BOFIT Weekly
Yearbook 2004

BOFIT Weekly is a brief compilation of leading economic news items in Russia and in China
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 Yearbook 2004

BOFIT Weekly 1/2004
- New Duma takes shape.
- Less money than expected transferred to Russia’s new stabilisation fund.
- Russian government sets meat import quotas for 2004.
- China relaxes use of yuan in Hong Kong.
- Partnership arrangements between China and its special administrative regions Hong Kong and Macao go into force at start of 2004.
- China’s new customs regulations on imports and exports now in force.
- Central bank continues with reforms of China’s rapidly expanding banking sector.
- Insurance company China Life lists on the New York and Hong Kong exchanges.

BOFIT Weekly 2/2004
- Russian inflation slowed last year.
- Russia’s current account surplus up slightly in 2003, capital flows vary.
- Russian share prices soared in 2003.
- Chinese parliament approves three new banking laws at the end of December
- China pays out $45bn of its currency reserves to shore up two state-owned commercial banks.

BOFIT Weekly 3/2004
- Economic growth strong; oil production hits new record.
- Russian economic growth expected to slow slightly this year.
- Last year rouble strengthened substantially against the dollar, while losing ground against the euro.
- State Audit Chamber set to investigate Russian privatisation sales during past ten years.
- Russia posts modest 2003 grain harvest.
- China to amend its constitution.
- Foreign trade boomed in 2003.
- Stock markets in 2003.

BOFIT Weekly 4/2004
- United-Russia-controlled Duma set to deal with tax reform and social security.
- Government seeks to revive bond markets.
- CBR lowers interest rates.
- CBR issues new rules on use of international accounting standards and presentation of key financial indicators.
- Deadline for enterprises to purchase or lease lots on which they are located extended to beginning of 2006.
- Inflation picked up towards the end of 2003.
- Deposits and credits continue to increase rapidly.

BOFIT Weekly 5/2004
- Russia’s economy grew briskly in 2003.
- CBR decides on deposit insurance requirements for bank supervision.
- Standard & Poor’s upgrades Russia’s credit rating.
- Record FDI inflows in 2003.
- Rural tax reform lightens burden on Chinese farmers.
- Income gap between cities and countryside continues to widen.
BOFIT Weekly 6/2004
- Russian GDP up 7.3 % in 2003.
- Inflation continues to decelerate.
- Russia’s foreign currency reserves increase, as does liquidity.
- Reform of the Russian insurance market.
- Yukos in trouble with government and Sibneft.
- Industrial output growth accelerates.
- China emerges as a major car manufacturer.
- Retail sales grew briskly in 2003.
- Government announces program to make capital markets more efficient.
- Real estate prices rose fastest last year in Shanghai.

BOFIT Weekly 7/2004
- Export earnings grew briskly in fourth quarter; import growth slowed slightly.
- Russia could join WTO next year.
- Corporate bond market grows; Gazprom issues large rouble bond.
- Seven candidates set to vie for Russian presidency.
- China’s strong economic growth expected to continue.
- Foreign trade growth slowed in January.
- Official figures underestimate true unemployment situation.
- Rural development given priority.

BOFIT Weekly 8/2004
- Share of EU countries in Russia’s imports shrank in 2003.
- Government sends bank reform package back for revision.
- Government delays new forest code until after presidential elections.
- Industrial output growth accelerates in January.
- Higher agricultural product prices lead January inflation.
- China seeks to dampen credit growth in fields suffering from over-investment.
- Standard & Poor’s upgrades China’s credit rating.
- Most new jobs created in the service sector.

BOFIT Weekly 9/2004
- Putin sacks prime minister and cabinet.
- Brisk economic growth continues.
- Foreign investment in Russia increased last year.
- Minimum wage system revised.
- China’s banking sector gradually opens to foreign banks.
- Inflation worries China’s central bank.
- Expensive raw materials and shortage of electricity boost producer prices.
- China’s Communist Party issues two anti-corruption decrees.

BOFIT Weekly 10/2004
- Duma confirms Putin’s prime minister nominee.
- Euro gains popularity as cash currency in 2003.
- Real wages continued to rise rapidly in 2003.
- Gazprom’s dispute over Belarus gas supplies continues.
- National People’s Congress convenes for annual session.
- Fixed investment soared in 2003.
- Rising foreign currency reserves heighten discussion of yuan exchange rate.
BOFIT Weekly 11/2004

- President names new cabinet.
- Inflation continues to slow.
- Oil exports and equipment imports up strongly in 2003.
- Industrial production growth accelerates in February.
- Banking sector assets surged in 2003.
- China hikes defence spending.
- New regulation on financial supervision of commercial banks.
- Private sector the main focus of constitutional amendments.

BOFIT Weekly 12/2004

- Putin wins second term.
- President reshapes federal organisation.
- President and prime minister outline near-term economic reform priorities.
- 2003 federal budget in surplus.
- Fixed investment growth accelerated in January-February.
- Land and resource ministry limits use of land for non-agricultural purposes to cool investment pace.
- Trade deficit widens in January-February.
- New Year holiday boosts retail sales.
- Inflation slows in February.

BOFIT Weekly 13/2004

- Robust growth of Russian economy continues.
- Changes in CBR exchange rate policy.
- Reform of government bodies in full swing.
- Parliament approves Perm krai merger.
- Russia and EU views on EU enlargement start to converge.
- Industrial sector shows robust profitability in January-February.
- Producer prices continued to rise in February.
- Real estate sector booms in 2003.
- China’s crude oil consumption rises rapidly.

BOFIT Weekly 14/2004

- Russian share prices hit record highs.
- 2003 sees diversification in bank deposits and credit.
- President Putin continues administrative reshuffle.
- The introduction of the Russian rouble in Belarus postponed.
- Central bank implements further measures to restrain credit growth.
- China prepares to sell stakes in two of its largest banks.
- US files complaint with WTO on China’s taxation of foreign made semiconductor components.

BOFIT Weekly 15/2004

- Rise in consumer prices continues to slow.
- Huge current account surplus sustained last year.
- Administrative reform continues in Putin’s second term.
- Adjustments in central bank leadership.
- New forex policies on Mainland Chinese seek to combat revaluation pressures.
- Short-term borrowing drove external debt growth last year.
- Amendments to foreign trade law.
- Mainland China’s rapid growth in 2003 also benefited economic development of Macao and Hong Kong.
BOFIT Weekly 16/2004
- Russia’s federal finances remain stable.
- Foreign debt of enterprises and banks grew in 2003.
- Tax system reform takes shape.
- Russia’s WTO talks will stretch into 2005.
- China Industrial output growth continues strong this year.
- Producer prices continued to rise in March.
- Strong domestic demand increases imports.
- Consumer confidence stable in first quarter.
- Central bank moves to cool credit market.

BOFIT Weekly 17/2004
- Current account surplus remains large in first quarter.
- Foreign-exchange policy to stress two-currency basket.
- Yukos assets frozen, creditworthiness downgraded.
- Hefty pay raises for senior officials.
- China’s economy continues to boom.
- China relaxes currency controls to cool money supply growth.
- Inflation accelerates in March.
- Growth in retail sales remains brisk.
- Housing prices up in China’s major cities.

BOFIT Weekly 18/2004
- Russian economic growth gathers steam in first quarter.
- Key economic forecasts put Russian growth at around 6 % this year.
- Higher taxation on oil exports and production.
- EU and Russia agree on EU enlargement measures.
- Russia plans to privatise over 4,000 businesses this year.
- Two key forecasts envision economic growth above 8 %.
- Official unemployment rate at 4.3 % in the first quarter.
- Reform of China’s banking sector continues.
- Euromoney and Institutional Investor release their semi-annual country-risk rankings.

BOFIT Weekly 19/2004
- Pace of consumer price rise steady in April.
- Wage growth remains brisk.
- Unemployment down.
- Russia launches new budget process.
- China’s foreign currency reserves up strongly in first quarter.
- CBRC urges commercial banks to restrain lending.
- Shareholding banks’ stock of non-performing loans rises in first quarter.
- Producer price growth surges to 3.9 % y-o-y in March.
- Incomes rise rapidly in both urban and rural areas.

BOFIT Weekly 20/2004
- Growth in export earnings and imports slightly slow in first quarter.
- Russian share prices plummet.
- Putin considers development of northern regions.
- Cabinet considers highway development program.
- EU-China negotiations in Brussels.
- Central bank foresees economic slowdown in third quarter.
- Overheating fears hit Chinese bourses.
BOFIT Weekly 21/2004

- Growth stays high in the first quarter for bank deposits and credits.
- Oil earnings prop up Russian budgets.
- Government considers measures to promote housing construction and development of housing markets.
- Rise in consumer prices accelerates.
- First quarter GDP figures revised upward.
- Robust growth of industrial production continues.
- Fixed investment growth decelerated in April.
- Trade deficit widens in April.
- China and Kazakhstan agree on further oil pipeline construction.

BOFIT Weekly 22/2004

- Output continues to rise rapidly in April.
- Last week’s EU-Russia summit.
- EU and Russia agree on conditions of Russia’s WTO entry.
- President Putin gives annual parliamentary address.
- Producer prices continued to rise in April.
- FDI inflows to China continue to increase.
- Government issues a 7-year bond.
- Real estate sector growth slowed in April.
- China begins building strategic oil reserves.

BOFIT Weekly 23/2004

- Interest rates decline slightly this year.
- Russian government approves 2005 tariffs for gas, electricity and rail freight.
- Yukos swings Russian stock market.
- Government approves draft law on competitive bidding in public procurement.
- Government considers reduction of the number of business activities requiring licences.
- EU and China resolve coke dispute.
- China Construction Bank auctions non-performing loans.
- Loans to fixed investment projects to be audited.
- Job creation remains strong.
- Electricity consumption increases strongly.

BOFIT Weekly 24/2004

- Inflation decelerates slightly.
- Oil exports and car imports boom in the first quarter.
- FDI on the rise.
- Meat imports from the EU resume.
- Gazprom signs natural gas deal with Belarus.
- Signs of slowing industrial output growth.
- Decade-old rules for automobile industry revised.
- Summer wheat harvest supports efforts to increase grain production.
- Currency controls tightened for foreign firms and banks.

BOFIT Weekly 25/2004

- Central bank eases money market in the midst of bank rumours.
- GDP grew 7.4 % y-o-y in the first quarter.
- Government reviews 2005 budget proposal.
- Pension reform progresses slowly.
- May consumer and producer prices.
- Investment and bank lending growth slowed last month.
- Retail sales grew rapidly in May.
- Trade surplus in May.
- Decreased spending on infrastructure produces fiscal surpluses.
BOFIT Weekly 26/2004
- Rapid economic expansion continues.
- Russians protest planned changes in social benefits.
- Russia’s new foreign currency act enters into force.
- Yukos continues to drive Russian share prices.
- Bankruptcy act submitted to National People’s Congress.
- Stricter regulations for non-performing loans lower banks’ capital adequacy ratios.
- Shenzhen stock exchange launches SME board.
- Ping An IPO goes smoothly.

BOFIT Weekly 27/2004
- Industrial producer prices rise rapidly.
- Duma approves social tax amendments.
- Russian economy ministry estimates economic growth will average around 6 % in coming years.
- IMF critiques Russian economic policy.
- Short-term external debt continues to rise.
- EU refuses to grant China market economy status.
- China and the US consider trade issues.
- Ministry of Trade formulates new legislation.
- Audit reveals misuse of public funds in several ministries.

BOFIT Weekly 28/2004
- Consumer price inflation unchanged in June.
- Rouble’s real exchange rate weakens in May-June.
- CBR lowers reserve requirements to calm banking sector.
- More tax claims against Yukos.
- Putin reminds business leaders of their social responsibility.
- Shaky start for Shenzhen bourse’s new SME board.
- Chinese economic growth apparently accelerated in the second quarter.
- Business climate index down in second quarter.
- China opens up to private air carriers.

BOFIT Weekly 29/2004
- Current account surplus remains large; banks channel capital outflows.
- Central Bank extends express deposit guarantee.
- OECD wants faster gas sector reform.
- Russian government discusses policy goals.
- Industrial output growth continues to slow
- Trade surplus in June.
- US and China resolve semiconductor dispute.
- FDI accounts for about half of growth in foreign exchange reserves.
- Two large state banks attempt to meet new capital adequacy requirements by selling subordinated bonds.

BOFIT Weekly 30/2004
- Brisk rise in industrial output.
- Yukos’ main production unit may be sold.
- Duma approves most of housing reform package in second reading.
- Putin demands closer CIS cooperation.
- Revisions of last year’s GDP figures lower second quarter growth.
- June consumer prices up 5.0 % y-o-y.
- Growth in fixed investment slows.
- Money and credit growth on target.
- Growth in real incomes remains strong.
BOFIT Weekly 31/2004
- Rise in Russian producer prices accelerates in June.
- Cabinet discusses changes in exports policies.
- Russia wants to reduce its foreign borrowing.
- Privatisation of Lukoil proceeds.
- June producer prices in China remain high.
- Higher grain prices drive up agricultural product price indices.
- Electricity consumption hits record levels.
- Travel to Mainland China continues to grow.
- China rises in UN standard-of-living comparison.

BOFIT Weekly 32/2004
- Russian real wages up in the first half over 14%.
- Banking sector calms.
- New tax investigation of Yukos launched.
- Russian government revises plan for reform of electrical sector.
- Newly revised regulation eases entry of foreign banks into China.
- Macao to follow Hong Kong in allowing use of yuan.
- Dispute arises over elimination of WTO textile and clothing quotas.
- Urban unemployment rate unchanged.

BOFIT Weekly 33/2004
- Russian inflation picks up in July.
- Differing views on economic growth.
- Reforming Russia’s social security system.
- Government contemplates privatisation plans, president approves list of strategic companies.
- Rise of Chinese industrial output and producer prices slows in July.
- Trade deficit continues to shrink in July.
- Housing prices on the rise.
- Inventories reach record levels in June.

BOFIT Weekly 34/2004
- High metal prices boost Russian foreign trade in first half.
- Foreign investments on the rise.
- Russia WTO talks continue on a broad front.
- Russia and Ukraine agree on settlement of gas debts.
- Inflation accelerates in China, retail sales up.
- Growth of fixed investments accelerates.
- Broad money growth and new lending continue to slow.
- HSBC acquires stake in Chinese bank.
- Crude oil imports continue to rise.

BOFIT Weekly 35/2004
- Growth of industrial output slows in July.
- Russian budgets still in surplus.
- Economy ministry issues cautious outlook for oil.
- Gazprom ownership relations under investigation.
- Profits of Chinese industry continue to rise.
- Trade deficit in agricultural products.
- State continues to reduce its holdings in companies.
- Direct investment flows in and out of China increase.
BOFIT Weekly 36/2004
- Russian government approves 2005 budget proposal.
- State stabilisation fund grows rapidly.
- Yukos distress grows.
- IMF expects slowdown in China’s total output growth.
- Role of private sector increasing.
- China hikes prices of refined oil products.
- Liberalisation of trade between mainland and Hong Kong moves ahead.

BOFIT Weekly 37/2004
- Inflation accelerated in August.
- Bank deposit growth slowed during summer.
- On-going issues for EU meat imports to Russia.
- Russia and Belarus reach accords on common currency launch and natural gas supplies.
- China plans to reform corporate taxation.
- Banks get new guidelines on real estate lending.
- West-east gas pipeline project completed.
- ASEAN grants China market economy status.

BOFIT Weekly 38/2004
- Foreign currency sales of banks in Russia skyrocketed this summer.
- Putin moves to consolidate central administrative power.
- Yukos tax debts keep climbing.
- Preliminary agreement on merger of Gazprom and Rosneft.
- No signs of a slowdown in inflation in China.
- Growth of industrial output accelerated slightly in August.
- Brisk growth in foreign trade continues.
- Investments and retail sales continue to boom.

BOFIT Weekly 39/2004
- Russian output accelerates slightly in August.
- CBR returns to bond market.
- Russia willing to change Soviet-era debt into market-tradable Eurobonds.
- Competition in rail transport to open up.
- Jiang Zemin steps down from last major post.
- Low interest levels slow growth of deposits.
- Stock markets rebound.
- China calculates Green GDP.

BOFIT Weekly 40/2004
- First-half shifts in the structure of investment.
- ConocoPhillips wins bidding for LUKoil stake.
- First banks accepted into general deposit insurance scheme.
- World Bank figures poverty has halved in Russia since 1999.
- This year’s harvest expected to be larger than last year.
- China to join Group of Seven meeting for the first time.
- Measures to improve minority shareholder rights.
- Partnership arrangements with mainland China benefit Hong Kong and Macao economies.
BOFIT Weekly 41/2004
- Russian inflation accelerates slightly.
- Decline in private capital outflow from Russia.
- Total assets of Russian banks on the rise again.
- Russian government decides to back Kyoto treaty.
- *23 candidates in first round of Ukrainian presidential election.*
- Mountain of non-performing loans held by Chinese banks may get bigger.
- Supply crunch pushes up housing prices further.

BOFIT Weekly 42/2004
- Rapid growth in Russia’s foreign trade.
- Rouble weakened slightly in third quarter.
- Gazprom wants to be an energy giant.
- *Yukos set to lose Yugansktegaz.*
- Chinese foreign currency reserve swells with capital and financial account surpluses.
- FDI surges in August.
- Rapid rise in tax revenues in January-September.
- Central bank report finds state-owned banks lag in competitiveness.

BOFIT Weekly 43/2004
- Growth in Russian oil production and exports has slowed.
- Putin’s China visit.
- Government considers ways to attract private capital to roads projects.
- *Yuganskneftegaz on the block in November.*
- China foreign trade continued to expand in January-September.
- Credit growth revives in September.
- China’s R&D spending surges.
- Slower car sales.

BOFIT Weekly 44/2004
- Russia’s production growth slowed in September.
- Economy ministry forecasts accelerating growth towards end of year.
- 2004 grain harvest better than 2003.
- *Russia retains 70th place in competitiveness ranking.*
- China’s total output growth slows a bit.
- Acceleration in consumer prices stalled in September.
- Industrial output and profits continue to rise rapidly.
- Producer prices accelerated in September.
- Fixed investment growth remains brisk.

BOFIT Weekly 45/2004
- Changes to 2004 budget act.
- Incomes continue to rise briskly.
- Tax demands on Yukos continue to mount.
- *First round of Ukraine presidential election ends in a draw.*
- China raises interest rates.
- Insurance companies can now invest directly in stock market.
- Rural household incomes grew briskly.
BOFIT Weekly 46/2004
- Russian inflation picks up in October.
- Russia ratifies Kyoto Protocol on climate change.
- Housing shifts to the market economy.
- Corruption down slightly in Russia.
- In China, brisk industrial output growth continued in October.
- The rise in producer prices continues to accelerate.
- Foreign trade growth slows slightly.
- Shortages of migrant and skilled workers emerge.

BOFIT Weekly 47/2004
- Huge upward revision in oil export figures.
- More oil companies hit with tax demands.
- Putin does not want to review privatisations.
- Regions make slow progress in social reform; more people than expected qualify for benefits.
- Rise in Chinese consumer prices slowed in October.
- Growth in retail sales accelerates, investment growth slows.
- SAFE eases rules on foreign currency transfers within multinational companies.
- China unifies reserve requirements for foreign currency deposits.

BOFIT Weekly 48/2004
- Production growth continues to slow in October.
- Fitch upgrades Russia’s credit rating.
- CBR affirms exchange rate policy lines for 2005.
- Yuganskneftegaz to be sold and Yukos ponders bankruptcy.
- Ukraine presidential election results.
- Economic growth expected to slow only slightly in 2005.
- Interest rate reform moves ahead.
- Eased rules on foreign currency transfers by private individuals.

BOFIT Weekly 49/2004
- Foreign investment in Russia continues to grow.
- CBR relaxes currency controls.
- WTO membership talks could be concluded next year.
- 14th Russia-EU summit held in The Hague.
- China and ASEAN agree on preparations for free trade area.
- Changes in securities market regulations.
- Car production continued to decline in October.

BOFIT Weekly 50/2004
- Annual inflation target exceeded in November.
- Strong federal budget performance continues.
- Growth of Russian exports and imports accelerated in the third quarter.
- Russian tax officials announce back-tax claims on mobile phone operator VimpelCom.
- Industrial output growth slows slightly in November.
- Foreign trade continues to boom.
- Opening up of banking sector ahead of schedule.
- China’s insurance markets open up to foreign companies.
- Further easing of yuan currency controls.
BOFIT Weekly 51/2004
- Decelerating GDP growth.
- Russian Duma approves 2005 federal budget.
- Sberbank reclaims some of its share of total bank deposits.
- Yukos petitions for bankruptcy protection in the US.
- Chinese inflation slowed in November.
- Investment growth slows slightly.
- Rising FDI inflows.
- Rapid expansion in lending and deposits last month.
- Retail sales growth remains brisk in November.

BOFIT Weekly 52/2004
- Unknown Baikal Finance Group wins bidding for Yuganskneftegaz; state-owned Rosneft buys BFG.
- Russian stock market volatility and uncertainty continue.
- Increasing investment risk in Russian regions.
- President to name regional governors from now on.
- Grain production up this year.
- Tax revenues surge in the first ten months of the year.
- Strong revenue growth sustains budget surplus through first eleven months of 2004.

BOFIT Weekly 53/2004
- Russian economic growth slower than in 2003.
- Russia approves new housing legislation.
- Yushchenko wins Ukraine’s presidential revote.
- China focuses on meeting its WTO commitments next year.
- Despite rapid trade growth, India remains a relatively insignificant trading partner with China.
- China imposes export tariffs on textiles ahead of the WTO liberalisation.
- China imposes export quotas and tariffs on key commodities.
**Russia**

**New Duma takes shape.** The central elections commission certified a 56 % voter turnout in the recent Duma elections (down from 62 % in 1999). The new Duma convened for its first session on December 29. Boris Gryzlov, who leads United Russia (UR) and recently resigned from his post as interior minister, was elected new speaker by a vote of 352 to 14. UR took both first deputy chairman posts along with five of eight deputy speaker posts. The remaining three deputy speaker posts went to the Communists, Liberal Democrats (LDPR) and the Motherland bloc. The UR bloc led by Gryzlov commands more than 300 seats (over 2/3 of the Duma), while Gennady Zyuganov’s Communists retain just 52 seats. LDPR (Igor Lebedev) and the Motherland bloc (Sergei Glazyev) each gained 36 seats. In his address to the opening session of the new Duma, president Putin asked deputies to focus on raising the living standards of Russians through improvements in health care, education and housing quality.

The previous Duma was the first unblemished by a power struggle between the president and parliament, and perhaps because of that was more effective at passing legislation than any of its predecessors. The previous Duma’s accomplishments include tax and pension reforms, balanced budgets, making headway in dismantling the electricity and railway monopolies and reform of the upper-house Federation Council. The Duma’s increased role has also raised the importance of groups outside the Duma involved in lobbying and financing. The differing views of these groups will surely be reflected in the new Duma agenda, despite the apparent consensus.

**Duma seats of major parties based on 2003 election results**

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<tbody>
<tr>
<td>United Russia</td>
<td>223</td>
<td>+82</td>
</tr>
<tr>
<td>Communist Party</td>
<td>54</td>
<td>-9</td>
</tr>
<tr>
<td>Liberal Democratic Party</td>
<td>36</td>
<td>+19</td>
</tr>
<tr>
<td>Motherland bloc</td>
<td>36</td>
<td>+36</td>
</tr>
<tr>
<td>People’s Party</td>
<td>19</td>
<td>+19</td>
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<tr>
<td>Yabloko</td>
<td>4</td>
<td>-16</td>
</tr>
<tr>
<td>Union of Right Forces</td>
<td>2</td>
<td>-27</td>
</tr>
<tr>
<td>Independents</td>
<td>75</td>
<td>-50</td>
</tr>
</tbody>
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* The predecessors to United Russia, Unity and Fatherland–All Russia won 141 seats in 1999.

**Legislation entering into force in 2004.** The most significant law to take effect at the start of this year was the customs act passed last May. In accordance with WTO guidelines, the new rules will bring Russian customs practices into international compliance. Another major law concerns deposit insurance of private individuals (see Week in Review 49/2003). The act, which entered into force in December 27, fully insures deposits of private persons up to 100,000 roubles (about 2,800 euros).

From the start of this year, the value-added tax was also reduced from 20 % to 18 %, extraction taxes on natural gas and crude oil were modified, the ceiling on the corporate property tax was lowered to 2.2 % and agricultural producers were given the possibility to consolidate several taxes into a 6 % unified agriculture tax. Amendments to the securities markets act lowered the securities tax rate from 0.8 % to 0.2 %. The 5 % sales tax, introduced after Russia’s 1998 financial crisis, was abolished from the start of 2004.

A new telecommunications act approved last summer came into force at the beginning of 2004, as did amendments, passed at the end of December, to the budget code pertaining the establishment of the stabilisation fund. The hardships on companies and entrepreneurs in obtaining registration and permits will be eased through the introduction of a “one stop” approach. A separate December amendment postponed to 2006 the deadline by which enterprise lots must be purchased or leased under the land code.

Other laws entering into force during this year include amendments to the insurance act, which will further open Russia’s insurance markets to foreign firms. The maximum share of foreign-owned insurance companies operating in Russia will be raised from 15 % to 25 %. The limits on insurance companies based in EU countries will be eliminated. New legislation coming into force in 2004 includes modified acts on currency controls, state regulation of foreign trade and specific protectionist measures on imports and changes to the forest code.

**Less money than expected transferred to Russia’s new stabilisation fund.** At the start of 2004, Russia’s reserve fund will be wound up and its assets transferred into the new stabilisation fund. The operations of the stabilisation fund are more strictly regulated than its predecessor’s. The finance ministry reported at the beginning of October 2003 that the reserve fund had assets of about RUB 140bn ($4.7bn) and that it expected the reserve fund’s assets to reach RUB 170bn ($5.7bn) by the end of 2003. Due to some legislative amendments, the amount of money to be transferred into the stabilisation fund will in fact be considerably less than earlier anticipated. Deputy finance ministry Tatyana Nesterenko estimates the amount of the transfer from the reserve fund to the stabilisation fund will only amount to RUB 80–90bn (about $3bn). Even so, the Duma budget committee still expects the stabilisation fund will reach RUB 200bn early autumn.

**Russian government sets meat import quotas for 2004.** The quota regime imposed on imports of beef, pork and poultry meat in April 2003 will continue in 2004. The quota on imported beef applies to a 420,000 tonnes of frozen beef and about 28,000 tonnes of fresh beef. The pork import quota is 450,000 tonnes, while poultry meat is around one million tonnes. All quotas are substantially larger than in 2003. The quotas also distinguish among countries and country groups. EU countries are allocated 80 % of the import quota for beef, about half the quota for pork and 20 % of the quota on poultry meat. The US, in turn, will get the lion’s share (over 70 %) of the 2004 poultry meat quota. Some 10 % of the beef and pork quotas were sold through competitive bidding. The current 15 % import tariff on beef and pork within the quotas will continue, while imports exceeding the quota must pay tariffs of 60 % and 80 %, respectively. The import tariff on poultry meat remains at 15 %. The quota may not be exceeded. The Russian government hopes the meat import quotas will further encourage domestic production. In the first ten months of 2003, production of poultry meat and pork rose about 10 % y-o-y, while beef production was up about 5 %.
China

China relaxes use of yuan in Hong Kong. Until 2004, CNY related banking businesses were restricted to the Mainland China, although large amounts of yuan are in circulation in several Asian countries e.g. due to tourism. An estimated CNY 70bn (€7bn) are in circulation in the Hong Kong special administrative region.

From the start of this year, Hong Kong residents and firms can exchange yuan for Hong Kong dollars, as well as make deposits and transfers in yuan in Hong Kong banks. Hong Kong banks can further provide their clients with yuan bankcards for use in their travels in Mainland China. Travellers from Mainland China, in turn, can use their yuan bankcards when visiting Hong Kong. The yuan transactions are restricted to the current account; the limitations on capital investments are not changed. Moreover, limits are imposed on the size of currency transactions, and officials will track such transactions to prevent abuse. The Hong Kong branch of the state-owned Bank of China will act as a clearing bank for Mainland China and Hong Kong. The decision aims at promoting mutual business.

Partnership arrangements between China and its special administrative regions Hong Kong and Macao go into force at start of 2004. The Closer Economic Partnership Arrangement (CEPA), an internal free-trade agreement, was approved last year and was designed to accelerate economic growth in the region affected by last spring’s SARS outbreak. From the start of the year, the CEPA eliminates mainland China’s import tariffs on nearly 300 categories of products from Hong Kong and Macao, and further removes tariffs on all products made in Hong Kong and Macao at the start of 2006. To qualify for the tariff exemption, goods must gain at least 30 % of their value added from operations in Hong Kong or Macao. The changes that will take place in the first phase are already seen as significant. For example, the tariffs imposed goods from Hong Kong are estimated to decrease by about 60% a year. Hong Kong and Macao, in turn, are bound to continue their zero import tariffs on products from Mainland China. The CEPA should also facilitate on Hong Kong and Macao firms operating in Mainland China in several service fields, as well as promote trade and investment in the region through e.g. simplified customs practices.

China’s new customs regulations on imports and exports now in force. The new regulations, which took effect January 1, 2004, replace the previous regulations from 1985. They specify how customs appraisals should be made and affirm prevailing customs tariffs that are consistent with WTO guidelines and international practice. The new rules also lower the average level of import duties from 11 % to 10.4 %. In addition, the rate of VAT rebates to state companies for products exported abroad will decline three percentage points on average. Up to the end of last year, VAT charged on many export goods was refunded in full amount. The change is expected to slow export growth this year. The basic VAT rate in China is 17 %. Some goods, however, are taxed at a rate of 13 % and small firms only pay a 6 % VAT.

Central bank continues with reforms of China’s rapidly expanding banking sector. In December, China’s central bank, the People’s Bank of China (PBC), announced it was broadening the limits on regulated lending rates. As part of banking sector reform, the PBC extended the range of rates offered by lenders from the start of this year. Banks can now charge up to 70 % above the central bank’s reference rate. The rate charged to large enterprises earlier could not exceed 10 % above the reference rate, while the rate charged to smaller enterprises could not exceed the reference rate by more than 30 %. The floor interest rate (90 % of the reference rate) remains the same. At the current 3.51 % reference rate, for example, interest rates may now range between 4.78 % and 9.03 %. Loans granted by rural credit may carry up to double the central bank’s reference rate.

The PBC expects no increase in the average lending rates. The reform is rather intended to expand lending to small and medium-sized private enterprises by making it easier to price in lending risk. To date, banks have been far more generous in granting loans to state-owned enterprises than their share of production of SOEs would justify. China’s banking sector is relatively large with respect to most emerging countries, and the current loan stock amounts to about 170 % of GDP. China’s banking sector is expanding rapidly; as of end-June, the lending stock of banks was CNY 19,000bn (€1,900bn), an increase of about 20 % y-o-y. Four large state-owned banks still dominate the sector, which is heavily burdened by non-performing loans. The PBC officially estimates that non-performing loans comprise about 20 % of the loan stock, while many observers put the share above 40 %.

Insurance company China Life lists on the New York and Hong Kong exchanges. The December listings raised by $3bn in capital for China’s largest insurance company, China Life. The listing was the largest on international financial markets in 2003. It raised broad interest among investors and the share emission was massively oversubscribed. The shares of the China Life rose 25 % in their first day of trading (Dec. 17) on the New York stock exchange, and 24 % a day later on the Hong Kong stock exchange. The Chinese state retains a 72 % stake in China Life after the listing.

Domestic credit at end of period, billion yuan

Source: People’s Bank of China
Russia

Russian inflation slowed last year. The on-year rise in consumer prices fell in December to a rate of 12.0% as inflation cooled to top end of the government’s 10–12% inflation target range for 2003. Consumer prices rose 15.1% in 2002. Modest development in administratively set prices for housing and municipal services in the latter part of the year accounted for much of the slowing. Prices for services, however, still managed to climb 22% for the year as a whole, well outpacing the rise in goods prices. The sharpest rise, 29%, was in municipal and housing services prices. Food prices were up 10% y-o-y, while prices of non-food goods rose 9%. Among food products, bread and the baked goods led the price rise with an increase of 30%. Prices for dairy products rose 13%. Among non-food goods, gasoline rose the fastest, up 17%.


Source: Goskomstat

Russia’s current account surplus up slightly in 2003, capital flows vary. Preliminary balance-of-payments figures released by the Central Bank of Russia indicate that the current account surplus in 2003 exceeded $39bn, the equivalent of more than 9% of GDP (compared to 8.5% of GDP in 2002). The goods trade surplus swelled to $60bn from $46bn in 2002, while the services trade deficit ballooned to over $9bn. Behind the net figure, non-repatriation of export proceeds, non-supply of goods and services against import contracts, and remittances against fictitious transactions in securities increased to over $14bn, while enterprise borrowing from abroad rose to nearly $13bn. Direct investment in Russia’s enterprise sector (not including banks) was slightly negative, due to a net outflow of FDI in the fourth quarter of 2003 of about $2bn. The net errors and omissions item in the balance of payments was about $6bn negative, suggesting that net outflow of unrecorded capital remained at about the 2002 level.

The large current account surplus swelled the CBR’s currency reserves last year by more than $26bn. At the start of this year, the CBR’s reserves stood at $77bn.

Russian share prices soared in 2003. Last year, the RTS index of shares on the main Russian stock exchange rose 57% to 567, hitting an all-time high of 643 in October. Trading last year was dominated by shares of energy companies, which saw their prices rise in response to high world prices for crude oil.

The volume of trading in RTS shares increased 33% to $6.1bn, i.e. the daily trading volume of RTS shares averaged about $24m. The most traded shares were those of energy giant UES (30% of RTS volume), followed by the shares of Lukoil (18%), Yukos (14%) and Surgutneftegaz (10%).

RTS index and Yukos daily share price 31.12.02–31.12.03

Source: RTS
China

Chinese parliament approves three new banking laws at the end of December. New and amended banking laws enter into force at the beginning of February. The laws clarify the legal framework for the banking sector, paving the way for future development.

The banking supervision and management act defines the operations of China Banking Regulatory Commission (CBRC), which was officially established in April 2003. The new law details the CBRC’s scope of authority and regulatory functions.

Amendments to the central bank law (People’s Bank of China law) are designed to increase the central bank’s role in setting and implementing monetary policy. Under the old law, the government (State Council) and the parliament (National People’s Congress) oversaw the central bank’s monetary policy committee; under the new law, the committee operates independently.

Revisions of the commercial banking law would make it possible for banks to invest in the stock market. The old law forbid commercial banks from investing in non-banking financial assets such as securities, insurance and mutual funds. The amended law lets banks to invest in the above-mentioned assets as long as they first get government permission. The change will help China’s banking sector to adapt to the opening of banking sector, which according to WTO rules will take place in 2006.

China pays out $45bn of its currency reserves to shore up two state-owned commercial banks. The bailout is part of the government’s ongoing efforts to reform China’s banking sector, the problems of which threaten the very stability of the country’s monetary system. The bailout was allocated in equal portions to the Bank of China and China Construction Bank. Two other large state banks, Commercial Bank of China and Agricultural Bank, will receive bailouts later. It is not yet known as to how the two banks receiving bailout funds will be allowed to use the foreign currency. In any case, they will have to pay interest on the bailout money. While the amount is substantial considering the capitalisation of these banks, it is insufficient to cover all of these banks’ non-performing loans. Official figures put the stock of non-performing loans held by China’s four largest banks at about $200bn, or over a fifth of the entire lending stock. The sum corresponds to nearly a fifth of China’s annual GDP.

Officials have established a joint company, Central Huijing Investments, to supervise investment of assets, progress in banking sector reform and improvement of corporate governance. Both the Bank of China and China Construction Bank have published plans for share listings on the stock market in the near future, which would be a significant step towards operating under market conditions.

The transfers, made at the end of 2003, drew down China’s foreign currency reserves by 10 %. Nevertheless, the reserves still amount to over $400bn and were up by about 30 % in 2003. In addition to China’s current account surplus, the rise in currency reserves has been driven by continued large inflows of foreign direct investment.


According to preliminary figures, the consolidated tax revenues of state and local administrations were up last year about 20 % y-o-y to CNY 2,050bn (€206bn). Available figures show income from the value-added tax rose to CNY 730bn (up 17 %), while the profit tax on domestic firms reached CNY 240bn (up 19 %). Rapid economic growth in 2003, now estimated at 8.5 %, was seen as the main reason for the increased tax take.

China’s public sector is still relatively small, although it has expanded far faster than the rest of the economy in recent years. In 2002 public sector revenues amounted to 18 % of GDP, while expenditures were 21 % of GDP.

China has allowed substantial public sector deficits in recent years when supporting economic growth by increased public investments and higher social spending. The 2003 budget foresaw a deficit equal to 2.3 % of GDP. The actual deficit will likely be slightly less, however, due to the increase in tax revenues. As of end-2002, the public sector debt was CNY 2,700bn, which corresponds to 26 % of GDP. By international standards this level of indebtedness is relatively small and consists mainly of debt owed to domestic creditors. One of the greatest challenges to China’s public sector in coming years will be improving tax collection. Moreover, ongoing pension reform will burden the state further and pressures for other social entitlements will also increase. A large stock of non-performing bank loans could also be costly for the state in the event of a major bailout.

The 2004 budget is scheduled for release in March.

Revenues and expenditures of China’s public sector
Russia

Economic growth strong; oil production hits new record. The combined production index of five base sectors of the economy was up 6.9% in the first eleven months of 2003. Construction increased 14%, retail sales rose 8%, and industrial output and freight transport were each up about 7%. Agricultural production grew just 1% due to the poor harvest.

Preliminary energy ministry figures indicate crude oil production rose last year a record 11% y-o-y to 8.46 million barrels per day. This output level makes Russia the world’s second largest oil producer after Saudi Arabia.

Russian economic growth expected to slow slightly this year. Russia’s economic development depends to a large extent on the price of crude oil on world markets. The price of crude oil is generally expected to fall this year and this in turn should slow Russian economic growth. Russia’s leading economic research institutes estimate GDP growth in 2004 in the range of 4.5–5.5%, assuming the price of Urals-grade crude averages between $22–25 a barrel. The government expects GDP will grow just over 5% this year. The EBRD and OECD both expect Russian GDP to rise 5% this year.

The government’s preliminary estimate is that GDP grew nearly 7% last year. The average price of Urals-grade crude last year was $27.40 a barrel. Goskomstat’s revised figures for economic growth in 2001 and 2002 show Russian GDP increased 5.1% in 2001 (previously 5.0%) and 4.7% for 2002 (4.3%). The average price of Urals-grade crude in 2002 was $23.80 a barrel and in 2001 it was $23.10.

Last year rouble strengthened substantially against the dollar, while losing ground against the euro. The nominal exchange rate for the rouble at year’s end was 29.45 to the dollar, up from 31.78 roubles to the dollar at the end of 2002. The rouble has strengthened over 7% in nominal terms to levels last seen in autumn 2001. Moreover, the rouble’s appreciation is even greater in real terms (i.e. accounting for inflation). At the end of December, the rouble was 19% stronger in relation to the dollar than at the beginning of 2003.

On the other hand, the rouble’s value against the euro fell 11% in nominal terms during the course of 2003. In real terms, however, the rouble’s value against the euro showed little change during the year (rouble’s nominal weakening essentially matched the difference in inflation rates in Russia and the euro zone).

The rouble appreciated 4% in real terms last year against a basket of currencies of Russia’s main trading partners. The Central Bank of Russia intervenes in the currency markets to smooth the development of the rouble’s value. The CBR’s exchange rate policy recently has been to let the real value of the rouble appreciate incrementally against the currency basket. Last year’s target, for example, was a 4–6% real appreciation. This year’s target range is 3–5%.

![Rouble's exchange rate against the dollar and the euro](chart.png)

Source: Central Bank of Russia

State Audit Chamber set to investigate Russian privatisation sales during past ten years. Audit Chamber chairman Sergei Stepashin agreed on the need for the review with president Vladimir Putin last month. The purpose of the wide-ranging audit is to clarify suspected abuses of the privatisation process. The task facing Stepashin’s agency is non-trivial: for example, during 1994–2002 nearly 5,500 large enterprises were privatised in Russia.

President Putin has given assurances on several occasions that the purpose is not to undo the privatisation sales. However, at a December meeting of the Russian Chamber of Commerce and Industry, Putin stated that the government intends to identify and investigate abuses of the privatisation process. Prime minister Mikhail Kasyanov observed that privatisation has generally benefited development of the Russian economy, and that privatisation sales should not be cancelled.

Russia posts modest 2003 grain harvest. The agriculture ministry’s current estimate puts the 2003 gross grain harvest at 73.5 million tonnes. The cleaned and dried net harvest is expected to be 67.2 million tonnes (86 million tonnes in 2002), or slightly less than the 71 million average of net grain harvests in the period 1996–2003.

The above-average 2002 grain harvest drove down domestic grain prices and eventually required state intervention in 2003 to bring grain prices back up. Despite the low grain prices, prices for bread and baked goods rose 30% in 2003. Since this year’s harvest is considerably smaller, the government has imposed export tariffs of 25 euros a tonne on wheat and rye. The export tariffs will be in force until the end of April. The government claims the tariffs are a temporary measure designed to restrain the rise of bread and baked goods prices.
China

China to amend its constitution. China’s current constitution was adopted in 1982 and has since been amended in 1988, 1993 and 1999. Early in March, the National People’s Congress, China’s parliament, will consider a total of 14 constitutional amendments. Their approval is seen likely as National People’s Congress typically approves legislative proposals submitted from the State Council. The parliament convenes annually in March for a full session lasting 10–14 days to decide on possible constitutional amendments and changes in other major laws. For the remainder of the year, the parliament works in smaller assemblies.

The most significant amendment is to include in the constitution the protection of ownership rights to legally obtained private property. Another major change would require that the state compensate owners of land or other forms of private property when a state taking occurs.

Another amendment to the current constitution, which merely acknowledges the existence of a private sector, would recognise that the state support the private sector. The revised constitution would also oblige the establishment of a social security system that reflects the economy’s level of development, and the securing of human rights.

Foreign trade boomed in 2003. The ministry of commerce reports the value of Chinese exports rose 35 % last year to over CNY 3,600bn (€380bn), while imports increased 40 % to over CNY 3,400bn. The trade surplus was CNY 210bn (€22bn), down slightly from CNY 250bn in 2002. Preliminary figures place China as the world’s fourth largest trading power in 2003.

Data for the first ten months of 2003 indicate that both China’s exports and imports rose steadily with all of its main trading partners. China’s trade surplus is mainly due to the trade with the US and to a lesser extent the EU. China runs substantial trade deficits with several Asian countries.

Exports of machinery and equipment, China’s leading export category, rose 42 % y-o-y in the first ten months of 2003. Exports of high-tech products, another important category, increased 60 %, while clothing exports were up 25 %. Exports of computers and computer parts doubled.

Imports of machinery and equipment rose 46 % y-o-y in the period January-October. High-tech imports also grew 46 %, while imports of parts and components for electronic devices climbed 61 %. The rapid growth in imports of raw materials and metals, such as steel, has pushed up their world market prices. Crude oil imports also soared last year.

China’s main trading partners in January-October 2003

<table>
<thead>
<tr>
<th>Exports, % share</th>
<th>Imports, % share</th>
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<tbody>
<tr>
<td>US</td>
<td>22</td>
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<tr>
<td>Hong Kong</td>
<td>17</td>
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<tr>
<td>EU</td>
<td>16</td>
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<tr>
<td>Japan</td>
<td>14</td>
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<td>ASEAN*</td>
<td>7</td>
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<td>Korea</td>
<td>5</td>
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*) The ASEAN member countries are Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand and Vietnam. Source: China’s ministry of commerce.

Stock markets in 2003. China’s two bourses, the Shanghai and Shenzhen stock exchanges, were established in 1990 for the purpose of privatising state-owned enterprises. At the end of 2003, the exchanges listed a total of 1,287 firms, with a total market value of €425bn. One of the biggest problems in creating functional stock markets in China continues to be the fact that the state still holds majority stakes in nearly all listed enterprises. Actual share trading only involves a small fraction of company shares.

Before the end of 2002, only domestic investors were permitted to buy and sell A-shares of listed companies. Since then, foreign investors have had limited possibilities to purchase A-shares. Very strict requirements have been imposed on foreign investors, including how long they must hold their investments and limits on the amounts they can invest. Purchase of A-shares requires a special permit, which to date has only been acquired by a few large international banks. Nevertheless, trade in dollar-denominated B-shares, which is allowed for domestic and foreign investors, constitutes a small part of a corporate share stock.

Chinese stock prices rebounded at the end 2003 after a near-continuous decline since 2000. Buoyed by the favourable development of the Chinese economy, the Shanghai and Shenzhen indices were up about 10 % overall for 2003. The combined turnover last year for the two exchanges exceeded €320bn.

Performance of Shanghai and Shenzhen indices in 2003

Source: Shanghai and Shenzhen exchanges.
Russia

United-Russia-controlled Duma set to deal with tax reform and social security. The United Russia faction reaffirmed its dominant status in the Duma’s opening session, with its deputies heading all 29 Duma committees. Prime minister Mikhail Kasyanov told the deputies at the opening session that poverty was Russia’s biggest problem. With nearly 28 million people living below the subsistence minimum, the government wants to focus this year on improving social security, health care and education.

During the spring session, the Duma will continue work on tax reform. Current legislation projects include reduction of the social tax from the start of 2005, a tax on windfall profits from crude oil exports, taxation of small firms, property tax on private individuals, taxation of inheritances and gifts, water and land taxes, as well as technical adjustments to the value-added taxation. The government also plans to propose amendments to the Duma on laws governing natural resource use such as the subsoil resources, the forestry code and the water code. Proposals on reforming the gas sector are also expected. The government declared its desire to retain a strong state role in determining use of natural resources.

Government seeks to revive bond markets. The Russian government is planning to substantially increase its domestic issues of debt securities this year to RUB 361 billion. Of that amount, RUB 290 billion would consist of long-term government bonds (OFZs), RUB 41 billion in short-term treasuries (GKOs) and RUB 30 billion in government savings bonds (GSOs). The average maturity on the issues would also be longer. At the end of last year, the Russian state had RUB 664bn ($22bn) in outstanding debt, of which 98 % was long-term OFZ bonds.

The government hopes to establish a functioning government debt securities market, where market-set yields would act as the reference rate for the financial markets. Since the 1998 financial crisis, the government bonds market has suffered from a lack of depth and illiquidity. Just two players, savings bank Sberbank and the state pension fund, have dominated the market by purchasing and holding in their portfolios most government bond issues. With the ongoing pension reform, Russia’s pension funds must now find low-risk investments for a growing wave of pension savings.

The government has asked the CBR and finance ministry to come up with market development proposals by mid-March. Plans include the establishment of a market maker system and the launch of derivatives markets.

A ceiling would also be placed on the share of a single bond issue that one investor could hold.

CBR lowers interest rates. On January 15, 2004, the Central Bank of Russia lowered the refinancing rate from 16 % to 14 %. The CBR last adjusted the rate in June 2003, when it was lowered from 18 % to 16 %. While the CBR’s refinancing rate has almost no practical significance as an instrument in setting monetary policy (banks do not take refinancing loans from the central bank), it is the basis for setting penalty rates for delinquent payments. The lowering of the refinancing rate reflects lower inflation and lower market interest rates.

Interbank lending rates are substantially lower than the refinancing interest rate; in January for example the 8–30 day offered rate has ranged between 5.5 % and 7 %. Real interest is negative and reflects excess market liquidity.

In conjunction with its lowering of the refinancing rate, the CBR also lowered its rates on overnight lending and currency swaps to 14 %.

CBR issues new rules on use of international accounting standards and presentation of key financial indicators. Banks now must submit financial statements to the CBR converted from Russian accounting standards to international standards. The first unconsolidated financial statements would cover the first nine months of 2004 and would have to be submitted by the end of November 2004. The first consolidated and audited version would cover all of 2004 and have to be submitted by the end of September 2005. Current Russian rules for banks in preparing their financial statements remain in force.

The CBR also modified its rules on the key financial indicators used in banking supervision. These new rules enter into force on April 1. The need to report some indicators on assets and liabilities will be eliminated. Changes also apply to calculation of liquidity and classification of risk for outstanding loans, which affects, for example, assessment of capital adequacy. Banks would continue to report their key indicators monthly to the central bank, but on request also provide them daily.

Deadline for enterprises to purchase or lease lots on which they are located extended to beginning of 2006. President Putin approved the change in the law in December. When Russian enterprises were privatised, the lots on which they were situated remained with the state. The land code originally required an enterprise to purchase its lot or make a long-term lease by the beginning of 2004. The Russian Union of Industrialists and Entrepreneurs (RSPP) criticized the law for its overly tight schedule and said the purchase prices planned by officials exceeded prevailing market prices.
China

**Economic growth accelerated in 2003.** Based on preliminary data, China’s real GDP grew 9 % y-o-y in 2003. Except for the Sars-induced slowdown in the second quarter, growth for the year overall was fairly steady. Nominal GDP rose to CNY 11,670bn (€1,230bn). GDP per capital was slightly over 9,000 yuan (950 euros).

Chinese statistics divide total output into three broad sectors. Primary industry, which includes agriculture and fishing, grew just 2.5 % last year and its share of total output shrank to 15 %. Industry, energy production, mining and construction climbed 12.5 % and accounted for 53 % of GDP. The service sector grew 7 % last year and contributed 32 % of GDP.

Domestic demand boosted GDP growth last year. Investment surged, with the investment rate exceeding its already high previous levels. Many analysts now fear that some industrial fields are already showing signs of over-investment. Retail sales were up 9 % y-o-y for the period January-November. While exports grew briskly, the rapid increase in imports held net export growth low.

China is currently revising its approach to measuring total output to improve statistical reliability. Some economists believe China’s statistics underestimated GDP growth last year. They put the actual figure in the range of 10–12 %.

**GDP growth, percentage change from previous year**

Inflation picked up towards the end of 2003. Consumer prices started to rise again last year. In December, on-year inflation climbed to 3.2 %. Higher food prices, which reflected the poor harvest, drove the acceleration in inflation. In November, food prices were up 8 % from a year earlier, while prices of some industrial products continued to fall. Factors that caused deflation in 2002 include higher production efficiency and lower food prices.

**Inflation, 12-month percentage change**

Deposits and credits continue to increase rapidly. The loan stock of Chinese banks grew 21 % last year. The credit expansion slowed slightly in the final months of 2003, after the central bank raised its deposit reserve requirements from 6 % to 7 % in September. The total loan stock at the end of 2003 was CNY 17,000bn or about 150 % of GDP. The central bank also reported that most loans last year went to agriculture, construction and households.

The narrow money supply, M1, which covers cash in circulation and cash deposits, was up 19 % y-o-y at the end of 2003. The broad money supply, M2, which comprised M1 and other deposits, expanded nearly 20 % y-o-y. Although growth slowed somewhat towards the end of the year, money supply growth exceeded the central bank’s target.

Part of the increase in the money supply is the result of China’s monetary policy, which seeks to keep the yuan’s exchange rate practically unchanged in relation to the US dollar. The current account surplus and large FDI inflows caused China’s foreign currency reserves to balloon by over $100bn. The People’s Bank of China has attempted to sterilise the excess liquidity from the markets by selling securities. As real yields have declined in recent months, interest in these securities has waned. Nevertheless, the PBC has refrained from raising interest rates on fears that higher rates might dampen economic growth as well as possibly stimulate the already massive inflows of foreign capital.

