter. Exports contracted faster than imports, which caused net export growth to be negative depressing economic growth.

Official figures show that about half of last year's growth came from fixed investment and rising inventories. It is difficult to make a more specific assessment of fixed investment trends, however, as China has either ceased to release certain critical economic indicators or continues to release inconsistent data. The strong contraction in real estate investment, however, points to other direction than GDP investment figures. It is likely that the overall trend in GDP growth last year was weaker than official NBS figures suggest. For example, BOFIT's alternative estimations indicate that there was no GDP growth whatsoever last year, and that fourth quarter growth was essentially unchanged from 4Q21. Other alternative estimations even suggest economic contraction.

BOFIT's alternative estimates of Chinese GDP growth suggest that growth stalled last year



Sources: NBS, Macrobond and BOFIT.

Population started to shrink last year. China's population has passed its high-water mark. The Chinese population shrank last year by about a million people to around 1.412 billion and India likely surpassed China as the world's most populous country. The contraction in the Chinese population was expected. The working-age cohort (15–64-year-olds) has contracted since 2013 and the number of economically active people has declined since 2015. China is ageing rapidly. The number of persons over 65 hit 210 million last year, an increase of 100 million from 2008. Despite these demographic eye-openers, shrinking population is seen as a minor concern compared to worries about China's record-low birth rate. Only 6.8 births per 1,000 people last year, compared to a global average of about 17.5 per 1,000. Even if the government has effectively abandoned all family-size restrictions and in many provinces having children is encouraged through increased support for families with small children and some have offered longer maternity leave, child-rearing in China remains an extremely expensive proposition for most people. Moreover, many Chinese have come to terms with the single-child family model or are choosing not to have kids. China's shrinking labour force creates by itself an impediment to economic growth. In addition, during the pandemic, the pace of urbanisation slowed sharply. Official figures show the registration of just 6 million new city residents in 2022. In comparison, the annual increase was still 20 million in 2018 and 2019. The contraction of the Chinese population and distinct slowdown in the move to cities should reduce urban investment needs.

Improved indicators raise optimism about growth this year. China's zero-covid policies, which caused severe economic distortions, were lifted the first half of December (BOFIT Weekly 50/2022). The dropping of covid measures allowed the virus to spread rapidly with the peak in the latest wave of covid infections likely already passed. On the eve of the Lunar New Year holiday, officials estimated that as much as 80 % of the population has been infected and that the number of covid-related deaths as of January 19 was about 73,000. Other estimates, however, put the number of covid-related deaths at least an order of magnitude higher. The World Health Organization (WHO) has asked China to provide more comprehensive data on covid deaths and excess mortality. Further increase in deaths are feared, as after three years of lockdown, Chinese were finally able to travel to their home districts for the Lunar New Year holidays, spreading the virus to more remote areas with poor vaccination rates and health care. Although new waves of covid infection likely lie ahead, the worst is past as China no longer has a covid-naïve population.

With the lifting of covid restrictions in China, hope and excitement are in the air as the normalisation of the covid situation allows for improved economic conditions. Consumer demand is expected to strengthen significantly and many await a spending gusher from savings built up over recent years that further boosts consumer demand. The main focus of decisionmakers has also turned to supporting the economy and bolstering consumer confidence in line with the policies adopted at the economic work conference in December (BOFIT Weekly 52/2022). Even if concrete measures are still unclear in most cases, fiscal policy should remain very accommodative. Measures to support the real estate sector and developers are already underway. The government's goal is to stabilise the real estate sector this year.

The rise in Chinese consumer prices remains modest (just 1.8 % y-o-y in December). There are expectations, that inflation kicks up this year with the economic recovery. However, inflation in China has remained exceptionally low and stable over the past decade compared other emerging economies. Pressure is on the central bank to provide economic support, especially to help the real estate sector and boost consumer demand. Expectations of a pick-up in inflation, however, can restrict the central bank's room to manoeuvre in the monetary policy sphere. China's quandary is how to ease monetary policy at a time when most advanced economies are raising rates. Such an environment can fuel capital flight from China and depress the yuan's exchange rate.

The lifting of covid restrictions and targeted measures to support the real estate sector have led to a rapid brightening of the growth outlook for 2023. A month or so ago most forecasters expected 2023 growth to remain in the range of 4–5 % or even lower. Recent forecasts now typically expect GDP growth in the range of 5–6 %. In addition, China's official growth target this year is expected to be "at least 5 %". China traditionally announces its annual GDP growth target at the March session of the National People's Congress.

Real 12-month change (%), consumer prices (%) and exchange rate

	2021	**2022**	**3Q2022**	**4Q2022**
GDP growth	8.4	3.0	3.9	2.9
	2021	**2022**	**11/2012**	**12/2022**
Industrial output	9.6	3.6	2.2	1.3
Retail sales	10.7	-2.2	-7.5	-3.6
Goods exports	17.4	-1.3	-10.9	-12.0
Goods imports	7.7	-6.6	-7	-4.6
Inflation	0.9	2	1.6	1.8
Yuan-dollar rate, avg.	6.45	6.74	7.18	6.98

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

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Ukraine

Ukraine's economy shrank by about a third last year. According to the preliminary assessments, the country's GDP contracted by roughly 30 % last year. Both private consumption and fixed investment have been deeply impacted since the Russia's illegal invasion almost a year ago. Ukraine exports have also collapsed, due, among other things, to the disruption of Black Sea shipping. GDP fell by 37.2 % y-o-y in the second quarter of 2022 and 30.8 % in the third quarter.

The trends, however, were quite unevenly distributed from a geographic standpoint. As might be expected, the economy has suffered the most in the southern and eastern war zones that are either under temporary Russian occupation or disputed. Most of Ukraine's export industries were based in the east or south of the country prior to the war.

In January, the macroeconomic survey firm Consensus Economics released a compilation of recent economic assessments suggesting that Ukrainian GDP contracted by 34.5 % last year and that the volume of fixed investment dropped by over 40 %. The January consensus forecast for GDP growth was 2.8 % this year and 9.1 % next year. The range of growth forecasts, however, remains quite wide as forecasting institutions use different assumptions about how and when the war ends, as well as the sort of peace accords reached.

In our latest BOFIT Policy Brief, we provide background information on the Ukrainian economy before the invasion and how the current war of aggression has impacted it. While pre-war Ukraine had a fairly low GDP per capita (lower middle income under the World Bank classification), its economy also exhibits features of advanced economies.

Ukraine's GDP was about 200 billion dollars in 2021. The cornerstones of the economy were agriculture and heavy industry such as steelmaking. Ukraine's most important agricultural exports were grains such as wheat and oilseed crops such as sunflower. Agricultural products accounted for over 40 % of the country's exports. Ukraine's Black Sea ports are crucial to its economic and geopolitical security; before the war nearly 70 % of the country's exports flowed through them, including over 90 % of agricultural exports. Due to Ukraine's trade agreement with the EU and Russia's actions, Ukraine's foreign trade was already pivoting away from Russia before February 2022.

	2013			2021		
	Total trade (USD bn)	Exports (USD bn)	Imports (USD bn)	Total trade (USD bn)	Exports (USD bn)	Imports (USD bn)
Russia	38.3	15.1	23.2	9.5	3.4	6.1
EU	42.3	16.7	25.7	55.7	26.8	29.0
Others	59.7	31.5	28.1	75.7	37.9	37.7
Total	140.3	63.3	77.0	140.9	68.1	72.8

Source: State Statistics Service of Ukraine.

Ukraine is characterised by social development features typical of both lower-middle-income countries and high-income countries. For example, in terms of access to financial services, Ukraine more closely resembles a high-income country than a lower-middle-income country. On the other hand, Ukraine must overcome large challenges such as poor infrastructure and the paucity of services in rural areas. In addition, corruption and the informal economy are big problems. The majority of Ukrainians responding to a 2020 corruption survey said that they had experienced corruption in such areas as public healthcare services. About a fifth of the Ukrainian workforce was employed in the informal economy in 2020.

War has been hard on Ukraine's public sector due to the decline in tax revenues to the state and increased government spending. As a result, the National Bank of Ukraine, the country's central bank, has had to finance the government. Ukraine has also seen an increase in support from the international community, albeit insufficient to cover the costs of Ukraine's war effort. In the more optimistic scenarios of Ukraine's future, reconstruction efforts are seen as getting underway already this year with Ukraine becoming an EU member as early as 2032. According to Ukraine's own estimates, the total costs of military assistance and reconstruction are likely to exceed 750 billion dollars by 2032. The estimates assume that two-thirds of funding would come from Ukraine's foreign partners. Ukraine would like to see its EU membership as soon as possible as it would help with reconstruction and improve access to foreign investment.

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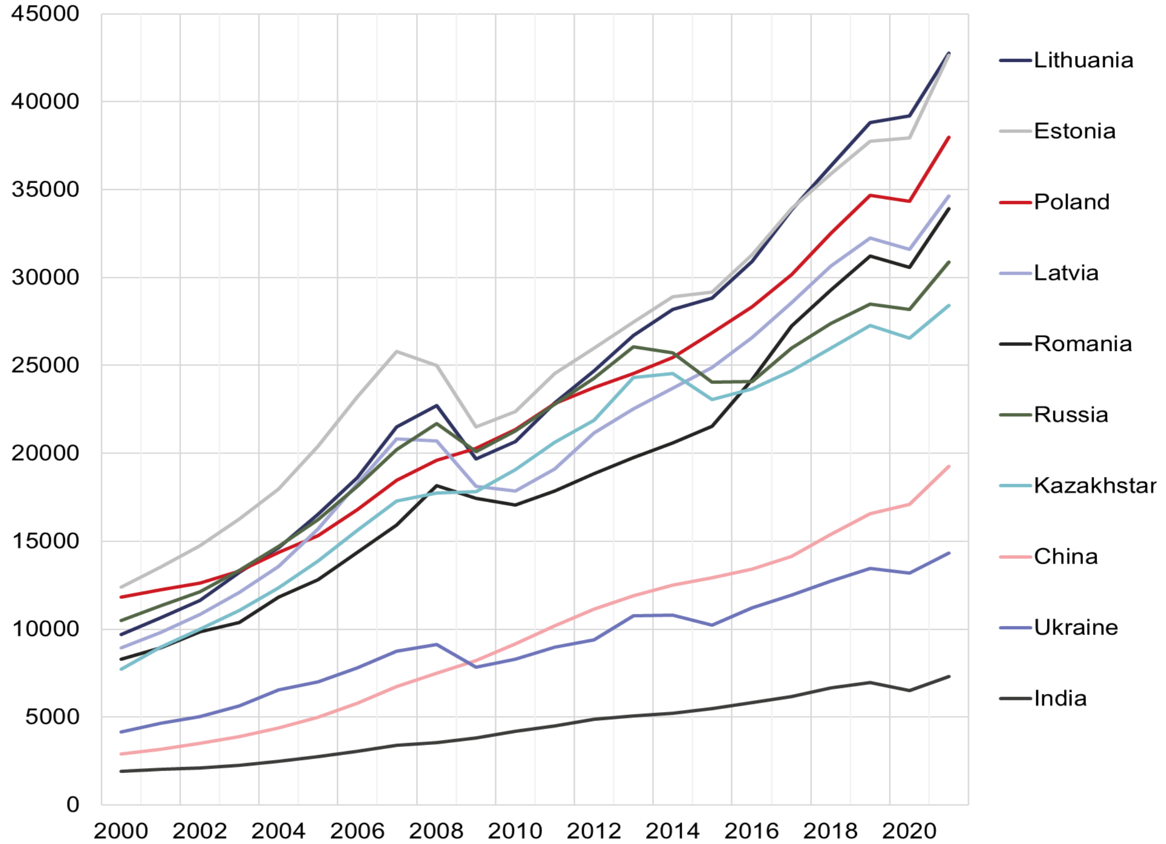
While Ukraine's GDP per capita (in PPP-adjusted dollars) is lower than its neighbours, it shares features with advanced economies



Source: IMF.

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China

Sharp drop in building construction continued, while infrastructure construction saw high growth. Building construction in China went into decline in summer 2021 after officials imposed strict limits on developer indebtedness. Last year's sizeable drops in building activity were apparent from several metrics. In terms of volume (floorspace), new building starts were down by 40 % y-o-y. Purchases of land use rights for building construction were down by half and property sales were off by 25 %. The volume of unsold apartments (measured in floorspace) was 10 % higher in December than a year earlier. The downturn has been broad-based, hitting construction of apartments, office buildings and commercial buildings equally hard. The National Bureau of Statistics (NBS) also reports housing prices have been falling throughout China, as last autumn housing prices began also to fall in the big cities, including Beijing and Shanghai.

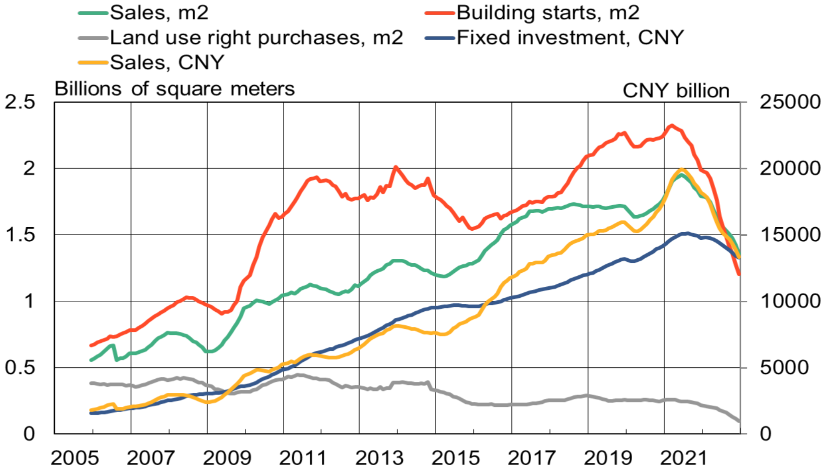
On the other hand, the outlook for building construction has brightened recently, following the government's December declaration that it will halt the contraction of the real estate sector this year. Indeed, it has already significantly eased the access of developers to financing (see BOFIT Weekly 6/2023). The end of zero-covid policies is expected to also revive apartment sales as people can again move about freely. Increased building construction activity should bring fiscal relief to local governments, which get a significant share of their revenues from the sale of land use rights.

In response to the slowdown in building construction, the government cranked up investment in infrastructure projects (up by 9 % y-o-y according to the NBS). While the pace of growth in infrastructure investment last year reached its highest level since 2017, information on how the money has been spent is fragmented. Investment is canals, ports and waterways grew by 17 %. Figures from November suggest that highway investment rose by about 10 % last year, with the strongest growth in the northeastern provinces of Liaoning and Heilongjiang. There was a lot of talk last year about increasing investment in China's telecommunications infrastructure, but no comprehensive statistics are available. The number of 5G base stations increased by 60 % last year, bringing the total number of base stations in use to 2.3 million at the end of 2022.

The emphasis in railway construction shifted during 2022. At the start of the year, the government expected to commission 3,300 km of new track. Last month, state rail company China Railway reported that 4,100 km of new track was commissioned last year. Even with the increase in track-laying, however, the amount was still 2 % below 2021 and just half of the amount of track laid in the peak years of 2014, 2015 and 2019. Less bullet-train track was commissioned last year than at any year in the past decade. NBS figures show that investment in China's railways has declined steadily since 2019. It appears that rail investment this year will also slide as the current plan is to commission just 3,000 km of new track in 2023.

China treats energy-sector investment as distinct from infrastructure investment. Energy-sector investment last year grew quite rapidly. Investment in energy production and electrical grids in the first eleven months of 2022 was up by 16 % y-o-y. High growth was posted in construction of nuclear and coal-fired power plants. Although no specific numbers are available, the huge increase in solar power capacity points to major increase in solar power investment. On the other hand, the investment in wind power declined slightly last year, but the value continued to be massive. Spending on development of the electrical power grid increased by 1 %.

Building activity in China has plunged since last spring



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

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BOFIT

China relaxes regulation of the real estate sector and provides additional stimulus. Among the top goals for 2023 spelled out at last December's economic work conference were stabilisation of the property market, prevention of financial risks and completing the construction of already purchased apartments. With the ongoing financial troubles of developers and China's lethargic housing market, officials have decided to increase economic stimulus to the sector this year. In practical terms, it means the abandonment of earlier policies designed to bring the sector's indebtedness under control.

A variety of targeted programmes have been introduced since last autumn with the goal of easing the financial distress of developers and depressed housing sales (BOFIT Weekly 42/2022). In November, the People's Bank of China and the China Banking and Insurance Regulatory Commission (CBIRC) released a 16-point programme that included extending developer repayment periods on bank loans and bonds, as well as lifting quotas on how much banks can lend to developers or housing buyers (BOFIT Weekly 6/2021). The programme also incentivises developers to use shadow banking sector financing instruments, particularly trust loans. Commercial banks were encouraged to increase their lending to developers to help them complete stalled projects. Soon after, the big state-owned banks announced that they have allocated roughly 1 trillion yuan (143 billion dollars) in credit lines to developers. Credit lines do not necessarily mean that the loans have actually been granted. The PBoC offers interest-free financing to banks through its relending facility for financing developers unfinished projects. In addition, limits on commercial bank lending to foreign subsidiaries of developers have been relaxed to help developers pay off their foreign debts. Developers can also use the money from presales of apartments more freely. The money was earlier locked in escrow accounts that could only be accessed for completing sold apartments.

After a hiatus of over ten years, exchange-listed developers can again raise money from China's equity markets. The money developers raise from share sales must go to paying down debt, completion of construction projects or corporate acquisitions. State-owned China Bond Insurance has promised to guarantee more developer bond issues.

So far the broad support measures have failed to invigorate construction activity or apartment sales. In January, officials released a new 21-point plan aimed at providing liquidity to "quality" developers and to strengthen their balance sheets. The plan does not mention which firms qualify or even clear conditions they must meet to receive financing. The lending programme will rely largely on tried and true measures. For example, the country's policy and commercial banks are encouraged to provide financing to stalled projects. In addition, state asset management companies will offer financing for acquisitions in the real estate branch. In a significant policy shift, a central bank representative said in January that China has ended the use of its "three red line" debt metrics (debt-to-cash, debt-to-assets and debt-to-equity) for 30 unnamed, but "well-performing" and systemically important developers. The extent of the stimulus measures for the property sector suggest that they are not necessarily binding for other firms either.

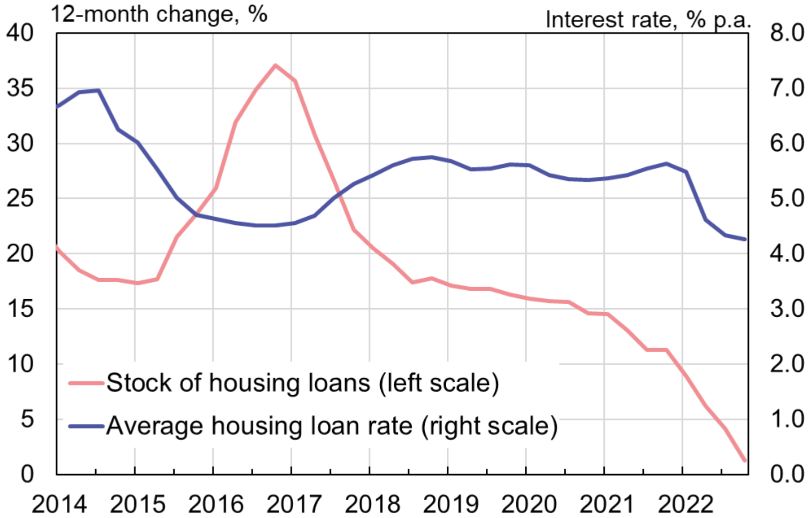
In addition to support measures directed at developers, restrictions have been eased to increase housing demand. Several areas last fall lowered the floor at which banks can grant housing loans. In January, the PBoC and CBIRC allowed for adjustment in the minimum interest rate charged on housing loans to first-time buyers in provinces where housing prices have fallen for over three months in a row. Many provinces have lifted their restrictions on housing purchases, e.g. allowing buyers to own multiple apartments in areas where purchase limits were earlier imposed to quell speculative buying. Together with low housing demand, the interest rate on housing loans has fallen. According to PBoC figures, the average interest rate on a housing loan as of end-December was 4.26 % (5.63 % in end-2021). There are no signs yet of revival in demand for housing loans. The stock of housing loans grew by just 1 % last year, down from 11 % in 2021.

Developers face a daunting range of financial problems. Some developers have sought debt restructurings of both their domestic and foreign bond issues in recent years, and sold off some of their businesses and land use rights. Bloomberg estimates that Chinese developers last year defaulted on over 140 domestic and offshore bond payments, collectively valued at 50 billion dollars. The investment research firm Refinitive puts the value of developers' domestic and offshore bond issues coming due this year at around 140 billion dollars, a 17 % increase from 2022.

The access of Chinese builders to foreign financing has been limited for years, but it could gradually revive with the abandonment of the sector's strict regulation. In January, real estate giant Dalian Wanda staged a dollar bond issue of 400 million dollars. The share prices of Chinese developer listed on the Hong Kong exchange have risen in recent months, even if they are still at low levels. The value of developer bonds have also recovered in recent months. Many traded last year at very low prices.

China has effectively lifted all restrictions imposed of the past two years that were designed to cope with soaring developer indebtedness and runaway housing prices. It remains unclear, however, whether the government has succeeded in reducing risk in the sector. The currently proposed support measures entail considerable funding. Some construction-related branches have already downsized. There is also the ongoing risk that problems in the real estate sector will spread to the banking sector or financial markets. The wide variety of targeted support measures is required as it is extremely difficult for officials to provide funds to stabilise the sector and rein in contagion risk while simultaneously tamping down speculation and moral hazard. A repeated theme at last December's economic work conference was still that "houses are for living in, not for speculation."

Interest rates on Chinese apartment loans have hit an all-time low, and growth in the housing loan stock continues to slow



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

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BOFIT

Russia

Government support keeps banking sector stable in first year of war

In Russia's bank centric financial markets, bank lending pays a significant role in corporate finance. Given that the state, either through direct ownership or via intermediaries, dominates commercial banking, the government assures that the system continues under all circumstances. The smoothest possible operation of the payments system and the banking sector have been a top government priority throughout the Russo-Ukraine war.

Most domestic payment traffic had already been shifted prior to the war away from the international SWIFT payment system to the SPFS system owned by the Central Bank of Russia. SPFS operation was expanded in 2022 and now operates around the clock. Russia's alternative to Western payment cards was rolled out on a broad scale in 2018. Since then social benefits and wages paid by the state have only been deposited in bank accounts associated with a Mir card. The market exit of Western mobile payment options has forced banks to offer solutions based on the CBR-owned Faster Payment System (SBP). While domestic payment traffic flows fairly smoothly, Western sanctions and the reluctance of Western banks to get involved with payments to or from Russian counterparties have made foreign payments increasingly challenging. Moreover, despite Russia's efforts to attract banks in "friendly" countries to join the Mir system, the response has been fairly muted.

Lending growth accelerated at the end of 2022. Following a sudden stop in March, domestic bank activity in Russia gradually returned to near-normal function. Total corporate lending contracted slightly in March-June, but the pace of new lending was quite brisk in the second half of the year. Growth in total lending was boosted by many state-backed programmes or interest support programmes for such groups as systemically critical firms and small-and medium-sized businesses, as well as funding for housing construction projects. Interest rates sank back to pre-invasion levels towards the end of last year. Besides support programmes, extensive loan restructurings increased the amount of total lending, which was up by about 14 % y-o-y at the end of 2022.

The growth in total household lending last year was driven by housing loans. The growth in housing loans, in turn, reflects the government's extremely generous interest-support programme. Housing loans for new apartment purchases were available at a fixed 7 % rate, i.e. significantly below the central bank's key rate for a large part of the year. Special breaks were offered to groups such as families with small children, soldiers sent to the front and IT professionals. The stock of consumer credits contracted in the spring and barely grew in the second half of the year. At the end of 2022, total household lending was about 10 % higher than a year earlier.

The market panic in the spring, the collapse of the ruble's exchange rate and high interest rates caused severe problems for many banks. A more granular assessment is not possible at this point due to the unavailability of bank-specific information for 2022. On the other hand, temporary easing of bank solvency rules and liquidity support from the central bank helped banks get through the worst of it. Bank balance sheets were generally healthy going into the war and the CBR has evaluated that the banking sector is capable of withstanding moderate credit losses. Although banks targeted by sanctions must effectively surrender their assets in the West, international operations were not a major aspect of activities for any of these banks. Losses can be absorbed over several years as domestic operations carry on at near-normal levels.

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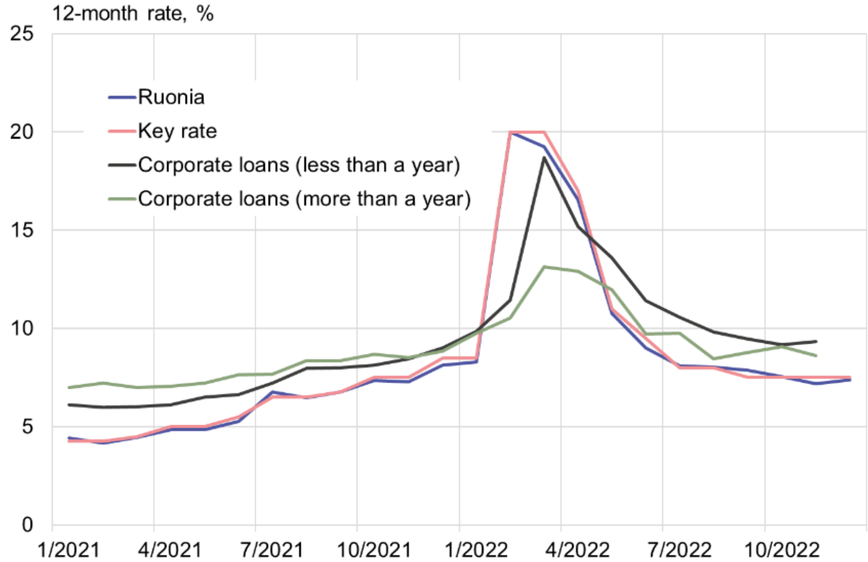
Russian interest rates fell back to pre-invasion levels by the end of last year

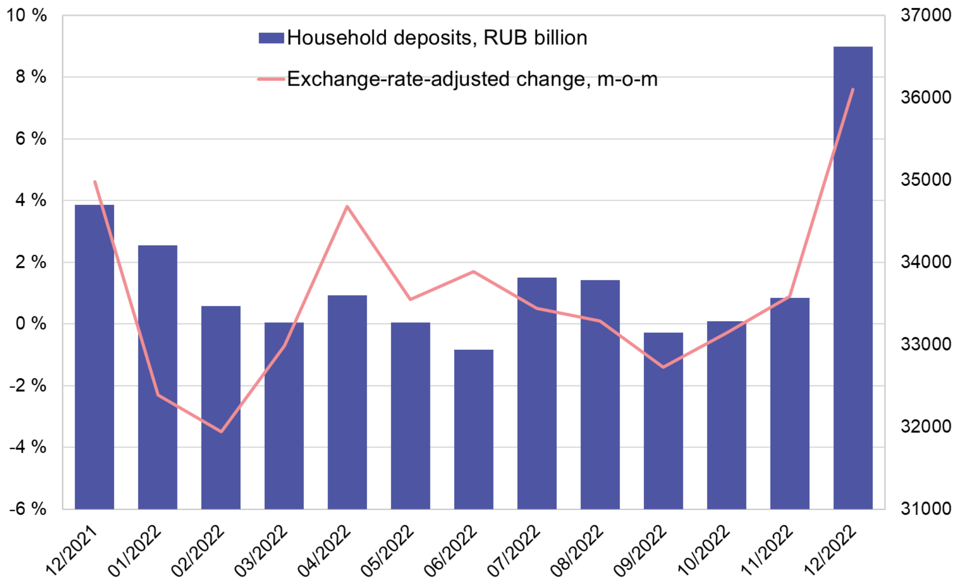


Source: Central Bank of Russia, BOFIT.

Brief dip in total deposits. Deposits of the general public are an essential source of bank funding, accounting for about two-thirds of banking sector total assets. At the end of 2022, finance ministry deposits and loans from the central bank accounted for about 10 % of banking sector total assets. During 2022, total deposits rose by 13 %, driven mainly by growth in corporate assets. In contrast, household assets grew by just 7 %. The on-year growth in household assets was due mainly to the payout of an exceptionally large amount of benefits in December. In January-November, the amount of household assets held by the banking sector contracted slightly from the same period in 2021.

During February and March, and again after the announcement of the partial mobilisation in late September, private customers shifted their assets out of banks. The sharpest drop was seen in foreign currency deposits, where the money was either converted into cash or transferred to foreign bank accounts. As different banks likely experienced deposit flight differently, an average for the entire banking sector can mask substantial variation across banks. Last year's growth in banking sector total assets (12 %) was nearly the same as growth in total deposits in 2022.

Total Russian household deposits declined last spring and autumn, then rose at year's end



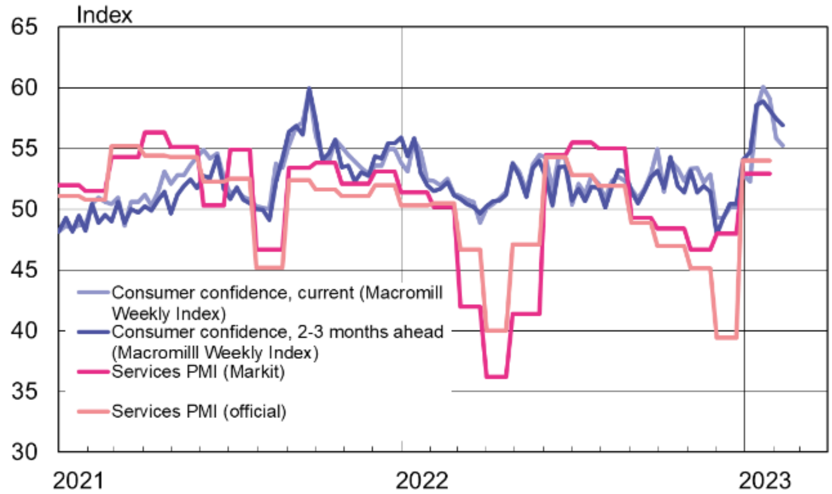
Sources: Central Bank of Russia, BOFIT.

China

End of zero-covid policies boosts consumer confidence in China. It has been about two months since China abandoned it strict zero-covid suppression policies. Because China releases most of its economic data for January and February as a single package next month, trends can only be implicated from morsels of January data. China combines its monthly data for the first two months of the year to overcome some of the huge variability caused by the Lunar New Year holiday week, which takes place sometime in late January to early February depending on the year. Thus, data on the wider effects of re-opening the Chinese economy after years of lockdowns on retail sales, industrial output, exports and imports, will only become available in March.

Inklings of rising consumer confidence and a revival in private consumption are already evident. The January readings of the official and Markit services purchasing manager indices were both well above the neutral 50-point mark. The reading for China's official services PMI was 54.4, and the Markit services PMI reading was 52.9. The improvement in consumer confidence about current and future conditions was obvious by late January, even if no historically sharp rises in confidence were detected. Daily metro ridership in many large cities has already returned to pre-pandemic levels.

Chinese consumer confidence was up in late January



Sources: Macromill, China Federation of Logistics & Purchasing, Markit, Macrobond and BOFIT.

This year's Lunar New Year fell on January 21. In the week preceding and week after New Year's Day, China traditionally sees massive internal movement as people travel to their home villages and other cities to see friends and family. After a two-year break, this year's holiday season saw daily intercity travel climb to around 45 million people. During the previous two pandemic years, daily travel remained well below 30 million. Even so, this year's travel numbers came nowhere near the pre-pandemic levels of nearly 85 million people a day travelling during and around the holiday week.

Unlike the service sector, readings for manufacturing PMIs in January were close to neutral. The official manufacturing PMI reading was 50.1, while the Markit reading (which gives greater weight to private firms and exporters) remained just under 50 points (49.2). Some of the manufacturing weakness could be attributed to the fall in demand in China's main export markets after the highs of 2020 and 2021. Demand, especially in the United States and Europe, has shifted from goods to services and high inflation has eroded purchasing power. The volume of China's exports, which have been contracting since August, was down by 12 % y-o-y in December. While the foreign trade figures for January will only be released in March, there seems to be little change in light of the January figures already released by some of China's trade partners. For example, the value of South Korea's imports from China in January was unchanged from a year earlier, while the value of Taiwan's imports from China were down by 27 % y-o-y.

Consumer price inflation rose from 1.8 % in December to 2.1 % in January. The rise in headline inflation was mostly due to food prices, while also the prices of free-time activities such as tourism and restaurants services were up modestly. Core inflation (does not include food and energy prices) was 1 % in January.

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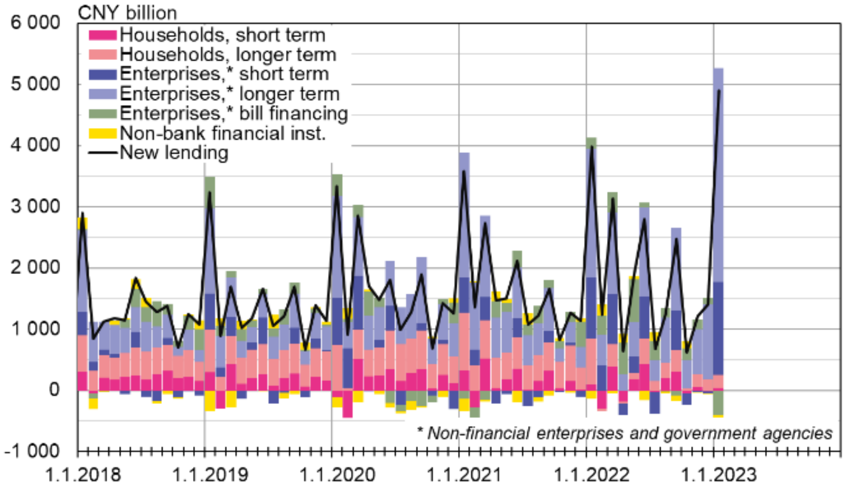
The government has sought to help the struggling real estate sector by encouraging banks to increase their lending and easing loan conditions for both developers and apartment buyers (BOFIT Weekly 6/2023). The volume of new bank loans issued in January rose to about 4.9 trillion yuan, a roughly 25 % increase from January 2022. The lion's share (over 70 %) of new bank credit issues were long-term corporate loans. There was apparently little change in the amount of new housing loans. Roughly 220 billion yuan in new long-term loans to households were granted in January, which is less than a third of the amount typically granted in January in recent years.

The volume of new loans to enterprises at record-high in January, housing loans remained muted



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

Indebtedness continues to climb and fiscal deficit remains large. As part of its annual Article IV consultation with China, the IMF released at the beginning of February a comprehensive Country Staff Report on China's economic policies and economic trends. The IMF assessment mentions the real estate sector's problems, slack consumer demand and the slowdown in global economic growth as factors driving the increase in private and public sector indebtedness and the deterioration of the balance sheets of especially smaller banks.

According the China's official statistics, the combined debt of central and local governments last year was just 52 % of GDP. The IMF's estimate, which doubles that to about 112 % of GDP, includes both official public sector debt and the debt of off-budget local government financial vehicles (LGFVs), as well as state funds. LGFV debt equalled 48 % of GDP last year and is expected to reach 53 % this year. With the downturn in the construction sector, sales of land-use rights have dropped off precipitously, substantially reducing an important revenue stream for local governments. To make up for lost sales, LGFVs have now been told to buy land-use rights, which only increases indebtedness. The IMF expects China's consolidated public debt to reach 121 % of GDP this year. Only a fifth of that is central government debt.

The IMF expects household indebtedness, which last year corresponded to 61 % of GDP, to remain at roughly the same level this year. Corporate indebtedness, on the other hand, is expected to keep rising. Corporate sector debt (not counting LGFVs) last year equalled 119 % of GDP, and is expected to rise to 123 % this year. The IMF estimates that overall Chinese debt outside the financial sector should rise this year to 306 % of GDP.

The official budget deficit last year corresponded to 9.5 % of GDP, but that does not include off-budget spending. The IMF calculates that the actual public sector budget deficit last year was closer to an eye-watering 17 %. The IMF also sees China maintaining a fairly accommodative monetary stance this year while it gradually phases out covid-era fiscal stimulus programmes. Thus, the actual public sector deficit should begin to shrink gradually, even if does not fall below the 15 % level until 2026.

Real on-year change and consumer prices, %

	2021	2022	3Q2022	4Q2022
GDP	8.4	3	3.9	2.9
	2021	**2022**	**12/2022**	**1/2023**
Industrial output	9.6	3.6	1.3	n/a*
Retail sales	10.7	-2.2	-3.6	n/a*
Goods exports	17.4	-1.3	-12	n/a*
Goods imports	7.7	-6.6	-4.6	n/a*
Inflation	0.9	2	1.8	2.1
Yuan-dollar rate, avg.	6.45	6.74	6.98	6.79

* Combined figures for January-February to be released in March.

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

Russia

Russia's economic contraction last year was mitigated by government spending. Rosstat last week released its first assessment of Russian GDP in 2022. According to its preliminary estimate, Russian GDP contracted by 2.1 % last year, a better-than-expected performance that surprised nearly everybody monitoring Russia. The economic contraction was slightly less than Russian officials expected (e.g. the Central Bank of Russia estimated just a week earlier that GDP contracted by 2.5 % last year). The CBR predicted last November an economic contraction of 3.3 % for all of 2022, while the Consensus forecast by international investment banks was still -4.2 %.

The initial on-year estimate of economic performance is typically inconsistent with quarterly data, so the 4Q22 GDP development is still unclear. Currently released data suggest that the Russian economy ceased to contract in early autumn.

In addition to the apparent year-end growth spurt, Rosstat's initial estimates of GDP by end use are difficult to interpret. Figures on the volume of total exports and imports are not released, and numbers inferred from other components imply about zero net exports last year. That estimate does not comport with available information on the value of foreign trade. Preliminary balance-of-payments figures indicate that the value of total imports contracted by 9 % y-o-y, while the value of total exports grew by 14 %. Using mirror statistics of Russia's main trading partners, the value of Russian goods imports fell last year by 23 %, while the value of goods exports rose by 23 %.

Looking again to the GDP by end use figures, private consumption contracted last year by 1.8 %, while public consumption rose by 2.8 %. The contraction in private consumption reflects the decline in real incomes (down by 1 % y-o-y). On the other hand, the contraction in retail sales (down by 6.7 %) suggests that the decline should have been more pronounced. We expect some of this confusion to resolve with the release of the 4Q22 figures. Last year's nominal growth in public spending (over 20 % according to preliminary figures) was exceptionally high. It implies that public spending increased by nearly 10 % in real terms. Federal budget spending was up by 25 % y-o-y. Most of the increased government-sector spending showed up in public consumption and public investment.

Gross capital formation fell by 3.2 % y-o-y. The decline was due almost entirely to a massive drop in inventories. Corporate inventories have been drained by the uncertainties of war, sanctions and disruption in logistics chains. In contrast, fixed capital investment shot up by 5.2 %. The growth in fixed investment is largely due to investment projects with public support launched before 2022 and the government's own investment projects. For example, the budget funding for national projects increased by 29 % last year. The bulk of the national project spending involves construction of transport infrastructure. In addition, procurements related to the war effort may have been booked as public investments.

The impacts of a year of war in Ukraine were reflected as uneven developments on the production side of GDP calculation. Agricultural value added was up by 8 % y-o-y, boosted by bumper harvests last year. Mining & quarrying (includes oil & gas extraction) showed almost no growth (up by just 0.4 %), while manufacturing output fell by an average of 2.4 %. The fluctuations have been quite large from branch to branch. Branches that rely on domestic demand or support the war effort grew rapidly (e.g. pharmaceuticals were up by 8.5 % and fabrication of metal products up by 6 %). Other industries, however, have been hit hard by sanctions (e.g. wood processing was down by 12.8 % and auto production down by 45 %). The growth in public investment was reflected in the strong growth in construction sector (up by 5 %). Public administration grew by 4 %.

Rosstat GDP estimates, 2019–2022, yoy change

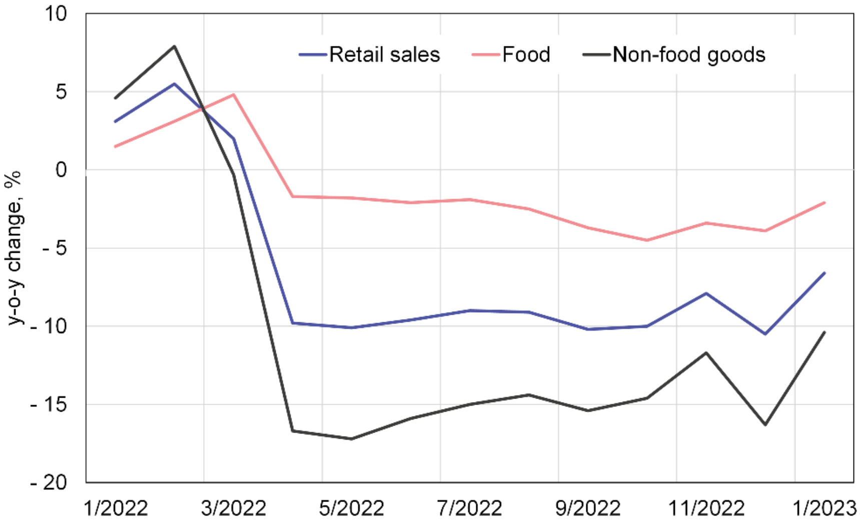
	2019	2020	2021	2022
GDP	**2.2 %**	**-2.7 %**	**5.6 %**	**-2.1 %**
Private consumption	3.8 %	-5.9 %	10.0 %	-1.8 %
Public consumption	2.4 %	1.9 %	2.9 %	2.8 %
Gross Capital formation	2.3 %	-4.3 %	14.2 %	-3.2 %
Fixed investments	1.0 %	-4.0 %	9.1 %	5.2 %
Exports	0.7 %	-4.2 %	3.3 %	
Imports	3.1 %	-11.9 %	19.1 %	

Source: Rosstat.

Weak economic performance continued in January. Rosstat's January figures suggest no quick turnaround of the Russian economy. While retail sales were down by 6.6 % y-o-y in January, on-month sales in January were up after a drop in December. In contrast, indicators of demand for household services, including hotel & inns, tourism and restaurant & catering services, continued in January to experience the strong growth they enjoyed in the final months of 2022. Manufacturing output contracted by 2 % y-o-y in January, while output of the mining & quarrying sector was down by 3 %. Among the hardest hit branches in the extractive sector were natural gas production (down by 14 %) and LNG production (down by 13 %). Crude oil production was down by 1 % y-o-y in January.

Federal budget revenues dropped sharply in January from a year earlier, while the pace of spending accelerated (up by nearly 60 % y-o-y). The federal budget deficit in January was already 64 % of the approved budget deficit for all of this year. This suggests that the 2023 budget deficit will be much larger than the 2 % of GDP planned for this year.

The on-year decline in Russian retail sales continued in January



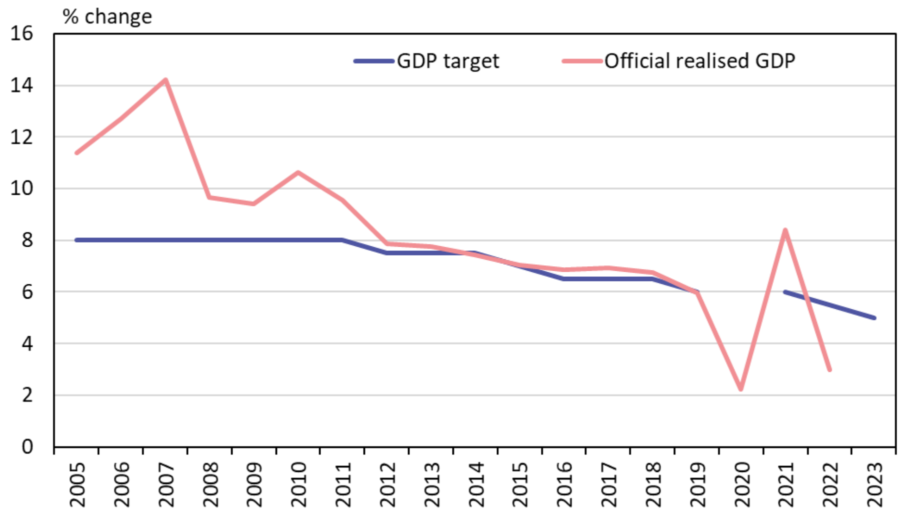
Source: Rosstat.

China

China's National People's Congress convenes to approve policy agenda, targets, administrative reforms and budget. China's highest decision-making body, the National People's Congress, is currently convening in Beijing for its annual plenary session, which runs from March 5 to March 12. Although most policy decisions were reached earlier, the NPC must still rubberstamp those decisions. China's leaders have put much emphasis on familiar themes at this year's meeting, including maintaining stability, national security, self-sufficiency and technological advancement. The main focus of policies, however, is reviving consumer demand. Other areas of focus are making progress in industrial modernisation, strengthening state-owned enterprises and supporting private firms, attracting foreign capital, decreasing economic risks, stabilising grain harvests, making the shift to a green economy, as well as improving certain aspects of social security and public services. Appointments to top posts this year are being closely watched. Today (Mar. 10), Xi Jinping was chosen for his third term as president. This weekend will see the selection of premier, finance minister and central bank governor among many other key positions.

Outgoing premier Li Keqiang announced the set numerical growth targets for 2023. The GDP growth target for this year is "around 5 %." Some observers expected a higher growth target as many forecasts predict higher growth for this year. However, the target should be seen as a floor or minimum requirement rather than a growth forecast. China's GDP growth target has been lowered incrementally since 2011 and for example in 2021 it was already clear that the goal would be reached when it was set. The reasonable GDP growth target might leave some room for officials to pursue other important goals and it also provides some breathing room for local governments digging out from under the large debts incurred from administering zero-covid measures. Other targets remain consistent with the current five-year plan (2021–2025). The household income growth should increase same pace with GDP growth. The inflation target (really more of ceiling than target) has been set at "around 3 %." Employment should remain at the current 5.5 % level and another 12 million new jobs in urban areas should be added, i.e. the average pace of job creation in recent years. The grain harvest target is 650 million metric tons a year. The government will seek to reduce the economy's "energy intensity" (reduced energy consumption per unit of GDP).

China's annual GDP targets vs. official realised GDP growth



**) How the GDP growth target is expressed has varied over the years. The chart shows the average target when a range was given. No growth target was set for 2020.*
Sources: China National Bureau of Statistics, CEIC and BOFIT.

Significant structural changes in China's administrative bodies were announced at the NPC. China will create new national financial regulator, the National Financial Regulatory Administration (NFRA). It will take over the China Banking and Insurance Regulatory Commission (CBRIC) in its entirety, as well as the central bank's current functions of overseeing financial holding companies and consumer finance protection and the functions of the China Securities Regulatory

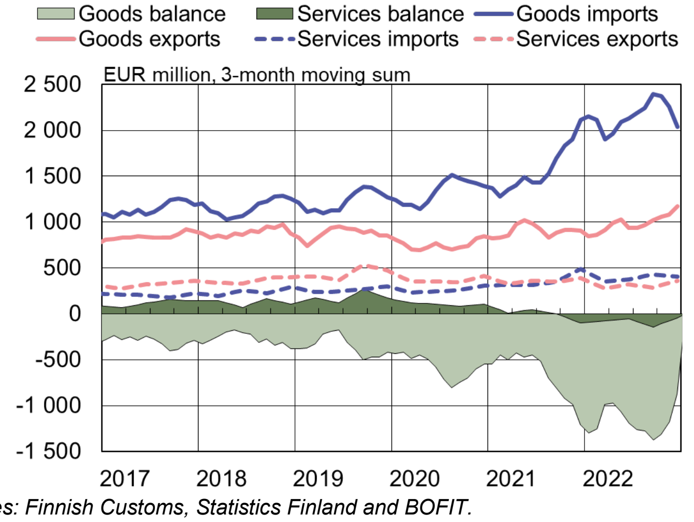
Commission (CSRC) involving investor protection. The securities regulator CSRC will take over approval authority of corporate securities from the National Development and Reform Commission (NDRC) and the CSRC will be elevated to the status of an agency operating directly under the State Council. China's National Intellectual Property Administration will also be elevated to the status of an agency that reports directly to the State Council. The county-level branches of the People's Bank of China (PBoC) will be closed. The Ministry of Science and Technology (MOST) will be given a larger role, even if some of its departments and operations will be spun off to other ministries. A new party organ, the Science and Technology Commission, has been established to oversee MOST. China also will establish a new National Data Administration that operates under the NDRC. Certain other administrative changes will also be implemented. At the same time, 5 % of the central government's current posts will be shifted to new "important and key" tasks. The transfers will apparently be based on the "cheese slicer" principle, i.e. personnel cuts of 5 % will be required at all current ministries, agencies and other units that report to the central government.

This year's budget was also presented to the NPC delegates. Nominal budget revenues and expenditures are expected to increase at a rate of just over 3 % a year, which seems quite modest pace in light of current inflation expectations and projected GDP growth. Little specific information on spending trends for individual administrative branches is yet available, but defence spending is set to increase at the same pace as nominal economic growth (7 % a year) as in numerous years before. The budget deficit will remain at around 3 % of GDP. The budget covers only a part of overall public-sector revenues and spending. At the local government level, off-budget spending is very significant. According to the IMF's January estimate (BOFIT Weekly 8/2023), China's actual general government deficit amounted to nearly 17 % of GDP last year. Moreover, that deficit is expected to remain nearly as large this year and public-sector indebtedness will continue to rise rapidly causing financial difficulties in many regions. Also the finance ministry notes in its budget assessment that some local governments have amassed large deficits and that certain cities and counties are struggling with their debt liabilities.

Finland's trade with China last year slightly underperformed Finnish foreign trade overall. The latest foreign trade figures released by Finnish Customs show that the value of Finland's good exports to China grew by 11 % last year to 4.04 billion euros. The value of total goods exports grew by 19 %, of which China saw its share decrease slightly to under 5 %. China is Finland's fifth most important export destination. The value of Chinese goods imports to Finland grew by 28 % last year, roughly the same pace as import growth overall (27 %). The value of goods imports was 8.47 billion euros, driving the trade deficit up to 4.43 billion euros. With the collapse of Russian trade, China has become Finland's third largest provider of imports, accounting for roughly 9 % of total imports.

Preliminary figures released by Statistics Finland show that the value of Finland's services exports to China fell by 13 % last year to 1.24 billion euros. The value of services imports from China grew by 6 % to 1.56 billion euros. Finland's services trade overall grew by 20 % last year. Finland's services trade balance with China has been negative after 2020. The contraction in services exports in recent years largely reflects China's strict zero-covid policies that only ended late last year. During that period, Chinese tourism in Finland was essentially non-existent. In pre-pandemic 2019, Chinese tourism in Finland accounted for about 15 % of Finland's services export to China. More detailed breakdowns of the services trade in 2022 have yet to be released.

