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# BOFIT Weekly

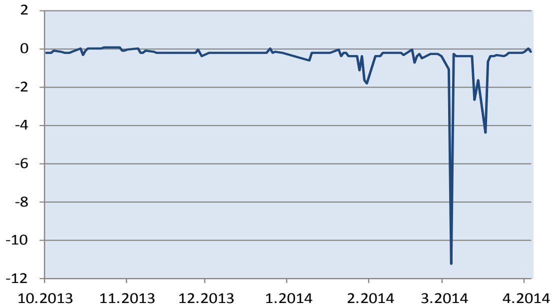
## 14 • 4.4.2014

# Russia

**After some strengthening during the past week, the ruble has again weakened.** The strengthening at the end of the first quarter was mainly caused by increased demand for rubles, due e.g. to scheduled corporate tax payments. After that, the ruble started to weaken again. The ruble is now more than 7 % weaker than at the start of the year.

Over the past week, the Central Bank of Russia has gradually cut down on its ruble-buying. On Wednesday (Apr. 2), the CBR spent no currency on interventions, but returned to the market on Thursday.

**CBR daily forex market interventions, USD billion, 1.10.2013–2.4.2014**




*Source: Central Bank of Russia*

**Russian government considers economic policy options in the case of possible toughening of sanctions.** According to the government and CBR, the current monetary stance and foreign exchange policy will remain in place, along with the commitment to allow a free-float of the ruble at the beginning of 2015.

The government is split, however, on fiscal policy. Finance minister Anton Siluanov rejected the proposal of economy minister Alexei Ulyukayev to loosen budget policy rules so that the amount of money transferred to the reserve fund from oil & gas revenues would be more dependent on the prevalent economic situation. The change would allow budget expenditures to be increased this year.

The finance ministry says a change in the budget policy amidst the current uncertainty could damage the economy by increasing investor skittishness about Russia's future. Siluanov said that stimulating demand by increasing budget spending would only fuel inflation. In his view, an economic crisis should launch fundamental reforms that would improve the investment climate and make businesses more efficient.

**Russia's finance ministry commits to backing corporate sector if economy worsens.** Finance minister Anton Siluanov announced at a meeting of the Russian Union of Industrialists and Entrepreneurs (RSPP) that companies will be eligible for subsidies if economic conditions worsen. However, the amount of support available is likely to be less than after the 2008 financial crisis.

Observers have criticised Russia's 2009 stimulus policies, which focused on bailing out big industries. They note that the bailouts allowed inefficient firms to continue with business as usual without implementing needed structural changes or efficiency measures. During 2009–2010, nearly 1.5 trillion rubles (€35 billion) in subsidies and supports were paid out of the federal budget. In addition, over 1.0 trillion rubles (€24 billion) of public money was used in investments and loans to prop up the financial system.

Siluanov said that this time around the cabinet will focus on supporting companies themselves rather than bailing out owners. Measures include providing financing to retrain workers and cover moving costs as well as promotion of small business. To make it easier for firms to borrow, the state loan guarantee system would be expanded. To get banks to increase lending, banks need higher capitalisation. Siluanov suggested that investments in state banks in 2009 be transmuted into capital. Economy minister Ulyukayev suggested that banks be required to lend for large investment projects at low interest rates to be eligible for refinancing from the CBR.

**Russia debates possibility of using rubles in all foreign trade.** Andrei Kostin, head of VTB Bank, Russia's second largest bank, first proposed universal ruble use.

Kostin argues that large energy exporters like Gazprom and Rosneft, as well as arms exporter Rosoboroneksport, should be the first to shift to all ruble payments. The firms affected, however, are not hot on the idea. They say it is difficult to get buyers to agree to payment in rubles. Moreover, few Russian companies are willing to give up their foreign currency earnings, without which most would e.g. find it harder to borrow on international markets.

The economy ministry says the cabinet is exploring the possibility of shifting to ruble use in foreign trade but no concrete plans have yet been made.

**Russia accelerates introduction of national credit card system.** Russia has been planning its own credit card system for years, but implementation has been thwarted by sophisticated technical demands and high costs, as Russia also wanted to use credit cards for other purposes such as personal identification.

The Russian credit card project got a reboot after Visa and MasterCard two weeks ago declined to accept credit cards of some Russian banks. The CBR and finance ministry then called upon banks to discuss the new system, only to be met with an array of opinions. President Putin will make the final decision on the payment system.

