BOFIT

BOFIT Weekly
Yearbook 2015

Bank of Finland, BOFIT
Institute for Economies in Transition

BOFIT Weekly
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BOFIT Weekly – Russia 2015

2.1.2015 BOFIT Weekly 1/2015

Russian GDP contracts in November; inflation soars.
Russia's forex markets remain turbulent.
Semblance of calm returns to banking sector.
Eurasian Economic Union agreement entered into force yesterday.

9.1.2015 BOFIT Weekly 2/2015

2014 exposed major weaknesses in the Russian economy.
Moscow stock prices tanked last year.
Russian inflation averaged 11.4 % in 2014.

16.1.2015 BOFIT Weekly 3/2015

Fitch downgrades Russia's creditworthiness.
Russian interest rates surged late last year.
Despite rapid growth, Russia's housing loan market is still relatively small.

23.1.2015 BOFIT Weekly 4/2015

Major institutions lower their outlooks for Russia and Ukraine.
CBR continues to defend the ruble.
Contractions in Russian exports and imports intensified.
Outflow of private capital from Russia and foreign currency cash holdings up sharply in 4Q2014.

30.1.2015 BOFIT Weekly 5/2015

Standard & Poor's downgrades Russia's creditworthiness to speculative grade.
Foreign debt of Russian banks and companies shrank last year, repayments ahead.
Federal budget turned to slight deficit in 2014.

6.2.2015 BOFIT Weekly 6/2015

Russian GDP grew by just 0.6 % last year.
Russian output shows transient spike in December.
CBR surprises with 2 p.p. cut in key rate.
Russian government approves economic support programme.

13.2.2015 BOFIT Weekly 7/2015

Russia's banking sector reflects economic uncertainty.
Russian foreign trade contracted sharply in the fourth quarter.

20.2.2015 BOFIT Weekly 8/2015

Russian inflation soars.
Russia to dip into its sovereign funds.

27.2.2015 BOFIT Weekly 9/2015

Russia's creditworthiness battered again.
Russia refining an increasing share of its oil production domestically.
Russian government considers ways to assure reasonable access to medicines.

6.3.2015 BOFIT Weekly 10/2015

Financial woes of Russian regions begin to bite.
Growth of government revenues and expenditures just kept up with inflation in 2014.

13.3.2015 BOFIT Weekly 11/2015

Russians experienced drop in real household incomes last year.
Finnish-Russian trade contracted last year.

BOFIT Weekly – Russia 2015

20.3.2015 BOFIT Weekly 12/2015

CBR cuts key rate to 14 %.
CBR sees Russian economy contracting 3.5–4 % this year.
EU and Russia squabble over Russian import tariffs continues.
Ukraine gets new 4-year IMF fund facility.
CBR launches English-language research paper series.

27.3.2015 BOFIT Weekly 13/2015

Latest BOFIT forecast sees further contraction of Russian GDP and imports this year, with slow recovery thereafter.
Transit shipments through Finland to Russia contracted sharply last year, while transit freight from Russia rose.

2.4.2015 BOFIT Weekly 14/2015

Investment in Russia declines; structure of branches targeted for investment continues to shift.
Duma takes up bill on granting amnesty for unauthorised capital exports.
Russia foregoes daylight savings time.

10.4.2015 BOFIT Weekly 15/2015

Ruble appreciation enters third month.
Russian inflation reached 16.9 % in March.
Russia moves to limit public sector wage hikes.
Russian carmakers have it rough.

17.4.2015 BOFIT Weekly 16/2015

Russian Duma approves adjustments to federal and social fund budgets for 2015.
Falling imports kept Russia's current account in surplus.
Capital outflow from Russia continued strong due to foreign debt payments.

24.4.2015 BOFIT Weekly 17/2015

Private demand down sharply in Russia.
Import disputes in the Eurasian Economic Union.

30.4.2015 BOFIT Weekly 18/2015

Economy ministry puts out ever-rosier forecasts.
Dispute over pension system resolved.
Russia bans re-export of plant products from Bulgaria.

8.5.2015 BOFIT Weekly 19/2015

CBR lowers key rate.
Russia launches its own national card payment system.
Consumers under major strain in Russian regions, industries struggle.

15.5.2015 BOFIT Weekly 20/2015

Exports of Russian pipeline gas down over 10 % last year.
Russia and China conclude cooperation agreements during Xi Jinping's visit to Moscow last week.
Russia's foreign trade collapsed in the first quarter.

22.5.2015 BOFIT Weekly 21/2015

The slide of Russian output deepened in April.
Nominal increase in public sector revenues comes to a near halt.
CBR returns to the forex market.

BOFIT Weekly – Russia 2015

29.5.2015 BOFIT Weekly 22/2015
Russian domestic demand down sharply in April.
Real wages continue to slide in Russia.
Russia's low unemployment partly reflects a shift of dismissed workers to the shadow economy.

5.6.2015 BOFIT Weekly 23/2015
Russia slashes public investment.
Russian government supports investment in production focused on import substitution.
Russia drops to sixth place among Finnish export markets.

12.6.2015 BOFIT Weekly 24/2015
No changes expected in Russian corporate taxation in coming years.
Loan stock growth stalls for Russian banking sector.
Foreign direct investment inflow to Russia last year was lower than in 2009.

18.6.2015 BOFIT Weekly 25/2015
CBR lowers key rate for fourth time this year.
CBR governor Nabiullina discusses outlook for Russia's foreign currency reserves.
Russia resumes TIR freight customs arrangement.

26.6.2015 BOFIT Weekly 26/2015
Depressed Russian demand and output continued in May.
Forecasters slightly improve their Russia forecasts for this year.
President Putin speaks to foreign investors at St. Petersburg international economic forum.
EU and Russia both extend economic sanctions.

3.7.2015 BOFIT Weekly 27/2015
Decline of investment limited by oil and gas sector.
Russian government budget framework assumes lean years ahead.
Russian finance ministry expects spending on defence and social security to plateau next year.

10.7.2015 BOFIT Weekly 28/2015
Russia's foreign currency reserves stabilised.
Russia spending oil funds in the first half.
Tourism accounts for nearly half of Russian services imports.

17.7.2015 BOFIT Weekly 29/2015
Russia's current account surplus persists, capital outflow diminishes
Russia's foreign debt remains unchanged.
Several hundred firms in Finnish ownership in Russia.

24.7.2015 BOFIT Weekly 30/2015
Signs that Russian economy's decline may be stabilising.
Consumption, real incomes and household borrowing in Russia remain down.
Exports of Russian military technology hold steady.

31.7.2015 BOFIT Weekly 31/2015
Views of Russian authorities differ slightly on outlooks for the economy's recovery; oil prices and the ruble slide.
Output down in most manufacturing branches.

7.8.2015 BOFIT Weekly 32/2015
CBR lowers key rate again.
IMF repeats its calls for Russia to implement economic reforms.
US extends sanctions, additional European countries join in certain EU sanctions.
IMF releases second loan tranche to Ukraine.

BOFIT Weekly – Russia 2015

14.8.2015 BOFIT Weekly 33/2015

CBR releases elaborated assessment of foreign debt servicing payments through end of this year.
Russian imports suffer as economy falters.
Kyrgyzstan becomes newest member of Eurasian Economic Union; Kazakhstan completes WTO accession talks.

21.8.2015 BOFIT Weekly 34/2015

Regions and local governments face precarious budget circumstances.
Russian accounts inspector finds problems with National Welfare Fund use.
Number of banks in Russia continues to fall.

28.8.2015 BOFIT Weekly 35/2015

Falling oil prices weaken the ruble and increase risks to Russia's economy.
Large shifts in structure of government revenues and spending.

4.9.2015 BOFIT Weekly 36/2015

Multiple impacts on Russia's labour market from current recession.
Government wants to increase competition but also restrictions on public sector procurements.
Finnish exports to Russia down sharply in the first half, exports to other countries unchanged.

11.9.2015 BOFIT Weekly 37/2015

Russian inflation continues to pick up steam.
Recession hits Russian regions.
Putin issues decree to speed up construction of Power of Siberia pipeline.

18.9.2015 BOFIT Weekly 38/2015

CBR leaves rates unchanged.
Russia's economy ministry and central bank revise their forecasts.
Significant changes again in structure of investments in Russia.

25.9.2015 BOFIT Weekly 39/2015

Fresh BOFIT forecast sees Russian GDP and imports contracting slightly further in 2016.
No easing of depressed demand and output in Russia.
Russia plans to increase food self-sufficiency goals, import bans not helping.

2.10.2015 BOFIT Weekly 40/2015

Tough negotiations over Russia's 2016 federal budget continue.
Improved profitability of Russian firms early this year gave support to paying down foreign debt.
Discussion on structural reforms of the economy in Russia.

9.10.2015 BOFIT Weekly 41/2015

Number of people in Russia living below minimum subsistence level up markedly.
Russian domestic demand down over 10 %.
Russia behind China in most international comparisons.

16.10.2015 BOFIT Weekly 42/2015

Russia's third-quarter exports and imports figures fall to 2010 levels.
Private sector capital flows between Russia and abroad remain modest.
Russia restarts gas deliveries to Ukraine; air travel between the two countries set to end.

23.10.2015 BOFIT Weekly 43/2015

Russian output up in September; consumption continued to fall.
Russia's foreign debt fell in the third quarter.
Ukraine's private creditors accept debt restructuring.

BOFIT Weekly – Russia 2015

30.10.2015 BOFIT Weekly 44/2015

Russian government issues lean proposals for 2016 federal and state social fund budgets.
Russia charts near depletion of Reserve Fund next year.
World Bank Doing Business report shows no major changes in Russia's business regulation last year.

6.11.2015 BOFIT Weekly 45/2015

Russian central bank keeps rates unchanged.
Russian firms borrow modestly.
Ruble remains weak.

13.11.2015 BOFIT Weekly 46/2015

Russian foreign trade remains very weak.
Large Russian private bank Uralsib faces bankruptcy prevention measures.
Finnish investment in Russia continues to heavily exceed Russian investment in Finland.

20.11.2015 BOFIT Weekly 47/2015

CBR monetary policy programme foresees drop in inflation and heavy reliance on Reserve Fund.
Russia's consolidated budget deficit fairly small so far this year.
Role of state-owned enterprises rising in Russia.

27.11.2015 BOFIT Weekly 48/2015

Mixed signals on direction of Russian economy.
Russian farm output provides a small ray of light.
Separate development plan approved for areas near Chinese border in Russia's Far East regions.

4.12.2015 BOFIT Weekly 49/2015

Russia bans travel to Turkey and restricts imports.
Impacts of Eurasian Customs and Economic Unions on the Kazakhstan market become clear.

11.12.2015 BOFIT Weekly 50/2015

Cheap oil hurts ruble.
Low oil prices challenge Russian government finances.
Russian energy export volumes at crossroads.

18.12.2015 BOFIT Weekly 51/2015

Russian central bank again passes on rate change.
Forecasters see the Russian economy contracting slightly in 2016.
Finnish-Russian trade scraping bottom.

22.12.2015 BOFIT Weekly 52/2015

Consumption and industrial output continued to decline in November.
Russia's state-owned Vnesheconombank needs large support.
Debt and trade disputes further erode economic relations between Russia and Ukraine; EU decides to keep Russian sanctions in place.

BOFIT Weekly – China 2015

2.1.2015 BOFIT Weekly 1/2015

Chinese 2013 GDP figures revised up.
China's leaders map out economic policy for the coming year.
China's stock markets end the year on an upswing.

9.1.2015 BOFIT Weekly 2/2015

Current forecasts see Chinese economy growing by about 7 % in 2015.
China eases export restrictions of rare earth metals.
For the first time in several years, the yuan loses ground against the dollar.

16.1.2015 BOFIT Weekly 3/2015

Inflation slow in China.
Lower commodity prices boost China's trade surplus.
Problems of China's largest real estate developers could affect financing possibilities for the entire sector.

23.1.2015 BOFIT Weekly 4/2015

Slowing Chinese GDP growth approached 7 % in 2014.
Inward FDI flows to China continue to exceed outward FDI.
Chinese real estate markets deteriorate further.

30.1.2015 BOFIT Weekly 5/2015

Growth of lending of China's shadow-banking sector still outpaces lending growth of formal banking sector.
Yuan rises to fifth-most-used currency in international payments.
Profits of Chinese industry showed record drop in December.
Pensions reformed and wages increased in Chinese public sector.

6.2.2015 BOFIT Weekly 6/2015

China's central bank lowers reserve requirement.
China's economy continued to slow in January according to purchasing manager indexes.
China's current account surplus grew slightly last year.

13.2.2015 BOFIT Weekly 7/2015

Drop in imports pushes foreign trade surplus to record levels.
Yuan appreciates in both real and nominal terms.
Chinese inflation falls further.

20.2.2015 BOFIT Weekly 8/2015

Prices for shares listed in Shanghai higher than in Hong Kong.
Capital controls liberalisation continues in Shanghai free trade zone.
China's New Silk Road Fund opens for business.

27.2.2015 BOFIT Weekly 9/2015

Financial markets enter the Year of the Goat calmly.
Chinese direct investment in Europe on the rise.
Foreign travel is now a thing in China.

6.3.2015 BOFIT Weekly 10/2015

China lowers economic growth target to around 7 %.
PBoC continues to deregulate interest rates.
Declining sales of machines for paper industry and furs hurt Finnish exports to China.

BOFIT Weekly – China 2015

13.3.2015 BOFIT Weekly 11/2015

China's struggling local governments can now convert more debts into bonds to deal with their debt problems.
Domestic demand shows signs of weakening in China.
Boom in Chinese tourism balances goods trade surplus.

20.3.2015 BOFIT Weekly 12/2015

Critical land reform experiment begins in China.
Europeans show keen interest in China's new development bank.
China could already this year introduce a deposit insurance scheme and deregulate interest rates.

27.3.2015 BOFIT Weekly 13/2015

BOFIT 2015–2017 forecast sees further slowdown in China's growth without certainty of a soft landing.
China strengthens its status as world's third most active patent-seeker.

2.4.2015 BOFIT Weekly 14/2015

Government approves long-awaited law on deposit insurance.
Profit growth at China's big banks slows significantly.
China is now the world's third largest arms exporter.

10.4.2015 BOFIT Weekly 15/2015

Chinese stock markets heat up.
China faces massive costs for environmental damage.

17.4.2015 BOFIT Weekly 16/2015

Chinese economic growth slows as expected in the first three months of the year.
Chinese export growth slowed in first quarter; value of imports plummeted.
IMF forecasts uneven development for the global economy.

24.4.2015 BOFIT Weekly 17/2015

China offers stimulus by lowering bank reserve requirements.
Chinese real estate markets remain shaky.
Real estate developer Kaisa defaults on bond payments.
China suspends implementation of bank cyber-security requirements.

30.4.2015 BOFIT Weekly 18/2015

Economic slowing adds to risk on Chinese financial markets.
Indebtedness of local governments continues to soar.
China's stock markets now among the largest in the world; meteoric rise causes concerns.

8.5.2015 BOFIT Weekly 19/2015

Chinese wage growth remains robust.
Policy changes to support China's labour markets.
China ends export duties on rare-earth metals.

15.5.2015 BOFIT Weekly 20/2015

PBoC cuts interest rates and continues deregulation of deposit interest rates.
Growth in number of migrant workers slows.
Gradual evolution in structure of China's foreign trade.

22.5.2015 BOFIT Weekly 21/2015

Investment growth slowed significantly in the first four months of the year.
China's FDI flows up in the first quarter.
Demographic shifts affecting Chinese labour markets.

BOFIT Weekly – China 2015

29.5.2015 BOFIT Weekly 22/2015
IMF no longer considers the yuan undervalued.
China's foreign currency reserves shrink as capital exports rise.

5.6.2015 BOFIT Weekly 23/2015
Chinese share prices ride the rollercoaster.
Banks ordered to continue financing local government construction projects in China.
China opens clearing market for payment cards.

12.6.2015 BOFIT Weekly 24/2015
China's exports and imports continue to shrink.
Chinese inflation slows further.
Mainland China stock markets not quite ready for in-corporation into global stock indexes.

18.6.2015 BOFIT Weekly 25/2015
Chinese economy continues to slow.
Impacts of economic slowdown worry European firms operating in China.
Actual progress in reform of China's state-controlled enterprises still unclear.

26.6.2015 BOFIT Weekly 26/2015
Chinese wages continue to rise, though at a slower pace.
Preparing for the rollout of the China International Payments System (CIPS).
Yuan now the top international payments currency in Asia.

3.7.2015 BOFIT Weekly 27/2015
China's central bank extends monetary easing.
Reforms on complete deregulation of interest rates move ahead in China.
Chinese stock markets continue to seesaw.

10.7.2015 BOFIT Weekly 28/2015
China takes serious measures to control stock market drop.
China and the EU agree on tighter economic cooperation.
Founding documents signed for AIIB development bank.
Official launch of BRICS New Development Bank.

17.7.2015 BOFIT Weekly 29/2015
China's Q2 economic growth remained at 7 %.
Structure of Chinese economy keeps evolving.
Slow export growth in China in the first half; value of imports declines.
China introduces draft legislation on foreign investment and cyber-security.

24.7.2015 BOFIT Weekly 30/2015
More liberal access for foreign investors to mainland China's financial markets.
China's housing market shows signs of recovery.

31.7.2015 BOFIT Weekly 31/2015
Increase in domestic indebtedness in China continues to outpace economic growth.
China restricts peer-to-peer lenders offering loans to share purchases.
Foreign investors reduce their stock investments in mainland China.

7.8.2015 BOFIT Weekly 32/2015
IMF report clarifies issues on possible inclusion of yuan in SDR basket.
Direct investment flows into and out of China continue to rise.
Official figures may overestimate FDI outflows from China.

BOFIT Weekly – China 2015

14.8.2015 BOFIT Weekly 33/2015
China devalues yuan and announces plans to increase role of markets in exchange-rate setting.
Chinese economic growth continues to slow.
Chinese foreign real estate holdings on the increase.

21.8.2015 BOFIT Weekly 34/2015
Turbulence continues on Chinese markets.
IMF says China's shift to a more sustainable growth model essential.

28.8.2015 BOFIT Weekly 35/2015
China's central bank continues monetary easing and liberalisation of interest rates.
On-going volatility on the Chinese stock markets.
Chinese oil import volumes up 10 % this year.

4.9.2015 BOFIT Weekly 36/2015
New car sales in China slowed in recent months.
China's state-owned enterprises climb in rankings of world's largest companies.
Finnish exports to China up in first half.

11.9.2015 BOFIT Weekly 37/2015
Chinese foreign trade down again in August.
New figures on Chinese local government debt.
Chinese food imports up.

18.9.2015 BOFIT Weekly 38/2015
Chinese retail sales support economic growth.
China's foreign currency reserves declined by $94 billion in August.
Reform plan for Chinese SOEs stresses increased state supervision.

25.9.2015 BOFIT Weekly 39/2015
Latest BOFIT forecast sees continued slowdown in China's growth in coming years.
Officials ease rules on foreign borrowing of Chinese firms.
International institutions concerned about soaring indebtedness in China.

2.10.2015 BOFIT Weekly 40/2015
China's president Xi visited US.
China steps up fiscal stimulus measures.
Situation in China's housing markets remains mixed.

9.10.2015 BOFIT Weekly 41/2015
IMF holds its China forecast unchanged, but warns of rising risk from slowing growth.
Yuan surpasses yen as the world's fourth-most-used currency in international payments.
Greater access to China's bond and forex markets.

16.10.2015 BOFIT Weekly 42/2015
TPP deal presents a positive challenge for China.
Small changes in regional structure of China's foreign trade.
Chinese corporate profits dragged down by long slide in producer prices.

23.10.2015 BOFIT Weekly 43/2015
China's growth remains strong and structures continue to change.
Central bank forex interventions and capital outflows from China have increased.
Yuan weakened slightly in the late summer.

BOFIT Weekly – China 2015

30.10.2015 BOFIT Weekly 44/2015
China frees interest rates.
China further eases monetary stance.
Chinese domestic indebtedness continues to soar
China's president promotes closer economic ties during UK visit.

6.11.2015 BOFIT Weekly 45/2015
China's latest five-year plan features two-child policy and economic reforms.
Growth targets problematic for guidance of Chinese economic policy.
China sets a low bar ahead of Paris climate conference.

13.11.2015 BOFIT Weekly 46/2015
Growth in Chinese retail sales outstrips fixed investment.
Reform in management of China's state-owned enterprises moves ahead.
Mainland China share prices soar again; CSRC lifts moratorium on IPO listings.

20.11.2015 BOFIT Weekly 47/2015
IMF head calls for including yuan in SDR basket.
No clear direction for China's housing market.
Foreign direct investment flows to China on the increase.

27.11.2015 BOFIT Weekly 48/2015
Chinese monetary policy is in search for a new framework.
China lowers and deregulates natural gas prices.
New yuan trading forum open in Europe.

4.12.2015 BOFIT Weekly 49/2015
Yuan will join IMF's SDR basket.
Reforms reach China's military.
China's nuclear power industry making strides at home and abroad.

11.12.2015 BOFIT Weekly 50/2015
Beijing's abysmal air quality reinforces importance of Paris climate summit.
Cheap oil and shifting exchange rates jostle China's foreign trade numbers.
China experiences increased labour unrest in November.

18.12.2015 BOFIT Weekly 51/2015
China publishes yuan exchange rate index.
China's industrial output recovered slightly in November.
China's grain harvests continue to get bigger.

22.12.2015 BOFIT Weekly 52/2015
China's trade surplus fairly stable with commodities removed.
Economic relations reaffirmed at China-Africa summit.
EU readies sanctions against China for steel dumping.

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BOFIT Weekly

1 • 2.1.2015

Russia

Russian GDP contracts in November; inflation soars. The economy ministry estimates 12-month GDP fell 0.5 % in November. While much of the drop reflected a sharp decline in manufacturing output, the dynamics in construction, wholesale and agricultural output were also disappointing. Russia last saw a GDP contraction in 2009.

The finance ministry estimates that on-year inflation climbed to over 11 % by the end of December. Again, the last similar spike in inflation in Russia occurred during the 2009 recession. The biggest factor driving inflation in the final months of the year was the ruble's collapse.

Russia's forex markets remain turbulent. After recovering considerable ground last week, the ruble resumed its decline this week. The ruble's latest drop was apparently sparked by economy ministry data showing negative economic growth in November, not to mention the on-going decline in crude oil prices. Russia's markets remain jittery, with high volatility in daily trading.

The Central Bank of Russia has refrained from large interventions in the currency markets since December 22. On December 31, the official CBR ruble exchange rates were 68.3 for the euro and 56.3 for the dollar.

To ease the situation on foreign currency markets, the government mandated on December 17 that five large state-owned export enterprises (Gazprom, Rosneft, diamond producer Alrosa, the specialised international oil venture Zarubezhneft and spirits distiller Kristall) exchange their extra foreign currency holdings for rubles. By the beginning of March 2015, the forex holdings of these companies should be reduced to their value of October 2014. These companies must also report their forex holdings on a weekly basis to the central bank. Observers note that if these firms convert their extra forex holdings into rubles, it would to some extent help in stabilising currency markets.

While the mandate does not concern other firms, president Putin has in his discussions with the heads of large privately held firms appealed to them to shoulder their responsibilities when the Russian economy and the ruble are struggling.

Semblance of calm returns to banking sector. The ruble's collapse crested in mid-December (Dec. 16–17), followed by a frenzy of withdrawals from bank deposit accounts. However, the situation calmed in a few days after banks sharply hiked interest rates on deposits.

In order to enhance confidence of the general population in banks, the Duma fast-tracked and passed legislation on December 19 to raise the maximum deposit insurance coverage from 700,000 rubles (about €10,000) to 1.4 million rubles. An earlier bill proposal to raise the level of deposit insurance coverage to a million rubles was submitted to the Duma in mid-2013, but was scrubbed on opposition from the finance ministry.

Several efforts are being made to boost the stability of the banking sector. On December 19 the Duma approved a law on recapitalising banks with a total sum of 1 trillion rubles (about €15 billion). All banks would be eligible to receive capital support up to the amount equivalent to their base capital. The banks with highest funding priority are systematically important banks, those that have major regional importance and banks that hold large amounts of the general population's deposits. The capital support will be financed through the sale of federal bonds (OFZ).

On December 23, the CBR introduced a new financing instrument that makes available to banks 28- and 365-day forex credits. The credits can be secured with euro or dollar bank loans to large export companies, and are intended to boost bank opportunities to help exporters service foreign debt.

Eurasian Economic Union agreement entered into force yesterday. The Russia-Belarus-Kazakhstan customs union, which was established in 2010, became the Eurasian Economic Union (EEU) on Thursday (Jan. 1). The new union also added a fourth member, Armenia, which had signed a membership agreement in October 2014. Kyrgyzstan penned its membership agreement in December, and is expected to join the EEU this coming May.

The EEU seeks greater economic integration among its member states, including coordinated economic policies and common financial and energy markets. The countries agreed already in 2012 to the free movement of goods, services, labour and capital, but with little success so far.

Even in the best-case scenario, the EEU will not function as declared for many years. Implementation still requires agreement on numerous issues left open in earlier negotiations. Moreover, the member countries face daunting tasks of harmonising their national legislation and regulations with those of the EEU. The EEU accession documents also grant member states numerous exemptions and several years of transition time. For example, Armenia has been granted an eight-year transition period before it must fully meet its membership requirements.

Deeper integration is also complicated by the fact that the customs union never functioned smoothly. Russia and Belarus have constantly squabbled, each blaming the other for e.g. violating customs union rules, especially since Russia banned imports of Western food products. Russia claims Belarus began to export banned products to Russia. Both countries have gone as far as again setting up customs inspection points on their borders to check goods before they cross into their territory.

Customs union partners have also suffered from the Russian ruble's recent demise. Belarus, for example, has demanded its food exports to Russia be priced in dollars or euros rather than rubles.

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EUROJÄRJESTELMÄ
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BOFIT Weekly
1 • 2.1.2015

China

Chinese 2013 GDP figures revised up. On December 19, China's National Bureau of Statistics, as expected, revised up its assessment of the 2013 national accounts based on its third economic census of industrial and service sectors (the first economic census was conducted in 2004 and the second in 2008). The new 2013 GDP figures add 3.4 % to the GDP estimate, or an extra 1.9 trillion yuan (€250 billion), and bring total GDP to 58.8 trillion yuan (€7.75 trillion). The increase was larger than Finland's entire GDP for 2013.

The GDP adjustment reflects the rapidly expanding service sector for which compiling reliable statistics has been a challenge. Service sector output was revised up about 5 % and industrial sector output was increased by about 3 %. Data from the earlier economic censuses caused the NBS to revise its GDP estimate up by 17 % in 2004 and 4.4 % in 2008. In both instances, the largest contributor to GDP gains came from adjustments in service sector figures.

The economic census provides extensive information on trends in Chinese corporations and shifts in economic focus. The number of private firms rose by 56 % between 2008 and 2013, while the number of state-owned enterprises declined. Some 96 % of the private sector is made up of micro and small companies. The relative importance of the service sector has grown steadily, accounting for 47 % of GDP in 2013 and exceeding the contribution of the industrial sector for the first time ever (44 %).

The census findings assist decision-makers in evaluation of the reliability of national accounts and provide guidance in assessing and dimensioning economic policies. NBS officials, however, have yet to implement the UN's System of National Accounts (SNA) as laid out in the most recent 2008 version. China's figures are based on the 1993 version, which e.g. treats R&D as a cost rather than an investment. If NBS officials were to adopt the latest SNA version, further upward adjustments to GDP would be inevitable.

In 2013, China became the world's second largest economy after the US. In terms of purchasing-power-adjusted GDP, China now nearly matches the US. In terms of GDP per capita, of course, China is still a lower middle-income country, and income distribution is still very uneven. Revisions to GDP made now and possibly later do not alter the overall fact that the Chinese economy is slowing. Further, the NBS notes its adjustment of 2013 GDP has no impact on 2014 growth figures.

China's leaders map out economic policy for the coming year. China held its annual Central Economic Work Conference in mid-December to chart out fiscal and monetary policy plans. In addition to discussing economic trends of the current year, the conference is supposed to lay out the course of economic policy for the coming year. The final conference statement emphasised the need for continued economic reform to help China adjust to the new lower-growth paradigm. Leaders admitted dealing with the shift was one of the biggest challenges they face in 2015.

As expected, the conference stated China's top economic goals today are assuring stable growth, identifying new paths to growth and achieving further progress in economic reform. Concrete actions to achieve these goals were not specified in the final statement. In keeping with protocol, the conference did not release the official 2015 GDP growth target. The finalised growth target is typically revealed at the National People's Congress in the spring. Most observers expect the target to be around 7 %.

China's stock markets end the year on an upswing. Mainland China stock exchanges ended the year with a strong sprint. The Shanghai Composite Index was up 21 % for December and, even with the rollercoaster volatility, finished the year up 53 %. Share prices on the Shenzhen stock exchange also rose, with the Shenzhen Composite Index up 34 % for the year. The rise in Hong Kong was much more subdued, with the Hang Seng Index up just 1 % for the year.

The surge in share prices reflects the increased interest of mainland Chinese in equities as yields on other forms of investment such as real estate and bank deposits have declined. The volume of share trading also exploded in the final two months of the year as new capital accounts were opened at a record pace.

There has been lacklustre response to "Through Train" cross-trading in listed shares on the Shanghai and Hong Kong stock exchanges, launched in mid-November. Foreign investment into the mainland China stock exchanges has been particularly weak. Through-train trading accounted for only about 1 % of the daily trading volume on the Shanghai exchange. Trading volumes have been nowhere near the ceilings imposed on the amounts of trading allowed under the arrangement. For the Shanghai exchange, just 25 % of the 300 billion yuan (€39 billion) quota had been used and just 4 % of the Hong Kong stock exchange's quota of 250 billion yuan.

Main share index trends in Shanghai and Hong Kong in 2014

Source: Macrobond

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EUROJÄRJESTELMÄ
EUROSYSTEMET

BOFIT Weekly
2 • 9.1.2015

Russia

2014 exposed major weaknesses in the Russian economy. Former finance minister Alexei Kudrin notes that the basic reason for the slowdown of the Russian economy since 2011 is the peculiar economic model Russia has created over the past ten years that often provides inappropriate signals for business activity.

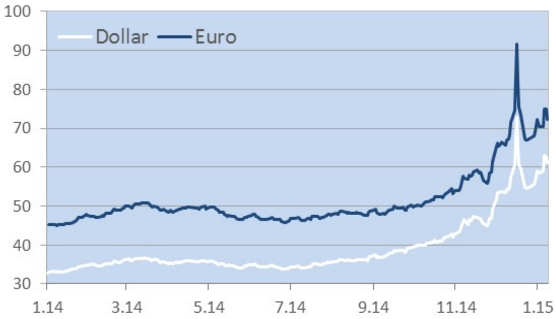
According to Mr. Kudrin, market mechanisms function poorly in Russia. In recent years, state participation in the economy has increased so that large state-owned or quasi-state-owned enterprises now dominate the economy. These firms have little incentive to modernise or seek out operational efficiencies. They seek instead to maximise their various forms of state support and get supply contracts with the government. These perverse business incentives are disseminated throughout the economy via distribution chains. All this together with uncertain business environment caused by stunted institutions encourage to short sighted business activity. Firms seek opportunities for quick profits rather than invest long term.

The Ukraine crisis last year increased uncertainty in the business environment. The annexation of Crimea and the on-going Donbass conflict, as well as the economic sanctions and countersanctions that followed, are likely to depress economic growth for years to come. The final nail in the coffin has been the sharp decline in world oil prices.

All these problems are reflected in the ruble's exchange rate. Over the course of the year, the Central Bank of Russia's official ruble rates showed a 34 % drop against the euro and a 42 % loss against the dollar.

The ruble's slide on currency markets continued this month with the exchange rate remaining above 70 rubles to the euro and the dollar rate holding close to or above 60.

Ruble-dollar, ruble-euro rates, 1 Jan. 2014 – 8 Jan. 2015 (falling trend indicates ruble appreciation)



Source: Thomson Reuters

The weakening of the ruble also reflects the international collapse in oil prices. The price of Urals crude, Russia's key export oil grade, lost 52 % last year, a bit more than North Sea Brent oil (down 48 %). The price of Urals crude tracks the Brent price and typically is a couple dollars cheaper per barrel.

Moscow stock prices tanked last year. The Moscow Exchange's RTS index fell 43 % last year from a high of 1,388 points to 791 points. The steepest drop came in December on the sharp drop in crude oil prices, even if the index has recovered somewhat thereafter.

The Moscow Exchange last year was among the poorest performing emerging market stock exchanges. The RTS Index has not seen such lows since spring 2009.

RTS index, 1 Jan. 2013 – 6 Jan. 2015

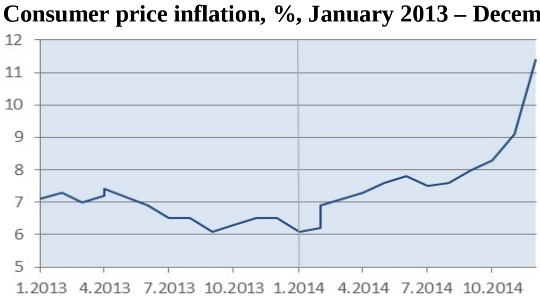
Source: Bloomberg

Russian inflation averaged 11.4 % in 2014. Inflation staged a dramatic pickup in November and December. Preliminary Rosstat figures show food prices increasing at an on-year rate above 15 % in December. Non-food goods were up 8 % and services over 10 %.

The pick-up in inflation at the end of the year reflected the ruble's sharp depreciation and the ensuing frenzy of household spending. Following the ban on certain categories of food imports last autumn, food prices have risen even if no food shortage has actually emerged.

Representatives of food producers and retail chains committed in September to a government initiative that their members would not raise prices without good reason or create artificial shortages in the market. There has been no move by the government as yet to impose price controls as in 2010. The agreement could have limited price increases somewhat.

Consumer price inflation, %, January 2013 – December 2014



Source: Rosstat

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China

Current forecasts see Chinese economy growing by about 7 % in 2015. China's indexes of manufacturing purchasing mangers (PMI) indicated further slowing of industrial output growth in December. The fall in growth of the service sector seems to have levelled off, however. The pace of retail sales growth and the services PMI reading have not changed significantly in recent months. The final GDP growth figure for 2014 is expected to be just over 7 %.

The estimates by a number of observers indicate that the slide in oil prices could probably add half a percentage point to GDP growth this year. Given that current economic growth is still boosted by excessive fixed capital investment and rising indebtedness and thus has no sustainable basis, the oil price boost is unlikely to reverse China's general trend towards a lower-growth paradigm. However, lower oil prices will relieve the need for fiscal and monetary stimulus measures.

Most leading forecasting institutions still see GDP growth above 7 % this year. Such strong growth will not come easily, however. Recent price swings on mainland China stock exchanges and revelation of a large real estate developer on the brink of bankruptcy provide fresh reminders of systemic risks lurking in the wings.

Recent GDP growth forecasts for China, % p.a.

	2014	2015	2016	Released
IMF	7.4	7.1	6.8	10/2014
OECD	7.3	7.1	6.9	11/2014
EIU	7.3	7.1	6.7	12/2014
CICC	7.4	7.3	7.5	12/2014
Deutsche Bank	7.3	7.0	6.7	1/2015
BOFIT	7	7	6	9/2014

China eases export restrictions of rare earth metals. At the start of January, China ended export quotas on rare earth metals and some other critical high-tech metals. The quotas have been replaced with export permits. Last August, a WTO panel upheld a US complaint that China's export quotas violated WTO rules. China had argued the quotas were needed in light of e.g. the environmental damage caused by mining rare earth elements (REEs). In 2010, China sharply cut its export quotas, causing world prices for REEs to soar. The elimination of quotas, however, is unlikely to have much of an impact on prices as export volumes in recent years have remained below the quota amounts. Some observers note that China is also planning to eliminate export duties on REEs, which would have a bigger impact on prices.

Other trade policy issues have also been in the news recently. A WTO panel in December found in China's favour on its complaint that US duties on Chinese-made solar panels violated WTO rules. The US commerce department recently conceded that the alleged price dumping of Chinese manufacturers was not as widespread as earlier believed and says it is ready to cut anti-dumping duties on solar panels.

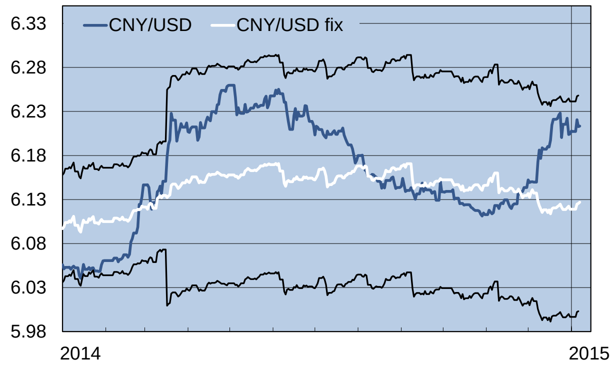
Talks on expanding the WTO-enforced Information Technology Agreement (ITA) have been delayed on issues such as a dispute between South Korea and China on duties for flat panel displays. Since the US and China broke their ITA deadlock in bilateral talks in November, the expanded ITA has been considered much more likely.

For the first time in several years, the yuan loses ground against the dollar. After years of steady appreciation, the yuan last year lost about 2.5 % of its value against the US dollar. The last time the yuan showed an on-year drop against the dollar was in 2009. In the first half of the year, markets were surprised by an unexpected depreciation of the yuan against the dollar, even as most economic fundamentals pointed to on-going yuan appreciation. Part of the weakening reflects deliberate central bank measures to curb speculation on yuan appreciation and prepare markets for the widening of the yuan-dollar trading band.

The People's Bank of China doubled the width of the trading band in March, allowing a daily divergence of 2 % from the central bank's daily fixing of the yuan-dollar rate. The move was intended to give markets greater power in formation of the yuan's external value. The trading band was last widened in April 2012. With these measures, the PBoC ushers in market-based exchange rates and promotes internationalisation of the yuan.

Following the widening of the trading band, the yuan showed more volatility and resumed appreciation. Towards the end of the year, however, slower economic growth and cut in reference rates, along with the improving performance of the US economy, resulted in yuan depreciation against the dollar. The yuan continued its appreciation trend against the euro in the second half, finishing the year up about 10 % against the euro.

Yuan-dollar exchange rate and trading band limits (black)



Sources: Macrobond and BOFIT

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Russia

Fitch downgrades Russia's creditworthiness. International credit ratings specialist Fitch announced last Friday (Jan. 9) that it had cut its ratings on Russian sovereign debt from BBB to BBB-, Fitch's lowest investment-grade rating. Fitch said the downgrade was warranted in light of the deteriorating outlook for the Russian economy over the second half of 2014.

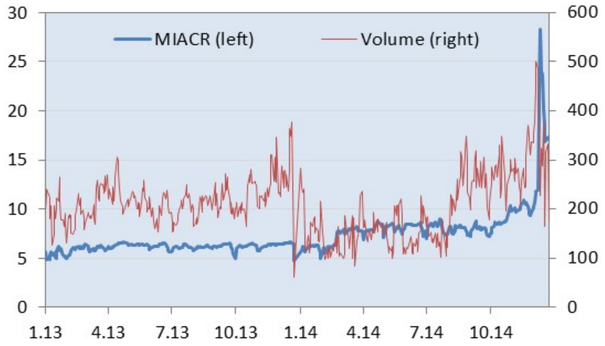
Standard & Poor's lowered its rating of Russian sovereigns to its bottom investment-grade category last April as the Ukraine crisis flared. The final big-three ratings agency, Moody's, continues to hold its rating of Russian sovereigns one notch above its lowest investment grade.

The outlooks of all three ratings agencies were negative. Any further lowering from Fitch or Standard & Poor's would push Russian borrowing down into the realm of "speculative grade." Many institutional investors have rules barring them from holding speculative-grade bonds, which are considered so risky that they are only recommended for well-informed investors capable of absorbing substantial losses.

Russian interest rates surged late last year. In order to calm inflation and capital exports, the Central Bank of Russia last year raised its key rate (the 7-day repo credit rate) six times. Over the course of last year, the key rate climbed from 5.5 % to 17 %.

Market interest rates increased in response to CBR hikes in its own steering rates. The one-day Moscow Interbank Actual Credit Rate (MIACR) rose above 17 % at the end of the 2014, having started the year just over 6 %. During the ruble's collapse in mid-December, the one-day MIACR briefly hit 28 %.

1-day Moscow Interbank Actual Credit Rate (MIACR) and lending volume, RUB billion, 2013–2014

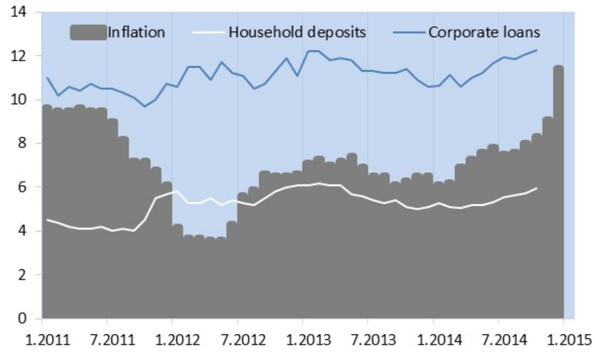


Source: CBR

CBR interest rate hikes have increased borrowing costs for banks, forcing them in turn to raise lending rates. Corporate loans at the end of December carried interest rates of as much as 20–30 % p.a. Given the rise in interest rates late last year, real lending rates (inflationary impact removed) could soar and further erode possibilities for corporate borrowing.

Banks have also increased their deposit rates in an effort to retain current assets. For the first time in a long while, real deposit rates are positive in some cases.

Interest rates for household deposits of less than a year, corporate loans of over a year, as well as 12-month inflation, %



Source: CBR

Despite rapid growth, Russia's housing loan market is still relatively small. Starting from a very modest level, the total stock of housing loans issued by banks has increased at over 30 % a year since 2011. As of end-September 2014, the stock of housing loans stood at 3.35 trillion rubles (€45 billion), up from 1.07 trillion rubles in 2008. At that time, just 17 % of housing purchases involved bank financing. In the first nine months of 2014, bank financing was involved in 28 % of all housing deals. Housing loans last year represented about 30 % of the stock of bank lending to households.

The average length of a housing loan has fallen from nearly 18 years in 2008 to just over 12 years in 2014.

Russia's biggest provider of housing loans by far is Sberbank, followed by VTB24. The two state-owned banks together account for over 70 % of housing loans currently on issue. Other banks issuing housing loans are typically mid-sized privately held banks.

The price of housing loans today reflects last year's rising economic uncertainty and across-the-board hikes in interest rates. Sberbank in December raised its average rates on new housing loans to a range of 14.5–15.5 % p.a., while the average rate of a VTB24 housing loan hit 14.95 %. In the case of certain private banks, the price of housing loans has risen to as much as 17–20 %. In recent years, the average interest rate for all housing loans on issue has averaged over 12 %.

Faced with rising risk in housing loans, banks began to deal with their exposure late last year by tightening lending criteria (e.g. raising the size of the downpayment requirement for the borrower).

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China

Inflation slow in China. December consumer prices were up just 1.5 % y-o-y. Food prices, up nearly 3 %, were the biggest driver of inflation. Prices other than food were up 0.8 % y-o-y, but were lower than in November. November consumer price inflation was 1.4 % y-o-y.

Domestic prices for fuels and other energy formats have not fallen as rapidly as on world markets, however. Officials have reduced the ceiling price on fuels twelve times since last June. In the same period, the fuel consumption tax was increased three times, slowing the decline in retail fuel prices. Gasoline prices are down 25 % from last June and diesel oil prices down 30 %. The drop in global oil prices, in contrast, was nearly 60 % over the period.

The slide in producer prices accelerated from a drop of 2.7 % y-o-y in November to 3.3 % in December. On-year deflation in producer prices has persisted since March 2012, and producer prices were down at the end of 2014 by about 7 % compared to spring 2012.

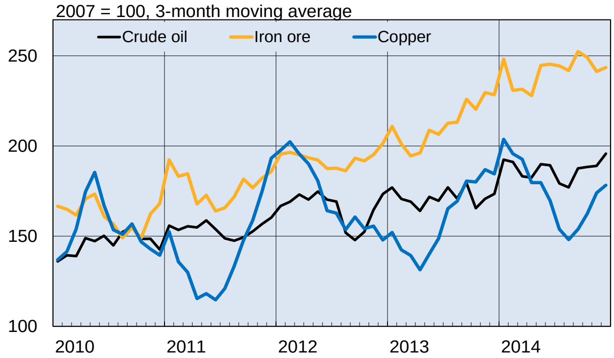
Price trends in China are also affected by price declines in other countries. November import prices were down 5 % y-o-y. Export prices remained roughly at the 2013 level. Consumer price inflation this year could be moderated especially by lower prices for manufactured products, energy and housing.

Lower commodity prices boost China's trade surplus. The December foreign trade numbers provided a pleasant surprise for China, with the value of exports increasing 10 % y-o-y and the drop in the value of imports a mere 2 %. Lower import prices helped push China's trade surplus in 2014 to a record $380 billion, an increase of nearly 50 % from the previous year. Chinese exports increased by 6 % last year, while imports rose less than 1 %.

The drop in the value of imports reflected lower commodity prices globally, and led to an increase in import volumes. The volume of crude oil imports last year climbed 9 %, while the volume of iron ore imports rose 14 %. China imported more crude oil than ever in 2014, about 308 million metric tons. The volume of iron ore imports rose to a record 933 million tons. The volume of copper imports increased 6 %, boosted in part by a sharp drop in copper prices towards the end of last year. Coal imports, in contrast, declined by 11 %. The October introduction of new tariffs on coal imports to support domestic coal production appeared to have no significant impact on coal imports, which declined steadily throughout 2014.

The fall in the prices of imported commodities has provided China with an opportunity to build up its strategic reserves of crude oil and also reserves of other basic commodities. Moreover, lower commodity prices could lead to the substitution of poorer-quality domestic production with imports. Thus, higher import volumes do not directly reflect a rise in demand for commodities.

Import volumes of key commodities to China



Source: Macrobond

Problems of China's largest real estate developers could affect financing possibilities for the entire sector. Kaisa Group Holdings, a real estate developer listed on the Hong Kong stock exchange, defaulted on a $52 million bank loan payment at the end of December. Last week, the firm became the first major Chinese developer to default its foreign bond servicing, when it missed $23 million in coupon payments. Several of Kaisa's top management have resigned, trading in Kaisa shares has been suspended, the price of its foreign bonds have collapsed and its bank accounts frozen, taking the company yet another step closer to bankruptcy.

For a company still renowned for healthy profitability six months ago to get into so much trouble so quickly raises a number of disturbing questions. Foremost is whether Kaisa's problems merely reflect bad decisions on the part of a single private enterprise or are they symptomatic of deeper problems running throughout China's real estate sector. Apartment prices continued to decline in December and during the holiday season around the turn of the year, sales volumes in large cities were less than half of what they were a year earlier. The slowdown in the housing market has hit highly leveraged builders particularly hard, and several developers encountered financial difficulties last year. Headlines reporting the resignations and arrests of leading figures in these enterprises hardly helped given widespread public suspicions of e.g. crooked land deals in the real estate sector.

Problems in China's real estate sector have also shaken foreign investors. The *Financial Times*, based on information from Dealogic, estimated last autumn that the outstanding amount of foreign bonds of Chinese developers was nearly $60 billion, while syndicated loans amounted to about $40 billion. Foreign bonds of Kaisa Group Holdings alone amount to about $2.5 billion, and in the case of a bankruptcy the position of foreign creditors seems to be weak.

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Russia

Major institutions lower their outlooks for Russia and Ukraine. The World Bank, IMF and EBRD have all released revised outlooks for *Russia*. Noting low crude oil prices, economic sanctions and structural problems of the Russian economy, they all project Russian GDP will shrink this year. The World Bank and IMF expect the GDP to contract 3 %, while the EBRD is predicting a fall of nearly 5 %. The World Bank assumes a crude oil price this year of $66/bbl, while the IMF and EBRD expect $57–58/bbl.

For 2016, the World Bank sees a slight return to growth for the Russian economy, while the IMF expects a further 1 % contraction.

Ukraine's GDP is projected to continue its fall, albeit at a rate slower than in 2014 (which has been estimated at about -8 %). The World Bank now expects Ukraine's GDP to contract just over 2 % this year, while the EBRD sees shrinkage of about 5 %.

CBR continues to defend the ruble. With the conclusion of the New Year's holiday season on January 11, the Central Bank of Russia during the next four days sold $2.2 billion on the currency markets, and has been issuing forex repo credits worth $8.3 billion, including $5.4 billion in credits with 28- and 364-day maturities. The CBR last year spent a net $83 billion propping up the ruble.

The CBR's foreign currency reserves, including gold, stood at $386 billion at the end of December, down from $510 billion at the beginning of January 2014. Russia's reserves are the world's sixth largest and cover over a year's imports of goods and services. Under normal conditions, such a robust reserve position is considered very good.

CBR gold and currency reserves 2007–2014, US$ billion

Source: CBR

Contractions in Russian exports and imports intensified. Preliminary CBR balance-of-payments figures show export earnings on goods and services in the fourth quarter of 2014 fell 19 % in dollar terms and 12 % in euros. Spending on imports of goods and services fell by the same rate. For all of 2014, exports were down 6 % and imports 9 % in both dollar and euro terms. The current account remained in surplus.

Full-year 2014 export earnings were down especially as regards gas and crude oil, while earnings from petroleum products also slid in the fourth quarter. Other goods exports remained fairly stagnant, and exports of services declined. Goods imports contracted 10 %. Spending of Russian travellers abroad, as well as other services imports, fell 5–6 %. In the fourth quarter, the contraction in goods imports deepened to 19 % (12 % in euro terms) and traveller spending plunged by over 20 % y-o-y.

Main balance-of-payments categories for Russia, 2013–2014

	USD billion			% of GDP		
	2013	2014	4Q14 (preliminary)	2013	2014	4Q14* (preliminary)
Current account	**34**	**57**	**11**	**1.6**	**3.0**	**2.2**
- exports (goods & services)	593	560	129	28.3	29.4	27.1
- imports (goods & services)	470	429	102	22.4	22.5	21.4
Trade balance (goods)	182	186	38	8.7	9.7	7.9
- exports	523	494	112	25.0	25.9	23.6
- imports	341	308	75	16.3	16.2	15.7
Services trade balance	-58	-55	-10	-2.8	-2.9	-2.2
- exports	70	67	17	3.3	3.5	3.5
- imports	128	121	27	6.1	6.4	5.6
Other items	-90	-74	-17	-4.3	-3.9	-3.5
Financial account + e&o	-56	-122	-40	-2.7	-6.4	-8.4
State (excl. central bank)	5	30	31	0.2	1.6	6.5
Private sector (A+B)	-62	-150	-70	-3.0	-7.9	-14.6
A. Banks	-7	-50	-31	-0.4	-2.6	-6.4
B. Other private, incl. e&o	-55	-100	-39	-2.6	-5.3	-8.2
- direct investments	-24	-29	-5	-1.1	-1.5	-1.0
- to Russia	61	19	-1	2.9	1.0	-0.2
- from Russia	85	47	4	4.1	2.5	0.7
- portfolio investments	-13	-19	-4	-0.6	-1.0	-0.9
- to Russia	-11	-14	-4	-0.5	-0.8	-0.8
- from Russia	2	4	1	0.1	0.2	0.1
- forex cash holdings #	0.3	-34	-18	0.0	-1.8	-3.8
- 'fictitious transactions'	-27	-9	-1	-1.3	-0.5	-0.2
- errors and omissions (e&o)	-11	3	-3	0.5	0.2	-0.7
- other items	20	-14	-8	0.9	-0.7	-1.7

* of average GDP of last four quarters
# negative value means increase in forex cash holdings

Source: CBR

Outflow of private capital from Russia and foreign currency cash holdings up sharply in 4Q2014. As the immediate reason to the ruble's slide, together the net capital outflow and the forex cash increase last year were about 2.5 times as high as in 2013. *Banks* reduced their foreign debt, especially in the fourth quarter, while finding international access to new credit very difficult.

Corporations appeared to have paid down their foreign debt in rather small amounts compared to payment schedules they faced. Portfolio investments, in turn, have steadily abandoned Russia. Direct investments from abroad stayed dried-up through the second half of 2014. DI outflows from Russia fell sharply in the fourth quarter, as did grey capital flows for the entire year. Hoarding of *foreign currency cash*, seen as a reaction to emerging problems already in the first quarter, soared in the fourth quarter.

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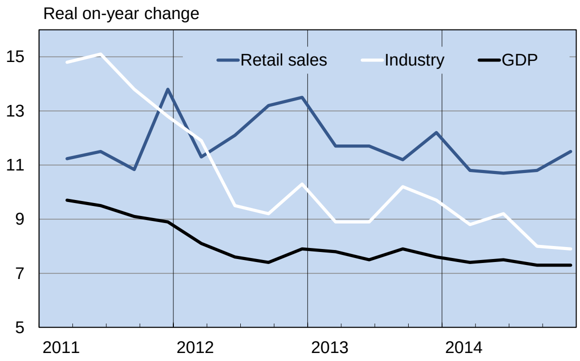
China

Slowing Chinese GDP growth approached 7 % in 2014. China's economic growth decelerated from 7.7 % in 2013 to 7.4 % last year. Fourth quarter GDP growth was 7.3 % y-o-y, or 1.5 % q-o-q. Growth in domestic consumption provided more than half of all economic growth. The service sector was the fastest growing part of the economy. Its contribution to GDP last year rose to 48 %, while manufacturing generated about 43 % of GDP.

GDP, industrial output and growth in retail sales, %



Source: Macrobond

The steady decline in growth of fixed capital investment continued, falling from 19 % y-o-y in 2013 to 15 % last year. As expected, construction investment slowed. Infrastructure investment, however, climbed over 20 % y-o-y.

Retail sales grew 11 % last year in real terms, while real wages were up about 8 % y-o-y. The structure of retail trade is undergoing a rapid transformation. Online retail last year accounted for over 10 % of retail sales. Online sales volumes were up 50 % y-o-y in 2014.

Commenting on employment trends, officials at China's National Bureau of Statistics noted that the unemployment rate in cities was 5.1 % last year – a percentage point higher than China's official unemployment figure has been. The NBS time series based on survey results have yet to be published, even if the NBS has indicated it plans to do so.

Economic growth is expected to slow this year and next. The IMF this month lowered its forecast for China by 0.3 percentage points to 6.8 % for 2015 and by 0.5 % percentage points to 6.3 % for 2016. The now-apparent slowdown in investment growth is likely to continue. Moreover, China is not expected to provide economic stimulus on a scale of recent years, but instead boost its emphasis on getting debt under control. The World Bank this month released its latest global outlook, which sees the Chinese economy growing slower than in its earlier forecasts. The World Bank expects economic growth of about 7 % in 2015 and 2016.

Inward FDI flows to China continue to exceed outward FDI. Preliminary balance-of-payments figures released by China's commerce ministry show that in 2014 flows of foreign direct investment into China continued to slightly exceed outbound FDI from China to other countries. Inbound FDI to China amounted to $120 billion, an increase of 2 % from 2013. Outbound FDI was $103 billion, an 11 % increase from 2013. China's FDI abroad increased significantly during the third quarter after the streamlining of the process for approving investment outside China. Growth, however, subsided in the final months of the year.

The gap between China's inbound and outbound FDI narrowed to its smallest size ever last year as China's investment abroad continued its robust growth. In comments on the latest release of balance-of-payments data, the commerce ministry noted that, if e.g. reinvested profits are included, China's FDI abroad last year amounted to $140 billion, making China a net FDI exporter.

China's foreign currency reserves (not including reserve assets other than foreign currency) amounted to $3.84 trillion at the end of December, down about $50 billion from the end of September. China's foreign currency reserves have been shrinking since last summer. Given the slight increase in the current account surplus, the drop in reserves likely reflects increased capital exports. The second half of the year also saw a modest weakening of the yuan's exchange rate, which may be a sign of increased capital exports. Final balance-of-payments data should help settle the issue of whether China last year became a net capital export for the first time.

Chinese real estate markets deteriorate further. Real estate sales contracted again in December. Real estate sales volume, measured in terms of floorspace, declined 8 % y-o-y. In value terms, sales fell 6 %. The NBS figures tracking sales in 70 cities indicate that, with the exception of a handful of cities in the eastern parts of the country, apartment prices declined across most of the country. Moreover, SouFun, a private portal service that tracks China's real estate markets, reports that the average apartment price at the end of December was down about 4 % from an April high and about 3 % from a year earlier. On-year investment in the real estate sector slowed to 11 %, down from over 20 % a year earlier.

The trends on China's real estate markets have long raised concerns among observers. Further fuelling uncertainty is the wide coverage of the financial struggles of some major real estate developers. Real estate markets have a significant effect on local governments, which earn considerable revenues from the sale of land use rights. Demand for land use rights has been hurt by the slowdown in growth of the real estate sector.

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Russia

Standard & Poor's downgrades Russia's creditworthiness to speculative grade. On Monday (Jan. 26), Standard & Poor's lowered Russian sovereign foreign currency borrowing to BB+, a notch below investor grade. Speculative-grade bonds are evaluated to have higher risk. S&P based the downgrade on e.g. Russia's deteriorating growth outlook, reduced possibilities for monetary policy to react to developments, as well as increased risks to the external balance and government finances. Russia's creditworthiness is now on par with Bulgaria, Indonesia and Turkey.

Fitch and Moody's, the two other big international ratings agencies, also lowered their ratings of Russia this month, but both still keep Russia barely in the investment-grade realm. All ratings agencies hold negative outlooks for the Russian economy.

The downgrade came as no big surprise to the markets. On the following day, the ruble weakened only slightly and Russian stock indices were roughly unchanged. The reduction in the credit rating complicates the availability of credit and raises borrowing costs, although the Russian government has no plans at the moment to increase its foreign debt. The borrowing of Russian firms from abroad has largely dried up already because access to credit has been limited due to factors such as increased uncertainty and economic sanctions.

Foreign debt of Russian banks and companies shrank last year, repayments ahead. The largest drop in foreign debt occurred in the second half of the year, and at year's end the debt stood at $548 billion, or slightly less than 30 % of GDP.

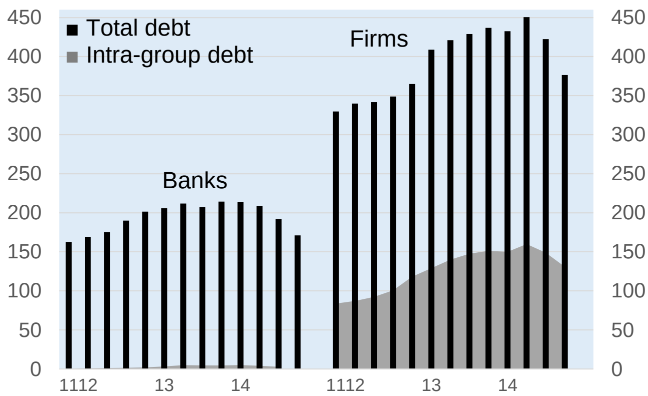
Bank foreign debt was reduced over the course of the year by $43 billion and stood at $171 billion at the end of the year. Most of the reduction came from paying down existing debt mainly in the second half of the year, due to the limited access of banks to foreign credit (caused e.g. by financial sanctions). The ruble's slide also notably reduced the size of bank debt as reported in dollars because about 15 % of the debt was actually denominated in rubles.

Corporate foreign debt declined last year by $60 billion to $376 billion. Most of the contraction came from the drop of the ruble, since about a quarter of corporate foreign debt was denominated in rubles. Moreover, unlike banks, about a third of corporate debt consists of debt within corporate groups, i.e. loans from foreign parent corporations or subsidiaries to Russian subsidiaries and parent companies. Many corporate groups have postponed payments on such debt. Other debt was repaid by Russian firms in rather moderate amounts last year, but there was an uptick in debt repayment in the second half.

According to the latest published information on payment maturities of debt owed by Russian banks and firms (situation at the beginning of October 2014), they face foreign debt repayment obligations in 2015 on principal totalling $108 billion and interest payments of $20 billion. Banks must pay down debt of $37 billion and firms $71 billion, of which payments not related to intra-group debt amount to $48 billion.

Given the scarcity of refinancing opportunities of banks and firms, certain firms burdened with foreign debt last year sought and were granted financing from government funds and the CBR. It looks for now that repayment of debt under these circumstances also this year will not have to be financed fully out of state coffers, as banks and firms have assets abroad that act as a source. For example, the short-term deposits of banks and firms abroad were about $120 billion at the beginning of last October.

