Weekly Review
31 • 3.8.2018

BOFIT

Russia

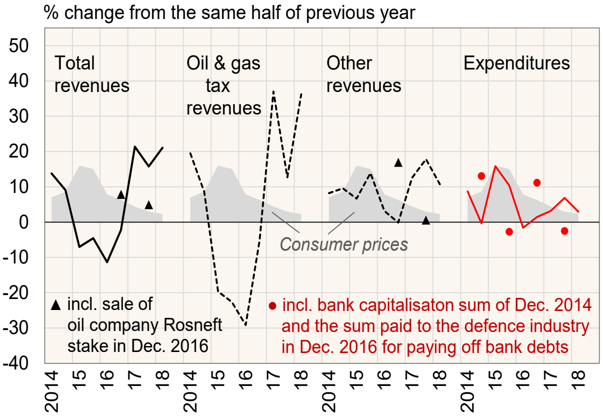
Russian central bank still keeps key rate unchanged at 7.25 %. The press release from the Central Bank of Russia's July board meeting on interest rates reads largely like the June release. The CBR said that it is highly likely that its monetary policy stance will shift to neutral next year. The CBR has earlier determined that the neutral key rate level is 6–7 % and further specified that the level has risen closer to the upper bound of this range in recent months.

The CBR expects inflation to rise from its current rate of around 2.5 % to at least somewhere near its target rate of 4 % by the end of this year. In addition to the direct effects of forthcoming tax changes on inflation, uncertainty persists over the strength of their impact on inflation expectations. Expectations of slightly higher inflation are further supported e.g. by the likelihood of a smaller harvest than the bumper harvest of 2017.

Oil revenues continue increasing for the Russian government. The second-quarter rise in federal budget revenues was so substantial that first-half revenues were up by over 20 % y-o-y. Most of the revenue boost came from oil & gas tax revenues, which increased by more than 35 %. Oil & gas revenues of the past 12 months were equivalent to over 7 % of GDP, which is the highest level of these revenues since autumn 2015. Other budget revenues continued to rise well, driven almost entirely by increased value-added tax revenues.

While federal budget spending climbed sharply in the second quarter of this year, it was only up 3 % y-o-y for the entire first half. Defence spending increased by 10 % and spending on domestic security, order and law enforcement by over 6 %. Other spending grew by less than 1 %. The federal budget deficit has shrunk considerably as a result of surging revenues. The federal deficit during the past 12 months was less than 0.1 % of GDP.

Federal budget revenues and expenditures, 2014–2018



Source: Russian Ministry of Finance.

Household borrowing up in Russia. Bank lending overall saw a slow recovery in the first half of the year. CBR figures show Russia's credit stock was up 3.4 % y-o-y at the end of June. Corporate lending grew slowly, with the stock of corporate loans rising by just 1.9 % in January-June (accounting for exchange rate changes). Initial figures show high lending growth in the construction sector, which could foreshadow a recovery in construction activity. In contrast, lending to manufacturers rose by just 1 % in the first five months of the year.

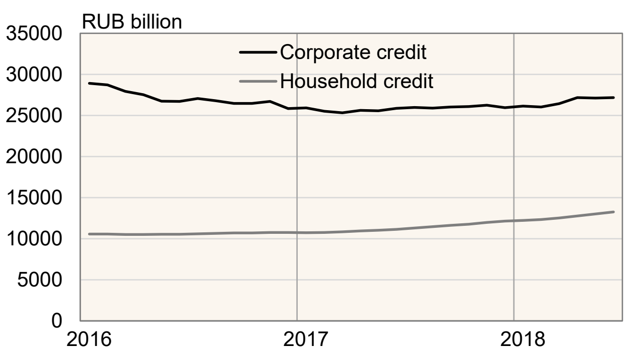
The rapid growth in household borrowing that began last summer continued throughout the first half of this year. The household credit stock was up 19 % y-o-y in June. Strong growth was registered in both consumer credit and housing loans, but particularly the rapid growth in unsecured consumer credit has created concerns about over-indebtedness. The CBR has responded to the situation by raising its risk-weightings for high-interest consumer credit to slow growth in this area.

Banking sector earnings overall in the first half of 2018 amounted to 634 billion rubles (8.7 billion euros), a slight drop from 1H17. In particular, profitability was dragged down by losses of banks undergoing the central bank's restructuring programmes. 145 banks declared losses in the first half of this year.

Under new regulations that entered into force at the start of the year, small banks may apply for a "basic" licence rather than the usual general banking licence. The basic licence permits limited banking activity and is only subject to limited supervision requirements. The basic licence has generated little enthusiasm so far. In the first half of this year, only six banks were granted basic licences.

The decline in the number of banks has continued, albeit at a slower pace than in previous years. In the first six months of 2018, the central bank cancelled the licences of 31 banks for regulatory violations. Another six banks merged with other banks. Most banks that lost their licences are small, controlling only a tiny fraction of the market. Russia's 50 largest banks account for about 90 % of total banking sector assets. At the end of June, 524 credit institutions operated in Russia, down from 589 a year earlier.