Finland's goods and services trade deficits with China widened last year

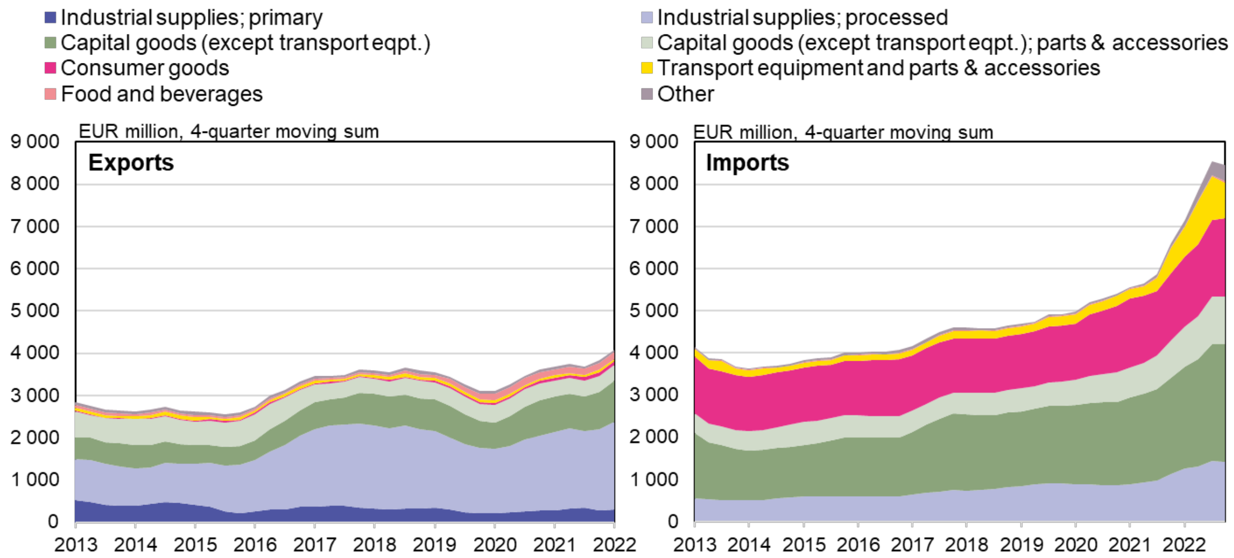


Sources: Finnish Customs, Statistics Finland and BOFIT.

Looking at Finland's goods trade with China, the value of exports of chemical substances and compounds to China last year more than quintupled from 2021, accounting for 5 % of exports to China. The value of nickel exports grew by more than six times and accounted for 2 % of the value of total exports to China. The value of pulp exports grew by 15 % y-o-y, with pulp accounting for over a quarter of Finland's exports to China last year. The value of imports of electrical machinery and equipment grew by nearly 30 % y-o-y, and accounted for about a third of Finland's total imports from China. The value of imports of mechanical machinery and equipment also grew, accounting for about a fifth of total imports. Finland depends on many specific Chinese imports. The dependencies of Finland and the EU on Chinese imports are discussed in our latest BOFIT Policy Brief (in Finnish, English version coming soon). The analysis extends through 2021.

Foreign trade figures are also available in the Broad Economic Category (BEC) classification system. The BEC figures reveal that over half of Finland's exports to China consisted of processed industrial supplies. Last year, exports of consumer goods to China grew, even if they only accounted for 3 % of the value of total exports. Finland mainly imports capital goods and related parts from China (nearly half of the value of imports), as well as consumer goods and processed industrial products. The value of transport vehicle imports from China increased by over 40 % last year, and represented about a tenth of total imports from China. Finland only imported a small number of passenger cars from China. Most transport vehicle imports consisted of vehicle components or vehicles intended for industrial use. This last category includes imports of cruise ships, which were worth roughly 230 million euros in both 2021 and 2022.

The structure of Finland's goods trade with China has changed somewhat in recent years



Sources: Finnish Customs and BOFIT.

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Russia

Russian government spending on investment rose sharply during the war, mixed performance in other investment. Fixed investment in Russia has recovered and grown briskly since the recession in 2020. In 2021, fixed investment was already several percent higher than in pre-pandemic 2019. On the other hand, investments that, among other things, support future economic growth were only at 2012–2014 levels as they fell sharply from autumn 2013 to early 2016 and subsequently performed tepidly.

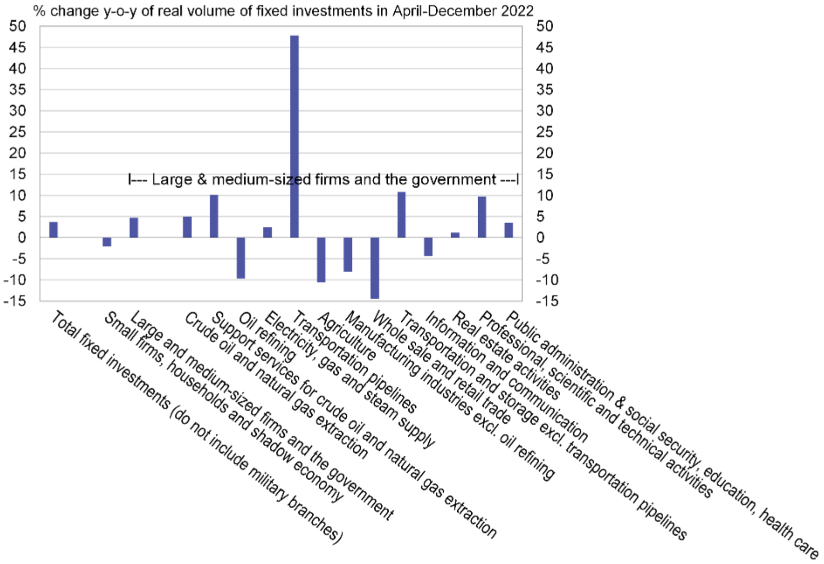
Fixed investment continued to rise in 2022 in real terms. It was up by over 5 % measured in terms of fixed capital formation (in national accounts) and according to Russian statistics on fixed investment up by about 4.5 %. Fixed investment has also increased since Russia's unprovoked invasion of Ukraine, although the pace of growth slowed significantly from winter 2021–2022. Investment in April-December 2022 was up in real terms by a couple percent from a year earlier. The subject of fixed investment in Russia was discussed as part of BOFIT's latest forecast for Russia and as a separate issue at our Russia briefing (in Finnish) streamed last Monday (Mar. 13) from the Bank of Finland.

The overall rise in total fixed investment disguises differences in investment performance in several respects. Rosstat's quarterly figures for fixed investment, which basically cover large and medium-sized firms as well as the government budget sector (77 % of total fixed investment), were up by nearly 5 % y-o-y in real terms in April-December. In contrast, the on-year change in fixed investment of other entities (i.e. small firms, households and shadow economy) in the same period was -2 % by Rosstat's estimate (a drop slightly similar to that seen in Russia's previous recessions).

Investment developments vary widely across branches in the wartime economy (Rosstat's quarterly figures for fixed investment in nearly all branches and industrial branches with large investment account for 85–99 % of annually released fixed investment data while neither of the two data sets covers military branches). Fixed investment in the energy sector increased considerably in April-December. This was especially evident in fields where state-owned enterprises play a central role such as crude oil and natural gas production, pipeline transmission of oil & gas as well as gas distribution. In branches where private firms dominate (e.g. manufacturing, agriculture and commerce), investment contracted sharply during the war. The published partial within-year data on fixed investment that cover 25 manufacturing branches show investment fell in all but five branches, notably including chemicals, metal refining and manufacturing of transport vehicles other than automobiles.

The investment moves for their part indicate that in the course of the war Russia's leaders and officials increasingly and in different ways influence corporate investment and operations more broadly. Earlier this month president Vladimir Putin issued a decree stating that failure of firms to uphold the conditions of contracts involving government procurement could result in the government taking over the company providing goods or services to the government.

Fixed investments in different branches of the Russian economy have developed quite differently during the war



Sources: Rosstat and BOFIT.

Coverage of the quarterly investment data for various types of fixed assets is relatively good in the case of non-residential buildings and different structures (89 % coverage in 2022) as well as machinery, equipment and transport vehicles (72 % coverage). Converting the data published in nominal prices to real volumes of fixed investment requires price data, but reasonable price data are only available for the machinery, equipment and transport vehicles category. On that basis, it appears that investment in this category fell by about 15 % y-o-y during April-December last year.

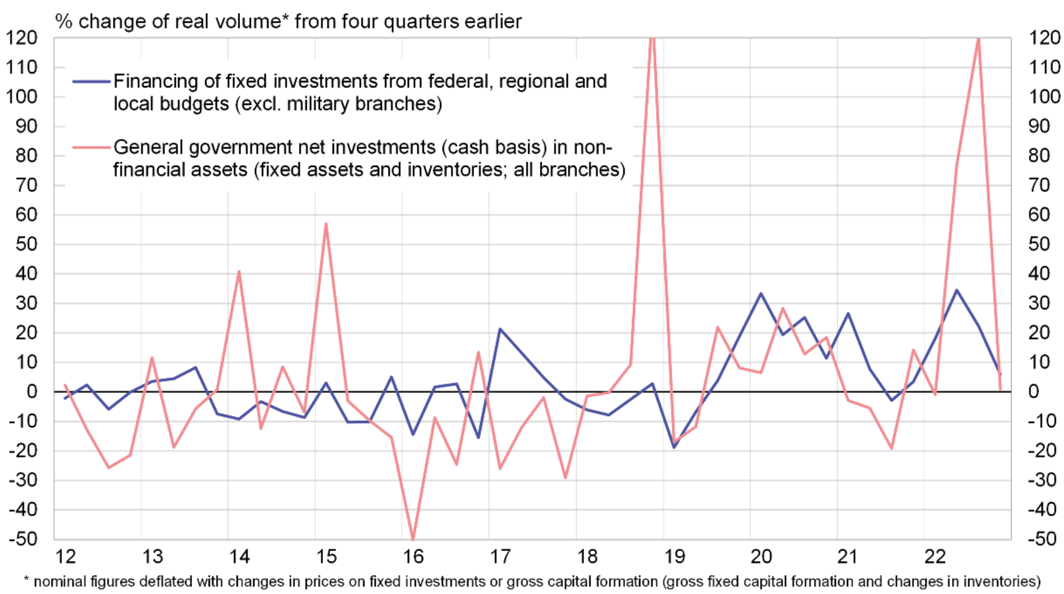
During the war, the government has increased funding to its own fixed investment and joint investments with firms. According to Rosstat's fixed investment data (i.e. without military branches) show that investment funding from federal, regional and municipal budgets rose by nearly 30 % y-o-y in real terms in April-October. Even with waning budget increases, growth was still over 15 % in April-December. This boost, however, did less to increase investment in state administration and mandatory social security or other mostly state operated branches such as education and healthcare as well as storage and support activities for transportation. Thus, state funding of fixed investments in other branches increased significantly.

Total government spending on the overall investment front has increased much more as general government budget spending on fixed investment and inventories (including military branches) doubled in real terms in the April-October period. This reflects the situation that the government has made an even more brutal push in military investment and inventories.

A comparison of the general government budget spending on investment and total investment (including inventories) in Russia shows that funding of the respective investments from non-government sources (corporations and households) in April-December remained roughly unchanged in real terms from the same period a year earlier. Fixed investments of fully or partly foreign-owned firms, however, dropped by about 25 % even when looking at the available annual data for all of 2022, due, among other things, to the fact that many foreign firms left Russia and ownerships were sold off to Russian investors. The investments of Russian firms as a whole increased.

Perspectives in fixed investment and the related cross-pressures this year and beyond are discussed in our latest [BOFIT Forecast for Russia 2023–2024], released this week.

Russian government spending on investments has soared during the war



Sources: Rosstat, Russian Ministry of Finance and BOFIT.

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BOFIT

China

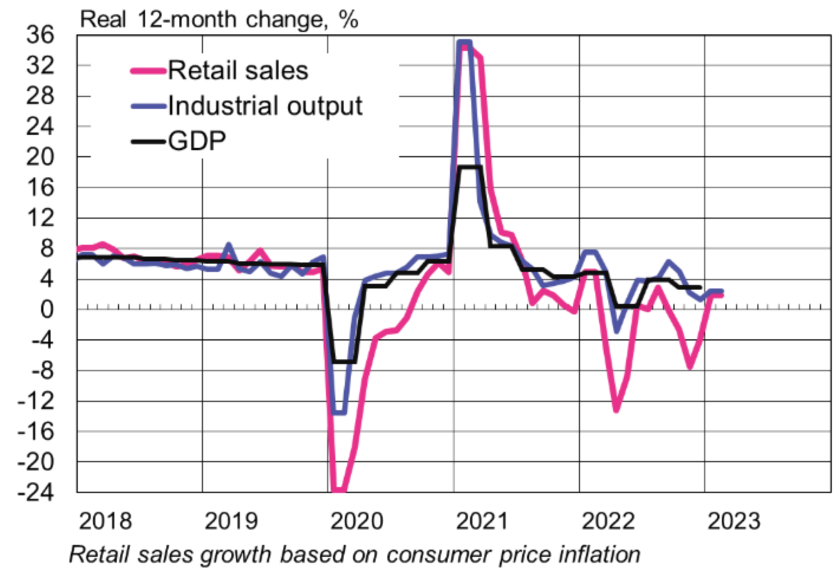
China sees cautious signs of reviving growth in the first two months of this year. Consumer confidence in China returned quickly with the ending of covid restrictions, signalling a return to growth for private consumption. The combined figures for January and February released in March show that retail sales grew by 3.5 % y-o-y in nominal terms. Based on average consumer price inflation, we estimate that real growth in retail sales was around 2 %. In the service sector, value-added grew by 5.5 % y-o-y and that growth was broad-based. Highest growth was posted for hotel and restaurant services (up over 10 %), IT services (up 9 %) and financial services (8 %). Consumer confidence has remained high in March, suggesting that the first quarter overall should show a strong performance.

For now, the worst may already be over for China's troubled real estate sector. Sales volumes fell by just 4 % y-o-y and building starts were down by just 9 %. In December, the declines in both categories were still in double digits. Officials have sought in recent months to make sure that construction projects underway are completed (BOFIT Weekly 6/2023). In the January-February period, the number of completed construction projects increased for the first time in twelve months, rising by 8 % y-o-y. The drop in apartment prices also appears to have ended, at least in some cities. The National Bureau of Statistics reports that 30 of 70 cities tracked still experienced price declines from previous month, down from over 60 cities at the end of last year.

Industrial output grew by 2.4 % y-o-y in January-February. Mining & quarrying rose by nearly 5 % y-o-y, largely a reflection of increased production of construction materials. Manufacturing increased by 2 % y-o-y. Turning to the February manufacturing purchasing manager indices (PMIs), the subindices for new orders and booked export orders rose to levels not seen since the 2020 growth spurt. Exports and imports were still contracting in January, falling sharply in both dollar and yuan terms. In February, however, exports for the most part returned to the growth track. Yuan-denominated exports grew in February by 5 % y-o-y and imports by 13 % (in dollar terms down by 1.3 % and up by 4 %, respectively). The volume of exports grew in January-February by a total of roughly 10 % y-o-y, while the volume of imports was up by nearly 8 %. Looking a raw material imports in January-February, China saw on-year increases in imports of iron ore and pulp, while imports of crude oil and copper declined.

Nominal growth in fixed investment was up by 5.5 % y-o-y in January-February. Although real estate sector investment fell by nearly 6 %, investment in infrastructure grew by 9 % and manufacturing by 8 %. China has ceased to publish some datasets, making more detailed assessments of investment trends very difficult. Moreover, those statistical datasets that continue to be released are somewhat contradictory.

With China's about-face on covid policy, retail sales returned to positive growth in the first two months of this year



Sources: NBS, CEIC, Macrobond and BOFIT.

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BOFIT

Consumer price inflation fell from 2.1 % in January to 1 % in February. Overall inflation moderated on the slowing rise in food and energy prices. The rise in food prices slowed from 6.2 % in January to 2.1 % in February. Services inflation fell from 1 % in January to 0.6 % in February. Energy inflation also slowed to just 0.6 % (down from 2.4 % in January). Core inflation, which excludes the fluctuation in food and energy prices, was 0.6 % in February.

The volume of new bank lending rose in January-February to 6.7 trillion yuan, which was nearly a third more than in the same period a year earlier. The lion's share of new loans were long-term loans to corporations. New housing loans in January -February was still less than half of the borrowing in the same period a year earlier (86 billion yuan).

Last Friday (Mar. 17), the People's Bank of China announced that it was lowering its reserves requirements for banks by 25 basis points. The reduction does not apply to those banks (including all small banks), for which the reserve requirement ratio has already been set at 5 %. The banking sector's combined weighted reserve requirement thus fell by 20 basis points to 7.6 %. The reserve requirement ratio was last lowered in December. When banks no longer have such a large share of their assets tied up as deposits with the central bank, they can more productively invest those assets, which in turn lifts bank profitability and encourages banks to lend more.

Central bank governor gets new term, political guidance remains strong. At the conclusion of the plenary session of the National People's Congress on Sunday March 12, (BOFIT Weekly 10/2023), the Communist Party of China affirmed policy directions and numeric economic targets for the coming year, as well as appointments to the highest posts in leadership. Li Qiang, Shanghai's CPC party chief, was tapped as the new premier. Somewhat surprisingly, central bank governor Yi Gang and finance minister Liu Kun were both given new terms even if both have reached retirement age and neither was recommended for even a deputy member post at the October 2022 plenary session of the CPC's central committee. Observers note that actual decision-making power in China rests increasingly with political office-holders. Guo Shuqing has served as central bank party secretary and deputy governor since 2018. The preserving of the old guard in economic policy at this point could be seen as part of ongoing efforts to stabilise the economic situation.

On March 16, the government announced the creation of the Central Financial Commission (CFC), a new agency for supervision of the financial sector and strategic policymaking. The CFC is intended to strengthen and focus the party's oversight of decision-making in the financial sector. The government also announced the convening of a new Central Financial Work Commission tasked with overseeing the party's ideological and policy roles in the financial sector. A commission of the same name was established in the wake of 1998 Asian financial crisis, but was disbanded a few years later. A similar Central Science and Technology Commission has also now been created for the technology sector, but the persons to head either of the new commissions have yet to be named. Both moves are consistent with a general tightening of central government control over the economy.

Real on-year change and consumer prices, %

	2021	2022	3n/2022	4n/2022
GDP	8.4	3	3.9	2.9
	2021	**2022**	**1/2023**	**2/2023**
Industrial output	9.6	3.6	2.4*	2.4*
Retail sales	10.7	-2.2	2.0*	2.0*
Goods exports	17.4	-1.3	10.0*	10.0*
Goods imports	7.7	-6.6	7.8*	7.8*
Inflation	0.9	2	2.1	1.0
Yuan-dollar rate, avg.	6.45	6.74	6.79	6.95

* As the dates of the Lunar New Year holiday week shift from one year to the next, China publishes combined January-February figures for industrial output, retail sales and foreign trade.

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

Russia

No signs of improvement for the Russian economy. Rosstat reports that industrial output contracted by 2 % y-o-y in January-February. Mining & quarrying production fell by 3.1 %, with the most notable drops in output of coal (down by 2.3 %) and natural gas (-13.5 %). Oil production fell only slightly (-0.6 %). The decline in manufacturing output continued with the volume of production in January-February down by 1.7 % y-o-y. Industry showed strong divergent trends. Production in branches dependent on foreign trade continued to shrink, while branches geared to serving the emerging wartime economy experienced strong growth.

The volume of retail sales shrank by 7.2 % y-o-y in the January-February period. Food sales were down slightly, but sales of non-food items were off by 11.4 % y-o-y. The drop in retail sales largely reflected the decline in sales of durable goods. Some of this decline reflects lack of supply as sanctions and logistical challenges limit imports of e.g. household appliances.

The February 2022 invasion sparked fears of higher prices, forced households to accelerate their spending plans and caused consumer spending to spike in March 2022. Although retail sales suffered an approximately 10 % drop in April last year, the situation stabilised thereafter. While the 12-month change in March retail sales this year is likely to be similar to the previous two months, the 12-month change is expected be diminish in the months ahead.

The economy continues to be supported by growth in the agricultural and construction sectors. Construction activity increased by 11 % y-o-y in the first two months of this year, although housing construction experienced no growth whatsoever. Most of the growth in construction likely came from the stepped-up pace of public infrastructure projects.

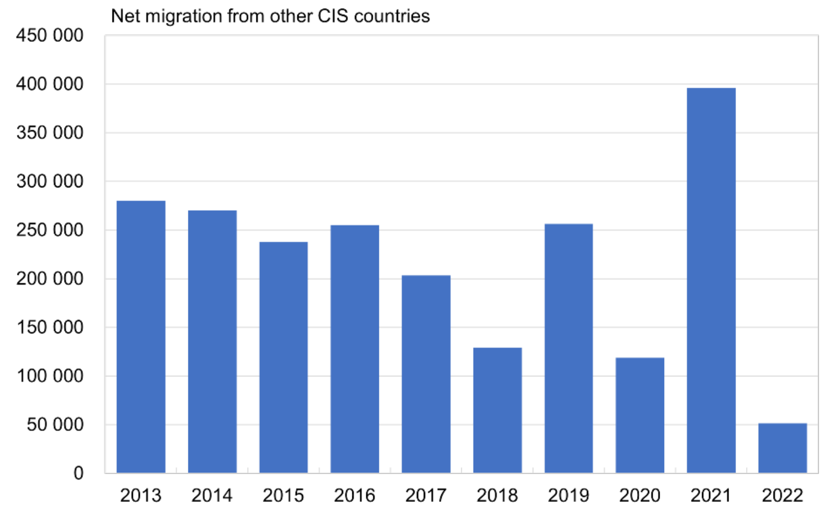
In January-February, nominal federal budget revenues plunged by nearly 30 % y-o-y, while expenditures increased by about 50 %. The spending burst is due in part to changes in public procurement policies. As much as 90 % of the value of projects this year will be paid up front in an effort to stimulate industrial output, particularly the military-industrial complex. Nominal spending on government procurements in January-February 2023 was up by about 350% from a year earlier. The federal budget deficit has skyrocketed, reaching nearly 4 % of GDP for the 12-month period ending in February. Spending growth in the consolidated budget (federal, regional and municipal budgets plus state social funds) remained rapid last year, with spending in the fourth quarter up by nearly 20 % y-o-y. The consolidated budget deficit in 2022 was 1.4 % of GDP. The federal budget deficit was 2.3 % of GDP.

Exceptionally low unemployment rate. As a consequence of war and mobilisation, Russia faces a labour shortage that can already be seen in wage growth. The national unemployment rate fell to just 3.5 % in February, its lowest level of the post-Soviet era. In the most industrialised regions in the Central Federal District of Russia, as well as Moscow and St. Petersburg, the unemployment rate is currently below 3 %. While there are still large fluctuations across regions, the sole regional unemployment rate in excess of 10 % was found in regions in the North Caucasus. Despite recession, growth in nominal wages has remained brisk. Moreover, real wages should start rising this year as inflation ebbs. In January, nominal wages were up by 12.4 % y-o-y, and the average real wage up by 0.6 %. The rise in the average wage was most pronounced in government administration and the currently thriving branches of industry such as metal refining and machine-building.

An important driver of Russia's low unemployment rate is its shrinking working-age population. The fastest decline has been seen in the past decade in the cohort of Russians aged 20–40 years. The labour supply is also influenced by changing migration patterns. In recent decades, the Russian labour market experienced a fairly stable flow of fresh workers from Central Asia and Caucasus regions. Many of these migrant workers were employed in construction or low-paid jobs in the service sector. Last year just 650,000 people moved to Russia from CIS countries (mainly Central Asia), while 584,000 returned from Russia to CIS countries. Thus, the net migration to Russia from other CIS countries was only about 51,000 people, a much smaller number that in the first year of Covid-19 pandemic in 2020. The rise in emigration from Russia last year was caused by a combination of factors that included economic recession, uncertainty about the war, fears of being sent to the front and distinctly better economic conditions in the countries to which Russians were emigrating.

Russia's migration statistics only tell part of the story. In particular, Russian citizens moving abroad do not always officially register as emigrees. Estimates as to the number of Russians who have permanently or temporarily left Russia since the invasion range between 500,000 and 800,000. The most popular destinations for Russian emigrees have been Kazakhstan, Armenia, Turkey and Georgia. Estimates of persons fleeing to Russia or Ukrainian nationals taken to Russia are all over the map. UN figures show that about 2.9 million Ukrainians crossed the border to Russia since the invasion. Many of these migrants continued their journey to third countries.

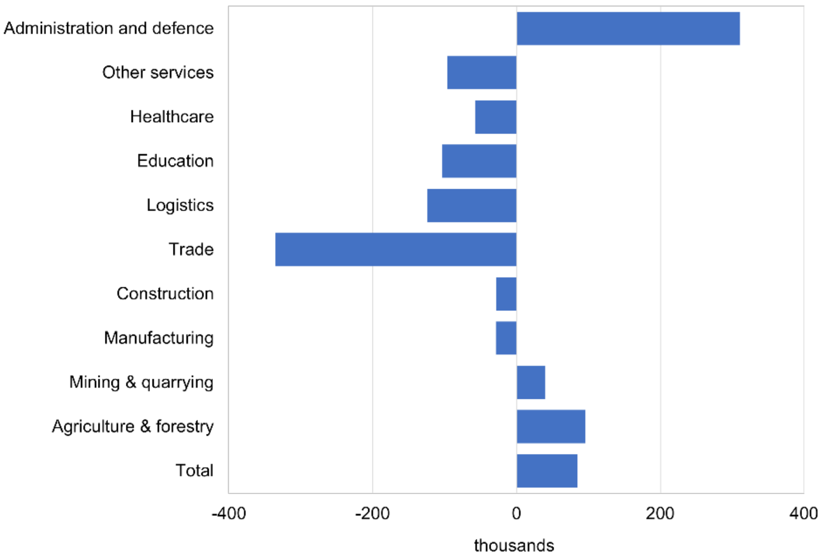
Net migration from other CIS countries to Russia was negligible last year



Sources: Rosstat, CEIC, BOFIT.

The pace of job creation and destruction always varies somewhat from branch to branch, but the effects on Russian employment are fairly clear after a year of war. In the second half of 2022, the number of persons employed contracted in the trade and logistics branches. Correspondingly, over 300,000 new jobs were created in public administration (which includes defence). Despite the changes, trade, manufacturing and logistics remain the three branches with the most workers. They employed a total of 31 million people at the end of 2022, roughly 40 % of all jobs in Russia.

Change in number of people employed by branch in July-December 2022 (thousands)



Sources: Rosstat, CEIC, BOFIT. Seasonally-adjusted number of employed persons using the Tramo/Seats method.

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China

Chinese inflation remains remarkably low. China's National Bureau of Statistics (NBS) reports that the 12-month rise in consumer prices slowed to just 1 % in February. Consumer prices were up by 2 % last year. Russia's invasion of Ukraine created an energy crunch in most countries with higher energy prices hitting just as post-pandemic demand was reviving and production bottlenecks were getting cleared. China appears to have largely avoided the inflation spike.

Some of China's modest inflation reflects the current phase of the business cycle and economic policies, but some is methodological. During the height of the pandemic, many countries provided generous supports to households that resulted in strong consumer spending after their economies reopened. China, in contrast, chose not to provide wide support to households but instead directed support almost exclusively to the corporate sector. Throughout the entire pandemic, and even after the lifting of covid restrictions, consumer demand in China has been tepid. Growth in retail sales has lagged far behind industrial output growth.

The labour markets in China are less tight than in many countries. After several months of decline, youth unemployment flared in February again to above 18 %. The large body of migrant labour that constitutes China's labour reserves does not show up in the unemployment statistics. Many migrant worker returned to their villages during the pandemic when work in the cities dried up. Many are now likely to return to jobs in cities as demand returns. Pressure to raise wages has remained quite modest, which is also reflected in prices of services. The NBS reports that real disposable incomes in urban areas rose by less than 2 % y-o-y last year.

Differences in the structure of the consumption basket used by Chinese officials to measure inflation as well as price regulation further explain China's modest inflation levels. The current weightings in the consumer basket are as follows: food and tobacco 29 %, housing 25 %, transport and communications 15 %, household goods and services (including clothing) 12 %, healthcare 10 % and education & culture 8 %. Compared to the euro area Harmonised Index of Consumer Prices, the Chinese consumer basket places greater weight on food, housing and healthcare components. Changes in Chinese consumer prices are particularly sensitive to changes in food prices. This was seen quite dramatically in 2019–2020 when pork prices skyrocketed due to the African swine fever epidemic.

Changes in energy prices do not channel as directly to consumer prices as in many other countries. Energy prices are reflected in consumer prices in housing and transport categories, but other than vehicle fuels, the price increases have been quite modest in China. This reflects the fact that domestic energy prices are largely regulated or government guided, i.e. fixed for finite periods or adjusted based on global prices. For example, retail fuel prices are adjusted every two weeks if global crude oil prices are in the range of USD 40-130 per barrel. Above or below the this range, prices are essentially kept unchanged to cushion the economy from potential shocks. In contrast, producer prices in China are quite sensitive to swings in global prices of energy and raw materials. The connection between producer price and consumer prices, however, is quite weak at the moment. Producer prices overall rose by over 4 % last year, but started to fall already last autumn as energy prices started to decline.

In addition to tracking consumer and producer prices, economy-wide price changes can be assessed with a GDP deflator that is used to translate national accounts in current prices to constant prices. While China does not publish an official GDP deflator, implicit deflator can be calculated by subtracting real GDP growth from nominal GDP growth. For example, the 2022 implied GDP deflator in official statistics was roughly 2.5 %. Some researchers have chosen not to use China's official figures in measuring real GDP and instead created their own GDP deflators. For example, BOFIT's alternative GDP calculation re-estimates the GDP deflator using official NBS-released price series. According to our alternative estimate, the price rise in China last year was higher, about 5 %. Real GDP growth also appears to have been well below the announced 3 %. BOFIT's alternative GDP calculations for 2021 also showed the rise in prices was clearly higher than the official consumer price inflation.

China's official inflation target (12-month inflation) sets a ceiling value for the rise in consumer prices. This year's target was set at 3 % at last month's session of the National People's Congress. As such, inflation is not expected to constrain monetary policy this year. Indeed, inflation has not been much of a factor in Chinese monetary policy-setting in recent years. The main policy priorities have been supporting the economy (especially though various targeted lending programmes to select sectors), assuring financial market stability and reducing debt when conditions permit. The Communist Party of China currently seems to prefer taking on debt to support growth rather than limiting indebtedness. The monetary policy toolkit in China is part of a larger set of instruments used by authorities to implement economic policy. The People's Bank of China has so far managed to only modestly ease monetary policy and in many cases using targeted policy instruments. For example, the reserve requirement ratio for commercial banks was lowered by only 25 basis points on March 27 (BOFIT Weekly 12/2023).

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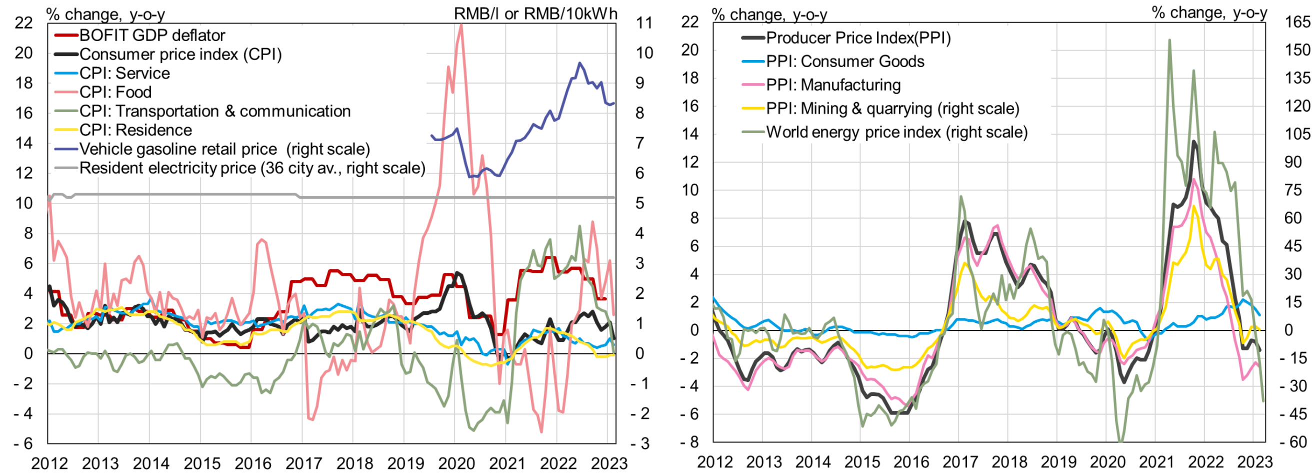
The PBoC has kept its key policy rates unchanged since last autumn. One factor limiting the use of more accommodative monetary policy is the widening gap between interest rates in China and the rest of the world as central banks in most countries have raised rates to quell inflation.

China consumer and producer prices and their sub-indices



Sources: China National Bureau of Statistics, NDRC price monitoring center, World Bank, CEIC and BOFIT.

2022 was a mediocre year for China's banking sector. The China Banking and Insurance Regulatory Commission (CBIRC) reports that total banking sector assets grew by about 10 % y-o-y last year. The pace of growth was on par with asset growth in 2020 but accelerated slightly from 2021. As in the previous two covid pandemic year, 2022 growth of balance sheets of large banks continued to be higher than in other banks and their share exceeded 40 % of the sector's entire total assets. The amount of deposits shown on bank balance sheets grew at its fastest rate (11 % y-o-y) since 2015, likely because the covid conditions last year caused households to save more and by some estimates reduce their investment assets. Growth in the lending stock slowed slightly to 11 % y-o-y, while sluggish economic growth, uncertainty and the downturn in the real estate sector slowed credit demand. The annual reports of large banks show that the average interest rate on corporate loans fell from 4.1 % in 2021 to 3.9 % last year, while the average interest rate on loans to households remained unchanged. In their earnings reports, banks claim that they were helping support the real economy by offering firms loans at discounted rates in line with government policies.

Banking sector profitability on average remained at a modest level last year. Total banking sector profits rose by 5 % y-o-y despite the fact that the main revenue stream for banks, the net interest margin (difference between lending and deposit rates) narrowed to 1.91 %, the tiniest margin in over a decade. Another measure of profitability, return on assets, fell to 0.76 %, its lowest level in at least 15 years.

In recent years, observers have expressed fears that problems in the construction sector might significantly increase the amount of non-performing loans (NPLs). There are no signs this came to pass, at least at the macro-level. Indeed, banks report that their NPL ratios have fallen to just 1.6 % of total lending. The true quality of the loan portfolios of Chinese banks is anybody's guess, however. The actual amount of NPLs is generally considered to be considerably larger than banks report, despite the fact that banks, and large banks in particular, have been able to write down or sell off their NPLs to government-sponsored bad banks. During the pandemic, firms were also allowed to suspend and extend their loan schedules. According to the latest policy decision, this possibility will terminate at the end of June 2023.

China has over 4 000 banks and the shape of their balance sheets varies a lot. The largest bank are quite solid and in good shape, while some smaller and mid-sized banks may have problems. The government has resorted to the use of public funds to bail out a handful of small and mid-sized banks in recent years ([BOFIT Weekly 34/2022](#)). Large difference in the sector can be seen in the capital adequacy ratios of banks. For example, the average capital adequacy ratio of the banking sector has risen in recent years, reaching 15.2 % at the end of last year. The rise, however, has been almost entirely driven by the big banks, which have seen a sharp improvement in their capital adequacy ratios to 17.8 %. The ratios of city commercial banks, in contrast, fell last year to 12.6 %. The minimum requirement is 10.5 %.

The collapse of Silicon Valley Bank and Signature Bank in the US and Credit Suisse in Switzerland are unlikely to have large impacts on China's banking sector. China's capital controls significantly insulates the country's banking sector from external shocks, as well as insulate the rest of the world from the turmoil in China's domestic banking sector. The outlook of

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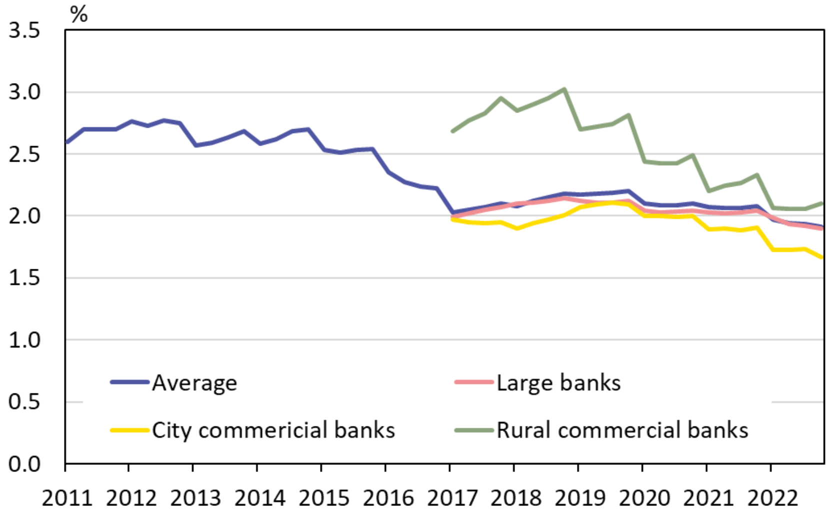
banks for this year has become brighter as lifting of covid measures will boost the economy and reduce uncertainty. The PBoC's quarterly survey of banker sentiment improved significantly in the first quarter of this year.

Bank net interest margins have been shrinking in recent years



Sources: CBIRC, CEIC and BOFIT.

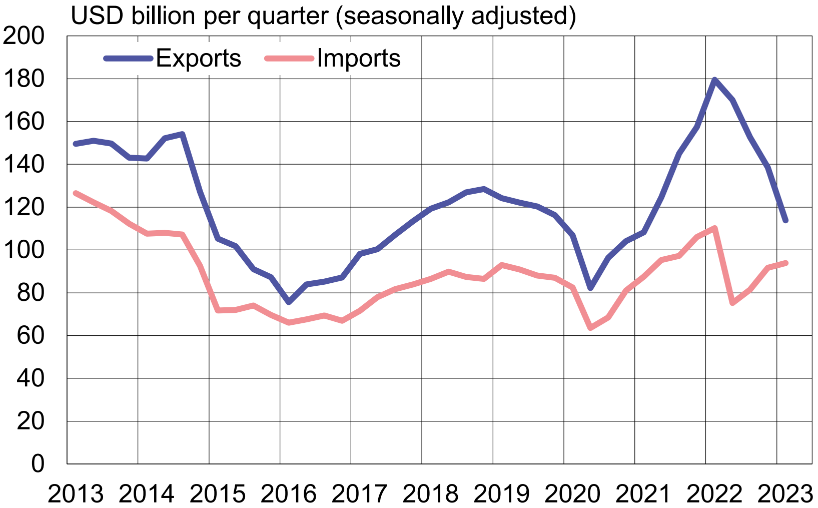
Russia

Russian exports down, imports up in first quarter. Preliminary balance-of-payments figures released by the Central Bank of Russia show that the value of Russia's imports of goods and services in January-March fell by 35 % y-o-y. The value of exports peaked last spring during the post-invasion spike in prices of crude oil and other commodities. The subsequent decline in prices was accompanied by a decrease in exports as Western countries implemented import bans on several Russian products, as well as Russia's own decision to reduce its natural gas exports to Europe. The value of exports in the first quarter was roughly the same as the 2019 quarterly average.

The CBR estimates that the value of Russia's imports of goods and services in the first quarter was down 3 % y/y. Compared to previous quarter, imports continued to grow (in seasonally adjusted terms). Although imports collapsed in the immediate aftermath of Russia's invasion of Ukraine last spring, they have gradually recovered. Some of the increase in imports probably reflects higher import prices as the acceleration in inflation has been a global phenomenon. Sanctions and decisions by many international firms to pull out of Russia altogether have also likely affected Russian import prices because Russia has been forced to find alternative sources for imports and alternative transport routes.

With the decline in export revenues and increased spending on imports, Russia's massive trade and current account surpluses have declined sharply. The current account surplus in January-March 2023 was 20 billion dollars, down from 70 billion dollars in the same period last year. The dwindling current account surplus has also been reflected in the ruble exchange rate. The ruble's official exchange rate this month is down by about 10 % from the end of last year. The ruble-dollar rate currently stands at about 82.

The value of Russian exports of goods and services contracted in 1Q23, while the value of imports of goods and services increased



Sources: CEIC, CBR, BOFIT.

Alternative estimates and official figures generally agree on current trends in Russian trade. After the attack on Ukraine last spring, Russia ceased almost entirely to release its foreign trade figures. In recent months, Russia has resumed the publication of some trade data. There has, however, been suspicions about the reliability of Russia's official statistics since the beginning of the war.

Foreign trade trends can be constructed from the mirror statistics published by Russia's main trading partners. Estimates based on mirror statistics show largely similar trends in Russian foreign trade as indicated by Russia's official figures, even if there are differences in the exact growth figures.

Analysed by product category, there was a notable increase in Russia's imports of chemical products last year. Some of this increase may just reflect higher raw material prices. On the other hand, the figures released by Russian customs and mirror trade statistics show the drop in imports of technology products has been larger than the general drop in imports.

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Russian customs figures show that last year the rise in value of exports was rapid for such commodities as fossil fuels, fertilisers and most metals. Some of this reflects higher global commodity prices. Russian customs data on export volumes of various export products is not available.

Volume of oil exports largely unchanged over recent months, but Urals export price has declined sharply. The International Energy Agency (IEA) estimates that the overall volume of Russian oil exports in January-February was essentially unchanged from the monthly average for 2022. The slight decline in the volume of exported petroleum products was offset by a small increase in the volume of crude exports. Although exports to EU countries have nearly ceased, exports to Asia in particular have risen and African countries have boosted their imports of refined oil products.

On December 5, 2022, the EU's import ban on Russian crude oil and the introduction of a price ceiling mechanism by the EU and G7 countries entered into force. This was followed by similar sanctions on Russian petroleum products, which entered into force on February 5, 2023. The sanctions are intended to end Russia oil exports to the EU with only certain exceptions. To avoid a major disruption of global energy markets, the EU and G7 did not seek to prevent Russian oil exports from being redirected to other countries. Instead, the price ceiling mechanism was designed to restrict Russia's export earnings, while allowing Russian oil exports to continue to flow.

The price of Urals blend crude oil has fallen significantly over the past 12 months. Russia's finance ministry reports that the average export price for Urals crude was about 48 dollars a barrel in the first quarter, a 45 % drop from 1Q22. Russia has announced plans to cut its oil production this year by about 5 % due to sanctions.

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China

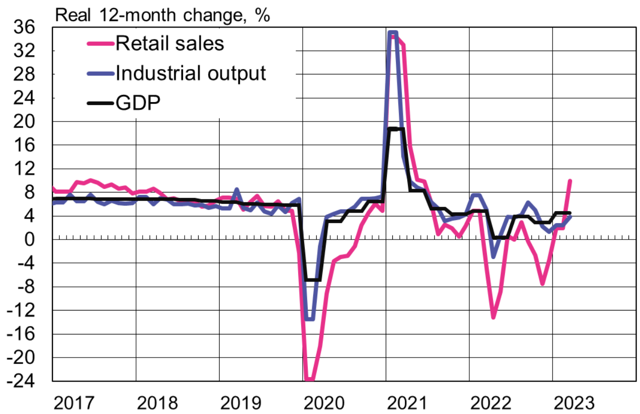
China's growth picked up in the first quarter as the economy reopened; BOFIT expecting relatively strong growth for the year. China's National Bureau of Statistics reports that the economy returned to its growth track with the ending of lockdowns and other zero-covid measures. Official GDP growth accelerated in the first quarter of this year to 4.5 % y-o-y. Increased consumer demand accounted for two-thirds of the growth. Looking at supply-side GDP indicators, wholesale and retail trade was up by 6 % y-o-y in January-March, a significant rise from 2022. After contracting for well over a year, the troubled real estate sector grew by 1 %. Hotel and restaurant services experienced rapid growth (up 14 %), bouncing back after last year contraction. Industrial output, on the other hand, rose by less than 3 %. In addition to official figures, alternative GDP figures produced by other institutions that monitor China (including BOFIT's own estimates of real GDP growth) showed distinct signs of economic recovery in the first quarter.

The revival of consumer demand could also be seen in March retail sales, which grew nominally by nearly 11 % y-o-y and approximately 10 % in real terms. The return of economic normality was particularly clear in restaurant sales, which, following a year of contraction, were up by 26 % y-o-y in nominal terms. March sales were notably robust in the categories of clothing, recreational goods and luxury goods such as jewellery. The downturn in housing is reflected in depressed sales of construction and decoration materials, furniture and household appliances.

The government has pushed this year to provide financing and other supports for completion of partially built projects that shows up in drop in floorspace under construction and increase in the floorspace awaiting sale. However, far fewer new construction projects have been launched this year that at any time since the start of the real estate crisis. The on-year contraction in real estate investment continues. On-year apartment sales still fell in March when measured by volume (floorspace), but showed a slight increase in terms of value for the first time since June 2021. NBS figures show March housing prices in China's big cities were up on-month, but still down from March 2022.

Growth in industrial output in March accelerated slightly from the first two months of this year to 3.9 %, but still failed to keep up with overall demand growth. Weakening demand in China's main export markets is a factor dampening growth in industrial output. While the value of March exports measured in dollars increased by 14 % y-o-y, there was no overall growth in exports in the first quarter. Imports contracted by 7 % y-o-y in the first quarter, and were down by 1 % in March. China's first-quarter exports to ASEAN countries were up in value terms by 18 % from 1Q22, while exports to Australia were up 10 %, South Korea 5 % and Russia 46 %. In the same period, exports to the US fell by 17 %, EU countries by 7 % and Taiwan by 22 %.

Retail sales showed a particularly strong rally in March as China recovered from zero-covid measures



Sources: China National Bureau of Statistics, CEIC and BOFIT. Real growth in retail sales based on consumer prices inflation.

Inflation slows, but indebtedness accelerates. Consumer demand is currently supported by household spending of savings amassed during the Covid-19 pandemic. The increase in the bank savings of many wealthier households also reflect a flight to safety as they have moved investments away from riskier portfolio investments and real estate holdings. The real disposable incomes of urban residents rose by 2.7 % in the first quarter. Real incomes in the three years of the pandemic (2020–2022) rose overall slower than official GDP growth. Labour market is currently affected with the rise in youth unemployment. Unemployment among persons aged 16-24 was nearly 20 % in March. The national unemployment rate for urban areas was 5.3 %.

Bank lending, which has revived this year, saw growth in the bank lending stock accelerating to 12.2 % in March. China's "aggregate financing," the central bank's broad term for the credit stock, rose by 10.3 %. Aggregate financing includes bank lending, bonds and equity financing by the government, households and non-financial firms, as well as credit extended through instruments of the shadow banking sector. China's aggregate financing credit stock at the end of March corresponded to 293 % of GDP, a 20-percentage-point increase from the end of 2021. In recent years, the government has pressed the banking sector to increase lending through various targeted programmes that help problem areas such as the real estate sector without significantly easing overall monetary policy. In China's case, inflation does not seem to be a factor preventing a more accommodative monetary stance in the near future. The rise in consumer prices in March was just 0.7 % y-o-y and the decline in producer prices continued. More relaxed financing conditions, however, would likely trigger even a faster plunge into debt and thereby increase financial risk, as well as assure depreciation pressure on the yuan by inducing capital flight.

Real annual changes and consumer prices, %

	2021	2022	4Q2022	1Q2023
GDP	8.4	3	2.9	4.5
	2021	**2022**	**2/2023**	**3/2023**
Industrial output	9.6	3.6	2.4*	3.9
Retail sales	10.7	-2.2	2.0*	9.9
Good exports	17.4	-1.3	-1.3	n/a
Goods imports	7.7	-6.6	10.3	n/a
Inflation	0.9	2.0	1.0	0.7
Yuan-dollar rate, avg.	6.45	6.74	6.85	6.90

** January-February combined*

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

BOFIT releases latest forecast for China. On Thursday (Apr. 20), BOFIT released its Forecast for China 2023–2025. The biggest adjustments from our October 2022 forecast reflect the government's surprise reversal on zero-covid policies late last year, as well as interventions in the real estate market that appear to have averted the downturn. The reopening of the Chinese economy has boosted consumer confidence and revived consumer demand. We now expect that the decline in real estate investment ends, and they should support GDP growth in the second half of this year.

Factors hampering long-term growth persist. China's labour force is shrinking, the population greying, political grip has tightened, and high indebtedness is hindering corporate profitability and investments. Real estate investments are unlikely to support economic growth as earlier. The lion's share of people's wealth is already tied up in apartments, which are now relatively more risky investments. This could restrain growth in consumer demand. The outlook for global demand is still clouded by rising living costs and higher interest rates in most countries. Thus, China's export sector no longer serves as the engine for domestic growth as it did in 2021.

We expect Chinese annual GDP growth to reach about 6 % this year, due in part to the opening up at the start of the year and last year's low reference basis which was revised even lower this April. The expected recovery in the real estate sector in the second half of this year should help lift GDP growth next year to 4 %. GDP growth then slows to around 3 % in 2025.

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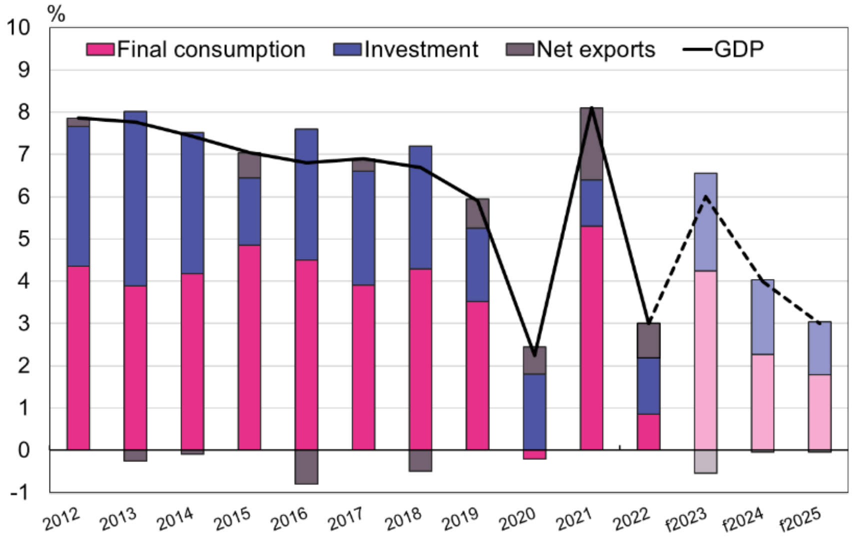
China's GDP growth, main contributors to growth and BOFIT forecast for 2023–2025



Sources: National Bureau of Statistics, CEIC and BOFIT.

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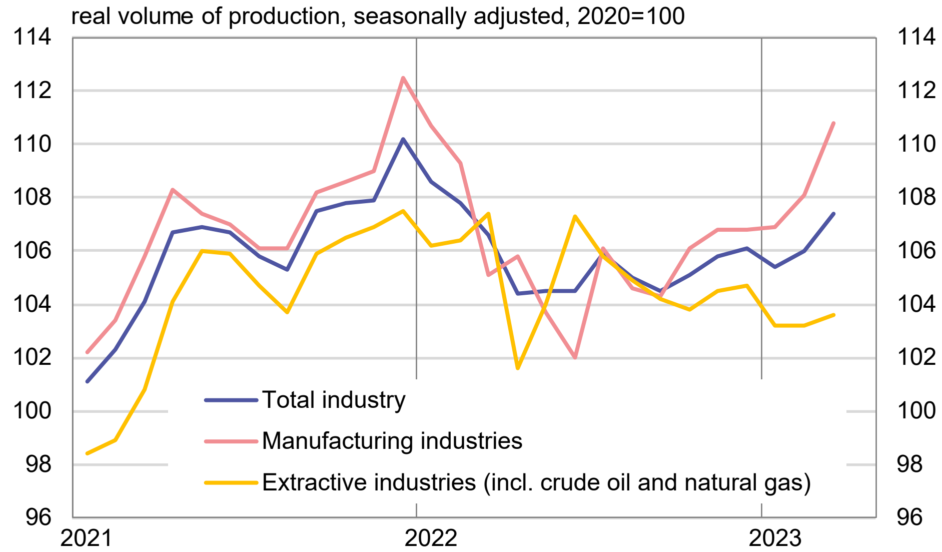
Russia

Russian industrial output grew in March; detailed 2022 GDP data released. Russian industrial output has increased significantly in recent months. Industrial output was up in March by over 1 % from a year earlier. The gains came largely from manufacturing (up by over 6 % y-o-y). Growth continued to be driven by production of foods, metals and metal products, electronics and vehicles other than automobiles. Much of the growth came from the state orders for e.g. national defence.

