SUOMEN PANKKI FINLANDS BANK EUROSYSTEM 1811

Weekly Review
48 • 1.12.2017

BOFIT

Russia

Recovery in fixed investment in Russia slows. Fixed investment grew by over 3 % y-o-y in the third quarter, down from growth above 6 % in the second quarter. Investment was up by 4.2 % y-o-y in the first nine months of 2017.

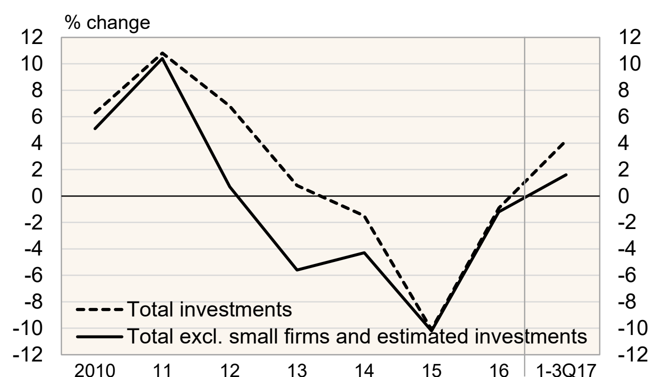
Especially the recovery in fixed investment of large and medium-sized firms, as well as government investment, slowed in the third quarter. In the first nine months of the year, the growth was just around 1.5 % y-o-y. Within-year statistics mainly cover these investments. In turn, Rosstat estimates investments by other entities such as small firms, grey economy actors and households. Rosstat says that the recovery of the estimated investments remained fast, holding at a pace of around 12 % y-o-y in January-September.

The recovery in the statistically recorded investment, however, has a narrow basis. After a couple years of decline, investment in pipeline transmission increased by over 25 % in January-September. Without this growth, recorded investment would have shown no increase, and total investment growth would have been about 3 %.

The electricity sector has been a major drag on the recovery in investment with the sector's recorded investment falling in January-September by nearly 10 %. Manufacturing (excluding oil refining) also saw investment fall by about 6 %. Sharp drops in fixed investment were registered in a few large manufacturing branches, most notably metal industries. Investment in oil & gas production contracted by 1 %. Third-quarter investment in oil refining showed a sharp increase after a couple years of steep decline.

Due to the transport sector the investment recovery has had regional focuses. In the first nine months of the year, well over half of the increase in investment came from the City of Moscow (much of that were investments in land transport projects). Additionally, about 30 % of investment growth was generated in the Amur region (Power of Siberia gas pipeline) and Crimea (Kerch Strait Bridge).

Real volume of fixed investment in Russia, 2010–17



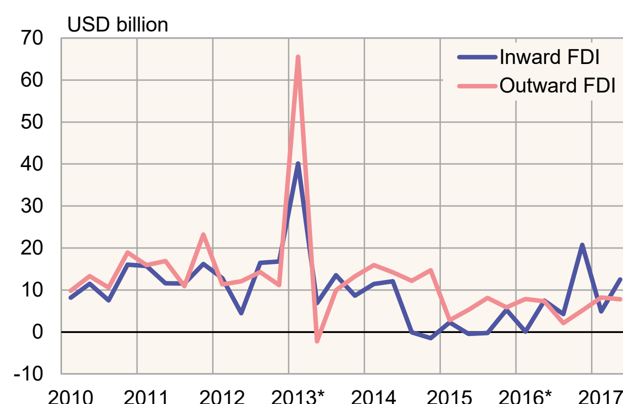
Source: Rosstat.

Russian FDI on the rise. The net flow of foreign direct investment into Russia from abroad in the first half of this year amounted to 17 billion dollars, which was clearly more than in the previous two years. Outward FDI flows from Russia increased slightly from 1H16, with a net outflow of 16 billion dollars. The total FDI stock in Russia was 405 billion dollars, while the Russian FDI stock abroad was 435 billion dollars (about 30 % of GDP).

While Russia's economic problems in recent years have reduced direct investment, the impacts have generally been limited. Most Russian FDI flows are, however, Russian capital that has been recycled through e.g. Cyprus or the Bahamas and invested back into Russia. The reasons for this recycling include e.g. Russia's own institutional weaknesses and a quest for more favourable tax treatment. The government has tried in recent years to diminish capital recycling and make Russian firms to repatriate their operations.

There are many challenges in compiling FDI figures in general and individual corporate acquisitions can cause huge swings in investment numbers over the short run. For example, at the end of 2016, there was a massive spike in Singaporean FDI flows into Russia after the sale of a stake in Rosneft to a Singapore-registered joint venture of the Qatar Investment Fund and the Swiss Glencore. On the other hand, this year the equity FDI flow from Russia to Singapore jumped.

Net flows of foreign direct investment to and from Russia



Source: Central Bank of Russia. **incl. Rosneft deal*

Russia's 2018–20 monetary policy guidelines stress the role of inflation expectations. The Central Bank of Russia reaffirmed its inflation target of "close to 4 %" a year on average. The CBR underlined that for its rate decisions it is important to see lower inflation expectations and their lower volatility. The CBR reminded of the sensitivity of food prices (nearly 40 % of the consumer price basket) to variations in harvests and world market prices as well as government mandates to set rates for services in the housing sector (6 % of the basket). The CBR aims e.g. at broadening the circle of interbank market, lowering the market costs and phasing out its special refinancing credits.

