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BOFIT Weekly
30 • 25.7.2014

Russia

Production and demand in Russia shrank in June. Economy ministry estimates GDP growth in the second quarter was 1.2 % y-o-y, a slight improvement from 0.9 % in the first quarter.

Most of the improvement in GDP growth came from industry. However, in June seasonally adjusted industrial production contracted notably, to just slightly above the level of December 2013. In particular, manufacturing growth slowed steeply after a spring recovery (observers have noted that transitory factors boosted growth in spring, such as the advantage conferred on certain industrial branches from the drop of the ruble and sharp growth in defence spending.) Manufacturing was up 2.6 % y-o-y in the first half and 0.3 % y-o-y in June.

Growth of seasonally adjusted resource extraction industries remained at zero for three months in a row. In y-o-y terms, output growth in June and for the entire first half came in at slightly below 1 %. Crude oil output increased 1.5 % y-o-y in the first half, while natural gas production declined 2 % y-o-y.

Seasonally adjusted retail sales contracted in the last three months, after a revival in late winter. Back then, people accelerated their purchases as the ruble slid and inflation rose. Although retail sales grew 2.7 % y-o-y in the first half, they were up just 0.7 % y-o-y in June. Households' real disposable income declined slightly in 1H2014 from 1H2013, e.g. due to their increasing debt servicing.

Investments fell almost 3 % y-o-y in the first half on weakness in the first quarter of the year. June investment, however, was up slightly from a year earlier. Some of this gain can be attributed to the low base of June 2013. Completed housing projects in June, on the other hand, continued at the record pace set in the first half. In terms of floor space, the volume of finished housing was up one third from a year earlier both in the entire first half and June.

US and Canada widen sanctions against Russia, and the EU. The annexation of Crimea and the on-going crisis in eastern Ukraine has pushed the US, the EU and a number of other countries (including Canada, Australia and Japan) to impose economic sanctions on Russia during spring and this summer. As a rule, the sanctions have mainly been applied to individuals or specific firms. The initial US sanctions froze the assets and imposed travel bans on 45 individuals and 30 firms. The EU's respective list has 72 private persons and two companies operating in Crimea.

On July 16, the US imposed considerable new sanctions on Russia. The sanctions list saw the addition of four Russians (including Oleg Savelyev, minister for Crimean affairs) and eight armaments firms (including Almaz-Antez, maker of the BUK ground-to-air missile system). State oil giant Rosneft, Russia's largest private gas producer Novatek, and two major state-owned banks (VEB and Gazprombank), saw their access to US debt markets restricted. The new sanctions decision forbids US persons from transacting in, providing financing for, or otherwise dealing in new debt of over 90 days maturity for them, and of new equity for the banks. The sanctions also extend e.g. to majority-owned subsidiaries of those listed. Trading e.g. in existing debt securities, short-term funding, payment transactions and other commercial activities are still permitted.

In practice, the new US sanctions block the named firms from access to long-term dollar-based borrowing. Rosneft and Novatek have relied actively on foreign borrowing to finance investments and refinance their debt. The lack of access to dollar-based financing will force these firms to turn to domestic financing sources or Mideastern and Asian financial markets. Availability of funds may not necessarily become a problem, but financing costs will increase.

On July 24, Canada imposed identical sanctions, among others, on VEB, Gazprombank and Novatek. Moreover, on July 25, the EU decided to add several further persons and entities to its list of those subject e.g. to an asset freeze. The list is to be published today.

Banking sector reflects growth of uncertainty. Growth in household deposits came to a standstill in early this year on uncertainty caused by ruble weakness and tensions from the conflict in Ukraine. The deposit stock shrank by 0.4 % in nominal terms from January to June. During 1H2013, the deposit stock still grew about 10 %. In March and April in particular, households changed bank deposits into foreign currency cash and moved up planned purchases. Foreign currency deposits at end-June amounted to over 18 % of all household deposits, about one percentage point higher than a year earlier.

The ratio of household deposits to total assets of the banking sector fell by two percentage points during the first half to 28 %. The shares of central bank financing and state deposits (including the finance ministry) as well as interbank lending have all grown. The share of central bank financing has nearly doubled over the past year; it now accounts for about 9 % of banking sector total assets, while it reached 12 % in early 2009, the crisis year.

Growth of corporate credit stock was 16 % y-o-y at end-June, slightly faster than a year earlier. The acceleration in growth of the credit stock may reflect increased difficulties in foreign borrowing. On-year growth of the stock of household credit slowed from 34 % at end-June 2013 to 21 % at end-June 2014. A driving factor was the central bank's earlier measures (see BOFIT Weekly 6/2014). The bulk of new household borrowing is however going to servicing existing loans.