Russia's manufacturing output has risen considerably in recent months



Sources: Rosstat and BOFIT.

New data show Russian GDP began to recover in the second half of last year. According to just-released Rosstat figures, Russian GDP contracted quite sharply in the second quarter of 2022 following Russia's invasion of Ukraine and the resulting increased uncertainty and sanctions. Seasonally adjusted GDP fell by 4.6 % from the first quarter. GDP grew by 0.5 % q-o-q in both the third and fourth quarters.

During the first wave of the Covid-19 pandemic in 2020, Russian GDP contracted by 7.5 % in the second quarter, but grew by 7.3 % in the third quarter with the easing of covid restrictions. The latest batch of statistical data is not directly comparable to earlier figures. The newest GDP figures use 2021 prices, while earlier releases are based on 2016 prices.

The development of the Russian economy across production branches was quite uneven in late 2022. In 4Q22, GDP overall contracted by 2.7 % y-o-y. The value added of public services was up by 7.6 % y-o-y, and strong growth was seen in agriculture (up 6.4 %), construction (6.1 %) and hotels and restaurants (6.5 %). Other branches saw sharp declines in value added in the fourth quarter. Retail and wholesale sales were down by 17.3 % y-o-y. The downturn in manufacturing accelerated to 4.8 % and the drop in transport was 4 %.

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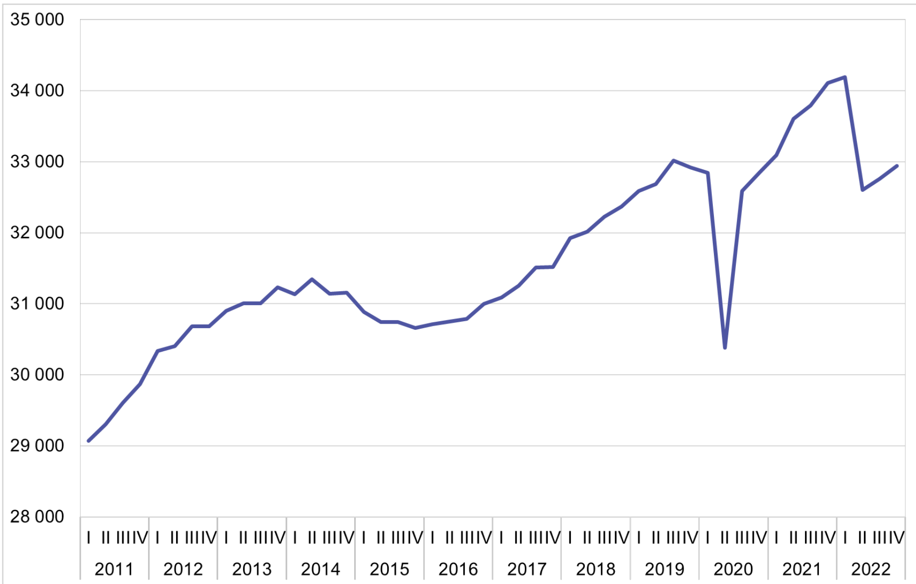
Russia's seasonally-adjusted GDP in the fourth quarter of 2022 fell by 3.7 % from the first quarter of 2022. (RUB billion in 2021 prices)



Source: Rosstat.

Increases in certain consumption categories moderated last year's dip in private consumption overall. In the revised 2022 GDP figures released this month, some features of last year's economic performance stick out, including the remarkably shallow dip in private consumption. According to adjusted figures, consumption contracted by just 1.4 %. The large drop in retail sales, the largest private consumption category, was partly offset by growth in other consumption categories. Growth in sales of services softened the real term pullback in household spending on domestically sold goods and services to about 4.5 %.

Travel imports, i.e. the goods and services purchased by Russians abroad, rose at least by one half in real terms as the number of Russians travelling from the country was far above normal. They also bought more and stayed abroad for longer times (in national accounts the persons staying abroad remain households of their home country until they reside more permanently in another country).

The figures for total private consumption and the abovementioned categories of private consumption indicate other consumption categories saw significant increases in 2022. The other items first and foremost include natural (in kind) consumption, consisting essentially of household agricultural production for own final consumption, services arising from living in one's own home as well as labour income received in the form of goods and services. The share of the other categories in private consumption is significant (about 15 % in 2014–2020 and 17 % in 2021).

According to the latest GDP data, fixed investment rose by 3.3 % y-o-y (down from the increase of more than 5 % announced earlier). This bolsters the view that while government budget sector investment increased sharply investment by other sectors, i.e. companies and households, performed tepidly and may have declined.

Some differences in forecasts for Russia. Differences in recent forecasts for the Russian economy largely reflect the current uncertainty. In its April forecast, the IMF said it expects GDP growth to recover from last year's roughly 2 % drop to a rise of 0.7 % this year, and GDP attain the 2021 level by 2024. The March forecasts of the OECD and European Bank for Reconstruction and Development (EBRD) see Russian GDP declining by 2.5–3 % this year. April consensus forecasts also predict a mild contraction in GDP though also with differences (Consensus Economics expects a drop of 0.9 % this year, while the consensus forecast compiled by the Bank of Russia only sees a decline of 0.1 %).

One reason for the IMF's rather favourable is an expected easing in government finances when measured in terms of the budget deficit. The IMF expects the deficit to increase to over 6 % of GDP this year (-2.2 % last year). The consensus forecasts see smaller deficits (the CBR consensus forecast for the balance of the government budget sector overall is -2.6 %, while the Consensus Economics forecast for the federal budget shows a deficit of 3.6 %). The federal budget, which is where the government budget sector deficit is concentrated, showed the deficit widening sharply in January-February. In March, the deficit of last 12 months was about 4.5 % of GDP.

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Weekly Review
18 • 5.5.2023

BOFIT

China

China-Russia trade continued to strengthen in first quarter of this year. China's imports from Russia have increased substantially faster than exports to Russia since February 2022. As a result, China's trade deficit with Russia has hit an all-time high of more than 35 billion dollars. The value of China's import from Russia in the first quarter of 2023 increased by more than a third from 1Q22. The bulk of China's imports from Russia, about 80 %, were energy products.

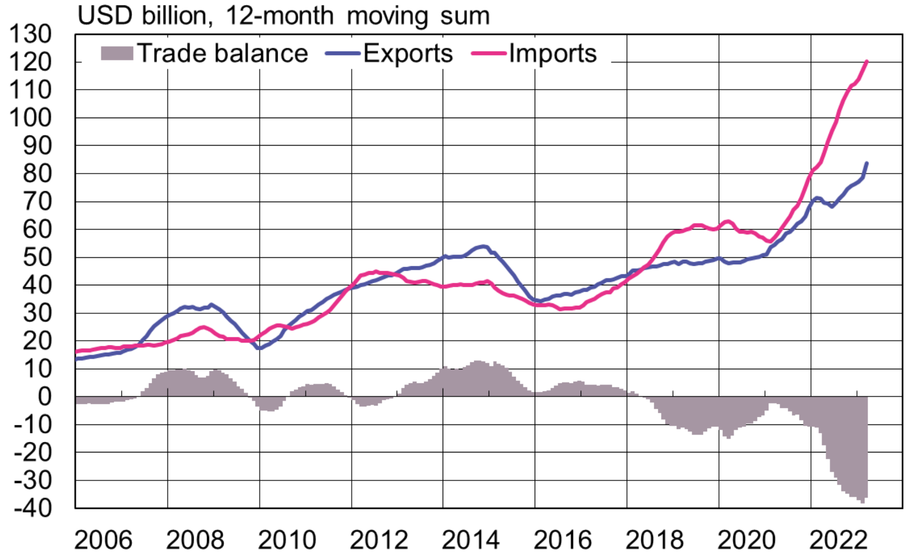
In January-March 2023, Chinese energy imports from Russia were up by 40 % y-o-y in dollar terms. Volume-wise, China's crude oil exports from Russia were up by a third from a year earlier, liquefied natural gas (LNG) by 66 % and coal by 145 %. Although the volume of natural gas imported via pipeline is no longer disclosed, its import from Russia in dollar terms was nearly five-fold in the first quarter of this year. Russia surpassed Saudi Arabia at the beginning of this year as China's largest supplier of crude oil, accounting for about 18 % of China's crude oil imports. Iraq was China's third-largest supplier of crude oil. In recent months, China has been able to buy Russian oil at an approximately 10 % discount compared to crude oil imported from elsewhere.

Non-energy imports from Russia were up by about 30 % y-o-y in the first quarter. Especially strong growth was seen in animal fats and plant fats, vegetables, chemicals, mechanical and chemical wood pulps, as well as imports of precious metals. Each category represented roughly a 2 % share of total imports. In contrast, imports of basic metals and metal products fell by 25 % (4 % of total imports), and wood products by nearly 10 % (2.5 % of total imports). After averaging just under 3 % between 2019 and 2021, Russia's share of China's total goods imports has increased to about 4.5 % after February 2022.

The value of China's exports to Russia was up by nearly 50 % y-o-y in January-March. Some of the high growth reflects the low reference basis of 1Q22. The largest export categories were machinery & equipment (24 % of exports), vehicles (20 %), electronics (15 %), as well as chemicals and plastics (14 %). Exports of motor vehicles were up sharply after last summer's halt, with the dollar value of motor vehicle exports to Russia in January-March nearly doubling from a year earlier. In March, China exported nearly 60,000 motor vehicles to Russia, up from fewer than 5,000 in August last year. Russian purchases of Chinese mobile phones were also up by over 40 % y-o-y in the first quarter. China's share of the mobile phone market in Russia grew from 50 % to 70 %. Exports of chemicals and plastics also increased by over 60 % y-o-y in dollar terms during 1Q23. Russia's share of Chinese exports has increased in recent months to around 3 %, up from an average of about 2 % earlier.

Our just-released [BOFIT Policy Brief 9/2023] shows that China's role in Russian foreign trade has increased substantially since the invasion of Ukraine. In December 2022, China accounted for about 40 % of Russia's imports, up from just 25 % a year earlier. At the same time, China's share of Russian exports rose from about 15 % to 20 %.

China's trade deficit with Russia reached an unprecedented level this year



Sources: China Customs, Macrobond and BOFIT.

China sees overseas lending risks materialise during Covid-19 pandemic. Over the past decade, China emerged as the world's largest bilateral lender to developing and emerging economies. World Bank figures show that Chinese lending to low-and middle-income countries stood at 180 billion dollars at the end of 2021, which was four times more than ten years ago. Most Chinese lending has gone to Asian countries, with Pakistan the largest borrower (27 billion dollars). The top African recipient of Chinese loans is Angola (20 billion dollars). The World Bank's debt figures, however, have been criticised for their incompleteness. China's actual international lending to developing and emerging countries is by some estimates more than double that show in the World Bank's International Debt Statistics. This is because some loan arrangements are classified information and the recipient can, for example, be a state-owned company excluded from the debt statistics. Moreover, the Chinese government typically does not engage directly in lending, but rather lends via its main two policy banks, China Development Bank (CDB) and Export-Import Bank (ExIm Bank), or to a lesser extent through its massive state-owned banks. In China's view, each of the abovementioned banks is an independent lender, even if it is quite clear that policy banks in particular are strongly subject to government control and guidance.

Many developing and emerging economies borrowed from international lenders in the past decade. The Covid-19 Pandemic, in particular, caused major damage to these economies and exacerbated their debt problems. In early 2020, the IMF, the World Bank and G20 countries reached a temporary agreement on suspension of loan payments from over 70 low-income countries (Debt Service Suspension Initiative). It was clear already then that many countries would eventually face debt restructuring. Debt restructuring talks, which are often quite difficult, have been traditionally handled under the auspices of the Paris Club of creditor countries. Despite being a major creditor, China is not a member of the Paris Club and has not sought membership.

To get China to join other creditors at the debt negotiating table, G20 countries, supported by the IMF and World Bank, agreed on setting up Common Framework for Debt Treatments (CFDT) in autumn 2020 to deal with low-income debtor countries in trouble. Countries that have asked help under the framework so far are Chad (China loans of 0.3 billion dollars at 2021), Zambia (3.8 billion dollars), Ghana (1.7 billion dollars) and Ethiopia (7.4 billion dollars). Of these countries only Chad has been able to restructure its debt in bilateral talks with creditors outside the CFDT. Talks with other countries under the CFDT have been in limbo as creditors have been unable to agree on restructuring principles.

Finding common ground has been difficult in particular due to Chinese so far have been unable to agree on suitable debt restructuring models that require the creditor to take a "haircut" on troubled loans, especially given that the IMF, World Bank and other international institutional lenders are traditionally excluded from the haircut requirement. Instead, Chinese lenders prefer to extend loan times. Last autumn, for example, Ecuador, which has borrowed about 5 billion dollars from China, entered into bilateral talks based on a common understanding on extending the maturity dates on loans from two of its biggest Chinese lenders (CDB and ExIm Bank). Another seriously distressed borrower, Sri Lanka (7.2 billion dollar in loans from China), was offered a two-year suspension of its debt-servicing payments to ExIm Bank. In February, China offered Pakistan, a country struggling with severe financial problems, an additional loan of 700 million dollars on top of its existing 27.4 billion dollars in debt to Chinese lenders.

Chinese loans to developing and emerging economies are tempting to many borrowers. They typically are granted without social advancement requirements such as for example reducing the child-labour force. For this reason, poor countries are often willing to pay higher interest rates than loans with social conditions attached. China also offers financing for turn-key projects that include Chinese engineering and project implementation. In some cases, the loan can eventually be paid off in raw materials generated by the project. Suspicions have been voiced that Chinese lenders might also offer persons in positions of power personal benefits when lobbying for Chinese loans. Despite common fears about China's predatory lending practices, however, there seems to be is little evidence to back up such claims. Instead, China's biggest problems as a lender have to do with incompetent evaluation of proposed projects and risk assessment. In any case, Chinese lending has given it greater influence in developing and emerging economies.

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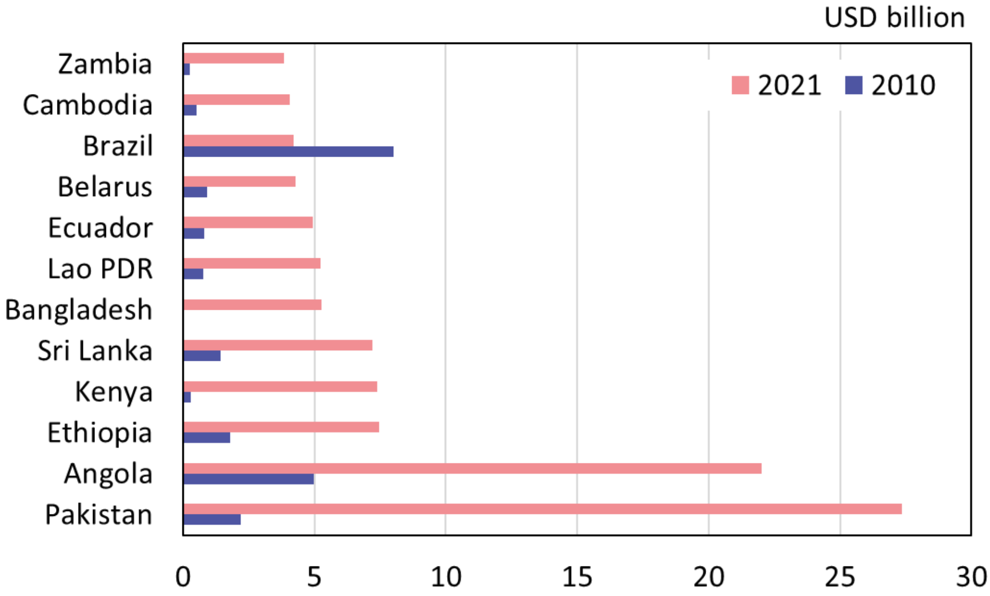
Chinese lending to low- and middle-income countries increased sharply over the past decade



Sources: World Bank International Debt Statistics (IDS) and BOFIT.

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BOFIT

Russia

Despite falling inflation, inflation risks in Russia continue to mount

At its scheduled inflation meeting at the end of April, the executive board of the Central Bank of Russia left the key rate unchanged at 7.5 %, as it has been since last September. Although Russian inflation has slowed significantly in recent months, the CBR has been reluctant to further lower the key rate due to the risks of higher inflation in the months ahead.

Inflation has slowed… Russian consumer prices soared last spring following Russia's invasion of Ukraine. 12-month inflation reached 17–18 % during March and April 2022, but gradually subsided thereafter. As of March 2023, consumer prices were up by just 3.5 % y-o-y, largely due to the basis reference. The slowdown in inflation reflects several factors, including reduced demand due to recession, a recovery in imports that has eased supply bottlenecks and a stronger ruble, which has negated some of the inflation pressures from import prices.

Russia's economic recession, the result of war and sanctions, has diminished demand. According to the economic development ministry's preliminary estimate, Russian GDP continued to contract in January-March at about 2 % y-o-y. The strong contraction in imports last spring limited the supply of many goods in Russia. Imports, however, have recovered gradually since last summer as Russia has found new import sources and built up new logistical chains. Russia has also managed to find substitutes for certain imported goods through increased domestic production. The rise in food prices has been dampened by last year's bumper harvests.

Ruble appreciation has also quelled inflationary pressures. Russia's invasion of Ukraine last year caused the ruble's exchange rate to plunge to historical lows. The ruble's exchange rate, however, has gradually returned to its pre-invasion level thanks to the government's imposition of strong capital controls and a string of large current account surpluses. In January-March 2023, the ruble's nominal effective (trade-weighted) exchange rate, or NEER, was 26 % higher than a year earlier.

…while inflation risks have been building. A number of factors could cause Russian inflation to accelerate in coming months. Government spending has skyrocketed and the government finances have gone into the red. Russia's current budget plan assumes that federal budget revenues will fall by 6 % this year and that spending will diminish by 4 %. The deficit is forecast to be around 2 % of GDP. In January-April, federal budget expenditures were up by 26 % y-o-y and revenues contracted by 22 %. In the first four months of this year, the budget deficit already clearly exceeded the budget deficit planned for the entire year. If Russia expects to continue waging war in Ukraine, it will be challenging for the government to find ways to cut spending. Thus the budget deficit is likely to rise and inflationary pressures increase.

Inflation risks are also caused by Russia's tight labour market. Russia suffered from a lack of skilled labour even before the Ukraine war, but the mobilisation of reserves and exodus of working-age people from the country have diminished the labour force further by hundreds of thousands of people. The lack of workers has created pressure to raise wages. Higher wages could, in turn, boost demand and add to inflationary pressures.

The ruble's exchange rate can also become a source of inflation risk. The ruble has recently depreciated with Russia's declining current account surplus. At the beginning of May, the official ruble-dollar rate was about 8 % lower than at the start of this year. The CBR reports that the roles of the US dollar and euro as payment currencies in Russian foreign trade have diminished considerably. While 65 % of Russian imports and 85 % of exports were still paid for in euros or dollars at the end of 2021, only about 50 % of payments were made in euros or dollars at the end of 2022. At the end of last year, the ruble's share as an invoicing currency was 30–35 % and the yuan 15–20 %.

Slight downward revision of this year's inflation forecast. The CBR released its updated economic outlook in conjunction with its inflation meeting at the end of April. The CBR raised its GDP growth forecast for this year to the range of 0.5–2 %. After a mild cut in its inflation forecast, the CBR now expects consumer price inflation to be in the range of 4.5–6.5 % at the end of this year. Central bank officials still expect to reach their inflation target of 4 % by 2024. The CBR expects the average key rate to be in the range of 7.1–8.6 % at the end of this year implying that pressures to raise rates this year are greater than pressures to lower rates.

The average of 2023 GDP forecasts compiled by Consensus Economics in April was -0.9 %. Russian inflation was expected to be around 5.7 % in December 2023.

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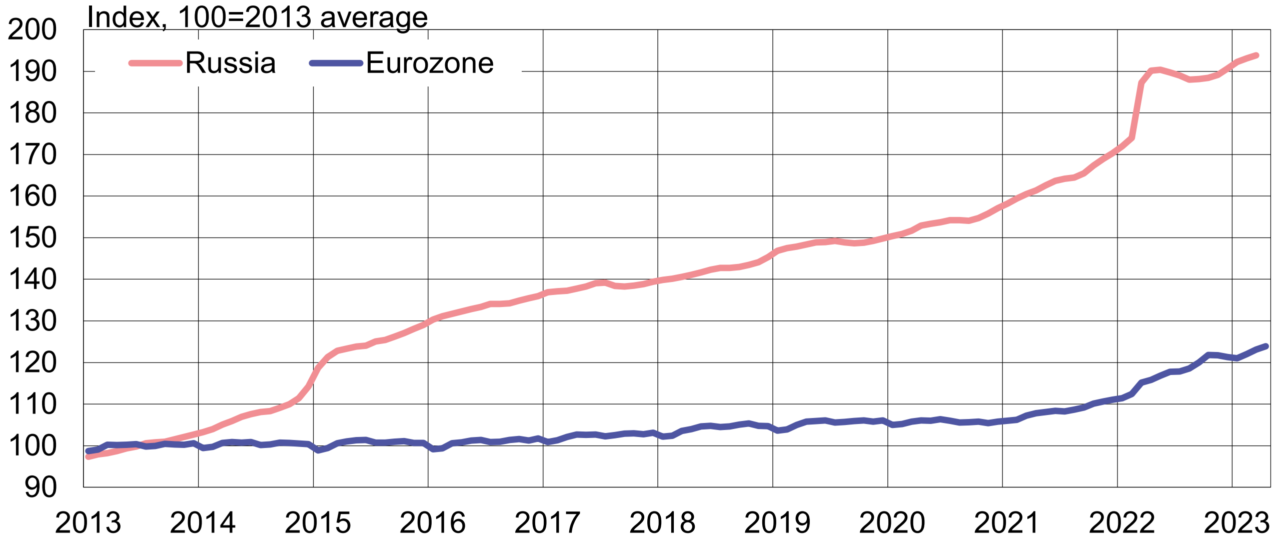
Consumer prices in Russia spiked in the first months of the Ukraine invasion



Sources: Macrobond, Rosstat, Eurostat and BOFIT.

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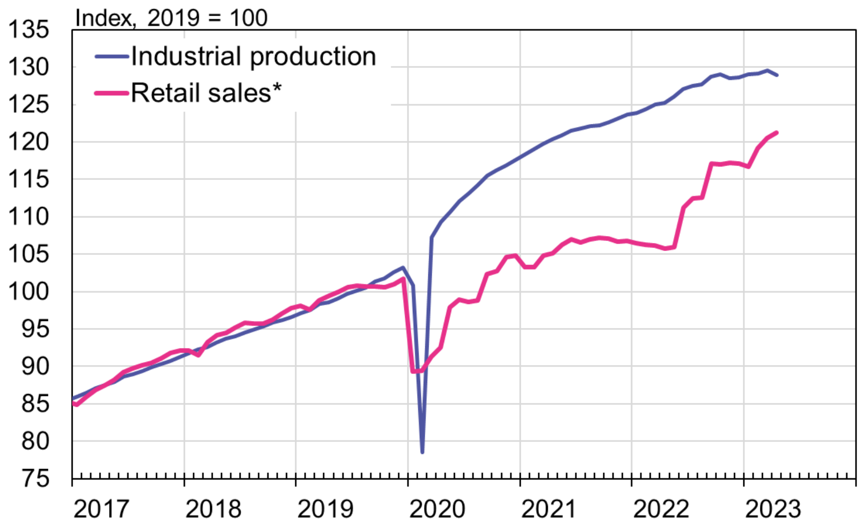
BOFIT

China

Strong annual growth numbers hide China's April slowdown. The dramatic 12-month change in retail sales growth in April reflects the fact that China was experiencing in the same month a year earlier widespread covid lockdowns that sharply reduced consumption demand. Although retail sales rose by 18 % y-o-y in April, growth was still below what many analysts had expected. Sharp recoveries were seen especially in restaurant sales (up 44 % y-o-y). April nominal retail sales were up by 0.5 % from March. On-month growth slowed compared to the February-March change.

12-month industrial output growth revived in April to nearly 6 %, and was also up from the first quarter of this year. Industrial output, however, was down from March, contracting by nearly 0.5 %. Growth in foreign trade also slowed from March. In April, exports were up by 8 % y-o-y and imports down by 8 % in dollar terms. During the first four months of this year, the value of China's good exports rose by 2 % y-o-y and the value of goods imports shrank by 7 %.

The level of industrial output in April was only slightly higher than at the end of last year, and the pace of retail sales growth slowed



*Sources: China National Bureau of Statistics, CEIC and BOFIT. *) Nominal growth in retail sales deflated by the consumer price index.*

Lending restrictions imposed on the real estate sector in 2020 have been abandoned almost completely and banks are again encouraged to support the real estate sector through lending – particularly lending to distressed projects to assure that they are completed (BOFIT Weekly 6/2023). This has led to a decline in the current volume under construction. As of end-April, the floorspace under construction was down by 6 % y-o-y and by 21 % from its peak at the end of 2021. The number of new project starts continued to dwindle. In January-April, the number of new building starts (measured in floorspace) was down by 21 % y-o-y. The latest round of support measures to the real estate industry have yet to fire up apartment buyers on a broad scale. April apartment sales (measured in floorspace) were still down by 12 % y-o-y. Month-on-month, however, the drop in apartment sales is finally appearing to halt. In the first four months of this year, the volume of apartment sales was down by 5 % y-o-y (measured in floorspace), while the value of apartment sales in the same period was up by 5 %.

Bank lending has picked up a bit from last year. PBoC figures show that bank lending was up by about 12 % y-o-y in April, the same increase as in March. Again, most lending went to the corporate sector, while growth in the stock of household loans was only about 3 %, reflecting tepid housing sales. The stock of household loans declined between March and April. The PBoC has kept its main policy rates unchanged since last August. Inflation situation would give the government room to ease its monetary stance, counter to the global trend. The April rise in consumer prices was roughly zero and the decline in producer prices accelerated to 3.6 % y-o-y (down by 2.5 % in March).

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Real on-year change and consumer prices, %

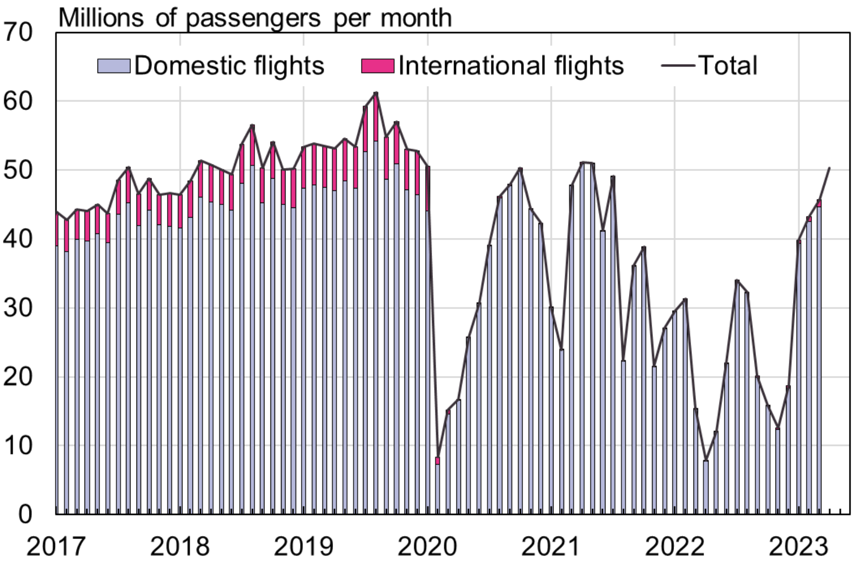
	2021	2022	4Q2022	1Q2023
GDP	8.4	3	2.9	4.5
	2021	**2022**	**3/2023**	**4/2023**
Industrial output	9.6	3.6	3.9	5.6
Retail sales	10.7	-2.2	9.9	18.3
Goods exports	17.4	-1.3	15.3	n/a
Goods imports	7.7	-6.6	6.6	n/a
Inflation	0.9	2.0	0.7	0.1
Yuan-dollar rate, avg.	6.45	6.74	6.90	6.89

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

Busy labour day holiday week for domestic travel; international travel revives. The five-day Labour Day holidays, which ran from April 29 to May 3 this year, saw domestic travel and domestic tourism revenues well exceed pre-pandemic levels. China's culture and tourism ministry reports that tourism revenues more than doubled from last year's holiday week and were 26 % higher than in 2019. The number of people travelling during the holiday week was also up by over 40 % from 2019. The popularity of visiting Hong Kong has risen rapidly this year with the reopening of the border. Hong Kong's tourism officials report that the number of mainland Chinese visiting Hong Kong in April was still down by 46 % from 2019, as was the total number of visitors (down by 37 % from 2019).

While the number of passengers on domestic flights returned to near pre-pandemic levels in March and April, the number of passengers on international flights in March were still just a fifth of the 2019 amount. China's large airlines report that April passenger numbers were up sharply from March, but still only about a quarter of the 2019 level. International travel has been limited by the small number of flights, which in turn has pushed up prices. Chinese officials report that the number of international flights from China rose to 2,240 flights a week in mid-April, nearly five times more than the number of international flights at the start of this year. Before the pandemic, China averaged about 7,700 international flights a week. Officials report international flights from China to 59 countries in April (Chinese airlines flew to over 70 countries before the pandemic). The number of international flights has gradually increased in recent weeks. The United States announced in May that it would permit Chinese carriers to increase their flights to the US from the current 8 flights to 12 a week – the same number that China allows for US airlines. The tension in US-China relations is well reflected in flight restrictions. Before the pandemic, each side allowed over 150 flights a week between the countries.

The air travel passenger volume in China has recovered close to pre-pandemic levels even with few international flights



Sources: Civil Aviation Administration of China, CEIC and BOFIT.

Forecasters raise their outlooks for chinese growth this year. With China's decision to abandon its zero-covid policies and reopen the economy at the end of last year, as well as the epidemic's subsequent minor impacts on the resumption of economic growth in the first quarter, a number of major institutional forecasters recently revised upwards their forecasts for Chinese growth this year. Several forecasts see growth reaching around 6 % this year (including our April BOFIT Forecast for China). While much of this growth stems from last year's low reference basis, China is expected to surpass its official 2023 growth target of "about 5 %" set last March at the National People's Congress without relying on broad-based stimulus measures.

Growth should begin to slow in the years ahead. Many institutional forecasters have also adjusted slightly downwards their predictions for Chinese growth next year. In its April World Economic Outlook, the IMF cut its forecast for China's medium-term growth. The forecast, which extends out to 2028, sees China's annual economic growth declining to around 3.5 % at the end of the forecast period, a significant reduction from its previous projection of 4.6 % growth. The IMF said that the reduction reflects, among other things, China's shrinking population, lower productivity growth and the negative effects of geoeconomic fragmentation.

Institutional forecasts for the Chinese economy this year and next, %

Institution		2023	2024
IMF	4/2023	5.2	4.5
World Bank	4/2023	5.1	
OECD	3/2023	5.3	4.9
FocusEconomics consensus	5/2023	5.3	4.9
Nomura	5/2023	5.9	4.4
Goldman Sachs	5/2023	6.0	4.6
EIU	5/2023	6.1	4,9
Citigroup	5/2023	6.1	5.0
JPMorgan	5/2023	6.4	5.3
BOFIT	4/2023	6	4

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Russia

Russian first-quarter GDP contracted by 2 % on year. Rosstat's preliminary estimate suggests that Russian GDP contracted by 2 % y-o-y during the January-March period. The rate of contraction was slowed by stabilising economic trends and the low basis reference of March 2022. Rosstat figures show that the drop in Russian GDP was sharpest in spring 2022 in the immediate wake of the Ukraine invasion, and that Russian GDP contracted by 2 % for 2022 overall. The consensus forecast from May expects GDP to contract by 0.3 % this year.

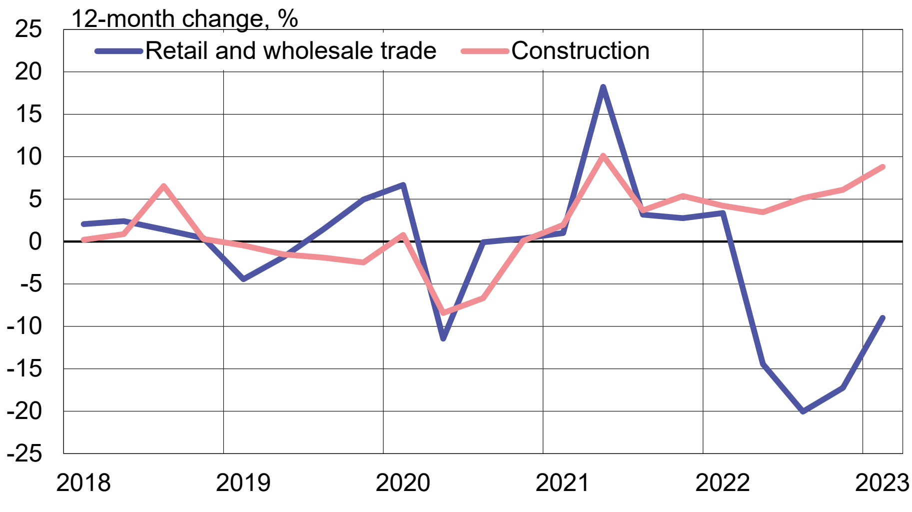
The impacts of war on the Russian economy have varied from sector to sector. Household consumption has shrunk, while fixed investment, stoked by government support, has been up. The war effort and economic stimulus caused government spending to soar.

Despite inklings of recovery, retail sales, a proxy for consumer trends, remained muted in January-March. The volume of retail sales contracted by 7 % y-o-y in the first quarter. Car sales, in particular, remained tepid. The volume of new car sales this year has been less than half the pre-invasion level.

Rosstat's preliminary estimate suggests that Russian's real disposable household income in the first quarter was unchanged from 1Q22. The decline in real incomes has been mitigated recently by slowing inflation and strong wage growth. Consumer prices rose by 9 % y-o-y in the first quarter. Pressures to increase wages continue due to the tight labour market. Russia's unemployment rate hit a post-Soviet low of 3.5 % in the first quarter. Russia's workforce was shrinking even before the war, which since caused hundreds of thousands of Russians to be sent to the front or flee the country.

Fixed investment has witnessed robust growth in recent months, fuelling construction activity and production of certain investment goods in particular. Construction increased by 9 % y-o-y in the first quarter. Growth was unaffected by a low basis reference from a year earlier as construction growth has accelerated since the February 2022 invasion of Ukraine. Construction growth was apparently driven by infrastructure projects and non-housing construction as construction of residential housing has declined.

While trade has contracted sharply since Russia's invasion of Ukraine 15 months ago, construction has enjoyed robust growth



Sources: Rosstat, BOFIT.

Manufacturing output rose by 1 % y-o-y in the first quarter. Manufacturing of metal products and production of many construction goods witnessed particularly strong growth. Production declined in branches dependent on foreign trade or foreign firms. Wood processing contracted by 17 % y-o-y due to weak exports. Automobile production fell by 40 %, while machine-building was down by 12 %. A survey published by the Central Bank of Russia at the start of this year finds that firms in the automobile and pharmaceutical industries, as well as machine-building, have encountered the most problems in finding substitutes for raw materials, machinery, components and spare parts where availability has been limited by sanctions.

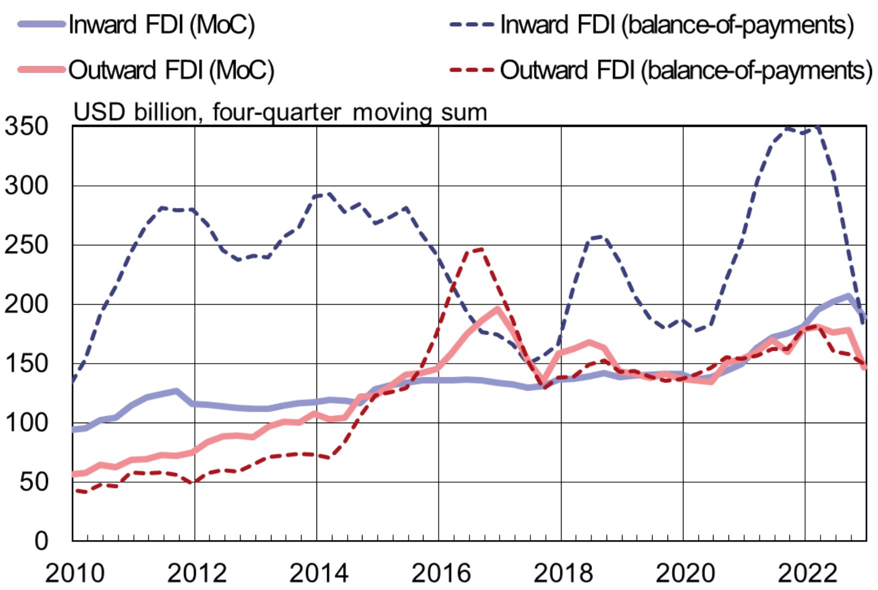
The 1Q23 trends for primary production were mixed. Agricultural output rose by 3 % y-o-y, while mining & quarrying production (including oil & gas) was down by 3 %. Natural gas production contracted by 14 %. Rosstat has ceased to publish figures on oil production, but the International Energy Agency (IEA) estimates that Russian crude oil production contracted by about 2 % y-o-y in the first quarter.

Production in many branches has been boosted by government spending this year. Federal budget spending in the first four months of this year was up by 22 % y-o-y, while revenues were down by roughly the same percentage. As a result, the government's projected budget deficit for all of 2023 was eclipsed already in the first four months of this year. Russia's approved budget framework for 2023 anticipates a federal budget deficit of 2 % of GDP – even with plans to reduce spending slightly from last year. Spending cuts will be difficult to make as long as Russia continues to make war in Ukraine.

China

Chinese foreign direct investment declined last year, particularly in the US and Europe. The official foreign direct investment (FDI) figures released by China's Ministry of Commerce show that FDI outflows from the country amounted to 147 billion dollars, an 18 % drop from 2021. FDI inflows to China last year amounted to 189 billion dollars, a 5 % increase from 2021. The commerce ministry has yet to release a breakdown of FDI by country. Moreover, commerce ministry figures diverge considerably from China's balance-of-payments FDI figures, which include e.g. disinvestments, reinvestment of earnings and financial flows between parent companies and their subsidiaries. China's balance-of-payments figures show contracting FDI flows into and out of China last year. The outward FDI of Chinese firms amounted to 150 billion dollars (down by 16 % from 2021) while inward FDI to China was 180 billion dollars (down by 48 %).

Outward FDI flows from China declined last year. Inward FDI to China shows wide statistical discrepancies



Sources: China Ministry of Commerce (MoC), SAFE, CEIC and BOFIT.

Preliminary figures from the OECD show that global FDI flows decreased by 24 % last year. China was the world's second-largest FDI destination last year after the US. In the rankings of FDI-source countries, China was the third-largest provider of FDI after the US and Japan. US FDI has risen since 2021, and accounted for almost a third of total global FDI. The OECD statistical data use China's balance-of-payments figures. The UN Conference on Trade and Development (UNCTAD) uses the commerce ministry's figures, creating significant differences in the FDI figures for China.

Other datasets are needed to break down Chinese FDI by country. China Global Investment Tracker (CGIT) compiled by the American Enterprise Institute and the Heritage Foundation attempts to list all Chinese FDI projects over 100 million dollars based on public information. The CGIT shows that Chinese firms made 86 such large investments worth a total of 42 billion dollars last year. The 2022 number was well below that of 2017, when large Chinese investments reached 174 billion dollars. About half of large investments last year, both in value and number, were greenfield investments and about half corporate acquisitions. Greenfield investment's share of Chinese FDI has increased in recent years. Large investments of Chinese firms in the US have declined considerably. CGIT figures put the value at just a few billion a year since 2019 (a dramatic drop from 2016, when Chinese FDI in the US exceeded 50 billion dollars). Chinese investment in Europe has also dropped considerably from 2016 and 2017, amounting to only about 10 billion dollars last year.

The German China studies institute Merics and the Rhodium Group together produce comprehensive figures on Chinese FDI in Europe. The 2022 figures are well off the boom years of 2016 and 2017. Investments in the EU-27 countries and the UK last year amounted to 7.9 billion euros (8.3 billion dollars), a 22 % decline from 2021. Two-thirds of FDI flows went to three large countries: Germany, France and the UK. Only a few large Chinese firms continued to make the bulk of the investments in Europe. Just five large Chinese firms accounted for over 70 % of all Chinese FDI in Europe last year.

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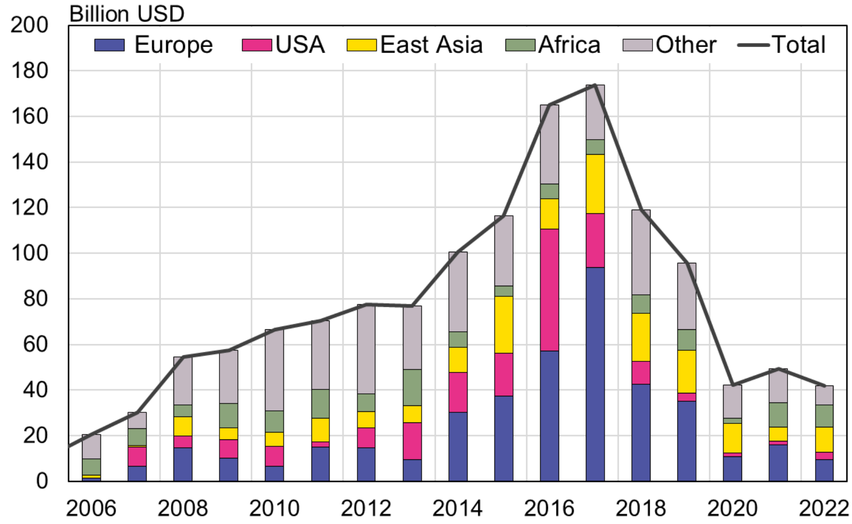
Investments of European firms in China in recent years have also been concentrated with just a few firms (BOFIT Weekly 40/2022). Last year, over half of Chinese FDI inflows to Europe went to the automobile sector. Chinese firms have made large investments in recent years in battery factories, particularly in Hungary, Germany, France and the UK.

Chinese firms have lost their appetite for foreign investment in recent years due to weaker corporate balance sheets, tighter Chinese government regulation of FDI outflows and drag from the Covid-19 pandemic. The ongoing trade war between the US and China has also heightened awareness of China risks, bringing increased scrutiny to Chinese FDI projects, particularly in the US and EU. While only few of the investments are banned outright, investors see that the increased screening makes the investment process more complicated and may affect the keenness of Chinese firms making foreign investments in these countries. Survey responses from many multinational firms operating in China suggest they are also thinking harder about possible future investments in China.

Large FDI projects of Chinese companies has fallen sharply from the peak years of 2016 and 2017



Sources: China Global Investment Tracker and BOFIT.

China's global car exports boom. China is both the world's largest car market and the world's largest car producer. Last year 27 million cars were produced in China, a 1-million-car increase from 2021, but still 2 million units fewer than in the peak year of 2018. The numbers of other car-producing countries pale against China's numbers. The next-largest producer, the US, last year produced 10 million cars, followed by Japan with 8 million. Of the Chinese production, nearly 24 million were passenger cars and slightly over 16 million of them had combustion engines, over 5 million were fully electrical vehicles (EVs), and about 2.5 million were hybrids. The shares of EVs and hybrids continued to grow rapidly. In addition to the passenger cars, just under 3 million trucks were produced and about 400,000 busses.

While there are plenty of domestic carmakers in China, most large international car manufacturers also produce cars in China. For a long time Chinese officials required foreign manufacturers to establish joint ventures with a Chinese manufacturer, a policy intended to develop the capabilities of domestic car producers, but in 2022 foreign firms were finally granted the right to operate fully foreign-owned car production facilities in China. Many foreign operators have nevertheless opted to continue producing in joint ventures with Chinese partners. Moreover, the state has offered support in various forms to support the development of local carmakers. For example, one of the priorities of the Made in China 2025 industrial policy programme is development on "new energy vehicles."

While China's domestic car market is vast, sales have recently only grown by about 2 % a year in terms of units sold. Car sales picked up slightly in January-April this year, with a 7 % y-o-y increase for the period. Volkswagen was the top-selling make for passenger car, while China's BYD, which is specialised in EVs, has also been popular. The top-selling model in China last year was the Tesla Model 3.

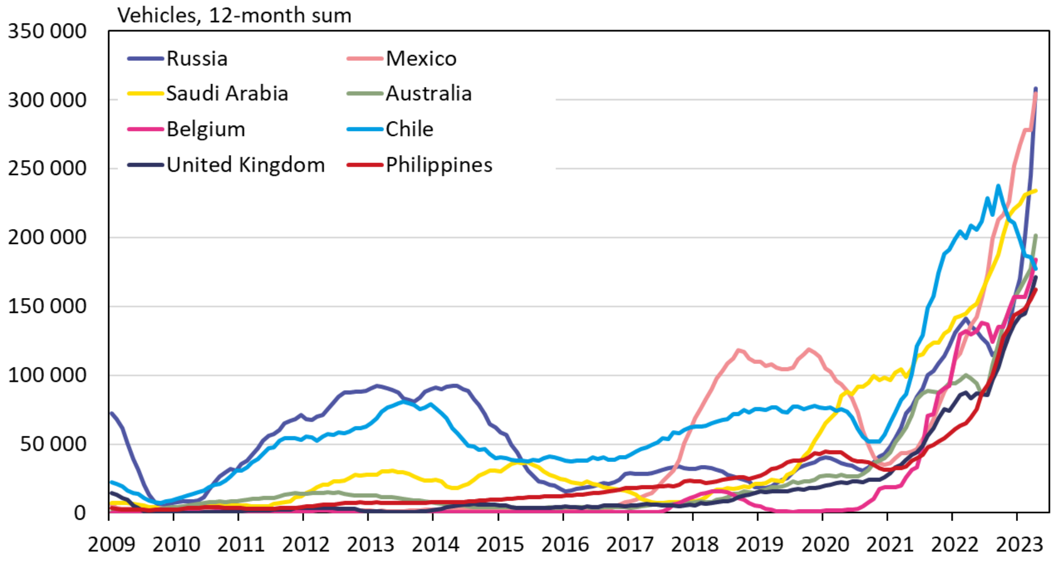
Sluggish growth in domestic car sales has been offset to some extent by booming car exports. Car exports averaged about 1 million units a year 2017–2020, jumped to 2 million in 2021 and last year exceeded 3.2 million. Growth in exports has remained strong this year too. Chinese media report that early this year the country surpassed Japan as the world's largest car exporter. Of China's car exports last year, nearly 2.7 million were passenger cars and their exports continued to rise quickly. Of the exported passenger cars, 1.6 million had a combustion engine, a 50 % increase from 2021. Nearly a million

EVs were exported, a 90 % increase from 2021. In addition, exports of hybrid cars more than doubled to over 100,000 units. Besides passenger cars, China last year exported 500,000 trucks, 50,000 busses and 8,000 specialised vehicles. Sales of electrical models of trucks and busses also increased.

Chinese car exports have been traditionally focused on emerging economies. Over the past twelve months, Russia has become China's largest car export market. China Customs reports that China exported 308,000 cars to Russia, which was just a few thousand more than car exports to Mexico. Chinese car exports to Russia have been booming since Western manufacturers pulled out of the Russian market due to the invasion of Ukraine. Unlike China's vehicle exports generally, EVs remain a tiny part of exports to Russia, while exports of busses and trucks have grown significantly more than passenger car exports. After Russia and Mexico, China's next most important export destinations over the past twelve months have been Saudi Arabia (234,000 cars) and Australia (201,000 cars). The biggest destinations for Chinese car exports to Europe are Belgium (184,000 cars) and the UK (171,000), while 69,000 Chinese-built cars were exported to the US.

Many European, American, Japanese and South Korean carmakers have plants in China. Available figures do not show how exports break down between foreign and Chinese manufacturers and across brands. Also Chinese carmakers have many plants abroad, most in emerging economies and Russia. Some of the assembly and product development is also in Europe concentrating much in England. Moreover, Chinese Geely has owned Volvo in Sweden since 2010. Also Swedish Saab was acquired by the Chinese carmaker NEVS, but it run into financial trouble. It was recently announced that the old Saab factory in Trollhättan, Sweden will begin to produce EVs under the Polestar brand owned by Volvo.

Most Chinese car exports (including chassis) go to Russia and emerging economies, but the number of cars going to Western markets is also increasing



Sources: China Customs, CEIC and BOFIT.

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BOFIT

Russia

Output in most branches of the Russian economy still below pre-invasion levels

Many branches of the Russian economy recorded growth in annual terms in April. The growth mainly reflects the weak reference basis of a year earlier. Many branches experienced sharp declines in April 2022 in the wake of Russia's unprovoked aggression against Ukraine in February and the negative repercussions from stepped up sanctions. The level of Russia's seasonally adjusted output in April 2023 was still below pre-invasion levels in most branches. There were also signs of emerging changes in some sectoral trends.

Consumer demand seems to be coming back, but fixed investment demand has plateaued. After months of weak performance, consumer demand appears to be reviving. Long-depressed retail sales has shown some signs of recovery. The volume of retail sales in April, however, was still about 6 % below pre-invasion levels. Real wages have continued to rise. The employment rate has risen while the unemployment rate has continued to fall. Russia's unemployment rate hit again a post-Soviet low of 3.3 % in April.

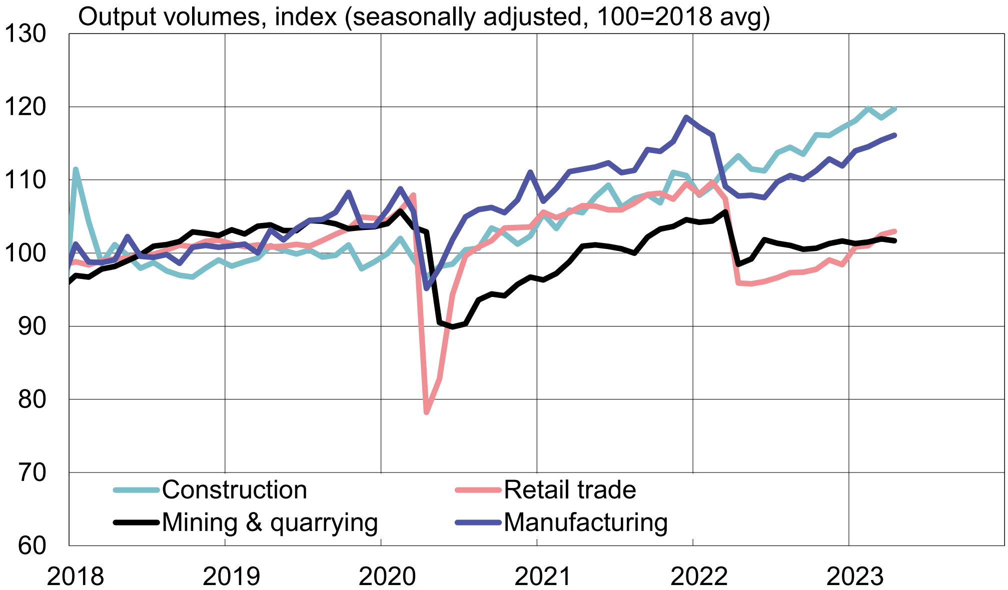
The latest figures suggest growth in investment demand has slowed this year. Fixed investments in January-March grew by just 0.7 % y-o-y, while growth for 2022 overall was 4.6 %. Rapid growth in the construction sector also appeared to plateau. The volume of construction output in April, however, was about 9 % higher than pre-invasion levels.

