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Russia

New CBR chairman Elvira Nabiullina commits to keeping monetary policy on its current course. Nabiullina's first comments after assuming her new post on Monday (June 24) concerned the importance for the CBR of keeping up the fight against inflation. In countering recent calls from some political corners for the CBR to get behind measures to stimulate growth such as lowering interest rates and devaluing the ruble, Nabiullina observed that the best way for the CBR to promote economic growth is to stabilise the macro-environment for business. Nabiullina also stated that she considers improving the investment climate an important contributor to economic growth through e.g. encouraging good corporate governance and transparency. Such changes would reduce creditor risk and ultimately lead to lower interest rates.

Chairman Nabiullina dismissed the economy ministry's proposal to give commercial banks recommendations on maximum lending rates, noting such ceilings would most likely lower banks' enthusiasm for lending.

Nabiullina also mentioned the possibility of cutting commercial banks' operating costs by easing requirements established by the CBR on e.g. document handling and information provision.

CBR first deputy chairman Alexei Ulyukayev tapped as new economy minister. Other appointments announced Monday (June 24) included rotation of former economy minister Andrei Belousov into the post of economic adviser to the president previously held by current CBR chairman Elvira Nabiullina.

During his stint as economy minister, Belousov stressed the role of public investment and state management in stimulating economic growth. Many observers think that the transfer of Alexei Ulyukayev, who has a reputation as a liberal economist and staunch defender of central bank independence, to the top post in the economy ministry could shift the economy ministry's policy focus towards structural reforms and encouraging private-sector investment.

The CBR and economy ministry have traditionally split over economic policy, but the gap could be closing with the economy ministry joining the CBR and finance ministry in promoting growth based on economic stability and structural reforms.

President Putin announces stimulus measures at this year's St. Petersburg International Economic Forum. The measures announced June 21 largely reflected proposals on ways to stimulate investment prepared this spring by the economy ministry at Putin's behest. The proposals have been met with criticism, especially from the finance ministry and the central bank, so the president's final proposal included views from both sides.

Putin announced three major infrastructure investments: a high-speed rail line between Moscow and Kazan, construction of an outer ring road around Moscow and upgrading Trans-Siberian rail lines between Moscow and Vladivostok. Putin suggested that the potential economic payoffs of the construction projects could be attractive to private investors, whose participation would assure the profitability of the projects. The president invited foreign investors participating in the forum to join in these projects.

Putin's announcement that the projects would be partly funded from the National Welfare Fund (mostly funded with oil & gas revenues) represents a clear shift from earlier policy. Fund assets to this point have largely been invested in high-quality, low-risk bonds and treasuries with a view to financing the pension system in coming years.

Putin said that the government plans to invest 450 billion rubles from the National Welfare Fund in the three projects, and other projects may be coming. Over the next few years, more than half of the National Welfare Fund resources would be invested in various infrastructure projects. As of end-May, the fund stood at about 2.7 trillion rubles (€64 billion). State Pension Fund assets might later also be made available for infrastructure projects. Observers put the price tag of the Moscow-Kazan high-speed rail project, for example, at over 900 billion rubles.

Russia witnessed an active debate this spring over the wisdom of investing sovereign wealth in domestic infrastructure. The finance ministry and the CBR have been wary of the initiative, which has largely come out of the economy ministry, expressing concern about the choice of projects and their economic feasibility. Some observers note that massive public works are prone to corruption, citing the building projects for the APEC summit in Vladivostok last year and the on-going Sochi Winter Olympics village construction. Moreover, one-off projects often have only a transitory economic impact and do little to accelerate economic growth over the long run. This was precisely the case in Vladivostok, which anticipated strong regional economic growth following the APEC summit held in autumn 2012. Despite massive public investment in buildings and infrastructure, such growth has yet to materialise.

Putin also announced measures to limit the rising cost of doing business in Russia. Russia's high inflation is driven by the rapidly increasing costs of public utilities produced by "natural monopolies" in e.g. energy, water, heating and rail transport. All have seen rates rising faster than inflation for several years now. Starting next year, rate hikes would be limited to the previous year's inflation rate, and the ceiling on rate hikes would remain in force through 2018. Putin encouraged natural monopolies to improve efficiency and cut costs now that further rate hikes are off the table.

