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BOFIT Weekly

31 • 1.8.2014

Russia

EU directs sanctions at core branches of the Russian economy. On Tuesday (Jul. 29), the EU decided to implement further sanctions against Russia. The new measures take effect today (Aug. 1). The most significant sanctions relate to key parts of the economy, particularly the financial sector and oil production. EU exports of certain oil exploration technology and drilling equipment to Russia are now banned. The defence sector, which Russia has developed intensively in recent years, is also subject to sanctions. Russia will not be permitted to import weapons systems or dual-use items for military purposes.

The sanctions on the financial sector affect all Russia's large state-majority banks. While equity and debt issues of these banks are now banned on European markets, the EU still allows Russian banks to take loans with maturities less than three months. The US extended on Tuesday its sanctions agreed upon a few weeks ago and now a total of five state banks are off limits for loans longer than three months. Unlike the EU sanctions, the US sanctions do not target the biggest Russian state bank, Sberbank.

Some of Russia's largest state banks have traditionally played important roles in brokering loans from international capital markets to meet domestic market needs. In the short-term, the constraints on access to financing are unlikely to have serious impacts as banks can still raise funds elsewhere (e.g. Asian markets). However, financing costs for Russia will likely go up in all markets due to Russia's heightened country risk and poorer prospects for economic growth caused by the sanctions. According to observer estimates, the relatively strong fiscal position of the Russian state and ample sovereign oil funds make it possible for banks to be financed from domestic sources for about a year.

As reciprocal sanctions, Russia has so far considered import restrictions on certain foodstuffs from the EU and the US. These goods can be rather quickly replaced with similar imports from elsewhere. The constraints on imports are hoped to provide domestic firms with an opportunity to increase production. However, higher prices are an obvious consequence of the measure. Russia's food safety agency banned from today imports of many Polish fruit and vegetables due to certification infractions and health risks from contaminated products.

Sanctions have already hit the Russian economy. The impacts of the latest sanctions will depend on how long they remain in place. The EU sanctions are set for one year, but the situation will be reviewed every three months.

Russia's economic development and long-term economic outlook have already for months suffered from the EU and US sanctions – and in particular from the uncertainty over possible further sanctions. While sanctions have until now been fairly limited, they have increased uncertainty at home and abroad about the Russian economy in general. Furthermore, Russia's actions in Ukraine have in itself been a major source of uncertainty.

Uncertainty has reduced Russia's access to financing, increased borrowing costs, caused capital exports to soar and decreased corporate willingness to invest. The latest round of sanctions further amplifies that uncertainty.

Even the modest growth of the Russian economy appears to have slowed to anaemic levels. The IMF last week confirmed their April prognosis; Russia's economy remains on track to grow just 0.2 % this year. The IMF expects Russia's economy to grow about 1 % next year.

CBR hikes the reference rate as international tensions rise. Last Friday (Jul. 25), the Central Bank of Russia raised its key rate by a half percentage point to 8 %. It was the third such hike since March.

The CBR noted its decision to raise the rate reflects increased risks of ruble's weakening and higher inflation caused by the international political tensions. The CBR also referred to domestic fiscal policies, i.e. hikes in tax rates and tariffs that are under preparation in the government for next year.

The central bank noted that the reasons for slow economic growth are structural in nature. Growth is restrained by the high rate of capacity utilisation particularly in sectors producing competitive products, near-full employment conditions and slow productivity growth. The CBR further noted that economic growth is depress by the tense international political climate, which increases uncertainty over entrepreneurial ventures, limits access to long-term financing and depresses investment demand. Under such conditions, the possibilities of monetary policy to promote growth are limited.

The CBR's end-year inflation target range is 6.0–6.5 %. As of mid-July, the central bank estimated 12-month inflation was still running at 7.5 %.

The rate hike came as surprise to most analysts. They now believe that the main motivation for the CBR's action was the concern about rising capital exports if the international political situation continues to deteriorate. Analysts also see the CBR's rate hike as an effort to convey its concern about the possible relaxation of fiscal policy.

Ruble slid again. Despite last Friday's rate hike, the ruble dropped early this week, but started to rise again towards the end of the week. The CBR did not intervene to prop up the currency.

As of August 1, the ruble-euro rate was 47.8 and the ruble-dollar rate was 35.7. The ruble has lost over 5 % of its value against the euro and nearly 8 % against the dollar since the start of the year. The ruble's weakest point this year occurred when the Crimean crisis flared in March.

