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BOFIT Weekly
Yearbook 2013



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EUROSYSTEMET

Bank of Finland, BOFIT
Institute for Economies in Transition

BOFIT Weekly
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The opinions expressed in this paper are those of the authors and do not necessarily reflect the views of the Bank of Finland.

BOFIT Weekly – Russia 2013

4.1.2013 BOFIT Weekly 1/2013

New leg of ESPO pipeline commissioned.
Project to enhance Russia's appeal to investors has yet to improve business environment.
Russian-Belarus-Kazakhstan customs union takes protectionist measures to deal with increased imports.

11.1.2013 BOFIT Weekly 2/2013

Russian stocks unperformed in 2012.
Cabinet prepares measures to crack down on offshoring.
Putin encourages firms to conduct IPOs on domestic exchanges.

18.1.2013 BOFIT Weekly 3/2013

Ruble strengthened slightly in 2012.
Russia returns to stricter fiscal policies.

25.1.2013 BOFIT Weekly 4/2013

Last year witnessed modest growth in Russia's oil and gas sector.
Slight reduction in current account surplus and lower import growth in 2012.
Corporate sector capital outflows up in 2012.

1.2.2012 BOFIT Weekly 5/2013

Russian economic growth slowed in 2012.
Federal Antimonopoly Service green-lights Rosneft acquisition of TNK-BP.
Ukraine-Russia gas fight flares again.

8.2.2013 BOFIT Weekly 6/2013

2012 federal budget in balance.
Government split on how to grow the economy faster.
Russia to reduce number of universities and institutes.

15.2.2013 BOFIT Weekly 7/2013

Despite demands, CBR refrains from lowering rates.
Rapid credit expansion last year.
Unemployment at record lows.

22.2.2013 BOFIT Weekly 8/2013

Growth in Russian foreign trade slowed substantially in 2012.
Trade growth within Russia-Belarus-Kazakhstan cus-toms union up slightly more than for other trading partners.

1.3.2013 BOFIT Weekly 9/2013

The government prepares to extend car recycling fee to Russian-made cars.
Car imports and car production in Russia hit record highs in 2012.
OECD takes up Russia's membership application again.

8.3.2013 BOFIT Weekly 10/2013

Economic growth helped public finances in 2012.
Trends in gasoline prices carefully monitored in Russia.

15.3.2013 BOFIT Weekly 11/2013

Latest BOFIT forecast for Russia sees slightly lower economic growth ahead.
Elvira Nabiullina tapped for CBR chairman post.
Cross-border travel between Finland and Russia hit record high in 2012.

BOFIT Weekly – Russia 2013

22.3.2013 BOFIT Weekly 12/2013

Plans move ahead to make Moscow a global financial hub.
Privatisation sales of state-owned enterprises to take place via the Moscow Exchange.
Growth in Finnish exports overall slowed last year, but exports to Russia provided a bright spot.

28.3.2013 BOFIT Weekly 13/2013

Russian economic growth slowed in the first two months of the year.
Small shift in investment structure last year.
New government budget administration programmes strive to maintain balance.

5.4.2013 BOFIT Weekly 14/2013

CBR's latest rate cuts have marginal impact.
Russian regions posted rather uneven economic performances last year.
Russia seeks to boost exports by easing border formalities and increasing state subsidies.

12.4.2013 BOFIT Weekly 15/2013

Russia's current account surplus shrinks and capital outflow declines.
Russia's massive grey economy contributes significantly to social sector underfunding.
What constitutes middle class in Russia?

19.4.2013 BOFIT Weekly 16/2013

Russia's economy ministry cuts its GDP growth forecast significantly.
Russia's WTO membership stumbles on lack of relevant expertise.

26.4.2013 BOFIT Weekly 17/2013

Russia's economy revived in March; government considers measures to boost recovery.
Russia's heavy bureaucracy adds to costs of doing business and constrains entrepreneurship.
Economy ministry has ambitious expectations on raising Russia's business friendliness.

3.5.2013 BOFIT Weekly 18/2013

Moscow Exchange stocks have four rough months.
Foreign subsidiaries of Finnish firms have expanded especially in Russia and China.

10.5.2013 BOFIT Weekly 19/2013

Gazprom's eroding dominance in Russia's domestic gas market.
Privatisation of Russia's VTB Bank continues.

17.5.2013 BOFIT Weekly 20/2013

Russia's employment hits record high.
Wages in Russia still rising rapidly, but high inflation erodes purchasing power.
Housing prices seem to be stabilising in Russia.

24.5.2013 BOFIT Weekly 21/2013

Russian municipalities get most of their funding from federal and regional budgets.
Gazprom refunds \$3.3 billion to European customers after readjusting its pricing scheme.
Russia accounted for about 2 % of global FDI flows last year.

31.5.2013 BOFIT Weekly 22/2013

Russia gradually takes into account the impact of lower growth on government finances.
Draft of 2014–2016 customs policy programme presented to the cabinet.

BOFIT Weekly – Russia 2013

7.6.2013 BOFIT Weekly 23/2013

Russian inflation accelerated to 7.4 % in May.

President Vladimir Putin calls for faster progress in eliminating cross-subsidies in the electrical power sector.

Ukraine reaches cooperation deal with Russia-Belarus- Kazakhstan customs union.

14.6.2013 BOFIT Weekly 24/2013

CBR leaves key rates unchanged.

No big tax changes ahead: Russian unveils tax policy framework for 2014–2016.

Further postponing of production at Shtokman gas field.

20.6.2013 BOFIT Weekly 25/2013

Russian foreign trade surplus shrinks in first four months of the year.

Customs union creates new opportunities to sneak capital out of Russia.

Ruble exchange rate down since the start of the year.

28.6.2013 BOFIT Weekly 26/2013

New CBR chairman Elvira Nabiullina commits to keeping monetary policy on its current course.

CBR first deputy chairman Alexei Ulyukayev tapped as new economy minister.

President Putin announces stimulus measures at this year's St. Petersburg International Economic Forum.

5.7.2013 BOFIT Weekly 27/2013

Russia moves to hold federal deficit in check.

Duma approves law on pardons for people convicted of financial crimes.

12.7.2013 BOFIT Weekly 28/2013

Russia's new privatisation programme more cautious than its predecessor.

Russia announces new subsidies to stimulate car sales; EU files complaint with WTO protesting old subsidies.

19.7.2013 BOFIT Weekly 29/2013

Russia sees export earnings and current account surplus shrink in the first half of this year.

Amendments to law give the CBR supervision of the entire financial sector.

CBR: Basel III requirements in place at the start of 2014.

26.7.2013 BOFIT Weekly 30/2013

As Russian economic growth falters, government moves ahead with stimulus measures.

Nearly 10 % of Russians plan to travel abroad in their summer vacation.

2.8.2013 BOFIT Weekly 31/2013

Ruble continues to slide; Moscow stock exchange down for the year.

Credit expansion in Russia tapering off.

Russian customs intends to change the treatment of TIR road transport.

9.8.2013 BOFIT Weekly 32/2013

Economic stimulus policy gaining ground in Russia.

Russia strives to increase waste recycling.

BOFIT Weekly – Russia 2013

16.8.2013 BOFIT Weekly 33/2013

Russian GDP up just 1.2 % y-o-y in second quarter.
Russian inflation slowed slightly in July; CBR board decides to keep interest rates unchanged.
CBR revises its organisational and operational model.

23.8.2013 BOFIT Weekly 34/2013

Russia's foreign trade weak in the first half.
Highlights from Russia's first year as a WTO member.
Ukraine-Russia exports tumble.

30.8.2013 BOFIT Weekly 35/2013

Russian economy ministry sees growth picking up in the second half of the year.
Better-than-average Russian grain harvest ahead.
New law bans Russian officials and representatives from keeping their money outside the country.

6.9.2013 BOFIT Weekly 36/2013

Sharp drop in Russian energy sector investment.
Russia-Belarus tiff over potassium exports widens.
Slowing Russian economic growth evident in Finnish- Russian trade.

13.9.2013 BOFIT Weekly 37/2013

Russia's \$7 billion sovereign bond issue proves a hit with international markets.
Russian companies cut back on borrowing from domestic banks.

20.9.2013 BOFIT Weekly 38/2013

BOFIT forecast sees Russian economic growth reviving.
CBR names new deputy chairwoman and streamlines its monetary policy instruments.

27.9.2013 BOFIT Weekly 39/2013

Russian economy and imports continue to falter.
Wages keep climbing in Russia, but wage gaps remain huge.
Foreign pharmaceutical makers dominate the Russian market.

4.10.2013 BOFIT Weekly 40/2013

Low economic growth forces high-level debate on structural reform.
Partial freeze on regulated prices hoped to revive Russian economy.

11.10.2013 BOFIT Weekly 41/2013

Major forecasts for the Russian economy lowered.
Russia's foreign trade and current account figures weaken further.
Capital outflow from Russia has continued and weakened the ruble.

18.10.2013 BOFIT Weekly 42/2013

World Bank now sees Russia as a high-income country.
Wealth in Russia is concentrated in the hands of a few, while income distribution is more even.
Strong pressures to crack open the National Welfare Fund piggy bank.

25.10.2013 BOFIT Weekly 43/2013

CBR moves closer to a free-floating ruble.
Russia's government budgets face hard times ahead.

BOFIT Weekly – Russia 2013

1.11.2013 BOFIT Weekly 44/2013

Russian Duma approves law extending recycling fee to domestic-built vehicles; new forms of subsidy for domestic car industry proposed.

Customs union summit exposes Kazakh and Belarusian unhappiness.

World Bank finds Ukraine, Ruanda and Russia make biggest strides in becoming more business friendly.

8.11.2013 BOFIT Weekly 45/2013

Russia postpones plans for tax reforms to energy sector.

Russia to liberalise gas export rules.

Russia creates separate ministry for construction, housing and public utilities.

15.11.2013 BOFIT Weekly 46/2013

Officials cut growth forecast on domestic economy weakness.

Putin says harsher criminal code needed to fight economic crime.

22.11.2013 BOFIT Weekly 47/2013

Latest figures show persistent low growth for Russia.

Russia raises corporate property tax.

29.11.2013 BOFIT Weekly 48/2013

Ukraine-EU association agreement put on hold.

Russian central bank intensifies bank supervision.

Russia to abandon TIR customs guarantee arrangement at Finnish-Russian border.

5.12.2013 BOFIT Weekly 49/2013

Ruble's decline continued in November.

Russia approves 2014 budget.

TIR system gets more time at Finnish-Russian border.

13.12.2013 BOFIT Weekly 50/2013

Russian ruble gets its own currency symbol.

CBR to beef up supervision of insurance sector.

Russian students show improvement in latest PISA round.

Finnish exports to Russia sustain growth in consumer-driven branches.

20.12.2013 BOFIT Weekly 51–52/2013

Russia to bail out Ukraine with massive economic support package.

Russian government cracks down on firms using offshore entities to avoid taxes.

Soaring costs of Sochi Winter Olympics hit investors and Russian development bank VEB.

BOFIT Weekly – China 2013

4.1.2013 BOFIT Weekly 1/2013

China's growth prospects for 2013 improving.
2012 saw a slight easing of monetary policy and dismantling of several regulatory structures.

11.1.2013 BOFIT Weekly 2/2013

Chinese exports and imports picked up in December.
Google's experience highlights opportunities and challenges for foreign companies in China.
Income disparity in China continues to widen.

18.1.2013 BOFIT Weekly 3/2013

Share of traditional bank loans in finance continues to decline.
Forecast revisions and financial market reforms rock stock prices.

25.1.2013 BOFIT Weekly 4/2013

China's GDP up 7.8 % in 2012.
Inflation accelerated in December; M2 growth remained moderate.
China releases first official estimate of income disparity in 12 years.

1.2.2012 BOFIT Weekly 5/2013

Though rate of growth slowing, China's population continues to rise.
Rise in wages slowed slightly in 2012; again big minimum wage hikes.

8.2.2013 BOFIT Weekly 6/2013

China's current account surplus grew in 2012.
Construction of China's trans-Myanmar oil and gas pipelines could help ease strained trade relations.

15.2.2013 BOFIT Weekly 7/2013

The modest recovery in Chinese exports to Europe, US and Japan indicate caution still warranted.
The domestic value added of China's exports is about 70 %.
China's economic changes reflected in shifts in FDI flows.

22.2.2013 BOFIT Weekly 8/2013

Yuan's role as an international payment currency still modest, but growing rapidly.
GDP growth highest in central China, provinces burdened with debt.

1.3.2013 BOFIT Weekly 9/2013

Real estate prices rising again.
Energy dominates China-Russia discussions on trade policy.
China-India trade stumbled last year.

8.3.2013 BOFIT Weekly 10/2013

Few surprises in economic targets announced for 2013.
Environmental issues underlie demands for a "beautiful China".

15.3.2013 BOFIT Weekly 11/2013

BOFIT's latest China forecast ties modest slowdown in GDP growth in 2013–2015 to gradual progress in structural reforms.
China continues to free capital movements.

22.3.2013 BOFIT Weekly 12/2013

No big surprises in National People's Congress.
China to increase spending on health care and social security.
Inflation accelerated to 3.2 % in February.

BOFIT Weekly – China 2013

28.3.2013 BOFIT Weekly 13/2013

OECD recommends that China improve status of internal migrants and push ahead with market-based solutions to environmental problems.
China matches Germany in international patent activity.

5.4.2013 BOFIT Weekly 14/2013

Banks show higher-than-expected profits for 2012.
President Xi's Africa tour highlights the rapid expansion of China-Africa relations.
Chinese arms exports continued to rise last year.

12.4.2013 BOFIT Weekly 15/2013

Robust export growth in the first quarter.
Chinese tourists off to see the world.

19.4.2013 BOFIT Weekly 16/2013

First-quarter GDP growth fails to meet expectations in China.
China's inflation slows sharply in March.

26.4.2013 BOFIT Weekly 17/2013

Yuan appreciates, international use continues to rise.
Chinese companies rule the roost in latest Forbes Global 2000 list.

3.5.2013 BOFIT Weekly 18/2013

Chinese eating more meat.
Bird flu concerns mainly affecting the Shanghai region.

10.5.2013 BOFIT Weekly 19/2013

Full convertibility of Chinese yuan coming soon?
Solid consumer and investment demand in China driving growth of the global economy.
Trade between China and North Korea has soared in recent years.

17.5.2013 BOFIT Weekly 20/2013

China's latest economic figures offer little indication that growth is picking up.
Foreign trade data suggest evasion of capital controls.
Rising food prices drive CPI, even as inflation pressures are otherwise modest.

24.5.2013 BOFIT Weekly 21/2013

Structure of corporate borrowing shows signs of improvement in China.
Despite a challenging operating environment, most US companies in China are turning a profit.
Shanghai shares flat for the year.

31.5.2013 BOFIT Weekly 22/2013

Trade policy disputes strain China-EU relations.
FDI inflows to China up slightly in the first four months of the year.

7.6.2013 BOFIT Weekly 23/2013

EU imposes anti-dumping tariffs on Chinese solar panels; China investigates countermeasures.
Latest PMI reading gives no clear sign about near-term prospects for Chinese manufacturing.
China emerges as a major trading partner for many Latin American countries.

14.6.2013 BOFIT Weekly 24/2013

No signs that Chinese economic growth accelerated in May.
Obama and Xi commit to improving bilateral relations through increased cooperation.

BOFIT Weekly – China 2013

20.6.2013 BOFIT Weekly 25/2013

True size of public sector budget deficit and debt likely much larger than official estimates.
Housing prices on the rise throughout China.
China eager to be part of cooperation in the Arctic and assessing the region's economic potential.

28.6.2013 BOFIT Weekly 26/2013

Interest rate spike in China frightened.
Chinese companies invest in a wide range of sectors.

5.7.2013 BOFIT Weekly 27/2013

China plans reforms to the household registration system to promote urbanisation.
China increases international use of the yuan through currency swap agreements.
Volume of Chinese goods imports to Finland drops significantly.

12.7.2013 BOFIT Weekly 28/2013

Chinese imports and exports contracted in June.
Inflation pressures in China remain modest.
Higher degrees increasingly common in China.

19.7.2013 BOFIT Weekly 29/2013

China's economic growth continued to slow in the second quarter.
China announces new round of measures to deregulate capital movements.
Yuan exchange rate stable since May.

26.7.2013 BOFIT Weekly 30/2013

China ends regulation of lending rates allowing banks less restrictive loan pricing.
IMF encourages China to address growing financial market risks.
Rich OECD countries lead in innovation, but China outranks many EU countries.

2.8.2013 BOFIT Weekly 31/2013

Official and unofficial PMI readings for July give mixed picture of Chinese economy; decision-makers still convinced China will hit its growth targets.
China attempts to figure out true scale of local government indebtedness.
EU and China resolve dispute over solar panel duties.

9.8.2013 BOFIT Weekly 32/2013

Chinese exports and imports picked up in July.
China's health care sector dogged by problems even as state spending on public health care continues to rise.

16.8.2013 BOFIT Weekly 33/2013

China industrial output grew faster than expected in July.
China's inflation remained modest in July.
China sovereign wealth fund's international investments turned profitable.

23.8.2013 BOFIT Weekly 34/2013

China continues to struggle with statistical reporting issues.
China turns to online shopping.

30.8.2013 BOFIT Weekly 35/2013

China's current account surplus remained stable in first half – while there was a large shift in capital flows.
Housing prices in China continue to climb.

BOFIT Weekly – China 2013

6.9.2013 BOFIT Weekly 36/2013

Shanghai free-trade zone prepares for launch.
Chinese yuan could soon become one of the world's top 10 global payment currencies.
Pressures build for China to deal with its urbanisation issues.

13.9.2013 BOFIT Weekly 37/2013

Good late summer economic performance dispels concerns over China and global economy.
Chinese firms piling on debt.
Lower growth in bank profits.

20.9.2013 BOFIT Weekly 38/2013

BOFIT sees China's economy growth slowing in 2013–2015.
EU Chamber of Commerce in China wants to see more space for market forces to operate.

27.9.2013 BOFIT Weekly 39/2013

Additional small steps to reform Chinese financial markets.
China surpasses Russia as top trading partner for Central Asian countries.

4.10.2013 BOFIT Weekly 40/2013

Game rules for Shanghai free-trade zone still unclear.
Yuan's real effective exchange rate has appreciated significantly.

11.10.2013 BOFIT Weekly 41/2013

International financial institutions lower their forecasts for China.
Share prices on China's stock markets bounce back from June lows.

18.10.2013 BOFIT Weekly 42/2013

PBoC and ECB make currency swap deal.
China inflation accelerates in September; housing prices soar.
China disappointed with flat-lining of export growth in September.
China's rising foreign currency reserves hint increased appreciation pressure on the yuan.

25.10.2013 BOFIT Weekly 43/2013

China's GDP growth accelerated in the third quarter.
Private consumption to GDP ratio increased in 2012.
Lower income growth in China.

1.11.2013 BOFIT Weekly 44/2013

China expected to announce new economic policy framework and renew commitment to reform.
China takes further steps in deregulating interest rates.
China's grain harvest increases again this year.

8.11.2013 BOFIT Weekly 45/2013

Beijing tries again to subdue investment craze at local level.
Car sales continue to boom in China.

15.11.2013 BOFIT Weekly 46/2013

China outlines blueprint for economic reforms.
China's economy shows stable growth in October.
China's inflation rate unchanged in October.

22.11.2013 BOFIT Weekly 47/2013

China reveals further details on reform plans.
Chinese firms' investments abroad are getting more diverse.

BOFIT Weekly – China 2013

29.11.2013 BOFIT Weekly 48/2013

EU and China launch talks on bilateral investment treaty.
China-Japan island dispute takes a dangerous turn.

5.12.2013 BOFIT Weekly 49/2013

Further details on Shanghai financial market experiment emerge.
Shanghai's air quality reaches ghastly levels.
China remains a mid-level country when it comes to corruption.
Shanghai 15-year-olds shine in latest PISA scores.

13.12.2013 BOFIT Weekly 50/2013

China moves ahead on deregulation of interest rates and preparations for launch of deposit insurance scheme.
China's stable economic conditions create a window of opportunity for reforms?
International yuan use increasing in many areas.

20.12.2013 BOFIT Weekly 51–52/2013

China's leadership discusses implementation of economic reforms.
Finland's trade deficit with China shrinks.
Wage rise likely to slow next year.

Russia

New leg of ESPO pipeline commissioned. Russian oil pipeline operator Transneft commissioned the second part of the Eastern Siberia–Pacific Ocean (ESPO) pipeline on Christmas Day (25 December). Phase 2 runs from Skovorodino near the Chinese border to the Port of Kozmino on the Pacific coast near the Russian city of Nakhodka. The operational first leg of the pipeline, ESPO1, runs from oil fields in eastern Siberia to Skovorodino. The opening of ESPO2 means that more expensive rail shipment of oil to the Kozmino oil terminal can be phased out. Pipeline capacity overall also rises as the capacity of the ESPO1 trunk pipeline has also been raised.

Russia has given high priority to boosting oil supplies to growing Asian energy markets, for which the ESPO pipeline is constructed. Some 15 million tons of crude oil coming through the ESPO1 pipeline continues to be diverted annually from Skovorodino to China. The rest will continue on to the Kozmino terminal, and from there loaded onto tankers and shipped mainly to the United States, Japan and China. The pipeline's annual capacity of 45 million tons corresponds to about a fifth of Russia's current oil exports.

The ESPO pipeline helps Russia diversify oil exports in particular from newly developed fields in northwest Siberia. The European Commission is concerned about the effect of the ESPO pipeline on oil deliveries to Europe via the Druzhba pipeline running through Belarus and Ukraine. In December, as part of the EU-Russian energy dialogue, the European Commission requested that Transneft disclose details of its investment plans. Since the opening of the Ust-Luga oil port in the Gulf of Finland last March, the volume of oil moving through the Druzhba pipeline has diminished and occasionally caused problems e.g. for oil refineries in the Czech Republic.

Russia hopes to use the ESPO pipeline to encourage regional development in Russia's Far East. The pipeline will deliver oil to the region's operating refineries as well as new refineries under construction.

Project to enhance Russia's appeal to investors has yet to improve business environment. Last month, economy minister Andrei Belousov reported to the cabinet on progress in increasing Russia's attractiveness to investors under a plan approved last spring. The "roadmaps" set goals and define measures to e.g. improve the functioning of the construction industry, make customs procedures more efficient and increase company access to energy.

The roadmaps are meant to help in attaining goals set by president Vladimir Putin, which would take Russia from 112th place to the top 20 countries in the world for business by 2018 as measured on the World Bank's annual *Doing Business* survey.

Belousov said the reforms have been the slowest in the construction sector. As of end-2012, the Duma should have approved 16 amendments to laws to improve the situation. Only two had been approved. Companies report that one of the biggest problems for them is getting building permits.

Amendments to laws regulating customs operations have seen some progress, even if their impacts have been marginal. A survey of companies dealing with customs found that 70 % of respondents had not noticed any speed-up in customs transactions last year.

Belousov claimed tangible improvements in access to the power grid. From the start of next year, companies should be able to connect to the grid more quickly. A timetable for gradual cuts in connection costs is under preparation.

Russian-Belarus-Kazakhstan customs union takes protectionist measures to deal with increased imports. The tri-nation customs union commission announced last week that it was imposing a temporary hike in the import duty for combine harvesters to 27.5 %. The tariff had just been lowered to 5 % in autumn as part of Russia's WTO membership. Pre-accession import duties were 15 % for new harvesters and 25 % for used.

The commission justified the hike by a spike in imports and loss of market share of domestic harvesters. The bulk of imported harvesters come from manufacturers in Belgium, Germany and the United States.

The temporary duty will enter into force at the end of February and remain in force until early July. Under WTO rules, a country can temporarily restrict imports when it causes severe damage to domestic producers. The customs union commission is currently studying whether the current case involves dumping. After the investigation, final measures will be considered.

Russia is also considering protectionist measures for other domestic branches affected by lower import duties under WTO membership. Rules are currently being drafted for e.g. restrictions on foreign pharmaceutical manufacturers in public procurements. A draft resolution would allow the exclusion of a foreign-made medicine if at least two domestic similar medicines are listed in official pharmacopeia. Under Russia's WTO commitments, the highest import duties on pharmaceuticals would fall from the current ceiling of 15 % to no more than 6.5 % in 2014. Foreign-made pharmaceuticals account for a substantial share of the market in Russia. For example, about 70 % of medicines purchased by hospitals are supplied by foreign manufacturers.

The agriculture ministry reports that imports of meat and dairy products rose substantially since autumn. In autumn, the import tariff e.g. on pork products was cut from 15 % to zero on imports within the quota, and the average duty on dairy products fell from 25 % to 15 %.

China

China's growth prospects for 2013 improving. The two just-released readings of manufacturing purchasing manager indexes (PMI) suggest slight improvement in December. The official index reading was 50.6, the same as in November, and the third month in a row the index reading was above the critical 50-point mark. The parallel HSBC China manufacturing PMI was up a point to 51.5, its highest reading in 19 months. The HSBC index gives greater weighting to smaller firms than the official PMI. Both surveys indicate current growth is driven by domestic demand; there were no signs in either index of a pick-up in export orders.

China's official non-manufacturing sector PMI for December rose slightly from November to 56.1. The expansive trend in the service sector highlights the importance of domestic demand at the moment.

The outlooks suggest better economic times ahead this year. The World Bank's latest forecast published in mid-December sees China's GDP growth accelerating from 7.9 % in 2012 to 8.4 % in 2013. Previous World Bank forecasts anticipated economic growth some tenths of a percentage point lower. The pick-up in growth reflects implementation of public investment programmes last autumn and gains in household incomes.

The World Bank sees only modest price pressures currently in China; it predicts the average inflation rate will accelerate from last year's below 3 % to slightly over 3 % in 2013.

Due to uncertainty in export markets and the strong growth in real wages now driving domestic consumption, the World Bank expects the current account surplus to contract this year to 2.2 % of GDP. The 2011 current account surplus was 2.8 % of GDP. The World Bank estimates China's 2012 current account surplus was 2.3 % of GDP.

Over the longer term, China's shift to consumption-driven growth combined with a reduction in the labour supply will reduce the growth potential of its economy. The World Bank forecasts 8.0 % growth for China in 2014.

GDP growth forecasts for China released in December, %

	2011	e2012	e2013	e2014
World Bank	9.3	7.9	8.4	8.0
CICC	9.3	7.7	8.1	8.0
BOFIT*	9.3	8	8	7
JPMorgan	9.3	7.6	8.0	
Mizuho	9.3	7.7	7.8	

*) released in September

2012 saw a slight easing of monetary policy and dismantling of several regulatory structures. Inflation slowed during 2012 to around 2 % in December, a level substantially below the government's official target of 4 %. The broad measure of money supply (M2) rose as predicted and was on target. Despite falling inflation and lower economic growth, the People's Bank of China only modestly eased monetary policy last year, as the economy still continues to digest the after-effect of the 2009 stimulus efforts. Key reference rates were lowered twice last summer a total of about half percentage point. The one-year deposit reference rate now stands at 3.0 % and the one-year credit rate at 6.0 %. Minimum reserve requirements for commercial banks were lowered last spring a percentage point, but are still high by international standards. The current reserve requirement for big banks is 20 % of deposits and for small banks 16.5 %.

In conjunction with the rate cuts, the PBoC last summer relaxed rules on interest rates to allow commercial banks to set their own rates more flexibly. After the latest adjustment, banks can offer loans at a rate as low as 70 % of the reference rate and pay interest on deposits as high as 110 % of the reference rate. The phasing out of rate controls is an important aspect of increasing competition in domestic financing markets. It is also a prerequisite for freeing up capital movements and international acceptance of the yuan.

Despite a three-month depreciation episode last summer, the yuan strengthened about 1 % against the US dollar last year. In April, the yuan's daily fluctuation band was expanded to 1 %. Growth in China's currency reserves slowed last year, reflecting conditions in the global economy and the fact that the yuan has been allowed to float more freely on foreign exchange markets.

China took small steps last year in promoting international use of the yuan. The latest step is a pilot programme that permits use of the yuan in cross-border loans for companies operating in the Qianhai special economic zone in Shenzhen near Hong Kong. Media reports state that the first loans should be issued in the coming weeks.

Yuan-dollar rates in Mainland China and Hong Kong



Sources: Reuters and Bloomberg

Russia

Russian stocks unperformed in 2012. Russia's main stock indexes last year trended with emerging markets elsewhere. The Moscow Stock Exchange's dollar-denominated RTS ended 2012 slightly up from the start of the year. Share prices overall, however, were still well below their 2007–2008 pre-crisis levels. Trading volume in 2012 was not just below pre-crisis levels but also lower than in 2010 and 2011.

Russia's stock indexes represent a narrow swath of firms. The RTS index comprises just 50 firms, with a third of the index weighted to oil companies, a fifth to gas companies and 18 % to banks. The individual companies with the greatest weightings are Gazprom, Lukoil and Sberbank, each representing 14–15 % of the RTS.

Share prices of Gazprom and metal producers fell partly due to lower export prices and ended the year well below 2011 levels. Russia's main oil companies, the largest privately held gas producer Novatek and Sberbank fared better through the year.

Although the merger of Moscow's MICEX and RTS exchanges was officially announced at the end of 2011, last year was spent working out many practical aspects of integration of the new Moscow Stock Exchange (MSE). The MSE continues to use the two standard indexes, the RTS and the ruble-denominated MICEX.

Moscow RTS Index and Morgan Stanley Capital International Emerging Markets Index, January 2007=100



Source: Bloomberg

Cabinet prepares measures to crack down on offshoring. In his wide-ranging policy speech on social and economic issues last month, president Vladimir Putin criticised the practice of offshoring Russian firms, whereby companies move assets out of Russia and use foreign law to govern contract disputes. Putin tasked the cabinet with coming up with measures to deal with the situation by next autumn.

Putin wants Russian law to govern in most company contracts, but today more than half of Russia's big firms (including state-owned enterprises) use almost solely foreign contract law in important contracts. This applies not

just to contracts between Russian firms and foreign parties, but domestic parties as well.

As a result, the number of cases involving Russian firms in civil courts outside Russia is significant. In 2009, for example, 12 % of the cases heard by the London Court of International Arbitration involved Russian firms. Duma chairman Sergei Naryshkin claims that national sovereignty may even be jeopardised with issues affecting the Russian economy being decided abroad.

Russian reliance on foreign contract law reflects the general distrust of Russian courts. Putin said that the judicial system needs a complete overhaul so firms do not feel a need to resort to foreign law or dispute resolution abroad. In addition to e.g. improving the protection of property rights, Russia needs an attitudinal shift away from a common presumption in litigation that firms are presumed guilty and have to show innocence. While several calls for remedying the situation have been made over the past years, little progress has been achieved.

Concern rose abroad last summer, when the Russian Supreme Court of Arbitration (SAC) voided a clause in a contract between a Russian firm and a foreign firm stating that in a dispute both parties may seek a judgement in an arbitration court, but only the non-Russian party can take the dispute to court (in practice outside Russia). Hence, the Russian firm was able to take the dispute to a Russian court. This kind of clause is standard in some international contracts, and the ruling may suggest a crack-down on the use of foreign law in resolving contract disputes with Russian firms.

In his speech, Putin also mentioned the need to increase monitoring of capital outflows from Russia. Putin said the civilised answer was to make bilateral treaties with individual tax havens on exchanges of tax and company information concerning Russian firms in a manner similar to what has been done by the US and many European countries.

Putin encourages firms to conduct IPOs on domestic exchanges. In his December policy speech, president Putin tasked the cabinet with making sure domestic stock exchanges get involved with IPOs of companies where the state holds a stake of at least 50 %. The goal is to advance development of domestic financial markets.

While such IPOs have taken place in Russian exchanges in recent years, the share of sales inside Russia have been modest. For example, when the CBR sold its stake in Sberbank last September only 3 % of the issue was sold through the MSE; 97 % were sold in London.

Observers say that the Moscow exchange can well accommodate a \$300–400 million IPO, but IPOs of over \$1 billion should combine sales on the MSE with sales on at least one major international exchange. More IPOs could be arranged on the MSE if it had the better technical infrastructure and more sophisticated practices.

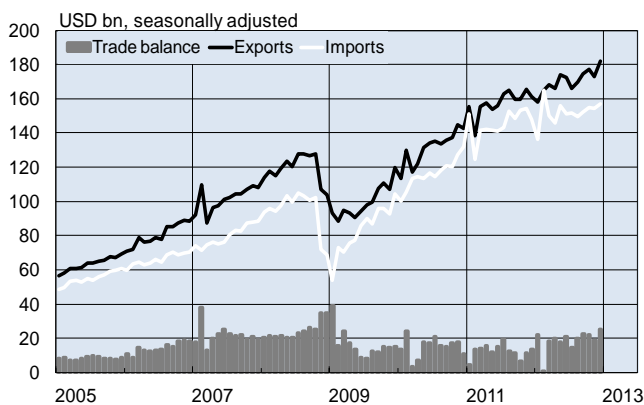
China

Chinese exports and imports picked up in December.

On-year growth in the value of goods exports accelerated in December to 14 %; imports were up 6 % y-o-y. Growth in exports to the US and the UK picked up, and the contraction in exports to the largest euro area countries slowed sharply. Political differences between China and Japan were reflected in a continuing slide in the value of exports to Japan. China's trade performance overall last month fuelled cautious optimism that recovery in the global economy is underway.

The value of Chinese exports rose 8 % in 2012 as a whole to \$2.05 trillion; imports were up 4 % to nearly \$1.82 trillion. The resulting trade surplus exceeded \$230 billion, up from a 2011 trade surplus of \$160 billion. Growth in China's trade surplus reflects higher export prices and a slight decline in prices of imports. Based on figures for January-November, export and import volumes both rose 5–6 % last year.

Value of China's monthly goods trade, USD billion



Sources: China customs and BOFIT

Google's experience highlights opportunities and challenges for foreign companies in China.

Google is best known in the West for its search engine, but in China, much of Google's success rests on its Android operating system for smartphones. The Android platform has enjoyed soaring popularity in China in recent years. By some estimates, Android is found on 90 % of late model smartphones in China. Google is increasing its push in development of phone and tablet applications for the Chinese user base.

Google introduced its search engine business to China in 2005, only to find its ability to offer services stymied by censorship guidelines. The company ultimately pulled out of the censored search business in 2010, claiming ethical rea-

sons. It redirected users in mainland China to its Hong Kong servers, which were not subject to Chinese censorship. Accessing and using the Hong Kong site, however, quickly became difficult as mainland officials filtered content with the "Great Firewall." To improve the functionality of its Hong Kong site, Google initially provided a list of terms flagged by censors for users to avoid when performing searches. The company abandoned this approach when users began to report access to the site had been blocked entirely. Google has also had severe cybersecurity issues in China, as hackers attempt access to Google software and user data.

With the handover of power to a new administration underway, limits of Chinese censorship have been tested several times. So far there are no signs of an easing of censorship restrictions. International attention recently focused on Chinese responses to a censor rewrite of a New Year's editorial in the *Southern Weekly* newspaper. The 30-year commemorative piece had called for a society based on the rule of law. The propaganda clampdown led to a national backlash on twitter and other social media. At the censor's behest, China's major papers all published editorials explaining that China was not yet ready for a free press.

Income disparity in China continues to widen. The Survey and Research Centre for China Household Finance released a report in December suggesting that China has now joined the group of countries with the greatest inequality in income distribution. Using the Gini coefficient as a measure of income disparity, the study found that China's Gini value reached an eye-popping 0.61 in 2010. The figure was arrived at after surveying nearly 10,000 households around China. On the Gini scale, a reading of 0.0 would indicate a situation of uniform income distribution, while 1.0 would signify that a single individual earned every penny. As a rule of thumb, a value of 0.40 is considered a threshold after which social unrest emerges.

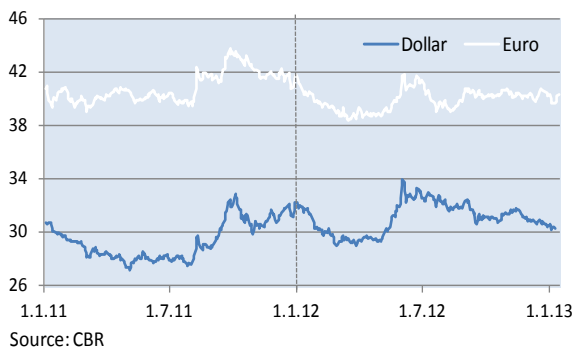
China has been reluctant to publish official estimates on income disparity. The most recent official figure is for 2000, when China's Gini coefficient was put at 0.41. Officials explain that they have held back on releasing estimates because it is nearly impossible to get reliable information on high earners. Even if releasing a Gini number is hard, officials do not dispute China's growing income disparity in recent years. A number of unofficial estimates of Gini values have been released. The World Bank came up with a value of 0.43 in 2005 and the Chinese Academy of Social Sciences (CASS) got a reading of 0.54 in 2008.

The widest income disparity in the world is found in South Africa, which has a Gini coefficient of 0.63. Income disparities above 0.60 are rare, however, and found mainly in a few African countries and small island nations. The lowest income disparities are found in the Nordic countries, where Gini coefficients are around 0.25.

Russia

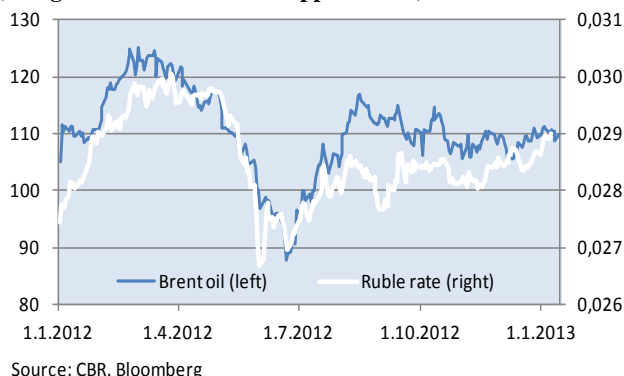
Ruble strengthened slightly in 2012. The ruble appreciated 2–3 % last year against the euro and US dollar. One euro bought 40.23 rubles at year's end, while one dollar fetched 30.37 rubles. The real exchange rate, which takes into account differences in the inflation rates of Russia and the US and EU countries, saw the ruble strengthen 7–8 % against the euro and dollar. The real appreciation of the ruble was greater than its appreciation in nominal terms, as the inflation rate in Russia was higher than in the EU and the US. Russian inflation was 6.6 % at the end of 2012.

Euro/ruble and dollar/ruble rates, 2011–2012 (rising trend indicates ruble depreciation)



The ruble's exchange rate continued to closely track world crude oil prices. The ruble strengthened as the oil price spiked in Q1/2012, then declined with the oil price in late spring and early summer. Since autumn, the oil price and ruble exchange rate have been less volatile.

Brent-oil price (US\$/bbl) and ruble/dollar-euro basket, 2012 (rising trend indicates ruble appreciation)



The Central Bank of Russia manages the ruble float with market interventions designed to keep the ruble within a preset fluctuation band based of its value relative to a dollar-euro currency basket. The band has been widened in recent years and the CBR has reduced its interventions so that the ruble's exchange rate is now more freely deter-

mined by the markets. The CBR last year only intervened to support the ruble with forex selling in June and July, and for a brief period in September. When the crude oil price shot up at the start of the year, the CBR smoothed the rise of the ruble by selling rubles.

Russia returns to stricter fiscal policies. In December, the Duma approved a law to check growth in federal budget spending and over-dependence on energy prices by setting limits on spending and creating a mechanism that automatically transfers excess budget revenues to reserve funds. Russia's heavy reliance on world energy prices is obvious from the fact that half of federal budget revenues and nearly 30 % of all public sector revenues are derived from production fees for oil and natural gas and export duties on oil, petroleum products and gas.

Similar, but stricter, budget restraints were in force from 2004 to 2008, before they were abandoned to deal with the recession. The reserves amassed during that period allowed Russia to power through the recession without having to cut federal spending or take on new government debt.

Under the new law, annual federal budget spending is based on revenue that would accrue if the price of oil would equal the average price over previous years. Spending can exceed that revenue by up to 1 % of the budget year's forecast GDP. Under the government budget guidelines for the 2013–2015 period, the rule was somewhat eased for the 2013 budget. Starting in 2014, however, the rules are applied in full. The price of oil at which the federal budget balances would be around \$105/bbl.

Excess revenues from oil and gas fees will be transferred to the Reserve Fund until it reaches a size equivalent to 7 % of GDP. Surplus revenues thereafter will go to the National Welfare Fund. Up to half of excess revenues can, however, be diverted to infrastructure projects. The Reserve Fund is currently worth about 3.5 % of GDP.

The government's debt policies for 2013–2015 call for the federal government to continue to ramp up its borrowing well beyond its needs to make up the possible budget deficit. The aim is to help in rebuilding reserves. The Reserve Fund would be rebuilt mostly through borrowing and privatisation sales so that by 2015 the Reserve Fund would reach about 5.5 % of GDP. The assets of the National Welfare Fund would not grow and would correspond to about 3.5 % of GDP in 2015. They amount currently to about 5 % of GDP.

Most of the planned government borrowing would come from domestic investors. Of about 1.45 trillion rubles of gross borrowing this year, over 1.2 trillion rubles is expected to be raised domestically. Borrowing from abroad is expected to reach around €6 billion a year during 2013–2015. Despite the borrowing, the gross federal debt will only rise to about 13.5 % of GDP in 2015. The gross federal debt at the moment is equal to just over 10 % of GDP.

China

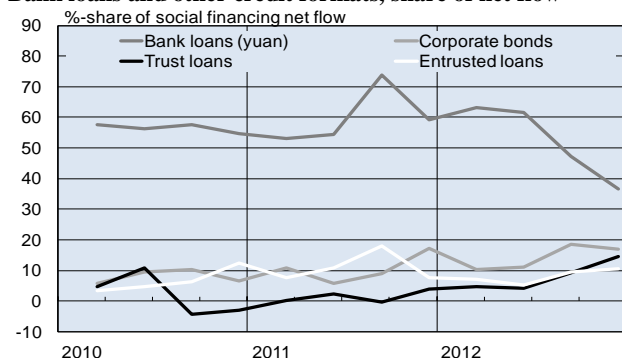
Share of traditional bank loans in finance continues to decline. Assessing macroeconomic conditions in China has become increasingly difficult in recent years with the dramatic change in structure of financial market. As officials have tried to rein in bank lending since the stimulus measures in 2009–2010, less-regulated modes of financing have become popular. For the last two years, officials have used the term “social financing” to describe this broader measure of financing. In addition to traditional bank loans, social financing includes forms of financing that do not show up on bank balance sheets such as bank accepted bills, corporate debt paper, equity financing, and entrusted loans and trust loans, where banks or specialised trust companies mediate money from private entities.

Although traditional bank loans still dominate the total financing stock, yuan bank loans now represent less than 40 % of new financing issues to firms and households. In contrast, financing based on corporate bonds, entrusted loans and trust loans has soared. The second half of 2012 also saw a distinct jump in forex bank loans, probably a response to yuan appreciation. Share emissions and short-term bank accepted bills, in contrast, saw hardly any uptick last year.

Out-of-pocket financing covers 70 % of corporate investment, compared to just over 20 % for bank loans (although firms are in highly disparate positions with respect to access to financing). New channels of finance have opened as private individuals and firms have sought better yields than for bank deposits. In addition to the above mentioned forms of financing, China has a vast informal and unregulated lending market that does not appear on official radar.

Altogether, China’s financing markets are quite opaque, which impedes supervision, complicates monetary policy and generates systemic risks. Regulators are also concerned about mounting default risk as the share of short-term borrowing has skyrocketed.

Bank loans and other credit formats, share of net flow



Source: Macrobond

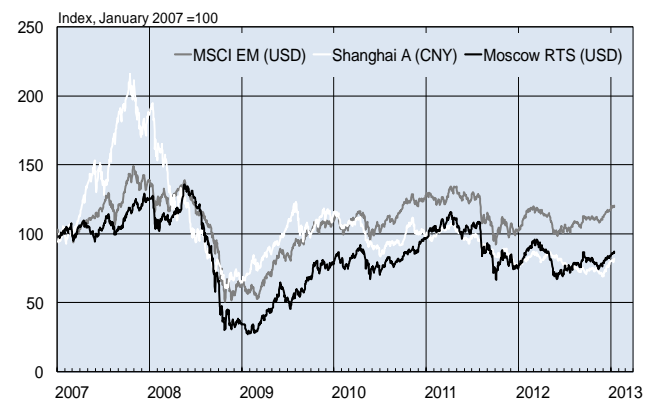
Forecast revisions and financial market reforms rock stock prices. China’s stock markets were down overall in 2012, and in early December A-share prices on the Shanghai stock exchange reached their lowest level since the start of 2009. Shares then jumped 16 % in the final weeks of 2012 on an improved outlook for Chinese growth. 2012 ended with the Shanghai A-share index up 3 % from 12 months earlier. In comparison, share prices were up 11 % on-year in Russia, and the Morgan Stanley emerging market index was up 15 %. Chinese stocks have continued on an upward trend in January.

Since China’s stock markets began to attract serious interest in the mid-2000s, it has experienced violent swings. Before the global financial crisis hit in autumn 2007, share prices reached a level more than 2.5 times their current valuations. The average price-to-earnings (P/E) ratio at times exceeded 70. At present, the average P/E for traded shares is about 12, a bit lower than the global average.

Chinese share prices have also been rocked by changes in China’s financing system and stock market reforms. At the start of January, prices of B-shares, which are directed to foreign investors, were hit by speculation that Chinese firms are phasing them out and replacing them with Hong-Hong-listed H-shares. The China Securities Regulatory Commission (CSRC) plans to further open up China’s markets through substantial increases in foreign quotas on China’s securities markets.

The nature of Chinese securities markets was evident last week when the Shanghai stock exchange assumed that it was its task to instruct members to pay out dividends equal to at least 30 % of profits to stimulate stock trading. Even if the instruction might have been well-justified in the case of many of China’s state-owned firms, a bedrock rule of corporations law is that the board, not a securities exchange, recommends the paying and size of a dividend to shareholders.

Shanghai, Moscow and Morgan Stanley Capital International Emerging Market indexes



Source: Bloomberg

Russia

Last year witnessed modest growth in Russia's oil and gas sector. Rosstat reports Russia's crude oil production rose less than 1 % in 2012 to slightly over 517 million tons (an average production of about 10.4 million barrels a day). Just over half of production went to domestic refineries; the rest to export. Russia and Saudi Arabia are the world's top producers of crude oil.

Crude oil exports contracted about 1 % from 2011, reflecting largely a rise in domestic refining to meet growing domestic demand for oil products and take advantage of lower exports duties on refined products. Russia is the world's second largest exporter of crude oil after Saudi Arabia.

Transneft, which handles most of the shipping of Russian oil exports, reports that pipeline transmission of oil as a share of exports supplied to non-CIS customers continued to contract and accounted for only about third of the exports in January-October 2012. Oil tanker shipping activity increased, especially in the Baltic Sea, with Transneft launching oil transshipping at the Port of Ust-Luga last year. Russian seaports by the Baltic Sea overall, and most notably the Port of Primorsk, accounted for 40 % of Russian oil exports to non-CIS destinations. The other major export channel is the Black Sea, which features the massive Novorossiysk oil terminal. Transneft's exports via Novorossiysk were nearly unchanged from 2011 to 2012, while exports through the Black Sea Port of Tuapse contracted.

Natural gas production fell nearly 3 % in 2012 to around 653 billion m³. Russia is the world's largest producer of natural gas together with the United States.

Gazprom, Russia's largest gas producer, experienced a sharper drop in production than gas production overall. Gazprom's share of Russian gas production fell to around 75 %. In contrast, privately held gas producers such as Novatek saw their production levels rise. Russia's domestic gas consumption contracted more than 7 %. About 70 % of production went to domestic consumption.

Russian gas exports contracted nearly 9 % last year. Demand for Russian natural gas fell in its main export markets in Europe due e.g. to the relatively high price of Russian contract gas compared to spot prices.

With the inauguration of the Nord Stream gas pipeline in late 2011, an increasing amount of gas is reaching Europe via the Baltic Sea. Ukraine's gas pipeline operator Ukrtransgas reports the volume of gas transmitted via Ukraine to western Europe fell about 20 % last year. Even so, roughly half of all Russian gas exports still passes through Ukraine.

Slight reduction in current account surplus and lower import growth in 2012. Preliminary balance-of-payments figures released by the Central Bank of Russia indicate the

2012 current account surplus was slightly smaller than in 2011, but still significant. The 2012 goods trade surplus was almost unchanged from 2011, but still sky-high by international standards. Russia's services trade deficit continued to widen, due e.g. to increasing travel spending abroad. The "other items" category in the current account (which includes e.g. interest payments and remittances of foreign workers) showed a slightly larger deficit than a year before.

Russian export earnings increased 4 % last year in dollar terms, mainly on higher crude oil prices. Growth, however, slowed substantially near the end of the year. Growth in spending on imports slowed last year to around 10 % and in the final months of 2012 was only up about 2 %.

Russia's balance of payments

	USD billions			% of GDP	
	2010	2011	2012 (preliminary)	2011	2012 (preliminary)
Current account	71	99	81	4.8	5.3
- exports (goods & services)	442	571	594	29.7	30.8
- imports (goods & services)	318	409	443	21.4	22.0
Trade balance (goods)	147	197	195	9.9	10.6
- exports	391	513	531	26.3	27.6
- imports	244	316	335	16.4	17.0
Services trade balance	-24	-35	-45	-1.6	-1.9
- exports	50	58	63	3.4	3.1
- imports	74	93	108	5.0	5.0
Other items	-52	-64	-69	-3.5	-3.4
Financial account + e&o*	-34	-86	-46	-2.3	-4.6
State (excl. central bank)	3	-3	9	0.2	-0.2
Banks	16	-24	24	1.1	-1.3
Other private, incl. e&o *)	-50	-58	-82	-3.4	-3.1
- direct investments	-13	-19	-5	-0.9	-1.0
- to Russia	38	47	39	2.5	2.5
- from Russia	51	66	44	3.4	3.6
- portfolio investments	-5	-12	-9	-0.3	-0.6
- to Russia	-5	-6	-8	-0.3	-0.3
- from Russia	0	5	1	0.0	0.3
- illegal transactions	-31	-32	-35	-2.1	-1.7
- errors and omissions	-8	-10	-10	-0.6	-0.5
- other items	7	15	-22	0.5	0.8
*) errors and omissions					

Sources: CBR and IMF

Corporate sector capital outflows up in 2012. The balance-of-payments figures show the financial account deficit shrank substantially. This was partly due to state borrowing on international markets, but mostly to notable increases in banking sector capital imports and decreases in capital exports.

The corporate sector net capital outflow from Russia increased substantially. Illegal exports of capital (e.g. to evade taxes) remained high. Foreign direct investment in Russia and direct investment outflows from Russia fell, and the repatriation of portfolio investments from Russia continued. Furthermore, corporate borrowing on international markets evaporated almost completely.

Figures for the first half of 2012 suggest that direct investment of the banking and the corporate sector especially to Cyprus has been active, mainly through loans to subsidiaries. The repatriation of assets, i.e. FDI inflows from Cyprus to Russia, declined.

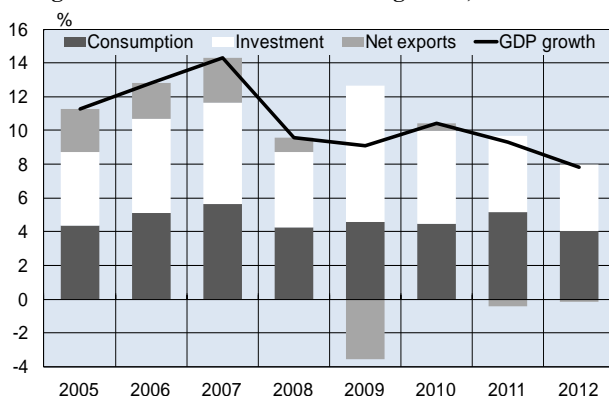
China

China's GDP up 7.8 % in 2012. China's gross domestic product last year slightly exceeded the official target of 7.5 %. The growth was slowest in the first quarter, after which it accelerated. In the fourth quarter of the year growth was 7.9 % y-o-y. Chinese GDP for 2012 was 52 trillion yuan (\$8.23 trillion), solidly establishing China as the world's second largest economy after the United States. GDP per capita hit \$6,080, putting China on par with countries like Peru, Serbia and Belarus.

Chinese economic growth last year was driven mainly by domestic markets. The increase in domestic consumer demand accounted for about half of all growth, with the rest coming from investment growth. In consequence, there was little evidence of structural changes in the economy to suggest a more consumption-driven system; investment still corresponded to nearly 50 % of GDP. Despite growth in the value of foreign trade surplus, the volume of exports increased slower than the volume of imports (i.e. the net exports declined). Thus, net exports made no positive contribution to the growth.

While economic growth is expected to remain strong throughout 2013, no substantial pick-up is expected; recent economic forecasts see GDP growth this year coming at around 8–8.5 %. If China sustains high economic growth, it may surpass the US economy already by 2017 when adjusted for purchasing power parity (PPP).

GDP growth and main contributors to growth, %



Sources: NBS and CEIC

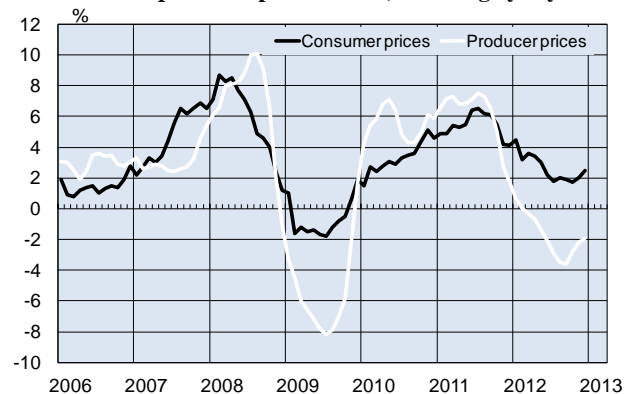
Inflation accelerated in December; M2 growth remained moderate. China's National Bureau of Statistics reports consumer prices rose 2.5 % y-o-y in December. Inflation remained well below the 4 % target announced by the People's Bank of China.

Inflation spiked in December on higher food prices, while prices for non-foods rose moderately. Food accounts for about a third of purchases by the average Chinese consumer, and any shift in food prices has a substantial impact on the consumer price index.

The upward pressure on food prices is expected to continue this year, which would accelerate inflation. On the other hand, prices of non-food goods and services do not face similar pressures. Producer prices, in fact, have been sliding for a while, reflecting declines in world commodity prices.

The broad measure of money supply (M2) was up nearly 14 % y-o-y at year's end, hitting the official M2 target for the year.

Consumer and producer price indices, % change y-o-y



Sources: NBS and CEIC

China releases first official estimate of income disparity in 12 years. A new estimate from China's National Bureau of Statistics puts China's Gini coefficient, a rough measure of income disparity in a society, at 0.47. At the same time, the NBS also released Gini estimate of 0.49 for 2008, and thus it claimed that income disparities have actually become smaller during recent years. The release of official Gini estimates surprised observers as China had not released an official Gini estimate since 2000.

The suggestion that income inequality has been decreasing in China in recent years defies anecdotal evidence and contradicts the NBS' own comments made in 2011 that income disparity was increasing. Moreover, all unofficial surveys of income disparity suggest a widening income gap. The release of official figures was most likely a response to the headline-grabbing 0.61 figure published by the Survey and Research Centre for China Household Finance in December.

A Gini coefficient of zero would indicate a society with perfect income distribution, while a society with a value of 1 would have one person taking all income in the society. The average Gini value for EU countries is around 0.30.

Russia

Russian economic growth slowed in 2012. The GDP grew last year 3.4 %, a fairly brisk pace relative to the global economy overall. Towards the end of the year, growth began to slow. Growth rate was affected e.g. by poor harvests. The manufacturing sector, in contrast, went ahead enjoying rather good growth. Major forecasting institutions expect GDP growth to remain well below 4 % this year.

Growth in the volume of retail sales slowed, but was still robust at year's end. The post-recession rebound in fixed investments continued, even if recovery was slower in the second half of 2012. The volume of investment exceeded its pre-recession peak in 2008. Export growth flagged and the rapid import growth of the first half lost momentum.

Demand, output and imports, % change from a year earlier

	2009	2010	2011	2012	2012 quarters			
					1Q	2Q	3Q	4Q
GDP	-7.8	4.5	4.3	3.4	4.9	4.0	2.9	2.3
Industrial output	-9.3	8.2	4.7	2.6	4.0	2.3	2.5	1.7
- mineral extraction	-0.6	3.6	1.9	1.1	1.9	0.4	1.2	0.9
- manufacturing	-15.2	11.8	6.5	4.1	4.4	4.7	4.5	2.8
Retail sales	-5.1	6.4	7.0	5.9	7.6	7.0	4.8	4.5
Construction	-13.2	3.5	5.1	2.4	5.0	4.6	-1.1	2.8
Fixed investments	-15.7	6.0	8.3	6.7	16.6	10.2	7.3	1.3
Exports	-4.7	7.0	0.3	1.8	4.4	-1.4	2.1	
Imports	-30.4	25.8	20.3	8.7	10.2	2.9	9.6	
Imports, <i>value</i> *	-27.6	34.8	22.0	17.6	19.7	15.4	20.2	10.2

* goods and services imports, change of euro value

Sources: Rosstat, Ministry of Economy, CBR

Federal Antimonopoly Service green-lights Rosneft acquisition of TNK-BP. State-owned oil giant Rosneft last month was granted permission to acquire Russia's number-three oil company, the Russian-British joint venture TNK-BP. The parties agreed on the sale last October. The sale value is around \$56 billion, making it one of the largest deals ever in the global oil industry.

The sellers are BP and Alfa-Access-Renova (AAS), a consortium of Russian investors. The TNK-BP sale arose after its owners could not resolve their differences. Rosneft will cash out AAS, while BP will be paid partly in cash and partly in Rosneft shares. After the deal, BP will own an approximately 20 % stake in Rosneft. BP's participation gives Rosneft access to high-level technological capabilities, while BP reinforces its position in the Russian oil sector.

