

Russia

CBR stress test findings show nearly a third of banks likely to fail with recurrence of 2008 financial crisis. As part of its programme of regular stress testing, the results of the Central Bank of Russia's latest tests were released at the end of April. The tests examined the capital adequacy of Russian banks in a hypothetical situation where their deposit stocks would be reduced 10–20 % and the inter-bank credit markets contract 30 % under withdrawal of foreign finance. The tests also assumed a 20 % ruble depreciation and 50 % slide in the stock market. The assumptions largely emulate the events of the 2008 financial meltdown.

According to test results, the biggest problems would be caused by credit losses and deposit flight. A collapse in securities prices would also affect banks significantly; in recent years banks have increased their holdings of securities. In contrast, currency risk was not regarded as substantial. The CBR notes that this is due to banks' well balanced currency positions.

The CBR concluded the banking sector would lose about half of its capital in a 2008-like crisis. About a third or 321 Russian banks would be unable to meet the CBR's minimum capital requirement of 10 % of risk-weighted liabilities. These 321 banks represent 51 % of all banking sector assets. The capital of 134 banks would fall to less than 2 % of liabilities. Although some of the banks would be eligible for bank support as in the 2008 crisis, the total number of banks would decline.

Experts argue that the stress test assumptions are overly harsh. Neither does the CBR expect things could return to the dire conditions of 2008 in the near future. Nevertheless, the stress testing shows that problems persist in Russia's banking sector and could readily be triggered by shocks to the global financial system.

A specific area of concern for Russian banking is concentration of risk. The majority of lending in many banks goes to their top five clients. In connection with the latest round of CBR stress tests, a special assessment of bank lending to owners found that in 74 banks, loans to owners exceeded the official limit of 50 % of bank capital. Even these findings may understate the actual concentration of risk. It is very difficult to trace the actual destination of loans as bank and corporate ownership structures are in many cases extremely complex and opaque. In addition, the CBR's supervisory powers are limited.

Inflows of foreign direct investment into Russia showed modest increase in 2010. CBR balance-of-payments figures find FDI inflows to Russia in 2010 increased 13 % y-o-y to \$41 billion. Even so, FDI inflows were below that of the pre-crisis years 2007 and 2008.

Foreign direct investment outflows from Russia last year amounted to \$52 billion, an 18 % increase from 2009. Investments returned to a level close to the 2008 peak.

Statistical data on foreign direct investment in Russia are kept by two separate government agencies, the CBR and Rosstat. Their statistical methods differ considerably from each other, as do their statistical figures. The methodology for preparing central bank statistics complies with internationally accepted standards, but the CBR does not release all breakdowns of its figures. Rosstat provides breakdowns, but the figures are prepared according to its own methodology. The OECD has focused attention on Russia's two-track statistics problem as part of Russia's OECD membership negotiations and provided assistance in developing statistical reporting.

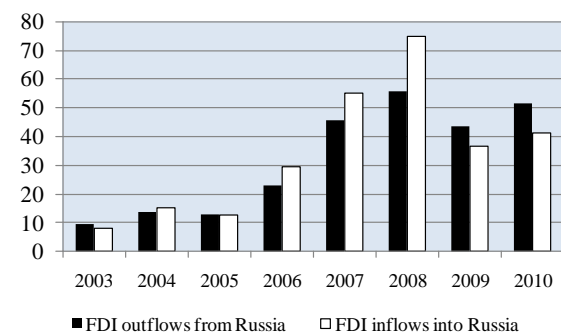
Legislation is currently being drafted to give responsibility for compiling official statistics on foreign investment solely to the central bank. The CBR has begun to prepare figures on the structure of investments, which would dramatically improve the quality of current reporting. At the beginning of May, the CBR published such data for the first time.

The CBR said the bulk of FDI last year went to manufacturing industries, which received 23 % of investment. The finance and insurance branch received 19 % and the trade sector 12 %. Mineral extraction (including oil and gas), as well as real estate and telecommunications, all had about 8 % shares.

As usual, the largest source of FDI inflows to Russia came from Cyprus, which accounted for 29 % of total FDI. The next largest FDI providers were Germany (8 %) and Ireland (7 %). The Virgin Islands and Bahamas each accounted for 5 % of FDI. Finland represented about 1 % of Russian FDI last year.

A large share of foreign direct investment last year consisted of reinvested earnings. They amounted to some \$17 billion and represented 42 % of all FDI inflows. Other capital (mainly loans from owners) was valued at \$15 billion and represented 36 % of FDI. Actual capital investment last year amounted to \$9 billion, or about 20 % of total foreign direct investment inflow.