Foreign debt of Russian banks and firms, end of quarter (31 Dec. 2011 – 31 Dec. 2014), USD billion



Source: Central Bank of Russia

Federal budget turned to slight deficit in 2014. Budget revenues increased by 11 % last year. There was a bigger rise in revenues in these nominal terms during the final months of the year, reflecting the continued slide of the ruble, which boosted dollar-denominated oil tax revenues, and a backlog of other revenues. Federal budget expenditures also rose by 11 %. The budget deficit corresponded to 0.5 % of GDP.

Growth in federal budget spending would have stayed below 4 % and the budget would have been clearly in surplus (nearly 1 % of GDP) without the 1 trillion rubles in support granted to the deposit insurance agency in December. Needs have already risen for the agency to use the grant for supporting operational banks that meet the criteria for eligibility. Budget spending caused by the support measure was financed by giving the grant to the agency in the form of government bonds that the agency turns over to select banks. The banks, in turn, can use the bonds as collateral when securing credit from the central bank.

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EUROJÄRJESTELMÄ
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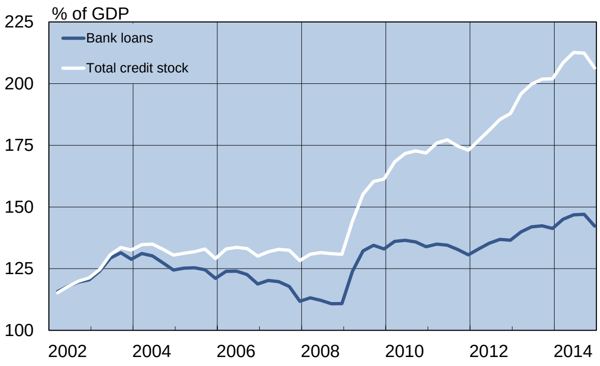
China

Growth of lending of China's shadow-banking sector still outpaces lending growth of formal banking sector. The broad-stroke Chinese notion of lending, "social financing," covers formal bank lending as well as a variety of instruments used in the shadow banking sector, which has seen its role increasing in China's bank-centred credit system. Growth in the volume of formal bank lending last year slowed to below 13 % y-o-y, while the stock of informal financing instruments was up 18 % y-o-y at the end of 2014.

Nevertheless, growth in lending in the shadow-banking sector has actually slowed. Officials have managed to make headway in cracking down on growth of the most problematic shadow banking instruments, trust loans, through increased supervision. On-year growth in trust loans remained at 11 % in 4Q2014. However, while growth in the stock of entrusted loans has also declined, an inter-company loan in which banks act as intermediaries for a fee, the loan stock anyhow increased 30 % from December 2013.

Given the slowdown in bank lending growth, China's ratio of domestic debt to GDP began to fall towards the end of the year. The ratio of total credit (including non-government and non-financial debt) to GDP, however, still exceeds 200 %, which is remarkable for a lower middle-income country like China.

Ratios of bank loans and credit to GDP for China, %



Sources: Macrobond, BOFIT

Yuan rises to fifth-most-used currency in international payments. The international payments transfers network SWIFT reports that the Chinese yuan accounted for 2.2 % of the value of global payments in December. The yuan surpassed both the Australian dollar and the Canadian dollar to become the world's fifth-most-used currency in international payments. So, the yuan is closing in on the Japanese yen (2.7 % share). The US dollar continued to dominate international payment traffic at 44 %, followed by the euro at 28 %. The British pound accounted for almost 8 % of the value of transfers in December.

The Russian ruble's ranking has long been dropping in the SWIFT Top 20 list of payments currencies. The ruble fell to 19th place in December, highlighting the trends of the Russian and Chinese currencies in recent years. In January 2012, the yuan ranked 20th in the SWIFT Top 20, while the ruble stood at 14th place.

Profits of Chinese industry showed record drop in December. Profits of large industrial firms fell 8 % y-o-y in December. On-year profit margins have been shrinking since October. While profits still rose for the year whole, profit growth in 2014 amounted to only about 3 %, down from about 12 % in 2013.

While declines in prices of oil and other commodities helped boost the profit margins of some Chinese producers, prices of the end products of many industrial firms have fallen sharply. Thus, the overall impact of lower commodity prices has been negative for many industries. Profitability also varies considerably across sectors. Hardest hit have been producers of basic commodities (e.g. mining, as well as oil and fuel production). At the same time, producers in such branches as machine-building and automobile manufacture, along with companies generating electric power and heating, have seen profits rise on lower input prices.

Pensions reformed and wages increased in Chinese public sector. The major reform of public sector pensions announced in January aims at unifying the pension schemes of public sector employees and workers in other sectors. Chinese public sector workers earlier were exempted from making pension contributions, while other workers had to pay 8 % of their wages to pension funds. Public sector contributions were paid out of the state budget.

The *Financial Times* reports that pensions of public sector employees are about 80–90 % of their wage income. Pensions in other sectors are typically about half of the wage. The decades-old double standard in the pension scheme was widely viewed as unfair and favouring state employees. The pension reform calls for a mandatory 8 % contribution from the wages of public sector workers. Public sector pensions will also be brought closer into line with the pension schemes of other workers by reducing the pension size relative to earned wages of future public sector retirees.

Along with the pension reform, officials announced substantial wage hikes for public sector workers. The increases affect China's approximately 40 million public sector workers, as well as some 15 million retired civil servants. Wages of public sector employees were last reviewed in 2006. The new plan is to review public sector wage levels roughly every two years. The wage hikes are not only sufficient to cover the extra costs of the pension reform, but will increase the net wages of state workers. The move is intended to reduce the temptation of civil servants to take bribes and stimulate consumer spending.

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Russia

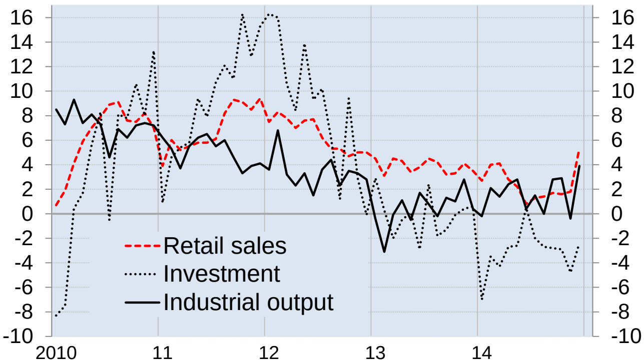
Russian GDP grew by just 0.6 % last year. 2014 saw a marked slowdown in the pace of economic growth last year from 1.3 % in 2013. Private consumer spending was the main factor supporting growth, but also the contraction in imports boosted the growth contribution of net exports.

Private consumption increased more slowly than in 2013 with a growth rate of 1.9 %. Real disposable income of households shrank last year for the first time since 1999, falling by about 1 %. Fixed capital investment also contracted last year by 2.5 %. In 2013, investment still managed to post meagre positive growth.

Russian output shows transient spike in December. Industrial output growth accelerated in December, particularly in a couple of manufacturing branches. Some experts suggest that the acceleration largely reflected the ruble's depreciation, which drove substitution of imports with domestic products. Mineral extraction sector output continued to show fairly good growth, and was up about 3 % y-o-y.

The volume of retail sales rose sharply in December. Consumers rushed to buy durable goods in response to the ruble's weakening in an effort to stave of their loss of ruble purchasing power. In the fourth quarter of 2014, real disposable incomes of households fell 3.5 % y-o-y.

Change in domestic demand and industrial output, % y/y



Source: Rosstat

CBR surprises with 2 p.p. cut in key rate. The key rate was lowered to 15 % starting from Monday (Feb 2). The Central Bank of Russia said the rate cut was possible because its 6.5-percentage-point increase of the key rate in December to 17 % has already calmed to some extent inflation expectations and devaluation expectations. The CBR views that the pick-up in inflation at the end of last year is temporary and largely a reflection of the ruble's decline.

The CBR noted that inflation may accelerate further in the months ahead until the economy has adjusted to the new external environment. After that weak demand should slacken the inflation rate. Data for January showed an on-year rise in consumer prices of as much as 15 %, up from 11.4 % in December. The CBR expects inflation to be back below 10 % in January 2016.

The CBR also motivated the rate cut by the weak economic development which needs support. It noted a lower key rate should improve corporate borrowing, which is one of the aims in the government's new support programme.

The rate cut caught most observers by surprise. Some see lower rates as a welcome form of stimulus although doubting whether a two-percentage-point reduction can have much impact. Others have viewed the preceding hike of the rate as a sign of primarily shifting back towards the old monetary policy focus of stabilising the ruble's exchange rate.

Russian government approves economic support programme. The aims of the programme adopted last week include stabilising Russia's economic conditions, supporting import substitution as well as improving diversification of the structure of Russian exports. Special emphasis is made on securing the activities of core branches and companies, supporting the banking sector and protecting social entitlements. The programme includes financial support and measures aiming to reduce bureaucracy and regulatory burdens. Many Russian economic experts have, however, criticised the programme for failing to address properly Russia's fundamental need for structural economic reforms and measures for restoring growth.

Total programme costs this year are estimated to exceed 1.3 trillion rubles (€17 billion), of which just over 200 billion rubles are designated as government guarantees. Half of the actual support funding should come out of the federal budget and half out of the National Welfare Fund.

Up to 550 billion rubles will come from the National Welfare Fund, or about 10 % of the fund's present value. The money will be used to recapitalise banks and provide more funding for the VEB development bank to boost lending. Banks receiving capital infusions, in turn, must forward the funds for the financing of major infrastructure projects.

Some 450 billion rubles in federal budget spending will go to social programmes and transfers to regional budgets, while 100 billion rubles will go to support various industrial branches. Most of the support is slated for agriculture, farm machinery and the car industry. The details and timing of budget funding have yet to be decided.

The programme does not abandon previously announced budget spending cuts and hence the support measures should be financed by cutting and making other spending more effective. The economy ministry would like to see the support measures implemented as fast as possible, while the finance ministry favours a more patient approach. According to media reports, initial agreement was reached on support measures worth just over 20 billion rubles to be implemented in the first quarter of this year.

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China

China's central bank lowers reserve requirement. The People's Bank of China cut the reserve requirement ratio for commercial banks on Thursday (Feb. 5). The ratio, which determines the amount of deposits a bank must hold in reserves in the central bank, was lowered by half a percentage point. Certain small banks specialised in lending to farms and small businesses, or financing water management projects, were entitled to a one-percentage-point cut. The PBoC also announced that the reserve requirement ratio for the state-owned Agricultural Development Bank of China would go down 4.5 percentage points. After the cut, the benchmark reserve ratios of the PBoC are 19.5 % for large banks, 17.5 % for small and mid-sized banks and 16 % for rural banks. The reserve requirement ratio for individual banks can vary.

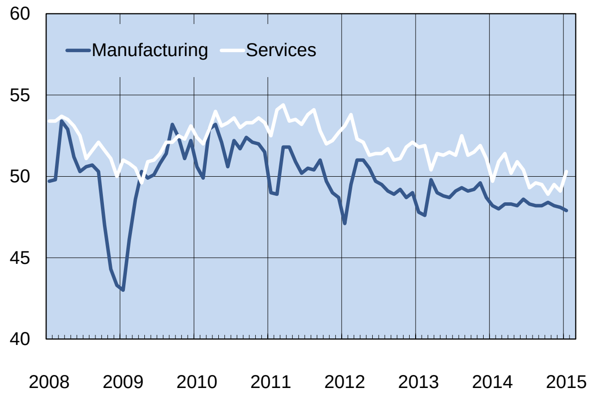
The last time the reserve requirement ratio was lowered was in spring 2012. Because monetary policy in China is not yet implemented through interest-rate policy as in the developed world, the ratio is still considered a key instrument of monetary policy. China's central bank has kept the reserve requirement ratio relatively high by world standards on concerns that easing monetary policy could e.g. result in overheating of stock markets or add to China's debt problems. Another reason for large reserve requirements is China's lack of a comprehensive deposit insurance scheme. The PBoC is currently drafting guidelines for the rollout of a new deposit insurance scheme, however.

China's economy continued to slow in January according to purchasing manager indexes. The latest reading of the official index of manufacturing purchasing managers (PMI) compiled by China's National Bureau of Statistics fell to 49.8 in January. The alternative PMI reading produced by HSBC uses a greater weighting for small, privately owned firms. It dipped below the 50-point level already in December, and stayed there in January. Of the key sub-indices of the NBS manufacturing PMI, Employment Index (manufacturing jobs) and New Order Index (export orders) post readings below 50 in January. The Employment Index hit 47.9, its lowest reading since the beginning of 2013.

A PMI reading below the "neutral" level of 50 points in theory should be reflected in seasonally adjusted output data that show a drop from the previous month. In practice, however, the correlation between industrial output and PMI readings is somewhat messier. The NBS figure for on-month changes in industrial output has been relatively strong even when PMI readings have been under 50. In any case, the ongoing slowdown in growth of industrial output remains clear. NBS figures for actual production in January-February will not be available until March.

Service sector growth, in contrast, appears quite resilient, even if growth has slowed a bit. The services PMI value was 53.7 in January. Even if growth in labour demand in the service sector also appeared to come to a halt in the second half of 2014, demand appeared to recover at least briefly in January.

Employment Index for Manufacturing and Services PMIs



Source: Macrobond

China's current account surplus grew slightly last year. The goods trade surplus ballooned last year, driven in particular by lower world commodity prices that made imports cheaper. Even so, the soaring services trade deficit meant that the current account surplus only grew slightly. The explosion of Chinese tourism was the single largest factor driving the rising services trade deficit. Chinese tourists last year spent $165 billion abroad, or nearly 25 % more than in 2013. The size of current account surplus relative to GDP rose from 1.9 % in 2013 to 2.1 % last year.

There was a distinct shift in capital flows last year from 2013. Preliminary figures show that China experienced a net outflow of capital in 2014, and that the outflow accelerated in the fourth quarter.

The value of China's gold and foreign currency reserves increased last year by $118 billion to around $4 trillion.

Balance-of-payments highlights for China, USD billion

	2011	2012	2013	2014
Current account	136	215	183	214
Goods trade balance	244	322	360	472
Services trade balance	-62	-90	-125	-198
Other	-46	-17	-52	-60
Capital and financial accounts	266	-32	326	-96*
Net errors and omissions	-14	-87	-78	-
Change in currency reserves	388	96	431	118

** Includes errors and omissions.*

Sources: SAFE, Macrobond

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Russia

Russia's banking sector reflects economic uncertainty. Total assets of the Russian banking sector at the end of last year amounted to 77.663 trillion rubles, an increase of 18 % y-o-y (all figures reported here are adjusted for the ruble's decline). While the overall rate of growth was similar to previous years, growth accelerated late in the year, particularly in December.

Banks increasingly relied on financing from the Central Bank of Russia to support this growth, with CBR participation in total assets rising from 9 % to 12 % just in the fourth quarter. CBR support last reached such levels in 2008 during the financial crisis. The CBR stepped in to support banks after access to other sources of financing had become more difficult (e.g. due to economic sanctions).

Uncertainty surrounding the ruble's weakening caused households to pull their deposits out of banks, causing the deposit stock to shrink by 2.5 % last year. Although deposit rates were hiked to more than 14 % in the second half of December, deposits still dwindled 1 % a month in December (m-o-m). This was actually less than most observers expected, and the stabilisation may reflect the government's decision in December to raise deposit insurance coverage from 700,000 rubles to 1.4 million rubles (nearly €20,000). Household forex deposits continued to increase, following standard Russian protocol during a crisis. As of end-2014, forex deposits represented 26 % of all household deposits, a nearly 10-percentage-point increase from January 2014.

Corporate deposits rose 24 % last year, outpacing their growth in recent years, including 2008. Deposits accounted for nearly 22 % of the banking sector's total assets, an increase of two percentage points from the end of 2013. The rise could signal that large state-owned enterprises increased their deposits in line with the government's recommendation.

Borrowing of both firms and households increased about 13 % last year. The pace of growth in corporate borrowing was about the same as before, while growth of household borrowing slowed significantly. The total stock of loans granted to households actually shrank in December, while the amount of non-performing loans increased. Non-performing household loans made up nearly 6 % of the loan stock at the end of the year. Non-performing corporate loans also jumped by about a third last year. Given the weak economy, the stock of non-performing loans is expected to rise significantly this year. Higher financing costs will further slow growth of the loan stock.

The capitalisation of banks worsened last year. The capital adequacy ratio slid from 13.5 % at the start of last year to below 12 % by the end of November. The government decided in December to provide 1 trillion rubles in capital support to 27 banks via the Deposit Insurance Agency. The amount equals 15 % of banking sector aggregate capital.

Russia's banking sector is in different shape than during the 2008–2009 financial crisis. Banks are struggling with larger portfolios of non-performing loans and capitalisation is weaker. Economic sanctions and higher interest rates have cut off the access of banks to affordable credit and hurt their ability to intermediate credit to the wider economy. The banking sector is also more concentrated than in 2008, when the five largest banks held 43 % of total assets. Today they hold 54 %. All five banks are state-controlled, so the state's role in the banking sector has grown further.

Stricter supervision has caused over 100 small and mid-sized banks to lose their licences since summer 2013, and more banks are expected to lose their licences this year. Some 835 banks operated in Russia at the end of 2014.

Russian foreign trade contracted sharply in the fourth quarter. Russian customs reports the value of goods exports and imports in the fourth quarter of 2014 were down nearly 20 % y-o-y, and that in December they fell 25 % y-o-y. Trade with CIS countries contracted more strongly than trade overall, due largely to the collapse of trade with Ukraine. Russian imports from Ukraine fell by half in the fourth quarter, while exports to Ukraine were down nearly 70 % y-o-y. While Russian trade was down generally, imports from Kazakhstan and Switzerland rose some 20 %.

The value of Russian exports shrank mainly on lower oil prices and reduced export volumes of crude oil and natural gas. The average price of Urals crude in October-December was down by nearly a third from 4Q2013. The volume of crude oil exports also slid nearly 7 %, while the volume of gas exports was down by nearly a third. In contrast, export volumes of petroleum products climbed 9 % y-o-y, even if they had lower value due to lower export prices. Export volumes for many metals were up, e.g. copper exports nearly doubled on year. Export volumes of coal and grain were also higher than in 2013.

The value of imports fell sharply in the fourth quarter in nearly all product categories. Imports of machinery, equipment and transport vehicles were down about 20 % y-o-y. Imports of many consumer goods fell also significantly. For example, imports of foodstuffs, textiles and passenger cars were each down over 20 % y-o-y. The slide in imports reflects e.g. the weak ruble and food import bans.

For 2014 overall, the value of Russian goods exports fell by 6 % to $500 billion. The value of goods imports was down 10 % y-o-y to $290 billion. Although slightly decreasing, the EU still accounted for nearly half of Russia's trade. CIS countries made up about 12 % of trade, while APEC's share rose to 27 %. Russia's largest single trading partner is still China, which saw its share of trade rise to over 11 %. The product structure of foreign trade remained practically same as before. 70 % of Russian exports consisted of oil and gas, and the other major export items were metals and chemicals. About half of imports consisted of machinery, equipment and transport vehicles. Chemicals and foodstuffs each accounted for about 15 % of imports.

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China

Drop in imports pushes foreign trade surplus to record levels. The value of Chinese goods exports in January was $200 billion, or 3 % less than in January 2014. Imports in January, however, were worth just $140 billion, or 20 % less than a year earlier. As a result of the import drop, the goods trade surplus ballooned to a record $60 billion. China's trade surplus for the past 12 months exceeded $400 billion. This figure includes bilateral trade imbalances of $240 billion with the US and nearly $130 billion with the EU.

While the feeble trend in imports is symptomatic of China's slowing economy, it may not be wise to extrapolate from the January figures. The halving of global oil prices, the 20 % drop in metal prices and depressed prices for farm products over the past year partly explain the drop in the value of imports. While also import volumes of certain raw materials have fallen in the last months, e.g. crude oil imports held at the same level in January as a year earlier.

Commodity price trends are also evident in Chinese exports, particularly in cases of lower export growth to many commodity-producing countries. This trend is strengthened by the fact that the currencies of many commodity producers have weakened relative to the yuan. Chinese exports to the United States, however, continued to improve in January, even if exports to EU countries went into the red and the decline in exports to Japan steepened. While Chinese exports reflect conditions in the global economy, special factors that come into play around the year shift tend to obscure deeper trends in exports as well as in imports.

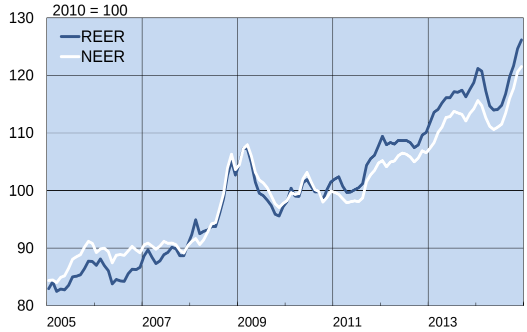
Yuan appreciates in both real and nominal terms. Discussions on trends in the Chinese currency typically focus on the exchange rate between the yuan and the US dollar due to the dominance of the dollar in international payments and its use as the reference currency for Chinese foreign exchange policy. However, just tracking one currency pair gives a limited picture of what is actually happening in the forex world and more generally in trends in China and the global economy. For example, since the start of the year the yuan's exchange rate relative to the US dollar has weakened nearly 1 %, but appreciated 7 % against the euro.

The trade-weighted "nominal effective exchange rate" (NEER) provides a broader overview of exchange rate trends. In 2014, the yuan's NEER rose about 6 % relative to the currencies of China's main trading partners. The "real effective exchange rate" (REER), in contrast, also takes into account differences in China's inflation rate relative to those of its main trading partners. Thus, the REER provides a clearer assessment of shifts in price competitiveness. The yuan's REER appreciated also about 6 % last year.

Over the past ten years, the yuan's NEER and REER have appreciated about 50 % due to China's robust economic growth and increased international use of the yuan.

With gradual liberalisation of exchange rate policy in recent years, the yuan has seen wider swings in its external value, as last spring's weakening episode demonstrated. Pressures driving yuan appreciation such as significantly higher growth of the Chinese economy relative to other large economies and a booming goods trade surplus have lately been moderated by the services trade deficit, rising capital exports and increased risk in China's financial markets.

Real and nominal effective exchange rates of the yuan



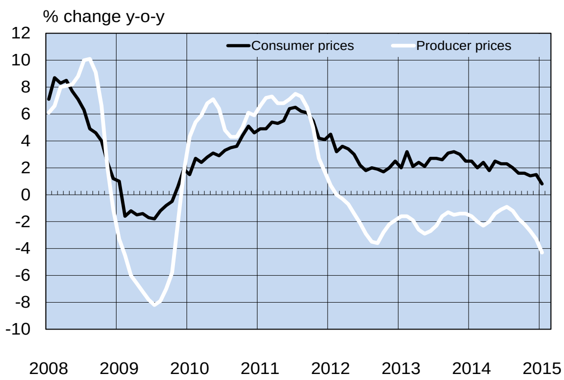
Source: BIS

Chinese inflation falls further. Consumer price inflation dipped to 0.8 % y-o-y in January, down from 1.5 % in December. China's inflation rate has not been this low since 2009. Factors driving down inflation include lower fuel prices and slowing food price inflation. When food and energy prices are removed, the slowing in the inflation rate was more modest, dropping from an on-year rate of 1.3 % in December to 1.2 % in January.

Producer prices in January fell 4.3 % y-o-y. Drops in commodity prices, along with overcapacity in some industrial branches and weak domestic demand continued to underlie the long deflationary slide in producer prices.

Concerns have increased in recent months over the slowdown in inflation and economic growth. While many expect further monetary easing, the PBoC has to take into account that this may exacerbate China's growing debt problems.

Consumer and producer price inflation in China, %



Source: Bloomberg

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Russia

Russian inflation soars. January consumer prices rose 15 % y-o-y. Inflation last ran this high in 2008. Food prices were up 21 % and other goods 11 %. The Russian government, concerned about the rapid inflation, has adopted numerous measures to deal with the situation. The Federal Anti-Monopoly Service and regional officials have been tasked with monitoring price trends and taking steps to rein in inflation. Their opportunities for trimming inflation are limited, however, as the biggest drivers of inflation are outside their scope of influence. For example, the economy ministry notes that of last year's 11.5 % inflation, over 4 percentage points came from the ruble's decline and over 1 percentage point from the ban on food imports.

The latest economy ministry forecast shows that the biggest impacts of banning food imports are only becoming apparent this year. It predicts the rise in food prices will accelerate in the first half of the year. About a quarter of the overall inflation will come from the ban on food imports.

Although Russian law only allows price controls for northern regions, officials in other regions have given guidelines to sellers and producers, and even regulations on the pricing of basic foodstuffs. Sellers and producers are committed e.g. to limiting profit margins or price increases. Some large retail chains have gone so far as to temporarily freeze their prices of basic goods.

Officials are also concerned about the sharp rise in prices of medicines. Prime minister Dmitri Medvedev warned last week that medicine prices could rise as much as 20 % this year. Health ministry price monitoring found that in January regulated prices of life-saving medicines were up 4 % and other drugs 15 %. The ministry is encouraging regional officials to be on the lookout for price gouging. Recently, the government expanded the list of medicines whose prices are regulated and is currently preparing a decree on regulating prices of medical equipment. Russia still imports a large share of its pharmaceuticals.

Oil companies have complained to the government about substantial hikes in pipeline prices, which have been driven up by prices in the domestic metal industry. Export earnings of the metal industry in ruble terms have risen with the collapse of the ruble, which has made the industry to increase its exports and hike domestic prices. Trade and industry minister Denis Manturov last week called on the metal industry to change its pricing policies. If this doesn't happen, he said, the government would have to impose heavy duties on metal exports and even "resort to other measures."

The government has imposed an export duty on wheat since the start of this month. The minimum duty is €35 per metric ton, and remains in force until the end of June. The limits on exports are seen as a way to lower the rapid rise in domestic prices and boost supply. Before imposing the export duty, wheat exports were limited by informal methods such as slowing the processing times of quality certifications and reducing rail transport. Grain exporters have complained to the government about the practices.

Russia to dip into its sovereign funds. At the end of January, Russia's sovereign funds amounted to $160 billion. Tax revenues from oil and gas have been accumulated to the funds since 2003. While the government largely stayed out of its funds last year, this year it is planning to draw on them more actively to support the economy.

Prime minister Medvedev last week signed a decree permitting the use of up to 500 billion rubles from the Reserve Fund to cover this year's budget deficit. The Reserve Fund was established indeed to cover budget deficits during economic downturns. As of end-January, the Reserve Fund stood at 5.9 trillion rubles ($85 billion). The money is invested in liquid foreign-currency-denominated assets, and is included in Russia's foreign currency reserves.

The government's support program approved earlier this year should get funding up to 550 billion rubles this year out of Russia's second major sovereign savings fund, the National Welfare Fund. The money will be used to capitalise banks, which will then redirect the money to finance large infrastructure projects and provide credit to firms. The National Welfare Fund was initially established to meet future pension obligations. The Fund was, however, used to support the economy already in the 2009 financial crisis.

The National Welfare Fund held assets worth 5.1 trillion rubles ($74 billion) at the end of January. Most of the Fund is kept by the CBR and is also counted as part of Russia's foreign currency reserves. About a quarter of the Fund's assets have been allocated in various forms to domestic banks for lending forward to companies. There has been huge demand for this money in recent months, as banks and firms actively pursue government grants and support.

Although the assets of the two funds are mainly in the form of foreign currency held by the central bank, the foreign currency reserve does not automatically shrink if the finance ministry withdraws money. The finance ministry uses the foreign currency for buying rubles from the CBR, and thus the value of the CBR's foreign currency reserve remains unchanged.§

Allocation of National Welfare Fund assets, 31 Jan. 2015

Form in which asset is held	US$ billion
Deposits with CBR	56.3
Deposits with state development bank VEB	9.1
Preferred bank shares (VTB, Rosselkhozbank, Gazprombank)	4.0
Ukrainian sovereign bonds	3.0
Deposits with VTB for infrastructure projects	1.5
Securities to fund infrastructure projects	0.1
Total	***74.0***

Source: Russian finance ministry

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EUROJÄRJESTELMÄ
EUROSYSTEMET

BOFIT Weekly
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China

Prices for shares listed in Shanghai higher than in Hong Kong. The sharp rise in prices on the Shanghai stock exchange at the end of last year has moderated. At the close on Tuesday (Feb. 17), the Shanghai Composite Index stood at the same level as on December 31. On Wednesday, Chinese exchanges began the week-long Lunar New Year hiatus.

Shares listed on the Shanghai exchange have risen rapidly, creating a situation whereby the same share in Shanghai is more expensive than in Hong Kong. The value of A-shares of Chinese firms listed in Shanghai has risen over 40 % since last September, while the rise in H-shares of Hong Kong's China Enterprise Index are up less than 10 %. The price-to-earning ratio (P/E), an indicator of share priciness, is now about 16 for Shanghai A-shares, but below 9 for Chinese companies listed on the Hong Kong exchange. In January, the shares of the same big firms listed on both the Shanghai and Hong Kong exchanges were on average 26 % pricier in Shanghai. Up to last autumn, Hong Kong-listed shares tended to carry a premium.

Shanghai A-share and Hong Kong H-share indexes

Source: Macrobond

The stock connect experiment launched last November on the Shanghai and Hong Kong stock exchanges offers investors (in theory, at least) equal access to both markets, so one would expect diminished price differences and fewer arbitrage opportunities. Trading in Shanghai-listed shares via the Hong Kong exchange has not been entirely seamless, however, and Chinese firms are still relatively unknown to foreign investors. Only 35 % of the 300-billion-yuan (USD 50 bln.) quota for foreign investors on the Shanghai exchange has been used, and foreign investors have on average accounted for less than 2 % of the Shanghai exchange's daily trading volume. The rapid rise in Shanghai share prices has largely been driven by the increased interest in share trading of private Chinese individuals. Only Chinese investors with large investment funds are permitted to invest in Chinese shares via the Hong Kong exchange, and just 10 % of the 250 billion yuan quota has been used.

Prices on mainland China's number-two exchange, the Shenzhen stock exchange, continued to rise in the first weeks of this year, and now are up about 15 % from the end of last year. There are also plans for a partial opening of the Shenzhen stock exchange to foreign investors via the Hong Kong exchange. Shenzhen has listed numerous growth firms, while large state-owned enterprises dominate the Shanghai exchange. This is also apparent in share pricing: the average P/E ratio of Shenzhen A-shares is 37.

Capital controls liberalisation continues in Shanghai free trade zone. The People's Bank of China has given firms and banks in the Shanghai Free Trade Zone (SFTZ) permission to seek funding from abroad without the need for a prior permission from the central bank or being subject to rules on loan length or currency. Additionally, the ceiling on foreign financing has been raised. At current interest rates, a foreign loan is cheaper now than a domestic loan. However, under the old rules, companies in the SFTZ tended to borrow very little from abroad, even if Chinese firms have generally been eager to get foreign financing. The new rules continue to limit the use of this financing channel.

The first full year of operation for the SFTZ, which was established in autumn 2013, has been disappointing for most firms. Deregulation of capital movements is still in midstream; use of the yuan in international transactions other than foreign trade is still forbidden and the deregulation of interest rates for yuan deposits has not proceeded as planned. Nevertheless, the SFTZ has seen reforms that make it easier for firms to deal with the rest of the world. At the end of January, the government agreed to extend certain eased restrictions in the SFTZ to the rest of the country. Their impacts will be limited, however.

Three new Shanghai-style free trade zones (Guangdong, Fujian and Tianjin) were approved last December. These new zones will also facilitate business between mainland China and the rest of the world. The new free trade zones should be operational next month, bringing new competitiveness and dynamism to China's reform policies and opening up to the world.

China's New Silk Road Fund opens for business. This week saw the official launch of a fund to finance projects of China's "New Silk Road" initiative. The initial capitalisation of the fund is about $40 billion. The funds come from China's foreign currency reserves, key policy funds and the China Investment Corporation, Export-Import Bank of China and China Development Bank.

The purpose of the fund is to provide financing and financial services for projects that support China's plans to build a "new silk road" between Southeast Asia and Europe for trade on both land and sea. China hopes this mega-project increases cooperation among the countries in the Silk Road belt, boosts Chinese FDI outflows and promotes international use of the yuan.

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Russia

Russia's creditworthiness battered again. Last Friday (Feb. 20), the international credit ratings agency Moody's lowered its rating of Russian foreign-currency government sovereigns from their lowest investment grade to speculative grade, following the lead of Standard & Poor's, which downgraded Russian sovereign debt in January to speculative grade. Fitch, which lowered Russia to its lowest investment-grade rating in January has kept its rating unchanged.

Moody's said its downgrade reflects both the further weakening of Russian economic conditions and the fact that international reactions to the Ukraine crisis may make Russian officials to adopt measures that could directly or indirectly affect the country's ability to stick to timetables for servicing international debt. At the moment, however, Moody's sees the likelihood of default to be quite small.

The finance ministry criticised Moody's for basing its decision on an over-pessimistic outlook for the Russian economy. Finance minister Anton Siluanov said that the decision was mainly motivated by politics.

Large institutional investors' rules usually allow them to invest in securities classed as investment-grade by at least two of the big-three international credit ratings agencies. Moody's decision could then force some investors to divest their Russian securities. A significant number of risk-averse investors have apparently already sold off their Russian investments on repeated credit downgrades that have taken place over the past 12 months. As a result, no huge selloffs or major capital exodus from Russia are expected.

The credit-rating downgrade will, however, raise the costs of servicing existing and new credit for both the Russian government and Russian firms.

Russia refining an increasing share of its oil production domestically. While crude oil production increased slightly in 2014 (0.5 %), the volume of crude oil exports decreased 6 % y-o-y. This means that a larger share of Russian oil production is refined domestically than earlier. Oil refinery production increased last year by 6 %. In recent years, Russian oil companies have invested significantly in increasing their refining capacity, and even more importantly the ability to produce higher-grade raffinates, which is clearly reflected in the production figures.

Because demand for domestic petroleum products is likely to rise only slightly in the best case, an increasing share of petroleum products will go to export. In 2013 and 2014, exports of petroleum products grew about 10 % a year. Currently, over half of exported oil products consist of heavy fuel oil, which requires little refining, but Russia's most modern refineries are changing the situation.
In particular, exports of diesel fuels to EU countries increased sharply last year.

Russian government considers ways to assure reasonable access to medicines. About 70 % of the medicines used in Russia are produced abroad, and even a large part of domestically produced pharmaceuticals are derived from imported raw materials. As a result, the collapse of the ruble has resulted in a huge increase in drug prices in Russia.

At the beginning of February, president Vladimir Putin issued a decree stating how the government must intervene to deal with soaring drug prices. The decree calls for the government to arrange for oversight of drug pricing at the retail level and to report the results on a monthly basis. The government is also working with regional officials to investigate the possibilities of establishing state or municipal pharmacies to assure universal access to medicines. The government is looking into how these new pharmacies might be supported. In addition, the cabinet has been tasked with building an automatic tracking system that would follow the route of medicines from manufacturer to consumer. The intention is to monitor the quality of medicines and reduce the amount of drug counterfeiting.

About 40 % of the medicines sold in Russia are subject to administratively regulated prices. The Duma this week approved a law that would make it possible to increase once a year prices of drugs in lower price categories in the list of regulated drugs, in order to guarantee drug manufacturers a minimum level of profitability. At the moment, many drug firms are losing money and may even be compelled to shut down their production.

Efforts are made to mitigate the higher costs of imported medicines subject to regulated pricing by substituting imports with domestically produced drugs – however, often of lower quality. By some estimates, only 15–20 % of Russian pharmaceutical manufacturers comply with the Good Manufacturing Practices (GMP) promulgated by the World Health Organisation.

Support to domestic producers is also provided in the form of import restrictions. The cabinet is currently considering a decree that would prevent foreign drug makers from participating in competitive bidding for public procurements if at least two manufacturers operating in Russia or inside the Eurasian Economic Union are taking part. The decree has been criticised precisely for the fact that domestic production is not considered to be of particularly high quality.

The government is currently preparing an action plan for replacing imports with domestic production. The programme strongly focuses on the pharmaceuticals industry, for which it would provide, among other things, low-interest loans. Further, companies building new drug plants in rural areas would e.g. get easier access to infrastructure for municipal heat, water and electrical services.

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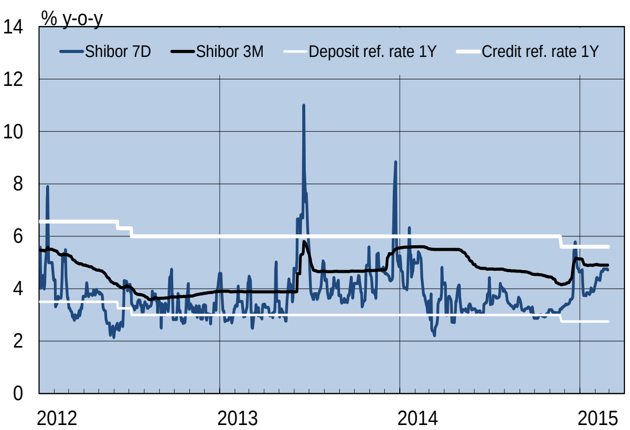
China

Financial markets enter the Year of the Goat calmly. There were few surprises when the financial markets reopened on Wednesday (Feb. 25) after the week-long Lunar New Year holiday. Key money market rates and share prices were barely changed from the start of the New Year's holiday.

Since the beginning of November, the yuan has lost value against the US dollar on the forex markets. This week the yuan-dollar exchange rate hovered around 6.26 to 6.27. As the People's Bank of China's yuan-dollar daily fixing rate has been about 6.14, the yuan's exchange rate was effectively hitting the ceiling of its widened 2 % trading band. So, further weakening against the dollar will require a resetting of the fixing rate or a wider trading band. Measured according to trade-weighted nominal and real exchange rates, the yuan has continued to appreciate.

The outlooks for economic and monetary policy have not substantively changed over the past couple of months. Monetary policy seeks to balance lower economic growth, low inflation and rising indebtedness. At the beginning of February the PBoC cut the reserve requirements of commercial banks by half a percentage point, but this has not yet broken the increasing trend of short-term rates on the money markets. Slowing inflation and falling producer prices have increased pressure on real interest rates to rise further. The PBoC's ability to use monetary policy to support economic growth is limited, but on the reform policy side there is plenty of untapped potential to secure healthy growth over the longer term.

Chinese interest rates (policy and market rates), %



Source: Macrobond

Chinese direct investment in Europe on the rise. Foreign investment flows from China to Europe have grown briskly in recent years. Latest figures from Eurostat show that the stock of foreign direct investment more than tripled in 2010–2012. According to the more recent figures from the Rhodium Group and the Heritage Foundation, which track large FDI investments of Chinese investors, the flow of investment from China to Europe more than doubled in 2014. Investments were worth about $18 billion.

The Chinese have been active investors in Europe in recent years. However, the stocks and flows of Chinese FDI are still relatively small compared to all foreign investment in Europe, which in large part still comes from the United States. Eurostat figures show that the stock of Chinese FDI in Europe is only about 1 % the size of the stock of US investments in Europe. At the same time the flow of Chinese investment in the total investment flow into Europe is a few per cent.

According to the latest figures, the volume of foreign direct investment from Europe to China is still larger than FDI flows from China to Europe.

The number of Chinese acquisitions of European firms is soaring at a time when growth in FDI from countries outside Europe has otherwise slowed. Both state-owned investment corporations and private companies have invested. Notable acquisitions include the real estate purchases of the China Investment Group in the UK, the China Investment Corporation's massive investment in the Italian energy sector, as well as Dalian Wanda Group's expansion into the European entertainment industry.

Foreign travel is now a thing in China. The Lunar New Year and the Spring Festival have traditionally been the main holidays when Chinese return to their home districts to gather with their families or do some local tourism. Based on early estimates from tourism officials, travelling abroad during the Spring Festival was much more common this year than earlier.

The volume of Chinese tourists has exploded since the early 2000s as middle-class wealth and consumer options have increased. The Chinese now account for nearly a tenth of the world's tourists. Top tourist destinations for the Chinese are nearby Thailand, Japan and Korea, but also many European cities are popular vacation destinations.

Shopping is one of the biggest drivers of Chinese tourism. They buy electronics from Japan and Korea, and especially brand clothing and luxury goods from Europe. According to Global Blue, a tourism shopping value-added tax refund service provider, Chinese tourists in 2014 (for the seventh year in a row) were the biggest claimers of tax-free refunds. Chinese tax-free purchases, which already account for about a third of global tax-free sales, rose last year by nearly 20 %.

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Russia

Financial woes of Russian regions begin to bite. Researchers at the Development Centre at Moscow's Higher School of Economics report combined regional budget deficits this year could reach as much as 1.8 % of GDP. While the finance ministry forecasts a deficit of about half of that this year, even that would be fairly substantial. After the 2009 recession, the deficit was typically a few tenths of a per cent of GDP, but in the past two years it has risen to around 1 % of GDP.

While there is large variation across regions, most of Russia's regions (74 of 83) are unable to cover their spending obligations with existing revenues.

The regional budget deficits are largely structural; regional expenditures mandated by law now exceed regional revenues. A big driver of increased spending has been the large public sector pay rises mostly paid out of regional budgets, which were demanded by president Vladimir Putin in his 2012 inaugural address. Under the president's decrees, wages of public sector workers are to be increased substantially, and real wages across the country are to grow 1.4–1.5 times by 2018. Regional spending on housing construction is also mandated to rise.

As spending on wages has risen, regions have been compelled to cut other spending. Investment has been the first to go, which weakens long-term regional development possibilities. Regions have also had to compromise on education and healthcare spending. Regions are responsible for 80 % of all spending on education and half of all healthcare spending.

Even though the government last year increased support paid out from the federal budget, the share of federal transfers to regional budgets has been declining over the past few years. Last year it was about 19 %.

Regions have had to finance their deficits by borrowing from the federal budget or banks. Bank loans were used last year to finance nearly half of regional budget deficits, which has made debt servicing a large component of budget spending. Interest on regional bank loans can go as high as 25 % p.a. depending on the region's creditworthiness. The biggest lender to regions is Sberbank, which accounts for about 75 % of loans to regions. The number-two financier is VTB Bank, accounting for 17 % of loans.

Several regions demand that the government forgive their federal budget loans and provide cheap budget financing to pay off their expensive bank loans, because they claim that federal-level budget policy is the reason regional budgets have been forced so far into the red. In response, the government is now offering regions budget financing at an interest rate of 0.1 % p.a. on the condition that commercial banks commit to lending to regions at rates no more than 1.5 percentage points above the CBR's current reference rate (15 %).

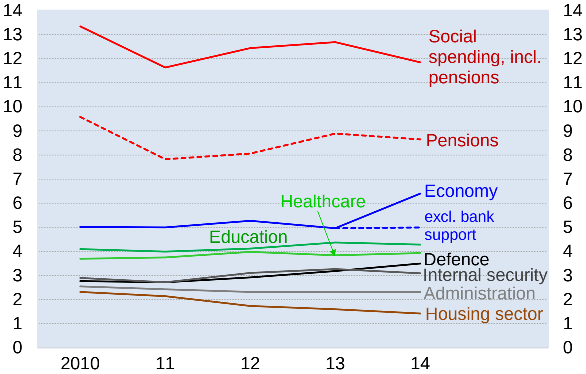
The government is also considering modification of how wage increases are calculated under the 2012 presidential decrees on wages in order to reduce future wage hikes. Regional spending obligations could also be reduced by focusing social support on the most needy, rather than providing support to everybody in some form. A targeted needs-based approach would, however, require a complete overhaul of the social support system.

Growth of government revenues and expenditures just kept up with inflation in 2014. Revenues to the consolidated budget, that is the overall government budget (federal, regional and municipal budgets plus state social funds), increased 8 % in nominal terms. The growth rate was higher than in 2013. Nevertheless, the rate of growth was about the same as the inflation rate (average for all of 2014), meaning that revenues remained unchanged in real terms. Growth in spending slowed slightly to below 8 %. The consolidated budget deficit amounted to 1.2 % of GDP, about the same as in 2013. Revenues rose slightly to an equivalent of 37 % of GDP, while spending was unchanged at just over 38 %.

Revenues from duties and taxes on production and export of oil, petroleum products and gas caused growth in consolidated revenues to accelerate. Even if the oil price declined from 2013, the decaying ruble exchange rate boosted revenues from dollar-denominated oil taxes and duties in ruble terms. They accounted for over 28 % of consolidated budget revenues, which was greater than at any time since the 2009 recession. Nominal growth in other revenues remained below 6 %, i.e. revenues fell in real terms.

For the fourth year in a row, defence spending was increased by nearly 20 %. Defence and internal security now account for over 17 % of all spending. Spending growth slowed for pensions and other social outlays even if they were still 31 % of total spending. National economy expenditures increased sharply with the Deposit Insurance Agency's December decision to grant large capital infusions to banks. Growth in healthcare spending kept pace with inflation, while education spending lagged.

Largest government spending categories, % of GDP



Source: Finance ministry

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China

China lowers economic growth target to around 7 %. In his opening address to this year's National People's Congress, premier Li Keqiang said the GDP growth target would be lowered from last year's target of around 7.5 % to "around 7 %". The vague phrasing suggests that the growth target is no longer a strict anchor for policy guidance. The numerical growth target can be perceived as an outdated approach to directing economic growth. Shanghai, for example, no longer even publishes a growth target. Instead, the Chinese should place emphasis on structural reform of the economy and tolerance of a lower-growth paradigm on the condition that employment situation remains strong.

Li said fiscal policy would be relaxed to sustain economic growth. Government spending is expected to rise this year to 17.15 trillion yuan (€2.5 trillion), an increase of about 11 % from 2014. The budget deficit would rise to 2.3 % of GDP. Special financing would be directed to e.g. railway and water supply projects, as well as agricultural reform. The inflation target falls from last year's 3.5 % to 3 %, while growth in the broad money supply (M2) is predicted to expand about 12 %.

Li's speech reiterated the familiar rhetoric on the inevitability of reform and the theme that high growth becomes increasingly challenging to sustain as China moves forward. In particular, Li stressed the need for reforming state-owned enterprises and continued deregulation of financial markets. Corruption and environmental pollution will also get higher profiles. Energy intensity and carbon dioxide intensity will both be cut by 3 % this year.

Nearly 3,000 representatives attended Thursday's (Mar. 5) opening session of the National People's Congress. Much of their duties involve rubber-stamping Communist Party decisions and familiarising themselves with the views of party leaders. A parallel People's Political Consultative Conference is being held in tandem to provide input to the NPC. Attendees to the People's Conference include representatives of NGOs and ethnic minority groups, as well as representatives who are not Communist Party members.

PBoC continues to deregulate interest rates. On Sunday (Mar. 1), the People's Bank of China lowered the reference lending and deposit rates for banks by a quarter of a percentage point. The reference one-year lending rate fell to 5.35 %, while the one-year deposit rate fell to 2.5 %.

Banks were also allowed to increase their power in setting deposit rates. Banks can now pay interest on deposits 30 % higher than the reference rate. Earlier the ceiling on deposit rates was 20 % above the reference rate. Deposit rate-setting rules were also relaxed as part of the previous rate cut. Lending rates were completely deregulated in summer 2013.

The PBoC this week lowered rates on special lending tools offered directly to commercial banks. The overnight rate was reduced by 0.5 p.p. to 4 % and the 7-day interest rate by 1.5 p.p. to 5.5 %. The measure will hopefully improve corporate access to credit. Interbank rates and money market rates, however, fell only slightly after the PBoC rate cuts. There have been public calls for the PBoC to adopt easing measures to deal with the slowdown in economic growth. Low inflation has indeed raised real interest rates, which was a reason the central bank stated for cutting rates.

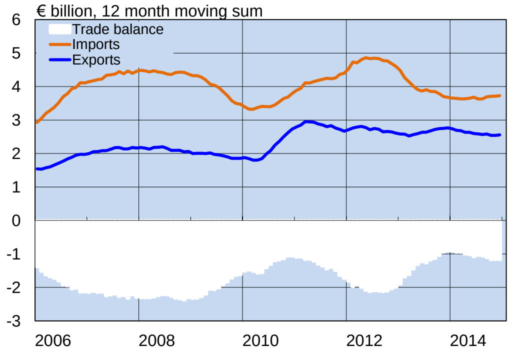
Declining sales of machines for paper industry and furs hurt Finnish exports to China. Finnish Customs reports that Finnish goods exports to China last year were worth €2.6 billion, or 8 % less than in 2013. The value of imports rose by 1 % to €3.7 billion, resulting in a trade deficit of nearly €1.2 billion.

Some 27 % of Finnish exports to China consisted of industrial machinery and equipment, while 17 % was electrical devices. Forest industry products accounted for nearly a quarter of Finland's exports to China. In the current decade, China has become a major market for Finnish furs and pelts, with over 40 % of pelt exports going to China. Last year the price of pelts fell, so the value of pelt exports to China fell by half to less than €200 million, or 8 % of the value of total Finnish exports to China. The reduction in sales of machines to China's paper industry also hurt Finland's exports.

Over 40 % of Finnish imports from China are electrical machinery and electronic devices such as mobile phones and computer equipment. Clothing, textiles and footwear account for about a fifth of imports. The rest consists of a wide variety of manufactured items. Finland imports only a tiny amount of raw materials from China.

Finland has so far failed to cash in on China's new enthusiasm for international travel. Statistics Finland reports that foreign travellers enjoyed 5.7 million overnight stays in Finnish hotels and inns last year, but only about 2 % of that involved Chinese travellers. The number of overnight stays of Chinese tourists increased just 1 % from 2013.

Finnish trade with China, 12-month moving total, EUR billion



Source: Finnish Customs

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Russia

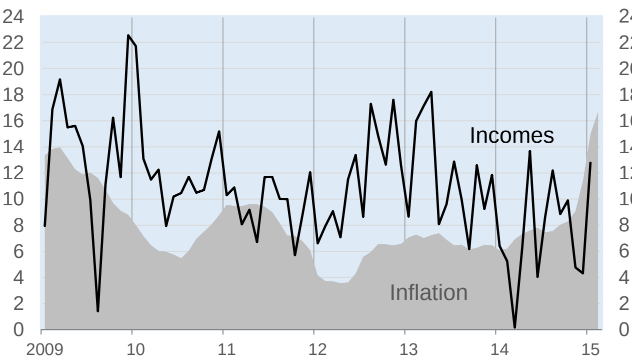
Russians experienced drop in real household incomes last year. Rising inflation caused real household incomes to contract by nearly 1 % last year. When inflation flared in November and December 2014, real incomes fell 5 % y-o-y. Russian incomes policy over the past 15 years has been to grow real incomes even in hard times. Real incomes had not sunk on-year at any time since 1999 until last year.

The slowdown in public sector wage growth has been profound. As recently as 2013, public sector wages were rising nearly 20 % a year. By the end of 2014, however, on-year nominal wage growth had fallen to zero, while inflation was running at 11.4 %. Hence, real wages in the public sector fell substantially. Room for wage hikes is eroded by the collapse in oil prices and the government's reduced tax take due to the economic slowdown. These trends were already apparent last year, and this year's budget parameters are likely to bring more pain.

Private sector wages managed a better showing last year, but still lagged the inflation rate by a couple of percentage points. While pensioners managed better (pensions were raised last year about 10 % on average), soaring food prices have decimated their purchasing power. For pensioners, food constitutes a larger spending category than for the population on average.

The drop in real wages continued in the first two months of this year, and if this year's forecast of inflation at or above 12 % pans out, the decline in real wages would accelerate.

Growth in household incomes and inflation, % y-o-y



Source: Rosstat

At the beginning of March, Rosstat revised its consumer goods and services basket, increasing the share of food items by nearly a percentage point to 37.3 % of household spending. The consumer basket, which is used in measuring consumer price inflation, is reviewed annually on the basis of the previous year's structure of consumption. Food items make up on average 17 % of the EU consumer basket.

The average 2014 wage (excluding grey-sector wages) was about €650 a month. In January this year, due to a massive drop in the value of the ruble, the average monthly wage was only about €450. The average pension last year was €220 a month, but in January, that amount had fallen to just €150.

Finnish-Russian trade contracted last year. The value of Finnish goods exports to Russia last year was just €4.6 billion, its lowest level since 2009. While the value of exports was down 14 % y-o-y for all of 2014, it was down over 20 % in the final two months of the year. Russia, which accounts for 8 % of Finland's total exports, remained Finland's third largest export destination.

Exports declined for the second year in a row, with the rate of decline steepening last year as economic conditions in Russia deteriorated. Import restrictions imposed at the beginning of last August hindered Finnish food exports to Russia, the value of which contracted in the final months of 2014 by 60–70 % y-o-y. Exports to Russia, however, only generate about 3 % of total sales of Finland's food industry.

Finnish exports to Russia this year are set to contract further on the ruble's weakness and the recession the Russian economy is experiencing. Recovery in exports will take time as Russian economic growth is expected to remain weak for a while. Due to the significant reduction in re-exporting goods produced in third countries to Russia, a return to the previous high levels of exports seems unlikely. Finnish Customs estimates that the share of re-exports in Finnish exports to Russia fell from nearly 40 % to 24 % between 2008 and 2013.

Some re-exports are prone to huge fluctuations due to rapidly shifting production and logistics chains. Re-exports of cars and mobile phones from Finland to Russia soared in the early 2000s. When Finnish exports to Russia peaked in 2008 at around €7.6 billion, some €2 billion of that figure consisted of mobile phones and cars made elsewhere than Finland. Following the 2009 financial crisis, re-exports of cars and phones evaporated, with production structures and transport routes shifting so that the business is unlikely to ever return. With the collapse in re-exporting of cars and mobile phones, the biggest re-export categories became e.g. pharmaceuticals and tools. While the 2014 estimate of re-exports has yet to be released, re-exports already dropped far more in 2013 than other exports, following the pattern of 2009.

The direct impact of re-exports on Finnish output and employment is not as large as for other forms of export, because re-exported goods are not manufactured in Finland.

The value of goods imports from Russia contracted by nearly a fifth last year to €8.7 billion. Much of the shrinkage was due to the fall in oil prices; some 80 % of Finnish imports from Russia consist of mineral fuels. Russia was still the top goods provider for Finland, accounting for 15 % of Finland's total imports. Low oil prices have continued to depress the value of imports this year. In January-February, the price of Urals-grade crude oil averaged just over $50/bbl, down from nearly $110/bbl a year ago.

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China

China's struggling local governments can now convert more debts into bonds to deal with their debt problems. On Sunday (Mar. 8), the finance ministry announced it would allow local governments to issue municipal bonds this year totalling 1 trillion yuan (€150 billion). The money raised would be used to pay down high-interest loans owed by local government financial vehicles (LGFVs). A new quota adds to an earlier municipal bond quota of 500 billion yuan for this year.

It is not clear how bonds will be issued under the new quota, how old debt obligations will be swapped for new bonds or what protections investors might enjoy. It is also unclear which regions are authorised to issue these bonds. The finance ministry estimates, that the debt-servicing costs of local governments this year will decline by 40–50 billion yuan (€6–7 billion) with the refinancing arrangements.

Earlier, local government budgets were mandated by law to be balanced. This forced local administrators to create off-budget LGFVs to fund their investment projects. This highly opaque approach to financing stood out during the stimulus policies adopted in the wake of the international financial crisis in 2008–2009. At the moment, the indebtedness of local governments is estimated to be around 20–25 trillion yuan (€3.0–3.7 trillion), or around 30–40 % of GDP. Moody's estimates that about 2.8 trillion yuan (€420 billion) of local government debt comes due this year.

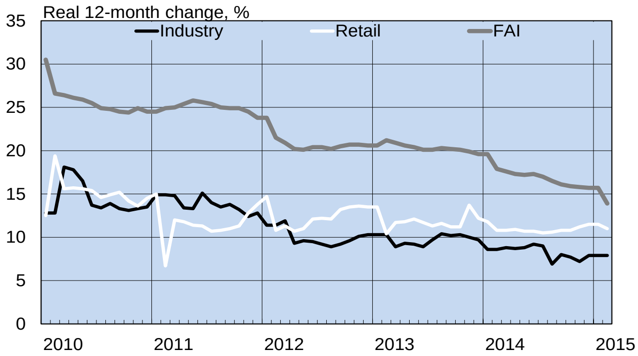
A representative of China's Banking Regulatory Commission warned this week that the indebtedness of local administrations constitutes the single largest risk to China's financial markets and fiscal policy. Budget documents, however, provide little indication as to the revenues that projects financed with debt will ultimately generate or how debt-servicing costs of local governments will be financed. This makes any attempt at risk assessment challenging. In any case, debt-swap agreements will only provide temporary respite to the deep debt problems of local governments.

Domestic demand shows signs of weakening in China. Several key economic indicators came in below market expectations for the first two months of this year. Among other things, the figures suggest a softening in domestic demand. January-February industrial output was up 7 % y-o-y, a percentage point less than in December 2014, while the markets expected 8 % growth. Weak domestic demand has been a large driver of slowing growth, while export growth continues to thrive. Although consumer demand is still robust, retail sales growth has also slowed by a percentage point from December. On-year growth in retail sales was 11 % in the first two months of this year.

The 12-month rise in consumer prices accelerated from 0.8 % in January to 1.4 % in February. While food prices largely explain the acceleration, prices in several other goods categories also increased. Producer prices are declining for the third year due to falling prices for energy and raw material inputs as well as industrial overcapacity. The slide in producer prices accelerated in February to 4.8 %.

Even with the slight pickup in inflation, real interest rates are still high, which for its part has slowed growth in fixed asset investment (FAI). FAI increased by 14 % y-o-y in the first two months of this year, down from 16 % in 2014. Growth in industrial investment slowed by 3 percentage points in January-February to 11 % y-o-y. In contrast, growth in real estate investment remained nearly unchanged at 10 %. Investment in infrastructure continued to grow at a 21 % y-o-y pace.

Industrial output, retail sales and fixed asset investment, %



Source: Macrobond

Boom in Chinese tourism balances goods trade surplus. The goods trade surplus hit record highs again in January and February, with exports rising 15 % y-o-y and imports dropping by 20 % y-o-y. The growth in exports reflected recovering demand in China's main export markets in Europe, North America and Southeast Asia. Exports to Russia and Japan contracted.

While the reduction in the value of imports largely reflected the on-going drop in global commodity prices, import volumes of commodities also declined. In addition to basic commodities, the value of other imported goods fell in the first two months of this year. This demonstrates the weak domestic demand, which is further indicated by the slowdown in industrial output growth despite strong exports.

The massive goods trade surplus is to some extent offset in the current account by the deficit in services trade, which continues to rise as Chinese travel abroad. Last year the goods trade surplus amounted to $470 billion, while the services trade deficit was just under $200 billion, with some 60 % of the services trade deficit generated by foreign travel. The number of Chinese tourist travelling abroad and the amounts they spend are expected to rise rapidly also in coming years.

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EUROJÄRJESTELMÄ
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Russia

CBR cuts key rate to 14 %. Last Friday (Mar. 13), the Central Bank of Russia cut its key rate one percentage point on the heels of its February lowering to 15 %. With risks of weaker economic growth still larger than inflation risks, the CBR noted the decision is for supporting the economy.

The weak economy dampens inflationary pressures, and the CBR cited the fact that inflation had slowed from nearly 4 % m-o-m in January to just over 2 % in February. February prices, however, were still up 16.7 % y-o-y. The central bank further observed the price surge at the turn of the year was of a transient event that reflected the double-whammy of a large drop in the value of the ruble and bans on imported goods. The CBR said it expects 12-month inflation to slow by the end of this year to a range of 12–14 % and further to 5.5–7.5 % by the end of 2016. However, this scenario was subject to threats from hikes in regulated energy prices, relaxation of fiscal policy and acceleration in the rise of nominal wages.

CBR sees Russian economy contracting 3.5–4 % this year. The central bank forecast further expects the GDP to fall 1–1.6 % in 2016 but return to growth of 5.5–6.3 % in 2017. The CBR's outlook assumes the price of oil will this year average $50–55 a barrel, $60–65/bbl next year and $70–75/bbl in 2017. Economic sanctions are expected to remain in place for most of the forecast period, thereby limiting the access of Russian firms to foreign financing.

The CBR estimates that this year private consumption will contract 5.6 % and fixed capital investment as much as 10–12 %. Last year, consumer demand grew 1.9 %, while fixed investment fell 2.5 %.

As oil prices will likely remain depressed and domestic investment has dried up, the CBR has had to lower its calculated potential growth of the Russian economy from 2 % a year to around zero. With economic recovery, the CBR sees potential growth rising to around 1 %. Before the 2008–2009 financial crisis, the CBR estimated the economy's potential growth was in the range of 4.5–5 % a year.

