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BOFIT Weekly
17 • 25.4.2014

Russia

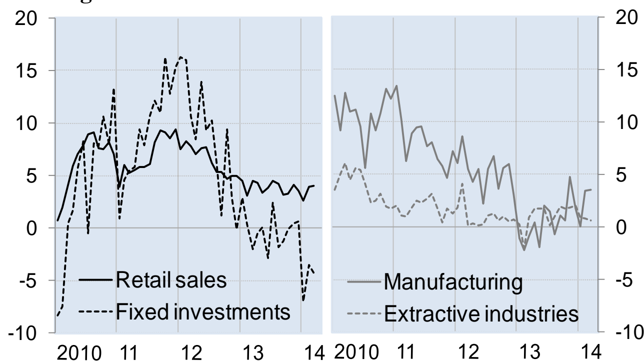
Distinct chill in the Russian economy. Preliminary economy ministry estimate shows GDP grew by 0.8 % y-o-y in the first quarter and seasonally adjusted first quarter GDP contracted 0.5 % q-o-q. Rosstat reported a revision of its GDP growth figures for 2013. The new figures indicate GDP growth picked up over the year, reaching 2 % y-o-y in the fourth quarter. Earlier figures showed a second-quarter dip in growth.

The 1 % y-o-y pace of industrial output growth in the first quarter was essentially unchanged from 4Q2013. The recovery in manufacturing that began late last autumn continued with growth holding at just under 2.5 % y-o-y. Most manufacturing growth came from brisk growth in the oil refining and chemical industries. Production of mineral extraction industries was up less than 1 %, or slightly lower growth than last year. Crude oil production increased by over 0.5 %, while natural gas production slid about 1.5 %.

Retail sales growth remained fairly brisk, with sales rising 3.5 % y-o-y. Russia, however, experienced a burst in sales of non-food goods in the first quarter. Observers believe there was a rush to buy things which came in response to higher prices and inflation expectations caused by the sharp drop in the value of the ruble.

Growth in consumer demand is constrained by real disposable incomes of households which fell over 2 % in the first quarter. The decline was partly due to increasing interest payments on household bank loans. The decline in household borrowing continued. Households drew down their bank accounts to an exceptional extent in the first quarter to finance goods purchases and hoard foreign currency cash.

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



Source: Rosstat

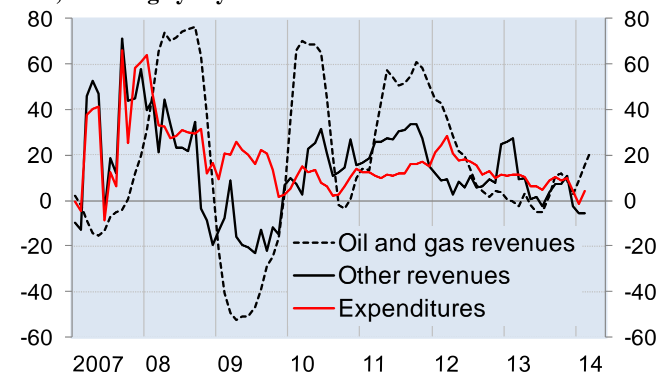
Fixed capital investment and construction activity both declined, 5 and 3.6 % y-o-y, respectively. The contractions in building and investment were already underway before the Crimean situation added to economic uncertainty.

Ministries at loggerheads over government spending and budget rule. The policy wrangle between the ministries of economy and finance ratcheted up this week and last. After the economy ministry's latest economic forecast included a recommendation to increase state spending, the finance ministry noted the economy ministry overstated the impacts of higher spending on economic growth.

The finance ministry does not want to deviate from the agreed budget rule limiting the size of the budget deficit to 1 % of GDP. The finance ministry argues that higher spending will lead to more imports and increased capital outflows, accelerate inflation, and together with more borrowing will lead to higher interest rates and degrade the investment climate. The finance ministry also noted that violation of the budget rule during the current geopolitical risks would be undesirable even with the new state spending on Crimean development. The finance ministry further explained that temporary boosts in spending do not secure sustained economic growth. The finance ministry is even suggesting tightening of the budget rule so that the basis for determining state spending would take into account the oil price and, instead of the budget deficit relative to GDP, an estimate of the state's access to financing. Prime minister Dmitri Medvedev has commented on a deviation from the budget rule by way of reserve.

