Weekly Review
26 • 30.6.2017

BOFIT

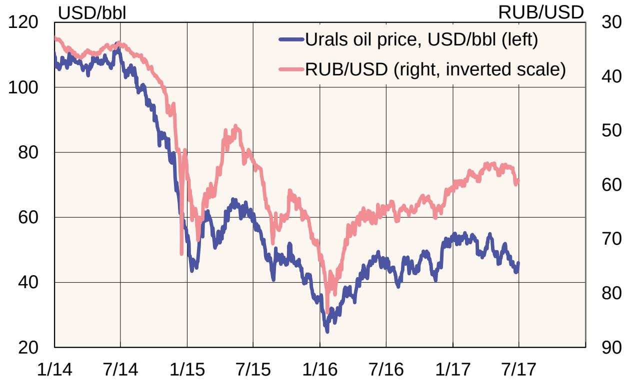
Russia

Ruble exchange rate turned to drop. After a long appreciation trend, the ruble has begun to depreciate along with falling oil prices. The price of Urals-grade crude has fallen by 10 % in June to below $45 a barrel and the ruble's exchange rate has depreciated by about 4 % against the dollar and euro.

The finance ministry has continued its forex purchases as announced as oil revenues have exceeded the budget forecast. Even so, the forex buying is of such limited scale that it apparently has little impact on the ruble's exchange rate. In June, the oil price measured in rubles fell for the first time below the average oil price assumption in this year's budget.

The ruble is still about 10 % stronger in real terms against the dollar and euro compared to a year ago.

Ruble exchange rate and oil price



Source: Reuters.

Russian bank lending turning to growth. The stock of corporate bank loans has contracted since early 2016, but in recent months the contraction seems to have halted. The corporate loan stock (corrected for exchange rate shifts) showed slight on-month growth in April and May. However, measured on-year, the stock of corporate loans continues to contract (down 2 % in May). The recovery of corporate lending has been supported by factors such as improved bank earnings and declining interest rates this spring.

The share of non-performing loans (NPLs) has remained at about 7 % of the total corporate loan stock throughout the past 12 months. However, the share of bad loans, which is a more comprehensive measure (including loans in categories IV and V) had increased to 11 % of the total corporate credit stock at the end of March. The Central Bank of Russia says that the amount of NPLs has been raised by reassessments of the loan stocks of banks in restructuring. This year, there has been 25 banks in the restructuring process overseen by the Deposit Insurance Agency. Among the newcomers to the restructuring process was Peresvet, earlier one of Russia's 50 largest banks.

Many NPLs involve the construction sector. As of March, over a fifth of non-performing ruble loans and 28 % of all bad loans were loans to companies in the construction sector. Forex loans of construction sector companies in particular have been restructured and converted to rubles, so forex loans now only represent about 12 % of construction sector borrowing (down from 25 % earlier). Forex loans currently represent about 30 % of the total stock of corporate borrowing. A large part of forex loans are held by companies operating in branches like mining and chemicals & petrochemicals that often have significant forex income flows.

Russia seeks to increase food supply independence through trade and agriculture policies. Russia, which has long sought to reduce its dependence on food imports, has increased its efforts in recent years with the heightening of geopolitical tensions. Russia's agricultural ministry estimates that self-sufficiency targets have been met in production of e.g. grains, potatoes, meat and sugar, but are still lagging in production of e.g. milk and salt.

The government has actively used trade policy to support domestic producers. Food imports have been restricted by e.g. public procurement rules and import bans imposed on Western countries and Turkey. Most of the sanctions imposed on Turkey were ended as the countries mended relations, but the ban on tomato imports remains in force. In addition, food imports are hampered by technical barriers to trade such as phytosanitary and veterinary measures which are sometimes applied in a discriminatory way.

Various other policy measures like production and interest subsidies and tax breaks have also been used to boost agricultural production. The OECD estimates that the total value of Russian agricultural support measures has averaged around 13 billion dollars a year (about 1 % of GDP) in recent years. The corresponding figures are 0.5 % of GDP for the US, 0.7 % for the EU and 2.4 % for China. The biggest subsidies in Russia go to production of sugar, milk and pork.

Most Russian agricultural subsidies are supplied under the State Development Programme. In recent years, annual spending from public sector budget funds has averaged around 300 billion rubles (4.5 billion dollars). Researchers at the Gaidar Institute assess that at least the subsidized investment credit is mainly directed to a few select large corporations. Last year, for example, 90 % of the subsidized investment credit in beef cattle production went to a single project of Miratorg, Russia's largest pork producer.

In addition to support measures, agricultural firms benefited from the sharp drop in the ruble's external value. In 2015, the total profits of farm firms rose by nearly 50 %. One of the fastest growing agricultural firms in Russia has been Agrocomplex, which is owned by the family of agriculture minister Alexander Tkachev. In recent years, it has become one of Russia's largest producers of e.g. pork and sugar, as well as one of the country's largest holders of farmland. After examining the issue last year, a government commission stated that this does not constitute a conflict of interest.

