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BOFIT Weekly
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Russia

Fitch downgrades Russia's creditworthiness. International credit ratings specialist Fitch announced last Friday (Jan. 9) that it had cut its ratings on Russian sovereign debt from BBB to BBB-, Fitch's lowest investment-grade rating. Fitch said the downgrade was warranted in light of the deteriorating outlook for the Russian economy over the second half of 2014.

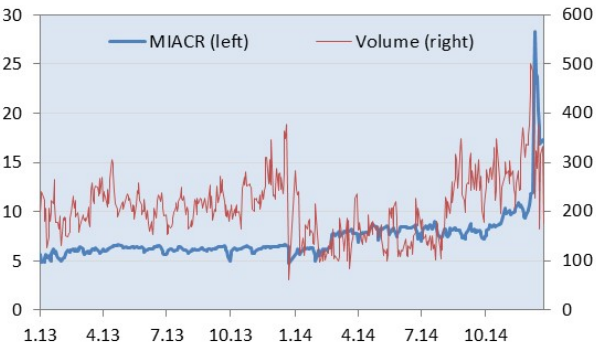
Standard & Poor's lowered its rating of Russian sovereigns to its bottom investment-grade category last April as the Ukraine crisis flared. The final big-three ratings agency, Moody's, continues to hold its rating of Russian sovereigns one notch above its lowest investment grade.

The outlooks of all three ratings agencies were negative. Any further lowering from Fitch or Standard & Poor's would push Russian borrowing down into the realm of "speculative grade." Many institutional investors have rules barring them from holding speculative-grade bonds, which are considered so risky that they are only recommended for well-informed investors capable of absorbing substantial losses.

Russian interest rates surged late last year. In order to calm inflation and capital exports, the Central Bank of Russia last year raised its key rate (the 7-day repo credit rate) six times. Over the course of last year, the key rate climbed from 5.5 % to 17 %.

Market interest rates increased in response to CBR hikes in its own steering rates. The one-day Moscow Interbank Actual Credit Rate (MIACR) rose above 17 % at the end of the 2014, having started the year just over 6 %. During the ruble's collapse in mid-December, the one-day MIACR briefly hit 28 %.

1-day Moscow Interbank Actual Credit Rate (MIACR) and lending volume, RUB billion, 2013–2014

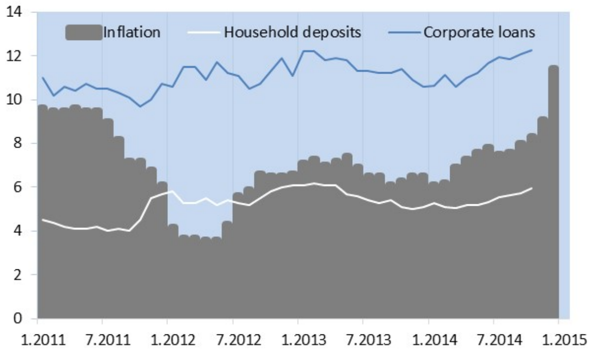


Source: CBR

CBR interest rate hikes have increased borrowing costs for banks, forcing them in turn to raise lending rates. Corporate loans at the end of December carried interest rates of as much as 20–30 % p.a. Given the rise in interest rates late last year, real lending rates (inflationary impact removed) could soar and further erode possibilities for corporate borrowing.

Banks have also increased their deposit rates in an effort to retain current assets. For the first time in a long while, real deposit rates are positive in some cases.

Interest rates for household deposits of less than a year, corporate loans of over a year, as well as 12-month inflation, %



Source: CBR

Despite rapid growth, Russia's housing loan market is still relatively small. Starting from a very modest level, the total stock of housing loans issued by banks has increased at over 30 % a year since 2011. As of end-September 2014, the stock of housing loans stood at 3.35 trillion rubles (€45 billion), up from 1.07 trillion rubles in 2008. At that time, just 17 % of housing purchases involved bank financing. In the first nine months of 2014, bank financing was involved in 28 % of all housing deals. Housing loans last year represented about 30 % of the stock of bank lending to households.

The average length of a housing loan has fallen from nearly 18 years in 2008 to just over 12 years in 2014.

Russia's biggest provider of housing loans by far is Sberbank, followed by VTB24. The two state-owned banks together account for over 70 % of housing loans currently on issue. Other banks issuing housing loans are typically mid-sized privately held banks.

The price of housing loans today reflects last year's rising economic uncertainty and across-the-board hikes in interest rates. Sberbank in December raised its average rates on new housing loans to a range of 14.5–15.5 % p.a., while the average rate of a VTB24 housing loan hit 14.95 %. In the case of certain private banks, the price of housing loans has risen to as much as 17–20 %. In recent years, the average interest rate for all housing loans on issue has averaged over 12 %.

