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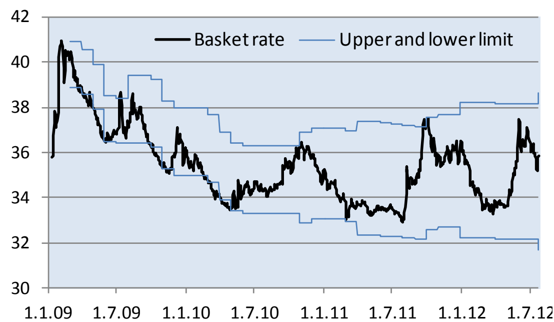
Russia

CBR widens fluctuation band for ruble exchange rate. The ruble's allowed fluctuation band relative to the Central Bank of Russia's hypothetical dollar-euro basket was broadened on Tuesday (July 24) from six to seven rubles. After the change, the band's lower limit is 31.65 and the upper limit 38.65.

At the same time, the CBR also relaxed the rule on the basis of which it moves the band. After the change, the position of the band will be shifted 5 kopeks up or down whenever CBR market operations exceed $450 million. Previously, the band adjustment limit was $500 million.

The central bank's current exchange rate policy, introduced in 2009, is geared to an incremental move away from heavy-handed steering of the ruble's exchange rate to a market-based float. The final aim is to allow the central bank to focus solely on fighting inflation with interest-rate policy.

Ruble-currency basket rate within fluctuation band



Source: CBR, Bloomberg

The ruble has recently faced both appreciation and depreciation pressures. The CBR's reduction in market interventions is clearly reflected in the increased volatility in exchange rate fluctuations. Experts posit that the central bank does not want to spend its foreign currency reserves on useless defending of the ruble. By widening the fluctuation band the CBR prepares for possible weakening of the ruble should international economic situation deteriorate further. On Friday (July 27), one dollar bought 32.6 rubles and one euro 39.6 rubles.

Russian economic growth slows slightly. However, on-year growth figures are respectable compared to the figures of many advanced economies. Especially domestic demand has grown rapidly. The volume of retail sales in the first half rose 7 % y-o-y, while investments were up 10 % y-o-y.

Manufacturing growth held at around 4.5 % y-o-y, even if output is still somewhat below the pre-recession highs of 2008. Minerals extraction increased less than 1 % y-o-y as crude oil production entered a period of low growth and natural gas production fell.

Seasonally adjusted figures reveal the sluggish trend of recent months. Industrial output growth has lain flat and, according to preliminary figures, growth in imports has neared zero. Investments have been contracting since last winter. Retail sales growth, in contrast, has continued to increase rapidly on the wings of booming demand for durable goods.

Preliminary economy ministry figures suggest GDP growth slowed in the second quarter to under 4 % y-o-y, down from nearly 5 % y-o-y in the first quarter. Leading forecasting institutions now expect GDP growth this year to reach (or at least approach) 4 %.

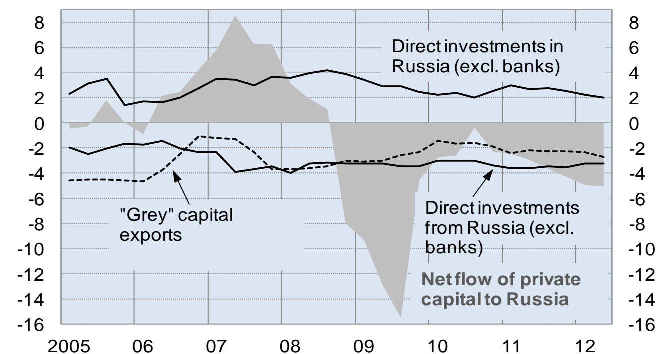
Russia's current account surplus and capital outflows remain substantial. Preliminary CBR balance-of-payments figures show the goods trade balance remained strongly in surplus in the first half of this year (11–12 % of GDP). While on one hand the surplus was dinged by the drop in world oil prices in the spring, on the other hand it was supported by a lower growth in imports.

The trade deficit in services increased in the first half slightly from 2011 to nearly 2 % of GDP. In the same period, the deficit of other current account items , which largely consists of interest and dividend payments, was nearly 4 % of GDP. The overall current account surplus, however, was still robust – nearly 6.5 % of GDP.

The net outflow of private capital from Russia has continued for nearly two years now. The outflow dwindled in the second quarter, but the drop appears to be due in part to seasonal fluctuations. Over the past twelve months the net outflow corresponded to 5 % of GDP for the period. The figure includes "grey" capital exports such as those associated with tax evasion, amounting to more than 2.5 % of GDP.

