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BOFIT Weekly

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Russia

2014 exposed major weaknesses in the Russian economy. Former finance minister Alexei Kudrin notes that the basic reason for the slowdown of the Russian economy since 2011 is the peculiar economic model Russia has created over the past ten years that often provides inappropriate signals for business activity.

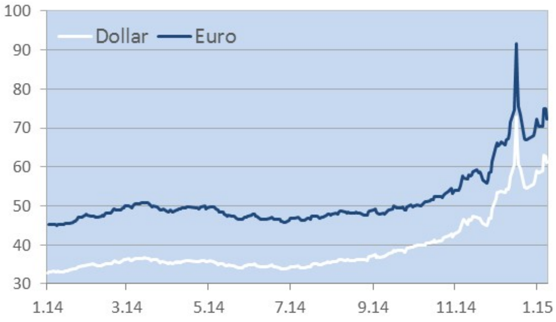
According to Mr. Kudrin, market mechanisms function poorly in Russia. In recent years, state participation in the economy has increased so that large state-owned or quasi-state-owned enterprises now dominate the economy. These firms have little incentive to modernise or seek out operational efficiencies. They seek instead to maximise their various forms of state support and get supply contracts with the government. These perverse business incentives are disseminated throughout the economy via distribution chains. All this together with uncertain business environment caused by stunted institutions encourage to short sighted business activity. Firms seek opportunities for quick profits rather than invest long term.

The Ukraine crisis last year increased uncertainty in the business environment. The annexation of Crimea and the on-going Donbass conflict, as well as the economic sanctions and countersanctions that followed, are likely to depress economic growth for years to come. The final nail in the coffin has been the sharp decline in world oil prices.

All these problems are reflected in the ruble's exchange rate. Over the course of the year, the Central Bank of Russia's official ruble rates showed a 34 % drop against the euro and a 42 % loss against the dollar.

The ruble's slide on currency markets continued this month with the exchange rate remaining above 70 rubles to the euro and the dollar rate holding close to or above 60.

Ruble-dollar, ruble-euro rates, 1 Jan. 2014 – 8 Jan. 2015 (falling trend indicates ruble appreciation)



Source: Thomson Reuters

The weakening of the ruble also reflects the international collapse in oil prices. The price of Urals crude, Russia's key export oil grade, lost 52 % last year, a bit more than North Sea Brent oil (down 48 %). The price of Urals crude tracks the Brent price and typically is a couple dollars cheaper per barrel.

Moscow stock prices tanked last year. The Moscow Exchange's RTS index fell 43 % last year from a high of 1,388 points to 791 points. The steepest drop came in December on the sharp drop in crude oil prices, even if the index has recovered somewhat thereafter.

The Moscow Exchange last year was among the poorest performing emerging market stock exchanges. The RTS Index has not seen such lows since spring 2009.

RTS index, 1 Jan. 2013 – 6 Jan. 2015

Source: Bloomberg

Russian inflation averaged 11.4 % in 2014. Inflation staged a dramatic pickup in November and December. Preliminary Rosstat figures show food prices increasing at an on-year rate above 15 % in December. Non-food goods were up 8 % and services over 10 %.

The pick-up in inflation at the end of the year reflected the ruble's sharp depreciation and the ensuing frenzy of household spending. Following the ban on certain categories of food imports last autumn, food prices have risen even if no food shortage has actually emerged.

Representatives of food producers and retail chains committed in September to a government initiative that their members would not raise prices without good reason or create artificial shortages in the market. There has been no move by the government as yet to impose price controls as in 2010. The agreement could have limited price increases somewhat.

Consumer price inflation, %, January 2013 – December 2014

Source: Rosstat

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China

Current forecasts see Chinese economy growing by about 7 % in 2015. China's indexes of manufacturing purchasing mangers (PMI) indicated further slowing of industrial output growth in December. The fall in growth of the service sector seems to have levelled off, however. The pace of retail sales growth and the services PMI reading have not changed significantly in recent months. The final GDP growth figure for 2014 is expected to be just over 7 %.

