

Russia

Sale of state-owned enterprises moving into new phase.

Efforts to decrease state-owned holdings are linked to president Dmitri Medvedev's goals of modernising Russia's economic structures and functioning, as well as reducing the state's role in the economy. Although the sale of state assets will help the federal budget deficit, it is not the main motivation for divestment. First deputy prime minister Igor Shuvalov is among those who criticize Russia's current brand of state capitalism. In his view, it is a barrier to economic development, supports corruption and inefficiency, distorts competition and diminishes incentives to develop and exploit new business ideas. Russia has seen little progress in selling off stakes in state-owned enterprises in recent years. The big exception was the 2008 breakup and sale of state electricity monopoly RAO UES.

Last autumn the government approved a programme for sale of stakes in state-owned firms. This spring, the president asked his cabinet to add more companies to the list. A new feature, according to the president, is that major state firms can begin to sell majority stakes; under last year's programme, the state would either sell only minority stakes in state companies or any sale of a majority stake would allow the state to retain a "golden share" that guarantees the veto right on important matters before the corporation. Medvedev would like to see the sell-off of majority stakes applied to all state-owned enterprises not involved in defence or infrastructure.

Medvedev has proposed sell-offs of the majority stakes in oil company Rosneft; Russia's number-two bank VTB and number-four agriculture bank Rosselkhozbank; as well as hydropower producer RusHydro. Medvedev's economic adviser Arkady Dvorkovich expects that the state can complete the divestment of VTB bank fully and Rosneft with the exception of the veto right within 3–5 years. Shares of other state firms to be offered include Russia's largest bank, Sberbank, Aeroflot, the Sovkomflot shipping company and farm equipment leaser Rosagroleasing. Dvorkovich said that earlier planned sales of minority stakes in certain companies, including oil pipeline operator Transneft, would not expand, and sale of shares in gas giant Gazprom has not been discussed. Finance minister Alexei Kudrin believes the state should relinquish all its majority stakes in oil, finance, transport and telecommunications companies over the next 3–5 years. The government is expected to finalise its revised asset sale list by the start of August.

The government has tapped 23 investment banks, including Troika Dialog, JPMorgan and Merrill Lynch, to arrange the practical details of large sales. This spring, investment banks submitted bids for companies on the government list for which they are willing to arrange sales.

First deputy prime minister Igor Shuvalov said the state does not want to repeat the mistakes made in the privatisation of state assets in the 1990s, when large enterprises in the mining sector and the industry were sold off on the cheap to private investors through shady deals.

Under last year's announced sales programme, the federal government would take in 300 billion rubles (€7.5 billion) a year from sales of stakes in state firms. Medvedev's new plan calls for increasing the level of sales to 450 billion rubles (€11.2 billion) a year.

Russia unchanged in international competitiveness ranking.

The World Economic Forum's recently-released 2010-2011 global competitiveness report indicates Russia's overall position at 63 out of the 139 countries surveyed. The ranking is essentially unchanged from five years ago, even if Russia climbed in the ranking before the global financial crisis and sank a year ago. Russia was ranked below the BIC countries: China was 27th, India 51st and Brazil 58th. The countries with the highest overall competitiveness were Switzerland, Hong Kong and Singapore.

The WEF measures competitiveness in terms of 12 "pillars" of competitiveness. These include institutions, infrastructure, macroeconomic environment, markets, business environment, technology, innovation, and health and education. These pillars cover a total of 111 factual or substantive appraisals.

The WEF said the biggest challenges facing Russia were weak public and private institutions (118th place), especially with regard to state regulation, property rights, trustworthiness of the police; functioning markets and competition (123rd), especially barriers to trade and customs practices; as well as financial markets (125th) and business practices (101st).

Russian competitive strengths remain its abundant natural resources and large domestic and foreign markets. The Russian population was 25th in terms of education enrolment. The report finds that the quality of education in Russia has declined over the last five years, and that post-primary education is now weaker than in India or China. Russia ranked a fair 57th in innovation, which however was lower than any of its BIC compatriots.

Russia's labour markets were fairly competitive (57th), putting it near the OECD average, and above both Brazil and India. Russia's competitive advantages were low severance pay relative to wages (only half the OECD average), and participation of women in the workforce (above the OECD and BIC averages). Wages and productivity were on par with the BIC countries. The report found that Russian productivity is above productivity e.g. in China and India, but the higher wages paid in Russia diminished Russia's pay-and-productivity position relative to lower-wage China and India.

China

Large debt load of local administrations adding to uncertainty and limiting flexibility in economic policy.

