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Weekly Review
23 • 7.6.2019

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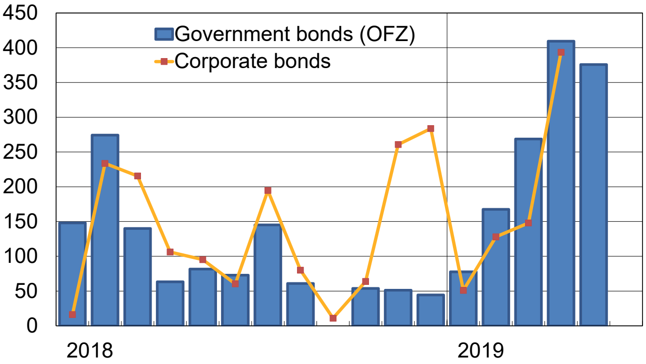
Russia

Russian share prices up this year; substantial growth in bond markets. The revival of investor interest in emerging markets has been apparent in Russia's financial markets. Share prices this year have also been buoyed by rising global oil prices and expectations of juicy dividends from Russia's biggest corporations. The Moscow Stock Exchange's RTSI index is up about 15 % from the start of this year, and now matches levels reached in early 2018. The improved market conditions have raised interest in ruble-denominated corporate debt securities and government treasuries.

During the first five months of the year, the finance ministry issued government bonds worth roughly 1.3 trillion rubles (18 billion euros), an amount greater than all issues in 2018. A monthly record of 404 billion rubles (5.6 billion euros) in new debt was sold in April. Government treasury issues remained brisk in May with the sale of 376 billion rubles in new issues. While the Russian government has no big need to issue debt, the current favourable market conditions have motivated the government to move up scheduled debt issues. The Central Bank of Russia reports that foreign investors purchased 45 % of treasury issues in April. Foreign investors currently hold about 27 % of all government ruble-denominated debt securities. Although the share has increased sharply in recent months, it is still smaller than in early 2018. Increased demand has reduced yields and the yield on e.g. the 10-year OFZ treasury bill is now below 7.9 %. The CBR's key rate is currently 7.75 %.

Investor appetite for corporate bonds has increased substantially. In the first four months of this year, 720 billion rubles (10 billion euros) in new corporate debt securities were issued. The lop-sided structure of the Russian economy is well-reflected in the bond market. About 40 % of corporate debt securities have been issued by financial institutions and about 31 % by oil & gas companies.

New bond issues, RUB billion

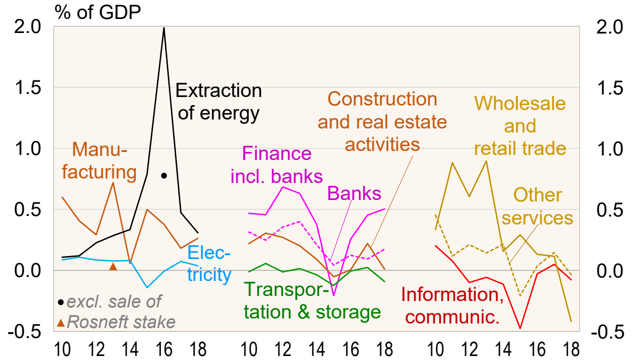


Source: Cbonds.

Fewer sectors in Russia targeted for direct investment from abroad. In recent years, FDI inflows have overwhelmingly focused on the financial sector, the energy sector (basically oil & gas production) and manufacturing. The amounts of FDI inflows to the oil & gas and manufacturing sectors have fallen notably, however, in the past two years.

The amounts of FDI flowing to the banking sector, as well as the construction and real estate branches, have diminished significantly from the years early this decade. An even more severe contraction in inward FDI has hit the trade branch, which witnessed a net pull-out of inward FDI last year. The allure of various service branches (mainly corporate services) has faded.

FDI inflows to major sectors of Russian economy, 2010–2018



Sources: Central Bank of Russia and Rosstat.

Intra-elite competition increasingly reflected in institutional behaviour in Russia and the economy more broadly. Observers note that the Duma's increasingly proactive role in legislating and the rise of competition among security services and state-owned companies exemplify Russia's shifting domestic internal power balance. It reflects behind-the-scenes jockeying for position among Russia's elites and preparations for the end of president Putin's fourth term in 2024.

As the latest example of the confusion created by the dispersed political landscape, experts cite the March arrests of Michael Calvey, CEO of the private equity firm Baring Vostok, along with five other businessmen. While Calvey was accused of embezzling billions of rubles, he atypically avoided being held in custody while the case was investigated and granted house arrest while awaiting trial. Kremlin spokesman Dmitry Peshkov said this week that he hoped that Calvey and the other accused would be vindicated. Observers say the inconsistent treatment shows a lack of official coordination.

President Putin's long-term goal has been to create a tightly concentrated vertical power hierarchy. Observers say current system relies too heavily on micromanagement from the top, i.e. everything that is not specifically permitted is forbidden. Inverting this power hierarchy means that the Kremlin relaxes its grip on guidance of other institutions. Doing so, however, reduces the predictability of official measures. Some observers claim the Security Council is emerging as the principal body of power, where the top members of the power elite meet to decide on national security and economic issues.