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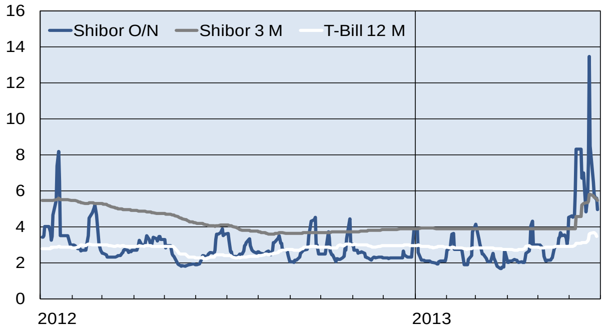
China

Interest rate spike in China frightened. A sudden liquidity drought in interbank market caused overnight lending rates to soar last week, even exceeding 13 % last Thursday (June 20). Banks' demand of liquidity rose because of the three-day Dragon Boat Festival holiday, tax deadlines and banks' need to meet deposit reserve requirements. Ultimately, however, the spike was caused by the People's Bank of China, which unlike earlier, refrained from providing liquidity to banks and allowed market rates to climb before intervening. The sudden rise in interest rates on China's already jittery financial markets was especially disconcerting for many as the PBoC was slow to explain its policy shift.

Liquidity shortage drove interest rates to record levels



Source: Macrobond

In fact, only this week did the central bank announce that there was no actual liquidity shortage, merely a situation where supply and demand did not meet. According to the central bank, it let interest rates rise to send a message to banks and companies on the risks of excessive indebtedness and the maturity mismatch of debt and payments. Officials are particularly concerned about the rapid growth of unregulated borrowing on the grey market. For example state enterprises, despite production overcapacity, still enjoy access to cheap loans, which they can then lend to other companies at higher interest rates.

Stock markets reacted to the liquidity shortage with a sharp decline in share prices. Many companies have postponed scheduled bond issues over interest-rate uncertainty. Although the central bank declared it possesses the tools to keep the financial market stable, last week's market disruption highlighted the vulnerability of the Chinese financial system. These factors in combination have depressed the short-term economic outlook.

Perhaps the silver lining from the experience has been its success in showing that China's new leadership is ready to go ahead with measures to address long-term problems at the expense of short-term growth. Last week's events also drove home the importance and feasibility of interest-rate policy that could encourage China to move forward with liberalisation of rate-setting and money market reforms.

Chinese companies invest in a wide range of sectors. China's Ministry of Commerce reports foreign direct investment outflows from China amounted to about $35 billion in the first five months of this year, an increase of approximately 20 % from last year. This figure does not include later-to-be-released financial sector's investment. Most FDI outflows went to Asia, but other continents have increased in importance in recent years.

Chinese firms actively invested in foreign food production, which is becoming an important investment area along with natural resources and the energy sector. According to Bloomberg, Chinese FDI going to agriculture and food processing this year already amounts to $7.8 billion, with much of the spending directed to the United States, Australia and Brazil.

US pork producer Smithfield Foods approved an acquisition offer in May from Chinese meat producer Shuanghui. Shuanghui sees the deal as a way to gain access to the US market and acquire food processing technology and related skills. Rising labour costs have put pressure on China to raise the efficiency of its food production and distribution systems. Greater technological capabilities would give Shuanghui a competitive edge in the domestic market that has been suffering from food scandals.

Smithfield, with an estimated sale price of $4.7 billion, has returned China-US trade relations to the spotlight. If the Committee on Foreign Investment in the United States (CFIUS) gives the green light, it would be the largest ever Chinese acquisition of an American company. Bilateral relations in the food industry have suffered e.g. from China's import a bans on food produced in the US. The US, in turn, earlier blocked some Chinese investment in e.g. its energy sector.

Chinese firms see acquisitions as a way to expand in international markets and develop opportunities in China's growing domestic market. This month, Dalian Wanda announced it was acquiring a majority stake in British yacht-builder Sunseeker, as well as investing in a number of foreign hotel projects. Wanda has been on a shopping spree; last year it bought the US-based AMC cinema chain for $2.6 billion.

This month, Sinopec paid $1.5 billion for the US-based Marathon Oil's rights to Angolan oil tracts, further cementing the Chinese presence in Africa. Another Chinese oil giant, CNPC, recently acquired a 20 % stake in the Yamal project to develop new Siberian oil fields. The project is spearheaded by Russian gas giant Gazprom.

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