SUOMEN PANKKI FINLANDS BANK EUROSYSTEM

Weekly Review
25 • 23.6.2016

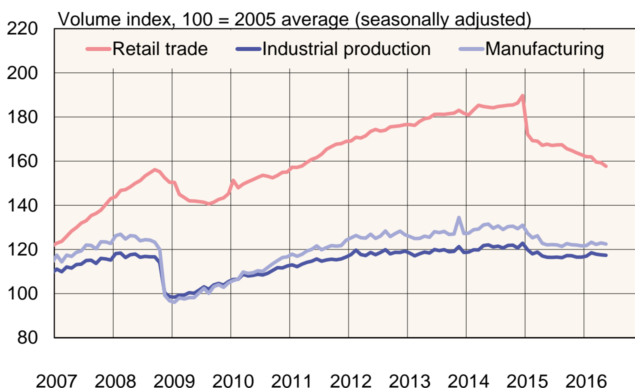
BOFIT

Russia

Russia posts weak economic figures for May. Several short-term economic indicators suggest growth has not yet returned to Russia. While May industrial output was up 0.7 % y-o-y overall and manufacturing 0.3 %, both showed seasonally adjusted contractions from April. Growth of extractive industries continued to slow in May, falling to 1.5 % y-o-y. Construction activity declined more sharply in May than in previous months and was down 9 % y-o-y.

The contraction in retail sales accelerated in May, with the volume of retail sales down 6 % y-o-y. Retail sales declined also in seasonally adjusted terms from April. Retail trade development largely reflects a contraction in real incomes. The average nominal Russian monthly wage in May was 36,600 rubles (€490), an increase of 6 % y-o-y. With inflation outpacing wage growth, real wages fell about 1 % and real disposable income (including pensions and various income transfers) was down nearly 6 %. May unemployment was 5.6 %, the same as the May 2015 figure.

Trends in retail sales, industrial production and manufacturing



Sources: Macrobond, Rosstat, BOFIT.

President Putin hits familiar themes in address to St. Petersburg Economic Forum. Among the priority themes of current economic policy, Putin stressed his vision of the Eurasian Economic Union as the driver of broad-based Eurasian integration. He noted also again the importance of import substitution policy and stated that the modernisation of Russian industry would be accelerated through legally requiring that from 2019 major manufacturers use only best-available technologies that meet the strictest environmental standards.

Most other themes of the speech were drawn from both of the main programmes for growth presented recently (see below). Putin stressed reducing the budget deficit and budget dependency on oil revenues. He set the long-term economic growth target of Russia to 4 % a year. This could be achieved, he noted, through e.g. increased labour productivity and a better business environment. These themes have been reiterated for several years now, indicating Russia's leadership is well aware of the country's economic problems but still lacks practical answers to deal with them. Putin announced that he was establishing a presidential council on strategic development and priority projects to make reforms more effective and seeing that major projects get implemented.

Russia debates course of economic policy. The economic council led by the president is set to prepare over the next year a new economic policy programme for Russia that will extend through 2025. The work began at the end of May when two main expert-drafted proposals on restarting economic growth were presented to the president at the council meeting. While both programmes seek to increase the investment rate, their views on the roles of monetary and fiscal policy in supporting change are diametrically different.

The programme espoused by Alexei Kudrin, former finance minister and current deputy chairman of the economic council, calls for moderate monetary and fiscal policies. Kudrin said that Russia needs a stable macroeconomic environment to attract investment, which would be best achieved by balancing government finances and keeping inflation relatively low and stable. In the current policy framework, the central bank and the finance ministry are closest to this view.

The Stolypin club offered a completely different approach, which has been prepared under the lead of the club's chairman, business ombudsman Boris Titov. In addition, the part concerning monetary policy seems to reflect largely the views of president's advisor Sergei Glazyev. Under the proposal, investment would be supported through increased government spending and pumping central bank money into the economy. The goal of exchange rate policy would be to target a steadily depreciating ruble exchange rate, with limits, if needed, on currency exchange to prevent excessive depreciation. In the current administration, the economy ministry supports looser monetary and fiscal policy, but its views are much more moderate than those of the Stolypin club.

Both programmes are quite unanimous on the needed major structural reforms, despite some differences in emphasis. Both programmes call for improving the business environment, reducing the government's role in the economy, diversifying the production structure and increasing international openness. The import substitution policy currently popular with the leadership receives no support under either proposal.

The president has yet to take an official stance on the proposals and the discussion of the economic policy framework will continue at future council meetings. It has yet to be seen how much of an effect the programmes will have on actual economic policy. Recently, at least, economic policy has been overshadowed by domestic and foreign policy issues, as well as aspirations of economic independence. Policy choices important for re-establishing economic growth have taken a back seat.

