Weekly Review
17 • 29.4.2016
BOFIT

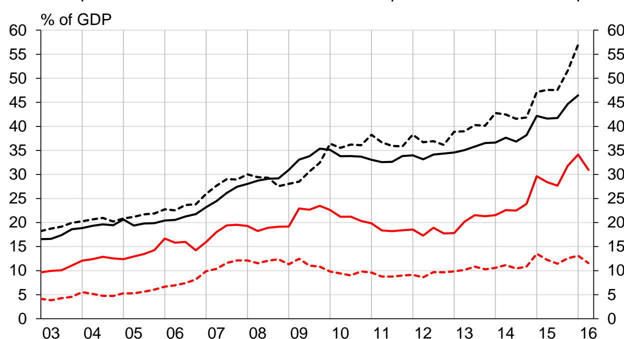
Russia

Little overall change in foreign debt of Russian firms and banks. The debts have gradually subsided since summer 2014, when foreign financial sanctions were imposed. The reduction tapered off in the first quarter, so that as of end-March the debt stood at $475 billion (under the recently applied GDP methodology over 35 % GDP; or over 40 % of GDP under the old method). Of that, corporate debt stood at $346 billion (over 25 % of GDP). In contrast to 2014 and 2015, the ruble's exchange rate has had little impact on dollar value of the ruble-denominated part of foreign debt this year.

Repayment of foreign debt by Russian banks has gradually fallen. In the first quarter of this year, the repayments amounted to not much more than a few billion dollars. Banks have paid off their loans as earlier in amounts not very far from their scheduled payments. Their foreign receivables have also diminished. On January 1, they amounted to $222 billion (of which $91 billion were short-term receivables). For over a year now, the repayment capability of banks has been bolstered by growth in domestic deposits.

As earlier, firms managed in the first quarter to keep their foreign debt repayments at a minimum. The foreign receivables of Russian firms remained at over $200 billion (of which about $70 billion were short-term receivables). Due to the small amount of foreign debt repayments, the need for companies to offset foreign debt with domestic borrowing has remained small.

Foreign and domestic debt of corporations and banks



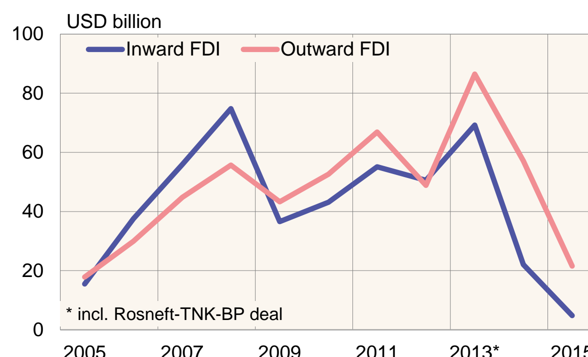
Source: Central Bank of Russia

Net FDI inflow to Russia falls to lowest level in over a decade. The net inflow of foreign direct investment into Russia last year was less than $5 billion and remained positive only due to reinvested profits. New equity investment did flow into Russia, but slightly more old equity investment was repatriated. As earlier, the bulk of FDI flows consisted of intra-group credit. The net inflow to Russia of intra-group credit was also slightly negative as firms paid down more old debt than acquired through new borrowing.

Net outbound FDI flows from Russia also contracted sharply last year to $22 billion. Equity investment of banks increased substantially, quite the opposite of non-bank firms. Non-bank firms, however, granted more intragroup credit abroad than ever, even as they also received much repayments of old debts.

The total value of the stock of Russian inward and outward FDI has shrunken dramatically over the past two years. As of end-2015, the values of inward and outward FDI stocks were about $340 billion each. The reduction in the value of the overall FDI stock primarily reflects changes in exchange rates and valuations. On-year, the net FDI flows have remained positive. Both in Russia's inbound and outbound FDI the share of various intermediate countries, like Cyprus, is still about 60–70 %. A large part of these investments is believed to be of Russian origin, but have taken a circuitous international route to e.g. avoid taxes.

Russia's net FDI flows



Source: Central Bank of Russia

Russia's services trade shrinks sharply. The value of Russian services exports last year was $52 billion and services imports $88 billion. Services accounted for about 13 % of total exports and nearly a third of imports. Russian services trade contracted last year some 25 % y-o-y, a faster contraction than has been seen since the start of the millennium.

The EU is by far Russia's largest trading partner both in services and goods. The EU accounted for nearly 40 % of Russia's services exports last year and nearly half of services imports. The services trade is partly related to FDI, which is why one of Russia's main trading partners is Cyprus. The share of Asian countries and especially China, is notably smaller in Russian services trade than goods trade, only about 10 %. The Eurasian Customs Union countries accounted for 8 % of Russian services exports and 3 % of services imports.

