Weekly Review
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BOFIT

Russia

Russian economy showing more signs of recovery. Following a weak spell in June and July, Rosstat reports that seasonally and workday-adjusted industrial output increased slightly in August from July. The rise was 1.5 % y-o-y and reached nearly 2 % y-o-y for the January-August period. Manufacturing output increased a bit in August, raising January-August output to nearly 1 % y-o-y. Mineral extraction industries saw an on-month contraction in output in July and August, but August as well as January-August output was still up by about 3 % y-o-y. Several sub-categories within the extractive sector other than oil production had experienced booms this spring and summer, but most of them witnessed distinct slowdowns in recent months.

After a weak performance in the early summer, agricultural output revived significantly in August as delayed harvesting got underway and worked towards normal rhythms. Recovery in other major sectors of the economy continued. Construction increased for the fifth month in a row, and the volume of construction activity in August remained at 6 % y-o-y. Growth in goods transport has increased also in recent months. For the January-August period, they were up by over 7 % y-o-y.

The volume of seasonally adjusted retail sales increased slightly in August. Sales have recovered gradually over the past half-year. They climbed to nearly 2 % y-o-y in August. Food sales clearly picked up in August, while sales of non-food goods continued a gradual rise that started in spring.

B&N Bank now under CBR administration. On Thursday (Sept. 21), the Central Bank of Russia announced it would become the largest shareholder in troubled B&N Bank (Binbank), which is privately owned and Russia's twelfth-largest bank by asset value. The bank's operations will continue normally, no moratorium on payments will be imposed and bail-in terms will not be applied. The measures also cover Rost Bank, which has been under resolution by Binbank. CBR deputy governor Vasily Pozdyshev estimated the recapitalization need of Binbank at 250–350 billion rubles (4-5 billion euros).

Following in the wake of Otkritie and Yugra banks, Binbank is the third large bank to fail in recent months. The CBR last week confirmed its resolution plan for Otkritie Bank which includes e.g. recapitalisation from the CBR. An earlier estimate by Pozdyshev put Otkritie's recapitalisation need at 250–400 billion rubles. The CBR filed Yugra for bankruptcy in August.

While market reaction to bank problems have been generally limited during past months, rumours concerning certain individual banks has put pressure on these banks. These banks suffered from deposit outflow in August and they needed liquidity financing from the CBR. Most of the liquidity financing went to Otkritie Bank, which as of end-August had nearly 1.1 trillion rubles (16 billion euros) of CBR credits on its balance sheet. However, the total stock of deposits held by the banking sector in August remained practically unchanged and interest rates on the interbank market were still relatively low. The CBR has e.g. implemented a supplementary liquidity financing facility and extended its list of systemically important banks. Recent problems are largely seen to reflect the activities of the individual banks, like excessive related-party lending and aggressive expansion through M&A, e.g. buying up banks in resolution.

In recent years, tighter banking supervision has forced many banks in Russia to close or submit to restructuring. Most failing banks tend to be small and are often involved in shady dealings and them CBR has tried to weed out systematically. A number of larger banks has, however, also fallen into trouble. The Deposit Insurance Agency, which had dealt with problem banks until this summer, has doled out about 2.3 trillion rubles (33 billion euros) on refunds to depositors for their losses or recapitalisation of failed banks since the beginning of 2014. A new Bank of Finland blog discusses Russian banking sector in more detail.

CBR lowers key rate; announces around 4 % inflation target for coming years. At its regular monetary policy meeting last Friday (Sept. 15), the CBR board decided to lower the CBR key rate by 0.5 percentage points to 8.5 %. It was the fourth rate cut this year. At the start of 2017, the rate was 11 %. The CBR still sees a further cut in the key rate possible during the remainder of this year.

The central bank said its last Friday's rate-cut decision was made largely on the grounds that inflation has been close to its 4 % target for the end of this year. Inflation fell in August to 3.3 %. In June, inflation was still running at 4.4 %. August's low score, however, was caused mainly by drops in fruit and vegetable prices, which saw unusually large seasonal declines (July-August prices have only experienced greater drops in four of the past 16 years). The CBR noted that one of the inflation risks comes from fluctuations of food prices and that overall the risk of inflation overshooting the target is larger than the risk of a downward deviation from the target.

The CBR noted inflationary risks coming also from swings in prices on global markets, wage increases, declines in the household savings rate and a powerful rise in consumption. It stressed that even if inflation expectations had (based on a survey it regularly orders) fallen to historically low levels, they were still not anchored at any low level and remain sensitive to price movements or changes in the ruble's exchange rate.

The CBR said it has specified its inflation target at around 4 % in the years ahead. The CBR did not set a fluctuation range for inflation, even if the possibility was discussed. Deviations of inflation from the target would only trigger a CBR response if they create a threat of longer-term departure e.g. via impacting inflation expectations. The CBR sees this summer's differences in inflation as a fluctuation within its inflation target rather than a deviation.

