Weekly Review
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BOFIT

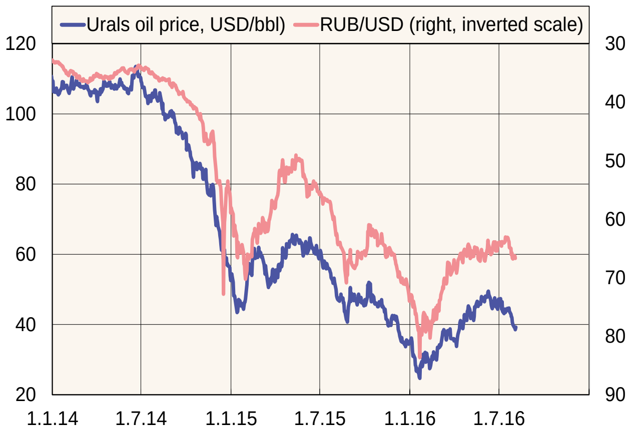
Russia

CBR keeps key rate unchanged. At the regular meeting last Friday (July 29), the board of the Central Bank of Russia decided to keep the key rate unchanged. The 10.5 % key rate has been in place since June 14. The CBR board noted that inflation expectations had not subsided enough to justify further rate cuts. July consumer prices were up 7.2 % y-o-y. The next regular rate review meeting of the CBR is set for September 16.

Oil price down sharply in July, ruble follows. Global crude oil prices hit their peak this year early in June, when the price of Urals-grade crude approached the $50-a-barrel mark. The oil price has since fallen, and in July the decline accelerated. Over the past month, the price of oil fell by more than 15 % and the current price of Urals-grade crude is slightly below $40/bbl. Oil futures suggest the price should rise by around $3/bbl by the end of the year. Urals hit a low this year of about $25/bbl in January.

Changes in the oil price are rapidly reflected in the ruble's external value. When oil prices rose this spring and early summer, the ruble's exchange rate strengthened. When the price of oil fell in July, the ruble shed about 4 % of its value against the US dollar.

Urals oil price and ruble-dollar exchange rate



Source: Reuters

A crucial issue for Russia's public finances is the oil price *in rubles*. As a rule, ruble depreciation cushions the budget impacts of a drop in the dollar price of oil. In recent weeks, however, the crude oil price in rubles has fallen sharply, because ruble depreciation has been less than the drop in oil prices in dollars. At the moment, a barrel of Urals-grade crude oil costs approximately 2,600 rubles. This year's budget assumes an average oil price in 2016 of 3,165 rubles a barrel. At that price, the public sector deficit this year would be about 3 % of GDP.

Russia has yet to see clear upturn in business cycle. Key economic indicators for June and July failed to show a distinct uptick in the Russian economy, even if positive growth is clearly taking hold in certain branches. The economy ministry's figures show total output fell in May by 0.6 % y-o-y and was down another 0.5 % in June. The seasonally-adjusted total economic output indicator was the same in June as in May.

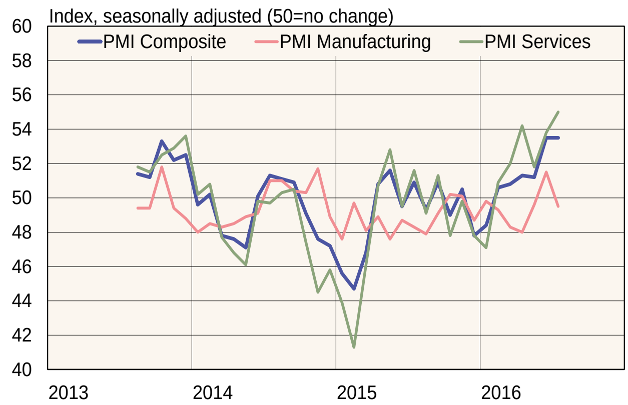
Broken down by core production sectors, in June industrial output rose 1.7 % y-o-y, agriculture 2.1 % and transportation 1.8 %, while the volume of retail sales declined 5.9 % and construction activity fell 9.7 %.

The economy ministry estimates that GDP contracted 0.6 % y-o-y in the second quarter. The CBR offered a slightly smaller figure for GDP shrinkage in the same period. Somewhat disconcerting for the prospects for Russian growth was the CBR's finding that fixed investment continued to contract in the second quarter, falling by over 3 % y-o-y. The CBR's estimate noted ongoing declines in construction activity and production of investment goods. Fixed investment in Russia has fallen since 2013.

Various confidence indices also give conflicting perspectives for Russia's near-term economic trends. The July PMI index reading for manufacturing activity, for example, was 49.5, suggesting a contraction. The June reading was 51.5. While July manufacturing output increased overall slightly, the volume of new orders fell. On the other hand, the services PMI index reading rose to 55, its highest level in over three years. The volume of new orders for services increased substantially.

