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# BOFIT Weekly

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# Russia

**IMF sees brisk economic growth ahead for Russia, but warns of loose fiscal policy.** The IMF's latest appraisal of the Russian economy is based on its annual Article IV consultations in the first half of June between the IMF mission and Russian officials. In its concluding statement, the IMF emphasised Russia's need to maintain fiscal restraint and begin withdrawing stimulus measures implemented during the financial crisis. The statement also remarked on the importance of pension reform, noting that Russians are living longer so the pension age needs to be raised to 63 years by 2030 to stabilise pension costs. With the economy running at near capacity, the IMF said any further increases in public spending could cause overheating of the Russian economy. The IMF sees the widening of the ruble's fluctuation band as beneficial for the economy overall and a step towards monetary policy largely based on inflation-rate targeting. As in previous years, the IMF kept with its encouragement to strengthen bank supervision and progress in structural reforms as prerequisites for balanced economic growth.

**FAS head concerned about government's lack of commitment to increasing competition.** Igor Artemyev, head of the Federal Antimonopoly Service (FAS), last week presented his bureau's annual report on the state of competition in Russian markets to the cabinet. He was particularly upset over the lack of progress in the Competition development programme, noting that a number of FAS proposals have never left cabinet committee or their discussion has been tabled continuously. Artemyev pointed out that many ministries not only see competition as a minor issue, but actively work to create or extend monopolies arguing to maximise scale advantages.

The FAS would especially like to see legislative reform in the governance of natural monopolies. In many cases, natural monopoly laws are outdated and conflict with newer legislation. The number of branches subject to administratively regulated prices needs to be reduced (e.g. stevedores) and legislation is needed to outlaw discriminatory behaviour in key infrastructure sectors (e.g. telecommunications and freight rail). Artemyev further cited the biased protection for individual international air passenger carriers, where Russia's existing bilateral agreements grant in many cases exclusive rights to country-to-country flights to a single carrier. The FAS calculates that just adding one competitor per air route would lower ticket prices for air travellers by about 25 %. The law package regulating passenger aviation, Artemyev noted, has been sitting in the Duma for seven years.

To speed reforms, Artemyev asked the cabinet to establish a competition development commission led by a deputy prime minister. Prime minister Medvedev then asked deputy prime minister Shuvalov to look into the matter.

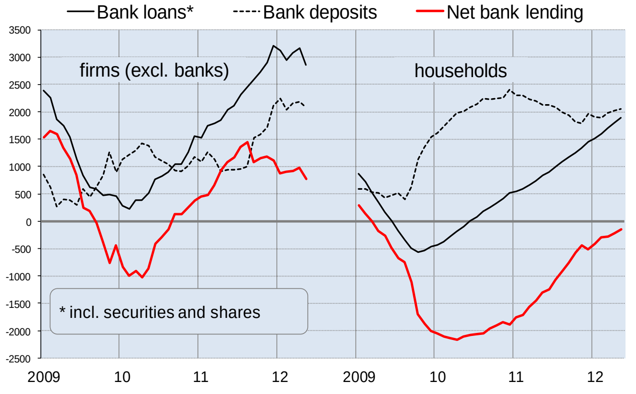
**Growth in corporate lending of Russian banks has levelled off.** Growth in the stock of corporate loans by banks has stabilised this year, even if on-year growth is still around 20 % (the impact of ruble exchange rate changes on foreign currency loans is eliminated). 12-month corporate borrowing flow from banks has been about the same this year as it was at the end of 2011. The growth in corporate borrowing has been limited by lower fixed capital investment. Moreover, interest rates on corporate loans have risen since last autumn. The nominal rate for ruble loans is now averaging around 10 %, significantly higher than forecast 2012 inflation (5–6 %).

Corporate bank depositing accelerated considerably last autumn. As a result, net corporate borrowing from banks has been sliding down slightly since then.

Household borrowing continues to accelerate, even at interest rates north of 20 %. The loan stock has grown over 40 % y-o-y. Credit growth has been sustained by consumer purchases of durable goods. While household bank depositing tended to decline last year, it appears saving has made some comeback over the past six months. However, the net flow of household borrowing has become nearly positive.

The overall net lending of banks to firms and households turned positive last year, tightening the liquidity situation for banks. In addition, capital outflows from Russia have continued, while the state has tapped the domestic market for borrowing. Lending from foreign banks and Russian interbank lending have both decreased. The CBR has helped banks by providing considerably more liquidity. Even so, the banking sector's tight liquidity situation has pushed up interbank rates to their highest levels since autumn 2009.

