Weekly Review
17 • 26.4.2019

BOFIT

Russia

Steady rise in Russian industrial output. According to Russian Statistics Service, the volume of industrial output rose by 2.1 % y-o-y in the first quarter of 2019.

The output volume for mineral extractive industries was up 4.7 % y-o-y. This reflects to some extent changes in the production ceiling agreement reached among a group of oil-producing countries. Last June, Russia and other countries interpreted earlier agreements in such a way that they could increase oil output. As a result, Russia's oil production grew by 4 % from June to October. In December, a new agreement was reached and Russia committed to cutting back on production by about 2 % (BOFIT Weekly 50/2018). The cuts are to be made during the first half of this year. Russian oil output declined by 1 % from December to March.

Manufacturing production volumes grew by 1.3 % y-o-y in the first quarter. Production of foodstuffs, beverages and paper were among the fastest growing branches. The clothing and textile industries were among the weakest performers.

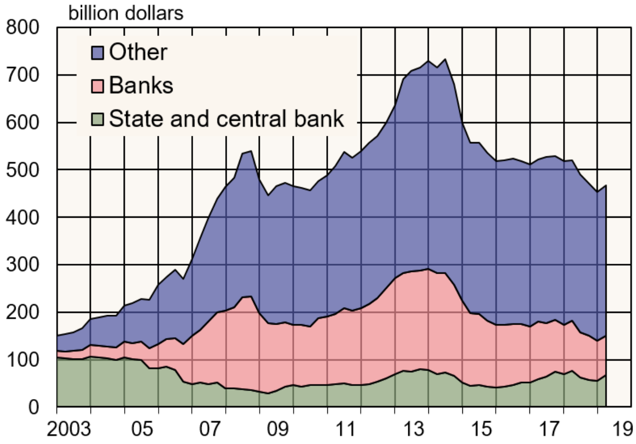
Construction activity rose by 0.2 % y-o-y in the first quarter. However, there are still grave concerns about the reliability of these numbers. The revised numbers released at the start of the year lifted the construction activity sharply to show a 5.3 % y-o-y increase in 2018. At least part of the revision seemed to be due to late recording of oil and gas projects in northern Russia. Given that the most intensive phase of construction on the Arctic coast is ending, construction activity can be expected to cool in the year ahead.

Russia's foreign debt up slightly in the first quarter. Growth in Russia's foreign debt basically came from government foreign debt. Russia's foreign debt is held mainly by non-bank corporations, banks and the government. Foreign debt has declined from a mid-2014 peak of about 733 billion dollars to around 468 billion dollars at the end of March.

Russians have reduced their foreign debt since the 2014 peak, mainly by paying down debt, due to sanctions and Russia's weak economic performance. Russians also paid down foreign debt during the 2009 financial crisis. However, the level of indebtedness at that time recovered rapidly after the crisis. The impact of sanctions is most evident in the continuous reduction of foreign debt of Russian banks. Russia's largest banks, which include giant Sberbank and VTB, are not able to get any new long-term financing from EU countries or the US.

At the end of March, the Russian government's foreign debt amounted to little over 53 billion dollars (11 % of total foreign debt). Banks owed over 82 billion dollars (18 %). Other sectors, mainly corporates outside the financial sector, owed about 318 billion dollars (68 %) to lenders abroad. Of that, 142 billion dollars was intragroup debt, i.e. debt owed between parent and subsidiary companies of the same corporate group.

Russia's foreign debt, 2003−2019



Source: Central Bank of Russia.

Recent restrictions on Russian trade add to challenges facing Ukraine's new leadership. The serious issues in Russia-Ukraine relations since the annexation of Crimea have been amplified by the latest rounds of trade restrictions. Russian economy minister Maxim Oreshkin estimates the restrictions imposed by Russia on Ukrainian goods affect nearly 30 % (4.3 billion dollars) of bilateral trade.

Russian president Vladimir Putin ordered his government last autumn to move ahead with new special economic measures on Ukraine in response to Ukrainian measures on Russian firms and individuals. In December, the government imposed new import bans on select Ukrainian goods. At the end of 2018, Ukraine extended its import bans of 2016 to the end of 2019. Russia last week widened its list of import bans and placed export bans and licencing processes on exports to Ukraine. Commodities subject to export licences include coal, coke, gasoline and diesel oil. Ukraine imported from Russia 3.5–4 billion dollars of these commodities in 2018.

