

Russia

Russia seeks to attract Chinese investment in Far Eastern Russia and Eastern Siberia. As part of last week's Sino-Russian trade and investment meeting in Moscow, Chinese deputy prime minister Li Keqiang took part in the signing of 27 agreements between Russian and Chinese companies. Although most of the agreements had in practice been finalised a long time before, they were publicly formalised at the meeting. The \$15 billion deal package provides insight into just how rapidly economic relations between Russian and China are developing.

The state Russian Direct Investment Fund (RDIF) agreed with China's sovereign investment fund, China Investment Corporation (CIC), on the establishment of a joint investment fund by the end of July. A memorandum of understanding on creation of the new fund was signed by the parties last autumn. RDIF and CIC will initially invest \$1 billion each. Other Chinese investors are expected to follow with another \$2 billion in investment. The fund would direct 70 % of investment to Russia and other CIS countries. The remaining 30 % would go to Chinese firms working in cooperation with Russian firms. The first investments will go to companies involved in the machine-building, forestry, agriculture and transportation sectors.

The Russians expect the new fund to attract hundreds of millions of dollars in investment already this year.

Russian officials note that China offers Russia a relatively inexpensive source of long-term financing, as well as unique skill sets. Russia, in turn, offers China large state-supported investment projects, particularly in development of natural resources in Eastern Russia. In his discussions with Li Keqiang, Russian deputy prime minister Igor Shuvalov said the Chinese were welcome to invest in projects in Eastern Siberia and the Russian Far East, for whose development Russia was creating a new state corporation.

Cooperation in the energy sector has not proceeded as hoped. After many years of wrangling over pricing schemes, Russia's state-owned oil company Rosneft last year finally began to supply crude oil to China by pipeline. The Chinese, however, continued to insist the price was too high, and Rosneft lowered the price earlier this year. Russia's prosecutor general office is now investigating the deal due to a complaint claiming that the decrease of the price results in lost profits to Rosneft and harms Russia's economy.

Russia and China have yet to resolve their years-running differences on construction of a natural gas pipeline that would run via Altai to China. The go-ahead has also been delayed by failure to agree on a gas-pricing scheme.

Last year, China was Russia's second largest export market and the largest source of imports.

Cabinet members at odds over how to develop Siberia and the Russian Far East. Russia's ongoing shift of economic focus eastwards has major implications for the thinly populated, resource rich regions of Eastern Siberia and the Russian Far East. The biggest challenge is development of resources that are in remote areas with harsh conditions. The eastern parts of Russia have gained more geopolitical significance with the rise of the Asia-Pacific region.

Sergei Shoigu, Russia's current emergency situations minister and soon-to-be Moscow region governor, proposed in January to prime minister Vladimir Putin the creation of a new state corporation to oversee development of Siberia and the Russian Far East. The economy ministry, tasked by the prime minister to prepare legislation on the envisioned state corporation, handed its draft to the government in March. The focus of the state company would be on construction of infrastructure to support large investment projects, but it could also participate in other projects.

The economy ministry has proposed that the state corporation be financed for the next 10 years by dedicating the interest from oil tax revenues allocated to the National Welfare Fund. Last year, the National Welfare Fund generated interest amounting to 48 billion rubles (€1.2 billion). In addition, the state corporation would be capitalised with shares of various state-owned enterprises. The corporation would also be eligible for large tax breaks. It would receive exceptional powers to decide on the region's investment projects and land use and have the authority to issue licences for the use of natural resources without competitive bidding stipulated by law.

State corporations are a special feature of the Russian economy. There are seven at the moment; they function under the president and are exempt from normal supervision. They deal with special missions (e.g. construction of the Sochi Olympic facilities) or are involved in sectors of the economy of special importance. Many organisations such as the State Inspection Office, have long criticised state corporations for their inefficiencies and lack of transparency. The finance ministry and earlier also the economy ministry have called for converting these state corporations to e.g. normal limited liability corporations subject to the corporate law.

At the end of April, finance minister Anton Siluanov sent a letter to Igor Shuvalov, the deputy prime minister tasked with responsibility for the project, strongly opposing the creation of a new state corporation for developing Siberia and the Russian Far East. As a reaction, this week Shuvalov proposed an alternative: an administratively much lighter development fund under the state development bank VEB. VEB just launched a development fund for the Baikal region and the Russian Far East at the start of this year. The proposed fund would expand the scope of the VEB fund without the need to create a new large organisation.

