



BOFIT

BOFIT Weekly
Yearbook 2011



EUROJÄRJESTELMÄ
EUROSYSTEMET

Bank of Finland, BOFIT
Institute for Economies in Transition

BOFIT Weekly
Editor-in-Chief Seija Lainela

Bank of Finland
BOFIT – Institute for Economies in Transition
PO Box 160
FIN-00101 Helsinki

Phone: +358 10 831 2268
Fax: +358 10 831 2294

Email: bofit@bof.fi
Website: www.bof.fi/bofit

The opinions expressed in this paper are those of the authors and do not necessarily reflect the views of the Bank of Finland.

BOFIT Weekly – Russia 2011

7.1.2011 BOFIT Weekly 1/2011

Public economy reforms under preparation.
Russian stock exchange posts positive performance in 2010.

14.1.2011 BOFIT Weekly 2/2011

High inflation persists.
State finances in better shape than expected.
Medvedev specifies regions along Russia's international borders where foreign land ownership will be restricted.

21.1.2011 BOFIT Weekly 3/2011

Russia's decade-long reform of electricity sector largely successful.
High oil prices buoy the ruble.
Current account surplus continued to swell in 2010.

28.1.2011 BOFIT Weekly 4/2011

Rosneft and BP agree on share-swap and strategic cooperation in the Arctic.
Despite rapid growth, Russia's state bureaucracy still not particularly large.

4.2.2011 BOFIT Weekly 5/2011

Economy recovered and imports soared in 2010.
Real wages rose and unemployment declined in 2010.
CBR tightens its monetary stance.

11.2.2011 BOFIT Weekly 6/2011

Oil and gas production increased in 2010.
Moscow plans to accelerate divestment of municipal properties.

18.2.2011 BOFIT Weekly 7/2011

Banking operations recovered last year.
State divests a 10 % stake in VTB.
Russia's machine-building industry stares into the abyss.

25.2.2011 BOFIT Weekly 8/2011

Russian foreign trade grew strongly last year.
Deputy prime minister/finance minister Kudrin demands changes in government economic policies.

4.3.2011 BOFIT Weekly 9/2011

Concern over rising inflation driving central bank policy.
Finland's exports to Russia up last year; re-exports not growing.

11.3.2011 BOFIT Weekly 10/2011

Public finances improved last year.
Borrowing of Russian state likely to be lower than forecast this year.
Consumer prices up 9.5 % y-o-y in February.

BOFIT Weekly – Russia 2011

18.3.2011 BOFIT Weekly 11/2011

Short-term impacts of Japan disasters on the Russian economy likely to be relatively small.
Large differences in regional industrial growth.
Despite rise in capital investment, no growth in construction activity last year.

25.3.2011 BOFIT Weekly 12/2011

Large differences in economic recovery in Russian regions neighbouring Finland in 2010.
Government approves development strategy for banking sector.

1.4.2011 BOFIT Weekly 13/2011

BOFIT forecast sees brisk GDP growth in 2011-2013
for Russia, despite slowing.
Russians travelling abroad more, including Finland.

8.4.2011 BOFIT Weekly 14/2011

Central bank continues with monetary tightening.
First results of last year's population census published.
Gazprom loses market share in the European natural gas market.

15.4.2011 BOFIT Weekly 15/2011

Despite rapid import growth, Russia's trade surplus kept expanding in first quarter.
Economic development ministry updates its 2011 forecast.
Economic development ministry downgrades its 2012–2014 forecast.

21.4.2011 BOFIT Weekly 16/2011

State banks moving aggressively to gain share in the finance sector.
Russia and Ukraine emerge with little to show from customs union and gas supply talks.
Kyrgyzstan government to launch negotiations with Russia-Belarus-Kazakhstan customs union.

29.4.2011 BOFIT Weekly 17/2011

Insecurity characterises first-quarter economic performance.
Budget revenues up sharply; slight increase in spending.
IMF commends Russian officials for efforts to stabilise banking sector during financial crisis.

6.5.2011 BOFIT Weekly 18/2011

CBR keeps raising rates.
Russia imposes ban on gasoline exports.

13.5.2011 BOFIT Weekly 19/2011

CBR stress test findings show nearly a third of banks likely to fail with recurrence of 2008 financial crisis.
Inflows of foreign direct investment into Russia showed modest increase in 2010.

20.5.2011 BOFIT Weekly 20/2011

GDP grew rapidly in the first quarter.
Manufacturing industries fared variably during the recession.
Study explores rise in Russian living standards, increased income disparity and changes in consumption patterns.

BOFIT Weekly – Russia 2011

27.5.2011 BOFIT Weekly 21/2011

Eurasian Economic Community rides to the rescue of struggling Belarus.
Important listing of Russian firm on Nasdaq.

2.6.2011 BOFIT Weekly 22/2011

Drafting of 2020 Strategy continues – economic policies discussed.
CBR raises interest rates again.
Russia to lift ban on grain exports from start of July.

10.6.2011 BOFIT Weekly 23/2011

No consensus yet on social security contribution amounts.
Debate over raising the retirement age reignites.

17.6.2011 BOFIT Weekly 24/2011

Russian WTO memberships in the final stretch – again.
Russian firms shift gradually to internationally accounting practices.
IMF: Russian economic policy needs to leverage current commodity boom to shift direction.

23.6.2011 BOFIT Weekly 25/2011

Medvedev reiterates reform goals at the St. Petersburg International Economic Forum.
Decision taken on reducing social security contributions.
How will Russians vacation this summer?

1.7.2011 BOFIT Weekly 26/2011

Sale of state-owned enterprises moving into new phase.
Russia unchanged in international competitiveness ranking.

8.7.2011 BOFIT Weekly 27/2011

Rosstat releases first-quarter GDP figures.
MICEX and RTS bourses sign merger agreement.
Bank Moskvyy restructures.

15.7.2011 BOFIT Weekly 28/2011

State budget spending set to increase next three years.
Russia posts large current account surplus.
Customs inspections at the Russia-Kazakhstan border ended on July 1.

22.7.2011 BOFIT Weekly 29/2011

Steady first-half growth; recovery in fixed capital investment yet to occur.
Inflation rate showed little change in first half.
Russian stock market closely tracking global economic trends.
Sberbank expands operations into Central and Eastern Europe.

29.7.2011 BOFIT Weekly 30/2011

Deposit insurance agency to pay out biggest settlement ever.
OECD: Russia's innovation policy in need of a make-over.
New law imposes stricter limits on alcohol sales and advertising.

BOFIT Weekly – Russia 2011

5.8.2011 BOFIT Weekly 31/2011

Some progress in Russia's WTO negotiations.
Passenger car production and car imports surging.
Decent harvest outlook.

12.8.2011 BOFIT Weekly 32/2011

Ruble falters and share prices slump.
Russia continued to export capital in the first half of the year.
Russia increases government borrowing.

19.8.2011 BOFIT Weekly 33/2011

State set to divest a majority stake in rail freight company.
Customers demand lower gas prices from Gazprom.
Gazprom lowers price of gas sold to Belarus; similar discount for Ukraine unlikely.

26.8.2011 BOFIT Weekly 34/2011

Major uncertainties cloud Russia's economic growth prospects.
Uncertainty on global markets could postpone government plans to sell shares in state-owned companies.

2.9.2011 BOFIT Weekly 35/2011

New regime for export taxes on petroleum products.
Lapses in banking supervision.
China Construction Bank announces plans to establish subsidiary in Russia.

9.9.2011 BOFIT Weekly 36/2011

Russia posts large consolidated budget surplus in the first half.
Oil production rises but exports decline.
Finnish exports to Russia up briskly in the first half.

16.9.2011 BOFIT Weekly 37/2011

Rising trend in federal budget spending will continue in coming years.
Fixed investment remained heavily focused on the energy sector in the first half.
Despite strong exports of wheat and arms to North Africa and the Middle East, the region still only has marginal economic significance for Russia.

23.9.2011 BOFIT Weekly 38/2011

BOFIT forecast sees relatively strong, but slowing, economic growth ahead for Russia.
CBR adjusts key interest rates.

30.9.2011 BOFIT Weekly 39/2011

Finance minister Alexei Kudrin resigns – bumpy times expected for Russian fiscal policy.
Ruble's recent slide started in early August.

7.10.2011 BOFIT Weekly 40/2011

Demand in Russia recovered starting in the second quarter.
Increases in public sector spending ahead affirmed.
New export duty scheme for crude oil and petroleum products now in force.

BOFIT Weekly – Russia 2011

14.10.2011 BOFIT Weekly 41/2011

Current budget framework calls for sharp hikes in spending on defence and national security.
Consumer prices remain flat.
Russia and China consider deeper economic cooperation.

21.10.2011 BOFIT Weekly 42/2011

Russia pushes for intensified economic cooperation among CIS members.
Russia's new international tax agreements seek to ban tax avoidance.

28.10.2011 BOFIT Weekly 43/2011

Output shows fair rebound this year.
Bumper grain harvest for Russia.
Energy continues to dominate Russian exports.

4.11.2011 BOFIT Weekly 44/2011

Is Russia finally on the brink of WTO membership?
Russia ready to help finance eurozone debtors.
Next year's regulated rate hikes to be postponed.

11.11.2011 BOFIT Weekly 45/2011

Russian exports weaker than forecast.
First gas passes through Nord Stream gas pipeline.

18.11.2011 BOFIT Weekly 46/2011

Russia one step closer to WTO membership.
Diversity in economic performance and 2012 forecasts.
Banking sector liquidity expected to improve by year's end.

25.11.2011 BOFIT Weekly 47/2011

Prices on Russia's stock markets now track international stock markets more closely than before.
Stock market reforms.
Russia, Belarus and Kazakhstan aim at a new phase in economic cooperation.

2.12.2011 BOFIT Weekly 48/2011

CBR braces for weaker economic conditions.
Russia and Belarus reach agreement on a new contract price for natural gas.
IEA pushes Russia on energy efficiency.

9.12.2011 BOFIT Weekly 49/2011

Election results unlikely to affect Russian economic policy.
Changes in taxation on the way.
Revived Russian consumption supports Finland's exports.

16.12.2011 BOFIT Weekly 50/2011

Stock market down after public protests over Duma elections.
Finance sector struggles with tight liquidity.

BOFIT Weekly – Russia 2011

23.12.2011 BOFIT Weekly 51/2011

WTO ministerial conference approves Russia's accession.

Russia's WTO membership positive for both the Russian and Finnish economies.

MICEX and RTS exchanges merge.

30.12.2011 BOFIT Weekly 52/2011

New Duma convened on December 21.

Changes ahead in federal and regional power-sharing.

Central bank adjusts rates and widens fluctuation band of ruble exchange rate.

BOFIT Weekly – China 2011

7.1.2011 BOFIT Weekly 1/2011

Yuan strengthens against US dollar in final week of 2010.
China increases dividend demands on state-owned enterprises.
2010: An uneventful year for Chinese shares.

14.1.2011 BOFIT Weekly 2/2011

China's trade surplus down in 2010.
China's currency reserves approaching \$3 trillion.
China increases military spending.

21.1.2011 BOFIT Weekly 3/2011

Chinese GDP up 10.3 % last year.
On-year inflation dropped to 4.6 % in December.
China continues to attract FDI as its own investments abroad take off.

28.1.2011 BOFIT Weekly 4/2011

China's public sector finances only modestly touched by the global financial crisis.
Frank discussions of China-US economic relations at last week's summit in Washington DC.

4.2.2011 BOFIT Weekly 5/2011

China systematically raising the yuan's international profile.
January PMI shows little change in outlook of Chinese manufacturers.
Chinese banks posted good profitability numbers throughout the financial crisis.
China launches property tax trial to restrain rising apartment prices.

11.2.2011 BOFIT Weekly 6/2011

China's central bank increases reference rates for deposits and credits, effective Feb. 9.
Severest drought in 60 years puts China on course for major crop failures this year.
China becomes the world's fourth biggest international patent-seeker.

18.2.2011 BOFIT Weekly 7/2011

Inflation picks up; housing's share of consumer shopping basket increased.
China's foreign trade surplus shrank to \$6.5 billion in January
United States files complaint with WTO on China's domestic electronic payments.

25.2.2011 BOFIT Weekly 8/2011

China's central bank further tightens monetary stance.
Yuan's exchange rate dominates Paris G20 discussions.
Chinese stock markets stabilise in January.
US ban technology transfers to Chinese telecommunications specialist Huawei.

4.3.2011 BOFIT Weekly 9/2011

National People's Congress lowers growth target.
Next five-year plan should clarify China's environmental goals.
Strong growth in Finnish exports to China.

11.3.2011 BOFIT Weekly 10/2011

China posts foreign trade deficit for February.
Incomes rising faster in the countryside than in cities.
China solidifies its position as world's biggest energy consumer.

BOFIT Weekly – China 2011

18.3.2011 BOFIT Weekly 11/2011

For China, the most immediate impacts of the Japanese disasters are likely to be felt in trade and tourism.
National People's Congress approves 12th five-year plan.
12-month inflation still below 5 % in February.
China now the world's biggest industrial producer.

25.3.2011 BOFIT Weekly 12/2011

China's central bank continues monetary tightening.
China approves 2011 deficit budget.
Libya crisis should have little impact on China's energy supply.

1.4.2011 BOFIT Weekly 13/2011

BOFIT's latest forecast sees China's GDP growth slowing to 9 % this year.
China now the world's second-largest coal importer.

8.4.2011 BOFIT Weekly 14/2011

PBoC raises rates again in battle to tame inflation.
Profitability of Chinese banks continued to improve last year.
No change in Taiwan's share of China's foreign trade.

15.4.2011 BOFIT Weekly 15/2011

IMF sees strong growth for China in coming years.
Chinese exports boomed in March.
Economic cooperation tops agenda in visit of Brazil's president to China this week.

21.4.2011 BOFIT Weekly 16/2011

New quarterly statistical data suggest slowing economic growth.
As inflation accelerates, China's central bank further tightens monetary policy.
Ballooning foreign currency reserves add to yuan appreciation pressures; no real yuan strengthening in the past 12 months.

29.4.2011 BOFIT Weekly 17/2011

Trucking firms protest rising costs.
European companies want easier access to China's massive public procurements market.
Trade ministers of China, Japan and South Korea met to continue work on drafting an investment policy agreement.

6.5.2011 BOFIT Weekly 18/2011

Yuan appreciation against the dollar gains steam.
Data for China sixth census suggest changing population structure.
World Bank warns of real estate market risks to the Chinese economy.

13.5.2011 BOFIT Weekly 19/2011

Slight slowdown in economic growth, but inflation remains high.
Trade surplus boomed in April.
The United States and China focus on market access at latest strategic and economic dialogue meeting.

20.5.2011 BOFIT Weekly 20/2011

Yuan rapidly gains international acceptance.
Values of Chinese brands gaining in world markets.

BOFIT Weekly – China 2011

27.5.2011 BOFIT Weekly 21/2011

China's exports to Russia grow rapidly.
Growing importance of securities on China's financial markets.
Drought continues nationally; critical rice production areas experiencing worst dry spell in over 50 years.

2.6.2011 BOFIT Weekly 22/2011

United States again refrains from accusing China of manipulating the yuan's exchange rate.
China keeps on buying gold.
Construction and transport projects most afflicted by corruption.

10.6.2011 BOFIT Weekly 23/2011

China finds supervision of credit markets challenging as deregulation proceeds.
Summer power shortages in China hit early this year.
Oil and gas deposits create incentive for current bound-ary disputes in South China Sea.

17.6.2011 BOFIT Weekly 24/2011

China posts strong May economic figures despite tighter monetary policy.
Growth in household demand continues to slow; car sales down.
Trade surplus up in May.

23.6.2011 BOFIT Weekly 25/2011

Chinese stock markets continue their slide; interest rates are in rise.
Rules further relaxed on travel from mainland China to Taiwan.
China imposes tighter rules on exports of rare earth metals, prices soar.

1.7.2011 BOFIT Weekly 26/2011

Large debt load of local administrations adding to uncertainty and limiting flexibility in economic policy.
Premier Wen Jiabao's 5-day European tour focused on promoting bilateral trade.

8.7.2011 BOFIT Weekly 27/2011

China continues to hike rates.
Strong growth in Chinese FDI outflows abroad; modest slowing in FDI inflow growth.
China's Communist Party turns 90.

15.7.2011 BOFIT Weekly 28/2011

Economic growth remains strong in second quarter.
China cuts personal income tax and steepens progressive tax rates.
Military spending tripled in the past decade; arms im-ports decline.

22.7.2011 BOFIT Weekly 29/2011

Tighter monetary stance reflected in lower import growth in the first half.
China-North Korea bilateral trade increased by nearly a third in 2010.
Chinese foreign travel on the rise.

29.7.2011 BOFIT Weekly 30/2011

China's high-speed rail network plagued by safety issues and alleged corruption.
Significant difference in wage levels across provinces and job sectors.

5.8.2011 BOFIT Weekly 31/2011

Chinese economy registers slight slowdown.
Foreign banks with established local branches will be allowed to expand into local mutual fund products.

BOFIT Weekly – China 2011

12.8.2011 BOFIT Weekly 32/2011

Inflation limiting China's economic policy choices.
Growth in industrial output and retail sales in July slowed as expected.
China's trade surplus ballooned in July.

19.8.2011 BOFIT Weekly 33/2011

Economic turmoil in the United States and Europe add to yuan appreciation pressures.
World economy worries and inflation depress Chinese share prices.
Summer grain harvest was 126 million tons.

26.8.2011 BOFIT Weekly 34/2011

China drafts new safety rules for nuclear power plants.
ASEAN countries are important trading partners for China.
Growth in car sales slowed substantially in the first seven months of the year.

2.9.2011 BOFIT Weekly 35/2011

Monetary screws keep turning as PBoC moves to include customer margin deposits as part of banks' reserve requirements.
Chinese banks not spared from insecurity of global financial markets in recent weeks.
Growth in domestic demand compensates for slowdown in export orders.

9.9.2011 BOFIT Weekly 36/2011

Western banks reduce their holdings in Chinese banks.
China gains in international competitiveness ratings.
China's share of Finland's foreign trade appears to be settling.

16.9.2011 BOFIT Weekly 37/2011

Industrial production growth remained strong in August.
Inflation declines as expected
Order-books of Chinese shipyards down.
China links offer of financing to indebted EU members with trade policy concessions.

23.9.2011 BOFIT Weekly 38/2011

BOFIT forecasts gradual slowing of Chinese economic growth.
Oil accounts for most of China's imports from North Africa and the Middle East.

30.9.2011 BOFIT Weekly 39/2011

Rise in Chinese housing prices appears to be abating.
Hope for improvement in the status of foreign firms.
Local administration land deals ignite unrest in southern China.

7.10.2011 BOFIT Weekly 40/2011

PMIs readings suggest China's real economy weathered September in passable condition.
Hong Kong's offshore yuan market hits quota ceiling, falls off cliff.
US Senate moves toward final vote on bill punishing China for currency manipulation.
Interest rates soar on grey loan market.

14.10.2011 BOFIT Weekly 41/2011

State increases its holdings in China's big banks.
US Senate approves bill aimed at punishing China for currency policy.
Oil and cars characterise challenges of China-Russia trade.

BOFIT Weekly – China 2011

21.10.2011 BOFIT Weekly 42/2011

Economic growth remained strong in third quarter.
3Q inflation remained high as housing prices plateaued.

28.10.2011 BOFIT Weekly 43/2011

China has to consider its involvement in euro zone rescue.
Local administrations get go-ahead on bond issues.
Considerable shrinkage of China's current account.

4.11.2011 BOFIT Weekly 44/2011

Income continues to climb.
China experiments with extending VAT to services.
OECD gives Chinese higher education a mixed report card.

11.11.2011 BOFIT Weekly 45/2011

October economic figures suggest economic growth continues to slow.
Yuan appreciates in real terms.
Chinese direct investment abroad still largely destined for Asia.

18.11.2011 BOFIT Weekly 46/2011

Economic slowdown yet to be reflected in a drop-off in metal imports to China.
IMF points to vulnerabilities of China's financial sector from inefficiency and risk exposure.

25.11.2011 BOFIT Weekly 47/2011

Growth in China's currency reserves slowed in the third quarter.
China tests effectiveness of different environmental policy approaches.
Boom in Finnish raw material exports to China.

2.12.2011 BOFIT Weekly 48/2011

China relaxes its monetary stance.
Industrial conditions weaken substantially in November.
Slide in apartment prices gathered force in October.
Bribery a prominent feature of Chinese and Russian firms conducting international business.

9.12.2011 BOFIT Weekly 49/2011

Growth also slowing in service branches.
Soaring credit card use – and overdue credit card payments.
Entertainment industry facing challenges in China.

16.12.2011 BOFIT Weekly 50/2011

China export growth continues to slow.
Inflation drops sharply in November.
Expectations of ongoing yuan appreciation begin to fade.

23.12.2011 BOFIT Weekly 51/2011

WTO membership has provided China many benefits...
...but WTO membership has also led to numerous squabbles.
China continues to relax capital controls.

30.12.2011 BOFIT Weekly 52/2011

High economic growth lifts China to middle-income country status.
Economic growth expected to slow in 2012.

Russia

Public economy reforms under preparation. The Russian government last year drafted a number of reforms for implementation in 2011 and 2012. The changes reflect the need for greater efficiency in the public sphere and better use of budget funds.

Russia is shifting to a “target-based” budgeting process for the public sector. The lion’s share of budget funding will be allocated to some 50 programmes run by various ministries. Financing will be determined on the basis of how well each programme hits its established targets. The new approach will be first applied in the drafting of the 2012 federal budget.

A second area of public economy reform focuses on organisations receiving state funding. Organisations will be classified according to whether they depend solely on state funding (e.g. ministries and state agencies), or if they are allowed to receive some of their funding from other sources (e.g. scientific and cultural institutions). The reforms are designed to clarify operations of these organisations and set their financing principles in the law.

Public procurement is an area where abuses and corruption have been constantly increasing. According to various authorities, the prices of goods and services purchased via the state procurement system are substantially higher than prices for the same items purchased on the open market. Earlier attempts at reforming the government procurement system included adoption of web-based competitive bidding, but generally there has been no improvement in the situation. The economy ministry is currently working with the Federal Anti-trust Service on a sweeping reform of the public procurement system.

Last year saw active public discussion – also within the government – concerning state’s increasing involvement in Russian business. According to the government, the role should be diminished. One of the reasons for the increase was that the recession made the state to acquire assets (e.g. shares of companies in financial trouble were transferred to state banks). This year the state hopes to sell off its stakes in many large firms. In many cases, however, the state will retain its majority stake, so the impact is expected to be minor. Furthermore, it remains to be seen how sales of smaller, less important state-owned firms will proceed.

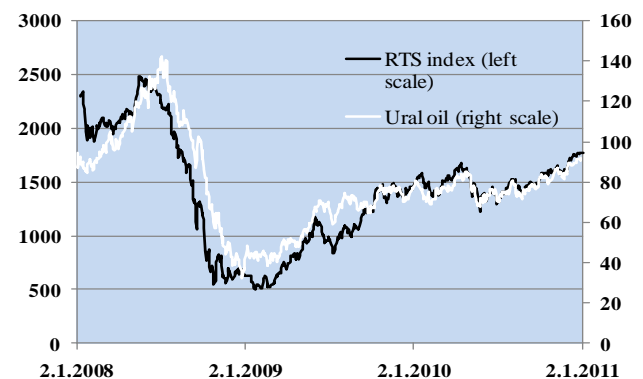
The government has ordered regional and local administrations to prepare their own privatisation programmes by July 2011. The goal is to make regional and municipal governments get rid of assets that are not necessary for carrying out their legally mandated operations. The government aims the sell-off of assets to start from production facilities, banks and regional media. Moscow, under the leadership of its new mayor Sergey Sobyenin, has already begun to prepare for extensive divestment of assets.

Russian stock exchange posts positive performance in 2010. The Moscow RTS stock exchange index continued its recovery from the low point it hit in early 2009. Over 2010, the index rebounded more than 20 %. Russia’s number-two MICEX index was also up over 20 % last year. In December 2010, the indexes reached their highest levels in two years.

The trend of Russian share indexes was similar to that of many emerging market stock exchanges, even if the overall rise in Russia outpaced the average for emerging markets. The S&P 500 index, which is composed of traded companies with the largest market capitalisations in the US, rose 13 % last year. The Dow Jones Industrial Average was up 11 %.

The RTS index trend closely tracked last year’s rise in global crude oil prices, which started the year at around \$80 a barrel and ended the year above \$90. The RTS index is heavily weighted to Russian oil and gas companies; the four biggest (Gazprom, Lukoil, Rosneft and Surgutneftegaz) represent about 40 % of the market capitalisation of all RTS companies. On the other hand, the country’s two largest financial institutions, Sberbank and VTB, represent about 18 % of the market capitalisation of companies in the RTS index.

RTS share index and Urals oil price (USD/barrel)



Source: Bloomberg

The most significant stock market reform last year was the act on insider trading and share price manipulation. The act was approved last summer and its main parts enter into force on January 27, 2011.

The Duma has just taken up legislation on basic infrastructure of securities exchanges, i.e. organisation of stock market trading, clearing procedures and securities custody. The legislation should be ready this year.

In the wake of the financial crisis, Russian officials announced stepping up supervision of market actors e.g. by increasing licensing requirements, raising capital requirements and devoting greater attention to risk management.

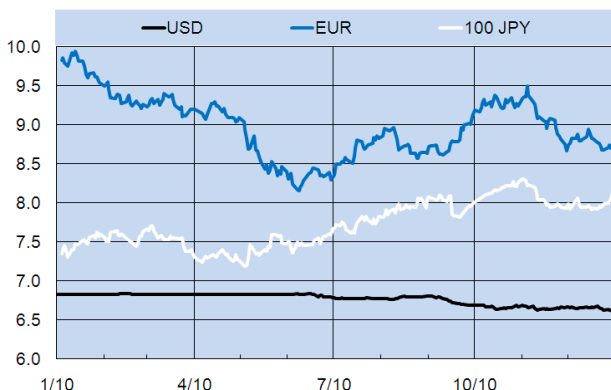
China

Yuan strengthens against US dollar in final week of 2010. The yuan ended 2010 at a yuan-dollar rate of 6.59. In contrast, the yuan-euro and yen-euro rates weakened slightly at year's end. For 2010 overall, the yuan appreciated 3.6 % against the dollar and 11 % against the euro, while losing about 10 % of its value against the yen. Yuan appreciation vis-à-vis the dollar and euro comports with China's rapid economic growth and tightening monetary stance. Financial markets expect yuan appreciation against the dollar to continue.

China ended its fixed peg of the yuan to the dollar in June 2010. The yuan was pegged at 6.83 to the dollar in July 2008 in reaction to the global financial crisis. As was evident at the G20 summit in November, many countries are dissatisfied with the slow rate of yuan appreciation. Critics note that artificial undervaluation of the yuan complicates China's own monetary policy, unfairly boosts competitiveness of its exporters and makes recovery more difficult for other economies.

China's decision at the start of 2011 to relieve export firms of their obligation to repatriate export earnings from abroad potentially could reduce appreciation pressure on the yuan. The change also potentially affects how foreign earnings that drive China's current account surplus get invested. Exporters will now participate in investment decisions along with the monetary authorities. The change may have little actual impact in current circumstances, however, as expectations of yuan appreciation reduce the interest of export firms in foreign investment.

Yuan rate vis-à-vis dollar, euro and yen in 2010



Source: Bloomberg

China increases dividend demands on state-owned enterprises. China's central government last November moved to increase dividend requirements for some 120 large state-owned enterprises from the start of 2011. The

dividend requirement for large enterprises in the energy and telecommunications sectors and tobacco industry will rise from 10 % to 15 % of profits. For other state-owned firms the duty rises from 5 % to 10 %. A 5 % dividend requirement will apply to companies in the defence sector. A dividend requirement depending on economic condition will also be extended to more than 1,600 other corporations under China's central administration.

The measures originate in a dividend policy launched on a trial basis in 2007. China made dividend payment mandatory for large firms operating under the central administration at the start of 2008. The arrangement exempts listed subsidiaries of state enterprises.

The more robust dividend policy has been widely welcomed. It levels the competitive playing field between state firms and private companies, and lowers the motivation for state firms to over-invest. Moreover, higher dividends provide additional revenues that the state can channel to socially beneficial investment. Although the new requirement could potentially generate tens of billions of dollars in revenues for the state, officials interviewed by the *Financial Times* noted that China's State-owned Assets Supervision and Administration Commission (SASAC) has had huge problems compelling large companies to pay out dividends.

2010: An uneventful year for Chinese shares. Despite China's strong economic growth, the price of shares on the Shanghai stock exchange ended the year down 15 % from the start of the year. In comparison, prices were up more than 10 % on average for shares trade on emerging market exchanges. Russian shares were up over 20 % last year. The last of China's four giant state banks to list, the Agricultural Bank of China, held its IPO in August. In general, dilution caused by an increase in the amount of market-tradable shares together with monetary tightening tended to depress share prices.

Shanghai A, MSCI emerging markets and Moscow RTS indexes, January 2007=100



Source: Bloomberg

Russia

High inflation persists. Russian consumer price inflation hit 8.8 % y-o-y in 2010. While the rise in consumer prices slowed in the first half of the year, it showed a marked acceleration in the second half due largely to poor harvests in many parts of the country.

Food prices climbed nearly 13 % last year. Certain basic food items were even temporarily unavailable, causing sharp spikes in prices. Whole grains and pulses were up nearly 60 %, vegetables and fruits 46 %, vegetable oils 27 % and butter and sugar 23 %. Prices of milk products rose 17 %, while prices of meat and fish increased 5 %. Rosstat calculations show that the price of a minimum food basket for a Russian individual escalated 23 % last year. The higher food prices are being felt most by poorest households, which devote a larger share of their income to food purchases than the average.

Two traditional drivers of inflation, housing and municipal services, were up 13 % last year. The rate of increase was less than in 2009 largely due to president Dmitri Medvedev intervention to rescind the largest rate hikes at the start of the year. Medvedev further imposed a 15 % ceiling on rate hikes for 2011. Municipal services consume an average of 12 % of a Russian household's income.

The government's official target for inflation this year sees inflation moderating to the range of 6–7 % by the end of the year. Observers are largely sceptical that the target is achievable as inflation is expected to remain high in the first half of the year as food prices continue to rise.

State finances in better shape than expected. Finance minister Alexei Kudrin announced this week that preliminary information puts the federal budget deficit for 2010 at 3.9 % of GDP. The original budget forecast for 2010 projected a deficit of 6.8 % of GDP. The improvement in Russia's fiscal circumstances reflects world prices for crude oil that were well above the budget assumption. High prices, in turn, boosted tax revenues from oil exports and production. The price of Urals-grade crude averaged \$78 a barrel last year, well above the budget assumption of \$58 a barrel. The realised budget deficit was further reduced by budget expenditures that were 2 % less (nearly 190 billion rubles) than anticipated in the original budget plan.

Finance minister Kudrin now expects the 2011 budget deficit to come in at about 3 % of GDP, i.e. slightly less than the original projection. The budget assumes an average crude oil price this year of \$75 a barrel.

Most of the remaining funds collected in earlier years to the state's reserve fund for financing budget shortfalls were used last year. The fund held some 1,831 billion

rubles (\$60.5 billion) at the beginning of the year and 775 billion rubles (\$25 billion) at year's end. However, there was more money in the reserve fund at the end of 2010 than planned as the budget deficit was smaller than originally forecast and the finance ministry preferred borrowing over draining the reserves. Money remaining in the reserve fund will be available to cover this year's federal budget deficit.

In addition to the reserve fund, the government has set aside monies collected in earlier years in Russia's national welfare fund, a sovereign savings fund intended to eventually finance major reforms such as the pension reform. The national welfare fund remained untouched last year, standing at 2,760 billion rubles (\$88 billion) on December 31.

Minister Kudrin hopes to start building up the reserve and national welfare funds again within a couple years if the price of crude oil allows.

Medvedev specifies regions along Russia's international borders where foreign land ownership will be restricted. Under Russia's land act, foreign citizens and legal persons cannot own land near Russia's borders. On Sunday (Jan. 9), president Medvedev decreed a specific list of 380 municipalities near Russia's borders where land ownership by foreigners is not permitted. Nearly all federally administered areas near Russia's international borders contain at least some listed municipalities.

The largest group (26 municipalities) are located in the maritime region of Primorski Krai in coastal areas on the Sea of Japan and along the Chinese border. The next largest group (19) is located in the Kaliningrad area. There are 18 municipalities in the North Caucasus region of Dagestan, and 17 in the Rostov area near the Sea of Azov and along the Ukraine border, as well as 16 on the Sakhalin peninsula. Among the municipalities, about 80 are incorporated cities (e.g. Khabarovsk, Vladivostok, Petropavlovsk-Kamchatski, Pskov, Novyi Urengoi and Magadan).

In the Krasnodar region on the shores of the Black Sea foreign landownership is prohibited in popular tourist destinations such as Sochi and Anapa and in the harbour city of Novorossiisk.

In Kaliningrad, the ban applies to nearly the entire Kaliningrad region, including the city of Kaliningrad. In the Arkhangel region, the land-owning restriction includes Arkhangel city. In the Murmansk region, it covers Murmansk city and nearly all of the Kola peninsula.

In the Karelian Autonomous Republic, which borders Finland, foreign land ownership is prohibited in 9 municipalities, including the cities of Kostamus and Sortavala. In the Leningrad region, the ban affects 5 municipalities, including Vyborg region. In St. Petersburg, foreign land ownership is forbidden in the island of Kronshtadt.

It has yet to be revealed how the ban will be applied in cases where a foreign real or legal person already owns land in a municipality specified in the presidential decree.

China

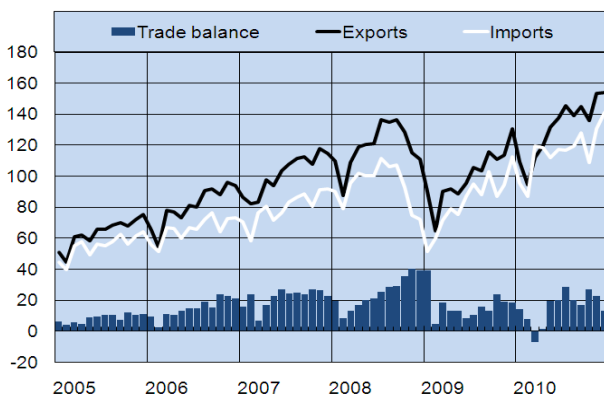
China's trade surplus down in 2010. The value of exports in December was about the same as in November, while growth in imports continued to surge. The trade surplus shrank more than expected falling to \$13 billion in December. The November trade surplus was \$23 billion.

China's 2010 trade surplus totalled \$183 billion, a slight dip from \$198 billion in 2009. China's 2010 trade surplus with the EU exceeded \$140 billion and over \$180 billion with the United States. China ran a \$55 billion trade deficit with Japan last year. In 2009, the trade surplus was \$108 billion with the EU and \$143 billion with the US. The trade deficit with Japan was \$33 billion.

The value of China's exports rose 31 % last year to nearly \$1.58 trillion. Imports climbed 39 % to over \$1.39 trillion. The strong growth in imports was driven in part by higher world prices for energy and raw materials. Figures for both the volume and on-month changes in value of trade indicate that, following a burst of recovery after the financial crisis, the rate of growth of China's foreign trade calmed towards year's end.

There were no significant shifts in foreign trading partners in 2010. The EU remained China's top export destination with an approximately 20 % share. There was also no detectable change from 2009 for the US (18 % share of Chinese exports) and Hong Kong (14 %). Japan's export share, however, fell slightly to under 8 %. Latin America's share rose one percentage point to 6 %. Africa accounted for 4 % of Chinese exports.

China's foreign trade 2005–2010, US\$ billion



Source: Bloomberg

China's imports are more evenly spread than its exports. Japan produced about 13 % of China's imports and the EU 12 %. South Korea supplied another 10 %, Taiwan 8 % and the US 7 %. Latin America's share has remained for the last couple of years around 6 %. After a brief set-

back, Africa's share recovered to 4 %. Australia continued steady ascendance as a raw material supplier, accounting for 4 % of China's total imports in 2010.

The rapid growth in Chinese trade pushed the Port of Shanghai ahead of Singapore to become world's largest container port.

China's currency reserves approaching \$3 trillion. In the fourth quarter of 2010, China's foreign currency reserves climbed by nearly \$200 billion to \$2.85 trillion. Perhaps about half of fourth-quarter growth came from the goods trade surplus and surpluses in other components of the current account, as well as a positive net inflow of direct investment. As the impact of exchange rate fluctuations in the fourth quarter was relatively minor, the growth in reserves was largely driven by capital flows, spurred by expectations of the strengthening of the yuan. For the same reason, importers were motivated to delay payments and take on foreign debt to pay for imports.

Japan's currency reserves, which increased in the last quarter of 2010 to nearly \$1.1 trillion, are the world's second largest after China. The currency reserves of other Asian countries have also increased since late 2008.

China increases military spending. The Stockholm International Peace Research Institute (SIPRI) estimates that China's military expenditures more than doubled over the past decade. SIPRI said that in terms of military spending, China is now the world's second largest military power after the US. Despite the rapid growth in military spending, defence spending as a share of China's GDP (about 2 %) is still lower than the international average. Among the world's military powerhouses, China is the top conventional arms importer.

SIPRI expects China to increase military expenditures to nearly 3 % of GDP in the coming years as the communist party wants to modernise the military as part of its current five-year plan. The challenge is seen considerable as the Chinese army lags well behind many leading countries in military technology. The current to-do list includes development of submarines capable of launching intercontinental ballistic missiles with nuclear warheads, building fighter planes that take advantage of stealth technology, as well as a missile defence system. To facilitate modernisation of the military, the Chinese have actively pursued the lifting of EU restrictions on arms sales to China that were imposed after the Tiananmen Square protests in 1989.

US Secretary of Defense Robert Gates said that China's military technology has developed surprisingly fast in recent years. The Chinese and US defence ministers met recently to discuss military issues in the run-up to next week's state meeting of presidents Hu Jintao and Barack Obama in Washington DC. US-China military relations have been icy since the US went ahead with arms sales to Taiwan in 2009.

Russia

Russia's decade-long reform of electricity sector largely successful. The over-ten-year reform of the national electrical power generation and transmission system has now reached its concluding phase. From the start of this year, electrical power rates in Russia have been largely deregulated, with the price of electricity set daily on a national electricity exchange. Retail-level rates for households will remain regulated at least through 2014.

A central goal of the reform was to effect large investments in electrical power generation and transmission. That goal is largely achieved as production companies are carrying out the investments that they agreed to undertake in the privatisation deals.

The reform affects all aspects of the electricity sector (generation, transmission, distribution, wholesale and retail trade). The break-up of state-run monopoly RAO United Energy Systems (UES) led to the creation of 15 production companies, of which 13 were privatised during 2007–2008. Only hydropower and nuclear power plants will remain in state ownership. In addition, Russia has a number of privately owned power companies that were never part of UES Holding. Competition among power companies is hoped to keep down wholesale prices of electricity.

The grids formerly owned by UES were reorganised into eleven regional operators. The state will continue to hold a majority stake in these operators, but the possibility of partial privatisation has not been ruled out. In contrast, the trunk grid and system operator will stay in state ownership due to the monopolistic nature of their operations.

The reform has made Russian electricity markets quite liberal by international standards; the price of electricity is set by a market made up of many individual producers that compete with each other. The critical details for the functioning of the markets, however, are just being formed, and there are big future challenges related to supervision and regulation. Without effective and transparent official oversight, the desired outcome of increased competition among firms – as in any sector of the economy – will not result.

High oil prices buoy the ruble. The ruble last year posted 7 % nominal appreciation against the euro and declined 3 % against the US dollar. In real terms (i.e. taking in differences in national inflation rates), the ruble strengthened 15 % against the euro and 4 % against the dollar. Ruble appreciation largely reflected higher oil prices.

The Central Bank of Russia steers the external value of the ruble using a dollar-euro currency basket. For the last couple of years the CBR has shown a willingness to tolerate larger swings in the ruble's exchange rate and greater

restraint in intervening in currency markets. In the first half of 2010, the CBR largely bought foreign currency to counter ruble appreciation pressures. In the second half, CBR operations focused more on supporting the ruble's external rate.

The central bank raised its deposit rates by a quarter of a percentage point on December 27 but left lending rates unchanged. The market expects the CBR will soon raise lending rates to decrease inflationary pressures. The CBR last adjusted its steering rates in June 2010. In 1H10, interest rates were lowered almost monthly to prop up economic growth.

Current account surplus continued to swell in 2010.

Preliminary CBR balance-of-payment figures show that Russia's 2010 current account surplus was \$73 billion, or 47 % more than in 2009. The value of exports increased 31 % to \$398 billion, while the value of imports climbed 30 % to \$249 billion. The value of crude oil exports rose 33 %, and accounted for 34 % of Russia's total exports. The Russian economy remains hugely dependent on energy raw materials. Crude oil, oil products and natural gas together accounted 63 % of total exports last year.

The CBR estimates Russia's net capital exports amounted to \$38 billion last year, a third less than in 2009. Most capital exports came from non-bank companies. Capital exports accelerated in 4Q10 to \$23 billion. The rapid growth in capital exports in the second half of the year surprised observers, who had expected the strengthening ruble to inhibit capital outflows. Officials are concerned that the increased outflow of capital indicates that illegally earned assets or assets for which taxes have not been paid are being transferred out of the country. This is supposed to take place in the form of payments for fictitious foreign trade deals. The finance ministry and CBR are currently preparing a proposal on tightening oversight of import and export payments.

FDI inflows into Russia last year amounted to \$29 billion, about the same as in 2009.

Russia's foreign currency reserves grew 9 % last year to \$479 billion. Currency reserves are sizable by international standards, sufficient to cover 18 months of goods and services imports. The reserves of most developed countries on average are sufficient for about two months of such imports.

Russia's public foreign debt as of Dec. 31, 2010 amounted to \$34 billion, a 10 % gain for the year. Public debt was boosted by the government's \$5.5 billion euro-bond issue last April (the first such borrowing since the 1998 ruble crisis). Russia's public foreign debt remains minuscule by international standards – a mere 3 % of GDP.

Private sector foreign debt grew by nearly 4 % last year to \$436 billion. Banking sector foreign debt increased from \$127 billion to \$145 billion, while non-bank corporate debt fell from \$294 billion to \$291 billion.

China

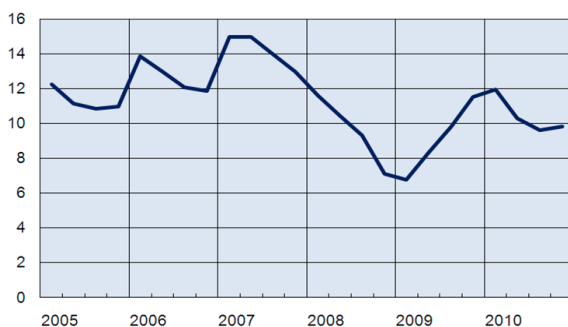
Chinese GDP up 10.3 % last year. In the fourth quarter of 2010, China's GDP climbed 9.8 % y-o-y, a slight pick-up from 9.6 % registered in the third quarter. Based on seasonally adjusted estimates, quarterly growth slowed in the first half of 2010 and then faintly picked up in the last quarter (reaching a rate of 2.3 % q-o-q in 4Q10).

China's National Bureau of Statistics put the value of China's total economic output last year at 39.8 trillion yuan (US\$5.88 trillion, €4.44 trillion). In nominal terms, China surpassed Japan in 2010 to become the world's second largest economy in terms of GDP after the United States.

In 2010, there were still no signs of such structural change in Chinese output that many would like to see as manufacturing and construction were up over 12 %, while growth in the service sector held below 10 %. Perhaps most striking were the 16 % growth posted by heavy industry and the 32 % increase in car manufacturing. Agriculture and other primary production showed increase of just over 4 %. Primary production represented about 10 % of Chinese GDP, manufacturing 43 % and services 47 %.

Although demand-side macroeconomic data are not yet available, published indicators suggest a slow-down in investment growth while retail sales climbed 15 % in real terms, suggesting robust spending on the part of private consumers. Per capita disposable incomes increased 8 % in cities and 11 % in rural areas.

China's GDP growth, % p.a.



Source: China National Bureau of Statistics

On-year inflation dropped to 4.6 % in December.

While the rise in prices of fruits and vegetables accelerated last month, inflation in food prices overall slowed to below 10 % y-o-y. The government continued efforts to stem the rise in food prices, including a variety of measures to boost availability of staple foods and imposition of price controls. Food prices on world markets have risen in recent months due to reduced crop yields and harvest fail-

ures in major producer countries. China recently backed out of several large contracts for maize deliveries due to high world market prices.

The latest confidence indicators suggest both companies and households expect higher inflation rates ahead. As an indication of inflationary pressures, growth in the Chinese credit stock and money supply (M2) accelerated to around 20 % p.a. in December, a rate significantly higher than in pre-crisis years.

The focal point of monetary policy has shifted from supporting economic growth to fighting inflation. The People's Bank of China continued to tighten its monetary stance by raising the minimum reserve requirement a half percentage point to 19 %, effective from yesterday (Jan. 20). The country's leading English-language newspaper, *China Daily*, said the PBoC plans to reduce the 2011 lending quota for banks by 10 %. Monetary tightening measures last month involved raising reference rates for deposits and credit.

China continues to attract FDI as its own investments abroad take off.

The financial crisis in 2009 was accompanied with a sharp reduction in foreign direct investment (FDI). Last year's recovery saw a healthy rebound in FDI with investment inflows to China reaching \$106 billion, a 17 % increase from 2009. FDI growth in the country's central and western provinces as well as in the service sector outpaced the national average.

Even as rapidly rising labour costs have been driving low-wage manufacturing to other countries, China's technological development and growing domestic markets continue to attract investments in advanced production. For example, it was reported in December that the Korean Samsung and LG are engaged in an over \$6 billion project to build state-of-the-art liquid crystal display manufacturing plants in Eastern and Southern China.

About 55 % of FDI inflows into China come from Hong Kong. Other Asian countries are also substantial FDI contributors, including Singapore (5 % share), Japan (3 %), Korea (3 %) and Taiwan (2 %). The EU accounts for about 6 % of FDI inflows to China and the United States some 3 %. Estimates of FDI inflows to China should be taken with a grain of salt, however, as nearly a fifth of investment flowing into China originates from tax havens.

China's outward foreign direct investment (ODI) really took off in 2008, and exceeded \$48 billion in 2009. China's direct investments abroad in 2010 amounted to \$59 billion. These figures do not include ODI from the financial sector (about \$9 billion in 2009).

About three-quarters of investments of Chinese firms in 2009 went to the Asia-Pacific region, 13 % to Latin America and 6 % to Europe. North America and Africa each had shares of about 3 %. Country-specific data for 2010 have yet to be released.

Russia

Rosneft and BP agree on share-swap and strategic cooperation in the Arctic. Russia's majority-state-owned oil company Rosneft and international oil giant BP agreed on January 14, 2011 on a share swap and extensive cooperation in exploration of Arctic hydrocarbon reserves. When the deal is completed, BP's stake in Rosneft would rise to 10.8 % and Rosneft would hold 5 % of BP's ordinary voting shares. At the moment, the Russian state still controls 75 % of Rosneft and state bank Sberbank another 13 %. Rosneft retains 9 % of its own shares.

Rosneft and BP will begin to explore three areas in the South Kara Sea (an area about the size of the North Sea), for which Rosneft received an exploration license from the government last year. The region's potential oil reserves have been estimated at nearly 40 billion barrels, which is equal to about half of Russia's current proven oil reserves. In addition, the companies are planning on establishing an Arctic technology research centre in St. Petersburg. The fact that the deal was realised appears to signal that Russia now sees foreign participation, and foreign expertise in particular, as essential to development of Russia's oil and gas reserves in the Arctic.

How well cooperation works will be watched quite closely as it should provide clues about any shifts in the investment climate to permit wider international participation in development of Russia's energy sector. In recent years, foreign investors for the most part have been compelled to reduce their exposure in Russia's oil and gas sector after the government designated it as a strategic sector.

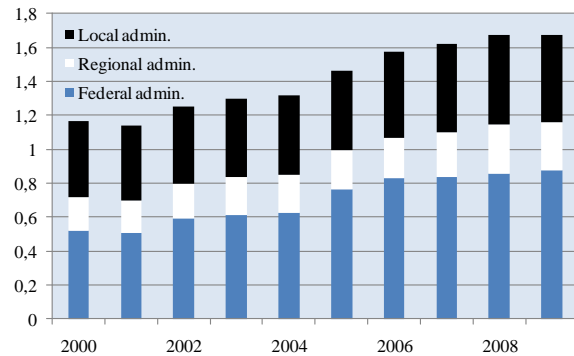
In practice, state-controlled Rosneft and Gazprom hold monopolies on Russia's largest fields and exploration of new off-shore areas. Exploration and development of new fields will be increasingly important in the future as production in Russia's currently operating fields begins to decline. While Russia's overall crude oil production increased 2 % last year, most of the growth arose from new Rosneft-operated fields coming on stream. In contrast, Russia's largest private oil company, Lukoil, saw its production in Russia decline 2 % last year.

Despite rapid growth, Russia's state bureaucracy still not particularly large. Rosstat reports that in 2009 the number of civil servants in Russia totalled just under 1.7 million, of which 52 %, or 878,000 persons, were in federal government service. Another 17 % of government employees worked for regional administrations and 31 % for local governments. Russian total employed labour force in 2009 was 69 million people.

The number of civil servants rose continuously throughout the 2000s. The fastest increase was seen in the

number of federal civil servants. During 2000–2009 the total number of state employees increased by 44 %, with the number of federal civil servants increasing 68 %. The sharpest rises in the number of civil servants occurred in 2005 and 2006.

State civil servants 2000–2009, million



Source: Rosstat

An extensive reform of local administration was carried out gradually since the mid-2000s leading to the creation of more than 20,000 local administrative units. In 2008, the state administrative system was reformed so that many duties implemented at the federal level were transferred to regional and local officials. These reforms were one of the reasons driving the expansion in the number of civil servants.

International comparisons of civil servant numbers are difficult as different countries use different definitions and Russia's own statistics do not lend themselves easily to interpretation. Generally speaking, the corps of Russian bureaucrats is not particularly large compared to other countries. Civil servants represent less than 3 % of the Russian employed labour force. The corresponding average for OECD countries was 9 % at the start of the 1990s. However, the share may have declined since then.

The need to reduce the number of civil servants has long been discussed in Russia. On December 31, 2010 president Dmitri Medvedev signed a decree on increasing administrative efficiency. The decree affects federal civil servants both in the federal administration and at regional and local levels. Under the decree, ceiling number of civil servants will be lowered by 20 % during 2011–2013. The first 5 % reduction will occur already at the end of March.

The 20 % reduction is calculated on the basis of a maximum allowed number of civil servants, not the actual number which is typically somewhat lower as many civil service posts are not filled. The finance ministry reports the programme will cut more than 100,000 posts over the next three years, which translates into a reduction in wage costs of more than 40 billion rubles (about €1 billion) in 2013. About half of the savings will be used to increase the pay of civil servants that still have jobs.

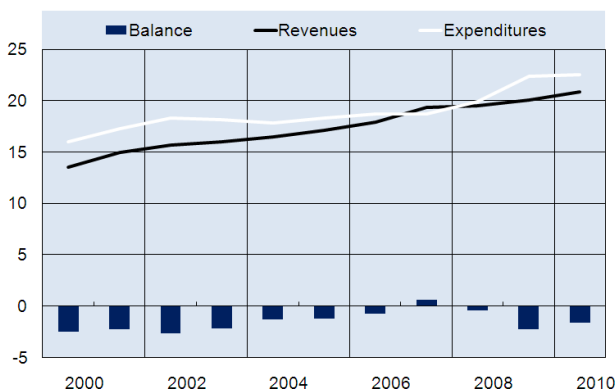
China

China's public sector finances only modestly touched by the global financial crisis. The deficit of China's public sector (central and regional administrations) last year fell to 1.6 % of GDP, down from 2.3 % in 2009. The shrinking public deficit reflected a sharp increase in revenues, which rose to an amount equivalent to 20.9 % of GDP, while government spending held at the previous year's level of about 22.5 % of GDP. As has been typical in recent years, the deficit undershot the original 2010 budget plan which used cautious revenue growth assumptions.

The central administration accounted for 46 % of public sector on-budget revenues last year and 52 % of expenditures. However, more than 30 % of central administration spending consisted of direct revenue transfers and tax refunds to regions and local governments, conceding to regions and localities great power in how budget money is ultimately spent. About 95 % of central administration revenues came from various taxes; about 80 % of revenues at the regional level were tax generated.

China's reported budget deficits over the last two years are surprisingly small given that the government implemented during 2009–2010 its 4-trillion-yuan (nearly \$600 billion) stimulus package. The value of the stimulus, which was announced in autumn 2008, exceeded 5 % of cumulative GDP for the past two years. There are several reasons for the stimulus' modest budget impact. For starters, the stimulus was not solely budget-financed but also financed by state-owned enterprises and banks. Perhaps the biggest reason, however, was the fact that a substantial share of investment projects funded by the stimulus was implemented outside regional-level budgets.

China's public sector (central and region administrations) budget revenues, expenditures and balance, % of GDP



Source: CEIC

It was revealed about a year ago that regional and local administrations had established off-budget companies to implement construction projects designated by officials. These new companies were quite active in acquiring bank financing in their own name, piling up loan obligations that are estimated to correspond to nearly 20 % of GDP. If this free-range debt is included, we get a significantly altered view of China's public sector debt – the official debt ratio of about 20 % of GDP rises to around 40 % (and perhaps even higher).

Reliable assessment of China's public economy remains challenging. In particular, the off-budget activities of regional and local administrations (especially the finances of firms owned by local governments and income from sales of land-use rights) make it hard to get a complete picture.

Frank discussions of China-US economic relations at last week's summit in Washington DC. In honour of the critical China-US trade partnership, and as a common practice during such summits, China's trade delegation announced purchase deals worth of tens of billions dollars with US businesses. At the end of the meeting, it was announced that the Industrial and Commercial Bank of China (ICBC) plans to acquire the majority stake in the Bank of East Asia's US subsidiary. If the deal is approved by US officials, it would be the first instance of a Chinese bank acquiring an American retail bank. ICBC already has branch offices in the US.

The parties did not advance, however, in the touchiest trade issue from the US perspective – China's exchange rate policy – during the visit. There was also no announcement of progress of the Chinese initiatives to promote Chinese direct investment in the US and the lifting of US restrictions on technology exports to China. Using traditionally round language, president Hu emphasised that the China-US trade partnership was an advantage to both parties and gave assurances that US concerns over China's increased military spending were unfounded as it was solely for national defence. He conceded that China's human rights record left "room for improvement."

As part of the visit, the Obama administration announced its conditional support for including the yuan in the IMF's Special Drawing Rights (SDR) mechanism. A criterion for SDR participation is currency convertibility – a criterion that will only be met when China's currency controls are eliminated. The SDR is derived from a basket of currencies and used mainly in the IMF setup. China's government sees excessive reliance on the US dollar as the global reserve currency as problematic and has expressed interest in developing the SDR mechanism.

Although discussion on the SDR continues, its use beyond IMF circles is unlikely for a while. The real issues for China and other actors at the moment are increasing the convertibility and international acceptance of the yuan.

Russia

Economy recovered and imports soared in 2010.

Rosstat preliminarily estimates that Russian GDP grew 4 % y-o-y last year, a sharp improvement from the 8 % decline in 2009. The value of GDP was put at 44.5 trillion rubles (just over €1.1 trillion), which translates into GDP per capita of nearly €8,000.

Retail sales volume, a good indicator of private consumption trends, rose more than 4 % last year, slightly less than expected. Fixed capital investment increased 6 %. The volume of exports grew more than 10 %, partly reflecting recovery in natural gas exports after an exceptional decline at the start of 2009.

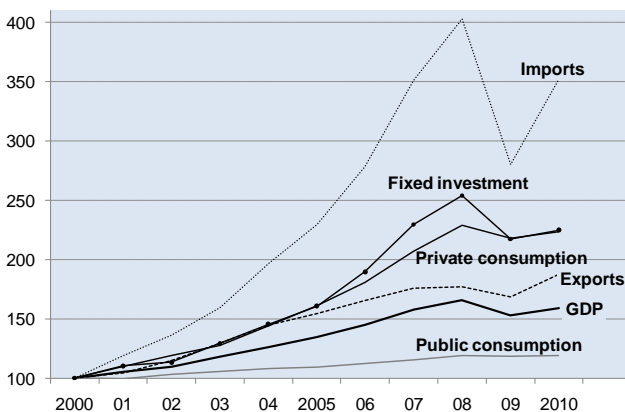
Private consumption as a share of GDP was 52 % last year, public consumption 20 % and fixed capital investment 21 %. Exports accounted for 30 % of GDP.

Recovery of the economy caused a roaring comeback in imports from a 30 % contraction in 2009 to 25 % growth last year. The shift highlights Russia's high propensity to import. Part of the shift back to imports this time came from substitution of domestic production hurt by the hot, dry summer.

Manufacturing grew more than 10 % last year. The transportation sector also recovered swiftly. Mining and mineral extraction industries saw production up 4–5 %; including an 11 % increase in natural gas output and a 2 % rise in crude oil production. Electricity production increased nearly 5 %. Commercial and housing construction remained depressed at the 2009 level. Hit with summer heat and drought, agricultural output fell more than 10 %.

After last summer's dip, the economy revived towards the year's end, led by growth in e.g. retail sales, capital investment and industrial output.

GDP, demand factors and imports, volume indexes (2000 = 100)



Source: Rosstat

Real wages rose and unemployment declined in 2010.

Rosstat reports that in 2010 wages increased 11 % in nominal terms and 4 % in real terms. A worker's average monthly wage at year's end was slightly less than 22,000 rubles (about €540).

The highest wages continued to be paid in the financial sector, where the average monthly wage was 47,600 rubles or about €1,200. Wages were also high in the energy sector. The lowest wages were paid in the textile industry, where the average monthly wage was slightly below 10,000 rubles (about €250), the agriculture sector and in public education.