The estimates by a number of observers indicate that the slide in oil prices could probably add half a percentage point to GDP growth this year. Given that current economic growth is still boosted by excessive fixed capital investment and rising indebtedness and thus has no sustainable basis, the oil price boost is unlikely to reverse China's general trend towards a lower-growth paradigm. However, lower oil prices will relieve the need for fiscal and monetary stimulus measures.

Most leading forecasting institutions still see GDP growth above 7 % this year. Such strong growth will not come easily, however. Recent price swings on mainland China stock exchanges and revelation of a large real estate developer on the brink of bankruptcy provide fresh reminders of systemic risks lurking in the wings.

Recent GDP growth forecasts for China, % p.a.

	2014	2015	2016	Released
IMF	7.4	7.1	6.8	10/2014
OECD	7.3	7.1	6.9	11/2014
EIU	7.3	7.1	6.7	12/2014
CICC	7.4	7.3	7.5	12/2014
Deutsche Bank	7.3	7.0	6.7	1/2015
BOFIT	7	7	6	9/2014

China eases export restrictions of rare earth metals. At the start of January, China ended export quotas on rare earth metals and some other critical high-tech metals. The quotas have been replaced with export permits. Last August, a WTO panel upheld a US complaint that China's export quotas violated WTO rules. China had argued the quotas were needed in light of e.g. the environmental damage caused by mining rare earth elements (REEs). In 2010, China sharply cut its export quotas, causing world prices for REEs to soar. The elimination of quotas, however, is unlikely to have much of an impact on prices as export volumes in recent years have remained below the quota amounts. Some observers note that China is also planning to eliminate export duties on REEs, which would have a bigger impact on prices.

Other trade policy issues have also been in the news recently. A WTO panel in December found in China's favour on its complaint that US duties on Chinese-made solar panels violated WTO rules. The US commerce department recently conceded that the alleged price dumping of Chinese manufacturers was not as widespread as earlier believed and says it is ready to cut anti-dumping duties on solar panels.

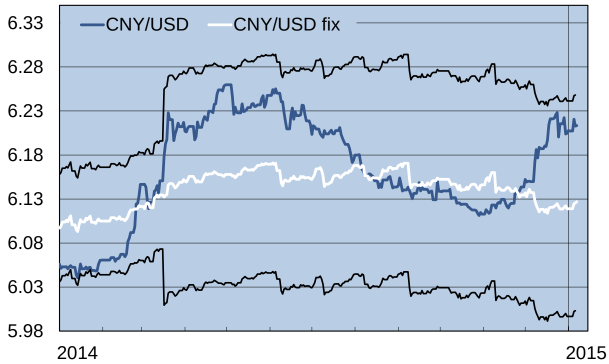
Talks on expanding the WTO-enforced Information Technology Agreement (ITA) have been delayed on issues such as a dispute between South Korea and China on duties for flat panel displays. Since the US and China broke their ITA deadlock in bilateral talks in November, the expanded ITA has been considered much more likely.

For the first time in several years, the yuan loses ground against the dollar. After years of steady appreciation, the yuan last year lost about 2.5 % of its value against the US dollar. The last time the yuan showed an on-year drop against the dollar was in 2009. In the first half of the year, markets were surprised by an unexpected depreciation of the yuan against the dollar, even as most economic fundamentals pointed to on-going yuan appreciation. Part of the weakening reflects deliberate central bank measures to curb speculation on yuan appreciation and prepare markets for the widening of the yuan-dollar trading band.

The People's Bank of China doubled the width of the trading band in March, allowing a daily divergence of 2 % from the central bank's daily fixing of the yuan-dollar rate. The move was intended to give markets greater power in formation of the yuan's external value. The trading band was last widened in April 2012. With these measures, the PBoC ushers in market-based exchange rates and promotes internationalisation of the yuan.

Following the widening of the trading band, the yuan showed more volatility and resumed appreciation. Towards the end of the year, however, slower economic growth and cut in reference rates, along with the improving performance of the US economy, resulted in yuan depreciation against the dollar. The yuan continued its appreciation trend against the euro in the second half, finishing the year up about 10 % against the euro.

Yuan-dollar exchange rate and trading band limits (black)



Sources: Macrobond and BOFIT

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