SUOMEN PANKKI FINLANDS BANK EUROSYSTEM 1811

Weekly Review
1 • 4.1.2019

BOFIT

Russia

Continued low growth forecast for Russian economy this year. Major forecasts for Russian GDP growth this year run around 1.5 % p.a. The low pace of growth roughly matches that of realised growth during 2017 and 2018.

The forecasts differ in their assumptions about changes in global oil prices from last year (in the first eleven months of 2018, the Brent oil price averaged around 72 dollars a barrel). Several forecasts note diminished sensitivity of Russian GDP growth to oil prices since the adoption of the new fiscal rule and the floating of the ruble's exchange rate. The sensitivity to oil prices remains, however. The fiscal rule limits budget spending mainly through use of a low oil price assumption.

The recovery in household spending is expected to slow with the hike in value-added taxes at the start of this year. Growth is expected to be around 1.5 % this year and just over 2 % in 2020. Fixed investment growth is expected to recover to around 2–2.5 % in 2019 and then accelerate quickly in 2020 on increased government investment. Growth in the volume of Russian exports, which has been brisk in recent years, is expected to slow in coming years to around 2 %. The revival in Russian imports is expected to continue at a rate of a couple of per cent each year.

Russian GDP growth forecasts, 2019−2020

	GDP 2019	20	Oil price, USD 2019	20
Bank of Russia (12/18)	1.2–1.7	1.8–2.3	Urals 55	55
	1.5–2.0	1.8–2.3	Urals 75	75
Ministry of Economy (11/18)	1.3	2.0	Urals 63½	60
World Bank (11/18)	1.5	1.8	71	71
OECD (11/18)	1.5	1.8	80	80
EU Commission (11/18)	1.6	1.8	80½	76½
IMF (10/18)	1.8	1.8	69	65½
Consensus forecast (12/18)	1.5		69	

State banks dominate Russian banking sector. A total of 499 banks operated in Russia at the end of October. Despite the high number of bank businesses, the banking sector is highly concentrated and dominated by state-owned banks. The four largest state-owned banks have over 55 % of the banking sector's total assets. In total, the assets of all state-controlled banks represent about two-thirds of the banking sector's assets. Over the last two years, the state presence in the banking sector has increased as several large private banks failed and were taken over by the central bank. Alfa Bank, Russia's largest private bank, controls about 4 % of the sector's total assets.

However, state-controlled banks are a fairly heterogeneous group. For example, Sberbank, which is majority-owned by the central bank, is in a class by itself. Over half of Russian wages and pensions are paid out through Sberbank. The bank controls nearly half of the market share for household deposits and housing loans. Despite economic recession and sanctions, Sberbank's operations have remained highly profitable. The other three giant state-owned banks (VTB, Gazprombank and especially agriculture bank Rosselkhozbank) have seen earnings strained by their large portfolios of non-performing loans. The government each year has pumped vast amounts of capital into the agriculture bank. This year, for example, it has set aside 40 billion rubles to support Rosselkhozbank.

In addition to commercial banks, government subsidies are granted to fund state development bank VEB. VEB is a 100 % state-owned institution tasked with supporting development of the Russian economy over the long term. VEB's 3.385-trillion-ruble balance sheet is strained by non-performing loans and repayment of foreign currency loans. In the federal budgets of 2017—2019, 150 billion rubles annually have been earmarked for VEB support. Under the government's latest plan, 900 billion rubles are budgeted for VEB recapitalisation and foreign debt repayment in 2019—2024.

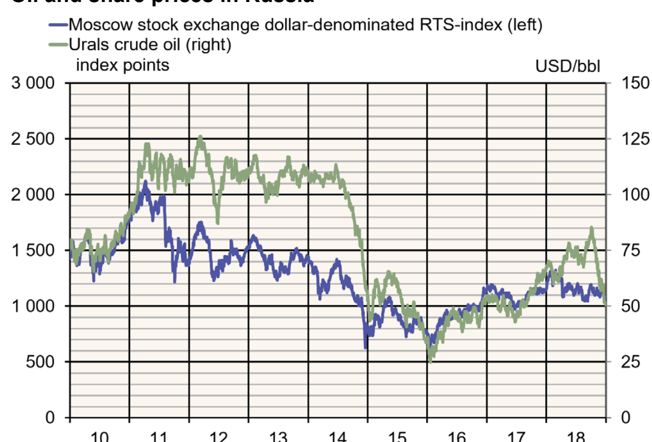
Largest bank groups as of end-October 2018

	Total balance sheet RUB bill.	Share of banking sector balance sheet %	Share of household deposits %	Share of banking sector loan stock %
Sberbank	26896	30	45	35
VTB	13693	15	13	18
Gazprombank	6259	7	3	8
Rosselkhozbank	3231	4	4	4
Alfa Bank	3185	4	4	4

Sources: banki.ru, Central Bank of Russia, BOFIT.

