Weekly Review
44 • 1.11.2019

BOFIT

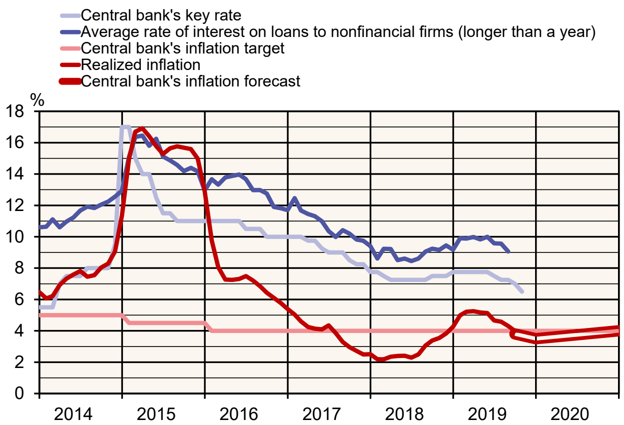
Russia

Central Bank of Russia lowers key rate. Last Friday (Oct. 25), the Central Bank of Russia lowered its key rate by 50 basis points. The new key rate is 6.5 %. The CBR board noted that 12-month inflation has slowed faster than forecasted. The rate cut was fourth in this year. The board also pointed out that the key rate could be cut further at one of the upcoming meetings.

12-month inflation slowed in September to 4 %, and the CBR estimated that it has further decelerated in October. Underlying the slowing inflation are such factors as rather weak economy, ruble appreciation against the dollar (up about 9 % from the start of the year) and a good harvest. The CBR now expects 12-month inflation to slow to a range of 3.2–3.7 % (previously 4.0–4.5 %) at the end of the year, around 3.5–4.0 % at the end of 2020 (previously 4 %) and thereafter remain close to the CBR's 4 % inflation target.

Market rates have declined following the CBR's key rate cuts. In August, the average rate on ruble-denominated corporate loans of more than one year was around 9 %. Ruble-denominated household loans of more than one year averaged around 13 %.

Russian interest rates and inflation



Sources: Macrobond, CEIC.

Russia's foreign debt increased slightly this year. At the end of September, Russia's foreign debt amounted to 470 billion dollars, including about 60 billion dollars in short-term debt. This year Russia's foreign debt has increased by 17 billion dollars, mostly due to rising government-sector borrowing. Non-bank corporate sector debt also rose, while banks continued to pay down debt.

The Russian government's foreign debt at the end of September amounted to 65 billion dollars, its highest level in over a decade. Most of this year's 20-billion-dollar increase in foreign debt came from ruble-denominated debt held by foreign investors. The Russian government has also issued roughly 6 billion dollars in eurobonds this year. Government borrowing is not essential; the federal budget continues to show large surpluses and excess earnings from oil have been set aside in the reserve fund. In the future, however, the issuance of foreign-currency debt by the government will be complicated by the US sanctions that went into effect at the end of August. The Russian government continues to hold little foreign debt, as it currently corresponds to about 4 % of GDP.

At the end of September, Russian banks still owed 74 billion dollars in foreign debt. However, banks have been actively reducing their bank debt since the 2013 peak of 214 billion dollars. Western sanctions are a key reason for banks paying down foreign debt so aggressively. The foreign debt of the non-bank corporate sector has increased slightly this year, standing at 322 billion dollars at the end of September.

New information about Russia's military-industrial complex and its bank debts. Russia's military industrial complex (*Oboronno-promyshlennyi kompleks*, OPK), which comprises over 1,300 firms, accounts for roughly 3 % of Russia's GDP according to analysts at Promsvyazbank, which was formed specifically to provide OPK financing. The OPK revenues of 65 billion euros last year correspond roughly to 2 % of total revenues of all Russian firms and organisations. The OPK provides nearly 2 % of Russian jobs.

Nearly half of OPK revenues in 2018 came from government defence orders, while another fifth came from civilian products and about 30 % from exports of defence products. For meeting the goal set to increase the share of civilian products to 30 % by 2025 requires increased financing from company revenues and banks.

Russia's OPK is currently quite heavily indebted, with its domestic bank debt at 2 % of GDP. OPK debts account for about 5 % of loans extended to the entire corporate sector by the domestic banking sector, but for significantly much more of the bank debt of the manufacturing sector. The ratio of bank debt to revenues in OPK is about 40 %, which is much higher than in the rest of the manufacturing industries. About 3–4 % of OPK revenues go to paying interest on bank loans.

According to deputy prime minister Yuri Borisov, who was raised to his new post last spring, about a third of OPK bank loans need to be restructured, an amount that corresponds to over 0.5 % of GDP. The situation resembles that of late 2016, when the government doled out from the federal budget in one go an amount corresponding to nearly 1 % of GDP in order to help OPK firms repay their bank loans.

OPK bank debts (including problem loans) are largely held by three big state-owned banks, i.e. Sberbank, VTB and Gazprombank. Part of their OPK loans have been transferred to Promsvyazbank, which currently holds about 20 % of OPK bank loans.

President Putin has asked all concerned to find solutions to OPK financing problems. Now the plan is to combine several approaches to deal with the problem loans. The government and creditor banks are considering the proportions to be used in combining remedies such as e.g. extensions of repayment times, recapitalisation of OPK firms with government budget funds and debt forgiveness.

