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Russia

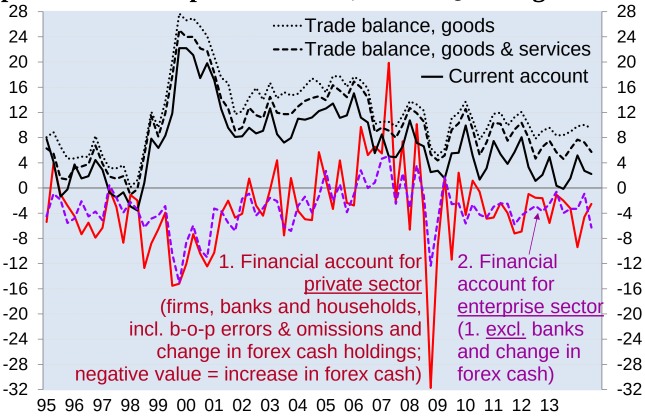
Falling imports support Russia's current account surplus. Preliminary Central Bank of Russia balance-of-payments figures show a third-quarter current account surplus again rivalling the quarterly surpluses of the previous two years. For the past four quarters, the current account surplus rose to nearly 3 % of GDP and the goods trade surplus continued to hold at nearly 10 % of GDP.

Russia's earnings from exports of goods and services fell slightly y-o-y in both the third quarter and the first three quarters of this year. Growth in export earnings has remained virtually flat for the past two-and-a-half years.

Russia's recent notable trade and current account surpluses reflect a contraction in Russian imports. The value of imports of goods and services (including spending of Russian travellers abroad) was down 6–7 % y-o-y in both the third quarter and the first nine months of the year. The corresponding drop in goods imports only was about 8 %. Regarding services imports, both traveller spending abroad and imports of other services contracted just a couple of percentage points and only during the past six months.

Access to foreign funding for Russian banks and corporations dried up. Preliminary CBR balance-of-payments figures indicate Russia's net private sector capital outflow fell in the third quarter. *Banks* repatriated a record high amount of their assets from abroad in order to balance their forex positions as Russian firms and households reduced their domestic forex deposit accounts with Russian banks. In addition, observers note that Russia's large state banks repatriated assets from abroad also in case there was an asset freeze. Net borrowing of banks from abroad was strongly, and to an unusual degree, negative.

Trade and current account surpluses, and net inflow of private sector capital to Russia, % of 4Q average GDP



Source: Central Bank of Russia

The net capital outflow from Russia's *enterprise sector* (non-bank corporations) increased substantially in the third quarter (up to more than 6 % of GDP of the four previous quarters). While corporate asset outflows remained largely unchanged, e.g. with respect to direct investments, corporate liability flows turned negative – a very exceptional situation. FDI in the corporate sector ground nearly to a standstill and firms paid down existing foreign debt in considerably larger amounts than what they received in new loans.

Russian prime minister and Chinese premier hold annual meeting in Moscow. With increased tension in Russia's relations with Europe and the US, Russia has stepped up its efforts to expand economic cooperation with China in order to develop alternative export markets and sources of international financing. The current situation has strengthened China's negotiation hand in defining the terms of co-operation. As in earlier meetings, most of the leaders' signing activities involved general memoranda on cooperation and policy frameworks concerning the energy sector.

Li Keqiang and Dmitri Medvedev also finalised the massive natural gas supply agreement that the two countries agreed on in May. The 30-year deal calls for Russia to export 38 billion m^3 of natural gas a year to China from 2018 onwards. State enterprises Gazprom and CNPC have commenced construction of the "Power of Siberia" gas transmission pipeline. Gazprom, which is responsible for pipeline construction on the Russian side, has requested a $25 billion downpayment from the Chinese, but says the pipeline can also be built without the downpayment.

Other Russian firms are also trying to get Chinese loans now that access to credit in Europe and the US has dried up. For the moment, Chinese banks appear rather cautious in lending to Russian companies, mostly granting financing to projects that include a Chinese partner. Press reports suggest that combined lending of China's largest banks to Russian businesses only amounts to around $1 billion, whereas the total foreign debt of Russia's private sector is about $615 billion.

The central banks of Russia and China also signed a currency exchange deal. The swap agreement, which allows up to 150 billion yuan ($25 billion) in foreign currency swaps, will remain in force for three years. China has made similar swap deals with a number of central banks in recent years to boost international use of the yuan.

Medvedev announced the goal of doubling bilateral trade to a level of $200 billion a year by 2020. Russia mainly exports oil and other commodities to China and imports mostly consumer goods from China. China is already Russia's largest supplier of imports (17 % overall), and e.g. over half of Russia's clothing imports and over a third of electronics come from China. Medvedev particularly hoped for increased trade in high technology. High-tech products currently account for about 1 % of Russia's total exports and a quarter of China's total exports. Chinese high-tech exports typically include a high third-country value-added component.

