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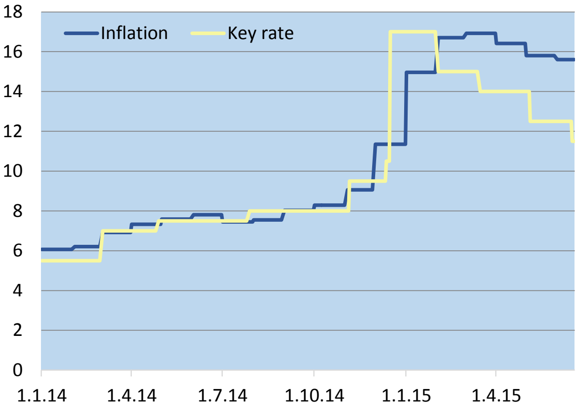
Russia

CBR lowers key rate for fourth time this year. The Central Bank of Russia lowered its key interest rate one percentage point on Tuesday (June 16) to 11.5 %. The CBR said the rate cut was justified in light of lower inflationary pressures and Russia's weak economy. The CBR expects inflation to fall further over the next 12 months to below 7 % and reach its 4 % target in 2017. The CBR said that, while it was prepared to keep cutting rates, emerging inflation risks could limit monetary easing in the months ahead.

As the effects of the price spike caused by the ruble's dive in the final months of 2014 have faded, inflation has gradually subsided in recent months. Moreover, the ruble enjoyed a period of strengthening between early February and end-May, while consumer demand continued to contract. The CBR also noted that most of the inflationary impact from Russian counter-sanction import bans introduced in August 2014 has been digested. However, as of end-May, consumer prices were still nearly 16 % higher than a year earlier. Food price inflation traditionally slows in the summer months as domestic produce reaches the market. On the other hand, the hikes of 7.5−10 % in rates for regulated utilities and services will add to inflationary pressures when they take effect on 1 July. The CBR stated that a possible relaxation of fiscal policy could also be an inflation risk.

Russian 12-month inflation and CBR key rate, %



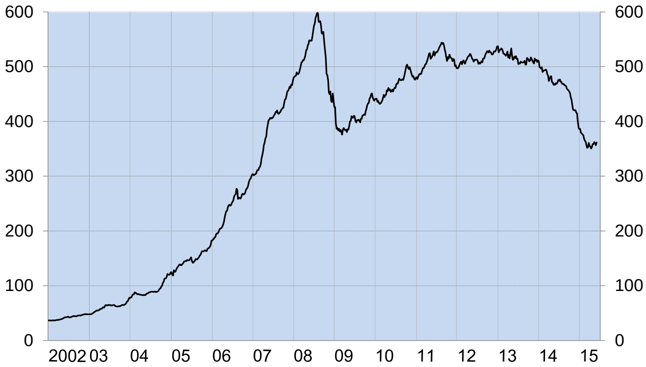
Source: Macrobond

CBR governor Nabiullina discusses outlook for Russia's foreign currency reserves. At a banking conference in St. Petersburg at the start of this month, CBR head Elvira Nabiullina noted that Russia's current level of foreign currency reserves (about $360 billion) is quite adequate by international standards. For example, the reserves are large enough to cover nearly eleven months' worth of imports. However, given the special features of the Russian economy and current market conditions, Nabiullina said she considered optimal that currency reserves would cover 2-3 years of substantial capital outflows. The CBR estimates this would require currency reserves of about $500 billion. Russia's currency reserves shrank last year by about $125 billion, largely on capital outflows.

Nabiullina said increasing the currency reserves to $500 billion would be accomplished through gradual currency purchases spread out over several years. The central bank began currency buying in mid-May and has been spending on average about $200 million a day. As of mid-June, currency purchases totalled about $3.8 billion.

The CBR has emphasised that gradual increasing of the currency reserves is not conflicting with the current policy of inflation targeting and that it is not meant to maintain the ruble at a specific exchange rate. The ruble began to lose ground against the euro and the dollar at the end of May after nearly four months of appreciation. In recent days, the ruble's exchange rate has stabilised. Many market participant comments on the CBR's currency buying have reflected surprise over the policy direction. Last November the CBR said it would let the ruble float.

Russia's currency reserves 4.1.2002−5.6.2015, USD billion



Source: CBR

Russia resumes TIR freight customs arrangement. Goods shipments under the TIR treaty (Transports Internationaux Routiers or International Road Transport) enjoy expedited treatment at border crossings. The use of TIR carnets has been at risk to ending in Russia for nearly two years. During this period, Russian customs has ceased to recognise the TIR system at nearly all border-crossing points due to a dispute over customs payments with Russia's national carrier organisation ASMAP, which guarantees TIR shipments. After a court decision, the government's intervention and finally president Putin's decree issued this spring, Russian customs announced last week that they had reached a deal with ASMAP on resuming the use of TIR carnets. Russia is now also in compliance with the Eurasian Economic Union's common practices approved at the end of last month.