Russian spending on goods imports and revenues from goods exports will each fall this year by about 27–28 %. Although the trade surplus will shrink slightly, the current account surplus will climb from $57 billion last year to $64 billion this year. That is partly due to a fall of 38 % of services imports, which is largely driven by foreign travel.

EU and Russia squabble over Russian import tariffs continues. In late February, the European Commission asked the WTO to assemble a dispute panel to rule on import duties imposed by Russia on paper products, refrigerators and palm oil. Russia's duties exceed rates Russia committed to in its 2012 WTO agreement. Russia presently imposes a 15 % import duty on paper products, even if its WTO obligations limit the duty to 5 %.

Last October, the EU submitted a request for WTO consultation on the matter. As the consultation produced no results, the EU called on the WTO to form a dispute panel. Should the panel find that Russia violated WTO rules, the WTO Dispute Settlement Body would be empowered to demand compensation from Russia and grant the EU the right to countermeasures.

The WTO filing is the fourth EU claim against Russia. Earlier complaints had to do with recycling fees on imported cars and restrictions on pork imports. Russia, in turn, has complained to the WTO about the EU's methodology for calculating dumping pricing, as well as the EU's "third energy packet," which Russia asserts is a restriction on Gazprom activities within the EU.

Ukraine gets new 4-year IMF fund facility. The IMF's executive board decided on March 11 to go ahead with a new lending programme for Ukraine. The new fund facility lasts four years, during which time Ukraine can borrow up to $17.5 billion from the IMF. The Extended Fund Facility (EFF) replaces the previous stand-by arrangement that had already provided $4.5 billion of funds paid to Ukraine.

Immediately upon the acceptance of the new programme, the IMF released a $5 billion tranche. Some $2.5 billion of the tranche went blitz to the National Bank of Ukraine's foreign currency reserves. With the approval of the EFF, Ukraine now has the possibility to access significant amounts of credit from other international lender institutions such as the World Bank as well as from individual nations. Despite the promised financing, Ukraine has been forced to begin negotiations with its private creditors on easing debt-servicing terms over the next few years.

Before approval of the EFF, Ukraine had to commit to enhancing economic efficiency and reducing its fiscal deficit, including prior actions. Progress in Ukraine's reforms will be monitored regularly, and compliance is required for receiving loan payments. Higher domestic natural gas pricing is critical as various gas subsidies equivalent to several per cent of GDP are a major contributor to the government deficit and encourage wasteful energy use.

The EFF conditions further call for stabilisation of the banking sector and reform of the social security system to make sure that the country's poorest households are better protected from taking the brunt of the financial crisis. The IMF foresees Ukraine's GDP will contract this year by about 5.5 % and that 12-month inflation at year's end will be running at around 27 %.

CBR launches English-language research paper series. The central bank's new Working Paper Series includes papers on inflation indicators, functioning of the loan markets and modelling of the Russian economy.

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China

Critical land reform experiment begins in China. Officials this month announced a pilot experiment in land reform that permits the sale of collectively owned rural construction land. The change is intended to harmonise rural and urban practices on the sale of land. Owners of rural construction land earlier had no option but to sell land to the local government. The pilot programme allows rural residents in pilot counties to sell their land directly to also private buyers at market prices. The reform should help reduce income inequality between rural areas and cities and increase the mobility of rural residents.

The reform trial applies to a few counties on the outskirts of fast-growing cities. Although it affects only a tiny slice of China's countryside (just 33 out of more than 3,000 counties), the implications are potentially huge as the move paves the way for liberalisation of a rural land sale and land ownership on a wide scale. The trend should eventually result in complete privatisation of rural construction land. Private land ownership would have a big impact on the Chinese economy by increasing the wealth of the rural population, as well as ease urban expansion and increase flexibility in the labour market. In this sense, the programme is part of the government's stated goal of dismantling the *hukou* housing registration system in order to make it easier for rural residents to move to cities.

Sales of rural construction land have been an important source of revenue for local governments as they have sold the land bought from rural households to real estate developers. Thus, the biggest challenge to the reform is how local governments will deal with the economic impacts of the change. Local government revenues have already been diminishing as demand for construction land by the real estate developers has slowed. The central administration is planning to shift the revenue base of local governments to taxes and bond issues.

The government also launched a trial system of real estate registration in 15 large cities at the beginning of March. The goal is to roll out a nationwide property owner registration system over the next two years. When implemented, the registry will provide a basis for collection of property taxes that potentially would provide a new revenue stream for local governments.

Europeans show keen interest in China's new development bank. The United Kingdom announced this week its intentions to become the first European founding member in the Asian Infrastructure Investment Bank (AIIB). Germany, France, Italy and Luxemburg are following the UK's lead, despite grousing from the US. The Chinese have generally welcomed the European interest in participation. Pacific-rim New Zealand and Indonesia have already joined, and Australia and South Korea are now contemplating AIIB membership. Some 32 countries are now already AIIB members or have officially announced their intentions to join.

The US and many other developed economies, as well as several major international institutions, have expressed concerns over AIIB's lack of operational transparency, governance structures and the potential for China to use the bank in promoting its foreign policy goals in Asia. The UK and other countries interested in taking part in the AIIB project note that they have better possibilities as members to assure AIIB operations comply with international standards. Other motives to join surely include trade policy and the hope to profit from increased yuan-based financing by improving political relations with China.

The initial capitalisation of AIIB is reportedly around $50 billion. The capital base of the US-Japan-led Asian Development Bank (ADB) currently amounts to $165 billion, while the World Bank's base capital is about $240 billion. Thus concerns over China using AIIB to outflank existing international arrangements seem overblown. Competition among development banks should also be as welcomed as it is in other fields of business. Even ADB president Takehiko Nakao noted that room for cooperation exists.

Moreover, there is little worry of over-supply in Asian infrastructure. The ADB estimates the region needs to spend over $8 trillion on development of infrastructure in the current decade (2010–2020). International agencies cannot close Asia's infrastructure investment gap, and the main responsibility for infrastructure development lies with national governments in the region.

China could already this year introduce a deposit insurance scheme and deregulate interest rates. In his speech to this month's assembly of the National People's Congress (NPC), central bank governor Zhou Xiaochuan said a deposit insurance scheme could be in place before July. Zhou noted that the proposed legislation on a deposit insurance scheme last November has enjoyed a positive reception, and given that deregulation of interest rates is linked to deposit insurance policy, both moves will likely take place this year.

A further goal this year is to open a linkage of the Hong Kong and Shenzhen stock exchanges similar to the arrangement already in place between the Hong Kong and Shanghai exchanges.

This year's NPC otherwise offered few surprises on the economic front. Premier Li Keqiang, following his closing remarks to the NPC last Sunday (Mar. 15), held the now-familiar press conference and covered about the same ground as in previous years. Li mostly talked about economic growth, environmental issues and corruption. He repeated concerns expressed in his opening address about slowing economic growth and emphasised that reaching the 7 % growth target this year will not be easy for China.

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Russia

Latest BOFIT forecast sees further contraction of Russian GDP and imports this year, with slow recovery thereafter. The Russian economy slowed for the third consecutive year with growth coming nearly to a standstill in 2014. With the price of oil down by nearly half (from last year's average price), the economy has entered a contractionary phase.

In our latest Forecast for Russia, we see Russian GDP contracting this year by over 4 % as long as the oil price does not rise much above $55 a barrel. Further, the Ukraine situation, financial and trade sanctions from the West, along with counter-sanctions from Russia and the slide in the oil price, have increased uncertainty surrounding the Russian economy. Sanctions are expected to remain in place for a considerable while and access to foreign financing will remain challenging. Government spending is expected to contract in real terms.

The volume of imports fell 7 % last year. We estimate that weak domestic demand, the frail ruble and Russia's reduced export earnings will cause imports to contract this year by approximately 20 %.

For 2016 and 2017, the average oil price will rise to around $65 a barrel. Russian export earnings will recover. The economic contraction and drop in imports shall gradually end and then begin slow recoveries in 2017. The real exchange rate of the ruble should also appreciate as inflation in Russia is significantly higher than in its main trading partners (the gap has widened to over 10 %).

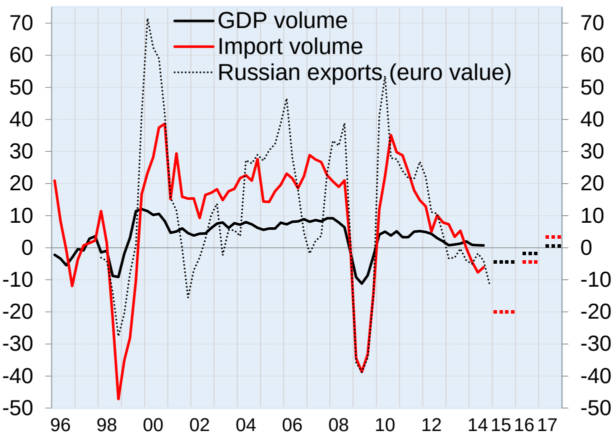
High inflation will cause private consumption this year to decline significantly. The outlook for wage increases is slim and recovery in consumption will take time. Investment is expected to contract substantially this year and also next. Private investment, in particular, has been stifled by uncertainty arising from the continuous tensions in eastern Ukraine, the unclear sanctions outlook and the possibility of more sanctions. The picture is further clouded by the unpredictability of Russia's economic and trade responses in a looming recession. Volumes of exports will increase quite slowly, due in part to hardly any growth in energy exports.

Russia's leadership has responded actively to the onset of recession. However, even if government spending cuts have now become policy, the 2015 federal budget deficit will amount to around 3.5 % of GDP (at an assumed oil price of slightly over $55) and may force the government to use about half of the Reserve Fund. Russia's reliance on the Central Bank of Russia to cover (via banks) the budget deficit and provide financing to firms for paying off foreign debt has for its part increased the CBR's receivables from banks to unprecedented levels. Besides providing state financing, the leadership has increased "manual steering" of parts of imports and exports of capital as the country has come to the brink of recession.

Our forecast sees large risks associated especially with fixed capital investment and imports. Various uncertainty factors could further erode the motivation of private firms in the real economy to invest, while increasing outflows of private capital from Russia. Changes in capital outflows and the oil price are rapidly reflected in the ruble's exchange rate, Russia's export earnings and imports.

Conditions that would foster economic growth and development continue to degrade as private investment declines and government spending focuses increasingly on defence and pensions. Subsidies and restrictive measures to stave off a recession are likely to reduce competition and choke off what little incentive remained for reforms.

Russian GDP, imports and earnings from exports of goods and services, % change y-o-y



Sources: Rosstat, CBR, BOFIT

Transit shipments through Finland to Russia contracted sharply last year, while transit freight from Russia rose. The value of transit freight to Russia via Finland contracted last year by over a fifth to €14 billion, even less than in the crisis year 2009. Transit shipments fell last year for the third year in a row. Although roughly a third of all Russian imports passed through Finland in the first half of the 2000s, last year just 8 % of Russia's total imports passed through Finland. This has been partly caused by Russia's weak economic development but also by improving transport infrastructure in Russia, particularly development of the Port of Ust Luga. Transport freight moving through Finland has also been hurt by increased competition from other transit routes, particularly the Baltic countries.

In contrast, transit freight moving from Russia via Finland to third countries rose last year for the second year in a row to a record level. This transit freight constituted 7 % of Finland's international sea transport volume. It largely consisted of ore concentrates and chemical products.

The most recent estimate of Finland's Ministry of Transport and Communications from 2012 put the Finnish economy's annual value-added from transit freight at around €90 million and job generation at about 1,200 jobs.

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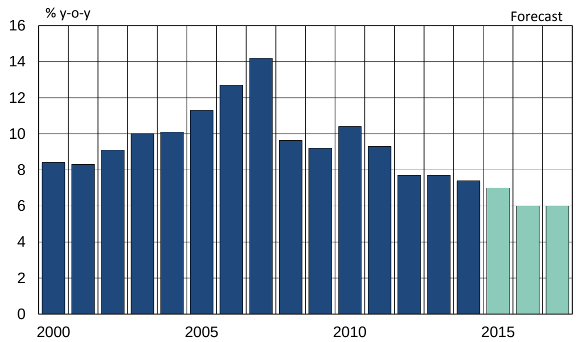
China

BOFIT 2015–2017 forecast sees further slowdown in China's growth without certainty of a soft landing. The latest BOFIT Forecast for China came out this week. We expect Chinese economic growth this year to come in at around 7 % and then slow to around 6 % in 2016. The new forecast largely matches our forecast of September 2014. Our forecast is based on the assumption that China continues to move ahead with bold reform policies and avoids large economic shocks. In this case China could also achieve GDP growth of around 6 % in 2017. A controlled "soft landing" of the economy is by no means set in stone, however, as risks to the economy have continued to grow.

Realised GDP growth and BOFIT forecast for 2015–2017



Sources: NBSC and BOFIT

Lower growth is by and large a good thing for China as it allows structural changes in the economy to continue, and increases the roles of private consumption and services in the economy. Excessive investment resulting from e.g. broad stimulus measures has exacerbated environmental harms, fuelled indebtedness, allowed assets to be squandered on unprofitable ventures and created excess supply in many branches. China's high-growth paradigm emphasising massive investment has reached the end of the road.

The slowdown in growth also highlights the importance of achieving deliberate progress in economic reforms. With the employment situation relatively strong and inflation running at modest levels, it seems an auspicious moment to move ahead with reforms. Indeed, reforms should be expanded to take on the thorniest issues such as reform of state-owned enterprises. Reforms of financial markets are at the moment proceeding for the most part as planned.

Risks to the economy have increased since our last forecast. The biggest risks are growing debt problems and increased challenges in the real estate sector. Dealing with the growing debt problems will be harder midst the lower economic growth. China's domestic credit stock now exceeds 200 % of GDP. The growth of credit has been especially high in the shadow banking sector, which is much less regulated and supervised than the regular banking sector. Low inflation has also driven up real interest costs. The debt problem limits monetary policy, and the central bank must carefully consider whether and how much monetary easing is appropriate, especially if labour conditions remain stable.

China strengthens its status as world's third most active patent-seeker. Latest figures from the World Intellectual Property Organization (WIPO) show the volume of international patents filed under the Patent Cooperation Treaty (PCT) in 2014 rose by nearly 5 % to around 215,000 applications. The United States and Japan together accounted for nearly half of PCT patent applications. The share of China, which is in third place, increased to 12 %. The number of patent applications from China increased nearly 19 %.

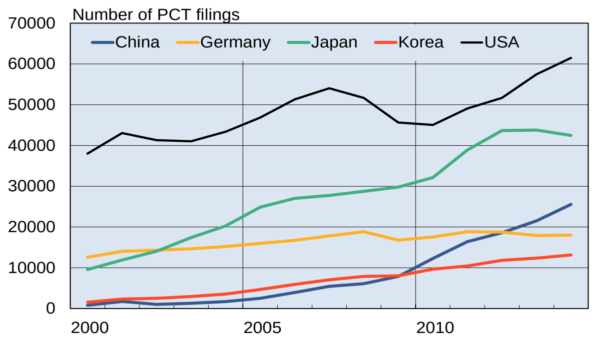
China's rising intellectual property strength was led by its flagship telecom companies Huawei and ZTE, which ranked first and third among large firms globally in terms of PCT applications submitted. US electronics giant Qualcomm occupied the number-two spot.

The number of Chinese applications in itself may overstate China's current innovation capabilities, however, because the quality and value of innovations of Chinese firms tends to be lower than that of firms in advanced economies. Even so, the double-digit growth in international patent activity provides an indication of Chinese ambitions in the technology branch. Here again China seems to be following the development strategy pioneered by Japan and South Korea. The technology-driven growth strategy of East Asia is further evidenced by China surpassing Japan in 2013 as the world's largest buyer of industrial robots.

China's filing of over 25,500 patents last year dwarfs the patent activity of other BRIC countries. India last year produced fewer than 1,400 patent applications, while Brazil fewer than 600. The volume of patent applications from Russia shrank by a quarter to below 900 applications.

Finnish firms last year submitted just over 1,800 PCT applications, a drop of 13 % from 2013. The top PCT filer was the Nokia Group with 630 applications. Nokia ranked 30th globally among large patent-seeking firms.

PCT patent activity of leading technology countries



Source: WIPO

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Russia

Investment in Russia declines; structure of branches targeted for investment continues to shift. Fixed capital investments in Russia fell nearly 3 % last year. The on-year change decayed further in January and February to over 6 %. A deepening of the decline is in line with several forecasts for the entire year.

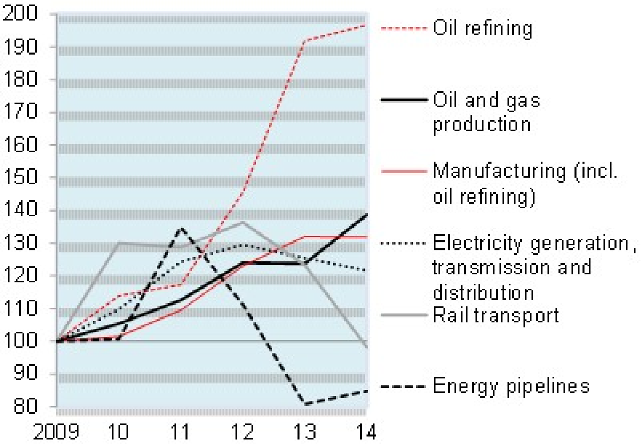
After a year-long break, investment in oil and gas production increased last year by over 10 %. Investments in oil refining, where boosting production and exports has been emphasised in recent years, rose mildly after several boom years. Investment in energy pipelines began to climb again after falling sharply in 2012 and 2013 on the completion of several major oil and gas pipeline projects.

Growth of investment in manufacturing came to a halt. Excluding oil refining, which accounts for nearly a quarter of all manufacturing investment, manufacturing investment contracted slightly. Investment in the electricity sector continued to decline. Investment in rail transport shrank by about a fifth.

The share of the energy sector and oil refining in total investment recovered to 2010–2012 levels of 30 %. Manufacturing (excluding oil refining) held on to a share of just over 11 %. Investment in the real estate and construction sectors rose to 17 %, while the share of investment in road and rail branches fell below 10 %.

Looking at the breakdown of investment by category, growth of investment in machinery, equipment and transport vehicles – which is essential for economic growth potential – fell 7 % in nominal terms in 2014 (information is only available on value of investment). It was the first time such a decline occurred since the 2009 recession. Investment in housing grew substantially, while investment in other types of construction remained unchanged from the previous two years in nominal terms.

Investment volumes for select core branches, 2009=100



Source: Rosstat

Duma takes up bill on granting amnesty for unauthorised capital exports. Last Friday (Mar. 27), the government submitted to the Duma a bill to release private individuals from liability for illegal expatriation of capital as long as the declarant willingly comes forward and provides information on their offshore assets. Russians with offshore assets have until the end of this year to declare their holdings. Two versions of the bill were considered at a meeting of the president and the cabinet last week (Mar. 25). A more liberal version granting full amnesty without sanctions was chosen.

Russian citizens, with the exception of government ministers, elected representatives and government officials, have the right to maintain bank accounts and own property abroad. However, an individual can only take up to $10,000 at a time out of the country without having to declare it. In certain instances, payments into offshore bank accounts have to be made via a Russian bank. Violation of these rules carry a fine.

The draft amnesty law includes guarantees of full confidentiality of declarant information and that all information provided will not be shared with other officials or used as a basis for pursuing criminal charges.

Declarants need not reveal the origins of their foreign-held assets. However, if the asset is subject to taxation and taxes have never been paid on it, the tax debt must be settled. The amount of such taxes will be specified in a later decree. The amnesty does not require repatriation of assets to Russia unless they are held in a tax haven.

The amnesty will allow private individuals to gain legal status for their foreign holdings held by other, nominal owners. It is quite common for Russians to use such an arrangement for their assets abroad.

Another decree will be issued to set the scope of the amnesty. It will specify whether the amnesty also covers other types of unauthorised wealth beyond mere tax avoidance such as assets related to money laundering or other criminal activity.

In drafting the new law, Russian officials have worked with the Paris-based intergovernmental Financial Action Task Force (FATF) on money laundering and other financial crimes. The watchdog group has already expressed concerns that the design of the new law may lack sufficient transparency. FATF recommendations require that officials share all information related to money laundering or the financing of terrorism. If the amnesty law fails to comply with FATF principles, Russia could be blacklisted for its insufficient efforts at preventing money laundering.

Russia foregoes daylight savings time. In line with the Duma's decision last summer that Russia would remain on standard time year round, Russians last Sunday did not "spring forward" an hour like the rest of Europe. The time difference between Russian time zones and western European time zones has now decreased by one hour.

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China

Government approves long-awaited law on deposit insurance. The deposit insurance scheme enters into force at the beginning of May, and will cover deposits up to 500,000 yuan (about €75,000). Over 99 % of China's depositors will be covered by the scheme. Banks will pay insurance payments into a fund, from which customer deposits will be reimbursed if the bank becomes insolvent. The People's Bank of China will administer the fund and change the amount of reimbursement. The size of bank premiums has yet to be announced. Foreign banks operating in China and foreign branches of Chinese banks will not be covered by the deposit insurance scheme.

After the introduction of deposit insurance, the PBoC is expected to continue the deregulation of deposit interest rates. The shift to market-based interest rates should increase competition among banks and reduce bank profit margins. Deposit insurance in principle allows banks to fail. So far the state has guaranteed bank deposits by preventing bank insolvencies through bail-outs. Even with the change, however, it is clear the government, which emphasises economic and social stability, would continue keep failed banks on life support. Most of China's banking sector is still publicly held.

Profit growth at China's big banks slows significantly. Three of the four giant, largely state-owned banks that dominate China's banking sector reported lower profit growth last year. Growth in profits of Industrial and Commercial Bank of China (ICBC) slowed from about 10 % in 2013 to 5 % in 2014. The Agricultural Bank of China (ABC) reported profit growth down from 15 % to 8 % and the Bank of China (BoC) down from 12 % to 8 %. Other Chinese banks, including China CITIC Bank and China Minsheng Bank, also reported lower growth in profits.

Lower bank profit growth reflects China's slowing economy and an increase in non-performing loans, of which all large banks reported. Still non-performing loans only accounted for 1.3 % of the total credit stock at the end of last year. The largest banks are expected to weather increases in non-performing loans better than smaller banks. Among the major banks, only ABC has a larger-than-average non-performing loan portfolio.

The slowdown in profit growth is also an indication that banks are preparing to the increase in non-performing loans and have had to increase their provisions. By some estimates, the actual stock of non-performing loans is considerably larger than the figures banks report. Growth in the stock of non-performing loans is still expected to continue with the economic slowdown and unwinding of unprofitable businesses. This trend is evidenced by the drop in profits of industrial firms, which started late last year. The profit slide has accelerated this year.

China is now the world's third largest arms exporter. The Stockholm International Peace Research Institute (SIPRI) reports that the volume of international arms exports rose 16 % in the five-year period 2010–2014 from the previous five-year period 2005–2009. The United States accounted for nearly a third of global arms exports, while fast-rising Russia accounted for over a quarter. Chinese arms exports rose over 140 %, narrowly beating out Germany and France, to become the world's third largest arms supplier. The three countries each accounted for about 5 % of global arms exports during 2010–2014, and they all lag well behind the US and Russia.

Over the last five years, 41 % of China's arms exports went to Pakistan, 16 % to Bangladesh and 12 % to Myanmar. Russia's three largest customers were India (39 %), China (11 %) and Algeria (8 %). US arms exports are far more diversified than those of Russia or China. The biggest US customers were South Korea, the Arab Emirates and Australia, but each has shares below 10 %. The US, Russia and China were all heavily focused on selling to customers in Asia.

The rapid growth and development of China's own weapons production has reduced the country's dependence on imports. The volume of arms imported to China during 2010–2014 declined 42 % from the previous five-year period, when China was the world's largest arms buyer. Despite the reduction in imports, China remains the world's third largest arms buyer and accounts for 5 % of global purchases. India rose to become by far the world's biggest arms buyer with a 15 % share, followed in second place by Saudi Arabia with a 5 % share (about the same as China). In this decade, Asia's share of arms imports has risen to 48 % of all global imports, up from 40 % in the last half of the 2000s.

The development of China's own arms production capabilities is clearly evidenced in the bilateral arms trade between China and Russia. During 2010–2014, the volume of China's arms imports from Russia fell 57 % from 2005–2009. Although Russia, with a 62 % market share, is overwhelmingly China's biggest arms supplier, Russia's has lost about 20 percentage points of its market share over the past five years. Moreover, with Russia's global arms exports growing and exports to China falling, Russia's dependence on Chinese arms purchases has fallen significantly. China accounted for about 35 % of Russian arms exports in 2005–2009. In the 2010–2014 period, China's share in Russian arms exports fell to 11 %.

After Russia, France and Ukraine are China's largest arms suppliers. SIPRI reports that helicopters, engines for aircrafts and ships represent a major part of China's arms imports and manufacturing of weapons systems under licence.

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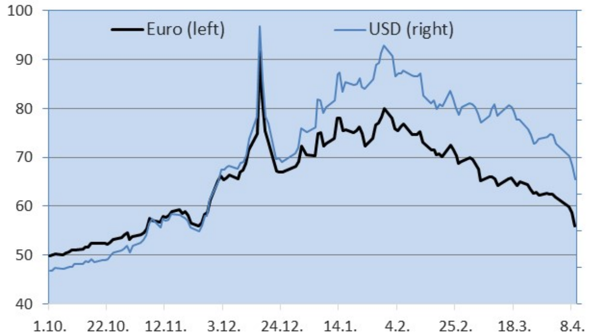
Russia

Ruble appreciation enters third month. The ruble's recent recovery reflects stabilisation of global oil prices and reduced foreign currency demand in Russia. Demand for foreign currency is no longer as acute as at the start of the year when Russian firms and banks paid significant foreign loan instalments falling due. The collapse in import demand and the introduction of the Central Bank of Russia's new forex repo credit arrangement have further dampened currency demand.

Observers note that the ruble's severe decline in December and January overshot the mark, setting the stage for the current correction. Some now argue that the rebound has largely run its course and that the ruble's exchange rate should soon stabilise.

Nevertheless, the ruble remains sensitive to international political events that could again lead to wide swings in the ruble's exchange rate.

Euro-ruble, dollar-ruble rates, 1 Oct. 2014–9 Apr. 2015
(falling trend indicates ruble appreciation)



Source: Thomson Reuters

Russian inflation reached 16.9 % in March. Russia last month returned to a level of consumer inflation not seen since 2002. Although the 12-month rise in prices soared, monthly inflation started to slow. The March rise was 1.2 % m-o-m, down from 2.2 % m-o-m in February.

The inflationary impacts of the ruble's sharp devaluation are expected to fade over the coming months and the rise in consumer prices to slow. By year's end, inflation could be running at around 11–12 %. In 2014, inflation was 11.4 %.

Russia moves to limit public sector wage hikes. On Monday (Apr. 6), president Vladimir Putin signed an amendment suspending current law on public sector wages for the next nine months. The law mandates cost-of-living adjustments keep up with inflation. The amendment also diminishes certain legally mandated adjustments in social entitlements. In light of the government's current financial struggles, public sector wages and social benefits will only be increased in line with the government's 5.5 % inflation assumption used in its initial draft of the 2015 federal budget.

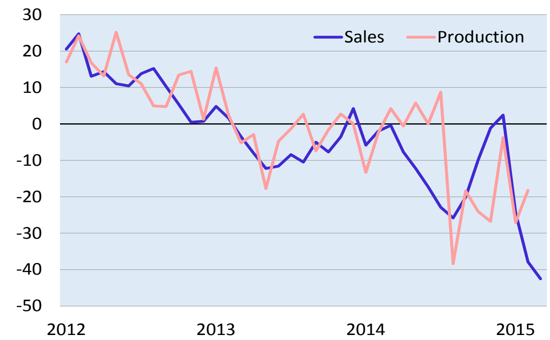
Russian carmakers have it rough. Car sales in Russia have been in trouble for a while. Even with a mini-shopping-spree at the end of last year based on expectations of further ruble devaluation and higher inflation, this year car sales have sunk again. On-year sales of new passenger cars in January-February shrank by a third, production fell 20 % and imports were down 45 %. Sales in March were off over 40 % y-o-y. Most forecasters now see new car sales falling at least 25 % for the whole year.

A number of car plants in Russia have already idled production temporarily, cut shifts or laid off workers – and further measures are planned. General Motors even announced it was shuttering its St. Petersburg plant indefinitely. The ruble's collapse has caused additional problems for the assembly plant production of GM and other foreign carmakers. Most components must still be imported due to the lack of local production in Russia, even if Russia has long sought to raise the domestic content of its car production.

Import substitution has become the key issue for the policymakers also in car industry. The industry ministry recently announced specific goals for reducing dependence on imported car parts. The plan includes even shifting by 2020 to totally domestic supply of many car parts that are at the moment not produced in Russia, but sourced from one or two countries (e.g. Germany, Italy or the Netherlands). The goal, however, may be hard to reach given current economic situation and worsening business climate that are not encouraging new foreign investment in Russia.

Some 2.3 million new cars were sold last year in Russia. Over half were foreign makes assembled in Russia, just under 20 % domestic makes and the rest imports. Most major international car manufacturers have at least some assembly capacity in Russia. Even the largest Russian car manufacturers AvtoVAZ and Kamaz are partly foreign owned.

12-month change in car sales and production, %



Source: Macrobond

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China

Chinese stock markets heat up. The main driver of the recent rise in Chinese share prices has been increased interest among small investors in owning stocks. Private investors account for about 80 % of trading on mainland China stock exchanges. The poor returns from alternative investments have further fed the frenzy to own shares. Share prices on both the Shanghai and Shenzhen stock exchanges are up nearly 90 % from a year ago, and there has been a manifold increase in the volume of trade.

The heightened interest of private investors can be seen by the fact that investors opened over 200,000 new brokerage accounts a day in March, up from an average of 30,000 accounts a day in March 2014. The practice of margin trading (i.e. purchase of shares on credit) has also exploded. As of end-March, the stock of margin-bought shares in mainland China exchanges totalled 1.5 trillion yuan (€225 billion), up from 400 billion yuan in March 2014.

Even ordinary people have taken interest in shares. Bloomberg reported that, based on data from the *China Household Finance Survey* from the end of last year, over 30 % of novice investors in stocks had only finished elementary school, up from 8 % earlier. Small investors prefer to buy shares with a low unit price; such shares have seen much greater appreciation than more valuable shares.

Observers worry that the private investor stampede into shares may increase price volatility. Share price performance defies the current outlook for the slowing real economy. Moreover, share prices have risen on investor expectations of looser policy. Recent monetary easing has further fuelled the rise and thus the impacts of the easing on the real economy have remained relatively small.

Share prices on Shanghai and Hong Kong exchanges

Source: Macrobond

Foreign investors in Hong Kong have stepped selling shares bought on the Shanghai exchange via the "Stock Connect" arrangement. The value of trades conducted under the arrangement amounted to 1.2 % of the turnover on the Shanghai exchange in March. Short selling of shares under limited conditions via the cross-border link was introduced in the Shanghai exchange in March. The short-selling possibility has yet to attract the interest of foreign investors.

The interest of Chinese investors in relatively cheaper Hong Kong shares has continued to climb in recent days and the share prices in Hong Kong have also risen sharply. Investing in Hong Kong via Stock Connect was recently allowed for mainland Chinese mutual funds, which has fuelled the increase in trade volumes. Mutual funds' investment in foreign shares was earlier allowed only under the qualified domestic institutional investor (QDII) programme. The overall trading share of mainland Chinese on the Hong Kong exchange has still remained modest.

China faces massive costs for environmental damage. A Rand Corporation report released last month considers the costs of China's environmental problems and the costs of feasible solutions. Healthcare and negative impacts on worker productivity represent some of the largest costs of environmental degradation to Chinese society. The costs from environmental damage in 2000–2010 averaged around 6.5 % of GDP. The costs in 2012 were around $535 billion, or more than double Finland's GDP that year.

The environmental impacts arising from China's model of rapid economic growth based on heavy industry are now so costly Chinese officials must take action. Pollution levels in nearly all urban areas in China exceed WHO allowed limits. In March, a documentary film posted online gained both national and global attention for its frank discussion of the extensive harms caused by air pollution in China.

China's government has already moved ahead with certain measures. China and the US last November signed a framework convention on climate change in which China for the first time committed to a timetable on limiting emissions and ending growth in carbon dioxide emissions by 2030. Environmental issues were also on the agenda at the National People's Congress last month, when premier Li Keqiang vowed the government would use best efforts to improve air quality and deal with related pollution issues. The government announced at the end of March that new environmental tax legislation was being fast-tracked. In addition, for the first time ever under China's revised environmental law a court has agreed to hear environmental damage claims filed by an NGO.

The Rand report reiterates the general view that the responses of China's government have been woefully inadequate given the scale of China's pollution problems. The report adds that the most effective ways to improve air quality would be to move swiftly from coal to natural gas heating, replace coal-fired power plants with renewable formats and nuclear plants, as well as getting high-polluting vehicles subject to outdated emissions criteria off the road. Annual costs of implementing mitigation measures are significantly less than living with the current pollution.

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Russia

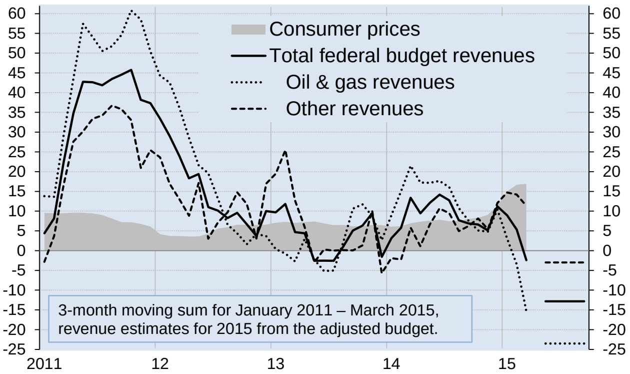
Russian Duma approves adjustments to federal and social fund budgets for 2015. The Duma made no change to the government's proposed federal budget in aggregate, even if the modifications had caused heated debates within the cabinet as they were hammered out. Spending will be cut 2 % from the earlier-approved 2015 budget. Spending rises 10 % in ruble terms from 2014, if the rather massive budget infusion in December to fund the deposit insurance agency's recapitalisation of banks is not included. With the infusion, budget spending rises less than 3 % this year. Given that consumer price inflation should hover at more than 15 % this year, spending will plummet in real terms.

The need to cut spending reflects a precipitous deterioration in the government's revenue outlook. Under the Duma-approved bill, federal budget revenues in rubles decline 13 % this year. The figure entails revenues from oil and gas taxes will fall by nearly a quarter and that other revenue streams will decrease by a couple of per cent. In such case, the budget deficit will be around 3.7 % of GDP. The price of Urals crude is assumed to average $50 a barrel this year, while GDP would contract 3 %. In January-March, revenues to the federal budget fell over 2 % y-o-y.

The Duma only made minor adjustments to the federal spending structure. Defence spending rises this year about 25 %, while spending on national security and law enforcement remains virtually unchanged. Budget transfers to regions were reduced and will decline by over 10 %.

Notably, transfers to the Pension Fund were increased and will rise by 25 % this year. The hike is to make up for a slight reduction in estimated revenue from a slower rise in wages than earlier projected. The estimate of Pension Fund out-go was also raised. Further pension hikes have been needed as inflation last year came in higher than assumed when earlier pension increases were set. Pension Fund spending will rise about 25 % this year and spending from all social funds even faster. The combined deficit of social funds amounts to about 1 % of GDP.

Federal budget revenues, % change y-o-y



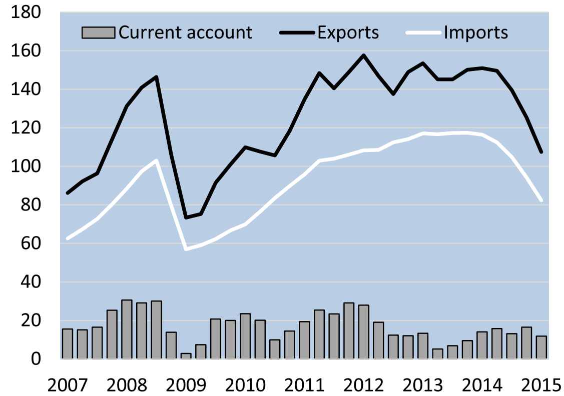
Sources: Finance ministry, Rosstat

Falling imports kept Russia's current account in surplus. Preliminary balance-of-payments figures show that Russia's current account surplus contracted slightly on-year in January-March, but was still substantial at nearly $24 billion. The combined current account surplus of latest four quarters corresponded to more than 3 % of GDP.

Depressed by lower oil prices, the value of goods exports shrank 30 % y-o-y. The average price of Urals-grade crude was in 1Q15 only about half of what it was a year ago. The value of other goods exports also fell 13 %. The value of goods imports was down 36 % in dollar terms and 23 % in euro terms. The contraction in imports has slightly moderated after January, however, with the recovery of the ruble. The ruble's effective (trade-weighted) exchange rate in the first quarter was down about a third from a year earlier in nominal terms and about a quarter in real terms.

The services trade balance was still in the red, even if the value of services imports in dollars fell by 24 % y-o-y in the first quarter. Import of travel services fell slightly faster than other services.

Exports and imports of Russian goods and services and current account surplus, USD billion (seasonally adjusted)



Sources: CBR, BOFIT

Capital outflow from Russia continued strong due to foreign debt payments. The net capital outflow of private sector in the first quarter was $33 billion, down from $48 billion a year earlier. Banks paid down considerably more old debt than took new, but also actively repatriated assets from abroad. Non-bank firms appear to have been able to extend their foreign loans as their net payments of foreign debt were much more modest. More forex cash was sold than bought in Russia for the first time in over a year.

As of end-March, Russia's total foreign debt was $560 billion. The value of debt has declined substantially since the peak at over $730 billion in mid-2014. Part of the reduction in the value of the debt reflects the ruble's depreciation (about a quarter of Russian foreign debt is denominated in rubles). In 1Q15 the effect of exchange rate changes has, however, been more modest. The public sector accounts for less than 10 % of foreign debt.

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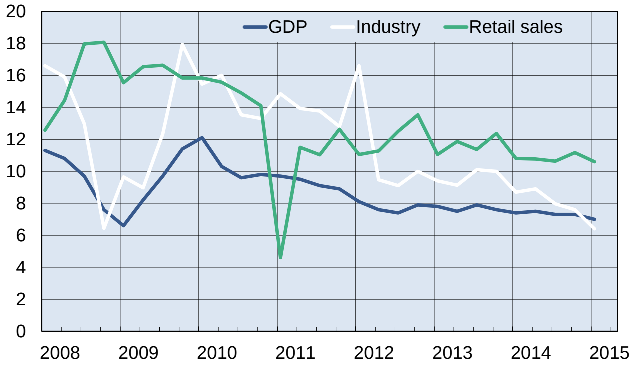
China

Chinese economic growth slows as expected in the first three months of the year. China's National Bureau of Statistics reports that the country's on-year GDP growth slowed to 7.0 % in the first quarter of this year, down from 7.3 % in the fourth quarter of 2014. Seasonally adjusted quarterly growth slowed to 1.3 % q-o-q, which corresponds to an on-year rate of 5.3 %.

Nearly every key economic indicator registered the expected lower growth. On-year industrial output growth slowed in January-March to 6.4 %, and last month came in well below 6 %. China witnessed a particularly large slowdown in its mining industry. Growth in electricity production, which is often used as a proxy indicator of total economic output, was close to zero for the first quarter.

Output growth in China, %



Source: Macrobond

In the service sector, output continued to grow by nearly 8 % in the first quarter, almost matching overall growth for 2014. Within the service sector, retail sales climbed 11 % for the first quarter as a whole, although March growth was closer to 10 %. The evolution of China's production structure has accelerated over the past few years as services have increased their share of GDP. Services now account for about 49 % of annual economic output, surpassing industrial output at 42 % and primary production (mainly agriculture) at 9 %.

Structural change can also be seen on the demand side. Growth in fixed asset investment (FAI) slowed sharply in the first quarter, as e.g. the number of new construction projects (measured in terms of floorspace) fell in the first quarter by about 20 % y-o-y. The evaporation of investment growth has been offset by robust growth in private consumption. Disposable household income increased in the first quarter about 8 % in real terms. Moreover, the employment situation has yet to show any significant weakness, despite the general economic slowdown. The NBS reports service sector growth has helped keep the unemployment rate at around 5 %.

On-year Chinese consumer inflation in March was unchanged from February's figure of 1.4 %. Producer prices, which have been declining for quite some time, were down 4.6 % in March.

Chinese export growth slowed in first quarter; value of imports plummeted. Exports in the first quarter grew 5 % y-o-y, down from 9 % in the fourth quarter of 2014. Exports to the US rose 11 % y-o-y, while exports to the EU were up 6 %. Exports to Japan slid a further 12 %.

Imports in the first quarter shrank 18 % y-o-y. Underlying the contraction in imports was in part the slide in global prices for oil and other commodities. Trends in import volumes, however, were varied. For example, volumes of crude oil imports were up 8 % from a year ago, while copper imports were down 18 %.

March's exceptionally large 15 % drop in exports mainly reflects the late arrival this year of the Chinese Lunar New Year holidays.

IMF forecasts uneven development for the global economy. In its latest World Economic Outlook (WEO) released this week, the IMF sees economic growth strengthening in advanced economies this year, while growth in emerging economies will slow for the fifth year in a row.

China's stimulus policies have exerted a large influence on growth in other emerging economies since the international global financial crisis. The IMF says China should now focus on dealing with the fallout from its stimulus policies, including dealing with debt and other problems, as well as move ahead with reforms. As China's growth continues to slow, it will depress commodity prices and slow the growth of commodity producers.

The IMF revised significantly downward from last October its growth projection for Russia. Factors for the increased pessimism include the collapse of global oil prices, the Ukraine crisis, on-going sanctions and the country's structural weaknesses – all of which have eroded confidence in the Russian economy.

IMF forecasts of GDP growth, %, f = forecast

	2014	2015(f)	2016(f)
World	3.4	3.5	3.8
Advanced economies	1.8	2.4	2.4
United States	2.4	3.1	3.1
Eurozone	0.9	1.5	1.6
Emerging economies	4.6	4.3	4.7
China	7.4	6.8	6.3
India	7.2	7.5	7.5
Russia	0.6	-3.8	-1.1
Brazil	0.1	-1.0	1.0

Source: IMF World Economic Outlook, April 2015

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Russia

Private demand down sharply in Russia. Following December's shopping spree sparked by the ruble's fall, the volume of seasonally adjusted retail sales fell three months in a row. Thus, first-quarter retail sales were down nearly 7 % from 1Q14, due in part to another shopping spree in February and March 2014. Food and non-food goods sales both contracted by virtually the same amount in 1Q15.

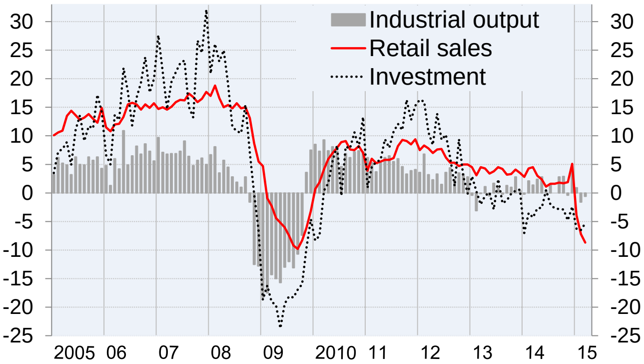
Although nominal wages were up 6.5 % y-o-y in the first quarter, Russia's nearly 17 % inflation rate meant that real wages had declined more than 8 % since 1Q14. The February 1 pension hike that increased February pensions to over 13 % y-o-y in nominal terms moderated the drop in real household incomes.

Fixed capital investment has been sliding down for about two years now. The rate of decline increased in 1Q15, when investment was down 6 % y-o-y. The corresponding change in the construction sector was -5 % y-o-y.

Industrial output in the first quarter was down only about 0.5 % y-o-y. Higher production of coal, oil and metallic ores increased output of mineral extraction industries to over 0.5 % y-o-y in the first quarter. Exports of oil and petroleum products were also up.

Manufacturing output in the first three months of the year was down about 1.5 % from a year earlier. In addition to continuous growth in oil refining, production of certain other basic commodities increased notably. Part of this growth may be due to the weak ruble. For food production, Russian countersanctions and other import restrictions are also likely having an effect. In any case, the contribution of the ruble is fading as the ruble's real exchange rate rebounded strongly in the past three months on high inflation in Russia and the rise in the ruble's nominal exchange rate. On the other hand, domestic industries should get considerable support from defence spending, which was up over 50 % y-o-y in the first quarter.

Change in core indicators of domestic demand and industrial output, % y-o-y



Source: Rosstat

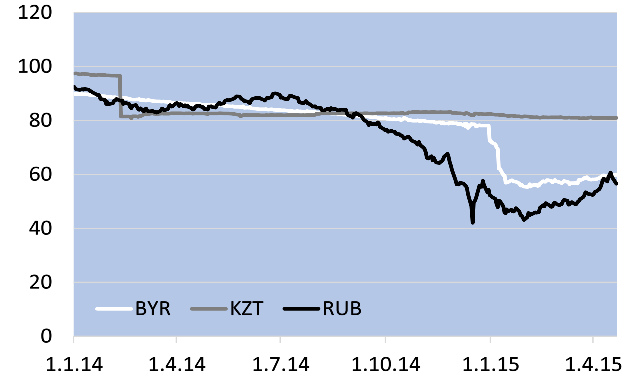
Import disputes in the Eurasian Economic Union. Kazakhstan announced last week that it would pull certain Russian food items off the shelves as they failed to comply with Kazakhstan's food safety regulations. Soon thereafter, Russia's Federal Service for Veterinary and Phytosanitary Surveillance responded by similar measures for some Kazakhstan dairy products. Several Belarusian meat producers have faced import bans from Russia since late last year for similar reasons and Belarus imposed corresponding restrictions to some Russian foodstuffs. In addition, Russia has inspected food shipments entering the country from Belarus to prevent abuse of EEU privileges to circumvent Russian bans on European food products.

In early March, Kazakhstan imposed a 45-day import ban on Russian petroleum products. As Kazakh imports are subject to an annual import quota of duty-free petroleum products from Russia, Kazakhstan officials said the ban was needed to rebalance fluctuations in demand. They noted that, without the break, the rapid growth in imports would have caused the entire year's quota to be filled too early. For January-February, the volume of exports of Russian oil products to Kazakhstan increased nearly 70 % y-o-y.

The ruble's collapse late last year increased other EEU members' imports from Russia. This raised discussion in Kazakhstan on whether to impose a temporary ban on imports of certain Russian products. Belarus president Alexander Lukashenko has also been unsatisfied on the effects of the ruble's collapse and demanded e.g. increasing the role of US dollars and euro in trade with Russia. Additional dissatisfaction in Belarus has arisen from changes in Russian oil taxation at the start of this year that have reduced the benefits of bilateral oil trade for Belarus.

While cooperation among EEU members is not always smooth, president Putin envisions nevertheless deeper cooperation. At the EEU meeting last month, Putin suggested it was timely to start exploring the possibility of adopting a common EEU currency. The EEU should also expand in May with Kyrgyzstan's accession.

Dollar rates for Russian ruble, Belarus ruble and Kazakhstan tenge, (100 = 1 Jan. 2013)



Source: Macrobond

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China

China offers stimulus by lowering bank reserve requirements. On Monday (Apr. 20), the People's Bank of China lowered the reserve requirement ratio (RRR) by a full percentage point. The RRR requirements of large banks fell to 18.5 % and to 15–16.5 % for other credit institutions. The PBoC has begun to apply the reserve requirement ratio as a targeted policy tool, granting reduced RRRs to certain banks (e.g. those focused on serving small businesses and farm lending). The RRR can even be bank-specific. RRR represents the amount of a bank's deposits held by the central bank. A higher RRR reduces the bank's ability to lend.

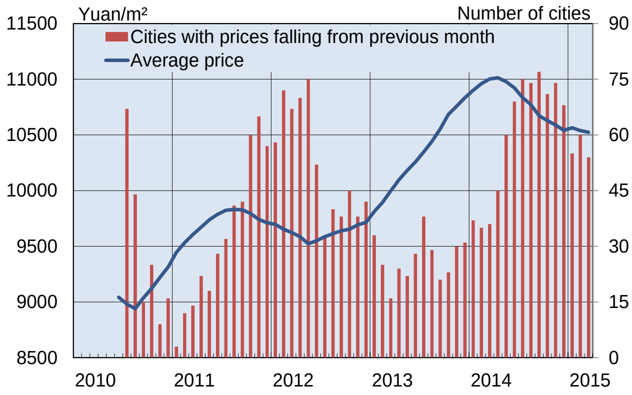
In the absence of a functional interest-rate system, the RRR is the central bank's primary instrument for regulating bank lending. Prior to 2015, the RRR had been unchanged for nearly three years, but this year it has been lowered twice for a total of 1.5 percentage points. The PBoC over the last six months has also twice lowered reference rates for loans and deposits. The PBoC also has lowered interest rates to banks on short-term (reverse repo) credits, with the result that short-term rates on the interbank market fell substantially in March. The PBoC has also granted banks short- and medium-term credit through other financing vehicles (SLF, MLF).

With the roles of various monetary instruments and their impacts unclear, China's current monetary policy is hard to discern. The country is shifting, however, to interest-rate-based monetary policy. A prerequisite is the upcoming rollout of a deposit insurance scheme. The facts that banks will need to pay deposit insurance premiums and follow interest-rate-based monetary policy may also justify lower RRRs.

Chinese real estate markets remain shaky. SouFun, a private company that gathers information about real estate markets in China, reports that housing prices overall continued to slide last month. Average apartment prices were about 4 % lower in March than a year earlier, when prices hit their peak. The price slide has appeared to be stabilising. Still, of the 98 cities SouFun tracks, 54 saw price declines in March.

Rules on housing investment were relaxed in March to support housing sales. Now apartments bought more than two years prior to sale are exempt from sales profit tax, instead of at least five years prior to sell as before. Further, the required downpayment for a second apartment was lowered from 60–70 % to 40 % for second apartment buyers still subject to a mortgage on their first apartment. Since autumn, any buyer who has paid off the existing mortgage on their apartment can purchase a second apartment on the same terms as a first apartment buyer. The downpayment for first apartment buyers is 30 %. The impacts of the measures remain unclear at this point. Many builders and city governments have already found ways to circumvent the tightened rules of 2010.

Average apartment price and number of tracked cities where prices fell from previous month



Sources: SouFun, Macrobond

Real estate developer Kaisa defaults on bond payments. Kaisa Group Holdings Ltd. this week failed to make interest payments on two separate dollar bonds. It was the first time a Chinese real estate developer defaulted on debt owed to foreign creditors.

As the underlying causes of Kaisa's problems remain unclear, the episode has clearly eroded the credibility of companies operating in the real estate sector and other branches suffering from overcapacity. Given that access to new credit will become more difficult to these companies and China's slowing economic growth, Kaisa is unlikely to be the last company in trouble.

China suspends implementation of bank cyber-security requirements. The US and China have quarrelled over China's intended measures related to net security and terrorism. China's new regulation proposal called for e.g. requiring IT-system suppliers in certain branches to retain data on Chinese citizens on servers located in China. Moreover, companies would have had to grant officials access to secret information. The rules implied banks should start favouring domestic suppliers in future IT procurements.

Recent information suggests the planned regulations will not be applied to Chinese banks as such. Large US tech firms considered the proposed regulations less of a data security issue than a trade policy strategy meant to bolster the competitive advantage of Chinese firms. Establishing and maintaining local server clusters would be very expensive for foreign firms. Chinese banks have themselves expressed concern that rules limiting them to domestic data security firms would weaken their existing data security technology significantly.

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Russia

Economy ministry puts out ever-rosier forecasts. Over the past two months, the economy ministry has drafted four economic forecasts. The latest draft reduces slightly its expected GDP contraction this year to 2.8 %. One reason for the upbeat revision comes from the ministry's preliminary first-quarter performance estimate that shows GDP declining only 2.2 % y-o-y. The ministry's assumption for the average crude oil price this year remains at $50 a barrel. Most forecasts of independent research institutions see Russian GDP contracting about 4 % this year. In a further departure from other forecasters, the economy ministry also expects GDP could grow as much as 2.3 % next year under its scenario of an average oil price of just $60/bbl. In the forecast, annual GDP growth in 2017 and 2018 reaches 2.5 %.

The draft forecast also includes a more optimistic scenario. On request from the president, a target variant of even faster growth has been drafted. In that case, growth would be boosted by targeted infrastructure investments using assets from the National Welfare Fund (up to 80 % of the fund's assets), as well as assets from pension funds.

The economy ministry has also prepared a draft version of the three-year government action plan. Goals include raising the investment-to-GDP ratio from below 18 % this year to a range of 22‒24 % by 2020. GDP growth should reach the average level of growth of the global economy by 2018, which would result from a resurgence in private investment. The draft places relatively heavy emphasis on encouraging private entrepreneurship.

Dispute over pension system resolved. On April 23, the government declared a resolution to its two-year dispute over the suspension of the "funded component" of the pension system. The funded component will be reintroduced at the start of 2016.

Russia fundamentally overhauled its pension system in 2002. At that time, Russia shifted to a two-pillar system that introduced the funded element. This required a part of the pension contributions paid in by employers for younger workers to be set aside in private pension funds or a state pension fund managed by state development bank VEB for covering their future pensions. Prior to 2002, Russia had a simple pay-as-you go scheme, whereby contributions paid by employers into the federal pension fund were paid out to meet existing obligations. The shift was justified on the basis that Russia needed to prepare for rising future pension costs from an aging population and a smaller workforce supporting a larger pensioner population.

The shift to including a self-funded component initially was a drag on the pension system as paid-in contributions no longer could be used in full amount to paying current pensions. Together with significant hikes in pensions, temporary reductions in pension contributions and several years of poor economic performance pushed the federal pension fund into deficit. The pension fund deficit has expanded especially rapidly since 2008.

The pension fund shortfall is funded out of the federal budget. In order to restrict the need for budget funding the government adopted an exceptional arrangement for 2014 and 2015, whereby pension contributions collected in these years would be used entirely on a pay-as-you-go basis.

The social ministry and the labour ministry have supported the suspension of the funded component, going so far as to suggest making the funded arrangement completely voluntary. The ministries have justified this by the so far poor returns of pension fund assets that has led to weaker pension security than the pay-as-you-go approach with indexed increases based on cost of living.

The finance ministry and the economy ministry opposed abandoning the funded component. One of the goals for the introduction of the funded component was to enhance the development of Russia's financial markets. Pension savings funds could offer the long-term capital for investment that Russia's financial markets are currently lacking.

Russia's acute need for investment financing was the specific factor that led the government to continue the funded component. Prime minister Dmitri Medvedev has now tasked the government with finding more productive ways to invest pension assets. Experts have not warmed to the finance ministry's proposal that private pension funds commit to investing part of their assets in high-priority state infrastructure projects.

Russia bans re-export of plant products from Bulgaria. The ban is designed to prevent imports of EU plant products from circumventing Russia's ban in food imports imposed last August. The Federal Service for Veterinary and Phytosanitary Surveillance (Rosselkhoznadzor) imposed the ban on Saturday (Apr. 25), noting that it sought to stop banned products from entering Russia via Bulgaria through deceptive practices. The agency cited as an example Polish apples with re-export documents indicating their origin outside the EU (e.g. Morocco and Brazil).

The ban on transit imports will remain in force for an unspecified period. Rosselkhoznadzor claims the document forging has reached substantial proportions, so it could widen the ban to cover all plant product imports coming via EU countries. To prevent fraudulent labelling, Rosselkhoznadzor is designing a system that would require EU officials to pre-deliver their export documents.

Most plant products imported to Russia from outside the EU are transported through EU countries, where large logistics hubs are located. The more extensive bans could significantly restrict plant product imports to Russia and increase import costs.

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China

Economic slowing adds to risk on Chinese financial markets. While corporate solvency struggles have been visible for years, the first default on a domestically listed corporate bond issue only occurred in March 2014. Last month saw the first state-owned enterprise default on interest payments. Last week, the first Chinese firm defaulted on foreign bonds payments, leading to open speculation of deeper problems brewing. The stock of non-performing loans held by banks has also soared, even if the share of nonperforming loans in overall credit stock is still relatively small.

Because the public sector typically intervened in payment issues earlier to prevent market disruptions, these defaults may be a positive signal of long-awaited market discipline. Despite their high visibility, the impacts of these defaults on markets have been limited.

The emergence of payment problems, however, also reflects risks of a slowing Chinese economy, declining corporate profits and soaring indebtedness. Local government debt struggles and the decoupling of stock markets from trends in the real economy further increase financial market tensions. The deregulation of interest-rate setting and capital movements, along with other reforms, add to tensions.

The current financial market developments have largely been anticipated and various degrees of disruption are expected ahead. An encouraging sign is that the government has stuck with reform policies. The experiences of other countries with debt problems and financial market deregulation, however, suggest possible unpleasant surprises ahead.

Indebtedness of local governments continues to soar. Preliminary figures released last week put the debt of local governments at the end of 2014 at around 16 trillion yuan (€2.3 trillion), or approximately a quarter of GDP. Figures from mid-2013 put local government debt at 10.9 trillion yuan, which translates to a rise of around 33 % a year.

The high growth may in part reflect the fact that some of the local government loan guarantees have been reclassified as their direct debt. In addition to their own borrowing, local governments are indirectly responsible for a smaller amount of loan guarantees (although no information for end-2014 has yet been released). The total amount of liabilities at end-2014 is thought to be around 20 trillion yuan (€2.9 trillion), up from 17.9 trillion yuan in mid-2013.

Local governments can now seek relief from debt problems in the bond markets. In March, the government allowed local governments to issue a total of 1 trillion yuan in bonds to pay off high-interest loans held by local government financing vehicles. Investors apparently have not found the low yields on these new bonds very attractive. Commercial banks are the biggest investors in Chinese bond markets. Market information suggests that the PBoC is currently planning an arrangement to allow banks to swap debt purchased from local governments for central bank loans.

China's stock markets now among the largest in the world; meteoric rise causes concerns. In April, the daily trading volume of the Shanghai stock exchange exceeded 1 trillion yuan (€150 billion), making it the world's busiest stock exchange. The turnover volume in Shenzhen now exceeds that of New York's exchanges, making it the second-most-traded exchange. In terms of market capitalisation, at the end of 2014, the mainland China stock markets were the largest after the United States. In April, the Shanghai stock exchange alone surpassed the Tokyo stock exchange as the world's third largest after the NYSE and Nasdaq. The market value of mainland China stock markets is now nearly 90 % of GDP, over double that of 2013.

Share prices are up about 120 % over the past year. The average price-to-earnings ratio (P/E) of shares has also more than doubled: to 23 for Shanghai and 52 for Shenzhen. Some company P/E numbers are very high. Observers note that the prices of China's technology shares are now double that of US prices during the IT bubble.

The China Securities Regulatory Commission (CSRC) has this year already approved listings of 123 firms (compared to 125 new listings for all of 2014). The current approval process is complicated and hundreds of firms await listing approvals. The National People's Congress is currently considering changes in securities law so that, instead of official approval, only registration would be required and exchanges could themselves determine which firms go on the market.

Observers now question the sustainability of the recent rise in stock prices. Higher share prices allow companies to raise capital at lower cost than on the debt markets. However, there are more and more small investors on the market, for whom the consequences of a drop in prices would be more severe. The conditions for buying shares on credit have been tightened a bit, but it has not significantly slowed the growth in buying shares on margin. On the other hand, short selling of shares has been made easier.

Stock market trends in mainland China

Source: Bloomberg

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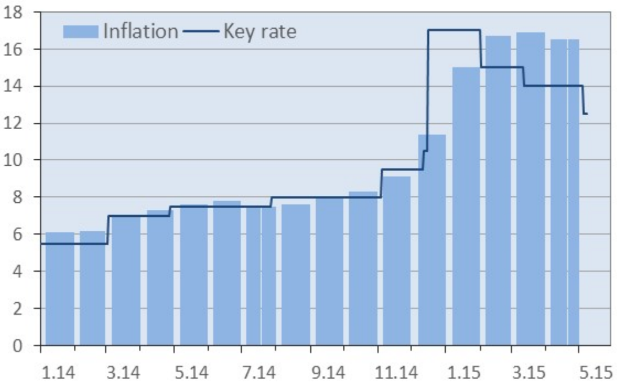
Russia

CBR lowers key rate. Effective Tuesday (May 5), the Central Bank of Russia lowered its key interest rate by 1.5 percentage points to 12.5 %. It was the third rate cut this year. The central bank said the move reflected lower inflation and a continuing weak outlook for growth.

