Weekly Review
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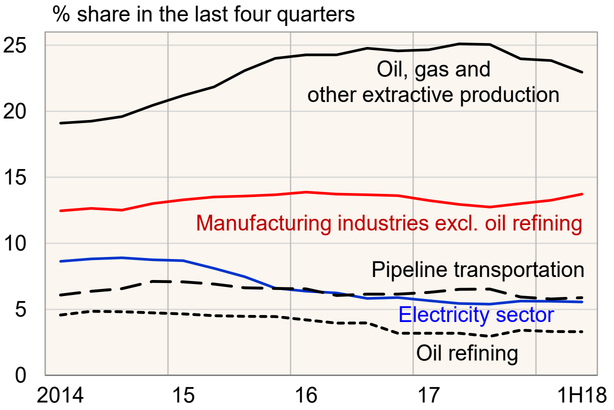
Russia

Changes in structure of fixed investment in Russia. Fixed investment rose by over 3 % y-o-y in the first half of this year, even if investments of large and mid-sized firms and the state, which are in the core of statistical recording of fixed investment, fell by 1 %. Thus, Rosstat figures imply an unusually large increase (well above 10 %) in fixed investment activity by small firms, firms operating in the grey economy and households.

Fixed investment by large and mid-sized corporations was drawn down by all significant categories of the energy sector. The multi-year decline in investment in the electricity sector continued, while investment in pipelines for the oil & gas sector dipped. Investment in oil production and oil refining turned downwards. The large investment wave in services related to gas production and transportation on the Yamal Peninsula came to a near complete halt. Manufacturing investment (excluding fixed investment in oil refining) rebounded strongly after a three-year decline. Much of the recovery reflects investment in the chemical industry and manufacturing of transport vehicles.

Looking at investment in various types of physical capital, growth of investment in machinery and equipment has remained brisk this year. In contrast, investment in various kinds of structures has declined, supporting the picture that the peak in various large investment projects, some of them government-led, has now passed.

Structure of fixed investment of large and mid-sized firms and the state



Source: Rosstat.

Russia modifies rules on repatriation of foreign trade earnings. Russia's finance ministry has sought this year to ease the forex repatriation demands on companies involved in foreign trade, with several proposals turned down. At the end of July, however, an amendment eliminating the repatriation mandate for companies affected by Western sanctions was approved. Proposals to ease the repatriation requirement on all companies e.g. on ruble-denominated foreign trade earnings are still under consideration.

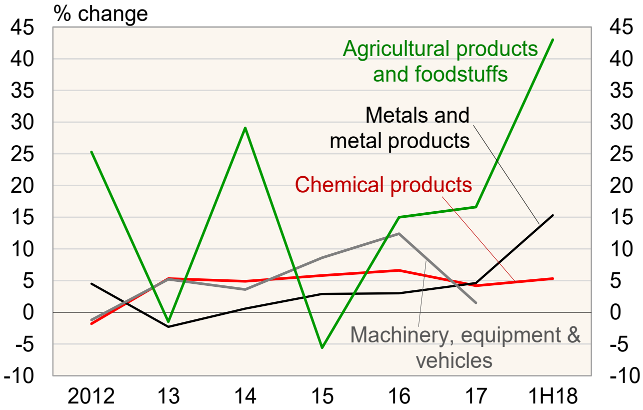
Under current legislation, firms are required to repatriate their foreign trade revenues. It is not required, however, that firms convert their earnings to rubles. This partly explains why about 30 % of corporate bank deposits in Russia are denominated in foreign currencies. CBR figures show that the largest export firms have typically converted over 50 % of forex earnings to rubles in order to pay e.g. wages and taxes. The rise in the export price of oil has increased export revenues, which are typically denominated in dollars, as well as ruble-denominated taxes and tariffs going to the budget. The finance ministry reconverts any surplus budget revenues back into foreign currencies before they are transferred to the National Welfare Fund.

Russian export volumes up significantly in recent years. Unlike other demand-side categories, the real volume of exports of goods and services grew overall at an average rate of 4 % a year in 2015–17. This year's growth has been even higher. Exports correspond to over a quarter of GDP. The pace of export volume growth in recent years has directly added about one positive percentage point a year to changes in GDP.

Most export growth over the past couple of years has come from non-energy exports. Led by grain exports that have tripled over this decade, exports of agricultural products have soared in recent years. Chemical exports have increased steadily for many years, mostly from traditional chemical exports such as fertilisers. Metal exports have also risen substantially this year, particularly ferrous metals and copper. Exports of services have increased significantly over the past year-and-a-half, not just in the core categories of transport and tourism, but other services as well.

Energy items in recent years accounted for about half of Russia's total earnings from exports of goods and services, while other goods accounted for over one third and services 14–15 %.

