Weekly Review
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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.

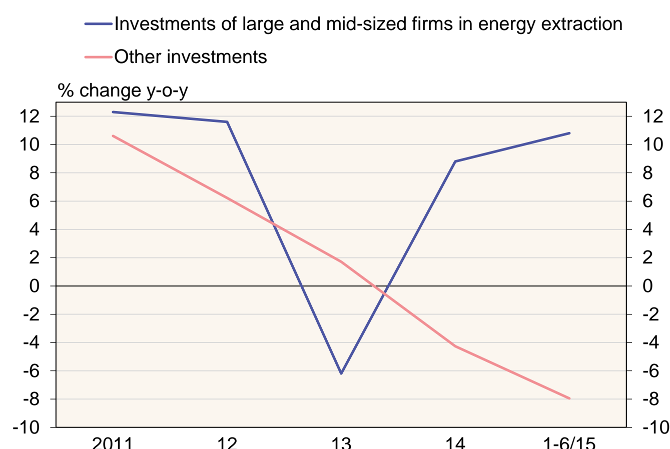
Other investment in the economy as a whole declined sharply. This was due mostly to starkly falling investment in electrical power generation and rail transport, which both declined already in 2013 and 2014. Investment in oil and gas transmission pipelines also fell steeply. Investment in oil refining 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.

Bank of Finland • Institute for Economies in Transition, BOFIT
P.O. Box 160, FI-00101 Helsinki
Phone: +358 10 831 2268 • Web: www.suomenpankki.fi/bofit_en

Editor-in-Chief Jouko Rautava• Email: Jouko.Rautava@bof.fi
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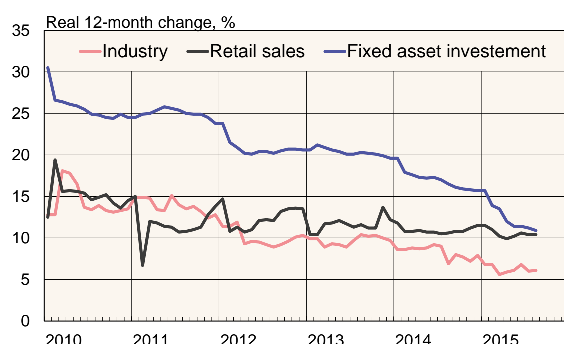
China

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.

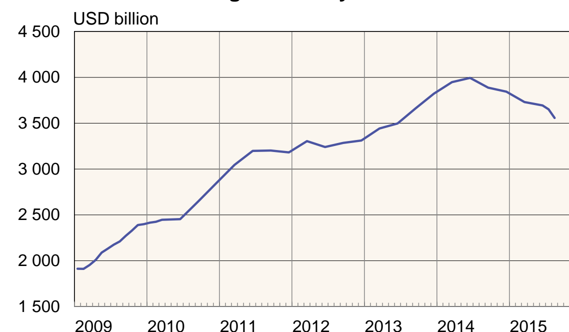
China's foreign currency reserves declined by $94 billion in August. Following a record monthly drop, the value of China's reserves held in foreign currencies at the end of August stood at $3.557 trillion. The decline in reserves reflects massive capital outflows and the central bank's response in propping 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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P.O. Box 160, FI-00101 Helsinki
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Editor-in-Chief Jouko Rautava• Email: Jouko.Rautava@bof.fi
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