SUOMEN PANKKI FINLANDS BANK EUROSYSTEM

Weekly Review
17 • 28.4.2017

BOFIT

Russia

New information on Russian industrial output. Rosstat has released more data based on new industrial branch classifications and other statistical changes. The new data now reach back to the start of 2014. The new figures show that Russian industry as a whole almost avoided a downturn over the past two years and only experienced a rather small contraction of production in 2015. Rosstat earlier this year laid out the reasons for its industrial output data changes (BOFIT Weekly 9/2017).

During the economy's recession, mining and quarrying (or extractive industries) all the time showed growth that was slightly higher in the new data. Figures on production and supply of electricity, gas fuel & heating were revised upwards.

The new figures show that the downward slide in manufacturing output in 2015 was quite moderate, although the situation has deteriorated this year. Output performed better in many manufacturing branches in 2014–2016 than the old Rosstat figures indicated. Comparison of old and new industrial output data is complicated by the reclassification of industrial production activities. Under the old classification, there were 14 main manufacturing branches; now there are 24. The main category for production of machinery, equipment & transport vehicles is now divided in 6 branches instead of 3 earlier. The food industry, beverages and tobacco products are now their own main categories, and pharmaceutical products are separate from the chemical industry.

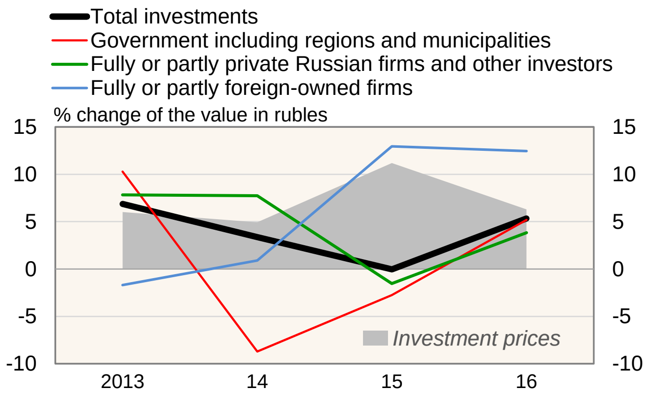
Output growth in largest industrial branches, 2014–2017

	2014	15	16	1Q17
	% change from the previous year			
Total industrial production	**2.5**	**-0.8**	**1.3**	**0.1**
(before new classification & other changes)	**(1.7**	**-3.4**	**1.1)**	
Mining and quarrying	**1.7**	**0.7**	**2.7**	**1.2**
(before new classification & other changes)	**(1.4**	**0.3**	**2.5)**	
- oil and gas production	0.3	0.4	2.2	1.7
- mining and quarrying industry services	13.1	-1.7	6.6	-0.2
Manufacturing	**3.2**	**-1.3**	**0.5**	**-0.8**
(before new classification & other changes)	**(2.1**	**-5.4**	**0.1)**	
- food industry, excl. beverages and tobacco	4.9	3.1	3.1	2.4
- oil refining (and coke production)	6.1	0.9	-1.7	-1.8
- chemical industry, excl. pharmaceuticals	2.3	5.8	6.3	7.5
- construction materials industry	1.1	-6.1	-6.0	2.9
- metal industry	7.2	4.0	-1.0	-8.9
- metal product industry	4.5	3.5	1.3	-8.4
- machinery and equipment, excl. electrical	-7.9	-4.7	-0.7	8.2
- car industry	-11.3	-23.1	0.5	13.5
- installation & repair of machinery and equip.	-5.6	-5.7	-11.4	2.0
Production and supply of electricity, gas fuel and heating	**1.0**	**-1.0**	**1.7**	**1.3**
(before new classification & other changes, including water & waste water services)	**(-0.1**	**-1.6**	**1.5)**	

Source: Rosstat.

Russian government and businesses have cut back on investments. Total fixed investments fell by about 12 % in real terms in 2014–2016. The ratio of fixed investments to GDP is just 21 %. Government investments (state, regions and municipalities) have shrunk. In 2015–2016, investments of domestic private and joint private-state firms have also declined. Except in 2015, investments of fully foreign-held firms have fallen sharply. In contrast, investments of joint firms of Russian and foreign owners have risen, especially in 2016 when the joint venture investment boom was driven entirely by investments in the natural gas sector (Yamal LNG project). Private domestic firms accounted for 55 % of total investments. The government's share has fallen to below 20 %.

Nominal growth of private sector and government investments



Source: Rosstat.

Russia announces changes in banking supervision and restructuring troubled banks. The weeding out of weak players in the banking sector has meant that the amount of support funds needed by Russia's Deposit Insurance Agency (DIA) has grown continuously as the DIA has received an increasing number of deposit insurance claims for failed banks, and has dealt with the costs of terminating or restructuring sick banks. Since the end of 2015, the DIA has largely relied on Central Bank of Russia funding to cover its liabilities. In 2016, CBR loans covered about 70 % of the DIA's 660 billion rubles (about €9 billion) in expenditures. The Duma last week approved a bill that will shift the responsibility for dealing with troubled banks to the CBR. The change is hoped to improve the effectiveness of bank restructurings and slow the pace of rising costs.

At the same time, the Duma approved a law on changes in bank licensing. From the start of 2018, banks will have either general or basic operating licences. A basic licence grants the right to engage in limited banking activities, and reduces the supervisory burden. The minimum capital requirement is 300 million rubles for a basic licence and 1 billion rubles for a general licence. Banks operating on a basic licence are believed to focus on regional banking and financing small and medium-sized firms. Banks with equity exceeding 3 billion rubles must have a general licence and are subject to full supervision. Russia had about 160 such banks at the beginning of March. The reform should clarify supervision and allow supervision to focus on the systemically most important banks. The law includes a 1-year transition period.