Rosneft was established in 1993 as the Russian oil sector was split into several companies. Rosneft remained a state company, inheriting a bunch of Russia's least efficient oil fields. The sleepy Rosneft business came alive in 2004 with the take-over of Mikhail Khodorkovsky's Yukos. The TNK-BP deal makes Rosneft Russia's largest oil company.

After the expansion, Rosneft will account for 40 % of Russian oil production and 30 % of Russian oil refining.

The state's increasing dominance in the country's oil sector has been criticised in Russia since the deal. The fear is that Rosneft may become a Gazprom-like Gargantua, operating inefficiently and averse to change.

Ukraine-Russia gas fight flares again. Gazprom announced last week it billed Ukraine \$7 billion for gas Ukraine refused to take last year. Like many of Gazprom's other European customers, Ukraine gets its gas under long-term take-or-pay supply contracts that allow Gazprom to invoice for a minimum annual volume of gas even if the customer has no use for it.

Ukraine last year bought 33 billion cubic metres of natural gas from Russia, well below the minimum contract supply of 42 billion m³. The reasons for Ukraine's reduced need for imported Russian gas include a slow recovery of Ukrainian industry after the 2009 recession and an increasing shift to coal by the nation's steel industry.

Ukraine disputes the Gazprom bill. It is also dissatisfied with gas price itself, which is substantially above the rate charged to Belarus. Russia responds that Ukraine would qualify for the discount rate if it joined the Russia-Belarus-Kazakhstan customs union. Gazprom uses for all its customers a pricing formula that ties the gas price to the price of petroleum products. Ukraine was charged a higher rate for gas last year than e.g. Germany. Price relations, however, vary across time as each contract has an individually negotiated pricing formula.

Gazprom has granted concessions to several big European customers after they threatened to take Gazprom to court over its unconscionable contract terms. In response, Gazprom reduced prices and relaxed rules on charging for undelivered gas. Ukraine is currently considering how to respond to Gazprom's eye-popping bill.

Information about the \$7-billion bill came to light after Royal Dutch Shell representatives and Ukrainian officials announced at the Davos Economic Forum that they had reached a deal on developing shale gas resources in eastern Ukraine. If the reserves meet initial estimates, Shell will invest about \$10 billion in the project. Ukraine has some of Europe's largest shale gas deposits. Shell won the right to develop the deposit after competitive bidding last year. Last year Ukraine also awarded Chevron with the rights to develop the slightly less massive shale gas deposits of western Ukraine. A consortium led by Exxon Mobil was chosen to develop offshore hydrocarbon formations in the Black Sea.

Ukraine is Gazprom's biggest customer. In recent years the country has sought to reduce its dependence on Russian gas e.g. though boosting the efficiency of domestic use and importing gas from alternative sources such as Germany. Ukraine's own gas production last year amounted to about 20 billion m³.

China

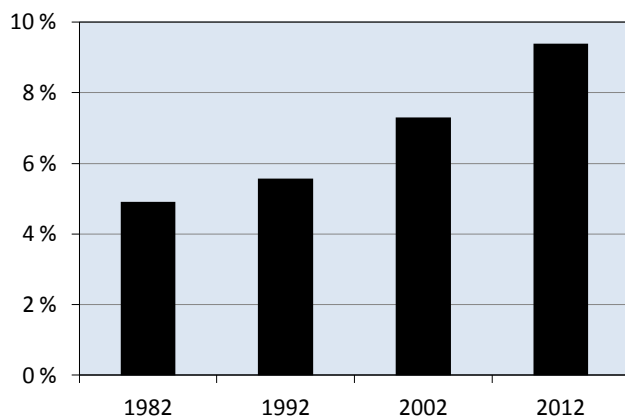
Though rate of growth slowing, China's population continues to rise. China's population grew 0.5 % last year to 1.354 billion. The one-child policy introduced in the late 1970s continues to reduce the rate of population growth. The rate of population growth was four times higher in the 1970s and twice as high in the 1990s. Population growth is expected to slow further as the current fertility rate in China is just 1.7 children per woman.

There have been huge demographic shifts since economic reforms began in the 1970s. The share of the population living in cities has increased about a percentage point every year over the past three decades. By 2010, the number of Chinese living in cities exceeded the number of rural dwellers. In 2012, already 53 % of Chinese lived in cities.

Social and economic development has also reduced the disparity between male and female births, although a gynocidal distortion is still evident. Official figures show 118 boys were born for every 100 girls last year.

Demographers are particularly concerned about China's shrinking working age population. The cohort of 15–59-year olds fell by 3.4 million last year to 69 % of the population. About one in ten Chinese is now over 65. The greying population is the reverse side of the one-child policy, and this revelation has become a hot topic in the media lately. While no official shift in policy has been announced, rumours abound that the government is considering ways to relax rules so that couples living in cities can have a second child. Currently, only urbanite couples who both come from one-child families qualify for having a second child. The new policy would likely enter into force as early as this year.

Percentage of population over 65



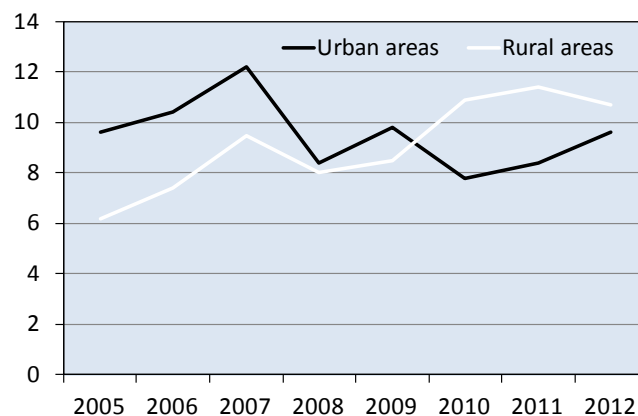
Source: CEIC

Rise in wages slowed slightly in 2012; again big minimum wage hikes. China's National Bureau of Statistics reports that real wages of city residents rose nearly 10 % last year. The average disposable monthly wage per urbanite was 2,050 yuan (about €250). In the countryside, real wages were up 11 % last year. Although the wage gap closed slightly, rural wages are still considerably lower than urban wages. Net earnings of rural dwellers last year averaged 660 yuan a month. Wages are expected to climb rapidly in coming years as the over-supply of labour has become less abundant.

The pressure to raise wages can be seen in recent hikes in minimum wage levels. At the start of this year, the minimum wage went up 10–15 % in Beijing and the Zhejiang, Henan and Shaanxi provinces. The minimum wage in Beijing is now 1,400 yuan (€170) per month. Many other provinces are expected to announce minimum wage hikes in the next few months as the law requires provinces to adjust their official minimum wage levels at least every other year. Some provinces and cities like Beijing have already shifted to annual minimum wage adjustments. Provinces decide minimum wages independently, and there is variation also within provinces. For example, in the Zhejiang province the minimum wage currently runs in the range of 1,080–1,470 yuan. In addition to a minimum monthly wage, China has introduced the notion of a minimum hourly wage, which ranges between 6 and 15 yuan (less than €1–2 an hour).

In addition to rising incomes, also the cost of living has been skyrocketing in big cities. A survey by the *South China Morning Post* at the end of 2012 compared prices of ten consumer goods in Beijing, Hong Kong and London. Of those ten items, the survey found that bread, shampoo, baby formula and Starbucks coffee were most expensive in Beijing.

Real income growth in urban and rural areas, % change y-o-y

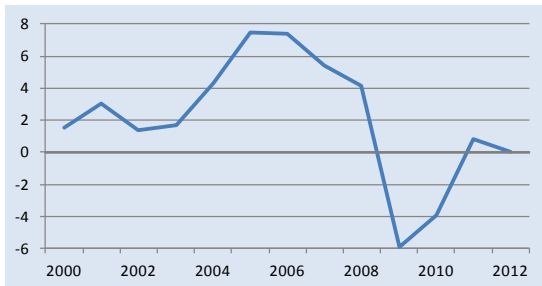


Source: NBS

Russia

2012 federal budget in balance. Preliminary figures from the finance ministry suggest a better-than-expected budget performance last year which is due to higher oil prices boosting state tax revenues. The original 2012 budget anticipated a deficit of 1.5 % of GDP. The average price for Urals blend last year was around \$110 a barrel.

Federal budget surpluses and deficits, % of GDP, 2001–2012



Source: Ministry of Finance

Government split on how to grow the economy faster. In his December policy address, president Vladimir Putin tasked the government with finding ways to boost GDP growth to a level of 5 % annually over the next ten years although the economy ministry's GDP growth forecast is just over 3 % this year and 3–4 % in coming years. Russia is currently engaged in an active public discussion over possible measures to speed up growth. Even the cabinet is divided over how this could be achieved.

The economy ministry contends that growth should be increased through state investment in infrastructure. Such investment would be funded by diverting revenues from crude oil and gas production fees and export duties normally destined for off-budget reserve funds. This approach would require a lifting of the strict budget rules just approved by the Duma in December (see [BOFIT Weekly 2013/3](#)). The selection and implementation of investment projects would be overseen by a development fund under the supervision of the economy and transport ministries, but independent of the finance ministry. The transport ministry has prepared a list of 28 potential projects that includes a new ring road for Moscow, a liquefied natural gas (LNG) terminal on the Yamal Peninsula, as well as a development project in the Urals region. The projects would be funded in part out of the Pension Fund.

The finance ministry rejects increases in state spending, noting that a wiser path to economic growth involves structural reform and improvements in Russia's investment climate. It stresses that balanced state finances and accompanying stability are key factors in improving the investment climate. Moreover, shrinking the reserve funds would increase risk if economic conditions turned bad. It was

precisely the reserve funds that allowed Russian government to weather the economic downturn in 2009 with relative ease. If large infrastructure investments were to be funded with income that depends on economic cycles, there is a substantial threat that the projects would be delayed or even abandoned if the world oil price falls precipitously.

Some cabinet members, and even president Putin, have criticised the CBR of keeping interest rates too high and thereby stifling corporate investment. The CBR's main monetary tool, the repo credit rate, currently stands at 5.5 %. January 12-month inflation was 7.1 %.

Russia to reduce number of universities and institutes.

The education and culture ministry last autumn performed a survey of institutions of higher education in Russia, and this year plans to reform or shut down the poorest performing schools. The survey is seen to be related to the government's current efforts to reduce the number of higher education institutions by 20 %.

Today, over 7 million students study in over 1,100 universities and institutes in Russia. While the amount of institutes has increased notably and the number of students has even more than doubled in the past two decades, educational funding has not. The number of teachers and academic posts has increased only about 60 %. The lack of resources has eroded the quality of education, and the knowledge and skills of teaching staff have not kept up with the times. Much of the curriculum has not changed since the Soviet era.

Educational standards have also been lowered by the appearance of for-profit colleges, where teaching standards in many fields are poorer than in public universities. There are significant exceptions, of course. About 40 % of schools are private and they account for about 17 % of enrolments. The general perception is that especially in private schools degrees can be bought. One reason for the popularity of university and institute enrolment is the possibility to avoid military service. Educational standards are a big issue also in distance learning, which has rapidly gained popularity. The share of distance learning has quadrupled over the past 20 years: about half of all students today are involved in it. Distance learning also offers major opportunities for abuse.

The education and culture ministry survey only covers state universities and institutes. The hope is that the survey would be conducted annually and expanded to include private colleges as well. The survey criteria have been criticised for not measuring institutional efficiency correctly. Criteria include e.g. quality of teaching, quality of research, international activities, teaching facilities and equipment, as well as the quality of students applying for admission.

About 25 % of the 500 universities and institutes participating in the survey were found to be "inefficient" at least to some extent. Schools with bad marks will have to reform their operations, merge with larger universities or close their doors.

China

China's current account surplus grew in 2012. China's State Administration of Foreign Exchange (SAFE), an agency of the central bank, reports a 2012 current account surplus of \$214 billion (2.6 % of GDP). China's current account surplus has been decreasing for some years, but in 2012 it was up about \$10 billion from 2011. China's current account surplus was driven by the goods trade surplus, whereas services trade is deeply on deficit.

Last year there was a big red shift in China's financial account, which turned to deficit. It reflects the lifting of capital controls and incentives to take money out of the country. In addition, China's rapidly growing production costs and the stickiness of global economic growth have also reduced inflows of foreign direct investment to China. The financial account deficit further reflects changes in foreign exchange policy at the People's Bank of China, which has given the markets more power to determine the yuan's exchange rate. The PBoC last year reduced interventions in foreign exchange markets and the growth in foreign currency reserves was kept below \$100 billion.

Key balance-of-payments items and currency reserves, USD bn

	2008	2009	2010	2011	2012
Current account	421	243	238	202	214
Capital and financial accounts	40	198	287	221	-117
Net errors & omissions	19	-41	-53	-35	-
Change in currency reserves	480	400	472	388	97
Currency reserves at year's end	1,946	2,399	2,847	3,181	3,312

Sources: CEIC and SAFE

At the end of 2012, China's foreign currency reserves stood at \$3.312 trillion. Although China does not reveal how its currency reserve assets are invested, most observers believe the lion's share is held in the form of sovereign bonds with about 60 % invested in dollars, 30 % in euro and the remaining 10 % distributed among other currencies such as Japanese yen and British pounds. As sovereign bonds traditionally are low yield, the Chinese are on the hunt for higher returns. A share of the currency reserves was transferred in 2007 to a sovereign wealth fund, China Investment Corporation (CIC). More recently, some of the reserves were made available via the state-owned China Development Bank to domestic firms as a way to fund international operations. In December, the central bank announced that the ceiling on corporate borrowing from currency reserves would be raised. No other central bank is known to arrange such corporate loans from its foreign currency reserves.

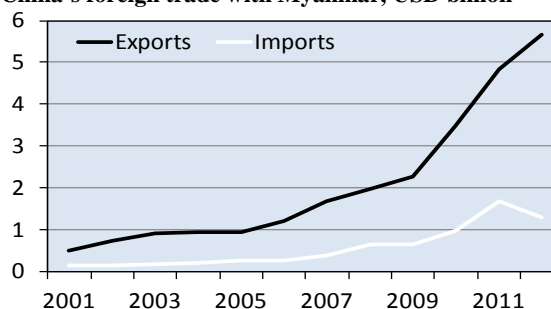
Construction of China's trans-Myanmar oil and gas pipelines could help ease strained trade relations. The 1,100-kilometre Myanmar-China oil pipeline will take transhipped oil from the Middle East, and a parallel gas pipeline carrying gas from fields on Myanmar's continental shelf in the Bay of Bengal. Construction of the pipelines began in 2009; only the finishing touches on parts of the pipeline in Yunnan province remain. The pipeline is scheduled for commissioning in May.

The construction work is being finished in a shifting political environment. A new era in trade relations began in 2011 when Myanmar's ruling junta allowed incremental political reforms so that international sanctions would be dropped. Before the changes, China had made big inroads into trade with Myanmar. Chinese exports to Myanmar include machinery and equipment, and Chinese imports from Myanmar are mostly natural resources such as ores, sawn timber, and precious stones. Chinese firms are engaged in huge projects in Myanmar to get at its resources. However, Chinese dominance in Myanmar's foreign trade has recently been challenged. Last year, China's share of Myanmar's imports fell by four percentage points to 30 %, and its share of exports fell by nearly half to 13 %.

Trade relations have been hurt by the poor image of Chinese businessmen in the eyes of the Burmese. Many Burmese feel that most of the benefit of trade with China has gone either to Chinese firms or corrupt Burmese officials. The Burmese also feel extensive environmental damage caused by some projects. China's state-funded Myitsone dam project has become a symbol of deteriorating China-Myanmar relations. The project was halted by Myanmar's new government when it came to power last year.

Japan, which saw its exports to Myanmar triple last year, is rapidly emerging as the biggest beneficiary of Myanmar's political reforms. Myanmar has granted Japanese firms rights to development vast land areas. Myanmar ranks among the poorest nations on earth, so there is no lack of development challenges. However, the country has vast natural resources, and is wedged between two of the biggest and fastest growing economies in the world: India and China. However, the success of commercial ventures requires political stability.

China's foreign trade with Myanmar, USD billion



Sources: CEIC and China customs

Russia

Despite demands, CBR refrains from lowering rates. At its February 12 meeting, the Central Bank of Russia's board of directors decided to leave reference rates untouched. The CBR's most potent monetary instrument, the one-day minimum auction repo credit rate remains at 5.5 %. The central bank justified its decision by pointing to a pick-up in inflation, which was running at a 7.1 % annual rate in January (well above the CBR target range of 5–6 % this year). Although the CBR expects inflation to slow this summer, higher prices could fuel inflation expectations and increase inflation risks in the future.

The CBR noted little change in economic conditions in recent months: industrial output growth remains flaccid and the pace of growth of capital investment continues to decelerate. On the other hand, the utilisation of industrial capacity is at a fairly high level, and low unemployment (see third item) and household borrowing fuel domestic demand. Total economic output is at or near a level considered normal for the Russian economy. The CBR pointed out that in such conditions the possibilities of monetary policy to influence economic growth are quite limited.

The central bank's full-throated defence of its decision to leave rates unchanged was a response to demands from the business community and commercial bankers for lower rates. The cabinet has also discussed rates with the CBR; several ministers have claimed rates are too high. Recent forecasts see Russia's economic growth slowing a bit this year, and demands for lower rates are based on the desire to enhance growth.

The CBR released its first quarterly Monetary Policy Report in January. The CBR hopes the publication will increase transparency by disclosing its principles and the reasoning behind its decisions.

Rapid credit expansion last year. The stock of credit issued by banks rose 19 % in 2012, reaching a level above 27.7 trillion rubles (€90 billion) at year's end. The stock of corporate loans increased 13 %, while the stock of loans granted to households climbed nearly 40 %.

Big banks, in particular, stepped up their lending to households. Despite high growth in borrowing, Russian households still carry relatively little debt relative to their counterparts in advanced economies. Household borrowing equalled 12 % of GDP in Russia, compared to an average of 65 % of GDP for EU countries.

The structure of Russian household borrowing is distinctly different from most developed countries; housing loans constitute less than 30 % of household borrowing. That corresponds to about 3 % of GDP, compared to 45 % in the EU. Most loans granted to households (60 %) are unsecured consumer loans. Such loans skyrocketed nearly 60 % last year. Banks are very active in selling loans to

households and developing new loan types. The average annual rates on short-term credit last year was around 25 %.

The National Bureau of Credit Histories (NBKI), Russia's leading credit bureau, reports its database contains information on 60 million borrowers, up from 47 million a year ago.

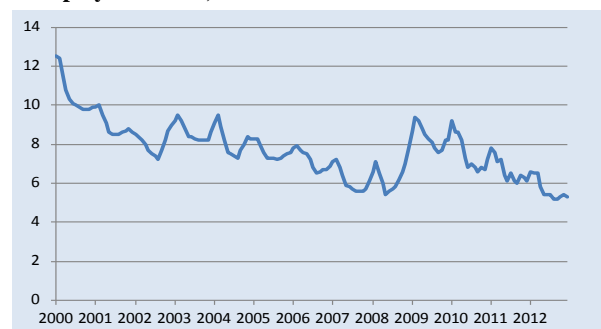
The CBR is increasingly concerned about rapid growth of consumer credit. During 2012, the stock of households' non-performing loans rose just over 7 % overall, while the share of non-performing consumer loans rose about 25 %. Debt servicing could emerge as a serious issue in Russia as an average of nearly 20 % of household income goes to debt servicing. In developed economies, debt servicing takes 10–15 % of household income.

Unemployment at record lows. Rosstat reports Russia's unemployment rate fell in December to just 5.3 % of the labour force. The figure is calculated using the ILO's methodology. Unemployment dropped below 6 % last spring – the first time unemployment dipped below the 6 % mark since the late-boom years of 2007 and 2008. The fact that unemployment has fallen so low suggests there is little reserve labour capacity left in the Russian economy. Indeed, Russia's big cities suffer from labour shortages.

Russia's lowest unemployment rate, 2.9 %, was posted in the Central Federal District, which includes Moscow. Unemployment in the City of Moscow was just 0.6 % of labour force. In St. Petersburg, the unemployment rate was only 1.1 % and 4.0 % on average in the Northwest Federal District. The highest unemployment rate posted in the Northwest Federal District was 8.6 % in the Murmansk region. The highest unemployment numbers in Russia were posted in the Northern Caucasus region, which includes Ingushetia with an unemployment rate of 47 % and Chechnya at 29 %. Some regions in the Siberia and Far East Federal Districts experienced relatively high unemployment rates of around 10 %.

Unemployment rates in rural areas are typically double that of cities. Unemployment among 15–24-year-olds was 14 %. Among all the unemployed, some 33 % are classed as long-time unemployed (i.e. out of work for over a year).

Unemployment rate, %



Source: Rosstat

China

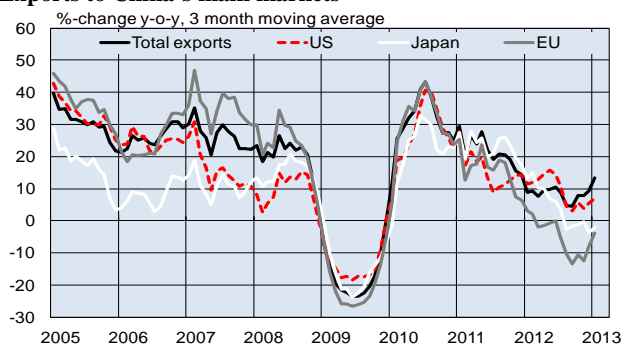
The modest recovery in Chinese exports to Europe, US and Japan indicate caution still warranted. As the world's largest exporter of goods, China's trade activity has become a barometer for the condition of the global economy. The on-year foreign trade performance in January, however, tends to exaggerate actual conditions as the Chinese New Year holiday week fell last year in the end of January and this year it took place this week. On the surface, the trend in Chinese foreign trade at the end of 2012 suggests a slight recovery in the global economy has been underway despite ongoing uncertainty in some of China's key markets. Exports to the US appear to be returning to the around 10 % a year growth trend, while exports to the EU stopped contracting relative to the December-January period a year earlier. The numbers for Europe do not change significantly if computations are in euros instead of dollars. While China's exports to Japan have been hurt by territorial island disputes and poor performance of the Japanese economy, Chinese exports to South Korea have revived.

Substantial export growth was mostly evident in Southeast Asia, where a powerful expansion in trade with Taiwan may indicate a revival of processing trade in Asia. Chinese export growth to Africa accelerated to nearly 20 %. Growth in exports to Latin America have long been slowing; even the boost in growth in the fourth quarter to 6 % y-o-y does not yet indicate recovery of demand in the region.

China's imports in November–January rose at an average of 10 % y-o-y, but a big pick-up came only in January. The January leap in imports, measured in value terms, partly reflected the timing of the Chinese New Year's holiday and hikes in world prices for iron ore and oil. So for the time being, imports depict a relatively modest outlook for Chinese economic growth.

In addition to the foreign trade figures, China's January purchasing manager index readings suggest modest growth in trade ahead. Both export orders and import indicators were below 50, indicating a pessimistic growth outlook.

Exports to China's main markets



Source: Macrobond

The domestic value added of China's exports is about 70 %. The share of domestic value added in China's exports is relatively small by international standards, but nothing exceptional. Countries with the highest domestic value added component of exports are typically resource-based commodity producers, while those with lower domestic value added such as countries in Europe tend to export finished goods. These assessments come from the latest release of the OECD/WTO [Trade in Value Added](#) database.

The share of domestic value added in exports provides insight into China's role in international production chains. Production chains typically originate in countries producing raw materials and end in countries where final assembly or sales occur. China's exports tend to be finished goods, so China is at the end of international production chains like most European countries. It falls somewhere between Germany and Finland. The lowest domestic value added in China is in electronics, chemicals and construction exports, while the highest domestic value added is found in the wholesale and retail sales, and finance exports.

Calculations by the OECD and WTO indicate that the share of services is about a fifth of the Chinese exports, and slightly over half of them represent domestic value added. Services constitute such a large share of exports after including the service component bundled with export goods (e.g. smartphone software). The services value added component is largest in electronics exports, and smallest in farm products and mining industry exports.

China's economic changes reflected in shifts in FDI flows. China's trade ministry reports foreign direct investment flows into China last year amounted to \$112 billion, a slight reduction from 2011. The poor growth outlook for the global economy largely explained the contraction, but there were also domestic factors involved. Investments in the electronics and textile industries continue to decline, reflecting China's rapidly rising production costs. Uncertainty over the direction of real estate markets has reduced investment in the real estate sector. In contrast, investment growth in the service sector remained robust, reflecting expectations of a structural shift to a consumption demand-driven economic model. Despite the changes, a large part (43 %) of FDI was still directed to goods manufacturing. The service sector's share was about 30 % and the real estate sector 22 %. The lion's share of investment still came from Hong Kong.

FDI outflows from China have boomed in recent years. The value of investments was \$77 billion last year, up from \$69 billion in 2011. Figures do not include financial sector investment, which has been running at \$5–10 billion in recent years. That data will be released later in the spring. A large share of Chinese investments abroad are directed to neighbouring countries, but investors are also increasing the prowl farther afield, especially in the search for raw materials investments.

Russia

Growth in Russian foreign trade slowed substantially in 2012. The value of goods exports increased last year slightly over 1 % and the value of goods imports grew just under 4 %. Year earlier, the value of goods imports and exports each rose about 30 %. In 2012, the value of goods exports was \$530 billion and the value of goods imports was \$340 billion. The trade surplus contracted slightly from 2011, but still amounted to around 9 % of GDP.

The slow growth in exports largely reflected flat growth in oil prices. The price of Urals blend averaged \$110 a barrel last year, just a dollar more than in 2011. While the export volumes of certain basic commodities such as crude oil and natural gas contracted on year, crude oil, petroleum products and natural gas continued to account for about two-thirds of the total value of Russia's exports. Most other big exports were also commodities. Among these, the value of metal exports declined mainly due to lower world prices. In contrast, the value of agricultural exports rose visibly.

The slowdown in import growth reflected largely weak investment demand as about half of imports consist of machinery, equipment and transport vehicles. Chemical products and foodstuffs each represent approximately 15 %. As expected, the first few months of Russia's WTO membership have not had visible effect on Russia's total imports. Membership caused some immediate reductions in import tariffs, which might have boosted imports of particular goods towards the end of the year. In contrast, the level of passenger car imports dropped precipitously in the last four months of 2012, which has been associated to the new recycling fee imposed on imported cars. However, the impacts of the various factors are difficult to assess over the short term given the large monthly variations.

China is still Russia's largest trading partner, accounting for over 10 % of Russia's foreign trade. Imports from China last year accounted for nearly 17 % of imports. Russia's largest export market was the Netherlands (15%). About 7 % of Russia's total trade was conducted with its customs union partners Belarus and Kazakhstan. Trade with Belarus contracted substantially, while trade with Kazakhstan soared, led by rapidly growing imports.

Trade growth within Russia-Belarus-Kazakhstan customs union up slightly more than for other trading partners. Some 10 % of the total exports of the Russia-Belarus-Kazakhstan customs union last year went to other members, and 17 % of total imports originated from the customs union. Intra-union trade is most important for Belarus, whose customs union partners account for about 37 % of Belarus exports and 60 % of imports. Some 7 % of Kazakhstan's exports and 40 % of imports were exchanged within the union. The comparable shares for Russia were 8 % of total imports and 7 % of total exports. Russia domi-

nates trade within the customs union, accounting for 65 % of the total value of trade. Kazakhstan had 25 % and Belarus 10 %.

When the customs union was launched in 2010, import duties for members were abolished, and the members imposed uniform import duties on products entering the union. Most of these duties were identical to Russian customs duties. Because the countries have different economic structures and their tariff systems were different, the impact of the new customs regime has been different on the trade flows of each member.

Generally speaking, trade flows within the customs union have increased in particular due to reduced non-tariff barriers to trade such as the elimination of customs inspections and simplification of import and payment procedures. A number of non-tariff barriers to trade still remain, however, e.g. technical, health and safety standards, as well as certification requirements. There is an effort to eventually harmonise these, too.

Before the creation of the customs union, Kazakhstan had lower import duties than the others. Membership forced it to hike about half of its import duties. For this reason, imports from inside the customs union have been able to substitute to some extent imports to Kazakhstan from outside the customs union. Kazakhstan has traditionally imported considerable amounts of food and consumer goods from China. Russia now suspects that significant amounts of Chinese products not declared to customs moved through Kazakhstan into Russia last year.

Over the past two years, Russia and Belarus have been in a squabble over exports of refined petroleum products. The countries agreed in 2010 that from the start of 2011, Belarus would be permitted to export crude oil imported from Russia exempt from export duties in the form of refined products to third countries. In exchange, Belarus would transfer to Russia all export duties that it collects on those refined products. According to the agreement, only refined energy products such as fuels are subject to export duties, leaving other products such as solvents and lubricants outside. As a result, exports of solvents and lubricants from Belarus skyrocketed in 2011, and continued to rise last year. It turned out that Belarus actually exported energy products such as gasoline under the classification of solvents and lubricants. At the end of 2012, Russia posted Belarus a \$1.5 billion bill for unpaid duties. Russia also cut crude oil supplies to Belarus.

Russia and Belarus have also been at odds over agricultural exports from Belarus to Russia, which have significantly exceeded the agreed annual quotas. Russia suspects that Belarus is dumping dairy products and that some meat imported from Belarus has a third-country origin. The Eurasian Economic Commission, the custom union's highest body, has discussed the possibility of coordinating the agricultural policies of member countries even by production quotas.

China

Yuan's role as an international payment currency still modest, but growing rapidly. The strategic goal of increasing international convertibility of the yuan can readily be seen in the sharp increase in liberalisation measures of capital movements in 2010. Since then, the pace of freeing capital movements has accelerated. Not a month goes by without announcement of higher quotas or easing of technical requirements. While fully deregulated foreign exchange and financial markets are still far off, China hopes to have deregulated most aspects of capital movement over the next 3 years.

At the beginning of February, opportunities for using the yuan outside mainland China increased after Taiwanese banks began offering banking services in yuan. Customers of banks operating in Taiwan can now make deposits, take loans or make international payments in yuan. It is also now easier for customers to engage in yuan-denominated securities trading. Use of the yuan in payment traffic with the mainland is expected to grow rapidly, especially with the recent favourable developments in economic relations between Taiwan and China. Taipei's position as a financial hub is expected to strengthen as operations earlier transacted via Hong Kong are now performed directly by banks operating in Taiwan.

Hong Kong maintains by far the largest yuan market outside mainland China, but both London and Singapore have begun to eye the opportunity of developing their own yuan markets. Standard Chartered estimates that Hong Kong currently controls about 81 %, Singapore 11 % and London 8 % of the offshore yuan market in these main centres. The Bank of England just announced it was considering a swap arrangement with the People's Bank of China to assure adequate liquidity in London's yuan market and increase the yuan's acceptance among traders.

Figures from the Society for Worldwide Interbank Financial Telecommunication (SWIFT) show that 0.6 % of all international interbank transfers in December were made in yuan. This moved the yuan up to the 14th position among most-used payment currencies. The yuan's rise has been rapid. At the start of 2012, the yuan accounted for 0.3 % of international transfers and ranked 20th. The yuan is currently set to overtake the 13th-ranked Russian ruble. However, while a country can break into the world's top ten payment currency with only a 1 % market share, it is premature to speculate about the yuan's challenge to the major currencies. The euro has a 40 % share, the US dollar 33 %, the British pound 9 %, and the Japanese yen 3 %.

GDP growth highest in central China, provinces burdened with debt. National Bureau of Statistics reports that GDP growth slowed last year throughout the country, but

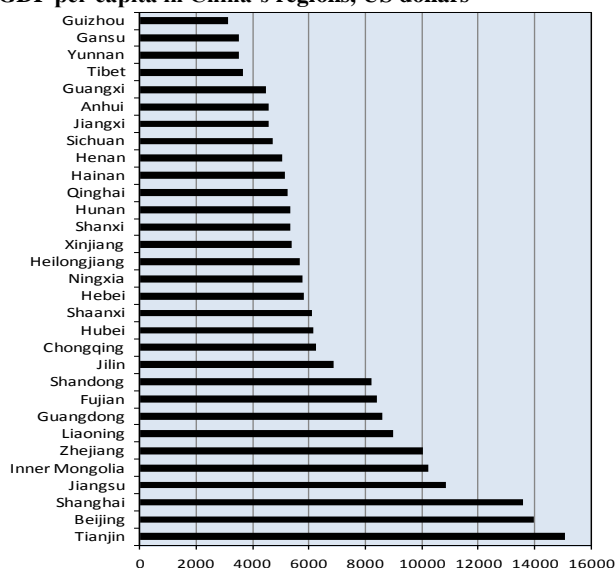
the variation across provinces was striking. Growth was highest (13–14 %) in Chongqing, Sichuan, Guizhou, Shaanxi and Gansu provinces, all located in central China. Growth was lower in the wealthy east coast provinces. The exception was the harbour city of Tianjin near Beijing, which had growth similar to provinces in central China.

Provinces were heavily involved in the government's stimulus programme in 2009–2010 and many took on massive debt. At the beginning of February, international credit ratings agency Fitch voiced concerns over the high indebtedness of some provinces. Fitch noted that 13 provinces had higher debt than total yearly revenues, and that a large share of that debt is coming due this year. It seems that the provinces have little alternative to rolling over their loans.

Mainland China has 31 province-level administrative regions (including 22 provinces, 5 autonomous regions and 4 municipalities). The regions vary considerably in terms of land area, population and wealth. Much of China's population and economic activity is located in the east of the country. The Guangdong province in the southeast has the most residents (105 million) and its economy is the largest among provinces (generating about 10 % of China's GDP). Other major provinces include Jiangsu (80 million residents; over 9 % of GDP) located north of Shanghai, and further north, Shandong (96 million people; nearly 9 % of GDP).

Although the NBS streamlined its data collection last year (see [BOFIT Weekly 8/2012](#)), province-level GDP figures must be viewed with caution. When added together, they give a GDP figure much higher than China's national GDP figure. Among other things, provincial leaders, whose career trajectories are determined by economic performance, are under pressure to fudge the numbers. The NBS is making its own studies in the regions to verify the correctness of its national GDP assessments.

GDP per capita in China's regions, US dollars



Sources: NBS, CEIC and BOFIT

Russia

The government prepares to extend car recycling fee to Russian-made cars. Economy minister Andrei Belousov reports that a decision on the matter has been reached, and that the cabinet is currently reviewing the necessary legislative changes for extending the recycling fee to all cars in Russia. The change was initially given impetus by president Vladimir Putin, who gave the government one month to come up with a solution to level the playing field for domestic and foreign carmakers after last December's EU-Russia summit. The recycling fee should enter into force in about six months.

The recycling fee was introduced together with reductions in auto import duties after Russia's WTO accession last year. The amount of recycling fees was matched to the reductions in import duties hence providing protection to domestic production from increased foreign competition. Russia's domestic carmakers have largely been protected by high tariffs since 2009, when import duties, especially on used cars, were raised substantially. Before the hikes, used foreign car imports had become the biggest competitors to mid-range cars built in Russia.

The recycling fee has been a point of contention for Russia's trade partners – so much so that the EU, the United States and Japan have brought the matter up in WTO. The recycling fee violates WTO rules because it is not applied to domestic manufacturers who have committed to handle the recycling of their vehicles themselves.

The extension of recycling fees to cars built in Russia has not pleased domestic carmakers or foreign manufacturers operating assembly plants in Russia. Belousov noted that the cabinet is currently considering measures that would offset the costs to Russian carmakers from the recycling fee. The law on foreign investment protects investors from measures that weaken their terms of contract, like recycling fees.

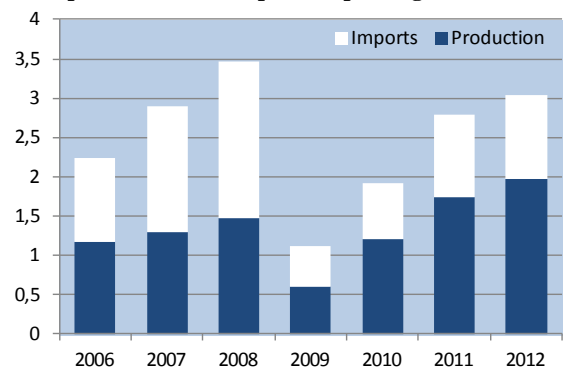
Car imports and car production in Russia hit record highs in 2012. Last year a total of nearly 3 million passenger cars were sold in Russia, narrowly beating out the 2008 record. Car sales last year were up over 10 % from 2011, even if sales growth slowed sharply in the final months of 2012. Russia was Europe's second largest car market last year after Germany. There are over 500 cars per 1,000 inhabitants on Germany, while the figure for Russia is only 240 per 1,000 inhabitants.

Russia would like to raise visibly the profile of its car industry. The output of the auto sector has amounted to only about 0.5 % of GDP past years. Vehicle manufacturing employs about a million people in Russia. The heartland for Russia's car industry is the city of Tolyatti in the Samara region, where an entire city has built up around the Avtovaz plant. Other carmaking complexes are found outside St.

Petersburg and in the Kaluga region near Moscow, where most of the assembly plants of foreign carmakers are located.

Russia wants to increase domestic car production and reduce its reliance on foreign car imports. Over two-thirds of cars sold in Russia last year were already built domestically. In the pre-crisis period, domestic production only accounted for about half of sales. Russian car production is focused on economy models, while most expensive cars are imported from abroad. Most domestic production, however, actually consists of assembly of foreign makes. The localization ratio of foreign assembly production is still quite low, largely due to the lack of parts suppliers in the manufacturing chain. A few percentages of Russian car production are exported, mainly to CIS countries.

Russian production and imports of passenger cars (million)



Sources: Rosstat, Russian customs.

OECD takes up Russia's membership application again.

Russia first applied for OECD membership in 1996. Processing of the membership application began in earnest in 2007, but discussions were sidetracked during Russia's final push in WTO talks. Now the process is continuing.

The OECD requires its members to commit to market-economy principles. The OECD's 22 special committees examine various aspects of the applicant's compatibility and embrace of the OECD approved principles and give recommendations and input on measures for the applicant to implement. Areas of focus include the applicant country's financial, social and competition policies, as well as its financial markets and consumer protection.

Russian officials claim their country already meets many of the OECD's most important membership criteria such as WTO membership and signing the UN Convention Against Corruption. They expect Russia's membership to take place within the next couple of years.

The OECD noted that Russia still has plenty of work ahead on harmonising its legislation, and in particular in the implementation of laws. During the processing of Russia's OECD application, special attention has been paid to e.g. the state's disproportionate role in the economy, treatment of foreign investors, corruption and environmental policy.

China

Real estate prices rising again. After a massive stimulus in 2009–2010, officials moved to rein in rising real estate prices by for example raising the percentage of downpayment required to finance a mortgage. Real estate prices dropped until the latter half of 2012, when they began to rebound throughout China. Officials in Beijing seem concerned about the rebound; local officials last week were ordered to curb real estate speculators and impose further restrictions on real estate deals if needed. There is also a proposal to extent the current property tax experiment to more cities. At the moment, there is a pilot property tax programme in Shanghai, where the tax affects owners of more than one apartment. There is also a trial in Chongqing that imposes higher tax rates for luxury apartments.

Housing prices vary tremendously around the country. The average apartment price, measured in square metres of liveable floor space, average 16,500 yuan (€2,000) per m² in Beijing and 14,000 yuan (€1,700) per m² in Shanghai. In contrast, prices in cities in Western China and most cities in Central China, averaged 3,000–4,000 yuan (€400–500) per m². Prices also vary considerably within cities.

The uncertainty about the direction of apartment prices was evident last year with a drop of about 10 % in new housing starts. The housing stock was growing so fast that more apartments were being built than sold. The stock of unsold apartments, measured in floor space, increased about 40 % to 365 million m² last year. The bulk of unsold apartments is located in China's smaller cities. Although the National Bureau of Statistics in recent years has tried to improve the quality of its statistical data on the real estate sector, trying to get a handle on what is actually happening in the sector is still difficult.

Energy dominates China-Russia discussions on trade policy. Chinese figures show that China's 2012 exports to Russia increased to just over \$44 billion and imports to just under \$44 billion (i.e. trade was roughly in balance). Russia's share of China's exports and imports have long remained in the 2 % range.

From Russia's perspective, bilateral trade looks quite different. Russian statistical authorities report that China accounts for 17 % of Russia's imports. The data also show that Russia has been running a sizeable deficit with China in recent years despite the relatively high price of crude oil.

China's exports to Russia consist of a diverse range of manufactured goods. Competition from Chinese car imports is rapidly becoming a huge headache for Russia's car industry. China exported 67,000 cars to Russia last year, which is about 40 % more than in 2011. Russia has accounted for about 14 % of China's car exports in recent years. Passenger cars exports to Russia are still a tiny business for the Chi-

nese; they only account for about 1 % of the value of China's total exports to Russia.

China's imports from Russia are mostly energy or raw materials. The inauguration of Russia-China oil pipeline at the beginning of 2011 meant that over 24 million tons of crude oil flowed to China last year. So, despite difficulties in early commissioning of the pipeline, Russian oil exports to China were up 60 % from 2010. Over the past two years, the share of China's imported oil that came from Russia rose from under 7 % to about 9 %.

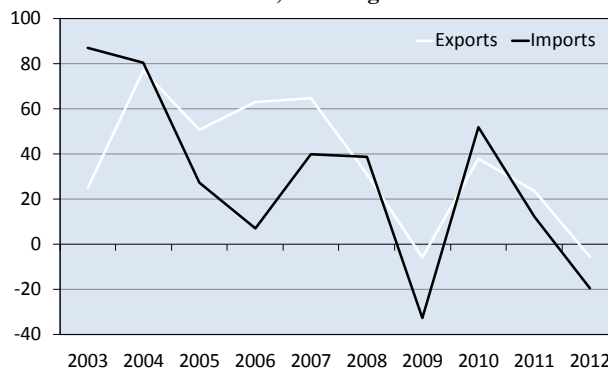
Even after years of wrangling, China and Russia have yet to reach agreement on a gas pipeline that would run from Siberian gas fields via Altai to China. Most of the dispute is over pricing. The countries have recently moved on to trying to negotiate liquefied natural gas (LNG) deliveries.

China-India trade stumbled last year. The value of China's imports from India contracted by nearly a fifth to \$19 billion last year, while the value of exports to India decreased by 6 % to \$48 billion. The weak imports figures are in part due to a weak global market for iron ore, which has caused fall in ore price. Moreover, India's supreme court has imposed a ban on operations at iron ore mines in northern India due to environmental damage. The mining operations have polluted groundwater and have been linked to deforestation. Observers say that India has allowed its environmental problems to get out of hand due to the corruption of local political machines. It was the unwillingness of public officials to oversee mining operations at an earlier stage that allowed conditions to get so bad.

China is India's largest trade partner. India's main exports to China are various raw materials, while India imports from China a vast array of consumer and investment goods.

India, in contrast, represents only a couple of per cent of China's foreign trade. However, growth has been rapid. In the 2000s, growth in the value of trade averaged over 30 % a year. The fluctuations, however, have been large. Trade between the countries collapsed during the recession in 2009, when India imposed tariffs on Chinese goods in reaction to dumping charges.

China-India bilateral trade, % change of value



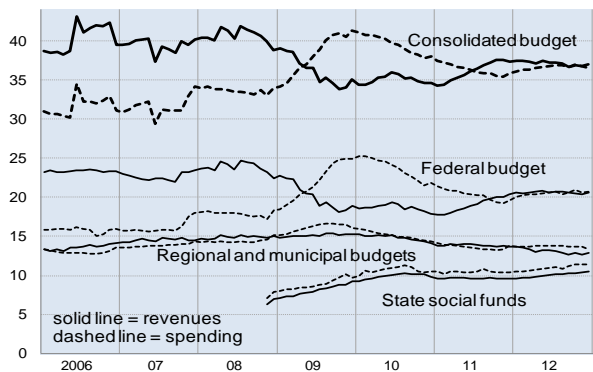
Source: China Customs

Russia

Economic growth helped public finances in 2012. The consolidated budget (combined federal, regional and municipal budgets, plus state social funds) was slightly in surplus, although the 2012 surplus was smaller (0.4 % of GDP) than in 2011 (1.5 %). Consolidated budget spending rose 14 % in nominal terms, keeping pace with 2011 and increasing in size to nearly 37 % of GDP. Revenue growth slowed to just over 10 %.

Federal budget revenues rose fast, and federal spending (excluding transfers to other budgets) rose faster than in earlier years. While federal spending was up about 25 %, some of this increase represented spending on police and law enforcement (once covered under regional and municipal budgets), which is now fully financed out to the federal budget. Revenues to regional and municipal budgets were up only 5–6 % as growth in tax revenues slowed and transfers from the federal budget declined. Growth in regional and municipal spending also remained below 10 %. The deficit for combined regional and municipal budgets last year was slightly larger than usual.

Government budget revenues and expenditures, % of GDP



Source: Ministry of Finance

Revenues to the consolidated budget from export duties and extraction fees on oil, petroleum products and natural gas fees continued to climb last year (up 14 %). Receipts from taxes and fees on oil and gas returned to pre-recession levels, accounting for 28 % of consolidated budget revenue and half of federal budget revenues.

The biggest spike in consolidated budget spending occurred in national security and law enforcement (up 27 %). Defence spending increased about 20 %, as did spending on healthcare. Spending was also up for infrastructure-related activity like road-building the transportation sector. Spending on education and social spending each rose about 14 %.

Social spending again accounted for about a third of total expenditures, while spending on national security, law enforcement and defence rose to over 16 % of total expendi-

tures. Both education and healthcare spending remained at 11 % each.

Russia's central government debt is low by international standards. As of end-2012, the combined domestic and foreign debt of the federal government amounted to just 8.5 % of GDP. In addition, the combined value of the two main national reserve funds are worth about 10 % of GDP, not to mention Russia's considerable reserves held by the central bank and state-owned commercial banks. Regional and municipal debt is just over 2 % of GDP.

Trends in gasoline prices carefully monitored in Russia.

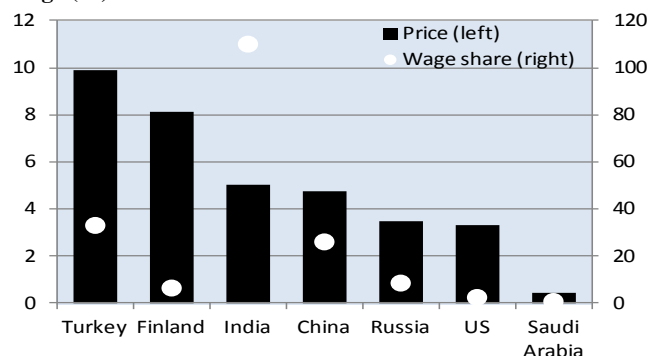
Gasoline prices have risen an average of nearly 10 % a year in recent years, and increased at nearly twice that pace in 2011. In February 2013, gasoline prices were up 9 % y-o-y. Part of the rise in the gasoline prices reflects booming domestic demand that occasionally outpaces local production causing regional gasoline shortages. To safeguard supply for domestic markets, government officials have resorted to temporary bans on gasoline exports or sharp hikes in export duties on gasoline. To temper the rise in consumer prices, oil companies are from time to time encouraged to "voluntarily" refrain from raising fuel prices. (see [BOFIT Online 2/2013](#))

Increased taxation undoubtedly adds to price pressures on the gasoline market this year. The excise tax on Euro-3 gasoline was increased at the start of this year and at the beginning of July the excise tax is set to be raised on other gasoline grades. Excise and value-added taxes account for about a third of the retail gasoline price.

Gasoline grades below Euro-3 grade were banned at the start of this year, i.e. the sale of Euro-2 was forbidden after a several reprieves. There were fears that the ban would exacerbate problems with gasoline supplies as some refiners have yet to modify their processes to produce higher octane gasoline. The shift has caused few problems to date, and official say that if there is a problem, gasoline can be imported from Belarus.

By international standards, gasoline is still relatively cheap in Russia. In income-adjusted terms, however, gasoline is more expensive in Russia than in the US or Finland.

Retail gasoline prices (€/litre) and in relation to an average daily wage (%) in select countries



Source: Bloomberg

China

Few surprises in economic targets announced for 2013.

The nearly two-week long National People's Congress (NPC) convened on Tuesday (Feb. 5). In his address to the opening session of the NPC, outgoing prime minister Wen Jiabao announced the government's economic targets for the coming year. The 2013 targets were prepared in cooperation with the incoming leadership. The GDP growth target for this year was set at 7.5 %, the same growth rate target as in 2012. Wen emphasised the importance of private investment in sustaining high economic growth in the years ahead. The growth target indicates China's leaders see the current real growth of about 8 % high enough, and no major stimulus measures are planned to promote growth. Most observers see China's GDP growth coming in at 8–8.5 % this year, a bit higher than in 2012.

The inflation target was lowered slightly from 4 % in 2012 to 3.5 % this year. 12-month inflation in January was only about 2 %, but inflation is expected to pick up in coming months. The growth target for the broad money supply (M2) was also cut. It is currently 13 %, which is less than last year's 14 % target. The lower targets are seen as an indication that no major changes in monetary policy should be expected this year. Wen did note, however, that the ongoing deregulation of the financial sector and relaxation of capital controls will continue.

Prime minister Wen also reported that the government expects the state budget deficit to rise slightly, in particular, due to higher spending to improve social services. Other presented goals include a 10 % hike in pensions for those who have spent their careers in the service of a company. The government also wants to create 9 million new jobs and hold down the number of registered unemployed. In addition, the real incomes of both urbanites and rural-dwellers should roughly keep pace with GDP growth.

The agriculture sector will get special attention. Grain harvests will be boosted by providing farmers with information about the latest production techniques and increasing the area of land under cultivation. Although China has managed to increase its grain harvest in recent years, grain consumption has also increased and consumption patterns are shifting, which are forcing China to increasingly resort to food imports. One of China's core political goals for decades has been to remain self-sufficient in food production.

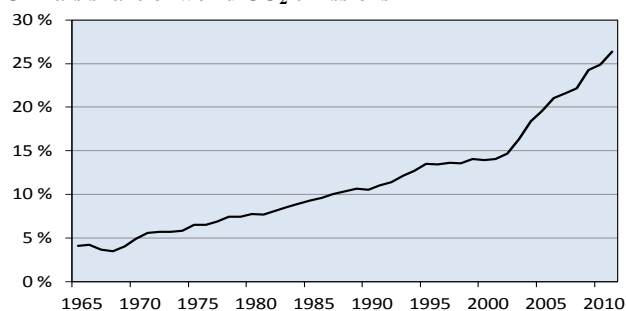
The National People's Congress comprises about 3,000 representatives. Although it is China's highest deliberative body under the law, it typically has done little more than rubber-stamp government proposals as submitted. During the current NPC, the representatives will endorse the new leadership, the economic targets laid out for the coming year, and approve the state budget and new laws.

Environmental issues underlie demands for a “beautiful China.” One notable aspect of Wen Jiabao address to the NPC was his take on China's serious environmental problems. He called for the incoming government is take concrete actions to safeguard the health and welfare of citizens. A work report released by the Wen administration defended the outgoing leadership's efforts towards protecting and improving environmental conditions. Many of the worst-polluting factories were shut down and water quality was improved through improvements in waste water treatment, sewage and drainage. China's energy consumption relative to GDP has improved due in part to stricter regulation and an emphasis on developing renewable energy resources.

During the outgoing administration's term in office, environmental degradation continued on a large scale. Now China's leaders face a backlash from average citizens, who have turned to expressing their dissatisfaction on the web and by staging demonstrations around the country. Anger and concern over the government's attempts to gloss over the issue was highlighted, when the environmental authorities pronounced a research report on soil pollution a state secret last week. The attempt to keep information from the public increased fears, that toxic soils constitute a threat to human health. Some researchers claim that about 10 % of rice consumed by people in China carries a risk of cancer due to high cadmium content. Cancer deaths in China are high by international standards.

Air pollution problems are apparent to the average person. Although small particle readings for Beijing air quality during the NPC were less than a third of the highs hit in January and February, they were still at health-endangering level. One of the more reliable measures of Beijing air quality is provided by air monitoring equipment at the US embassy, which tracks microscopic particles (the PM 2.5). The current reading indicates that Beijing air quality is extremely unhealthy. China's air pollution also affects other countries directly. Citizens of Kumamoto, Japan, which is located about a thousand kilometres from the Chinese coast, have been advised to avoid activity outdoors due to poor air quality caused by Chinese air pollution. China's contribution to global greenhouse gases increased sharply during the term of the outgoing leadership.

China's share of world CO₂ emissions



Source: British Petroleum

Russia

Latest BOFIT forecast for Russia sees slightly lower economic growth ahead. In the second half of 2012, Russia's on-year economic growth slowed to below 3 %. The latest [BOFIT Forecast for Russia](#) sees GDP rising 3.4 % this year and next year, and then slowing to 3 % in 2015. Our forecast sees Russia's GDP growth restrained by declining oil prices (down about 15 % over the forecast period). On the other hand, growth will be supported by a gradual recovery in the global economy and global trade this year and next.

Import growth still revived in the autumn, but plateaued in the final months of last year. In the coming years, import volumes are expected to show moderate growth. Our forecast projects growth of about 5 % this year and next, with a slight acceleration in growth in 2015.

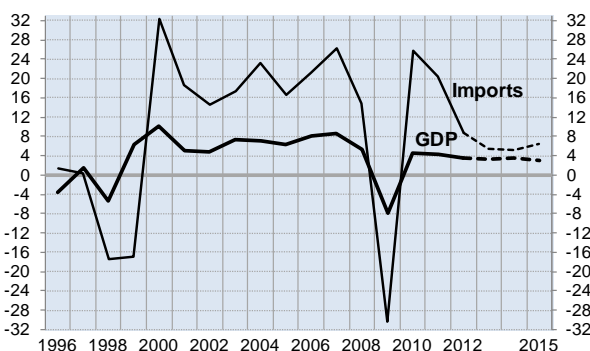
Growth in private consumption will slow a bit, but remain brisk. The rapid rise in public sector wages during election season should slow, but should still outpace growth in private sector wages. The private sector remains under pressure to keep wage growth in line with productivity gains. Soaring growth in household borrowing will slow.

Growth of fixed capital investment should revive gradually, given Russia's need for new plant capacity and the abating of uncertainty in the global economy.

The volume of exports will increase quite slowly. The outlook for energy exports is weak; crude oil exports should rise slightly and exports of petroleum products will decline.

Our forecast is subject to both upside and downside risks. The price of oil could drop faster or stay higher than assumed. The volume of Russian exports also depends on trends in global trade. Private consumption could rise faster if the large hikes granted to certain parts of the public sector are extended to other public sector workers. Higher-than-forecast import growth is also possible; Russians could turn more strongly to imports to meet demand as domestic inflation continuously exceeds the rise in import prices.

Russian GDP and imports; realised growth and BOFIT 2013–2015 forecast (percentage change per year)



Sources: Rosstat and BOFIT

Elvira Nabiullina tapped for CBR chairman post. On Tuesday (March 12), president Vladimir Putin said that he would be submitting to the Duma the nomination of his economic policy adviser Elvira Nabiullina as the next chairman of the Central Bank of Russia. The Duma is likely to confirm the president's selection. Nabiullina is known as a strong, liberally inclined economist. She served as economy minister in Putin's cabinet until 2012, when Putin was elected to his third presidential term and she moved to become a member of the presidential administration staff. Current CBR chairman Sergei Ignatyev will retire in June after serving the legal limit of three consecutive four-year terms as CBR chairman.

The CBR has recently been receiving heavy criticism for its unaccommodating monetary stance under Ignatyev. As economy minister, Nabiullina talked up the advantages of well-applied stimulus. The big question now is whether the CBR will actually adjust its policy thrust. Most observers argue that the CBR will stick to its guns and continue moving its monetary policy gradually towards inflation targeting in accordance with long-announced plans.

Among the biggest challenges facing the incoming CBR chairman is implementation of the planned centralisation of supervision and regulation of the entire financial sector under the central bank. The CBR is currently creating a "megaregulator" agency to regulate and oversee the markets for banking, securities and insurance. The central bank earlier was only in charge of supervising the banking sector, while supervision of securities and insurance markets was performed by the Federal Financial Markets Service.

Cross-border travel between Finland and Russia hit record high in 2012. Preliminary Rosstat figures show that Finland continues to be the top destination for Russian travellers. Nearly a fifth of all Russians that travelled to non-CIS countries went to Finland. Finland benefits in particular from shopping tourism from Russian regions lying close to the border. As in earlier years, Turkey, China and Egypt were other popular destinations for Russian tourists.

Russians were clearly the largest group of travellers visiting Finland during 2012. Over 700,000 Russian's spent at least one night in a Finnish hotel, which was about 16 % more than in 2011. Russians accounted for a quarter of hotel stays of foreigners. Russians also shopped more than earlier. The value of tax-free purchases by Russian tourists increased about 25 % to over €280 million. January 2013 purchases, which coincide with the later Russian Orthodox Christmas holiday, increased 14 % y-o-y.

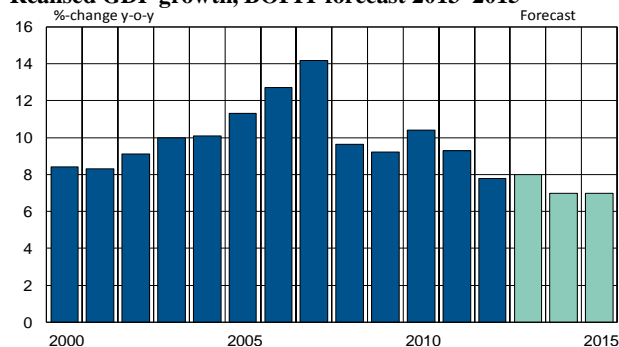
Finns formed the largest non-CIS group of travellers to Russia last year, but the biggest reason was business. Finns represented a fifth of all non-CIS business travellers visiting Russia.

Figures released by the Finnish Border Guard show that border crossings between Finland and Russia reached a record level of nearly 12 million.