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China

China intensifies anti-US rhetoric. China released a white paper last Sunday (Jun. 2) accusing the US of walking away from the current round of trade negotiations and making unreasonable demands on China. In response to the hikes in US import tariffs that went into effect on May 10, the Chinese raised countermeasure tariffs on US imports, effective June 1 (see BOFIT Weekly 20/2019). Over the past weeks, exchanges between the two countries have heated up and moved from targeting goods to specific businesses.

It remains unclear as to whether the countries plan to resume talks when their presidents meet at the G-20 summit at the end of the month. The negotiation stakes have risen since president Donald Trump in mid-May banned US firms from using telecom equipment that posed a threat to national security. In practice, the ban was directed at Chinese technology giant Huawei. Furthermore, the US commerce department banned firms from doing business with Huawei without first obtaining a special permit. While this effectively halts deliveries to Huawei of critical components and systems, products already in existence have been given a 90-day extension as of May 20.

China's commerce ministry plans to release its own list of "unreliable firms and persons" and national development and reform commission (NDRC) suggested the country may consider export restrictions on rare earth metals if products made from them are used against China. In addition, officials have asked Chinese tourists and students planning to go to the US to reassess carefully the risks involved, and warned Chinese companies operating in the US to prepare for increased harassment from law enforcement officials. Moreover, Chinese news coverage has recently grown critical of the US.

Another troubled Chinese bank hits the headlines. Bank of Jinzhou's announcement last Friday (May 31) that it was changing its auditors precipitated a strong reaction from China's bond markets. Ernst & Young's auditing team quit after differences arose with the bank's management.

The auditors said the bank failed to provide the requisite information and documentation on credit reviews of loan recipients, which raised suspicions that some corporate clients were using their credit for purposes outside the loan agreements. The bank's 2018 financial statement have yet to be published or ratified. Bank of Jinzhou's total assets (about 110 billion dollars) make it slightly larger than Baoshang Bank, which officials recently took over (see BOFIT Weekly 22/2019). One of the main indicators of Baoshang's distress was the refusal of its management to release the financial statement.

Like Baoshang, Bank of Jinzhou expanded rapidly in recent years. Its balance sheet grew by nearly 50 % in 2016 and over 30 % in 2017. In particular, lending to industrial firms grew quickly. Jinzhou Bank is mostly owned by private Chinese investors. It has a very broad ownership base. Jinzhou shares are listed in Hong Kong. Trading in Jinzhou shares was suspended in April on the delayed release of the bank's financial statement. However, there is still a market for Bank of Jinzhou's debt instruments (AT1 instruments), which will be first in line to cover the losses of weakened solvency of the bank. The market price for Bank of Jinzhou AT1's on Monday (Jun. 3), was about 78 % of their nominal value.

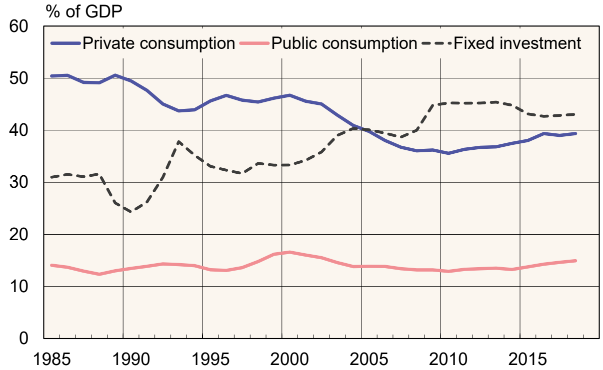
With the severe troubles of two privately held banks within two weeks, wider concerns have arisen about the condition of the Chinese banking sector, particularly small and mid-sized banks and the correctness of financial statements. Small banks are especially dependent on funding from the interbank market, so increased uncertainty can cause their financial health to degrade quickly. The People's Bank of China attempted to calm markets last weekend by declaring that it had no plans to take over any more banks.

The structure of Chinese GDP changes only slowly. At the end of May, National Bureau of Statistics published the demand structure of GDP for 2018. China's evolution towards a consumption-driven economy seems to be making slow, if any, progress. Fixed investment, which corresponded to an astronomical 43 % of GDP last year, grew slightly. Both private consumption (39 % of GDP) and public consumption (15 %) also increased their shares of GDP slightly. The GDP share of net exports of goods and services fell below 1 %.

China's ratio of fixed investment to GDP is remarkable by any measure. Similar ratios are only temporarily seen is small developing countries and more persistently in unusual economies like Bhutan. During Japan's rapid development in 1960–1990, the ratio of fixed investment to GDP averaged slightly more than 30 %, reaching a peak of just over 36 % in the 1970s.

The size of an economy is usually measured roughly speaking either by figuring out the amount of goods and services produced (supply measure) or determining the amount of goods and services used (demand measure). China has traditionally measured the supply, while Western economies typically primarily measure the demand. Notably, the two measures of Chinese nominal GDP have begun to diverge in recent years. China's supply-measure GDP for 2018 is 1.6 trillion yuan (nearly 2 %) larger than the demand measure, even if in principle they should be equal.

China's evolving demand-side economic structure



Sources: China National Bureau of Statistics, CEIC and BOFIT.

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