Weekly Review
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BOFIT

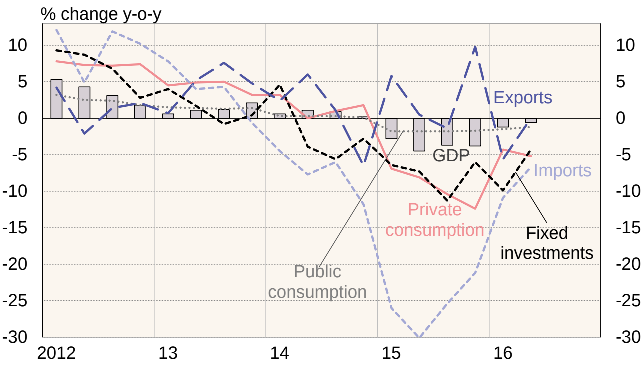
Russia

Still waiting for Russia's economic recovery. The latest Rosstat figures on GDP demand components and imports show that the volume of Russian exports of goods and services recovered from a first-quarter slump in the second quarter, with exports rising to a level on par with 2Q15. The decline in imports of goods and services also began to level off, with the volume of imports down less than 7 % y-o-y in 2Q16 compared to nearly 9 % for the first half overall.

The foundations for economic recovery look still rather shaky, with private consumption decline deepening to 5 % y-o-y in 2Q16. The drop in fixed investment slowed considerably, however, but was still over 4 % y-o-y. As in 1Q16, decline of the overall GDP was in 2Q16 cushioned by the considerably milder inventory adjustment than a year earlier.

CBR preliminary estimates for the third quarter indicate the economy's 3Q performance was much like in the first half. Consumption and investment on-year were down a few per cent, but GDP overall was down just about 0.5 % y-o-y thanks to stabilising inventories and bumper harvest. The CBR estimates that seasonally adjusted GDP remained largely unchanged from the second quarter.

Change in Russia's real GDP, imports and demand components



Source: Rosstat.

CBR announced organisational changes to improve banking supervision. In recent years, the Central Bank of Russia has worked determinedly to clean up the banking sector from financial institutions that fail to comply with legal requirements. At the beginning of this week, CBR governor Elvira Nabiullina announced that solving the problems accumulated in Russian banking sector requires a profound rearrangement of banking supervision. Some board members currently responsible for banking supervision will shift to new duties, while first deputy governor Dmitri Tulin, who earlier was responsible for conducting monetary policy, will be in charge of banking regulation and supervision. Monetary policy is now directly under Nabiullina's purview.

The process of culling bad banks over the past three years has resulted in roughly 280 financial organizations losing their licences. Some of them were merged with other banks, some restructured and others declared insolvent and wound down. Most of the culled banks have been tiny, but some mid-sized banks have also run into trouble recently.

With a rising backlog of sick banks to deal with, criticism has turned to the agency charged with resolving bank insolvencies, the Deposit Insurance Agency (DIA). As of June 2016, the DIA had 271 insolvency cases still open. Insolvency processes take a long time and case processing has slowed lately. In the first half of 2016, the DIA only managed to finalize the insolvency process for eleven banks. Not only are DIA claim costs up as the condition of sick banks entering receivership is worse than earlier, but Russia's complex banking insolvency rules and lengthy procedural requirements invite abuse. To make resolution procedures more effective, the CBR has proposed that it would directly oversee resolution of failed banks, but the proposal has received a reserved reception from the DIA and the economy ministry.

Most insolvent banks are covered by the deposit insurance scheme, which guarantees each depositor 100 % coverage on deposits up to 1.4 million rubles (€20,000) for each bank where the depositor has accounts. In 1H16, DIA coverage extended to deposits of 44 banks (218 billion rubles). In 2015, the insurance scheme covered 77 banks and about 435 billion ruble in deposits.

At the beginning of September, Russia had 659 operating banks, the lion's share of which were still extremely small. The fifty largest bank held nearly 90 % of total banking sector assets at the beginning of September. State-controlled banks held over half of total assets.

Firms with foreign ownership cutting back operations in Russia. Large and mid-sized firms with at least some share of foreign ownership reduced their personnel more than other firms over the past year-and-a-half by a few per cent to the 2011 level. Firms with foreign participation employ about 5 % of the Russian workforce, and nearly 15 % of workers in manufacturing industries.

The turnover of large and medium-sized firms with foreign ownership have fallen in real terms for several years. Nominal growth in sales has been lower than for purely domestic firms, with their share of total corporate sales falling to just over 20 %. When small firms are included, the 2015 share rises to over 35 %, and to 45 % in manufacturing. Some 35–40 % of the turnover of firms with foreign participation comes from the retail and wholesale trade, and a third from manufacturing, which have a high ratio of sales per worker.

Firms with foreign participation have accounted for 14 % of Russia's total fixed investment in recent years. In the manufacturing sector, they account for 28 % of investment and in the trade sector for about a quarter. Majority foreign-owned firms accounted for over 7 % of the country's total fixed investment. These firms have cut back sharply on investment since the 2011–12 boom.