China

BOFIT's latest China forecast ties modest slowdown in GDP growth in 2013–2015 to gradual progress in structural reforms. China's on-year GDP growth slowed to 7.8 % in 2012. [BOFIT's Forecast for China](#) still sees GDP growth of around 8 % this year. However, the investment-driven growth model, which is heavily dependent on resource inputs and generates massive pollution, appears to have run its course. Future growth will likely be sustained increasingly through domestic consumer demand. The structural change towards a model based on consumer demand should slow GDP growth to around 7 % in 2014 and 2015.

Realised GDP growth, BOFIT forecast 2013–2015



Sources: NBSC and BOFIT

Following a weak first half, economic growth revived in the second half of 2012 as expected. The first two months of this year have given little indication of any substantial change in the situation. In January-February, industrial output continued to grow at around 10 % y-o-y, while retail sales growth in real terms slowed by a couple percentage points to 12 %. Growth in imports by value held steady at 5 % y-o-y.

On the expenditure side, growth was robust in capital investment and exports. Inflation accelerated in February to over 3 % y-o-y. At the annual National People's Congress currently in progress, the announced GDP growth target for this year was the same as last year's (7.5 %), but the inflation target for 2013 was slightly reduced to 3.5 %. Current conditions call for no large changes in the near term in the monetary or fiscal stance.

China's acknowledged need to move away from an investment-focused growth model to one driven by domestic consumer demand assumes continuation of reforms in all sectors of the economy. The new political leadership is expected to demonstrate their commitment to deep reforms already this year. Certainly, the time is ripe for reform from the labour market viewpoint. There are no alarming indications of a pick-up in unemployment and most dismissed workers seem to be finding jobs in other fields.

Despite the slowdown, China's economic growth is still strong and China's imports are helping the global economy. China's current account surplus, once a major source of imbalance in global trade, has shrunk to just 2.6 % of GDP and growth in China's foreign currency reserves has slowed. The slower reserve growth partly reflects a huge increase in foreign direct investment by Chinese firms. These investment outflows likely do more to bolster the global economy than earlier central bank investments in treasuries and bonds of other countries. Now that China is no longer running massive imbalances, much of the immediate pressure for yuan appreciation has abated. Given China's high economic growth, the yuan could still appreciate (at least in real terms) during the forecast period. Yuan exchange rate swings could also be larger.

Our generally positive forecast assumes that political disputes remain on the back burner, particularly with respect to domestic reform policies and issues with China's main trading partners. Our prognosis could be jeopardised by another outbreak of problems in the real estate sector or revelations that the levels of debt held by local administrations are higher than earlier thought.

China continues to free capital movements. The China Securities Regulatory Commission (CSRC) announced last week that Hong Kong investors will have greater opportunities to invest in Mainland China financial markets. The broadening applies to investors certified under the Renminbi Qualified Foreign Institutional Investor (RQFII) programme that allows large institutional investors to invest directly in yuan-denominated securities. The reform means that a greater number of actors in Hong Kong's financial sector can participate in RQFII, and investments can be made in wider range of mainland Chinese securities.

The RQFII programme was inaugurated in December 2011, and is geared to increasing the selection of yuan investment possibilities available outside mainland China. Such investment possibilities are still quite modest, and due to the lack of them, Hong Kong investors have been forced to hold yuan in low-interest deposit accounts. After an initial burst of enthusiasm, RQFII investors have become quite cautious. Of the allotted 270 billion yuan (€33 billion) quota, only about 70 billion yuan has been used.

In recent years, China has implemented a wide range of small measures to liberalise capital movements. However, serious barriers and restrictions to capital movements remain in place. Authorities have sought to manage the liberalisation process e.g. by setting quotas or requiring permits for liberalised capital movements. Deregulation of capital movements is difficult to oversee as e.g. Finnish and Swedish authorities discovered in the 1980s. For the moment, China's cautious approach has served it well. Moreover, the time seems convenient in many ways to continue liberalisation. Some officials have mentioned that China's goal is to achieve free capital movements by the end of 2015.

Russia

Plans move ahead to make Moscow a global financial hub. The cabinet last month approved the state program to turn Moscow into an international financial centre and is now preparing measures to lay the foundation for its creation. While the plan envisions Moscow as a major player in Eurasian financial markets, many observers are sceptical as the city does still not attract enough foreign investors.

To improve the situation, the government has given priority to creating an institutional base that would provide sufficient investor protections and make investment more attractive. This would be achieved through such measures as effective market supervision through a “megaregulator” and revision of the civil code.

A working group is currently investigating potential sites for Moscow’s new financial centre. The City of Moscow currently lacks the functional prerequisites that would support operations of the financial centre. Mayor Sergei Sobyenin remarked that, for starters, Moscow’s epic traffic congestion needs to be dealt with.

One step towards an international financial centre is an attempt to boost trading on the Moscow Exchange. The boost effort is supported by president Putin’s initiative that gave rise to a decision in principle that IPOs of state-owned enterprises will take place on the Moscow Exchange (see following item).

Privatisation sales of state-owned enterprises to take place via the Moscow Exchange. President Putin insists the state needs to restrict its holdings in companies to those involved in defence and the energy sector as well as natural monopolies. The program to divest state property approved by the cabinet in February requires that all state-owned firms be evaluated by 2015 and all state-owned firms deemed not to require state ownership be put up for sale.

The program would thus involve a large number of privatisation deals in the coming years, including share offerings. It would also mean that the state would reduce substantially its holdings in the banking sector. Similar privatisation plans in the past, however, have materialized weakly.

The Russian state plans this year to sell off stakes in a number of firms, including VTB Bank, shipping company Sovkomflot and diamond mining giant Alrosa. The requirement that share sales take place on the Moscow Exchange has received a mixed reception. Some experts suspect that prices formed in Moscow would be lower than those formed on a major international stock exchange. Although the Moscow Exchange is continuously evolving, it has yet to achieve internationally acceptable levels of regulation or functionality that would make it more attractive to foreign investors. The National Settlement Depository (central securities depository) established last year has yet to become operational, and procedures for clearing and set-

tlement of stock market trades have yet to conform to international practice. Moreover, the pool of domestic investors remains fairly small. There are few institutional investors such as pension funds and few households have share savings plans.

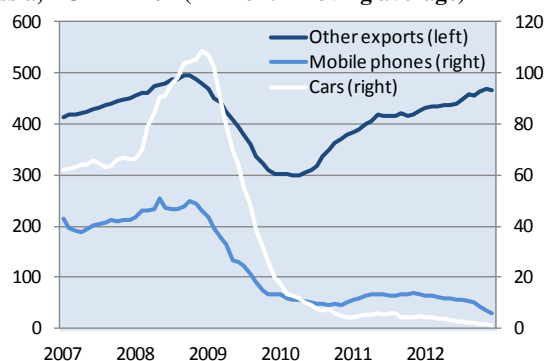
Growth in Finnish exports overall slowed last year, but exports to Russia provided a bright spot. Finnish goods exports to Russia last year exceeded €5.7 billion, up 7 % from a year earlier. While Finland’s total exports showed no growth from 2011, Russia’s share of Finnish exports increased slightly. Russia, which accounted for 10 % of all Finnish exports last year, was Finland’s second largest export market after Sweden.

Finland’s top export products to Russia are still machinery and equipment (about a third) and chemical products (about a quarter). Textiles and mineral products saw the highest export growth. Exports of electrical equipment and transport vehicles contracted, however, largely reflecting the steady decline in re-exports of mobile phones and passenger cars made in third countries.

Road freight transiting Finland to Russia fell 8 % in volume terms last year. The biggest drop was in transit shipping of passenger cars, which was down about 25 % from 2011. On the other hand, significantly larger quantities of e.g. pharmaceutical products were shipped. The value of transit freight transported by road exceeded €20 billion. Hence, in total about 10 % of Russia’s imports came from Finland as exports or transit freight.

The value of Finnish goods imports from Russia last year was €10.6 billion, a decrease of 7 % from a year earlier. The falling value of imports largely reflected lower import prices. The value of several key import commodities fell (e.g. oil, wood and metals), while the value of certain imported chemical products increased. Russia is still Finland’s largest source of imports, accounting for 18 % of Finland’s total imports. Russia is very important to Finland as a source of oil, gas and other energy commodities. Finland’s energy imports from Russia roughly cover half of its energy consumption.

Finnish exports of mobile phones, cars and other goods to Russia, EUR million (12-month moving average)



Source: National Board of Customs

China

No big surprises in National People's Congress. The nearly two-week National People's Congress adjourned last Sunday (Mar. 17) after setting out national goals for 2013 (see [BOFIT Weekly 10/2013](#)) and approving the incoming administration. As expected, Xi Jinping was chosen as president and Li Keqiang for the premier's post. After their selections, the leadership pair reiterated their commitment to staying the course on economic reforms. One of premier Li's first acts was to announce easing of permitting requirements to eliminate red tape. President Xi has a fully booked state visit schedule in the coming months as leaders around the world seek a meet-and-greet with China's new president. In his first days in office, Xi has managed to meet a number of high-level international officials, including the new US treasury secretary Jacob Lew. Finland's president Sauli Niinistö will meet with Xi at the beginning of April.

The new administration means shakeups at a number of ministries, large state companies and provincial administrations. The influential National Development and Reform Commission (NDRC) will be headed by former minister of land and natural resources Xu Shaoshi. The head of China Investment Company (CIC), Lou Jiwei, will serve as finance minister. The closest thing to a surprise was the decision to extend the tenure of central bank governor Zhou Xiaochuan, who has already served in the post for ten years. Guo Shuqing, who has run the China Securities Regulatory Commission (CSRC) for less than two years, will become governor of Shandong province. He is replaced by Bank of China CEO Xiao Gang. Jiang Jiemin, head of state-owned oil company CNPC, was tapped to lead the State-owned Assets Supervision and Administration Commission (SASAC).

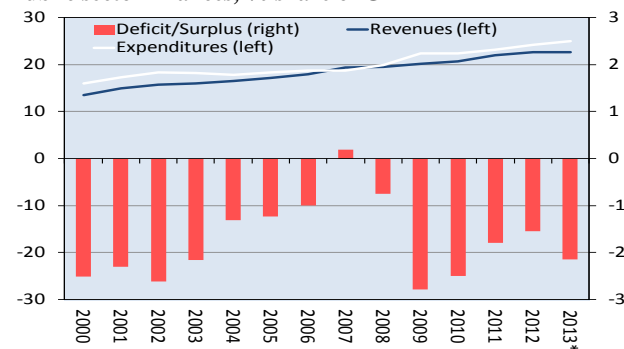
The NPC approved major changes in administrative structures to improve government efficiency. The number of ministries will be cut from 27 to 25, and a number of small agencies will be merged. For example, the Population and Family Planning Commission will be merged with the Health Ministry, while the coast guard, fisheries administration and anti-smuggling police will be under the State Oceanic Administration. After racking up billions of yuan in debt during recent years, the NPC decided to divide China's rail ministry into two parts. Supervision and other official duties were placed under the jurisdiction of the transport ministry, while railway operations were spun off as a separate business.

China to increase spending on health care and social security. The National People's Congress signed off on the realised 2012 state budget and this year's proposed budget. State revenues increased last year by 13 % to 11.7 trillion yuan (€1.44 trillion), while spending was up 15 % to 12.6 trillion yuan. Growth in revenues and expenditures was

slightly higher than the budget forecast of spring 2012. As planned, the public sector deficit was 800 billion yuan (€100 billion). According to this year's budget projection, the public sector deficit will increase to 1.2 trillion yuan (€150 billion) due to lower revenue growth from tax cuts approved in recent years. Spending growth is expected to slow only slightly. This year's budget emphasises substantial boosts in spending on health care, social security, energy conservation and environmental protection.

It is challenging to evaluate what is actually happening in public sector or identify emerging trends. Even defining the public sector in China is a non-trivial task. Financial statements only provide skimpy information on use of funds and sources of income. There is also uncertainty over the true size of government debt (see [BOFIT Online 3/2013](#)).

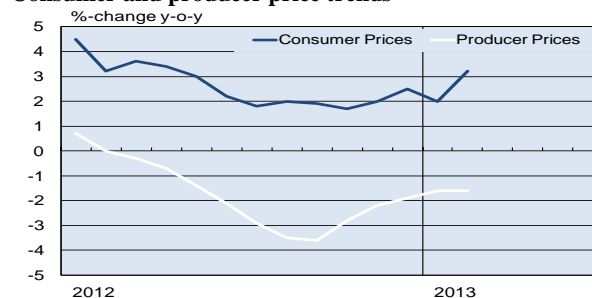
Public sector finances, % share of GDP



Sources: CEIC, Ministry of Finance and BOFIT, *) forecast

Inflation accelerated to 3.2 % in February. Although inflation is still running below the central bank's target of 3.5 % for 2013, February figures have raised concerns among experts and officials in charge of monetary policy. The numbers show consumer prices are on a steep upward trend that threatens monetary policy goals. Even more disconcerting, however, was evidence that the acceleration in inflation is being driven by food prices, which reached 6 % y-o-y in February, double the January figure. Central bank governor Zhou Xiaochuan, just installed to a new term, noted that the People's Bank of China is on "full alert" for inflation and prepared to rapidly tighten its monetary stance.

Consumer and producer price trends



Source: NBS

Russia

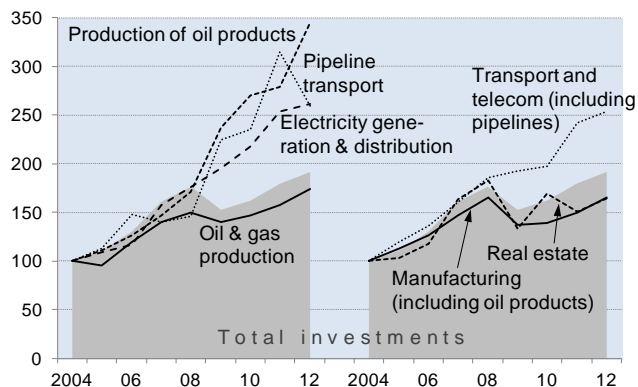
Russian economic growth slowed in the first two months of the year. The economy ministry has estimated that seasonal, work-day adjusted GDP contracted slightly on-month in January and February, and that GDP was up only about 1 % over the past 12 months. Industrial output fell on-month in the first two months of this year and was down slightly from a year earlier. Most of the decline was due to reduced production and exports of oil & gas. Manufacturing output was unchanged from a year ago. However, industrial firms are still quite optimistic about their outlook for the coming months.

Growth in domestic demand was quite slow. Retail sales grew 3 % y-o-y while consumer expectations cooled. Growth in retail sales slowed mainly because household borrowing is no longer growing. Fixed capital investments were up slightly from a year ago. Imports continued to grow moderately.

Forecasts expect weak growth in the first half of 2013 with a recovery in the second half as growth of the global economy picks up. Most forecasts expect GDP to rise 3–3.5 % this year (GDP grew 3.4 % last year).

Small shift in investment structure last year. The volume of fixed capital investments increased nearly 7 % overall last year, although growth slowed sharply over the year. Investments in the energy sector (production and pipeline transport of oil, gas and oil products, as well as investments in electricity generation and distribution), continued to account for well over 30 % of all investments, even if that share was slightly lower than in 2011. The reduction was due to a drop in investments in pipelines as the pipeline building boom of the past couple of years abated (7–8 % of total investments). Investments in oil refining, in contrast, continued their strong rise of several earlier years. Growth of investments in oil and gas production picked up (12 % of investments).

Volume of investments in key sectors (2004 = 100)



Source: Rosstat

Looking at other areas attracting major investments, manufacturing (excluding oil products) again accounted for nearly 11 % of total investments and was up again less than 10 % as in the previous year. Investments in the transport sector not including pipeline transport (share about 20%) continued to grow at an over 15 % pace. Investments in the real estate branch (13 % share) saw a considerable uptick. Housing construction activity continued to rise.

New government budget administration programmes strive to maintain balance. This month the government approved two budget programmes: one focused on the federal budget and one on regional and municipal budgets.

The federal budget programme is aimed at securing budget balance. The programme stresses the new budget rule that ties federal spending to the average oil price in previous years. The programme notes that by following the budget rule the non-oil budget deficit (i.e. the difference between budget revenues other than revenues from taxes on production and exports of oil, gas and oil products and total budget expenditures) would be reduced from over 10 % in 2012 to around 7.5 % by 2018 based on a roughly stable oil price. This would keep the budget in balance. Federal government debt is not expected to grow larger than 15–20 % of GDP in the period, even if domestic borrowing is planned to continue in order to increase the state reserve funds. The biggest risks noted include a decline in the oil price and scheduling spending e.g. in economic development programmes so that it outstrips budget revenues.

The background to the programmes includes projections by the finance ministry, presented in last autumn's budget frame, of budget revenues from oil & gas which all go to the federal budget (they stood for half of federal budget revenues and 28 % of all government budget revenues in 2012). In the policy frame, the size of budget revenues from oil & gas relative to GDP will shrink considerably as the export price of oil is assumed to remain broadly unchanged and meagre development is expected in oil and gas output and exports (in line with the economy ministry forecast).

Other objectives of the federal budget programme are to improve Russia's international creditworthiness via budget balance and sufficient reserve funds, develop budget administration in various ways, e.g. by simplifying tax payments, and further raising Russia's already rather good ranking in international budget transparency comparisons.

The programme for regional and municipal budgets seeks to increase tax revenues to regions and reduce dependence on transfers from the federal budget. The transfers represented about a fifth of all regional and municipal budget revenues in 2012. Regional governments and the finance ministry are set to sign agreements on enhancing revenues in the regions and effective use of funds. The programme notes it could lead to cuts in the public sector workforce in such areas as education and health care. The programme also seeks to improve the reduction of economic disparities across regions.

China

OECD recommends that China improve status of internal migrants and push ahead with market-based solutions to environmental problems. The latest OECD [Economic Survey of China](#) deals extensively with the economic challenges facing China. The OECD asserts China can sustain high economic growth in the future as its development path in many respects seems to follow that of Japan and Korea in earlier decades. China still has plenty of room to grow. Adjusted for purchasing power, the Chinese economy will surpass the US as the world's largest economy around 2016. Even then, however, Chinese per capita GDP will only be about a quarter of the US level.

China's economy faces multiple challenges. Many stem from a wave of loans, unproductive investments and other imbalances that occurred after China's massive stimulus programme in 2009–2010. China also has to take on accelerating inflation. One solution to rising housing prices might be to zone more land for residential purposes. The OECD wants to see greater transparency for local borrowing and other off-budget financial actions by local administrations that became common during the stimulus. Financial market reforms should be continued. Commercial banks should be given greater latitude in setting interest rates, and more foreign investment should be permitted in China's financial markets.

China has experienced one of the fastest and largest scale urbanisation in human history, yet its administrative structures have failed to keep up with the development. In particular, China's *hukou* household registration system must be reformed in order to give internal migrants to cities access to standard public services such as schooling and healthcare. Due to the *hukou* system, such services are presently not available to migrant workers outside their home district. Urban planners should also focus more on public transport, which has failed to keep up with rapidly growing cities.

China's growth model has resulted in a vast increase in energy consumption, which, in turn, has boosted emissions of greenhouse gases and other pollutants and led to serious environmental degradation. So far China has largely relied on regulation to deal with its environmental messes. The OECD suggests China employ market-based solutions. For example, regulated pricing of coal and other fuels, as well as electricity, could be abolished. Because regulated prices are so low in China, they fail to provide consumers with a price signal that would make them aware of actual production costs and thus encourage them to save energy. The price of water should also be raised to reduce waste. Emissions reductions could also be achieved by raising various taxes and fees on polluters.

China matches Germany in international patent activity.

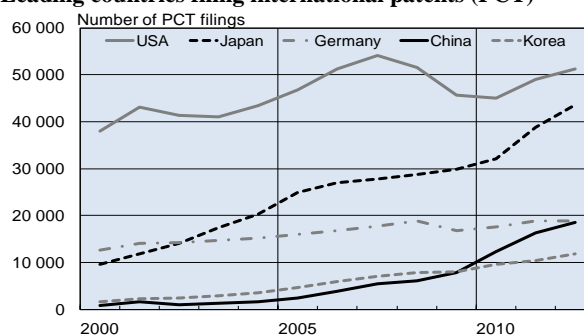
The World Intellectual Property Organization (WIPO) reports that the number of patent applications submitted under the international Patent Cooperation Treaty (PCT) exceeded 194,000 last year, an increase of nearly 7 % from 2011. The most patent applications were filed by companies in the United States and Japan, which together accounted for nearly half of all applications. Although growth in patent applications from Chinese firms slowed to 14 % last year, applications from China reached around 19,000, putting it on par with Germany in patent submissions. Germany and China each accounted for about 10 % of total PCT applications. South Korea ranked fifth in PCT filings.

Asia's strong emphasis on product development can be seen in the 12–14 % increases in patent filings from Japan, China and South Korea. However, in protecting designs and trademarks, Asian firms still lagged well behind their European and North American counterparts.

The most PCT patent submissions were made by Chinese telecom giant ZTE, followed by the Japanese Panasonic and Sharp, and China's other big telecom equipment maker Huawei. ZTE and Huawei accounted for about a third of all applications submitted by Chinese firms. Only a couple of other Chinese institutes made it into the top 100 organisations applying for patents globally. However, there were over 100 Chinese firms and research institutes that filed at least ten applications, suggesting that Chinese patent activity is wide-ranging. The overall quality of Chinese patent applications and patents is low compared to Western companies, so simply counting the number of applications overstates the abilities of Chinese firms to come up with true innovations. Nevertheless, there is no reason to belittle Chinese firms as they are increasingly displaying an ability to come up with novel solutions and have shown that they can follow the lead of Japan and South Korea in this area.

Measured in PCT patent applications, China is a far bigger player than India or Russia. India last year filed 1,200 patents and Russia less than 1,000. Finnish firms, in contrast, filed nearly 2,400 applications, putting Finland 13th in patent-seeking activity. Nokia and Nokia-Siemens accounted for over 40 % of Finnish patent applications.

Leading countries filing international patents (PCT)



Source: www.wipo.org

Russia

CBR's latest rate cuts have marginal impact. The Central Bank of Russia kicked off April by moving up its monthly monetary policy meeting by about two weeks from the typical mid-month scheduling. As the markets anticipated, the CBR lowered rates, but not all. The CBR's most important credit rate, the 1- to 7-day repo auction minimum, remained at 5.50 %. The rate cuts were focused mostly on longer-term credit rates that allow non-marketable securities as collateral. The credit rates were lowered by 25 basis points to 7–8 %.

The CBR based its decision on a projected slowdown in inflation in the second half of this year (12-month inflation was 7 % at the start of April) and the view that the chances of a further economic slowdown have increased. The CBR said the rate cuts would not significantly affect money market rates, but instead move rates on the longer-term loans closer to the rates of the CBR's basic operations.

Demands from Duma deputies and government circles for interest-rate reductions have increased as economic growth has slowed. Companies complain that high interest rates make it hard for them to operate (the average rate on ruble loans up to one year hit 9.6 % in February). Some experts note that, given the current state of the economy, the CBR's rate cuts will only affect bank lending rates slightly. Russia's high interest rates mainly reflect high risks associated with lending. Thus, interest rate cuts are likely to do little to promote capital investment as long as companies are uncertain about future business prospects.

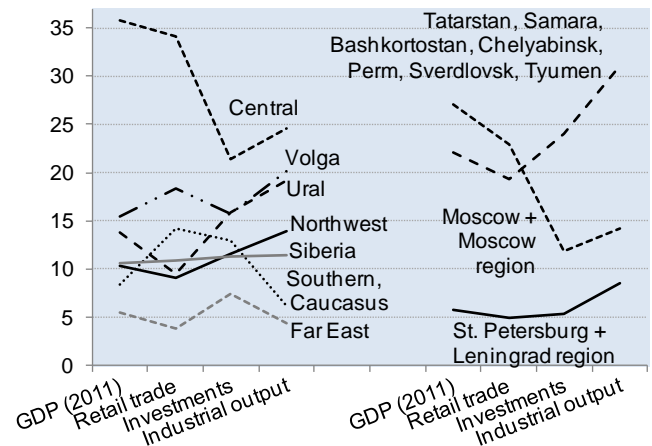
Russian regions posted rather uneven economic performances last year. In the Central Federal District that includes Moscow and in the eastern parts of Russia, growth in retail sales slowed last year, but even so growth averaged 5–8 %. In Moscow and the Moscow region, growth slowed sharply (below 2 % for Moscow). Nevertheless, the concentration of consumer activity in these regions still accounted for 23 % of all retail sales in Russia. In Northwest Russia, retail sales growth picked up, especially in St. Petersburg (up 8 %), as well as in the southern parts of Russia and all the way to east of the Urals (7–8 %). In January and February this year, retail sales growth outside Moscow, the Moscow region and St. Petersburg was still quite rapid.

Capital investment growth tended to stabilise in most regions. In St. Petersburg, investments fell (as in 2011), as did investments in the Far East Federal District as spending around the APEC summit dried up. Investments in the City of Moscow and the Moscow region picked up notably.

Growth in industrial output moderated in all eight Federal Districts. In the western parts of the country, output was up 4–6 % with the exception of the Northwest Federal District (up 2 %). In January-February, output growth weakened except in the Southern Federal District.

The economy ministry's long-term growth scenario sees highest growth in the next few years in the Southern and Far East Districts. Growth in the Northwest and Central Districts should also be slightly higher than farther east.

Shares of Federal Districts and largest regional concentrations in the Russian economy in 2012, %



Source: Rosstat

Russia seeks to boost exports by easing border formalities and increasing state subsidies. The cornerstone of the government's recently approved programme to promote foreign trade involves strengthening Russia's position in the global economy through more exports, especially machinery and equipment. Russia has tried for years to diversify and increase the added-value component of its exports, but to rather little avail. Oil, petroleum products and gas still account for 70 % of all Russia's goods exports, and the rest is mainly other commodities like metals and wood.

Now exports boost is to be achieved through improving customs services and border crossings. These are seen as major obstacles to exports. Indeed, nearly all of the over 400 billion rubles (€10 billion) allocated from the federal budget for 2013-2018 will go to smoothing border traffic. More efficient border traffic, in turn, is hoped to reduce export costs and increase the competitiveness of exports. No specific measures to improve efficiency are mentioned.

The programme also includes state support such as export credits and guarantees, and assistance from state agencies in marketing and information gathering. Despite finance ministry opposition, the programme allocates 20 billion rubles (€0.5 billion) in subsidies from the federal budget. The finance ministry argues that no new money is needed for export subsidies as only a fraction of currently budgeted subsidies has been used.

CIS countries are a focus of international cooperation, and specifically the formation of a Eurasian Union based on the current customs union. The programme also states that Russia needs to be more active in international organisations such as the WTO to strengthen its presence in global trade policy-making and to secure its national interests.

China

Banks show higher-than-expected profits for 2012. The combined profits of China's four largest commercial banks, Industrial and Commercial Bank of China (ICBC), China Construction Bank (CCB), Bank of China (BoC) and Agricultural Bank of China (ABC) last year amounted to 720 billion yuan (€90 billion), an increase in profits of 15 % from 2011. A large part of bank revenues were generated from the margin spread, i.e. the difference in interest paid by borrowers on loans and interest paid to depositors. Lifted by strong profits, ICBC is acquiring a 20 % stake in the Taiwanese SinoPac Bank. Since the beginning of this month, Taiwan has allowed investments from Mainland China in its financial sector.

The continued robust growth in commercial bank profits came as a mild surprise to many observers. The media report that competition has increased among banks, since the People's Bank of China last summer gave commercial banks greater flexibility in rate-setting by allowing greater divergence from reference rates. Another surprise has been that the wave of non-performing loans from the 2009 and 2010 stimulus has failed to materialise or even have significant impact on bank balance sheets. In fact, the non-performing-loan ratios of the big banks fell again last year. At the moment, the ratio of non-performing loans to the total loan stock of these big banks averages around 1 %.

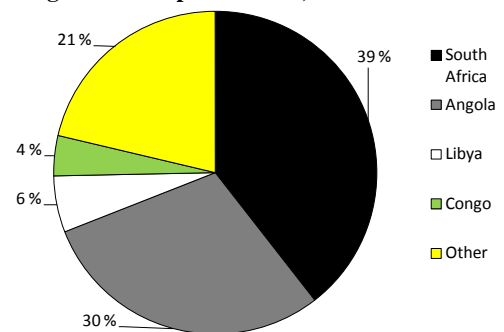
President Xi's Africa tour highlights the rapid expansion of China-Africa relations. Trade between China and the African continent, which increased nearly 20-fold during the 2000s, grew by about 20 % y-o-y last year to \$200 billion. The rapid growth has made China Africa's top trading partner and Africa now accounts for 5 % of all of China's foreign trade. China mainly imports raw materials from Africa that it converts into a vast array of consumer and investment goods. China overall runs a trade deficit with the African continent. Relations are not limited to trade, as China has become a major investor in large projects in Africa. Chinese direct investments in African countries increased last year by 50 % to over \$3 billion.

South Africa is China's largest African trading partner, accounting last year for 18 % of China's exports to Africa and 39 % of imports from Africa. South Africa is an important source of e.g. iron ore and precious metals for China. Chinese companies are involved in a number of major investment projects in South Africa, including platinum mines and cement plants. During the visit, China Railway Construction Corporation announced it had signed a memorandum of understanding on construction of high-speed rail in South Africa. President Xi also visited Tanzania and the

Republic of Congo. In Tanzania, the Chinese committed to financing and constructing a large port project. In the Congo, discussions centred around conceptual plans for developing bilateral trade further.

China's role in Africa is not seen by all in an entirely positive light. Some critics claim the Chinese have a colonialist attitude, that they ignore environmental standards and do not hesitate to make deals with corrupt officials. Moreover, competition from Chinese firms tends to put domestic producers at a disadvantage. Critics aside, it is also clear the Chinese have invigorated African economies that have long been in the doldrums. The Chinese see economic opportunity in places where European and North American investors see problems.

China's leading African import sources, % share



Source: CEIC

Chinese arms exports continued to rise last year. The Stockholm International Peace Research Institute (SIPRI) reports that China last year surpassed Germany and France to become the world's third-largest arms exporter. The world's two biggest arms sellers are still the United States and Russia, which sell far more weapons than China. Most of China's customers are found in the developing world. The biggest buyer by far is Pakistan, which has bought the full range of Chinese arms, including tanks, jet fighters, helicopters, ships, submarines, radar systems, missiles and bombs.

Although China spends huge sums on development of weapons systems, the country is still the world's second biggest arms buyer after India. Following the Tiananmen Square protests of 1989, the United States and the European Union imposed a ban on arms sales to China that is still in force to this day. The embargo has forced China to turn to Russia for most of its arms purchases. The countries have an uncomfortable relationship in this respect. Russia claims China has been reverse engineering its own versions of Russian weapons systems and military aircraft. Despite these claims, Chinese media report that the countries agreed last month that Russia will supply China with four Amur-class submarines and 24 Sukhoi SU-35 jet fighters.

Russia

Russia's current account surplus shrinks and capital outflow declines. Preliminary first quarter data from the Central Bank of Russia show a current account surplus of \$28 billion, a slightly lower amount than in first quarter of the previous three years. The surplus for the four most recent quarters exceeded 3 % of GDP, which was the smallest surplus since the beginning of 1999.

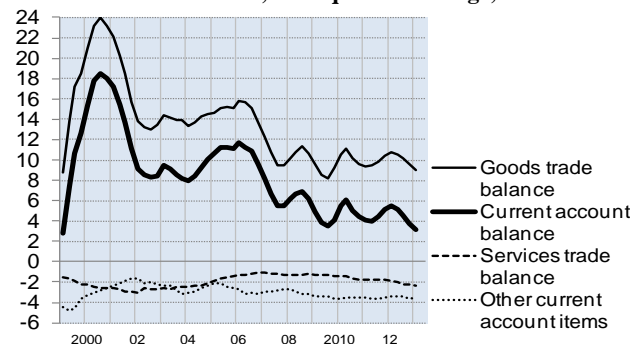
Russia's current account surplus began to contract about a year ago as export revenue growth began to flag while fair growth in spending on imports continued. In the first quarter of this year, earnings on exports of goods and services fell for the first time in over three years. The on-year decline in goods exports was a few per cent, dragged down both by exports of crude oil, petroleum products, natural gas and other commodities. In contrast, services exports continued to rise.

Spending on imports increased about 6 %. Imports of services, including spending of Russian travellers abroad, rose about 15 %. Import growth was down significantly.

Net private capital outflow from Russia in the first quarter amounted to \$26 billion, or slightly less than in 1Q2012. Capital exports by the banking sector increased substantially. The CBR noted that an increase in domestic forex deposits forced banks to rebalance their forex positions.

The net capital outflow from the corporate sector fell to its lowest level in several years. Direct investment inflows and outflows of the corporate sector as well as borrowing from abroad showed an exceptional increase, partly from the big deal between Russia's largest oil company Rosneft and multinational BP.

Current account balance, four-quarter average, % of GDP



Source: Central Bank of Russia

Russia's massive grey economy contributes significantly to social sector underfunding. Social affairs minister and first deputy prime minister Olga Golodets stated last week at a conference at the Higher School of Economics in Moscow that only about 45 % of Russia's working age population pays taxes, social contributions or pension payments. Studies at several research institutes put the share of the

workforce employed by the grey economy at 24–30 %. The narrow tax base is a big factor driving the large deficit the state pension fund runs. To make up for lost fund revenues, social contributions and pension payments have been hiked several times with varied success.

Russia's decline in unemployment is essentially the flip side of growth in grey sector employment. Even for declared employees, companies now pay an increasing share of wages under the table. This is partly a reaction to the 2011 hike in the mandatory social contribution of employers from 26 % to 34 % of the wage bill. Although the government backed off last year and lowered the contribution to 30 %, companies have remained unwilling to declare the full extent of their wage payments. The hike in the mandatory social contribution decreased income tax revenue and imposed financial losses on the public sector overall. At the beginning of this year, the pension contribution of sole proprietors was doubled. Their representative organisations complain this is forcing an increasing share of sole proprietors into the grey sector.

Payment of wages under the table and companies that operate off the books are typical for Russia, and they are intertwined with other problems of the economy. There is little incentive to pay taxes or register a business as the state cannot guarantee that companies can operate securely or will receive fair treatment from officials. Neither companies nor workers trust that their tax contributions will always be used for their stated purpose.

What constitutes middle class in Russia? The Moscow-based Independent Institute for Social Policy (IISP) reports that nearly 20 % of Russian households qualify as "middle class". IISP researchers say the share of middle-class households has increased about one percentage point annually since 2004, and that the structure of Russia's middle class has shifted since the late 2000s. The share of people employed by companies in the private sector, entrepreneurs, and professionals has been shrinking, while the share of public sector experts, managers and representatives of power organisations has been increasing (power organisations include e.g. those ministries that operate directly under the president such as the interior ministry, justice ministry and defence ministry). These public-sector groups now make up about 20 % of the Russian middle class.

IISP researchers use several criteria to define membership in the middle class, including wealth, education level, work quality, and the household's own assessment of its social status. On the basis of wealth alone, 28 % of households qualify for the middle class, up from 21 % in 2004. Households' own appraisals of their status has also risen overall, even if there were pronounced differences across groups. Entrepreneurs are more pessimistic about their fortunes now than in 2004, while civil servants and representatives of power organisations feel much more confident about their status.

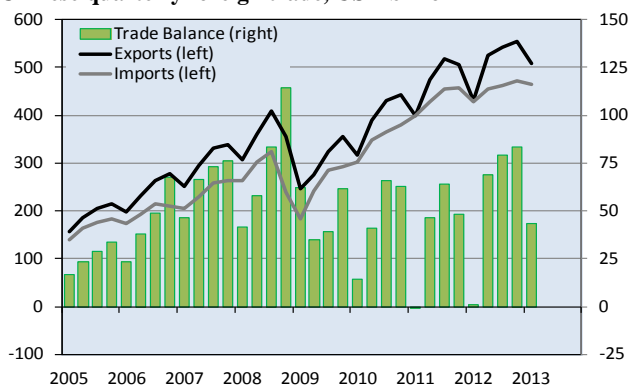
China

Robust export growth in the first quarter. China customs reports the value of exports rose to slightly over \$500 billion, an increase of nearly 20 % y-o-y. Exports were up sharply to countries in Southeast Asia, as well as to Taiwan and Hong Kong, which operates as intermediate port for Chinese goods. Exports to the United States grew 7 %. Export growth to Europe remained stagnant and exports to Japan contracted. A number of economists monitoring the Chinese economy have expressed suspicions that some Chinese companies may be fudging their export numbers. They note that companies have incentives to exaggerate their exports either to gain tax benefits or to repatriate capital back to China to take advantage of the yuan's strengthening against the dollar in recent months. China customs is investigating the matter.

The value of China's imports grew significantly slower than exports in the first quarter, and was up by less than 10 % y-o-y. Imports from the US increased some 20 %, and also imports from Taiwan rose rapidly. Imports from Europe and Japan fell sharply. China has benefitted from the drop in global commodity prices, which has reduced the value of imports from most of China's trading partners that supply it with raw materials.

The strong growth in exports and feeble growth in imports generated a trade surplus of \$44 billion in the first three months of this year. If export growth remains strong and import growth remains weak, the trade surplus for 2013 will be substantially larger than last year.

Chinese quarterly foreign trade, USD billion



Source: China customs

Chinese tourists off to see the world. The number of Chinese tourists travelling abroad increased about 20 % last year, nearly keeping pace with the record growth of 2011 and 2010. If the growth in tourism continues to rise at its current rate, the number of Chinese tourists travelling

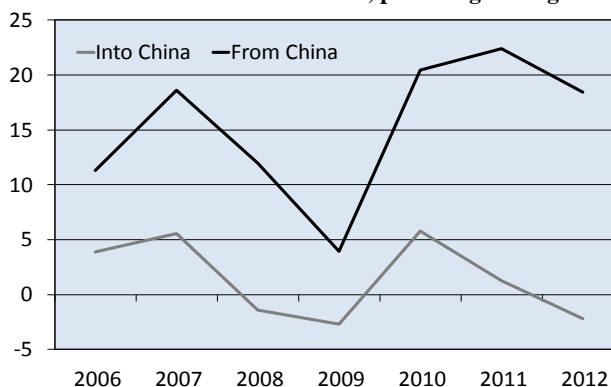
abroad should exceed 100 million this year. The Chinese show a great willingness to spend money on travel. According to the UN's World Tourism Organization (UNWTO), spending by Chinese tourists exceeded \$100 billion last year, putting them at the forefront internationally as income generators for tourism-dependent businesses.

More than two-thirds of all Chinese tourists headed to Hong Kong or Macao, which official Chinese statistics treat as foreign destinations. Japan, Korea and Taiwan were also popular with Chinese tourists. Europe and the United States each accounted for roughly 2 % shares of Chinese tourism. About 60,000 Chinese travellers spent at least one night in a Finnish hotel or hostel last year.

In contrast, the interest of foreign tourists in China shows signs of waning. The number of foreign tourists visiting China last year shrank about 2 %, and China's National Tourism Administration reports that the loss of tourists continues this year. Several studies have shown that foreign tourists visiting China are increasingly disappointed with the experience. The most recent surveys of tourists reflect discontent with the degradation of China's natural environment and water quality. Recent international news coverage has done little to promote China's attractiveness to potential tourists. This winter's air pollution events and the outbreak of H7N9 avian influenza may give many people who think of a trip to China further cause to consider an alternative tourist destination.

China's competitiveness as a tourist destination has declined slightly in the World Economic Forum's survey. Of the 140 countries surveyed, China still makes it into the top third of tourist destinations with a ranking of 45th place. The WEF study shows that China has a huge potential as a tourism destination thanks to its natural and cultural attractions. China does well in terms of air, rail and bus connections, as well as price competitiveness and availability of competent service staff. To attract more tourists, China needs an attitude shift on how it treats tourists, better hotel accommodations and more focus on cleaning up the environment.

Tourist travel into and out of China, percentage change



Source: CEIC

Russia

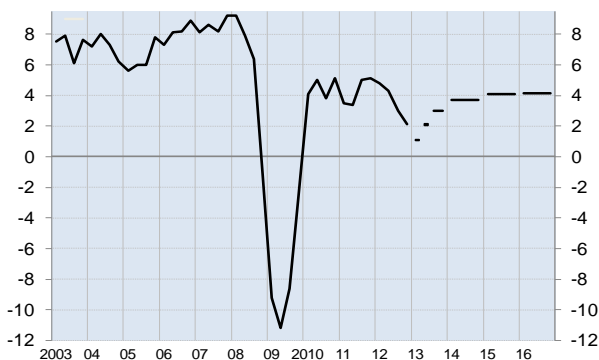
Russia's economy ministry cuts its GDP growth forecast significantly. The economy ministry's latest forecast still sees GDP growth picking up in the second half of this year, but now expects overall growth for 2013 to come in at 2.4 %. In its previous forecast for 2013, the ministry expected growth to hit 3.6 %. The ministry cut its growth forecast even as it boosted its average oil price assumption for the year from \$97 a barrel of Urals blend to \$105.

The new forecast cuts growth projections across the board. Even so, retail sales and fixed capital investments are now expected to rise about 4.5 % this year. Wages are expected to rise more than 10 % and thereby support consumption growth – especially if inflation slows to around 5–6 % this year as projected. For the ministry's projected consumption scenario to materialise, however, deputy economy minister Andrei Klepach noted that households will have to refrain from rushing excessively to saving and spend instead. With regards to investments, Klepach said it was important that Gazprom and other state monopolies not go through with planned investment cuts. Corporate borrowing also needs to start growing again.

The export volume is expected to remain at last year's levels, because crude oil exports should decline slightly. The volume of natural gas exports will only increase about 2 %, much lower growth than earlier forecast. Lower prices for exports would reduce export earnings by 4–5 %.

The economy ministry estimates industrial output will rise 2 % this year and that the volume of imports will increase over 5 %.

Realised and forecast GDP growth (on-year change), %



Sources: Rosstat (2003–2012), economy ministry forecast (2013–2017)

Economy minister Andrei Belousov noted that the economy could even slide into recession this autumn if no stimulus measures are applied. His assertion made president Putin's GDP growth target of 5–6 % a year seem increasingly remote.

Some observers interpret the economy ministry's exceptionally pessimistic forecast as a marker in the ongoing economic policy debate. The economy ministry favours traditional expansionary policies to deal with low growth, including higher public sector investment and increasing corporate credit.

On the other side of the fiscal and monetary policy debate are the finance ministry and the central bank. Both assert that stimulus would just add to inflationary pressures without increasing investment. Criticism of this has risen as domestic and global growth have slowed. President Putin's adviser Elvira Nabiullina, who takes over in June as CBR chairman, reiterated in her recent public comments that the central bank's biggest commitment is to fight inflation, i.e. that the current fairly tight monetary stance will continue. Nabiullina mentioned, however, that the CBR also needs to consider economic growth in its policy-setting.

Russia's WTO membership stumbles on lack of relevant expertise. In its just-released audit, the Accounts Chamber of Russia finds that Russian officials have been slow to implement measures to bring Russia into compliance with its WTO commitments.

Companies have failed to take full advantage of Russia's WTO membership as they have yet to use export and agricultural subsidies that in theory are available to them. A big obstacle here is the lack of public experts familiar with how the WTO operates. Russia has yet to set up its permanent mission to the WTO in Geneva, as well as organise and finance the handling of the complex legal issues related to WTO membership.

Major business organisations proclaim that domestic producers will suffer if cheap imports flood the market. Public discussions usually treat Russia's WTO membership as a negative factor for the economy.

Economy ministry department chief Maxim Medvedkov, who led Russia's WTO accession talks, notes that it is easier for lobbies to ask the government to protect non-competitive industries than to become fluent in WTO rules or push for specific interests in official negotiations.

Russian pork production is widely seen as one victim of WTO membership. The branch has seen the complete elimination of duties on pork products within the import quota, along with a reduction in import duties for pork exceeding the quota. Wholesale prices of pork products in Russia have fallen 30 % since the change, even though feed prices have risen considerably due to last year's poor grain harvest. Many producers have seen their businesses crippled financially, which has made the government increase subsidies to producers.

Consumers, however, have hardly seen any decline in pork prices at the retail level; sellers are keeping the benefit of lower producer prices. Prime minister Dmitri Medvedev said he would look into the possibility of changing in the law to remedy the situation.

China

First-quarter GDP growth fails to meet expectations in China. The National Bureau of Statistics reports GDP grew at 7.7 % y-o-y in the first quarter, a slight slowdown from 7.9 % posted in the fourth quarter of 2012. China's low GDP growth figure was disappointing to stock and commodity markets in Asia, Europe and North America. The disappointment was also reflected in forecasts. Eager forecasters that had raised their forecasts for the year during January and February have been forced to revising their earlier projections downwards. BOFIT forecasts 8 % growth for 2013.

China's GDP growth



Sources: NBS and BOFIT

Much of the slowdown in growth was due to low growth in demand for capital investment. There were signals, however, that several major investment projects were launched in March, which are expected to revive investment growth in the coming months.

Over half of GDP growth in the first quarter was generated by domestic consumer demand. Growth in disposable household income slowed slightly, which might affect consumer demand in the near term. The combination of low investment activity and strong consumption growth has caused the structure of the Chinese economy to become a bit more consumption-driven. Reduction of China's extremely high investment ratio will take time, however. It will be years before the ratio falls even close to usual international levels.

In addition to domestic consumption, economic growth has been supported somewhat surprisingly by rising global demand. China's export growth was robust in the first quarter, and import growth was modest.

Despite lower economic growth, capital investment flows have once again turned to China. Capital inflows, combined with a large foreign trade surplus in the first quarter, have

forced the People's Bank of China to purchase considerable amounts of foreign currency in its reserves to stave off excessive yuan appreciation. As a result of these actions, China's foreign currency and gold reserves increased by over \$100 billion in the first quarter, standing as of end-March at \$3.44 trillion, roughly 40 % of GDP. By any measure, China's foreign currency reserves are enormous.

China's inflation slows sharply in March. Consumer prices were up just 2.1 % y-o-y in March, a percentage point less than in February. The March inflation numbers came as a relief to China's monetary policymakers, who had worried that February's spike in inflation augured a rise in underlying inflation pressures. The latest figures affirmed the view that inflationary pressures in China remain modest, allowing the policy focus to remain on supporting economic growth.

Much of the volatility in the inflation rate in the first quarter reflected changes in food prices. Growth in food prices slowed to 2.7 % y-o-y in March, about half of the February on-year rate. The March drop seemed to indicate that the February spike in food prices was transitory and most likely reflected the Chinese New Year holidays rather than longer-term supply issues related to pollution or avian influenza. Prices of non-food items have developed more steadily since the start of the year. Inflation in the prices of industrial products slowed, while growth in prices for services and housing picked up in the first quarter.

Growth accelerated in March for key financial indicators associated with creation of inflationary pressure over the long term. Growth in M2, the main broad measure of the money supply, accelerated by more than a percentage point to 15.7 % y-o-y. The stock of new loans issued in March reached one billion yuan, well exceeding expectations. A rise in the figure for social financing, a broader indicator of financing availability than bank lending alone, suggests that access to finance rose faster than anticipated.

Growth in consumer prices



Source: China National Bureau of Statistics

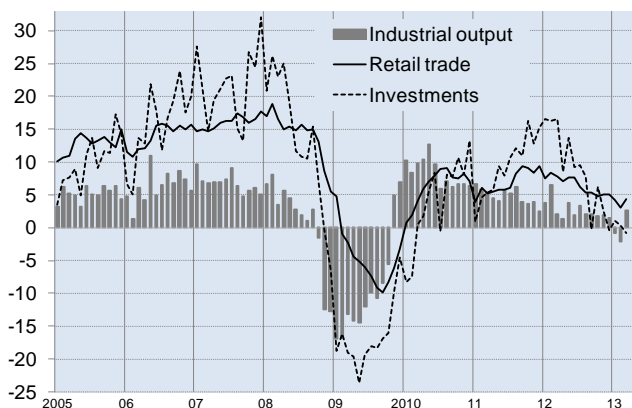
Russia

Russia's economy revived in March; government considers measures to boost recovery. After a bumpy start in the first two months of this year, the economy ministry estimates that workday-adjusted and seasonally adjusted GDP grew in March and was up over 2 % y-o-y. Manufacturing output also rose nearly 3.5 %. Nevertheless, first-quarter growth was only about 1 % y-o-y for GDP and manufacturing. The slow growth in the mineral extraction sector last year turned to decline in the first quarter. While oil production volumes were unchanged, gas production fell from a year earlier. Exports of oil, petroleum products and natural gas were all down slightly.

Retail sales, which account for nearly 40 % of domestic demand, rose nearly 4.5 % y-o-y in March. Rising consumer demand has been sustained by still good gains in real household incomes. Fixed capital investments, which got into sharply slowing growth last year, were unchanged y-o-y in the first quarter.

Despite increased retail sales activity and industrial output, households and businesses have turned gloomier about future prospects. The fitful economic performance in the first quarter of this year has given more impetus to discussion in Russia as to whether the economy is poised for recession or whether there are signs of recovery. President Putin this week arranged a discussion of possible stimulus measures with the prime minister, the finance and economy ministers, central bank chairman, chief economic advisers, select Duma deputies and several economic experts (including former finance minister Alexei Kudrin). The meeting emphasised that fiscal balance would not be sacrificed. Economy minister Andrei Belousov and finance minister Anton Siluanov noted that there are grounds to reduce bank lending rates which have risen further in recent months. Putin charged the cabinet with preparing a proposal by May 15 on measures to secure economic growth.

Change in volume of industrial output, retail sales and fixed investments from 12 months previous, %



Source: Rosstat

Russia's heavy bureaucracy adds to costs of doing business and constrains entrepreneurship. Surveys show that burdensome bureaucracy persists year in and year out as one of the most difficult aspects of Russia's business environment. A study from the Higher School of Economics estimates that official inspections alone (e.g. fire inspections, health inspections and tax audits) cost roughly 800 billion rubles to the economy in 2011, an amount that corresponded to nearly 1.5 % of GDP. Moreover, the HSE researchers noted that, despite the inspection activity, firms frequently violated regulations because the sanctions are often arbitrary. According to Opora, an organisation that represents the interests of small and medium-sized enterprises, many regulations are so outdated that compliance is practically impossible. Oversized bureaucracy also incentivises corruption. Many companies find it preferable to bribe officials in order to avoid the time and costs associated with inspections and audits.

Bureaucracy also reduces the motivation of Russians to start their own businesses. According to the latest [GEM entrepreneurship comparison](#), Russia ranked last among the 69 countries studied in terms of persons contemplating starting a business. Only 2 % of Russian respondents said they had considered starting their own business, when the average for countries with similar income level was around 26 %. The share of entrepreneurs that had businesses ongoing in Russia was also slightly lower than in most other countries of the comparison. GEM researchers note that heavy bureaucracy and lack of access to financing are among the biggest obstacles growing a business in Russia.

Economy ministry has ambitious expectations on raising Russia's business friendliness. President Putin has laid out as one of the major administrative goals to lift Russia's overall ranking into the top 20 countries in the World Bank's annual *Doing Business* survey over the next several years. [Doing Business 2013](#) ranks Russia (represented by Moscow), 112th out of the 185 countries surveyed.

Doing Business rates business friendliness by a number of criteria. Administration is now trying to push rapidly improvements in these criteria through legislative and regulatory reform. A summary released by the economy ministry two weeks ago estimated that if all the legal and regulatory changes accepted so far and slated for this year are actually realized, Russia's *Doing Business* ranking would rise. In the category of getting a building permit, for example, Russia would jump 161 places to 17th position. For getting an electrical hook-up to a warehouse, Russia would rise 121 places to 63rd, and registering a business would climb 31 places to 70th. Thus, Russia could theoretically climb to 44th place in the overall rankings by 2014, assuming business environments in other countries stay the same. Realisation of this improvement naturally requires that the new measures are actually implemented also in practice.

China

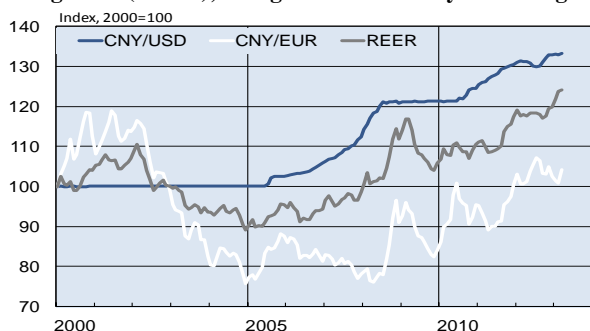
Yuan appreciates, international use continues to rise.

The yuan's exchange rate has appreciated 2 % against the US dollar since the start of this year. On Thursday (Apr. 25) one dollar bought 6.17 yuan. The yuan has also risen 3 % against the euro this year. One euro bought 8.07 yuan. Despite the assertion of the People's Bank of China that the yuan's external value is determined relative to a basket of currencies of China's main trading partners, the exchange rate movements suggest that the yuan still basically tracks the dollar's exchange rate. The yuan-euro exchange rate has followed the ups and downs of the dollar-euro rate.

The exchange rates of floating currencies are driven by supply and demand. However, the yuan does not float freely and it is affected by capital controls and exchange rate policy. The PBoC every morning sets an initial exchange rate from which the value of the yuan can vary up to one percent during the course of the day. If the yuan appreciates or depreciates more than 1 %, the PBoC will intervene by buying or selling currency from its reserves until the yuan is brought back within limits. This year's interventions have mostly involved buying currency on heavy demand for yuan. At the moment, capital flows are heavily skewed towards China and the country's trade surplus continues to grow.

The real effective exchange rate (REER), which takes into consideration inflation differences and trade shares with a country's main trading partners, is generally considered a better indicator of the price competitiveness than the nominal exchange rate. Since the yuan's nominal exchange rate has appreciated and China's inflation has been running higher than in its main trading partners, the yuan's REER rose nearly 4 % in the first quarter of this year. Price competitiveness of goods produced in China has been further diminished by rising production costs such as higher wages.

Nominal yuan-dollar, yuan-euro and yuan real effective exchange rate (REER); rising trend indicates yuan strengthening



Sources: BIS and Reuters

China continues to take steps to promote international use of the yuan. Since the beginning of April, it has been possible to exchange yuan directly for Australian dollars, eliminating the requirement of going through a third currency. Australia's central bank announced this week it would begin to hold 5 % of its currency reserves in yuan-denominated bonds and treasuries.

Chinese companies rule the roost in latest Forbes Global 2000 list.

Forbes magazine reports that the world's biggest company this year is Industrial and Commercial Bank of China (ICBC), with the number-two spot going to China Construction Bank. Also making it into the top ten were Agricultural Bank of China (8th largest) and PetroChina (9th). Joining the four Chinese companies in the top ten spots were the American firms JPMorgan Chase, GE, Exxon Mobil and Berkshire Hathaway, along with Royal Dutch Shell (Netherlands) and HSBC Holdings (UK). Ranks were based on sales, profits, assets and market value.

Looking at the 100 largest publicly traded firms, nearly a fifth were from Asia (mainly China, Japan and South Korea). Eight mainland Chinese firms made it into the top 100. As a rule, the Chinese firms making the list were state owned, and the state is a major owner in all of China's biggest companies. The role of state-owned enterprises in the Chinese economy had been gradually declining from the launch of economic reforms in 1978 until the 2000s. Many China observers point to a shift back towards state capitalism under the administration of former president Hu Jintao.

The size ranking of companies depends on which criteria are taken into consideration. Companies in the financial sector tend to dominate the *Forbes Global 2000* list, which takes into account total assets. In contrast, industrial firms were more likely to make it in top of the *Fortune Global 500* list, which uses revenues as the size metric. Chinese companies ranking in the top 10 in the Fortune rankings included oil and petrochemical refiner Sinopec (5th), PetroChina (6th) and electrical power company State Grid (7th).

Chinese firms included in top 100 of the Forbes Global 2000 rankings for 2013

Corporation	Ranking
ICBC	1
China Construction Bank	2
Agricultural Bank of China	8
PetroChina	9
Bank of China	11
Sinopec	26
Bank of Communications	54
Ping An Insurance Group	83

Source: *Forbes*

Russia

Moscow Exchange stocks have four rough months. As of end-April, the Moscow Exchange's MICEX stock index had lost over 8 % since the start of the year, clearly underperforming most world stock markets. The decline reflects falling commodity prices as well as the uncertainty caused by the crisis of Cyprus. By sector, the only MICEX gainer has been the consumer & retail index whereas other sectors saw declines.

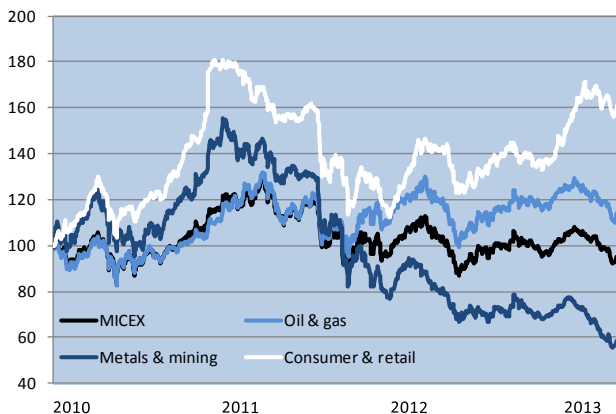
The oil & gas sector accounts for nearly half of the MICEX index. The sub-index has declined 10 % since the start of the year on falling oil prices. In the oil sector, from additional uncertainty have suffered the minority shareholders in TNK-BP Holding, the subsidiary of the TNK-BP venture acquired recently by Rosneft. Minority shareholders fear Rosneft will siphon off the assets of TNK-BP Holding and other subsidiaries instead of paying out dividends.

The banking and financial sector sub-index also slid 10 % since the start of the year. It currently represents just under a fifth of the MICEX index. The sector has been affected directly by uncertainty caused by the Cyprus banking crisis. The share issue of VTB bank announced this week, however, was relatively well received by the markets and according to VTB e.g. the sovereign wealth funds of Norway, Qatar and Azerbaijan have plans to participate.

The metals & mining sector now represents about 10 % of the MICEX index. It has fallen over 20 % from the start of the year. The decline reflects lower commodity prices that reduced 2012 revenues of metal firms. The sector index stands even well below its reading at the start of 2010.