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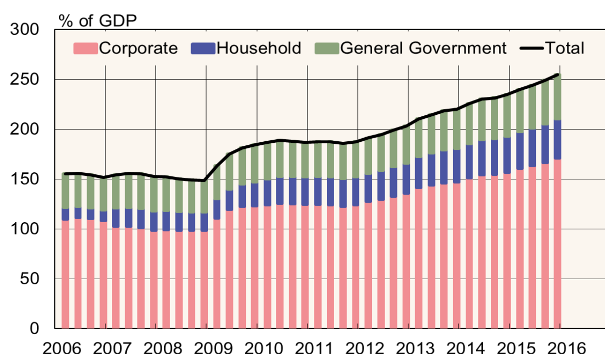
China

Rapid lending growth in China continues. China's own broad credit stock measure, total social financing (TSF), grew 13 % y-o-y in May. Credit growth remained stable throughout the first five months of this year, rising about twice as fast as nominal economic growth. Yuan-denominated bank loans, the largest of TSF's subsets, were up 14 % y-o-y. Lending of the shadow banking sector (trust and entrusted loans) showed high growth. The stock of forex-denominated loans continued to shrink, as yuan weakness and uncertainty over future exchange rate trends reduced borrower interest in new forex loans, and borrowers increasingly paid down debts in foreign currencies.

China adopted the TSF measure in 2011 to capture the rapid growth in non-traditional financing activity (i.e. the use of credit forms other than bank loans). Lately, however, doubt has been cast on the TSF indicator's ability to capture credit creation. Analysts at Goldman Sachs estimated at the beginning of this month that the volume of credit creation last year was about 30 % higher than the TSF figure.

The Bank for International Settlements (BIS) reports that China's total debt at the end of 2015 was equivalent to about 255 % of GDP, a level far higher than is typical for emerging economies. The ratio of corporate debt to GDP was 171 %, public sector debt 44 % and household debt 40 %. Because the state is also an active participant in the corporate sector, it is difficult to differentiate public-sector and corporate debt. The IMF, for example, puts China's public sector debt at around 60 % of GDP. Given the strong rise in borrowing in the first five months of this year, the debt ratio already likely exceeds 260 % of GDP.

China's debt structure



Source: BIS.

Despite years of incessant debt rise, China has made limited progress on tackling the issue. The IMF last week warned that China's government needs to promptly get a handle on already high – and rising – corporate debt to avoid serious problems. The IMF would like to see China move ahead with measures such as stricter budget constraints for state-owned enterprises, restructuring or closing down problem firms and preparing to deal with the ensuing social costs. The experiences of other countries suggest that sustained rapid rises in credit growth are likely to end in financial market meltdowns and severe economic slowdowns or even economic contractions. The good news in China's case is that it may still manage to deal with its debt problems as nearly all debt is denominated in yuan and the state controls large financial buffers that it can deploy to avoid a systemic crisis.

Familiar themes get most play at annual China-US strategic and economic dialogue meeting. At the start of Barack Obama's presidency, China and the United States agreed on extending the ministry-level strategic dialogue of the two countries to include other pressing issues in addition to economic matters. At the latest meeting in Beijing this month, many of the topics discussed were the same as eight years ago. The tone of the final communiqué showed that discussions were between two major global powers.

In principle, the two countries share common views on what China needs to do to strengthen the role of the market in its economy. China confirmed its plans to increase the role of markets in determining the yuan's exchange rate and conceded that production needs to be cut in the steel industry and other industries suffering from overcapacity. This will be helped by China's commitment to ongoing deregulation of energy prices. China will continue to improve the quality of its economic statistical data collection and communication on economic policy. The problems with corporate cybersecurity continued to be on the agenda. Many of the issues mentioned during dialogue have already been addressed or at least noted in China's own programmes or at international meetings, so emphasis was mainly on strengthening reform policies rather than launching new initiatives.

China promised this spring to ease foreign investment to China by introducing a "negative list" that limits or bans outright the access of foreign firms to certain sectors. The Americans suggested that further reduction of the negative list is a threshold issue to finalising the key bilateral investment protection agreement. China last week delivered a whittled-down list, which Reuters reports still contained 35–40 sectors off-limits to foreigners (down from about 80 sectors earlier). Given the relative freedom Chinese firms enjoy in investing in the US, the Americans still feel the list is too long,

The US is about to revisit the issue of whether China finally fulfils the criteria for market-economy status. The common view is, however, that the status will not be granted. The status would make it more difficult to impose anti-dumping duties on Chinese products sold below their producing costs to the US markets. Just last spring, the US imposed, in line with its WTO commitments, very high additional tariffs on certain Chinese steel products. China wants its market status classification conferred automatically at the end of 2016 as it completes its 15th year of WTO membership. The EU Commission will review its assessment of China's market-economy status in July.

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