**Bank credit and deposit flows for households and firms (12-month change of the stocks), RUB billion**




*Source: Central Bank of Russia*

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# China

**Liberalisation of money markets continues; interest rate competition among banks increasing gradually.** The People's Bank of China dropped its key reference rates at the beginning of this month by a quarter percentage point, bringing the benchmark one-year credit rate down to 6.31 % and the deposit rate to 3.25 %. Perhaps more important than the rate cuts was the PBoC's shift to a regime that lets the market have greater impact on rate-setting. Banks can now offer loans as much as 20 % below the reference rate (about 5.05 %). Earlier, the allowed divergence was only 10 % below the reference rate. Ceiling on loan interest does not exist. Bank deposit interest rates can exceed the reference rate by 10 % (about 3.58 %).

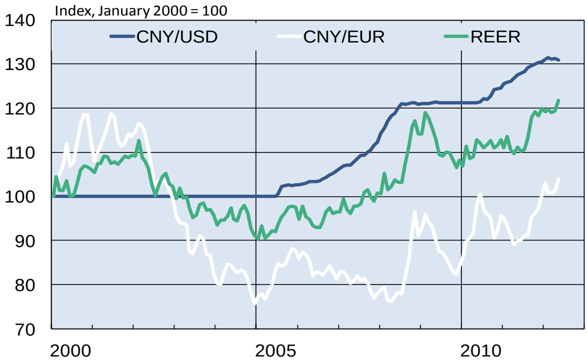
Easing of interest-rate policy is hoped to improve the functioning of markets and encourage healthy competition in formal banking sector. The measures seem to be working as both large and small banks have reportedly boosted their interest rates for depositors to levels at or near the PBoC's ceiling. Interest rates for loans in the informal market, which are still critical for many firms, are still vastly higher. PBoC figure suggest that the average informal loan rate in e.g. Wenzhou in April approached 22 %.

China's financial markets have become more complicated and harder to regulate through administrative measures such as reserve requirements and issuing guidelines to banks. The importance of the price-setting mechanism and interest rate policy is emphasised by the blurring of the distinction between official and unofficial markets. The IMF also stressed the importance of interest-rate policy in its stability assessment of China's financial sector last autumn. Before this latest move to relax interest rate policy, China has taken many small steps in market liberalisation. The relatively good economic situation and currency market stability creates prospects for progress towards deregulation of China's money and forex markets.

**Yuan weakens against dollar but strengthens in real terms.** From late December 2011 to end-April 2012, the yuan's exchange rate against the dollar remained fairly stable. Then in May the yuan lost about 1 % of its value against the dollar. The yuan slid despite essentially no change in currency flows in May according to figures at hand. The foreign trade surplus in May was just as big as in April and foreign direct investment inflows into China increased slightly. Once the balance-of-payments and currency reserve figures for the period are published, it will be easier to decipher what is happening. On Wednesday (June 20), one dollar bought 6.36 yuan.

Although the yuan has depreciated against the dollar, the yuan's nominal and real effective (trade-weighted) exchange rates (NEER and REER) have continued to rise. The REER, which incorporates inflation differences with major trading partners and trade shares by country, is a better measure of price competitiveness of Chinese firms than the NEER.

**Dollar-yuan, euro-yuan, and REER; rising trend indicates yuan appreciation**




*Sources: Bloomberg and BIS*

**China hit by another food safety scandal; demand for foreign-produced dairy products increases.** The Yili Industrial Group of Inner Mongolia, one of the leading producers of dairy products in China, has been forced to recall infant formula found to contain mercury. The latest crisis is a big setback for the dairy sector, which is still recovering from the 2008 melamine scandal.

Earlier milk scandals significantly reduced demand for Chinese dairy products both domestically and internationally. In October 2008, the volume of dairy exports briefly fell to near zero. Since then they have recovered to only half of their pre-crisis levels. Chinese per capita consumption of milk and milk powder also fell sharply in 2009 and 2010. The scandals have bolstered consumer confidence in foreign-made milk products, with imports of foreign milk products nearly quadrupling since 2008.

Food safety issues are a side effect of China's rapid economic growth. Tainted food crises have also exposed endemic corruption. To protect the food supply, China enacted a food safety law in June 2009. The purpose of the law was to update monitoring mechanisms in the food sector and respond to the rapidly evolving demands of the growing food industry. The law tightens monitoring requirements at every stage of production by e.g. unifying food safety standards, reforming licensing processes, eliminating exemptions and tightening sanctions for possible abuses and malpractice. The central administration's responsibility for coordinating oversight was also emphasised, as tracking of the food safety is currently dispersed across a dozen institutions. Despite the new law, violations still occur at regular intervals.

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