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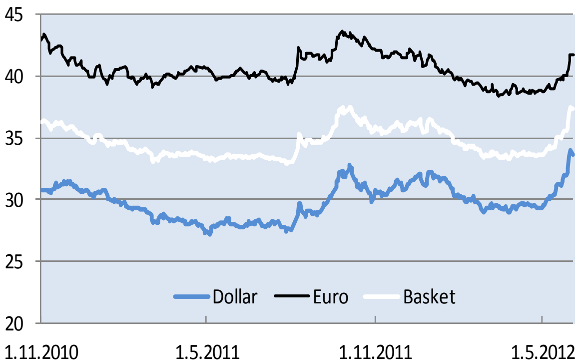
BOFIT Weekly
23 • 8.6.2012

Russia

Ruble drops along with crude oil prices. The ruble has lost ground against its binary dollar-euro currency basket since the end of April. Last weekend, the ruble's value brushed against the 38.15 basket ceiling set by the Central Bank of Russia. The market uncertainty was enhanced by the fact that the CBR has according to its modified exchange rate policy during the past few years gradually allowed wider swings in the ruble's exchange rate. The situation calmed after the CBR interventions and the bank's announcement that it would not let the ruble stray above the basket's upper band limit. This week the ruble showed modest appreciation.

Since the end of April, the ruble has lost 11 % of its value against the dollar and 6 % against the euro. The steep drop in the ruble-dollar rate also reflects the appreciation of the dollar in international currency markets as worried investors fled to safety. Despite the ruble's recent recovery against the dollar, it is still weaker than at the start of this year. The ruble has strengthened slightly against the euro since the start of the year.

Dollar-ruble, euro-ruble and basket-ruble exchange rates



Source: Bloomberg

The drop in world oil prices is a big reason for the ruble's decline. The price of North Sea Brent crude fell last week below the $100-a-barrel mark, a level not seen since early February. Although Russia's main export oil grade, Urals, is slightly cheaper than Brent due to its higher sulphur content, it closely tracks changes in the Brent price.

Depreciation of the ruble also reflects uncertainty in the global economy that is causing investors to retreat from emerging markets. The CBR estimates that net exports of private capital from Russia in May amounted to around $6 billion. Since the start of the year, the net capital outflow has been $47 billion. Capital exports have been driven largely by non-bank firms in the form of e.g. direct investment. Banks have also been active in capital exports, and in addition they have seen reductions in their stocks of deposits, loans and investments from abroad.

The high level of capital exports is in part a natural consequence of Russia's massive earnings on energy exports. Russia at the moment is simply unable to offer adequate investment opportunities. Investors also see the risk-return ratio better abroad than domestically.

Cabinet braces for possible shocks from euro-area crisis. Finance minister Anton Siluanov says the government is preparing for eurozone problems by including in the next year's budget an emergency fund to supply liquidity to firms and banks in the event of sudden pressure from external shocks. This year's budget includes funding for state guarantees that can be granted as collateral to firms seeking investment loans. Such guarantees can also be used to support firms facing operational difficulties if necessary. The economy ministry is preparing a list of firms that play core roles in the Russian economy and would qualify for state support in an emergency.

Finance ministry calculations indicate that a 1 % contraction in GDP reduces annual budget revenues by about 150 billion rubles (€3.7 billion), or more than 1 % of state budget revenues. A drop of $1 in the price of a barrel of Urals crude reduces government revenues by 56 billion rubles (€1.4 billion), or slightly less than 0.5 % of revenues.

Skolkovo innovation centre takes shape, state-owned companies grudgingly contribute to funding. A cornerstone of the Skolkovo Project launched in 2010 was the creation of the Skolkovo Institute of Science and Technology (Skolkovo Tech). Its mission is the become an internationally unique cross-discipline pioneer, linking education, research and commercialisation of scientific innovations. Since the start of the project, the institute has sought foreign partners. Last October, Skolkovo Tech and the Massachusetts Institute of Technology (MIT) penned a three-year cooperation agreement. The institute is set to begin operations in 2014 and be fully operational in 2020.

Skolkovo Tech's operations will be funded through a special foundation created last year to administer donor funds from e.g. private firms. Current prime minister Medvedev ordered in March that participation in the financing of Skolkovo Tech was mandatory for state enterprises, and would cost them 1 % of current annual R&D spending.

The order upset many large state enterprises which had sharply boosted R&D spending over the past two years (at least on paper). The spending jump came out of a 2010 government order requiring large state-owned enterprises and corporations to spend heavily on innovation and research.