Wages were highest in Russia's oil and gas producing regions, Moscow and St. Petersburg. The lowest wages were paid in the North Caucasus region.

Pensions rose rapidly last year with large across-the-board hikes in the first half of the year. For the year, Russian pensions rose 30 % in real terms. However, Russian pensions are still quite modest. The average monthly pension at year's end was just 7,600 rubles or about €190.

The number of people living below the poverty line increased slightly during the recession, but began to decline again last year. At year's end, about 14 % of the population had income levels below the official subsistence minimum, or slightly more than the pre-recession level of 13 %.

Rosstat notes that income inequality increased slightly during the 2000s. International figures suggest that the income disparities in Russia and the United States at the end of the decade were about the same. Even so, Russian income distribution is considerably more egalitarian than in certain Latin American countries.

Russia's unemployment rate contracted in 2010 from 9 % to 7 %. In Moscow and St. Petersburg, the unemployment rate was just above 2 % in December.

CBR tightens its monetary stance. On Tuesday (Feb. 1), the Central Bank of Russia increased bank reserve requirements. The required reserve requirement of domestic liabilities rose from 2.5 % to 3 % and from 2.5 % to 3.5 % for foreign liabilities. The CBR also raised its deposit rate 0.25 percentage points in December.

The CBR said the hikes were justified by increased inflationary expectations and possible influx of short-term capital resulting from high global oil prices.

The central bank further announced that, despite recent positive economic performance, its company surveys suggest that confidence in economic growth is still uncertain. Therefore, the central bank is implementing monetary policy decisions that consider countervailing risks stemming from either slowing economic growth or fuelling inflation. The central bank's board meets once a month to decide monetary policy measures.

China

China systematically raising the yuan's international profile. Yi Gang, who serves as both central bank deputy chairman and head of the State Administration of Foreign Exchange (SAFE) announced in January that the country plans to make the yuan a free-floating currency over the next five years. This will require phasing out of the current heavy-handed controls on capital movements. The announcement came just one week after the People's Bank of China gave Chinese firms and banks, which are involved in yuan-denominated foreign trade, permission to conduct direct foreign investment in yuan. The government also announced last month that selected Chinese financial institutions would be granted the opportunity to invest foreign funds to China's financial markets. The state-majority-owned Bank of China was last month granted permission to begin yuan trading in the US.

January's announcements are consistent with the government's ongoing efforts to increase the yuan's international profile. In mid-2009, a group of Chinese companies were given permission on a trial basis to conduct foreign trade payments in yuan. Since then yuan use has expanded to cover almost all foreign trade companies, and China's financial markets have gradually opened to foreign participants.

Hong Kong has been ground-zero for this experiment in yuan internationalisation. The stock of yuan deposits in banks in the special administrative region doubled from September to 315 billion yuan (€35 billion) at the end of December. Yuan appreciation pressures have created such strong international demand for yuan that occasionally the yuan's exchange rate in Hong Kong has been substantially higher than in Mainland China.

As the use of the yuan in foreign trade and investments is rapidly increasing, banks around the world are feverishly developing new yuan-based products and training staff to deal in the Chinese currency. While cross-border yuan flows are still small, the significance of the yuan both in China and globally seems to be rising faster than anyone might have expected a few years ago.

January PMI shows little change in outlook of Chinese manufacturers. China's official PMI, published by the China Federation of Logistics and Purchasing, fell from 53.9 in December to 52.9 in January. The parallel PMI of Hong-Kong-based HSBC for January was 54.5, essentially unchanged from the previous month. Both indexes were above 50, suggesting the robust growth continues.

PMI surveys are used to assess output trends. In contrast to China, PMI indexes in the US and EU rose sharply in January on predictions of accelerating growth.

Chinese banks posted good profitability numbers

throughout the financial crisis. Despite the global downturn, net income of China's banking sector increased 30 % y-o-y in 2009 and healthy profitability growth continued in the first three quarters of 2010. The total assets of Chinese banks soared during the global financial crisis as the state implemented part of its stimulus policies through bank lending. During 2010, bank total assets climbed nearly 20 % y-o-y. Even with the increased lending, the China Bank Regulatory Commission (CBRC) said the stock of non-performing loans held by commercial banks continued to shrink, standing at just over 1 % of the bank loan stock as of end-December. Tighter monetary policy is expected to slow growth of bank balance sheets this year.

The People's Bank of China reports that China's financial system did well in recent on-site tests under the joint IMF and World Bank's Financial Sector Assessment Program (FSAP). FSAP is a comprehensive evaluation of the financial system that is now conducted in about three quarters of IMF member states under common principles. The PBoC said the FSAP highlights China's progress in structural reform of its financial system and how well the sector weathered the global financial crisis.

Despite a positive general picture, the assessment identified problems that the PBoC would not specify, and the IMF did not publish the report. One acknowledged problem area is off-balance-sheet lending by banks. Bank supervision officials have committed to moving such activities onto balance sheets during 2011.

China launches property tax trial to restrain rising apartment prices.

After long discussion, property taxes were introduced on a trial basis at the end of January in Shanghai and Chongqing. The annual tax in Shanghai is 0.6 % or 0.4 %, depending on the apartment's selling price. It applies to second apartments owned by Shanghai residents and all apartments owned by non-residents. In the inland city of Chongqing, the annual tax is 0.5 %, 1.0 % or 1.2 %, depending on the purchase price of the apartment relative to the average price in the local market. In other words, buyers are only liable for property tax if their apartment is substantially pricier than average apartments.

The impact of the property tax on housing prices will depend on e.g. the stock of expensive apartments sitting empty. The tax's market impact will only be seen after the Lunar New Year holiday period, when apartment buying and selling returns to normal.

Despite last year's measures to fight overheating, the housing sector continues to give China's leaders headaches. Just ahead of the launch of the trial property tax, the downpayment requirement for second apartment buyers in China was raised from 50 % to 60 %. First-time homebuyers must produce a 30 % downpayment.

Russia

Oil and gas production increased in 2010. Russian crude oil production increased 2 % last year to 505 million metric tons, returning to levels last seen in the early 1990s. In coming years, Russia's oil output is not expected to increase substantially due to the lack of investment in development of new fields. While many OPEC producers operate well below full capacity, Russia operates its producing fields at maximum.

Russia's largest oil producer, state-owned Rosneft, pumped 112 million tons of oil last year and accounted for over a fifth of total Russian oil production.

Balance-of-payments figures show the value of crude oil exports climbed some 33 % last year, due largely to a sharp rise in world oil prices. The rising trend in oil prices continues this year; at the beginning of February, Urals-grade crude was just under \$100 a barrel. Oil prices were last at such levels during the commodity price spike that occurred in 2008 just before the world economy went into recession. Crude oil generated \$134 billion of Russia's export earnings last year.

Russia's total crude oil exports last year amounted to around 245 million tons, approximately the same amount as in 2009.

The Port of Primorsk, located in the Gulf of Finland, has become Russia's largest oil shipping terminal. Last year it transhipped 72 million tons of crude oil. The Port of Novorossiysk, Russia's largest freight-handling port, transhipped 42 million tons of crude oil last year. Export volumes at both ports contracted about 5 % in 2010. Oil exports grew at the Far Eastern ports of the Sakhalin Island and Kozmino. The Port of Kozmino, located on the shores of the Sea of Japan near Vladivostok, opened in 2009. The ESPO (Eastern Siberia – Pacific Ocean) oil pipeline, which is currently under construction, ends in Kozmino. From there, oil will be loaded onto tankers and shipped to Asian markets. Oil is currently reaches Kozmino by rail.

Russia exported some \$70 billion worth of oil products last year, an increase of 45 % from 2009. In January 2011, shipping of export oil products began from the new oil product terminal at the Port of Ust-Luga on the Gulf of Finland.

After falling in 2009, natural gas output rose last year by 11 % to 649 billion m³. The 2009 drop in international demand was the cause of lower production that year; in 2010, production was just 3 % below pre-crisis levels. Gas giant Gazprom accounts for nearly 80 % of Russia's natural gas production.

In 2010, the volume of natural gas exports increased about 6 % to around 170 billion m³. The value of exports was up by 15 % y-o-y to \$48 billion. The volume of Rus-

sian exports of natural gas peaked at 207 billion m³ in 2005.

Moscow plans to accelerate divestment of municipal properties. As soon as Sergei Sobyenin was named Moscow mayor last October by president Dmitri Medvedev, the former presidential chief of staff began shaking up Moscow's municipal administration and is currently embarked on preparing a new economic strategy for the city. The extent of planned reforms in economic policy were foreshadowed last December with the appointment of Andrei Sharonov, a former deputy economy minister and CEO of the Troika Dialog investment bank, to the post of deputy mayor responsible for economic issues.

Moscow's new administration has undertaken extensive plans to sell off city assets. The hope is to sell stakes in over 230 companies over the next two years and raise at least 200 billion rubles (€5 billion) from the sales. Moscow's rush to divest conforms to the Russian government's exhortation to regions and municipalities several months ago to increase their divestment efforts. The sell-off should also help the city dig its way out of its current fiscal hole. Without income from property sales, the City of Moscow's 2011 budget anticipates a deficit of about 150 billion rubles (€3.7 billion).

The broad sales programme is a distinct departure from the policies of Yuri Luzhkov, Moscow's previous mayor. According to deputy mayor Sharonov, Moscow will ultimately divest everything except companies involved in providing critical municipal services. Sharonov criticised his predecessors' policies, which extended city business operations into new fields and constrained development of the private sector businesses.

In addition to some 350 municipal companies, the City of Moscow holds large stakes in over 400 corporations (of which the city holds the majority stake in 140). For example, Moscow holds a 74 % stake in the Vnukovo Airport, Russia's third busiest airport. It also has a 22 % stake in oil-driller Sibir Energy and owns 27 % of United Bakers (a holding company that includes 15 companies and is a large player in the food industry even by European standards). Among others, the United Bakers portfolio includes three of Russia's best-known confection producers. The city also owns stakes in Intourist Travel Agency, the Radisson-Slavianskaya Hotel, the Metropol Hotel and the Gostinyi Dvor Department Store.

Moscow's decision to sell off its 50 % stake in Bank Moskvyy, Russia's fifth largest bank, has raised eyebrows far and wide. The city has agreed to sell its stake to Russia's second largest bank, state-dominated VTB, without competitive bidding. Russia's largest private bank, Alfa-Bank, is interested buying the stake and has pushed for officials to arrange a fair, competitive bidding. Experts lament the city's plan to sell Bank Moskvyy without competitive bids.

China

China's central bank increases reference rates for deposits and credits, effective Feb. 9. Following Wednesday's quarter-percentage-point increase, the 12-month deposit rate is now 3.0 % and the credit rate 6.06 %. The People's Bank of China has aggressively tightened monetary policy in recent months in its efforts to get inflation under control. Consumer price inflation hit 4.6 % in December, which means the current deposit reference rate is still negative in real terms. Monetary tightening is expected to continue in coming months.

The official US treasury department February report on the state of the world economy and currency policies notably refrained from accusing China of currency manipulation. The toned-down assessment staves off the threat of a possible trade war. The report comments on China's deliberate efforts to limit appreciation of the yuan's nominal exchange rate and affirms the US government's belief that it would be healthier for the world economy if the yuan was allowed to appreciate faster. However, the report notes that yuan's real exchange rate (which takes into account differences in inflation rates among countries) has appreciated faster as inflation in China has been running some 5 % higher than in the US. The treasury department report also observes that China is in the process of phasing out currency controls, and thus expects the yuan to become more sensitive to market forces.

The yuan's nominal exchange rate relative to the US dollar has continued to appreciate slowly. On Thursday (Feb. 10), the official exchange rate in Shanghai (CNY) was 6.59 yuan to the dollar. On the less regulated Hong Kong currency markets, the off-shore exchange rate (CNH) was 6.57. Over the past year, the yuan nominally appreciated 3 % against the dollar and nearly 10 % against the euro, which has been plagued by troubles in the euro-zone's heavily indebted member states. The Japanese yen gained about 7 % against the yuan last year.

Real trade-weighted yuan exchange rate, index 2005 = 100



Source: BIS

Severest drought in 60 years puts China on course for major crop failures this year. The situation is especially critical in major wheat-producing areas, where drought effects may be aggravated by the arrival of warmer spring weather. In China, crop failures will put pressure to further hike food prices, which already soared last autumn. The drought in China is reflected in global wheat prices, which have now hit record levels.

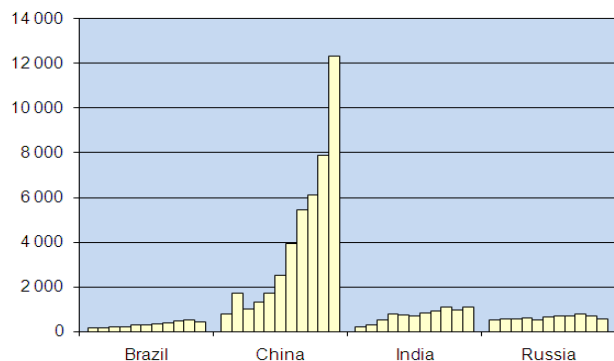
While access to water is a common issue in developing countries, China's water problems have been exacerbated over recent decades because water supply has failed to keep up with rapid economic growth and population growth. In addition, pollution has degraded as much as half of China's existing water supplies, which are unevenly distributed across the country. Generally, the north is the driest part of the country, while water is more abundant in river valleys and the south, where monsoon rains augment surface waters.

China's central administration will target water supplies as a key area of emphasis in the new five-year plan. The state will spend 4 trillion yuan (€440 billion) on water projects over the next decade. The last 5-year plan saw spending on water projects double.

China becomes the world's fourth biggest international patent-seeker. The World Intellectual Property Organization (WIPO) this week released preliminary figures on international patent filings last year made under the Patent Cooperation Treaty (PCT).

The number of international patent applications globally was up 5 % last year to 162,900 filings. China's filings increased to over 12,300 (a 56 % leap from 2009), surpassing Korea as the world's fourth most active international patent-seeker. China accounted for about 8 % of international patent filings worldwide. That was still well behind the US, which accounted for 28 % of filings. Japan had at 20 % share and Germany 11 %.

Number of PCT patent filings in BRIC countries, 2000–2010



Source: WIPO

Russia

Banking operations recovered last year. After slumping in previous years, growth of household deposits accelerated rapidly throughout 2010. Deposits increased 31 % in nominal terms, almost resuming their pre-crisis growth path. Foreign currency deposits as a share of total household deposits contracted from 26 % to 19 %, suggesting that Russian households had greater confidence in both the economy and the ruble.

Lending to households saw a nominal increase of 14 % in 2010, while loans to firms increased 12 %. (The stock of loans to households in 2009 contracted 11 % and the stock of corporate loans was unchanged). Last year's development reflects improving economic conditions and lower interest rates. The average rate on short-term corporate loans of less than a year fell to just 9.2 % at the end of 2010. 12-month inflation is expected to be around 8 % this year.

The economic crisis has driven banks to sharply increase investment in securities, particularly bonds. As of end-December, securities constituted 17 % of total banking sector assets (up from 8 % in January 2009). Banks prefer to support firms by purchasing their bonds as banks can use bonds as collateral in their own borrowing.

At the end of last year, Russia had 1,012 credit institutions, 955 of which were banks. The number of banks declined by 52 over the course of 2010. The Central Bank of Russia pulled the licenses of 27 banks for regulatory infringements. Other banks were swallowed up in mergers, a growing phenomenon in Russia. A few tiny banks lost their licenses simply because they could not meet the minimum capital requirement. These banks continued to operate under a limited license that e.g. does not include the right to take in household deposits.

The number of banks is expected to continue to shrink. One reason is a further increase in the minimum capital requirement. The minimum capital requirement for banks operating in Russia will rise in January 2012 from the current 90 million rubles (€2.3 million) to 180 million rubles.

Russia's five largest banks are all state-owned and together control 48 % of total banking sector assets. The banks owners are the central bank, the state, state enterprises or municipalities. The share of total assets held by banks owned by public-sector entities increased from less than 40 % in 2007 to over 50 % in 2010.

Moreover, Russia's large public-sector banks continue to increase their market position. The country's largest bank, Sberbank, is currently in negotiations to buy the private investment bank Troika Dialog. State-owned VTB is acquiring a stake in Transkreditbank (which is majority-

owned by Russian Railways), as well as a stake in Bank Moskvyy (majority-owned by the City of Moscow).

State divests a 10 % stake in VTB. The VTB offering held last week was the biggest privatisation sale since the government last year approved its plan to divest important state assets. The state majority-owned VTB has expanded rapidly over the past few years and is now the second largest bank in Russia.

The share offering took place on February 7. With a sales price close to the previous day's average price on the Moscow and London stock exchanges, the sale raised just under 96 billion rubles (about €2.4 billion) for the state. After the sale, the Russian state holds a 75.5 % stake in VTB.

According to press reports, the largest individual investor was Russian billionaire Suleiman Kerimov. Most investors were non-Russians, led by the Italian Generali finance group and the American investor group TPG Capital. Other institutional investors included the Harvard Endowment and China Investment Corporation (CIC). CIC is the first Chinese institutional investor to make significant investments in the Russian economy. Foreign investors already holding VTB shares also increased their holdings.

After the deal, VTB's owners will consist of the Russian state and 5–10 major investors, each with stakes of about 1 %. The sale increased the free float of VTB shares to about a quarter.

Russia's machine-building industry stares into the abyss. Russia's ministry of industry and trade reports that the domestic machine-building industry has over the past years lost market share both domestically and internationally. As Russia's economy grew briskly during the 2000s, an increasing part of new machinery and equipment was bought from abroad. Companies building machinery for the oil and gas, mining and metal refining and fabrication industries have been some of the hardest hit among domestic producers.

The average capacity utilisation of machine-building businesses has fallen to around 30 %, and over a quarter of all companies in the branch are currently operating in the red. The ministry of industry and trade says antiquated production technology and broken-down facilities have rendered most production facilities uncompetitive.

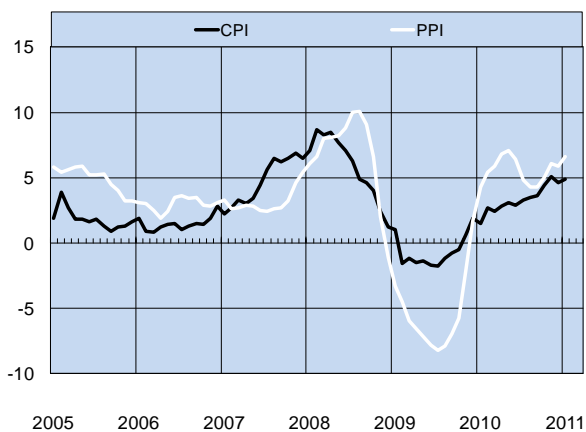
The ministry of industry and trade has drafted a policy paper on revitalising the machine-building sector over the next decade. State support would be used to stem the decline and modernise companies in the branch. The ministry has suggested support such as interest subsidies for investment loans, direct budget funding for innovation and more favourable customs treatment. The ministry has also proposed establishing joint ventures with top international firms.

China

Inflation picks up; housing's share of consumer shopping basket increased. China's consumer price index was up 4.9 % y-o-y in January (4.6 % in December), slightly below consensus expectations. Producer price inflation was 6.6 % y-o-y (5.9 %). The main factors fuelling inflation also in the coming months are soaring food and commodity prices driven by revived global demand and supply disruptions due to extreme weather events. The recent flooding in eastern Australia, for example, hit China's supplies of coal and iron ore, while drought in northern China has threatened the winter wheat crop in some of the country's main wheat-growing areas.

Lending was lower than expected in January and money supply growth (M2) slowed to about 17 % y-o-y (down from nearly 20 % in December). While the People's Bank of China is believed to continue monetary tightening, the fact that it has not published its target for credit growth for this year is an indication of ongoing small changes in the current monetary policy framework. Also reserve requirements policy focusing on bank deposits will be adjusted to better take into consideration the specific characteristics of individual banks.

China's inflation, 12-month percentage change

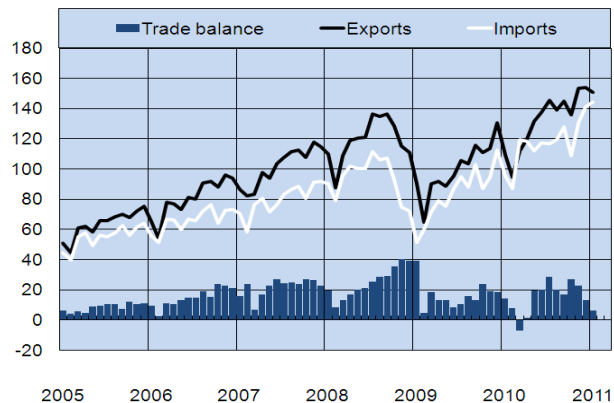


China's National Bureau of Statistics has slightly adjusted the structure of the basket of goods and services used in calculating consumer price inflation. The weighting of spending on food was lowered two percentage points to about 30 % of the basket. The share of spending on housing, long seen as understated, was increased four percentage points to 17–18 %. Weightings for other items were reduced slightly. The change had only a marginal impact on the January inflation figure.

China's foreign trade surplus shrank to \$6.5 billion in January. Exports in January hit \$150 billion (annual growth 37 %), and imports climbed to a record \$144 billion (51 %). As a result, China's trade surplus shrank more than \$6 billion from December and was substantially lower than a year ago.

The robust import growth reflects rising domestic demand and higher world commodity prices. China, the world's largest iron ore purchaser, saw the volume of iron ore imports increase nearly 50 % y-o-y in January, but the value of iron ore imports was up 150 %. Similarly, the volume of oil imports rose 25 %, but the value of oil imports was 50 % higher than in January 2010.

China's monthly foreign trade figures, USD billion



United States files complaint with WTO on China's domestic electronic payments. The US complaint says China restricts yuan-based card payments exclusively to cards issued by the Chinese UnionPay. After bilateral talks launched last autumn failed to resolve the dispute, the matter moved to WTO committee (which could take up to two years to decide the matter).

During its ten-year WTO membership, 21 complaints on 13 matters have been filed against China. The complaints include equal treatment of domestic and foreign firms, pirate production and supply of financial information. Nine of these cases were resolved with Chinese promises to make regulatory changes. Besides payment cards, disputes over corporate subsidies, raw material exports and metal product imports remain unresolved.

China has filed seven complaints with the WTO; five against the US and two against the EU. All China's claims concern anti-dumping measures, and it has won on half of its complaints. Last autumn China won its challenge to the EU's imposition of a five-year anti-dumping duty on Chinese steel fasteners. The WTO is currently hearing a Chinese complaint on EU anti-dumping duties on Chinese footwear.

Russia

Russian foreign trade grew strongly last year. Russian customs reports that the value of Russian exports last year hit \$396 billion, a 31 % increase from 2009. The volume of exports rose 10 % and export prices climbed an average of 20 %.

Some 53 % of exports went to EU countries and 15 % to CIS countries. China and Turkey each accounted for 5 % of Russia's exports and the United States 3 %.

About 70 % of exports consisted of energy products, 11 % metals and metal products, 6 % chemicals and 5 % machinery & equipment and transport vehicles. The three-percentage-point increase in energy exports as a share of total exports from 2009 largely reflected higher prices for crude oil.

Russian customs reports that the value of imports climbed to \$229 billion, a 37 % increase from 2009. Most of the growth came from a 35 % volume increase. As import prices rose just 2 %, Russia saw a marked improvement in its terms of trade.

Some 42 % of Russian imports came from EU countries, 17 % from China and 14 % from CIS countries.

About 45 % of imports belonged to the machinery & equipment and transport vehicles category. That share was slightly higher than a year ago, but still lower than in pre-crisis 2008, when 53 % of imports consisted of products from this category. Chemicals and food products each accounted for about 16 % of imports, and metals and the textiles and footwear category accounted for 6–7 %.

Central Bank of Russia balance-of-payments figures put the value of Russian exports last year at \$400 billion and value of imports at \$248 billion. The CBR's export and import figures are consistently higher than Russian customs figures as the CBR augments the customs figures. The adjustments are substantially larger for imports than exports. The CBR adjusts import figures by e.g. adding an estimate of the value of "grey" double-invoiced goods. Double-invoicing has been popular as a way to falsely understate the declared value of import goods. The CBR arrives at its estimate by comparing the combined values of imported goods and domestic production against sales of goods on the Russian market.

Throughout the 2000s (not counting the 2009 recession year) the gap between CBR and customs import figures narrowed. CBR import figures in 2000 were 24 % higher than customs figures. In 2010, the gap was just 8 %. The trend apparently reflects a drop in grey imports, improved customs inspections and better statistical recording.

Russian customs is currently shifting to paperless electronic customs declarations, which serves to hinder double-invoicing. Russian customs says that by the end of last year slightly over half of customs declarations were in electronic form.

Deputy prime minister/finance minister Kudrin demands changes in government economic policies. At last week's economic forum in Krasnoyarsk, finance minister Alexei Kudrin announced that federal budget expenditures can no longer keep increasing and that budget balance must be restored over the next few years.

Among the reasons for Kudrin's critique were development scenarios for the Russian economy until 2030 submitted to the government last week by the economic development ministry. The scenarios offered two options, an "innovative" development path and a development path based on production of raw materials. The innovation path would support annual GDP growth of around 4 % and help diversify the economy into new areas of production. This path demands higher public investment in critical fields and years of running budget deficits on the order of 2–3 % of GDP. Public debt would rise from the current level of less than 10 % to around 30 % of GDP. In contrast, public investment under the raw-material-weighted path would remain at current levels and budget balance would be restored by 2015. GDP growth would be under 3 % a year and little diversification of Russia's production structure would occur.

Kudrin noted that the first scenario is simply un-doable in the current fiscal predicament; Russia cannot afford to take on as large budget deficits and public debt as developed nations. Russia is highly dependent on raw material exports and therefore exposed to fluctuations in the global economy, which can cause significant variations in annual budget revenues.

Russian finance minister also said the government needs to abandon its economic policies of recent years that have allowed public spending to increase dramatically. Economic policy should be based on improving overall operating conditions for business, not supporting individual firms as was done in the recent downturn. The new policy needs to support efforts to fight inflation and stabilise the ruble's external rate, which will promote development of Russia's capital markets and ease companies' access to long-term finance. Tight fiscal policy is also instrumental in reaching these goals.

Kudrin called on his colleagues to acknowledge that public power is routinely abused and that companies are often treated by different standards. This dampens corporate interest for developing business.

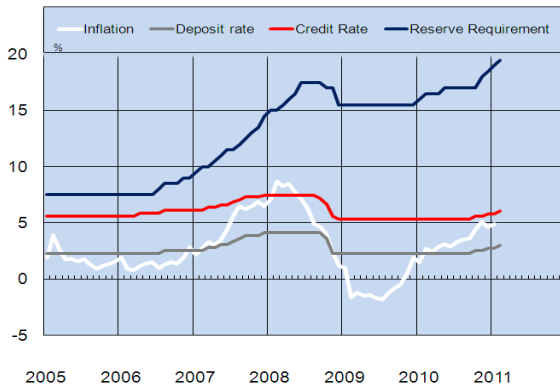
Public discussion of the speech has focused on Kudrin's assertion that no reforms can occur without a vote of confidence from society. That vote of confidence can only be delivered in free and fair elections where all leading political forces are represented. The minister's statement drew immediate criticism from United Russia, Russia's ruling party. Russia is currently preparing for the upcoming Duma elections in December. The presidential election is set for March 2012.

China

China's central bank further tightens monetary stance.

Only two weeks after raising interest rates on loans and deposits a quarter of a percentage point, the People's Bank of China hiked the minimum reserve requirement on large banks a half percentage point to 19.5 %, effective February 24. Inflation could partly be restricted also by the yuan's appreciation against the US dollar but the strengthening has been slow and spotty. As of Thursday (Feb. 24), the yuan had appreciated a mere 0.3 % against the dollar and declined about 2.6 % against the euro since the start of the year.

Inflation, interest rates and minimum reserve requirement



Sources: PBoC and NBS

Yuan's exchange rate dominates Paris G20 discussions.

At last week's G20 meeting of finance ministers and central bankers in Paris, talk focused on reduction of global imbalances and prevention of future systemic failures. The ministers and bankers agreed on a set of variables for tracking imbalances. The list includes savings rates, budget deficits and external balances. Although no binding agreements were achieved, the list of indicators is hoped to encourage discussion and provide individual nations with a tool for tracking economic conditions in other countries. The decisions were part of the Mutual Assessment Program (MAP) to restore balance to the global economy agreed at last autumn's G20 meeting.

The rate of yuan appreciation is no longer just an issue between China and developed countries; it has recently become a point of contention between China and other emerging economies. As China wants to proceed only gradually in this area, it has been reluctant to discuss the issue and has tried to avoid binding goals in multilateral discussions.

The new G20 tracking approach will give other countries an opportunity to revisit China's currency stance. The divisiveness displayed at the meeting, however, provided

little hope that global leader group can effectively deal with the world's financial imbalances.

Chinese stock markets stabilise in January. The decline in share prices that began last November reversed trend in January, lifting the Shanghai A-share index above the 3,000-mark last week.

The volume of freely traded shares on the Shanghai exchange increased sharply last year and is now 80 % of the total market capitalisation. The price-to-earnings (P/E) ratio continues to hold around 22 (down from 26 a year ago). The Hong Kong stock exchange's P/E ratio is around 17, the same level it was at a year ago.

Recovery of the global economy and higher commodity prices caused share prices to rise in many emerging markets last year. Russian share prices, for example, closely track prices of crude oil.

Current concerns about rising inflation have hit share prices in all emerging markets. The unrest in North Africa has also put pressure on exchanges in emerging markets.

Shanghai A-share index, MSCI emerging markets index and the Moscow RTS index (2007=100)



Source: Bloomberg

US ban technology transfers to Chinese telecommunications specialist Huawei. Invoking the US national security implications of sensitive exports to China, US officials denied an application from Huawei to acquire patents though the purchase of US-based 3Leaf Systems. The patents involve cluster computing, which binds multiple computers together for demanding visualisation tasks typically done by supercomputers. Huawei denies any plans to incorporate the technology into Chinese weapons systems.

Huawei itself was the world's fourth most active company last year in applying international patents under the Patent Cooperation Treaty (PCT). Of other Chinese firms, only telecommunications technology giant ZTE made into last year's top 100 companies in international patent activity. Last year, only the Japanese Panasonic had more PCT-patent applications than ZTE.

Russia

Concern over rising inflation driving central bank policy. As part of its inflation-fighting efforts, the Central Bank of Russia on Tuesday (Mar. 1) raised deposit rates and several key credit rates by a quarter of percentage point. The deposit rate now stands at 3 %, and the one- and five-day repo credit rates are up to 5.25 %. The CBR expects the hike in deposit rates to mop up at least some of the vast excess liquidity in banking sector. Unfortunately, with the sector awash in liquidity, banks feel practically no need to turn to the central bank for financing. As a result, the rate hikes are expected to have little impact on market rates or inflation.

The CBR also boosted its bank reserve requirements by a half percentage point. The move increases the reserve requirement for foreign liabilities of banks to 4.5 % and to 3.5 % for domestic liabilities. The increase in the reserve requirement for foreign liabilities is intended to discourage possible short-term capital flows into the country driven by the interest rate hike.

Higher oil prices have increased the influx of foreign currency into Russia in recent months. With the ruble gaining nearly 6 % against the dollar and nearly 3 % against the euro since the start of the year, the CBR has been actively buying up forex to contain appreciation pressure on the ruble. Russia's foreign currency reserves increased by \$13 billion to \$492 billion in the first two months of 2011.

CBR first deputy chairman Alexei Ulyukaev explained that, given the current circumstances, the most effective short-term remedy to quell inflation is allowing the external value of the ruble to rise. The CBR has long used interventions to keep the ruble's exchange rate within a fluctuation band against its euro-dollar currency basket. In recent years, the central bank has tolerated larger swings in the ruble's external value, and the CBR further widened its band limits on March 1. The wider band limits are seen as an accommodation to appreciation pressure on the ruble.

Finland's exports to Russia up last year; re-exports not growing. Customs Finland figures show Finnish exports to Russia increased 16 % last year with an overall value of €4.7 billion. Finnish imports from Russia were up by 30 % to €9.2 billion. Russia's total imports climbed last year 37 %, while exports rose 31 %.

Russia was Finland's third-largest export market, accounting for 9 % of total exports. Finland's top export destinations were Sweden (11 % share of total exports) and Germany (10 %). Russia was Finland's largest source of imports with an 18 % share of imports. The next largest sources of imports were Germany (13 %) and Sweden (10 %).

Finland's largest individual export goods categories were paper and cardboard, which represented 10 % of exports to Russia. These were followed by medical and pharmaceutical products (8 %), iron and steel (8 %), and industrial machinery and equipment for general use (7 %). All groups registered robust growth relative to 2009. Strong growth was seen in the iron and steel product group, which saw the value of exports soar 540 %. About 77 % of the value of the group's exports came from oil and gas pipelines.

Energy products represented 82 % of Finnish imports from Russia, a three-percentage-point increase from 2009. Crude oil alone accounted for 50 % of imports. Higher oil prices largely caused the 43 % increase in the value of imported crude oil. The volume of oil imports was up 5 %. Natural gas accounted for 11 % of total imports and electricity 6 %. The categories for chemical products, as well as iron, steel and other metals both represented 5 % of total imports. Sawn timber and cork represented 4 % of imports.

The rise and fall of so-called re-exporting activity has had a profound impact on Finnish export statistics. Re-exports are goods produced in a third country that are recorded as Finnish imports when brought into Finland prior to their re-export to Russia, when they are recorded as Finnish exports. Re-exporting soared during the 2000s until 2009. The identification of all re-exports is impossible, but Customs Finland issues an annual estimate. The newly published 2009 estimate saw the value of re-exports contracting 70 % from 2008. In 2006–2008, re-exports accounted for about a third of all Finnish exports to Russia. In 2009, they were roughly a fifth of Finnish exports to Russia (estimated value €788 million).

According to the latest export figures the decline in Finland's top re-export categories – passenger cars and mobile phones – continued in 2010. Exports of passenger cars were down 70 %, and exports of mobile phones dropped 25 %. This suggests that re-exports were on decline or in any case did not grow in 2010.

The value and volume of road transshipments via Finland to Russia increased 17–18 % last year. The value of transshipped goods was just under €17 billion – nearly four times the value of Finland's total exports to Russia. Even with the growth, however, the volume of transshipped goods was just half of pre-crisis levels. The largest product categories were machinery and equipment (about 20 % of the value of transit shipments) and passenger cars (14 %).

Although Russian total imports increased sharply in 2010, Russian customs figures show imports of passenger cars had fallen to a level of about a third of the 2008 level. This is seen in the decline of Finland's re-exports and transshipments to Russia from the peak years of 2006–2008.

China

National People's Congress lowers growth target. The annual two-week National People's Congress, starting on Saturday (Mar. 5), is set to discuss general policy issues, macroeconomic policy, budgets and critical legislative amendments. Topping this year's agenda is the specification of China's 12th five-year plan (2011–2015).

Last weekend, premier Wen Jiabao said that China will target average GDP growth of 7 % a year during the upcoming five-year plan. While the growth target of the previous five-year plan (2006–2010) was a half-percentage point higher, the realised average GDP growth in the period was 11 % p.a. Moreover, even if a half-percentage-point reduction appears marginal in this context, it reflects a rethinking of China's economic and social ambitions. Indication of the coming change was already evident in last autumn's party central committee framework document for the next five-year plan ([see BOFIT Weekly 42/2010](#)), which stressed the need to shift the growth emphasis from capital investment to private consumption, a move that almost inherently calls for lower economic growth. Other themes in the next five-year plan include reductions in income disparity, investment in high technology and innovation, development of strategic branches of industry and energy efficiency. This National People's Congress may also tackle labour market issues such as improvements in wage guarantees for workers and collective bargaining rights.

The uprisings in North Africa and the Middle East have added a topical edge to this year's meeting. China's leaders have called for resolution to the country's existing problems (e.g. rising inflation), while tightening censorship and cracking down on planned public demonstrations.

Next five-year plan should clarify China's environmental goals. The recent statements of China's premier and environmental minister suggest a shift away from high growth towards a sustainable growth paradigm. While environmental goals have long been on the political agenda, robust economic growth has consistently taken precedence.

Chinese quality of life has been seriously affected by degraded air and water quality. The NBS reports that only about 70 % of measurement points of potable water supplies complied with minimum drinkability criteria last year and that only 77 % of urban waste water was treated. Air quality was reportedly "satisfactory" in 83 % of China's big cities, but that figure is more an indicator of the laxity of China's air-quality standards. The smoggy air of China's large cities would not be considered satisfactory in developed countries.

China participates in UN climate talks with the group of developing countries not subject to binding climate goals. Even so, China has targeted reduction of "carbon intensity" (CO₂ emissions relative to GDP) to 40–45 % of its 2005 level by 2020. In the same period, China also plans to increase the share of biofuels in national energy production to 15 % and increase forestation of the country by 40 million hectares.

China's integration with international climate talks progressed at the Cancun summit late last year when China agreed to an evaluation of its environmental policies under the ICA consultation and evaluation process.

Strong growth in Finnish exports to China. Customs Finland reports that the value of Finnish exports to China climbed to €2.7 billion last year. Exports to China were up 45 %, compared to an overall 16 % increase in Finland's exports. China took 5 % of Finnish exports, surpassing the UK as Finland's sixth largest export destination.

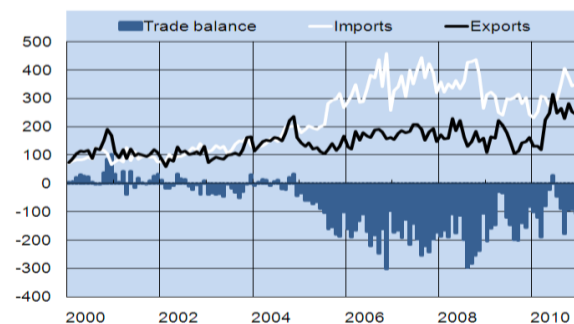
The value of imports from China in 2010 was €3.8 billion. Imports grew a modest 9 %, even as Finland's imports overall rose 20 %. Although China's share of Finnish imports contracted to 7 %, China retained its position as Finland's fourth most important import provider. Finland continued to run a trade deficit with China, but the trade gap contracted by a third in 2010.

Hong Kong and Taiwan together accounted for less than 1 % of Finland's foreign trade.

Finland saw growth in all its main goods exports categories to China with the exceptions of telephone equipment and motors. Finns exported to China last year a wide range of machinery, paper industry products, metals and furs. Large sales of paper mill equipment boosted export figures significantly. The value of fur exports doubled from 2009, while chemicals exports increased by 20 %.

The modest growth in imports reflected an 18 % decline in telephone and radio equipment. Imports of telephone equipment still accounted for a quarter of Finnish imports from China. Last year, Finland also imported various kinds of electrical equipment, office and IT equipment, clothing and metals from China.

Monthly Finland-China goods trade (EUR million)



Source: Customs Finland

Russia

Public finances improved last year. Public sector revenues (federal, regional and municipal budgets, as well as state social funds) increased 17 % in nominal terms, substantially better performance than expected. Expenditures were up 8 % in nominal terms. Thus, the overall public deficit shrank to 3.6 % of GDP, down from 6.3 % in 2009.

The rapid rise in revenues represented a partial rebound from a 16 % drop in revenues in 2009. In nominal terms, revenues were still lower than in pre-crisis 2008 and about the same level in real terms as in 2006.

It was with the realised price of Urals-grade crude oil averaging \$78 a barrel last year (compared to a budget assumption of \$58 a barrel) that revenues well exceeded the budget plan. In addition to taxes from oil production and oil export duties, government coffers were replenished by corporate profit taxes that had fallen dramatically during 2009. The public sector's energy dependence began to increase again last year as taxes collected from the oil and gas sector comprised nearly a quarter of total revenues.

Revenue from value-added taxes and excise taxes also bounced up as industrial production and imports returned to growth. Income tax revenues and mandatory social contributions from employers did not fall much during the recession, so there was much less room for recovery.

Nominal growth in public spending slowed over the past two years, and spending has risen only about 3 % in real terms since 2008. Federal spending (excluding transfers to regional budgets and social funds) and spending of regional and local administrations declined slightly in real terms last year.

In contrast, spending from Russia's social funds was boosted by the ongoing rapid rise in pensions and other social security spending. Their share of public spending increased dramatically. Spending on the economy shrank as stimulus funding implemented during the recession was wound down. Most other major spending categories – except for health care – remained unchanged in real terms.

Major public spending categories

	2009			2010		
	RUB bn	share %	change %	RUB bn	share %	change %
Public administration	1 054	6.6	-4.4	1 178	6.8	11.8
Economy	2 782	17.3	23.2	2 324	13.4	-16.5
Defence	1 191	7.4	14.1	1 280	7.4	7.4
National security	1 246	7.8	14.1	1 339	7.7	7.5
Social security	4 546	28.3	20.7	5 863	33.9	29.0
- pensions	3 235	20.2	25.5	4 436	25.6	37.1
Education	1 778	11.1	6.8	1 894	10.9	6.5
Health care	1 653	10.3	6.9	1 709	9.9	3.4
Housing	1 006	6.3	-12.8	1 072	6.2	6.5
Total	16 048	100.0	13.4	17 301	100.0	7.8

Source: Finance ministry

Borrowing of Russian state likely to be lower than forecast this year. High global prices for crude oil will sharply reduce the projected federal budget deficit this year and thereby shrink the state's projected borrowing needs. Finance minister Alexei Kudrin announced that the federal budget deficit this year is on target to come in below 2 % of GDP at about 1 trillion rubles (\$35 billion). The original budget plan foresaw a 2011 deficit of 3.6 % of GDP or 1.8 trillion rubles.

The Russian state does not plan to use revenues from oil and gas taxes accrued in the reserve fund to cover the budget deficit as it has in the last two years. Instead, Russia will focus on rebuilding the reserve fund with revenues from oil and gas taxes in the current environment of higher oil prices. As of end-2010, the reserve fund held assets of 775 billion rubles (\$27 billion). Kudrin expects the reserve fund holdings to nearly double by the end of this year. The reserve fund hit its all-time high of \$143 billion in August 2008.

The government's initial plan this year was to cover the budget deficit by borrowing some 1.7 trillion rubles in ruble-denominated loans both at home and abroad, along with up to \$7 billion in foreign currency denominated loans. The finance ministry now plans to cut this year's borrowing by 500 billion rubles. In order to allow the reserve fund to build up again, borrowing will exceed the budget deficit.

Late last month, the Russian state held its first ever ruble sovereign bond issue. The ruble-eurobond, which has a 7-year maturity and 7.85 % coupon, raised 40 billion rubles (about \$1.4 billion) and was heavily oversubscribed. The finance ministry now plans to continue with ruble sovereign bond issues in coming years in order to promote the emergence of a ruble-bond market segment. The finance ministry hopes to use ruble bonds as a means to raising the ruble's profile in international financial markets and eventually see the ruble gain acceptance as an international reserve currency.

At the end of last year, Russia's public debt reached 4.2 trillion rubles (about \$138 billion), or nearly 10 % of GDP. Foreign debt represented about 30 % of public debt.

Consumer prices up 9.5 % y-o-y in February. The CPI rise last month was nearly as fast as in January. On-month inflation, however, slowed from 2.4 % m-o-m in January to 0.8 % in February. The January figures were affected by annual hikes in regulated prices for housing and related services such as electricity, gas, water and heating. Regulated prices were raised at the start of the year an average of 9 % from December.

Prices for food and housing are among the most important drivers of inflation in Russia. Food prices in February were up 14 % y-o-y and housing prices 12 %.

It is expected that food prices will continue growing fast at least for the first part of the current year.

China

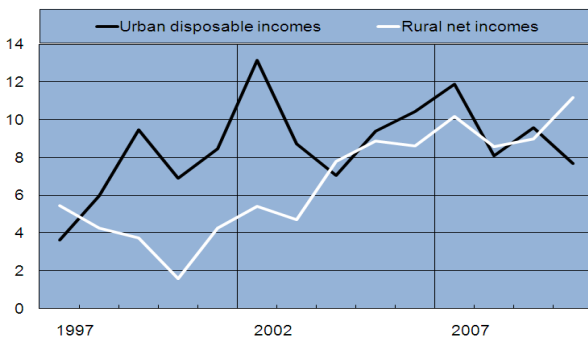
China posts foreign trade deficit for February. The value of China's exports last month was \$97 billion, a 2 % increase from a year ago. With imports rising about 20 % to \$104 billion, China produced a surprising \$7 billion trade deficit last month, the largest monthly trade deficit since February 2004. Although China's Lunar New Year holidays largely explain the February numbers, both exports and imports saw far less growth than expected.

China's foreign trade surplus typically rises as the year wears on, so few doubt that monthly trade surpluses will soon return. The size of this year's trade surplus will largely be determined by China's own rate of economic growth. High growth and raw material imports have sustained soaring commodity prices. The volume of imports in January rose 35 % y-o-y, while exports grew 24 %.

There is huge interest in China's export trends, as the post-New-Year's exports figures could provide indications not just about the condition of the global recovery but also how fast labour prices are rising in China and whether the much-discussed move of light industry away from China's coastal provinces inland and to other Asian countries is gaining momentum.

Incomes rising faster in the countryside than in cities. In 2010, the real net incomes of rural dwellers increased 11 % y-o-y, while disposable incomes of urbanites were up 8 %. Even so, the income gap between the countryside and cities remains large. City folk had annual disposable incomes of 16,500 yuan (€1,830), or triple the net incomes of rural residents (5,100 yuan, €570). The official standard minimum wage rose 23 % to 870 yuan (€100) a month.

Real disposable incomes 1997–2010, %-change y-o-y (CPI deflator)



Sources: NBS, BOFIT.

Human resources and social security minister Yin Weimin said the new 5-year plan will target base real income growth of at least 7 % annually in both the cities and the countryside. The minimum wage growth target is

13 % a year or higher. The goal of raising household incomes is a cornerstone of China's latest economic policies, which emphasise private consumption over capital investment and exports. In order to promote household incomes, minister Yin also suggested as-yet-unspecified changes in the current wage bargaining model.

China's growth strategy based on cheap migrant labour is gradually being phased out. The number of migrant workers registered increased less than 6 % last year. New work opportunities for migrant workers in their home districts have become available with the rise of entrepreneurial activity in China's interior provinces. Along with a general rise in Chinese income levels, the emphasis on labour supply seems to be shifting to higher-value-added industries and away from cheap labour industries where labour shortages are already apparent.

China solidifies its position as world's biggest energy consumer. According to preliminary NBS figures, China's energy consumption increased about 6 % in 2010. Preliminary figures from the International Energy Agency (IEA) show China surpassed the United States already in 2009 as the world's largest energy consumer.

China's statistics for energy consumption show average annual growth of 6 % over the past 30 years. Growth in energy consumption and production peaked in 2003–2004, when growth in energy consumption actually outstripped GDP growth. Since 2004, the rate of energy consumption growth has gradually slowed, but still remains quite high by international standards. Due to China's consistently high economic growth, energy intensity (the ratio of energy consumption to GDP) has fallen. Despite this, the country remains among the world's 30 worst countries in terms of energy efficiency. China presently accounts for about a fifth of global energy consumption, which is in line with its share of the world population. Energy consumption per capita in the United States is five times higher than in China.

Coal accounts for about 70 % of China's primary energy consumption, and about 17 % comes from oil. As such China's energy intensity remains exceptionally high. The country's carbon dioxide emissions increased about 150 % in the past decade and now China accounts for almost a quarter of global CO₂ emissions. While China has increased its focus on natural gas and various forms of renewable energy in recent years, the road ahead is long. The NBS reports coal consumption increased 5 % in 2010, while oil consumption, which is largely used to fuel transportation, climbed 13 %. Natural gas use was up over 18 % last year. China's installed wind power capacity is now about a quarter of global wind power capacity, and last year China's investment in new wind farms represented about half of the world's total investments in wind power. Even so, wind power represents less than 1 % of China's primary energy consumption.

Russia

Short-term impacts of Japan disasters on the Russian economy likely to be relatively small. The biggest impacts for Russia are expected to be felt through prices of energy exports. World oil prices have fallen in recent days, and capital is expected to flow out of Russia as in other emerging markets. The ruble exchange rate weakened a bit this week. Looking ahead, Japan's recovery and partial substitution of nuclear power with other forms of energy should support prices for oil and gas.

The direct impacts via trade should be small as Japan only accounted for 3 % of Russia's exports last year and 4 % of imports. The biggest immediate impact will likely be on imports of Japanese cars to Russia; 44 % of cars imported to Russia last year were Japanese brands.

Large differences in regional industrial growth. Industrial output rose last year in 79 of Russia's 83 regions. Some 39 regions saw industrial output recover to pre-crisis levels. Russia's industrial output increased 8 % overall last year.

Growth was particularly brisk in regions focused on heavy industry, machine-building and assembly work. Many of these regions were situated in the Volga Federal District, including Ulyanovsk (23 % growth), Udmurtia (20 %), Perm (18 %) and Samara (16 %), as well as regions near Moscow, e.g. Oryol (21 %) and Kaluga (45 %). Industrial output growth in Kaluga led the nation, thanks in part to the opening in April last year of a joint assembly plant of Peugeot, Citroën and Mitsubishi. In Russia's biggest oil producing regions, industrial output growth slightly lagged the national average. Industrial output was up 2 % in Moscow, and 9 % in St. Petersburg.

The contraction of industrial output continued in the republics of Chechnya and Ingushetia, which are among the most backward regions in the Russian Federation. Industrial output also fell in the northern Nenets and Chukotka autonomous okrugs. The two regions defied the industrial output trend during the 2009 downturn, posting exceptionally high growth. Growth in Nenets came from the inauguration of a new oil field, while in Chukotka growth was driven partly by sharp increases in gold and silver production.

The biggest fixed capital investments last year were made in the Tyumen region in western Siberia, which took 11 % of total capital investment in Russia. Tyumen is home to Russia's biggest oil and gas production areas – the Khanti-Mansi and Yamal-Nenets autonomous okrugs. Above-average investment was also made e.g. in the City of Moscow and St. Petersburg, as well as the Moscow oblast and the Krasnodar region, which includes Sochi, the site of the 2014 Winter Olympics. The above mentioned regions together accounted for 31 % of Russia's total fixed investment.

Despite rise in capital investment, no growth in construction activity last year. Rosstat reports fixed capital investment increased by 6 % y-o-y in 2010, after declining 16 % 2009. Growth was still modest compared to 2000–2008, when growth averaged 13 % a year.

The low level of capital investment is problematic for the Russian economy. Investment last year represented 21 % of GDP. While that share is average for an EU member, it is low for an emerging economy, where investment rates typically are in the range of 25–35 %. The rate is around 40 % in China and India. With the high economic growth of recent years, Russia's investment rate rose from 17 % in 2000 to a peak of 22 % in 2008.

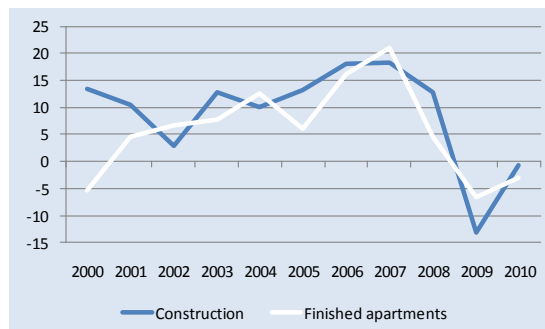
The financing structure used by Russian firms differs from most countries. Rosstat reports that in Russia 59 % of investment by firms last year was made out of pocket or with funds from other firms in the same conglomerate. About 19 % was financed from federal, regional or local budgets. Only 9 % of investment was financed with bank loans. Foreign direct investment was the source of financing of 4 % of all investment.

The private sector accounted for 46 % of investment, while the share of public sector (including public-private alliances) was 38 %. Firms either wholly or partly foreign-owned accounted for 16 % of investment.

The energy sector continued to dominate fixed capital investment. Some 16 % of investment went to oil and natural gas production, and a similar share went to manufacturing, where the biggest investments involved oil refining, basic metal industries and the food industry. Some 26 % of total investment went to the transportation and telecommunications sectors, including 9 % to pipeline transmission and 6 % to railways. Some 9 % of investment went to electricity production and transportation, and a similar amount to the real estate sector.

Although construction activity began to recover in the second half of 2010, 2010 overall still saw construction slightly lower than in 2009, when production fell 13 %. Residential housing production was down 3 % last year from 2009, when housing production was off 6 %.

Construction activity and finished apartments, %-change y-o-y



Source: Rosstat

China

For China, the most immediate impacts of the Japanese disasters are likely to be felt in trade and tourism.

While Japan struggles with the triple-whammy of the 9.0-magnitude Tohoku earthquake, subsequent tsunami and nuclear power plant failures, the initial impacts on China appeared minimal. Even so, it is becoming clear that the ongoing crisis could significantly impact bilateral trade and tourism. Japan is a part of highly integrated international production chains in such industries as cars and electronics, so problems with Japanese component supplies can also have significant knock-on effects for Chinese manufacturers. China will be exposed to movements in commodity (particularly energy) markets, but China's heavily regulated financial system remains fairly insulated from shocks to the international financial system. As elsewhere, the security safeguards of China's nuclear power industry are now under the extreme scrutiny.

To assist with the crisis, China has dispatched rescue teams and supplies to Japan, and has pledged to help Japan with reconstruction. Chinese firms are in a good competitive position to help with reconstruction and China could also play a substantial role in financing reconstruction. Chinese airlines have increased flights to Japan to help with evacuation of Chinese nationals.

Japan accounted last year for 7 % of Chinese exports and 13 % of imports. China was Japan's largest trade partner, accounting for about a fifth of foreign trade. Over half of bilateral trade involved machinery & equipment, and electronics products. In addition, the two countries enjoy an extensive tourism relationship. Japanese last year made 3.7 million trips to China, while the Chinese made 1.4 million visits to Japan. The two countries each account for about a sixth of the other country's foreign tourism.

National People's Congress approves 12th five-year plan. The annual two-week National People's Congress (NPC) was concluded last Monday (Mar. 14). The approved five-year plan 2011–2015 aims for sustainability by rebalancing China's growth model to put greater emphasis on domestic consumption and better distribution of wealth. The average annual GDP growth target was lowered to 7 %, half a percentage point below the previous five-year plan. Realised annual growth over the 11th five-year plan slightly exceeded 11 % as exports and investment soared.

The current five-year plan puts private consumption ahead of investment as the main driver of economic growth. Services are also expected to contribute to a greater share of GDP. To reduce the disparity in living standards, the government will spur domestic demand with measures such as supports to farmers and urban poor, and

by investing in healthcare and affordable housing. Science and technology, as well as education, will be geared to promote innovations.

At the news conference held on the final day of the NPC, premier Wen Jiabao announced an inflation target of 4 % for this year. Mr. Wen said China's exchange rate policy and yuan appreciation will not play a central role in reaching the inflation target. Instead, the yuan will be allowed to appreciate gradually. He further stated that threading the balance between robust job creation and putting the brakes on inflation presented a great challenge that will be made harder by international factors such as lax monetary policy in the United States, high world commodity prices and rising domestic wage levels.

Despite the lack of official discussion of political reforms on the NPC agenda, the upcoming change in leadership in China next year and the ongoing political unrest in North Africa provided an interesting back-narrative to the meeting. Wen defended the right of people to criticise and keep an eye on government officials, but refused to find parallels between the situations in China and North Africa. The government cracked down on freedom of assembly during the event, as well as tightened rules for journalists.

12-month inflation still below 5 % in February. China's National Bureau of Statistics reports that consumer prices in February were 4.9 % higher than a year ago, i.e. unchanged from the 12-month rate in January. The single most important factor driving inflation was again rising food prices (up 11 % y-o-y). Producer price inflation accelerated in February to 7.2 % y-o-y.

It appears that the monetary tightening measures introduced last year have begun to affect consumer prices, while producer prices continued to soar due to increased commodity prices. Growth in the credit stock slowed in February to 16.2 %, matching the 2007 pre-crisis level.

In the first two months of this year, China's industrial output grew 14 % y-o-y. Industrial output growth was slightly higher than at the end of last year. Growth in retail sales fell three percentage points from year's end to 16 % y-o-y. Lower growth in car sales diminished growth in both industrial output and retail sales.

China now the world's biggest industrial producer. At the start of the week, both the Financial Times and Bloomberg referenced a report by IHS Global Insight that found the value of China's industrial production in 2010 slightly exceeded that of the US. The US and China each now account for about a fifth of global industrial production. In China, that manufacturing value-added (MVA) is achieved with about 100 million workers. The same of MVA is achieved in the United States with just over 11 million workers. The IHS Global Insight comparison used last year's output measured in US dollars and nominal exchange rates.

Russia

Large differences in economic recovery in Russian regions neighbouring Finland in 2010. Industrial output was on the upswing last year in the City of St. Petersburg, the Leningrad and Murmansk regions, and the Republic of Karelia. Rosstat reports that St. Petersburg, which suffered one of its biggest drops in industrial output in 2009 (a decline of 20 % compared to a national drop of 9 %), saw its industrial output rebound 9 % last year (compared to a national average of 8 %). Recovery in manufacturing last year was observed especially in auto assembly (more than 200 % growth), which suffered a massive drop-off in 2009.

The City of St. Petersburg is surrounded by the Leningrad region, where industrial output, after suffering a 6 % drop in 2009, climbed 15 % in 2010. Growth was driven by e.g. increased vehicle production: passenger car and tractor production grew around 100 % from the 2009 level. In addition, manufacture of tyres for passenger cars increased about 50 %. Many auto component makers operate in the Leningrad region, including the Finnish Nokian Tyres.

In the Republic of Karelia, industrial output last year rose 11 % y-o-y (industrial output contracted 10 % in 2009). Growth was led by e.g. the timber and pulp & paper industries. In the mining-dominated Murmansk region, industrial output rose 4 % y-o-y (down 6 % in 2009). Compared to the national average, industrial output in the region was tepid throughout the 2000s, averaging only about 1 % a year.

