Weekly Review
6 • 10.2.2017

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# Russia

**Official figures indicate Russian economy contracted only mildly in 2016.** Defying forecasts and various earlier estimates by others based on output data, Rosstat reported its first calculations that Russian GDP contracted just 0.25 % last year. Earlier figures suggested that in the first three quarters the GDP fell by 0.7 % y-o-y. The fresh annual data suggest those quarterly figures will likely change to less negative. Moreover, the rate of the 2015 GDP contraction became smaller again, scoring less than reported at end-December, and was now -2.8 %.

The supply-side items that kept the 2016 GDP drop mild included manufacturing, the real estate sector and agriculture, which showed fair increases in their value added to the GDP. The volume of Russian goods and services imports fell by 5 %, and was 35 % smaller than in the peak year of 2013.

As for demand-side items, private consumption fell 5 % in 2016, while revised estimates for 2015 show a decline of nearly 10 %, a larger drop than reported in last December's revision. Public consumption shrank just slightly last year. Fixed investment fell only about 1.5 % last year, but the revised 2015 drop was again clearly deeper (-9.5 %) than shown by earlier figures. The volume of Russian goods and services exports, which grew briskly already in 2015, increased by a couple of per cent last year. Inventories turned from a fall to rise, further braking the slide in GDP tangibly.

The re-revision of the 2015 GDP decline within a short period has raised comments about possible impacts of changes in Rosstat's statistical methodology. Rosstat recalled that the revisions are not due to change of methodology which was applied already earlier, starting from 2014 data published in December 2015. Rosstat noted the revisions of 2015 GDP reflect better data on operations of small and medium-sized firms and additional information on the government sector. In the normal course, the fifth round of publishing GDP 2015 data is planned to take place at the end of 2017.

**CBR holds key rate unchanged; policy outlook slightly adjusted.** At its regular meeting, the board of the Central Bank of Russia last Friday (Feb. 3) decided to keep the key rate at 10 %, the level it has been at since last September. The CBR said that disinflation was in line with its forecast, with a gradual decrease in inflation expectations and a more-rapid-than-expected economic recovery. At the end of January, 12-month inflation had fallen to 5.0 %. The CBR said the slowdown in inflation was due in part to transient factors (last year's record harvest and the ruble's exchange rate). The CBR expects inflation to slow to its target rate of 4 % p.a. by the end of this year.

The CBR said that the daily forex purchases made for the finance ministry ([BOFIT Weekly 2017/5]) do not represent considerable inflation risks, given that monetary policy will remain moderately tight. It also mentioned other risks to meeting the inflation target, including the possibility that inflation expectations remain high or the household savings rate decreases.

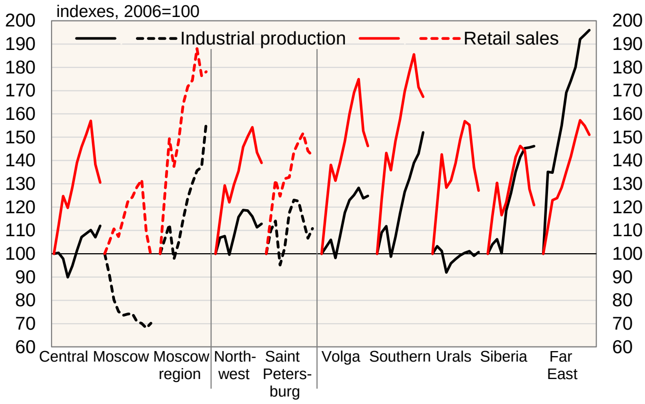
The CBR slightly adjusted its outlook for lowering the key rate. A rate cut had earlier been envisioned for the first half of 2017 if inflation fell as expected. Now the CBR said that internal and external developments have reduced its capability to cut the key rate in the first half of this year. The key rate is notably positive now in real terms. The next regular CBR board meeting is scheduled for March 24.

**Industry recovers in Russia's federal districts, while retail sales continue to contract.** Industrial output increased in 2016 in all of Russia's federal districts (FD), which encompass numerous regions, and in greater Moscow, which includes the city and the surrounding Moscow region, as well as St. Petersburg. Growth was only 0.5–1.5 % in the Northwest, Volga and the three FDs east of the Urals, but over 6 % in the greater Moscow region and in the south.

In contrast, the volume of retail sales continued to fall last year in all FDs. While the drop was no longer deeper than a couple of per cent in the Northwest, Volga and the south, it was 6–7 % in the Central and Urals FDs. In 2015–16, retail sales dropped 16–18 % quite widely, i.e. in the greater Moscow region and elsewhere in the Central FD, as well as in the Volga, Urals and Siberian FDs. Retail sales in St. Petersburg fell about 6 % during the two years.

Over the past decade, industrial output and retail sales have grown at very different rates in different parts of Russia (chart). The sharpest increases in retail sales were in the south, and in the Volga and Far East FDs. Greater Moscow still dominates, however, accounting last year for well over 20 % of all retail sales in Russia. Industrial output has risen fast in the Far East and Siberia due to extractive industries, and in the south due mainly to manufacturing. Industrial growth has been slow in the Central and Northwest FDs, and non-existent in the Urals, where growth has been constrained by high dependence on declining oil & gas production.

