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EUROJÄRJESTELMÄ
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Russia

CBR cuts key rate to 14 %. Last Friday (Mar. 13), the Central Bank of Russia cut its key rate one percentage point on the heels of its February lowering to 15 %. With risks of weaker economic growth still larger than inflation risks, the CBR noted the decision is for supporting the economy.

The weak economy dampens inflationary pressures, and the CBR cited the fact that inflation had slowed from nearly 4 % m-o-m in January to just over 2 % in February. February prices, however, were still up 16.7 % y-o-y. The central bank further observed the price surge at the turn of the year was of a transient event that reflected the double-whammy of a large drop in the value of the ruble and bans on imported goods. The CBR said it expects 12-month inflation to slow by the end of this year to a range of 12–14 % and further to 5.5–7.5 % by the end of 2016. However, this scenario was subject to threats from hikes in regulated energy prices, relaxation of fiscal policy and acceleration in the rise of nominal wages.

CBR sees Russian economy contracting 3.5–4 % this year. The central bank forecast further expects the GDP to fall 1–1.6 % in 2016 but return to growth of 5.5–6.3 % in 2017. The CBR's outlook assumes the price of oil will this year average $50–55 a barrel, $60–65/bbl next year and $70–75/bbl in 2017. Economic sanctions are expected to remain in place for most of the forecast period, thereby limiting the access of Russian firms to foreign financing.

The CBR estimates that this year private consumption will contract 5.6 % and fixed capital investment as much as 10–12 %. Last year, consumer demand grew 1.9 %, while fixed investment fell 2.5 %.

As oil prices will likely remain depressed and domestic investment has dried up, the CBR has had to lower its calculated potential growth of the Russian economy from 2 % a year to around zero. With economic recovery, the CBR sees potential growth rising to around 1 %. Before the 2008–2009 financial crisis, the CBR estimated the economy's potential growth was in the range of 4.5–5 % a year.

Russian spending on goods imports and revenues from goods exports will each fall this year by about 27–28 %. Although the trade surplus will shrink slightly, the current account surplus will climb from $57 billion last year to $64 billion this year. That is partly due to a fall of 38 % of services imports, which is largely driven by foreign travel.

EU and Russia squabble over Russian import tariffs continues. In late February, the European Commission asked the WTO to assemble a dispute panel to rule on import duties imposed by Russia on paper products, refrigerators and palm oil. Russia's duties exceed rates Russia committed to in its 2012 WTO agreement. Russia presently imposes a 15 % import duty on paper products, even if its WTO obligations limit the duty to 5 %.

Last October, the EU submitted a request for WTO consultation on the matter. As the consultation produced no results, the EU called on the WTO to form a dispute panel. Should the panel find that Russia violated WTO rules, the WTO Dispute Settlement Body would be empowered to demand compensation from Russia and grant the EU the right to countermeasures.

The WTO filing is the fourth EU claim against Russia. Earlier complaints had to do with recycling fees on imported cars and restrictions on pork imports. Russia, in turn, has complained to the WTO about the EU's methodology for calculating dumping pricing, as well as the EU's "third energy packet," which Russia asserts is a restriction on Gazprom activities within the EU.

Ukraine gets new 4-year IMF fund facility. The IMF's executive board decided on March 11 to go ahead with a new lending programme for Ukraine. The new fund facility lasts four years, during which time Ukraine can borrow up to $17.5 billion from the IMF. The Extended Fund Facility (EFF) replaces the previous stand-by arrangement that had already provided $4.5 billion of funds paid to Ukraine.

Immediately upon the acceptance of the new programme, the IMF released a $5 billion tranche. Some $2.5 billion of the tranche went blitz to the National Bank of Ukraine's foreign currency reserves. With the approval of the EFF, Ukraine now has the possibility to access significant amounts of credit from other international lender institutions such as the World Bank as well as from individual nations. Despite the promised financing, Ukraine has been forced to begin negotiations with its private creditors on easing debt-servicing terms over the next few years.

Before approval of the EFF, Ukraine had to commit to enhancing economic efficiency and reducing its fiscal deficit, including prior actions. Progress in Ukraine's reforms will be monitored regularly, and compliance is required for receiving loan payments. Higher domestic natural gas pricing is critical as various gas subsidies equivalent to several per cent of GDP are a major contributor to the government deficit and encourage wasteful energy use.