Investment growth in 2010 was quite varied across regions close to Finland. The volume of investment in the Leningrad region soared 32 % (and grew 8 % even in the crisis year 2009). Investment nationally contracted 16 % in 2009 and increased 6 % in 2010. Investment was up 15 % in Karelia (down 32 % in 2009) and up 6 % in St. Petersburg (down 17 % in 2009). In Murmansk, investment fell 22 % in 2010, after declining 18 % in 2009.

Growth in retail sales, a good indicator of private consumption trends, was stronger in Finland's neighbouring regions than the national average (just over 4 %). In St. Petersburg, retail sales rose 6 % (down 5 % in 2009), 11 % in the Leningrad region (down 2 % in 2009), 5 % in Karelia (down 5 %) and 3 % in Murmansk (down 3 %).

The average income in the four regions was slightly higher than the national average. The official average monthly salary in Russia in November 2010 was 21,000 rubles (€530). In Murmansk and St. Petersburg, the average salary was about 28,000–29,000 rubles (€700–720). Murmansk wages were higher due to its industrial structure and focus on the relatively well-paid mining industry. In the Leningrad region and Karelia, the average monthly wage was 25,000–26,000 rubles (€500–530).

Russia's official unemployment rate averaged 7 % nationally in the November-January period (2010–2011). In contrast, it was just 2 % in the City of St. Petersburg and 6 % in the Leningrad region. Unemployment was 9 % in the Murmansk region and 11 % Karelia.

Government approves development strategy for banking sector. The strategy laid out by the government and central bank extends through 2015 and follows up earlier strategy documents released in 2001 and 2005.

The new strategy focuses on making banks more active participants in modernisation of the economy, improving the quality and efficiency of banking and banking services, assuring stability of the banking sector and increasing competition and transparency. The broad tasks facing the government are still developing effective legislation and improving the business environment, and a little more specifically, inter alia, developing banks' corporate governance and risk management, banking supervision of e.g. banking conglomerates, reducing bureaucratic red tape and improving the consumer's position and protection. Improving banking legislation should make the banking system conform to most international standards by 2015.

The strategy calls for reducing state ownership in the banking sector in the medium term. This would happen over a three-year period for Russia's largest, second-largest and fourth-largest banks (Sberbank, VTB and agriculture bank Rosselkhozbank), which together account for nearly 40 % of the entire banking sector. However, during that period the state will retain its majority stake in these banks. In the longer term, the strategy calls for further reduction of state ownership in the above-mentioned banks. Similar divestiture is planned for Post Bank, which is in formation, although the Russian state aims at divesting its majority ownership within five years from the bank's establishment. State-owned companies are called to prepare plans to divest stakes in banks in the medium term. Gazprom, which owns the country's third-biggest bank (Gazprombank), is mentioned in the strategy. The plan also calls for regions and municipalities to gradually divest holdings in banks.

To achieve the essential goal of banking sector stability the minimum capital requirement for banks will continue to rise. The strategy calls for an increase to 300 million rubles (€7.5 million) starting in 2015. Under current law, the minimum capital requirement goes up at the start of next year from 90 million rubles to 180 million rubles.

By 2015, the total assets of Russia's banking sector are expected to exceed 90 % of GDP. Currently, total assets equal about 75 % of GDP, which is lower than in developed countries and even many emerging economies. At the same time, corporate and household borrowing, which is also low relative to the size of the Russian economy, is expected to rise from 40 % of GDP at present to 55–60 %. Tier 1 capital should rise from 10 % to 15 % of GDP.

China

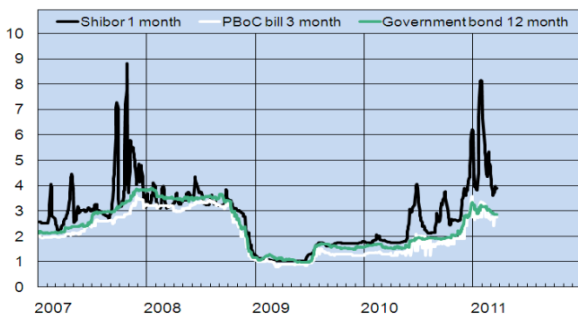
China's central bank continues monetary tightening.

The People's Bank of China (PBoC) announced that effective today (Mar. 25), the deposit reserve requirement ratio will increase by 0.5 percentage point as part of efforts to quell credit growth and inflationary pressures. Following the rate hike, the ratio is 20 % for largest banks and 16.5 % for other banks. The increase in the reserve requirement is the third this year, and follows the PBoC's February move to raise key reference rates by a quarter of a percentage point. Even as the global economic outlook has been clouded by the unfolding events in Japan and Libya, China's leaders are moving ahead with monetary tightening as worries over rising domestic inflation take priority.

Boosting the reserve requirement is a far cheaper way for the PBoC to mop up excess liquidity in the system than by issuing central bank debt securities. The PBoC currently pays only about 1.6 % p.a. on mandatory reserve-deposits, while the market rate for e.g. three-month paper has been running at around 2.8 % p.a. in recent weeks. Banks hate the move, of course; with more of their money stagnating in a low-yield central bank account, they see their potential profits reduced.

Liquidity varies hugely from bank to bank. Recently, small banks in particular have reported liquidity shortages. The liquidity situation is reflected in money market rates. In the second half of 2010, market rates rose sharply; in recent weeks they have fallen. Unlike advanced economies, where interest rates play a major role in monetary policy, China still relies largely on regulation of the credit stock. The pressure to shift to a more transparent monetary policy based on interest rates continues to increase as China's financial markets evolve.

Money market rates in China



Source: Bloomberg

China approves 2011 deficit budget. The finance ministry presented its proposed 2011 budget to the National People's Congress that ended last week. Revenues to the public sector (central and local administrations) are ex-

pected to rise 8 %, while expenditures will increase 12 %. The resulting budget deficit of 2 % of GDP is a half percentage point lower than the forecast last year. Indeed, the realised 2011 deficit could be even smaller as China tends to be cautious in its forecasting of GDP growth. Formulating an accurate picture of China's public economy is challenging as revenues and spending by local administrations are not specified accurately.

This year's budget is about improving living standards and raising private consumption. China is contemplating an increase in the minimum monthly taxable income threshold from 2,500 yuan to 3,000 yuan. Central administration spending has been boosted by about 15 % this year in such areas as construction of affordable housing, education, social security and healthcare. National defence, science & technology and energy-saving will also see funding increases of more than 10 % this year.

China's public sector revenue and expenditures (% of GDP)

	2007	2008	2009	2010	2011*
Revenues	19.3	19.5	20.1	20.9	20.3
Spending	18.7	19.9	22.4	22.5	22.3
Balance	0.6	-0.4	-2.3	-1.6	-2.0

Public sector = central and local administrations.

*Estimate, GDP based on 2011 budget deficit (900 billion yuan).

Sources: China Ministry of Finance, CEIC, BOFIT.

Libya crisis should have little impact on China's energy supply. China is the world's second largest oil consumer after the United States, accounting for about 10 % of total world consumption. China today imports about half of its crude oil, with imports rising 17 % last year to 239 million metric tons. Libya provided about 3 % of China's crude oil imports last year.

The Libyan crisis illuminates the challenges China faces in its efforts to secure oil supplies from politically unstable regions. China's trump card over other resource competitors has been its ability to provide cheap skilled labour and financing while steering clear of domestic politics of the target country. China has acquired rights to oil fields in developing countries by offering payment in infrastructure projects that Western actors are otherwise reluctant to fund due e.g. to corruption issues.

However, most such projects have been realised largely with Chinese labour, annoying their foreign hosts. The unwillingness to hire local labour is part of the reason China lost its production rights in Angola, the biggest foreign supplier of oil to China, and Libya in 2009. Poor management led to the failure of several projects in Nigeria. In recent weeks, China has had to evacuate about 36,000 Chinese workers from Libya without guarantee that Chinese investments in the country will be recovered. It is estimated that there are about 75 Chinese firms operating in Libya with projects worth a total of \$19 billion.

Russia

BOFIT forecast sees brisk GDP growth in 2011-2013 for Russia, despite slowing. The recovery of Russian output from one of the deepest drops globally slowed temporarily in autumn 2010 but continued in winter. Imports, in contrast, recovered in 2010 faster than predicted due in part to an exceptionally hot and dry summer that decimated agricultural production in particular.

The latest [BOFIT Forecast for Russia](#) sees GDP rising briskly and even stronger import growth. GDP growth should reach 5.5 % this year, due e.g. to a rise of prices for oil and Russia's other key exports in 2009-2010, as well as the relatively low GDP level of 2010. Starting from the first half of 2011, GDP growth is projected to decelerate gradually as the impact of the earlier rise of export prices on the economy ebbs and prices in the forecast period remain at the level of early this year (we assume an average oil price of about \$100 a barrel). GDP growth is expected to be 4.7 % in 2012, and just over 4 % in 2013.

Consumption growth is forecast to pick up and become the main driver of economic growth. This should help spur a recovery in agriculture, which experienced a sharp decline in 2010. The brisk rise in wages should continue, with inflation and the upcoming elections next winter adding to the pressure to raise public sector wages and pensions. Household saving is expected to fall from its recession height. Growth in purchasing power is restrained by inflation, which has accelerated to nearly 10 % due to rising food prices. Consumption growth is also curbed by a slow decline in unemployment, as underemployment in firms is higher than before the recession.

Public spending is expected to rise slowly. This view is supported by government extra revenue which flows from a higher oil price than assumed in the budget. That will also make it easier for the government to meet its target of returning the state budget to balance by 2015.

The volume of exports is expected to grow rather slowly in relation to global trade as exports of crude oil and fuel oils are not expected to increase. Natural gas and other basic export commodities should mend some of the slack.

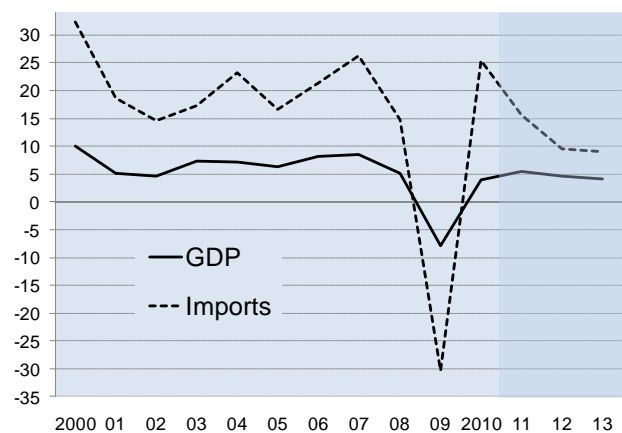
Investment is expected to recover strongly this year and next year as production capacity utilisation climbs back this year to pre-crisis levels. Banks have sufficient liquidity to meet the financing needs of investors. As in the 1998 recession, inventories have had a large impact on GDP, with inventories first declining and then rising. The economy has now largely moved beyond this down-up cycle.

Imports, which are expected to increase about 15 % this year and about 10 % p.a. in 2012-2013, will restrain GDP growth. The Russian economy's propensity to import, while high, should ease off gradually. On the other hand, appreciation in the ruble's real exchange rate should en-

courage imports. The current account surplus should be sufficient to support appreciation of the ruble's nominal exchange rate even if import prices would rise substantially.

This forecast carries with it inherent upside and downside risks. Oil prices could rise from the level assumed, while the impact might be slower due to oil taxes. Higher-than-expected inflation from e.g. higher food prices could shrink the consumption base. Import growth could possibly outstrip the projection.

Changes in Russian GDP and import volume, %



Sources: Rosstat and BOFIT Forecast 2011-2013

Russians travelling abroad more, including Finland.

Based on at-border interviews of travellers, Statistics Finland reports that during the 2010 May-October summer tourist season, the number of Russian tourists visiting Finland rose 18 % y-o-y after contracting still in 2009-2010 winter season. In the May-October period, the total number of visits increased 5 %. For the 12-month period from November 2009 to October 2010 over 2.4 million travellers, or 40 % of all travellers visiting Finland came from Russia. Some 63 % of Russian trips were day journeys; the share of Russians of nights spent by foreign visitors in Finland last year remained at 14 %.

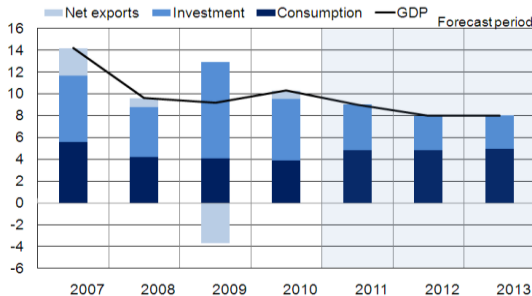
During the May-October 2010 tourist season, Russian tourists spent on average about €270 during each visit, or about 11 % more than in the 2009 tourist season. Balance-of-payments figures from the Bank of Finland show that in 2010 Finnish earnings on tourism from Russia amounted to a total of €750 million, or more than a third of all earnings from tourism (€2.2 billion). Tourism earnings from Russian visitors were up about 20 % from 2009. Tourism earnings overall rose 8 % in 2010.

Rosstat reports that Russians made over 39 million trips abroad last year, an increase of 15 % from 2009. Some 25.5 million trips were to non-CIS countries. The most popular non-CIS destinations were Finland (3.4 million visits, or 9 % of all trips), Turkey (8 %), Egypt (6 %) and China (6 %).

China

BOFIT's latest forecast sees China's GDP growth slowing to 9 % this year. China used massive public investment to sustain robust economic growth throughout the international financial crisis. Credit growth due to increased borrowing, rapid money supply growth, and higher prices for food and other commodities have caused inflation to pick up. As a result, the focus of economic policy has shifted from propping up growth to fighting inflation. Given tighter monetary policies, the latest [BOFIT Forecast for China](#) sees real GDP growth slowing this year to 9 % p.a. Growth is expected to slow further to around 8 % p.a. in the coming two years (2012 and 2013). Such growth is still quite robust given the size of the Chinese economy, which now significantly affects trends in commodity prices and the global economy. China's GDP grew 10.3 % last year to 39.8 trillion yuan (\$5.88 trillion /€4.44 trillion), surpassing Japan to become the world's second largest economy after the United States.

GDP growth and contribution of demand components, %



Sources: CEIC and BOFIT

Domestic demand, buoyed by rising incomes and a higher yuan exchange rate, will drive GDP growth in the forecast period. Private consumption has only accounted for about 35 % of GDP in recent years which leaves plenty of room to expand the role of consumption in the economy. Investment is expected to grow more slowly, with the investment rate falling few percentage points in the forecast period from the current 46 %. Urbanisation, new infrastructure and structural changes in the economy, however, will continue to support investment demand.

Now the world's largest exporter, China's exports are expected to grow slightly faster than 7 % p.a., the predicted growth in global trade. Given GDP growth substantially higher than in other countries, China's import growth should outstrip its export growth. China's current account surplus equalled about 5 % of GDP last year. In the forecast period, the current account surplus may decline slightly, but the trend will largely depend on foreign trade prices.

Underlying problems lurk even with the robust growth of the past two years. These are already becoming apparent with the pick-up in inflation and problems emerging in the real estate sector. For policymakers, inflation has become the top concern and missteps in monetary policy could very well destabilise growth. The murkiness of real estate sector data also challenge officials in shaping appropriate policies. Even though China has an on-going need for new housing, there may be substantial overhang of unsold apartments on the market. In such circumstances, a price collapse could reduce housing production and lower economic growth, which would have knock-on impacts on local administration budgets and the banking sector. Forecasting trends in China's real estate markets is especially difficult due to the poor quality of available data and huge differences in practices across provinces.

China now the world's second-largest coal importer.

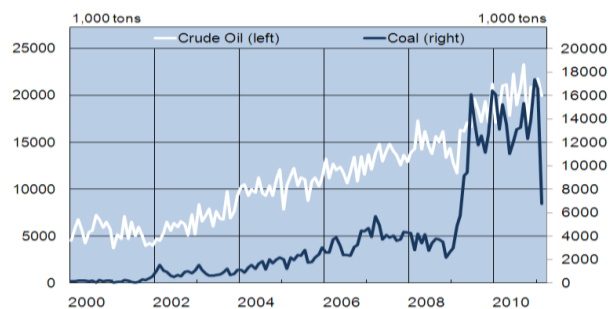
China's National Bureau of Statistics reports that China produced about 3 billion metric tons of coal last year, or about 45 % of global production. China's coal production increased 8 % and consumption rose 5 % last year. China is by far the world's biggest coal producer and consumer.

Despite a doubling of domestic coal production over the past decade, it has not kept up with soaring demand. As a result, China's coal imports increased 30 % last year, and as coal prices surged, the value of coal imports rose 60 %. Despite the rapid growth, coal imports in 2010 reached 170 million tons which only accounts for 5 % of China's total energy consumption.

Although coal production is a minor aspect of the Chinese economy, it has profound global impacts. China is now the world's second-largest coal importer after Japan, and during 2000–2008 China accounted for about 75 % of growth in global coal demand. Import growth was especially high in 2008–2009, when demand for coal outside Asia contracted sharply due to the global recession.

Coal provides about 70 % of China's primary energy consumption, and crude oil about 18 %. The volume of China's crude oil imports increased 17 % last year, accounting for 7 % of China's total energy consumption.

Volumes of crude oil and coal imports to China



Source: CEIC

Russia

Central bank continues with monetary tightening. Last Friday (Apr. 1), the Central Bank of Russia raised banks' mandatory reserve requirement for foreign liabilities from 4.5 % to 5.5 %, and from 3.5 % to 4.0 % for domestic liabilities. The CBR said the purpose of the move is to discourage flows of short-term foreign capital into the country, which high oil prices can boost. Capital inflows complicate central bank efforts to rein in inflation.

Consumer prices in March were up 9.5 % y-o-y. While the on-year rise was the same as in February, the on-month increase of inflation in March was lower than in February, falling to 0.6 %.

First results of last year's population census published. According to preliminary data gathered during the October 2010 census, Russia has a permanent population of 142.9 million persons. Since the previous 2002 census, Russia's population has shrunk by about 2 million persons or about 1.5 %. At the time of the break-up of the Soviet Union in 1991, Russia's population was 148.3 million, or 4 % more than today.

Between censuses the Russian State Statistical Service Rosstat makes estimates on the size of the population. According to the estimates, Russia's population has declined since the first half of the 1990s. In 2009 the decline came to an end, and at the end of the year Russia's population was estimated at 141.9 million persons. The October census revealed that Russia has about one million inhabitants more than what Rosstat had estimated.

According to the census, population decreases were witnessed in 63 of Russia's 83 regions over the 2002–2010 period. The sharpest population falls were seen in the Far East Federal District as Russians migrated west to regions in European Russia. The population of Russia's Far East has declined over 20 % since 1991. Following the 2002 census, the biggest population gains were seen in Russia's big cities and e.g. the North Caucasus region. The population of the City of Moscow climbed 11 % to about 12 million, while the City of St. Petersburg witnessed an increase of 4 % to nearly 5 million.

Some 74 % of the population lives in cities – and that share has not changed since 2002. The degree of urbanisation of Russia is about the same as for the EU.

After the world wars, Russia was left with considerably more women than men – a situation that has yet to rebalance. The female share of the Russian population even increased from 2002 census by 0.3 of a percentage point to 53.7 %. The trend reflects the exceptionally high mortality rates among working-age men, largely caused by extensive alcohol abuse. Although the average expected lifespan for men recently rose to 63 years, it is still at a level quite low

for a mid-income country like Russia. The average expected lifespan for Russian women is currently 74 years.

Gazprom loses market share in the European natural gas market. Russian gas giant Gazprom, which is state-majority owned, last year exported 139 billion cubic metres of natural gas to Europe, its main market area. The amount was smaller than during 2009 when the global recession hit consumption. In 2008, Gazprom exported 159 billion m³ of gas to Europe, and the company was expecting at least the same volume for 2010 – especially considering that gas consumption in Europe began to recover after the recession.

Gazprom figures show that 52 % of revenues last year came from exports to Europe. The company supplied 23 % of the gas sold in Europe, its lowest market share in six years. Gazprom blamed the trend on the sale of large quantities of low-priced LNG on European spot markets.

The lion's share of Gazprom gas is supplied to Europe under long-term contracts. Its contract prices were generally higher than spot-market prices last year. Gas prices under Gazprom long-term contracts are tied to prices of oil products with a certain lag.

Gazprom expects gas exports to Europe to return to growth this year. Growth should recover as prices on the spot markets rise. Gazprom has also agreed to discounts for their biggest European customers with whom they have long-term supply contracts. After the contract modifications, Gazprom has supplied 7 % of the gas it sells to Europe at the prevailing spot-market price.

With the boom of fracking (hydraulic fracturing) of oil shales in the US, Gazprom's plans to export liquefied natural gas (LNG) to the US are currently on hold. Earlier plans called for Gazprom to supply 10 % of US natural gas consumption by 2020. The company, however, believes shale gas over the long run will not boost global gas supplies substantially due to its high production costs. Some experts, on the other hand, expect the role of shale gas to increase.

Gazprom plans to invest heavily in LNG production. Gas liquefaction would increase flexibility in supply that to date largely uses rigid pipeline transmission. Gazprom accounted for just 2 % of global LNG sales last year, but it intends to increase that share to around 14 % by 2030.

The mighty Shtokman gas field in the Barents Sea is planned as a major source of LNG. The construction schedule for the Shtokman field should be finalised this year. Under preliminary plans, production was set to commence in 2016 or 2017, but market rumours now suggest that the true date when the field comes on stream is likely to be later.

Russia is also planning LNG plants in the Far East, which is the emerging focus of Russian gas exports.

China

PBoC raises rates again in battle to tame inflation. The People's Bank of China raised key interest rates a quarter of a percentage point, the fourth such hike in the past six months. As of Wednesday (Apr. 6), the benchmark one-year lending rate stands at 6.31 % and the one-year benchmark deposit rate at 3.25 %. As with the previous rates hike in February, the markets anticipated the central bank's latest move. Inflation roared to a 5 % p.a. level in recent months, and the government has declared it will subdue the rate back below 4 % this year.

China's central bank started the latest string of rate hikes last October in quarter-point increments, which means reference rates are a percentage point higher than six months ago. During the same period, the PBoC has also raised bank minimum reserve requirements.

Profitability of Chinese banks continued to improve last year. The China Banking Regulatory Commission (CBRC) reports that total net profits after taxes for the banking sector climbed by a third in 2010 to 899 billion yuan (€100 billion). Bank balance sheets increased about 20 % and staffing 5 %. The banking sector employed nearly 3 million people last year. The capital adequacy ratio of the banking sector rose to 12.2 %, while the stock of non-performing loans held by the largest commercial banks fell to 1.2 % of the total loan stock. The number of banks in China fell 2 % to 3,769.

Development of the banking sector reached a historical milestone when the share of total assets in the sector controlled by state-owned banks fell to less than half (49 %) of the sector's total assets. Highest growth was registered by commercial banks in rural areas and cities, as well as non-bank financial institutions. The public listing of the last of China's four giant state banks, Agricultural Bank of China, took place in autumn 2010. It was the largest IPO ever, raising \$22.1 billion. Private minority participation is already quite extensive in China's three other state banks (Industrial and Commercial Bank of China, Bank of China and China Construction Bank).

On the operations side, banks dealt last year with such issues as explosive growth in electronic banking services, implementation of modern risk management methods and state policy measures to tighten lending rules. In particular, stringent lending policies in the real estate market caused on-year growth in the lending stock to slow to 16.5 % y-o-y as of end-2010, slightly over half of the growth rate a year earlier.

China's largest banks expect lending policy in coming years to reflect the strategic directions laid out in the current five-year plan (2011–2015). Access to credit for real estate and in branches with heavy environmental impact is

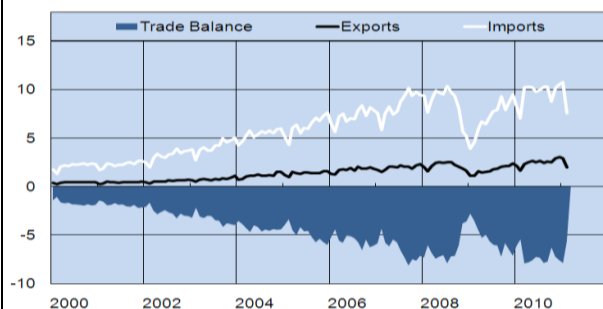
expected to remain tight, while the credit expansion will continue in the service sector, consumer credit and less-developed provinces. Banks and supervisory officials reject claims that the boom in real estate lending in recent years (including loans granted to off-budget real estate companies set up by local administrations) poses a threat to stable development of the banking sector.

No change in Taiwan's share of China's foreign trade. Exports from mainland China to Taiwan grew 45 % last year to about \$30 billion. Imports from Taiwan rose 35 % to \$116 billion. As in previous years, about 2 % of exports from mainland China went to Taiwan and 8 % of China's imports came from Taiwan. Mainland China accounts for about a fifth of Taiwan's foreign trade and is Taiwan's largest trading partner. Mainland China's share of Taiwan's total foreign trade remained unchanged.

Incremental implementation of the Economic Cooperation Framework Agreement (ECFA) signed last June has been underway since January. Under the ECFA framework, trade between China and Taiwan will be eased e.g. by reducing import tariffs ([BOFIT Weekly 24/2010](#)). ECFA will also make it easier for other countries to trade directly with Taiwan, which should improve the competitiveness of Taiwanese firms in Southeast Asia. The Taiwanese, however, have mixed emotions about ECFA as they fear closer cooperation may lead to tighter political integration with mainland China.

In any case, the economic integration of mainland China and Taiwan seems to be intensifying. The Taiwanese have suggested permitting mainland Chinese investment in Taiwanese technology firms. Some 90 % of laptop computers are built in Taiwan, and new rules would open the way to Chinese investors in Taiwan's most globally competitive firms. Allowing investment would give Taiwanese firms the possibility to form strategic alliances with Chinese clients and suppliers. Possibilities for cooperation in the high-tech and clean energy technology sectors have also been brought up. The combination of Taiwan's technological expertise and the size of mainland China's markets could have an effect on renewable energy industries in such fields as solar power.

Monthly China-Taiwan trade, US\$ billion



Sources: CEIC, China customs

Russia

Despite rapid import growth, Russia's trade surplus kept expanding in first quarter. Preliminary balance-of-payments figures from the Central Bank of Russia show Russia's trade surplus in 1Q11 was \$48 billion. The quarterly current account surplus was the biggest since 2008.

The value of exports reached \$113 billion, an increase of 22 % y-o-y. Crude oil, oil products and natural gas accounted for 68 % of total exports.

Imports picked up steadily for most of 2010. In the first quarter of this year, imports were up 41 % y-o-y and valued at around \$65 billion.

Russia traditionally runs a services deficit – and the first quarter was no exception. The deficit amounted to \$5 billion, an increase of 18 % y-o-y for the period. Revenues from services amounted to \$10 billion, while spending on services reached \$15 billion. Service revenues were up 8 % y-o-y and spending up 12 % y-o-y in the first quarter. Russia's services earnings are largely generated from transport and logistics, while the biggest spending on services goes to tourism.

The current account surplus in the first quarter was nearly \$32 billion. Large capital exports from Russia reduced growth in the foreign currency reserves to just \$10 billion. At the end of 1Q11, the CBR's gold and currency reserves stood at \$502 billion.

The surge in private sector capital exports began in the 4Q10 and remains a concern for officials. A preliminary CBR estimate found that the net capital exports by the private sector 1Q11 exceeded \$21 billion, matching the 4Q10 level. Some \$7 billion of that was exported by banks and \$14 billion by others in the private sector.

Explanations for the high capital exports are elusive. Expensive oil should induce ruble appreciation and suck capital into Russia. Some analysts attribute the capital outflows to the 8-percentage-point increase in the mandatory social tax contribution of firms at the start of 2011. It may have encouraged firms to shift operations to other CIS countries to take advantage of lower tax rates. CBR chairman Sergei Ignatyev said the reason may be of a more fundamental nature, suggesting Russia's operating environment for businesses, which is perceived as problematic by many domestic and international investors.

Economic development ministry updates its 2011 forecast. Trends of recent months have caused Russia's economic development ministry to adjust its forecast assumptions. For example, it lifted its assumed average price of crude oil this year from \$81 a barrel to \$105 a barrel. The average price of crude oil on world markets was \$102 a barrel in the first three months of this year.

On the other hand, consumption and investment growth were reduced from the earlier forecast. Real incomes of Russians are expected to rise just 1.5 % this year, and retail sales will grow 4 %. Investment is now expected to increase 6 %, which is the same rate of growth as last year. The economy ministry said its reduction in the investment growth outlook largely reflected changes in investment activity of big firms. Gazprom, for example, trimmed its investment plans for this year by 40 %. Other companies cutting back on investment include Russia's state railways, several energy producers and carmakers.

Despite the above-mentioned modifications, the economic development ministry expects GDP to rise 4.2 %, the same rate as in its earlier forecast. The ministry predicts on-year inflation to slow in December to 7.5 %, while the ruble's exchange rate is expected to weaken slightly to a rate of 28.4 rubles to the dollar.

If the higher forecast for crude oil prices materialises, the finance ministry says the federal budget deficit will shrink this year to 1.0–1.4 % of GDP. The budget deficit was initially forecast to hit 3.6 % of GDP this year.

The IMF's *World Economic Outlook, April 2011* forecasts Russian GDP will grow 4.8 % this year.

Economic development ministry downgrades its 2012–2014 forecast. The basic scenario of the renewed forecast from the economic development ministry lowers the GDP growth outlook to 3.5 % in 2012, 4.2 % in 2013 and 4.6 % in 2014. The forecast is based on a fairly cautious oil price assumption that puts the average price of oil at \$93 a barrel in 2012, with a gradual rise to \$97 a barrel in 2014. The IMF *World Economic Outlook* sees Russian GDP growing 4.5 % next year.

The economic development ministry and the finance ministry have a long-running dispute over the role of fiscal policy as an engine of economic growth. The economic development ministry, which sees GDP growth constrained by tight fiscal policy, has proposed increases in public investment to boost development of new production areas and modernise production to make Russian industry more competitive. The related public expenditure would increase the budget deficit and require more borrowing. The finance ministry argues that Russia needs to stay focused on balancing the budget and preparing for downswings in the business cycle by building up a buffer from oil tax revenues. It currently appears that the economic development ministry has lost the debate and adopted the finance ministry's more rigid budget assumptions.

The economic development ministry forecast assumes investment growth will average of 9 % p.a. in 2012–2014. Public investment should increase just over 3 % a year, about the same rate as in 2010. It forecasts real incomes will increase at 4 % p.a. in the 2012–2014 period.

Inflation is expected to slow to the range of 4–5 % by the end of 2014.

China

IMF sees strong growth for China in coming years. The IMF's latest *World Economic Outlook, April 2011* sees relatively stable growth ahead for the global economy overall with uneven rates of recovery. Advanced economies will continue to struggle with slow recoveries, while emerging and developing countries are more likely to face economic overheating and inflationary pressures.

The IMF predicts China will enjoy robust economic growth of around 9.5 % this year and next. The forecast is in line with that of the Asian Development Bank (ADB), while the World Bank has offered a more cautious estimate. China's private sector is expected to drive growth with private consumption fuelled by a rapid credit expansion, a good jobs market and public sector policies. The IMF, however, is concerned about China's inflation rate and current account surplus, which it believes is poised to start rising again. To rebalance China's economy and alleviate global imbalances, the IMF calls on China directly to let the yuan appreciate faster than at present as a stronger yuan would support household consumption and promote development of the service sector as touted by China's leadership. The IMF expressed rising concern that management of credit aggregates, used to exercise macro-economic control, is being undermined by banks' financial innovation and off-balance-sheet activities.

The IMF expects Russian growth to accelerate slightly this year, although it will be constrained by the banking sector's ability to provide credit for private consumption. The Fund said it was concerned that inflation could surpass 9 % this year, but praised Russia for increasing flexibility in the rouble's exchange rate. Given the considerable banking risks facing Russia, the IMF called for strengthening capital adequacy requirements, enhancing supervisory powers and implementing legislation on consolidated supervision and connected lending.

IMF annual GDP forecasts, %

	2009	2010	e2011	e2012
World	-0.5	5.0	4.4	4.5
Advanced economies	-3.4	3.0	2.4	2.6
Emerging and developing economies	2.7	7.3	6.5	6.5
China	9.2	10.3	9.6	9.5
Russia	-7.8	4.0	4.8	4.5

Source: IMF *World Economic Outlook, April 2011*

Chinese exports boomed in March. The value of March exports increased 36 % y-o-y to \$152 billion. Imports grew 27 % to \$152 billion. The trade balance, which had shown a \$7 billion deficit in February, returned to balance

in March. High prices for raw materials caused China to post a trade deficit in the January-March period, the first quarterly trade deficit for China since 2004.

The increase in the value of March imports was due largely to higher raw material prices; import volumes rose only modestly compared to March 2010. The volume of crude oil imports flowing into China in March was up a mere 3 % y-o-y, while the value of imports lurched 37 %. Similarly, the volume of iron ore imports rose less than 1 %, while the value of iron ore imports soared 60 %.

Being the world's largest exporter, recovery from the global financial crisis and reviving private consumption in many countries benefits China. China's export growth was particularly strong vis-à-vis Russia (up 63 %) as well as ASEAN countries (up 40 %). Exports to Japan were up 37 % y-o-y in March. So, the tsunami and nuclear catastrophe in Japan did not have a considerable effect on China's foreign trade in March.

Economic cooperation tops agenda in visit of Brazil's president to China this week. On a per capita basis, China is considerably poorer than its South American BRIC partner. While China's nominal GDP is triple that of Brazil's, GDP per capita is only about half. Recently the paths of economic development in both countries have shown some strong parallels. Both countries experienced high GDP growth in 2010 (7.5 % in Brazil; 10.3 % in China). Fighting inflation has become the main focus of monetary policy. 12-month inflation rate has accelerated to 5 % in China and above 6 % in Brazil during the recent months.

China-Brazil bilateral trade is thriving. However, while China is now Brazil's top trading partner, accounting for about a sixth of foreign trade, Brazil still represents only a few percent of China's foreign trade. The most important categories in bilateral trade are various types of machinery and electronics. Brazil has significant clothing imports from China and China imports raw materials from Brazil. Trade relations can sometimes get strained as Brazil competes with China in some markets and China's growing economic influence is sometimes seen as a threat in Brazil. Brazil has also criticised China for its exchange rate policy.

China's interest in Brazil is driven by the country's vast natural resources. China supports development of those resources in numerous ways. For example, Sinopec, China's state-majority-owned oil company, is the biggest buyer of Brazilian oil. Last autumn Sinopec acquired the rights of the Spanish Repsol to develop Brazilian oil deposits. Petrobras, Brazil's state oil company, has funded its off-shore oil exploration with money borrowed from China. The Chinese have also invested in development of Brazilian ore reserves and food production. Furthermore, China has provided financing for infrastructure projects in Brazil to make it easier to move raw materials to China.

Russia

State banks moving aggressively to gain share in the finance sector. Sberbank, Russia's largest bank and majority-owned by the Central Bank of Russia, has agreed to acquire Russia's oldest investment bank, privately held Troika Dialog. The deal diversifies Sberbank operations, giving it a prominent role in Russian investment banking. The deal should be finalised by the end of this year and the merger completed by 2013.

Russia's second largest bank, state-owned VTB, is also focusing intensely on investment banking. VTB24, the VTB Group's retail bank, has grown rapidly through, among other things, bank acquisitions. At the start of 2011, VTB purchased Russia's fifth largest bank, Bank Moskvyy, from the City of Moscow. A privately held bank, Alfa, was also interested in acquiring Bank Moskvyy.

Some experts are concerned about the consolidation of state banks' position in the finance sector. According to Oleg Vyugin, CEO of the private MDM Bank and former head of the Federal Financial Markets Service, state banks are preventing the growth of private banks. They e.g. benefit from access to considerably cheaper credit than private banks.

At year's end, 25 % of Russian banking sector capital was of foreign origin. In addition to the 80 fully-foreign-owned banks operating in Russia, another 31 banks are majority-owned by foreign investors. Of course, the "foreign" owners in some cases are likely Russian as investment is made via registered firms from abroad.

Among the wholly-foreign-owned banks, the biggest in terms of capital are the Austrian Raiffeisenbank, the Italian Unicredit Bank, the French Société Générale Vostok and its subsidiary Rusfinans Bank, and the Italian Bank Intesa. All of these banks have operated a long time in Russia. Russia does not allow foreign banks to set up branches; under Russian law, foreign banks are expected to operate as independent subsidiaries.

The recession was tougher for foreign banks that have only operated on the Russian market for a few years than for foreign banks that had established themselves in the early 2000s during the period of rapid economic growth. Latecomer banks were hit hardest by the recession as they failed to sufficiently increase market share to weather the crisis. Some banks have already closed their doors or are planning on pulling out of Russia. In some cases, retreat was due to trouble with the parent bank that forced to close less important foreign operations. Last year, for example, the Spanish Santander divested its Russian operations, and the Swedish Swedbank began to take steps to pull out of retail banking. UK-based Barclays announced in February plans to sell its retail banking operations in Russia.

Russia and Ukraine emerge with little to show from customs union and gas supply talks. At the meeting of Russian prime minister Vladimir Putin and Ukrainian prime minister Mikola Azarov last week in Kiev, Ukraine requested that Russia lower the price of natural gas that it supplies to Ukraine. The terms on gas deliveries were agreed in 2009 by Putin and Ukraine's then-prime minister Julia Tymoshenko. Ukraine's current government sees that the country at that time agreed to pay a premium for Russian gas. Ukraine also asked Russia to lower barriers to imports of products critical to Ukraine's export sector.

In response, prime minister Putin invited Ukraine to join the Russia-Belarus-Kazakhstan customs union. He said that Ukraine would benefit annually from membership between \$6 billion to \$9.5 billion from easier market access. The amount apparently largely comes from the removal of export tariffs on Russian natural gas exports to Ukraine. Ukraine's economy, particular the important iron and steel branches of the export sector, are highly dependent on Russian energy imports.

Ukraine is currently negotiating a free-trade agreement with the EU. The free-trade agreement is part of an EU-Ukraine association agreement (AA) under preparation. The parties aim at concluding their free-trade agreement talks by the end of this year. Commenting on EU-Ukraine talks, Putin said he was worried that if the free-trade agreement lowers tariffs significantly, it would increase the flow of imported goods to the Ukrainian market harming the competitiveness of Ukraine's own products. As a result, Ukrainian goods could flow to Russia, Belarus and Kazakhstan. In this end, Putin said, retaliatory measures would be invoked against Ukrainian exports.

Ahead of the prime ministers' meeting, Ukraine's president Viktor Yanukovich said that his country was uninterested in customs union membership. Yanukovich instead proposed a free-trade agreement between Ukraine and the customs union. Igor Shuvalov, Russia's first deputy prime minister, said Ukraine may find it difficult to reconcile membership in two free-trade areas.

During his visit to Ukraine at the start of the week, France's prime minister François Fillon said that Ukraine's association agreement with the EU and membership in the Russia-Belarus-Kazakhstan customs union were not per se in conflict. Fillon noted, however, that moving forward with the AA could get difficult if Ukraine pushed for both at the same time.

Kyrgyzstan government to launch negotiations with Russia-Belarus-Kazakhstan customs union. Some 45 % of Kyrgyzstan's foreign trade is with Russia, Belarus and Kazakhstan. Kyrgyz merchants make considerable money buying goods in China and reselling them in Kazakhstan. Kyrgyzstan seeks to preserve this reselling business through customs union membership.

China

New quarterly statistical data suggest slowing economic growth. The latest figures from China's National Bureau of Statistics (NBS) show real GDP increased 9.7 % in the first quarter of 2011, a tiny drop from the 9.8 % y-o-y GDP growth in 4Q10. In 2010 – no matter whether one looks at the entire year or the first quarter – growth was driven by investment rather than consumption. In the first quarter of 2011, however, the contribution of consumption to growth was greater than that of investment. The contribution of net exports to growth in 1Q11 was slightly negative.

Although China's economic growth remains strong, the first quarter-on-quarter data ever released by the NBS suggest that growth is slowing. NBS figures show China's GDP grew 2.4 % q-o-q in the last quarter of 2010, which translates to an annual rate of 10 % y-o-y. In the first quarter of 2011, the 2.1 % q-o-q growth annualises to a rate of 8.7 %. Although for the time being the NBS has only published the growth figures for 4Q10 and 1Q11 and has given no indication as to how quarterly GDP growth is calculated, the new practice indicates increased sophistication in China's statistical systems and makes monitoring of the country's economic trends substantially easier.

Industrial output climbed nearly 15 % y-o-y in March and retail sales 12 %. Real disposable incomes of city-dwellers increased about 7 % in the first quarter, while first-quarter real growth in monetary incomes (the earnings measure used in this case) of rural residents was up 14 % y-o-y.

China's real GDP growth, y-o-y change (%)



Sources: NBSC, BOFIT

As inflation accelerates, China's central bank further tightens monetary policy. Following the release of the March economic figures, the People's Bank of China raised bank reserve requirements a half percentage point effective today (Thursday, April 21). After the increase, the reserve requirement ratio for the largest banks is

20.5 % of deposits. China's government began to tighten monetary policy in January 2010 and since then the reserve requirement has been gradually increased by a total of five percentage points. Starting last autumn, the PBoC has also incrementally raised reference credit and deposit rates a total of one percentage point and encouraged banks to restrain lending.

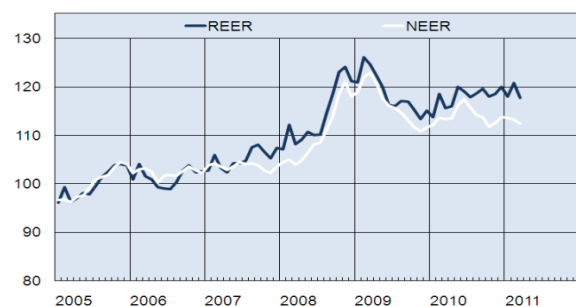
Central bank governor Zhou Xiaochuan said monetary tightening must continue to get inflation under control. 12-month inflation accelerated to 5.4 % in March. Food prices were up 11.7 % y-o-y, housing 6.6 % and pharmaceuticals and healthcare 3.2 %. While the rise in prices has been modest in many product groups, inflation as a whole has accelerated in non-food categories. This increases the risk of rising inflation expectations despite the fact that the bulk of the acceleration in the inflation rate still reflects high prices on the world market for raw materials and food.

Ballooning foreign currency reserves add to yuan appreciation pressures; no real yuan strengthening in the past 12 months.

Central bank deputy governor Hu Xiaolian said that the flexibility of the yuan's exchange rate could be increased to deal with external price pressures. There is huge pressure at the moment for yuan appreciation, despite the fact that China's trade showed virtually no surplus in the first quarter. China's foreign currency reserves climbed by \$197 billion in January-March to \$3,045 billion. That growth nearly matched the record rate of growth at the end of 2010. Foreign direct investment inflows to China accounted for \$30 billion of the growth in currency reserves during the first quarter.

Since the beginning of this year, the yuan's exchange rate has appreciated less than 1 % against the US dollar and lost over 5 % of its value against the euro. Using the real effective (trade-weighted) exchange rate, or REER, the measure preferred in assessing competitiveness and exchange rate trends, the yuan's exchange rate has remained unchanged for a year now. The nominal effective exchange rate (NEER) actually weakened a bit over the last 12 months.

Yuan effective exchange rates (REER and NEER), 2005=100



Source: BIS

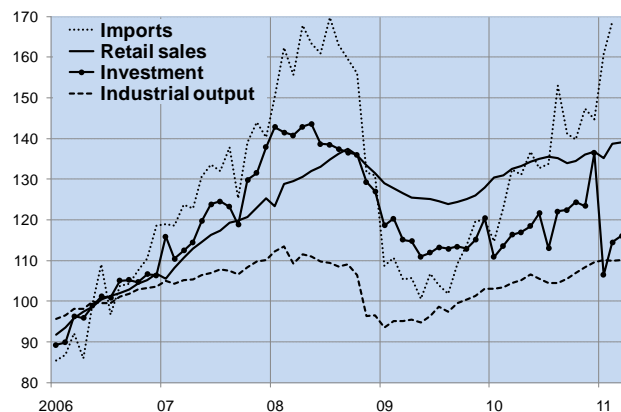
Russia

Insecurity characterises first-quarter economic performance. After a feeble January, the Russian economy bounced back in February and March. Recovery was apparent in retail sales, the main item of domestic demand. The volume of retail sales increased in the first quarter almost 5 % y-o-y and reached the pre-crisis peak of autumn 2008. The volume of food sales, however, was up just 1 % y-o-y, while sales of non-food goods roared ahead. Retail sales of non-foods were up 8 % y-o-y.

High inflation, in particular, may threaten the development of consumption in the near future. It has eroded real household incomes, dragging them down 3 % y-o-y in the first quarter according to statistics. However, the increase in the social tax in January may have caused employers to go “grey” and pay a bigger part of salaries under the table, i.e. without registering them, which might explain part of the decrease in income.

Investment recovered in February-March, but was still down more in 1Q11 than in 1Q09 or 1Q10. Investment is still more than 20 % below the pre-crisis peak.

Seasonally adjusted core demand and production items (volume indexes, 2006 = 100)



Sources: Rosstat, BOFIT, World Bank

Industrial output was up nearly 6 % y-o-y in the first quarter, and manufacturing was up over 10 %. Production of mineral extraction industries saw low growth with only tiny increases in crude oil and natural gas output.

The recovery in GDP growth that began in winter, continued relatively brisk. The economy ministry preliminarily estimates that GDP increased 4.5 % y-o-y in 1Q11.

The boom in imports continued with the value of imports rising about 40 % y-o-y in the first quarter. The seasonally adjusted value of imports actually exceeded pre-crisis levels. Preliminary data also suggest the volume of imports reached back to pre-crisis levels.

Budget revenues up sharply; slight increase in spending. Finance ministry figures show the federal budget is on track to take in 1.46 trillion rubles (€36 billion) in additional revenues above its original forecast. Most of the revenue boost is attributed to higher tax revenues on crude oil due to the surge in world prices.

The higher revenues will be used to reduce the budget deficit, which is now expected to stay below 1.4 % of GDP this year. Part of the unexpected earnings will be transferred to the Reserve Fund to cover future fiscal shortfalls. At the end of 2011, the finance ministry expects the Reserve Fund to reach 1.5 trillion rubles, which corresponds to about 3 % of GDP.

At the end of last week, the government approved its first supplemental budget for 2011; federal budget spending will rise about 360 billion rubles (€9 billion) in reflection of higher tax revenues. The spending hike represents a slightly greater than 3 % increase from the original figure.

Most of the extra spending will go to the social sector; some 74 billion rubles will be used to cover the deficit in the Pension Fund in anticipation of a possible extra increase in pensions at the end of the summer. If inflation exceeds 6 % in the first half of this year, pensioners get an additional raise. It is now expected that the index trigger will be activated; consumer prices were up 3.8 % in the first three months of the year.

Some 62 billion rubles (€1.5 billion) of the supplementary budget will be invested by the state as foundation capital in a “Direct Investment Fund” currently being put together. President Medvedev introduced the idea of establishing a national investment fund at the last summer’s economic forum in St. Petersburg. The fund’s purpose is to participate in important projects that foreign investors carry out in Russia and thereby attract foreign investors. The fund will be administered by Vnesheconombank and its capital will gradually be raised to \$10 billion. Project participation of the fund would typically be 10–25 %.

IMF commends Russian officials for efforts to stabilise banking sector during financial crisis.

Although state support measures strengthened large banks and reduced competition among banks, the IMF said the Russia’s banking sector overall is rapidly recovering from the recession. However, the sector’s development will also in future depend on global business cycles. The IMF noted that while bank supervision still does not conform to international standards, the situation should be improved by legislation currently before the Duma.

The British HSBC, one of the world’s largest banks, announced Monday that it was terminating its retail banking business in Russia. HSBC will now concentrate on corporate and investment banking activities in Russia, just like Swedbank, Barclays and Morgan Stanley that recently pulled out of retail banking in Russia.

China

Trucking firms protest rising costs. International news agencies report that truckers held protests and halted movement of goods in some parts of the world's largest container port in Shanghai. The actions by mainly independent trucking companies were in response to rapidly increasing costs. The companies have to face higher fuel prices and various taxes, tolls and fees charged by officials and harbour operators. The Shanghai city government, after arresting many striking drivers, caved to demands last weekend by demanding that harbour operators eliminate or lower certain fees imposed on truckers.

China's taxi firms, also hit hard by higher fuel prices, last week forced the government to concede permission to charge higher fares and work rule changes, as well as help with certain expenses. Inflation is an exceptionally delicate subject in China. Domestic news coverage made no mention of the events in Shanghai.

China's government this year has already raised fuel prices twice (a total rise of about 10 %). The increases were smaller than the rise of crude oil prices on the global markets or what the government's new and more flexible fuel pricing policy adopted in 2009 would have suggested. Although the price of imported oil was about one third higher in March than a year earlier, the price of transport fuels has increased only 12–17 % in the same period. As a result, the government must compensate oil refiners for losses caused by higher oil prices to assure that they continue to meet their supply obligations. This week, the price of a litre of regular gasoline averaged around €0.80 in China, €0.70 in the US and €1.60 in Finland.

European companies want easier access to China's massive public procurements market. The recent publication on public procurement of the European Union Chamber of Commerce in China criticises the current system as inconsistent and discriminatory. The report finds foreign firms do not receive equal treatment in public procurements. European firms interviewed for the report complained that information about upcoming projects was not revealed in time and that the criteria for supplier selection remain unclear. Lower-level administrations often decide on procurements, which increases supplier costs in bid preparation and lowers transparency. Moreover, European bidders have little opportunity to appeal when a decision appears unfair.

The report estimates that the value of all forms of public procurement in China corresponds to 20 % of GDP. China itself has suggested far more modest numbers. China has observer status in the WTO government procurement agreement (GPA) and is seeking full member status. GPA countries rejected China's 2007 and 2010 applications for full membership.

Trade ministers of China, Japan and South Korea met to continue work on drafting an investment policy agreement. The agreement has been under preparation for several years. While the details have yet to be made public, such investment agreements typically call for elimination of barriers to investment between the party nations and seek protection for investments and intellectual property. At the same time, the ministers accelerated drafting of a trilateral free-trade agreement. The countries form a core of foreign trade as Japanese and Korean electronics makers and firms serving the car industry have production in China. Japan and South Korea together last year accounted for over 10 % of China's exports and nearly a quarter of China's imports.

All three partners already have free-trade agreements with the ASEAN-countries. Current negotiations are part of the Asia's economic integration, driven in part by rapid wealth accumulation in the region. In addition to regional and bilateral free-trade arrangements, there has also been modest progress in integration of Asia's financial sector with the ASEAN+3 regional liquidity support facility (Chiang Mai initiative), which entered into force a year ago. Progress in integration, however, remains problematic due to national differences, competitive strains and dependence on markets in the developed world. Another brake to integration is fear of Chinese dominance.

The disasters in Japan, which will take years to deal with, added colour to the ministers' meeting. The investment agreement would improve the opportunities for Chinese and South Korean firms to participate in Japan's reconstruction. Production stoppages in Japan in recent weeks have led to component shortages at car plants and electronics factories around the world, also in South Korea and China.

Foreign trade figures show trade between China and Japan in March was not impacted by the event in Japan; China's imports from Japan showed the same trends as imports from elsewhere.

China total imports (left scale) and imports from Japan (right scale), USD million



Source: CEIC

Russia

CBR keeps raising rates. The Central Bank of Russia increased its key deposit rates and certain credit rates by 25 basis points, effective Tuesday (May 3). The deposit rates now stand at 3.25 %. The minimum interest rate for one-day and seven-day repo auctions increased to 5.5 %, while fixed repo rates still remained unchanged at 6.75 %. Since the CBR halted its monetary easing policies last summer, deposit rates have been raised three times (the first hike occurred in late 2010) and various CBR credit rates twice (first hike on March 1).

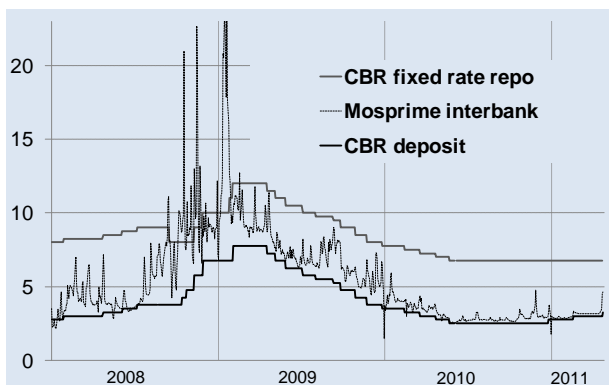
Russia's banking sector currently has plenty of liquidity, and from the standpoint of tightening monetary policy CBR deposit rates exert much greater influence than CBR credit rates. CBR deposit rates provide a basis for setting interbank rates.

The latest hikes signal, as the CBR stated, concerns about high inflation expectations. It sees the surge in food prices subsiding but inflation sustained by monetary factors.

Bank reserve requirements, which have been raised three times since the beginning of February, were allowed to remain unchanged in the CBR monetary policy assessment in April. Central bank bonds, which, along with required reserves and other deposits, are among the CBR's main monetary policy debt instruments, have not been sold by the CBR quite as actively as last year.

This year the high world prices of oil and Russia's other basic export commodities have driven large current account surpluses, which exceeded the unusually high net capital outflows. This has continued pressure for monetary tightening. The CBR was active in buying foreign currency in the first four months of this year to partly contain ruble appreciation pressures, thus increasing liquidity in the system. Partly the CBR has conceded to the appreciation pressure by allowing the ruble to rise about 5 % this year against its dollar-euro currency basket.

One-day money market rates in Russia, %



Source: CBR

Russia imposes ban on gasoline exports. The ban arose from the current fuel shortage in Russia and will last at least through May. Shortages have been reported in about ten regions, including the City of St. Petersburg. Deputy energy minister Sergei Kudryashov said most of the shortage concerns gasoline; diesel fuel supplies are guaranteed. The export ban naturally balanced the situation.

The government also decreed that, effective May 1, the export tax on gasoline increased to \$408 (\approx €270) per metric ton, a 44 % increase from April.

In fact, the volume of Russia's gasoline exports has been on a declining trend for several years, and only a small amount of gasoline produced is exported. In the second half of 2010, only 5–6 % of production went to exports. For all of 2010, Russia exported slightly less than 3 million tons. Gasoline export earnings of just \$2 billion accounted for 0.4 % of Russia's total export earnings.

Gasoline production in Russia has remained fairly stable in recent years, while gasoline consumption has risen steadily. As the gap between production and consumption has shrunk, production dips such as in February and March, can more easily impact consumption than earlier.

Lukoil's deputy CEO Leonid Fedun said the current shortage reflects mainly domestic price regulation and increasing domestic demand for gasoline caused by the increasing number of cars in Russia. Indeed, the stock of passenger cars grew even in the recession in 2009, when the stock exceeded 33 million. In 2010, domestic car production and net imports recovered to nearly 2 million cars.

Russian officials also noted distribution problems caused by different gasoline prices in different regions. Kudryashov said another reason for the current shortage has been the introduction of new technical standards for Euro 3 low-sulphur refining introduced in January. Some refiners have been unable to meet the new rules, which have hampered refinery operations.

Gasoline producers, like crude oil and fuel oil producers, face a two-front pricing scheme. Export prices are typically higher than domestic producer prices. The difference in gasoline prices, which has historically ranged from €50 to €90 a ton (15–25 % of export prices), began to widen last summer and by winter had reached about €160 a ton (\approx 30 % of the export price). The state uses export duties to adjust for the price differential.

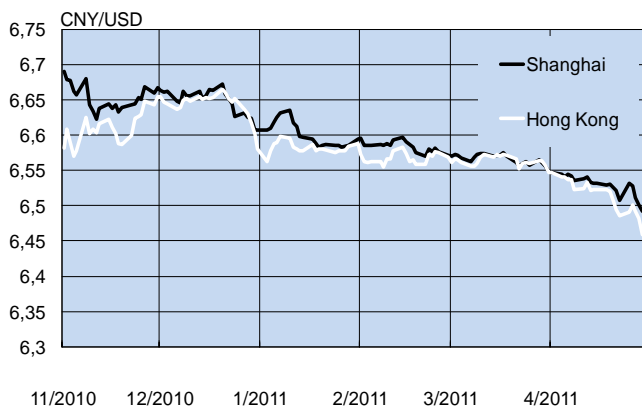
Retail gasoline prices have risen modestly in Russia in recent years, even as the recession came to an end last year. In January 2011, the retail price rose to its pre-crisis peak, partly due to a rise in the excise tax, and was up about 15 % y-o-y. In February, the government limited gasoline price hikes, causing prices to drop slightly, while prices surged again at the start of May, with 95-and-more-octane gas now over 26 rubles (€0.65) a litre. Prices vary considerably across regions, with the average price ranging last winter from 22 to 30 rubles a litre (not counting a couple of remote regions).

China

Yuan appreciation against the dollar gains steam. The yuan's exchange rate has fallen below the 6.5 yuan-to-the-dollar. Yuan futures are trading at a year-end target below 6.4, suggesting markets expect the appreciation trend will continue. The widening spread between the official exchange rate (CNY) and the Hong Kong offshore rate (CNH) also indicates rising appreciation pressure. The recent trend confirms the People's Bank of China's message that greater exchange rate flexibility will be allowed to reduce inflationary pressures.

The change in exchange rates is still so small that it has no impact on the external imbalance of the Chinese economy or the current account surpluses that have chafed trade relations. The yuan has continued to devalue against the euro and has remained fairly stable against the Japanese yen. The US dollar's weakness in the currency markets reflects the US Federal Reserve's decision to stay with its accommodative monetary stance. In China, monetary tightening is in full swing, and the eurozone has begun to exit the recession with a rate hike.

