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Russia

Russia's $7 billion sovereign bond issue proves a hit with international markets. Russia's finance ministry this week offered about $7 billion in eurobonds to international investors. Market observers report demand was more than double the supply of bonds on offer. The issue covers the entire foreign borrowing requirement budgeted for 2013. The bond issue, under planning since spring, was postponed until September when market conditions were seen as more favourable for the bond sale. The issue consisted of $6 billion in 5-, 10- and 30-year dollar-denominated eurobonds, and €725 million ($962 million) in euro-denominated 7-year bonds. It was Russia's first bond issue denominated in euros.

The Russian state has issued roughly $21 billion worth of eurobonds since 2010, even if the borrowing was done without any pressing need to go to international markets. In Russia's case, the issue of sovereign eurobonds is tied to fiscal policy goals and maintaining a market for Russian bonds in international capital markets. The main purpose of the bond sales is to simplify pricing of debt securities issued by Russian firms to make it easier for firms to raise money on international markets.

Russian central government debt is currently less than $200 billion, which corresponds to less than 10 % of GDP. Of that amount, $41.3 billion is denominated in foreign currencies and about $150 billion (4.97 trillion rubles) in rubles. The Central Bank of Russia reports that about $58 billion of total state debt is held by foreign investors.

In the first half of the year, Russia's domestic bond issues slightly outpaced the volume of bonds repaid. The finance ministry reports that some 470 billion rubles in debt securities were issued during January-August. The debt-repayments by the Russian state for domestic OFZ bonds and maturing bonds amounted to 418 billion rubles.

The presence of foreign investors in Russia's domestic debt security markets increased notably in the first half. The rise in foreign participation reflects a change in the law that entered into force in February. The amended law gives international central securities depositories Euroclear and Clearstream permission to participate directly in trading of ruble-denominated paper. Growth in the share of foreign trading, however, has raised concerns over rising volatility in domestic markets and pricing to be driven to foreign market places. The Central Bank of Russia says it is looking into the matter.

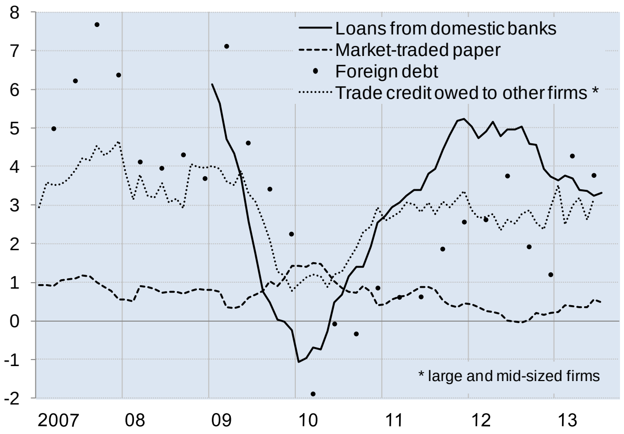
Russian companies cut back on borrowing from domestic banks. Corporate borrowing from banks has been in decline in Russia for about 18 months now. Loans with maturities longer than six months have decreased overall, and as regards the longest loan maturities, due to growth of fixed capital investment grinding to a halt. Short-term corporate borrowing remains relatively modest. The nominal interest rate charged on corporate loans has fallen slightly this year together with inflation, while real interest rates have remained at around 4–5 %. Observers note that real interest rates are still quite high relative to risks of fixed capital investment from e.g. uncertainty over the outlook for demand. Banks have also tightened their lending requirements concerning the economic condition of borrower companies.

Corporate borrowing from abroad this year has remained roughly equal to last year because the spike in foreign borrowing figures early this year was due to state oil company Rosneft's acquisition of TNK-BP. The deal boosted corporate sector foreign debt by over 10 %. To finance the deal, Rosneft borrowed heavily on international markets and then used the money to pay for most of the TNK-BP shares it bought from British Petroleum.

Issuing of corporate debt securities has recovered this year. Companies have managed to raise funds a bit more cheaply with longer payback terms by issuing paper rather relying on bank loans. Banks, in turn, have been allowed to use the bonds as security for liquidity loans from the CBR. Companies have granted trade credits to each other at about the same pace as in 2011 and 2012. Trade credits are a significant source of short-term finance for firms. Corporate debt-servicing problems, which could arise from Russia's severe slowdown of economic growth, are only seen at the moment in the trade credit arena, where the share of belated payments began to rise in the early months of this year.

The debt of Russian businesses to domestic banks as of end-June was 30 % of GDP. The foreign debt of Russian companies and domestic inter-firm trade credit were each at levels that corresponded to about a fifth of GDP.