The information is compiled and edited from a variety of sources. The Bank of Finland assumes no responsibility for the completeness or accuracy of the information, and opinions expressed do not necessarily reflect the views of the Bank of Finland.

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China

China's Silk Road Project targets countries of Central and Eastern Europe (CEE). At the 16-country CEE summit with China (16+1) this week in Hungary, last three CEE countries completed their signing of memoranda of understanding concerning China's Silk Road Project. A dozen other deals were also signed at the get-together, mainly in the areas of transportation, investment cooperation, infrastructure and financing. Chinese sources claim China has already invested about 9 billion dollars in the CEE area. The deals made at the summit add another 3 billion dollars in new investment commitments.

The 16+1 group, first convened in 2012, is a Chinese initiative to bolster cooperation with eleven EU member states and five non-EU states in the Balkans. China has prioritised three areas for cooperation: infrastructure, advanced technology and environmental technology.

The 16+1 group, which long operated under the radar, now finds itself in the media spotlight. Part of the reason for the change is soaring Chinese foreign investment and the overall attention this raises in Europe. Moreover, some circles in the EU worry that inundation of Chinese FDI may result that China gains too much influence in the CEE region which in turn may indirectly shape EU-China policy. These suspicions have only increased with EU's problems with certain CEE countries. In the end, however, the financing assistance offered by China is small compared, for example, to EU structural funds available to CEE countries.

China lowers import duties on consumer goods. China's finance ministry announced last week that import duties on 187 consumer goods will be reduced starting from today (Dec 1). Import duties drop on average from 17 % to under 8 %. The wide-ranging list of consumer products includes seafood, cheeses, nuts, mineral water, alcoholic beverages, pharmaceuticals, perfumes, cosmetics, hygiene products, clothing, home appliances, household devices and baby diapers. Many products on the list are considered luxury items.

The WTO reports that the average import duty on non-agricultural products in China was 9 % in 2015, a level that is relatively low compared to other emerging economies (duties range from 6 to 60 %), but is clearly higher that in developed economies (2–4 %).

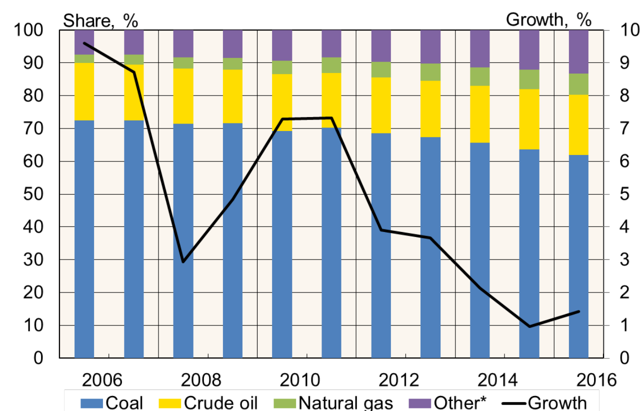
Even if the duty cuts are substantial, many observers expect their impact to be minor. The last round of duty reduction in 2015 had relatively marginal effects. Instead, the main goal of the measure seems to be levelling the playing field for online retailers and brick-and-mortar outlets. Online purchases from foreign sellers are duty-free in China if they are worth less than 2,000 yuan (250 euros). During the year, a buyer can make duty-free purchases of foreign goods up to 20,000 yuan (2,500 euros). In addition, online retailers can offer much lower value-added tax and consumption tax rates than brick-and-mortar shops.

Coal will still account for over half of Chinese power generation in 2030. China remains heavily dependent on coal. The IEA's latest *World Energy Outlook* reports that coal accounted for 73 % of domestic energy production in 2016 and 65 % of energy consumption (production and imports). With its current production and consumption structure, China accounts for half of global coal demand, even if it only accounts for roughly a quarter of total global energy demand. Air-pollution problems caused by coal largely drive China's efforts to reduce coal use.

The IEA expects Chinese energy demand to increase by 21 % between 2016 and 2030 if existing plans move forward and announced intentions are fulfilled. Growth is clearly lower than in the 2000–16 period, when demand rose by 180 %. The IEA forecast sees energy demand rising as much as 31 % without effective reforms. Sustainable development would require demand to grow by just 5 %. The report predicts that China's own energy production will increase by just 17 % by 2030, which means the country becomes more dependent on energy imports and remains the world's largest net importer of energy. China's self-sufficiency in oil and natural gas is low and further increases in demand lower China's energy self-sufficiency overall. By 2030, the IEA expects more energy demand to be covered by natural gas (10 %), various forms of renewable energy (13 %) and nuclear energy (6 %). Coal-based production, however, will still satisfy 52 % of energy demand.

Structural reforms of the energy sector require considerable investment, which IEA estimates to reach 200 billion dollars a year by 2025. On top of that, most currently operating coal-fired plants are fairly new (70 % of coal capacity consists of plants commissioned in 2005 or later) and taking them offstream might mean abandoning of otherwise usable power infrastructure worth roughly 90 billion dollars by 2030.

Structure of China's total energy demand by energy source and annual growth of total demand, 2006–2016



*) Other category (12 % in 2015) includes hydropower (8 %), nuclear power (1 %) and other energy forms.

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

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