**Development of real industrial output and retail sales in federal districts and Russia's two largest urban areas, 2007–2016**




*Source: Rosstat.*

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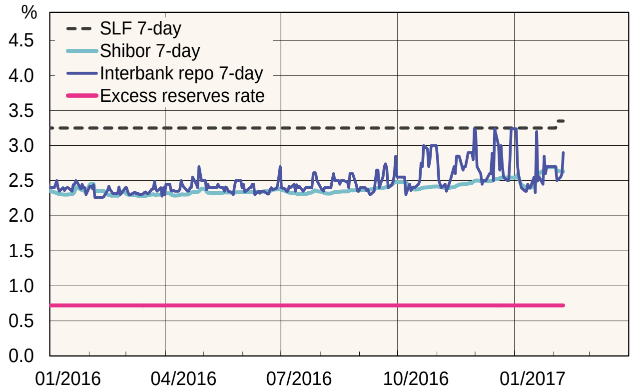
# China

**PBoC tightens monetary stance; policy toolbox needs clarity**. With the reopening of China's financial markets after the Chinese New Year Holiday, the People's Bank of China applied slightly higher interest rates than before the holiday for its open-market operations and for its short-term lending facilities. The main open-market operations tool for the PBoC currently is reverse repos, where the central bank loans money to commercial banks against collateral for certain maturities. The reverse repo rate was increased by 10 basis points so that last Friday (Feb. 3) the 7-day lending rate stood at 2.35 %. The central bank also supplies short-term lending to commercial banks through standing lending facility (SLF), which saw rates raised by 1o–35 basis points. The PBoC earlier this year raised rates on credit provided to banks under its medium-term lending facility (MLF).

**Money market rates and proposed interest rate band**




*Sources: CEIC, Macrobond, BOFIT.*

While the rate hikes are quite modest, they signal the readiness of the PBoC to tighten monetary stance and that the PBoC has the blessing of the country's top leadership to do it. On the monetary policy front, the challenge is still balancing rising indebtedness and the outflow of capital against the supporting economic growth and providing life support to struggling state-owned enterprises through cheap loans.

Besides the tightening of the monetary policy stance, China's monetary policy is undergoing a huge systemic overhaul, whereby administrative regulation will be gradually phased out in favour of market-driven policies. The interest rates that commercial banks set for their customers were deregulated in October 2015, after which central bank's lending rates and open market operations have taken a higher profile in implementing policy. China, however, has never announced an official guidance rate and monetary policy has involved a wide selection of instruments. Apparently, the central bank is introducing an interest-rate band, with SLF rate acting as the upper boundary of the band. The natural lower boundary would be the interest rate that the PBoC pays on deposits in excess of the reserve requirement. The central bank claims it uses MLF rates to guide longer-term interest rates. The problem with such an arrangement is that the SLF and MLF rates are only published after loan deals are completed, so the actual interest rate at a given moment is not necessarily public knowledge. Communication of the policy would also be much easier if the PBoC would pick one money market interest rate as its target rate.

The sheer number of targets are a burden on monetary policy in China. The PBoC still steers exchange rates and uses monetary policy tools for fiscal policy purposes. For example, the PBoC offers cheap financing to projects favoured by the state. Pledged supplementary lending (PSL), and to some extent MFL instruments, are used for these purposes. Reserve requirements are also lowest for banks that support preferred projects and sectors. The IMF would like to see Chinese monetary policy focused more on inflation targeting, paving the way for a fully floating exchange-rate regime for the yuan.

**China's currency reserves fall below USD 3 trillion.** At the end of January, China's foreign currency and gold reserves stood at $2.998 trillion, or about $1 trillion less than at the summer 2014 peak. The contraction in the forex reserves shows that China's foreign trade surplus is not sufficient to cover its net outflow of capital.

Depreciation expectations on the yuan currently drive the increased outflow of capital from China. To influence expectations, China's central bank has sold currency in the forex markets to quell yuan depreciation. The PBoC has also sought to stem the outflow of capital through stricter capital controls, while making it easier to invest in China.

The value of China's reserves fell by $12 billion in January, which was considerably less than the $50-billion-per-month average of October to December. While tighter regulation and heavy-handed intervention in currency markets seem to have achieved their objectives for the time being, they represent a set-back for Chinese reforms and do nothing to solve fundamental issues related to the current situation.

**Consensus growth forecasts adopt China's growth targets.** China's gross domestic product rose 6.7 % in real terms last year. The latest IMF and World Bank forecasts now expect Chinese GDP to rise 6.5 % this year. The OECD foresees 6.4 % growth. All three forecasters see growth in 2018 slowing to around 6 % p.a. Moreover, most of the other major forecasters expect China's economic growth this year and next to be somewhere in the range of 6.0–6.5 %.

The IMF last month raised its growth forecast for China this year, because it expects China's current stimulus policy to support growth more than originally thought. The World Bank also noted stimulus-led growth in its January forecast, as well as the OECD in its forecast last autumn. International institutions are concerned about debt-fuelled stimulus policies that add to China's debt and help keep old, inefficient structures in place.

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