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China

Chinese economy continues to slow. May figures reinforce the view that China's economy remains on a lower growth trend. As it has for months, on-year industrial output growth hovered around 6 % y-o-y, while the volume of retail sales (a rough indicator of service sector performance) was up 10 %. Electricity production in recent months has held at the same levels as a year ago.

While the slowing of growth in industrial output and retail sales appears to have ended, demand factors indicate further slowing ahead. On-year growth in fixed asset investment (FAI) slowed again significantly last month, while foreign trade figures for the first five months of the year reveal sluggish export demand. Under the current situation, it is difficult to see how private consumption alone could make up for the slowdown of other demand factors and stop the overall growth rate from falling.

The key purchasing manager indices (PMIs) show industrial labour demand remains steadily on a long-term downward trend. In contrast, labour demand in the service sector eroded rapidly in the first five months of this year. However, there is no other evidence of a wider weakening of labour market conditions.

Impacts of economic slowdown worry European firms operating in China. The European Chamber of Commerce in China has just released its annual business confidence survey European Business in China. As last year, nearly half of the European firms operating in China again reported the country's slowing economy as their biggest challenge. More than half of the over 500 firms responding to the survey still saw rising revenues, but their expectations of growth and profitability has dimmed.

The survey reflected general concern among firms about China's rising labour costs. Faced with flagging growth prospects and eroding profit margins, many firms said they were considering curtailing investment plans and reducing wage costs. Although companies primarily strive to stay in the important Chinese markets through cost-cutting, rising labour costs and the yuan's appreciating exchange rate have caused many labour-intensive branches to move their production elsewhere in Asia.

Respondents noted that problems related to the legal and regulatory environment have remained largely unchanged from a year ago. Foreign firms still find Chinese regulations unclear, and have big problems with bureaucratic red tape and inconsistent rule enforcement.

In their efforts to move up the value chain, European firms would like to see China moving ahead with reforms and improvements in the business environment to promote e.g. product development and innovation. The share of companies in China actively engaged in R&D activities has not increased in the past five years, and most of the firms engaged in R&D mostly localize products and services for Chinese clients. Nearly 60 % of responding firms said China's strict Internet regulation and blocking of international service providers such as Google interfered with their everyday operations. It is clear that the government's tighter monitoring of the Internet and increased censorship are impacting operations of foreign and domestic companies alike in China.

Actual progress in reform of China's state-controlled enterprises still unclear. Despite an impressive launch in 2013, China has little to show for its latest attempt at reforming inefficient state-owned enterprises (SOEs) to make them operate in accordance with market principles. Reform efforts seem to have taken a step forward and a step back.

Efficiency measures announced this spring included pilot programmes for six large SOEs. The programmes are intended to provide lessons that can be applied on a wider basis to managing state firms. The nature of the pilot programmes suggests that privatisation will only play a minor role in reform efforts. At least as far as firms controlled by the central government are concerned, the main goal appears to be increasing market guidance through other means. Local administrations, which are in weaker economic shape than the central government, may have a greater appetite for privatisation sales of their businesses.

Only a tiny fraction of the huge number of companies owned by the central government and local governments have any actual strategic significance. The State-owned Assets Supervision and Administration Commission (SASAC) oversees such firms. SASAC currently manages 112 firms, but a two-thirds reduction in that number has been proposed. Progress was made this spring in the planning and implementing of mergers of SOEs, with a view to exploiting economies of scale. The consolidation of SOEs might result in significant synergies and raise the international competitiveness of Chinese SOEs, but competition in domestic markets will not increase.

Media reports note that SASAC has submitted to the government an outline of measures to increase efficiency and productivity at state firms. Sectors are currently classified according to their strategic importance and the government's goal is to have absolute control, strong control or some influence over the sector. The SASAC proposes moving from the closed-sector model to an arrangement with ten or so large SOEs operating in strategic sectors.

The government's latest policy framework is a clear step backward in reform. It calls for the Communist Party to take the reins in SOEs and increase state control. It says that appointment of top management in SOEs should be left more to party officials and the reporting duties of SOEs to the party should be increased. Such measures are inconsistent with efforts to raise market-based efficiency and competition. They also erode confidence that the government can succeed in reforming state enterprises.

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