Foreign direct investment, US\$ billion



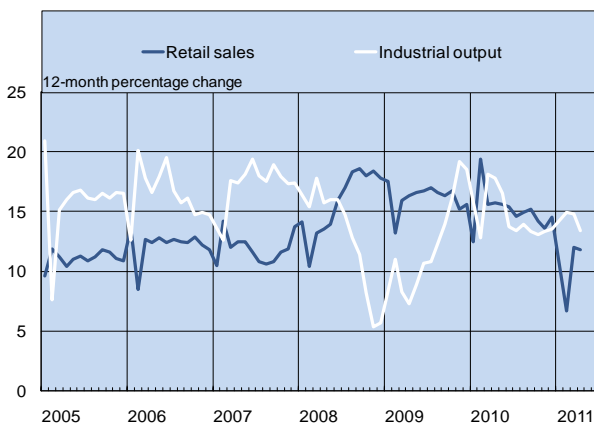
Source: Central Bank of Russia

China

Slight slowdown in economic growth, but inflation remains high. Figures released by China's National Bureau of Statistics on Wednesday (May 11) show on-year growth in real industrial output slowed in April to 13 %, a drop of one-and-a-half percentage points from March. With the exception of electricity production, industrial output rose in all branches in April at lower rates than the first-quarter average. In the first quarter, passenger car production climbed 8 % y-o-y, but the volume of 813,000 cars produced in April was only 1 % more than in April 2010.

Despite the high growth in fixed capital investment in April, there were signs of possible slowing ahead. Construction investment remained strong; measured in terms of floorspace, the volume of new housing starts in the January-April period was up 20 % from the same period a year earlier. The volume of housing starts in April, however, was lower than in March, and April housing sales were down substantially from the previous month. The dip may only be seasonal, however. Growth in household demand flagged slightly when measured in terms of real retail sales.

Real growth in industrial output and retail sales,* %



* Deflator consumer price index

Source: Bloomberg

Consumer prices in April were up 5.3 % y-o-y, and the inflation rate was unchanged from March (5.4 %). Producer price inflation slowed in April to 6.8 %, a half percentage point less than in March. China's government has been tightening monetary policy since late autumn with the target of bringing 12-month inflation under 4 % by the end of this year. While the stricter monetary policy has reduced the rate of new loan issues, the rate still exceeds the pre-crisis level of summer 2008.

On Thursday (May 12), the People's Bank of China announced a half-percentage-point hike in the reserve requirement for commercial banks. From next Wednesday

(18 May), the reserve requirement for China's biggest banks rises to a record 21 % of deposits.

Trade surplus boomed in April. China's exports in April amounted to \$156 billion. April export growth was up 12 % m-o-m and 30 % y-o-y. Despite rapid growth, the rate of export growth has been sliding gradually since the start of this year. The slowdown in import growth has been even more dramatic. April imports fell 7 % m-o-m and about 20 % y-o-y to \$144 billion. April import volumes for several key commodities such as iron ore and copper showed on-month declines. While high commodity prices and unusually high inventories built up at the start of the year partly explain the drop in imports, tighter economic policies also appear to account for some of the slowdown.

Typically the trade surplus rises as the year wears on when imported goods are processed and exported as finished goods. The April surplus was expected, but it grew faster than forecast due to the unanticipated slowing in import growth. The trade surplus grew to \$11 billion in April (\$140 million for March), further increasing appreciation pressures on the yuan.

The United States and China focus on market access at latest strategic and economic dialogue meeting. China and the US met in Washington DC on Monday and Tuesday (May 9–10) as part of their regular strategic and economic dialogue. The discussion concentrated on four areas of economic cooperation: macroeconomic stability, trade and investment, financial sector rules and international cooperation. In this meeting, the allowance of greater exchange flexibility was again one key issue. The discussion mainly concerned the rate of appreciation to which the Chinese responded that gradual appreciation was critical.

The latest round of talks placed greater emphasis on market access issues, with both sides claiming progress. China committed to increasing the opportunities for foreign banks to engage in mutual fund trading and QFII securities futures, as well as raise their investment quotas for debt securities and equities markets. China promised to open the world's fastest growing car insurance market to foreign firms. It also said it would do more to make sure software used in the public sector is legal. China promised to change the rules on public procurements by relaxing the current demands which tie procurements to enhancements of the domestic technology level. This would help foreign companies gain access to China's huge public procurements market.

For its part, the United States promised to revisit its restrictions on technology exports to China, as well as ease access of Chinese firms to the US market. The Chinese also expressed concern about the ability of US treasuries and bonds to hold their value.