Several observers note that slowing the growth of the money supply and credit is necessary to prevent inflation from kicking up and overheating in certain sectors of the economy.

The amount of cash in circulation in China is disproportionately large compared to the size of its economy. Broad money is nearly double the annual GDP figure, while the narrow money supply is about 75 % of GDP. The large money supply reflects China’s high savings rate, which has exceeded 40 % of GDP in recent years.
Russia

Russia’s economy grew briskly in 2003. The combined production index of five base sectors of the economy rose 7.1% last year. Growth was robust in four out of the five sectors and largely based on substantial increases in production of oil and other raw materials, as well as the impact these gains had on the rest of the economy.

Industrial output increased 7%. The fastest growing industries (all around 9% y-o-y) were fuel production, machine building and metal fabrication, and ferrous metallurgy. In the fuel industry, crude oil production increased 11%, coal production 8% and natural gas production 5%. Despite the gains in crude oil production, oil refining went up just 2%. In the machine building and metal fabrication category, growth was highest in the manufacture of electronic devices (45%) and production of railway equipment and rolling stock (36%). Notably, production of freight cars more than doubled, driven by strong growth in rail shipments of crude oil. In the ferrous metallurgy category, pipeline production (mainly for oil shipment) increased 19%, making it one of the fastest growing product groups. Among other industries, food-stuffs production grew 5% last year and the forest industry and wood processing was up 1.5%. Light industry continued its decline last year, sliding 2%.

Construction rose 14%, far outpacing growth below 3% in 2002. The large increase in building activity partly reflected construction of new oil transport infrastructure, including pipelines and harbours. Growth in housing construction lagged behind other construction categories, but still managed to match its own 7% pace set in 2002.

Freight transport increased over 7%. This growth was mainly due to higher volumes of rail and pipeline transport, which again reflected the increase in crude oil production and exports. Rail shipments grew 10% and pipeline shipments 8%. The volume of crude oil and oil products shipped by rail freight rose 15% y-o-y. Crude oil and oil products constitute the largest product group, accounting for 18% of all rail freight.

Rapid growth of retail sales has continued since 2000. Retail sales last year rose 8%. The growth reflects higher personal incomes. Real wages rose 10% in 2003, bringing the official average monthly wage to 5,512 roubles (about 160 euros).

The 1.5% figure for agricultural output was a result of last year’s relatively poor harvests. The grain harvest was just over 67 million tonnes, over 20% below the harvests of 2001 and 2002. Other crop cultivation was more successful; e.g. green vegetable and potato production increased over 10% y-o-y. Meat production also grew nearly 5%, while milk and egg production remained at the previous year’s level.

The structure of agricultural production has slowly changed, and today the share of small farms in total production is on the rise. Large farms still account for the overwhelming share of grain production. In 2003, they accounted for 84% of grain production, a slight drop from 87% the previous year. Small farms last year produced 22% of sunflowers and 10% of sugar beets, up a couple of percentage points from 2002. Household garden patches also remained last year the source of the lion’s share of potatoes and other vegetables (93% of potatoes and 80% of other vegetables).

Growth of five base economic sectors, percentage change from previous year

![Graph showing growth of five base economic sectors](Image)

Source: Goskomstat

CBR decides on deposit insurance requirements for bank supervision. The CBR is charged with evaluating the reliability of banks’ accounts, compliance with mandatory banking regulations and the stability of banks. The stability of banks will involve tracking key indicators for liquidity, profit margins, cost structure, capitalisation and claims. The CBR will use weighted averages of these indicators to set the limits in which banks must operate. The banking supervisors will also evaluate bank management from the standpoint of transparency of ownership structure, risk management and quality of internal auditing.

Standard & Poor’s upgrades Russia’s credit rating. S&P bumped up Russia’s rating on long-term foreign-currency sovereigns a notch from BB to BB+, or just below investment grade. S&P said the upgrade was justified by improvements in Russia’s external liquidity and falling government debt. S&P previously lifted Russia’s rating in December 2002. S&P said Russia still has problems stemming from unfinished structural reforms, heavy dependence on raw material sectors and a lack of development of political institutions and public governance.
China

Record FDI inflows in 2003. Foreign direct investment in China reached $53.5bn last year, an amount exceeded only by the United States. Yet, the amount of investment in China grew just 1.4 % y-o-y, slowed possibly by last year’s Sars outbreak and constraints on production such as power shortages.

Most investment flowed to the eastern seaboard city of Shanghai and the Guangdong, Jiangsu and Shandong provinces. About 70 % of investment went to manufacturing. The main sources of investment were Hong Kong, the Virgin Islands, Japan, South Korea and the United States. A significant share of investments moving through the Virgin Islands is thought, however, to be of Chinese origin. Such funds are simply being recycled through foreign countries to take advantage of tax relief granted to foreign investors. Many European, Asian and US firms also invest in China via Hong Kong.

Foreign direct investment in China

Source: People’s Bank of China

Rural tax reform lightens burden on Chinese farmers. On-going rural tax reform, an experiment launched in 1994, was extended in 2002 to include most Chinese farmers. The tax reform seeks to decrease the heavy tax burden on farmers, raise living standards in rural areas and foster development. The differences in taxation of rural and urban incomes have long been perceived as unfair to farmers, who have been taxed on their production without receiving tax deductions. Moreover, local governments have usually exercised discretion in imposing excessive fees to balance their budgets.

The main objective of the reform is to shift to a tax system that is more accountable and discourages corruption at the local government level. The system was simplified by reducing the number of agricultural taxes from some dozens to merely three or four. Many fees for permissions or certificates were abolished. Although the reform has stressed lowering the tax burden on farmers in grain producing areas, it also seeks to abolish taxes on other agricultural products. The Chinese government will send inspection teams to all provinces to assess the progress of the implementation.

The ministry of agriculture says rural tax reform will considerably reduce farmers’ tax burden, which has grown substantially in proportion to the size of the sector during the last decade. In 1990, the share of agricultural taxes was 3 % of all tax revenues. In 2002, the share had risen to 4 %, even as the share of agriculture in GDP had decreased considerably.

Income gap between cities and countryside continues to widen. The national statistic bureau reports per capita disposable income in rural areas in 2003 was 2,600 yuan (260 euros), a 4 % increase from 2002. At the same time, nominal incomes in urban areas grew 9 % to over 8,400 yuan. The rise in rural incomes was slowed by a number of natural disasters and the Sars epidemic. Droughts and flooding impacted grain production, while Sars hurt sales of agricultural products abroad. Sars also caused a decrease in rural incomes as rural residents abandoned their work in the cities. In recent years, money sent home by rural residents working in the cities has become a critical source of income for those remaining in the countryside.

Increasing income levels in rural areas has become a top priority for the Chinese government. In 2002, slightly more than 60 % of Chinese (nearly 800 million people) lived in the countryside. For this reason, boosting regional purchasing power is seen as crucial to sustaining China’s economic growth. The government wants to raise rural living standards through such measures as mechanisation of agriculture, higher investment and tax reform.

Per capita disposable income (yuan) of China’s urban and rural populations

Source: National Bureau of Statistics of China
Russia

Russian GDP up 7.3 % in 2003. Preliminary Goskomstat figures show total production growth accelerated substantially from the 4.7 % rate posted in 2002. Some 60 % of GDP last year was generated by the private and public services sectors. Industry contributed a 27 % share, construction 7 % and agriculture 6 %.

Russian GDP last year amounted to RUB 13,305bn (€384 bn). At the official exchange rate, Russia’s economy would be roughly the size of the combined economies of Finland and Sweden. However, when corrected for purchasing power, Russian GDP is about three times greater. GDP per capita in 2003 was 2,655 euros according to the official exchange rate, about a tenth of Finnish figure of 26,800 euros in 2002.

Inflation continues to decelerate. In January, consumer prices rose 11.3 % y-o-y, a slight slowing from 12 % y-o-y in December. The drop in inflation reflected a two percentage point reduction in the value-added tax and the elimination of the 5 % sales tax at the start of the year. The effect was particularly visible in certain services such as postal and phone rates, which decreased. Municipal services, on the other hand, rose rapidly after slowing in late 2003. In January, the prices of gas and electricity rose 11 % and water and wastewater 13 %.

Russia’s foreign currency reserves increase, as does liquidity. In recent months, the Central Bank of Russia has increasingly relied on interventions in the currency markets to counter pressure on rouble appreciation against the dollar. In addition to the inflow of currency from constant current account surpluses, the net flow of capital movements has shifted in the direction of Russia in recent months. Since last autumn the country’s currency reserves have ballooned by nearly a third, reaching $84bn on January 30. The ratio of reserves to GDP is quite large by international standards, nearly 20 %.

Russia’s relatively rigid exchange rate target has caused problems in implementing monetary policy. Each currency intervention increases domestic liquidity, which is, in turn, difficult to neutralise. The federal government has absorbed some liquidity by increasing central bank deposits. The state has also begun to collect oil export earnings in a special stabilisation fund. For its part, the CBR has soaked up the excess liquidity of firms and banks through money market interventions, mainly through encouraging deposits with the central bank. The interest rates offered in these operations have been kept fairly low so as to keep capital imports low. On the other hand, this approach has limited domestic interest rate policy. The monetary stance, which is focused on an exchange rate target, inevitably continues to be quite loose with respect to economic growth and inflation.

Reform of the Russian insurance market. The amendments to the 1992 act on insurance, which entered into force last month, are seen as part of Russia’s preparations for WTO membership. The changes were designed to harmonise Russian legislation with international norms, and include specification of insurance market concepts and strengthening of measures for insurance market supervision. Restrictions on operations of foreign-owned insurance companies have been relaxed so that the ceiling on overall foreign ownership increases from 15 % to 25 % of the total statutory capital of all Russian insurance companies. Moreover, foreign ownership rules no longer apply to companies based in EU countries, meaning that such companies are free to operate in the mandatory insurance market and e.g. sell life insurance. The statutory capital requirements of insurance companies were defined for the first time; those insurance companies already operating on the market have until the end of June 2007 to raise their statutory capital to the level set by the new law.

Yukos in trouble with government and Sibneft. At the end of December, the tax ministry concluded its investigation of Yukos’ income statement for 2000, and found that the company had an outstanding tax debt of $3.4bn. The tax ministry is now reviewing Yukos income statements from 2001 and 2002. Yukos has responded that like many Russian companies, it has taken advantage of the possibilities granted by the tax code in tax planning. The charges were the first to be directed at Yukos itself. Previously, only directors had been charged with such abuses.

At the end of January, the prosecutor general’s office issued international warrants for several of Yukos’ main owners and colleagues in companies close to them. Warrants have been issued for ten persons so far, and the charges include tax evasion. To calm the situation, particularly with respect to foreign investors, Yukos owners have left operational management. The last major owner to leave, Mikhail Brudno, was relieved of his board duties on February 2.

The natural resources ministry is currently assessing compliance of oil companies with the conditions of their operating licences. The investigations started with Yukos, and officials report to have found widespread malfeasance. The state already has cancelled Yukos’ licence for the Talakan deposit located in Yakutia.

The merger agreed last spring between Yukos and Sibneft (another major oil company in Russia) remains in the air. Sibneft announced it was pulling out of the merger last November after members of Yukos management were accused of possible crimes. Yukos has refused to let Sibneft back out of the deal.
China

Industrial output growth accelerates. Industrial output grew 17% in 2003, up from 13% in 2002 and 10% in 2001. Heavy industry advanced 19%, while light industry rose 14%. The state sector trailed the average with 14%, while foreign-owned enterprises posted a 20% increase. With few exceptions, major industrial good outputs posted double-digit gains. Computer production, for example, rose 14%. The state sector trailed the average with 14%, while foreign-owned enterprises posted a 20% increase. With few exceptions, major industrial good outputs posted double-digit gains. Computer production, for example, rose 14%. The state sector trailed the average with 14%, while foreign-owned enterprises posted a 20% increase. With few exceptions, major industrial good outputs posted double-digit gains. Computer production, for example, rose 14%. The state sector trailed the average with 14%, while foreign-owned enterprises posted a 20% increase. 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Russia

Export earnings grew briskly in fourth quarter; import growth slowed slightly. Figures from the Central Bank of Russia indicate Russia’s earnings on goods exports in the fourth quarter of 2003 rose over 25 % y-o-y in dollar terms, exceeding the previous two quarters pace. Russian goods imports also rose over 20 % in the fourth quarter, slightly off the pace of previous quarters. Imports from non-CIS countries were up less than 20 %. In euro terms, growth in imports from non-CIS countries was essentially stagnant. Measured against a basket of currencies of Russia’s main trading partners, import growth was about 10 %.

Russian goods imports, percentage change from four quarters previous

![Graph showing total imports, USD, non-CIS imports, USD, and non-CIS imports, EUR from 1998 to 2003.](image)

Source: Central Bank of Russia

Russia could join WTO next year. This winter’s bilateral and multilateral talks on Russia’s WTO membership have covered Russian import tariffs (particularly tariffs on automobiles and aircraft), trade in agricultural products (including meat import quotas, animal and phytosanitary measures) and agricultural subsidies, technical barriers to trade (including pharmaceuticals and alcohol), Russian legislation on protection of intellectual property and Russia’s new customs act. The double tariff on Estonian products, already in place for years, continues to be an unresolved issue. Deputy prime minister Alexei Kudrin said Russia could reduce the average level of import tariffs from the current 10–11 % to 5–7 % after a transition period. Deputy prime minister Boris Alyoshin stated that high import tariffs hamper the technological development of domestic industry.

The talks also touched on access to Russian financial markets (particularly, the establishing of bank branch offices in Russia), insurance markets, telecommunications markets (including Rostelekom’s monopoly on long-distance calling), transportation markets and the motion picture industry. Russia’s gas sector (domestic gas price, transportation prices, export tariffs, rights of export, transit and pipeline construction) remains a central topic. President Vladimir Putin said the EU concerns about Russia’s energy-intensive industries do not require a radical increase in energy prices in Russia, since the EU can, whenever needed, impose its own protection measures against dumping or retaliate against subsidies.

Last week’s 22nd meeting of the WTO working group dealt with intermediate taxes, transit of goods, export tariffs, fees for customs services, customs unions, free-trade areas and currency controls. The working group’s next meeting is scheduled for March or April. Economy minister German Gref estimated that under the best circumstances Russia’s WTO talks could be wrapped up this year. The subsequent ratification process would take at least a year to 18 months.

Corporate bond market grows; Gazprom issues large rouble bond. The amount of bonds outstanding issued by Russian firms is about $18.5bn or 4.3 % of GDP. About $12.5bn of this consists of foreign currency bonds, like eurobonds. The corporate bond market has grown rapidly in recent years. At the beginning of 2000, the value of rouble bonds was just RUB 1.1 bn, while foreign currency bonds were some $1.6bn. However, the market remains small in relation to economy as whole.

On February 3, gas giant Gazprom placed a RUB 10bn bond. It was the largest rouble bond ever issued by a Russian enterprise. The three-year bond has a yield of 8.1 %. The placement was oversubscribed by 60 %. The money raised, however, only covers a fraction of Gazprom’s planned investment spending of RUB 212 billion ($7.2bn) this year. Most of this spending will be financed out of retained earnings and foreign currency loans.

Seven candidates set to vie for Russian presidency. The central election commission has confirmed the candidates that will appear on the March 14 presidential election ballot. Incumbent president Vladimir Putin (52) is the only candidate with previous presidential campaign experience. In the 2000 election, Mr. Putin won an outright majority of 53 % and thus avoided a run-off election. Recent polls indicate Putin enjoys nearly 70 % voter support at the moment.

Other candidates are long-time Duma representative Sergei Glazyev (43), one of three leaders of the Rodina bloc; Oleg Malyskhin (53), deputy chairman of the Liberal Democratic Party; former Federation Council speaker and Life Party chairman Sergei Mironov (51); Liberal Party leader Ivan Rybkin (57); former Duma deputy speaker Irina Khakamada (48), the only right winger; and Communist Party candidate Nikolai Kharitonov (55).
China

China’s strong economic growth expected to continue. Research institutes and banks forecast China’s GDP will rise in the range of 7.5–9.5 % this year. Growth in consumer demand will accelerate due to expected rise in disposable income. On the other hand, government efforts to restrain public investment and limit enterprise investment into industrial fields possibly suffering from overinvestment could slowdown growth slightly. While exports are expected to benefit from a global economic recovery, the cutting back of tax breaks and possible reduction in FDI inflows to China may slow export growth overall. Inflation is expected to be about 2 % this year.

The research department of the State Development and Reform Commission, which is closely tied to the government, forecasts GDP will grow 8.3 % this year. Investment growth is expected to slow to 16–18 %, while export growth should fall to around 15 %. The research department expects the growth in consumer demand to accelerate to 11.5 %. In particular, tourism, catering services, and sales and production of automobiles are expected to increase rapidly.

Foreign trade growth slowed in January. The Ministry of Commerce reports that in January China’s exports grew 20 % y-o-y and imports 15 % y-o-y. Both imports and exports were valued at about $36bn. The Chinese New Year holidays in January reduced the number of working days in the month and appeared as a slowing of trade. The slowing in export growth also reflected regulations introduced at the start of this year that reduced by an average of three percentage points the amount of value-added tax rebates paid to companies for products exported abroad (see BOFIT Weekly 1/2004). The slowing of import growth manifested government efforts at reining in rapid investment growth.

Chinese exports and imports, percentage change from twelve months previous

![Graph showing exports and imports percentage change from twelve months previous](image)

Source: China Ministry of Commerce

Official figures underestimate true unemployment situation. The State Statistical Bureau reports that urban unemployment averaged 4.3 % in 2003. While the official unemployment rate has risen steadily since 1997, when it was 3.1 %, official figures are believed to grossly underestimate the actual number of unemployed. Some of the problems in getting realistic estimates include difficulties in collecting reliable data, the tendency of local administrators to embellish their figures and the exclusion of specific groups of unemployed from the statistics. Estimates of actual urban unemployment rates fall in the range of 6–13 %. For example, structural reforms of state-owned enterprises have increased the number of unemployed persons. Government sources say that despite of earlier reforms still 15–20 % of workers on the books at state enterprises are surplus labour. External observers say such hidden unemployment in state enterprises could run as high as 30 %.

The government does not publish official rural unemployment figures. The ILO estimates that about 30 % of China’s working age rural population is either unemployed or underemployed.

Rural development given priority. The Central Committee of the Communist Party has proclaimed that the living standards of the 800 million persons living in rural areas will be improved.

According to the government, agriculture employs 60 % of the Chinese workforce, yet only accounts for 15 % of total economic output. In 2003, agricultural output rose 3 %, a figure well below the overall rate of Chinese economic growth.

The new plan seeks to raise income levels of farmers. Grain production has fallen over the last five years. In 2003, production fell 6 %, which led to a 10–20 % rise in prices of agricultural products in the fourth quarter of 2003. The government now seeks to promote industrial development and emergence of a service sector in rural areas to diversify the earning opportunities of farmers. To achieve this, they envision special treatment of rural enterprises and broader private ownership. The government wants to improve the living and working conditions of rural migrants working in the cities. Last year, some 99 million migrant workers worked in cities, about 5 million more than in 2002. During the period 2000–2002, income sent home by migrant workers accounted for nearly half of the increase in earnings in rural areas. The government wants to improve the treatment of migrant labour and increase training aimed at preparing rural residents for wage labour.

The rural reform program is connected also to the tax reform (see BOFIT Weekly 5/2004). This year, the government will increase the amount of budget funds available for rural development from CNY 120bn to CNY 150bn ($14bn, over 1 % of estimated GDP).
Russia

Share of EU countries in Russia’s imports shrunk in 2003. The State Customs Committee said EU countries accounted for 38% of total goods imports (40% in 2002). The EU’s share of Russian exports remained at about 35%. The share of accession countries joining the EU this May 1 rose to nearly 8% of Russian imports, while their share of Russian exports fell to 12%. Imports from CIS countries climbed to 24%, while their share of Russian exports remained at 15%.

In using Russian import figures, it is worth remembering that the CBR adds its estimate of unrecorded imports to the official customs figure. For 2003, the CBR estimate was 24% of total imports, the same as in 2002. Russia’s declared levels and changes of exports and imports may differ substantially from the trade figures published by its trading partners. Part of the growth in the value of imports and exports last year reflects the US dollar’s collapse against other major currencies (e.g. 16% against the euro).

The main sources of imports last year were Germany (14%, i.e. the same share as in 2002), Belarus, Ukraine, China, Kazakhstan and the US. The top destinations for Russian exports were Germany, the Netherlands, Italy, China, Ukraine, Belarus and Switzerland.

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<th>Russia’s main trading partners in 2003</th>
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Sources: State Customs Committee and CBR

Government sends bank reform package back for revision. The draft program submitted by the finance ministry last week covered several areas of banking in need of reform. The program suggestions included measures to improve creditor protection (in particular, realisation of collateral) and simplification of the bankruptcy process for banks. A 10% capital adequacy requirement would apply to banks with authorised capital of less than 5 million euros from next year and all banks by 2007. The minimum capital requirement would be raised to 5 million euros for new banks in 2007 and all banks in 2010. To reduce state ownership in the banking sector the sale of bank stakes held by state enterprises is envisaged for this year and next year.

The officials preparing the new program have about a month to resubmit a new draft program to the government. The new version should respond to government wishes for e.g. amendments to the deposit insurance act that entered into force at the end of last year so that the state’s current 100% deposit guarantee will remain in place until 2007 only for those household accounts in Sberbank that were opened before the new law took effect. The government also wants a timetable for when the CBR would divest its shareholdings in banks, as well as estimates on the impact of the program’s envisioned lowering of reserve requirements for banks.

Government delays new forest code until after presidential elections. A draft code prepared by the economy ministry and the natural resources ministry should be submitted to the government by the end of March. The forest reform is intended to extend the principles of land ownership and land use of the land and civil codes to cover forests. Although the natural resources ministry called for greater emphasis on the forest industry’s needs, the economy ministry’s view dominates so far.

The issue of private ownership of forests continues to arouse controversy. Under the draft code, forests are state property, which could be privatised. 99-year leases on state-owned forest tracts would be auctioned to private entities. The lessee would be responsible for reforestation, and would also have the right to sublease the tract or use it as collateral. The lessee could buy the tract after a leasing period of 15 years. The government would retain responsibility for administering and monitoring forests. Forest industry leaders are unhappy that auctions would be the sole method for acquiring forest leases as well as the long leasing time before the land purchase would be allowed.

The draft recognises Everyman’s Right, which allows anyone to move freely in forests, as well as collect berries and mushrooms. Under the draft, foreigners would be permitted to own forest, while the Russian president would decree regions where foreign ownership is prohibited.
China

Industrial output growth accelerates in January.
China’s industrial output was up 7% y-o-y last month, while workday-adjusted growth was 19% (Chinese New Year celebrations reduced the number of working days in the month). Heavy industry dominated industrial production growth enjoying growth more than double that of light industry. Exports of industrial products increased 16% y-o-y in January. Workday-adjusted growth was 29%.

Higher agricultural product prices lead January inflation. January consumer prices rose 3.2% y-o-y. Much of the on-month 1.1% rise was due to Chinese New Year holiday. Food prices, up 8% y-o-y in January, continued to drive inflation. Non-food prices rose only 0.7%. The large rises in chicken and egg prices, largely in response to the bird flu outbreak, could continue if the epidemic spreads. Prices of home appliances, clothing and phone calls continued to fall, reflecting the capacity growth in these industries.

China seeks to dampen credit growth in fields suffering from over-investment. Premier Wen Jiabao, talking to financial officials at their annual meeting, said the time had come to clamp down on credit access in fields suffering from over-investment. In particular, the government sees overcapacity in the steel, aluminium and cement industries. The return on existing investments is estimated to have suffered with rapid increases in production capacity that in turn has caused, e.g. higher raw material prices, power brownouts and outages and excessive demand for transportation. The government hopes to rein in investment growth, e.g. through tightening environmental requirements on new industrial enterprises and slowing the processing of business licences.

The Banking Regulatory Commission announced early this month that it was attempting to ascertain how much bank lending had been extended to the above-mentioned industries, as well as to real estate and the car industry. A final assessment should be available in April. Several private banks have already announced they are tightening their lending requirements to industries possibly suffering from over-investment.

Although the central bank (the People’s Bank of China) wants to slow credit growth from 21% in 2003 to 16% this year, it has yet to announce what measures it intends to take to slow the growth of credit. Last year, the PBoC attempted to limit credit expansion by clamping down on real estate lending and raising cash reserve requirement. The central bank also wants to hold the growth of broad money (M2) this year to 17%, compared to 20% in 2003. Currently, it is difficult to restrain money supply growth as an anticipated revaluation of the yuan has increased capital inflows into China. The original 2003 money supply growth target of 16% was revised up during the year to 20%.

Standard & Poor’s upgrades China’s credit rating. On Tuesday (Feb. 17), the international credit rating agency lifted the rating on China’s long-term foreign currency borrowing one notch to BBB+ (the same as e.g. Poland and Latvia). S&P said the boost reflected greater resilience in the Chinese economy. In particular, the agency noted that China’s public sector has become more efficient and the government has expanded the revenue base. At the same time, dependence on public sector consumption for spurring economic growth has fallen and the country has become more market oriented. The upgrade was further justified by China’s strong external payments position, which is supported by a large foreign currency reserve and a shrinking foreign debt. China’s creditworthiness, however, remains threatened by a potential rapid growth in public sector debt, particularly due to non-performing bank loans.

The S&P’s rating is still lower than Moody’s (A2) given last October and Fitch’s (A-) given even earlier.

Most new jobs created in the service sector. The Ministry of Labour reports that in 4Q03 more than half of all new jobs were created by private businesses. State-owned enterprises accounted for only a small share of new jobs. 67% of new jobs were in the service sector, particularly trade and catering. 32% were in industry, while only 2% were in agriculture and related sectors.

The figures indicate jobs have shifted from state-owned enterprises to privately owned firms, particularly those in the service sector. Despite strong growth in recent years, the ILO finds China’s economy incapable of creating new jobs fast enough to absorb the current pool of unemployed and new workers entering the labour market.

At the end of last year, prospects of finding a job were best for women, people aged 16–34 and the highly educated. Demand for employees with higher education in, for example, business administration, economics, computer science and engineering exceeded supply.

Breakdown of employment by sector, %
Russia

Putin sacks prime minister and cabinet. The deposed cabinet, led by Mikhail Kasyanov (46), was formed in May 2000 after then-prime minister Vladimir Putin was elected president. After firing the prime minister and cabinet on Tuesday (Feb. 24), Mr. Putin appointed Viktor Khristenko (46) acting prime minister. Other cabinet members will continue in the caretaker government. Besides Khristenko, Kasyanov was the last important minister, who participated in Boris Yeltsin’s governments in the 1990s.

Kasyanov’s government was fired just 18 days before the March 14 presidential election, when, under the constitution, it would have had to disband in any case. Putin has two weeks to submit a new prime minister candidate to the Duma, which then has a week to approve or reject the president’s nominee.

When informing of the dismissal, Putin said that the move was to let voters know before the election the type of cabinet he envisioned if elected for a second term. The president further justified his actions by saying he wanted to assure the typically lengthy change of government occurred as swiftly as possible. He said it was essential from the standpoint of such matters as on-going federal administrative reform.

Other reasons suggested for the dismissal include increasing voter interest in the presidential election. There will be a new election if voter turnout falls below 50 %. There was also speculation that Kasyanov’s cozy relations with large enterprises and the cabinet’s slow progress in implementing certain economic reforms provoked the shake-up.

The government’s sacking had virtually no impact on financial markets. Russian stocks fell only momentarily on Tuesday, and on Thursday (Feb. 26) the RTS index hit an all-time high of 664. The government’s sacking also had no major impact on the external value of the rouble. The exchange rate has held at around the 28.5 roubles to the dollar throughout February.

Brisk economic growth continues. The combined production index of five base sectors of the economy rose 7.6 % on year in January (the workday-adjusted figure was 9.2 %). Construction (up over 13 %) posted the highest output growth. Retail sales rose nearly 10 %, industrial output was up over 7 % and freight transportation rose more than 5 %. Agricultural output fell about 1 %.

In January, crude oil production continued to ramp up rapidly (10 % y-o-y) and averaged 8.8 million barrels a day. Light industry, on the other hand, was hit by higher imports due to real appreciation of the rouble. In particular, imports from the Far East compete with domestic produc-

Economic growth overall was spurred by a 14 % y-o-y increase in investment and a 15 % y-o-y rise in real wages.

Foreign investment in Russia increased last year. Goskomstat reports that foreign investment in Russia amounted to almost $30bn last year. Investments increased 50 % y-o-y. The lion’s share of investment (76 %) came in the form of lending from abroad and trade credits. Such investment was up 47 % on year. Portfolio investments accounted for just 1 % of total foreign investment. They fell 15 % y-o-y. Foreign direct investment (FDI) experienced fastest growth and amounted to almost $7bn, a 69 % increase from 2002.

Half of FDI went to industry, particularly the all-important fuel industry, which accounted for 28 % of total FDI. Food industry, machine building and metal fabrication, as well as the forest industry and wood processing each received about 5 % of FDI.

Rapid growth in bank deposits and credits in 2003. Households and company deposits in banks operating in Russia last year posted 35 % nominal growth and 20 % real growth. However, growth slowed substantially in the fourth quarter of 2003. Growth in rouble deposits remained brisk, up 37 % in real terms, while, exceptionally, foreign currency deposits were down for the year. At year’s end, rouble deposits corresponded to about 15 % of GDP, while foreign currency deposits were less than 6 % of GDP.

Growth in the amount of rouble cash in circulation accelerated substantially, to 34 % in real terms. The supply of rouble cash amounted to nearly 9 % of GDP.

The growth of credit granted by domestic banks slowed in the fourth quarter. Bank claims on private companies and households were up at year’s end nearly 30 % y-o-y in real terms. Bank claims on companies and households equalled 22 % of GDP.

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Deposits and credits of banks operating in Russia, as well as rouble cash supply (% change in real value from previous year)
China

Minimum wage system revised. From the beginning of March, China’s Ministry of Labour and Social Security will enforce new regulations that define minimum monthly and hourly wages. Factors considered in determining the minimum wage include living costs of the worker and his or her dependents, trends in consumer prices, social security and the local average wage level. The new regulations allow for wage differences among regions and municipalities caused by differences in economic development and labour market conditions.

The minimum monthly wage is about half of the average wage. It must be sufficient to cover basic living costs and social security contributions. Officials, labour unions and enterprises will annually determine among themselves the minimum wage. The minimum monthly wage in Beijing this year was 495 yuan (47 euros). A survey made among foreign firms, however, found that the actual lowest monthly wage in such firms last year was about 3,000 yuan. Although China has had minimum wage laws for years, they have not been enforced. The new regulations now carry penalties for non-compliance.

China’s banking sector gradually opens to foreign banks. Foreign banks currently play only a minor role in China. According to the People’s Bank of China, 150 foreign banks maintain branches in China. In addition, some ten banks have foreign ownership, but their share of the banking sector’s assets only amounted to about 1% as of end-June 2003. That tiny share has even fallen a bit in recent years.

The operations of foreign banks in China are restricted in many ways. Typically, such banks can only offer banking services in foreign currencies. However, foreign banks have been granted permits to provide yuan-based services to foreign enterprises and persons in 13 cities. In February, China granted some foreign banks permission to expand their yuan-based business in those 13 cities to Chinese businesses. The market for providing yuan-based services to households will open up to foreign banks in 2006. The yuan-denominated assets of foreign banks are limited as their borrowing on the interbank market is strictly regulated.

Last autumn, the ownership ceiling in a Chinese bank for a single foreign investor was raised to 20%. The total share of foreign ownership in a Chinese bank is still limited to 25%.

Under China’s WTO commitments, most restrictions on the banking sector will be eliminated at the beginning of 2006. Nevertheless, it is anticipated that practical constraints will hold back the growth of foreign bank operations in China for the next few years.

Inflation worries China’s central bank. The People’s Bank of China expressed its inflation concerns in its annual monetary policy report. In Q403, consumer prices were up slightly more than 3% on year. In addition, the broadest measure of inflation, the GDP deflator, rose 2.1% in 2003, compared to a drop of 0.3% in 2002. The central bank forecasts consumer price inflation will reach or exceed 2.2% this year.

The PBoC will again attempt to ease inflation pressures by reigning in credit growth, i.e. the same approach that failed in 2003 (see BOFIT Weekly 8/2004). The monetary policy report also states that the PBoC will keep both interest rates and the exchange rate stable this year.

Chinese inflation, percentage change from previous year

Expensive raw materials and shortage of electricity boost producer prices. January producer prices were up 3.5% y-o-y, the largest increase in nine months. Consumer prices jumped 3.2% on year in January – the fastest rise in seven years. The surge in producer prices was due mainly to higher raw material and electricity prices, which climbed 7.4% y-o-y. Prices for non-ferrous metals shot up 31.5%. Food production prices rose 3.8%, while durable goods prices, on the other hand, fell 4.6%.

China’s Communist Party issues two anti-corruption decrees. The new priority tasks seek to reduce corruption, especially at higher levels, increase self-discipline of public officials and internal supervision within the Party. Party officials and their close relatives will be prohibited from participating in corporate activities that might involve conflicts of interest. Special efforts will also be made to increase corruption-fighting activities in rural areas. The Central Commission for Discipline Inspection reported 175,000 high-level disciplinary actions last year. Of those, 21 involved misbehaviour at the ministerial level.
Russia

Duma confirms Putin’s prime minister nominee. The Duma bloc of United Russia and the Liberal Democrats supported president Putin’s surprise pick for prime minister, Mikhail Fradkov (53). The Communists opposed Fradkov. Some observers interpret the selection of Fradkov as indication of the president’s desire to have the cabinet led by an experienced bureaucrat, who will closely toe the president’s policy line.

Mr. Fradkov, who most recently served as Russia’s EU ambassador, has a long résumé that includes head of Russia’s GATT representative office in Geneva in 1991–1992. During the 1990s, he also served as Viktor Chernomyrdin’s foreign trade minister and trade minister in the governments of Sergei Stepashin and Vladimir Putin. In 2000–2001, he was first deputy secretary of Russia’s security council under current defence minister Sergei Ivanov. Fradkov also worked two years as chief of the tax police until the agency was disbanded in 2003.

The central tasks facing the Fradkov government are ongoing administrative and tax reforms. Fradkov announced that he wants to make government work more efficiently by reducing the number of deputy prime ministers and ministers, cut by half the over-one-thousand-person cabinet staff and limit the staff’s oversight of ministries. Fradkov picked Duma first deputy speaker and long-time budget and tax commission chairman Alexander Zhukov (47) as his first deputy prime minister. Zhukov is considered an experienced economic reformer.

Euro gains popularity as cash currency in 2003. Central Bank of Russia figures show that, unlike in previous years, purchases of cash dollars by banks from private individuals exceeded banks’ sales of dollars to individuals. Purchases of dollar cash rose sharply to over $17bn, while sales reached $16bn. In contrast, net sales of euros by banks grew considerably, as cash euro purchases increased to $2.2bn, while euro sales climbed to $6.4bn.

In addition, net imports of cash dollars by banks contracted sharply from earlier years as imports fell to $7bn and exports rose to $3.3bn. Cash euro imports were nearly $5bn, and, as there were virtually no exports, net euro imports were worth nearly as much.

The CBR said that Russia had at the beginning of last year cash foreign currency of about $39bn, which corresponded to slightly more than 11 % of GDP or roughly the same amount as rouble deposits in banks. The sum was far greater than currency deposits or the amount of rouble cash in circulation. Much larger estimates of the amount of cash foreign currency in Russia have also been put forward.

Real wages continued to rise rapidly in 2003. Goskomstat preliminary figures indicate wages rose last year 10 % in real terms; pensions were up nearly 5 %. Growth was clearly slower than the previous year.

The average monthly wage in 2003 was 5,512 roubles (which amounts to 160 euros at the current exchange rate and about 450 euros when adjusted for purchasing power).

Wages in the transportation sector were about 40 % higher than the average wage, in telecommunications 30 %, in industry 20 % and in construction 15 %. The highest wages in industry were paid in oil and natural gas production, where they exceeded the average wage by more than 300 %. Wages in non-ferrous metallurgy were 130 % above average, while in coal production and ferrous metallurgy they were 45 % above average.

Financial sector wages exceeded the average wage by 140 %, while they were 30 % higher in scientific fields and 24 % in administration. Wages were lower than average in several other service fields. In retail sales they were 60 % of the average, in education 67 % and in health care 73 %.

Gazprom’s dispute over Belarus gas supplies continues. At the moment, giant Gazprom has been unable to wrap up new gas supply and transhipment agreements with Belarus. Gazprom offered Belarus a long-term delivery contract at a significantly higher price than previously, while Belarus refused. Gazprom began to use tougher measures last month, going so far as to shut off gas supplies to Belarus as well as some countries in Western Europe for 24 hours.

Gas deliveries into Belarus are temporarily being handled by independent gas supplier Trans Nafta on a month-to-month basis.
China

National People’s Congress convenes for annual session. The full session of parliament, the top legislative body, opened today and is scheduled to last ten days. Matters topping the agenda include several major constitutional amendments (see BOFIT Weekly 3/2004) and this year’s budget act.

The current parliament’s five-year term seeks to improve the legal framework so that it corresponds to current economic developments. Some of the main points on the agenda include property rights, social security and regional disparities.

Fixed investment soared in 2003. Fixed investments last year climbed 27 %, up from a 16 % pace in 2002. Investment growth, however, was quite uneven among economic sectors and regions. Investments in primary production (mainly agriculture) grew 4 % and accounted for just 3 % of total investments. Investments in industry grew an impressive 39 % and represented 35 % of total investments. Investments in raw material processing industries soared 72 %. The largest share of investments, however, went to the service sector. Investments in China’s eastern and central regions grew more than a third, while western regions experienced investment growth of 26 %.

Chinese firms financed about a third of their fixed investments out of their cash flow, while borrowing from domestic banks accounted for 24 % of financing. Foreign investment’s share of total investments was less than 5 %, while 6 % of investments were funded out of the state budget. However, a significant share of public infrastructure investment was financed off-budget.

Rapid investment growth is seen as one of the reasons for last year’s pick up in inflation. The flood of investment has driven up prices of raw materials and energy, and further increases are expected this year. Investment growth last year was the highest since the economic overheating of 1993–94.

Foreign currency inflows surge in 2003. Preliminary figures indicate China’s current account surplus in 2003 increased to $40bn, or about 2.9 % of GDP. In 2002, the current account surplus was 2.8 % of GDP.

Capital inflows to China increased substantially in 2003. The surplus on the capital and financial accounts grew 86 % to $60bn. In addition, the net errors and omissions item in the balance of payments was about $22bn to the positive, i.e. capital inflows to China also entered outside official recorded channels. This is significant because up to 2001, net errors and omissions item in the balance of payments was negative, i.e. capital was moving out through unofficial channels. The capital inflows to China partly reflect expectations of a yuan revaluation, as well as repatriation of Chinese investments abroad.

Last year, Chinese banks and firms borrowed extensively from abroad – $15.6bn in the first three quarters of 2003.

The tide of capital into China has significantly increased the central bank’s currency reserves. As of end-2003, the People’s Bank of China held foreign currency reserves of $403bn, compared to $287bn at the end of 2002. China’s currency reserves at the end of 2003 were sufficient to cover nearly a year’s worth of goods imports, a figure quite high by international standards.

Rising foreign currency reserves heighten discussion of yuan exchange rate. The yuan’s exchange rate has been kept nearly unchanged with respect to the US dollar for about ten years. In the past two years, the dollar’s decline has also brought down the yuan’s exchange rate against a number of key currencies. Combined with China’s robust economic growth, many observers are now questioning how much the yuan is undervalued. Estimates range from a few per cent to as much as 40 %.

At the end of January, China’s foreign currency reserves had reached $416bn. Despite market expectations of a revaluation, China’s highest political leadership and the People’s Bank of China have repeatedly insisted in recent weeks that the yuan’s exchange rate is kept stable. On the other hand, the head of the State Administration of Foreign Exchange (SAFE) and the People’s Bank of China vice-governor Guo Shuqing said at the end of February that the massive capital inflows into China are putting increasing pressure on the country’s independence in monetary policy and are increasing the risk of higher inflation.

Although China’s long-term goal is to introduce more flexibility for setting the yuan’s exchange rate, most analysts expect China to first try to reduce the demand for yuan by other means. Such measures could include encouraging imports or Chinese investment abroad. Last week, SAFE announced it was tightening controls on non-residents’ foreign currency transactions in order to reduce capital inflows to China. SAFE may also grant Chinese export firms the right to retain a larger share of their export earning in foreign currencies. Alternative exchange rate mechanisms include pegging the yuan to a basket of currencies instead of only the US dollar, as well as widening the fluctuation range of yuan. A floating of the yuan is generally viewed as virtually impossible, given e.g. the underdevelopment of China’s financial sector.
Russia

President names new cabinet. Russia’s new government, led by prime minister Mikhail Fradkov, pared the number of deputy prime ministers from six to one, and ministerial posts from 23 to 15. Former Duma deputy speaker and United Russia member, Alexander Zhukov, was tapped for deputy prime minister. Prime minister Fradkov declared his government’s goals for ongoing structural reform, a to-do list that included reform of state administration, so-called natural monopolies, the tax and pension systems, banking and housing.

Reform-minded economy-bloc ministers retained their posts: Alexei Kudrin continues as finance minister and German Gref as economy minister. Former deputy prime minister Viktor Khristenko will lead the newly created industry and energy ministry. Most heads of “power” ministries, which report directly to the president, kept their posts. The exception was the interior minister portfolio. Former interior minister Boris Gryzlov already serves as Duma speaker. He is replaced by deputy interior minister Rashid Nurgaliyev (47), who previously has served as deputy director of the FSB intelligence agency and headed the criminal police service. Observers were perhaps most surprised by the selection of Sergei Lavrov (53) as foreign minister. A career diplomat, he spent nearly all of the last ten years as Russia’s envoy to the UN. Dmitri Kozak (45) from the presidential administration was selected as the chief of government staff.

Under Russia’s constitution, the Fradkov government must be disbanded after Sunday’s presidential election. A new government is then installed when the new president takes office. As most experts and polls agree that Putin’s re-election is nearly certain, the renaming of the Fradkov government is expected to be a formality.

Inflation continues to slow. February consumer prices were up 10.7 % y-o-y. The 12-month rise in prices was 11.3 % in January and 12.0 % in December. This year, the traditional inflation spike at the start of the year failed to materialise. On-month increases in prices of municipal services in February again outpaced the average. For example, rents were up about 5 %, while water and trash collection increased about 3 %. Telecommunications prices fell slightly.

Oil exports and equipment imports up strongly in 2003. Higher export volumes helped boost growth in Russia’s export earnings last year. Economy ministry reports the export volume grew well over 10 %, beating the rate of growth in 2002. Crude oil exports climbed a record 18 %, while exports of oil product rose just under 4 %. Russian crude oil exports have risen 66 % and oil products 38 % in the past four years. Natural gas exports were up 2 % last year. Strong export volume growth was also seen in coal production, some metals, and certain chemical and forest products.

The development of export prices in 2003 largely depends on the currency in which they are measured. In dollars, Russian export earnings increased by a quarter and export prices rose over 10 %. Measured against a weighted currency basket of Russia’s main trading partners, however, export earnings grew 15 % and export prices a couple of per cent. In dollar terms, the export price of crude oil rose 13 %, oil products nearly 20 % and natural gas about 25 %. The export prices of several metals increased substantially.

Crude oil brought in 30 % of Russia’s export earnings, followed by natural gas (15 %) and oil products (10 %). Metals (including precious metals) and metal products represented 18 % of total exports, machinery and equipment 9 %, chemical products 7 % and forest industry products 4 %.

The volume of Russian imports rose about 20 % in 2003. In dollar terms, import prices were up a couple of per cent. Against the currency basket, they fell significantly. Imports of machinery and equipment grew slightly faster than imports as a whole; their share of total imports rose to 37 % and their share of imports from non-CIS countries was over 40 %. Growth was propelled by the 50 % volume increase of passenger car imports in the machinery and equipment category, as well as a boom in cellular phone imports. Foodstuffs represented just 21 % of total imports, due in part to Russian meat import restrictions. The rapid growth in imports of alcoholic beverages continued, with volume up nearly double over the past two years. The share of chemical products in total imports rose 17 %, due in part to a rapid increase in pharmaceutical imports. Approximately a quarter of goods imports are not recorded by Russian customs. This can be a reason, for example, for clothing’s small share in Russian import figures.

Russian goods exports and imports, % change

Source: Goskomstat, Russian Economy Ministry/Customs

Information herein is compiled and edited from a variety of sources. The Bank of Finland assumes no responsibility for the completeness or accuracy of the information.
China

Industrial production growth accelerates in February. Industrial output grew an impressive 23 % y-o-y in February. Industrial output also advanced 17 % y-o-y in the first two months of the year. The industrial output boom has clearly strained electrical production capacity. In the first two months of this year, total electricity production was up 15 %, while the power consumption of large enterprises rose 30 %.

Banking sector assets surged in 2003. China’s banking regulatory commission reports that last year total banking sector assets increased 17 % y-o-y, slightly faster than the 14 % rate posted in 2002. The total assets reached €2,762bn, or about 240 % of GDP. State-owned commercial banks recorded lower-than-average growth in assets (14 %), reflecting intense efforts on their part to reduce non-performing loans. In any case, state-owned banks retain their dominant position in China’s banking system. Their assets accounted for 55 % of total banking sector assets in 2003. Assets in foreign banks and financial institutions represent only 1.4 % of total banking sector assets.

China hikes defence spending. China’s 2004 budget was presented to the annual session of the People’s National Congress (PNC). Finance minister Jin Renqing said central government revenues this year should reach $157bn, up 7 % from 2003. Expenditures are also planned to rise 7 %. Thus, the central government deficit should come in at around $38.7bn. In dollar terms, the 2004 deficit is identical in size to last year’s deficit, which was 2.7 % of GDP. The budget assumes the economy will grow 7 % this year.

The government wants to give priority to spending on defence and rural development. Defence spending has risen sharply for several years, and is forecast to rise another 11.6 % this year to about $26bn. In 2003, defence spending was about 1.6 % of GDP. Observers note that China’s actual defence spending is considerably larger than the budget figure.

China’s economic growth in recent years has been focused on specific areas, which has allowed living standards of rural inhabitants to lag. The 2004 budget seeks to raise the living standards of the rural population by increasing rural spending by 20 % and reducing the tax burden on farmers.

New regulation on financial supervision of commercial banks. The banking regulatory body drafted its new regulation in accordance with the new Basel Capital Accord. It is the first concrete implementation of China’s recently passed banking regulatory act. The regulation follows the basic structure in the new Basel accord, employing three reinforcing components of banking sector supervision: minimum capital requirements, supervisory review processes and market discipline.

Although China’s earlier commercial bank act required that a bank’s capital adequacy ratio remain above 8 %, ratio calculations suffered from the lack of strict definitions for risk categories and total capital. The new regulation relies on ratings from international credit ratings agencies in determining a commercial bank’s foreign credit risk. Earlier, loans to the large state-owned enterprises were considered low risk, as were loans with real estate or land as collateral. Now such lenders will lose their preferential credit risk rating. Moreover, banks will have to acknowledge their non-performing loans in full in their total capital by 2005. The new regulation also introduces market risk when determining the capital adequacy ratio for certain large commercial banks.

The new regulation addresses the earlier deficiencies in supervision and enforcement in cases where banks failed to meet their minimum capital requirements. Banks must institute internal controls for which the board of directors will be held accountable. The banking regulatory body now categorises banks as capital sufficient, insufficient and extremely insufficient. When a bank is found capital insufficient, the supervisory authorities can intervene in the bank’s operations. In severe cases, the authorities may take over the bank or replace the management.

Market discipline should also be strengthened by the requirement that banks follow detailed disclosure requirements at various stages. The new regulation was effective immediately, and it is expected to depress bank capital adequacy ratios. Banks have until the beginning of 2007 to achieve the minimum capital adequacy ratio of 8 %.

Private sector the main focus of constitutional amendments. Thirteen proposed constitutional amendments are to be voted on at the PNC’s annual session. The amendment on increasing the role of the private sector is widely seen to be among the most significant. While private economic activity has been constitutionally allowed since 1988, the proposed amendment would require that the state encourage and nurture the private sector.

The All-China Federation of Industry and Commerce reports that the domestic private sector accounted for nearly half of the GDP in 2002. It generated 37 % of tax revenues and 42 % of total employment (excluding farmers). The private sector also implemented 40 % of total fixed investment in 2002. The more broadly defined non-public sector (which includes enterprises with foreign participation) accounted for 64 % of GDP, 58 % of tax revenue and 60 % of total exports in 2002.
Russia

Putin wins second term. Vladimir Putin took 71 % of the vote in last Sunday’s (Mar. 14) election (53 % in 2000). Second place went to Communist candidate Nikolai Kharitonov with 14 % of the vote, and third place to Sergei Glazyev with 4 %. Voter turnout was 64 % (69 % in 2000). Mr. Putin begins his second term on May 7.

President reshapes federal organisation. As part of Russia’s on-going administrative reforms, a new three-tier system of federal organisations has been announced. Central authority will be represented by ministries, federal services (sluzhba) and federal agencies (agentstvo). Federal ministries, the number of which has been reduced from 23 to 14, are responsible for setting policy and adopting regulations. While most federal services are supervisory bodies, several of them are special services reporting directly to the president. Federal agencies produce state services and administer state property.

The reform seeks to distinguish regulatory, supervisory and service functions of administrative bodies. Following the changes, ministers’ political responsibility will be enhanced; in addition to being accountable for their particular ministry, they will be accountable for operations of services and agencies under their ministries. A commission made up of representatives of ministries, the presidential administration and government staff has two weeks to submit proposals putting the government reform into practice.

President and prime minister outline near-term economic reform priorities. President Putin and prime minister Mikhail Fradkov have targeted tax reform as one of the near-term priorities. The government plans to rush its legislative proposal to the Duma so that new laws will be in place when the 2005 budget is prepared. The reform plan aims, among other things, at further reduction of the value-added tax and increasing taxes on the energy sector. Revised tax schemes for the energy sector have long been considered and various ministries have prepared competing alternatives.

During the Duma’s spring session, the government also plans to submit a proposal on a new act on subsoil use. It is hoped that the new act will increase the transparency of the permit-granting process and better secure the status of companies holding licences (something foreign oil companies, in particular, have wanted). Putin also made cautious comments on reform of natural gas monopoly Gazprom. Reform of Gazprom, the last great state monopoly, has been planned for years. Putin noted, however, that Russia’s economic development could be threatened if domestic gas prices were raised abruptly. Instead, the government will work to promote domestic competition by giving other gas producers an opportunity to use domestic gas pipelines owned by Gazprom. However, such producers would not receive free access to export gas.

