EUROJÄRJESTELMÄ
EUROSYSTEMET

BOFIT Weekly

51–52 • 20.12.2013

Russia

Russia to bail out Ukraine with massive economic support package. Russian president Vladimir Putin and Ukrainian president Victor Yanukovych agreed on Tuesday (Dec. 17) that Russia would provide support to Ukraine's deteriorating economy for refraining from signing its EU association agreement.

Russia committed to purchasing $15 billion in Ukraine government eurobonds with money from its National Welfare Fund, a sovereign fund built up over the last ten years through setting aside part of Russia's tax revenues from oil and gas. The announcement was somewhat of a surprise as the National Welfare Fund was set up to meet future pension obligations. Its rules limit foreign investment to high-grade securities, something Ukrainian sovereigns are certainly not. As of end-November, the National Welfare Fund held assets of $88 billion. Russia's other sovereign wealth fund, the Reserve Fund for covering budget deficits, stood at $87 billion.

President Putin also promised that Gazprom would cut the price at which it sells gas to Ukraine from $406 per thousand cubic metres to $268.50. The cut is temporary, however. The future gas price will depend on how the "situation develops." Ukraine has long demanded that Gazprom lower its gas prices as Ukraine pays more for Russian gas than the EU average. Russia abandoned its earlier demand that Ukraine join its Russia-led customs union to get gas at discount prices.

Russian government cracks down on firms using offshore entities to avoid taxes. Most of Russia's foreign capital flows move to and from international tax havens or countries with specific tax advantages. Thus, these countries show up in official statistics as the main destinations for Russian capital exports and as domiciles of companies investing in Russia. Much of this is explained by the fact that many large Russian firms have arranged their ownership through companies registered in a tax haven or low-tax country. The Russian firms then transfer to their foreign parent e.g. interest payments, dividends and licensing fees.

The Duma this spring will take up the finance ministry's proposed amendments to the tax code. The changes include treating foreign-registered or foreign-owned firms that in actual fact operate in Russia or are managed from Russia as domestic firms subject to Russian taxes. Firms with foreign ownership arrangements would be excluded from bidding on public procurements and ineligible for state support or guarantees.

Several large firms, including Rusal and Kamaz, announced they are repatriating assets from abroad after Putin showcased "lost" state revenues from offshore tax havens in his state-of-the-nation address last week.

Soaring costs of Sochi Winter Olympics hit investors and Russian development bank VEB. With the 2014 Olympics set to kick off on February 7, construction costs now exceed 1.5 trillion rubles (€33 billion), five times the original cost estimate. Officials justify the cost creep by noting that the original estimate was based on very rough assumptions. Since construction started, numerous new venues have been added and many existing facilities have had to be upgraded to meet the criteria of the International Olympic Committee. A significant share of costs is due to the need to build basic infrastructure for entire districts where there was none.

Some of Russia's biggest firms and oligarchs have invested in Olympic facilities. For example, Sberbank has paid for the media centre and the ski-jumping venue. Gazprom is sponsoring the biathlon course and gondola lift. Oleg Deripaska's Basic Element has paid for one of the three Olympic villages, a freight seaport and airport upgrade. Vladimir Potanin's Interros financed the ski centre. Viktor Vekselberg's Renova Group has invested in a 3,600-room hotel complex, Russia's largest. Tycoons have also had to chip in for construction of regional infrastructure.

Investing firms were eligible for loans from a pool of 240 billion rubles (over €5 billion) provided through Russian's state development bank VEB.

The wider scope of Sochi construction and huge cost increases assure that projects with poor economic prospects initially are now definitive money pits. Several big investors, including Sberbank and Gazprom, asked the government to restructure their project loans. VEB reports that of the 20 Olympic projects receiving loans, the nine largest are to be restructured. The value of the restructured loans totals 190 billion rubles (over €4 billion). The first loan repayments were originally set for next spring, but this week prime minister Dmitri Medvedev announced that repayments will not commence until the start of 2016. By that time it should be possible to see how the investments are performing and how much further support is needed.

The government has struggled to find ways to ease the situation of firms that have invested in Sochi projects. Observers note that it would be necessary e.g. to grant interest subsidies on loans and breaks on land and property taxes. The finance ministry opposes interest subsidies and the Krasnodar regional administration would not like to see a reduction of its expected tax income. The government plans to hold large publicly financed events such as investment forums in Sochi to create demand for the region's services.

VEB itself needs a capital infusion as it struggles with a large portfolio of non-performing loans. VEB's portfolio has been hit by its Olympic project lending, its loans issued to troubled firms during the 2008–2009 financial crisis and the costs of bailing out three banks. The Russian cabinet this week decided to give VEB a subordinated loan of 200 billion rubles (just over €4 billion). The funds will come out of the National Welfare Fund.