Early this month, a WTO dispute settlement panel issued a first-time conclusion regarding the grounds for Russian transit bans imposed on Ukrainian goods, particularly in January 2016. Russia argued that the measures were necessary to protect "essential security interests" in an "emergency in international relations". Against Russia's view, the panel saw it had jurisdiction to review the matter. In the panel's view, Russia's basis for its bans comply with WTO rules. A focus was on deterioration of Russia-Ukraine relations to such a point that they constituted an international emergency. The panel saw evidence in a reference to armed conflict in a UN General Assembly Resolution on the Crimean situation, and third-country sanctions imposed on Russia. The panel stressed that in the absence of this international emergency the transit bans would appear to be inconsistent with WTO rules. The parties have 60 days to appeal.

In the second round of Ukraine's presidential election, Volodymyr Zelenskyi beat the incumbent Petro Poroshenko by gaining more than 73 % of votes against Poroshenko's just over 24 %. Voter turnout was 62 %.

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China

China moves slowly to dismantle hukou household registration system. The National Development and Reform Commission (NDRC) last week announced that this year all cities with populations of 1 to 3 million shall grant *hukou* status to anyone requesting it. For cities of 3–5 million inhabitants, the rules on petitioning for hukou status will be eased. For cities with populations of more than 5 million, the requirements for obtaining household registration shall be clarified so that more people have the opportunity to obtain hukou rights.

China has moved slowly in dismantling the hukou system. The latest reforms are part of a broader package approved already in autumn 2013 and an implementation plan published in spring 2014 (BOFIT Weekly 14/2014). Ending the hukou system is a critical reform as it makes it easier to move around and increases the equality between the rural and urban population. The government hopes it will accelerate urbanisation and sustain economic growth. As of end-2018, about 60 % of the Chinese lived in cities.

Hukou status is determined by place of birth. Changing status to another jurisdiction is difficult, especially if a person wants to move from the countryside to a city. Hukou complicates access of internal migrants to public services such as healthcare and education for their children because the services are tied to hukou status. Services, however, can usually be accessed today by paying additional fees. Some cities have arranged services specifically for the migrant community.

Even if the hukou system complicates moving around the country, it hasn't prevented people from moving to places with better job prospects. The National Bureau of Statistics reports that China had 288 million internal migrants in 2018. The average age of an internal migrant is 40 and about two-thirds are men. Roughly speaking, half of China's migrant workforce find jobs in the service sector, 30 % in manufacturing and 20 % in construction.

IMF still sees elevated risk for China's financial sector. In the latest *Global Financial Stability Report* released this month, IMF finds that China's tightened financial sector supervision and regulation has partly slowed the growth in bank balance sheets and risks, but further notes that the financial sector still has major vulnerabilities.

Distortions in how funds get distributed constitute a problem for the entire financial sector. As the government is expected to support real estate prices in troubled times and as financing is raised commonly by an entity assumed to have full government backing, banks continue to provide cheaper financing for real estate and infrastructure projects than for other branches. In recent years, such favourable lending has increased faster than other lending, increasing the already high land and real estate prices. Infrastructure projects may also lack sufficient cash flow to pay back loans, with the result that such loans end up on the public ledger.

The IMF noted specific problems facing China's small and mid-sized banks. Many of these banks have weak balance sheets, low profitability and are barely able to meet capital requirements. The IMF recommended that these banks cut back on lending to bolster their balance sheets.

The IMF sees that easing of monetary and credit policies to stimulate the economy could only exacerbate the financial sector vulnerabilities and at the end it might risk the financial stability.

Last year saw fewer new apartments built for the Chinese market than in previous years. According to the NBS, the volume of completed building area (measured in terms of floorspace) in 2017 and 2018 declined relative to previous years and that the drop continues this year. The volume of real estate sales has been quite steady, however, and the inventory of unsold real estate has declined.

The volume of new buildings completed in the first three months of this year fell by 11 % from the same period in 2018 to 185 million m² of floorspace. Of that, 130 million m² was residential buildings. In contrast, building starts measured in floorspace were up by 12 % y-o-y in the first quarter.

The total floorspace of buildings sold in January-March was 298 million m², of which residential apartments were 260 million m². Both declined slightly from the same period last year. Sales have risen steadily overall at the national level, and last year apartment sales measured by floorspace were up by 2 % from 2017. There are huge regional differences in sales trends, however. For example, apartment sales in Beijing recovered considerably in the first quarter from last year's decline, while apartment sales in Guangdong, one of China's largest provinces, saw its decline in apartment sales continue.

Chinese regulations on buying and selling apartments are city-specific, so sales volume and price trends vary considerably. In many small or mid-sized cities, prices are rising at 10–20 % y-o-y. Most of the decline in prices take place in China's big cities. Housing-market tracker SouFun found that in March average prices were lower than year ago in 5 of its 99 cities surveyed. The weighted average price per square metre of apartment floorspace rose by 4 % y-o-y. The price levels in Beijing, Shanghai and Shenzhen are now the same as in March 2018.

Average apartment prices in select cities

Sources: SouFun and Macrobond.

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