2003 federal budget in surplus. In line with government targets, budget revenues and expenditures relative to GDP shrunk substantially in 2003. The budget surplus was 1.7 % of GDP, or roughly the 2002 level. Thus, Russia has produced budget surpluses for four years running. Taxes as a share of GDP fell last year. In particular, the profit tax and value-added tax accounted for smaller shares of the tax take, while customs fees accounted for an increased share. The reduction in profit tax reflects a shift in tax distribution in favour of regional budgets. Observers note the contraction in tax revenues also was the result of increased use of tax loopholes and increased malfeasance.

Expenditures as a share of GDP contracted, which reflected a reduction in the ratio of interest payments on domestic and foreign debt to GDP. The GDP share of non-interest expenditure was unchanged. The largest spending item in the federal budget was regional transfers, which also saw the biggest increases. As an aggregate, regional and local budgets in 2003 were slightly in deficit (-0.4 % of GDP), although federal subsidies to regions were up and a greater share of profit tax revenues was transferred to regions.

Preliminary figures show that in January and February 2004, the federal budget was in the red because budgeted transfers to regions were paid out early to make sure salaries were distributed ahead of the presidential election.

Federal budget 2002 and 2003

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<td><strong>Surplus</strong></td>
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Sources: Goskomstat and Economic Expert Group
China

Fixed investment growth accelerated in January-February. Fixed investment was up 53 % y-o-y in the first two months of this year. Fixed investment by state-owned enterprises rose 55 % and accounted for 60 % of total investments. Manufacturing registered a 79 % increase and accounted for 39 % of total investments. Investment growth as particularly strong in certain industries: for example, investment in non-ferrous metal processing was up 176 %. Construction also boomed, up 44 % y-o-y in the first two months of 2004. Construction of residential housing led the sector, soaring 49 %. Fixed investment in primary production continued to decline, however, and was down 25 % y-o-y in January-February (see BOFIT Weekly 10/2004).

The rapid expansion of fixed investments at the beginning of this year partly reflects a pick-up in fixed investment at the end of last year. Not only have many projects launched last year been extended into this year, but the schedules of many other investment projects have also been moved up due to apprehension over rising raw material prices. Prices of iron and cement, for example, have risen sharply.

The investment boom has challenged China’s government to find ways to preventing economic overheating. The value of fixed investment last year was equal to 47 % of GDP.

Land and resource ministry limits use of land for non-agricultural purposes to cool investment pace. China’s ministry of land and resources announced it was shifting its mission from supervision to macroeconomic management based on control of land use. The ministry said it would limit the use of farmland for industrial development purposes to 120,000 hectares this year as a measure to dampen investment.

Farmland per capita is less than 40 % the world average. From 1996 to 2003, almost 7 million hectares of farmland disappeared, with 2.7 million hectares re-purposed in 2003 alone. The shift has denied about 40 million farmers their livelihoods. The National People’s Congress recently approved a constitutional amendment that requires the government to compensate farmers fairly in the event of a taking of agricultural land for a different use.

Trade deficit widens in January-February. China’s trade deficit reached $ 7.9 billion in the first two months of this year, far greater than the $560m deficit for the same period last year. For all of 2003, however, China posted a trade surplus of $26bn.

The trade surplus is expected to shrink considerably this year, due in part to the fact that the government has cut VAT rebates on export goods. Both exports and imports rose briskly in the January-February period: the value of exports climbed 29 % y-o-y, while imports were up 42 %. Practically all the deficit for the first two months of this year was incurred in February.

The negative effect of the new VAT rebate regime on exports has been surprisingly modest. Thus, the widening trade deficit mainly reflects higher import volumes and import prices. In January, imports of crude oil jumped 23 %, while the oil price rose 8 %. The volume of iron ore imports was up 12 % and the price doubled. The steep increase in raw material imports apparently continued in February, although detailed figures are still unavailable. The trade deficit is generally seen as a passing phenomenon. The Chinese government is implementing measures to cool investment growth, which is expected to lead to lower import growth. On the other hand, export growth is expected to remain strong.

In any case, the trade deficit is too insignificant to alleviate revaluation pressures on the yuan. China will continue to amass foreign exchange reserves as long as the strong capital account inflows continue.

New Year holiday boosts retail sales. Retail sales climbed 11 % y-o-y in the first two months of 2004. Sales of large retailers increased over 20 % during the week-long Chinese New Year holiday. Cars, oil products and telecommunications equipment, which account for just 7 % of total retail sales, drove growth. New car sales were up 60 % y-o-y.

A survey at the end of February by the People’s Bank of China found consumer confidence had plunged to a record low. Only 31 % of interviewees said they intended to consume more at current price and interest levels. On the other hand, 10 % said they intended to buy a car in the coming quarter, while 21 % expressed their plans to buy an apartment. Some 46 % of those surveyed said they expected to make bank deposits or invest in stocks and mutual funds.

Inflation slows in February. After rising by over 3 % for three consecutive months, consumer prices increased just 2.1 % y-o-y in February. Food prices rose 5.6 %, while non-food prices were up only 0.3 %.
Russia

Robust growth of Russian economy continues. The combined production index of five base sectors of the economy increased 8.3 % y-o-y in January-February. Construction was up nearly 14 %, retail sales 10 % and industrial production and freight transportation about 8 % each. Agriculture, however, continued to contract with output falling 1 %.

In January-February, the fuel industry, ferrous metalurgy and wood processing were up 9 % y-o-y. Output of chemical and petrochemical industries climbed 11 %. A 12 % increase in production of construction materials evidenced brisk construction. The machine building and metal products sector grew 20 %, led by production of rail freight cars (up 90 %) and passenger cars (up 40 %)

Investment, which rose over 13 %, continues largely to drive economic growth.

Changes in CBR exchange rate policy. Since the floating of the rouble in 1998, the Central Bank of Russia’s exchange rate regime has sought to steer the rouble’s external value so that it closely tracks the dollar. At the beginning of this month, CBR deputy chairman Oleg Vyugin commented that Russia’s exchange rate regime should be modified to reflect the realignment of dollar and euro rates. Vyugin explained that the CBR could abandon its dollar anchor and steer the rouble’s exchange rate in relation to a dollar-euro currency basket. While most Russian exports are priced in dollars, half of imports come from Europe.

In February, the rouble was nominally up 11 % y-o-y against the dollar and 21 % in real terms. At the same time, the rouble’s value against the euro had nominally fallen 4 %, but strengthened 4 % in real terms. Observers point out that the CBR already considers both the dollar and euro in steering the rouble’s exchange rate. Over the past twelve months, the rouble’s nominal value has held rather steady against a basket of currencies of Russia’s main trading partners (the basket is heavily weighted to the dollar and the euro).

Reform of government bodies in full swing. In addition to prime minister Mikhail Fradkov, the central movers for economic reforms are the cabinet’s legislation head and sole deputy prime minister Alexander Zhukov and chief of staff Dmitri Kozak, coordinator of the reform of state administrative bodies. Other key reformers include economy minister German Gref, finance minister Alexei Kudrin and industry and energy minister Viktor Khristenko. They all now have more responsibilities than in the previous government.

The number of bodies within the central administrative bureaucracy (including ministries) has risen from 58 to 76.

The number of voting cabinet members, however, has declined from 58 to 17.

The industry ministry has experienced the biggest changes. It took over the energy ministry, atomic energy ministry, and space agency. It will also be responsible for production-sharing agreements. The industry and energy ministry together with transportation and telecommunication ministry will deal with reforms of monopolies in their sectors.

Goskomstat, the customs committee and the energy tariffs commission will all become services under the economy ministry. The former tax ministry is now under the finance ministry and is called the tax service.

Central bank deputy chairman Oleg Vyugin was tapped to lead an expanded financial market service. In addition to taking care of the functions of the former securities market commission, the new service oversees the investment activities of pension funds and activities of stock exchange. Although characterised as a financial super regulator, the service is not responsible for oversight of the banking or insurance industries. The service reports directly to the prime minister.

The government expects to finalise the divisions of duties among the various bodies on April 1.

Parliament approves Perm krai merger. The new region was created by the first amendment to Russia’s constitution since it entered into force in 1993. Constitutional amendments must be ratified with a 2/3 majority in the Duma and a 3/4 majority in the Federation Council.

Perm oblast, located in the Urals region, will merge with the Komi-Permyak autonomous okrug. President Vladimir Putin submitted his legislative initiative on the merger to the Duma a month ago after a large majority of regional residents approved the merger by referendum. The Komi-Permyak autonomous okrug has not been economically viable since the break-up of the Soviet Union. The new administrative region will come into existence on December 1, 2005.

Russia and EU views on EU enlargement start to converge. In a phone conference on March 11, Russian prime minister Mikhail Fradkov and EU Commission president Romano Prodi reached initial agreement on how to proceed regarding Russian concerns over EU enlargement.

Russia’s main worry is retaining its trade advantages in the face of EU expansion. The EU takes the view that all new EU members are parties to the partnership and cooperation agreement (PCA) with Russia.

The parties have accelerated the negotiations in order to make a joint declaration on the impact of EU enlargement at the same time as the PCA is extended to cover the new EU members.
China

Industrial sector shows robust profitability in January-February. In the first two months of 2004, net profits of large enterprises in the industrial sector climbed to CNY 144bn and were up 38% from the same period in 2003. The National Bureau of Statistics survey includes all state-owned enterprises and other industrial enterprises with annual sales over CNY 5m. SOEs accounted for 55% of total profits in the survey. The growth in SOE profits was hardly surprising as many of them hold monopolies on production of key raw materials.

Out of 39 industries in the sector, 34 recorded improvements in profitability. Highest profit growth was registered in metals refining, chemical industries and electrical power generation.

The improved profitability likely reflects strong sales of industrial products, which rose 29%. SOE profit margins exceeded 8% – two percentage points higher than foreign-owned enterprises.

Producer prices continued to rise in February. Producer prices climbed 3.5% y-o-y in February, matching January’s figure. Prices of production materials rose 4.6%, while prices of consumption goods rose 0.5%. Higher raw material and energy prices (up 8.1% y-o-y) lifted prices of production materials.

Ex-factory industrial product prices, % change, y-o-y

![Graph showing ex-factory industrial product prices]

Source: NBS

Real estate sector booms in 2003. Despite the SARS epidemic and tighter government policies on bank lending and land sales, strong demand drove robust growth in the real estate sector last year. Investments in real estate topped CNY 1,000bn (€100bn), a 30% increase from 2002. Investment growth was the highest since 1995. Investment in residential housing rose 29% and constituted two-thirds of total investment. The total floorspace of construction projects started was 29% greater than in 2002. Growth also accelerated last year.

Demand absorbed the supply quite well despite increased real estate production. Although the floorspace of completed construction projects rose 22% in 2003, the floorspace of vacant real estate rose only 2%. The average sales price per square meter of floorspace rose 4% y-o-y. The average price per square meter at the end of 2003 was about CNY 2,400 (230 euros).

China has sought to restrain the pace of construction by restricting land sales from the beginning of 2003. Nevertheless, the area of land sold increased 22% in 2003. Moreover, despite tighter bank lending measures on the real estate sector, domestic bank credit to the sector soared 45% in 2003. Down payments and prepayments accounted for 39% of total financing of real estate investments.

Development in the real estate sector varied considerably from project to project and region to region. Last year, investment in low-priced residential housing decreased 2% and only represented 6% of total investments. In western China, the stock of vacant real estate increased 16% and prices dropped.

China’s crude oil consumption rises rapidly. The International Energy Agency (IEA) reports demand for crude oil in China rose last year to 5.5 million barrels a day. China is now second only to the US in oil consumption. China’s annual consumption rose 10% and exceeded 250 million tonnes in 2003. The growth in China’s demand for oil has been reflected in higher world oil prices. This month the IEA revised its estimate for China upwards so that it now expects oil consumption to average over 6 million barrels a day this year. Rapid economic growth in the first two months of 2004 has increased demand even faster.

Just a decade ago, China was a net exporter of oil. Today, an increasingly large share of the country’s oil needs must be satisfied with imports. Increases in domestic oil production are outstripped by the rapidly rising demand.

China’s domestic crude oil output rose 1.5% last year to about 170 million tonnes, while imports rose 31% to about 90 million tonnes. China exported almost 10 million tonnes of crude oil in 2003. By 2030, China’s annual oil imports could grow to nearly 500 million tonnes, or 80% of national consumption.

Over half of the oil currently imported to China comes from producers in the Middle East. In coming years, China wants to increase its oil imports from e.g. Russia, Central Asia, and Africa. In February, China and the Russian oil company Yukos tentatively agreed that Yukos would increase its annual rail shipments of oil to China to 10 million tonnes by 2006. China has also negotiated with Russia on construction of an oil pipeline running from Siberia to Daqing in northeast China. The pipeline would transport nearly 30 million tonnes of oil a year to China. Russia is also in talks with Japan on the possible construction of an oil pipeline to Nakhodka. Construction of both pipelines is generally considered out of the question. In February, it was rumoured that Russia was leaning towards the Japan pipeline. No official decision has yet been taken, however.
Russia

Russian share prices hit record highs. The RTS Stock Exchange index reached an all-time high on March 31 of 755. The RTS index is up 33 % since the start of the year. The market capitalisation of listed companies now totals about $230bn, or about 50 % of GDP. Share prices are generally higher, but Sberbank, Gazprom and the oil companies have chalked up the largest gains. The value of Sberbank shares has been buoyed by the bright outlook for the Russian economy and the recent GDR-program (Global Depository Receipt) of Sberbank shares arranged by Deutsche Bank. The soaring shares of oil companies mainly reflect high oil prices. Gazprom shares have been driven up e.g. on rumours that trading in them will be opened up to foreign investors.

RTS index

Source: RTS Stock Exchange

2003 sees diversification in bank deposits and credit.

The nominal value of household deposits held by the over 1,300 banks operating in Russia continued to grow almost at the previous year’s pace, 47 % (consumer price inflation in 2003 was 12 %). Deposits with Sberbank, Russia’s largest bank, rose nearly 40 %. The bank’s share of household deposits at the end of last year was 63 % (67 % at the end of 2002). The growth in deposits of smaller banks (those not in the top 20) was about 80 %, and their combined share of deposits rose to 22 % (18 % in 2002).

Corporate deposits increased 33 %. Growth was strongest among the 51–200 largest banks, a category which now holds over a fifth of corporate deposits. For banks larger than this, the share of corporate accounts fell; for banks smaller than this, the share remained unchanged.

Corporate lending expanded over 40 % last year, which was faster than in 2002. Lending was up 50–60 % for banks in the category of the 6–20 largest banks and in the category of banks ranked 51 or smaller. These smaller banks accounted for nearly 25 % of the corporate loan stock.

Rouble credits rose 46 % and represented 67 % of corporate credits at the end of the year. In both rouble and foreign currency lending, fastest growth was in loans for over one year. Such loans accounted for 38 % of total corporate loans.

The stock of bank loans to households more than doubled. Banks in the 21–50 largest category saw lending increase 550 %, while the banks ranked 6–20 experienced a rise of 350 %. The share of household loans of the sum of household and corporate loans at the end of the year was nearly 12 % (8 % a year earlier). Rouble loans to households grew slightly faster than foreign currency loans. Over 80 % of all household loans were rouble loans.

Share of deposits and loans held by Russia’s approx. 1,330 banks, Jan. 1, 2001–Jan. 1, 2004, % (banks ranked by assets)

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<th>Household</th>
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Source: CBR

President Putin continues administrative reshuffle. The presidential administration head Dmitri Medvedev will only have two deputies, Vladislav Surkov and Igor Sechin (reduced from eight). Surkov is the president’s most trusted political adviser, while Sechin, who hails from St. Petersburg, is a representative of the “power” ministries. A new expert department will replace the former departments for the economy, domestic policy and regions. The shake-up is essentially formal, like in the federal central bureaucracy, when actual administrative tasks and procedures will remain essentially unchanged and few personnel cuts are expected. The six former deputy heads will continue as presidential advisers. Among those continuing are the president’s economic adviser Andrei Illarionov and the presidential representatives for the seven federal administrative districts.

The introduction of the Russian rouble in Belarus postponed. Russian finance minister Alexei Kudrin said that Belarus’ planned shift to the Russian rouble must be delayed until 2006. Belarus is still not prepared to handle the proposed currency union, nor has Russia approved financing the budget costs Belarus has required for the switch-over.
China

Central bank implements further measures to restrain credit growth. To quell credit growth, the People’s Bank of China decided last week to modify some banks’ reserve requirements and two interest rates. In January-February credit growth substantially outpaced the central bank’s 16% target for 2004. At the end of February, the credit stock was up 21% y-o-y. Many observers consider the PBOC’s measures last week insufficient to rein in credit growth.

The central bank decided to redefine the reserve requirement so that it will reflect banks’ capital adequacy ratio and level of non-performing loans. As of April 25, the reserve requirement will rise 0.5 percentage points to 7.5% for banks that fail to meet the capital adequacy requirement. Notably, the central bank has yet to declare what this requirement will be. It has said, however, that the reserve requirements for China’s four main state-owned banks, as well as rural and urban credit unions, will remain unchanged. Thus, the change mainly affects regional and other commercial banks, which currently control about a fifth of the lending stock. Although the lending of such banks has grown rapidly in recent months, the changes are not expected to have a significant impact.

The PBOC also increased the rate it charges banks for loans without collateral by 0.63 percentage points. The 20-day rate is now 3.33%. The ceiling on the rediscount rate was also raised 0.27 percentage points to 3.24%. The measures are expected to have little effect as such rates are rarely applied. On the other hand, the reference rate for one-year loans, which the central bank has traditionally relied on as a major monetary policy instrument and which provides benchmark in determination of bank loan interest rates, was held unchanged at 5.31%.

Development of bank lending

The PBOC released a 10-point program for restoring the health of the Bank of China and China Construction Bank. The goals include improved corporate governance, formation of a development strategy and effective decision-making and management. The banks should immediately begin the migration to international accounting standards and improve staff skill sets. Foreign and domestic strategic investors will be invited to buy stakes in the two banks. The sale will most likely take place through a stock market listing. At the beginning of March, prime minister Wen Jiabao set out the goal that within three years the Bank of China and China Construction Bank operate under commercial bank principles and are internationally competitive banks.

The two banks are by most standard measures the healthiest of China’s four large state-owned banks. Last year, the banks managed to reduce their stock of non-performing loans to 12–16% of total loans. However, the reduction was achieved mainly as a result of the rapid credit expansion. Ahead of listing, officials want to increase their capital adequacy ratios above 8% and reduce the stocks of non-performing loans below 10%. Reform of the Bank of China and China Construction Bank was accelerated at the end of last year when China invested $45bn of its foreign currency reserves in strengthening the capital structure of the banks (see BOFIT Weekly 2/2004).

US files complaint with WTO on China’s taxation of foreign made semiconductor components. On March 18, the US submitted a complaint to the WTO on China’s imposition of a 17% value-added tax on imported semiconductors. Semiconductors made in China, in contrast, are subject to 3% VAT. Chinese officials counter that the system of rebates assures domestic and foreign manufacturers of equal treatment, and in fact the arrangement was intended to attract foreign investment. International trade experts, however, doubt China will be able to justify such tax treatment to the WTO. EU, Japan, the Philippines and Taiwan have all preliminarily declared support for the US initiative. China has granted bilateral talks with the US. Under WTO rules, the countries have 60 days to resolve the issue. It is the first time any country has filed a complaint against China since it joined the WTO over two years ago.

China’s massive electronic assembly sector still imports 80% of its components from abroad, but the share of domestically produced components is growing rapidly. Semiconductors are among the most important export goods of the US to China. Semiconductor manufacturing employs 225,000 people in the US.
Russia

Rise in consumer prices continues to slow. March consumer prices were up 10.3 % y-o-y. During the month, prices rose 0.8 %. Unlike in previous months, prices for goods increased faster than services. In particular, the rise in prices of housing and municipal services in March was well off the pace of previous months.

Industrial producer prices have soared since the start of the year, in part reflecting developments in world market commodity prices. The latest figures (February) show that producer prices were up nearly 19 % y-o-y. Freight transport prices rose 20 % y-o-y in February. In industry, the largest increases were seen in ferrous metal products (33 %), non-ferrous metal projects (28 %) and crude oil and natural gas (up 22 % each). The rapid rise in producer prices and freight costs could put upward pressure on consumer prices.

### Trends in consumer prices and industrial producer prices

(Previous month = 100)

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Source: Statistics service

Huge current account surplus sustained last year. CBR’s fresh statistics place the current account surplus for 2003 at $36bn, up from $29bn 2002. The surplus corresponded to about 8 % of GDP.

The goods trade surplus grew significantly last year to $60bn. The services balance, on the other hand, showed an $11bn deficit that was largely driven by the tourism abroad. The income balance deficit hit a record of $13bn. Most of the deficit was generated by interest and dividends paid out to foreign investors.

Last year, the net outflow of capital from Russia was about $2bn. The net outflow of foreign direct investment was $3bn and portfolio investments $5bn. Russia netted $6bn from other investments, mainly borrowing from abroad. (In gross terms, Russia received nearly $19bn in other investments.) Russia’s foreign currency and gold reserves increased by an impressive $26bn last year.

The net errors and omissions item in the balance of payments was $7bn. This figure is typically lowered in the revised balance-of-payments figures. The item partly suggests illegal foreign currency outflows. Revised 2002 figures for net errors and omissions were almost $7bn.

Administrative reform continues in Putin’s second term. The goals set by the president include improving the general standard of living of Russians in coming years and improving the business climate. Other goals are raising the efficiency of public administration while reducing costs and slashing corruption. Last month, Dmitri Kozak, chief of government staff, was put in charge of a special administrative reform commission.

Russia’s bureaucracy currently employs about 1.3 million administrative officials, including almost 600,000 at the federal level. One job of Kozak’s commission will be to decide on how to reduce the number of workers and departments in federal government bodies. The remaining officials would get pay raises under the current budget parameters. Critics of the plan include deputy economy minister Arkadi Dvorkovich, who notes that the reductions are decided by the government not necessarily taking into account the actual needs in various bodies.

To date, administrative reform has involved election and political party legislation, the courts and the convention of the Federation Council.

Last year considerable effort went to clarifying the administrative and budgetary relations of federal, regional and local levels. Reform of budgetary relations in all sectors remains a priority and will strongly affect education, health care, social security, culture, housing and municipal services.

Company registration and the procedures for getting operating licences have been simplified in recent years. However, these reform efforts are not necessarily evident in the daily operations of companies.

The organisations of federal administrative bodies and the presidential administration were reformed in March, and further reforms are expected to affect the government staff, as well as regional and local administrations.

Finance minister Alexei Kudrin estimates that so far only 10 % of the administrative reform has been implemented.

Adjustments in central bank leadership. Deputy finance minister Alexei Ulyukaev (48) will replace CBR deputy chairman Oleg Vyugin, who was named last month to head the new federal financial market service. Ulyukaev will be responsible for monetary policy and macroeconomic issues.

Dmitri Tulin (48) becomes CBR deputy chairman in charge of banking supervision. His most recent post was head of Russia affairs at the EBRD.
China

New forex policies on Mainland Chinese seek to combat revaluation pressures. The state administration of foreign exchange (SAFE) has taken measures on controlling capital inflow and easing foreign currency purchases to relieve currency revaluation pressure.

Since the beginning of April, the maximum amount of foreign currency a private individual can exchange into yuan in a single transaction in commercial banks was reduced from $200,000 to $50,000. For transactions above the designated amount, individuals must obtain permission from SAFE.

Last October when SAFE boosted the amount of foreign currency private persons can take with them when travelling abroad. Private individuals can now take up to $2,000 in foreign currency with them when travelling for tourism. If their trip is to last longer than six months, they may take up to $5,000. Students abroad may purchase up to $20,000 without SAFE approval. Transfers of foreign currency abroad are also easier than before.

The slackening of foreign exchange rules has increased forex buying. From October 2003 to February 2004, the foreign currency buying of private persons rose 51 % to $475 million. Departing tourists increased their purchases of foreign currency 164 %. Foreign exchange statistics indicate that Hong Kong consolidated its position as the most-favourable travel destination. In the five-month period, it attracted 40 % of the total foreign currency cash purchased by travellers.

Short-term borrowing drove external debt growth last year. China’s foreign debt rose 13 % last year to $194bn. Nearly all the upsurge was due to short-term borrowing, which increased 38 % y-o-y to about $76bn. At the end of 2003, short-term borrowing represented 40 % of total foreign debt, the highest level since 1985.

The state continued to be the largest borrower with 34 % of external debt. Foreign-owned enterprises and domestic financial institutions trailed with 24 % each. Foreign banks also increased their foreign borrowing.

While China’s foreign debt has grown in absolute terms, it remains under 14 % when measured by the ratio of external debt to GDP. In 2002, the ratio of debt servicing to exports of goods and services was 40 %, while the ratio of short-term debt to foreign currency reserves was 19 %. Both ratios are low by international standards.

Foreign-currency-denominated loans by financial institutions operating in China have increased evidently on the expectation of a possible yuan revaluation. At the end of February, the balance reached $136bn, or 30 % of increase from a year before. Meanwhile, foreign-currency-denominated deposits shrunk by 3 % to $146bn.

Amendments to foreign trade law. The standing committee of China’s parliament endorsed amendments to the foreign trade law on Tuesday (Apr. 5). The earlier version of the law, which dates back to 1994, is generally considered outmoded. The new law is expected to reduce the state’s role in foreign trade and corresponds better the WTO membership requirements. One of the most significant amendments allows individuals to participate in foreign trade, a move that effectively abolishes the trade license regime that earlier gave the state absolute control over foreign trade. To address the concerns of China’s trading partners, the new law also includes protection of patent rights in foreign trade. Changes were also made on the rights of importing some special products like oil, grain and cotton. Previously only state-owned enterprises could import these products. In 2003, China ranked fourth in the world in foreign trade. Its combined imports and exports corresponded to over 60 % of GDP. China’s share of international trade has grown rapidly. In 1994, China ranked 11th globally in foreign trade.

Mainland China’s rapid growth in 2003 also benefited economic development of Macao and Hong Kong. The GDP of China’s Macao special administrative region rose 15.6 % last year, well exceeding growth under 10 % in 2002. GDP per capita reached about €16,000. Economic growth accelerated towards the end of the year thanks to a flood of tourism from Mainland China. The boom in tourism stimulated growth in other sectors such as construction. A third of Macao’s GDP derives from the gambling industry. Nearly a half million people live in Macao.

According to preliminary figures, the Hong Kong special administrative region posted GDP growth of 3.3 % y-o-y last year. The service sector, which dominates the Hong Kong economy, grew 4 %. Hong Kong’s financial service and insurance services, up 10 %, benefited considerably from Mainland China’s rapid economic growth. Foreign trade services rose 14 %. Losers included restaurant and hotel services (-11 %), manufacturing (-9 %) and construction (-5 %). Hong Kong’s GDP per capita last year was about €21,000. Hong Kong has a population of nearly 7 million.

Real GDP of Macao and Hong Kong, percentage change from previous year

Source: IMF, Macao and HK statistical offices
Russia

Russia’s federal finances remain stable. Preliminary figures from the finance ministry for 1Q04 indicate the federal budget produced a RUB 63bn (€1.8bn) surplus, even with large interest payments. The surplus corresponded to 1.8 % of estimated GDP for the quarter. Budget revenues were RUB 689bn, exceeding the budgeted amount by 8 %, while expenditures were 8 % less than budgeted.

Finance minister Alexei Kudrin estimates this year’s overall budget surplus will equal 1 % of GDP, i.e. exceed the target of 0.5 % of GDP set out in the 2004 budget act. Some observers even foresee a budget surplus of nearly 2 % of GDP. The growth in the surplus reflects higher-than-anticipated oil export prices, which, in turn, have boosted customs and tax revenues.

The first quarter surplus was transferred to the stabilisation fund, which stood at RUB 143bn (€4bn) at the end of March. The purpose of stabilisation fund is to provide for budget needs in years when the oil price is low. Sources in the Russian government expect the stabilisation fund to reach RUB 300bn (€8.4bn), about 2 % of GDP, by the end of this year. When the stabilisation fund reaches RUB 500bn, further surpluses may be used for other purposes.

Foreign debt of enterprises and banks grew in 2003. CBR figures show that the gross foreign debt of banks rose last year to $25bn. At the same time, the net foreign claims of banks shifted by year’s end to several billion dollars in net debt. Enterprises actively borrowed from abroad and their gross foreign debt at year’s end was $50bn. The gross federal foreign debt (debt to non-residents) was nearly $98bn, of which $58bn was inherited from the Soviet Union.

Tax system reform takes shape. Last week, the government approved tax reform proposals from the finance ministry and then submitted the proposal on to the Duma. The tax reform, which has been under way for the past two years, seeks to clarify taxation and lower the overall tax burden. The current amendments shift tax burden from value-added industries towards extracting sectors. The revised system takes effect in 2005 and 2006. Thereafter, no further significant changes to the tax system are anticipated.

Under a draft bill, the maximum rate companies would contribute to the unified social tax (a regressive tax) would fall from 35.6 % to 26 %. The reduction is designed to expand the tax base by reducing the incentive to take wages under the table. The finance ministry estimates the reform will lower the effective tax rate on company payrolls from 29 % to 24 %.

In addition, the oil export tax will be raised already this year. The oil export tax rate is dependent on the prevailing world market price of oil. The current maximum rate of 40 % is raised under the law to 65 %. The lowest rate will remain at 35 %, and will be applied when the oil price is between $15 and $20 a barrel. Under the government’s proposal, the oil extraction tax would rise 15 % as of the start of 2005.

Government sources also said that the value-added tax, which was lowered to 18 % at the beginning of the year, will be lowered further. The matter, however, has yet to be decided. The finance ministry has also proposed increasing dividend tax from 6 % to 9 %. The idea here is to reduce the use of dividends as a cheap surrogate for wages (income is currently taxed at a rate of 13 %).

Russia’s WTO talks will stretch into 2005. The sessions of WTO talks in March dealt with a broad spectrum of issues. Russia has made bilateral agreements with a few countries on access of goods to the Russian market. The agenda of the WTO working group held in Geneva at the beginning of this month covered e.g. technical barriers to trade, trade and customs legislation and free-trade agreements.

Russia’s lead negotiator Maxim Medvedkov commented that the most contentious issues involve customs tariffs on automobiles and civil aircraft, agriculture, Rostelekom’s monopoly on long-distance calls, access to Russian insurance markets, establishing bank branch offices in Russia and intellectual property rights protection. A big issue is Russia’s energy sector, particularly domestic pricing of electricity and natural gas. Medvedkov claims that the domestic gas price is no longer below production cost. Economy minister German Gref says that raising domestic energy prices is an important way to promote energy savings. However, he favours the gradual phasing in of any price increases.

Medvedkov said the talks have also raised other questions. Does Russia violate the WTO’s anti-discrimination principles if it sells natural gas more cheaply to CIS countries than other countries? Does the special economic zone of the Kaliningrad enclave function in conformity with WTO requirements? How might WTO rules limit Russian regional policy?

The WTO working group’s next meeting is scheduled for June. The agenda will include pricing practices of state-owned enterprises, customs clearance regulations and export financing arrangements. Medvedkov expects the talks to be completed during spring 2005.

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Information herein is compiled and edited from a variety of sources. The Bank of Finland assumes no responsibility for the completeness or accuracy of the information.
China

Industrial output growth continues strong this year. Industrial output was up 19 % y-o-y in March, exceeding the rate for January-February of 17 % y-o-y. Industrial output was up 17 % for all of 2003.

The National Bureau Statistics identified three factors driving growth. Foremost was investment growth, which remained brisk in the first quarter. For example, steel production was up 26 % y-o-y, steel products production 30 % and cement production 24 %. Moreover, strong domestic demand and booming exports increased production of automobiles (37 %), mobile phones (42 %), digital cameras (93 %) and laptop computers (65 %). Energy production, in response to strong economic growth, was up 16 % y-o-y in the first quarter.

Firms that were wholly or partly foreign-owned posted the biggest production gains in 1Q04, 21 %. Industrial state-owned enterprises showed 15 % production gains.

Producer prices continued to rise in March. A central bank monitoring report finds that producer prices climbed 8.3 % y-o-y in March. The on-month change was 1.3 %. Investment goods rose 8.8 % y-o-y, while consumer goods were up 7.4 %. Prices of agricultural products increased 14 % y-o-y, while grain prices rose 28 %. Prices for smelting and processing of nonferrous metals rose 32 %, and coal prices were up 24 %. While rocketing raw material prices indicate the Chinese economy is overheated, prices of durable goods actually fell 2 % y-o-y. Car prices, for instance, were down 4 %.

Strong domestic demand increases imports. In the first quarter of 2004, China’s trade deficit rose to nearly $8.5bn. A year ago the deficit was only about $1bn. The expanding deficit reflects a rapid rise of imports. In the period January-March 2004, imports to China rose 42 % y-o-y, outpacing the 34 % growth in exports.

Strong domestic demand underlies China’s import growth. The investment boom has increased demand for both raw material inputs and energy. The value of such imports in January-March increased 62 % y-o-y. Both higher import volumes and higher prices for raw materials were behind the increase. Foreign direct investment also increased imports to China in the form of machinery and equipment. Moreover, the strong export growth has increased imports of parts and components.

55 % of China’s exports were machinery and electrical devices, which grew 47 % y-o-y. Textile exports also increased sharply.

Exports and imports, percentage change from four quarters previous

Consumer confidence stable in first quarter. The National Bureau of Statistics reports that consumer confidence in the first quarter remained at the same level as at end of last year. Chinese consumers were confident about their current economic conditions, with 71 % planning to buy durable goods in the near future. Consumer confidence for the medium term slipped, however, reflecting growing economic uncertainty. Over 30 % of consumers were unsure over the direction of the economy.

Central bank moves to cool credit market. The People’s Bank of China to increase the reserve requirement for select underperforming banks (see BOFIT Weekly 14/2004). By raising the deposit reserve requirement for all banks, the PBoC hopes to rein in credit growth and curb investment.

PBoC regulations do not apply to all credit institutions, however. Rural and city credit cooperatives will continue to be subject to a 6 % deposit reserve requirement. On the other hand, banks failing to meet the capital adequacy requirement face a deposit reserve requirement of 8 %. It is estimated that the higher deposit reserve requirement will freeze around CNY 110bn in bank reserves.

The higher deposit reserve requirement is expected to dampen money supply growth in China. The broad money supply measure M2 was up 19 % y-o-y in March, while credits in both foreign and domestic currencies were up 21 %. China’s M2 growth target for this year is 17 %.
Russia

Current account surplus remains large in first quarter. Preliminary figures from the Central Bank of Russia show the current account surplus in the first quarter was $11bn. Although the amount represented a slight decline from 4Q2003, the surplus was still 9 % of GDP. The trade surplus rose to $17bn. The services deficit, and notably the investment income balance deficit (mainly interest and dividends paid to foreigners) deepened.

Russian earnings on exports of goods and services exports increased nearly 15 % in dollar terms from a year earlier, mainly reflecting an over 25 % jump in crude oil export earnings. Spending on imports grew nearly 20 %. Like last year, much of the growth in the trade figures could be attributed to the ongoing decline of the dollar.

The banking sector transferred notable amounts of capital abroad. The most significant figure for the corporate sector, according to the preliminary figures, was foreign direct investment inflows, which rose to nearly $3bn.

Foreign-exchange policy to stress two-currency basket. In recent years, the CBR has set annual limits for the rouble’s effective exchange rate against a foreign-trade-weighted basket, while lacking a simple exchange-rate target. This year, the rouble’s real effective exchange rate will be allowed to strengthen up to 7 %. That amount of strengthening is considered acceptable in light of productivity gains.

Public debate previously has centred on the rouble-dollar exchange rate. Central bank deputy chairman Konstantin Korishchenko said a basket with euro and dollar components would be the basic measure in setting foreign-exchange policy. Initially, the euro’s share would only be 10–20 % of the basket, but eventually it would rise to 50 %. In place of a trade-weighted basket, the 7 % ceiling would apply to the real value of the new currency basket. The central bank, however, has made no official decision.

The share of euro trading in the Russian forex market is still quite small. Moreover, a third of Russia’s foreign trade is conducted with countries of the euro area, a considerable amount of pricing is done in dollars. In this respect, a 50 % euro weighting in the currency basket would be quite large.

Despite CBR interventions, the rouble has continued to strengthen as a result of the large current account surplus. In the first quarter of 2004, the rouble strengthened nominally 3.2 % against the dollar, 3.1 % against the euro and 2.6 % against the trade-weighted currency index. In real terms, the rouble strengthened 4.7 % according to the trade-weighted index. This month, the rouble weakened slightly against the dollar and strengthened against the euro.

The uncertainty over exchange-rate policy was further increased recently by the fact that some officials have started to emphasise an inflation target. Both the government and the central bank have targeted an 8–10 % rise in consumer prices for this year.

Rouble’s exchange rate, January 2002–March 2004

Yukos assets frozen, creditworthiness downgraded. On April 16, a Moscow arbitration court ordered a ban on the sale and transfer of Yukos assets. The ruling followed a tax authority filing to recover over RUB 99 billion ($3.5bn) in unpaid taxes in 2000. The initial court hearing on the dispute between the ministry and Yukos is set for May 7.

While experts are divided on the impact the freeze will have on the company’s day-to-day operations, it will affect liquidity management and strategic decisions. The asset freezing also drove international credit agencies Standard & Poor’s and Moody’s to lower Yukos’ ratings. S&P downgraded Yukos from BB- to CCC, while Moody’s dropped the company from B3 to B1. Finance minister Alexei Kudrin said Yukos’ tax problem could still be settled out of court. The market capitalisation of Yukos remains among the largest of listed Russian companies.

Hefty pay raises for senior officials. A presidential decree of April 10, granted the largest raise to state officials in post-Soviet history. The increase affects about 35,000 federal officials in mid- and high-level positions. In some cases, the salary hikes amount to hundreds of per cent. Observers generally praised the move, which is intended to attract well-educated specialists into civil service careers, encourage job performance and discourage bureaucrats from supplementing their salaries with bribes.

The increase boosts the president’s monthly salary to about €4,300, the prime minister’s salary to €3,400 and ministerial salaries to around €2,500. The hikes will be financed through reductions in personnel. Predictably, the pay hikes incited a debate in the Duma and Federation Council. Under a law passed in August 2001, the parliamentary speakers’ salaries should match the prime minister’s and deputy salaries should match ministerial salaries. The average monthly wage in Russia in March was €190.
China

China’s economy continues to boom. In the first quarter of 2004, China’s GDP grew 9.7% y-o-y. Last year, GDP growth was 9.1%, and 9.9% in the fourth quarter.

Growth was strong in all sectors of the economy. On-year growth in fixed investments was a sizzling 43%. Investments rose sharply in heavy industry, which benefited from China’s current building boom. Exports also expanded an impressive 34%.

China’s rapid growth has reinforced the perception that the economy is severely overheated. The government wants to restrain GDP growth to 7% this year and the authorities have sought to slow the pace of investment e.g. by raising the deposit reserve requirement (BOFIT Weekly 16/04). It is doubtful whether such measures will have much effect. The People’s Bank of China has no plan to raise key interest rates in the near future, in part because the effect of such a hike in curbing economic growth may be small. Given the current situation, a rate hike could actually stimulate capital flows into China. The PBoC’s current one-year lending rate to commercial banks is 5.31%.

GDP, percentage change from four quarters previous

<table>
<thead>
<tr>
<th>Year</th>
<th>GDP Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>7.0%</td>
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<tr>
<td>2001</td>
<td>9.0%</td>
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<tr>
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<td>10.6%</td>
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<td>2004</td>
<td>10.5%</td>
</tr>
</tbody>
</table>

Source: National Bureau of Statistics of China

China relaxes currency controls to cool money supply growth. China’s officials announced an easing of currency controls last Friday (Apr. 16). Starting May 1, Chinese enterprises will be allowed to hold a larger share of their export earnings in foreign currencies. The move is designed to slow growth of the money supply.

Under the old rules, companies were compelled to convert 80% of their export earnings into yuan. The currency control regime was last modified in October 2002.

Inflation accelerates in March. Consumer prices were up 3% y-o-y in March. On-year inflation was 2.1% in February. Food prices rose fastest, prices climbing 7.9% from March 2003. Grain prices soared 30%, reflecting the fact that grain production in China has fallen for four consecutive years. The price rise in other product groups has not been as rapid, and in certain product groups prices have fallen steadily. For example, car prices were down 3.8% y-o-y and prices for telephone equipment were 15.7% lower. Goods prices on average rose 3.4% y-o-y, while the rise in the average price of services was just 1.8%.

Chinese inflation picked up in autumn 2003, and has remained in the 3% range since last December.

Consumer prices, percentage change from 12 months previous

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<thead>
<tr>
<th>Year</th>
<th>Inflation</th>
</tr>
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<tr>
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<td>-2.0%</td>
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<tr>
<td>2001</td>
<td>-2.3%</td>
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<td>1.4%</td>
</tr>
<tr>
<td>2004</td>
<td>3.0%</td>
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</table>

Source: PBoC

Growth in retail sales remains brisk. In the first quarter, retail sales volumes rose 9.2% y-o-y. Sales increased in all sectors, and were especially strong in car sales (up 57% y-o-y), oil products (38%) and telephone equipment (60%). Retail sales grew faster in urban areas (12.3%) than in rural areas (7.6%).

Housing prices up in China’s major cities. A recent survey by the National Development and Reform Commission found that for the first quarter of this year, housing prices rose on average 8% y-o-y in 35 cities. A large hike was seen in Shanghai, where housing prices shot up 30%. Shenyang (population 4.5 million) in northeast China experienced an increase of 20%, while in Qingdao (pop. 7 million) in eastern China housing prices rose 16%. In the capital Beijing, housing prices grew just 2%.
Russia

Russian economic growth gathers steam in first quarter. Preliminary figures from the economy ministry indicate that Russian GDP grew 8.2% y-o-y in 1Q04. The State Statistics Service (Goskomstat’s new name) reports that among the five basic production sectors of the economy, growth was highest in construction (up 14% y-o-y). Next came retail sales with 10% growth. Industrial production and freight transport increased about 8%. Agricultural production contracted approximately 1%.

Fuel production grew 9%, although coal production rose only 1% and natural gas production 3%. Crude oil production rose 11%. Machine building and metal product industry increased nearly 18%, construction material production 12% and foodstuffs 7%. These figures reflect rapid growth in investment and consumption. Investments increased 13% and real wages 16% from a year earlier.

Key economic forecasts put Russian growth at around 6% this year. Russia’s economy ministry has revised its GDP forecast upwards in its more optimistic scenario to 6.4% growth this year. The scenario assumed world oil prices remain essentially unchanged from 2003.

The most recent analyst consensus forecasts are also in the 6% range.

Looking ahead, the economy ministry expects the average pace of GDP growth to exceed 6% a year in the period 2005–2007 even if oil prices decline (5% in 2005 and 8% in 2006). The IMF also awaits Russian GDP growth clearly above 5% in 2005, even if oil prices fall 10%.

Higher taxation on oil exports and production. On April 23, in three back-to-back readings, the Duma approved changes in oil taxation. The export tax on crude oil will continue to be based on the world price of Urals-grade crude. Under a new four-tier regime, the tax rate will rise to 35% when the oil price is in the range of $15–20 a barrel; to 45% when the price is $20–25 a barrel and to 65% when the price exceeds $25 a barrel. No export tax will be charged for oil price below $15 per barrel. The current tax rate ceiling is 45%.

The tax increase takes effect as of August. When the oil price is above $25, the tax liability of oil exporters will increase substantially as compared with current rates. At the prevailing $30 price, for example, exporters would owe $7.25 per barrel.

The mineral extraction tax (MET) on oil production rises 15% at the beginning of next year. After the increase the MET is calculated from a base rate of 400 roubles per tonne, which corresponds to an Urals oil price of $18 a barrel. The tax automatically adjusts upward or downward with the rise and fall of world oil prices.

EU and Russia agree on EU enlargement measures. The EU and Russia have signed a protocol to their Partnership and Cooperation Agreement (PCA), confirming that the PCA will cover the ten new EU members (their memberships become effective tomorrow). Both Russia and the EU were deemed to have shown flexibility in the talks.

The joint statement on EU enlargement and EU-Russia relations mentions that tariffs on goods of Russian origin will decline on average from 9% to 4% in the acceding countries, special transitory measures will apply to certain Russian aluminium exports and import quotas on Russian steel products will be raised. Transitory measures will also be put in place regarding certain anti-dumping measures applied by the EU in order to prevent sudden disruptions of trade flows. Current agreements on exports of Russian nuclear materials with new EU members may remain valid. The EU confirmed that no limitations will be imposed on imports of Russian fossil fuels and electricity. The EU and Russia affirmed transit policies on goods moving between the Kaliningrad enclave and other parts of Russia, i.e. such transit of goods should be reasonably unimpeded, timely and free from duties.

Current visa issuance regimes will remain in place to the extent that such practices are compatible with EU and Russian legislation. Conditions for visa-free travel will continue to be examined over the long term. Both sides welcomed EU membership as a guarantee of protection of human rights and minorities, and both the EU and Russia reaffirmed their commitment to the protection of human rights and those belonging to minorities.

Russia plans to privatise over 4,000 businesses this year. The privatisation line-up this year identifies over 2,200 enterprises and over 1,900 unitary enterprises. The government expects to raise at least RUB 30bn (€900m) for the sales. The largest sales include stake in the Lukoil oil company, telecommunications giant Svyazinvest and the Magnitogorsk smelters and refinery. According to economy minister German Gref, the government will soon consider the conditions of sale of a 7.6% stake in Lukoil. The bidding is likely to start at around €1.6bn.

Last year, Russia privatised over 2,000 businesses, mainly in the defence industry, agriculture and transport sector. The sales raised about RUB 90bn, or RUB 40bn more than planned. The windfall earnings were mostly generated in the sales of Slavneft and Lukoil shares.
China

Two key forecasts envision economic growth above 8%. Both the IMF and the Asian Development Bank recently released their economic forecasts for China in 2004 and 2005. The IMF’s World Economic Outlook sees China’s GDP rising 8.5% this year and 8% next year. Investment growth will continue and Chinese exports will remain vibrant. The IMF noted that the Chinese economy now faces the threat of overheating and recommended that the country tighten economic policy and begin moving towards a more flexible exchange-rate policy. The Fund suggested that a controlled appreciation of the yuan could help stave off overheating of the economy.

The Asian Development Bank forecasts GDP growth this year of 8.3%. In 2005, total production would grow 8.2%. The ADB also warned of China’s overheated economy, but the growth pace of investments is expected to be cut in half to about 16% both this year and next. The current account surplus should shrink, because import growth is outpacing export growth.

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<tbody>
<tr>
<td>GDP growth</td>
<td>8.5</td>
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<tr>
<td>Inflation</td>
<td>3.5</td>
<td>3.0</td>
<td>3.0</td>
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<tr>
<td>Current account, % of GDP</td>
<td>1.6</td>
<td>1.9</td>
<td>1.3</td>
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</tr>
<tr>
<td>Public economy, % of GDP</td>
<td>-2.7</td>
<td>-2.5</td>
<td>-2.5</td>
<td>-2.3</td>
</tr>
</tbody>
</table>

Official unemployment rate at 4.3% in the first quarter. China’s unemployment rate remained at the same level as in 2003. Unfortunately, unemployment measured in terms of those officially registered as unemployed tells very little about the actual employment situation in China. Three major deficiencies can be readily identified. First, unemployed persons must live in a city to register for unemployment. Second, unemployment statistics do not apply to workers dismissed from state-owned enterprises or cooperatives, because their employers are supposed to provide them with a basic income. Third, unemployment figures exclude workers from the countryside that have moved to urban areas to seek work.

Reform of China’s banking sector continues. Banking sector reforms has become a hot topic in China, in part because the terms of its WTO membership require that it open up its banking markets to foreign competition no later than December 2006.

Partial privatisations of Construction Bank and Bank of China, two of China’s four large state-owned banks, are planned to take place at the end of this year or next year. In anticipation of the sale, the banks have until September to reorganise their operations. Construction Bank succeeded in slightly reducing its stock of non-performing loans in the first quarter to below 9% of the bank’s entire loan stock. This level is considerably lower than the non-performing loans stocks of other large state-owned banks, in part because Construction Bank received a $22.5bn bailout from the state at the end of last year. About one-fifth of the Chinese banking sector’s loan stock consists of non-performing loans.

Four asset management corporations were established earlier to take over non-performing loans. These companies then repackage the debt and sell it on to other investors. Although this process has moved ahead quite slowly, on Tuesday (Apr. 27), the world’s largest financial company, Citigroup, announced the purchase of CNY 2bn (approx. €200m) in non-performing loans from the Great Wall asset management firm, a company established to resolve the non-performing loans of the Agricultural Bank of China. The sale, however, is pending approval from the Chinese authorities. Apparently, the Bank of China recently had to halt its sale of non-performing loans to foreign investors after the authorities decided that the sale price was too low. To date, a total of CNY 1,400bn (€141bn) in non-performing loans have been transferred to the custody of asset management firms.

Euromoney and Institutional Investor release their semi-annual country-risk rankings. The March issues of Euromoney and Institutional Investor rate 185 countries and 172 countries, respectively. China and Russia moved up in the rankings in both surveys. The rankings of Hong Kong and Taiwan were essentially unchanged.

Country risk rankings
March 2004, September 2003 and September 2003
Russia

Pace of consumer price rise steady in April. Consumer prices in April increased 1.0 % m-o-m. Their on-year rise was 10.3 %, the same pace as in March. Food prices climbed more than 9 %, with baked goods up as much as 40 %. The prices of non-food goods rose 7.6 % y-o-y. Prices for services soared nearly 18 %, driven by higher prices for housing and related services (up 23 %). For the month, service prices rose 2.0 % due i.a. to a 7 % hike in rents of state and municipal housing.

Wage growth remains brisk. Preliminary figures from the State Statistical Service indicate that nominal wages rose in the first quarter of this year on average nearly 30 % from a year earlier. Real wages rose over 15 %. In 1Q03 the comparable increase was 10 %. The rise for all of 2003 was also 10 %. The rise of real wages has substantially outstripped productivity gains. Some analysts believe that part of the claimed wage gains in previous years were statistical illusions, because the introduction of the universal 13 % income tax at the beginning of 2001 merely brought under-the-table wage payments into the taxation and statistical spheres. The official average monthly wage in Russia in March was less than 6,600 roubles or about 190 euros a month. However, viewed against other relevant statistics, Russian wage statistics may miss about a quarter of actual paid wages.

Pensions were up on average about 20 % y-o-y (or 7 % in real terms) in the first quarter. Last year, pensions rose less than 5 % in real terms. The average pension in March 2004 was almost 1,800 roubles or 50 euros a month.

Reported real wages and pensions, percentage change from 12 months previous

Unemployment down. Russia’s State Statistical Service reports the number of unemployed persons actively seeking work was 5.7 million at the end of March (calculated according to ILO methodology), and a drop of over half a million persons from a year earlier. The share of unemployed persons to the labour force fell about a percentage point from a year earlier to 7.9 % at the end of March. The number of unemployed individuals registered with unemployment offices grew in the same period to almost 1.7 million. The number of employed persons increased by nearly two million to 66.5 million. At the same time, Russia’s labour force grew by 1.3 million to over 72 million persons.

Russia launches new budget process. The government has approved most of framework for a new budgetary process covering the years 2004–2006 and based on the principle of “target budgeting.” Budget planning will now begin with priority expenditures such as income transfers, public services, implementation of long-term programs, debt servicing, and transfers to regional and local budgets. Finance minister Alexei Kudrin reports the new approach will be tested already this year in the preparation of the 2005 budget.

