Weekly Review
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Russia

Few surprises in Putin's state-of-the-nation address. President Putin delivered his annual state-of-the-nation address last week at the Kremlin to a packed audience of Duma deputies, Federation Council members and invited guests. Breaking from recent years, the Russian president focused on domestic policy. Education, health care and preconditions for economic growth were some of the main themes.

In discussing the economy, Putin noted that domestic, not external, factors were largely responsible for restraining growth. He said Russia must resolve at least some of its structural issues or economic growth may remain sluggish for years to come. Among the specific challenges mentioned were harmonisation of inconsistent regional legislation, improving the effectiveness of regulators and continuing the fight against corruption. He also stressed the importance of having a healthy, well-supervised banking sector to assure financial intermediation and financing of investment in Russia. The address ended with a hat-tip to Russia's new science and technology strategy, which involves support for young scientists and a digital leap forward for the Russian economy.

Putin offered no new initiatives and no concrete proposals in dealing with long-acknowledged economic problems highlighted in his annual address.

Gas sector drives growth in fixed investment. Newly released Rosstat figures show a small recovery in seasonally adjusted fixed investment happened earlier than what the figures showed in late summer. The fresh figures suggest fixed investment returned to growth in the first half of this year. Fixed investment was up 0.3 % y-o-y in the third quarter.

Rosstat estimates that fixed investment of small firms and those operating in the grey economy continued to experience an unusually strong reduction in investment that began last year. In contrast, other fixed investment, which is mainly investment by large and mid-sized firms, experienced modest growth.

However, increase in fixed investment rests on a very narrow basis. In fact, all growth of total investment came from investment in producing and shipping liquefied natural gas (LNG) – an area where investment has multiplied this year. Observers note that this burst basically reflects massive investment on the Yamal gas production peninsula.

Fixed investment declined from last year for all other branches when taken together. Investment in oil production contracted significantly, and the steep decline in investment in the electricity sector and pipeline transmission capacity continued. In the manufacturing sector (excluding oil refining), fixed investment continued to slide, even if the drop was less steep than last year. The biggest drops in manufacturing investment were in the machinery, equipment and transport vehicles category. Investment in the chemicals industry continued to rise. The metallurgy branch returned to growth after three years of contraction.

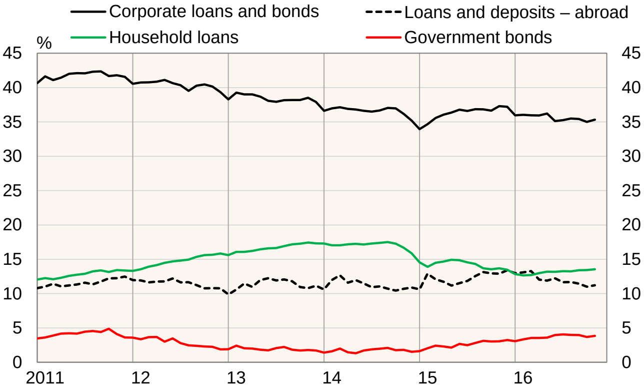
Growth of Russia's banking sector has stalled. Household deposits held by banks increased at a brisk pace last year and the early months of 2016. More recently, however, the stream of household deposits to banks has subsided. A more striking change has been the unusually rapid draining of corporate bank accounts over the past six months. As a result, growth of banking sector total assets this year has come to an exceptional standstill. In addition, the value of forex-denominated items converted to rubles and thereby the balance sheet total in rubles has shrunk considerably with the ruble's appreciation.

The growth in receivables on the banking sector balance sheet has been limited by weakness of lending, especially corporate lending. The stock of domestic corporate loans granted by banks has shrunk considerably this year. Part of this is due to ruble appreciation, but another equally large reason is that the corporate sector has paid down bank loans faster than it has taken new loans. The drop in corporate borrowing from banks has been slightly offset by banks increasingly acquiring corporate bonds. In contrast, borrowing of Russian households has recovered a bit this year, even if households have been cautious about new borrowing compared to the pre-recession period from 2011 to 2014.

The modest borrowing of the private sector has created an opportunity at least for the time being for the government to fund part of the federal budget deficit through the sale of bonds to domestic banks. If private borrowing does not recover significantly, the state should have no great difficulty in increasing domestic borrowing under the budget deficit financing plan as presented.

Bank receivables from companies based abroad, as well as from non-resident banks and foreign governments have declined this year. In addition to ruble appreciation, banks in Russia have reduced their deposits in foreign banks.

Share of main balance sheet receivables in total assets of Russia's banking sector



Source: Bank of Russia.

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China

China tightens capital controls to reduce depreciation pressure on yuan. China has recently tightened considerably its capital controls. At the start of this month, the State Administration of Foreign Exchange (SAFE), which operates under the People's Bank of China, announced that any transaction exceeding $5 million must be declared to its vetting. The previous limit was $50 million. The chambers of commerce in China of the United States and the EU reacted quickly, noting that the new rule imposes a burden on foreign businesses operating in China. European firms said this week that they have recently been unable to repatriate dividends from China. Dividends are included in the current account, and under China's international commitments, it should not restrict them.

