Weekly Review
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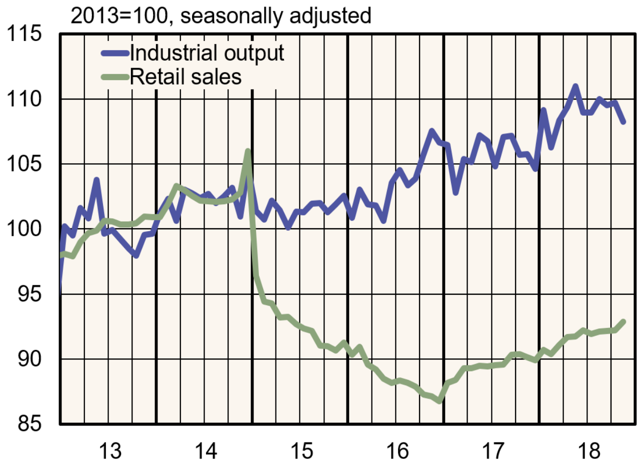
BOFIT

Russia

Modest growth in Russian industrial output continues. The volume of industrial output rose by 2.4 % y-o-y in November. The pace of growth was in line with the industrial output trend of several years. Output growth remained quite unbalanced, however, with the output volume of extractive industries rising 7.8 % y-o-y, while the volume of other manufacturing output was unchanged from a year earlier. The multi-year decrease in construction turned into growth in October. November construction activity was up 4.3 % y-o-y.

Real disposable household incomes have shrunk in recent years. In November, they were down by nearly 3 % from a year earlier. Retail sales, in contrast, grew y-o-y by 3 %. However, they were still 10 % lower than in summer 2014 just before the collapse of oil prices and the ruble's exchange rate.

Industrial output and retail sales



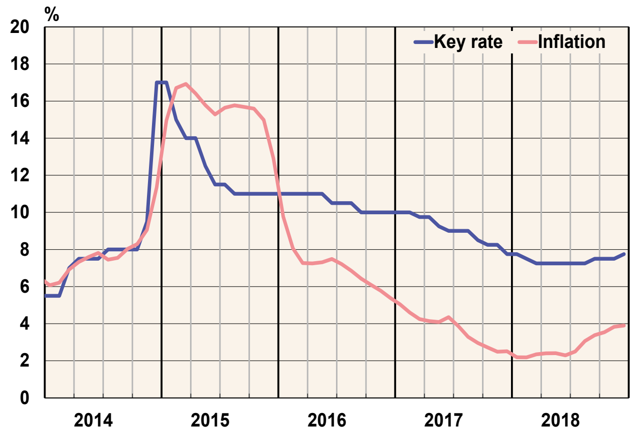
Sources: Rosstat, BOFIT.

CBR raises key rate and announces resumption of the fiscal-rule forex buying in January. The Central Bank of Russia decided to raise the key rate by 25 basis points to 7.75 %. The increase went into effect on Monday (Dec. 17). The CBR last raised the key rate in September. The CBR also announced that on January 15, 2019 it would resume foreign-currency purchases, which were on halt in fall, in accordance with the fiscal rule on behalf of the finance ministry.

The CBR said its decision was driven largely by inflation risks that have remained elevated over the short term. The CBR estimates that on December 10 consumer price inflation was running at 3.9 % y-o-y. It pointed, however, to the upcoming increase in the value-added tax from 18 % to 20 % at the start of next year and the ruble's depreciation this year of about 15 % against the US dollar (and about 10 % against the euro) as factors that will fuel inflation next year. The CBR expects inflation to be in the range of 5—5.5 % at the end of next year, potentially spiking temporarily in the first half to as high as 6 %. Under the forecast, inflation settles back to the CBR's 4 % target level in the first half of 2020. Capital outflows from emerging economies and geopolitical factors were mentioned by the CBR as some of the external inflation risks. In addition, the CBR noted the increased risk of a glut in global oil supplies next year.

The CBR's rate on interbank overnight deposits moved up to 6.75 % after the key rate decision. Overnight interbank money market rates (MIACR and RUONIA) stood at about 7.6 % at the start of the week. For ruble corporate loans from banks (not including Sberbank) with maturities over one year, the average lending rate in October was 9.2 %.

CBR key rate and 12-month inflation



Source: Macrobond.

Ukraine gets new IMF programme. At its meeting this Tuesday (Dec. 18), the executive board of the International Monetary Fund (IMF) voted to grant Ukraine a new Stand-By Arrangement (SBA). The 3.9-billion-dollar SBA will run for 14 months. It replaces Ukraine's Extended Fund Facility approved in 2015 that was set to expire in March 2019. Under the new SBA, Ukraine gets immediate access to credit worth 1.4 billion dollars.

According to preliminary information, the other loan tranches will be released to Ukraine in May and November next year. The World Bank has also granted Ukraine 750 million dollars in loan guarantees. Ukraine last month received a 500-million-euro loan from the European Union after preliminary agreement was reached on the IMF's SBA.

The SBA required Ukrainian authorities to accept a number of loan conditions. For example, regulated energy prices had to be increased to levels close to actual producer costs. The 2019 budget approved by Ukraine foresees a deficit corresponding to 2.3 % of GDP.

