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Russia

Ukraine-EU association agreement put on hold. The Ukraine government decided late last week not to go ahead with its planned signing of its EU association agreement at the EU Eastern Partnership Summit under way in Vilnius. Ukraine said it needed time to sort out the economic implications of the deal. It also announced that talks with Russia's three-country customs union should be intensified.

Ukraine has a difficult needle to thread. It wants to get closer to the EU, while preserving economic relations with Russia. Russia has been inviting Ukraine to join the Russia-Belarus-Kazakhstan customs union for several years, but Ukraine has always refused. Russia says joining would benefit the Ukraine economy by billions of dollars a year through e.g. lower energy costs and tighter economic relations. According to Russia, getting closer to the EU, in contrast, would mean a collapse of Ukrainian industry and higher unemployment.

Russia has clearly indicated to Ukraine that signing the EU association agreement would have consequences. In spring 2012, Russia reduced natural gas supplies to Ukraine and then imposed sanctions that included import restrictions on Ukrainian foodstuffs and a temporary intensification of customs inspections procedures for Ukrainian exports to Russia. Russia implied that the free-trade agreement Ukraine has with Russia and other CIS countries might have to be revisited if Ukraine goes ahead with the EU association agreement. This would mean imposing duties on goods imported into the CIS from Ukraine. Russia could also raise prices on natural gas supplied to Ukraine. Russia hinted recently the gas price might fall if the agreement stays unsigned.

Ukraine presently imports about 60 % of its natural gas from Russia, and about 30 % of Ukraine exports go to Russia. Ukraine's fear is that it could lose the Russian markets under the EU deal. There is very little demand for Ukrainian products outside the CIS.

Ukraine now says the association agreement could lead to unbearably large short-term economic losses. The EU deal also involves high direct costs such as changing to EU technical standards. Ukraine has asked the EU for support to pay for the transition, but the EU has so far balked.

Russian central bank intensifies bank supervision. Elvira Nabiullina, the Central Bank of Russia's new chairwoman since June, says the supervision will now focus especially on operations of banks suspected of involvement in money laundering. A second area of focus are banks that attract deposits by offering very high interest rates and invest the money in risky assets.

The CBR has cancelled the licences of over 20 banks since July. In comparison, only a few bank licences were cancelled in the first half of 2013. The CBR has typically pulled about 15 bank licences a year in recent years.

The highest profile licence losses this autumn involved Pushkino bank and Master bank. Pushkino is Russia's 134th largest bank based on total assets and Master is 74th. The termination of the two banks' operations has led to Russia's largest deposit insurance compensation claims ever, totalling 50 billion rubles (€1.1 billion). Given the entire deposit insurance fund has about 230 billion rubles (€5 billion), the pay-out has many asking whether the deposit insurance fund is adequate to cover future claims. Deposit insurance is today 700,000 rubles (€16,000) per bank for private individual deposit accounts. Draft legislation would increase coverage to 1 million rubles. A number of experts have pointed out that the current deposit insurance scheme encourages customers to put their money in high-interest accounts with risky banks.

The banks losing their licences are relatively small, so the CBR actions have presented little threat to the stability of the banking sector as a whole. Many banks, however, have become more cautious about lending on the interbank market, restricting access of smaller banks to credit.

Russia has about 900 banks today, but the bulk of banking activity is concentrated among the five largest state banks.

Russia to abandon TIR customs guarantee arrangement at Finnish-Russian border. Russian customs officials have announced that from the start of December they will no longer recognise expedited treatment of freight under the TIR (Transports Internationaux Routiers or International Road Transport) at the Russia-Finland and Russia-Lithuania borders. Russia eliminated TIR procedures at other borders earlier this autumn.

Under the TIR system, imported goods are not declared at border crossing, but only at the final destination. If the goods vanish, the national transport organisation of the importing country must pay the duties. Russia's Association of International Road Transport Carriers (ASMAP) has often refused to pay the duties. This results in loss of federal budget revenues, for which the customs administration is responsible. The customs administration's answer to the problem has been to reject the TIR system.

In place of the TIR system, Russian customs will now require companies moving goods to Russia to take customs insurance for each declared load from a Russian organisation or use a Russian transport firm that has customs authority to handle transport without extra insurance. Finnish transportation companies worry that the new arrangement will substantially impede freight border crossing.

Negotiations are still going on, and it may be possible that Russia will postpone the introduction of the new rule at the last minute.