Yuan-dollar exchange rate



Source: Bloomberg

Korea's central bank hopes to invest some of its reserves in yuan-denominated securities. It has applied to the PBoC under the Qualified Foreign Institutional Investor (QFII) programme. Three other central banks (Norway, Malaysia and Hong Kong) are already on the QFII list.

Data for China sixth census suggest changing population structure. New census data released on April 28 show China's population has become increasingly urbanised, population growth has slowed, and the age structure is changing. China's population grew about 6 % from the previous 2000 census, with the rate of growth slowing.

The number of people living in cities increased more than 10 %.

Part of the slowing in population growth is a consequence of China's one-child policy. The number of children under 14 years fell 6 percentage points (pp) from the previous census to 17 % of the population, while the share of people over 60 increased 3 pp to 13 % of the population. These new figures show the number of people of working age in China has yet to shrink. However, in e.g. Shanghai, the share of individuals over 60 now exceeds a fifth of the total city population, which is adding to pressures to develop senior care institutions. Traditionally, children have been expected to care for their elders in China, but this arrangement has become fairly challenging for both the young and old due to the one-child policy.

For the first time, the census was based on the actual residence to get a better picture of the degree of Chinese urbanisation, given that many migrant workers from the country live in cities. In 2010, over 250 million Chinese lived elsewhere than their registered domicile, which meant that the number of migrants has grown over 80 % from the previous census. The huge number of migrant workers burdens development of city healthcare services, energy supply and infrastructure.

World Bank warns of real estate market risks to the Chinese economy. The World Bank's latest quarterly survey for China finds the government's balancing between increasing housing prices driven by market pressures and the need to apply monetary tightening measures could lead to a slowdown in construction activity. The slowdown could impact on big industries such as steel and cement that serve the construction sector. Construction investment is a substantial part of GDP, and local governments play a huge role in determining construction investment. The World Bank analysts note that a substantial slowdown in construction would have broad macroeconomic consequences and could erode bank balance sheets. Fear of slowdown in property construction is diffused by the Chinese government's ambitious social housing construction goals set forth in the current five-year plan.

Official tightening measures such as increasing cash downpayment on housing, stricter lending rules and trial introduction of real estate taxes in few large cities have failed to stem the rise in housing prices. According to Soufun Holdings Ltd., a small uptick was registered in April when prices in 77 Chinese cities rose 0.4 % m-o-m. In Shanghai, housing prices rose 0.32 % from the previous month and 2 % y-o-y. In Beijing the drop in April was 0.14 % from March, but an increase of 4 % y-o-y.

It is difficult to determine the overall state of the housing market due to regional differences and changes in the statistical methodology at the start of this year that makes it difficult to compare new figures with previous years.

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.

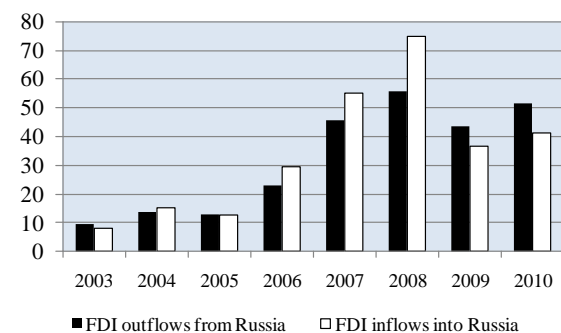
Legislation is currently being drafted to give responsibility for compiling official statistics on foreign investment solely to the central bank. The CBR has begun to prepare figures on the structure of investments, which would dramatically improve the quality of current reporting. At the beginning of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



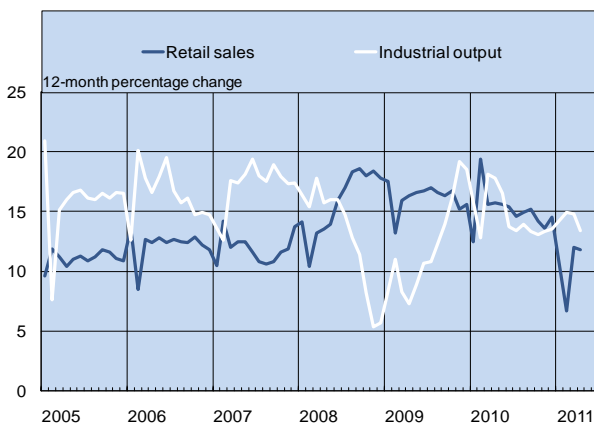
Source: Central Bank of Russia

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.

Russia

GDP grew rapidly in the first quarter. Preliminary Rosstat figures show GDP grew 4.1 % y-o-y. The economy ministry's earlier-released preliminary figures indicated 4.5 % growth. Seasonally adjusted GDP climbed at a good pace in the first quarter, up 1.3 % q-o-q. GDP was only a couple percentages below its 2Q08 peak.

The rate of first-quarter GDP growth was dragged down by a sharp drop in capital investment and the ongoing boom in import growth. Growth was fuelled by brisk consumption growth, and according to preliminary figures rapid growth in the volume of exports.

Manufacturing industries fared variably during the recession. Many of Russia's primary domestic producers, including producers of oil, gas and electricity, as well as farmers, were scarcely touched by the global financial meltdown. In contrast, construction and manufacturing were hit hard by the downturn.

Manufacturing output overall fell from its quarterly peak about 25 % before hitting bottom. Despite a rapid recovery, production in 1Q11 was still well below the 2008 peak. The structure of manufacturing appears not to have returned to its previous stand, so far, as many branches sustained different impacts from the recession.

One of the largest manufacturing branches, Russia's food industry, contracted only slightly in the recession and has seen steady growth, for a year at levels above the pre-crisis level. Production, however, dipped in 1Q11.

At the other extreme, the machinery & equipment industries and the construction materials industry, which produce largely for domestic investors, saw steep declines in the recession and are still about 25 % off their pre-crisis peak; even if one part of the machinery & equipment segment, defence production, saw growth of over 10 % a year throughout the recession. Government subsidies for consumption and production have helped manufacturing of vehicles rebound to levels of the summer 2008 peak.

Developments in branches manufacturing both for the domestic market and exports were varied. Production of oil products was relatively scarcely touched by the recession, and production has grown, at levels surpassing pre-crisis highs. The chemicals industry and the plastics & rubber industry, as well as metals production rebounded from deep dips well with chemicals and plastics & rubber industries surpassing pre-crisis levels. Production in the hard-hit forest industries remain far off their 2008 highs, partly due to a decline this past winter.

Study explores rise in Russian living standards, increased income disparity and changes in consumption patterns. A joint survey conducted by the Moscow Higher School of Economics (*Vyschaya shkola ekonomiki*) and

Russia's leading economy magazine *Expert* examined changes in the living standards of the Russians and their material well-being between 1990 and 2009. Living standards and well-being were determined using a variety of measures related to e.g. incomes and income distribution, purchasing power and consumption patterns, as well as the kinds of household goods stocked in Russian homes.

Per capita consumption was estimated to have risen on average 45–50 % between the early 1990s and 2009. Depending on the statistical data used, however, the results vary considerably. The study found that purchasing-power-adjusted income per capita increased 45 %, while the volume of consumption per capita more than doubled according to GDP-based consumption figures (the difference is not explained by increased savings).

The relatively modest change of purchasing power in relation to the time span is explained by the drop in household income after the collapse of the Soviet Union. Real incomes only began to increase after the 1998 financial crisis and really only took off in the roaring boom of the 2000s. The researchers also note shortcomings in the data that diminish their reliability and comparability of Soviet-era figures with figures based on current methods.

Thus, regarding incomes, either 40 % or 80 % (depending on the measure) of Russians enjoy higher real incomes than 20 years ago; in any case, the income of every fifth wage-earner has not improved since the end of the Soviet Union. Professor Yevgeni Yasin of the Moscow Higher School of Economics says Russia has split into two parts. In comparison with OECD countries, the survey recalls quick growth of income disparity; the Gini coefficient for Russia in the past 20 years has risen way faster than in any OECD country, and is on par with Turkey and Mexico.

Consumer purchasing power has mostly grown, but also diminished, depending on the good. Compared to the Soviet era, a consumer could buy 70 % more durable goods in 2008 and 25 % more food. The consumer could also buy two to three times more cigarettes, alcoholic beverages, cars and clothing, but only a third as much services related to housing such as heating and electricity.

Although household wealth has grown, the mere number of traditional household appliances has changed little. On the other hand, the numbers of entertainment electronics devices and cars have skyrocketed. There are currently about 50 cars and 160 televisions per 100 households in Russia. The average amount of living space per capita has risen about 40 % over the past two decades to a current level of about 22 m² per capita. In Finland, the corresponding figure in 2009 was 39 m² per capita.

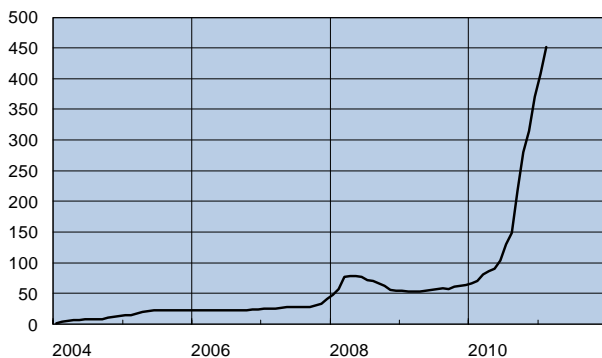
Household spending on child care and education, which were provided for free during the Soviet era, has increased substantially. Private health care spending has increased many-fold in real terms. The survey notes that the World Health Organization (WHO) data says private spending constitutes about 40 % of all health care spending, a level above the EU average.

China

Yuan rapidly gains international acceptance. An important sign of yuan adoption is the rapid growth of yuan-based financial services in Hong Kong. Yuan deposits in March climbed about 10 % m-o-m to 451 billion yuan (US\$ 69 billion), and were up over five times from April 2010. Growth in yuan currency trading and bond sales remained strong.

The Bank of International Settlements (BIS) reports that one year ago, the yuan's share of international currency trading was less than 1 %, or about the same level as the Russian ruble. The top-traded currency was the US dollar with an 85 % share. The second-place euro had a nearly 40 % share. (Note that a currency may have an up to 100 % share of trading out of a total 200 % as there are always two sides to a currency trading transaction.) The second-tier reserve currencies include the Japanese yen and the British pound which accounted for 10–20 % shares of currency trading. The yuan is now emerging from the small currency group to status that better reflects the world's second largest economy.

Yuan deposits in Hong Kong, RMB billion



Source: Hong Kong Monetary Authority

There are many reasons for the yuan's surge on international foreign exchange markets. These include the opening up of China to foreign investment, steady economic expansion, the gradual lifting of currency controls and expectations of yuan appreciation. Currency controls still fragment international yuan markets into three parts. In addition to the official on-shore market (CNY) and the offshore market based in Hong Kong (CNH), there is considerable indirect trading in the offshore dollar-settled non-deliverable forward market (NDF market). The latest BIS estimates from April 2010 show that the NDF market was double in size relative to the CNY market. The CNH had only about a tenth of yuan trading.

Due to currency controls, the USD/CNH rate has typically been the high side of the spread with the USD/CNY spot rate. Adding the complexity is the "Dim Sum" offshore CNY/RMB bond market in which RMB bonds are issued and settled in Hong Kong. Interest rates on Dim Sum bonds have recently been running about two percentage points lower than interest rates in mainland China, so international firms find such bonds the preferred mode of yuan financing. Corporate bond issues in mainland China declined 15 % last year. This shift in the markets is seen as transient, however. Things will even out as soon as China's official goal of free yuan convertibility is achieved.

Values of Chinese brands gaining in world markets. The 2011 BrandZ Global Top 100 survey based on Millward Brown's Optimor model adds twelve Chinese firms to the list: five in banking, two in insurance, two in telecommunications, two in internet services and an oil company. The world's largest mobile service provider, China Mobile, broke into the top ten, becoming the world's ninth most-valuable brand (brand value estimated at \$57 billion).

Five Chinese firms made the list for the first time: China Life Insurance (ranked 33rd); Agricultural Bank of China (43rd); leading instant messaging software Tencent/QQ (52nd); Ping An Insurance (83rd); and China Telecom (91st). Others continuing in the list besides China Mobile were ICBC (11th), China Construction Bank (24th), China's top search engine company Baidu (29th), Bank of China (37th), PetroChina (78th) and China Merchants Bank (97th).

In total, the Chinese companies accounted for about \$259 billion, or 11 % of the value of the world's top 100 brands. The top spots in the brand-value list were taken by computer-maker Apple (\$153 billion) and search engine giant Google (\$111 billion).

Production in China earlier focused on competitive advantage based on low production costs. The current rise of Chinese brands reflects the country's progress up the value chain to high-skill production, increased product reliability and creation of trusted, high-quality brands. The challenge for companies in China is how to cut through the massive number of domestic brands and exploit the rising brand-awareness of Chinese consumers. As a result, companies are grappling with issues related to image-building and innovation in products and services as a path to sustained competitive advantage.

Branding has been China's official government policy since 2004 as part of efforts to promote exports. Most of China's leading brands are controlled by state-owned firms that enjoy state subsidies and a competitive advantage on the domestic market (and sometimes even monopoly status). Even so, the Chinese face a long slog in matching top brands in Europe and North America. Given their large cash reserves, Chinese firms could choose to enter Western markets through corporate acquisitions, but cultural differences have often interfered with the merger process.

Russia

Eurasian Economic Community rides to the rescue of struggling Belarus. The Belarus central bank devalued the Belarus ruble by 36 % on Tuesday (May 24). The devaluation was expected as the country's economic situation, particularly its external balance, has worsened dramatically over the past year.

In 2010, the current account deficit widened to \$8.5 billion, or 16 % of GDP. Foreign debt (public debt and private debt that consists largely of state-owned corporations' debt) increased by nearly 30 % to around 50 % of GDP. Belarus' foreign currency reserves dwindled by 25 % this year as companies and private individuals shifted their money into foreign currencies on fears of an impending devaluation. The rise in consumer prices accelerated to 18 % y-o-y in April; last year inflation was 8 %.

The central bank steers the Belarus ruble's external value against a currency basket composed of the US dollar, euro and Russian ruble. Over the past couple of months, it has been possible to trade the Belarus ruble at rates determined by the interbank and over-the-counter markets. The exchange rate for the Belarus ruble in these markets has been substantially lower than the official exchange rate. While the devaluation brought the official exchange rate down to levels close to market rates, it did not calm foreign exchange markets as demand for foreign currency continues to exceed supply. As part of the devaluation, the central bank re-imposed limits on interbank and over-the-counter currency trading so that the deviation may be no more than 2 % from the official rate.

Russia has supported the Belarus economy for years by selling its natural gas and crude oil at low prices. Belarus has refined most part of the oil for export, which has made petrochemical products an important source of foreign currency. Over the past couple of years, Russian efforts to wean Belarus off its cheap oil dependence have been one factor contributing to the current economic malaise of Belarus.

Belarus asked Russia in March for \$6 billion to cover its current account deficit. Last week, Russia responded with an announcement that Belarus would be eligible for a \$3 billion loan from the crisis fund of the Eurasian Economic Community. The money would be paid out in tranches over three years. The crisis fund board will make its final decision on the loan in early June. The Eurasian Economic Community is composed of Russia, Belarus, Kazakhstan, Kyrgyzstan, Tajikistan and Uzbekistan. Russia is the main financier of the EurAsEC crisis fund.

The loan conditions call for Belarus to adopt more flexible foreign exchange policies, and specifically a devaluation of the ruble. Belarus must also provide its own financing by privatising assets in the corporate sector

(some 70 % is still state owned). Russian finance minister Alexei Kudrin reported Belarus had accepted the conditions and committed to sell off \$2.5 billion a year in state assets over the next three years.

The first divestiture may be a 50 % share in state gas pipeline operator Beltransgaz, which, among other things, pipes gas from Russia to Western Europe. In 2006, Russia's Gazprom acquired a 50 % stake in Beltransgaz as part of a deal on gas supplies and pricing for 2007–2011. Gazprom, which has been eager to purchase all of Beltransgaz, will apparently get the remaining stake for around \$2.5 billion.

The loan from the Eurasian Economic Community will only provide Belarus with temporary relief as the country continues to face daunting structural problems. The country still operates for the most part as a command economy, largely enabled by the fact that cheap commodities from Russia served as a de facto form of economic subsidy. The IMF has recommended that Belarus move ahead with structural reforms (such as privatisation), adopt a more flexible foreign exchange policy and reduce state spending. Public spending surged last year in the run-up to the December presidential elections, including large hikes in wages and corporate subsidies that significantly added to Belarus's economic troubles.

Important listing of Russian firm on Nasdaq. Russia's biggest search engine company, Yandex, debuted on May 24 on the technology-oriented US Nasdaq exchange with a \$1.3 billion initial public offering. On the first day of trading, the company's shares rose strongly from the IPO starting price of \$25 a share, closing at \$36. It was the largest technology IPO in the US since the Google IPO in 2004.

Nasdaq information states Yandex had 64 % of the market for Russian search engine activity in 2010. In second place was Google with a 22 % market share and Mail.ru with an 8 % market share. In Russia Yandex sees Mail.ru as its biggest competitor; in addition to search services, Mail.ru provides Russia's most popular email service.

Since the listing boom of 2006 and 2007, there have been relatively few listings of Russian firms on foreign stock exchanges. Most Russian companies that have listed abroad in recent years have listed on the London Stock Exchange. There are 30 Russian firms on the London Stock Exchange. Most of them operate in the metals and mining sector and the oil and gas sector. The biggest Russian companies on the London Stock Exchange are Gazprom, Rosneft and Lukoil.

At present, five Russia-domiciled companies are listed on the New York Stock Exchange. The actual number of US-listed Russian companies is likely larger. For example, Yandex is domiciled in the Netherlands.

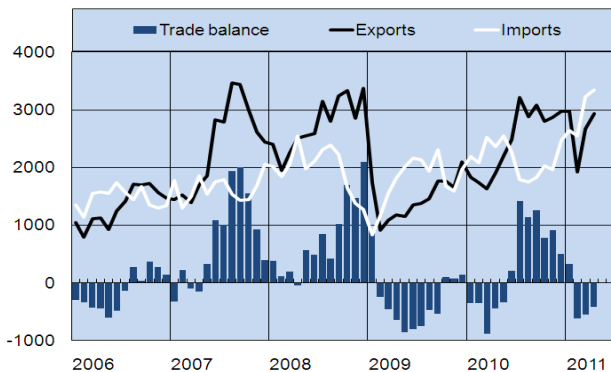
China

China's exports to Russia grow rapidly. China's exports to Russia in the first four months of 2011 amounted to nearly \$11 billion, a 48 % increase from the same period a year earlier. Exports to Russia increased substantially faster than China's exports overall (27 %). China's imports from Russia amounted to nearly \$12 billion in the period, a 30 % rise from January-April 2010. Imports from Russia increased at about the same pace as China's imports overall. The trade deficit with Russia for the first four months reflects seasonal factors; China is still on track to post a trade surplus with Russia this year. While Russia's share of China's exports grew slightly on-year in January-April, Russia remains a minor trading partner for China, accounting for only 2 % of exports and imports.

China's exports to Russia are quite diverse. The leading export categories include machinery and equipment, as well as textiles, clothing and footwear. The value of exports of transportation vehicles soared 135 % from 1Q10, but was still just over \$400 million. China's imports from Russia were composed almost exclusively of energy, raw materials and low-value-added products. The share of machinery and equipment imports was just a few per cent.

For the January-March period, 6 % of China's crude oil imports came from Russia. Oil imports from Russia actually decreased in the first quarter 13 % y-o-y compared to 1Q10, even if import capacity was increased substantially with the January inauguration of the Siberia-Daqing pipeline. China's total oil imports rose 12 % y-o-y in the first quarter of this year. While the bulk of China's coal imports come from Russia, coal imports overall are dwarfed by domestic production. Coal imports were down considerably in the first quarter for Russia and other countries.

Monthly levels of China-Russia trade, USD million



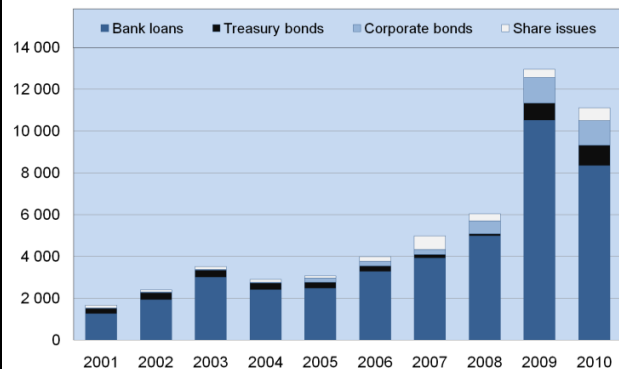
Source: CEIC Data

Growing importance of securities on China's financial markets. According to the quarterly monetary policy re-

port of the People's Bank of China, the volume of financing for households, enterprises and the public-sector branches doubled in 2009 to about 13 trillion yuan due to the global financial crisis. Most of the financing was dispersed in the form of bank loans. In 2010, bank loans accounted for about 75 % of total financing, state treasury bonds 9 %, corporate bonds 10 % and equity financing raised on stock markets for about 5 %. The relative shares of corporate bonds and share issues of the total financing structure increased from 2009.

According to the National Bureau of Statistics, in 2010 over 60 % of corporate fixed asset investment was financed with retained earnings. The next largest sources of credit were domestic loans (15 %), state budget (5 %) and foreign capital (nearly 2 %). About 15 % of financing came from other sources. The financing structure for fixed investment in China has not shifted significantly in recent years.

Structure of China's credit markets (CNY billion)



Sources: PBoC and CEIC Data

Drought continues nationally; critical rice production areas experiencing worst dry spell in over 50 years.

Now more than 200 days into a severe drought, rainfall in the central and lower zones of the Yangtze Basin remain about half their seasonal average. The drought affects irrigated crops, which include much of the rice produced in China. As a result, grain prices have risen on world commodity markets in recent weeks. The agriculture ministry is considering increasing the amount of land dedicated to rice-growing to counter an expected shortfall.

Drought has caused village water supplies to dwindle and forced the government to restrict heavier barge traffic on the Yangtze River. The water level is currently about three meters below normal.

To ease conditions, more water is being released from the Three Gorges Dam. China faces a challenging water future; the country's limited fresh water resources are not only allocated quite unevenly from a geographic perspective but also polluted in many cases. The World Bank estimates that potable water supplies per capita in China are only a quarter of the world average.

Russia

Drafting of 2020 Strategy continues – economic policies discussed. In February, prime minister Vladimir Putin set up 21 working groups to prepare the national “Strategy for Social and Economic Development of Russia until 2020.” The working groups are tasked with creating development scenarios for various branches of the economy in the wake of the financial crisis.

The Strategy should be ready ahead of the upcoming Duma elections in December and the presidential election in March. The Strategy would discuss how well the economy has been managed in recent years and what needs to be done in the years ahead. The work is supposed to be as transparent as possible; preparation of the strategy can be followed at the [2020 Strategy website](#) (in Russian).

The working groups will be coordinated by two well-known liberal economists: Vladimir Mau, rector of the Academy of National Economy and Public Administration, and Yaroslav Kuzminov, rector of Moscow’s Higher School of Economics. The working groups will deal with various aspects of the economy and society, including macroeconomy, healthcare system, pension reform, tax policy, state administration, education and the financial sector. The working groups comprise over 1,100 members from the public sector, business and research institutions. They also include foreign experts.

Yaroslav Kuzminov would like to see the working groups identify ways to achieve economic development in conditions with scarce public resources. This is unfamiliar territory for Russia, where oil earnings permitted a vast expansion in public spending during the second half of the 2000s; most notably the social sector. Social spending is expected to keep increasing at 8 % a year, which will provide a substantial drag on the budget, so it is important to find ways to make delivery of social services more efficient.

In their first preliminary reports, the working groups identified factors dragging down economic performance. Fixing these problems will require fundamental changes in the relations of the state and the business community. State-owned companies unbound to market rules often dominate in the corporate sector. There is little competition, the economy is not open enough internationally and the share of shadow economy is significant.

Vladimir Mau commented that development of Russia’s political and economic institutions seriously suffered in the past decades as Russia could earn money from exporting commodities and did not need to concern itself with raising productivity. Yevgeni Yasin, scientific director of the Higher School of Economics said Russia’s largest challenge is its lack of competitiveness on world markets: Russia is not a modern innovator like advanced

economies, nor is it a low-cost producer like many developing countries.

Experts also offer criticism of Russian policies during the boom years preceding recession. Wages in low-wage sectors as well as pensions saw dramatic increases, which fuelled inflation and increased imports, as domestic producers were unable to satisfy burgeoning demand. These measures served to aggravate the effect of the global downturn on Russia.

Russia has a long tradition of preparing economic roadmap programmes that have varied in importance over the years. The significance of the 2020 Strategy may be in the fact that it draws attention to the need to adjust economic policy and develops policy alternatives. The working groups most probably won’t produce any totally new policies, as the views they present have occurred repeatedly in policy debates in Russia.

CBR raises interest rates again. On May 30, the CBR surprised the markets with a 25 basis-point increase in the deposit rate. The one-day deposit rate is now 3.25 % and the one-month deposit rate is up to 5.5 %. The goal of the rate hike was to reduce liquidity in the banking sector and relieve inflationary pressures. Ongoing heavy capital exports were also seen as a justification for the hike. The CBR left credit rates untouched this round.

Rates were hiked just four weeks ago. The CBR board meets once a month to deal with monetary policy issues and review key rates.

Russia to lift ban on grain exports from start of July.

Russia banned grain exports in August 2010 after a poor harvest due to summer’s exceptional drought. Last year’s grain harvest totalled a mere 61 million tons, 37 % less than in 2009. The purpose of the export ban was to calm rocketing food prices on the domestic market.

The export ban seriously depressed domestic grain prices. Grain in Russia is currently selling in the range of 5,200–5,400 rubles (€130–135) a ton, or about 40 % below the current world price.

The CBR expressed concerns that ending the export ban could drive up food prices and inflation. In announcing the ban lifting, prime minister Putin said the government remained ready to take further measures if the impact on prices was substantial.

The agriculture ministry’s forecast for 2011, released in March, sees for this year a grain harvest of around 85 million tons, which is about average for the past decade. Russia still has about 6 million tons of grain in its reserves. An average harvest would be sufficient to support exports, as domestic demand averages about 75 million tons a year.

With the exception of 2010, Russian wheat exports increased rapidly throughout the 2000s and made Russia one of the world’s main grain exporters.

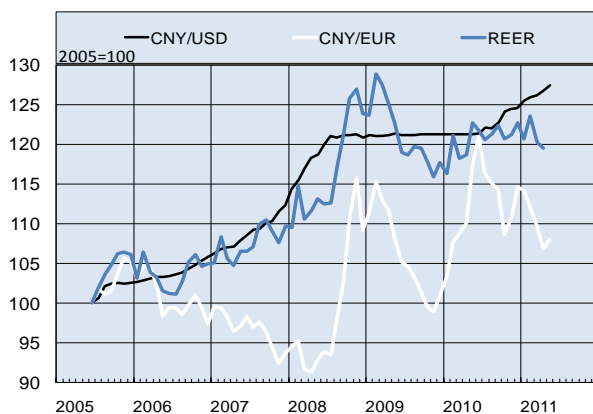
China

United States again refrains from accusing China of manipulating the yuan's exchange rate. Last week the US Treasury Department released its Semi-Annual Report to Congress on International Economic and Exchange Rate Policies. The report evaluates the policies of major trading partners. A central issue is whether trade partners are artificially manipulating their exchange rates to boost competitiveness. China's exchange rate policies have long been mentioned as a matter of large concern, and the report released last Friday (May 27) was no exception.

As previously, the report stated that the yuan remains significantly undervalued; a situation evidenced by China's rapid accumulation of foreign currency reserves and the fact that the yuan's real effective (trade-weighted) exchange rate has not appreciated despite China's productivity gains. The report further notes the IMF's forecast that China's current account surplus will continue to grow in coming years.

Once again, the treasury department refrained from directly accusing China of exchange rate manipulation. Such a charge would oblige the US to implement a range of retaliatory measures against China. The US decision to back away from charges on exchange rate manipulation reflects the fact that the yuan has to some extent decoupled from its dollar peg, appreciating 5 % in nominal terms against the dollar since July 2010. With inflation currently running higher in China than in the US, the yuan has gained about 9 % against the dollar in real terms. The report notes that China needs to keep its public commitments to increase flexibility of the yuan exchange rate and limit further growth in external imbalances.

Yuan-dollar, yuan-euro exchange rates and real effective exchange rate



Sources: BIS, Bloomberg

The yuan has lost about 7 % of its value against the euro since last July. BIS figures show China's nominal effective (trade-weighted) exchange rate at the end of April was 3 % lower than in July 2010.

China keeps on buying gold. In a report released in May, the World Gold Council (WGC) noted that Chinese demand for gold increased sharply in the first quarter of this year. The WGC attributed the rise in gold demand in China to the pick-up in inflation and low deposit rates. The People's Bank of China last year relaxed gold import restrictions on banks, thereby allowing an increase in the supply of gold investment products. The price of gold has risen to an all-time high not just on the Shanghai Gold Exchange but in world markets generally (\$1,532 oz., June 3).

In January-March, China's purchases of gold bullion and coins increased to 90 tons, surpassing India, traditionally the world's biggest gold buyer. China's gold-buying was up 123 % from 40 tons in 1Q10. In 1Q11, India purchased 86 tons of gold, an 8 % increase from a year earlier.

China's purchases of gold jewelry increased about 20% in the first quarter to 143 tons. India purchased 207 tons of gold jewellery in the same period (an increase of 12 % y-o-y). The combined total of investment and jewelry gold made China in January-March the world's second largest buyer of gold at 234 tons (an increase of 47 % y-o-y), while India retained its status as biggest buyer at 292 tons (up 11 %).

China has been the world's largest gold producer since 2007. Last year, it produced 360 tons of gold – an increase of 9 % from 2009. The WGC estimates that China's total demand last year was 700 tons, of which about 340 tons were imported. Chinese officials do not release information about gold imports. Chinese gold producers and investment companies recently appear to be active in investing in gold mining operations elsewhere in Asia and in Africa.

Construction and transport projects most afflicted by corruption. During the first quarter of 2011, nearly 2,000 people were charged with corruption in a variety of projects in the construction branch. China's official Xinhua news bureau recently reported that during 2003–2009 over 200,000 corruption cases were filed.

By international corruption standards, China is in the mid-range in country comparisons. For example, China ranked 78 of 178 on Transparency International's Corruption Perception Index (CPI). Even so, China's corruption level is hardly satisfactory.

In recent months, premier Wen Jiabao has urged making the battle against corruption a political priority. Fighting against corruption is complicated by the government's hostility towards those who criticise it.

Russia

No consensus yet on social security contribution amounts.

The government was initially scheduled to submit to the president by June 1 a proposal on ways to lower the mandatory social security contribution of employers back to a level nearer last year's 26 % of the wage bill. Companies have been less than complacent about the government's decision to raise the social security contribution of employers to 34 % from the start of this year. The contribution is regressive; the base rate applies to the part of the wage below a certain annual limit. The current limit is 463,000 rubles (€11,400). Wages exceeding this level are subject to a lower percentage. The regressivity built into the social security payment is designed to encourage firms to reduce under-the-table wage payments.

In January, prime minister Vladimir Putin tasked the government with identifying ways to reduce its just-hiked social security charge. In March, president Dmitri Medvedev followed up by asking the cabinet to come up with ways to get back to the lower social security contribution. The reduction is seen as concession to firms in order to leave them with more money e.g. to invest in keeping with the president's campaign to modernise the economy.

The problem is that a 26 % social security payment per se is insufficient to cover social security costs, particularly pensions. Every year a substantial amount of the federal budget is used to cover the pension fund deficit. Indeed, the pension fund has been in the red ever since 2005, when the base rate was lowered from 36.5 % to 26 %.

The finance ministry, economy ministry and the health and social affairs ministry have yet to reach agreement on how the social security contribution could be lowered. The finance ministry proposes that the reduction in the payment percentage be compensated for with an increase in the wage limit, below which the base rate is applied. The proposal would lift the limit from the current 463,000 rubles a year to 1–2 million rubles (€24,500–49,000). This would increase the social security contribution of sectors paying the highest wages, e.g. oil & gas and the financial sector. The economy ministry criticises the proposal, because it would also increase the tax burden of high-tech branches.

The ministries could only agree that from the start of next year the social security payments of small enterprises (excluding retailers) would drop to the old level. The payment of other sectors would be reset in a couple years after the impacts on the pension system are clear.

For its part, the presidential administration wants social security payments for all firms to drop from the start of next year. To make up for the lost income, the presidential administration has suggested e.g. boosting the corporate

tax rate back to 24 % (it was lowered four percentage points to 20 % in 2009 as companies struggled with the recession). Other proposals include hikes in e.g. excise taxes on alcoholic beverages and tobacco. Putin's stance, however, is that consumers should not have to pay for the reduction in social security payments.

After the government and president Medvedev discussed the situation on Wednesday (June 8), Medvedev gave his cabinet two weeks to choose from two alternatives. Under the first choice, the social security payment would remain at 34 % for large firms, for mid-sized firms it would drop to around 26 % and for small firms to 16–20 %. Under the second alternative, the payment for large and mid-sized firms would drop to 30 % and small firms to 16–20 %. The cabinet still needs to consider how the loss of revenue would be made up to the pension fund.

The cabinet decisions would remain in force only for two years, after which a complete reform of the pension system would be carried out.

Debate over raising the retirement age reignites. Reports of the pension reform working group in Russia's upcoming economy development Strategy 2020 project find that raising the general retirement age is inevitable if the pension system is to remain solvent. The working group says the pension age should rise starting in 2015. An often-mentioned solution would be to raise the retirement ages of both men and women to 63 by 2030. The current retirement age is 60 years for Russian men and 55 years for Russian women. Furthermore, the number of years in the workforce to be eligible for a full pension should be increased from the current five years to 15 or 20 years.

The proposed changes are not sufficient to put Russia's pension system on a steady footing. In addition to the current financing problems, the stability of the pension fund will be affected by a decline in the number of people paying into the pension system. The size of the Russian labour force has already started to shrink with the diminished size of cohorts entering. At the same time, the pensioner population is growing. Thus, renewal of the pension system is inevitable, even if it has been less than ten years since the last major pension reform.

Pensions are an important income source for the bulk of Russian households. According to a survey by the Moscow-based Independent Institute for Social Policy, nearly half of Russian families are entirely or partly dependent on pension income. More than a quarter of the Russian population receives a pension, and pensioners often help out their children and family members with their pensions. Over a quarter of pensioners are still working after reaching retirement age, and pension income is an important supplement for low wages. Hence, from a social perspective, raising the retirement age is an extremely touchy subject.

China

China finds supervision of credit markets challenging as deregulation proceeds. The power of officials to determine bank lending policies and thereby macroeconomic behaviour such as investment and housing purchases has long been a cornerstone of Chinese economic policy.

The People's Bank of China seems to have recently abandoned the notion of regulating the economy via the credit channel. This year it has set no targets for growth in the stock of bank loans. Instead, monetary policy appears to be shifting to management of broader financial aggregates (although no specific targets have yet been announced).

The gradual liberalisation of China's financial markets and the emergence of regulatory loopholes have diminished the ability of officials to regulate the credit channel. Actors in the financial sector operate outside the official sphere when opportunities appear. The amount of financing activity outside the scope of regulation in China is impossible to quantify, but there is substantial evidence to suggest that the phenomenon is now widespread.

According to official sources, tighter monetary policy and thereby tighter bank lending policies have caused many firms to turn to lending sources outside the regulated loan market. Borrowing rates on the grey market are often much higher than official lending rates. Banks themselves participate in the grey markets through off-balance-sheet lending via investment companies. China's banking regulatory commission has cracked down on banks with a heavy hand. In January it ordered banks to reinstate 1.7 trillion yuan (4 % of GDP) in loaned funds on their balance sheets.

Liberalisation of financial markets and the ending of currency controls pose serious challenges for Chinese officials. As witnessed on other countries, poor handling of the transition can result in big problems such as economic overheating or a full-blown financial crisis.

Summer power shortages in China hit early this year.

As a rule, China's electricity shortages and rolling power cuts are most likely to occur in July and August. Power shortages this year arrived already in March, largely due to reduced coal imports at the start of the year and pricing policies harming electrical power producers and distributors. The electrical power shortage has been worsened by the most severe drought in decades in Southwest China. The lack of water has deeply affected power production at hydropower plants. Power shortages this summer are expected to be unusually serious as the shortfall should be about 40 GW, or 1 % of total electrical power consumption last year.

Coal is an important raw material in Chinese power generation. In February, some 84 % of Chinese power

generation was supplied by coal-fired plants. Coal imports fell 25 % y-o-y in January-April due to high world prices. The shift to domestic coal increased the price of coal on China's home market. The price of Qinhuangdao coal, which is considered a reference rate in China, rose in May nearly 30 % y-o-y to \$145 a ton. State regulated electricity rates have not been raised enough to cover soaring coal costs. As a result, production of electricity has become unprofitable and caused halts in production. Chinese officials are now planning to lower the VAT and port fees on imported coal to boost imports.

All sorts of answers to the power shortage have been tried, with electricity use restrictions imposed on households and industries alike. For the first time in one-and-a-half years, Chinese officials are planning to increase the electricity transmission tariffs by almost 3 % to commercial, industrial and agricultural users in 15 provinces. The rate hikes will not apply to households. Officials are reluctant to rely on rate hikes to deal with the electrical power shortage as it could fuel already worryingly high inflation and hurt industrial output growth.

Oil and gas deposits create incentive for current boundary disputes in South China Sea. This week saw the latest in a string of international incidents in the South China Sea. Vietnam again accused Chinese of damaging the survey cables of Vietnamese oil ship. On May 26 China's coast guard cut the cables of a Petro Vietnam oil and gas exploration vessel. The Chinese have also engaged the Philippines in territorial disputes in recent months. China sees in practice the whole South China Sea as its exclusive territory, while Taiwan, Vietnam, the Philippines, Malaysia and Brunei all declare claims to sea areas and islands.

One reason for the territorial disputes is a desire to take control of potential gas and oil deposits in the South China Sea. While the estimated size and locations of possible reserves vary, the US Geological Survey reports that 9 % of Southeast Asia's undiscovered natural gas reserves and 12 % of oil reserves are located on the continental shelf areas of the South China Sea. With rising energy consumption, locating and developing the oil and gas sources increase tensions among countries with territorial claims.

China has an increasing interest in South China Sea gas reserves. A recent report by International Energy Agency (IEA) sees China becoming one of the world's biggest natural gas producers. The importance of natural gas is also emphasised in China's latest five-year plan. Despite strong growth, natural gas still satisfies only a few per cent of China's total energy consumption.

In addition to its gas and oil reserves, the South China Sea is a major trade route of geostrategic importance. ASEAN has long provided a forum for discussion of the territorial disputes. Inconclusive discussions were conducted last weekend in Singapore at the Shangri-La Dialogue, a key Asian defence summit.

Russia

Russian WTO memberships in the final stretch – again. Since Russia entered into WTO membership talks 18 years ago on June 16, 1993, discussions have restarted and halted on numerous occasions. One factor in the on-again-off-again nature of the talks has been Russia's own insecurity over whether it actually wants to join the WTO and to which extent it is willing to accept commitments that accompany membership. As the Russian economy has experienced ups and downs over the lengthy negotiation process, interest in WTO membership has waxed and waned accordingly.

Russia's attitudes towards WTO membership again grew positive last year. Russia has been in a far more compromising mood in its membership discussions this time around. Both the US and the EU reached agreements in principle with Russia on outstanding bilateral issues. Russia quickly adopted a law governing intellectual property rights, which was a key issue for the US. With the EU Russia agreed it would cut export duties on round timber after WTO accession.

In recent months, however, there has been less progress on the few outstanding issues, including Russia's approaches to veterinary and phytosanitary inspections of imports, which differ from international practice. From the perspective of Russia's trading partners, Russia uses health and food safety inspections as a way to restrict imports. Another open issue is Russia's non-conforming demands on foreign firms investing in certain fields. For example, foreign car manufacturers with assembly plants in Russia have committed to certain levels of investment and annual production and certain degrees of domestic content to be allowed to bring in needed components at low duty rates.

Last week at the EU-Russia summit in Nizhni Novgorod, president Dmitri Medvedev presented his hope that the outstanding issues could be resolved within a month. EU representatives said Russian accession could take place this year, but for that negotiations should be extremely active. Medvedev is seen as a proponent for Russia's WTO membership, and it seems that both parties aim at accession to take place before Russia's presidential elections next March.

Russian firms shift gradually to internationally accounting practices. Finance minister Alexei Kudrin announced to a cabinet meeting on June 14 that, starting next year, corporate conglomerates would be required to prepare their financial statements in accordance with International Financial Reporting Standards (IFRS). The purpose of the reform is to increase transparency and make such

firms more attractive to outside investors. Other companies will make the shift to international standards later.

The change is not totally new for Russia; some of Russia's largest corporations have used IFRS for years as it is necessary when a company seeks to raise money on international markets.

Banks have been required to prepare IFRS-compliant financial statements for some years, but have yet to be relieved of the requirement that they also prepare their accounts in accordance with Russian accounting standards as a basis for determining their tax liabilities. This dual accounting requirement imposes a substantial burden on banks.

IMF: Russian economic policy needs to leverage current commodity boom to shift direction. The fresh report to the IMF board on Article IV consultations with Russian officials at the start of the month finds that, without significant reforms, GDP growth in the medium-term is likely to remain below 4 % a year. As long as the Russian economy remains dependent on energy earnings, there remains a risk of a new recession in the event of a sharp decline in oil prices. If the government chooses to promote reforms, it is possible to achieve annual GDP growth as high as 6 % over the medium term.

The current high commodity prices on world markets are providing Russia with a window of opportunity to make needed reforms, including tightening fiscal and monetary policies, shoring up of the financial sector and implementing structural reforms.

According to the IMF the efforts of the Russian government to tighten fiscal policy are too cautious. Russia faces a risk that if economic growth accelerates budgetary policy may become procyclical and speed up inflation. The IMF recommends that Russia more quickly phases out corporate subsidies introduced during the recession and improves the targeting of social spending. Effective social spending, in turn, calls for fundamental reforms in pensions, social security and healthcare systems.

The IMF encourages Russia to continue tightening its monetary stance to get inflation under control and welcomes the CBR's current exchange rate policy, which allows for larger swings in the ruble's external value. The IMF recommends that Russia allow the ruble to appreciate if the inflow of foreign capital into the country swells again.

While the Russian financial sector is stable, the Fund notes that bank balance sheets may disguise serious shortcomings. The IMF encourages Russia to step up banking sector supervision to international levels.

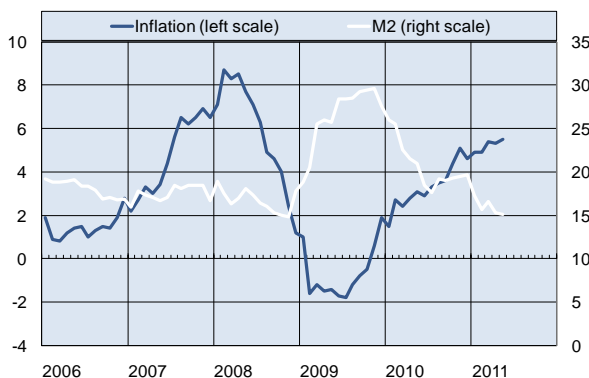
The IMF expects Russian GDP to grow 4.8 % this year and 4.5 % next year. It also sees inflation falling to 8 % at the end of this year and further to around 7 % at the end of 2012.

China

China posts strong May economic figures despite tighter monetary policy. On-year industrial output growth in May showed little change from the previous month's 13.3 % growth. Industrial output was up in all industrial branches; most notably machine-building and the metals industries, which were both up nearly 20 %. Investment in fixed assets and real estate continued to soar in May. Inflation accelerated slightly last month, with consumer prices up 5.5 % y-o-y.

While tightening of monetary policy has yet to bring inflation under control, it has significantly cut into rates of growth for both bank lending and the broader measure of the money supply (M2). Although the loan stock and money supply were still up 15 % y-o-y in May, they were down from rates close to 20 % y-o-y at the start of this year. Official financial market figures should be viewed with some scepticism, however, as stricter bank lending policies have meant that banks have shifted some of their lending activity off their balance sheets and channelled money into the grey market.

Inflation and M2 money supply, %-change, y-o-y



Source: China's National Bureau of Statistics

The International Monetary Fund IMF gave China generally high marks in its concluding report to the IMF board in its latest Article IV consultation. The IMF sees a positive economic outlook for China: growth of the Chinese economy is expected to remain strong this year and next year (on-year growth of 9.5 % in 2011 and 2012), while 12-month inflation is expected to decline to around 4 % by the end of this year.

The IMF considers measures taken by the Chinese officials to tighten monetary policy and to limit credit growth as appropriate. The risk in a pick-up in inflation, however, will persist if world commodity prices continue to rise, and risk of real estate bubble exists. The IMF supports policies

geared to liberalisation of the financial markets, the ending of currency controls, and allowing the yuan to appreciate. As part of its Article IV consultation, China participated for the first time in the IMF-World Bank's Financial Sector Assessment Program.

Growth in household demand continues to slow; car sales down. Retail sales of consumer goods grew in May 16.9 % y-o-y in nominal terms, 0.2 percentage points below April and 1.8 percentage points lower than in May 2010. Due to higher inflation, growth in retail sales of consumer goods was up 11.4 % y-o-y in real terms in May, or nearly the same as the 11.8 % rate posted in April.

Growth in retail sales was supported in January-May by a 40 % y-o-y nominal increase in sales from petroleum and related products. The higher sales of petroleum and related products are due to both higher consumption and price growth. Sales of cosmetics and communications devices were also much higher in the first five months of 2011 compared to the same period last year. While the nominal growth in both groups was well over 20 %, they represent only a few per cent of the total value of retail sales. The Chinese New Year celebrations traditionally boost sales of gold and silver jewellery; in January-May, jewellery sales were up an average of 50 % in nominal terms. Jewellery sales accounted for 3 % of total retail sales last year.

Car sales are a big part of Chinese retail sales, accounting for nearly 30 % of total retail sales in 2010. Car sales increased 13 % y-o-y in nominal terms in January-May. However, the growth rate has decreased, dragging down the overall retail sales figure. Tax incentives to car buyers introduced during 2009 were phased out at the end of 2010, which might suggest that the growth in car sales returns to the long-term trend. The decline in car sales was partly due to the natural disasters in Japan, which resulted in a breakdown of the car part supply chain. This has impacted car production in China. Higher fuel prices and housing costs might also have dampened car demand.

Trade surplus up in May. The value of imports to China in May was about \$144 billion, unchanged from the previous month. The 28 % y-o-y rise in import value was driven largely by high world commodity prices.

China's exports in May were up 19 % y-o-y to a level of \$157 billion. The growth rate for exports was lower than in March and April reflecting seasonal fluctuations and e.g. the debt problems of the eurozone and the feeble economic recovery in the US. The US and EU are China's top export markets.

With May imports remaining unchanged from April and exports growing slower than average, the trade surplus was lower than expected. While the monthly surplus in May increased by a couple billion dollars from April to \$13 billion, it was still a third smaller than in May 2010.

Russia

Medvedev reiterates reform goals at the St. Petersburg International Economic Forum. At last week's annual economic forum, which has become an important international PR event for the Russian economy, president Dmitri Medvedev again stressed the necessity of modernising Russia's economy.

Medvedev suggested a number of concrete measures to improve the investment climate and business environment. One proposal was to expand divestment of state assets and increase the number of state firms listed last autumn in the government's sales programme. Under last year's plan, in large companies only minority stakes would be sold; now Medvedev suggested majority stakes should also be available. Implementation of the programme approved last year has been slow, due e.g. to the fact that it takes time to get many of these firms in shape for sale. The Federal Agency for State Property Management, which handles sales of state assets, has also been accused of dragging its feet.

Medvedev said more power needs to be transferred from the federal level to regional and local administrations particularly in economic matters. Russia is simply too big to be administered from one place. His proposal reverses policies of the 2000s, when decision-making power was taken from the hands of regional and local administrators.

A lawyer himself, the president noted the court system remains in dire need of reform, so e.g. specialisation of judges must be encouraged, the process for picking judges needs to change and more effective disciplinary measures must be developed. The fight against corruption must be strengthened e.g. by making it easier to sack corrupt officials and fully disgorge their illegal gains.

He said efforts to transform Moscow into an international financial hub should continue, pointing out that major legislation on the financial sector was being drafted. While many experts consider the notion of Moscow as an international financial centre far-fetched, the plan seems to serve as an impetus to bring about important legislative initiatives. The legislation under preparation includes improvements in the status of minority shareholders through better access to financial information and better reporting requirements for substantial changes in a company's ownership structure. Preparations for merger of Moscow's RTS and the MICEX securities exchanges are currently underway. In conjunction with that a single national securities depository and clearing centre is being created; a move most welcome to foreign investors.

The president promised that visa rules for foreign investors and businesspersons involved in large-scale business in Russia would be eased – a move that would indicate a significant shift in Russian visa policies.

The president proposed that the area of the City of Moscow be expanded and that federal administration offices downtown be transferred to new areas on the outskirts of the city to open up the centre to other activities and reduce traffic congestion.

Medvedev has over the past few years repeatedly pushed for action to improve the operating environment for firms, but often with little impact. However, progress on certain concrete questions seems to be happening. For example, he ordered in March that state representatives be replaced by experts on the boards of state-owned firms. This has meant that many ministers and high-level officials have had to give up their seats on boards of major state firms. The shake-up should be complete by the end of September.

Decision taken on reducing social security contributions. At the St. Petersburg economic forum, president Medvedev announced that he had reached agreement with the government on reducing the mandatory social security contributions of firms from the start of 2012.

After an intricate process (see [BOFIT Weekly 23/2011](#)), a compromise was agreed whereby the basic social security contribution rate would fall from the current 34 % to 30 %. For small businesses not involved in retailing, the social security contribution would fall to 20 %. The current rates for employer social security contributions entered into force at the start of this year.

How will Russians vacation this summer? According to the annual poll conducted by the Levada-Center research institute, 46 % of respondents said they expect to spend their summer holidays at home this year. Of those, 40 % will stay home because they lack the resources to travel anywhere. The share of Russians taking "staycations" has declined steadily throughout the 2000s; in 2000, 68 % of respondents planned to spend summer at home.

Approximately one in four Russians spends their summer vacations at their summer house or farm plot. The *dacha* is not merely a holiday destination, but crucial to the household economy as Russians actively cultivate vegetables and fruits, as well as harvest forest treats like mushrooms and berries in conjunction with summer-house living. For part of the Russian population, produce from tiny farm plots makes an important contribution to the household food supply.

6 % of respondents said they would be vacationing in states of the former Soviet Union (including the Baltics), and 3 % would be visiting non-FSU countries.

Rosstat reports that for all of 2010, Russians made a total of nearly 13 million vacation trips to non-FSU countries. The number of travellers has nearly doubled since 2004, when statistical records of tourist travel began to be kept. The favourite destinations of Russian tourists are Turkey and Egypt.

China

Chinese stock markets continue their slide; interest rates are in rise. After small gains in the first three months of 2011, Chinese share prices have declined since April. Share prices on the Shanghai exchange this week were off 13–14 % from their April highs. The price-to-earnings ratio (P/E) on the Shanghai exchange for A-shares (aimed at domestic investors) is currently about 16. On the Shenzhen stock exchange, which is geared to shares of smaller firms, the average P/E is about 29.

Prices on China's stock exchanges reflect a set of global shocks, including the ongoing fiscal problems in Europe, a slowdown in the US economic recovery and Japan's post-earthquake challenges. Share prices in China have also been depressed by monetary measures to restrain inflation and expectations of an impending economic slowdown. Share prices have been pushed down further by worries over the real estate sector that could have profound impact on the banking sector.

In recent days, money market rates have risen sharply as banks prepare to meet their mandatory end-quarter reserve requirements. At the beginning of the week, the reserve requirement for banks was increased by 0.5 percentage points. The reserve requirement for China's large banks now stands at 21.5 % of deposits.

Key share indexes for China, Russia and emerging markets, January 2007=100



Sources: Bloomberg, BOFIT

Rules further relaxed on travel from mainland China to Taiwan. Progress was made in normalising relations at the third Straits Forum in Xiamen. On June 28, mainland China and Taiwan will launch a pilot travel program allowing mainland tourists to visit Taiwan individually. Travel to Taiwan was earlier only possible for mainland Chinese in group package tours arranged by travel agencies. Direct flights between the mainland and Taiwan will be increased and air traffic expanded to include several new cities.

Relations between Taiwan and the mainland have improved gradually since 2008, when Taiwan's president Ma Ying-jeou took office. Direct flights between Taiwan and the mainland were introduced in 2008, and travel from the mainland to Taiwan has boomed ever since. News of eased travel rules was welcomed by Taiwan's service sector; measured by tourist arrivals, mainland Chinese last year surpassed the Japanese as Taiwan's top tourist group. Taiwan statistics suggest that about 1.6 million mainland Chinese travelled to Taiwan last year, a third of total tourist traffic. In 2009, about a fifth of tourists visiting Taiwan came from mainland China.

China imposes tighter rules on exports of rare earth metals, prices soar. At the end of May, China's commerce ministry and the government announced to tighten their control over the rare earth element (REE) metals by expanding the export quota system and applying higher taxes on crucial minerals needed in many high-tech products. The government has prepared guidelines aimed at concentrating over the next two years some 80 % of heavy rare earth production in southern China under three largest Chinese companies. In addition, mining permits will be limited, especially in areas designated by the state as national strategic reserves. Officials justified the move on environmental grounds, but the aim is also to rein in over-production and illegal sales.

Since the Chinese government's announcement, prices of several REEs have more than doubled on the Shanghai commodity exchange. The rise in REE prices is expected to continue if China further reduces export quotas.

China's demand for REEs is expected to soar, due to e.g. the massive rollout of electrified transport systems and investment in wind power. China has sought to meet demand by limiting its rare earth exports. China produced 119,900 tons of rare earth metals in 2010, with some 40,000 tons going to export. This year's REE production has been limited to 93,800 tons and export quotas in the first half of the year have been limited to 14,500, a 35 % reduction from last year. At the moment, no nation has filed complaints with the World Trade Organization (WTO) on China's decision to limit exports.

In January-May, exports of rare earth metals climbed 26 % y-o-y to 23,740 tons, indicating that China, once again, cannot hold its own export quota this year. While China only has about a third of the world's known REE reserves, it presently accounts for 97 % of production. With global demand well exceeding China's export quotas, smuggling has become a serious issue for China. Annual smuggling levels are estimated to have reached 10,000 tons, which is a great amount compared to the total export. The shortfall in supply is expected to last through 2013 while mines in the West come on stream. At that point, China's production share is estimated to fall to around 60 % of world production.

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.

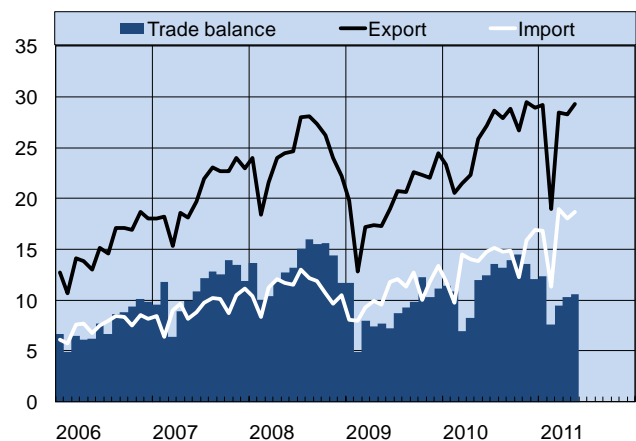
China's public sector remains one of the least transparent parts of the Chinese economy. The current situation highlights the need for deep and extensive reforms of the public sector economy. In addition, staying ahead of the debt problem demands continued robust economic growth in the years ahead.

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

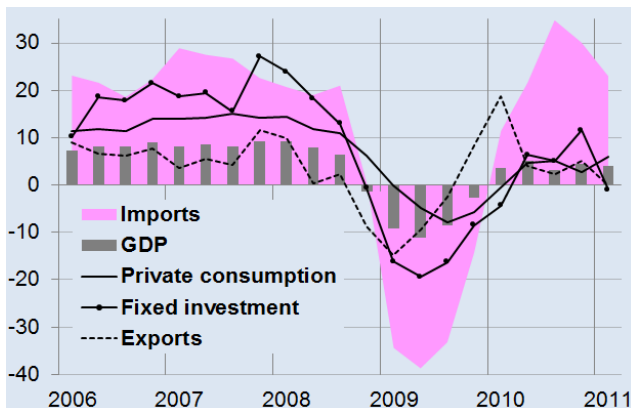
Russia

Rosstat releases first-quarter GDP figures. Rosstat reports GDP grew well over 4 % y-o-y in the first three months of 2011. Private consumption rose substantially; up 5.7 % y-o-y. For the second quarter in a row, there was no on-year change in public consumption. The volume of exports was the same as in the first quarter of 2010. Fixed investments continued to contract slightly on year. Increased inventories were again a large contributor to GDP growth.

The trend of pre- and post-recession dynamics, where growth in demand has led to more rapid growth in imports than in GDP seems to have remained, with imports climbing 23 % y-o-y in 1Q11.

Preliminary figures show that in late spring growth in private consumption was fairly strong, exports and investments revived and import growth remained high.

GDP, imports and major demand components, change from the corresponding quarter of the previous year (%)



Source: Rosstat

MICEX and RTS bourses sign merger agreement.

After long negotiations, Russia's two largest securities exchanges moved ahead with a June 29 framework agreement to merge trading. The practical aspects of the merger should be completed at the beginning of 2012. The initial public offering of the merged exchange is expected in 2013.

The agreement still requires approvals from the Federal Antimonopoly Service and an extraordinary general meeting of the exchange shareholders that is set currently for August.