The Duma quickly passed both bills on unanimous votes, signalling broad political support.

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China

IMF concerned about sustainability of China's financial system; China changes its tune on financial risk. The IMF's latest Global Financial Stability Report suggests that the risks to China's financial system are still rising. Indebtedness continues to soar as meeting official growth targets requires on-going debt-fuelled stimulus. Vulnerabilities of the financial system are highlighted by the fact that financial institutions rely on extremely short-term market financing to cover their long-term liabilities. Thus, financial institutions are quite susceptible to changes in money market rates. In addition, the structure of the financial sector has become more complex as the shadow banking sector provides means to increase leverage through various financial chains. The IMF would like to see China make special efforts to supervise smaller banks and the shadow banking sector, as well as focus its attention on possible contagion problems in the interbank markets. The policy contradiction between the need for deleveraging and high growth targets must be resolved. The IMF said that it is as urgent as ever to solve the debt problem as the likelihood of a major financial crisis increases the longer action is postponed and the larger is the size of the debt.

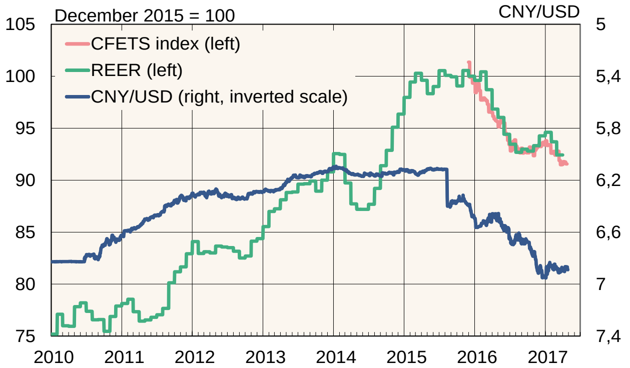
The Chinese have become far more serious about rising financial market risk in recent weeks. In a speech to the politburo this week, president Xi Jinping stated that government should attach great importance to ward off any financial risks and make sure there are no systemic risks. Since Guo Shuqing took over as chairman of the China Banking Regulatory Commission (CBRC) at the end of February, banking rules have been tightened and oversight increased. For example, the CBRC has tried to crack down on shadow banking operation designed to evade banking regulation and banned certain types of complex financial arrangements. Issuance of certificates of deposit on the interbank market has been restricted and banks are required to provide more information than earlier to officials. Officials last week announced that they would begin to reassess collateral and loan guarantors. A number of cases have emerged in recent months in which companies have cross-guaranteed each other's loans.

The growth of Chinese debt remained brisk in the first quarter of this year. The stock of total social financing, China's broader concept of credit, grew by 12.5 % y-o-y. The strong growth in bank lending remained steady overall, even if lending by the shadow banking sector accelerated to its highest growth level in two years. Some observers expect the new measures to restrain the growth of indebtedness. However, hitting growth targets requires rapid debt growth. In any case, disturbances like those seen before are likely to continue on China's financial markets.

China keeps the yuan-dollar exchange rate steady. Already for a long time, the growth in the amount of Chinese debt and volatility on financial markets has increased depreciation pressures on the yuan's exchange rate. At the end of last year, Chinese officials significantly tightened rules on buying foreign currency and capital controls to stem forex outflows and alleviate some of the more immediate depreciation pressure on the yuan. The restrictions have helped the People's Bank of China keep the yuan's exchange rate extremely stable in the first quarter around 6.9 yuan to the US dollar.

The current situation gave the US no ground for portraying China as a currency manipulator in the US Treasury Department's report published in April.

Yuan CFETS, REER and USD exchange rate

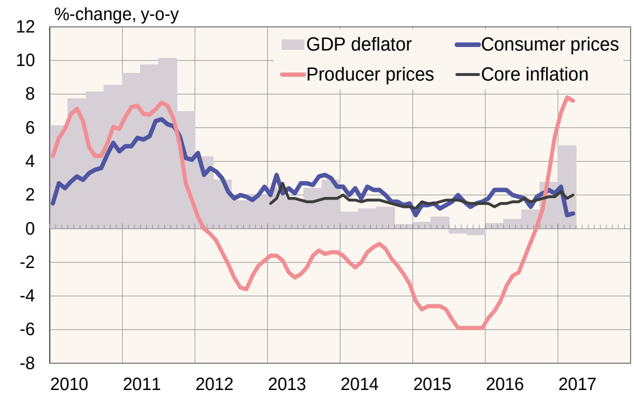


Source*: Macrobond.*

Industrial prices rising quickly in China. With the decrease in prices of fresh foods, the rise in consumer price inflation, remained below 1 % in February and March. Core inflation (energy and food prices removed) stayed around 2 %.

Lifted by rising commodity prices, Chinese producer prices rose 8 % y-o-y in March. The month-on-month rate of increase has slowed, however. Commodity prices were exceptionally low at the start of 2016, so their base impact the start of this year on inflation will moderate as this year proceeds. Import prices were up 14 % y-o-y in March, while export prices were up 5 %. The rise in industrial prices was also apparent in China's GDP deflator (difference between nominal and real GDP growth), which was up 5 % in the first quarter.

Chinese price trends



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