Weekly Review
35 • 2.9.2016

BOFIT

Russia

Fixed investment in Russia increasingly goes to oil & gas production. The total volume of fixed investment fell over 4 % y-o-y in the first half of this year (down over 8 % in 2015). Rosstat estimates that small firms and grey economy investment fell well over 10 %, which is about the same as in the 2009 recession. The three-year drop in other investment moderated considerably, with the decline in the first half only amounting to about 1 % y-o-y.

In core branches, the developments largely resemble those of previous years. Growth in fixed investment in oil & gas production remained strong for the third year in a row. However, in other parts of the energy sector, i.e. oil & gas pipeline transmission and electrical power generation and distribution, last year's large drop in investment persisted quite strong. The slide in oil refining investment that began last year became considerably steeper. In other manufacturing, the drop in investment of last year stabilised; the investment remained roughly at the same level as last year.

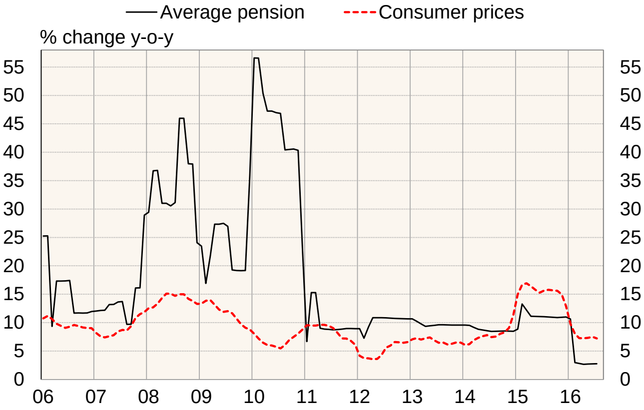
Russian pensioners get one-time payment and a return to inflation-indexed pensions. The government announced last week that every pensioner will receive a one-time payment of 5,000 rubles (about €70) next January. The sum corresponds to over 3 % of an average annual pension. In addition, the government said it would return (at least for next year) to traditional inflation indexing of pensions as set forth in the law. That indexation means the annual pension increase, which usually occurs in February, is based on the rate of consumer price inflation at the end of the previous year. At the start of this year, however, the government introduced a new rule that pensioners who keep working will no longer be eligible for inflation adjustments. Official figures show that about 35 % of Russia's over 45 million people receiving different government pensions are still working. The most recent forecasts expect inflation to be running at about 6–6.5 % at the end of this year.

The typical cost-of-living adjustment to cope with inflation was not granted this year. Despite the fact that inflation was running at nearly 13 % at the end of 2015, pensions were only increased by 4 % in February. At that time of the feeble adjustment, the government said a second increase would be possible in the second half if economic conditions allowed.

Russian pensions this year and last year fell in real terms for the first time since 1999 – and the drop has been stunning. At a meeting of cabinet ministers on pensions, prime minister Dmitri Medvedev last week noted that the government's fresh decision to hike pensions was based on both social and political considerations. Many observers had expected for some while the government to raise pensions with the approach of the national Duma election on September 18.

Low oil prices, economic contraction, and the ensuing drop in budget revenue, have made the government rein in cost-of-living adjustments of pensions. Pension spending has risen to a quarter of total government spending, and about 9 % of GDP.

Russian pensions and inflation, 2006–2016



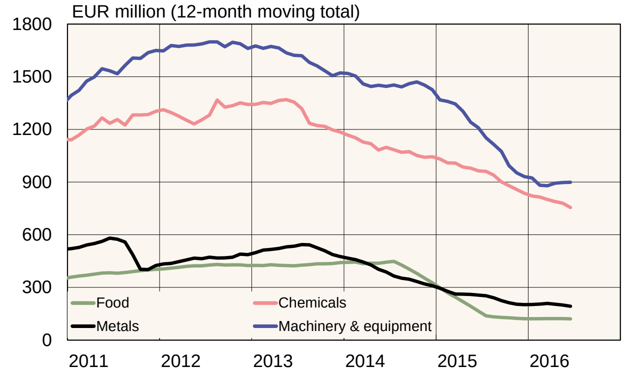
Source: Rosstat.

Finnish-Russian trade continues to shrink. The value of Finland's goods exports to Russia fell 11 % y-o-y in the first half of the year to €1.3 billion. The slide in exports slowed in the spring, but accelerated in recent months on lower sales of e.g. chemical and metal products. Figures also suggest that the decline in exports of machinery & equipment, food products and mineral fuels has hit bottom and stabilised in recent months. However, there were few signs of real recovery. Russia accounted for 5 % of Finland's total goods exports.

The value of goods imports in the first half was €2.7 billion. Imports contracted 8 % y-o-y, but in recent months there has been a return to growth on higher world prices for commodities and increasing import volumes of many goods.

In addition, exports of tourist services to Russia continued to contract. In the first six months of the year, the number of Russian overnight stays in Finnish hotels and inns fell by about 20 % y-o-y. Border-crossings on the eastern border were also down 7 % in the same period.

Finnish exports to Russia in select goods categories



Source: Finnish customs, BOFIT.