Before the new SBA was approved, Ukraine had 9.9 billion dollars in outstanding loans from the IMF. Ukraine's 2019 debt-servicing costs to the IMF will be about 1.9 billion dollars. In total, nearly 5 billion dollars in Ukraine government foreign debt comes due next year.

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China

China celebrates 40 years of economic reform. The milestone was celebrated on Tuesday (18.8.) in the high level meeting in Beijing. The meeting, however, offered nothing new concerning the future of reforms.

In 1978, the Chinese economy was in bad condition when party leader Deng Xiaoping announced that the country was embarking on reforms. The command economy used resources so inefficiently that it had become an obstacle to the country's economic development. In terms of GDP per capita, China ranked with some of the world's poorest countries, including Burundi, Guinea-Bissau and Malawi.

From the beginning, Deng's reforms focused on improving productivity by giving workers and firms new operating possibilities and by opening the Chinese economy to the rest of the world. Under the "household responsibility system" farmers were allowed to farm their own plots of land and after making their quota to the local collective allowed to sell whatever was left. Agricultural output rose rapidly. In the business world, the 1980s saw the government grant small firms increased freedom to operate. The first "special economic zones" were established. Within these zones the business rules were distinctly more flexible than elsewhere in China. The Chinese economy was further strengthened by the fact that decision-making power was devolved from the central government to provinces in the mid-1980s and local decision-makers were given incentives to stimulate economic growth.

The 1980s saw the introduction of a two-tier pricing system that allowed firms to sell production above their quota at market prices. The pricing reform was extended in the 1990s and markets were allowed to play an increasing role in price-setting. In 1994, China unified its dual exchange rates. Two years later, the yuan became fully convertible under the current account. State-owned enterprises were also reformed extensively during the 1990s. Restructuring of the weak banking-sector started and continued well into the 2000s.

China's opening up to the rest of the world began in the 1980s. In order to strengthen the economy, it was necessary that domestic firms got modern machinery and production methods from abroad. Foreign direct investment was allowed in certain fields. China's opening to the world was further boosted by the country's accession to the World Trade Organization (WTO) in 2001. Globalisation got a huge boost as hundreds of millions of Chinese workers were integrated into global production chains. By the end of the decade, China had become the world's largest goods exporter.

Efforts to reform the economy began, however, to wane. As a result, many of the reforms launched over the past ten years in the spheres of monetary policy and financial markets have only been partially implemented. Although the People's Bank of China officially ended interest rate regulation in 2015, commercial banks today still do not compete on rates. While rules on capital movements have been eased, outward capital movements are still highly controlled. The fixed peg of the yuan to the US dollar was abandoned in 2005, but in practice the PBoC still plays a key role in guiding the yuan rate to desired levels. Half-finished reforms have created a messy hybrid system in which participants seek to exploit the advantages of the old and new systems, with a variety of unintended consequences.

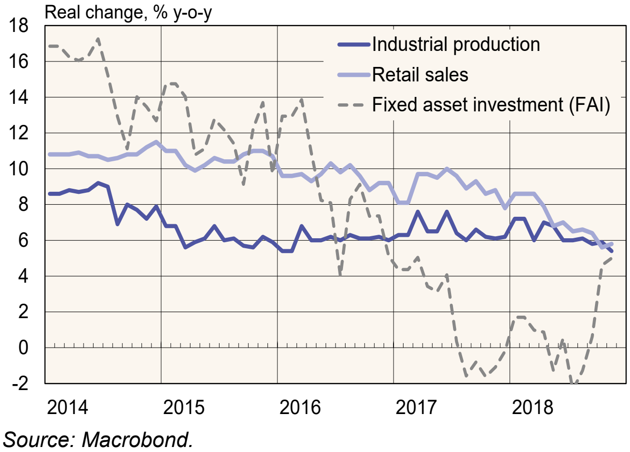
Decades of rapid economic growth have lifted hundreds of millions of Chinese out of poverty. China is the world's second largest economy after the United States. In 2017, China's GDP per capita was on par with Mexico and ranked in the same class of upper middle income countries as Russia.

China's economic growth continues to slow. Figures from the National Bureau of Statistics show industrial output growth slowed in November to around 5 % y-o-y, while retail sales remained under 6 % for the second month in a row. Despite a slight pick-up in fixed investment last month to 5 % y-o-y, weak import and export trends reinforced the perception of a substantial slowdown in China's economic growth.

The situation of the car industry is interesting as the performance of carmakers extends to many other industries and is widely seen as a measure of consumer sentiment. Car sales fell 16 % y-o-y in November, the fifth consecutive month of decline. For the first time in several decades, it appears that growth in car sales will be negative for the entire year. Regarding other consumer goods, mobile phone sales and production seem to have declined which has caused a drop, for example, in the sales of some industrial robots. Some of this has to do with the maturation of China's mobile phone market, uncertainty caused by the trade war with the US and problems in export markets.

China's official statistics, long criticised for their failure to provide a reliable basis for realistic appraisal of economic conditions, are unlikely to improve much over the near term. The central government this week forbid Guangdong province from releasing its own manufacturing purchasing managers' index. The move only added to suspicions that the Chinese economy is in weaker shape than official numbers suggest.

Official monthly core indicators for Chinese economy



Source: Macrobond.

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