Faced with rising risk in housing loans, banks began to deal with their exposure late last year by tightening lending criteria (e.g. raising the size of the downpayment requirement for the borrower).

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China

Inflation slow in China. December consumer prices were up just 1.5 % y-o-y. Food prices, up nearly 3 %, were the biggest driver of inflation. Prices other than food were up 0.8 % y-o-y, but were lower than in November. November consumer price inflation was 1.4 % y-o-y.

Domestic prices for fuels and other energy formats have not fallen as rapidly as on world markets, however. Officials have reduced the ceiling price on fuels twelve times since last June. In the same period, the fuel consumption tax was increased three times, slowing the decline in retail fuel prices. Gasoline prices are down 25 % from last June and diesel oil prices down 30 %. The drop in global oil prices, in contrast, was nearly 60 % over the period.

The slide in producer prices accelerated from a drop of 2.7 % y-o-y in November to 3.3 % in December. On-year deflation in producer prices has persisted since March 2012, and producer prices were down at the end of 2014 by about 7 % compared to spring 2012.

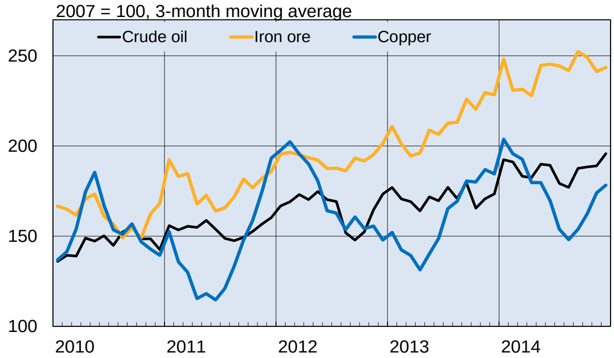
Price trends in China are also affected by price declines in other countries. November import prices were down 5 % y-o-y. Export prices remained roughly at the 2013 level. Consumer price inflation this year could be moderated especially by lower prices for manufactured products, energy and housing.

Lower commodity prices boost China's trade surplus. The December foreign trade numbers provided a pleasant surprise for China, with the value of exports increasing 10 % y-o-y and the drop in the value of imports a mere 2 %. Lower import prices helped push China's trade surplus in 2014 to a record $380 billion, an increase of nearly 50 % from the previous year. Chinese exports increased by 6 % last year, while imports rose less than 1 %.

The drop in the value of imports reflected lower commodity prices globally, and led to an increase in import volumes. The volume of crude oil imports last year climbed 9 %, while the volume of iron ore imports rose 14 %. China imported more crude oil than ever in 2014, about 308 million metric tons. The volume of iron ore imports rose to a record 933 million tons. The volume of copper imports increased 6 %, boosted in part by a sharp drop in copper prices towards the end of last year. Coal imports, in contrast, declined by 11 %. The October introduction of new tariffs on coal imports to support domestic coal production appeared to have no significant impact on coal imports, which declined steadily throughout 2014.

The fall in the prices of imported commodities has provided China with an opportunity to build up its strategic reserves of crude oil and also reserves of other basic commodities. Moreover, lower commodity prices could lead to the substitution of poorer-quality domestic production with imports. Thus, higher import volumes do not directly reflect a rise in demand for commodities.

Import volumes of key commodities to China



Source: Macrobond

Problems of China's largest real estate developers could affect financing possibilities for the entire sector. Kaisa Group Holdings, a real estate developer listed on the Hong Kong stock exchange, defaulted on a $52 million bank loan payment at the end of December. Last week, the firm became the first major Chinese developer to default its foreign bond servicing, when it missed $23 million in coupon payments. Several of Kaisa's top management have resigned, trading in Kaisa shares has been suspended, the price of its foreign bonds have collapsed and its bank accounts frozen, taking the company yet another step closer to bankruptcy.

For a company still renowned for healthy profitability six months ago to get into so much trouble so quickly raises a number of disturbing questions. Foremost is whether Kaisa's problems merely reflect bad decisions on the part of a single private enterprise or are they symptomatic of deeper problems running throughout China's real estate sector. Apartment prices continued to decline in December and during the holiday season around the turn of the year, sales volumes in large cities were less than half of what they were a year earlier. The slowdown in the housing market has hit highly leveraged builders particularly hard, and several developers encountered financial difficulties last year. Headlines reporting the resignations and arrests of leading figures in these enterprises hardly helped given widespread public suspicions of e.g. crooked land deals in the real estate sector.

Problems in China's real estate sector have also shaken foreign investors. The *Financial Times*, based on information from Dealogic, estimated last autumn that the outstanding amount of foreign bonds of Chinese developers was nearly $60 billion, while syndicated loans amounted to about $40 billion. Foreign bonds of Kaisa Group Holdings alone amount to about $2.5 billion, and in the case of a bankruptcy the position of foreign creditors seems to be weak.

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