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
44 • 1.11.2019
BOFIT

China

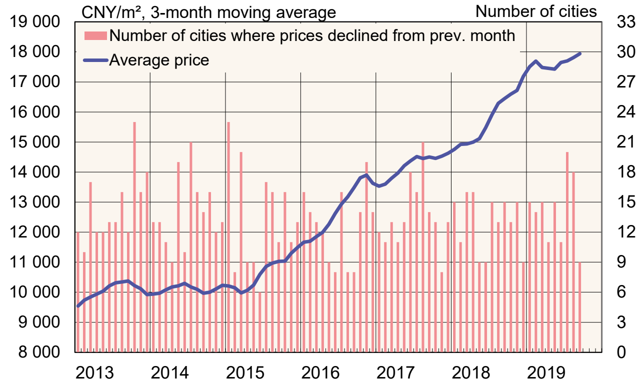
Chinese housing prices are rising, but huge regional differences persist. Based on the National Bureau of Statistics (NBS) 70-city sample, prices of existing apartments were up by 5 % y-o-y on average in September, while prices of new apartments rose by 9 % y-o-y. NBS figures indicate that price trends over the past two years have been quite stable and differences between cities range from drops of several per cent to increases of nearly 20 %. Other information, however, suggests that price changes and regional differences in price trends are actually much larger.

SouFun, a major real estate portal that tracks apartment prices, reported that average prices of new and existing apartments in its 31-city sample were up by 11 % y-o-y in September. SouFun's reported differences across cities are larger than those reported by the NBS, with price trends ranging from a 10 % drop in some cities to dozens of percent increases in many others. Prices were down in September from August in nine of the 31 cities in the sample. There were 18–20 cities showing declines in July and August.

SouFun's figures show that apartment prices (measured in liveable floorspace) in September were up on average by 14 % y-o-y in Beijing, 10 % in Shanghai, 12 % in Guangzhou and 6 % in Shenzhen. Among these cities, prices for a square metre of apartment ranged from 57,500 yuan (7,300 euros) in Shenzhen down to 29,200 yuan (3,700 euros) in Guangzhou. The average price in the total 31-city sample was 18,300 yuan (2,300 euros) per m². Housing prices in China, when disposable household incomes are noted, are among the highest in the world.

Housing construction is a fundamental driver of the Chinese economy. While new housing starts in terms of floorspace were still up in the third quarter by 6 % from 3Q18, growth in the volume of new starts faded. In 3Q18, new apartment starts were up by 27 % y-o-y. Construction companies have acquired rights to far fewer lots than a year ago.

Apartment prices (CNY/m²) and number of cities where prices fell from the previous month (31-city sample)



Sources: SouFun-CREIS, Macrobond.

IMF reports risk exposure of China's financial sector remains large. The IMF's latest *Global Financial Stability Review* notes that while financial conditions in China are relatively stable, the risks confronting the financial sector are daunting. Problems concern almost all actors in the financial sector, i.e. banks, other financial entities, the non-bank corporate sector and households.

In the latest stability report, the IMF focuses specifically on risks facing the corporate sector where most Chinese debt is concentrated and where there is great uncertainty about the ability of borrowers to service their loans. The IMF estimates that the debt of companies where debt-servicing costs exceed earnings now corresponds to about 35 % of GDP. Such debt is expected to soar to around 70 % of GDP if China experiences a rapid economic slowdown and financing dries up. When corporate revenue is inadequate to service debt, the problems are likely to be manifested in the banking sector.

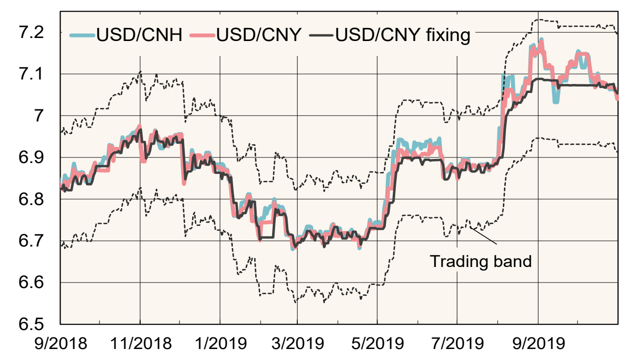
The IMF also called attention to last summer's bailouts of three banks (Baoshang, Jinzhou and Hengfeng) as they highlight the challenges facing small and mid-sized banks. The IMF said it was critical for China to rapidly establish a bank resolution system along with other financial market reforms.

No major changes in the yuan's exchange rate since August. In response to the US announcement at the beginning of August of new tariff increases, the yuan's exchange rate weakened to a rate of over 7 yuan to the dollar. At the end of August, the yuan weakened further with the US announcement of new tariff increases, even if they were not implemented after further talks. The yuan has since recovered somewhat. The US has kept its exchange rate concerns, however, at the top of the negotiating agenda in the current bilateral trade talks.

In recent months, central bank's daily yuan-dollar fixing rate has typically been stronger than the market rate. On the markets, the onshore USD/CNY rate is allowed to diverge by up to 2 % from the daily fixing rate. The CNH rate in Hong Kong, which in theory floats freely without limits on its fluctuations, closely tracked the CNY rate throughout October. The rates sometimes diverged during August and September.

The yuan-dollar rate at end of October was 2 % weaker than at the start of the year (the euro rate was unchanged).

Yuan-dollar rates in mainland China (CNY) and Hong Kong (CNH)



Source: Macrobond.

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