Volume growth of non-energy goods exports



Source: Russian customs.

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China

China's official statistics getting more suspect. The Hong Kong daily *South China Morning Post* (SCMP) last week reported potential new cases of anomalous statistical reporting by Chinese officials. The SCMP article found evidence to question recently published data from the China National Bureau of Statistics (NBS) on the profitability of large industrial firms, retail sales, electricity consumption and coal output. SCMP reporters assert that officially reported July industrial profit growth was seriously overstated compared with growth figures calculated from absolute yuan figures. The NBS explained that the difference reflects annual changes in the size of the corporate sample. The NBS sample is limited to firms with revenues above 20 million yuan. Some experts interviewed think that the NBS may, for example, deliberately adjust the sample size to make the numbers look better and meet official growth targets.

Last month, Chinese media reported that the housing expenditure component of the consumer price index failed to reflect actual trends in housing costs.

The poor reliability of official Chinese figures has been discussed for years, but in recent years the problem seems to have grown worse. The remarkable stability of reported GDP growth figures is not credible. Moreover, it has been found that, for example, in the Liaoning and Inner Mongolia provinces and Tianjin's Binhai special zone official data have been significantly manipulated. Many suspect part of the statistical reporting problem is related to the China's ambitious official target of doubling real 2010 GDP by 2020. The goal may have forced officials to cheat in meeting their mandated targets.

Data discrepancies are always problematic. They can distort assessments of the economic situation leading to inappropriate economic policies and bad business decisions.

China cuts income taxes. The Standing Committee of the National People's Congress last week announced an income tax reduction, with the largest cuts going to low- and middle-income individuals. Under the income tax tables coming in October, individuals earning less than 5,000 yuan (EUR 630) a month pay no income tax (earlier 3,500 yuan). The three lowest income tax brackets for individuals (3 %, 10 %, 20 %) were adjusted so that e.g. the income ceiling in the third-lowest (20 %) rises from 9,000 yuan a month to 25,000 yuan. Other tax bracket definitions remain unchanged. China's highest income tax rate (45 %) applies to individuals with monthly earnings exceeding 80,000 yuan (EUR 10,000).

The reform also provides more opportunities for income tax deductions. For example, larger shares of the costs of education, care for serious illness or injury, housing and elder care can now be deducted. The government plans to give more detailed deduction rules during the autumn. Those rules come into force at the start of 2019. The comment period on proposed tax changes ran through July. Media reports note that hardly any of the over 100,000 comments resulted in changes to the government's original proposal.

The government hopes the tax cuts will boost consumption to support economic growth. China's finance ministry estimates that the cuts will increase the average urban-dweller's consumption by about 300 yuan (EUR 40) a month. The impact of the tax change on public sector revenues is expected to be small, however. Unlike the US, where income taxes account for half of the tax take or Finland with over 60 %, they only accounted for about 8 % of total government revenues in China last year. Value-added tax is China's largest tax revenue stream, accounting for 39 % of last year's tax take. Corporate taxation generated 22 % of the tax take.

Local governments in China encouraged to boost growth. At the end of July, the central government leadership encouraged local administrators to increase their borrowing, especially to fund infrastructure projects. The message seems to have taken hold. In July and August, local governments issued 1.64 trillion yuan (240 billion dollars) in new debt. Local governments this year have issued bonds worth over 3 trillion yuan, while the value of maturing bonds this year has been less than 400 billion yuan.

A quarter of the new borrowing involves "special-purpose" bonds that local governments may use for acquisition of land or financing road projects. These bonds are to be paid back from revenues from the completed project. The finance ministry this year significantly increased its special-purpose bond quota for local governments to 1.35 trillion yuan (200 billion dollars), while the ceiling on new standard local government bonds was limited to 830 billion yuan. Local governments, under orders from the finance ministry to use their quotas, are rushing to find land acquisition and road construction projects. The finance ministry wants local governments to use 80 % of this year's special-purpose bond quota by the end of September and the rest by the end of October. China's large state-owned banks have already announced plans to increase their investments in local government bonds, most of which are already held by Chinese banks.

China's leadership made reducing indebtedness a main goal of the current five-year plan. In the second half of 2017, infrastructure investment projects already started were put on ice and new projects approvals halted on worries over rising indebtedness and potential project insolvencies. Somewhat ironically, the policy stance has reversed and many new local government infrastructure projects re-authorised.

The exhortations to finance investment projects and support economic growth come in the face of rising uncertainty over rising local government indebtedness. There is no comprehensive estimate of local government debt loads, but China's own estimate puts official debt at about 20 % of GDP as of end-2017. The IMF estimates that local government off-budget financing vehicles amounted to indirect debt obligations at the end of 2017 equal to 24 % of GDP, which put total local government debt at around 45 % of GDP.

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