In the economy ministry's view, higher spending would be supported by state oil and gas revenues, which are denominated in dollars and in ruble terms will exceed this year's budget revenue projection by over 1 % of GDP. The finance ministry dismisses this argument, noting that other budget revenues and state financing (including refinancing of debt) through borrowing and privatisation sales will be considerably lower than expected. Government revenues from production taxes and export duties on the oil & gas sector increased over 20 % y-o-y in the first quarter. Growth in other revenue streams, however, failed to match inflation.

Russian government revenues and expenditures, 3-month sum, % change y-o-y



Source: Finance ministry

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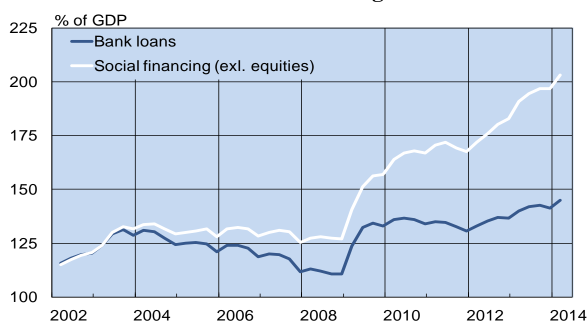
China

First-quarter data show mounting debt levels in China. China's pace of economic growth slowed in the first three months of the year, partly on lower growth in investment demand. The slowdown in growth was also reflected in credit stock growth. Using a broader definition that includes social financing arrangements but not equity, credit stock growth slowed in the first quarter. March on-year growth slowed one percentage point to 16 %. Diminished credit growth could be seen in both formal bank lending and financing granted by the shadow-banking sector. Broad money supply growth (M2), which consists of cash and bank deposits, slowed by over a percentage point to around 12 %, a record low for Chinese money supply growth in recent decades.

Despite the slowdown, the growth in the credit stock exceeded nominal GDP growth. As a result, indebtedness relative to GDP increased in the first quarter. China's total credit stock now exceeds 200 % of GDP.

Overall credit stock and bank lending stock relative to GDP



Sources: Macrobond, BOFIT

China's slowing economic growth has fuelled a debate over the need for further stimulus measures. The government has already lowered capital adequacy requirements of rural banks by 0.5–2.0 percentage points to 13–15 %. The move is mainly intended to support agriculture; due to a small size of rural banks, the step is not expected to have specific liquidity or interest-rate effects. The government will also support small-business employment through modest tax breaks, commission new infrastructure projects and ease restrictions on real estate markets to sustain activity.

The debt loads on enterprise sector and local administrations, however, are now so large that they must be considered in economic policy. Reducing debt growth under the current circumstances could yield greater benefits for the Chinese economy than stimulus measures as long as the job market shows no signs of weakening.

Government aims to curb shadow-banking risks by tightening regulation and clearing path for the local government bond market. China's Banking Regulatory Commission (CBRC) announced this month new measures designed to rein in risks arising from financing activity outside the formal banking system. The new regulations target trust companies operating in financial markets. Trust companies collect funds from private individuals and firms via commercial banks, and lend the collected funds forward as trust loans. Reuters reports the new regulations will prevent trust companies from issuing new trust products to fund repayments to investors on maturing loans. Under the reform, trust products must also specify the underlying assets of the investment, which allow investors to understand their risk exposure better. The details and timetable for the rollout of the new rules has yet to be announced.

The new regulations require trust companies to clarify their operational procedures and demonstrate access to adequate financing (e.g. from company owners) in the event of financial market tightening. Because financial companies outside the formal banking system lack access to the central bank's emergency financing arrangements, officials are paying particular attention to the liquidity management of shadow banks.

By banning trust companies from issuing new debt to pay off old debt, officials hope to avoid situations where investors' risks are prevented from realising as it only postpones and piles up problems. A big issue for many companies financed by shadow banks is that they rely on access to financing because they have financed long-term projects with short-term loans. New measures aim to prevent these maturity-mismatches in the future to reduce liquidity risks.

Individual investors will also be banned from using borrowed funds to invest in trust products. The regulatory measures are designed to stave off a build-up of problems and the emergence of systemic risks.

The shadow-banking sector has defaulted on repayments for certain wealth management products this year, but so far investors have been bailed out. The bailouts, in turn, have raised questions about investor liability and moral hazard. In several recent events, investors have assumed seller banks were responsible for reimbursement for trust product losses, suggesting that liability issues still need clarification.

China is going to speed up the rollout of local administration bond markets. Standard Chartered Bank estimates 20–30 % of assets raised from shadow-banking sector's wealth management products have been loaned to local administrations. The introduction of bond financing is hoped to improve transparency of the accounting practices and debt of local administrations.

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