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BOFIT Weekly

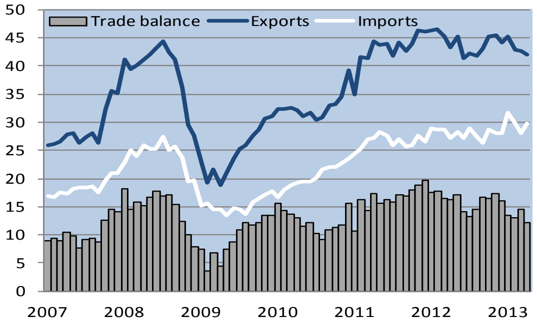
25 • 20.6.2013

Russia

Russian foreign trade surplus shrinks in first four months of the year. During January-April, the value of goods exports fell 4 % y-o-y, due in particular to weak energy and metal prices. The value of goods imports, in contrast, rose 5 % y-o-y. Import growth has slowed sharply in past months, however, as demand has evaporated.

There has been relatively little change in the product structure of Russian foreign trade; over 70 % of exports still consist of oil and natural gas. Metals and chemical products also remain important export categories. The largest import product categories are machinery & equipment, chemical products and foodstuffs.

Russian monthly goods exports, goods imports and trade balance, USD billion (seasonally adjusted)



Sources: CBR, BOFIT.

China and Germany remain by far Russia's biggest import suppliers, but notably the US moved into third place in January-April. Growth of Russian imports from the US and China has also clearly outpaced import growth overall this year. Imports from CIS countries, in contrast, have declined in recent months. The value of imports from Ukraine and Belarus was down nearly 20 % from a year ago. Imports from Kazakhstan, however, were up nearly a fifth.

Customs union creates new opportunities to sneak capital out of Russia. A report from the Central Bank of Russia finds that Russian firms have found a new way to skirt official scrutiny by paying invoices for fictitious imports. The scam involves Russian firms paying fake bills for imports from Belarus or Kazakhstan to a third-country bank account.

The evasion became considerably easier with the establishment of the Russia-Belarus-Kazakhstan customs union in 2010. The elimination of customs inspections at common borders has meant that banks are no longer verifying the deals from customs documents. The exporting of capital using the new ruse has largely replaced other informal capital export channels, which have gradually been shut down through stepped up monitoring by Russian officials.

The CBR estimates that the amount of capital exported last year using forged invoices for nonexistent imports from Belarus resulted in $15 billion whereas the total private sector net capital outflow from Russia was $ 54 billion. There are no similar estimates for Kazakhstan.

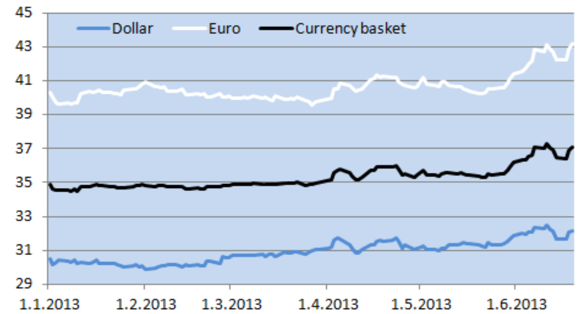
Ruble exchange rate down since the start of the year. From the beginning of the year to mid-June, the ruble slid some 4.5 % against the euro and 3.7 % against the dollar. The exchange rate has during the past few days averaged around 42.7 rubles for the euro and 32 rubles for the dollar. The last time the ruble was this low against the euro was in October 2011. Against the dollar the ruble was this low in September 2012.

The ruble's exchange rate has been influenced by the drop in world oil prices in the early spring. Urals-grade crude peaked in February at over $115 a barrel and then hit a low of $95 in April. Since May, the price has fluctuated between $100 and $105. Pressure on the ruble has also come from Russia's economic slowdown and uncertainty on global markets, which has reduced investor appetite for risk.

While the central bank continues to steer the ruble's external value, it shows much greater restraint than in the past. The CBR refrained from interventions in the market between autumn 2012 and March this year. In April the CBR started to prop up the falling ruble by currency sales. The sales were marginal, however, with the bank selling about $900 million and €60 million during April and May.

The ruble's value relative to the CBR's dollar-euro currency basket is now about 37 rubles. The central bank steers the ruble's value within the limits of a fluctuation band. The lower limit for the fluctuation band today is 31.65 rubles and the upper limit 38.65 rubles. The CBR moves the fluctuation band upwards or downwards whenever its interventions exceed a certain limit in order to accommodate to changes in economic fundamentals. The CBR last adjusted the fluctuation band in spring 2012 in the face of appreciation pressure on the ruble. In summer 2012, the CBR extended the width of the band to the current 7 rubles.