RTS is valued at 34.5 billion rubles (about €860 billion) and 103.5 billion rubles (about €2.6) for the MICEX. MICEX accounts for about 70 % of stock trading in Russia. The RTS is focused largely on derivatives trading.

According to MICEX and RTS agreement on merging the top Russian bourses represents a step towards creation of a major global financial centre. The goal of the new exchange is to become one of the world's top ten exchanges within five years.

New securities markets regulations were signed last week; President Dmitri Medvedev issued an order that the act on the single central depository will be approved by early September. The act on the central depository was approved by the Duma a few years ago. Officials have yet to reach agreement as to who will operate the central depository. So far, the RTS and MICEX have maintained their own depositories. A single central depository would greatly increase trading efficiency.

Medvedev also ordered to abolish limits on international IPOs by Russian firms. Previously, Russian companies holding IPOs on international markets were limited to offering no more than 25 % of the company's total stock. The limit was meant to encourage development of domestic stock markets. However, many companies skirted the restriction by simply listing their subsidiaries on foreign exchanges.

Bank Moskvyy restructures. The current efforts to save struggling Bank Moskvyy represent one of the largest bailout operations in Russian history. In May, Bank Moskvyy was Russia's sixth largest bank when measured in terms of total capital.

The CBR has agreed with the Ministry of Finance and the Deposit Insurance Agency (DIA) on a plan to bailout the bank, whereby the DIA grants Bank Moskvyy a 10-year loan of 295 billion rubles (about €7 billion) at an interest rate of 0.51 % p.a., i.e. well below current market rates. The remaining 100 billion rubles (about €2.5 billion) is to be raised from the bank's largest shareholder, VTB. The bailout package is only about 20 % smaller than the total capital of VTB, Russia's second largest bank.

One condition for receiving bailout assistance is that VTB commits to increasing its share of bank ownership from the current 46 % to 75 %. VTB, which is largely state-owned, purchased Bank Moskvyy's voting share majority at the start of this year from the City of Moscow.

There have been several estimates as to the true size of Bank Moskvyy's bad loan portfolio. Finance Minister Alexei Kudrin estimates the value of non-performing loans at around 250 billion rubles (over €6 billion), which represents about a third of the bank's total loan stock. As of end-May 2011, Bank Moskvyy's total loan stock stood at about 740 billion rubles.

Bank Moskvyy claims that it was saddled by the problem loans through the reckless lending activities of earlier management. The investigating committee at the Ministry of the Interior is currently looking into the role of former CEO Andrei Borodin in the case.

China

China continues to hike rates. Starting Thursday (July 7), the People's Bank of China increased its core rates 25 basis points. The hike means that the one-year deposit rate now stands at 3.5 % and the credit rate at 6.56 %. It was the third rate hike this year. As part of monetary tightening, the PBoC has also raised bank reserve requirements six times this year. Market rates have been sharply higher at the start of July than at the start of June.

The rate hike was long expected as Chinese 12-month inflation appeared to accelerate last month from the 5.5 % reported in May. Market participants are split as to how long the monetary tightening will continue. Those expecting further tightening note that real deposit rates remain negative and there is no hard evidence that inflation is subsiding. Others expect that the cooling economy will reduce pressures to raise prices and see China's decision-makers as reluctant to sacrifice growth potential by continuing measures to tighten the monetary stance.

The latest readings of the official indexes of purchasing manager sentiment suggest that growth in industrial and services output slowed in June from previous months. The lower growth was expected and desirable in order to gradually redress economic imbalances. The spectre of local administrations defaulting on their massive borrowing of recent years combined with lower growth, however, has increased worries about China's economy during the last month.

Strong growth in Chinese FDI outflows abroad; modest slowing in FDI inflow growth. China's foreign direct investment abroad was greater in the first five months of this year than in the first six months of 2010. For January-May, China FDI outflows reached \$20 billion, compared to \$18 billion in January-June 2010. Financial sector investments are not included in this figure. Sector-specific figures are only released once a year. China's largest receivers of investment last year included the service sector, mining, manufacturing and retail. Access to raw materials and acquisition of technology remained the top drivers of Chinese foreign investment.

Country-level figures are not yet available for 2010, but the 2009 statistics show that about 75 % of Chinese investment went to the Asia/Pacific region, 13 % to Latin America and 6 % to Europe. North America and Africa each received about 3 %.

Hong Kong was by far the biggest source of FDI for China, account for about 55 % of total FDI inflows. Asia's dominance in FDI was further backed by the contributions of Singapore (5 %), Japan (3 %), Korea (3 %) and Taiwan (2 %). The EU's share was about 6 % and the United States 3 %.

January-May FDI inflows to China amounted to \$48 billion, an increase of 23 % y-o-y. Despite this, the flow of investment to China seems to have slowed since March. The value of US FDI declined nearly 30 % in January-May, possibly reflecting the US economy's tepid recovery. Europe's debt crisis appears to have had only minimal effect on China FDI provided by large EU countries. Moreover, even with the impacts of Japan's natural and nuclear disasters, Japanese investment in China rose 56 %.

In terms of value, FDI inflows to China in January-May were led by investments in industrial production (share 40 %) and real estate (20 %). Although they account for 5 % of FDI, highest growth was registered in mining (up 145 % y-o-y), transport, storage and postal services (86 %), and banking and insurance (54 %).

China's Communist Party turns 90. Thousands of party leaders and members gathered in Beijing on July 1 to celebrate the party's 90th anniversary. In his keynote address, president Hu Jintao warned that corruption is a serious problem inside the party that corroded the people's confidence in the party. The PBoC recently estimated that thousands of government officials had embezzled or stolen over \$120 billion between 1995 and 2008.

With 80 million members, China's Communist Party is the world's largest political party. Party membership is more than an ideological statement; members enjoy enhanced opportunities for career advancement and access to China's ruling elite. The party reports that last year 31 % of members worked in state offices or state enterprises. The average party member is quite elderly – only a quarter of party members are under 35 years old. The prestige of party membership can be seen in the number of applicants. Of the 21 million who applied to join the party last year, only 10 % were accepted. To be eligible, applicants must demonstrate good standing in the community and loyalty to the party by submitting recommendations from current party members and their companies or work unit leaders. Applicants must also write an essay supporting the party.

China's single-party system clashes with the needs of a functioning market economy. In addition to opportunities for corruption, economic reform has meant a gradual transfer of power away from the central administration to local and provincial governments. Demand for political reforms has increased, and within the party there is an ideological struggle over the party's future direction. In the view of the party's more liberal members, increased social problems indicate a need for political reform. Members at the grass-roots level are calling for greater democracy within the party. China witnessed a minor political crackdown as the 90-year anniversary approached. For example, over 100 activists were arrested and the Chongqing's Communist Party leader Bo Xilai has made headlines with his revival of Maoist propaganda.

Russia

State budget spending set to increase next three years.

On July 7, the government discussed its initial budget policy for 2012–2014. Under an already detailed plan, *federal* budget spending would experience nominal growth of over 10 % a year during 2012 and 2013. That translates to real growth of 4.4 % a year, which slightly exceeds the forecast rate for GDP growth. Real growth in spending this year should go over 2 %. In the 2011–2013 budget approved last December, spending falls in real terms in 2011 and 2012, and increases a couple of per cent in 2013.

The biggest reasons for the change are the state's improved revenue situation and current estimates that see the situation remain good in coming years. The revenue projection was increased largely on a higher oil price assumption, which is now \$93–95 (Urals-grade) a barrel for 2012–2013. In the budget approved in December, the assumption was under \$80 per barrel. Revenues should also be boosted by planned tax hikes, especially higher gas extraction fees. Compared to the December budget, revenue estimates are affected downwards by revised projections of GDP growth (3.5 % in 2012 and 4.2 % in 2013), and a stronger ruble exchange rate (which reduces customs revenues). Companies will also pay lower mandatory social contributions (see [BOFIT Weekly 25/2011](#)).

Although spending rises, the federal budget deficit will narrow both nominally and as a ratio to GDP, to 2.7 % of GDP in 2012 and 2013, as budget revenues are so much bigger than in the December budget. Still, the deficit is larger than the roughly 1 % of GDP deficit expected this year. During the spring, prime minister Vladimir Putin and finance minister Alexei Kudrin stressed the goal of balancing the budget by 2015. Putin also stated at the cabinet meeting that efforts to achieve a balanced budget must definitely be continued. Even so, the budget plan foresees a deficit of over 2 % of GDP in 2014 although real spending would grow just 1.4 %. Under the plan, budget balance requires an oil price of about \$125 a barrel in 2012–2014.

Changes are planned in the structure of federal budget spending (including those transfers to regional budgets that are designated to spending categories). High real growth in spending on defence, national security and law enforcement, and debt servicing will continue. Spending on education, health care, the housing sector, supports to the economy and administration all decline in real terms, although they may receive more funding from the spending item not yet specified in 2013–2014 spending plans.

Total public sector spending is also seen to increase in real terms at over 4 % a year during 2012–2013. Regional and municipal budget spending, however, should remain at recession levels in real terms as transfers from the federal

budget to the regions are cut. Regional and local administrations should see their share of all public sector spending slide towards 30 %. Along with defence and national security, social spending is set to rise as outlays from the social funds will continue to be boosted at a brisk rate. The funds' share will rise to over 30 % of public spending. Pensions should see nominal hikes of around 10 % a year.

Russia posts large current account surplus. Preliminary CBR balance-of-payments figures show Russia's current account surplus in the first half of 2011 amounted to nearly \$58 billion, which corresponds to about 6.5 % of GDP. The current account surplus was large also in the second quarter.

Although imports to Russia grew rapidly, export earnings drove the goods trade balance to over \$100 billion, on par with last peak of 1H08. The services deficit in recent years has deepened gradually, and was now \$15 billion. The income account deficit, which is composed largely of dividends, interest payments and wages from abroad, continued to rise, and was up to nearly \$28 billion (over 3 % of GDP).

Higher prices for oil and Russia's other basic export commodities (fuel oils, natural gas and metals) lifted export earnings in the first half to a record level; the earnings were up about 25 % y-o-y. Oil, fuel oils and gas continued to generate about 60 % of export earnings for goods and services. The value of imported goods and services increased about 35 % in both the first and second quarters.

Customs inspections at the Russia-Kazakhstan border ended on July 1.

The elimination of border customs inspections is an important aspect of the customs union of Russia, Belarus and Kazakhstan. Customs inspections will take place at the outer borders of the customs union. Traffic inspections at the Russia-Kazakhstan border will continue. Russia's customs committee said that it also ended on July 1 its remaining activities at the Russia-Belarus border regarding transit goods from third countries. Traffic inspections at the Russia-Belarus border ended last spring.

Within the customs union, Russia clearly dominates trade relations. Trade between Kazakhstan and Belarus is less significant. Russia accounts for about 45 % of Belarus' foreign trade and nearly 20 % of Kazakhstan's foreign trade. Kazakhstan accounts for about 1 % of Belarus' foreign trade and Belarus about 0.5 % of Kazakhstan's foreign trade. Belarus represents about 4–5 % Russia's foreign trade and Kazakhstan about 2–3 %.

Prime minister Putin stated that all members of the customs union continue their WTO accession talks and have in mind eventual free-trade talks with the EU. Russia, Belarus and Kazakhstan started talks on free trade in goods with the European Free Trade Association (EFTA) in January.

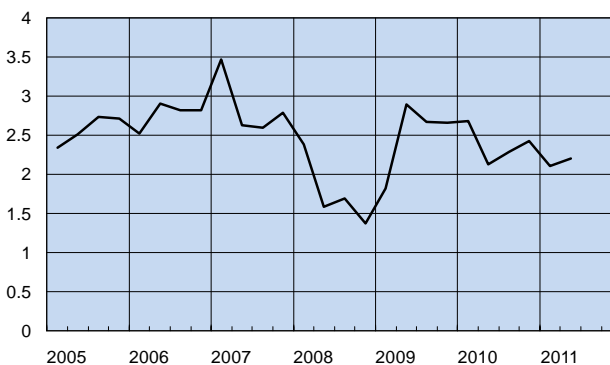
China

Economic growth remains strong in second quarter.

GDP increased 9.5 % y-o-y during the second quarter when changes in prices are taken into consideration. As expected, economic growth has slowed since the recovery years of 2009 and 2010, when economic growth exceeded 10 % p.a. The declining growth indicates that monetary tightening policies to fight inflation are beginning to bite. Given this narrative, observers were a bit surprised by reports that quarterly GDP growth (2.2 % q-o-q) accelerated slightly from 1Q11 (2.1 % q-o-q).

In addition, expectations were slightly exceeded in June for industrial output, retail sales, core credit and monetary aggregate growth, as well as the trade surplus. China's strong economic figures boosted stock prices that have been depressed on gloomy news about the European debt crisis.

Real GDP growth, % change from previous quarter (seasonally adjusted)



Sources: China National Bureau of Statistics, BOFIT

The rise in consumer prices surprised with an acceleration in June to 6.4 %. The official inflation target this year is 4 %. The setback in the fight against inflation was attributed to exceptional occurrences that have hurt food production. Food prices rose 14.4 % y-o-y. Due to the dry winter, prices of vegetables are up nearly 50 % and the blue-ear disease epidemic has caused pork prices to rise even more. Pork production in the first half was down 0.5 % y-o-y.

In addition to exceptional factors driving up food prices China's inflation has been fuelled by e.g. higher prices for clothing and home appliances during the first half of 2011. Given the recent figures for output and inflation, it is quite likely that official measures to tighten monetary policy will be continued in the second half of this year.

China cuts personal income tax and steepens progressive tax rates. The Standing Committee of the National

People's Congress decided on June 30 to raise the amount of non-taxable monthly income from 2,000 yuan (\$309) to 3,500 yuan (\$541). At the same time, the number of income tax brackets was reduced from nine to seven. The tax reform, which seeks to boost private consumption and reduce income disparity, is being implemented as part of the government's current five-year plan.

When the tax reform enters into force on September 1, the lowest income tax rate will fall from 5 % to 3 %. This change is hoped to ease the tax burden on low-income earners, who have been hit hard by high inflation. At the same time, the progressivity of income taxation will get steeper. Persons with gross monthly incomes exceeding 38,600 yuan (\$6,000) will pay higher income taxes than earlier.

Most of China's hundreds of millions of farmers are taxed under another tax law. China's income tax law covers about 300 million urban workers, or about 40 % of the country's total workforce. Under the reform, the number of income tax payers will fall from 84 million to 24 million (from 28 % to 8 % of the urban workforce). The income tax reform will cause the state to lose annually about 160 billion yuan in revenues, or about a third of last year's personal income tax revenues. The income tax loss, however, is minor; it only constitutes about 2 % of total government tax revenues.

Military spending tripled in the past decade; arms imports decline.

The Stockholm International Peace Research Institute (SIPRI) reports that imports of conventional arms to China fell by half during the 2006–2010 period from the 2001–2005 period. In the latest reviewed period, India surpassed China as the world's largest importer of conventional weaponry. India and China together account for about a sixth of world arms imports.

Weapons exports from China have increased in recent years, which could indicate a growth in China's domestic arms production. The biggest suppliers of conventional weapons are still the US and Russia, which have a combined share of 53 % of world arms exports.

SIPRI estimates that China's military spending has tripled over the past ten years. Even so, China is still far from the US. China accounted for about 7 % of total global military spending last year, while the US accounted for over 40 %. In addition, China's military spending has remained around 2 % of GDP during the past decade, while the US military spending is over 4 % of GDP.

Modernisation of China's military is emphasised in the latest five-year plan. Military spending was boosted 12.6 % in the 2011 budget. Recent news coverage has discussed China's advances in such areas as reconnaissance satellites, aircraft carriers and missile systems.

Russia

Steady first-half growth; recovery in fixed capital investment yet to occur. Industrial output in January-June increased 5 % y-o-y. Among the categories of industrial output, mining and mineral extraction (including oil and gas production) increased nearly 3 % y-o-y, while manufacturing was up 8 %. Electricity, gas and water supply remained at roughly 2010 levels.

Production of crude oil and coal each rose about 1 %, and natural gas production grew 5 %. Growth in crude oil production is limited by the fact that production capacity is stretched to the limit. Gas production volumes, in contrast, are currently limited by demand.

Production of machinery and equipment climbed 12 %, electrical and electronic equipment production 7 % and transport vehicles 35 %. Some of the brisk growth was due to the low comparison point a year ago. The flagship for growth was unquestionably passenger cars, which saw an increase in production of 77 % y-o-y. The recovery in production of passenger cars was supported by Russia's incentive programme to get drivers to turn in their old cars, as well as the substantial 2009 hike in duties on imported cars (a move that for all practical purposes has ended imports of used cars to Russia).

Construction, however, remained in slow recovery mode. In the first half, construction activity was up just 1 % from the 1H10, while apartment construction declined 4 %. It was the third year in a row for decrease in apartment production.

The trend in fixed capital investment in the wake of the recession has been halting and slower than expected. In the second quarter of this year, fixed capital investment returned to growth after falling in the first quarter. For the first half, fixed capital investment was up 3 % y-o-y.

Consumption has long been a more significant driver of domestic demand than fixed capital investment. Retail sales increased 5 % in the first half. Consumer demand has been lifted by gains in real wages, although they haven't been as big as before the recession, when real wages grew more than 10 % a year. In June, real wages were up 4 % y-o-y. According to Rosstat the average monthly wage in June was 24,601 rubles or €620.

Since the recession's bottom, unemployment has recovered steadily. June's unemployment rate was 6.1 %, which was the lowest since August 2008.

Inflation rate showed little change in first half. Consumer price inflation remained at a brisk 9.5 % in the first half. For June, 12-month inflation slowed to 9.4 %. Food prices were up 12.5 % y-o-y in June, while non-food goods rose 6.6 % and services 8.8 %. Costs related to

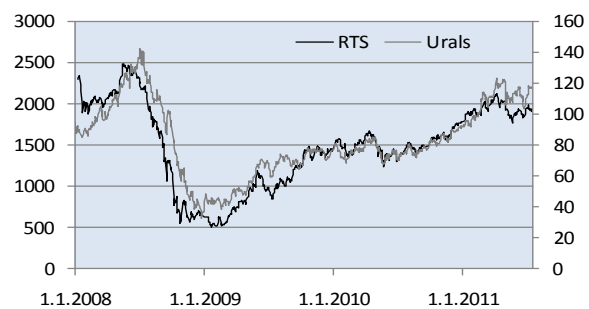
housing such as rents, power and heating continued to increase rapidly (11.1 %).

Inflation has been slowing this month, mainly due to calmer global trends in food prices and food prices' seasonal decrease.

Russian stock market closely tracking global economic trends. Prices on Moscow's RTS exchange in the first six months of the year reflected trends on other world's stock exchanges, although RTS price swings were sharper.

Share prices in Russia have traditionally been driven by world market prices for oil. Russian share prices climbed steadily from early 2009 to peak in April 2011, when Urals-grade crude oil briefly surpassed \$120 a barrel. Since then share prices have declined as on the other world's exchanges. The declines reflect concerns over trends in the global economy.

RTS index (left scale) and Urals oil price, \$/bbl (right scale)



Sources: RTS, Bloomberg

Sberbank expands operations into Central and Eastern Europe. Russia's largest bank, majority state-owned Sberbank, made a landmark deal last week with the Austrian Volksbank to purchase its Volksbank International (VBI) unit. The sales agreement should be signed this month, and the deal should be closed before the end of the year.

The deal covers VBI's nearly 400 sales offices in eight countries in Central and Eastern Europe. VBI mainly provides retail banking services to households and small and medium-sized companies. The parent Volksbank was among the eight banks failing the European Banking Authority's stress tests last week. Volksbank will use money from the VBI sale to bolster its own capital adequacy.

Sberbank CEO German Gref said the deal represents Sberbank's first step in a strategy to penetrate international markets. The bank plans that by 2014 it will generate 5–7 % of its profits from operations in Central and Eastern Europe and CIS countries. Sberbank is also planning to expand operations gradually into the Chinese and Indian markets. Sberbank currently has subsidiaries in Kazakhstan, Ukraine and Belarus, as well as a branch office in India.

China

Tighter monetary stance reflected in lower import growth in the first half. Growth in imports saw its biggest slowdown in 20 months in June as it slowed to 19 % y-o-y (28 % y-o-y in May). The value of imports in 1H11 was \$829 billion. Growth for the first half overall was 28 %, reflecting high commodity prices at the start of the year.

To help importers, China lowered import duties on 33 commodities from the start of July. Most of the duty reductions apply to energy, raw materials and textiles. Duties on gasoline and fuel oil were cut to 1 %, while duties on diesel and jet fuel were eliminated altogether.

Export growth also slowed slightly in June, but exports were still up 18 % y-o-y. For the first six months of the year, the value of exports was \$874 billion (up 24 % y-o-y). Exports to developing countries remained strong, while growth in exports to the United States and the EU region continued to slow. Due to weaker exports and domestic demand, China's trade surplus expanded in June to \$22 billion, up from \$13 billion in May. In the first half, the trade surplus shrank 18 % y-o-y to \$45 billion.

China's trade partners are less than sanguine about China's imposition of export quotas on certain metals. On July 5, the WTO sided with the US, EU and Mexico in their 2009 complaint that certain Chinese raw material export quotas were invalid. The complaint pertained to e.g. bauxite, magnesium and zinc, all products where China is the world's leading producer. The WTO ruling increases pressure on China to relax restrictions on high-tech rare earth metals. China has so far responded with a decision to double export quotas for some rare earth metals for the second half of 2011. The higher quotas, however, are somewhat illusory as the list of metal compounds subject to export quotas was lengthened in May.

China-North Korea bilateral trade increased by nearly a third in 2010. The value of China-North Korea trade reached \$3.5 billion last year. Cooling relations between North and South Korea helped enhance China's role in foreign trade with the otherwise isolated North Korea. South Korea last year imposed trade sanctions on its northern counterpart after North Korea sank a naval ship and directed artillery fire on Yeonpyeong Island. With the imposition of sanctions, Korean bilateral trade was down in 2010 about 15 % to \$1.7 billion.

There are many reasons for the limitations on North Korea opportunities to engage in foreign trade. One reality is simply the country's low production levels and government solvency. The UN has banned the selling of luxury goods and arms to North Korea, and the US and Japan have in practice imposed complete trade bans on North Korea. In April, the United States blacklisted the North Korean

DongBang bank for facilitating arms trade between North Korea and Iran.

China is also bound by the UN sanctions on North Korea. According to official figures, China's imports from North Korea consist largely of coal and iron ore. China exports to North Korea much of its needed raw materials, energy and manufactured products. According to newspaper reports, Chinese firms have also financed North Korean infrastructure projects such as bridges and harbours. Hunger remains a problem in North Korea. In June, the UN launched a programme to feed starving Koreans.

In June, bilateral cooperation with China and North Korea deepened with the establishment of three special economic zones in North Korea. China's official press briefing said that mutual understanding had been achieved for creating special economic zones in the Rajin-Sonbong (Rason) region and on Hwanggumpyong and Wi Hwan islands. The special economic zones are located along North Korea's northern border near China. North and South Korea are already engaged in industrial cooperation in the Kaesong special economic zone near the demilitarized zone.

Chinese foreign travel on the rise. China's National Bureau of Statistics reports 57 million Chinese travelled abroad in 2010. The number of travellers rose by about a fifth from 2009. The most recent available breakdown of travel by country destination is available for 2009, when 85 % of Chinese foreign travel was bound for countries in Asia. The biggest destinations were Hong Kong and Macau, which accounted for 70 % of Chinese foreign travel. The other top-five destinations were Japan (3 %), Korea (3 %) and Taiwan (2 %). Taiwan opened up to Mainland travellers in 2008.

A recent report by the Boston Consulting Group (BCG) shows that Chinese tourists are younger than their American counterparts and prefer to travel with friends rather than family. The Chinese tend to use travel bureaus to book their trips and arrange visas. According to BCG, half of the spending of Chinese tourists abroad goes to buying goods. Western travellers in contrast, spend most of their money on meals and hotels.

Chinese "shop till you drop" behaviour reflects in part the prominence of gift-giving in Chinese society. According to some Chinese sources, shopping is one of the main reasons for foreign travel. The Chinese purchase considerable amounts of luxury goods from Hong Kong and Macau. Luxury items are considerably cheaper than on the mainland where prices are subject to high import duties. In France and the United Kingdom, for example, Chinese tourists have become an important purchaser group of luxury products. In recent weeks, the Chinese media have reported on government plans to lower import taxes on luxury items.

Russia

Deposit insurance agency to pay out biggest settlement ever. Last week, the Central Bank of Russia pulled the licence of AMT Bank for abuse. AMT Bank invested in high-risk assets without setting aside sufficient reserves and hid the true situation in its books. The CBR's concrete reason for the pulling of the bank's licence was inadequate capital.

Although it ranks 83rd among Russia's approximately 900 banks based on its balance sheet, AMT Bank is relatively small. Russia's banking sector is highly concentrated; the five largest banks control almost half of total banking sector assets and top 30 banks control nearly 80 % of total deposits.

AMT holds about 15 billion rubles (€375 million) in household deposits, of which the deposit insurance agency will remunerate some 12 billion rubles to depositors. It is the largest settlement the agency has ever had to pay for a single bank. The remaining 3 billion rubles will be collected in the bank's winding down process.

Last year, the deposit insurance agency dealt with the fallout from the de-licencing of 16 banks, which resulted in a total compensation of 15 billion rubles. The largest settlement for a single bank was 5 billion rubles. The number of banks having their license pulled has returned to pre-crisis levels. In 2008 and 2009, there were about 30 licence cancellations a year. The related compensation amounted to 6 billion rubles in 2009, and 16 billion rubles in 2008.

The deposit insurance scheme was introduced in 2004. Deposits of up to 700,000 rubles (€17,500) are covered. At the end of 2010, some 99.7 % of bank accounts had deposits below the ceiling limit. About 70 % of the total sum of deposits is covered under the deposit insurance scheme.

Sberbank, the traditional choice of household depositors, held 48 % of total deposits at the end of last year. Most Sberbank accounts fell below the coverage ceiling, while in smaller banks that more often serve well-heeled clientele more than 50 % of accounts exceeded the deposit insurance ceiling.

The use of banking services in Russia is still lower than in advanced economies. Last year, some 73 million people (about 66 % of Russia's adult population) used banking services. Some 45 million people, or about 40 % of the adult population had a bank deposit account.

OECD: Russia's innovation policy in need of a make-over. An OECD review on innovation policy in the Russian Federation released in June finds that innovation policy still suffers from overemphasis on state research bodies rather than private companies. In most OECD countries, the private sector is the principal driver of inno-

vation. In Russia, the leading role is still played by state research institutes and engineering offices. The effectiveness of these institutions is crippled by the fact that as a Soviet-era legacy they function in isolation from production and markets. User needs are not known, and commercialisation of innovative products is restrained by missing links to industrial producers.

Innovation and modernisation are the new taglines in Russia's current economic policy. The OECD criticises this policy for excessive focus on high-tech innovation, when the economy would actually benefit more from more mundane innovations. They would be important in particular for Russia's regions, where production capabilities are at modest technical levels.

Russia spends a relatively small amount on R&D. In 2008, Russian spending on R&D amounted to over 1 % of GDP, compared to an OECD average of over 2 %. The Russian state provided 65 % of R&D funding in 2008 while in OECD countries, the corporate contribution averages 65 %. The review noted Russian R&D funding is often distributed without clear targets or oversight.

In order to encourage innovation activity in the private sector, companies need to aim for long-term gains. This requires a more stable economic environment in Russia. Innovation, like most private corporate activities, is victim to e.g. bureaucracy, corruption and poor property protection. According to the OECD, increase in innovation activity is impossible without gains in these areas.

Recommendations in the OECD report include development of existing state research facilities by connecting them more closely to industrial production, improving protection of intellectual property and boosting competitiveness. The OECD further suggests increasing funding for innovation.

New law imposes stricter limits on alcohol sales and advertising. An important distinction in the new legislation approved last week is that beer is now regarded as alcohol. Hence, restrictions concerning alcohol now cover beer, too. E.g. the sale of beer to persons under 18 years of age is now banned.

Under the new rules, sale of alcoholic beverages in places other than restaurants is forbidden between the hours of 11pm and 8am. Alcoholic beverages may not be sold at kiosks, currently one of the most popular places for buying beer. Beer kiosks and night selling of beer, however, will be phased out at the end of 2012.

Alcohol ads may not use human or animal images, and ads for beverages with alcohol content above 5 % will be forbidden on tv, radio and billboards from next summer.

Consumption of alcohol is banned in public places such as public transport, train and bus stations, market squares and parks.

Work on the new law started after president Medvedev suggested alcohol restrictions in 2009.

China

China's high-speed rail network plagued by safety issues and alleged corruption. Approximately 40 people were killed and over 200 injured in a bullet train accident in Eastern China last Saturday (July 23). The crash with another train has forced a revisiting of China's ambitious plans to roll out a vast bullet train network and move into lucrative export markets. Bullet train projects have been harshly criticised for creating opportunities for corruption, while breakdowns in safety precautions have stained the image of infrastructure projects. Railways minister Liu Zhijun was dismissed last February on suspicion of bribe-taking. Bullet train connections have recently suffered from operational failures and delays. Following the accident, the shares of China's largest train manufacturers CSR Corp. and China CNR Corp. dipped about 8 % on the Shanghai Stock Exchange.

China presently has built and operates 8,400 kilometres of high-speed rail. The government hopes to expand the high-speed rail network to 13,000 kilometres of track this year and 16,000 kilometres by 2020. Cost overruns on the project are already on the record. China's Ministry of Railways now estimates the actual costs of the project will rise by about \$430 billion from an initial estimate of \$300 billion.

The massive investments in high-speed rail have raised concerns over the debt burden of Ministry of Railways. In its 2011Q1 interim report, the ministry showed an exceptional \$574 million pre-tax loss and debts of \$279 billion (60 % of total assets or 4.6 % of China's 2010 GDP). The Ministry of Railways has been financing the rail projects mostly through domestic bank loans and bond issues. For the first time ever, the Ministry of Railways failed to sell all of its issued debt at auction; out of some 20 billion yuan in bonds offered in July 21, only 18.7 billion yuan's worth were purchased.

Total railway passenger traffic for 2010 was about 1.7 billion persons, up 10 % from 2009. In the first six months of 2011, passenger traffic overall grew 12 %. The number of bullet train passengers, however, has not risen as hoped due to pricy tickets that depress bullet train ridership.

Significant difference in wage levels across provinces and job sectors. In the second quarter of this year, nominal wages rose on average over 15 % y-o-y. Real wages were up 9 %. With the pickup in inflation, real wage growth somewhat lagged the pace seen in previous years. According to National Bureau of Statistics' wage figures, the average annual wage last year was 36,500 yuan (€4,100).

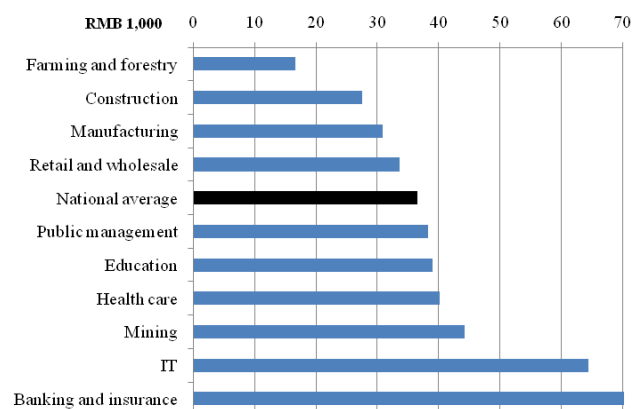
The rise in wage levels reflects new policies geared to encourage consumerism by giving Chinese higher disposable incomes and increasing purchasing power. Last year's efforts to raise the minimum wage will continue this year. In the first half of this year, minimum wage levels have been raised on average more than 15 % in 18 regions. Under the current five-year plan, officials have targeted an increase of at least 13 % p.a. for minimum wages. In addition to policy measures, companies in China's coastal provinces have been rapidly increasing wages to hang on to workers as the skilled labour shortage deepens. Such rapid wage growth is helping to fuel inflation in China.

China's highest wage levels are enjoyed by residents of China's east-coast metropolises – Beijing, Shanghai and Tianjin. In the second quarter of 2011, wages in Beijing were nearly double the national average. The average wage nationally was exceeded only in China's coastal provinces and the Tibet province.

Wage growth in coastal areas has been more modest than the national average, except for the large urban areas and lower-wage Fujian and Liaoning provinces. Wage growth this year spiked sharply in Beijing and Shanghai. On the other hand, wage development in lower-wage provinces in Central China has been above average. The trend reflects the inland shift of production away from expensive coastal areas. This impact, however, has failed to extend to Southern and Northern China, where the rise in average wage levels has been slower than the national average. The big exceptions are the Inner Mongolia and the Xinjiang provinces, which have enjoyed brisk wage growth.

The differences across various branches were also huge. Wages have risen fastest this year in retail and wholesale, and banking and insurance. Wage development in manufacturing has also exceeded the national average. Accelerating labour costs cause China to lose competitiveness vis-à-vis Asian countries that offer cheaper labour.

Average annual wages in selected branches in 2010.



Source: China National Bureau of Statistics

Russia

Decent harvest outlook. Russia's agriculture ministry is currently projecting a 2011 grain harvest in the range of 85–90 million metric tons, a considerable improvement over last year's drought-depressed figure of 61 million tons. The 2009 harvest topped 97 million tons, while the bumper 2008 harvest holds the record at 108 million tons.

Russia is expected to export about 18 million tons of grain this year, including some 16 million tons of wheat. The government last August banned the export of certain grains, including wheat and oats, due to the poor harvest. The ban was only lifted at the end of June. In 2009, Russia exported 22 million tons of grain, of which 18 million tons was wheat. Russia that year was the world's third largest wheat exporter after the United States and Canada.

With last year's poor harvest, the state substantially increased agricultural subsidies, including increases in interest support for loans to producers and assistance in re-scheduling of loans. Producers were also given money for fodder to avoid massive slaughter of livestock.

After the depressed 1990s, agricultural subsidies were increased throughout the 2000s in Russia. Today they are close to EU levels (due in part to reductions in EU farm subsidies in the same period). The OECD estimates that subsidies represented 22 % of farm income in Russia in 2008–2010, when the OECD average was 20 % and the EU average 22 %.

Agricultural subsidies are still an open issue in Russia's WTO accession talks. Russia wants to boost subsidies in coming years and then gradually return them to their current level within 5–7 years.

Passenger car production and car imports surging. In the first six months of this year, 818,000 passenger cars were produced in Russia, a 77 % y-o-y increase. First-half production exceeded more than half of the production set in 2008.

According to Autostat, the leading tracker of Russian car industry, in 2010 the number of foreign-make cars produced in Russia exceeded domestic-make units for the first time ever. Foreign-make cars were 52 % of total production.

AvtoVaz, Russia's largest car producer and maker of the ubiquitous Lada, produced 295,000 cars in the January-June period, and accounted for 36 % of domestic production. Production was up 35 % y-o-y. AvtoVaz has been rapidly losing market share, however; last year it accounted for 45 % of Russian car production. Production of foreign car makes increased sharply in the first half of this year on a quadrupling of output from Hyundai, GM, Nissan and Toyota plants located in the St. Petersburg region. Their production climbed to around 99,000 cars or 12 % of total national production. In addition, Avtotor's assembly plants for BMW, Kia, Opel and some others in the Kalin-

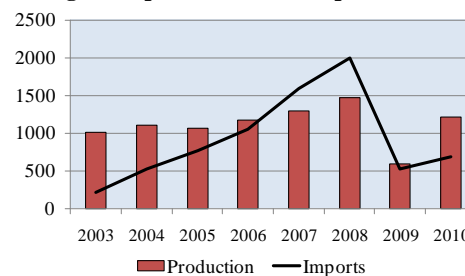
ingrad enclave accounted for 14 % of Russia's total car production. Volkswagen's Kaluga plant accounted for 7 % of total production.

Demand for new cars built or assembled in Russia was boosted by a trade-in programme launched in 2010. The "cash for clunkers" programme enjoyed about 30 billion rubles (€750 million) in funding and 600,000 new cars were sold under the programme. The largest beneficiary was AvtoVaz, which raked in 77 % of the programme's total funding. The programme ended in June.

The International Organization of Motor Vehicle Manufacturers reports that about 2 % of global car production was based in Russia in 2010. China accounted for 24 % of world car production and the EU 26 %.

Passenger car imports rose 93 % y-o-y in January-May to 371,000 vehicles. Even so, imports were far below the peak levels of 2008. This was due largely to the 30–35 % duty imposed on car imports in the midst of the 2009 recession.

Passenger car production and imports (thousands)



Sources: Rosstat and Russian Customs

Some progress in Russia's WTO negotiations. Late last month in Geneva, Russia's multilateral talks with the WTO working group tackled thorny outstanding issues, including automobile assembly plants, meat import quotas and agricultural subsidies. The most progress was achieved on the farm subsidy front.

Although Russia has failed to keep to the ambitious accession timetable laid out at the start of this year, it remains technically possible that Russia could be approved for WTO membership before the end of December. As long as outstanding issues can be resolved by November, Russia's petition for accession could be brought before the WTO General Council meeting in December.

Membership requires unanimous approval of the General Council, which includes Georgia, a declared opponent of Russian membership. Switzerland has served as a mediator in the Russia-Georgia dispute, but the three-party talks have yet to reach a solution.

After the General Council approves membership, Russia must ratify its accession documents, which could take several months. Moreover, it takes another month after ratification for membership to be official. Given these constraints, Russia's could join the WTO in the first half of 2012 at the earliest.

China

Chinese economy registers slight slowdown. Although China's GDP still climbed a respectable 9.5 % y-o-y in the second quarter, there are numerous signs that growth overall is slowing. The official index of manufacturing purchasing managers (PMI) suggested dimmer but still positive trend, dropping slightly to 50.7 points in July. The reading was still around 53 points a half year ago. The alternative PMI released by HSBC, which is based on smaller sample and covers a larger share of small and medium-sized enterprises, dropped below the critical 50-point threshold to 49.3 points, indicating that manufacturing output was already in decline in July.

Despite evidence that growth in the service sector remains brisk, the duelling PMI numbers gave an inconclusive picture. The official PMI showed output of services revived in July from June, while the HSBC PMI portrayed the growth in services as slowing.

The latest data on foreign trade volume suggests that domestic factors such as the pick-up in inflation and monetary tightening, as well as the evaporation of foreign demand are depressing growth. The growth in on-year volumes for June imports and exports fell substantially from previous months; import volume was up just 3 % y-o-y and exports up 6 %.

Foreign banks with established local branches will be allowed to expand into local mutual fund products. The China Securities Regulatory Commission (CSRC) announced in June that foreign banks operating in China and Chinese private mutual fund companies can sell Chinese mutual fund products starting October 1. The new rules also make it possible to charge a wider selection of service fees than was previously possible. Indeed, there are relatively few services yet available in the mutual fund market because fund managers have not been allowed to charge higher fees for value-added services. As a result, Chinese investors have typically invested abroad via large international asset management firms.

Chinese commercial banks and securities brokerage houses were previously the only institutions permitted to sell Chinese mutual fund products. Chinese private mutual fund operators traded indirectly via banks, which meant their operations were outside the scope of CSRC regulation. A range of estimates of the size of China's mutual fund market has been presented; e.g. the *Financial Times* reports that registered mutual fund companies administer assets worth about 2.4 trillion yuan (€262 billion).

Officials hope that allowing foreign banks to get into the mutual fund business will increase competition in the field and reduce the dominant market position of Chinese commercial banks. Rules concerning the operations of

foreign banks are strict in China, and the market share of foreign banks has remained under 2 %. A PricewaterhouseCoopers survey released in June found that foreign banks operating in China are optimistic about their future prospects, despite the strict regulatory environment. Banks believe China's markets will continue to open up and international acceptance of the yuan will create new growth opportunities. On the other hand, China's tight monetary stance has made it hard for foreign banks to lend and strict regulation remains a big challenge for the markets.

Investments in real estate markets remained brisk in the first half of the year. Construction investment grew 33 % y-o-y in January-June. This was partly due to huge state investments in construction of affordable housing and the fact that real estate continues to be seen as a good investment by Chinese. The volume of foreign investment grew significantly. Foreign direct investment doubled from a year ago to 33 billion yuan (\$5 billion). Foreign investors were focused on various types of commercial space.

Prices for commercial space have risen fastest in coastal provinces. Sales of commercial space increased 20 % y-o-y in January-June. Apartment sales were somewhat slower, rising 12 % y-o-y. Investment in commercial space and apartment buildings overall increased nearly 40 %.

Despite the government's tightening measures, the rise in housing prices remained brisk in the first half. Housing prices rose an average of 7 % y-o-y in the period. Tightening measures to date have had their strongest impact in the major metropolises such as Beijing and Shanghai. Over the past two months the on-year rise in housing prices in the metropolises have been around 2 %.

Large regional cities have seen a greater rise in housing prices in recent months. The 5 % y-o-y pace is faster than in the major metropolises. The government not only plans to extend its housing purchase restrictions from major metropolises to other cities and large towns, it also expects further tightening measures.

The risk persists of a housing bubble in China. Construction activity remains an important economic driver, accounting for 12 % of GDP last year. The IMF earlier warned of the contagion effects of a housing crash on the economy and the banking system.

Housing prices remain high relative to household incomes. Although the framework of the current five-year plan calls for construction of 10 million affordable apartments this year, construction has only just begun. The estimated cost of the new housing is \$200 billion, of which more than half will be provided by the private sector. The public sector will contribute \$75 billion, with some \$60 billion coming from local administrations and the remainder from the state budget. The ability of local administrations to fund their contribution is doubtful in some cases, so the central government is planning to help out by allowing certain local administrations to issue bonds.

Russia

Ruble falters and share prices slump. After being relatively steady since the spring, the ruble's external value plummeted in recent days as jitters on international markets spread to emerging markets.

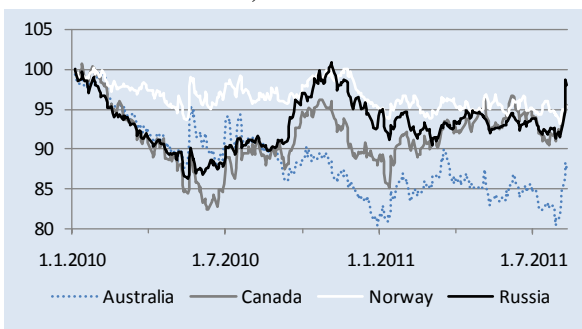
The ruble has lost about 6 % of its value since August 1 against the Central Bank of Russia's dollar-euro currency basket. The drops witnessed this week were the largest since January 2009. Currency trading volumes were also exceptionally large as both domestic and foreign investors dumped rubles. Relative to its dual-currency basket, the ruble is now at the same level as in late 2010. On August 12, one dollar bought 29.4 rubles and one euro 41.9 rubles.

On Tuesday (Aug. 9), the CBR intervened for the first time this year in an effort to stem ruble depreciation. Observers estimate the central bank burned through \$200–700 million to support the ruble.

The CBR's foreign currency and gold reserves have continued to grow since the start of the year. As of end-July, Russia's currency reserves stood at \$534 billion, up from \$479 billion at the start of the year.

The ruble's slump partly reflects the global drop in crude oil prices that began at the end of July and picked up steam this week. As of August 11, the price of Urals-grade crude oil stood at \$107.0 per barrel, down from \$115.6 on August 1. In the first half of this year, Urals oil averaged \$109.1 a barrel.

Exchange rates of commodity-exporting countries' currencies vis-à-vis the euro, 1.1.2010=100 (declining trend = appreciation vis-à-vis the euro)



Source: ECB

As on stock exchanges around the world, Russian share prices plummeted this week, with the RTS index shedding 15 % of its value. After the drop, the RTS index was down 27 % from its post-crisis peak in April. The RTS currently stands at the same level as in October 2010. Observers report that foreign investors, in particular, have been shifting their assets out of Russia on worries that declines in oil and other commodity prices will continue.

The rise in consumer prices stalled in July, reflecting the summer drop in food prices. 12-month inflation was 9 %, down from 9.4 % in June.

Russia continued to export capital in the first half of the year. Preliminary CBR balance-of-payments figures show Russia exported a net of \$31 billion in private capital in the first half of 2011. Banks exported \$12 billion in capital in the first half of the year, while non-banks exported \$19 billion. In 1H10, private capital exports amounted to \$12 billion, and were \$34 billion for all of 2010.

Capital exports of banks in the first half largely reflected large loans granted by state-dominated Sberbank to Russian firms. Such loans are booked as capital exports when paid outside Russia.

Foreign direct investment enjoyed a robust rebound in the first half of this year as Russia received \$27 billion in FDI, an increase of 50 % from 1H10. Despite the strong growth, direct investment inflows into Russia were still smaller than FDI outflows for the third year in a row.

Russia increases government borrowing. The government approved on Thursday (Aug. 11) a state debt policy programme for 2012–2014, prepared by the finance ministry. The policy message stresses that the federal budget is likely to remain in the red through 2014 due to growth in spending, even if revenues remained strong due to high world commodity prices.

The federal deficit will be financed largely through borrowing, which will increase sharply from current levels. The increase in indebtedness is expected to be quite manageable, however, as Russia currently has a small debt burden relative to GDP. Even so, the programme warns that the increase in indebtedness and debt-servicing costs carries risks, especially if growth in the global economy suffers another major setback.

Domestic bond issues will finance nearly 90 % of the deficit, which translates to an average of about 2.0 trillion rubles (\$70 billion) a year in borrowing. Foreign bond issues will amount to about 200 billion rubles (\$7 billion) a year. Russia's public debt is expected to rise to 12 trillion rubles (\$410 billion) or 17 % of GDP by the end of 2014.

Russia's finance ministry reports that Russia's public debt stood at around 4.6 trillion rubles (about \$160 billion or 9 % of GDP) at the end of June. Of that, domestic investors held 3.6 trillion rubles (\$125 billion) and foreign investors \$37 billion.

Russian officials say the country's creditworthiness has been underrated by the major international credit ratings agencies given its low debt-to-GDP ratio. Russian bonds are barely considered investment grade, on par with the sovereign debt of Mexico or Brazil.

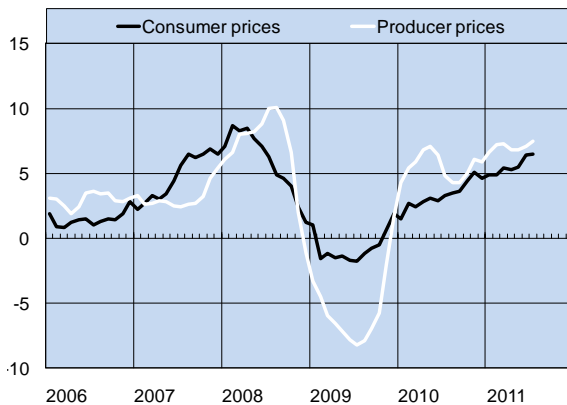
China

Inflation limiting China's economic policy choices. July consumer prices hit 6.5 % y-o-y, up from 6.4 % in June. July prices rose 0.5 % on-month, up from 0.3 % m-o-m in June. Consumer price inflation was driven by rising food prices, which were up nearly 15 % y-o-y, while the average price for the other items in the shopping basket rose 2.9 % y-o-y. Housing prices climbed 5.9 % y-o-y, but showed virtually no change from June to July.

Despite high inflation, China's leadership is not expected any time soon to further tighten its monetary policy stance as inflation is not expected to accelerate further. While the rather bleak outlook for the global economy lessens commodity price pressures, the current situation also poses risks to China's growth prospects.

Yuan strengthening against the dollar is also quelling rising import prices. On Thursday (11.8.), the yuan-dollar exchange rate fell below 6.40 for the first time since the unification of yuan exchange rate in the beginning of 1994.

Chinese inflation rates, 12-month percentage change



Source: Bloomberg

Growth in industrial output and retail sales in July slowed as expected. July industrial output climbed 14 % y-o-y in real terms, a percentage point lower than in June. Seasonally adjusted industrial output rose 0.9 % m-o-m in July, the smallest monthly increase this year. While growth in e.g. the textile industry was below 9 % y-o-y, cement production, which reflects levels of construction activity, increased 17 % y-o-y. Electricity production was up 13 % y-o-y in July, suggesting that China's economic growth was fairly broad based.

The value of retail sales in July was up 17 % y-o-y, or a half percentage point lower than in June. The pick-up in inflation ate into real growth in retail sales; the 12-month rate fell below 11 % in July. In addition, seasonally ad-

justed on-month changes suggest the slowdown continued from the previous months.

There were few surprises in investment trends in July. Fixed capital investment was up 25 % y-o-y in January-July in nominal terms, or about the same growth pace as seen earlier this year. Manufacturing accounted for over a third of total fixed capital investment, while investment in housing was about a fifth. Monthly investment statistics do not reflect the national accounts figures as they include e.g. land buying transactions.

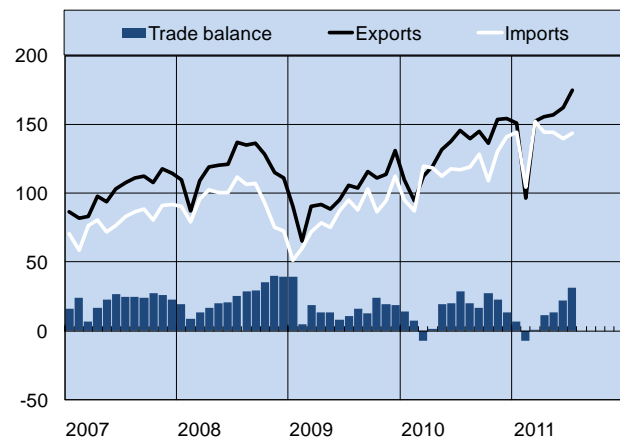
China's trade surplus ballooned in July. The value of China's exports climbed 20 % y-o-y in July to \$175 billion. The value of exports in January-July was up 23 % y-o-y. Despite the damage inflicted by natural disasters and the Fukushima nuclear accident, growth in Chinese exports to Japan held steady relative to 2010. Exports to Japan climbed an average of 24 % in January-July, about the same as in the first seven months of 2010.

The debt problems in Europe and the United States were reflected in a slowdown in China's exports to both regions. Exports to the EU still rose 18 % in January-July, but the growth was down from 37 % in the same period last year. Growth in exports to the US was up 16 %, compared 30 % growth in the same period last year.

The value of imports into China reached \$144 billion in July, an increase of 23 % y-o-y. In January-July imports were up 27 % y-o-y. The high value of imports largely reflected high commodity prices in the first half of the year; import volumes increased only modestly.

The recent global economic nervousness will eventually show up in China's trade figures. China still showed a \$32 billion trade surplus in July, which was about 10 % bigger than in July 2010. The trade surplus once again boosts China's large foreign currency reserves, which adds appreciation pressures on the yuan.

Monthly foreign trade for China, US\$ billion



Source: CEIC

Russia

State set to divest a majority stake in rail freight company. Freight One Company PGK (*Pervaya Gruzovaya Kompaniya*) is a subsidiary of the 100 % state owned Russian Railways. The sale of PGK shares has been long planned, but the Russian government has found it difficult to agree on the terms of the sale. The sale of stakes in companies owned by the Russian Railways is part of the government's privatisation programme.

A 75 % stake (minus two shares) in PGK will be sold at an auction to take place this year. Qualified buyers must be companies registered in Russia to engage in rail freight operations and own at least 15,000 rail wagons. The requirements limit the pool of potential buyers to Russia's largest freight firms. Interested buyers include three of Russia's oligarchs, whose business empires include shipping fleets. PKG is valued at around 154 billion rubles (nearly €4 billion).

PGK, which carries over 20 % of Russia's rail freight, is Russia's largest rail freight company.

Russian rail operations can be divided into three categories. State-owned Russian Railways controls most of the track and rail network, and handles the lion's share of rail passenger traffic and part of freight business. The second category is made up of firms that belong to industrial companies. They have own rail lines that connect their often remotely located production operations to the national rail grid. Gazpromtrans is a typical rail company in this group. The third group consists of mostly private firms, sometimes with multinational ownership, that only own rolling stock.

Customers demand lower gas prices from Gazprom.

Over the past couple of years, several western European energy companies have pushed Gazprom to renegotiate their gas pricing arrangements. Gazprom supplies gas under 10- to 25-year contracts, where the gas price is tied to prices for certain oil products. Over the past two years spot-market prices for gas have been lower than the prices in the long-term contracts.

In 2010, Gazprom agreed with some European gas buyers (e.g. the German E.ON, the Italian Eni and the French GDF) that part of their gas supplies would be provided at spot-market prices through to 2012. Gazprom has not been willing to decrease its prices significantly, and negotiations are continuing.

In summer 2010, the Italian Edison took the initiative by bringing its gas price dispute with Gazprom to the Stockholm Arbitration Institute. The parties settled last month before the Arbitration Institute's decision, with Edison getting lower prices.

Edison is relatively small customer; it annually purchases less than 2 billion cubic metres of gas from Gaz-

prom. An Edison press release noted that the revision would be worth about €200 million for the company.

The German energy giants E.ON and RWE have also turned to arbitration for contract modification. Granting similar discounts would cost Gazprom billions of euros in potential income. E.ON annually purchases 15–20 billion m³ of gas from Russia; RWE around 9 billion m³.

Gazprom last year supplied 24 % of the gas used in Europe. Gazprom lost market share in recent years as it was forced to compete with new gas sources such as shale gas, which has lowered spot-market prices for natural gas globally. In recent months, Gazprom clawed back a bit of market share due to supply disruptions in the Middle East.

Gazprom lowers price of gas sold to Belarus; similar discount for Ukraine unlikely. On Monday (Aug. 15), prime minister Vladimir Putin announced that Russia would reduce the price of gas sold to Belarus. The deal goes into effect from the start of next year simultaneously with the launch of the common economic space between Russia, Belarus and Kazakhstan.

Under the new pricing scheme, the price of gas sold to Belarus will be based on Gazprom's European prices lowered by a coefficient negotiated by Gazprom and Belarus gas monopoly Beltransgaz. Belarus prefers the gas price to be lowered all the way to Gazprom's domestic price level as the countries will be part of a common economic space. Gazprom's domestic price in regions near the Belarus border is currently about 40 % of the \$286 per thousand cubic metres paid by Belarus. President Dmitri Medvedev advised Gazprom to reach agreement on the price well before year's end to avoid the risk of supply disruptions.

In 2006, when Russia and Belarus agreed on gas supplies for the next five years, it was also agreed that Gazprom would purchase a 50 % stake in Beltransgaz. As part of this year's gas supply negotiations in January, the two countries agreed that Gazprom would purchase all outstanding Beltransgaz shares. The sale of Beltransgaz has been instrumental in putting the pricing issue to rest.

At their meeting last week, president Dmitri Medvedev and Ukrainian president Viktor Yanukovich were unable to make progress on resolving the gas pricing issue. Ukraine demands rescission of its 2009 agreement on the grounds that the agreed base price, which is corrected quarterly, is unconscionably high. The high price was negotiated by Ukraine's previous prime minister Yulia Timoshenko. The price Ukraine pays in 3Q11 is \$348 per thousand cubic metres of gas, which is above what EU buyers are currently paying.

According to Yanukovich, Ukraine is ready to take the matter to court. In July, Gazprom CEO Alexei Miller said that the price of gas is negotiable as long as the merger of Gazprom and Ukraine's gas monopoly Naftogaz can be agreed.

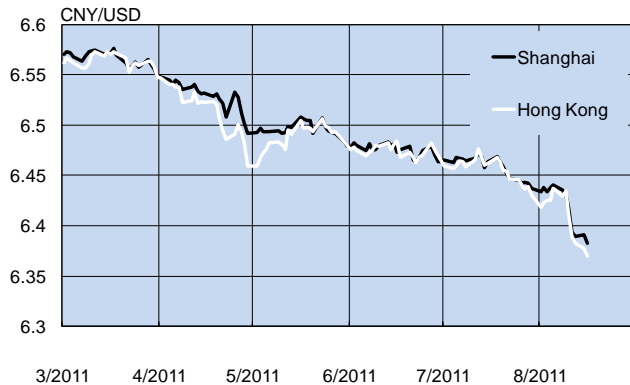
China

Economic turmoil in the United States and Europe add to yuan appreciation pressures. Investors skittish over the debt crisis in advanced industrialised countries have begun to look to investment opportunities in emerging markets such as China. Demand for China's state bonds sold on the Hong Kong's Dim Sum market (yuan-denominated bonds) exceeded expectations last week, when the Chinese state issued 20 billion yuan (€2.2 billion) in new bonds. The high demand for the bond issue reflects strong investor confidence in Chinese economy.

China's deputy prime minister Li Keqiang promised this week that much of the capital movements related to investment activity between Hong Kong and mainland China will be deregulated.

The yuan has strengthened 0.7 % this month against both the dollar and the euro. Today, one dollar bought 6.39 yuan and one euro 9.18 yuan.

Yuan-dollar exchange rates (mainland and offshore)



Source: Bloomberg

World economy worries and inflation depress Chinese share prices. The global drop in stocks continued to be reflected on the Shanghai stock exchange. On Friday (Aug. 19), the Shanghai A-share index for shares sold to domestic investors was down 19 % from its peak in November 2010. The B-share index, which tracks company shares that can be traded by foreign investors, was down 20 % from its recent April peak. The decline in share prices in China in recent weeks was set off by Standard & Poor's decision to downgrade US sovereign debt. In response, Shanghai's A-share index tumbled last week to its lowest point this year.

The Shanghai A-share index comprises over 900 firms with a total market capitalisation currently worth of €1.8 trillion. The average price-to-earnings ratio (P/E) is about 14.

The index for dollar-denominated B-shares geared to foreign investors once closely tracked the A-share index. Since the end of 2009, however, the B-share index has outperformed the A-share index and reacted more sharply to global markets. The B-share index is composed of 54 Chinese firms. With a value of €9 billion, its total market capitalisation is much lower than the A-share index. The average P/E for B-shares is presently around 15.

