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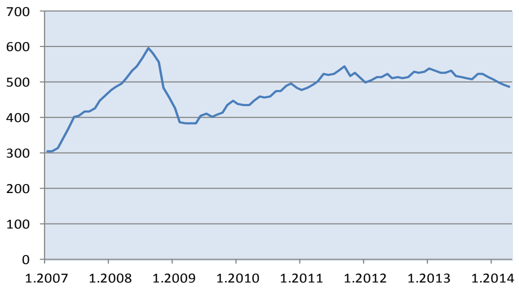
Russia

Uncertainty on Russian markets increased this week on eastern Ukraine unrest. The ruble again weakened, provoking the Central Bank of Russia to sell an average of $180 million a day of its foreign currency reserves. On Friday (Apr. 11), one dollar bought 35.62 rubles and one euro 49.50 rubles.

Russia's foreign currency reserves down in first quarter. The CBR's foreign currency reserves (including gold), which have steadily dwindled since November, stood at $486 billion at the end of March. The shrinking reserves reflect increased capital exports from Russia and the CBR's on-going sales of foreign currency to prop up the ruble's exchange rate.

Russia's foreign currency reserves are substantial, however. At the moment, they are sufficient to cover the value of over a year's worth of imports of goods and services, well above the internationally recognised minimum of three months' worth of imports. Russia's foreign currency reserves are the world's fifth largest after China, Japan, Saudi Arabia and Switzerland.

Russia's foreign currency reserves, USD billion



Source: Central Bank of Russia

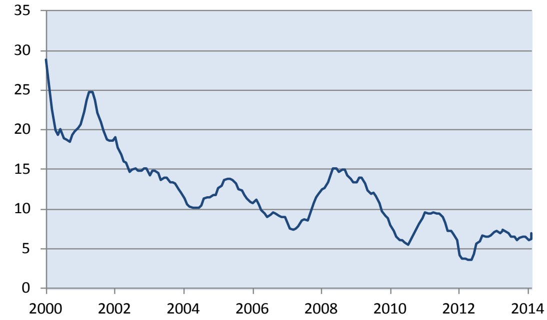
Russian inflation picked up in March. March consumer prices rose 1 % m-o-m. In March 2012, on-month inflation was 0.3 %. 12-month inflation was 6.9 %.

The slide in the ruble's value has fuelled inflation. March food prices were up 1.8 % m-o-m, rising four times faster than in March 2013. Prices for non-food goods increased 0.7 % m-o-m, nearly double the rate of rise in March 2013. Over the past 12 months, food prices were up 8.4 % and non-foods 4.6 %.

The largest price rises over the year, however, have affected utility rates. Gas rates are up 15 % y-o-y, electricity 13 % and heating 11 %, following sharp hikes last summer.

Observers expect the ruble's devaluation to keep prices rising until summer. The likelihood that the government will hit its inflation target of 5 % at the end of the year seems increasingly remote.

12-month consumer price inflation in Russia, %



Source: Rosstat

Gazprom hoists Ukraine's gas price to $485 per thousand cubic metres. Gazprom last week revoked discounts granted earlier to Ukraine's national gas company Naftogaz, which is $2.2 billion in arrears to Gazprom. The price Ukraine now must pay is considerably higher than what Gazprom charges its most EU customers. For example, German gas buyers have been paying this year an average of about $380 per thousand cubic metres of gas. Traditionally, the price Ukraine has paid for its gas to Gazprom has been largely determined in political negotiations with Russia, not by transparent market pricing.

Ukraine openly admits that it cannot pay its gas bills at the moment without outside help. Russian gas covers about 60 % of Ukraine's gas consumption and 20 % of the country's total energy needs. Most other gas Ukraine produces domestically, mainly in the Kharkiv and Poltava regions in eastern Ukraine. Ukraine fears Russia might again cut off gas supplies like in the 2006 and 2009 pricing disputes, as already implicated by president Putin.

However, a heavy-handed approach could hurt Gazprom as well; Ukraine is one of its biggest customers. A number of analysts have warned that the current price hike could crush Ukrainian demand for Russian gas, and ultimately reduce the overall value of Gazprom sales to Ukraine. If Gazprom would halt gas sales to Ukraine, it could create problems for Gazprom deliveries to the EU and Turkey via pipelines running through Ukraine. About a third of Gazprom's sales by volume and about half by revenues come from exports to the EU and Turkey.

Nearly half of all Russian gas exports to the EU are piped via Ukraine. This amount corresponds to a few per cent of total EU primary energy consumption, but in many countries in Central and Eastern Europe, reliance on Russian gas is substantially higher. Experts say temporary supply disruptions are unlikely to cause severe problems for the EU at the moment. Its gas reserves are still half full and gas consumption is falling as the home heating season comes to an end.

