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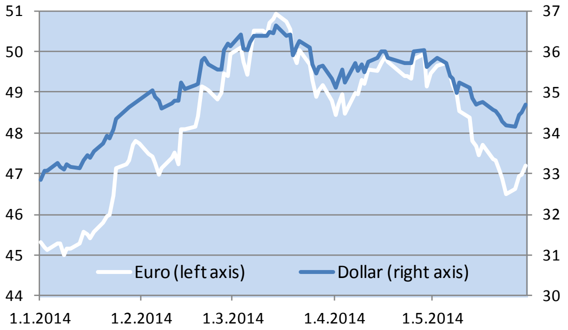
BOFIT Weekly
22 • 30.5.2014

Russia

Ruble weakening again; CBR permitting larger daily swings in ruble exchange rate. In May the ruble clawed back some of its losses since the start of the year. This week the ruble, however, has again declined on news of violent clashes in east Ukraine. The Central Bank of Russia ended interventions to prop up the ruble in mid-May and has since turned its focus to building up currency reserves.

Euro-ruble, dollar-ruble exchange rates, Jan. 1–May 29, 2014 (falling trend indicates ruble appreciation)



Source: Reuters

The CBR last week gave notice that it has diminished the amount of foreign currency used for interventions when the ruble's external value comes close to the boundaries of its prescribed fluctuation band, which means greater volatility in daily swings. The move is another step in achieving the CBR's ultimate goal of a free-floating ruble.

Russian government approves economic forecast used in drafting medium-term budget plan. Differences over budget policy made approval of the forecast particularly challenging this time around as the amount of state support for the economy is seen to be one of the decisive factors affecting economic growth.

In the end it was decided to stick to the stringent budget policy line. Hence, the low-growth scenario was approved as the basic forecast with GDP expected to rise 0.5 % this year and 2 % next year.

Russian economy to be developed under state guidance. At last week's annual St. Petersburg Economic Forum, president Vladimir Putin expressed his concerns about Russian growth falling below the global average.

In his address, Putin laid out a number of measures to restore growth. The structure of Russian exports must be rapidly altered so that the share of non-energy products in Russian exports will rise 6 % a year. At the same time, Russia must actively develop production to replace imports in fields where it is possible to gain a competitive edge.

Putin said Russian industry now needs a fundamental overhaul of its production technology. The changes will be attained by improving access of companies to low-cost financing for their capital investments, making it easier to get government loan guarantees and providing tax breaks for greenfield investment. Punitive taxes and tax breaks will be used to encourage producers to replace out-dated equipment with modern, green production technologies.

In order to reduce imports Putin asked proposals by next autumn on products for public procurement that could be bought solely from domestic companies or suppliers within the customs union. For example, supply of Russian radio-electronics, computer software, textiles and food products can all be increased through modernisation of production methods and investment. Putin promised that fields identified as competitive would be eligible for various types of support.

Putin asked the cabinet to make sure that there would be sufficient funding in the 2015–2017 budgets for the proposed measures.

Russian firms finding it harder to get international financing. CBR figures show that the foreign debt stock of Russia's corporate sector at the end of March was just over $430 billion. Some 62 % of foreign financing had been provided in the form of bank loans, 35 % as loans provided through direct investment and 2 % as bonds and other paper. Until recently, corporate borrowing had risen steadily as Russian firms borrowed actively from international markets. The borrowers as a rule are Russia's large, well-known companies.

International tensions have forced foreign banks and investors to pull back on lending to Russian firms to reduce their exposure to Russian risk. In some cases, loan talks have been terminated or more stringent conditions imposed on new loans. Companies are also finding it harder to roll over old loans. So far this year, Russian companies have had significantly fewer international bond issues than last year. Observers say this situation could continue the rest of the year.

The possibilities of domestic financial markets are limited. If corporate borrowers turn more to the domestic market, it may become difficult for banks to meet the 10 % capital adequacy requirement even if they now meet it with ease. Putin promised at the St. Petersburg Economic Forum that the state would support addition capital injections for the banking system and that the cabinet is currently looking a ways to do this. The CBR's new long-term, low-priced credit instrument should bring relief to the situation as it makes it easier for banks to offer refinancing for capital investment projects.

Observers note that Russia's problem is not so much the lack of financing as the lack of profitable projects in which to invest.