Shanghai A- and B-share indices, January 2007=100



Source: Bloomberg

Summer grain harvest was 126 million tons. Despite a severe drought in the first half of the year followed by major flooding, China's summer grain harvest was still up 2.5 % y-o-y. The summer harvest accounts for about a quarter of the year's total grain harvest, most of which is harvested in autumn. The total harvest last year amounted to 546 million metric tons.

China is the world's largest producer and consumer of many farm products. The country is largely self-sufficient in grain production as well as several other staples. With the exception of certain critical ingredients, China imports relatively little food from abroad. Among the top imported foods are soybeans and various vegetable oils. A tiny sliver of China's agricultural production ends up as exports. The biggest export categories are fresh fruits, vegetables and fish.

In 2010, agriculture generated about 10 % of GDP and provided livelihoods for some 300 million people (40 % of China's labour force). The supply of arable land is quite limited – about 160 million hectares for all of China which translates to about 0.54 hectares per farmer.

The government's top priorities in farm policy include self-sufficiency in domestic grain production, higher wages for farmers, as well as rural development. Raising rural wages is a way to reduce the yawning earnings disparity between the countryside and urbanites, as well as stave off potential social unrest. The quality of food and food safety has recently gained attention as the agricultural sector continues to develop and wages rise.

Russia

Major uncertainties cloud Russia's economic growth prospects. Rosstat reports that GDP growth slowed significantly in the second quarter to just 3.4 % y-o-y. In the first quarter, GDP still grew over 4 % y-o-y, making first-half growth 3.7 % overall. Preliminary estimates from the economy ministry suggest GDP growth perked up clearly in July.

A number of institutions that track the Russian economy have revised downwards their forecasts of Russian GDP growth this year. Most 2011 forecasts now run in the range of 4.0–4.8 %. Growth is expected to pick up in the second half, as e.g. grain harvests recover from last year's poor result. On the other hand, economic indicators based on company surveys point to slower pace of growth over the coming months.

Despite increasing oil prices since early 2009, demand in the private sector and the public sector (which heavily taxes oil export earnings) has not increased as fast as in the pre-recession years. Developments of GDP demand-side components have been uneven. Retail sales have climbed rather steadily since February even with a slight drop in real household incomes from last year due to higher inflation. Inflation is expected to slow in the second half of this year, so consumption should remain strong.

A revival of investment has been awaited ever since the recession's bottoming, yet after the latest recovery this spring, investment has remained in the doldrums. On a seasonally adjusted basis, investment has actually fallen slightly since late spring. Investment has traditionally been seen as rather strongly supporting domestic production. Investment is foreseen to finally begin to recover this year as utilisation of production capacity has returned towards pre-recession levels and production will relatively soon reach a point where new investment becomes essential. However, the investment revival may be dragged out to next year as uncertainty continues to affect the corporate operating environment, which may be subject to a negative extra until the upcoming Duma elections in December and the presidential election next March.

The volume of Russia's exports contracted slightly in the first quarter of this year compared to 1Q10, as crude oil exports fell more than expected. There was also an unpredicted decline in fuel oil exports. Preliminary data suggest exports started to recover in the second quarter and are anticipated to grow this year by a few per cent as natural gas exports should rise substantially.

Rapid growth in imports continued in the first quarter, at 23 % y-o-y. Growth slowed, however, in the second quarter. Current forecasts reflect expectations that import growth in the second half of the year should be significantly

lower than in the past two years, when imports were recovering from a deep crater.

Uncertainty on global markets could postpone government plans to sell shares in state-owned companies. A tranche of 7.6 % of shares in Sberbank, Russia's largest bank, is set to go on sale next month on the Moscow stock exchange and international bourses. The seller is the Central Bank of Russia, which holds a 57.6 % stake in Sberbank. After the sale, the CBR would still retain a 50 %-plus-one-share majority stake in the bank.

The sale is now apparently being postponed due to the prevailing turbulent market conditions. Sberbank's share price on Moscow's RTS exchange has declined 25 % since the start of July. In the same period, the RTS general index has lost 17 % of its value.

The sale of Sberbank shares is part of the government's privatisation programme approved in October 2010. Earlier this year, president Dmitri Medvedev demanded expansion of the divestment programme to include more companies and increase the stakes for sale from what was originally planned. In response, the government has prepared an expanded version of the privatisation programme that includes the reinstatement of oil pipeline operator Transneft on the partial divestment list. Other infrastructure companies on the list include Russian Railways and national power grid operator FSK. The state will retain its majority stakes in infrastructure firms, with all divestments leaving the state with at least a 50 %-plus-one-share holding.

Under the revised programme, the state would gradually sell off its holdings in six large firms by 2017. The six targeted firms include oil company Rosneft, telecom Rostelekom and struggling diamond miner Alrosa. Here, the government would keep a "golden share" in each company that confers veto power over shareholder meeting decisions.

In addition, the Russian government hopes to divest all its holdings in seven large corporations, including shipping giant Sovkomflot, Rosselhozbank, VTB bank and state airline Aeroflot. Currently, the Russian state owns 100 % of Sovkomflot and Rosselhozbank, 75.5 % of VTB and 51 % of Aeroflot. VTB is Russia's second-largest bank in terms of total assets, while Rosselhozbank is number four. Last February the state sold a 10 % stake in VTB on the Moscow and London stock exchanges.

Under government plans, the selling of shares in companies such as Rosneft and Sovkomflot could begin as early as next year.

In its commentary published in July, credit rating specialist FitchRatings noted that the sell-off of state assets in Russia and other CIS countries, which implies a subsequent decline in state support, is likely to result in ratings downgrades for many companies. The downgrades could impact up to 60 % of rated state-owned enterprises in the CIS region subject to partial or complete divestiture.

China

China drafts new safety rules for nuclear power plants.

In the wake of the Fukushima nuclear accident last March, the Chinese government decided to suspend approvals of construction permits for nuclear power plants until safety regulations for the industry could be reviewed. Inspections of all operating nuclear power plants were ordered immediately. Inspection of nuclear plants currently under construction was also completed early this month. The inspection findings are to be submitted to the government for action.

The World Nuclear Association (WNA) reports that China currently has 14 operational nuclear reactors and another 28 under construction. Production capacity in 2010 was estimated at just under 11 GW. Nuclear power, however, accounts only for about 2 % of Chinese energy production. China's current goal is to increase nuclear production capacity to 80 GW by 2020, at which time nuclear energy would account for 5 % of the country's power production. China invested 63 billion yuan (€6.8 billion) in nuclear power last year; nearly 10 % more than in 2009. Nuclear power production in China is rising faster than in any other country.

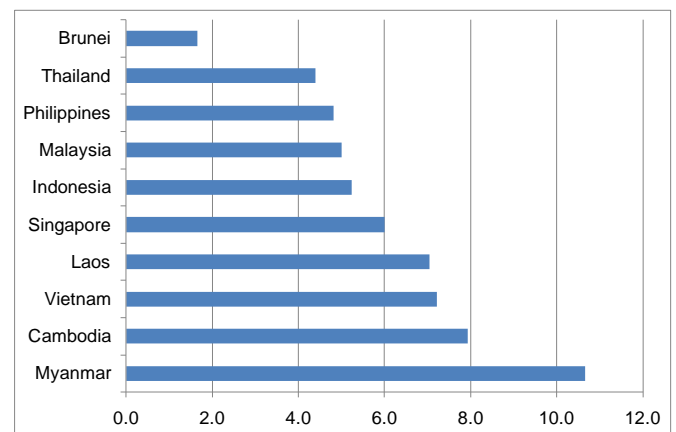
The increased reliance on nuclear energy in China to some extent depends on the availability of uranium fuel. At the moment, China imports most of its uranium. It imported 17,136 tons of uranium in 2010, a three-fold increase from 2009. The WNA estimates China's uranium consumption will reach 20,000 tons a year by 2020 and that domestic uranium production will only be sufficient to meet 12 % of demand.

ASEAN countries are important trading partners for China. ASEAN member countries have accounted for about 10 % of Chinese exports and imports in recent years. China's share of ASEAN countries' foreign trade has also been running slightly above 10 %. ASEAN was founded by Indonesia, Malaysia, the Philippines, Thailand and Singapore in 1967. Currently the organisation boasts ten members with the admissions of Brunei, Myanmar, Laos, Cambodia and Vietnam. Although a free-trade agreement between China and ASEAN countries entered into force at the start of 2010, it has yet to result in any discernable shift in trade flows between China and the ASEAN bloc.

All ASEAN economies grew in the past decade, but rates of growth varied widely. The poorest ASEAN members (Myanmar, Cambodia, Vietnam and Laos) all enjoyed on-year growth averaging 7–11 % during the period 2000–2010. Even as the poorest ASEAN countries continue to play catch-up, however, their GDP per capita remained only about \$1,000 in 2010, which amounts to less than 3 % of the GDP per capita of Singapore, ASEAN's richest member.

Japan's struggles this spring are reflected to varying extent in the performances of different ASEAN economies. The shocks to global supply chains from Japan's triple hit of earthquakes, tsunamis and nuclear meltdowns had profound impacts on the exports of Singapore, Thailand and the Philippines that led to declines in GDP in those countries during the late spring and early summer. With Japan's recovery from disaster underway in the third quarter, exports in these hard-hit ASEAN countries are expected to rebound. The near-term growth prospects are still uncertain, however, as developed nations struggle with their own debt crises, the impacts of which are still hard to predict with respect to ASEAN members. Over the long term, the growth outlook for ASEAN countries in China's neighbourhood is excellent.

Average yearly GDP growth of ASEAN countries, 2000–2010, %



Source: IMF

Growth in car sales slowed substantially in the first seven months of the year. For the January-July period, 10.6 million cars were sold in China, an increase of 3 % y-o-y for the period. Car sales were rising at about 40 % a year in 2009 and 2010.

About 10.5 million cars were manufactured in China in January-July period, an increase of 2 % y-o-y. Car sales growth and car production have slowed at about the same pace over the past two years.

One reason for the slowdown in car-buying has been the phasing out of 2009 tax incentives to car buyers. In addition, fuel costs have risen and car purchases have actually been restricted in some cities. Car sales account for a big part of retail sales (nearly 30 % in 2010).

Strong export growth indicates Chinese carmakers are now eyeing foreign markets. China customs officials report that China exported 460,000 passenger cars and service vehicles in the January-July period, an increase of 64 % from the same period in 2010. The volume of exports, however, equalled just 4 % of domestic sales.

Russia

New regime for export taxes on petroleum products.

Russia has long contemplated reform of how it sets export duties on oil products. After a request of prime minister Vladimir Putin to the relevant ministries in July, the cabinet decided on the issue last week. The revised “60/66” duty scheme will enter into force on October 1. The new approach unifies export duties on petroleum products, which are tied to the crude oil export duty. The unified rate is 66 % of the crude oil export duty, which is reviewed monthly to reflect world market price changes. Under the new scheme the export duty on light fuel oil (diesel oil, jet fuel) will be lowered a percentage point, while the export duty on heavy fuel oil will rise by about 19 percentage points.

The new tariff does not apply to gasoline, which already carries a stiff export tariff. The gasoline export duty was raised in May from 70 % to 90 % of the crude oil export duty after a domestic shortage of gasoline emerged in Russia that caused prices to spike.

A goal of the revised schedule is to reduce exports of heavy fuel oil, which account for about half of all oil product exports. Oil companies have been attracted to exporting heavy fuel oil precisely because of the low duties, even if heavy fuel oil is only about 3 % more expensive than crude oil. The low export duty even gave oil companies incentive to export slightly processed crude oil as heavy fuel oil.

The increased duties are intended to encourage oil companies to increase the value-added component in their refining operations by producing light fuel oil products rather than heavy fuel oil. Under the cabinet’s plan, export duties on heavy fuel oil and crude oil will be unified by 2015.

The government, which has long struggled with lowering the crude oil export duty, is expected to decide on the matter soon. A change is hoped to encourage oil companies to increase their investments. Taxation of crude oil production and exports is strict and highly progressive with respect to the oil price. At high oil prices the state captures about 90 % of any increase in the oil price.

Lapses in banking supervision. Major abuses by Russian banks have come to light over the past year. It has been nearly a year since the default of Moscow-based Mezhprombank, which went down with 80 billion rubles (€2 billion) in debt (including unsecured loans from the Central Bank of Russia to support the bank during the 2008–2009 recession). Sentiments about Mezhprombank flared last month with news that the bank’s head, billionaire Sergei Pugachev, had fled to London. The CBR also pulled the AMT Bank’s licence in July, forcing Russia’s Deposit Insurance Agency to pay out its largest settlement ever to depositors – 12 billion rubles (€300 million). There is also continuing concern over the struggling Bank Moskv. Last

February, the City of Moscow sold its 46 % stake in the bank to state-owned VTB Bank. Details of the poor condition of Bank Moskv slowly emerged after the deal, making the CBR grant a low-interest loan of 295 billion rubles (€7 billion) to complement the capital infusion of 100 billion rubles (€2.5 billion) from VTB.

In all of the above instances, the issue is fraudulent bookkeeping that misstates e.g. tier-1 capital, reserves or loan collateral, or loans granted to fictional firms or entities closely tied to the banks. Gennady Melikyan, CBR deputy chairman in charge of banking supervision since 2006, said the CBR was aware of the malfeasance long before the bank licence cancellations, but due to the lack of formal evidence to establish fraud the CBR was unable to act.

The IMF, among others, has encouraged Russia to bolster its banking supervision with appropriate legislation. Bank supervision has developed substantially in recent years, but there are still gaps in the system.

Though widely praised for his work, Melikyan gave notice in July, and chairman Sergei Ignatyev accepted his resignation last week. Melikyan’s predecessor was Andrei Kozlov, who was shot in Moscow in 2006.

China Construction Bank announces plans to establish subsidiary in Russia. The board of China Construction Bank (CCB) decided on August 19 to put up about \$150 million in capital to set up a banking operation in Russia. The large amount of capital allows the bank the possibility to get a general licence immediately. A general licence allows the bank to provide services to businesses and households. In terms of capital, the new bank would join the ranks of Russia’s 100 largest banks.

CCB is mainly owned by the Chinese state. It is China’s second-largest bank, and its assets at the end of 2010 amounted to 11 % of China’s banking sector’s total assets. The bank’s IPO was in 2005, and as of end-2010 CCB was the world’s second largest bank in terms of market capitalisation. About 35 % of CCB shares are held by non-Chinese.

Two Chinese banks currently operate in Russia. Both are subsidiaries of large state-owned banks. Although one has a general licence, they only rank among Russia’s 280–300th largest banks in terms of total assets. The CBR categorises both as small banks.

Some 220 banks with foreign capital currently operate in Russia. About half are majority owned by a foreign entity. Three foreign-owned banks are included in Russia’s top ten banks measured in terms of total assets. The Italian Unicredit Bank ranks eighth, followed by the French Rosbank in ninth place and the Austrian Raiffeisenbank in tenth. The three banks combined account for 5 % of the banking sector’s corporate lending, 7 % of household lending and 3 % of household deposits. The respective shares for Russia’s largest bank, Sberbank, are 31 % of both corporate and household lending, and 47 % of household deposits.

China

Monetary screws keep turning as PBoC moves to include customer margin deposits as part of banks' reserve requirements. Investment bank analysts and media sources report the People's Bank of China is moving ahead with a requirement that customer margin deposits will be included under the minimum reserve requirements. Margin deposits are held by the customer firm's bank as collateral related to customer's payment commitments to another firm or bank. News sources report that margin deposits account for anywhere between 2 % to over 20 % of a bank's total deposit stock.

The stiffened reserve requirement will erode bank profit margins. Currently, the reserve requirement, i.e. the share of deposits a bank is required to keep with the central bank, is 21.5 % for large banks. At the moment the PBoC pays an interest rate of only 1.6 % p.a. on mandatory reserve deposits, while the reference rate for a one-year bank deposit is 3.5 %.

Banks are under orders to increase reserve deposits during the coming autumn until their new reserve requirement including margin deposits is met. Investment banks estimate the change will suck about 900 billion yuan in liquidity (€100 billion) out of the markets. To achieve a similar effect simply by raising the traditional reserve requirement, the PBoC would have to increase the requirement 2 or 3 times by a half percentage point. If inflation calms, the central bank might postpone other monetary policy tightening measures in coming months.

Because the new margin deposit requirements relate mainly to off-balance-sheet bank lending, the change is seen as broadening the monetary policy impact of reserve requirements. Authorities have recently managed to limit on-balance-sheet bank lending, but off-balance-sheet lending has increased fast. The recent measures show how difficult it is for officials to regulate rapidly evolving markets with administrative measures. With the deregulation of markets, at some point interest-rate policy will become a more important tool in PBoC operations.

Chinese banks not spared from insecurity of global financial markets in recent weeks. During August, the perceived riskiness of Chinese banks appeared to increase dramatically if measured by pricing of credit default swaps (CDSs). The price of a CDS indicates the risk premium that is demanded by investors on international financial markets when they invest in a Chinese bank. A rise in the risk premium means that Chinese banks have to pay more for financing when they borrow on international financial markets.

Using CDSs as a measure, the risk premium of China's big banks has increased to about 2.5 %, when the risk pre-

mium was running at around 1 % as recently as late spring. Despite the recent rise in the risk premium for large Chinese banks, it is still not particularly high by international standards. The risk premia for Chinese banks at the moment are at a level comparable to the risk premia paid by large German or French banks.

Also other countries' risk premia have increased since the summer. The rise in China's risk premia appears connected more to the general jitters on international financial markets than any specific bad news about Chinese banks. The profitability of China's largest banks rose in the first half of this year to record levels. According to media reports, the profits of the five largest banks were up by more than 25 % from last year.

The profitability figures of Chinese banks are routinely criticised for their opaqueness as they are thought to disguise large problem areas such as the lending risks of loans to local authorities. Even so, last summer's IMF Article IV consultation report said that China's banking system was on a steady footing. The banking system is stable, unless China encounters a large simultaneous shock on many fronts (e.g. a sharp drop in economic growth combined with a collapse in real estate prices and a spike in interest rates). The IMF, however, points out that its analysis was based on incomplete knowledge about Chinese banks.

Price of 5-year credit risk swaps for large Chinese banks in 2011, basis points



Source: Bloomberg

Growth in domestic demand compensates for slowdown in export orders. The manufacturing purchasing manager indexes (PMIs) published by the China Federation of Logistics and Purchasing and the Hong-Kong-based HSBC investment bank both rose slightly in August after a long slump. The end of the decline in PMIs was interpreted as a reflection of strong domestic demand in China. Companies reported in the latest surveys that their export order books have shrunk due to uncertainty in the global economy.

Russia

Russia posts large consolidated budget surplus in the first half. Revenues of Russia's consolidated budget, which comprises the federal budget, regional and local budgets, as well as state social funds, have continued their recovery very well since last year. Revenues in the period were up 30 % from 1H10. In real terms, however, revenues were still considerably below the pre-crisis level in 2008.

Consolidated budget expenditures increased 11 %, matching last year's pace of growth. In real terms (CPI adjusted), expenditures were up less than 1.5 %. The increase in revenues pushed the budget surplus as high as above 7 % of GDP. Of that, the federal budget surplus accounted for a little less than 3 % of GDP, while regional and local budgets accounted for an equal amount. The big surplus was not simply due to the pace of spending; indeed, spending in the first half this year is not becoming lower than it typically is in the first half of the year. On September 7, finance minister Alexei Kudrin observed that the federal budget seemed headed for a zero balance in 2011 as revenues are expected to well exceed original budget projections, due e.g. to higher-than-assumed oil prices and improved oversight of the VAT system.

The fastest growing revenue categories in the consolidated budget were mandatory social contributions based on wages, up more than 50 % from 1H10. Social contributions were hiked substantially from the start of this year; however, the government has since decided to reduce social contributions from the start of 2012 (see [BOFIT Weekly 25/2011](#)). Revenues were also lifted by higher prices for energy exports; revenues from production taxes and export tariffs on oil, oil products and gas soared over 40 %. These revenues accounted for over a quarter of consolidated budget revenues and nearly half of the federal budget revenue. VAT revenues grew nearly 40 %, while revenues from corporate profit taxes rose about a third. There was continued rather little growth in revenues from personal income tax and property taxes.

Federal budget expenditures increased 10 %, excluding transfers to regional budgets and state social funds (which, unlike in previous years, declined a bit). Regional and local budget expenditures also increased about 10 %, roughly the same rate as in 2010. While the rapid rise of social funds expenditure slowed, expenditures were still up by nearly a fifth.

The fastest growing spending categories in the consolidated budget were public administration and the economy (14 %), which, like last year, saw considerable increases in funding on e.g. transport and roads. Spending on education rose nearly as fast, after a slow-growth period in 2009–2010. Defence spending growth rose to 11 %. Social spending also grew 11 %, much less than in previous years. Pension spending remained unchanged now, while other social

spending was up by nearly half. Expenditures on national security and law enforcement, as well as healthcare, increased about 6 %. Public spending on housing rose a mere 2 %.

Oil production rises but exports decline. Russian crude oil production has increased on average about 1.5 % a year since 2005. Rosstat reports that in January–July this year, production was up nearly 1 % y-o-y. Russian oil production today slightly exceeds that of Saudi Arabia, which is the second largest producer. Russia exports about half of its crude oil production. Despite the increase in production, however, export volumes have remained roughly the same since 2005 at about 250 million tons a year. Exports of oil products, in contrast, have risen strongly in recent years. In particular, there has been an increase in exports of lightly taxed heavy fuel oil. Last year, Russia exported about 72 million tons of heavy fuel oil and about 41 million tons of diesel oil. Total exports of oil products amounted to about 133 million tons.

Crude oil exports shrank 5 % y-o-y and exports of oil products fell 7 % y-o-y in the January–June period. The contraction in exports largely reflected robust growth in domestic demand. Refining of heavy fuel oil and diesel oil in Russia increased about 7 %, but export volumes contracted sharply (down 8 % and 6 % y-o-y, respectively). The upcoming change in export duties next month (see [BOFIT Weekly 35/2011](#)) should show up in the second half figures as a slight drop in the volume of heavy fuel oil exports and a corresponding increase in the volume of crude oil exports.

Finnish exports to Russia up briskly in the first half. Measured by value, goods exports from Finland to Russia climbed 27 % in the first half from 1H10. If the major re-export goods are excluded (i.e. passenger cars and mobile phones), exports grew at 25 % y-o-y. Even so, the level was still about 15 % below pre-crisis 1H08.

Recovery in exports in the machinery & equipment category continued, with growth rebounding to nearly 30 % (excluding passenger cars and mobile phones). Again, the value of exports was still some 40 % below pre-crisis 1H08. Among the largest sub-categories of machine exports, growth was notably fast as regards exports of power machines and electrical machines. Other categories of exports than machinery & equipment rose over 20 %, recovering to their 1H08 level. Exports in the plastics and rubber branch, for example, grew briskly.

Transit goods from third countries transported through Finland to Russia (which are not recorded as imports or exports) increased in January–June. Road-transported transit goods were up 14 % by volume and nearly 30 % by value. The value of transit goods was €10 billion or about 10 % of Russia's total goods imports. This share has gradually been declining in recent years.

China

Western banks reduce their holdings in Chinese banks.

On August 29, Bank of America reported it was selling off half of its 10 % stake in China Construction Bank (CCB). The sales reflect harsher capital adequacy requirements globally under the Basel Committee for Banking Supervision's latest reform (Basel III). Bank of America will get about €6 billion from the sale. BofA already earlier sold parts of its original stake in CCB, which at one point amounted to 19 % of all CCB shares.

Most available shares of CCB were picked up by Chinese government agencies and entities, including the State Administration of Foreign Exchange (SAFE), China's National Social Security Fund and Citic Securities, China's largest brokerage and subsidiary of state-owned investment bank Citic Group. The Chinese state currently owns 59 % of CCB via Central Huijin, a unit of China's sovereign wealth fund. As a result, no substantial changes in the state's dominant role in CCB are expected. The sovereign funds of Singapore and Qatar also bought smaller stakes in the offered shares.

Foreign banks have been able to acquire stakes in China's large state banks since 2005. Western banks in recent years sold shares in Chinese banks as they struggled with their own economic challenges. For example, UBS and Royal Bank of Scotland sold their stakes in Bank of China, while Allianz and American Express divested their holding in ICBC during the 2008–2009 financial crisis. Goldman Sachs sold part of its stakes in ICBC in September 2010. In many cases, strategic partnerships continue despite the sale of shares.

China gains in international competitiveness ratings.

The World Economic Forum (WEF) released its annual assessment of country competitiveness (*Global Competitiveness Report 2011–2012*) at the beginning of September. China has climbed in the rankings to become the world's 26th most competitive country, up one notch from last year. Russia dropped three places in the rankings to 66th place. The index is compiled from interviews with about 13,000 corporate leaders and competitiveness scores allocated for 12 different criteria. Score weightings are adjusted for each country to take into account economic development.

China's competitiveness is sustained by large markets (2nd in market size) and macroeconomic environment (10th), which was supported e.g. by China's high savings rate. Other competitive advantages included innovation (29th) as well as health and primary education (32nd). A significant improvement was seen in development of financial markets (up 9 places to 48th). China's weak points continued to be technological readiness (77th) and higher education and training (60th), even if it has been moving up slowly in the

rankings. Corporate leaders said their biggest headaches came from inflation and access to financing.

Russia's competitive advantages were market size (8th), infrastructure (48th) and higher education and training (52nd). Russia's competitive weaknesses were institutions (128th), financial market development (127th) and goods market efficiency (128th), which the WEF found particularly disconcerting. Managers complained they were plagued by corruption and inefficient state bureaucracy.

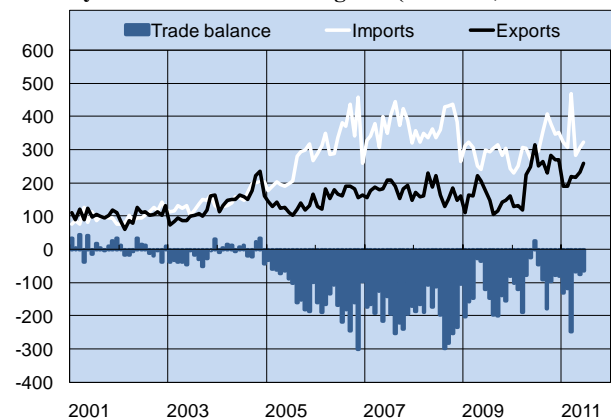
China's share of Finland's foreign trade appears to be settling. The value of Finland's imports from China climbed to €2.0 billion in January-June, an increase of more than 20 % from a year earlier. Exports to China climbed 12 % y-o-y to €1.3 billion, yielding a trade deficit of €700 million, or over €200 million more than a year ago.

Nearly half of Finnish imports from China are composed of various kinds of electronic devices such as mobile phones, televisions, computers and electrical appliances. Clothing accounts for a 13 % share of imports, and perennially remains an important import category. Transportation vehicles accounted for about 5 % of imports. China provided 37 % of all electronics and over a third of all clothing and footwear imported to Finland.

Finland's exports to China were led by industrial machinery and equipment (36 % of total exports – by far the biggest category) and electrical machinery (14 %). Pulp accounted for 12 % of exports in the first half, while paper was less than 5 %. Nearly a quarter of all of Finland's pulp exports now go to China. Hides and furs represented 8 % of Finnish exports to China in the first half. In that industry, nearly 30 % of exports now go to China.

Despite brisk growth, China is no longer increasing its share of Finnish foreign trade as in previous years. Its share of Finland's total imports fell slightly below 7 % in the first half. Finnish exports to China covered less than 5 %. The combined share of Hong Kong and Taiwan was 0.5 % of Finland's total imports and about 1 % of exports.

Monthly Finland-China trade figures (€ million)



Source: Customs Finland

Russia

Rising trend in federal budget spending will continue in coming years. Russia's finance ministry this week released a summary of its new proposed budgetary framework for 2012–2014. The cabinet will take up the full proposal next week.

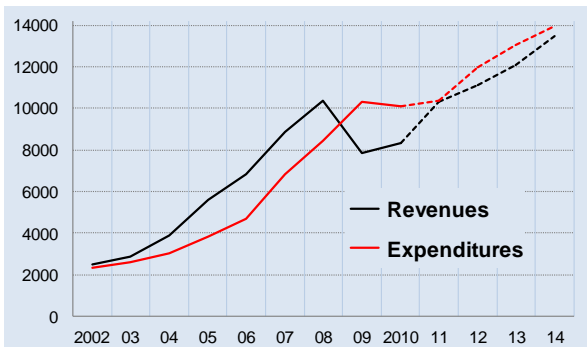
Compared to the framework projections of early July, the latest plan increases estimated budget revenues substantially. Revenues are now expected to grow next year 7 % in nominal terms and 9 % a year over the following two years. Growth depends to a large extent on the assumed average Urals oil price of about \$100 a barrel in the 2012–2014 period. This year's budget revenues are expected to increase by a third.

Budget expenditure projections were also raised from the June framework. Nominal expenditures are now seen as rising 15 % next year and 7–8 % in 2013 and 2014. In real terms, spending should increase about 1 % this year 7–8 % next year.

With the strong revenue performance, the budget deficit should fall to just 1.5 % of GDP in 2012 and 2013, and 0.7 % of GDP in 2014. The finance ministry noted that the price of Urals oil would have to reach a level of \$116/bbl to bring next year's budget into balance.

Finance minister Alexei Kudrin remarked that he was surprised by how great the pressure to increase spending before the elections has been. If most election promises are kept, the new government that will be formed after the elections will have to raise taxes. The IMF also has expressed worries that increased spending based on high crude oil prices heightens the economy's dependence on energy and increases its sensitivity to external shocks.

Russian federal budget (actual and projected) in real terms, billions of 2010 rubles (consumer price deflator adjusted)



Source: Russian Ministry of Finance

Fixed investment remained heavily focused on the energy sector in the first half. Rosstat estimates that total fixed capital investment increased in the first half of the

year nearly 3 % over 1H10. The figure includes estimates of investments by small firms and investments not reported in the data-gathering process. Investments in both the small-firm and unreported categories declined sharply in the first half, while investment in other categories, mainly large and medium-sized firms, climbed 12 %.

As in previous years, investments of large and medium-sized firms were dominated by increases in the oil and gas pipeline category, which again climbed over 40 %. Investments in oil and gas production also rose briskly (up 13 %). Unlike in previous years, however, investment in oil refining capacity showed almost no growth and investment in the electricity sector declined. The share of the four main energy categories (oil & gas transmission, production, and refining, and electricity) in overall investment was over 40 %.

Investment in manufacturing increased a bit faster than last year (up 10 % y-o-y). In the major industrial branches, investment grew fastest in metallurgy and food processing. The share of manufacturing branches (excluding oil refining) in total investment remained at about 13 %. Investment in the real estate sector fell slightly after suffering a huge decline last year.

Despite strong exports of wheat and arms to North Africa and the Middle East, the region still only has marginal economic significance for Russia. Russia posts huge trade surpluses with Arab countries in North Africa and the Middle East. Last year, the value of Russian exports to the region totalled \$7.5 billion, compared to just \$970 million in imports. Even so, exports to the region constitute less than 2 % of Russia's total exports. The share of imports is minimal, consisting largely of food items and low-value-added goods.

Russia's top export goods to the region are assorted grains, arms, and steel and steel-industry products. Egypt is the largest export market for Russian grains, buying over a third of all Russian grain exports. Last year, Egypt imported a quarter of all its grain imports from Russia. About 60 % of Russian grain exports now go to Arab countries.

Russia is the world's second largest arms exporter after the US. India and Arab states are the main buyers of Russian arms. According to the Stockholm International Peace Research Institute (Sipri), about a quarter of Russian arms exports in recent years have gone to Arab countries in North Africa and the Middle East. Of these, Algeria, the United Arab Emirates and Syria were the biggest buyers of Russian arms. The lion's share of arms imported by Algeria and Syria came from Russia. Russian arms exports have recently been reduced by unrest in Arab states and the UN ban on arms exports to Libya imposed in February.

The biggest investments of Russian firms in Arab countries in Northern Africa and the Middle East are at the moment in the energy and infrastructure branches.

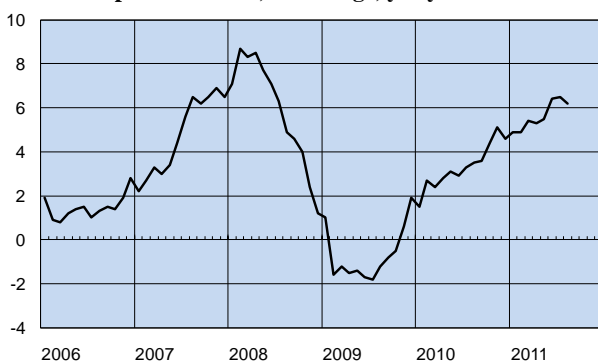
China

Industrial production growth remained strong in August. Industrial output climbed 13.5 % y-o-y in August, a half percentage point below July. The industrial output figures were awaited with particular interest this time as they could have signalled an impact on China's economic growth from the debt crisis in the industrialised world. In fact, the latest figures reinforced the view that China's economy is resilient to the first-world debt problems.

Highest growth in the August numbers was posted in metal products and machine-building; lowest growth was recorded for the textile industry. The strong growth in metal products and machinery and the 25 % y-o-y growth of fixed capital investment in the January-August period indicate that investment demand continues to play a strong role in economic growth. The investment figures also reveal a geographic shift in emphasis from coastal provinces to inland provinces. Investment growth in Central and Western China was up about 30 %, well outstripping growth in Eastern China (up 22 %).

Growth in retail sales remained fairly brisk throughout the late summer, and were up in August 17 % y-o-y. The highest growth (around 40 % in terms of value) was posted in retail sales of jewellery and petroleum products, reflecting in part sharp rises in raw material prices over the past year. Sporting goods registered the lowest growth of any retail sales category.

Consumer price inflation, %-change, y-o-y



Source: China National Bureau of Statistics

Inflation declines as expected. The 12-month rise in consumer prices fell to 6.2 % in August. The rise in food prices, which has become a sensitive political topic in China, slowed slightly to 13.4 %.

Although the slowdown in inflation is generally good news, China's policymakers remain well off their declared inflation target of 4 % for the year. However, any further monetary tightening measures at this point could choke off

growth which is challenged by the debt crisis in industrialised countries that affects the global growth outlook substantially.

Order-books of Chinese shipyards down. Figures published by the China Association of National Shipbuilding Industry (CANSI) show that in the first seven months of this year, the total stock of ships built was 38 million dead-weight tons, an increase of 9 % y-o-y. The order-book for ships has shrunk dramatically due to uncertainty about the outlook for the global economy. New ship orders fell 30 % in January-July to a total of 24 million dwt. The order-book in January-July amounted to 176 million dwt, a 6 % decline from a year earlier.

A large share of ships built in China is exported. Some 84 % (32 million dwt) of ships completed in January-July went to export. Some 78 % (18 million dwt) of new orders received in the period were also for export.

The shipbuilding industry is a strategically important branch for China. The Chinese government has enshrined the development of the shipbuilding sector in the latest five-year plan. Shipbuilding activities currently focus on freighters, especially dry-cargo container ships. While China dominates in price competitiveness in construction of basic ships, its efforts to build technologically advanced vessels has yet to pay off internationally. The competitive challenge for China's shipbuilders at the moment is developing sophisticated labour skills, while dealing with rising raw material and labour costs and yuan appreciation.

South Korea, Japan and China have long ranked as the world's top shipbuilding countries. Over the past two years, China has risen from third to first place. In 2010, China built 38 % of ships globally. Former shipbuilding king South Korea accounted for 33 % of world production and Japan 21 %. China scooped up 43 % of new ship orders in 2010, followed by South Korea (36 %) and Japan (14 %).

China links offer of financing to indebted EU members with trade policy concessions. The Italian government has expressed hopes that China would make substantial investments in Italian sovereign debt and companies. The Italian government is highly indebted. The demand for its bonds has declined significantly at the financial markets in connection with the escalation of the EU sovereign debt crisis.

Speaking at this week's World Economic Forum in Dalian, China, premier Wen Jiabao encouraged European debtors to "get their houses in order." According to the *Financial Times*, Wen linked future financing to the requirement that the EU first grant China market economy status – a long-time goal of Chinese trade policy. Market economy status would make it easier for Chinese companies to defend themselves in trade policy disputes over e.g. dumping claims.

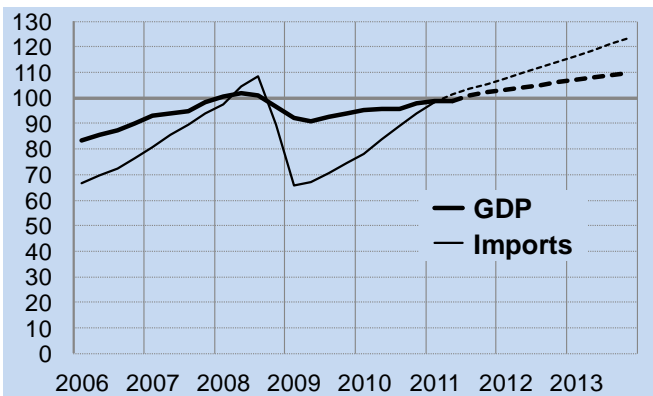
Russia

BOFIT forecast sees relatively strong, but slowing, economic growth ahead for Russia. In the latest BOFIT forecast for Russia, GDP keeps on climbing rather briskly, even with a mild slowdown over the next two years. The Russian economy is expected to return to the pre-crisis GDP level of 2008 as soon as this autumn.

BOFIT forecasts Russian GDP will grow at a rate of nearly 4.5 % p.a. this year and next year, before slowing to below 4 % (i.e. close to the trend growth) in 2013. The average oil price assumption has an important impact on the growth forecast as the Russian economy remains rather dependent on the price of crude oil. In our latest forecast, we assume a slight decline in the world price for crude oil over the forecast period. The assumed average price of \$110 a barrel in 2011 slides to \$105 a barrel in 2013.

Imports to Russia are forecast to rise rapidly in coming years, although their growth rate will slow. Rising domestic demand continues to drive strong growth in imports, but this growth to some extent reflects recovery from the recent recession. As a result, imports still rise nearly 20 % this year but as the situation normalises in 2012 and 2013, import growth will slip below 10 % a year. The volume of imports will surpass the 2008 pre-crisis peak level sometime this winter.

GDP and import volume, 2008=100



Sources: Rosstat, BOFIT forecast 2011–2013

Most of the caveats for the current forecast concern the downside risks. Deterioration of the international economic situation can cause crude oil prices to drop along with prices of Russia's other main export commodities. A modest reduction in the volume of Russian exports can also be possible, as well as a decline in capital inflows into Russia. Uncertainty in the global economy can make Russian con-

sumers more cautious and increase uncertainty among investors. Both occurrences would hurt domestic demand.

CBR adjusts key interest rates. On September 15, 2011, the Central Bank of Russia lowered some of its credit rates by 25 basis points and raised deposit rates by 25 basis points. The CBR's main monetary instrument, the minimum auction-based one-day repo credit rate currently stands at 5.25 %. Longer-term minimum repo credit rates were also lowered. The CBR kept the overnight credit rate and its largely symbolic refinancing rate at 8.25 %.

Along with auction-based credits, the CBR provides banks with fixed-rate loans as needed at rates above auction rates. Banks typically resort to fixed-rate credit in circumstances when standard financing is not sufficient. The CBR e.g. grants loans of up to three months with a 7 % interest rate. The loans can be collateralised with non-traded securities (e.g. corporate paper) while other central bank financing requires the borrower to put up market-traded securities as collateral. This form of financing eases access to credit of in particular smaller banks. In August, the central bank introduced a new 3-month credit that can be backed by gold. The credit carries an interest rate of 6.75 %. It seems, however, few banks can actually offer gold as collateral.

The CBR has been criticised for providing a baroque palette of credit instruments distinguished e.g. by interest rate, maturity and required collateral. As rate changes usually only affect some instruments, the effectiveness of rate changes in monetary policy suffers due to reduced signal value and impact. The CBR justifies its wide selection of instruments by the high heterogeneity of the banking sector. Instruments are designed to influence specific parts of the market. Some banks, for example, lack access to the inter-bank money market. The CBR's position on the issue seems to be evolving; it recently shortened its instrument menu by phasing out certain longer-term credit formats.

In conjunction with credit rate cuts, the CBR raised deposit rates so that the one-day and seven-day central bank deposits now carry a rate of 3.75 %. The interest rate decisions narrowed the margin between CBR credit and deposit rates, which has been relatively big (even if it has shrunk in recent years). The CBR has moved to reduce the credit/deposit margin to stabilise fluctuations in market rates, which have been large in particular when the banking sector has encountered tight liquidity situations. Observers expect a tightening in liquidity if the international financial situation continues to deteriorate. Reduction of interest-rate margin is also seen as a step towards the central bank's goal of increasing the role of interest rates in steering monetary policy.

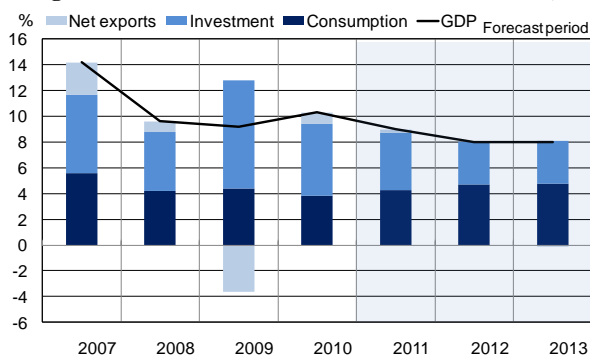
The last interest rate adjustment was in late May. The CBR board is set to meet again at the end of October to decide on possible monetary policy measures.

China

BOFIT forecasts gradual slowing of Chinese economic growth. China's gradual tightening of monetary policy over the past year to fight inflation has had the expected effect of a mild slowdown in economic growth. Growth overall, however, remains strong. The latest BOFIT forecast for China sees GDP growth of 9 % this year. In 2012 and 2013, BOFIT expects annual growth to decline to 8 %. The forecast assumes that the economic slowdown and uncertainty in Europe and the US do not escalate further, as these economies together take 36 % of Chinese exports.

China's growth continues to be based on investment – currently the equivalent of 45 % of GDP! While private consumption's share is currently below 35 % of GDP, consumption is expected to play a greater economic role in coming years. The assumption of higher consumption share is supported by the annual 9 % growth in real wages and the political pledges to sharply hike minimum wage levels. The volume of China's foreign trade should climb about 10 % a year during 2011–2013. Strong domestic demand should keep imports growing slightly faster than exports. Thus, foreign trade (net exports) will make a relatively small contribution to economic growth (see chart). China posted a current account surplus of 5 % of GDP last year. In the next three years, the current account surplus may shrink slightly.

GDP growth and contributions of demand-side factors, %



Sources: CEIC, BOFIT

Despite the monetary tightening of the past year, inflation continues to run at around 6 % p.a. The robust economic growth and strongly negative deposit rates mean any relaxation of monetary policy is unlikely in the near future even with the dark outlook for the global economy. A stronger yuan exchange rate, in contrast, would calm price pressure and promote structural change by bolstering household purchasing power.

Beyond the turbulence in the global economy, China's outlook is clouded by problems in its housing sector and the

rapid indebtedness of local administrations. Supervision authorities must also deal with the deregulation of money markets and currency markets.

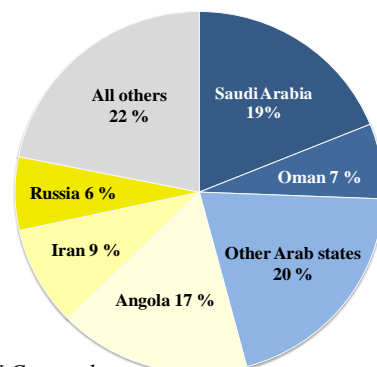
Oil accounts for most of China's imports from North Africa and the Middle East. For the Chinese economy, the biggest worries emerging from the recent unrest in North Africa and the Middle East are security of oil supplies and potential increases in world oil prices. About 45 % of China's crude oil imports come from North Africa and the Middle East. After the US, China is the world's second largest consumer of oil. China's domestic oil production today only covers about half of its consumption.

Oil and petroleum products account for over three-quarters of China's imports from Arab countries in North Africa and the Middle East. Among these countries, Saudi Arabia is China's most significant trading partner. Crude oil imports from Saudi Arabia last year accounted for 19 % of China's \$135 billion in oil imports. Oman, Sudan, Iraq, Kuwait and Libya also rank among China's top ten oil suppliers. China's imports from Arab countries in 2010 were valued at \$67 billion (5 % of China's total imports). China's exports to these countries were \$63 billion (about 4 % of total exports). The biggest export categories were machinery & equipment and electronics.

China is eager to promote cooperation in the region, especially with the oil-rich Arab states of the Persian Gulf. China has bilateral trade agreements with all Arab states. In May this year, the second round of talks between China and the Gulf Cooperation Council (GCC) was held, in which also a free-trade agreement was discussed. GCC members include Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates.

Economic cooperation with China provides Arab states with an alternative to Western investment. China has long practiced a policy of non-interference in the region's internal conflicts. Recent political unrest in the region, however, is seen as a challenge for this policy as China occupies the world stage through increasing presence in trade relations and greater investment in conflict countries.

Breakdown of China's crude oil imports by country, 2010



Source: UN Comtrade

Russia

Finance minister Alexei Kudrin resigns – bumpy times expected for Russian fiscal policy. The resignation of finance minister Alexei Kudrin on Monday (Sept. 26) is considered to have more important repercussions for Russian economic policy than the fact that Vladimir Putin will return to presidency next year, which was announced two days earlier.

Kudrin had occupied the post of finance minister since 2000. He is credited with rebuilding of public finances after the 1998 financial collapse that e.g. forced Russia to restructure its sovereign foreign debt. Kudrin is also credited with stabilising the public economy by strict spending limits in the face of growing tax income, the creation of sovereign reserve funds for oil earnings and paying down the restructured foreign debt ahead of schedule. The reserve funds provided the Russian state with a buffer that allowed it to make it through the recent global recession without having to take on additional foreign debt. The Russian state's current foreign debt equals only about 3 % of GDP; domestic public debt stands at about 7 % of GDP. By international standards, the Russian state carries very little debt.

Tight budget policy, however, has not always been a given. The finance ministry has often fought tooth-and-nail with the presidential administration and a number of other ministries, particularly the economy ministry, on spending issues. In the late 2000s, budget spending began to rise quickly despite opposition from the finance ministry. The increased spending led in part to the federal budget deficits of 2009 and 2010. The higher spending was partly based on increased tax revenues from crude oil whose price rose sharply. For the federal budget to balance next year, the world price for crude oil must average \$116 a barrel. In 2006, the federal budget was strongly in surplus at an oil price of just \$61 a barrel. As a result of the increased spending, Russia's public economy has become substantially more dependent on the global business cycle in recent years.

Kudrin openly criticised decisions made over the past year to cut taxes and increase spending on e.g. defence and the social sector. He said these moves endangered the stability of state finances and the Russian economy.

Observers now expect looser budget policy ahead without Kudrin to defend finance ministry policy.

At the cabinet meeting on Wednesday (Sept. 28), Putin announced that deputy finance minister Anton Siluanov, who had been in charge of regional budgets and defence spending would be acting finance minister. Overall steering of fiscal and economic policy in the government shifts to first deputy prime minister Igor Shuvalov, who had been charged with investment issues, long-term economic forecasting and issues related to international finance and the

corporate sector, among others. The ministerial appointments are expected to extend no later than next March's presidential election, after which a new cabinet will be formed.

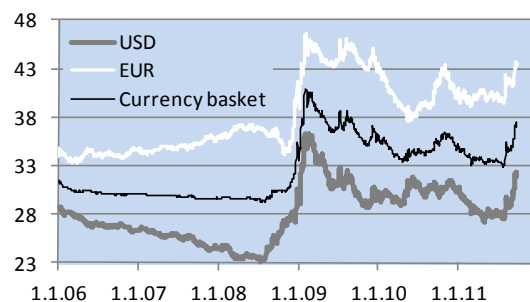
Ruble's recent slide started in early August. After an abrupt drop at the start of the week, the ruble stabilised over the last two days. The ruble has depreciated 11 % against the Central Bank of Russia's dollar-euro currency basket from its highest post-crisis value of late July. The ruble's exchange rate today (Sept. 30) was 31.9 to the dollar and 43.4 to the euro. The ruble's weakness not only reflects international economic insecurity but also the current flight from currencies of commodity-producing countries.

During September, the CBR has sold \$6 billion in foreign currency to prop up the ruble. CBR chairman Sergei Ignatyev explained that the market interventions, the largest since 2009, were motivated by unusually high capital exports from Russia (and other emerging economies) in reaction to the uncertain outlook for the global economy.

In reaction to the big interventions the CBR moved the fluctuation band within which the ruble's exchange rate can move relative to the currency basket. The move allowed continued depreciation of the ruble. The CBR shifts the position of the band by 5 kopeks whenever the cost of market operations to keep the ruble within its fluctuation band exceeds \$600 million. The CBR interprets the need for such large interventions as a signal of changes in the operating environment that require a reset of the exchange rate level. The current upper limit of the fluctuation band is 37.5 rubles and the lower limit 32.5 rubles. On Friday (Sept. 30), the exchange rate was 37.1 rubles per unit of the dual-currency basket.

Ignatyev said the CBR has no plans to further widen the ruble's fluctuation band. The band was last widened from four to five rubles. Since the recession ended, the CBR has gradually moved towards its long-range goal of a free-floating ruble. The increased reluctance to engage in market operations has translated into greater volatility in the ruble's exchange rate.

Dollar/ruble, euro/ruble and currency basket/ruble rates



Source: Central Bank of Russia

China

Rise in Chinese housing prices appears to be abating.

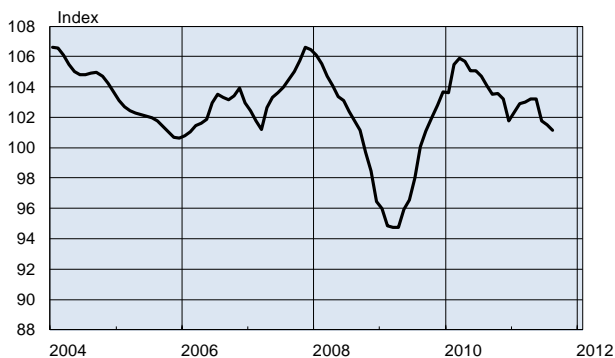
Prices of new apartments in August remained unchanged in many of China's biggest cities, while prices for older apartments began to slump. Indeed, there have only been minor changes in housing prices over the past nine months. In Beijing, a fairly typical Chinese metropolis in this regard, the August reading of the price index for new apartments was up a bit over 1 % from last year.

The stalled rise in housing prices reflects official measures to tighten credit to prevent overheating of the market. Following official orders, banks have closed the loan spigot with the result that the growth in the stock of housing loans has slowed to a crawl. In July, the housing loan stock grew a mere 0.1 % m-o-m to 12.6 trillion yuan (€1.4 trillion), which corresponds to just under a third of China's GDP.

The becalmed housing market and tighter borrowing terms are bad news for the residential construction sector, which now sees the years of explosive growth behind them. Worries about how they can cope with the drop in demand have surfaced at the financial markets. Share prices of construction firms have continued to slide, and some large, heavily indebted, constructors have seen their creditworthiness downgraded.

There is even speculation that the cooling of the housing market may lead to widespread bankruptcies within the construction sector and mounting credit losses for the banks. Officials can be expected, however, to let banks reopen the loan spigot to the construction sector if signs of crisis appear. At the moment, there are no signs of widespread crisis in the construction sector, and the construction sector's confidence index for August actually showed minor growth in construction activity. The confidence index for August stood at 101.1, slightly above the zero-growth level of 100.

Construction sector confidence index



Source: China National Bureau of Statistics

Hope for improvement in the status of foreign firms.

The 13th annual position paper published by the European Union Chamber of Commerce in China lists factors that act as barriers to business for European firms operating in China. The report is compiled from surveys of various industries and cities, as well as nationwide issues affecting business conditions. Over 600 recommendations for resolving barriers to doing business appear in the report.

The challenges mentioned in the latest report are hardly new. Improvement is most desired in market access of foreign firms and receiving the same treatment as domestic firms. Progress is also hoped for in legislative transparency and predictability, coordination between different regulatory authorities and protection of intellectual property. Companies would like to see EU decision-makers launch negotiations on an EU-China investment treaty and a harmonized EU trade policy for China.

The report also notes several region-specific issues. Increased competition for skilled workers has emerged in Chengdu, Chongqing, Shanghai, Shenyang and the Pearl River Delta. In addition, European business called for improvement in Shanghai's regulatory environment and hoped for a cut in the corporate tax, which is higher than elsewhere in China. Shanghai currently imposes a corporate income tax up to 30 % on foreign firms; the corresponding tax rate in Hong Kong and Singapore is about 17 %. Other issues raised included, among many others, the problems of energy availability in Chongqing, as well as slower internet speed in Shanghai compared to the rest of China. Tianjin's biggest problems were its incomplete transport networks and traffic safety.

Local administration land deals ignite unrest in southern China.

Residents in the southern parts of Guangdong province last week demonstrated against official measures to acquire control over land rights in order to sell them to developers. The protesters claim that officials have threatened people, evicted them from their homes and given empty promises about future compensation for their inconvenience. Protests have turned violent in some cases.

Since China's central government intervened in the dispute, several local administration officials have been convicted of illegally acquiring and selling land rights, as well as related abuses. The situation is touchy for the central administration; the government in reaction to earlier protests in January provided local administrations with new guidelines on acquisition and sale of land rights. The guidelines were supposed to protect the rights of current residents on the land. According to an expert interviewed by the *South China Morning Post*, the guidelines are unclear and incomplete. As a result, similar problems are expected to recur as sale of land use rights are an important source of income for local administrations.

Russia

Demand in Russia recovered starting in the second quarter. GDP demand indicators released by Rosstat this week indicate growth in seasonally adjusted private consumption slowed just slightly in the second quarter, but fixed investment came back. Consumer growth was up 6–7 % from 2Q2010 and capital investment 5 %.

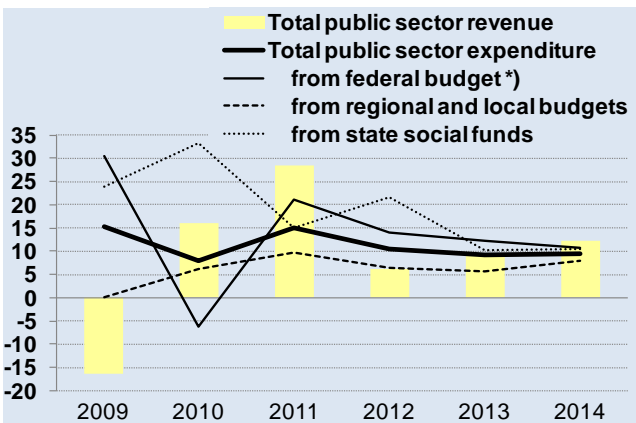
In contrast, growth in seasonally adjusted public consumption remained low with very modest on-year growth. Growth in exports volumes came to a halt while scoring an increase of a few per cent on year. The growth rate in inventories also slowed, even if growth was still brisk.

Seasonally adjusted GDP growth faded to a very slow pace in the second quarter, yielding 3.4 % y-o-y growth. One aspect behind the slowing GDP growth was the ongoing strong growth in imports, up 23 % y-o-y in the second quarter (the same as registered 1Q2011).

Preliminary figures suggest good growth in consumption, investment and GDP towards the end of summer. Other data indicate slowing growth in exports and imports.

Increases in public sector spending ahead affirmed. The plan for aggregate government finances (federal budget, regional and local budgets and state social funds), attached to the proposed federal budget submitted to the Duma at the end of September, sees public sector revenues rising much faster this year than expected earlier – nearly 30 % in nominal terms and almost 20 % in real terms. The estimates for 2012–2014 revenues were also raised slightly. The oil price assumption was raised to around \$100 a barrel (Urals export blend) for 2012–2014.

Public sector revenues and spending, % change



*) excluding transfers to regional budgets and state social funds

Source: Finance ministry

Public sector spending should increase 15 % this year in nominal terms and 6–7 % in real terms. On top of this, expenditures should rise in 2012–2014 at a nominal pace of 9–10 % a year. Spending out of the state social funds will grow rapidly, especially in 2012. Federal budget spending (excluding transfers to regional budgets and social funds) will grow briskly. Regional and local budget spending should also increase, but nominal growth is estimated to be only slightly above projected inflation.

The aggregate public sector budget will slide into deficit after achieving balance this year. Higher revenue projections hold the deficit to 1.5 % of GDP in 2012 and 2013.

New export duty scheme for crude oil and petroleum products now in force. In August, prime minister Vladimir Putin signed a decree reforming export duties on oil products. The export duty on light fuel oils was reduced, while the export duty on heavy fuel oil was increased. The duty scheme launched on October 1 sets the average export duty on petroleum products at 66 % of the crude oil export duty (see [BOFIT Weekly 35/2011](#)). The duty on gasoline remains unchanged at 90 % of the crude oil export duty. The reform is designed to promote refining of light fuel oils and reduce production and export of heavy fuel oil.

The crude oil export duty was reduced from 65 % to 60 % on October 1. This marginal duty on exports applies to that portion of the export price above \$25 a barrel. The government's original intention was to lower the marginal rate permanently to 60 %, while for the time being it is decided monthly at the same time as calculating the export price for determining the export duty.

For producers, crude oil taxation in Russia is exceptionally harsh. While the main form of taxation is export duties, oil production is also subject to an extraction fee that amounts to 22 % of the price of a barrel above \$15. VTB Capital calculates that oil companies currently pay taxes amounting to about 72 % of their gross sales revenue.

After over a year of preparation, the cut in the oil export duty is hoped to encourage companies to invest more in oil exploration and production. Most oil pumped in Russia today comes from peaking fields that face declining production in the years ahead. New investment is needed simply to sustain current production levels. East Siberian fields such as Vankor and Talakan have been granted temporary reductions on export duties to fund their development.

Over the long term, observers say the taxation scheme for the oil sector needs to be overhauled to give producers incentive. The role of export duties needs to shrink and emphasis shifted from taxing sales to taxing profits.