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China

Reform of China's public sector moves ahead. China's government announced last week that it was launching a reform to clarify the division of duties and reduce overlaps in them between the central government and local governments, as well as shift some local government tasks to the central government. The reform, which seeks more effective use of public funds, will proceed stepwise and it should be fully implemented in 2020. The need for public administration reform has long been apparent. The current system, introduced in 1994, dedicates 85 % of public spending to provincial and municipal levels, even if these tiers only collect slightly more than 50 % of public revenues. Even if the imbalance is largely covered by massive transfers of central government funds to provinces and municipalities, sale of land use rights has become a major revenue source for local administrations. Many see that imbalance between revenues and spending has fuelled the current indebtedness of local governments through creation of off-budget investment vehicles.

The last big public finance reform in 2014 involved letting provinces and municipalities issue their own bonds with central government approval. The change was supposed to subdue off-budget activity of local governments and improve transparency. While the 2014 changes have yet to be fully implemented, regional bond issues have increased substantially. Off-budget activity, however, remains substantial.

Official figures show that China's public sector revenues and expenditures have been around 20–25 % of GDP in recent years, with deficits around 2–3 % of GDP. The IMF notes that when off-budget liabilities of local governments are included, revenues are slightly larger than official estimates and spending considerably higher. The IMF calculates the public sector deficit has been running at around 10 % of GDP in recent years and that China's public sector debt as of end-2015 was close to 60 % of GDP. The IMF expects the public sector debt ratio to grow further in coming years.

China seeks to rein in online P2P lending market through increased regulation. In the latter half of August, Chinese officials released regulations on direct online peer-to-peer (P2P) lending. An individual is now permitted to borrow no more than 200,000 yuan from a P2P lender or platform and the total value an individual's P2P borrowing may not exceed 1 million yuan ($150,000) at any time. The limits on corporate borrowing are five times higher. Moreover, P2P firms that conduct most of their business online are now banned from engaging in activities such as taking deposits from the general public, sale of asset management products or giving loans guarantees.

The crackdown had been planned since last spring, after the Ezubao P2P platform, which was set up in 2014, turned out to be a 50 billion yuan ($6 billion) pyramid scheme. Bloomberg and the Yingcan Group, which tracks P2P lending, report that the volume of P2P loans last year rose to 1 trillion yuan ($150 billion). As of July, P2P firms had matched 3.4 million investors with 1.2 million borrowers. Credit offerings vary from consumer loans to high-risk corporate loans. The average interest rate on P2P loans this summer was 10.3 %.

Even if the volumes of P2P lending and the numbers of investors and borrowers are miniscule relative to China's financial markets overall, the concern is the explosive growth and fraud opportunities in online shadow banking activities and the possible spillover effects. For example, the Ezubao scam directly affected 900,000 investors.

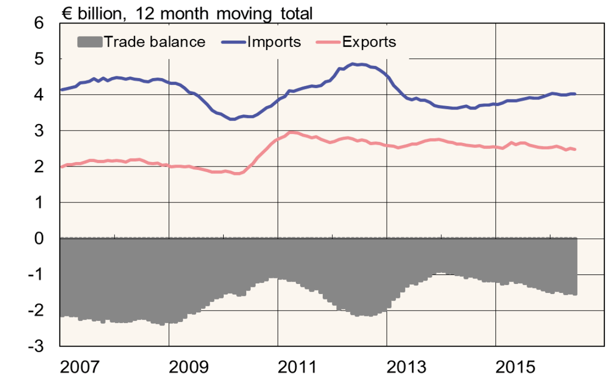
First-half trends in Finnish-Chinese trade slightly more upbeat than Finnish foreign trade overall. Finnish Customs figures put the value of goods exports to China in the first six months of the year at €1.27 billion, a decrease of 4 % y-o-y. The overall value of goods exports fell by 5 %. Imports from China increased 1 % y-o-y to €1.9 billion, while the overall value of imports fell by 1 %. China is Finland's fifth most important trading partner, accounting for 5 % of Finnish goods exports and 7 % of goods imports.

The structure of exports to China has remained largely unchanged in that machinery & equipment account for over a third of exports. Pulp was the single largest export item in 1H16, accounting of nearly a fifth of the value of Finnish exports to China. Exports of wood and wooden products increased sharply, accounting for about 10 % of the value of Finnish exports. Exports of furskins, in contrast, declined rapidly and their share of total exports fell from 15 % in 1H15 to 5 % this year. About 30 % of Finland's exports of pulp and nearly half of its fur exports go to China.

About half of Finland's imports from China consists of machinery & equipment, and their imports have followed the trend of overall imports. Imports of clothing and footwear rose 6 % y-o-y in 1H16, accounting for 15 % of imports overall. A third of Finland's clothing and footwear imports come from China. Other imports consist of a diverse mix of goods.

The number of Chinese travellers visiting Finland has increased rapidly. In the first half of the year, Finnish hotel and inn accommodations served over 60,000 Chinese guests, an increase of 39 % y-o-y. Chinese guests accounted for 5 % of foreign guests staying in Finnish accommodation establishments.

Finnish-Chinese trade



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