Weekly Review
24 • 17.6.2016

BOFIT

Russia

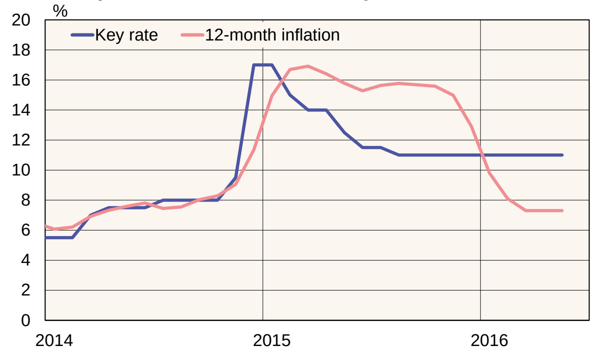
Russian central bank lowers key interest rate. At its monthly meeting last Friday (June 10), the Central Bank of Russia's board of directors voted to lower the key rate by 50 basis points to 10.5 %. The CBR last lowered the key rate in August 2015.

The board based its decision to reduce the key rate on more benign inflation development and outlook. 12-month consumer price inflation was below forecast, stabilising at 7.3 % in past months and inflation expectations have continued to decline. The board noted that inflation risks have subsided, although remain elevated due to e.g. the stickiness of inflation expectations and uncertainty related to fiscal policy.

The CBR also announced its reduced inflation outlook for this year in conjunction with the meeting. The earlier projection that 12-month inflation would end the year at around 6–7 % was revised down to 5–6 %. The CBR expects the economy to come out of recession at latest in the second half of this year. Economic growth is, however, expected to remain slow next years and therefore not accompanied by higher inflation pressures. The CBR expects to hit its 4 % inflation target by the end of 2017.

The board added that it would consider further rate cuts if inflation risks abate and inflation continues to drop as expected. The next board meeting is set for July 29.

Consumer price inflation and CBR key rate



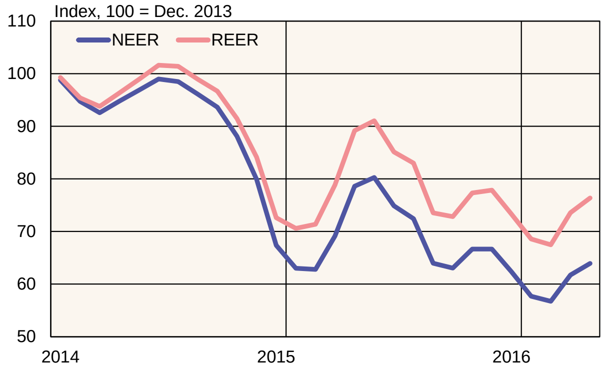
Source: Macrobond.

Ruble strengthening on higher oil prices. This week the ruble-dollar exchange rate hovered around 66 RUB, while the euro-ruble rate held around 74 RUB. The ruble has appreciated more than 20 % against the dollar and euro after hitting this year's bottom in late January. Since the CBR floated the ruble in November 2014, the ruble's exchange rate has closely tracked oil prices because the bulk of Russian forex earnings comes from oil and related exports. Depreciation pressures on the ruble have also subsided due to a sharp slowdown in capital outflows. The CBR estimated that the net outflow of private sector capital in the first five months of 2016 amounted to $13 billion, down from $50 billion in the same period in 2015.

Due to higher inflation rate in Russia than in most of its trading partners, the ruble has strengthened even more in real than nominal terms, although its value is still far below pre-collapse levels. The ruble's real effective (trade-weighted) exchange rate in May was 22 % below end-2013.

Many Russian firms are satisfied with the ruble's strengthening. A recent survey committed by the CBR found that over 60 % of responding firms want a stronger ruble because it would support their investment in imported machinery and equipment and reduce production costs as imported inputs would become cheaper. Firms in nearly all branches favoured ruble appreciation regardless of whether they serve the domestic market or are involved in exports.

Nominal and real effective ruble exchange rates



Sources: Central Bank of Russia, BOFIT.

Liquidity in Russian banking sector recovers. Poor economic performance, fluctuations in the ruble's exchange rate, the drop in foreign financing and increase in household savings rate have affected the banking sector in multiple ways. Measured in nominal terms, bank loan portfolios grew just 8 % in 2015 and contracted by 4 % in the first four months of this year. About 30 % of bank lending is denominated in foreign currencies. Adjusting for shifts in exchange rates, bank loan portfolios have seen no growth for over a year. Especially lending to households has fallen dramatically.

