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BOFIT Weekly
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Russia

CBR raises key rate to 7.5 %. Ahead its decision last week (Apr. 25), the Central Bank of Russia's key rate, i.e. the 7-day repo credit rate, was 7.0 %. In its press release, the CBR said the hike reflected faster-than-expected inflation caused by the slide in the ruble's exchange rate. The economic slowdown, the central bank noted, was unlikely to quell inflation as most of the slowdown in growth is due to structural reasons.

The CBR last increased its key rate in March to ease market uncertainty caused by the Crimean crisis. The decision to raise the repo credit rate came as a surprise to the markets, which widely expected the central bank to keep the key rate unchanged. Many observers note that the rate hike supports the markets now that the uncertainty cause by international developments has again heightened. Deputy economy minister Andrei Klepach criticised the rate hike. In his opinion, the move further weakened conditions for economic recovery.

The announcement of new sanctions imposed on Russia this week by the US and EU have had minimal impact on Russian financial markets.

CBR introduces three-year refinancing tool. At the start of last week, the CBR announced that it would begin to grant banks a new three-year refinancing instrument. The loans can be used to secure bank loans for investment projects. The refinancing rate is fixed at 6.5 %.

The new refinancing tool should increase the supply of long-term investment financing, something Russia's financial markets generally lack at the moment. The initiative for a refinancing tool came from the corporate sector, and the government and the central bank have been working on the arrangement for a while.

Only large banks with capitalisations of at least 50 billion rubles (just over €1 billion) are eligible for the refinancing deal. This group comprises fewer than 20 banks. Investment loans are eligible for refinancing if the project meets the same criteria that are required in order to get a state guarantee for a loan.

Standard & Poor's downgrades Russia's creditworthiness. Last Friday (Apr. 25), S&P announced a downgrade of Russian sovereign foreign currency debt to BBB-, the lowest of investor-grade rating. Ratings below this are considered junk, i.e. too risky for prudent institutional investors. Moody's and Fitch, the other major international credit rating agencies, are keeping their sovereign ratings for Russia unchanged for the time being, even if both warned of possible downgrades in March.

S&P said its decision to downgrade Russia reflected large capital exports, which can even increase if the political situation worsens. Government creditworthiness is hurt by capital exports as they erode economic growth possibilities.

Russia's downgrade will have little impact on day-to-day activities of the Russian government, at least in the short run. With its public finances in relatively good shape, Russia has no acute financing problems at the moment. Russian firms, on the other hand, could be affected by further limiting of their access to international financing and higher financing costs. However, international corporate borrowing has already been hit by heightened international political tensions.

Russian government discusses establishing its own national-level credit rating agency. There is a need for a national rating agency, as according to the first deputy prime minister Igor Shuvalov, Western governments can currently influence the three leading international credit rating agencies' evaluations.

Russian market participants, on the other hand, are loathe to the idea of one national credit rating agency. Instead, Russia's already functioning domestic rating agencies' evaluations should be used in the country in the same way as evaluations of the international credit rating agencies. However, such a move would require the development of world-class rating proficiency that does not exist in Russia at the moment. In any case, e.g. the finance ministry has no plans to stop relying on the ratings on the big three international credit ratings agencies any time soon as without them it would be impossible to market Russian government debt.

Russian unemployment still at low levels for now. The economic downturn has yet to be reflected in the labour market. The first-quarter unemployment rate fell to a historically low national average of 5.5 %. In recent months, however, both official data and company surveys hint at weakness in the labour market. For example, downsizing is now slightly more often reported as the reason for terminating employment. In addition, the number of advertised open positions is lower than a year ago.

The differences in unemployment rates across regions are still large. In Moscow and St. Petersburg, the unemployment rate was under 2 %, while it was nearly 10 % in the Karelian republic and almost 40 % in the restless North Caucasus regions. Unemployment has already risen or threatens to rise substantially in many *monograds* (single-industry cities), where the core industry struggles with a weak economy.

Official figures show that only around 2 % of Russians work outside the region where they live, even if that share has grown gradually in recent years. There are plans to provide public funds to support resettlement from areas hardest hit by unemployment, specifically *monograds*.