The market capitalisation of Moscow Exchange-traded companies is over \$800 billion. However, the free-float is less than 30 % which is clearly lower than in most major exchanges. The Moscow Exchange nevertheless continues to evolve, e.g. by launching its first exchange-traded fund (ETF) this week.

Moscow Exchange MICEX stock index and sector sub-indexes, 100 = January 11, 2010



Source: MICEX

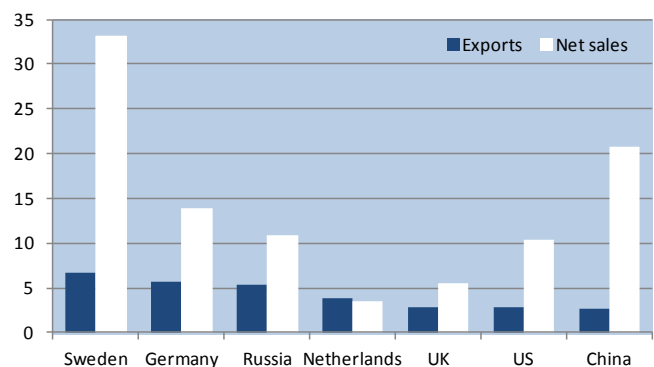
Foreign subsidiaries of Finnish firms have expanded especially in Russia and China. Figures released last week by Statistics Finland show that Sweden is still the most important location for the foreign subsidiaries of Finnish firms when measured in terms of personnel. However, the latest figures from 2011 show that China and Russia have moved into the number-two and three slots. In mainland China, Finnish firms operated subsidiaries employing in total over 70,000 people, while Finnish subsidiaries in Russia employed over 50,000. Chinese subsidiaries ranked second in net sales (€1 billion), while Russian subsidiaries ranked fourth (€1 billion). The numbers for personnel and net sales of Finnish subsidiaries located in China and Russia are considerably larger than similar figures for personnel and net sales of Finnish subsidiaries in all of South America or Africa.

China and Russia have increased in importance for Finnish firms at the expense of e.g. Finland's traditional European trading partners. Over the past decade, the net sales of Finnish subsidiaries based in EU-15 countries have only seen their net sales rise about 8 % and the overall share of EU-15 subsidiaries measured in net sales has fallen from nearly 60 % ten years ago to just over 40 % today.

In contrast, net sales of Finnish subsidiaries in Russia have increased more than ten-fold over the past decade and subsidiaries in mainland China have seen their net sales climb nearly five-fold. The value of Finnish exports to Russia and China over the past decade has also doubled. Finnish firms appear to prefer establishing businesses on the ground in China, while exporting is still relatively more important in business operations with Russia.

Finnish subsidiaries in China are larger on average than those located in Russia. Subsidiaries in China in 2011 had average net sales of nearly €100 million and just over 300 employees whereas subsidiaries in Russia had net sales of €30 million and 130 employees. Finnish companies have just over 400 Russian subsidiaries and over 200 Chinese subsidiaries.

Finnish exports and net sales of foreign subsidiaries in Finland's largest export countries in 2011, EUR billion



Sources: National Board of Customs, Statistics Finland

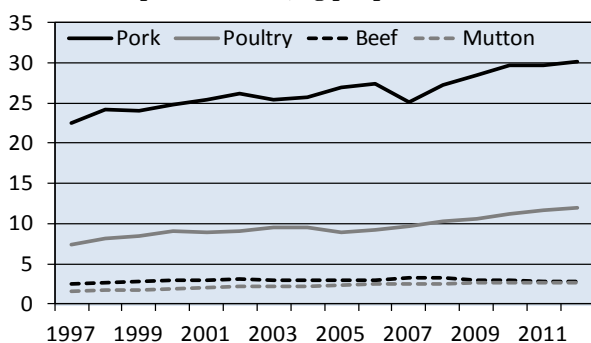
China

Chinese eating more meat. The UN Food and Agriculture Organization (FAO) reports the Chinese are now eating nearly 50 kilograms of meat a year, or about 10 kg more per capita than in 2000. Much of the increase in meat consumption reflects the fact that Chinese are getting richer, which tends to change dietary habits. Chinese meat consumption is approaching the developed world average of 65 kg a year. Much of the meat consumed in China is pork; China accounts for about half of global pork consumption. In addition to pork, poultry consumption, mainly chicken, has increased sharply. The developed world in contrast prefers to stick with white meat, with consumers generally eating more chicken than pork. Beef consumption is significantly higher in the developed world than in China.

Domestic meat production has risen substantially in recent years. National Bureau of Statistics figures show that 700 million swine were slaughtered last year, or 35 million more than in 2011. Production has been hurt, however, by serious epidemics such as the 2007 blue ear disease outbreak that caused a sharp drop in pork production. Pigs dying *en masse* from the disease are a big problem for producers. Even if the state reimburses farmers 80 yuan (€10) per swine for proper disposal, some seem to find it easier to toss their dead animals in the river. Shanghai residents were surprised in March when the bodies of over 16,000 dead pigs showed up in the nearby waters of the Huangpu River. In April, another hundred deceased pigs were found floating in the Liuyang River in Hunan province. Some news reports claim diseased swine have also been butchered and sold for consumption.

Despite efforts to ramp up meat production in China, the country has failed to keep up with meat demand. Meat imports have risen sharply in recent years. In 2006, China imported as much meat as it exported. In 2011, meat imports were three times higher than meat exports.

Meat consumption in China, kg per person



Source: FAO

Bird flu concerns mainly affecting the Shanghai region. Products containing commercially raised poultry have been removed from hotel and school menus, and demand for chicken in particular has dried up. The international fast food chain KFC (Kentucky Fried Chicken) reports that fears related to the H7N9 flu virus have caused a major loss of business at its outlets. Share prices of many big Chinese food producers have also dropped. Some Chinese firms have asked their workers to avoid travel. Nevertheless, no panic over an impending pandemic has occurred. Nearly all cases so far have been limited to the Shanghai region.

The World Health Organization (WHO) reports 128 laboratory-confirmed cases of H7N9 and 26 deaths as of Thursday (May 2). The single case outside China in Taiwan involved a person who had recently travelled to China. The number of infected individuals is still very small compared to previous epidemics. For example, the SARS coronavirus epidemic resulted in 5,328 cases in China with a total of 349 fatalities. The initial pandemic of the novel H1N1 flu virus in 2009 that was first identified in Mexico, ultimately infected about a hundred thousand Chinese in its first wave. H1N1 cases are still reported in northern China. Official figures in China likely underreport the incidence of flu; most cases (even flu-related deaths) never make it into the official statistics.

In the current novel H7N9 flu outbreak, Chinese public health officials have been praised for their swift response and transparency. Officials clearly learned lessons from the SARS epidemic, which started with officials initially denying the outbreak altogether, thereby allowing infected individuals to travel internationally and making containment of the epidemic extremely challenging. In the current instance, international experts have been involved from the start. WHO experts are on site trying to identify reservoirs and vectors of the virus. The WHO posts infection [updates on its website](#).

Health officials believe transmission of H7N9 between people is very rare. Although the origins of the virus are still unclear, studies are currently focused on commercial poultry operations and producers have been asked to operate with due caution. Officials note that since poultry markets in Shanghai have been shut down, the spread of the disease in the region has slowed. With the virus apparently isolated, the WHO is not calling for increased border inspections to prevent the spread of H7N9. The situation could change if the virus mutates. Human-to-human spread would increase the risk of a global pandemic, as was the case when SARS virus cases began to show up outside China.

Russia

Gazprom's eroding dominance in Russia's domestic gas market. Russian natural gas production dropped slightly last year to a level of 655 billion m³. Gazprom's share of Russian gas production also continued to slip, falling to around 74 %. Just a decade ago, Gazprom still accounted for 88 % of Russian natural gas production. In recent years, privately held gas producer Novatek and several oil companies in particular have increased their contribution to domestic gas production. Gazprom's biggest emerging competitor on the domestic market appears to be the state-owned oil giant Rosneft, which has announced plans to more than double its current gas production by 2020. According to a Rosneft strategy paper, production growth is largely limited at the moment by the lack of access to trunk and distribution pipelines owned by Gazprom. Gazprom only grants other producers the possibility to transmit their gas via its pipelines on a limited basis.

There has recently been an active discussion on the status of Gazprom in the Russian economy. Several gas producers are seeking to challenge Gazprom's export monopoly by constructing LNG export terminals in the Arctic and on the Pacific coast. Gas producers (particularly Rosneft) are also demanding greater access to Gazprom's pipelines or a break-up of Gazprom's production and transmission functions into separate corporations. The investigation launched last autumn by the EU anti-trust authority into whether Gazprom has abused its dominant market position is also challenging Gazprom's traditional operations model.

By production volume, Gazprom is the world's biggest exchange-traded gas producer. Because Gazprom plays a major role in the Russian economy, plans to reform it are difficult to implement. *Forbes* magazine ranks Gazprom as the world's 17th largest listed company. The next largest Russian company in the *Forbes* rankings is Rosneft at 59th place. Gazprom's high ranking reflects its eye-popping profits. The company's declared profit for 2012 was \$40 billion, the third highest of all international firms after Exxon Mobil and Apple. Gazprom's profits are also huge relative to the size of Russia's economy; Russia's federal budget revenues in 2012 totalled about \$420 billion.

Gazprom's 2012 profits, however, shrank nearly 10 % from 2011. The financial result was mainly hurt by lower sales volumes, which declined in 2012 by about 7 % to 482 billion m³. Over half of the gas volume supplied by Gazprom went to Russia's domestic market.

Gazprom reports that its average prices last year were €71 per thousand cubic meters for Russian customers, €35 for customers in the CIS area, and €97 for customers elsewhere in Europe. As there is no spot market pricing of

gas supplied by pipeline, prices paid by European energy companies to Gazprom vary considerably from country to country. Media reports suggest that the ultimate price of gas including transmission costs ranged from \$313 to \$564 per 1,000 m³ in the first half of 2012 depending on the buyer.

Privatisation of Russia's VTB Bank continues. Russia's second largest bank, VTB Bank, held a share emission on the Moscow Exchange at the end of April. Post emission, state ownership in the bank shrank from 75 % to 61 %.

The additional capital raised from investors should help VTB continue the strong growth it has enjoyed during the past few years. VTB has grown through acquisitions of several banks in Russia and abroad. VTB Bank is part of the VTB Group, which includes the VTB24 Bank that serves households and small businesses. VTB24 has witnessed explosive growth and now is Russia's fifth largest bank both in terms of total assets and lending.

The Russian government's target for the VTB share offering was to increase the bank's capital base by at least 100 billion rubles (€2.5 billion), while retaining at least a 60 % stake in the bank. VTB said that the emission was fully subscribed, with over half of the subscribed shares going to just three investors: Qatar Holding, Norway's sovereign wealth fund manager Norges Bank Investment Management and the State Oil Fund of Azerbaijan.

VTB Bank IPO on the London Stock Exchange in 2007 involved the sale of 15 % of the bank's shares. Another 10 % of shares were sold on the London and Moscow stock exchanges in 2011. Under the Russian government's privatisation programme, the state hopes to divest all of its VTB holdings by 2016.

VTB holds the majority stake in Russian Commercial Bank (RCB), which operates in Cyprus and mainly serves Russian clients. Bank operations have been complicated by the limits on capital exports imposed by Cypriot officials. Russian finance minister Anton Siluanov announced last month at the G20 meeting in Washington DC that Russia is ready to renegotiate the terms of the €2.5 billion loan that Russia granted to the Cyprus government in 2011, provided that RCB's assets in Cyprus are released. Siluanov reported that talks on the matter continue.

RCB's share emission and dividend policies have raised eyebrows in some quarters. In 2009, RCB arranged a directed emission for a company owned by VTB Group's upper management. The emission raised \$39 million for a 40 % stake in RCB, which earlier had been fully owned by VTB. Less than a year later, RCB distributed \$130 million in dividends to its shareholders. While the size of the 2010 RCB dividend was never released, RCB reportedly paid out dividends of \$100 million to shareholders last year. RCB does not release precise information on the entities or persons who own the 40 % share of the bank that was sold off.

China

Full convertibility of Chinese yuan coming soon? On Monday (May 6), the State Council announced plans to release later this year a specific set of measures and timetable to increase yuan convertibility. Greater yuan convertibility basically means that controls on capital flows into and out of China will be relaxed. Convertibility is essential in promoting international use of the yuan. Although the announcement of specific measures and targets was significant, it was hardly surprising. International use of the yuan has gradually been liberalised during the past few years and a number of administrative agencies have already signalled that the government's goal is to achieve full yuan convertibility by the end of 2015.

When restrictions on capital movements are eased step by step, opportunities to circumvent remaining capital controls increase. Indeed, this seems to be precisely what is happening in China as capital inflows increased substantially during the first four months of this year. The State Administration of Foreign Exchange (SAFE), which operates under the auspices of the central bank, last week declared it was imposing limits on bank lending in foreign currencies. Commercial banks currently have lent about double the amount in foreign currency as they hold in foreign currency deposits. Corporations have been enthusiastically piling on foreign currency debt as the yuan is expected to appreciate further. Chinese officials have also stepped up monitoring of firms engaged in foreign trade. By overstating export prices, export firms are believed to be sneaking capital into China and evading capital controls.

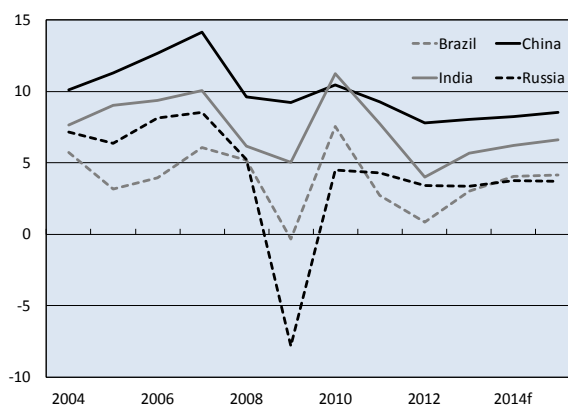
Large forex inflows have forced the People's Bank of China to buy up foreign currency to dampen yuan appreciation pressures. As forex purchases increase the supply of yuan circulating in the economy, the PBoC this week announced that, after an 18-month break, it would resume issuing of bills to soak up liquidity and slow money supply growth.

Solid consumer and investment demand in China driving growth of the global economy. The IMF's latest [World Economic Outlook 2013](#) suggests the outlook has deteriorated both in developed and emerging economies. However, outlook looks brighter for next year as growth returns to the euro zone and the US recovery finds stable footing.

The IMF outlook cuts its growth forecast for China and now expects growth to hold at around 8 % this year and next. Achieving sustainable, balanced growth requires increase in the share of consumer demand. Chinese investment as a share of GDP is exceptionally high by international standards.

The IMF would like to see China focus more on risks created by rapid credit growth and take measures to deal with its overcapacity in certain industrial sectors. However, it will not be easy to curb lending growth in the midst of a major structural change of the financial system. About half of all new lending in China now takes place outside more tightly regulated traditional bank lending channels, and is thus partly immune to regulatory measures.

GDP trend and forecast 2013–2015 for BRIC countries, %



Source: IMF World Economic Outlook 2013

Trade between China and North Korea has soared in recent years. China's imports from North Korea increased 70 % a year during 2011–2012 in certain product categories of metal, energy and transport vehicle production. At the same time, China's exports to North Korea grew annually by nearly a third. Coal constitutes the bulk of China's imports from North Korea, while its exports are dominated by petroleum products. China, by far, is North Korea's largest trading partner. Observers estimate that China accounted for over two-thirds of North Korea's foreign trade last year.

The rapid growth in trade between China and North Korea since 2010 has increased suspicions that North Korea is circumventing international sanctions by routing trade through China. The UN and several member countries have imposed trade sanctions on North Korea over the past decade. Sanctions were significantly tightened in 2010 after North Korea shelled a nearby South Korean island. Following the incident, Japan and South Korea pulled back sharply from foreign trade with North Korea. It appears that North Korea has managed to make up part of the lost trade by turning to China.

Recent events in North Korea have pushed China to taking a harder line towards North Korea. Under the guidelines laid out by China's transportation ministry, the new UN ban on military material shipments will be enforced and it has added several new North Korean firms to the sanctions list. In addition, the Bank of China has closed the accounts of a North Korean bank.

Russia

Russia's employment hits record high. The number of people working in Russia has hit its highest level for two decades. As of March, Russia's employed included 71 million people, nearly a million more than a year earlier. The number of unemployed persons was down by nearly 500,000 from a year ago and by 1 million from two years ago. Using the methodology of the International Labour Organization (ILO), the number of unemployed in Russia in March was 4.3 million.

The share of unemployed people in the overall labour force has declined in the past year to a record low of 5.7 % as regards the season, down from 7 % two years ago. The number of part-time and furloughed workers remains low. Unemployment still falls more on the young. At the end of last year, persons 20–24 years old accounted for over 20 % of all unemployed. The unemployment rate for young people was 13 %, a level unchanged from a year ago.

Russia's rising employment has helped increase the size of the labour force (employed and unemployed individuals combined) by more than 500,000 persons since March 2012. Not only have the unemployed found jobs, but a sizeable chunk of the population that have been outside the labour force and are beyond the official retirement age has been drawn into the labour force. The number of all people outside the labour force who say they are willing to work has stabilised.

Observers note that Russia's labour force could become a bottleneck that may stifle economic growth even at the stage where demand begins to recover.

Russia's labour force, employment, and unemployment (millions of persons, 12-month average)



Source: Rosstat

Wages in Russia still rising rapidly, but high inflation erodes purchasing power.

On-year growth in wages has

largely remained in the range of 10–15 % since late 2009. In March, the average Russian monthly wage as reported in official statistics was just under 29,000 rubles (€720), an increase of 11.5 % from a year earlier. Growth in real wages (actual purchasing power) has slowed considerably from last year due to rising inflation. Real wage growth in March was slightly above 4 %, which has been reflected also as a slowdown in consumption growth. According to the latest survey published by the Central Bank of Russia, however, income expectations of households brightened in the first quarter, possibly a signal of stronger consumption coming later this year.

Despite slowing Russian economic growth, inflation accelerated in the first four months of this year. Consumer prices in April were up 7.2 % y-o-y, and the CBR estimates that inflation continued at the same pace in the first half of May. At its monthly monetary policy meeting, the CBR board decided to leave short-term interest rates unchanged, while lowering slightly its key longer-term rates.

Housing prices seem to be stabilising in Russia. Rosstat reports that the average price for residential apartments (measured in square metres of living space) in the first quarter of this year rose by slightly more than 1 % q-o-q, while prices of older apartments declined nearly 2 % q-o-q. In Moscow prices continued to climb fairly briskly in the first quarter, but analysts estimate that in past weeks Moscow housing prices have witnessed a slight drop.

In recent years, housing prices in Russia have risen quite rapidly and are close to record levels. Now pressure for further price increases has begun to abate with many people priced out of the market, increased consumer unwillingness to commit to large purchases due to higher uncertainty and rising interest rates on housing loans. In March, the annual growth rate of new housing loans was still 20 % and the average interest rate was 12.9 % p.a.

Housing prices vary considerably in Russia from region to region. The highest prices are in Moscow and St. Petersburg. Rosstat reports that in January–March the average price for residential apartments was just over 160,000 rubles (€4,000) per square metre in Moscow and 90,000 rubles (€2,300) in St. Petersburg. If housing costs are adjusted to wages, the most expensive regions to live in are the City of Moscow and the surrounding oblasts, as well as the City of St. Petersburg. In wage-adjusted terms, the most affordable housing is found in resource-rich regions in the north and Far East. A Muscovite's average monthly wage is sufficient to purchase 0.3 m² of apartment, while the average monthly wage in Russia's relatively most affordable housing market, the Yamal-Nenets autonomous region (the centre of Russian natural gas production in western Siberia) buys 1.2 m² of apartment. In Finland, the average monthly wage is sufficient to purchase about 1.5 m² of apartment (national average).

China

China's latest economic figures offer little indication that growth is picking up. The National Bureau of Statistics reports that retail sales, an indicator of domestic consumer demand, rose at the same pace in April as in the previous three months of this year. On the other hand, the April reading of the service sector purchasing manager index (PMI) suggests slowing economic growth. Growth in fixed capital investment remained at the same pace as in previous months and industrial output growth picked up slightly. However, the short-term outlook does not seem particularly bright, as the manufacturing PMI showed growth in domestic orders had slowed and export orders had declined.

After three decades of high growth, China's leaders seem ready to live with lower growth rates. The state has refrained from applying the usual stimulus measures, and this week premier Li Keqiang said he wants to see growth supported by market forces rather than state intervention.

Foreign trade data suggest evasion of capital controls.

China's foreign trade figures show 12-month growth accelerated in April to 15 % and import growth rose to 17 %. In the first four months of this year, the value of exports was up 17 % y-o-y and the value of imports increased 11 %. Rapid export growth was reflected in a ballooning trade surplus of \$62 billion in the first four months of 2013 (\$20 billion in the first four months of 2012).

Chinese exports to the EU, US and Japan continued to decline in April, mirroring the ongoing struggles in the global economy, particularly Europe. The loss of exports was compensated for with booming growth in exports to Hong Kong and Taiwan. Growth in imports from the US was robust for the second month in a row. Moreover, April imports also from Europe were finally up, alleviating worries over China's slowing economic growth. Political disputes continued to depress imports from Japan.

The biggest worry surrounding China's recent trade statistics stems from inconsistencies between mainland Chinese figures that show strong export growth to Hong Kong and Hong Kong's more modest assessment of import growth from mainland China. Up to autumn 2011, when yuan use as an instrument of payment in foreign trade was expanded to cover all of China, the difference between China's official figures for monthly exports to Hong Kong were typically less than \$5 billion above Hong Kong's official figures for imports from the mainland. Over the past 18 months, however, the gap has widened dramatically, and reached \$28 billion in March. The growing disparity does not stem from the increased turnover of trade between Hong Kong

and mainland as the differences have grown also in relation to trade flows.

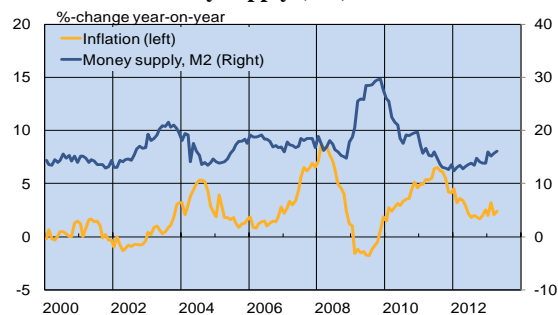
The statistical disparity suggests that companies import capital into China by exploiting foreign trade pricing. As China's capital markets have been gradually liberalised, companies have learned to exploit loopholes and grey areas in the law to get funding and seek out higher-yield investments. Chinese and Taiwanese trade figures also suggest that foreign trade is being used as a means to channel capital out of China.

The use of foreign trade as a way to move capital seems largely restricted to Hong Kong and Taiwan at the moment, but there are signs that the phenomenon could be spreading. In many countries that earlier eased their capital controls, similar patterns in capital movements have been seen. If the widening gap in foreign trade figures reflects increased capital movements and the situation persists, interpretation of Chinese trade and current account figures could become problematic. As a guesstimate, the figures for 2013 suggest that perhaps over a third of China's trade surplus consists of capital imports.

Rising food prices drive CPI, even as inflation pressures are otherwise modest. April consumer prices rose 2.4 % y-o-y, up slightly from March. An on-year increase of 4 % in food prices was the biggest reason for the pick-up in inflation. There have been sharp fluctuations in food prices in recent months. Prices of vegetables spiked in April. Food makes up about a third of China's consumer price index. Prices of non-food goods continued to rise modestly.

Slowing economic growth, falling global commodity prices and an accompanying fall in producer prices have generally helped to relieve inflationary pressure. The current situation potentially offers political decision-makers an opportunity to reduce some of the price regulation of domestic markets. On the other hand, the PBoC reported that growth in the broad measure of the money supply (M2) accelerated in April to 16.1 % y-o-y, well above the official 13 % target for this year. Higher than targeted money supply growth might add inflationary pressure in the future.

Inflation and money supply (M2)



Source: Bloomberg

Russia

Russian municipalities get most of their funding from federal and regional budgets. A recent brief from the finance ministry notes that about 60 % of revenues to municipalities last year were provided in the form of transfers and subsidies from federal and regional-level budgets. The rest was raised through taxes, fees and other forms of revenue. Tax revenues as a share of total revenues varied tremendously from municipality to municipality, however. The aggregate budget of local administrations was slightly in the red last year.

The most important source of tax revenue for municipalities was Russia's 13 % personal income tax. The tax, which has a flat rate set by the federal government, last year accounted for 70 % of municipal tax revenues. Revenues from personal income tax initially go to regional budgets, after which at least 20 % must be transferred by the region to its municipalities.

The most significant municipal taxes are the land tax and the tax on personal property. These two taxes last year accounted for about 15 % of the tax take of municipalities on average.

Municipalities are responsible for providing basic services such as primary schools and health care, as well as certain social services. The largest expenditure category for local governments is education, which last year accounted for 41 % of total spending. Other major spending areas included housing (15 %), administration (9 %), social policy (9 %), health care (5 %) and culture (5 %).

Gazprom refunds \$3.3 billion to European customers after readjusting its pricing scheme. Gazprom's revenues from gas sales to its non-CIS customers amounted last year to \$47.3 billion after export duties. The refunds on gas supplied in 2010 and 2011 are part of negotiated price settlements for long-term supply contracts between European gas buyers and Gazprom.

The German E.ON and the Italian Eni reached deals with Gazprom on reducing their gas prices last spring and summer. Gazprom also agreed to lower prices by about 10 % for its French, Slovak and Austrian customers. Some other gas importers such as the Czech RWE preferred to haul Gazprom into arbitration court to ask for modifications to what they see as unconscionable contract terms that require them to pay for a specified amount of gas for a given supply period even if they do not need the full amount stated in the contract. The RWE-Gazprom case is pending.

Gazprom had to refund less than it had initially expected because some of its customers had swapped lower prices for more flexible payment terms or smaller supply volumes.

Analysts expect Gazprom this year will again be on the hook for a similar amount of refunds.

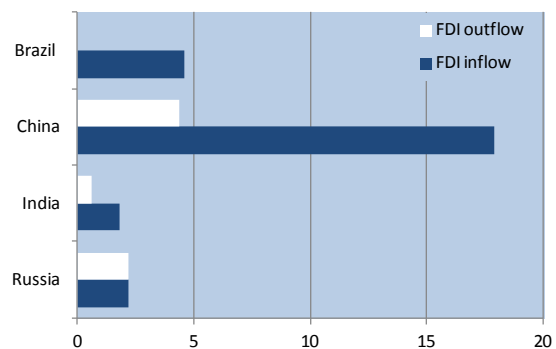
Russia accounted for about 2 % of global FDI flows last year. The latest [OECD figures](#) on investment flows show that just over \$30 billion in foreign direct investment flowed into Russia last year, a slight decline from 2011. Russia's share of global FDI inflows has declined in recent years by about half from its 4 % pre-crisis peak in 2008.

The biggest destination of global FDI flows last year was again China, which surpassed the US in 2011. Nearly a fifth of all global FDI flows went to China last year. Direct investment inflows to Brazil in 2012 were about double that of those going to Russia, while FDI to India was slightly less than the amount going to Russia.

The OECD also noted that Russia's FDI outflows amounted to just over \$30 billion, a substantial decline from 2011. Russia's share in global outward FDI has declined slightly in recent years and was about 2 % last year. Outward FDI flows from China rose to represent around 4 % of global investment. The United States remained the world's top source country of FDI, accounting for about a quarter of all global FDI outflows.

Unlike most mid-income countries, FDI outflows from Russia have exceeded FDI inflows to Russia in recent years.

BRIC shares of global FDI flows in 2012 (%)



Source: OECD

Central Bank of Russia figures show that the biggest net FDI inflows to Russia last year came from Luxembourg, the Netherlands and Ireland. Investment inflows from Cyprus, earlier Russia's top provider of FDI, contracted sharply.

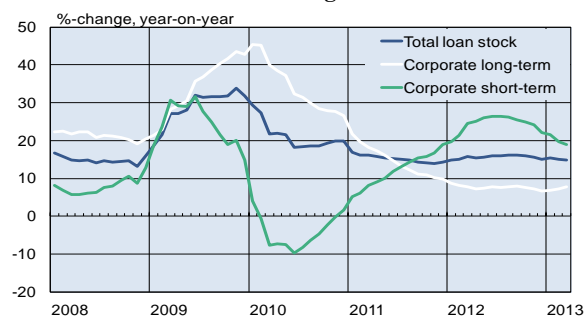
The biggest destination for Russia's FDI outflows in the first nine months of 2012 was still Cyprus. Turkey's status as a Russian FDI destination rose to second place for the first time.

China

Structure of corporate borrowing shows signs of improvement in China. The slowdown in the growth in short-term corporate borrowing that began in 2012 has continued this year. Growth in long-term borrowing, in contrast, has accelerated slightly in recent months. Over half of corporate borrowing is in the form of long-term loans. The loan stock structure is changing, as the volume of short-term loans still continues to grow faster than long-term loans but that growth is slowing.

The persistently increasing dependence on short-term borrowing has raised questions about the sustainability of corporate finances in China. Reliance on short-term debt to fund long-term projects is risky for firms if their access to funding suddenly dries up. Thus, most observers see the current slowdown in growth in short-term corporate borrowing as a positive trend that enhances stability of the financial system and contributes to sustained economic growth. Acceleration in growth in long-term lending may also indicate a larger appetite for new corporate investment. Growth in the loan stock remained around 15 % in April. The stock of yuan-denominated loans is now around 66.5 trillion yuan (€8.4 trillion), or 130 % of GDP. Growth of the loan stock has outpaced GDP growth in recent years. Corporate loans account for about 70 % of total lending in China.

Trends in Chinese bank lending



Sources: Macrobond, CEIC, BOFIT

Despite a challenging operating environment, most US companies in China are turning a profit. According to the [2013 White Paper](#) of the American Chamber of Commerce in China (AmCham China), which is based on a survey at the end of 2012, most of its 325 member companies operating in China see demand for their products and services continuing to rise. Over 70 % of respondents said China's domestic markets were their main reason for being in China; only about 20 % said they produce products for export.

American firms said they planned to keep investing in China, but said slowing economic growth and barriers to market access had reduced their willingness to invest. Firms

also perceived themselves to be in a weaker competitive position than local firms. State-owned enterprises, for example, receive financial subsidies and local Chinese firms have an easier time getting the required licences to operate their business.

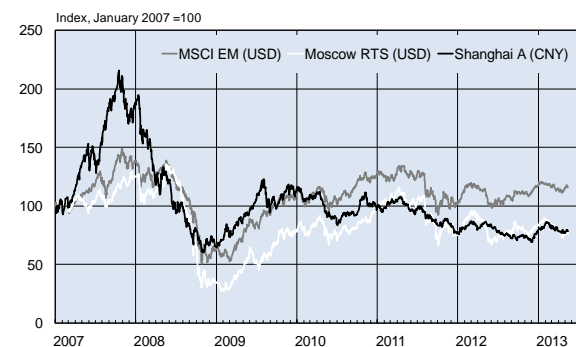
The rising cost of labour was the main reason that over 10 % of respondents cited for their decision to move their production operations out of China in 2012. In addition, US firms complained that it is getting harder to find qualified employees in the Chinese labour market. Corporate profit margins have narrowed as competition has increased, but the profit margins in China of over 40 % of the multinational respondents were still above their global average. Production in China is still profitable and nearly 80 % of respondents report that their operations are profitable.

China's goal is to create an operating environment conducive to corporate innovation that promotes productivity gains. China's new laws to protect intellectual property rights and proprietary technologies went into force last year, but over 70 % of the responding US firms felt that the laws were still ineffective (the share arose from about 60 % in 2011). Uncertainty over legislative amendments and theft of intellectual property were seen as growing threats.

Shanghai shares flat for the year. After rising in December and January, Chinese share prices began to drop in February. The Shanghai A-share index has lately clawed its way back to near the level it started the year. Shares remain depressed by lower growth forecasts for China, as well as ongoing fiscal struggles in Europe and the United States.

China's other big stock exchange, the Shenzhen stock exchange, has tracked a similar trend as the Shanghai exchange. The main indices for both rose in recent weeks but the rebound on the Shanghai exchange was more muted. Some observers see share prices in China buoyed recently by statements from the new leadership on structural reforms designed to support economic growth. The trends on China's stock exchanges this year have tended to follow stock markets in other emerging economies.

Shanghai A, Moscow RTS and Morgan Stanley Emerging Markets indices



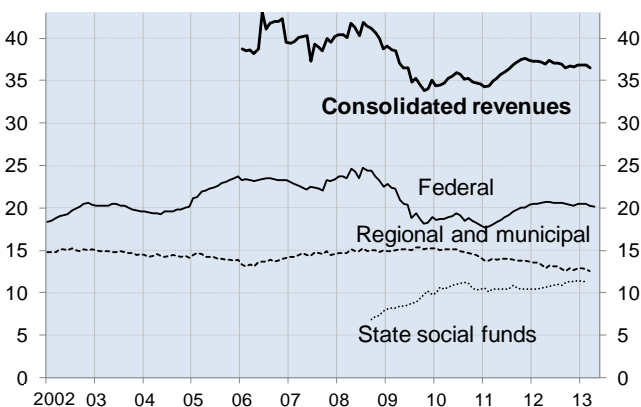
Source: Bloomberg

Russia

Russia gradually takes into account the impact of lower growth on government finances. The finance ministry recently noted that federal budget revenues this year would be slightly above their earlier forecast made last autumn as long as the oil price assumption used to calculate the budget matched the increased oil price 2013 average projected by the economy ministry this spring (Urals-grade crude \$105/bbl). Finance minister Anton Siluanov says revenue projections may have to be revisited, given the substantial cut e.g. in the GDP growth forecast. Both the finance ministry and the accounts chamber (which audits the budget) note that this year's budget amendments taken to the Duma (including allocating a share of spending while keeping the overall expenditures unchanged from the original budget) are based on revenue projections that do not incorporate the lowered forecast.

The finance ministry is preparing a new budget estimate for the medium-term based on the spring economic forecast. The ministry preliminarily sees federal budget revenues declining as a share of GDP to 18 % in 2015 from a current level of 20 %. The relative decline in revenues mostly comes from low growth in income from production taxes and export duties generated by the oil & gas sector. Siluanov notes that this lower revenue growth and compliance with the budget rule adopted at the start of this year means that spending in the contingent category must be trimmed to levels that bring nominal federal spending growth to 6–7 % a year in 2014–2015. That would keep the budget deficit at 0.6–0.7 % of GDP. Siluanov added that a similar deficit in 2016 makes it very difficult for the government to meet all its spending commitments. The finance ministry's annual medium-term forecast for total consolidated government finances (including regional and municipal budgets and state social funds) is expected this summer.

Government budget revenues, % of GDP (12-month average)



Source: Ministry of Finance

In January-March, consolidated government revenues increased 6 % y-o-y (11 % in 2012). Revenues also rose at approximately the same pace for federal budget and state social funds. The situation appeared toughest for regional and municipal budgets, which saw revenues failing to grow due to reduced transfers from the federal budget.

Draft of 2014–2016 customs policy programme presented to the cabinet. The programme envisages import duties to be gradually reduced over an average transition period of three years to levels that meet Russia's WTO commitments. At the end of 2012, after Russia gained WTO membership, the average tariff on imports from non-CIS countries fell from 9.9 % to 8.6 %. The average duty is slated to fall further to 6.4 % by the end of 2016. Russia last year collected 730 billion rubles (€18 billion) in import duties, which accounted for nearly 6 % of federal budget revenues.

The programme emphasises the need for import protection for cars and agricultural products in the future, but with measures compatible with WTO rules. Imports of certain listed goods (e.g. agricultural and paper products, as well as vehicles) will continue to get heightened scrutiny. Protection measures would be invoked if the growth of imports of these products increases so swiftly that it damages domestic producers.

While Russia plans to gradually reduce most export duties, the export duties on e.g. oil, natural gas and raw timber are planned to be kept unchanged for now. These duties could eventually be lowered as Russia's WTO agreement only stipulates the maximum-allowed duty rates. Exports of oil and petroleum products for domestic use in CIS countries are planned to be exempted from duties if those countries commit in writing e.g. to not reselling to third countries.

The customs programme also includes goals for improving the function of customs administration. For example, the time for customs inspections and number of required documents would be reduced under the government's earlier approved "roadmap" and the use of electronic documentation increased.

The programme tackles operational development of the Russia-Belarus-Kazakhstan customs union. Particular attention is given to speeding up decisions on anti-dumping and other special protection measures. These measures are currently entirely in the hands of the customs union and typically take 5 to 9 months for a decision to be reached. The programme mentions that Russia should actively monitor its interests during Kazakhstan's ongoing WTO negotiations. The rates for about half of the duty categories Kazakhstan has committed to at this point are lower than those in Russia's WTO agreement. Over longer term, Russia hopes to expand the customs union. Preparations for Kyrgyzstan's accession are under way and Tajikistan has expressed interest in joining.

China

Trade policy disputes strain China-EU relations. Chinese premier Li Keqiang warned the EU about its recent decisions to impose punitive duties on solar panels and telecommunications equipment. Mr. Li said that such duties violate not only the interests of Chinese manufacturers but also European consumers. The trade dispute became a main theme of the Chinese premier's visit to Germany this week. Since last autumn, the EU has been actively preparing to impose punitive duties in response to what it sees as Chinese price dumping of goods at the expense of European manufacturers. The EU is expected to soon reach a decision on whether to move ahead with sanctions. The US has already imposed protective duties on Chinese solar panels.

China's solar panel manufacturers invested heavily in recent years only to be crippled with serious overcapacity problems exacerbated by diminished export prospects in Europe, where demand has been hurt by the financial crisis and austerity policies. Chinese solar panel producers have attempted to reduce their inventories by stepping up domestic sales and discounting solar panel prices in Europe. Chinese officials consider smoothing the situation by providing additional measures to boost domestic sales such as lowering the costs of hooking up a solar panel collection field to the electrical power grid and paying direct subsidies to companies that produce solar-generated electricity.

While the solar panel dispute seems likely to continue, the fight over telecommunications equipment seems likely to be resolved. The EU has yet to move ahead with preparing anti-dumping sanctions, and EU leaders have faced substantial blow-back from EU telecommunications equipment manufacturers. Both the Swedish Ericsson and the Finnish-German Nokia-Siemens have opposed protective duties. China plans to invest heavily in its own networks in the coming years, and large European telecom equipment manufacturers fear that a trade dispute would hurt access of European firms to China's growing telecom equipment market.

FDI inflows to China up slightly in the first four months of the year. The flow of foreign direct investment into China in January-April rose 1.2 % y-o-y. The Ministry of Commerce reports that FDI inflows in the first four months of this year totalled \$38 billion. FDI growth was in line with the government's target for the year. FDI inflows contracted by nearly 4 % in 2012, but China has encouraged FDI recently by reducing red tape facing foreign investors. This month, China's State Administration of Foreign Exchange (SAFE) simplified FDI rules to make it easier for foreign firms to open bank accounts and transfer funds to China.

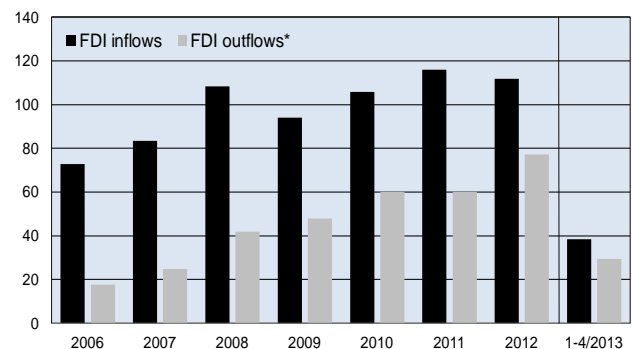
The reform is part of China's ongoing deregulation of capital movements. SAFE's previous round of rule-easing for FDI took place in December 2012.

The industries targeted by FDI inflows to China have been shifting, with an increasing share of investment this year going to the service sector. Although the real estate sector's share of FDI inflows has bounced around in recent years, it held fairly steady at around 21 % in the first four months of the year. Businesses involved in wholesale and retail sales received nearly 10 % of FDI inflows. About 43 % of total FDI inflows went to manufacturing sector, and especially the share of investment channelled to the textile and electronics industries has been falling for several years and is now down to 7 % altogether. This year's figures reflect that rising production costs in China are driving investment in these sectors to lower cost countries.

Particularly high growth in FDI inflows was registered for Japan, the United States and EU countries. Hong Kong accounted for nearly 60 % of total FDI inflows to China, but it should be noted that investments from mainland Chinese and some foreign firms are channelled through Hong Kong to China. Investment flows from Singapore, South Korea and Taiwan contracted at the start of the year, but still represented about 10 % of FDI inflows.

The Ministry of Commerce reports that direct investment abroad by Chinese firms increased over 27 % y-o-y in the first four months of the year to nearly \$30 billion. Growth this year has been running well ahead of the government's target of 15 % growth for 2013. Chinese firms import a large share of raw materials and basic commodities from abroad, and the bulk of FDI outflows go to exploitation of natural resources. While the largest share of outward-bound FDI went to Asia, the Chinese are also investing heavily in extraction of natural resources in Latin America.

Direct investment flows to and from China (US\$ billion)



*) Does not include financial sector investments

Sources: China's Ministry of Commerce and CEIC

Russia

Russian inflation accelerated to 7.4 % in May. The slight acceleration in 12-month consumer price inflation came as a surprise to many; the central bank and the economy ministry had expected inflation to fall after April.

The pick-up in inflation was largely driven by higher food prices and higher costs related to housing services and utility rates. Food prices were up over 9 % y-o-y, while housing-related costs increased 10 %. Prices of baked goods rose 17 % y-o-y, fruits and vegetables 19 %, natural gas rates for residential housing 14 %, water 12 % and heating 11 %.

Russian 12-month inflation, % change, Jan. 2011 – May 2013



Source: Rosstat

The economy ministry is considering various measures to cut inflation, including the possibility of reducing the size of planned hikes in regulated wholesale prices for gas over the next few years. In recent years, the wholesale gas price has been hiked 15 % a year, but now the economy ministry is considering raising the gas price much less, one of the options being a hike of only 5 % a year.

The economy ministry also says that restraining the rise in gas rates could promote economic growth. The government is currently looking into president Putin's request to find ways to stimulate growth. Some analysts note that the impact of smaller gas rate hikes could, however, reduce investment in the gas sector (mainly by Gazprom), which represents a significant share of all public investment.

The economy ministry will present its final proposal on gas rates to the cabinet next autumn.

President Vladimir Putin calls for faster progress in eliminating cross-subsidies in the electrical power sector. Under Russia's current electricity pricing arrangement, households pay rates that are below production costs for power generation. The cheap electricity of households is offset by charging higher rates to companies. Cross-subsidisation under the current "last mile" model has even increased in recent years. Last year the government paid out cross-subsidies of 220 billion rubles (€5.5 billion). Energy

minister Alexander Novak said his ministry has prepared a proposal on a mechanism to reduce cross-subsidies to just 50 billion rubles by 2022. All cross-subsidies could be eliminated by 2030.

The Russian president noted that present arrangement mainly harms small and medium-sized enterprises, which, unlike big firms, have no possibility of buying power directly from the national grid, building their own power plants or shifting production to regions with cheaper power.

Putin emphasised that reducing cross-subsidies should not lead to unreasonably high costs in electricity for SMEs or households. The social impacts of the final solution will be studied for regions around the country. Measures to reward energy efficiency will also be added.

Ukraine reaches cooperation deal with Russia-Belarus-Kazakhstan customs union. On May 31 in Minsk, Ukraine signed a preliminary agreement with the highest body of the Russia-Belarus-Kazakhstan customs union, the Eurasian Economic Commission, under which Ukraine will have observer status when the Eurasian Economic Union launches in 2015. The EEU is a more developed form of the existing customs union, and initially has Russia, Belarus and Kazakhstan as its members.

Ukraine has long sought a cooperation arrangement with the customs union, but Russia has refused to grant it on the grounds that the customs union charter does not mention observer members. Under a compromise deal, Ukraine can sit in as an unofficial observer member before the EEU launch.

Observer status will let Ukraine participate in all customs union activities, including meetings of the Commission and working groups, access to the same information as customs union members and present proposals to customs union bodies.

Russia has maintained a long-standing invitation to Ukraine to join the customs union, including promising Ukraine the same large discounts of natural gas that other members enjoy. In recent years, Ukraine and Russia have had ongoing gas pricing and supply disputes. Ukraine roughly pays about the same price for gas as customers in Western Europe. Ukraine would like to get gas at the same low prices as enjoyed by Belarus, which pays about the same price as Russian domestic prices plus transmission costs.

Ukraine has pushed the idea of joining the EU for years, while at the same time pursuing the benefits of the Russia-Belarus-Kazakhstan customs union. The EU and Ukraine have agreed in principle to formation of a free-trade area, but there are obstacles to clear before any final agreement is reached. The EU claims that Ukraine cannot simultaneously participate in the EU free-trade area and the Russia-Belarus-Kazakhstan customs union. Ukraine could only join the EU free-trade area after all customs union members agree to free trade with the EU.

China

EU imposes anti-dumping tariffs on Chinese solar panels; China investigates countermeasures. The anti-dumping tariffs imposed by the EU this week are set to remain in force for six months, unless China and the EU resolve the dispute earlier. A levy of 11.8 % of the solar panel's price will be charged during the first two months of the sanctions. Thereafter it will rise to 47.6 %. The United States already imposed anti-dumping tariffs on Chinese solar panels last year.

The problem emerged after the Chinese government subsidised its solar panel sector to the extent that the industry now suffers from massive overcapacity. Chinese solar panel makers have attempted to reduce their inventories by selling panels at discount prices abroad, which is seen as a threat by non-Chinese solar panel manufacturers. Some observers report that Chinese firms are moving their plants to Malaysia to get around the anti-dumping tariffs. Immediately after the EU announcement punitive tariffs on Chinese solar panels, China announced it was looking into imposing anti-dumping tariffs on wine produced in Europe.

Latest PMI reading gives no clear sign about near-term prospects for Chinese manufacturing. China's latest official manufacturing purchasing manager index suggests that manufacturers have a largely neutral view of their near term prospects with the PMI ticking upward slightly from 50.6 in April to 50.7 in May. An index value above 50 indicates that purchasing managers expect improving conditions relative to the previous month.

In contrast, the PMI published by the HSBC Bank, which is based on a smaller number of respondents, saw its outlook for manufacturers weakening in May. The HSBC PMI reading for manufacturing fell from 50.4 in April to 49.2 in May. The reading was the lowest in seven months, which caused concern in the markets that China's economic growth next year may underperform current forecasts.

Both PMI readings saw new export orders falling in May on weaker foreign demand. The main reason for the difference between indices arises from the development of domestic orders. The HSBC PMI showed domestic orders began decrease in May, while the official index showed the volume of domestic orders continuing to grow. The size of companies surveyed may explain the differences in the index readings; large companies might have benefitted more than small companies from China's recent credit expansion. The official index has emphasis on large firms, while the HSBC index is weighted more to small and medium-sized firms.

The May situation in the service sector was largely unchanged from the previous month. The HSBC PMI for the service sector had a slightly positive reading of 51.2 (51.1 in April), indicating modest growth expectations. The volume of new orders increased slightly from the previous month.

HSBC's combined manufacturing and services sector index showed that total employment fell slightly for the second month in a row in May. Increased labour demand in the service sector made up only partly for weak labour demand in the manufacturing sector.

China emerges as a major trading partner for many Latin American countries. President Xi Jinping spent this week on a tour of Latin America. He began with a visit to Trinidad and Tobago to talk about cooperation in the energy sector. Trinidad and Tobago has large natural gas deposits and would like to find new export markets for its liquefied natural gas (LNG) since the shale gas boom is reducing the US gas imports. China, which is interested in developing natural gas fields in the Caribbean region, promised to build a children's hospital in the capital city of Port of Spain. In Costa Rica, China agreed to provide almost two billion dollars in financing for modernisation of an oil refinery, highway improvements and a public transport project. Mr. Xi is currently in Mexico, after which he travels to the US.

Foreign trade between China and Latin America has exploded in recent years. Latin America overall accounts for about 7 % of China's imports and exports, but many Latin American countries have substantially larger trade relationship with China. For example, 15–25 % of goods exports from Brazil, Chile, Cuba, Peru and Uruguay go to China.

Nearly all countries in the region import significant amounts of goods from China, with China's average share of imports approaching 10 %. The large emphasis on imports means China has a trade surplus with most Latin American countries besides Brazil, Chile, Costa Rica, Peru and Venezuela.

Chinese trade with Latin America, US\$ billion



Sources: CEIC and China customs

Russia

CBR leaves key rates unchanged. At the monthly board meeting of the Central Bank of Russia held Monday (June 10), the board decided to leave unchanged at 5.5 % the minimum rates on one- and seven-day repo auction credit. The CBR again lowered its longer-term credit rates (over 180 days) by 25 basis points for the third time in a row. Long-term credit rates now range between 7.25–7.5 % depending on the quality of the loan guarantee.

Although the central bank has faced strong pressure to lower rates to boost economic growth since late last year, it has so far not budged on its most important steering rates. CBR chairman Sergei Ignatyev has noted on repeated occasions that the current economic conditions present a macroeconomic quandary. On one hand, Russia's healthy employment situation and high inflation would justify stringent monetary policy. On the other hand, however, both the slowing economic growth and an impending decline in inflation would call for a looser monetary stance.

The CBR has over the recent months slightly eased monetary policy by lowering long-term credit rates. There is little actual demand for such credit, however, and the CBR explains the main reason for the rate cuts is to bring the longer-term rates closer to rates of its short-term instruments. The incremental rate realignment is part of CBR efforts to increase the impact of its rate-setting policies in the market.

The CBR board noted that its decision to keep key rates unchanged was based on evidence that inflation has been accelerating. Reading from both May and early June indicated that 12-month inflation was running above this year's inflation target. At the end of May, inflation was 7.4 %. CBR analysts expect inflation to slow in the second half of this year to a level within the bank's 5–6 % target range for 2013. Given that the CBR's key steering rates already have negative yields in real terms, the CBR rates will only be lowered once inflation actually begins to subside.

Much of the credit for the CBR's prudent and independent monetary policy goes to departing chairman Sergei Ignatyev, who steps down on June 23 as he completes his third (legal maximum) term as CBR head. President Putin has tapped Elvira Nabiullina, his current economic adviser and former economy minister, to take over as CBR chairman. Ignatyev has agreed to continue as a senior adviser at the central bank at Putin's request.

No big tax changes ahead: Russian unveils tax policy framework for 2014–2016. The cabinet last week took up its annual tax policy framework discussion by reaffirming several measures it adopted last year. No major changes in tax policy are likely over the next few years. The mandatory social contribution of employers will remain at 30 % of the worker's wage. Russia will keep its flat 13 % income

tax rate in the coming years rather than adopt a more progressive income tax scheme.

Changes, however, are planned for a number of taxes and fees in the oil & gas sector. The government reaffirmed its earlier decision to raise natural gas production fees by over 10 % a year, which has generated a boisterous debate. Starting in 2016, the fee would be based on both the domestic wholesale price for natural gas and export prices of oil and gas. The government wants to reduce the difference in the production fee rates levied on Gazprom and other gas producers. The size of the reduction depends on the extent to which other producers will be allowed to export their gas.

The guidelines are quite general as regards taxation of oil production and oil exports, one possibility being that export duties on crude oil could be gradually lowered while production fees could be increased. The fees, taxes and duties generated by the oil & gas sector constitute a significant share of public sector revenues.

Hikes in excise taxes will continue. The planned increases in excise taxes on various motor fuels are based on the fuel type and grade. As part of Russia's anti-smoking efforts, the government plans to raise the excise tax on tobacco products about 30 % a year through 2016. Annual increases of 20–25 % in the excise tax on alcohol are also scheduled for 2013–2015, but the hike in 2016 would be much more modest. The Russia-Belarus-Kazakhstan customs union limits hikes as it aims at harmonising excise taxes to discourage smuggling.

Further postponing of production at Shtokman gas field. Gazprom deputy board chairman Andrei Kruglov stated at the end of May that development of the Shtokman gas field located 650 kilometres north of Murmansk in the Barents Sea will be postponed due the current upheaval in the world gas market. The gas produced from the Shtokman field was originally planned for export, particularly to the US market. However, US is currently experiencing a boom in production of shale gas and other unconventional gas. Production under the harsh conditions of the Shtokman field would not be profitable at present.

Gazprom CEO Alexei Miller says Gazprom's main markets for LNG are located in Asia and the Pacific Rim, so the company is currently planning an expansion of its LNG terminal on Sakhalin Island, as well as a new LNG facility to be built in Vladivostok. Both facilities would be supplied with gas from currently producing Sakhalin fields and the new Sakhalin 3 fields under development. The exact timing of when Sakhalin 3 production will be inaugurated is still not set.

According to press reports, Gazprom is planning a smaller LNG facility on the Gulf of Finland. The gas would be supplied via the Nord Stream pipeline, and the liquefied gas would be sold to customers in Europe. Gazprom would use the LNG sales to offset lower domestic demand.

China

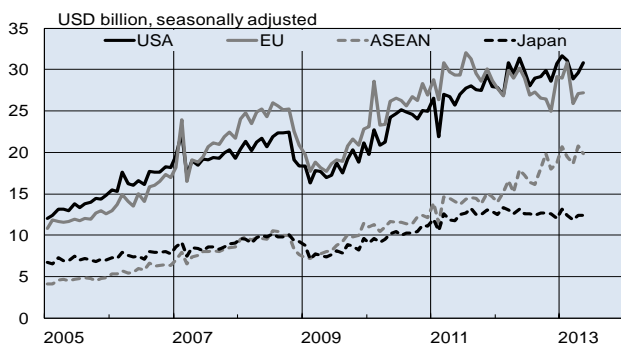
No signs that Chinese economic growth accelerated in May. Just-released May figures from the National Bureau of Statistics show economic growth trending unchanged from previous months. Growth in industrial output held at a modest pace of 9 % y-o-y. Looking at demand-side indicators, growth in fixed capital investment slowed slightly, while growth in retail sales remained basically unchanged from earlier months. Various corporate surveys suggest that growth will continue to be rather slow also in the near future.

China's on-year growth in goods exports slowed in May. However, the interpretation of the foreign trade data is difficult, as some firms apparently have exaggerated their export numbers to circumvent capital controls and move capital back into China. Officials have reacted to the problem and there is evidence that firms have reduced their efforts to evade capital controls for the time being. Chinese goods imports fell in May, while the foreign trade surplus remained at around \$20 billion for the month.

May inflation slowed to 2.1 %, due largely to a slower rise in food prices. The rise in prices of non-food items has remained below 2 % for already about 18 months. Although inflation remains well below the official inflation target of the People's Bank of China, the central bank has been warning all spring that inflation could accelerate later this year.

Given the relatively weak economic figures, a number of institutions over the past two months have lowered their forecasts for Chinese GDP growth this year and next. For example, the IMF and OECD last month dropped their forecasts for 2013 to below 8 %. Most forecasts currently fall into the range of 7.5–8.0 % GDP growth for 2013 and 7.0–8.5 % for 2014. Despite China's relatively low growth by recent historical standards, its leaders do not seem particularly concerned about the situation.

Chinese goods exports to US, Japan, EU, ASEAN countries



Sources: China customs, CEIC and BOFIT

Obama and Xi commit to improving bilateral relations through increased cooperation. China's new president Xi Jinping and US president Barack Obama met in their official capacities for the first time last weekend at a retreat hosted by Obama near Palm Springs, California. The visit of president Xi affirmed the perception that China's new leader is less conservative in his approach to international relations than predecessor Hu Jintao. Much of official décor was replaced with a more laid-back approach. Obama and Xi held free-ranging talks over the two-day visit, discussing mutual challenges facing their nations.

The two leaders agreed to increase military cooperation by establishing regular meetings between their armed forces. *China Daily* reports that China will participate next year for the first time in a US-led joint military exercise. Communication and joint cooperation between the armed forces of both countries are important to maintaining balance in the Asia-Pacific region. China wants to increase its presence in the Pacific in areas where the US has traditionally enjoyed a dominant presence. At the moment, the US military is involved in a shift to the Pacific region, and US arms exports to Taiwan and military commitments with Japan have caused friction between China and the US. President Xi, however, said during his visit that there is room for two great powers in the Pacific.

US-China relations have been frayed in recent months by cybersecurity breaches, particularly hacking focused on stealing sensitive data or disrupting operations of corporations and government agencies. US observers claim that Chinese cyberattacks geared to theft of American technology and proprietary research damage US international competitiveness and national security. Xi gave assurances that China is committed to strong cybersecurity.

The US and China also want to work together on slowing climate change and preventing North Korea from further expanding its nuclear weapons programme. The commitment to reduce carbon dioxide emissions was timely. According to an IEA report released Monday (June 10), China has the highest growth in carbon emissions globally, even if the rate of growth is slowing as Chinese energy efficiency improves. Carbon emissions in the United States have been falling with the shift away from coal to shale gas that is changing the structure of US energy markets.

The meeting was also important as it helped establish personal relationships between statesmen and promote dialogue between countries that will exert profound political and economic influence globally in coming decades.

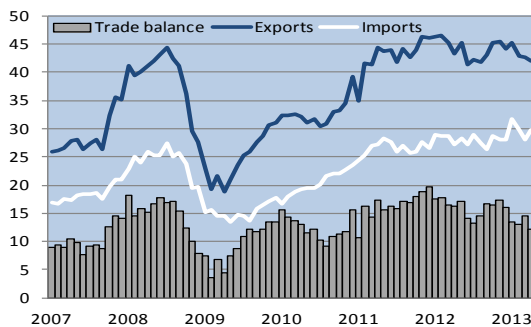
US-China trade has enjoyed robust growth, with the US now rivalling the EU as China's top export market. In the first quarter, Chinese imports from the US grew slightly faster y-o-y than exports to the US. The situation slightly reduced the US trade deficit with China, but the unbalance is still high (\$220 billion in 2012).