Over the past twelve months, direct investment outflows from Russia continued to exceed DI inflows into Russia: over 3 % of GDP (excl. banks), compared to 2 % of GDP.

Russia's private capital inflows and outflows, % of GDP, 4-quarter moving average



Sources: CBR, BOFIT

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China

Good summer grain harvest. China's National Bureau of Statistics reports that the summer grain harvest was 130 million metric tons, which was a few per cent higher than summer 2011, and an all-time record. Despite the good number, the harvest was actually slightly smaller than expected. Farmlands in Central China were inundated, while farmlands in North China suffered drought. Grain harvested in the May–June period, mostly wheat, accounts for about a fifth of China's total annual grain harvest. The bulk of the grain harvest occurs in autumn, and the upcoming autumn grain harvest is poised to be larger than in 2011. Growth in other farm production such as meat production also continued in the first half.

The area of land under cultivation as well as grain crops contracted sharply in the early 2000s as agricultural land was repurposed for e.g. industrial use. Since 2003, China's harvests have been getting larger as the amount of land under cultivation stopped shrinking and average yields climbed. Farm efficiency has been improved by e.g. increased irrigation and fertilizer use. China now uses more fertilizer per hectare than any other country in the world. However, pressures are growing to cut back on and rationalise fertilizer use.

China seeks self-sufficiency in staple food production, and it imports large amounts of only soybeans and vegetable oil. In recent years, imports of other agricultural products have started to grow, as consumption has soared, prices have risen and consumer habits have evolved. At the same time, exports of many agricultural products have decreased.

In order to maintain self-sufficiency in food production, China, like many countries, actively subsidises its agriculture. The OECD finds that farm subsidies, although they were boosted sharply in the 2000s, are still well below the OECD average in 2008–2010. Agriculture accounts for about 10 % of China's GDP, but official statistics show it employs a third of the workforce.

Direct investments in China contract – China's investments abroad grow rapidly. In the first six months of this year, foreign direct investment inflows to China were $59 billion, or 3 % less than in 1H2011. The drop was largely driven by contractions of investments in manufacturing and real estate – sectors that traditionally have attracted most investments.

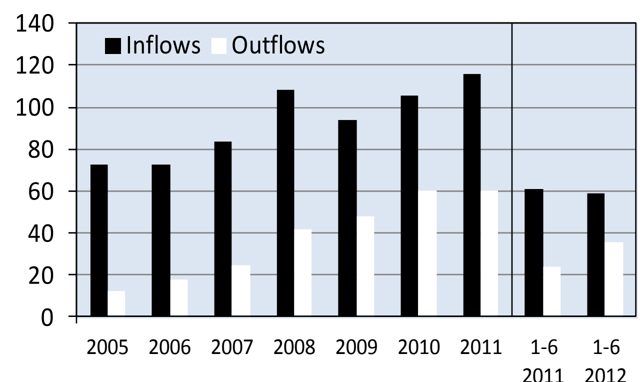
The slowdown in demand from Western economies has a direct impact on the investment enthusiasm of foreign firms as a large chunk of corporate investment in China has focused on manufacturing for export. Soaring production costs have also hurt corporate investment in China. The *Financial Times* reports China plans to respond to the drop in FDI by e.g. significantly lowering tax rates on repatriated profits of foreign firms. The reforms, however, only apply to those countries that have signed a double-taxation agreement with China.

The bulk of investments in China comes from Asia, particularly Hong Kong, which accounts for 63 % of China's FDI inflows. The massive investment presence of tiny Hong Kong reflects the fact that foreign and mainland Chinese firms channel much of their investment flows through Hong Kong to take advantage of its numerous benefits. There are also large investment inflows to China from Taiwan, Japan and Singapore. Investment flows from the United States fell slightly, but the US continued to account for about 3 % of all investment. Investment from the EU grew slightly, accounting for 6 % of all investment in China.

Direct investments of Chinese firms abroad climbed 48 % y-o-y to $35 billion. (Investment from China's financial sector is not included in this figure.) Part of the rapid growth can be attributed to the "go out" -policy pursued since 2000. The policy continued to be stressed in the most recent five-year plan approved in 2011. China's investment abroad is supported in many ways: banks are encouraged to lend, institutions specialised in foreign investment have been bolstered and access to investment permits has been gradually eased. Further easing of permitting processes is expected.

Chinese firms tend to invest abroad in natural resources. This week, China's state-owned oil company CNOOC committed to purchase the Canadian oil company Nexen for $15 billion. Nexen has claims on vast energy reserves around the world. The deal still has to be approved by e.g. Canadian and US officials. If the deal goes through, it would be the largest ever foreign acquisition by a Chinese corporation.

China's direct investment inflows and outflows, US$ bn



Source: CEIC

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