The differences in performance of various industrial branches continue. The output of the mining & quarrying sector, which includes oil & gas, has remained nearly unchanged over recent months. Output volumes in April were down by about 3 % from pre-invasion levels. Natural gas production has decreased sharply compared to a year earlier due to reduced exports. Mining of certain non-ferrous ores (e.g. ores containing lead and gold) grew briskly in January-April in comparison to a year earlier.

Rosstat no longer publishes crude oil production data. The International Energy Agency (IEA) estimates that the level of Russian crude output in April was unchanged from March, and only slightly less than at the start of the year. According to the IEA, Russia has not yet cut output as much as it has declared and committed to under the OPEC+ agreement.

Manufacturing continued to show signs of recovery in April. Manufacturing volumes in April were only about 1 % below levels in the months preceding the February 2022 invasion.

Output of most of Russia's core sectors were still below pre-invasion levels in April



Sources: CEIC, Rosstat, BOFIT.

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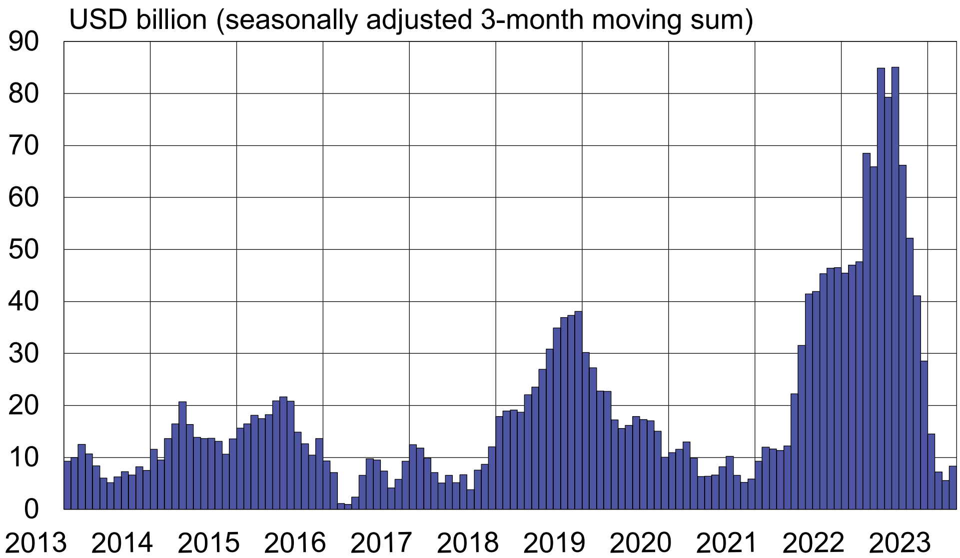
Serious shrinkage in Russia's current account surplus and federal budget energy revenues. Russia's current account surplus, which last year spiked to historical highs, has fallen sharply in recent months. Preliminary CBR estimates show that the current account surplus for the first four months of this year was around 23 billion dollars, a 77 % decline from the same period last year. The surplus was last this small in the first four months of 2017. The current account surplus has evaporated with the declining value of exports and increased imports.

The value of exports has fallen sharply as the price of crude oil has fallen. The IEA reports that the average export price for Russian crude oil (weighted average of Urals and ESPO blends) in April was around 60 dollars a barrel. Export revenues have also been cut by the major drop in natural gas exports. Russia has ceased to sell pipeline gas to most EU customers. Russia's imports, in contrast, have revived significantly from last spring's nadir. Figures from the Central Bank of Russia show that the value of goods imports in March was down by about 8 % from pre-invasion levels (in seasonally adjusted terms).

Russian current account surplus has contracted sharply in recent months



Sources: CEIC, Central Bank of Russia, BOFIT.

Russia's federal budget revenues well reflect the drop in global crude oil prices. Preliminary figures show that the federal budget collected 2.9 trillion rubles (38 billion dollars) from taxes and fees on oil & gas production and exports during the first five months of this year, approximately half of the amount collected in the same period last year. Federal budget revenues from oil & gas, measured in rubles, were last this low in January-May 2020. While revenues fell, budget spending increased, creating a federal budget deficit in January-May of over 3.4 trillion rubles (about 2 % of GDP).

Contraction of Russian GDP expected to continue this year. Recent forecasts see Russian GDP still contracting slightly this year and returning to modest growth next year. On Wednesday (Jun. 7), the OECD released its latest Economic Outlook, which expects Russian GDP to contract by 1.5 % this year. The World Bank's Global Economic Prospects, released Tuesday (Jun. 6), forecasts Russian GDP will fall this year by 0.2 %. The World Bank sees the Russian economy dragged down this year by shrinking exports, weak domestic demand, political uncertainty and sanctions. The OECD expects Russian GDP to contract still in 2024 by 0.4 %, while the World Bank expects GDP to grow by 1.2 %. According to the May consensus forecast, GDP should contract by 0.3 % this year and grow by 1.3 % next year.

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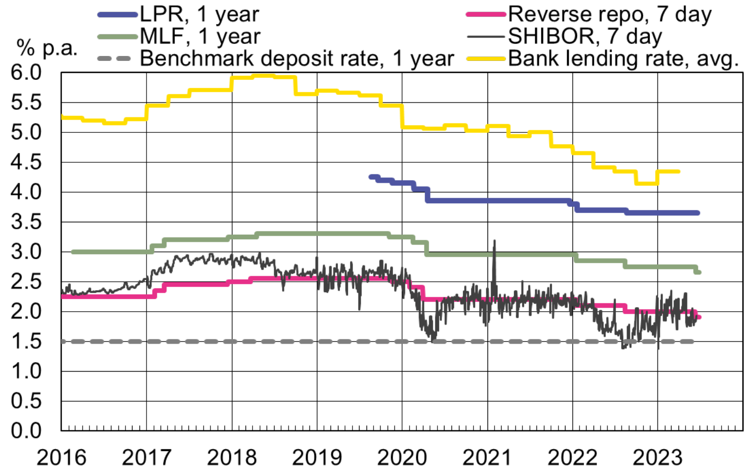
China

People's Bank of China eases monetary stance as economic recovery remains more sluggish than expected. In mid-July China's central bank cut all main policy rates by 10 basis points. The rate cut came at the same time as the May economic figures were released by NBS, which showed that the 12-month change for industrial output and retail sales slowed in May. Industrial output increased by 3.5 % y-o-y. Retail sales were up by 12.7 % in nominal terms. The PBoC last lowered its policy rates in August 2022.

The PBoC lowered rates under the programmes it uses to inject liquidity into the financial system. The tenth-of-a-percent cut was quite modest. On Thursday (Jun.15), the 1-year rate for the medium-term lending facility (MLF) for banks was lowered from 2.75 % to 2.65 %. On Tuesday (Jun. 13), the 7-day reverse repo rate, used in daily open market operations, was cut to 1.9 % and the rates for the standing lending facility (SLF) were lowered. The overnight SLF rate declined to 2.75 %. The loan prime rate (LPR), the reference rate for bank lending set by the PBoC based on the recommendation of 18 panel banks, is expected to be lowered next as it is based on the MLF rate. LPR rates are announced on the 20th day of each month. The May LPR rate for a 1-year loan was 3.65 % and the 5-year loan rate 4.3 %. Banks add their own margins to the rates in setting the actual loan cost.

The PBoC lowered its main policy rates by 10 basis points in mid-June



Sources: CEIC, PBoC, National Interbank Funding Center and BOFIT.

News sources report the PBoC gave guidance to commercial banks in May and June in advance of the rate cuts that they should lower their deposit rates by 5 to 30 basis points. To give the guidance teeth, the central bank resurrected the "interest rate self-disciplinary mechanism" it oversees. The mechanism was originally introduced in 2013 (few years before regulated bank rate setting was abolished), and in practice, it still defines the upper bound for loan rates based on the benchmark deposit rate the PBoC still continues to publish. Commercial banks cannot breach this ceiling, but they can offer lower deposit rates. Banks worries about eroding profitability were apparently the main reason for the PBoC's decision to issued guidance on lowering the deposit rates. The interest margin of banks are a record low even before the policy rate cuts, as central bank has instructed banks to lower their corporate lending rates to support the businesses. Media reports note that mid-sized banks in May lowered their 1-year deposit rate to 1.85 % and 3-year deposit rate to 2.95 %.

The rate cuts are hoped to stimulate demand for bank loans, which weakened in May. Lower deposit rates are also hoped to revive consumption. Growth of the bank lending stock slowed from 12.2 % in April to 11.8 % in May. The rise in aggregate financing to the real economy (AFRE) slowed to 9.8 % y-o-y (10.3 % in April). Notably, corporate bank lending growth slowed down. Very low inflation could permit even more accommodative monetary policies. The on-year rise in consumer prices in May was just 0.2 % (0.1 % in April). Producer prices, which largely track energy prices, declined in May by 4.6 % y-o-y.

Increased depreciation pressure on the yuan and the risk of increased capital flight are, however, restricting more aggressive monetary policy easing. Since mid-April, the yuan has lost about 4 % of its value against the dollar, and its real effective (trade-weighted) exchange rate (REER) has dropped by 5 %. With the US and most advanced economies tightening

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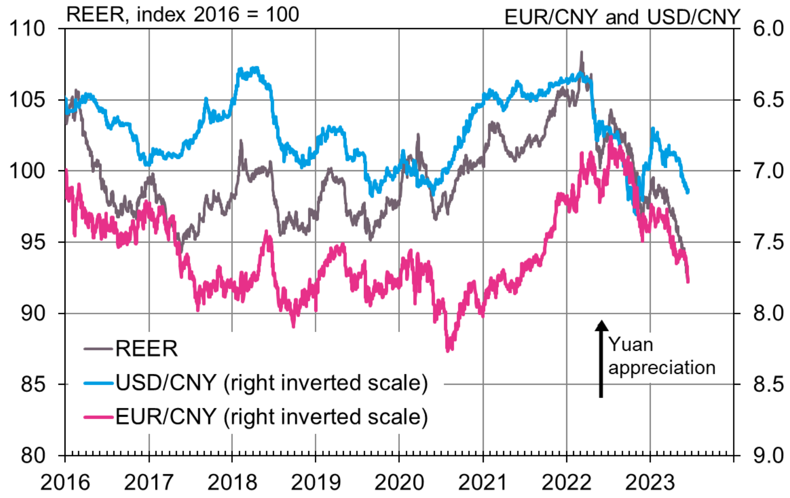
their monetary stances, the interest rate spread with China has widened. On Wednesday (June 14), the yield on China's 10-year government bond was 2.61 %, compared to 3.83 % for the US 10-year bond. As a result, foreign investors have been pulling their money out of the mainland China markets. The Institute of International Finance finds that foreign investors, who returned to mainland China's stock markets with the economic reopening in the first quarter, cut their investments in April-May. Foreign investors have also been reducing their exposure to China's debt markets since March. In the first five months of this year, the shareholdings of foreign investors in equity markets have risen by 34 billion dollars, while their holdings in the bond market have fallen by 59 billion dollars.

The yuan has lost ground this year against both the dollar and euro



Sources: Macrobond, J.P. Morgan and BOFIT.

Hong Kong economy recovering from a tough year, but much depends on external factors. Hong Kong's economy last year had to deal with severe covid lockdowns and interest rate increases in the US that increased financing costs also in Hong Kong. Hong Kong's GDP contracted by 3.5 % last year. The reopening of the economy early this year helped revive private consumer demand and lifted Hong Kong's main purchasing manager index above a neutral reading of 50 points. In the first quarter of this year, GDP grew by 2.7 % y-o-y. The April IMF forecast expected Hong Kong's GDP to rise by 3.5 % this year and by 3.1 % in 2024.

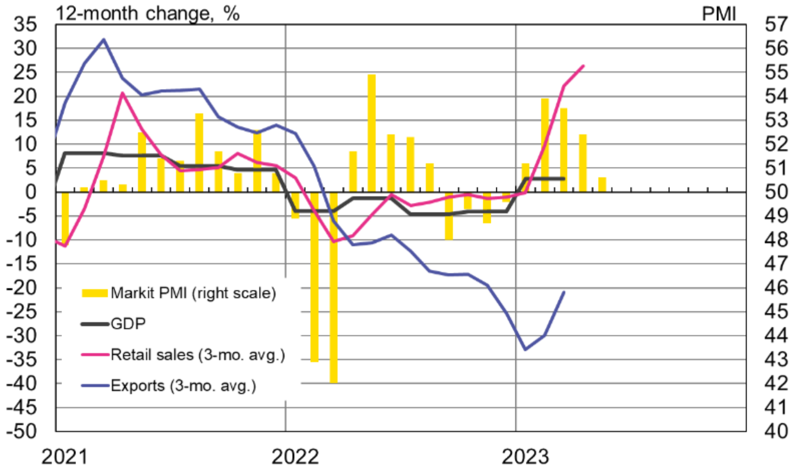
The Hong Kong dollar is pegged (fixed peg) to the US dollar, which forces the Hong Kong Monetary Authority to react immediately to any rate changes announced by the US Federal Reserve. Interest rates can thus rise in Hong Kong even if local economic conditions would warrant a more accommodative monetary policy stance. This happened last year when rates in the US went up just as Hong Kong was fighting the highly contagious omicron variant of the covid virus. Unlike in mainland China, where most covid support measures have been aimed at the business sector, the Hong Kong government has also supported households and private consumption throughout the pandemic. Electronic purchase coupons were distributed to households, employment supported and taxes on wage income reduced. As looser monetary policy is unlikely over the short term, fiscal stimulus measures have been extended.

Hong Kong's service sector accounts for 94 % of GDP. Over the years, Hong Kong's industrial production has gradually been offshored almost entirely to mainland China and manufacturing today only generates about 2 % of Hong Kong's GDP. With the opening of the economy after the lifting of covid restrictions at the start of 2023, private consumption has returned to the growth track. The volume of retail sales in the first four months of this year rose on average by about 20 % y-o-y. The growth in private consumption has been boosted by the return of tourists, especially tourists from mainland China. Even if 2.9 million tourists visited Hong Kong in April (with 2.3 million coming from mainland China), the numbers remained well below pre-pandemic levels. In 2019, a monthly average of just under 4.7 million tourists visited Hong Kong, of which 3.6 million came from mainland China.

Hong Kong is also highly dependent on the global economy for its export demand. The value of goods and services trade is nearly four times larger than GDP and reexporting accounts for a huge part of Hong Kong's foreign trade. Mainland China is still by far Hong Kong's largest trading partner, although its share of imports has fallen from just under 50 % ten years ago to about 40 % last year. During the first three pandemic years (2020–2022), mainland China's share of exports increased slightly, but has since dropped back to around 55 %. The volume of foreign trade last year was nearly 30 % below its 2021 peak. For the first months of this year the volume of exports continued to decrease, but the worst of the contraction in exports is likely to be over.

A total of 187,300 people emigrated from Hong Kong in 2020–2022, reducing the special administrative region's population by 2.5 %. In January 2023, the UK's Home Office announced that 144,000 Hong Kongers had moved to the UK on special (Hong Kong British Nationals Overseas) visas. As British nationals overseas, Hong Kongers can immigrate to the UK with little paperwork and have access to an accelerated citizenship path. The UK began to grant special visas in January 2021, a half year after Hong Kong's draconian national security act went into force. Freedom of speech and freedom of the press have been sharply curtailed in Hong Kong due to China's crackdown on dissent.

The Hong Kong economy has begun to show signs of a post-pandemic recovery



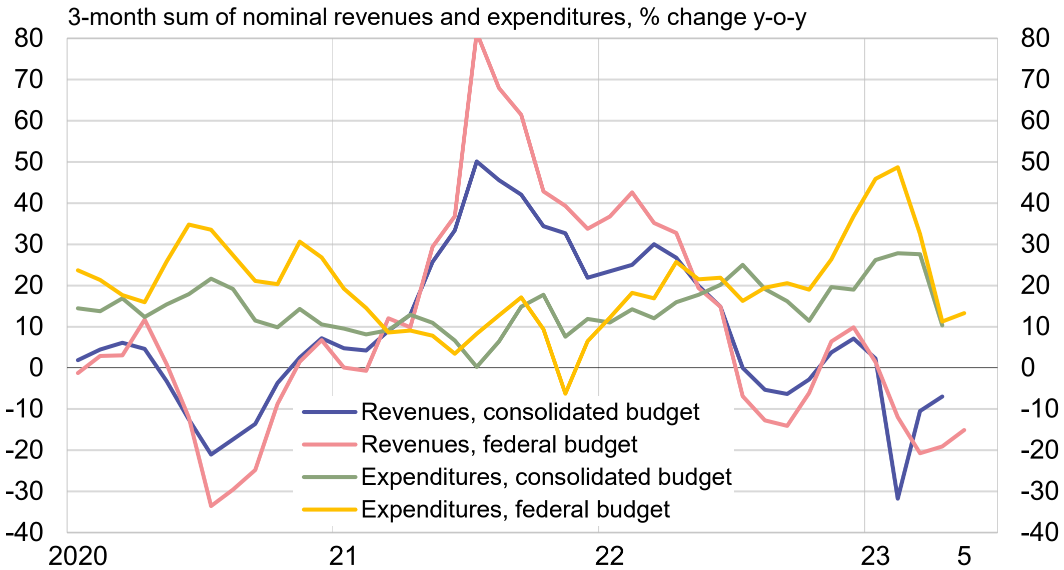
Sources: Hong Kong Census and Statistics Department.

Russia

Significant weakening of Russia's government finances

Budget revenues declined while spending still increased even after a pull-back. Russia's government budget revenues have slipped in recent months. Nominal three-month revenues to the consolidated budget (federal, regional and municipal budgets plus budgets of state social funds) were down in April by 7 % from a year earlier. Government revenues were off by about 10 % in real terms. Purchasing power of government revenues is no longer eroding as quickly as last year because consumer and producer price inflation has slowed to 3–4 % y-o-y, mostly due to the on-year drop in producer prices of domestic supplies in recent months.

Russia's government budget revenues are down and efforts to restrain spending growth have been made



Sources: Russian Ministry of Finance and BOFIT.

Revenues other than oil & gas tax revenues (nearly 80 % of consolidated budget revenues in 2022 and 86 % of revenues in January-April 2023) have recovered to levels higher than a year ago. VAT revenues from domestic production have increased and budget revenues from imports such as VAT and import duties have recovered. Revenues from labour income taxes and social taxes on wages, on the other hand, have withered.

Oil & gas tax revenues have dropped by half on-year in recent months. The price of Urals blend was down by about 25 % y-o-y. While taxation of crude oil continues to be based on the price of Urals, a lower limit for the price used for taxation, relative to the Brent crude, has been defined (more than 30 dollars a barrel below Brent in April-May and 25 dollars below Brent from the beginning of July). On the other hand, the slide in oil & gas tax revenues, which are measured almost entirely in dollars, has been constrained by the ruble's depreciation. Crude oil production is also an essential factor as crude oil production taxes accounted for 80 % of total oil & gas tax revenues in January-May. Monitoring of Russian oil production by international agencies indicates that Russia has so far implemented only a small part of its announced crude oil output.

The rise in consolidated budget spending has slowed significantly in recent months to around 10 % y-o-y. Budget spending on fixed investments and inventories, however, jumped by nearly 80 % y-o-y in January-April as war and support to the economy require funding.

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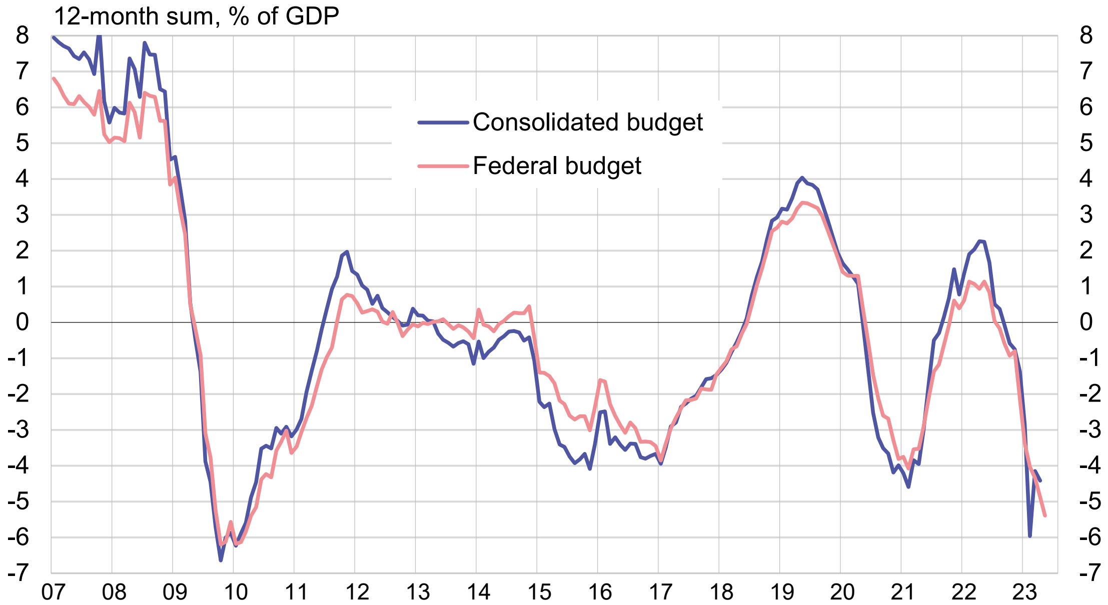
Budget deficit ballooned and budget revenues are supported with additional taxation. The decline in budget revenues, even with recent efforts to quell spending growth, has caused the budget deficit to widen. The running 12-month consolidated budget deficit grew to roughly 4.5 % of GDP in April. The federal budget deficit deepened to nearly 5.5 % of GDP in May. Russia's deficit is currently its largest since the global financial crisis in 2009. The finance ministry says it is attempting to reduce the budget deficit based on the setup that this year's spending has been unusually front-loaded. The deficit this year has been mostly funded out of government accounts. A relatively small amount of that has been taken from the liquid assets of the National Wealth Fund. The government has also relied moderately on bond issuance.

The state needs money and has increased its efforts to squeeze out additional revenues. The Duma is considering a bill that will apply a one-time windfall tax to firms with "excessively large" profits. The tax will not apply to small and medium-sized firms, firms operating in the oil & gas sector or coal producers. Companies included in the tax calculation will be those with a profit exceeding about 12 million euros for the period 2021–2022. The tax is defined as 10 % of a corporation's profits in 2021–2022 in excess of its 2018–2019 profits. The determined amount must be paid in January 2024. If the tax is paid this year in October or November, the rate of taxation should drop to 5 %. The finance ministry noted earlier this year that this one-time tax could increase budget revenues by an amount equal to roughly 0.2 % of annual GDP. Firms in the oil & gas sector will face tax hikes, largely of production taxes. A higher tax on coal production has already been implemented. The finance ministry estimates that the government could raise considerable sums from these supplementary taxes, possibly more than 2 % of GDP.

Russia's government budget deficit has increased sharply into depths not seen since the global financial crisis in 2009



Sources: Russian Ministry of Finance and BOFIT.

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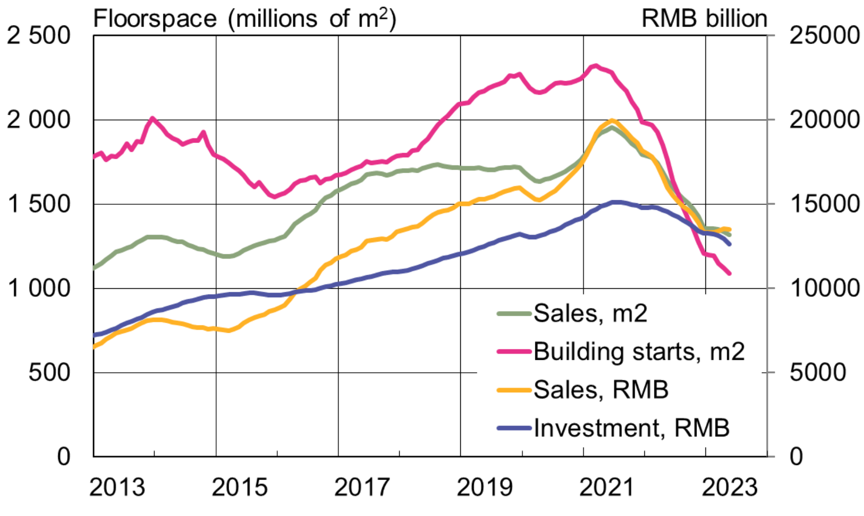
China

China's economic performance showed no clear signs of improvement in May; lacklustre performance reflected in financial markets. China's National Bureau of Statistics (NBS) reports that industrial output growth slowed to 3.5 % y-o-y in May. On-year growth in retail sales declined from over 18 % in April to below 13 % in May. A factor upholding high on-year growth in retail sales has been the low basis reference numbers of 2022, when China experienced widespread covid lockdowns that limited the possibilities for consumers to spend. The value of restaurant sales, which account for over 10 % of total retail sales, was up 35 % y-o-y in May. Car sales, which account for nearly 10 % of retail sales, also saw sales growth rebound to 24 % y-o-y in May. Concurrently, the value of retail sales declined in such categories as food, household and office appliances, as well as construction and decoration materials. The NBS calculations for seasonally adjusted monthly growth show that industrial output and retail sales were up in May compared to April.

The struggles of China's real estate sector continue. The volume of May apartment sales, measured in terms of liveable floorspace, decline by 20 % y-o-y. Sales were off by 5 % in yuan terms. The volume of housing sales in recent months has remained close to level of late 2022, so the floor for sales may have been reached. The government's current real estate sector support measures are directed at finishing works in progress. Measured in floorspace, the volume of completed construction projects was up by 25 % y-o-y in May, while the stock of uncompleted building projects was 6 % smaller than a year ago. Nevertheless, the pullback in real estate investment and drop in new building starts continued. The volume of new building starts (floorspace) has fallen in recent months to levels less than half of the average volume of new starts in 2020 and 2021, when tighter regulation of the construction sector was introduced.

The drop in apartment sales has begun to ease this year, but the volume of new residential building starts continues to decline (series are 12 month moving sums)



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

The total survey-based unemployment rate has fallen slightly from the end of last year to 5.2 % in April and May. Youth unemployment (16–24-year-olds), however, has remained stubbornly high, reaching 20.8 % in May. Officials are concerned about high youth unemployment. China's Ministry of Human Resources and Social Security announced this month the launch of a six-month campaign to support unemployed young people.

China slightly eased its monetary stance this month (BOFIT Weekly 24/2023). In mid-June, the government revealed that it was planning an economic support package with details to be provided later. The only measure already announced is that the current tax breaks (due to expire this year) on purchases of all-electric and hybrid cars (so-called new energy vehicles) will be extended for the next four years. Market observers expect the government could use its default support measures of helping developers by easing restrictions for housing purchases and bank lending, as well as increased infrastructure investment. Both forms of support have their limits. Housing demand cannot recover without the return of investor confidence, and pushing additional funding into the real estate sector could compound current debt problems as

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well as fuel another real estate bubble. Additionally, the profit potential of infrastructure investments has fallen at a time when provincial finances are severely weakened. Provinces and municipalities are increasingly reluctant to take on large investment projects. Even with weaker-than-expected economic performance, China should hit its relatively modest 5 % growth target this year without major stimulus thanks to last year's low reference basis.

China's trade with russia blooms as export demand in the rest of the world fades. China's export trends generally weakened in May. The value of exports declined by 8 % y-o-y in dollar terms, and the value of imports fell by 5 %. Some of the drop in the value of foreign trade reflects lower prices and yuan depreciation. China Customs figures show more robust export volumes, and put the volume of May exports roughly on par with the May 2022 level. The volume of imports, in contrast, rose by 7 % y-o-y. While the dollar-value of exports in the first five months of this year was about the same as in the first five months of 2022, the value of exports fell in the case of the US (down by 15 % y-o-y), EU countries (down by 5 %) and Taiwan (down by 23 %). Exports to ASEAN countries were up by 7 % y-o-y. The value of imports fell by 6 % in January-May. Among China's top trading partners, imports from South Korea were down by 27 % y-o-y, Taiwan (down by 27 %) and Japan (down by 17 %).

China-Russia trade has been going gangbusters this year. Russia now accounts for 3 % of China's total exports and 5 % of China's imports. The value of China's exports to Russia in January-May was up by 75 % from the same period last year, while the value of China's imports from Russia was up by 24 %. The value of imports to Russia and exports from Russia this year has more than doubled from January-May 2019 (i.e. before the covid pandemic and Russia's invasion of Ukraine). Vehicle exports, which now account for about a fifth of China's exports to Russia, have nearly tripled from the same period in 2022. The value of imported oil and petroleum products (nearly 80 % of imports) was up by 22 % y-o-y in January-May. In terms of volume, China imported 24 % more crude oil than it did a year earlier. Russia also surpassed Saudi Arabia as China's largest oil provider, and currently accounts for about 18 % of China's total oil imports. According to figures from China Customs, China last month paid an average of 528 dollars per metric ton of Russian crude oil, compared to 633 dollars for a ton of Saudi Arabian crude. China's average price paid for imported crude in May was 589 dollars a ton.

Flat first-half performance for chinese stocks. Mainland China stock exchanges were up at the end of last year and January this year on the reopening of the Chinese economy after the lifting of covid restrictions. The price gains have since largely evaporated. In end-June the main indices of the Shanghai and Shenzhen exchanges were up by just 3 % from the end of last year. The average share price on the Hong Kong Stock Exchange (Hang Seng index) was down by 5 % from the start of this year, while shares of companies listed on the Shenzhen bourse's high-growth ChiNext index were down by 7 %. In the same period, the average price of shares listed on US exchanges (S&P 500) were up by 15 %, while share globally (FTSE All World) rose by 12 %.

Slower-than-expected economic growth and monetary policies running counter to the rest of the world have driven foreign investors to reduce their mainland China exposure. During the second quarter of this year, the value of shares sold by foreign investors via the Stock Connect programme with the Hong Kong Stock Exchange was 6 billion yuan greater than the value of shares purchased by foreign investors via Stock Connect. The value of shares purchased under an exchange link programme that gives Chinese investors access to the Hong Kong Stock Exchange saw Chinese investors purchasing 47 billion yuan more in shares than they sold.

Driven by the above-mentioned factors, the yuan's external value continues to slide. The yuan-dollar exchange rate is 8 % weaker than its January peak. As of end-June, one dollar bought 7.26 yuan. It seems currently the People's Bank of China has not tried meaningfully restrain the yuan's fall with its daily mid-point reference rate-setting to the dollar or intervention in forex markets. The value of China's foreign currency reserves has remained fairly stable since the start of the year, standing at 3.177 trillion dollars at end-May.

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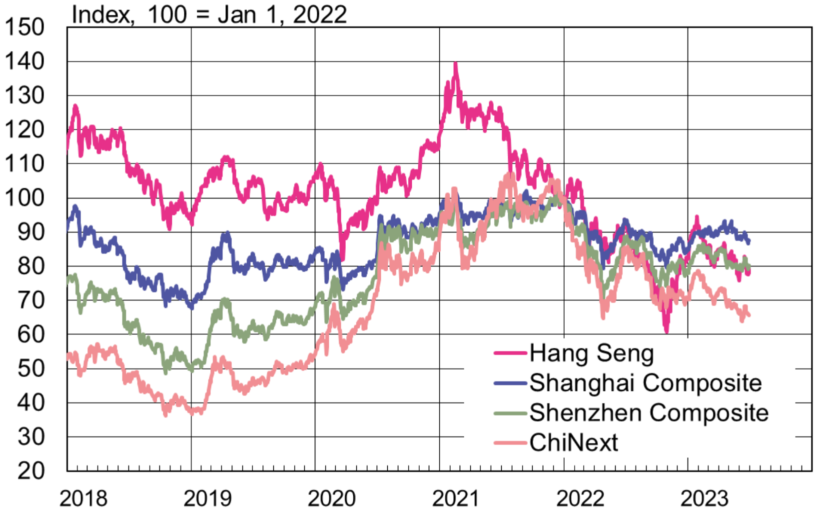
Chinese share prices were at roughly the same level at the end of June as they were at the start of this year



Sources: Macrobond and BOFIT.

Real 12-month change in key indicators and consumer prices, %

	2021	2022	3Q2022	4Q2022	1Q2023
GDP	8.4	3	3.9	2.9	4.5
	2021	**2022**	**3/2023**	**4/2023**	**5/2023**
Industrial output	9.6	3.6	3.9	5.6	3.5
Retail sales	10.7	-2.2	9.9	18.3	12.5
Goods exports	17.4	-1.3	15.3	10.9	-0.3
Goods imports	7.7	-6.6	6.6	4.4	7.1
Inflation	0.9	2.0	0.7	0.1	0.2
Yuan-dollar rate, avg.	6.45	6.74	6.90	6.89	7.01

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

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BOFIT

Russia

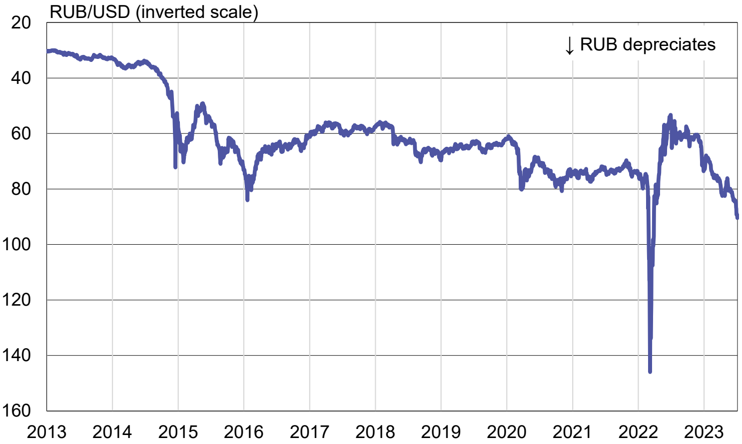
Despite signs of economic recovery, imbalances in the Russian economy continue to grow

Ruble depreciation. While Yevgeny Prigozhin's short-lived insurrection had little immediate economic consequence, it has increased uncertainty about the Russian economy. The events on June 23 and 24 are reflected in a drop in the ruble's exchange rate to levels not seen in over a year. In early July, the ruble-dollar exchange rate went above 90 for the first time since March 2022.

The ruble has been on a downward trajectory already for months, reflecting mainly Russia's shrinking current account surplus. Preliminary estimates from the Central Bank of Russia (CBR) show that the current account surplus for the first five months of this year fell to 23 billion dollars, an 82 % drop from the record-high level in the same period in 2022. The declining current account surplus manifests a sharp drop in Russia's export earnings and a recovery in imports as Russia pivots to other import routes and suppliers.

The CBR says that the value of goods exports in January-April was down by about a third from the same period a year earlier. While lower oil prices were the biggest factor in reduced export revenues, Russia has also ceased transmission of pipeline natural gas to most EU countries. The value of goods imports in January-April rose by 12 % y-o-y, mainly due to the weak reference basis of 2022. The value of goods imports in April hovered near pre-invasion levels.

The ruble has faced strong depreciation pressure in recent months



Sources: Macrobond, BOFIT.

Inflation picks up. Ruble depreciation can further fuel inflationary pressures in Russia. The CBR noted at its June policy meeting that inflation appears to be accelerating, putting the annualised rate at that time around 4 %. Although the CBR decided at the same meeting to keep its key rate unchanged at 7.5 %, it also signalled that rate hikes are possible at upcoming meetings. In addition to the ruble's slide, the CBR mentioned several other factors that increase inflation risks, including increased public-sector spending, tight labour markets and potential extensions of sanctions against Russia.

Russia's federal budget spending rose by 27 % y-o-y in the first five months of 2023. Revenues contracted by 19 % y-o-y as oil & gas revenues fell by half. At the same time, the budget deficit ballooned. Thus, the realised January-May budget deficit already well exceeded the government's budget deficit target for all of 2023. The running 12-month deficit for May corresponded to 5.5 % of GDP. Russia last saw such a large budget gap in 2009 during the global financial crisis.

Russia's labour markets continue to tighten. The unemployment rate hit again a post-Soviet low of just over 3 % in May. The Russian labour force was already shrinking before the Ukraine invasion. With the war and last October's partial mobilisation of reserves, as well as large-scale emigration, the size of the Russian labour force has contracted by at least several hundred thousand people. The CBR noted that the labour market conditions are increasingly limiting Russia's capacity to expand production. The lack of workers has also caused wages to rise rapidly and added to inflationary pressure.

Sanctions aimed at Russia continue to widen as the EU approved its 11th sanctions package on June 26. The latest package includes a number of measures to prevent circumvention of sanctions. For example, the ban on goods transiting Russia has

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been expanded and a new mechanism has been introduced making it possible to target firms in third countries that abet sanction evasion, particularly with regard to sensitive dual-use goods and technology. The new sanctions package includes further export bans on e.g. electronic components and semiconductor materials, as well as import bans on such goods as coal and peat products. According to the European Commission, trade restrictions currently cover 54 % of EU exports to Russia and 58 % of EU imports from Russia based on 2021 trade valuations. Sanctions reduce Russia's export earnings and limit the availability of many goods in Russia.

The CBR expects consumer prices to rise by 4.5–6.5 % this year and that inflation will subside to the central bank's 4 % target next year. The inflation estimates of major international institutional forecasters currently run in the range of 5–6.5 % for this year and 4–5 % for 2024.

Output generally recovered in May, but varied considerably from industry to industry. Retail sales, a proxy for private consumption trends, continued to recover in May. The volume of retail sales, however, was still down by about 4 % from pre-invasion levels in seasonally adjusted terms. Sales of durable goods have been hit particularly hard. For example, sales of new passenger cars were still in May down by about half from pre-invasion levels. Car sales have been further restrained by supply issues due to Western sanctions.

The development of extractive industry output remains tepid. Natural gas production in May was down by 15 % y-o-y. The International Energy Agency (IEA) reports that Russian oil production has fallen in recent months, but not enough to satisfy Russia's commitments under the current OPEC+ agreement. Russia this week announced that it would further reduce its oil exports to 500,000 barrels a day in August.

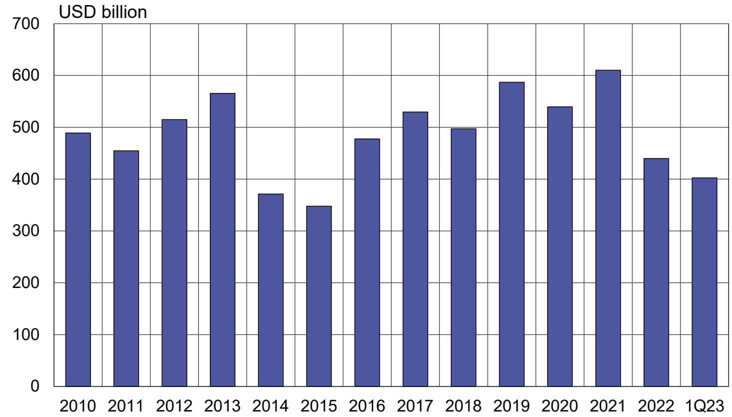
Construction and manufacturing have provided the strongest support to the Russian economy. Construction has grown rapidly despite the war, with growth in construction activity further accelerating in May. Most manufacturing growth is related to construction and branches involved in supplying the war-time economy. Branches dependent on foreign trade continue to experience economic headwinds.

The forecasts of the European Commission, EBRD and OECD released in May and June anticipate drops of 0.9–1.5 % in Russian GDP this year. The Consensus Economics forecast for June found an average expectation of 0.4 % growth for the Russian economy this year and 1.3 % growth next year.

Outlook for Russian economy further clouded by sharp drop in direct foreign investment. CBR figures indicate that the stock of foreign direct investment (FDI) has shrunk considerably since Russia's unprovoked invasion of Ukraine. The value of the stock of FDI in Russia amounted to 610 billion dollars at the end of 2021, but stood at just 402 billion dollars at end of March 2023. Russia has not released detailed FDI information specifying country of origin or branch of activity since 2021. Observers note that a large portion of FDI inflows to Russia before the war was likely just Russian capital round-tripping via third countries for purposes such as evading taxation.

The stock of FDI has decreased by about a third since the start of the war despite Russia's efforts to block the exit of foreign firms from the Russian market. For example, the possibilities for foreign firms to repatriate their capital investments have been severely restricted. Divestment sales of foreign-owned firms require official approval, which is typically a long drawn-out process. Current legislation also allows the government to seize assets of foreign-owned firms.

The stock of foreign directed investment in Russia has contracted significantly since Russia's invasion of Ukraine



Sources: Central Bank of Russia, BOFIT.

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BOFIT

China

China's central bank ongoing digital yuan pilot project enters its fourth year. The People's Bank of China launched its foray into development of a central bank digital currency (CBDC) already in 2014, and pilot-scale testing of the digital yuan or "digiyuan" (symbol e-CNY) commenced in four large cities at the end of 2019 (see e.g. BOFIT Weekly 14/2021). As the digiyuan roll-out continues, the opportunities for its use have increased geographically and commercially. The e-CNY is presently used in 26 cities in 17 provinces. No official launch date for nationwide use of the digiyuan has yet been announced.

China's digiyuan pilot scheme is focused on domestic retail transactions (retail CBDC), but interbank wholesale transactions (wholesale CBDC) and cross-border payments are also currently under development. The digiyuan is fully controlled by the PBoC, and like cash, generates no interest. Commercial banks and payment institutions act as the payment intermediaries. The digiyuan is seen as an official alternative to digital payment solutions developed by private-sector actors (most notably the Ant Group's Alipay and Tencent's WeChat Pay). These private solutions currently dominate China's vast mobile payments arena. The PBoC says it introduced the digiyuan in order to improve the efficiency and security of payment systems and to improve financial inclusion. Although the anonymity protections of digital currency transactions are weaker than for cash, CBDC is also harder to counterfeit, launder or use in illegal trade. The PBoC claims that in principle digiyuan transactions are anonymous in the case of low-value payments and that traceability only enters the picture in the case of high-value payments.

Use possibilities have been expanded beyond retail outlets to cover, for example, public transport, public healthcare services and financial services. School tuition and taxes can be paid in digiyuan, and social security benefits in some areas are distributed in digital currency. Changshu in the Jiangsu province made the news in May when the city began to pay its public sector workers entirely in digiyuan.

Just before the 2022 Beijing Winter Olympics, the central bank released an e-CNY app in cooperation with nine of China's major commercial banks. The app allows users to transfer money between their digiyuan wallet and bank account, as well as make online and offline payments and transfers to the wallets of others using the app. Four types of wallets are currently available. The easiest form of registration only requires giving a phone number, in which case the central bank cannot (at least directly) identify the user's identity. Such accounts can hold a maximum of 10,000 yuan and daily use is limited to 5,000 yuan (625 euros). The amount available for use increases if the registrant provides their government-issued resident identity card number or links their wallet to their physical bank account. Users can gain unlimited spending on their digiyuan account if they personally identify themselves at a bank branch. The PBoC says that digiyuan wallets collect less information about users than the digital payment solutions offered by private providers. In July, two of China's largest banks (Bank of China and ICBC) announced they launched a feature in the app together with China's teleoperators that exploits near-field communication (NFC) data transfers and enables making payments without being connected to the internet.

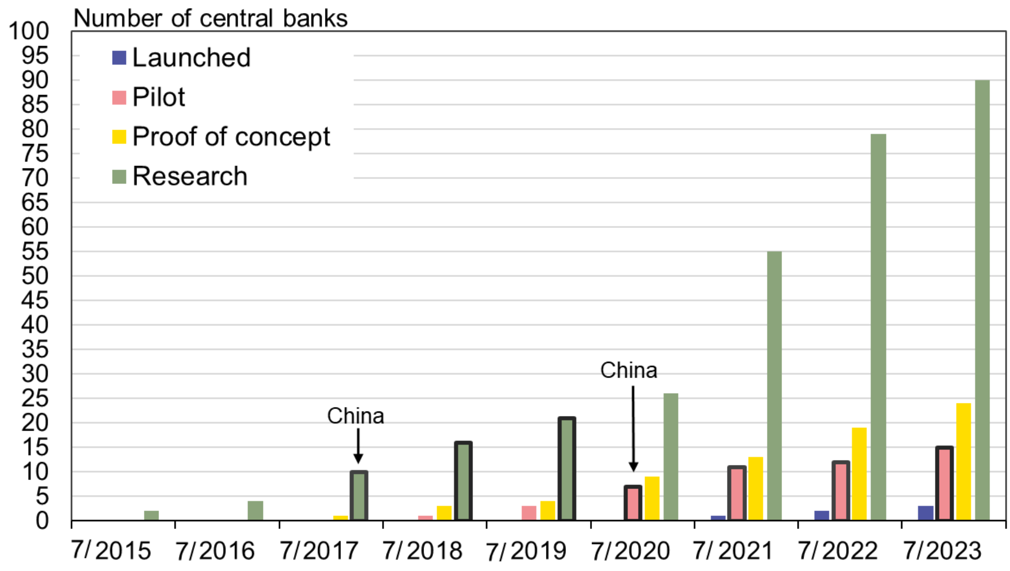
The digiyuan can be used for payments on Alipay and WeChat Pay, as well as on popular shopping platforms such as Taobao, Meituan and JD.com. Consumers seem reluctant, however, about changing their payment habits and switching to digiyuan. Several provinces have tried to support CBDC by offering discounts or simply giving digital money to consumers. As part of covid support measures, provinces distributed or raffled off digiyuan coupons which had to be used by a certain date and typically were subject to rules on where they could be spent. During this spring's holiday week, there was news coverage of Shenzhen's digiyuan coupons to support for local restaurants.

The government has not published comprehensive figures on the volume or use of e-CNY. According the PBoC, 261 million digiyuan wallets had been established as of end-2021. In August 2022, the PBoC announced that the value of digiyuan transactions had surpassed the 100-billion-yuan mark. Hitting that milestone involved over 360 million transactions in 15 provinces. CBDC transactions, however, are still dwarfed by the volume of mobile payments. The digiyuan was reported to be in use at nearly 6 million points of sale at that point. Central bank figures also show that the supply of CBDC in circulation at the end of last year totalled 13.6 billion yuan (1.7 billion euros). That amount corresponded to 0.13 % of the narrowest definition of money supply (M0), which includes cash in circulation, commercial bank reserves at the central bank and in China the amount of e-CNY in circulation.

China is also participating in international CBDC experiments. Along with China, the recent Bank for International Settlements (BIS) project (mCBDC Bridge) included the central banks of the United Arab Emirates, Hong Kong and Thailand. Several of China's largest banks participated in pilot testing of wholesale cross-border use of CBDC last autumn. Cross-border digiyuan payments are seen as a way to possibly make the international use of the yuan easier and cheaper in the future. During the 2022 Beijing Winter Olympics, digiyuan was available to foreign visitors. Shenzhen this spring began to offer travellers coming from Hong Kong the possibility to set up a digiyuan account with a card that allows users to transfer money from their own Hong Kong Octopus card.

Interest in central bank digital currency is increasing around the world. The Atlantic Council reports that 130 countries, which together account for 98 % of global GDP, are either studying or planning to introduce their own CBDC. The European Central Bank, for example, launched an investigation phase on introduction of a digieuro in 2021. The digiyuan is overwhelmingly the world's largest central bank digital currency experiment in terms of value and size of user base. The Bahamas, Nigeria and Jamaica have already launched their own CBDCs.

An ever increasing number of central banks have digital currency projects in the research or pilot stages



Sources: CBDCTracker and BOFIT.

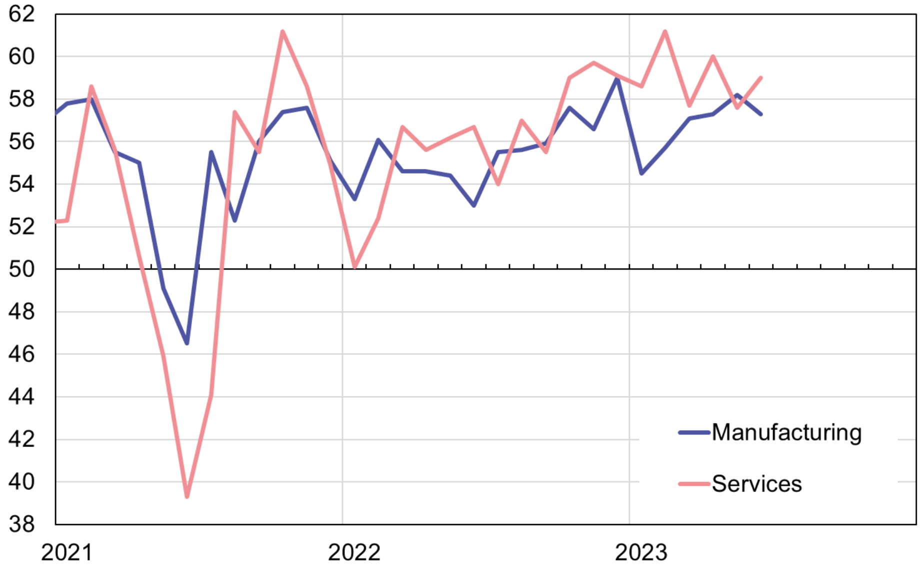
Indian economy remains on a balanced growth path. Preliminary estimates from May suggest that economic growth in India in the most recent fiscal year (April 2022–March 2023) was 7.2 %, or two-tenths of a percent higher than earlier estimates. The country's robust economic performance was largely due to the rise in gross fixed capital formation, which was up by 11 % y-o-y. Aggressive government investment policies have driven up gross fixed capital formation to 34 % of GDP. Private consumption also experienced strong growth (8 %) in the last fiscal year, while public consumption remained flat. Imports grew by 17 % and exports by 14 %. India's foreign trade deficit corresponded to about 2 % of GDP.

Monthly indicators such as purchasing manager indices suggest that growth has remained strong throughout 2023. In its latest *World Economic Outlook*, the IMF estimates that India's economic growth should remain around 6 % in coming years. The Reserve Bank of India expects 6.5 % GDP growth this year.

Rapid investment driven growth reflects India's fiscal policies stressing support for infrastructure investment in public funds. The central government budget for this fiscal year released in February shows that public or government subsidised spending will increase by about a third. Finance minister Nirmala Sitharaman claims that the current investment in public infrastructure will bolster private commerce in India. The central government budget for the current year is expected to be 6.4 % in the red, which is still sufficient to keep India's debt ratio (public sector debt to GDP) roughly unchanged at around 83 %.

India's monetary conditions are fairly stable at the moment. The latest available figures from May show consumer prices rising at just 4.3 % p.a., which is close to the central bank's 4 % inflation target. The latest trends suggest that the spike in India's annual inflation to around 7 % last summer and autumn on higher global commodity prices has largely subsided. The central bank expects inflation to remain within its 2–6 % target band for the current year. The monetary policy committee decided at its June meeting to keep the key steering rate (repo rate) unchanged at 6.5 %.

The purchasing manager indices for India have remained well above the neutral reading of 50 for the past 18 months



Sources: IHS Markit, Macrobond and BOFIT.

