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BOFIT Weekly

21 • 23.5.2014

Russia

Even as the Russian economy stalls, industrial output revives. Rosstat's first assessment of Russian first-quarter economic growth was a mere 0.9 % y-o-y. However, seasonally adjusted GDP contracted in the first quarter (according e.g. to the calculations of the economy ministry). These preliminary data are subject to later revision.

In contrast, growth in seasonally adjusted manufacturing output recovered in the first four months of the year. January-April manufacturing output was up nearly 3 % y-o-y. April manufacturing output climbed nearly 4 % y-o-y. Observers say some of the (perhaps temporary) improvement in the industrial output figures may be due to a boost in defence spending that has enhanced defence industry activity. The ruble, which has been losing ground for about a year, may have also helped demand for domestic goods. The ruble's drop makes imports relatively more expensive. There were additionally signs that inventories have started to fill up after a period of contraction.

Russia shifts to domestic payment cards. Amendments to the Law on the National Payment System were approved in rapid order in late April and early May. The revised law enters into force on July 1.

The fundamental goal of the amendments is to assure all payment card transactions in Russia are processed via data centres located inside Russia. International payment card companies operating in Russia would have to establish their own data centres within the country. This would avoid payment freezes from outside interventions such as economic sanctions.

To promote wide acceptance of a national payment card system, all pension payments, social benefits and public sector wages must be paid to bank accounts tied to a domestic payment card.

Visa and MasterCard look to be hardest hit by the new law. They currently handle the lion's share of Russian card transactions. The new law requires international card issuers operating in Russia to deposit with the Central Bank of Russia a guarantee equalling two day's worth of their Russian turnover. Visa and MasterCard, along with most experts in the field, consider the deposit requirement excessive as it exceeds the value of their annual net sales in Russia. Visa has already announced that it is considering pulling out of the Russian market at the beginning of July if concessions are not forthcoming.

Finance minister Anton Siluanov observed that Russia needs the international card companies as they process a large share of payment transactions. Officials are currently trying to resolve the impasse with the big card companies, and there are signs that the amount of the guarantee deposit required from foreign card issuers may be reduced.

Use of national cards outside Russia would be limited. If the international card issuers pull out from Russia, it would complicate life for Russian tourists abroad and on-line shoppers making international purchases.

The setting up of the national payment card system is just getting underway. A CBR-owned corporation is to be established, but most practical aspects of the system have yet to be dealt with.

Russia and China sign major gas agreement during Putin's visit to China. The gas deal, representing over ten years of tough negotiations, was the crowning event of president Putin's visit to China this week, and was extremely important for the Russian side. The issues in the lengthy negotiations concerned the routing of the new Russia-China pipeline, China's financial participation in the project and the ultimate price of the gas supplied (an issue that remained open right up to the last minute).

The haggling over pricing was intense, continuing even after Putin's arrival. As a last minute solution, Putin suggested that Russia could excuse gas supplied to China from the usual resource extraction tax in exchange for China dropping its import duty on gas. While the parties never released the agreed gas price, observers put the price in the range of \$370–390 per 1,000 m^3. Observers consider the price to be slightly on the low side.

Some of the issues included in the contract were left open for further negotiations. These include the mutual tax and duty exemptions for gas.

The 30-year contract calls for annual gas deliveries of 38 billion m^3. Gas deliveries will ramp up gradually, starting as soon as 2018. Just a year ago, the project's annual transmission capacity target was 70 billion m^3 a year.

China's interest in Russian gas exports has diminished over the years as other global supply sources became available. China's hand was further strengthened by Russia's efforts to find buyers for its gas outside Europe.

The presidents signed a number of other trade and cooperation agreements during the meetings. Some of the deals had actually been signed earlier, so the occasion was used as a formal commemoration.

China has long been one of Russia's top trading partners, especially with regard to imports. China has this year supplied 18 % of Russian imports and 8 % of exports. Russia has recently run substantial trade deficits with China.

About half of Russia's imports from China fall into the machinery & equipment category, but textiles are also an important product category. Russian exports to China are mainly oil and other basic commodities such as industrial minerals, metal and timber.

The Russian and Chinese presidents pledged to raise the level of bilateral trade from just under \$90 billion this year to \$100 billion by 2015.

