Weekly Review
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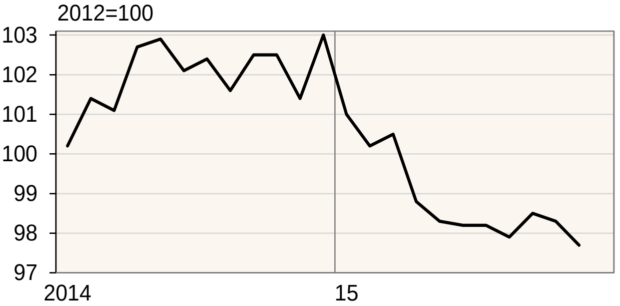
BOFIT

Russia

Consumption and industrial output continued to decline in November. Rosstat reports that the seasonally adjusted volume of retail sales contracted in November for the eleventh month in a row this year. Retail sales were down nearly 13 % y-o-y. The 12-month drop in food sales was over 11 % and non-food goods nearly 15 %. The magnitude of the drop in part reflected slightly above normal sales a year ago, when rapid ruble depreciation and a pick-up in inflation started to give a rise to a spending spree among households. Private consumption this year has held at about the same level as four years ago while it has been about 10 % higher than in 2008 just before the previous economic crisis struck.

Rosstat further noted that seasonally adjusted industrial output fell in November. Production of extractive industries in November was unchanged from a year earlier. The drop in manufacturing production, however, followed the decline set in September and October, and the volume of production in November was down about 5 % y-o-y. The impact of increased defence spending that supported manufacturing industries earlier this year is likely fading. First-half defence spending grew on-year by over a third, but since autumn defence spending has fallen.

Industrial output (seasonally and workday-adjusted)



Source: Rosstat.

Russia's state-owned Vnesheconombank needs large support. Most estimates put Vnesheconombank's (VEB) needs for support funding at €15–20 billion to cover at least the next few years. The government could give its decision on the magnitude and set the support time schedule before the end of this year. To date, VEB has been sustained by deposits totalling more than €8 billion from the National Welfare Fund, with most of the money used to inject capital into VEB as well as subordinates. VEB this year has also received about €500 million in other monies, mostly from the CBR's 2014 profits.

Loans extended by VEB (specifically, handing out money at the behest of the Russian cabinet) are the main cause of its need for support. VEB, for example, granted loans to finance construction projects for the Sochi Winter Olympics. The lending increased VEB's loan stock by about 25 % in ruble terms in 2013 and doubled it in 2014. There has been practically no growth since then in lending. With the deterioration of its loan portfolio, VEB has made large loan-loss reserves, especially last year and further this year, pushing its financial result well into the red. Last year, the VEB Group's Russian banks posted losses of about €5 billion. Losses in the first half of this year amounted to nearly €1.5 billion. The losses of the VEB Group have been made slightly worse by the weakened conditions of VEB's Ukrainian subsidiary.

The need for the support also highlights VEB's debt situation. VEB is subject to US and EU financial sanctions, which in practice has denied VEB of potential refinancing from international lenders. At the end of June, estimates put VEB's total debt taken from markets at €15–20 billion, of which nearly €9 billion was in eurobonds. A large part of this debt is fairly long-term, but the finance and economy ministries note that in 2016 VEB needs €2.5–3 billion on its debt service. VEB should get some reprieve as China's development bank this month committed to a five-year loan of 10 billion yuan (€1.4 billion).

Although VEB engages in some commercial banking, it is not registered as a bank and not subject to central bank supervision. The total assets of VEB Group banks located in Russia amount to about €45 billion, which would make VEB Russia's fourth largest bank with holdings that correspond to about 4 % of the banking sector's total assets.

Debt and trade disputes further erode economic relations between Russia and Ukraine; EU decides to keep Russian sanctions in place. As expected, Ukraine announced late last week that it cannot pay back Russia a $3 billion loan, which came due on December 20, as agreed under the original loan conditions. While the IMF has said it interprets the debt as public sector debt, it made a rule-change at the start of the month so that public sector debt arrears do not automatically disqualify a country from receiving IMF aid, thus allowing Ukraine's current program to continue. Russia fiercely criticised the decision. Ukraine and Russia have failed to reach a compromise on restructuring of the debt and Russia has threatened to commence legal proceedings if Ukraine does not pay by the end of this month.

Russia also announced it would end its free-trade arrangements with Ukraine from the start of next year, when Ukraine's free-trade agreement with the EU enters into force. In addition, Russia bans imports of Ukrainian agricultural and food products. Russia-Ukraine bilateral trade has contracted strongly since Russia annexed Crimea in 2014. In the first nine months of this year, trade with Ukraine accounted for about 3 % of Russia's total imports and exports. Russia accounted for 13 % of Ukraine's exports and 20 % of its imports. The EU's trade share has risen this year to 33 % of Ukraine's exports and 41 % of its imports.

The EU decided to keep its restrictions on Russian foreign trade and financial markets in place until July 31, 2016.