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Russia

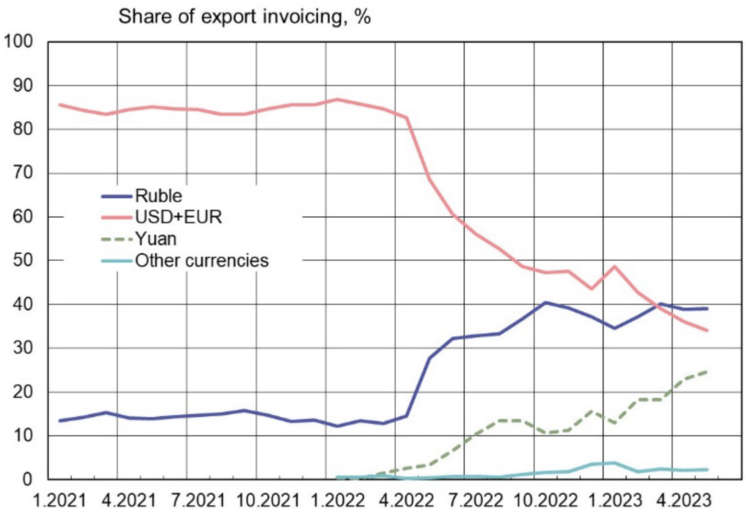
Yuan's role in Russia's foreign trade continues to grow. As a result of sanctions and the decision by many Western firms to sever ties with Russia, most major Russian banks no longer can handle payment traffic in dollars and euros. During the war, Russia has tried to move away from the main global trading currencies in its foreign trade. President Vladimir Putin has decreed, for example, that natural gas contracts should be invoiced in rubles. To develop a new export customer base, Russia is offering deep discounts in crude oil and petroleum products, with the option of paying for the purchases in other currencies.

For the first time since Russia's invasion of Ukraine last year, the Central Bank of Russia has released a breakdown of Russia's foreign trade payments. According to the data, the share of currencies of "unfriendly" countries (mainly the US dollar and euro) in invoicing exports of goods and services had declined to about a third, while the ruble's share had climbed to nearly 40 %. All other currencies accounted for just under 30 %.

There has been a substantial change over the past two years. Before the invasion, the combined share of the dollar and euro in export invoicing was about 85 %, with the ruble's share at just over 10 %. The "other currencies" category, which includes the Chinese yuan, the Indian rupee and the UAE dirham, was close to zero, but today exceeds 25 %. The "other currencies" component is especially large for Russian exports to countries in Asia (34 %) and Africa (32 %). Elsewhere, "other currencies" are rarely used in trade with Russia. The trading currency data release in conjunction with the CBR's latest financial market stability report suggest that Chinese yuan's portion of the "other currencies" in payments was overwhelming. Indeed, the yuan's share in export invoicing already reached 25 % in May.

The data also fit with reporting on the shift in oil exports to Asia (including China and India) to the use of currencies other than the US dollar in payment. It is worth remembering that Russia's main export products are still basic commodities, the price of which at generally set in US dollars. Therefore, in many cases, the invoicing currency in Russian exports differs from the currency used in price-setting. Moreover, payment of oil & gas taxed to Russia's federal budget are still based on oil prices in US dollars. The US dollar remains unchallenged as the global reserve and pricing currency, so even large changes in Russia's foreign trade practices can only have a negligible impact.

In the last 15 months, there has been a significant shift in Russian foreign trade payments in favour of the ruble and yuan

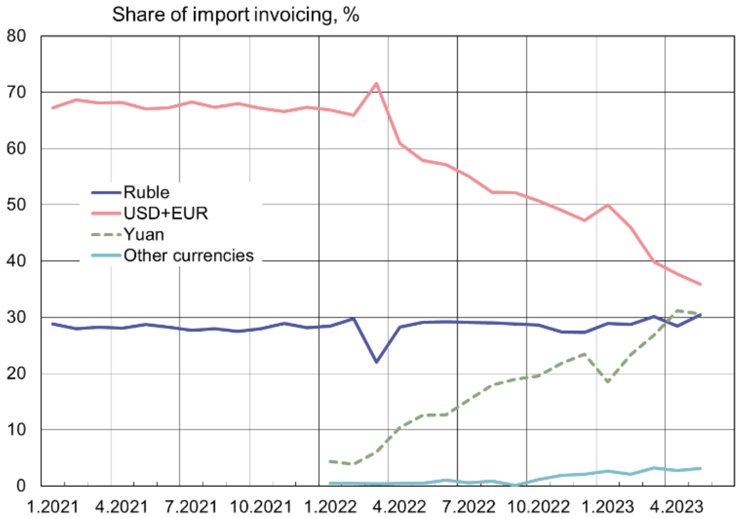


Sources: CBR balance-of-payments payment currency data (CBR credit statistics Excel file download) and CBR financial market stability report 6/2023 (in Russian).

Yuan increasingly used as invoicing currency for Russian imports. With the shift in geographic emphasis of Russian imports to Asia, the use of the yuan as an invoicing currency has grown significantly. Prior to the war, the dollar's share of imports was about 35 %, the euro's share approximately 30 % and all other currencies only a few percent at most. In May, the combined share of the dollars and euro in import invoicing was only a bit more than a third, while the yuan's share had climbed to about 30 %. The change highlights the geographic shift in trade; Russia's EU imports are only about half their pre-war levels.

The yuan appears to have replaced Western currencies in Russia-China bilateral trade. While Russia currently has stopped releasing country-level data, about 70 % of Russia's imports from China in 2021 were paid for in Western currencies and about 25 % in "other currencies" (mostly yuan). The CBR reports that only about half of May imports coming from Asian countries were invoiced either in rubles or Western currencies. Unlike in exports, Russia has not succeeded in increasing ruble use in imports. For the months of April and May, the yuan's share in invoicing was already larger than the ruble's share. Most payments for imports coming from member countries of the Eurasian Economic Union have historically been paid for in rubles.

Use of the dollar and euro in Russian imports has also decreased steadily over the past 15 months



Sources: CBR balance-of-payments payment currency data (CBR credit statistics Excel file download) and CBR financial market stability report 6/2023 (in Russian).

The CBR reports that at the monthly level payments for imports in euros and yuan have been larger than export revenues in these two currencies, implying that a portion of ruble- and dollar-based export revenues have been converted to yuan and euros. Russia's efforts to move away from dollar-based trade and find different import providers have clearly boosted demand for Chinese yuan inside Russia. The yuan was only introduced as a traded currency on the Moscow Exchange's foreign currency market a year ago, but its share of trading has grown steadily. In June this year, ruble-yuan trades represented 36 % of currency market trading in Russia. The other top currency pairings still involve dollar or euro. In addition, the CBR's forex operations under the government's fiscal rule are currently conducted in yuan.

The yuan's importance in the banking sector is still limited, but growing. For example, corporate forex deposits not denominated in dollars or euros have risen from close to zero last year to about 40 % at present. While the stock of forex loans has generally shrunk, its composition has changed considerably. Share of loans issued in "other currencies" has risen to about 20 %. Although the reporting does not give a detailed breakdown of currencies, the yuan apparently dominates the "other currencies" category. Broader use of the yuan is impeded by the fact that the yuan is not a freely convertible currency. The yuan only accounts for a few percent of global currency trading and over-the-counter (OTC) derivatives trading conducted by banks (BOFIT Weekly 24/2022). In addition, large Chinese banks are extremely wary of doing business with counterparties subject to sanctions.

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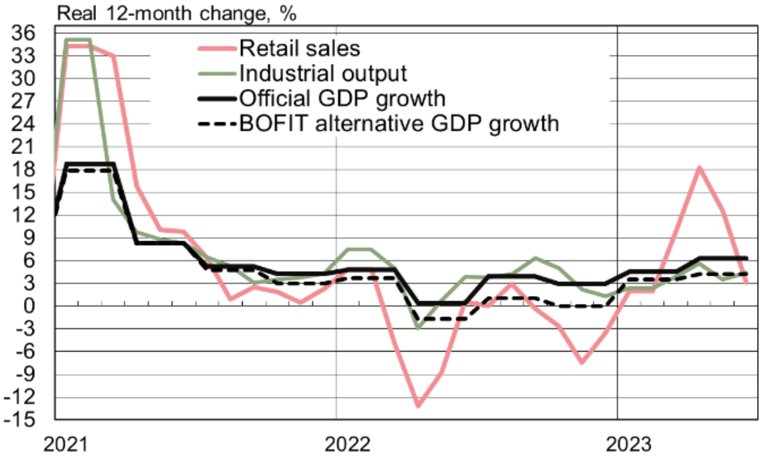
China

Economic growth in China slowed in the second quarter of this year. China's National Bureau of Statistic (NBS) reports GDP grew 6.3 % year-on-year in the second quarter, up from 4.5 % in the first quarter. However, the growth acceleration from the first quarter was largely due to the low basis reference of 2Q22. On-quarter growth in the second quarter was just 0.8 %, well below the 2.2 % growth posted in the first quarter. The slowing of economic growth reflects weak private demand, the ongoing struggles in China's real estate sector and subdued export demand.

The growth spurt after the ending of covid restrictions seems to have been short-lived. BOFIT's alternative calculations of Chinese GDP growth suggest that the pace of growth in the second quarter was a couple percentage points lower than official figures. According the China's official figures, nearly two-thirds of 2Q GDP growth came from the service sector, and around third from manufacturing and construction. NBS figures show that the value-added in the service sector rose by 7.4 % y-o-y. Value-added was up by 4.5 % in manufacturing and 8 % in the construction sector.

On average, in the first half of this year, real disposable income growth kept pace with GDP growth (up 5.8 %), but was clearly lower in urban areas (4.7 %). Real growth in retail sales slowed to just 3.1 % in June, while consumer price inflation fell to zero. The fall in inflation was contributed especially by housing-related services and products (down 0.5 % y-o-y), as well as transport and communications services, the category that includes vehicle fuel prices (down 6.5 %). Food prices rose by 2 %, while education, cultural activities and recreational services were up by 1.5 %. June producer prices fell by 5.4 % y-o-y. The biggest drop in producer prices was seen in the mining & quarrying sector (down 16 %) and raw material industries (down 10 %). Producers prices for consumer durable goods, for example, were down by just 1.5 %.

The much-anticipated growth spurt in China's post-lockdown economy seems to have fizzled out



Real growth in retail sales based on consumer price inflation

Sources: NBS, CEIC, Macrobond and BOFIT.

Industrial output was up by nearly 5 % y-o-y in June and about 4 % higher for the first half of this year. Particularly high growth was posted in manufacturing of solar panels (up 55 % in 1H23 from a year earlier), electrical vehicle (up 35 %) and industrial computers and systems (up 34 %).

Non-growth in China's foreign trade is now well into its second year following the strong performance in 2021. In June the value of exports was down by 14 % in dollar terms. For all of the second quarter, the value of exports was down by more than 5 %. The value of imports in June fell by 8 % in dollar terms, while the decline for the second quarter was 7 % overall. Part of the drop in dollar terms is a reflection of yuan depreciation against the dollar and falling prices. According the figures from China Customs, export volume were up by about 3 % y-o-y in the second quarter, while import volumes grew by 6 %. Volumes of both exports and imports have contracted by 1 % over the past twelve months.

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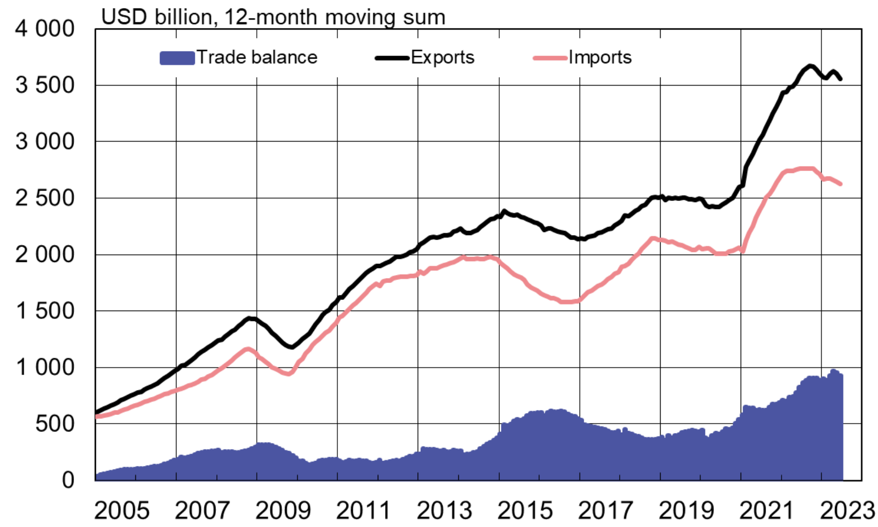
BOFIT

Chinese foreign trade growth has been stalled for over a year



Sources: China Customs, CEIC and BOFIT.

China's real estate sector continues to struggle. After a few months of stability, apartment sales, measured both in terms of yuan valuation and square metres of floorspace, started to decline again. The number of new building starts continues to plunge. The volume of new production measured by floorspace in June reached a level not seen since 2009. In the first half of this year, the real estate sector's investments were off by 14 % from a year earlier. Even so, there has been progress in clearing some of the backlog of uncompleted construction projects. Measured in floorspace, the volume of completed buildings increased from a year earlier for the sixth straight months in a row. In June, 15 % more buildings were completed than in the same period a year earlier, and the number of unfinished projects fell by 7 %. The NBS reports that housing price trends remain tepid.

The loan stock of banks grew by about 12 % y-o-y in June. Most growth came from corporate lending as the total stock of lending to households rose by just 3 % y-o-y. On-year growth in China's broad measure, total social financing, which was up by over 9 % in the second quarter, has remained well above the pace of GDP growth and the debt levels have continued to climb. The bank loan stock relative to GDP rose to 186 % in the second quarter. China's total debt-to-GDP ratio, which combines private and public-sector debt, hit 295 % in June, 13 percentage points higher than in June 2022. The fiscal condition of local governments has become a source of particular concern for the country's leaders.

Politburo signals need for increased stimulus spending. The politburo of the Communist Party of China (CPC) met on Monday (July 24). The July meeting typically deals with economic policy issues for the rest of the year. The statement released from this year's meeting acknowledged the country's difficult economic situation and announced the need of actions to get economic growth back on track. Among other things, the politburo's statement emphasised the need to bolster domestic demand, improve investor confidence and reduce risks associated with the indebtedness of local governments. It is likely that concrete stimulus measures will be announced in coming months.

With respect to the real estate sector, perhaps the most important change went unsaid. For the first time in years, Xi Jinping's "houses are for living, not speculation" mantra was removed. This could point towards more demand-side stimulus, for example, an easing of restrictions on apartment buyers. The government has already abandoned most regulations initially intended to decrease China's major developers debt (BOFIT Weekly 06/2023).

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Real 12-month changes and consumer prices, %

	2021	2022	4Q2022	1Q2023	2Q2023
GDP	8.4	3	2.9	4.5	6.3
	2021	**2022**	**April 23**	**May 23**	**June 23**
Industrial output	9.6	3.6	5.6	3.5	4.4
Retail sales	10.7	-2.2	18.3	12.5	3.1
Goods exports	17.4	-1.3	10.9	-0.3	-1.8
Goods imports	7.7	-6.6	4.4	7.1	6.5
Inflation	0.9	2.0	0.1	0.2	0.0
Yuan-dollar rate, avg.	6.45	6.74	6.89	7.01	7.20

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

IMF raises its forecast for global economic growth. In its latest World Economic Outlook released this week, the International Monetary Fund now sees annual global growth reaching 3.0 % both this year and next. Thanks to a better-than-expected start of the year, the July forecast was adjusted by 0.2 percentage point upwards from the previous April forecast. On-year growth will still come in below last year's figure (3.5 %) as well as the long-term (2000–2019) average of 3.8 %. In developed economies, growth is expected to slow from 2.7 % last year to 1.5 % this year. In contrast, economic growth in developing countries this year is expected to remain at the same level as last year (4.0 %). There is, of course, considerable variation across developing countries.

Higher-than-expected global growth has been sustained by the recovery in consumption of services after the ending of covid-era restrictions. However, it starts to reach pre-pandemic levels, so the pace of growth should slow. In contrast, the slowing of growth in industrial output and fixed investment has been most pronounced in developed economies, a situation that reduces export demand for developing economies.

The IMF forecasts for China 5.2 % growth this year and 4.5 % next year. After fast growth in the first quarter of the year, economic activity has unexpectedly slowed in recent months (see China weekly review this week). The IMF raised its growth outlook for Russia to 1.5 % due to fairly strong growth in the first half, while it expects Indian growth to come in at 6.1 % this year. The Asian Development Bank also released its 2023 economic outlook last week. The ADB's forecast for China closely aligns with the IMF, anticipating 5.0 % growth this year and 4.5 % next year. The ADB expects somewhat higher growth for India: 6.4 % this year and 6.7 % next year.

The IMF points out that any slower-than-expected abatement of inflation poses a risk to global economic growth. While energy and food prices have fallen from their 2022 highs, core inflation, which excludes volatile food and energy prices, has remained stubbornly high. On the bright side, a faster-than-expected drop in inflation would grant central banks an opportunity to relax their monetary stances, thereby improving the global growth outlook. In addition to worries about inflation, the IMF identified the threat to global economic growth from effects of potential heating-up of the war in Ukraine and larger-than-expected impacts from El Niño ocean surface warming to food production.

IMF's July GDP growth projections, % (April 2023 figures in parentheses)

	2021	2022	e2023	e2024
World	**6.3**	**3.5**	**3.0 (2.8)**	**3.0 (3.0)**
Developed economies	**5.4**	**2.7**	**1.5 (1.3)**	**1.4 (1.4)**
Developing economies	**6.8**	**4.0**	**4.0 (3.9)**	**4.1 (4.2)**
China	8.4	3.0	5.2 (5.2)	4.5 (4.5)
Russia	5.6	-2.1	1.5 (0.7)	1.3 (1.3)
India	9.1	7.2	6.1 (5.9)	6.3 (6.3)

Source: IMF World Economic Outlook, July 2023.

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Weekly Review
31 • 4.8.2023

BOFIT

Russia

Russian production and imports recovered, government still posts large deficit

Increases in production, consumption, employment and imports. The Russian economy has recovered from the downturn of spring 2022. The latest forecasts point to recovery of GDP this year. The IMF's forecast now sees GDP growth of 1.5 % this year, while the Bank of Russia forecast expects growth in the range of 1.5–2.5 %. The July forecast average published by Consensus Economics puts growth this year at around half a per cent.

After several consecutive months of recovery, growth in seasonally adjusted industrial output yet stalled in June. The situation was about the same in both mining & quarrying and manufacturing. Mining & quarrying output has increased slowly since the start of the year, while manufacturing output has grown considerably. Manufacturing output in May-June was up by about 8 % from the same period two years ago.

The rise in manufacturing has been driven by those industrial branches that benefit from higher military spending such as metal products, electronics, electrical machinery & equipment, and manufacture of vehicles other than automobiles. During the first six months of this year almost three quarters of the over 6 % y-o-y growth in manufacturing came from these four branches.

Growth in construction activity plateaued in June, but construction was still up 10 % y-o-y thanks to steady growth for over a year. The on-year volume of goods transport fell due to decreased pipeline transmission of oil & gas. Rail transport increased only slightly. In contrast, growth in road transport remained rapid as in 2022. Passenger ridership on public transport, which already grew last year, was up further this year for both bus and especially rail transport.

The recovery in private consumption from the spring 2022 slump has continued. In the second quarter of this year, household spending on purchases of goods and services, as well as retail sales, were up 9–10 % y-o-y in real terms from last year's downturn and roughly at the same level as in spring 2021. Real household incomes continued to rise and were up a few percent from two years earlier. The rise in real wages accelerated.

Employment in the second quarter was up by over 2 % y-o-y (2Q22 saw a rise of 0.5 % y-o-y as well). The number of people in the labour force in the second quarter was also up by nearly one and half a per from 2Q22. People starting to work came not only from unemployed persons but to a significant degree from people outside the labour force. Thus, Russia's employment rate has risen significantly.

Russia's imports have bounced back on the economic recovery. Russian spending on imports was up by more than 30 % y-o-y in the second quarter and slightly higher than two years ago. The rise in the real volume of imports has been somewhat more moderate as import prices have risen quite a bit this year (export prices in many of the countries that export to Russia have risen rather quickly).

Government budget revenues recovered while spending growth slowed; deficit still substantial. Government revenues have risen in recent months. Nominal revenues to the consolidated budget (federal, regional and municipal budgets plus government social funds) were up in March-May by over 15 % y-o-y. Budget revenues have increased significantly on higher output and wages, a rapid recovery of imports as well as corporate profits. In addition, the rise in budget revenues in real terms has been supported by an on-year slowdown in the rise of consumer prices and an on-year drop in producer prices for manufactures. Federal budget revenues in April-June were still down from twelve months previous as they remained depressed from the sharp slide in revenues from oil & gas taxes. The price of Urals blend crude oil has been much lower this year than a year ago, although oil tax revenues in ruble terms have been buoyed in recent months by the ruble's low exchange rate compared to spring 2022.

On-year growth in consolidated budget spending slowed in late spring to around 10 %. Federal budget spending growth eased to a slightly lower pace. The budget deficit that accrues basically to the federal budget has remained for its 12-month running sum at around 4.5–5 % of GDP in recent months.

On July 27, the Bank of Russia raised its key rate by 100 basis points to 8.5 %. The Bank noted that production is not meeting the increase in domestic demand, which has added to inflationary pressure.

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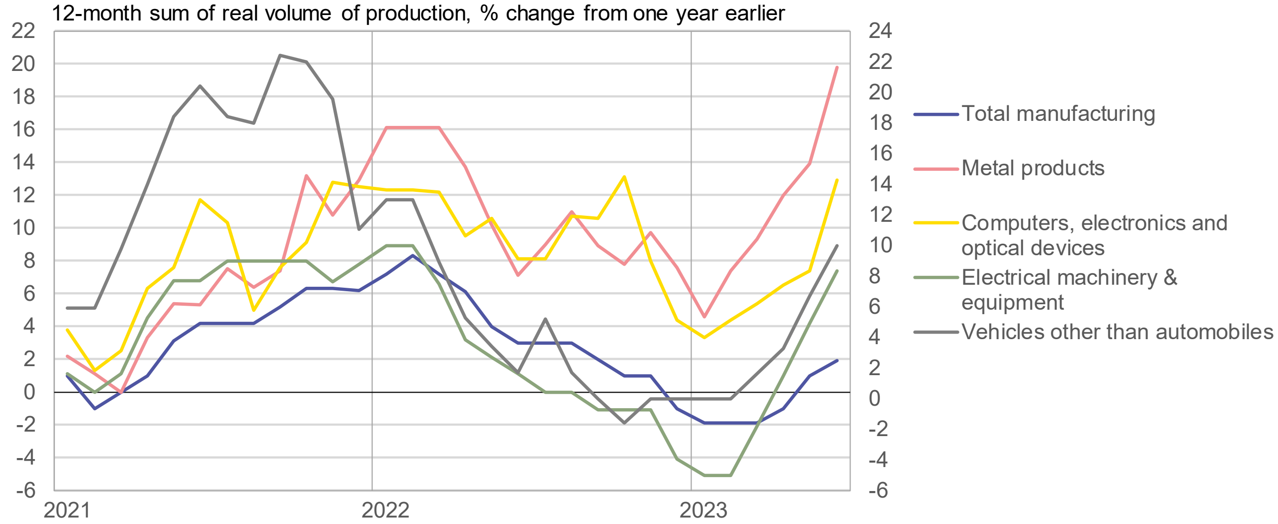
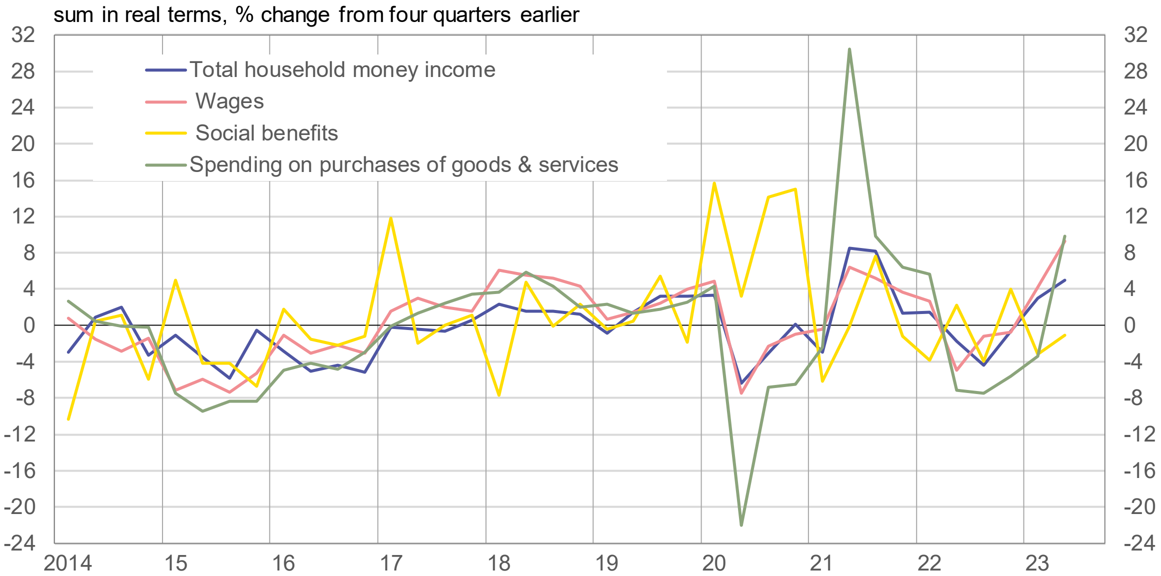
The increase in manufacturing output in Russia has been led by metal products and certain branches of the machinery & equipment industry



Sources: Rosstat and BOFIT.

Household wage incomes and consumption have recovered since last year’s decline



Sources: Rosstat and BOFIT.

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BOFIT

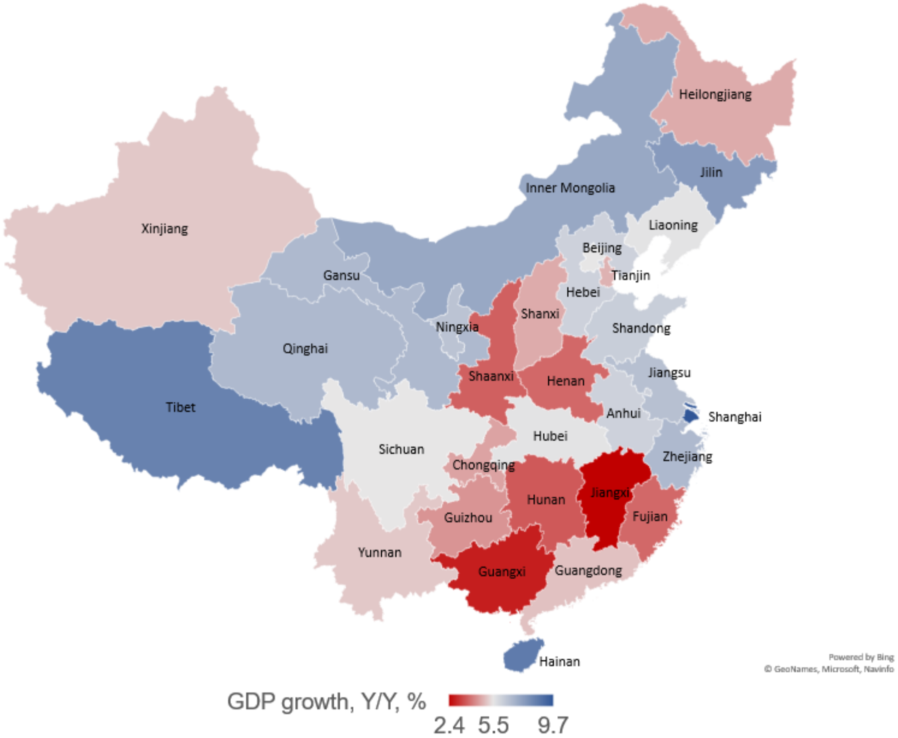
China

Economic growth in provinces of central and southern China lower than in the rest of the country. In the first half of 2023, economic growth in 16 of China's 31 provinces did not surpass the national average for on-year GDP growth of 5.5 %. The lowest growth numbers were posted in central and southern coastal provinces. GDP growth remained below 3 % in the heavily agrarian southern provinces of Jiangxi and Guangxi. Below-average growth also occurred in the southeastern coastal province of Fujian, as well as the interior provinces of Henan and Hunan, where the largest contributors to economic growth are agriculture, raw material production and manufacturing.

Among all province-level administrative regions, Shanghai registered the highest growth (9.7 %), a somewhat deceptive number due to the exceptionally low reference basis due to covid lockdowns of spring 2022. Shanghai's 3 % first-quarter growth was distinctly more modest and lagged the pace of national GDP growth. Guangdon, the country's largest province, also experienced below-average GDP growth this year (5 % in 1H23). The southern coast province's economy is highly dependent on foreign trade and industry, core sectors that have slowed throughout China. Jiangsu, China's second largest provincial economy, recorded substantially higher growth (6.6 %). Jiangsu's economic structure is quite diverse. In addition to agriculture, the province is a major producer of e.g. raw materials, electronics, chemicals, cars and renewable energy equipment. This populous province is also a major tourist destination, allowing for a thriving service sector.

The revival of tourism has also benefitted China's southern island province of Hainan, as well as the highlands of Tibet. In both provinces, GDP growth in January-June climbed to around 8.5 % y-o-y. Rapid growth was also posted in Jilin (7.7 %), renowned for its auto and rail industries, as well as in Inner Mongolia (7.3 %), helped by strong growth in exports of machinery & equipment.

Provincial GDP in January-June 2023 was below the on-year national growth rate of 5.5 % in central and southern China



Sources: NBS, regional statistical agencies and BOFIT.

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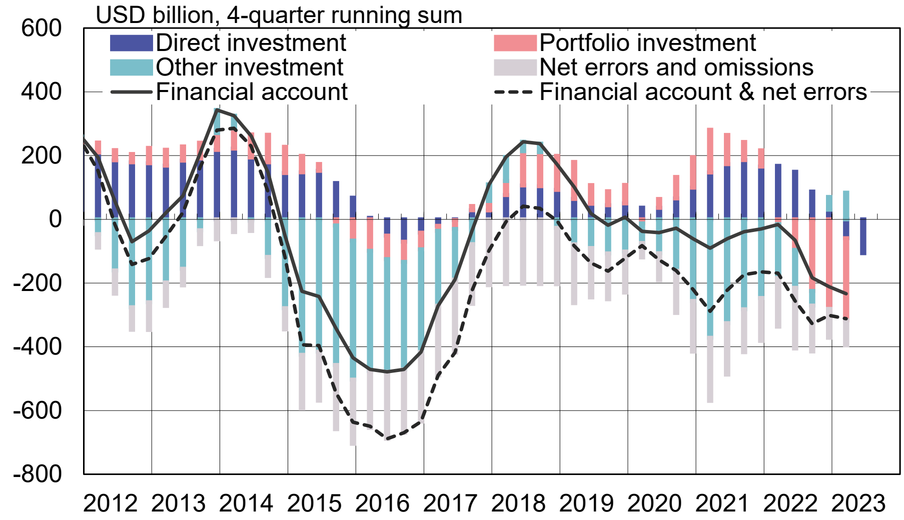
BOFIT

China's large current account surplus persists; capital outflow continues. According to preliminary balance-of-payments figures, China's current account surplus in the second quarter was 65 billion dollars, a modest drop from the 82 billion dollars surplus of the first quarter. The goods trade surplus increased in the second quarter to 163 billion dollars. At the same time, the services deficit continued to widen (55 billion dollars in the second quarter), due in part to the recovery in international travel that has boosted the deficit in tourism and transport services.

The balance-of-payments figures reveal that the outflows of direct investment from China surpassed the investment inflows in both the first and second quarters. Capital flight in the first quarter was also driven by portfolio investment, as the portfolio deficit increased to 56 billion dollars. As the current account remained in surplus, and there was little change in China's foreign reserves (down by 16 billion dollars), it seems that capital continued to flow out of the country in the second quarter either through recorded (other items in the financial account) or unrecorded items (b-o-p "net errors and omissions" term). More granular second-quarter financial account data will be released later with revised figures for current account items.

For all of last year, China's goods trade surplus rose to 669 billion dollars, an increase of nearly 20 % y-o-y. The services trade deficit in 2022 shrank by nearly 10 % (92 billion dollars) from year before. As a result, the overall current account surplus rose to 402 billion dollars or 2.2 % of GDP (the 2021 current account surplus was 353 billion dollars or about 2 % of GDP). Last year's overall financial account deficit was 211 billion dollars. The largest deficit among financial account items was recorded for portfolio investment (281 billion dollars), while the derivatives balance was also slightly in the red (6 billion dollars). The direct investment account last year last year still ran a slight surplus (30 billion dollars).

Securities investment accounted for the single largest stream of capital outflow from China last year



Sources: SAFE, Macrobond and BOFIT.

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BOFIT

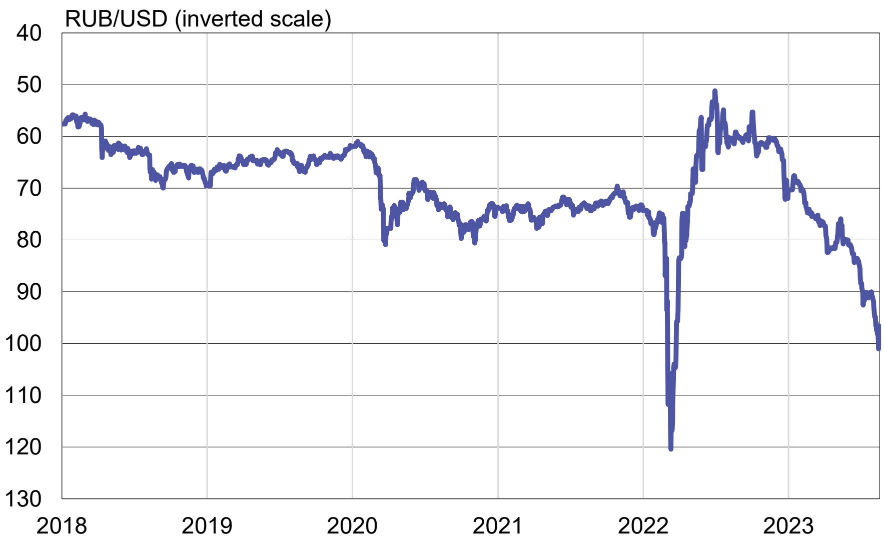
Russia

Ruble plummets as Russia's current account surplus evaporates. The ruble's exchange rate in August reached its lowest reading against the US dollar since spring 2022. The official ruble-dollar exchange rate this week crept above 100, making the ruble worth less than one US cent. The ruble has lost about 40 % of its value since last August.

To quell inflationary pressures caused by the ruble's dramatic slide and constraints on domestic demand, the Central Bank of Russia raised its key rate by 350 basis points at an unscheduled meeting on August 15. The key rate currently stands at 12 %. Media reports claim that reinstatement of various currency controls in Russia is under discussion.

The ruble's vanishing value mainly signals the end to an episode of exceptionally high current account surpluses. The preliminary CBR estimate is that the current account surplus for January-July this year was just 25 billion dollars, or 85 % less than in the same seven-month period last year. A BOFIT blog post (in Finnish) this week deals specifically with the implications of Russia's growing imbalances.

The ruble has lost considerable value against the US dollar this year



Sources: Macrobond and BOFIT.

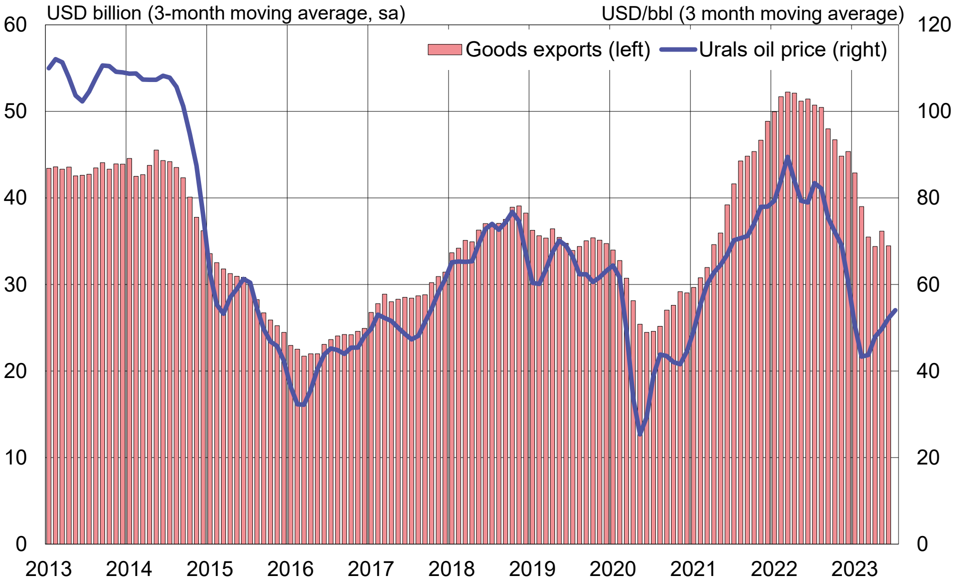
Russian export earnings down, but nowhere near historical lows. Russia's export earnings in the first half shrank considerably from last year's record highs. According to preliminary CBR figures, the value of goods exports in January-June was a third less than a year earlier. Export revenues were hurt most by lower prices due to global market developments and sanctions on Russian exports. The volume of Russian natural gas exports has also contracted sharply with Russia's decision to cease supplying pipeline natural gas to many EU countries. The value of goods exports is nowhere near the historical lows of the past decade, but hovering around the same level as in the first half of 2019.

The International Energy Agency (IEA) estimates that the average price of Urals blend crude oil was 48 dollars a barrel in January-June, or about 40 % less than a year earlier. The volume of Russian crude oil exports in the first half shrank by about 4 % y-o-y. The combined volume of exports of crude oil and petroleum products in 1H23 remained at the same level as a year earlier. Nearly 60 % of Russia's total oil exports (crude oil and refined petroleum products) now go to China and India.

The volume of Russian oil exports has been declining in recent months and has been accompanied by a rise in the export price of Urals crude. The IEA estimates that in July Russia produced slightly less oil than was allowed under its OPEC+ agreement quota. Russia has also said it will reduce oil exports during August and September. The IEA estimates that the average price of Urals crude rose above the 60-dollar mark in July and exceeded 70 dollars a barrel in the first days of August. Prices of all oil grades have risen in recent weeks. The price difference between Urals and other oil grades has also narrowed.

Under the price ceiling mechanism imposed on Russian oil by G7 countries and the EU, corporations headquartered in these countries are not allowed to provide services like shipping or insurance related to sea cargoes of Russian oil if the contracted price of the oil exceeds 60 dollars a barrel. According to the IEA, in recent months about 70 % of Russian crude oil shipments have involved transport or insurance provided by companies based in G7 countries.

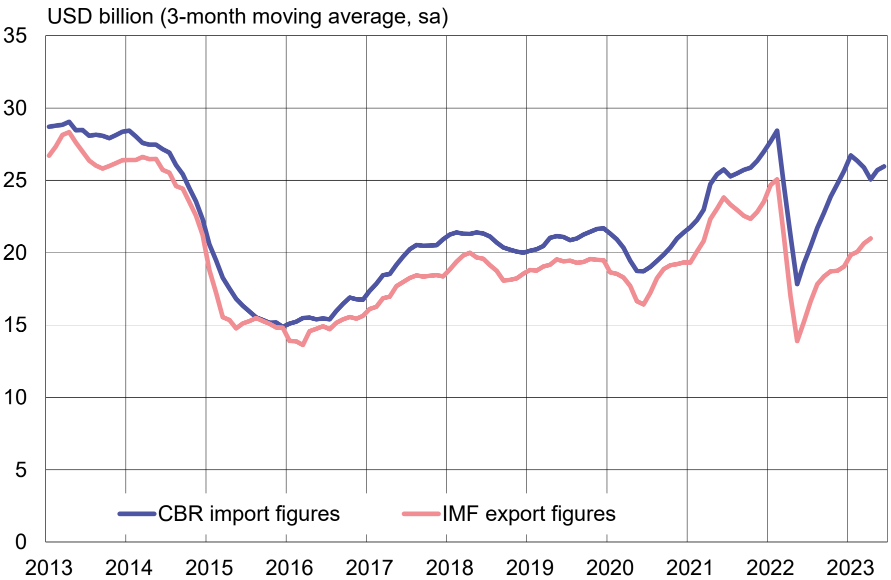
The value of Russian goods exports has contracted due to lower oil prices, but is still above historical lows



Sources: Central Bank of Russia, Macrobond, IEA and BOFIT.

Slower recovery for Russia's technology imports than for other imports. Russian imports have recovered gradually since the sharp decline of spring 2022. Preliminary CBR figures show that in recent months the value of goods imports (seasonally adjusted) has stabilised at roughly the same level as the 2021 average, but was still slightly lower than in the months leading up to the February 2022 invasion of Ukraine. The IMF's export figures, which cover nearly all countries, allow for mirror calculation of Russian imports. While the numbers of countries exporting to Russia generally show the same trends as noted by the CBR import figures, the mirror export figures suggest a slightly slower recovery in Russian imports.

Russian goods imports have recovered to near pre-invasion levels



Sources: CBR, IMF DOTS and BOFIT.

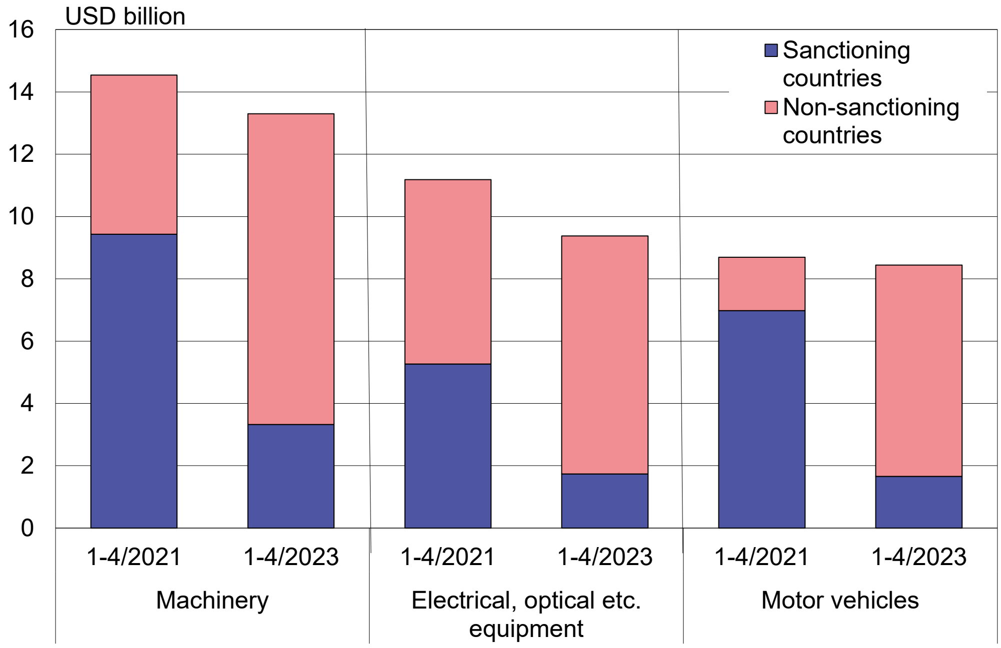
Russian Customs has ceased to regularly publish foreign trade figures, so up-to-date official statistical breakdowns of Russian imports by country of origin and product category are unavailable. Mirror statistics of Russia's trading partners can also be used to evaluate shifts in Russia's trade structure.

Based on the estimates of about 80 countries' goods exports to Russia, the value of exports was down in January-April by about 6 % from the corresponding time period in 2021. Imports of technology products have recovered more slowly than imports generally. Imports of electrical, optical and similar equipment were still down by about 15 % in January-April from the same period in 2021. The value of machinery imports was also down by nearly 10 %. In contrast, car imports were only down by 3 % and imports of other goods were at about at the same level as in January-April 2021. The trend in the volume of imports is likely weaker than the import value trend as prices of many imported goods and shipping costs have risen.

Imports of technology products have recovered more slowly due mainly to Western sanctions. While export restrictions focus on technology products, tech exports to Russia are generally not banned. Moreover, sanctions on exports of passenger cars typically only apply to high-end models.

Based on IMF export figures, the EU accounted for about 20 % of Russian goods imports, while China and Hong Kong provided about 40 % of imports, followed by the countries of the Eurasian Economic Union with about 15 % and Turkey with 5 %.

Russia's imports of technology products have yet to recover to 2021 levels according to mirror statistics



Sources: Global Trade Tracker, Kazakhstan Bureau of National Statistics and BOFIT.

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BOFIT

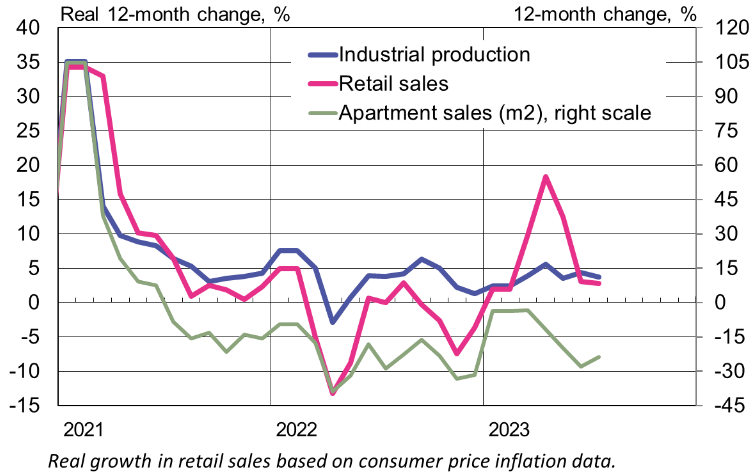
China

China posts modest July growth numbers; problems persist in real estate sector. Nominal growth in retail sales slowed in July to just 2.5 % y-o-y. Real retail sales growth adjusted for consumer price inflation was below 3 %. The service sector purchasing managers indices (PMI) were still well above the neutral reading of 50 in July. Restaurant services, for example, grew by nearly 17 % y-o-y in nominal terms.

Industrial output was up in July by nearly 4 % y-o-y, roughly matching the average pace for January-June, but still a couple percentage points lower than the pre-pandemic levels of 2019. On-year growth above 10 % was posted for metal and chemical industries, as well as for production of electrical machinery & equipment. The largest declines were recorded for ore excavation and production of various consumer goods (clothing, houseware, sports equipment). The pace of industrial output growth is slow partly due to weak export demand, suggesting that foreign trade currently does not serve as an engine for economic growth. Exports contracted in July by 15 % y-o-y in dollar terms, while imports were down a bit less (- 13 %).

Even with nominal growth in fixed asset investment (FAI) of 3.4 % in January-July, seasonally adjusted monthly growth figures from the National Bureau of Statistics (NBS) showed zero growth in July (the second consecutive no-growth month). Real estate investment continued to decline (down by 18 % y-o-y in nominal terms).

The pace of growth of industrial output and retail sales slowed slightly in July



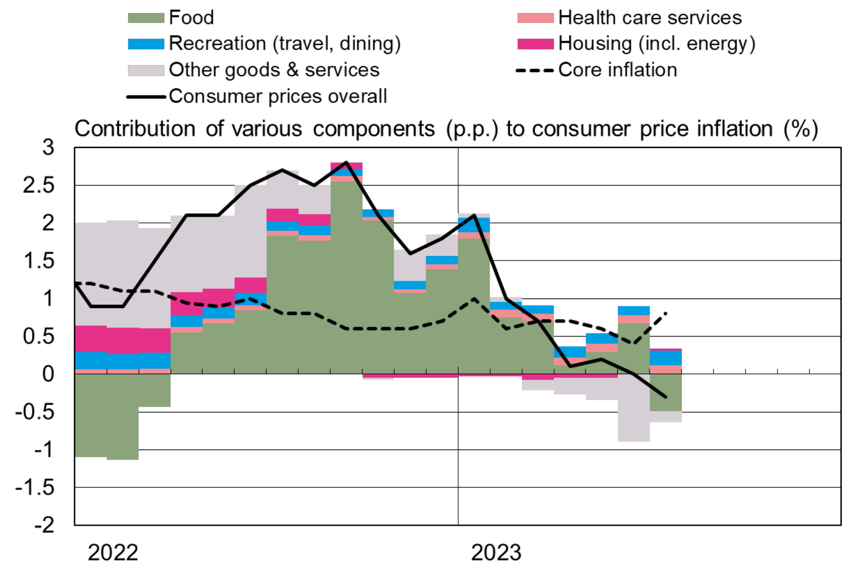
Sources: NBS, Macrobond, CEIC and BOFIT.

China's consumer price inflation turned negative in July, mainly because of on-year declines in food and energy prices. Due to their high volatility, food and energy are excluded from the calculation of core inflation, which was up by 0.8 % in July (0.4 % in June).

China's most important consumer price inflation category is food, tobacco and alcohol, which has a relatively large 29 % weighting in the computational basket of consumer goods. Food has a much greater weight in the Chinese consumer basket than e.g. in the euro area or the US. In contrast, the impact of energy prices is typically smaller in China, due to the fact that most domestic energy prices are regulated or subject to state guidelines (BOFIT Weekly 14/2023). Prices of pork and pork products, which account for about a tenth of the entire food category, have experienced wild price swings since the 2019 outbreak of African swine fever virus. Indeed, pork prices are one of the largest single factors affecting consumer price inflation in China. Producer prices fell by 4.4 % y-o-y in July (down by 5.4 % in June). The biggest drops in producer prices were registered in the mining & quarrying sector (- 15 %) and in raw material production (- 7.6 %). The drop in industrial producer prices was more modest (- 3.8 %).

Chinese inflation has been restrained by slack consumer demand and administrative price regulation, as well as reduced pressure to raise wages. Chinese labour markets currently have significantly more available workers that in Europe or North America. Following the announcement that youth unemployment hit a record high of 21.3 % in June, the NBS declared that it was suspending further publication of such figures. Internal migration of workers from the countryside to cities in search of work continues to serve as China's largest domestic labour reserve and is the first to adjust to any shift in economic conditions (BOFIT Weekly 50/2022). Inflationary pressures for the rest of this year should be constrained by reduced overall demand and by the fact that the reference basis for the second half of 2022 was a period of relatively high food and energy prices.

The negative trend in Chinese consumer price inflation in July was largely driven by declining food and energy prices



Sources: NBS, Macrobond and BOFIT.

Problems of China's real estate sector persist; PBoC eases monetary stance slightly. Although real estate giant Evergrande became insolvent already a couple years ago, the company only sought bankruptcy protection in the US this month. Bankruptcy protection is meant to prevent US-based creditors from suing the company or confiscating assets. The declaration may indicate that the long-grinding negotiations on allocating Evergrande's debts have neared completion. The financial problems of other large developers have also recently made headlines. Country Garden, still China's largest developer as of last year, is currently struggling with serious payment issues. Even if Country Garden is carrying substantially less debt than Evergrande (often cited as the world's most indebted firm), it has nearly four times more domestic construction projects. Moreover, the problems of the sector are not confined to private developers. Bloomberg analysts report that 18 of China's 38 state-owned developers listed on the Hong Kong stock exchange have reported losses for the first half of this year. Eleven developers reported losses last year and just four in 2021.

With demand still withering, the government's efforts to correct problems in the real estate sector appear increasingly daunting. Real estate sales, measured either in yuan or by volume of floorspace, were down by about 25 % y-o-y in July. Construction starts were down by 27 % y-o-y. On the other hand, developers have managed to complete many previously stalled construction projects. This is politically important as apartment sales before their completion is a standard practice in China. In July, 33 % more apartments were completed than a year earlier, while the volume of buildings under construction declined by 7 % y-o-y. On-year growth in the stock of household loans slowed to 2.9 % in July. Growth in the stock of corporate loans remained just under 15 %.