The CBR said it now expects inflation to cool faster than it had predicted earlier this year due to the ruble's recent exchange rate rebound and a sharp decline in consumer spending caused by the drop in real incomes.

In April, the rate of inflation was 16.4 %, down slightly from March. The CBR expects that inflation will fall to 8 % by April 2016 and reach the target level of 4 % in 2017.

Inflation and CBR's key rate, %, 1.1.2014–8.5.2015



Sources: Rosstat and CBR

The CBR also noted that interest rates generally have fallen a bit since its previous key rate cuts in January and March. Even so, the central bank conceded that interest rates remain relatively high. While the situation is favourable for attracting ruble deposits, it slows the expansion of credit needed to promote economic development.

Russia launches its own national card payment system. Russia moved ahead with its own card payment system after Visa and MasterCard blocked payment processing for US-sanctioned Russian banks amidst the Ukraine crisis in March 2014.

To avoid interference with domestic payment transactions, the Duma amended the law on payment systems to require that all card transactions taking place in Russia be processed in Russia's national processing system. After that, Russia began to erect the physical system needed for the processing of card transactions. Credit card companies had until end-March this year to migrate to the new system.

Visa and MasterCard, which account for 95 % of Russian card payments, are currently migrating their payment processing operations to the Russian system. They were prompted to move on rapidly with the transfer, as according to the law, a credit card company processing its transactions outside Russia will have to deposit such a large collateral guarantee with the CBR that it would make its operations in Russia unprofitable.

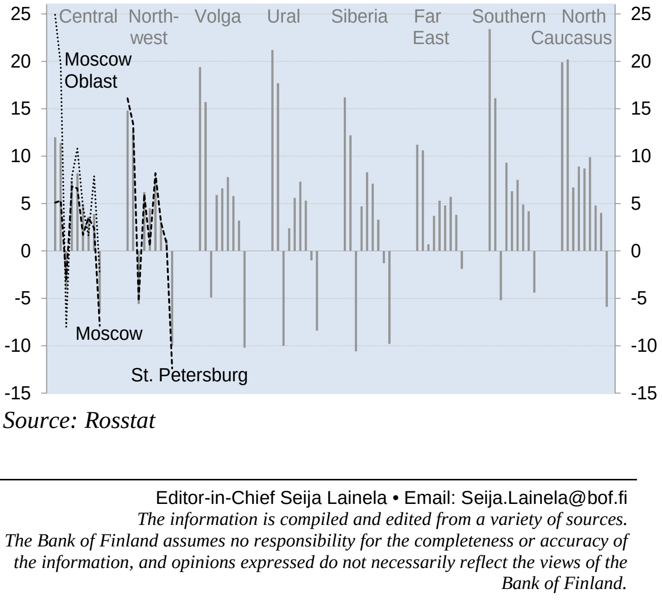
Russian officials say the next step in the creation of the national payment card system is the issue of a Russian credit card by the end of this year. The long-term goal is to gain international circulation for the Russian credit card.

Consumers under major strain in Russian regions, industries struggle. Russia has experienced a nationwide slump in private consumption. In the first quarter of this year, the volume of *retail sales*, a focal indicator of consumer purchasing power, showed on-year declines in all eight of Russia's federal districts. Decreases were almost as large or larger than in the crisis year 2009.

Retail sales last year shrank in 15 of Russia's 83 administrative regions. Conditions have continued to degrade this year. In the first quarter of 2015, retail sales fell on-year in 73 regions, with drops greater than 10 % registered in 18 regions. The biggest drops were registered in Murmansk Oblast, the Republic of Tatarstan and Novosibirsk Oblast.

The slight first-quarter decrease in *industrial output* was not distributed evenly across Russia. Output fell most sharply in the Central Federal District, where the drop in output was 10 % y-o-y. The district includes the Moscow Oblast, which saw a drop of 23 %, the City of Moscow (down 15 %) and the Kaluga Oblast (down 7 %), famous for its car-manufacturing cluster. The biggest output drop in the Northwestern Federal District was seen in St. Petersburg (down over 7 %). In all other federal districts, output was essentially unchanged.

Change in retail sales volumes in federal districts and Russia's biggest cities, % y-o-y, 2007–1Q2015



Source: Rosstat

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China

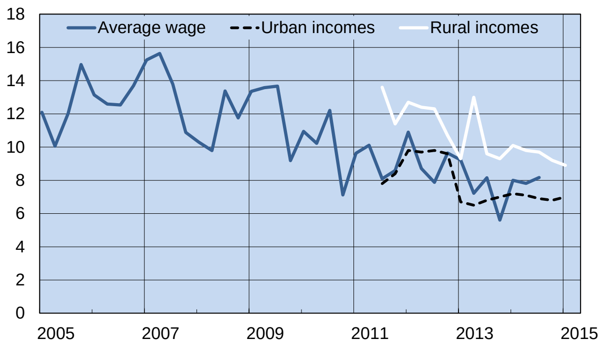
Chinese wage growth remains robust. Even with the overall slowdown in Chinese economy, wage growth has slowed only modestly. Factors supporting real wage growth, in addition to economic growth itself, include China's shrinking labour supply and low inflation.

The latest official figures show the average monthly wage in the third quarter of 2014 was 4,460 yuan (€550 at the time or €640 at the current exchange rate). The average nominal wage showed a gain of 10 % y-o-y and the real wage 8 %. Nevertheless, differences across sectors and provinces are large. Average wages in Beijing and Shanghai were 80 % higher than the national average. Wage levels were below average in most interior provinces.

A second wage divide can be seen between the countryside and cities. The latest China Household Finance Survey found that the average monthly wage in rural areas was less than 1,100 yuan (€160) in January-March, while the average wage in urban areas exceeded 2,850 yuan (€400). The National Bureau of Statistics put the average monthly wage of China's more than 160 million internal migrant workers at around 3,000 yuan (€430) for the first quarter.

In dollar terms, Chinese labour costs are perhaps already on par with Malaysia and Thailand, and several times higher than in their poorer Asian counterparts. The growth of China's domestic markets and the shift of production to cheaper interior provinces still attract production investment to China, but labour-intensive export industries are now looking elsewhere.

Real growth in average wages and disposable incomes, %



Sources: Macrobond, BOFIT

Policy changes to support China's labour markets. The government said late last month that it would seek to ease labour market conditions through measures such as tax breaks and access to preferential loans for businesses, as well as reduced red tape in setting up a business. The tax breaks are aimed at companies that employ job-seekers who have been unemployed for half a year or more and migrant workers returning to their home districts to start a business.

Figures released last week showed lower growth in job creation in urban areas. First-quarter job growth was the weakest since 2009. The number of new jobs created was 3.24 million, a decrease of nearly 6 % y-o-y.

Huge regional differences could also be seen in the employment situation. In China's eastern provinces, the number of open jobs and applicants decreased by roughly the same extent. In the central parts of the country, the number of open jobs fell faster than the number of people seeking work. For all of China, the number of open jobs was down 16 % y-o-y in January-March, but the number of people seeking work was also down 15 %. As a result, the official unemployment rate in urban areas showed virtually no change, standing at 4.05 % as of end-March.

China's official published unemployment rate continues to hover in the range of 4.0–4.3 % as it has for the past decade. The figure understates the actual unemployment situation. Chinese officials themselves rely on a classified indicator that gives a more realistic description of the unemployment rate. Observers note, however, that while the unpublished indicator puts unemployment about a percentage point higher, it too does not seem to have fluctuated much over the past decade. The government support measures may indicate softening of the labour markets. Officials point out that supporting employment is a fundamental goal for economic policy. As long as the employment situation remains relatively good, officials seem willing to show greater flexibility in setting growth targets. Indeed, China needs to focus more on actual trends in prices and employment than meeting specific GDP growth targets.

China ends export duties on rare-earth metals. At the beginning of May, export duties were abolished for 17 metals classed as rare-earth elements (REEs), as well as tungsten and molybdenum. The move is expected to have little impact on global prices, however, as the loss of duty revenue is to be offset by a resource tax of 7–27 %, based on metal sale price. In addition, export duties on certain aluminium products were abolished. China's aluminium industry has long struggled with overcapacity issues.

China abolished REE export quotas in January. The quotas were reduced in 2010 that had caused REE prices to spike globally. The WTO last year condemned the quotas as a rule violation. China is not involved in any similar major trade disputes at the moment.

China used export quotas and taxes to protect its domestic processing industry. Officially the quotas are claimed to reflect the environmental impacts of producing REEs. The government has sought to reduce overcapacity in the REE industry by consolidating production into six large firms and shutting down illegal mining operations. The latest measures are hoped to reduce widespread grey production and REE smuggling, while boosting profitability in the sector. China, with under 25 % of the world's REE reserves, accounts for over 80 % of the global production.

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Russia

Exports of Russian pipeline gas down over 10 % last year. The Central Bank of Russia reports that about 175 billion m^3 of natural gas were exported last year. Exports to Ukraine were down significantly, falling by 44 % to 15 billion m^3. Exports to Europe and Turkey declined by 9 % to 126 billion m^3. In addition, Gazprom's pipeline grid transmitted 20–30 billion m^3 of gas to Europe from Central Asian countries (mainly Kazakhstan, Turkmenistan and Uzbekistan). Gazprom said that last year it sold 147 billion m^3 of gas to European and Turkish markets.

There are four main pipeline routes for exported gas: Nord Stream, which runs along the Baltic Sea bottom; Blue Stream, which passes under the Black Sea to Turkey; the Yamal-Europe pipeline through Belarus; and the Druzhba pipeline that goes through Ukraine. Druzhba is by far the biggest and most important of these four pipelines, with about half of the gas piped to the EU moving through it.

Gazprom has long sought to circumvent transmission routes through Ukraine. The South Stream pipeline, the brainchild of a consortium led by Gazprom, would run under the Black Sea to Bulgaria. The project was abandoned, however, in December 2014, largely on opposition from the EU. In response, Gazprom announced it was planning a similar pipeline to run under the Black Sea to Turkey that would stream gas to the markets in both Turkey and the EU. This "Turkish Stream" project is pending final approval from the countries involved.

In September 2014, construction of the first gas pipeline to Asian markets was officially christened. A year ago, Gazprom and China's CNPC concluded a 30-year gas supply agreement that provides China with 38 billion m^3 of gas delivered every year. The "Power of Siberia" pipeline should be operational in 2019.

The required investment in the Power of Siberia pipeline and development of gas fields in Yakutia and Irkutsk in eastern Siberia are huge, both in terms of scale and cost. Russia has long sought agreement from China on a more western route that could stream gas from existing fields in western Siberia. In conjunction with the Moscow visit of Chinese president Xi Jinping, Gazprom and CNPC agreed on May 8 to go ahead with construction of this Altai pipeline. No details on the agreement have yet been released.

At the moment, only liquefied natural gas (LNG) is exported from Russia to markets in Asia. LNG production and exports last year remained at around 14 billion m^3, the same levels as in 2013. Russia' sole LNG producer is currently Sakhalin II in Russia's Far East Federal District. An LNG terminal is under construction at the northern tip of the Yamal Peninsula. It is majority-held by the private gas company Novatek. Gazprom has plans to build LNG facilities in the Gulf of Finland in Ust-Luga and in Vladivostok in the Far East Federal District. These plans, however, will likely remain on the drawing board in the coming years.

Russia and China conclude cooperation agreements during Xi Jinping's visit to Moscow last week. Most of the agreements are very general in nature and their implementation will require long negotiations and agreement on details. Goals of the agreements include developing cooperation in the fields of finance, investment and production technology.

Russia hopes especially for investments and financing from China, which is ready to provide 300 billion rubles (€5.3 billion) in financing to build a high-speed rail connection between Moscow and Kazan. The rail project is part of a planned transportation corridor between Moscow and Beijing.

During the visit, the Eurasian Economic Union and China representatives said they were beginning wide-ranging negotiations on trade and economic cooperation. Such cooperation would include measures to facilitate trade other than the elimination of customs duties.

Russia's foreign trade collapsed in the first quarter. The value of goods exports plunged 28 % y-o-y, mainly on lower export prices. Export volumes of many products, in fact, increased. Crude oil exports were up 13 % y-o-y and petroleum products over 24 %. Export volumes of copper and fertilisers increased sharply, while grain exports were up slightly from a year earlier. Oil and gas accounted as usual for two-thirds of goods exports. Other important export products included metals and chemicals.

The EU remained Russia's biggest export market by far, accounting for half of all exports. The value of exports fell by a third, however. APEC countries took over a fifth of Russia's exports.

The value of goods imports slid 37 % y-o-y. Imports were down significantly in all product categories on the weak ruble, poor consumer demand and the lack of investment demand. APEC countries were the biggest suppliers of imported goods to Russia, surpassing the EU as imports from the EU declined 44 %. China remained the largest single import provider. Its share of Russia's overall imports rose to more than 20 %, even though imports from China fell by nearly a third.

The sharpest drop in Russian foreign trade was again seen with CIS countries. Ukraine trade fell by nearly 60 % y-o-y (a year ago Ukraine was still Russia's biggest CIS trading partner). Russian trade fell considerably with Belarus and Kazakhstan, too, which are partners with Russia in the Eurasian Economic Union (EEU). Russian imports from Armenia, which joined the EEU at the beginning of this year, fell even more than imports from Ukraine.

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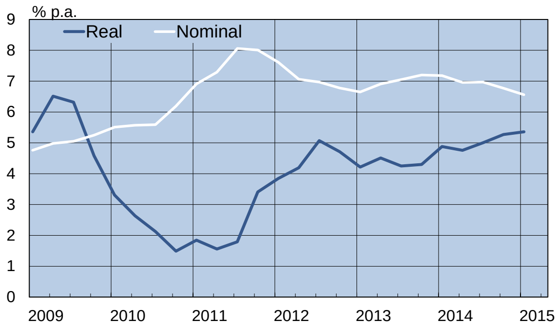
China

PBoC cuts interest rates and continues deregulation of deposit interest rates. On Monday (May 11), the People's Bank of China lowered its reference credit rates by 25 basis points. The one-year credit reference rate for banks now stands at 5.1 % and the deposit reference rate at 2.25 %. The rate cuts reflect the weak growth outlook and low inflation environment. Consumer price inflation accelerated only marginally to 1.5 % in April, while producer prices were down 4.6 % y-o-y, the same as in March.

The rate cut has only minor effect on the real economy as credit rates were deregulated in summer 2013. Interbank rates have gone down sharply over March–May, but this has yet to be reflected in general interest rates (see chart).

The deregulation of deposit rates is actually more important than the reduction of reference rates. Banks are now permitted to pay deposit rates 50 % above the reference rate (earlier 30 % above the reference rate). As a result, the ceiling on deposit interest rates is now 3.38 %. The formal deregulation of deposit rates is no longer a big step, although even after that China's banking system and monetary policy will not automatically function on a market-driven basis due to the central role of the state banks.

Average bank lending rates, %



Sources: Macrobond, BOFIT

Growth in number of migrant workers slows. The millions of internal migrant workers who leave their rural homes to work in cities is a special feature of China's labour market. A survey released in conjunction with labour market statistics showed that, according to the survey's definition, there were 274 million migrant workers in China last year, or 5 million more than a year earlier. The growth of the number of the migrant workers has slowed in recent years, and is now around 2 % a year.

Migrant workers lack official residency in the cities where they work due to China's household registration system (*hukou*). When work ends, they must often return to their rural domicile as many social services are tied to residency. While migrant workers increase labour market flexibility, they make it hard to judge labour market conditions, as migrant workers are not included in official unemployment figures.

Migrant workers traditionally have had little education, so they ended up in low-wage fields such as assembly, manufacturing or construction. The nearly endless flow of low-wage migrant workers to cities in past decades has helped fuel the Chinese economy's high growth and avoid large-scale labour shortages, even in coastal regions where growth was highest. The surge in wages, however, suggests pressure on labour markets.

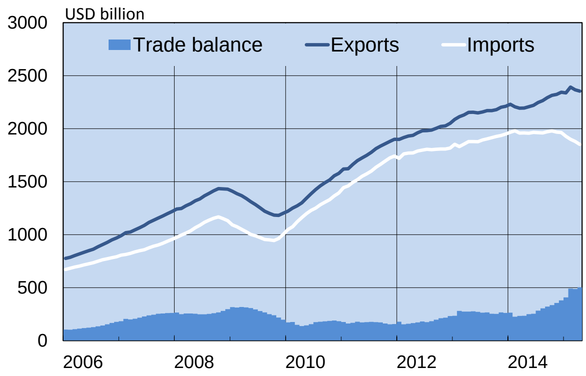
Slowing growth in the number of migrant workers indicates structural change in China's labour markets. The demand for low-skill cheap labour has fallen as assembly work has shifted to countries with lower labour costs. The Chinese economy's development and structural changes have shifted the focus away from production in low value-added branches to e.g. the service sector. Lower growth in the number of migrant workers also indicates that workers are increasingly finding work near their homes, so moving to big cities is no longer necessary.

Gradual evolution in structure of China's foreign trade. China's foreign trade slipped in April, with exports down 6 % y-o-y and imports off 16 %. China's April trade surplus amounted to $34 billion. The sub-index of new export orders in the purchasing managers' CPI also indicated a weak outlook for foreign trade.

There were large differences across export product groups. Exports of high-tech products fell only 2 %, while exports of mobile phones increased by nearly 24 %. Exports of labour-intensive goods plunged. For example, clothing exports were down 21 %. Underlying this trend are China's rising labour costs that have boosted prices of export products, and yuan appreciation. This trend, in turn, reflects the structural adjustment of the Chinese economy as it transitions from low add-value assembly industries to high value-added production.

While the on-going slide in commodity prices is partly responsible for the drop in imports, the volume of imports was also down about 8 % y-o-y in the first quarter of 2015.

China's foreign trade, 12-month moving total



Source: Bloomberg

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Russia

The slide of Russian output deepened in April. Rosstat reports Russian GDP contracted 1.9 % y-o-y in the first quarter, and that the volume of economic activity as measured by indicators for the five core sectors of the economy (industry, agriculture, construction, trade and transportation) contracted 2.3 %. This was despite much poorer domestic demand, as e.g. fixed capital investment and retail sales plunged 6–7 % y-o-y. Several observers noted that the weak ruble supported output in certain branches of basic industries. Export volumes in the oil and metals branches were also up. Public sector spending rose a lot.

Strikingly, the minor contraction in industrial output in the first quarter turned to a dive in April. Industrial output overall was down 4.5 % y-o-y. The drop in manufacturing output exceeded 7 %.

Nominal increase in public sector revenues comes to a near halt. First-quarter revenues to the consolidated budget, which includes federal, regional and local government budgets, as well as state social funds, increased by 1 % y-o-y in nominal ruble terms. Taking inflation into account, real revenues plummeted.

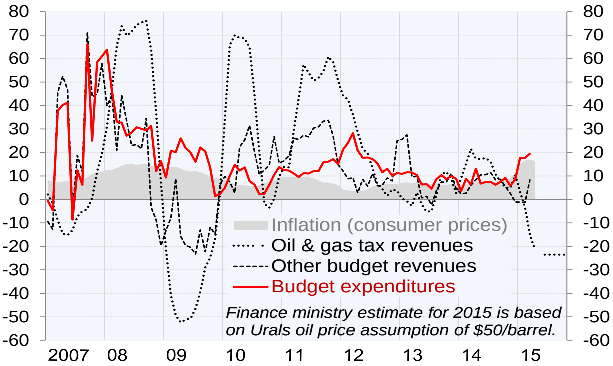
In the January-April period, revenues from export duties and production taxes in the oil & gas sector (which are nearly all denominated in dollars) were down over 20 % y-o-y in nominal terms (15 % in the first quarter). While lower oil prices reduced these revenues, the weakened ruble strongly offset the drop. The change in oil taxation implemented at the start of this year has also altered the revenue picture by reducing the oil export duty and raising oil production taxes. Other revenue streams to the consolidated budget were up 8 % y-o-y in the first quarter.

First-quarter consolidated budget spending increased by 20 % y-o-y in nominal terms. Topping spending growth was defence, this year an unusually front-weighted category (high outlays at the start of the budget year), which rose 50 % in the first quarter and 45 % for January-April. Pensions and other social security spending also increased about 30 %. Among spending in other major budget categories, spending on the economy and housing rose about 10 %. Spending on education and healthcare was unchanged in nominal terms from a year ago, while nominal spending on domestic security and law enforcement decreased slightly.

Federal budget revenues fell by more than 2 % y-o-y in the first quarter and more than 4 % in January-April. Regional and local government budget revenues, as well as revenues to state social funds, fell sharply. Federal budget transfers were used to make up for the reduced regional revenues and replenish social funds.

The consolidated budget deficit in the first quarter equalled 2.5% of GDP.

Change in public sector revenues and expenditures, 3-month moving total, %

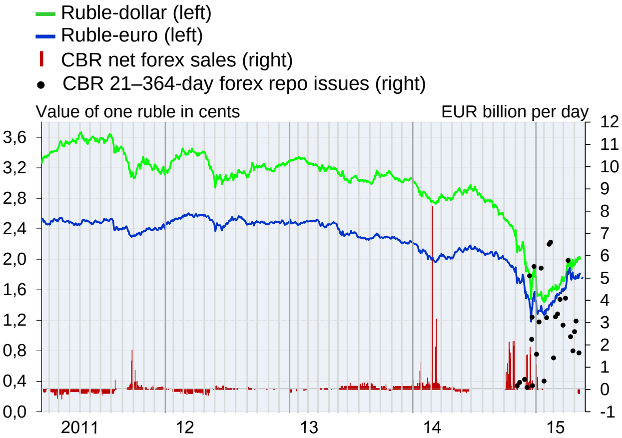


Sources: Finance ministry and Rosstat

CBR returns to the forex market. Last week (May 14), the CBR announced it started regular forex purchases to increase its forex reserves. The central bank emphasised that the purpose of the forex buying was not to support the ruble's exchange rate at any determined level. The CBR will purchase $100–200 million in forex daily on the market, but that amount can change with market conditions.

Since it announced the floating of the ruble last November, the CBR has made ruble support purchases only in exceptional situations. Also from November, the CBR has weekly provided banks with 6–364-day forex repo credits to help them repay foreign debt (which at the same time has supported the ruble). The ruble has also been supported by the government guideline issued in December to large state-owned exporters to limit the size of their forex assets, accompanied by signals from the state leadership that particular private companies should also limit their forex holdings.

Ruble exchange rate, CBR forex interventions and forex repo credits



Source: CBR

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China

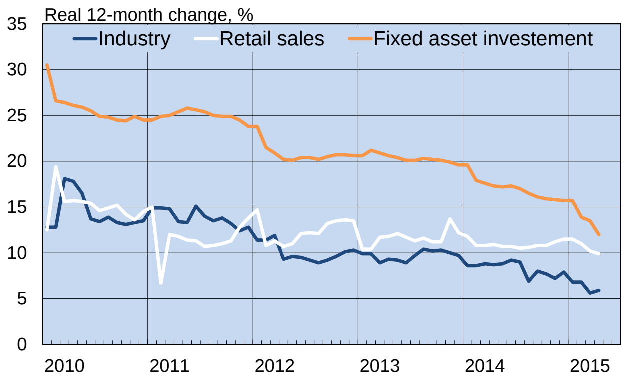
Investment growth slowed significantly in the first four months of the year. Growth in fixed asset investment (FAI) has slowed significantly all year, and was up just 12 % y-o-y in January-April. In comparison, FAI climbed 17 % y-o-y in the first four months of 2014. Falling growth in real estate investment caused by cooling in real estate markets particularly depressed investment growth.

Indeed, FAI growth, which was still above 20 % y-o-y in late 2013, has not been this tepid in at least a decade. The slowdown in growth reflects both China's cooling economy, and perhaps more importantly, on-going structural changes in the Chinese economy. The focus of Chinese economic activity continues to shift from manufacturing and primary industrial investment to consumption and services. As a result, FAI's significance is gradually waning as the Chinese economy evolves.

Several other indicators also point out to slowing economic growth in the first part of the year. For example, industrial output was up just 6 % y-o-y. While electricity production bounced back from a slight dip in March, the April level was nearly unchanged from a year earlier. On the other hand, retail sales, up 10 % y-o-y in April, grew faster than the economy and disposable incomes. Retail sales growth slowed only slightly in the first months of the year.

The April reading of the purchasing manager index (PMI) suggested a small rebound in industrial output. The PMI also tells of structural shifts in the economy; the service sector outlook remains strong, while new export orders are poised to fall.

Industrial output, retail sales and fixed investment



Source: Macrobond

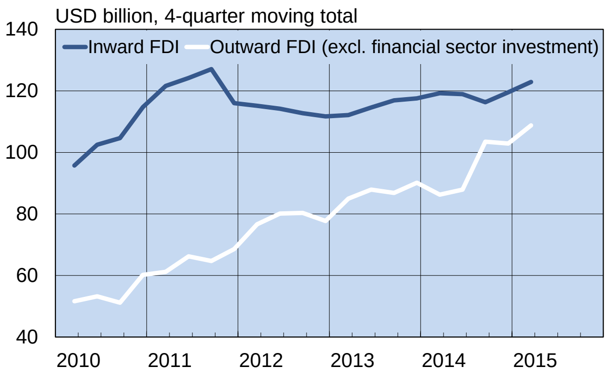
China's FDI flows up in the first quarter. China's foreign direct investment flows showed an overall increase in the first quarter of this year. Inbound FDI flows to China amounted to about $35 billion, up over 11 % from 1Q14. Outbound FDI flows from China increased 30 % y-o-y to $26 billion.

Although FDI flows from China have increased sharply over recent several years, they have yet to match inbound FDI flows to China. The difference in the amount of investment flows continues to narrow steadily, falling by half in the past year. When figures on the financial sector direct investments abroad are later compiled and included in outbound FDI, China's investment outflows are nearly on par with investment flows into the country.

The growth in FDI inflows to China has slowed and even remained flat in the recent few years, reflecting both lower growth of the Chinese economy and global growth in recent years. As Chinese companies continue to actively increase their foreign direct investment, the inbound-outbound FDI gap should vanish.

The OECD reports that last year China was the biggest receiver of FDI, followed by the US. The overall stock of FDI in China will remain considerably larger than the total stock of Chinese FDI abroad for years to come.

Chinese FDI inflows and outflows, USD billion



Source: CEIC

Demographic shifts affecting Chinese labour markets. Labour market figures released at the end of April show the number of job applicants fell 15 % y-o-y in the first quarter. The trend reflects China's aging population and fewer working-age Chinese relative to the general population – a trend exacerbated by China's one-child policy. While recent policy changes have sought to loosen rules to allow families to have more children, several observers note that many Chinese do not want more children, so the child-policy changes are unlikely to have much impact.

Given an environment of lower economic growth, the reduction in the labour supply has not led to significant labour shortages. Still, for example, there are more job openings than applicants in China's high-growth coastal provinces. The rapid rise in Chinese real wages, however, does clearly reflect pressure in the labour market. Soaring wages have accelerated the shifting of production of low-value-added export goods to countries with lower labour costs and to China's interior provinces that have lower wage levels.

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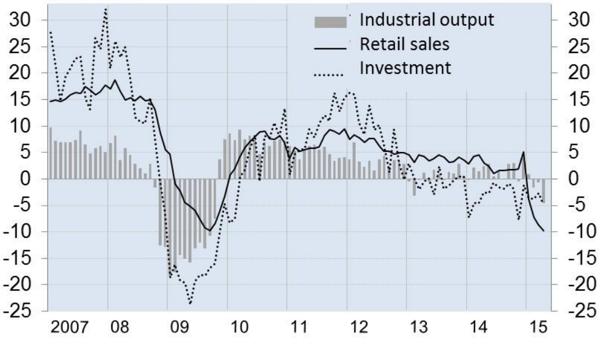
Russia

Russian domestic demand down sharply in April. The slide in the volume of retail sales accelerated to 10 % y-o-y, a drop similar to that witnessed during the 2009 recession. In January-April, the contraction was 7.5 % y-o-y.

The decrease in fixed capital investment continued last month at an annual rate of 5 %. For January-April, investment fell about 4 %. Construction activity was off 5 %. Measured in liveable floorspace, however, there was a 30 % increase in the volume of completed new apartments from a year ago. The increase echoes a building boom ignited a few years ago, when housing loans and mortgages were made widely available.

The economy ministry estimates Russian GDP contracted 4 % y-o-y in April, a rate higher than in the first three months of the year. The GDP contraction was accentuated by lower retail sales and industrial output.

12-month change in retail sales, investment and industrial output, %



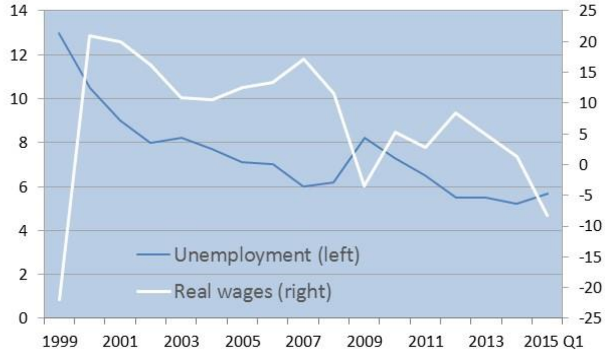
Source: Rosstat

Real wages continue to slide in Russia. Real wages declined in the fourth quarter of 2014 – the first time this has happened since the 2009 recession. The decrease has continued this year. For January-March, preliminary figures show real wages declined 8 % from 1Q14. The slide accelerated to 13 % y-o-y in April. Wage arrears also rose.

The real value of pensions began to fall at the end of last year, but not as fast as wages. Preliminary figures for January-March show a 4 % decline from 1Q14. Despite hard economic times and slated budget cuts, the government still struggles to hold the line on the real value of pensions. Russia's leaders still remember the 2005 nationwide demonstrations of disgruntled pensioners precipitated by changes in the social security system.

Russia's economic difficulties now affect the daily lives of most people. A March survey by the Sociology Institute of the Academy of Sciences found that 46 % of respondents said their economic situation had deteriorated over the past year. In October, only 22 % of interviewees held this view.

Unemployment rate and on-year change in real wages, %



Source: Rosstat

Russia's low unemployment partly reflects a shift of dismissed workers to the shadow economy. Based on ILO methodology, Russia's unemployment rate was 5.8 % in April. The unemployment rate has climbed gradually since last summer after hitting a post-Soviet record low of 4.9 %. In light of Russia's deteriorating economic conditions, the relatively modest increase in unemployment is striking.

A low unemployment rate may not so much reflect a robust labour market as the special characteristics of the Russian economy, particularly low labour productivity. Furthermore, wages are flexible, but jobs tend to be more or less permanent. As much as half of a worker's wage package in Russia can consist of various bonuses that the employer finds easier to adjust than wages. Workers, in turn, tend to stick with their employer even after a wage cut due to the modest size of unemployment benefits.

A part of the workforce is employed in the shadow economy, where taxes and social security contributions are not paid. As redundancies in the formal economy increase and unemployment benefits are small, workers move to the shadow economy, even to take jobs unrelated to their skillsets. The social affairs ministry reports the number of the people working in the shadow economy increased by 5 % in 1Q15.

Russia's low unemployment rate is also a manifestation of its shrinking labour pool. The latest cohorts of people reaching working age are smaller than before. This demographic trend is set to continue, restricting the growth possibilities of the economy also over the long run.

The government decided in March to finance work projects in localities threatened with rising unemployment. The regions getting the most support feature large or regionally important companies such as Tatarstan and Samara, home to Russia's car industry. Observers have criticised the plan for directing support to large, established enterprises, which have significant influence on social conditions in their regions. Such support, they note, does not promote the structural change needed to grow the economy and reinforces old structures.

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China

IMF no longer considers the yuan undervalued. Concluding its annual Article IV country review, the IMF consultation mission this week released a brief appraisal of the Chinese economy and its policy recommendations. The IMF expects China's economic growth to slow this year to 6.8 % and inflation to remain around 1.5 % at year's end. It said China's labour market has performed well under slowing growth, which has supported household consumption.

Since the global financial crisis, China's growth has been largely based on fixed asset investment financed with debt. The problems related to debt and overcapacity will require an on-going response in the years ahead. If the GDP growth exceeds the official 7 % target due to further declines in oil prices and stimulus actions already taken, China should reduce its debt and overcapacity problems faster. If GDP growth falls below 6.5 %, however, further stimulus should come transparently from fiscal easing. Furthermore, any stimulus should be geared to protecting those in weakest position and supporting balanced economic growth and reforms.

To increase productivity, IMF recommends transition to a market-based financial system. In practice, it is time to liberalise deposit interest rates and transit to monetary policy based on interest-rates. This requires the introduction of genuine policy interest rates in implementing monetary policy. The implicit guarantees that affect the entire financial system must be gradually lifted.

The IMF estimates that the yuan's real effective exchange rate has strengthened to the point where the yuan should no longer be considered undervalued. However, the large current account surplus requires further reforms to reduce excessive saving. The IMF strongly recommends allowing more adjustment of the yuan and moving to a floating exchange rate within 2–3 years. The IMF said it will be only a matter of time when the yuan will be added to its Special Drawing Rights (SDR) basket currency.

Nominal and real effective yuan exchange rates

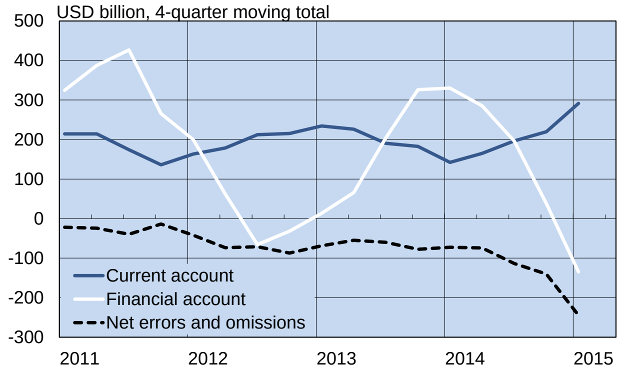
Source: BIS

China's foreign currency reserves shrink as capital exports rise. The goods trade surplus continued to rise in January-March on lower commodity prices that reduced the value of imports. The services trade deficit was up on increased Chinese tourism abroad. The services deficit was, however, insufficient to balance overall trade surplus growth, so the current account surplus was still up in the first quarter. On-year, the current account surplus reached nearly $300 billion, or about 2.8 % of GDP.

Net capital flows have recently been negative. Preliminary balance-of-payments figures show a net outflow of capital from the country in the past four consecutive quarters. The aggregate deficit of the capital and financial accounts amounted to $135 billion for 2014. The balance of payments "net errors and omissions" item was deeply negative, suggesting covert capital exports on a large scale and/or a smaller current account surplus than reported.

With increased capital exports and shifts in foreign exchange rates, China's currency reserves decreased in January-March by $113 billion to about $3.73 trillion.

Chinese balance-of-payments main items, USD billion



Source: Macrobond

Changes in capital flows reflect natural trends in the Chinese and global economies. Besides the government encouraging companies in recent years to invest in production abroad, the possibilities for Chinese to invest abroad have increased in step with rising living standards and relaxation of capital controls. There will be even more foreign investment options for Chinese at the beginning of July, when mainland Chinese will be allowed to invest in mutual funds in Hong Kong and mainland Chinese mutual funds can sell their products in Hong Kong.

The increased mobility of capital in the evolving environment forces the government to come to grips with the challenges of policy formulation. It is evident that China's former expansionary policy no longer yields the same benefits it once did, and that capital flows now play a greater role in the formulation of exchange rate policy and monetary policy as a whole.

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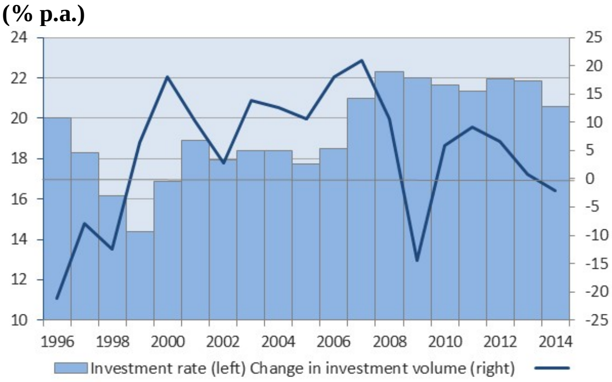
Russia

Russia slashes public investment. Economy minister Alexei Ulyukayev has announced that investment spending from the federal budget would have to be limited over the next few years due to Russia's frail financial condition. The federal budget framework for 2016–2018 is currently under preparation, including planning of investment outlays. After long negotiations, a working group with members from various administrative branches reached agreement on making 1.8 trillion rubles available for investment this year and next and 1.6 trillion rubles in 2018. This year, about 1.6 trillion rubles (€28 billion) in investments will be financed out of the federal budget. The sum was reduced already in April as part of agreed across-the-board spending cuts for the current year. In addition to cuts at the federal level, regional governments also have to cut back on investment spending.

Federal budget investment spending relative to GDP has fallen every year since 2009, when it amounted to 3.1 % of GDP. Investment spending is estimated to be 2.1 % of GDP this year and 1.5 % in 2018.

Given president Putin's order that spending on social security and defence remain untouched, the reduction in fixed investment was inevitable. The ministry of economy hopes that the effectiveness of investment will be improved by cutting back on new investment projects and paying special attention to the actual need when choosing new projects. Furthermore, focus must be put on completing the unfinished projects that are at their final stages. This is done to reduce the large number of unfinished projects. Those unfinished projects proved ineffective may face cancellation.

Investment rate (% of GDP) and change in investment volume (% p.a.)



Source: Rosstat

Lack of investment is a big problem for the Russian economy. Fixed capital investment (both private and public) has been inadequate to meet Russia's needs throughout the post-Soviet era. At its highest, Russia's investment rate has reached 22 % of GDP. While that is quite acceptable for a developed economy, it is far too low for a county seeking to modernise and diversify its production structures.

Russian government supports investment in production focused on import substitution. The state Industry Development Fund has selected its first candidates for financing support. The projects to be financed include companies operating in the machine-building branch, pharmaceuticals and scientific research. The firms involved in machine-building include those making diesel engines, railway cars, automobile parts and farm equipment.

Over 900 companies so far have applied for loans from the fund. The fund grants loans for up to seven years at 5 % interest. The loan can represent 15–74 % of the total value of the project. On average, about a third of the project is financed with fund credit.

The loans are an extremely good deal for borrowers, given that Russia's current inflation rate is about 16 %. Industry minister Denis Manturov said the fund loans are most important in terms of economic development, because long-term financing for new investment projects has dried up for Russian companies.

Many observers doubt domestic production can fully make up for the loss of imports, however. Implementation of a modern production base usually requires huge investment, not to mention the fact that profitable production requires also export capabilities, i.e. attaining internationally competitive quality and price. The fund capital is also rather small; currently just 20 billion rubles or about €345 million.

Russia drops to sixth place among Finnish export markets. After falling for a couple years, Finland's exports to Russia decreased by an additional third on-year in January-March to €700 million. In the first quarter, Russia's share of Finland's exports fell to just over 5 % of total exports. Russia now ranks sixth among destinations for Finnish exports. Exports to Russia declined in all categories of goods.

After hitting bottom in January, the fall in exports has slowed, due in part to the stronger ruble. Finland's top exports categories, i.e. machinery and chemical products, remained at about the same level as in March 2014.

In January-March, the value of imports was €1.8 billion, down by nearly a quarter from a year earlier. The fall in imports largely reflected a decrease in import prices, as import volumes of e.g. crude oil and certain metals rose. Russia, which accounts for 13 % of Finland's imports, is now Finland's second most important import provider after Germany.

Russian tourism to Finland decreased in January-March. Compared to a year earlier, crossings of Russians along the eastern border were down by a quarter and overnight stays by Russians down by half.

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China

Chinese share prices ride the rollercoaster. At the end of last week, Chinese share prices plunged dramatically, leading many to believe a major correction was under way. Share prices fell 6 % in one day on the Shanghai stock exchange. On the Shenzhen exchange, prices were down 5.5 % and in Hong Kong 2.2 %. Trading in a specific share on the Shanghai exchange is halted if its intraday price falls or rises 10 %. Last Thursday, about a quarter of traded shares hit their bottom limits.

At the start of this week, share prices rebounded, returning to the same level as before last week's panic. A variety of explanations have been offered as to the cause of recent spikes and falls in share prices, but shifting market sentiment is likely an underlying factor. The continuing rapid rise in the number of small investors entering the market and increased trading on margin have contributed to higher volatility. Chinese stock market trends have become increasingly speculator-driven, and, in the view of many, decoupled from trends in the real economy.

Stock market trends in mainland China

Source: Bloomberg

Share prices have skyrocketed over past five months. In mainland China, where most trades involve small investors, share prices have risen considerably faster than share prices elsewhere in the world. On the Shanghai exchange, share prices are up nearly 50 % since the start of the year, while Shenzhen share prices have doubled. In Hong Kong, too, share prices are up about 20 % since the beginning of the year. Price-to-earnings (P/E) ratios, a rough measure of share value relative to company performance, are now seen as unrealistic.

A major correction in share prices would create a new set of problems, particularly for investors who have bought shares with borrowed money. Thanks to trading rules, share prices in mainland China by definition cannot collapse overnight. Over the long run, however, the collapse of a share bubble is likely to depress stock market activity for years as it did after the collapse of the 2007 share bubble. This would increase China's debt problems by making companies more dependent on debt financing. An even more serious problem from a market collapse would perhaps be to impede progress in much-needed financial market reforms for stock market development.

Banks ordered to continue financing local government construction projects in China. In mid-May, the government announced a rule change, whereby banks are obliged to continue financing construction projects initiated by the local governments if the decision to lend to the project had been made before last September.

In addition, the new rule calls for continued bank funding even if revenues from the construction project are ultimately insufficient to repay the loan or even service interest costs. In such cases, the bank must renegotiate the interest rate of the loan and revise the loan repayment schedule to correspond to project returns. The local government retains ultimate responsibility for repaying the loan. If the revenues of the project are insufficient to cover the loan, the local government must finance repayment of the loan either by finding private investors for the project or including the debt in its budget.

Local governments were earlier subject to a balanced budget rule that prevented them from taking on debt. Many circumvented this rule through the use of local government credit vehicles (LGCVs). LGCVs were outlawed last autumn and in their place local governments were granted the right to issue municipal bonds. By allowing local governments to restructure their debts the central government aims to reduce servicing costs and foster financial transparency. These bond-based debt restructurings have not gone without problems. After the low bond yields failed to generate investor interest, the central government had to order banks to purchase the bonds. Jiangsu province was the first local government to sell its bonds in May after a failed bond sale in April.

China opens clearing market for payment cards. Since ending UnionPay's national monopoly on processing yuan-denominated electronic card payments last month, Chinese and foreign entities can now apply to the central bank for permission to engage in yuan payment processing. Among other things, qualified applicants must demonstrate registered capital of at least 1 billion yuan (€142 million.) and at least five years experience in banking or clearing activities. Foreign companies must establish a subsidiary in China. The PBoC and CBRC have yet to release detailed rules.

The value of bank and credit card payments last year increased a third from the previous year to 42.4 trillion yuan (€6 trillion). Electronic cards are now used in almost half of all retail sales in China, where 4.9 billion cards have already been issued.

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BOFIT Weekly
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Russia

No changes expected in Russian corporate taxation in coming years. Last week, finance minister Anton Siluanov presented his ministry's proposed tax policy framework for 2016–2018. He promised that the tax burden on Russian corporations would not increase and that no major tax reforms were planned for the next few years. Siluanov noted that Russia's tax system is already largely in place, with nearly all of the major reforms of recent years now implemented. Big changes include revision of taxation of the oil sector (see BOFIT Weekly 48/2014), subjecting foreign-registered Russian firms to tax liability (BOFIT Weekly 48/2014), as well as laws on intra-group transfer pricing and conglomerate taxation (BOFIT Weekly 35/2012). In the future, attention will focus on improving the practical functioning of the tax system.

Under the released framework, the tax system would be developed over the coming years to support economic growth and increase tax fairness. The minister emphasized the need to immediately start the measures aiming at bolstering economic growth. Beyond traditional subsidies for capital investment, the ministry hopes to stimulate investment through e.g. lowering the tax burden on companies during the initial investment phase to when an investment becomes profitable. Companies will be allowed to deduct investment expenses from their profit tax and the government will try to speed up payment of value-added tax refunds of exports. In federal districts targeted for development (e.g. the Far East Federal District), companies will get additional benefits for investing. Special tax incentives will also be made available to encourage operation of small and medium-sized enterprises (SMEs).

To increase tax fairness, the ministry would make tax evasion harder and grant benefits to prudent taxpayers. To limit the extensive abuses of the VAT refund system, tax officials are moving increasingly to on-line services. The Duma this spring passed a law on tax amnesty for private individuals voluntarily declaring off-shore assets of to the tax authorities. The law took effect this week (June 8). The law grants tax amnesty to repatriated assets (except the fruits of criminal activity) if the declaration is filed by the end of this year (BOFIT Weekly 14/2015). It is hoped that the law will increase openness and in longer term broaden the tax base.

Loan stock growth stalls for Russian banking sector. The stocks of both corporate loans and loans granted to households contracted in the first four months of this year. SMEs, in particular, found it hard to get bank financing. At the end of April, SMEs accounted for 18 % of banks' corporate loan stocks, down from 22 % in April 2014.

In annual terms, the loan stock still increased, but the growth was lower than previously. In January-April, the stock of corporate loans was up 17 % y-o-y and the stock of loans granted to households up 4 %. Taking into account Russia's current inflation of around 16 %, the volume of corporate borrowing has practically not increased at all in real terms and household borrowing is down substantially.

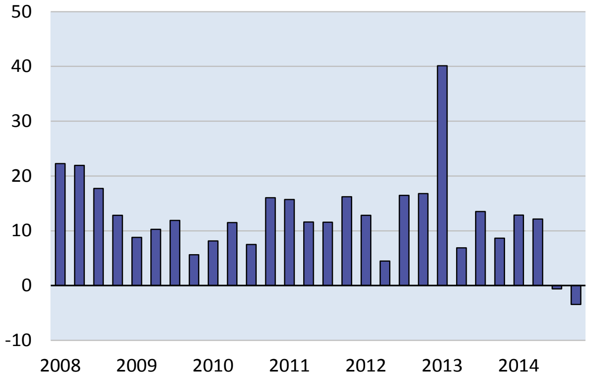
About half of corporate loans exceed three years, and about a third of corporate loans are denominated in foreign currency. The stock of non-performing corporate loans increased by a third in the first four months of this year, but the rate of increase has been lower than during the 2008-2009 financial crisis. Non-performing loans represented 6 % of the corporate loan stock at the end of April. The share of non-performing loans to households was 7 %.

Foreign direct investment inflow to Russia last year was lower than in 2009. Inbound foreign direct investment flow to Russia last year fell to $21 billion, down from an average of $55 billion a year during 2007–2013, and even well below the $37 billion registered during the crisis year of 2009. Supported by the early months, the FDI flow was still positive for the year as a whole, but in second-half net FDI flows turned negative, i.e. more investment flowed out of Russia than into Russia.

As usual, the largest inbound flows came from Cyprus, the Bahamas and the British Virgin Islands. Many large Russian firms are registered or have subsidiaries in these countries for e.g. tax purposes, and a large share of investment flows into Russia from these countries is apparently of Russian origin. Largest FDI flows went last year to the service sector, particularly finance and insurance and trade.

FDI outflows from Russia amounted to $56 billion last year, which was close to the annual average for 2007–2013. The flow of outbound FDI was about the same in all four quarters of 2014. Cyprus was the top destination, accounting for nearly half of outbound FDI (and tripling from a year earlier as the economic situation of Cyprus was more stable than in 2013). High growth was also seen in investment flows to other major destination markets. For example, Russian FDI flows doubled to the United States and quadrupled to Switzerland.

Quarterly flows of inbound FDI to Russia, USD billion



Source: Central Bank of Russia

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China

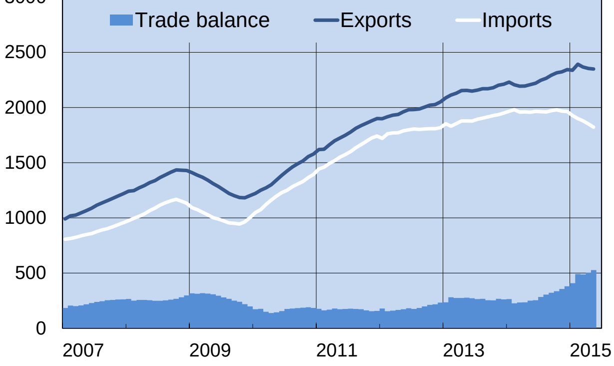
China's exports and imports continue to shrink. China's foreign trade statistics show that the value of exports compared to a year earlier contracted by 2 % in May, while the value of imports was down 18 %. The May trade surplus again approached the all-time monthly record of $60 billion. In the three-month March-May period, the value of exports declined 8 % and the value of imports was down 16 % from March-May 2014.

The sharp drop in the value of imports reflects falling global prices for energy and other commodities, but also lower import volumes, which in recent months have been running slightly below levels a year earlier. However, the volume of crude oil imported to China in March-May was up 4 % from the same time in 2014. Also export prices have been on a mild downward trend and export volumes have remained lower than a year earlier.

The decline in import volumes reinforces the wider view of a slowing Chinese economy. Export trends have been affected by growth in export markets and shifting foreign exchange rates. While the yuan-dollar exchange rate was relatively stable since last year, the yuan has appreciated against most of the currencies of its other main trading partners. This shift partly explains why China's exports to the US in recent months have continued to rise, while exports to the Eurozone and Japan have declined 10–15 %.

A notable trend is the significant decline in China's processing trade as a share of total goods exports. At the start of this decade, the processing and assembly activities in international production chains accounted for over 50 % of the total value of goods exports in China's foreign trade figures. Since then, the share of processing trade has gradually declined, and was about 40 % in January-May of this year. At the same time, the structure of imports has not undergone a similar shift. Imports reported as processing trade have held steady at around 30 %.

China's foreign trade, USD billion



Source: Bloomberg

Chinese inflation slows further. The 12-month rise in consumer prices slowed from 1.5 % in April to 1.2 % in May. The slowdown largely reflects the decline in food prices in recent months. Consumer price inflation for non-food goods and services, however, remained largely unchanged in April and May. May producer prices slid 4.6 % y-o-y. Chinese producer price have fallen since spring 2012, evidencing struggles with structural issues like overcapacity.

According to both official and private data sources, the drop in apartment prices on housing markets has ceased and prices may actually have started to rise a bit in most cities. Stock markets, on the other hand, face the risk of a price bubble due to market participants buying shares on margin. The overall trend in prices does not indicate a risk of deflation that would require easing of monetary policy.

Mainland China stock markets not quite ready for incorporation into global stock indexes. On Tuesday (June 9), the global stock index provider MSCI announced that China's yuan-denominated A-shares were still ineligible for inclusion in its Emerging Market (EM) stock index. Despite substantial liberalisation of China's capital markets during last year such as the stock connect of the Shanghai and Hong Kong exchanges, the extension of the RQFII (renminbi qualified foreign institutional investor) programme to several new cities, as well as specification of tax rules for capital gains, MSCI noted that making portfolio investment to China remains difficult. Investor roadblocks include the inflexibility, unpredictability and the lack of transparency of the current quota system, as well as limits on capital mobility and liquidity of many investment instruments. Suspicions also linger about protections for "beneficial owners" in the investment chain, despite efforts of the China Securities Regulatory Commission (CSRC) to clarify rules.

MSCI said that China is progressing at a good pace in resolving its accessibility issues, and that the ultimate inclusion of mainland A-shares into the MSCI EM index would happen gradually. The weighting of mainland Chinese H-shares listed in Hong Kong in the MSCI EM index is already about 25 %, and over the next year the index will incorporate shares listed elsewhere abroad. Adding mainland A-shares to the EM index starts after overcoming technical hurdles related to investing. The opening up of China's capital markets to the world and increasing A-shares to their full weight in the indexes could, by current estimates, lead to a weighting of Chinese shares in the MSCI EM index of as much as 44 %. Alternatively, MSCI could distinguish China with its own index as it does for several large developed economies.

Share indexes guide the actions of many investors. Changes in the weighting of indexes like the MSCI EM would force adjustments in stock markets and capital flows.

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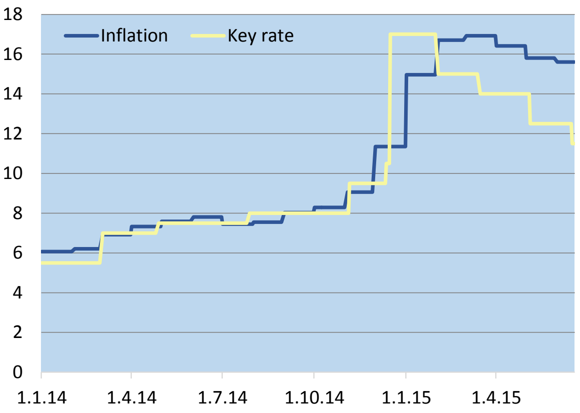
Russia

CBR lowers key rate for fourth time this year. The Central Bank of Russia lowered its key interest rate one percentage point on Tuesday (June 16) to 11.5 %. The CBR said the rate cut was justified in light of lower inflationary pressures and Russia's weak economy. The CBR expects inflation to fall further over the next 12 months to below 7 % and reach its 4 % target in 2017. The CBR said that, while it was prepared to keep cutting rates, emerging inflation risks could limit monetary easing in the months ahead.

As the effects of the price spike caused by the ruble's dive in the final months of 2014 have faded, inflation has gradually subsided in recent months. Moreover, the ruble enjoyed a period of strengthening between early February and end-May, while consumer demand continued to contract. The CBR also noted that most of the inflationary impact from Russian counter-sanction import bans introduced in August 2014 has been digested. However, as of end-May, consumer prices were still nearly 16 % higher than a year earlier. Food price inflation traditionally slows in the summer months as domestic produce reaches the market. On the other hand, the hikes of 7.5−10 % in rates for regulated utilities and services will add to inflationary pressures when they take effect on 1 July. The CBR stated that a possible relaxation of fiscal policy could also be an inflation risk.

Russian 12-month inflation and CBR key rate, %



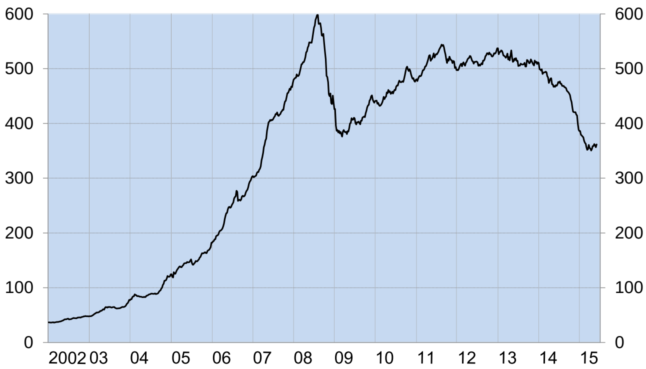
Source: Macrobond

CBR governor Nabiullina discusses outlook for Russia's foreign currency reserves. At a banking conference in St. Petersburg at the start of this month, CBR head Elvira Nabiullina noted that Russia's current level of foreign currency reserves (about $360 billion) is quite adequate by international standards. For example, the reserves are large enough to cover nearly eleven months' worth of imports. However, given the special features of the Russian economy and current market conditions, Nabiullina said she considered optimal that currency reserves would cover 2-3 years of substantial capital outflows. The CBR estimates this would require currency reserves of about $500 billion. Russia's currency reserves shrank last year by about $125 billion, largely on capital outflows.

Nabiullina said increasing the currency reserves to $500 billion would be accomplished through gradual currency purchases spread out over several years. The central bank began currency buying in mid-May and has been spending on average about $200 million a day. As of mid-June, currency purchases totalled about $3.8 billion.

The CBR has emphasised that gradual increasing of the currency reserves is not conflicting with the current policy of inflation targeting and that it is not meant to maintain the ruble at a specific exchange rate. The ruble began to lose ground against the euro and the dollar at the end of May after nearly four months of appreciation. In recent days, the ruble's exchange rate has stabilised. Many market participant comments on the CBR's currency buying have reflected surprise over the policy direction. Last November the CBR said it would let the ruble float.

Russia's currency reserves 4.1.2002−5.6.2015, USD billion



Source: CBR

Russia resumes TIR freight customs arrangement. Goods shipments under the TIR treaty (Transports Internationaux Routiers or International Road Transport) enjoy expedited treatment at border crossings. The use of TIR carnets has been at risk to ending in Russia for nearly two years. During this period, Russian customs has ceased to recognise the TIR system at nearly all border-crossing points due to a dispute over customs payments with Russia's national carrier organisation ASMAP, which guarantees TIR shipments. After a court decision, the government's intervention and finally president Putin's decree issued this spring, Russian customs announced last week that they had reached a deal with ASMAP on resuming the use of TIR carnets. Russia is now also in compliance with the Eurasian Economic Union's common practices approved at the end of last month.

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China

Chinese economy continues to slow. May figures reinforce the view that China's economy remains on a lower growth trend. As it has for months, on-year industrial output growth hovered around 6 % y-o-y, while the volume of retail sales (a rough indicator of service sector performance) was up 10 %. Electricity production in recent months has held at the same levels as a year ago.

While the slowing of growth in industrial output and retail sales appears to have ended, demand factors indicate further slowing ahead. On-year growth in fixed asset investment (FAI) slowed again significantly last month, while foreign trade figures for the first five months of the year reveal sluggish export demand. Under the current situation, it is difficult to see how private consumption alone could make up for the slowdown of other demand factors and stop the overall growth rate from falling.

The key purchasing manager indices (PMIs) show industrial labour demand remains steadily on a long-term downward trend. In contrast, labour demand in the service sector eroded rapidly in the first five months of this year. However, there is no other evidence of a wider weakening of labour market conditions.

Impacts of economic slowdown worry European firms operating in China. The European Chamber of Commerce in China has just released its annual business confidence survey European Business in China. As last year, nearly half of the European firms operating in China again reported the country's slowing economy as their biggest challenge. More than half of the over 500 firms responding to the survey still saw rising revenues, but their expectations of growth and profitability has dimmed.

The survey reflected general concern among firms about China's rising labour costs. Faced with flagging growth prospects and eroding profit margins, many firms said they were considering curtailing investment plans and reducing wage costs. Although companies primarily strive to stay in the important Chinese markets through cost-cutting, rising labour costs and the yuan's appreciating exchange rate have caused many labour-intensive branches to move their production elsewhere in Asia.

Respondents noted that problems related to the legal and regulatory environment have remained largely unchanged from a year ago. Foreign firms still find Chinese regulations unclear, and have big problems with bureaucratic red tape and inconsistent rule enforcement.

In their efforts to move up the value chain, European firms would like to see China moving ahead with reforms and improvements in the business environment to promote e.g. product development and innovation. The share of companies in China actively engaged in R&D activities has not increased in the past five years, and most of the firms engaged in R&D mostly localize products and services for Chinese clients. Nearly 60 % of responding firms said China's strict Internet regulation and blocking of international service providers such as Google interfered with their everyday operations. It is clear that the government's tighter monitoring of the Internet and increased censorship are impacting operations of foreign and domestic companies alike in China.

Actual progress in reform of China's state-controlled enterprises still unclear. Despite an impressive launch in 2013, China has little to show for its latest attempt at reforming inefficient state-owned enterprises (SOEs) to make them operate in accordance with market principles. Reform efforts seem to have taken a step forward and a step back.

Efficiency measures announced this spring included pilot programmes for six large SOEs. The programmes are intended to provide lessons that can be applied on a wider basis to managing state firms. The nature of the pilot programmes suggests that privatisation will only play a minor role in reform efforts. At least as far as firms controlled by the central government are concerned, the main goal appears to be increasing market guidance through other means. Local administrations, which are in weaker economic shape than the central government, may have a greater appetite for privatisation sales of their businesses.

Only a tiny fraction of the huge number of companies owned by the central government and local governments have any actual strategic significance. The State-owned Assets Supervision and Administration Commission (SASAC) oversees such firms. SASAC currently manages 112 firms, but a two-thirds reduction in that number has been proposed. Progress was made this spring in the planning and implementing of mergers of SOEs, with a view to exploiting economies of scale. The consolidation of SOEs might result in significant synergies and raise the international competitiveness of Chinese SOEs, but competition in domestic markets will not increase.

Media reports note that SASAC has submitted to the government an outline of measures to increase efficiency and productivity at state firms. Sectors are currently classified according to their strategic importance and the government's goal is to have absolute control, strong control or some influence over the sector. The SASAC proposes moving from the closed-sector model to an arrangement with ten or so large SOEs operating in strategic sectors.