Russia also supplies gas to EU countries via Belarus and via the Baltic Sea with the Nordstream pipeline.

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China

China's foreign trade remains weak. The value of goods exports fell in March for the second month in a row, sliding nearly 7 % y-o-y to $170 billion. Imports were down 11 % y-o-y. First-quarter trade figures were tepid. In the first three months of this year, exports declined 3.5 % and imports climbed only 2 %. The trade surplus fell sharply from a year earlier to just $17 billion.

In part the lower growth numbers reflect last year's rife over reporting of export prices, which allowed Chinese firms to circumvent capital controls and bring capital to China to take advantage of yuan appreciation. The bulk of the pricing distortions involved trade with Hong Kong. Based on monthly figures, the level of distortion seems to have peaked in March 2013. When the Hong Kong numbers are excluded from the rest of the trade figures, China's exports grew in January-March over 3 % y-o-y, while import growth held at 2 %. The figures likely give a more realistic idea of Chinese trade, but do not alter the fact that China is experiencing weaker foreign trade growth.

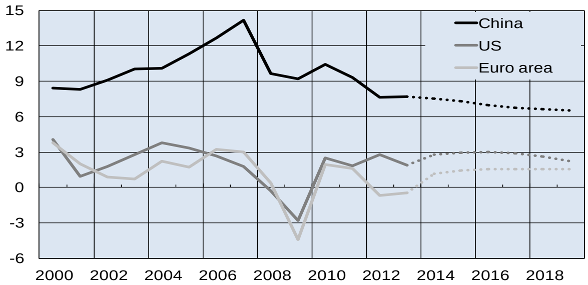
First-quarter export performance to the EU and Southeast Asia was better than the average. Exports to the US were basically unchanged from a year ago. Strongest import growth was with the EU, US and Australia.

IMF recommends China to curb lending growth. The International Monetary Fund's World Economic Outlook released this week sees uneven global growth ahead. The IMF says two-thirds of growth in the global economy will come from emerging economies in coming years. The biggest engines of growth will be China and other emerging economies in Asia. The IMF sees China's GDP growth slowing from 7.5 % p.a. this year to 6.5 % in 2019. The forecast assumes economic reforms will be implemented as planned.

The IMF's warnings for China mainly pertain to financial markets. Lending has boomed in recent years and a considerable amount of money has been poured into unprofitable investments. The IMF says China needs to cool the credit growth and curb indebtedness of local governments, especially off-budget borrowing. The IMF emphasised the need to liberalise interest rates to assure risk is better priced into loans than at present.

The IMF regards China's financial sector problems as a risk to the global economy. China's economic growth is still heavily tied to fixed capital investment, so officials might be reluctant to act in timely fashion to deal with emerging problems in investment financing. If the problems get out of hand, the IMF notes, it could lead quickly to a severe slowdown in economic growth with broad implications for the global economy. The IMF, however, stressed this scenario is unlikely at the moment and the financial sector's problems are manageable as long as regulators take proper measures.

Chinese GDP growth, % (IMF)



Source: IMF World Economic Outlook

China's increasing clout in the global arms trade. The Swedish Stockholm International Peace Research Institute (SIPRI) reports that China's arms exports in 2013 increased 8 % from a year earlier, climbing to nearly 10 % of the international arms trade. Over the past five years, China has become the world's third largest arms-seller, surpassing France, Germany and the United Kingdom. The value of China's global arms sales, however, represents only about a fifth that of US or Russian sales at the moment.

Most of China arms go to low and middle-income countries. About 40 % of all China's arms exports go to Pakistan, which buys most of its armaments from China. Other major customers include Myanmar and Bangladesh. China's weapons production has diversified and includes tanks, missiles, radar systems and fighter jets. SIPRI notes that China also recently received orders from such countries as Turkey, Morocco and Indonesia, which reflects China's rapidly developing military technology as also Russia and the US competed for the same orders.

China's military spending grew at over 10 % a year throughout the 2000s. At the moment, military spending corresponds to about 2 % of GDP. However, Chinese military spending this year is likely to exceed economic growth, thereby increasing its relative share of GDP. Russia and the US, for example, spend over 4 % of GDP on military.

Arms sales to China, in contrast, have shrunk considerably, an indication that China has become much more self-sufficient in arms technology than earlier. During the 2009–2013 period, China imported about half of the arms it had imported in the previous five years. Russia has traditionally been China's largest arms supplier. China has developed much of its own arms production capacity based on Russian technology, which has reduced China's need for imports. in part due to this copying, Russia has refused to sell its most advanced weapons technology to China.

China and Russia have not signed the international Arms Trade Treaty, which bans the arms sales to conflict zones in certain instances. Russia has provided explosives and air defence missiles to the Syrian government during the civil war as well as helicopters to Egypt amid the political unrest.

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