In conjunctions with July's weak economic figures, the People's Bank of China cut its one-year medium-term lending facility (MLF) by 15 basis points to 2.5 % and its 7-day reverse repo rate by 10 basis points to 1.8 %. The PBoC rate cuts are intended to reduce bank refinancing costs. The size of the MLF rate cut was the largest since April 2020. MLF adjustments are usually followed within a few weeks by changes in the lending prime rate (LPR) used in setting bank lending rates. However, the five-year LPR used in pricing housing loans was left unchanged at 4.2 %, while the one-year LPR mainly used as the reference rate for pricing corporate loans was cut by 10 basis points to 3.45 %. The modest drop in lending rates likely reflects the already historically narrow interest margins of Chinese banks that are hurting profitability and would be squeezed further by additional loan rate cuts. Policy rate cuts also increase devaluation pressure on the yuan at a time when monetary officials are otherwise seeking to curb the recent slide in the yuan's external value.

Real 12-month change and consumer prices, %

	2021	2022	4Q2022	1Q2023	2Q2023
GDP	8.4	3	2.9	4.6	6.3
	2021	**2022**	**May 2023**	**June 2023**	**July 2023**
Industrial output	9.6	3.6	3.5	4.4	3.7
Retail sales	10.7	-2.2	12.5	3.1	2.8
Goods exports	17.4	-1.3	-0.3	-1.8	n/a
Goods imports	7.7	-6.6	7.1	6.5	n/a
Inflation	0.9	2.0	0.2	0.0	-0.3
Yuan-dollar rate, avg.	6.45	6.74	7.01	7.20	7.20

Sources: NBS, China Customs, WTO, CEIC and BOFIT.

Weekly Review
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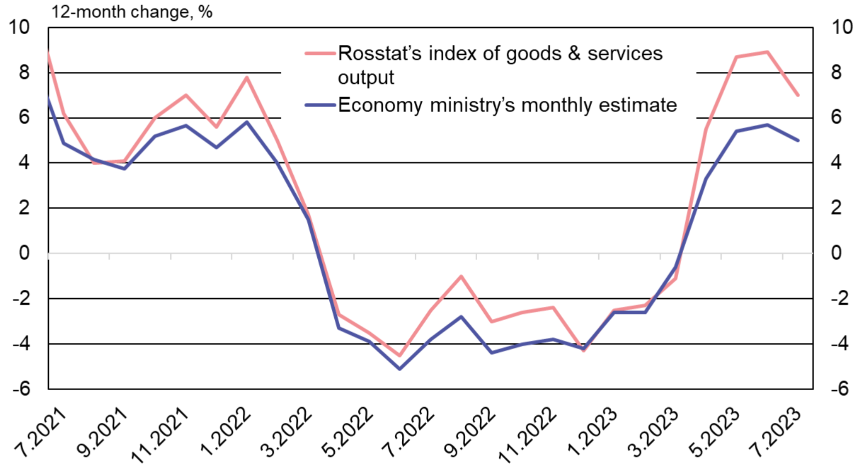
BOFIT

Russia

Russian growth supported by increased bank lending and heavy public spending

Russian economy again showed positive growth in July. Even with the pace of growth moderating in recent months, the latest Rosstat figures show that on-year growth remained strong in July. Growth was especially robust in service branches such as restaurant services (up 11 %) and retail sales (up 10.5 %). Some of the growth figures in these branches reflects the low reference basis of a year earlier. Growth in real wages and consumer credit helped fuel domestic demand for services. Private consumption was also supported by increased public spending on wages, social support and compensation to mobilised reservists.

The pace of economic growth has stabilised in recent months



Sources: Rosstat, Russian Ministry of Economic Development, CEIC, BOFIT.

Consolidated budget spending rose in nominal terms by 18 % y-o-y in the first six months of this year. Growth in federal budget spending focused on supplying the needs of the war effort, which was reflected in the high growth posted in some manufacturing branches. In July, industrial output overall grew by 4.9 % y-o-y. Vigorous growth continued to be registered in manufacturing branches associated with defence: “other metal products” (10 %), transport vehicles other than automobiles (67 %), computers and electronics including navigational devices (43 %), electrical equipment (30 %) and special-purpose clothing (40 %).

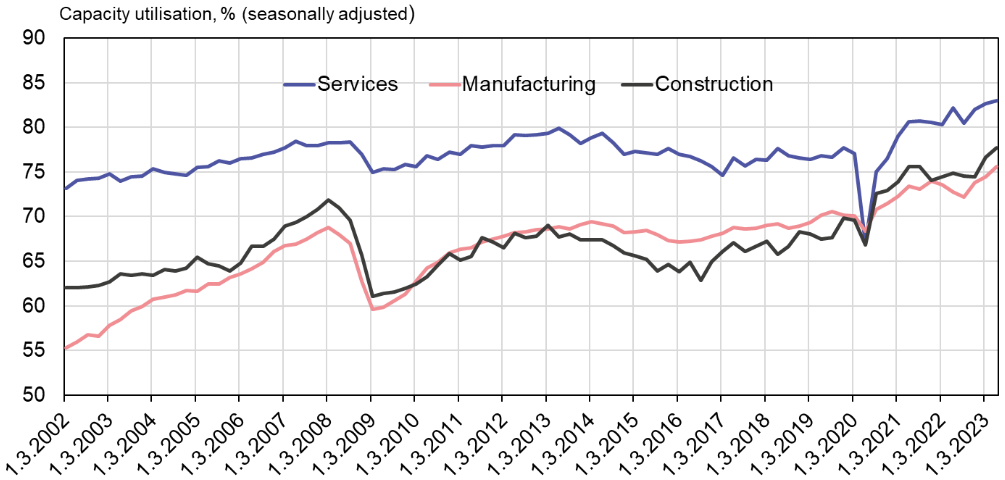
Some of the growth in defence spending was reflected in increased fixed investment. Rosstat reports that fixed investment growth accelerated in April-June, and for all of the first half was up by 7 % y-o-y. At the same time, the average share of direct budget outlays for financing of all fixed investment rose slightly to 17 %. Investment growth was highest in branches supporting the defence industry: “other metal products” (42 %), transport vehicles other than automobiles (29 %), computers and electronics including navigational devices (54 %), electrical equipment (36 %) and public administration (75 %), as well as pipeline transmission of natural gas (77 %).

Construction activity was up 7 % in July, even if growth slowed slightly. The contraction in housing construction that began late last year continued, however. The volume of completed apartments fell by 2 % y-o-y in July. Despite growth in the stock of housing loans, demand for new housing appears to have subsided.

The strong resurgence in domestic demand has left many branches swamped with orders. Utilisation of industrial capacity has reached all-time highs and unemployment has fallen to record lows. Many firms report that the lack of qualified workers is their biggest obstacle to growth. The production bottlenecks increase price pressures. As a result, both inflation and inflation expectations have increased again. Russia’s on-year inflation was 4.3 % in July and is expected to have reached 5 % in August.

Preliminary Rosstat figures show GDP contracted by 1.8 % y-o-y in the first quarter of this year and grew by 4.9 % in the second quarter. In January-June, growth reached 1.6 % y-o-y.

Capacity utilisation has reached all-time highs in production of both goods and services



Source: Central Bank of Russia.

Sharp increase in bank lending in the first half of 2023. The credit stock of firms was up 9 % at the end of July, and the household credit stock was up 11 % from the start of this year. The stock of corporate loans in July was up by 21 % y-o-y and household loans by 18 %. The growth in lending has been supported by government interest subsidy programmes and an improved outlook for the Russian economy.

Household borrowing, in particular, was substantially impacted by housing loan programmes introduced during the Covid-19 pandemic. At the start of 2022, the share of housing loans eligible for interest subsidies represented just 5 % of bank lending to households. Today, they account for over a quarter of all household loans. About half of the stock of housing loans now benefits from various forms of government interest subsidies. Demand for consumer loans and car loans dried up almost completely last year, but in the first half of this year demand has revived. As of end-July, the stock of consumer credit had grown by 13 % y-o-y and car loans by 19 %.

New corporate lending was up by about 25 % y-o-y in the first half of this year. The biggest borrowing increases were seen in the transport vehicle and chemical industries, retail and wholesale, as well as the real estate branch. With rapidly rising demand in these branches, capacity utilisation rates have been stretched to all-time highs. The growth in lending is also reflected in the revival of capital investment in these branches.

The currency allocation in bank lending has changed considerably since the outbreak of the Ukraine war. New foreign-currency loans are extremely rare and older loans have been redenominated either in rubles or Chinese yuan. At the beginning of 2022, about a quarter of corporate loans were in foreign currencies. As of July this year, forex loans accounted for just 17 % of the total loan stock. The yuan's share of forex loans has risen from zero to around 20 %.

The tightening of CBR's monetary stance and hike in its key rate to 12 % (BOFIT Weekly 33/2023) are expected to slow the pace of lending growth in the months ahead. Interest rates on new corporate loans and consumer credit generally react rapidly to changes in the key rate. Changes in housing loan servicing costs, in contrast, tend to be quite modest. The finance ministry reports that the subsidized interest rate on loans to first-time apartment buyers will remain at 8 % despite the key rate hike. Loans to households are typically fixed rate, so fluctuations in interest rates have little impact on household loan payments.

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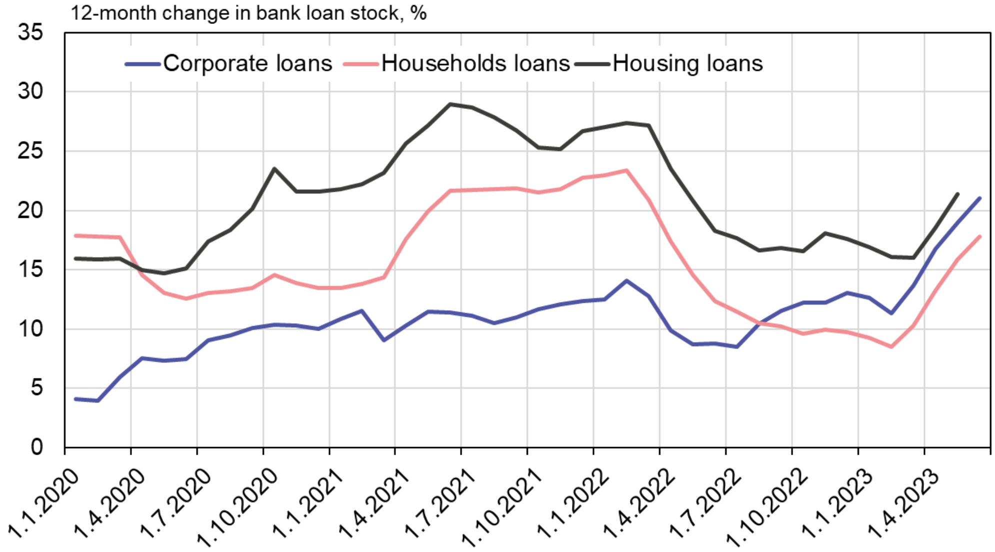
Bank lending in Russia has increased rapidly this year



Source: Central Bank of Russia.

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China

China using many small measures to support the economy. With China's economic growth slowing, most institutional forecasters now see GDP growth falling a bit below the official government target of 5 % this year. To combat cooling growth, Chinese officials have responded with a slew of support measures targeting specific sectors or regions. Most significantly, China seems to have resisted the use of its classic support measure – a massive stimulus programme based on fixed investment. Indeed, the idea of boosting fixed investment is scarcely mentioned, which is a welcome change as more investment-fuelled stimulus would only exacerbate China's misallocation of capital and increase its already stratospheric debt levels. While it is difficult to assess the cumulative impact of many small actions, the general view is that the announced measures are insufficient to reverse the slowdown in economic growth. Consumer confidence continues to be weak, many branches suffer from overcapacity, export growth has stalled and local governments have limited stimulus options available.

China's struggling real estate sector has been a central focus of current support efforts. Already last December, the government declared stabilisation of the real estate sector as a top priority for 2023. At end-August, the newly-created National Administration of Financial Regulation (NAFR) and the central bank announced a national minimum downpayment standard of 20 % of the purchase price for first-time apartment buyers and 30 % for buyers of a second apartment. Nevertheless, the required downpayment and most other real estate market regulations still get decided at the local level. After the announcement, several cities have rapidly decided on reductions in their downpayment percentages. An other important change is that China's biggest cities (Beijing, Shanghai, Guangzhou and Shenzhen) have redefined who qualifies as a "first-time buyer". First-time buyers in these metropolises now include persons who once owned an apartment in the city, but then ceased for some reason to have their own city abode. This is a large change as the required downpayment for first-time buyers is significantly lower than for second home buyers, and they get a small reduction in the interest rate charged on their apartment loan. The minimum interest rate for first-time apartment buyers is the benchmark 5-year Loan Prime Rate (LPR) minus 20 basis points. For buyers of a second apartment, the minimum rate has just been cut to LPR plus 20 basis points. Many of the real estate sector tax breaks set to expire this year have been extended until the end of 2025.

Local administrations, which typically take the lead in implementation of economic stimulus, now often find themselves struggling with huge debt burdens. To ease their financial distress, the central government has granted local governments the possibility of issuing bonds worth a total of 1 trillion yuan that they can then use to pay down high-interest off-budget "hidden debt". Some reports suggest that the government has also arranged de facto zero-interest bank loans for troubled local governments by paying interest costs directly to lender banks.

The government is seeking to enlarge disposable household incomes by increasing income tax breaks. The 1,000 yuan-a-month tax deduction for daycare costs of children younger 3 years and school costs for older children has been raised to 2,000 yuan (previously 1,000 yuan). The monthly deduction for caring for an elderly parent has also been increased from 2,000 yuan to 3,000 yuan. The changes are retroactive to the beginning of 2023.

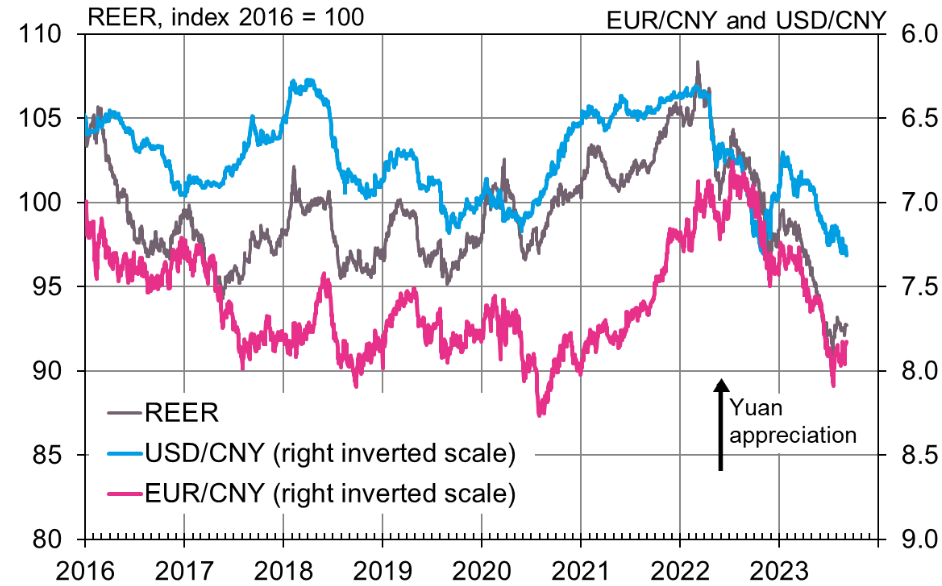
Another important signal is the government's extension of the tax advantage for foreign workers to the end of 2027. The number of foreign workers in China has fallen sharply, and the previously planned ending of the tax break would have only compounded the problem. The government also decided this summer to extend tax breaks granted during Covid-19 pandemic to sole proprietors and SMEs, as well as suspend certain administrative payments to the end of 2027. In addition, the National Development and Reform Commission (NDRC) announced it is establishing a new office to oversee development of the private sector.

The government wants to revive financial markets using a variety of measures, including a 50 % reduction in the stamp duty on share trades. Firms have been encouraged to buy back their own shares, new rules limit IPOs and large institutional investors such as state funds and banks have been requested to increase their long-term equity holdings. The China Securities Regulatory Commission (CSRC) has announced that it is moving ahead with regulatory changes that will permit insurance funds and pension funds to increase the share of equity holdings in their portfolios. Officials are pondering increasing the time markets are open for trading.

Central bank juggles needs to lower financing costs and slow yuan depreciation. The PBoC slightly lowered the rates at which it provides financing to banks and cut its 1-year LPR by 10 basis points in August (BOFIT Weekly 34/2023). It did not reduce the 5-year LPR, China's main housing loan reference rate. Observers say the cuts were likely driven by eroding bank profitability. More recently, large commercial banks reportedly began to lower deposit interest rates starting this month. Bank margins will be increased by reducing the 1-year deposit rate by 10 basis points and 5-year deposit rate by 25 basis points. Deposit rates were cut a year ago and again in August. Housing loans in China are typically fixed-rate or adjusted once a year, so the recent rate cuts have yet to affect current housing loans. The central bank has now encouraged banks to renegotiate housing loan terms to help households reduce their interest costs. This move is also hoped to support the housing market.

Due in part to dollar strength, the yuan-dollar exchange rate is currently at its lowest point since 2007. The PBoC has tried to slow the rate of yuan depreciation by setting its daily fixing rate above the market rate. The dollar-yuan rate is permitted to fluctuate within a band 2 % above or below the daily fixing on mainland China markets. To slow the weaking of the yuan, the PBoC in July raised its "macroprudential parameter" on cross-border financing. This affects the capacity of financial institutions and firms to borrow overseas. In an effort to support the yuan's exchange rate, the PBoC announced at the beginning of September that it was reducing its foreign currency reserve requirement from 6 % to 4 % of forex deposits as of September 15 to increase slightly the amount of forex available to mainland China markets. Neither measure, however, is expected to have a significant impact on the exchange rate. According to media reports, the PBoC resorted to providing "guidance" to commercial banks to support the yuan and look into whether domestic firms are speculating on the currency's further decline. State-owned banks are reportedly supporting also the offshore yuan (CNH) rate used outside mainland China. The central bank in August also issued more yuan-denominated bonds in Hong Kong than were maturing, thereby reducing the yuan liquidity in the offshore market. The measure is seen as an effort to support the CNH exchange rate.

The yuan has been losing value against the dollar for over a year



Sources: Macrobond, BIS and BOFIT.

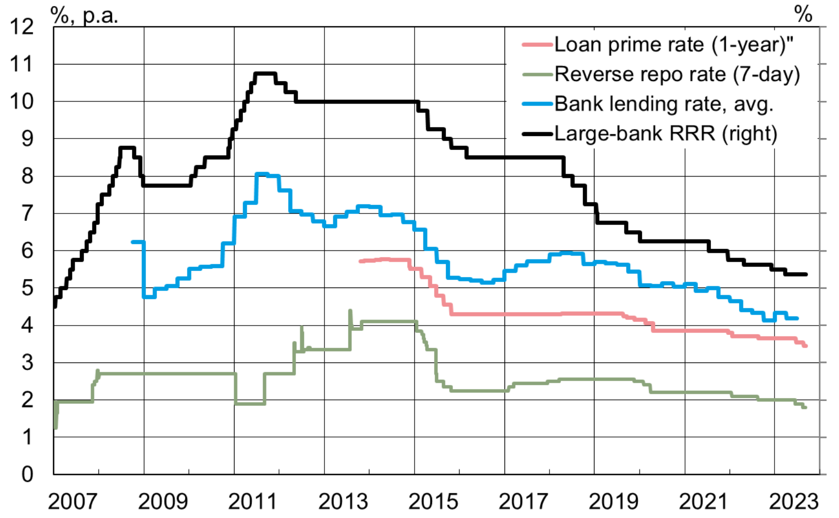
People's Bank of China gets new governor. The Communist Party of China on July named Pan Gongsheng (60) as central bank party secretary (effective July 1) and governor (effective July 25). Previously Pan served as a PBoC deputy governor. He continues to head the central bank's State Administration of Foreign Exchange (SAFE), the post he has held since 2016. Yi Gang (65) stepped down from his post as governor and Guo Shuqing (67) has retired from his duties as central bank party secretary.

Pan Gongsheng is considered a consummate technocrat with extensive financial market experience. He took his doctorate at Beijing's Renmin University and worked as a post-doc researcher at Cambridge University in the UK and visiting researcher in Harvard University in the US. Before joining the PBoC in 2012, Pan worked at two of China's giant state-owned banks (ABC and ICBC). Like his processor Yi, Pan does not belong to the 205 permanent members of the CPC's standing committee, and his political influence within the party is considered relatively minor. Some commentators have speculated that Pan's appointment signals a reduction in the central bank's role and influence on Chinese economic policy. The new governor is expected to continue similar policy to Yi. The central bank has been an advocate for market-based reforms, but the political appetite for such change has diminished in recent years.

Pan finds himself in charge of a central bank and currency regulator dealing with an unfavourable operating environment. His dual challenge will be to support economic growth and market stability while slowing the growth of indebtedness. Because China's central bank lacks independence, it ultimately must comply with the party's economic policy goals. The PBoC possesses a large policy toolbox with instruments that can be used to target at specific sectors or regions.

Due to the baroque character of Chinese monetary policy, however, it is difficult to form a clear picture of monetary policy stance. Not only do financial market risks become increasing difficult and costly for the government to deal with, but a managed exchange rate creates headaches for a central bank currently struggling to deal with devaluation pressures – especially when central banks elsewhere have set interest rates well above the Chinese level. As recently as a decade ago, China's officials aspired to a floating exchange rate. Today no one dares mention floating rates, and the officials want to have both the exchange rate and capital movements in their control. With the current rise of financial market risk and the government's tightening grip on the economy, implementing market-based reforms has become increasingly difficult.

China has maintained an accommodative monetary policy stance for over a decade



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

Russia

Latest BOFIT forecast sees Russian GDP growing this year, but sustaining growth will be difficult

BOFIT forecast sees 2 % GDP growth for this year, but a gradual fading in growth is underway already. Russia's economy is expected to grow this year due to robust first-half performance, even if the quarterly growth is set to slow towards the end of the year. The higher-than-expected growth in the first half of 2023 was largely the result of increased public spending that also supported private consumption and fixed investment to some extent. First-half growth also benefitted from last year's low reference basis.

BOFIT's latest Forecast for Russia expects Russian GDP to grow by 2 % this year. Growth mainly reflects higher public spending and increased bank lending. Strong growth in demand has boosted capacity utilisation in many branches to historical highs and driven unemployment to historical lows. Mobilisation and emigration have exacerbated Russia's already chronic labour shortage due to demographic trends. Economic activity has recovered to near pre-war levels and sanctions continue to limit imports, particularly imports of investment goods. As Russia lacks the prerequisites for sustained growth, we expect GDP growth to slow to around 1 % next year.

Russia has essentially abandoned its earlier pillars of economic policy – balanced budgets, free movement of capital and development of a market economy. Prosecuting the war has become Russia's top priority, and in this sense Russia has already shifted to a wartime economy. As a new post (in Finnish) on our BOFIT blog notes, the usual relationship of GDP growth and improved living standards breaks down in wartime.

The current Russia forecast remains subject to exceptionally high uncertainty. A major shift in the course of the war could significantly alter the trajectory of Russia's economic development. The external operating environment for Russia has also become unpredictable due to Russia's invasion.

Annual change in Russian GDP, realised and forecast (shaded)

	2020	2021	2022	2023F	2024F
On-year change	−3 %	6 %	−2 %	2 %	1 %

Sources: Rosstat, BOFIT Forecast for Russia 2/2023.

Current account surplus continues well below last year's record-high level. Preliminary CBR figures show that Russia posted a current account surplus of about 26 billion dollars for the first eight months of this year, a figure dwarfed by last year's record surplus of 185 billion dollars in the same period. The shift in foreign trade is the biggest factor eroding the current account surplus. Spending on imports has risen, but export revenues have fallen sharply.

Preliminary CBR figures show that the value of goods exports contracted by 32 % y-o-y in January-August, while the value of goods imports rose by 17 %. The biggest factors reducing exports were Western sanctions banning the import of many Russian goods and lower commodity prices. The International Energy Agency (IEA) reports that the average export price for a barrel of Urals-blend crude oil in January-August was about 40 % lower than in the same period in 2022. Economic recovery has helped revive goods imports since their plunge in spring 2022. While the value of imports has returned to pre-invasion levels, growth seems to have plateaued in recent months due e.g. to depreciation of the ruble.

Russia's goods trade balance still showed a surplus in January-August. In contrast, the services trade deficit doubled due to high growth in tourism imports. While the net capital outflow from Russia continues, it is more modest than last year's record levels.

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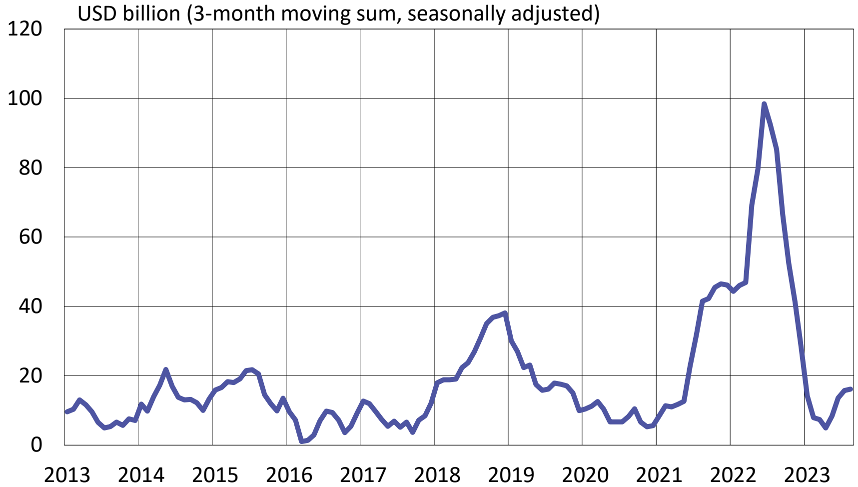
Russian current account surplus has remained in relatively moderate levels in recent months



Sources: CEIC/Central Bank of Russia, BOFIT.

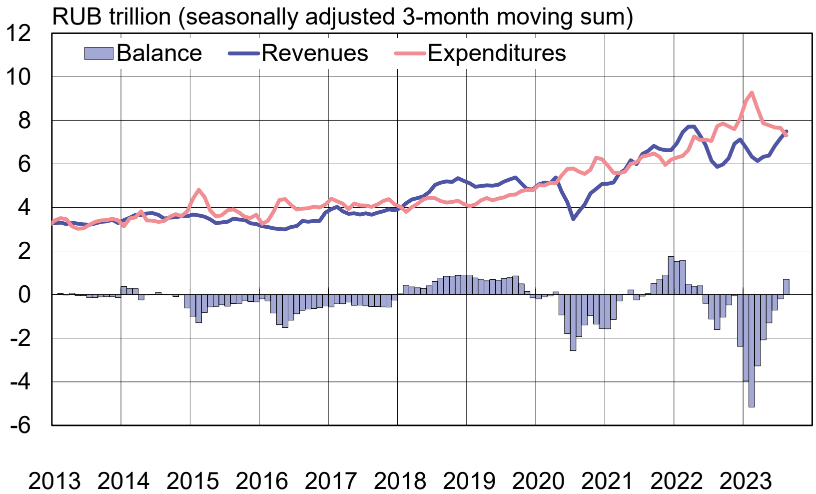
Growth in federal budget spending cooled in recent months. Although federal budget spending soared in the first months of 2023, it has decreased in recent months. For January-August, spending was up by 12 % y-o-y. In August alone, however, spending was down by nearly 8 % y-o-y.

Federal budget revenues have been on the rise in recent months. In January-August, revenues overall contracted by nearly 4 % y-o-y (but have been on the upswing in recent months). Revenues from oil & gas in January-August were down by 38 % y-o-y. Revenues in recent months have been bolstered by rising oil prices and ruble depreciation. Thanks mainly to increased value-added tax revenues, other federal revenues were up in the first eight months of this year by 24 % y-o-y.

The federal budget deficit has narrowed with decreased spending and improved revenue performance. In August, the cumulative 12-month federal budget deficit was 5.8 trillion rubles or about 4 % of GDP.

Under Russia's approved 2023 budget plan, federal budget spending should contract by about 7 %. For the government to hold to its budget plan, it would have to cut spending for the rest of the year (September-December) by about 30 % from the same period last year. Such a pull-back in spending would significantly reduce economic growth. It is highly unlikely that Russia would cut spending dramatically as it has a war to pursue and a presidential election coming up next year. Russia's finance ministry is currently preparing a new three-year budgetary framework.

Russia's federal budget spending growth has cooled in recent months



Sources: CEIC/Russian Ministry of Finance, BOFIT.

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China

No slowdown in Chinese growth in August. The rapid deceleration in China's growth in early summer prompted officials to announce a number of measures to support the economy (BOFIT Weekly 36/2023). The growth slowdown seems to have ended in August, when growth in consumption and manufacturing slightly exceeded the pace of previous months. Even with the support measures, however, the pace of growth is not expected to increase much for the rest of the year. Thus, institutional forecasts for China this year continue to be downgraded, with many forecasters now expecting 2023 growth to remain slightly below the government's 5-percent target.

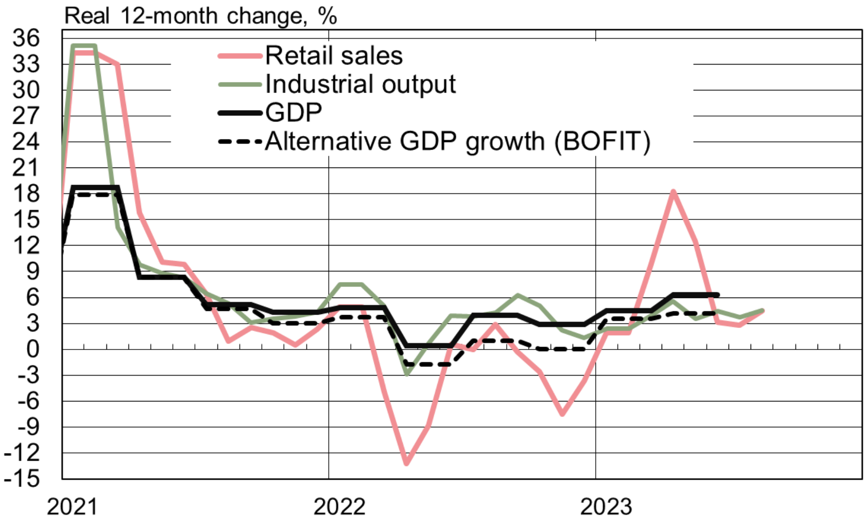
Retail sales, an indicator of consumer demand, revived slightly in August (up by 4.5 % y-o-y in real terms). Growth in June-July remained at 3 % y-o-y . Retail branches (e.g. restaurants) hit hardest by covid lockdowns showed the highest growth. Other branches affected by covid restrictions such as domestic tourism, hotel services and movie theatres have also seen sales soar since the end of lockdowns. In August, the value of car sales increased by 1 % y-o-y, while the sales of home remodelling and interior decoration materials continued to contract (down by 12 % y-o-y). Even if official unemployment figures show no further deterioration, rising uncertainty has motivated households to save more of their incomes. There has been some news reports mention local-level reductions in worker benefits, but the extent of such cuts is still unclear.

On-year industrial output growth accelerated slightly in August to 4.5 % y-o-y. In the May-July period, growth was in the range of 3.5–4.5 %. The differences in growth across branches, however, were quite large. Large industries saw big jumps in output volumes, e.g. chemical industry branches (up 15 % y-o-y), steel production (+15 %), manufacturing of electrical machinery & devices (+10 %) and car manufacturing (+10 %). On the other hand, clothing manufacture has contracted for over a year (down 10 % in August). The main purchasing manager surveys for China indicated that new domestic orders for manufacturing firms were no longer declining in August, while export orders continued to decline.

While figures on fixed investment trends released by the National Bureau of Statistics were contradictory, standard indicators suggest that nominal growth in fixed investment continued to slow in August. As in previous months this year, fixed investment of state-owned enterprises remained quite strong in August. Launches of new investment projects has declined sharply in recent months, while the investment has grown in projects already in-progress, expansions and machinery & equipment investments. However, capacity utilisation in many industries is at historically low levels in many industrial branches, which has reduced incentive for further industrial investment.

The sharp contraction in construction activity continues. Investment in real estate, measured both in terms of sales volumes measured by floorspace and value, as well as new building starts, all declined in August by about 20 % y-o-y. On a brighter note, the contraction no longer seems to be accelerating. The impact of measures taken during late August and early September to support the housing market will only begin to show up in the statistical data of coming months.

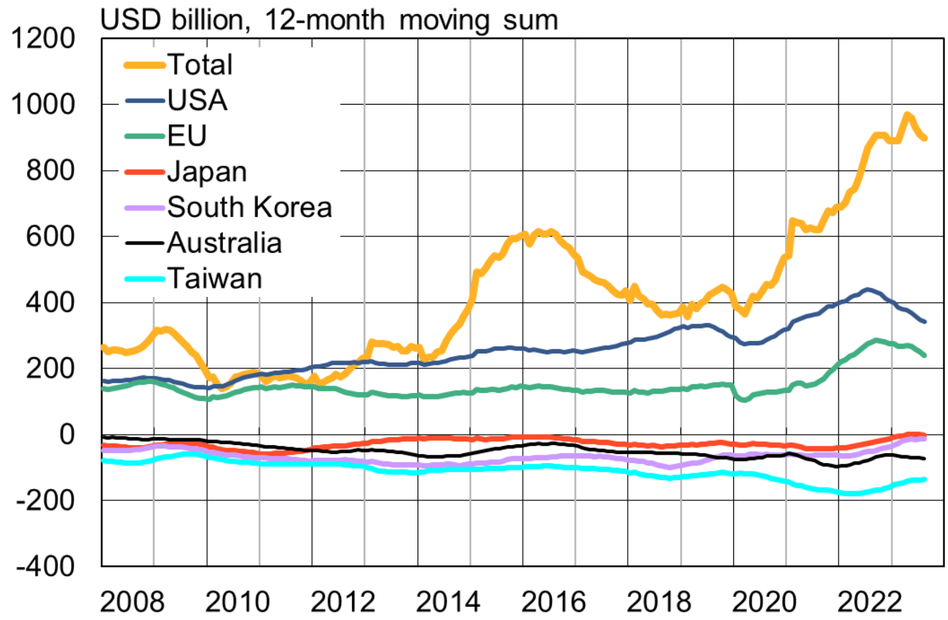
Growth in manufacturing and retail sales both perked up slightly in August



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

With economic growth slowing in China's main export markets and a lethargic domestic economy, China's foreign trade performance in August remained weak. The dollar value of exports was down by 9 % y-o-y and imports by 7 %. Due to exchange-rate fluctuations, the contraction in trade measured in yuan was somewhat smaller. The export and import volume indices for August have yet to be released, but the volume of exports in July was down by 4 % y-o-y. The volume of imports increased (up 2 % y-o-y in July), with drop in the value of imports due to large reductions in import prices. Even with weak foreign trade trends, China's trade surplus has remained huge. While China's surpluses with the US and Europe have narrowed, the deficit with developed East Asian economies has simultaneously narrowed.

China's overall goods trade surplus remains very large



Sources: China Customs, Macrobond and BOFIT.

China continues accomodative economic policies. Following the central governments' policy changes and instructions, an increasing number of cities in China have announced measures to relax their rules on apartment purchases in order to revive the housing market. However, the most significant measure in the past two weeks, however, has been the People's Bank of China's announcement of a 25-basis-point cut in the reserve requirement ratio for banks, effective September 15. The drop in the reserve requirement does not apply to smaller banks, which already enjoy the lowest possible reserve requirement of 5 %. The general reserve requirement was dropped to 10.5 % for large banks and 7.5 % for mid-sized banks. Reserve requirements are further adjusted for individual banks, depending such factors as the bank's lending structure. The PBoC reports that the weighted average reserve requirement ratio for the banking sector fell from 7.6 % to 7.4 %. The reserve requirement was last lowered in March.

Having already cut rates in August, the PBoC decided this month to keep its main policy rates unchanged. A reduction in the reserve requirement for banks will give a slight boost to banking sector liquidity but not remedy the slack demand for financing. Growth in the PBoC's measure of aggregate financing to the real economy (includes bank loans, new financing acquired through bond and equity issues, as well as financing provided via the shadow banking instruments) has slowed since the start of the year and was up by 9 % y-o-y in August. Household borrowing demand (mainly housing loans) is lacklustre, with the stock of household loans rising by less than 3 % y-o-y in August.

China's relatively low inflation rate would allow for even bolder monetary easing. In August, the 12-mongh change in consumer prices was a mere 0.1 %, and July prices were slightly lower than a year earlier. Price inflation in China has been subdued by on-year drops in energy and food (particularly meat) prices. Prices for non-food and non-energy products were up by 0.8 % y-o-y in August. Inflation is currently expected to remain low. Producer prices in China have been falling for about a year and were down by 3 % y-o-y in August. The drop in producer prices has been very broad-based.

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Real 12-month change and consumer prices, %

	2021	2022	4Q2022	1Q2023	2Q2023
GDP	8.4	3	2.9	4.6	6.3
	2021	2022	Jun. 23	Jul. 23	Aug. 23
Industrial output	9.6	3.6	4.4	3.7	4.5
Retail sales	10.7	-2.2	3.1	2.8	4.5
Goods exports	17.4	-1.3	-1.8	-4	n/a
Goods imports	7.7	-6.6	6.5	2.4	n/a
Inflation	0.9	2.0	0.0	-0.3	0.1
Yuan-dollar rate, avg.	6.45	6.74	7.20	7.20	7.26

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

India

New Delhi summit winds up India's G20 presidency. Hosted in the capital city of New Delhi, Indian prime minister Narendra Modi welcomed a large contingent of world leaders to the G20 summit on September 9–10. Notably absent were Russian president Vladimir Putin (who is subject to an international arrest warrant issued by the International Criminal Court in the Hague) and Chinese president Xi Jinping (who likely scrubbed his visit due to ongoing differences with India about border disputes and other matters).

Initial appraisals of the summit chalked it up as a win for India, which displayed skill in building consensus in a difficult geopolitical environment. India succeeded in getting a watered-down final declaration on the Ukraine war that called for respecting territorial sovereignty and a condemning threats of using nuclear weapons, but absent any references to Russia's latest actions. India also proposed inviting the African Union to join the G20 as a permanent member.

The G20 declaration stressed the importance of "strong, sustainable, balanced and inclusive growth." It called for picking up the pace in meeting the UN's Sustainable Development Goals (SDGs) and committing to targets set under the Paris Climate Agreement in order to mitigate global warming. Achieving these goals will require strengthening of the core institutions of the global economy and supporting digital development. The declaration also emphasised solving issues related to international taxation, gender equality and empowering women and girls, financial stability and countering terrorism and money laundering.

On the sidelines of the summit, the leaders of the US, India, Saudi Arabia and the EU announced a trade corridor initiative to connect India, the Middle East and Europe. The India-Middle East-EU Corridor (IMEC) creates a maritime connection running from India's west coast through the ports of Oman and UAE in the Middle East, by rail to Israeli ports and then on to the EU. The initiative includes construction of high-speed data connections. The parties also announced the creation of a Trans-African Corridor to connect resource-rich landlocked countries of Zambia and the Central African Republic by rail to Angolan ports.

Logo for India's G20 presidency

Source: G20 India.

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Russia

Russia plans for increased government spending, tighter monetary policy

Latest 3-year federal budget framework anticipates leap in military spending. The Russian government last week approved a draft version of the federal budget framework for 2024–2026. The budget framework now goes to the lower-house Duma for consideration. The framework anticipates significant increases of both spending and revenue compared to the earlier budget plan approved in December 2022.

Under the revised budget framework, total federal budget spending in 2024 and 2025 would be about 20 % higher than in the previous budget framework and more than double spending on defence in 2024 and 2025. The framework calls for raising 2024 defence spending to about 10.7 trillion rubles (roughly 110 billion dollars at the current exchange rate) and 8.5 trillion rubles in 2025. The draft budget framework also sees national security spending increasing by 13 % more than previously budgeted, while spending on social expenditure would increase by just 5 %.

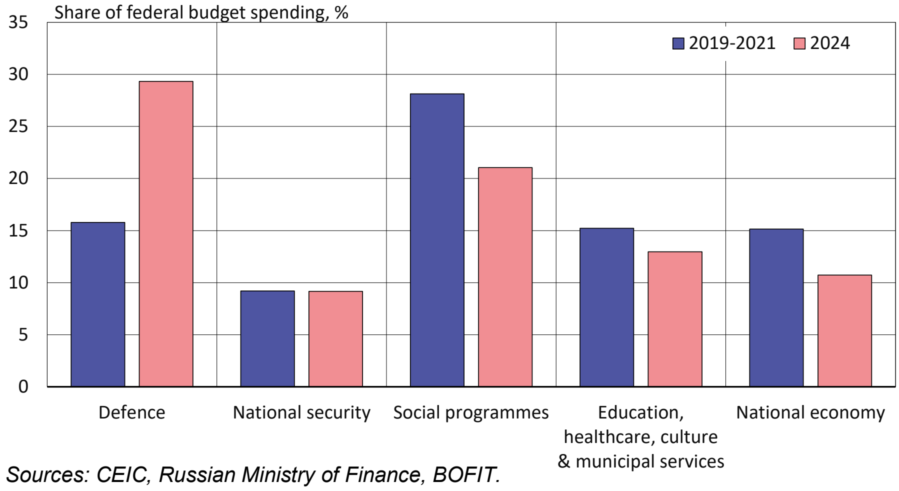
Under the budget framework, defence spending's share of the federal budget would rise next year to an historical high of 29 %. Furthermore, 9 % of spending would go to national security. Spending on social expenditure, in contrast, would drop sharply from pre-invasion years to 21 % in 2024.

Based on this year's updated spending projection, federal spending should grow by 16 % next year. The budget projections are based on the economic development ministry's estimated average inflation of 7 % next year, meaning that spending will also climb in real terms. Hitting even the updated spending target this year, however, would require a substantial cut in government spending in the final four months of this year compared to a year earlier. It is thus possible that spending may exceed even the updated estimate this year and thus experience lower growth next year.

The budget framework also anticipates significantly higher revenues for 2024-2025 than the previous framework or the expected 2023 revenues. Higher oil prices and a weak ruble should increase tax revenues from oil & gas. The current budget assumes that over the 2024–2025 period the export price for Russian crude oil averages 70 dollars a barrel compared to 63 dollars in 2023. The ruble's exchange rate is expected to average 90–91 rubles to the dollar compared to 85 in 2023. Revenues other than those from oil & gas are expected to increase by about 20 % next year. A large part of the revenue boost is expected to come from one-off items, including a new export tax that is set to remain in force to the end of 2024.

The federal budget is expected to be in the red this year and the following three years under the latest budget framework. This year's deficit is still expected to be around 3 trillion rubles (2 % of GDP), but then decline to about 1.6 trillion rubles in 2024 and 900 billion rubles in 2025. The deficit shortfall would be made up with domestic debt. If the deficits remain within the framework projections, Russia should be able to fund its deficits without much difficulties. However, the revenue presumptions in the current framework appear quite optimistic. Moreover, the government may have to further boost spending as the war drags on and the 2024 presidential election next spring approaches.

Russia's latest draft budget framework sees the share of military spending increasing sharply while the share of social spending declines



Sources: CEIC, Russian Ministry of Finance, BOFIT.

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Tighter monetary policy in the face of rising inflationary pressures. At its September inflation meeting, the board of the Central Bank of Russia decided to again raise the key rate by 100 basis points, which now stands at 13 %. The CBR said inflation risks remain significant. It warned, for example, that if the budget deficit grows larger than expected, further monetary tightening may be necessary. The CBR noted that the large share of government-supported loans in the lending stock has weakened the impact of key-rate decisions on lending activity.

Russian inflation has accelerated in recent months, hitting over 5 % p.a. in August. The acceleration in inflation has been largely driven by growth in domestic demand supported by government spending. Domestic supply has not managed to keep up with demand due to capacity constraints. Labour shortages, in particular, have emerged as a major problem. Due to the scarcity of workers, rising wages have added to inflationary pressures. A particular worry for the administration recently has been the rise in retail fuel prices. In its latest effort to deal with situation, the government has imposed temporary export bans on gasoline and diesel fuel. This policy measure is discussed in our latest BOFIT blog posting (in Finnish).

Inflation pressures have also been exacerbated by the recent deterioration in the ruble's exchange rate. The official ruble-dollar rate in late September is about 30 % below levels at the start of the year (96.5 rubles to the dollar as of Thursday, September 28). Russia's finance ministry and the economic development ministry have proposed increased capital controls and, similar to the Chinese model, adoption of an offshore rate for the ruble. The CBR opposes both proposals.

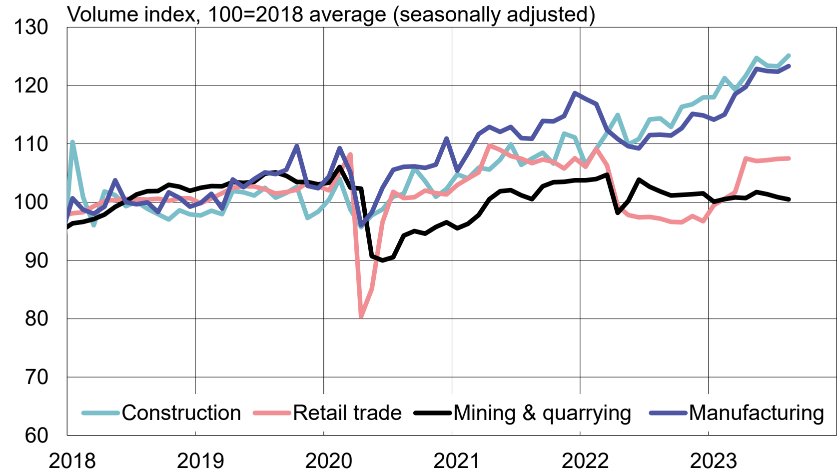
In conjunction with its inflation meeting, the CBR released its latest economic outlook. The new forecast sees GDP growing by 0.5–1.5 % next year with inflation averaging in the range of 5–5.6 %. The economic development ministry's projected GDP growth of 2.3 % and inflation rate averaging around 7 % are used as assumptions in the budget framework.

War-related industries still drive production growth. Russia's economic development continued relatively stable in August. Construction activity continued growth, while the development of manufacturing has moderated in recent months. On-year manufacturing in August was still up by 10 % and construction by 9 %. Most growth came from branches somehow tied to the wartime economy.

In recent months, consumption-driven retail sales have been tepid despite substantial wage increases. In January-July, the average real wage increased by 7 % y-o-y. The unemployment rate in August remained at 3 %.

The development of extractive industries has been modest. The IEA estimates that Russian crude oil production has declined slightly in recent months. Russia has announced that it is cutting its production and exports of crude oil this year. The economic development ministry forecasts crude oil production to contract by about 1 % this year and next.

Russian production growth in most core sectors of the economy has stabilised in recent months



Sources: CEIC, Rosstat, BOFIT.

Impacts of war evident in regional trends for industrial output and construction. Industrial output has soared in those manufacturing branches in Russia servicing the war effort. In certain branches closely linked to the military-industrial complex, production has increased by several hundred percent from pre-war levels.

Growth has been particularly robust in many traditional military-industrial hubs such as the Sverdlovsk, Chelyabinsk and Kurgan regions and the Udmurt Republic. Local media in such regions often report increased military production, widespread recruitment efforts and factories moving to around-the-clock operations. In some regions, the strong growth in production is clearly associated with specific military-industrial plants and firms.

Many of the regions where economic performance has been weakest in Russia's wartime economy are those hardest hit by the exodus of foreign firms from Russia, sanctions or both. Examples of regions suffering major economic losses include the Karelian Autonomous Republic, which has seen the loss of its forest industry export markets, and regions central to Russian automobile production, which suffer from the departure of Western carmakers.

The consequences of war can also be seen in the figures for construction activity in border regions. In several of the Russian regions near the Ukraine border, the pace of construction has clearly outstripped the pace of construction growth nationally. These areas have seen extensive construction of fortifications similar to the Ukraine regions currently occupied by Russia. The periods of extremely high construction growth seem to match the periods of reported extensive fortification work. Strong construction growth in Russia's border regions may also reflect repair work after drone strikes and sabotage of railways and other infrastructure.

Our latest BOFIT Policy Brief considers these production adjustments in Russia's regions since the invasion of Ukraine.

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BOFIT

China

European firms report increased uncertainty surrounding China's business environment. The European Union Chamber of Commerce in China (European Chamber) in late September released a position paper calling for improved political and commercial dialogue between China and Europe. The European Chamber's 2023/2024 position paper provides an assessment of the Chinese business environment from the perspective of European firms operating in China and offers more than a thousand recommendations on ways the Chinese government can improve business conditions.

The report notes that European firms felt that predictability and reliability, which are essential to attracting foreign investment, eroded during the Covid-19 pandemic due to erratic political decisions. The lifting of covid restrictions in late 2022 was a positive surprise, but corporate confidence in the long-term growth possibilities offered by China has been damaged. With China increasingly focused on economic self-reliance, European firms felt that only those industries directly supportive of China's policy goals could prosper as they did back in the days of consistent high growth in China.

The pandemic years revealed the weak links in international supply chains. Geopolitical uncertainty and Russia's war on Ukraine have further increased the risk awareness of European firms, and this is reflected in business as actions to make their production chains more durable. Some European firms are considering or have already shifted their investments out of China to increase supply chain resilience, or have on-shored supply chains into China, detaching them from global value chains.

The European Chamber reports that the mixed messaging from the Chinese government has further increased uncertainty. For example, earlier this year China announced that it would concentrate on attracting foreign investment and liberalising the economy, but thereafter has taken little action to promote these goals. At the same time, China's push for technological self-reliance continues to restrict the access of foreign firms to the Chinese market. The new national security legislation has also made foreign firms more cautious.

To improve the business environment, the European Chamber recommends that China's political decision-makers focus on tackling structural impediments to economic growth and the challenges facing the private sector. The report's concrete recommendations pertained, among other things, to supporting consumer demand and increasing productivity through market liberalisation. The European Chamber would like to see improved political decision-making by allowing greater space for discussion and constructive feedback, reduction of corporate risks by separating political issues from the business world, as well as maintained focus on the green transition during economic recovery. Such measures would strengthen confidence in China's business environment and the willingness of international firms to operate in China – and possibly even increase investment in China.

The EU is China's most important trading partner, accounting for about 15 % of Chinese goods exports and 11 % of Chinese imports. In January-August, Chinese goods exports to the EU contracted by 10 % y-o-y in dollar terms, or more than exports overall (down by 5 %). The value of China's goods imports from the EU shrank by 2 % y-o-y (total value of imports down by 8 %). Nearly half of China's exports to the EU fell under the machinery & equipment category. The value of exports in this category fell by 8 % y-o-y in the January-August period. In contrast, the value of exports in the transport vehicle category rose by 17 % and accounted for 8 % of total exports. China's most important EU import categories were machinery & equipment (30 % of the value of EU imports), chemicals (19 %) and transport vehicles (16 %).