The government's latest policy framework is a clear step backward in reform. It calls for the Communist Party to take the reins in SOEs and increase state control. It says that appointment of top management in SOEs should be left more to party officials and the reporting duties of SOEs to the party should be increased. Such measures are inconsistent with efforts to raise market-based efficiency and competition. They also erode confidence that the government can succeed in reforming state enterprises.

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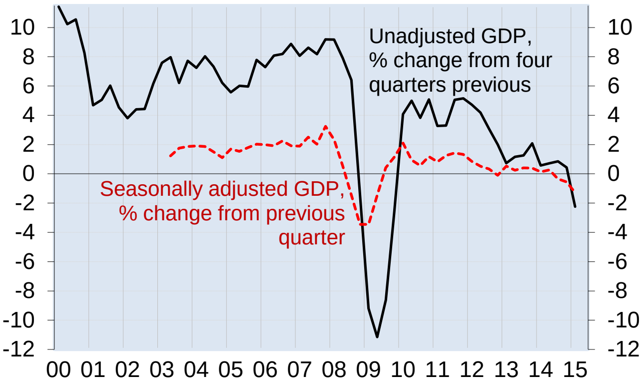
Russia

Depressed Russian demand and output continued in May. For the third month in a row, the volume of retail sales was down about 9 % y-o-y. The contraction for the first five months of 2015 was over 7.5 %. When seasonally adjusted and cleaned up for differences in the number of working days, retail sales held steady for the period following a large drop in January. Real disposable household incomes have declined gradually since autumn 2014. Real incomes in April-May were down about 5 % y-o-y.

Investment decline deepened in May, scoring about 7.5 % from May 2014. The on-going year-and-a-half contraction in the construction sector worsened in May. In the first five months of the year, investments were down nearly 5 % y-o-y and over 8 % from two years ago.

The slide in industrial output continued in May. The output was down about 5 % y-o-y in April-May. Most of this reflects the fall in manufacturing, down over 8 % y-o-y in May. Thanks to a relatively merciful first quarter, the on-year drop in manufacturing for January-May was 4 %.

Changes in Russian GDP, %



Source: Rosstat

Economy minister Alexei Ulyukayev noted his ministry's estimate that GDP contracted 3.2 % y-o-y in the first five months of this year. Deputy economy minister Alexei Vedev, who is tasked with forecasting and economic monitoring, reported that seasonally adjusted GDP contracted in May, but less than in previous months. State-owned Vnesheconombank (VEB) has also begun to release rapid GDP estimates. VEB calculates that GDP contracted 3.4 % y-o-y in January-May, and that the on-year drop in April-May was about 5 %. VEB's chief economist is Andrei Klepach, Vedev's predecessor who headed up macro economy at the ministry for many years. The latest Rosstat figures show GDP shrank 2.2 % y-o-y in the first quarter. After minor adjustments in the GDP data over many previous years, Rosstat now says seasonally adjusted GDP started to contract already in 3Q2014.

Forecasters slightly improve their Russia forecasts for this year. In May and June, a number of authorities, including Russia's economy ministry, the Central Bank of Russia, the IMF, the World Bank, the OECD and the EBRD, issued revised 2015 forecasts for the Russian economy. Most forecasts gave a little improved outlooks for the oil price, at or almost at $60 a barrel in 2015. Nearly all, including the Consensus Economics forecast of June, now expect GDP to contract 2.7–3.5 % this year.

Most expect inflation to slow a bit better than in their earlier forecasts, but this has not lead to across-the-board alleviations in expectations of the drop in private consumption. The forecasts of the economy ministry, the CBR and Consensus Economics see private consumption declining around 6 % this year. Estimates of the expected decline in investments have become milder, even if the differences among forecasters remain quite large (e.g. the three above-mentioned forecasts see drops ranging from 5 % to 11 %). The economy ministry and the CBR now foresee the volume of goods and services imported to Russia will not drop by a third in 2015, but rather by 22–25 %.

President Putin speaks to foreign investors at St. Petersburg international economic forum. Putin thanked investors who have continued to operate in Russia despite the political situation. He noted that, because the economy was in better shape than many had feared at the end of last year, Russia could now return to dealing with its structural challenges such as improving the business environment. The latest plan to attract investment largely relies on preferential tax treatment: the corporate tax burden is not to be increased over the next four years, and small and medium-sized enterprises, as well as newly established firms, are to get special tax breaks. Putin assured listeners that the Russian economy was on track for growth and development. Many observers were puzzled by the president's optimistic take on the current state of the economy, as well as the narrowness of solutions proposed to deal with difficult, long-standing structural problems.

EU and Russia both extend economic sanctions. The EU voted on Monday (June 22) to keep economic sanctions against Russia in place through January 2016. These sanctions were imposed last August and expanded in September. Capital market sanctions restrict financing of over 30 days to certain large Russian banks as well as energy and defence companies. Arms trade with Russia is forbidden, along with restrictions on exports of dual-use products and products and services for oil exploration and production.

On Wednesday (June 24), Putin responded with a decree maintaining Russia's import bans until August 6, 2016. Last August, Russia banned the imports of many food items from the EU, Norway, the US, Canada and Australia. The list of banned products published after the extension had only minor changes compared to the one in effect currently.

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China

Chinese wages continue to rise, though at a slower pace. The average wage for city workers last year rose 9 % to around 4,700 yuan (€560). Wages were up in all major sectors: manufacturing 10 %, wholesale and retail trade 9 %, construction 9 % and finance 9 %. In euro terms, wages were up about one percentage point less as the yuan strengthened against the euro in 2014.

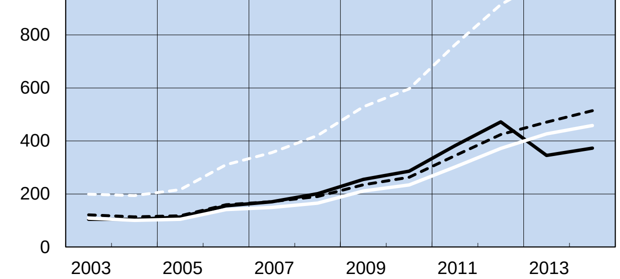
The overall wage growth slowed from 10 % in 2013 as expected. Wages continued to rise rapidly, however, and wage hikes were large also in real terms as inflation remained below 2 % last year.

There are significant regional variations in labour market conditions and wages. Wages have climbed fastest and been highest in the big cities and fast-growing coastal regions. For example, a survey of Standard Chartered Bank found that industrial firms in the coastal Guangdong province this year again expect to face labour shortages. In particular, they expect that they will have to raise migrant worker wages in the province more than 8 %.

Wages in China have risen on average more than 15 % a year over the past ten years, giving indication about the huge productivity gains the country has made. Total productivity has risen dramatically as millions of under-employed people from rural areas have moved to work in cities. As the growth in the inflow of migrant labourers has slowed, productivity gains have been invoked by production shifting to producing goods with more value added.

The rapid rise in wages also indicates pressures in China's labour markets as the coastal industrial regions face labour shortages. The slowdown in economic growth and lower growth in demand for workers in part explain the slowdown in the rise of wages. In addition, pressure to raise wages further will be eased by the fact that labour-intensive industries are shifting their production to emerging economies where labour costs are lower.

Average monthly wages by branch



Source: Macrobond

Preparing for the rollout of the China International Payments System (CIPS). The People's Bank of China reports that its new international payments processing system is now ready and should be in regular use by the end of this year. CIPS facilitates yuan-denominated payments and allows direct clearing of yuan payments to and from China. CIPS operates in a manner similar to e.g. the TARGET system used for euro payments. CIPS allows foreign firms to make payments to China directly from their own bank accounts. The new system is in trial use in 20 banks.

Currently, only PBoC-designated clearing banks can process international yuan payments. All of China's 15 designated clearing banks are subsidiaries of large state-controlled banks. CIPS allows foreign banks to engage in processing of yuan payments through a direct connection between CIPS and the bank.

Clearing of payments in yuan at the national level is already done with the China National Payments System (CNAPS). CIPS apparently will operate in parallel with CNAPS. CNAPS will also be brought into compliance with international standards.

CIPS has been designed in accordance with SWIFT standards and supports both Chinese and English languages. CIPS can process yuan payments for such purposes as foreign trade or direct investment. As with many other reforms in China, the rollout will involve several phases. In the first phase, the central bank says the system will be available 11 hours a day to allow processing of payments to Asia, Europe and Oceania.

The international payments clearing system has been under construction since 2012. It was originally scheduled for kick-off last year, but the launch was delayed due to technical issues. CIPS represents another step by China towards full international acceptance of the yuan.

Yuan now the top international payments currency in Asia. SWIFT, the international provider of information services for the financial sector, reports that in April the yuan became to most-used currency in payments between Asian countries and the China-Hong Kong region. The yuan's share of payments traffic between the China-Hong Kong region and the rest of Asia has risen from 7 % to 31 % over the past three years. Some 80 % of payments between South Korea and Taiwan with the China-Hong Kong region are now made in yuan, while the figure for payments with Japan was still just 5 %. The launch of new Chinese clearing banks in Australia, South Korea, Malaysia and Thailand will further increase opportunities to use the yuan.

While the yuan's share of global payment traffic is only slightly more than 2 %, the yuan has rapidly risen to fifth place (just behind the Japanese yen) among the world's most-used currencies in international payments.

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Russia

Decline of investment limited by oil and gas sector. Total investment of the economy has fallen since spring 2013. Last year, investment contracted 2.5 % y-o-y, and in the first quarter of this year, investment was down about 3.5 %. Nevertheless, investment has shrunk markedly less than forecast (at least until May, when the decline accelerated).

The drop in total investment has been mitigated in particular by briskly increasing investment in oil and gas production (up about 10 % in 2014 and about 15 % in the first quarter of 2015). In other core sectors, investments of large and medium-sized firms have declined considerably this year, with the exception of manufacturing, where investment (excluding oil refining) increased in the first quarter.

Rosstat reports that investment of small firms and the grey economy have seen higher investment than the rest of the economy over the past three years (2012–2014), as well as the first quarter of this year. One reason for this is the rapid growth of housing investment in recent years, though housing investment slowed in the first quarter of this year.

Russian government budget framework assumes lean years ahead. In its latest budget framework proposal to the government, the finance ministry expects the nominal value of government revenues to fall this year about 4 % in ruble terms. Revenues relative to GDP will decline to 35 %. The revenue projection is based on the economy ministry's forecast, which cautiously assumes the price of oil this year will average $50 a barrel. GDP is expected to contract 3 % this year and inflation to average about 15.5 %.

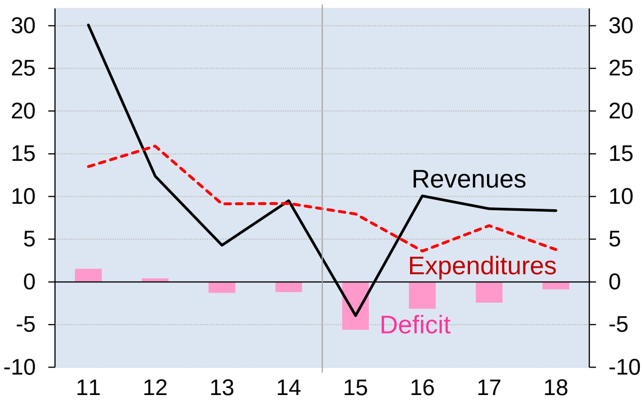
The ministry expects nominal federal budget revenues to fall this year by close to 15 % on a 25 % drop in tax revenues from oil and gas. Tax revenues raised by regional and municipal governments should increase about 6 %, but their total revenue growth will only amount to 2–3 %, because transfers to regions from the federal budget will be reduced significantly. Government social fund revenues will climb by over a fifth, because asset transfers (especially to the pension fund) will increase sharply. Tax revenues to these funds will also grow relatively well.

The ministry estimates that government spending will increase 8 % this year in nominal terms, and that the share of spending will rise to nearly 41 % of GDP. Federal expenditures, excl. transfers to other budgets, will grow a bit more (when figures exclude the large bank support paid out in December 2014). Regional and municipal budget expenditures will increase a mere 5 %. In contrast, social fund expenditures will increase by roughly one quarter.

The finance ministry calculates that the government deficit will worsen this year to 5.5 % of GDP. The federal budget deficit will be over 3.5 % of GDP. Financing the gap will be accomplished by depleting about half of the federal government's Reserve Fund. Regional budget deficits will be funded in part out of loans from the federal budget. The finance ministry is concerned about regional deficits and has proposed a legal deficit limit to be imposed on regional budgets that would be proportional to regional budget revenues without federal budget transfers.

The revenue estimates for the years ahead assume an oil price averaging $60 a barrel in 2016 and $65 a barrel in 2017, as well as GDP growth above 2 % a year. Government revenues would recover in the period. However, the ministry's calculations indicate that nominal spending growth would have to be limited to 5 % a year, i.e. slightly below the forecast inflation rate. In such case, the government deficit would be constrained to 2.5 % of GDP in 2017.

Change in government revenues and expenditures (%), and deficit (% of GDP)



Source: Finance ministry

Russian finance ministry expects spending on defence and social security to plateau next year. In its budget policy framework proposal, the finance ministry noted it expects defence and social spending to grow by about 25 % this year. Social spending will rise as high as to more than 14.5 % of GDP and defence spending to 4.3 % of GDP. Defence spending, however, is expected to decline in 2016, while spending on domestic security and law enforcement will continue flat in nominal terms this year and next. Spending directed to various sectors of the economy is expected to remain unchanged starting next year. There is an effort to match growth in social spending to the inflation rate from next year onwards. Such a move, however, would require pension increases are wound down, in line with the ministry's proposal, to slightly less than the projected inflation rate. The ministry further proposed increasing the general retirement age by six months a year until the pension age reaches 63 for both women and men (currently 55 for women and 60 for men).

Assuming the ministry's forecast materialises, spending on education in coming years will still only match inflation and healthcare spending will rise just slightly faster than inflation.

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China

China's central bank extends monetary easing. Last Saturday (June 27), the People's Bank of China announced it was lowering reference rates by a quarter of a percentage point. The one-year loan rate now stands at 4.9 % and the one-year deposit rate at 2.0 %. The PBoC also lowered the deposit reserve requirements for most banks by a half percentage point. Bank reserve requirements, however, remain high, averaging 14.5–18.5 % of bank deposits and tying up considerable lending potential.

Simultaneous declines in reference rates and reserve requirements are rare. The last time such an event occurred in China was during the international financial crisis in 2008. The PBoC gives no justification for its decisions, causing speculations on what triggered the policy shift. Chinese officials are clearly concerned about the economic slowdown. The timing might point to the latest round of monetary easing being a response to increased uncertainty after the plunge in share prices. It might also be that the stock market drop created an opportunity for relaxing the monetary policy stance without having to worry that further easing might fuel borrowing and add to a stock market bubble.

In addition to the lack of a well-articulated policy, the opacity of Chinese monetary decision-making is increased by its unfinished nature. In principle, interest rates on bank loans to the general public have been freed and flexibility in setting deposit interest rates increased to such an extent that it is hard to determine what the current role of reference credit rates is. There is still no definitive steering rate for financial markets, however. The central bank also steers funding directly to strategic sectors, but the rules of granting of loans and methods for calculating reserve requirements are less than transparent. This time funding of farmers or small and medium-sized firms was set as a perquisite for a reserve requirement decrease, but the actual definition for such criterion remains unclear.

Reforms on complete deregulation of interest rates move ahead in China. Last week the State Council approved an amendment that removes the required loan-to-deposit ratio of commercial banks. Under current law, the loan stock of a bank may not exceed 75 % of its deposit stock, thereby limiting the bank's ability to lend. In March, the ratio for the banking sector averaged 66 %, although many banks were near the 75 % ceiling. The change is expected to take effect next year and is likely to reduce lending costs and promote market-based pricing.

The deposit insurance scheme implemented at the start of May is considered a prerequisite for ending rate regulation. Moreover, from the start of June, banks are allowed to issue certificates of deposits (CDs) to private investors and non-financial institutions. At this point, the arrangement is only available to large investors that invest enough to meet minimum requirements. Earlier trading in CDs was only possible on the interbank market. All of China's largest banks have emitted new CDs, which can be priced freely and are not subject to deposit interest rate restrictions.

The range in which banks can offer deposit interest rates relative to the central bank's reference rate has gradually widened so that the current ceiling is 150 % of the reference rate. As there is little reason to increase flexibility, the next step is likely to be elimination of the ceiling altogether. Lending rates were deregulated in 2013, when also the lower limit on deposit rates was eliminated. According to central bank governor Zhou Xiaochuan, complete deregulation of interest rates will likely happen before the end of this year.

Chinese stock markets continue to seesaw. The boisterous rise in mainland China stock markets in the early part of the year gave way to declines last week. Shares prices in Shanghai declined for several days in a row at a pace of about 5 % a day. Shenzhen share prices plunged an average of 6 % a day for several days. Prices of over two-thirds of Shanghai's listed shares declined 10 % of their value last Friday, the maximum permitted change in price per trading session before trading in such shares is suspended.

Since their mid-June peak, prices of Shanghai-listed shares have dropped over 20 %, while the tech-heavy Shenzhen is down over 25 %. Share prices on the Shanghai exchange on average are still about 25 % higher than at the start of the year, while the average price of Shenzhen-listed shares is still up about 75 % from the start of the year.

China's extreme stock market volatility is driven by the rush of small investors into the market, rapid growth in margin buying and large swings in market sentiment. Several observers have noted that stock price trends have become delinked from trends in the Chinese economy. Even if private investors hold the lion's share of mainland-exchange-traded shares, only 7 % of Chinese households hold stocks. As a result, a market correction might not have a particularly large impact on household consumption.

Stock market trends in China

Source: Macrobond

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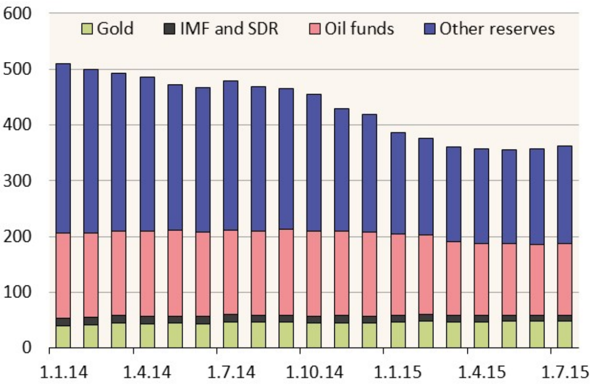
Russia

Russia's foreign currency reserves stabilised. Although Russia's foreign currency reserves shrank visibly overall in the first half of this year, the situation has ceased to deteriorate in recent months and even recovered slightly. Capital outflow from Russia has slowed in recent months and the dollar value of reserves has also been affected by changes in exchange rates. The Central Bank of Russia announced in mid-May that it will start buying foreign currency to boost reserves. The CBR has since averaged a daily volume of nearly $200 million in currency purchasing. The value of Russia's currency reserves were $362 billion at end-June.

In line with international standards, Russia's reserves consist of monetary gold, IMF reserves and Special Drawing Rights (SDRs), as well as other reserves. Russia's other reserves include majority of the country's oil funds as they are in liquid foreign assets and controlled and invested by the CBR according to finance ministry guidelines.

Russia's foreign currency reserves, USD billion



Sources: CBR, Russian finance ministry, BOFIT

Russia spending oil funds in the first half. Over the past decade, Russia has accumulated tax revenue from oil and gas export earnings in two state funds. The Reserve Fund is used to fund fiscal deficits during economic downturns. The National Welfare Fund is intended primarily for pension funding, but has also been used for economic stimulus during weaker economic development.

The value of the Reserve Fund diminished by $11 billion (700 billion rubles) during January-June. Most of it was withdrawn to cover budget spending, but the dollar value of the Fund is also affected by exchange rate changes. At end-June, Reserve Fund assets stood at $77 billion (4.3 trillion rubles). The finance ministry expects the Reserve Fund to contract by the end of this year to around 2.4 trillion rubles (3 % of GDP) and to 500 billion rubles (0.5 % of GDP) by the end of 2017. These prognoses assume e.g. that the price of oil will rise from an average of $50 a barrel this year to $65 in 2017. The Reserve Fund is invested in liquid foreign assets and included in Russia's currency reserves.

Over $4 billion (240 billion rubles) from the National Welfare Fund has been invested this year in bank deposits and securities for financing infrastructure projects. According to last spring's government decision, up to 550 billion rubles in the fund's assets may be used this year on measures to support the economy. As of end-June, the National Welfare Fund was worth $76 billion (4.2 trillion rubles). A third of its assets are invested in longer term assets (e.g. long-term deposits), while the rest is invested in liquid foreign assets and counted as part of Russia's currency reserves.

Although the majority of the assets of the two funds are included in Russia's currency reserves, currency reserves do not automatically shrink when the finance ministry withdraws money if the money is withdrawn in rubles.

Tourism accounts for nearly half of Russian services imports. Services imports to Russia in 2014 were $121 billion or €91 billion (28 % of total imports). The EU provided 46 % of services imports, APEC countries 12 % and CIS countries 7 %. Finland had a 3 % share and China 2 %. Travel services represented 42 % of services imports, transportation 13 %, intellectual property 7 %, construction 6 % and communications and IT services 6 %. The rest of services imports consisted mainly of other business services.

Imports of travel services grew strongly until last year's dip when the value of imports was down 6 % and the number of trips 16 %. Nearly all travel imports consist of private travels. The largest tourism spending markets in 2014 were Turkey, Germany, Egypt and Finland.

The value of services exports in 2014 was $66 billion or €50 billion (12 % of total exports). Some 40 % of exported services went to the EU, 15 % to CIS countries and 13 % to APEC countries. Finland and China each had 2 % export shares. By category, services exports broke down as follows: transportation 30 %, travel 17 %, construction 7 % and communications and IT services 7 %. The remainder consisted mainly of other business services.

Value of Russian services trade, USD billion

Source: CBR

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China

China takes serious measures to control stock market drop. With the on-going volatility in Chinese stock markets, the China Securities Regulatory Commission (CSRC) relaxed terms for purchasing shares on margin and tightened short-sale rules. Last week, the finance ministry offered an amendment to also allow pension fund money into stock markets from the beginning of August. Insurance companies have been permitted higher share ownership. The People's Bank of China recently dropped its key reference rates and bank reserve requirements, however without specifically mentioning the stock market situation. The PBoC also made more liquidity available to brokers involved in margin trading. Transaction fees will also go down at the start of August.

Additionally, IPOs have been halted for the time being and the state enterprises are not allowed to reduce their ownership stake. On the contrary, they have been advised to increase their shareholdings. At the weekend, 21 securities brokers revealed they would invest at least 120 billion yuan ($20 billion) in a market stabilisation fund. They have committed to holding share at least until the Shanghai Index returns to 4,500 points (at Friday's opening, the index stood at 3,707). Many other investment funds and mutual funds have announced plans to invest their own assets in shares. Some firms have repurchased their own shares.

By Wednesday (July 8), it was clear government stabilisation measures were inadequate, so the CSRC banned investors owning 5 % or more of an exchange-listed company from selling their shares for the next six months. The ban extends to officers and management of listed firms. As of Wednesday, nearly half of China's firms listed in mainland had requested trading in their shares suspended. Shares recovered in Thursday and Friday markets, but the increase is difficult to interpret as trading of so many shares had been suspended.

Shares in Shanghai have slid about 30 % from their June peak. Shenzhen shares are off about 40 %. Even with the plunge, Chinese shares are still up 70–80 % from a year ago, which has made some observers to question the reasons behind the recent government actions.

China and the EU agree on tighter economic cooperation. While deeper economic ties were the theme of premier Li Keqiang's visit to Brussels last week for the annual EU-China summit, talks were also launched on several fronts, including environment and visa issues. China would like to have practical cooperation with the EU on environmental issues. For its part, the EU said it was opening 15 new visa centres in China to ease Chinese holiday and business travel to Europe.

The biggest attention-getter was China's decision to invest in the European Fund for Strategic Investment (EFSI). The decision was based on the synergy benefits arising from EFSI's €315 billion investment package and China's €38 billion Silk Road Fund. EFSI's mission is to develop both infrastructure and communications and transport connections within Europe. The Silk Road Project aims at connecting Asia and Europe. The size of China's investment in EFSI has yet to be announced, but could be in the range of several billion euros. China's participation could also increase the willingness of other groups interested in investing in EFSI. China has also welcomed new foreign investors to the Silk Road Fund.

The EU has been China's top trading partner for over a decade. After the US, China is EU's second largest trading partner. Besides foreign trade, investment flows between China and the EU have grown rapidly in recent years, even if they still have a much smaller significance than trade. In 2014, the value of China's EU exports was $370 billion and the value of EU imports $240 billion. Chinese foreign direct investment flows to the EU remained below $20 billion, even if it doubled from the previous year. Chinese FDI still account for only a few percent of all FDI received by Europe.

Founding documents signed for AIIB development bank. The founding agreement for the China-led Asian Infrastructure Investment Bank (AIIB) was signed at the end of June by 50 counties, including Finland. A remaining seven founding members are expected to sign the agreement before the end of the year. The bank's authorized capital will be $100 billion. China's share of the bank's capital will be about 30 % and its voting share about 26 %. In other words, China has veto power over bank's decisions. The next largest voting shares are held by India (7.5 %), Russia (5.9 %) and Germany (4.2 %). Finland's participation is a 0.3 % capital share and a 0.5 % voting share.

AIIB came out of a Chinese initiative that was part of China's efforts at increasing its international economic presence. Non-Asian founding members hope that membership will strengthen economic and trade relations with Asian countries, especially China. The bank is expected to launch operations by the end of the year.

Official launch of BRICS New Development Bank. All five BRICS countries (Brazil, Russia, India, China and South Africa) are members of the New Development Bank (NDB) with equal capital shares. All member countries have ratified the founding agreement and the bank's initial capital has been collected. NDB starts operations next year. The bank's capital is planned to rise up to $100 billion in the future. The authorisation of the new development bank was revealed at BRICS meeting in Ufa, Russia. The countries also agreed that the BRICS "Contingent Reserve Arrangement", a $100 billion reserve liquidity facility, will start its operation by the end of July.

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Russia

Russia's current account surplus persists, capital outflow diminishes. Preliminary balance-of-payments figures show that Russia's current account surplus amounted to nearly $20 billion in the second quarter of this year. Over the past four quarters, the surplus corresponded to about 4 % of GDP.

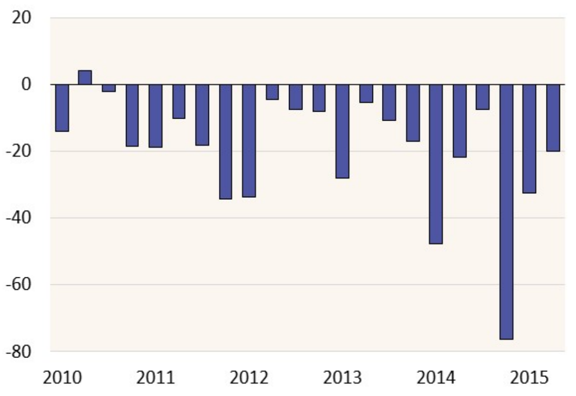
In the second quarter, the value of goods and services exports shrank nearly 30 % y-o-y in dollar terms, while imports were down 40 % in dollar terms (20 % in euros). Foreign trade also contracted nearly as much in the first half as a whole. For the January-June period, the value of exports was $210 billion and the value of imports $140 billion.

Capital outflows from Russia continued in the second quarter, but were slower than earlier. The private sector's net capital outflows amounted to about $20 billion.

Banks continued to pay down their foreign debt faster than they acquired new foreign debt, but not quite as fast as in the first months of 2015. Moreover, banks invested more of their assets abroad than they repatriated.

In contrast, the foreign debt held by other firms increased in the second quarter for the first time in nearly a year. Most of the new debt is from direct investors. Non-banks, however, still invested more abroad than repatriated their assets.

Quarterly net capital flow of Russia's private sector (USD billion)



Source: Central Bank of Russia

Russia's foreign debt remains unchanged. The Central Bank of Russia estimates that Russia's foreign debt stood at nearly $560 billion (30 % of GDP) as of end-June. Russia's second-quarter foreign debt remained practically unchanged from the first quarter as banks paid down their foreign debt while other firms acquired more of it.

However, the value of foreign debt has contracted sharply compared to a year ago. As of end-June 2014, Russia's foreign debt was still $730 billion. While a substantial amount of debt has actually been repaid, part of the decline reflects exchange rate fluctuations. About a fifth of Russian foreign debt is denominated in rubles.

Russia's public-sector foreign debt amounted to $35 billion at the end of June. Banks' foreign debt stood at $150 billion and that of other firms at $360 billion. State-controlled firms accounted for more than 60 % of banks' foreign debt and for about 40 % of other firms' foreign debt.

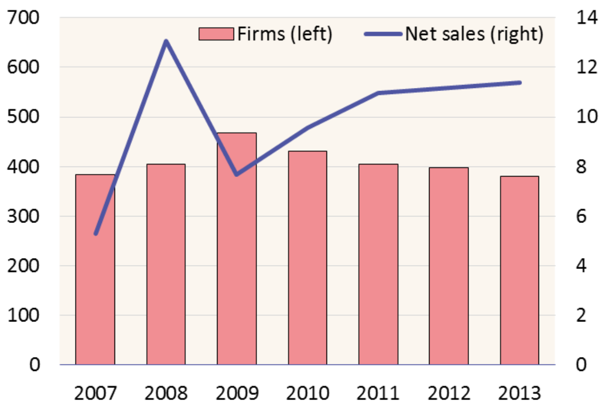
The CBR estimates debt servicing obligations coming due in the second half of this year will total nearly $80 billion.

Several hundred firms in Finnish ownership in Russia. The latest figures from Statistics Finland show 380 subsidiaries of Finnish firms operating in Russia in 2013. The net sales of Finnish subsidiaries operating in Russia at that time amounted to €11.3 billion and provided employment for over 46,000 people. Finland's exports of goods and services to Russia amounted to €7.5 billion in 2013.

Rosstat reports there were 460 Finnish-owned firms in Russia in 2013. Rosstat figures also include firms, where Finns hold a minority stake. Some 60 % of Finnish-owned firms are sited in Northwest Russia, mostly in St. Petersburg, in the Leningrad region or in the Karelian Republic. About a quarter are based in and around Moscow.

Finnish-owned firms accounted for about 2 % of foreign firms operating in Russia. A substantial portion of foreign firms in Russia are, however, Cypriot-owned, and it is estimated that the ultimate owners in most of such cases are in fact Russian. The region where Finns accounted for the largest share of foreign-owned firms is the Karelian Republic. Well over a third of foreign firms there have Finnish owners.

Number and combined net sales (EUR billion) of Finnish-owned subsidiaries in Russia



Source: Statistics Finland

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China

China's Q2 economic growth remained at 7 %. China's National Bureau of Statistics reports second-quarter GDP growth of 7.0 % p.a. First quarter GDP growth was also 7.0 %. On-quarter growth in the second quarter was 1.7 %.

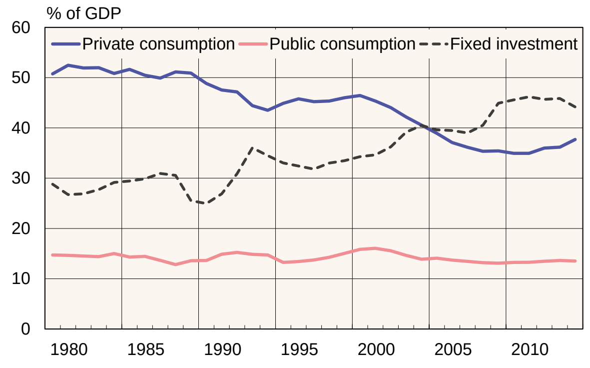
Industrial output growth in the first half lagged GDP growth. In June, however, industrial output perked up to 7 % y-o-y. On-year growth in fixed asset investment slowed in the first half to 11 %. Growth in housing investment, in particular, slowed in the first half to 5 %, down from 14 % in 1H14. Real estate sales, however, rebounded in the first half after falling for nearly one-and-a-half years.

Private consumption increasingly is the main engine of growth in China. Real disposable incomes rose about 8 % in the first half, while retail sales growth in June remained above 10 %. Consumer price inflation accelerated slightly in June to 1.4 % y-o-y. Producer prices fell 4.8 % y-o-y.

Structure of Chinese economy keeps evolving. Demand-side factors in the just-released 2014 GDP figures show that private and public consumption corresponded to over half of China's GDP for the first time since 2006. Private consumption's share of GDP has again begun to rise after several years of stagnation, while the relative importance of fixed capital investment continues to decline. Even so, Chinese fixed capital investment equalled over 40 % of GDP, which is remarkably high by global standards.

As economic emphases change, China is moving gradually from an export- and investment-driven growth model to growth based on the service sector and domestic consumption. In 2013, the service sector generated for the first time a larger share of GDP than manufacturing. In the first half of 2015, the service sector accounted for half of GDP.

Structure of Chinese GDP



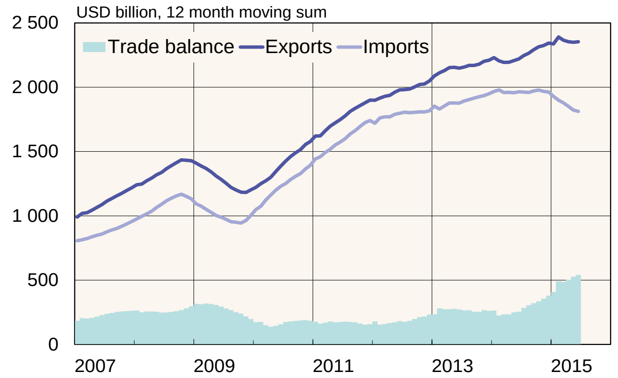
Sources: CEIC, Macrobond

The World Bank latest China Economic Update finds China has made progress in its attempts at economic reform. As growth slows in China, the assessment noted that reforms of the financial sector will require special focus, so that financing will be channelled to sectors that are capable of sustaining growth over the longer term. The World Bank continues to hold the view of continued modest slowing of Chinese economic growth.

Slow export growth in China in the first half; value of imports declines. In the first six months of 2015, the value of exports increased about 1 % from 1H14. The value of imports declined 16 %. Exports to the US rose 9 %, while exports to EU countries declined 3 % and to Japan 11 %. China's 1H trade surplus was $263 billion, up over 150 % y-o-y. The trade surplus boost reflects lower import prices.

Foreign trade picked up in June. Exports were up 3 % y-o-y, while the slide in imports was only 6 %. June crude oil imports reached nearly 30 million metric tons, up 27 % y-o-y. Stocking of the country's strategic reserves partly explains the surge in oil imports. Imported oil volumes were up 8 % y-o-y in the first half. The import price of oil in the first half of the year averaged about 30 % less than in 2014.

Value of China's foreign trade



Source: Bloomberg

China introduces draft legislation on foreign investment and cyber-security. The proposed laws e.g. would give officials the possibility to shut down online connections in some situations and require foreign firms to store their data collected in China on servers physically located in China. In addition, foreign investments would need official approval in cases where such investment could be seen as a threat to national security. The draft laws presented last week are now out for comment. The drafts are part of a larger, recently approved, legislative package on national security.

Problems arising from the tighter regulation worry foreign firms operating in China. Already tight Internet surveillance affects e.g. corporate research efforts. Many firms see the new laws as an effort to bolster the competitiveness of Chinese firms. The EU, for example, has voiced strong concerns over the impacts of the new legislation on the operations and investment climate for foreign firms, and offered comments and amendments to Chinese officials.

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Russia

Signs that Russian economy's decline may be stabilising. The on-month contraction in seasonally adjusted industrial output as well as a core part, i.e. manufacturing output, was smaller in June than in earlier months. The drop in output from June 2014, while still large, was also lower than in late spring. On the other hand, the on-year drop figure of June was moderated by the fact that there were more workdays last month than in June 2014.

The slide in manufacturing accelerated in spring. In addition to a cooling of the defence-spending boom, the deepening reflected e.g. the fact that the rate of growth in exports of certain basic commodities decelerated after a very strong start this year.

While other mineral extraction categories have shown growth, a large drop in natural gas output has depressed the overall extraction figure. Crude oil production has continued to climb on a strong increase in exports.

The fall in fixed capital investments eased slightly in June, but remained deep. The latter also concerns construction where earlier high growth in housing construction cooled in May and June.

Key output and demand figures for Russia, % change y-o-y

	2014	2015 Q1	April	May	June
Industrial output	1.7	-0.4	-4.5	-5.5	-4.8
- manufacturing	2.1	-1.6	-7.2	-8.3	-6.6
- mineral extraction	1.4	0.7	-0.8	-0.9	-0.9
- crude oil	0.8	1.2	1.2	1.3	1.6
- natural gas	-4.3	-6.2	-1.9	-9.1	-9.1
Construction	-4.5	-4.7	-5.2	-10.3	-10.0
Investments	-2.7	-3.6	-4.8	-7.6	-7.1
Transport, incl. pipelines	-0.1	-1.6	-1.3	-4.0	-3.4
Retail sales	2.7	-6.4	-9.6	-9.2	-9.4
- food	0.0	-6.4	-8.7	-8.8	-9.1
- non-food	5.1	-6.6	-10.4	-9.6	-9.7

Source: Rosstat

Consumption, real incomes and household borrowing in Russia remain down. The seasonally adjusted volume of retail sales in June still remained virtually unchanged and was thus down nearly one tenth from a year earlier. The gradual slowing in the inflation rate since last winter's price spike slightly helped restrain the drop in real household incomes. In addition, nominal wages, despite the recession, revived in both the private and public sectors. Even so, wages were up 6–7 % y-o-y in May-June, while consumer prices were still up 15–16 %.

While households have reined back consumption, their net borrowing has turned negative. Over the past 12 months, the stock of household loans granted by banks has not changed, i.e. households' loan repayments to banks have equalled their borrowing. Since the start of this year, however, household debt repayments have far outstripped borrowing – in fact to the extent that was seen during the 2009 recession.

Additionally, after the drop at the end of last year, household funds have flowed into banks so strongly that the flow of money from households to banks has exceeded the flow of money from banks to households in an exceptional manner. Households have been increasing their deposits to a remarkable degree by winding down their ruble and forex cash holdings.

Exports of Russian military technology hold steady. Russia's Federal Service for Military-Technical Cooperation (FSMTC) reports the value of military technology exports last year amounted to $15.5 billion, about the same as in the previous two years. The export order book also remained at the $50 billion level as in previous years.

The FSMTC reports that nearly half of Russia's exports of military technology consisted of aerospace technology, while about a quarter was made up of technology for use by ground forces. Russia's Federal Customs Service reports that $4.8 billion in weapons and ammunition was exported last year. Russia's largest export markets for military technology are in Asia (e.g. India and Vietnam).

Russia's total goods exports amounted to about $500 billion last year, of which military technology represented 3 % (or about 9 % of exports other than oil and gas). The share of military technology exports has remained roughly stable in recent years.

The industry and trade ministry says Russia's defence sector generates some 4 % of GDP and employs over 2 million people.

Exports of Russian military technology (USD billion); share of total goods exports (%)

Sources: FSMTC and Central Bank of Russia

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China

More liberal access for foreign investors to mainland China's financial markets. The People's Bank of China announced a rule change last week that eases access of certain foreign institutional investors to mainland interbank bond markets. All foreign investors earlier needed permission from the PBoC to invest in Chinese bonds. Now central banks, international financial institutions such as the World Bank, and state-owned investment funds may invest in mainland bond and repo markets without quotas or permits.

The interbank bond markets of mainland China have grown rapidly in recent years to nearly $6 trillion and now rank among the world's largest. At the moment, foreign bond holdings (mainly central banks) represent just a couple of per cent of the bond market. Foreign investors can freely invest in yuan-denominated Dim Sum bonds issued in Hong Kong, although the market is considerably smaller than the mainland bond market.

Yuan clearing banks and foreign banks participating in yuan-settlement operations have had the right to invest in the mainland interbank bond market since 2010. Last month, the PBoC also granted such banks access to mainland market for bond repurchase agreements (repos). Yuan assets raised from repo issues can also be repatriated outside China. The Singapore branch of the Industrial & Commercial Bank of China (ICBC), which has yuan-clearing status, last week became the first foreign institution to issue bond repos in mainland China. More than 100 banks located outside mainland China can now have access to domestic interbank bond and repo markets.

In addition, a new investment fund cooperation programme was launched at the start of July. It lets asset management firms in mainland China and Hong Kong sell shares of officially approved funds on each other's markets. The arrangement gives Chinese private investors the opportunity to invest in foreign mutual funds and the opportunity for Chinese mutual funds to sell their wares to international investors. The current investment quotas covered by the programme (both directions) are 300 billion yuan ($49 billion). About 850 mutual funds in mainland China and 100 funds in Hong Kong are eligible for the programme.

Foreign investors have been able to invest in certain Shanghai-listed shares via the Hong Kong stock exchange under the Stock Connect arrangement launched late last year. A similar linkage is planned for the Shenzhen and Hong Kong exchanges. Outside these programmes, foreign portfolio investment in mainland China has been limited to special programmes for qualified foreign institutional investors (QFII) and renminbi-qualified foreign institutional investors (RQFII). The granted investment quotas for both programmes have been raised sharply this year. The total quota under the QFII programme at the end of June stood at $76 billion (up 30 % y-o-y), while the quota for the RQFII programme reached 391 billion yuan ($64 billion), up 112 % from June 2014.

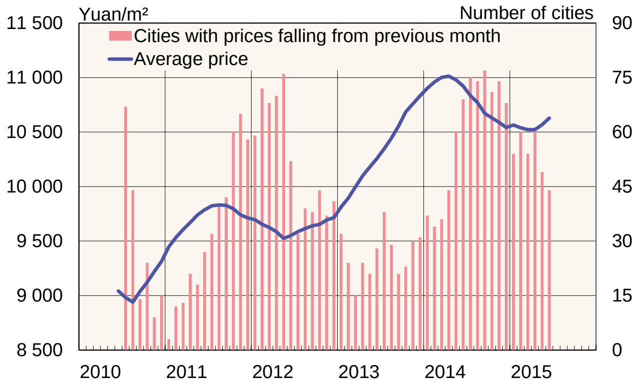
China's housing market shows signs of recovery. SouFun, a private real-estate information tracking service, reports average apartment prices showed a slight uptick overall in the second quarter. Apartment prices were still down 3 % y-o-y in June, however, and 3.5 % below their peak in April 2014. Two other major private real-estate tracking firms also detected a rise in average apartment prices in June.

SouFun noted price declines from the previous month in 44 of the 99 cities tracked, compared to last autumn when prices were down in three-fourths of the cities tracked. China Real Estate Information Corporation reports prices rose in about half of the 288 cities it monitors. China's National Bureau of Statistics also noted in its housing price survey of 70 cities that prices for new apartments were up in 27 cities in June (compared to 20 in May). Notably, rises were seen in the major metropolises such as Beijing, Shanghai and Guangzhou (each up 2 % in May), as well as Shenzhen (up 7 %). Still, prices continued to fall in almost half of the cities tracked by the NBS. Prices fell in smaller cities that, in particular, are suffering from an oversupply of apartments.

Officials last autumn sought to support the housing market by easing rules on purchasing of a second apartment. The PBoC has lowered its key rates this spring and summer, as well as reserve requirement ratios for banks. Certain local governments have also purchased unsold apartments and resold them to low-income households at discounted prices.

Growing uncertainty on stock markets could increase demand for the perceived relative safety of real estate investment. Indeed, a China Household Finance Survey conducted at the end of last month suggests households may be increasingly pulling out of the stock market and investing instead in an apartment.

Average housing prices and number of surveyed cities (99 city sample) where housing prices fell from previous month



Sources: SouFun, Macrobond

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Russia

Views of Russian authorities differ slightly on outlooks for the economy's recovery; oil prices and the ruble slide. Several official authorities in Russia last spring proclaimed the worst of Russia's economic contraction was over. Yet, prime minister Dmitri Medvedev last week stated that the Russian economy may return to growth only late this year or early next year. Economy minister Alexei Ulyukayev, on the other hand, repeated his ministry's earlier assessment that the economy was still on course to enter recovery in the third quarter of this year. The ministry now sees inflation moderating a bit faster than in its late spring forecast. This improves their outlook for real household incomes and private consumption.

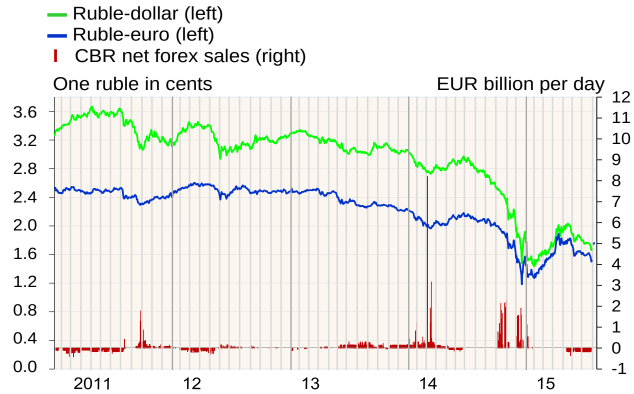
Alexei Kudrin, who served as finance minister from 2000 to 2011, expects the economic contraction to continue in the fourth quarter of this year, even if more slowly than until then, and growth to return in the first half of 2016. Kudrin noted that the drop in economic output accelerated in the second quarter of this year, adding that fixed capital investment continued to fall much.

Observers note that expectations of recovery have moderated as more recent figures on the deepening of the economic contraction have emerged. The economy ministry estimates GDP in the second quarter was 4.4 % lower than a year earlier, even if seasonally adjusted GDP only contracted slightly in June.

The oil price has also declined, after recovering from the plunge of the second half of 2014 to around $65 a barrel in early May. The latest slide sharpened at the end of June. This week the Urals price dipped below $55/bbl.

The drop in oil prices and financial uncertainty in China especially since mid-June have eroded exchange rates in other emerging economies as well as the ruble's exchange rate which this week was down about 15 % from end-May against both the euro and the dollar.

Ruble exchange rates and CBR forex sales on Russian market



Source: Central Bank of Russia

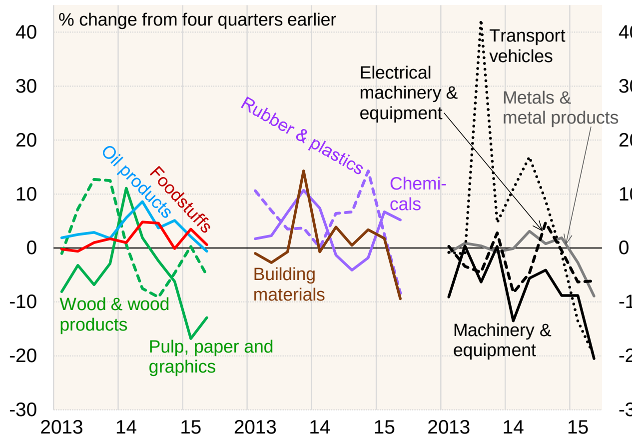
On Tuesday (July 28), the CBR, citing increased market volatility, suspended its daily forex buying on Russia's forex market. The CBR in mid-May initiated the buying policy in order to gradually rebuild the country's foreign currency reserves. From the standpoint of the ruble's exchange rate, the currency buying, usually $200 million a day, has had no decisive impact.

Output down in most manufacturing branches. In the second quarter of this year, manufacturing output was down over 7 % y-o-y, a distinct deepening from the start of the year. Lower fixed capital investment, in particular, has meant that falling production of machinery and equipment has now entered its third consecutive year. Production of transport vehicles has also plunged this year, following an earlier boom that observers attribute largely to higher defence spending, The industry and trade ministry reports that Russia's military-industrial complex output rose 10 % in 2013 and over 15 % in 2014. Production of metals and metal products has contracted considerably this year as well, despite increased metal exports.

Russia's building-materials industry, as well as the pulp and paper industry, was in a slump. Even the long-booming rubber and plastics industry has fallen.

Despite a sharp reduction in sales of domestic processed foods, food industry production has enjoyed mild growth this year as food imports have declined precipitously. Exports of oil products grew sharply in the first half of the year, but output growth came to a halt due to the domestic recession. Growth in the chemical industry recovered on higher exports this year. Moreover, output of "other chemical products" rose to a boom in the first half. Some observers say this could reflect an increase in the production of explosives (defence spending was up nearly 40 % y-o-y in the first half of 2015).

Output in major manufacturing branches



Source: Rosstat

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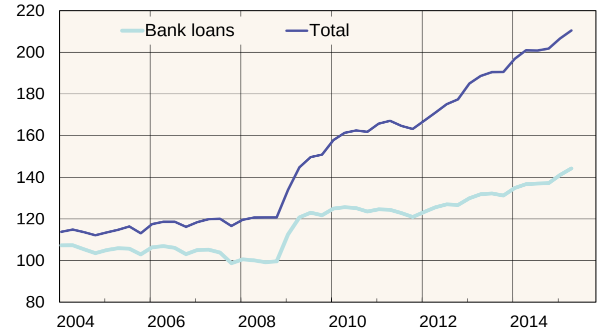
China

Increase in domestic indebtedness in China continues to outpace economic growth. Total social financing, the broader definition of the credit stock used by the People's Bank of China, was up 12 % y-o-y in 2Q15, while nominal GDP growth was 7.1 %. Even so, growth of the credit stock slowed from a year earlier, when it ran at nearly 17 %.

April-June figures also indicate the structure of China's credit stock is changing. On-year growth in the stock of bank loans remained at around 13 %, while growth of other financing formats was up just 11 %. Lending outside the formal banking sector has slowed significantly. Notably, growth in loans from trust firms fell below 2 % y-o-y.

Funds raised through share emissions are also included under the total social financing concept. The rise in share prices and new IPOs on China's stock exchanges helped fuel growth in the category in the first half. Assets raised through share emissions, however, represent just 5 % of the increase in China's total credit stock in 1H15.

Credit stock to GDP, percentage of GDP



Sources: Macrobond, BOFIT

China restricts peer-to-peer lenders offering loans to share purchases. The China Securities Regulatory Commission (CSRC) announced this month that it was banning share purchases financed through online loan-shopping services, so-called peer-to-peer (P2P) lenders. High-interest P2P services are considered high risk as they offer investors a quick way to go deep in debt. There are over 2,000 P2P services providers in China. They have traditionally provided financing to small firms, but recently have seen strong growth in providing money for buying shares on margin.

P2P services represent a tiny fraction of the informal credit financing of share purchases. Most of the money comes from various investment vehicles, including high-leverage umbrella trusts. Bank and investment firms, for example, have channelled funding to umbrella trusts via their wealth management products. Banks' direct stock investments in China are not permitted. While the scale of unofficial financing used for share buying is unknown, most estimates range between 1.7 and 3 trillion yuan (€250–440 billion), or 3–6 % of the value of stock markets.

Formal brokerage-provided margin financing at end-July amounted to 1.4 trillion yuan (about 3 % of total stock market capitalisation), down from the June peak of 2.3 trillion yuan. Debt finance through official channels is subject to more regulation and stringent conditions relative to informal financing. Investors have been able to borrow about twice the value of their own input in margin buys and investments are limited to certain shares. In January, the CSRC amplified the rules that brokers can only lend to well-heeled investors with at least 500,000 yuan of their own money to invest. On July 1, the CSRC reneged on the rule and borrowing conditions were eased as the government undertook to deal with the collapse in share prices.

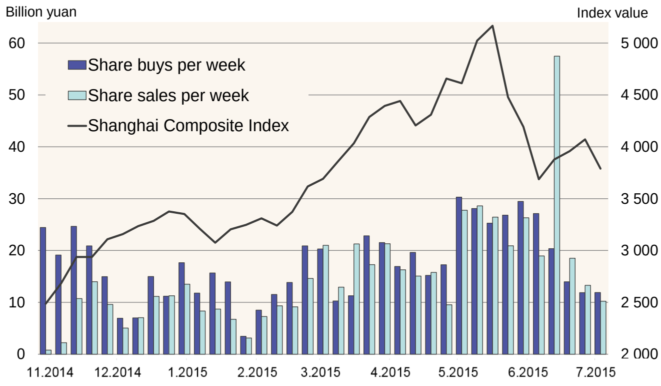
Markets stabilised this week after Monday's (July 27) plunge in Chinese share prices.

Foreign investors reduce their stock investments in mainland China. PBoC figures show yuan assets held by foreign investors in June were worth 4.42 trillion yuan (€645 billion), or about 10 billion yuan less than in May. The decline reflected decrease in stock holdings, which slid nearly 10 % from May. Of all foreign yuan investments in June, 14 % were share investments. Foreign investments in assets other than shares increased.

In recent weeks, the volume of share selling has outpaced buying under the Stock Connect arrangement (see chart below) that allows reciprocal access to trading on the Shanghai and Hong Kong stock exchanges. Share trades by foreign investors in the Stock Connect system in June-July accounted for roughly 1 % of the Shanghai exchange trading volume. Qualified and renminbi-qualified institutional investors can also invest in Chinese stock markets under the QFII and RQFII programmes.

Total foreign investments in the Shanghai exchange via Stock Connect amounted to 126 billion yuan at the end of July, or less than 0.5 % of the exchange's market capitalisation. Similarly, mainland Chinese share investment flowing to the Hong Kong exchange via the program constituted less than 0.5 % of Hong Kong's market cap.

Volume of foreign investor trades on Shanghai exchange under Stock Connect programme (17.11.2014–29.7.2015)



Source: CEIC

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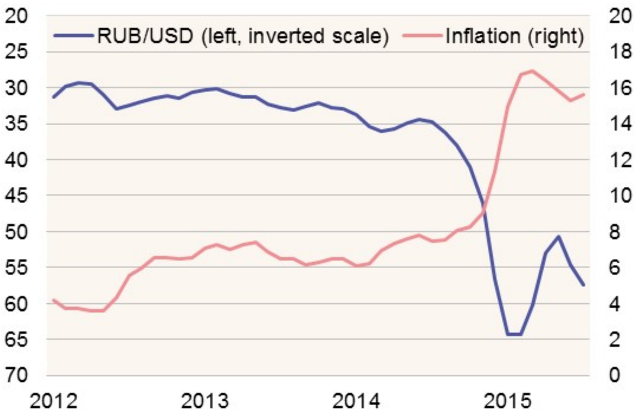
Russia

CBR lowers key rate again. Effective Monday (Aug. 3), the key rate was lowered a half percentage point to 11 %. The Central Bank of Russia stated that the weak economy justified a further rate cut, although inflation risks have risen due to external factors. The ruble has lost considerable ground in recent weeks primarily pushed by the drop in oil prices.

The CBR has gradually lowered interest rates since February in response to the weakening economic development as money markets have been calming. The key rate now stands just a half percentage point above its level of last December, when the CBR was forced to raise rates quickly in an effort to stem the ruble's slide and the resulting spike in inflationary pressure.

Consumer prices were up 15.6 % y-o-y in July. Inflation accelerated a bit from June to July, mainly on hikes in regulated prices that were larger than last year. The on-year rise in food prices slowed slightly in July, but was still 18.6 %.

Ruble-dollar rate and 12-month consumer price inflation (%)



Sources: Rosstat, Reuters

IMF repeats its calls for Russia to implement economic reforms. A report on the IMF's annual Article IV consultations with Russia states that Russian GDP is expected to contract 3.4 % this year and then recover slowly to a meagre growth of 0.2 % next year. The IMF said increased geopolitical tensions were the largest risk to the Russian economy, but pointed out that e.g. a further drop in oil prices and inward-looking policies could also produce even more anaemic economic trends than currently expected. The report noted, however, that Russia still has substantial buffers to confront risks over the short term.

Over the medium term, the IMF was most concerned about the sustainability of public finances as oil prices are expected to remain low. The IMF encouraged Russia to modify its budget rule to more quickly respond to changes in oil prices and put greater emphasis on saving. For example, the Fund noted that substantial fiscal savings could be achieved by reforming the pension system, and e.g. cutting energy subsidies and better targeting of social transfers. In addition, the IMF would like to see more tailored capital support to the banking sector with strengthened supervision, as well as eliminate the temporary regulatory forbearance measures to minimize the costs for the public sector.

Because Russia has failed to tackle its structural economic problems, the IMF estimates that potential growth of the Russian economy has slowed to 1.5 %. Unfavourable demographics and low retirement ages mean a shrinking labour force. A weak business environment and poor infrastructure cause disincentives to invest. The large role of state-owned and state-controlled firms in the economy hampers competition and efficiency. In addition, many recent measures to support the economy have generated additional distortions that further impair growth potential. The IMF noted that reforms to support growth could include reform of the pension system, reduction of barriers to trade and improved oversight of large government capital investment projects.

Russian officials broadly agreed on the need for structural reforms.

US extends sanctions, additional European countries join in certain EU sanctions. The United States treasury department announced on July 30 that it was adding certain individuals and entities under the economic sanctions that have been put in place as a response to the Ukraine situation. The new measures are intended to prevent circumvention of existing sanctions. They mainly focus on Russian and Ukrainian firms and people, but e.g. a few Finnish companies and individuals have been affected, too.

The EU announced at the end of last month that several non-EU countries, including Montenegro, Iceland and Georgia, have aligned themselves with the EU's economic sanctions on Crimea. Russia, in turn, is considering widening its countersanctions, i.e. the restrictions on food imports, to include the new sanction participants.

IMF releases second loan tranche to Ukraine. On July 31, the IMF Board voted to release the second tranche of the Extended Fund Facility (EFF) approved last March. The latest tranche was for $1.7 billion (the first tranche in March was for $5 billion). Ukraine's foreign currency and gold reserves stood at $10.4 billion at the end of July.

The EFF lasts four years. Within its framework, Ukraine can borrow up to $17.5 billion from the IMF. Meanwhile Ukraine is continuing to negotiate with its private creditors in order to reduce the country's debt burden. To date, Ukraine has met all its debt servicing requirements in a timely manner.

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China

IMF report clarifies issues on possible inclusion of yuan in SDR basket. The IMF Board will decide this November on adding the Chinese yuan to the IMF's Special Drawing Rights (SDR) basket reserve currency. In a review of methods for evaluating SDR criteria released this week, the IMF considers the yuan's eligibility for inclusion in the SDR basket, providing a wide-ranging discussion of the yuan's status in international trade and financing in the light of two major criteria.

The SDR above all is a synthetic currency of large exporting nations. Included currencies must also be freely usable. While the yuan met the gateway export criterion in the previous SDR review in 2010, it failed at that time to fully meet the free use criterion, which considers how widely the currency is used in various financial operations and in different markets.

The IMF report notes that, despite the rapid rise in international use of the yuan, generally its use is still less than that of the top SDR currencies: the US dollar, euro, Japanese yen and British pound. In its survey, the IMF found that 38 member states held yuan in their foreign reserves in 2014, but the yuan's share of global foreign official assets was just over 1 % (which was still less than the share of official foreign asset holdings for the Australian and Canadian dollars). The report's authors suggest that the markets' capacity to absorb potential forex conversions associated with SDR operations would be higher for the current SDR basket currencies than for the yuan.

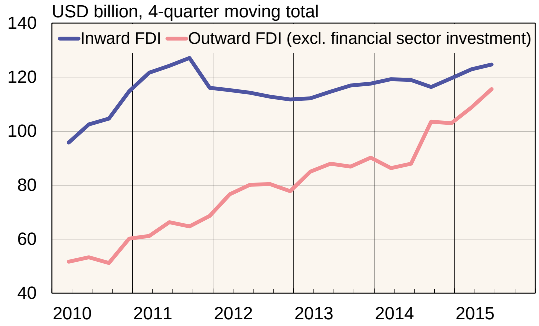
In the final analysis, any decision on incorporating the yuan into the SDR basket will depend on the judgement of the IMF Board. A positive decision requires that China commits to opening up capital movements, a requisite that appears to already be in place. To assure market participant wishes are met and assure the technical smoothness of SDR operations, however, IMF staff recommend that no matter what the IMF Board decides in November, the current composition of the SDR basket should remain unaltered until the end of September 2016.

Direct investment flows into and out of China continue to rise. Foreign direct investment (FDI) into China in the second quarter amounted to $34 billion, an increase of 6 % from 2Q14. Outbound FDI from China (excluding the financial sector) was up 29 % y-o-y, reaching $30 billion in the second quarter of this year.

Growth in inbound FDI to China has accelerated this year. Of the major countries, the biggest sources of inbound FDI were Japan, the United States and Germany. However, a significant share of investment flows to China came via financial centres and tax havens, so their original home country cannot be discerned from official figures.

Chinese firms earlier had to get permission from officials before investing abroad. Since last autumn, they only have had to report their investments to officials. Moreover, Chinese officials this summer eased the rules on buying forex needed for foreign investments. Consequently, Chinese outbound FDI growth has continued to pick up the pace over the past year. Large investments in e.g. hotels in the US, as well as real estate and the energy sector in Europe, have attracted wide attention. FDI from Chinese firms only began to rise in recent years, so the overall stock of Chinese FDI abroad is still quite modest.