Households have responded to economic uncertainty by saving more. Adjusting for exchange rate shifts, households increased their bank deposits 17 % last year and another 1 % in the first months of this year. Deposits by households and corporations now account for 60 % of total banking sector liabilities. With growth in domestic deposits, borrowing from the central bank has fallen sharply. At its peak in early 2015, CBR funding accounted for nearly 12 % of banking sector liabilities, but as of April that share had fallen below 4 %.

Even with bank profits affected by hikes in loan-loss reserves and reduced lending, banking sector liquidity improved this spring and interbank overnight rates trended below the CBR key rate. The CBR is monitoring the situation and prepared to intervene as needed. The minimum reserve requirement for forex deposits rises to 6.25 % on July 1.

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

Weekly Review
24 • 17.6.2016
BOFIT

China

Foreign investors still face too many hurdles in accessing mainland China stock markets. The international indices and analytics producer MSCI yet again decided not to include mainland China's yuan-denominated A-shares in its emerging markets (MSCI EM) index. Despite significant reforms, China's stock markets still do not fully meet international standards. In its annual review of market classifications, MSCI noted that in recent months Chinese officials have improved the rules on beneficial owners, improved quota allocation under the qualified foreign institutional investor (QFII) programme, eased capital mobility restrictions and enhanced regulation on voluntary trading suspension policies. Because the reforms have been implemented so recently, however, China has yet to establish a track record on the effectiveness of the changes.

A significant barrier to inclusion of Chinese A-shares in the MSCI EM index appears to be repatriation limits for invested assets and pre-approval restrictions imposed by Chinese stock exchanges on releasing international investment products containing A-shares. The thorniest problem for investors seems to be the 20 % repatriation limit, i.e. only a fifth of previous year's net value of QFII investments can be repatriated in a given month, which means it takes about five months to close out a position. MSCI EM index currently includes Chinese shares listed on the Hong Kong or US exchanges, and the shares have about 20 % weight in the index.

The fundamental barrier to access to Chinese stock markets is that international investors can only invest through special programmes with imposed quotas. As an example of this market access constraint, share prices for the same firm currently average about 35 % more on the Shanghai and Shenzhen exchanges than in Hong Kong. The linking of the Shenzhen and Hong Kong exchanges is set to begin shortly. Even if this improves access of international investors to the Chinese market, however, China's hoped-for inflows of foreign capital and investor knowhow into its financial markets have remained meagre since the Shanghai-Hong Kong process began in late 2014.

A- and H-share prices on Shanghai and Hong Kong exchanges

Source: Macrobond.

Fixed investment in China loses steam. Fixed investment growth accelerated a bit in early spring as the public sector ramped up infrastructure construction. Now it appears fixed investment growth has again slowed. Nominal growth in fixed asset investment (FAI) fell below 10 % y-o-y in January-May as growth in both public and private investment faded. Growth in private investment, which accounted for slightly more than 60 % of all FAI in the first five months of the year, slowed in May to around 1 %. Heavy industry investment fell rapidly in the northern parts of the country.

Production trends in May were in line with previous months. Industrial output growth has long remained around 6 % and the growth of retail sales this year has remained below 10 % in real terms, which reflects slowdown in average disposable income to 6.5 % y-o-y in 1Q16.

May price trends held few surprises. Consumer price inflation slowed to 2 %, and there was a slight rise in the core inflation rate (food and energy excluded). Although May producer prices were still lower than a year earlier, prices on a monthly level have risen for three months in a row.

Weaker outlook for European firms operating in China. The European Chamber of Commerce in China last week published its annual survey of member companies in China. The survey, conducted in February and March, drew responses from over 500 European firms operating in China. The firms reported that China's business environment had become increasingly hostile and that firms were more pessimistic about their prospects than earlier. In 2011, nearly 80 % of firms surveyed still expected their businesses in China to grow over the next two years. Last year, that share fell to 58 % and this year it was just 44 %. In addition, firms increasingly report that profit growth has stalled and that only 20 % of surveyed firms expect their profitability to improve over the next two years. Given the degraded outlook, fewer companies are considering expanding their operations in China and more are moving to slash costs.

About 70 % of responding firms said they were in China to serve the domestic market. The largest concern by far for firms remained the slowdown in growth of China's economy. The next biggest worries were rising production costs and slowing growth of the global economy. A large and still growing share of firms feel operationally challenged due to unpredictable regulatory shifts. Nearly 60 % of firms noted that tight Internet controls complicate their business. Notably, firms felt that China's anti-corruption efforts were successful and the share of firms still seeing corruption as a significant problem has become smaller.

European industrial firms also suffer from China's overcapacity problems. The capacity utilisation rates in most industrial branches have fallen and 45 % of the surveyed firms remarked on significant overcapacity problems in their field. The firms felt that market-driven change and a level playing field with Chinese SOEs were the best ways to deal with overcapacity problems.

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