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BOFIT Weekly

13 • 28.3.2014

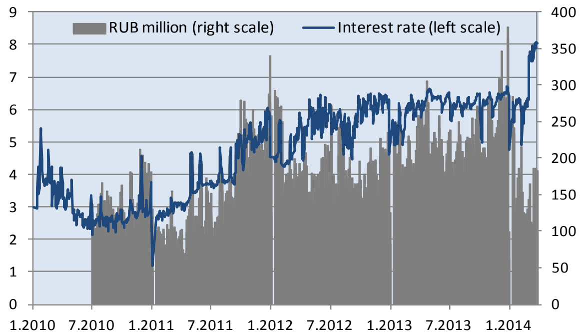
Russia

Russian financial markets bounce back. Russia's financial markets calmed this week as the Crimean crisis settled into a holding pattern and sanctions directed at Russia so far appear to have little economic effect. The ruble has strengthened for more than a week now and in recent days the appreciation trend has intensified. On Friday (Mar. 2), a dollar bought 35.58 rubles and a euro 49.05 rubles. The ruble's exchange rate is now back at the same level as at the end of February before the Crimean crisis broke out. The Central Bank of Russia continues to buy rubles to prop up the currency's value, but its daily ruble purchases now average just some $280 million a day.

The Moscow Exchange's RTS index has also recovered in recent days to early March levels.

Liquidity remains tight on Russian money markets, however. The interbank lending rate soared at the start of the Crimean crisis, when also the CBR raised its key rate. When the crisis hit, the most important interbank rate, the one-day credit rate, jumped 130 basis points from 6.3 % to 7.6 %. On Wednesday (Mar. 26) the one-day Moscow Interbank Actual Credit Rate (MIACR) was 8.0 %.

One-day MIACR, lending volumes (1H2010 not included)



Source: Central Bank of Russia

Rising economic uncertainty has made banks cautious about risk taking and forced many to cut back on their services offered, including trade financing. Banks are also wary about lending to each other, which means that smaller banks, in particular, find it difficult to access credit on the interbank market. This situation, in turn, limits the corporate and household lending of banks, hindering economic growth.

Latest BOFIT Russia forecast sees further growth slowdown this year. Russia's GDP growth of 1.3 % last year undershot forecasts. The main reasons for the slowdown were a steep decline in fixed capital investments of state enterprises and the state as well as a slowdown of consumption growth. Export prices have not risen at all in the past two years and their impact on growth has faded.

BOFIT forecasts GDP growth will slow further this year to around 0.5 %, and then recover in 2015 and 2016 to around 1.5 % p.a. While the recovery in the global economy will support growth, we expect the oil price to decline slightly over the forecast period. These impacts, however, pale in comparison to the effects of the economic and political uncertainty caused by the Crimean crisis even with relatively contained market reactions and sanctions.

While events in Crimea will postpone private-sector investments this year, the contraction in total investments should remain moderate as long as the drop in investments of state enterprises and the state can be brought to a halt. Investment growth should begin a gradual recovery next year. The slow recovery in investments, however, will hamper growth in the capital stock and limit productivity gains. This, in turn, could restrain output growth. Although growth in private consumption will slow substantially, it will still be moderate. Sluggish export growth is expected as Russia's outlook for energy exports remains weak.

The volume of Russian imports grew 6 % last year. Imports this year will contract a couple of per cent due to the recent deep slide of the ruble. In 2015 and 2016, import growth will recover to a couple of per cent per annum.

Imports will revive because the ruble's real exchange rate is not expected to depreciate substantially as Russian inflation is running well above the inflation rates of its main trading partners. The ruble's nominal exchange rate will gradually decline as the current account surplus evaporates and net capital flows remain outbound.

Russia's leaders have so far had no enthusiasm for launching a broad-based stimulus. Low budget revenue growth will depress spending growth as long as the government is committed to its budget rule of keeping the deficit to around 1 % of GDP. There is also no appetite for monetary stimulus as inflation still exceeds the pace desired and the impacts of monetary stimulus on borrowing from banks are uncertain. However, the government is currently drafting new measures to support businesses.

There are exceptional downside risks with the current forecast, due especially to the potential effects of the Crimean crisis. Investments could be weaker than expected, as could growth of the global economy and public sector revenues; especially the latter could reduce consumption growth. Strong depreciation episodes of the ruble would fuel inflation and depress consumption and import demand. On the other hand, disruptions in the global oil market could raise oil prices. Russia's leadership could respond to weak growth through increasing state spending by taking on debt or boosting credit to companies and households via the banking system.

Over the longer term and under more peaceful conditions, we see GDP growth staying near a 2 % p.a. trend as long as the country does not move ahead faster and on a broader basis with systemic economic reforms than it has in recent years.