The main aims of altering the budget process are increased efficiency and transparency. In the future, each budget level will be responsible for the ultimate distribution of budgeted monies. Budget planning will also shift to three-year periods and sectoral spending categories will harden so that financing flows must go only through the category designated under the budget act. In addition, the government will attempt to reduce the number of entities directly receiving budget funding.

At the end of last month (Apr. 29), the government failed to reach consensus on giving money to different entitlement groups, instead of current non-monetary benefits. These entitlement groups include about 35 million pensioners, war veterans and invalids. The state’s intent is to eliminate the mass of social entitlements set forth in Russian legislation that lack definite funding. President Putin has requested that none of the possible changes will diminish the status of currently entitled beneficiaries.

The government also seeks to consolidate the administration of all budget levels under the state treasury. Currently, only about half of budget accounts are administered by the state treasury. The other half is administered by commercial banks or regional and local administrations, which is difficult from a monitoring standpoint. Not surprisingly, regional and local officials oppose the government’s proposal.
China

China’s foreign currency reserves up strongly in first quarter. China’s foreign currency reserves climbed to a record $440bn at the end of March. In the first quarter of this year, China’s reserves grew $37bn. Since end-March 2003, they were up $120bn.

Preliminary figures indicate that surpluses in the capital and financial accounts drove the increase in reserves. China posted a trade deficit of over $8bn in the first quarter. Foreign direct investment inflows were up 8% y-o-y to about $14bn. Observers note that other capital flows, driven largely by expectations of a revaluation of the yuan, swelled the financial account surplus. Some of this money consisted of repatriated Chinese investments and some was capital from foreign investors. Investments have increased e.g. in the real estate market.

According to the State Administration of Foreign Exchange (SAFE) most of China’s foreign currency reserves are invested in dollars. The euro also plays an important role, but reserves are also invested in Japanese yen, British pounds, and Canadian and Australian dollars. Officials aim at greater diversity in currency investments.

China’s foreign currency reserves

Shareholding banks’ stock of non-performing loans rises in first quarter. The share of non-performing loans (NPLs) in the total loan stocks of China’s four major state-owned banks declined, while NPLs were up at eleven shareholding banks due to the rapid credit expansion.

As of end-March, the NPL stocks in the 15 banks mentioned above stood at CNY 2.080bn (€206bn) when classified under a new strict credit-risk regime. Although the overall figure represented a decline of CNY 34bn from last year, NPLs for shareholding banks rose by CNY 0.5bn. On the other hand, the average NPL ratio of these eleven banks was considerably lower (7%) than that of the four largest banks (19%).

These 15 banks hold over 70% of the total assets of China’s banking sector. The remainder is held by 112 regional banks and over 35,000 rural credit cooperatives. These smaller entities are believed to be in much worse condition than the major commercial banks. In the first quarter, the overall assets of China’s banking sector rose 17% y-o-y. The total assets of the four major state-owned banks grew 13%, while the assets of the eleven shareholding banks increased 34%. Assets in regional banks and rural cooperatives were up 25% and 17% respectively.

Producer price growth surges to 3.9% y-o-y in March. The National Bureau of Statistics reports the rise in producer prices accelerated to its highest rate in eleven months. Producer prices rose 3.5% in both January and February. The strength of China’s investment boom could be seen e.g. in the 30% y-o-y average growth in prices of steel products. Input prices for iron ore and coal were up 56% and 39%, respectively.

The large discrepancies in price figures from the NBS and the People’s Bank of China deserve mention. For example, the PBoC reported producer prices rose 8.3% in March (BOFIT Weekly 16/04).

Incomes rise rapidly in both urban and rural areas. NBS figures indicate that growth in rural incomes recovered strongly in the first quarter of 2004. The per capita monthly income of a rural inhabitant was 280 yuan (28 euros). Real incomes rose 9% y-o-y. At the same time, the per capita disposable monthly income of urban residents was 880 yuan, an on-year increase of 10% in real terms. The average income of urban dwellers last year rose 9%, while the corresponding growth was just 4% in rural areas.

In January-March, the rise in rural incomes was led by higher food prices. Wage earnings sent home by rural residents working in cities also boosted rural revenues. The current tax reform lowered taxes and other charges paid by rural residents on average by a third.
Russia

Growth in export earnings and imports slightly slow in first quarter. Figures from the Central Bank of Russia show that the country’s first-quarter earnings on goods exports increased 20 % y-o-y in dollar terms. Export earnings rose over 25 % y-o-y in 2003. Goods imports to Russia also climbed over 20 % in the first quarter, which was slightly off the pace from 1Q2003. Imports from non-CIS countries grew just under 20 %. The growth gains reflect to a certain extent the dollar’s depreciation. Measured by a basket of currencies of Russia’s trading partners, imports rose about 10 % in the first quarter (13 % in 2003).

Russian goods exports and goods imports, four-quarter moving sum 1Q1998–1Q2004

<table>
<thead>
<tr>
<th>USD billion</th>
<th>EUR billion</th>
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<tr>
<td>120</td>
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Source: CBR

Russian share prices plummet. RTS, the leading index of shares traded in Russia fell 24 % from a record peak of 786 in mid-April to 574, its lowest level this year. Shares in companies involved in oil, energy, metals and telecommunications fell 15–25 %, while the shares of Sberbank, the only bank in the RTS, dropped about 20 %. Shares in the Yukos oil company lost more than 40 %. Gazprom shares, however, were off less than 10 %. Observers say the decline in share prices was due to several reasons, including expectations of an impending interest rate hike in the US and rumours that the authorities are about to launch further tax audits of Yukos and other large companies. Share prices in other emerging markets also have fallen in recent weeks.

On Thursday, the RTS index rebounded to the 600-point level. The RTS index has been through similar big drops in the past year; it lost about a fifth of its value last summer and a quarter of its value last autumn, following the arrests of Yukos directors.

Putin considers development of northern regions. President Putin declared that Russia’s old programs for developing vast northern regions are outmoded. In the future, Russia needs well considered long-range policies for northern regions, which are important from the geopolitical, economic and national defence standpoints. Besides problems related to isolation and harsh climatic conditions, the president noted that northern regions tend to be dominated by single industry towns, simplistic production structures, less-than-desirable social circumstances and poor housing accommodations. Moreover, it is not uncommon for northern administrative regions to run large budget deficits.

Many enterprises are loss-making. Indeed, some speak of two norths: the first driven by successful, natural-resources-based firms and the second consisting of shrivelling industrial enclaves that remain dependent on state support.

Northern regions cover about 70 % of Russia’s land area, yet only contain about 12 million inhabitants. These regions contain about 80 % of Russia’s proven mineral resources and generate about 20 % of Russian GDP.

Cabinet considers highway development program. On May 6, the government tackled development of roads and highways as part of its program for development of transportation infrastructure through to 2010. Prime minister Mikhail Fradkov observed that the absence of a functional highway system impedes Russian economic development and hurts the competitiveness of Russian products in global markets. The transportation and communications ministry added that over 70 % of Russian goods transport is currently handled via highways. Total road sector spending corresponded to 2.9 % of GDP in 2000, but just 1.5 % of GDP in 2003.

The highway development program will concentrate on expansion of the national road network, general improvement of roads and reduction of costs of road construction and maintenance. Road financing and maintenance responsibilities will be shared among the federal, regional and local levels in a way that corresponds to the new budget arrangements. Special attention will be paid to integrating road systems with international transport routes and completion of existing projects. The goal is to extend Russia’s current national road network of 600,000 km to 850,000 km by 2010.

The government is considering the possibility of using private financing and toll roads as ways to finance road construction. Such moves would require new legislation and improved terms in order to attract investors. The government must discuss by next October the main goals of a highway system reform and development program that extends through 2025. Approval of the revised federal transportation strategy is expected before the end of this year. At the end of April, Russia became the 25th participant in the UN-coordinated Trans-Asia Highway agreement, under which some 140,000 km of highways stretching from the Far East to Western Europe would be constructed or improved.
China

EU-China negotiations in Brussels. Chinese premier Wen Jiabao at last week’s discussions asked EU Commission president Romano Prodi when the EU plans to grant China market-economy status. Prodi said the EU studies the matter and promised to give its initial evaluation of the study to China by the end of June. The granting of market-economy status can mean a reduction in anti-dumping tariffs imposed on Chinese products, so that in the event of suspected dumping, the normal price can be determined based on Chinese prices. Under current practices, China pricing is compared against those in a similar market economy. None of China’s main trading partners have granted China market-economy status.

China and the EU signed in Brussels several agreements, including agreements on trade and customs cooperation, and promised to continue the trade policy talks. The parties failed to reach an agreement on Chinese export restrictions on coke. China is the world’s largest producer of coke. In order to secure inexpensive supplies of this key raw material for its own huge steel industry, the state requires coke exporters to have a special permit. The EU claims the restrictions violate WTO rules and has threatened that if China fails to drop the restrictions by today (May 14), it will submit the dispute to the WTO for resolution. The matter would be the first complaint the EU brings against China in the WTO. In March, the US brought the first ever complaint against China before the WTO. The dispute relates to China’s tax treatment of imported semiconductors.

Central bank foresees economic slowdown in third quarter. The People’s Bank of China expects strong economic growth to continue through the second quarter. Inflation is also expected to remain at its current pace. Measures to rein in economic growth should begin to take effect in the third quarter. The PBoC still considers its targets for this year of 7% GDP growth and 3% inflation to be realistic.

In March, the money supply expanded at an on-year rate of 19%, exceeding the PBoC’s growth target of 17% for the entire year. Bank lending grew 20% in local currencies; the growth nevertheless was off slightly from the end of 2003. In the first quarter, the volume of new loans granted already amounted to 32% of the central bank’s target for the entire year. The share of loans held by China’s four large state-owned banks fell in the first quarter to 48% of the aggregate loan stock as their new lending contracted 25% from a year earlier.

The PBoC has employed a range of monetary measures to dampen economic growth. The central bank’s open market operations are directed at neutralising the impact of currency flows from abroad on money market liquidity. At the end of April, the deposit reserve requirements for banks were raised a half percentage point, which should reduce bank sector liquidity by almost CNY 110bn. In addition, the PBoC is encouraging commercial banks to shift their lending focus away from overheated sectors to rural areas and government-approved jobs-creation programs.

There is no evidence so far that these measures have had any effect. Indeed, investment soared 43% in the first quarter. The central bank nevertheless says it intends to stay with its current policies and that putting brakes on the expansion of the money supply and credit growth should begin to cool the economy in the third quarter. The PBoC added that it also strives for stability in interest and exchange rates.

Overheating fears hit Chinese bourses. In the first quarter of 2004, the combined daily trading volume of the Shanghai and Shenzhen stock exchanges rose to CNY 29 billion (an increase of nearly 150% from the same period a year earlier). The price index of the Shanghai stock exchange hit its highest level in three years, with share prices climbing 16% in the first quarter. Chinese firms also raised CNY 13 billion in new capital from the markets.

The rapid rise in stock markets was caused in part by the Qualified Foreign Institutional Investor (QFII) scheme, which was launched in 2003 to provide foreign institutional investors with greater freedom to invest in shares of Chinese firms. News of higher corporate profits and the state’s decision to postpone its planned divestment of shares in state-owned enterprises have buoyed share prices. Closer inspection of profit growth, however, reveals that it is almost exclusively limited on fields that benefit from higher raw material prices. Moreover, the State Administration for Foreign Exchange (SAFE), in order to stem the flood of capital into China, has not granted a single new QFII quota in the last five months.

In April, share prices fell nearly 15%, as investors worried that authorities would raise interest rates to put the brakes on economic expansion.

Composite indices of A-shares on Shanghai and Shenzhen stock exchanges

Sources: Shanghai and Shenzhen exchanges
Russia

Growth stays high in the first quarter for bank deposits and credits. In 1Q04, household and corporate deposits with banks operating in Russia continued to grow at a nominal rate above 30 % y-o-y and at a real rate of 20 %. Measured in nominal terms, the growth of rouble deposits accelerated to over 50 %, while foreign currency deposits fell slightly. At the start of April, rouble deposits corresponded to 16 % of GDP, while foreign currency deposits were around 5–6 % of GDP.

The growth of rouble cash in circulation picked up clearly to 55 % y-o-y. The amount of rouble cash equalled 8.5 % of GDP. The rouble’s appreciation in the first quarter largely drove the rapid expansion in rouble deposits and cash.

The growth in lending by the banks also remained brisk. At the beginning of April, the stock of credit extended by banks to private firms and households was nearly 50 % greater than a year earlier. Borrowing of publicly owned enterprises grew much slower than earlier. Bank claims on all enterprises and households amounted to nearly 23 % of GDP.

Oil earnings prop up Russian budgets. In the first quarter of 2004, the consolidated (combined) federal and regional budget produced a large surplus (4.4 % of estimated GDP). The finance ministry reported budget revenues of RUB 1,045bn (€30bn; 29.8 % of GDP) and expenditures of RUB 890bn (€26bn; 25.4 % of GDP). Compared to 1Q03, revenues as a share of GDP fell slightly and spending as a share of GDP declined sharply. Revenues were depressed largely by a reduced revenue flow to budgetary funds and a drop in non-tax revenues. Tax revenues flowing to budgets constituted over 80 % of total budgetary revenues and represented approximately the same share of GDP as in 2003. Among specific tax categories, revenues from profit tax, customs fees and natural resource use fees grew fastest, reflecting the recent boom in oil production and exports. In contrast, the drop in budget spending was due mainly to lower interest payments on debt.

Federal budget revenues (including social tax money channelled to the state pension fund) in the first quarter amounted to RUB 690bn (19.7 % of GDP) and expenditures of RUB 554bn (15.8 % of GDP). Regional budget revenues were 12.4 % of GDP and expenditures 11.8 % of GDP. Regional budgets saw their share of spending relative to GDP fall in comparison to their share in 1Q03. As a result, regional budgets in the first quarter of 2004 were overall in the black (0.6 % of GDP). This was a clear improvement from the 2003 deficit (-2.1 % of GDP).

Higher-than-expected oil revenues have increased stabilisation fund contributions this year. The finance ministry expects the stabilisation fund will hold RUB 384bn ($13bn) by the end of 2004. Earlier forecasts were below RUB 300bn.

Federal budget, four-quarter moving sum, % of GDP

Government considers measures to promote housing construction and development of housing markets. The lack of appropriate legislation, the relative poverty of the Russian population and other factors have prevented the emergence of well-functioning housing markets and the production of housing for average consumers. Therefore, the Russian government intends over the next six years to put the necessary legislation in place and develop a housing loan system that would increase the volume of housing loans granted annually from RUB 10bn this year to nearly RUB 350bn (€10bn) in 2010. The underlying motive for significantly increasing annual housing production from the current 36 million square metres of floor space to 70–80 million m$^2$ is to increase per capita living space by 2 m$^2$, to 21.7 m$^2$. Construction of some 10 million m$^2$ of housing would receive direct public support.

Observers report that reform of the housing loan system could have a wide range of impacts, including a rapid rise in housing prices in Moscow, which suffers from a dearth of available lots on which to build. Elsewhere in the country, housing prices are expected to track the rise in nominal incomes of the population, i.e. above the inflation rate.

This spring, the government will submit to the Duma a legislative package, containing a total of 27 laws that would enter into force at the start of 2005. The package includes amendments designed to provide guidelines for housing rentals and housing cooperatives, as well as broaden consumer protection of housing buyers. In addition, local budgets would collect a property tax amounting to 2 % of assessed market value, and the profit tax on real-estate-based securities would be lowered from 24 % to 6 %. The notarisation requirement for real-estate sales and housing loans would also be eliminated.
China

Rise in consumer prices accelerates. Annual inflation was running at 3.0 % in March, but accelerated in April to a rate of 3.8 %. Inflation has picked up steadily since last summer. April’s pace was the highest seen since March 1997 and exceeded the government’s 3 % inflation target.

Food, the fastest rising component of the consumer price index (10 % y-o-y), comprises about a third of the CPI. Grain prices, in particular, have risen during the past 12 months. Part of this rise reflects a decline in the area of land under cultivation. Housing costs rose 4 % y-o-y, while health care costs went up 7 %. Prices of durable goods, on the other hand, continued to slide. In April, durable goods were on average 3 % cheaper than a year earlier.

At the beginning of May, the government announced new price controls to quell inflation. According to the government’s latest instructions, local administrations are not allowed to raise regulated prices when consumer prices rise faster than 1 % from the previous month or annual inflation exceeds 4 %. Local administrations these days decide mainly on prices of public transport, natural gas, electricity, and water. The new rules are unlikely to have significant impact on the inflation rate.

First quarter GDP figures revised upward. After revision, GDP grew by 9.8 % y-o-y, up from a preliminary figure of 9.7 %. The increase reflected growth in the service sector, which had its growth estimate increased by 0.3 percentage points.

Robust growth of industrial production continues. Industrial output in April was up 19 % y-o-y. Growth has continued stable since the start of the year. For January-April, production gained 18 % y-o-y. Growth in the production of several key consumption goods, energy and raw materials was exceptionally brisk in April. For example, production of mobile phones rose 66 % y-o-y, computers 42 %, automobiles 35 %, coal 19 % and electricity 16 %. Exports of industrial products increased 31 % in the first four months of this year.

Fixed investment growth decelerated in April. Fixed investment in April grew by 35 % y-o-y, down from the 43 % pace of the first quarter. Growth in investment by state-owned enterprises was down 9 percentage points and off 3 percentage points in residential housing. The industrial sector, on the other hand, saw investment climb 58 % y-o-y. The construction industry recorded a 75 % increase in investments, while investment growth in raw material industries averaged over 80 %.

Investment growth in the primary sector accelerated to 18 % y-o-y, due in part to the government’s recent decision to emphasise development of rural economies. Investments in oil and oil refining grew 120 %. It is worth noting, however, investment in oil and oil refining constituted less than 3 % of total fixed investment.

The slower pace of fixed investment in April may suggest that the government’s tightening measures to cool the economy are having effect. Nevertheless, the level of fixed investments remains very high.

Trade deficit widens in April. Last month’s trade deficit was $2.3bn, due mainly to the continued high growth of imports (up 43 % y-o-y). Exports climbed 32 % y-o-y. The April’s trade deficit was the fourth consecutive monthly deficit for China. The cumulative deficit for the first four months of the year was $11bn.

Monthly trade balance, $bn

Source: Ministry of Commerce

China and Kazakhstan agree on further oil pipeline construction. On Monday (May 17), China’s largest oil company (state-owned China National Petroleum Corp.) and Kazakhstan’s leading oil company (state-owned KazMunaiGaz) signed an agreement on construction of an approximately 1,000-kilometre oil pipeline from Kazakhstan to China. Under the agreement, construction would break ground in August and would be completed at the end of 2005. The pipeline would have an annual capacity of 10 million tonnes. The pipeline represents the second phase of a 3,000-kilometre pipeline grid, through which Kazakhstan hopes to eventually deliver to China 20 million tonnes of crude oil yearly. China’s annual crude oil consumption increased to 250 million tonnes last year.
Russia

Output continues to rise rapidly in April. The combined production index of five base sectors of the economy was up 7.7 % y-o-y in April and 7.9 % y-o-y for the period January-April. Investment growth continued to exceed 12 %. Construction was particularly brisk, up 14 % y-o-y in the first four months of the year. In April, retail sales growth accelerated, rallying nearly 11 % for January-April. Industrial output and freight transport increased about 7.5 %. Agricultural output continued to fall and was down about 1 %.

Workday-adjusted industrial output growth in January-April was about 6.7 %. Fuel production increased nearly 8 %, while crude oil output rose 9 %. Machine building and metal products manufacture grew 14 %, driven by a strong demand for rail freight cars. Growth in the chemical and petrochemical industries exceeded 10 % and the food industry was up 7 %. Production of construction materials increased more than 9 %.

Industrial output, % change

Source: State Statistical Service

Last week’s EU-Russia summit. The EU-Russia summit on May 21 in Moscow noted the EU-Russia agreement on Russia’s impending WTO membership. Discussions included development of a common economic space. President Vladimir Putin said that the EU proposal received at the end of April could lead to a joint action plan by the autumn summit. He added that Russia would accelerate its efforts to ratify the Kyoto protocol on the environment.

EU and Russia agree on conditions of Russia’s WTO entry. Alongside last Friday’s EU-Russia summit in Moscow, EU trade commissioner Pascal Lamy and economy minister German Gref signed an agreement on access of goods and services to the Russian market. Under the agreement, Russia’s average import tariff level cannot exceed 7.6 % on industrial products and 13 % on agricultural products. Gref noted transition periods would be allowed to adjust to new tariff levels. Russia agreed to open its markets in several service areas, e.g. regarding services offered across borders and commercial presence.

Lamy reported that Russia resisted the idea of granting direct branching rights to foreign banks and insurance companies in Russia. However, Russia took a commitment to raise domestic natural gas prices for industrial users to levels that cover production and investment costs and assure profitability. The natural gas prices would rise 80–100 % from the current $27–28 /m³ by the year 2010 (i.e. in line with Russia’s current long-term energy strategy). It was also agreed that Siberian overflight fees would be changed to a cost basis and discrimination against airlines based in EU countries would be eliminated by 2013 at the latest.

Russia must still complete bilateral agreements with several other WTO trading partners, including the US, China and Japan. The Russia WTO working group must also review, among other things, all Russian legislation that could have trade implications.

President Putin gives annual parliamentary address. In his yearly state of the nation address to a joint session of parliament on Wednesday (May 26), president Putin stressed that the current main goals for Russia are high living standards, a mature civil society and a strong position in international affairs. Despite the positive development of the Russian economy in recent years, the president noted that there are daunting challenges in many areas. He singled out problems related to poverty, housing, education and health care.

The Russian leader emphasised the importance of rapid and sustainable economic development in defeating poverty and repeated his goal announced last year of doubling GDP in the next ten years or possibly sooner. Putin said it was fully possible to reach an annual inflation target of 3 % and achieve full convertibility of the rouble within a few years. He touched on budget and tax reform, and said tax policy should promote economic growth. He added that Russians deserved high-quality health care services and equal access to high-level education. By 2010, he would like at least one in three Russians to have the opportunity to purchase an apartment that meets modern standards. In practice, this implies ending construction monopolies and development of an efficient mortgage finance system.

He mentioned the need to develop transport infrastructure as a precondition for economic growth and international competitiveness. He said Russia needs its national economic centres linked with advanced infrastructure, and that he expected fast action from his cabinet on developing a framework on transport infrastructure policy.

Putin commented that Russia will continue to integrate with the global economy and give top priority to deepening CIS cooperation. He rebuked charges of authoritarian tendencies, saying that the government’s current policy of strengthening Russia’s statehood must continue.
China

Producer prices continued to rise in April. China’s National Bureau of Statistics (NBS) reports that the producer price index rose by 5 % y-o-y in April. Growth was fuelled by a rise in world oil prices and the on-going rise in non-ferrous metal prices. Prices of investment goods climbed 6.2 %, while consumption goods were up 1.8 %. According to the People’s Bank of China’s (PBoC) corporate goods price index (CGPI), April producer prices rose 9.3 % y-o-y. The central bank reported investment goods prices rose 9.5 %, which was higher than the NBS figure. The large discrepancies between the NBS and PBoC indices mainly stem from the recorded prices of consumption goods. The central bank’s estimate of 8.8 % rise also was much larger than the NBS figure.

The substantial differences between the two official price indices underscore the problems in China’s statistical practices. For example, poor quality statistics undermine the ability of the authorities to identify appropriate monetary policies for the current economic situation.

Producer prices in China, 12-month change, %

FDI inflows to China continue to increase. The Ministry of Commerce reports that in January-April, foreign direct investment to China reached nearly $20bn, an increase of 10 % from the same period a year earlier. During the first four months of the year, the Ministry of Commerce also granted permits on establishing over 14,000 foreign-owned firms in China. As of end-April, China had received FDI inflows worth $520bn and nearly 500,000 foreign-funded firms had been established in the country. Officials expect the growth in foreign investment to continue as the value of future investment contracts in January-April climbed by 54 % y-o-y.

In recent years, over 60 % of foreign direct investment in China has gone directly to foreign-owned companies. The share of investment in joint ventures, on the other hand, has fallen below 30 %.

Government issues a 7-year bond. This latest government bond issue was the fourth this year. The bond auction raised more money than expected, nearly CNY 37bn (€3.7bn). This new 7-year note carries a coupon of 4.89 %.

The government last year issued CNY 630bn (€63bn) worth of bonds. This year the government hopes to issue nearly CNY 700bn in bonds.

Real estate sector growth slowed in April. The monthly index of development in the real estate sector published by the National Bureau of Statistics comprises eight indicators. These indicators include the volume of construction projects on line and price developments by region and market segment. The index has fallen since the start of the year, and April’s index value was the lowest since 2003. Much of the decline reflected a reduction in the volume of completed projects and new construction projects.

In January-April, the total floor space (square metres) of completed construction projects increased 23 % y-o-y. Last year, comparable growth was 38 %. The floor space of new real estate projects grew 20 % from last year, when growth was 32 %. In January-April, the average price for commercial and housing construction was 2,650 yuan (265 euros) per square metre, an increase of 7 % from last year. In Shanghai and neighbouring Jiangsu province, housing prices rose over 20 %.

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China begins building strategic oil reserves. The construction of storage facilities is the first phase of a 15-year, three-phase program to ultimately provide China with a strategic reserve equal to 90-days worth of crude oil net imports. China currently has practically no strategic oil reserves. Both construction of storage facilities and oil storage will be implemented gradually so that the impact on world markets is minimised. Contrary to some observations, China has not yet begun to build up oil reserves. The goal of the first phase of reserve building is to build up reserves sufficient to cover 30 days of net imports by 2006–2008. China places great importance on having a strategic oil reserve, because it has become highly dependent on oil imports from the Middle East. China’s oil imports are expected to increase about 10 % or to 100 million tonnes this year.
Russia

Interest rates decline slightly this year. The Central Bank of Russia reports that the average rate on rouble-denominated corporate bank loans of up to one year has fallen below 12%. The average interest rate is thus less than 2% above consumer price inflation and substantially below industrial producer price inflation. Rouble loans for up to one year represent about 70% of all rouble loans to corporates.

The average interest banks now pay on household rouble deposits of up to one year has fallen to approximately 4%. Such short-term deposits account for over half of all household rouble deposits. The average rate on up to one-year rouble time deposits is over 9% (under Russian legislation, it should be possible to withdraw such deposits at any time).

The average rate on short-term government paper fell to about 4% in the first quarter. Several observers note that the low interest rates largely reflect the high liquidity of banks.

Average annual interest on rouble loans and deposits, %

[Graph showing interest rates]

Source: CBR

Russian government approves 2005 tariffs for gas, electricity and rail freight. The government has decided to raise next year’s tariffs on natural gas 20%, electricity 9.5% and rail freight transport 8.5%. The hikes for 2004 were 20%, 16% and 12%, respectively. The economy ministry estimates that inflation next year will average about 8.5%, so that this year’s rate hikes for electricity and rail freight imply practically unchanged real prices. Economy minister German Gref said that the increases in regulated prices are expected to have a less-than-2.5-percentage-point effect on consumer prices, thus the rise in regulated prices next year will not account for more than 29% of overall inflation. The economy ministry has also suggested ceilings on 2006 tariff hikes of 11% for natural gas and 7.5% for electricity and rail freight.

Yukos swings Russian stock market. Shares in the troubled oil company Yukos have lost over 50% from their April high. The share price was hit after an arbitration court’s ruling that Yukos owes over $3 billion in back taxes and reference by Yukos to the threat of bankruptcy. Yukos’ problems have depressed Russia’s leading RTS index, which as of June 1 stood at 557 points – nearly 30% below April highs. The RTS index has moved in the 560–580 range most of this week. Norilsk Nickel, energy giant UES, Lukoil and Yukos, which all carry heavy weightings in the RTS index, have dominated the RTS trading focus this year.

Government approves draft law on competitive bidding in public procurement. Russia still lacks consistent rules governing public sector procurement practices. Instead, officials are guided by conflicting decrees and regulations at the federal, regional and local levels. The draft law approved in its main features by the government last month is designed to unify prevailing practices and ease access of companies to the bidding process. Moreover, the government wants to discourage abuses and corruption associated with public procurement.

The proposed change will lighten the restrictions on foreign operators participating in public sector bidding competitions. The new law would also give public officials the possibility to make procurements through agents. The draft defines the threshold value where bidding competition would be mandated – currently 60,000 roubles (about 1,700 euros). If a contract value exceeds this threshold, it must be bid competitively.

Government considers reduction of the number of business activities requiring licences. The government’s proposed law amendment is part of an ongoing administrative reform that has lasted several years. It further cuts the number of business activities requiring licences from the 2002 reduction. A cabinet study found that there are still many business activities that should not be subject to licence. Moreover, licensing authority is overly concentrated at the central administration level, the process of obtaining information and licences is troublesome and the legal protection of licence-seekers suffers from numerous deficiencies. The government now wants to eliminate licence requirements on 50 activities from the start of 2005 and another three activities in 2006. Thereafter, on 70 business activities licences will remain. The state will still be able to influence e.g. security monitoring, registration, certification and compulsory insurance.
China

EU and China resolve coke dispute. After failing to defuse a dispute over restrictions on Chinese coke supplies to Europe at last month’s summit (see BOFIT Weekly 20/04), the EU and China spent two more weeks to resolve the problem. Last Friday’s (May 28) agreement only covers 2004, but negotiations on coming years are underway and decisions are expected within a few weeks. The deal guarantees that EU steelmakers will be able to purchase at least as much coke from China as they did in 2003 (4.5 million tonnes). The agreement also eliminates the export licence fees China set on coke. The licence fees rose during the past two years from $5 to $200 a tonne. With the elimination of the fees, the world price of coke is expected to fall from its current price of about $450 a tonne to around $250. The China-EU agreement is likely to become the basis for other bilateral agreements.

China Construction Bank auctions collateral assets from non-performing loans. The assets purchased at auction went for about 35% of its nominal value and brought in about CNY 1.4bn (€140m) for state-owned China Construction Bank. The assets were divided according to three geographic regions. Morgan Stanley purchased two regional blocks, while Deutsche Bank picked up one. The ownership of only 28% of the sold assets is clear and China Construction Bank is committed to buy back all assets where ownership cannot be determined within three years. The international auction of collateral assets was the first for a state owned commercial bank. In accordance with its WTO commitments, China is preparing to open up its banking sector to foreign competition by reforming its banks. One measure is to reduce the amount of non-performing loans (NPL). Before the auction, officials reported that China Construction Bank had its ratio of NPLs to total loans under 9%, the lowest of any of the four large state-owned banks.

Loans to fixed investment projects to be audited. On Monday (May 31), China’s Banking Regulatory Commission announced it was halting bank lending to investment projects lacking official government permission. They will also commence inspection on loans granted before the end of March for fixed investments. The audits will concentrate on investments exceeding CNY 30 million (€3m). In addition to the steel, aluminium and cement industries, which are already on the watch list, the current audit will also review loans for government buildings, city fast rails, golf courses, exhibition centres and shopping malls. The current round of audits should be completed by mid-June. Previously, a separate review was launched for automobile loans. The measures represent government’s intensified efforts to rein in growth of fixed investment and lending.

Job creation remains strong. Some 3.6 million new jobs were created during January-April. Practically all of these new jobs appeared in private enterprises. The government’s goal is to create 9 million new jobs this year and a total of 40 million new jobs during the current 2001–2005 five-year plan. The government specifically seeks to boost jobs in the service sector and among small and medium-sized enterprises.

The number of people working rose last year to 744 million, which meant that nearly 7 million new jobs were created. About half of all jobs in China are in agriculture. Industry accounted for 22% of jobs, while the service sector had 29%.

Electricity consumption increases strongly. China generated 647 terawatt-hours (TWh) of electricity in the first four months of this year, i.e. 16% more than a year earlier. For all of 2004, electrical power consumption is forecast to rise 11% on-year to nearly 2,100 TWh.

China’s power generation capacity has failed in recent years to keep up with booming consumption demand with the result that power outages occur frequently in most Chinese provinces. As power disturbances are feared to increase this summer, China is ramping up power production capacity quickly. Indeed, the current strains should diminish already next year as new power plants come on stream. In 2006, production capacity should be sufficient to cover all demand. This year production capacity will rise about 10%.

China is currently building two nuclear power plants and has solicited tenders on construction of four more in the coming years. Nuclear power plants presently generate less than 2% of Chinese electrical power. By 2020, China wants to increase its nuclear power production capacity from 8 to 40 gigawatts. This requires construction of two new power plants every year. Currently, about 80% of electricity is generated by fossil fuels (mainly coal). The role of hydropower, however, will increase substantially with the completion of major dam projects.

A kilowatt-hour in China costs on average less than 0.5 yuan (0.05 euros). The price is regulated and varies considerably depending on the consumer and the time of day. The price of electricity this year has remained essentially unchanged from 2003 despite rocketing oil and coal prices. This has put excessive strain on many local power plants. Up until two years ago, the State Power Corporation (SPC) dominated China’s electrical power market. After the SPC was split up into smaller units, a special regulatory body was established. To increase the role of market forces in the Chinese electricity market, officials announced in May that the largest electricity consumers would be permitted to buy their power directly from producers. The reform is expected to reduce the market dominance of transmission grid operators.
Russia

Inflation decelerates slightly. May consumer prices were up 10.1 % y-o-y, compared to 10.2 % in April and 10.3 % in March. The on-year increase in prices for services was 17.8 %, foodstuffs 8.9 % and other goods 7.8 %. In the services category, housing and health care each rose over 20 % y-o-y. In the foodstuffs category, bread and grain products rose 38 %, while meat and milk rose 14 %. The on-month rise in gasoline prices was 4.6 %; on-year they were up 15.6 %.

Consumer prices, % change from previous month

Oil exports and car imports boom in the first quarter. The rise in export earnings from goods exports in the first quarter (20 % y-o-y in dollar terms) was mainly driven by an approximately 10 % increase in export volumes. The pace of growth in crude oil exports remained above 15 %. Exports of oil products increased 6 %, while natural gas exports rose just 1 %. The overall higher export prices (which in fact only occurred when prices are measured in dollars) were sustained by export prices for key metals, which have risen tremendously over the past year. In dollar terms, the price of natural gas was up about 10 % y-o-y in the first quarter, while the oil prices were essentially flat from a year earlier.

The growth in goods imports in the first quarter (an increase of slightly over 20 % y-o-y in dollar terms) was concentrated on the category of machinery, equipment and transport vehicles, in which imports rose 46 % in dollars. A large part of this increase, however, reflected the trebling in the volume of passenger car imports. Of total goods imports registered with the Russian customs, the share of machinery and equipment (excluding passenger cars) was about 35 % and the share of passenger cars was 6 %. The share of foodstuffs and ingredients dropped to below 20 % of total imports, dragged down by a halving of Russian meat imports (subject to import quotas). The chemical industry’s share of imports was 16–17 %.

FDI on the rise. The State Statistical Service reports that, in the first quarter of 2004, foreign investment in the enterprise sector (excluding banks) was $6bn, or 1.5 % less than a year earlier. The slight reduction in the amount of investment reflected a drop in foreign borrowing, which was down 12 % from a year earlier. Foreign borrowing represented 75 % of total foreign investment. FDI, in contrast, grew briskly, with a net inflow of $1.5bn in FDI to Russia in 1Q04 (up 43 % y-o-y). Direct investments constituted 24 % of total foreign investment. Some 47 % of all foreign investment was directed at industry, while 31 % went to the trade sector. Industry received 70 % of direct investment, with the lion’s share going to the oil industry. Portfolio investment accounted for a tiny 1.4 % ($89m) of total foreign investment. The total stock of foreign investment in Russia as of end-March stood at $57bn, of which direct investment was $25bn. The largest providers of direct investment in Russia have been the Netherlands, Cyprus, the United States and Germany.

Meat imports from the EU resume. Early this week, Russia and the EU reached a compromise on ending Russia’s ban on meat imports from EU countries. Russia imposed the ban at the beginning of June, after the parties failed to settle on Russia’s demand for an EU-wide veterinary certificate for meat originating from anywhere in the now-expanded EU. The parties agreed to find ways to resolve the matter permanently by the end of September. An EU representative claimed that the introduction of an EU-wide veterinary certificate would require legislative changes in the EU. At present, all EU countries have their own veterinary certifications, which, in turn, comply with EU directives on health and safety. All WTO countries accept the EU approach.

The EU annually exports about €1.3bn worth of meat to Russia. Russia decided at the beginning of 2004 to keep meat import quotas imposed in April 2003 in order to promote domestic meat production. Under the quota allotments, 80 % of the beef quota, about half of the pork quota and 20 % of the poultry quota is reserved for EU producers.

Gazprom signs natural gas deal with Belarus. After months of deliberation, Gazprom and the Belarusian Beltransgaz have signed an agreement covering the rest of 2004. It provides for delivery of 10.2 billion cubic meters of natural gas to Belarus, as well as the conditions for transshipment of gas via Belarus to destinations in Europe. The price Belarus pays for natural gas was raised from about $31 to nearly $47 per thousand cubic meters. Belarus has paid the $47 price since the start of the year under month-to-month interim contracts. In the future, the tariff Gazprom pays Belarus for gas transshipment will be $0.75 per 1,000 m3 per 100 km shipped.
China

Signs of slowing industrial output growth. Industrial output was up 17.5 % y-o-y in May, a slight deceleration from 19 % in April. Industrial output increased 18 % y-o-y during the January-May period. Growth slowed in May in many key industries. For example, growth in steel production fell to 13 % y-o-y (down from 21 % in April), passenger car production was up 31 % (43 %) and coal production rose 15 % (19 %). Computer production rose 21 % in May (down from 42 % in April), while mobile phone production rose 53 % (66 %). However, growth accelerated slightly in power generation and the cement sector; both were up 17 % y-o-y.

Decade-old rules for automobile industry revised. Regulatory changes proposed by the National Development and Reform Commission (NDRC) are intended to strengthen the competitiveness of domestic industry through either the termination of small, inefficient firms or by merging them into larger configurations to assure their survival when China’s markets open to international competition in accordance with WTO requirements. In addition, the new rules seek to curtail over-investment in China’s rapidly expanding car manufacturing industry (see BOFIT Weekly 6/04). New car manufacturing projects are required to make a minimum investment of CNY 2 billion (€200 million), of which 40 % must be invested immediately in the initial phase of the project. In addition, investors must also devote CNY 500 million to research and development. Moreover, the operating licenses of auto plants on the verge of bankruptcy would be cancelled, so that the licences could not be sold to companies in other sectors trying to break into automobile manufacturing.

Demand for cars in China is not growing quite as fast as at the start of this year because China’s Banking Regulatory Commission (CBRC) has to some extent cooled the market by tightening the conditions for getting car loans. For January-April, car sales rose 28 % y-o-y, while in May growth was 20 %. Another reason for the slowing in demand growth is that many Chinese are postponing their car purchase until next year. Car prices are expected to fall substantially next year, when China eliminates import licence fees and lowers customs tariffs in accordance with its WTO commitments. The government sees the car industry as a pillar of the economy and intends to develop some of China’s car plants into major multinational manufacturers.

Summer wheat harvest supports efforts to increase grain production. The Ministry of Agriculture now estimates that this year’s summer wheat harvest will be 3 %, or 2.5 million tonnes, higher than last year’s. Over half of the crop has already been harvested. The production increase, according to the Ministry of Agriculture, was due to a combination of factors, including favourable weather conditions and successful state subsidy programmes. Wheat is clearly the main summer grain product. Nearly a quarter of China’s annual grain harvest is collected in the summer.

The Ministry of Agriculture has set this year’s grain harvest target at 455 million tonnes, or 20 million tonnes more than in 2003. Chinese grain consumption exceeded production by 55 million tonnes in 2003. The difference was covered with increased imports and depletion of national grain reserves. The land area dedicated to grain cultivation has been contracting and grain production has fallen since 1998, when grain production reached a record 512 million tonnes. The reduction in land used for grain cultivation is due in part to low grain prices. In autumn last year, however, grain prices shot up in the wake of a poor harvest. In April, grain prices were 34 % higher than a year earlier. New regulations approved by the government in May are intended to let markets play a greater role in setting grain prices.

Currency controls tightened for foreign firms and banks. The new measures are designed to stem the swelling of China’s foreign exchange reserves, the result of expectations of a yuan revaluation (see BOFIT Weekly 19/2004). Most foreign currency inflows have come via the financial account. Foreign enterprises and banks are involved in most currency exchange transactions on the capital account.

The State Administration of Foreign Exchange (SAFE) will thus further tighten the capital account forex transactions of foreign enterprises from July. Currently, a single transaction or daily transfers of less than $1 million did not require immediate notification to SAFE. From July 1, the ceiling will fall to $200,000. Moreover, the exchanged amount will not be deposited back to a firm’s bank account, but transferred directly to the stated recipient of the exchange. The current regulation forbids foreign enterprises from exchanging foreign currency to repay yuan-denominated debts.

Meanwhile, a separate rule issued jointly by the National Development and Reform Commission (NDRC), the Banking Regulatory Commission (CBRC) and SAFE enhances supervision of borrowing by foreign banks. Under the new regulation, foreign banks must submit by February of each year preliminary plans for their annual external borrowings and get approvals from the NDRC and SAFE. The balance of short-term external loans must not exceed limits set by SAFE. The new rule also forbids foreign banks from converting external borrowings into yuan. Previously, foreign banks were not subject to limits on their external borrowings and could exchange their borrowings into yuan with SAFE approval.
Russia

Central bank eases money market in the midst of bank rumours. Interest rates on Russia’s thin interbank market rose towards the end of May as several banks lowered or froze their lending limits after the Central Bank of Russia had revoked the operating licence of Sodusinessbank on the basis of multiple violations, including suspected money laundering.

The events prompted rumours that other banking licences might be revoked and depositors scared off. Several market assessments, however, dismissed the possibility that large banks would suffer similar problems. Of Russia’s 1,330 banks, the share of household deposits held by the 1,130 smallest banks was just 8 %. Viktor Zubkov, head of the Federal Financial Monitoring Service, which fights money laundering, said no banks were blacklisted, although several have received remarks. In a meeting last week with CBR chairman Sergei Ignatyev, president Putin said he hoped that the CBR would accurately implement bank supervision without having to resort to a massive abrupt cleanup of the banking system.

The CBR announced last week that it was ready, as needed, to increase banking-sector liquidity. This week, the CBR lowered the reserve requirements for all corporate deposits and household foreign-currency deposits from 9 % to 7 % (last lowered on April 1, 2004), the same level as for household rouble deposits. The terms for rouble and foreign-currency deposits are now identical for the first time since June 1999. The CBR further lowered the refinancing rate (which may provide guidance in setting market rates) and its overnight rates to 13 %. The central bank also extended the variety of bonds that can be used in its money market operations.

Short-term interbank rates and CBR refinancing rate, % per annum

GDP grew 7.4 % y-o-y in the first quarter. The figure from the State Statistical Service does not take into account the possible larger number of workdays in this leap year.

The economy ministry earlier forecast 8 % growth in the first quarter.

The official statistics suggest that in 2003 the share of industry in the GDP was over one quarter, the trade sector over one fifth and private services over 15 %. Public services accounted for about 10 % and the transport and telecom sector for less than 10 % of the GDP.

Government reviews 2005 budget proposal. The 2005 draft budget foresees revenues of RUB 3,103bn (about 17 % of the GDP) and expenditures of RUB 2,916bn, which results in a surplus of 1.0 % of GDP. The government plans to use the surplus to bolster the stabilisation fund and pay down debt. The economy ministry’s forecast sees GDP growth of 5.9 % next year. The budget assumes an average 2005 price for Urals-grade crude oil of $26 a barrel and expects the annual average rouble exchange rate to weaken slightly to about 30.2 roubles to the dollar.

Pension reform progresses slowly. Since the start of this year, employees have had the possibility to direct part of their pension contributions (a so-called “savings component”) to privately managed pension funds. It is estimated that only 700,000–800,000, i.e. less than 2 % of the 38 million Russians whose future pensions will be paid under the new system, have actually put money in such private funds. The underwhelming response has disappointed the over 50 private funds approved to invest savings-component contributions. Most of these funds have not managed to attract enough clients to justify profitable investment operations. Indeed, over 60 % of savings-component contributions directed to private funds have gone to just five funds. These have succeeded in getting the entire personnel of several corporations, sometimes due to ownership connections between fund operators and the client corporations.

Fund operators say the situation reflects Russians’ traditional wariness of new schemes and the state’s constantly changing regulations. For example, the Russian government has just decided to lower the social tax. It is proposing that the resulting budget loss be partly covered by making a given segment of the population ineligible for the savings component. If the Duma approves the proposal, it will have a significant impact on the operation of private funds. It is estimated that a third of private fund clients would be excluded under the new arrangement. A much larger share of savings-component funds already invested has come from this threatened group. Under current legislation, private funds cannot unilaterally refuse to invest money already contributed to the fund; rather they must continue investing the money for at least five years – even if the investment company has to take a loss on it. Only a fund client can terminate the relationship. In the event the fund goes bankrupt, investment of the savings component will be transferred to state-owned Vnesheconombank.
China

May consumer and producer prices. Consumer prices were up 4.4 \% y-o-y last month. The largest price increases occurred in foodstuffs (especially grain), fuel and car parts. Part of the apparent burst in on-year inflation reflects last year’s low figures due to the Sars epidemic. Although on-year inflation was clearly higher in May than in April, when prices rose 3.8 \% y-o-y, consumer prices actually fell 0.1 \% on-month from April to May. Grain and car prices, for example, were down slightly.

The on-year rise in producer prices accelerated in May to 5.7 \% (5.0 \% in April). Unlike the figures published by the National Bureau of Statistics of China, the central bank reported that producer prices rose 9.4 \% y-o-y in May (9.3 \% in April). According to the central bank producer prices fell 0.3 \% from April to May. May steel prices, for example, were up 22 \% y-o-y, but down 8 \% m-o-m. By the same token, construction materials were 5 \% more expensive than in May 2003, but 0.7 \% cheaper than in April 2004.

Investment and bank lending growth slowed last month. Fixed investment rose in May by 18 \% y-o-y, i.e. sixteen percentage points less than in April. In May, the number of starts on new investment projects decreased by 16 \% from the same period a year earlier. The overall level of fixed investment in the first five months of this year, however, remains high. From January to May, fixed investment grew 35 \% y-o-y, compared to 27 \% in 2003. Nonferrous and ferrous metal industries saw investment growth slow, but still posted over 60 \% y-o-y growth. The investment still increased 77 \% in the steel industry, 55 \% in the cement industry and 38 \% in the aluminium industry, although growth has fallen substantially from last year.

New yuan-denominated bank loans issued witnessed a 55 \% decline in May. New short-term loans decreased 70 \%, with the short-term loans to the construction sector decreasing most. The amount of new medium- and long-term loans fell 17 \%. In the period January-May, a total of CNY 1,150bn (€115bn) in new loans were granted, which represents roughly 44 \% of the PBoC’s target for the year.

The new figures on fixed investment and new loan growth may signal a deceleration in economic activity. Officials, however, have vowed to continue tightening measures.

Fixed investment and new yuan-denominated bank loans, 12-month % change

Retail sales grew rapidly in May. China’s retail sales grew in nominal terms 18 \% y-o-y in May and amounted to CNY 420bn (€42bn). Again, the strong growth figures are in part due to the last year’s depressed figures during the Sars epidemic. When also price increases are taken into account, the National Bureau of Statistics retail sales growth figures are relatively stable for the first five months of this year. In January-May, retail sales grew 13 \% y-o-y and amounted to CNY 2,100bn. In May, retail sales climbed especially fast in the catering sector, telecommunications equipment and oil products.

Trade surplus in May. The trade surplus was $2.1bn in May, which was the first monthly surplus in 2004. The surplus was mainly the result of government measures to curtail imports of iron ore and steel. Thus, import growth slowed from 43 \% in April to 35 \% in May. Exports grew 33 \% y-o-y, about the same pace of growth as in April. In the first five months of this year, exports increased 33 \% y-o-y and imports 41 \%. In January-May, the trade deficit was $8.7bn.

Decreased spending on infrastructure produces fiscal surpluses. In January-May, China’s public sector produced a record surplus of CNY 365bn (€37bn), an on-year increase of 112 \%. Public revenues rose by 32 \% in the same period, while expenditures grew only 14 \%. The lower spending growth reflected a scaling back on infrastructure projects. Expenditures on infrastructure projects were down 15 \% y-o-y in May.
Russia

Rapid economic expansion continues. The State Statistical Service reports that workday-adjusted industrial output rose 7.2% y-o-y in May and 6.5% for January-May compared to same period a year earlier. The combined production index of five base sectors of the economy rose 7.7% in January-May. Also in the first five months of the year, the fastest growing major production sectors were machine building (14%), construction (14%), and the chemical and petrochemical industries (10%). Retail sales and investment each climbed 12% y-o-y in May.

Crude oil production in the first five months of the year grew 10% y-o-y, which in turn helped boost production of railway rolling stock 50%. In contrast, production of oil raffinates remained at about the same level as in January-May 2003.

Russians protest planned changes in social benefits. Several Russian newspapers report that most Russians are unhappy with the government’s proposed substitution of social benefits with monetary payouts. The country’s labour unions held protests to the proposed reforms in all of Russia’s eleven time zones. The Communist Party announced it will seek a national referendum on the matter. The government plans mainly affect subsidised health services and medicines and free public transport enjoyed by pensioners, war veterans and disabled persons. The government claims the current system is outdated and corrupt. In addition, the government seeks changes in the distribution of powers between federal and regional levels in social issues.

Russia’s new foreign currency act enters into force. The new law, which came into force last Friday (June 18), generally allows for free capital movements. The new rules have had little impact on markets, since previous constraints on capital movements have had relatively small impact on financial operations.

An important feature of the new act is a possibility to impose deposit requirements on capital movement transactions at zero interest. Such additional costs imposed on capital movements constitute a sort of Tobin tax. Under the law, this threat of imposed deposit requirements on capital transactions expires at the end of 2006.

Statements of CBR deputy chairman Alexei Ulyukayev suggest that officials are formulating rules for deposit requirements for both capital imports – which, at the moment are Russia’s number-one foreign exchange policy headache – and some capital export transactions. The new rules could be introduced as soon as August. It is unlikely that the deposit requirements would initially come anywhere near the ceilings of the currency act. The only exception might be foreign investments in government securities.

In principle, up to 20% of the value of a capital import transactions can be held at zero-interest for up to a year; for capital exports, up to 100% of the value of the transaction can be held for up to 60 days. The CBR may first implement the system in a moderate form so as to make it function in case higher requirements are needed due to serious disturbances.

Yukos continues to drive Russian share prices. After president Vladimir Putin commented on June 17 that the insolvency of a company like Yukos is not in the state’s interest, shares in Yukos rose sharply, taking with it Russia’s benchmark RTS index. In the course of a week, share of Yukos shot up about 40%. All this, despite the fact that Yukos is presently in tax court and has been hit with a $3.4bn tax bill. Some observers had begun to speculate on the possibility of bankruptcy.