Officials note that Russia will have to continue cooperation with international credit card companies in any case if e.g. Russian travellers want to be able to use their credit cards abroad.

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# China

**China announces another "mini-stimulus."** With relatively sluggish economic growth in the first three months of this year, many have been questioning whether China will actually hit its official GDP growth target of "around" 7.5 % this year. Also China's leadership seems to be concerned about the slowdown. Premier Li Keqiang last month remarked that slightly lower growth would be acceptable. With the increased likelihood China might not even meet a loosened target, the government on Wednesday (Apr. 2) declared it was initiating measures to support growth.

This latest small-scale or "mini-stimulus" will feature directed tax cuts and a boost in public spending. Small businesses will get a tax break that reduces their income tax obligation by half. On the spending side, China will take on another 150 billion yuan in debt (about €18 billion or 0.3 % of GDP) to speed up railway projects in progress or planned. Moreover, China Development Bank was ordered to finance low-income housing projects. An immediate goal this year is to replace about five million dwellings in shantytowns with affordable apartments.

A similar mini-stimulus was applied last summer. If growth fails to pick up sufficiently, further measures, especially to maintain employment, are expected.

**China wants to redirect internal migrants to smaller cities.** The government last month released its urbanisation plan, including urbanisation targets through 2020. The plan follows the decisions made at the Central Committee's plenary session last November, and recognises the outline for policies that encourage urbanisation such as land use regulations and gradually dismantling of the *hukou* household registration system. China also hopes to avoid the big pitfalls of rapid urbanisation such as increased inequality, environmental degradation and soaring housing prices. The government aims to boost the share of the population living in cities from under 54 % at the moment to 60 % over the next six years. The increase calls for approximately 90 million rural-dwellers to pack up and move to cities. As the desire of the rural population to move to big cities is already high, China hopes to channel this latest influx of new urbanites to small and mid-sized cities.

The government is moving ahead with its efforts to dismantle restrictions of the *hukou* system in smaller cities. *Hukou* is used to control the migration flows as it defines the social benefits to which everybody, including internal migrants, are entitled. The restrictions on migrants seeking a place in China's megalopolises will stay in place, however. For example, applicants seeking residence in Beijing will still have to meet the age limit on eligibility as well as other requirements such as completing a university degree. To improve rural dwellers' financial possibilities for moving, the government is easing the selling and leasing of rural land. The mini-stimulus announced on Wednesday helps the government meet its urbanisation goals with such measures as supporting construction of low-income housing.

With the cohort of working-age people shrinking, China's leadership is focusing on urbanisation to maintain the supply of cheap labour. The leadership has also long emphasised the role of urbanisation in moving to a consumption-based model for growth as it increases e.g. demand for services.

In addition to housing construction, urbanisation requires massive investment in health care, public transport and infrastructure. Many local administrations are heavily in debt, so further public investment means the government must give local administrations more access to financing. Dismantling of the *hukou* system will increase demand for public services even further and thereby increase the need for a sustainable basis for funding public administration.

A World Bank report released last week says China needs to build cities smarter and denser to reduce infrastructure expenses and mitigate pollution. The report estimates better urban planning could save China as much as $1.4 trillion. Improvements could be achieved, for example, by changing the method for pricing plots of land. The current pricing of land on outskirts encourages expansion of urban areas. Traffic congestion as well as air and water pollution increase when the cities expand far from the centre. The World Bank calls China to evaluate local administrations based on efficient and sustainable urban planning.

**WTO panel concludes China's export controls on rare earth metals violate its WTO commitments.** China in 2010 imposed export quotas and raised export tariffs on rare earth elements (REEs), arguing that quotas were needed to protect the nation's natural resources. China produces about 90 % of the world's REE supply. REEs are critical in many high-tech applications including electronic devices, permanent magnets and alternative energy production. After China imposed the REE export ban, world prices soared. The resulting outcry led affected countries to file a complaint with the WTO in spring 2012. At the end of March 2014, an expert panel set up by the WTO found that China's export restrictions violate its WTO commitments. The plaintiffs included the United States, EU, Japan and 16 other countries. Under the ruling, China must present its plans to comply with its commitments, and if approved by the panel, implement them within a reasonable time. China has the possibility to appeal the ruling.

Trade disputes over export restrictions are extremely rare. Most trade disputes involve import restrictions.

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