Russia

Russian foreign trade surplus shrinks in first four months of the year. During January-April, the value of goods exports fell 4 % y-o-y, due in particular to weak energy and metal prices. The value of goods imports, in contrast, rose 5 % y-o-y. Import growth has slowed sharply in past months, however, as demand has evaporated.

There has been relatively little change in the product structure of Russian foreign trade; over 70 % of exports still consist of oil and natural gas. Metals and chemical products also remain important export categories. The largest import product categories are machinery & equipment, chemical products and foodstuffs.

Russian monthly goods exports, goods imports and trade balance, USD billion (seasonally adjusted)



Sources: CBR, BOFIT.

China and Germany remain by far Russia's biggest import suppliers, but notably the US moved into third place in January-April. Growth of Russian imports from the US and China has also clearly outpaced import growth overall this year. Imports from CIS countries, in contrast, have declined in recent months. The value of imports from Ukraine and Belarus was down nearly 20 % from a year ago. Imports from Kazakhstan, however, were up nearly a fifth.

Customs union creates new opportunities to sneak capital out of Russia. A report from the Central Bank of Russia finds that Russian firms have found a new way to skirt official scrutiny by paying invoices for fictitious imports. The scam involves Russian firms paying fake bills for imports from Belarus or Kazakhstan to a third-country bank account.

The evasion became considerably easier with the establishment of the Russia-Belarus-Kazakhstan customs union in 2010. The elimination of customs inspections at common borders has meant that banks are no longer verifying the deals from customs documents. The exporting of capital using the new ruse has largely replaced other informal capital export channels, which have gradually been shut down through stepped up monitoring by Russian officials.

The CBR estimates that the amount of capital exported last year using forged invoices for nonexistent imports from Belarus resulted in \$15 billion whereas the total private sector net capital outflow from Russia was \$ 54 billion. There are no similar estimates for Kazakhstan.

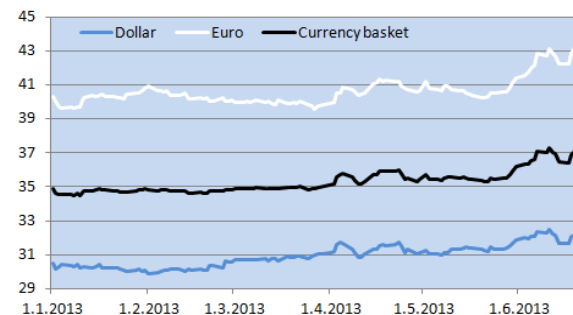
Ruble exchange rate down since the start of the year. From the beginning of the year to mid-June, the ruble slid some 4.5 % against the euro and 3.7 % against the dollar. The exchange rate has during the past few days averaged around 42.7 rubles for the euro and 32 rubles for the dollar. The last time the ruble was this low against the euro was in October 2011. Against the dollar the ruble was this low in September 2012.

The ruble's exchange rate has been influenced by the drop in world oil prices in the early spring. Urals-grade crude peaked in February at over \$115 a barrel and then hit a low of \$95 in April. Since May, the price has fluctuated between \$100 and \$105. Pressure on the ruble has also come from Russia's economic slowdown and uncertainty on global markets, which has reduced investor appetite for risk.

While the central bank continues to steer the ruble's external value, it shows much greater restraint than in the past. The CBR refrained from interventions in the market between autumn 2012 and March this year. In April the CBR started to prop up the falling ruble by currency sales. The sales were marginal, however, with the bank selling about \$900 million and €60 million during April and May.

The ruble's value relative to the CBR's dollar-euro currency basket is now about 37 rubles. The central bank steers the ruble's value within the limits of a fluctuation band. The lower limit for the fluctuation band today is 31.65 rubles and the upper limit 38.65 rubles. The CBR moves the fluctuation band upwards or downwards whenever its interventions exceed a certain limit in order to accommodate to changes in economic fundamentals. The CBR last adjusted the fluctuation band in spring 2012 in the face of appreciation pressure on the ruble. In summer 2012, the CBR extended the width of the band to the current 7 rubles.

Ruble-dollar, ruble-euro and ruble-currency-basket rates (rising trend indicates ruble depreciation)



Source: Bloomberg

China

True size of public sector budget deficit and debt likely much larger than official estimates. This month the National Audit Office (NAO) issued a warning that indebtedness of local administrations continues to rise and that debt continues to take on ever murkier forms. About 46 % of debt acquired by local administrations is now held under off-budget financial entities known as “local government financial vehicles” or LGFVs. As central government officials have tried to make it more difficult for regular banks to lend to LGFVs, local governments and their financial entities have turned to borrowing also from China’s unregulated grey markets. This has made it even more difficult to estimate the true extent of local government borrowing. The NAO notes, however, that the situation varies tremendously from province to province. In the case of heavily indebted local administrations and LGFVs, debt-servicing costs have already become a major burden.

In the final statement of IMF’s Article IV consultations at the end of May, the IMF stressed the importance of taking control over the indebtedness of local administrations. IMF analysts estimate that China’s public sector debt ratio is now nearly 50 % of GDP if the debts of LGFVs are included. This implies also that China’s overall public sector budget deficit in 2012 was around 10 % of GDP. China officially reported its budget deficit was around 2 % of GDP.

Housing prices on the rise throughout China. The increase in housing prices that began in the second half of 2012 has continued into this year, even accelerating in recent months. The National Bureau of Statistics reports that prices of newly built apartments in May were up an average of 5 % y-o-y in the 70 largest cities in China. In megalopolises such as Beijing, Shanghai and Guangzhou, prices were up 10–15 %. The sole decline in new housing prices was registered in the city of Wenzhou.

The average price for a square metre of apartment last year was 16,500 yuan (€2,000) in Beijing and 14,000 yuan (€1,700) in Shanghai. If average incomes are compared to apartment prices, housing in China’s big cities is much more expensive in relative terms than in e.g. Helsinki. Officials have long worried about soaring housing prices. State-supported housing production has been stepped up and a variety of measures to stem rising housing prices have been implemented. Officials are expected to introduce further measures to cool the housing market soon.

Evaluating the situation in the housing sector is challenging as market is so fragmented and reliable statistical data are unavailable. As a result, there is no consensus among analysts on the outlook for the sector. Some analysts see no major problems in the market; apartments are selling well and buyers are making large down-payments. At the other

end of the spectrum, Vanke, one of China’s largest real estate developers, has expressed concerns about a bubble in the market and the massive amounts of debt being carried by developers.

China eager to be part of cooperation in the Arctic and assessing the region’s economic potential. China was last month granted permanent observer status on the Arctic Council along with Japan, Singapore, India, South Korea and Italy. The new observer countries extend participation in the Arctic Council to countries outside the Arctic region. The purpose of the council is to strengthen governmental cooperation in the Arctic region, protect natural endowments and habitat, as well as the interests of native peoples of the North. The council acts as a forum for discussion, makes policy recommendations and coordinates projects in the Arctic region. Observer status gives China the right to participate in council meetings and make proposals, but confer no vote and thus no direct involvement in the decision-making process. Finland is one of eight permanent members on the council with voting rights.

The central reason for China’s growing interest in the Arctic region is its unexploited hydrocarbon and mineral endowments. The loss of permanent ice makes natural resources in the Arctic Sea more accessible. The Chinese are also interested in harvesting northern fish stocks. *China Daily* reports that China is establishing a China-Nordic Arctic Research Centre in Shanghai. Chinese research focuses on evaluating the region’s economic potential, resource reserves and changes caused by the loss of glaciers and sea ice.

With the loss of perennial ice, it has recently become possible to navigate the Northeast Passage (a.k.a. North Sea Route) between the Atlantic and the Pacific in the summer months. Access to the route would be a boon for China as the overwhelming share of the sea traffic moving between Asia and Europe currently passes through the Strait of Malacca near Singapore and the Suez Canal. The distance from Shanghai to Rotterdam via the North Sea Route is about two-thirds of the southern alternative. Shipping via the Arctic would also help China to diminish the political leverage of other countries on China because it would reduce the need to transport through multiple territorial waters using the southern route.

China’s new Arctic policy was recently evident in Iceland, with whom China signed a free-trade agreement in April. According to *The Economist*, it is likely that China sees the deal as a stepping stone to increasing its influence in the Arctic and the development of Arctic sea lanes. Early this month, CNOOC, one of China’s largest oil companies, penned a joint venture deal with an Icelandic energy firm on exploration for Arctic hydrocarbon reserves. Chinese firms have also shown an interest in investing in mining projects in Greenland.

Russia

New CBR chairman Elvira Nabiullina commits to keeping monetary policy on its current course. Nabiullina's first comments after assuming her new post on Monday (June 24) concerned the importance for the CBR of keeping up the fight against inflation. In countering recent calls from some political corners for the CBR to get behind measures to stimulate growth such as lowering interest rates and devaluing the ruble, Nabiullina observed that the best way for the CBR to promote economic growth is to stabilise the macro-environment for business. Nabiullina also stated that she considers improving the investment climate an important contributor to economic growth through e.g. encouraging good corporate governance and transparency. Such changes would reduce creditor risk and ultimately lead to lower interest rates.

Chairman Nabiullina dismissed the economy ministry's proposal to give commercial banks recommendations on maximum lending rates, noting such ceilings would most likely lower banks' enthusiasm for lending.

Nabiullina also mentioned the possibility of cutting commercial banks' operating costs by easing requirements established by the CBR on e.g. document handling and information provision.

CBR first deputy chairman Alexei Ulyukayev tapped as new economy minister. Other appointments announced Monday (June 24) included rotation of former economy minister Andrei Belousov into the post of economic adviser to the president previously held by current CBR chairman Elvira Nabiullina.

During his stint as economy minister, Belousov stressed the role of public investment and state management in stimulating economic growth. Many observers think that the transfer of Alexei Ulyukayev, who has a reputation as a liberal economist and staunch defender of central bank independence, to the top post in the economy ministry could shift the economy ministry's policy focus towards structural reforms and encouraging private-sector investment.

The CBR and economy ministry have traditionally split over economic policy, but the gap could be closing with the economy ministry joining the CBR and finance ministry in promoting growth based on economic stability and structural reforms.

President Putin announces stimulus measures at this year's St. Petersburg International Economic Forum. The measures announced June 21 largely reflected proposals on ways to stimulate investment prepared this spring by the economy ministry at Putin's behest. The proposals have

been met with criticism, especially from the finance ministry and the central bank, so the president's final proposal included views from both sides.

Putin announced three major infrastructure investments: a high-speed rail line between Moscow and Kazan, construction of an outer ring road around Moscow and upgrading Trans-Siberian rail lines between Moscow and Vladivostok. Putin suggested that the potential economic payoffs of the construction projects could be attractive to private investors, whose participation would assure the profitability of the projects. The president invited foreign investors participating in the forum to join in these projects.

Putin's announcement that the projects would be partly funded from the National Welfare Fund (mostly funded with oil & gas revenues) represents a clear shift from earlier policy. Fund assets to this point have largely been invested in high-quality, low-risk bonds and treasuries with a view to financing the pension system in coming years.

Putin said that the government plans to invest 450 billion rubles from the National Welfare Fund in the three projects, and other projects may be coming. Over the next few years, more than half of the National Welfare Fund resources would be invested in various infrastructure projects. As of end-May, the fund stood at about 2.7 trillion rubles (€64 billion). State Pension Fund assets might later also be made available for infrastructure projects. Observers put the price tag of the Moscow-Kazan high-speed rail project, for example, at over 900 billion rubles.

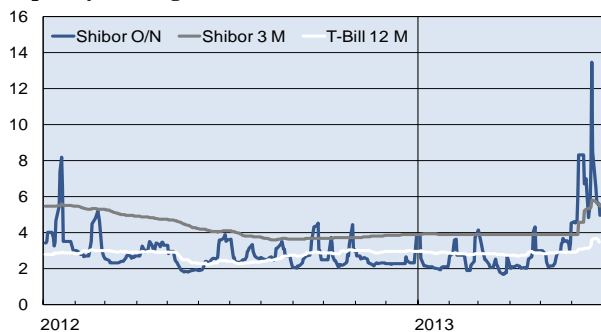
Russia witnessed an active debate this spring over the wisdom of investing sovereign wealth in domestic infrastructure. The finance ministry and the CBR have been wary of the initiative, which has largely come out of the economy ministry, expressing concern about the choice of projects and their economic feasibility. Some observers note that massive public works are prone to corruption, citing the building projects for the APEC summit in Vladivostok last year and the on-going Sochi Winter Olympics village construction. Moreover, one-off projects often have only a transitory economic impact and do little to accelerate economic growth over the long run. This was precisely the case in Vladivostok, which anticipated strong regional economic growth following the APEC summit held in autumn 2012. Despite massive public investment in buildings and infrastructure, such growth has yet to materialise.

Putin also announced measures to limit the rising cost of doing business in Russia. Russia's high inflation is driven by the rapidly increasing costs of public utilities produced by "natural monopolies" in e.g. energy, water, heating and rail transport. All have seen rates rising faster than inflation for several years now. Starting next year, rate hikes would be limited to the previous year's inflation rate, and the ceiling on rate hikes would remain in force through 2018. Putin encouraged natural monopolies to improve efficiency and cut costs now that further rate hikes are off the table.

China

Interest rate spike in China frightened. A sudden liquidity drought in interbank market caused overnight lending rates to soar last week, even exceeding 13 % last Thursday (June 20). Banks' demand of liquidity rose because of the three-day Dragon Boat Festival holiday, tax deadlines and banks' need to meet deposit reserve requirements. Ultimately, however, the spike was caused by the People's Bank of China, which unlike earlier, refrained from providing liquidity to banks and allowed market rates to climb before intervening. The sudden rise in interest rates on China's already jittery financial markets was especially disconcerting for many as the PBoC was slow to explain its policy shift.

Liquidity shortage drove interest rates to record levels



Source: Macrobond

In fact, only this week did the central bank announce that there was no actual liquidity shortage, merely a situation where supply and demand did not meet. According to the central bank, it let interest rates rise to send a message to banks and companies on the risks of excessive indebtedness and the maturity mismatch of debt and payments. Officials are particularly concerned about the rapid growth of unregulated borrowing on the grey market. For example state enterprises, despite production overcapacity, still enjoy access to cheap loans, which they can then lend to other companies at higher interest rates.

Stock markets reacted to the liquidity shortage with a sharp decline in share prices. Many companies have postponed scheduled bond issues over interest-rate uncertainty. Although the central bank declared it possesses the tools to keep the financial market stable, last week's market disruption highlighted the vulnerability of the Chinese financial system. These factors in combination have depressed the short-term economic outlook.

Perhaps the silver lining from the experience has been its success in showing that China's new leadership is ready to go ahead with measures to address long-term problems at

the expense of short-term growth. Last week's events also drove home the importance and feasibility of interest-rate policy that could encourage China to move forward with liberalisation of rate-setting and money market reforms.

Chinese companies invest in a wide range of sectors.

China's Ministry of Commerce reports foreign direct investment outflows from China amounted to about \$35 billion in the first five months of this year, an increase of approximately 20 % from last year. This figure does not include later-to-be-released financial sector's investment. Most FDI outflows went to Asia, but other continents have increased in importance in recent years.

Chinese firms actively invested in foreign food production, which is becoming an important investment area along with natural resources and the energy sector. According to Bloomberg, Chinese FDI going to agriculture and food processing this year already amounts to \$7.8 billion, with much of the spending directed to the United States, Australia and Brazil.

US pork producer Smithfield Foods approved an acquisition offer in May from Chinese meat producer Shuanghui. Shuanghui sees the deal as a way to gain access to the US market and acquire food processing technology and related skills. Rising labour costs have put pressure on China to raise the efficiency of its food production and distribution systems. Greater technological capabilities would give Shuanghui a competitive edge in the domestic market that has been suffering from food scandals.

Smithfield, with an estimated sale price of \$4.7 billion, has returned China-US trade relations to the spotlight. If the Committee on Foreign Investment in the United States (CFIUS) gives the green light, it would be the largest ever Chinese acquisition of an American company. Bilateral relations in the food industry have suffered e.g. from China's import a bans on food produced in the US. The US, in turn, earlier blocked some Chinese investment in e.g. its energy sector.

Chinese firms see acquisitions as a way to expand in international markets and develop opportunities in China's growing domestic market. This month, Dalian Wanda announced it was acquiring a majority stake in British yacht-builder Sunseeker, as well as investing in a number of foreign hotel projects. Wanda has been on a shopping spree; last year it bought the US-based AMC cinema chain for \$2.6 billion.

This month, Sinopec paid \$1.5 billion for the US-based Marathon Oil's rights to Angolan oil tracts, further cementing the Chinese presence in Africa. Another Chinese oil giant, CNPC, recently acquired a 20 % stake in the Yamal project to develop new Siberian oil fields. The project is spearheaded by Russian gas giant Gazprom.

Russia

Russia moves to hold federal deficit in check. Federal budget revenues this year are forecast to remain at the same level as last year due to significant reductions in income from taxes and fees on production and exports of oil and gas.

The latest finance ministry calculations further suggest a tighter medium-term outlook. Next year's budget revenues are estimated to rise just 5 % in nominal terms, reflecting the downward revision of the GDP forecast. During 2015–2016, the growth in budget revenues is expected to accelerate only slightly with the return to higher economic growth. Also, the fairly large hikes on excise taxes on for e.g. gasoline, alcohol and tobacco products will begin to bite.

Regional budget outlooks have also tightened. Revenue from corporate tax, which last year accounted for about a quarter of all regional budget revenues, is down significantly this year. Finance ministry reports that corporate tax revenue in the medium term will also likely come in well below earlier forecasts due to reduced profitability in the corporate sector. As a result, finance minister Anton Siluanov questioned the wisdom of economic stimulus measures started this year that grant generous capital depreciation to firms and allow firms classed as small companies access to a lighter tax burden. Companies with as many as 200 workers can currently take advantage of the lower tax.

Despite the flat numbers on the revenue side, the recently approved rather tight budget rule will be implemented. The rule calls for limiting the federal budget deficit during 2014–2016 to about 0.5 % of GDP. This requires that nominal growth in budget spending remains under 3.5 % next year (nearly 4 % this year).

Siluanov mentioned three ways to limit growth in budget spending. It has been agreed with the defence ministry to postpone parts of the massive arms programme until after 2016. Also other government procurement plans will be curtailed. The growing deficit of the Pension Fund, which is covered by federal budget, is proposed to be limited by adjusting the mandatory social security contribution of employers. If Russia does manage to reform its pension system, something it has struggled with for years, it would improve the situation of the Pension Fund as well.

On the other hand, Siluanov noted the need to fund new public megaprojects, which include development of the Far East and Baikal regions, construction of the Moscow-Kazan high-speed rail line, as well as preparations for the 2018 FIFA World Cup soccer championship.

Duma approves law on pardons for people convicted of financial crimes. At the recent St. Petersburg international economic forum, president Vladimir Putin voiced surprising support for an economic crimes pardon bill under

preparation. On Tuesday (July 2), the Duma approved the bill in an accelerated procedure.

The scope of the pardon extends to specified economic crimes and is subject to certain conditions. The listed crimes include copyright and patent infringement, unauthorised business activities, tax evasion, money laundering, and corporate fraud. The pardon includes the provisions that the pardoned individual must not have been convicted of a financial crime earlier and that he or she pays full compensation for damages during the six months the pardon act is in force. The law covers those convicted of crimes, persons officially charged with economic crimes and those currently under investigation.

Boris Titov, Russia's first ombudsman for corporate rights, began pushing for the pardon act as soon as he stepped into his office last summer. The current legislation is much more limited than the draft proposal prepared by Titov's working group in May. Observers estimate the pardon act affects several thousand individuals.

A cornerstone of the act is the liberalisation of the criminal code in recent years, which has led to a situation where many persons now serving sentences could not be convicted under the current criminal code. There are also many cases of business people convicted on the basis of false charges laid by competitors or corrupt officials in order to prevent competition or fraudulently acquire their business.

Critics of the act include those who refuse to accept the pardons and those that think the pardon scheme is too limited. The requirement that pardoned people pay compensation within a six-month period could be difficult for individuals in prison. Payment of compensation and a pardon are technically admissions of guilt, something innocent persons convicted at trial may find hard to swallow.

Titov admits that the impacts of the compromised legislation will be marginal. In his view, however, the pardon act is at least a step in promoting a healthier business climate as it indicates that the state is ready to admit its earlier mistakes in its relations with businesses. However, property rights and the rule of law need to improve significantly if entrepreneurship in Russia is to become more attractive. It is important to change officials' attitudes that still reflect Soviet-era prejudices about economic crime, resulting in taking sides against the charged individual and court processes that assume guilt, placing the burden of proving innocence on the accused. The most important thing to do now, Titov said, is to make sure that public officials and courts comply with the pardon act.

The reform of the criminal code was started during Dmitri Medvedev's presidential term in order to reduce arbitrariness in dealing with financial crimes. The code revisions e.g. reduced the classes of financial crimes and the prosecutor's ability to hold individuals suspected of financial crimes during an investigation.

China

China plans reforms to the household registration system to promote urbanisation. The influential National Development and Reform Commission (NDRC) last week released a report on urbanisation issues that introduces steps how the *hukou* household registration system will be relaxed. The report says a first step will be the lifting of restrictions on migration to China's smaller cities. The reform will then be extended to larger cities through gradual relaxation of restrictions. The NDRC has yet to publish a timetable for the reform, but China has already been experimenting for some time with ways to phase out the *hukou* system. China's new leadership has repeatedly stressed the importance of urbanisation as part of its economic growth strategy.

The *hukou* system excludes migrant workers from access to social services such as education and health care in cities, because the social benefits of the worker in their official rural domicile cannot be transferred to the city where they work. *Hukou* has been treated as a tool for controlling internal migration and preventing urban public services from being overwhelmed. Unfortunately, it does so by restricting the free movement of labour and impedes the pace of urbanisation. Further pressure to reform comes from the ever-widening wage gap between cities and the countryside and a shrinking workforce due to China's aging population.

The hope of higher earnings, nevertheless, motivates rural residents to seek work in the city, creating tensions between unregistered migrants and officially registered urbanites. The National Bureau of Statistics reports that there were over 260 million migrant workers in cities at the end of 2012. The *South China Morning Post* reports that only 25 million rural people managed to register as official city residents during 2010–2012.

The *hukou* system reinforces the disparities between migrant workers and the rest of the population through growing discrimination, poverty and aggravation of social problems, so *hukou* reform is also important for reducing social inequality. The reforms call for large investments in public services and infrastructure that should sustain public investment at high levels well into the future.

The report also emphasises that rural residents need greater protection to the right to own land. At the moment, a rural resident who moves his or her domicile to the city surrenders their rural land rights, which reduces the incentive to move to the city.

China increases international use of the yuan through currency swap agreements. At the end of June, The People's Bank of China and the Bank of England entered into a

swap arrangement under which the Bank of England can swap pounds for yuan up to 200 billion yuan (€25 billion). The three-year agreement is intended to guarantee firms in the UK have ready access to yuan. In practical terms, it means that yuan denominated trading in London's market can expand significantly. Moreover, companies can pay imports from China in yuan.

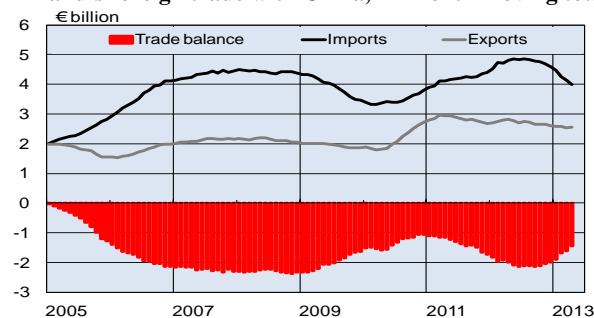
Since the financial crisis, China has signed swap agreements with about 20 central banks around the world. The motives for choosing partner countries typically include country size, proximity to China, the scale of foreign trade and whether the country has a free-trade agreement with China (see [BOFIT Discussion Paper 12/2013](#)). The size of the swap deals range from 0.7 billion yuan for Uzbekistan to 400 billion yuan for Hong Kong. China sees the agreements as a way to promote international use of the yuan. Because the yuan is not freely convertible, yuan use outside China is problematic in the absence of the swap agreements.

Volume of Chinese goods imports to Finland drops significantly. Finnish Customs reports that goods imports from China dropped by about a third in January–April compared to the same period in 2012. The biggest declines were registered in imports of telephones and related parts. At the same time, Finnish exports to China remained fairly stable, causing a dramatic contraction in Finland's foreign trade deficit this year.

Although China is the most important export destination for Finnish firms, operating in China is even more important for Finnish firms. Finnish goods exports to China amounted to less than €3 billion in 2011, while the turnover of subsidiaries of Finnish firms operating in China well exceeded €20 billion.

According to a [survey](#) completed this March by the Finnish Business Council Shanghai, most Finnish companies operating in China see a bright future. The majority of Finnish companies operating there expect their profits to keep rising and plan to invest more in China. Finnish firms say the biggest challenge they face is finding competent workers.

Finland's foreign trade with China, 12-month moving total



Source: Finnish Customs

Russia

Russia's new privatisation programme more cautious than its predecessor. The government approved the list of state companies slated for divestment during 2014–2016. The previous plan accepted in 2010 covered the years 2011–2013. The new round affects about 1,200 corporations. Just over 400 firms on the new list are debuting, while nearly 800 are holdovers. Towering over the privatisation of many smaller and medium-sized enterprises, however, are the sales of several major state companies.

Russia's privatisation plans have consistently failed to meet their targets. Part of the blame can be attributed to domestic and global economic conditions in recent years that did not favour sales. The situation was hurt generally by reduced investor appetite for risk and lower profitability projections that convinced officials that it was a less-than-optimum time to sell off state property.

Prime minister Dmitri Medvedev said at the end of June, when the proposed new programme came before his cabinet, that it had been tough earlier to go ahead with the sales given the weak economic conditions and powerful lobbying efforts from certain state organisations and specific officials against privatisation. Medvedev said the main purpose of selling state property was not simply to boost budget revenues but also to send a signal to the market about the direction of development of the Russian economy. Thus, it is critical that the programme is implemented in full.

The amount of shares offered was cut or sale deadlines postponed for several large enterprises under the current programme. Economy minister Alexei Ulyukayev blamed unfavourable market conditions. For example, the Rosneft oil company, the RusHydro power company, the Sovkomflot shipping company, VTB Bank, diamond producer Alrosa and state airline Aeroflot, which were all on track for complete divestment by 2016, will now remain partially in state ownership at least until 2016. The privatisation of Sberbank is not even mentioned in the programme.

However, the new programme brings forward the sale of state telecom Rostelecom to 2016, when it is hoped that the firm can be sold off in its entirety to private investors.

The government estimates that sales of companies or company stakes could raise over 1.7 trillion rubles (€40 billion) over the next three years. Observers see the price hopes as extremely optimistic and the likelihood all stakes and companies would be sold as very small.

Russia announces new subsidies to stimulate car sales; EU files complaint with WTO protesting old subsidies. Sales of new passenger cars and vans in Russia have been on the decline in recent months. In the first six months of this year, car sales were down 6 % from the same period in 2012. Car production fell 2 % and imports declined 8 % during January–April.

To boost the car market, the government hopes to introduce an interest subsidy programme for car buyers this month similar to the one that ran from 2009 to 2011. The plan calls for an interest subsidy on car loans of about 5.5 percentage points. The maximum price of a car eligible for the programme is 700,000 rubles (€7,500).

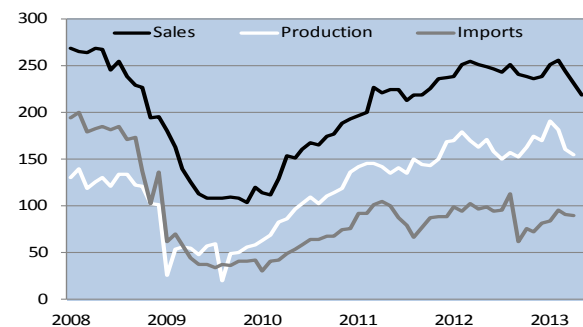
To avoid breaking WTO rules, Russia would this time make the subsidy available also for imported cars. Russia's industry ministry predicts that the interest subsidies would be used in the sales of 200,000–250,000 cars by the end of the year. Interest subsidies were granted on the purchases of nearly a half million cars during the previous programme.

Russia subsidises car assembly plants through reduced tariffs on imported components. Under Russia's WTO commitments, the reductions, which are seen as giving domestic car assembly operations an unfair competitive advantage, must be revoked by 2018 when the negotiated transition period ends. As the Duma wound up its spring session on July 5, it approved a law whereby the hike in component import duties will be compensated for the assembly industry during 2018–2020, in fact cancelling out the effect of the duty rise.

Russia still subsidises its domestic car industry with recycling fees that amount to at least 20,000 rubles (€500) on every imported car. Cars manufactured in Russia are not subject to the fee. The recycling fee went into force when Russia joined the WTO last autumn, and has ever since been criticised as a violation of WTO rules. The EU has often brought up the issue with Russia, and Russia has routinely promised to do something about it. Fed up with Russian intransigence, however, the EU filed a request for an official WTO investigation into the recycling fee on Tuesday (July 9).

In mid-June, the Russia-Belarus-Kazakhstan customs union imposed anti-dumping tariffs on vans built in Germany, Italy and Turkey. Russia's own car exports have been hurt by Ukraine's import duty hike this spring. Russia says the hikes violate both WTO rules and the CIS free-trade agreement. Many other WTO members also oppose Ukraine's duty hike.

Monthly seasonally adjusted numbers for Russian car sales, production and imports (in thousands)



Sources: AEB, Rosstat, BOFIT.

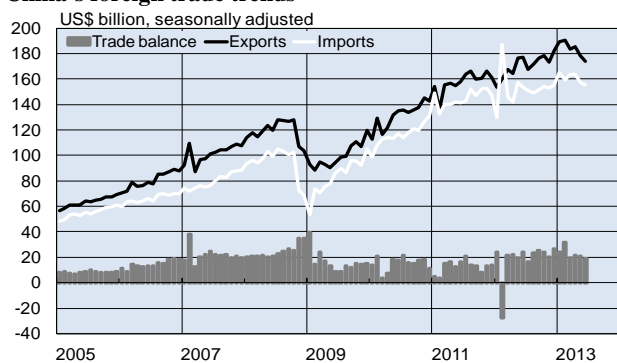
China

Chinese imports and exports contracted in June. There was a drop in exports and imports of machinery and equipment, but commodity imports continued to rise. For example, the imported volumes of wood pulp, iron ore and crude oil have continued to grow at similar pace as in previous years.

A number of company surveys have found export orders dwindling in recent months, a situation that foreshadows lower export growth ahead in coming months as well. China's foreign trade trend has raised concerns that growth of the global economy will be worse than earlier forecasts and that China's domestic economic growth could face more serious slowdown than expected. China releases its GDP growth figures for the second quarter on Monday (July 15).

The contraction in foreign trade could also signal success through intensified efforts by state officials in recent months to identify false reporting of foreign trade transactions. Chinese companies may have exaggerated their export and import figures to move money in and out of China and circumvent restrictions on capital movements.

China's foreign trade trends



Sources: China Customs and BOFIT

Inflation pressures in China remain modest. June consumer prices were up 2.7 % y-o-y, which is six-tenths of a percentage point higher than in May. Inflation, however, is still well below the 3.5 % ceiling on the government's target range for this year. The biggest driver of inflation at the moment is the nearly 5 % increase in food prices. This year's rise in housing prices has also driven up housing costs, which were up about 3 % y-o-y.

There were large hikes in pork prices in June. Prices of fruits and vegetables were down, even if they were clearly more expensive than last summer. Food has a large weighting in China's consumer price index, so changes in food prices heavily impact inflation. Hikes in non-food prices have held below 2 % y-o-y for several months now.

Producer prices fell 2.7 % y-o-y in June. Producer price deflation has continued now for 16 months in a row. Producer prices in the mining industry, for example, fell 8.5 % as the slide in world commodity prices continued. Lacklustre demand and overcapacity issues in many industries have intensified price competition, which should keep producer prices in check in the months ahead.

Higher degrees increasingly common in China. Chinese colleges graduated over 6 million students last year. This year that number is approaching 7 million. Due to China's concerted efforts during the 2000s to improve access to education, the number of students graduating with college degrees has been rising at around 17 % a year. China's ambitious national goal is for a fifth of the working-age population to have received higher education by 2020. Many international institutions, including the OECD, have advised the Chinese to put greater effort into improving the quality of education. The number of competent educators has not kept up with the rising numbers of students.

In May, McKinsey released a white paper that claimed employers see numerous problems with recent graduates. Among other things, employers said the new wave of graduates lacks the flair for innovation and critical thinking, have challenges with teamwork, inadequate English language skills and a lack of technical skills. It appears that the job market for graduates suffers from a structural problem, i.e. employer hiring criteria and the areas students take their degrees don't match up despite ever-growing need for skilled workers. The expectations of recent graduates do not necessarily reflect the realities of the labour market, which is a common reason job-seekers turn down job offers.

While there are no exact figures on the number of unemployed persons with academic degrees, the China Household Finance Survey released late last year found that 16 % of 21–25-year-olds who graduated in 2011 were still without work.

China wants an educated population capable of producing its own innovations in ways that sustain economic growth as the current model based on adopting foreign technology and methods will not be generating the high growth it used to. As working-age population begins to shrink, productivity gains become ever more critical in sustaining the rise in living standards. Students, however, do not prefer as their top choice to work in private companies, especially start-ups where innovation is vital. According to the *Wall Street Journal*, two-thirds of recent graduates would prefer a secured public sector post to a private sector job, and just 4 % say they would specifically prefer to work in a privately held firm. It appears that the job market is skewed in favour of state-owned enterprises, which is not optimal for creating much-needed innovations.

Russia

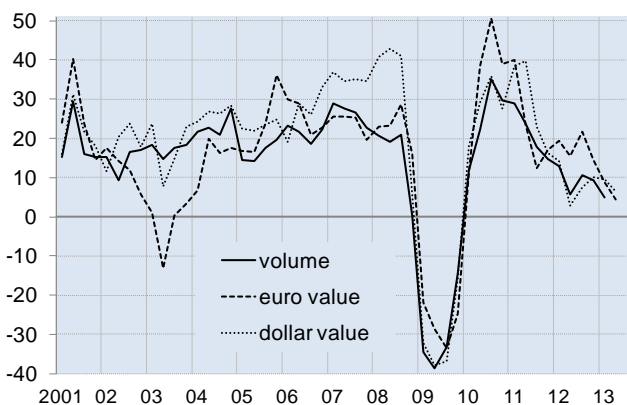
Russia sees export earnings and current account surplus shrink in the first half of this year. Preliminary balance-of-payments figures show Russia's export earnings fell in both the first and second quarters by 2–3 % y-o-y. Apart from a surge in exports of services, export earnings in the biggest export categories were flat or down. Revenues from exports of gas remained unchanged, while earnings from exports of oil, petroleum products and other goods declined. The reason was that both export volumes and prices declined.

Growth in Russian spending on imports continued to slow in the second quarter, even if growth was still running at 5–6 % a year. The value of goods imports increased only about 2 %. Spending by Russian travellers abroad as well as other services imports rose nearly 20 % in the first half. Services imports accounted for over 25 % of all spending on imports.

Due largely to the weak trend in export earnings, the goods trade surplus has been contracting but still exceeded 8 % of GDP in the previous four quarters. Due to on-going deficits in services trade and other current account categories, the current account surplus fell below 2.5 % of GDP (4–6 % during 2010–2012). In the second quarter, the current account surplus reached its lowest level since the end of the 1990s.

The flow of private capital abroad continued in the second quarter and was slightly larger in net terms than in previous years. Looking at the last four quarters, however, the net outflow of capital has fallen clearly from last year and was 2.5 % of GDP. Outflows created by means of fictitious business transactions and unrecorded capital outflows together remained around 2.5 % of GDP.

Russian imports of goods and services (percentage change from four quarters previous)



Sources: Rosstat, CBR

Amendments to law give the CBR supervision of the entire financial sector. Following its passage in the Duma on July 5, the Federation Council on July 10 approved major changes to Russia's Central Bank Law. The amendments call for integrating the functions of the Federal Financial Markets Service (FFMS) with the CBR. The CBR will now regulate all parts of the financial market, not just traditional credit institutions. New areas to be supervised include securities and insurance markets, pension funds, credit cooperatives, firms involved in microcredit and credit ratings agencies. The CBR will also supervise share and other securities offerings of corporations to assure they follow regulations, including e.g. shareholder protection. The amended law enters into force on September 1. Supervision of certain mandatory insurance such as medical insurance will not be performed by the CBR.

The need to enhance financial market regulation and supervision has long been under consideration, as well as the notion of creating a single super-regulator as in the case of the UK's Financial Services Authority. The idea started to gain support last summer, when FFMS head Dmitri Pankin noted that his agency needs substantially more resources to oversee increasingly complex markets. An integrated organisation is expected to be able to more efficiently supervise financial markets than the current separation of organisations, e.g. in overseeing consolidated corporate groups that cover various blocks of the financial sector.

Other amendments to the central bank act include the emphasis on stability of the ruble and prices as the fundamental monetary policy goal in creating conditions to economic growth. Arrival at this notion was preceded by discussions on the emphasis between price stability and economic growth. The CBR will also have the right to offer loans of over one year to banks. The terms of the CBR chairman and other board members will be extended from four to five years and the number of board members increased from 13 to 15.

CBR: Basel III requirements in place at the start of 2014. The CBR recently proposed slightly delaying the scheduled launch of Basel III capital adequacy requirements from October 1 to January 1, 2014 to coordinate the launch with the EU and the US.

The CBR is proposing partly less onerous capital adequacy requirements than the relatively tight requirements envisioned earlier. Even the new proposals are in line with Basel III capital requirements recommended by the Bank for International Settlements (BIS). The BIS guidance calls for an overall capital ratio of 8 % (Tier I + Tier II), while the CBR wants to maintain its current overall capital ratio requirement of 10 %. The large international credit ratings agencies recently noted that under the stricter requirements proposed earlier some of Russia's 20 largest banks would have needed more, in a case or two considerably more, paid-in capital or other Tier I assets in coming years.

China

China's economic growth continued to slow in the second quarter. The National Bureau of Statistics reports a further slowdown in Chinese GDP growth. GDP growth decelerated from 7.7 % y-o-y in the first quarter to 7.5 % in the second quarter. The overall rate of growth was met with little surprise as observers have been adjusting their expectations in recent months. Just last winter, most observers still expected growth this year to exceed 8 %, but as the spring wore on forecasts were repeatedly revised downward. For example, the IMF last month dropped its forecast to 7.8 %, and most of the other forecasts are also around China's official growth target of 7.5 %. Forecasts for Chinese growth next year have also been cut, with the consensus range for GDP growth now at 7–8 %.

Domestic demand drove second-quarter growth. Nearly half of economic growth came from consumer demand sustained by an incessant rise in wages. Just over half of economic growth came from investment growth, which somewhat surprisingly picked up in the second quarter. Investment growth was largely driven by public procurement. Growth in industrial investment, in contrast, continued to slow as a number of sectors struggle with overcapacity issues. Although exports remain critical to the Chinese economy, the contribution of net exports to economic growth has been fairly modest for several years now. The impacts of exports are mainly manifested indirectly through effects on domestic consumption and investment demand.

The government has refrained from major stimulus measures despite the recent downturn. It appears that the current pace of growth is sufficient in the eyes of China's new leadership as it focuses on restructuring of the economy. Finance minister Lou Jiwei remarked in July that even a lower growth rate than the current one would still be sufficient to keep unemployment at bay.

China's GDP growth



Source: NBS

China announces new round of measures to deregulate capital movements. The People's Bank of China an-

nounced last week that firms operating in China can now grant yuan-denominated loans to their foreign affiliates. In addition, yuan-denominated foreign trade settlement procedures were relaxed. The reforms allow for companies to aggregate yuan payments arriving on different days.

The China Securities Regulatory Commission (CSRC) announced in July that it was extending its Renminbi Qualified Foreign Institutional Investor (RQFII) programme to Singapore and London. The RQFII programme was launched in 2011 in Hong Kong and extended earlier this year to Taiwan. China's financial markets are strictly regulated for foreign investors, but RQFII firms can invest in certain yuan-denominated securities in mainland China. At the same time, the CSRC announced it was raising the overall quota for its foreign investor programmes to \$150 billion. The change is not expected to have immediate impact on capital inflows as only slightly more than half of the previously allotted \$80 billion quota has been used.

Yuan exchange rate stable since May. Although the yuan has overall gained about 1.5 % against the dollar this year, its value has been essentially stable since late May at 6.13 yuan to the dollar. In the first half of the year, capital poured into China, causing the yuan to appreciate. On any given day, the PBoC allows the daily yuan-dollar exchange rate to fluctuate no more than 1 % from the midpoint rate it sets every morning. If there is pressure for yuan to appreciate or depreciate more than the limit allows, the PBoC intervenes. The PBoC has usually prevented yuan appreciation by purchasing currency from the market in its currency reserves.

An examination of the PBoC's currency reserves purchased in the second quarter shows its currency purchases were rather small and there appears to have been a slight net outflow of capital from China. Under these circumstances, the trend in the yuan exchange rate suggests only modest appreciation pressure on the yuan. Forward contracts indicate a weakening of the yuan ahead based on interest rate differentials, but a Reuters survey this month found that most banks expected the yuan to appreciate during the coming 12 months.

Nominal dollar-yuan and euro-yuan exchange rates



Source: Reuters

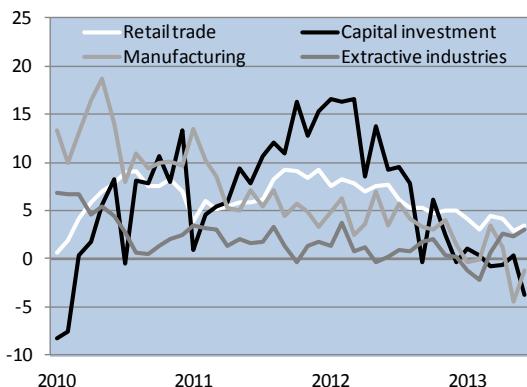
Russia

As Russian economic growth falters, government moves ahead with stimulus measures. Russia's economic growth slowed rather abruptly in the first half of the year. While GDP growth for all of 2012 was near 3.5 %, growth this year fell to just 1.6 % y-o-y in the first quarter and, according to the economy ministry's preliminary figure, about 2 % in the second quarter.

The industrial situation has weakened significantly, with industrial output essentially showing no growth from a year earlier. Growth in manufacturing has evaporated, even if part of the drop can be attributed to short workweeks. The sharpest drop was registered in machinery & equipment production, even if defence industry production has risen substantially. Resource extraction industries did slightly better in the second quarter, mainly due to higher production of crude oil.

Consumer demand is increasingly the main demand driver of the Russian economy, even if growth in consumer demand has also slowed slightly. Retail sales volumes were up 3.5 % y-o-y in the second quarter. Food sales volume continued to show a modest increase (2 %), while sales of non-foods were up over 4.5 %. Anaemic first-quarter investment declined further in the second quarter with fixed capital investment slightly below the 2Q2012 level. Development of exports has also been weak.

12-month change in Russian domestic demand and industrial output, %



Source: Rosstat

Lower economic growth has revived the stimulus discussion led especially by president Putin. Over the summer, the debate has resulted to decisions that include e.g. borrowing assets from the National Welfare Fund and pension funds to pay for transportation projects. Other stimulus measures include the Central Bank of Russia's recent decision to auction 12-month loans secured by non-marketable assets from end of this month. The finance ministry has

increased its bank deposits and deputy finance minister Moiseyev says that more is coming in early autumn. Putin recently issued a written instruction limiting administratively set rate hikes (on e.g. gas and electricity) over the next five years to no more than the inflation rate, a far lower level of rate hikes than originally planned.

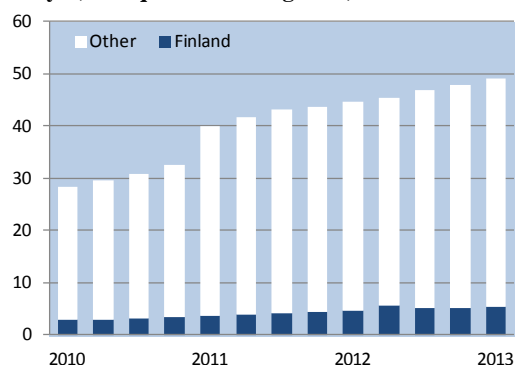
Nearly 10 % of Russians plan to travel abroad in their summer vacation. Despite the slowdown in the Russian economy, Russian holiday plans seem to be similar to last year. The share of Russians wanting to travel abroad for a vacation (especially a beach vacation) is actually three times larger than those planning to travel, but in most cases the price of such trips is prohibitive. Hence, according to recent surveys by the VTsIOM, Levada and FOM institutes, most Russians plan to spend their summer vacation at home or at their *dacha*.

Most Russian travellers save up for their holiday. Only a few per cent of those surveyed planned to borrow money to fund their trip. Russians plan to spend slightly more money on their trip abroad this year than last year. The average planned is just under 28,000 rubles (€700) per family member. The average monthly wage nationally in June was 31,200 rubles. A fifth of Moscow residents, about 2 million Muscovites, plans to travel abroad during their summer holidays this year, and plan to spend about €1,000 per family member.

The surveys show that Russians have begun to plan ahead more for their summer holidays than earlier. Russians continue to prefer to arrange their travel and activities themselves; less than a fifth of tourists reported that they had purchased package vacation deals for their most recent vacation abroad.

During the 2012 summer vacation season (July-September), Turkey was by far the top tourist destination among the non-CIS countries, accounting for 10 % of all Russian leisure travel. In terms of numbers of journeys, Russia's number-2 summer vacation destination was Finland with a 3.5 % share.

Russian trips abroad, Finland and other destinations, millions of journeys (four-quarter moving total)



Source: Rosturizm

China

China ends regulation of lending rates allowing banks less restrictive loan pricing. The People's Bank of China announced last Friday (July 19) interest-rate policy reforms designed to further liberalise China's heavily regulated financial markets. The main reform eliminates the minimum lending rate for commercial banks. The rate floor was previously set at 70 % of the PBoC benchmark lending rate. The reform allows banks to compete by offering lower loan rates. This is considered a step towards market-based interest-rate setting.

An important exception to the reform concerns interest rates on mortgages. They remain regulated as officials seek to prevent overheating of the housing market due to excessively low rates. Housing prices have increased sharply this year.

The immediate impact of eliminating the interest-rate floor should be minor. PBoC figures show that only about 11 % of housing loans are priced below the 6 % benchmark rate. If financial market conditions change, however, and competition among banks intensifies, companies with low credit risk could gain access to cheaper loans. In this respect, the reform could hurt bank profits by narrowing the margin between credit and deposit rates.

The PBoC reports that China is not yet ready to deregulate deposit rates and will continue to place a ceiling on them. Banks can now offer 12-month deposit rates up to 3.3 %. A maximum deposit rate reduces competition and provides banks access to cheap money, which is aimed to assure bank profitability and banking sector stability.

IMF encourages China to address growing financial market risks. In its annual [Article IV consultation](#) released last week, the IMF said it generally expects Chinese economic growth to remain relatively strong, while being concerned over risks facing its financial markets. Hence the IMF called for China to rein in rapid credit growth and increase regulatory presence in informal banking activity. This year's report continues to stress the importance of financial market reforms for the development of Chinese economy. Financial market liberalisation combined with better regulatory oversight would reduce further build up of risk and help channel investment to more profitable projects.

The IMF is also pushing for a faster transition from investment-driven to consumption-driven growth. Potential fiscal stimulus should support this goal, but stimulus measures should only be considered if economic growth would fall well below the current official target. More important for achieving balanced economic growth, however, are structural reforms such as reducing income inequality and overhauling the tax system.

The IMF still expects Chinese GDP growth to approach 8 % this year as the economy is expected to pick up slightly in the second half of this year. There are no signs, however, of a pick-up in the economy at the moment. For example, the preliminary number for the July HSBC purchasing manager index released this week fell to its lowest level in eleven months on weak numbers for manufacturing output and new orders.

Rich OECD countries lead in innovation, but China outranks many EU countries. The UN's World Intellectual Property Organization (WIPO) this month released its [Global Innovation Index 2013](#), which provides a snapshot of innovation activity in 142 countries. The index uses 84 measures of innovation both from input and output side. Innovation inputs include education spending, quality of top universities, graduate student populations, national justice systems, infrastructure, and spending on research and product development. Innovation output is measured by e.g. patents awarded, scientific publications, the share of royalties and licensing fees in services exports, and web presence.

As expected, rich OECD countries rank high in the survey, but also many emerging economies make relatively impressive showings. The Top Ten is dominated by small OECD countries traditionally active in e.g. ICT technology and pharmaceuticals. Somewhat surprisingly, neither Germany nor Japan made it into the Top Ten. Their rankings were dampened by e.g. their points on educational systems and internet use.

The highest-ranked non-OECD country outside the EU was Malaysia at 32nd place. China ranked 35th. A number of EU countries ranked lower than China, with Greece taking the cellar at 55th place. China's ranking was boosted especially by its high activity in patent applications but also R&D spending. Both China and Russia have significantly increased spending on innovation activity from 2012.

Selected countries on WIPO's 2013 Global innovation index

Ranking 2013 (2012)	Country	Innovation inputs	Innovation outputs
1 (1)	Switzerland	7 (4)	1 (1)
2 (2)	Sweden	5 (3)	3 (2)
3 (5)	UK	4 (5)	4 (6)
4 (6)	Netherlands	10 (15)	2 (3)
5 (10)	US	3 (9)	12 (16)
6 (4)	Finland	6 (6)	8 (5)
35 (34)	China	46 (55)	25 (19)
62 (51)	Russia	52 (60)	72 (49)
64 (58)	Brazil	67 (69)	68 (52)
66 (64)	India	87 (96)	42 (40)

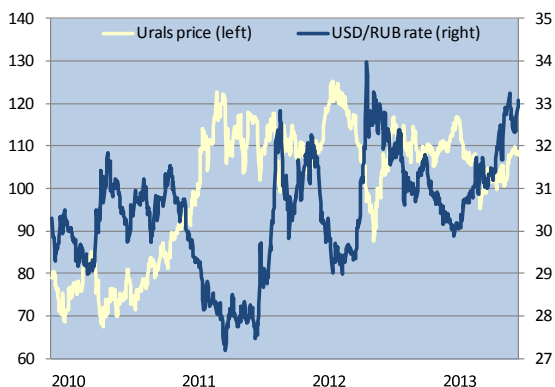
Source: WIPO

Russia

Ruble continues to slide; Moscow stock exchange down for the year. The ruble this year has lost nearly 8 % of its value against the dollar and 9 % against the euro as of end-July. One dollar was worth 33.1 rubles and a euro bought 43.8 rubles. The ruble slid throughout much of the first half of this year with the contraction in Russia's export earnings and capital outflows. The Central Bank of Russia sold substantially larger amounts of dollars from its foreign currency reserves in June and July than in previous months to support the ruble's exchange rate. Dollar sales in July alone exceeded \$4 billion, a level of intervention not seen since autumn 2012.

Although the price of Urals-grade crude oil has hovered above \$100 a barrel in recent months, continued uncertainty on international financial markets has depressed stock prices in Russia as in many other emerging markets. On Wednesday (July 31), the Moscow Exchange's MICEX index was down 9 % from the start of the year.

Price of Urals crude (\$/bbl) and dollar-ruble exchange rate (rising trend indicates ruble weakening)



Source: Bloomberg.

Credit expansion in Russia tapering off. The loan stock of banks increased 18 % y-o-y in the first half of this year. Total corporate and household borrowing rose at slower pace than earlier, reflecting general trends in the economy. The growth in corporate borrowing as of end-June was just under 12 % or half the growth rate registered last year.

The stock of household loans increased 34 %, down from 44 % last year. Even this lower growth is still a headache for the CBR, which considers household credit growth of around 20 % a year sustainable. Nearly two-thirds of household borrowing consists of unsecured consumer loans. The average interest rate on household loans with maturities of less than 12 months was 25 % for households and 10 % for corporate loans in June.

The stock of non-performing household loans has risen rapidly and the trend is expected to continue. New estimates find that about a third of the income of indebted households now goes to servicing debt. The CBR is plan-

ning measures to rein in the growth of unsecured consumer credit through such measures as restricting actual interest rate costs and limiting the share of income that can be devoted to debt servicing.

Household deposits grew by 22 % y-o-y in the first six months of the year, about the same pace of growth as in 1H2012. The share of foreign currency deposits remained at just under a fifth. Corporate deposits rose at 23 % y-o-y, slightly faster than last year. The ratio of loans to deposits for the banking sector overall slightly exceeds 90 %.

Total assets of the banking sector at the end of June stood at just under 53 trillion rubles (€1.24 trillion), an increase of about 20 % from last year. Total banking sector assets equalled about 79 % of GDP at the beginning of this year, which is still fairly modest compared to advanced economies and many emerging economies as well.

Russia had 1,091 credit institutions operating at the end of June which is eleven fewer than in June 2012. Russia's banking sector is highly concentrated as the five largest banks control about 51 % of total banking sector assets. All of these banks are majority-owned by the state. Some 248 banks have foreign investors, and foreign investors hold majority stakes in about half of them. Foreign banks, however, control less than 20 % of total banking sector assets. Of these, Rosbank and Unicredit rank among Russia's ten largest banks in terms of total assets.

Russian customs intends to change the treatment of TIR road transport. Russian customs announced that, as of mid-August, TIR (Transports Internationaux Routiers or International Road Transport) freight will be treated the same as other transit freight in terms of e.g. mandatory payments into escrow to cover customs duties and taxes. The TIR convention was created under the auspices of the UN and it includes Russia. Shipments under the treaty enjoy expedited treatment at border crossings. Under the TIR systems, national organisations act as guarantors of payment of customs duties and taxes, so separate escrow accounts or other collateral to secure payment is unnecessary.

Russian customs claims the local TIR representative, Russia's Association of International Road Transport Carriers (ASMAP) owes a substantial amount in unpaid customs duties and taxes. ASMAP denies the claim and states that the planned measures of Russian customs violate Russia's international commitments. Russian importers fear that the planned change would increase the duration and cost of transport. It would also hamper the government's objective to simplify customs procedures as manifested in the Road Maps aiming to enhance the Russian business environment.

A large share of road transit freight moving from Finland to Russia falls under the TIR system. Finnish Customs reports that the total value of transit goods shipped to Russia via Finland last year amounted to €20 billion or about 10 % of Russia's total imports. In the first six months of this year, the value of transit freight and shipment volumes have, however, fallen visibly from a year earlier.

China

Official and unofficial PMI readings for July give mixed picture of Chinese economy; decision-makers still convinced China will hit its growth targets. The July reading for China's official purchasing manager index (PMI) rose slightly to 50.3 points, up from 50.1 in June. The PMI from HSBC that also came out this week dropped a half point to 47.7, its lowest reading in nearly a year. Readings below 50 points indicate deteriorating business conditions.

The difference between the two CPI readings may be explained by the fact that the official index is more heavily weighted with large firms serving China's domestic market than in the HSBC index, which reflects more the outlooks of smaller firms and the predicament of export-oriented firms. The sub-indexes of the official main PMI also put the situation for small and medium-sized firms below the critical 50-point mark, while the sub-index for larger firms rose to 50.8. Both indexes found that unemployment rose and export orders still fell in July.

The Chinese government decided at the end of July to support growth through such measures as tax breaks for small firms, construction of low-income housing and acceleration of spending on railway investment. Additional measures are possible in the second half of this year. On the other hand, the modest level of stimulus measures indicates that China's leaders still believe that the country will hit its 7.5 % GDP growth target this year without the need for large stimulus and the risks that come with it. Short-term growth prospects are not the sole concern of China's leadership as they must deal with risks in the financial markets and move ahead with economic reforms. This was clear from the press reports on this week's politburo meeting.

China attempts to figure out true scale of local government indebtedness. The National Audit Office (NAO) announced last week it will conduct an audit on public sector debt including both central and local administrations. The State Council initiated the audit in response to concerns over public sector indebtedness. Especially the true debt levels of local governments remain unclear as a large share of debts has been left off the balance sheet through the use of financial companies owned by local administrations.

It appears that China's leadership is using the audit to get a better picture of the sustainability of local government finances ahead of the possible launch of a new round of stimulus spending and measures to deregulate the financial markets. The OECD and IMF have long encouraged China to adopt greater transparency of local administration finances to provide a better basis for fiscal and monetary policy decisions. The IMF says that the room for stimulus is clearly less than China's official figures suggest.

The last national audit conducted in 2011 found that the debts of local administration equalled about 27 % of GDP at the end of 2010. The National Audit Office performed a more limited audit of 36 local administrations in June this year. The audit found that the debts and debt servicing costs continued to grow after 2010, despite less official stimulus spending in the wake of the global financial crisis. In its latest country report, the IMF estimates that public sector debt currently stands at about 45 % of GDP, but many investment banks and research institutions put the public sector debt somewhere between 50 % and 70 % of GDP. China's debt ratio is not particularly high compared to many developed economies, but the levels of debt have soared in recent years.

The audit is apparently being used also as a means to motivate local administrations to get better control of their finances. Furthermore, China's leaders have begun to focus on public sector investments. Last week, for example, China imposed a restriction on public sector construction of office space over the next five years. The limits are intended to rein in unproductive investment of public funds.

EU and China resolve dispute over solar panel duties.

The EU-China dispute over solar panels reached a resolution last week as the countries agreed to implement new rules on import duties of solar panels. The deal is to be in effect until the end of 2015. The EU imposed an 11.8 % import duty on Chinese solar panels in June of this year that was set to rise to 47.6 % in August (see [BOFIT Weekly 23](#)). The agreement allows Chinese firms to avoid the hikes in import duties.

Under the terms of the deal, panels cannot be sold in the EU area below a minimum price. According to Reuters, the minimum price is close to the average sale price of solar panels in July. In addition, solar panels imported from China will be under a quota. If Chinese producers exceed the quota, the 47.6 % import duty will be imposed. The *Financial Times* estimates the quota represents about 60 % of the EU area's solar panel market this year. Chinese firms control about 80 % of the market at the moment, so the deal should provide a bit more room for other solar panel manufacturers to compete.