In contrast, on June 16, the RTS index hit its low point for the year, 533, off nearly 32% from its April high. The shares of Norilsk Nickel, RAO UES, Lukoil and Yukos, all of which have heavy RTS weightings, have dominated RTS trading this year.

Yukos shares and RTS index performance
China

Bankruptcy act submitted to National People’s Congress. The Standing Committee of the National People’s Congress began discussion of the proposed new bankruptcy act this week. The bill has been under preparation for a decade and could enter into force as early as in summer 2005. Enactment of new bankruptcy law will help China meet its WTO commitments and promote equal treatment of domestic (state-owned and private) and foreign firms.

China’s current bankruptcy act, approved in 1986, has lost relevance in the current economy and applies solely to state-owned enterprises. The bankruptcy process for other types of companies is inadequately governed under company laws. Under current law, the salaries and other worker benefits take priority over creditors when the assets of a failed state-owned enterprise are distributed. Thus, when the creditor is a state-owned bank, the loans are often simply carried on the books. The new law is intended to improve the position of creditors. So far, the operations of nearly 3,400 enterprises had been terminated under the old law.

State-owned Assets Supervision and Administration Commission says that China will still apply the old bankruptcy rules to about 2,000 loss-making state enterprises in the coming years. These companies operate mainly in the defence industry or mining. Bankruptcies of state companies outside these categories will be subject to the new law.

Stricter regulations for non-performing loans lower banks’ capital adequacy ratios. Despite capital injections of $45 billion made at the end of last year, the Bank of China (BoC) and the China Construction Bank (CCB) have witnessed declines in their capital adequacy ratios since last year. BoC’s capital adequacy ratio fell from 7.7 % to 7.0 %, while CCB’s dropped from 6.9 % to 6.5 %. The decline in capital adequacy ratios was expected as stricter regulations for non-performing loans (NPLs) were tightened. The new rules substantially increase the capital requirements for commercial banks.

At the end of last year, the BoC announced that it had increased its provisions for bad debts from CNY 88bn at the beginning of the year to CNY 268bn (€27bn). It also ended 2003 with an NPL ratio of 16 %, or CNY 352bn. There is still a considerable gap between the provisions and the NPL volumes. The CCB has managed to cut its NPL ratio from 15 % to below 10 % this year. The BoC has vowed to reduce its NPL ratio by 10 % during this year.

The new regulations on commercial banks require that two state-owned commercial banks that received capital injections should maintain their capital adequacy ratios at least at 8 % from this year. This will require both banks to recapitalise to meet their capital adequacy ratio requirements, and will probably involve issuing subordinated debt.

Shenzhen stock exchange launches SME board. The Standing Committee of the NPC proposed the idea of a second board for small and medium-sized enterprises (SMEs) on the Shenzhen stock exchange in 1999. The original idea was to establish a separate board for growth enterprises along the lines of the NASDAQ in the US; the current configuration is an interim solution. The listing requirements and trading rules are the same as those on the main board, and the SME board is technically integrated into the main board. However, the watchdog Securities Regulatory Commission plans stricter monitoring of listed SMEs to enhance investor protection. Thus, several new regulations on the listing of SMEs are expected soon. Trading commences tomorrow (June 25).

The establishment of the second board should alleviate some of the difficulties SMEs face in acquiring adequate financing. According to the National Development and Reform Commission, SMEs last year generated 56 % of China’s GDP, 75 % of industrial value added, 46 % of tax revenue, 62 % of exports and 75 % of employment. Even so, China’s financial markets still cater mainly to large state-owned enterprises.

The Growth Enterprise Market (GEM) board on the Hong Kong stock exchange is thought to be the main competitor of the Shenzhen exchange’s SME board. Notably, the GEM, which undoubtedly has higher corporate governance standards, has recently been dragged down by several high-profile corporate scandals.

Ping An IPO goes smoothly. China’s second largest life insurer, Ping An, raised $1.8bn in an initial public offering (IPO) arranged in Hong Kong. The company sold a total of 1.39 billion shares. Ping An wants to expand its business in China’s rapidly growing insurance sector. Insurance premia grew by 27 % last year to CNY 388bn (€39bn), slightly off the 29 % per year average over the past ten years. Ping An hopes to raise $2.7bn in equity this year and thereby upgrade its credit rating.

China’s three state-owned insurance companies dominate the insurance market, controlling a combined market share of about 95 %. China’s Insurance Regulatory Commission (CIRC) has relaxed restrictions on private investors in the insurance sector, which has resulted in several IPOs. In June, CIRC lowered the minimum capital requirement on foreign insurers from CNY 200 million (€20m) to CNY 20 million (€2m). Given that the insurance sector must open fully to foreign competition by the end of 2004 in accordance with China’s WTO agreement, CIRC measures were anticipated. Only about 30 % of residents of China’s large cities carry any kind of insurance, so the insurance sector is expected to continue growing at 30 % per annum.
Russia

Industrial producer prices rise rapidly. Industrial producer prices rose nearly 24% between May 2003 and May 2004. Producer prices were led by a 56% increase in ferrous metallurgy. The take-off in producer prices was also driven by the fuel industry. Prices in the crude oil industry were up 41%, in the coal industry 34%, as well as about 30% in oil refining and the natural gas industry. Producer prices rose over 20% in non-ferrous metallurgy, chemicals and the construction materials industry. Freight transport prices overall rose over 20% during the past twelve months. Prices for rail freight were up over 26% y-o-y and pipeline transport 17% y-o-y.

Industrial producer prices and freight transport prices, % change from 12 months earlier

Source: State Statistical Service

Duma approves social tax amendments. The amendments, which enter into force at the beginning of 2005, change the unified social tax’s regressivity while lowering rates and reapportioning rate categories. There will be three tax categories. On the first 280,000 roubles (€8,000) of annual income, the highest rate (26%) applies. For the portion of earnings above 280,000 but below 600,000 roubles, the rate is 10%. For the earnings above 600,000 roubles, the rate falls to just 2%. The current highest social tax rate will remain at 35.6% and the lowest 2% until the end of this year. Most social tax contributions go to the federal budget. These revenues in turn are transferred to pension, health insurance and social funds. Thanks to the change in the tax law, companies are expected to reveal grey salaries and use more money on investments.

Russian economy ministry estimates economic growth will average around 6% in coming years. The ministry’s forecast prepared in June foresees the Russian economy growing 6.6% this year. It assumes the price of Urals-grade crude oil will average $29 a barrel, i.e. slightly higher than in 2003. Economic growth is anticipated to slow to around 6% during the years 2005 to 2007, assuming the price of Urals-grade crude averages around $25 a barrel. Consumer price inflation is expected to slow this year from 10% to 4–6% in 2007, while the rouble’s real exchange rate is anticipated to appreciate 4–5% a year from 2005 to 2007. Imports are foreseen to grow at about 10% a year.

IMF critiques Russian economic policy. In conjunction with its annual Article IV consultation, the IMF mission expects Russian GDP to grow 7.25% this year, in part, due to high world oil prices. The IMF also anticipates that Russia’s economic growth will slow to 6.5% next year.

Despite the strong growth figures, the IMF mission warned about threats to the Russian economy. For example, the rise in real salaries exceeds gains in productivity at a time when inflation pressures are increasing and the rouble’s real exchange rate is strengthening. The IMF believes an early reduction of inflation is possible if the central bank refrains from resisting the rouble's appreciation. Russia should be able to lower its current 10% inflation rate about two percentage points a year.

The IMF encouraged a tight fiscal stance, noting that some of the expenditure cuts in next year’s draft budget are unrealistic. If the oil price is $26 a barrel, Russia’s draft 2005 budget estimates a general government surplus of 1.25%, while the IMF foresees a nearly balanced budget. The IMF calls for measures to reduce inflation pressures and provide the public sector with greater flexibility in case oil prices fluctuate. Moreover, the IMF believes that reform of social taxation and benefits will weaken next year’s budget balance more than anticipated. The Fund also remarked on the need for strict discipline in Russian regional budget planning, as there is no room to loosen fiscal policy.

The IMF considered it ill-advised to release excess oil revenues into the economy as long as private sector demand is growing and inflation pressures persist. Therefore, the mission opposed the government’s plan to use surplus oil revenues in 2005 for purposes other than funding the stability fund or paying down external debt early.

The IMF encouraged Russia to reduce the economy’s large dependence on oil revenues and improve the investment climate. The Article IV consultation stressed the importance of proceeding with structural reforms. The IMF mission visited Moscow June 15–25, 2004.
China

Short-term external debt continues to rise. China’s external debt rose 4.5% in the first quarter compared to Q4/2003. Total foreign debt at the end of March stood at $202bn, or just under 15% of 2003 GDP. Despite the surge in short-term external borrowing in the past two years, the level of indebtedness is relatively low by international standards. Short-term debt now accounts for over 40% of China’s external debt. The increase in short-term debt has been fuelled by strong economic and trade growth, large interest-rate differentials and yuan revaluation expectations.

EU refuses to grant China market economy status. Monday’s (June 28) refusal from the European Commission was accompanied by a press release that identified four key areas where China needs to make progress before it receives market economy status (see BOFIT Weekly 20/04). These areas are reducing state involvement in the economy so that all companies receive equal treatment; increased emphasis on good corporate governance to assure compliance with the existing Accounting Law; improvements in property and bankruptcy law; and promoting an independent financial sector. The EU said it was ready to grant China market economy status as soon as significant progress in these areas occurs. China is presently preparing its response to the EU.

China and the US consider trade issues. A US trade mission visited China at the end of June. From China’s standpoint, the central goal was achieving market economy status. The US, however, refuses to grant market economy status until China substantially reduces government intervention in the economy and increases economic transparency. The US brought up the current pegging of the yuan to the dollar. In the Americans’ opinion, the current rate confers a huge competitive advantage on Chinese companies. China in turn promised to reduce its trade surplus with the US already this year. US figures indicate last year’s trade surplus amounted to $124bn; Chinese figures show a much smaller surplus.

Dumping allegations currently afflict trade relations between the two countries. Last week the US slapped antidumping duties on Chinese wooden furniture ranging from 5% to 200%. This followed a May antidumping duty on Chinese-made televisions, which became subject to a 5–20% additional duty. China, for its part, has imposed a duty of up to 46% on optical cable (the world’s largest producer is a US firm). Observers say the increased strains in trade relations are symptomatic of the rapid increase in trade between the two countries and US domestic politics.

Ministry of Trade formulates new legislation. The ministry hopes to work its current versions of 104 acts and regulations into final form by the end of this year. The proposed amendments apply mainly to regulation of domestic trade – a particularly weak area of Chinese legislation. The proposals cover such issues as oil markets, representative offices of foreign firms and franchising activities. Among the most significant legislation is an antitrust law, which has been under preparation for a decade. Drafting work on the bill has been stepped up in recent months after a study by officials last spring found that lack of adequate rules was often the main incentive for abuses. The proposal includes regulations on abuse of dominant market position, state monopolies and ending the government department’s power to compel persons to buy or sell a certain company’s products.

New regulations are also expected as a result of the new foreign trade act, which entered into force at the beginning of July (see BOFIT Weekly 15/04). Although firms engaging in foreign trade still have to register with the authorities, under the new law, they will no longer need to get official permission.

Audit reveals misuse of public funds in several ministries. The 2003 report of the National Audit Office (NAO) found misuse of public funds in 41 of the 55 central government agencies investigated. The report identifies embezzlement schemes such as falsifying the number of personnel and investing in nonexistent building projects. For example, officials used funds granted for the 2008 Olympics on construction of their own apartments and subsidising their own businesses.

At the same time, the State Development and Reform Commission overestimated investments in infrastructure projects. Only 57% of planned projects included in last year’s economic estimate were implemented. These miscalculations in turn provided the opportunity for central and local administrations to misuse or withhold funds illegally. Local tax officials also frequently used tax revenues to boost their local economies.

The NAO reviewed publicly financed investment projects. Their investigations found low economic returns on most investment projects. Of the 526 infrastructure projects reviewed, 136 projects had been postponed. Of 320 completed infrastructure projects in urban areas, poor construction prevented 32 projects from being commissioned and 69 are only in partial use.

The NAO auditors said that tax evasion and corruption are widespread in state-owned enterprises and in state and local level agencies. Auditing of 788 enterprises revealed that collectively they had avoided CNY 25bn (€2.5bn) in taxes between January 2002 and December 2003.
Russia

Consumer price inflation unchanged in June. The rise in consumer prices slowed in the first half of this year from 11.3 % y-o-y in January to 10.1 % in May and June. The government’s inflation target this year is 8–10 %. Food prices increased 8.8 % y-o-y in June, slightly off the pace in the first months of this year. Prices of other goods rose 7.9 % y-o-y, driven mainly by higher gasoline prices, which were up 11.5 % during the May-June period. The on-year rise in prices of services in June was 17.4 %, down from nearly 22 % y-o-y at the start of the year. Among key services, large increases were seen in housing and housing-related services (23 %); health care, education and child care (17–19 %); followed by passenger traffic (14 %).

Rouble’s real exchange rate weakens in May-June. After strengthening in February-April, the rouble’s nominal exchange rate weakened during May and June against the basket of currencies of Russia’s main trading partners. Nevertheless, the nominal rate in June was still 2 % higher than a year earlier. Since June 2003, the rouble has strengthened 5 % against the US dollar and 1 % against the euro. The rouble’s real exchange rate, which takes into account nominal exchange rate developments and differences between national inflation rates, appreciated briskly in January-April, then fell in May-June against the basket of currencies of Russia’s main trading partners, the dollar and the euro. The real exchange rate strengthened from June 2003 nearly 12 % against the dollar, over 9 % against the euro and 7.5 % against the currency basket. The Central Bank of Russia aims to hold appreciation of the rouble’s real exchange rate below 7 % this year.

Rouble’s nominal exchange rate against the dollar and euro

Source: CBR

CBR lowers reserve requirements to calm banking sector. The CBR lowered its reserve requirements for all rouble and foreign currency liabilities from 7 % to 3.5 %, effective on Thursday (July 8). The central bank also announced its readiness to apply bank-specific reserve requirements if the need arises. The relaxation of monetary stance followed a liquidity squeeze in certain segments of Russia’s interbank market alongside problems at Guta Bank (Russia’s 22nd largest bank), which closed its doors to depositors at the beginning of the week due to liquidity problems. With reports about other banks recently suffering liquidity problems and speculation that some banking licences may be revoked, Russian markets have turned cautious and concerns about deposit runs on some banks have grown. Russia’s second largest bank, state-owned Vneshtorgbank, announced that it was in talks with the government and the CBR on possibly acquiring Guta Bank.

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The Yukos situation has kept the markets unstable. Since the RTS share index hit an all-time peak of 780 in April, it has fallen to a level of 570–575 points, or the same level as at the end of 2003.

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China

Shaky start for Shenzhen bourse’s new SME board. The new list for small and medium-sized enterprises (see BOFIT Weekly 26/04) opened with a roller-coaster performance on the first two days of trading. On the first day (June 25) shares rose an average of 130 %, only to have nearly all of the listed companies to decline and hit the 10 % daily price movement limit the next day. The huge swing was followed by a lacklustre week during which prices of listed firms on the SME board never recovered to their opening levels. During June, China’s two main bourses slid on fears of an impending economic slowdown and possible interest rate hike.

Many analysts say the rocky start merely reflects the high volatility of Chinese stock markets. Although speculation will remain, they say the crucial determinant of the SME board’s success will be the ability to attract high-quality firms with transparent disclosure practices. Unfortunately, the China Securities Regulatory Commission’s decision to apply to the SME board the same regulatory scheme it uses for the main board may be unworkable as firms listed on the SME board are unlikely to improve their corporate governance practices voluntarily unless the state imposes higher disclosure requirements.

As of Tuesday (July 6), 13 firms with a combined market capitalisation of CNY 19bn (€1.9bn) were listed on the SME board.

Composite indices of A-shares on Shanghai and Shenzhen exchanges

Sources: Shanghai and Shenzhen exchanges

Chinese economic growth apparently accelerated in the second quarter. On Tuesday (July 6), deputy prime minister Zeng Peiyan announced that, according to preliminary information, GDP growth accelerated in the first half to over 10 % y-o-y. The National Development and Reform Commission (NDRC) also released a preliminary evaluation at the start of the week that estimated GDP grew 10.5 % in the first half and 11.3 % in the second quarter. The NDRC expects GDP growth to slow to about 8 % in the latter half of this year as measures to curb growth by the government take effect. The GDP figures for the second quarter at 2004 will be released on July 16.

Business climate index down in second quarter. The National Statistics Bureau releases its business climate index figure on a quarterly basis. The index is compiled from surveys of 19,500 domestic industrial enterprises on their assessments of current and future economic conditions. The index is weighted according to each surveyed industry’s output as a percentage of GDP.

At the end of June, the index stood at 134, an increase of 18 points from the second quarter of 2003. Last year’s second-quarter drop is largely attributed to dampening effects of the Sars epidemic. Compared to the first quarter of this year, the index was down slightly by 1.5 points, which likely reflects the government’s tighter stance.

Business climate index, quarterly

Source: National Statistics Bureau

China opens up to private air carriers. Civil Aviation Administration of China has granted initial approvals for the creation of three private airlines. Currently, China’s airlines are essentially state owned. The companies with preliminary permits are small and not expected to challenge the large state-owned airlines. They should commence operations in 2006.

In the first five months of 2004, China’s airlines carried over 46 million passengers, an increase of more than 35 % within the next six years. The agreement permits the opening of transnational routes between all cities in both countries. US air cargo carriers will be able to set up hub operations in China before 2007 and operate within and near China without returning to the US. Only 21 air cargo planes presently operate in China.

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Russia

Current account surplus remains large; banks channel capital outflows. Preliminary balance-of-payments figures from the Central Bank of Russia indicate that the current account surplus rose to nearly $23bn in the first six months of the year, but remained at 9% of GDP. The goods surplus climbed to $35bn. The services deficit and investment income balance deficit (mostly interest payments and dividends) deepened from last year and totalled nearly $12bn.

Export earnings on Russian goods and services increased over 20% y-o-y in dollar terms. Revenues from crude oil exports rose 40%, while earnings on natural gas were up only a few per cent. Revenues from both exports of oil products and other exports rose about 20%. In the same period, import expenditures increased nearly 25%. Interest payments and dividends paid out by the corporate sector grew tremendously. Part of the growth figures, however, can be attributed to the dollar’s continued slide.

The financial account deficit widened dramatically to $7bn as net capital flows via the banking sector reversed to the outbound direction, reaching nearly $7bn. The corporate sector’s borrowing from abroad rose to over $7bn. On the other hand, nearly $8bn in capital outflows abroad involved fictitious transactions mainly for imports of services never performed or fictitious sales of securities. Direct investments in Russia rose to nearly $9bn, while FDI outflows from Russia also showed strong growth.

Central Bank extends express deposit guarantee. On July 10, the Duma passed a special law that obliges the CBR to cover in full the deposits of any private individual up to an amount of 100,000 roubles (about 2,800 euros) for deposits with any bank declared insolvent after December 27, 2003. The Duma also approved amendments that allow the central bank to impose a ceiling on interest paid on deposits (although not below the legally mandated levels). The move is designed to prevent abuse of the deposit guarantee.

Vneshtorgbank will also acquire the majority stake in Guta Bank, which had temporarily closed its doors. To finance the deal, the central bank extended Vneshtorgbank a low-interest $700 million loan.

Withdrawals from private Russian banks increased last week; some of the money was redeposited with state-owned banks, which have enjoyed full deposit insurance protection for years. Although the act creating a general deposit insurance scheme entered into force at the end of 2003, the system has yet to operate properly. The CBR is currently performing bank inspections to determine which of the over 1,100 banks that have applied to join the general deposit insurance system are eligible.

OECD wants faster gas sector reform. An OECD just-released Economic Survey of the Russian Federation 2004 notes that GDP growth averaged 6.7% annually during the years 1999–2003. The figure was higher than all expectations. The OECD noted that the strong growth was mainly a reflection of high world oil prices. It restated the importance of a tight fiscal stance and gave cautious support to Russia’s plans to reduce taxes on other parts of the economy at the expense of natural resource industries. The report observed that collecting excess oil revenues in a stabilisation was a good idea, but the current ceiling of RUB 500bn was probably too low in relation to Russian GDP. Like the IMF last month (see BOFIT Weekly 27/04), the OECD warned of the danger of releasing extra oil revenues into the economy. Both institutions recommend that Russia should instead accelerate retirement of debt in addition to contributing to stabilisation fund.

The study notes that growing the natural gas sector may help reduce Russia’s dependence on oil revenues. For this reason, the reform of state-owned Gazprom, which has a virtual monopoly on the sector, should have top priority. The OECD encouraged Russia to end Gazprom’s dual roles of both monopoly operator and sector supervisor. Instead, Gazprom needs to be broken up into several companies. The state would then assume the roles of supervisor and regulator. The report also called for greater market access for small gas producers, and noted the need to raise prices on electricity and natural gas to levels where they fully cover costs.

The OECD reiterated IMF’s observation that the price of resisting a rise of the rouble is likely to be paid domestically through higher inflation at a time when fighting inflation should be the main monetary issue. The survey acknowledged that, although the Russian government has decisively launched numerous structural reform programmes, their implementation is hampered by institutional inefficiency, the weak justice system and corruption.

Russian government discusses policy goals. On July 8, prime minister Mikhail Fradkov said the government has five main policy goals, i.e. raising living standards, improving the competitiveness of enterprises, supporting regional economic programmes, rational integration with the global economy and developing strategic investment programmes and projects. Fradkov observed that Russia needs to focus on attracting investment in science and technology as well as increase research activity. Priority should be given to aviation, defence, nuclear power, telecommunications, pharmaceuticals, biotechnology, and software development. Educational systems need to be developed to meet the needs of the market economy. Tax cuts are crucial to improving overall economic competitiveness, while the natural resources sector can shoulder a slightly higher tax burden. In the banking sector, the aim is to promote voluntary bank mergers and more thorough supervision and monitoring of bank operations.
China

**Industrial output growth continues to slow.** Industrial output in June was up 16.2 % y-o-y, evidencing a slowing trend that has continued since March. In the first half of the year, industrial output was nearly 18 % higher than a year earlier. Official measures to restrain growth have taken effect particularly in heavy industry. At the start of the year, the pace of growth in heavy industry was about double that of light industry. By June, growth had fallen to 20 %, while light industry grew at 16 %. Production of steel products slowed to 17 % growth, while cement production fell to 13 %. Electricity production increased 14 % y-o-y for June and 16 % for the first half.

The ratio of sales to production, reflecting growth of inventory, was 97.2 % for 1H04, or slightly higher than a year earlier. For example, inventories of metal products and cars have shown growth.

**Industrial output, % change from 12 months previous**

![Graph showing industrial output growth from 2000 to 2004](image)

Source: National Bureau of Statistics

**Trade surplus in June.** China’s June trade surplus of $1.8bn was the second monthly surplus in a row. Exports climbed at a record 47 % y-o-y to $51bn. Imports soared 51 % to $49bn. The growth in exports probably reflects increased demand in Europe, Japan and the US. The higher imports, in contrast, showcase higher oil prices and growth in domestic demand. For 1H04, Chinese exports rose 36 % to $258bn. Imports grew 43 % to $265bn. The trade deficit for the period was $6.8bn.

**US and China resolve semiconductor dispute.** Facing the threat of WTO arbitration (see BOFIT Weekly 14/04), the two parties worked out their differences in bilateral negotiations. China agreed to eliminate its preferential tax treatment for domestic manufacturers by April 2005 and stop giving such treatment to new firms. China’s semiconductor industry claims the advantage conferred by the preferential treatment was negligible in any case. Observers believe the Chinese government will continue to support its semiconductor industry through WTO-accepted measures, such as allowing deductions for R&D expenses. The Chinese government wants to make the semiconductor industry a pillar of the national economy.

**FDI accounts for about half of growth in foreign exchange reserves.** In the first six months of this year, foreign direct investment in China rose by 12 % y-o-y to $34bn. By June, there has been nearly a half million enterprises with foreign participation operating in China, and China had received $535bn in direct investment.

China’s foreign exchange reserves swelled $67bn in the first half, despite a trade deficit of nearly $7bn. The ongoing inflow of foreign currency has complicated the efforts of China to practice effective monetary policy. As of end-June, China had foreign currency reserves of $471bn.

**Two large state banks attempt to meet new capital adequacy requirements by selling subordinated bonds.** At the beginning of July, the Bank of China issued subordinated bonds worth a total of CNY 14bn ($1.4bn). China Construction Bank has also announced it will sell up to CNY 15bn ($1.5bn) in subordinated bonds early next month. The sale of subordinated debt was expected, since neither bank satisfies the official capital adequacy requirement of 8 % – even after securing a $45bn capital injection last year (see BOFIT Weekly 26/04). While the 10-year bonds confer last-in-line creditor status in the event of bankruptcy, their issuance is expected to bolster the capital adequacy ratios of both banks to levels above the regulatory threshold.

China’s revised rules comply with the Basel Capital Accord, defining subordinated debt as supplementary capital. Supplementary capital, within limitations, can be included when calculating a bank’s capital base. The new regulations also sanction cross-holding of subordinated debt among banks up to 20 % of an individual bank’s core capital (equity capital plus disclosed reserves).

Apparently, China Construction Bank, which bought CNY 3.7bn of the bonds, was the largest single buyer of the Bank of China issue. Moreover, the Bank of China’s coupon rate of 4.87 % was below the prevailing market rate of 4.95 %. This raised concerns that the cross-holding was part of a scheme to artificially inflate the capital base of both banks and drive down the issue’s interest costs. Cross-holding of subordinated debt can increase systemic risk in the banking sector.
Russia

Brisk rise in industrial output. The State Statistical Service reports industrial output grew 7.4% y-o-y in the first half of 2004 and 9.2% y-o-y in June. The workday-adjusted increase in the first half was 6.7% and 7.5% in June. Above-average growth in the first half was registered in glass production (18.1%), machine building (14.9%), chemicals and petrochemicals (9.1%), construction materials (8.5%) and the fuel industry (8.2%). Production fell in four industrial fields, including pharmaceuticals (down 4.5%). Production of nearly all main products of the textile industry was off from January-June 2003.

Industrial output and 3 main industries, on-year change, %

Source: State Statistical Service

Yukos’ main production unit may be sold. On Tuesday (July 20), the justice ministry announced its intentions to sell Yuganskneftgas, Yukos’ main production unit, to recover taxes Yukos owes from the year 2000. Yukos claims it has already paid RUB 8.73bn of its original RUB 99.4bn (€2.8bn) tax debt. The company has promised to pay off its tax debt, but has requested an up-to-three-year payment plan. Yukos is currently in court fighting an additional tax bill of RUB 98bn (€2.8bn) for 2001. With its assets frozen, cash-strapped Yukos is beginning to experience production problems. Yukos is warning of impending bankruptcy unless tax officials release some of the assets. Without access to its assets, Yukos claims it can only operate through mid-August.

Yuganskneftgas accounts for about 60% of Yukos’ production. Yukos values the unit at €24.7bn, while the brokerage house Aton Capital puts the value of the company in the range of €13.6–19.1bn, depending on the calculation method used. No information is yet available on how the company will be appraised or its sale price, but it is clear that loss of its main production company would mean that Yukos would no longer be able to appraise or its sale price, but it is clear that loss of its main production unit would mean that Yukos would no longer be able to continue operations.

The troubles of Yukos have shaken confidence of Russian markets. Following the justice ministry’s announcement, the price of Yukos fell 30%, by noon today (July 23). The RTS index of leading Russian shares, which stood at 604 just last week, was at 564 by mid-today.

Duma approves most of housing reform package in second reading. The Duma approved 18 bills in a package of 27, transferring the more controversial nine remaining bills to its autumn session. Among the bills postponed are the housing act and urban construction act. The housing reform package also contains a building act and a real property registration act. The law package under consideration by the Duma should help president Vladimir Putin meet his target of making it possible for at least a third of citizens to be able, either through their savings or a housing loan, to acquire a good quality, modern apartment by 2010.

The legislative package is hoped to stimulate both supply and demand for apartments. Demand is sought to increase by reforming the law on hypothecary banks, and conditions for receiving housing loans and eased collateral basics. The legislative reform seeks to spark explosive growth in demand for home loans. Russia’s current housing loan market is only about RUB 10bn a year. Under the framework of the new laws, it is expected to climb above RUB 300bn (€8.3bn) a year. Interest rates are also expected to fall from currently around 18% to 7–10%. After the change, banks will be in a better position to liquidate collateral when loans go sour.

Housing supply, in turn, would be stimulated through elimination of construction monopolies and speeding up construction schedules. The reform package also includes regulatory bases for certain tariffs as the government wants to preserve a degree of regulation in municipal water, heating, natural gas and waste collection fees. The reform package in itself is not expected to affect housing prices, but demand is expected to take off as soon as reforms in the home loan market are in place.

Putin demands closer CIS cooperation. Last week, president Vladimir Putin reminded Russian ambassadors of the importance of CIS cooperation. He said that strengthening such cooperation – both politically and economically – should be Russia’s top foreign policy objective. After that, come the relations with the EU, NATO and the US.

Mr. Putin returned to the subject at a session of the Russian security council at the start of the week. He noted that companies and all levels of public administration invest too little in promoting this cooperation. The president said political and economic competition within the CIS area has grown. He envisioned an economically vibrant and internationally significant CIS area and reminded his listeners that Russia’s expanding market, energy endowments and migrant labour within the CIS should be motors for growth for the entire region. He noted that Russia needs to preserve its position as the leader of cooperation or the cooperation will fall apart.
China

Revisions of last year’s GDP figures lower second quarter growth. The National Statistics Bureau (NSB) reports economic growth slowed from 9.8% y-o-y in the first quarter to 9.6% y-o-y in the second quarter. The deceleration in the second quarter constitutes a much-desired outcome in the government’s efforts to ensure a “soft-landing” of the overheated Chinese economy. In conjunction with the release of the latest quarterly results, the NSB revised figures for 2Q03 GDP growth from 6.7% to 7.9%. The revisions were adjustments to service sector figures that adjusted the impact of last year’s Sars epidemic. Without the revision, the second quarter of 2004 growth figure would have been clearly higher.

The government’s tightening efforts have been particularly effective in curbing excessive fixed asset investment, which responded well to administrative measures. However, industrial production growth and price levels are still high. The inconsistencies among indicators, unfortunately, cloud the picture of the actual state of the economy.

GDP growth, %

Source: National Statistics Bureau

June consumer prices up 5.0% y-o-y. On-year inflation in May was 4.4%. The largest driver of consumer price inflation was food prices, which increased over 14% y-o-y in June. Housing costs were also higher in June compared to a year earlier. On the other hand, declines were registered for such items as clothing and home appliances.

Inflation has accelerated at a fairly even pace since last summer. The June rise in inflation partly reflected last year’s comparatively low figures, which covered the period of the Sars epidemic. Consumer prices declined 0.7% from May to June. This does not necessarily foreshadow a slowing in inflation, but rather is at least partly attributable to seasonal fluctuations in prices. Officials expect inflation to begin to slow in the autumn, when the comparison figures begin to trend upwards again.

The promise of a bumper grain harvest this year also could spell end the rapid rise in grain prices.

Growth in fixed investment slows. Fixed investment grew 29% y-o-y in the first half of 2004 and amounted to CNY 2,600bn (€260bn). Growth, however, was three percentage points lower than a year ago and 14 percentage points below the first quarter of this year. Real estate investment grew 29% y-o-y in the second quarter, down from the blistering 41% pace in the first quarter. The slowdown in investment is likely the result of government’s efforts to slow credit growth.

Money and credit growth on target. The money supply grew 16% y-o-y in the first half of 2004, one percentage point off the pace targeted by the central bank for 2004. New loan growth also continued to slow. At the end of June, the balance of the loan stock rose by 16% y-o-y, 7 percentage points slower than the same period last year. The considerably reduced pace can be partly attributed to the four major state-owned banks’ dumping of their non-performing loan portfolios. Contraction of both the money and credit supply is seen as crucial to cooling China’s overheated economy.

Growth in real incomes remains strong. Real incomes in China’s rural areas climbed 11% y-o-y in the first half of the year. The average monthly income per capita was 220 yuan (22 euro). The average city dweller’s monthly earnings were 800 yuan, a 9% increase in real terms from a year earlier. The rapid growth in rural incomes is due mainly to the rise in prices for agricultural produce. The number of Chinese living below the poverty line grew last year by 800,000 persons to a total of 29 million, most of whom live in the countryside. The government seeks to improve the status of rural residents by eliminating all taxes on agricultural produce within the next five years. The income improvements were reflected in first-half gains in retail sales, which were up 10% y-o-y in real terms. Retail sales for the first half were valued at CNY 2,500bn (€250bn). Sales grew especially fast in telecommunications equipment (52%), oil products (44%) and motor vehicles (44%). Rapid growth in incomes is expected to further boost consumption in the second half of this year.

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Rural residents only account for about a third of retail sales, even though about a 60% of the China’s population lives in the countryside.
Russia

Rise in Russian producer prices accelerates in June. With June producer prices up nearly 26% from June 2003, the rise in producer prices has continuously picked up from a pace of 12% y-o-y in November 2003. The sharpest on-year increases in producer prices were seen in ferrous metallurgy (62%) and crude oil production (59%). While producer price also climbed in other energy fields, they increased more than earlier. In the fuel industry, producer prices were up over 52% y-o-y in June 2004; a year ago growth was only 2%. Oil refining and the natural gas witnessed price increases of 44% and 32%, respectively; a year earlier prices were falling in both industries. The electricity and petrochemical industries were the only major fields where the rise in prices slowed significantly from a year earlier. In June, the on-year rise in producer prices in electricity and petrochemicals was 12% and 10%, respectively.

Transportation prices have risen fairly steadily throughout this year, with the on-year rise ranging between 19% and 21%. June transportation prices were up 21% y-o-y. For the first six months of the year, rail transport price inflation was 27% y-o-y, while increases in prices for road transport have fluctuated between 9-11%. The on-year rise in prices for pipeline transport accelerated from 11% in January to 17% in June.

Cabinet discusses changes in exports policies. Prime minister Mikhail Fradkov said both machinery and equipment and high technology should represent larger shares of Russian exports. In his opinion, the state needs to identify more effective ways to promote exports. Fradkov wants to raise the share of machinery and equipment in total exports from its current level of 8.6% to 10%. Some 70% of last year’s $137 billion in exports consisted of raw materials and unrefined goods. Russian only exported about $100 million in high-tech goods. Economy minister German Gref considered it unrealistic to reach Fradkov’s goal within a year. Finance minister Alexei Kudrin suggested a target of increasing the share of machinery and equipment to 15% of total exports within five years.

The economy ministry proposed that at least $600 million of the 2005 budget be set aside for export support ($500 million to cover subsidies to exporters and $100 million in export guarantees to be provided through Roseximbank). Another $100 million in interest subsidies for export companies were also proposed. Although the 2004 budget set aside $500 million for similar purposes, less money than planned has been taken out of special funds because the current budget act makes it difficult to access fund money. The economy ministry has proposed amendments to the budget act to improve access to funds for providing export guarantees.

Russia wants to reduce its foreign borrowing. On July 15, the cabinet discussed its 2005 borrowing plan, which seeks to raise €3 billion from international financial markets and institutions, and €6 billion from securities markets. Prime minister Mikhail Fradkov stated that the government’s goal is to reduce its borrowing from international credit institutions. Finance minister Alexei Kudrin noted that last year Russia only used 37% of its credit facility from the World Bank. Instead, he said, Russia’s priority is completing current projects before starting any new ones. He added that the only new World Bank project slated for next year involves housing reform.

The government plans to cover most of next year’s debt servicing costs as well as the paying down of principal from sources: the surplus from the stability fund, income from privatisation sales and eurobond issues totalling €2.1 billion. Mr. Kudrin said that the government’s total foreign debt obligation would reach $120 billion next year. On the other hand, although foreign debt will only shrink by €200–300 million by 2008, its share of GDP will fall to just 20–25% during the same period due to rapid expansion of the Russian economy.

The government hopes to increase foreign lending this year by €83 million to a total of €618 million. The government also plans to lend €568 million next year. Its largest loan this year was a €330 million loan to China for construction of the Tianwan nuclear power plant. The largest loan planned for next year is a €348 million loan to India for construction of the Kudankulam nuclear power plant.

Privatisation of Lukoil proceeds. On July 22, prime minister Mikhail Fradkov signed a cabinet decision that the state will divest its remaining stake in Lukoil, which, in terms of output, is currently Russia’s second largest oil company. The state’s 7.59% stake will be sold as a single block of shares. The bidding competition will likely take place in September. This year’s largest privatisation sale is expected to raise about $1.7 billion, given the company’s current valuation of around $23 billion.

ConocoPhillips, America’s third-largest oil company is currently seen as the most likely buyer. ConocoPhillips CEO James Mulva and Lukoil president Vagit Alekperov met last week with president Vladimir Putin at the Kremlin. They discussed ConocoPhillips’ investment plans for Russia. The markets presume the president has already given his blessing to the deal.
China

June producer prices in China remain high. Both the central bank’s Corporate Goods Producer Index (CGPI) and the National Bureau of Statistics’ Producer Price Index (PPI) showed higher producer prices for June. The CGPI rose 9.3 % y-o-y, while the PPI was up 6.4 %. Thus, the large discrepancy in the two producer price indices persists (see BOFIT Weekly 22/2004).

The central bank reported on-month deflation of 0.3 % in June, while the NBS claimed on-month inflation of 0.4.

Higher grain prices drive up agricultural product price indices. The National Bureau of Statistics (NBS) compiles a quarterly price index of agricultural products based on surveys of 27,000 enterprises. Its general index (Agricultural Product Price Index) covers price developments in farming, forestry, animal husbandry and fisheries. These categories are further broken down into prices of individual products. According to the NBS, agricultural product prices rose 11 % y-o-y in the second quarter. The higher prices mainly reflected higher grain prices, which were up an average of 29 %. Rice prices led the increase, climbing 41 %. Food prices are believed to make up one third of China’s consumer price index.

Prices of agricultural products, on-year % change

Source: NBS

Electricty consumption hits record levels. Electrical power consumption in China increases almost daily. The latest record in daily electricity use was set last week, when consumption exceeded 6,400 gigawatt-hours. New records are expected in the coming weeks as a heat wave is forecast for southern China. Increased use of air conditioning in hot weather increases electricity consumption.

In the first six months of 2004, electrical power production soared 16 % y-o-y to 1,000,000 gigawatt-hours. In the third quarter, China’s daily power deficit is expected to reach 30 gigawatt-hours.

China has undertaken electricity-saving measures to deal with the situation. Measures include reductions in street and commercial lighting. Several cities have even decreed that some production facilities must shut down during peak consumption periods. Consumption restrictions are currently in force in 24 provinces or regions. The National Development and Reform Commission has sought to ease and stabilise electrical power consumption by raising prices and allowing greater differences in prices for various times of the day. To alleviate the power crunch, China is building new nuclear power plants. It has also has pressed the Three Gorges hydroelectric power plant into partial service (see BOFIT Weekly 23/2004).

Travel to Mainland China continues to grow. In the first six months of this year, over 51 million travellers visited China. Of those, some 44 million came from Macao, Hong Kong or Taiwan, and about 40 % were tourists.

The number of visitors increased 24 % from the first half of 2003 and brought in $11bn in foreign currency earnings. Foreign currency earnings were up 45 % y-o-y. (The Sars epidemic a year ago lowered the basis of comparison.) Travel accounted for over 5 % of China’s GDP last year. China hopes to be the world’s most popular tourist destination by 2020 and expects travel to account for 11 % of GDP.

Over 13 million Chinese travelled abroad in the first half, an increase of 63 % y-o-y. Over 73 % of Mainland Chinese travellers went to Hong Kong or Macau. Travel within China has also taken off. Despite the Sars epidemic last year, China had 870 million domestic travellers. This year, domestic travel is expected to increase further.

China rises in UN standard-of-living comparison. The United Nations Development Programme’s (UNDP) 2004 Human Development Reports assesses living standards in 177 countries. The ranking criteria include life expectancy in 2002, quality of education and health care, as well as average per capita incomes. China rose ten places to 94th place. Hong Kong ranked 23rd. The UNDP noted that Norway continues to rank as the world’s most-developed nation. Finland ranked 13th. Russia moved up six places in the rankings to 57th.

Life expectancy was 70.9 years in China, and an impressive 79.9 years in Hong Kong. In Norway, it was 78.9 years. Life expectancy in Russia was 66.7 years.

Official figures show the spread of HIV in China and Hong Kong is at a level equivalent to Norway, where 0.1 % of the population is HIV positive. In Russia, for example, the infection rate is 1.1 %.
Russia

Russian real wages up in the first half over 14 %. The State Statistical Service reports real wages rose 14.1 % in the first six months of 2004. Disposable income was up 9.8 % y-o-y. The average monthly wage increased to 6,980 roubles (200 euro), compared to 5,550 roubles in the same period a year ago. One out of eight workers was owed back pay as of end-June. June unemployment, measured by ILO methodology, was 7.9 % of the workforce. Just 2.2 % of the Russian workforce was officially registered as unemployed.

Banking sector calms. Uncertainty in the banking sector has eased for the moment. Central Bank of Russia measures have quelled a depositor scare and new liquidity problems at banks have been averted. State-owned Vneshtorgbank acquired an 86 % stake in troubled Guta Bank with a CBR-secured $700 million loan.

Last month saw a run on Alfa Bank, Russia’s largest private bank. Alfa Bank claims depositors withdrew more than a half billion dollars in a two-week period. The bank managed to cover the withdrawals by its owners making additional contributions to the bank capital. Media reports claim the net total amount withdrawn from all private banks during July may have exceeded a billion dollars. Last week, the central bank continued its clean-up of the banking sector by cancelling the licences of four small banks.

State-owned Sberbank has benefited most from the financial turmoil. According to news reports, Sberbank received about $350 million in new deposits in the first week of July.

Thanks to a state deposit guarantee, Sberbank currently holds about 60 % of all private deposits. Under new legislation before the Duma, Sberbank could lose its exclusive status. The bill proposes that, from the beginning of October, the maximum guaranteed amount of deposits in Sberbank will be 100,000 roubles (3,400 dollars), just like in any other bank admitted to the new deposit insurance system. About 1,140 banks have applied to join the new deposit insurance scheme. The CBR will give its first responses to applicants to the new deposit insurance arrangement later this month.

New tax investigation of Yukos launched. Tax officials announced last week that they had initiated an investigation of Yukos’ 2002 taxes, adding they may seek an increase in the tax obligation owed by Yukos for 2001. Yukos is already on the hook for RUB 197bn ($5.6bn) in unpaid taxes for 2000 and 2001. Officials have given Yukos until the end of this month to pay off the remaining RUB 79bn on its 2000 tax bill.

Russian markets reacted strongly after tax officials demanded (then retracted) Yukos cease production at three major oil fields. The uncertainty drove the price of a Yukos share below three dollars, its lowest level since October 2001.

Tax officials are still moving ahead with the sale of Yukos’ core production unit, Yuganskneftegaz. Early this week, Yukos offered to pay part of its debt with the sale of its 56 % stake in Rospan International, a Siberia-based natural gas producer, to TNK-BP for €298 million. Official approval of the deal is pending.

Although the value of Yukos shares has collapsed, world oil prices have soared to record heights. On August 3, oil futures hit $44 dollars a barrel on the New York commodities exchange, its highest level ever. Given the high price of oil and increases in output, the economy ministry raised its GDP estimate for this year by a tenth of a percentage point to 6.7 %.

Daily output of major oil companies (thousands of barrels)

<table>
<thead>
<tr>
<th>Company</th>
<th>January-July 2004</th>
<th>Annual growth, %</th>
<th>Share exported, %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yukos</td>
<td>1,708</td>
<td>8.9</td>
<td>42</td>
</tr>
<tr>
<td>LUKoil</td>
<td>1,663</td>
<td>7.7</td>
<td>40</td>
</tr>
<tr>
<td>Surgutneftegaz</td>
<td>1,164</td>
<td>10.5</td>
<td>34</td>
</tr>
<tr>
<td>TNK-BP</td>
<td>959</td>
<td>16.0</td>
<td>47</td>
</tr>
<tr>
<td>Sibneft</td>
<td>670</td>
<td>10.2</td>
<td>39</td>
</tr>
<tr>
<td>Tatneft</td>
<td>501</td>
<td>2.0</td>
<td>49</td>
</tr>
<tr>
<td>Total/Average</td>
<td>9,016</td>
<td>10.3</td>
<td>40</td>
</tr>
</tbody>
</table>

Source: Aton

Russian government revises plan for reform of electrical sector. Last month, prime minister Mikhail Fradkov signed an updated schedule for reform of the electrical power sector. The changes seek to dismantle the state monopoly and open the sector to international competition. The new 29-step timetable keeps to the original deadline for deregulation of the Russian electricity markets at the beginning of 2006. Implementation of some reforms is already delayed over a year from the original schedule. On the other hand, development of regulations for the wholesale electricity market is on track so that at least this part of the reform would be in place by the third quarter of 2005.

Plans for privatisation of state-owned electricity giant UES were tabled at the end of June, and the new plan still fails to suggest a time frame for the divestment. Plans for sell off the state’s stake in UES have been shelved until the government better studies the possible impacts of privatisation. Fradkov announced the government would get back to the UES privatisation before the end of the year.
China

Newly revised regulation eases entry of foreign banks into China. Revised regulations on foreign-owned banks operating in China enter into force next month. After the founding of China’s Banking Regulatory Commission (CBRC) in 2003, the original rules, drafted in 2002, needed updating. Under the new regime, the burden of responsibility shifts from the People’s Bank of China (PBoC) to the CBRC. The revised regulation, which significantly lowers entry requirements for foreign banks, is in line with the WTO’s demand for greater international access to China’s banking sector.

The changes eliminate the one-year waiting period for foreign banks filing to open new branches. Capital required for conducting local-currency-denominated transactions with Chinese firms and households have been reduced by CNY 100 million (€10 million), so that CNY 300 million (€30 million) in operating capital is needed to handle corporate transactions and CNY 500 million (€50 million) for household transactions. Administrative responsibilities are clarified so that applications for establishing foreign-owned banks or branches of a foreign bank are filed directly with the CBRC. Other administrative matters will be dealt with at local CBRC branches. Previously, all administrative matters had to be reported both to local branches and the CBRC. The new regulation follows current international banking supervision standards and guarantees foreign banks equal treatment with domestic banks.

Foreign-owned banks have enjoyed robust growth in recent years. The CBRC reports that, as of July 15, a hundred foreign banks now have permission to conduct yuan-denominated transactions in 13 designated cities. At the end of 2001, only 30 banks had such authorisation. While total yuan-denominated assets in foreign banks were up an impressive 49 % y-o-y in first half of 2004 (compared to 16 % for the entire banking sector), such assets only amounted to CNY 84bn (€8.4bn), a tiny share of the CNY 30 trillion in assets held by China’s banking sector.

An earlier rule jointly issued by the National Development and Reform Commission (NDRC) and the State Administration of Foreign Exchange (SAFE) on offshore borrowing continues to restrict funding options for foreign banks (see BOFIT Weekly 24/2004).

Macao to follow Hong Kong in allowing use of yuan. On August 4, the PBoC signed an agreement with Macao’s monetary authority that lets Macao banks provide yuan services from October 1. The move has been anticipated ever since the Hong Kong special administrative region signed an almost identical agreement at the end of 2003. Chinese authorities expect to focus strongly on preventing money laundering via gambling – Macao’s top industry – once the new arrangement begins. Debit cards issued by mainland banks cannot be used in gambling establishments. Moreover, a single Macao bank will be designated as clearing bank. Other banks must then make agreements on yuan-denominated services with the clearing bank.

Dispute arises over elimination of WTO textile and clothing quotas. In accordance with a WTO agreement, distortional import quotas on textiles and clothing will be eliminated at the beginning of 2005. China is the world’s largest exporter of textiles and clothing, the value of which is estimated at $42bn for the first half of 2004. Prices of Chinese exports are expected to fall with the elimination of the quotas as manufacturers will no longer need to purchase quota shares. Some observers say as much as 80 % of global clothing manufacture could shift to China if import barriers are lifted completely.

Wide opposition to ending the quota system has been generated in industrial countries, which have used import quotas for four decades to shield domestic producers. For example, an alliance of 90 trade organisations wants the lifting of quotas postponed until 2008. They claim that the move would cause the loss of 30 million jobs worldwide by 2007, including 650,000 jobs in the US.

On the other hand, delay of the quota lifting appears unlikely, given WTO rules allow member countries alternative protective measures such as higher customs duties and safeguard quotas. Member countries are entitled to use such measures until 2008 if they can show that their domestic industries are threatened by imports. The US is currently considering safeguard quotas on China-produced socks.

As most European producers have shifted to high-end goods and Chinese producers focus on inexpensive wholesale goods, the EU Commission expects European producers of clothing and textiles to be largely unaffected by the elimination of quotas. Chinese manufacturers argue that strong growth of demand in China will mitigate much of the impact on world markets, because domestic demand will raise prices of raw materials and finished goods.

Urban unemployment rate unchanged. As of end-June, the Ministry of Labour and Social Security reports the unemployment rate in cities was 4.3 %, up from 4.1 % a year earlier. Some 8.4 million urban residents were registered as unemployed. The number of jobless is expected to increase at the end of this year, when about 10 million trade school and college graduates enter the labour market. NBS figures show that in 2003 China had 750 million registered workers, with about a third living in cities. According to some sources, about 20 % of the rural population is either unemployed or underemployed. Employment is a cornerstone of the government’s current policy agenda. The government hopes to create 3 million new jobs by the end of this year and to hold the urban unemployment rate below 4.7 %.
Russia

Russian inflation picks up in July. After slowing for about a year, on-year growth in consumer prices accelerated last month to 10.5%. The rise in food prices was 9.4% y-o-y, while prices for other goods were up 8.2%. The annual rise in prices of services, however, continued to slow, and was 16.7% y-o-y (in July 2003, prices of services were up 31.2% y-o-y). State Statistical Service figures show that the price of the basic food basket rose 9.4% between the start of this year and the end of July.

The economy ministry reports that inflation this year may exceed the government’s target range of 8–10%. For the first seven months of the year, prices rose 7.1%. Economy minister German Gref still feels the 10% target is achievable as long as monetary policy is kept sufficiently tight. The pick-up in inflation may be largely attributed to high oil prices, which have increased the amount of money in the economy. The broad money supply (M2), which includes all forms of legal tender and deposits, rose 15% from the start of the year to the beginning July, and was up 4.7% in June.

Consumer prices, % change from 12 months previous

Differing views on economic growth. In his August 5 presentation, economy minister German Gref said his ministry had decided to add a tenth of a percentage point to the ministry’s economic forecast for the remainder of 2004 and 2005. High world oil prices and good export prospects are expected to boost GDP growth to 6.7% for this year and 6.0% next year. Gref noted the GDP growth in the first half of this year was 7.4% and that the ministry’s predictions tend to be cautious. Gref’s personal view was that 2004 GDP growth would come in at between 6.8% and 7.1%.

On Monday (Aug. 9), deputy prime minister Alexander Zhukov announced the cabinet was raising its GDP growth outlook to 6.9% for 2004 and 6.3% for 2005. Zhukov attributed the increase to the rapid expansion of Russian industry and reduction of the country’s dependence on oil income, noting e.g. that the metal fabrication and machine-building sector expanded 15% in H104.