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China

BRICS to establish their own development bank and currency reserve arrangement. Leaders of the world's biggest emerging economies, the BRICS (China, India, Brazil, Russia and South Africa), met last week at the BRICS-UNASUR summit in Brazil and took a considerable step towards concrete cooperation by setting up a New Development Bank (NDB). The initial mission of the NDB will be to provide financing for public and private infrastructure projects in emerging and developing countries. The bank will grant project loans, provide loan guarantees and offer capital financing. The headquarters will be located in Shanghai, a reflection of China's political and economic clout in the initiative. Other counties outside the founding members could also eventually join the NDB.

Under current plans, the NDB's initial subscribed capital will rise over the next seven years to $50 billion. The NDB can also raise additional capital by issuing $50 billion in shares that will be available for subscription to founding members and new members. The initial capitalisation plan gives all founding members equal voting shares, but acquisitions of new shares will allow individual members to increase their voting power. With further capital infusions, the bank capitalisation could rise to $100 billion. For example, the World Bank's subscribed capital is $230 billion.

The diverse characters and geographic disparities of the member countries make it difficult to predict the type of projects that will be the NDB's focus. Most of the member countries have their own national development banks already overseeing their national interests. For example, China's National Development Bank agreed this week to grant new loans to Venezuela in exchange for oil shipments. Regional development banks such as the Asian Development Bank (ADB) and the Inter-American Development Bank for Latin America are currently major lenders in projects geared to regional development.

Several observers have noted that the NDB is part of an effort to diminish the current dominance of first world countries in international organisations. For example, the United States and Japan play key decision-making roles in the IMF and ADB. Also the fact that the reforms to voting power in the IMF have not been enforced has further disillusioned several emerging economies.

In addition to the NDB, the BRICS agreed to form $100 billion "Contingent Reserve Arrangement" meant to function as a risk management mechanism. It could, for example, provide short-term liquidity or help support the exchange rate of an individual member country. The arrangement is based on member financial commitments, whereby funds are not pooled into a currency reserve. China's contribution would amount to $41 billion. The currency arrangement is not economically significant in China's case as its own foreign currency reserves neared the $4 trillion mark in June.

The gap between China's foreign direct investment inflows and outflows narrows. China's commerce ministry reports that direct investment outflows from China rose 8 % y-o-y in the second quarter of this year. On the contrary, foreign direct investment inflows to China were down 1 % from the same period a year earlier. In the first six months of this year, FDI from China (not including the financial sector) amounted to $43 billion, down 5 % y-o-y due to a weak first quarter. FDI inflows to China amounted to $63 billion (up 2 % from 1H2013).

Over the longer term, the difference in direct investment flows into and out of China has been shrinking. FDI outflows from China (not including the financial sector) increased 16 %, while investment inflows into the country grew 5 %. UNCTAD estimates that China's direct investment abroad will exceed FDI inflows within the next couple of years. UNCTAD figures differ from the commerce ministry figures as the data collected by the commerce ministry occurs in conjunction with its investment approval process, which is why the reported deal values can differ from the actual numbers. Nevertheless, the overall image of investment flows is undisputed for both agencies.

The commerce ministry figures reveal that FDI inflows to China's manufacturing sector have dwindled in recent years. In the first half of this year, FDI going to manufacturing was down 14 % y-o-y. Nevertheless, a third of China's incoming direct investment still goes to manufacturing. Growth in real estate sector investment remained brisk (up 31 % y-o-y in 1H2014). The real estate sector received nearly 30 % of FDI inflows to China. FDI to China from South Korea, in particular, jumped in the first half, while FDI from Japan fell significantly.

According to the China Global Investment Tracker database, a large share of large outbound investments (over $100 million each) by Chinese firms in the first half went to resource extraction industries and the energy sector. Investment in resource extraction was boosted in the first half by a nearly $6 billion copper mine investment in Peru. This year has seen increased technology investment coming from Lenovo's deals with IBM and Motorola, each of which worth over $2 billion.

UNCTAD reports that China was the world's third largest source of FDI last year after the United States and Japan. Given the size of its economy, the total FDI stock from China is relatively small by international standards. The stock of FDI from China last year corresponded to 7 % of GDP, compared to 24 % for Russia, 18 % for South Korea and 15 % for Thailand.

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