In terms of impact on the state budget, changes in taxation of oil and petroleum products are among the largest changes of taxation planned for the time being, although the finance ministry expects the government to lose oil revenue only the equivalent of about 0.1 % of GDP in coming years.

China

PMIs readings suggest China's real economy weathered September in passable condition. Chinese share prices plunged nearly 10 % in September, but the PMI readings published at the beginning of October indicate no significant deterioration in conditions in the real economy. The official manufacturing purchasing manager index published by the China Federation for Logistics and Purchasing (CFLP) actually rose slightly to 51.2 for September (50.9 in August). The reading was particularly good news for the global economy as the subindex for export orders broke above the critical 50-point mark. This indicates a rebound in export orders increased in September relative to August, when export orders dipped below 50 for the first time since spring 2009. However, the persistent rise in input prices in the 20 industries surveyed suggest it will be difficult for officials to fine-tune economic policy.

The "flash" PMI published by Hong Kong-based HSBC and Markit Economics signalled a slight slowdown in manufacturing activity for the third month in a row. The flash PMI value for September, however, did not indicate any exceptional drop from August.

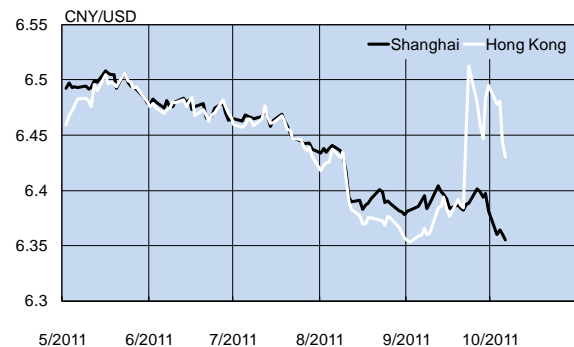
Economic conditions in the service sector appear healthier than in the industrial sector; the official and unofficial PMI reading both stayed above the 50-point mark in late summer and early autumn, and both indexes strengthened in September. The recent trend appears to indicate an increased role for the service sector both relative to industry and in the domestic market. In contrast, industrial output grew faster than services in the first half, when the contribution of industrial output to GDP rose to 50 %, compared to service sector's contribution of 42 %.

Hong Kong's offshore yuan market hits quota ceiling, falls off cliff. The offshore yuan weakened sharply last week when the quarterly yuan quota set by the People's Bank of China reached its 4-billion-yuan trading limit a week before the end of the quarter. The difference between the offshore and official (Shanghai) yuan exchange rate widened to a record level. The event was a drawback to the Hong Kong's offshore yuan market, and revealed how easily China's currency controls can disrupt the nascent market. To calm the situation, the PBoC said it would double the quota for the fourth quarter to 8 billion yuan.

A month earlier, sentiment was upbeat on Hong Kong offshore yuan market. During his mid-August visit, Chinese vice premier Li Keqiang announced plans to increase market cooperation by permitting investments in securities issued by mainland China financial institutions and the issuance of corporate paper of mainland Chinese firms in Hong Kong. Although no timetable has been specified,

China's long-term goal is to phase out currency controls. In August, officials announced that companies anywhere in China can make foreign trade payments in yuan.

Official (Shanghai) and offshore (Hong Kong) yuan rates



Source: Bloomberg

US Senate moves toward final vote on bill punishing China for currency manipulation. While passage in the Senate now seems likely, the bill still faces an uncertain future in the Republican-controlled House of Representatives and would have to be signed by the president to become law. The bill would permit the US to impose retaliatory tariffs on Chinese products if China is found to be engaging in currency manipulation. China has condemned the bill and warned that such measures would lead to a trade war. China's official view is that the yuan is not undervalued. The bill has also divided the US business community and experts.

Interest rates soar on grey loan market. Interest rates on China's informal "grey" market are typically multiples of regulated bank lending rates. The rise in already high interest rates has hit worst small and medium-sized enterprises (SMEs), which do not have access to normal bank credit. Chinese news media say that SME credit struggles have become so tough that some 80 CEOs of SMEs have "disappeared." The list includes heads of fairly sizable enterprises. The situation appears worst in the city of Wenzhou, where the officials set a ceiling on grey market rates. However, regulating the grey loan market is impossible.

An increasing amount of capital this year has moved to the grey market. Tight monetary policy has reduced opportunities for commercial banks to lend, which, in turn, has driven SMEs to the grey market. Moreover, private entities wishing to lend directly to companies have increased as inflation has kept real interest rates on deposits negative and the short-term yields of housing and stock market investment have shrunk. Moreover, firms with access to bank loans sometimes relend to SMEs at substantially higher rates.

Russia

Current budget framework calls for sharp hikes in spending on defence and national security. Under the federal draft budget before the Duma, defence spending is set to increase very rapidly during 2012–2014. Much of next year's boost in defence spending will go to raising the pay of members of the military.

Spending on national security and law enforcement will increase next year, in part because funding of police operations that have been covered partly by regional and local budgets will now be exclusively funded out of the federal budget. Moreover, higher police salaries are part of the wider reform of police operations.

Social spending will continue to rise next year with more money for pensions, including larger transfers to the state Pension Fund. The already underfunded Pension Fund will lose income with the reduction in the mandatory social contributions of employers in January 2012.

Funding for the economy will be reduced overall, with increases mainly slated for road construction and applied research. While there will be a bump in spending on health care and education next year, part of funding health care and education will shift in the out years from the federal budget to regional and local administrations.

Main federal budget spending categories, 2012–2014

	2012	2013	2014	2011	2014
	change (%)			share (%)	
Total expenditure	14	8	6	100	100
Public administration	-1	0	-2	8	6
Defence	21	26	18	14	19
National security & law enforcement	47	9	5	11	14
Social security	24	7	0	28	29
Economy	1	-4	-4	16	11
Health care	9	-9	-8	5	3
Education	8	-7	-11	5	3
Housing	-42	-23	-29	2	1
Debt servicing	11	24	20	3	4
General transfers to regional and local budgets	-11	-9	-12	6	3

Source: Ministry of Finance

Consumer prices remain flat. There was no change in consumer prices during the third quarter of the year, and it appears the same trend has continued this month. The cause appears to be the seasonal drop in food prices, a regular annual event in Russia.

The rise in consumer prices overall was still 7.2 % y-o-y in September. Inflation is expected to remain at this level for the rest of the year.

The structure of consumer spending shows 37 % of spending going to food items (consumer price basket, including alcoholic beverages), followed by transportation 12 %, housing 11 % and clothing 11 %.

Russia and China consider deeper economic cooperation. During his visit to China this week (Oct. 11–12), prime minister Vladimir Putin kept the emphasis on economic issues, indicating Russia's growing interest in economic cooperation with Asian countries.

During the visit, the Russian Direct Investment Fund (RDIF) and the China Investment Corporation (CIC) signed a memorandum of understanding on creation of a joint Russia-China investment fund. RDIF was established last summer to participate in joint investments in the Russian economy with foreign investors. CIC is the fund's first partner. The parties each committed to contribute \$1 billion to the fund initially. Other participants, mainly Chinese investors are expected to pony up \$1–2 billion. The Russia-China investment fund would make 70 % of its investments in Russia, Belarus and Kazakhstan, and would focus on the agriculture, consumer goods manufacturing and eco-friendly energy production.

A highlight of the visit was an agreement on Russia-China cooperation in economic modernisation. China has surpassed Germany as Russia's top foreign trade partner, and Russia wants to diversify its structure of exports and develop technology with China. For its part, China is interested in improving transport connections between the two countries through e.g. construction of the bridges, roads and railways needed to increase economic cooperation. For the time being, Russia gave a cautious reaction to the notion of improving transport connections.

Russia and China have haggled all this year over the price of crude oil supplied by Russia. From the start of this year, Russia has been supplying China with crude oil under its long-term contract tied to completion of the first phase of the East Siberia–Pacific Ocean Pipeline (ESPO). China, however, would like to see a discount to what it says is a steep contract price given the excessive transport fees built into the pricing structure of the contract. In fact, China has paid less than the official contract price all the time. As part of Putin's visit, the parties agreed in principle on a new pricing arrangement.

Even with years of discussion, no agreement was reached on how Russian natural gas supplied by pipeline transmission will be priced. The countries agreed in principle on gas supplies by pipeline in 2006. Russia would like to bind the natural gas price to the price of oil products, as it does for its European customers. China continues to balk at this type of arrangement. Rapid growth in gas supplies to the booming Chinese market is an opportunity for Russian export growth and market diversification.

China

State increases its holdings in China's big banks. Central Huijin, the domestic arm of the state sovereign wealth fund manager China Investment Corporation, announced it would purchase shares of China's four largest banks on the secondary market. However, the amount of share purchases to date has been rather small. Central Huijin is already the largest stakeholder in all four of China's big state banks.

The measure is part of state efforts to prop up weak share prices. Bank shares, in particular, have fallen as credit losses from the exuberant stimulus-driven lending of 2009–2010 are expected to appear in the future. Shares of raw material producers have also been hit by the official announcement of plans to apply the source tax nationwide, as well as extend the tax to include coking coal and rare earth metals. The announcement that the state was buying bank shares had a slightly positive impact, but stock traders remained nervous ahead of other macroeconomic news.

Share price trends on China's main stock exchanges



Source: Bloomberg

US Senate approves bill aimed at punishing China for currency policy. The authors of the bill said they were making good on repeated warnings that China was holding the value of the yuan against the dollar artificially low to give Chinese firms an unfair competitive advantage over American firms. If implemented, the law would give American companies the right to impose sanctions on goods imported from China. Despite Senate approval on Wednesday (Oct. 12), however, chances of the bill becoming law are slim; not only must it pass House of Representatives and garner president Barack Obama's signature to become law, it must also conform to WTO rules to be enforceable. Chinese officials and also many influential American business lobbies have condemned the bill.

Oil and cars characterise challenges of China-Russia trade. During his two-day visit to China this week (see

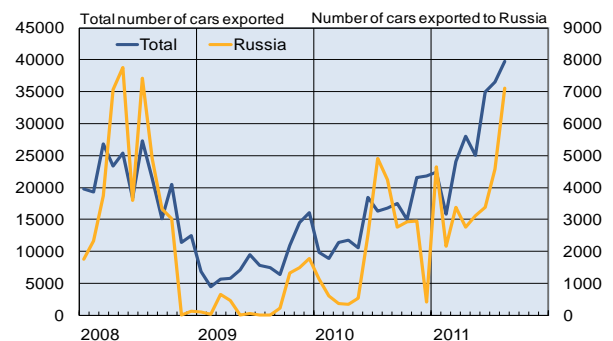
Russia section), Russian prime minister Vladimir Putin raised a number of issues, including measures to enhance bilateral trade. Although trade between the two countries has increased rapidly, Russian decision-makers have been dissatisfied with a structure of exports that emphasises providing raw materials to China. China's leaders, in contrast, appear quite content with the current situation.

Chinese figures show China's exports to Russia and imports from Russia increased about 40 % y-o-y in the January-August period. The value of exports and imports were both put at about \$25 billion, although for the year China appears to be running a trade surplus. Russia still only accounts for 2 % of China's total exports and imports.

China's imports from Russia consist largely of energy products, raw materials and low-value-added goods. Very little in the way of machinery and equipment is imported. Trade discussions between the countries have been dominated for years by wrangling over plans to build a natural gas pipeline from Russia to China, gas pricing and the China branch of ESPO oil pipeline inaugurated last January. Start-up of oil pipeline has been fraught with problems, with both sides blaming the other for contract breach and poor performance. Despite a huge leap in oil shipment capacity, oil imports from Russia were up less than 4 % y-o-y in the first eight months of the year, about two percentage points below China's overall growth in oil imports. Russia accounts for less than 7 % of China's oil imports.

China's exports to Russia are a diverse selection of products. While the largest product categories are machinery and equipment, clothing and footwear, cars are definitely an interesting export item. Over the past year, China has exported about 40,000 passenger cars to Russia; export volumes now approach the pre-crisis level of early 2008. Russia is an important foreign market for Chinese carmakers. About 13 % of Chinese car exports currently go to Russia. The arrival of Chinese-made cars is a blow to Russia's already struggling domestic carmakers and it highlights the competitive advantages of the Chinese car industry over the Russian car industry. In both countries, domestic carmakers have enjoyed strong government support.

Number of passenger cars (sedans) exported from China



Source: CEIC

Russia

Russia pushes for intensified economic cooperation among CIS members. At the CIS summit for heads of government in St. Petersburg this week, the participants agreed on establishing a free-trade area within the CIS. The free-trade area was initially created in 1994, but it never got off the ground as several countries, including Russia, never ratified the treaty.

Talks on a free-trade area were reinvigorated in 2009, when Russia began to push for closer economic cooperation among states of the former Soviet Union. The signatories of the new free-trade agreement made this week in St. Petersburg include Russia, Belarus, Kazakhstan, Armenia, Kyrgyzstan, Moldova, Tajikistan and Ukraine. Economic cooperation is most advanced in the case of Russia, Belarus and Kazakhstan as the three countries launched their own customs union last year. Ukraine signed on to membership in the free-trade area, although it continues to fend off Russian pressure to join the customs union. Azerbaijan, Turkmenistan and Uzbekistan, which still have certain open issues concerning the free trade area, were given until the end of December to decide whether they will pursue membership.

A free-trade agreement would replace the jungle of bilateral trade agreements currently in force among participating countries. It would unify foreign trade practices and largely conform to WTO rules. Import duties and quotas would be incrementally phased out for free-trade area participants, although the agreement includes several waivers and transition periods. In principle, the parties would also eliminate or lower export tariffs. The parliament of each signatory country must ratify the free-trade agreement before it enters into force. There was no proposed date yet for launch of free-trade area operations.

Cooperation within the free-trade area is expected to increase with expansion of the Russia-Belarus-Kazakhstan customs union. Kyrgyzstan and current customs union members agreed in principle at the summit to admit Kyrgyzstan and formed a working group on Kyrgyzstan membership. Kyrgyzstan is already a member of the WTO, so integrating its WTO commitments with custom union demands could lead to a lengthy membership process (e.g. Kyrgyz customs duties presently are substantially lower than customs union duties).

From the start of 2012, customs union member states will form a “common economic space” intended to intensify economic cooperation among customs union members. The common economic space will provide a framework for coordinating e.g. foreign-exchange policy, energy policy and transport policy. Moving to such a regime will require major changes in national legislation, which is a lengthy process.

In the longer term, Russia’s economic unification ambitions extend to transforming the CIS into a Eurasian Union, an entity with supranational bodies and operations modelled on the European Union. Prime minister Vladimir Putin presented the idea in a speech earlier this month.

Russia’s new international tax agreements seek to ban tax avoidance. Over the last couple of years, Russia has negotiated amendments to double taxation treaties with countries where Russian companies are domiciled to minimise their tax obligations. The changes comply with the OECD’s Model Tax Convention on Income and Capital.

At the end of September, Russia and Switzerland agreed to changes in their tax treaty so that the Swiss now promise to provide Russian tax officials with information on accounts held by Russian citizens in Swiss banks when legitimate grounds exist to suspect that the money in the account is the product of illegal activity such as tax evasion or money laundering. The agreement, yet to be ratified by either country, would enter into force at the start of the year following the year of ratification.

Changes to the 1998 Double Taxation Treaty with Cyprus agreed in October 2010 moved this summer to the Duma for ratification. The amended treaty calls for increased information exchanges on e.g. corporate tax violations and bank information. Under the changes, a Cyprus-registered Russian firm must demonstrate a reason for registering in Cyprus other than avoiding taxes before it can avail itself of Cypriot tax benefits.

The change in the Russia-Cyprus tax treaty is important as Cyprus is the most popular off-shore domicile for Russian firms. Of all foreign-registered Russia firms, 40 % (70,000–80,000) are estimated to be domiciled in Cyprus.

The Russian cabinet is currently examining a change in the Russia-Luxembourg Double Taxation Treaty. The change would ease exchange of tax information and improve the possibilities for tracking operations of Russian-Luxembourgian holding companies that have recently become popular.

The above-mentioned treaty changes may not necessarily achieve their intended effect. Getting information about suspect companies requires that the investigating agency provide a highly specified request, which may often be rejected for failing to comply with minor formalities. Moreover, Russian companies can quickly shift domiciles as needed. For example, during the past two years as the Russian-Cyprus agreement has been drafted, thousands of Russian firms have pulled out of Cyprus and headed for other tax havens.

It is common for large Russian firms to operate through subsidiaries registered in tax havens. Ownership in firms is also often organised through complicated chains of tax haven domiciled companies.

China

Economic growth remained strong in third quarter.

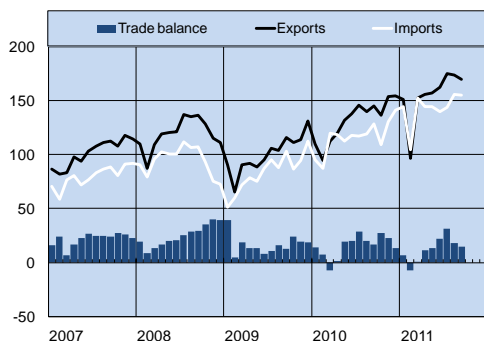
GDP figures for the third quarter eased concerns that the European debt crisis would lead to a rapid deceleration in growth of the Chinese economy. GDP growth, however, did slow slightly in the third quarter to an on-year rate of 9.1 % and 2.3 % from the previous quarter. The numbers were close to consensus expectations.

Agricultural output provided a positive surprise, posting growth of nearly 3 % y-o-y for the third quarter. The National Bureau of Statistics estimates that China's overall grain harvest this year will exceed that of 2010, despite last winter's exceptional drought in central and northern China and major flooding in eastern China last summer. Primary production (i.e. agriculture, forestry and fisheries) increased about 4 % y-o-y in the third quarter.

Manufacturing, mining and construction activity all rose 11 % y-o-y in the third quarter. The highest growth among specific branches in September was registered in manufacturing of mineral products (up 18 % y-o-y) and lowest in the textile industry (8 % y-o-y).

The statistical data failed to provide strong indications that Chinese consumers had suddenly developed an appetite for shopping. Increased consumption would be in line with the Chinese official five-year plan, and hopes have even been expressed that the Chinese consumer could help save the global economy. Nevertheless, growth in retail sales was robust (up 18 % y-o-y), a pace that matched the growth of late spring and early summer. Growth in service sector output was 9 % y-o-y in the third quarter.

Trends in China's foreign trade, USD billion



Source: CEIC

China's foreign trade has yet to be significantly affected by turmoil in the global economy, even if on-year growth in exports slowed in September to 17 % (enough to spook

international financial markets). Import growth slowed in September to 21 % y-o-y.

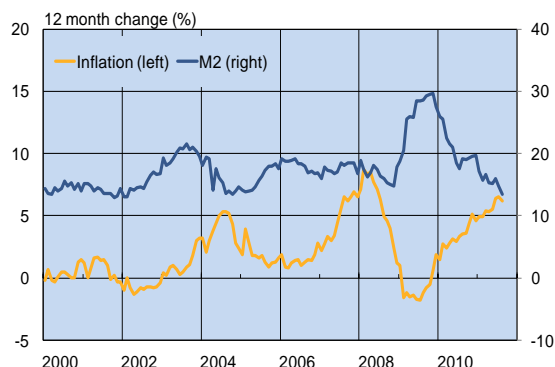
3Q inflation remained high as housing prices plateaued.

Consumer prices rose 6.1 % y-o-y in September, a rate only slightly lower than in August. Prices of nearly all consumer goods rose, led by a sharp spike in food prices (up 13 % y-o-y in September). The NBS sees the rise in food prices moderating towards the end of the year as the autumn grain harvest, which was larger than in previous years, makes its way to market. In addition, the 12-month rise in producer prices seems to be abating. Despite a slight diminution in inflationary pressures, consumer price inflation continues to exceed the central bank's 12-month target of 4 % by year's end.

Official measures to halt soaring apartment prices have begun to take effect. The average price of apartments in three of China's biggest cities (Beijing, Shanghai and Guangzhou) has been flat since June. The Chinese themselves have been sceptical of official statistics of apartment prices, and the statistical system has been significantly modified over the past year. There is anecdotal evidence to support the view that the apartment market is cooling. For example, Beijing real estate brokers have announced plans to cut back their operations and the volume of apartment sales in some markets have dropped sharply.

Much of the recent rise in prices echoes the massive government stimulus of 2009 that exploded the money supply through an aggressive expansion of bank lending. The effects of changes in money supply growth typically lag inflation. Although money supply growth has slowed since 2009 and economic growth has subsided a bit, the People's Bank of China is still expected to maintain a tight monetary stance as long as high inflation persists.

Changes in money supply (M2) and consumer prices



Source: Bloomberg

Russia

Output shows fair rebound this year. The economy ministry estimates GDP rose 4.2 % in January-September relative to the same period in 2010. Rosstat reports manufacturing increased over 7 % y-o-y in the period, although growth was slightly lower in the second and third quarters. Highest growth in the big industrial branches was registered in the construction materials industry and machinery & equipment, both of which are still reviving from the recession. Passenger car production was up by over 50 % from January-September 2010. Refining of petroleum products was up 4 %. The mineral extraction industries saw production increase 2 %, largely sustained by production of natural gas (up nearly 5 %) and non-energy mining. Crude oil production increased less than 1 %.

Construction activity continued to climb out of a deep recession, reaching growth of nearly 8 % y-o-y in the January-September period thanks to a strong third quarter. Goods transport increased nearly 4 %, while rail shipments were up over 5 %.

The volume of retail sales increased over 6 % y-o-y, with particularly robust growth in the third quarter (up 8 % y-o-y). Sales of foodstuffs were up over 2 % y-o-y in the first nine months of the year, while sales of non-food goods were up over 10 %.

Bumper grain harvest for Russia. Russia's agriculture ministry estimates this year's grain harvest could reach 90–92 million metric tons, an increase of about 50 % from last year's exceptionally poor harvest. The average annual grain harvest in the past decade was around 80 million tons.

Agriculture ministry calculations predict domestic grain consumption this year will reach about 72 million tons, leaving as much as 23–24 million tons available for export when grain reserves are taken into account.

Russia has exported a record amount of grain since July. As of end-September some 10.7 million tons had been exported. There are two reasons for the export boom: the good harvest and the end of a ban on exports in June (which had resulted in a large accumulation of grain in stores). The government banned grain exports in August 2010 due to last year's poor harvest, a move that helped drive up world grain prices.

Agriculture minister Viktor Zubkov announced a couple weeks ago that if exports exceed 24 million tons, the government is ready to limit exports by imposing tariffs to keep domestic prices from rising excessively.

About 55 million tons of this year's grain harvest is wheat. In 2009, the last time Russia had a good harvest,

Russia exported 18 million tons of wheat, making it the world's third largest wheat exporter that year.

Total agricultural output was up 16 % y-o-y in the first three quarters of 2011. Meat production grew 4 % y-o-y.

Energy continues to dominate Russian exports. Preliminary balance-of-payments figures show the value of Russian exports and imports rose over 30 % y-o-y in the January-September period. The value of exports exceeded \$380 billion and the value of imports \$230 billion, keeping the trade balance strongly in surplus.

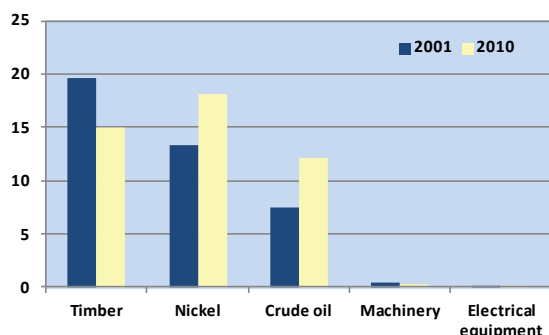
The upward trend in Russia's exports was mainly due to increasing oil prices as oil and gas constitute the lion's share of Russian exports. Although Russia has for years sought to diversify its export structure and add high-tech products into the mix, there is little evidence of progress. Energy and other commodities have steadily accounted for about 90 % of exports over the past decade. High-tech products still only account for a slightly over 1 % of total exports.

Russia's share of global exports has climbed over the past decade from 1.6 % to 2.6 %. During the same period, China's share nearly tripled (to 11 % in 2010). On the world stage, Russia is a significant exporter practically only in some commodities. Russia has a share of over 10 % in global exports of e.g. oil, natural gas, timber and some unrefined metals (nickel, iron, copper, aluminium, titanium). In more refined products, Russia is only a significant exporter of fertilizers and nuclear reactors.

Russian imports meet demand in the Russian market that domestic producers fail to satisfy (mainly high value-added consumer goods and investment goods). However, the rise in income and domestic production in Russia has changed the structure of consumer goods imports in past years. The share of foodstuffs has fallen, while the share of e.g. cars, clothing and cosmetics has risen.

Russia's share of global imports doubled over the last ten years and in 2010 it was 1.4 %. At the global level, Russia is a major importer of e.g. meat and fur products.

Russia's share of global exports by value, %



Source: International Trade Centre

China

China has to consider its involvement in euro zone rescue. The sheer scale of the euro zone crisis implies financing may have to come from countries outside the euro zone. This has turned attention to emerging economies showing large current account surpluses, particularly China. China has the world's largest currency reserves, \$3.2 trillion, an amount more than ten times larger than that of Greece's 2010 GDP and enough to cover all of the expected financing needs of European crisis countries.

The current issue for the Chinese is how to invest securely in the euro zone. This issue also came up at this week's European summit to put long-term measures in place to stabilise European economy. After the summit, European leaders eventually reached a common understanding on supporting crisis countries by increasing the assets of the European Financial Stability Facility to \$1.4 trillion. It is hoped that China will help cover part of EFSF funding.

China would like to see rapid resolution to the European debt crisis if only for the fact that the EU is China's biggest trading partner and takes about a fifth of all Chinese exports. China has significant investments in the euro zone, but its biggest concern is the risk of contagion to the rest of the world. With Europe's leaders struggling to find solutions, premier Wen Jiabao expressed hope Europe would show political backbone to avert a major global crisis.

In recent years, China has developed bilateral economic relations with Greece. China has traditionally run a huge trade surplus with Greece, and China's exports to Greece last year were nearly ten times greater than its imports. Chinese have invested in Greek infrastructure (e.g. ports) as well as the Greek telecommunications and food sectors.

From the Chinese standpoint, the European crisis poses both threats and opportunities as China's negotiating position is rather strong at the moment. Europe offers Chinese firms an opportunity to invest in well-known quality brands.

Local administrations get go-ahead on bond issues. On October 20, the finance ministry announced that the cities of Shanghai and Shenzhen, as well as the Guangdong and Zhejiang provinces, would be allowed to issue bonds on a trial basis. The total quota of the new three- and five-year bonds would amount to about 23 billion yuan (€2.6 billion).

In 1994, the central government limited access of local administrations to external financing by forbidding bond issues. Although the finance ministry issued bonds on behalf of some provinces during the recent financial crisis, it was apparent that provinces need more access to financing. The financial conditions of local and provincial governments have deteriorated as they must now pay back loans

used for economic stimulus programmes, cope with lower revenues from sales of land use rights (a major source of revenue for local and provincial governments) in a cooling real estate market and increased spending obligations associated e.g. with affordable housing programmes.

Opening of local and provincial bond markets has long been considered a pillar of reform policy as it would contribute to development China's bond markets and diversify investments. Moreover, provincial governments would have to open their books and submit to monitoring by investors to get market financing – a major advance given the present opacity and closed nature of China's public sector.

As usual, China moves forward by first experimenting how municipal bonds will work. Selling of bonds and repayments are tightly monitored by the central government and so e.g. issues related to possible defaults and guarantees will remain to be tested. It is also interesting to see how local and provincial bonds are received by the markets. In summer, the finance ministry issued bonds on behalf of provincial governments only to meet a tepid response from markets demanding higher yields.

Considerable shrinkage of China's current account.

According to preliminary balance-of-payments figures, the current account surplus in the first half of the year was \$88 billion, or 2.8 % of GDP – a surplus far lower than in previous years. Most of the current account surplus was generated by goods trade (\$88 billion). The deficit in the services account (\$20 billion) was driven by transportation costs. The surplus in income account (interest and wages) was \$2 billion and current transfers (remittances) \$18 billion.

Cross-border financial flows have increased substantially with relaxation of controls on capital movements. Simultaneously, the financial account surplus has increased. In January-June, the flow of direct investment into China was \$111 billion, while FDI outflows were modest (\$18 billion). The international borrowing of Chinese firms increased significantly, with companies issuing bonds, especially in Hong Kong.

Although the current account surplus was smaller than earlier and global imbalances in this sense declined slightly, with the rising financial account surplus, China's currency reserves continued to grow rapidly.

Main balance-of-payments categories, US\$ billion

	2010H1	2010H2	2011H1
Current account	127	178	88
Capital account	2	3	3
Financial account	88	133	181
Net errors and omissions	-39	-21	12
Currency reserves increase	178	293	284
Total currency reserves	2,454	2,847	3,197

Source: SAFE

Russia

Is Russia finally on the brink of WTO membership?

Georgia and Russia have initially accepted a Swiss-moderated proposal to end Georgia's hold on Russia's WTO accession. Russia's acceptance was announced late Wednesday evening (Nov. 2) by the country's chief WTO negotiator Maxim Medvedkov. Georgia had been the sole holdout against Russia's WTO accession, taking a hard stance against what it saw as Russian occupation of Georgia's breakaway regions of South Ossetia and Abkhazia since 2008. Under the Swiss-mediated compromise, goods shipments crossing Russia's borders with South Ossetia and Abkhazia will be inspected by an international agency. Although Georgia failed to get its own inspectors, it hailed the compromise as acknowledgement of its true borders.

Russia last year resolved most of its bilateral discussions with the United States and the European Union. A few thorny matters were left unsolved, however, and Russia has been actively negotiating on them with the EU this autumn. Final resolution of these issues now seems at hand.

One of the most difficult issues has been a local-content requirement for foreign-made automobiles assembled in Russia. Russia boosted its local content requirement at the start of 2011. Last week the EU Commission announced that the EU and Russia had agreed on a compensation procedure that would enter into force if exports of European car parts to Russia decline as a result of Russia's new local-content requirement. Local content requirements designed to protect domestic producers are a direct violation of the WTO's Agreement on Trade Related Investment Measures (TRIMS). Russia has requested a TRIMS exemption to allow its domestic content rule to continue until 2020, an unusually long transition period by WTO standards.

The differences between the EU and Russia also extend to governing sanitary and phytosanitary (SPS) rules for imports of agricultural products. In the EU's opinion, Russia has used its SPS regulations to restrict food imports. The Commission announced it has now agreed with Russia on clearer SPS rules.

According to the Commission's announcement, the EU has obtained assurances from Russia that it will soon lower the overflight fees it charges European airlines. Overflight fees are seen as a violation of WTO rules as they are handed over to a competing domestic carrier, Aeroflot. According to Russian sources, the amount of the fee reduction has yet to be agreed.

The EU hopes all the above-mentioned issues will be resolved as swiftly as possible. If the necessary technical preparations are handled rapidly, too, Russia's membership could be approved in December at the WTO Ministerial

Conference in Geneva. Russia's membership would enter in force in the first half of 2012 at earliest, after the ratification process has been concluded.

Russia ready to help finance eurozone debtors. Arkady Dvorkovich, president Medvedev's economic policy adviser, announced Monday (Oct. 31) that Russia could provide up to \$10 billion (€7.3 billion) to help struggling European states. Russia prefers to channel the support via the IMF, which has a system in place for monitoring borrowers. Russia could also consider bilateral lending to specific EU countries, but still via the IMF. All loans assume the EU adopts a clear strategy to resolve its debt crisis.

Russia recently negotiated with Spain on purchasing its Eurobonds, but Dvorkovich says Russia has no further plans at the moment to expand sovereign bond-buying in the EU. Russia and Cyprus agreed last month on a loan to Cyprus, but Russia's finance ministry says it was one-off deal (described by the Cypriot government as a €2.5 billion four-and-a-half-year loan). The 4.5 % yield on the bond is well below current market rates. The loan would allow refinancing of debts coming due next year. Cyprus is the preferred tax haven of Russian corporations and the single largest source of FDI for Russia, thanks to repatriated Russian monies.

As of end-October, the Russian state held \$118 billion in off-budget reserve funds. Part of these assets is held as deposits in Vneshekonombank and the rest is invested in high-grade bonds as part of Russia's foreign currency reserves. After China and Japan, Russia holds the third largest foreign currency reserves in the world. The current value of Russia's reserves is about \$515 billion.

Next year's regulated rate hikes to be postponed. The Russian government typically adjusts rates for municipal services such as water supply, electricity, gas and heating at the start of the year. With the March 2012 presidential election approaching, it has decided to wait until July.

Heating rates will go up at least 6 % next July and regional authorities will be allowed to further increase rates if they deem necessary in September. Electricity rates for consumers will go up by a maximum of 6 % and natural gas rates 15 %. Larger rate hikes were earlier anticipated to allow for increased investment in municipal services and reduction in the subsidy burden that below-market rates place on municipalities providing such services. Last spring, prime minister Vladimir Putin said 2012 rate hikes could not exceed the year's forecast inflation, which is currently expected to run at 5–6 %.

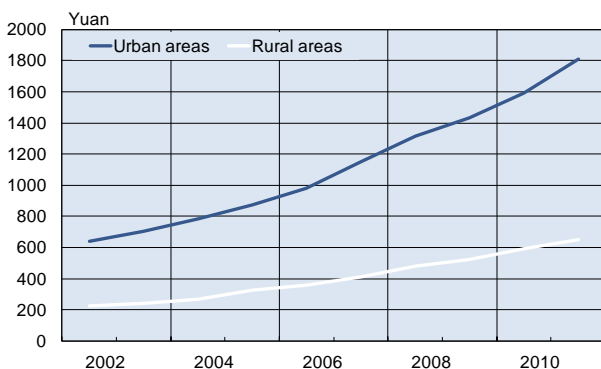
Regions are free to set rates for municipal services as long as they stay within certain limits set at the federal level.

China

Income continues to climb. China's National Bureau of Statistics reports per capita monthly disposable income of households in January-September reached 1,811 yuan (about €200), a 14 % increase from the same period in 2010. Income rose 8 % in real terms. The rise in wages was slightly lower than the increase in other forms of income. In the countryside, disposable incomes rose substantially faster than in urban areas. Soaring food prices have significantly boosted the income and wages of farm workers. Although still well below urban income levels, the average rural cash income in the period reached 653 yuan (€71) a month.

The long and steady rise in income (and wages) has begun to impact on the structure of the Chinese economy. At first glance, consumer purchasing power has risen, which is seen as a driver of private consumer demand. On the other hand, rising labour costs for firms and a stronger yuan mean that companies are seeing competitive advantage over foreign competitors erode to some extent. Previously, this was not much of a problem as rising costs could be dealt through productivity gains and offsetting smaller profit margins with higher volumes. This wiggle room has diminished and higher input costs force producers to raise their prices. Indeed, quoted dollar prices for Chinese goods delivered to the US have begun to rise. The increase not only reflects appreciation of the yuan's exchange rate, but also signals that the steady slide in yuan-denominated prices that began in 2003 has ended.

Per capita income of households, 2002–2011 (Jan.–Sept.)



Sources: NBS and CEIC

China experiments with extending VAT to services.

Starting in January, Shanghai will introduce on a trial basis an extension of value-added tax to transport services and other yet-to-be-specified service branches. Two new VAT

tax categories (6 % and 11 %) were introduced and those will probably be applied to services. If the pilot programme succeeds, VAT on services will be applied nationwide.

Rather than VAT, service providers currently pay a turnover tax, which is for example in transport services 3 %. Although the current tax rate for service providers is lower than the proposed VAT rates, the change should lower the tax burden on firms and reduce public tax revenues somewhat. VAT is a pass-through tax, which means firms can deduct the VAT taxes they have paid on production inputs. The turnover tax, in contrast, does not allow such deductions. The experiment will not alter the status of local administrations or the central government with respect to tax collection, because the value-added tax will be paid to local administrations just as the turnover tax is currently paid. The goal of the pilot programme is to reduce double taxation and clarify taxation practices.

OECD gives Chinese higher education a mixed report card.

A new OECD report says China needs to significantly increase its number of universities and improve the quality of instruction. At the moment, only a fifth of young people attend university, and many of them never graduate. Exporting companies are distressed by the lack of highly educated employees; nearly two-thirds say the lack of university-educated staff prevents them from expanding their operations. By recent estimates, the Chinese state spends less than 2 % of GDP on higher education, far less than in advanced industrialised countries and even below the average of its Asian neighbours.

China must develop its university system if the country is to shift its economic emphasis to high-value fields based on demanding technologies and know-how. China's strength relative to other Asian countries is that it has state and university support systems to make higher education available to as many promising students as possible, regardless of their economic background or geographic origins. To raise the level of university education to the international forefront, universities have been granted considerable academic freedom and financial resources. The vanguard of Chinese universities has been separated from the regular university system. These top-tier universities stress research and receive preference in state funding.

Top-tier universities have seen such vast improvement that five of Asia's top ten universities are now in Hong Kong or mainland China. About 36,000 people took science or technology PhDs last year in China, which was about half of all PhDs granted in East Asia. The latest figures show that about a fifth of China's over 3,000 universities are privately operated. Tuition typically runs around \$700 a semester. Over 400,000 Chinese study in universities abroad.

Russia

Russian exports weaker than forecast. In forecasts from last summer and early autumn, exports – which account for over 30 % of Russian GDP – were projected to grow 3–4 % in volume terms this year. However, exports have fared much more weakly than predicted. Rosstat's GDP demand-side indicators, which cover goods and services exports, find the *volume* of exports increased only 1.7 % y-o-y in the first half of the year. Moreover, seasonally adjusted export volume figures show no growth from the first quarter to the second quarter. Russian customs reports the volume of goods exports declined slightly in the first half from the first half of 2010, and was down about 2 % y-o-y in January–September.

The total export volume figure would have been even more feeble were it not for a large increase in exports of natural gas. Natural gas exports rose 13 % y-o-y in January–September. Crude oil exports, in contrast, fell a couple of per cent on-year, as did oil products, since domestic demand growth for oil and petroleum products is outstripping production growth. The temporary ban on grain exports in force in the first half of 2011 also depressed Russia's overall export volume figures.

Metal production and metal fabrication industries, which constitute an export category nearly as large as natural gas, exported significantly less raw metals in January–September than in the same period in 2010, but at the same time managed to increase some value-added exports. Export volumes of ferrous metals contracted over 10 %, due e.g. to increased amounts of value-added production diverted to satisfy domestic demand. Among Russia's non-ferrous metal exports, copper saw exports dive about 70 % y-o-y. This was offset to some degree by volume increases in exports of semi-finished and finished products. The shift partly reflects a new copper export tariff imposed earlier this year. Nickel exports fell by a third due to reduced global demand.

The increase in Russian export earnings this year, as in most years in the past decade, is due to *export prices*. According to Russian customs, export prices were up 25–30 % y-o-y in the first nine months of this year. However, among prices of core export items the only major export item to enjoy a significant price increase in the course of this year has been natural gas. The Russian gas price generally lags changes in the oil price by about six months. Export prices for crude oil and petroleum products have been gradually declining since last spring. Prices of ferrous metals and non-ferrous metals have declined around 15–30 % after rebounding to new post-crisis heights during the first half of this year.

Quarterly volume and prices of Russian exports, 2003=100



* Quarterly average in US dollars

Sources: Rosstat, IMF

First gas passes through Nord Stream gas pipeline. The joint Nord Stream venture, made up of Russian gas giant Gazprom and four European energy companies, saw gas transmission through its Nord Stream gas pipeline begin on Tuesday (Nov. 8). Construction of the pipeline began in April 2010. Nord Stream consists of two pipelines with a transmission capacity of 27.5 billion cubic metres each. The first pipeline is now in service and its twin is slated for completion about a year from now. The Nord Stream pipeline is buried in the Baltic seabed and runs from Vyborg, a port city in the eastern Gulf of Finland, to Lubmin on Germany's Baltic coast. From there, it hooks in to the European gas grid.

In 2010, Gazprom exported about 150 billion m³ of natural gas to Europe. The owners of the Nord Stream pipeline expect demand for natural gas to increase in Europe over the long-term to the extent that there will be need for additional transmission capacity. In the near future, however, demand for gas should grow modestly. However, Gazprom asserts that Nord Stream will reduce the political risks of gas transport as part of the gas can be piped directly to customers without going through third countries.

About two-thirds of Gazprom's gas shipments to Europe in 2010 transited Ukraine. Several observers now expect that the Nord Stream pipeline will reduce the amount of gas transiting Ukraine by 20–30 %.

Overall, Gazprom exported about 220 billion m³ of gas from Russia in 2010. That figure includes Gazprom's pipeline grid that also carries gas produced in other CIS countries. Russian authorities report that Russia last year exported 174–178 billion m³ of gas produced in Russia. In its economic forecast, the economy ministry says it expects gas exports to rise this year to nearly 200 billion m³, next year to over 210 billion m³ and in 2013 to over 230 billion m³.

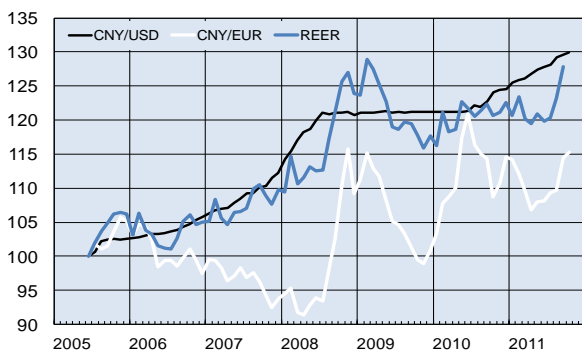
China

October economic figures suggest economic growth continues to slow. Industrial output growth slowed in October to 13 % y-o-y after having held steady at 14 % y-o-y in the previous three months. Export growth also slowed. In contrast, 12-month growth in fixed capital investment and retail sales remained basically unchanged from September. In earlier months, investment growth has been slowing down. October consumer price inflation fell to 5.5 % y-o-y (6.1 % in September), while the increase in producer prices declined to 5.0 % y-o-y (6.5 % in September).

October figures indicate that the measures taken by China's officials to prevent overheating of the economy have an impact. The slowing of the economy also reflects the weaker outlook for export markets. On the bright side, price pressures domestically appear to be easing, which grants officials the possibility to begin a gradual easing of monetary policy to support growth.

Yuan appreciates in real terms. When the global financial crisis hit in summer 2008, China moved to protect its export industries by re-pegging the yuan to the US dollar. In summer 2010, the government allowed nominal appreciation of the yuan against the dollar to resume. Since then, the yuan has gained about 7 % against the dollar in nominal terms.

Yuan-euro, yuan-dollar and real effective exchange rate; 2005 = 100 (rising trend indicates yuan appreciation)



Sources: BIS and Bloomberg

The real effective exchange rate (REER) takes into account trade-weights and differences in inflation rates, thereby providing a better indicator of exchange rate trends than classic comparison of nominal bilateral exchange rates. The yuan's REER had been fairly stable for about two years, but in August-September it climbed nearly 7 %. Even with the rise, however, the REER for the yuan is still lower than it was at its peak in early 2009.

The main reasons for the strengthening of the yuan's real exchange rate has been acceleration of Chinese inflation this summer and the US dollar's appreciation against the euro and the currencies of many emerging economies in late summer and early autumn. Although strengthening of the real exchange rate indicates China's rapid growth in wages and a relative decline in price competitiveness, the stronger exchange rate is a natural feature of an economy with rising productivity and high economic growth.

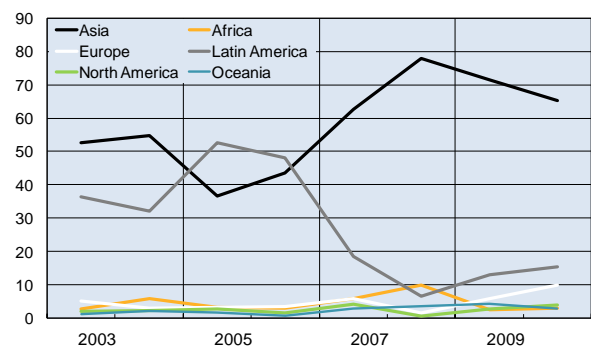
Chinese direct investment abroad still largely destined for Asia. China's foreign direct investment in other countries reached \$41 billion in January-September, an increase of 12 % y-o-y. The figures omit direct investment to the financial sector, which amounted to just over \$2 billion in the first half.

In 2010, China's FDI abroad amounted to \$69 billion, with about \$9 billion of that going to the financial sector. The lion's share of FDI went to business services, which accounted for over 40 % of FDI. Other major branches of interest to Chinese investors included wholesale and retail operations, mining and manufacturing.

At the end of 2010, the stock of FDI of Chinese firms abroad totalled \$317 billion. Of that, over 70 % was invested in Hong Kong or elsewhere in Asia. Latin America's share of investment was 14 %, Europe 5 % and Africa 4 %. North America and Australia & the Pacific region each account for about 3 % of investment. However, using figures for annual investment flows (see chart below), investment share in Europe and Latin America has increased in recent years with corresponding reductions in the share of Asian countries.

FDI flows into China increased 17 % y-o-y in January-September and amounted to \$87 billion. Asia was the top source of FDI inflows to China: 60 % of investment came from Hong Kong, 6 % from Japan, 5 % from Singapore and over 2 % from Korea. As regards other countries, Germany's share of FDI inflows to China during January-September was only 1 %.

Chinese FDI outflows, regional shares, %



Source: CEIC

Russia

Russia one step closer to WTO membership. On November 10, the WTO working group on Russia's membership gave the go-ahead to the final conditions of the country's accession. Based on the working group's recommendation, the WTO Ministerial Conference in mid-December is expected to approve Russia's membership.

Only some membership conditions have so far been released. Information from the WTO and Russia's economy ministry give an idea of Russia's commitments to lowering import duties; the average import duty should fall from about 10 % at present to less than 8 %. About a third of the tariff reductions enter into force immediately upon accession, with the remaining reductions phased in over various transition periods. The most common transition periods are 2–3 years, but some of the most sensitive products (e.g. passenger cars) have been granted transition periods as long as seven years.

Lower duties will apply to a number of product groups in the technology category. For example, import duties on computers will be phased out completely after a three-year transition period. Import duties on passenger cars will be reduced incrementally over a seven-year period from their current level of 30–35 % to 15–20 %. Domestic content rules imposed on car assembly plants in Russia will remain in force until summer 2018. Average import duties on agricultural products will fall from over 13 % to under 11 %.

The WTO agreement also covers services. According to Russia's accession rules, foreign insurance companies will be able to establish branch offices in Russia after a nine-year transition period. Foreign banks, on the other hand, won't be able to establish branches in Russia even after WTO accession, and must instead operate as Russian subsidiaries.

From the EU's standpoint, a significant improvement is Russia's commitment to give advance notice of changes in export duties. Russia promised to consult the EU on planned change in export duties at least two months in advance. The shift affects about 600 raw materials not covered under Russia's WTO deal, but of which Russia is a significant exporter.

Russia has until June 15, 2012 to ratify its WTO agreement. Membership would become effective one month after ratification.

Diversity in economic performance and 2012 forecasts.

Rosstat figures show GDP increased by 4.8 % y-o-y in the third quarter, and that GDP growth in the first half of the year was well under 4 %. The high third-quarter figure reflects the low comparison point of 3Q2010. The down-

and-up development this year and last year has been considerably influenced by the agricultural output, which rebounded from its steep drop in 3Q2010.

Seasonally adjusted GDP growth revived in the third quarter after distinctly weak second-quarter performance, supported by the construction and retail sales segments. Manufacturing has fluctuated in recent months; after a weak September, output growth returned in October.

Most observers expect economic growth to slow at the end of this year due to flagging exports. After notable consensus earlier, forecasts for 2012 have diverged in recent months. One group of analysts still sees growth of around 4 % or even higher next year if the oil price does not sink below \$100 a barrel. Another group has lowered their projections to below 4 % next year due to the weak outlook for the global economy. Some top forecasters put growth next year at 3 %, or even 2.5 %, if the oil price drops to the range of \$80–90 a barrel.

Banking sector liquidity expected to improve by year's end.

The substantial tightening of liquidity for Russian banks in recent months has been reflected in a sharp increase in demand for liquidity facilities provided by the central bank and the finance ministry. Interbank lending rates have also increased substantially from late summer: for example, the one-day Mosprime lending rate in August was below 4 %, but by mid-November had climbed to over 5.5 %.

The tight liquidity has been caused in part by an outflow of capital that accelerated in September as the outlook for the global economy began to weaken. As the capital outflows increased, the Central Bank of Russia made its largest currency selling interventions at the end of September in domestic currency markets. The CBR estimates that net capital exports in October–December will remain at about the same level as in July–September, i.e. \$20 billion. For the year as a whole, the CBR expects the net outflow of capital to be around \$70 billion, up from \$34 billion last year.

A second major cause of the tightened liquidity situation is the budget. Unlike last year, the current budget is in surplus with spending financed from tax collections rather than tapping into the reserve fund. The finance ministry has sought to ease the situation through increasing the amounts offered at its auctions providing cash to banks in the form of temporary deposits.

Budget spending in Russia is traditionally weighted towards the end of the year, so budget spending tends to increase liquidity especially in December. Preliminary finance ministry data suggest that only slightly over 70 % of budgeted spending for 2011 had occurred in the January–October period, which means that in the remaining two months of this year the public sector should spend over 3 trillion roubles (about €72 billion) in budgeted funds.

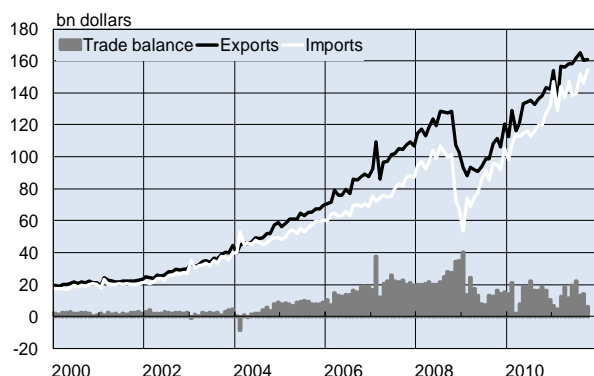
China

Economic slowdown yet to be reflected in a drop-off in metal imports to China. China customs figures show the value of imports continued to climb rapidly in October. China has reinforced its position as the world's largest consumer of raw materials, with continued strong growth registered for such commodities as pulp and copper. Imports of iron ore continue to rise, even with a build-up in ore stockpiles at Chinese ports. The ore stockpiling evidences both the cooling of the building boom and uncertainty caused by negotiations between the Chinese and international iron ore producers on adjustments to the pricing mechanism. China's construction sector is the world's largest steel consumer, and the lion's share of iron ore consumed by China goes to steel production.

After nearly ten years of steady growth, crude oil imports have stabilised; import volumes have held this year at a level of about 20 million metric tons a month. China does not publish comprehensive figures on its national oil stores, but by some estimates refiners have depleted their own stockpiles in an effort to keep up with rising domestic fuel consumption. Natural gas imports have increased rapidly as new liquefied natural gas (LNG) receiving terminals have been pressed into service.

Despite the increase in China's raw material imports, the struggles of developed economies have restrained global commodity prices. The lack of demand in developed economies is apparent in China's export figures, which showed marked declines in September-October relative to July-August. Nearly all of the decline can be attributed to plunging exports to the EU, China's largest export market. Weaker exports and higher imports have eroded China's trade surplus in recent months. One factor in export weakness and import strength has been appreciation of the yuan's exchange rate.

China's foreign trade (seasonally adjusted)



Sources: China customs and BOFIT

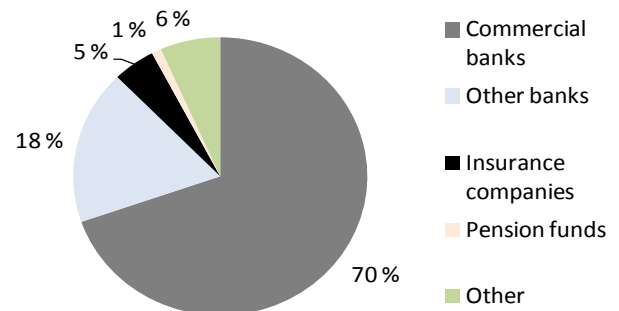
IMF points to vulnerabilities of China's financial sector from inefficiency and risk exposure. The IMF's views are based on the Financial Sector Assessment Program (FSAP), which was carried out a year ago, but the report was only released this week. The report states China's financial sector, while generally robust, faces a build-up in vulnerabilities from regulatory distortions. The over-involvement of officials in guiding bank policy means that banks fail to pay adequate attention to credit risk and assuring adequate returns on their investments. Excessive regulation prevents development of financial markets, including broader access to credit and more diverse savings strategies.

The IMF would like to see Chinese officials embark on a fundamental modernisation of the financial sector. Regulation of interest rates should be phased out and officials should extricate themselves from involvement in bank lending decisions. Banking operations need to be based on commercial objectives rather than broad government policy goals. The report further calls for greater focus on financial supervision and crisis management, as well as putting a reliable deposit insurance scheme in place.

Despite these deficiencies, China's financial institutions weathered the global economic crisis in fairly good condition. Bank profitability remained good and solvency increased. The largest risks facing banks relate to the explosive growth in lending, off-balance-sheet activity, a real estate bubble and unbalanced economic development. Stress testing showed that the largest banks would be fairly resilient to isolated shocks. However, risk rises if banks have to deal with multiple shocks such as a deterioration of economic growth combined with a collapse in real estate prices.

Commercial banks represent over two-thirds of the total net assets held by China's finance sector, with the biggest commercial banks still state-majority owned. While the number of foreign banks now exceeds 200, their operations remain quite narrow. The other major banking cluster is made up of nearly 3,000 cooperative financial institutions. There are also nearly 800 other financial entities in China, including insurance companies, pension funds and companies providing asset management services.

Structure of China's financial sector in 2010



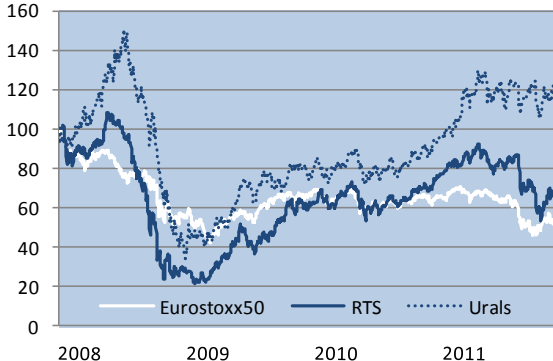
Source: IMF

Russia

Prices on Russia's stock markets now track international stock markets more closely than before. In recent weeks, Russian share prices have been on the rise after hitting their 2011 low point in early October. However, volatility has remained strong as in most of the world.

Trends on the Russian stock exchange have traditionally followed the world price of crude oil, but in recent months the linkage appears to have weakened. For example, the price of Urals oil in mid-November was nearly a fifth higher than at the start of this year, yet the RTS and the MICEX share indices have been about 15 % lower relative to the start of the year. Russia's stock markets this year have been tracking moves on international stock exchanges more closely than earlier; e.g. the Eurostoxx50 index and the MSCI's 21 emerging market index were down in mid-November more than 20 % from a year ago.

Eurostoxx50 and Russian RTX stock indices, Urals price, 2008–2011, Jan. 3, 2008=100



Source: Bloomberg

Stock market reforms. Last summer, Russia's most important exchanges, the Russian Trading System (RTS) and the Moscow Interbank Currency Exchange (MICEX) agreed to merge. The MICEX's biggest shareholder is the Central Bank of Russia. Preparations for the unification of the exchanges are currently underway, with the merger to be completed early next year. The goal of the merger is to strengthen Russian markets and make them attractive to foreign investors. The merger should also encourage more Russian firms to list and offer shares in domestic markets.

Russia's stock markets have fairly low volumes, most trading is concentrated around firms involved in the energy and finance sectors, and investors are scarce. In recent years, Russian firms have preferred to arrange IPOs on big international exchanges (particularly London), rather than

domestically. Dealogic, which tracks international capital markets, reports that in 2010 and 2011, only about 30 % of Russian share offers were domestic.

The MICEX says the unified securities exchange is to become the world's third largest exchange by market capitalisation by 2015, a goal that would require the current market cap to treble. Having a large securities exchange is seen as supporting Russia's aspirations to make Moscow an international financial centre.

A second step towards becoming an international financial hub was the creation of one centralised electronic share depository. Its creation was pushed forward by the merger of exchanges, as both exchanges maintain separate share registers. The project has been delayed for years by squabbles among various actors in the financial markets. A law on establishing a centralised share depository was finally approved last week by the Duma. The law enters into force at the start of next year and the depository will begin operations in 2013.

A centralised depository means that hundreds of tiny securities depositories will stop registering shares quoted on stock exchanges. One problem has been that some of these depositories have registered ownership of non-existent securities in the names of their clients. Non-existent shares, in turn, have been used e.g. to make bank capitalisations appear larger than in actuality – a phenomenon exposed in recent bank insolvencies.

Russia, Belarus and Kazakhstan aim at a new phase in economic cooperation. Since the trio founded their own customs union in 2010, they have pursued an ambitious schedule to widen their cooperation. At a meeting of the presidents of Russia, Belarus and Kazakhstan in Moscow on November 18, the leaders confirmed that their countries will move over from customs union to a common economic space on January 1, 2012.

At the same event, the leaders of states also agreed that their countries would by 2015 transform the common economic space into a Eurasian Union similar to the EU. The creation of a Eurasian Union was first proposed by prime minister Vladimir Putin in October this year.

Free movement of goods, services, capital and labour will be gradually introduced within the common economic space starting in January 2012. Further areas where gradual unification takes place include member country economic policy, competition legislation, industrial policy and agricultural policy.