Corporate debt (not including banks), change of stock from 12 months or four quarters previous, % of GDP



Sources: Central Bank of Russia, Rosstat, Cbonds

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China

Good late summer economic performance dispels concerns over China and global economy. Chinese industrial output climbed slightly over 10 % y-o-y in August, while retail sales growth continued steadily at nearly 11 % y-o-y in real terms. Earlier-released purchasing manager indices (PMIs) also indicated slight improvement in industrial output and an on-going positive trend in the service sector. Nominal annual growth in fixed capital investment has long been at around 20 %. Changes in price trends were modest in August. Consumer prices were up 2.6 % y-o-y, while producer prices were down 1.6 % y-o-y.

August foreign trade figures also provided heartening news for China and the global economy. The value of Chinese exports and imports were up 7 % y-o-y last month. Higher exports to the United States and Europe supported the view that recovery was under way in both regions. In addition, concerns about a slowdown in Asia were allayed by a sharp rise in exports to South Korea, Taiwan and ASEAN countries. The frayed Japan-China relationship, however, continued to dampen Chinese exports to Japan. The trade surplus for January-August reached $156 billion, an increase of over $30 billion from the same eight-month period a year earlier.

The view of the real economy from the perspective of financial markets was somewhat cloudier. Total credit provision (social financing) grew faster than expected in August, possibly reflecting the improved outlook for producers. However, the interpretation may not be so simple, as the growth of lending was driven by short-term borrowing from the informal sector. In contrast, the pace of traditional bank lending was largely unchanged from previous months. Only 45 % of new credit granted in August came in the form of traditional bank loans, which may suggest that companies are again finding themselves increasingly forced into the grey market for credit due to liquidity problems and need to repay earlier debt. The situation could also show that the grey money market remains active despite efforts of regulators to rein them in.

Minor changes in indicators for the Chinese economy often receive considerable media attention and lead easily to over-interpretation. Anyway, compared to concerns a few months ago, the figures for July and August on balance suggest a positive trend, although they reflect stimulus measures by the government, increased enterprise borrowing and a recovery on the export front. The dissipation of immediate worries about economic growth now gives China's leaders the opportunity to focus on pushing ahead with structural reforms aimed at sustainable economic growth.

Chinese firms piling on debt. A recent assessment by Spanish bank BBVA found that Chinese firms (excluding banks) had debt totalling about 65 trillion yuan, or nearly 130 % of GDP at the end of 2012. China's corporate debt stock has soared in recent years. As recently as end-2008, it was still less than 100 % of GDP. Even higher debt figures have been suggested. Estimates of corporate indebtedness vary depending on how the debt of firms owned by local administrations is included. It is clear, however, that the debt carried by Chinese firms is massive by any measure. Indeed, there are very few countries in the world with higher levels of corporate debt relative to GDP.

Chinese financing is still mostly bank-based, despite a strong trend in recent years to use alternative modes of finance. BBVA estimates that approximately two-thirds of corporate debt is held in the form of bank loans, another 10 % as corporate debt securities and about a quarter as financing raised from grey market sources. Chinese firms hold very little foreign debt.

Corporate indebtedness reflects the fact that Chinese firms have been living in an era of relatively cheap money. Large amount of their loans were granted at interest rates below the central bank's reference rate, which at the moment is 6 % for a one-year loan. For small and medium-sized enterprises (SMEs), however, it is not always possible to get a bank loan. SMEs must turn to the grey credit market, where interest charges are substantially higher. In Wenzhou, for example, the rate on a one-year loan from the grey market currently averages around 15 %.

The costs of debt servicing for companies, however, has been rising. The credit ratings of companies involved with metal and mineral extraction, in particular, have been downgraded and the yields on their bond issues have increased sharply. Media reports also note bankruptcies, as a coal producer in southern China ceased operations in August under the weight of billions in debt. More bankruptcies in the industry are expected.

Lower growth in bank profits. The profits of Chinese commercial banks rose an average of 14 % y-o-y in the first half of 2013, down sharply from last year. Most bank profits came from provision of basic banking services, i.e. loaning out deposits at higher interest rates. The rise in profits was largely limited by the fact that the margin between interest paid on deposits and interest charged on loans narrowed during the first six months of the year. The narrowing was seen as evidence of increased competition for customers. The People's Bank of China eliminated at the end of July its minimum floor on lending rates, a move expected to further increase competition among banks.

Banks expect tougher times ahead even with profit growth. Stocks of non-performing loans have so far increased only slightly, but the default rate is expected to increase in the near future as the volume of overdue payments has surged.

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