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China

China ramps up transparent financing options for local governments. This week the finance ministry said it would move ahead with a plan to allow ten local administrations issue their own bonds. The ministry is permitting local governments this year to sell bonds with a combined value of up to 400 billion yuan (€47 billion). The project involves wealthy east coast provinces and cities, including Beijing, Shanghai, Guangdong and Qingdao. The project stems from a 2011 pilot programme that allowed several local governments to issue bonds totalling 23 billion yuan (€2.6 billion).

The project should enhance financial transparency; local governments must open their books to investors to assess issuer creditworthiness. Beijing further hopes to improve market discipline by requiring local government bonds to be rated by an independent credit rating agency. The requirements should replace earlier incentives that encouraged local governments to take on debt in order to boost their output figures without paying attention to the sustainability of their financial position. It remains to be seen how investors will actually price local government credit risk in the bond market. Market discipline will not be achieved if investors believe the central government will always intervene to bail out a local government default. The central government has previously issued bonds on behalf of local administrations, which has further added uncertainty about the responsibilities of various levels of government.

The rapid growth in local government indebtedness is forcing China's leaders to move swiftly on reforms related to local government financing. Rapid debt accumulation demonstrates the need for a broader local government tax base and transparent financing channels. The reason why local governments need more transparency in their financing stems from a balanced-budget requirement imposed on local governments in 1994. To circumvent the rule, local governments have turned to off-budget borrowing. By some estimates, half of all local government debt is held under off-budget financing vehicles.

It is further estimated that about a fifth of the lending of the shadow banking sector goes to local administrations, mostly in the form of short-term loans. China's leaders hope that shifting to a stable municipal bond market will lengthen average debt maturity and thus reduce liquidity risks. The bonds will carry maturities of 5, 7 and 10 years.

Russia becomes a new gas provider for China. A deal to supply gas from Siberian gas fields to China crowned president Vladimir Putin's state visit to China this week (May 19–20). The negotiations on the pipeline from Siberian gas fields to China have lasted over a decade. Under the agreement, Russia will supply China with 38 billion cubic metres of gas a year for a 30-year period. If no new barriers to the deal are raised and the massive investment needed is mobilised promptly, gas deliveries could begin as soon as 2018.

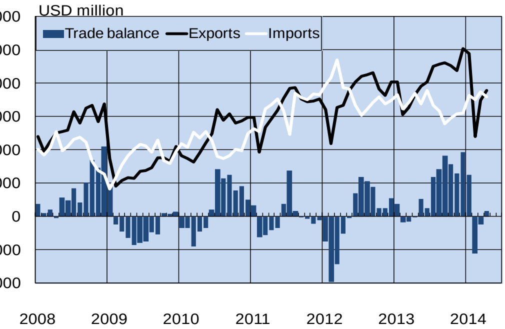
Although China gets just 4 % of its energy from natural gas at the moment, the need to wean itself from its environmentally disastrous reliance on coal suggests a rapid increase in the use of gas. Over 50 billion m^3 of China's total gas consumption of 170 billion m^3 last year was imported. Imports from Turkmenistan accounted for about half of the imports. The supply from Turkmenistan is expected to rise to 65 billion m^3 a year by 2020. China last year inaugurated a gas pipeline (12 billion m^3 annual capacity) running from Myanmar to China. China also imports liquefied natural gas (LNG), mainly from Qatar and Australia.

The Russian gas deal fits nicely with China's goal of diversifying its import sources and making its suppliers compete on price and supply terms. Russia was supposedly forced to make pricing concessions as the Ukraine crisis bolstered China's negotiating position. The new gas agreement was the result of a long, difficult process for both sides. In this sense, the deal signals no major shift in China-Russia relations.

Russia accounts for just 2 % of China's foreign trade. China's oil imports from Russia have been rising since the first Russia-China oil pipeline came on stream in 2011. China currently imports about 27 million tons of crude oil a year from Russia, or about 10 % of China's total oil imports. Oil constitutes over half of the value of China's imports from Russia. However, beside some other raw materials, Russia is overall not a significant supplier for China. While nearly all China's imports from Russia are basic commodities, China's exports to Russia comprise a diverse range of goods. Recently, China has run a large annual trade surplus with Russia.

With the slowdown in the Chinese and Russian economies, growth of bilateral trade has tapered off. In January-April, China's exports to Russia and imports from Russia were up about 3–4 %. Russia has long accounted for just over 2 % of China's imports and exports.

China-Russia bilateral trade



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