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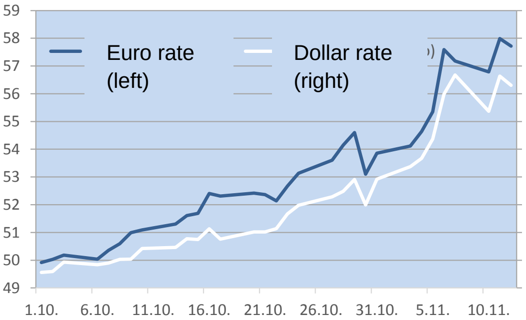
Russia

CBR floats ruble ahead of schedule. The Central Bank of Russia announced in 2010 it would gradually move away from trying to steer the ruble's exchange rate. In 2012, it confirmed further that it would have measures in place to allow a free-floating ruble by the end of 2014. The float should allow it to focus on fighting inflation through interest-rate policy instead of ruble steering.

Recent market instability and a steep drop in the ruble's exchange rate forced the CBR late last week to accelerate the float date. Since Monday (Nov. 10), the CBR no longer seeks to restrain the exchange rate within a trading band by buying and selling currency.

Euro-ruble, dollar-ruble rates, Oct. 1 – Nov. 12, 2014 (rising line indicates ruble weakening)



Source: Bank of Russia

In addition to phasing out the trading band based on the performance of the ruble relative to a dollar-euro currency basket, the CBR will also abandon rule-based market interventions. Naturally, the CBR retains the option of market intervention if it sees that the stability of the financial sector is threatened. Making the timing of interventions less predictable reduces opportunities for ruble speculation.

In lieu of rule-based interventions, the CBR will now offer banks euro or dollar credit if market demand for forex increases. The CBR in October introduced auctions of 7-day and 28-day forex repo contracts. Later this year it will also initiate auctions for one-year forex repo contracts. Repo contracts allow banks to borrow foreign currency from the central bank against approved collateral. The CBR says it will regularly arrange forex repo auctions as long as Russian banks lack access to international credit markets.

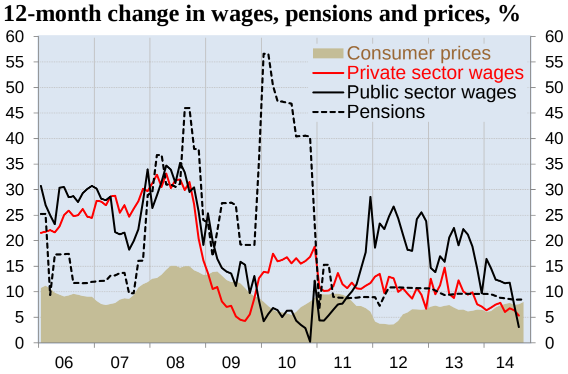
Weak outlook for Russian household income growth. Disposable real incomes of households have shrunk in recent months compared to a year earlier e.g. due to debt-servicing. The government September forecast sees real incomes growing very slowly in coming years. Since then, the outlook for household income has deteriorated further.

Rise of private sector wages has been gradually dampened by lower economic growth and deteriorating corporate profitability. The average wage rise of recent months has barely kept up with inflation, i.e. real wages are stagnant.

Real wage growth in the public sector has also slowed sharply in recent years and even lagged inflation in recent months. Also for next year the federal budget sees wage increases at a rate below inflation. This means that the promised wage growth by president Putin in his 2012 inauguration decrees will not happen.

The rise in pensions has also been close to inflation. The government will next year seek to raise pensions more sharply than planned earlier. After that, pensions should rise at about the same rate as inflation.

12-month change in wages, pensions and prices, %



Source: Rosstat and BOFIT

Russia and China continue gas talks at APEC summit. Last Sunday, executives of Gazprom and the Chinese CNPC signed a framework agreement on the "western route" for natural gas supplies from Russia to China. After years of talks, the parties now agreed on a schedule for next steps in the talks and basic precepts. These include the annual supply volume of 30 billion m^3 which would be transported via the yet-to-be-constructed Altai pipeline. The Altai pipeline route and the gas price have yet to be specified.

Russia has been pushing the western route in order to take advantage of existing transmission infrastructure. It also provides a strategic alternative market for Western Siberian gas, which currently is only exported to Europe. China, on the other hand, is more interested in the eastern route because it is closer to end-users. China already has several pipeline gas suppliers on its western borders.

After several years of price talks, China and Russia agreed earlier this year on eastern-route gas supplies. Under the deal, Russia will annually pipe to China 38 billion m^3 of gas starting in 2018. In order to fulfil the deal, Russia should bring new gas fields in Eastern Siberia on stream, as well as construct the 4,000-km "Power of Siberia" pipeline.