China

Foreign direct investment inflows to China continue to decline. In the first three months of 2012, foreign direct investment inflows into China amounted to just over \$29 billion, about 3 % less than in the same period a year earlier. The downturn in FDI inflows (y-o-y) started last November.

One reason for the decline in investment has been the low growth in demand from Western economies. A substantial share of inbound investment to China is targeted at component assembly plants that produce finished goods for re-export. Although China's rise in real incomes and increased domestic demand will undoubtedly attract future investment, the drop in investment inflows reflects cyclical conditions and may provide evidence that China has entered period where production based solely on cheap labour is being shifted to countries with lower production costs.

In 1Q2012, Hong Kong accounted for nearly 65 % of FDI inflows into China. Asia's pre-eminence as a source of Chinese FDI was further bolstered by investment from Japan, Taiwan and Singapore. In contrast, FDI inflows from the EU fell below 5 %, and the US contributed an approximately 3 % share. As the major role of Hong Kong suggests, companies can currently channel investment flows through locations most suitable for them so these figures should be read with caution.

FDI by Chinese companies internationally nearly doubled to about \$17 billion in the January-March period. The figure does not include the financial sector. More detailed statistical data on investment outflows of Chinese firms abroad will be released later.

China's air traffic on the rise. The number of air travellers increased about 9 % last year, with the total number of passengers reaching nearly 300 million. Air transport in general has a bright future in China, where flying is a rarity for most of its huge population. In 2010, there were only about 2,500 civil aircraft in service and fewer than 200 manned airports. The air industry employed less than 300,000 persons in 2010.

Air travellers in China typically fly in fairly new planes and most of the airports they visit are shiny and new. The biggest frustration for passengers are flight delays, which have only increased in recent years. Frustrated by delays, travellers have sometimes even endangered air traffic by running onto the tarmac to protest their stranding. Observers attribute the delays to a lack of fleet, the lack of competition, old-fashioned administrative structures and the relatively small amount of air space set aside for civil aviation.

Indeed, the majority of Chinese airspace is reserved for military purposes; civil aviation is confined to less than a

third of the national airspace. Foreign airlines are banned from flying any domestic routes inside China, and over 90 % of domestic air routes are controlled by four airlines (Air China, China Eastern Airlines, China Southern Airlines and Hainan Airlines). The first three are state-majority owned.

The world's largest aircraft manufacturers, the European Airbus and the American Boeing, see China as a promising market for their products in coming years if the projected demand for more air travel, planes and airports materialises.

China's own aerospace industry would like to hang onto its piece of the growing civilian aviation business. While domestic aircraft makers have seen little success in head-on competition against the majors, cooperation is available. Boeing and the Commercial Aircraft Corporation of China (COMAC), for example, are creating a technology centre for study of aviation energy conservation and emissions reductions in Beijing. Currently on the drawing board is a fuel-efficient jumbo passenger jet that will be entirely Chinese-built. The jet is scheduled to be in service in 2016.

Shake-out ahead for China's shipbuilding industry.

Before the international financial crisis, world trade and sea shipping grew briskly and many shipyards enjoyed bulging order books for new vessels. High demand helped China establish itself in the top tier of shipbuilders along with Korea and Japan. Measured in dead-weight tons, Chinese ship production increased nearly ten-fold between 2005 and 2011, and the number of shipbuilding companies doubled.

Shipbuilding boom, financial crisis and prevailing uncertainty created vast overcapacity of ships that will depress demand for new ships for years to come. Although the volume of ship production in China in the first quarter matched that of 1Q2011, the volume of new orders booked in January-March was half that of a year earlier. A decline in production seems inevitable.

Chinese shipbuilders compete against their international rivals on the basis of price, while Korea and Japan compete on construction of the most advanced and energy-efficient ships. The Chinese have focused on increasing the range of vessels available and improving quality, but their competitors have a large lead in these areas. With orders drying up, Chinese shipbuilders have turned to large discounts; some observers claim the most desperate builders are selling ships at prices below actual production cost.

While the shipbuilding industries in Korea and Japan are controlled by a few large players, China has 1,500 shipbuilders. Low demand at the moment will force mergers of Chinese shipbuilders into larger entities. Some observers believe that half of Chinese shipbuilders will survive the impending shake-out, but the most pessimistic expect only about 10 % of companies to survive.