Weekly Review
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BOFIT

Russia

Chinese CEFC to acquire 14 % stake in Russian oil giant Rosneft. The deal is valued at around 7.5 billion euros. The Russian state retains its majority position in Rosneft even if the deal materialises, as CEFC buys the stake from a joint venture of the Qatar Investment Authority and Glencore. The deal with CEFC surprised many as the joint venture bought a 19.5 % stake in Rosneft from the Russian state just last December for 10.2 billion euros. Some observers regarded the motivations for the original deal and its financing arrangements as unclear.

CEFC is reportedly a private company focusing on oil trading and finance. It has no record of investment in Russia. The Chinese energy firm Sinopec owns a stake in Rosneft subsidiary Udmurtneft. CNPC also acquired a few per cent stake in Rosneft last decade, but negotiations to increase the stake have not progressed. If approved, the CEFC deal will be the biggest Chinese investment in Russia so far. Over the past decade, China has become Russia's largest export market of crude oil and Russia is China's largest foreign oil supplier.

Problems surrounding Rosneft's acquisition of a majority stake from the state last autumn in the Bashneft oil company have also received attention recently. Alexei Ulyukayev, who served as economy minister at the time of the deal, is currently on trial for demanding related bribes from Rosneft CEO Igor Sechin. Multibusiness corporation Sistema, which owned the majority of Bashneft before the state seized it, was recently ordered by the court to pay Rosneft 136 billion rubles (2 billion euros) for stripping assets from Bashneft.

Russia introducing new import restrictions on public sector and SOE procurements. Russia's import restrictions in recent years have been aimed at supporting domestic producers under an import substitution policy. Current import restrictions on public sector procurements already range from pharmaceuticals and food to software. A new government decree prohibits public sector purchases of select imported furniture and wooden veneers from December 1. The ban applies to imports from outside the Eurasian Economic Union and lasts two years.

The Duma also received a bill to tighten oversight of procurement of imported goods and services in state-owned companies and companies receiving state support. At the moment, procurement rules e.g. grant domestic producers a 15 % price advantage. Large investments in imported machinery also require approval from the import substitution commission. The bill calls for expanding the list of procurements needing commission approval to include e.g. ships and aircraft in order to protect the interests of domestic producers. In addition, the requirements for state-owned enterprises are to be extended to apply also to their subsidiaries.

Impact of support measures for Russian monotowns hard to determine. From 2009 to 2016, support to single-company towns, or monotowns, were arranged on the basis of presidential or government decrees. The development programme for monotowns was only approved in late 2016. A study by the Federal Accounts Chamber (FAC) found the programme lacking in terms of comprehensive scope, concrete measures and long-term objectives. FAC noted overlapping functions and insufficient coordination. At the federal level, the programme involves e.g. 12 ministries and 9 lenders (including 4 large state banks). Monitoring statistics are compiled by 4 federal authorities without unification. Several relevant monitoring indicators were only decided early this year. Information on the companies forming a town is often partly confidential.

The FAC said it was not possible to sort out the results of support measures, noting that no federal executive authority has reliable information even on the amount of support granted. Transfers from other government budgets to monotowns equalled 0.6 % of total consolidated government budget spending in 2010–16. Of that, 30 % went to the 8 largest monocities. Besides budget money, support has been provided in the form of credit and tax reliefs. Monotowns have made agreements on co-financing infrastructure projects and have established zones of accelerated economic development.

The number of towns officially listed as monotowns has declined slightly since the 2009 recession, and now stands at 319. A town is defined as a monotown if it has over 3,000 inhabitants and one industrial firm (excluding oil & gas production) accounts for at least 20 % of employment in the town during five years before the listing. The monotown distress ranking (three categories) uses such criteria as termination of a town company, the number of lay-offs planned by a town company, prospects for a town company's industry, the local unemployment rate and town residents' assessments of local conditions compiled in official surveys. 100 monotowns are currently ranked as *problem* towns (75 in 2013). Nearly 150 are classed as having a risk of *deterioration*, and over 70 are classed as *stable*. The FAC says the list needs updating.

61 of Russia's over 80 administrative regions have monotowns. In over 200, and in over 70 problem towns, the town company's industry is machinery, equipment & transport vehicles, metals, mineral extraction or forest industry.

The officially listed monotowns had 13.6 million inhabitants or 9.3 % of the Russian population at the start of 2017. Monotowns stood for 8.5 % of the employed and 11 % of the unemployed nationally. The town companies represent 5–6 % of goods supplied nationally and they employ one million workers, or 1.5 % of the employed. Almost 3 % of the Russian population lives in the *problem* towns. Three monocities have populations in excess of 500,000, of which two are problem cities. FAC's own separate survey found that 70 % of monotown residents find the living conditions unfavourable or barely tolerable and that 60 % would like to move elsewhere. Under 8 % found the measures of local officials adequate. The FAC reports that the population of monotowns has decreased in recent years and the real volume of goods supplied by the town companies shrank by about 6 % during 2015–16.