Ruble-dollar, ruble-euro and ruble-currency-basket rates (rising trend indicates ruble depreciation)



Source: Bloomberg

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China

True size of public sector budget deficit and debt likely much larger than official estimates. This month the National Audit Office (NAO) issued a warning that indebtedness of local administrations continues to rise and that debt continues to take on ever murkier forms. About 46 % of debt acquired by local administrations is now held under off-budget financial entities known as "local government financial vehicles" or LGFVs. As central government officials have tried to make it more difficult for regular banks to lend to LGFVs, local governments and their financial entities have turned to borrowing also from China's unregulated grey markets. This has made it even more difficult to estimate the true extent of local government borrowing. The NAO notes, however, that the situation varies tremendously from province to province. In the case of heavily indebted local administrations and LGFVs, debt-servicing costs have already become a major burden.

In the final statement of IMF's Article IV consultations at the end of May, the IMF stressed the importance of taking control over the indebtedness of local administrations. IMF analysts estimate that China's public sector debt ratio is now nearly 50 % of GDP if the debts of LGFVs are included. This implies also that China's overall public sector budget deficit in 2012 was around 10 % of GDP. China officially reported its budget deficit was around 2 % of GDP.

Housing prices on the rise throughout China. The increase in housing prices that began in the second half of 2012 has continued into this year, even accelerating in recent months. The National Bureau of Statistics reports that prices of newly built apartments in May were up an average of 5 % y-o-y in the 70 largest cities in China. In megalopolises such as Beijing, Shanghai and Guangzhou, prices were up 10–15 %. The sole decline in new housing prices was registered in the city of Wenzhou.

The average price for a square metre of apartment last year was 16,500 yuan (€2,000) in Beijing and 14,000 yuan (€1,700) in Shanghai. If average incomes are compared to apartment prices, housing in China's big cities is much more expensive in relative terms than in e.g. Helsinki. Officials have long worried about soaring housing prices. State-supported housing production has been stepped up and a variety of measures to stem rising housing prices have been implemented. Officials are expected to introduce further measures to cool the housing market soon.

Evaluating the situation in the housing sector is challenging as market is so fragmented and reliable statistical data are unavailable. As a result, there is no consensus among analysts on the outlook for the sector. Some analysts see no major problems in the market; apartments are selling well and buyers are making large down-payments. At the other end of the spectrum, Vanke, one of China's largest real estate developers, has expressed concerns about a bubble in the market and the massive amounts of debt being carried by developers.

China eager to be part of cooperation in the Arctic and assessing the region's economic potential. China was last month granted permanent observer status on the Arctic Council along with Japan, Singapore, India, South Korea and Italy. The new observer countries extend participation in the Arctic Council to countries outside the Arctic region. The purpose of the council is to strengthen governmental cooperation in the Arctic region, protect natural endowments and habitat, as well as the interests of native peoples of the North. The council acts as a forum for discussion, makes policy recommendations and coordinates projects in the Arctic region. Observer status gives China the right to participate in council meetings and make proposals, but confer no vote and thus no direct involvement in the decision-making process. Finland is one of eight permanent members on the council with voting rights.

The central reason for China's growing interest in the Arctic region is its unexploited hydrocarbon and mineral endowments. The loss of permanent ice makes natural resources in the Arctic Sea more accessible. The Chinese are also interested in harvesting northern fish stocks. *China Daily* reports that China is establishing a China-Nordic Arctic Research Centre in Shanghai. Chinese research focuses on evaluating the region's economic potential, resource reserves and changes caused by the loss of glaciers and sea ice.

With the loss of perennial ice, it has recently become possible to navigate the Northeast Passage (a.k.a. North Sea Route) between the Atlantic and the Pacific in the summer months. Access to the route would be a boon for China as the overwhelming share of the sea traffic moving between Asia and Europe currently passes through the Strait of Malacca near Singapore and the Suez Canal. The distance from Shanghai to Rotterdam via the North Sea Route is about two-thirds of the southern alternative. Shipping via the Arctic would also help China to diminish the political leverage of other countries on China because it would reduce the need to transport through multiple territorial waters using the southern route.

China's new Arctic policy was recently evident in Iceland, with whom China signed a free-trade agreement in April. According to *The Economist*, it is likely that China sees the deal as a stepping stone to increasing its influence in the Arctic and the development of Arctic sea lanes. Early this month, CNOOC, one of China's largest oil companies, penned a joint venture deal with an Icelandic energy firm on exploration for Arctic hydrocarbon reserves. Chinese firms have also shown an interest in investing in mining projects in Greenland.

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