Many European solar panel manufacturers are unhappy with the ruling as they feel the minimum price is still too low. Differences among EU member states on the matter could undermine the EU Commission's bargaining position, however. Germany and the UK, for example, have opposed the import duties.

Trade policy disputes are expected to dominate China-EU trade talks. EU trade commissioner Karel De Gucht said China is willing to engage in discussions on China's planned tariff on wines imported from Europe.

Russia

Economic stimulus policy gaining ground in Russia. The stimulus measures planned so far do not appear to have increased the federal budget deficit, which is limited to 0.5 % of GDP this year. However, part of the savings in the National Welfare Fund garnered from fees and taxes on oil and gas production and exports have been designated for investing in domestic projects, which is a clear deviation from earlier policy.

Economy minister Alexei Ulyukayev, known as a proponent of strict monetary policy when he acted as Central Bank of Russia deputy chairman until late June, argued for stimulus at the cabinet meeting on July 25. He noted that the long-term growth outlook for the Russian economy has been eroded by weakness in the global economy and changes in international trade patterns. He added that the episode of record growth of the Russian economy a few years ago was largely driven by a huge increase in export earnings that is unlikely to be repeated. The government this year forecasts GDP growth of 2.4 %.

Ulyukayev justified stimulus measures by noting that Russian economic growth has recently fallen below its potential level. Unemployment has begun to rise, even if, at 5.4 % in June, it is still low by international standards. Moreover, the utilisation of industrial production capacity has begun to decline (again, from relatively high levels). Ulyukayev said that application of fiscal and monetary stimulus measures to boost output would not accelerate inflation under current conditions.

The need to improve business conditions in Russia has been brought up as one of the measures to boost economic growth. At its July 25 meeting, the government approved Ulyukayev's proposal for a programme addressing these issues.

The first goal of the programme is to simplify operations for small and medium-sized enterprises (SMEs), particularly access to finance. For this purpose, the government will create e.g. an organisation to guarantee loans to SMEs. The organisation would be in part funded out of the National Welfare Fund.

To revive capital investment, money from e.g. the National Welfare Fund and the State Pension Fund would be made available for large public projects that are being prepared as part of the stimulus. The programme calls for repayment of the investment and requires that clear criteria will be formed for project selection and effective oversight systems are in place during project implementation.

The CBR would extend credit to banks and thus businesses by allowing loans to SMEs to be used as collateral.

Public procurement by the federal government and municipal governments would in certain cases be limited to contractors within the Russia-Belarus-Kazakhstan economic area.

Russia strives to increase waste recycling. Sergei Donskoi, minister of natural resources and environment, wants to see Russia raise the utilisation and neutralisation level of waste from 11 % to 80 % by 2020. Municipal waste handling and recycling in particular are to be improved, which practically means a need to create a whole new industrial branch. The IFC, a World Bank agency, estimates that Russia presently exploits or recycles only a few per cent of its municipal waste. The EU average is about 60 %.

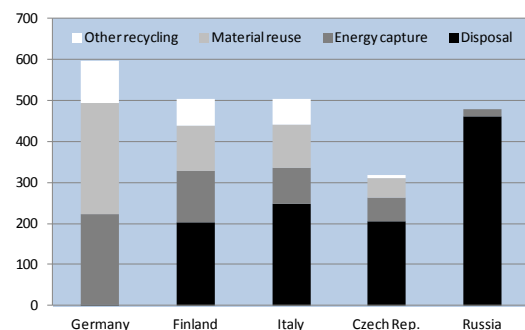
Massive investment is required to make significant improvements waste handling and recycling in Russia. The IFC estimates that reaching a municipal waste recovery rate of 40–45 % by 2025, calls for investing €40 billion.

Despite tremendous potential, it may be hard for Russia to attract investment to the waste management business, due, according to operators in the field, to inadequate regulation and legislation. For example, a law on recycling fees has been under preparation for three years. With the current schedule, the law should be finalised by next spring. The bill requires manufacturers of products made of e.g. glass, plastic and certain metals to assume recycling responsibility for their products. Manufacturers would have the option of recycling their products themselves or paying a recycling fee to the state to cover recycling costs. The recycling fees are estimated to come into force in 2016 at the earliest.

State-owned conglomerate Rostech has already shown interest in getting into the waste management business. CEO Sergei Chemezov says his company wants to be one of Europe's biggest waste handling and recycling companies. Rostech puts the current value of Russia's waste market at 50 billion rubles (€12 billion) a year and has already begun to acquire domestic waste handling facilities.

Russian consumers show a gradual increase in their interest in recycling. Research company VTsIOM reports that the majority of Russians see sorting of their trash and use of recyclable materials in consumer products as important or very important. On the other hand, only a third of respondents said they were ready to spend their own money on environmental protection or to pay environmental taxes.

Municipal waste handling in five countries in 2011, kg/person



Sources: Eurostat, OECD, IFC

China

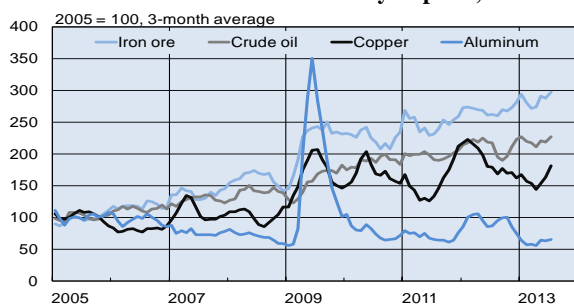
Chinese exports and imports picked up in July. After a lacklustre May and June, China's goods exports measured by value grew 5 % y-o-y in July. After showing weakness during spring and early summer, exports to Europe and the United States showed signs of strengthening in July, suggesting balancing within the global economy. Thanks to a strong first half, the value of China's total imports in the first seven months of the year was up about 10 % from the same period a year earlier.

After showing virtually no growth in May and June, China's imports in value terms were up 11 % y-o-y in July. US imports experienced robust growth for the second month in a row and imports from the EU showed signs of improvement. China's increased commodity imports may also signal improving conditions in the Chinese economy following fairly tepid growth in the first half of this year. The value of China's total imports increased 7 % y-o-y in the January-July period.

Japan-China trade continued to dwindle, both in terms of China's exports to Japan and imports from Japan. The deterioration of bilateral political relations is taking a long-term toll on both economies.

Growth of China's trade surplus slowed in July to \$18 billion for the month. The trade surplus for January-July amounted to \$127 billion, over \$30 billion more than in the same period in 2012. Price trends partly accounted for the increase in the trade surplus. Chinese statistics show import prices fell over 2 % in the first half, while export prices were unchanged from the first half of 2012.

Volumes of select Chinese commodity imports, 2005–2013



Sources: Macrobond, BOFIT

China's health care sector dogged by problems even as state spending on public health care continues to rise.

The Ministry of Finance's budget estimate shows China spent 380 billion yuan on public health care in the first half of the year, an increase of 22 % from 1H2012. Health care services now account for over 6 % of public sector spending, but the figure is still quite low by international standards.

OECD figures (OECD Health Data) released this summer show total health care spending (public and private) in China amounted to about 5 % of GDP in 2011. In comparison, health care spending as a share of GDP is about one percentage point higher in both Russia and Mexico. The average share of health spending to GDP in the OECD's 34 member states, most of which have long-established market economies, is around 9 %. Per capita spending in absolute terms varies much more widely, however. Per capita health care spending in 2011 was around €300 in China, €1,000 in Russia and €2,500 in Finland. The ratio of doctors and nurses to the general population in China is also far below the OECD average.

The prices for health care services in China have long been rising faster than wages. The *South China Morning Post* reports China's leadership is attempting to respond to the situation this year by cutting the cost of medical bills. At the moment, many Chinese have to turn to private providers for health care services, which means that about 44 % of health care spending in China is shouldered by private individuals (OECD average 28 %). Publicly funded health care has been on the rise in recent years as services covered under national health insurance have been expanded. Moreover, planned reforms to China's *hukou* household registration system would extend health care access to migrant populations currently outside the system (see [BOFIT Weekly 27/2013](#)).

China's extensive use of coal and its long-term impacts on health constitute a huge burden on the Chinese health care system. A study released in June found that the policy of providing free coal for home heating from the 1950s to the 1980s in Northern China decreased the average lifespan of residents by about 5.5 years relative to their neighbours in surrounding regions where free coal was not distributed. The OECD says the average Chinese lifespan has been rising steadily since the 1960s and currently stands at about 73 years (OECD average 80 years). A number of studies suggest that air pollution is a big factor restraining further life-span gains. The *China Daily* reports that China plans to spend nearly €80 billion in coming years to prevent further contamination of air and water, as well as take measures to correct environmental damage that has already occurred.

China's health care system is plagued by corruption. One of the biggest reasons contributing to this problem is that most hospitals lack an adequate financial base. Hospitals also engage in side businesses such as pharmacies, which, in turn, may motivate doctors to over-prescribe medicines. Media reports also indicate it is common practice for patients to offer money to doctors to assure they get adequate quality treatment. The pervasive corruption in the pharmaceutical industry was highlighted in late June when China started investigating UK-based GlaxoSmithKline for bribing hospital administrators and doctors to raise retail prices on certain medicines and boost sales.

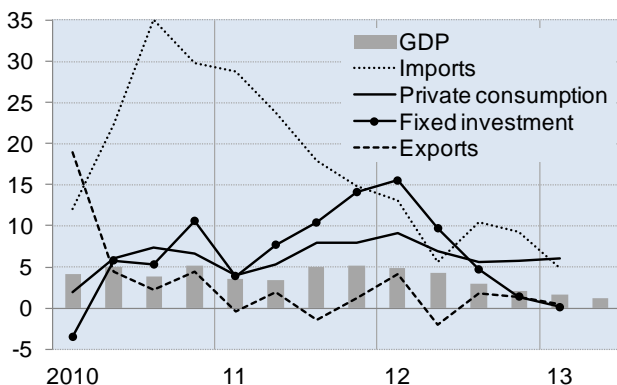
Russia

Russian GDP up just 1.2 % y-o-y in second quarter.

Rosstat's first estimate of second-quarter GDP growth came in well below earlier projections and consensus expectations. The poor growth performance may reflect weak capital investment and, according to some reports, a reduction in inventories.

Economic growth projections had already been adjusted downwards after the slow growth in the first quarter. For example, Russia's economy ministry and the IMF this spring and summer lowered their GDP growth forecasts for all of 2013 to around 2.5 %. The Central Bank of Russia's latest assessment, which was prepared at the beginning of this month and published this week, sees GDP growth for this year at around 2 %.

Russian GDP, volume of imports and demand, % change from four quarters previous



Source: Rosstat

Russian inflation slowed slightly in July; CBR board decides to keep interest rates unchanged. July consumer price inflation was 6.5 % y-o-y, a slight slowing from the 6.9 % posted in June. The fall in the inflation rate bolsters CBR expectation of hitting its 5–6 % inflation target range by the end of the year.

At its monthly meeting on August 9, the CBR board concluded that the risk of a further slowdown in economic activity remains significant for both the short and medium term. The board decided it would leave rates unchanged for the time being, even if the market expects the CBR to cut rates sometime in the autumn. The CBR last lowered rates in June, but the cut concerned only the longest, 1-year credit rates.

In mid-July, the central bank introduced a new financing format – a 1-year adjustable-rate credit. Banks can secure their borrowing on this instrument with non-marketable securities such as corporate debt paper. The interest rate of the new kind of loan is tied to the CBR's main financial instrument, the 1-week repo credit rate. Whenever the cen-

tral bank adjusts the repo credit rate, the rate on an adjustable-rate credit is adjusted to the same extent. The repo credit rate is currently 5.50 % and the rate charged to banks for an adjustable-rate credit is 5.75 %.

The CBR hopes the new instrument will improve the transmission of interest-rate policy to the money market. The reason for accepting non-marketable collateral is that it leaves banks with market-worthy collateral to be used in securing credit from the interbank market.

Thus far the new adjustable-rate credit has failed to generate much interest. At the end-July auction, banks picked up only slightly over 300 billion rubles of the 500 billion rubles in credit offered.

CBR revises its organisational and operational model.

Russia's Federal Financial Markets Service will be abolished and become part of the central bank as of September 1, when the CBR takes over regulation and supervision of the entire financial sector. The incorporated Financial Markets Service will continue to operate as a separate agency initially, but should be fully integrated into the CBR organisation within a couple years. The central bank's earlier mission was limited to supervision of the banking sector.

The CBR wants to improve the effectiveness of its banking sector supervision by creating a separate department that will focus exclusively on Russia's 20 largest banks. Taken together, these banks hold over 70 % of total banking sector assets and are critical for the overall function of Russia's banking sector.

The CBR currently carries out enhanced supervision of 200 banks, which include the large national banks as well as the main regional banks. The consolidation of supervision of large banks should improve the use of CBR resources and allow specialised supervision of the most important banks. The new department launches operations on October 1.

The CBR also decided to streamline its extensive regional organisation. It currently operates 79 regional offices, or nearly one for each of Russia's 83 administrative regions. The regional offices, in turn, have their own separate centres for payment, clearing and settlement operations. The reform calls for the creation of eight regional administrations on the basis of the biggest regional offices, one for each of Russian eight federal districts with other regional offices becoming their departments. Regional payment, clearing and settlement centres would be closed and their operations consolidated at regional departments.

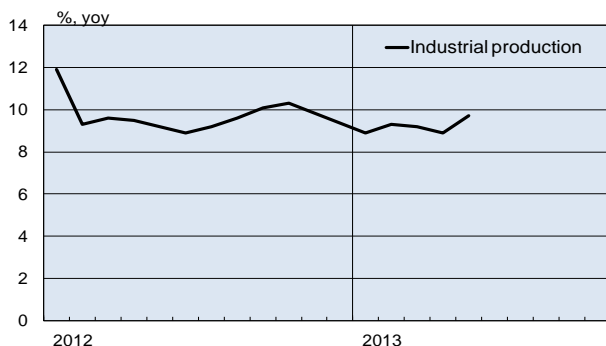
The intensive development of in the financial sector in recent years and advances in computer technology are the main drivers behind the reorganisation of the CBR's regional structures. The CBR says the changes will allow it to achieve cost savings that make it possible for the central bank to continue to have representation in nearly all Russian regions. The changes would be implemented during 2014.

China

China industrial output grew faster than expected in July. The posted growth for last month was 9.7 % y-o-y, which was nearly a percentage point higher than in June. Highest growth was seen in production of computers and cars, which experienced over 15 % y-o-y growth in both categories. The combined pick-up in industrial output growth and last week's news of reviving foreign trade have brightened the outlook for the Chinese economy after a sluggish first-half performance. First-half growth in industrial output disappointed most forecasters.

The optimism for an improving Chinese economy is not, however, backed up by recent figures for retail sales or fixed capital investment. July growth in both categories slowed from June. Retail sales climbed 13.2 % y-o-y. Precious metals sales grew fastest, increasing by nearly a third, and sales of furniture and building materials were brisk. Private investment rose by nearly a quarter, and growth in energy investment was especially strong. Construction-related investment, however, declined nearly 3 % y-o-y.

China's industrial output growth, %



Source: China National Bureau of Statistics

China's inflation remained modest in July. Consumer price inflation in July was 2.7 % y-o-y, the same level as in June. The decline in producer prices slowed to 2.3 %. Food prices were the fastest-growing category of consumer goods, averaging around 5 % y-o-y. Prices of transport vehicles and telecommunications equipment dropped slightly.

The mild inflationary environment has provided the government a window of opportunity to employ expansive economic policies. Modest rises in export prices and domestic demand further suggest a modest inflation outlook. Monetary aggregates give a mixed picture of inflation trends over the longer term. Growth slowed for the most liquid and narrowest money supply aggregate, M0, while growth of the broad money supply aggregate, M2, accelerated. M2 is generally considered the more important money supply measure.

China sovereign wealth fund's international investments turned profitable. The 2012 annual report of sovereign wealth fund CIC (China Investment Corporation) shows the company's international investments were profitable last year. The 2012 result was a stark contrast to the losses CIC suffered in 2011. CIC was established in 2007 to manage a share of China's massive foreign currency reserves in ways that would yield a better return on investment and diversify types of investment. CIC had earlier been criticised for poor investment returns. The 2012 report showed that CIC's assets had risen in value to around \$579 billion at year's end. CIC accounts for a substantial amount of Chinese investments internationally.

About a third of assets are invested in long-term projects in such sectors as real estate, infrastructure, energy and mining. CIC acquisitions last year included a 10 % stake in London's Heathrow Airport Holdings Limited for about \$690 million. Moreover, CIC invested directly in US-based EP Energy Corporation and Polyus Gold, Russia's largest gold producer.

Another third of assets are invested in exchange-traded shares. In geographic terms, investment in US shares rose to nearly half of equity investments. The remainder was spread evenly between other developed economies and emerging economies. Most equity investments are made in financial stocks, the weight of which in the stock portfolio rose from 19 % to 22 % last year. CIC, for instance, is a major owner in US-based investment bank Morgan Stanley. In contrast, the weighting of companies involved in energy and commodities shrank, while other sectors remained largely unchanged.

CIC's remaining assets are invested in fixed income securities, most of which are sovereign bonds of advanced industrialised countries or investment-grade corporate bonds. CIC has broadened its investment activities in recent years to include riskier asset classes to reach higher returns on its capital. These assets are invested in e.g. high-risk hedge funds and derivatives.

Under CIC's official investment strategy, all investment decisions are market-based and thereby free of political motives. However, the members of the company's management team usually have heavy political backgrounds. For example, former CIC head Lou Jiwei took over the finance minister position this March. Ding Xuedong, his successor, has earlier held numerous posts in the finance ministry and party administration. The CIC also has close ties with China's banking sector as it earlier participated in the recapitalisation of China's big state-owned banks via its subsidiary Central Huijin Investments. As a result, CIC today owns significant shares in all of China's large state banks.

China's foreign currency reserves are mostly managed by the State Administration of Foreign Exchange (SAFE), an agency of the central bank. SAFE does not release information on how assets under its management are invested.

Russia

Russia's foreign trade weak in the first half. The value of goods exports fell in the first six months of 2013 by 4 % y-o-y and amounted to just over \$250 billion. The contraction in exports reflected lower commodity prices; the volume of exports increased nearly 3 %.

The volume of Russia's top export, crude oil, declined slightly, while volumes of refined petroleum product exports were up sharply. The share of exports in crude oil production continued to fall, whereas a greater share of refined petroleum products went to export. The volume of gasoline exports rose 40 % y-o-y, which was also reflected in increasing domestic gasoline prices.

The trend for metal sector exports was also weak with substantial declines in both export prices and export volumes. Export volume of copper was down over 30 % y-o-y and nickel exports over 20 %. Arms exporter Rosoboron-export reported first-half exports of \$6.5 billion, putting it on track to match last year's total exports of \$13 billion. The company handles the vast majority of Russian exports of arms and military supplies.

The value of goods imports in January-June was \$160 billion, which helped Russia sustain a large trade surplus. The value of imports was up 4 % y-o-y. The volume of imports was practically unchanged from a year earlier, while prices of imported goods from non-CIS countries rose, due in part to a weaker ruble.

Growth in imports was held back especially by a flatlining in on-year growth in imports of machinery, equipment and transport vehicles (categories that account for about half of Russia's total imports). The volume of imported passenger cars, one of the biggest import product groups, fell 12 %. Food imports, especially from CIS countries, were up sharply, while non-food imports from outside the CIS, e.g. clothing and plastic products, grew rapidly.

Russia's top export destinations were again the Netherlands and Germany. The biggest import suppliers were China and Germany. Of the CIS countries, Russia's trade with Kazakhstan continued to grow briskly in the first half, while trade with Belarus and Ukraine continued to shrink. The value of Russian exports to both countries contracted by about 25 % y-o-y.

Highlights from Russia's first year as a WTO member.

Russia was admitted to the World Trade Organization on August 22, 2012. Only a few impacts of the membership on Russian imports are yet discernable, notably product groups such as pork. The impacts, however, should become gradually evident as Russia lowers import duties incrementally over the next few years.

The WTO and its member countries consider the possibility of getting Russia to adopt generally accepted international trade practices a major benefit of Russia's accession.

Russia is not yet in compliance with a number of WTO principles, however. A recent example is the July announcement of Russian customs that it was halting international shipments under the TIR system in mid-August (see [BOFIT Weekly 31](#)). Faced with a strong international reaction, Russian customs have backed off and are postponing the proposed measures for at least a month.

Maxim Medvedkov, the economy ministry department head who led Russia's WTO accession negotiations, says Russia's biggest challenges in adjusting to the WTO have been psychological. Russia must overcome its traditionally defensive stance and start implementing its commitments.

WTO membership has been widely discussed in Russia, where the general attitude is still quite wary of the arrangement. Elimination of barriers to trade is seen as a threat as rising imports weaken the position of domestic producers. In contrast, the positive impacts for consumers such as access to higher quality goods at lower prices are rarely mentioned.

Russia's Civic Chamber, an organisation created in 2005 to oversee the public's interest in actions of official legislative and executive bodies, released in August its own study on the impacts of WTO membership on food prices. The study determined that, even though wholesale prices for agricultural products have fallen during the past year, there was no evidence of a decline in prices at the retail level. Observers attribute much of the phenomenon to the lack of competition in Russia's retail trade, especially outside large cities.

Ukraine-Russia exports tumble. On August 14, Russian customs introduced a policy of inspecting every goods shipment from Ukraine, backing up border traffic and seriously disrupting Ukrainian exports to Russia. Russia gave no forewarning of its plans to change its customs practices as required e.g. under WTO principles. The policy change drew swift international criticism, including a statement from the EU condemning the Russian measures. On Tuesday (Aug. 20), Russia announced it was reinstating its earlier customs inspection procedures at the Ukraine border.

Presidential advisor Sergei Glazyev explained Russia was trying out the measures in preparation for adoption of the new customs procedures needed if Ukraine signs an association and free-trade agreement with the EU. Glazyev said Russia was concerned that the adoption of the EU-Ukraine agreement could allow goods imported duty-free to Ukraine to end up on the Russian market.

Ukraine and the EU are expected to sign the association agreement in November at the EU Eastern Partnership summit to be held in Vilnius, Lithuania.

Russia would like Ukraine to join the Russia-Belarus-Kazakhstan customs union, and the Russia's measures are seen as a way to pressure Ukraine to join. At the end of July, Russian health officials banned imports from Ukraine's largest candy factory.

China

China continues to struggle with statistical reporting issues. Christopher Balding, of the Peking University HSBC School of Business published an article in August claiming official Chinese statistical data seriously underestimate the actual rise in housing prices and its impact on general price level. Balding estimates that Chinese annual output has been about 10 % lower than officially claimed for the last ten years and he claims openly that China's figures have been manipulated for political reasons.

China's difficulties in collecting reliable statistical data are no secret and the assertion that officials deliberately fudge their numbers is not new even if there is no consensus among academic researchers about the impacts of possible manipulation on GDP growth figures. The poor quality of housing market price data and the weighting of housing in the consumer price index as well as price trends in the overall economy are among the main problems concerning Chinese statistics. Moreover, nobody takes seriously China's official unemployment figure which has been stuck at 4 % for a decade. The true condition of the public sector economy is even a question mark for the Chinese leadership, which recently created its own taskforce to determine the extent of local administration indebtedness.

Ballooning local administration debt exemplifies how gradual changes in the system create a need for new kinds of statistical data. The development of financial markets and emergence of grey markets have forced the adoption of new concepts and methodologies, even as data collection has failed to keep pace with changing conditions. With part of the market already liberalised and some still subject to heavy regulation, interpretation of even fairly standard statistical reporting is a challenge. For example, there was a huge disparity in the figures released this spring by mainland China for its exports to Hong Kong and Hong Kong's own figures for imports from mainland China. Chinese firms are suspected of falsifying their export figures upwards as a way to circumvent currency controls when importing capital into the country.

For anyone hoping to make use of statistical data for the Chinese economy, it is important to compare available information from several perspectives in order to minimize problems related to any single data. Getting a reasonable assessment of the actual size of China's economic output, for example, has long vexed researchers. The Balding study mentioned above notes that underestimation of price inflation in certain areas such as housing leads to overestimation of the real GDP figure. On the other hand, many experts think that deficiencies in Chinese collection of output figures could mean that GDP is actually larger than the reported figure as the contribution of the service sector is understated. Indeed, the last major statistical revision, which

occurred in 2005, revised Chinese GDP upwards by 17 % due to understatement of the service sector's contribution to economic output. It is a separate issue as to how these distortions in levels of GDP impact the overall figure for economic growth.

China's National Bureau of Statistics last year began to calculate GDP with data collected directly from firms to avoid provincial-level manipulation of reported data. The NBS has made a serious effort to improve its methodologies, but there is still unnecessary secrecy and lack of transparency around data collection and publication. Ongoing developments in Chinese society, markets and media all add to pressures to produce and release accurate statistical data. The need for change in this respect was highlighted last December when the Southwestern University of Finance and Economics in Chengdu published its own household survey that found disconcerting differences with official figures for income inequality and unemployment.

China turns to online shopping. The value of online retail sales in China rose over 40 % y-o-y in the first half to around \$120 billion. The share of online sales in retail sales overall rose to nearly 7 %, up from 3 % in 2010. In comparison, online retail in the US currently represents about 5 % of retail sales. Many observers expect China to surpass the US as the world's largest online market this year.

China's most recent five-year plan refers to online retail as an important area for development. It supports the goal of shifting the emphasis of economic growth away from investment to domestic consumption. A report from McKinsey Global Institute claims that shopping on the web not only replaces traditional consumption, but encourages people to consume more increasing the overall consumption. This is due to such factors as the greater selection of products and services available to shoppers also in rural areas.

The Chinese firm Alibaba dominates domestic online sales. Its subsidiary Taobao, for example, controls about 90 % of all online consumer auction transactions. Western Internet entrepreneurs have failed to take market share from Alibaba and other Chinese companies. Bloomberg reports that US-based e-commerce giant Amazon's market share in China is slightly below 1 %. Furthermore, the aggressive expansion campaigns of many Western Internet companies such as eBay and Yahoo! have failed.

Although online sales have skyrocketed, there is plenty of room for growth in China. At the end of June, China had about 590 million Internet users, or 44 % of the population. As recently as five years ago, the share of Internet users was just 19 %. China had 25,000 online retailers at the end of last year and competition for customers remains stiff.

Most online trade in China still takes place between companies at the wholesale level, but the share of retail sales on the Web has increased rapidly in recent years to. About a sixth of all online transactions involved retail sales at the end of 2012.

Russia

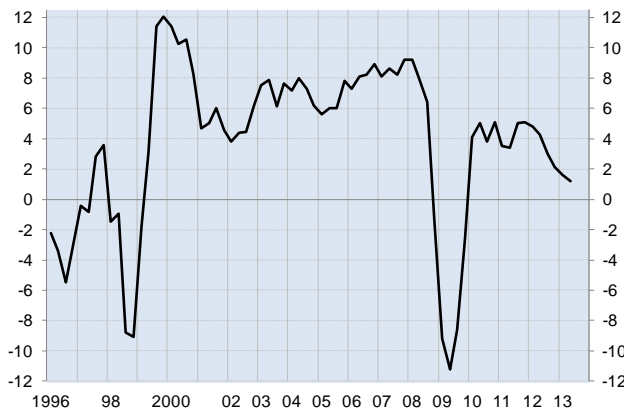
Russian economy ministry sees growth picking up in the second half of the year. Due to weakness in Russian economic activity in the first half, the economy ministry this week reduced its overall GDP growth forecast for 2013 from 2.4 % to 1.8 %. Growth, however, is expected to pick up in the second half. The earlier estimate of industrial output for the current year was revised down to around 0.5 %, while the estimate for investment growth was lowered to 2 %. Growth in retail sales should continue to rise this year at a pace above 4 %.

GDP growth in 2014 is currently forecast to reach about 3 %. Retail sales growth will continue at about 4 %, while investment growth is expected to climb to 4–5 %.

The forecast assumes an average price for Ural-grade crude of \$106 a barrel this year and around \$100 in subsequent years. Russian export earnings are expected to decline slightly this year and then plateau in 2014.

The economy ministry also lowered its forecast for imports. The value of goods imports is expected to increase about 2 % this year and 3–4 % next year. The ruble should weaken slightly against the dollar this year and a few per cent next year.

Russian GDP, percentage change from four quarters previous

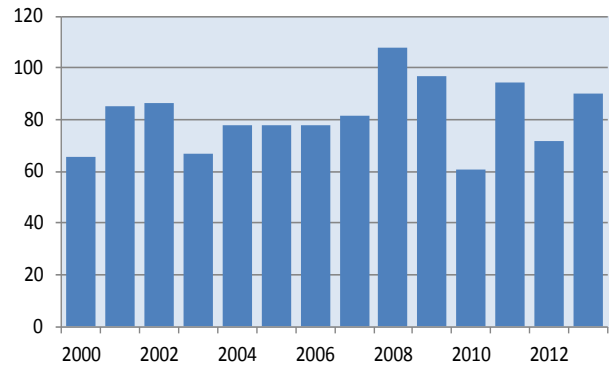


Source: Rosstat

Better-than-average Russian grain harvest ahead. Russian officials predict that this year's grain harvest will reach around 90 million metric tons, which is about 25 % higher than last year's poor harvest. Russian grain harvests averaged 82 million tons from 2000 to 2012. Wheat accounts for over half of Russia's total grain output.

Russia's grain exports this year are expected to increase to about 19 million tons. Grain exports in 2012 were 16 million tons, while in 2011 they were as much as 27 million tons. That year Russia was world's fourth largest grain exporter after the United States, Argentina and Australia.

Russian grain production (millions of metric tons)



Source: Rosstat

New law bans Russian officials and representatives from keeping their money outside the country. Under a law passed in April, people with jobs that involve setting policy affecting Russia's sovereignty or national security are forbidden from keeping their wealth abroad in foreign banks or holding foreign securities. The ban extends to e.g. members of representative bodies at all levels of government from parliament to local administrations, government officials, prosecutors, judges, members of the central bank board of directors, as well as all employees of state-owned corporations. The ban further applies to the spouses and minor children of the above-listed individuals.

The law gave those under the ban three months to repatriate their offshored wealth or resign their posts by August 17. Only a few members of Russia's upper-house Federation Council and a single deputy minister resigned their posts. Such notables as first deputy prime minister Igor Shuvalov and the chairman of technology fund Rosnano Anatoli Chubais said that they had repatriated their offshore holdings.

The state-owned bank VTB 24, which mainly serves private individuals, reports that its deposits rose 20 % in the first half of the year, or about the same amount as for all of 2012. Much of the growth is due to large one-time deposits. The bank's "VIP" client base increased about 25 % in the first half.

While the law does not forbid ownership of real property abroad, it requires the owner to declare annually his or her foreign real estate holdings and the sources of finance for their acquisition.

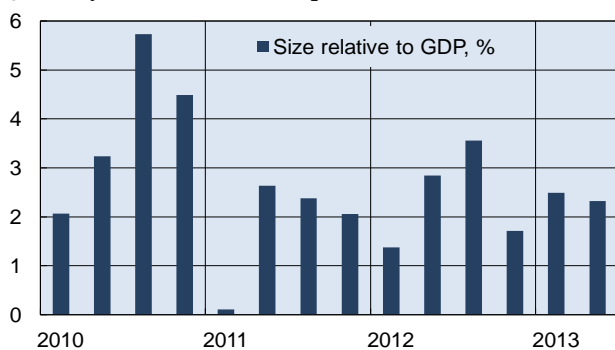
The purpose of the law is to "assure national security, improve transparency of lobbying activity, increase domestic investment and make anti-corruption measures more effective." Observers note it is rather easy to circumvent the ban, however. An affected person could e.g. hold their accounts under the names of third parties and keep shares in a managed securities register. Furthermore, it is rather difficult for officials to determine the existence of offshore accounts.

China

China's current account surplus remained stable in first half – while there was a large shift in capital flows.

China's current account surplus for the first half of this year was \$96 billion, an increase of about \$18 billion from 1H2012. The size of the surplus relative to the economy also grew a bit. The 1H2013 surplus was about 2.4 % of GDP compared to 2.1 % in 1H2012. The size of the current account surplus during the first six months of this year was rather stable; shifts in first-quarter and second-quarter current account balances in previous years have been more visible.

Quarterly current account surpluses



Source: Macrobond

While the full balance-of-payments data for 2Q2013 becomes available at later date, preliminary figures released by China's State Administration of Foreign Exchange (SAFE) show the combined capital and financial account balance was about \$1.6 billion in the red for the second quarter. The direction of net money flows apparently shifted sharply during the second quarter as the financial account balance showed a \$90 billion surplus in the first quarter.

The commerce ministry reports that foreign direct investment inflows into the country picked up during the second quarter. Some \$62 billion in FDI had flowed into China this year as of end-June, or 5 % more than in 1H2012. The factors boosting the pace of investment could be a more optimistic outlook than earlier for China's structural adaptation and stronger financial positions of foreign firms allowing them to increase their investments in China. In July, FDI inflows into China were up 24 % y-o-y.

The swift growth in Chinese foreign investment continued. Direct investment abroad by Chinese firms in the first half totalled around \$46 billion, an increase of nearly 30 % from a year earlier. The rapid growth in Chinese investment abroad seems to partly explain the shift in the financial account balance although net FDI inflows into China are still larger than FDI outflows from China.

China's foreign currency reserves grew by about \$130 billion in the first quarter, but growth slowed in the second to just \$50 billion. The lower growth in China's foreign currency reserves reflects the shift in the direction of net capital flows and the resulting abatement of appreciation pressures on the yuan. The yuan appreciated against the dollar in the spring but the exchange rate remained fairly stable during the summer. The US Federal Reserve announced its plans at the end of May to cut back on its bond-buying programme (QE) sometime this year. The policy shift seems to have impacted China's capital flows along with other developing economies.

China hopes to liberalise its capital account and permit exchange rates to be set increasingly based on supply and demand. The shift, however, will be gradual in order to prevent sudden shifts in the current account and capital movements. An IMF report released in July claims that the yuan is moderately undervalued relative to a basket of currencies. This would imply that the Chinese currency should continue to appreciate as yuan convertibility becomes easier and thereby cause China's current account surpluses to shrink.

Housing prices in China continue to climb. The rise in housing prices continued throughout the first seven months of the year. The housing price index published by the National Bureau of Statistics showed that prices of newly built apartments in 70 large and mid-sized cities were up over 6 % y-o-y in July. The increase in apartment prices in large cities was well above the average rise. In Guangzhou and Shenzhen, for example, prices were up 17 % y-o-y. In smaller cities like Nanjing and Tianjin, the rise in housing prices was around 7–9 %. Prices of older housing posted rises similar to new housing in July.

The rise in prices is driven by several factors, including the availability of housing loans. Growth in the stock of housing loans accelerated sharply in the first half of 2013. People's Bank of China figures indicate the loan stock increased about 20 % y-o-y or about 10 percentage points more than in 1H2012. Growth in the volume of borrowing by real estate developers also accelerated slightly in the first half. Real-estate-related construction investment picked up in the first half by around 20 % y-o-y, suggesting that developers expect prices to climb further.

The rise in housing prices over the long term is also affected by the ceiling on bank deposit rates and regulation of financial markets. Investments in housing have offered better returns than most other investments in recent years, which is why excessive amounts of capital are channelled to the real estate sector. Prices have been on the increase this year despite official measures to limit excessive real estate investments.

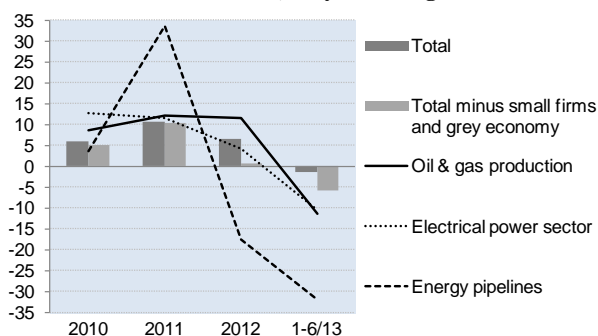
Russia

Sharp drop in Russian energy sector investment. Rosstat reports that after the end in the boom in construction of oil & gas pipelines last year, a further sharp contraction in the investment occurred in the first half of this year. Investment in production of oil & gas and the electrical power sector also declined considerably, and growth in manufacturing investment came to a halt. (These Rosstat figures do not include investment by small firms or investment in the grey economy. The data cover about 85–90 % of total energy sector and manufacturing investment.)

Presidential adviser Andrei Belousov told the cabinet this summer that the investments of large infrastructure companies such as Gazprom, Russian Railways and the state-owned electrical grid operator FSK, as well as public sector investment, fell about 10 % last year, and that a similar contraction is expected this year.

Rosstat estimates investment of small firms and grey-economy investment rose considerably in 2012 and the first half of this year. Without such investment, growth in total investment came to a near standstill last year and went into precipitous decline in the first half of this year.

Fixed investment volumes, on-year change (%)



Source: Rosstat

Russia-Belarus tiff over potassium exports widens. The export joint venture of Russian potassium producer Uralkali and the Belarussian Belaruskali formed in 2005 fell apart in August with both sides accusing the other of breaching their agreement. After the split the companies will compete against each other in the export market, which is expected to depress substantially the global potassium price. The joint firm controlled over 40 % of the global potassium market.

With the break-up of the joint venture, Belarus officials arrested Uralkali's Russian CEO at the end of August in Minsk during a negotiation trip. He was then charged with abuse of authority. Two days later, Russian pipeline operator Transneft announced that the oil pipeline running through Belarus needed immediate repairs, forcing Russia

to reduce its September oil export quota to Belarus by about 25 %. On the same day, Russian health officials confirmed that a number of dairy products imported from Belarus failed to comply with health and other standards.

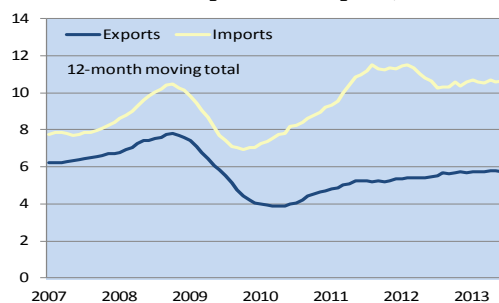
Slowing Russian economic growth evident in Finnish-Russian trade. The value of Finland's exports to Russia rose 2 % y-o-y in the first half to €2.6 billion. All of the growth was in the first four months; the value of exports declined in May and June. Some 9 % of Finland's exports went to Russia.

Petroleum products showed the highest export growth in the first six months of the year, rising nearly 30 % y-o-y in value terms. Petroleum products also became the largest single product category for Finnish exports to Russia. Other important export goods from Finland going to Russia included paper, pharmaceuticals, earth-moving equipment, cheese and butter. Broken down by category, machinery & equipment and chemical products clearly dominated. Exports of metals and textiles displayed brisk growth, while exports of mobile phones and passenger cars plunged 30 % y-o-y, reflecting a sharp decline in re-exports from Finland of products produced in third countries.

Transit freight moving through Finland to Russia contracted 16 % y-o-y in the first half. Finnish Customs puts the value of goods freight transiting Finland in the first half at about €2 billion. Machinery & equipment, cars and textiles remained the most common categories of transit products. The number of cars being brought into Russia via Finland continued to fall, with the number of cars transported down by a fifth from 1H2012.

The value of Finland's imports from Russia rose by 1 % y-o-y in the first half and was valued at €5.2 billion. Russia accounted for 18 % of all Finnish imports. Over 80 % of all Finnish imports from Russia were mineral products, mainly crude oil. Russia is by far Finland's main oil supplier. In the first six months of this year, 86 % of Finland's crude oil imports came from Russia. Oil imports from Russia have become more and more important for Finnish exports. Exports of petroleum products to Russia and other countries accounted for over 10 % of Finland's total exports.

Finnish-Russian exports and imports, €billion



Source: Finnish Customs

China

Shanghai free-trade zone prepares for launch. A recent press release from China's Ministry of Commerce reports that the State Council has given the green light to the proposed Shanghai free-trade zone. The new free-trade zone covers Shanghai's existing bonded areas including Pudong airport, the Waigaoqiao logistics park and Yangshan port. The areas are all incorporated under the new pilot project. Beyond playing the role of a traditional duty-free zone, the project is geared to promoting international trade, freeing up capital movements and encouraging investment by reducing red tape and bureaucratic barriers.

The commerce ministry says the government is seeking new ways to open up mainland China to foreign firms and investors. The initiative goes beyond solely developing the Shanghai economic area to overhauling the reform model for the whole country. The pilot project should give China's leadership a clearer understanding of the consequences of opening up China's markets and provide a sound basis for implementing reforms elsewhere in the country. The project can thus be seen as part of the structural reform that China's leaders hope will secure sustained economic growth over the long term.

The press release emphasises the importance of opening and reforming the banking sector. The project may portend further deregulation of China's financial markets if authorities decide to carry out new financial market experiments in the zone.

Shanghai's status as an international logistics and finance centre is enhanced once the market-based reforms under the plan are implemented. Regulation of interest rates and capital controls currently prevent serious competition with Hong Kong. Strict capital controls and relatively high corporate tax rate in mainland China have traditionally pushed many foreign investors to set up operations preferably in Hong Kong.

The details and timetable for the reforms will be announced later. The *South China Morning Post* reports that implementation could start as soon as this month. Ai Baojun, Shanghai's current vice mayor, will oversee development of the new free-trade zone.

China has a long history of experimenting with pilot reform projects at the regional level. The Shenzhen special economic zone developed rapidly after it was established in the late 1970s thanks to special privileges and tax breaks for companies in the zone. The city of Wenzhou is currently experimenting how to formalise private credit market in order to improve e.g. the access of SMEs to finance and bring oversight to the grey banking sector.

Chinese yuan could soon become one of the world's top 10 global payment currencies. According to the Society

for Worldwide Interbank Financial Telecommunication (SWIFT), the yuan was used in 0.9 % of international payments in July. Although there was no change from the previous month, yuan use in international payments doubled from July 2012. The Chinese yuan overtook the Norwegian krone and the Thai baht in June to become the world's 11th most used payments currency, and was hot on the heels of the 10th Swedish krone.

The share of euro in international payments was nearly 38 %. It was followed by the US dollar with 36 % and the British pound with nearly 9 %. The Japanese yen, often a benchmark for the yuan, had a 2 % share of the payment currency market in July, putting it in 4th place. The Hong Kong dollar ranked 8th with an approximately 1 % market share.

Chinese statistical data show that about 11 % of foreign trade payments in China were made in yuan in July. After a rapid increase up to the end of 2012, the share of the yuan in foreign trade payments has held steady.

Pressures build for China to deal with its urbanisation issues. A report from the United Nations Development Programme (UNDP) published at the end of August, [China National Human Development Report 2013](#), tackles the issues facing China as a result of on-going urbanisation. The report was drafted in cooperation with several Chinese agencies, including CASS and the NDRC. Urbanisation has long been a driving factor for Chinese economic growth and China's current leadership emphasises its importance also as an engine for growth in the future. If China's current rate of urbanisation continues, the report estimates China would add another 310 million city-dwellers by 2030 and that cities would be home to about 70 % of the population.

The move to cities has brought many problems. Urban housing prices have soared, income disparities have widened, social security is inadequate and the status of migrants is weak. Development of social services, public transport and road infrastructure has also failed to keep up with urbanisation's pace. The environmental problems in Chinese cities are daunting: nearly 70 % of cities lack adequate fresh water supplies and poor air quality is a big health issue in most cities.

The report calls for rapid implementation of bold reforms. Without them, the problems of cities will continue to get worse, and will become increasingly costly to fix. Among the report recommendations are that success of cities should be measured not just in terms of economic growth but a range of criteria. This would give city leaders greater incentive to focus on sustainable development policies. China also needs to see improvements in urban planning, and internal migrant workers should have access to the same benefits and public services as official residents. Use of resources also needs to become more efficient and there needs to be a greater emphasis on environmental protection.

Russia

Russia's \$7 billion sovereign bond issue proves a hit with international markets. Russia's finance ministry this week offered about \$7 billion in eurobonds to international investors. Market observers report demand was more than double the supply of bonds on offer. The issue covers the entire foreign borrowing requirement budgeted for 2013. The bond issue, under planning since spring, was postponed until September when market conditions were seen as more favourable for the bond sale. The issue consisted of \$6 billion in 5-, 10- and 30-year dollar-denominated eurobonds, and €725 million (\$962 million) in euro-denominated 7-year bonds. It was Russia's first bond issue denominated in euros.

The Russian state has issued roughly \$21 billion worth of eurobonds since 2010, even if the borrowing was done without any pressing need to go to international markets. In Russia's case, the issue of sovereign eurobonds is tied to fiscal policy goals and maintaining a market for Russian bonds in international capital markets. The main purpose of the bond sales is to simplify pricing of debt securities issued by Russian firms to make it easier for firms to raise money on international markets.

Russian central government debt is currently less than \$200 billion, which corresponds to less than 10 % of GDP. Of that amount, \$41.3 billion is denominated in foreign currencies and about \$150 billion (4.97 trillion rubles) in rubles. The Central Bank of Russia reports that about \$58 billion of total state debt is held by foreign investors.

In the first half of the year, Russia's domestic bond issues slightly outpaced the volume of bonds repaid. The finance ministry reports that some 470 billion rubles in debt securities were issued during January-August. The debt-repayments by the Russian state for domestic OFZ bonds and maturing bonds amounted to 418 billion rubles.

The presence of foreign investors in Russia's domestic debt security markets increased notably in the first half. The rise in foreign participation reflects a change in the law that entered into force in February. The amended law gives international central securities depositories Euroclear and Clearstream permission to participate directly in trading of ruble-denominated paper. Growth in the share of foreign trading, however, has raised concerns over rising volatility in domestic markets and pricing to be driven to foreign market places. The Central Bank of Russia says it is looking into the matter.

Russian companies cut back on borrowing from domestic banks. Corporate borrowing from banks has been in decline in Russia for about 18 months now. Loans with maturities longer than six months have decreased overall,

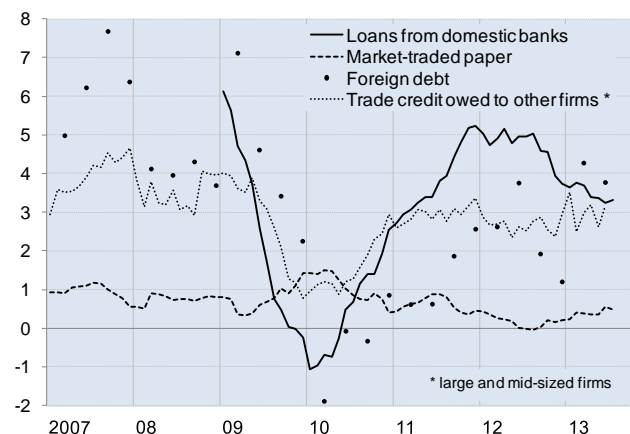
and as regards the longest loan maturities, due to growth of fixed capital investment grinding to a halt. Short-term corporate borrowing remains relatively modest. The nominal interest rate charged on corporate loans has fallen slightly this year together with inflation, while real interest rates have remained at around 4–5 %. Observers note that real interest rates are still quite high relative to risks of fixed capital investment from e.g. uncertainty over the outlook for demand. Banks have also tightened their lending requirements concerning the economic condition of borrower companies.

Corporate borrowing from abroad this year has remained roughly equal to last year because the spike in foreign borrowing figures early this year was due to state oil company Rosneft's acquisition of TNK-BP. The deal boosted corporate sector foreign debt by over 10 %. To finance the deal, Rosneft borrowed heavily on international markets and then used the money to pay for most of the TNK-BP shares it bought from British Petroleum.

Issuing of corporate debt securities has recovered this year. Companies have managed to raise funds a bit more cheaply with longer payback terms by issuing paper rather relying on bank loans. Banks, in turn, have been allowed to use the bonds as security for liquidity loans from the CBR. Companies have granted trade credits to each other at about the same pace as in 2011 and 2012. Trade credits are a significant source of short-term finance for firms. Corporate debt-servicing problems, which could arise from Russia's severe slowdown of economic growth, are only seen at the moment in the trade credit arena, where the share of belated payments began to rise in the early months of this year.

The debt of Russian businesses to domestic banks as of end-June was 30 % of GDP. The foreign debt of Russian companies and domestic inter-firm trade credit were each at levels that corresponded to about a fifth of GDP.

Corporate debt (not including banks), change of stock from 12 months or four quarters previous, % of GDP



Sources: Central Bank of Russia, Rosstat, Cbonds

China

Good late summer economic performance dispels concerns over China and global economy. Chinese industrial output climbed slightly over 10 % y-o-y in August, while retail sales growth continued steadily at nearly 11 % y-o-y in real terms. Earlier-released purchasing manager indices (PMIs) also indicated slight improvement in industrial output and an on-going positive trend in the service sector. Nominal annual growth in fixed capital investment has long been at around 20 %. Changes in price trends were modest in August. Consumer prices were up 2.6 % y-o-y, while producer prices were down 1.6 % y-o-y.

August foreign trade figures also provided heartening news for China and the global economy. The value of Chinese exports and imports were up 7 % y-o-y last month. Higher exports to the United States and Europe supported the view that recovery was under way in both regions. In addition, concerns about a slowdown in Asia were allayed by a sharp rise in exports to South Korea, Taiwan and ASEAN countries. The frayed Japan-China relationship, however, continued to dampen Chinese exports to Japan. The trade surplus for January-August reached \$156 billion, an increase of over \$30 billion from the same eight-month period a year earlier.

The view of the real economy from the perspective of financial markets was somewhat cloudier. Total credit provision (social financing) grew faster than expected in August, possibly reflecting the improved outlook for producers. However, the interpretation may not be so simple, as the growth of lending was driven by short-term borrowing from the informal sector. In contrast, the pace of traditional bank lending was largely unchanged from previous months. Only 45 % of new credit granted in August came in the form of traditional bank loans, which may suggest that companies are again finding themselves increasingly forced into the grey market for credit due to liquidity problems and need to repay earlier debt. The situation could also show that the grey money market remains active despite efforts of regulators to rein them in.

Minor changes in indicators for the Chinese economy often receive considerable media attention and lead easily to over-interpretation. Anyway, compared to concerns a few months ago, the figures for July and August on balance suggest a positive trend, although they reflect stimulus measures by the government, increased enterprise borrowing and a recovery on the export front. The dissipation of immediate worries about economic growth now gives China's leaders the opportunity to focus on pushing ahead with structural reforms aimed at sustainable economic growth.

Chinese firms piling on debt. A recent assessment by Spanish bank BBVA found that Chinese firms (excluding banks) had debt totalling about 65 trillion yuan, or nearly 130 % of GDP at the end of 2012. China's corporate debt stock has soared in recent years. As recently as end-2008, it was still less than 100 % of GDP. Even higher debt figures have been suggested. Estimates of corporate indebtedness vary depending on how the debt of firms owned by local administrations is included. It is clear, however, that the debt carried by Chinese firms is massive by any measure. Indeed, there are very few countries in the world with higher levels of corporate debt relative to GDP.

Chinese financing is still mostly bank-based, despite a strong trend in recent years to use alternative modes of finance. BBVA estimates that approximately two-thirds of corporate debt is held in the form of bank loans, another 10 % as corporate debt securities and about a quarter as financing raised from grey market sources. Chinese firms hold very little foreign debt.

Corporate indebtedness reflects the fact that Chinese firms have been living in an era of relatively cheap money. Large amount of their loans were granted at interest rates below the central bank's reference rate, which at the moment is 6 % for a one-year loan. For small and medium-sized enterprises (SMEs), however, it is not always possible to get a bank loan. SMEs must turn to the grey credit market, where interest charges are substantially higher. In Wenzhou, for example, the rate on a one-year loan from the grey market currently averages around 15 %.

The costs of debt servicing for companies, however, has been rising. The credit ratings of companies involved with metal and mineral extraction, in particular, have been downgraded and the yields on their bond issues have increased sharply. Media reports also note bankruptcies, as a coal producer in southern China ceased operations in August under the weight of billions in debt. More bankruptcies in the industry are expected.

Lower growth in bank profits. The profits of Chinese commercial banks rose an average of 14 % y-o-y in the first half of 2013, down sharply from last year. Most bank profits came from provision of basic banking services, i.e. loaning out deposits at higher interest rates. The rise in profits was largely limited by the fact that the margin between interest paid on deposits and interest charged on loans narrowed during the first six months of the year. The narrowing was seen as evidence of increased competition for customers. The People's Bank of China eliminated at the end of July its minimum floor on lending rates, a move expected to further increase competition among banks.

Banks expect tougher times ahead even with profit growth. Stocks of non-performing loans have so far increased only slightly, but the default rate is expected to increase in the near future as the volume of overdue payments has surged.

Russia

BOFIT forecast sees Russian economic growth reviving.

The slowdown in Russian economic growth in the first half of 2013 to less than 1.5 % p.a. was significantly sharper than predicted. This was mainly due to a reduction in investment of state-owned enterprises and the public sector. In our latest [BOFIT Forecast for Russia 2013–2015](#), we expect the Russian economy to pick up in the second half of this year as the global economy revives. GDP growth for all of 2013 is now forecast to reach nearly 2 %.

Growth should be restrained somewhat by a slight decline in the oil price. In 2014 and 2015, nevertheless, GDP growth should exceed 3 % p.a., supported in part by the recovery in world trade that should gradually increase Russian exports and end the contraction in fixed capital investment. Russian import growth should pick up slightly to around 5 % p.a.

Growth in exports will remain low due to a slight deterioration in the outlook for energy exports. Growth in household incomes will also slow as room for granting wage hikes has narrowed. On the other hand, the decline in inflation should give a slight boost to household purchasing power. Also, household borrowing should recover. Driving factors behind revived capital investment include the facts that production capacity utilisation levels are high and the state will begin to grant long-term loans to finance a number of massive transport infrastructure projects. Other stimulus measures in the government's current plan are somewhat scattered and seem likely to have limited impact. The increase in state spending will slow as growth in state revenues has decreased sharply and the goal, at least for the moment, is to keep the budget deficit small.

Russian GDP and import volumes, realised and BOFIT forecast 2013–2015, %

	2008	2009	2010	2011	2012	2013f	2014f	2015f
GDP	5,2	-7,8	4,5	4,3	3,4	1,8	3,3	3,2
Imports	15	-30	26	20	9	4	5	6

Sources: Rosstat, BOFIT

Economic growth will be weaker than forecast if the recovery of the global economy is delayed, the oil price falls, growth in household incomes and state expenditure slows more than predicted or if uncertainty about demand and the business environment limits investment. Russia's high employment rate could also constrain growth.

Over time, economic growth will gradually head towards its long-term trend as long as the oil price does not rise. Our calculated long-term trend has moved to a distinctly lower level since the 2009 recession. The trend hovers around 2 % unless Russia accelerates its efforts to improve its business climate and attract more investment.

CBR names new deputy chairwoman and streamlines its monetary policy instruments. Presidential economic policy adviser Ksenia Yudaeva (43) was named Central Bank of Russia first deputy chairwoman on September 11. Yudaeva, who took her PhD at MIT in the US, will be in charge of CBR monetary policy.

The CBR board decided last Friday (Sept. 13) to eliminate many of its financing instruments. The goal of a smaller toolbox is to increase monetary policy transparency to better signal monetary moves to the markets. The CBR also expects the change to promote development of the inter-bank market

Russia's central bank has had at its disposal a wide array of interest rate tools, due in part to the heterogeneity of Russia's banking sector. Interest rates have been inconsistent and they have been changed at different times, which has diminished the effectiveness of monetary policy. The new system is structured along the lines of e.g. the European Central Bank (ECB).

The 7-day repo auction credit rate was announced as the main monetary policy tool, the "key rate." These credits have even to date been the most important form of central bank financing to banks. The rate currently stands at 5.5 %.

The standing facilities consist of the overnight credit rate (6.5 %) and overnight deposit rate (4.5 %). A change in the key rate will cause a corresponding shift in these rates, which in principle form the upper and lower limits for short-term interbank rates.

Starting in February 2014, the bank will no longer grant e.g. one-day and 7-day repo credits. On the other hand, the CBR is introducing the possibility of fine-tuning operations in the same manner as the ECB to adjust market liquidity.

The CBR in July introduced a new longer-term financing facility, the three-month adjustable-rate credit. Non-marketable assets will be approved as collateral to secure the loans so that marketable assets are available for use as collateral in the interbank market. The interest rate is tied to the central bank's key open-market rate.

The CBR's refinancing rate, currently at 8.25 %, serves no role in monetary policy, but instead provides a legal reference rate for many types of payments. By the end of 2015, the CBR hopes to have gradually cut the refinancing rate to a level matching the key rate so it can be phased out altogether. A transition period is needed to enact amendments to legislation that refers to the refinancing rate.

Main CBR financial instruments and their interest rates, %

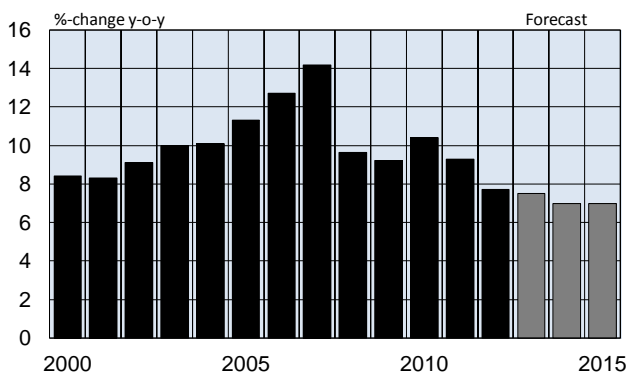
Liquidity boosting	Overnight credit	6.50
	3-month credit	minimum 5.75
	7-day repo credit	minimum 5.50
Liquidity reducing	7-day deposit rate	maximum 5.50
	Overnight deposit	4.50

Source: Central Bank of Russia

China

BOFIT sees China's economy growth slowing in 2013–2015. This week, we released our latest [BOFIT Forecast for China 2013–2015](#). China's economy slowed slightly more than expected in the first half of this year, motivating us to lower our March forecast of 8 % p.a. in 2013 to 7.5 %. Otherwise, however, growth over the forecast period conforms to our earlier long-term outlook that sees economic growth moderating to around 7 % p.a. in 2014 and 2015. Annual growth in export volumes is expected to reach 5–6 % during the forecast period. Because economic growth in China is higher than in its trading partners, imports are expected to rise slightly faster than exports. Depending on the development of foreign trade prices, the current account surplus could slide over the next two years from about 2.5 % of GDP at present to around 2 % of GDP.