With the onset of international financial crisis, China's government put a 4-trillion-yuan stimulus package in place in November 2008. A key element of the stimulus was providing loans to local administrations to support infrastructure projects. Repayment of those loans, however, is now becoming a serious problem for entire public economy.

In order to finance projects, local administrations established local government finance vehicles (LGFVs) as Chinese law proscribes direct borrowing from banks or securities markets. This week, the National Audit Office (NAO) released its first official report on local governments and LGFV indebtedness. The report finds that, as of end-2010, local officials had set up 6,576 LGFVs and that the debt obligation of local administrations had reached 10.7 trillion yuan (€1.2 trillion). At the time, a small percentage of LGFVs were in arrears, and about 5 % had resorted to further borrowing to roll over old loans. In some cases stimulus money loans have been used improperly to purchase real estate or invest in the stock market.

The NAO said that liabilities of local administrations last year corresponded to 27 % of GDP. The People's Bank of China recently estimated that such borrowing is closer to 35 % of GDP. Victor Shih, a professor of political economy at Northwestern University, notes the discrepancy in the size of the debt load of local administrations (*Financial Times* 28.6.2011) likely reflects the fact that the NAO uses the stricter definition of debt, i.e. it only counts debt directly assumed by local administrations or through direct loan guarantees. The PBoC's higher figure comes from including independent borrowing made in the name of subunits of local administrations and LGFV debt collateralised with land owned by local governments. Shih calculates on the basis of officially published figures that local government debt probably exceeds 20 trillion yuan, or about 50 % of GDP. When central government debt (20 % of GDP) is included, China's public debt rises to somewhere in the range of 50–80 % of GDP.

Uncertainty over the size of local administration debt and solvency of local administrations has dragged down the outlook for the banking sector – even if the situation is still manageable and the problem may only get out of hand a few years down the road. Credit ratings agencies and analysts, however, warn that the stock of non-performing loans is set to increase significantly. The biggest risk at the moment is a possible cooling of the real estate sector as it would also hit land prices, while land is an important source of revenues for local administrations and collateral of their debts.

Ultimately, the central government would have to step in and bail out both the local administrations and the state-owned banks. This poses a timely dilemma for economic policymakers. Efforts to curbing inflation require a tighter monetary stance, but doing so inevitably weakens the solvency of local administrations.

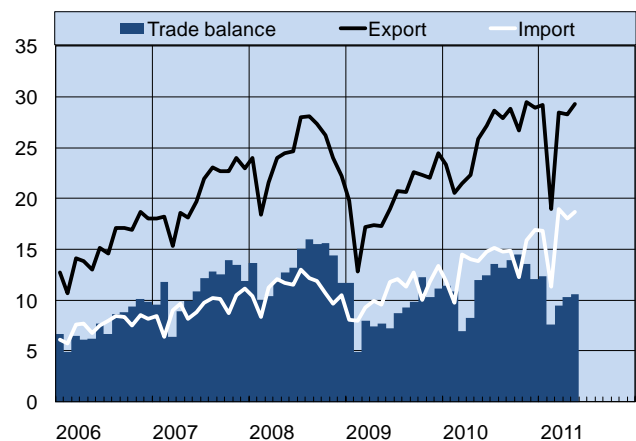
China's public sector remains one of the least transparent parts of the Chinese economy. The current situation highlights the need for deep and extensive reforms of the public sector economy. In addition, staying ahead of the debt problem demands continued robust economic growth in the years ahead.

Premier Wen Jiabao's 5-day European tour focused on promoting bilateral trade. The biggest trade deals signed during Wen's visit were with Germany in the areas of car-making and a deal to purchase planes from Airbus, with a list price of \$7 billion. The total value of deals penned was put at \$15 billion. Wen Jiabao also visited Hungary, the then holder of the rotating EU presidency, and the UK.

During his visit, Wen pledged his support in resolving the eurozone debt crisis and gave assurances that China would remain a long-term investor in European sovereign debt. He also promised that China would continue to invest in eurozone debt as needed. No specific details about the investments or amounts were mentioned, however.

China does not publish information about how its foreign currency reserves are invested. A survey by the Standard Chartered investment bank found that China has apparently been building up its position in the European bond markets, while reducing its relative dollar exposure. Euro-denominated investments are seen as offering higher yields and give China an opportunity to diversify its foreign currency reserves. An estimated quarter of China's more than \$3 trillion foreign currency reserves are invested in euro-denominated assets. In this respect, China has a vested interest in a stable euro.

Monthly China-EU trade, US\$ billion



Sources: China Customs, CEIC