Weekly Review
10 • 10.3.2017

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Russia

Despite stable oil prices, the ruble strengthens and Russia's stock markets fall. In recent years, the ruble's exchange rate and Russian stock market prices have closely tracked trends in oil prices. The oil price to a large extent defines the value of Russian exports, and the weight of oil & gas companies in Moscow stock index is over half. This year, however, the ruble has appreciated and share prices fallen even as the price of a barrel of Urals crude has remained relatively stable at around the $53 level.

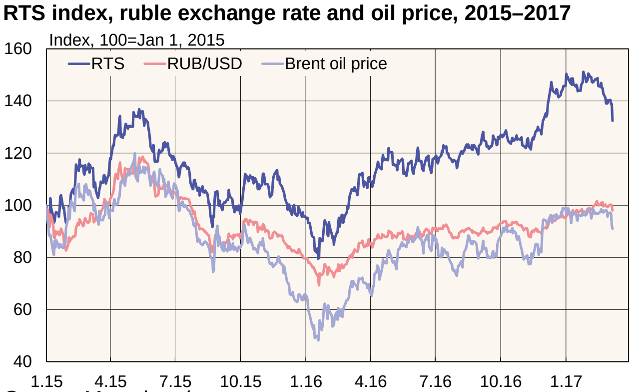
Many analysts have been surprised by the ruble's gains of around 5 % against the dollar and the euro since the start of the year. The finance ministry's decision to start buying foreign currency was expected to slightly *lower* the ruble's external value, but the volume of purchases has been quite modest. Currency-buying in February amounted to around $2 billion and the amount announced for this month is $1.2 billion.

Many market analysts view the ruble's recent strengthening to stem from "carry trade" investing that takes advantage of Russia's relatively high interest rate level. The Central Bank of Russia's research department, however, notes that the ruble's attractiveness as a carry trade currency is reduced by its higher volatility. It sees the recent appreciation instead as a reflection of seasonal fluctuations in the current account, capital flows related to the December sale of the Rosneft stake and a general increase in interest among international investors in emerging markets.

The ruble's appreciation has been slightly stronger in real terms due to Russia's higher inflation rate relative to its main trading partners. Moreover, compared to its lows in the first months of 2016, the ruble has recovered considerably. The ruble's nominal effective (trade-weighted) exchange rate (NEER) in February was up 36 % y-o-y. The real effective exchange rate (REER) was up 38 %.

The Moscow exchange's dollar-denominated RTS index is down about 9 % this year. Among reasons mentioned for the decline are the rapid rise in share prices last year (up nearly 30 %) and the disappointment of some investors from overly optimistic expectations of an early lifting of US sanctions.

RTS index, ruble exchange rate and oil price, 2015–2017



Source: Macrobond.

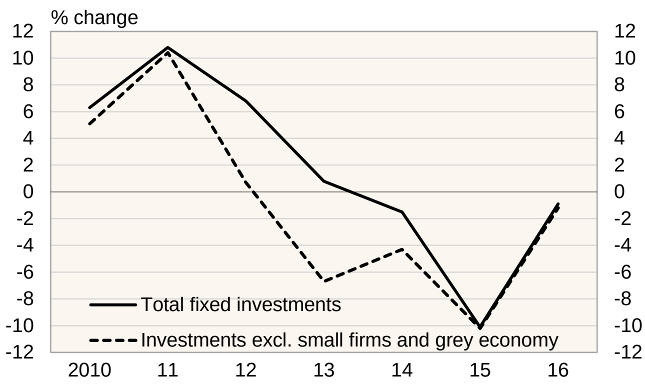
Fixed investment by Russia's large and mid-sized firms still in low territory. Rosstat reports that the recovery in seasonally adjusted total fixed investment continued in the fourth quarter of 2016. As for the year in its entirety, 4Q16 investment was down about 1 % from 2015. The slide was notably less than Rosstat's earlier figures suggested for the previous quarters of 2016. However, last year fixed investment was down by 11 % from 2014, because Rosstat's revised figures deepened the drop in investment in 2015.

About a quarter of total investment comes from small firms and the grey economy. Rosstat figures mean that such investment remained at about the same level in 2016 as in the previous year. During the current recession, these investments only contracted in 2015, when they fell several per cent. Other fixed investments, which are mostly investments of large and mid-sized companies, shrank by about 1 % last year. However, the slide in such investments in the previous three years was steep (down 10 % in 2015 alone), so their level last year was several per cent below that of the 2009 recession.

Investments of large and mid-sized companies saw a strong increase last year in investment in oil & gas production. It was the third year in a row of investment growth in that sector. Last year's growth, however, came from an investment boom in the LNG sector. The decline in investment in oil refining was still really sharp for the second year in a row, and other manufacturing investment continued to fall quite steeply. Investment in the electricity sector and the energy pipeline transmission branch also continued to decline.