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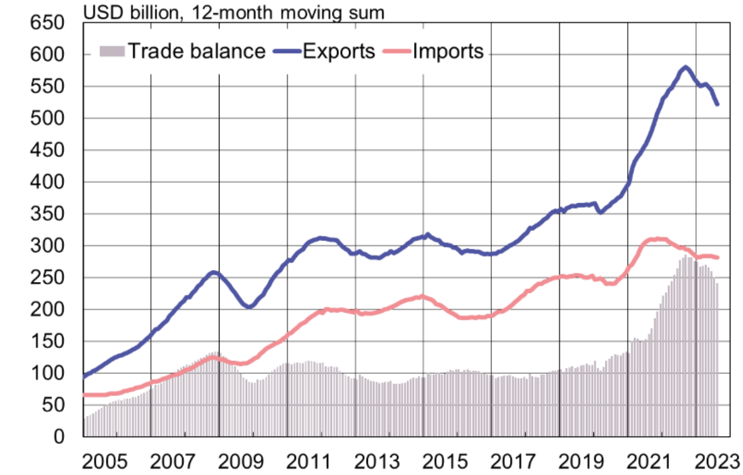
The value of Chinese goods exports to the EU27 countries surged during the Covid-19 pandemic, but has declined somewhat recently



Sources: China Customs, Macrobond and BOFIT.

China and US governments attempt to increase communication to heal frayed economic relations. The leadership in both China and the United States have recently stepped up their frequency of meetings and contacts. The hope is to relax the tense relations between the two countries, increase the exchange of views and reduce the likelihood of a mutual misunderstanding. At the same time, economic "decoupling" of the two nations continues, with US firms operating in China also feeling the pressure.

The US and China announced in late September the launch of two new working groups to deal with bilateral economic and financial market issues. The US treasury department reports that the Economic Working Group, in cooperation with China's finance ministry, will look into ways to bring bilateral relations back into balance and address global issues such as debt restructuring for poorer countries. The Financial Working Group, which involves cooperation with the People's Bank of China, will pursue regulatory and financial stability issues. Regular economic discussions ended in 2018 after the Trump administration pulled out of the talks. This month's announcement of renewed discussion was preceded by the August visit of US commerce secretary Gina Raimondo to China. As part of her visit, the countries established a separate working group to deal with bilateral commercial issues and information exchange mechanism on the use of export controls. The commercial issues working group will meet twice a year, with its first meeting taking place in early next year. China earlier this summer hosted visits by US secretary of state Antony Blinken, treasury secretary Janet Yellen and presidential climate envoy John Kerry.

Even with the improved dialogue between the two countries, bilateral business relations continue to degrade. In addition to last year's restrictions on the export of sensitive technologies, US president Joe Biden issued an executive order in August that permits banning or restricting new US investment in Chinese firms involved in quantum computing, artificial intelligence or the manufacture of advanced microchips. The executive decree is due to enter into force next year. China, among other things, has invoked "national security" by banning the use of US chipmaker Micron's products in critical infrastructure and, in July, restricted the exports of germanium- and gallium-related compounds used in microchip production. Bilateral tensions have also been inflamed by US claims that Chinese firms are providing Russia, either directly or indirectly, with technology used in its war of aggression on Ukraine. In September, the US placed ten more Chinese firms and one person on its Entity List. The firms were accused of providing military assistance to Russia and Iran. In August, the US removed 27 Chinese firms from being added to the Entities List after officials announced that they had completed their end-use investigations into the firms and established that they were competent to receive US exports, such as technology.

In September, the American Chamber of Commerce in Shanghai (AmCham) released its annual report, which showed that US companies in China have become more pessimistic about the Chinese markets and operating environment. Only 52 % of respondents said they were optimistic about the upcoming five years of operation in China, which was the lowest AmCham survey reading in its 25-year history. Only 40 % of respondents expected their medium-term revenue growth in China to exceed their global revenue growth. Over the medium term, the biggest challenge will continue to stem from tensions between the US and China. Most firms said that they had experienced pressure from government authorities to manifest efforts at decoupling. Two-thirds said that the most pressure was coming from the US government, while the remainder said it was coming from the Chinese government.

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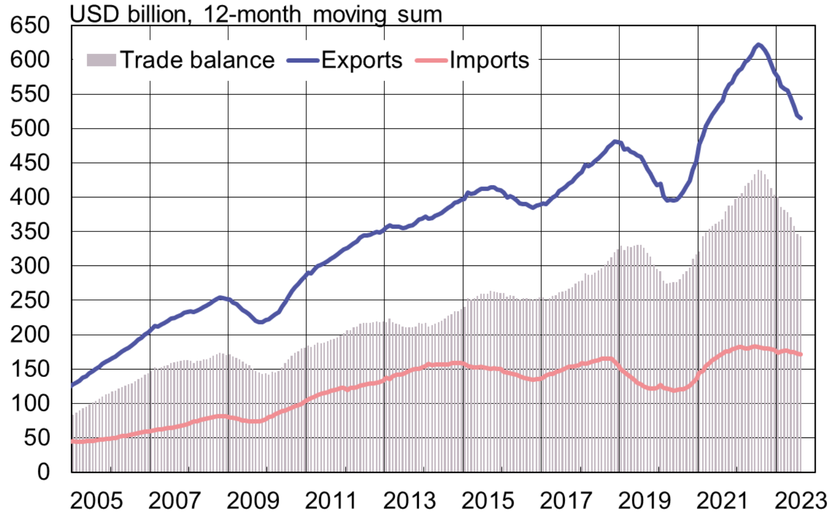
China was the top supplier of US goods imports up until last year. Mexico surpassed China this year. China currently provides about 14 % of US goods imports, while China takes about 8 % of US goods exports. The punitive import tariffs imposed in 2018–2019 during the Trump administration remain in force, and there has been little change in the tariff scheme in recent years. According to the Peterson Institute for International Economics (PIIE), the average US import duty rate on Chinese imports is currently 19 % and the average Chinese duty on imports from the US is 21 %. PIIE estimates show that the US has imported little in the way of goods from China in categories subject to higher duties throughout the trade war. The imports of such goods from the rest of the world has increased. The highest 25 % import duties, which target such products as semiconductors and consumer electronics, have caused imports from China to fall significantly. By the same token, higher imports from China are almost exclusively in categories not subject to the additional duties. Some of the drop in the Chinese imports is likely explained by the fact that also some Chinese companies have moved US export production out of the country (to Mexico for example) to avoid the higher tariffs.

In 2017, the US accounted for 19 % of China's goods exports. That share has fallen currently to 15 %. US share in China's goods imports are now less than 7 % (over 8 % in 2017). China Customs figures show that China's goods exports to the US fell in January-August by 17 % in dollar terms (total exports down by 5 %). The value of goods imports from the US contracted by just 5 % (total imports down by 8 %), and the goods trade surplus started to shrink. The biggest export categories were machinery & equipment (42 % of the value of exports), clothing & textiles (10 %), as well as certain types of manufactured goods (14 %). During January-August, exports in these categories fell at roughly the same pace as total exports. Chinese imports from the US are more diverse. Machinery & equipment accounted for about 20 % of the value of goods imports, vegetables (mainly soybeans) 15 %, minerals (about a quarter of which is crude oil) 15 %, chemicals 13 % and transport vehicles 9 %. Of these groups, only the on-year value of mineral product imports grew during the January-August period.

China's goods trade surplus with the US has contracted over the past year, but is still substantial



Sources: China Customs, Macrobond and BOFIT.

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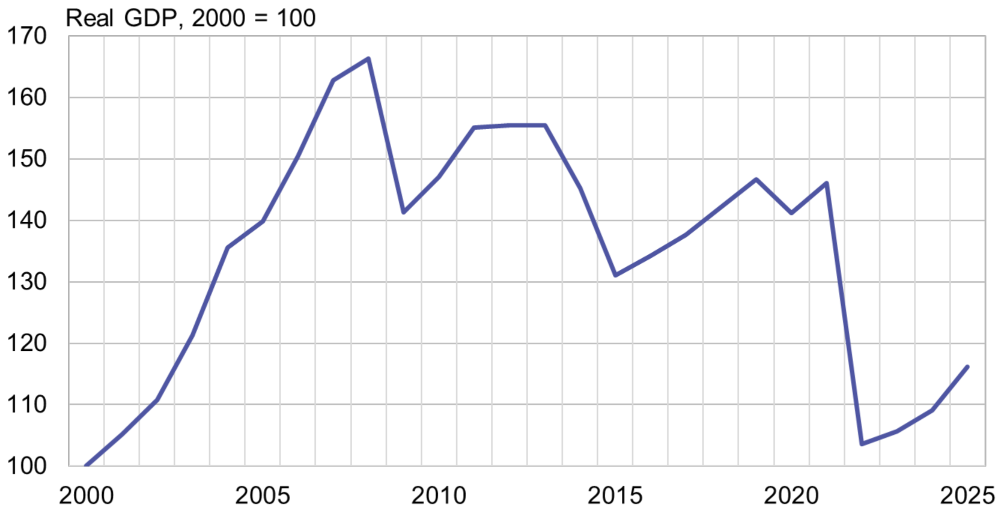
Ukraine

Ukraine's economy returns to growth, but recovery from war's destruction takes time. Ukraine's GDP contracted by 29 % last year due to Russia's illegal war of aggression. Economic activity declined most in the first half of 2022 after Russia occupied large areas in eastern and southern Ukraine. Millions of Ukrainians were forced to leave their homes and move to western Ukraine or abroad. Russian acts of war have destroyed a substantial part of Ukraine's economic capacity. The partial or complete disruption of maritime shipping in the Black Sea has significantly affected Ukrainian exports. Before the February 2022 invasion, about 90 % of Ukraine's food exports were shipped via Black Sea ports. In 2021, foodstuffs represented about 40 % of Ukraine's total exports.

The contraction of economic activity last year was quite broad-based. The sectors with highest growth this year have been retail & wholesale, as well as transport. Some of this growth reflects the return of people who fled the country last year. Significant portion of people who left the country in 2022 have returned. Economic activity in many regions in western Ukraine had recovered to pre-invasion levels by the end of last year. Russia's attacks on Ukraine's energy infrastructure last winter affected economic performance throughout the country.

Growth in Ukrainian GDP has resumed, but still has a long way to go to make up for production lost during the war



Sources: IMF, BOFIT.

Ukraine's economy returned to positive growth late last year, but that growth starts from a very low level. The International Monetary Fund (IMF) forecast released this week sees Ukrainian GDP growing by 2 % this year, while the European Bank for Reconstruction and Development (EBRD) expects GDP growth of 1 % this year. The average of forecasts collected by the Consensus Economics research institute was 2.7 % for 2023 as of September. The GDP forecast released in August by the National Bank of Ukraine (NBU), predicted growth of 2.9 % this year. The upcoming NBU October forecast is expected to foresee even higher growth this year.

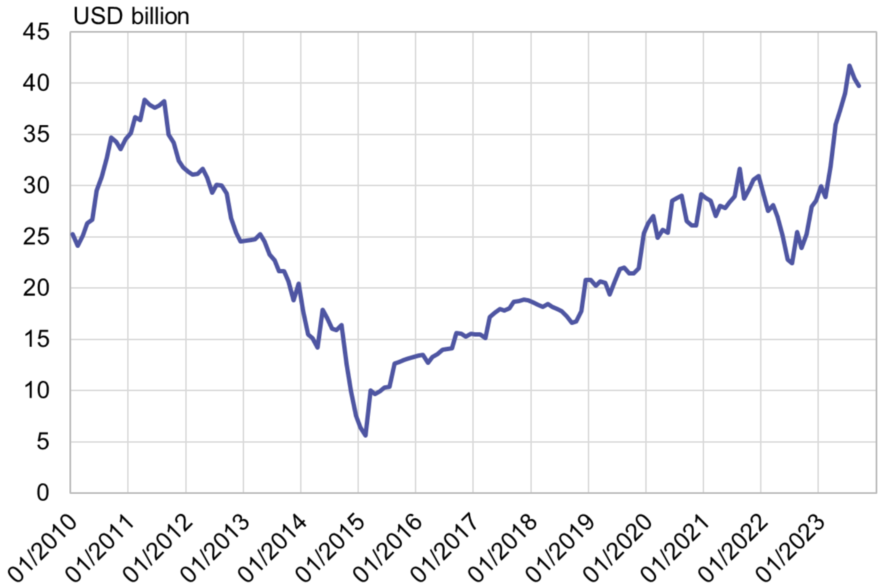
Virtually all major institutional forecasters expect Ukraine's economic recovery to accelerate next year. The IMF forecast for 2024 sees GDP growth of 3.2 %, the EBRD 3 %, the NBU 3.5 %, and the average of major forecasts compiled by Consensus Economics 5.2 %. All forecasts are subject to tremendous uncertainty stemming from the future course of war and commitment of Ukraine's economic supporters.

A significant share of Ukraine's economic activity and the current counteroffensive has been supported by economic assistance in the form of donations or loans. Under the IMF's four-year Extended Fund Facility (EFF) programme, Ukraine is permitted to borrow up to 15.6 billion dollars. The EFF was approved in March, and Ukraine has currently drawn about 3.6 billion dollars (3.4 billion euros) of its allocation. The EFF includes guidance on macroeconomic policy as well as recommendations on structural reforms to the Ukrainian economy.

Ukraine's biggest financial supporter this year has been the EU. Under the EU's Macro-Financial Assistance Programme, Ukraine has received 12 billion euros in loans. Aid from individual countries has also been important for Ukraine. Data compiled by the Kiel Institute for World Economics show the total amount of promised and delivered financial assistance from EU institutions since January 2022 amounted to 77 billion euros. The United States is Ukraine's biggest supporter in terms of military aid.

Ukraine's central bank last year covered the bulk of the public sector deficit, but this year the situation has changed dramatically. For the first nine months of this year, Ukraine's fiscal deficit amounted to roughly 32 billion dollars. Nearly all of the deficit was covered with international financing, of which about a third came in the form of donations. The easing of Ukraine's financial struggles has given the NBU an opportunity to relax e.g. capital controls. As of end-September, the central bank's gold and currency reserves amounted to about 40 billion dollars. With Ukraine's foreign currency reserves at their highest level since 2011, Ukrainian financial markets have stabilised somewhat.

Ukraine's foreign currency reserves have grown considerably since mid-2022



Sources: National Bank of Ukraine and BOFIT.

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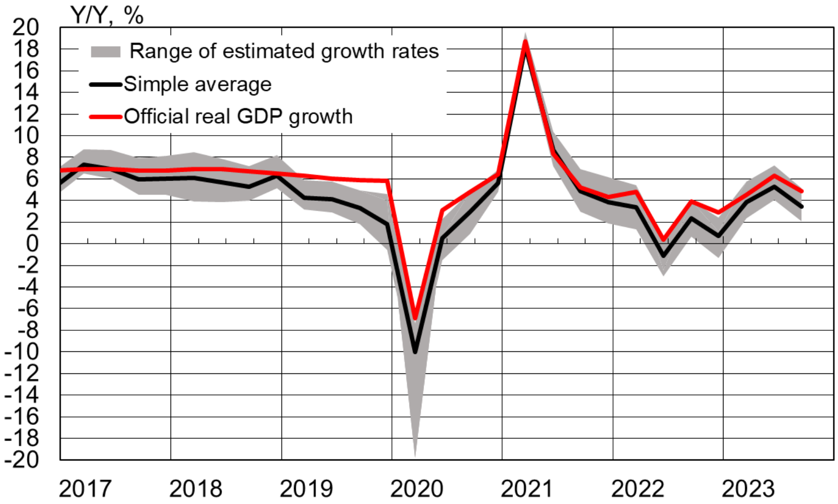
China

Growth of China's economy appears to be stabilising. China National Bureau of Statistics reports that the country's GDP grew by 4.9 % y-o-y in the third quarter, down from an average of 5.5 % in the first six months of this year. Third quarter growth reached 1.3 % q-o-q, well above the on-quarter growth of 0.5 % posted in the second quarter. Uncertainty over the reliability of official figures has increased as the economy has slowed. BOFIT's alternative calculation indicates that real GDP growth slowed substantially in the third quarter and the growth might have been well below the official assessment. Other regularly updated alternative calculations of Chinese growth also undershoot official figures. Fourth-quarter GDP on-year growth is expected to be higher than the third quarter as it will be referenced to the fourth quarter of 2022 when China was in the midst of Covid-19 lockdowns.

BOFIT alternative calculation of Chinese GDP shows a distinct third-quarter slowdown



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

Increased consumption has been the biggest driver of growth this year. It gained more traction in the third quarter, when consumption accounted for 4.6 percentage points of GDP growth. During the pandemic years and first half of this year, households squirreled away larger share of their disposable income than usually. In the third quarter of this year, however, households began to spend a larger share of their earnings. The highest growth was seen in services hardest hit by covid restrictions. Households have spent considerably more on domestic travel, restaurant services, healthcare and cultural activities, entertainment and education. During the Golden Week autumn break at the start of October, tourism was up sharply from a year earlier. The volume of domestic tourism, however, was up by just 4 % from 2019 and consumer spending less than 2 % higher than in 2019.

Contraction of the real estate sector continued throughout the third quarter. For July-September, the volumes of housing sales and new construction starts measured in terms of floorspace fell by 22 % y-o-y. The downturn in property construction put the brakes on investment growth, with investment contributing just 1.1 percentage points to GDP growth in the third quarter. The government's limited economic support measures have mainly targeted apartment sales. The real estate sector, however, is likely to struggle as uncertainty about the economy continues to depress demand.

Weak foreign trade picture persists. The value of Chinese September exports measured in dollars contracted by over 6 % y-o-y. In the third quarter, exports overall fell by 10 % y-o-y. The value of imports in dollars also contracted by over 6 % in September, and was down by 9 % in the third quarter. Even if the trade numbers looked gloomy, the contractions of exports and imports in September were smaller than in August.

The yuan's depreciation explains some of the contraction in the dollar-value of China's foreign trade. Yuan-denominated trade statistics show a smaller decline in both the value of exports and imports. Nevertheless, China's foreign trade unquestionably has been struggling with weak demand on the both the domestic and international fronts. The United States

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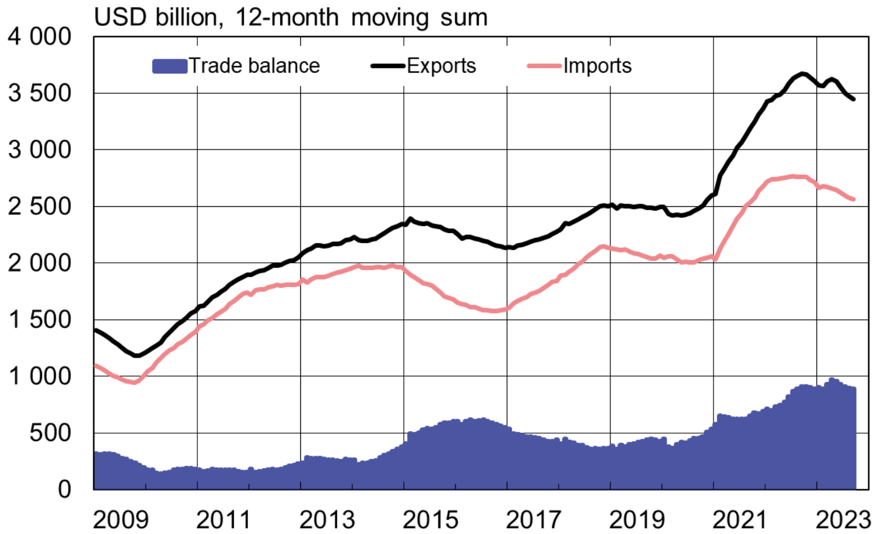
and Europe, China's most important export markets, are experiencing lower economic growth while uncertainty about China's economic prospects and weak domestic demand are reflected in reduced imports.

A closer look at China's individual trading partners reveals that the rising trend in China's trade with Russia is at odds with the declines seen for practically all other countries. In dollar terms, the value of China's exports to Russia rose by 28 % y-o-y in the third quarter, while imports held steady at last year's level, growing at about 1 %. Another interesting outlier shows up among China's foreign trade product categories. Although exports overall are declining, China's global vehicle exports are booming. Annual growth measured in dollars exceeded 50 % y-o-y in the third quarter.

China's foreign trade has decreased from last year



Sources: China Customs, CEIC and BOFIT.

Public indebtedness drives up debt-to-gdp ratio. Despite a modest easing in monetary policy during August and September, growth in China's domestic indebtedness remained relatively flat due to low demand for financing. Because nominal GDP grew by just 4 % over the previous 12-month period, the ratio of borrowing to GDP still rose. In September, the People's Bank of China's total domestic debt measure – aggregate financing to the real economy (AFRE) – grew as in previous months at a pace of 9 % y-o-y and exceeded 298 % of GDP. On-year growth in the stock of yuan-denominated bank loans remained just over 11 % in September. A quarter of the lending stock is consisted of household loans, which only grew by about 3 %.

Government debt in the AFRE measure includes general bonds issues of the central and local governments, as well as special-purpose bonds issued by local governments. The stock of government bonds grew by 12 % y-o-y in September to a level equivalent to 53 % of GDP. The IMF notes that when the off-budget debt of local governments and indebtedness of state funds are taken into account, China's public debt is considerably higher (estimated at 110 % of GDP as of end-2022). The government has recently sought to deal with off-budget indebtedness of local governments by a debt-swap program, making it possible for local governments to pay off off-balance-sheet debt by issuing bonds to make the situation more transparent. According to media reports, the government also this month encouraged large state banks and policy banks to increase lending at attractive rates to local governments and their off-budget local government financial vehicles (LGFVs) to pay off their high-interest loans. According to state media, the agenda of the CPC standing committee meeting that began today (Oct. 20) includes a discussion of provincial finances and the possibility of again allowing local governments to use next year's quotas in advance. Provincial finances are typically stretched in the second half of the year. As of end-August 2023, local governments had already issued 76 % of their annual quota of 720 billion yuan in general bonds and 83 % of their 3.8 trillion yuan quota for special-purpose bonds. Earlier in October, Bloomberg reported that China's central government was considering issuing additional sovereign debt of at least 1 trillion yuan.

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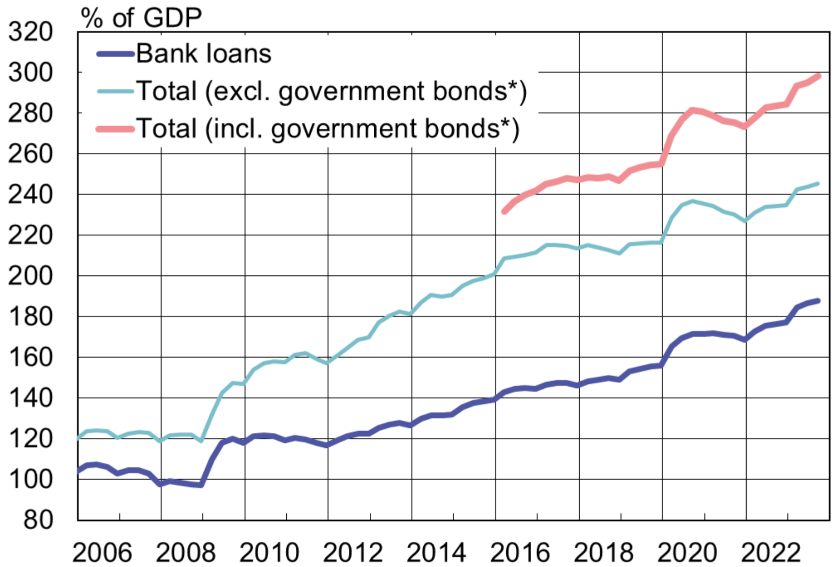
China's aggregate financing to the real economy (AFRE) currently stands at nearly three times gross domestic product



*Sources: PBoC, CEIC and BOFIT *) Bond issues of central and local governments. The IMF estimates China's actual public liabilities as of end-2022 at 110 % of GDP.*

Sluggish growth in global trade. Several international forecasters have revised their economic outlooks in recent weeks. The IMF's *World Economic Outlook* (WEO) released last week now sees global economy growing by 3.0 % this year and 2.9 % next year. The forecast comports with those of other forecasting institutions such as the ECB and OECD. The forecast growth is well below longer term average annual growth of 3.8 % per year during 2000–2019. The IMF says that global economic growth recently has been hobbled by central bank tightening to bring down inflation, strict national fiscal policies, the long-term effects of the Covid-19 pandemic, implications of Russia's attack on Ukraine, geoeconomic fragmentation and extreme weather events such as El Niño-Southern Oscillation weather pattern in the Pacific.

The IMF slightly lowered its growth projections for China for both this year and next from its July forecast. It now expects the Chinese economy to grow by 5.0 % this year and 4.2 % next year. China's economic growth is held back by problems in the real estate sector. Because so much Chinese economic activity and household wealth are tied to property, the downturn affects consumption and consumer confidence. Corporate output and fixed investment also struggles with reduced export demand and geopolitical uncertainty. The IMF has raised its forecast for Russian growth this year to 2.2 % due to increases in public spending, fixed investment and private consumption. For next year, the IMF predicts the Russian economy will grow by 1.1 %.

The October WEO calls for growth in global trade of 0.9 % this year and 3.5 % next year. The global trade outlook of the World Trade Organization (WTO) released this month is quite similar to that of the IMF. The growth numbers are quite low from a historical standpoint. During 2000–2019, growth in global trade averaged 4.9 % a year. Growth has been affected by increased barriers to trade, weak global demand and a shift in consumption that favours domestic services since the lifting of covid restrictions.

The table below presents recent growth forecasts for several emerging economies. The IMF's forecasts extend through 2028. Such a long-range forecasts can be interpreted as estimates of the growth potential of these economies as cyclical effects of monetary and fiscal policy are moderated. The implications of the latest WEO are also considered in a recent Bank of Finland blog piece (in Finnish).

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Institutional forecasts of economic growth, %. Spring and summer 2023 forecasts in parentheses

Country	Forecasting institution	2023	2024	2025–2028 average
China	IMF	5.0 (5.2)	4.2 (4.5)	3.8
	ADB	4.9 (5.0)	4.5 (4.5)	-
	World Bank	5.1 (5.1)	4.4 (4.8)	-
	OECD	5.1 (5.4)	4.6 (5.1)	-
Russia	IMF	2.2 (1.5)	1.1 (1.3)	1.0
	EBRD	1.5 (-1.5)	1.0 (1.0)	-
	OECD	0.8 (-1.5)	0.9 (-0.4)	-
India	IMF	6.3 (6.5)	6.3 (6.3)	6.3
	ADB	6.3 (6.4)	6.7 (6.7)	-
	OECD	6.3 (6.0)	6.0 (7.0)	-
Ukraine	IMF	2.0 (-3.0)	3.2 (-)	4.9
	EBRD	1.0 (1.0)	3.0 (3.0)	-
Brazil	IMF	3.1 (2.1)	1.5 (1.2)	2.0
	OECD	3.2 (1.7)	1.7 (1.2)	-
South Africa	IMF	1.6 (0.9)	2.0 (2.0)	1.5
	OECD	0.6 (0.3)	1.1 (1.0)	-
Kazakhstan	IMF	4.6 (4.3)	4.2 (4.9)	3.1
	ADB	4.1 (3.7)	4.3 (4.1)	-
	EBRD	5.0 (3.9)	5.0 (4.2)	-

Sources: Asia Development Bank (ADB); World Bank's East Asia and Pacific Office; European Bank for Reconstruction and Development (EBRD); OECD and BOFIT.

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BOFIT

Russia

Ruble sinks even as Russia's current account surplus grows

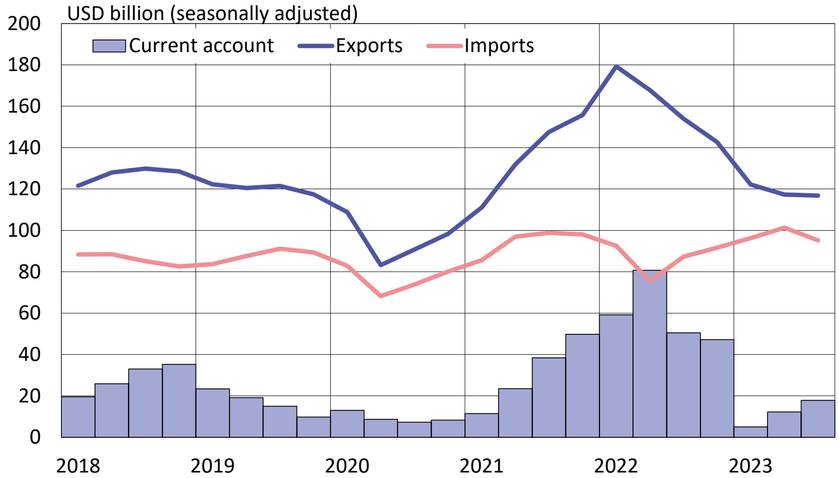
Current account surplus increased in the third quarter. Preliminary figures released by the Central Bank of Russia show the country's third-quarter current account surplus amounted to 16 billion dollars. After a sharp decline in the first months of this year, the current account surplus turned to a slight growth in July-September. The cumulative surplus for the first nine months of this year was 41 billion dollars.

Following a sharp drop in the first half, the value of Russian goods & services exports stabilized in the third quarter and was 116 billion dollars. Export earnings were mainly supported by higher oil prices. The International Energy Agency (IEA) reports that the average export price of Urals blend crude in the third quarter was 71 dollars a barrel, up from an average of 48 dollars a barrel in the first half of this year.

The value of Russia's imports of goods & services has declined in recent months. The value of imports in the third quarter was about 95 billion dollars, or 4 % less than in 3Q21 (i.e. before Russia's invasion of Ukraine). Imports of tourism services, however, were up substantially.

The flow of capital out of Russia continued in the third quarter. Russia received some foreign capital inflows in the form of other investment, but foreign net portfolio investment was still outward bound. The outflow of capital of Russian firms was still greater than inflow.

The value of Russian exports of goods and services stabilised in the third quarter, while the value of imports declined



Sources: Macrobond, Central Bank of Russia, BOFIT.

Ruble's slide continues. Despite Russia's growing current account surplus, the ruble's exchange rate has been on a downward trend most of this year. At the end of June, the exchange rate was 87 rubles to the dollar. By early October, the rate flirted with a level of 100 rubles to the dollar. Concerned about the ruble's slide, the Russian government has pondered a range of measures to prop up the floundering currency.

The government this month reinstated the requirement that firms convert repatriated export earnings to rubles (effective Oct. 16). The new rule applies to 43 corporate entities operating in major export branches such as oil & gas and metal industries. These firms are required to deposit at least 80 % of their forex export earnings in a Russian bank and then convert at least 90 % of such deposits to rubles.

One factor diminishing the supplies of dollars and euros in Russia has been the shift in export invoicing to other currencies. According to the CBR, about 40 % of exports in July-August were invoiced in rubles, nearly 30 % in Chinese yuan and 25 % in euros or dollars. The shares of other foreign currencies only amounted to a few percent. Russian firms have found that repatriating earnings from some countries is not straightforward. For example, Indian rupee-denominated export earnings are subject to India's own currency controls.

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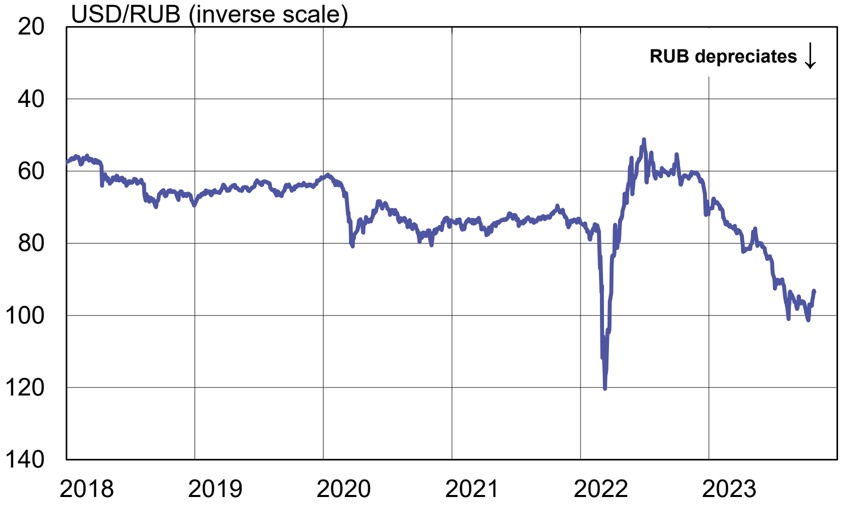
The ruble has lost value for most of this year



Sources: Macrobond, Central Bank of Russia, BOFIT.

Weak ruble has boosted budget revenues. Federal budget revenues in January-September matched the level of the same period last year. Following a big decline in the first half of the year, oil & gas revenues rose in the third quarter, recovering to a level of their 2021 average. The boost to oil & gas revenues benefits from both the higher oil price and ruble weakness as the oil taxes are dollar-based.

A new export tax based on the ruble's exchange rate also increases budget revenues when the ruble falls. The tax, which applies to many exporting firms, features a percentage that goes up if the ruble weakens. The tax's ceiling rate of 7 % applies when the exchange rate exceeds 95 rubles to the dollar. No tax is required when the exchange rate falls below 80 rubles to the dollar.

Despite improved revenue performance, budget spending has stabilised in recent months. After brisk growth in the first half of the year, budget spending was down by 4 % y-o-y in the third quarter and the budget deficit narrowed. The finance ministry's preliminary deficit estimate for the first nine months of this year is roughly 1.7 trillion rubles (1 % of GDP).

For the first nine months of 2023, budget expenditures were up by about 10 % y-o-y due to a spending boom in the beginning of the year. The lower-house Duma is currently considering a three-year budget framework for 2024–2026 that calls for large spending increases next year. While the biggest spending increases go to the war effort, the plans also call for increased social spending next year, including a 7.5 % hike in old-age pensions.

Inflationary pressures on the rise. Rapid credit growth combined with growth in government spending and the ruble's depreciation have stoked inflation. In September, on-month growth in consumer prices reached its highest level since the peak of spring 2022. Consumer prices were up by 6 % y-o-y in September. In recent months, prices of food and petroleum products have risen rapidly.

The CBR raised its key rates by 550 basis points in July-September. The interest rate currently stands at 13 %, its highest level since spring 2022 (when the CBR raised the key rate to 20 % to curb the financial market panic caused by Russia's invasion of Ukraine and new Western sanctions). Markets expect another hike in the key rate to be announced after the CBR board meets today (Oct. 27).

Russian economic growth expected to slow. According to preliminary figures, Russia's economic development appears to have been stable in September. Growth is expected to slow gradually over the coming months. Seasonally adjusted industrial output for September remained at nearly the same level as in previous months. Manufacturing continued to support industrial output growth, while production of extractive industries remained subdued.

Subsiding growth in government expenditure in recent months and rising interest rates are expected to hinder Russian economic growth in coming months. The government, however, also aims to boost growth again next year through increased budget spending. The latest institutional forecasts for Russia see GDP growing by 1.5–2 % this year and about 1 % next year.

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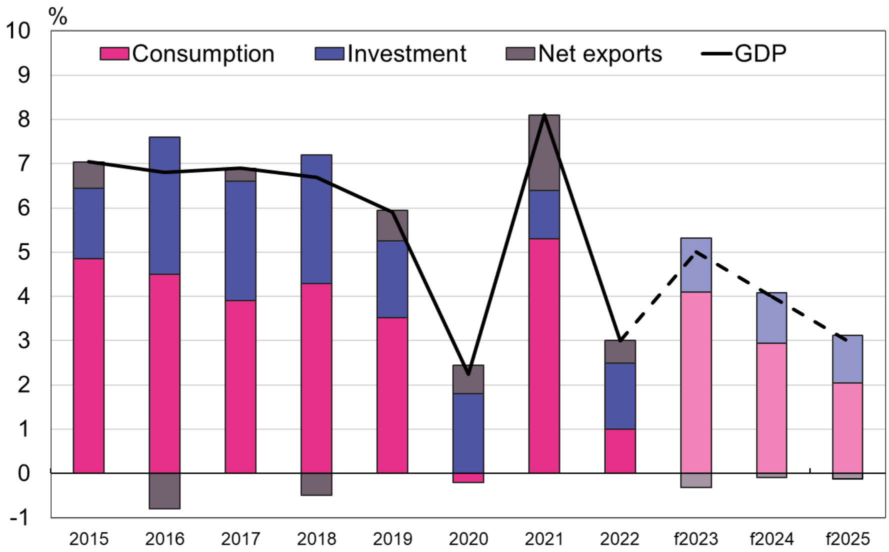
BOFIT

China

BOFIT expects Chinese economic growth to slow in coming years. On Monday (Oct. 30), BOFIT released its latest Forecast for China 2023–2025 and held a briefing in Finnish on the Chinese economy (here). We expect the Chinese economy to slow gradually over the forecast period. While GDP growth should still reach about 5 % this year, it slows to around 4 % next year and 3 % in 2025. The biggest hindrances to growth are structural factors, including China's shrinking working-age demographic, an ageing population, modest productivity gains and stalled political efforts to move from an economic paradigm based on fixed investment to a growth model driven by consumption. China is unlikely to make much progress in the extensive structural reforms needed to correct the situation during the forecast period. The country's leadership instead is likely to remain fixated on increasing self-sufficiency and strengthening national security, objectives broadly reflected in economic policymaking.

Chinese GDP growth, factors contributing to growth and BOFIT Forecast for China 2023–2025



Sources: China National Bureau of Statistics and BOFIT.

The possibility for the government to support economic growth are more limited than earlier. Public-sector deficits have been very large in recent years, creating a mountain of debt. Local governments, which typically are responsible for implementing stimulus measures, are struggling, especially those outside China's richest provinces. Large pressures to export capital from the country and the yuan's weak exchange rate are expected to keep the central bank cautious on its monetary policy stimulus measures. The future outlook also carries considerable risks. For example, how the leadership will try solve problem areas it recognises? How much more tense already-strained relations between China and the west will become? Risks in China's complex and opaque financial sector continue to mount as the county piles on debt. Could we see major a disturbance that shocks the financial system?

Additional support measures. Since the release of our latest forecast, the October readings of the official purchasing manager indices have been released. They indicate a weak economy in October. The manufacturing PMI fell below the 50, indicating that the conditions of manufacturing firms were worse than in September. The latest services PMI index slightly exceeds the neutral reading of 50, implying that the situation of service-providers only improved slightly in October. Officials have announced numerous minor measures to support the economy in recent months (BOFIT Weekly 38/2023), and further measures in recent weeks. Although the measures will boost economic growth slightly, their overall impacts will likely be limited.

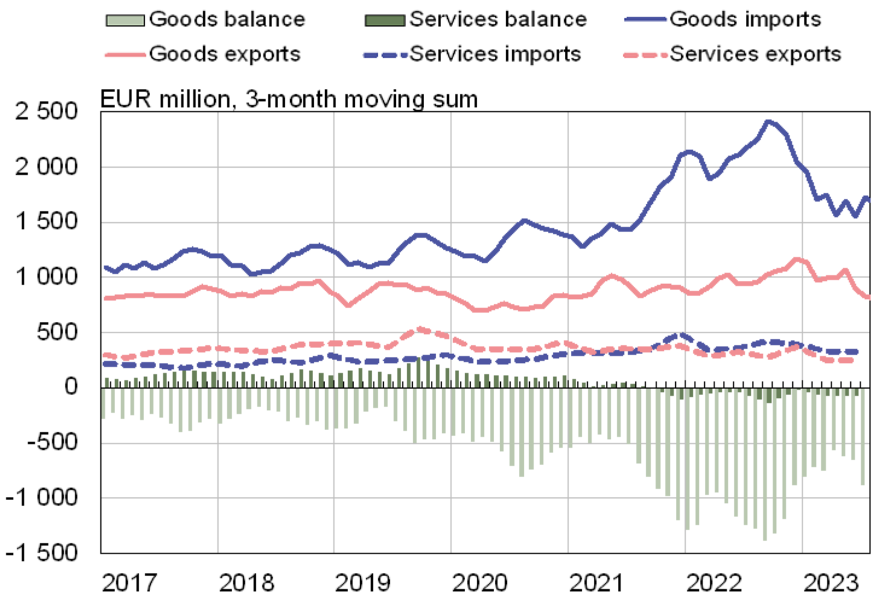
In late October, the central government announced it was increasing its borrowing this year by 1 trillion yuan (roughly 0.8 % of GDP). The measure is exceptional; the last time the central government decided on a supplemental budgetary increase during a fiscal year was in 2000. According to some reports, the additional funds would be spent on infrastructure projects such as repairing flood damage from last summer and building resilience for future flooding. Moreover, local governments have been given permission to to begin issuing their bond 2024 allocations as the special debt quota granted to local governments this year is nearly exhausted already. The purpose of the decision is to smooth the transition of local finances going into the coming year. Local governments have also been granted the possibility its issue bonds to pay off typically high-interest debt hidden in their off-budget local government financial vehicles. Some provinces have already done this. The measures ease the financial position of local governments and mitigate debt-servicing costs.

The government has even become involved in propping up traded share prices. Central Huijin, which manages government stakes in China's giant state-controlled banks, has announced it has bought more shares of state banks from the market. Several state-owned firms have also announced share buy-back programmes in recent weeks. Moreover, officials reportedly changed rules for insurance companies this week to make longer-term investment in company shares easier.

China's imports from Finland down sharply from highs two years ago; Chinese tourism in Finland has yet to revive. The value of goods imported to Finland from China grew rapidly in recent years, but this year the trend has come to a halt. Finnish Customs figures show that in the first eight months of this year, the value of goods imports from China (including Hong Kong) was 4.5 billion euros, a decrease of 20 % from the same period a year earlier. The change is fairly dramatic as Finland's imports from China grew by 29 % in 2022 and by 22 % in 2021. Finland's weaker imports from China, however, are not unique. Finland's imports overall have contracted by 17 % y-o-y so far this year, a reflection of Finland's weak economic performance and the fading of pent-up goods demand after the country emerged from pandemic restrictions. China is Finland's third-most important source of imports after Sweden and Germany. Nearly a tenth of Finnish goods imports come from China, about half of which consist of machinery and electronic devices.

While Finland's goods exports to China continue to sputter, their situation is still better than for imports. In the first eight months of this year, exports to China were valued at 2.5 billion euros, about 4 % less than in the same period a year earlier. During 2022, Finland's goods exports to China rose by 10 %, when last year they grew by 19 %. China's current economic problems and weak domestic demand explain this year's lacklustre performance. Nevertheless, a slowdown in the global economy is also reflected in the Finnish external sector, with Finland's total goods exports down by 6 % from the same 8-month period in 2022. China is Finland's fifth most important goods export market after Germany, Sweden, the US and the Netherlands. China accounts for about 5 % of Finnish goods exports. Finland's largest export product categories for China are pulp & paper products, as well as machinery and electronic devices.

Finland-China trade has been in flux this year



Sources: Finnish Customs, Statistics Finland and BOFIT.

With respect to bilateral services trade, the situation is somewhat different. Statistics Finland reports that Finland's services imports from China (including Hong Kong) amounted to 763 million euros in the first half of this year, an 11 %

increase from 1H22. In the first half of this year, exports of services to China contracted by about 6 % y-o-y to around 684 million euros. China accounted for just over 4 % of Finland's total services imports and exports.

Finland's top services exports to China included licensing of Finnish R&D patents (28 % of services exports to China in 2022), data processing services (26 %), as well as various transportation services (15 %). Finland's top imports from China include technical or trading services, and other commercial services (20 %), as well as various transportation services (28 %). Before the pandemic, tourism services were also an important part for Finland's services exports to China. Following a stark drop during the pandemic, the number of Chinese tourists visiting Finland has only recently started to recover. According to preliminary information released by national tourism promoter Visit Finland, Chinese tourists accounted for less than 3 % of overnight stays by foreign tourists in September, down from over 6 % before the pandemic in 2019. The outlook for China's foreign trade was discussed at BOFIT's briefing (in Finnish) on the Chinese economy held at the Bank of Finland on Monday (Oct. 30).

The popularity of Finland with Chinese tourists increased rapidly in pre-covid years

Sources: Visit Finland and BOFIT.

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BOFIT

Russia

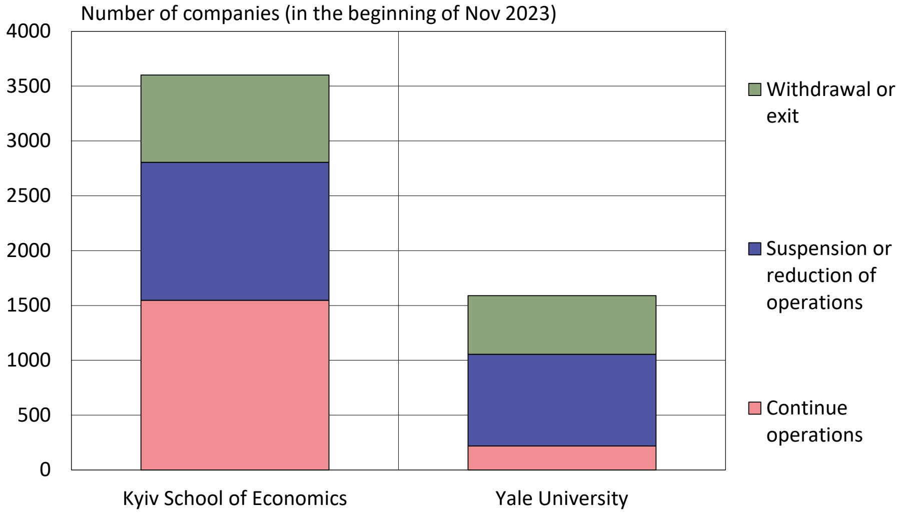
Hundreds of foreign firms continue to do business in Russia despite huge risks

With Russia's all-out war of aggression on Ukraine in February 2022 and the wide-ranging economic sanctions it triggered, many foreign companies announced plans to exit the Russian market altogether. Estimates of the number of firms that have actually exited the Russian market vary, but it is also evident that hundreds of foreign corporations continue to do business in Russia despite the war.

The Leave Russia database maintained by the Kyiv School of Economics (KSE) shows that about 20 % of foreign firms have withdrawn all business in Russia or exited the market. The database currently tracks about 3,600 firms. The Yale CELI List of Companies Leaving and Staying in Russia tracks roughly 1,600 firms and estimates that about third of these firms has withdrawn or exited Russia. The methods and sources used in the databases differ somewhat in their methods of evaluating company operations.

The share of companies that have left Russian markets varies much across countries. The KSE database shows that about half of firms from countries that imposed sanctions on Russia are either in the process of leaving or have already withdrawn from the Russian market. In relative terms, Finnish and other Nordic companies have been most active in leaving the Russian market. Within EU, the share of companies still present in Russia is highest (about 80 %) among companies based in Greece, Italy and Austria. Only a tiny percentage of Chinese, Turkish and Indian firms have announced any plans to exit Russia.

Hundreds of foreign firms have chosen to keep doing business in Russia



Sources: Kyiv School of Economics, Yale University, BOFIT.

Underlying economic and administrative factors. Despite the war, some foreign firms are tempted by the juicy profit potential of remaining in the Russian market. Many competitors have left and import competition has also reduced. According to a report by the KSE, corporations that chose to continue to operate in the Russian market collectively earned profits from Russia of about 14 billion dollars last year. At the same time, they supported Russia's budget revenue by paying 3.5 billion dollars in profit taxes alone. Some firms have argued that they need to stay in Russia for humanitarian reasons because they produce or sell necessities such as medicines and food.

Some companies exiting Russia have experienced huge losses from having to dispose of assets at fire-sale prices or write down Russian assets as complete losses. The *Financial Times* estimates that firms on its list of Europe's top 600 companies have collectively suffered losses of roughly 100 billion dollars in withdrawing from the Russian market. The largest losses have been borne by international energy giants such as BP and Shell. The pain of such losses last year was offset to some extent, however, by robust profits these companies enjoyed on the spike in oil & gas prices following Russia's invasion of Ukraine.

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Russia has made exiting from the market very difficult since the invasion of Ukraine. For example, a firm from a "non-friendly" country (country imposing sanctions on Russia) that seeks to sell its business in Russia must first get official permission. The process of getting such permission can take several months. Officials also expect the sale to be realised at substantial discounts with some of the money from the sale surrendered to Russian officials. Russian media reports that such surcharges to date have raised 80 billion rubles (about 1 billion dollars) for state coffers. Under Russia's 2024 budget framework, however, this temporary revenue stream is expected to dry up next year.

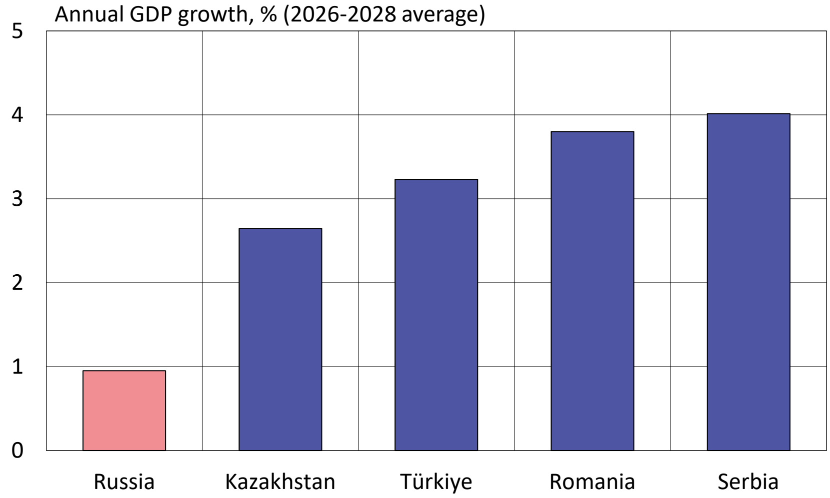
Russian market risks large, growth outlook weak. The risks associated with operating in the Russian market have increased tremendously since the start of the war. The overall attitude towards foreign companies is hostile and their operations have been complicated by administrative measures. Limits on capital movements make it very difficult for corporations to move money abroad. These problems are not limited to companies from "unfriendly" countries. For example, Indian oil companies are currently struggling to repatriate roughly 600 million dollars in Russian dividends.

According to a recent report by a Russian law office, cases brought against foreign firms in Russia have increased substantially since the war started. Ever more often in these cases assets of foreign companies become subject already to pre-judgment seizure of assets or arrests. The report notes that such measures against foreign firms are likely to increase.

Changes in Russian law this year now permit freezing or seizure of the assets of foreign firms by Russian officials. Russian officials have already this year confiscated the Russian operations of Finnish energy company Fortum, Danish beverage-maker Carlsberg and French food giant Danone. In addition, Russian officials can commandeer any firm operating in Russia to participate in the war effort.

Despite huge risks, especially the longer-term growth outlook for the Russian economy is quite feeble. According to the IMF's latest WEO, Russia is among the most slowly growing economies in coming years together with countries like Equatorial Guinea and Belarus. Russian GDP growth is predicted to be significantly lower compared to most other countries with a similar income level.

The IMF expects Russian GDP to grow considerably more slowly in 2026–2028 than GDP of other countries with similar income level



Sources: IMF WEO October 2023, BOFIT.

Most Finnish firms no longer do business in Russia. The business relations of Finnish firms with their Russian counterparts have collapsed since the invasion of Ukraine. Finnish firms have left the Russian market entirely with but a few exceptions. According to a just-released survey of Finnish export firms by Finland's Chamber of Commerce, only 2 % of respondents said that their company still had operations in Russia, down from a pre-invasion level of 80 %. A few firms reported that their withdrawals from Russia were still ongoing.

A VATT Institute for Economic Research study finds that the impacts from the loss of exports to Russia on Finnish firms have generally been quite limited. Although exports of firms exporting to Russia contracted more severely than those of other export firms in spring 2022, affected firms made the transition with little change their levels of overall sales or number of personnel compared to pre-invasion levels. The authors argue that the small impact reflects the waning importance of Russia as an export market and the ability of affected firms to identify alternative export markets.