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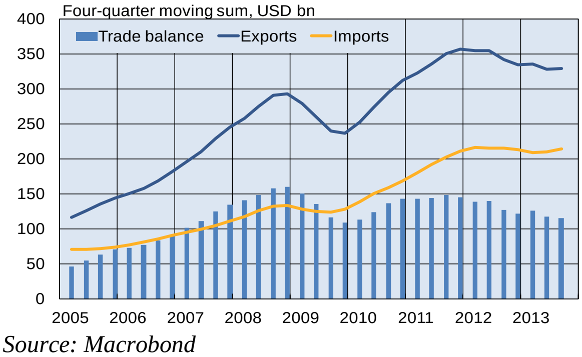
China

EU and China launch talks on bilateral investment treaty. At the hastily arranged EU-China summit last week in Beijing, the participants outlined cooperation ways to strengthen their strategic partnership agreed ten years ago. The outcome of the summit seems to be little more than an acknowledgement that there is still plenty of unused potential for deeper economic relations.

The most important achievement of the summit was an agreement that the EU and China would commence talks on an investment protection deal. In addition to the lack of investment protection, issues concerning intellectual property rights and market access have frayed EU-China relations. In these areas, at least, the need for an investment treaty is important. The OECD reports China limits inflows of foreign direct investment more than any of the 40 countries it evaluated. In the EU's view, free-trade talks proposed by China will only be timely after China ends extensive subsidies to domestic companies.

China's premier Li Keqiang was on the ground in Romania this week promoting economic relations with 16 Central and Eastern European countries at their second joint event. China promised infrastructure investment (including railways) for the region, as well as cooperation in the energy branch and agriculture. The meeting was largely a marketing event as China's delegation included 300 corporate representatives.

China's quarterly trade with EU, 2005–2013



Source: Macrobond

Measured in goods trade, China is EU's second largest trading partner after the United States. Germany dominates EU's trade with China, accounting for 47 % of exports to China and nearly a third of all EU-China trade. The EU's trade imbalance with China, which earlier caused concern, has been shrinking over the past two years.

The latest EU figures show that EU-based firms only invested 2–3 % of their FDI in China in 2011. FDI from Chinese companies to EU countries took off in 2011, but Chinese FDI was still only about 0.5% of the EU's entire FDI inflow.

China-Japan island dispute takes a dangerous turn. On Sunday (Nov. 24), China announced it was enlarging its air defence identification zone over the disputed Senkaku/Diaoyu islands in the East China Sea. Any aircraft moving in the identification zone must report flight plans and declare their presence to China's military under threat of "emergency defence measures." The enlarged airspace means that the Chinese identification zone now overlaps with Japanese, Korean and Taiwanese zones. The decision has received severe criticism. Japan announced that it does not approve it and the US, which maintains an airbase in the East China Sea, has said it will not acknowledge the Chinese decision. During this week US, Japanese and Korean military aircraft have flown over the new identification zone without notifying Chinese authorities.

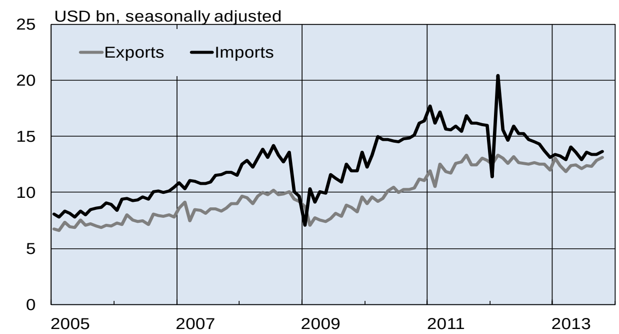
The incident comes at an economically sensitive time. Last week, a delegation representing over 100 large Japanese firms went to China to improve relations with their Chinese counterparts after a two-year break. China is an extremely important market for many Japanese firms and many Japanese firms have production facilities in China.

Although the countries' political disputes have affected e.g. sales of Japanese products in China, FDI from Japan to China this year has been rising rapidly. FDI of Chinese firms in Japan is insignificant.

The political disputes can be seen in the countries' bilateral trade figures. However, with the end to the two-year hiatus, China's exports to Japan have growing quite rapidly in recent months. The island dispute could put an end to this burst of growth. China's imports from Japan have also increased.

The disputes have severely reduced tourist numbers. The flow of Japanese tourists to China this year is down considerably from last year and the numbers of Chinese tourists visiting Japan is down as well.

China's monthly trade with Japan



Sources: CEIC and China customs

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