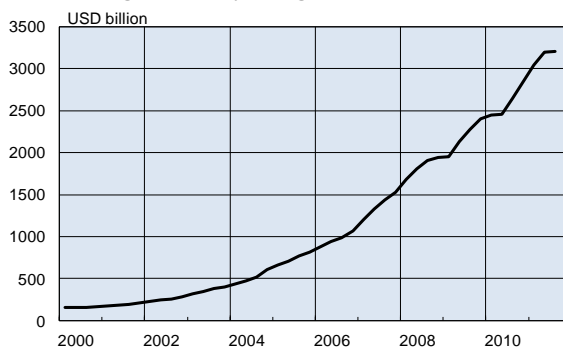
The Eurasian Union would in addition to further unifying economic policies engage in cooperation in policy-setting generally. A highlight in economic integration would be the introduction of a common currency, although no concrete proposals to this effect have yet been made.

China

Growth in China's currency reserves slowed in the third quarter. Growth in China's foreign currency reserves measured in dollars nearly flat-lined in the third quarter after posting high growth late last year and in the first half of this year. In September, the reserves actually fell \$61 billion, due in part to the fact that in September the euro weakened 6 % against the dollar. Another underlying driver of the shift was a likely decline in net capital inflows into China. As China holds some 30–40 % of its foreign currency reserves in non-dollar-denominated instruments, fluctuations in other major currencies, particularly the euro and the yen, impact the size of the reserve calculated in dollars. China's foreign currency and gold reserves stood at \$3.2 trillion at the end of September.

According to preliminary 3Q balance-of-payments figures, the surpluses in the current account and FDI remained large, while other capital inflows to China were close to zero in net terms. Presumably, this not only reflected Western banks repatriating assets from China to deal with their domestic capital and liquidity needs but also was a sign that uncertainty in China's housing and financial markets, combined with lower economic growth, has reduced interest of foreign investors in Chinese assets.

China's foreign currency and gold reserves, USD billion



Source: Bloomberg

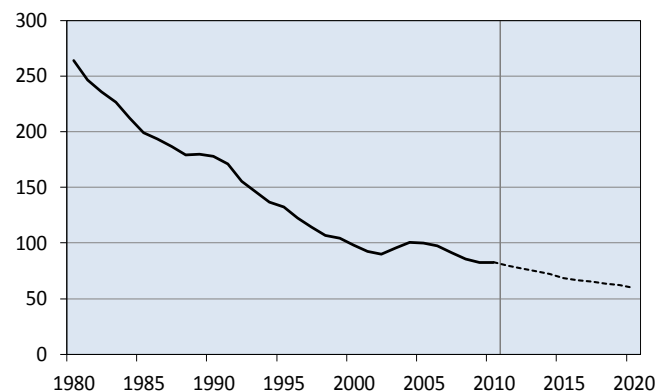
China tests effectiveness of different environmental policy approaches. Local news sources report measures to limit greenhouse emissions will be tested in the cities of Chongqing, Peking, Shanghai, Shenzhen and Tianjin, as well as the Guangdong and Hubei provinces. Specific information on the measures used to limit environmental impacts was not revealed, but the discussion focused on both voluntary and mandatory emissions targets, as well as carbon trading schemes. The trials would begin by 2013.

China is the world's largest source of greenhouse emissions, accounting for about a quarter of all global green-

house gas emissions. As part of its climate-change negotiations, China committed to voluntarily reducing greenhouse emissions by 40 % relative to GDP by 2020 compared to its 2005 level. Under the current five-year plan, the goal is a 17 % reduction. China's greenhouse gas emissions relative to GDP contracted sharply during 1980–2000, but as the low-hanging fruit of environmental fixes have been taken, further improvements in reducing environmental impact have been harder to achieve in recent years.

Considered long term, China's emission goals are hardly ambitious. If China's GDP growth continues at the current pace of 9 % a year, emissions would rise more than 70 % above the current level in absolute terms by 2020, even if they fall about 40 % relative to GDP.

China's CO₂ emissions to GDP and target trend, 2005=100



Sources: British Petroleum and IMF

Boom in Finnish raw material exports to China. Customs Finland reports that China is Finland's biggest Asian trading partner, although China's position is no longer strengthening. Finland's exports to China in the first eight months of 2011 were valued at nearly €2 billion and the country's share of Finland's total exports was almost 5 %. Half of exports consisted of machinery & equipment. A quarter of exports were raw materials, which have increased rapidly this year. In the January-August period, wood pulp amounted to 12 % of exports and furs 8 % – increases of over 100 % from the same period a year earlier. In addition to goods exports, Statistics Finland reports exports of services from Finland to China last year were worth about €1 billion.

In the January-August period, Finland imported nearly €3 billion in goods from China, with China accounting for about 7 % of total imports. Imports were dominated by phones (about 20 %) and other equipment, machinery and transport vehicles (40 %). Clothing and footwear accounted for slightly over 15 %. The annual value of imported services in recent years has hovered around €0.5 billion.

Russia

CBR braces for weaker economic conditions. The Central Bank of Russia last week eased access of banks to central bank financing by relaxing its requirement on the quality of securities used as collateral. The move essentially reinstates the looser collateral requirements for banks applied during the 2008–2009 financial crisis.

The troubles of European banks are being reflected in the operations of their Russian subsidiary banks. The subsidiary banks have recently lent substantial amounts to help recapitalise their parent banks. Indeed, a large part of the net capital exports from Russia in recent months has been in the form of loans to parent banks. A side-effect has been to suck liquidity out of the Russian banking sector. The CBR responded with a not-so-gentle admonition to subsidiary banks that they cut back on funding their parents.

At their November 25 meeting, the CBR board decided to leave key rates unchanged. For example, the minimum one-day auction repo credit rate is 5.25 %. The CBR said interest rates were appropriate for current conditions, given that inflation is gradually slowing and liquidity in the banking sector has tightened. 12-month inflation was about 7 % in November.

Russia and Belarus reach agreement on a new contract price for natural gas. Under the current supply contract that runs out at the end of this month, Belarus has had to pay substantially more for Russian natural gas than Russian regions along its border. Belarus has argued for a cut in its gas price to Russia's domestic level e.g. because Russia, Belarus and Kazakhstan will establish a common economic space from the start of 2012.

Under the three-year agreement signed last Friday (Nov. 25), Gazprom commits to initially reducing the price of gas it sells Belarus from the current rate of \$244.00 per thousand cubic meters to \$165.60 for all of 2012. In the following two years, the price would be tied to the consumer price for natural gas in the Yamalo-Nenets autonomous okrug plus e.g. transmission and delivery costs. The average price next year for Gazprom gas to its Western European clientele will be somewhere around \$400 per 1,000 m³.

Meanwhile, Russia committed to give Belarus more time to pay for its gas purchases this year; Belarus has been struggling with financial difficulties and has been unable to pay its bills lately.

In connection with the deal, Belarus sold its remaining 50 % stake in its gas pipeline monopoly Beltransgaz to Gazprom for a price of \$2.5 billion, giving Gazprom complete ownership of the company. The initial 50 % stake was sold to Gazprom in increments during 2007–2010 as part of gas supply contracts at that time. One condition of the dis-

counted gas price was Beltransgaz divestiture. The deal gives Gazprom for the first time complete control of a foreign natural gas pipeline operator. Reaching a deal was an important step for Russia in assuring the stability of gas supplies to Europe via Belarus.

The Eurasian Economic Community's crisis fund, which is overseen by Russia, agreed last week to pay out in December the second tranche of a \$3-billion emergency loan to Belarus. The first tranche of \$800 million was released to Belarus last summer. Payment of the second \$440-million tranche depends on how well Belarus keeps to the terms of the loan in reforming its economy. Under the funding conditions, the Central Bank of Belarus ended in October the use of dual exchange rates for the ruble (a regime it instituted after the large ruble devaluation last May). With the unification of the exchange rate on October 20, the external value of the ruble declined further. At the same time, the Belarus central bank announced it was introducing a managed float regime for the ruble, i.e. letting the market have a greater role in setting its value. Another loan condition was wide divestiture of state assets, of which the Beltransgaz sale is so far the only example. Several large Russian firms are currently in negotiations to buy Belarussian state companies.

IEA pushes Russia on energy efficiency. The latest annual *World Energy Outlook* from the International Energy Agency sees Russia having plenty of room for improvement in the sphere of energy efficiency. If Russia's energy efficiency merely matched the OECD average, it would cut its annual energy consumption by 30 %, an amount equivalent to what the entire UK uses in a year.

The IEA noted the biggest savings were to be had by making heat production and distribution more efficient, as well as end use of heat in households. It also mentioned that plenty of saving potential remains in industry and the transport sector. Improving energy efficiency requires investment to replace aged production and distribution systems, as well as upgrading building stock. The report noted deregulation of energy rates, a move Russia has already partly made, provides economic incentive to reduce energy waste.

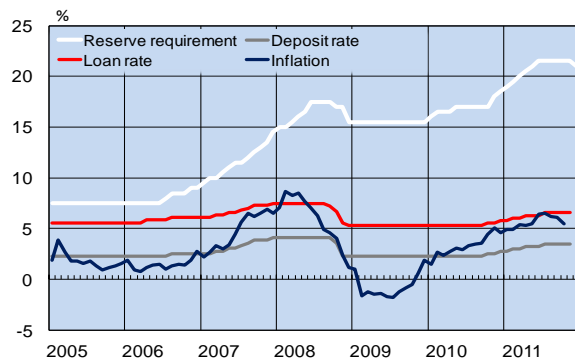
Besides cost savings, energy efficiency was also seen as a way to sustain exports of energy products. The IEA forecasts that Russian oil production will soon start to decline and natural gas production will only grow at about 1 % a year over the coming decades, assuming \$30 billion a year is invested in both oil and gas production. Rosstat reports that investment in the oil and gas sector together reached \$40 billion in 2010, its highest point in a decade.

If Russia's energy efficiency does not improve, growing domestic demand for oil and gas will eat away the volumes of oil and gas exports. The basic scenario of the IEA sees the volume of gas exports continuing to rise slightly, while oil exports decline.

China

China relaxes its monetary stance. The People's Bank of China announced this week a cut in the minimum reserve requirement for commercial banks. From December 5, the reserve requirement ratio will fall to 21 % of bank deposits for big banks and 17.5 % of deposits for small and medium-sized banks. Still in June, the reserve requirement was raised to deal with rising inflation. Relaxation of the monetary stance was expected as inflationary pressures have begun to wane, economic growth has slowed and the outlooks for major export markets (particularly Europe) continue to weaken. Many observers expect the loosening of monetary policy to continue in coming months.

Major monetary policy tools and the inflation rate, %



Sources: PBoC and NBS

Industrial conditions weaken substantially in November. The November reading of official manufacturing purchasing managers' index (PMI) dropped to 49, indicating contraction for Chinese industry relative to October. In the PMI sub-index categories, manufacturing output continued to increase from October, but a greater share of finished products remained in company inventories. The size of the labour force, the level of imports and new domestic and international orders all declined and the delivery times of subcontractors shortened. The last time similar developments were seen was in autumn 2008 at the onset of the global financial meltdown. However, the shock at that time was considerably more pronounced.

Slide in apartment prices gathered force in October. China's National Bureau of Statistics tracks apartment prices in 70 large and mid-sized cities in China. In October, prices fell in 33 cities, while prices were unchanged from September in 23 cities. In September apartment prices declined in just 17 cities, so the October change is significant. The reversal in apartment prices has been expected since the government increased actions to break the rise in prices.

In addition, weakening of the economic outlook has been reflected in the housing market.

Although official figures show only a modest decline in apartment prices, other indicators have emerged to suggest a definite chill in the housing markets with a period of declining prices ahead. According to China's largest real estate website, SouFun, apartment prices declined for the third month in a row in November.

A survey of housing developers conducted by the Standard Chartered investment bank during October and November found housing sales remained below target and that the volume of unsold apartments was rising. In the same period, prices of building lots and sales volumes fell, so revenues to cities, which earn considerable amounts from the sale of land use rights, have fallen an average of more than 20 % since a year earlier. The Standard Chartered survey found that banks expect apartment prices to drop 10–20 % in the near future. Other institutions also expect a price adjustment of similar magnitude. A lot depends, however, on how quickly economic policy is relaxed. The survey also found that the much-publicised wave of social housing production has failed to materialise, despite ambitious government goals. Many of these projects are now on hold, meaning that actual production of new apartments may be only a third of the official target.

Trends in the housing market affect the economy overall as housing investment constitutes nearly a fifth of urban fixed capital investment and the housing sector accounts for about 10 % of GDP. When the real estate sector has problems, it impacts not only the construction industry but the functioning of the banking sector and local administrations.

Bribery a prominent feature of Chinese and Russian firms conducting international business. A recent survey by Transparency International (TI) gives Russian firms the lowest marks and Chinese firms next-to-bottom marks for their propensity to use bribery in foreign operations. The survey was based on responses to questions directed to top corporate management in 28 countries. The study found that company behaviour abroad tended to reflect domestic business attitudes, i.e. bribery abroad was commonplace for firms from countries with high levels of corruption. China ranks in the middle-tier of countries on the TI index of perceived corruption, while Russia is included among the most corrupt countries.

Chinese firms are also under scrutiny for alleged accounting fraud. The shares in Chinese technology firms listed in the US declined sharply in September with the revelation of accounting inconsistencies, and shareholders have brought claims against dozens of Chinese firms for giving out misleading information. The problem for Chinese companies that comply with international best practices is that they may be unfairly labelled as bad actors and suffer loss of brand value and goodwill.

Russia

Election results unlikely to affect Russian economic policy. Preliminary results from last Sunday's (Dec. 4) Duma elections show United Russia garnered nearly 50 % of the vote (United Russia won 64 % of the vote in the 2007 Duma elections). Despite a loss of 77 Duma seats, United Russia maintains its dominance as the largest party. The largest gains in the elections were achieved by the Communists, who took over 20 % of the vote. Parties close to United Russia, the Liberal Democratic Party and A Just Russia, also posted gains.

While the election result has been characterised as a vote of no confidence for United Russia, the outcome is unlikely to impact current economic policies directly. The budget framework for 2012–2014 was set and approved before the elections, including plans to significantly raise defence spending in coming years. The budget framework calls for relatively small federal budget deficits that eventually vanish by 2015. The days of massive budget surpluses and a ballooning stabilisation fund are gone. Many observers expect short-term social spending to increase with the approaching presidential election in March.

When the new Duma convenes in January, its agenda will probably include ratification of Russia's WTO accession. Over its five-year term, the Duma must tackle challenging issues such as reforms of pension, health care and education systems, as well as energy sector taxation. None of these topics were prominent campaign issues.

Changes in taxation on the way. The mandatory social security contribution of employers will drop next month from its current 34 % of wage bill to 30 %. This adjustment in the rate remains in force until the end of 2013. (The rate was 36.5 % up to 2005, when it was lowered to 26 % and raised again to 34 % in at the start of 2011.) Finding an appropriate rate for the employers' contribution has been a thorny topic within the cabinet. On one hand, the government wants to support entrepreneurship by keeping the mandatory contribution as low as possible, but on the other hand social security contributions are insufficient to cover the actual costs of the system. Specifically, extensive underfunding of the pension fund has meant that a large share of pension payments has needed funding directly out of the federal budget. The funding need will increase further next year when the social security contribution is lowered again.

A number of taxes will be raised to compensate for reduced social security payments. Russia amended its tax code in November to allow hikes in the tobacco and alcohol excise taxes in the 2012–2014 period. The excise tax on tobacco will triple by 2014, bringing it into line with the European average. The biggest increase in alcohol taxation

applies to distilled spirits, the excises tax of which will double by 2014. Also the gasoline excise tax will be increased notably more than the rate of inflation during 2012–2014. The biggest excise hikes will probably be imposed only next summer instead of January.

The extraction fee (resource use tax) for natural gas is significantly lower than the extraction fee on crude oil. This gap will be narrowed by doubling the current resource use tax on natural gas by 2014.

The finance ministry is currently reviewing the grounds for the numerous tax breaks granted to firms. The ministry's assessment shows that the overall value of tax breaks granted to firms in 2010 amounted to around 700 billion rubles (17 billion euros), an amount equivalent to about 10 % of combined federal and regional tax revenues. Of that, about 170 billion rubles constituted temporary relief on the resource use tax granted to oil and gas producers. Some 100 billion rubles was given in the form of property tax reductions for Russia's "natural monopolies," which include the railway network, oil and gas pipeline operators, and electrical power grid operators. Another 100 billion rubles came in the form of depreciation-related reductions of corporate profit tax. Next summer, the finance ministry will present recommendations on dealing with tax breaks and incentives. Some relatively small tax reductions that have been prone to abuse will be abolished already at the start of 2012. The overall goal of the ministry's assessment, however, is not to reduce tax breaks so much as to better focus their application.

Revived Russian consumption supports Finland's exports. Consumption in Russia has recovered rather rapidly since the 2008–2009 financial crisis. This is reflected clearly also in Russian imports. Imports measured in euros were up 25 % y-o-y in January–September.

Finnish exports to Russia have also shown a gradual recovery. In January–September, the value of exports was up 16 % y-o-y. Growth in export of investment goods, in particular, was brisk in the first nine months of the year, exceeding 30 % y-o-y. But as exports of investment goods declined sharply during the economic crisis their level is still far below pre-crisis levels.

In contrast, exports of consumer goods from Finland to Russia already exceed pre-crisis levels. The share of consumer goods in Finnish exports to Russia exceeded 10 % in January–September, up from pre-crisis level of 5 %. Food and medicines were among the biggest export categories.

This year has seen large increases in clothing exports and also transit shipments of textiles via Finland to Russia. The value of clothing exports increased 50 % y-o-y in January–September, while the value of textile and clothing transit shipments doubled. The value of total road transit transport from Finland eastward increased by 27 % y-o-y, but remained well below pre-crisis levels.

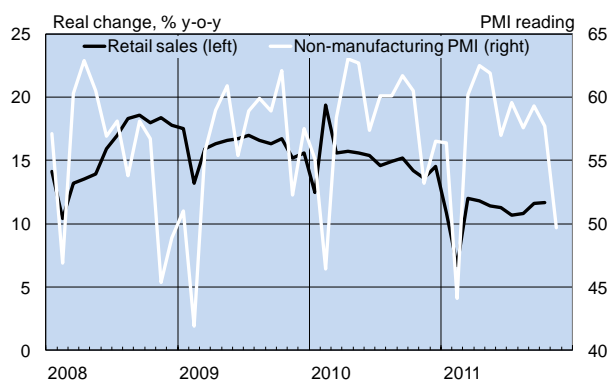
China

Growth also slowing in service branches. The latest reading of China's official purchasing managers' index (PMI) for the non-manufacturing sector dropped below 50 from a reading of nearly 58 in October. Although part of the drop registered by the China Federation of Logistics and Purchasing (CFLP) could be due to seasonal factors, the reading was accompanied by other strong indicators the economy is slowing. The CFLP's earlier-released November reading of the PMI for the manufacturing sector also dipped below the critical 50-point mark.

Getting an idea about conditions in the service sector is difficult due to the lack of good statistical data. Retail sales growth has gradually faded from earlier years, but even so was still up nearly 12 % y-o-y in September-October. The indicators of confidence of business-owners show growth subsiding from the first half. The biggest confidence drops were registered in the real estate and construction sectors, while confidence exceeded the average in data processing and hotel and restaurant services.

Services currently account for about 42 % of China's GDP, while industry generates about 48 % of GDP and primary production 10 %. Although agriculture and fishing have steadily declined relative to GDP, primary production still employs 38 % of China's 780-million-person labour force. Services employ about 34 % of the labour force and industry 28 %.

Real growth in retail sales and CFLP non-manufacturing PMI



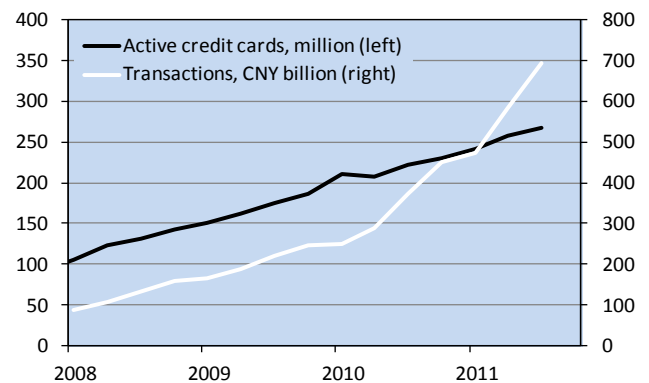
Source: Macrobond

Soaring credit card use – and overdue credit card payments. According to the People's Bank of China, the value of credit card payments over six months late exceeded 10 billion yuan (€1.2 billion) at the end of September. Overdue payments have risen quickly; at the beginning of the year the stock of late payments stood at just 7 billion yuan. The loss exposure for commercial banks from late payments and

probable defaults, however, is relatively small compared to the size of banks' overall assets.

The biggest driver of soaring credit card debt is the rapid proliferation of credit cards. In the last four years, the number of issued cards has more than tripled. As of end-September, Chinese held 268 million active credit cards meaning one in five Chinese carries a credit card. An average credit limit per card is 9,000 yuan (about €1,000). In addition to the rapid rise in the amount of credit card holders, paying with a credit card has become much more common. Card use doubled in the January-September period compared to a year earlier, which in part might reflect overall tightened liquidity situation.

Number of credit cards and monthly value of transactions



Sources: CEIC and PBoC

Entertainment industry facing challenges in China.

Official pronouncements declare that popular entertainment is an engine of Chinese economic growth that supports domestic demand and helps soften the image of China abroad. Not all is well in Chinese entertainment heaven, however, after the recent imposition of new restrictions by the State Administration of Radio, Film and Television (SARFT). International entertainment shows and sci-fi/fantasy programmes that refer to Chinese history face censorship. Some popular Western music has been banned on the basis of bad taste. To the chagrin of advertisers, SARFT has forbidden the showing of ads in the middle of TV programmes from the start of next year, and many popular shopping channels will be unavailable.

China's entertainment field experienced dizzying growth in recent years. Local tv channels focusing on entertainment rapidly outstripped their state tv counterparts in viewership. 520 feature-length films were produced in China last year, a level that exceeded the US and came second after India in quantity. Over half of the approximately 235 billion yuan in net sales of China's 250,000 ad agencies was generated by state-owned ad agencies. By unofficial estimates, China's advertising market this year surpassed Japan as the world's second largest after the US.

Russia

Stock market down after public protests over Duma elections. Following a rash of demonstrations in cities across Russia last weekend over Duma elections, share prices on Russia's main stock exchanges plummeted for two days (Dec. 12-13). State treasuries also shed value. Some of the drop reflected the general weakness of global stock markets.

Since Wednesday (Dec. 14), share prices have plateaued at a level above this year's low point in early October. Given the traditionally very volatile share prices in Russia, the current drop does not seem exceptionally large.

RTS index Jan. 1, 2010–Dec. 15, 2011



Source: RTS

The ruble's exchange rate weakened dramatically following the announcement of results of Duma elections. This week, however, the exchange rate rebounded somewhat, partly on euro weakness. Observers say the Central Bank of Russia seems to have been intervening in the currency market to prop up the value of the ruble.

Probably due to worries on high capital outflows, the CBR last week limited its liquidity credits available to banks. As a result, interbank lending rates have risen sharply and now stand at levels not seen for over two years.

Finance sector struggles with tight liquidity. The tightening liquidity situation has forced banks to rely increasingly on the central bank credit. As of end-November, CBR financing represented nearly 3 % of the banking sector's total liabilities while after the 2008–2009 financial crisis the share has typically been around 1 %. During the crisis, the share of CBR credit exceeded 12 %.

Average deposit and lending rates have also been on the rise since October. Especially the ten largest banks by deposit volume have hiked their rates significantly and started the hikes already in July. Rising interest rates and falling

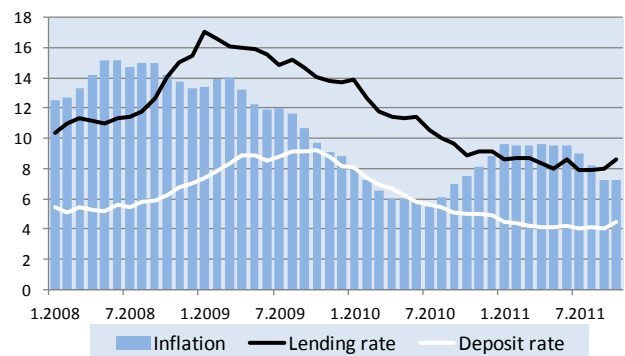
inflation have pushed average real lending rates back into positive territory.

In November, the finance ministry submitted a legislative proposal to the cabinet giving the CBR authority to limit deposit interest rates in situations where a bank is attempting to offer interest rates well above prevailing market rates to attract money during unstable economic conditions. The proposal would also set minimum rates for deposits; e.g. the minimum rate for ruble-denominated deposits would be 2/3 of the CBR refinancing rate (currently 8.25 %). The CBR was given similar authority during the 2008 financial crisis, but the enabling legislation expired in 2010. At the moment, the central bank merely provides guidance on appropriate interest rates. Rates on household deposits should not exceed by more than 1.5 percentage points the average of the deposit rates of the ten largest banks by deposit volume.

A 2008 law on bank restructuring set to expire in December has been extended through 2014. The shaky global recovery forced the extension. The law gives the central bank and the deposit insurance agency that deals with bank restructurings the right to intervene in troubled banks early on to help avert bankruptcy.

Under a new law passed this month, the minimum capital requirement for banks will rise from the current 90 million rubles (€2.1 million) to 300 million rubles (€7.2 million). The change applies to all new banks established after 1 January 2012, while the minimum capital requirement for existing banks increases to 180 million rubles next year and to 300 million rubles in 2015. The decision on hikes was made a couple of years ago, and after that smaller banks have gradually increased their capital or merged with other banks to keep their doors open. At present there are some 990 banks operating in Russia. Of those, 69 banks still had capital below 180 million rubles as of end-November. That was down from 103 at the end of October.

Average rates for household deposits, corporate credit and 12-month inflation, 2008–2011, % p.a.



Source: Central Bank of Russia

China

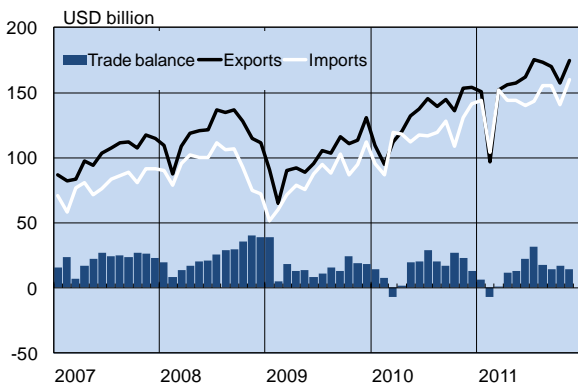
China export growth continues to slow. China's goods exports in November reached \$174 billion, a 14 % increase from a year earlier. Although 12-month growth remained brisk, it has shown signs of steady slowing since August. Seasonally adjusted figures indicate exports have held at the same level since late summer. The slowdown in exports largely reflects problems in the Eurozone; exports to Germany and France were flat and exports to Italy were down considerably. Export growth to Japan in recent months has fallen to 18 % y-o-y. Exports to the United States, in contrast, recovered to 13 % y-o-y growth in November. Although Chinese exports to emerging economies are still climbing rapidly, that growth, too, seems set to fade. Growth in emerging economies and, hence their imports are slowing, and their currencies have already declined against the yuan in recent months.

The value of Chinese imports climbed to \$160 billion in November, up 23 % y-o-y. Although growth in the value of imports has slowed this autumn, there is no indication of a dramatic slowdown in Chinese economy. The trend in import volumes of core commodities suggests demand remains strong.

China's goods trade surplus in November was about \$15 billion, which puts the trade surplus for all of 2011 on track to hit \$150 billion. In 2010, China's trade surplus was \$185 billion.

China's foreign trade provides a valuable snapshot of the overall condition and direction of global trade. During the global financial crisis in 2009, China surpassed Germany and the United States as the world's largest exporter. China currently accounts for about 11 % of world exports, while Germany and the United States each account for about 8 %. China's share of global imports is currently 10 %, while the US share exceeds 12 %.

Trends in China's foreign trade



Source: China customs

Inflation drops sharply in November. China's National Bureau of Statistics reports inflation slowed in November to 4.2 % y-o-y, down from over 6 % in September. The rise in prices of consumer goods, particularly food, slowed as the ample autumn grain crop made its way to market. Food prices have a large impact on Chinese inflation as food represents about a third of the CPI. November non-food inflation was 2.2 %.

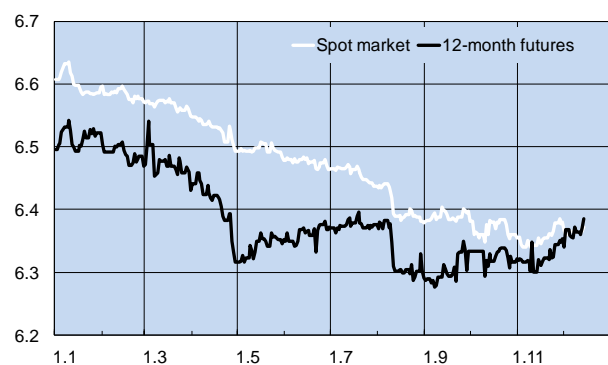
China's massive stimulus in 2009 and 2010 helped fuel inflation, and People's Bank of China reacted by tightening monetary stance during 2010 and 2011. The monetary measures have begun to bite, as inflation has fallen and growth in the broad money supply (M2) has slowed. M2 growth was 12.7 % y-o-y in November, the lowest growth in over ten years.

China began to relax its monetary stance this month by reducing the reserve requirement ratios for commercial banks. The loosening is expected to continue in the first half of 2012, as inflation is forecasted to decline.

Expectations of ongoing yuan appreciation begin to fade. The yuan-dollar exchange rate has remained around 6.36 in recent weeks, essentially unchanged from late October. Expectations about exchange rate trends are reflected in the price of yuan futures contracts, which currently anticipate modest yuan depreciation. The last time such a situation was seen was in the midst of the 2009 international financial meltdown. As at that time, yuan relative weakness appears to be due to repatriation of foreign investments in China to struggling developed countries.

The shift in exchange-rate expectations can also be seen in cooling of the Hong Kong's unregulated offshore yuan market. After massive growth that was still occurring three months ago, yuan-denominated deposits declined slightly in October. At the annual working conference on economic issues, China's senior leadership said that the yuan's exchange rate would be held basically stable in 2012. The message does not indicate a change in exchange rate policy as similar wording has also been used in the past.

Yuan spot and futures rates vs. US dollar in 2011



Source: Bloomberg

Russia

WTO ministerial conference approves Russia's accession. According to the accession agreement Russia will commit e.g. to lowering import duties and opening its service sector to foreign businesses. Russia, in turn, gets easier access to markets for certain exports and can e.g. participate in trade dispute resolution within WTO mechanisms.

There are a range of views as to the magnitude of the concessions Russia had to make or received in its WTO negotiations. In general, Russia managed to negotiate relatively long periods (as much as 7–9 years) for opening its markets for foreign products.

Russia also negotiated a possibility to apply even higher restrictions than currently on access of foreign goods and services to its markets in some branches. The limits will not necessarily ever be fully implemented, however, as the affected branches are already considering whether there is any need to implement the stricter limits at all. For example, Russia can set stricter rules on legal services provided by foreign attorneys.

The WTO agreement gives Russia the possibility to double agricultural subsidies from their current relatively low levels. However, any increased subsidies could only be paid during the transition phase; thereafter Russia would have to return to its current subsidy levels.

The discussion surrounding Russia's WTO membership has largely focused on which production branches benefit from improved access to foreign markets and which branches suffer most from the opening up of the domestic market. Very little mention has gone to how the consumer benefits from the increased domestic competition that should result from lower import tariffs. This benefit could, however, be hampered by informal barriers to market access, like corruption and bureaucracy, both of which significantly impair business in Russia.

Russia's parliament has 220 days from the time of WTO council approval to ratify the accession agreement, i.e. the treaty must be ratified by next summer. Russia's WTO membership would become effective one month after ratification.

The US could be the exception to Russia's WTO agreement as the US Congress has yet to repeal the Jackson-Vanik amendment, a piece of Cold War legislation that forbids granting of permanent "most-favoured" nation status" to Russia as a US trading partner. Unless Congress repeals the Jackson-Vanik amendment, US firms cannot take full advantage of improved access to Russia's markets as granted other trading partners under the WTO deal.

Russia's WTO membership positive for both the Russian and Finnish economies. Russia's WTO accession is generally expected to have a positive impact on the Russian

economy – even if the immediate benefits are minor. A World Bank assessment a few years ago found membership would add over 3 % to Russia's annual GDP over the medium term.

Finnish export firms could also benefit from this growth. Based on the World Bank assessment and the Bank of Finland's own forecasting model, BOFIT sees Russia's WTO membership could boost export demand so as to add €200–300 million a year to Finnish GDP in medium term and employment gains of 4,500–6,500 jobs over the non-accession scenario. Finnish companies operating in Russia may also benefit from growth in local markets. The current uncertainty in the global economy, however, could delay these positive medium-term gains.

With the WTO membership Russia is committed to lower also several export duties in addition to import tariffs. For Finland, among the most important ones are export duties on raw timber. Russia currently applies export duties to most timber exports (typically 25 % of the stated value of the wood with a minimum floor of €15 per cubic metre). With WTO membership, the export duty for birch will decline to 7 %. Export quotas will be imposed on softwoods and the export duty on spruce will fall to 13 % and pine to 15 %. Russia can freely impose export duties on timber exceeding the quota. Russia has defined the quota for spruce exported to EU countries at 6 million m³ and 3.6 million m³ for pine.

Imports of Russian raw timber into the EU peaked in 2005–2006 and declined after Russia imposed large increases on raw timber exports. In 2005–2006, the EU imported nearly 9 million m³ a year of spruce, as well as about 4 million m³ of pine a year. Last year import of both spruce and pine was around 2 million m³, which is well below quotas agreed with the WTO.

MICEX and RTS exchanges merge. On Monday (Dec. 19), the newly formed MICEX-RTS exchange conducted its first trading day. Many of the practical aspects of the merger of the two exchanges are yet to be completed and a number of major changes won't occur until next year.

Both exchanges still maintain separate securities depositories and clearing centres. The RTS and MICEX indices also continue to be calculated separately. Securities depositories, clearing centres and indexes should all be integrated next year. The combined exchange's technical infrastructure will be brought up to international standards and trading formats expanded.

By combining its two largest exchanges, Russia strives to create a major international trading hub. The MICEX was established in 1992 for trading of stocks and other securities, as well as foreign currency. The RTS was founded in 1995, mainly for securities and derivatives trading. RTS stock trading is conducted in dollars and the index is Russia's most-tracked share index.

China

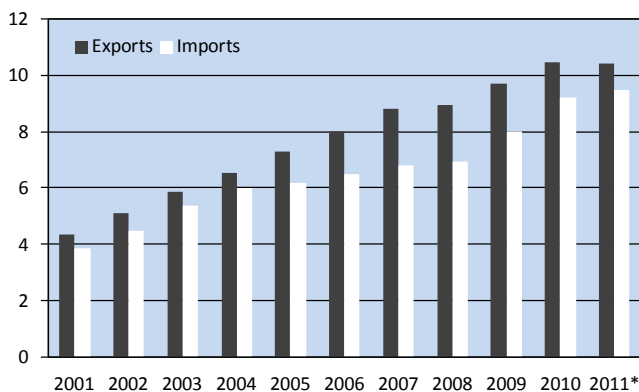
WTO membership has provided China many benefits...

China joined the World Trade Organization in December 2001. At that time, it committed to reducing tariffs and opening its markets to foreign entities. China's volume of exports and imports, as well as the number of foreign-based firms operating in the country, started to rise more rapidly after accession.

Over the last ten years, the values of China's goods exports and imports have increased seven-fold. In 2009, China became the world's largest exporter, and it is currently the world's second largest importer after the United States. Exports and imports of services have also increased about six-fold over the past ten years. In 2010, China was the world's fourth largest exporter of services and the world's third largest importer of services.

In addition to higher exports, WTO membership has helped raise domestic demand. Chinese-owned export businesses, as well as on-shored foreign companies, now employ huge numbers of Chinese and have helped increase the purchasing power of average individuals. Besides the heavy capital investment of export firms, the export sector has promoted internal migration from the countryside to cities by offering employment. The population shift, in turn, has put pressure on cities to step up their own investments in housing construction and infrastructure. The presence of foreign firms has also aided domestic companies in some sectors to improve their production processes and develop their products.

China's share of world goods trade since joining the WTO, %



*) estimate

Sources: China customs and the IMF

...but WTO membership has also led to numerous squabbles. Although China has risen to become the world's largest exporter, many say the opening up process has come to a standstill and that Chinese favouritism towards its do-

estic firms has actually increased in recent years. Accusations that Chinese products are being dumped continue to increase, so that they are commonplace; there are currently over 100 antidumping tariffs in force around the world that apply to Chinese products. The amount is the largest in the world. Over the past ten years, countries have filed 15 official complaints on separate topics against Chinese regulations that affect areas as diverse as exports of rare earth metals and limits on electronic payment services. Critics say China's domestic markets remain unpredictable for foreign firms. China continues to favour state-owned firms and refuses to adequately protect intellectual property rights, particularly patents and copyright.

Competitive bidding in public procurements emerged this year as a core theme in trade policy disputes. China stayed outside the WTO framework signed by 42 countries on public procurements, an arrangement intended to encourage competitive bidding on public procurements of the signatory nations. The US claims that China is still unprepared for wide-scale liberalisation measures and dealings with its public sector are far from transparent. The lack of competitive bidding in public procurements was also noted in a recent EU Chamber of Commerce in China report, which estimated China's public procurements at \$1 trillion a year, or almost a fifth of GDP.

China continues to relax capital controls. In keeping with an August promise, China last week began to allow on a trial basis the use of yuan-denominated deposits in Hong Kong for the purchase of securities traded in Mainland China. Initially, the participating qualified foreign investor institutions (QFII) are limited to a ceiling quota of 20 billion yuan (€2.4 billion). Moreover, 80 % of investments must go to the public sector or corporate bonds. The other 20 % can be used to buy shares of Chinese enterprises.

Yuan investments in securities are a natural extension of a trial launched in October, in which yuan acquired abroad were allowed to be used for foreign direct investment in China. The quota is currently tiny relative to the size of China's securities markets overall, but if the trial is successful, it should spread rapidly like in other liberalisation experiments. Even if the starting quotas are tiny, the reform opens access of foreign investors to China's previously off-limits A-share stock markets.

Over the long term, China expects to achieve free movement of capital and increased international use of the yuan. A recent decline of appreciation pressure on the yuan and a rise in the net outflow of capital from China has increased possibilities to try out new liberalisation schemes in calmer exchange rate conditions. In the best-case scenario, liberalisation measures act as a stimulus measure for China's flagging economic growth in a way that avoids the risk of overheating which typically follows the lifting capital controls.

Russia

New Duma convened on December 21. Presidential chief of staff Sergei Naryshkin was elected Duma chairman by the votes of the ruling party, United Russia. Of the Duma's 29 committees, 15 will be chaired by members of the United Russia and 6 by members of the Communist Party. A Just Russia Party and the Liberal Democrats each received chairmanships on four committees. In the previous Duma, United Russia held chairmanships on 26 of the Duma's 32 committees.

The previous Duma, which convened first in 2007, will go down as one of the most productive in history if measured simply in terms of legislative output. For example, in the recent spring session, the Duma passed a record 270 bills. Due to the dominance of United Russia, proposed bills submitted by the government and presidential administration generally moved through the Duma quickly with few amendments and little discussion. Although the position of United Russia is somewhat weaker in the current Duma, it still controls a simple majority.

Changes ahead in federal and regional power-sharing.

This autumn, two working groups examined the possibility for decentralising some powers and duties from the federal level to regions and municipalities. President Dmitri Medvedev appointed the working groups last summer after stating at the St. Petersburg International Economic Forum that Russia was too big to be run completely by a central administration.

According to experts, the concentration of economic decision-making power at the federal level has gone too far. Former finance minister Alexei Kudrin said that the final phase of decentralisation started before the 2008 presidential election when so-called "National Priority Projects" were launched by the initiative of Vladimir Putin. The projects promote housing construction and agriculture and improve healthcare and education systems. They are guided by the federal centre and funded in part through the federal budget. In addition to national priority projects, the government runs a multitude of other federally steered programmes in social and economic spheres around the country.

In 2011, the federal government transferred over 500 billion rubles (€12 billion) in general funds to the regions, i.e. about 6 % of federal budget spending. Regions also receive from the federal budget subsidies earmarked for specific uses. The value of these dedicated subsidies exceeds the general transfers to the regions.

Funds provided by the federal budget to regions have increased steadily as the regional share of taxes has dwindled. In 2005, regions received directly 45 % of the total federal and regional budget revenue. In 2010, that share had fallen

to 37 %. Growth in transfers from the federal budget to regions has eroded regional decision-making powers. Furthermore, the subsidy system is extremely complicated and even an obstacle to regional development.

The working group proposals were taken up at Monday's (Dec. 26) meeting of the president, prime minister and regional governors. Working groups' presentations included a list of over 100 functions that could be shifted from the federal to the regional level, including measures to improve the investment climate such as registration of real property, oversight of natural resources and administration of state property. Another proposal focused on increasing direct revenue collection by regions by surrendering them certain tax streams in their entirety such as the corporate profit tax and excise taxes on sales of tobacco and alcohol. Regional subsidies would be standardised and regions would be responsible for allocation of such subsidies.

The division of labour between the federal government and regions was also taken up in the large expert working group that is part of Russia's Strategy 2020 development programme (see [BOFIT Weekly 22/2011](#)). The working group's premise is that a mere mechanical shifting of duties and funds to lower administrative levels is insufficient; there must also be political change, i.e. development of democratic processes at the regional and municipal levels. To achieve this, working group recommendations include a return to direct elections of regional governors. Medvedev suggested restoring directly elected governorships last week in his speech to the new Duma.

Central bank adjusts rates and widens fluctuation band of ruble exchange rate. On Monday (Dec. 26), the Central Bank of Russia lowered rates on some fixed-interest financing instruments by 0.25 percentage points and hiked rates on fixed-interest deposit instruments by 0.25 percentage points. The refi rate was also lowered from 8.25 % to 8 %. The CBR left unchanged its main financing instrument, the minimum auction rate for one-day repo credit. The CBR said the rate changes are neutral from the monetary policy standpoint, but the narrowing of the margin between credit and deposit rates should smooth swings in market rates. The CBR last adjusted rates in mid-September.

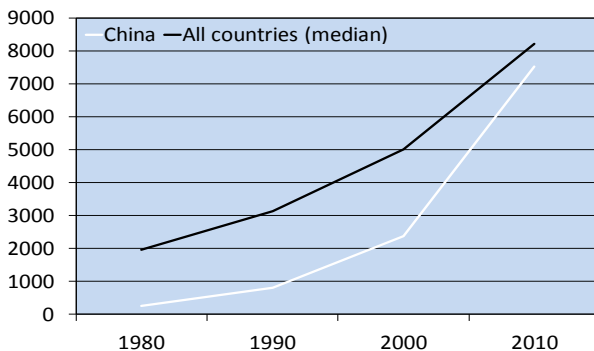
The CBR raised interest rates last spring to soak up excess liquidity in the financial sector, but as the economic conditions changed over the summer it reversed course and started to drop rates. The one-day minimum repo credit rate is currently 5.25 %, the same as at the beginning of the year. The one-day deposit rate has risen from 2.25 % in January to a current level of 4 %.

The CBR continues to gradually relax the ruble's exchange rate. On Tuesday (Dec. 27), the central bank announced that the ruble's fluctuation band relative to its dollar-euro currency basket had been widened from five rubles to six rubles. The CBR also decided to make it easier for the ruble to devalue or revalue beyond band limits.

China

High economic growth lifts China to middle-income country status. At some point in 2012, China should leave behind its status of low-income country and break into the ranks of countries with living standards above the global median for GDP per capita adjusted for purchasing power parity (PPP). China's rise is one of human history's more remarkable accomplishments; when economic reforms launched in 1978, China ranked among the world's poorest countries. Gradual introduction of market mechanisms has helped Chinese GDP to grow on average 10 % a year over the past three decades – higher and more consistent growth than in any other economy on earth with the exception of tiny, oil-rich Equatorial Guinea.

GDP per capita, US\$ (purchasing power parity adjusted)



Source: IMF

The rise in living standards in China's provinces reflects their geopolitical importance. Inner Mongolia, in particular, has been a big winner among the provinces, with incomes per capita soaring faster than any other province during the 1980–2010 period of market reforms. The province's GDP per capita rose three percentage points a year faster than the average for China during the period and has propelled the province to the rank of China's sixth wealthiest province. Inner Mongolia's is strong in primary commodities such as agricultural products, coal and rare earth metals which are critical to 21st century technologies. Most of China's fast-rising provinces are found along the eastern seaboard (Zhejiang, Jiangsu, Fujian and Shandong), where much of China's export industry is concentrated.

Growth in terms of GDP per capita in Shanghai was three percentage points lower than the national average from 1980 to 2010. Shanghai and its sister megalopolises Beijing and Tianjin have seen their wealth grow more slowly than elsewhere, but remain China's wealthiest areas. The gap between their standards of living and the national average erodes as the growth shifts to the periphery.

Heilongjiang, Manchuria's old industrial core, offers a particularly weak growth in living standards relative to the rest of China as modernisation plans have not proceeded as hoped. Impacts from the "Economic revival plan for the northeastern provinces" to bring northeastern China's traditional manufacturing centre back to life remain unseen. The impoverished Tibetan economy has also failed to keep pace with the rest of Chinese growth. The structure of the Tibetan economy is alarming; nearly half of its GDP is generated by "other production," which is likely generated by civil service and the military. Tibet was occupied by China 60 years ago, yet regular reports of strife between the local population and government administration continue.

Economic growth expected to slow in 2012. Numerous forecasting institutions have revised their growth outlooks for China downwards in recent months. This year's growth should come in at just over 9 % and most forecasts for 2012 put GDP growth in the range of 8–9 % (see table). The lowered outlook for growth reflects uncertainty about the global economy, particularly Europe's economic prospects. Europe is China's largest export market. Moreover, there are downward pressures in China's domestic economy. For example, a decline in real estate prices is underway and should continue next year. GDP growth is expected to begin to revive towards the end of 2012 as demand in key export markets recovers.

The impacts of a new global crisis are discussed in several forecasts. The Asian Development Bank estimates China's economic growth could fall as low as 7 % in 2012 if both Europe and the United States slide into recession. The IMF figures a new global recession would depress Chinese GDP growth to around 6 %. The on-shoring of problems in advanced economies would be transmitted mostly through a decline in exports. China's banking sector is fairly delinked from the international financial system and would likely be spared much of the damage from a global turndown.

GDP growth forecasts for 2012 and 2013

	Released	2012	2013
BOFIT	September	8 %	8 %
IMF	September	9 %	9.5 %
World Bank	November	8.4 %	–
OECD	November	8.5 %	9.5 %
ADB	December	8.8 %	–
Deutsche Bank	December	8.3 %	8.6 %
JP Morgan	December	8.2 %	–
Mizuho	December	8.6 %	9 %
Standard Chartered	December	8.1 %	8.7 %

Central Bank of Russia / Exchange rates 2011

http://www.cbr.ru/eng/currency_base/dynamics.aspx

Date	USD	Euro
1.1.2011	30,3505	40,4876
12.1.2011	30,6252	39,6076
13.1.2011	30,3988	39,5154
14.1.2011	30,0926	39,4815
15.1.2011	29,954	40,1264
18.1.2011	30,0534	39,968
19.1.2011	29,8881	39,9066
20.1.2011	29,8252	40,1895
21.1.2011	29,9147	40,2113
22.1.2011	30,0109	40,5807
25.1.2011	29,8516	40,5624
26.1.2011	29,7948	40,7027
27.1.2011	29,7768	40,7198
28.1.2011	29,6738	40,6205
29.1.2011	29,6684	40,6487
1.2.2011	29,8018	40,5811
2.2.2011	29,6548	40,7368
3.2.2011	29,4219	40,7258
4.2.2011	29,3489	40,5279
5.2.2011	29,4136	40,0819
8.2.2011	29,3689	39,9593
9.2.2011	29,255	39,8892
10.2.2011	29,301	39,9871
11.2.2011	29,3535	40,135
12.2.2011	29,32	39,7667
15.2.2011	29,2583	39,604
16.2.2011	29,285	39,4703
17.2.2011	29,2735	39,6802
18.2.2011	29,2447	39,6821
19.2.2011	29,2585	39,7682
22.2.2011	29,1549	39,8868
23.2.2011	29,2859	39,6795
25.2.2011	29,1611	40,0294
26.2.2011	28,9405	40,0073
1.3.2011	28,9028	39,8136
2.3.2011	28,7569	39,7219
3.3.2011	28,6277	39,3974
4.3.2011	28,3228	39,2752
5.3.2011	28,188	39,3476
6.3.2011	28,1717	39,4038
10.3.2011	28,2945	39,3039
11.3.2011	28,4356	39,3151
12.3.2011	28,6317	39,5375

Central Bank of Russia / Exchange rates 2011

http://www.cbr.ru/eng/currency_base/dynamics.aspx

Date	USD	Euro
15.3.2011	28,664	39,9347
16.3.2011	28,7263	39,9813
17.3.2011	28,6582	40,0728
18.3.2011	28,7422	40,1097
19.3.2011	28,4763	40,0633
22.3.2011	28,3675	40,1996
23.3.2011	28,1561	40,0858
24.3.2011	28,27	40,0642
25.3.2011	28,4015	39,9495
26.3.2011	28,2237	40,0156
29.3.2011	28,411	39,9288
30.3.2011	28,3436	40,0325
31.3.2011	28,429	40,0223
1.4.2011	28,5162	40,3875
2.4.2011	28,3684	40,198
5.4.2011	28,2277	40,1624
6.4.2011	28,3113	40,1652
7.4.2011	28,2164	40,2789
8.4.2011	28,2286	40,3528
9.4.2011	28,1211	40,4859
12.4.2011	27,9758	40,439
13.4.2011	28,1456	40,5268
14.4.2011	28,1145	40,7604
15.4.2011	28,1886	40,8791
16.4.2011	28,2212	40,8304
19.4.2011	28,1636	40,4739
20.4.2011	28,4213	40,4407
21.4.2011	28,1457	40,5523
22.4.2011	27,9398	40,8117
23.4.2011	27,9396	40,7443
26.4.2011	27,9924	40,7933
27.4.2011	27,8964	40,5837
28.4.2011	27,7144	40,6681
29.4.2011	27,4977	40,8121
30.4.2011	27,5022	40,8078
4.5.2011	27,3348	40,5211
5.5.2011	27,3675	40,5751
6.5.2011	27,2625	40,5421
7.5.2011	27,6635	40,2974
11.5.2011	27,8645	39,8657
12.5.2011	27,6288	39,7827
13.5.2011	27,9472	39,6934
14.5.2011	27,8497	39,7137

Central Bank of Russia / Exchange rates 2011

http://www.cbr.ru/eng/currency_base/dynamics.aspx

Date	USD	Euro
17.5.2011	28,122	39,683
18.5.2011	28,1177	39,8512
19.5.2011	28,0466	40,0113
20.5.2011	27,9608	39,8889
21.5.2011	27,9145	39,9652
24.5.2011	28,3418	39,8117
25.5.2011	28,437	39,9938
26.5.2011	28,4794	39,9566
27.5.2011	28,228	40,0217
28.5.2011	28,1166	40,0802
31.5.2011	28,0685	40,0594
1.6.2011	27,9805	40,2444
2.6.2011	27,9682	40,3497
3.6.2011	28,0419	40,3074
4.6.2011	27,8751	40,3436
7.6.2011	27,7752	40,6879
8.6.2011	27,7814	40,6581
9.6.2011	27,6847	40,6273
10.6.2011	27,7033	40,5244
11.6.2011	27,7907	40,2298
15.6.2011	27,8984	40,2825
16.6.2011	27,8957	40,128
17.6.2011	28,19	39,8184
18.6.2011	28,1778	39,8913
21.6.2011	28,1783	40,047
22.6.2011	28,0118	40,2277
23.6.2011	27,896	40,1814
24.6.2011	28,0568	40,0791
25.6.2011	28,1655	40,1189
28.6.2011	28,3478	40,0923
29.6.2011	28,2352	40,3029
30.6.2011	28,0758	40,387
1.7.2011	27,8726	40,4153
2.7.2011	27,8536	40,4824
5.7.2011	27,8037	40,4155
6.7.2011	27,8622	40,311
7.7.2011	27,8907	40,2435
8.7.2011	27,9853	40,0917
9.7.2011	27,888	40,0193
12.7.2011	28,0839	39,8033
13.7.2011	28,3842	39,5051
14.7.2011	28,2557	39,5919
15.7.2011	28,061	39,8214

Central Bank of Russia / Exchange rates 2011

http://www.cbr.ru/eng/currency_base/dynamics.aspx

Date	USD	Euro
16.7.2011	28,1277	39,7388
19.7.2011	28,1775	39,5894
20.7.2011	28,1505	39,7316
21.7.2011	28,0466	39,728
22.7.2011	27,908	39,8415
23.7.2011	27,7169	39,9484
26.7.2011	27,7413	39,8365
27.7.2011	27,546	39,9389
28.7.2011	27,4439	39,7937
29.7.2011	27,5907	39,5982
30.7.2011	27,6796	39,5182
2.8.2011	27,5204	39,6431
3.8.2011	27,8154	39,5173
4.8.2011	27,8996	39,5923
5.8.2011	27,8432	39,8158
6.8.2011	28,3382	39,9625
9.8.2011	28,521	40,959
10.8.2011	29,4166	41,9039
11.8.2011	29,3065	42,0285
12.8.2011	29,417	41,9075
13.8.2011	29,4452	41,7768
16.8.2011	28,8576	41,2895
17.8.2011	28,7032	41,2924
18.8.2011	28,7207	41,3061
19.8.2011	28,9115	41,6355
20.8.2011	29,2709	41,8749
23.8.2011	29,2555	42,0226
24.8.2011	28,9547	41,66
25.8.2011	28,9037	41,6618
26.8.2011	28,8825	41,6746
27.8.2011	28,8717	41,6705
30.8.2011	28,7108	41,7455
31.8.2011	28,8569	41,8396
1.9.2011	28,9278	41,7631
2.9.2011	28,8911	41,4732
3.9.2011	29,0604	41,3762
6.9.2011	29,3436	41,483
7.9.2011	29,6107	41,6771
8.9.2011	29,4905	41,4902
9.9.2011	29,5015	41,5175
10.9.2011	29,6904	41,2786
13.9.2011	30,3034	41,0914
14.9.2011	30,1872	41,2267

Central Bank of Russia / Exchange rates 2011

http://www.cbr.ru/eng/currency_base/dynamics.aspx

Date	USD	Euro
15.9.2011	30,3643	41,3531
16.9.2011	30,5042	41,8792
17.9.2011	30,5328	42,2482
20.9.2011	30,868	42,2058
21.9.2011	31,496	42,9164
22.9.2011	31,4122	43,0127
23.9.2011	31,9106	43,2421
24.9.2011	32,1083	43,3655
27.9.2011	32,4619	43,4535
28.9.2011	32,2201	43,6357
29.9.2011	31,818	43,2216
30.9.2011	31,8751	43,3979
1.10.2011	32,11	43,4191
4.10.2011	32,589	43,4411
5.10.2011	32,6799	43,1571
6.10.2011	32,6374	43,4632
7.10.2011	32,5085	43,3728
8.10.2011	32,2005	43,2614
11.10.2011	32,0096	43,1425
12.10.2011	31,427	42,8601
13.10.2011	31,4151	42,8785
14.10.2011	31,2014	43,0236
15.10.2011	30,9905	42,7328
18.10.2011	30,737	42,6169
19.10.2011	30,9694	42,5551
20.10.2011	30,9257	42,7084
21.10.2011	31,3788	42,9858
22.10.2011	31,3361	43,1373
25.10.2011	30,8255	42,9153
26.10.2011	30,4971	42,4001
27.10.2011	30,5732	42,5457
28.10.2011	30,2421	42,3571
29.10.2011	29,8977	42,383
1.11.2011	30,1245	42,1833
2.11.2011	30,6448	42,2469
3.11.2011	30,683	42,1431
4.11.2011	30,8438	42,2128
8.11.2011	30,5694	42,0727
9.11.2011	30,5014	41,9394
10.11.2011	30,1033	41,5998
11.11.2011	30,8454	41,6937
12.11.2011	30,5282	41,5886
15.11.2011	30,2921	41,6638

Central Bank of Russia / Exchange rates 2011

http://www.cbr.ru/eng/currency_base/dynamics.aspx

Date	USD	Euro
16.11.2011	30,66	41,6884
17.11.2011	30,8417	41,4605
18.11.2011	30,7337	41,4997
19.11.2011	30,919	41,7035
22.11.2011	30,9693	41,8612
23.11.2011	31,0612	41,9109
24.11.2011	31,2133	42,0256
25.11.2011	31,4365	42,0337
26.11.2011	31,5788	42,0251
29.11.2011	31,4117	41,7744
30.11.2011	31,3216	41,8457
1.12.2011	31,4001	41,7559
2.12.2011	30,8486	41,5068
3.12.2011	30,8099	41,4824
6.12.2011	30,9068	41,4707
7.12.2011	31,1026	41,5842
8.12.2011	31,1527	41,8661
9.12.2011	31,2308	41,8711
10.12.2011	31,5691	42,0153
13.12.2011	31,4134	41,9023
14.12.2011	31,6704	41,7891
15.12.2011	31,7655	41,4127
16.12.2011	31,8957	41,4389
17.12.2011	31,7701	41,3933
20.12.2011	32,0323	41,6868
21.12.2011	32,0519	41,7059
22.12.2011	31,7645	41,6718
23.12.2011	31,5634	41,225
24.12.2011	31,2575	40,8848
27.12.2011	31,2266	40,7632
28.12.2011	31,0847	40,6339
29.12.2011	31,5633	41,228
30.12.2011	32,0197	41,4079
31.12.2011	32,1961	41,6714