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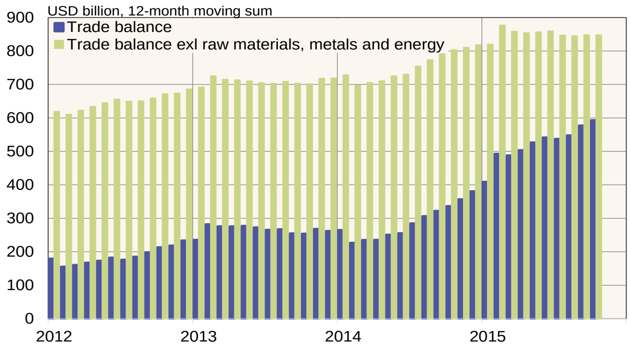
China

China's trade surplus fairly stable with commodities removed. With the slowdown in China's economic growth, the debate over the country's price competitiveness and exchange rate policy has heated up. The trade balance trend is an important indicator in considering these issues.

China's overall trade surplus has soared this year, with the trade surplus for the first ten months of the year reaching \$490 billion, a rise of nearly 80 % y-o-y. Metals, energy and other commodities last year accounted for nearly 40 % of the value of China's imports. Their share of imports has fallen slightly along with lower commodity and energy prices. They also only represent slightly over 10 % of China's exports. As commodity prices do not tell about China's competitiveness, it is interesting to consider Chinese balance-of-payments figures with commodities trade removed entirely.

The January-October trade surplus stripped of metals, energy and other commodities was up just 5 % y-o-y. This year the running 12-month trade surplus without commodities has stayed largely unchanged. Thus, the trade balance trend with commodities excluded does not indicate any large changes in China's external balance or competitiveness.

China's overall trade balance and trade balance with metals, energy and other commodities removed



Sources: CEIC, BOFIT.

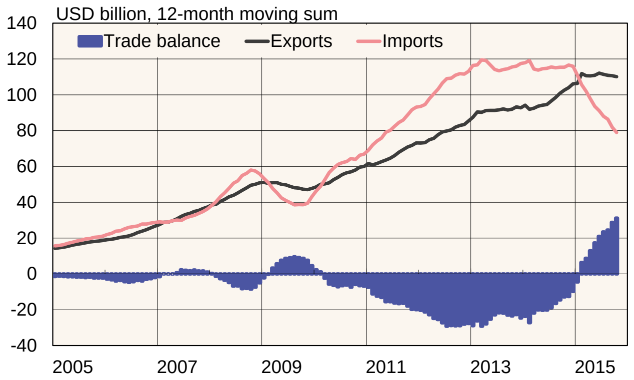
Economic relations reaffirmed at China-Africa summit. South Africa hosted the sixth ministerial conference on China-Africa Cooperation early this month in Johannesburg. Chinese president Xi Jinping highlighted China's commitment to deeper cooperation with African nations despite his own slowing economy. Drops in China-Africa trade and Chinese foreign direct investment in African countries have raised concerns as to whether some countries can cope with effects of China's evolving economy. Xi promised African countries \$60 billion in financing supplied via several channels as well as debt restructurings.

China has long been Africa's most important trading partner. African countries mainly export raw materials to China and import consumer goods from China. On average, 20 % of Africa's imports come from China and about 15 % of African countries' exports are destined for China. The dependence on China is much higher for some countries. For example, over half the exports of Eritrea, Congo and Angola go to China. Among the 54 African nations, 16 send over 20 % of their total exports to China. While the value of China-Africa trade turnover exceeded \$220 billion last year, the value of African imports to China in October was down over 30 % y-o-y due to low commodity prices. China's exports to Africa in October continued to rise at about 7 % y-o-y.

Chinese investment in Africa has grown rapidly over the past decade, even if only 3 % of China's outbound FDI was destined for African countries and China was only the seventh largest investor in Africa (the US is Africa's largest provider of FDI). Figures from China's trade ministry show FDI outflows to Africa in January-June amounted to \$1.2 billion, a drop of over 40 % y-o-y. Most Chinese investment in Africa went to the raw materials and energy sectors.

The *South China Morning Post* reports the number of projects in Africa involving Chinese firms has risen this year, even if the volume of FDI has fallen. Chinese firms are participating in e.g. port, rail and pipeline projects. In the first half of this year, the total volume of agreed Chinese projects and investments was \$18 billion. For all of 2014, the volume of such projects and investments was \$34 billion.

China's trade with African countries



Source: Macrobond

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EU readies sanctions against China for steel dumping. Adding to its earlier decision this month on Chinese cold-rolled steels, the EU Commission on December 17 voted to impose a registration requirement on specific steel products used in construction, foreshadowing wider imposition of anti-dumping tariffs on disputed steel products. The decision allows for imposition of provisional duties by end-January and definitive five-year duties by end-July.

European steel producers have long complained that Chinese state enterprises and state-subsidised companies sell steel at prices below production cost. The EU complaint said that the dumping margin of Chinese steel was 15–30 % off the market price. The basic problem is that Chinese steelmakers have been stuck with massive overcapacity since its construction boom ended and have been desperate to find buyers for their steel. Western steelmakers say China currently accounts for 60 % of excess global capacity.

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