To reduce the burden of company contributions to the foundation, firms now have the option to contributing either 1 % of their R&D budget or 3 % of profits.

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China

China implements battery of stimulus measures; reference rates cut today. Slowing growth in investment demand and an export sector hurt by a floundering Europe have led to lower economic growth for China in the first five months of this year. Slack growth was reflected in the May reading of the official purchasing managers index (PMI), suggesting that the outlook for manufacturers remains weak.

In response, Chinese officials have moved ahead with modest stimulus policies, albeit nothing on the scale of the massive stimulus of 2009 and 2010. For example, permitting processes have been streamlined to speed up work on major public investment projects. During spring the central government gave go-aheads for six new airport projects, and local administrations moved ahead on numerous smaller investment projects. Officials, however, have yet to lift temporary measures imposed last year on the construction sector to lower apartment prices.

To spur household consumer demand, the government announced a subsidy programme for purchases of energy-efficient home appliances. The benefits are available to households from the start of this month (June 2012) to end-May 2013 and run as high as 400 yuan (€50) per appliance qualified under the programme. Also local administrations are considering their own subsidy programmes. For example, the city of Chongqing announced this week that it would grant subsidies to buyers of new cars with engines displacing less than 1.6 litres.

The People's Bank of China relaxed its monetary stance by dropping its key reference rates by a quarter percentage point today (June 8). In May, the PBoC lowered its reserve requirements for commercial banks. Although consumer price inflation has fallen to a level of around 3 % y-o-y, the central bank has shown reluctance to loosen monetary policy, suggesting it still fears a potential flare-up in inflation.

President Putin's China visit does little to move gas pipeline project forward. Russian president Vladimir Putin paid an official 3-day visit to Beijing this week. Putin's meeting with president Hu Jintao produced the usual statements on the importance of Sino-Russian partnership along with a promise to double trade between the two countries by 2020. The visit produced little in the way of concrete commitments to economic cooperation.

The project to build a gas pipeline running from Russia via Altai to China tops the joint project checklist. Despite a nearly complete framework agreement, the project remains deadlocked as the parties continue to disagree on gas pricing. Media reports claim Russia is demanding a gas price in the range of $350–400 per 1,000 cubic metres, which is about the same price its European customers are paying. The Chinese, who are helping construct the pipeline, are only willing to pay $200–250 per 1,000 cubic metres. The deal would last 30 years and transmission at full capacity would reach 68 billion m^3 a year.

Bilateral China-Russia trade has grown briskly. In January-April, the value of China's exports to Russia increased 14 %, while imports from Russia were up over 40 % y-o-y. Russia today accounts for about 2 % of China's total exports and nearly 3 % of China's imports. The rise in imports largely reflects the fact that the volume of Russian crude oil supplies to China has increased over 60 % from last year. Russia also now accounts for about 10 % of Chinese oil imports. So, after a trouble-plagued commissioning last summer, the new oil pipeline between Russia and China today seems to operate as planned.

Although the countries' strategic partnership is intended to give an impression of extensive cooperation, the reality of economic relations is that there is no clear framework or direction, and most cooperation is limited to a few huge infrastructure projects. There have been very few efforts to harness the potential benefits of economic cooperation, and investment flows between the two countries have been modest. Conflicting interests between China and Russia as well as the superficiality of cooperation are reflected also on the work of the Shanghai Cooperation Organization, in the summit of which Putin participated during his visit.

Increasing number of European firms contemplate pulling investments out of China. The latest member survey of the EU Chamber of Commerce in China finds nearly a quarter of its member companies are considering taking investments out of China. Lower labour costs in nearby countries and rapidly growing markets in Southeast Asia, India and South America are becoming more attractive than remaining in China, where business regulation and legal structures still invite capricious interpretation. Promises of Chinese officials to improve the treatment of foreign enterprises do not hold much credibility with foreign businesses.

The survey also points out other problems in the business environment. For example, there are huge challenges in recruiting the right people. Chinese workers often have excessive wage expectations, while the living conditions present a major obstacle in attracting to and keeping foreign workers in the country.

The problems of foreign workers have been in the news in Chinese media lately. Racist online postings have increased concern about xenophobia. The communist party has tried to calm the discussion with assurances that foreigners are welcome in China. However, the fact that racist comments have managed to get through the censorship might suggest the party is using nationalist sentiments to safeguard its status.

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