FDI flows into and out of China



Source: CEIC

Official figures may overestimate FDI outflows from China. Foreign direct investment flows from China abroad have risen much faster in recent years than FDI inflows into China. With financial sector investments included China's FDI figures are even larger, but they are reported with a lag. There are also uncertainties associated with official FDI figures based on trade-ministry-approved FDI transactions registered since last autumn that could lead to overestimation of FDI flows.

Interpretation of official figures is complicated by "stop-over" investments, which flow through intermediate countries for e.g. tax reasons, but are invested immediately in a third country of final destination. A significant share of such investments may also be recycled back to mainland China ("round-tripping") and should not be counted as FDI. The figures show that the most FDI inflows into China come from Hong Kong (70 % in 2014) and the Virgin Islands (5 %). The largest investment outflows from China went to Hong Kong (60 % in 2014) and the Cayman Islands (10 %). A recent BBVA Working Paper asserts that China's 2013 outbound FDI may have been as much as 25 % over-estimated after investments flowing from Hong Kong and tax havens back to mainland are properly acknowledged.

The Rhodium Group, which tracks Chinese FDI flows, notes that the trade ministry's registered outbound FDI flows for years have been larger than Chinese acquisitions of foreign companies abroad. This suggests that part of outbound Chinese FDI has gone to securities investments.

Inbound FDI to China may also suffer from similar inconsistencies.

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Russia

CBR releases elaborated assessment of foreign debt servicing payments through end of this year. The Central Bank of Russia estimates the actual amount for foreign debt of banks and non-bank corporations coming due in the final four months of this year is $35 billion rather than its statistically recorded $61 billion. The CBR's specified estimate aims at excluding "intra-group operations" which the CBR views as having a high likelihood of becoming refinanced. The estimate is based on earlier debt-servicing trends and a survey of Russia's 30 largest companies.

As a result, the CBR does not expect excessive forex demand in the final months of this year to pay off foreign debt. It noted bank and non-bank firms currently hold about $135 billion in liquid foreign assets. Russia can also pay down foreign debt out of its current account surplus. The CBR now projects a current account surplus of $20–28 billion for 2015, if the oil price stays in the range of $40–60 a barrel. The CBR also said it has $14 billion in untapped funds it can make available as forex repo credits.

With foreign debt-servicing payments set to peak in September and falling oil prices depressing the ruble, forex markets have become quite skittish in recent weeks.

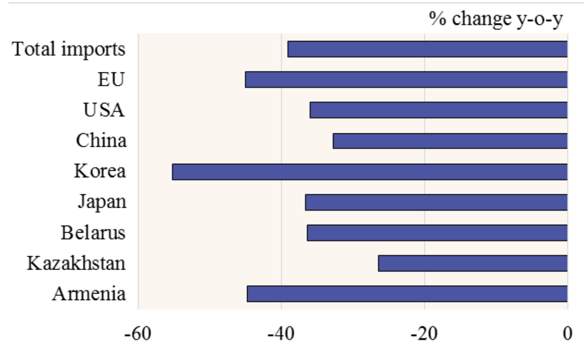
Russian imports suffer as economy falters. Preliminary Rosstat figures show the pace of contraction in Russian GDP reached 4.6 % y-o-y in the second quarter of this year. At the same time, the dollar value of Russia's good imports declined 40 % y-o-y (24 % in euro terms). Preliminary figures from Russian customs also show the nosedive in imports became slightly worse in July. Highlighting the drop in investment, imports of machinery, equipment & transport vehicles were off by nearly 50 % y-o-y in 2Q15.

As trade sanctions imposed on Russia by the EU, US and other countries have been narrowly drawn, their direct impact on Russian imports has been rather mild. Russia's counter-sanctions on food imports also concern only a small share of the country's total goods imports. Imports from Russia's trading partners have in fact contracted sharply across the board, not just with countries participating in sanctions.

In dollar terms, the value of Russian goods exports contracted 30 % y-o-y in 2Q15, due mainly to lower oil prices. Nevertheless, crude oil export volumes were still up 7 % y-o-y and petroleum products 10 % (even if growth was lower than in the first quarter). Export volumes of certain metals and fertilisers were also up in the second quarter. The EU remains Russia's largest export market, accounting for about half of all exports.

Russian goods exports in 1H15 contracted nearly 30 % y-o-y to just over $180 billion. Goods imports were worth just over $90 billion, down nearly 40 % from a year ago.

12-month change in Russian goods imports (January-June)



Source: Federal Customs Service of Russia

Kyrgyzstan becomes newest member of Eurasian Economic Union; Kazakhstan completes WTO accession talks. The Eurasian Economic Union (EEU), which includes Russia, Kazakhstan, Belarus and Armenia, welcomed the entry of Kyrgyzstan on Wednesday (Aug. 12). The impact from Kyrgyzstan's joining should be modest as it is the smallest and poorest of the EEU economies. Free movement of labour will be one of the important benefits for Kyrgyzstan, where wages earned abroad (mainly from Russia) account for a quarter of GDP.

In related news, Kazakhstan wound up nearly 20 years of WTO accession talks in June. WTO members in July approved the terms of Kazakhstan's admission. Kazakhstan has until the end of October to ratify its WTO agreement, under which the country's commitments include reducing the average import duty to 6.1 % and ending restrictions on foreign ownership in several branches of the service sector. With Kazakhstan's WTO membership a done deal, Belarus now stands as the only EEU member outside the WTO.

Reconciliation of EEU membership with WTO commitments brings new challenges for the EEU countries. Kyrgyzstan has been a WTO member since 1998. Kazakhstan's WTO talks were at an advanced stage already when the EEU's predecessor customs union was established. As a result, both countries have tariff commitments to WTO members that are partly lower than the external duty levels of the EEU.

Russia is worried about imports from third countries outside the EEU entering via Kazakhstan, which has lower import duties. Kyrgyzstan is worried that higher import duties from EEU membership will hurt its economy, as over half of the country's imports come from China. Russia has promised Kyrgyzstan $500 million to cover integration costs.

More talks will be needed to reconcile the duty levels. In a similar case, Armenia's accession to the EEU at the start of this year caused its import duties to rise, forcing the country into a new round of talks in the WTO on compensatory measures.

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China

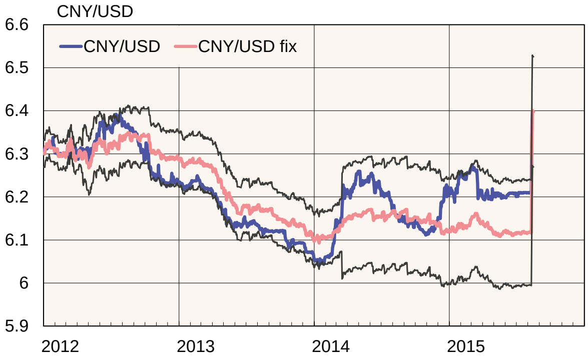
China devalues yuan and announces plans to increase role of markets in exchange-rate setting. The People's Bank of China announced Tuesday (Aug. 11) a lowering of the yuan daily reference rate by 1.9 %. The central bank fixes the reference rate for China's forex markets every trading morning. Trading during the day can be conducted within a fluctuation band of ± 2 % of the fixing rate. The entire band was shifted on Tuesday. The spot market rate has undershot the daily fixing rate since late 2014.

More significantly perhaps, the PBoC said it would let the market, and specifically large designated market-maker banks, play a greater role in determining the reference rate. Many observers now expect that the yuan's external value will experience wider swings as market conditions vary. The regime change is an important step in China's efforts to liberalize its exchange rate practices ahead of the yuan's possible incorporation into the IMF's SDR basket currency. IMF experts recently recommended that China move to a floating exchange rate within 2–3 years, and the Fund has welcomed the central bank's latest move.

The yuan enjoyed years of appreciation pressure from strong growth of China's economy. The yuan last year was relatively stable vis-à-vis the US dollar, but gained roughly 20 % against the euro and about 18 % against the Japanese yen. In June, the yuan's real effective (trade-weighted) exchange rate (REER) was up about 14 % y-o-y. In early summer IMF estimated that the yuan's REER has risen so much that the yuan can no longer be considered undervalued. While the yuan's daily swings seen this week were substantial from a Chinese perspective, the fundamental changes in the exchange rate regime are what matters.

Several observers note that the ostensible purpose of the latest devaluation was to help Chinese exporters, who saw the value of exports fall nearly 9 % y-o-y in July. On the other hand, the value of imports also contracted in the first half of the year, causing China's current account surplus to soar. Moreover, Chinese officials must also consider the additional effects of yuan depreciation on capital outflows.

Yuan-dollar rate, daily fixing rate and fluctuation band

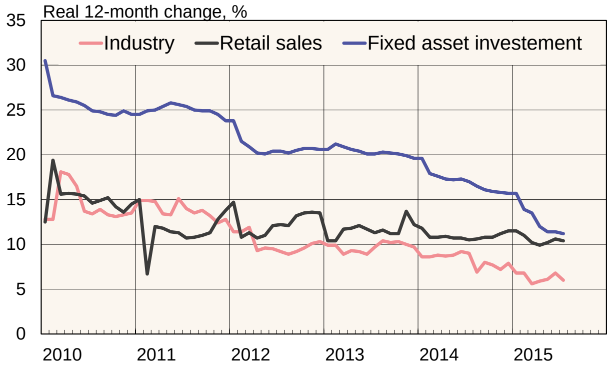


Source: Macrobond, BOFIT

Chinese economic growth continues to slow. July figures released this week on foreign trade and trends in the domestic economy support the view that China's economy continues to slow. Even so, China's poor foreign trade performance was weaker than expected and worse than in June. Exports and imports were both down about 8 % y-o-y. The contraction in exports came as a surprise as June exports had returned to positive growth. The contraction in imports mainly reflected lower global commodity prices.

Industrial output, retail sales and fixed asset investment (FAI) in July grew slightly slower than in June. Industrial output in July was up 6 % y-o-y, down by nearly a percentage point from June. The various purchasing manager indices all foreshadowed a slowdown in industrial output. FAI was up 11 % y-o-y, the lowest growth seen in at least a decade. Retail sales increased in July about 10 %, and private consumption has increasingly become the driver supporting economic growth. Consumer price inflation accelerated slightly in July to 1.6 % y-o-y, while the fall in producer prices accelerated to 5.4 %.

Industrial output, retail sales and fixed investment, %



Source: Macrobond

Chinese foreign real estate holdings on the increase. Stock market jitters at home have increased the interest of wealthy Chinese in purchasing real estate abroad. Bloomberg wrote recently about a recent survey directed to Chinese households showing that many Chinese investors are considering diversification of their assets into foreign real estate markets. In addition to wealthy households, Chinese entities such as state-owned investment funds and Chinese firms have expanded their foreign real estate portfolios.

A report released in June by the US National Association of Realtors also tells of increased foreign real estate investments of Chinese investors. According to the report Chinese buyers accounted for 16 % of all residential housing sales to foreign nationals in 2Q13–1Q14. For the first time ever, Chinese overtook Canadians, who traditionally have comprised the largest group of foreign buyers of US housing. The report found that sales to Chinese buyers were up 30 % y-o-y for the four-quarter period.

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Russia

Regions and local governments face precarious budget circumstances. First- and second-quarter revenues to the consolidated budget (federal, regional and local government revenues plus state social funds) were unchanged in nominal ruble terms from a year earlier. With 12-month inflation running at 16 %, however, revenues collapsed in real terms. While non-oil-&-gas budget revenues were up 9 % y-o-y nominally, revenues from taxes on oil, oil products & gas production and exports in 1H15 were down about 20 %.

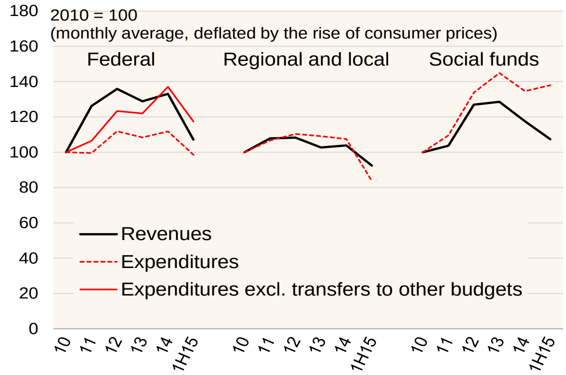
Spending in nominal terms rose by about a fifth, yielding a budget deficit equivalent to 2.6 % of GDP. Disbursements this year have followed an accelerated schedule compared to typical annual spending cycles. If the finance ministry's summer projection for 2015 spending is realised, the second half of 2015 will be very grim as nominal spending growth for the second half will be limited to just 1 %.

While federal non-oil-&-gas revenues were up over 6 %, the slide in oil & gas tax revenues reduced federal budget revenues by 7 % y-o-y. Transfers from the federal budget to other budgets were up over 15 %, with most of the new spending going to the Pension Fund. Other federal spending also rose over 15 %. The budget deficit was 2.3 % of GDP.

Revenues to regional and local budgets (incl. transfers) rose by over 10 %. While nominal received transfers only increased 6 %, other revenues were up 12 %, which is somewhat notable given the current recession. Budget expenditures, in contrast, rose just a few per cent, which kept the budgets in surplus. Most regions struggle with financing deficits and debt. Local budgets were already stretched in 2014 and this year they have only seen revenues, income transfers and spending increase 3–4 %. Growth in local revenues and spending also significantly lags long-term inflation.

Tax revenues of social funds and inter-budget transfers rose well in nominal terms. Due to the very rapid rise in spending, the social funds deficit was about 1.5 % of GDP.

Budget revenues and spending in real terms



Source: Ministry of Finance, BOFIT

Russian accounts inspector finds problems with National Welfare Fund use. The Accounts Chamber of the Russian Federation reports that assets invested from the National Welfare Fund to finance large infrastructure projects have not all been used as intended. The abuses of road-builder Avtodor, which is tasked with construction of a ring road around Moscow, received specific criticism. Avtodor has this year received from the Fund nearly 40 billion rubles (€600 million) through Gazprombank purchasing Avtodor bonds. The Accounts Chamber criticized Avtodor for not using the disbursed funds to break ground on construction work as planned, but deposited most of the money in Gazprombank also receiving interest income. The Accounts Chamber also uncovered similar discrepancies with most other investment projects funded out of the National Welfare Fund.

Number of banks in Russia continues to fall. There were just 783 banks operating in Russia at the end of July, down about 10 % from a year earlier. The reduction reflects license cancellations and bank mergers. The CBR has continued an activated cleaning up of the banking sector over the past two years. It has revoked 50 bank licenses already this year. Most banks losing their licenses are small or mid-sized. In about two-thirds of the cases, licenses were withdrawn due to suspected abuses such as illegal transfers of funds or violation of money-laundering regulations. In half of the cases, the reasons cited by the CBR included financial issues such as undercapitalisation or insolvency.

Banking sector problems are also reflected in the reliance on the deposit insurance fund. The fund paid out a record of 202 billion rubles (€4 billion) to depositors last year, and another 107 billion rubles in the first half of this year. The fund's assets have fallen from about 200 billion rubles at the start of 2013 to 30 billion rubles. The deposit insurance agency has given assurances that it can continue to compensate depositors – even if its obligations to depositors of Rossiyskiy Kredit, which lost its license in July, exceed 40 billion rubles. The fund gets most of its funding from member bank payments, but when needed it can also receive state support. Last year, a significant part of the fund's financing came from the state and the situation is expected to continue.

About 20 bank mergers have been initiated or completed since July 2014. A quarter of the acquired banks are mid-sized, and the rest are small. The buyers are mainly mid-sized banks. The markets expect more mergers ahead.

Russia's banking sector is still quite concentrated and the largest banks are state-controlled. The five largest banks held 54 % of total assets of the banking sector at the end of July. There were 106 banks with foreign majority owners at the end of June, and those banks held nearly 13 % of banking sector assets.

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China

Turbulence continues on Chinese markets. Uncertainty on Chinese stock markets persists despite official efforts to stabilise the markets. The stock market turbulence is due to e.g. increased volatility in foreign exchange markets and speculation that officials may withdraw stock market support. On Tuesday (Aug. 18), share prices plunged over 6 % on the Shanghai and Shenzhen exchanges, and the markets remain shaky.

Chinese share prices, 1.1.2014–19.8.2015

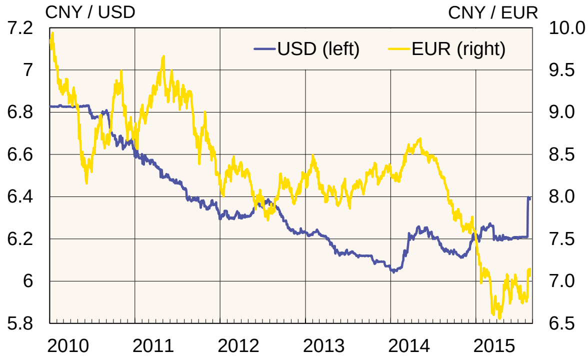
Sources: Macrobond, BOFIT

Uncertainty on foreign exchange markets increased last week after the People's Bank of China shifted to a more market-based regime for setting the yuan's exchange rate. The move was accompanied with a small devaluation; the yuan now stands about 3 % lower against the dollar than it did at the beginning of last week. The minor drop in the exchange rate will have only a tiny impact on the price competitiveness of Chinese export industries, so market comments emphasizing the devaluation appear as overblown. Daily fluctuations in the exchange rate have since been minimal, but volatility is expected to increase. A more market-based formation of the yuan's exchange rate is important in setting the stage for progress in economic reforms and increasing the flexibility of monetary policy.

Chinese exchange rate policy also has to deal with the acceleration in capital outflows seen in the first half of this year. According to media reports the PBoC has stabilised the yuan's market rate to reduce pressures that might otherwise cause capital outflows to pick up. Officials have also given assurances that they will continue to support stock markets. Government intervention to stabilise stock markets is not a sustainable solution, if the aim really is to give markets more power in the economy.

While the risks associated with the opening of financial markets should not be understated, there are no clear signs that the real economy is in excessive trouble. Indeed, available information suggests growth has slowed more or less as expected. Related to exchange rate issues, the contraction in exports has been balanced by a contraction in imports, so China's current account surplus continues to grow.

Yuan-dollar and yuan-euro exchange rates



Source: Reuters

IMF says China's shift to a more sustainable growth model essential. The IMF has released its latest annual staff review of the Chinese economy (Article IV Consultation). The main theme is that slower economic growth in coming years is an inevitable feature of more resilient economic structures. China's slowing growth is not simply related to the business cycle, but a needed structural accommodation to a more sustainable growth paradigm. The challenge for China's leaders is to accomplish a soft landing without exposing existing vulnerabilities.

The staff report repeatedly stresses the importance of rapidly advancing structural reform essential to raising China's growth potential. Important reforms include moving to a more market-based financial system, reforming state-owned enterprises and taking action to improve the competiveness and investment efficiency of the private sector. The IMF reiterated its wish that China move to a floating exchange rate regime within two to three years.

The IMF considers the latest trend of slower growth of credit (particularly evident in the shadow banking sector and real estate investment) a positive step. The IMF said that economic resilience would have to come from reducing the debt-to-GDP ratio and excess supply in real estate markets. The staff praised China's new budget act, aimed at helping local governments reduce off-budget borrowing. Financial market reforms have proceeded as expected. GDP is generated increasingly by labour-intense activities, having a positive impact on the labour market trends.

The IMF assessment assumes China will succeed in invigorating its economy and advancing economic reforms. GDP growth should come in at 6.8 % this year, 6.3 % next year and 6 % in 2017. Under the base scenario, economic growth will then cease to slow as the positive effects from reform begin to be felt.

The IMF emphasised that rising economic vulnerabilities need to be addressed immediately. One of the biggest risks is that economic reforms will move too slowly as China clings to its old growth paradigm. Failure to embrace change could seriously impair growth over the long run and hurt the global economy.

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Russia

Falling oil prices weaken the ruble and increase risks to Russia's economy. The ruble's slide accelerated after the price of Urals-grade crude oil approached the $40 mark last week. The ruble has lost about a third of its value against the euro and dollar since its recent peak in late May. It hit new lows of the year this week. The currencies of other commodity-producing countries have also been affected. For example, oil-producer Kazakhstan last week announced of switching to free-float and saw the tenge drop over 20 % against the dollar.

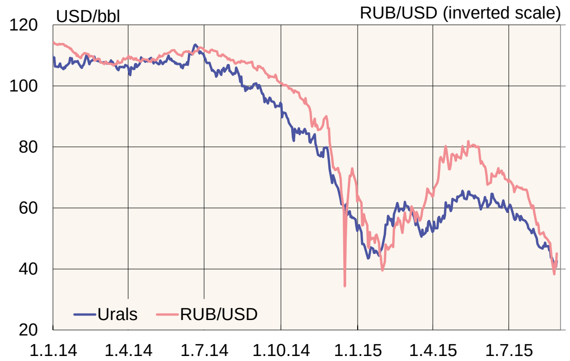
Adding to depreciation pressures on ruble, nearly double the recent average monthly amount of private-sector foreign debt comes due in September. The Central Bank of Russia has, however, estimated that a large part of the debt is intragroup and could be refinanced. Prime minister Medvedev recently expressed his confidence in the ruble, saying the exchange rate should get a boost when exporter firms will sell additional forex proceeds in the near future. Medvedev added that the government has not relaxed its supervision of exporters' sales revenues launched at the end of 2014.

The global drop in oil prices and anxiety on international financial markets was evident also on the Russian exchange this week as the RTS index fell to its lowest point this year.

Low oil prices forced the economy ministry to revise downward by a half percentage point its GDP forecasts for 2015 and 2016. In the new forecast, GDP shrinks 3.7 % this year, but next year grows 1.8 % (still optimistic compared to the consensus view) assuming an average oil price of $55 a barrel. If the oil price stays at $40 a barrel next year, the ministry sees GDP contracting 0.9 %.

Low oil prices also put pressure on the government for further fiscal tightening. The current 2016 draft budget assumes an average oil price of $60/bbl, an exchange rate of 57 rubles to the dollar and 2.3 % GDP growth. Even under these parameters, the 2016 federal budget deficit would still be 2.4 % of GDP. As part of its July budget calculations, the finance ministry also estimated that the Reserve Fund will correspond to 2.9 % of GDP at the start of next year.

Ruble-dollar exchange rate and price of Urals crude



Source: Reuters

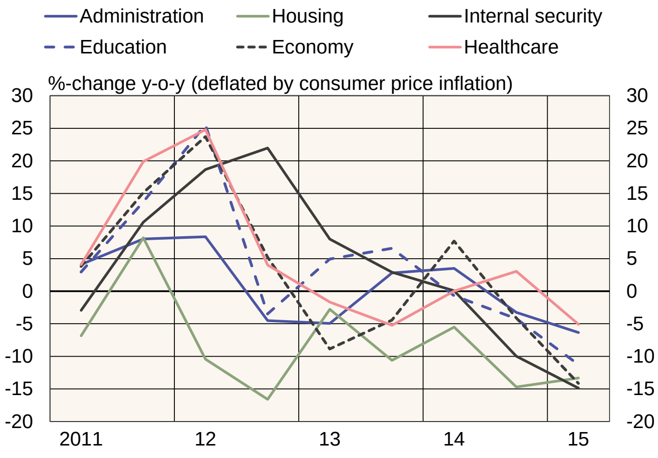
Large shifts in structure of government revenues and spending. In the first half of 2015, revenues to the consolidated budget (federal, regional and local governments, plus state social funds) remained unchanged in nominal ruble terms as 9 % y-o-y growth in other budget revenues offset a 20 % drop in tax and fee revenues from oil & gas. The non-oil share of revenues rose to 77 % and equalled over 28 % of GDP.

Nominal ruble revenues from income and excise taxes increased just a few percent and VAT revenues were up 6 %. Revenues from mandated social contributions, however, rose 9 % and revenues from corporate profit taxes were up even 30 %. The unusually large increase mostly came from higher profits of exporters in the oil and metal branches. These firms have seen their ruble denominated profits rise sharply due to ruble depreciation. Nominal budget revenues from property taxes were up 10 %. Revenues from state property rose 60 % as income from investment of government assets quadrupled (again, partly due to the ruble's collapse) and the transfers to the state from CBR surplus increased by 2.5 times.

A nearly 20 % rise in first-half consolidated budget spending (in nominal ruble terms) was driven largely by higher social and defence spending (both up by over a third). As defence spending increase was more front-loaded than usually (i.e. allocated early in the year), its share of budget spending rose to 14 % and exceeded 5.5 % of GDP. Social spending rose by 36 % to 14 % of GDP. Debt-servicing costs, due in part to ruble weakness, also increased over 30 %.

The government increased healthcare spending by 10 % in the first half of this year. Other main spending categories rose slowly in nominal ruble terms or were unchanged from a year earlier. Inflation picked up dramatically last winter, so all spending not related to defence or social spending fell sharply in real terms relative to the first half of 2014.

Real changes in select government spending categories



Source: Ministry of Finance

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China

China's central bank continues monetary easing and liberalisation of interest rates. On Tuesday (Aug. 25), the People's Bank of China announced a rate cut of 25 basis points. The reference one-year lending rate now stands at 4.6 %, while the corresponding deposit rate is 1.75 %. The PBoC simultaneously eliminated the interest rate ceiling on time deposits over a year. The interest rate commercial banks can offer on deposits with shorter maturities is still limited to 150 % of the reference rate. This means that interest rate liberalisation in China is very near to completion.

The PBoC also told that it will lower its reserve requirements from September 6. The reserve requirement ratio for all banks will go down by 0.5 percentage points. The impacts were hard to assess last time the reserve requirement was lowered as it only applied to banks meeting certain criteria. Now the PBoC again targeted some banks for reserve requirement cuts greater than 0.5 percentage point.

China has relaxed monetary policy already six times this year. The PBoC said its latest move was needed to keep real interest rates moderate and inject liquidity in money markets. Tighter liquidity conditions were partly due to the central bank yuan purchases to stabilise the exchange rate. An interest rate cut may create pressure to yuan depreciation and increasing capital outflows.

On-going volatility on the Chinese stock markets. On Monday (Aug. 24), Shanghai share prices fell 8.5 %, and continued to fall the next days. On Wednesday (Aug. 26) Shanghai stocks were still down about 27 % from the start of last week, but the market has since recovered some 5 %. Monetary easing has somewhat calmed the markets, but officials have refrained from market bailouts similar to what was done during the July plunge in share prices. Direct interventions in equity markets are poorly suited to the long-term goals of market liberalisation and modernisation.

Share prices on other emerging markets have also had a volatile two weeks. On Wednesday, emerging stock markets were still down on average about 7 % from the start of last week. In Hong Kong share prices also fell sharply, down 11 % y-o-y on Wednesday from the beginning of last week.

Stock trends in China and other emerging markets

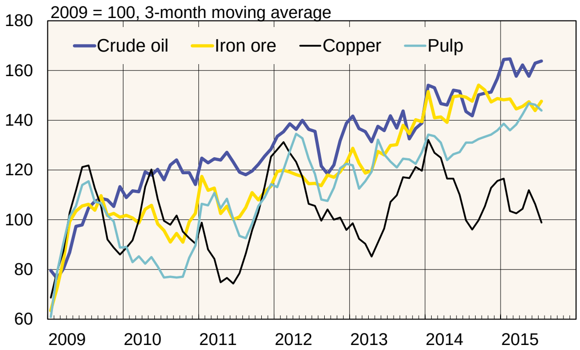
Source: Bloomberg

Chinese oil import volumes up 10 % this year. The slowdown in economic growth has yet to be seen in China's oil imports. In the first seven months of this year, China imported 194 million metric tons of crude oil, an increase of 10 % y-o-y. Imports soared in June and July, when China's imports of crude oil were up 28 % y-o-y. Due to the sharp drop in oil prices, the value of oil imports in dollar terms was down 40 % y-o-y in January-July.

Most of the growth in China's oil imports comes from a conscious effort to increase the national strategic reserves. The International Energy Agency (IEA) believes that demand for oil will exceed consumption for some time as China continues to add to its new strategic reserves.

In the January-July period, imports of crude oil from Russia amounted to 23 million tons, i.e. 12 % of China's total oil imports. Oil imports from Russia, measured by volume, increased faster than oil imports from the other major oil producer. Crude oil imports from Russia in January-July were up over 30 % y-o-y. At the same time, imports from Saudi Arabia were up 10 %, while imports from Iran and Angola declined. The value of oil imports from Russia fell 28 % in dollar terms in the period.

Commodity imports to China by volume



Source: Macrobond

Imports of many other commodities declined. Measured by volume, coal imports in the first seven months of the year were down 34 % y-o-y and copper 9 %. The volume of imported iron ore remained roughly unchanged from a year earlier. The on-going structural changes in China, even without a significant economic slowdown, will impact China's imports. Most affected are those commodities needed earlier during China's rapid infrastructure build-out. For example, imports of copper as well as iron ore and coal used in manufacture of copper and steel have fallen on the slowdown in construction.

Excess domestic capacity (e.g. in the steel industry) also affects commodity imports. China wants to reduce overcapacity and increase production efficiency. This will be manifesting in the reshaping of domestic production. Reduced emissions targets have also led to at least temporary shuttering of the worst polluting factories.

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Weekly Review
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BOFIT

Russia

Multiple impacts on Russia's labour market from current recession. Despite a strong pick-up in inflation, the rise of private sector wages in nominal ruble terms has stayed at a record-slow rate this year. Private sector wages in the first half were up only 6–7 % y-o-y. Public sector wages, which are feeling pressure to restrain government spending, were up a mere 3–4 % y-o-y. Wage arrears are up only slightly, however, unlike in the 2009 recession.

Although production in Russia has contracted significantly, the number of people in the workforce shrank only about 0.5 % y-o-y in the first half. The number of unemployed persons increased 10 % y-o-y in the second quarter. Russia's standard ILO unemployment rate has risen slightly, to around 5.5 %. Under a wider definition of unemployment that includes workers outside the labour force but willing to work, the number of these outsiders has also climbed notably and the wider unemployment rate has approached 10 %. The number of part-time and laid-off workers has clearly increased. In the second quarter, these conditions affected over 3 % of the personnel at large and mid-sized firms. Hours worked per employee were down about 1 % y-o-y in the first half of 2015.

Government wants to increase competition but also restrictions on public sector procurements. A recent economy ministry report notes that there is still plenty of room for increasing competition and transparency in the procurement processes of public-sector-owned companies. The report stated that procurements in recent years have concentrated increasingly on small pool of suppliers, with only a small share of procurement awards based on open bidding or auction. Procurement announcements were also often obscure and award processes poorly documented.

Russia's new law on public-sector-owned companies' procurements entered into force in 2012 and was amended last time in the summer. Public-sector-owned companies are now required to register online and announce all procurements exceeding a specified ruble amount on the website. Nearly 80,000 firms have registered, and the total value of announced procurement contracts corresponds to almost a quarter of Russian GDP. A handful of large firms make most of the procurements (e.g. Rosneft, Gazprom and the national railways RZD). The new law aims at increasing transparency, competitiveness and efficiency in procurements.

On the other hand the current objective of import substitution has resulted in several government proposals which could rather have opposite effects. The government is seeking e.g. a greater say in supplier selection in large procurements, limits on the use of imported goods and services, and minimum quotas on the share of innovative products in procurements.

Finnish exports to Russia down sharply in the first half, exports to other countries unchanged. Finnish goods exports to Russia amounted to €1.5 billion in the first half, down by a third from a year earlier. Much of the weak export trend was driven by the contraction in Russian demand and the weak ruble. In the first half, the euro-value of total goods imports to Russia contracted 24 % y-o-y, and the ruble was down 13 % in real terms against the euro. Exports to Russia also suffer from the general competitiveness problems of Finnish exports, but Finland's goods exports to other countries contracted only 0.1 % y-o-y. Russia was Finland's fifth largest export market with a share of less than 6 % of total exports.

Finnish exports to Russia contracted in all major product categories. The biggest contributions for the export contraction were due to machinery and equipment since it is the largest export product category, as well as food exports, which experienced the sharpest drop. Machinery exports recovered a bit in June, up 1 % y-o-y, but month-to-month fluctuations are large. Food exports have had to struggle with the additional burden of Russia's import bans. Food exports to Russia contracted in January-June by over 70 % y-o-y, drawing down Finnish food exports overall (even if food exports to other markets were mostly up). Finnish food exporters seem to have been unable to find other markets for e.g. fish and certain dairy products whereas exports of butter to other markets soared.

The value of transit goods from third countries via Finland to Russia dwindled in January-June to less than €4 billion. Transit shipments this year have fallen below levels seen in the early 2000s.

Export of travel services to Russia appears to have also declined further. Border-crossings between Finland and Russia fell by over a fifth in the first half, and the number of Russian travellers arriving to Finnish inns and hotels was down by nearly 50 % y-o-y.

Finnish goods imports from Russia in the first half shrank 36 % y-o-y to €3 billion. The drop in the value of imports was largely from low oil prices. Russia fell to Finland's third largest import supplier providing 11 % of Finnish goods imports.

Russia's goods imports and Finnish exports to Russia (EUR)

Sources: Central Bank of Russia, Finnish Customs.

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China

New car sales in China slowed in recent months. According to the China Association of Automobile Manufacturers (CAAM), sales of new cars were down on year in the June-July period. Overall, the pace of car sales was unchanged in the first seven months of this year. Car sales in the January-July period amounted to 13.4 million vehicles. A total of 23.5 million new cars were sold last year, an increase of 7 % from 2013. Cities are increasingly limiting the number of new car registrations to rein in pollution and traffic jams.

Sales of domestic makes increased in January-July by 14 % y-o-y. In the same period, sales of Japanese makes were up 5 %, while German makes were down 6 % and US makes down 3 %.

Sales of electric and hybrid cars have risen rapidly. Over 90,000 electrics and hybrids were sold in the first seven months of the year. While this was a relatively small share of car sales overall, it was more than triple the number of such cars sold in January-July 2014. Purchasers of electric vehicles enjoy price incentives, tax breaks, as well as registration preference over other cars in cities.

CAAM figures show that 13.6 million cars were built in China in January-July, which was 100,000 more cars than a year earlier. China also imported 530,000 new cars and exported 400,000 new cars in the first half.

China's state-owned enterprises climb in rankings of world's largest companies. The 2015 *Fortune Global 500* rankings include 98 Chinese firms (includes companies headquartered in Hong Kong), up from 10 Chinese firms in the year 2000. 128 US-based firms and five Russian firms also made this year's list. The list is based on reported total revenues for the financial year ending March 31 or before. China's state oil company Sinopec rose to the number-two spot this year. All twelve of the biggest Chinese firms are state-controlled, mostly banks or companies in the energy sector. Only 22 of the 98 Chinese firms listed were private.

2014-2015 rankings of world's largest companies by total revenue

2015	2014	Company	Country
1	(1)	Walmart	US
2	(3)	Sinopec Group	China
3	(2)	Royal Dutch Shell	Netherlands
4	(4)	China National Petroleum	China
5	(5)	Exxon Mobil	US
6	(6)	BP	UK
7	(7)	State Grid	China
		//	
18	(25)	ICBC	China
26	(17)	Gazprom	Russia
29	(38)	China Construction Bank	China
36	(47)	Agricultural Bank of China	China
37	(52)	CSCEC	China

Source: Fortune Global 500

The skyrocketing rise in share prices in the first half boosted the market capitalisations of Chinese firms, catapulting them into the highest tier of global firm valuations. US firms occupied five of the top spots in the Financial Times *FT Global 500* list as of end-March. The company with the world's highest market capitalisation was Apple ($725 billion). Petro China ($330 billion) rose to sixth position on the FT list and ICBC ($275 billion) to ninth.

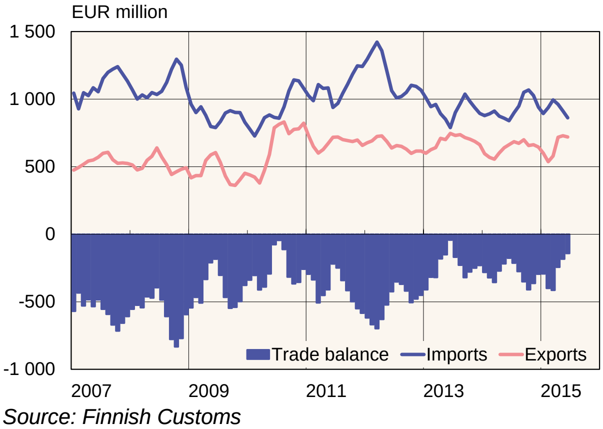
Finnish exports to China up in first half. Foreign trade figures from Finnish Customs show that the value of Finnish goods exports to China in January-June was €1.3 billion. Goods exports rose 7 % from 1H14. The development of Finnish exports to China has been positive compared to last year, as in 1H14 exports fell 12 % y-o-y. In the first half, China's share of Finnish total goods exports remained around 5 % as in earlier years.

Finland's top exports to China were paper pulp, furs, as well as industrial machinery & equipment. Paper pulp has been Finland's top export item to China for several years now. In the first half, pulp accounted for 19 % of Finland's total exports to China and the value of paper pulp amounted to €244 million, an increase of 16 % y-o-y. The share of fur exports (€192 million, up 83 % y-o-y) in total exports rose to 15 % in the first half, up from 8 % last year. Exports of industrial machinery (10 % of total exports) climbed 24 % to €133 million.

Imports from China also grew 6 % y-o-y in the first half. The value of imports from China was €1.9 billion. Imports of phones (14 % of total imports) and other electrical devices (13 % of imports) increased about 6 %. Imports of computers (13 % of imports) and clothing (12 % of imports) fell 5 %. Despite higher export growth than import growth, Finland's trade deficit with China increased in the first half to €557 million, up from €533 million in 1H14.

Based on overnight stays at Finnish inns and hotels reported to Statistics Finland in the first half, the number of Chinese tourists visiting Finland increased sharply from a year earlier. In 1H15, Chinese travellers recorded 70,403 overnight stays, an increase of 38 % from 1H14. The second largest increase was registered for French tourists (up 7 %). Chinese, however, represent only a tiny share of tourists visiting Finland, accounting for about 3 % foreign travellers.

Finnish goods trade with China, 3 month moving sum



Source: Finnish Customs

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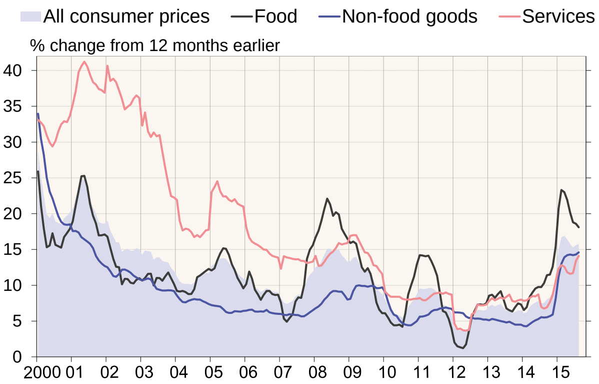
Russia

Russian inflation continues to pick up steam. Consumer prices showed in July-August their fastest on-month rise for years. In August consumer price inflation was nearly 16 % y-o-y and food prices were up over 18 %.

Following a price spike late last autumn and winter, food prices fell slightly in the summer in line with normal seasonal fluctuations. However, the rise in prices of non-food goods accelerated in July-August in a manner similar to (but milder than) what happened last winter and spring. An underlying factor was a sharp drop and increased volatility in the ruble exchange rate. Prices of services also rose faster than in many years, mostly due to unusually large rate hikes in July for household energy and water supply.

Consumer price inflation



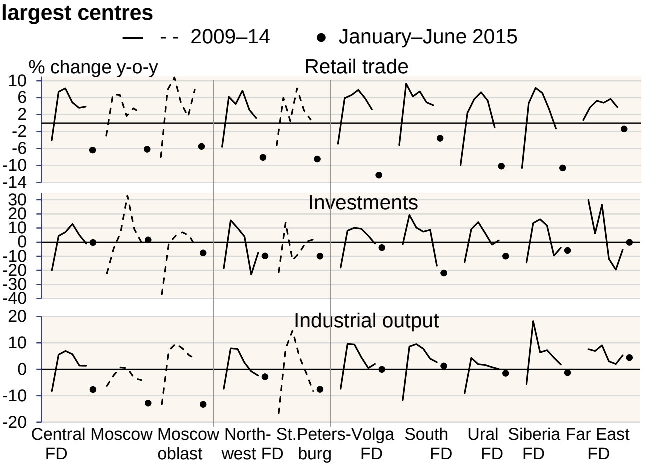
Source: Rosstat

Recession hits Russian regions. Private consumption has fallen considerably. The volume of retail sales in the first half was down 6–12 % y-o-y in most of the eight Federal Districts. The decline in the three most northwestern Federal Districts was distinctly worse than during the 2009 recession. In 22 of Russia's 83 administrative regions, the on-year contraction was 10 % or more.

Fixed capital investment, which began to fall in almost every Federal District already in 2014, has continued to slide this year. In the first half, investment nationwide was down more than 5 % y-o-y. Variations at the regional level were huge, however. Some 33 regions showed investment declines of at least 10 % y-o-y, while 19 regions saw investment slide at least 20 %. At the same time, investment increased by more than 5 % y-o-y in 23 regions.

Industrial output has been falling especially in the Central Federal District due to notable contraction in the production of several sectors in the City of Moscow and surrounding Moscow region. In the first half of the year, industrial output in 15 regions fell by more than 5 %, while output was up over 5 % in 24 regions.

Real economic growth in Russia's seven Federal Districts and largest centres



Source: Rosstat

Putin issues decree to speed up construction of Power of Siberia pipeline. It was hoped that president Putin's state visit to Beijing last week would give a boost to China-Russia economic relations, but the meeting produced little of substance. There was no progress in talks on construction of the Altai pipeline to bring gas into Western China and the new initiative on building a one more pipeline from the Far East received little attention.

Construction of the Power of Siberia natural gas pipeline has proceeded slowly since it began a year ago. Gas transmission is scheduled to begin in 2019, which requires that construction of the massive transmission pipeline grid be completed and two new gas fields brought on stream. Gazprom expects the Chayandinskoye field (Yakutia) to be producing in 2017 and the Kovykta field (Irkutsk) in 2022.

The Power of Siberia project is a key part of Russia's efforts to diversify gas export routes. The country's leaders have repeatedly described the project as a good example of intensified cooperation with China. At the end of August, Putin signed a decree to speed up implementation of the project and the cabinet moved ahead with enabling rules. The machinery and equipment needed for the construction of the Power of Siberia pipeline and new production areas will be exempt from import tariffs (if comparable domestic products are unavailable) and value-added tax. Moreover, numerous government agencies and state firms have been encouraged to support the project in many ways. For example, the state railways and other transport businesses have been encouraged to give priority to project shipments, while power grid operator Rosset has been asked to give priority to projects related to the Power of Siberia pipeline.

Construction of a 2.2-kilometre rail bridge across the Amur River commenced last year has not proceeded as anticipated either. The Chinese partner says it should complete its 1.9-kilometre stretch of the bridge by the end of October. The Russian partner has yet to start construction work.

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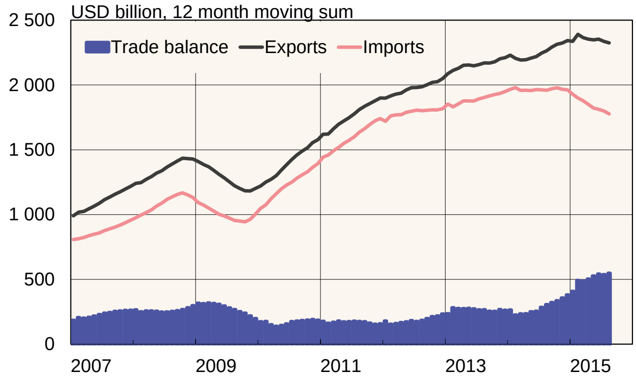
China

Chinese foreign trade down again in August. Exports continued to contract in August, falling 6 % y-o-y. For the first eight months of the year, the value of goods exports was down 1 % y-o-y. Growth in the volume of exports remains sluggish.

The value of imports fell 14 % y-o-y in August, continuing a trend seen all this year. The main reason for falling import values is the collapse in prices of energy and other basic commodities. After several consecutive months of decline this spring, import volumes in June-July began to rise. The cumulative trade surplus for January-August climbed to $366 billion.

Value of China's foreign trade



Source: Bloomberg

New figures on Chinese local government debt. Chinese officials report that the total amount of local government debt at the end of 2014 amounted to 15.4 trillion yuan (€2.3 trillion), or about 25 % of GDP. The new number is slightly lower than the official estimate released this spring. A full set of figures on local government indebtedness was last released in June 2013, when the overall debt figure was estimated to be around 10.9 trillion yuan.

The debt stock has risen 40 % over the past 18 months. Part of the increase reflects a reclassification of loans guaranteed by a local government as direct local government debt. In addition local governments are indirectly liable for loans they have guaranteed. The value of loan guarantees was put at 8.6 trillion yuan (€1.3 trillion), or 23 % more than in July 2013. Loans and guarantee obligations totalled around 25 trillion yuan (€3.5 trillion).

The government has turned to the bond markets for solutions to the debt problems of local governments. Under the latest guidelines, local governments are allowed this year to issue bonds worth up to 3.2 trillion yuan to refinance their existing credit obligations. Local governments have also been given the option of issuing new debt in the amount of 600 billion yuan. The ceiling on local government debt was raised this year to 16 trillion yuan.

Local governments have so far this year issued 1.4 trillion yuan in their own bonds. These issues have largely been met with low investor enthusiasm due to their modest yields. Regulatory officials are again allowing local governments to borrow via external off-budget financial vehicles for certain types of financing. Policy banks have also begun to assist local governments in financing their infrastructure projects through directed bond issues.

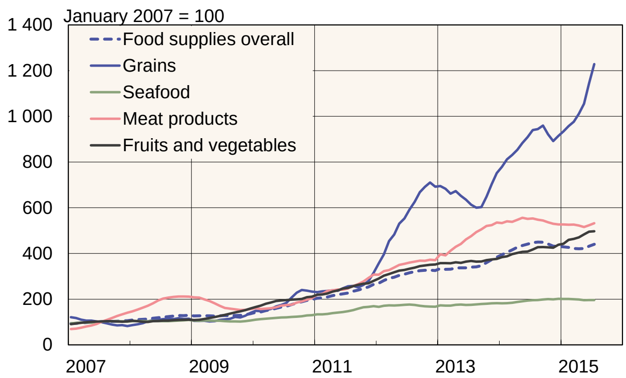
Chinese food imports up. Growth in domestic food production has failed to keep up with growing consumer demand and shifting consumer habits, even if China seeks to achieve self-sufficiency in many basic agricultural products. Agriculture now accounts for about 9 % of GDP, down from 15 % at the start of the 2000s. In the meantime, food imports have risen 18 % a year on average.

Despite low productivity, China remains the world's largest agricultural producer. Chinese farms are typically quite small and poorly suited to modern mechanised farming techniques. Further, the total area of available farmland continues to decline as a result of increasing environmental degradation and the loss of natural services. Agriculture has been hurt particularly by the lack of clean irrigation water and soil pollution. An official report released in 2014 found that nearly 20 % of China's farmland is toxified due to pollution and excessive use of fertilisers and pesticides.

Urbanisation reduces the rural labour force and the amount of available farmland, but it also increases average consumer incomes and reshapes consumption habits. China's environmental problems and scandals in the food industry have increased demand for foreign products, which are seen as safer than the local option in many cases. Strong growth has been seen in imports of grains, meat, vegetables and fruits.

Data compiled by China Global Investment Tracker show how China has invested $43 billion over the past ten years in agricultural projects around the world. Chinese firms have partnered with foreign agricultural producers in order to learn how to enhance their productivity with the latest production methods and to import foreign produce to China. China has also entered into bilateral trade agreements with numerous countries to ease food imports.

Value of Chinese food imports and of various food supplies



Source: Macrobond

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Russia

CBR leaves rates unchanged. As the markets expected, the Central Bank of Russia suspended systematic rate cuts at last week's meeting, leaving the key rate at 11 %. Having cut at every meeting since the start of the year, the CBR board noted that, while recent sharp depreciation of the ruble has accelerated inflation and increased inflationary pressures in the coming months, Russia's economic prospects overall remain weak. With the drop in global oil prices and more uncertainty on international financial markets, there is a heightened risk output will fall further than earlier expected and reduce inflationary pressures.

Russian 12-month inflation accelerated to nearly 16 % in August. The CBR now sees inflation slowing to 7 % by September 2016, and further expects to reach its 4 % inflation target in 2017. As one of the major risks for inflation the CBR regards further deterioration of international economic conditions. If world oil prices would drop further and uncertainty on international financial markets would increase, the ruble would be subjected to further depreciation pressures causing increased inflation risks. The CBR has, however, estimated that the net outflow of private sector capital has slowed in recent months, which eases depreciation pressure on the ruble. According to preliminary CBR figures, private sector net capital outflow in the first eight months of the year amounted to $52 billion, while the current account surplus for the period was about $51 billion.

Among other inflation risks the CBR mentioned possible changes in planned hikes in regulated prices in 2016 and 2017 and relaxation of fiscal policy.

Russia's economy ministry and central bank revise their forecasts. Both the economy ministry and the CBR have lowered their forecast assumptions on the oil price after the price had decreased since mid-summer. The economy ministry now assumes that the price of Urals-grade crude oil will average just $50 a barrel both this year and next. It further expects GDP to contract by 3.6 % this year, slightly more than in its previous forecast. Despite low oil prices, the economy ministry forecasts GDP growth of nearly 1 % in 2016.

The CBR's latest forecast assumes an average oil price of $52 a barrel this year and $50 in 2016–2017. The CBR forecasts GDP will contract this year by 3.9–4.4 % and by 0.5–1 % in 2016. The central bank expects it will take at least two years for private consumption and fixed investment to recover from their large declines this year. The CBR notes investor sentiments would remain negative on Russia. In the CBR forecast, Russian imports contract this year by about a fifth and recover only after a couple of years.

Significant changes again in structure of investments in Russia. Overall investment in the economy in the first half of this year contracted over 5 % y-o-y, but there were significant variations across sectors. As in 2014, large and mid-sized firms involved in energy extraction, mostly oil and gas production, continued with large investments, hindering a larger drop of overall investment in Russia.

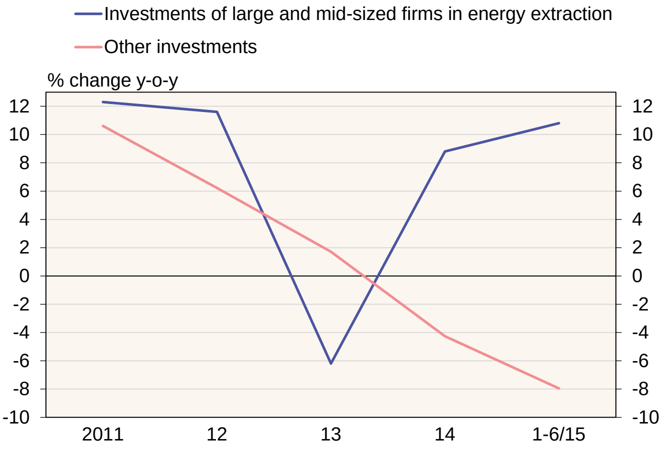
Other investment in the economy as a whole declined sharply. This was due mostly to starkly falling investment in electrical power generation and rail transport, which both declined already in 2013 and 2014. Investment in oil and gas transmission pipelines also fell steeply. Investment in oil refining went into decline after several years of growth. Investment in large and mid-sized firms in other manufacturing branches contracted a couple of per cent, for the third year in a row.

Rosstat reports that in the first half of this year investments of small firms and the grey economy were unchanged from 1H14. Indeed, there was very little change in these investment categories also from 2013 to 2014.

Even if there is only ruble-denominated data available during the year for other structures of investment, they, too, reflect weak investment developments. Even in nominal ruble terms, investment in housing construction, as well as other construction, was down slightly on year. Investment expenditure in machinery and equipment, as well as transport vehicles, grew by just 1 %.

Most increases in investment came from firms' out-of-pocket financing, even if in nominal ruble terms the increases did not come close to keeping up with inflation. Underlying most of this was improved profitability in the oil and gas industry early this year, which, in turn, was the result of the benefits from ruble depreciation to export-oriented firms. Spending on fixed investment of all levels of government increased slightly overall, but investment spending in regional and municipal budgets fell. The sharpest drop was seen in corporate borrowing to finance fixed investment.

Investment developments in real terms



Source: Rosstat.

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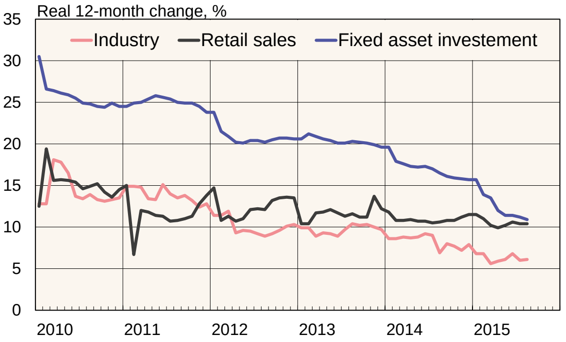
China

Chinese retail sales support economic growth. August figures on the real economy reinforce the view that, while China's economy continues to slow, its structure is also evolving. Growth of fixed asset investment (FAI) slowed in January-August to 11 %. There has been a distinct slowdown in real estate investment and to a lesser extent lower growth in production investment. On the other hand, investment in infrastructure has picked up slightly. Industrial output continued to rise at 6 % y-o-y. Retail sales grew over 10 % in real terms, indicating robust increases in both consumer demand and expansion of the service sector (roughly, of course, as retail sales are an imperfect indicator of consumption or production of services). Consumer price inflation accelerated from 1.6 % in July to 2 % in August.

Industrial output, retail sales and fixed asset investment



Source: Macrobond.

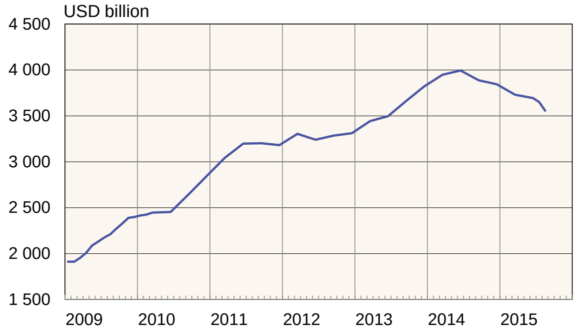
China's foreign currency reserves declined by $94 billion in August. Following a record monthly drop, the value of China's reserves held in foreign currencies at the end of August stood at $3.557 trillion. The decline in reserves reflects massive capital outflows and the central bank's response in propping up the yuan's exchange rate. Media reports note that the People's Bank of China has supported the yuan's exchange rate through currency interventions, even if the central bank does not publish information on this. Officials are trying to quell forex outflows e.g. by setting a 20 % reserve requirement ratio on forex forward contracts from October 15 onwards. Because interest is not paid on such deposits, hedging against currency fluctuations becomes more expensive.

Shifts in the value of China's reserves depend on multiple factors, and the effect of one factor is hard to judge due to the lack of available information. Included here are capital outflows in the form of outbound foreign direct investment, money spent by Chinese tourists abroad and investment opportunities abroad – all of which are on the rise. Stock market uncertainty has caused foreign investors to pull their investments out of China. Thus, even if China's goods trade surplus has increased, capital in net terms is currently flowing out of China and the outflow has picked up in recent months. The outflows are reflected in the drop in the country's foreign currency reserves.

The value of foreign currency reserves is also affected by exchange rate changes. While China does not release an exact breakdown of the currencies in its reserves, they are held partly in currencies other than the US dollar. Moreover, China is drawing on its foreign currency reserves to finance various national projects. The Silk Road Fund and the Chinese-led development banks (AIIB and NDB) have received financing support from China's foreign currency reserves.

China has embraced the IMF's Special Data Dissemination Standard (SDDS), which improves reporting on its foreign currency reserves and foreign debt. China now reports all categories of its reserve assets on a monthly basis: forex, IMF reserves, special drawing rights (SDRs) and gold. In August, $62 billion was invested in gold. China's total reserve assets stood at 3.634 trillion as of end-August.

Value of China's foreign currency reserves



Source: Bloomberg.

Reform plan for Chinese SOEs stresses increased state supervision. China's State-Owned Assets Supervision and Administration Commission (SASAC) of the State Council last week released an overview of its programme to reform state-owned enterprises (SOEs). The core message is that SOE reform does not mean extensive privatisation of state firms, but rather stricter state governance. The Communist Party will now have greater say in the appointment of directors. Corporate reporting duties to the party will also increase. The reform plan calls for reasserting SOEs instead of decreasing their significance and giving private firms a larger role in the economy.

China's large SOEs have vast holdings that extend to businesses completely unrelated to their core business and tolerate much lower productivity than private firms. Under the reform plan, productivity would be boosted e.g. by increasing private minority stakes and having SOEs divest firms that perform poorly or are unrelated to the core business and provide opportunities for corruption. For example, state oil company CNPC owns hotels it now must sell. The reform plan calls for the closure of unprofitable SOEs, which seems difficult given the political backlash officials will likely face from such actions.

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BOFIT

Russia

Fresh BOFIT forecast sees Russian GDP and imports contracting slightly further in 2016. Russia's economy has shrunk substantially this year, in response to the collapse of oil prices in 2014. The newest BOFIT Forecast for Russia 2015–2017 sees Russian GDP contracting about 4 % this year (assuming the oil price averages slightly less than $55 a barrel). Uncertainty depresses fixed investment, while consumption suffers from the effects of last winter's inflation flare-up. Government spending falls in real terms. Defying earlier expectations, however, the volume of Russian oil exports has shown robust growth. The volume of imports to Russia has fallen, and is expected to be about 25 % smaller than in 2014.

Even if a moderate rise in the oil price is assumed for 2016–2017, the fallout from the 2014 oil price collapse will continue to weigh on the economy through 2016. Tensions in eastern Ukraine and sanctions, which are not assumed to ease soon, sustain uncertainty. Adding further to uncertainty is lack of clarity about Russia's use of measures that curtail economic activity and trade. BOFIT expects GDP to still contract 2 % in 2016, along with a slight decline in imports. GDP will increase about 1 % in 2017 and imports will recover gradually. Growth opportunities have been limited, however, by low investment rates and Russia's systemic deficiencies that have not been addressed.

Revival of imports will be supported by recoveries in the economy and export earnings, as well as the ruble's real exchange rate, which will appreciate as Russian inflation remains higher than inflation in its main trading partners.

Private consumption should still contract slightly next year as inflation calms slowly and wage rises remain tame. Labour market pressures will be dealt with largely through temporary layoffs and moving workers to part-time status. Export volumes overall will grow slowly as oil sector exports are expected to decline. Investment will fall slightly from uncertainty about the economy and business environment.

Application of monetary stimulus is tricky due to weak desires of firms to make fixed investment. The government, due to lower oil earnings, faces fiscal constraints and thus pressures to cut spending. Restrictive policies to bolster domestic producers have been lifted to the forefront.

There are large risks associated with the forecast. First, the oil price could depart up or down from our assumption. Second, the situation in eastern Ukraine could worsen or also improve. However, the impact of improvements on fixed investment would take longer to materialise than the effects of negative events, which would affect investment rather quickly. The biggest risk to the import forecast comes from possible negative events that would weaken the ruble. Higher government spending could be possible if social pressures rose significantly as elections approach.

No easing of depressed demand and output in Russia. Rosstat reports that the volume of seasonally adjusted retail sales was unchanged in July-August, i.e. the same as in the preceding half a year. Since March, retail sales have been down about 9 % y-o-y. The slide in fixed investment continued; investment has been down 7–8 % y-o-y since May.

Over the course of the summer, seasonally adjusted industrial output declined slightly, while differences between the main industrial categories have widened. Seasonally adjusted manufacturing output has contracted virtually every month this year. Manufacturing output in the course of this summer has been down about 7 % y-o-y.

In contrast, seasonally adjusted output of extractive industries turned to growth in July-August, also showing on-year growth. Since early this year, crude oil production has shown on-year growth due mainly to oil exports, which performed fairly well also in late summer. Production and exports of natural gas increased in late summer, ending a large slump that lasted about a year.

Russia plans to increase food self-sufficiency goals, import bans not helping. The draft for Russia's updated national food security agenda calls for raising the degree of self-sufficiency to at least 85 % in nearly all product groups. Rosstat reports that the goals were met last year e.g. in grains, potatoes and sugar. On the other hand, Russia remains particularly dependent on imports of dairy products and beef. Domestic production in both categories has fallen in recent years and the production levels are lower than in 2000.