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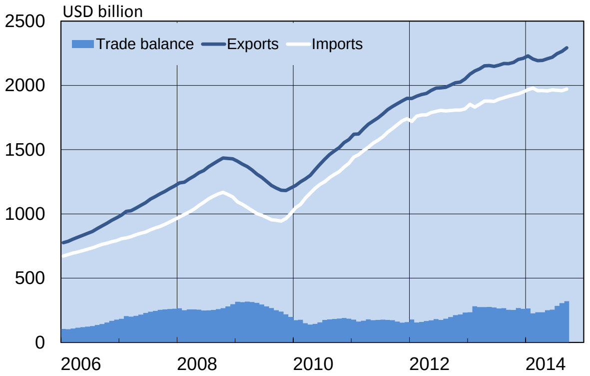
China

China's goods trade surplus reaches record high. The value of Chinese exports in September clearly exceeded market expectations, surging 15 % y-o-y. Seasonally adjusted export figures show strengthening growth for several consecutive months. The top markets for Chinese exports, Europe and the United States, were up 15 % and 11 %, respectively. Exports to Japan, however, declined 5 %.

While conditions in China's export markets were generally favourable in the third quarter, September exports were boosted by a couple of transient factors. Phone exports exploded with the release of Apple's iPhone 6 and exports to Hong Kong rose by over a third. The Hong Kong numbers, however, were called into question, as mainland companies may have reported far more exports to Hong Kong than Hong Kong figures will later probably indicate as imports from mainland China. Observers suggest there might have been a relapse to phoney invoicing schemes for avoiding capital import controls. Even excluding Hong Kong, however, the rest of China's exports were still up 12 % y-o-y in September.

China's foreign trade, 12-month moving total



Source: Bloomberg

The 7 % rise in imports (measured by value) also beat market expectations. However, import growth was driven entirely by a sharp increase in inputs for assembly industries. Imports associated with assembly production, which is determined by demand outside China, rose 30 % y-o-y in September. The value of Chinese imports for the country's own consumption declined about 2 % y-o-y. Drops in energy and commodity prices slowed the rise in the value of imports. Imports from Europe were up 9 %, from the United States 13 % and from Japan 4 %.

China has apparently increased its market share in Russia due to the current tense relations between Russia and the West. While Russian imports are down almost 10 % overall, Chinese goods exports to Russia in January-September rose 11 % y-o-y. In the August-September period, growth exceeded 20 %. Despite falling commodity prices, the value of China's imports from Russia were up 3 % in the first nine months of 2014, largely on higher crude oil import volumes.

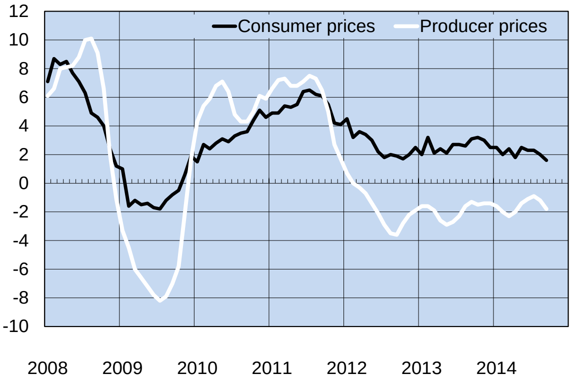
Even if China's September goods trade surplus was less than in August, the 12-month trade surplus surged to a record of slightly over $320 billion. The overall foreign trade picture was balanced by China's rising services trade deficit, which is largely driven by a huge increase in Chinese international tourism. As a result, the current account surplus should continue to hold at around 2 % of GDP.

Key monetary indicators suggest permanent slowdown in growth. Over the past two years, the rise in Chinese consumer prices has remained in the range of 2–3 % a year, but 12-month inflation now fell from 2 % in August to 1.6 % in September. Such a low inflation was last seen in January 2010. Stable or falling food and fuel prices have been major drivers slowing Chinese inflation. Lower growth in housing expenses has also helped dampen inflation.

In addition to lower consumer price inflation, the decline in producer prices steepened from a fall of 1.2 % y-o-y in August to a slide of 1.8 % in September. Producer prices have now fallen in every month since March 2012. The drop in producer prices reflects lower global commodity prices, as well as China's own problems with excess supply. Many branches in China, and notably the coal and steel industries, for example, have long suffered from overcapacity issues.

In addition to low inflation, indicators on the supply of credit and money reflect a cooling economy. Growth in bank lending slowed a bit to 12.4 % y-o-y, while growth of entrusted and trust loans' stock outside the regular banking sector slowed to 26 %. The volume of trust loans, the most problematic of these shadow-banking products, actually declined in recent months. The broad money supply measure (M2) continued to rise at 12.9 % y-o-y, even if growth in bank deposits appears to have slowed substantially.

Consumer price and producer price inflation in China, %



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