After contracting for two consecutive years, investments in machinery & equipment by large and mid-sized companies remained more or less flat last year. Construction activity was down over 4 % last year, thus falling for the third year in a row. Notably, despite a drop already in 2015, far fewer commercial and industrial buildings were completed last year than in 2015. Fewer apartment buildings were also completed last year compared to 2015. It was the first drop in housing completion since 2010.

Real fixed investment developments in Russia, 2010–2016



Source: Rosstat.

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China

China yet to abandon strict GDP growth target. In his address on Sunday (Mar. 5) to the opening session of the annual National People's Congress, premier Li Keqiang presented a passel of numeric targets to provide guidance for this year's economic development plans. The 2017 GDP growth target was set at "around 6.5 % or higher if possible." Last year GDP target was a range of 6.5–7 % and realised growth was 6.7 %. The leadership's current focus on rigid numerical growth targets limits its ability to proportion economic policy appropriately and focus on pressing issues.

Despite the structural change and needed economic reforms, the government aims to sustain high growth through boosting domestic consumption and fixed investment. However, Li's speech emphasised the need to keep financial market risks in check. One aspect of maintaining stability is to rein in the rapidly rising indebtedness of state-owned firms through such measures as closing unviable "zombie" firms. This year's goals include increased energy efficiency and improved environmental protection, greater emphasis on innovation and reducing production capacity especially in the coal and steel industries. The themes are familiar from previous years, even if many partial reforms e.g. in the corporate sector have failed to reach their intended targets. The government this year wants to create 11 million new jobs in urban areas, while keeping the pace of income growth in line with economic growth. The economy created 13 million new jobs last year.

China's monetary policy is constrained by the rapid rise in debt levels and, among other things, the anticipated interest rate hikes in the US. The monetary policy targets were set a little bit tighter than last year. The money supply (M2) and total social financing (TSF) are targeted to increase 12 % this year, a percentage point less than last year. The growth target, however, is significantly higher than nominal GDP growth, which suggest that the growth in indebtedness will continue. This year's 3 % inflation target is not expected to constrain monetary policy, however. Premier Li said that measures to liberalize the exchange rate will continue. Unlike earlier years, his speech did not emphasise the importance of exchange rate stability, but instead stressed maintaining stable position of the yuan in international monetary system.

Li emphasized the stability of economic development and president Xi's mantle-bearing as the "core" of the party. He set the stage for the Party Congress meeting in October-November, when the persons selected for the next five-year administration are approved and start setting directions in economic policy. The National People's Congress and People's Political Consultative Conference will meet through next week.

Growing worries that the China Manufacturing 2025 programme may distort markets. The European Union Chamber of Commerce in China this week released a report giving its assessment of the Manufacturing 2025 programme that China announced in May 2015. The programme reflects typical Chinese industrial policy. Officials have selected ten fields with promising futures that the government commits to support. The designated fields are high-tech aerospace, shipbuilding, rail equipment, IT, electrical equipment, electric and hybrid cars, farm machinery, robotics, new materials, biopharmaceuticals and medical equipment. The EU Chamber claims that the central government and regional administrations have committed hundreds of billions of euros already to support these fields.

The EU Chamber also noted that guidance through heavy-handed industrial policy conflicts with China's efforts to continue with market reforms and grant market greater say in directing the economy. According to the EU Chamber, a strong industrial policy will likely result in the same types of problems encountered earlier. Chinese firms will overinvest in these fields creating overcapacity, which will depress price levels. As a result, firms struggle with low profitability in both China and abroad. Resources are wasted. Moreover, overcapacity may lead to protectionist measures in other countries. Manufacturing 2025 places high emphasis on domestic content and indigenous innovation. The EU Chamber fear that the position of foreign firms will be further eroded.

Instead of heavy-handed industrial policy, the EU Chamber would like to see China pursue market reforms. Markets are often much better at deciding on how economic resources should be allocated than public officials.

Mobile payments catch on in China; PBoC developing own virtual currency. In recent years, China has become the global leader in mobile payments. The Chinese consulting firm iResearch Global estimates that about 450 million Chinese used mobile payments services last year. The apps of the largest mobile payments service providers (Alibaba's Alipay and Tencent's WeChat Pay) are now in such wide use in China's big cities that people can get through an entire day with only their phone. Mobile payments are now a standard option in restaurants, taxis, shops, cafes and parking fees. The shift of providers of investment services to mobile platforms has fuelled the growth of mobile payments. Many Chinese seem to be switching directly from cash to mobile payments without ever going through the intermediate step of acquiring a credit or debit card.

Various forms of virtual currency such as bitcoin are also popular in China. The PBoC has also been developing its own virtual currency for couple of years. The currency and its related payment systems are now in trial use in select banks in Shenzhen and Guiyang. China's central bank will probably become the first central bank in the world to issue its own virtual currency. A goal of China's virtual money is to increase efficiency of interbank payments and transparency, thus making banking supervision easier and financial crime more preventable. The PBoC's eagerness of release own virtual currency may also be motivated by the fact that virtual currencies can be used to circumvent China's capital controls. Lately, officials have significantly increased supervision and tightened regulations concerning virtual currency transactions.

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