Russia has strived to promote domestic food production and import substitution for years. Indeed, the Russian government partly justified its countersanction bans on food imports with the need to support domestic producers. However, a report by Russian researchers released in August found that import bans have not encouraged import substitution, but mainly just reduced imports. The report was compiled by the Analytical Center for the Government, although the Center's status has since been changed from a state-funded government institution to an autonomous non-profit organization.

The report says that this year production of certain foods such as pork and cheese has increased thanks to earlier investment. In contrast, it notes that import restrictions have had a severely negative impact on competition in the Russian food market. As a result, food prices have risen substantially, while product quality has declined.

Many experts worry that the same difficulties could also hit the markets for other products, as import substitution has emerged recently as one of Russia's key economic policy goals. Import restrictions have already been imposed on government procurements in several branches. Expansions to e.g. other branches and firms participating in investment projects that receive government financing are now planned.

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Weekly Review
39 • 25.9.2015
BOFIT

China

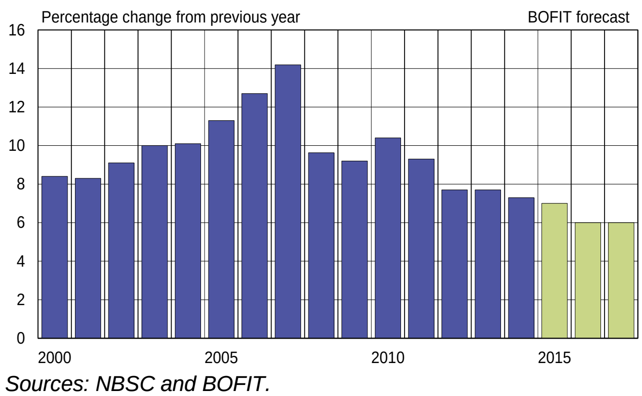
Latest BOFIT forecast sees continued slowdown in China's growth in coming years. As in our earlier forecasts, the latest BOFIT Forecast for China 2015–2017 sees GDP growth this year still near 7 % p.a., then slowing to around 6 % p.a. in 2016–2017. Fiscal and monetary stimulus measures, as well as the positive terms-of-trade effect stemming from lower prices for energy and other commodities, will support growth over the near term. Securing high growth in coming years will require measured progress in implementation of reform policies so the country can develop new engines of growth. Economic reforms are also needed in resolving China's existing problems.

The deceleration in China's economic growth is a natural development, and partly reflects a shift in the growth paradigm from one based on fixed investment and goods manufacturing to one driven by consumer demand and services. Private and public consumption last year accounted for over half of GDP for the first time since 2006. Nevertheless, China's sky-high level of fixed investment (40 % of GDP) indicates there is still plenty of room to run for structural changes for many years to come. On the demand side, the service sector now accounts for almost half of GDP and plays a major role in supporting employment.

Given the scale of systemic and structural changes in China, they will inevitably force adjustments and cause disturbances. Such disruptions at least partly indicate the economy is evolving in the desired direction. What matters is that reforms proceed despite market upheavals.

While volatility should be expected at this point in the evolution of China's economy, the seriousness of disruptive shocks should not be understated. Indebtedness in China has risen to where it has become a major economic policy headache for the leadership – and debt, along with the accompanying risks, is increasing. At worst, serious market disturbances could bring reforms to a halt which would cause a reassessment of the country's development outlook.

Realised GDP growth and BOFIT forecast for 2015–2017



Sources: NBSC and BOFIT.

Officials ease rules on foreign borrowing of Chinese firms. Chinese officials last week announced they were simplifying the rules on issuing long-term bonds (maturities over one year) abroad and the taking of overseas bank loans in foreign currencies. Firms can now issue private bond abroad or take foreign loans without official approval on every deal if it is done within their debt quota.

The outflow of capital from China in recent months has picked up, due e.g. to uncertainty in the stock market and foreign currency markets. In response, the central bank has sought to offset depreciation pressures on the yuan through interventions in the currency markets and by tightening regulations. Easing restrictions on foreign borrowing could help increase capital imports, which would offset capital outflows. Over the short term, foreign borrowing of Chinese firms is unlikely to increase rapidly as any interest in borrowing is restrained by the expectations of yuan depreciation and recent declines in interest rates at home.

China's total foreign debt in March 2015 amounted to $1.67 trillion, of which about 25 % consisted of long-term debt and 75 % debt with maturities of less than a year.

International institutions concerned about soaring indebtedness in China. The Bank for International Settlements (BIS) data for January-March reveal several "early-warning" indicators that point to increased risk of a domestic banking crisis in China. The rate at which Chinese have been piling on debt was particularly alarming. The ratio of China's credit stock to GDP has risen to 25 % above the long-term trend. The trend divergence is so large that in two of three cases this has historically led to a banking crisis. Brazil and Turkey also exceeded this critical level. Earlier, also the IMF has noted that, historically, in countries where indebtedness has occurred as rapidly as in China, the rise has led to banking crises.

One of the BIS early-warning indicators, the debt-servicing ratio, has soared in China. The debt-servicing ratio is the share of earnings going to paying interest and loan principal. This ratio is already 20 % for China's private sector, or 6 percentage points above the long-term average. Among countries tracked by BIS, the only larger divergences from the average long-term trend are in Hong Kong and Russia. In particular, a rise in interest rates in China would send the debt-servicing ratio skyward.

In January-June, China's five largest banks reported that they were writing down 140 billion yuan's worth of non-performing loans (NPLs), or more than for all last year. The amount of NPLs held by the banking sector rose by about 250 billion yuan in the first six months of the year, matching the amount of increase for all of 2014. As of end-June, the NPL stock of Chinese banks amounted to 1.09 trillion yuan (€150 billion) and represented about 1.5 % of the credit stock (up from 1.3 % at the end of 2014). Many observers note that the NPL stock is likely much larger than officially reported.

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BOFIT

Russia

Tough negotiations over Russia's 2016 federal budget continue. President Vladimir Putin last week declared that the federal budget deficit next year should not exceed 3 % of GDP. Putin's target matches the forecasted deficit for this year. Under the finance ministry's budget proposal, a deficit under 3 % is achievable if budget spending in nominal rubles remains at the same level as this year. Assumptions used in next year's budget revenue prediction include an average crude oil (Urals) price of $50 a barrel and a ruble exchange rate slightly weaker than 60 rubles to the dollar. In the final two weeks of September, the ruble rate averaged 65–66 to the dollar.

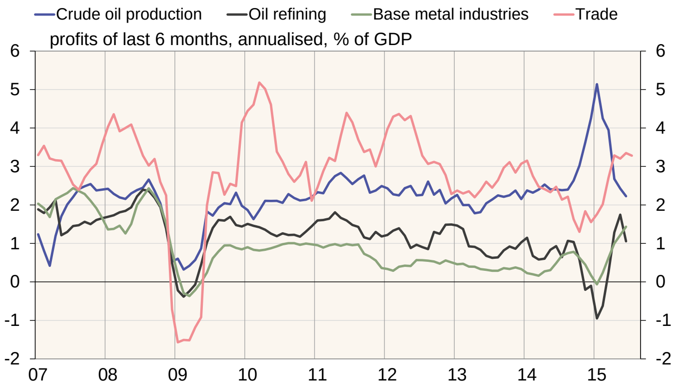
Over the past two weeks, the government has gone through intense discussions on limiting budget spending and increasing revenues. The biggest differences over 2016 budget expenditures have to do with pensions. The finance ministry has proposed restarting contributions to pension savings that had been frozen during 2014–15. Prime minister Dmitri Medvedev this week made an initial decision to continue the freeze next year (i.e. channel all moneys to the pay-as-you-go arrangement), which would increase available budget funds for spending by nearly 0.5 % of GDP. The second point of contention regards the pension indexation. Under the finance ministry's proposal, next year's pension increases would no longer be indexed to actual inflation but to a level even below the forecast inflation rate, i.e. down from 12 % to just 4 %. Ministers in charge of social affairs have reiterated their starting point that the current indexation scheme should continue. The finance ministry calculates that its approach would save the government well over 0.5 % of GDP. The cabinet now seeks a compromise.

The biggest question in the budget revenue forecast is taxation of increased profits of large export firms, given that the profit growth was basically generated by the ruble's depreciation. President Putin asked the cabinet to solve the matter. The finance ministry wanted a hike in the oil production tax, which, if implemented, would have increased budget revenues by close to 1 % of GDP. Prime minister Medvedev, however, rejected the proposal this week. The cabinet and the finance ministry are now considering slowing down the earlier-approved reduction in oil export duties, hikes on production taxes on natural gas and some metallic ores, as well as raising the share of central bank surplus channelled to the budget. The financial markets are following the turns with uncertain sentiments.

Improved profitability of Russian firms early this year gave support to paying down foreign debt. Even entering recession, corporate sector profits relative to GDP in the early months of this year soared to their highest level since 2008. As has been the case with the amount of profits in the economy, the growth in profits also centred on core export branches, i.e. production of oil and petroleum products, as well as metal industries. Their profits were enhanced above all by the ruble's sharp drop last winter. Wholesaler profits also climbed after two fairly weak years. Profits in the corporate sector overall returned to normal levels this summer.

The rise in profits early this year has supported investment in oil production, while investment in other branches has gone down from 2014. The special profit situation has meant companies have been able to pay down their foreign debt without relying very much on new borrowing from domestic banks. In addition to paying off their debts abroad, the corporate sector this year has also continued to ship capital abroad e.g. in the form of direct investment.

Corporate profits in Russia



Source: Finance ministry.

Discussion on structural reforms of the economy in Russia. The Civil Initiative Committee think tank launched by former finance minister Alexei Kudrin, this week released a comprehensive report on Russia's status in the global economy and the related challenges arising over the longer term. The report notes the importance of e.g. opening up the Russian economy, global integration and improving the business environment to bolster economic growth. Similar themes were mentioned also in an article by prime minister Medvedev last week. The article states that macroeconomic stability, a precondition for economic growth, requires prudent fiscal and monetary policies. For supporting growth, attracting private investment and improved market competition are also needed, but these goals can be hampered by current import substitution policies, heavy-handed regulation and the state's excessively large role in the economy.

The views expressed in these publications on the reforms that Russian economy needs are not presented for the first time. However, the issues have not received much attention lately in Russia's economic policy discussion, which has tended to focus on import substitution and government support measures. Moreover, the reforms presented are perhaps more relevant than ever as they have been long neglected in implementing economic policy.

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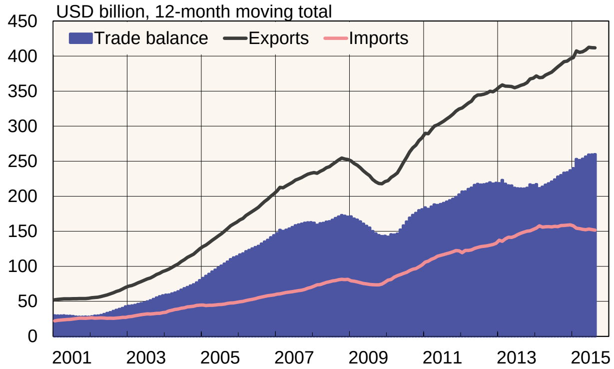
China

China's president Xi visited US. During his late-September visit to the US, Chinese president Xi Jinping discussed topics ranging from deeper economic cooperation to cybersecurity.

Xi promised to improve treatment of foreign firms operating in China and announced that China would assume a greater role in development cooperation. One achievement of the visit was an agreement in principle on fighting cyber attacks. China and the US engaged in discussion of a bilateral investment treaty, but had little to show for it. The countries have tried since 2008 to move ahead on the matter, but significant differences remain on the terms of such an agreement. The Americans argue that China wants to protect too many branches from foreign competition.

The United States is China's most important export market (17 % of all exports), and China is the third largest export market for the US after the EU and Canada. US services exports to China have grown particularly fast. The countries are also major sources of foreign direct investment for each other. Not only are the Chinese increasingly borrowing from American banks but also holding large amounts of US government treasuries, thus increasing interdependence.

China-US trade



Source: Macrobond.

China steps up fiscal stimulus measures. Officials have announced several measures to soften the impacts of a slowing economy. Last month saw the approval of a raft of large infrastructure projects. Unlike after the 2008 financial crisis, fiscal policy measures now appear to focus on supporting infrastructure over industrial investment. One risk to increasing stimulus is that the already high growth of indebtedness will accelerate further. Although the official central government budget deficit is expected to increase only slightly this year to 2.3 % of GDP, the IMF estimates the public sector deficit overall will be around 10 %.

The government is trying to better focus and expand funding for infrastructure projects. China has e.g. lowered the minimum capital requirement for construction of ports, airports, railways and highways. The finance ministry also announced changes in the terms of new public-private partnership (PPP) projects to make them more attractive to private investors. The launches of some projects scheduled for 2016 have been moved up.

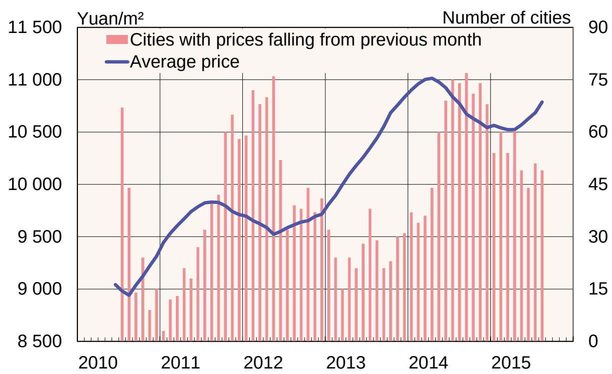
Policy banks have been instructed to support infrastructure investments through issuing bonds, with the investment aimed at local governments. The China Development Bank and Export-Import Bank of China have received additional funding from the State Administration for Foreign Exchange (SAFE) for the same purpose. To support firms, the government will expand tax breaks and tax advantages now granted small firms to larger firms as well. In addition, incentives to engage in R&D activity will be increased and broadened. The government also hopes to increase foreign trade through cuts in certain import and export duties.

Situation in China's housing markets remains mixed. Official figures and data produced by private firms indicate that housing prices overall continued to rise in August. According to SouFun, China's largest real estate portal, average apartment prices in August were up 2 % from the start of this year and roughly the same as a year ago. Official figures, in contrast, show that apartment sales, measured by liveable floor space and value of sales, were down 10 % y-o-y.

Several policy changes have been made to support the housing market. The downpayment required of buyers of a second apartment who have paid off their previous apartment mortgage was lowered at the beginning of September from 30 % to 20 % of the second apartment price. The reference rate on loans of five years or more and the interest rate on loans taken from public housing savings banks were also lowered at the end of August. The possibilities for foreign institutions and private individuals to purchase an apartment were expanded.

Growth in real estate investment continued the slow, falling below 4 % y-o-y in August. New housing starts were down 17 % y-o-y. The volume of construction-zoned land sales fell 32 % y-o-y in the first half. Developers still are stuck with a significant backlog of unsold new apartments, even if the overall number is declining.

Trends in China's housing markets (98-city sample)



Sources: SouFun, Macrobond.

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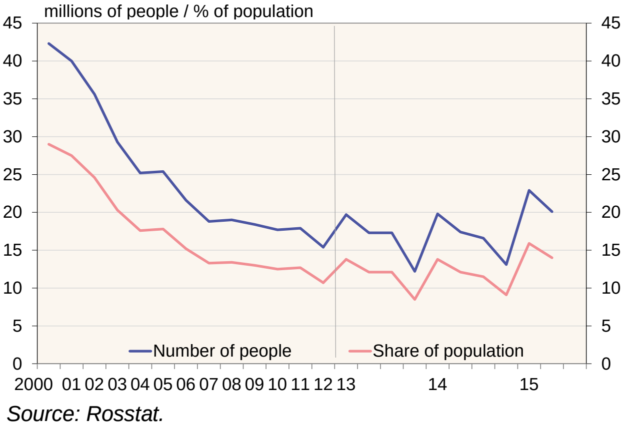
Russia

Number of people in Russia living below minimum subsistence level up markedly. Largely stemming from last winter's burst in inflation, real household incomes have been 4–5 % smaller on an on-year basis since last spring. Real wages are down about 9 % since the start of the year. Based on consumer price inflation, pensions have shrunk on-year about 4 % in real terms. Real incomes of pensioners and other people with small incomes have actually contracted more than official figures indicate as food prices this year are up over 20 % y-o-y (consumer prices overall are up 16 %). In 2014, spending on food accounted for over a third of Russian household spending but close to one half in the case of the one fifth of households that have lowest income.

The number of Russians living below the official minimum subsistence level has declined for years, but this year's contraction in real incomes reversed that trend. In the first half of 2015, close to 22 million people (about 15 % of the population) were living below the minimum level, erasing 8–9 years of gains against poverty. The officially defined monthly subsistence minimum in the second quarter was 10,800 roubles (about €160) for a working individual and 8,200 roubles (€120) for a pensioner. Rosstat's income surveys have found that the share of households with children of all households living below the subsistence level had increased to 63–64 % in recent years (36 % of households surveyed).

People living below the official minimum subsistence level



Source: Rosstat.

Russian domestic demand down over 10 %. First-half data on demand-side GDP components confirm the view that private consumption contracted nearly 10 % y-o-y and that fixed investment slid by 8 %. Moreover, similar to the 2009 recession, a reduction in inventories strongly curbed both domestic output and import volumes; the import volume was down 30 % y-o-y in the second quarter. The drop in demand was also reflected in wholesale, which saw sales volumes drop 10 % in January-August.

Russia behind China in most international comparisons. The latest World Economic Forum (WEF) Global Competitiveness Report 2015-16, which rates competitiveness among 140 countries, ranks Russia 45 and China 28. Overall country scores are based on performance in twelve pillars that are derived from 114 indicators gathered from survey and statistical data. Both Russia and China received their highest rankings for market size. Russia's other strengths included a high share of population with higher education, as well as wide coverage and use of telephones and internet which are among the indicators depicting ICT infrastructure and "technological readiness". These subcategories, however, were nearly the only ones where Russia outperformed China, i.e. Russia only outscored China in 25 out of the 114 indicators. Russia ranked weakest in institutions, market competition and quality of its roads. Russia's and China's rankings were also nearly the same in the latest IMD Competitiveness comparison.

The competitiveness rankings also utilise indicators from the World Bank's Doing Business comparison, which considers the challenges facing firms in terms of the encountered regulatory environment and bureaucracy based on ten example processes. Russia and China ranked 62nd and 90th, respectively. Both countries were at the bottom end with regards to construction permits and getting hooked up to the electrical grid. In terms of property registration and starting a business, Russia ranked considerably higher than China, while in trading across borders it was far behind China. The poorest performances for both Russia (136) and China (100) were recorded in Transparency International's Corruption Perceptions Index.

International comparison indexes sum up vast complex realities that are difficult to measure, let alone compare across countries. To their credit, they provide a fast and easy general overview of relative conditions in different countries. When interpreting such rankings, however, one should remember that these comparisons often rely on proxy variables and focus only on conditions in the largest cities. Specific focused measures may have huge impacts on the country's rankings, even if little changes in the broader picture (as has sometimes been the case e.g. for Russia). Indexes are constantly developed further, but this also complicates comparisons over time.

International rankings of Russia, China and Finland, 2014–15

	WEF Competitiveness (x/140)	IMD Competitiveness (x/61)	WB Doing Business (x/189)	TI Corruption (x/174)
Russia	45	45	62	136
China	28	22	90	100
Finland	8	21	9	3

Sources: WEF, IMD, WB, Transparency International.

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China

IMF holds its China forecast unchanged, but warns of rising risk from slowing growth. In its latest World Economic Outlook (WEO) this week, the IMF slightly lowered its July estimate for growth of the global economy this year and next. The IMF now sees the global economy growing 3.1 % this year and 3.6 % next year. The global economy expanded by 3.4 % last year. The slight deterioration in the growth outlook was mainly due to the slowdown in emerging economies and countries dependent on commodity exports. The expected US rate hike, declining commodity prices, reduced capital imports and the accompanying depreciation pressure on currencies added to uncertainty facing specifically emerging and developing countries that produce commodities. China as a major consumer of energy and commodities plays a significant role in the WEO forecast.

The IMF expects Chinese economic growth to slow from 7.3 % in 2014 to 6.8 % in 2015. For 2016, the IMF forecasts growth of 6.3 %. Thereafter growth slows to around 6 % a year through 2020. China has to balance between stimulus measures to prevent a hard landing, stopping soaring indebtedness and continuing market reforms. IMF noted that China should move ahead with reforms giving e.g. greater prominence to interest rate policy in setting monetary policy and moving gradually to a floating exchange rate. Given the size and global importance of China's economy, growth below forecast poses a significant risk to world economic growth overall.

The October WEO revised downward the IMF's Russia forecast, which now sees a contraction of 3.8 % this year and further contraction of 0.6 % next year. Russia's feeble growth prospects also seem locked in over the longer term; the IMF now predicts growth will remain at 1–1.5 % a year from 2017 to 2020. The reasons for poor growth performance included low oil prices, on-going sanctions and long-term structural problems. The IMF made its usual appeal for Russia to improve its business environment, even if conditions in reality still seem headed in an opposite direction.

The WEO report sees the average price of oil (Brent grade) rising from $53 a barrel this year to $66 in 2020.

Yuan surpasses yen as the world's fourth-most-used currency in international payments. SWIFT, the Brussels-based provider of global financial communications services, reports that in August the Chinese yuan accounted for 2.8 % of the value of international payments, putting it ahead of the Japanese yen for the first time as the world's number-four payments currency. Given the slim margin of difference in valuations of yuan and yen transactions, the ranking could shift back and forth in coming months. Nevertheless, China's growth prospects and the increasing interest in adopting the yuan point out to yuan establishing its position. Still ahead of the yuan in international use are the British pound (8 % of international payments), the euro (27 %) and the US dollar (45 %).

The rise of the yuan's use in international payments has been rapid. In just the past three years, it has overtaken seven currencies used in international payments. The yuan is now the most-used currency in Asia Pacific for payments with China and Hong Kong.

Development of China's market infrastructure has also helped support wider acceptance of the yuan. As a latest measure, this week the People's Bank of China announced that the new China International Payments System (CIPS) was now operational. The system facilitates international yuan clearing for businesses.

Greater access to China's bond and forex markets. Prime minister Li Keqiang last month announced forex trading by foreign central banks in the mainland China interbank markets could commence soon, though no exact schedule was set. In the following days, the central bank added that foreign central banks would also be allowed to engage in derivative trades on the interbank forex market. In July, access to China's interbank bond markets was granted to central banks and international financial institutions.

Officials announced last month that they were easing issuance rules for "Panda" bonds (yuan-denominated bonds issued by a foreign agent in mainland China). Hong Kong branches of HSBC and the Bank of China will become the first issuers under the new rules as the PBoC approved issues of 1 billion yuan ($157 million) and 10 billion yuan, respectively. Panda bond issues have been available since 2010, but only a few were ever issued due to the strict rules. Interest of foreign banks and firms in Panda bonds has been hurt by restrictions on capital movements, accounting practices that depart from international standards and lengthy approvals.

Despite market turbulence, China has implemented a slew of financial market reforms this year. Forex market uncertainty, accelerated capital outflows and plunging stock markets, however, have also pushed officials to set new limits and tighten old ones. Still, there is no reason to assume the pace of reforms should slow or that there will be excessive delays in implementation of announced reforms.

The rising difficulty of supervising an increasingly complex economic system has added to reform pressures. The increasingly negative "net errors and omissions" term in the balance of payments indicates a rise in capital outflows circumventing official channels. Capital controls are also bypassed via the trade account. The leadership remains committed to reforms because they want the yuan to have a reserve currency status in addition to being a trading currency. Many recent reforms have been aimed at locking in the yuan's acceptance into the IMF's Special Drawing Rights (SDR) basket currency. The SDR issue will determine China's operations on forex and financing markets in the near future.

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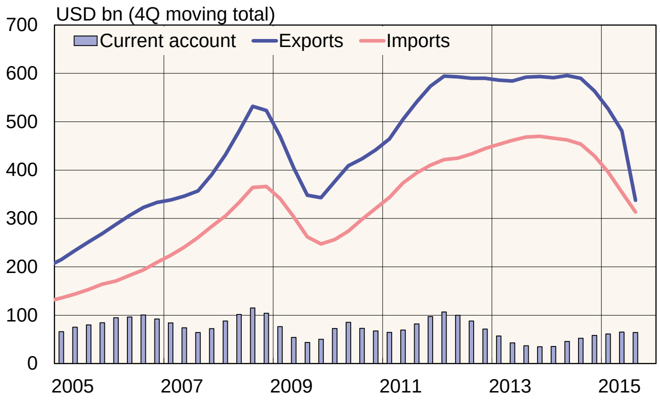
Russia

Russia's third-quarter exports and imports figures fall to 2010 levels. Preliminary balance-of-payments figures from the Central Bank of Russia show earnings on exports of goods and services fell yet further in the third quarter. Export earnings on-year were down by over a third (25 % in euro terms), sinking to a level last seen five years ago. Low export prices have caused export revenues to sag in the past year, with the export values of crude oil and petroleum products hit hardest. Earnings on gas exports recovered from a deep slump of over a year, but were still historically low. The slide in other export earnings accelerated.

The contraction in spending on imported goods and services in the third quarter continued at the same pace as earlier this year. The value of imports was down by 35 % y-o-y (over 20 % in euro terms), which meant that spending on imports plunged to levels not seen since 2010. Goods imports were down nearly 40 % in dollar terms (25 % in euros), while service imports fell 30 % y-o-y (15 % in euros). Tourism spending was down by nearly a fifth in euro terms.

The goods trade surplus has shrunk this year, but the current account surplus has been supported by a reduced services trade deficit and a decline in private sector payments of dividends and interest abroad. In line with seasonal variation, the current account surplus was relatively small in the third quarter. The cumulative current account surplus over the most recent four-quarter period (4Q14–3Q15) remained at just under $65 billion whereas in relation to GDP it increased to nearly 5 %.

Russian trade in goods and services; current account balance



Source: Central Bank of Russia.

Private sector capital flows between Russia and abroad remain modest. Preliminary balance-of-payments figures show private sector net capital flow reversed in the third quarter mildly into Russia. Banks continued to pay down foreign debt, but reduced also their receivables from abroad by about the same amount. In contrast, non-bank enterprises paid down even less foreign debt in relation to scheduled debt payments than in previous quarters, implying that they were able to roll over a large share of their debt.

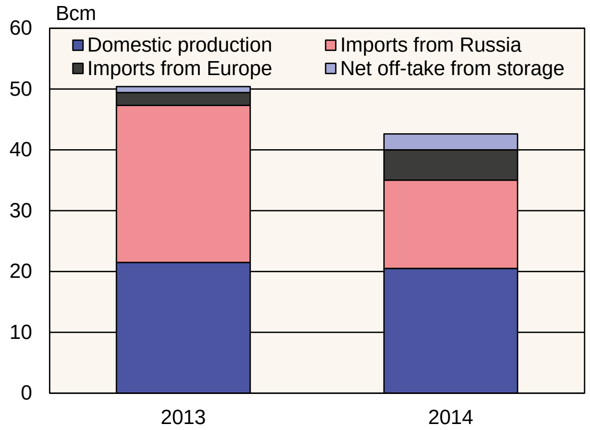
As in the first half, outbound flows of grey capital were practically non-existent and more forex cash was sold than purchased. Inbound direct foreign investment flows remained very modest. As earlier, more FDI flowed out of Russia than came in, even if FDI outflows were also considerably diminished from previous years.

Russia restarts gas deliveries to Ukraine; air travel between the two countries set to end. Having received from Naftogaz a $230 million advance payment for next winter's gas, Gazprom this week again began to supply gas to Ukraine after an interruption of a few months. In earlier negotiations involving Russia, Ukraine and the EU, a gas price of $227 per 1,000 cubic metres was set to extend through end-March 2016. The price is about the same as the average price of exported Russian gas in April-June.

For the winter season 2014-15, Ukraine purchased a total of 1.5 billion m^3 of gas from Gazprom for just over $500 million. The contract price for gas last winter was $380 per 1,000 m^3, reflecting higher oil prices. Ukraine bought only a tenth of its typical winter gas purchase from Gazprom last year, but increased substantially its gas imports from Europe. The imports from Europe, of course, largely consisted of gas originating in Russia. Ukraine's total gas imports last winter amounted to almost 8 billion m^3 and were valued at about $2.5 billion. Gas consumption in Ukraine in the first nine months of this year contracted by about 20 % y-o-y.

Air traffic between Russia and Ukraine seems set to end. Ukraine has banned flights of Russian airlines into the country as part of sanctions it decided to impose on Russian companies and individuals. Russia has responded by imposing a similar ban on Ukrainian airlines. Both bans are set to go into effect on October 25.

Breakdown of Ukraine gas supplies, 2013-14



Source: Naftogaz of Ukraine.

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China

TPP deal presents a positive challenge for China. In early October, the US, Japan, and ten other Pacific Rim nations finalised the Trans-Pacific Partnership (TPP) trade agreement. It is the first broad-based multilateral deal aimed at liberalising trade since the mid-1990s expansions (NAFTA and WTO). It covers trade aspects from agriculture to services and increases competition through reduced tariff levels and numerous other measures. TPP member countries account for nearly 40 % of global GDP, so the arrangement will play a major role in setting the ground rules of international trade – even if ratification of the agreement by member countries turns out to be a difficult, protracted process.

China did not participate in the US-led TPP-negotiations. Instead, it has tried to push for a more modest Pacific Rim free-trade zone and bilateral arrangements. It remains unlikely that China will sign on to the TPP agreement any time soon as it is unwilling to commit to TPP terms such as those affecting state-owned enterprises, right of workers to organise, protection of intellectual property and Internet censorship. Even without participating, the TPP agreement affects China in many ways, because companies must make their investment decisions in light of opportunities created by the new free-trade zone. A free-trade agreement will increase trade and production in the Pacific Rim area, which should thus benefit China and other non-signatory countries. On the other hand, TPP channels trade and production investment to the free-trade zone members, weakening China's position as a destination for industrial investment and its role in international production chains.

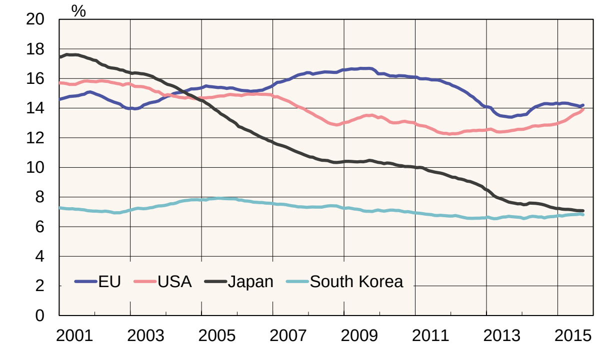
Many observers have characterised the goals of TPP countries and China as conflicting and speculated how China might respond with its own projects (e.g. Silk Road and AIIB) to meet the challenges of the new free-trade area. From another perspective, however, it is clear that TPP brings new norms to global trade that China, too, should adopt. TPP membership would comport well with China's long-term opening-up policy, which led to China's last major trade advance with its WTO accession in 2001.

Small changes in regional structure of China's foreign trade. Foreign trade contracted again in September. For the first nine months of 2015, the value of goods exports declined 2 % y-o-y, while the value of imports declined 15 %, mainly on falling prices for energy and commodities. The January-September trade surplus was over $420 billion.

The US and EU remain China's largest export markets, accounting for 18 % and 15 %, respectively, of total exports. Japan, which accounts for 6 % of Chinese exports, has seen its share fall steadily for years. South Korea, with a 4 % export share, is also an important export market for China. About half of China's exports go to Asia, while some 6 % goes to Latin America and 5 % to Africa.

Some 13 % of Chinese goods imports come from the EU, followed by South Korea (10 %), Japan (9 %), the US (9 %) and Taiwan (8 %). South Korea and the United States have increased their shares in recent years, while the shares of Japan and Taiwan in China's imports have declined. Asian countries provided 57 % of China's imports, while 6 % came from Latin America and 4 % from Africa.

Foreign trade shares of China's largest trading partners



Source: Macrobond.

Chinese corporate profits dragged down by long slide in producer prices. Producer prices were down 5.9 % y-o-y in September. Producer prices have fallen for nearly four years in a row and are now 12 % lower than in September 2011. September consumer price inflation was 1.6 %. Inflation slowed slightly, rising 0.1 % m-o-m in September. Prices of food and oil cause swings in consumer prices. With prices of food and energy removed from consumer prices, the increase this year has remained around 1.6 %.

In addition to falling producer prices, the profits of Chinese firms have been hurt recently by the slide in stock prices and exchange rate shifts. The National Bureau of Statistics reports that profits of large industrial firms were down 2 % y-o-y in the first eight months of the year. Profits of state-owned enterprises declined, while profits of privately held industrial firms increased by 7 %. Profits of companies operating in the mineral extraction sector were hardest hit, down by half from a year earlier. Profits were up, however, for manufacturers and utility providers of electricity, water and natural gas. Growth in corporate revenues overall slowed. The average profit margin for industrial firms (profit-to-revenue ratio) was 5.4 % in the first eight months of the year, or about the same as in the first eight months of 2014.

Much of the drop in producer prices reflects excess capacity and overproduction in many sectors, as well as drops in prices of energy and raw material inputs. China is not alone in struggling with this set of problems. Also several other emerging economies in Asia have witnessed declines in producer prices and corporate profits. August producer prices were down in e.g. South Korea (-4 % y-o-y), Thailand (-4 %), Malaysia (-5 %), the Philippines (-8 %) and India (wholesale prices -5 %).

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Russia

Russian output up in September; consumption continued to fall. Rosstat reports that seasonally adjusted industrial output rose considerably in September to its fastest growth since December 2014. Output of extractive industries increased for the third month in a row on continued growth in oil and gas production. Seasonally adjusted manufacturing output increased for the first time this year.

Agriculture typically makes its biggest contribution to GDP in the third quarter, so the notable rise in agricultural output in August and September helped brighten the economic growth picture overall. Thanks to the good September performance, economy ministry figures show mild seasonally adjusted 3Q GDP growth from the previous quarter, even if the 3Q GDP fall was 4.3 % y-o-y.

The on-year drop in fixed investment in September was smaller than during the summer. In contrast, the volume of seasonally adjusted retail sales continued to contract in September, falling over 10 % y-o-y. The slump in retail sales of non-food goods deepened, while retail food sales have also been down 9–10 % y-o-y since spring. Rosstat also reports that sales of services to households this year have contracted slightly less than retail sales. At the same time, Russian tourism abroad, which accounted for about 5 % of private consumption in 2014, has shown a significant decline. GDP demand figures show total volume of private consumption in the first half was down nearly 9 % y-o-y.

Consumption suffered in August and September as seasonally adjusted real household incomes continued to contract. Uncertainty about the future has prevented bank borrowing of individuals from turning to rise, while the savings rate has remained quite substantial.

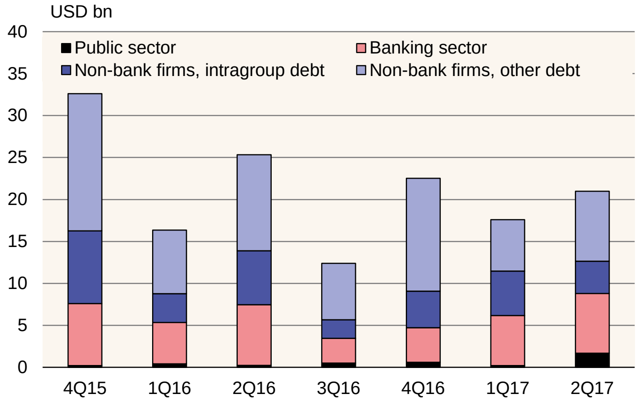
Russia's foreign debt fell in the third quarter. Preliminary Central Bank of Russia figures put Russia's foreign debt at $522 billion as of end-September, down by just over $30 billion from end-June. Approximately half of the debt reduction apparently came from actual loan payments and about half from ruble depreciation. As of end-June, about a fifth of Russian foreign debt was held in rubles.

Nearly $40 billion in foreign debt came due in the third quarter. While banks largely stuck to their payment schedules, non-bank corporations apparently have rolled most of their debt. Nearly 40 % of non-bank corporate debt is "intragroup" debt resulting from arrangements between parent companies and their subsidiaries. The proportion of intragroup debt in the non-bank sector has risen slightly in recent months, which may indicate other foreign debt has been partly refinanced through increased intragroup loans.

The scheduled debt payments coming due over the next three months exceed $30 billion. About half of that comes due in December. However, nearly a third of this maturing debt is intragroup debt, so extended payment schedules and rollovers are expected. Based on its company survey, the CBR expects that the actual amount of payments may be even smaller.

In the coming four quarters (4Q15-3Q16), a total of $87 billion in foreign debt principal comes due. Russia's foreign currency reserves stood at $371 billion at end-September. A common rule-of-thumb suggests that a country's reserves need to be sufficient to cover at least 100 % of its short-term foreign debt to avoid liquidity problems.

Scheduled Russian foreign debt principal payments



Source: CBR

Ukraine's private creditors accept debt restructuring. Ukraine's private creditors voted on October 14 to accept the debt restructuring negotiated earlier. Under the deal, creditors agreed to write down 20 % of the nominal value of Ukraine's $18 billion debt. Loan payback times were also extended by a four-year moratorium on repayment of Ukraine's debts to private creditors. Ukraine's IMF programme assumes payments to private lenders can be reduced by $15 billion over the next four years. The restructuring as approved is not sufficient alone to fully meet this goal as it only provides $11.5 billion in debt relief in that time.

A $3-billion Ukrainian government bond held by Russia comes due on December 20. Russia says it expects the bond to be repaid in full at that time. Russia also notes that Ukraine's latest deal with private creditors is inapplicable to the bond, as it was granted by a sovereign entity. The distinction is important as it governs whether the IMF can continue to release loan tranches to Ukraine. Even if Ukraine is in default on payments to private entities, IMF lending can continue. Default to a public entity, however, would mean suspension of the loan programme. Ultimately, the IMF board must decide on whether or not the bond is public debt. The bond was issued in Ireland in December 2013 and purchased entirely by Russia's National Welfare Fund.

After approval of the debt restructuring, the international credit ratings agency Standard & Poor's raised Ukraine's foreign sovereign debt rating to B-, which, while still considered speculative grade, was an improvement from the earlier rating of Selective Default (SD).

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China

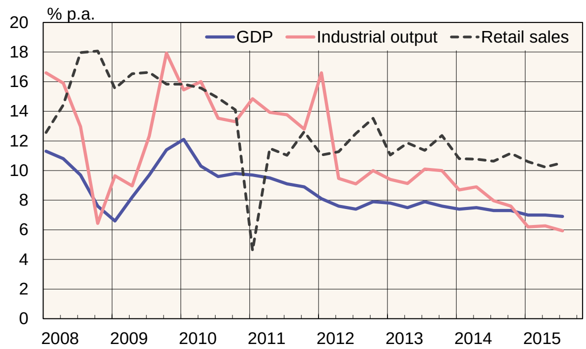
China's growth remains strong and structures continue to change. China's National Bureau of Statistics reports that GDP grew 6.9 % y-o-y in the third quarter. For the first six months of 2015, GDP growth was 7.0 % y-o-y. GDP growth in the third quarter was up 1.8 % q-o-q, a growth pace matching the second quarter.

The supply-and-demand structure of the Chinese economy continues to shift as economic reforms are implemented and living standards rise. China's growth depends increasingly on domestic consumption. CNBS does not yet release a quarterly breakdown of GDP demand components, but it reports consumer demand in January-September was responsible for 58 % of GDP growth (up from 49 % a year earlier). Steady income gains also support rising consumption. Average per capita disposable income was up 8 % y-o-y in January-September. Even as the contribution of fixed investment declines relative to consumption in overall demand, China's investment rate remains exceptionally high.

The evolution of economic structures is also seen in the output figures. Growth in manufacturing and construction was significantly lower than in services. Industrial output growth dipped below 6 % y-o-y in September and new housing starts measured by floorspace fell sharply from a year earlier. In contrast, retail sales, an indicator of services output, rose nearly 11 %, and online retail sales rose by 35 %.

The latest figures indicate a fairly steady situation in China, despite the turmoil in stock and currency markets in the third quarter. Economic growth continued its gradual slowdown and economic structures shifted. While China's official unemployment data is poor, no information suggest any significant weakening in labour market conditions.

Growth in China's GDP, industrial output and retail sales, %



Source: Macrobond

Central bank forex interventions and capital outflows from China have increased. The US treasury department's semi-annual exchange rate policy report also considers China's capital flows. The newest edition finds capital outflows from China accelerated in August to $200 billion, up from $70–80 billion in July. For the first half of the year, $250 billion flowed out of China, up from less than $30 billion in 1H14. Estimates do not include FDI.

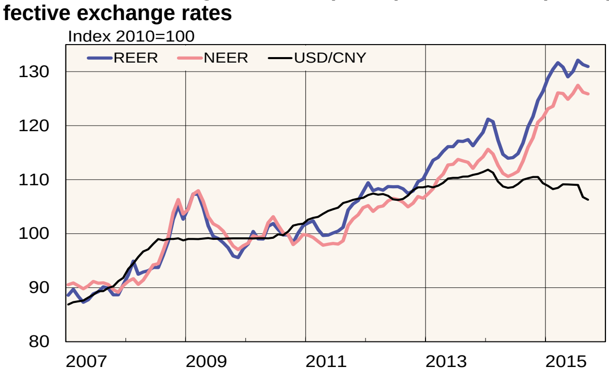
China does not publish information on its forex operations, but the PBoC has largely refrained from daily interventions since summer 2014. After the exchange rate change in August, the central bank re-entered the forex market. The report estimates that PBoC interventions in July-September totalled $229 billion. In particular, the central bank slowed the slide of the yuan during the August turbulence by purchasing $136 billion worth of yuan.

The value of China's foreign currency reserves fell by $180 billion in the third quarter to $3.514 trillion. Media reports claim that the PBoC and commercial banks have also indirectly supported the yuan through forex derivative instruments (such measures are not directly visible in changes in currency reserves). Some observers believe the central bank also intervened in September in CNH trading outside mainland China to keep the CNH exchange rate near the CNY rate and dampen expectations of yuan depreciation.

Yuan weakened slightly in the late summer. The real effective (trade-weighted) exchange rate (REER), which takes into account inflation differences between China and its main trading partners, was down 1 % in September from its July peak. Compared to a year ago, the REER was up 9 %. Similarly, the nominal effective exchange rate (NEER) strengthened in September by 9 % y-o-y, but weakened slightly from July. On Friday (Oct. 23), one dollar bought 6.36 yuan and one euro 7.06 yuan. Compared to a year ago, the yuan has weakened 4 % against the dollar and gained 9 % against the euro.

For years, complaints that China was deliberately undervaluing its currency were common. But after a long episode of yuan appreciation, most of this criticism has died down. Even the US treasury department has changed its view in this respect, commenting that the US no longer considers the yuan significantly undervalued. The treasury department notes, however, that the yuan's exchange rate is still below its medium term valuation. The report sees yuan appreciation continuing over the long run, even though in the short run the yuan faces depreciation pressures on e.g. capital outflows driven by stock market volatility.

Yuan-dollar exchange rate; real (REER) and nominal (NEER) effective exchange rates



Sources: BIS, Bloomberg

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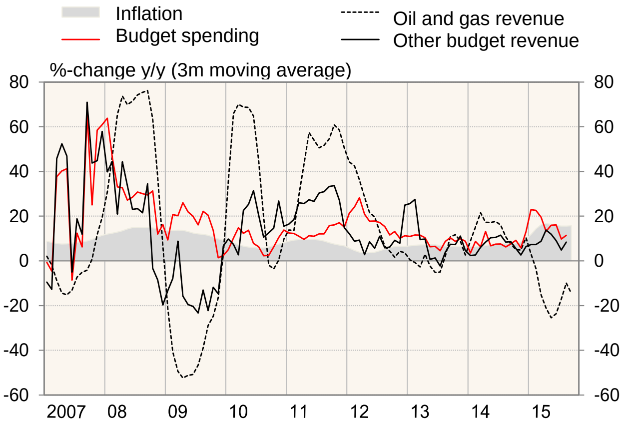
Russia

Russian government issues lean proposals for 2016 federal and state social fund budgets. In submitting its draft budgets to the Duma, the finance ministry included an estimate for total government-sector revenues (regional and local government budgets included) that anticipates a growth of around 5 % next year in nominal ruble terms. The calculations are based on the economy ministry assumptions of an inflation rate of 7.4 % next year, along with an average price of crude oil (Urals) of $50 a barrel and GDP growth of 0.7 %. Government spending is expected to increase about 2 % in nominal terms.

The finance ministry projects the government deficit next year will equal 3.8 % of GDP. The estimate includes a federal budget deficit of 3 % of GDP as laid out by president Putin.

The projected increase in federal budget revenues next year reflects changes in specialised taxes and fees. Along with changes decided earlier, the biggest revenue boost will come from revised taxes on oil production and oil exports. Adjustments in the tax on gas production, the automobile use fee, and distribution of central bank profits and income of state reserve funds are also important to bring extra revenue. Tax revenues from oil & gas, which in practice go entirely to the federal budget, should increase about 3 % after a roughly 20 % drop this year. The finance ministry expects the increase in revenues overall to be spread rather evenly across the various budget categories (federal, regional, municipal and social funds).

Change in public-sector revenues and expenditures



Source: Russian finance ministry

Federal budget spending will grow slightly faster than other categories, but still only about 4–5 % y-o-y (also excluding inter-budget transfers). Defence spending will not rise even in nominal rubles. In contrast, funds reserved for support spending (which must be decided by the president or the cabinet), as well as spending on space exploration, are likely to grow substantially. Asset transfers to the Pension Fund should rise, while transfers to regional budgets should fall slightly.

The nominal amounts of regional budget spending are expected to remain roughly unchanged next year, as well as Pension Fund and other social fund spending. To curb Pension Fund spending growth, hikes in pensions will be limited to just 4 %. The cabinet has, however, agreed on the option of a supplemental increase that will depend on the economic situation in the first half of 2016.

Russia charts near depletion of Reserve Fund next year. Under the current federal budget draft, 90 % of the budget deficit will be financed with money from the state Reserve Fund. The finance ministry estimates that the Reserve Fund would be depleted by the end of 2016 to a level that corresponds to 1.3 % of GDP. The finance ministry reports that the Reserve Fund held assets equal to 6.4 % of GDP at end-September and that the Fund is on track to shrink to 4.6 % of GDP by the end of this year. The contraction of the Reserve Fund's value this year has slowed in ruble terms with the decline in the ruble's exchange rate.

There are no plans at the moment to borrow nothing more than a tiny bit from the National Welfare Fund to finance the deficit (i.e. the situation remains similar to previous years). Under the latest budget proposal, the National Welfare Fund will still have assets corresponding to 6 % of GDP at the end of next year. It will also not be used very much to finance e.g. infrastructure projects or corporate support by acquisition of equity stakes. Possible investment in loans and shares do not alter the size of the fund, but remain on the fund balance sheet as receivables (although they extend maturities of receivables and may increase fund risk).

World Bank *Doing Business* report shows no major changes in Russia's business regulation last year. Russia ranked 51st out of 189 countries examined in the World Bank Group's annual *Doing Business* report, which was released this week. Taking into account methodological changes and data revisions, Russia's comparable ranking last year was 54th. CIS countries Georgia, Armenia, Kazakhstan and Belarus posted rankings better than Russia. EU members Greece, Luxemburg and Malta all underperformed Russia. China (84th) was nearly unchanged in the rankings.

Especially in Russia's case, *Doing Business* seems to mainly reflect formal business regulation, where e.g. legislation has improved visibly over the past decade. In practice, however, companies often experience the Russian business environment very differently. Numerous surveys in recent years have noted that the main problems encountered in Russia largely have to do with capricious application of the law and the costs of corruption – factors overlooked in the Doing Business indicators. In addition, Doing Business indicators are based on very narrowly specified case studies which cannot necessarily be generalised to the overall business environment, even if it eases comparison across countries.

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China

China frees interest rates. Effective last Saturday (Oct. 24), the People's Bank of China eliminated its last remaining interest rate limits – the interest rate ceiling on deposits of less than one year. Following deregulation of credit interest rates in 2013 and the ending in August of the rate ceiling on deposits of more than a year, the era of limits on bank interest rates is now formally over. Freeing of interest rates is seen as a major step on China's road to a market economy; it promotes financial market competition and allows further liberalisation of capital movements. Progress in actual deregulation of deposit rates is going to have the salutary effect of reducing demand for the more problematic and hard-to-regulate investment instruments of the shadow banking sector.

Deregulation of interest rates also encourages the shift to monetary policy implementation used in developed economies, i.e. use of true monetary policy interest rate as the main policy tool. Lacking this tool, China has been left with adjustment of reserve requirements as its main monetary policy option while the role of current reference rates is unclear. Further muddying monetary signalling is the fact that the central bank still provides funding directly to certain enterprises via state development banks. Moreover, bank lending remains directly subject to "window guidance," which is neither transparent nor well suited to market economy rules.

China further eases monetary stance. The PBoC last week also lowered its reference rates. The reference rate on one-year bank loans was lowered by 25 basis points to 4.35 % and the one-year deposit reference rate to 1.5 % by a similar amount. Even with the end of formal rate regulation, banks appear timid to stray far from reference rates in their deposit and credit pricing. Lending rates were permanently freed in summer 2013, yet today most bank loans are still granted at rates close to the reference rate.

Bank reserve requirements were also lowered at least 50 basis points (the requirement was lowered 100 basis points in some cases). The reserve requirement of large banks is now 17.5 % and smaller banks 2–3.5 percentage points less.

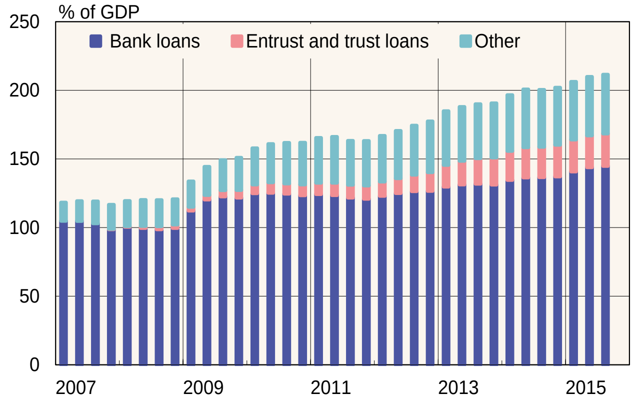
The latest cuts in interest rates and reserve requirements followed on cuts at the end of August. This month, the PBoC also expanded its trial programme of providing commercial banks with credit secured by debt securities held by banks.

The shaky economic outlook is the main motivation for monetary easing. Even with repeated rounds of easing and Chinese third-quarter GDP growth holding steady at nearly 7 %, price development remains lax. The central bank's latest moves may also reflect anticipation of an eventual US rate hike, which, when implemented, would make monetary easing more difficult also for China. The bigger problem, however, is that monetary stimulus worsens the debt problem, already the biggest risk to China's economy.

Chinese domestic indebtedness continues to soar. Using its broad concept of "total social financing," China's central bank reports that domestic indebtedness climbed 13 % y-o-y in the third quarter while the nominal value of GDP increased 6.2 %. Growth of the credit stock slowed slightly from 2014, when on-year growth was 15 %. In contrast, growth in the stock of bank deposits has accelerated this year, increasing 17 % y-o-y in the third quarter. Deposits in 2014 increased about 13 % y-o-y.

On-year growth in the stock of bank loans has been steady, remaining at 13 % for about a year. However, the stock of foreign currency-denominated bank loans has contracted during this year. In the third quarter, the stock of entrust and trust loans issued in the shadow banking sector grew by 14 % y-o-y. Growth in shadow bank lending has slowed significantly over the past two years. A year ago, lending of the shadow banking sector grew by nearly 30 % y-o-y.

Ratio of domestic credit stock to GDP



Sources: Macrobond, BOFIT

China's president promotes closer economic ties during UK visit. During his visit to the UK last week, president Xi Jinping focused on deepening economic cooperation and promoting international use of the yuan. The UK wants to see London become the West's main hub of yuan exchange.

In connection with Xi's visit, the PBoC issued in London its first offshore bond ever, a 1-year bond worth 5 billion yuan ($790 million). The bond issue was well received by the market, with demand far exceeding supply. Earlier this month, two Chinese banks (Agricultural Bank of China and China Construction Bank) also issued yuan-denominated bonds in London. The PBoC's successful bond issue should encourage other Chinese banks to seek yuan-denominated financing in London.

The visit included deals on several major Chinese investments in the UK energy sector, health care, car manufacturing and the entertainment industry. The single largest investments were from China's state-owned China General Nuclear in two nuclear power plant projects in England.

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Russia

Russian central bank keeps rates unchanged. The Central Bank of Russia last week decided to keep its key rate at 11 %, a level held since the start of August. The CBR noted that, while inflation risks remain significant, it expects inflation to slow from the current rate of 15.6 % to below 7 % by October 2016. The markets were slightly surprised by the CBR's announcement that it will start lowering rates if inflation slows as expected.

Regarding inflation risks, the CBR reminded of high inflation expectations and a possible weakening in the global economy. Low oil prices would drag down the ruble and translate to inflation. The CBR reiterated its assessment that there is also an inflation risk stemming from a possible relaxation of fiscal policy, e.g. if there would be a decision to revisit indexation of various social benefits paid out by the state. Presently, the 2016 index adjustments for pensions and many other social payments are on track to be lowered significantly from previous years.

Russian firms borrow modestly. Russia's troubled economy and financial market sanctions have contributed to a collapse this year in the issued volume of international corporate bonds and syndicated loans. Media reports estimate that the value of syndicated loans granted this year between January and September amounted to $2.7 billion, a 70 % drop from the same period in 2014.

Moreover, companies have been paying off existing eurobonds much faster than issuing new ones. In the first nine months of this year, only five eurobonds, totalling about $700 million, were issued. Bond issues in January-September 2013 and 2014 amounted to $47 billion and $10 billion, respectively. Gazprom and Norilsk Nickel last month held successful issues of one-billion-dollar eurobonds, suggesting international investors may be regaining some appetite for Russian debt.

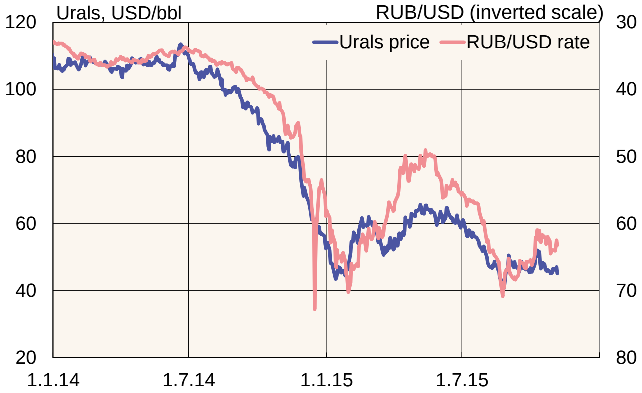
Companies have not retreated from the domestic bond market. For January-September, nearly 1.5 trillion rubles ($25 billion) in debt securities were issued, i.e. slightly more than in the first three quarters of 2014. Large firms in the oil and gas sector dominate the market.

Corporate borrowing from domestic banks fell significantly on-year in the first nine months of 2015. As of end-September, the valuation of the corporate loan stock in rubles has risen by about 20 % over the previous twelve months (i.e. a few percentage points above the inflation rate). The lion's share of growth came from the impact of ruble depreciation on the value of forex loans. Slowing growth in the loan stock and ruble depreciation have also increased the share of forex loans in the overall corporate loan stock. Some 45 % of the loan stock of the top ten corporate lenders were forex loans at the end of September. The share of forex loans in the total corporate loan stock was about 30 %.

Credit is granted mainly to large, wealthy firms. CBR data show that the loan stock of small and medium-sized firms has shrunk even in nominal terms during 2015. Lending is highly concentrated among big banks. The ten largest lenders account for about 75 % of the stock of corporate loans.

Ruble remains weak. While the ruble has recovered slightly from the low it reached at end-August on a slight rise in oil prices and fading capital outflows from Russia, the ruble-dollar rate has in past days still stood at around 63 and the ruble-euro rate around 69. Thus, the ruble is still clearly weaker than it was a year ago, having lost over 30 % of its value against the dollar and over 20 % against the euro. The ruble has also lost about a fifth of its value in real terms from a year ago in relation to both the euro and the trade-weighted currency basket of Russia's main trading partners.

Ruble-dollar exchange rate and price of Urals crude oil



Source: Reuters

The first step towards liberalisation of ruble's exchange rate was taken 25 years ago. Starting from November 1, 1990, the commercial ruble exchange rate was set to 1.8 rubles to the dollar by president Mikhail Gorbachev's decree. The commercial rate (more favourable than the official exchange rate) was used in converting corporate forex income to rubles. Thereafter, the ruble's exchange rate was gradually liberalised. In November 2014, the CBR announced it would no longer steer the ruble's external rate.

The ruble's use in Russia's international payments has gradually increased. In the first half of this year, over 10 % of Russian exports and nearly 30 % of Russian imports were settled in rubles. The ruble is mainly used in trade between Russia and CIS countries, but a rather large share of Russian imports from the EU are also settled in rubles. In addition, about a fifth of Russian foreign debt is in rubles.

The ruble's use in overall international payments remains marginal and has decreased recently. SWIFT, the provider of global financial communication services, reports that the ruble's share of all international payments this year has been just 0.2 %, making it less popular than e.g. the Turkish lira or the South African rand.

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China

China's latest five-year plan features two-child policy and economic reforms. At the end of October, the Central Committee of the Chinese Communist Party finalised its proposed 2016–2020 five-year plan. The draft plan emphasises the importance of sustainable high growth, thereby implying a need to continue economic reforms and open the economy further to international competition. In the financial markets, capital movements are to be freed further and international use of the yuan promoted. Foreign investment will be attracted through implementing a "negative list" access model that more clearly delineates branches where foreign firms are not allowed to invest and deregulates all other branches.

The decision to end the controversial one-child policy, introduced at the national level in 1979, has attracted considerable attention. From now on, a Chinese couple can as a rule have two kids. Although the motivation for the decision is China's aging population, encouraging more births will not bring rapid demographic change. Indeed, it remains to be seen what effect the change will have on the birth rate, given that the costs of having a child and the challenges of arranging day-care make the one-child option attractive to many parents. The decision however provides perspective on China's development and the possibility to focus on implementation of other reforms.

In other respects, the latest plan themes are familiar and general in nature, e.g. eliminating poverty, narrowing income inequality, improving healthcare and increasing vocational training opportunities. There are also plans to widen social security and pension coverage, as well as intent to gradually increase the retirement age. The new five-year plan places heavy emphasis on improving the environment but there is no room for political reforms in the draft.

The National People's Congress is expected to ratify the new five-year plan when it convenes next March.

Growth targets problematic for guidance of Chinese economic policy. The Chinese leadership's recent speeches on the new five-year plan often reference an earlier goal of doubling 2010 GDP and per capita incomes by 2020. Reaching this goal requires average annual GDP growth of at least 6.5 % over the next five years.

These days, however, such numeric growth targets no longer serve economic policy goals. For example, corporate production decisions are driven by other considerations. The irrelevance of growth targets should become even more apparent as economic reforms proceed. Indeed, striving by all possible means to meet numeric growth targets has led to inappropriate investment and piles of unneeded debt as it seems clear that high employment could have been sustained even at lower levels of growth. Thus, there are strong arguments that China should replace growth targets with economic policy targets that apply directly to employment or inflation.

The sensibility of tight growth targets can also be considered in the context of the data. Even if growth over the coming years remains at just 5 % p.a., China's 2020 GDP would be about 85 % larger than in 2010 and the GDP doubling target would be met in 2022. Such an achievement for the massive Chinese economy can only be seen as impressive, and even more so if achieved through sustainable policies.

Starting this year, numeric growth targets were no longer set for Shanghai and dozens of smaller cities. This is to emphasize the quality instead of the rate of growth.

China sets a low bar ahead of Paris climate conference. With the Paris climate conference set to begin at the end of November, China revealed its climate targets: reducing of carbon dioxide emissions from at the latest 2030 onwards, a reduction in CO_2 intensity (CO_2/GDP) of 60–65 % from the 2005 level and an increase in the contribution of renewable energy sources to 20 % of primary energy consumption by 2030. The goals are considered relatively modest and easily achievable for China. At their recent meeting, Chinese president Xi Jinping and French president François Hollande agreed to review their climate goals at five-year intervals. As China's environmental problems have become a hot topic in domestic politics, emission targets also provide political cover for China's leaders.