Reforming Russia’s social security system. A controversial reform of Russia’s social security system that would replace entitlements for certain population groups with financial benefits has been approved by the Duma (Aug. 5) and the Federation Council (Aug. 8). The first phase of the reform would not affect benefits involving housing or municipal utility services.

According to preliminary information, recipients in the revised system would receive a basic monthly benefit for costs of medicines, spa treatments and public transport (worth 450 roubles, 15 dollars) from the start of 2005. An additional monthly benefit of 350–1,550 roubles in cash would then be granted based on the classification of the needs of different groups. From the start of 2006, those eligible for benefits could choose between taking the basic 450-rouble benefit as cash or in services.

The reform also modifies federal and regional responsibilities for funding the benefits. The provision of benefits for war veterans, disabled persons and a number of other special groups would come out of regional budgets. Critics say the plan shifts too much of the burden to regional budgets, which will not necessarily make their ends meet. Several population groups have also expressed doubt that the envisioned monetary benefit would in fact be sufficient to compensate for the value of services under current entitlements. On Monday (9 Aug.), president Putin was presented with a petition, signed by 80,000 citizens, asking him to exercise his veto power by not signing the bill into law.

Government contemplates privatisation plans, president approves list of strategic companies. In his presentation of the government’s privatisation plans in coming years, economy minister German Gref observed that state-owned enterprises tended to operate considerably less efficiently than their private-sector counterparts and therefore the government needs to push harder on privatisation issues. He also wants to rely more on open bidding competitions than earlier. In 2005, the government plans to divest over 1,300 state unitary enterprises and sell off stakes in almost 600 companies. These sales are expected to raise RUB 40bn (€1.1bn), about the same amount as this year.

On August 4, the president issued a decree listing state businesses that would require presidential approval before they could be privatised. The list identifies 514 state unitary enterprises and 549 companies in which the state holds a stake of at least 25%. Strategic companies, including national airline Aeroflot, telecommunications giant Svyazinvest and insurer Rosgosstrakh, are currently set for privatisation in 2005. The list also includes Vneshtorgbank, Transneft, Gazprom and Rosneft. In total, about 3,000 firms in Russia are subject to at least some privatisation restrictions. Mr. Gref responded that the restrictions are overly broad; limiting the scope to about 200 state firms involved in defence and national security should be enough to meet the state’s objectives.

Source: State Statistical Service

Information herein is compiled and edited from a variety of sources. The Bank of Finland assumes no responsibility for the completeness or accuracy of the information.
China

Rise of Chinese industrial output and producer prices slows in July. Industrial output growth fell from 16.2% y-o-y in June to 15.5% y-o-y last month. Industrial export growth, meanwhile, continues to contribute an ever-growing share of industrial output growth. The 33% y-o-y rise in exports accounted for a quarter of all industrial output growth. Even with a slowing growth in relation to previous months, production of energy and raw materials continued to grow briskly in July. In the durable consumer goods category, however, automobile production was up only 5.4%, with growth dropping 15 percentage points from the previous month.

The National Bureau of Statistics’ producer price index rose 6.4% y-o-y in July, slightly up from 6.3% in June. Oil prices, which were up 25% y-o-y in July, added nearly eight-tenths of a percentage point to producer price inflation. For the first seven months of the year, producer prices were up 4.9%.

Trade deficit continues to shrink in July. The customs administration reports Chinese exports in July climbed to $51bn (up 34% y-o-y), while imports were $49bn (34%). July was the third month in a row to show a trade surplus. The $6.9bn trade deficit for January-June shrank by $2bn to $4.9bn in July. In the first seven months of this year, exports were up 36% and rose to $310bn, while imports rose 41% to $314bn.

Export growth has been led this year by high technology. Exports of high-tech products, valued at $84bn, rocketed 58% y-o-y and accounted for 27% of total exports.

Observers point out that the increase in Chinese exports reflects both foreign manufacturers’ transfer of production to China and increased demand in Europe, the US and Japan. The growth in imports to China signals strengthened domestic demand and higher oil prices.

China’s Ministry of Trade expects 2004 exports to rise 15% y-o-y and imports 20%. This would create a foreign trade surplus of about $10bn.

Housing prices on the rise. The National Bureau of Statistics reports housing prices were up in the first half of the year an average of 12% y-o-y. Growth was five percentage points lower in the first quarter. Driven by insufficient supply, the price of office space soared 23%.

The People’s Bank of China expects housing prices to continue to rise. Some of the factors driving the upward trend include a legacy of underinvestment in the sector and government measures to rein in economic growth (which has further dampened investment). Chinese purchasing power is also rising. Housing prices have risen steadily for the last four years.

Inventories reach record levels in June. A central bank survey of 5,000 industrial enterprises found inventories grew 22% y-o-y in June. Raw material inventories rose 25%, while finished goods inventories were up 16%.

The value of inventories has reached its highest level since 1996. The National Bureau of Statistics’ monthly indicators show the value of finished industrial goods climbed 20% y-o-y in June to nearly a CNY 1,000bn (€100bn). In June 2003, growth in inventories was about 10%.

Despite the fact that the level of inventories as the share of current assets reached 30% at the end of June, the People’s Bank of China’s survey found few enterprises attempting to reduce their long-term investment position in the face of growing liquidity risk. For the first half of the year, enterprises had increased their stock of long-term investments by 11% or nine percentage points more than in the same period last year.

New short-term lending in the banking sector also contracted by CNY 170bn (€17bn), while the accounts receivable of industrial enterprises rose 19% y-o-y to CNY 2,000bn (€200bn). The rapid growth in inventories and receivables has reduced liquidity of enterprises and put pressure on the banking sector to lend more money.

Value of inventories, % change y-o-y

![Image of inventory value chart]

Source: PBoC
Russia

High metal prices boost Russian foreign trade in first half. Central Bank of Russia figures show a January-June trade surplus of $36bn (about 14 % of GDP). Export growth accelerated in the second quarter, scoring 25 % in 1H04. The value of exports in January-June was $79bn. The value of imports also grew 25 % in 1H04. CIS countries increased their share of Russia’s foreign trade by six percentage points from a year earlier to 16 % in the first half.

Russian customs figures indicate the share of oil and gas products in exports to non-CIS countries during the first half of 2004 was 57 %, four percentage points less than in 1H03. The volume of crude oil exports increased 6 %, while export prices rose 21 %. The volume of gas exports remained unchanged, however. The value of exported refined oil products rose 4 %.

The share of metals and metal products in exports to non-CIS countries rose to 19 % for the period January-June, a four-percentage point increase from a year earlier. High metal prices worldwide pushed up the value of exports by 62 %. Russia’s main import products from non-CIS countries were machinery and equipment (44 % share of imports) and foodstuffs (19 %).

According to customs statistics, Germany remains Russia’s largest trading partner, followed by Belarus and the Netherlands. With a 25 % on-year increase in the value of its trade with Russia, Finland was Russia’s eighth largest trade partner.

Russian exports and imports, 12-month % change

Foreign investments on the rise. The State Statistical Service announced investment flows into Russia grew nearly 50 % in the first half of this year. The value of investments totalled $19bn, of which foreign direct investment represented $3.4bn. Direct investment increased over 35 % from a year earlier. Some $129 million went to portfolio investments, an increase of 240 % from 1H03. Foreign loans and trade credits grew 53 % y-o-y. Investment flows to industry represented over 54 % of total investments in the first half.

As of end-June, the stock of foreign investment in Russia was $66bn, a 37 % on-year increase. Direct investment made up 40 % of the stock, while investments in securities accounted for just 2 %. The remainder consisted of trade credits and loans from abroad. Over half of investment came from Germany, Cyprus, the Netherlands and the UK.

Russia WTO talks continue on a broad front. Russia’s head negotiator Maxim Medvedkov says Russia’s bilateral talks have produced agreements on access of goods to the Russian market with eleven negotiating parties (including the EU). Russia has also reached agreement with two WTO members on access of services to the Russian market (also including the EU). At the July meeting of the accession working group, topics included customs activities, foreign trade licensing and protection of intellectual property.

Medvedkov said the most problematic categories in goods negotiations since an agreement with the EU was reached in May (see BOFIT Weekly 22/04) have been agricultural products (especially with the US and some countries in Latin America and Europe), aircraft, cars and textile products. In talks on services, the toughest discussions have concerned the finance and insurance sectors, and energy services. Core issues yet to be resolved also include protection of intellectual property (especially with the US), regulation of domestic natural gas prices (which is being negotiated with some non-EU countries), pricing differences of rail transport services for domestic and foreign trade (including with the EU). Several issues covered under the agreement on Trade-Related Investment Measures (TRIMs) have also been problematic. Moreover, legislative amendments to be made relate to alcohol production and protection of intellectual property.

The next meeting of the working group is scheduled for end-October. Medvedkov said Russia is trying to finish up the bilateral negotiations before the end of this year.

Russia and Ukraine agree on settlement of gas debts. Russian natural gas monopoly Gazprom and Ukraine’s state-owned gas company Naftogaz last week agreed on a restructuring of Ukraine’s approximately $1.5bn in unpaid gas bills for 1997–2000. The companies agreed that Gazprom would credit Ukraine up front for $1.25bn in transit shipment fees for 2005–2009, and then offset that amount against the total debt of Naftogaz. Russia will also reduce its gas transit through Ukraine from the current level of 26 billion cubic metres a year to 21 billion cubic metres. Ukraine, in turn, plans to increase transit of Turkmen gas.

Gas transit fees currently fund about 15 % of Ukraine’s budget. Ukraine, Belarus and Moldova collectively owe Gazprom over $3bn in unpaid gas bills.
China

Inflation accelerates in China, retail sales up. Consumer prices, driven mainly by higher food prices, rose 5.3% y-o-y in July. Inflation was at the highest level seen in over seven years. Food prices climbed fastest (15%), while non-food products were up just 0.8%. Grain prices rose by 32% y-o-y. Housing costs continue to climb as prices for construction and interior decoration materials advanced 4.9%. Utilities such as water, electricity, and fuel, rose by 7.6%. On the other hand, prices of durable goods fell 2.5% in July. Rural areas experienced 5.9% inflation compared to 4.9% in urban areas. For the first seven months of this year, consumer prices were up 3.8% y-o-y.

July retail sales reached CNY 420bn (€42bn), up 13% from July 2003. Sales growth was on the same level as in the first half. Food sales were up 20%, while oil products increased 50%. In July, retail sales in urban areas rose 15%, compared to 11% in rural areas.

Value of retail sales and consumer prices, 12-month % change

Growth of fixed investments accelerates. The National Bureau of Statistics (NBS) reports fixed investments increased 31% y-o-y in the period January-July, compared to 29% in January-June. Investments during the first seven months of the year amounted to CNY 2,700bn (€270bn). Although the NBS provided no separate figure for July, observers infer growth accelerated to nearly 32% y-o-y. The statistical authority noted investment growth was especially high in the transportation, electrical machinery and chemical sectors. Real estate investment grew to CNY 600bn (€60bn) in January-July, an increase of 29% from a year earlier.

Growth in fixed investments is expected to slow this quarter, however, as the government continues to implement measures to dampen credit expansion. Analysts say that if investment growth reaches 30% this year, China’s GDP growth would exceed last year’s pace.

Broad money growth and new lending continue to slow. The PBoC reports that growth of the broad measure of the money supply (M2) slowed in July to a rate of 15.3% y-o-y. On-year growth was down from 16.2% in June, and down considerably from nearly 21% in July 2003. The central bank’s money supply growth target for this year is 17%.

According to the PBoC, growth in the value of yuan-denominated loans slowed to 16% y-o-y in July. Government measures to slow economic growth appear to have had some effect; the growth of the loans in the same period in 2003 exceeded 23%.

HSBC acquires stake in Chinese bank. International banking giant HSBC has purchased a 20% stake in China’s fifth largest bank, the Bank of Communications (BoCom) for just over CNY 14bn (€1.4bn). It was the largest foreign investment in China’s financial sector to date. HSBC’s 20% stake represents the largest holding currently allowed for foreign investors in Chinese banks. BoCom operates 2,700 branches in 137 cities throughout China. The deal is expected to facilitate BoCom’s IPO plans next year and raise interest in the listing. Under its WTO commitment, China must open up its banking sector to foreign competition by 2007.

Crude oil imports continue to rise. China’s Ministry of Commerce reports that the volume of crude oil imports will reach 110 million tonnes this year, an increase of 21% from 2003. Imports of refined oil products are expected to jump 40% this year to 40 million tonnes. A third of oil consumed in China is now imported. Observers say rising oil prices could slow China’s economic growth by eight-tenths of a percentage point this year.

Russia is trying to boost its oil exports to China and expects rail shipments of oil to China to double from 2003 to over 6 million tonnes this year. Longer term, Russia wants to increase the volume of rail shipments of oil to 15 million tonnes by 2007. China imported a total of 4.3 million tonnes of crude oil from Russia last year.
Russia

Growth of industrial output slows in July. The State Statistical Service reports that workday-adjusted industrial output was up 6 % y-o-y in July (7.5 % in June). For the first seven months of the year, industrial output rose 7 % y-o-y. Despite the slowing production growth, machine-building growth still reached nearly 12 % in July. Growth in fuel production slowed, while growth in production of chemicals and petrochemicals accelerated (workday-adjusted growth in both industries was 7.4 %). The contraction of output in light industry continued.

On-year growth of output measured by the index of five base sectors of the economy was 6.3 % in July. Construction in January-July was up 13 % from a year earlier. Strong agricultural production figures in July lifted the cumulative figure for January-July output to 1.5 % y-o-y. Retail sales climbed over 11 % y-o-y. Cargo transport rose 7 % y-o-y in the first seven months of the year.

Russian budgets still in surplus. For the first six months of 2004, Russia’s federal budget surplus was RUB 354 billion (4.7 % of GDP), compared to 3.1 % of GDP for the same period last year. The consolidated regional budget surplus increased to RUB 58 billion (0.8 % of GDP).

In relation to GDP, federal budget revenues remained at about the same level as in 1H03 (20.5 % of GDP), while regional revenues fell from 14.5 % of GDP to 13.9 % of GDP. The growth in raw materials exports was evident in both federal and regional budget revenues. The value-added tax continued to provide the largest federal revenue stream (nearly a third of total federal revenues). The customs fees and natural resource payments increased their role in federal revenues. Their total share in the first half of 2004 exceeded 36 %. Abolition of the gas excise tax at the beginning of this year significantly reduced the share of excise tax revenues in the federal budget.

Revenues from the profit tax have become the largest single revenue stream for regional budgets, accounting for over a quarter of all regional budget revenues. Although income tax revenues grew slower, their share of total revenues remained just below 25 %.

Expenditures relative to GDP shrank for both the federal budget and regional budgets in January-June, amounting to 15.7 % and 13.1 %, respectively. The largest spending items in the federal budget were transfers to regions (17 % of expenditures), defence spending (16.5 %) and national security and law enforcement (11.5 %). Interest payments as a share of GDP fell considerably. Regions spent most on education, health care and housing (a total of 50 % of expenditures), although the share of spending on housing was actually less than last year.

Economy ministry issues cautious outlook for oil. In its latest forecast, the ministry foresees oil production increasing about 3 % in 2005 and about 2 % in both 2006 and 2007. While production was up 10 % y-o-y for the period January-July 2004, the ministry expects growth to slow towards the end of this year. For all 2004, the ministry predicts production will reach 453 million tonnes, which corresponds to on-year growth of 7.5 %. Oil exports are expected to increase about 3 % in 2005 and 3–4 % in 2006–2007 (growth last year was 21 %). The export forecast for this year is 235 million tonnes (an increase of 13 % from 2003). Many analysts believe the ministry’s forecast as cautious; for example, analysts at Troika Dialog expect oil production to rise at a rate of around 4 % during 2005–2007, with exports increasing about 6 % a year during the same period.

As nearly all the export capacity of national pipeline operator Transneft, and all suitable rail transport capacity is currently in use, it is hard for Russia to boost its oil export capacity in the near term. The pipelines of Transneft currently under construction do not allow for major capacity expansion, and decisions on construction of new pipelines are apparently on hold. The rapid rise in metal prices has made construction of new pipelines considerably more expensive. Under the economy ministry’s forecast, the current lack of export capacity has weakened Russia’s ability to take advantage of high oil prices.

Gazprom ownership relations under investigation. Duma deputy Yuri Savelyev (Motherland Party) demanded an investigation into Gazprom’s so-called grey foreign ownership. Under current legislation, foreigners are only allowed to own Gazprom ADRs listed in London. The total market value of these ADRs is about 57 % more than the total value of Gazprom shares listed in Russia. At the request of Savelyev, the interior ministry has launched an investigation into the ownership relations of the Russian-German United Financial Group (UFG). UFG is believed to own over €1.6bn worth of Gazprom domestic shares. Deutsche Bank, in turn, owns 40 % of UFG.

The investigation of Gazprom launched last week, as well as the government’s open dispute over modernisation plans for Gazprom and UES, have fanned uncertainty in the markets. After the investigation was announced, Gazprom’s share price fell about 8 %. Last week, Gazprom’s share price hit its lowest level in four years. According to its original reform plan, the state wants to increase its stake in Gazprom from the current 38 % to 51 % by the end of this year, when domestic shares will become available to foreigners. Official figures show foreigners own 12 % of the Gazprom shares (ADRs), while Russian firms and private individuals hold 50 %. Already in 2001, it was estimated that foreign participation is 6–8 percentage points higher than officially reported.
China

Profits of Chinese industry continue to rise. The profitability of China’s industrial enterprises was up 40% y-o-y in January–July, slightly off the profit growth pace of 42% in January–June. Total profits amounted to CNY 610 billion (€61bn). The profits of state-owned enterprises rose 41%, while private firms enjoyed an increase of 46%. In firms with foreign capital participation, profits rose 34%. Growth in profits of the steel, non-ferrous metal and construction industries slowed slightly, but remained brisk. The strongest profit growth acceleration was seen in the oil industry.

The National Bureau of Statistics tracks industry profits on a cumulative basis from the start of the year, and does not release month-to-month figures. The statistics only include companies with turnovers greater than CNY 5 million (€0.5 million).

Trade deficit in agricultural products. China’s Ministry of Agriculture reports that the trade deficit in agricultural products reached nearly $4 billion in January–June. Exports of agricultural products were about $11 billion in the period, an increase of 11% y-o-y. Agricultural imports exceeded $14 billion, increasing 63% y-o-y. Grain imports nearly doubled, although the domestic summer wheat harvest was about 5% larger than in 2003. In January–June 2003, foreign trade in agricultural products showed a surplus of nearly a billion dollars. China’s annual agricultural trade surplus has averaged $4 billion for nearly a decade.

The trade deficit in agricultural products has raised discussion of China’s food self-sufficiency. The share of agricultural products in foreign trade, however, remains small. In 2003, China produced 430 million tonnes of grain. By some estimates, grain demand exceeded production this year by 37.5 million tonnes. Domestic observers stress that China is not dependent on agricultural imports.

State continues to reduce its holdings in companies. In September, China will offer auction stakes in various companies to foreign investors. The auctions will be held in Hong Kong. The sales involve state holdings in over one hundred companies, about half of which are entirely state owned. The state expects to raise a total of CNY 5 billion (€500 million) from the 79 share packages offered. The holdings include hospitals, food processors and construction industries slowed slightly, but remained brisk. The strongest profit growth acceleration was seen in the oil industry.

China is also preparing to sell off eleven power plants to foreign investors. The sale price is estimated at around $2 billion and the sale is set for the autumn. China will use the money raised from the sale to develop its electricity sector. Virtually no foreign firms currently operate in the Chinese energy market.

Direct investment flows in and out of China increase. For the first seven months of this year, $38 billion in foreign direct investment (FDI) flowed into China, a 15% increase from the same period a year earlier. At the same time, the Ministry of Commerce granted permits to 25,000 foreign firms to invest in projects in China, a significant increase in permit-granting from a year earlier. The Ministry of Commerce reports that the total stock of direct investment in China amounted to $540 billion as of end-July.

Although China has been one of the world’s largest FDI recipients for several years, the amount of investment relative to the size of the Chinese economy is not particularly large for an emerging economy. In recent years, FDI inflows have corresponded to about 4% of annual GDP. In the near term, it is expected that an increasing amount of investment will be channelled to service industries. Under China’s WTO commitments, the access of foreign companies to China’s service sector will gradually open up. The government’s privatisation plans should also boost China’s FDI figures.

Since last year, the government has been encouraging Chinese firms to invest abroad. The Ministry of Commerce and the Ministry of Foreign Affairs released guidelines in July to help Chinese companies with the process of making foreign investments, e.g. by simplifying the permit process. The latest figures released by the UN conference on trade and development (UNCTAD) show that, as of end-2002, China had approved about 7,000 investment projects abroad and the stock of Chinese FDI abroad exceeded $35 billion. In addition to production facilities, the Chinese have acquired ownership in natural resources, including several oil fields.
Russia

Russian government approves 2005 budget proposal. The government proposal foresees next year’s federal budget revenues amounting to RUB 3,326bn (€94bn or 17.8 % of GDP) and expenditures of RUB 3,048bn (16.3 % of GDP). It would thus produce a surplus of RUB 276bn (1.5 % of GDP). The budget figures include social tax collections, which will be transferred via the federal budget to the national pension fund. Social tax revenues and spending would correspond to around 1.5 % of GDP. Revenues, expenditures and the surplus (excluding the social tax) in relation to GDP would be higher than in this year’s budget. The proposed budget will soon be submitted to the Duma for consideration.

The 2005 budget aims at supporting government economic policies, including the promotion of economic diversity, increasing investment especially outside the raw material sector and completion of tax reforms. The budget assumes a drop in oil prices to 28 a barrel for Ural-grade crude, which in turn will diminish the tax take from this year’s projection. Lower tax revenues are also due to a real appreciation of the rouble’s external value (3–5 % a year). Because customs duties, mineral extraction taxes and certain excise taxes, as well as the profit tax on exporters, are affected by the rouble’s exchange rate, tax revenues overall are expected to fall. Federal budget revenues in 2005 from the lowered social tax will be only about half of the amount in 2004.

Budget spending will focus on financing social reform, modernisation of Russia’s defences and infrastructure development. Regions will have greater leeway in deciding how their own budgets are spent in 2005. Regional support will continue to be paid out of the federal budget and will slightly increase in real terms.

State stabilisation fund grows rapidly. The stabilisation fund was established at the start of this year with the transfers of assets from the 2003 budget surplus and the fund’s predecessor, the reserve fund. At the beginning of February 2004, the fund held RUB 106bn (€3.3bn). During March-July, the monthly contribution increased continuously so that the fund was estimated to be worth about RUB 260–270bn at the beginning of August. The government estimates fund assets to exceed RUB 550bn by the start of 2005. By the end of 2005, the fund should hold RUB 720–800bn.

Under the budget code, stabilisation fund assets can be used to cover budget deficits when the price of Urals-grade crude oil falls below $20 a barrel. Assets can also be used for other purposes when the fund exceeds RUB 500bn. The government has requested proposals from the ministries by the end of November on how to use fund money in 2005.

The government currently would like to restrict the use of fund assets next year to paying down foreign debt and covering the expected deficit in the state pension fund.

The budget code specifies that stabilisation fund assets can be invested in cabinet-approved foreign government bonds. No specific information on the investments has been released.

Yukos distress grows. The August 31 deadline for Yukos to pay off its €2.8bn tax bill for 2000 passed with the company only managing to pay €1.7bn. Tax officials have also socked the company with an additional tax bill of about €2.7bn for 2001 and launched investigations into tax irregularities in 2002–04. Last week, tax officials seized the company’s books for the years 2003–04 and announced they were considering an extra tax of about €2.8bn from Yukos’ core production unit, Yuganskneftegaz. The tax authorities previously announced they had seized Yuganskneftegaz as collateral for earlier debts and had hired a German banking firm to assess the value of Yuganskneftegaz.

The official measures appear to be interfering with Yukos’ ability to operate. Due to frozen accounts, the company has had to cut costs. Yukos also announced it was reducing daily oil production by 100,000 barrels to 1.7 million barrels. Nevertheless, Yukos so far retains its position as Russia’s top oil producer.

With the company’s tax problems causing market uncertainty and world oil prices at record levels, Russian oil exports have lately gained more international attention. China, in particular, is worried about its Yukos oil deliveries. Yukos contracted with China at the beginning of the summer to increase exports from 120,000 barrels a day to 400,000 barrels by 2006. Last week prime minister Mikhail Fradkov assured China that his country would honour its export agreements with China. In addition, president Vladimir Putin has promised the leaders of the US, France and Germany that Russia will continue to increase its oil exports.

The Bank of Finland assumes no responsibility for the completeness or accuracy of the information.
China

IMF expects slowdown in China’s total output growth. Concluding their annual Article IV consultation, the International Monetary Fund’s executive board says it expects China’s GDP to grow around 9% this year and about 7.5% next year as economic tightening measures continue to take effect.

The executive board reported that the effects of the Chinese authorities’ measures to slow down credit and investment growth appear to be taking the country in the desired direction. The soft landing of the economy, however, has yet to be achieved and the risk of overheating persists. Chinese authorities need to continue their efforts to address the risk while preserving the stability of the financial system and achieving tighter integration of China into the world economy. A special challenge is to harness China’s strong potential for economic growth to achieve macroeconomic balance and sustainable economic development. In addition, a number of executive directors warned that Chinese actions to curb investments are so far insufficient to eliminate the risk of economic overheating. In that case monetary policy should be further tightened, and the board encouraged China to develop indirect monetary policy measures and improve the effectiveness of market-based instruments. The IMF board also stressed the role of the public economy in dampening economic growth.

The executive directors agreed that increasing exchange rate flexibility would help China improve the effectiveness of its monetary policy and the economy’s ability to adjust to shocks. However, several directors recognised that China alone must decide on the timetable for change.

Regarding structural reforms, the directors stressed the need of putting the banking sector, state-owned enterprises and labour markets on sound footings.

Role of private sector increasing. According to the annual survey of the governmental All-China Federation of Industry and Commerce, the private sector’s role in economic growth and job creation continues to increase. The survey covers privately owned and privately managed domestic companies with annual earnings over CNY 120 million (€12 million). The number of companies surveyed has risen from below 1,600 companies in 2002 to nearly 2,300 companies in 2003. Of these, only five showed a loss last year, while the net profit of the 500 largest companies grew 40% y-o-y and totalled CNY 51bn. Among the interviewed firms, foreign exports grew just 6% last year, although China’s exports overall increased 35%. The numbers indicate that the export sector is still firmly in the hands of foreign firms and joint ventures of state-owned enterprises and foreign firms. Computer manufacturer Lenovo continued to top the survey in terms of turnover. Most of the surveyed companies are located around Shanghai. The study probably understates the role of private firms in China, as many eligible companies refused to be interviewed.

China hikes prices of refined oil products. The National Development and Reform Commission (NDRC) has raised benchmark prices for gasoline and diesel oil about 7%. Oil companies must keep their prices within 8% of the benchmark price announced by the state. The increase in the benchmark price raised the average price of a litre of gasoline or diesel to about 34 eurocents in Beijing. Although China lifted the benchmark price on gasoline and diesel earlier this year, the hike has been insufficient to keep up with the rise in world market prices. Benchmark prices are determined e.g. from price averages on the Rotterdam, New York and Singapore exchanges.

Under its WTO commitment, China must open up retail sales of refined oil products to foreign companies by the end of 2004 and to wholesalers by the end of 2005. Foreign companies currently operate about 2,000 service stations as joint ventures with Chinese partners. Crude oil prices in China are not as regulated as refined oil prices. The NDRC only gets involved in crude oil pricing when producers and refiners cannot agree on the price. Crude oil from China’s largest oil companies has averaged about $30 a barrel this year. In comparison, the price of higher grade Brent crude has averaged $33 a barrel.

In keeping with its WTO commitments, China eliminated import quotas on crude oil and refined oil products at the beginning of this year. Importers, however, are still required to hold import licences. Before August 18, 73 companies held import licences. China granted another 20 new oil import licences at the end of August. China’s oil imports have risen rapidly in recent years and are expected to continue to grow (see BOFIT Weekly 34/04).

Liberalisation of trade between mainland and Hong Kong moves ahead. On August 27, Hong Kong and mainland authorities signed the second phase of the Closer Economic Partnership Arrangement (CEPA II), which further relaxes trade in goods and services. Under the new agreement, China will eliminate customs tariffs on 713 Hong Kong products and grant preferential treatment to eight new service sectors (including information technology, airport services and employment agencies). The new rules enter into force at the beginning of 2005. The total list of tariff-free products at the beginning of next year will slightly exceed 1,000, while 26 service sectors will enjoy preferential treatment. CEPA I, signed last year, entered into force at the beginning of 2004 (see BOFIT Weekly 1/04). Hong Kong’s economic growth is expected to get a boost from CEPA II.
Russia

Inflation accelerated in August. The on-year rise in consumer prices continued to gather steam for the second month in a row, reaching a rate of 11.3 % y-o-y in August. The monthly rise for August was 0.4 %, the highest August inflation rate seen in four years. While food prices were unchanged from July, their on-year increase accelerated to 11.1 %. The on-year rise in prices of other goods, however, slowed to 8.1 %. Prices for services shot up at a rate of 17.1 % y-o-y. As late as July, the government was still expecting the summer harvest would put downward pressure on food prices and slow inflation in August. Despite the government’s official 10 % inflation ceiling this year, most observers expect inflation to reach at least 11–12 %.

Bank deposit growth slowed during summer. Deposits of households and corporations with banks operating in Russia have grown rather briskly since spring 2003. However, rumours of banking sector problems in July led to deposit withdrawals at some banks, which slightly slowed overall annual growth in deposits. Still, the shrinking of the deposit stock from the previous month was well within the normal fluctuations of recent years. While uncertainty clouded certain private banks, household deposits grew well at the large state-owned banks, Sberbank and Vneshtorgbank, which enjoy state deposit guarantees.

The high growth of rouble deposits last winter slowed considerably as spring and summer wore on, and was replaced with an increase in foreign currency deposits. The rapid growth in rouble cash slowed in spring, then returned to steady growth in July. The shifts were influenced by changes in the use and holding of foreign currency and the above-mentioned developments in bank deposits.

Bank deposits and rouble cash (% change of rouble value of stocks from 12 months earlier)

![Graph showing bank deposits and rouble cash](source: CBR)

On-going issues for EU meat imports to Russia. Last week, the EU Commission announced it had agreed with its Russian counterparts that imports of meat products of EU origin could continue under the current system of import permits until the end of this year. Under the deal, new import permits and a universal certificate of origin for all EU members would be introduced from the start of October. The new arrangement would gradually replace old national certificates. Russia initially demanded that its own inspectors be in all 25 EU member states, but ultimately agreed with the Commission’s view that such an arrangement was impractical. Russia also agreed to the principle that when animal diseases appear, Russia would accept the EU’s internal restrictions instead of shutting down EU imports entirely.

The dispute over meat imports from EU countries to Russia arose in early June, when the Russians extended the national safety certificate requirement to the end of September. The EU annually exports about €1.3bn of meat products to Russia.

Russia and Belarus reach accords on common currency launch and natural gas supplies. Following their meeting a couple weeks ago, president Vladimir Putin and president Alexander Lukashenko announced their countries will postpone the introduction of the Russian rouble as a common currency until the beginning of 2006. The road to a common currency still holds many political and economic twists, including the creation of a common economic space and whether Russia should pay Belarus any financial compensation for shifting over to the Russian rouble.

In the natural gas sphere, the Russian government has decided to grant Belarus a $150-million loan to cover purchases of natural gas from Russia. Before signing the new loan agreement, however, Belarus must pay off $25 million in outstanding gas bills. Russian gas monopoly Gazprom has promised to meet all of Belarus’ gas needs in 2005 (19 billion cubic metres) at a price of about $50 per thousand cubic metres. The average export price of Russian natural gas (excluding Belarus) in January-July was $110 per thousand cubic metres. While Belarus wants to use “independent” natural gas suppliers other than Gazprom, president Putin reiterated that Russia’s offer of delivering gas to Belarus at Russian domestic prices was predicated on the condition that the two countries would establish a jointly owned gas company. The two countries have been planning the joint gas company for years.
China

China plans to reform corporate taxation. The agencies overseeing the reform of corporate taxation, including the Ministry of Finance and the State Administration of Taxation, have completed their reform proposal, which is now on government agenda. After years of preparation, the government hopes to decide the reform of corporate taxation next year.

A major goal of the reform is to assure equal tax treatment of domestically owned and foreign-owned firms. Under existing legislation, the tax rate on corporate profits is 33%. Especially foreign-owned firms, however, are often granted tax breaks that are justified for such reasons as location or foreign exports. For example, the tax rate has not only been reduced to 15% in China’s numerous special economic zones, but many foreign-owned firms also have been exempted completely or partly from their tax obligation for their first years of operation. Since 2000, as part of its regional development policy, the government has also granted many foreign-owned companies operating in Western China a 15% tax rate until 2010. Due to the many exemptions, foreign-owned companies are estimated to pay real tax rates of 10–15%, while domestic companies pay about 25%. No decision has yet been reached on the new tax rate, but it is expected to fall into the range of 25–30%.

Banks get new guidelines on real estate lending. At the beginning of this month, China’s banking regulatory commission (CBRC) published new guidelines for banks on real estate loans. The CBRC said that the guidelines are intended to improve banks’ understanding of the risks associated with lending for land acquisition, construction projects and housing purchases. In order to reduce risks, the new rules increase the minimum down payment requirement for property developers from 30% to 35% of the project’s total value. Apartment buyers, in turn, must be able to come up with at least 20% of the purchase price. Greater attention will also be given to the ability of individual borrowers to pay back their housing loans; under the new rules the monthly housing loan payment cannot exceed 50% of the borrower’s monthly income and the borrower’s total loan payments cannot exceed 55% of his or her monthly income.

The purpose of the guidelines is believed to restrain over-investment and rising real estate prices. Despite earlier efforts of the government and the central bank to restrict lending in overheated sectors of the economy (including real estate), real estate investment continued to climb in the second quarter, while housing prices were up over 10% from a year earlier.

West-east gas pipeline project completed. The new 3,900 km natural gas pipeline runs from western China to Shanghai. The project was completed in two parts, with the western part finished last week. The eastern section was completed last year and the transmission of gas from Central China to Shanghai already began at the start of this year. The project was priced at $8.5 billion and implemented by PetroChina, one of China’s large state-owned oil companies and China’s largest producer of natural gas. Foreign investors were originally invited to participate in the project, but PetroChina terminated negotiations in August.

Trial use of the complete pipeline will begin at the start of October. Commercial service is planned officially to begin at the beginning of 2005. PetroChina has agreed to supply 8 billion cubic metres of gas each year. The pipeline’s designed annual capacity is 12 billion cubic metres. Based on known gas reserves and planned capacity, the West-east pipeline should supply gas for more than 30 years. China has already negotiated extension of the pipeline to handle future supplies from e.g. Kazakhstan.

The gas pipeline is a cornerstone of Chinese energy policy, and part of the country’s efforts to reduce dependence on coal. Gas, which now meets just 3% of China’s energy needs, is expected to provide over 10% in 2020. Gas consumption has grown at a rate of about 15% a year; that growth is expected to accelerate with the opening of the new pipeline.

Most gas in China is currently used in fertilizer production, but the use of gas for electrical power generation and residential purposes is expected to grow briskly. Gas prices in China are governed by local regulations, which vary from region to region. China is drafting a new law to regulate the natural gas sector.

ASEAN grants China market economy status. Last week’s meeting of economy ministers of the Association of Southeast Asian Nations (ASEAN) granted market economy status to China. China had already been recognised as a market economy by e.g. New Zealand, South Africa and ASEAN members Singapore, Malaysia and Thailand. Thus, the remaining ASEAN members (Brunei, Cambodia, Indonesia, Laos, Myanmar, the Philippines and Vietnam) now gave their blessing to China’s market economy status. In particular, the move should give China a better position in anti-dumping disputes.

ASEAN is the first of China’s major trading partners to grant it market economy status. In 2003, exports from ASEAN countries to China rose 51% from a year earlier and amounted to $47bn. Imports rose 31%, reaching $31bn. Trade with ASEAN nations currently accounts for about 11% of China’s foreign trade. China and ASEAN countries are also negotiating the creation of a free-trade area. The free-trade area would apply to six ASEAN members from 2010 and all ASEAN nations from 2015.
Russia

Foreign currency sales of banks in Russia skyrocketed this summer. The sale of foreign currency cash by banks operating in Russia boomed both in gross and net terms. Banks also significantly increased their imports of cash foreign currency from abroad. Gross sales of cash currency in January-July amounted to approximately €14bn, while gross imports were worth about €8bn. The US dollar regained favour as the euro’s share of cash currency sold by banks fell in January-July to over a fifth and of cash imports fell to below a quarter. The slide of the rouble against the US dollar, which began in the spring, continued through the summer. In May-July, some Russian banks were shaken by insolvency rumours, which slightly reduced bank deposits overall.

Purchase and sales of cash foreign currency by banks operating in Russia, billions of dollars per month

![Diagram showing purchase and sales of cash foreign currency by banks operating in Russia, billions of dollars per month.](Image)

Source: CBR

Putin moves to consolidate central administrative power. In the wake of the Beslan school siege tragedy, president Vladimir Putin spoke to the cabinet and 89 regional leaders on Monday (Sept. 13). Putin said the state needs to strengthen the role of the federal government in administration of Russia’s 89 regions. He proposed that the president would select candidates for regional governor posts that would then be voted on by regional legislators. Currently, regions propose candidates and choose governors themselves.

The president also said he wants to scrap Duma seats for single-member constituencies altogether and shift to fully proportional party representation. At present, half of the Duma’s 450 deputies are selected by proportional representation (party lists). All other deputies are elected in one-man representative districts.

President Putin reminded his audience that national unity was essential in the face of the terrorist threat and called for stronger cooperation between national security officials. Putin assigned current cabinet chief of staff Dmitri Kozak two new roles: chairman of a new anti-terrorism commission and presidential envoy to the southern federal district, which includes Chechnya and Northern Ossetia. The president appointed former envoy Vladimir Yakovlev to the re-established post of regional development minister. Deputy chief of staff Sergei Naryshkin, 49, was promoted to new cabinet chief of staff.

Yukos tax debts keep climbing. Tax officials increased their claim on Yukos unpaid 2001 taxes by €700 million to €3.4bn. The tax officials launched their collection efforts last week, even though the court will not convene until the end of this month to consider the company’s appeal. Officials have also warned that core production unit Yuganskneftegaz could lose its drilling licence if the taxes are not paid. Yukos admitted that Yuganskneftegaz had not paid taxes for the past two weeks, but that it had not done so because officials had frozen the company’s bank accounts. The value of tax claims on Yukos and its subsidiaries currently total more than €9.9bn and more tax claims are expected.

At a meeting with foreign journalists and academics last week, president Vladimir Putin repeated his view that a Yukos bankruptcy is not in state’s interests.

Preliminary agreement on merger of Gazprom and Rosneft. The world’s largest gas producer Gazprom and the Russian government reached accord on the merger of Gazprom and the state-owned Rosneft oil company by the end of the year. The merger would be accomplished by a share swap in which the state would take Gazprom shares, held by Gazprom subsidiaries, in exchange for state shares in Rosneft. The arrangement would allow the government to increase its current stake in Gazprom from 38 % to over 50 %. After the merger, Rosneft would operate as a Gazprom subsidiary.

The government wants a majority stake in Gazprom before it relaxes restriction of foreign ownership of Gazprom shares. Current law limits foreign ownership to 20 %, and foreign investors can only hold Gazprom ADRs, which are listed on foreign exchanges. The ADRs are much more expensive than Gazprom shares sold on Russian domestic exchanges. The president, prime minister and Gazprom’s CEO consider it important to abolish the dual system of Gazprom share ownership.

The merger plans lifted the price of Gazprom shares on domestic stock exchange 20 % this week (to over 2 euro). The price of one ADR, which officially corresponds to ten domestic shares, also rose more than 10 % to about 30 euro. It is not currently known how the government plans to integrate Gazprom share series.
China

No signs of a slowdown in inflation in China. Consumer prices rose 5.3 % y-o-y in August. 12-month inflation was also 5.3 % in July. Although the on-year rise in food prices slowed slightly to below 14 %, their impact on consumer prices remains significant. The rise in prices for fuel and electricity pushed up transportation and housing costs. Cars and mobile phones, on the other hand, were cheaper than a year ago. As in previous years, the negative monthly trend in early summer ended in August with prices rising 0.7 % m-o-m.

The National Bureau of Statistics reports the rise in producer prices continued to accelerate in August, when producer prices were up 6.8 % y-o-y compared to 6.4 % in July. Producer prices have increased more in the past year than in any similar period in the past eight years. Two major reasons for the increase were the continued rise in prices of oil and coal, and the resurgence of prices for certain investment goods. For example, steel products in August were about 17 % more expensive than in August 2003.

12-month change in prices, %

![Graph showing 12-month change in prices (%)](image)

Source: National Bureau of Statistics

Growth of industrial output accelerated slightly in August. China’s industrial output climbed 15.9 % y-o-y in August and 17.1 % in the first eight months of the year. August saw the end of a seven-month slowing trend as growth of industrial output began to accelerate, while in July, on-year growth of industrial output was only 15.5 %. However, a larger share of production went to inventories; sold production was only 98.2 % compared to 98.7 % in July.

Growth in recent months slowed in many of branches where the government has attempted to rein in investment growth. The biggest drop was registered in the car industry, where growth cooled to 4 % y-o-y in August. There was practically no growth in production of passenger vehicles, a remarkable drop from last year’s growth pace of 80 %. Growth in production of cement and aluminium has also slowed dramatically since the beginning of the year. Despite official efforts to restrain growth, steel production continued to accelerate. In August, steel production was up over 22 % from a year earlier. Growth in the energy sector also continued to pick up. Natural gas production in August was up 23 % y-o-y, coal production 17 %, electrical power generation 12 % and crude oil output 6 %. China’s industrial output figures include data for all state-owned enterprises as well as companies with annual sales exceeding CNY 5 million (£0.5 million).

Brisk growth in foreign trade continues. The value of China’s exports and imports in August was nearly 38 % greater than a year ago. In January-August, exports grew 36 % and imports 41 %. This year, trade has nearly in balance, as the value of exports and imports in January-August was over $360bn in both cases. China’s trade deficit was under one billion dollars.

China’s Ministry of Commerce also released sector-specific foreign trade data for January-July. Firms either partly or wholly foreign-owned accounted for 57 % of total foreign trade (exports and imports combined). Wholly foreign-owned firms accounted for about two-thirds of these, while joint Chinese-foreign enterprises accounted for the remaining third. China’s leading exports are machinery and equipment, which account for over 40 % of all exports. Their value grew 49 % compared to the same period a year earlier. Textiles accounted for 15 % of exports and textile exports increased 24 % from a year earlier.

Investments and retail sales continue to boom. Investments grew 26 % y-o-y in August. Although growth has generally slowed since the early part of the year, investment growth continued strong. For the period January-August, investments exceeded CNY 3.2 trillion (£320bn), 30 % more than in the same period a year earlier. The value of investment projects sponsored by the central government, however, increased only 4 % from a year ago, while projects sponsored by local governments were up a stunning 37 % y-o-y. Some 59 % of investments went to the service sector, 40 % to industry and less than 1 % to agriculture. Nearly 60 % of investments went to companies that were either entirely or partly state-owned.

Retail sales continued their strong growth in August; the value of sales jumped 13.1 % from a year earlier. Sales grew in the cities 14 % y-o-y and 11 % in rural areas. For the first eight months of the year, retail sales were up 13 %.
Russia

**Russian output accelerates slightly in August.** The production index of five base sectors of the economy climbed 7.2 % y-o-y in August and 7.5 % for the period January-August. Corresponding on-year production growth in July was 6.3 %. Growth in construction slowed substantially in July and August and the on-year growth in construction for January-August was 12 %, while in January-June it was 14 %. Although agricultural output grew quickly in July and August, growth was just 3.7 % y-o-y for the first eight months of this year. Retail sales grew 11.4 % in January-August. Growth of freight transport was 6.9 % y-o-y for the first eight months of the year.

Russian industrial output grew 6.9 % in January-August. Growth slowed slightly from the brisk pace of 7.4 % set in H104. The workday-adjusted figure for on-year industrial production in January-August was 6.4 % and 5.2 % in August. The highest growth in January-August was registered in machine building (13 %) and the chemical and petrochemical industries (7.9 %). Production fell in four industrial branches.

### Four base sectors of the economy, % change in output, y-o-y

![Graph](image)

*) workday-adjusted  
Source: State Statistical Service

**CBR returns to bond market.** On September 16, the Central Bank of Russia issued its first bonds in three years. The issue consisted of a rouble-denominated zero-coupon bond maturing December 2005. The bond included a buy-back clause for end-September, i.e. the bond could also serve as a short-term instrument. Of the RUB 50 billion bonds offered, RUB 34.5bn (€970 million) were sold. The yield is 1.75 %, slightly higher than the central bank’s current two-week deposit rate. The CBR expects the new instrument to absorb some of the excess market liquidity, which has been created e.g. by the CBR’s injections of bank support during last summer’s liquidity crisis.

**Russia willing to change Soviet-era debt into market-tradable Eurobonds.** The matter has become topical since Germany issued in June €5bn (S6bn) in bond derivatives that use Soviet-era debts as the underlying asset. Russia opposed the bond sale, because it was barred from the process. Finance minister Alexei Kudrin later said, however, that Russia wants more of this kind of repackaging of Soviet debt. Russia may make such a proposal to the Paris Club of sovereign creditors, while it cannot decide how its debts are restructured. The matter was discussed last week, when Paris Club president and French foreign minister Jean-Pierre Jouyet visited Moscow. He said the Paris Club was ready to discuss alternatives, but Russia had not presented an official proposal. Observers suggest that at least Italy, France and Germany could be interested in arrangements to reissue debt in market-tradable forms. Finance ministry figures indicate at the beginning of 2004 Russia’s Soviet-era debts to the Paris Club totalled about $47bn.

**Russia’s Soviet-era debt to Paris Club creditor countries, Sbn**

<table>
<thead>
<tr>
<th>Country</th>
<th>Debt</th>
<th>Country</th>
<th>Debt</th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany</td>
<td>20.3</td>
<td>Finland</td>
<td>0.6</td>
</tr>
<tr>
<td>Italy</td>
<td>5.7</td>
<td>Netherlands</td>
<td>0.6</td>
</tr>
<tr>
<td>Japan</td>
<td>3.7</td>
<td>Australia</td>
<td>0.4</td>
</tr>
<tr>
<td>USA</td>
<td>3.5</td>
<td>Switzerland</td>
<td>0.3</td>
</tr>
<tr>
<td>France</td>
<td>3.4</td>
<td>Belgium</td>
<td>0.2</td>
</tr>
<tr>
<td>Austria</td>
<td>3.0</td>
<td>Denmark</td>
<td>0.2</td>
</tr>
<tr>
<td>Canada</td>
<td>1.6</td>
<td>Norway</td>
<td>0.1</td>
</tr>
<tr>
<td>UK</td>
<td>1.5</td>
<td>Portugal</td>
<td>0.1</td>
</tr>
<tr>
<td>Spain</td>
<td>1.1</td>
<td>Sweden</td>
<td>0.1</td>
</tr>
</tbody>
</table>

Source: Finance ministry

**Competition in rail transport to open up.** At the beginning of September, the government considered the second phase of its program to reform national railway services. The goal is to open up rail freight and passenger transport to private competition. The railway grid will continue to be controlled by the state-owned Russian Railways Corporation, while about a dozen private operators now own a quarter of current locomotive and rolling stock. To establish a competitive environment, the government needs to revise existing regulations in such areas as competition and taxation. Private operators must currently apply to the Federal Service on Tariffs for determination on rail tariffs, a situation that has not promoted competitive conditions. Russia’s transport ministry wants to shift to licensing operators. Licensed operators would be permitted to make commercial agreements directly with the Russian Railways Corporation. Observers say the reform will increase rail transport prices.
China

Jiang Zemin steps down from last major post. The September 19 meeting of the Central Committee of the Communist Party accepted the resignation of former president Jiang Zemin from his duties as chairman of China’s Central Military Commission. The 78-year-old Jiang served as China’s president from 1989 to 2003. Current president Hu Jintao, 61, will now head the Central Military Commission.

Low interest levels slow growth of deposits. The pace of deposit growth has slowed considerably this year. At the end of August, the value of total deposits held by financial institutions was CNY 24,500 billion (€2,450bn), an increase of 14.5 % from a year earlier. Growth was still about 16 % y-o-y in July and nearly 20 % in January. Household savings deposits represented about half of the total deposit stock, while corporate deposits accounted for over a third. Growth in both the household and corporate deposits has been hindered by the negative real interest rate (interest rates have not been hikes despite the pick-up in inflation). The People’s Bank of China has set the interest rate for one-year deposits at 1.98 %, even though consumer prices in August were up 5.3 % y-o-y.

As a result of the slowing in deposit growth, broad money supply (M2) growth also slowed in August to 13.6 % y-o-y. Money supply growth was still above 15 % in July and around 19 % in the first months of the year. Growth in the stock of loans granted by financial institutions slowed in August to 14.5 %. Some of the slowing in credit growth in recent months reflects the removal of non-performing loans from banks’ balance sheets. The PBoC added that growth in new lending has also slowed substantially.

Bank of China and China Construction Bank incorporated. Incorporation is seen as another step towards the Chinese central bank’s main objective of listing these large state-owned banks. Central Huijing Investment, the joint entity created at the end of 2003 to oversee assets and improve corporate governance in the two banks, holds the largest stake in both banks (see BOFIT Weekly 2/2004).

Stock markets rebound. The continuous slide in Chinese share prices that extended through last spring and summer, ended last week. The A-share indices of the Shanghai and Shenzhen bourses rose over 16 % last week after a speech on September 13 by prime minister Wen Jiabao. In his speech, Wen stressed the rapid implementation of the capital market development program announced last winter (see BOFIT Weekly 6/2004). The rise in share prices was also driven by the PBoC’s declaration that it would allow Chinese commercial banks to invest in the stock markets. No timetable for the reform has yet been announced, however. The government’s commitment to improving price formation on stock markets was evidenced in its decision to temporarily suspend further listings on Chinese stock markets until the supervisory authorities prepare new rules on listing (particularly, pricing of new listings).

The government hopes the new measures will finally halt the decline in share prices by regulating supply and demand. Actually, all earlier attempts eventually failed. Indeed, some measures made matters worse by increasing short-swing speculation and market volatility. The drop in share prices in the last two days indicates how short-lived the effects of government measures to the market are in the absence of concrete actions to assure the quality of listed corporations.

Shanghai and Shenzhen bourses, A-share indices

China calculates Green GDP. The methodology for calculating “Green GDP” created by the National Bureau of Statistics and the State Environmental Protection Administration (SEPA) will be introduced first in six provinces and cities (including Shanghai and Beijing). China calculates Green GDP by subtracting the costs of natural resource use and pollution from its standard GDP figure. Thus, some analysts assert that in the years 1985–2000 annual Green GDP grew about two percentage points less than official GDP. Last month, Shanxi province officials announced that when environmental damage is taken into consideration, GDP had hardly grown from the 1980s. Shanxi is one of China’s most polluted provinces. Government figures say Chinese pollution increased 12 % y-o-y in 2003.