China has also clamped down on oversight of capital movements to and from the Shanghai Free-Trade Zone, as well as tightened the rules on purchasing gold from abroad. Moreover, Reuters reports that corporate lending from China in yuan to foreign units must be reported to SAFE, which has imposed a ceiling on such lending based on the size of the firm. Thus, firms will no longer be able to transfer yuan abroad and then convert the money to other currencies. Media reports that additional measures are planned. More measures are expected to be introduced in coming months. The State Council, for example, is discussing a requirement that all "extra-large" investments abroad, i.e. exceeding $10 billion, will require top-level approval. Property investments of more than $1 billion by SOEs and direct investment projects outside the firm's core business will also be scrutinised.

Officials have shown increasing willingness to go after attempts to circumvent capital controls when they suspect illegal activities are involved. For example, several illegal banks operating mostly in southern China were recently raided. Officials claim that the banks arranged unreported cross-border transfers worth tens of billions of dollars.

The tightened restrictions are designed to reduce capital flows out of China and diminish depreciation pressure on the yuan. The yuan's exchange rate has weakened 3 % against the dollar since the end of September, but has strengthened nearly 1 % against the euro over the same period. China's foreign currency reserves fell by $114 billion during October and November.

It is difficult to predict the impact of the new measures. Starting next month, private persons will be subject to a reset $50,000 annual forex quota. This might temporarily raise forex demand. Overall, at this stage of China's development, it is difficult to use direct restrictions to stem capital outflows. Even if capital controls would temporarily reduce depreciation pressure on the yuan, they are at odds with China's strategy of opening its markets to the world and promoting the yuan's use in international trade. In the final analysis, these factors determine China's economic success.

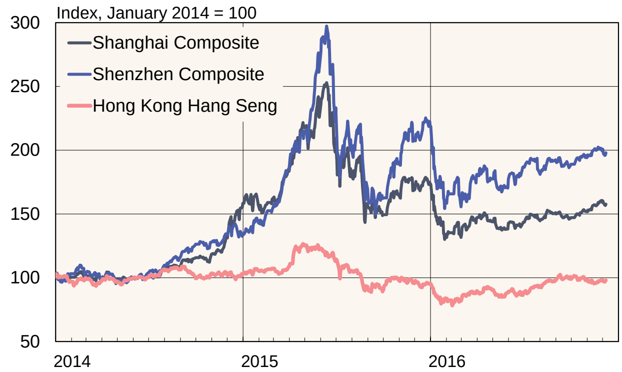
Foreign investors gain new trading link to Shenzhen exchange. The gradual opening of China's stock exchanges to the world continues, even with new restrictions on capital movements. The long-awaited Shenzhen-Hong Kong Stock Connect trading link launched operations on Monday (Dec. 5), giving foreign investors the ability to invest via Hong Kong in 678 firms on the Shenzhen exchange's main and SME boards. Brokers and institutional investors can also now invest in 203 firms on the tech-heavy ChiNext board. Many of the 1,850 firms listed on the Shenzhen exchange are "high growth." The average P/E ratio for Shenzhen-listed firms is 44, compared to 16 for firms on the Shanghai exchange.

Large mainland Chinese investors (investments over 500,000 yuan, approx. €70,000) have access to shares of 417 companies traded on the Hong Kong stock exchange. The amount includes shares of about 100 new (mostly small) firms, while the rest are the same as in the Shanghai-Hong Kong Stock Connect link, which opened two years ago. As with the Shanghai link, the net daily quota for foreign investors (buying minus selling) is 13 billion yuan (€2 billion). The daily quota for mainland Chinese investing in Hong Kong via the Shenzhen exchange is 10.5 billion yuan.

The first day's trading after the launch of Stock Connect was subdued. The average daily trading volume of foreign investors on the Shenzhen exchange was around 2.2 billion yuan (1 % of the exchange's daily turnover). Investors from mainland China on average bought shares worth nearly 600 million yuan in Hong Kong. The Shanghai-Hong Kong Stock Connect link accounts for about 1 % of the Shanghai exchange's daily turnover and 3 % of Hong Kong's turnover.

Stock markets in mainland China have picked up since the doldrums of summer. The main indexes of the Shanghai and Shenzhen exchanges are up 8 % from the end of July. Shares of companies listed in mainland China are still on average over 20 % more expensive than the same shares listed in Hong Kong, but the price gap has narrowed. The new Stock Connect link is not expected to significantly reduce the price difference as share prices on the mainland China and Hong Kong exchanges are affected by different factors. In addition, intraday trading and short sales via Stock Connect are impractical, reducing opportunities for arbitrage.

Main indexes: Shanghai, Shenzhen and Hong Kong exchanges



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