Weekly Review
19 • 12.5.2017
BOFIT

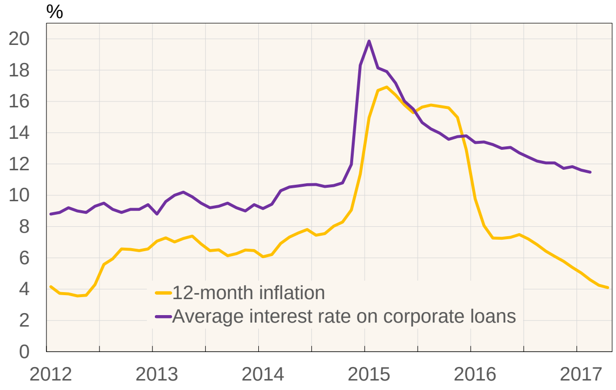
Russia

Inflation slows in Russia. April 12-month consumer price inflation was 4.1 %, slightly lower than the first-quarter pace (4.5 %). Inflation was running at 5.4 % at the end of 2016.

The rise in consumer prices peaked at around 17 % in spring 2015 after the sharp fall of the ruble in late 2014 and early 2015 led to a spike in consumer and producer prices. Over the past two years, the pace of inflation has slowed gradually due to the ruble's exchange rate recovery, two consecutive bumper grain harvests and the Central Bank of Russia's reconfiguration of monetary policy that has set inflation targeting as its objective.

The CBR's inflation target remains 4 % by the end of this year. Given the high inflation episodes of the past two decades, however, inflation expectations remain considerably higher than the inflation target. Expectations have also softened somewhat in recent months, providing the CBR with room to lower rates (the key rate is currently 9.25 %). Nevertheless, real interest rates in Russia are historically high, with the nominal average rate on corporate loans of under a year's maturity above 11 %.

12-month inflation and average interest rate on corporate loans, %



Sources: CBR and Rosstat.

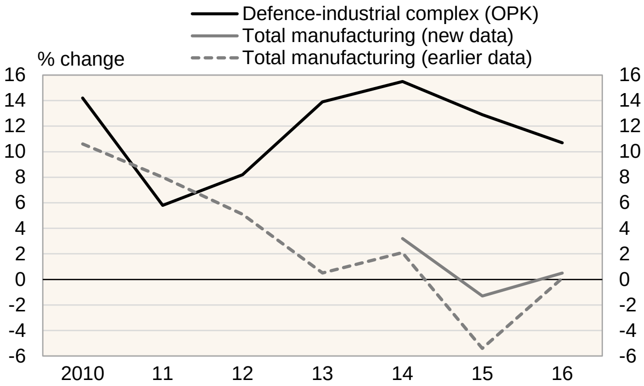
Russian defence industry continued to show fast growth last year. Preliminary figures show that production of military and civilian products by Russia's defence-industrial complex (OPK) increased by over 10 % in real terms last year, even if the pace of growth slowed from the previous three years. Despite the rapid growth of the OPK, manufacturing overall, which includes OPK, has shown sluggish growth and even contraction in recent years. In fact, during 12 of the past 15 years growth of OPK production has been much faster than overall manufacturing growth.

Within the OPK, production of military products increased substantially faster than civil industry for over a decade. Unlike the military industry, the civil industry was not spared large drops in production during the Russian economy's recession years of 2009 and 2015. Production intended for civilian use amounted to just 17 % of OPK production in 2016, down from about 45 % in the mid-2000s.

Boosting OPK production by about 9 % a year, and bringing growth in OPK's civilian production to 5 % a year is the aim of the 2016–2020 OPK development programme approved a year ago by the government. While this year's federal budget would reduce defence spending to below the 2016 level, Russia's defence ministry has pointed out that the cuts do not affect the armament programme. Prime minister Dmitri Medvedev recently noted that the share of civilian production in the OPK is intended to increase notably in the 2020s.

The OPK employs about 2 million people, of which over 1.4 million work in the defence industry. Estimates put the share of OPK in Russia's total industrial output at 5–6 %.

Real growth of the defence-industrial complex and total manufacturing output



Sources: Industry ministry, Federalnyj spravochnik and Rosstat.

Russian authorities reconsidering the idea of virtual currency. Russian officials have earlier viewed the concept of virtual currency with scepticism. In spring 2016, for example, the finance ministry proposed a bill that included a fine of up to 2.5 million rubles (€34,000) and 7 years in prison for those caught using virtual currency. The proposal was premised on the ideas that virtual currency represented a threat to the financial system and was potentially connected to crime. Experts in the field and at the justice ministry responded with critiques of the proposal. In autumn 2016, the proposal was in practice withdrawn as it was on indefinite hold.

Russian officials this year have warmed to the idea of virtual currency. In February, CBR deputy governor Olga Skorobogatova said a national virtual currency could be possible in the future. Last month, deputy finance minister Alexei Moiseyev said authorities could recognize bitcoin and other virtual currencies as legal tender as early as 2018. One reason for using a virtual currency would be preventing illegal money transfers. However, no final decision on regulation of virtual or cryptocurrencies has been taken yet.

