BOFIT Weekly
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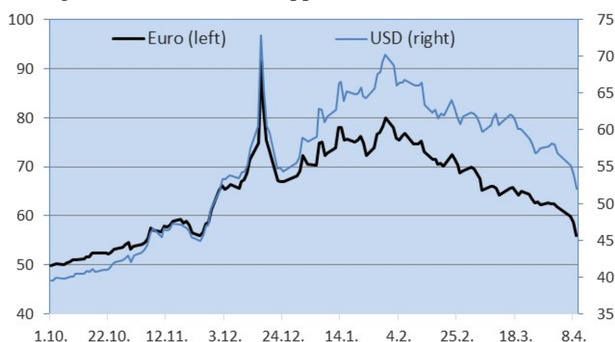
Russia

Ruble appreciation enters third month. The ruble's recent recovery reflects stabilisation of global oil prices and reduced foreign currency demand in Russia. Demand for foreign currency is no longer as acute as at the start of the year when Russian firms and banks paid significant foreign loan instalments falling due. The collapse in import demand and the introduction of the Central Bank of Russia's new forex repo credit arrangement have further dampened currency demand.

Observers note that the ruble's severe decline in December and January overshot the mark, setting the stage for the current correction. Some now argue that the rebound has largely run its course and that the ruble's exchange rate should soon stabilise.

Nevertheless, the ruble remains sensitive to international political events that could again lead to wide swings in the ruble's exchange rate.

Euro-ruble, dollar-ruble rates, 1 Oct. 2014–9 Apr. 2015
(falling trend indicates ruble appreciation)



Source: Thomson Reuters

Russian inflation reached 16.9 % in March. Russia last month returned to a level of consumer inflation not seen since 2002. Although the 12-month rise in prices soared, monthly inflation started to slow. The March rise was 1.2 % m-o-m, down from 2.2 % m-o-m in February.

The inflationary impacts of the ruble's sharp devaluation are expected to fade over the coming months and the rise in consumer prices to slow. By year's end, inflation could be running at around 11–12 %. In 2014, inflation was 11.4 %.

Russia moves to limit public sector wage hikes. On Monday (Apr. 6), president Vladimir Putin signed an amendment suspending current law on public sector wages for the next nine months. The law mandates cost-of-living adjustments keep up with inflation. The amendment also diminishes certain legally mandated adjustments in social entitlements. In light of the government's current financial struggles, public sector wages and social benefits will only be increased in line with the government's 5.5 % inflation assumption used in its initial draft of the 2015 federal budget.

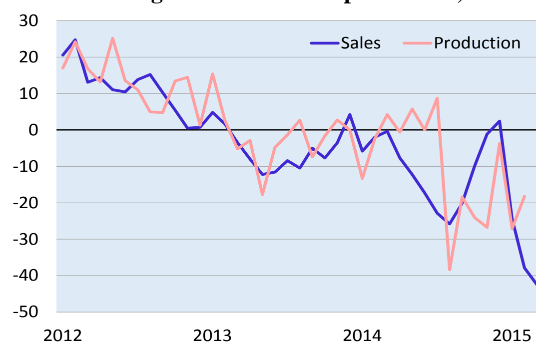
Russian carmakers have it rough. Car sales in Russia have been in trouble for a while. Even with a mini-shopping-spree at the end of last year based on expectations of further ruble devaluation and higher inflation, this year car sales have sunk again. On-year sales of new passenger cars in January-February shrank by a third, production fell 20 % and imports were down 45 %. Sales in March were off over 40 % y-o-y. Most forecasters now see new car sales falling at least 25 % for the whole year.

A number of car plants in Russia have already idled production temporarily, cut shifts or laid off workers – and further measures are planned. General Motors even announced it was shuttering its St. Petersburg plant indefinitely. The ruble's collapse has caused additional problems for the assembly plant production of GM and other foreign carmakers. Most components must still be imported due to the lack of local production in Russia, even if Russia has long sought to raise the domestic content of its car production.

Import substitution has become the key issue for the policymakers also in car industry. The industry ministry recently announced specific goals for reducing dependence on imported car parts. The plan includes even shifting by 2020 to totally domestic supply of many car parts that are at the moment not produced in Russia, but sourced from one or two countries (e.g. Germany, Italy or the Netherlands). The goal, however, may be hard to reach given current economic situation and worsening business climate that are not encouraging new foreign investment in Russia.