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China

Latest BOFIT forecast sees further slowing of Chinese growth, increased risks. BOFIT's Forecast for China, released this week, predicts the Chinese economy will still grow at around 7 % p.a. in 2014 and 2015, but slow in 2016 to about 6 %. Of course, even at 6–7 %, Chinese economic growth remains impressive by any measure.

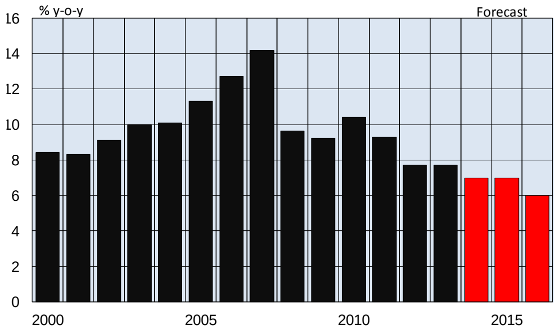
Many factors explain China's decelerating growth. The number of working-age people has begun to decline. Moreover, after sustaining over three decades of rapid economic growth, urbanisation and catching up, Chinese productivity can no longer be expected to keep rising as fast. Growth will also be constrained by the limited availability of natural resources and immense environmental problems that are forcing China to adopt a growth model that puts sustainability ahead of high growth. One factor immediately depressing growth is China's rapid increase in indebtedness. It forces the government to take relatively strict fiscal and monetary policy stances, which is likely to constrain investment by the public sector and the business community.

Certain conditions for favourable economic development are in place as the reform policies announced late last year suggest China's leaders are committed to deep and far-reaching reforms. The view that reforms are likely to be implemented is further supported by the fact that market conditions demand reforms to bring emerging systemic risks under control. The reform agenda includes implementation of a deposit insurance scheme, liberalisation of deposit rates and capital movements, as well as increasing the role of interest-rate policy. China's healthy employment situation and an inflation rate holding at 2–3 % also give the leadership an opportunity to focus on reforms.

The gradual liberalisation and diversification of financial markets, poor supervision of shadow banking activity and considerable amount of debt have increased uncertainty in financial markets. This uncertainty is expressed through occasional tightening on financial markets and the general rise in interest rates. It is clear that progress in market reforms will bring with it the realisation of losses and bankruptcies in financial sector. Our basic forecast assumes the financial buffers of banks and other firms, and ultimately the government's ability to bail out troubled banks and businesses, are sufficient to prevent widespread contagion. This view is bolstered by the fact that the Chinese public sector controls vast assets it can sell to raise money and the fact that Chinese firms have not borrowed extensively on international markets. Rapid economic growth continues to be a prerequisite to China's ability to deal with its emerging problems.

Because the role of fixed capital investment is so large in the Chinese economy, any difficulties in financing could undercut investment plans and lead to sharp reduction in economic growth that could not be offset through boosting consumption and exports. Given the nature of these problems, there is a far greater risk that growth will fall below our forecast than exceed it. This view draws on experiences elsewhere with credit bubbles and financial market liberalisation causing excesses. A number of these symptomatic financial trends are already well established in China.

Realised GDP growth and BOFIT forecast for 2014–2016



Sources: NBS and BOFIT

Losses on Chinese financial markets force investors to assess their risk exposures more carefully. Certain investors and banks have recently had to swallow losses on insolvencies of a construction company and a solar panel manufacturer, which has heightened uncertainty in Chinese financial markets. Unlike earlier, the government did not bail out the troubled firms, signalling that China's capital markets are moving to a more market-based financial system.

Developer Zhejiang Xingrun Real Estate Co. this month defaulted on 3.5 billion yuan (€420 million) in bank loans. The magnitude of the default has raised concerns over the Chinese construction sector's financial sustainability. Many companies depend on the availability of credit, which means that they are exposed to considerable risk of default if housing prices decline or interest rates go up.

Just two weeks earlier, China saw its first-ever corporate bond default, when solar panel maker Chaori Solar failed to pay 90 million yuan (€11 million) interest payments. While the fact that investors could lose their money on a corporate bond issue is unprecedented in the Chinese experience, it has long been known that the solar panel business suffers from significant overcapacity.

In a statement issued Tuesday (Mar. 25), the State Council reiterated its commitment to reforms that promote transparency of capital markets and improve the ability of investors to manage risk. The Xinhua news agency reports rules on share issues will be reassessed and the bond market diversified by allowing the sale of a wider variety of debt securities to investors. Derivatives markets will be further developed. The goal is to diversify capital markets by expanding investment opportunities. While no timetable has been given, China's booming shadow banking sector puts pressure on the leadership to move ahead with reforms.

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