Bank of Finland • Institute for Economies in Transition, BOFIT
P.O. Box 160, FI-00101 Helsinki
Phone: +358 9 183 2268 • Web: www.bofit.fi/en
Editor-in-Chief Jouko Rautava• Email: Jouko.Rautava@bof.fi

Weekly Review
19 • 12.5.2017

BOFIT

China

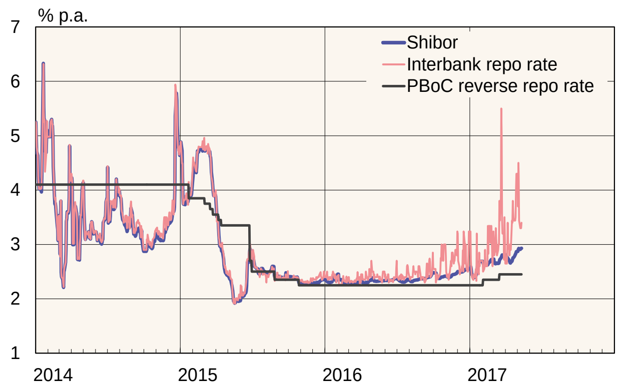
Rates rise as China attempts to quell rising indebtedness. Money market rates have risen in all maturity classes. The overnight Shibor rate in May has averaged 2.8 %, up from 2.2 % in January. In addition to higher interest rates, the volatility of interbank repo rates has increased. Shibor rates are calculated from rates quoted by 18 highest-rated commercial banks, while the repo rate is based on the average rate of completed transactions. Over the past six weeks, the People's Bank of China has stepped up open market operations to increase market liquidity and reduce pressure to further rate increases.

Financial market risks have been put in the spotlight in recent weeks by president Xi Jinping and supervisory officials announcing stricter guidelines. The shift has been manifested in lower liquidity on the interbank markets and efforts to take a stronger stance on risks created by the shadow banking sector. The China Banking and Regulatory Commission (CBRC) this month issued new guidelines on increased supervision of collateral used to secure loans.

The PBoC this year revised its macro prudential assessment framework to include wealth management products for the first time as part of banks "broad credit." Banks have used wealth management products to increase their income through off-balance-sheet lending to "wealth" managers for reinvestment. While these products have higher returns than bank deposits, investors generally have a poor grasp of the associated risks. The market for wealth management products last year reached 29 trillion yuan (39 % of GDP), double its valuation at the end of 2014.

The rise in interest rates is also visible in bond markets, where the yield on the one-year government bond has risen from 2.7 % in January to 3.5 % this week. Yields on corporate and local government bonds are also rising. Real interest rates have risen faster than nominal rates this year due to low consumer price inflation at the start of the year. Consumer price inflation was 1.2 % in April, while producer prices rose on-year by 6.4 %, even if they declined on-month.

7-day interbank offered and repo rates; PBoC reverse repo rate used in open market operations



Sources: CEIC and Macrobond.

Central government increases scrutiny of local government borrowing arrangements. The Chinese media outlet *Caixin* reports that officials established a new system for oversight of local government indebtedness at the beginning of May. The arrangement seeks to take a pro-active approach to reducing systemic risk. Six major agencies and commissions are involved in the supervision effort.

Even as the central government has tightened local government budget policy and borrowing, local officials keep devising new ways to avoid scrutiny and take on new debt. Caixin's list of recent avoidance tactics included public-private partnerships (PPP), use of various funds for bond issues and procurement contracts that effectively increase the local government's debt load. The new rules limit the use of such gimmicks.

The IMF estimated last summer the total debt of local administrations and their financial vehicles was on track to exceed 33.4 trillion yuan ($4.8 trillion), or 42 % of GDP, by the end of 2016. The IMF put the combined debt of central and local governments (including their financial vehicles and other off-budget borrowing) at about 60 % of GDP.

Slight drop in Chinese share prices. Share prices on Chinese exchanges have been relatively stable since early 2016 and volatility this year has been exceptionally low. In recent weeks, however Chinese stock indices have fallen, largely on lower share prices for industrial firms. The Shanghai A-index is now 1 % lower than in the start of the year and the Shenzhen A-index is down 8 % for the year. This week there were a reminder of the heavy-handed role of officials in Chinese stock markets. *Bloomberg* reports that officials are keeping an eye on large investors and have ordered funds operating in domestic stock markets to be prepared to act if there are any surprises in the lead up to the Silk Road summit on May 14–15.

MSCI, a leading provider of international stock indices, is reconsidering whether to include Chinese A-shares in its Emerging Markets Index. A new twist is that the index could initially include only a limited selection mainland China shares traded in Hong Kong under the Stock Connect programme. The weight of Chinese shares in the index could start out small and increase gradually over time. Even so, it would be the first time that mainland Chinese shares were included in a major international stock index.

Stock market trends in China and Hong Kong

Source: Macrobond and BOFIT.

Bank of Finland • Institute for Economies in Transition, BOFIT
P.O. Box 160, FI-00101 Helsinki
Phone: +358 9 183 2268 • Web: www.bofit.fi/en

Editor-in-Chief Jouko Rautava• Email: Jouko.Rautava@bof.fi