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China

Yuan becomes part of IMF's SDR currency basket. The addition of the yuan to the IMF's Special Drawing Rights (SDR) currency basket last Saturday (Oct. 1) went smoothly and generated little market reaction this week. The IMF announced its decision to make the yuan an SDR currency in November 2015. Addition to the currency basket is a largely symbolic recognition of the opening up of China's financial markets to the world and increased international yuan acceptance. In China's domestic policy, SDR status has helped in the push for key domestic financial market reforms. The yuan has an 11 % weighting in the revised currency basket, which is significantly more than the yuan's current use in international payments. The yuan plays an important role in Asia, however. SWIFT figures show the yuan is used in 45 % of international payments in Asia and the Pacific region that involve China (includes Hong Kong). In Europe, the share of yuan in China transactions already exceeds 30 %, while in Americas it is still less than 5 %.

The SDR is the IMF's reserve asset and accounting unit, which value is based on a basket of currencies. The SDR is used in lending of the IMF and a small part of member state currency reserves is in SDRs. The interest rate charged on IMF loans and SDR deposits are based on average national interest rates of SDR currencies.

Economy size, use in cross-border payments and weight in SDR basket, %

	Share of global economy (2015 market prices)	Share in international payments (August 2016)	Weighting in SDR basket
US	24.5	42.5	41.7
Eurozone	15.8	30.2	30.9
China	15.0	1.9	10.9
Japan	5.6	3.4	8.3
UK	3.9	7.5	8.1
Total	64.8	85.5	100

Sources: IMF and SWIFT.

China's soaring housing prices again causing concern. Just over a year ago, average apartment prices in China began to climb again. The rate of climb has been increasing ever since. The real estate portal SouFun, which tracks housing prices in nearly 100 Chinese cities, found that the average price of one square meter of liveable floorspace surpassed 12,600 yuan (€1,700) in September, a 17 % increase from September 2015. Price rises were largest in China's main metropolises. September prices were up 19 % y-o-y in Beijing, 27 % in Shanghai and 42 % in Shenzhen. SouFun's sampling found average apartment prices fell in only 17 cities, suggesting that the recent price rise is exceptionally broad-based.

Following a brief pickup in spring, the rate of housing construction has subsided. In August 2016, new housing starts were up less than 4 % y-o-y. In spring 2015, new starts were up 20–25 % y-o-y. The pace of building growth could remain moderate in the future as purchases of building rights on lots has fallen sharply since the building boom peaked a couple years ago. In July-August, the volume of lots purchased by companies were down by about 20 % y-o-y.

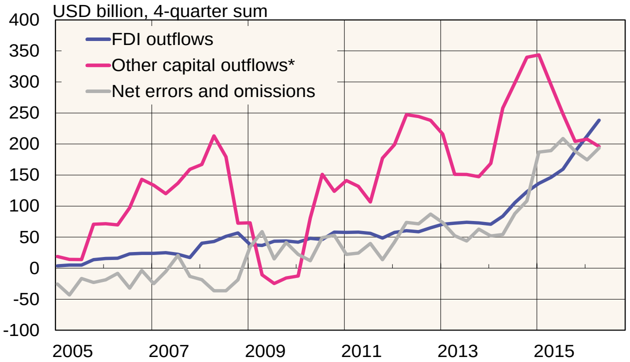
From the economic policy perspective, the housing market situation is problematic. Some of loans intended to stimulate economic output have gone instead to housing investment, further fuelling the rise in housing prices. A housing bubble, in turn, makes it more difficult to deal with the debt problem. Local governments have tried to deal with the price rise by tightening city-specific rules on apartment purchases and loan conditions, as well as encouraging real estate developers to move ahead with new construction projects. At the moment, these measures have had little effect and the situation continues to degrade.

Capital outflows from China strengthen. Balance-of-payments data for the first half of 2016 show capital outflows from China amounted to $236 billion, while capital inflows were just $64 billion. Thus, the financial account deficit (changes in currency reserves not included) was $172 billion. In contrast, the current account still showed a strong surplus, but the PBoC, especially in January, still had to sell currency from its reserves to calm forex market worries about yuan devaluation.

In the first half, about half of capital outflows from China were direct investment or comparable capital flows (e.g. intragroup corporate financial arrangements). Chinese also actively lent to borrowers abroad and increased other receivables from abroad. The net errors and omissions term in the balance-of-payments figures, which indicates unreported cross-border money transfers, suggests heavy capital outflows.

The increase in capital outflows from China reflects several factors. The lift of capital controls is China has allowed capital flows to increase. Measures to increase international use of the yuan through the creation of offshore trading centres have supported these outflows. In addition, the slowdown in economic growth and increased risk have made investment abroad more attractive to Chinese investors.

Capital outflows from China



*) Portfolio investments, derivatives, deposits, loans, trade credits and other recievables.

Sources: Macrobond and BOFIT.

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