If both Russia-China gas pipeline projects are realised according to plan, Russia could annually export to China nearly 70 billion m^3 of gas annually in the next decade. Russia's total gas exports to Europe last year amounted to 170 billion m^3.

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China

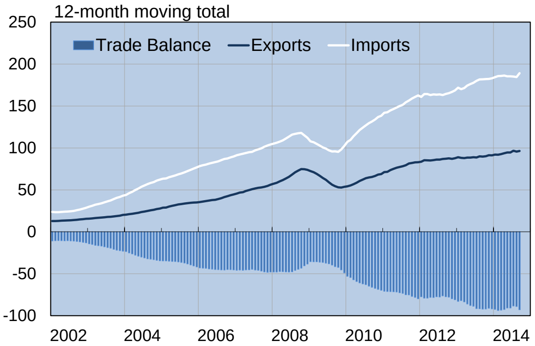
Free-trade agreements top APEC agenda. China hosted the Asia-Pacific Economic Cooperation (APEC) summit in Beijing during the first two weeks of November. Notably, China and South Korea (which has run trade surpluses with China for over two decades) announced they had concluded a free-trade deal. While both countries still must ratify the agreement, local media reported that China had committed over the next 20 years to eliminating tariffs on 85 % of imports from South Korea by value and that South Korea would cut tariffs on about 90 % of Chinese imports by value. The agreement, however, omits important goods categories such as agricultural and automotive products, and appears to be narrower in scope than, say, the South Korea-EU free-trade agreement.

China's General Administration of Customs reports that in September South Korea surpassed Japan as China's third main trading partner after the EU and US. Trade between the two countries last year was valued at $274 billion, about 7 % of China's foreign trade. China is South Korea's most important trading partner, with a quarter of its exports going to China.

Ten years of talks on a bilateral free-trade deal between China and Australia also appeared to be in the home stretch. China is Australia's biggest trading partner. Bilateral trade last year reached $136 billion, or about 3 % of China's foreign trade. In addition to South Korea and Australia, China has six FTA agreements under negotiation. China has twelve free-trade agreements in force at the moment.

Given the intricacies of free-trade arrangements within the 21-member APEC, China is pushing for creation of a regional "Free-Trade Area of the Asia-Pacific" (FTAAP). The summit's final communiqué mentions establishment of a study group to scope out possibilities towards FTAAP realization. The US supports creation of a more restricted Trans-Pacific Partnership (TPP) that does not include China.

Chinese trade with South Korea, USD billion



Source: Macrobond

China and the United States reach deal to eliminate duties on many IT products. The WTO's Information Technology Agreement (ITA) got a huge boost this week when China and the United States agreed to expand the agreement and completely eliminate duties on over 200 IT products ranging from smartphones to medical equipment and game consoles. The expansion would eliminate tariffs on globally traded goods with an estimated value of $800 billion to $1.4 trillion a year. China is the world's largest exporter of IT products.

The ITA trade pact that entered into force in 1997 sought to end tariffs on high-tech products. It has lagged technological advance from the start. Although the need for a treaty expansion has been apparent for 17 years, agreement still seemed in doubt last year as the US and China suspended ITA talks several times. The treaty includes 80 WTO members and covers 97 % of globally traded IT products.

China's New Silk Road vision comes closer to reality. President Xi Jinping last year proposed creating a modern version of the ancient Silk Road trade route running from China to Europe. The ambitious New Silk Road (NSR) project took a big step forward last week when Xi announced that China would create a $40 billion NSR fund to provide financing for infrastructure projects and economic cooperation among countries along the route. The project is part of China's regional cooperation strategy and is connected to the establishment of several new development banks. It is, however, still unclear how the new fund will operate.

The NSR plan has land and maritime aspects. The NSR involves rail lines connecting Central Asia with regional economies, as well as sea routes running from Southeast Asia to Europe. The NSR plan calls for large-scale construction of railways, road infrastructure, seaports and airports. The land route would traverse southwest China, several countries in Central Asia and the Middle East, as well as Turkey before reaching Europe. The sea routes would run from China's southern coast to Southeast Asia, India, East Africa, then on via the Suez Canal to the Mediterranean Sea.

China hopes the plan will promote regional cooperation, boost foreign direct investment abroad and increase international use of the yuan. The huge project would also create demand for Chinese heavy industry, which is suffering at the moment from overcapacity in several branches.

The lion's share of freight between China and Europe presently moves by sea. China is linked to Europe via rail lines running through Kazakhstan, Russia and Belarus. While maritime shipping offers greater freight capacity and lower transport costs, land shipping is attractive where speed or reliable timing of delivery are issues. Overland shipping from China to Europe would take half the time of sea shipping. Given the heightened tensions between Russia and Europe at the moment, the NSR could seek alternative (i.e. non-Russian) land routes to China for European exports.

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