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China

China's leadership discusses implementation of economic reforms. A closed-door Central Economic Work Conference was held last week to shed a light on next year's fiscal and monetary policy objectives. President Xi Jinping, premier Li Keqiang and the all five other senior members of the politburo participated in the four-day conference. Implementation of economic reforms announced at last month's plenary session of the central committee topped the agenda.

The official conference statement stressed that next year's fiscal and monetary policy stances should enable progress in reforms. This does not imply any major shifts in current policies as long as economic conditions remain more or less stable. Local administrations were encouraged to monitor progress with the reforms to make the process more efficient.

Rather than specifying a precise 2014 GDP growth target, the central leadership signalled that it targets sufficient economic growth. Most analysts interpret this to mean that the growth target for next year is about the same as this year's level, i.e. 7.5 %.

The high priority accorded structural reforms was reiterated, but the new theme of sustainable economic growth also got considerable play. The huge debt loads of some local administrations are now considered a serious threat to the success of economic policies. Reforms aimed at reining in growth of local administration debt include revising the budgeting processes and increasing debt transparency of local administrations. News agency Xinhua reports the evaluation of local administrations will include indebtedness. Further insight into local debt problems is expected with the release of results from the local governments' debt audit initiated last July.

Demands for a more stable and higher quality food supply also were addressed at the conference with e.g. increased support for domestic production. This partly reflects concerns over the inflationary pressure from spiking food prices. Food prices have risen considerably faster than prices on non-food goods and services, causing inflation on occasion to approach the official inflation target ceiling of 3.5 %.

Finland's trade deficit with China shrinks. Finnish Customs reports that imports from China in the first nine months of this year contracted about 20 % y-o-y. Finland's imports overall fell 3 % in the same period.

Nearly half of Finland's imports from China were classed as machinery and equipment, of which the most important categories were office and home electronics. The drop in phone imports was the biggest factor in the overall decline in imports. Other finished goods accounted for 34 % of imports, over half of which was clothing or footwear.

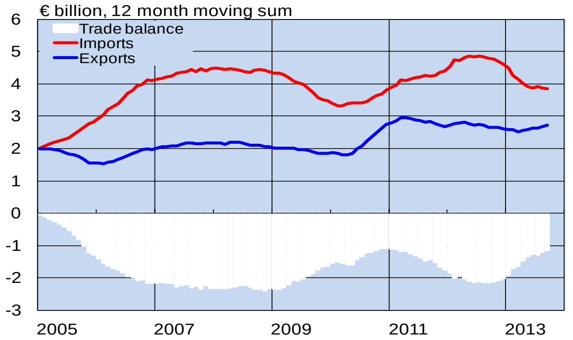
Although Finnish exports overall declined 3 % during January-September, exports to China were up 5 %. Specialised machinery and equipment used in primary industry and manufacturing accounted for 40 % of Finnish exports to China. Surprisingly, raw materials also accounted for nearly the same share of exports, reflecting a huge demand for Finnish furs and pelts (16 % share of exports to China) and pulp (14 % share).

Lower imports and higher exports reduced Finland's on-year goods trade deficit with China by nearly half. China (including Hong Kong) accounted for about 6 % of Finnish imports and 6 % of exports.

Although China is an important export market for Finnish firms, it is even more important as a site of their operations. Statistics Finland reports that the net sales of subsidiaries of Finnish corporations operating in China amounted to over €20 billion in 2011. These subsidiaries employed over 70,000 workers in total.

Labour supply issues have become serious concerns for Finnish firms operating in China. China's pollution problems e.g. make it difficult to recruit key personnel.

Finland-China trade



Source: FinnishCustoms

Wage rise likely to slow next year. A survey of 700 firms operating in China conducted by the British recruiting consultancy Michael Page International finds that about 60 % of firms plan to raise wages next year by 6–10 %. Some 20 % of respondents said they planned to increase wages even more, while about 20 % said they planned raises of less than 6 %. Worker turnover rates are expected to remain high. Similar findings were reported by the Chinese job website 51job.com, which, according to its own survey of Chinese firms, expects wage increases to average 9 % next year.

If expectations hold, wage growth should slow slightly next year. Wage growth this year has averaged just over 10 %, which is already a lower pace than in previous years.

The incessant rise in wages, surging input costs and yuan appreciation have all driven up Chinese production costs. Labour-intensive industries, in particular, have opted to move operations to other Asian countries with lower production costs.

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