*The information is compiled and edited from a variety of sources.
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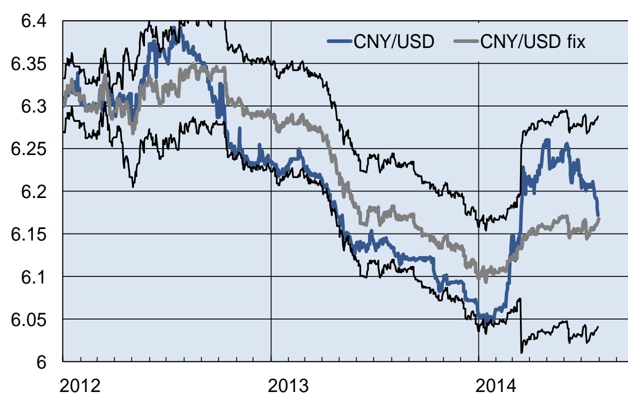
China

Yuan appreciation returns; current account surplus rises. The yuan's exchange rate relative to the US dollar weakened significantly in the beginning of this year in response to the People's Bank of China's deliberate policy of frustrating appreciation pressures from one-sided speculation urges. The "policy package" also included a widening of the yuan's daily fluctuation band. Since mid-March, the yuan has been allowed to rise or fall 2 % in value against the PBoC's daily reference exchange rate.

The yuan's exchange rate stabilised at a level of 6.23–6.25 to the dollar in late spring. The PBoC has since allowed the exchange rate to strengthen. One dollar bought 6.17 yuan at the end of July. The appreciation has been supported throughout the summer by economic data that suggest a stable growth outlook for the economy. The second quarter also saw a return to growth in the current account surplus. The moving 12-month current account surplus climbed to 1.7 % of GDP in the second quarter, up from 1.5 % in the first quarter. At the end of June last year, the moving 12-month current account surplus was still about 2.6 % of GDP.

The yuan's real effective (trade-weighted) exchange rate in June was 4 % lower than at the end of 2013. In a publication released this week, the IMF estimates that the yuan's exchange rate is still 5–10 % undervalued in light of economic fundamentals and policy needs. A number of investment banks anticipate modest yuan appreciation.

Yuan-dollar rate, PBoC reference rate and fluctuation band



Sources: Macrobond, BOFIT

Summer grain harvest exceeds old record – FAO and OECD encourage China to rationalise agricultural production. China's National Bureau of Statistics reports that the summer grain harvest increased by 5 million metric tons from last summer's total to 137 million tons. The summer crop accounts for about a fifth of China's total annual grain harvest. The long-trending gains in China's agricultural output reflect, e.g. more efficient land use and farm subsidies. Farmers are subsidised for procurement of fertilisers and pesticides, and the use of fertilisers has been an important factor in boosting agricultural output. China subsidises domestic farming in order to guarantee 95 % self-sufficiency in key staples such as wheat and rice.

The OECD-FAO Agricultural Outlook 2014 released in July suggests that China's agricultural output is unsustainable as chemical overuse is causing farmland degradation. The report recommends that China should boost agricultural productivity by rationalising farming instead of escalating fertiliser use. The government could also replace many input subsidies with income transfers to farmers.

The jointly compiled report notes that farm production could be made much more efficient by consolidation of smaller farms into large units. China's current farming economy, which is based on small farmers, makes the efficient use of modern farm equipment difficult. Improved land rights for farmers would encourage larger farms and mechanised production. The aging population and urbanisation continue to increase pressures to mechanize farming further.

According to OECD and FAO, China needs to stress efficient use of irrigation water. Adjusting the pricing of irrigation water would encourage farmers shift away from water-intensive plant varieties. Currently a number of provinces suffer from water shortages that are already starting to affect food production. However, it appears that China is moving ahead with concrete measures to remedy the situation. Reuters reported last week that seven provinces have been granted permission to host pilot markets to trade water rights in a scheme to bring water to wherever it is most needed. Officials have yet to decide if the rights will be granted to private firms or local authorities.

Modernisation and development of agriculture is important for social reasons. The FAO and OECD note that currently 11 % of Chinese suffer from malnutrition and that the lack of food is concentrated in the areas where living is based on small-scale farming.

Latest WTO decisions on US-China trade disputes. A World Trade Organization arbitration panel found that countervailing duties levied by the US on 17 products manufactured by Chinese state-owned companies violate WTO rules. The US claimed the public companies were in fact public bodies that enjoy state subsidies and distort competition. The WTO concluded that state-ownership per se does not necessarily mean that a company is a public body under the WTO definition. The US can still appeal the decision.

In May, a WTO expert group found in favour of the United States in a dispute where the US claimed China's import duties on certain large engine vehicles violated its WTO commitments. The decision was largely symbolic as China had already abolished the disputed duties.

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