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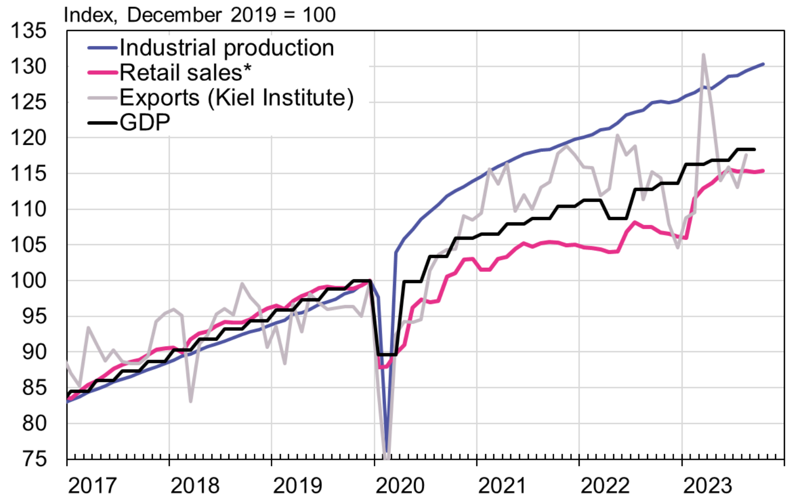
BOFIT

China

China's economic numbers signal more stabilised growth in October. Last month's economic growth, however, was lower than in pre-pandemic years and recovery from the lifting of covid restrictions remains disappointing. Industrial output was up by 4.6 % y-o-y in October, about the same pace as in August and September. Automobile production (up 11.3 % y-o-y in January-October) has grown faster this year than overall industry, while output of high-tech manufacturing lagged average production growth (1.9 %). The real estate market has yet to show any signs of recovery. The declines in both real estate investment (down 17 % y-o-y) and the volume of housing sales (down 20 % measured by floorspace) continued in October.

Retail sales climbed by nearly 8 % y-o-y in October, but the increase was due mainly to last year's relatively low basis reference. Compared to the previous month, retail sales growth was marginal. In the retail sales category, restaurants and other services have been the fastest growing sub-item this year. Consumer prices fell in October by 0.2 % y-o-y. This was due mainly to a drop in pork prices (down by 30 % y-o-y in October). Core inflation (excludes food and energy prices) slowed slightly to 0.6 %.

Industrial output has grown faster that retail sales since the first wave of the Covid-19 pandemic



*Sources: China National Bureau of Statistics, Kiel Institute, CEIC and BOFIT. *) Nominal retail sales deflated by the consumer price index.*

The value of goods exports in October was down by 8 % y-o-y in dollar terms (down 5 % in yuan). Imports, in contrast, picked up in October, with the dollar value of goods imports rising by 2 % y-o-y (up 6 % in yuan). The development of China's foreign trade volumes this year has been more favourable than foreign trade measured in terms of value. Prices of both exports and imports have been falling since last spring. According to WTO figures, the volume of Chinese goods exports in the second quarter rose by 2 % y-o-y, but its value declined by 4 %.

On-year growth in China's broadest debt measure, aggregate financing to the real economy (AFRE), accelerated a bit in October to 9.3 %. Much of the increase was due to bond issues by local governments. Demand for private sector loans is still fairly weak. For example, on-year growth in household loan stock remained at just 3 % in October. Local governments have this year been granted permission to issue a quota of 1.5 trillion yuan (205 billion dollars) in new special purpose bonds to pay off some of their hidden high-interest debt. As of early November, 1.2 trillion yuan in such bonds had been issued.

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Real 12-month change and consumer prices, %

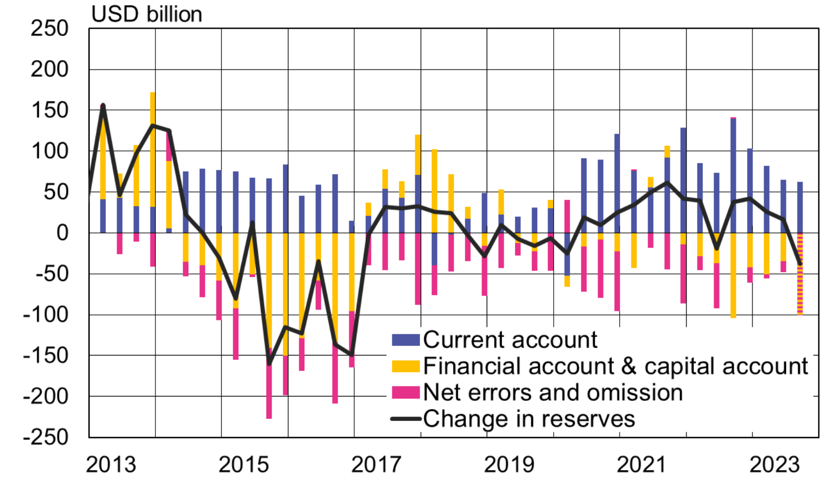
	2021	2022	1Q2023	2Q2023	3Q2023
GDP	8.4	3	4.6	6.3	4.9
	2021	**2022**	**Aug. '23**	**Sept. '23**	**Oct. '23**
Industrial production	9.6	3.6	4.5	4.5	4.6
Retail sales	10.7	-2.2	4.5	5.5	7.8
Goods exports	17.4	-1.3	5.9	7.9	n/a
Goods imports	7.7	-6.6	5.3	2.2	n/a
Inflation	0.9	2.0	0.1	0.0	-0.2
Yuan-dollar rate, avg.	6.45	6.74	7.26	7.30	7.31

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

Balance-of-payments figures show increased capital outflows from China. In its balance-of-payments statement, the People's Bank of China reports that China's still large goods trade surplus helps to offset the again growing services trade deficit and that the financial account has shown a deficit for two years running. Additionally, the "net errors and omissions" term in the balance-of-payments remains negative, indicating that more assets are flowing out of China than officials have managed to classify. According to the PBoC's preliminary balance-of-payments figures, the cumulative goods trade surplus for the first three quarters of this year amounted to 454 billion dollars. The total current account surplus was 209 billion dollars, reduced largely by a growing services trade deficit that amounted to 168 billion dollars in January-September (up from 62 billion dollars in the same period last year). The financial account and net errors and omissions term in the first three quarters of this year showed a combined deficit of 205 billion dollars, suggesting that the level of China's foreign exchange reserves has been largely unchanged this year.

Among the sub-items in the financial account, however, especially the direct investment flows clearly turned outward. The direct investment balance has been negative (i.e. Chinese direct investment flows outward have surpassed inward foreign direct investment flows) since the end of 2021. For the first nine months of this year, the balance-of-payments data show foreign direct investment inflows to China of 15 billion dollars and an outflow of 143 billion dollars. In the third quarter, the inflows of direct investment into China also turned negative by 12 billion dollars for the first time since China started keeping quarterly balance-of-payments records in 1998. This indicates that foreign firms operating in China in net were seeking to repatriate profits or divest assets in China. Recent surveys of foreign firms operating in China also indicate that the firms have become more cautious with respect to new investment in China and more interested in finding alternative countries for their additional investments. The portfolio investment balance of the financial account was negative last year and in the first two quarters of this year (3Q figures have yet to be released). For the January-June period, Chinese investors made portfolio investments abroad valued at 52 billion dollars, while foreign investors reduced the amount of their holdings in China by 10 billion dollars.

Balance-of-payments net flows turned negative in the third quarter

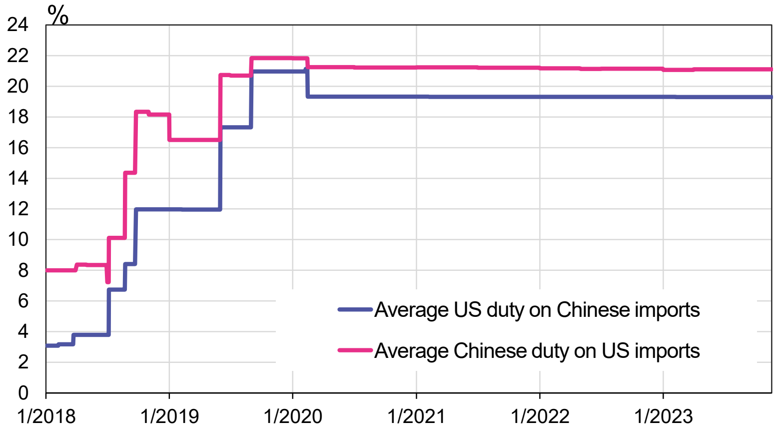


Sources: SAFE, Macrobond and BOFIT. Note: Financial account, capital account and net errors and omission terms combined for 3Q2023.

Meeting of presidents Joe Biden and Xi Jinping yields no notable improvements in US-China economic relations. On Wednesday (Nov. 15), US president Joe Biden and Chinese president Xi Jinping met in San Francisco while participating in a meeting of the Asia Pacific Economic Cooperation (APEC) forum. Although the presidential get-together failed to produce a significant shift in the economic relations of the world's two largest economies, the fact that the top leaders of both countries are back on speaking terms is significant in itself. The two presidents revived the dialogue they started in Bali last year, and discussed cooperation despite their many fundamental differences. The two countries, for example, conceded that they share interests in such areas as climate change and regulation of artificial intelligence (AI). The presidents also discussed the importance of maintaining bilateral relations and keeping channels of communication open. Two concrete examples of thawing relations could be seen in the decisions to resume high-level military communications and push ahead on an agreement on Chinese production of the chemical precursors used in the illicit production of the synthetic opioid fentanyl. Among the top geopolitical topics discussed were the Israel-Hamas conflict, Russia's war of aggression on Ukraine, the Taiwan situation, and human rights.

US-China relations have been tense since 2018, when a trade war broke out and both countries found themselves in greater competition as "decoupling" advanced. The dynamics of global trade have shifted over the past five years since the US and China decided to impose import tariffs and export restrictions on each other. The latest actions involve updates to US bans on technology exports to China introduced in October 2022. The updates extend the bans to include Nvidia's H100 and H800 chips used in AI applications and certain chips for the AI training and autonomous vehicle sectors, as well as the inclusion of several new Chinese firms to the entity list of firms subject to US export bans. US-China trade relations are not expected to improve in the near future and import tariffs will remain high. Differences over access to certain technologies is particularly thorny as the US would like to have greater say in China's emergence as a technological superpower.

Average customs duties between the US and China remain high

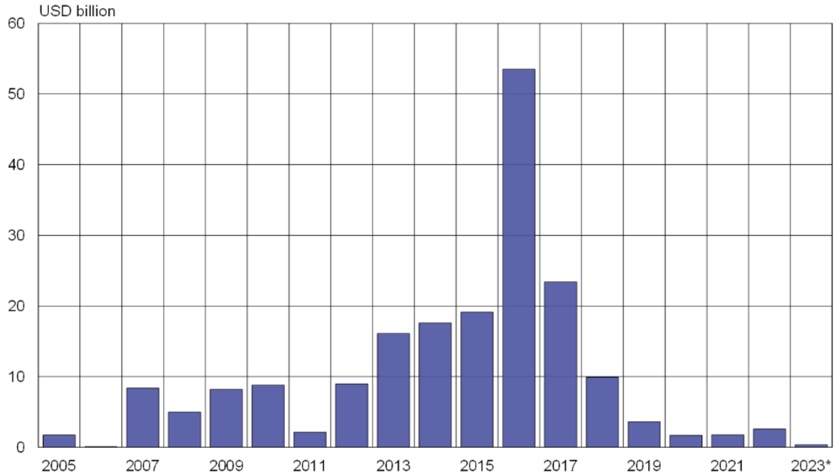


Sources: PIIE and Macrobond.

Poor relations between the world's two largest economies affect the global economic situation by, among other things, undermining economic confidence. In addition, broad export restrictions and customs duties make the business environment more challenging for many international companies. The current trade war has effectively reshaped the structure of world trade, and the mutual importance of the US-China trade partnership has diminished in recent years. The US currently accounts for about 11 % of China's goods trade (imports and exports), down from over 14 % before the trade war. China's share of US goods trade has declined from around 16 % to 13 %. At the same time, the significance of Southeast Asia as a trading partner has increased for both parties during the trade war – an indication that production chains have also been reshaped by this new dynamic.

Increased US monitoring of foreign direct investment and a shared bipartisan understanding in the US Congress of the need for strict China policies are reflected in the drop in Chinese investment in the US. Figures compiled by the American Enterprise Institute show that the total value of large direct investment flows into the US (investments over 100 million dollars) from China totalled 130 billion euros for the 2013–2017 period. During the trade-war years of 2018 to 2022, the value of new direct investment flows amounted to only about 20 billion euros, or 15 % of the amount in the previous five-year period. Part of the drop, of course, reflects the massive drop in investment during the peak pandemic years. Given the technology-related differences of the two countries, it is hardly surprising that investment has collapsed in the technology sector.

Chinese direct investment flows to the United States (total of individual investments greater than 100 million dollars)



*Sources: American Enterprise Institute and BOFIT. *) 2023 January-June.*

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BOFIT

Russia

Russian financial markets seek new equilibrium

Foreign investors have abandoned the Moscow stock market. As a result of Western economic sanctions imposed on Russia in March 2022 after the invasion of Ukraine, Russia's financial markets have changed in many respects. A critical change is the exit of foreign investors. Prior to the war, foreign investors – mainly large Western investment funds – accounted for about half of the trading volume on the Moscow stock exchange and hold about 20 % of government treasuries. Western sanctions and Russia's own measures to restrict the sale of securities have effectively driven foreign portfolio investors out of the market.

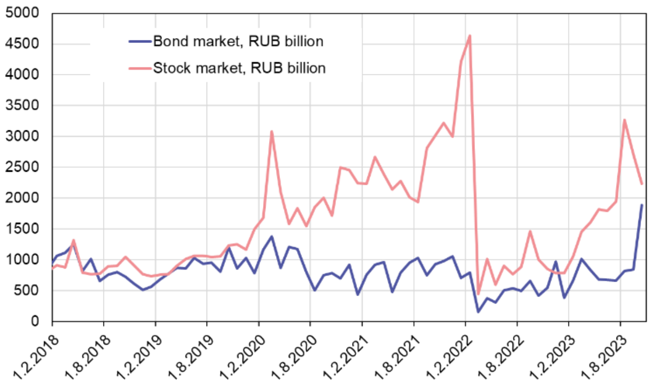
The fallout from all this is a very different market. Russia has essentially no large domestic institutional investors, so the share of private individuals trading on the Moscow stock exchange since the invasion of Ukraine has been around 80 %. The volume of trading contracted sharply in spring 2022. By the end of last year, the average daily trading volume had fallen to around 30 billion rubles. Thanks to positive wage trends this year as well as gradual adjustment to the new reality, the appetite for owning shares has begun to return. The average daily turnover has increased by about 50 % from end-2022 levels, but the volume of trading is still below the pre-war level. The exceptionally large participation of private individuals in the market makes forecasting stock market developments very difficult.

Milder changes in the bond market. Trading volumes in corporate and government bond markets have been smaller than in the stock market. Domestic commercial banks are important counterparties in the bond market, and the share of foreign investors was smaller even before the invasion of Ukraine. Based on Central Bank of Russia data, about 9 % of total banking sector assets are held in government treasuries and about 5 % in other bonds. Overall, these shares have remained essentially unchanged during the war, but bank-specific data on total assets or the main balance-sheet items of banks are no longer available.

In total, about half of ruble-denominated bonds on issue are government bonds, with the remaining half split equally between bonds of financial institutions and other corporate bonds. While the amount of new government treasury issues in 2023 has been lower than budgeted, there has been a flood of new corporate bond issues (particularly by financial institutions). There was an exceptional spike in trading in October as companies sought to exploit relatively low interest rates. The recent bump in interest rates, however, is likely to put back bond issues planned for the end of this year.

As a consequence of sanctions, the share of domestic foreign currency-denominated bonds has increased slightly. According to a presidential decree from May 2023, all eurobonds must be converted by the end of this year into "replacement" bonds pegged to foreign currency, but with all settlements done in rubles. At the beginning of 2022, the stock of of corporate eurobonds on issue was valued at roughly 110 billion dollars. As of end-October, the outstanding eurobond amount after repayments and conversion of some eurobonds to replacement bonds was still 52 billion dollars. The value of replacement bonds on the Moscow exchange today is roughly 16 billion dollars. Some firms last year issued yuan-denominated bonds on a trial basis, but investor interest in this product seems to have evaporated this year. Yuan bonds have yet to replace eurobonds by any measure.

While the volume of stock trades on the Moscow exchange has decreased in recent months, bond trades are up strongly.



Sources: Moscow Exchange, CEIC, BOFIT.

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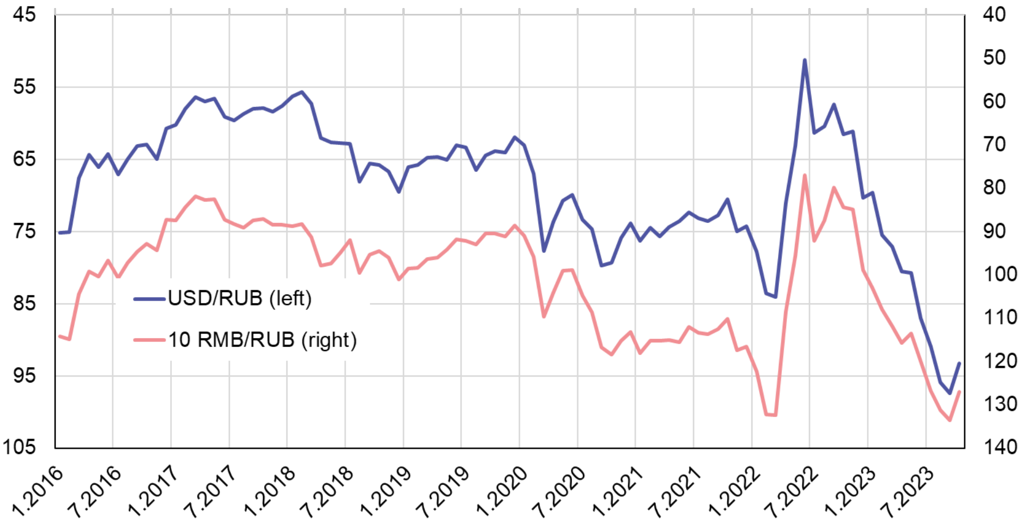
The reshaping of Russia's forex market reflects the exit of foreign participants and tighter Russian capital controls. Before the war, foreign investors and foreign banks were major participants in Russia's forex exchange. Today, almost all counterparties at the Moscow currency exchange are domestic banks. Besides export prices, administrative restrictions affect foreign currency exchange rates far more than earlier. Although use of currencies of countries considered "friendly" to Russia is supported in many contexts, the ruble-dollar rate remains the key indicator of Russia's economic performance in many circles. The rapid weakening of the ruble against the dollar since early autumn has forced the government to tighten many capital controls. Government efforts to prop up the ruble include regulating the financial activities of foreign-owned firms, repatriation requirements of export earnings, increased reporting requirements concerning foreign bank accounts and central bank forex operations. These measures, however, do not address any of the underlying reasons for ruble's weakness. The ruble's decline reflects a loss of confidence in the ruble as an investment currency and an incessant demand of importing firms for Western currency.

The ruble-dollar pairing now only accounts for about a third of trades on the Moscow currency exchange, while the share of yuan-ruble pairings has risen to nearly 40 %. The rise of the yuan reflects the rapid increase in the role of the yuan as an invoicing currency in foreign trade. The yuan is involved in less than 10 % of currency transfers by private individuals. In October, the euro accounted for 12 % of forex trading, roughly the same level as in January 2022. The dollar's share in currency trading outside the exchange has only diminished slightly and still accounts for over half of total trading volume.

In fear of Western sanctions, companies and banks currently enjoy looser rules on mandatory reporting of ownership relations and economic performance. Foreign analysts, credit-rating agencies and auditors have also left the Russian market. As a consequence of the exodus of Western investors, demand for transparency and good governance practices has evaporated. In its place, the state has an ever-increasing role, not just as owner of large firms and the largest banks, but also as owner of domestic systems for payment and settlement to assure that domestic financial intermediation continues. In any case, Russia's financial markets today are significantly more isolated, smaller and riskier than before the war.

The ruble has been losing value against the US dollar since summer 2022



Note: The y-axis is inverted, so a falling trend indicates ruble depreciation.
Source: Central Bank of Russia.

China

Yuan's depreciation trend likely over; Chinese currency's internationalisation progresses slowly. The yuan's persistent weakening bias, which have lasted for most of this year, appears to have ended. The yuan strengthened against the US dollar last month as part of a larger trend of the dollar losing ground against major currencies. The USD/CNY rate reached 7.08 by end-November from 7.32 a month earlier, representing a 3.3 % gain for the yuan. Nonetheless, the Chinese currency is still down by 2.6 % against the dollar from the start of this year. The yuan-euro rate also appears to have stabilised, even if there is still a slight downward trend as the euro has strengthened against other major currencies. The EUR/CNY rate is currently at 7.77, down 5.3 % from the start of this year and 0.5 % weaker than at the end of October. China's real effective (trade-weighted) exchange rate, or REER, has weakened by 4.8 % since the start of this year, but has remained relatively stable over the past month.

The yuan's recent gain against the dollar follows a multi-month period in which the yuan faced notable depreciation pressures on the back of interest rate hikes by the US Federal Reserve and China's weak economic outlook. The yuan's weakness forced the People's Bank of China to go on the defensive. The PBoC regulates the yuan's exchange rate through daily publication of a fixing rate, around which the yuan may fluctuate by up to 2 % in either direction. The setting of the fixing is based on estimates by large commercial banks that take into account the yuan's market moves against a basket of currencies. The yuan's weakness became too much for the PBoC this autumn and it stopped allowing market forces to guide the currency further down. Between mid-September and mid-November, for instance, the PBoC kept the daily fixing extremely stable, within USD/CNY 7.17–7.18, regardless of the exchange rate's market closing level for the previous day.

The dollar's appreciation trend appears to have ended, reflecting market expectations regarding the US Fed's monetary policy bias. As US inflationary pressures abate, market participants now believe that the Fed no longer has incentive to raise interest rates further. Accordingly, the yuan has appreciated against the dollar, and China's central bank no longer needs to defend the yuan. This situation gives China greater monetary policy flexibility, allowing for a more accommodative monetary policy stance should the Chinese leadership assess the economy to need further support.

The internationalisation of the yuan is a long-term strategic goal of China's leadership. Nevertheless, as the currency's use globally increases, steering the yuan's exchange rate will become harder for the PBoC. The process of international acceptance of a new major currency, however, is slow and circuitous. Indeed, progress this year has consisted of steps forward and backward. Use of the yuan in China's foreign trade increased, especially after Russia launched its war of aggression against Ukraine. As a consequence of Western sanctions, the yuan has been used more particularly in Russia-China trade. The yuan's share in China's foreign trade settlement has risen from about 15 % before the war to 19 % a year ago and 25 % currently. The yuan now is the fifth-most-used currency in the international SWIFT payment system. It was used in 3.6 % of all international transactions in October (up from 2.1 % in October 2022). At the same time, international use of the yuan as an investment currency has declined, likely due to China's own economic problems and the decision by many foreign investors to pull their capital out of China. Central bank reporting to the IMF on currency reserve allocations shows that the yuan only comprised about 2.5 % of global foreign reserves as of mid-year, down from a 2.8 % share a year earlier. Even if mainland China's stock and bond markets are currently the world's second largest after the United States, foreign investors hold only a tiny fraction of Chinese securities. Just 4.0 % of mainland China's stocks are currently held by foreigners (compared to 4.2% a year earlier), while the holdings of Chinese bonds by foreign investors fell to 2.2 % (from 2.6 % a year earlier).

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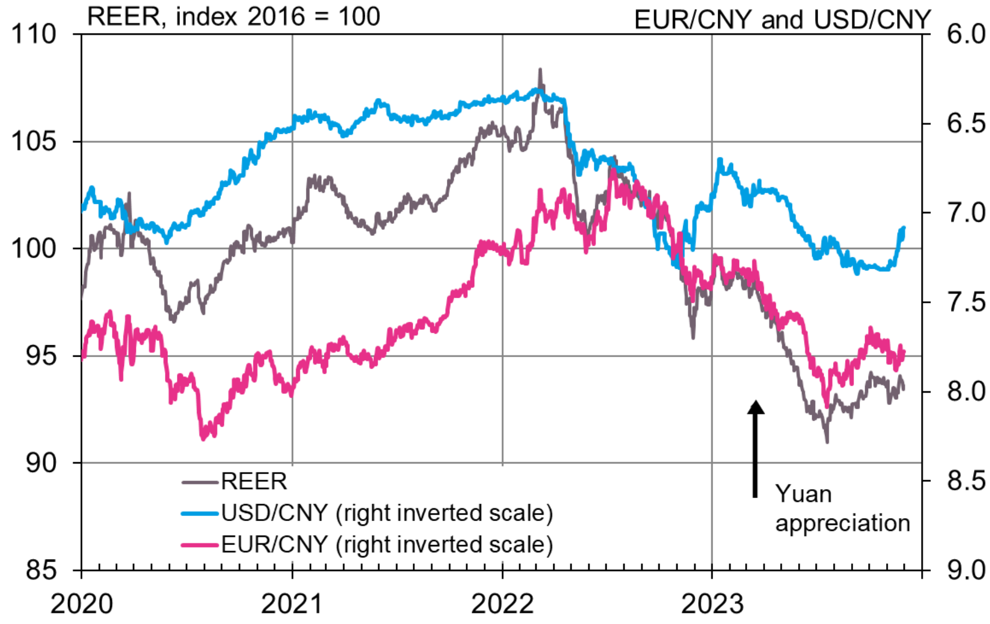
BOFIT

The yuan's depreciation trend against the euro and dollar appears to have ended



Sources: BIS, Macrobond and BOFIT.

China critical to resolving global climate issues. The United Nation's COP28 opened on Thursday (Nov. 30) in the city of Dubai in the United Arab Emirates. This year's 2-week event (Conference of the Parties to the UN Framework Convention on Climate Change) is expected to attract tens of thousands of guests from nearly every country in the world. Topics include evaluation of global progress in hitting the climate targets agreed in Paris in 2015, necessary increases in investment in the green transition and accelerating the move away from fossil fuels. Following last year's COP27 in Egypt, the parties voted to establish a loss and damage fund to assist poor countries in mitigation of climate change effects and address the harms caused by emissions. This year's meeting will take up the critical details like the financing of the fund. The discussions in Dubai are expected to be difficult. It is significant, however, that China and the United States, the world's two biggest carbon emitters, agreed two weeks ago to re-engage in high-level bilateral talks on climate issues.

China, by far the world's largest emitter of greenhouse gases, is a key factor in reducing climate disruption. Although the country continues to build coal-fired power plants and has accounted for about half of all global coal consumption in recent years, it has also made prodigious efforts to increase the use of renewables. About 40 % of global wind power and solar power generation capacity is in China. In addition, the country has significantly increased electricity production at its nuclear power plants, making it the second-largest generator of electricity from nuclear power plants in the world after the US. Moreover, China is serious about electrification of its transport system. Over half of the global fleet of electrical vehicles now operates in China. Large investment in green technologies and capacity to produce such technology has given China an important role in global decarbonisation efforts.

China's leadership has targeted its declining CO_2 emissions to commence by 2030 and reaching carbon-neutrality by 2060. The slight drop in China's carbon emissions last year reflected its struggles with covid lockdowns and restrictions; emissions this year are up as economic activity has revived. Two research institutes – the Centre for Research on Energy and Clean Air (CREA) and the Heinrich Böll Foundation – last week jointly published their second annual assessment of Chinese greenhouse emissions. The study notes that China could begin to reduce emissions in just a few years as long as the country's heavy investment in green energy technologies continues. The sharp downturn in China's construction sector has also helped reduce emissions. On the other hand, China continues to build considerable numbers of new coal-fired power plants. Clinging to coal assures that the country will miss its official target for reduced energy intensity (energy consumption per GDP), but also more makes the achievement of China's long-term emission targets more daunting.

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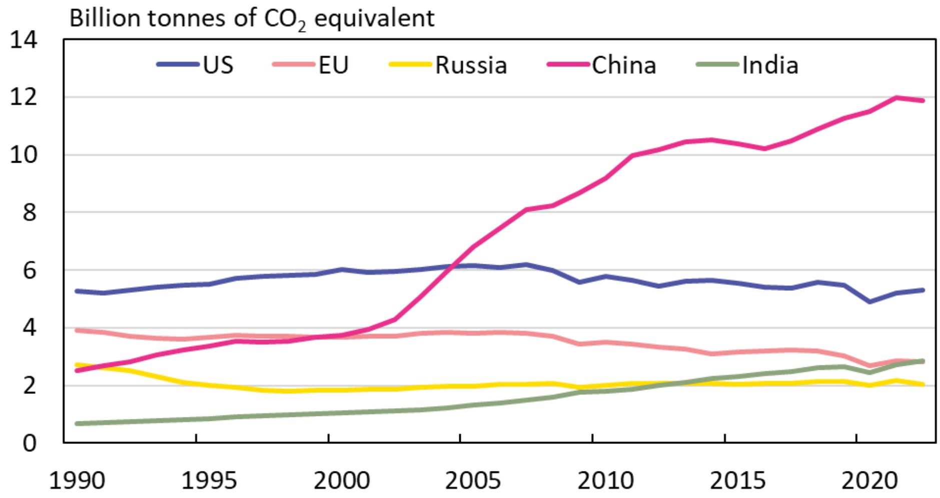
China has been the world's largest producer of CO_2 emissions for a two decades



Sources: BP Statistical Review of World Energy and BOFIT.

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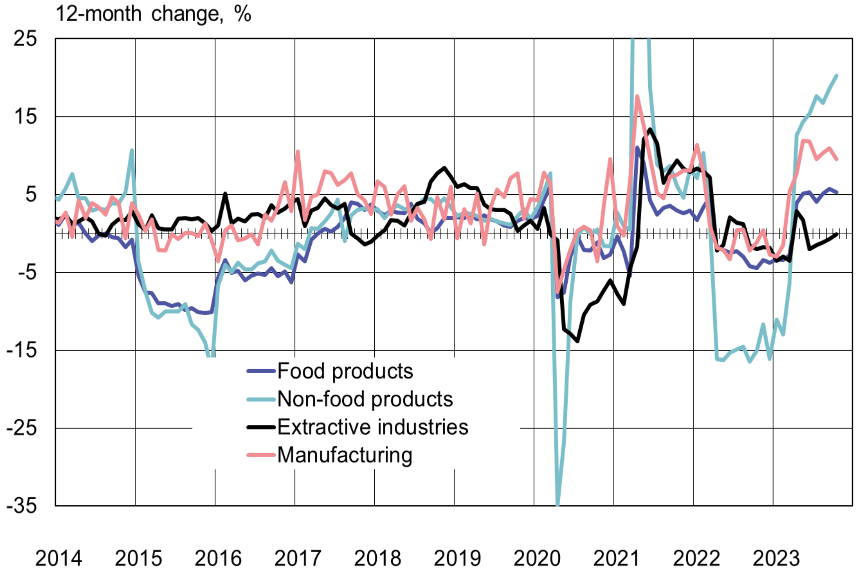
BOFIT

Russia

Inflationary pressures in Russia still on the rise

Retail sales and war-related industries drove output growth in October. Russia's ministry for economic development estimates that GDP grew by 5 % y-o-y in October. As in previous months, October manufacturing maintained high growth (up 9.5 % y-o-y), especially those branches that are associated with the military-industrial sector such as production of metal products and transport vehicles other than passenger cars. October output of extractive industries, which includes oil & gas, was unchanged from 12 months earlier. Growth in retail sales was particularly strong (12.7 % y-o-y), reflecting both last year's low reference basis and the large wage hikes of recent months.

Sales in non-food trade soared in October

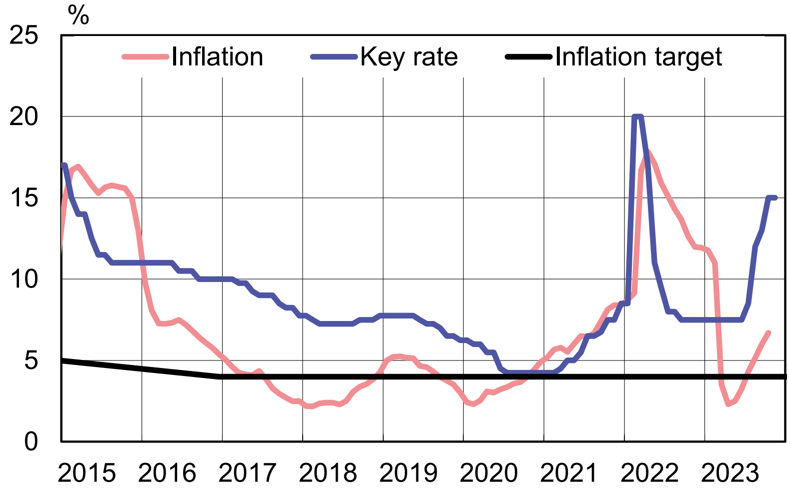


Sources: Rosstat and BOFIT.

Labour shortages, record-low unemployment and soaring nominal wages. Inflation has accelerated partly due to high wage hikes in many branches. In nominal terms, the average wage rose by 13.6 % y-o-y in September. The average real (inflation-adjusted) wage was up by 7.2 %. The hefty wage increases reflect an extremely tight labour market. This is also seen in Russia's record low unemployment rate (2.9 %). Wage hikes have been particularly large in manufacturing (up 18.8 % y-o-y on average in September) and especially in branches linked to the military-industrial sector (up over 20 %).

Accelerating inflation and increased inflation expectations. Consumer price inflation accelerated in October and was 7.5 % y-o-y. As part of its inflation-fighting efforts, the Central Bank of Russia has raised its key rate several times since July. Household inflation expectations soared to levels close to the 2022 peak, indicating that Russians still expect inflation to accelerate further. Corporate inflation expectations have climbed along with soaring labour costs. Therefore, most analysts expect that the CBR will again hike the key rate from its current level of 15 % when it meets next week on December 15. The key rate was last at such an elevated level in May 2022.

The CBR has had to raise its key rate in response to high inflation



Sources: Central Bank of Russia, Rosstat and BOFIT.

Loose fiscal policies making it hard to corral inflation. Growth in government spending has also increased inflation pressures. In January-October, federal budget spending increased by 12 % y-o-y. In addition to spending on the war, Russia's upcoming presidential election in spring 2024 has added pressure for the government to boost spending in coming months. The index increases for pensions next year have already been announced.

The relaxation of spending discipline represents a big change from Russia's pre-invasion fiscal policies. With ongoing war spending, government expenditures next year are set to rise significantly. Given the tightening of Russian monetary policy and the uncertain outlook for the global economy, critics see the government's revenue projection for the 2024 budget as overly optimistic.

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BOFIT

China

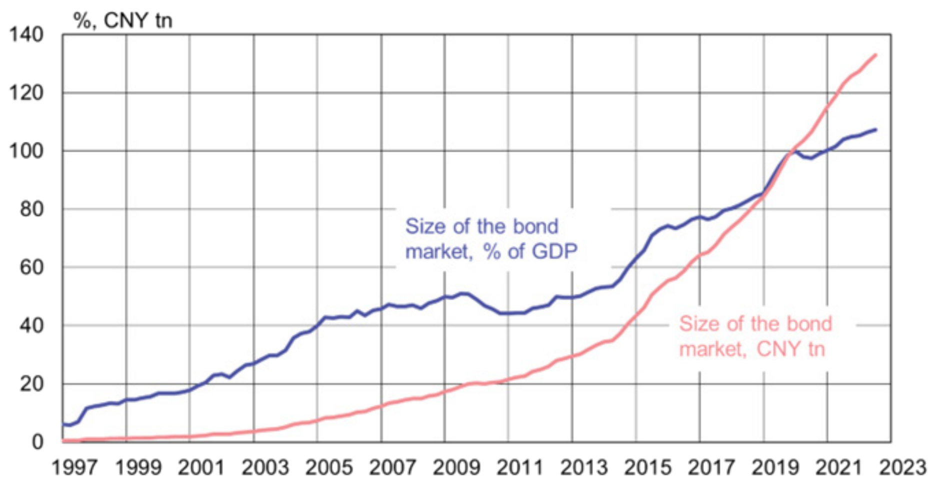
China's bond market growing rapidly, even as foreign investor interest remains weak. China's onshore bond markets have continued to experience high growth despite the country's many economic challenges. AsianBondsOnline, a site run by the Asian Development Bank, reports that the size of China's yuan-denominated bond market as of mid-2023 hit 133 trillion yuan (18.3 trillion dollars), an amount equal to 107 % of China's GDP. China's bond market still grew by 8 % y-o-y, even if the rate of growth has slowed significantly from earlier years. China's domestic bond market is the world's second largest after the US bond market.

The public sector is the largest bond issuer in China. The central government, local governments and policy banks together account for about two-thirds of all bond issues in China. Corporate bonds roughly account for the other third. Despite its massive size, potential foreign investors in China's bond market are put off by China's capital account restrictions. Chinese commercial banks are the largest bond market investors, owning about two-thirds of bonds currently outstanding. In contrast, the bond holdings of foreign investors have declined this year to around 2 %. The share of foreign investors is expected to grow in coming years, however, as Chinese sovereign bonds have been incorporated into major international bond indices in recent years. This should motivate institutional investors to reallocate their investments and increase their Chinese portfolio holdings if they directly track global bond indices.

Although the number of foreign investors participating in China's bond market has continued to rise steadily thanks to market reforms and eased access for investors, the value of yuan-denominated holdings of foreign investors has shrunk this year. Figures from the People's Bank of China and the operators of the Bond Connect programme between the bond markets of Hong Kong and mainland China indicate that bond holdings of foreign investors fell by 150 billion yuan (21.2 billion dollars) from the end of 2022 and stood as of October at 3.237 trillion yuan (457 billion dollars). The poor growth outlook for the Chinese economy, the ongoing real estate sector crisis and high interest rates in advanced economies such as the US and the euro area have motivated foreign investors to take their capital elsewhere.

Chinese sovereigns face the risk of a credit-rating downgrade. Although international credit agency Moody's Investors Service announced on December 5 that it was holding its credit rating for Chinese sovereigns at A1 (the fifth-highest level on Moody's 21-level ratings scale), it cut China's rating outlook from stable to negative. Moody's decision was partly based on an expectation that China's central administration must ultimately provide financial support to local governments and state-owned firms. Moody's decision also reflects China's poor economic outlook and the growing risk from the troubled real estate sector. Even with these red flags, however, demand by Chinese investors for domestic bonds has been sufficient to support the bond market this year as holding bonds is seen as a rational strategy for reducing risk exposure in an uncertain economic environment. As a result, the interest rate on China's 10-year bond has fallen by about 0.2 percentage points from the start of the year to 2.7 % currently. Our latest *BOFIT Discussion Paper* provides valuable insights into the changing features of China's bond market.

China's onshore bond market continues to grow rapidly



Sources: AsianBondsOnline and BOFIT.

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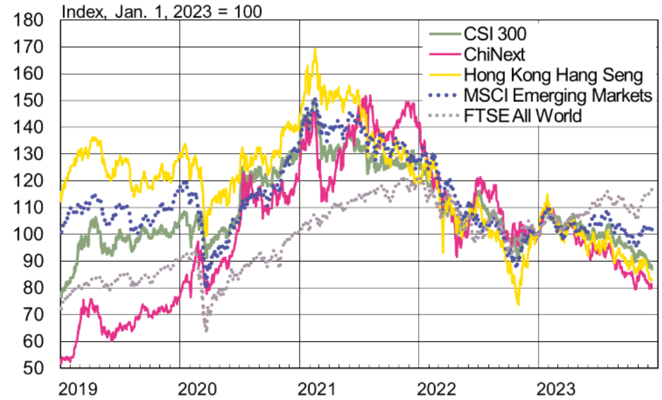
Chinese stock markets down for the year. Despite a bump in share prices following the lifting of covid restrictions at the start of this year, share prices have drifted downward for most of 2023 due to ongoing troubles in the real estate market and China's disappointing economic performance. In addition, rate hikes in advanced economies, particularly the US, have led to an investor exodus from China and other emerging markets. The large firms listed on mainland China's CSI 300 index are down 13 % from the start of the year. The Hong Kong exchange's Hang Seng index has also fallen by 17 % since the start of the year. Growth and technology firms have been hit particularly hard by the downturn. Share prices of companies included in the Shenzhen stock exchange's ChiNext list of growth firms have fallen by 21 % this year. In the same period, shares included in the US S&P 500 index are up by 23 % on average, while the MSCI Emerging Markets index of developing countries is up by 4 % on average.

Share listed on mainland China and Hong Kong exchanges have underperformed the global average this year



Sources: Macrobond and BOFIT.

Officials have tried to encourage share trading after the State Council in July called for "invigorating the capital market and boosting investor confidence." In August, tax officials halved to stamp duty on share transactions. For its part, the China Securities Regulatory Commission (CSRC) in September eased the use of borrowed funds in share purchases, and followed up in October by tightening short-selling rules to support the market. In addition, new stock exchange listings (IPOs) have been more restricted. In November, the finance ministry changed its regulations to allow insurers to make longer-term investments in publicly traded stocks.

Large investors have also been asked to chip in with the CSRC encouraging significant shareholders to take a more balanced approach to share sales. In October, the government financing firm Central Huijin said it had invested in the country's four largest state-owned banks for the next half year. At that time, the announced overall increase in its holdings was still marginal (Central Huijin holds stakes of 35–64 % in China's four giant state banks). Several dozen large state-owned firms (including Sinopec and China Mobile) have announced share buy-back programmes. According to media reports, the CSRC is also preparing a state-backed fund of at least 1 trillion yuan (0.8 % of GDP) to support China's stock markets. Perennial pressures to downplay poor market performance in China has increased. For example, media reports suggest that partially state-owned investment bank CICC has forbidden its employees from using a negative tone when commenting on the state of the Chinese economy or its markets.

Efforts of officials have failed so far in restoring investor confidence. Trading volumes on Chinese stock markets, however, were up somewhat in November compared to the previous two months. About 40 % of share trading volume took place on the Shanghai exchange and about 60 % on the Shenzhen bourse. A tiny sliver of trading (about 0.5 % of value traded) also occurred on the Beijing stock exchange created in 2021. Notably, Beijing bourse trading volumes have skyrocketed over the past six weeks. The Beijing bourse now lists 236 firms (up from 142 a year ago) and has a market capitalisation that represents 0.4 % of the total market cap of all stocks listed on mainland Chinese exchanges.

Foreign investors have reduced their holdings of shares traded on the Shanghai and Shenzhen exchanges. Share sales via the Stock Connect programmes between Hong Kong and the mainland exchanges have exceeded share purchases since August. The net holdings of foreign investors on China stock markets under the programmes have fallen by 200 billion yuan (28 billion dollars) since August, which in turn has dragged down the overall performance of China's stock exchanges. Although the holdings of foreign investors acquired under the Stock Connect programmes represent just 2 % of the value of shares listed on the Shanghai and Shenzhen stock exchanges, trading under the Stock Connect programme accounts for 13 % of the total share trading volume of the two exchanges.

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BOFIT

World Economy, China and Russia

Moderate global growth expected next year. The strength of global economic growth surprised many observers this year. A major driver was the robust performance of the US economy, which marched ahead even with monetary tightening by the US Federal Reserve and similar tightening in major economic blocs such as the euro area. Growth going forward is expected to slow slightly. The latest OECD forecast sees the global economy growing by 2.9 % this year and 2.7 % next year. These figures are distinctly lower than in previous decades. During 2000–2019, for example, the global economy grew at an average rate of 3.8 % a year.

In addition to monetary tightening policies, global economic growth is hampered by the long-term impacts of the Covid-19 pandemic, tighter fiscal policies and declining global trade. The OECD expects exceptionally low global trade growth of just 1.1 % this year and 2.7 % next year. Both figures are well below the average growth of 4.7 % a year during 2000–2019.

Several factors are depressing growth in international trade. First, barriers to international trade have increased, due in part to geoeconomic fragmentation (i.e. policy-driven reversal of integration with the global economy). For example, the WTO says that trade related to international production chains has fallen by 10 % since 2021. Second, demand is weak in Europe and Asia, two major trading blocs. Finally, the consumer focus since the lifting of covid restrictions has shifted more towards services that are less traded internationally than goods. However, international trade in services such as tourism services has experienced robust growth this year.

The outlook next year for the global economy and world trade is governed mainly by the same factors as this year. Monetary policy should remain tight, and the impacts of monetary measures taken this year likely have yet to fully work their way through to the global economy. Geopolitical conditions will remain a major risk factor. A worsening of conflicts in the Middle East, for example, would likely depress global trade further and cause energy prices to rise. Risks related to China's economic development can also have large implications for the global economy.

OECD November 2023 forecast for GDP and global trade growth, %

	2023	2024	2025
Global economy	2.9	2.7	3.0
Global trade	1.1	2.7	3.3
China	5.2	4.7	4.2
Russia	1.3	1.1	1.0
India	6.3	6.1	6.5
United States	2.4	1.5	1.7
Euro area	0.6	0.9	1.5

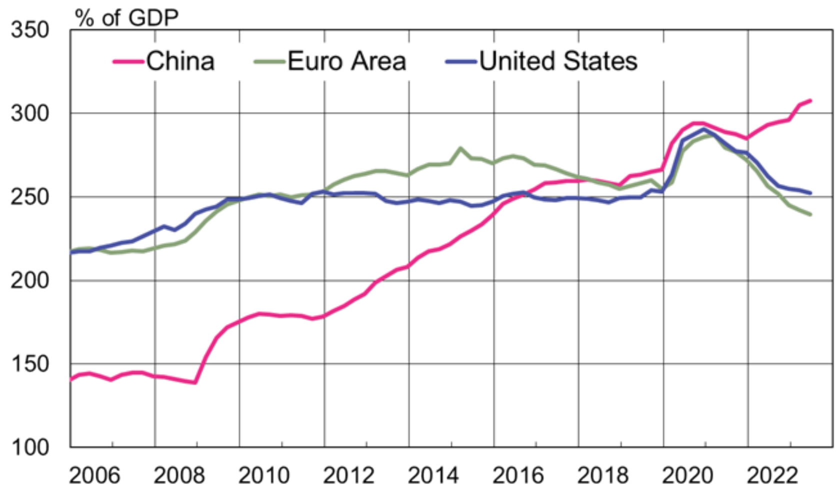
Source: OECD.

Chinese efforts to stave off economic slowdown to continue in 2024. In recent months, China has employed a wide variety of measures to stimulate economic growth (BOFIT Weekly 44/2023). Most of these measures have been modest and are only beginning to have an impact. For example, industrial output and retail sales in November perked up a bit from October. Improved on-year growth in many branches, however, partly reflects the low basis last year when China was still struggling with widespread covid infections and covid restrictions were still in place. Fixed investment remained weak in November. Despite the fact that many of the government's support measures were directed at the construction sector, declines continued for many indicators, including new building starts, investment and apartment sales. In December, the cities of Beijing and Shanghai announced that they were further reducing the downpayment requirement for apartment purchases and cutting the profit tax on apartment sales. GDP growth is still expected to slightly exceed 5 % this year.

China's economy is expected to continue slowing next year. The economy is no longer getting the same boost from the initial post-pandemic recovery as last year and structural factors continue to depress growth (BOFIT Forecast for China 2023–2025). The outlook for exports is weak as growth of the global economy should remain low and the tense relations with the West persist. Despite a battery of economic measures in recent months, the contraction of the real estate sector appears unlikely to end anytime soon. The central government announced it will issue an additional 1 trillion yuan in bonds to finance a range of projects for various purposes, such as repairing flood damage. It is not clear, however, whether the fiscal policy will be more supportive in general. Local governments are highly indebted and they may have to rebalance their budgets.

Key Chinese decision-makers met in Beijing on December 11–12 for the annual Central Economic Work Conference to decide next year's areas of policy focus. While the 2024 economic growth target has yet to be announced, most observers expect it to be the same "about 5 %" target as this year. Economic themes of previous years continue to be highlighted, including maintaining stability, strengthening domestic demand, supporting technological development, as well as enhancement of national security. This year's plan notably includes calls for strengthening economy-related propaganda, intervening in inter-provincial protectionism and designing reforms for public-sector finances. The government has also targeted alleviation of problems related to the real estate sector, local government indebtedness and small and medium-sized financial institutions.

China's debt-to-GDP ratio continues to climb



Sources: BIS, Macrobond and BOFIT.

Low oil prices due to weakened global economic prospects could weigh on Russia's economic development next year. The price of crude oil has fallen in recent months as the prospects for economic growth have darkened and the global supply of oil has exceeded expectations. The Brent oil price averaged 76 dollars a barrel in first weeks of December. Based on the price of oil futures contracts, markets expect the price of crude oil to remain at about the same level next year.

The trend in oil prices on the world market is central to Russia's economic outlook. About a third of revenues flowing to Russia's federal budget next year should come from taxes on oil and natural gas. The most important revenue stream is the mineral extraction tax on oil, reflecting the fact that the emphasis in Russian oil taxation has shifted gradually in recent years away from exports to production. At the start of next year, oil export taxes are set to be eliminated altogether. The mineral extraction tax is determined by volume of oil production, global oil prices and the ruble-dollar exchange rate.

Russia's budget next year assumes that the average export price of Russian oil will be 71 dollars a barrel. After the imposition of sanctions on Russian oil, the export price for taxation is defined in terms of the Brent crude price. Next year, the tax is calculated based on a price with a discount of 15 dollars from the prevailing Brent price. If oil prices remain at current levels as implied by the futures markets, the average level of 2024 oil price used in Russian oil taxation would be 61 dollars a barrel, i.e. 10 dollars less than the current budget assumption. Both Russian and non-Russian forecasts suggest that Russian crude oil production will decline slightly next year.

Russia's budget framework for next year anticipates a federal deficit of around 1 % of GDP. Budget revenue expectations for revenues other than oil & gas are rather optimistic. The current price expectations suggest that also Russia's oil revenues could be more modest than officially anticipated, so the budget deficit next year could be larger than currently presumed. Lower oil prices can also reduce Russian GDP growth. Most forecasts currently anticipate Russian GDP growing by 1–1.5 % next year.

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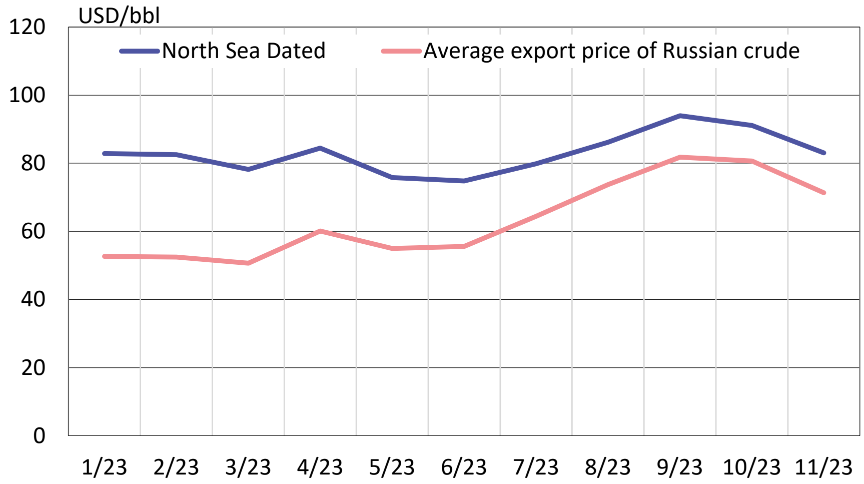
Russian oil is still sold with a discount, although the discount has declined



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