Determination of environmental damage and the costs of pollution are among the most difficult facts to quantify in money terms when calculating Green GDP. Officials are expected to release estimates of Green GDP for 1997–2003 later this year.
Russia

First-half shifts in the structure of investment. Total investment in Russia grew 13 % y-o-y in the first half of 2004. Industry’s share of investments fell to 44 %, a reduction from its 1H03 level. The shift in investment emphasis above all reflects a substantial drop in oil production investments. The share of investment going to natural gas and the food industries also declined. The shares of investment in ferrous metallurgy and the forest industry increased.

The telecommunication sector saw its share of total investment nearly doubled to just under 7 %. The shares of the trade sector and the transport sector also increased, while the housing sector’s share contracted to about 13 %.

ConocoPhillips wins bidding for LUKoil stake. On Wednesday (Sept. 29), American oil producer ConocoPhillips was declared the winner of Russia’s privatisation auction for the state’s remaining 7.59 % stake in LUKoil. ConocoPhillips paid just under $2bn (€1.6bn) for the stake, which corresponds to a price of $30.76 per share, or $2.26 above the starting price. Other bidders accepted were the Russian Promsvyazbank and PromregionHolding, each with bids of about $1.9bn. ConocoPhillips announced its aim to raise its stake in LUKoil to 10 % by the end of the year. The company hopes to raise its LUKoil ownership to 20 % stake within the next two to three years.

Most analysts expected ConocoPhillips to win the auction, since ConocoPhillips had spent months carefully preparing its tender offer in cooperation with LUKoil. The company’s top management also met with president Vladimir Putin on the matter in July. Putin is believed to have personally approved the deal. Observers note that with the sale of the state stake in LUKoil to an American company Russia aims to calm foreign investors’ jitters about the current investment climate in Russia, which has worsened due e.g. to the Yukos affair.

First banks accepted into general deposit insurance scheme. Over the past two weeks the Central Bank of Russia qualified 48 banks for the deposit insurance scheme. Over 1,100 of the approximately 1,300 banks operating in Russia have applied to participate in the deposit insurance scheme. The approvals, which are determined on the basis of a series of bank inspections, are decided at the weekly meetings of the CBR’s banking supervision committee. Rejections will not be published and banks failing to qualify have opportunities to reapply for a new review.

Three deposit insurance schemes currently exist in Russia. The general system requiring inspections will be based on banks’ contributions to the general deposit insurance fund. The system was created under a new law that entered into force at the end of 2003. State-owned banks, in contrast, have enjoyed no-cost state deposit guarantee for years. They would be brought into the general deposit insurance scheme in 2007. Moreover, the Duma enacted a temporary emergency act in July after market rumours sparked runs on several banks in early summer. The act makes the central bank guarantee bank deposits of households.

World Bank figures poverty has halved in Russia since 1999. The World Bank’s poverty assessment on Russia was released September 22. The report found that the number of persons living below the poverty line in Russia, defined by the World Bank, had fallen from over 40 % following the 1998 financial crisis to about 20 % in 2002. Russia’s own official poverty estimate for 2002 was 24 % of the population. The report noted that the rapid halving of poverty after a severe financial crisis reflected buoyant economic growth that has also increased consumption and raised wages.

The report concluded, however, that a fifth of Russia’s population still lives in poverty and that the effects of high world oil prices and the competitive advantage offered after the financial collapse have essentially been realised. Russia cannot rely on to sustained higher levels of economic growth that would further reduce poverty. The report was doubtful of the Russian government’s plan to halve poverty as current policies are insufficiently focused on the poor.

The World Bank estimates that poverty is concentrated among low-wage urban families with incomes just adequate to cover essentials. The report stated that economic growth and higher wages would increase disposable income and stimulate consumption. For the current pace of poverty reduction to be maintained, Russia must boost consumption at least 5 % a year, requiring a GDP growth of over 5 %.

Estimates of Russian poverty, % of population

![Graph showing poverty estimates in Russia](image)

* Based on monthly consumption of 1,808 roubles (€61) in 2002.
** Based on monthly consumption of 1,056 roubles (€36) in 2002.

Source: World Bank
China

This year’s harvest expected to be larger than last year. Chinese official harvest target of 455 million tonnes of grain, rice, maize, beans and potatoes should be met this year. The summer period harvest was up over 5% to 100 million tonnes and early rice harvests have been larger than in previous years. The maize harvest is also expected to rise from last year. The total harvest last year was just 431 million tonnes, the smallest in over a decade.

Consumption of the mentioned cultivated products this year is estimated to be 487 million tonnes. The state expects to cover the difference in production and consumption through reducing its stores and increasing imports.

Annual harvests, million tonnes

![Graph showing annual harvests, million tonnes](image)

* Forecast
Source: National Bureau of Statistics

China to join Group of Seven meeting for the first time. Finance minister Jin Renqing and Central Bank chairman Zhou Xiaochuan are today (Oct. 1) participating in the meeting of G7 finance ministers and central bankers in Washington DC. The financial heads of G7 countries (the US, Britain, France, Germany, Italy, Japan and Canada) are meeting just ahead of IMF and World Bank meetings on Saturday and Sunday. The hottest item on the agenda is expected to be China’s exchange rate policy. Some claim the yuan is undervalued and its fixed peg to the US dollar distorts international trade and promotes the transfer of manufacturing jobs to China. Most analysts say it is unlikely that the Chinese will decide to switch to a more flexible exchange rate regime during the meeting.

Measures to improve minority shareholder rights.
A preliminary version of the new regulation on minority shareholder rights was released by China’s Securities Regulatory Commission (CSRC) earlier this week. The new regulation calls for strengthening protection of minority shareholders’ rights, especially those of individual investors. Individual investors are presently allowed to invest in shares listed on China’s two main bourses. These tradable shares constitute roughly a third of total outstanding corporate shares in China. The remaining two-thirds of outstanding shares are not traded and are concentrated in the hands of large shareholders. Large shareholders, mainly parent companies of listed firms, routinely invoke business policies that hurt minority shareholders.

The new regulation seeks to make it easier for individual investors to monitor listed firms. It includes two controversial measures. The first is a requirement that, in addition to the general shareholders’ meeting, all major decisions must also be approved by the majority of owners of tradable shares, which are typically the individual shareholders. The second measure calls for a more transparent dividend policy, especially the cash dividends distributed to individual investors. Other measures include setting up independent board of directors to better monitor the management of listed firms. Better information disclosure and the legal consequences of failing to meet all these requirements are also tackled in the new regulation.

The new regulation offers cost-efficient monitoring mechanisms, such as proxy voting, to individual investors. In absence of an efficient takeover market for state-owned shares and more severe costs, both legal and economic, in case of offences, these measures are still intermediate steps towards a better corporate governance structure on the Chinese stock market.

Partnership arrangements with mainland China benefit Hong Kong and Macao economies. Hong Kong’s real GDP soared 12% y-o-y in the first half of this year. The growth clearly outpaced 2003, when total output growth was over 3%. The boom is driven by rapid growth in the service sector as trade and transport sectors have benefited from mainland China’s growing foreign trade. The growth figure is also a reflection of the low growth in 2Q 2003 caused by the Sars epidemic. For example, tourism posted over a 100% annual growth in the second quarter. New partnership arrangements between the mainland and Hong Kong have increased travel to Hong Kong by mainland Chinese. Private consumption in Hong Kong has also soared ahead this year. The Hong Kong government has raised its growth forecast for this year from 6% to 7.5%.

Growth in Macao’s total output accelerated to 36% in the first half of this year, as the dip in growth caused by last year’s Sars epidemic boosted on-year growth to nearly 48% in the second quarter. Macao’s gambling industry, in particular, has benefited from increased tourism from the mainland, which also has been promoted through various partnership arrangements with mainland China. Private consumption and construction grew briskly. Macao’s real GDP grew 16% in 2003.
Russia

Russian inflation accelerates slightly. The on-year rise in consumer prices in September was 11.5%. The monthly rise for September was 0.4%, about the same pace as in the previous month. Although September food prices remained essentially at August levels, the on-year rise accelerated to 11.3%, reflecting the drop in prices in August and September 2003. The annual rise in prices of other goods prices remained at 8.1%. The rise in prices of services slowed slightly to 16.7%. Given the current figures, it appears unlikely that the government’s 10% inflation target for this year will be achieved. The current consensus view is that 2004 inflation will come in at around 11%.

Decline in private capital outflow from Russia. According to revised central bank balance-of-payment figures, private capital net exports climbed to $88bn in the first half of the year. Capital outflows mainly comprised capital exports of the banking sector and the fictive transactions of corporations. According to preliminary CBR figures, private capital net exports should have slowed in the third quarter and would have amounted to $10.9bn in the first nine months of the year. Preliminary information also suggests that bank capital exports would have slowed substantially, but total private capital outflows continued as Russian firms accelerated investment abroad, mainly through fictive transactions. According to 9-month figures, foreign direct investment inflow into Russia remained at the same level as a year earlier.

As usual, oil earnings drove the current account surplus. Thus, the increases in private capital outflow and the central bank’s foreign currency reserves (over $95bn at the beginning of October) are hardly surprising.

Net capital outflow of the private sector (-), US$ billion

* preliminary data
Source: CBR

Total assets of Russian banks on the rise again. In the wake of rumours of bank closures and operating difficul-
China

Mountain of non-performing loans held by Chinese banks may get bigger. The stock on non-performing loans (NPLs) held by China’s top 15 banks contracted in the second quarter of 2004. Of these banks, the four largest are state owned and the next eleven are shareholding banks. As of end-June, the total amount of NPLs held by these banks amounted to CNY 1,660bn (€166bn), about CNY 400bn less than at the end of March. At the same time, the average ratio of NPLs to total loans fell to 13%. The value of NPLs held by China’s four largest banks at the end of June exceeded CNY 1,500bn (16% of all loans), while the NPLs of the other eleven top commercial banks were estimated at CNY 140bn (5% of all loans).

The decline in NPL exposure largely reflects efforts to clean up the balance sheets at China’s two largest banks (Bank of China and China Construction Bank). In June, nearly CNY 300bn in NPLs were transferred to a state-operated asset management company. As a result, the Bank of China’s NPL ratio plummeted to 5.5% at the end of June and to just over 3% at China Construction Bank. NPLs, however, continue to represent a sizable share of the loan stock of the two other large state-owned banks. Moreover, a bank in the next tier of eleven banks, the Bank of Communications, disposed of CNY 40bn worth of NPLs in June via an asset management company to clean up its balance sheet in preparing for its stock market listing.

Most Chinese banks still have suffered from large NPL ratios and lousy capital adequacy ratios. In addition, some outside analysts, including international credit rating agencies, have charged that official figures conceal the true magnitude of the problem. Chinese officials themselves have warned banks against further increases in their NPL ratios as a result of the rapid credit expansion of the past several years. A preliminary estimate by China’s Banking Regulatory Commission (CBRC) indicated that overall NPL ratios would have risen back to near 15% as of end-September.

New borrowing rules spur short-term borrowing by foreign banks in China. In June, the National Development and Reform Commission (NDRC), the CBRC, and the State Administration of Foreign Exchange (SAFE) jointly issued a regulation on external borrowing by foreign banks operating in China. The regulations were designed to halt the increasing currency inflow driven by expectation of a yuan revaluation (see BOFIT Weekly 24/2004). SAFE subsequently issued more detailed rules on the amount of short-term borrowings foreign-owned banks would be allowed to hold. Under these rules, the balance of short-term borrowings at the end of 2004 must not exceed the balance at the end of June 2004. In anticipation of the upcoming change, foreign banks dramatically increased their balances of short-term borrowings in June. SAFE figures indicate that the balance of external borrowings by foreign banks at the end of June rose over 80% from a year earlier (45% in 2003) and accounted for 62% of the total increase in China’s foreign borrowings. Although foreign banks accounted for 18% of all foreign-currency loans granted in China at the end of July, they held only 1.8% of total assets in China’s banking sector.

The balance of China’s external borrowings at the end of June amounted to $221bn, an increase of 14% from the beginning of this year. Short-term borrowing represented 45% of total borrowing, up from 40% at the end of 2003. Because of rapid economic expansion and government tightening of the credit supply from domestic banks, Chinese companies have resorted increasingly to foreign borrowing. In the first half of 2004, China’s economy grew 9.7% and the foreign trade overall rose 39%.

Supply crunch pushes up housing prices further. Government efforts to rein in fixed investment in the real estate industry appear to be having an effect. The National Bureau of Statistics (NBS) reports on-year growth of fixed investment in housing slowed to 18% in August, down from a 43% pace in February. During the same period, the supply of land and bank loans to the real estate industry fell substantially. The dwindling supply caused housing prices to rise sharply. In January-August, the average housing price nationwide reported by NBS rose 11%. The average price per square metre (m²) rose to CNY 2,525 (€250). The country’s wealthy eastern region saw average prices reach CNY 3,421 (€340), an increase of more than 15% y-o-y.

Growth in housing investment and housing prices, % change y-o-y

<table>
<thead>
<tr>
<th>Fixed investment in housing (m²), left</th>
<th>Average price (per m²), right</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.3.04 1.4.04 1.5.04 1.6.04 1.7.04 1.8.04</td>
<td></td>
</tr>
<tr>
<td>10% 15% 20% 25% 30% 10% 12%</td>
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</tr>
</tbody>
</table>

Source: NBS
Russia

**Rapid growth in Russia’s foreign trade.** Central Bank of Russia balance-of-payments figures for the first three quarters of 2004 show exports of Russian goods and services grew 27% y-o-y and had a value of $139bn. The largest rise in January-September was in export earnings for crude oil (40%) and oil products (27%). Due to higher oil prices, the value of exports increased especially fast in the third quarter. January-September growth was also brisk for other goods (26%) and services (22%). The CBR goods trade figures indicate exports to CIS countries increased 39% y-o-y in January-August. Exports to non-CIS countries grew 25% y-o-y in the first eight months of 2004.

Preliminary current account figures show imports of goods and services increased 26% y-o-y in the first nine months of this year, and were valued at $92bn. Goods imports from CIS countries exhibited particularly strong growth (35% y-o-y) in January-August. Imports from non-CIS countries grew 22% in January-August.

Trade has grown considerably, despite the fact that dollar weakness exaggerates the growth figures. The dollar’s value in January-September was lower than in the same period a year earlier (about 10% against the euro and 6-7% against the basket of currencies of Russia’s main trading partners).

The rapid increase in import revenues has increased the current account surplus, which was $36bn in January-September, an amount that corresponded to nearly 9% of GDP. The large current account surplus has added pressure for rouble appreciation and directly conflicts with the Kremlin’s stated foreign exchange policy.

**Rouble weakened slightly in third quarter.** After strengthening in the early months of this year, the rouble has weakened since the beginning of May against the dollar, euro and a basket of currencies of Russia’s main trading partners. For September, the rouble was 4% weaker against the euro compared to a year earlier. It was also down 1% against the currency basket and 4% stronger against the dollar. The exchange rate weakening in part reflected central bank interventions in currency markets aimed at dampening the rouble’s rise. The market operations swelled the CBR’s foreign currency reserves to $95bn at the beginning of October (compared to $77bn at the start of the year).

Since May, the rouble’s real exchange rate (which reflects the nominal exchange rate and the inflation rates) has weakened slightly in relation to the currency basket and the euro. In real terms, the rouble was 5% stronger in September against the currency basket and the euro than a year earlier.

**Gazprom wants to be an energy giant.** Last week CEO Alexei Miller revealed that his company owns over 10% of Russian electricity giant UES and is actively seeking to increase its ownership stake. Miller’s goal of shaping Gazprom into a diversified energy giant is backed by the company’s recent stock purchases. Press reports claim the company has acquired over 25% of Moscow’s city power utility Mosenergo. By taking a 25% position in Mosenergo, Gazprom gains veto authority and a significant say-so in the break-up of Russia’s largest regional electrical power company. Miller’s grand plan can also be seen in last month’s deal on the merger of Gazprom and Rosneft, whereby Russia’s largest gas producer is set to also become one of the country’s largest oil producers.

Not all cabinet members support the expansion of state-owned Gazprom into other parts of the energy sector. Last week, German Gref, who is both economy minister and a member of Gazprom’s board, criticised Miller’s expansion vision of an expanding monopoly. According to some estimates, the government plans to refuse Gazprom permission to increase substantially its stake in UES.

Gazprom has also broadened its international cooperation, agreeing this week with Petro-Canada to build a natural gas terminal on the outskirts of St. Petersburg. The terminal would have an annual export capacity of 3.5 million tonnes of liquefied natural gas, which corresponds to about 2.5% of the world’s total LNG production. In addition, Gazprom is in talks with ExxonMobil, ChevronTexaco and Statoil on new possibilities for cooperation.

**Yukos set to lose Yuganskneftegaz.** The government announced at the beginning of this week that Yukos’ core production unit Yuganskneftegaz may be sold at auction as early as next month to pay off Yukos’ outstanding tax debts. The government also released a German investment bank’s assessment of €8.4bn, which observers expect to be the initial asking price. Other analysts put Yuganskneftegaz’s value in the range of €12-14bn. Tax officials claim Yukos owes a total of €6.9bn in back taxes, of which the company has paid about €2.1bn.
China

Chinese foreign currency reserve swells with capital and financial account surpluses. The State Administration of Foreign Exchange (SAFE) reports China’s foreign currency reserve grew $67bn in the first half. At end-June China’s currency reserves stood at $471bn. Capital and financial accounts registered a surplus of $68bn in the same period. During January-June, foreign direct investment increased $31bn, or 13 % y-o-y.

The weakened trade balance hurt the current account surplus, which was a modest $7bn. The trade surplus also shrank from $14bn a year earlier to $6bn in the first half, and then was essentially erased by the service account deficit. The current account surplus thus mainly reflected current transfers, which increased by $10bn, or 32 % y-o-y (excluding government transfers). These transfers are mainly remittances from ethnic Chinese living abroad. They are typically invested in real estate properties or the stock market.

Anticipation of a yuan revaluation has brought China large foreign currency inflows through both legal and illegal channels over the past two years. The “net errors and omissions” item in the balance-of-payments figures is widely considered an indicator of illegal currency flows. After peaking at $18bn in 2003, the number turned to a negative $7bn in the first half of 2004. SAFE deserves much of the credit for stemming these illegal currency inflows. In a press release on Tuesday (Oct. 12), a SAFE spokesperson ruled out an imminent currency revaluation, in a press release on Tuesday (Oct. 12), a SAFE spokesperson ruled out an imminent currency revaluation, and reiterated that SAFE’s objective is to move to a more flexible, market-based currency exchange mechanism.

Rapid rise in tax revenues in January-September. China’s tax revenues in January-September exceeded CNY 1,900bn (€190bn), a 26 % y-o-y increase. Rapid economic growth boosted indirect tax collections as consumption grew and certain consumer prices rose. The impact of indirect taxes are particularly large in China as the combined share of value-added tax, consumption tax and business tax account for over half of total tax revenues. For January-September, the on-year rise in import duties was up about a third to nearly CNY 300bn.

Central bank report finds state-owned banks lag in competitiveness. The People’s Bank of China (PBoC) recently published a competitiveness ranking of commercial banks. The study lists 37 bank branches operating in the Beijing area. Rankings were based on several criteria such as profitability and credit growth. The four large state-owned banks – Industrial and Commercial Bank of China, Bank of China, Construction Bank and Agricultural Bank of China – took the bottom four spots on the list. The top twelve places went to foreign-owned banks.

The four leading state-owned banks control over 70 % of market share of Beijing loan business. In accordance with WTO requirements, the process of opening the local-currency denominated transactions to foreign banks will be continued. At the end of this year, foreign banks will be allowed to engage these transactions in Beijing and several other cities. It is estimated that out of the 23 foreign-owned banks currently operating in Beijing, half plan to apply for local-currency authorisations from the China Banking Regulatory Commission.
Russia

Growth in Russian oil production and exports has slowed. The State Statistics Service reports Russian crude oil production rose 10 % y-o-y in January-August. Oil production grew 11 % y-o-y last year. Although crude oil exports increased some 20 % last year, they only rose about 2 % y-o-y in the first seven months of 2004. According to economy ministry forecast published in July, growth of crude oil production was expected to slow to about 8 % and export growth to 13 %.

The surprising slowing of growth in oil exports has raised questions in analyst circles. Some suspect what is actually happening is an increase in illegal oil exports. Early this week, Semyon Vainshtok, CEO of Transneft, which has a monopoly on the Russian oil pipeline grid, said that Russian oil companies produced 14 million tonnes (0.4 million barrels a day) less in the first three quarters of this year than forecast by the economy ministry. According to Vainshtok, the previous rapid growth in oil production is over. He now expects output growth this year to only hit 7 %. He also stated that, due to the slowing output growth, Transneft will have trouble utilising all the new capacity it has added in recent years.

Crude oil production and exports (million barrels per day)

<table>
<thead>
<tr>
<th>Year</th>
<th>Production</th>
<th>Exports</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td>10</td>
<td>8</td>
</tr>
<tr>
<td>2003</td>
<td>8</td>
<td>6</td>
</tr>
<tr>
<td>January-August 2004*</td>
<td>4</td>
<td>3</td>
</tr>
<tr>
<td>Forecast 2004</td>
<td>10</td>
<td>8</td>
</tr>
</tbody>
</table>

* Export figures for January-July 2004

Sources: State Statistics Service and economy ministry

Putin’s China visit. Chinese president Hu Jintao hosted Russian president Vladimir Putin last week in Beijing. During the visit, China declared its support for Russia’s WTO membership effort and promised to increase investment in Russia by at least a billion euros a year. The parties also stated they were trying to settle their border disputes and promote bilateral trade. The trade balance between the two countries this year is expected to reach €16 billion.

The heads of state also discussed energy cooperation. Demand for oil continues to rise faster in China than elsewhere in the world (15 % a year), and China is keenly interested in closer cooperation with Russia in the energy sector.

Putin balked on commitments to increase oil exports to China or construction of the proposed oil pipeline to Daqing (and despite China’s offer to finance the project). The Russian president noted that Russia had to prioritise its own interests and reach out to wider oil markets. He stated that the oil pipeline from Siberia to China simply was not on the table until the northern pipeline to Nakhodka is completed, as hoped by Japan.

In conjunction with the meeting, the Chinese gas company CNPC and Gazprom met to discuss strategic cooperation. No agreement was reached on a new gas pipeline to China, although it is on China’s wish list. The Russian contingent remained reserved and cautious throughout the meeting, avoiding commitment on any issues important to the Chinese.

Government considers ways to attract private capital to road projects. On October 7, the government took up development of Russian road system and decided that a revised 2020 transportation strategy should be submitted to the cabinet by December and a new version of the roadway modernisation program for 2002–2010 by January. The government also took its first official look at public-private partnerships. The state would like to use this new cooperation format to attract private-sector participation in long-term roads projects that are otherwise unaffordable for the state or where the project risk is too much for private investors to handle alone. There are already examples of successful public-private cooperation, e.g. in construction of harbours in the Gulf of Finland.

The economy ministry will identify by December 15 road projects where private investor participation is appropriate. The government also expects proposals for legislation on road tariffs in November.

Yuganskneftegaz on the block in November. The Russian federal property fund has announced it will sell as soon as at the end of next month Yukos’ core production unit, Yuganskneftegaz, to pay off Yukos tax debts. Media reports claim the initial asking price will be just over €3 billion, or considerably less than the €8.4bn figure suggested earlier. The starting price roughly equals Yukos’ unpaid 2000 and 2001 tax debts. Observers speculate that Yuganskneftegaz’s low asking price also suggests that the state plans to collect Yukos’ 2002 and 2003 tax bills by selling off Yukos’ two other production companies, Tomskneft and Samaraneftegaz.
China

China foreign trade continued to expand in January-September. The value of Chinese goods exports in the first nine months of this year was $416 billion (€340bn), or 35 % more than a year earlier. Meanwhile, the value of imports climbed 38 % to $412 billion. Thus, trade was nearly in balance, producing a surplus of just under $4 billion, or less than 0.5 % of GDP. Export growth has remained steady throughout the year, while import growth slowed to 31 % in the third quarter from 43 % in the first half. Some of the slowdown reflects last year’s same period high growth figures. Processing activities still account for nearly half of China’s foreign trade.

The recently enlarged EU became China’s most important trading partner this year. According to the Chinese figures, EU-China trade accounted for 16 % of China’s total trade in the first nine months of 2004. The next largest trading partners were the US and Japan.

In January-September, exports of machinery and electrical devices jumped nearly 50 % compared to the same period a year earlier. Their share of total exports was about 40 %. Exports in the high-tech product category (particularly computers, mobile phones and digital cameras) soared 54 % in January-September and their share of total exports rose to 27 %. Exports of clothing and textiles expanded over 20 % and accounted for 17 % of total exports.

Although the value of raw material imports leapt 60 % y-o-y in the first nine months of the year and the volume of imported crude oil was up 34 %, growth in both these categories slowed substantially in September. Steel imports contracted 15 % y-o-y in January-September. The value of imported machinery and electrical devices increased about a third from last year and was sufficient to cover 41 % of total imports.

Credit growth revives in September. Chinese banks issued CNY 250 billion (€25bn) in new yuan-denominated loans in September, up from CNY 116 billion in August. The total loan stock, after declining briefly in June, continues to growth. As of end-September, the total stock of yuan and foreign-currency loans amounted to CNY 18,500 billion, an increase of 14 % from a year earlier. During the last three quarters, CNY 640 billion in short-term yuan-denominated loans were issued, 26 % less than during the same period last year. New long-term yuan loans were valued at CNY 980 billion, or 8 % less than the same period last year. The rapid decline in short-term lending has put pressure on company cash flows, which are typically financed with short-term bank loans.

Foreign-currency loans constitute only a fraction of the total loan stock in the banking sector. At the end of September, the balance was just $135 billion, although 16 % higher than a year earlier.

Growth in deposits declined for the eighth consecutive month this year. The total stock of bank deposits amounted to CNY 24,800 billion at the end of September, an increase of 15 % y-o-y. Growth of the broad money supply, M2, which includes the balance of deposits in the banking sector, was 14 % y-o-y at the end of September when M2 amounted to CNY 24,400 billion. Money supply growth has slowed steadily and is now below the central bank’s target ceiling of 17 %.

At end-September, China’s foreign currency reserves stood at $515 billion, an increase of $111 billion from the beginning of this year.

China’s R&D spending surges. The National Statistics Bureau, Ministry of Technology and Ministry of Finance say China’s spending on research and development climbed to CNY 154 billion (€15bn) in 2003, an increase of 20 % y-o-y. Last year’s R&D spending corresponded to 1.3 % of GDP. The government provided CNY 98 billion in funding, an increase of 20 % from 2002. R&D spending represented 4 % of government spending last year. Companies accounted for most R&D expenditure (62 % or CNY 96 billion). State research institutes and universities spent CNY 39 billion (26 %) and CNY 16 billion (11 %), respectively.

Slower car sales. Sales of passenger cars have slowed significantly since the start of the year. Approximately 183,000 passenger cars were sold in September, a 4 % decrease from a year earlier. There were also signs that car buyers are switching to cheaper models. Although car sales growth was about 50 % in the first months of this year, it was up just 17 % y-o-y in January-September.

There are several reasons for the slowdown. Government measures to tighten credit had put the brakes on car loans. Moreover, the steady decline in car prices has encouraged many Chinese to delay their car purchases. Observers further note that buyers expect a further decline in car import tariffs. Depending on engine volume, import duties on cars presently range from 34 % to 38 %. These tariffs will fall incrementally in coming years, and by July 2006 they will only be 25 %.

The current situation has also hardened competition in the car market, which is evidenced by the declining profitability of several car companies. A number of car companies have also announced that they plan to scale back their investment programs.
Russia

Russia’s production growth slowed in September. The index of five base sectors of the economy, which gives a picture of the GDP growth, was up less than 3% y-o-y in September. On-year growth for the third quarter was 5.4%, compared to nearly 7% for the first nine months of the year. Growth decelerated in several sectors. However, retail sales, an indicator of private consumption, continued to rise in September at the 12% pace set since last spring. Non-food sales continued to climb even faster (14–15% since last spring). Construction growth, on the other hand, has been moderating; growth was about 7% in the third quarter compared to 14% in the first half. Agricultural production grew over 2% in the third quarter and was unchanged in January-September from the same period a year earlier. Growth in goods transport slowed from the over 7% pace set in the first half to about 6% in the third quarter, due e.g. to reduced growth of pipeline transmission volumes.

Growth in workday-adjusted industrial output slowed to 3.5% in September. On-year growth in the third quarter was less than 5% and 6% in January-September. Growth slowed in nearly all major industrial fields in the third quarter. Nevertheless, machinery and equipment still increased nearly 9% and the chemical industry 5–6% (growth in 1H04 was 14% and 8–9%, respectively). Foodstuff production grew 3% (over 5% in 1H04). Ferrous and nonferrous metallurgy industries witnessed growth slowing from 4–5% in the first half to 3–4% in the third quarter. Growth in fuel production slowed from nearly 7% in the first half to less than 6%. Crude oil output rose 9% in the third quarter compared to 10% in the first half. The corresponding figures for natural gas production were 1% and 3%.

Economy ministry forecasts accelerating growth towards end of year. Preliminary figures from the economy ministry show GDP growth in the first nine months of this year rose 6.9% y-o-y. GDP growth was just 6.0% in the third quarter, compared to 7.4% in the first half. September GDP growth slowed to 4.3%.

The latest forecast from the economy ministry anticipates a slight increase in GDP growth towards the end of this year and anticipates GDP growth for the entire year to come in at 6.8–6.9%. The ministry also expects industrial production growth of 6.5–6.7% for this year and annual inflation of 10.5%, which slightly exceeds the government’s 8–10% inflation target.

2004 grain harvest better than 2003. Agriculture minister Alexei Gordeyev said the dry weight of this year’s grain harvest should be about 76 million tonnes. This would be a nearly 14% improvement from 2003, which saw the smallest grain harvest in recent years. The minister put the gross grain harvest at 84 million tonnes. About 10% of the gross weight is lost after the grain is cleaned and dried. The harvest of potatoes and other vegetables, however, is expected to be 3–5% smaller than last year.

Russia retains 70th place in competitiveness ranking. The World Economic Forum’s annual Global Competitiveness Report again placed Russia as the world’s 70th most competitive nation. Finland topped the list as the world’s most competitive country. The survey identified corruption, tax regulations, and lack of access to financing as the biggest hurdles facing Russian companies. Russia did, however, receive high marks for government surpluses (ranking 8th out of 104) and flexible hiring and firing practices (5th of 104). Russia scored its lowest marks for bank money-laundering activities (102/104), political involvement in corporate activities (102/104) and the business cost of corruption (100/104). Russia also got low marks for its high inflation and irregularities in payments. The survey questionnaire, which covered 8,700 business leaders in 104 countries, consists of about 320 survey questions. China ranked 46th in the survey.

Russia and Finland in competitiveness rankings, 1995–2004

Source: World Economic Forum

Editor Timo Harel

Information herein is compiled and edited from a variety of sources. The Bank of Finland assumes no responsibility for the completeness or accuracy of the information.
China

China’s total output growth slows a bit. Real GDP grew 9.1 % y-o-y in the third quarter, a slight deceleration from 9.7 % growth in the first half of this year. Total output in January-September was up 9.5 % from the same period a year earlier.

In the primary sector of the economy, where production is weighted towards agriculture, growth accelerated to 5.5 %. The primary sector accounted for 13 % of GDP.

The secondary sector, which includes industrial activity and construction, grew 11 %, and represented 55 % of total GDP. Service sector output increased 8.5 %, and its share of total production was 31 %.

Last month, China revised its figure for 2003 GDP growth upwards from 9.1 % to 9.3 %.

Acceleration of consumer prices stalled in September. Consumer prices were up 5.2 % y-o-y in September, slowing slightly from 5.3 % in August. Higher food prices continued to push up consumer prices. The rise in prices slowed, however; September food prices were only 11 % higher than a year earlier, compared to 13 % in August. Grain prices rose fastest, up 28 %. The rise in grain prices should slow gradually if this year’s actual harvest matches the forecast. Housing costs were up 4 % y-o-y in September. Prices fell in categories such as clothing, home appliances, health care and transportation.

Industrial output and profits continue to rise rapidly. In the first three quarters, industrial production grew 17 % y-o-y to CNY 3900 billion (€390bn). On-year growth was 16 % in September, unchanged from August. For the first nine months of the year, industrial production growth was fastest in foreign-invested enterprises, as production jumped 20 %. State-owned enterprises, with profits 43 % higher than a year ago, generated half of total profits. State-owned enterprises dominate raw material industries, including oil, chemicals and steel production. These industries account for over half of the increase in profits. As of end-September, finished goods inventories were valued at CNY 990 billion, an increase of 22 % y-o-y. Accounts receivable reached CNY 2,120 billion, a 17 % increase from a year earlier.

Producer prices accelerated in September. The National Bureau of Statistics reports that the producer price index (PPI) rose 7.9 % y-o-y in September and 6.8 % in August.

Higher prices for oil and other raw materials accelerated the rise in producer prices.

Both oil and coal prices rose 20 % y-o-y in September. PPI was up 5.5 % for the first nine months of the year.

The People’s Bank of China also released its corporate goods price index (CGPI) for September. The CGPI was up 9.6 % y-o-y for September, and 8.7 % for the first nine months of the year.

Consumer and producer prices, 12-month % change, January 2003–September 2004

![Graph showing consumer and producer prices, 12-month % change, January 2003–September 2004.](image)

Source: National Bureau of Statistics

Fixed investment growth remains brisk. Fixed investment ascended 28 % y-o-y in January-September, a slowing of only one percentage point from the pace set in the first half of the year. Growth in fixed investment peaked at 43 % in the first quarter. CNY 4,510 billion (€450bn) in fixed investment was implemented in the first nine months of the year.

Investment in urban areas was 30 % higher than in the same period last year, constituting 84 % of total fixed investment. Investments in rural areas were up just 17 %. Fixed investment in the industrial sector boomed 43 % y-o-y, and accounted for 32 % of total fixed investment. Fixed investment in oil refineries increased 123 % y-o-y, while energy-supply investments were up 48 %. Fixed investment in real estate increased 28 % y-o-y, accounting for 19 % of total fixed investment.

Although fixed investments by foreign-invested enterprises only represented 6 % of total fixed investments, they grew 60 %. Some 73 % of total fixed investment came from state-owned companies, which increased their investments 28 % from a year earlier.

Tighter credit controls cut into fixed investment financed by the domestic banking sector. In the first nine months of this year, only a fifth of fixed investment in urban areas was financed by domestic bank credits. Nevertheless, bank credit as source of finance was still 19 % higher than a year earlier.
Russia

Changes to 2004 budget act. In three back-to-back readings, the Russian Duma approved amendments to the 2004 budget act. The government requested the changes due to higher-than-expected world oil prices. The amended budget increases its revenue estimate 19 % and spending 4 %. Most of the extra revenues came from the mineral extraction tax and export tariffs. Transfers to regions, international operations, agriculture, and road administration received the largest shares of the nearly RUB 49 billion (€1.4bn) spending increase. The lion’s share of this year’s surplus will be transferred to the state stabilisation fund, which is estimated to reach RUB 565 billion (€16bn) by the start of 2005.

Main 2004 federal budget categories and approved amendments, RUB billion (% of GDP), unless otherwise noted

<table>
<thead>
<tr>
<th>Category</th>
<th>2004 (original)</th>
<th>2004 (revised)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues</td>
<td>2,743 (17.9)</td>
<td>3,274 (20.1)</td>
</tr>
<tr>
<td>Expenditure</td>
<td>2,659 (17.4)</td>
<td>2,768 (17.0)</td>
</tr>
<tr>
<td>Surplus</td>
<td>83 (0.5)</td>
<td>506 (3.1)</td>
</tr>
<tr>
<td>Inflation (% at year-end)</td>
<td>8–10</td>
<td>10</td>
</tr>
<tr>
<td>GDP</td>
<td>15,300</td>
<td>16,130</td>
</tr>
</tbody>
</table>

Source: Russian government

Incomes continue to rise briskly. The State Statistics Service reports that per capita nominal money incomes in Russia grew 22 % on-year in January-September. In real terms, incomes rose 10 % for both the nine-month period and the third quarter. Real incomes increased 14 % in 2003.

Wages, which account for nearly two-thirds of the money incomes, rose 25 % in both January-September and the third quarter, matching last year’s pace. Because inflation slowed in the first half of this year, real wages were up 12–13 % y-o-y, compared to 11 % last year.

The average reported monthly salary in the third quarter averaged just under 7,000 roubles (€195) for the economy as a whole and about 8,500 roubles in industry. Actual wages are somewhat higher; it is estimated about a fifth of total wages are paid under the table. In January-September, pensions climbed 17 % y-o-y in nominal terms and 6 % in real terms. The average pension in the third quarter was almost 2,000 roubles (€55) a month.

Real income, wages and pensions, July 1998=100

Source: State Statistics Service

Tax demands on Yukos continue to mount. Tax officials rocked Yukos this week with new back tax demands, raising the total in back taxes for 2002 to €5.3 billion. The company had already previously been ordered to pay a €6.2-billion tax bill for 2000 and 2001. The outstanding tax claim on core production unit Yuganskneftegaz was also raised by €2.9 billion.

Prior to the presentation of the new tax bill, Yukos won a couple of rounds in its battle with the tax authorities. The company announced at the beginning of the week it had paid its entire €2.9 billion back taxes for 2000 in full. An assessment ordered by Yukos from the investment bank J.P. Morgan also put the true value of Yuganskneftegaz in the range of €12–14 billion, which questions the tax officials’ earlier publicly announced lower valuation of €8.4 billion as the starting bid in the Yuganskneftegaz sell-off. The low asking price and rising tax claims have increased speculation that the government plans to sell the production unit to a domestic producer. The most likely buyer is state gas giant Gazprom, which has recently begun to expand into all aspects of the energy sector.

First round of Ukraine presidential election ends in a draw. Leading presidential candidates, prime minister Viktor Yanukovych and opposition leader Viktor Yushchenko, both held their own in a first-round match-up that saw each man taking around 40 % of the vote. Many international observers considered the election fraudulent and undemocratic. Yanukovych’s strongholds were located in the Donetsk mining region, the Crimea peninsula and Kharkov, the country’s second largest city. Yushchenko made his best showings in the capital Kiev and the Rovno and Chernovitsky regions in the west. Round two is set for November 21. A central issue in the campaign has been a constitutional amendment proposal before parliament that would reduce presidential powers.
China

China raises interest rates. The People’s Bank of China raised deposit and lending rates on October 29, its first rate hike in nine years. The one-year deposit and lending reference rates rose 0.27 percentage points. Other deposit and lending rates have also risen. Perhaps most significantly, the central bank scrapped ceilings on regulated lending rates for all commercial banks except rural credit unions (see BOFIT Weekly 1/2004). The rate ceiling for rural credit unions was lifted to 2.3 times reference rates.

The interest rate hike indicates that government efforts to cool economic expansion have met with only marginal success. China’s economy continued to boom in the third quarter, and in September, on-year inflation exceeded 5 % for the fourth consecutive month. GDP grew 9.1 % y-o-y in the third quarter.

Reference deposit and lending rates by maturity, %

<table>
<thead>
<tr>
<th>Deposits</th>
<th>6 mo.</th>
<th>1 yr.</th>
<th>2 yrs.</th>
<th>3 yrs.</th>
<th>5 yrs.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Before</td>
<td>1.89</td>
<td>1.98</td>
<td>2.25</td>
<td>2.52</td>
<td>2.79</td>
</tr>
<tr>
<td>Now</td>
<td>2.07</td>
<td>2.25</td>
<td>2.70</td>
<td>3.24</td>
<td>3.60</td>
</tr>
<tr>
<td>Loans</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Before</td>
<td>5.04</td>
<td>5.31</td>
<td>5.49</td>
<td>5.58</td>
<td>5.76</td>
</tr>
<tr>
<td>Now</td>
<td>5.22</td>
<td>5.58</td>
<td>5.76</td>
<td>5.85</td>
<td>6.12</td>
</tr>
</tbody>
</table>

Home loan  

<table>
<thead>
<tr>
<th></th>
<th>under 5 yrs.</th>
<th>over 5 yrs.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Before</td>
<td>4.77</td>
<td>5.04</td>
</tr>
<tr>
<td>Now</td>
<td>4.95</td>
<td>5.31</td>
</tr>
</tbody>
</table>

Source: PBoC

Insurance companies can now invest directly in stock market. Insurance companies gained permission in 1999 to invest in the stock market indirectly through mutual funds. At that time, the ceiling on mutual fund holdings was set at 15 % of their total assets declared at the end of previous fiscal year. Under new rules, insurance companies can now engage directly in trading of stocks and corporate bonds on the stock market as long as these investments do not exceed 5 % of their current total assets. The jointly issued regulation of the China Securities Regulatory Commission (CSRC) and China Insurance Regulatory Commission (CIRC) also sets forth measures to curb excessive risk-taking. Insurance companies are forbidden from investing in listed companies that are undergoing restructuring or fail to meet disclosure requirements, as well as companies with share prices that have more than doubled in the past twelve months.

Most insurance company assets are presently held as bank deposits or government bonds. As of end-September, they accounted for 65 % of total insurance industry assets. Insurance companies are dissatisfied with returns on these assets due to low interest rates. The change could increase insurance companies’ opportunities for higher yields from stocks. Direct ownership by insurance companies as institutional investors is also expected to improve corporate governance of listed companies. It is estimated that the change could bring CNY 60 billion (€6bn) in insurance assets into the stock market.

CIRC’s September statistics, however, showed insurance companies’ allocation of assets in stock mutual funds accounted for only 7 % of total assets, less than half the amount allowed by CIRC. The uninspiring performance of China’s stock exchanges after the announcement of the new rules suggests that the new arrangement is essentially cosmetic without real improvement in the quality of listed companies.

Rural household incomes grew briskly. In the first nine months of this year, real per capita incomes of rural households rose 11 % y-o-y, while urban households saw real incomes rise 7 %. Nevertheless, the huge gap between income levels in rural and urban households persists. In the first three quarters, per capita monthly cash income was 230 yuan (€20) in rural households and disposable income 790 yuan in urban households.

In the same period, 45 % of rural household incomes were derived from selling agricultural products. Another 11 % was money sent home by rural residents working in cities. On the other hand, rural households received an additional 12 yuan a month per person from government subsidies. In the first three quarters, the per capita tax burden was lightened to 2.50 yuan a month for rural households, a 33 % drop from the same period a year earlier.

Higher agricultural product prices were an important factor in boosting rural household incomes. The National Bureau of Statistics reports agricultural product prices rose 15 % y-o-y in January-September. Grain prices were up 35 %, while the price of cooking oil increased 15 %.

Nominal growth of per capita household incomes, % y-o-y

Source: National Bureau of Statistics
Russia

Russian inflation picks up in October. The rise in consumer prices continued to gain steam in October, up 11.6 % y-o-y, a tenth of a percentage point increase from September. On-month inflation in October was 1.1 %, the highest monthly inflation level since January. The sharpest increases were seen in food prices, which rose 11.6 % y-o-y. The main contributors to the increase were bread and grain products (20 %), meat products (17 %), and milk and milk products (14 %). The on-year rise in other goods was 7.8 %, while gasoline prices spiked 31 %. The rise in services prices accelerated to 17.2 %. Housing costs, up 24 % y-o-y, led the increase in the services category.

Russian consumer prices 2001–2004, % change y-o-y (monthly data)

Source: State Statistics Service

Russia ratifies Kyoto Protocol on climate change. On November 5, President Vladimir Putin signed a ratification act on the Kyoto treaty. Upon ratification, the worldwide climate agreement will enter into force in all signatory countries. The treaty requires ratification by developed nations that account for at least 55 % of global greenhouse gas emissions. The United States and Australia have refused to sign the treaty. This made the ratification of Russia, which generates 17 % of the world’s carbon dioxide emissions, essential for the treaty to enter into force.

The Kyoto Protocol seeks to reduce global greenhouse gas emissions to their 1990 level. Russia’s current emissions level is about 30 % lower than in 1990, which gives Russia an opportunity to sell emission “credits” to other countries. An at times heated discussion has arisen over the possible impacts of emission limits on the Russian economy. Some observers estimate that sales of emission credits will bring in substantial income for Russia, while others fear that the need to curb emissions will retard industrial output growth and thus slow growth of the economy as a whole.

Housing shifts to the market economy. If the government’s end-October decisions are implemented, Russians can expect to be charged for all their housing costs by the beginning of 2006. The cabinet’s latest decisions are part of the ongoing national housing program for 2001–2010. Industry and energy minister Viktor Khristenko said residents should currently pay 82 % of housing costs, but in practice only pay about 57 %. The current plan is to shift away from housing support as a perk to a needs-based system of housing support during 2005.

About 70 % of Russia’s housing stock is currently in private hands, and part of housing sector prices is already formed on the open market. Housing-sector firms now annually provide about RUB 750 billion (€20bn) in services, which corresponds to about 8 % of GDP. The most pressing problems facing housing managers appear to be financing and the poor condition of aging housing stock.

Corruption down slightly in Russia. Corruption watchdog Transparency International published its annual Corruption Perception Index (CPI) for 146 countries. Russia’s CPI has yet to break 3 (above which corruption is no longer considered “rampant”) but it is getting close with its latest CPI value of 2.8. The CPI scale goes from 0 (absolutely corrupt) to 10 (absolutely honest). In recent years, Finland has claimed the top spot as the world’s least corrupt country. This time, Finland’s CPI value was 9.7. Russia’s CPI averaged 2.5 during 1999–2004. Even with the gains, Russia’s ranking has fallen as the list has expanded and relatively less-corrupt newcomers have been added to the index. This year Russia tied for 90th place with India, Mozambique and Tanzania.

The most corrupt CIS country was Azerbaijan with a CPI of 1.9 and rank of 140. Georgia, Tajikistan and Turkmenistan also posted poor CPI scores of 2.0 to tie for 133rd place. Ukraine’s CPI was 2.2 and its ranking 122nd. The CPI also suggests corruption in China has fallen slightly since 1999. China currently has a CPI of 3.4 and ranking of 71. Transparency International’s CPI comprises 18 polls reflecting the corruption perception of business people and country analysts.

CPI rankings for Russia, China and Finland, 1999–2004

Source: Transparency International

Editor Timo Harell
Information herein is compiled and edited from a variety of sources. The Bank of Finland assumes no responsibility for the completeness or accuracy of the information.
China

In China, brisk industrial output growth continued in October. Industrial output was up nearly 16 % y-o-y last month, with the growth pace remaining near that of recent months. Growth, however, has slowed from the first months of the year. For January-October, industrial output increased 17 % y-o-y.

Production of export goods climbed 34 % y-o-y in October. On-year growth in electricity production accelerated to 16 %. The high demand for energy was also seen in soaring production of coal (up 16 % y-o-y in September) and natural gas (22 %). The manufacture of machinery and equipment for power generation also increased strongly. Growth remained strong in production of steel (22 %) and cement (13 %), and export growth led to higher production of home appliances. Meanwhile, the car industry’s difficulties continued, with car production falling 14 % y-o-y in October.

China's industrial output growth, % y-o-y

The rise in producer prices continues to accelerate. The National Bureau of Statistics reports October producer prices were up 8.4 % y-o-y. In September, the annual rise in producer prices was 7.9 %. Thus, the rise that began at the end of 2003 has continued to strengthen.

The largest increases in October were seen in crude oil, which was 41 % more expensive than a year earlier. Prices of oil products, too, have risen considerably in the past twelve months. Prices for raw materials were on average 11 % higher than a year earlier. The price of coal rose 10 % and steel products 15 %. Prices of consumer goods were down 4 % y-o-y.

Foreign trade growth slows slightly. The value of Chinese exports in January-October was up 35 % y-o-y. Imports in turn rose 37 %. While the growth in foreign trade has slowed since the start of the year, exports were still up 28 % in October and imports 29 % compared to a year earlier.

Trade has been nearly in balance this year. In January-October the surplus was just over $11 billion (less than 1 % of estimated GDP), i.e. the surplus was 3.5 billion dollars less than a year earlier. The whole year 2004 surplus is expected to outpace the January-October period as China’s trade surplus typically strengthens in the final months of the year.

China's foreign trade, US$ billion

Shortages of migrant and skilled workers emerge. The Ministry of Labour and Social Security (MOLSS) has warned in its latest report that the more developed costal areas are experiencing shortages of migrant labour. The most severe shortage is in the Pearl River Delta, where nearly 20 million migrant workers reside. MOLSS estimates a current shortfall of two million migrant workers in the region. The shortage is most evident in labour-intense industries such as footwear, toys and plastic product manufacture. Around 80 % of migrant labour demand in the Pearl River Delta is for women aged 18 to 25. In the area, average monthly salaries for low-skilled jobs have actually declined in real terms in the past twelve years.

The MOLSS survey found a nationwide shortage of skilled labour. The September survey was conducted in 115 cities, comprising 71 % of China’s urban population. The survey found that the most crippling shortage was for workers with technical backgrounds, who are only half the people available to satisfy demand. In Shanghai, an electronic component technician can expect to receive on average 27 job offers.

Although China is not expected to face a significant labour shortage in the near term, the current situation indicates severe structural imbalances in China’s labour market. In response, the government has moved to increase professional training in rural areas. According to the Ministry of Agriculture, 1.5 million peasants received supplemental training at over 5,500 designated training centres nationwide during the first three quarters of 2004.
Russia

Huge upward revision in oil export figures. On November 9, the central bank noted that the Federal Customs Service would revise export figures for April-August. The revised figures reveal a large difference between oil export figures for January-August and January-September. The State Statistics Service said earlier crude oil exports in January-August averaged 4.4 million barrels a day, while the revised figures show an average of 5.1 million barrels a day in January-September, i.e. 15 % increase in Russia’s total crude oil exports. The new numbers indicate that in the first nine months of this year crude oil exports increased 14 % y-o-y, while the unadjusted figures for the first eight months of the year showed an on-year rise of less than one per cent. The customs service also revised its figures for cumulative volume of refined oil products from 197,000 tonnes a day for January-August to 219,000 tonnes for January-September, an increase of 11 %. Oil production figures were not revised.

The revisions are now incorporated into the Central Bank of Russia’s foreign trade figures, which are mainly based on customs figures. They show a considerable increase in the value of exports in the second and third quarters of 2004. Exports for April-August are now valued at $75 billion, or $3 billion more than before the revision. The revisions apply mainly to exports to non-CIS countries.

Before the revisions, some analysts had become suspicious of the reported tepid growth in Russian oil exports, which contradicted far more optimistic official forecasts. One theory was that grey-market exports had increased. The revised figures are quite in line with the economy ministry’s export forecast for 2004.

Russian crude oil exports, million barrels a day

More oil companies hit with tax demands. Last week tax officials announced that they had completed their audit of Russia’s third-largest oil company, TNK-BP. Based on their findings, TNK-BP was ordered to pay RUB 2.5 billion ($67 million) in back taxes for 2001. According to press reports from the beginning of this week, Russia’s fifth-largest oil company, Sibneft, has also been hit with a tax claim of RUB 21 billion ($565 million) for 2000. Tax officials have reportedly launched audits of the 2001 tax filings of Slavneft, Rosneft, Sibneft and Tatneft.