Russia's top export services are transportation services and miscellaneous business services such as consulting and engineering services. The largest import category by far is travel services, but the share of miscellaneous business services is also significant. Russian imports of travel services contracted by nearly a third last year to $35 billion.

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China

IMF concerned about state of Chinese businesses. The IMF's April 2016 edition of its Global Financial Stability Report finds that at the end of last year nearly 16 % of Chinese companies borrowing from commercial banks had less revenue than their interest costs. The IMF puts the amount of potentially at risk bank loans to corporations at $1.3 trillion or 12 % of GDP. That amount rises to about $2 trillion or 18 % of GDP, when loans channelled through the shadow banking sector, policy banks and the off-budget financing vehicles of local governments are included. Not all at-risk loans end up as bank losses, of course, because corporate profitability may recover or the shortfall made up by e.g. selling off company assets. The rapid growth and sheer volume of potentially at risk loans, however, has triggered alarms regarding the state of China's business sector.

There are other signs of the weakened condition of Chinese businesses. The average time of it takes to settle intercompany payments has soared in the past year, and the practice of companies using their own shares as collateral for bank loans has become widespread. The IMF says that the value of equity used to secure bank loans was $460 billion at end-2015, a 30 % increase from July 2015. Moreover, the report notes that the use of equity as collateral is among the financial measures companies use as the last resort.

The origins of the current struggles of Chinese businesses can be traced to the provision of cheap loans in particular to state-owned enterprises to finance unprofitable projects. As company profits have declined, it has become harder for these companies to service their loans. Problems have emerged in real estate, manufacturing, mining, steel production, as well as in the retail and wholesale trade sectors.

Despite rising debt, the IMF says China has sufficient buffers to handle the situation. Banks are still showing healthy profitability and have sizeable reserves. If needed, the central government can afford to help resolve banking sector problems. The IMF emphasised, however, that officials must take prompt action now to break China's debt spiral before the situation gets out of hand. The IMF would most like to see improvements in risk management practices and banking efficiency, whereby reasonably priced lending is directed to healthy firms for viable projects. It also suggests banks should write down their loan losses sooner and called for an end to market-distorting implicit government guarantees to state-owned enterprises.

China's programme to lower corporate debt levels and reduce bank NPLs moves ahead. Chinese officials this spring have been formulating a programme to ease corporate debt problems and reduce the stock of non-performing loans (NPLs) held by banks. The arrangement lets companies swap their equity for bank loans and banks could also bundle the NPLs for sale at a discount. Similar arrangements were made in the wake of the Asian crisis. The programme's contents have yet to be specified, but media reports suggest some of China's big banks are experimenting with the bundling and sale of NPLs. Media reports suggest that the ceiling of the equity-debt conversion programme will be 1 trillion yuan ($650 billion). The first swap took place in March, when the Hong-Kong-exchange-listed shipbuilder Huarong Energy announced it had reached deal with its creditors on restructuring $2.7 billion in debt.

This week, three IMF economists released a technical note on the debt-equity conversion and NPL securitisation programme. In their view, the programme needs to be carefully designed due to the real danger that debt restructuring will simply give non-viable "zombie" firms extended time to fail and increase the overall cost to the state. This insight specifically concerns the restructuring of inefficient state-owned enterprises. The authors further note that banks generally lack the competence to turn around money-losing businesses and that bank involvement in non-bank businesses involves moral hazard issues. The IMF economists propose that firms be carefully vetted before admission to the programme, banks retain the right to replace corporate managers and directors as necessary, debt-equity conversions be based on actual market price of the shares, and that the percentage of a bank's stake in a participating firm be limited and temporary. In addition, the regulatory framework should be geared to improving bank risk management and require banks to report their problem loans in greater detail.

China eliminates foreign trade subsidies that violated its WTO commitments. The United States a year ago filed a dispute with the World Trade Organization that claimed China's central and local administrations were subsidising export firms in 179 industrial branches through under-pricing of services and monetary incentives in violation of its WTO commitments. The claim included products ranging from agriculture and textiles to the pharmaceutical industry. In mid-April, China made a bilateral agreement with the US on elimination of these subsidies. The deal benefits China's other trade partners as well, including the EU, which joined the US's WTO dispute at a later stage.

The export subsidies mandated for elimination have relatively little economic significance and do nothing to ease China's burning trade policy issues. The agreement highlights how vague and impractical China's subsidy system is also from China's own development viewpoint. Moreover, it suggests that efforts to clear China's subsidy jungle would not proceed efficiently without outside pressure.

The China-US agreement on cutting export subsidies that violate WTO commitments supports China's integration with the global economy and systemic adjustment. It is also important from China's perspective to show that the country is ready to operate by market-economy rules. At the end of the year, the EU and US will decide on whether to grant China market-economy status. If granted, it would become more difficult for China's trading partners to impose anti-dumping tariffs on products imported from China.

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