Moscow stock exchange's dollar-denominated RTS index declined 8 % last year. With over half of the RTS general index weighting consisting of companies in the oil and gas sector, it is easy to overlook shifts in the value of companies serving Russia's domestic market. While the shares of oil and gas firms rose by 10 % last year, the prices of firms involved in consumer products and retail trade declined by 27 %. Shares of companies involved with finance were down 34 %. The prices of these shares fell sharply in April and August in reaction to US sanctions announcements. The ruble also dipped during both episodes.

Oil and share prices in Russia



Source: Macrobond.

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China

China starts to the year with darkened outlook. China's economic conditions deteriorated last year as its trade war with the US heated up. Impacts were evident in falling share prices, heightened depreciation pressures on the yuan and financial market spasms. While the triggering factor for market anxiety was the US-China trade war, the roots of the worries are in China's domestic problems such as slowing growth and burgeoning debt.

Share prices on the Shanghai stock exchange fell by about 25 % last year. Overall, China's major stock exchanges lost roughly 2.4 trillion dollars in market capitalisation, an amount roughly equal to 18 % of estimated 2018 GDP. The evaporation of asset value had a knock-on effect that hurt consumer demand as households in China hold an exceptionally large portion of all shares.

The yuan's exchange rate strengthened against the dollar early last year, then began a downward spiral in April as trade tensions increased and the US central bank moved forward with interest-rate hikes. At the end of 2018, the yuan-dollar rate was down 10 % from its April level, even if the decline for all of last year was just 6 %. The yuan gained about 1 % last year against the euro.

The manufacturing purchasing managers' index (PMI) released on the cusp of this year suggests that industrial output growth came to a halt in December, when both the official and Caixin/Markit PMI readings dropped below 50. Chinese growth is increasingly dependent on services, and the services PMI readings are still above the 50 mark.

Share prices on the Shanghai stock exchange

Source: Macrobond.

China's economic work conference produces no big changes in economic policies. In mid-December, mainland China's top decision-makers convened for the annual economic work conference. Reports from the meeting indicated that economic policy is likely to remain on its current course with stimulus supporting economic growth, efforts to improve the quality of growth and industrial development.

The government hopes to deal with slowing economic growth through tax cuts, reduction in fees paid to officials and increased public spending. The biggest spending increases will go to public services such as education, child care, health care, recreation and culture. A number of large investment projects were mentioned such as construction of 5G networks, development of rural transport infrastructure and upgrading of wastewater treatment facilities.

Even if the "Made in China 2025" programme was not mentioned specifically, the government will strive to increasing the sophistication of technologies used in manufacturing and give greater support to innovation. Another goal is to shutter unprofitable "zombie" businesses, while making state firms generally bigger and stronger. For example, China plans next year to turn the state railways into public corporations. Due to massive investment, China's railways are currently struggling with trillions of yuan in debt while losing tens of billions annually. A science and technological innovation board was proposed for the Shanghai stock exchange.

There was also renewed commitment to opening up the economy to foreign investors. Direct investment by foreign firms in China will be made easier and intellectual property protections improved. Official payments related to imports will be reduced. Immediately after the meeting adjourned, China announced plans to amend the law governing foreign direct investment so that mandatory technology transfers are banned and state-owned enterprises eliminate all excess benefits. The measures as stated respond to many of the foreign grievances aired against China, but it waits to be seen what those measures look like when implemented.

Slowdown in China's economic growth expected to continue in 2019. The slowing in China's GDP growth is largely driven by weakening domestic demand. However, foreign demand is also expected to weaken as growth in China's export markets is slowing and no peace in the current trade war with the US is on the horizon. China is expected to press ahead with some stimulus measures though a substantial debt overhang precludes any major stimulus programme.

Bloomberg's compilation of economic forecasts see GDP growth slowing to the range of 6–6.5 % in 2019 and 6 % in 2020. The spread across forecasts is surprisingly narrow. If the forecast in economic growth materialises, China will achieve its target of doubling real 2010 GDP by 2020. Economic forecasts for China suffer from the unreliability of official GDP figures. When official GDP figures fail to reflect reality, forecasts are fundamentally flawed from the get-go.

Looking beyond the traditional business cycle, it is apparent that Chinese economic growth inevitably slows over the longer term. China's population is aging quickly and the labour force is shrinking. Productivity gains are increasingly difficult to achieve and the structural evolution to a service economy makes productivity gains even harder to achieve. Increasing growth in fixed investment is particularly challenging as the investment ratio is already excessively high. The sheer size of the Chinese economy and environmental problems also hamper possibilities for high growth.

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