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BOFIT Weekly

16 • 20.4.2012

Russia

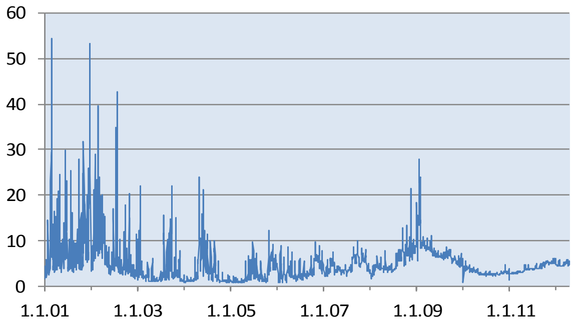
CBR expands its monetary toolkit. The Central Bank of Russia this month introduced a new one-week deposit instrument and modified certain market operation practices. The CBR said the purpose of the moves was to improve the effectiveness of interest-rate policy, as well as to reduce the gap between deposit and credit rates to limit volatility in market rates. Compared to advanced economies, CBR interest-rate policy is still ineffective and needs to be improved in order to gradually shift from ruble exchange rate steering to inflation targeting as planned by the CBR and the government.

The CBR's current view is that the days of large excesses in money market liquidity as seen in the mid-2000s are gone forever. To help banks meet their financing needs, the central bank has extended the maturities of certain credit instruments and increased their availability by e.g. easing collateral requirements.

At its April 9 meeting, the CBR board decided to leave rates unchanged. The one-day repo credit rate, the CBR's key open market operations rate, was kept at 5.25 %. Central bank chairman Sergei Ignatyev said he expects interest rates to decline a bit in the near future.

In February, the average interest rate on ruble-denominated bank loans of under a year granted to firms was 8.9 %, while the average rate of household deposits of under a year was 5.3 %. In the interbank market, the one-day Moscow Interbank Actual Credit Rate (MIACR) has fluctuated around the 5 % level in the first three months of this year.

One-day Moscow Interbank Actual Credit Rate, % p.a.



Source: CBR

Government eyes return to tighter fiscal policies. Presidential economic policy advisor Arkady Dvorkovich said a decision in principle had been reached at the start of this year to limit federal budget spending so that tax revenues from oil and gas are not devoted entirely to spending, but part of revenues will again be set aside in reserve funds, reinstating similar practice as used prior to the 2008–2009 financial crisis. Starting in 2003, Russia began to collect a share of oil and gas revenues in off-budget reserve funds instead of using all of them for budget expenditure. In 2008, the build-up of the reserve funds was halted due to the collapse of global oil prices and economic recession in Russia. Money from the Reserve Fund was used to finance the federal budget deficits in 2009 and 2010.

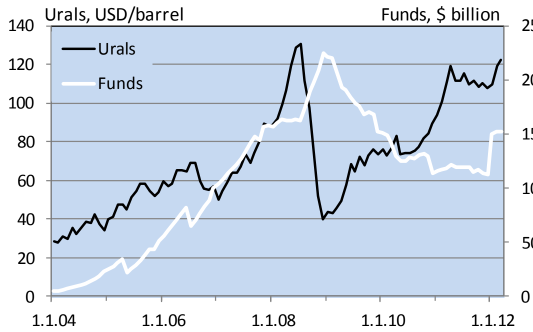
Many oil producing countries collect part of their oil revenue in off-budget funds. Also Russia's leaders view that it is necessary to return to systematic building of the reserves. At the request of president Dmitri Medvedev, the finance ministry submitted in April a proposal on new principles for collecting funds to the reserves. Under the proposal, the part of revenues from taxes and fees on production and export of oil, petroleum products and gas that is due to oil price exceeding its previous ten-year average in the global market, would be set aside. If the price is lower than this average, then no money would be allocated to the reserve funds. This approach would mean that fiscal policy be tighter than at present, albeit still looser than before the recession when a considerably larger share of revenue from oil earnings was channelled to the reserve funds.

Over the past ten years, the price of Urals-grade crude oil has averaged $61 a barrel. If the suggested allocation principle were applied directly to the budget starting next year, it would require slashing current budget spending by nearly half. For this reason, the finance ministry has proposed that over the next three years a smaller share of revenue be shifted to the reserve funds (e.g. next year to reserve funds would be transferred the share of tax revenues originating from the oil price exceeding $102 a barrel). Starting 2016, the government would use the ten-year average.