In addition to earlier announced emissions targets, president Xi announced during his visit to the United States in September that China would introduce a nationwide emissions-trading scheme by 2017. When implemented, China's emissions-trading scheme would become the world's largest. Experimentation with emissions-trading schemes has been conducted in a number of Chinese cities, but their results have hardly been impressive. China has also promised to provide $3 billion to support clean energy production in less-developed countries.

The now-concluding 2011–2015 five-year plan called for a reduction in CO_2 intensity of 17 % from the 2010 level and an increase in renewable energy to 11 % of primary energy consumption. The World Resources Institute estimates that China is well on track to meet its targets. Already last year renewable energy accounted for over 11 % of energy production.

China is the world's biggest polluter. Coal is the largest source of China's CO_2 emissions and still represents about two-thirds of primary energy consumption. Coal production has fallen this year, in part due to the economic slowdown and structural changes in the economy. China hopes to replace coal with other energy sources such as natural gas, nuclear and renewables.

According to the REN21 Global Status Report, China had the world's largest renewable energy production capacity (a quarter of global production capacity) last year and China invested the most in renewable energy sources. Over half of China's renewable energy last year came from hydropower and about a quarter from wind power.

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Russia

Russian foreign trade remains very weak. The value of Russian goods exports in the third quarter was down nearly 40 % y-o-y in dollar terms and about 25 % in euro terms. Low export prices were largely responsible for the drop. The price of Urals-grade crude oil hit its lowest level since early 2009. Third-quarter growth in crude oil export volumes also slowed from the first half to 5 % y-o-y, while exports of petroleum products contracted 12 % after strong growth in the first half of the year. In contrast, the volume of natural gas exports picked up sharply in the third quarter after shrinking in the first half. Exports to nearly all of Russia's trading partners were down, but exports to countries where oil plays a smaller role, e.g. the Eurasian Economic Union (EAEU) and the US, were off considerably less.

The value of goods imports in July-September fell about as fast as the value of exports. The contraction in imports was broad-based, with falling demand and the weak ruble affecting nearly all product groups and markets. Economic sanctions did not play a crucial role in the overall reduction in imports. Imports from EAEU countries, however, have been supported since late August by sharp depreciation of the Kazakhstan tenge and the Belarus ruble. In the largest product categories, the value of imports of machinery, equipment & transport equipment was down 40 % y-o-y, while imports of chemical products and foodstuffs each contracted by 30 %.

The value of Russian goods exports in the first nine months of the year amounted to about $260 billion, while goods imports were valued at roughly $140 billion. The structures of imports and exports in terms of countries and product groups have not changed significantly lately. Nearly half of exports consisted of crude oil and petroleum products. Natural gas accounted for about 15 % of exports, followed by metal and chemical products at about 10 %. Over 40 % of imports consisted of machinery, equipment & transport equipment, followed by nearly 20 % share of chemical products and nearly 15 % of foodstuffs. The EU as a whole was clearly Russia's most important trading partner, while the single largest market in Russia's foreign trade was China.

Russian foreign trade, January-September 2015

	Exports		Imports	
	Share, %	On-year change, %	Share, %	On-year change, %
EU28	49	-37	38	-43
EAEU	8	-24	8	-32
China	8	-26	19	-33
Japan	4	-22	4	-41
Korea	4	-26	3	-52
USA	3	-8	7	-40

Source: Russian customs.

Large Russian private bank Uralsib faces bankruptcy prevention measures. Nikolai Tsvetkov, the previous majority owner of Uralsib, this week completed the sale of an 82 % stake to Vladimir Kogan, who is known for his successful banking career in the 1990s to mid-2000s and his association with president Putin. The idea of a private individual as the successor owner of a troubled bank is exceptional, but according to the Central Bank of Russia, as well as several private market actors, the most favourable offer was chosen in a process that has been evolving during the year.

Finding a new owner for a minimum of 75 % of Uralsib's shares was a precondition for the bank to qualify for two recapitalisation credits (a 6-year loan priced at 6 % p.a. and a 10-year loan at 0.5 % p.a.) supplied by the Deposit Insurance Agency (DIA) and financed by the CBR. The combined nominal value of the loans is 81 billion rubles (€1.2 billion). The DIA would have faced a liability of about 100 billion rubles if Uralsib was allowed to go bankrupt.

Uralsib is Russia's 27th largest bank in terms of assets, although it holds less than 0.5 % of the banking sector's total assets. In addition, the CBR notes that the actual value of the bank's assets is notably overestimated due to valuation applied to some of the balance items. Uralsib has posted losses for several years now and its credit rating has been downgraded. Former owner Tsvetkov has poured considerable amounts of his own money into the bank this year.

Finnish investment in Russia continues to heavily exceed Russian investment in Finland. Statistics Finland (SF) reports that the stock of Finland's foreign direct investment (FDI) in 2014 amounted to €2.2 billion for Russia and €200 million for China. Finland's total FDI stock abroad was €97 billion. It should be noted that bilateral FDI figures do not necessarily give a complete picture of corporate real investment abroad as they reflect financial flows. Firms with international operations may seek investment financing from multiple countries, which complicates compilation of bilateral investment figures. The Confederation of Finnish Industries (EK) estimates that Finnish firms have invested a total of about €12 billion in Russia and over €10 billion in China.

Russia's total FDI stock in Finland was €1.1 billion in 2014, while Chinese FDI in Finland was negligible. The total FDI stock in Finland last year amounted to €77 billion.

Indicators of Finnish international business 2014, EUR billion

	Goods exports	Services exports	Investment stock (SF/EK)	Subsidiary sales (2013)
Russia	4.6	1.6	2.2 / 12	11.3
China	2.6	0.6	0.2 / 10	8.1
World	57.2	21.2	96.6 / -	148.3

Sources: Statistics Finland (SF), Confederation of Finnish Industries (EK).

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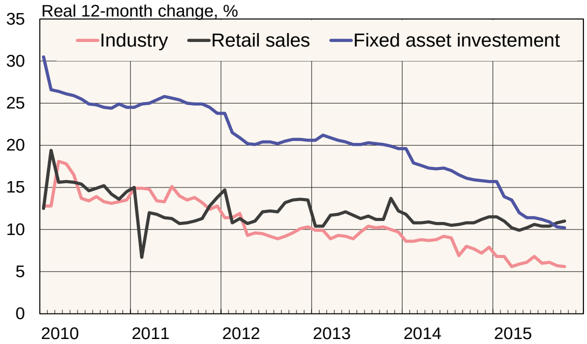
China

Growth in Chinese retail sales outstrips fixed investment. With growth accelerating slightly from previous months, retail sales growth hit 11 % y-o-y in October. In contrast, October growth in fixed asset investment (FAI) remained at 10 % y-o-y, its lowest growth pace since 2000. The fact that FAI is growing slower than retail sales provides further evidence of the structural readjustment of China's economy. Industrial output rose 6 % y-o-y in October.

Looking at the foreign trade picture for the first ten months of the year, the value of goods exports fell 3 % y-o-y. The value of imports in January-October was down 16 %, reflecting the fact that prices of energy and raw material inputs continue to fall. The January-October trade surplus climbed to nearly $490 billion.

12-month inflation slowed from 1.6 % in September to 1.3 % in October. The core inflation rate (omits food and energy prices) was 1.5 %, largely unchanged from previous months. October producer prices were again down, falling 6 % y-o-y.

Industrial output, retail sales and fixed investment



Source: Macrobond

Reform in management of China's state-owned enterprises moves ahead. At the beginning of this month, the State Council released a more detailed plan for overhauling the management of state-owned enterprises (SOEs). Under the envisioned model, SOE operative management will be shielded from direct intervention of state officials by shifting oversight duties to state-owned investment companies. Similar state ownership models are followed in many countries, including Finland.

The investment company model has already been tried in China in a couple cases. The State-owned Assets Supervision and Administration Commission (SASAC) in charge of SOE reforms notes that new firms will be selected for an expanded pilot programme over the coming two years. Consequently, the progress in reform remains slow, even if the need for SOE reforms is acknowledged e.g. in the latest five-year plan. Moreover, the earlier released reform plans have emphasised greater state supervision as opposed to market-based competitiveness.

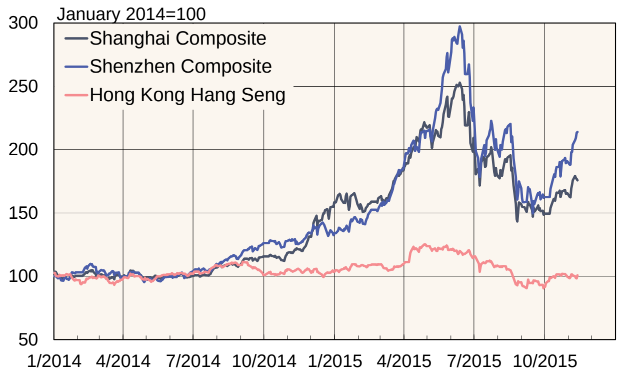
Mainland China share prices soar again; CSRC lifts moratorium on IPO listings. Share indexes in October were up 11 % on the Shanghai stock exchange and 17 % on the Shenzhen exchange – and the upward trend has continued in recent weeks. Even with last summer's stock market collapse, prices of mainland China shares are up about 50 % from a year ago. The price-to-earnings ratio (P/E) is up again, averaging 17 in October for firms listed on the Shanghai exchange and 45 for companies on the Shenzhen exchange. Banking-sector firms, which have a large weighting of shares on the Shanghai exchange, currently have an average P/E ratio of 8. In contrast, the P/E values are much higher for other sectors, for example manufacturing firms (average 37), commerce (37) and information technology (68).

On the Hong Kong stock exchange stock prices are lower than they were a year ago. The difference in prices between Shanghai and Hong Kong stock exchanges has widened, despite the fact that the Stock Connect programme, which in principle permits arbitrage between the exchanges, has been in place for a year. The prices of shares of firms listed on both exchanges are currently about 40 % higher on the Shanghai exchange than in Hong Kong.

The China Securities Regulatory Commission (CSRC), which oversees stock markets in mainland China, said it would begin to allow initial public listings starting November 20. The CSRC also said it would no longer require that shares must be paid for in full upon subscription. The practice has caused severe drops in market liquidity whenever IPOs occur. Chinese IPO share prices typically soar immediately after listing and thus IPOs tend to be heavily oversubscribed and shares are allocated by lottery.

The CSRC halted IPOs in July as Chinese stock markets plunged. With markets on the rise, IPOs will again be permitted. Firms approved for IPOs before the interruption will go first. During the first part of this year, more IPOs were approved than before. Over 170 firms staged IPOs on the Shanghai and Shenzhen exchanges in January-July, raising a total of 147 billion yuan (€20 billion), over twice the amount for all of 2014. Hundreds of firms currently await their IPOs.

Stock market index trends (Jan. 1, 2014 – Nov. 12, 2015)



Sources: Macrobond, BOFIT

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Russia

CBR monetary policy programme foresees drop in inflation and heavy reliance on Reserve Fund. The Central Bank of Russia's latest monetary policy programme keeps in place almost all the outcome of its September economic forecast, with the basic scenario largely unchanged. The difference is a cut in the figure for 2015 imports; now the volume of imports is expected to drop 26–30 % this year along with related adjustments in demand components. The 2016 forecast remains unchanged – including the assumptions on the average price of Urals oil ($50), GDP contraction (0.5 % to 1 %) and the drop in imports (about 2 %). CBR governor Elvira Nabiullina pointed out that the GDP forecast, in fact, entails that economic recovery will begin in the second half of 2016.

The CBR expects inflation numbers to become lower so that consumer prices in the first quarter of 2016 will be *8 % higher y-o-y* (12-month inflation is currently at nearly 15 %) as the spike in prices last winter enters the 12-month calculation. The CBR's inflation target is *4 % by the end of 2017*, and as long as on the projected track the CBR is ready to gradually reduce its key rate.

The dependence of banks on the central bank for maintaining liquidity has decreased this year due to a contraction in bank lending from last year and a return of household deposits. The CBR now expects its receivables from liquidity provision to shrink considerably by the end of 2016 and further on as the credit stock of banks is foreseen to increase slowly (next year 4–7 %) and banks should enjoy incoming money boosts as the government dips into the Reserve Fund to cover budget deficits.

The CBR estimates that Russia's current account surplus will continue as imports remain depressed, and anticipates foreign currency reserves to remain roughly unchanged. The central bank expects to restart its programme of buying small amounts of currency to gradually build up its foreign currency reserves from about $370 billion currently to $500 billion. The forex purchase programme was active in early summer this year. Nabiullina said the goal of the programme is to create a safety buffer, but that reaching the reserve's planned size should take at least five years.

Russia's consolidated budget deficit fairly small so far this year. The consolidated budget (which combines federal, regional and municipal budgets, plus state social funds) showed a January-September deficit of about 1.5 % of GDP. Government revenues have not suffered quite as much as Russian officials earlier estimated for the whole year. Revenues have been less weak than expected for oil and gas (even if these revenues were down nearly 20 % y-o-y), as well as other revenues to the federal budget and regional budgets. Total government revenues increased by about 1.5 % in nominal ruble terms.

The deficit has remained rather small despite high outlays early in the year which have made spending less back-weighted than in previous years. Russia's traditional end-of-year spending spree should be more subdued this year, but could still significantly increase the deficit. The finance ministry this summer forecasted that the 2015 consolidated budget deficit would be around 5.5 % of GDP. The Accounts Chamber of the Russian Federation has since given a slightly more modest deficit projection of 4.5 % of GDP.

Role of state-owned enterprises rising in Russia. Seven of the top ten companies listed among the largest Russian firms of 2014 based on sales were state owned, according to *Expert*, a Russian business weekly. The list shows that the role of state-owned enterprises (SOEs) has increased sharply in recent years. SOEs in 2007 accounted for just over 30 % of the total sales of Russia's 400 largest firms. By 2014 that figure exceeded 40 %, nearly matching the sales of privately held Russian firms on the list. In ruble terms, SOE sales corresponded to nearly a third of GDP. The largest foreign-owned company, telecom specialist Vimpelcom, ranked 21st. Energy company Fortum, the largest Finnish-owned firm making the list, ranked 176th.

The situation is quite similar in terms of market capitalisation. SOEs accounted for over half of the combined value in Expert's top-200 market cap list in banking, oil & gas, electricity and machine-building sectors.

Russia's corporate sector continues to be fairly concentrated. The total sales of Russia's 400 largest firms last year amounted to 52 trillion rubles ($1.4 trillion), with the ten largest firms generating over 40 % of that. Companies in the oil & gas sector contributed about a third of the largest firms' sales, while 10 % came from banks.

Firms in the defence sector posted some of the biggest sales gains in 2014 (e.g. the sales of United Shipbuilding Corporation increased significantly). The largest profits in ruble terms were posted by the big oil & gas companies and Sberbank. The five firms with the largest profits accounted for 70 % of the total profit of the 400 largest firms.

The 2015 *Forbes 2000* list of the world's biggest companies ranks Russia's Gazprom at 27th place. 27 Russian companies made the Forbes list this year.

Russia's largest firms by sales in 2014

	Sales, RUB billion	Market cap, USD billion	Ownership
1. Gazprom	5,477	55.5	State
2. Lukoil	4,718	35.4	Private*
3. Rosneft	3,681	40.9	State
4. Sberbank	2,167	25.4	State
5. RZD	1,402	n.a.	State
6. VTB	926	15.5	State
7. Surgutneftegaz	891	20.3	Private*

Source: Expert. * Private domestic investors

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IMF head calls for including yuan in SDR basket. IMF managing director Christine Lagarde last week declared her support for including the yuan in the Fund's Special Drawing Rights (SDR) basket. Lagarde's comments lean on the recommendations of the background report by the IMF experts. In their view, the yuan now meets all the criteria for inclusion in the SDR basket. The IMF board will meet on November 30 to decide on whether to include the yuan in the SDR basket. If they give the green light, technicalities still prohibit the yuan's SDR linkage before October 2016 at the earliest.

The decision hinges on the free usability of yuan. China in recent months has rapidly dismantled currency controls and deregulated its financial and forex markets to meet IMF criteria. The IMF notes that now Chinese officials have eliminated remaining operational barriers to wider use of the yuan. The yuan already met the IMF "major exporter" criterion in the last quinquennial review of SDR; i.e. the size of China's export share in global commerce was already sufficient.

As the fifth SDR currency, the yuan would be on par with the US dollar, euro, British pound and Japanese yen, and thereby signal the heightened role of China in the global economy. How the IMF decision affects international acceptance of the yuan will depend on how other actors perceive China's and the yuan's development. While becoming an SDR currency is unlikely to have much immediate economic impact, the decision supports China's reform policies and increased use of the yuan over the long term. Since joining the WTO, China has demonstrated that it can follow international trade rules. It is hard to imagine that China would want perception of the yuan in a worse light than other major currencies.

While the trend to greater international use of the yuan is unquestionable, the transition to the new operating environment is unlikely to be straightforward or free of setbacks. This week the People's Bank of China instructed clearing banks abroad (window guidance) to limit the capital exports from China. The measure helps to support the yuan's exchange rate ahead of the IMF's SDR decision.

No clear direction for China's housing market. The tracking of average housing prices last month in 99 Chinese cities by the private real estate portal SouFun indicated a modest sustained increase in housing prices since last spring. The trend was uneven, however, as prices declined in about half of the tracked cities and price drops affected more cities than in September. Housing prices mostly rose in China's largest cities. Official figures on price trends comport with SouFun's findings.

Even if official figures indicate that support measures for housing markets reversed the first-half drop in volume of apartment sales, the overall outlook for the housing sector looks rather bleak when investment figures are included. Measured in liveable floorspace, the volume of new housing starts in January-October was down 15 % y-o-y. Plot purchases of builders this year are down a third from last year.

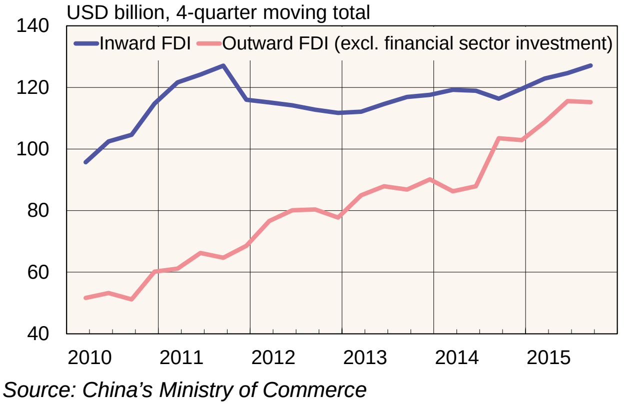
The importance of the real estate and construction branches to the overall economy is accentuated by the fact that companies in the field are deeply indebted. As such, the sector still constitutes a major threat to the overall economy.

Foreign direct investment flows to China on the increase. Figures released by China's commerce ministry show that foreign direct investment into China in the first ten months of this year amounted to $104 billion, an increase of 8 % y-o-y. After several years of slack growth, inward FDI this year were up significantly. Most FDI to China are channelled via financial centres or tax havens, so the true country of origin does not show up in bilateral figures. Aside these investments, the biggest FDI sources were South Korea, Japan, the United States and Germany.

The volume of new outward foreign direct investment (OFDI) from China (excluding financial sector investments) in January-October was $95 billion. Investment has increased 11 % y-o-y, even if investment in the third quarter was about the same as in 3Q14. In 2014, 70 % of China's OFDI went to Asia, 9 % to Europe, 9 % to South America and 7 % to North America. The largest part of China's OFDI goes to financial centres such as Hong Kong or tax havens such as the Cayman Islands. Again, the ultimate destination of investments cannot be discerned from official figures and some investments may be recycled back to mainland China.

Interpretation of Chinese FDI figures is further complicated by the fact that official figures published by the commerce ministry only include approved new investments. The figures lack data on repatriated investments and thus the net flow of investments. Balance-of-payments FDI data are also suspect. For example, net OFDI has remained flat for several years now. Given that Chinese investments in e.g. Europe and North America have targeted branches where investments are by their nature extremely long term, it is quite unlikely that repatriation of Chinese investment has grown at the same rate as the volume of new investment.

Foreign direct investment flows to and from China



Source: China's Ministry of Commerce

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Russia

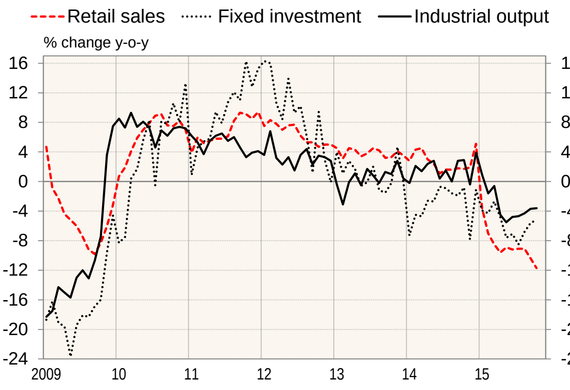
Mixed signals on direction of Russian economy. The slide in domestic demand continued in October as seasonally adjusted retail sales, reflecting private consumption which is the largest demand component, continued to contract. The volume of retail sales was down nearly 12 % y-o-y. While real disposable household incomes fell only modestly, the incomes suffered especially because nominal on-year growth of public sector wages remained essentially flat since summer. Given high consumer price inflation, still nearly 15 % y-o-y, the real wages were down strongly.

Industrial output rose slightly, due almost entirely to the growth in the mineral extraction industries. Crude oil exports continued to rise and natural gas exports recovered further. Manufacturing output again fell slightly in October. GDP contracted 4.1 % y-o-y in the third quarter and for the first nine months of the year 3.7 %.

Russia's leaders have been saying for some months that the bottom of the recession has been reached and recovery should lie just ahead. The economy ministry is sticking with its forecast that the economy will grow slightly in 2016. The Central Bank of Russia, however, is still predicting that the economy will not recover until the second half of 2016.

When considering the outlook for 2016, a core issue for forecasters is the oil price, which again has been declining in the past month and a half. Several other factors that might weaken recovery have also come increasingly to the fore: inflation forecasts have been revised up slightly while growth in nominal household incomes may stay lower than even the earlier inflation projections. The latest estimates of Russian officials bolster the view that an increase in government budget expenditure, as they have been decided for now, will be slower than inflation. Russian officials and the International Energy Agency (IEA) also estimate that export volumes of Russian crude oil and petroleum products decline next year after strong growth this year.

Key indicators of Russia's real economy performance



Source: Rosstat.

Russian farm output provides a small ray of light. The official end of the harvest season passed at the start of this month, even if it was estimated that less than 8 % of the land area dedicated to grain cultivation still remained to be harvested. Total agricultural output, including livestock, was up 3 % y-o-y in January-October and nearly 8 % in October (slightly reducing the overall contraction of the economy).

At the start of November, the grain harvests had reached nearly 106 million metric tons, or about 1 % less than in the same harvest period in 2014. The grain harvests for this year and last year, however, are both considerably larger than other harvests since 2008. Harvests of other crops such as potatoes, sunflowers, sugar beets and vegetables were up 5–10 % from last year.

Meat and poultry production increased nearly 5 % y-o-y in January-October, while dairy production was down slightly.

Separate development plan approved for areas near Chinese border in Russia's Far East regions. In recent years, Russia has focused greater attention on its Far Eastern regions, but despite development programmes, a special fund and a special ministry, rather little has been accomplished. The latest approved programme is the first to specifically tackle areas along the Chinese border. The programme applies to the Primorsk, Khabarovsk, Amur and Jewish Autonomous regions and reflects Russia's split-mindedness in relations with China. Even as major speeches proclaim closer cooperation and economic ties with China, many Russians are worried about China's emergence as a global economic superpower. This year, for example, planned Chinese agricultural projects in the Far East and Siberia have aroused intense opposition over fears of an influx of Chinese immigrants. Bilateral cooperation in the border areas has otherwise stumbled and e.g. of the 38 investment projects mentioned in the 2009 joint development programme, 30 have already been abandoned due to lack of investor interest.

The stated purpose of this latest development programme is to secure Russia's national interests in the Far East in an unfavourable international economic and political environment. To try to assure stable economic and social development in the Far East, the plan calls for e.g. supporting small and medium-sized firms and dealing with the region's poor infrastructure. To increase the population numbers, e.g. social support to families with children will be increased and new residents attracted through distribution of land. A bill proposal has already been submitted to the Duma that would give every Russian citizen the possibility to have up to one hectare of land in the Russian Far East. The programme also brings forth the issue of increasing the competitiveness of regions on the Russian-side relative to the Chinese side, which enjoys clearly higher growth and population number vastly greater than the Russian side. Russia's limited fiscal capacity to finance the public sector aspects of the programme suggest it may be even harder to implement than earlier.

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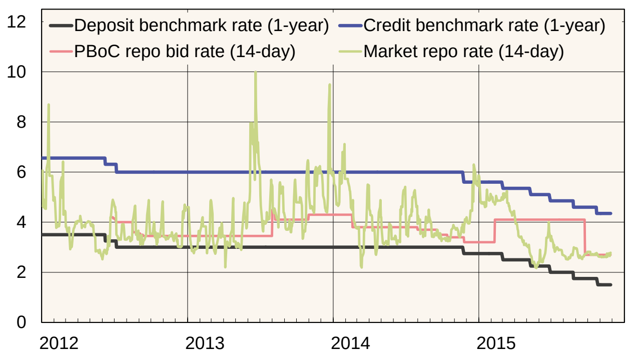
China

Chinese monetary policy is in search for a new framework. While interest rates were permanently freed in October and the People's Bank of China is on a path to market-based monetary policy, how the new monetary policy approach will be implemented is still unclear. There is no central bank policy rate yet. According to media reports, the PBoC will introduce an interest rate corridor to guide market rates. The floor of the proposed band would likely be the central bank's offered rate for banks' excess reserves, while the ceiling would be the short-term rate for its standing lending facility (SLF).

The rate paid on excess reserves has stood at 0.72 % since late 2008. While little data on SLF rates is available, the PBoC in November mentioned on a social media account that it had lowered SLF rates for smaller banks. For example, the rate on the seven-day credit for local banks was 3.25 %. Information about earlier rate levels was not revealed. The workings of the SLF are hardly transparent, so it could not form an effective reference rate at the moment. SLF lending is not implemented frequently as e.g. open market operations. The PBoC has not conducted any SLF lending since last April.

The PBoC sets several interest rates, including benchmark rates for commercial bank loans and deposits, interest rates paid on mandatory and excess reserves of banks with the central bank, as well as rates used in open market operations (e.g. repo rates). Since 2013, China has launched a number of central bank lending instruments. Besides the SLF, the PBoC has rolled out a medium-term lending facility (MLF), a facility for targeted lending called "pledged supplementary lending" (PSL) and the short-term liquidity operation (SLO) to cover possible brief episodes of liquidity stress.

Interest rate trends, 1.1.2012–27.11.2015 (%)



Source: Macrobond

The PBoC discloses details on the use of the new lending instruments and applied interest rates only weeks or months afterwards. Transparency of these instruments needs to improve significantly, if they are to be used as tools in monetary policy communication. During the transition period, PBoC benchmark rates will provide important guidance for pricing by commercial banks and serve as a means of communicating the monetary policy stance. Reserve requirements, however, will remain the main policy tool until the shift to an interest rate policy is completed.

China lowers and deregulates natural gas prices. Last week (November 20), China's National Development and Reform Commission (NDRC) lowered the average price of natural gas by 28 %. The cut applies to the "city-gate" price local gas distributers pay pipeline operators at the city limits. Lower gas prices should especially benefit domestic businesses, which accounts for 80 % of gas demand. The decision to lower gas prices does not directly affect the subsidised price paid by households.

With the drop in global energy prices, the competitiveness of gas in China has fallen due to regulated rates. As a result, many operators have shifted to dirtier fossil fuels. On-year growth in demand for gas, which decelerated already last year, is only 2 % this year (well below the double-digit growth figures seen just a few years ago). The government hopes to stimulate gas and overall demand through lower prices.

The NDRC also deregulated gas rates for non-residential use and continued with its critical pricing reforms in the gas sector that it began five years ago. The reform is aimed at making domestic rates reflect the world market gas prices. Operators can now agree on gas prices below the reference price, and within a year will also be allowed in their contracts to price gas as much as 20 % above the reference price. The NDRC wants to see price formation taking place on the Shanghai gas exchange, which was launched last summer. In this way, the markets will genuinely develop and function in a transparent manner.

Natural gas represented less than 6 % of Chinese primary energy consumption in 2014. Under the latest energy strategy, gas should exceed 10 % by 2020. Domestically produced gas met about 70 % of demand last year, with the rest satisfied by imported gas.

New yuan trading forum open in Europe. The China Europe International Exchange (CEINEX), a joint venture of the Frankfurt and Shanghai stock exchanges and the China Financial Futures Exchange, opened for trading on November 18. The Frankfurt-based operation facilitates investments in yuan-denominated products. The product selection consists of exchange-listed funds (ETFs) made up of mainland China shares and bonds.

CEINEX represents the latest step towards deregulation of Chinese capital movements and China's integration with global markets. Because the venture includes two central players in Chinese financial markets, it gives added credence to the view that Chinese officials are serious about opening the country to international business. This year both the London exchange and the Paris-based Euronext, began trading in yuan-denominated ETF funds, although with a product range narrower than on CEINEX.

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BOFIT

Russia

Russia bans travel to Turkey and restricts imports. In reaction to Turkey's shooting down of a Russian military jet on November 24, Russia's foreign minister immediately declared a terrorist threat in Turkey and called on all Russians to avoid travel there. Russia's state tourism agency recommended that Russian travel agencies stop arranging trips to Turkey and promised sanctions if companies continue to offer trips. Thereafter, President Putin and the cabinet issued orders affirming a ban on arranging tours and an immediate cessation of charter flights to Turkey. The explicit purpose is to protect national security and Russian citizens from criminal and other illegal activity. Increased security inspections were ordered for schedule airline flights. Russia suspended part of its bilateral agreement as regards visa-free travel of Turkish citizens to Russia from 1 January 2016.

Turkey is a top destination for Russian tourists. In 2014, Russians logged some 4.4 million private trips to Turkey, while CBR figures show they spent €5 billion (13–14 % of total Russian spending on tourism abroad) in Turkey on goods and services. Due to the Russian recession, the figures for the first half of 2015 were clearly down from 1H14, but still amounted to 1.4 million trips and purchases in Turkey for €1.7 billion. About 36 million foreign tourists visited Turkey in 2014. Russian government circles indicated that compensation to travel agencies was unlikely.

Measures aimed at goods imports were also tightened before Russia laid down the afore-mentioned orders. Russia's consumer protection agency and the agricultural inspection agency announced that they were stepping up inspections of Turkish products. Several importers also reported there were intensified customs inspections and Turkish lorries were backed up at Russian borders. The president's ban on imports of Turkish imports from 1 January 2016 mainly applies to some poultry products, and selected fruits and vegetables. Overall, Russia imported over €1 billion worth of fruits and vegetables from Turkey in 2014 and over €500 million in the first half of this year as Turkey has made up for part of the produce lost by Russia under its countersanctions against EU food and farm imports.

Based on the experiences with the countersanctions launched in late summer 2014, the government ordered certain ministries to track prices of the newly banned products in the domestic market. Some economists, however, estimate the import ban will raise consumer prices 2–3 %.

Next week, the cabinet will take up application of the president's order to ban imports of Turkish services, i.e. which services and firms will be affected, as well as delivery and labour contracts. The impact of the final decision could be large as Turkish construction companies are quite active in Russia. The CBR reports that Turkey received about €2 billion last year from construction services in Russia, and this year at least 60,000 Turks were working at construction sites in Russia. Further on the services front, the president ordered authorities to intensify security inspections of Turkish ships in Russian harbours and Turkish lorries. The cabinet decided to cut sharply the quota of permits granted to Turkish road freight firms next year.

For the time being, money markets have remained rather calm about Russia-Turkey tensions.

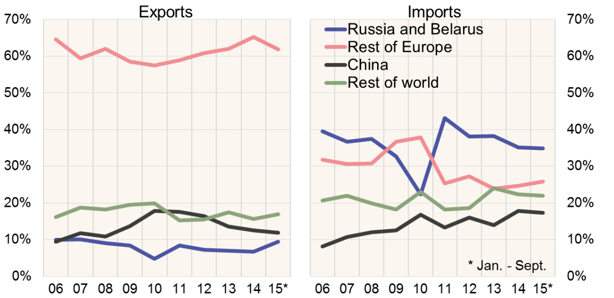
Impacts of Eurasian Customs and Economic Unions on the Kazakhstan market become clear. Even before Russia, Belarus and Kazakhstan established the Eurasian Customs Union (EACU) and unified their import duties in 2010, tariffs were all but eliminated between CIS countries under free-trade agreements. Thus, the establishment of the EACU affected to a large extent only import duties on goods from non-CIS countries. The weighted average of duties fell slightly in Russia and Belarus, while Kazakhstan's average rose from just over 5 % to nearly 10 %.

Russia's WTO accession in 2012 bound it to reducing its import tariffs by 2019. Since then, the EACU states have lowered the external duties according to Russia's WTO commitments. In Kazakhstan's case, it remains to be seen what happens. Its WTO agreement came into force this week with even lower tariff bindings than Russia's.

When the Customs Union became the Eurasian Economic Union (EAEU) at the start of this year, some barriers to market entry were lifted. In Kazakhstan, for example, European emissions standards no longer apply to cars produced within the EAEU. Russia's share of Kazakhstan's passenger car imports has increased from less than 10 % in 2010 to over 70 % in the first nine months of this year. Imports of e.g. Russian industrial machinery, televisions and chocolate, as well as Belarus tractors, lorries, meat, and dairy products have increased significantly. At the same time, imports of these products from developed economies have decreased.

Russia's and Belarus's share of Kazakhstan's total imports has not grown, however, because the flow of Chinese products such as clothing, footwear and machinery into Kazakhstan continues to rise. Russia accounted for 33 % of Kazakhstan's imports in the first nine months of this year ($7.8 billion) and Belarus 1.6 % ($360 million).

Breakdown of Kazakhstan's goods trade



Sources: Kazakhstan Customs, Eurasian Economic Commission

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China

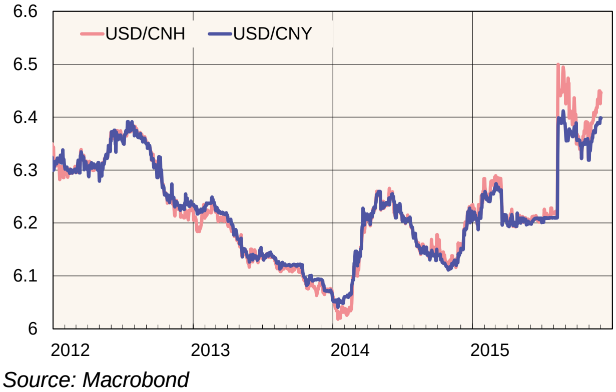
Yuan will join IMF's SDR basket. On Monday (Nov. 30), the IMF executive board voted to add the yuan as its fifth currency in its Special Drawing Rights (SDR) valuation basket. The incorporation of the yuan will officially take place on October 1, 2016. The yuan's weighting in the updated basket will be 11 %, with the US dollar maintaining it weighting of 42 %, and smaller weightings for the euro (from 37 % to 31 %), Japanese yen (9 % to 8 %) and the British pound (11 % to 8 %).

The IMF's decision, above all, is a symbolic acknowledgement of China's recent economic policies and the country's opening to the world. The People's Bank of China has promised to continue with reforms. SDR status does not directly influence the international attractiveness of yuan-based investments or use of the yuan in foreign trade. Rather how the yuan is perceived as a store of value is affected by China's economic development and how well China creates a balanced, predictable market environment.

The SDR is an international reserve asset available to help IMF member countries boost liquidity, so part of each member states' reserves is denominated in SDRs. At the end of November, a total of 204 billion SDR units (about $280 billion) had been allocated to IMF member states. The introduction of the yuan will impact IMF rate of lending and the rate paid on SDR deposits (weighted average of SDR basket to the national short-term interest rate).

The decision was expected. Markets barely reacted to the board's Monday announcement as IMF managing director Christine Lagarde had earlier declared her support for adding the yuan in the SDR basket. Since China's exchange rate reforms this summer, the yuan has faced depreciation pressure with the offshore yuan persistently trading in Hong Kong at a discount to the mainland rate. Many market participants expect the PBoC to let the yuan depreciate further after the SDR decision. The PBoC, however, has given assurances that it will hold the exchange rate steady and only intervene in the markets to mitigate exceptionally large shifts in capital flows.

Mainland yuan-dollar (CNY) and Hong Kong offshore (CNH) exchange rates



Source: Macrobond

Reforms reach China's military. The *South China Morning Post* (SCMP) reports president Xi Jinping announced on November 24 to China's top military officers that long-planned military reforms were finally underway. The goal is to reshape the military from Soviet-era structures to a Western-style organisation and operational capabilities, including larger roles for the navy and air force. Ground force command will be centralised from its current four branches and the number of military regions will be cut from seven to four. The reform gives more power to the central military committee led by president Xi, as well as the defence ministry's role in oversight relative to military leadership.

SCMP estimated in September that the army's size would shrink by 500,000 people to around one million. Additionally, the armed police force will form a national guard with about one million people. China wants to complete most of its biggest military shakeup in decades by 2020.

China's nuclear power industry making strides at home and abroad. In recent years, China has increased its efforts at developing a national nuclear power industry. Currently, China has 30 operating reactors, 21 reactors under construction and several projects waiting to break ground. About a third of active construction projects globally are located in China. The government wants 100 new reactors brought on line over the next ten years. The push for nuclear power plants is mainly a response to the country's air pollution problems, which can only be solved by moving to energy production that does not rely on fossil fuels, particularly coal.

China has actively utilised the world's leading nuclear power technology in joint projects, developing its own expertise and reactor technology. Many nuclear power plants to be soon completed in China are based on domestic "third-generation" reactor technology. The logical next step for China is to export its latest nuclear technology. China's government has established a goal of exporting eight reactors based on Chinese technology by 2020. Chinese banks participating in project financing help to meet the export target.

China's nuclear reactor exports have boomed this year, with state nuclear power companies CGN, CNNC and SNPTC joining in a number of international projects. Two projects underway in Pakistan use reactors based on Chinese technology. Projects in the UK were agreed this autumn, two of which are led by the French EDF with Chinese partners. The construction work of the first plant is getting underway. The second two-reactor plant, still under negotiation, would be the first nuclear power plant built in the West based on Chinese technology. CGN will begin construction in 2017 in Romania of a plant that uses Canadian technology. CNNC will begin construction of two nuclear power plants in Argentina in 2016 and 2017, which will be 85 % financed by Chinese banks. The second reactor will use Chinese technology. SNPTC is in negotiations with Turkey and South Africa.

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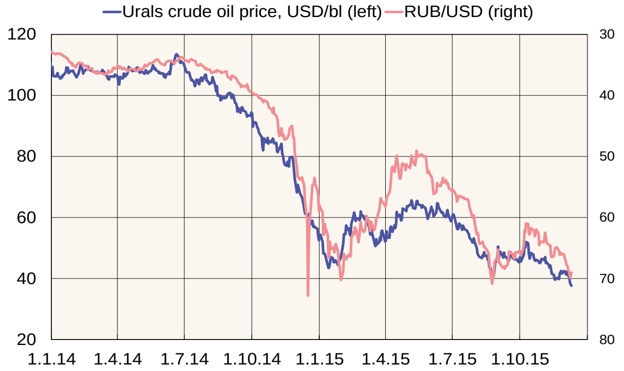
Russia

Cheap oil hurts ruble. The recent slide in crude oil prices has again affected the Russian ruble's external value. The price of Urals-grade crude oil has fallen by nearly 25 % since mid-October. Today (Dec. 11), the price of Urals crude went under $38 a barrel (Brent crude close to $39/bbl). In the same period, the ruble has lost over 10 % against the US dollar. One dollar currently buys 69.9 rubles and one euro 76.6 rubles. Since the start of this year, the price of Urals crude has slid nearly 30 % and the ruble-dollar rate about 35 %.

In recent months, the Central Bank of Russia has refrained entirely from intervening in forex markets to support the ruble's value. The value of the CBR's foreign currency reserves has fluctuated this year between $310 billion and $320 billion. The value of CBR currency reserves at the end of November was $317 billion. In addition, the value of its gold reserves was about $48 billion. In its monthly meeting today, the CBR kept its key rate at 11 %, where it has been since early August. The central bank cited inflation risks as the reason for maintaining the current level of the key rate.

Price of Urals crude oil and ruble's exchange rate, 2014–2015



Source: Reuters

Low oil prices challenge Russian government finances. The houses of the Russian parliament (Duma and Federation Council) during the past two weeks approved the draft 2016 federal budget. In its decisive second reading of the bill, the Duma reallocated about 2 % of the total spending to other categories, including e.g. new spending to remodel or replace dilapidated school buildings.

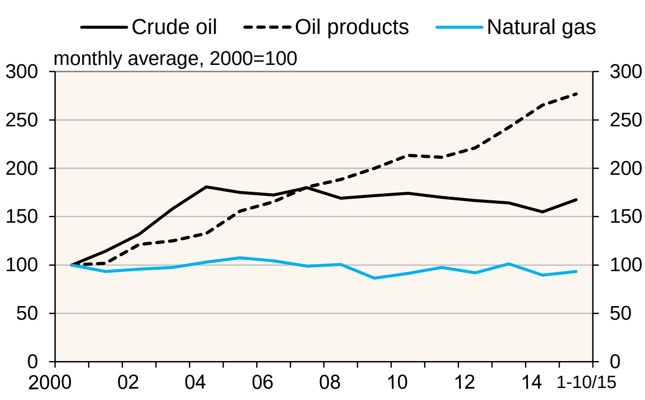
As in previous years, the government's draft of total federal budget expenditures and revenues was accepted as is. Thus, revenues (measured in nominal rubles) are set to rise 3.7 % from this year's current budget estimate. Revenues from taxes on oil & gas will increase by less than 3 % if the assumption holds that next year the average price of Urals crude will be $50/bbl and the ruble's exchange rate 63.3 rubles to the dollar. Other revenues will increase nearly 4.5 % if GDP grows 0.7 %. The federal budget deficit would then amount to 3 % of GDP, i.e. the maximum deficit size that president Putin has said he would accept.

While the parliament considered the budget bill, finance minister Anton Siluanov noted that the recent drop in oil prices threatens the budget. Siluanov said federal budget revenues at the current low oil price and ruble exchange rate would undershoot the freshly approved budget revenue projection by an amount equivalent to roughly 2 % of GDP. In that case, the finance ministry would call for spending cuts. If further cutting amidst lower revenue would not be made, the Reserve Fund would not be sufficient to finance the deficit until the end of 2016.

Russian energy export volumes at crossroads. In volume terms, the export performance of Russia's oil sector this year has exceeded expectations. Early this year, Russia's economic forecast predicted the volume of crude oil exports would rise by about 1.5 % this year and exports of oil products would drop 1 %. In reality, exports of crude oil increased remarkably in the first half, and even more for oil products. Growth in the volume of crude oil exports also remained strong after mid-summer. For January-October, oil exports were up nearly 8 % y-o-y. Exports are still clearly below the levels of 2004–2011, however. The volume of oil product exports have contracted substantially since mid-summer, while the volume exported in January-October was still up nearly 5 % from the same period in 2014. In its September forecast, the economy ministry predicted that export volumes of crude oil and oil products would decline 1–2 % next year.

The volume of natural gas exports fell in the second half of 2014 by 30 % y-o-y as exports to non-CIS countries fell and exports to Ukraine nearly vanished. Gas exports remained rather low through the spring, but since have recovered on increased demand from non-CIS countries. Ukraine, which has sought to wean itself from dependence on Russian gas, has purchased only a very small amount of Russian gas this year. Russia's September economic forecast sees the volume of natural gas exports rising in coming years, but still not coming near the high levels of previous years, e.g. 2003–2008.

Volumes of Russian oil & gas exports



Sources: Russian customs and CBR

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China

Beijing's abysmal air quality reinforces importance of Paris climate summit. The two-week UN climate summit in Paris, COP21, which convened at the start of this month, appears to be making more headway than the 2009 COP15 summit in Copenhagen. Political decision-makers from 195 countries this week continued to work on a final document based on a draft proposal from last week. The biggest open questions have to do with the timetable for meeting emission reduction targets and amount of financial support developed economies are willing to give developing countries in assisting with their climate efforts. The final document should be ready by 6pm today (Dec. 11).

China's role in Paris has changed from earlier climate summits, where it opposed binding commitments and timetables. This time around, China wants to see approval of a final document. Not only has China committed to reducing its CO_2 emissions by 2030, but has promised to launch a nationwide emissions trading scheme (cap-and-trade) in 2017. The NDRC, which is responsible for the emissions trading scheme, announced that the scheme will apply to about half of all China's carbon emissions. Nearly 10,000 firms representing six branches of the economy will participate. Given that China is the world's largest source of carbon emissions, its commitments are however rather modest.

China's huge air pollution problems and environmental degradation have become hot topics in the current domestic policy debate, and underlie the country's about-face at the Paris talks. Moreover, the slowing economy and structural changes have made it easier to reach emission targets. By some estimates, the economic slowdown and efforts at improving air quality mean that Chinese carbon consumption has already peaked.

Beijing's recent air quality readings give some indication of the seriousness of China's pollution problems. On Tuesday (Dec. 8), officials issued the highest-possible air quality warning with harmful particulate readings in some places exceeding by 40 times the level considered safe under WHO recommendations. While it was the first time a red alert on bad air had ever been issued in Beijing, many residents observed that the air quality has been worse, e.g. the previous week. On Tuesday, factories and construction sites were shut down, driving of private cars restricted and heavy transport vehicles banned altogether. Schools were ordered to remain shut and people were advised to stay indoors.

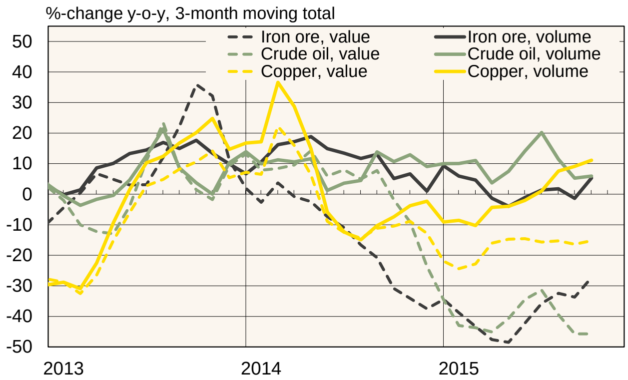
Air quality alerts were also issued in a number of cities in Beijing's surrounding provinces, leading to restrictions on driving and factory production. For example, several cities in Hebei province issued red alerts. The measures are expected to impact December's economic output figures.

Cheap oil and shifting exchange rates jostle China's foreign trade numbers. China's goods exports in November amounted to $197 billion, a 7 % y-o-y decrease. Goods imports fell 9 % to $143 billion. In the first eleven months of this year the value of Chinese exports fell 3 % and the value of imports 15 %. The trade surplus for January-November 2015 amounted to $543 billion, an increase of 64 % y-o-y.

The value of China's exports to the US in the first eleven months of this year increased 4 % y-o-y, while exports to Japan fell by 8 % and exports to EU countries contracted by 5 %. At the time, the yuan strengthened against the euro and yen. If China's exports to EU countries are measured in euros, they were up 14 % y-o-y in January-November. Measured in yen, exports to Japan were up 6 % y-o-y.

The drop in commodity prices was the main factor dragging down the value of imports. The value of China's oil imports in January-November was over 40 % less than in the same period last year. In volume terms, China this year has imported over 300 million tons of oil, or about 9 % more than the first eleven months of 2014. Imports of iron ore in the same period were up 2 % by volume, even if the dollar value of iron ore imports this year was down 38 % y-o-y. In January-November, the volume of imported pulp increased 12 % y-o-y. In contrast, coal imports have fallen significantly (down 24 % by volume and down 41 % by value).

Changes in selected commodity import volumes and values, %



Source: Macrobond

China experiences increased labour unrest in November. *China Labour Bulletin* (CLB), a Hong-Kong-based publication, reports that the number of strikes and labour protests in November exceeded all previous records since 2011, when the bulletin first began to publish figures. The CLB counted 301 protests in November, up from around 200 a month in previous months. Given China's massive labour force, the numbers seem small. Nevertheless, they appear to reflect the deteriorating economic situation.

Most of the demonstrations were over unpaid wages. Looked at nationally, it is clear that the protests are concentrated in the construction sector. In the southern coastal Guangdong province, the most protest activity was seen in manufacturing, highlighting a wave of wage non-payments and abuses stemming from factory closures, mergers and shifting of production elsewhere.

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Russia

Russian central bank again passes on rate change. The Central Bank of Russia's key rate has remained at 11 % for over four months now. In its decision to leave rates untouched the CBR emphasized that inflation risks have grown as household expectations of inflation have increased slightly. The CBR noted that even though the pace of consumer price inflation has slowed, it was still running at nearly 15 % a year in early December. The January on-year figure, however, is expected to fall below 10 % due to the spike in consumer prices last January. The CBR expects that the import restrictions recently imposed on Turkey would only add 0.2–0.4 percentage points to inflation.

The CBR said interest rates on bank deposits and loans are, despite their decline, still rather high and for their part stifle borrowing. The CBR noted several other factors hurting corporate borrowing and investment, including economic uncertainty, stricter bank lending rules (e.g. tougher collateral requirements), limited access to foreign credit and high levels of corporate indebtedness. The average rate charged on corporate loans in October was about 14 %, while the rate on one-year and longer household loans was 18–19 % and the shorter household lending rate around 25 %.

The CBR also said it was equalising the refinancing rate (a rate that belongs to the past from the monetary policy standpoint) to the key rate from the beginning of 2016. Until now, the refinancing rate had been set 2.75 percentage points below the key rate. The government also confirmed that it would begin to use the key rate in all government regulations as applicable.

Forecasters see the Russian economy contracting slightly in 2016. Recent economic forecasts, with the exception of the brighter projection of Russia's economy ministry, see GDP contracting about a half per cent. A couple of forecasts expect a drop of about 1 %. The average price of oil next year is assumed to average $50–55 a barrel. Most forecasts also see imports declining a bit further.

Almost all forecasts see private consumption shrinking next year, most by about 1 %. The CBR's forecast update this month, however, reduced its earlier projection and now expects private consumption to contract by nearly 4 %. The consumption projections reflect the anticipation that household income growth will not keep up with inflation, especially as increases of public sector wages and pensions have been set very low due to the frail condition of government budgets.

The forecasts also see fixed investment slipping further by roughly 1 %. Estimates of the volume of Russian exports vary more widely, but forecasters generally expect exports to rise slightly in 2016.

Select recent forecasts for the Russian economy in 2016

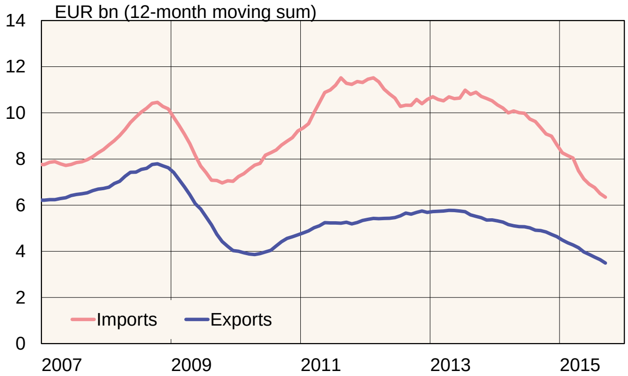
	month issued	GDP % change	Imports % change
Bank of Russia	Dec.	-1 — -0.5	-3.3 — -2.8
Economy ministry	Oct.	0.7	3 (goods)
IMF	Oct.	-0.6	-0.5
World Bank	Sept.	-0.6	
OECD	Nov.	-0.4	-0.4
EBRD	Nov.	-1.2	
EU Commission	Nov.	-0.5	0.3
UN (DESA)	Dec.	0.0	
Consensus Inc.	Nov.	-0.2	4.5 (goods, value)

Finnish-Russian trade scraping bottom. The value of Finnish goods exported to Russia in the first nine months of this year was down by a third from the same period in 2014. Despite slightly better performance in the summer months, the contraction in exports accelerated again in September. Exports have fallen rather steadily in all important product groups on lower Russian demand and the weak ruble. The contraction in food exports has slowed in recent months, largely because the base effect of the import bans imposed in August 2014 has begun to fade. After over two years of contraction, the total value of goods exports is already below the lows hit after the 2008-09 international financial crisis.

The weakness in services exports to Russia also appears to have persisted throughout the autumn. The number of Russian travellers staying in Finnish hotels and inns was down by nearly half from a year earlier in January-September and the number of crossings at Finland's eastern border fell by 20 % in January-November.

The value of goods imported to Finland from Russia in the first nine months of this year declined by a third from a year earlier. The value of imports closely tracks trends in oil prices as the lion's share of imports consists of crude oil and petroleum products. The volumes of crude oil and petroleum products have also contracted this year.

Finland's goods trade with Russia



Source: National Board of Customs.

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China

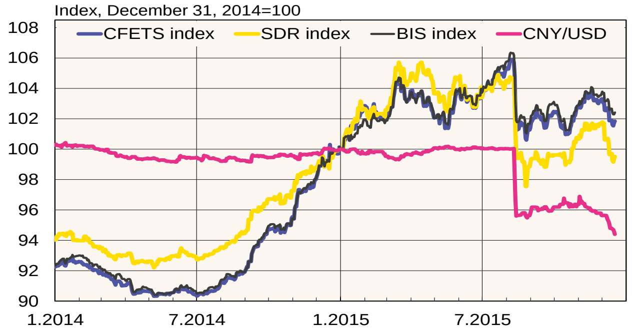
China publishes yuan exchange rate index. The China Foreign Exchange Trading System (CFETS), the agency under the People's Bank of China tasked with oversight of currency trading, introduced a CFETS yuan exchange rate index on December 11. The index is based on the weighted average of the currencies of 13 of China's trading partners. The largest weights in the currency basket are allocated to the US dollar (0.26), euro (0.21), Japanese yen (0.15) and Hong Kong dollar (0.07). The introduction of such index was explained to serve the need for an index that gives a broader perspective on exchange rate trends than the yuan-dollar rate alone. Fluctuations in the yuan-dollar rate are still constrained to a 2 % band based on daily fixing of a yuan-dollar reference rate.

Publication of the index does not mean pegging yuan to it. The yuan's exchange rate is formally set with reference to a currency basket established in 2005 as part of China's exchange rate reform. The PBoC has never revealed the precise composition of its currency basket, and the day-to-day exchange rate policy has focused on the yuan-dollar rate.

Publication of the CFETS yuan index has cause uncertainty about its intended role and the direction of central bank exchange rate policy. Some believe that the introduction of the index signals that the PBoC is ready to permit larger fluctuations in the yuan-dollar exchange rate, as the index serves to show a promised relatively stable exchange rate development. With the opening of China's economy, the trend is nevertheless towards less restrained exchange rate formation.

The yuan has been allowed to weaken against the dollar in recent weeks. On Friday (Dec. 18), one dollar bought 6.48 yuan. The yuan has fallen about 2 % in November–December, and has lost nearly 6 % against the dollar since the end of last year. Measured on the CFETS index, the yuan has risen about 2 % since the end of 2014. CFETS reported that it would begin to publish currency indexes based also on the BIS currency basket (comprises currency of 40 countries) and the IMF's SDR basket (dollar, euro, pound and yen). Since the end of 2014, the yuan has depreciated nearly 1 % against the SDR basket and appreciated 2 % against the BIS basket.

Yuan-dollar rate and three trade-weighted indexes



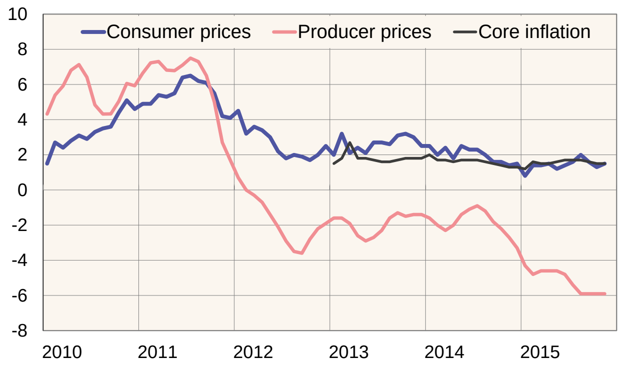
Sources: Macrobond, BOFIT

China's industrial output recovered slightly in November. Industrial output grew 6.2 % y-o-y last month, up from 5.6 % in October. Growth in fixed asset investment in the first eleven months of the year remained at 10 %. Infrastructure investment increased rapidly (18 % y-o-y), while growth in real estate investment slowed to 1 %.

Growth in retail sales remained high in November, with retail sales up 11 % y-o-y in real terms. "Singles Day" on November 11 boosted online sales, and helped raise the share of goods trade conducted online to 18 % of all good trade in November. Online sales of goods and services were up 35 % y-o-y in January-November.

Consumer price inflation accelerated slightly in November to 1.5 %. Base inflation (food and energy prices removed) remained unchanged at 1.5 %. Producer prices continued their rapid decline.

Price trends in China, % change y-o-y



Source: Macrobond

China's grain harvests continue to get bigger. China's National Bureau of Statistics reports that the 2015 grain harvest rose 2 % from last year to 620 million metric tons. The 2014 grain harvest also increased 1 % from 2013. Harvests of China's top grain crops (maize, rice and wheat) were up 3 %. While the total harvest has increased for over ten years in a row, this year's growth was exceptional. Officials say this is due to wider adoption of new production methods and favourable weather. Fields have also been repurposed from cotton to grain crops in some provinces.

The cultivated land area for grains increased slightly last year to 113 million hectares. Constraints on available farmland have become one of the biggest problems facing Chinese agriculture. The amount and quality of available farmland reflect China's widespread environmental problems, which have been caused by industrial pollution and excessive use of fertilizers and pesticides. Soil contamination and lack of access to clean irrigation water limit agricultural productivity. The small size of the average farm also hurts farm productivity. Farm subsidies support the raising of crops in areas poorly suited for farming or a particular crop. Chinese grain production is centred in the eastern provinces. Nearly 30 % of the total harvest comes from the Heilongjiang, Henan and Shandong provinces.

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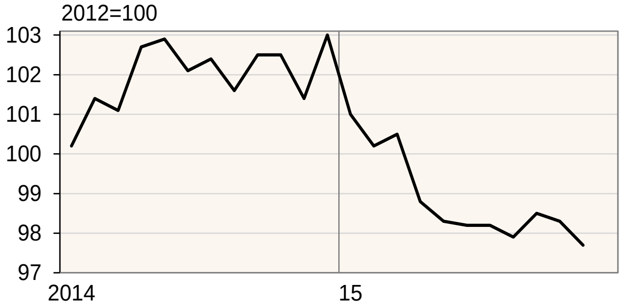
Russia

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

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

Industrial output (seasonally and workday-adjusted)



Source: Rosstat.

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

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

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

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

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

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

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

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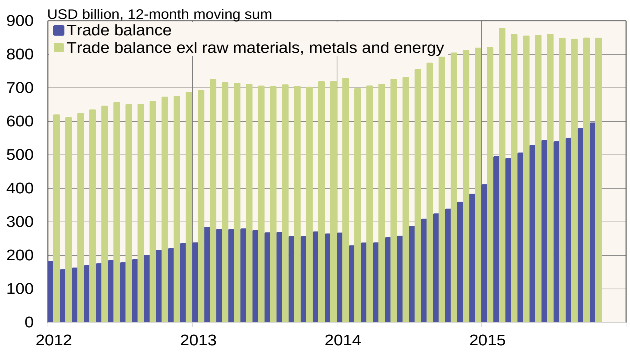
China

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

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

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

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



Sources: CEIC, BOFIT.

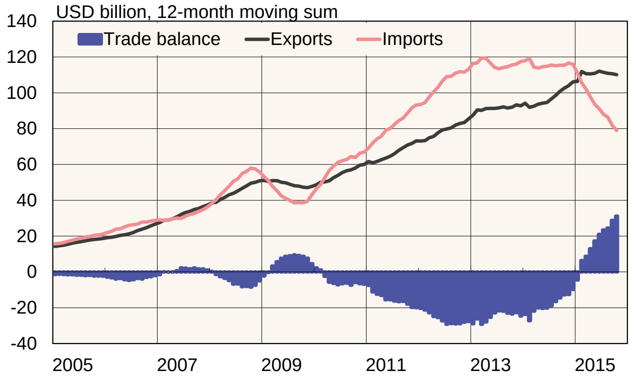
Economic relations reaffirmed at China-Africa summit. South Africa hosted the sixth ministerial conference on China-Africa Cooperation early this month in Johannesburg. Chinese president Xi Jinping highlighted China's commitment to deeper cooperation with African nations despite his own slowing economy.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

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

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

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

China's trade with African countries



Source: Macrobond

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

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

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