Some 2.3 million new cars were sold last year in Russia. Over half were foreign makes assembled in Russia, just under 20 % domestic makes and the rest imports. Most major international car manufacturers have at least some assembly capacity in Russia. Even the largest Russian car manufacturers AvtoVAZ and Kamaz are partly foreign owned.

12-month change in car sales and production, %



Source: Macrobond

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China

Chinese stock markets heat up. The main driver of the recent rise in Chinese share prices has been increased interest among small investors in owning stocks. Private investors account for about 80 % of trading on mainland China stock exchanges. The poor returns from alternative investments have further fed the frenzy to own shares. Share prices on both the Shanghai and Shenzhen stock exchanges are up nearly 90 % from a year ago, and there has been a manifold increase in the volume of trade.

The heightened interest of private investors can be seen by the fact that investors opened over 200,000 new brokerage accounts a day in March, up from an average of 30,000 accounts a day in March 2014. The practice of margin trading (i.e. purchase of shares on credit) has also exploded. As of end-March, the stock of margin-bought shares in mainland China exchanges totalled 1.5 trillion yuan (€225 billion), up from 400 billion yuan in March 2014.

Even ordinary people have taken interest in shares. Bloomberg reported that, based on data from the *China Household Finance Survey* from the end of last year, over 30 % of novice investors in stocks had only finished elementary school, up from 8 % earlier. Small investors prefer to buy shares with a low unit price; such shares have seen much greater appreciation than more valuable shares.

Observers worry that the private investor stampede into shares may increase price volatility. Share price performance defies the current outlook for the slowing real economy. Moreover, share prices have risen on investor expectations of looser policy. Recent monetary easing has further fuelled the rise and thus the impacts of the easing on the real economy have remained relatively small.

Share prices on Shanghai and Hong Kong exchanges

Source: Macrobond

Foreign investors in Hong Kong have stepped selling shares bought on the Shanghai exchange via the "Stock Connect" arrangement. The value of trades conducted under the arrangement amounted to 1.2 % of the turnover on the Shanghai exchange in March. Short selling of shares under limited conditions via the cross-border link was introduced in the Shanghai exchange in March. The short-selling possibility has yet to attract the interest of foreign investors.

The interest of Chinese investors in relatively cheaper Hong Kong shares has continued to climb in recent days and the share prices in Hong Kong have also risen sharply. Investing in Hong Kong via Stock Connect was recently allowed for mainland Chinese mutual funds, which has fuelled the increase in trade volumes. Mutual funds' investment in foreign shares was earlier allowed only under the qualified domestic institutional investor (QDII) programme. The overall trading share of mainland Chinese on the Hong Kong exchange has still remained modest.

China faces massive costs for environmental damage. A Rand Corporation report released last month considers the costs of China's environmental problems and the costs of feasible solutions. Healthcare and negative impacts on worker productivity represent some of the largest costs of environmental degradation to Chinese society. The costs from environmental damage in 2000–2010 averaged around 6.5 % of GDP. The costs in 2012 were around $535 billion, or more than double Finland's GDP that year.

The environmental impacts arising from China's model of rapid economic growth based on heavy industry are now so costly Chinese officials must take action. Pollution levels in nearly all urban areas in China exceed WHO allowed limits. In March, a documentary film posted online gained both national and global attention for its frank discussion of the extensive harms caused by air pollution in China.

China's government has already moved ahead with certain measures. China and the US last November signed a framework convention on climate change in which China for the first time committed to a timetable on limiting emissions and ending growth in carbon dioxide emissions by 2030. Environmental issues were also on the agenda at the National People's Congress last month, when premier Li Keqiang vowed the government would use best efforts to improve air quality and deal with related pollution issues. The government announced at the end of March that new environmental tax legislation was being fast-tracked. In addition, for the first time ever under China's revised environmental law a court has agreed to hear environmental damage claims filed by an NGO.

The Rand report reiterates the general view that the responses of China's government have been woefully inadequate given the scale of China's pollution problems. The report adds that the most effective ways to improve air quality would be to move swiftly from coal to natural gas heating, replace coal-fired power plants with renewable formats and nuclear plants, as well as getting high-polluting vehicles subject to outdated emissions criteria off the road. Annual costs of implementing mitigation measures are significantly less than living with the current pollution.

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