The cabinet is still not in full agreement on the proposed spending arrangement; discussions on this topic could go on for a long time.

As of end-March, Russia's reserve funds held assets totalling $152 billion. Of that, $62 billion was in the Reserve Fund to cover budget deficits in coming years. The remaining $90 billion was in the National Welfare Fund, which is meant to be used e.g. for the pension system reform.

Price of Urals crude (left scale) and reserve funds (right scale)



Sources: Russian Ministry of Finance, Bloomberg

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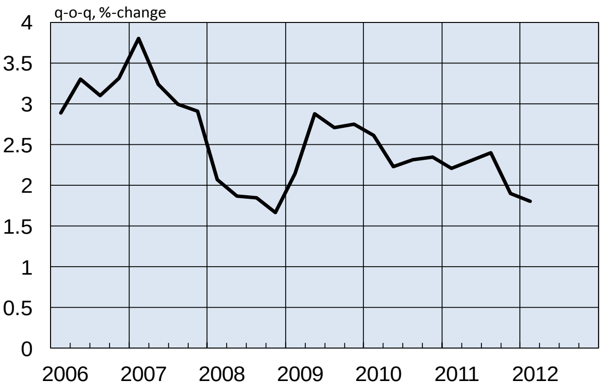
China

China's economic growth slows as expected. China's National Bureau of Statistics reports real GDP growth in the first quarter climbed 8.1 % y-o-y and 1.8 % q-o-q. Both measures were lower than in the fourth quarter of 2011, when real growth was 8.9 % y-o-y and 1.9 % q-o-q. Realised growth was in line with consensus forecasts in the range of 8–9 % for this year, including BOFIT's own projection of 8 %. Despite consensus projections, markets expected China to release slightly bigger numbers.

Quarterly change in China's GDP growth (percentage change from previous quarter, seasonally adjusted)



Sources: BOFIT estimates for 2006–2010 and official NBS quarterly figures for 2011 and 2012

Other economic figures released in conjunction with the GDP numbers also were in line with expectations. Notably, there were still no indications that the Chinese economy has begun its much-touted shift from an investment-driven regime to consumption-driven growth. Retail sales growth, an indicator of domestic consumption, has been fairly stable in recent months. Although the rate of investment growth has slowed, the increase in fixed capital investment continued to outstrip growth in retail sales in the first quarter.

The slowdown in construction activity continued in the first quarter as measures implemented over the past two years to calm overheating in the sector take effect. In the first quarter, prices of new and existing apartments fell in almost every major city in China, there were fewer housing project starts compared to a year earlier and sales of residential and commercial properties, as well as land-use rights, were down on-year. In addition, stocks of existing commercial space and apartments for sale were up. Confidence in the real estate sector today stands at near-historical lows, and builders expect prices to decline much further. The first wave of small construction company bankruptcies has already occurred. Despite the weak situation, the mood in the sector seems surprisingly calm.

People's Bank of China widens yuan-dollar fluctuation band from 0.5 % to 1 %. The change that entered into force on Monday (Apr. 16) concerns the maximum allowed fluctuation in the yuan's interbank spot foreign exchange rate during a given business day. While the move has little impact for the general public, it is considered to be an important step towards freer yuan convertibility. Currently, it is expected that People's Bank of China will move to free convertibility of the yuan by 2015.

After a one-and-a-half-year episode of yuan appreciation against the dollar, the yuan-dollar rate has held quite steady over the past four months. Both the official Shanghai yuan-dollar rate and the Hong Kong off-shore rate have stabilised around the 6.3 level. Moreover, expectations of yuan appreciation in the forex markets appear to have evaporated; 12-month yuan futures rates are no different from the current exchange rate level.

According to media reports, the central bank sees the current yuan-dollar exchange rate at or near equilibrium. One piece of evidence cited is that the trade balance overall was near perfect balance in the first quarter of 2012. On the other hand, it is typical for China to post its weakest trade balance figures for the year in the first quarter, which always embraces the Chinese New Year holidays. Growth in China's foreign currency reserves slowed in January-March, even if the PBoC appeared to be purchasing foreign currencies on the market to prevent yuan appreciation. Should the trade surplus start to increase rapidly in the current quarter and growth in the foreign currency reserves accelerates, the debate about the yuan exchange rate will no doubt resurface again.

Yuan-dollar exchange rate, Shanghai and Hong Kong

Source: Bloomberg

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