Realised GDP growth and BOFIT forecast 2013–2015



Sources: China National Bureau of Statistics and BOFIT

The immediate causes of China's economic slowdown are lower export growth, rising debt problems and overcapacity in many sectors that reduce capital investment possibilities. China's growth is still quite robust even with the slowing, so China's decision-makers apparently see no need at present to support growth as earlier with a flood of credit. Instead, they emphasise targeted fiscal spending measures e.g. in the form of tax breaks to small businesses and accelerating the pace of investment in railway projects. The authorities are forced to this partly due to mountains of debt held by local administrations and firms that resulted from easy access to credit under the previous stimulus package.

Over the longer term, rapid urbanisation and the following increase in demand for services will gradually change the structure of economy. Consequently, also the economic growth will slow down. As this shift to a more consumption-driven model can be promoted through structural reforms, China's new leadership later this year is expected to announce, among other things, reforms to the *hukou* household

registration system, as well as changes in public sector administration and budget systems. Officials this summer ended regulation of bank lending rates and incremental reforms of the financial market will continue as before. International use of the yuan should continue to rise and currency controls will be relaxed.

If debt problems worsen and expose vulnerabilities in the financial and real estate sectors, economic performance would likely fall below our basic outlook. Despite significant troubles brewing, the near-term risks appear quite manageable overall in relation to projected economic growth. The new leadership's commitment to reform shown this year portends less hardship down the road, even if reforms are difficult to implement and may come with surprises.

EU Chamber of Commerce in China wants to see more space for market forces to operate. The European Chamber of Commerce in China last week released its annual business climate assessment [Position Paper 2013–2014](#). The Chamber argues current economic conditions call for extensive reforms if the government hopes to sustain high economic growth in the future.

The Chamber sees that the state currently plays too big role in the corporate sector. Reforms reducing the role are critical for the economy as they would reduce market distortions and promote better use of resources. This applies in particular to the financial markets, where state-owned enterprises (SOEs) and local administrations have access to low-interest loans that they often use on unprofitable projects. SOEs are also shielded from competition through various industrial policy measures such as subsidies, which allow inefficient businesses to survive. The Chamber would like to see domestic and foreign firms treated equally in terms of access to state support. Moreover, the red tape encountered by firms could be reduced by clarifying the responsibilities of ministries and the various levels of government that currently overlap and occasionally conflict with each other. The Chamber would also like to see enhanced enforcement of patent and copyrights.

The Chamber was particularly concerned about the increase in recent years of actions taken in the name of China's innovation policy. According to the position paper, many innovation measures do not strengthen China's innovation capacity, and can be seen as masked attempts to grow market share of a particular domestic firm. The state has taken on the role of picking winners and losers, i.e. deciding the future branches and technologies with the best possibilities, and then lavishing them with support. The Chamber notes that such prioritisation is hard for firms themselves, let alone the state, and such picking up is likely to tie up large amounts of capital in unprofitable ventures. The Chamber also states that favouring domestic innovation in public procurement does not actually promote innovation, but it merely protects Chinese firms from competition.

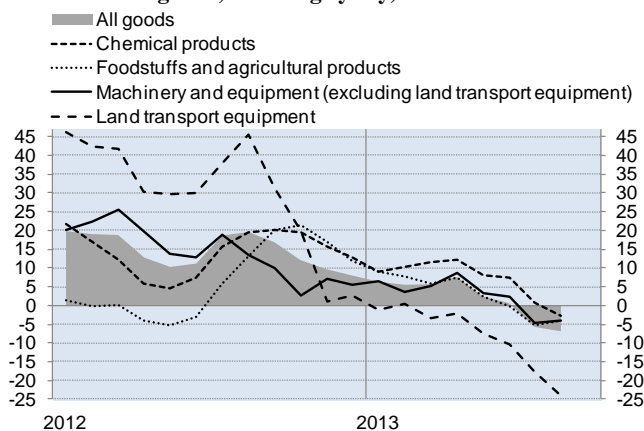
Russia

Russian economy and imports continue to falter. The economy ministry estimates GDP (workday-adjusted and seasonally adjusted) increased only slightly during the summer months. In year-on-year terms, GDP growth in August was 1.5 %, the same growth figure as posted for the whole January-August period.

Growth in manufacturing output has slowed considerably over the past twelve months. By early summer, manufacturing output was lower than a year earlier. In August, fixed capital investment was again lower than a year earlier. Retail sales, in contrast, have continued to display decent growth; August retail sales were up 4 % y-o-y.

Imports became weaker. The value of goods imports in July and August was lower than a year earlier. Until late spring, the decline was led by a drop in imports of passenger cars, but in recent months contractions have also been seen in other major imported goods categories.

Russian goods imports from non-CIS countries (in euros, 3-month moving sum, % change y-o-y)



Source: Russian customs

Wages keep climbing in Russia, but wage gaps remain huge. Rosstat reports that the average monthly wage in Russia in August was up nearly 13 % from a year earlier. A tight labour market continues to support brisk wage gains. Moreover, Russia's unemployment rate has long held at a historically low level of 5 %, despite the fact that Russian economic growth has slowed considerably. The labour ministry said that at the start of August there were nearly 2 million unfilled positions available in the country.

The average monthly wage of a Russian in August was 29,000 rubles (about €70), but wage levels vary considerably across regions and branches of employment. The highest wages are paid in Moscow and regions in the Far East involved in oil and gas production (price levels are also higher in these areas). The lowest wages are paid in Southern Russia and in the southern Siberian republics.

The business branches paying the highest wages are finance and oil & gas production. Branches that pay below-average wages include agriculture and the textile industry. In Moscow, for example, employees working in the companies of mineral extraction sector earned an average monthly salary of over €3,000, which is nearly the same as in Finland. In contrast, the average monthly wage of a textile worker in the Karelian Republic was less than €200, which is on par with the current official minimum wage in Guangdong province in China. Moreover, the wage differences between management and workers are substantially greater in Russia than in most developed countries.

The Russian minimum monthly wage by law this year is 5,250 rubles (about €120). That amount is considerably less than the official "subsistence minimum" and about the same as e.g. the low-end of the minimum wage spectrum for Chinese cities. Official statistics show that a couple of percent of those employed in Russia (over a million people) work for minimum wage. However, actual wages are often higher than reported, as many workers still take part of their pay under the table. Rosstat estimates about a fifth of the country's workers are employed in the grey economy.

Foreign pharmaceutical makers dominate the Russian market. Russian pharmaceutical sales last year were estimated to reach 818 billion rubles (about €20 billion), with foreign pharmaceutical makers controlling nearly 80 % of the market. The Russian government has tried numerous measures to promote domestic pharmaceutical production. Its goal is to raise the share of domestically produced medicines to half of the value of the pharmaceutical market by 2020. The goal is to increase the share of domestic-made "essential" medicines, i.e. those critical to survival and subject to price regulation, to 90 % by 2020.

Under a government ruling that remains in force until the end of this year, offers from foreign drug-makers submitted as part of a competitive bidding for public procurement cannot in practice win the bid unless the price offered is at least 15 % below the price offered by a Russian or Belarus firm. The Russian government is currently considering a draft proposal, whereby foreign manufacturers would be banned altogether from public procurement bidding competitions starting next year if two or more drug-makers from Russia or Belarus have registered the medicine in question in Russia.

While Russia's large market is attractive to foreign pharmaceutical manufacturers, Russian rules favour domestically produced medicines and the siting of production facilities in Russia. Several foreign pharmaceutical makers are currently building plants in Russia. A recent Deloitte survey, however, noted that foreign drug-makers find it hard to green-light investments in Russia due to market uncertainty caused by e.g. frequent changes to the laws and regulations governing the pharmaceutical branch.

China

Additional small steps to reform Chinese financial markets. At the beginning of September, China launched trading in government bond futures, increasing the selection of instruments available to investors and making it easier to hedge against interest-rate risk. The opening of a bond futures market in China was last tried 18 years ago, when market manipulation by one brokerage house led to a collapse of the market and forced the state to ban all futures trading. Officials are now proceeding cautiously and trading is permitted only among a fairly exclusive group of brokers and investment firms. Banks and insurance companies, which hold the lion's share of government bonds, are currently not allowed to engage in bond futures trading.

China this month also took a small step towards deregulation of capital movements by granting six global hedge funds in Shanghai permission to raise money from Chinese institutions and invest it abroad. The amount of funds that can be raised is still limited to relatively small quotas. The move is the first step in the pilot Qualified Domestic Limited Partner (QDLP) programme, which is designed to complement earlier trials in liberalised capital movements. The QFII and RQFII programmes let qualified foreign investors invest foreign-currency- and yuan-denominated assets in mainland China within specific quotas. The QDII programme, in contrast, allows select domestic institutions to invest Chinese assets abroad.

China's financial markets have already been reshaped dramatically by existing financial market reforms, on-going financial sector trial programmes around the country and the explosion of grey financial markets. The changes have set off a self-sustaining chain reaction, whereby each minor reform makes it easier to move ahead with the next reform. The forces for further changes gain strength, in turn, as all market participants lobby for the same rights and opportunities as others. The September reforms are seen as important opening moves for financial market participants and create a basis for further liberalisation measures. The next financial market transformation is expected to come from the new free-trade zone established in Shanghai.

China surpasses Russia as top trading partner for Central Asian countries. Chinese president Xi Jinping earlier this month toured Kazakhstan, Kyrgyzstan, Uzbekistan and Turkmenistan. Central Asia is important to China mainly because of its large hydrocarbon endowments. China has begun to tap into those reserves now thanks to large-scale oil and gas pipeline construction in the 2000s. Additional pipeline transmission capacity is under construction.

President Xi's tour was clearly oriented to energy issues. During his visit to Kazakhstan, a number of cooperation

agreements were signed. The most important deal pertains to the massive Kashagan offshore oil field, located the Kazakh sector of the Caspian Sea. State-owned China National Petroleum Corporation will acquire an approximately 8 % stake in the oil field for \$5 billion, and China promised to provide the financing for development of the oil field in exchange for future oil supplies.

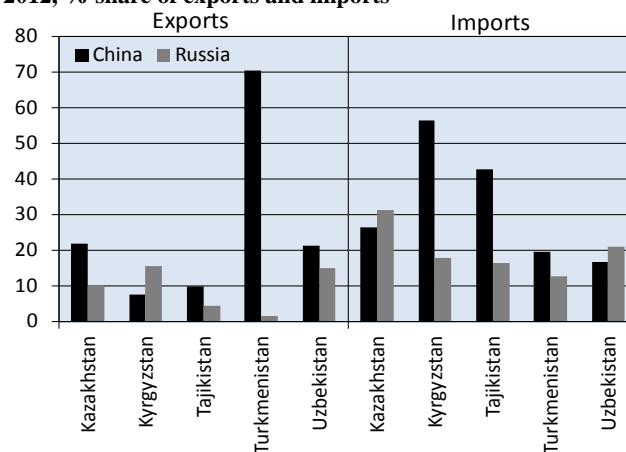
In Turkmenistan, Xi attended the inauguration the newly developed Galkynysh gas field. Gas produced at the field will go to China, and the Chinese have been extensively involved in developing the infrastructure of the field. China and Turkmenistan agreed to increase annual gas supplies by 25 billion cubic metres to 65 billion cubic metres by 2020. Turkmenistan's exports consist almost entirely of natural gas, most of which goes to the Chinese market.

In Uzbekistan, several energy-related deals were signed with a combined value of about \$15 billion. The projects relate to development of Uzbekistan's oil and gas reserves, as well as exploitation of its uranium reserves. The countries also agreed on construction of a railway to run from Uzbekistan via Kyrgyzstan to China.

China granted a \$3 billion loan to Kyrgyzstan. Half of the money is earmarked to fund construction of a new gas pipeline running from Turkmenistan via Kyrgyzstan to China. The rest will be used for various projects such as refurbishing of an electrical power plant, highway construction and expansion of an oil refinery.

Although China imports huge amounts of energy from Central Asia, Central Asia collectively only accounts for 1.3 % of China's total goods imports, and only about 1 % of China's exports go to Central Asian countries. In contrast, China has become an important trading partner for Central Asian countries as an alternative to their traditional main trading partner Russia. In nearly all countries of Central Asia, China has now surpassed Russia as the number-one trading partner.

Trade of Central Asian countries with China and Russia in 2012, %-share of exports and imports



Source: IMF Directions of Trade

Russia

Low economic growth forces high-level debate on structural reform. Top government officials presented their insights on the economy and needed reforms recently at investment forums in Sochi and Moscow. Most attention was devoted to familiar themes such as Russia's poor business climate and how it impedes economic growth by scaring off investment.

President Vladimir Putin noted that progress in reforms to improve the business climate has been very modest so far and gave a time limit of two years for the reforms. He said that basing Russia's living standards on natural resource extraction is ultimately unsustainable. A big issue in Putin's view is the lack of efficiency in the Russian economy; labour productivity is substantially lower in Russia than in advanced economies.

Economy minister Alexei Ulyukayev reported that economic output contracted in the second and third quarters of this year. The economy ministry now forecasts yearly GDP growth of just over 3 % over the next few years.

Prime minister Dmitri Medvedev repeated his critique of the state's overblown role in the economy and the size of Russia's public sector. He said that the state plays too great a role in driving output growth. Medvedev's view is that public sector activity should be reduced and made more efficient. In the sphere of competition, Ulyukayev noted that ministries and government agencies may be too oriented to the public sector and do not always grasp the importance of the private sector.

Some less frequent topics also came up. Medvedev, in particular, called for greater efficiency in employment policy. In his view, efforts to support full employment at any cost now need to end, even if it means reduction of ineffective jobs. He called for special attention to restructuring of *monogorods*, towns built around a single enterprise or business. Medvedev added that possibly even a significant share of Russians might have to change jobs – and even their professions or where they live – if the structure of Russia's economy is to be reformed. Both Putin and Ulyukayev reiterated this theme.

Efficiency problems have received attention also in company level recently. For example, according to media reports, a draft of the new development strategy of the giant state-owned shipbuilder OSK recently revealed plans to possibly even close some of the company's inefficient shipyards.

Structural reforms are difficult to implement due to their negative short-term impacts, even if they are necessary to sustain economic growth of the Russian economy over the longer run. Many observers hoped that the 2008–2009 financial crisis would incentivise Russian decision-makers to move ahead with structural reforms of the economy. Instead

the state moved to support large firms regardless of their inefficiencies. This was done to support household income development and prevent social unrest. The result was preservation of old inefficient production and reduction of state's oil revenue funds.

Partial freeze on regulated prices hoped to revive Russian economy. Regulated prices of goods and services produced by "natural monopolies" (e.g. gas, water, heating and rail transport) have been increased a pace higher than inflation in recent years to achieve cost recovery levels. Such rate hikes have been a major factor in keeping inflation high. For example, the rates households pay for gas were hiked by 15 % last year and again by the same amount this year, while rates for heating went up 10 %. Consumer price inflation last year was 6.6 %, and this year it is expected to moderate to 6 %.

The government wants to slow inflation in order to boost economic activity. To accomplish this, it will limit rate hikes of natural monopolies over the next few years. The measure reduces cost pressures on other sectors of the economy and shifts revenues from infrastructure monopolies to the manufacturing sector. This is hoped to encourage investment in diversification of production. Restraining rate hikes should also lead to a situation where infrastructure monopolies are forced to become more efficient.

In September, the government decided that rates of goods and services sold by monopolies to the corporate sector would not be raised at all next year. In 2015 and 2016, rates will only be increased to the extent of the previous year's inflation. Rates paid for household heating, water, electricity and gas will be increased during 2014–2016. The average increase is to match the inflation rate of the previous year minus 30 %. Using this formula, the average rate hike next year would amount to 4.2 %.

The downside of reduced rate hikes is that they lower the revenue projections of infrastructure monopolies and limit their investment possibilities in a situation where all investments would be important in order to accelerate economic growth.

The cabinet admits that there is a risk that infrastructure monopolies may cut back existing investment plans somewhat as their revenues will be smaller than earlier projected. This could negatively affect also sectors servicing infrastructure monopolies. According to the government, strategic development plans of monopolies need revision that takes into account the reduced income prospects. To support this, the government is seeking measures that lower the monopolies' operating and investment costs without harming their operations or reducing their investments. One of the ways of doing this would be the introduction of public control over infrastructure monopolies. The government is also considering partial financing of monopoly investments out of the federal budget, pension fund or oil tax revenues set aside in the National Welfare Fund.

China

Game rules for Shanghai free-trade zone still unclear. At the end of September, China officially opened the Shanghai free-trade zone (FTZ) along with a list of reforms the government hopes to test in the 29-square-kilometre zone over the next 2–3 years. Most of the extra freedom to set up new companies and operate them will go to firms providing services. Financial services is the focus area with the highest profile, but other areas getting a chance to partake in the experiment include logistical services, trade, professional consulting services, entertainment, health care and training services. A small group of telecommunications services are also listed. The FTZ trials extend to 18 branches. At this week's launch, operating permits for the zone had already been granted to 36 companies. Two foreign banks, Citibank and DBS, are included among the dozen banks given berths in the FTZ.

Many practical questions remain open, however. Although fine-tuning and adjustments may come over the next three months, many of the pilot projects by nature require the laying of extensive groundwork. This applies particularly to the financial sector. The plan is to lift restrictions on bank operations, free up capital movements and yuan convertibility, which presumes officials should be able to monitor regulations are followed both in the FTZ and in the rest of China. The proposed deregulation of interest rates would create additional arbitrage position and moral hazard that could encourage some parties to exploit the different rules of the parallel systems and increase risk of abuse. While officials have experimented with e.g. monitoring money transfers between Hong Kong and mainland China, it will be a long time before financial supervision and financial market infrastructure in the FTZ reach the level of Hong Kong.

The decision to create the Shanghai FTZ is in itself a fascinating step in Chinese reform policy. It signals that the country's new leadership has committed to developing an advanced market based economic system. The experiment is being conducted under the direct supervision of the government, and Shanghai officials have been specifically tasked with implementation. The top-down arrangement is hoped to minimise inter-ministry turf battles and mis-communication.

A broader issue is whether regional experiments have lived their usefulness given China's current circumstances. In particular, given the nature and rapid evolution of financial markets, the FTZ experiment should not impede national reforms to the financial sector or on-going learning processes of firms and officials elsewhere. Indeed, with regard to the financial market, the Shanghai experiment may come a bit late and, consequently, may bring little in the way of added value. What China's financial market may need today is simply carrying on with reforms at the national level.

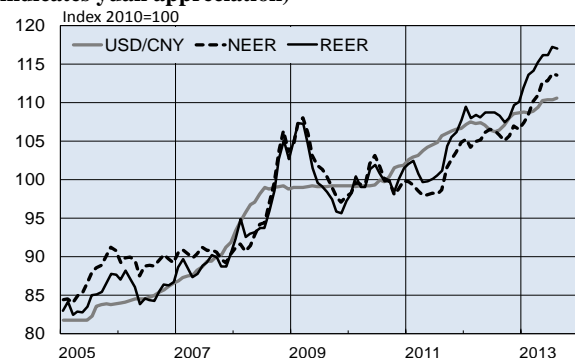
Yuan's real effective exchange rate has appreciated significantly. The real effective, or trade-weighted, exchange rate (REER), a measure of China's price competitiveness with its trading partners, has strengthened over 6 % this year. REER gains have been led by sharp yuan appreciation against the Japanese yen, although the yuan has also been appreciating rapidly against the currencies of many emerging economies. The yuan has appreciated less than 2 % against the dollar this year in nominal terms. On Thursday (Oct. 3), one dollar bought 6.12 yuan. The yuan has weakened slightly against the euro over the past nine months.

Despite the erosion of price competitiveness in the export sector, the volume of Chinese exports has grown around 10 % this year. Chinese export firms appear to have been bearing the costs of yuan appreciation. For example, prices of Chinese products shipped to the US have declined an average of about 1 % this year.

While economic growth has slowed significantly in recent years, authorities have refrained from re-pegging to the dollar to boost export growth, as occurred in 2008 when the financial crisis broke out. Central bank interventions in the foreign exchange market have become less frequent, suggesting that market forces are increasingly allowed to guide the yuan's exchange rate and that the yuan's exchange rate is closer to equilibrium than earlier. Indeed, an IMF assessment last summer found the yuan's exchange rate would be in equilibrium with an appreciation of just 5–10 %.

Guiding of the yuan's exchange rate is accomplished in practice with the central bank setting the yuan's reference exchange rate on the morning of each trading day. The central bank then refrains from intervention as long as the yuan appreciation or depreciation amounts to less than 1 % against the US dollar. If pressure for a bigger swing occurs, the central bank will begin to buy or sell currency. Although the official statement says the yuan's exchange rate is defined relative to a currency basket, yuan steering seems to be tracking the US dollar. Changes in the yuan's exchange rate against other currencies largely reflect their changes against the dollar.

Yuan-dollar exchange rate, REER and NEER (rising trend indicates yuan appreciation)



Sources: BIS and Reuters

Russia

Major forecasts for the Russian economy lowered. Following the Russian economy ministry's lowered forecast in late summer, the IMF and the World Bank cut their forecasts for Russian GDP growth this year to 1.5 % and 1.8 %. The IMF's October [figure](#) reduces its April figure by nearly two percentage points. Like the economy ministry, the IMF and the World Bank expect Russia's GDP growth will revive to over 3 % in 2014 as long as the world economy and global trade recover. The draft of the Central Bank for the annual monetary policy programme notes that for a basic forecast one could also consider a more cautious path that puts GDP growth at about 2 % in 2014 and about 3 % in 2016. The forecasts assume a slight decline in the oil price in the next few years.

The rates of economic growth under the IMF and World Bank forecasts require on-going moderate growth of consumption and revival of investment growth. The IMF expects the volume of Russian exports to increase about 3 % a year if export growth outside the energy sector remains relatively brisk. The IMF says Russian imports would grow 2–3 % this year and about 5 % p.a. in coming years.

The IMF and World Bank caution that their Russia forecast figures are subject mostly to downside risks relating to the global economy and the oil price, as well as factors that could depress consumption and investment in Russia. Earlier Russia's economic growth was supported by e.g. the rising oil price and increased utilisation of production capacity. The IMF emphasised that Russia's future growth rate depends on improving productivity and investment, which calls for an improved investment climate. The state's role in the economy should also be diminished.

Russia's foreign trade and current account figures weaken further. Preliminary balance-of-payments figures from the CBR indicate that the current account surplus contracted to just over \$1 billion (0.2 % of GDP) in the third quarter of this year. The surplus for the past four quarters shrank to below 2 % of GDP. The decline in the size of the current account surplus reflects a shrinking goods trade surplus, a gradually deepening services trade deficit and increased interest payments on debt to foreign creditors. Russia's current account figures were the grimmest since 1998, when the current account last showed a deficit.

The value of exports of goods and services in the third quarter was about the same as a year earlier. Earnings declined on exports of crude oil and petroleum products, as well as other non-energy commodity exports such as metals. The drop in total export earnings was prevented mainly by growth in services exports and a recovery in natural gas exports.

The value of goods and services imports in the third quarter was only slightly larger than a year earlier. Goods imports alone, however, were slightly lower than a year earlier. Services imports continued to boom, driven in part by spending of Russian travellers abroad (up over 25 %).

Russian exports and imports valued in euros, % change from four quarters previous



Source: Central Bank of Russia

Capital outflow from Russia has continued and weakened the ruble. Preliminary balance-of-payments figures from the CBR show the net outflow of private capital abroad picked up in the third quarter. This was most pronounced for the corporate sector (excluding banks). For the past four quarters, the net outflow from the private sector was about 2.5 % of GDP, while the net outflow from the corporate sector (excluding banks and foreign currency held as cash) was nearly 3 % of GDP.

Corporate direct investment (DI) outflows from Russia increased substantially in the third quarter. For the first time in over a year they exceeded DI inflows to Russia's corporate sector from abroad (this includes the TNK-BP deal in March, which generated a one-time DI net outflow equal to 2 % of annual GDP). In the past four quarters, more DI flowed into the corporate sector (3 % of GDP) than out of the corporate sector abroad (2 % of GDP). Fictitious transactions by the corporate sector and unrecorded capital outflows have remained steady at 2–2.5 % of GDP.

The ruble's exchange rate has increasingly reflected the effect of capital outflows as the current account surplus has shrunk. With the net direction of capital flows outbound, the ruble has faced depreciation pressure since late spring. While the CBR refrained almost entirely from intervening in Russia's foreign currency market from autumn 2012 to early summer this year, it has since slowed the rate of ruble depreciation somewhat by purchasing relatively small amounts of rubles every trading day. In any case, the ruble's exchange rate has declined since May by 5–6 % against the CBR's dollar/euro currency basket used to steer the external value of the ruble as well as the CBR's trade-weighted currency basket.

China

International financial institutions lower their forecasts for China.

The IMF's latest [World Economic Outlook](#) (WEO, October 2013) slightly lowers its previous forecast, and now sees the world economy growing 2.9 % this year and 3.6 % in 2014. A leading cause of the downward revision in the growth forecast was lower growth in emerging economies, due in large part to a decline in commodity prices and lower potential growth. The slowing of growth, combined with a possible tightening of United States' monetary policy and rising interest rates will complicate economic policy in emerging economies also in the future.

Economic growth in China in recent years has largely been predicated on fixed capital investment financed with credit. This has worsened the imbalances in financial markets, as well as the disparity between private consumption and fixed capital investment. The IMF estimates that China's public sector overall runs an actual budget deficit of about 10 % of GDP if all commitments are included. In comparison, China's official deficit is reported to be just over 2 % of GDP. Such underlying structural problems and risks to the financial markets have dampened the government's enthusiasm for economic growth rates above the current level.

GDP growth forecasts for China, %

	2012	2013	2014	2015
IMF	7.7	7.6	7.3	7.0
WB	7.7	7.5	7.7	7.5
ADB	7.7	7.6	7.4	-
BOFIT	7.7	7.5	7	7

The IMF, WB and ADB forecasts were all released in October 2013. The BOFIT Forecast for China is from September 2013.

The IMF expects China's government to attempt a correction of its economic imbalances. This means a gradual slowing in economic growth to 7 % over the next two years (see table). The flip-side benefit of reforms and lower economic growth is that China could see more sustainable gains in living standards. The managed slowdown is also the best choice from the global economy's standpoint as cheaper commodities more than make up for China's lower import growth. Continuing imbalances could lead to a sharp slowdown in the Chinese economy and a lengthy recession that would cut global GDP by as much as 1.5 %. Under the IMF's basic scenario, China's current account surplus rises from 2.5 % this year to 3 % in 2015.

In October, the World Bank (WB) and the Asian Development Bank (ADB) also released new growth forecasts for China that were substantially lower than their earlier forecasts. Besides China, both forecasts cut their growth out-

looks for other emerging economies in East Asia and the Pacific. Despite this, the World Bank estimates that the region will account for about 40 % of this year's world economic growth and a third of growth in world trade.

Share prices on China's stock markets bounce back from June lows. When liquidity dried up in June, China's interbank market tightened dramatically, causing share prices to plunge. Share prices on China's stock exchanges have clawed their way back during late summer, and are still continuing to rise. In many other countries in East Asia, share prices rose sharply in September.

Share prices have been on a long downward trend on both the Shanghai and Shenzhen stock exchanges. Following the international financial crisis, share prices rebounded to a high point in 2009. Since then they have largely been in decline. The market capitalization of the average Shanghai A-share listed company has declined about 30 % from the start of 2010. Stock price gains have also clearly been weaker in China than in other emerging economies on average. For example, the Morgan Stanley Capital International emerging markets index (MSCI EM) and the Moscow Exchange's RTS index now sit broadly at the same level as in early 2010. Moreover, the MSCI EM index includes the Shanghai stock exchange and without inclusion the index would be on higher level.

A number of explanations have been offered to explain the weakness of Chinese share prices. China's economic growth and growth in corporate profits have slowed. Listed firms have not necessarily been particularly transparent on their actions and investors find it hard to trust the information companies disseminate. Companies also dedicate a large part of their profits to investment at the expense of shareholder dividends.

Overall, Chinese shares have failed to yield expected returns. As a result, many have found it preferable to put their money in real estate, where prices have been soaring in recent years despite state efforts to slow the rise in prices.

Stock exchange trends in Shanghai and Moscow, as well as MSCI Emerging Markets index



Source: Bloomberg

Russia

World Bank now sees Russia as a high-income country.

As part of its annual income comparison, the World Bank this summer reclassified Russia from a middle-income country to the high-income group.

World Bank classifications use Gross National Income (GNI) per capita and recognise four groups: low-income, lower middle-income, upper middle-income and high-income countries. Under the World Bank methodology that uses nominal exchange rates, Russia's GNI per capita last year was \$12,700. That was enough to lift Russia into the league of rich countries, defined in 2012 as a minimum of about \$12,600 per capita. Russia's GNI per capita is on par with Poland and Croatia. Last year's GNI per capita was \$9,800 for Kazakhstan, \$6,500 for Belarus and \$3,500 for Ukraine.

Finnish GNI per capita was \$46,900 last year, while the figure for the United States was \$50,100.

Wealth in Russia is concentrated in the hands of a few, while income distribution is more even. Credit Suisse's *Global Wealth Report 2013* ranks Russia the country with the most uneven wealth distribution in the world. The study found that just over 100 people have a net worth exceeding \$1 billion, and that the wealth of these individuals together represents about 35 % of all the wealth held by Russians. The corresponding share of billionaires globally is 1–2 % of total wealth. Russia is the number-two country in the world after the US by its number of billionaires.

Looking at average per capita wealth, Russia ranks rather poorly from a global perspective. The average per capita wealth in Russia was estimated at \$8,700, when the world average is nearly \$34,000. Russia is one of the rare countries, where average per capita wealth is smaller than the per capita GDP. The wealth distribution for Russia shows that 94 % of adults have net wealth of less than \$10,000. That share is about the same as in e.g. India and Africa.

Income distribution in Russia is far more even than property distribution. According to the *CIA Factbook*, Russia ranks 52nd out of 136 countries in terms of income inequality (inequality is highest in the top ranking countries). Income distribution is more uneven e.g. in the US and most developing countries than in Russia.

The average net worth of a Chinese, according to the Credit Suisse wealth report, was \$16,400, with far more even wealth distribution in China than in Russia. The report notes wealth in China was allocated fairly evenly at the start of the 2000s due e.g. to the virtual non-existence of inheritable property. In recent years, the wealth gap has widened rapidly. The divergence is partly driven by uneven income gains. The *CIA Factbook* ranks China 29th and Hong Kong 11th in income disparity.

Strong pressures to crack open the National Welfare Fund piggy bank. The government has announced it will use stimulus measures to revive economic growth, but the tight budget situation means that the measures must be financed also from sources other than the federal budget. As a result, attention has turned to tapping assets amassed in National Welfare Fund from taxes and fees on oil & gas production and exports.

National Welfare Fund assets were initially set aside to fund liabilities that will arise in coming years from changes in the pension system. For this reason, most assets were invested as cautiously as possible in high-grade, low-risk foreign securities. The most significant exception was an investment of about 400 billion rubles in state-owned banks to stabilise the financial sector during the 2008 financial meltdown. The Fund currently holds about 2.9 trillion rubles (about €65 billion). The state's second large oil money fund, the Reserve Fund, sets aside money to cover budget deficits. It currently holds about 2.8 trillion rubles.

President Putin announced a change in investment policy regarding the National Welfare Fund last June. He said that 450 billion rubles (about €10 billion) in Fund assets would be used to finance three large projects: Moscow Ring Road III, construction of the Moscow-Kazan high-speed rail line and modernisation of Siberia's railways.

At the beginning of October, Putin also promised that the National Welfare Fund could be accessed for other purposes than the three above-mentioned projects. The organisations interested in such financing include state hydropower company Rushydro, electrical power distributor Rosseti and nuclear power company Rosatom. The government's decision last month to limit rate hikes of infrastructure companies in coming years has fuelled interest of these companies in financing.

The economy ministry has proposed that financing could also be allocated to high-tech projects, including shipbuilding and aerospace industries, as well as space technology companies. According to recent finance ministry proposals, National Welfare Fund assets could be invested in bonds issued by domestic companies. Risks would be greater than under the current investment model, but the yield potential would also be higher.

Due to the ever-deteriorating outlook for the pension system, National Welfare Fund assets could soon also be needed for their original purpose, i.e. funding pensions.

The finance ministry stresses that the National Welfare Fund money invested in the projects must really be paid back. The ministry is particularly sceptical about the viability of the big transportation projects and worries about lowballing of investment calculations.

Observers wonder why there was no thorough debate before a significant change in the Fund's investment policy was made. They also doubt whether the three large transportation projects already announced are the most efficient choices for enhancing economic growth.

China

PBoC and ECB make currency swap deal. Under the currency swap arrangement made this month, the European Central Bank gains the possibility to swap up to €45 billion for yuan. The agreement remains in force three years. The yuan is not a freely convertible currency, so the availability of yuan internationally is limited. Under the deal, the risks associated with yuan settlements in the eurozone are reduced as the ECB can provide yuan and thereby ensure the stability of financial markets.

The People's Bank of China has made swap deals with about 20 central banks as part of its efforts to promote international use of the yuan. The PBoC last summer signed a swap agreement with the Bank of England. London has long been an active supporter of developing a yuan settlement market and has been eager to introduce the yuan into regular market transactions. Facilitating yuan-based transactions is today viewed as an important competitive factor among international financial centres.

China inflation accelerates in September; housing prices soar. China's National Bureau of Statistics reports the rise in consumer prices accelerated from 2.6 % in August to 3.1 % in September. Food prices, up over 6 % y-o-y in September, drove most of the increase. There has also been a slow, but steady, rise in prices of non-food goods over the past nine months; the on-year increase in September was slightly below 2 %. Food prices have a large impact on Chinese inflation figures as they make up about a third of the consumer basket used to measure Chinese consumer price inflation. Shifts in global energy prices, on the other hand, are usually mitigated or slow to appear as domestic energy prices are regulated.

Lower world commodity prices and over-capacity in certain industrial branches kept producer prices in overall decline in September. Producer prices have been declining since the start of 2012.

Housing prices in 70 of China's large cities climbed over 8 % y-o-y in August – the fastest rise in over two years. It appears that the official measures to cool property prices no longer have much effect. Prices rose fastest in the major metropolises, and the latest surveys indicate a further acceleration in prices in September. According to stock market press releases, several large builders are reporting that they had already sold their entire target for the year by September. Despite brisk sales, some builders appear to be struggling as they are deeply indebted and financing costs have been rising faster than revenues according to some media reports.

China disappointed with flat-lining of export growth in September. Markets were clearly disappointed to learn that the value of China's September exports in dollar terms was unchanged from September 2012. Flagging growth in exports was seen to indicate the fragility and unevenness of the global economy recovery. China's exports to e.g. Germany, France, Italy, Brazil, as well as many important Asian countries went into decline. Exports to the US and UK, in contrast, were strong. After a long while, exports to Japan also began to revive. The weak export growth also reflects the large number of holidays falling in September; i.e. there were fewer working days than in September 2012. In January-September, China exported 8 % more goods than in the same period a year earlier.

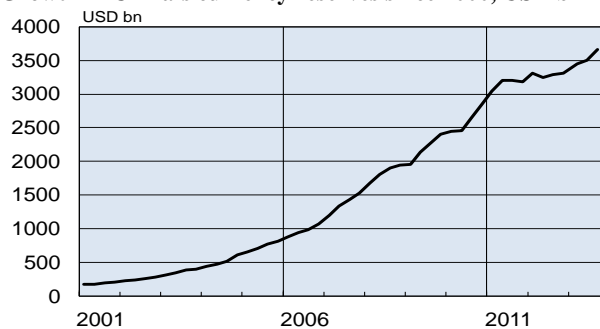
Goods imports were up 7 % y-o-y in September, and imports for January-September rose at the same pace. The steady rise in imports in recent months suggests that China's near-term economic growth outlook is on relatively stable footing. The increase in energy and metal imports likely signals a pick-up in construction activity and inventory growth. This was reflected in higher prices for sea freight.

China's trade surplus shrank to \$15 billion in September. The trade surplus for January-September amounted to \$170 billion, about \$20 billion more than a year before.

China's rising foreign currency reserves hint increased appreciation pressure on the yuan. As of end-September, China's foreign currency and gold reserves hit \$3.66 trillion, an increase of about \$160 billion from the end of June. Even though detailed balance-of-payments figures will be released later, it is already clear that higher reserve growth is driven by an increase of tens of billions of dollars in capital imports compared to April-June on top of the rise of the value of euro-denominated investments in dollar terms. During July-September, capital outflows from other emerging economies increased.

The balance-of-payments figures indicate strong demand for China's currency that is putting appreciation pressure on the yuan. After remaining stubbornly at 6.12 since July, the yuan-dollar exchange rate jumped to 6.10 this week.

Growth in China's currency reserves since 2000, USD billion



Source: Macrobond

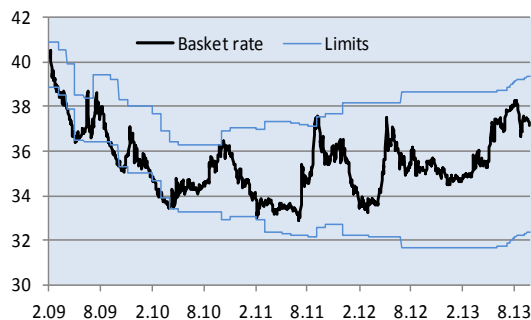
Russia

CBR moves closer to a free-floating ruble. The Central Bank of Russia has used a managed float since 1999 to guide the ruble's exchange rate. In recent years it has gradually allowed the market to play a larger role in determining the rate. The CBR employs a dollar-euro currency basket in steering the ruble's external value. The ruble fluctuates within a 7-ruble-wide corridor relative to the basket. To smooth daily movements, the CBR has intervened in the currency markets also when the rate has been close to the midpoint of the corridor. On October 7, the CBR decided to intervene only when the ruble's value approaches the upper or lower limits of the float boundaries. The CBR last month reduced the amount of money available for daily volatility smoothing.

The corridor shifts automatically to provide the ruble with extra room to rise or fall whenever central bank interventions (other than daily volatility smoothing) reach a certain amount. This is interpreted as a profound change in market conditions that the ruble rate must accommodate. The fluctuation band has shifted twelve times since the start of June, and last month the CBR modified the trigger mechanism to make it even more sensitive to market shifts.

The CBR seeks to achieve a free-floating ruble by 2015, when it will turn its monetary policy focus wholly to inflation targeting. The CBR would still defend the ruble's exchange rate in exceptional circumstances.

Ruble exchange rate against dual-currency basket and corridor limits, 27 February 2009 – 21 October 2013 (rising trend indicates ruble depreciation)



Source: Central Bank of Russia

As part of measures to increase the transparency of its operations, the CBR this month published for the first time detailed information on the guiding principles of its exchange rate policy.

Observers note the consistency with which the CBR's policy of incremental ruble deregulation has been carried out over the past couple of years. The latest measures may reflect devaluation pressure on the ruble and signal a desire of policymakers to let the ruble depreciate more freely.

Gradual liberalisation of the ruble exchange rate brings increased volatility and higher risk in e.g. foreign trade. The ruble has lost about 8 % of its value against the euro and over 4 % against the dollar since the start of the year. The drop is evident e.g. in the financial results of some of the foreign corporations operating in Russia.

Russia's government budgets face hard times ahead.

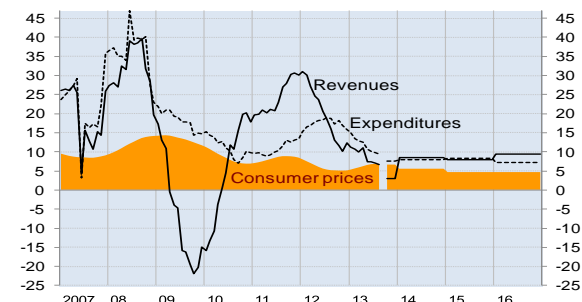
The finance ministry's latest estimates show growth in revenues to the consolidated government budget (combined federal, regional and municipal budgets, and state social funds) compared to earlier years will slow considerably in coming years even if growth recovers from this year's exceptionally low growth to over 8 % from next year onwards. Government revenues relative to GDP declined this year and should then remain just below 36 % of GDP.

The latest revenue projection is based on the economy ministry forecast that sees GDP growth accelerating next year to over 3 % a year. Government revenues from oil and gas are not expected to rise if the oil price hovers around \$100 a barrel. Production and exports of oil & gas are expected to rise very slowly in coming years. Thus, the state is raising revenues through hikes in various minor taxes such as excise taxes. The finance ministry says achieving expected revenue levels also requires better tax collection and efforts to reduce the size of the shadow economy.

The finance ministry estimates that the rise in government spending will slow in coming years, remaining at around this year's 8 % pace. The share of spending in GDP will only shrink slightly in 2014 and 2015. The share this year should be slightly less than 37 % of GDP.

While the deficit target for the consolidated government budget has been slightly increased, the deficit estimate for 2014 and 2015 is still just 1 % of GDP. Government debt (including state-granted guarantees) relative to GDP will increase by about two percentage points and the state Reserve Fund will grow slowly. Government debt at the end of 2016 should be just over 14 % of GDP and the Reserve Fund and National Welfare Fund combined should equal nearly 8 % of GDP.

Consolidated public sector revenues and expenditures, and consumer price inflation, 12-month moving average, % y-o-y



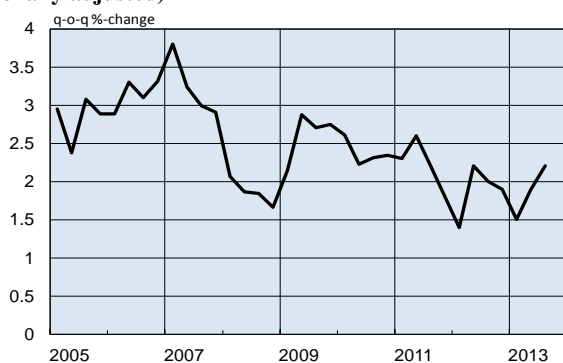
Sources: Rosstat, Ministry of Finance, Ministry of Economic Development

China

China's GDP growth accelerated in the third quarter.

China's National Bureau of Statistics reports GDP rose in real terms 7.8 % y-o-y in the third quarter, and 2.2 % q-o-q. 12-month growth accelerated slightly from the second quarter, while on-quarter growth accelerated sharply (see chart). China's growth target for this year is 7.5 % and most international institutions and investment banks expect 2013 GDP growth to come somewhere in the range of 7.5–8.0 %.

Change in real GDP growth from previous quarter, % (seasonally adjusted)



Sources: BOFIT (2005–2010); NBS (2011–present)

The revival in economic growth largely originates from a pick-up in the pace of growth in fixed capital investment. During the summer, China's leadership was concerned about meeting its growth targets for this year so it implemented a "mini-stimulus" to accelerate economic growth. The stimulus was mainly directed at fixed capital investment. Growth in disposable household income has slowed this year from previous years, which has also dragged down domestic consumer demand growth. While the contribution of net exports to GDP growth has long remained quite modest, the economic significance of exports to the Chinese economy is much larger, as export earnings drive both domestic investment demand and consumer demand.

China's government this week announced that it was satisfied with the current pace of economic growth and indicated that GDP growth was on target for this year. The government is probably redirecting its economic policy focus back to long-term structural economic reforms.

Private consumption to GDP ratio increased in 2012. The NBS finally released its long-awaited 2012 GDP data this month. One fascinating jewel in 2012 data was that private consumption accounted for 36 % of GDP, a full percentage

point increase from 2011. Public consumption was unchanged from previous years at just over 13 %.

Nevertheless, last year's figures did not show any significant shifts in the structure of the Chinese economy. Fixed capital investment still accounted for slightly below 46 % of GDP. Instead, private consumption was given room by inventory investment, which saw its share to decline a full percentage point to 2 % of GDP. China's trade surplus for goods and services increased slightly from 2012, but net exports still remained below 3 % of GDP.

China's GDP grew 7.7 % in 2012. About half of that growth came from consumption and half from investment. The contribution of net exports was essentially near zero. The continued reliance on capital investment this year to sustain economic growth could actually increase the share of investment in GDP this year.

Some researchers claim that China's private consumption relative to GDP is actually much higher than official figures suggest as a significant share of private consumption never gets recorded and some private consumption is recorded as corporate investment.

Lower income growth in China. The NBS reports that real disposable incomes of urban households increased slightly less than 7 % y-o-y in the first three quarters of 2013. Income growth, especially in wages, has slowed this year. The average per capita monthly income for an urban household was 2,240 yuan (about €70). In the countryside, the rise in household incomes remained brisk, rising nearly 10 % y-o-y. While the rise in incomes has long been higher in the countryside than in cities, the rural average monthly income was still just 850 yuan (about €100) per capita.

In addition to officially tracked earnings, the Chinese earn large amounts of under-the-table income. A research study published in September found that total grey-income equalled about 12 % of GDP in 2011, or nearly 4,500 yuan per capita. Off-the-books earnings, however, are not distributed evenly. Most of the money goes to the richest households, which, the study suggests, have higher actual incomes. Thus, income disparities in China are considerably greater than official figures show. The study was based on interviews with 5,000 households.

Thanks to relatively high economic growth and rising earnings, the number of super-rich individuals in China continues to rise. *Forbes* latest global billionaire survey found 150 Chinese with net wealth exceeding \$1 billion. Wang Jianlin, China's richest man and chairman of the Dalian Wanda Group, made his money in the real estate sector. With net assets of about \$14 billion, he is ranked as around the world's 60th richest person. China's richest woman is Yang Huiyan with net assets of about \$7 billion. She, too, is a real estate mogul.

Russia

Russian Duma approves law extending recycling fee to domestic-built vehicles; new forms of subsidy for domestic car industry proposed. EU-Russia trade relations have been strained ever since Russia joined the WTO in August 2012 due to Russia's imposition of a recycling fee on all imported cars. The fee equals the duty reduction for cars mandated in Russia's WTO membership negotiations. The recycling fee violates WTO principles as it exempts domestically produced vehicles from the fee.

Russia promised last January to correct the situation within six months. After nothing happened, the EU and Japan filed in July an official request for consultations with the WTO. The EU further asked the WTO last month to form a working group on the matter. The legislation requiring domestic carmakers to pay the recycling fee was rapidly processed by the Duma and passed on October 16. The law goes into effect at the beginning of next year. As a result, the WTO is holding off on its investigation, which would be a first for Russia under the WTO's dispute resolution process.

Russia's industry and trade ministry has drafted a bill that extends subsidies to the car industry from the start of next year. Subsidies would be paid to all car manufacturers engaged in assembly operations, and thus would cover practically all major carmakers. The subsidies would be paid for production of low-emission vehicles, as well as for covering costs related to product development and maintaining employment, among others. Russian experts say that the proposed subsidies conform to WTO rules.

Customs union summit exposes Kazakh and Belarusian unhappiness. The summit was held last Friday (Oct. 25) in Minsk. Kazakhstan's president Nursultan Nazarbayev offered the strongest criticism of the custom union. In his opinion, trade imbalances have increased since the customs union was created in 2010. Producers in Kazakhstan and Belarus find it difficult to get their products onto the Russian market due to technical barriers to imports. Part of the problem is that the customs union has yet to adopt common product standards. Russia's certification system differs substantially from the Kazakh system, making export of meat products from Kazakhstan to Russia essentially impossible. Kazakhstan's economy has also suffered from the fact that the country has yet to be allowed to export electricity to Belarus via Russia. Nazarbayev also wants to see relaxation of inspection measures for goods at the outside borders of the custom union.

Nazarbayev complained that the Russian members of the Eurasian Economic Commission, the customs union's highest regulatory body, take their orders from Moscow, even if the commission is supposed to be independent. For this

reason, Kazakhstan sees no point in supporting proposals to increase commission powers.

Belarus president Alexander Lukashenko complained that exceptions and restrictions on free trade for specifically agreed products during the formation phase of the customs union have actually increased for the time being, even if the ultimate goal is to gradually eliminate such exceptions altogether. The thorniest issues relate to exceptions for crude oil and petroleum products. Russia and Belarus disagree e.g. on duties of petroleum products refined from Russian crude in Belarus for export to third countries.

Customs union members are currently drafting a basic agreement on the Eurasian Economic Community that will replace the customs union in 2015. President Vladimir Putin said the agreement must clearly specify obligations of members in various spheres of economic regulation. The agreement should guarantee free movement of goods, labour and capital. Putin lamented that all customs union goals have yet to be implemented.

World Bank finds Ukraine, Ruanda and Russia make biggest strides in becoming more business friendly. The latest World Bank [Doing Business 2014](#) survey notes that over the past year Russia has risen from 112th to 92nd place among the 189 countries surveyed. Russia's current business environment is on par with e.g. Albania and Serbia.

The World Bank survey measures the impact of state regulation on business activity in the largest city of each country in the survey. The survey ranks each country in ten categories, each of which is evaluated by three or four indicators. Assessments of experts and regulatory officials provide the basis for each country's scoring.

President Putin decreed in May 2012 that Russia would become one of the top 20 most business-friendly countries in the world by 2018. The move has made Russian officials look into what should be done to make such gains in each of the World Bank categories.

Russia saw its largest gain this year in the category for how long it takes for a company to get hooked up to the electricity grid, with the average number of days for a connection falling from 280 to 195 days. The average number of days to process a building permit fell from 344 to 297 days, while the number of days to register property dropped from 44 to 22 days.

A noteworthy limitation to the World Bank survey is that it only covers one of the areas affecting business environment, namely state regulation. Hence, it omits such important factors as ease of access to markets, free and fair competition, judicial independence and existence and extent of corruption. The survey also overlooks the qualitative aspects of official activity.

Russia's generally weak business environment is a big reason that domestic firms invest relatively little in their home country, preferring to hold significant amounts of their assets offshore.

China

China expected to announce new economic policy framework and renew commitment to reform. The third plenary session of the 18th Central Committee of Communist Party convenes next week (9–12 November). The Central Committee is made up of 204 members, who serve a five-year term. The committee assembles annually, but traditionally the third plenum is reserved for hammering out major economic policy themes. Expectations were raised even further that something was in the works late last week, when Yu Zhengsheng, a member of politburo standing committee, described the reforms in consideration as “unprecedented.”

Ministries, research institutes and other central players have prepared reports and policy recommendations for the Central Committee. While there have been no official announcements of the proposed reforms, some draft documents have been circulating in public.

The Development Research Centre (DRC), which serves as a think tank for the State Council, has reportedly proposed moving towards a more market-based economy, improving transparency in public administration and increasing legal protections. To achieve these goals, the DRC is calling for reforms in such areas as public administration, fiscal system, state monopolies, land ownership, financial sector, state ownership and treatment of foreign firms.

Other reforms that have been suggested include changes in the *hukou* household registration system and relaxation of the one-child policy so that couples could have a second child if only one of the parents is a single child. Currently, both parents have to be only children to be eligible for a second child.

No matter what the nature of the reform plans announced, what matters most is that China’s leaders show a strong commitment to future reforms. The lesson from China and other countries suggests that structural reforms only succeed with decision-makers genuinely behind them.

China takes further steps in deregulating interest rates. Late last month, the People’s Bank of China introduced its new loan prime rate, which is calculated daily based on the weighted average rate that the nine largest banks charge their best corporate customers. The PBoC hopes the loan prime rate will provide more information about the level of market rates and help banks adjust, as the central bank is gradually giving them more freedom to set their rates.

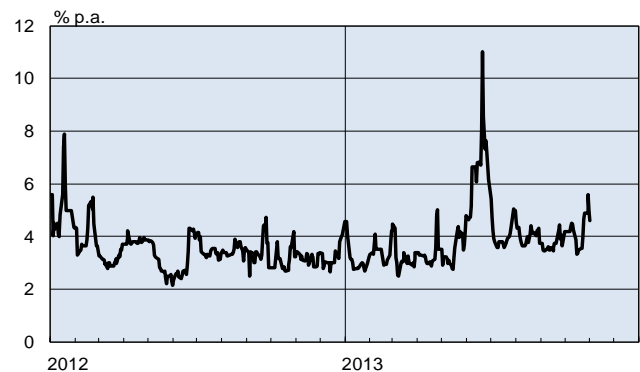
The situation will, however, remain complicated for interest-rate policy in general. As the large state banks dominate how the loan prime rate is determined, the new rate will likely reflect the government’s view of the appropriate interest rate. The loan prime rate now coexists with the PBoC’s reference lending rates, even if lending was freed

from interest rate regulations last July. The first loan prime rate (one-year) quote last week was 5.7 %, while the one-year reference rate stood at 6.0 % for the second year in a row.

Deposit rates, in contrast, are still subject to strict regulation, although the central bank has said it will soon allow market-based interbank trade on certificates of deposit. In addition to helping liquidity management of banks, freeing up the trade for wholesale savings is seen as a step towards deregulation of deposit rates. Among the obstacles to extensive deregulation of deposit rates is the lack of legislation on depositor protection. The government is considering new initiatives in this area.

At the end of October, bank liquidity again tightened and short-term interest rates spiked as corporate tax payments came due. Although no rate shock similar to that of late June is looming, rates are up since last spring.

Shanghai interbank offered rate (7-day Shibor)



Source: Macrobond

China’s grain harvest increases again this year. The National Bureau of Statistics reports that this summer’s grain harvest reached 132 million metric tons, up two million metric tons from last summer’s harvest. The summer harvest constitutes about a fifth of the overall harvest. The main harvest season is autumn. Preliminary reports suggest the autumn harvest will also be bigger than last year. Meat production has tracked the increases in grain production, with both up just over 1 %.

China seeks to be 95 % self-sufficient in its main grain crops. Although farm output has risen in recent years, consumption has risen faster, forcing China to rely more on food imports from abroad. As imports have risen, China’s self-sufficiency has fallen by some estimates to below 90 %.

Farm output has been boosted by switching to higher-yield varieties, increased irrigation and better training of farmers in fertiliser use. However, there is still plenty of room for improvement in Chinese farming methods. For example, the size of the average farm is still tiny (0.5 hectare), which prevents, among other things, efficient use of modern farming equipment.

Russia

Russia postpones plans for tax reforms to energy sector.

Russia for several years now has been discussing a make-over of its policies on oil sector taxation. The current system based on charges based on production and export volumes would be replaced by taxing profits to encourage higher production levels and boost investment in exploration and development of new capacity. Russia faces the challenge that many of its largest current oil fields in production are in decline, while new oil and gas deposits are geographically remote and hard to access. Bringing new fields on stream is crucial for the sector's development.

Russia charges two different taxes on crude oil: a natural resource extraction fee and an export duty. The oil export duty, which has been applied since 1999, is calculated based on export volume and the prevailing world price of crude oil. The export duty schedule was made sharply progressive in 2004. The principles of resource extraction fees have remained essentially unchanged since they were introduced in 2002. The extraction fee, which is also progressive, is based on oil production volume and the prevailing world price for crude oil. Since 2007, the state has adjusted the extraction fee based on e.g. production conditions and location of the production site.

Oil companies and the energy ministry have proposed shifting to a tax scheme that targets operating profits. This would encourage companies to invest in development of new fields (including deposits with daunting technical and logistical challenges), as well as trying to squeeze more oil out of mature fields where production has become increasingly expensive. The current system tries to achieve these same goals by fashioning customized tax breaks.

Last week, the government took up changes in the taxation regime. Due to opposition from the finance ministry, however, none of the proposed changes are likely to be implemented any time in the near future. The finance ministry's main objection is that the move would reduce tax revenues. The energy ministry and oil companies are striving to introduce the new taxation model as a pilot project at select sites to evaluate the model's performance.

Given Russia's bleak fiscal outlook, the government decided this autumn in its draft version of the 2014 budget to raise resource extraction fees incrementally over the next three years. Export duties on oil and petroleum products, in contrast, would be lowered as part of the finance ministry's long-term goal of reducing export duties on the oil sector and shifting the tax emphasis to resource extraction.

Russia's taxation of its oil sector is extremely severe by international standards. The state currently captures over 80 % of any rise in oil prices. The gas sector, in contrast, enjoys a much lighter tax burden. About half of federal budget revenues come from oil and gas taxation.

Russia to liberalise gas export rules. Late last month, the government approved a draft bill allowing companies other than Gazprom to export liquefied natural gas (LNG) from the start of 2014. Fast passage in the Duma is expected.

Gazprom has had the sole right until now to export natural gas. The government says its decision should help increase Russia's share of the global gas market, which has seen demand for LNG increase much faster than demand for gas transmitted by pipeline.

In the government's draft law, several demands are placed on LNG exporters related e.g. to the scope of company operations and ownership base. In practice, there are just two companies at the moment that meet the requirements: state oil company Rosneft and Russia's second largest gas producer, the privately held Novatek. The decision to allow others to export LNG means both companies could eventually become major competitors of Gazprom. Even more important, perhaps, would be that other companies could gain easier access to Gazprom's gas pipeline grid. At the moment, Gazprom has the sole right to export gas via pipeline.

The liberalisation of LNG exports is a significant step in weakening Gazprom's gas monopoly.

Russia creates separate ministry for construction, housing and public utilities.

Last Friday (Nov. 1), president Vladimir Putin announced that the federal agency handling services for construction, housing and utilities, Gosstroy, will now be elevated to ministry status. Gosstroy, established last year, failed in its tasks of moving ahead on stuck reforms in the municipal service sector and eliminating bureaucracy related to construction.

The problems facing the new ministry remain huge. The quality of housing and level of municipal services in Russia is extremely low. Much of Russia's housing stock is old and in poor shape. Two-thirds of apartment buildings need basic repairs and the situation worsens every year. Money set aside by the state for basic repairs is insufficient and residents lack the funds to finance necessary major repairs themselves.