The EFF conditions further call for stabilisation of the banking sector and reform of the social security system to make sure that the country's poorest households are better protected from taking the brunt of the financial crisis. The IMF foresees Ukraine's GDP will contract this year by about 5.5 % and that 12-month inflation at year's end will be running at around 27 %.

CBR launches English-language research paper series. The central bank's new Working Paper Series includes papers on inflation indicators, functioning of the loan markets and modelling of the Russian economy.

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China

Critical land reform experiment begins in China. Officials this month announced a pilot experiment in land reform that permits the sale of collectively owned rural construction land. The change is intended to harmonise rural and urban practices on the sale of land. Owners of rural construction land earlier had no option but to sell land to the local government. The pilot programme allows rural residents in pilot counties to sell their land directly to also private buyers at market prices. The reform should help reduce income inequality between rural areas and cities and increase the mobility of rural residents.

The reform trial applies to a few counties on the outskirts of fast-growing cities. Although it affects only a tiny slice of China's countryside (just 33 out of more than 3,000 counties), the implications are potentially huge as the move paves the way for liberalisation of a rural land sale and land ownership on a wide scale. The trend should eventually result in complete privatisation of rural construction land. Private land ownership would have a big impact on the Chinese economy by increasing the wealth of the rural population, as well as ease urban expansion and increase flexibility in the labour market. In this sense, the programme is part of the government's stated goal of dismantling the *hukou* housing registration system in order to make it easier for rural residents to move to cities.

Sales of rural construction land have been an important source of revenue for local governments as they have sold the land bought from rural households to real estate developers. Thus, the biggest challenge to the reform is how local governments will deal with the economic impacts of the change. Local government revenues have already been diminishing as demand for construction land by the real estate developers has slowed. The central administration is planning to shift the revenue base of local governments to taxes and bond issues.

The government also launched a trial system of real estate registration in 15 large cities at the beginning of March. The goal is to roll out a nationwide property owner registration system over the next two years. When implemented, the registry will provide a basis for collection of property taxes that potentially would provide a new revenue stream for local governments.

Europeans show keen interest in China's new development bank. The United Kingdom announced this week its intentions to become the first European founding member in the Asian Infrastructure Investment Bank (AIIB). Germany, France, Italy and Luxemburg are following the UK's lead, despite grousing from the US. The Chinese have generally welcomed the European interest in participation. Pacific-rim New Zealand and Indonesia have already joined, and Australia and South Korea are now contemplating AIIB membership. Some 32 countries are now already AIIB members or have officially announced their intentions to join.

The US and many other developed economies, as well as several major international institutions, have expressed concerns over AIIB's lack of operational transparency, governance structures and the potential for China to use the bank in promoting its foreign policy goals in Asia. The UK and other countries interested in taking part in the AIIB project note that they have better possibilities as members to assure AIIB operations comply with international standards. Other motives to join surely include trade policy and the hope to profit from increased yuan-based financing by improving political relations with China.

The initial capitalisation of AIIB is reportedly around $50 billion. The capital base of the US-Japan-led Asian Development Bank (ADB) currently amounts to $165 billion, while the World Bank's base capital is about $240 billion. Thus concerns over China using AIIB to outflank existing international arrangements seem overblown. Competition among development banks should also be as welcomed as it is in other fields of business. Even ADB president Takehiko Nakao noted that room for cooperation exists.

Moreover, there is little worry of over-supply in Asian infrastructure. The ADB estimates the region needs to spend over $8 trillion on development of infrastructure in the current decade (2010–2020). International agencies cannot close Asia's infrastructure investment gap, and the main responsibility for infrastructure development lies with national governments in the region.

China could already this year introduce a deposit insurance scheme and deregulate interest rates. In his speech to this month's assembly of the National People's Congress (NPC), central bank governor Zhou Xiaochuan said a deposit insurance scheme could be in place before July. Zhou noted that the proposed legislation on a deposit insurance scheme last November has enjoyed a positive reception, and given that deregulation of interest rates is linked to deposit insurance policy, both moves will likely take place this year.

A further goal this year is to open a linkage of the Hong Kong and Shenzhen stock exchanges similar to the arrangement already in place between the Hong Kong and Shanghai exchanges.

This year's NPC otherwise offered few surprises on the economic front. Premier Li Keqiang, following his closing remarks to the NPC last Sunday (Mar. 15), held the now-familiar press conference and covered about the same ground as in previous years. Li mostly talked about economic growth, environmental issues and corruption. He repeated concerns expressed in his opening address about slowing economic growth and emphasised that reaching the 7 % growth target this year will not be easy for China.

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