At the end of October, presidential advisor Igor Shuvalov clarified the term “responsible tax treatment,” saying that it meant all oil companies were subject to audit, not just Yukos. The claims imposed now for back taxes are considerably less than the €10-billion-plus demands on Yukos.

Putin does not want to review earlier privatisations. In a speech to the annual meeting of Russia’s influential Union of Industrialists and Entrepreneurs, president Vladimir Putin declared that the state must guarantee that the results of the privatisations that have already taken place will not be reviewed. The state must also ensure all possible protection of private property rights – a cornerstone of the market economy. The president said he hoped for cooperation with the business world in nationally important projects and reminded his audience of the social responsibility of corporations. The meeting included long discussions on corporate needs. The president said he well understood the need to redistribute the tax burden among companies. At the same time he noted that the state must be cautious in tax reform and that it cannot underestimate the ability of the main industrial sectors, particularly the energy sector, to pay.

Regions make slow progress in social reform; more people than expected qualify for benefits. Russia moved last summer to replace in-kind social benefits with monetary compensation from the beginning of 2005. Regions will assume the burden of the monetary benefits arrangement, while their budgets have already been saddled with other spending mandates in connection with earlier modification of responsibilities between federal and regional budgets. Implementation of the reforms has been complicated by the fact that regions cannot identify how many people qualify for benefits or how much the reform will cost. Initially, beneficiaries were estimated to number just over 12 million, but on closer inspection that number has already risen to 15 million. Finance ministry budget department director Anton Siluanov said just two of Russia’s 89 regions had approved the necessary legislative changes as of mid-October. The reform is so confused that on November 9 president Vladimir Putin had to ask his cabinet look into ways to clarify the situation.
China

**Rise in Chinese consumer prices slowed in October.**
Chinese consumer prices were up **4.3 %** y-o-y in October, a distinct slowing from September’s annual rise of **5.2 %**. The most substantial cooling was seen in prices for foods, particularly meat and eggs. Although October food prices still increased **10 %** from a year earlier, they had been rising at a **13 %** rate just a month earlier. On the other hand, the on-year rise in prices of fuels, electricity and water accelerated in October to **12 %**. Prices for services increased modestly, less than **3 %** for the year.

While prices were up **3.7 %** y-o-y in cities, they climbed **5.4 %** in rural areas. The higher inflation in the countryside is mainly due to the fact that foods, and notably grains, have a heavier weighting in the basket of consumer goods than in the cities. Grain prices soared **29 %** y-o-y in October.

**Consumer prices and food prices, % change y-o-y**

![Graph showing consumer prices and food prices](source:national bureau of statistics)

**Growth in retail sales accelerates, investment growth slows.** In nominal terms, the value of retail sales rose **14 %** y-o-y in October. Growth has accelerated since the start of the year, especially in the countryside, where sales increased **13 %** y-o-y in October (compared to **8 %** in the first quarter). Sales in cities grew **15 %** y-o-y in October. Sales of oil and oil products were estimated to have skyrocketed **56 %**, while sales of home construction and renovation materials jumped **38 %**. Sales of food and beverages, clothing and household goods all increased **18 %**. In contrast, car sales were only up **2 %** from a year earlier.

Although China’s monthly figures for fixed investments only include cities, they still report the lion’s share of investment in China. These statistics indicate investments were up **26 %** y-o-y in October. Thus, investment growth remains brisk, even though the pace of growth has slowed substantially since the early part of this year. Investments leapt **30 %** y-o-y for the period January-October. Investments in real estate continued to boom despite government measures to rein in growth. Real estate investment rose **29 %** y-o-y in January-October. Growth actually accelerated slightly in October from previous months. Investments in mineral production and refining grew **48 %**, while investments in metal production and refining increased **41 %** from a year earlier.

**SAFE eases rules on foreign currency transfers within multinational companies.** The State Administration of Foreign Exchange (SAFE) has issued new regulations that make it easier for multinational companies to transfer foreign currency among their units. In the past, foreign currency transfers from one unit to another had to pass through the multinational company’s headquarters and every foreign currency transfer required separate and prior approval from SAFE. From now on, transfers among units of multinational companies operating in China will no longer need SAFE approval.

Transfers from units in China to units abroad have also been made easier. Under the new regime, SAFE will grant permits to multinational companies that regularly transfers money abroad. Companies with permits will not need any additional approvals to make foreign currency transfers. Chinese-owned multinational companies are now allowed to transfer capital directly from China to finance overseas investment projects. Previously, SAFE approval was required for investments in excess of $1 million. Now Chinese multinational companies do not need any additional approvals as long as their investments do not exceed **20 %** of their shareholder equity stated on the company balance sheet.

**China unifies reserve requirements for foreign currency deposits.** From January 15 next year, all banks operating in China will be subject to a reserve requirement of **3 %**. The current reserve requirement is **2 %** for domestic banks and **5 %** for foreign banks. The People’s Bank of China reports total foreign currency deposits in China’s banking sector at the end of June amounted to $150 billion.

The move was intended to stem the flood of foreign currency inflows caused by speculation on a possible yuan revaluation and is part of the central bank’s recent struggle to minimise the impact of recent foreign currency inflows on the money supply. China’s foreign exchange reserves stood at $515 billion (€ 400 billion) at the end of September, up from $403 billion at the start of this year.
Russia

Production growth continues to slow in October. The production index of five base sectors of the Russian economy was up 3.8 % y-o-y in October and 6.6 % y-o-y for the first ten months of the year. Construction slowed from September and on-year growth in January-October was 10 %. In the first half, construction grew at a robust pace of 14 % y-o-y. On year, agricultural output fell in both September and October. Retail sales, an indicator of private consumption, were up 12 % in January-October and October growth was also 12 %. Freight transport grew 6.5 % y-o-y in January-October.

Workday-adjusted industrial output growth was 6.1 % y-o-y in the first ten months of 2004. Growth was slightly higher in October than for 3Q04. Industries enjoying above-average growth in January-October included machine-building (12 %), fuels (7.5 %) and chemicals (7.5 %). Output of ferrous and nonferrous metallurgy grew 4–5 %.

Fitch upgrades Russia’s credit rating. On November 18, international credit rating agency Fitch raised its rating of Russian government long-term domestic and foreign currency bonds one notch to its lowest investment-grade rating (BBB-). Fitch is the second international credit ratings agency to upgrade Russia to investment grade. Moody’s lifted Russia’s creditworthiness to investment grade in October 2003. Standard & Poor’s has not yet granted Russia an investment-grade rating. Fitch said the higher rating reflects Russia’s successes in pursuing prudent fiscal and debt-servicing policies, as well as the rapid build-up in the state stabilisation fund and foreign currency reserves. Fitch noted, however, that oil earnings were largely responsible for the rapid accumulation of funds, and warned of the economy’s excessive dependence on natural resources and slow progress in structural reforms. The investment-grade rating is expected to open Russia to a new group of more prudent international investors that only invest in credit-worthy countries.

CBR affirms exchange rate policy lines for 2005. A central feature of the monetary and exchange rate policy approved by the Central Bank of Russia last week is that the rise of the rouble’s real exchange rate will be capped at 8 % next year against a basket of currencies of Russia’s various trading partners. The CBR considered five scenarios in which the average world price of Russian Urals-grade export oil varies between $22.50 and $35 a barrel in 2005. The rouble’s average nominal exchange rate vis-à-vis the dollar is assumed to fall 3–5 % next year. The CBR notes that its scenario last year assumed the rouble’s exchange rate against the dollar would fall 2 % this year if Urals-grade crude would average just $22 per barrel. In fact, the price of Urals oil averaged $33 a barrel in January-September and the rouble strengthened 6 % against the dollar from the same period a year earlier.

In line with its current policy, the CBR continues to use a managed float of the rouble’s external value, even if it strives in principle to minimise its currency market interventions that impact the rouble’s exchange rate. The policy document notes that the CBR is switching to a euro-dollar basket to guide the rouble’s exchange rate fluctuations, which is sufficient to reflect the rouble’s exchange rate against all major currencies. CBR deputy chairman Konstantin Korischenko said the central bank is using for this purpose a currency basket weighted 60 % to the euro and 40 % to the dollar. Deputy chairman Alexei Ulyukaev further stated that the CBR is considering increasing the share of the euro in its foreign currency reserves. Ulyukaev’s comment propped up the euro’s value on currency markets this week. The euro is currently estimated to represent 25–30 % of Russia’s foreign currency reserves. The CBR’s foreign currency reserves stood at about $114 billion at the end of last week.

Yuganskneftegaz to be sold and Yukosonders bankruptcy. Russia’s state property fund announced Yukos core production unit Yuganskneftegaz will be auctioned on December 19 to cover some of the company’s outstanding tax debts.

Contrary to earlier expectations, foreign companies will be allowed to participate. The sale involves 77 % of shares in the production unit. The starting price is €6.7 billion, which is both far below the €12–14 billion assessment of Yuganskneftegaz’s value commissioned by tax officials and insufficient to cover the €15 billion in back taxes owed by Yukos and its subsidiaries. Even so, the initial bid price is so high that only a few Russian companies have the resources to participate in the auction. Russian gas giant Gazprom is widely expected to win the bidding.

The auction is scheduled a day before Yukos’ December 20 shareholder meeting, at which the possible bankruptcy of the company will be discussed. The market capitalisation of Yukos on RTS bourses is now only about €3 billion, which is less than a tenth of the company’s peak value just over a year ago.

Ukraine presidential election results. Following last Sunday’s (Nov. 21) runoff between opposition leader Viktor Yushchenko and prime minister Viktor Yanukovich, the elections commission announced Yanukovich had beaten Yushchenko by 49.46 % of the vote to 46.61 % – a difference of about 870,000 votes. About 2.3 % of voters voted against both candidates. The opposition accused the government of manipulating the result, and international election observers say the Sunday’s vote failed to meet European standards for democratic elections.
China

Economic growth expected to slow only slightly in 2005. Gross production of China’s economy during 2004 has grown faster than forecast at the start of the year. GDP growth is now expected to substantially exceed the government’s 7% target for 2004. In recent months, China’s main research institutes and international agencies have raised their 2004 forecasts for real GDP growth to around 9%.

Economic growth is expected to slow slightly next year. China’s leading economic research bodies, the Chinese Academy of Social Sciences and the National Development and Reform Commission (NDRC) project GDP growth will reach 8–9% in 2005. Both agencies consider higher prices and negative real interest rates on deposits (which have reduced the real value of household savings) as the main threats to high GDP growth. The NDRC further noted that overinvestment could continue at the local level.

The new forecasts of international agencies are slightly more cautious. The IMF, World Bank and Asian Development Bank expect Chinese GDP growth will slow next year to 7.5–8%. According to these agencies, the current economic environment faces serious risks to economic growth. Further, crude oil prices exert a significant effect on Chinese economic growth. The Asian Development Bank estimated earlier this month that an oil price around $50 a barrel is sufficient to reduce Chinese GDP growth by another 1.5 percentage points next year.

Interest rate reform moves ahead. A central question in China’s ongoing bank reform has been the liberalisation of commercial bank interest rates. Since the beginning of this year, commercial banks have been able to issue loans at interest rates ranging between 90% and 170% of the central bank’s official reference rate (see BOFIT Weekly 1/2004). The goal of widening the lending rate band is to get commercial banks to adopt market-based pricing. In its latest monetary policy review, the People’s Bank of China hailed the change as a success. The figures for the first three quarters show that, although over a third of new loans issued by state-owned and small shareholding banks carried interest rates above the reference rate, most new loans were issued at rates that either matched or were below the reference rate. In other words, the higher lending rate ceiling did not appear to trigger a general rise in interest rates. This is partly due to the current high liquidity of the banking sector. The PBoC went on to note that the risk management mechanisms of regional banks and rural credit unions are still notably inadequate.

Central bank figures also show that commercial banks price their lending according to the size of the enterprise applying for a loan. Only a quarter of new loans issued to large enterprises had interest rates above the reference rate, while over half of loans to small enterprises exceeded the reference rate. The typically higher lending rates to smaller enterprises reflect to some extent the associated higher risk. Another reason could be that large enterprises, who are often state-owned, continue to receive preferential treatment.

The latest relaxing of interest rate policy was declared in October (see BOFIT Weekly 45/2004), when the lending rate cap was eliminated in connection with the interest rate hike. The central bank now also allows deposit rates in commercial banks to float below the reference rate. These changes are hoped to foster banking sector reform and enhance the role of interest rates in China’s monetary policy.

Distribution of lending rates within the official range, Jan.–Sept. 2004, % of new loans

<table>
<thead>
<tr>
<th>% of reference rate</th>
<th>90–100</th>
<th>100</th>
<th>100–130</th>
<th>130–150</th>
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<tr>
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<td>32</td>
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<td>16</td>
<td>33</td>
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<table>
<thead>
<tr>
<th>% of reference rate</th>
<th>90–100</th>
<th>100</th>
<th>100–130</th>
<th>130–150</th>
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<tr>
<td>Small firms</td>
<td>12</td>
<td>33</td>
<td>50</td>
<td>5</td>
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</tr>
</tbody>
</table>

Source: People’s Bank of China

1) The ceiling for rural credit unions is 200%.
2) Firms with sales exceeding CNY 300 million.
3) Firms with sales in the range of CNY 30–300 million.
4) Firms with sales of less than CNY 30 million.

Eased rules on foreign currency transfers by private individuals. From the start of next year, it will be easier for Chinese nationals studying abroad to purchase currency and transfer their tuition costs and living expenses from China. A new regulation from the State Administration of Foreign Exchange (SAFE) allows students to transfer up to $20,000 per year without the need for special permission. Students currently have to apply for SAFE approvals.

The PBoC also issued separate regulations on transfers of private assets abroad. These regulations allow Chinese citizens immigating abroad and foreign citizens entitled to inheritance under Chinese law. Transfers of assets abroad still require approvals from SAFE or its local branches depending on the value of the assets. The new rules should improve protection of private property (the Chinese constitution was amended to include private property rights at the beginning of this year). They also relax controls on capital account transactions, including immigrant and inheritance assets. The new regulations enter into force at the beginning of December.
Russia

Foreign investment in Russia continues to grow. The State Statistics Service reports the flow of foreign investments into Russian firms totalled $29 billion (excluding the financial sector) in the first three quarters of this year. Of that, $5.6 billion consisted of foreign direct investment, a 20% increase from January-September 2003. The FDI figure included $3.6 billion in investment in company share capital, which was more than double the amount for the same period a year earlier. Foreign owners also granted $1.2 billion in loans to Russian companies they owned either wholly or partly, which was 15% less than a year earlier.

Portfolio investment in Russian firms in January-September amounted to just $200 million. Foreign trade credits and other lending to firms amounted to $23.3 billion, a 44% y-o-y increase.

In the first three quarters, half of all investment went to industry and half of that to the fuel industry. As of end-September, the stock of foreign investment was $73 billion, of which $30 billion was FDI. The main sources of foreign investment during January-September were Luxembourg, the UK, the Netherlands and Cyprus.

Russian firms invested $25 billion abroad in January-September. The bulk of investments went to the US, Cyprus, the UK and the British Virgin Islands.

FDI inflows into Russia, US$ billion

![Graph showing FDI inflows into Russia from 1997 to 2004.](image)

Source: State Statistics Service

CBR relaxes currency controls. On November 26, the Central Bank of Russia announced it was reducing the minimum share of foreign earnings that companies must convert into roubles. While the repatriation requirement on foreign currency earnings remains 100%, exporters are now only compelled to convert 10% of their foreign earnings into roubles rather than 25%. The foreign currency act gives the central bank the authority to set the minimum requirement as high as 30% or lower as appropriate. The requirement of converting some of export earnings into roubles will be completely eliminated from the start of 2007 in accordance with currency act.

The CBR’s move to lower the minimum conversion share reflects its efforts to stem appreciation pressures on the rouble. However, in reality the measure has little implications for monetary policy, as companies typically convert a much larger share of their export earnings into roubles.

WTO membership talks could be concluded next year. The economy ministry reports that so far Russia has signed bilateral agreements on access of goods to Russian markets with about 20 countries (Russia is in negotiations with over 50 countries and the EU). Agreements on access of services to Russian markets have been concluded with some ten countries (out of a total of about 30 countries). This autumn, countries concluding agreements included China and South Korea. Bilateral talks continue e.g. with the US, Canada, Australia, Japan, Switzerland and several Latin American nations. The economy ministry said the toughest negotiation points include certain agricultural products, cars, aircraft and furniture, as well as transport, telecommunications and financial services (e.g. the opening of bank branches).

Russian customs topped the agenda of the 25th meeting of the WTO accession working group in November. The approval process is now nearly concluded for legislative changes aimed at improving appraisal of goods valuations and pricing of customs services. Russia’s lead WTO accession negotiator, Maxim Medvedkov, said the stickiest multilateral discussions continue to revolve around agriculture, veterinary and phytosanitary measures, technical regulation of goods, protection of intellectual property and the state-regulated domestic energy prices (particularly with the US and Canada). The dates of the working group’s next meeting will be set in January. Economy minister German Gref stated Russia could wrap up its membership talks before the end of next year.

14th Russia-EU summit held in The Hague. Despite high hopes for the November 25 meeting, the parties failed to reach agreement on deepening partnership relations. Even so, both sides still look forward to a positive outcome at the next meeting in Moscow in May 2005. The EU and Russia want to deepen relations on four areas: economic cooperation, internal and external security, and research and education.

The parties publicly expressed their satisfaction with the extension of the EU and Russia’s partnership and cooperation treaty to include the ten newest EU members, as well as Russia’s ratification of the Kyoto protocol on climate change. In the wake of the disputed outcome of the Ukrainian presidential election, both sides expressed hope that the matter would be resolved peacefully and according to Ukraine’s constitution.
China

China and ASEAN agree on preparations for free trade area. On Monday (Nov. 29), members of the Association of Southeast Asian Nations (ASEAN) and China penned an agreement on transition towards a free-trade area in July 2005, when participating nations will begin to lower incrementally customs tariffs on 7,000 products. China and six ASEAN members (Brunei, Philippines, Indonesia, Malaysia, Singapore and Thailand) hope to have the free-trade area fully implemented by 2010. The free-trade area would be expanded by 2015 to include recent ASEAN members (Cambodia, Laos, Myanmar and Vietnam). About 1.8 billion people live in the region, making it the largest free-trade area in the world. The ASEAN countries also agreed at the Laotian summit on the creation of an ASEAN economic area by 2020.

Trade between China and ASEAN countries has expanded briskly in recent years, with China typically running trade deficits. In 2003, the value of Chinese exports to ASEAN countries was $31 billion (7% of China’s total exports), while the value of imports was $47 billion (11%). The value of trade this year is expected to exceed $100 billion. Chinese imports from ASEAN countries are dominated by raw materials, semi manufactures and components. Machinery and equipment lead Chinese exports to the ASEAN region.

Changes in securities market regulations. At the end of August, the Standing Committee of the People’s National Congress approved amendments to the companies act and securities act. Under the changes, the China Securities Regulatory Commission (CSRC) no longer oversees pricing of initial public offerings, but rather allows the listing companies themselves and investment banks to decide on appropriate pricing. Pricing earlier required CSRC approval. The CSRC often used P/E ratios (price/net earnings) that were lower than market figures. At the beginning of September, the CSRC began reform of IPO pricing, and all IPOs have been temporarily suspended. The new regulations should be released this month.

At the end of November, both the Shanghai and Shenzhen bourses published new rules on initial public offerings and disclosure requirements. They contain important specifics and are expected to ease implementations by authorities. However, fundamental changes are absent and major loopholes still exist. For instance, the new rules allow listed companies to delay disclosures under loosely defined national interests or other similar considerations.

Shanghai and Shenzhen bourses, A-share indices

Car production continued to decline in October. Production fell in October for the second straight month and was down 14% from a year earlier. The decline in car production is expected to continue, and this year’s production target of 2.4 million cars is unlikely to be realised. Nevertheless, January-October production was still up 17% from the same period a year earlier.

The rapid growth in car production, tougher terms for car loans and high oil prices have caused many to postpone their car purchases. In October, sales of passenger cars in Beijing plummeted 27% y-o-y. Automaker profits also fell for the first time in six years, declining 8% y-o-y for January-September. In the third quarter alone, profits were off 45% y-o-y.

Change in monthly car production in China this year, % y-o-y
Russia

Annual inflation target exceeded in November. Despite the government’s target of slowing the rise in prices in 2004 to a range of 8–10 %, the rise in consumer prices for the first eleven months of the year reached 10.5 %. Consumer prices were up 11.7 % y-o-y in November. Much of the high inflation was due to an unexpectedly large influx of foreign currency into Russia resulting from high world prices for crude oil. In the longer perspective, however, Russian inflation has slowed steadily for several years (consumer prices rose 12 % in 2003, 15 % in 2002, nearly 19 % in 2001 and about 20 % in 2000).

Strong federal budget performance continues. The State Statistics Service reports the federal budget showed a surplus of RUB 588 billion (4.9 % of GDP) for the first three quarters of the year. Revenues were RUB 2,425 billion (20.5 % of GDP), while expenditures amounted to RUB 1,837 billion (15.2 % of GDP). The figures include social tax collections passing through the budget to the pension fund. In the period January-September 2003, federal budget revenues were 19.5 % of GDP, expenditures 17.1 % of GDP and a surplus equal to 2.5 % of GDP.

This year’s hefty surplus reflects persistently high oil prices. About a quarter of federal budget revenues are estimated to derive from taxes on oil and gas production and export tariffs. In the first three quarters, the largest budget revenue categories after the value-added tax were natural resource extraction fees and export tariffs. These already cleared their budget targets for the whole year in January-September.

Compared to January-September 2003, total federal budget spending in relation to GDP fell substantially. This was due mainly to a reduction in transfers from the federal budget to regional budgets and lower debt interest payments. Most of the other expenditure categories were unchanged or shrank slightly with respect to share of GDP.

Growth of Russian exports and imports accelerated in the third quarter. Adjusted January-September figures for Russian exports show earnings on goods exports climbed over 30 % y-o-y in dollar terms. In the third quarter, the earnings rose nearly 40 %. Data released by the State Statistics Service also confirmed that the customs had adjusted their earlier published export figures for April-August by adding over 20 million tonnes of crude oil (about a million barrels a day), the equivalent of 8–9 % of Russia’s annual crude oil exports.

Earnings on crude oil exports soared nearly 45 % y-o-y in the first three quarters. In the same period, the price of exported crude oil rose over 25 % from the previous year, while the export volume climbed 14 %. The volume of exported oil products gained 4 %. Natural gas exports increased 9 %, although the price of natural gas was just one per cent higher on average than in January-September 2003. Earnings on metal exports swelled over 60 %, due mainly to higher export prices but also increased export volumes.

Spending on imported goods increased 25 % in the first three quarters of 2004. The pace of growth held up throughout the third quarter. Imports from countries outside the CIS grew 22 % in January-September and slightly faster in the third quarter. Spending on imports of goods in the machinery and equipment category jumped 47 % in the first three quarters. That growth was driven by an approximately 160 % rise in the number of passenger cars imported. Food imports grew 13 %. Measured in euro terms, imports from countries outside the CIS grew over 10 % in January-September and 15 % in the third quarter.

Monthly export earnings for 2004, US$ billion

Russian tax officials announce back-tax claims on mobile phone operator VimpelCom. Observers’ fears that the officials would not stop with Yukos and its subsidiaries were realised on Wednesday (Dec. 8) when the tax authorities slapped VimpelCom, the country’s second largest mobile telephone company, with back-tax claims for 2001 totalling RUB 4.4 billion (€118 million). Most of the claim consists of unpaid profit and value-added taxes. VimpelCom shares slumped over 20 % on the news of the tax troubles, wiping nearly €2 billion off the company’s market capitalisation. The RTS index of leading Russian shares also dropped over 5 %, closing the day at 574. The RTS index had not seen such lows since the end of 2003.

VimpelCom was founded in 1992 by a group of workers in the defence industry. The company’s largest shareholders are the Norwegian Telenor and the Russian Alfa-Telecom.
China

Industrial output growth slows slightly in November. Although on-year industrial output growth in November was still nearly 15%, it has slowed slightly during 2004. Industrial output for the first eleven months of the year was up nearly 17% y-o-y. Export growth remained brisk in November and export products accounted for about a quarter of the value-added generated by the industrial sector. Growth in inventories appears to be accelerating as 98.0% of production was sold in November. The ratio of sales to production in October was still 98.5% and 98.7% in July.

Car production continued to decline, with a 6% fall in November compared to the same period a year earlier. Excluding the car industry, growth remained strong in all major industrial branches. Heavy industry output was up 16% y-o-y in November, while light industry climbed 13% y-o-y. Despite government measures to rein in growth, steel production in November was still up 21% y-o-y and steel products 24%. Production of the ten main non-ferrous metals rose 13% y-o-y. Computer production increased 33%. Rapid growth in the energy sector also continued. In November, natural gas production was up 24% y-o-y, electricity production 14% and coal production 13%. However, further growth in crude oil output (up 5% in November) was found to be difficult. The increased consumption has been covered mainly by boosting imports.

Foreign trade continues to boom. November exports were up 46% y-o-y and imports 39%. Last month’s high growth figures were due in part to the low reference figures for November 2003. Nevertheless, the data indicate that the robust growth of China’s foreign trade continues. Exports rose 36% y-o-y during January-November, while imports rose 37% y-o-y (nearly matching the pace set in 2003).

The trade surplus in January-November was nearly $21 billion, which was slightly higher than the surplus for the same period in 2003.

Opening up of banking sector ahead of schedule. China’s WTO agreement requires that foreign banks be allowed to engage in yuan-denominated banking from December 2006. Currently, foreign banks can do local currency transactions in only 18 cities and they can only serve corporate customers. Private individuals will be able to do yuan transactions in foreign banks in 2006.

Although China’s WTO deal only calls for the opening up of three cities this year, China’s Banking Regulatory Commission (CBRC) added five more cities on December 1. Under the original schedule, the last two cities should join the current group next year ahead of the elimination of all geographic restrictions in 2006.

Foreign banks that set up branches in the less-developed western and north-eastern regions will now also enjoy less stringent profitability requirements and swifter application handling. In addition, foreign banks will be allowed to sell insurance products starting next year.

As of end-October, 204 foreign-owned financial institutions operated in China. Of these, 105 had permission to engage in yuan-denominated business. Some 223 representative offices have also been established by foreign financial institutions in China. Assets in foreign banks represented just 1.8% of the total assets of China’s banking sector at the end of October.

China’s insurance markets open up to foreign companies. From December 11, China will significantly increase the freedom of foreign insurance companies to operate. Restrictions on certain products such as group insurance, sales and where companies can operate will be eliminated for the approximately 30 foreign insurance companies currently operating in China. Sales of new products and operations in previously off-limits areas will still require official permission. Foreign insurance companies control 14% of the market in the main cities already opened (Beijing, Shanghai and Guangzhou).

Further easing of yuan currency controls. Starting this month, travellers abroad can take up to CNY 20,000 (€1,800) with them. Previously, the maximum amount was fixed at CNY 6,000. The currency control relaxation is expected to promote bilateral trade and tourism between China and neighbouring countries. Although the yuan is still not officially convertible, it is effectively in circulation in many Asian economies. The official use of the yuan outside mainland China is currently authorised only in Hong Kong and Macao Special Administrative Regions, where clearance services are provided by designated banks (see BOFIT Weekly 1/04 and 32/04). China also has bilateral border trade clearance agreements with Vietnam, Mongolia and Russia. Cash in circulation today represents 8% of China’s broad money supply, thus cash in circulation outside China is not expected to have any significant impact on domestic monetary policy.

Currency control regulations have undergone a number of changes since 1951, when taking yuan out of the country was banned. The limit was raised to 200 yuan in 1987 and 6,000 yuan in 1993.
Russia

Decelerating GDP growth. According to preliminary data from the State Statistics Service, GDP grew 7.0% y-o-y in the first three quarters of 2004, or slightly less than in the same period a year ago. Growth decelerated sharply in the autumn. In 1H04, GDP was still growing at 7.4% y-o-y, but by 3Q04 on-year GDP growth was just 6.4%. The biggest slowing was seen in goods production, which saw growth fall below 5% in the third quarter. Notably, industrial output growth was under 5% and construction growth fell by half to less than 7%. On the other hand, services production increased over 8%, a faster pace than in the same period last year. This growth was attributed in part to over 11% growth in retail trade. According to a survey of purchasing managers by Moscow Narodny Bank, the slowing of growth in goods output continued in October and November.

The factors behind the slowing economic growth include lower investment growth (fixed investments rose in October less than 8% y-o-y, while growth was close to 12% in summer). The slowing of growth has set off an uncommon debate with liberal economists in the federal administration openly criticising public authority. Finance minister Alexei Kudrin, deputy economy minister Andrei Sharonov and chief of the federal financial markets service Oleg Vyugin, among others, have stated that recent disciplinary measures aimed at large corporations have increased uncertainty over Russia's economic operating environment and damaged the investment climate.

Russian Duma approves 2005 federal budget. This year, the budget made it through all four Duma readings with record speed and in accordance with the policy line set forth by the Kremlin and the cabinet.

Compared to the original 2004 budget, revenues and expenditures (excluding the social tax, which passes through the budget to the pension fund) will both increase in 2005 in relation to GDP. However, compared to actual budget developments during the current year, the revenues as a share of GDP are lower in the 2005 budget while the expenditures are higher. Natural resource extraction fees and customs duties accounted for well over 40% of total revenues. The growth in profit tax revenues largely reflects a change in the tax's allocation in favour of the federal budget.

Over 30% of 2005 budget spending will go to defence and security. These expenditures have increased steadily in recent years. Subsidies paid out to regional and local budgets represent about 12% of expenditures. They will actually fall slightly in relation to GDP.

Main categories of Russian federal budgets for 2004 and 2005

<table>
<thead>
<tr>
<th>Category</th>
<th>2005, % of GDP</th>
<th>2004, % of GDP</th>
<th>2005</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total revenues</td>
<td>17.8</td>
<td>17.9</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Total, excl. social tax</td>
<td>16.3</td>
<td>15.1</td>
<td>92.0</td>
<td>84.0</td>
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<tr>
<td>VAT</td>
<td>6.0</td>
<td>6.5</td>
<td>33.7</td>
<td>36.0</td>
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<tr>
<td>Profit tax</td>
<td>1.3</td>
<td>1.0</td>
<td>7.6</td>
<td>5.8</td>
</tr>
<tr>
<td>Excise taxes</td>
<td>0.4</td>
<td>0.6</td>
<td>2.4</td>
<td>3.4</td>
</tr>
<tr>
<td>Natural resource fees</td>
<td>2.6</td>
<td>1.8</td>
<td>14.5</td>
<td>10.2</td>
</tr>
<tr>
<td>Export and import duties</td>
<td>4.9</td>
<td>3.5</td>
<td>27.6</td>
<td>19.4</td>
</tr>
<tr>
<td>Total expenditures</td>
<td>16.3</td>
<td>17.4</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Total, excl. social tax and interest payments on debt</td>
<td>14.9</td>
<td>14.5</td>
<td>91.3</td>
<td>83.4</td>
</tr>
<tr>
<td>General administration</td>
<td>13.5</td>
<td>12.6</td>
<td>82.9</td>
<td>72.6</td>
</tr>
<tr>
<td>Defence</td>
<td>1.1</td>
<td>1.3</td>
<td>7.7</td>
<td>6.4</td>
</tr>
<tr>
<td>Security</td>
<td>2.8</td>
<td>2.7</td>
<td>17.4</td>
<td>15.6</td>
</tr>
<tr>
<td>Production, transport etc.</td>
<td>2.1</td>
<td>2.1</td>
<td>13.1</td>
<td>11.9</td>
</tr>
<tr>
<td>Transfer to regions</td>
<td>1.3</td>
<td>1.4</td>
<td>7.7</td>
<td>8.0</td>
</tr>
<tr>
<td>Surplus</td>
<td>2.0</td>
<td>2.1</td>
<td>12.1</td>
<td>11.9</td>
</tr>
</tbody>
</table>

Sberbank reclaims some of its share of total bank deposits. After several years of decline, last summer’s tumult in the banking sector helped Sberbank reclaim some of its lost share of household deposits. Sberbank controlled 62% of household deposits at the beginning of August, while other banks in general had experienced fairly consistent across-the-board declines. As the situation normalises, Sberbank’s share is no longer growing, and deposits at other banks have increased. Before the mini-crisis, private banks (unlike state-owned banks) lacked state-backed deposit insurance. Last July, the Duma passed emergency legislation covering all banks.

Yukos petitions for bankruptcy protection in the US. Yukos chief executive Steven Theede announced on Tuesday (Dec. 14) that Yukos had submitted its petition for bankruptcy protection with the federal district court in Houston, Texas. The move was intended to head off the forced auction this Sunday (Dec. 19) of Yukos core production unit Yuganskneftegaz. Deutsche Bank, which is financing Gazprom (the most likely buyer), said it opposed the Yukos’ bankruptcy filing in Houston. The Houston court found the case subject to its jurisdiction and issued an injunction preventing the auction of Yuganskneftegaz from going forward for 10 working days. The Russian authorities reaffirmed the auction take place as fixed.

Arkady Volisky, president of the Union of Industrialists and Entrepreneurs, which represents big industry in Russia, said that circumstances justified turning to the Houston federal district court. Observers, however, hold out little hope that the filing in Houston will save Yukos.
China

Chinese inflation slowed in November. Consumer prices were up 2.8 % in November compared to a year earlier, and considerably off the 4.3 % pace in October. The highest on-year inflation this year was 5.3 % registered in July and August. Prices in November rose 2.4 % in cities and 3.6 % in rural areas. Food prices rose just 6 % y-o-y in November, compared to 10 % in October and 13 % in September. Grain prices were up 19 % y-o-y, but still down significantly from the 29 % rise seen in October. Prices for clothing and home appliances continued to slide, and prices of durable goods overall declined 3 % y-o-y. Housing costs increased 6 %, fuelled mainly by 12 % higher energy prices.

Producer prices were up 8.1 % y-o-y in November, or 0.3 percentage points less than in October. Crude oil prices continued to soar (up 45 % y-o-y). Coal prices were up 23 % y-o-y. Prices of production materials rose 11 %. This was due almost entirely to higher prices for raw materials and power.

Investment growth slows slightly. Although investment growth remains brisk, monthly information on urban fixed investments reveals that investment growth continued to slow in November to 25 % y-o-y. Growth exceeded 26 % in October. Investments were up 29 % y-o-y for the period January-November.

Investment growth has been rapid everywhere in China. In eastern China, investment rose 27 % in the first eleven months of the year. Growth reached 33 % y-o-y in both western and central China. Moreover, investment growth has been strong in practically all economic sectors this year. Booming growth (47 %) has been witnessed in electrical power generation, natural gas production and water distribution. The investment in real estate and metal industries has also increased despite government measures to restrain investment in these fields.

Rising FDI inflows. For the period January-November, foreign direct investment in China reached nearly $58 billion, a 22 % increase from a year earlier. Nevertheless, the volume of investments only amounted to about 4 % of the estimated GDP, which is not particularly large compared to the investment inflows to many other emerging markets.

According to China’s Ministry of Commerce, there are some 250,000 foreign-owned enterprises currently operating in China that have made FDI in the country. This year, nearly 40,000 new enterprises had been approved as of the end of November. The inflow of direct investment into China is expected to remain strong next year. The total contractual value of pending investment made during January-November this year was 35 % higher than a year ago.

Rapid expansion in lending and deposits last month. China’s total loan stock at the end of November was 14 % larger than a year earlier. New yuan-denominated loans skyrocketed 52 % y-o-y last month. Although there is good reason to look critically at monthly data, the volume of short-term loans granted in November quintupled from the same period a year ago, while newly issued long-term loans were up 11 % y-o-y.

The stock of yuan-denominated deposits swell 16 % y-o-y at the end of November. Corporate deposits and household savings deposits rose at essentially the same pace. New deposits were up 60 % y-o-y in November. Within this category, household savings deposits increased 89 % y-o-y and corporate deposits soared 260 %. The surge in November deposits is widely believed to reflect the interest rate hike at the end of October and improved enterprise profitability.

Broad money (M2) at the end of November was up 14 % y-o-y. Seasonally adjusted, the annualised on-month growth stood at 18 %. The central bank has targeted 17 % growth for this year.

Credit and deposit stocks, on-year, % change

Source: PBoC

Retail sales growth remains brisk in November. In nominal terms, total retail sales increased 14 % y-o-y in November, which is roughly the same as in October. Sales were up 15 % y-o-y in cities and 13 % in rural areas. Once the higher inflation of rural areas is taken into consideration, however, consumption in rural areas continues to lag behind.

A 51 % y-o-y increase in sales of construction and renovation materials led growth in retail sales. Food sales increased 14 % y-o-y, while car sales recovered to post a 12 % increase.
Russia

Unknown Baikal Finance Group wins bidding for Yuganskneftegaz; state-owned Rosneft buys BFG.
A controlling 77 % stake in Yukos core production unit Yuganskneftegaz was sold at auction on December 19 to cover back tax obligations of the parent company. The winning bid was about €7 billion, only slightly above the minimum starting bid. During his recent visit to Germany, president Vladimir Putin revealed that the owners of the buyer – Baikal Finance Group – are private individuals with long experience in the energy field.

According to observers, Gazprom – the most probable winner in the auction – pulled out after the Houston court’s last week order (see BOFIT 51/2004). Nevertheless, Gazprom seems to be the one behind the scenes for its merger with 100 % state-owned Rosneft has been prepared for months.

Yukos asked the Houston judge to find whether Gazprom violated the court’s order by being present at the auction.

Russian stock market volatility and uncertainty continue. The RTS, Russia’s leading stock market index, was down from mid-November about 20 % by the beginning of last week. At the beginning of this week, the RTS recovered 7–8 % to late summer levels. During the drop before this week’s recovery, most of the major RTS stocks fell 15–30 %. Much of the stock market’s capitalisation remains concentrated in the shares of just a few companies: Lukoil (with about 30 % of the RTS index’s market capitalisation), Surgutneftegaz (nearly 25 %), Norilsk Nickel (8 %) and Sberbank (7 %). Gazprom, with a market capitalisation more than double that of Lukoil, also saw its shares fall almost 15 % (Gazprom shares are not part of the RTS list).

Like earlier downturns since summer 2003, the latest drop was mostly due to actions of the tax authorities. Besides Yukos, tax officials in recent weeks have imposed back tax demands on some other companies in oil and telecom sectors. The impending forced auction of Yuganskneftegaz may have also contributed to the stock market jitters. RTS-listed Yukos shares have lost about 90 % of their value since October and 97 % since April.

Increasing investment risk in Russian regions. The ninth annual survey of the investment climate in Russia’s 89 regions appeared in the December issue of the Russian magazine Ekspert. Ratings are based on two main indicators – investment risk and investment potential. Both indicators are compiled from several sub-indicators.

According to the survey, the investment risks in Russian regions have generally increased. The rising risk reflects e.g. changes in regional legislation due to administrative and social reforms, as well as changes in fiscal relations between the federal centre and the regions. Looking exclusively at investment risk, it was the first time in nine years that no region made it into the bottom risk group. The three regions with lowest risk were Novgorod, Yaroslav and St. Petersburg. Moscow City’s investment risk ranking has weakened substantially from previous years. In the 2003 ranking, Moscow fell from a second-place ranking to 6th place. This year it was 15th. From an invest standpoint, Moscow has been hurt by its poor regulatory framework, ecological deterioration and the growth of crime. In terms of investment potential, the best regions are Moscow City, St. Petersburg and Moscow oblast, which all retained their rankings from the 2003 survey.

The ultimate investment climate rating combines both main indicators, which have been weighted according to the views of a panel of Russian and foreign experts. Regions were ranked into eight groups out of twelve. The twelve groups range from the “low investment potential – extremely high risk” group to the “maximum potential– low risk” group. The best rankings (high potential, moderate risk) were given to Moscow City, Moscow oblast, St. Peters burg, Sverdlovsk oblast and the Khanti-Mansi autonomous okrug. At the other extreme of the investment spectrum, i.e. regions with little potential and large risk were Chechnya, Ingushetia and the Koryak autonomous okrug.

President to name regional governors from now on. The Duma passed amendments to the acts on regional administration and elections with practically no discussion, in line with much of the Duma’s recent legislative behaviour. The changes that entered into force on December 15 mean in practice that governorships will be determined by the Kremlin from now on. While each of the president’s governor nominees will need approval from their regional parliament, analysts consider such approval essentially a formality. The revised law gives the president the right to disband the regional parliament if the parliament refuses twice to accept the president’s nominee for a governorship. However, the Duma session moved to limit the presidential power to disband regional parliaments by requiring a one-month consultation period, after which the president can either propose a new nominee, appoint an acting governor or disband the regional parliament. Currently elected governors will be allowed to serve out their terms.

Season’s Greetings!
China

Grain production up this year. According to preliminary data, production of maize, rice, beans, wheat and potatoes exceeded the 2003 harvest by 25 million tonnes. The good harvest thus slightly surpassed the government’s 455-million-tonne target for this year. Land area under cultivation increased by 2 million hectares to 101 million hectares. Consumption of the above-mentioned crops was about 35 million tonnes higher that domestic production. The difference was covered by drawing down reserve stocks and increasing imports.

The government has encouraged production by lowering the tax burden on growers of maize, rice, beans, wheat and potatoes and by increasing producer prices for these crops. The support to farmers will also be continued next year. The direct subsidies for the above-mentioned crops and tax cuts to farmers are intended to increase the amount of land under cultivation. In January-September, 138 million households received direct farming subsidies; the amount per household averaged 74 yuan (nearly 7 euro). The current taxation of farmers is generally considered unfair as tax assessment is based on gross production and does not allow for tax deductions.

The push to increase production of the above-mentioned crops was launched at the beginning of this year after the poor 2003 harvest of just 431 million tonnes – the smallest harvest in over a decade. The government is concerned over China’s increased dependence on imported grain and the large income disparities between urban and rural populations. To correct the situation, the government wants to increase production of the above-mentioned crops next year to 465 million tonnes and further to 480 million tonnes in 2006. In 2007, production and consumption should be in balance.

Tax revenues surge in the first ten months of the year. For January-October, total tax revenues (excluding customs duties and agricultural taxes) increased 27 % y-o-y in nominal terms. Value-added tax collections rose 24 % y-o-y and constituted 35 % of total tax revenues. The rapid increase of value-added tax collections was driven mainly by a robust increase in industrial production, which was up 17 % y-o-y in January-October. Business, consumption, and corporate income tax revenues combined were also up 33 % y-o-y in the first ten months, and accounted for over 40 % of total tax revenues. The strong growth in these three taxes reflected brisk growth in sales revenue and improved profitability of enterprises.

In addition to healthy economic growth, the surge in tax revenues also evidences efforts by the tax authorities to improve efficiency in tax collection. For the first nine months of 2004, disposable income per capita in urban area in nominal terms was up 11 % y-o-y, while income tax collection increased 23 %.

Strong revenue growth sustains budget surplus through first eleven months of 2004. In the period January-November, state revenues grew 24 % from the same period last year, while expenditures were up just 14 %. As of end-November, China’s budget showed a surplus of CNY 280 billion (€26bn, or 2 % of GDP). In 2003, budget revenues increased 15 % for the year, while expenditures rose 12 %. China had a budget deficit of CNY 290 billion last year, which corresponded to 2.5 % of GDP. Total state revenues this year are expected to reach CNY 2,600 billion, or 19 % of GDP.

Solid revenue growth in January-November has helped secure the government’s key spending programs. This year, for instance, supports to the agriculture and forestry sectors have increased 31 % y-o-y, social sector spending is up 20 % and money for education 14 %. In 2003, spending to support agricultural output represented just 5 % of total expenditures. Social sector spending was just 2 %.

China adopted an aggressive “pro-active” fiscal policy after the 1997 Asian financial crisis. At least part of the robust economic growth in recent years can be attributed to this pro-active fiscal policy. Although economic growth is currently strong, the government has vowed to refrain from imposing immediate restrictive fiscal measures. Instead, it has announced it will take a rather neutral stance next year. The government justifies its stance by the ongoing need to reduce disparities in regional economic development – a top priority of the current government platform.

Budget revenues, expenditures and balance, % of GDP

Season’s Greetings!

The information here is compiled and edited from a variety of sources.

The Bank of Finland assumes no responsibility for the completeness or accuracy of the information.
Russia

Russian economic growth slower than in 2003. The composite production index of five base sectors of the Russian economy, which proxies GDP growth, rose 6.6% in the first eleven months of the year from the same period a year earlier and was slightly off the 2003 pace. Highest growth (12%) was registered in retail sales. It has been the only base sector to enjoy steady acceleration in volume growth during the past year. The growth reflects the ever-increasing role of consumer demand in Russian economic growth.

Construction output increased 10% in January-November. After a brisk first half, growth began to slow in summer as problems in the banking sector caused a pull-back in lending to builders. Both freight transport and industrial output increased over 6% in the first eleven months of the year. The slight deceleration in industrial output growth mainly reflects lower growth in fuel production. Crude oil production, nevertheless, was still up about 9% in January-November. Agricultural output in January-November was essentially unchanged from 2003.

Four base sectors of the economy, % change of monthly volume from 12 months earlier

![Graph showing four base sectors of the economy, % change of monthly volume from 12 months earlier.](image)

*) workday-adjusted figure
Source: State Statistics Service

Russia approves new housing legislation. The first part of a legislative package containing altogether some 30 laws and amendments was passed last summer. The second part includes acts on housing and urban construction. Overall, the legislation is designed to promote housing supply and demand in accordance with the government's 2001-2010 housing program. This program seeks to provide nearly a third of the Russian population with opportunities to purchase their own apartment by 2010 either with savings or a loan. Currently, only about 10% of the population has this opportunity. The housing program also seeks to increase the average living space of Russians. The possibilities for low-income citizens to get housing based on social needs will increase because such housing will only be provided to people who meet specific criteria. Currently, housing provided on the social basis is distributed on a first-come first-served basis for anybody living in cramped quarters.

The newly approved laws and amendments will come into force gradually over the next five years. Implementation of the full legislation package must necessarily take time as each administrative level still needs to formulate a substantial amount of regulations compliant with the new laws. Moreover, the Duma has only approved the first readings of acts on real property taxation and private investments in municipal infrastructure.

Yushchenko wins Ukraine’s presidential revote. Ukraine held the second round of presidential balloting again in the wake of massive demonstrations by opposition parties and international criticism of the fairness of the election process. Preliminary returns from last Sunday’s revote show opposition leader Viktor Yushchenko garnering 15.1 million votes (51.99% of the vote) and prime minister Viktor Yanukovich with 12.8 million votes (44.19%). The differences in candidate support widened substantially in the revote compared to the first two rounds. Voter turnout was 75%, a few percentage points lower than in the previous rounds.

Yanukovich refused to acknowledge the revote, and due to his challenge to the results, the final election outcome will not be announced until next month.

The first tasks facing Ukraine’s new president will be consolidating the nation and taking care of relations with Russia. Russia supplies nearly all of Ukraine’s energy needs, and Russian oil and gas pipelines to Western Europe pass through Ukraine. Yushchenko has announced, among other things, that he intends to bring home Ukraine’s troops from Iraq and help Ukraine become a NATO member within the next six years.
China

China focuses on meeting its WTO commitments next year. China joined the World Trade Organization (WTO) in 2001. Under its WTO commitments, the country has to lower customs tariffs on over 900 categories of imported goods from the year 2005. The average customs tariff rate will be lowered from 10.4% this year to 9.9% next year. China’s WTO commitments also call for diminishing non-tariff restrictions on imported goods such as the quota system and import licences. Next year, China will eliminate non-tariff restrictions on over 400 categories of goods, including electronic equipment, oil and rubber products, and car parts.

The WTO wants the share of state trading reduced and a correspondingly greater role allocated to the private sector. For example, imports of crude oil by non-state enterprises are expected to reach 13 million tonnes in 2005. In comparison, China’s total crude oil imports this year should reach around 110 million tonnes. The role of state enterprises in importing grain and fertilizers will also decline next year, and trading rules that grant rights to certain companies to engage in trading of select products will be abolished. Such designated trading rights currently apply to goods such as natural rubber, timber, plywood, wool, acrylic fibre and steel.

The WTO reviews the world’s four largest traders every other year. China now claims fourth position and will have its first review in April 2006.

Despite rapid trade growth, India remains a relatively insignificant trading partner with China. In dollar terms, the value of China’s exports and imports has grown by about a third this year. Trade between China and India has grown even faster; Chinese figures show the dollar value of exports to India rose 76% during January-November, while imports were up 87% y-o-y for the same period. Chinese firms mainly export industrial products to India and import mostly raw materials from India. Iron ore alone accounts for about 57% of China’s total imports from India this year. Although the growth in India trade in recent years has clearly outstripped overall growth of China’s foreign trade, India only accounts for one per cent of China’s exports and imports from India represent just over one per cent of China’s imports. Although the Indian economy measured in dollar terms is Asia’s third largest economy after Japan and China, it ranks only eighth among China’s Asian trading partners.

China imposes export tariffs on textiles ahead of the WTO liberalisation. Effective Saturday (Jan. 1), China will impose export tariffs on textiles and clothing. The customs duties apply to 148 product categories, including such standard clothing items as underwear, coats and trousers. Duties are defined either in terms of quantity or weight. They typically only constitute 1–3% of the export price for most articles of clothing. However, in the case of the cheapest articles of clothing, such as underwear, the customs share of the export price has some significance.

China’s export tariffs are a response to tough discussion related to elimination of import quotas on clothing and textiles at the beginning of 2005 (see BOFIT Weekly 32/2004). Although China only accounted for 17% of world clothing and textile exports last year, the WTO expects that China’s share will exceed 50% within three years if no measures to restrain exports are taken. Many countries with clothing and textile industries are concerned about their futures and have threatened countermeasures against China if it fails to rein in its clothing and textile exports. Most recently, Turkey decided to impose import restrictions on certain Chinese products. The US also set limits on imports of certain Chinese clothing in the autumn. The EU has appealed to China to restrain growth of exports of its clothing and textiles to give other developing nations a chance to secure their own market positions.

China imposes export quotas and tariffs on key commodities. China has announced it will impose a 5% export tariff on aluminium and a 2% export tariff on nickel as of January 1, 2005. Copper and copper products will be subject to export tariffs in the range of 5–10%. China will also eliminate VAT refunds for certain metal exports. The main reason is that these products tend to be energy intense. Apparently, the country would also like to slow the growth of investment e.g. in aluminium production.

This autumn, China’s trade ministry set 2005 export quotas on coking coal, or coke, of 14 million tonnes and gave export licences to 48 companies. The original export quota for 2004 of 9 million tonnes had to be raised to 13 million tonnes during the year as demand drove up world prices for coke dramatically (see BOFIT Weekly 23/2004). China’s coke exports represent over 50% of world exports of coke used in steel production. With China’s November decision, the world price of coke is expected to remain fairly stable in the coming year.

China’s ceiling on coal exports next year is 80 million tonnes, which is 14% less than this year. The reduction in coal exports is intended to secure adequate supplies for growing domestic consumption. In addition, only designated companies are permitted to export coal, even though China has several hundred coal producers. Next year, China should produce about 1,800 million tonnes of coal or 130 million tonnes less than its expected consumption.
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