Bank credit stock in Russia



Source: Central Bank of Russia.

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
31 • 3.8.2018

BOFIT

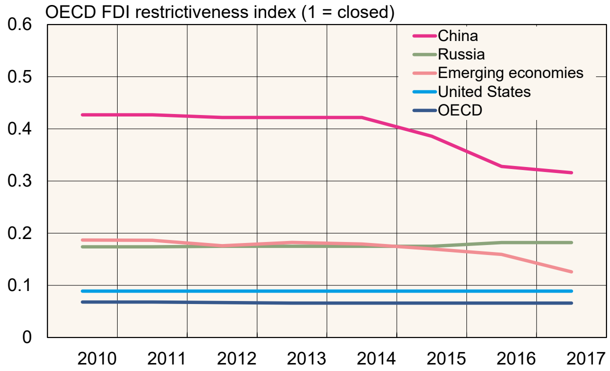
China

IMF wants China to continue with reforms. The IMF's 2018 Article IV Consultation praises China for its recent reform progress. It especially welcomes the actions taken tackling vulnerabilities facing the financial system as well as the risks to stability posed by China's large shadow banking sector and its links to the formal banking sector. While credit growth has slowed, it is still high, so the IMF repeated its earlier warnings on the dangers of excessive indebtedness. While reining in credit growth inevitably restrains economic growth over the short run, it lays the foundations for sustainable long-term growth.

Now that China has 40 years of reform under its belt, the IMF encouraged its leaders to continue the shift in monetary policy away from money supply instruments to interest-rate based guidance. Measures should be actively developed to help the yuan achieve a free-floating exchange rate regime. The IMF team expressed hope that China would hold to its commitment to opening up its economy and allowing markets to play an increasing role. While there has been some incremental progress in removing barriers to foreign trade and investment, China is still far more closed to foreign direct investment and services trade than typical emerging economies. Despite restrictions imposed in branches suffering from overcapacity, the IMF said the sustainable answer is to let unprofitable "zombie" businesses fail. It also said the government has generally dragged its feet in reforms of state-owned enterprises.

Due to tightened financial market regulation and abatement of foreign demand, the IMF estimates that growth of Chinese GDP will slow slightly to 6.6 % this year and to 5.5 % by 2023. Although the impact of import duties currently imposed on China by the US will have little impact on economic growth, the IMF believes that embracing protectionist policies may represent one of the biggest challenges to growth. The IMF wants China to soothe its strained trade relations through negotiated settlement that emphasise free trade and support international and regional cooperation.

FDI restrictiveness index has fallen in China



Source: OECD FDI Restrictiveness Index.

China concerned about slowing growth. Official figures show China's 12-month GDP growth slowed marginally in the second quarter to 6.7 %. Readings of the two major purchasing manager indices also suggested a slight slowdown. In contrast, the eagerness of Chinese decision-makers to increase fiscal and monetary policy stimulus suggests a more serious deterioration in the growth outlook.

In late July, the government promised large tax cuts (estimated at 1.4 % of GDP) to businesses and similar scale spending increases for local-government infrastructure projects. The monetary policy easing in July granted banks access to the central bank's medium-term lending facility (MLF) on the condition that they use the money to buy corporate bonds of their clients. *Bloomberg* reports that multiple sources have confirmed higher quotas for bank corporate loans and a relaxing of rules related to corporate lending.

The flaring of trade tensions reminiscent of a trade war with the US has been an important driver of concerns over lower economic growth. China's long-term growth concerns, however, relate to the country's own problems. Besides the complex structural problems (part of which are also responsible for the current trade disputes), over-indebtedness is a big issue.

Stimulus measures at this point only kick the structural reform can down the road and increases the debt burden on the economy. Politicians, nevertheless, are lured by the hope that stimulus will help them meet their official growth targets, the achievement of which was reiterated in the final communique from the Communist Party's politburo meeting at the end of July. Official figures that suggest stable, high growth and a policy stance framed around providing stimulus are hard to reconcile, especially in light of the already over-leveraged economy.

Stakes escalate in China-US trade dispute. The US this week raised its earlier threat on new punitive tariffs from 10 % to 25 %. The list of products concerned, currently out for comments, covers $200 billion a year in Chinese imports. China announced that it would respond immediately to such measures. The 25 % import tariff hikes on both sides affects currently $34 billion in bilateral imports. An additional $16 billion in imports on both sides is under consideration (BOFIT Weekly 28/2018).

The US this week announced $113 million in investments in emerging Asian economies. US Secretary of State Mike Pompeo described the gesture as a "downpayment on a new era of US economic commitment to the Indo-Pacific region." The investment will focus on energy, technology and infrastructure. Pompeo said the US seeks an independent and open Asia, where no single country dominates. The initiative is a response to the Silk Road project and China's growing regional influence.

One of Trump's earliest acts as president was to issue an executive order to withdraw from the Trans-Pacific Partnership (TPP). Last April, Trump said the US was considering rejoining the trade pact.