Consumer food prices rose by over a third in 2014–16. 38 % of Russian household spending presently goes to food.

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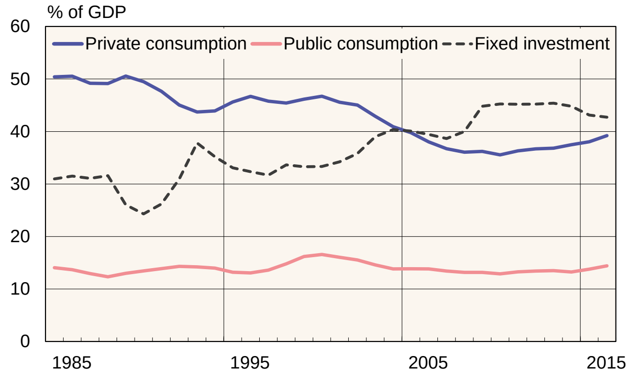
China

China's fixed investment ratio drops slowly. Preliminary 2016 demand component figures released this month by data provider CEIC show that China is making progress in structural reform of its economy. The change has been slow, however, as fixed investment still equalled nearly 43 % of GDP. In other words, the investment ratio fell by just a half percentage point from 2015. China's fiscal policy response to the Great Recession in 2009 was to launch a massive stimulus that quickly drove up the investment rate to 45 %. The purpose of the stimulus was to compensate for the huge drop in export demand, but its impact eight years later is still seen in China's excessive investment ratio.

Private consumption accounted for 39 % of total demand last year, a percentage point increase from 2015. Despite its growing share, private consumption still accounts for an exceptionally tiny fraction of GDP.

Caution should be used in interpreting China's GDP figures. Demand-side figures, despite earlier promises to start releasing quarterly data, are only reported on yearly basis indicating various problems in data collection.

Main demand components of Chinese GDP



Source: CEIC.

China's state-owned enterprises embellish financial data while resisting capacity cuts. According to a report released last week by China's National Audit Office, 18 out of 20 state-owned enterprises (SOEs) provided falsified financial figures to auditors. Revenues and profits were exaggerated through fictitious payments, arcane payment arrangements and manipulated financial statements. Some of the audited SOEs were among the largest businesses in China.

Media reports mention that the audit report also critiqued SOEs for violation of official Communist Party policy. Many of the audited firms failed to close down their loss-making "zombie" firms and resist dealing with their overcapacity issues. The report also criticised the backsliding of local governments on overcapacity problems and rapid increases in indebtedness.

While the overstatement of profits by the audited firms represented less than 2 % of their profits overall, the financial statements show how the career paths of upper management in state firms face the same perverse incentives as local administrators. Many provinces have recently been shown to give rosier pictures of their financial development than reality warrants. Part of the problem also stems from China's rigid growth targets in conditions where the emphasis should otherwise be on reform policy. This burdens local governments and SOEs with conflicting expectations.

Mainland China exchanges shrug off MSCI index inclusion; foreign investors in wait-and-see mode. MSCI Inc., publisher of the Emerging Markets (EM) Index, decided on June 20 to include mainland China shares in its MSCI EM Index (BOFIT Weekly 25/2017). The decision had little immediate impact on share prices. The biggest effects were seen in the share prices of large firms, i.e. those to be included in the MSCI EM Index next year. The CSI300 Index of 300 firms listed on the Shanghai and Shenzhen stock exchanges and the SSE180 Index of 180 firms listed on the Shanghai exchange have both risen 3 % since MSCI's decision to include Chinese shares.

Although mainland Chinese stock indices have been relatively stable this year, Chinese shares listed on foreign exchanges have done better. MSCI's China index is up over 20 % and the Hong Kong stock exchange's China Enterprise Index is up 10 %. However, shares of Chinese firms in Hong Kong are over 20 % cheaper than shares of the same firm listed on a mainland China stock exchange.

Foreign investments in mainland Chinese stock markets do not seem to have increased significantly in the immediate wake of the MSCI decision. The average volume of stock trading via the Stock Connect programme with Hong Kong has seen a slight increase since early summer, while the total transaction value of shares only represent 3 % of the Shanghai exchange's turnover and just 2 % of Shenzhen's turnover.

Qualified foreign investors can also trade on mainland-China's stock markets under the QFII and RQFII programmes. As of end-March, foreign investors held shares traded only in mainland China worth 780 billion yuan (113 billion dollars). That amount corresponds to 1.4 % of the market capitalisation of all Chinese stock markets. MSCI estimates that the implementation of its expanded EM Index next year will boost foreign holdings of mainland Chinese share immediately by about 17 billion dollars.

The inclusion of mainland Chinese firms will take place in two steps in May and August 2018. The EM Index will initially include 222 Chinese firms with more to be added later. Over two-thirds of the included firms are owned by the state or local governments, which has aroused suspicions concerning e.g. the actual power of shareholders to influence corporate decisions. The state still plays a huge role in stock markets, so any further increase in the weight of mainland Chinese shares in the MSCI EM Index will require further stock market reforms.

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