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China

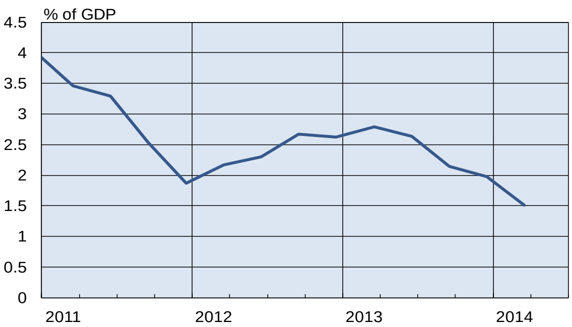
China's current account surplus shrank in first quarter. China's January-March current account surplus was just $7 billion, down from $48 billion a year earlier and the smallest since 1Q2011.The current account surplus fell to 1.5 % of GDP.

Although the current account surplus fell substantially, net capital inflows into China remained strong. China's foreign currency reserves rose by nearly $130 billion in the first quarter to $3.95 trillion.

The yuan's exchange rate continued to slide in April, falling to 6.25 yuan to the dollar. The exchange rate has remained at the weak end of the 2 % fluctuation band for the daily fixing rate set by the People's Bank of China.

Although the rebalancing of foreign trade removes some appreciation pressure on the yuan, it also indicates that the yuan's decline in the midst of fairly robust economic conditions in the first quarter, large capital inflows and growth in China's foreign currency reserves has not been entirely market driven. A similar weakening episode occurred in 2012, after which the yuan returned to its long-term appreciation trend. With China's shrinking current account surplus, lower economic growth and recoveries underway in some of its main trading partners, the current situation is more in balance than earlier.

Ratio of current account surplus to GDP, four-quarter moving average



Source: Macrobond

Amendments to China's environmental protection law give authorities more power to take on polluters. The National People's Congress last week approved an amendment expanding the scope of environmental regulation and permitting harsher measures to mitigate pollution. The law will give officials the power to impose larger sanctions on firms violating environmental laws. The current ceiling on penalties will be eliminated when the amendments come into force at the start of 2015. The regulatory changes were the first to China's environmental protection law since it was enacted in 1989. Although the law has always sought to limit soil, air and water pollution, its implementation to date has been rather toothless.

Current punishments for violating the environmental protection law are inadequate as firms find it cheaper to pay fines for their excessive emissions than to implement environmentally friendly production technology. Under the current rules, polluting firms get off with a single fine. China's official news agency Xinhua reports that the new law will allow authorities to impose fines that accumulate daily during the period when the violator is out of compliance. It remains to be seen whether environmental protection officials will actually exercise their new powers to take on violators. If they do, it should increase demand for clean technologies in China.

The reforms also tighten emission-reporting requirements of firms. Companies will have to reveal more detailed information about the environmental impacts of their production. Non-governmental organisations that fulfil certain criteria can bring a lawsuit against a polluting company. This means that, in principle at least, citizens have a channel to seek legal action in challenging China's worsening pollution problems. The level of dissatisfaction of average Chinese with the country's pollution problems has soared in recent years.

The amendment provides hard evidence that China's leadership is taking climate and environment issues seriously. The leadership is starting to implement policy measures and provide more information on these issues. In April, the Ministry of Environmental Protection (MEP) published a research report on soil contamination after it was classified as a state secret a year ago. The MEP report notes that about a fifth of China's farmland is contaminated with heavy metals such as lead, arsenic and cadmium. China has also begun to post its own official air quality index along side the US embassy's air quality measures. Air quality has long been an extremely sensitive topic for Chinese politicians.

Foreign car manufacturers increase market share in China. The 13th Beijing International Automobile Exhibition Show, which ended on Tuesday (Apr. 29), brought Chinese carmakers and nearly all major Western car manufacturers to town. Car sales in China have increased more than ten-fold over the past 13 years the annual event has been held. China has surpassed the US as the world's biggest market for passenger cars and new car sales rose 14 % to 22 million cars last year.

In the first quarter of this year, nearly 6 million cars were sold in China, a gain of 9 % y-o-y. However, sales of Chinese brands shrank by over 1 % in the same period. Consequently the market share of foreign brands exceeded 60 %, a five-percentage-point gain from last year. German brands, in particular, have seen their popularity rise.

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