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

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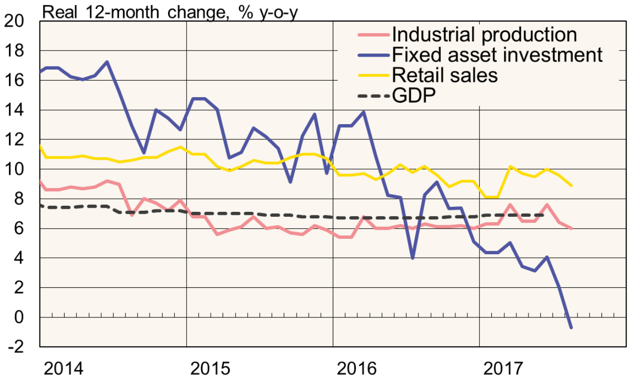
China

Fixed investment subdues Chinese economic growth. Figures released by China's National Bureau of Statistics suggest lower economic growth in August. Real growth in retail sales fell to 9 % y-o-y, while industrial output growth decelerated to 6 %. The sharpest slowdown was registered for fixed asset investment (FAI), which, even with cautious inflation estimates, contracted in real terms in August. Private investment growth, in particular, was sluggish, while also public investment barely topped 1 %.

Looking at core sectors of the economy, on-year contractions in real investment in the industrial and construction sectors have been registered every month this year. The sharpest drop has been in investment in extractive industries. Investment in the service sector, in contrast, continued to rise, but growth has slowed significantly and investment in retail and wholesale has been shrinking. Some observers believe the weak investment trend may reflect company efforts to reduce debt. People's Bank of China figures, however, show that indebtedness continues to soar.

Key real economy indicators for China, %



Sources: NBS and BOFIT.

EU Commission proposal for increased oversight of corporate acquisitions gets mixed reception. In mid-September, Jean-Claude Juncker, president of the European Commission, suggested that the EU create a new framework for overseeing acquisition activity of non-EU firms inside the EU area. The European Commission is particularly concerned about foreign firms taking over companies involved with advanced technology, logistics, data communications, energy or other businesses in strategic sectors. The European Commission said it would begin to analyse extra-EU direct investment and create a coordinating group of member-state representatives to discuss concerns and solutions to issues in the area of foreign direct investments.

A significant increase in Chinese investment in Europe is a key factor behind the European Commission's proposal. Twelve member states, however, already have national foreign investment screening systems in place that allow these countries to restrict foreign access to strategic technologies and critical sectors. Thus, while French president Emmanuel Macron called upon the EU to act on the matter this summer, many member states consider their national screening systems as sufficient and fear implementing the European Commission's proposal would only increase bureaucracy.

Unsurprisingly, China condemned the EU plan and claimed it supports free flow of trade and investment. OECD monitoring, however, finds China to be one of the most vigorous limiters of foreign investment, while EU members tend to be among the most easy-going. This contradiction increases pressures in the EU to limit the activities of Chinese firms.

China shuts down cryptocurrency-related activities. Chinese officials announced at the start of the month the banning of all fund-raising schemes offering tokens in exchange for investments in virtual coins (a practice known as *Initial Coin Offerings* or *ICOs*). ICO campaigns seek to raise capital from the public in exchange for virtual coinage such as Bitcoin or Ethereum coins in order to launch a business or project. In exchange, investors receive tokens that entitle them to an ownership stake in the firm or to a certain amount of the firm's future products and services.

Last week the central bank declared a complete end to trading on virtual currency markets in China. China's three largest bitcoin exchanges announced the suspension of trading in yuan would occur at latest in October. After the announcement Bitcoin, by far the most popular virtual currency, plunged from about 4,000 dollars to around 3,000 dollars before rebounding close to the earlier level.

ICO campaigns in China have intensified this year and the amount of money raised from such campaigns has exploded. In the first half of 2017, ICO campaigns raised an amount equivalent to 400 million dollars in cryptocurrencies from roughly 100,000 investors. ICO campaigns are beyond the scope of official regulation, which has created additional risks for Chinese financial markets. Due to the anonymous nature of virtual coins, ICO campaigns are ideal vehicles for financial scams and money laundering.

Trading in digital currencies had been quite lively up until February 2017, when officials announced that bitcoin exchanges had to monitor transactions. Moreover, the loading of cryptocurrency into the digital wallets of customers, i.e. the final step needed to allow them to use digital currency in normal payments, was frozen for four months. At the end of 2016, when transaction volumes had reached their peak, over 90 % of global trade in virtual currencies was conducted in yuan. Since the freeze, the amount of global transactions, all currencies combined, has plummeted to about 3 % of the December 2016 level. The Chinese have been quite astute at using cryptocurrencies to e.g. ferry capital out of the country.

Even with the recent crackdown on the use of digital money, the PBoC is apparently contemplating its own virtual currency. Besides the cost savings in payment handling, an official cryptocurrency would provide better tracing of financial transactions.

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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