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China

Yuan appreciated substantially against the dollar. The yuan strengthened 4 % against the dollar between late July and early September. While some of the appreciation reflected dollar weakness (the dollar's nominal effective, or trade-weighted, exchange rate fell by 2 %), the yuan appreciated also against the currencies of other major trading partners. The PBoC's CFETS index climbed nearly 3 % and the yuan-euro rate was up by 1 %. On Friday (Sept. 15), the yuan-dollar rate was still 6 % higher from December 31, while the yuan has lost about 6 % against the euro this year.

The mechanism for setting the yuan's daily trading rate has incorporated a *countercyclical factor* since early summer (see [BOFIT Weekly 22/2017]). The new feature appears to provide an additional means for the PBoC to influence the yuan-dollar exchange rate in a desired manner.

The yuan lost ground slightly this week after the PBoC on Monday (Sept. 11) dropped its 20 % reserve requirement on forex forward transactions and on yuan-denominated deposits in Hong Kong and other clearing centres abroad. The PBoC imposed the reserve requirements in late 2015 and early 2016 in response to yuan weakness and high capital outflows. Ending the reserve requirement reduces the forex trading costs and makes it cheaper to cover against rate shifts.

Although the value of yuan deposits in Hong Kong fell by half during 2015–16, the stronger yuan has slightly revived them. The freely set Hong Kong offshore yuan rate (CNH) is often used to measure adjustment pressures on the yuan. However, when there was strong depreciation pressure on the yuan in 2016, China manipulated also the CNH rate. The difference between the mainland China onshore rate (CNY) and the offshore CNH rate this year, however, has been negligible.

Exchange rate appreciation and the state's tighter measures have calmed capital outflows from China. The value of China's foreign currency reserves has risen by 81 billion dollars this year, standing at 3.092 trillion dollars as of end-August. Some of the valuation increase comes from exchange rates changes. When gold, SDR and IMF reserve components are included, the value of total reserve assets rises to 3.188 trillion dollars.

Yuan-dollar, yuan-euro rates; nominal effective exchange rate

Source: Reuters, EKP, J.P. Morgan.

Margins of China's big banks narrow. China's four largest banks recently released their financial reports for the first half of this year. The total profits of these banks increased by 3 % y-o-y to 510 billion yuan (70 billion euros). Compared to last year, however, their headline profitability indicators generally continued to weaken and their margins shrank. The large banks noted, however, that their profitability levels have stabilised. The average lending rate of banks fell by about 0.3 percentage points from a year earlier to a level of 3.9–4.2 %. Average rates fell for both short-term loans of less than a year and longer term loans. People's Bank of China figures show lending rates in the banking sector overall have risen slightly.

All banks claimed to be devoting heightened attention to risk management. They had raised reserves to deal with nonperforming loans (NPLs), even if banks reported that their NPL ratios relative to the overall loan stock was still at low levels (1.5–2.5 %). The bulk of nonperforming loans were held by companies involved in extractive industries, manufacturing or retail. Banks are widely seen as reluctant to declare a loan nonperforming. In addition, banks report that 3–4 % of their current loans are likely to become NPLs at some point. The share of such loans declined slightly.

Among the large banks, only ICBC mentioned banking challenges. It noted that financial sector risks were becoming increasingly complex, which complicated banks' efforts to manage risk exposure. With the ending of regulated interest rates, competitive pressure has forced banks to accept smaller margins. Competition has also stiffened with the appearance of online peer-to-peer credit providers.

The situation of small and mid-sized banks differs from that of large banks. When large banks suck up large amounts of the deposit business, small banks are forced to seek out assets on money markets. This limit them mostly to short-maturity lending activities. Interbank market rates have risen this year, which has made it more expensive to resort to the interbank market for funds. Interest rates also face upward pressure if China moves ahead with measures to bring the debt problem under control. Indeed, financing-associated risk alone was enough for the international credit ratings agency Moody's to last week lower its credit rating of Bank of Communications, China's fifth largest bank.

Chinese inflation accelerated in August. Consumer price inflation rose to 1.8 % p.a. in August, up from about 1.5 % in the previous three months. The surge in prices was driven by higher prices for food and fuel. Core inflation, which omits food and energy, only picked up slightly to 2.2 %. The general rise in prices does not yet cause concerns for policy-makers and no sudden changes in conditions are expected. This year's official inflation target is 3 %.

Producer price inflation in August accelerated to 6.3 %, up from 5.5 % in the previous three months. The pick-up in price inflation was highest in energy and other extractive industries, where higher prices have improved the firms' profitability and eased their debt situation.

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