Rosstat also makes a quarterly survey of consumer confidence. Its consumer confidence reading for the second quarter was −26, a slight improvement from −30 in the first quarter. Consumer confidence, however, was weaker than in Q2 last year and well below the long-term average.

Russia's Purchasing Managers' Indices (PMIs)



Sources: Markit, Macrobond

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China

Chinese decision-makers struggle with conflicting policy goals. Reaching an official 6.5 % growth target, slowing the rising tide of indebtedness and moving forward with structural reforms needed for sustainable growth are part of an economic policy package that is hardly possible to carry out without a compromise on some of targets. The difficulties were apparent at last month's meeting of the Communist Party Politburo, as top decision-makers debated over the economic outlook and policy challenges for the rest of the year. The official statement mentioned pressures for lower growth and raised demands on more proactive fiscal policies, as well the need for "prudent" monetary policy to sustain the current pace of economic growth. The release also stressed accurate targeting of credit to assure development of the real economy. Prominent mention went to problems arising from industrial overcapacity and debt, implying serious reform of large state-owned enterprises is needed. The politburo sees the current strong trend to urbanisation of China's population as a partial solution to existing problems. The leaders at the meeting defended the need for a stable yuan exchange rate and noted the need to prevent financial market bubbles. To dampen rising costs, China's leaders expressed willingness to lower taxes and allow greater labour market flexibility.

The general phrasing of meeting findings and lack of distinct economic policy priorities and clarity of action suggest that China's leaders themselves are not unanimous on how to proceed. Differences over the economic policy framework emerged in May, when a member of China's senior leadership anonymously criticised debt-financed stimulus and failure at implementing needed reforms. Differences over policy were subsequently seen, for example, in last month's statement by a People's Bank of China representative calling for stimulus through fiscal policy rather than monetary policy. This week the influential National Development and Reform Commission (NDRC) demanded additional monetary stimulus through lower interest rates and bank reserve requirements in order to halt the current slowdown in investment.

Some observers, however, believe the politburo meeting has improved the position of decision-makers who question debt-financed stimulus measures and push the reform agenda. There is also a sense, however, that tough reforms of state-owned enterprises, which could impede short-term economic growth, are unlikely to be implemented before the 19th National Communist Party Congress in autumn 2017, when major personnel changes will occur.

China's economic conditions have remained stable this summer. According to the Purchasing Managers' Indices (PMI), problems in heavy industry worsened in July, while small firms saw distinct improvements in their activity. Both the official PMI index and the private Caixin/Markit PMI registered service-sector growth in July.

Revised GDP methodology helps only little with China's 2020 growth target. In 2012, president Hu Jintao declared that by 2020 Chinese GDP and per capita incomes would be double that of 2010. These goals still seem unrealistic and even unwise from the standpoint of sustainable economic policy. With the change in GDP calculation methodology at the start of July, these goals are not much closer. Annual real GDP growth in 2016–2020 still needs to be on average around 6.5 % to push real GDP across the "doubling" finish line in 2020. The doubling of per capita income also requires continued rapid growth.

The notion of setting growth targets is a legacy from command economy times. As China's economy has embraced market elements, the wisdom of pursuing numeric growth targets has become questionable. Strict adherence to growth targets and linking them to career advancement in high posts leads to perverse incentives that drive inefficient expansion plans and waste national resources, which in turn creates economic imbalances and other problems.

China's bond markets show strong growth. Chinese bond markets this year have grown at about 30 % y-o-y. Since the rules on bond-issuing have been loosened, local governments have been particularly keen to issue bonds. China's bond market is valued at around $8 trillion, making it the world's third largest after the United States and Japan. The stock of issued bonds can be divided roughly into three categories of the same size: bonds of financial institutions, corporate bonds and government (state and local) bonds. With a few exceptions, all bonds issued in mainland China are denominated in yuan. Media reports indicate that when the yuan is incorporated into the IMF's SDR currency basket this autumn, several other institutions (including the World Bank) plan to issue SDR-denominated bonds in China.

While there is still relatively little foreign investment in China's markets, foreign investment has increased significantly this year for three main reasons: China has relaxed its regulations on foreign investment, yields are quite low in developed economies and investors have moved their biggest concerns over Chinese economic growth to the back burner.

As growth of the Chinese economy slows and economic structures evolve, an increasing number of Chinese firms are expected to face difficulties servicing their bond debt. This year, at least 17 firms have defaulted on either interest or principal payments. The number of defaulting firms is nearly as high as for all of 2015 and the defaults include multi-billion-yuan bond issues. Heavily indebted firms involved in overcapacity branches such as steelmaking and shipbuilding seem to be in the worst shape. Programmes to convert bond debt into company shares have generally been met with low enthusiasm in the bondholder community.