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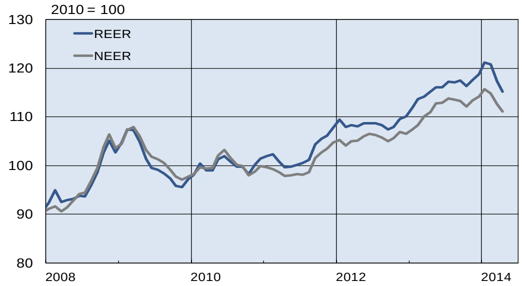
China

China's money markets calm in May, yuan exchange rate stabilises. The situation in the interbank money market has been stable in recent weeks, with the benchmark 7-day Shibor (Shanghai Interbank Offered Rate) hovering in the range of 3.1–3.6 % throughout May. The situation contrasts starkly with last year's interest rate hikes following the liquidity tightening in May 2013. The interbank repo rate eventually hit 11 % in June, after which the People's Bank of China intervened and stabilised the market. Companies and banks face a wave of scheduled tax and other mandatory payments next month, but this time the PBoC is not expected to allow similar market turbulence as last year.

With 12-month inflation settling to 1.8 % in April, officials have little motivation to tinker with the current monetary policy stance.

While the yuan lost 3 % of its value against the dollar during February-April, it stabilised in May at a rate of 6.2 to the dollar. The yuan's drop can be seen in both its real and nominal effective (trade-weighted) exchange rates (REER and NEER). The REER is down 5 % from its January high, while the NEER is off about 4 %.

Real and nominal effective exchange rates (REER and NEER)



Source: BIS

Territorial disputes threaten the positive development in China-Vietnam trade. Territorial disputes in the South China Sea flared at the start of May, when state-owned China National Offshore Oil Corporation (CNOOC) anchored an oil-drilling platform in a disputed sea area east of Vietnam's Ly Son Island and south of China's Hainan Island. Anti-China demonstrations erupted throughout Vietnam in response to the action. A number of Chinese-owned manufacturing facilities were shuttered as a precaution to the inflamed atmosphere. The Vietnamese response resembles the Chinese reaction to Japan's attempt to nationalise control of two tiny islands in the East China Sea in 2012. At that time, Chinese protestors sought to disrupt operations of Japanese-owned firms in China.

Potential offshore oil and gas deposits in the South China Sea largely drive the territorial dispute. Tensions over the islands last erupted in 2011, when Vietnam claimed that China damaged its oil and gas exploration in the area.

Escalation could cost both sides. In 2013, the value of China-Vietnam trade increased by nearly a third to $50 billion, or about 1.2 % of China's total foreign trade. China runs a huge trade surplus with Vietnam, thanks in part to Vietnam's rising wealth. China's top exports to Vietnam include electronics, machinery & equipment and base metals. A substantial share of China's imports from Vietnam is made up by electronics; many foreign consumer electronics firms, including Samsung, have production in Vietnam.

China is Vietnam's biggest trading partner. Imports from China account for nearly 30 % of the value of Vietnam's total imports, and 10 % of its total exports.

China plans to progress on structural reforms in second half of the year. On May 17, China's influential National Development and Reform Commission (NDRC) released a report on economic reforms planned for the second half of 2014. The report includes no big surprises as it builds on the policy guidelines laid down at the plenary session of the Central Committee last November. The report, however, can be seen as a signal that the country's leaders remain committed to implementing announced reforms in the following months. The emphasis is to increase the role for the private sector.

The NDRC report reiterates the State Council's demand for more competition in sectors dominated by state-owned enterprises. In the remainder of the year, China plans to move ahead with measures that include eliminating barriers to market entry, reducing bureaucracy and boosting the competitiveness of SOEs. The aim to increase competition should also imply cuts in subsidies and other benefits that state firms now receive. However, this is politically difficult as the heads of SOEs are a politically powerful group.

The NDRC report stresses financial sector reform. The share of private capital will be increased in investment projects. The NDRC also announced last week that it would permit private investment in projects earlier off limits. For example, private investors can now participate in many rail and energy projects. China's closed banking sector is also gradually being opened up to private operators. Banking regulators earlier this year gave the go-ahead on establishment of five private banks.

Deregulation of deposit rates constitutes a major capital market reform. In its latest monetary policy report, the PBoC notes that commercial banks can now offer certificates of deposit to the public at rates above official regulated rates. Sales of certificates of deposit were earlier limited to the interbank market. It appears that China is following the example of other countries in deregulation of its capital markets. In March, PBoC governor Zhou Xiaochuan said regulation of deposit rates would be phased out over the next two years.

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