About a quarter of all district-heating networks and about 40 % of water and wastewater networks are in need of complete overhauls. Consumer rates for heat, water and gas have risen rapidly in recent years as part of the government's efforts to bring rates up to a level where they cover production costs. Rising rates, however, have not translated into improved quality of service and have become a source of general dissatisfaction among the populace. Part of the problem is that housing and utilities are among the most corrupt sectors in Russia.

The government says one solution to improving municipal services would be to attract more private investment into the sector.

China

Beijing tries again to subdue investment craze at local level. The central administration has worried for years about overcapacity in many industries that has been mainly driven by the desire of local administrations to sustain growth and improve their own chances for managerial advancement. Unfortunately, central government demands that locals do something about their excess capacity problems have fallen on deaf ears. This month, the central administration again warned again local authorities not to challenge government restrictions on investment. This time the government specifically named steel, glass, cement, aluminium and ship-building as branches which, in its opinion, suffer from excess capacity.

Excess capacity and low capacity utilisation have repeatedly been cited as potential problems for China. In addition to the branches mentioned by the state, excess capacity and falling prices have recently plagued such industries as copper fabrication and solar panel production. Construction of additional capacity has been fuelled by the availability of cheap bank financing due often to active involvement by local administrators. The drop in prices due to overcapacity and eroded profitability may lead to debt-servicing problems that affect the entire economy through the financial system.

A lasting solution might be to change incentive systems and switch to market-based pricing and financing. These issues will no doubt be touched on at the third plenary session of the central committee that starts tomorrow (Nov. 9). The party gathering will focus on economic reforms. Whatever resolutions come out of meeting, it is clear that many industries in China will face some sort of consolidation in coming years.

Car sales continue to boom in China. Car sales in the world's largest market for passenger cars have remained brisk this year. The number of new cars registered in January-September was up 14 % y-o-y. If the pace continues, it puts China on track for registering 17 million new cars this year. In 2012, China registered nearly 15 million cars.

Competition is fierce in the passenger car market, which in the first nine months of this year saw the registration of over 100 different car brands. The popularity of foreign brands continues to rise, and currently foreign brands account for about two-thirds of all registered passenger cars. Sales of several European, American and Korean brands have grown rapidly this year. China-Japan relations seem to have affected Japanese car sales as registration of major Japanese brands has either declined or remained at the same level as last year.

The most popular make by far is still Volkswagen, which has maintained a strong market presence in China since the

1980s. About 15 % of all registered cars in China are VWs. The next most popular makes are the Chinese Wuling, which concentrates on multi-purpose vehicles, and the Korean Hyundai. Both have market shares of about 6 %. The Japanese Toyota and the American Buick each have market shares of about 5 %.

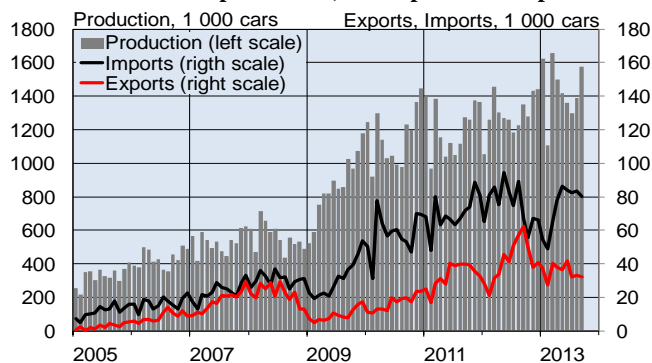
Most of the cars sold in China are also manufactured or assembled there. Nearly all large international carmakers have production in China. Chinese rules require production plants be held as a joint venture with a Chinese car manufacturer and cannot be fully foreign owned. China has used this approach to promote transfer of technology and business skills to domestic car manufacturers.

900,000 passenger cars were imported to China last year. The volume of imports this year is likely to be slightly lower than last year. China also exports passenger cars. This year China will export about 400,000 cars, about 100,000 fewer cars than in 2012. Most exported cars are reportedly Chinese brands.

There were about 90 million passenger cars on the road in China at the end of 2012, a roughly ten-fold increase from 2000. It is estimated that every fourth Chinese household has a car. Most are small passenger cars, which have been popular recent years partly because they have enjoyed special tax breaks. China's highways are further clogged with about 20 million lorries and trucks. The numbers of large vehicles has not risen as fast as the number of passenger cars.

The rapid increase in the number of cars on the road has created epic traffic jams and increased vehicle emissions. Big cities are now trying to rein in the growth the number of cars on the road by e.g. limiting car registrations. Since 2011, in Beijing license plates have been offered only by lottery and the amount has been limited to 240,000 plates per year. The city will reduce the number of plates issued by a third from the start of 2014. About 1.5 million people have participated every month to license plate lotteries this year. License plates are auctioned in Shanghai, with the lowest winning bid exceeding 80,000 yuan (€10,000) in October.

China's domestic car production, car imports and exports



Sources: China Association of Automobile Manufacturers and CEIC

Russia

Officials cut growth forecast on domestic economy

weakness. The economy ministry last week released its new economic projections out to 2030. The basic forecast sees Russian GDP growth slowing at the end of this decade to around 2.5 % a year. In the long-range forecast published last March, the ministry estimated the economy would grow at over 4 % a year under its most likely scenario and still exceed 3 % a year under the most pessimistic scenario. The forecasts are well below the average 5 % annual rate demanded by president Putin.

The economy ministry forecast is unchanged for the near future. It still sees GDP growing at just over 3 % a year in 2014–2016. The Central Bank of Russia's forecast is somewhat more pessimistic. In its monetary policy program published last week, the CBR projected GDP growth of 2 % next year, 2.5 % in 2015 and 3 % in 2016. The forecast is conditional on a recovery in growth of the global economy.

The economy ministry sees slow import growth in the next few years. On the other hand, the CBR does not expect extensive substitution of imports with goods and services produced domestically.

In its forecast, the economy ministry held to its earlier forecast of 1.8 % GDP growth this year. On Wednesday (Nov. 13), however, economy minister Alexei Ulyukayev announced that growth this year would fall below forecast, coming in at around 1.5–1.6 %. The revised view is based in part on Rosstat's latest preliminary data on GDP growth in the third quarter. In contrast to most forecasts, growth failed to accelerate. The 1.2 % pace of on-year growth was actually a bit lower than in the first half.

Observers have noticed that the reduced growth outlook reflects a lower estimate of authorities as to the performance of the Russian economy. This can be seen in the fact that in the latest projections of the economy ministry there is hardly any change from earlier in the assumptions about growth of the global economy and trends in the price of crude oil, which has an important role in the Russian economy. The economy ministry also expects growth to slow at the end of the decade, even if it assumes the price of oil will start to rise mid-decade from the level of around \$100 and thereafter increase at nearly 4 % a year.

Putin says harsher criminal code needed to fight economic crime.

President Putin said that the 2011 relaxation of the criminal code has failed to achieve its intended results. He noted that public officials convicted of bribery under current law usually get off with fines, which is not efficient as most of those fines are never paid.

The law was changed during Dmitri Medvedev's presidency. Many economic crime classifications were elimi-

nated and the possibility of holding suspects in jail during a crime investigation was limited. Penalties for economic crimes were also reduced. The changes were part of reforms to improve the business environment in Russia. They are often cited as one of the major accomplishments of the Medvedev presidency.

The goal of the reform was to reduce coercive practices used on firms. It is not unusual in Russia for competitor firms or corrupt officials to haul companies into court on trumped up charges in order to push the victim firm out of a certain market, take it over or strip it of its assets. Even the mere threat of a lawsuit is often sufficient to obtain a bribe.

Especially charges for tax avoidance have been used for this purpose. The possibilities of doing so were, however, greatly reduced when the 2011 reform specified that only tax officials could file charges for tax-related crimes. Earlier it was possible also for the investigative authorities. Under the proposed amendment that Putin submitted to the Duma on October 11, charging authority would be returned to investigators. The argument for the amendment is that the efficiency in solving tax-related crime has been sharply curtailed.

The bill proposal was so out of the blue that even the economy and finance ministries were unaware of it. Russia's most important economic interest groups – the Chamber of Commerce and Industry, the Union of Industrialists and Entrepreneurs (RSPP), Delovaya Rossiya (represents medium-to-large companies), Opora (represents small firms), the Foreign Investment Advisory Council and Russia's business ombudsman – all urged the president to reconsider the proposed legislation. Even the economy ministry criticised the president's proposal, as did prime minister Dmitri Medvedev, which was exceptional.

The petitioners point out that with the proposed changes possibilities for using false accusations as a means of extortion on firms would increase again. Businesses would face a more uncertain operating environment and see further degradation of the investment climate. The economy ministry further noted that the damage to the economy from increased harassment of business would be much more costly to society than any possible tax recoveries.

Since the 2011 reform was instated, the volume of charges filed for tax-related crimes has fallen substantially while the number of successful convictions has risen. Business interest groups see this as a sign that the number of baseless prosecutions for tax crimes has diminished.

Many experts say the best way to limit tax avoidance is to make the operations of tax officials more efficient rather than increasing the power of investigative authorities. The problem of unpaid fines cited by Putin could be corrected e.g. by freezing the assets of a person suspected of tax fraud or transforming fines into imprisonment penalties.

China

China outlines blueprint for economic reforms. The Third Plenary Session of the Central Committee of the Communist Party of China adjourned on Tuesday (Nov. 12). The final document released after the meeting was full of references to reforms, but lacked detail or concrete information as to how reforms will proceed. While there are many questions outstanding, there appears to be several major adjustments to the economic policy framework. A special economic reform committee was established to oversee implementation of the changes.

Allowing the market economy to play “decisive” role in the allocation of resources was a basic theme in the final document. The importance of private sector in economy will be enhanced by making it easier for companies to operate and improving protections on intellectual property rights. Some price controls could also be dismantled. On the other hand, the breakup and privatisation sales of large state-owned enterprises were not announced contrary to what was speculated ahead of the meeting. The final document stated only that the operational methods of state enterprises would be modernised. Reform of state-owned firms is difficult partly because many decision-makers have close relations to state firms. Financial sector reforms will continue, and independence of the judicial system will get greater emphasis.

The final document promised to break down the barriers between cities and the countryside. This likely implies changes in the *hukou* household registration system mentioned before the meeting. In addition, changes in land ownership are on the way. According to some experts, it appears reading between the lines that further relaxation of certain aspects of the one-child policy is under consideration.

Public sector reforms include a balancing of revenue and spending streams between central and local administrations. At the moment, the central administration collects the bulk of revenues and redistributes them to local administrations, which, in turn, are obliged to do the lion’s share of public spending. Budgeting processes and taxation will be developed to improve administrative transparency.

China decided to establish a national security council that brings together the country’s top security officials. While no details on the council’s status are yet available, it is clear that the council will pack considerable authority in setting policy. Similar security councils are found e.g. in the United States and Russia.

The markets were disappointed by the final document of Third Plenary Session. Share prices fell in China and in many other countries. The true impacts of the meeting, however, will only become apparent once further information about the decisions reached is revealed and reforms proceed.

China’s economy shows stable growth in October.

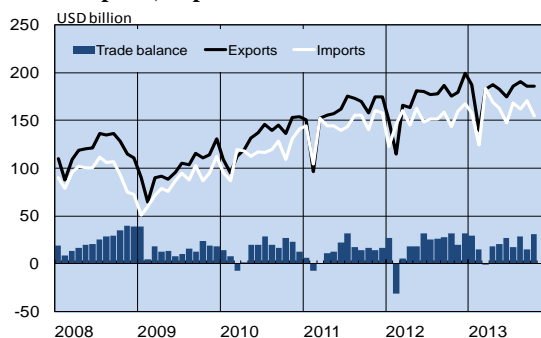
China’s National Bureau of Statistics reports that industrial output rose this year in October slightly over 10 % y-o-y, which was roughly the same pace as in earlier months. Business surveys, however, indicate that the situation for industry improved slightly in October.

Growth in retail sales, a proxy for private consumer demand, remained roughly the same as in previous months with retail sales rising at about 10 % y-o-y. Growth in retail sales this year has been lower than in previous years, which reflects the slowdown in household income growth.

Growth in fixed capital investment slowed slightly in September and October from the summer months, when investment growth was boosted with a “mini-stimulus.”

In October, China’s exports slightly beat expectations, with the value of exports rising 6 % y-o-y. Exports to Europe showed robust growth. Imports, in contrast, increased nearly 8 %, which was in line with projections. The October trade surplus hit an impressive \$31 billion, keeping China on track for a slightly larger trade surplus than last year.

China’s exports, imports and trade balance



Source: China customs

China’s inflation rate unchanged in October. In October, the 12-month rise in consumer prices was 3.2 % y-o-y, or about the same as in September. The rise in prices, however, picked up from spring, when inflation was still around 2 %. Food prices went up over 6 % y-o-y, and the rise in prices of other products was below 2 %.

Growth in the broader measure of money supply (M2) remained at just over 14 % y-o-y. The volume of new finance granted by grey financing operations in October was sharply down from previous months. The shift was seen to reflect stepped up official intervention to curb the growth of the grey financing sector.

As economic growth has revived since last summer’s period of uncertainty and inflation has picked up to near the 3.5 % ceiling of the government’s inflation target range, central bank seems to be shifting its attention away from stimulating growth back to fighting inflation by gently tightening its monetary stance.

Russia

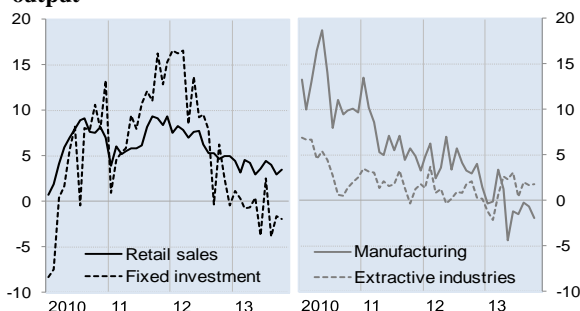
Latest figures show persistent low growth for Russia.

Fixed capital investment fell in October about 2 % y-o-y. The contraction in fixed investment has continued at roughly the same pace for several months now. Construction activity, in particular, was down 3 % y-o-y. Retail sales, in contrast, continue to grow. Over the last six months, the sales growth has stayed in the range of 3–4 % y-o-y.

Industrial output growth has remained flat for quite a while. Over the last six months, on-year industrial output growth has been at or just below zero. The weak performance mainly reflects the struggles of manufacturing, the output of which has over the last six months been about 1 % less than a year earlier. Production drops have been especially evident in the categories of machinery & equipment, metallurgy and pulp & paper. Mineral extraction industries, which include mining as well as oil & gas, recovered after a poor performance in the first quarter of the year. Since last spring, these industries have experienced growth averaging almost 2 % y-o-y. Much of this comes from the rebound in natural gas production, which climbed at an on-year rate of over 10 % during the last three months.

The decline in imports to Russia continued. Imports from non-CIS countries over the last six months were down about 5 % y-o-y, with the rate of contraction increasing to about 7% in October. The contraction concerns nearly all major goods categories, including machinery & equipment.

12-month change (%) in domestic demand and industrial output



Source: Rosstat

Russia raises corporate property tax. Under tax code amendments approved at the beginning of November, the method for determining the property tax paid on commercial space based on book value can be replaced with the valuation indicated in the property register that more closely reflects the actual market value of the property. Officials say the current tax paid on commercial properties is too low relative to the huge profits they generate. The Duma took up and passed the amendments to the tax code with exceptional speed. They enter into force next January.

According to the amendments, the new method can be applied to commercial and office space only. The tax on other types of space (e.g. industrial facilities) will still be determined according to book value. To be eligible for the new method, at least 20 % of a property's floorspace must be dedicated to commercial purposes.

Property tax is collected by regional governments, which can decide the details of the tax within a framework set forth under the federal law. Only a few regions will introduce the new tax practice immediately next year. This is because the majority of regions are unlikely to be able to make the requisite legislative amendments to their own tax codes before the end of this year.

The federal law establishes different ceilings for the tax rate during a transition period (1.5 % in 2014 and 1.7 % in 2015 for Moscow; 1 % in 2014 and 1.5 % in 2015 everywhere else). Starting in 2016, the ceiling will be 2 % nationwide. Although the current ceiling is actually higher (2.2 %), revenues are likely to rise sharply as the taxable values of properties are adjusted up. The change profoundly affects the taxes paid on large, old properties that today carry miniscule book values. These properties will likely see vastly higher tax appraisals under the new method.

The City of Moscow has been the biggest proponent of the reform. Moscow saw a substantial drop in tax revenues last year after changes were made in laws governing transfer pricing and conglomerate taxation. Taxes collected from conglomerates such as large energy companies are now shared among all regions where the business group has operations. Earlier, the lion's share of taxes went to the region where company headquarters were located.

The City of Moscow this week decided to introduce the new tax arrangement from the start of next year. The new method applies to buildings with floorspace of at least 5,000 m². In practice, this means large commercial centres such as shopping malls and office buildings are affected. In response to an initiative from business lobbies, the tax rate next year will be cut to 0.9 %, which is below the minimum set by federal law for Moscow. Under the change, Moscow's tax revenues will increase next year by about 17 billion rubles (€390 million), or about 1 % of Moscow's budget revenues.

The Moscow region will also adopt a new tax scheme at the start of next year. The Moscow region's new tax rate will be 1 % and the new method will only apply to commercial space, not offices. In St. Petersburg the reform enters into force in 2015.

Over the past two years, Russian regions have made a massive effort to assess property values and list them in property registers. However, property owners often dispute valuations as unrealistic, and in some cases, these valuation disputes end up in court. Given the extensive uncertainty over property values, business lobbies argue the new taxation method has been introduced prematurely.

China

China reveals further details on reform plans. Last Friday (Nov. 15), China released blueprint on how decisions reached at the Third Plenary Session of the Central Committee will be implemented. The markets reacted positively to the revealed plans and share prices rose sharply. Many of the reforms mentioned in the plan, however, have been under preparation for a long time or are already in use as pilot programmes. Indeed, the reforms are largely driven by realities facing China and there is probably little leeway for authorities to manage the situation without bold reforms. No schedule for the reforms has been released, but it is expected most will be implemented by 2020.

Moscow RTS, Shanghai A and Morgan Stanley Emerging Markets (MSCI EM) indexes



Source: Bloomberg

The government remains committed to continue reforms of the financial sector, which have been underway for years. Market forces will play an increasing role in determining the yuan's value, capital controls will be further relaxed and the interest rate liberalisation will continue. Establishing private financial institutions will also become easier.

Standardised budgeting processes will be introduced to improve public sector transparency. Local administrations will be permitted to issue their own bonds and their notoriously complex financial structures will be simplified and made more transparent. Some taxes such as property tax and the value-added tax on services that are currently in the trial phase will be rolled out nationally. Various environmental taxes and fees will also be increased.

Administratively set rates for e.g. water, gas, electricity, fuel, telecommunications and transport prices will be freed and for municipal utilities and services the rate-setting mechanism will be reviewed.

The *hukou* household registration system will be modified so that anybody will be free to move to a small city and

restriction on moving to mid-sized cities will gradually be lifted. The restrictions on moving to large cities, however, will remain in place. The reform is intended to promote further urbanisation in China. In addition, rural residents will be granted the possibility to sell or rent their personal share of land owned by the farm collective.

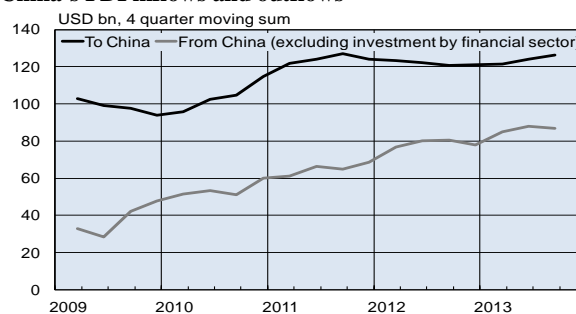
As expected, the one-child policy will be fine-tuned so that couples can have two children if at least one of the parents is an only child. Earlier both parents had to be only children for the couple to be eligible for a second child. Some demographic estimates see the birth rate rising about 10 % a year, or 1.5 million more children than would be born without the change. Such estimation is difficult, however, as lifestyles tend to change with growing prosperity. There are already many couples that do not want any children.

Chinese firms' investments abroad are getting more diverse. China's foreign direct investment abroad (excluding investments by the financial sector) in January-October amounted to \$70 billion, a fifth more than in the same period in 2012. About two-thirds of investment has gone to Asia in recent years, but Chinese firms have also been active globally. Last year, 8 % of China's FDI went to Europe, 7 % to Latin America, 6 % to North America, 3 % to Africa and 3 % to the Pacific region.

Looking at the current stock of Chinese investment, the focus seems to be on various types of business services, the financial sector, retail and wholesale trade, and the mining industry. The investment activities of Chinese firms, however, have become more diversified, and the share of investment in manufacturing has increased. Recently, Chinese companies have been making headlines in the United States and Great Britain for their real estate investments, as well as investment in oil production and the banking sector in Latin America.

After a brief dip, FDI inflows into China are rising again. In the January-October period, \$97 billion in FDI flowed into China, a 6 % increase from the same period in 2012. Most FDI came from countries neighbouring China.

China's FDI inflows and outflows



Source: CEIC

Russia

Ukraine-EU association agreement put on hold. The Ukraine government decided late last week not to go ahead with its planned signing of its EU association agreement at the EU Eastern Partnership Summit under way in Vilnius. Ukraine said it needed time to sort out the economic implications of the deal. It also announced that talks with Russia's three-country customs union should be intensified.

Ukraine has a difficult needle to thread. It wants to get closer to the EU, while preserving economic relations with Russia. Russia has been inviting Ukraine to join the Russia-Belarus-Kazakhstan customs union for several years, but Ukraine has always refused. Russia says joining would benefit the Ukraine economy by billions of dollars a year through e.g. lower energy costs and tighter economic relations. According to Russia, getting closer to the EU, in contrast, would mean a collapse of Ukrainian industry and higher unemployment.

Russia has clearly indicated to Ukraine that signing the EU association agreement would have consequences. In spring 2012, Russia reduced natural gas supplies to Ukraine and then imposed sanctions that included import restrictions on Ukrainian foodstuffs and a temporary intensification of customs inspections procedures for Ukrainian exports to Russia. Russia implied that the free-trade agreement Ukraine has with Russia and other CIS countries might have to be revisited if Ukraine goes ahead with the EU association agreement. This would mean imposing duties on goods imported into the CIS from Ukraine. Russia could also raise prices on natural gas supplied to Ukraine. Russia hinted recently the gas price might fall if the agreement stays unsigned.

Ukraine presently imports about 60 % of its natural gas from Russia, and about 30 % of Ukraine exports go to Russia. Ukraine's fear is that it could lose the Russian markets under the EU deal. There is very little demand for Ukrainian products outside the CIS.

Ukraine now says the association agreement could lead to unbearably large short-term economic losses. The EU deal also involves high direct costs such as changing to EU technical standards. Ukraine has asked the EU for support to pay for the transition, but the EU has so far balked.

Russian central bank intensifies bank supervision. Elvira Nabiullina, the Central Bank of Russia's new chairwoman since June, says the supervision will now focus especially on operations of banks suspected of involvement in money laundering. A second area of focus are banks that attract deposits by offering very high interest rates and invest the money in risky assets.

The CBR has cancelled the licences of over 20 banks since July. In comparison, only a few bank licences were

cancelled in the first half of 2013. The CBR has typically pulled about 15 bank licences a year in recent years.

The highest profile licence losses this autumn involved Pushkino bank and Master bank. Pushkino is Russia's 134th largest bank based on total assets and Master is 74th. The termination of the two banks' operations has led to Russia's largest deposit insurance compensation claims ever, totaling 50 billion rubles (€1.1 billion). Given the entire deposit insurance fund has about 230 billion rubles (€5 billion), the pay-out has many asking whether the deposit insurance fund is adequate to cover future claims. Deposit insurance is today 700,000 rubles (€16,000) per bank for private individual deposit accounts. Draft legislation would increase coverage to 1 million rubles. A number of experts have pointed out that the current deposit insurance scheme encourages customers to put their money in high-interest accounts with risky banks.

The banks losing their licences are relatively small, so the CBR actions have presented little threat to the stability of the banking sector as a whole. Many banks, however, have become more cautious about lending on the interbank market, restricting access of smaller banks to credit.

Russia has about 900 banks today, but the bulk of banking activity is concentrated among the five largest state banks.

Russia to abandon TIR customs guarantee arrangement at Finnish-Russian border. Russian customs officials have announced that from the start of December they will no longer recognise expedited treatment of freight under the TIR (Transports Internationaux Routiers or International Road Transport) at the Russia-Finland and Russia-Lithuania borders. Russia eliminated TIR procedures at other borders earlier this autumn.

Under the TIR system, imported goods are not declared at border crossing, but only at the final destination. If the goods vanish, the national transport organisation of the importing country must pay the duties. Russia's Association of International Road Transport Carriers (ASMAP) has often refused to pay the duties. This results in loss of federal budget revenues, for which the customs administration is responsible. The customs administration's answer to the problem has been to reject the TIR system.

In place of the TIR system, Russian customs will now require companies moving goods to Russia to take customs insurance for each declared load from a Russian organisation or use a Russian transport firm that has customs authority to handle transport without extra insurance. Finnish transportation companies worry that the new arrangement will substantially impede freight border crossing.

Negotiations are still going on, and it may be possible that Russia will postpone the introduction of the new rule at the last minute.

China

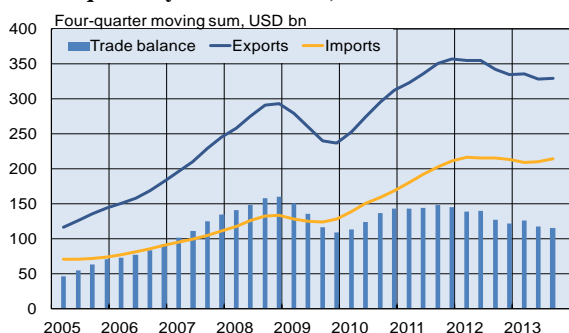
EU and China launch talks on bilateral investment treaty.

At the hastily arranged EU-China summit last week in Beijing, the participants outlined cooperation ways to strengthen their strategic partnership agreed ten years ago. The outcome of the summit seems to be little more than an acknowledgement that there is still plenty of unused potential for deeper economic relations.

The most important achievement of the summit was an agreement that the EU and China would commence talks on an investment protection deal. In addition to the lack of investment protection, issues concerning intellectual property rights and market access have frayed EU-China relations. In these areas, at least, the need for an investment treaty is important. The OECD reports China limits inflows of foreign direct investment more than any of the 40 countries it evaluated. In the EU's view, free-trade talks proposed by China will only be timely after China ends extensive subsidies to domestic companies.

China's premier Li Keqiang was on the ground in Romania this week promoting economic relations with 16 Central and Eastern European countries at their second joint event. China promised infrastructure investment (including railways) for the region, as well as cooperation in the energy branch and agriculture. The meeting was largely a marketing event as China's delegation included 300 corporate representatives.

China's quarterly trade with EU, 2005–2013



Source: Macrobond

Measured in goods trade, China is EU's second largest trading partner after the United States. Germany dominates EU's trade with China, accounting for 47 % of exports to China and nearly a third of all EU-China trade. The EU's trade imbalance with China, which earlier caused concern, has been shrinking over the past two years.

The latest EU figures show that EU-based firms only invested 2–3 % of their FDI in China in 2011. FDI from Chi-

nese companies to EU countries took off in 2011, but Chinese FDI was still only about 0.5% of the EU's entire FDI inflow.

China-Japan island dispute takes a dangerous turn. On Sunday (Nov. 24), China announced it was enlarging its air defence identification zone over the disputed Senkaku/Diaoyu islands in the East China Sea. Any aircraft moving in the identification zone must report flight plans and declare their presence to China's military under threat of "emergency defence measures." The enlarged airspace means that the Chinese identification zone now overlaps with Japanese, Korean and Taiwanese zones. The decision has received severe criticism. Japan announced that it does not approve it and the US, which maintains an airbase in the East China Sea, has said it will not acknowledge the Chinese decision. During this week US, Japanese and Korean military aircraft have flown over the new identification zone without notifying Chinese authorities.

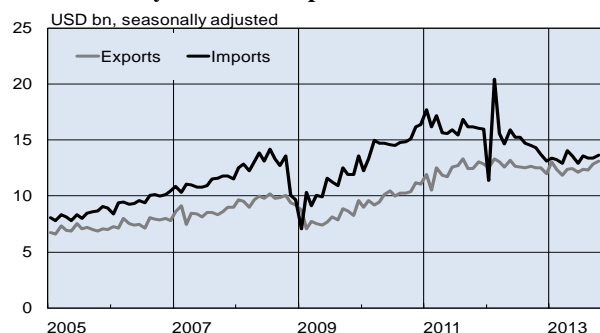
The incident comes at an economically sensitive time. Last week, a delegation representing over 100 large Japanese firms went to China to improve relations with their Chinese counterparts after a two-year break. China is an extremely important market for many Japanese firms and many Japanese firms have production facilities in China.

Although the countries' political disputes have affected e.g. sales of Japanese products in China, FDI from Japan to China this year has been rising rapidly. FDI of Chinese firms in Japan is insignificant.

The political disputes can be seen in the countries' bilateral trade figures. However, with the end to the two-year hiatus, China's exports to Japan have growing quite rapidly in recent months. The island dispute could put an end to this burst of growth. China's imports from Japan have also increased.

The disputes have severely reduced tourist numbers. The flow of Japanese tourists to China this year is down considerably from last year and the numbers of Chinese tourists visiting Japan is down as well.

China's monthly trade with Japan



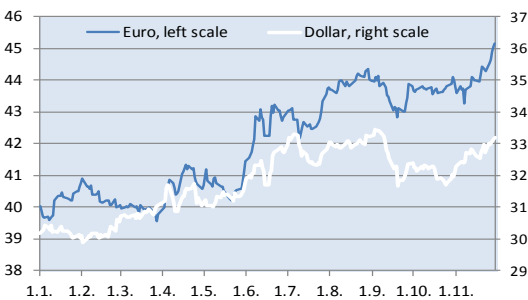
Sources: CEIC and China customs

Russia

Ruble's decline continued in November. The ruble lost nearly 12 % of its value against the euro and over 8 % against the dollar in the first eleven months of this year. The ruble now stands at its lowest value against the euro since the end of 2009. On Thursday (Dec. 5), one euro bought 45.2 rubles and one dollar bought 33.3 rubles.

In line with its goal of gradually moving to a free-floating ruble, the Central Bank of Russia has allowed a large drop for the ruble. Even so, the CBR has intervened by selling foreign currency from its reserves to control the rate of the depreciation. The CBR has used about \$23 billion of its reserves since the ruble drop began last spring. CBR reserves are still substantial, however; about \$524 billion at the end of October.

Euro-ruble, dollar-ruble exchange rates in 2013 (rising trend indicates ruble depreciation)



Source: CBR

Russia approves 2014 budget. The budget revenue calculations are based on economy ministry's autumn forecast of 3 % GDP growth next year. The budget plan also assumes inflation will be 5 % and the price of Urals-grade crude oil will average \$100 a barrel. The federal budget deficit is 0.5 % of GDP. For the budget to reach balance, the oil price would have to be about \$103 a barrel. On Tuesday (Dec. 3), the economy ministry announced it had revised down its GDP growth projection for next year to 2.5 %. This will undoubtedly affect budget realisation.

This year, the expected budget deficit is little less than 1 % of GDP. Urals oil has averaged \$108 a barrel.

Federal budget revenues will rise about 5 % next year in nominal terms as about half of budget revenues come from taxes and fees on oil and gas, which are only expected to increase slightly. Revenues will not rise in real terms (i.e. accounting for inflation). Also expenditures will increase slowly, some 4 %, although defence spending will rise about 20 % as Russia's military upgrade programme is implemented. Russia's budgeted defence spending will approach 4 % of GDP. The Stockholm International Peace Research Institute (SIPRI) estimates Russian defence

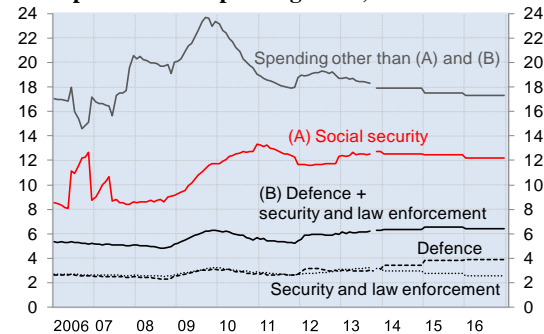
spending overall (on- and off-budget) was about 4.5 % of GDP in 2012.

Growth of spending from social funds (pension, social security and health insurance funds) will decelerate, but is still 10 % next year. Like earlier, spending from the Pension Fund will be partly covered by large transfers from the federal budget. Social spending will remain above 12 % of GDP. The rise in social and defence spending leaves less room for spending increases in other areas such as health-care and education.

Similar to previous years, regional and municipal budgets are to be almost in balance, which will be secured by transferring funds from the federal budget. Regional and municipal spending is only expected to rise 4–5 %, i.e. remain almost unchanged in real terms.

Revenues of the consolidated budget (includes federal and regional budgets, as well as social funds) will equal nearly 36 % of GDP next year. Spending is nearly 37 % of GDP and the deficit 1 % of GDP.

Main public sector spending areas, % of GDP



Source: Finance ministry

TIR system gets more time at Finnish-Russian border.

Late last week, first deputy prime minister Igor Shuvalov annulled the customs authority's decision to abandon the TIR customs guarantee arrangement at border crossings between Russia and Finland from the start of this month. The government decided that TIR procedures can remain in place until the end of June. The decision does not affect border crossings elsewhere where the termination of TIR procedures will stay in force ([see BOFIT Weekly 48/2013](#)).

The TIR reprieve in Finland's case was allowed because most goods flows into Russia covered under the TIR guarantee scheme take place via Finland. During the autumn, several Russian businesses asked the government to reverse the customs authorities' decision. In its press release about the reprieve, Russian customs stated that it needed time to negotiate with Transports Internationaux Routiers (International Road Transport), the body that administers the TIR system. Russia wants to revise TIR procedures so that the right of the customs to get duty payments when the goods vanish will be strengthened.

China

Further details on Shanghai financial market experiment emerge. Initial information released in late September indicated that trial programmes in the new Shanghai free-trade zone would include relaxation of financial market regulation and capital movements. At the beginning of this month, the People's Bank of China elaborated plans for the free-trade zone.

Companies and investors registered to operate in the zone can use tagged bank accounts to transfer funds between the zone and abroad more easily. Although capital movements between the rest of mainland China and the free-trade zone will remain strictly regulated, banks and companies operating in the zone will enjoy more relaxed rules on cross-border transactions than in the Shenzhen and Wenzhou pilot areas. Companies operating in the free-trade area will apparently be able to e.g. get yuan-denominated financing from abroad and invest the money raised on the mainland. Other pilot programmes in the zone include deregulation of deposit rates, although initially the change will only apply to certificates of deposit and foreign currency deposits.

The new policies in the zone still remain subject to broad interpretation and no deadlines for implementation have been specified. Limiting financial market deregulation to select geographic locations is also a challenge.

Shanghai's air quality reaches ghastly levels. At the beginning of December, Shanghai's official air pollution index exceeded the 300-mark, putting it in the highest and most "severe" level of its six-level system. It was the first time that pollution levels reached the highest health threat level since Shanghai began to officially release real-time air quality assessments last year. News agency Xinhua reported that in the first days of this month PM2.5 pollution (particulates under 2.5 microns) in Shanghai was 10 times above the World Health Organization's recommended limit. Those at risk were encouraged to stay indoors. Air quality has been exceptionally poor in many other parts of China as well.

China's continued reliance on coal in energy production, the on-going construction boom and increased road and air traffic are all major factors in degrading air quality. The International Energy Agency (IEA) reports that China currently uses as much coal as all other countries in the world combined. China's CO₂ emissions per capita now nearly match those of the EU. While EU emissions per capita are falling, Chinese emissions per capita are rising.

Despite increasing focus on environmental degradation, pollution and related production shutdowns already impact economic growth. Moreover, China's environmental problems also make it more difficult for international firms to get key personnel to relocate to China.

China remains a mid-level country when it comes to corruption. This week Transparency International released its annual Corruption Perceptions Index (CPI), which this time covered 177 countries. Based on extensive survey material, China's CPI value rose from last year's 39 to 40 suggesting slightly lower levels of corruption. The CPI ranges from 0 (absolutely corrupt) to 100 (absolutely clean). Despite the improvement, China's ranking relative to other countries was unchanged from last year. Denmark and New Zealand tied for the world's least corrupt countries in 2013.

President Xi Jinping has launched a wide-ranging anti-corruption campaign this year. In addition to arrests of top party officials, news agency Xinhua reported this week that nearly 20,000 officials have been punished for corruption and other abuses this year.

Select Transparency International CPI rankings for 2013

Country	Index value (0–100)	Ranking
Denmark	91	1
New Zealand	91	1
Finland	89	3
Sweden	89	3
United States	73	19
Spain	59	40
China	40	80
Greece	40	80
Russia	28	127
North Korea	8	177

Source: Transparency International

Shanghai 15-year-olds shine in latest PISA scores. On Tuesday (Dec. 3), the OECD released its latest PISA testing results. The PISA comparison looks at the performance of 15-year-old students in the areas of mathematics, science and reading comprehension. The PISA comparison this time covered 61 countries, as well as Shanghai, Hong Kong, Macao and Taiwan. As in the last PISA study, Shanghai students topped the list in all three categories. In addition, their results improved sharply from the last PISA round. The top seven performers come all from Far East, as Shanghai was trailed by Hong Kong, Japan, Korea, Singapore and Taiwan. Russian students showed modest improvement, but still fell into the mid-range of rankings.

As the study covers only Shanghai in China's case and other countries submit national results, the results are not fully comparable. Interest in developing the educational system, however, has increased in China. National participation in PISA testing could yield valuable data in designing measures to improve the performance of all Chinese students.

Russia

Russian ruble gets its own currency symbol. The Central Bank of Russia announced on Wednesday (Dec. 11) the official graphic symbol for the ruble. The Cyrillic “R” letter, which looks like a Latin P is dashed mid-section to get the double-bar configuration found in the e.g. yen and euro symbols.



In an online crowd-sourced vote on the CBR website last month, over 60 % of voters picked the winning symbol from five alternatives. About 280,000 people participated in the vote.

CBR to beef up supervision of insurance sector. The Federal Financial Markets Service was last summer integrated with the central bank. Since then, the directors of the Service have mentioned publically on several occasions that the insurance sector needs cleaning up. The officials note that Russia’s insurance sector is still rife with companies engaging in questionable practices. Some simply collect premia and then vanish; others fail to maintain sufficient assets to cover their liabilities.

Russia currently has about 440 insurance companies, most of which are only minor players in the industry. Nearly all insurance companies in Russia at the moment are privately held. In the first half of 2013, almost 60 insurers had no income from premium payments and over 200 collected premium payments of up to 120 million rubles (€2.7 million). The 20 largest insurers together controlled about 73 % of the market.

The CBR and finance ministry are planning to raise the capital requirements for insurance companies. Capital requirements currently vary from 60 million rubles to 480 million rubles (from €1.3 million to €1.5 million) depending on the types of insurance offered by the company. Capital requirements were last raised at the start of 2012. That change caused about 120 insurers to exit the market. The minimum capital requirement for insurance companies operating for instance in Finland is €2–3 million depending on the types of insurance offered.

The CBR and the finance ministry decided that before raising capital requirements this time the quality of insurance companies’ stated capital should be investigated, as in some cases the capital is highly suspect. To support prudential supervision, proposals of the Financial Markets Service include the introduction of regulations on quality of assets and an assets-to-liabilities ratio similar to that used for the banking sector. In addition, generally agreed measures for winding down troubled insurers should be established.

Russian students show improvement in latest PISA round. Despite better results, Russia still ranked below the

OECD average in all three PISA categories (mathematics, natural sciences, reading comprehension). Russia’s latest performance shows considerable improvement from the first PISA round in 2000. At that time, Russia scored near the bottom of all the 32 countries participating in the survey (including 28 OECD members). The latest PISA study includes 34 OECD countries and 31 other countries and regional economies (a total of 65 countries and economies).

Russia’s scores in the PISA 2012 round were highest in math, with the country ranking 34th. Russia ranked 37th in natural sciences and 42nd in reading comprehension. Russia’s performances in math and science were on par with students in Portugal, Sweden and Hungary. In reading, Russian 15-year-olds did about as well as their peers in Greece, Lithuania and Sweden.

Russian students ranked well below the OECD average when measuring the share of top performers among students.

Finnish exports to Russia sustain growth in consumer-driven branches. Modest growth in private consumption in Russia held up throughout the autumn, supporting Finnish exports to Russia. Although the value of goods exports overall contracted 4 % y-o-y in January-September, the value of exports of consumer goods such as foodstuffs and textiles still recorded an increase of a few percents.

The total value of exports was driven down by lower exports in the largest product categories of chemical products and machinery & equipment. Exports have been hampered by a contraction in demand for capital goods in Russia due to weak development of fixed investment. Finland’s goods exports to Russia in January-September were about €4 billion and goods imports from Russia nearly €8 billion.

Continued growth in Russian consumption apparently helped support the export of Finnish travel services to Russia. The numbers for Russians crossing the border into Finland, overnight stays in Finnish hotels and inns, as well as tax-free purchases continued to rise, even if growth was lower than last year.

The traditional spike in Russian consumption is approaching as the Russian New Year’s holiday season gets under way. Despite weakened economic performance in Russia, a Deloitte survey found that Russians plan to spend more money this New Year’s season than last year. The survey covered Russia’s largest cities and found the average budget for New Year’s celebrations was €140, about the same as the average European’s Christmas budget. Russians spend most of that money on food and gifts, of which the most desired are electronics, trips abroad and jewellery.

Surveys of firms, in contrast, show no signs of a significant recovery in investment demand. Most firms said they had no plans to increase investment in near term.

China

China moves ahead on deregulation of interest rates and preparations for launch of deposit insurance scheme.

The People's Bank of China announced on Sunday (Dec. 8) that trade in certificates of deposit (CDs) will be permitted on the interbank market. The SHIBOR rate will be used as a benchmark for CD rates. Although officials last week said that the reform would first be piloted in the newly created Shanghai free-trade zone, it now appears the central bank will fall back to its original plan to allow trade on the interbank market announced earlier this autumn. Liberalisation of CD trading gives banks an additional avenue for arranging finance and the reform is considered an important step in ending state regulation of deposit rates. The central bank will still strictly regulate bank deposits rates, however. During recent years China gradually relaxed regulation of lending rates and last summer final regulations were removed.

The PBoC is making progress on other fronts, too. *Caixin Media* reports the central bank is preparing to introduce a deposit insurance scheme. Deposits would be fully insured up to 500,000 yuan (about €60,000). As reference, deposit protection in EU countries extends up to €100,000 per depositor. Chinese depositors now rely on the implicit guarantee of the government, which owns most of the banking sector and is expected to protect its banks from insolvency.

Liberalisation of interest rates and the deposit insurance scheme are key factors in developing the domestic financial sector and preparing for liberalisation of capital movements.

China's stable economic conditions create a window of opportunity for reforms? Economic growth in November remained stable as in previous months. After a relatively weak second quarter, over the past five months industrial output rebounded to around 10 % y-o-y. The situation in the service sector has also been quite stable. There were no big shifts in private consumption, as growth in retail sales remained strong. Moreover, the rise in market interest rates does not appear to have significantly curtailed investment.

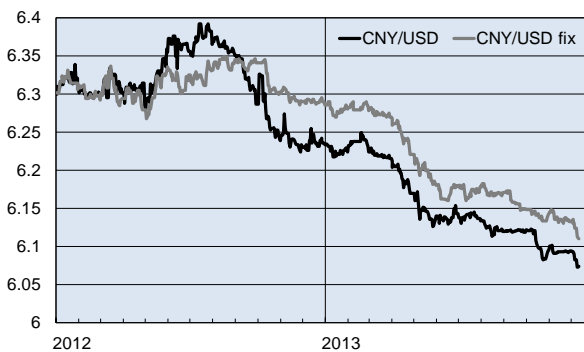
While monthly foreign trade figures fluctuate significantly, the fact that exports rose 13 % y-o-y in November suggests a pick-up in export growth and recovery in China's export markets. Exports to Europe and the United States rose 18 %. The high export numbers, however, have again raised suspicions that companies are artificially exaggerating the value of their exports to import foreign currency. A similar phenomenon was seen last spring and now officials repeat they will investigate the matter. China's imports, which reflect trends in domestic demand, rose 5 %, a rate of growth nearly matching the previous three months.

Due to rapid export growth (and possible capital imports included in the export figures), China's trade surplus jumped

to over \$33 billion in November. Faced with so much upward pressure on the yuan, the PBoC this month has allowed the yuan to appreciate. Yuan trade is currently conducted at levels stronger than the PBoC's daily reference rate, indicating the markets expect further yuan strengthening.

With 12-month inflation slowing slightly to 3 %, the stars seem aligned for moving ahead with reform policy. No exceptional measures are demanded by the current overall economic situation or employment conditions, so the government is free to focus on limiting the growth of credit and implementing its announced reforms.

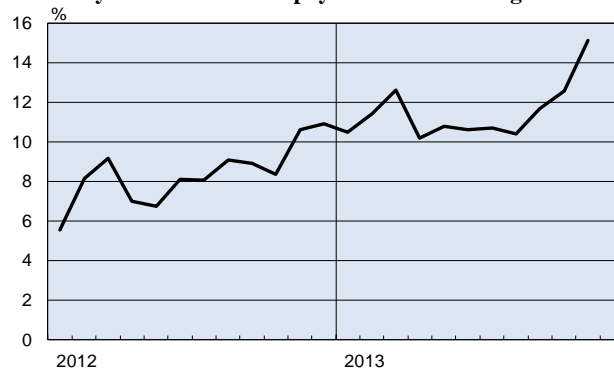
Yuan-dollar market rate and central bank reference rate (fix)



Source: Macrobond

International yuan use increasing in many areas. Renewed appreciation of the yuan has helped propel strong growth in yuan-denominated deposits in Hong Kong. Use of the yuan in pricing of China's goods exports and imports has risen sharply during the autumn and now exceeds 15 %. SWIFT, the association overseeing international bank communications, reports the yuan has already overtaken the euro to become the world's second most used currency in trade finance based on letters of credit with a nearly 9 % market share. The yuan's share of all international payments, however, remains below 1 %, making it the 12th most-used currency in world payments. China's tight capital controls hinder the expansion of yuan's international use.

Share of yuan-denominated payments in China's goods trade



Source: Macrobond

Russia

Russia to bail out Ukraine with massive economic support package. Russian president Vladimir Putin and Ukrainian president Victor Yanukovich 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 Russia'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.

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.

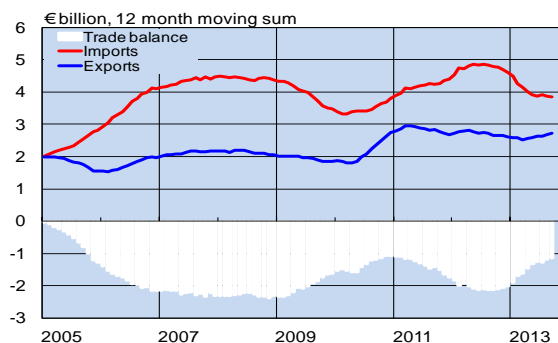
Although Finnish exports overall declined 3 % during January-September, exports to China were up 5 %. Specialised machinery and equipment used in primary industry and manufacturing accounted for 40 % of Finnish exports to China. Surprisingly, raw materials also accounted for nearly the same share of 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: Finnish Customs

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.

Central Bank of Russia / Exchange rates 2013

http://www.cbr.ru/eng/currency_base/dynamics.aspx

Date	USD	EUR
10.1.2013	30.4215	39.8096
11.1.2013	30.365	39.6385
12.1.2013	30.2537	40.1104
15.1.2013	30.2607	40.5009
16.1.2013	30.2556	40.4003
17.1.2013	30.3399	40.3096
18.1.2013	30.3431	40.3472
19.1.2013	30.2065	40.4314
22.1.2013	30.297	40.3617
23.1.2013	30.195	40.3194
24.1.2013	30.2292	40.22
25.1.2013	30.1648	40.2036
26.1.2013	30.0451	40.2364
29.1.2013	30.0782	40.4552
30.1.2013	30.1513	40.5414
31.1.2013	30.0277	40.5134
1.2.2013	30.0161	40.7138
2.2.2013	29.9966	40.8674
5.2.2013	29.9251	40.7789
6.2.2013	30.1231	40.6029
7.2.2013	29.9598	40.6435
8.2.2013	30.0496	40.6691
9.2.2013	30.1575	40.4171
12.2.2013	30.159	40.3618
13.2.2013	30.1713	40.3873
14.2.2013	30.0692	40.428
15.2.2013	30.0773	40.3698
16.2.2013	30.1139	40.2713
19.2.2013	30.1258	40.1969
20.2.2013	30.1277	40.2265
21.2.2013	30.0502	40.3394
22.2.2013	30.2337	40.0748
23.2.2013	30.3596	40.1111
26.2.2013	30.3368	40.081
27.2.2013	30.5889	39.9216
28.2.2013	30.6202	40.042
1.3.2013	30.5124	40.1024
2.3.2013	30.6381	40.0563
5.3.2013	30.787	40.0293
6.3.2013	30.6963	40.0126
7.3.2013	30.6214	40.0007
8.3.2013	30.7628	39.9732
12.3.2013	30.7576	40.0187
13.3.2013	30.7499	40.0364

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http://www.cbr.ru/eng/currency_base/dynamics.aspx

Date	USD	EUR
14.3.2013	30.7209	40.0631
15.3.2013	30.7769	39.8715
16.3.2013	30.7196	40.0123
19.3.2013	30.8908	39.8491
20.3.2013	30.8285	39.9075
21.3.2013	30.9446	39.8752
22.3.2013	30.8923	39.9746
23.3.2013	30.9325	39.906
26.3.2013	30.7585	40.0845
27.3.2013	30.8734	39.7526
28.3.2013	30.863	39.6559
29.3.2013	30.9962	39.6627
30.3.2013	31.0834	39.8023
2.4.2013	31.1093	39.8168
3.4.2013	31.1178	40.0113
4.4.2013	31.3918	40.1752
5.4.2013	31.7203	40.7035
6.4.2013	31.6207	40.8413
9.4.2013	31.6144	41.0481
10.4.2013	31.2086	40.6523
11.4.2013	31.0036	40.593
12.4.2013	30.8814	40.3651
13.4.2013	30.9308	40.5132
16.4.2013	31.3051	40.9283
17.4.2013	31.4512	41.1193
18.4.2013	31.232	41.1544
19.4.2013	31.7151	41.3787
20.4.2013	31.4605	41.1157
23.4.2013	31.5664	41.2352
24.4.2013	31.6414	41.3142
25.4.2013	31.5917	41.0629
26.4.2013	31.3169	40.8498
27.4.2013	31.2196	40.6635
30.4.2013	31.2559	40.8358
1.5.2013	31.0433	40.6264
7.5.2013	31.0839	40.7386
8.5.2013	31.0789	40.645
9.5.2013	31.0829	40.7404
14.5.2013	31.3777	40.7345
15.5.2013	31.2778	40.6768
16.5.2013	31.4281	40.5517
17.5.2013	31.4166	40.4175
18.5.2013	31.3931	40.3747
21.5.2013	31.3406	40.2633

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http://www.cbr.ru/eng/currency_base/dynamics.aspx

Date	USD	EUR
22.5.2013	31.177	40.1903
23.5.2013	31.228	40.3372
24.5.2013	31.4711	40.4026
25.5.2013	31.3164	40.514
28.5.2013	31.3025	40.4867
29.5.2013	31.3784	40.5189
30.5.2013	31.5203	40.5666
31.5.2013	31.5893	40.965
1.6.2013	31.7979	41.4486
4.6.2013	32.0487	41.7274
5.6.2013	31.8344	41.6076
6.6.2013	31.9816	41.8447
7.6.2013	32.1385	42.1464
8.6.2013	32.2397	42.7176
11.6.2013	32.3246	42.6426
12.6.2013	32.3951	42.9753
14.6.2013	32.3467	43.2443
15.6.2013	31.8029	42.4442
18.6.2013	31.679	42.2249
19.6.2013	31.8824	42.5216
20.6.2013	32.1201	43.0409
21.6.2013	32.7041	43.3526
22.6.2013	32.7433	43.3489
25.6.2013	32.9097	43.1018
26.6.2013	32.714	42.9698
27.6.2013	32.8876	42.9841
28.6.2013	32.8766	42.8349
29.6.2013	32.709	42.718
2.7.2013	32.8517	42.8025
3.7.2013	32.9475	43.0525
4.7.2013	33.2204	43.0736
5.7.2013	33.1605	43.0954
6.7.2013	33.2247	42.8399
9.7.2013	33.321	42.7342
10.7.2013	33.0842	42.6389
11.7.2013	32.9112	42.1033
12.7.2013	32.5867	42.6234
13.7.2013	32.6429	42.6643
16.7.2013	32.622	42.6076
17.7.2013	32.5417	42.5906
18.7.2013	32.4526	42.6232
19.7.2013	32.3998	42.4437
20.7.2013	32.4288	42.592
23.7.2013	32.3236	42.5088

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Date	USD	EUR
24.7.2013	32.3106	42.6209
25.7.2013	32.3462	42.7229
26.7.2013	32.5376	42.9919
27.7.2013	32.6371	43.3421
30.7.2013	32.8556	43.606
31.7.2013	32.8901	43.609
1.8.2013	33.033	43.7786
2.8.2013	32.9741	43.727
3.8.2013	33.0978	43.7387
6.8.2013	32.8811	43.6628
7.8.2013	32.939	43.6574
8.8.2013	32.9848	43.8764
9.8.2013	32.9401	43.9717
10.8.2013	32.8606	43.9806
13.8.2013	32.891	43.8305
14.8.2013	33.0426	43.9665
15.8.2013	33.1583	43.9845
16.8.2013	33.0004	43.8509
17.8.2013	32.9421	43.9382
20.8.2013	32.9226	43.8628
21.8.2013	33.0006	44.0294
22.8.2013	32.9737	44.2144
23.8.2013	33.1908	44.2765
24.8.2013	33.0552	44.1022
27.8.2013	32.9564	44.0891
28.8.2013	33.1224	44.2714
29.8.2013	33.1798	44.3879
30.8.2013	33.1783	44.084
31.8.2013	33.2474	44.0129
3.9.2013	33.2522	43.9561
4.9.2013	33.3693	43.954
5.9.2013	33.4656	44.0742
6.9.2013	33.3901	43.9814
7.9.2013	33.4338	43.8919
10.9.2013	33.3243	43.9014
11.9.2013	33.06	43.8607
12.9.2013	32.9629	43.6824
13.9.2013	32.6731	43.4748
14.9.2013	32.7406	43.4664
17.9.2013	32.2907	43.1597
18.9.2013	32.3237	43.1457
19.9.2013	32.245	43.0761
20.9.2013	31.5892	42.7465
21.9.2013	31.7326	42.9501

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http://www.cbr.ru/eng/currency_base/dynamics.aspx

Date	USD	EUR
24.9.2013	31.9106	43.2038
25.9.2013	31.8167	42.9653
26.9.2013	31.9343	43.0251
27.9.2013	32.1736	43.4987
28.9.2013	32.3451	43.6497
1.10.2013	32.4839	43.8143
2.10.2013	32.2965	43.8005
3.10.2013	32.2979	43.6603
4.10.2013	32.125	43.6932
5.10.2013	32.1005	43.7337
8.10.2013	32.2931	43.8314
9.10.2013	32.2984	43.8225
10.10.2013	32.3619	43.8471
11.10.2013	32.3564	43.6844
12.10.2013	32.2133	43.6039
15.10.2013	32.2663	43.766
16.10.2013	32.2676	43.7645
17.10.2013	32.2561	43.6102
18.10.2013	32.0816	43.5123
19.10.2013	31.846	43.559
22.10.2013	31.9013	43.6378
23.10.2013	31.9346	43.661
24.10.2013	31.7448	43.7126
25.10.2013	31.6618	43.7249
26.10.2013	31.6775	43.7625
29.10.2013	31.8119	43.9036
30.10.2013	31.9445	44.0323
31.10.2013	32.0613	44.0586
1.11.2013	32.0758	43.9406
2.11.2013	32.1808	43.6179
6.11.2013	32.3509	43.6672
7.11.2013	32.4511	43.822
8.11.2013	32.3803	43.7879
9.11.2013	32.5479	43.6305
12.11.2013	32.6622	43.6563
13.11.2013	32.8076	43.9228
14.11.2013	32.8184	44.1046
15.11.2013	32.6874	44.0201
16.11.2013	32.6807	43.9751
19.11.2013	32.5658	43.9541
20.11.2013	32.6098	44.0624
21.11.2013	32.7417	44.3421
22.11.2013	33.018	44.33
23.11.2013	32.9055	44.3533

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http://www.cbr.ru/eng/currency_base/dynamics.aspx

Date	USD	EUR
26.11.2013	32.7733	44.3685
27.11.2013	32.9879	44.6392
28.11.2013	33.0041	44.8262
29.11.2013	33.1332	44.9949
30.11.2013	33.1916	45.187
3.12.2013	33.1482	45.0882
4.12.2013	33.246	45.0417
5.12.2013	33.2632	45.1748
6.12.2013	33.114	45.1013
7.12.2013	32.9514	45.0116
10.12.2013	32.7782	44.9127
11.12.2013	32.7848	45.0758
12.12.2013	32.7315	45.0418
13.12.2013	32.7518	45.1549
14.12.2013	32.8663	45.1944
17.12.2013	32.8658	45.2135
18.12.2013	32.8646	45.2644
19.12.2013	32.9404	45.3688
20.12.2013	32.9527	45.0628
21.12.2013	32.9798	44.968
24.12.2013	32.9506	45.0863
25.12.2013	32.6284	44.652
26.12.2013	32.6487	44.6438
27.12.2013	32.671	44.7005
28.12.2013	32.6282	44.8736
31.12.2013	32.7292	44.9699